

The Forgotten Economic Transformation

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The concept of economic transformation has completely disappeared from the vocabulary of the current political establishment. It was replaced by the concept of revitalization. After the government approved the revitalization program, minister Grégr is trying, with the help of two important Czech commercial banks that are not in the best condition, to push through another form of revitalization which the government already once refused. It is realistic that fights over the character of revitalization within the government will make its achievement impossible. This solution would probably cause less damage. After three quarters of a year worth of discussions about restructuring of the economy, the social democrats only succeeded at completely stopping the already slowing transformation. The only positive steps are measures for the privatization of banks and regional energy distribution companies, which the social democrats are forced to accept against their will and former announcements, because of the growing budget deficit and spontaneous privatization. The government, along with the parliament, thus participates very little in the creation of conditions for a smooth economic transformation. On the contrary, it reacts too late and too slowly to the changing economic realities. In many cases, it also reacts incorrectly (for example, the national employment plan, revitalization, etc)

1. Klaus' therapy

Even Václav Klaus does not offer any new alternatives for the completion of the transformation in his catchy new book "Land Two Years Ungoverned". This readable pamphlet includes a set of strong evaluations of our post-November economic development. The positive impression is unfortunately shadowed by Klaus' therapy of our current economic problems:

- A. jump-start of the economy (by means of a clear impulse in the sector of monetary policy)
- B. revitalization of particular units of the economy (in the banking sector as well as in real economy)
- C. continuation of liberalization, deregulation and privatization
- D. improvement of the institutional system and the legislative framework

According to the author, the order of these steps should respect the time pressures and the effectiveness of the individual measures.

If we avoid searching for the scapegoat of today's economic situation among the central bank, government or the parliament, and search for the real causes of our current economic problems, we must conclude that besides the natural cyclical development of economy the other important factor was inconsistency. Inconsistency in the completion of the originally correct transformation project. This inconsistency manifested itself in the suspension of price liberalization, in an unsystemic and unfinished privatization, and in the never initiated deregulation of some economic sectors. In 1995 Václav Klaus made the same mistake that he is repeating now. Threatened by the risk of losing votes in 1996, he put price liberalization, full privatization and deregulation of some economic sectors (including railroads) on hold,

and his administration reached for effective short-run measures, for example, unsystemic and overestimated valorization of pensions, as well as other inadequate budget expenses.

2. Monetary injection

The first step of the suggested therapy – a monetary injection – might be in the current situation not only ineffective, but also counterproductive. The relevant facts are unfinished privatization of key Czech commercial banks and the consequent decision-making style of their managers, unequal position of the creditor and borrower, and a high inclination toward breaking contractual relationships. Our longtime experience shows that a growth in money supply will, by means of commercial banks, only transfer money to those that the banks are capable – hence glad – of giving it to. These are big firms, mostly owned by the state or under public-private ownership, which are currently the biggest debtors of the banks. The mixed ownership structure of these firms does not create appropriate conditions for the acceptance of basic investment decisions. That is why these firms either do not invest, and then the commercial banks have a problem with placing their loan sources, or they invest ineffectively. Given the experience of Czech banks with loans, which is frustrated by the current credit crunch, it is highly improbable that monetary expansion will help small, middle and big competitive firms gain access to money and will lead to growth in their output and productivity. Monetary injection will increase the total demand created by income growth, which will have to be saturated mostly by imported goods and services, which will benefit the growing imbalance in our balance of trade. The growing flow of money into the economy will flow abroad or it might dissolve in growing inflation, which does not have to be a problem given its current level. The central bank will, however, react by increasing interest rates, so it can attract foreign capital, which is necessary for equalizing the growing deficit in the balance of trade.

In a situation of expected increase in budget deficits, monetary injection becomes two times as risky. Expectations of positive effects of a monetary injection are too optimistic. This measure will not make access to financial resources easier for small and middle-sized companies, it will only make possible the survival of big and noncompetitive firms, and it will lower the pressure for their restructuring. This will increase moral hazard, a common occurrence in the behavior of managers of our big companies.

The title of the second suggestion of Václav Klaus, the revitalization of certain selected entities in the economy, is reminiscent of the title of the social democratic revitalization program, even though its author did not say what it could possibly entail. It probably deals with building a bridge from the opposition contract to a “big” government coalition. It is possible that only such a configuration of our political scene will force the government to lose its unrealistic expectations of the effectiveness of government interventions, which might lead to a progress in the solving of the systemic problems of our economy. Any acceptable solution must respect the requirement of minimizing economic losses.

3. Possible solution

This requirement is best fulfilled by measures that are compatible with the original project of economic transformation, which was at the time appraised not only by the majority of domestic economists, but also by renowned foreign institutions, such as IMF, World Bank,

OECD and others.

The continuation of price liberalization will not only improve market signals that are necessary for rational decision making of managers and owners of firms, but it will also have positive effects on the structure of domestic consumption, whose change will lower the pressures toward foreign trade imbalance.

Deregulation of economic sectors (electric energy, gas, pipe transport, etc) will lead to growing competition, which is the most effective regulator and in the middle-run it will certainly lead to a decrease in prices, which will have a positive effect on domestic producers, who will face lower input costs. In this way it is possible to achieve the same effects as by market protection or export subsidy, which are measures that, besides other things, keep us away from the EU or which cause problems in WTO.

Full privatization will bring, along with the long awaited foreign capital and investments – the sources of our economic growth – a positive secondary effect for the dying capital market, which is now fighting the childish illness of the Czech Security Exchange Commission.

In comparison with the nine-month time limit necessary for the effectiveness of monetary measures, which are also accompanied by great risks and uncertainties, the liberalization, deregulation and privatization measures are feasible in a comparative time limit with lower risks and higher probability of achieving a stable long-run growth.

The positive effect of these measures would be strengthened by a tax reform based on the current structural changes, and by the lowering of tax rates, which would stimulate growth in savings and investment. The consequent economic growth would eliminate the necessity of disruptive budget cuts, though the need of change in their structure is obvious.

Achievement of these changes requires more courage and commitment to fighting the special interests of lobby groups, which have overtaken the transformation of the Czech economy.

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