Velvet Devolution

Is the "Czech Miracle" over? Or still to come? A report from Prague.

By Thomas W. Hazlett

When the Velvet Revolution politely bid adieu to 40 years of Soviet-style socialism on November 27, 1989, the Czech economy hosted the most anemic private sector in the entire Eastern Bloc, producing just 3 percent of the country's gross domestic product. But between December 1989, when an obscure bank economist named Vaclav Klaus became the country's first post-communist finance minister, and March 1995, when the second of two waves of privatization was completed, the country was transformed. In 1995 three-quarters of GDP was generated by private firms. With an economy shifting into high gear, Prague a lively tourist mecca, an amicable 1993 "Velvet Divorce" from Slovakia, and a political stability rare in the region, citizens could be proud of the "Czech Miracle," as it was enthusiastically described in the April 1995 issue of this magazine.

But the Czechs' mood has now turned darker. Klaus, the financial guru who became prime minister in 1992, resigned in November amid what the U.S. press called "scandal and a slumping economy." His fall has triggered a wave of obituaries in the American media not only for the Czechs' once-vaunted economy but also for the free market principles Klaus propounded. Yet an examination of the Czechs' difficulties indicates that, while there are mistakes to overcome and problems to solve, the only real bankruptcy to be found is that of American journalistic vision, and the only real poverty that of the newspapers' economic understanding.

Certainly, the "scandal" half of the press's indictment was juicy enough. It revolved mostly around reports that Klaus's Civic Democratic Party maintained a secret Swiss bank account filled with money from investors who were purchasing privatization favors. In 1996, the Czech press got hold of a party report that attributed substantial donations to a pair of men in Hungary and Mauritius; the Hungarian, it turned out, had been dead for

12 years, and the Mauritian, while alive, had never heard of Klaus's party. Last November, a Czech entrepreneur who had won a stake in a privatized steelworks admitted that he was the source of the money. He denied he'd received any favors, but he did claim that Klaus had known about the money. Klaus disputed this claim, and his party split into squabbling factions. After Klaus's own finance minister threatened to go public with what he said were dubious privatization deals, his home was bombed. So much for political civility.

In the meantime, the country had been suffering a series of financial setbacks, including a plunging stock market racked by conflicts among stockholder interests in 1995 and 1996 and a currency crisis in May 1997, when a burgeoning trade imbalance produced a run on the Czech koruna. After an expensive attempt to defend a fixed exchange rate--in effect donating $3 billion in taxpayer funds to international speculators--the central bank gave up and let the currency fall, resulting in a 15 percent devaluation. The central bank was then forced to tighten monetary policy, and the country's economic growth dipped sharply: Projected 1997 GDP growth of 5.3 percent fell to 1.2 percent in the first half of the year.

The country's fiscal slowdown naturally produced political fallout. The government reacted clumsily, seeking to co-opt opposition cries for state controls. Klaus refused to step down because, he explained modestly, there was simply no one who could take his place. But under the combined weight of the scandals and the wheezing economy, Klaus's popularity plummeted, and finally--eight years and three days after the collapse of Czechoslovakian communism--his government was dissolved.

The reaction in the American press was not restrained. "Czech's Downfall Shatters Hope for Economic Miracle; Outgoing Prime Minister's Failed Reforms Viewed as Too Absolute, Arrogant to Succeed," *The Washington Post* concluded sternly. Economic reform and prosperity had been but a fantasy, realized *The New York Times*: "For the Czechs, The Fairy Tale Is All Over Now." The situation was even more terrifying than real life, according to a front-page feature in the *Chicago Tribune* published last summer: "Czechs' Economic `Miracle' Looking More Like Nightmare."

The "Czech Miracle" was more heralded in its alleged death than it had ever been in life. But at least it didn't die alone. The *Tribune* declared a mass funeral for market forces. "[P]rime minister Vaclav Klaus had visited the University of Chicago and patterned his policies on the free-market teachings of the school's Nobel Prize-winning economist, Milton Friedman....Klaus once looked down on his neighbors Poland and Hungary, but now the economic boom is proving illusory....In the meantime, the University of Chicago is out of style in Prague."

Capitalism, one might easily conclude from all this, had been as much a bust in the Czech Republic as communism. So last fall I returned to Prague to see this purported collapse for myself. During annual pilgrimages from 1990 through 1994, I'd had the privilege of observing that glorious capital come roaring back to life after decades of Soviet-induced inertness. What

had once been a city where a visitor had trouble finding a restaurant that welcomed customers or a shop that featured inventory was resurrected as a vibrant metropolis boasting superb dining and every consumer convenience, its once somnolent streets buzzing with commerce and ringing with Dixieland jazz.

What I learned in Prague on this journey was a lesson very different from those blared in the American headlines. Rather than finding a nation of shattered hopes and punctured fairy tales, I found an upwardly mobile country that still exudes the enthusiasm of a dynamic people newly liberated. Far from finding a place trapped in an economic nightmare, I found a land which still ranks at the very top of the "emerging nation" success stories.

It was impossible to miss the signs of lost economic momentum. The Czech economic trajectory, while still pointed up, is noticeably flatter than it was just a few years back. Even so, rather than discrediting all previous economic progress--as some Western press reports have perversely done--an investigation of the Czech situation reveals a rather conventional political failure, bred by an almost unique success and nurtured by the arrogance of power.

Indeed, the main source of difficulty in the Czech Republic now is the policy gridlock that followed the exhaustion of mass privatization from 1991 to 1994 --just as Klaus and other advocates of "fast privatization" had predicted. Extending the economic reforms further and deeper, including the establishment of legal protections for capitalists and entrepreneurs, are the devilish details that have been left for a new government to deal with. Rather than demonstrating the shortcomings of laissez-faire capitalism, the current travails of the Czech transformation exhibit the dangers of letting communist-era institutions, including courts that fail to protect individual rights and a state that refuses to take responsibility for its actions, survive into the modern era.

Most troubling was that despite Vaclav Klaus's brave rhetoric and well-reasoned essays on the radical transformation to capitalism, and despite an impressive start on rapid privatization of large enterprises, the Czech reform program had largely ground to a halt after 1994. Klaus's explanation of this failure was defensive, evasive, and shockingly unpersuasive.

The irony is that Klaus had made himself famous as an economic Johnny Appleseed sowing one simple idea: The key to a successful transformation from socialism is speed. Momentum for reform would be lost in a "reform trap," he argued, if the interest groups that stood to lose were given the chance to forge alliances and amass organizational strength. Quick turnaround of assets from public to private was the only reliable solution. Failing to seize the moment would "prolong the pre-privatization period of agony," Klaus reminded the Czechs and the rest of us in his many speeches and essays in the early reform period.

His logic was not subtle. In an economic netherworld where state-owned enterprises are slated to be taken over by new private proprietors, the incentives and opportunities for looting are abundant. The classic scheme in Eastern Europe has been for a state manager to sell off the lucrative pieces of "his" enterprise to his brother-in-law's company at bargain prices, turning over a debt-ridden shell for privatization.

Resources are squandered in this process of asset stripping, and the public soon loses patience with such "pirate capitalism." Demand builds for beefing up state enterprises--a happy outcome for the *apparatchiks* who control them--and liberalization slows. Russia has vividly demonstrated this cycle of reform and backlash, and countries throughout the region have shown how quickly anti-capitalist parties (including former communists) can gain the upper hand.

But what happened in the Czech Republic was very different. Price liberalization and economic deregulation were quickly followed by a large restitution program and privatization of small enterprises: Twenty thousand restaurants, printing shops, gas stations, and other "mom and pop" businesses were auctioned off under the authority of local governments in 1990-91. Then the Czechs proceeded rapidly--some said recklessly--with privatization of large businesses.

This is the heavy lifting in post-communist reform, because separating the assets and liabilities of major state enterprises is extraordinarily complex. In a world where no operations went bankrupt because they were all state-owned, firms lent each other money willy-nilly. Good loans? Bad loans? Hey--we're all one big happy mega-state. Who's responsible for environmental liabilities? Pensions owed? Accounts payable? Not even your Excel-crunching CPA wants a piece of this action.

The Czechs cut this Marxist knot by sponsoring two ingeniously crafted competitions for the two "waves" of large-scale privatization in 1992 and 1994. The Ministry of Privatization required each of the 4,000 or so major state enterprises to file a privatization proposal describing the firm's asset base, its business plan, and the optimal means of privatization. (The proposals included various means of assigning equity, but shares in a newly private company were often set aside for "voucher privatization," wherein stock shares were distributed to the three-quarters of Czech adults who bought coupon booklets for the nominal sum of $35.) Then, with very short deadlines to limit mischief or delay, competing proposals were entertained by the ministry. The 20,000 proposals it received composed a database that allowed it to go where no government had gone before: turning most of a country from state socialism to private capitalism in under four years.

What happened next involved sins of omission and commission. What Klaus's government missed, at least in part, was the importance of property rules that went beyond the initial distribution of equity shares to private owners. Klaus had assumed that rules would develop spontaneously to create a vibrant capital market, and he was not far off--not nearly so far off

as *BusinessWeek* was in its December 15, 1997, issue when it dismissed the Czech financial markets as "another place where free-market rhetoric went haywire."

But Klaus did not recognize that the new economy needed a new legal structure to spark spontaneous order. Unconventional approaches such as "one man, one share" successfully moved huge state-owned enterprises into private hands. But this could be accomplished only through rules that explicitly did *not* respect property rights: Government bureaucrats were called on to create ownership, cancel old assets and liabilities, and then distribute the new shares like the Tooth Fairy. Once those private rights were out in the marketplace, however, a new system was required to define what private ownership really meant.

In your standard-issue capitalist economy, shareholders have strong assurances that managers, or those who own more shares than they do, won't steal them blind through the sort of insider schemes for which socialist enterprises have become notorious. This is because firms, to attract equity investors *to begin with*, have to convince people that they will utilize funds for the good of all stockholders. Through a combination of private law (corporate charters), capital markets, and public rules (including courts to adjudicate fraud and embezzlement), corporate agents have incentives to treat your invested capital like it's yours and not theirs.

But while the demand for transparency and integrity operates powerfully on firms that must attract investors, the newly minted Czech firms were created out of thin air (or, rather, a dense communist fog). No corporation had to attract fresh capital to get going. Hence, a different set of incentives were in place. Many firms, focusing on growth, behaved pretty much like firms in developed economies, taking pains to protect the interests of their shareholders in the hope of attracting more investors. In some situations, however, managers or a majority of shareholders found that, without much trouble from the legal system, they could transfer company assets to other corporations which they alone controlled. This effectively cashed out the minority shareholders.

Under such circumstances, the Prague stock exchange has not done well in recent years: The PX50 index, set at 1,000 when trading began in 1993, hovers at about 500 today, the main problem being investor uncertainty about protection of minority shareholders**.** As Tomas Jezek, chairman of the Prague stock exchange, notes, "There have been too many cases of disappearing value because assets were stolen**.** The success of fast privatization risks being lost if the government is unprepared to protect private property."

The failure to establish a new legal framework for ownership is particularly glaring in the case of bankruptcy laws, which were suspended altogether for two years during mass privatization. This was, perhaps, a logical thing to do in order to prevent reform from drowning in a sea of litigation. But no comprehensive bankruptcy law has yet been crafted, and the current procedures lead to very confused and lengthy litigation. The incentives

created by the delays and confusion are clear: "Clients know how to shift assets to create new companies," asserts one Czech economist.

A related failure involves the simple establishment of the rule of law--well, simple to you and me, safely tucked into a cozy Western bed every night. In a country without an independent judiciary--indeed, where the judicial system is widely feared and distrusted (and widely disobeyed, a holdover from the hostility courts engendered during the days of communist rule)--enforcing the law isn't so simple.

Consider a civil lawsuit in the courts right now. The case springs from an instance in which an investment fund was robbed of $870,000 in assets when the securities registration agency wrongly issued fund shares to some guy who showed up with a fake passport and a forged letter demanding them. The embezzler was never captured, but he did manage to sell the shares to new "investors." So the fund is suing the Finance Ministry, which supervises the official registry system. As cut and dried as the state's liability may appear, the case is being widely followed because it is unclear if the government will make good on its mistake. While the stock registry now uses smartcards and other devices to reduce fraud, uncertainty about investor rights plainly discourages capital formation.

While Klaus's initial reform program failed to adequately ensure property rights, his government seriously exacerbated the problem by putting the brakes on the privatization of key "strategic" sectors: the railways, telecommunications, airlines, petroleum refining, gas and electricity, and, perhaps most important of all, banks. Some Czech firms were exempted from privatization altogether, remaining in the hands of government ministries. Others, while turned into joint stock companies, continued to be closely tied to government by virtue of huge equity stakes deposited in the National Property Fund, a state agency managing the government's portfolio of privatization shares. (During the privatization of large enterprises, the Ministry of Privatization approved many plans that deposited substantial ownership shares in the NPF.) While state assets with a book value of some CZK341 billion (about $10 billion) were dispersed to citizens through voucher privatization, some CZK209 billion (about $6 billion) in assets remain in state hands. According to the NPF vice chairman, Petr Cermak, the state retains significant holdings in numerous industries (see table).

But it is the banks that are crucial to the overall health of the system. They dole out capital to the various sectors of the economy, largely determining which industries will grow and which will wither, which new technologies will be adopted and which will be rejected. The government owns 49 percent of the largest Czech bank, Komercni, and between 20 percent and 50 percent of the other major ones. Jezek, the stock exchange chairman, was minister of privatization in the first elected post-communist government, from 1990 to 1992. He says the status of bank privatization is just where it was "when I left the Privatization Ministry in June 1992. Klaus made no change--nothing."

Leaving the banks in state hands undermines efficiency throughout the economy, as money is invested not just in firms which promise to show the greatest productivity gains but in failing firms for political reasons. Letting the railways remain 100 percent state-owned, for example, allows an enormous amount of featherbedding. That deprives expanding economic sectors of affordably priced labor and limits international competitiveness (particularly problematic in the currency crisis spurred by a burgeoning trade deficit). Overall, restructuring--which, even more than in the West, is a euphemism for laying off unproductive workers--is slowed because no governing party likes unemployment. With unemployment only now rising to 5 percent, the government has been persistently criticized by *The Economist* for having too *few* people out of work. The alleged culprit: state-owned banks propping up economically shaky firms.

The effect of central banking is similarly problematic. The Czech government, like all others, protects liquidity in the banking system socially. Hence, the economic irrationalities of socialism, in which firms are bailed out of the consequences of bad decisions with subsidized credit, reappear. When banks are tied to the state via social ownership, their political clout lessens the independence of the central bank, distorting credit allocation. If a bad loan made by or to a politically important customer is guaranteed by the state, there is a clear moral hazard. Lots of inefficient (or corrupt) enterprises get the money; taxpayers (and efficient firms denied credit) get the boot.

As Alena Buchtikova, an economist at the Czech National Bank, explains: "The old big state banks were privatized only partially, and the state guarantees in these banks enabled the persistence of some of the old rigidities and inefficiencies." Banks faced new clients with no economic track records and felt political pressure from above; the result was "rather uncritical lending." The problem of bad debt began a spiral, with banks preferring "to extend credit to ailing firms, rather than enforce the credit contracts, in order to hide the real extent of the nonperforming loans in the banks' balances." By June 1996, an astounding 39 percent of bank loan portfolios were "classified," meaning that "there exists uncertainty about their repayment."

Klaus's famous liberalism finally collapsed under the temptations of office. By the time he was forced to resign, he was barking at foreign investors and imposing government sanctions to keep wages in the private sector down. Even the opposition Social Democrats were complaining that 45 very large "strategic" firms held by the Klaus government should have been privatized long before. As economist Jiri Schwarz, president of the free market Liberal Institute, put it: "We are very happy with the progress we have made since 1989. But we are not at all happy with the progress we have made since 1994."

"We simply stopped," declares Jezek. He says Klaus "was interested in the transformation effect of privatization, and once that had been done, he declared it finished. It was only halfway accomplished." Jezek believes

bureaucratic inertia--precisely the factor that Klaus described in 1990 as the "reform trap"--has overtaken the zeal to privatize remaining "strategic" industries. "Many people in control of the National Property Fund are simply not interested in finishing the job," he says. "They are on boards of directors and do not desire change. Government has not the dynamism and force to finish its task."

With serious problems still to be tackled, Klaus delivered no program. He barely survived a June 1996 election, having to form a coalition government with two other parties. Blaming his coalition partners, Klaus all but shelved further efforts at economic liberalization and declared the transformation complete.

Did Klaus, the radical capitalist, turn soft on socialist control? I spent an hour with him a few weeks before he finally resigned. It was a notably contentious interview, in which he began by vehemently denying that he had ever declared any "Czech Miracle" to begin with (while pointedly invoking the term only moments later in the conversation) and then zealously defended state ownership of at least 25 percent of the economy. The question I was most anxious to ask him concerned the pace of privatization. Here's how that exchange went:

Me: "The question that a lot of people are asking now, and not just critics but people who are quite sympathetic, is, What is the current status of the privatization program? The concern is that great progress was made up through 1993 and 1994, but it seems that no progress has been made since."

Klaus: "That's really not true. [It] is a very simplified evaluation of events in this country. It is definitely much easier to start with the small privatization, to privatize small-scale businesses. It is simple, and it can be done in a very short period of time. The privatization of standard firms is more or less over....we are now privatizing with a much slower pace firms which are in [a] typical European country somewhere between the private and public sector. So, to privatize telecom, to privatize railways, to privatize nuclear power stations, to privatize some network industries in the distribution of, let's say, gas or electricity--is a ...different story. [There's] just no connection whatsoever with the transition from communism to capitalism. Most of the Western European telecoms are in...public hands, most of European railways are in...public hands. And so on and so forth."

After this curious mixture of denial and confirmation concerning the slackening pace of privatization, Klaus went on to compare the policy situation in the Czech Republic to that of France's state-owned telecommunications sector. While a country ruled for most of the past two decades by socialists, boasting a top-heavy bureaucracy, high taxes, and heavily regulated labor markets, struck me as an odd model for what Klaus had once called "capitalism without adjectives," his example was even more provocative because it was out of date: France has privatized its telecommunications monopoly and begun to open its market--as have all

the other major countries of Europe.

Bravely defending perhaps the last state-owned telecommunications monopoly in the Organization of Economic Cooperation and Development is in striking contrast to Klaus's emphatic rejection of the social-democratic "third way," and to the pledge he made in a 1990 interview with REASON ("No Third Way Out," June 1990) to attack the "giant, powerful state monopolies" with a "philosophy [that] can be summed up as *demonopolization*" (his emphasis). Perhaps, as the press has widely alleged, Klaus became fearful of the destabilizing political effects that widespread layoffs in the new firms would have, or perhaps he was seduced by the realpolitik advantages of go-slow privatization on a case-by-case basis, presided over by the governing party. Whatever Klaus's motivation in pulling back, the current situation ironically confirms his own early warnings about the disastrous consequences of slow privatization.

Transforming an entire society from socialism to capitalism is complicated business. You can be right about almost everything and still foul up some very important stuff. The process is not quite an academic exercise; when you play with real money, hopes, and dreams, conflict and gamesmanship rear their heads. Political coalitions form, group dynamics kick in, a free press piles on--and egos blow up like mushroom clouds.

So here on planet Earth, we're forced to grade on a curve. And the thing that strikes one as most remarkable about the Czech Republic's situation, post-Klaus, is how favorably that country's transformation compares to that of virtually
any other nation in similar straits. In a September 1997 draft of a forthcoming book comparing East European post-communist reform experiences, economists Patricia Dillon and Frank Wykoff of the Claremont Colleges write that "today's Czech Republic is usually considered the most successful of all the transition economies." It is not difficult to see why.

Take a look at the numbers. Even with the current difficulties, the post-transition growth rate has been stable and positive: 0.6 percent in 1993, 2.7 percent in 1994, 5.9 percent in 1995, 4.1 percent in 1996, 1.8 percent in 1997, and 2.8 percent (predicted by the Czech Statistical Office) for 1998. Labor productivity has grown an impressive 10 percent in the past year, and real wages have been rising almost as fast (7.7 percent in 1995 and 8.5 percent in 1996). This has occurred in the context of moderate inflation, rising recently to 10 percent, and very low unemployment. Both are much below the levels found in Slovakia, Poland, Hungary, and Russia.

Moreover, the Czechs are clearly leading the liberalization race. The country ranks 12th in *The Wall Street Journal*'s "economic freedom" index (compared to 21st for Germany, 64th for Hungary, and 85th for Poland), while the World Bank's "Liberalization Index" gives the Czech Republic a score of 0.93--tied with Hungary and Estonia for the freest economy in the

developing world (compared to 0.89 for Poland and 0.69 for Russia).

Given the barrage of publicity about the failure of Czech privatization to reorient the bulky, overstaffed state industries, I was surprised to learn that total industrial employment declined by *half a million workers* from 1990 to 1996 (from 1.7 million to 1.2 million). The bloated agricultural sector also has been slashed without massive unemployment: In 1990 it accounted for 8 percent of GDP; by 1995 it was down to 5.2 percent. Capital and human resources are streaming into the booming high-tech sectors and the previously starved service industries (see table).

World Bank studies show that, for all their shortcomings, the emerging Czech capital markets have tended to monitor corporate managers relatively effectively. A May 1997 World Bank report finds that, from 1992 to 1995, "Czech firms had the highest growth rates in labor and total factor productivity" among Eastern Bloc countries. The analysis even found that the much-maligned investment funds, including those owned by the banks, had performed OK. "The Czech model," the World Bank concludes, "offers useful lessons for other transition economies: the speed of privatization matters, and both more concentrated ownership and indirect ownership by banks leads to faster restructuring." In other words, Czech capital markets, compared to the relevant alternatives, work pretty well.

So the sky, while a bit darker these days, seems not to have fallen on the Czech Republic. True, growth has slowed, and real problems must be solved. But the economy has been transformed through the most aggressive reform program in the entire Eastern Bloc (save, perhaps, Estonia's), and further progress will no doubt accompany continued liberalization. Elections are likely to be held in June or November, and it is quite possible that Klaus's party, which now trails the Social Democrats by six to 10 percentage points in the polls, will become the loyal opposition. Perhaps more important, the communists have no party and no chance--a situation nearly unique in the region--and no serious electoral entity will attack Klaus's transforming achievements.

Except, perhaps, Klaus. When the prime minister announced pro-regulation policies in April 1997, *The Prague Post* reported, "Ironically, the concept of greater controls was criticized by the prime minister's allies while being heartily supported by his opponents." Klaus was finally forced from office in November 1997 by members of his own liberal coalition. One of them, Civic Democratic Alliance leader Jiri Skalicky, complained that Klaus's movement had to be saved from its leader: "I am afraid that Klaus...is trying to ruin all the good things he's done for this country." Purged of their contentious and confused messiah, perhaps the forces of liberalism can regroup. There's more of the Czech Miracle yet to be performed.

Contributing Editor Thomas W. Hazlett teaches economics and public policy at the University of California at Davis. He is a senior fellow of the Liberal Institute in Prague.

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