Roads to a Market System
A Study of Economic Transition Policies in Poland, Hungary, and the Czech Republic

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Introduction: The Failure of Central Planning in Europe

On November 9, 1989, we witnessed one of the most gratifying events of this century. East Germany, often considered the most zealous ally of the former Soviet Union, had opened its borders to the west. The most visible sign of socialism's downfall in Europe, the Berlin Wall, was crumbling before the eyes of the world.

The economies of Central and Eastern Europe, by Western standards considered backward, finally had reached points of stagnation during the eighties. Between 1979 and 1989, average annual growth of the Gross Material Product per capita amounted to only 1.5 per cent each in Poland and Czechoslovakia. Central planning failed to fulfill the many promises political leaders had given the people of Central and Eastern Europe in the 1950s. Instead of economic prosperity, misery and frustration prevailed among the population. The failure of planned economies became a main factor undermining the credibility of the socialist regimes and contributing to their downfalls.[1]

Marxist ideology taught that central control over economic processes produces more "justice and efficiency" than could prevail under the anarchy of the market. The many examples of socialist countries around the globe demonstrated, however, that central planning was not efficient, and socialism was not just. In order to understand the changes that occurred in Europe in the late eighties and early nineties, one should spend a moment examining the major shortcomings of the centrally planned economies (CPE).

János Kornai described planning as a "coherent process of setting targets and assigning instruments to achieve them."[2] A socialist nation's economic plan was in most cases prepared by a national planning office, endorsed by the socialist party's Central Committee and the government and subsequently enacted by parliament. Central planning covered every aspect of activity in the economy. Aggregate indicators aided in establishing the national production volume and the distribution of this volume among the sectors of the economy. Moreover, the plan prescribed how resources were to be used in the different sectors, it established labor, investment, and import quotas, and it set new technology targets and targets for the banking system.[3]

The national planning office also determined most prices. Prices in socialist economies conveyed little information on the relative scarcity of resources and products and did not contribute to the creation of equilibrium between production and consumption. The government's desire to maintain the greatest possible level of social stability prescribed price stabilization. Attempting to keep prices stable, however, prevented them from conforming to the costs of production, which varied in time. The centrally planned economy therefore relied on a complex system of subsidies and levies to bridge the gap between costs and prices.

Because prices in socialist countries did not reflect the relative availability of products, CPEs experienced what János Kornai termed "general, frequent, intensive, and chronic shortages."[4] State-owned enterprises (SOEs) often lacked incentives to inform themselves of shortages or unmet demand for their products, which aggravated the shortage and inefficiency problems. SOEs had little interest in adapting to the buyer's demand by shifting their supply. Central planning could not cure this shortage dilemma. In fact, the vast amount of information needed for annual plans overwhelmed the planning bureaus. It was impossible to effectively collect, process, and use the necessary data to determine exactly at what level prices or production volumes should be set.[5]

Distortions induced by centralized planning in Central and Eastern Europe were reinforced by years of import substitution and dependence on the Soviet economy for trade. Leszek

Balcerowicz termed much of the output of the Warsaw Pact economies "socialist output," since it could be maintained only under a socialist economic system "and the related existence of a Soviet-orchestrated trading bloc like the Comecon."[6] Heavy industry dominated the structure of a socialist economy, with light industry and services playing only a subordinate role. Most firms were inefficient, relying on outdated machinery and poor labor skills.

The weak role played by money represented an additional problem in Central and Eastern Europe. According to Kornai, "money failed to perform the integration of . . . transactions; it was not actually a 'universal means of exchange.'"[7] The national currency was neither externally nor internally convertible. Domestic currency could not be exchanged for foreign currency and money earmarked for investment, for instance, could not be converted into money for wages or materials. This nonconvertibility "heightened the rigidity of economic activity and frequently prevented rational substitution taking place between the factors of production."[8]

Kornai summarized money's passive role in a centrally planned economy as follows:

> Instead of the actual processes being adjusted to the economic decision makers' financial means (the cash in hand, the credit, and all the money supply available to them), the opposite [occurred]: the cash in hand, credit supply, and all the available money supply of the firms are adjusted to the decision makers' actual actions.[9]

In lieu of the soft budget constraints on SOEs, inflation was likely to develop in socialist countries, as governments often printed money in order to finance subsidies or credits to state firms. Excess demand for products and services and upward pressures on wages caused by labor shortages further augmented inflationary pressures. In most centrally planned economies inflation was nevertheless invisible, since the government used price and wage policies to repress increases in the price level, as mentioned above.[10]

The preceding paragraphs did not represent an exhaustive list of debilities encountered in centrally planned economies. However, this short overview should have conveyed a sense of how inefficient classical, or Marxist, socialism actually was.

In light of the shortcomings of the classical system, several socialist nations, including Poland and Hungary, initiated economic reforms at various times between the mid-fifties and the eighties. The reforms preserved the basic characteristics of socialism, most significantly the one-party rule and the predominance of public ownership, but aimed at decentralizing some economic decision making. Reformers desired to create a "market socialism," a combination of capitalism and classical socialism, which would prove its superiority over both.

Reality looked different than envisioned, however. The economic slowdown experienced by socialist nations was at best temporarily halted, but not reversed. In addition to a stagnating GDP, real consumption stagnated or declined and budget deficits developed. Technical advancements remained insignificant and increased trade with the west only resulted in high trade deficits and expansions in foreign debt.[11]

According to Jeffrey Sachs,

> "the timidity of reforms, the power of the nomenklatura to avoid a real opening of the economy to international competition, and even the introduction of domestic competition; the political illegitimacy of the regime; and the corruption and arrogance of the Communist party all contributed to the failure of the pre-1989 reforms."[12]

With government promises of an improved system unfulfilled, people in Central and Eastern Europe increasingly voiced their discontent with the low quality and limited choice of products, the political constraints on freedom, and the destruction of nature caused by the leaderships' lack of concern for the environment. The examples of Western European and North American capitalism looked too attractive to ignore and prompted in the people of Central and Eastern Europe the desire to transform their political and economic systems.[13]

In the late eighties, Hungary, Poland, and Czechoslovakia finally broke the power monopolies of their socialist parties and held democratic elections. The new governments faced a task never before encountered in history: They intended to transform centrally planned economies into more efficient market systems in only a few years.[1*] Although several precedents already existed on gradual transition, the political situation in Central Europe recommended a rapid transformation to a market economy. In China and Vietnam, two nations that experienced remarkable successes in the first stages of economic transformation, the unbroken power monopoly of the socialist party allowed for a more gradual and controlled transition. In the new Central European democracies, however, the public's desire to enhance its welfare to Western levels as soon as possible made a gradual transition similar to China's or Vietnam's unrealistic.

Economists in and outside Europe expected the transformation to bring economic hardship upon the people of Central Europe in the short run. Anticipated were declines in output and employment, possible budget deficits, and a terms of trade shock, as imports would initially rise faster than exports. Economists also predicted price shocks to ensue from the liberalization of prices, as the monetary overhang that accumulated under socialism became apparent. Stanley Fischer and Alan Gelb define the monetary overhang as the "involuntary accumulation of financial claims because

[1*] Whenever referring to a "market system," I am not speaking of a laissez-faire market, but rather a "mixed-enterprise economy," or partly regulated system, such as the economies of the U.S. and Western Europe.

of the rationing of acceptable goods and/or the absence of alternative assets."[14] In spite of these expected short run travails, many scholars remained convinced of the reform countries' abilities to recover quickly and emerge as healthy and stable market economies within only a few years.

In reality, the road to the free market was more arduous than most people had foreseen in the late eighties, and economic performance in Central Europe between 1989 and 1994 remained far below expectations. The large variance between what had been anticipated and what occurred rested partially in a naive understanding in 1989 of the complexities involved with the transformation of economic structures and institutions. The following country studies will also reveal, however, that government policies in Central Europe might have contributed to the delay in economic recovery in the early nineties. First, the leaderships in Prague, Budapest, and Warsaw, in their adherence to 19th century liberal thought, often ignored economic arguments for a more active state role in the transition economy. By strengthening the government's role in financial reforms, for instance, the nations of Central Europe might have prevented some problems encountered in economic restructuring.

Second, the relatively fragile political environment in Central Europe often prompted the governments to replace policies that would have been economically beneficial in the long run with policies that received more popular support. The new democracies consequently delayed certain reforms in the institutional arena by many years, and macroeconomic stabilization policies were sometimes not sufficiently restrictive.

The following chapter provides a list of possible reforms for a nation intending to transform its planned into a market economy. Chapters II, III, and IV portray in detail the reform paths of Poland, Hungary, and the Czech Republic from 1989 to 1994. These countries, together with

Slovakia, compose the area known as Central Europe. Having enjoyed the most publicity of the former Warsaw Pact nations, Poland, Hungary, and the Czech Republic lend themselves to a closer investigation into the reality of transition. The concluding chapter will summarize the economic progress made in Central Europe until 1994 and will specify how policy might have delayed economic recovery.

NOTES

1. Martin Myant, Transforming Socialist Economies: The Case of Poland and Czechoslovakia (Aldershot, England: Edward Elgar Publishing Co., 1993) 7-12.

2. Myant 14.

3. János Kornai, The Socialist System: The Political Economy of Communism (Princeton, NJ: Princeton University Press, 1992) 110-113.

4. Kornai, Socialist System 233.

5. The previous two paragraphs were based on:
Kornai, Socialist System 131-159.
Myant 13-15.

6. Leszek Balcerowicz, lecture,"Understanding Postcommunist Transitions," Lexington: Washington and Lee, 5 May 1995.

7. Kornai, Socialist System 133.

8. ibid.

9. ibid 147.

10. ibid 284.

11. The previous two paragraphs were based upon:
János Kornai, Highway and Byways: Studies on Reform and Post-Communist Transition. (Cambridge, MA: The MIT Press, 1995) 4-10.

12. Jeffrey Sachs, Poland's Jump to the Market Economy (Cambridge, MA: The MIT Press, 1993) 33.

13. Kornai, Socialist System 388.

14. Stanley Fischer, Alan Gelb, "Issues in Socialist Economy Reform," The Transition to a Market Economy, vol. 1, ed. Paul Marer, Salvatore Zecchini (Paris: OECD, 1991) 185.

Chapter One: The Arenas of Transition

When the people of a formerly socialist nation aspire to transform their planned into a market economy, they face an overwhelming number of decisions on both the macro- and microeconomic levels. The country's government makes these decisions in six different "arenas:" institutional reforms, macroeconomic stabilization, price liberalization, foreign economic liberalization, privatization, and financial reforms. Each of these arenas comprises a variety of reforms the government can address.

Before presenting an overview of the arenas of transition, I would like to stress three points in the hope of preventing misunderstanding. First, it is impossible to identify an optimal transition theory. Most of the reforms acknowledged below I pieced together after reading a multitude of works on post-socialist economic transition, including papers by János Kornai, Jeffrey Sachs, Rudiger Dornbusch, Stanley Fischer, and Ronald McKinnon.

Second, whether the country chooses to emphasize certain reforms more than others might be influenced by its political, social, or cultural backgrounds, but also depends on the CPE's initial macroeconomic condition, the degree of decentralization of economic management, and the size of the private sector before transition. Czechoslovakia, for instance, boasted a more stable economy than Poland and Hungary in 1989, with lower unemployment and inflation rates, and a higher level of foreign reserves. Although Prague still wished to maintain its economic stability in the first years of transition, its fiscal and monetary authorities enjoyed slightly more maneuvering space than Warsaw's and Budapest's in designing aggregate demand policies.

Czechoslovakia also possessed a lesser degree of decentralization, however, and a much smaller private sector than the other two countries. In 1989, state firms in Poland and Hungary enjoyed more autonomy than SOEs in Czechoslovakia, and the Warsaw and Budapest governments had been progressively shifting the distribution of products onto a market basis. People in Poland and Hungary were therefore more familiar with markets than the citizens of Czechoslovakia. Stanley Fischer and Alan Gelb furthermore emphasize that countries with a large private sector can rely on it to absorb laid-off employees during the reform and/or privatization of the public sector. According to this view, Poland and Hungary would experience fewer obstacles in their privatization efforts.[1]

Third, the following arenas of transition are closely interrelated. Success in each of stabilization, liberalization, and institutional changes depends, to an extent, upon the progress made in the other two fields. For the sake of simplicity, however, I decided to divide the transformation into six areas for the first four chapters, which alleviates a direct comparison of the policies enacted in each country. The concluding chapter will not draw upon this organizational pattern, since evaluating Poland's, Hungary's, and the Czech Republic's overall economic progress calls for a more general approach to organization.

Institutional Reforms

Reforms in this arena aim at establishing or improving market mechanisms and institutions. One can divide institutional reforms into two groups: reforms necessary for the proper functioning of the free market, and changes that may prove beneficial to a market economy, but might not be prerequisites for its success. The first group of reforms include the establishment of a new legal system, with special emphasis on private property rights, bankruptcy, and antitrust laws, and the adoption of common accounting practices. According to Rudiger Dornbusch, the legal system should "protect the right to conduct economic transactions and functioning courts [ought to] provide the possibility of sanctions and redress."[2] The government should, if necessary, amend the constitution to include private property rights. The national legislatures furthermore ought to pass bankruptcy and antitrust laws and create an anti-monopoly office that would prosecute anti-competitive action and promote competition. Large SOEs can, if not divided into smaller divisions, dominate their respective markets as private monopolies after privatization. The merits of bankruptcy laws are also obvious. Insolvent firms ought to disappear from the economic landscape, which would provide the new private enterprises with easier access to scarce credit.[3]

It is furthermore desirable to build an accounting system based on western standards as quickly as possible. This need arises out of the reasoning that only by employing an effective and precise valuation system for assessing enterprise assets and liabilities, can the country in transition properly decide whether to privatize, dissolve, or keep a firm under public ownership. Putting modern accounting techniques into effect will naturally take time and one has to expect valuation errors at the onset of transition.

The second group of reforms, beneficial but perhaps not necessary for the new market economies, include the enactment of new labor laws, company laws governing the registration and liability of firms, privatization laws, as well as reforms of tax and social benefits systems and the banking structure.

A new tax system could substitute for the revenues formerly derived from state corporations and provide incentives for the privatization of SOEs by offering private firms tax holidays. However, the government should not use tax incentives for private firms excessively, since its revenues will otherwise shrink with the growing private sector. Shifting more taxing emphasis from corporations to individuals would also aid in maximizing revenues, as personal income taxes had only contributed diminutively to total tax receipts under socialism.

The new government ought to direct its attention to the development of a social safety net and a modern pension system as well. At the onset of transition one should expect a drastic decline in GDP coupled with a rise in the unemployment rate, reflecting the costs of restructuring and curbing the public sector.[4] This result makes the development of unemployment compensation and retraining programs desirable.

The reform country should also introduce a two-tiered banking system, separating the central bank from the commercial banks. The country's monetary authority ought to work as independently from the government as possible in order to avoid policies geared towards too much expansion and away from inflation control. It is advisable also to pay close attention to the banks' balance sheets during transition. Many state-owned banks will carry over vast amounts of bad debts from socialism. Implementing debt clean up and restructuring programs would aid in relieving the commercial banks of their non-performing assets.

Although reforms in the institutional arena help establish or improve market mechanisms and institutions, they by no means suffice to create a market economy. In order to transform a CPE into a market system, the government also needs to liberalize prices and foreign trade, and expand the private sector. Before addressing market reforms, however, I will briefly discuss macroeconomic stabilization in the transition economy.

Macroeconomic Stabilization

The major macroeconomic problems the reform country faces after the fall of socialism, are declines in output and employment, as well as threats of sustained inflation and sustained budget deficits. In its efforts to respond to these problems and stabilize the economy, the government can rely on four policy tools: fiscal, monetary, wage, and exchange rate policy.

Macroeconomic stabilization might present the most difficult challenge for the new government, since restrictive aggregate demand policies at the onset of transition postpone urgently needed economic growth. High inflation is in most cases undesirable, since it, among other things, "impairs the currency's ability to function as a medium of exchange, [and thereby] weakens incentives to save and invest, and creates damaging, self-fulfilling expectations about future inflation."[5] On the other hand, in a nation facing the results of massive declines in output the government is eager to loosen macroeconomic policies as soon as possible in order to boost the economy and strengthen public support.

The administration should nevertheless use restrictive aggregate demand policies in the short run, especially if the reform country already suffered from high inflation before transition. As Balcerowicz phrased it: "A large macroeconomic imbalance, containing elements of hyperinflation, may be compared to a fire: it is very dangerous to delay putting it out, or to put it out slowly."[6] As soon as the macroeconomy is sufficiently stabilized, i.e. the threat of hyperinflation has become improbable and government deficits have started to decline, the reform country ought to concentrate its efforts on spurring economic growth and employment.

Fiscal and Monetary Policies: The emphasis of fiscal policy, probably the most widely used stabilization tool in the transition economy, should be on balancing the government budget as well as possible. It might prove difficult to avoid a fiscal trap. In the first few months of transition, the nation's budget may actually appear to be balanced. This illusion is created by a rapid growth in tax revenues, as the government introduces a new tax system, and by few initial government expenses for the emerging social safety net. As more and more firms go bankrupt or are liquidated, however, tax receipts will decline dramatically and unemployment compensation and worker retraining programs will consume immense shares of the government's budget. Consequently, the transition economy might experience large budget deficits. As economic activity starts migrating to the private sector and state enterprises begin experiencing increasing fiscal difficulties, the budget deficit is unlikely to be resolved through improvements in economic activity.[7] If fiscal deficits cannot be financed by public borrowing, the government might be tempted to cure the deficit by creating money as their socialist predecessors did. This monetization, however, will undermine the monetary authorities' efforts to reduce inflation.

The administration can avoid the fiscal trap by drastically cutting public expenditures and replacing general subsidies with need-based programs. Such actions would not only aid in balancing the budget, but also reduce aggregate demand and thus inflationary pressures. Furthermore, tax laws ought to provide for as few loopholes as possible (while still granting some tax incentives for private firms), and tax collecting authorities should be prepared to enforce the payment of taxes, as tax evasion is likely to occur. Reforms could include the introduction of value-added taxes, as well as personal income and corporate profit taxes. Subsidization of the enterprise sector has to cease and an investment policy emphasizing infrastructure development is desirable.[8]

Economic theory also advises reform countries to maintain a restrictive monetary policy at the onset of transition. In the first years of reform, temporary price adjustments resulting from price liberalization can quickly result in sustained inflation if interest rates are too low. One problem with the implementation of monetary policy is the underdevelopment of financial markets in the transition economies. Because monetary policy usually draws upon changing interest rates in the financial markets, it might have little initial effect in Central and Eastern Europe. The government could, of course, create laws favorable for the long term development of money markets needed for effective monetary policy. In the short and medium term, however, fiscal policy will remain the more powerful stabilization tool. [9]

Wage Policy is a third policy category under macroeconomic stabilization. The government should contain wage growth in the transition economy, in order to oppose inflationary pressures. The administration can achieve this goal by putting a cap on wage raises, i.e. permitting increases in the wage rate only up to the previous month's inflation rate or a fraction thereof. Enterprises allowing wage increases to exceed this limit would be subject to high additional taxation. An alternative to this idea are productivity-based wage increases: The government might grant firms the right to increase wages exceeding the rate of inflation, if they have proven to be more productive (higher output per worker) than the average enterprises in their industry.

Exchange Rate Policy: When a nation decides on an exchange rate system, the question arises whether to let the rate float or peg the domestic currency to one or more hard foreign currencies. For small economies such as Central Europe's, it is advisable not to adopt a floating exchange rate. Immediately after the onset of transition, monetary indicators are still difficult to interpret and the domestic central bank might be unable to conduct monetary policy autonomously. The main advantage of a pegged exchange rate lies in its ability to slow down domestic inflation by conveying the effects of the western central banks' monetary policies onto the domestic currency. The state should nevertheless peg the domestic currency to a market basket of foreign currencies, instead of fixing it to merely one. Market baskets spread the risk of negative spillover effects in case one of the foreign countries experiences an economic crisis.

One could argue, however, that trade deficits often accompany a nominal exchange rate anchor. Domestic inflation can cause an overvaluation of the fixed currency, leading to a decline in the competitive position of domestic enterprises and a subsequent fall in exports. If a reforming country has enough confidence in its fiscal and monetary policies and in the ability of the exchange rate anchor to slow inflation, it should nevertheless opt for a fixed rate or adjustable peg for the short run. The best long run alternative would probably be an adjustable peg, rather than a floating exchange rate. In a world where currency trading is reaching exorbitant proportions, with nearly one trillion U.S. dollars traded daily, the limited reserves of small countries like Poland, Hungary, or the Czech Republic could not justify a managed float.

Price Liberalization

The market pricing system serves to allocate resources and ration goods and services. Price liberalization converting a socialist into a market pricing system essentially has two effects: First, it leads to an increase in the general price level, when the monetary overhang that accumulated during the decades of socialism becomes apparent. This price adjustment need not lead to sustained inflation, however, as long as the reforming country sufficiently restrains aggregate demand through its stabilization policies. Second, price liberalization changes the financial situations of enterprises and their employees.

One can identify two general approaches to price liberalization: The first alternative incorporates an "economy-wide relative price adjustment followed by an adjustment in the aggregate price level."[10] A variant of this concept relies on the price adjustment on a sector-by-sector basis. It might be advantageous for prices in politically sensitive market segments like the food sector or sectors producing essential factor inputs to remain under price controls in the short run. A sudden price increase for those products could have disastrous effects. Also, while some sectors would profit from domestic or international competition, other, less productive, sectors would experience a surge in unemployment upon opening up to market prices.

The second approach, implemented by the Polish government, calls for an economy-wide introduction of markets, with as little interference from the government as possible and no institutional preparation. According to its proponents, prices, reflecting the relative scarcity of products, would soon lead to an efficient operation of markets in this scenario.[11]

Foreign Economic Liberalization
(Liberalization of International Trade and Capital Flows)

Under socialism, foreign economic relations were mostly subordinate to political criteria. The members of the Council for Mutual Economic Assistance (CMEA) constantly aspired to increase trade with their socialist partners, while showing little interest in more trade with the west. Most states furthermore prohibited direct capital inflows from capitalist firms.[12]

International trade is desirable for three reasons: First, as Rudiger Dornbusch notes, the outside world provides a "referential system of prices. The ability to trade freely assures that resource allocation is driven into conformity with [one] alternative cost of those resources."[13] Second, trade strengthens competition by creating alternative markets in which to buy or sell. Finally, trade brings the transition economy into contact with superior technology and products.

The new market economy would be well advised to open up to the world market as soon as possible. Sometimes, however, import tariffs or quotas, voluntary export restraints, or export subsidies may prove beneficial in the short run. If the transition economy believes it can obtain a competitive advantage in a certain industry, trade barriers will help shelter those infant industries until they are strong enough to compete internationally.

On the other hand, by definition overly protectionist countries will experience prices at variance from world price levels, especially if the countries are as small as most of the Central and Eastern European nations and do not have monopsony powers. Many economists argue that free trade improves society's welfare. The country in transition should therefore reduce trade restrictions as soon as possible.

> There is for the countries of central and eastern Europe a pressing need to enter into the international economy because they are small economies and could barely survive under autarky.[14]

Likewise, in order to ensure enhanced levels of foreign investment, a formerly planned economy could reduce or eliminate taxes on capital flows, especially on the flow of profits from direct investments. Providing tax incentives for foreign investors may further stimulate the inflow of international capital. However, a downside to extensive foreign investment exists as well: Profit repatriation is a long-term drain of income and could disfavor small domestic firms. Poland's small business class, for instance, experienced difficulties competing with foreign firms for capital from local financial institutions.

During the transition years, it is particularly important for the new market economy to cultivate international trade relations with its neighbors in Central and Eastern Europe. While a reorientation of trade towards the west is highly desirable, the Central and Eastern European nations should attempt to find a replacement for the former socialist trade bloc as soon as possible.

Privatization

Economists define privatization, the key step to a competitive market environment, as the transfer of ownership from the public to the private sector. According to Farid Dhanji and Branko Milanovic, two senior economists at the World Bank, there are several major motivations for privatization. First, it introduces the market economy by distributing state assets into the hands of competing individuals or groups of individuals. Second, it enhances productive and allocative efficiency; and third, it boosts government revenue.[15] The increase in net revenue, however, only pertains to the short run, when the government trims or completely eliminates subsidies it had been paying to inefficient SOEs. In the long run, increased social benefits expenditures and lower tax receipts will cut net revenue substantially, as described above.

The challenges of privatization are: 1) what its scope ought to be, 2) how to design the legal framework that regulates to whom state property can be sold, and 3) the problem of reprivatization and "compensating the former owners for their lost property."[16]

The biggest issue is probably the desired extent of privatization across the economy. Some economists argue that privatization is not necessary to boost economic efficiency in a transition economy. The state should instead emphasize a reform of incentive structures in SOEs. Giving state firms and collectives greater autonomy could improve incentives by linking individual effort and personal reward. Such a reform enacted in China in the seventies and eighties encouraged the autonomous entrepreneurs to allocate the new flow of resources to the more profitable suppressed sectors.[17] Instead of attempting rapid privatization of SOEs, the transition economy could therefore delay the privatization of some firms, while granting them more autonomy in the interim. In many cases it might even be desirable to retain firms under state ownership in the long run.

Reprivatization and compensation turn out to be controversial issues as well. Many people agree that instead of compensating former owners of real estate assets, the government ought to focus on restitution, i.e., returning land to people who owned it before the socialist occupation. Restitution will likely raise concerns about fairness, as some land, because of environmental burdens, might be in poorer shape than before the communist era, while socialist planners might have developed other land extensively. The question of who and where the former estate owners or their legitimate heirs are, poses an even deeper problem for the government and makes the establishment of title after half a century nearly impossible.

Turning to the issue of privatization itself, Czech economists Michal Mejstřik and Jiří Hlávaček present three different privatization schemes. The first scheme is called "spontaneous privatization," the second focuses on what Mejstřik and Hlávaček term the "internal market," and the third one involves the creation of a stock market. Spontaneous privatization is similar to a management buy-out of a firm: the management initiates it and the workers support it. In the internal market, banks and other financial institutions play a crucial role in supervising corporate management: The state gives vouchers to citizens, who use them to acquire shares in investment and restructuring funds. Those funds, in turn, buy shares of the firms to be privatized.

The stock market can be created by giving corporate shares to the population or by selling them to domestic and international investors. Of course, domestic investors often do not possess the money to participate in the latter scheme, while selling shares to foreigners would call for close supervision of their investment activities. On the other hand, however, promoting foreign direct investment brings capital, technology and western know-how into the transition economy and opens it up to foreign markets.[18]

András Köves, an economist at the Budapest Institute for Economic and Market Research and Informatics, concludes that:

> foreign direct investment means capital inflow that does not increase [public] indebtedness - a crucial advantage for countries whose ability to service their debts remains to be demonstrated from day to day . . .. [19]

The three main questions associated with the model of free distribution of enterprise shares are: 1) who are the beneficiaries? 2) should shares be distributed directly, through intermediaries, or through vouchers? and 3) what role do the beneficiaries have in governing the privatized firms? Should they be active or passive shareholders? The Czech Republic, for instance, adopted a voucher scheme, in which it sells vouchers to citizens for some low nominal value. The voucher holders may then bid for shares of former SOEs or for shares in investment funds. The main advantages of using the free distribution model lie in the reduction of valuation problems and the elimination of problems related to the low level of domestic savings.[20] Valuation problems might arise out of the distorted price structure in the transition economy. The distortions make it difficult to calculate the discounted value of future net earnings, one of the most widely used variables determining the selling price of a public firm.

In sum, the issue of privatization gives rise to many conflicting theories and opinions. An optimal privatization path probably does not exist. Whether a transition economy privatizes rapidly or slowly, whether it chooses to privatize only a fraction of its state firms, how it handles the questions of restitution and compensation, and which privatization methods it opts to employ, depends, to a great extent, on the structure of the economy and the citizens' preferences.

Financial Reforms

The reforming country ought to address two major issues under this topic. First, it should, as mentioned in the section on institutional reforms, transform its socialist banking system into a two-track system, where central bank and commercial banks are separated from each other. The commercial banks may be privatized immediately or may remain under the control of the state in the beginning. An argument for immediate privatization is that state-owned banks are often tempted to continue lending to traditional customers, lacking incentives to "get tough with recalcitrant debtors and supply capital to the nascent private sector."[21] By continuing to extend loans to defaulting enterprises, however, banks increase the supply of credit further than desirable and counteract the effects of tight monetary policy. Reforming countries therefore need to enact legislation divorcing the rigid financial relationships between banks and state firms.

The second issue is less urgent than the establishment of a capitalist banking system. It involves the creation of capital markets in which longer-term debt and equity instruments can be traded, such as stock and bond, foreign exchange, futures, and options markets. Capital markets can prove beneficial to a new market economy, especially during the privatization phase. They alleviate mass privatization by providing a secondary market for the trading and distribution of shares.[22] However, since the development of securities markets will take time, banks remain the major suppliers of enterprise capital in the short run. The government should therefore ensure the creation of conditions favorable for the establishment of private commercial banks, both of domestic and of foreign origin.

The above account of reform possibilities in the six arenas of transition cannot serve as a strict guideline for economies in transformation. Ultimately, the reform path of a formerly socialist country will depend on its initial economic conditions and unique political, social, and cultural backgrounds. Generally speaking, however, effecting the reforms presented in this chapter will eliminate the centrally planned structure and thus hopefully the shortage and inefficiency problems prevalent under socialism. The reforms will aid the formerly socialist country in creating a stable and growing market economy. And although the new system will not be devoid of flaws, it will eventually prove its superiority over socialism through its higher aggregate level of welfare and greater safeguards for human rights.[23]

Theories on the Sequencing of Reform Steps[24]

After presenting an overview of the six arenas of transition and the most important reforms in these arenas, the thesis will now briefly address the controversial question of how to sequence economic reforms.

Almost without exception, sequencing theories agree on the importance of assigning priority to institutional reforms. Intricate institutional reforms are necessary for a successful transformation to a well functioning market economy. As János Kornai elaborates:

> A market economy based on the predominance of private ownership cannot operate without a requisite legal infrastructure. The safety of private property must be guaranteed, the observance of private

> contracts enforced, and enterprises and citizens protected from arbitrary interference from the bureaucracy.[25]

Because it takes time for changes in the economy's institutional structure to take effect, the government should enact these changes at the onset of transition. Large consensus also exists among economists with regard to macroeconomic policies. The government should initiate monetary and fiscal stabilization at the outset of reforms, since preventing hyperinflation usually has a less devastating effect on output and employment than trying to battle inflation once it has already proliferated.

Aggregate demand policies should be especially restrictive during the liberalization of domestic prices and external trade. Reforms of the price system and foreign trade ought to occur early in the transition and should precede privatization, as they put into place the correct price signals. Until prices reflect open market conditions, profits and losses are not good indicators of the efficiency of firms, and therefore not an ideal guide to decisions as to which SOEs should be liquidated, which justify privatization, and which should remain in the hands of the state. Many economists advocate a simultaneous freeing of prices and international trade, since sequencing these reforms would "entail successive waves of relative price adjustments, with each wave imposing additional adjustment costs on enterprises."[26] Opponents of this view fear that a simultaneous liberalization of prices and foreign trade might overextend the macroeconomy's capabilities to adapt and result in quickly rising unemployment.

Further disagreement applies to the issue of privatization. Despite general consensus on the desirability of privatizing most state-owned enterprises, the question of whether to delay the privatization of large SOEs remains controversial. Several economists reason that selling large state firms at the onset of transition would lead to an explosion in unemployment, thereby potentially increasing public resistance against the government's policies. Stanley Fischer and Alan Gelb are proponents of a policy that would include the immediate privatization of small firms while delaying large privatization.[27]

Possibly the widest disagreement exists on the appropriate time to effect reforms of the financial markets. Manuel Hinds and Oxford's Tad Rybczynski are among the economists assigning an early priority to the development of financial markets. Many scholars, however, advocate implementing financial reforms only after the government has addressed stabilization, and price and trade liberalization. As Stanford's Ronald McKinnon argues, without price level stability, the volatility in interest or exchange rates might make unrestricted domestic borrowing and lending by banks too risky.[28]

In sum, while most economists concur that the transforming economy should give priority to institutional reforms and macroeconomic stabilization and liberalize prices concurrent with foreign trade, little agreement exists on the proper initiation time of privatization or financial reforms.

After examining the arenas of transition and briefly discussing the varying views on the sequencing of reforms, the stage is now set for a closer look at how Central Europe actually approached the tremendous undertaking of reforming its multi-billion dollar economies. The following chapters present an overview of the transition policies in Poland, Hungary, and the Czech Republic between 1989 and 1994.

NOTES

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14. András Köves, Central and East European Economies in Transition (Boulder, CO: Westview Press, 1992) 50.

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20. László Szakadát, "Property rights in a socialist economy: the case of Hungary," Privatization in the Transition to a Market Economy, ed. John S. Earle, Roman Frydman, Andrzej Rapaczynski, 24.

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23. Kornai, Highway and Byways 227.

24. The following section is based on the results of a study conducted by German economists Martin Falk and Norbert Funke in "Zur Sequenz von Reformschritten: Erste Erfahrungen aus dem Transformationsprozeß in Mittel- und Osteuropa," Die Weltwirtschaft 2(93). In it the authors compare and contrast sequencing theories by: Rudiger Dornbusch, Stanley Fischer, Alan Gelb, Cheryl Gray, Manuel Hinds, David Lipton, Jeffrey Sachs, Ronald McKinnon, Domenico Nuti, Gérard Roland, Tad Rybczynski, and Horst Siebert.

25. Kornai, Highway and Byways 217.

26. Fischer, Gelb 188-197.
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Poland

- Population: 38.4 mil.
- Area: 313,000 sq. km
- GNP per capita (1992 $): 1,910
- Structure of GDP 1991:

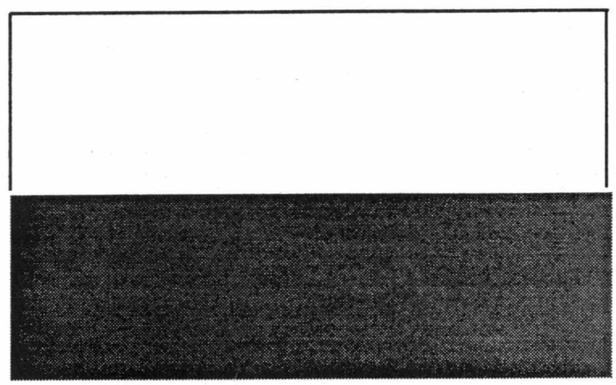
  Industry: 40.2 %

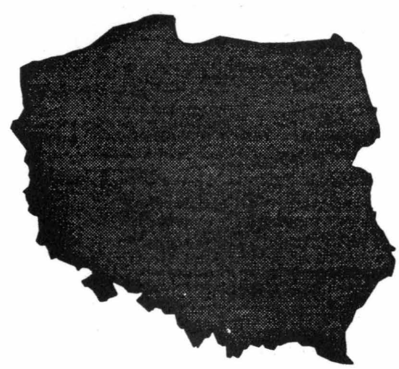
  Trade: 13.1 %

  Construction: 10.2 %

  Agriculture: 6.9 %

  Other: 29.6 %





Chapter Two: Poland's Shock Therapy

When the first democratic government under premier Tadeusz Mazowiecki and his finance minister, Leszek Balcerowicz, gained control in Poland in August 1989, the Polish economy was in severe imbalance. Poland had, throughout the eighties, experienced economic crises that surpassed those of other Warsaw Pact members (Table II.2). In 1980, responding to public discontent with the economic reality of socialism, Warsaw had attempted to grant enterprises more autonomy and allow the gradual freeing of product prices. The reform effort had little success, however, and Poland's macroeconomic condition worsened in the following years. Even though a substantial number of prices were still under state control in early 1989, hyperinflation was already raging and the budget deficit amounted to approximately eight per cent of the gross domestic product.[1] Under these conditions, it was important for the administration to focus on demand-restricting policies and sacrifice short term growth for a stable price level and a balanced budget.

A 1989 lecture by visiting Harvard professor Jeffrey Sachs served as stimulus for the speed with which Warsaw enacted most of its transition policies. Leszek Balcerowicz adopted and developed the Sachs plan, which came to be known as shock therapy, since its effects were predicted to harm the economy in the short term. According to British economist Martin Myant, the five key elements of the Balcerowicz Plan were 1) a balanced budget, 2) the freeing of nearly all prices from state control, 3) a restrictive monetary policy aimed at achieving positive real interest rates, 4) wage controls through punitive taxes on wage increases, and 5) the establishment of currency convertibility at a fixed exchange rate.[2]

TABLE II.1: Economic Transition in Poland

Time	Institutional Reforms	Macroeconomic Stabilization	Price Liberalization	Liberalization of Intern. Trade and Capital Flows	Privatization	Financial Reforms
1988	Economic Activity Act: Deregulation of public enterprises					
1989	Jan: New bank laws	Tight fiscal-, monetary policies (tax increases, subsidy removals)	Aug: Subsidy cuts; begin price liberalization	Jan: Begin abolishing all quantitative import restrictions and restrictions on capital flows		Jan: Two-track bank system with central bank + publ.& priv. commercial banks
1990 Jan-Jun	Feb: Anti-Monopoly Law	Introduction of Popiwek tax; Exchange rate fixed	90% of prices liberalized, few commodities remain under control			
Jul-Dec	Jul: Privatization laws	Aug: Tax holidays; Monetary policy loosened		Oct: Import quotas abolished; average tariff: 8 per cent	Jul: Creation of MOT; begin small privatization, reprivatization	
1991 Jan-Jun	Personal Income Tax Apr: Stock Exchange, Exchange and Securities Commission founded	Tighter monetary pol.;new person. income tax; increase corp. income tax;			Feb: Concept of mass privatization emerges;	April: Creation of Warsaw Stock Exchange
Jul-Dec		Oct: Crawling peg system; Loosening of mon. policy		July: Free int'l capital flows Aug: tariffs raised to 18%	Mass privatization stalls; reliance on sectoral privatization	
1992				Free trade agreement signed with EFTA		
1993	Reform of tax system	Introduction of Value Added Tax			Mass privatization implemented	
1994 Jan-Jul				Feb: Implementation of Association Agreement with EU		

Institutional Reforms

Two major institutional reforms preceded the actual transition begun under Mazowiecki in early 1990: the Economic Activity Act and the restructuring of Poland's banking system. The 1988 Economic Activity Act deregulated enterprise activities in all sectors of the economy and liberalized the financial and legal environment for the emerging private sector. In late January 1989, Warsaw enacted new banking laws restructuring its financial system to consist of the National Bank of Poland, or NBP (the country's central bank), fifteen state-owned banks, thirty-five mostly private commercial banks, and several cooperative banks.[3]

After Poland's new government gained control in mid-1989, it announced plans for the full transition to a market economy. In December, the prime minister introduced economic reform legislation which the parliament approved on December 28 and 29. Two days later, on January 1, 1990, Poland began the most expeditious economic transformation in Central and Eastern Europe.[4]

In February 1990, the Law on Counteracting Monopolistic Practices took effect and Warsaw created the Anti-Monopoly Office. Five months later, Poland enacted the privatization laws and established the Ministry of Ownership Transformation, the body directly overseeing privatization. The privatization laws delineated a framework with the following objectives: 1) ownership transformation, 2) increased efficiency through competitive forces, 3) demonopolization, and 4) the development of financial markets. Also in July 1990, the government devised the legal foundation for a stock market, granting workers special privileges in obtaining stock in their firms.[5]

In April 1991, the government created the Warsaw Stock Exchange and Securities Commission. Its main task was the "protection of investors' interest expressed mainly in the procedures of accepting stocks for trade as well as licensing and monitoring the brokers."[6] In January

1993, Poland finally reformed its tax system, which had consisted until then primarily of SOE turnover taxes and a 1991 personal income tax.

Macroeconomic Stabilization

Fiscal Policy

Fiscal policy in 1989 was restrictive and remained tight throughout 1990, owing to fear of accelerating inflation. The administration released a plan in 1989 calling for the removal of all government subsidies, including those for energy and housing, by the end of 1990. Warsaw managed to reduce the share of state subsidies in its GDP from 15 per cent to six per cent between 1989 and 1990. The government also increased corporate income taxes, revoked tax exemption privileges, and reduced tax relief for public enterprises near bankruptcy during the first months of the new administration. Consequently, the budget deficit, as a proportion of total public expenditures, decreased from 44 per cent in the first six months of 1989 to slightly above six per cent during the second six months. In August 1990, the national budget seemed to be balanced for the first time in decades. The Finance Ministry thereupon decided to grant private proprietorships one-to-three year long tax holidays applying to sales and turnover taxes. These tax exemptions contributed to a growth in Poland's budget deficit throughout 1991.

The adverse effects on the deficit were enhanced by the collapse of trade between the members of the Council for Mutual Economic Assistance (CMEA) and an additional decrease in tax revenues caused by rising unemployment and a greater number of insolvent enterprises. Moreover, weak tax collection and enforcement mechanisms enabled many Polish firms and individuals to evade tax payments.[7]

In 1991, Poland introduced a new personal income tax and increased the corporate income tax. Raphael Shen, professor of economics at the University of Detroit, claims the government was hoping that the resulting reduction in investment capabilities of corporations would lower inflationary pressures. The new government under Olszewski made plans to maintain the deficit at five per cent of GNP in 1992 and gradually eliminate it by 1994. Warsaw therefore increased indirect consumption taxes and introduced a value added tax. These changes contributed to a deficit reduction from 4.9 to 3.8 per cent of GDP and a substantial decline in inflation between 1992 and 1994.[8]

Monetary Policy

The Polish government introduced tight monetary control in 1989, mostly in response to the inflation of early 1989 (The monthly rate for January amounted to 78.9%.) After additional drastic increases in the price level caused by price liberalization in early 1990, the government managed to completely stop hyperinflation by the summer of that year. This temporary success in containing inflation, and the government's earlier promises to spur economic recovery, prompted Warsaw to loosen its macroeconomic policies during the second half of 1990. Inflation thereupon increased until the end of the year, convincing the government that it would have to revert to a tighter monetary policy.[9]

In 1991, monthly increases in consumer prices remained above anticipated levels. Annual inflation, however, dropped from 555 per cent in 1990 to a relatively moderate 76 per cent one year later (Table II.2). Economic recovery had still not begun. Poland was instead witnessing a second, policy-induced recession. The second half of 1991 saw a loosening of monetary policy again. Economic recovery began in early 1992, continuing into 1993. Inflation dropped and the increases in unemployment leveled off. Poland's real GDP, which had fallen only minimally in 1990, increased from 77.9 to approximately 86.9 billion U.S. dollars between 1991 and 1993.

Table II.2: Selected Macroeconomic Indicators

Year	1980	1983	1985	1987	1988	1989	**1990**	1991	1992	1993	1994
Π a)	9.4	22.1	14.6	25.2	60.2	251.1	**555.4**	76.7	45.3	36.9	33.4b)
GDPc)	56.7	75.5	70.4	63.9	68.8	82.2	**62.3**	77.9	83.6	85.9	94.0
E d)	130.2	121.7	120.3	119.9	118.0	144.5	**100.0**	100.1	90.6	88.0	n.a.
O f)	123.3	112.1	121.9	131.8	138.1	134.1	**100.0**	84.0	87.3	n.a.	n.a.
G-T g)	n.a.	n.a.	n.a.	1.4	2.3	(8.0)e)	**2.7**	(1.9)	(4.9)	(2.3)	(3.8)
C h)	66.9	64.8	61.7	51.6	49.3	51.4	**45.6**	68.9	67.4	n.a.	n.a.

Sources: IMF International Financial Statistics, European Marketing Data and Statistics, Bank Austria, OECD, Frankfurter Allgemeine Zeitung
a) Average annual inflation in per cent, b) Average % change in CPI IV/93-III/94, c) Gross Domestic Product in billions of current U.S. $, d) Industrial Employment Index (period averages), e) estimate, f) Industrial Production Index (period averages), g) Government Surplus (Deficit) in per cent of GDP, h) Private Consumption in per cent of GDP.

The Balcerowicz Plan not only aimed at reducing aggregate demand by restricting monetary and fiscal policies, but also aspired to decrease inflationary expectations by temporarily freezing some nominal variables, called anchors. These anchors were wage controls and a fixed exchange rate.[10]

Wage Policy

The Polish administration introduced the Popiwek tax, a tax on wage increases in the SOEs beyond a permissible level, in 1990. Warsaw permitted wage increases only as a given percentage of the previous month's inflation rate. If a state firm wished to raise wages beyond that level, it would become subject to high taxation. Private and foreign firms were exempt from penalty taxation.

In anticipation of the price shocks of early 1990, Poland granted a real wage increase for state firms of 25.6 per cent in December 1989. The following month's inflation rate, however, amounted to 78.6 per cent, lowering real wages drastically. Economic distress in 1989 (average real income had eroded by 40 per cent in less than a year), had led to a decline in the marginal propensity to save. Consequently, the Popiwek tax decreased consumption severely, lowering aggregate demand and exerting downward pressure on inflation.[11]

Foreign Exchange Policy

Warsaw introduced zloty convertibility in early 1989 with the legalization of free market currency trading. From January 1990 until May 1991 the Polish government retained an adjustable peg system, with the zloty initially fixed at 9,500 units per dollar (Table II.3). This official rate was at first higher than the market rate, but over time domestic inflation caused an overvaluation of the zloty. Poland's overvalued currency reduced the competitive position of domestic companies, which led to a decrease in Polish exports. In 1990 and 1991, the zloty underwent two currency devaluations, the first reducing its fixed value by 45 per cent, the second by 17 per cent.

These efforts to restore health to Poland's trade balance were of little avail and the newly fixed rates still did not reflect the true value of the zloty. The Polish government therefore decided to introduce a crawling peg on October 27, 1991. The zloty's monthly devaluations against a market basket of currencies containing the U.S. dollar, the Deutsche mark, the British pound and the Swiss and French francs, equalled two per cent. The fixed devaluations, however, remained lower than the domestic inflation rate.[12]

Table II.3: Exchange and Interest Rates

Year	1980	1983	1985	1987	1988	1989	1990	1991	1992	1993	1994
X-R a)	44	92	147	265	431	1439	9500	10576	13626	18115	23145 b)
i c)	n.a.	3	4	4	6	140	55	40	38	35	33d)

Source: IMF International Financial Statistics
a) Zloty per U.S. $ (period averages), b) October 1994, c) Refinancing rate (end of period), d) September 1994.

Price Liberalization

In August 1989, Warsaw undertook drastic cuts in subsidies and started liberalizing prices. By early 1990, 90 per cent of prices had been completely liberalized. Only a few selected commodities such as coal, gas, and rent remained subject to state control. The government also freed prices of services on January 1, 1990. Public transportation, health care, postal, and communication sectors were permitted to increase their prices in accordance with market conditions.

Consumer prices soared after the price liberalization in early 1990. Monthly inflation in January was at 78.6 per cent, in February at 23.9 per cent, and by March down to 4.7 per cent, as a result of tighter aggregate demand policies.[13] Inflation thereupon declined from 555 to 37 per cent between 1990 and 1993.

Foreign Economic Liberalization

In order to stimulate foreign investment, Poland gradually eliminated its restrictions on capital repatriations between 1989 and July 1991. Between January 1989 and October 1990, the Polish government furthermore abolished most quantitative import restrictions in manufacturing and reduced the average tariff level from 13.3 to eight per cent. The reduction in tariffs helped introduce international competition into the Polish market, thereby to an extent controlling inflation. The opening to international markets also encouraged local firms to export and find foreign joint venture partners. In August 1991, however, a new tariff regime more than doubled the average tariff level to 18.1 per cent. Warsaw probably undertook this step in order to counter rapidly declining tax revenues from domestic sources.

The May 1990 devaluation of the zloty and reductions in domestic demand led to a merchandise trade surplus of $1.4 billion in that year (Table II.4). A deficit replaced this surplus in 1991, after the Council for Mutual Economic Assistance abandoned its trade regulations.[14]

The Warsaw administration signed a free trade agreement between Poland and the European Free Trade Association (EFTA; consisting of Poland, Hungary, and the Czech and Slovak republics) at the end of 1992, which took effect November 15, 1993. The centerpiece of this contract called for the elimination of all tariff and non-tariff barriers in the region by the year 2001. Several months earlier, on March 1, 1992, Poland had signed an interim trade agreement with the European Union, which was to remain in effect until the implementation of the Association Agreement. The latter became effective February 1, 1994. Since January 1995, Poland is able to export all goods except for steel and textiles tariff-free into the EU. Furthermore, the General System of Preferences is applied to all exports from Poland into the U.S.A., Japan and various other industrialized nations.[15]

Table II.4: Foreign Trade and Investment (Minus Sign Indicates Debit)

Year	1980	1983	1985	1987	1988	1989	1990	1991	1992	1993	1994
Trade a)	-1,776	303	347	790	1,089	47	3,589	-711	-131	-3,505	-296b)
Trade c)	-934	744	573	1,021	847	-114	1,410	-786	-85	-3,316	-268b)
D.I. d)	-11	15	14	4	-7	-7	89	298	665	1,697	113b)
D.I. e)	4	3	2	2	-18	-12	88	256	577	1,293	113b)

Source: IMF International Financial Statistics
a) Trade Balance for transactions in all currencies (Millions of U.S. $), b) end of first quarter, c) Trade Balance for transactions in convertible currencies (Millions of U.S. $), d) Direct Investment in all currencies (Millions of U.S. $), e) Direct Investment in convertible currencies (Millions of U.S. $).

Privatization[16]

In 1988, Poland 's state sector accounted for 81.2 per cent of national income. Two years later, in July 1990, Warsaw set the legal framework for the privatization of most remaining SOEs and created the Ministry of Ownership Transformation (MOT). Under the new privatization laws, state firms were first "commercialized" into joint-stock companies, in which the State Treasury would initially constitute the sole shareholder. The MOT subsequently assessed the companies' value by estimating discounted future profit streams or the firm's book value. Within two years of commercialization, the state sold the company's stock through one of several privatization methods depending on the firm's size. The most widely used method was individual privatization. Individual privatization involved either a public offer or a so-called "trade sale," in which domestic and international bidding processes determined the firm's new owner(s). The Mazowiecki government mostly sold large industrial firms through public offers.[17]

Commercializing and selling the firms proved to be a slow process, however. By November 1990, only 20 of 157 large enterprises chosen for privatization had been commercialized and only 5 firms had actually been sold. Most of the problems stemmed from the difficulties assessing the firms' values in the absence of a well-functioning stock market.

In February 1991, the new government under Bielecki announced a privatization offensive and introduced the mass privatization concept, through which Warsaw hoped to privatize 400 of the largest SOEs and create more than twenty investment funds managed by Western firms. Each citizen age 18 or older could obtain, free of charge, shares in any fund. In the ensuing parliamentary quarrel over the effectiveness of mass privatization, many politicians voiced concerns that the large investment funds could become unaccountable to their 27 million owners and the managing firms could manipulate the funds. When the parliament finally put mass privatization into effect in April 1993, two years had passed since its conceptualization.

While mass privatization stalled in 1991, the government relied heavily on a concept called sectoral privatization. Western consulting firms analyzed current and future prospects of an enterprise in a given sector and then suggested a sector-specific privatization strategy.

Small privatization in Poland between 1990 and 1992 was more successful than mass privatization. In 1990 alone, Warsaw transferred 35,000 state-owned and cooperative retail stores to private owners. Popular privatization methods were manager or worker buy-outs and liquidation. According to Ben Slay, "In addition to providing a mechanism for bankrupting insolvent firms and reallocating their assets, liquidation was an effective avenue for privatizing relatively healthy small and medium-sized firms as well."[18] Another method of transferring ownership was reprivatization. Between 1990 and 1992, the state returned only those properties, whose seizure was originally illegal and whose "restitution was not clouded by the issues of property alteration or modernization."[19]

In sum, the slow pace of individual privatization of large companies and the failure of the mass privatization program suggests that the legal framework developed in 1990 may have failed to impose a well-thought out structure on privatization.

> The slow pace [of privatization] had a negative impact on the stabilization program, which counted on privatization to improve enterprise supply response to the eventual relaxation of macroeconomic austerity.[20]

In addition to an uncertain privatization structure, the Polish legal framework also failed to implement regulatory and enforcement mechanisms for conducting business in the new private sector. Many entrepreneurs could take advantage of loopholes and "lax enforcement of fiscal and financial regulations to bilk the state treasury out of trillions of zlotys."[21]

Financial Reforms

The Economic Activity Act of 1988 authorized the establishment of private banks and the banking law of January 1989 divided Poland's financial sector into a two-track system with a central bank (NBP), independent of government control, and several state-owned and private commercial banks. The duties of the National Bank of Poland are

> the issuing of bank notes, participating in the formulation of monetary and credit policies, supervising the operation and practices of member banks, determining rate and level of foreign exchange, maintaining foreign reserves, setting the reserves for member banks, representing the government in its dealings with foreign financial institutions, adjusting the discount rate [...], issuing treasury bills and discount bonds and promoting the circulations of money through the new two-tier banking system.[22]

In April 1991, the Polish administration established the Warsaw securities market, but as of June 1993, stock of only 17 firms was traded. Throughout the 1990-1992 period the stock market contracted, as real share prices declined drastically. Few foreigners invested in Polish securities, for fear of inflation and political instability.[23]

Until 1992, the state-owned commercial banks dominated the financial market. Their control over the market, combined with the absence of well-developed bankruptcy procedures and slow progress in privatization, produced an increase in the debts of many Polish enterprises. The state banks had no economic incentive to force debtors into paying back their loans, since the threat of bankruptcy of these relatively large state banks was not credible until 1992. According to a World Bank study, in February 1992, 30-40 per cent of bank credits extended to state enterprises were doubtful or unrecoverable. Likewise, non-bank state enterprises were also neglectful in pushing insolvent debtors into bankruptcy in order to obtain part of their assets. Consequently, inter-enterprise debt reached $14.8 billion, or 15 per cent of GDP, in April 1992.[24]

Poland's problems, such as those encountered in the financial sector, bear resemblance to those faced in the Czech Republic and Hungary. However, since neither of the other two nations implemented such radically swift reforms, Polish policy makers in a sense became scouts for the governments in other socialist countries. Especially the Czech Republic was able to profit from Poland's early experiences, since it initiated economic transformation one year after the outset of Polish reforms. Chapter III will present an account of economic transition in Czechoslovakia, and, after January 1993, in the Czech Republic. In order to be able to compare Poland's transition with those of Czechoslovakia and Hungary, I will postpone a summary of Poland's economic progress between 1990 and 1994 until the last chapter.

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4. Shen, The Polish Economy 96-97.

5. Information taken from:
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10. Material in the previous two paragraphs drew upon:
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11. The *Wage Policy* section was based on:
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15. "Osteuropa" 4.
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18. Slay, The Polish Economy 107.

19. ibid 107-108.

20. ibid 109.

21. ibid 110.

22. Shen, The Polish Economy 107.

23. Slay, The Polish Economy 150.

24. Previous two paragraphs: ibid 151-153.

Czech Republic

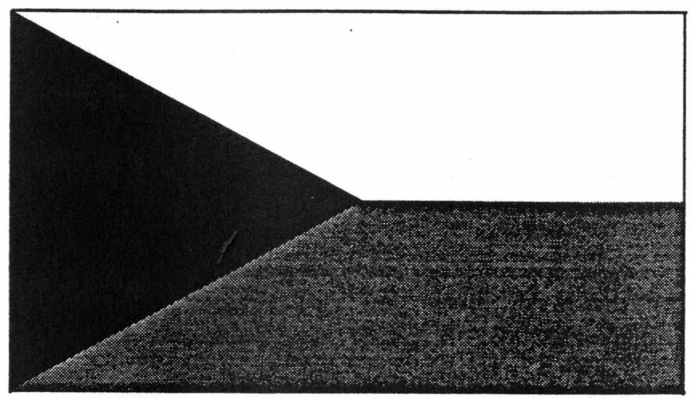
- Population: 10.3 mil.
- Area: 79,000 sq. km
- GNP per capita (1992 $): 2,450
- Structure of GDP 1991:

  Industry: 51.5 %

  Construction: 8.7 %

  Agriculture: 6.2 %

  Other: 33.6 %



Chapter Three: Economic Transition in the Czech Republic[1]*

Economic transition in Czechoslovakia began on January 1, 1991, one year after the new democratic government had gained power. Prague enjoyed more favorable macroeconomic conditions than Warsaw before the onset of its transition (Table III.2). 1989 inflation in Czechoslovakia, for instance, amounted to only 1.4 per cent. In 1990, inflation rose to ten per cent, but remained below pre-transition levels in Poland. Yet with 99 per cent of national income still produced by state enterprises in 1988, Czechoslovakia's private sector was much less developed and experienced than Poland's at the beginning of transformation.

Czechoslovak policy makers considered as the main elements of transition: 1) rapid price liberalization, 2) foreign trade liberalization, including immediate current account convertibility, 3) wage controls, 4) restrictive monetary and fiscal policies, 5) a new legal system consisting of a commercial code and revised acts on banking, foreign investment, competition, taxation, social security and environmental protection, and 6) privatization.[1] Czechoslovakia's emphasis at the beginning of transformation indeed lay on price and trade liberalization and restrictive aggregate demand policies. It was not until after the Czech and Slovak states had become two separate republics in January 1993, however, that institutional reforms became a priority for the government in Prague.

1* Policies enacted by Prague before January 1, 1993 were those of Czechoslovakia. The thesis only follows the development of the Czech Republic after 1993.

TABLE III.1: Economic Transition in the Czech Republic

Time	Institutional Reforms	Macroeconomic Stabilization	Price Liberalization	Liberalization of Intern. Trade and Capital Flows	Privatization	Financial Reforms
1990 Jan-Jun	Bank Laws; Law on Private Bus. Activity			Joint Venture Act		Jan: Two-track bank system established
Jul-Dec			Partial price liberalization, subsidy removal prior to 1991	Taxes on profit repatriation eliminated		
1991 Jan-Jun	Reorganization of Central Bank; Small Privatiz. Law; Competition Act; Turnover Tax	Jan: Tight fiscal-, monet.-credit policies; subsidy cuts; cap on wage raises; pegged exchange rate	Jan: Freeing of prices representing 85% of sales; temporary price guidelines for food	Jan: Current account restrictions removed; CMEA agreements abandoned; 20% import surcharge	Jan: Small Privatization begins April: 1st wave of Large Privatization begins	Jan: Begin establishment of private banks; March: Establ. of Consolidation Bank
Jul-Dec			Price guidelines abandoned in Nov.			
1992 Jan-Jun	Laws on Restit. of Property	Continuation of tight monetary and credit pol.			Begin restitution of property	Feb: Reorganiz. of central bank
Jul-Dec			Dec:95% of prices liberalized		First wave ends	
1993 Jan-Jun	New Tax system; April: Bankruptcy Law implemented; Debt Cleanup Prg.	Value Added Tax; new income and excise taxes; Loosening of cred.& mon. pol.		Import surcharge abolished Parliament signs trade agreements with E. Europe, European Union		April: Stock Exchange opens
Jul-Dec					Early 1994: Second Wave, voucher scheme	
1994					Begin 2nd wave; emphasis on voucher scheme	

Institutional Reforms

Czechoslovakia's government implemented new bank laws in January 1990. These laws contained a provision dividing the banking sector into a two-track system, with a central bank (State Bank of Czechoslovakia, or SBCS) and three state-owned commercial banks. In the same year, the Law on Private Business Activity took effect, granting all citizens the right to establish their own businesses within the Czechoslovak legal framework.[2]

In January and February 1991, the government proceeded to develop the fledgling market economy by implementing a new turnover tax, a small-scale privatization law, and the Competition Act, modeled to a great extent on the anti-trust laws of western Europe.

> In addition to prohibiting restrictive practices [e.g., entry barriers] and requiring permission for merger activities, [the Competition Act] grants the anti-monopoly office power in molding an appropriate market structure for any given industry. In other words, on the basis of economic efficiency and consumer well-being, an anti-monopoly office may order the decomposition of large state enterprises into smaller, independent units.[3]

The Czech parliament amended the Competition Act in November 1993, bringing business associations and chambers of commerce under the jurisdiction of the anti-trust office.

In 1992, the laws on the restitution of property took effect. Former owners of large enterprises expropriated after 1948 would be compensated or receive back their property. The Czech parliament furthermore passed the Law on the Value-Added Tax, as well as laws on income and excise taxes in November 1992. This new tax system went into effect in January 1993.[4]

In April 1993, Prague decided to amend and enact the bankruptcy law that had been designed two years earlier. The Czechoslovak authorities had waited with the implementation of this law for fear of a domino effect, through which business debt defaults were believed to lead to a wave of bankruptcies. When the bankruptcy law finally took effect in 1993, it was accompanied by a massive debt cleanup program involving two procedures: Insolvent enterprises were to be liquidated and their assets taken away from the management, while businesses that were merely illiquid through delayed customer payments had to be restructured.[5]

Macroeconomic Stabilization

Fiscal policy

The Prague government designed fiscal policy "to further the disengagement of the state from the economy and to help stabilize the economy in the turbulent period following the [price and] terms of trade shock[s]."[6] Fiscal policy for 1991 aimed at an overall budget surplus of roughly one per cent of GDP. The government expected revenues to increase with the implementation of the profits tax, while hoping that expenses for the social safety net would not put a strain on the budget until 1992. In 1991 all components of government expenditure declined in real terms, lowering the ratio of G to GDP by about eleven per cent. The most severe cuts occurred on subsidies, while retrenchments on the social safety net and public investment remained moderate.

In 1991, Prague reduced the rates of both the profit and turnover taxes. Turnover tax rates rose again in September 1992 by an average of nine per cent. Two months later the parliament approved the Law on the Value Added Tax, stipulating five per cent and 23 per cent tax rates. Starting January 1, 1993, basic food products, mineral oils and fuels, and antibiotics were taxed at five per cent. Most other products were taxed at 23 per cent. The Czechoslovak parliament also adopted laws on income and excise taxes in November 1992, which took effect January 1993.

Throughout 1992, Czechoslovakia managed to reduce further the ratio of government spending to GDP from 54 per cent to 49 per cent. In April 1993, the Czech Council on Social and Economic Agreement, a coalition comprising the government, trade unions, and employers, approved a plan for providing tax and social security breaks to private entrepreneurs. The plan offered private businessmen a tax credit on ten per cent of reinvested profits.[7]

Monetary policy

From the outset of reforms, Prague also observed a generally restrictive monetary policy. A tight credit policy in 1991 not only avoided an inflationary spiral, but also added to the drastic fall in output in the following year. In 1992 the SBCS's tight monetary policy continued. The State Bank of Czechoslovakia abolished ceilings on interest rates in April 1992 and credit limits for large commercial banks in October 1992, phasing out two direct instruments of monetary policy. In order to retain its grip on the money supply, the State Bank introduced reserve requirements, a discount rate, refinance auctions, and started selling government bills. In June 1993, the Czech National Bank (CNB), the successor of the SBCS in the Czech Republic, responded to falling inflation and the high level of foreign reserves by lowering its discount rate and the reserve ratio on demand deposits.[8]

Notwithstanding these encouraging news, between 1990 and 1993 the Czech economy experienced a 40 per cent fall in industrial output -- an indicator that Prague's fiscal and monetary policies might have been excessively restrictive in the first years of transformation (Table III.2).

Table III.2: Selected Macroeconomic Indicators

Year	1980	1983	1985	1987	1988	1989	1990	**1991**	1992	1993 a)	1994 a)
Π b)	2.9	0.9	1.7	0.1	0.1	1.4	10.0	**57.7**	10.8	20.4	9.6c)
GDP d)	35.4	30.2	39.5	51.9	51.5	50.4	45.2	**33.2**	30.8 24.7	25.2e)	12.7g)
E f)	102.1	105.5	106.1	107.0	107.2	106.9	100.0	**106.5**	95.9e)	77.3	73.2h)
O i)	83.0	88.4	95.2	100.7	102.7	103.8	100.0	**106.5**	65.6e)	60.4	58.4h)
G-T j)	n.a.	k	n.a.	(k)	(2.2)	(3.8)	(0.6)	**(2.8)**	n.a.	2.6	n.a.
C m)	43.8	53.8	44.0	44.3	44.6	45.2	47.2	**39.9**	n.a.	54.2	n.a.

Sources: IMF International Financial Statistics, European Marketing Data and Statistics, OECD
a) Until 1992 all figures are for Czech and Slovak Republics, 1993 and 1994 figures are for Czech Republic only. Index figures for 1993 and 1994 refer to base year 1990 in the Czech Republic, b) Average annual inflation in per cent, c) Average % change in CPI IV/93-III/94, d) Gross Domestic Product in billions of current U.S. $. Top row (until 1992): Czech and Slovak Republic. Bottom row (after 1993): Czech Republic only, e) estimate, f) Industrial Employment Index (period averages), g) first half 1994, h) Average index for August 1994, i) Industrial Production Index (period averages), j) Government Surplus (Deficit) in per cent of GDP, k) Surplus (Deficit) <0.1%, m) Private Consumption in per cent of GDP.

Wage Policy

Wage policy in 1991 focused on the containment of wage growth as the Czechoslovak government established a cap on wage raises. If a firm's wage increases exceeded the predetermined level, the company would have to pay penalty taxes. After the Czech government lifted wage caps several months later, they were reintroduced in July 1993 for non-financial enterprises with more than 24 employees. In August 1993, economic ministers voted to impose wage controls on banks and other financial institutions, calling for special taxation of companies whose wage increases exceeded inflation by five per cent. These controls were extended into 1994.[9]

Foreign Exchange Policy

The Czechoslovak government decided in January 1991 to peg the crown to a market basket of currencies of major partner countries in the west. In the absence of a foreign exchange futures market and hedging facilities, a fixed rate would, if maintained, reduce exchange rate volatility and facilitate trade. Furthermore, the government's commitment to this pegged rate would also strengthen its credibility in maintaining low inflation rates and therefore discourage speculative capital outflows. On April 2, 1993 the CNB approved an adjustment of the market basket of currencies to which the crown was linked. Starting May 3, the Czech currency was fixed only to the German Mark (with 65 per cent weighing) and the U.S. Dollar (35 per cent weighing).[10]

Table III.3: Exchange and Interest Rates

Year	1980	1983	1985	1987	1988	1989	1990	**1991**	1992	1993 a)	1994 a)
X-R b)	14.3	14.2	17.1	13.7	14.4	15.0	18.0	**29.5**	28.3	29.2	27.6c)
i d)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	8.5	**9.5**	9.5	8.0	8.0 e)

Source: IMF International Financial Statistics
a) Until 1992 all figures are for Czech and Slovak Republics, 1993 and 1994 figures are for Czech Republic only, b) Koruny per U.S. $ (period averages), c) October 1994, d) Discount Rate (end of period), e) September 1994.

Price Liberalization[11]

An early priority of the Prague administration was price liberalization. The Czechoslovak government had already begun partial price deregulation and subsidy removal before 1991. On January 1, 1991 Czechoslovakia freed prices of goods and services representing 85 per cent of total sales at both producer and retail levels. Public utility and transport rates, as well as rents and a few vital products such as medication still remained subject to restrictions. The government furthermore retained temporary price guidelines for a list of specified products including foodstuffs. Prague feared that the monopolized structure of some industries could lead to unwarranted price rises at the onset of reforms, when competition was still underdeveloped. The state abandoned these price guidelines in November 1991.

The CPI was expected to increase by at least 25 per cent in early 1991, not solely as a result of price liberalization, but also of the collapse of CMEA trading arrangements and a rise in the international price of oil. Aggregate demand policies therefore anticipated an initial price jump of 25 per cent, and an underlying annual inflation rate of no more than five per cent. These targets appeared ambitious, even in light of the low level of monetary overhang in Czechoslovakia compared to other formerly socialist economies. Actual inflation in 1991 reached 58 per cent. Czechoslovak authorities managed to reduce this figure to a relatively low eleven per cent in the following year. The introduction of the value-added tax (VAT) in January 1993 led to a temporary surge in the price level, contributing to an inflation rate of 21 per cent in 1993.

By the end of 1991, prices representing only 18 per cent of Czechoslovakia's gross domestic product were still regulated. One year later this figure dropped to six per cent.

Foreign Economic Liberalization

The Joint Venture Act of 1990 established the framework for international joint ventures and foreign-owned companies. The act called upon Czechoslovak authorities to regulate foreign exchange accounts and borrowing from banks abroad less strictly for foreign-owned firms. Prague furthermore eliminated all taxes on profit repatriation from foreign direct investments and in April 1992 also lowered duties on profit repatriation from portfolio investments.

The Czechoslovak government removed virtually all restrictions on current account transactions on January 1, 1991. On the same day, CMEA members dismantled their trade and payments arrangements. Czechoslovakia's trade with its traditional partners subsequently collapsed, especially since Soviet importers could not secure the necessary crowns in order to maintain their imports from Czechoslovakia.[12]

Czech authorities also temporarily imposed a 20 per cent surcharge on a majority of imports in early 1991. Their initial argument was that high demand for imported consumer goods might raise the price of foreign currencies. Subsequently, however, the government reduced this surcharge to 15 per cent in mid-1991, ten per cent in 1992, and completely abolished it in early 1993.

On July 8, 1993, the Czech parliament passed the Central European Agreement on the creation of a free-trade zone with Slovakia, Hungary, and Poland (EFTA). Three months later the Czech government signed the Association Agreement with the European Union, facilitating trade with western Europe and laying the framework for the Czech Republic's future EU membership.[13]

Table III.4: Foreign Trade and Investment (Minus Sign Indicates Debit)

Year	1980	1983	1985	1987	1988	1989	1990	**1991**	1992	1993	1994
Trade a)	n.a.	348	277	-270	385	143	-1,422	**-121**	-1,834	n.a.	n.a.
Trade b)	-12	803	697	-124	-83	417	-650	**-482**	-1,834	-213e)	14
D.I. c)	n.a.	n.a.	n.a.	n.a.	n.a.	257	187	**586**	1,073	n.a.	n.a.
D.I. d)	n.a.	n.a.	n.a.	n.a.	n.a.	257	173	**583**	1,073	371e)	n.a.

Source: IMF International Financial Statistics, OECD
a) Trade Balance for transactions in all currencies (Millions of U.S. $), b) Trade Balance for transactions in convertible currencies (Millions of U.S. $), c) Direct Investment in all currencies (Millions of U.S. $), d) Direct Investment in convertible currencies (Millions of U.S. $), e) Cumulative total for the Czech Republic only, August 1993.

Privatization

The privatization of small enterprises began in January 1991. The state sold firms through auctions open to all citizens of Czechoslovakia. Until November 1991, authorities managed to privatize 20,000 companies and to repay the companies' debts out of the proceeds of the auctions.

By the end of 1992, the government had completed 68 per cent of the planned privatizations and one year later concluded the small privatization program.[14]

The Large Privatization Program began in April 1991 and proceeded at a much slower pace than initially projected. December 1992 had been the anticipated completion date for the sale of large enterprises. In fact, the end of 1992 merely saw the completion of the first of three Privatization Waves. In the first wave, Czechoslovak authorities sold large SOEs mostly through orthodox methods of privatization, such as direct sales, auctions, public tenders, etc. In the second wave, launched in the first quarter of 1994, the government placed more emphasis on a new method, the so-called voucher scheme. All citizens were entitled to acquire a voucher book with 1000 investment points for a low price. Voucher holders could then use their points to bid for shares of individual companies or to buy shares in mutual funds (Investment Privatization Funds, or IPFs). Voucher privatization had two major advantages over the more orthodox privatization schemes: The low price of vouchers enabled nearly all citizens to invest in privatized enterprises, therefore increasing public support for the government.[15] Enterprises with restitution claims were excluded from regular privatization. Former owners of firms expropriated after 1948 either received back their property or were compensated by the state.

In May 1993, the Voucher Privatisation Center began issuing those shares in Czech businesses that had been sold during the first Privatization Wave. The distribution of shares had been postponed because of a "row over Czech-Slovak property division, which led prime minister Klaus to withhold the . . . shares in Czech firms that had been bought by Slovaks in the first round of voucher privatization as well as to delay the allocation of shares to Czech participants."[16]

Although large privatization in the Czech Republic proceeded at a slower pace than expected between 1991 and 1994, it nevertheless progressed faster than privatization in Poland or Hungary. This relative success rested partially in the higher degree of political stability in Prague, which contributed to the consistency of privatization policies.

Financial Reforms

In January 1990, the Czechoslovak government enacted the new state bank laws. These laws converted Czechoslovakia's single-track bank system into a two-track system, consisting of the State Bank of Czechoslovakia and three publicly-owned commercial banks.[17] One year later the government allowed the establishment of private banks, and by November 1991 the number of private banks in Czechoslovakia had reached 38.

In March 1991, Czechoslovak authorities established the Consolidation Bank. This new institution was to acquire a large portion of credits that commercial banks were consistently rolling over and give the debts new long-term maturities. By relieving commercial banks from these questionable loans, the Consolidation Bank was supposed to make financial intermediation more efficient. Unfortunately, however, many of the questionable loans were not transferred. As late as June 1994, 20 per cent of loans on the balance sheets of Czech commercial banks were of high risk, a large portion of which were inherited credits.

The Banking Act of February 1, 1992, called on the SBCS for the enforcement of capital adequacy, liquidity, credit exposure, and foreign exchange provisions in Czechoslovakia's financial markets. The new act also modeled the central bank's administrative structure on the Bundesbank's. The government furthermore allowed branches of foreign banks to commence business operations in Czechoslovakia and freed its three state-owned banks from state control, preparing them for privatization. As of January of 1994, 56 banks were licensed to operate in the Czech Republic and 49 foreign banks were waiting for approval to commence operations.[18]

The Prague Stock Exchange opened on April 6, 1993, a month before the Voucher Privatization Center started distributing shares from the first wave of privatizations. The exchange started trading the first shares from this wave on June 22. By January 1993, "an influx of foreign investment had transformed the market into an active one, as the Prague Stock Exchange qualified for investment by emerging markets mutual funds that send US investments around the world."[19] Overall, the Czech capital market still suffers from low liquidity, however, and analysts have stated that it may take several years before the market stabilizes.

Nevertheless, the Prague Stock Exchange experienced faster growth than its counterpart in Warsaw, which is indicative of the Czech Republic's relative success in privatizing its economy. As indicated above, the privatization of large enterprises in the Czech Republic was structured more clearly than in Poland. Prague not only excelled in privatization, but was also able to stabilize its macroeconomy faster than the Polish government. Before presenting a complete summary of the Czech Republic's economic progress, however, the discussion will first turn to Hungary's reform efforts.

NOTES

1. OECD, Economic Surveys 1994: The Czech and Slovak Republics (Paris, France: OECD, 1994) 26.

2. Jörg Borrmann, Andrea Manzotti, Frank A. Schmid, "Die Entstehung des Bankenmarktes in der CSFR," Osteuropa-Wirtschaft 4 (1992): 299.
   OECD, Economic Surveys 1991: Czech and Slovak Federal Republic (Paris, France: OECD, 1991) 65.

3. Shen, Economic Reform 200.

4. The previous two paragraphs drew upon:
   Delegation of the Commission of the European Communities in Prague, Czech Economic Highlights November 1992 and November 1993.
   Falk, Funke 191.

5. OECD Economic Surveys 1991 64.

6. Quote and current paragraph draws upon: Aghevli, Borenzstein, Willigen 11.

7. The previous two paragraphs drew upon:
   Czech Economic Highlights July/August 1992, November 1992, April 1993.
   OECD Economic Surveys 1994 30.

8. Material in the previous paragraph based on:
   Aghevli, Borensztein, Willigen 13.
   OECD Economic Surveys 1994 27.
   Czech Economic Highlights June 1993.

9. The previous paragraph drew upon:
   Aghevli, Borensztein, Willigen 11.
   OECD Economic Surveys 1994 79.
   Czech Economic Highlights August 1993.

10. The previous paragraphs drew upon:
    Aghevli, Borensztein, Willigen 10.

11. The following section on *Price Liberalization* draws upon:
    Aghevli, Borensztein, Willigen 8.
    OECD Economic Surveys 1994 33.

12. The previous two paragraphs drew upon:
    Aghevli, Borensztein, Willigen 9.

13. The previous two paragraphs drew upon:
Aghevli, Borensztein, Willigen 9.
Falk, Funke 192.
Czech Economic Highlights July 1993.

14. Aghevli, Borensztein, Willigen 17-19.
Falk, Funke 192.

15. Jiři Snobl, personal interview, August 1994.
Jan Mladek, The different paths of privatization: Czechoslovakia, 1990-?, Privatization in the Transition to a Market Economy, ed. John S. Earle, Roman Frydman, Andrzej Rapaczynski (New York, NY: St. Martin's Press, 1993) 130.

16. The previous two paragraphs drew upon:
Aghevli, Borensztein, Willigen 19.
Czech Economic Highlights May 1993.
Sharon Fisher, "The Czech and Slovak Capital Markets," RFE/RL Research Reports 29 April 1994, 30. Quote by Fisher.

17. Borrmann, Manzotti, Schmid 299.

18. The previous paragraph drew upon:
Borrmann, Manzotti, Schmid 302-304.
OECD Economic Survey 1994 29
Czech Economic Highlights January 1994.

19. Fisher 31.

Hungary

- Population: 10.3 mil.
- Area: 93,000 sq. km
- GNP per capita (1992 $): 2,970
- Structure of GDP 1991:

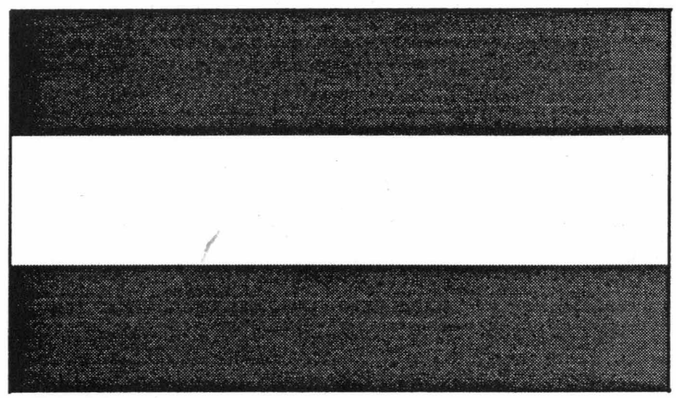
  Industry: 27.6 %

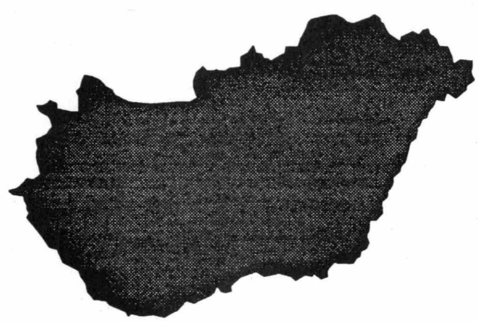
  Trade,Tourism: 14.9 %

  Agriculture: 10.2 %

  Other Services: 29.7 %

  Other: 11.8 %





Chapter Four: Hungary's Gradual Transition

The economic situation in Hungary in 1989 differed from that of other socialist nations. Hungary had embarked on its venture to build a market economy not with the fall of the Berlin Wall in 1989, but in the late 1960s. The Hungarian government had been liberalizing prices gradually since 1968 and a private sector had existed for a long time, accounting for eight per cent of national output in 1988. Until 1989, however, Budapest merely aimed its policies at reforming certain features of its socialist economy, while retaining public ownership as the key element of Hungary's economic structure. Under Prime Minister Nemeth, the government in Budapest first worked out concrete plans in the fall of 1989 for a complete transformation to a market economy These plans regarded private property and foreign investment as the primary driving forces of economic development. While Hungary was indeed remarkably successful in attracting foreign investment between 1989 and 1994, its privatization efforts suffered from numerous problems. The following is an overview on how Hungary approached reforms in the arenas of transition after the late eighties.[1]

TABLE IV.1: Economic Transition in Hungary

Year	Institutional Reforms	Macroeconomic Stabilization	Price Liberalization	Liberalization of Int'l Trade and Capital Flows	Privatization	Financial Reforms
1986			Prices liberalized since 1968	State loosens monopoly		
1987						Two-track bank system
1988	New Value-Added Tax introduced	Restrictive fiscal and monetary policies begin			Company Act	
1989	Reform of enterprise laws and tax system	New tax system	90% of prices liberalized	Begin cut in import quotas		
1990	Creation of State Privatization Agency	Begin lowering producer and consumer subsidies		Liberalization of capital flows	Creation of SPA; begin 1st Privatization Program	Establish-ment of stock market
1991	Establishment of Antitrust Agency and competition laws	Looser monetary policy; begin currency devaluations		Complete liberalization of trade	Failure of 1st PP; creation of privatization firms; begin small privatization	
1992	Banking laws; bankruptcy and liquidation laws; accounting reforms	Monetary policy tightened again		10% of imports still restric-ted; avg. tariff is 17% EU Association Agreement	Creation of SAA	New bank laws
1993		Increase in VAT and income tax, new exchange rate system				Bank Consolidation Act

Institutional Reforms

At the onset of transformation, Budapest placed little emphasis on the rapid development of a new institutional structure in which the market could function efficiently. Early institutional reforms included the separation of the central bank from the commercial banks in 1987, the introduction of a value-added tax in January 1988, a reform of the complete tax structure in January 1989, and the introduction of enterprise laws in the same year.[2]

Hungary underwent the bulk of institutional reforms in 1991 and 1992, however. The government effected its new competition laws and created its antitrust agency in January 1991. By that time Hungary had been privatizing a considerable amount of its SOEs for three years without an antitrust agency to oversee competition in the quickly growing market economy. What had even worse consequences, however, is that Hungary's privatization agency did not begin operating until 1990. Budapest created this bureau only after the population had voiced considerable dissatisfaction about the uncontrolled privatization process -- often dominated by manipulation and corruption.[3]

In January 1992, the Hungarian government put three different laws into effect: New banking laws, which further defined the responsibilities of the central bank; bankruptcy and liquidation laws; and accounting laws based on Western accounting standards. The bankruptcy laws directed all insolvent firms to declare bankruptcy beginning April 1, 1992. By December 1993, 5130 Hungarian enterprises had declared bankruptcy.[4]

Use of the new accounting conventions exposed formerly hidden financial losses and significant weaknesses in most Hungarian firms. They not only provided proper valuation standards for the assessment of enterprise assets and liabilities, but also required that debts owed by one non-bank firm to another (i.e. inter-enterprise debts) be moved to the state-owned commercial banks. The debts then appeared on the banks' balance sheets as non-performing loans.

Until 1994, Budapest displayed no interest in reforming the social benefits system that had been in place during socialism. Karoly Okolicsanyi, an expert on Hungary writing for the Research Institute of Radio Free Europe/Radio Liberty, claims that medical benefits, funding for education, and regulations concerning maternity leave and the retirement age remain too generous in Hungary. Political leaders indicate that a restriction on outlays for the social safety net would enhance public discontent to a politically destabilizing level.[5]

Macroeconomic Stabilization

Fiscal Policy

Hungary's fiscal policy remained less restrictive than was desirable from 1989 to 1994. Budapest reformed its tax system in 1989 in order to secure government revenues during the financially tight period immediately following the onset of transition. Between 1990 and 1993, Hungary also managed to lower production and consumer subsidies from eleven to five percent of total goods and services. High expenses for the nation's social safety net, however, combined with a decline in tax revenues and inefficient tax collection mechanisms, contributed to severe budget deficits until 1994. Tax revenues decreased because of the implementation of the bankruptcy laws, the dismantling of the CMEA trade arrangements, the decline of competitiveness of large SOEs, and a drop in consumer demand. The government deficit increased from 4.9 per cent of GDP in 1991 to seven per cent in 1993 (Table IV.2).[6]

As a result of the rising deficit, Budapest decided to raise value-added taxes in August 1993 and five months later increased personal income taxes for the highest tax bracket. Unemployment finally began to decline throughout 1993, from 14 per cent to twelve per cent, and industrial production grew for the first time in three years, with a growth rate of four per cent. The changes in Hungary's tax structure did not, however, significantly curb the growth of the budget deficit. According to Okolicsanyi, the projected deficit for 1994 was nine per cent of GDP, mostly a result of high government expenditures.[7]

Monetary and Foreign Exchange Policies

With a few exceptions, monetary authorities in Hungary geared their policies towards the confinement of inflation since the separation of the central bank from the commercial banks in 1987. Inflation in 1990 stood at an annual rate of 29 per cent. The Hungarian Central Bank decided to loosen its monetary policy at the end of the year, thereby contributing to a 35 per cent rise in the CPI in 1991. The following year saw a tightening of monetary policy and the central bank managed to reduce inflation to 23 per cent. The increase in the value-added tax and reduction in subsidies early 1993 contributed to a surge in prices in the first half of 1993, but the rate of inflation was soon under control and declined between 1993 and 1994 (Table IV.2).[8]

Foreign exchange policy in Hungary succeeded in fixing the forint to several stable currencies. Until September 1993, the forint was tied to the ECU, but after the insecurity in European currency markets in 1993, Budapest decided to peg its currency to a market basket consisting of the U.S. dollar and the German mark (each weighted by 50 per cent). Although Hungary experienced more moderate price increases than Poland in the early nineties, inflation was still high enough to force Budapest to devalue the forint numerous times between 1991 and 1993 (five times in 1993 by a total of 15 per cent). These devaluations, however, were not drastic enough to match the inflation rate, therefore increasing Hungary's trade deficit. Exports declined by three per cent in 1993, while imports picked up by 32 per cent (Table IV.4).[9]

Table IV.2: Selected Macroeconomic Indicators

Year	1980	1983	1985	1987	1988	1989	1990	1991	1992	1993	1994
Π a)	9.1	7.3	7.0	8.2	16.3	16.9	29.0	34.2	22.9	22.5	19.6 b)
GDP c)	22.2	21.0	20.6	26.1	26.8	29.3	32.9	30.9	35.5	38.1	n.a.
E d)	131.1	123.2	121.4	117.6	114.3	109.7	100.0	93.1 e)	89.2 e)	88.5e)	n.a.
O f)	98.5	104.6	107.8	112.5	111.7	109.3	100.0	80.8	75.1	n.a.	n.a.
G-T g)	n.a.	(0.7)	(1.0)	(3.3)	(0.2)	(1.9)	0.8	(4.9)	(6.0)	(7.0)	(9.0)e)
C h)	61.2	61.5	62.8	63.5	60.5	60.2	61.7	69.5	69.2	72.3	n.a.

Sources: IMF International Financial Statistics, European Marketing Data and Statistics, BfAI
a) Average annual inflation in per cent, b) Average % change in CPI III/93-II/94, c) Gross Domestic Product in billions of current U.S. $, d) Industrial Employment Index (period averages), e) estimate, f) Industrial Production Index (period averages), g) Government Surplus (Deficit) in per cent of GDP, h) Private Consumption in per cent of GDP.

Table IV.3: Exchange and Interest Rates

Year	1980	1983	1985	1987	1988	1989	1990	1991	1992	1993	1994
X-R a)	32.5	42.7	50.1	47.0	52.5	59.1	63.2	74.7	79.0	91.93	109 b)
i c)	n.a.	n.a.	10.5	10.0	10.5	14.0	20.0	26.0	20.0	22.2	25.0 d)

Source: IMF International Financial Statistics
a) Forint per U.S. $ (period averages), b) October 1994, c) Discount rate (end of period), d) June 1994.

Liberalization of Domestic Prices, International Trade and International Capital Flows

Hungary began reshaping its price structure earlier than any other country in the former Eastern Bloc. Beginning in 1968, Budapest gradually liberalized prices for food products, fuels and services, as well as manufactured goods. In 1985, when the pace of price liberalization increased, market forces determined 40 per cent of prices. By 1989, 90 per cent of prices had been liberalized. Milk, bread, energy and most public services such as public transportation remained subject to price regulation. By freeing prices at a gradual pace, the Hungarian government avoided price shocks like those experienced in former Czechoslovakia and Poland.

In the trade sector the state loosened its monopoly as early as 1986 and by January 1991 trade was completely liberalized for all entrepreneurs. Budapest phased out quotas from 65 per cent of imports in 1989 to 10 per cent in 1992. The average tariff in 1992 was 17 per cent plus fees, compared to 18 per cent in Poland.[10]

Hungary's focus in international trade shifted from its former Central and Eastern European allies to Western Europe and the United States after its transformation to a democracy in 1988. In 1990, Hungarian trade with the members of the Council for Mutual Economic Assistance (CMEA) still accounted for 34 per cent of imports and 32 per cent of exports. With the 1991 dismantling of the CMEA, however, trade with Hungary's former allies dropped by more than 50 per cent. In 1992, the trade portion of the Association Agreement with the European Communities (now European Union) took effect and the EU reduced trade barriers for imports from Hungary. Hungary's trade position nevertheless declined after 1990, caused partly by high domestic inflation. The trade deficit reached a record high of $4 billion in 1993, up from $11 million in 1992 (Table IV.4).[11]

The other end of the balance of payments seesaw, capital flows, expanded between 1991 and 1993. Hungary liberalized international capital flows in 1990 and, over the following three years, attracted almost 50 per cent of foreign capital flowing into the former socialist nations in Central and Eastern Europe. In 1991 foreign direct investment in Hungary reached levels three times higher than FDI in Czechoslovakia and ten times higher than in Poland. According to Okolicsanyi, "the reasons for this astonishing success include tax incentives for foreign investors; the opportunity to repatriate capital in hard currency; relatively cheap labor; and, above all, the country's political stability."[12] A

December 1994 study of the German Dresdner Bank, however, revealed that Hungary had become the most expensive nation in Central and Eastern Europe. According to the study, wages in Hungary were 30 per cent above Polish and 50 per cent above Czech levels. These high wage rates, combined with an unattractively high and growing foreign debt, contributed to a 1994 slowdown in capital inflows. [13]

Table IV.4: Foreign Trade and Investment (Minus Sign Indicates Debit)

Year	1980	1983	1985	1987	1988	1989	1990	1991	1992	1993	1994
Trade a)	n.a.	434	448	80	583	1,043	534	358	-11	-4,021	-1,036 b)
Trade c)	n.a.	773	128	37	489	541	338	187	-55	-3,249	n.a.
D.I. d)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,462	1,479	2,339	504e)

Source: IMF International Financial Statistics
a) Trade Balance for transactions in all currencies (Millions of U.S. $), b) end of second quarter,
c) Trade Balance for transactions in convertible currencies (Millions of U.S. $), d) Direct Investment (Millions of U.S. $),
e) I+II/94.

Privatization

Privatization in Hungary underwent a variety of different approaches. In 1988, the government passed the Company Act, liberalizing private business activity and permitting the establishment of Western company forms. This act resulted in partial self-privatization, with enterprises transferring their productive assets to new joint-ventures while abandoning unproductive assets. Increasing public dissatisfaction with this manipulated distribution of assets led to a centralization of privatization activities in 1990. The government created the State Property Agency (SPA) and delegated to it the responsibility of overseeing the privatization of 1600 large and medium-sized and over 10,000 small enterprises.[14]

The SPA's First Privatization Program included 20 large companies, mostly in the energy, aluminum, and mechanical engineering sectors. The goal -- to have these firms privatized by the end of 1991 -- was not accomplished. Reasons for the failure of the SPA to sell the companies include severe understaffing of the agency -- by the end of 1993 the SPA employed only 370 persons -- as well as lack of expertise among SPA's employees, a tight budget, and lack of information about the enterprises the agency was managing and selling. In addition, since no reliable methods for valuation of SOEs existed before the implementation of the 1992 accounting standards, sales prices of firms were often exaggerated.[15]

In 1991, the SPA introduced a more successful small privatization program, designed to privatize the 10,000 smaller units. By 1994, only 1,000 remained in the hands of the SPA. 1991 also experienced a shift towards supervised self-privatization and management buy-outs. Small enterprises increasingly took responsibility for their own privatization but were required to consult one of 84 SPA-certified privatization firms in their privatization efforts.[16]

Budapest created the State Asset Management Corporation or State Asset-Handling Agency (SAA) in July 1992. The SAA received the mandate to "manage, operate and partially privatize the 160 largest enterprises in Hungary (producing 35-45 per cent of GDP, assets estimated at $12.9 billion)."[17] These enterprises included state-owned commercial banks and state energy monopolies. When the SAA took responsibility for the firms, 20 per cent were experiencing severe financial difficulties. Consequently, in 1992 the SAA suffered losses of 38.6 billion forint, four per cent of its total assets or roughly ten per cent of GDP.

According to estimates by the National Bank of Hungary, the private sector in 1993 accounted for 45-50 per cent of GDP (other sources, such as the German Agency for International

Trade Information, speak of 35 per cent) The number of private enterprises increased from 10,000 in 1990 to about 200,000 in 1993.[18]

Financial Reforms

Hungary began decentralizing its financial sector with the creation of a two-track banking system in 1987. Three years later Budapest established a stock market, which soon experienced a rapid increase in trading volume. Trading in 1993 was valued at 185 billion forint, or five times the 1992 level, and was expected to grow substantially throughout 1994.

Privatization and recapitalization of state-owned financial institutions proceeded at a slow pace. A World Bank study on Hungary's financial system conducted in the summer of 1993 revealed that most state-owned banks were technically insolvent. The culprits were -- as in the Czech Republic and Poland -- the large amounts of unrecoverable debts inherited from the socialist era. The dismal situation of Hungary's financial institutions prompted the passage of the Bank Consolidation Act in December 1993. This act included the direct rescue of twelve large state-owned firms involving debt forgiveness, debt-equity swaps, etc. Banks received treasury "discount bonds" from the government in exchange for their bad loans. The Bank Consolidation Act did not help motivate the banks change their credit policies, however. Numerous banks continued to lend to traditional debtors who were unwilling or unable to pay back their loans. Because of this lending policy, small private enterprises struggle to obtain the credit needed for investment. Although in 1994 Hungary boasted 44 commercial banks, most of them still remained in state hands.[19]

As in Poland and the Czech Republic, financial reform in Hungary did not progress beyond its initial stages. State banks still control a majority of the banking sector and bad debts continue to blemish their balance sheets. Hungary need not privatize all of its state banks, but should at least force banks to improve their lending policies.

The following chapter will provide a summary of the progress made in Hungary, the Czech Republic, and Poland until 1994 and will delineate how certain policies might have aggravated transition problems.

NOTES

1. The preceding paragraph drew upon the following:
   Falk, Funke 191.
   Tamás Bauer, Building Capitalism in Hungary, The Transformation of Socialist Economies, ed. Horst Siebert (Tübingen, Germany: J.C.B. Mohr, 1991) 288.
   Heidemarie Englert, Umbruch in Ungarn (Potsdam, Germany: Staatskanzlei Brandenburg, Landeszentrale für politische Bildung, 1993) 42.

2. Falk, Funke 191.

3. Falk, Funke 191.
   Kemal Derviş, Timothy Condon, "Hungary--Partial Successes and Remaining Challenges: The Emergence of a "Gradualist" Success Story?" The Transition in Eastern Europe, vol. 1, ed. Oliver Blanchard, Kenneth Froot, Jeffrey Sachs (Chicago, IL: The University of Chicago Press, 1994) 138-139.

4. Joachim Probst, Ungarn am Jahreswechsel 1993/94 (Köln, Germany: Bundesstelle für Außenhandelsinformationen, 1994) 94.

5. The previous two paragraphs drew upon:
   Karoly Okolicsanyi, "Macroeconomic Changes in Hungary 1990-1994," RFE/RL Research Report, vol. 3, no. 24: 23-25.

6. Okolicsanyi, "Macroeconomic Changes," 23-25.
   Deutscher Industrie- und Handelstag, Aktuelle Wirtschaftstrends aus Ungarn (Bonn, Germany, 1992) 12.

7. Okolicsanyi, "Macroeconomic Changes" 23-25.
   Karoly Okolicsanyi,"New Hungarian Government's Economic Plan," RFE/RL Research Report, vol. 3, no. 30: 31.

8. Information in the previous paragraph drew upon:
   Probst 4.
   Bundesstelle für Außenhandelsinformationen (BfAI), Republik Ungarn (Köln, Germany, April 1994) 2.
   "Ungarn," Presseschau Ostwirtschaft 1994: 23-27.

9. Probst 5 and BfAI 2.

10. The previous two paragraphs drew upon:
    Bauer 289.
    Falk, Funke 190-198.

11. Okolicsanyi,"Macroeconomic Changes" 21.
BfAI 2.

12. Okolicsanyi, "Macroeconomic Changes" 21.

13. Okolicsanyi, "Macroeconomic Changes" 24.
Falk, Funke 199.
"Ungarn teuerster Investitionsstandort," Handelsblatt 12/27/94.

14. Derviş, Condon 138-139.

15. The previous paragraph drew upon:
Englert 46-47.
Derviş and Condon 138-139.
Karoly Okolicsanyi,"The Hungarian State Sector's Dismal Performance", RFE/RL Research Report, vol. 3, no.15: 23.

16. The previous paragraph drew upon:
Okolicsanyi, "State Sector" 22.
Deutscher Industrie- und Handelstag, Informationen zur Privatisierung (Bonn, Germany, 1992) 4-5.

17. Quote and current paragraph based on: Okolicsanyi, "State Sector" 23-24.

18. Okolicsanyi, "Macroeconomic Changes" 22.

19. Information in the *Financial Reforms* section taken from:
Okolicsanyi, "Macroeconomic Changes" 24.
Okolicsanyi, "State Sector" 24-25.

Chapter Five: Summary and Conclusion

As the preceding chapters illustrated, the road to the free market contained more obstacles than most people had anticipated before transition. The governments and public of Central Europe had vastly underestimated in 1989 the challenges of transforming their multi-billion dollar economies. And after enduring painful reductions in industrial output and GDP, massive declines in their currencies' purchasing power, and levels of unemployment not seen since the Great Depression, the citizens' optimism turned into disappointment, anger, and frustration.

Concluding this study on transformation, I now present a summary of the economic progress achieved in Central Europe until 1994. In evaluating the success of transition, I will compare 1989 and 1994 with regard to macroeconomic conditions, the degrees of liberalization and privatization, and the institutional frameworks of the economies.

MACROECONOMIC CONDITIONS

With the exception of Poland, Central Europe suffered from greater macroeconomic imbalances in 1994 than before the onset of reforms. Since the early nineties, however, all three countries surveyed have made considerable progress in overcoming the economic shocks that accompanied price and trade liberalization. Poland, entering transition with a severely unstable economy, managed to curtail inflation significantly between 1990 and 1994. While Polish inflation topped 555 per cent in the first year of transformation, it amounted to only 33 per cent between October 1993 and September 1994.

Czech inflation dropped from 58 per cent at the onset of transition in 1991 to a mere ten per cent in 1994. The initial macroeconomic conditions in Czechoslovakia definitely aided transition. Yet Prague's commitment to restrictive fiscal and monetary policies also created a favorable environment for a stable price level. By drastically removing subsidies, for instance, Prague managed to avoid the fiscal trap and high budget deficits experienced in Poland and Hungary. In 1993, Prague's government receipts outweighed expenditures by 2.6 per cent of GDP, a significant improvement over the 3.8 and 0.6 per cent deficits of 1989 and 1990.

Hungary remains the only country in Central Europe that failed to reduce its inflation rate significantly since the beginning of transition in the late eighties. Consistently high inflation might not only be a result of Budapest's more gradual approach to economic reform, but also of its unfortunate budget position. Hungary experienced budget deficits throughout most of its transformation, and the gap between government outlays and receipts rose significantly from 1990 onward, reaching an estimated nine per cent of GDP in 1994.

Table V.1: Average Annual Inflation (Please Refer to Graph A.1 in the Appendix)

Year	1989	1990	1991	1992	1993	1994 a)
Poland	251.1	555.4	76.7	45.3	36.9	33.4
Czech Republic	1.4	10.0	57.7	10.8	20.4	9.6
Hungary	16.9	29.0	34.2	22.9	22.5	19.6

Sources: IMF International Financial Statistics, European Marketing Data and Statistics
a) IV/93-III/94.

Table V.2: Government Surplus (Deficit) in per cent of GDP

Year	1989	1990	1991	1992	1993	1994
Poland	n.a.	2.7	(1.9)	(4.9)	(2.3)	(3.8)
Czech Republic	(3.8)	(0.6)	(2.8)	n.a.	2.6	n.a.
Hungary	(1.9)	0.8	(4.9)	(6.0)	(7.0)	(9.0) e)

Sources: IMF International Financial Statistics, Bank Austria
e) estimate.

In addition to varying degrees of high inflation, all three countries experienced severe declines in national output and employment. The industry sector in the Czech Republic suffered especially from the transition to a market economy. Industrial output declined sharply between 1989 and 1993, with 1993 figures reaching only 60 per cent of pre-transition levels in the Czech Republic (Graph A.3 in the appendix).

In contrast, Poland's output recuperated quickly after 1990. Between 1991 and 1994, real GDP grew from $77 billion to an estimated $90 billion, owed in part to an increase in industrial output after 1991. Yet unemployment in Poland grew substantially between 1990 and 1994. In January 1994, 16 per cent of the Polish labor force was out of work. Total unemployment in the Czech Republic, despite high figures for industrial unemployment, remained lower than in the rest of Central Europe: By the end of 1994, only about eight per cent of the Czech labor force were out of work and both domestic and international observers expected the level to decline further.

Hungary's employment levels are comparable to the Czech Republic's: after a rise in the unemployment rate in the early nineties, levels have declined since mid-1993 and amounted to only eleven per cent in 1994. Hungary's gross domestic product began its expansion even earlier. Between 1991 and 1993, it grew from $31 billion to $38 billion. The increasing trade deficit between

1992 and 1994, however, prevented faster GDP growth. Hungary's trade position has declined since 1989, when the country enjoyed a convertible currency trade surplus of $541 million. In 1993, Budapest announced a trade deficit of $4 billion, partly attributable to expanding budget deficits since 1990.

Poland's trade position looked equally grim in 1993. The trade balance for transactions in convertible currencies fell from a $1.4 billion surplus to a $3.3 billion deficit between 1990 and 1993. Former Polish finance minister Leszek Balcerowicz admitted that government authorities did not expect the disintegration of the CMEA to have such a significant impact on Polish trade.[1] The Czech Republic solely managed to keep trade deficits to a minimum. After the separation from the Slovak Republic in 1993, Prague's trade deficit waned and was replaced by a $13 million surplus after the first four months of 1994. Yet covert import barriers protecting several import-sensitive industries contributed to this success in foreign trade. When Prague finally dismantles these barriers, it ought to expect an increase in imports and a deterioration of the trade balance.[2]

Table V.3: Real Gross Domestic Product in millions of U.S.$ (Graph A.2 in Appendix)

Year	1989	1990	1991	1992	1993	1994
Poland	82.2	62.3	77.9	83.6	86.9 e)	90.4 e)
Czechosl. Czech R.	50.4	45.2	33.2	30.8 24.7	25.2 e)	12.7 a)
Hungary	29.3	32.9	30.9	35.5	38.1	n.a.

Sources: IMF International Financial Statistics, European Marketing Data and Statistics, BfAI
a) First half 1994, e) estimate.

Table V.4: Trade Balance (Convertible Currencies) in millions of U.S.$

Year	1989	1990	1991	1992	1993	1994
Poland	-114	1,410	-786	-85	-3,316	-268 a)
Czech Republic	417	-650	-482	-1,834	-213 b)	14 c)
Hungary	541	338	187	-55	-3,249	n.a.

Sources: IMF International Financial Statistics, OECD
a) End of first quarter, b) 1993 data for CR only until end of August, c) End of April 1994.

In sum, while the Central European countries enjoyed improvements in their macroeconomic conditions, they have not fully recovered yet from transition. High inflation and unemployment especially continue to plague Poland, and Hungary's high budget deficits represent substantial obstacles to private investment, and thus economic growth. Industry in the Czech Republic still has to recover from its massive decline in output, and both Hungary and Poland should seek to improve their trade balances.

Initial macroeconomic conditions and economic structures contributed significantly to the successes of macroeconomic policies. Prague's macroeconomic balance in 1989, for instance, certainly alleviated its transformation. The Czech Republic's trade position furthermore profited from the country's relatively large industrial base for exports. Roughly half of Poland's exports, by contrast, consisted of agricultural or only partly processed products.[3] Yet Warsaw's and Budapest's foreign exchange policies also contributed to their relatively worse trade balances: in attempting to maintain their currencies at fixed exchange rates in the face of high inflation, Poland and Hungary reduced the competitive position of many domestic companies, thus curtailing exports.

and Hungary as insolvent.[5]

Despite the slow pace of large privatization, the private sector expanded considerably in all three countries, owing mostly to the large successes in small privatization and the establishment of new firms. According to The Wall Street Journal, the Polish private sector controlled roughly two thirds of the economy in early 1995, with two million entrepreneurs having formed businesses since the onset of reforms.[6] By comparison, in 1988, Poland's state sector had still accounted for more than 80 per cent of national output. In the Czech Republic and Hungary, private sector growth reached similar proportions. While in 1988, private enterprises controlled only eight and one per cent of GDP in Hungary and the Czech Republic, the private sector accounted for roughly 50 and 40 per cent six years later.

INSTITUTIONAL FRAMEWORK

In 1994, the countries of Central Europe possessed all institutions necessary for the proper functioning of the market. They had established new legal systems, including bankruptcy and antitrust laws, their constitutions guaranteed private property rights, and they had adopted modern accounting standards. In addition, Poland, Hungary, and the Czech Republic had created two-tiered banking systems, reformed their tax structures, and implemented privatization laws.

The pace of reforms in the institutional arena differed substantially across Central Europe. Poland effected its changes fastest, with only the restructuring of the tax system remaining after mid-1991. Thus, the vast majority of institutional reforms occurred within eighteen months of the onset of Polish transition. Prague enacted its bankruptcy and tax laws relatively late, stretching its reform period to about two and a half years. Hungary, finally, delayed its accounting and bankruptcy reforms until 1992, more than three years after the official onset of transition, and has yet to restructure its social benefits system.

CONCLUSION

After summarizing the economic progress in Poland, Hungary, and the Czech Republic between 1989 and 1994, I will conclude the thesis by returning to the two points emphasized in the introduction: First, in several instances the governments in Central Europe failed to intervene in the economy when doing so might have alleviated transformation. Second, the relatively fragile political environment in Central Europe often prompted the governments to replace policies that would have been economically beneficial in the long run with policies that received more popular support.

Although excessive state intervention is undesirable in a market system, during economic transformations such as in Central Europe, the government should exercise close supervision over certain sectors of the economy. At the root of the unsuccessful financial reforms in Poland, Hungary, and the Czech Republic, lay the governments' failure to exert pressure on state-owned banks to change their lending policies and on defaulting enterprises to implement cost-cutting programs and establish efficient bankruptcy procedures.

Many non-performing loans on bank balance sheets were legacies from socialist times. Sizeable amounts of bad debts, however, accumulated between 1989 and 1994, as state-owned banks continued to lend to their traditional, often insolvent debtors: large state-owned enterprises. Dealing with private clients required more work, as it was difficult for banks to establish the creditworthiness or the value of the collateral of new firms who never had had a bank account. It was therefore easier to discriminate against the private sector and instead continue lending to SOEs. Since many state firms defaulted on their loans, however, bad debts on bank balance sheets accumulated. Furthermore, because many debtors lacked effective bankruptcy procedures, banks did not possess the legal mechanism to gain access to their debtors' assets and force them to change their inefficient and wasteful policies. [7]

One can argue that the governments of Central Europe could have reduced such massive accumulations of bad debts by penalizing financial institutions who continued to lend to recalcitrant debtors, and by enacting legislation that would enable banks to seize assets of defaulting debtors. Such reforms might have accelerated the privatization of state-owned banks, and prevented financial institutions from expanding the supply of credit further than desirable, thus making money and credit policies more effective. [1*]

Furthermore, although the ultimately victorious Hungarian Democratic Forum condemned uncontrolled spontaneous privatization in its election campaign of 1987/88, the Hungarian government undertook no efforts between 1988 and 1990 to stop or at least supervise self privatization. The administration's passive stance toward ownership transformation enabled those people in control of SOEs, most of them close to the old socialist power structure, to manipulate the distribution of assets. Yet problems continued to mount even after Budapest had created the SPA: Hungary dismantled its centrally planned reporting system on SOEs, and the State Property Agency thus lacked information on the enterprises it was temporarily managing before selling them off. Since Budapest did not come up with an adequate replacement for the reporting system, the SPA was unable to follow the rapid financial and market changes affecting the firms under its management.

[1*] In 1993, Poland became the first country finally to combine selective bank recapitalization with bankruptcy reform and incentives for banks to toughen their policies toward defaulting debtors (Slay).

According to the State Audit Agency, the SPA's financial losses in 1992 equalled $71 million per month.[8]

Privatization agencies need not be operated by the government. In fact, Poland's example illustrated the downside of a state-run agency: as political leadership in Warsaw changed, so did privatization policy. Hungary's SPA and Germany's Treuhand, on the other hand, were "quasi-nongovernmental agencies."[9] But while they remained relatively independent in conducting privatization within their legal frameworks, the SPA and the Treuhand were ultimately accountable to their parliaments. By clearly defining the goals and supervising the actions of quasi-independent privatization agencies, economies in transition could avoid the difficulties encountered in Hungary and Poland.

The second point emphasized in the introduction regarded the Central European governments' tendency to replace economically beneficial policies with those receiving more popular support. As in all democratic countries, the desire to win the next election drives many politicians' actions in Prague, Warsaw, and Budapest. In the election campaigns of the late eighties, candidates for the nations' leadership positions attempted to convince the public that their policies would ensure a minimally painful transformation. When it later became obvious that economic transition would not be as smooth as envisioned, the governments often delayed certain reforms that would have curtailed the nations' welfare even further in the short run. However, a delay in enacting these reforms possibly postponed the economic recovery and thus the achievement of a higher state of social welfare in the long run.

Prague and Budapest, for instance, set their bankruptcy laws into effect relatively late, fearing that an early wave of bankruptcies would undermine public support for the government. On the other hand, absence of or inadequate bankruptcy codes at the onset of reforms enabled large SOEs to continue soaking up credit readily provided by state banks.

Budapest politicians also anticipated that public dissatisfaction would follow fiscal cutbacks in Hungary's social benefits system and therefore made no efforts to reform the system. By limiting benefits payments and perhaps replacing them with less costly worker retraining programs, Budapest could have avoided the high budget deficits after 1990.

Fear of losing public support might also explain Warsaw's failure to shift its tax system's emphasis from state-owned enterprises to private firms and personal incomes in 1990. Reforming its tax structure at the onset of transition in the eighties, Hungary avoided the collapse of public revenues experienced by the Poles when increasing numbers of Polish state firms became insolvent. By diversifying its tax system and not merely relying on SOE turnover taxes for state funds, "fluctuations in revenue from one particular source became less damaging to the state budget and the fiscal system as a whole."[10]

Political motivations also guided Warsaw's and Budapest's inexpedient decisions to loosen monetary and fiscal policies whenever economic indicators pointed to signs of recovery. Instead of maintaining a restrictive stance on money and credit in 1990, Poland's central bank loosened its monetary policy during the second half of the year. In addition, Warsaw granted large tax breaks to private firms after the balanced budget illusion of mid-1990. By failing to maintain sufficiently restrictive aggregate demand policies, Poland, and to an extent Hungary, prolonged periods of high inflation and thus aggravated their macroeconomic conditions.

It is likely that the complexities of the legislative process contributed to delays in the implementation of certain policies or reforms. In September 1993, the Polish citizens elected seven parties into their parliament. The parliament in Budapest also embraced seven parties in the early nineties, and in Czechoslovakia the number of parties amounted to ten.[11] It is easily imaginable that, with such numbers, legislative decisions often took a long time to bear fruit. Consequently, many reforms that should have been enacted earlier in the transition, did not make their way through parliament until years later. It is also probable, however, that the governments intentionally postponed changes they thought to have politically destabilizing effects. Losing the support of the people at the onset of transition could have threatened the survival of the administration, and therefore exacerbated the political and economic difficulties prevalent during transformation.

The previous assertion returns us to our first observation about the changes in Central Europe: Popular expectations, influenced to a large extent by government officials, were too optimistic in 1989. It remains difficult to ascertain to what extent the leaders of Central Europe had anticipated the upcoming trials of transition. Had the governments known the true extent of the challenges awaiting them, they could have warned their countries that only with the combined effort and determination of all citizens could the transition be mastered quickly. It is uncertain whether the Central Europeans would have actually understood the warnings, given the low levels of public knowledge about economics. However, with a more determined and prepared electorate backing them, Central Europe's leaders might not have hesitated to enact above reforms detrimental to national welfare in the short run. Knowing that these reforms could shorten the economic transition, the people of Poland, Hungary, and the Czech Republic, might have been more supportive of them.

One should keep in mind that this thesis merely provided an assessment of the relative successes and disappointments of transition in Central Europe. It can by no means serve as a strict guideline for other socialist nations in the world who might someday make the transition to a free market. In effecting the reforms of economic transition, each country should give due consideration to its unique cultural, political, economic, and sociological backgrounds. Although certain government policies can provide for an easier and more agreeable transformation, an "optimal" road to the free market probably does not exist.

NOTES

1. Balcerowicz.

2. Shen 239.

3. Misala 9-10.

4. Slay, Postcommunist Economic Transition 38-40.

5. Karoly Okolicsanyi, "Visegrad Banking Systems Stunt Economic Growth," RFE/RL Research Report, vol. 2, no. 42, 34.

6. Dana Milbank, "Polish Entrepreneurs Revitalize Economy But Battle Huge Odds," The Wall Street Journal, March 30, 1995.

7. The previous paragraph drew upon:
   Okolicsanyi, "Visegrad" 34-37.
   Slay, "The Postcommunist Economic Transition: Barriers and Progress," 40-41.

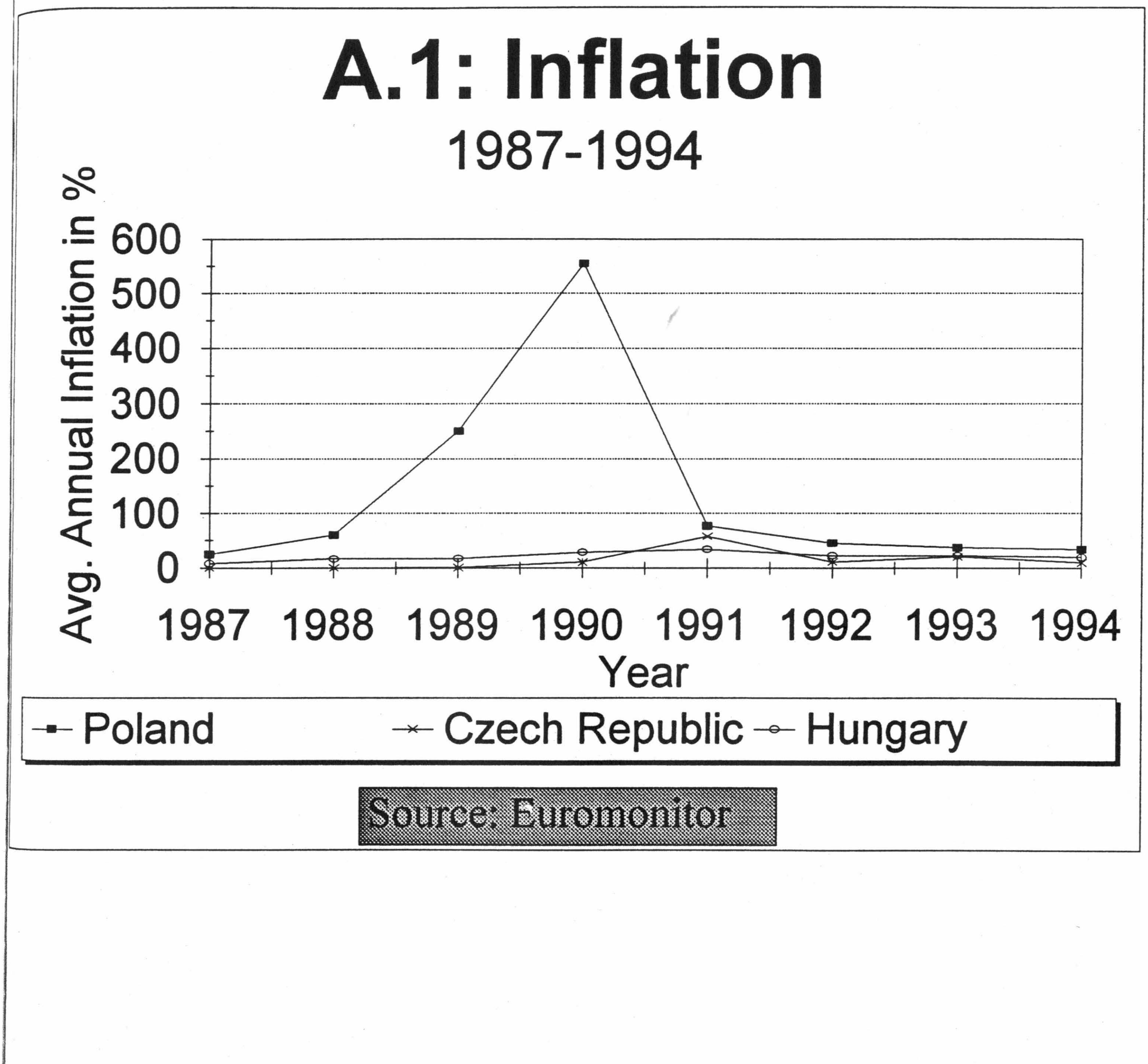
8. Okolicsanyi, "The Hungarian State Sector's Dismal Performance" 23.

9. Wolfgang Feese, lecture, "The History of the Treuhand," Berlin, 27 July 1994.

10. Winiecki 821.

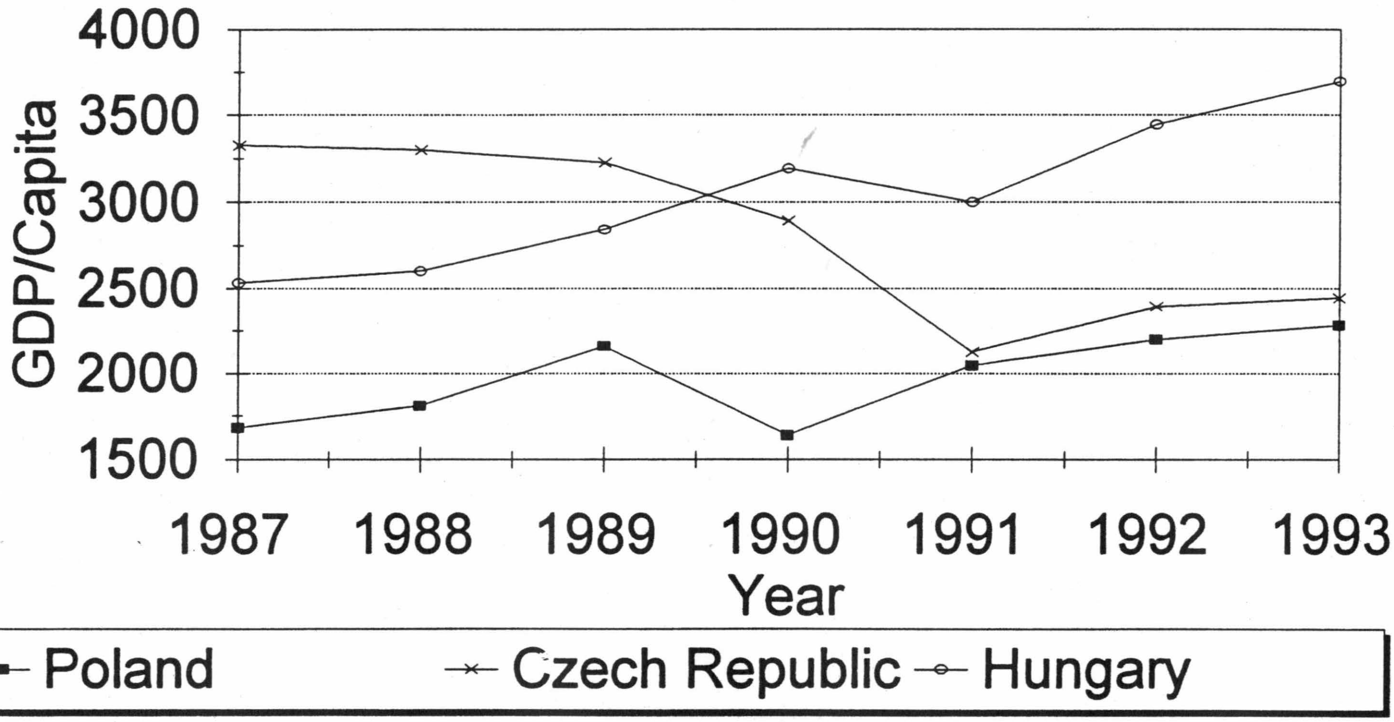
11. "Osteuropa" 3-14.

Appendix


A.1: Inflation
1987-1994
Avg. Annual Inflation in %
600
500
400
300
200
100
0
1987
1988
1989
1990
1991
1992
1993
1994
Year
Poland
Czech Republic
Hungary
Source: Euromonitor

A.2: GDP Per Capita

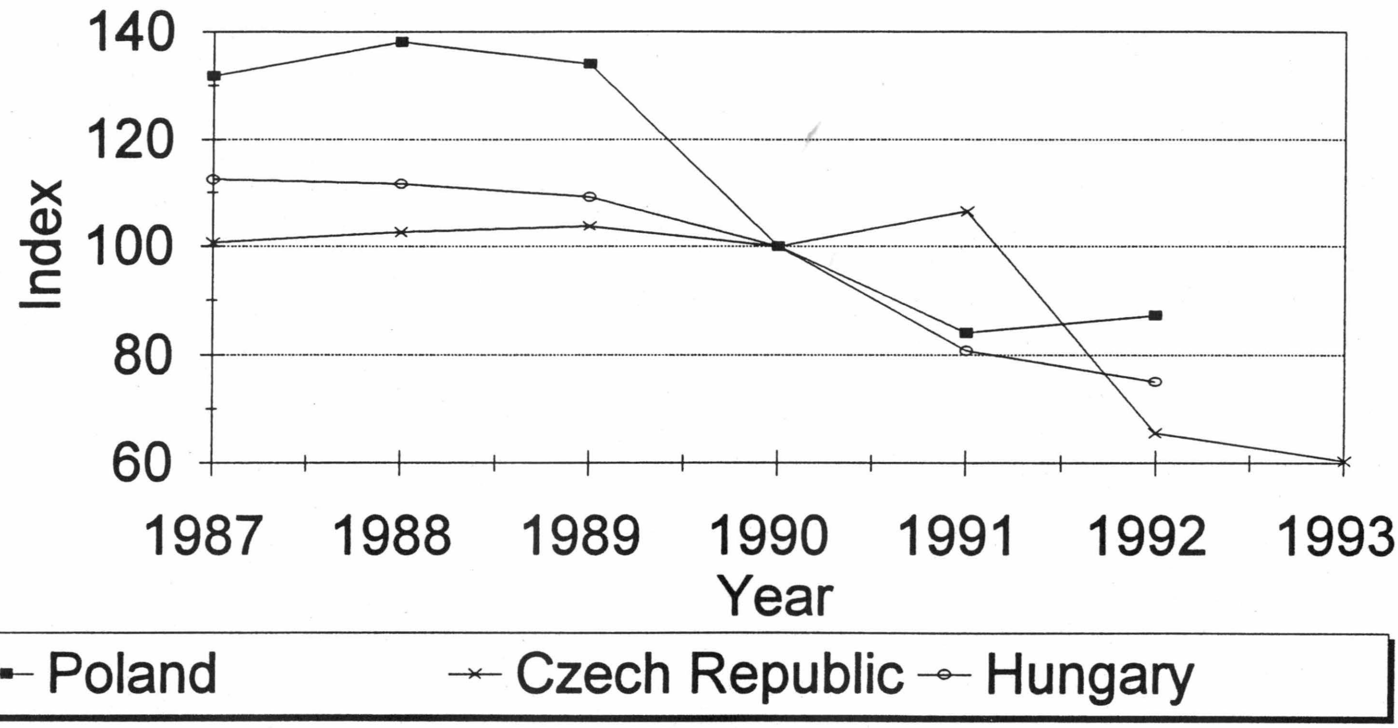
1987-1993



Source: IMF

A.3: Industrial Output

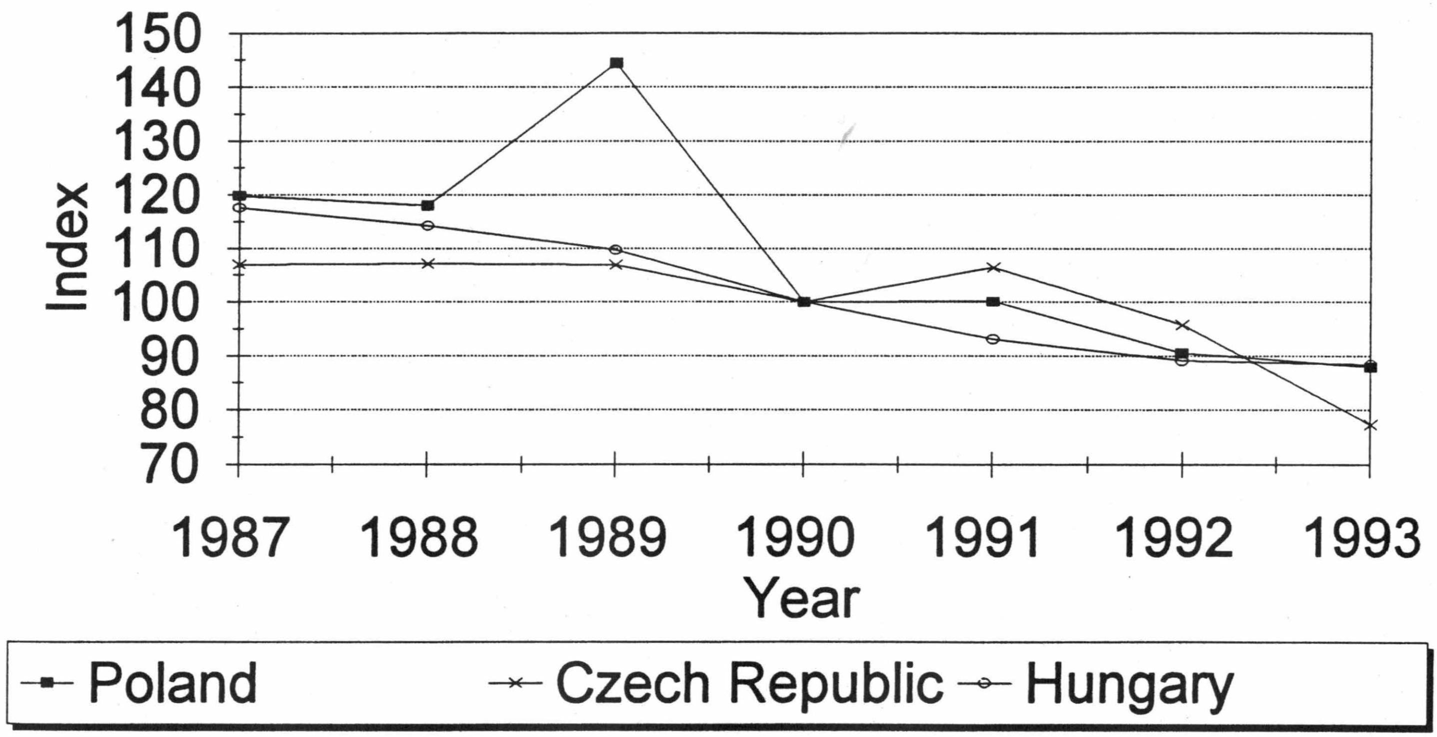
1987-1993



Source: IMF

A.4: Industrial Employment

1987-1993



Source: IMF

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