PROGRAMMING PHARE

Czechoslovakia's economic reforms; how can the EC best help sustain them?

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A. Introduction

This paper attempts to evaluate the process of economic reform undertaken by the new Czechoslovak government and to make suggestions for areas where external assistance is required, with particular reference to assistance for the reform programme itself; the latter is the focus of the EC aid programme PHARE, for which this paper was prepared.(2)

The paper has three parts; the first examines the Czechoslovak economic situation, stressing features relevant for the process of economic reform. Emphasis is placed on the difficulties of the Balance of Payments situation, as it is believed that they pose a danger for the reform programme; the second section examines the reform process undertaken, as well planned, attempts to evaluate it; the final section makes suggestions for EC aid.

B. The economic situation for economic reform implementation

Positive features

Within Central and Eastern Europe, Czechoslovakia had a relatively favourable economic situation at the end of 1989, when the "velvet revolution" that overthrew the Communist government took place. Its GDP per capita is the second highest in the region (after the GDR), and its living standards are high relative to most other countries in Eastern Europe. (See Table 1).

Table 1

GDP and Standard of Living Indicators (Czechoslovakia and rest of Eastern Europe

	GDP per capita (US S) estimates for 1988	Automobiles per 1.000 (a)	Telephones per 1.000 (b)	Human development ranking (c)
Czechoslovakia	7603	173	226	106
German Democratic Republic	9361	209	211	110
Hungary	6491	145	134	101
Bulgaria	5633	120	200	104
Poland	5453	105	118	98
Romania	4117	11	130	90

(a) Source: Plan Econ Western Investor's guide to Eastern Europe and Soviet Union Plan Econ Report Vol. VI, no. 42-43, November 1989; figures also used in OECD Economic Outlook June 1990.

(b) Source: IIF, op. cit. in Note 1.

(c) Source: UNDP, op. cit. in Note 1. Countries are ranked from lowest human development (1) to highest human development (130). Variables used are life expectancy at birth, adult literacy rate and purchasing power parity real GDP.

Given the difficulties of interpreting various measures of GDP per capita, an assessment of living standards needs to be supplemented by quantitative indicators. If human development is examined (see Table 1), Czechoslovakia ranks first in Eastern Europe; for access to consumer goods such as automobiles per 1000 or telephones per 1000 (see again Table 1), Czechoslovakia ranks first or second in the region.(3)

Another positive feature of Czechoslovakia's economy is the prudence of fiscal and monetary policies, maintained throughout the whole post-war period. As a result, the new Czechoslovak government has inherited a relatively small external debt (at US$ 7.9 bn) and relatively small scheduled debt service obligations (in comparison with other countries in the region, see Table 2) and a very low level of inflation.

Table 2

External Debt Indicatiors for Czechoslovakia and Selected East European Countries, 1989

	External debt as percent of goods and services exports (a)	External debt (b) (billions US $)	External debt as percent of exports of goods and services (a)&(b)
Czechoslovakia	18.6	7.9	104
Bulgaria	74.4	9.2	227
Hungary	54.5	20.6	319
Poland	90.6	40.5	486
Yugoslavia	29.1	16.7	96

Source: International Monetary Fund

(a) In convertible currencies

(b) End of year.

Czechoslovakia continued honouring all its debt service obligations on a timely basis throughout the 1980's. Czechoslovakia is reportedly regarded by private bankers as one of the best credit risks in the region; as a result, it could tap the international credit market at fairly fine margins.[4]

Prudent macro-economic policies also led to very low levels of inflation and to a global equilibrium in the Czechoslovak consumption goods market. Official consumer price rises in Czechoslovakia averaged around 2.0% annually in the 1975-85 period, and fell to 1.4% annually in 1986-89 period. Dlouhy[5] estimates that in 1964-80, hidden inflation was around 2.0% per annum; it is estimated to have increased somewhat in the late eighties (to 2.5%); this would imply that total inflation in Czechoslovakia at the end of the 1980's was around 5%, well below that of several other East European countries.

Czechoslovakia's relatively favourable economic situation (as compared to the rest of Eastern Europe) is to an important extent explained by its history. In the 1930's, Czechoslovakia ranked as one of the most industrialised countries in Europe, with a strong tradition of skilled craftsmen producing machinery and other manufactures and businessmen able to export. Industrialisation progressed rapidly between the wars; destruction of property, plant and infrastructure was limited during World War II. As the post-war period began, Czechoslovakia's quality of industrial products and exports was comparable to that of similarly advanced countries.

During the forty-two years when Czechoslovakia was a centrally planned economy, it broadly followed the Stalinist Soviet model, despite differences in initial levels of development; industries and services were nationalised, development of heavy industry was emphasised and trade flows were diverted from West to East. Its economic growth performance was variable, with declining trends over the past twenty years. The country's growth has, however, consistently and increasingly lagged behind average growth for developed market economies. During the 1960's and 1970's, growth rates, though fairly high, were around 30% below the OECD average; the gap widened to one-half during 1981-85 and to one-third during 1986-89. Growth rates that take hidden inflation into account show that the real growth rate was lower than official estimates, and that in the late 1980's growth became slightly negative.[5]

Even though growth slowed down, given the nature of the economic system, there was no open unemployment in Czechoslovakia even in the 1980's.

Because the economic situation in the 1980's was relatively good (in comparison to the rest of Eastern Europe), many observers have argued that the 1989 revolution in Czechoslovakia (CSFR) was driven more by political and less by economic issues.

The fact that the revolution was so peaceful (even though very radical) and that the transition to democracy has till now been rapid and clear is another favourable feature of the Czechoslovak situation. In spite of tensions (particularly nationalist ones between Czechs and Slovaks), there seems to be a very good chance that - drawing on its pre-war political traditions - the country can consolidate democracy successfully.

Furthermore, at the time of writing, nationalist tensions were diminished by institutional measures, such as the new powers given to the Czech and Slovak governments.

The favourable economic situation initially affected the economic reform process. In certain circles, the relatively good situation in the economy is (or was) seen as an argument for more prudent and slower movement towards a free market economy, due to fears that very radical and rapid change could destroy positive aspects and/or capacity of the inherited economic structure. For example, fears have been expressed in Czechoslovakia that too rapid changes could lead to substantial unemployment; as Stevens, op. cit, points out, in societies like CSFR it will be very difficult to accept substantial unemployment (to which they are not accustomed), especially because immediate improvements are expected from the transition to the free markets. However, the dominant position within the Cabinet (lead by Finance Minister Vaclav Klaus) does not share these fears; on the contrary, supporters of radical economic reform have argued that the best way to ensure an increase in the population's welfare is through rapid and radical reform.(6) The line supporting more radical and rapid reform has clearly gained in strength with the election of the Finance Minister, Vaclav Klaus, as president of Civic Forum in mid-October 1990. Furthermore, the media also seem to increasingly take a line more in favour of rapid and radical economic reform.(7)

Finally, the inheritance of past prudent macro-economic management and low inflation is particularly positive. It implies that - unlike countries such as Poland and Hungary - contractionary stabilisation should <u>not need to accompany or precede structural adjustment</u>, unless external shocks are very severe.

<u>Difficulties in the economic situation, for the reform process</u>

The Communist authorities in the 1980's were committed to continuing raising consumption levels at rates higher than output growth. As a result, the share of net fixed investment to NMP (National Material Product) fell significantly. The decline of investment ratios, accompanied by postponement of repair of over-aged capital stock and neglect of the environment, indicates that in the eighties, the relatively rapid expansion of consumption was partly based on insufficient increase and modernisation of capital stock and insufficient effort to preserve the natural environment.

A second problematic feature in the current context is that Czechoslovakia adopted particularly fully the centralised planned economy and that economic reform, though attempted several times, was in practice very limited. The most ambitious attempt at economic reform, started in the mid 1960's, was crushed by the Soviet invasion.

The State plays a particularly dominant role in the Czechoslovak economy, with more than 90 per cent of the labour force employed in the state and cooperative sectors; the private sector (even including the informal economy) does not produce more than 2% of non-agricultural output. Between the summer of 1969 and early 1989 (when a new partial attempt at economic reform began), there was a sharp return to <u>centralised planning</u>.

The task of economic reform is therefore greater than in several neighbouring countries, as the magnitude of the change to transform the Czechoslovak economy into a free-market one is so large, both as regards privatisation of property and creation of market relations, whose existence at the end of 1989 is so limited. Furthermore, there was in Czechoslovakia lack of recent experience with economic reforms (here a clear difference emerges with Poland and Hungary). Because political changes in late 1989 were so revolutionary and unexpected, blueprints for a market economy and for the process of reform from a centrally planned to a market economy had not been prepared and not been thoroughly debated.(8) This also has positive aspects, in that in Czechoslovakia, the economic reform process starts at a point when it has strong political and popular backing.

A third problematic feature of the Czechoslovak economy is its very close integration into CMEA, which makes it very vulnerable to rapid changes occurring in CMEA and possibly less able to diversify its trade relations in the short-term with the rest of the world.

Indeed, except for Bulgaria, Czechoslovakia is the county in Eastern Europe with the highest CMEA trade intensity; at the end of the 1980's, trade (both exports and imports) with socialist countries (including Yugoslavia and China) accounted for 60% of the country's total trade. Over 40% of Czechoslovak exports went in 1989 to the Soviet Union, one of the highest concentrations in the world on a single trading partner.

Furthermore, the structure of exports is significantly different, with the CMEA and Western areas. While manufactured exports account for the major part of exports to both the CMEA and Western areas, the share of machinery and transport equipment in exports to the CMEA area (60 per cent) is considerably higher than in exports to Western markets (21 per cent). Czechoslovakia's international competitiveness for industrial exports, particularly of machinery, has declined. This is illustrated by the fact that CSFR's export shares of electric machinery in OECD exports were cut in half between the early 1970's and mid 1980's; export shares of manufactured products and non-electric machinery to OECD countries also fell, but less sharply.

The ongoing review of CMEA arrangements, which will lead to intra-CMEA trade being conducted at world prices and in convertible currencies, will harm Czechoslovakia as the prices of capital goods and other manufactures are likely to fall and those of raw materials and energy will rise. Already in mid-1990, the Soviet Union cut supplies of oil, forcing CSFR to import from the world market. According to World Bank estimates, assuming a price of $18 per barrel of oil (the 1989 average), the switch of Soviet sales of oil and gas to market prices, implies an import increase of $1.8 billion or about 3.6% of G.D.P.

Economic changes in the CMEA region are rapidly disrupting trade patterns. Due mainly to the recession in the first half of 1990, CSFR's exports to Poland fell sharply; exports to the USSR and East Germany also fell.(9) As countries like the USSR and East Germany (first and second largest markets for CSFR) undertake rapid reforms, they may prefer to purchase more modern Western capital goods and their demand for CSFR exports may continue to decline; economic problems in the Soviet Union and German unification are also likely to reduce demand for CSFR exports.

A key policy issue is whether CSFR can reverse or slow down its declining exports to the CMEA countries, as well as diversify its exports to Western markets. In 1989 and the first half of 1990, following devaluation and other measures, the export volume to Western countries grew. [10]

An important problem affecting Czechoslovakia's immediate economic prospects and possibly influencing the future of the reform program is a completely exogenous one, the sharp rise of the international price of oil and the broader effects this may have on the world economy. Looking only at the direct effects, every $1 increase of the price of a barrel of oil adds about $110 million to Czechoslovakia's import bill. If for example, import prices were to average $30 p.b. for 1991, an additional increase (beyond that estimated above) of $1.3 bn. in the oil and gas import bill of CSFR would be registered; adding this to the effect of the switch to market prices calculated above, the total increase in the oil and gas import bill would be $4.1 bn. or around 6.0% of G.D.P.

The <u>increase in the oil and gas import bill</u> (should all oil and gas imports be paid at market prices and should this market price reach an average of $30 a barrel) would in 1991 be <u>well above 50%</u> of CSFR's 1989 total exports in convertible currencies (which reached $7.6 billion).

The difficulties linked to trade with CMEA and with rising oil prices are persuading the Czechoslovak authorities to accelerate the pace of economic reform, as well as their commitment to such reforms.[11]

The decline of CMEA demand for CSFR exports will force the country to search for new markets, thus putting pressure on the need to enhance foreign competitiveness; this will accelerate the pace of reform. However, previous experience (for example in the Southern Cone of Latin America in the mid-70's) shows that certain types of economic and structural reform become far more costly in terms of loss of output and employment if carried out in a deteriorating international environment.

The commitment to reform will initially increase in the government, and external influence for rapid reform (via international financial institutions) will grow, due to the difficult balance of payments situation; there is a risk that in the medium-term future, resistance to reform may grow due to the increased economic and social cost caused by external factors. This may be strengthened by the unfortunate overlap of the effects of economic reform with the deteriorating international environment, which may not allow the public to clearly distinguish between them. Vaclav Klaus clearly put this point:[12] "To our great regret, we will be blamed now. Our citizens will not be able analytically to distinguish what was involved by our reform strategy and what is coming from abroad".

The Czechoslovak authorities do have a range of manoeuvre to control the timing and sequencing of reform, particularly as regards trade liberalisation. A difficult Balance of Payments situation would seem to require to put up-front reform measures that directly encourage exports (such as a competitive exchange

rate and very active efforts in fields like international marketing) while possibly slowing down liberalisation of imports not directly necessary for the export promotion effort. Particularly if backed by some international financial support, an appropriate handling of economic reform in difficult international circumstances, could strengthen support for the reform programme amongst the population.

B. The reform process and its viability

The reform process

As pointed out above, except for a short period around 1968 strict central planning has characterised the Czechoslovak economic system. In December 1987, the Communist government did start a rather limited reform programme. The role of the planning system was somewhat reduced, leaving to enterprises many of the detailed decisions previously contained in the annual plans. The state monopoly on trade was weakened and a foreign exchange retention scheme was introduced to encourage exports to the convertible currency area. A step towards a market exchange auction was introduced in August 1989. However, deeply entrenched obstacles to economic reform remained in almost every aspect of the political and social context.

The 1989 revolution was a fundamental watershed for real reform in Czechoslovakia, as in other East European countries. After the revolution, the transitional government that held office from December 1989 to June 1990 allowed the already planned reform measures prepared by the Communist regime to take place at their planned date; furthermore, it took a number of important initiatives to begin a clear transition to a market economy; finally, and most importantly, the provisional government, headed by President Havel, provided a commitment to a broad but complete plan for Czechoslovakia's transition to a market economy.(13)

The transitional government and parliament passed a number of new laws and amendments to existing legislation to remove previously existing almost prohibitive restrictions on private economic activity, encourage foreign investment and prepare denationalisation of state enterprises. A law on private enterprise was adopted, providing that private entrepreneurs can engage in virtually any economic activity. A law on joint-stock companies was passed, setting out procedures for their foundation and guaranteeing their independence; special efforts were made to make it similar to Western countries' laws, so as to attract foreign businessmen. The foreign trade law was amended to allow all economic units, including private entrepreneurs, to export their own products and import inputs for their own production.

The existing law on joint ventures was amended to allow 100 per cent foreign ownership in Czechoslovak enterprises. A total of 640 joint ventures are reported to have been set up since the revolution.(14)

In addition to legislative changes, the transition government took important fiscal measures, revising the 1990 budget with the aim of showing a surplus of 0.9% of NMP. Though expenditure restraint was important, some provision was made for a social safety net, including a programme of retraining and relocation for displaced workers. Furthermore, the exchange rate for convertible currencies was unified and devalued; another, major devaluation, was later (in October 1990) carried out by the elected government.

Given the unexpected nature of the revolution, the time constraints, and the significant differences of opinion within the government the progress of reform during the transitional government was fairly impressive.

While these initial measures were being taken, extensive discussions on economic issues took place. As Charap and Dyba, op. cit in (11) point out, the major disagreements were on the concepts and speed of privatisation and the extent of devaluation. In May 1990, a resolution setting forth the government's preferred economic strategy was made public, which was later endorsed by the new government formed following the June elections.

A lively debate on the speed and depth of different aspects of the reform process has continued after the elections. However, greater convergence in thinking has gradually emerged, and has been reinforced by the difficult external circumstances; furthermore, the need for a clear path to be chosen seems to have reinforced commitment to more rapid and radical economic reforms. The leading five economic research institutes, including the Institute of Forecasting headed by Valter Komarek, who leads thinking favouring a more gradualist approach to reform, basically backed the reform programme sent by the government to Parliament, with only somewhat minor reservations. In the autumn of 1990, Parliament approved this framework for economic reform (known as scenar ekonomicke reform), which will introduce a number of simultaneous major measures, mainly starting in January 1 , 1991.

The core measures of this reform programme refer to: price liberalisation, "internal convertibility" of the Koruna, privatisation and support for private sector development, anti-inflationary macro-economic policy, support for a social safety net and for environmental protection.

Great priority is placed to the control of inflation, as "the fundamental objective, to which all other macro-economic objectives, such as growth, employment and balance of payments equilibrium, must be subordinated" (own translation). As Stevens, op. cit, points out, the task of inflation control is made difficult by the need to keep a balance between controlling excessive demand and supporting a supply response, particularly in the emerging private sector; furthermore, planned changes in relative prices will cause an important one-time rise of inflation.

The Government intends to launch "internal convertibility" of the Koruna on January 1, 1991, which would mean that the buying and selling of foreign exchange for current account transactions would be liberalised and that a single (unified) exchange rate would be determined on the foreign exchange market. This would be a major step in the country's transition to a market economy; if accompanied by relatively low and uniform tariffs and limited use of licensing and firm subsidies, it will provide a close link between the domestic and international economy. However, if the measures to cushion the impact of internal convertibility are initially too limited, this may lead to an excessive expansion of imports or a very dramatic initial devaluation. An initial large devaluation, planned for January 1, 1991 was already carried out in October 1990; a valid critique of the government has been made, as regards its pre-announcement (and long debate in press and parliament) over a future major devaluation. This made enterprises unnecessarily increase imports (and stocks), leading to the need to advance the devaluation. This type of error in economic management can clearly be attributed to lack of experience of policy-making in a market economy. To make this exchange rate sustainable, a temporary international credit facility would be very helpful.

As regards price policy, the authorities in July 1990 eliminated negative turnover tax on many items, including basic foodstuffs, which implied a price increase of 25% on average; the population was compensated for these increases, making the change budget neutral. Further price changes (eg, in transport tariffs) are being carried out during 1990, and a substantial price liberalisation - of both retail and wholesale prices - is to begin in January 1991. Fears have been expressed that - given the present monopolistic organisation of industry and commerce - price liberalisation could lead to an inflationary spiral; price liberalisation needs therefore to be supported by cautious macro-economic policies, encouragement of domestic competition and an increase in foreign competition, which would be provided by "internal convertibility"; the balance is delicate so as to avoid declining output but the economic authorities seem fairly clear about the difficult 'trade-offs'.

However, at the time of writing, more emphasis than on the above issues was being placed in debates about privatisation, and specially about two key questions; whom to sell to and particularly how to structure the transactions. It should be stressed that the government has clearly established encouragement of private property and privatisation as key elements in its reform programme. Furthermore, there is strong support in Parliament, the media and the population for this objective. The government determined a broad programme for privatisation, deciding that small and medium state enterprises will be sold quickly, and that this will be implemented at a municipal level, that prior restructuring and demonopolisation will be required before privatisation for the larger state companies and that only a few key industries and natural monopoly social service providers will remain in the state sector. Furthermore, a restitution law has been introduced, detailing property nationalised by the Communists that former owners may reclaim; the government sees the law on restitution as the "legal anchor" for subsequent reforms, as it will start to clarify property rights, which is a key pre-condition for private entrepreneurship (both domestic and foreign) to develop.

The debate is particularly heated about the form of privatisation of large companies, with much emphasis on the pros and cons of a voucher system, strongly supported by Finance Minister Klaus. There seems to be agreement about the initial steps of privatisation of large scale companies; after de-nationalisation the company's shares will not be owned by the sectoral ministry, but by a National Assets Foundation, to be attached to the Federal and Republic Ministries of Privatisation.

It is the next step - actually transferring ownership to private investors - which will be the most complex and has provoked much public debate in Czechoslovakia.

The government stated its preference to distribute ownership among all citizens. This poses problems. Ordinary citizens do not have sufficient means to buy the firms that will be put up for sale; there is concern that the few with substantial capital are those who acquired it in the black market and/or were members of the nomenklatura. Furthermore, capital markets do not exist, and thee is little expertise for valuation of the assets being offered. Detailed discussion within the government have produced a variety of proposals to overcome these problems, but the proposal attracting most attention is the coupon one, supported by Minister Klaus. In this alternative, citizens would receive vouchers denominated in points, to be used to bid on shares in state-supervised auctions of state-owned enterprises. The vouchers would be given free or at low cost; thus, this would imply a transfer rather than a sale of property. Amongst its advantages are that it avoids need for prior valuation and would permit the process to start soon; furthermore it would delay - though not prevent - concentration of share ownership.

There are, however, several problems with the voucher system. The scheme would place a great administrative burden on the government. Wide dispersion of ownership would risk creating shareholders too fragmented to control management effectively. Giving citizens high-risk shares could create political pressure to use public funds to bail out non-viable firms. Last, but not least, free or nearly free distribution of vouchers would imply that privatisation would not mobilise resources needed both to cover enterprise restructuring costs, expanded social safety net for the public sector, as well as increased required spending in social sectors and the environment. To overcome this problem, the parliamentarian Milos Zeman has proposed a variant to the voucher plan, which would imply selling shares, but with long-term repayment; the funds thus obtained would be used by the government to fund spending in health, education and the environment, thus supporting long-term development. Probably, privatisation can best be carried out by many different mechanisms, as there is no perfect solution. Though it is important that privatisation is fairly rapid (and that the search for the best method does not delay action too much), it is necessary to realise that other countries' experience points to the difficulties of very speedy implementation; besides speed, fairness, protection fo the nation's Treasury, improving chances for effective management and guarding against new concentration of economic and political power, need to be highlighted as important objectives of privatisation methods.(15) In the Czechoslovak case, speed however may be particularly important, as the size of the State enterprise sector is so overwhelming, and there is a need to rapidly create a meaningfully large private sector which can be done by both supporting new private sector development and by rapidly beginning to privatise state owned enterprises.

Several of the other important structural reforms to be implemented cannot be discussed in great detail here. Amongst those potentially most relevant in the context of this paper (as they, like the previously discussed changes, may potentially require technical assistance) are: industrial restructuring, private sector development, encouragement of foreign direct investment, creation of a social safety net, new rules for state-owned enterprises, financial reform, support for production of tradeables and for marketing of exports, and environmental protection. In most of these areas, the Czechoslovak government has begun to propose legislation and take action - in most of them, sustained action in the medium-term is required to assure a rapid and efficient supply response, and to protect social and environmental goals of economic reforms.

Industrial restructuring, both at the sectoral and enterprise level, is essential for Czechoslovakia to increase competitiveness in Western markets. The country can draw on its tradition of technological innovation with its skilled and cheap labour force; its location and expertise can imply that Czechoslovak companies could act as a bridge for Western companies wishing to trade with the rest of Eastern Europe and the Soviet Union. Amongst difficulties for restructuring are: lack of familiarity with Western markets, relatively outdated plant and machinery and labour productivity, limited links and incorporation of Western technology. Finally, there are fears of lack of flexibility both amongst management and workforce to adapt to the new environment; inertia is seen as an important risk.(16) There is an important sector of enterprises which will require substantial restructuring to become competitive under market conditions, and which is at risk of becoming needlessly bankrupt if timely and appropriate assistance is not forthcoming in re-training, technological innovation, knowledge about markets and access to credit.

As regards private sector development, this seems more likely to take place initially in the under-developed service sector. Elimination of bureaucratic impediments to private entrepreneurship is an important necessary step; however, it also needs to be accompanied by some preferential temporary treatment. It seems important to create a focal point within the government to coordinate assistance to small and medium private enterprises. In Czechoslovakia, such a focal point could for example be the Czech and Slovak Ministries for Economic Policy and Development, which could operate in close collaboration with representatives of the business sector and other relevant Ministries, such as the Ministry of the Economy. A package of services could be provided, including access to credit (possibly subsidised), information on technology and markets, relevant training, etc. There is an important experience of support for small and medium enterprises in the Western countries that could be drawn on and adapted to Czechoslovak circumstances.

Encouragement of foreign direct investment is seen as crucial in the Czechoslovak government for providing management and technological skills, as well as access to international markets. Important steps have already been taken to attract foreign capital, which seems to be responding with interest. Measures outlined above, such as clarification of property rights and internal convertibility, should make the country more attractive for FDI. The recent creation of a new unit in the Ministry of Economy to encourage FDI should provide a valuable focal point.

Creation of a social safety net is crucial in the Czechoslovak transition to a market economy, both to avoid human suffering and to maintain political support for the economic reform programme. Though open unemployment is at present still very low (estimated at 0.2% of the labour force in June 1990), there are fears that it may increase significantly as a result both of the reform process and the external shocks outlined above. The social safety net must cover not only the unemployed, but also other vulnerable groups that may suffer due to declines in their real incomes, eg, pensioners and families with small children. It seems important that an adequate social safety net is put in place before unemployment rises; it is also crucial to link the social safety net with measures for increasing labour mobility, via re-qualification programmes and programmes to provide housing in areas of expanding employment opportunities; the latter may be particularly relevant as unemployment may be far larger in certain regions. It seems important to incorporate workers' representatives (which are now grouped in the new democratic trade union movement CSKOS) in the discussion of social safety net and re-qualification. A mechanism for this has been created in the fall of 1990, through the formation of a Tripartite Commission, with equal number of representatives from the government, state enterprises and unions.

Though most emphasis is being placed in Czechoslovakia on the process of privatisation, it is also important (particularly during the transition period) to define new rules for state-owned enterprises. This implies giving greater authority and responsibility to managers and, above all, clarifying the new objectives of state-owned enterprises, which imply becoming profit-making businesses.

Very significant for a market economy is the existence of an appropriately functioning financial system, and particularly a modern banking system. Commercial banking is only just beginning to be developed (since January 1990) and is very rudimentary; its role in Czechoslovakia will be particularly important, to support the development of the practically non-existent private sector. Technical assistance seems important, not just to improve (and create) certain basic banking techniques, but also to design banking supervision.

The transition to a market economy should provide a valuable opportunity to address environmental problems, which are largely linked to the country's previous development strategy, which was both energy-intensive and wasteful. Market mechanisms need to be complemented by government action in this field.

Last but not least it should be emphasised that the reform process is being carried out in Czechoslovakia by democratically elected institutions. The bloodless November revolution was followed by peaceful and fair elections in June, 1990. This gives a strong legitimacy to the economic reform process undertaken by the government; moreover, polls indicate general support for economic reforms amongst the population. It seems important to strengthen "civil society" further, by supporting intermediate (between the state and the individual) social groups which will inform about economic reform, stimulate ideas and help initiate and implement action. This can refer to associations of entrepreneurs, of professionals, as well as other interest groupings (e.g. trade unions, consumers, parents).

Viability of the reform process.

As regards the viability of the reform process, the above-described relatively favourable initial economic conditions (such as fairly high living standards, full employment, low inflation, low debt overhang, relatively strong - if somewhat obsolete - industrial base), as well as political conditions provide clear advantages for it.

Amongst the main difficulties (discussed in detail in section B) are: the high degree of centralisation in planning throughout most of Communist rule, and the corresponding lack of experience with economic reform and with market relations; the very close trade integration with CMEA and adaptation of productive structures to this trade at a time when CMEA is itself being rapidly restructured, and all of the countries integrating it are undergoing rapid changes and, in several areas, recession; the latter point, accompanied by relative lack of competitiveness, and lack of knowledge of and adaptation to, non-socialist markets poses the short-term risk of declining export markets; the double shock caused by the transformation from heavily subsidised to market prices for oil and gas imports, accompanied by sharp increases in the price of oil caused by the gulf crises, will accentuate pressure on the balance of payments.

A potential problem is the intensity of the debate on speed and depth of the reform process; initially such debate is a healthy sign of a new democracy; should it drag on for a long time (which seems less and less likely), continuous disagreement on every detail could complicate and slow down the reform process. In the Czechoslovak case, economic reform laws have also been somewhat delayed by the need for Parliament to discuss other issues, eg, new institutional structures to respond to regional and nationalist aspirations. Now that these seem resolved, emphasis needs to be placed on the reform process. Further support for the reform process is originated in the fact that the supporters of more radical and quick change have gained influence, with Klaus winning the presidency of Civic Forum (the leading party in government) and with the approval of important laws (eg, small privatisation, restitution). It is important that the pace of change is maintained, and that social measures (social safety net, social spending) accompany the economic reforms; both will help maintain support for the reform programme amongst the population. It would seem that policy conditions from the EC and other donors should not so much emphasise the choice of a particular path of reform (as the transition from a socialist to a market economy is largely unchartered territory, with no clear conclusions available on optimum paths), but donors should stress the need for the government and society to clearly opt for a particular structure of reform and pursue it fairly consistently, though flexibly. As regards the previous points, lack of experience in Czechoslovakia with the market and with economic reform would seem to suggest some tolerance by donors for somewhat more gradual implementation (in aspects such as privatisation). It is important however that policy decisions are taken quickly. As experience in developing countries' structural adjustment efforts has shown, the discussion between "big bang" and "evolutionary" approach is a simplification which diverts attention from more pragmatic solutions. An important distinction exists between measures that can be made effective immediately (eg, devaluation) and those that take a long time to implement (eg, privatisation). Where institutional change is involved, the reform's process implementation is necessarily slow, but it has to be started as soon as possible. Particular emphasis must be placed on efforts made for the vigorous development of a market infrastructure (regarding not just property rights, but also corporate law, specialised financial institutions, with their appropriate regulatory bodies, labour laws with clear procedures for settling disputes). Because foreign direct investment is seen to have so many positive effects for the reform process, emphasis should be placed on policies to attract it, particularly in sectors where it will provide special benefits.

As regards the problems posed by the difficult and rapidly changing external environment facing Czechoslovakia as it starts to undertake the reform process, it would seem that the EC should:

a) emphasise the need for the Czechoslovak government to put up-front economic reform and other measures which will help it adapt as quickly and painlessly as possible to the new and more difficult external environment; measures to encourage exports (and substitute imports, if feasible) will clearly have a priority here, as will the development of the private sector,

b) emphasise the need to continue pursuing prudent macro-economic policies, so as to avoid additional pressures on the balance of payments arising from demand expansion, together with structural policies to encourage supply response,

c) stress the need that any adjustment cost be fairly equitably distributed through society, for example, by giving benefits and re-training to the unemployed, and

d) Last but certainly not least, the EC should support requests for temporary external finance assistance to moderate the impact of external shocks and accelerate more liberal access to Western markets of Czechoslovak products.

C. Proposals for orienting EC aid

The type of external assistance required in helping to set up an infrastructure of market relations and behaviour needs to focus first on contributing to a broad understanding in the country of the nature of these future market relations and of the process of transformation from a planned to a market economy in the Czechoslovak context.

Given Czechoslovakia's previous isolation from the West (in relation not just to trade links but also lack of professional and academic links) and its lack of recent experience with market mechanisms, a high priority would seem to lie in providing technical assistance for:

a) involvement of European and other experts in discussions of different aspects of the reform and adjustment programme, either directly as consultants or via collaborative policy-applied research, and

b) rapid re-training of Czechoslovak professionals, is required, in fields such as economics, accountancy, management, political science and law, both on Western theory and practice and on Western (particularly West European) experience relevant to economic reform, market economy and political democracy. Such training should not be limited to Czechoslovak government officials and state managers, but should very much include professionals working for intermediate groups, such as associations of private entrepreneurs, trade unions, consumer groups and others.

Training and support for consumer groups and associations is very important in the transition to a market economy, as price liberalisation in a monopolistic situation could lead to price over-shooting. Effective action by consumer groups can help reverse such a negative trend, as well as control quality of products. Both advisory support and training to consumer groups would be relevant. Priority should also be given to support for re-training university lecturers and teachers of social sciences in schools. There is a need to provide support for translation of modern textbooks, and writing of appropriate textbooks, teaching materials relevant for the new Czechoslovak situation.

Such technical assistance would not only contribute to improving the technical efficiency of economic reform and stabilisation programmes, but to the equally important domestic consensus-building and support for those programmes. The E.C. would seem to be particularly well placed to contribute in these fields, as it has rich and varied experience of market institutions (and the role of government in a market economy) and as Czechoslovak people clearly wish to model their economies and societies to an important extent on those of Western Europe. Furthermore, given Czechoslovakia's interest in integrating more closely into the E.E.C., it would greatly benefit from training on both general and detailed aspects of the Community's functioning, including developments relating to 1992.

As regards training, the modalities adopted should be suited and tailored to the needs of economic reform in Czechoslovakia. Priority should be given to training within the country, so as to reach a wider number of people. Language teaching (tailored for the special needs of the subject) should precede, where necessary and feasible, training courses; knowledge of Western languages is very poor, and is a barrier for communication. Courses should be designed for specific economic reform; ideally foreign lecturers' presentations on Western theory and practice should be linked with presentations by Czechoslovak lecturers on local practice. Such training would increase pressure and support for economic reforms at middle levels. Such an approach would be superior to just bringing foreign experts/lecturers to teach on Western theory and practice, without relating it to local conditions, as reportedly[17] has often happened and reduced effectivity of teaching. Length of courses could be variable and related to the time availability (seniority) of those trained.

Focal points need to be found for training and re-training state employees, state enterprise managers, private entrepreneurs, re-qualification of unemployed and banking staff. Training in management, public administration and economics, for state employees and state enterprise managers could be based in a Ministry, for example, that of Economics, which expressed interest in such activities. Special courses for export promotion (an area of high priority, see below) could for example be organised by the Research Institute for Foreign Economic Relations, jointly with other bodies. In the case of private entrepreneurs, the Association of Private Entrepreneurs, which represents around 100,000 small businessmen, could coordinate training in management, economics, accountancy, law, etc.

Short-term training in Czechoslovakia should naturally be complemented with studying abroad. Priority in this should be given either to very applied skills (eg, international marketing) or to lecturers who can disseminate the knowledge widely on their return. Stays abroad should preferably not exceed a year.

Given the likelihood that CSFR will face rapidly deteriorating terms of trade and loss of CMEA markets, which could pose some potential dangers for the future sustainability of the reform process, and that it wishes to increase its orientation to Western markets, high priority should be given in technical assistance to rapidly increasing production of tradeables, both as regards exports and import substitution. Relating to exports, priority should be given to assistance and training to support for rapid increase of export supply (via product development, advice on rapid innovation, technological change, quality control, etc.) and market access (via information on international market possibilities, improved international marketing and technical support services, with particular emphasis on European standards and certification systems, as well as language training for marketing personnel, etc).

Technical support (via consultants) could be provided to advise on the creation of a Board of Trade, which would centralise key actions for export promotion, such as the creation of data bases, market research, etc. Preferably consultants would have detailed knowledge of such activities in Western countries. Financial support could also be given to the establishment of the Board of Trade and particularly its representatives abroad (in key markets). The possibility of regional (Central and East European) trade promotion schemes could be explored.

Where specific bottlenecks exist for exports to Western markets (eg, need to add electronic components, or otherwise adapt products), not only technical assistance could be provided for such actions, but EC resources could contribute to provide credits to be granted for export promotion. Where modern machinery was required for bottleneck elimination for exports to Western markets, the credit could either be used to purchase it or lease it. Such credits could also be granted for financing new plants devoted to production of exports. Finally, transformation of factories previously devoted to arms exports to other production (particularly tradeables) could also have access to credit. Possibly also credit lines could include import substitution activities, where a clear foreign exchange saving can be demonstrated. In particular, the transformation of prices to market ones (both domestically and internationally, via CMEA) has dramatically changed the relative price of energy, to reflect its scarcity value. Credit could be granted for necessary expenditure/investment to ensure energy savings in the new market conditions; this could finance both foreign energy consultants to save energy in existing plants and investment to reduce energy costs; this would also ease pressure on the Balance of Payments.

Given the priority for private sector development in the reform programme, and the fact that the private sector may - at least initially - be concentrated in small and medium enterprises (as privatisation will start with that sector and as new private companies are initially more likely to be small and medium), it seems desirable to provide technical assistance to that sector.

A consultant or a team of consultants, with knowledge of Western successful institutional experience of support for small and medium enterprises (SME) could be financed to suggest institutional arrangements and policy actions to support small and medium enterprises. The consultants would collaborate closely with the authorities, private sector, etc. A special unit for SME development could then be rapidly created to provide training to SME, define credit policy and priorities for them and provide other relevant services (eg, advice on technology and management). The focus for such action could for example be the Czech and Slovak Ministries for Economic Policy, collaborating with other relevant Ministries, with the Association of Private Entrepreneurs, and with the bank/s in charge of granting the credit. A particular bank or section of a bank could be designated to this purpose; it would be important that enough regional offices would be opened, to spread access to credit throughout the country. An initial (limited in time) subsidy to credit for these SME could be granted and possibly funded by the EC grant. External funds could also help fund training of professionals in the new SME unit (in investment appraisal, etc) and in the relevant bank (in credit risk). Emphasis should be placed on flexibility and speed, and on the need to enable, rather than merely control, new activities. The involvement of private entrepreneurs' representatives in the SME unit's Board would help ensure agility and reduce red tape, seen as a major problem currently for private enterprise in CSFR. Support for SME should not be restricted to industry, building and services. As small private entrepreneurs start emerging in agriculture (once relevant laws on property are passed by Parliament), subsidised (initially) credit and other support will become necessary. EC support could be useful both for helping design appropriate institutional support and helping fund credit to agriculture (with part of the grant being possibly used, as in the case of the other sectors, for subsidising credit).

As regards financial sector development technical assistance is required, to advise on agile functioning of new commercial banking, starting at a fairly basic level to provide training in credit analysis, accounting, computing, etc. Duplication of efforts with bilateral donors should be avoided. Technical assistance for central banking on appropriate regulation of the financial system, both to avoid financial distress and for the government to integrate financial sector policy, including credit limits on banks, into its overall macro-economic policy, would also seem important.

The EC could provide technical assistance for the formation of an appropriate social safety net (aspect which seems somewhat neglected in CSFR) and for re-training unemployed workers for new fields of employment. This is an area which seems key for the sustainability of the economic reform programme, as under the previous regime there was no open unemployment and as the difficult international environment and the reform process itself may require adjustments that may well lead to important increases in unemployment; furthermore, re-training will provide an opportunity to provide part of the labour force with the skills required for the new market-oriented economy. Trade unions and the Association of Private Entrepreneurs should be involved in the design of re-training programmes. The authorities would also play a crucial role in helping determine the sectors and regions where employment is more likely to expand. Clarity on this key point seems insufficient at present.

Technical assistance is also required for the process of privatisation, particularly in the field of asset valuation, a key previous step for certain modalities of privatisation where foreign expertise is either essential or very helpful. However, if the coupon method is used (see above), valuation of assets may not play such a crucial role.

Legal experts could also be provided to advise on new legislation (and its interpretation) related to the economic reform programme, (in particular on relevant experience and practice in other countries). Indeed, several new laws are already being re-drafted due to problems with the original ones; such trial and errors could hopefully be diminished by the advice of foreign consultants. Legal consultants could be based in Parliament and in key Ministries.

A specific field where both legal and other foreign expertise would be valuable is in the promotion of foreign direct investment. Knowledge of the previous experience of other countries would be of interest, on how to attract FDI, how to negotiate with foreign investors successfully, how to assess the impact of FDI on the national economy, in the context of a market economy, etc.

Another area where EC technical assistance could be valuable is to support the reform and development of the accountancy profession. Support to be provided (for training and consultancy) by European bodies of accountants and auditors would be especially useful.

Funding a number of broader studies could be useful to support the reform programme, and to help acquire knowledge of the experience of market economies in this field. These studies could combine applied research with a consultancy mode, and combine foreign expertise with Czechoslovak professionals. Such studies could include:

a) The role of government in a market economy. The limits of markets, the role of public goods; suggested reorganisation to the public administration, so as to contribute most effectively to the operation of the economy, in a market context.

b) The role of intermediate groups in the design of economic policies in a free-market economy, with a democratic government. The role of private entrepreneurs and trade unions in defining policies relevant to them. Such a study could be particularly useful for the work of the newly created Tripartite Commission, (state, entrepreneurs and unions).

c) Macro-economic policies in the transition to a market economy. The link between macro-economic policies and market reforms. Lessons from other East European countries and from relevant elements in policies of Western European and developing countries.

d) The design of sectoral and regional strategies in the context of a market economy.

e) Education needs in a market economy.

Finally, support seems necessary to improve information (and its quality) amongst the population about the reform process and its effects. Similarly, greater dissemination of the international support for the reform programme, its size, characteristics, priorities and procedures would seem valuable.

NOTES

(2) For further details, see C Stevens Key Issues Paper Programming Phare 1991, September 1990, which provides the conceptual framework in which this and other country papers are written.

(3) Data based on Institute for International Finance Building Free Market Economies in Central and Eastern Europe: Challenges and Realities, Washington, DC April 1990 and UNDP Human Development Report 1990, Oxford University Press.

(4) See, for example, Financial Times, May 9, 1990 "International Banking III", and IIF, op. cit.

(5) Drabek, Z, and Dyba, K, "Reformni politiky, rustovy vykon a makrockonomicka stabilita", Ekonomicky Ustav, CSAV, 1990.

(6) For a clear statement of this position, see J Charap and K Dyba "The Benefits of Unemployment" Mimeo 1990.

(7) Interview material

(8) For a good analysis, see J Batt "Czechoslovakia" in The Limits to Economic Reform under Communism (ed) S Gomulka, OUP 1991.

(9) E.I.U. Czechoslovakia's Country Report No.3, 1990.

(10) E.I.U., op. cit.

(11) Wall Street Journal, August 21, 1990 "Czechoslovaks speed free-market reforms as pressure for decisive action increases" and Financial Times, Sept. 24, 1990 "Oil price hardens Czechoslovak resolve". See also, J Charap and K Dyba "Transition to a Market Economy: the Case of Czechoslovakia", forthcoming.

(12) "Gulf fears pack them into the IMF bunker". The Times, Sept. 25, 1990.

(13) See, for example, V. Sabell "Czechoslovakia Almost Ready for Economic Transformation" Report on Eastern Europe Vol. no.23, Radio Free Europe, Munich.

(14) Interview material.

(15) See, D. Lipton and J.Sachs "Creating a Market Economy in Eastern Europe: The Case of Poland" Brookings Paper on Economic Activity. 1:1990, Washington D.C.

(16) Interview material.

(17) Interview material, several Czechoslovak sources, particularly Dr Frgal and Ing Ptacek.