The Per Jacobsson Lecture

Ten Years On–Some Lessons from the Transition

Josef Tošovský

Prague, Czech Republic • 2000

ISSN 0252-3108

Editor: Gail Berre
Composition: Alicia Etchebarne-Bourdin
Cover design: IMF Graphics Section

Foreword

On Saturday September 24, 2000, the Per Jacobsson Foundation organized a lecture at the Radio Free Europe Building in Prague, Czech Republic, with the joint sponsorship of the Prague Association of Banks. The lecturer was Josef Tošovský, at that time Governor of the National Bank of the Czech Republic, and he spoke on the topic "Ten Years On—Some Lessons from the Transition."[1]

The Per Jacobsson events, which include both lectures and occasional symposiums, are usually held annually, on the occasion of the Annual Meetings of the Boards of Governors of the International Monetary Fund and the World Bank. In some years, a lecture or symposium is also organized in Switzerland with the sponsorship of the Bank for International Settlements. The foundation was established in 1964 in honor of Per Jacobsson, the third Managing Director of the IMF, to promote informed international discussion of current problems in the field of monetary affairs.

The lectures are published in English, and some are also available in French or Spanish translation. They are distributed free of charge by the Foundation (see page 28). Further information may be obtained from the Secretary of the Foundation or may be found on the website at www.perjacobsson.org. The most recent lectures are also available electronically on the website.

[1]In October 2000, Mr. Tošovský was appointed Chairman of the Financial Stability Institute (FSI) of the Bank for International Settlements.

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Opening Remarks

Jacques de Larosière

Ladies and gentlemen, it is a great pleasure to welcome you all to today's Per Jacobsson Lecture, which is being sponsored by the Prague Bankers Association.

A first word for my friend and predecessor, Sir Jeremy Morse. This is the first time I take the baton after his leadership, and I'd like to pay tribute to him.

Before I ask the president of the Bankers Association to speak, I will introduce our speaker of the day, Mr. Tošovský, and then I should make a few organizational announcements.

Mr. Tošovský, as you all know, is Governor of the Czech Republic National Bank. He was born in Náchod, Czechoslovakia, in 1950, and he has had a very interesting career. After graduating from the Prague School of Economics in 1973, where he specialized in foreign trade, Mr. Tošovský was employed at the State Bank of Czechoslovakia. He progressed through a series of posts to serve as an adviser to the president of the bank in 1982. He subsequently joined the London branch of the Živnostenská Banka, working first as an economist and later as deputy director.

In 1989, Mr. Tošovský was appointed President of the State Bank of the then Czechoslovakia, which was transformed into an independent central bank under his leadership. He helped draft and implement the Czech Republic's economic reform strategy. He has firsthand knowledge and experience of the transition process, having contributed to the achievement of macroeconomic stabilization, the building of the financial infrastructure of the post-communist economy, and the introduction of currency convertibility. He prepared and managed the split of the former Czechoslovak currency and the central bank that followed the breakup of the Czechoslovak federation in 1993. And as you all know, he was appointed Governor of the newly established Czech National Bank in January 1993.

You also know that, in December 1997, he was appointed Prime Minister of the Czech Republic in a caretaker capacity. He led the government until the early elections in July 1998, after which he returned to his position as Governor of the Czech National Bank.

I would like to pay tribute to Mr. Tošovský. I have known him for the past 11 years, and we have shared many meetings together in Basel, in particular when we were both in the same circles. He is one of the most prominent central bankers of this generation, and I am weighing my words in saying that.

Mr. Tošovský, as Governor of the Czech National Bank, has played a key role in the stabilization of the macroeconomic and monetary situation of his country. He is a man of integrity. He is a man of high principles and also, if I may add, a man of personal courage. I would like to recall in particular the crucial role he played in shaping monetary policy under difficult conditions and also the extremely courageous decisions he took as Prime Minister at the time.

We also know that he is an academic and that he has written and spoken in many circles. He is an associate professor, member of the Scientific Board, and member of the Management Board at the Prague School of Economics. He is also a member of the Management Board of Charles University.

Before I give him the floor, I should explain that today's lecture will be on the public record once it is delivered, and copies of the text will be available immediately after the meeting. In addition, the Foundation will publish the lecture, as usual, and it will soon be available on the website of the Foundation. Following the lecture, Mr. Tošovský will be prepared to answer questions. I would like to thank especially Mr. Jîrí Kunert, President of the Prague Bankers Association, which has generously sponsored this lecture and the reception that will follow, and Dr. Ivan Angelis, who supervised the arrangements. I now invite Mr. Kunert to take the floor.

Mr. Kunert: Good afternoon, ladies and gentlemen. It is my honored privilege to welcome you on behalf of the Board of the Bankers Association in Prague.

When I was asked last year by the President of the Foundation, Mr. Van Houtven, to sponsor this lecture, I didn't hesitate; I agreed, despite the fact that I didn't have the agreement of my colleagues on the Board. Later on, when I discussed it with them, they asked who would be the lecturer. I didn't know at that time who it would be; only later on were we given the name. I was even more delighted that this lecture would be delivered by Mr. Tošovský.

I was privileged to work with Mr. Tošovský twice in Živnostenská Banka, and I always enjoyed not only his lectures but also, obviously, cooperating and discussing banking with him.

We are all curious to hear what Mr. Tošovský will say, and I hope that you will enjoy the lecture.

Ten Years On—Some Lessons from the Transition

Josef Tošovský

Ladies and gentlemen, I am greatly honored to be invited to deliver this year's Per Jacobsson Lecture. I would like to take this occasion to offer you some reflections on ten years of experience with the transformation of the former centrally planned economies into free market economies. Some may wonder whether the lessons from such a transition are still relevant today. As I will presently explain, I believe that the transition process is still incomplete. And the latest *World Economic Outlook* clearly shows that there are still large differences among individual transition economies. Some have already traveled a long way toward a modern market economy, while others still have a lot of work to do. The countries whose transitions are less advanced certainly can and should benefit from the lessons and mistakes of the more advanced transition economies.

I will try to take a broad view of the issues of transition, and not focus only on the experience of the Czech Republic. But I must admit that my thinking about the issues of transition is most strongly influenced by the experiences of my own country—where I had the privilege, as governor of the Central Bank and for a short time as Prime Minister as well—to pass the whole of the last decade in helping to implement major steps in the reformation of our economy.

Early in the 1990s, as their Communist regimes collapsed, all the states of the former COMECON faced the same challenge: to learn how to do business, how to communicate, trade, and cooperate with the advanced Western world. This was a huge challenge. It required adjusting to an entirely new world; building new institutional frameworks from scratch; privatizing the economy; embarking on a far-reaching restructuring to remove accumulated distortions and deformations; and strengthening ties with the markets of the West. It also required paying off the debts of the past and acquiring enough capital to pay for the needed modernization of companies, in ways that would not burden future generations with excessive debt. Perhaps the most important and most difficult task was to change, fundamentally, the mentality of the people, so that their criterion of success would no longer be how well they meet the plan, but what profits their companies generate and how well they succeed in competing with their rivals.

Everyone knew that this could not be done overnight. But many seemed to share the naïve idea that all these changes would be achieved in a matter of several years at most. Some politicians were reluctant to admit publicly that the transition from a deformed command economy to a modern market economy might be a long and painful process. It is true that the self-confident optimism displayed by many politicians was helpful, in the beginning, in mobilizing broad support for the economic reforms. But later it led to disappointment and disenchantment when the reforms did not deliver the promised benefits as quickly as expected. Far wiser were the words of Winston Churchill on becoming Prime Minister: he promised the British people "blood, toil, tears, and sweat"—and by doing so, helped win the war.

Arguing, after ten years of transition, that most of our failures and difficulties are still rooted in the past may sound like a worn-out alibi. I do not want to belittle the problems caused by our own lack of experience, knowledge, or foresight. Many problems were also caused by unscrupulous persons who abused this period of rapid political and economic change to dishonestly amass unprecedented fortune and influence. But I would argue that even these problems are part of the legacy of totalitarian regimes.

What was this legacy, and how did it affect the economic transformation? I would like to describe some of the important ways.

The Legacy and Starting Conditions: An Objective Factor of the Transformation

Today, it is all too easy to forget the actual state of the economies that the new democracies of Central and Eastern Europe inherited ten years ago. Such forgetfulness can cause us to exaggerate the importance of the subjective errors that were made in the course of the transformation. Sometimes it can also cause the previous regime to be idealized in certain strata of society. This is why I consider it essential to remind ourselves constantly how greatly the problems and deformations inherited from the previous regime contributed to the difficulties of transition.

First of all, we must keep in mind that ten years ago the transition economies were mostly or completely nationalized. To illustrate: in the Czechoslovakia of the 1980s, state enterprises accounted for more than 87 percent of national income, cooperatives accounted for 10 percent, and only slightly more than 2 percent was accounted for by small individually owned businesses. In 1949, there were some 2 million private farmers in Czechoslovakia. At the end of the 1980s, there were only about 10,000. Sure, there were differences. In Hungary and Poland, and also in the former East Germany, small private businesses and enterprises were not so rare. But Czechoslovakia was under the control of a rigid ideology that forbade any form of "exploitation of man by man," which was a euphemism for the private sector. As a result of this almost total nationalization of the economy, a program of mass privatization was needed to move quickly to a market economy. It was simultaneously necessary to create an adequate institutional framework for this newly appearing private sector. In the clear light of hindsight, it is apparent that the second task was more demanding than the first.

The second and equally serious legacy was the inherited deformations and distortions of the real economy. These deformations took different forms. Let me mention the most important. The first deformation was the economy's exclusive geographic orientation toward eastern markets. For example, 70 percent of Czechoslovakia's foreign trade was with the countries of COMECON. After the collapse of COMECON, this heavy dependence had severe consequences for many Czech companies. Czechoslovakia's situation may be compared with that of Finland after the collapse of the former Soviet Union at the beginning of the 1990s. Finland's problems were quite serious even though Finland was much less dependent on Soviet markets than were those of the COMECON countries.

Deformations in the structures of production and trade were aggravated by the policy of economic self-sufficiency. An example will illustrate this deformation. The former Czechoslovakia produced almost 1,000 kilos of steel per capita, making it the top steel producer by that measure. There was just one problem: Czechoslovakia had no comparative advantage in steel production. Also, Czechoslovak industry produced a wide range of all possible product, and built new production facilities aimed at supplying Soviet markets, though these were gradually collapsing. Such a wide range of products did not allow the development of desirable specialization, nor did it allow industry to focus enough on improving quality and technology to the levels achieved by their Western competitors.

Last, but not least, the deformations of the real economy were intensified by excessive concentration, resulting from the deliberate creation of big enterprises and monopolies. Large enterprises had become the rule because they corresponded best to the needs of a centrally planned economy, but these colossuses created problems during the transition because dismantling them frequently caused sensitive social problems. The political changes that took place in 1989 made it possible to determine the true extent of the distortions and deformations inherent in centrally planned economies and the true magnitude of the implicit, hidden indebtedness.

As to external debt, the starting conditions of individual countries were widely different at first glance. At one end of the spectrum were the heavily indebted economies of Poland and Hungary, the latter paying off the debts of the "goulash Communism" of János Kádár. At the other end was Romania, which had inherited from Ceausescu a zero financial obligation toward other countries. His reduction of Romania's external debt to nearly zero had been achieved, however, at the heavy cost of a pauperized society and economy. From these examples, it is evident that officially reported external debt cannot be considered the only relevant indicator of favorable or unfavorable conditions for transformation.

Far more important was the growth of internal debt. An important goal of ruling Communist parties was to avoid social unrest by providing an acceptable living standard. But because the productive capacities of the Communist economies were eroded by their inherent inefficiencies, a decent living standard could only be achieved by mortgaging the future, i.e., by living on hidden debt. This hidden debt mostly took the form of environmental devastation and neglect of environmental investment, and of deteriorating infrastructure. There were other ways to keep people happy with the limited resources generated by inefficient economies, including artificial employment, free health care, and free education. State companies supported this artificial employment through their guaranteed access to bank credits and, more generally, by maintaining operations regardless of profitability. It is not surprising that the consequences of the long-standing allocation of resources based on political priorities instead of on profitability and of the low efficiency of the credits continued to haunt reformers during the 1990s, as massive amounts of bad loans began to surface.

Many of the economic problems of transition stem from human factors. Two basic kinds of problems are involved. The first is that the structure of education and the mix of skills in a command economy do not match the needs of a market economy. The second is the ways in which living under socialism shaped people's qualities, mentality, and morals.

At first glance, the former Czechoslovakia had a reasonably qualified workforce. The number of university graduates quadrupled since 1960, and the number of persons with a secondary education diploma tripled. But the workforce did not possess as wide a range of knowledge and skills as is required by a modern market economy, and this deficiency was felt most acutely during the first years of the transition.

It was even more difficult to overcome habits associated with planned economies. Instead of focusing their efforts on increasing efficiency and profits, workers and managers gave priority to complying with plans and ensuring easy plans and norms for the future. The behavior of economic agents was still being influenced by the practices native to a socialist economy, including excessive leveling of wages, whose structure did not always reflect skills and effort; a guaranteed right to work; automatic (though modest) claims for social benefits; guaranteed provision for old age; and affordable but heavily subsidized housing. These were not exactly the skills and habits needed to succeed in the intense competition of the increasingly global economy of the 1990s.

I must not forget to mention another fact which is that the behavior of people was also influenced by a relatively extensive, peculiarly socialist shadow economy. This came into existence not so much as a means of tax avoidance and evasion, but rather in response to the numerous supply shortages created by the rigid state economy. This shadow economy often operated by using inputs from state companies, which did not enjoy the same degree of protection as private property. Public property was thus used to generate private profits. This activity was frequently tolerated, serving as yet another means of keeping people happy. Unfortunately this system did not breed a strong respect for property rights.

One way or another, all of the countries striving to make the transition to a standard market economy have had to cope with the problems outlined above. In addition, the past decade saw the emergence of yet another serious problem. The economies of the new democracies were confronted with the environment of a rapidly moving globalization involving widespread liberalization of flows of goods and capital, which is to say the conditions of increasingly tough competition. Of course, all countries had to accept these changes and adapt to them. But the transition economies were at a special disadvantage. Their "delayed start" had given them much less time to adjust, and they were forced to proceed quickly with integration into the global economy and international financial system, regardless of the risks connected with such rapid integration.

Naturally each of the individual transition economies had its share of unique features, but it was the mass of common problems they had inherited that shaped the generally accepted strategy of economic reform.

It is beyond the scope of this presentation to discuss in detail the approaches of individual transition economies in implementing these reforms. But it could be instructive to discuss in more detail the subjective errors, misperceptions, and mistakes in implementation that combined with the inherited distortions and deformations to hinder and complicate the transformation process.

MISTAKES AND ERRORS: A SUBJECTIVE FACTOR OF THE TRANSFORMATION

The unique initial conditions in the transition economies of Central and Eastern Europe and the former Soviet Union called for an approach fundamentally different from the adjustment approaches applied in Latin America, Asia, and elsewhere. In these latter countries there was no need to rebuild a private sector from scratch, create a market-compatible institutional environment, or correct the serious inherited deformations and distortions of the real economy. It is likely that some of the errors made during transition stem from the underestimation of these particular difficulties. In addition, analysts from the advanced countries and from international institutions sometimes provided standardized policy recommendations that failed to take sufficient account of important special conditions affecting transition countries. Also the inexperienced authorities of newly independent transition countries sometimes gratefully accepted this flawed advice. Understandably there was occasionally a sort of competition among the newly independent transition countries that encouraged the belief that their own approach to reform was the best or only approach. Misplaced national pride thus sometimes interfered with learning from the experiences of other transition countries.

One widespread and very damaging mistake was the misconception that the systemic measures that could actually be implemented "overnight"—such as liberalizing prices and foreign trade, moving to a more realistic exchange rate, or creating market institutions on paper—would mean completion, then and there, of all the necessary institutional and structural reforms. Many analysts now agree that the present difficulties of some transition economies whose economic performance has been unexpectedly slow to catch up stem from their initial misunderstanding of the importance of institutions in a market economy.

In the advanced market economies, the institutions, legal framework, and formal and informal norms and ethics are the products of continuous and gradual development over decades. But economic transformation required the transition economies to abolish their existing institutions, laws, and norms and replace them with completely new ones. The state inescapably has an important role to play in the development of new institutions, but in fact it often failed in that role. There is little or no profit in debating, at this late date, whether this failure was a predictable consequence of the actions of old administrative structures that were unwilling or unable to grasp the nature of the institutions needed in a free market economy, or whether the failure resulted from the naïve idea that the market alone would magically mold these institutions in its own image. It is even possible that the neglect of institutional reforms resulted from purposeful behavior on the part of groups whose natural resistance to regulation—developed under the system of directive control—persisted due to their association of free market economics with opposition to any official regulation or control.

Underestimation of the importance of the institutional framework was common during privatization. Many countries, the Czech Republic prominently among them, were trying to achieve rapid privatization. At the time, the only form of domestic private capital, the cash savings of households, covered in the aggregate only a small percentage of the book value of the state properties to be privatized. In addition, the condition of many of these enterprises made them unattractive to foreign investors, while the companies that might have been attractive were usually considered too important to be sold to foreigners. Under these conditions, distributing ownership of the state's assets, free of charge, to the domestic population seemed the only way of completing the privatization process rapidly, after having exhausted the possibilities of other privatization methods, including extensive restitution of properties nationalized in the early days of the Communist regime to their former owners.

Many economists still criticize this privatization approach, saying that it did not bring in the capital needed for restructuring and that the scattering of ownership did not improve, but rather worsened, the corporate governance of the privatized companies. The authors of the privatization scheme were aware of these problems. They knew that many of the new owners would probably only be temporary proprietors, who, more often than not, would prefer to consume the dividends of ownership rather than reinvest them to enhance their companies' development. But faced with a choice between continuing the command economy for a long time or privatizing fast, the authors of the scheme chose the lesser of two evils. In a situation where the state held most of the country's productive assets, the people did not have the needed capital, and foreign buyers were not exactly flooding into the country, the standard privatization methods could not be applied. Looking back, it does not appear that the choice was fundamentally wrong, though the clear light of hindsight does reveal that some of the risks of rapid privatization were underestimated.

A serious mistake, in my view, was the neglect of the regulatory framework needed for the privatized economy to function smoothly. The unconventional method of voucher privatization, which had some claim to justification, took place in an unconventionally conceived institutional environment where the subsequent activities of the new owners were also to take place. The specific inadequacies of this institutional environment included insufficient regulation of the capital market; minimal protection for minority shareholders; and, most important, lack of transparency of the various financial operations through which the assets of the privatized firms were siphoned into the private accounts of new owners. Another very frequent error connected with privatization was the embracing of false, nationalistic ideas. In the Czech Republic, as in several other countries, the processes of privatization and transformation were hindered by polemics about unsalable "family silver" or irrational insistence that our own national way of privatization should be applied to a number of important assets.

The behavior of the new owners, who preferred consumption to improving the operation of their companies, contributed to another serious problem of the transition: namely, the growth of external imbalances. True, there were also many inherited contributing factors: the widespread shortages of the command system had created an overhang of money supply over domestic supplies of goods and an exaggerated demand for goods not previously available. In addition, current account deficits are, to some extent, a natural phenomenon of both emerging market countries and transition countries, due to the exigencies of a more expeditious restructuring. Many countries had relatively low external debts and could therefore partly finance the new consumption with easily available external resources. But the Czech Republic's reliance on foreign savings soon became excessive, even by emerging-market standards. In 1996, the inflows of foreign, mostly short-term, capital that covered the trade deficit reached a peak at 16 percent of GDP, and the gross external debt of the Czech Republic, founded only four years earlier in 1993, had tripled.

The vigor of the response of national authorities to a worsening external imbalance is affected, among other things, by the domestic political cycle in the individual countries. The approach of elections does not usually favor the implementation of necessary but unpopular restrictions. But whenever political calculations have prevailed over the objective needs of the economy, the day of reckoning has only been postponed. Hungary is an example of a country that undertook a politically difficult but economically necessary adjustment. Early in 1995, Hungary was generally viewed in the financial markets as a candidate for a crisis similar to that of Mexico. But a strong stabilization package, adopted by a government determined to maintain stringent fiscal and monetary policies, averted the crisis, and since then Hungary has enjoyed the benefits of rapid growth. But in my own country, in 1996 and early 1997, what was economically necessary was not politically feasible, and the result was the crisis of May 1997.

Here let me touch briefly on the role of central banks in addressing macroeconomic imbalances. In the advanced market economies, central bank independence has grown as political authorities and the public have gradually become aware of the advantages of low inflation and stable growth for the whole economy. It is the recognition of these advantages that has made national central banks increasingly independent of the national political cycle and the momentary political constellation.

In general, transition economies formally embraced most of the European legal framework's elements defining the position of central banks. But the principle of central bank independence embodied in that framework has not yet been fully accepted by the public and especially by politicians. When macroeconomic imbalances accumulated, central banks often had the unpopular task of announcing the bad news. If in addition a central bank responded with an appropriate tightening of monetary policy, it fell into even greater disfavor, and was blamed for the slowing of growth, increasing unemployment, and social unrest. The reaction of governments or representative bodies was to try to get the central banks under control. This political pressure has been a fact of life for the central banks of most countries in our region. I see this as a symptom of the immaturity of the transition economies, a symptom that fortunately may soon disappear as these countries become members of the European Union.

As to the financial sector, it may be said that most likely all transition economies have had one or more serious financial crisis. These crises were a result of subjective but often unavoidable mistakes and errors. I would like to emphasize the word "unavoidable" because it is the financial sector that undergoes the greatest changes in the course of an economic transition. The transformation of a centrally planned financial sector—with its full subordination to the state plan and possessing one state monobank, one insurance company, etc.—to a market economy financial sector was a complete systemic overhaul requiring the development of a totally new financial infrastructure. Institutions never seen before (e.g., capital markets) had to be created, and the functioning of those that already existed had to be fundamentally changed. The financial sectors of post-Communist countries continue to be criticized, but it should not be forgotten that the task of creating from scratch a strong, efficient, and globally competitive financial sector, operating in a suitable legal environment, was a lot to expect in only ten years. The many subjective mistakes made along the way could hardly have been avoided.

As might be expected, financial sector problems tend to be concentrated in banks. Banks were practically the only financial institutions that existed to collect savings. Therefore, in the absence of a well-developed capital market or other sources of financing, banks had major responsibilities for the success of the economic transition. Aside from the legacies of the past—nonperforming loans that had been granted under political pressure for dubious projects—there were other reasons why the costs of the transition were bound to fall on the banking sector. Some of the banks' problems stemmed from the obvious inexperience of the managers and shareholders of banks and their supervising agencies. Even more arose from the difficulty of the banks' tasks: they had to invest in an unstable environment and provide credit to unknown firms and projects that could not be evaluated because they had no history. And of course there were cases where the problems of a bank resulted from schemes to defraud clients or from corrupt lending decisions—behavior for which there is no excuse.

RESULTS

What then were the results of transition when highly unfavorable starting conditions were combined with many subjective mistakes and errors?

There have been many studies of the quantitative characteristics of developments in individual transition economies. Of course, economics cannot do without quantitative analysis. But there is the risk that an excessively mechanical interpretation of quantitative data may not fully capture either their informative value or their limitations. Achieving a five percent inflation rate may represent success for one country and total failure for another. Growth data alone may not say all that can be said about the improvement of living standards. And so on. Such limitations must be kept in mind while interpreting dry statistical data.

I will limit myself to a single very frequently used indicator of the success of any economy: the behavior of gross domestic product. A study of GDP growth rates in six transition economies indicates that the decline in GDP at the beginning of the 1990s was a general phenomenon. During the subsequent recovery, only Poland attained a GDP level that exceeded its 1989 level. Based only on these data, the 1990s might appear to be a decade of failure for transition. This conclusion would seem to be confirmed by the fact that instead of approaching the economic level of the more advanced Western countries, the transition countries seem to be lagging further and further behind.

A radical economic transformation, however, is precisely the kind of situation where calculated GDP is not necessarily the ideal indicator of a country's social well-being and its quality of life. For example, the amount of electricity being produced in the Czech Republic is presently about the same as in 1990; but its production is now much sounder from an environmental standpoint, and the general improvement in the environment is visible on every hand. Data show that emissions of sulfur dioxide were cut by more than two-thirds in the past decade, while emissions of particulate solids are down to one-tenth of their former volume. As far as I know, similar changes have also been accomplished in Hungary and Poland. Also, it is a little-known fact that during the last decade average life expectancy in the Czech Republic increased by more than three years, and it increased in Poland, Slovenia, Slovakia, and Hungary as well.

A superficial look at GDP data also fails to reveal that the production structures developed under central planning were responding to other agendas and priorities than the benefit of the consumer. As a result, GDP data alone cannot take into account the inferior quality of the goods produced under that system. Also relevant here are the ideas of János Kornai, famed for his analysis of shortages in a nationalized economy. Those widespread shortages entailed additional costs, such as time spent searching for goods, but the elimination of these costs is not reflected in the official GDP data. All these considerations undermine the informative value of a mechanical comparison of the volumes of products recorded before and after the political changes of ten years ago.

As we can see, evaluating the results of transition is quite a complex task because transition has many aspects, not all of which are captured by official economic data. If I were asked to answer briefly the question whether I consider that the transformation of the economy of the Czech Republic and other economies at a similar stage of their transition has been successful, my reply would be an emphatic "Yes!" It is true that the difficulties and problems were much greater than we could have imagined a decade ago. It is true that we made a lot of mistakes. But I think all will agree that the countries of Central and Eastern Europe that have made the most progress in adapting themselves to the conditions of a free market economy are today incomparably better off than the countries that have postponed these reforms.

Each of the transition countries has had its share of problems and its episodes of imbalances and setbacks, but the generally positive direction of the trend is beyond question. In the past ten years, the pitiful economic conditions that prevailed in the closing days of real socialism have become a distant memory, and the most advanced transition countries are serious candidates for membership in the European Union. Their maturity is attested to by the extent to which they satisfy the well-known Copenhagen criteria, which, in addition to the political requirement "that the candidate State has achieved stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities," also emphasize "the existence of a functioning market economy, as well as the capacity to cope with competitive pressure and market forces within the Union."

Today there is not time for me to discuss in more detail how this requirement is being met. Let me just mention two facts. First, the volume of trade between the Czech Republic and Germany is about the same as between Germany and Sweden. And second, the volume of trade between the transition economies and the European Union is growing two or three times faster than the total volume of trade in the whole of Europe. This evidence of increasing economic integration with Western Europe is an important signal that the transition must be regarded as essentially successful.

Conclusion

In conclusion, let me quote from a speech that the former President of the Deutsche Bundesbank, Mr. Hans Tietmayer, presented about a year ago in Prague: "There exists no theoretical model of optimal transformation. In general, it will not be possible to avoid future mistakes. The transformation of an economic system is after all one of the most complex economic tasks, mainly because neither the business sector nor the politicians could prepare for a radical historical change ten years ago."

What I find important in this quotation is his stress on the idea that the time allowed for seeking ways to complete the remaining transition tasks, and for making mistakes, has not yet come to an end. It was not possible ten years ago to design and implement the optimal procedure. How could it have been, when even today we still do not know everything about the best transformation strategy, and many issues are still the subject of intense discussion? All this makes me very cautious about drawing general conclusions and lessons from the transition process so far.

But one fact cannot be questioned. Transformation was always inescapable—a consequence of the 40 or more years of experimenting with what we called "the socialist planned economy," and what others called "the centrally planned economy." The Germans probably had the most apt expression for it: *Kommando Wirtschaft*. Had there never been this deviation from the principles of a democratic society and free market economy, we never would have had to deal here with the problems of transformation, and the economies of Central and Eastern Europe would probably not have differed much from the neighboring economies located to the west.

As events turned out, however, development in the western and eastern parts of Europe diverged diametrically. In Western Europe, living standards were improving rapidly; economies were gradually becoming more integrated; and barriers to the free movement of people, goods, services, and capital were gradually disappearing. This trend has culminated in the present with the introduction of a common European currency. Contrast this with Eastern Europe, where even the integration of economies was proceeding in compliance with directives. This is why the ten years of transition have also become the period of disengagement from dictated political and economic ties. This process has not been peaceful and free of violence everywhere, and I am grateful that the 1993 breakup of the former Czechoslovakia was conducted in a civilized manner, earning it the title of “the velvet divorce.”

The return to the standard principles of a democratic market economy—and this is the principal goal of transition—was often painful and was accompanied by many mistakes and errors. From some mistakes we can learn; others are unrepeatable and untransferable by nature. The main historical lesson is that the real root cause of all the problems was the deviation from the norm—an attempt to make human nature conform to an artificial philosophical model; an experiment that survived in our part of Europe for over 40 years. The best way to avoid the mistakes and errors of transformation therefore is never to repeat a similar experiment.

Questions and Answers

MR. DE LAROSIÈRE: Thank you very much indeed, Mr. Tošovský, for this remarkable, candid, and comprehensive presentation. The way you explained the distortions—the "deformations" as you called them—of the economy and of the planned regime, as well as the way you very lucidly described the mistakes that had been made in the process was very informative. Also, you have shown us the lessons to be drawn from these mistakes and the results which I think, like you, have been striking, given the very small number of years since you started from scratch.

We have been impressed by your vision and also by the moral point of view that you explained toward the end of your exposé, which I thought was most telling and most moving.

Now we have a number of written questions from the audience.

The transition in Russia and other countries formerly inside the Soviet Union has been marked by the emergence of mafioso criminality. How has your country managed to avoid this?

MR. TOŠOVSKÝ: I think, first of all, that we prepared a clear scenario of economic reform. We then gained public support. It was well sold to the general public. Then I must say that for us the starting conditions were more favorable than for the former Soviet Union because, before 1948, there had been a market economy and a democracy in the Czech Republic before the Communist regime started. So for some people, especially elderly people, it was just a return back to normality. Of course for the new generation the situation was completely new.

How could we avoid criminality? We didn't avoid it. It was evident in the financial market and during privatization. But probably our institutional development, despite all the criticism, was not so bad, and we were able to handle and to minimize all this. I think that, to a certain degree, criminality is probably unavoidable in such a period of rapid privatization and change of political and economic systems. I think it's part of this process because what happened in developed market economies and societies in the last hundred years or so was concentrated in our country into a very short period of time between 1990 until now.

We had to go through some difficulties. I am happy that we could minimize them, and I think that the bulk of this problem is, as concerns the Czech Republic and countries in Central Europe, behind us.

How has the independence of the central bank developed during the 1990s? Do you see any threats to it? Also, some Czech politicians say that the level of independence of the national bank is uncommon in Western economies and therefore the new law won't be an attack on the independence of the Czech National Bank.

MR. TOŠOVSKÝ: I would like to stress here that the Czech Republic and some other countries in the region didn't go through a period of very high inflation, and our country didn't experience how damaging high inflation could be for the economy and for growth. We were given a certain kind of independence by law, and we were trying to build the credibility of our central bank. The independence is not given just by legislation.

To build credibility is a long-term process, but it can be destroyed within days or even hours: for example, when there are problems in the banking sector. All central banks in the region are now under political pressure. There is no secret that the Hungarian, Czech, and Polish central banks are under pressure. As I mentioned in my presentation, the main reason is that the central bank is viewing matters from a long-term horizon, while politicians have their own political cycle—especially in newly born democracies there is no experience with such a phenomenon as an independent central bank. Then if the central bank starts to criticize the government, for example for its fiscal policies or for something else, then the central bank must be punished.

In the Czech Republic we now have a big political debate about the amendments to the Central Bank Act, which, under normal circumstances, could be quite easy to pass because we just need to make small changes to make our Central Bank Act compatible with the European Union legislation. But some politicians wish to add more amendments in order to have better control over the central bank. I think that for the guaranty of independence of the central bank, we can rely on the European Union.

Concerning the large volume of loans of Czech banks, what is the central bank doing to assist the banks with these problems, and does it stand behind them?

Mr. Tošovský: This is the biggest problem we are facing. It's a common phenomenon in all central and eastern European countries partly due to the legacy of the past; when nonperforming loans were inherited from the inexperienced commercial banks' managements and shareholders. Then, especially during and after privatization, inexperienced managers of new firms, companies without track records, and projects that were difficult to evaluate created a lot of problems.

What are we doing with old nonperforming loans and with new nonperforming loans in the 1990s? There were basically two possible approaches to deal with the problem. The first was to clean up the portfolios on the books of commercial banks at the initial stage of transition, which happened partially in some countries. But usually the problem was dealt with through hyperinflation, by reducing the debts but also destroying savings.

We didn't experience that scenario. On the contrary, from the beginning we tried to keep a very firm macroeconomic policy, and we used the method that I would call "salami." We cut off the pieces of salami when the problem arose. Now we are finalizing this process. Except for one bank, all banks are privately owned, and, before the privatization of what is now the second largest bank, there was a substantial cleaning-up operation. So the bulk of the problem has been eliminated and solved.

One more remark: don't be misled by the volume and percentage of nonperforming loans because on the other side there is a huge volume of provisions and reserves. Due to the inflexibility of the taxation system, it is difficult to write off nonperforming loans. These are more than covered by the provisions and reserves for the banking system as a whole.

What are the views of the central bank regarding the arrival of foreign banks in the Czech Republic?

Mr. Tošovský: We went through a debate, especially in the mid-1990s, about whether to keep Czech banks in the hands of domestic shareholders or to privatize them and seek foreign strategic partners.

We in the central bank solved this problem relatively early. We decided to give priority to foreign strategic partners for our banks rather than to insist on domestic ownership. It was more complicated to persuade politicians that this was the appropriate approach. The reason was that the behavior of domestic shareholders was not always in the best interest of the banks, and these shareholders didn't have enough capital to support the banks if necessary.

Now only one large bank is still facing privatization. All others are mostly owned by foreign strategic partners. We have about 40 banks in the system. More than half are fully foreign owned, and all the others are mostly foreign owned.

What is the role of the stock market in the transition process?

MR. TOŠOVSKÝ: At the beginning of 1990, we faced the task of building the whole financial infrastructure for a market economy. We had to start with a banking system that was created for another type of economic system. It was necessary to restructure the banking system completely.

Then we started to work on the other segments of financial infrastructure: first the bond market and then the stock market. The stock market had a good potential for rapid expansion in our country, especially after privatization, because suddenly out of ten million inhabitants there were six million shareholders. So it should really have been possible to build quickly a large capital market and stock exchange.

Due to improper institutional developments, however, there were a lot of problems for foreign investors and minority shareholders, and the idea of fast development of the domestic stock exchange collapsed.

Are high-tech industries emerging in the Czech Republic?

MR. TOŠOVSKÝ: I will tell you my opinion on this issue. The United States leads technological progress, but the catch-up process will mean that, sooner or later, Asia and Europe, including central and eastern European countries, will join this.

I think we have a good advantage to become one of the front-runners in this catch-up process because of our good education system, which is important for the rapid improvement of technological progress. For example, in mathematics, nuclear physics, and some others areas, our universities were not touched by communist ideologies as was political science. Our education system creates good preconditions for the fast development of technological progress in the Czech Republic.

Some analysts argue that better starting conditions in Central Europe account for the superior performance of these economies compared to those farther east. Do you agree with that?

MR. TOŠOVSKÝ: Yes, it's clear that starting conditions were better in Central Europe than farther east.

The European Union is a political "collective" and is engaged in a massive extension of regulation, i.e., control. Why, contrary to the aspirations expressed at the end of your lecture, is the Czech Republic seeking to "revert" to this new form of collectivization?

MR. TOŠOVSKÝ: That's a good question! I think the Czech Republic and other candidates can see large advantages to being a part of such an integrated circle as the European Union.

Of course, the European Union itself has a lot to do in order to improve its own institutional framework. This is rather difficult for us because we want to be a member but are not very happy sometimes with certain regulations and legislation, for example the common agricultural policy. It is even more complicated that these things are and will be changing in the European Union. So we are now targeting something that possibly will not exist in the future—we are shooting at a moving target. But we are outsiders, and if we want to join the club we have to obey the rules of the club. I believe that the benefits of being a member of the European Union for a small open economy such as the Czech Republic are important.

How will we, and you, recognize that the transition is finally over?

MR. TOŠOVSKÝ: I can tell you that some of our politicians were talking about the end of the transition in the mid-1990s. Probably they didn't realize that the end of the transition process doesn't mean just to liberalize prices and trade, introduce convertibility, and privatize the economy. This can be done relatively quickly by decision of the government.

But to develop all the infrastructure for the market economy, and especially the institutional framework, is a gradual process. Some economists believe that there is nothing we can do to speed up this process. I don't agree. I think that government can do much to speed up the process of building the needed market institutions. Once these institutions function perfectly, we can probably declare the end of the transition process period. In my view, such a date can be close to our membership in the European Union.

MR. DE LAROSIÈRE: Thank you very much, Mr. Tošovský, for this remarkable presentation and also for the very systematic, careful, and thoughtful answers you gave to the many interesting questions that were put to you.

Biography

Josef Tošovský was Governor of the Czech Republic National Bank when he delivered this lecture. Since then, he was appointed Chairman of the Financial Stability Institute of the Bank for International Settlements.

After graduating from the Prague School of Economics in 1973, where he specialized in foreign trade, Mr. Tošovský was employed at the State Bank of Czechoslovakia. He progressed through a series of posts to serve as an adviser to the president of the bank in 1982. He subsequently joined the London branch of Živnostenská Banka, working first as an economist (1984–85) and later as deputy director (1989).

In December 1989, Mr. Tošovský was appointed President of the State Bank of Czechoslovakia, which was transformed into an independent central bank under his leadership. He helped draft and implement the Czech Republic's economic reform strategy. He has firsthand knowledge and experience of the transition process, having contributed to macroeconomic stabilization, building the financial infrastructure of the post-communist economy and the introduction of currency convertibility. He prepared and managed the split of the former Czechoslovak currency and central bank, which followed the breakup of the Czechoslovak federation in 1993. He was appointed Governor of the newly established Czech National Bank in January 1993.

In December 1997, he was appointed Prime Minister of the Czech Republic in a caretaker capacity. He led the government until the early elections in July 1998, after which he returned to his position as Governor of the Czech National Bank. Under his leadership, the government restored political stability, moved forward the economic reform process, and stepped up the campaign against corruption and financial crime.

Lecturing widely at academic institutions at home and abroad, Mr. Tošovský holds the posts of associate professor, member of the Scientific Board, and member of the Management Board at the Prague School of Economics. He is also a member of the Management Board of Charles University.

In 1993, he was named "Central Banker of the Year" in Washington. In 1994, he was voted "European Manager of the Year" by the European Business Press Foundation and was awarded the Karel Engliš Prize at Masaryk University in Brno. In 1996, he was named "European Banker of the Year" by leading European economic and finance journalists.

Born in Náchod, Czechoslovakia, on September 28, 1950, Mr. Tošovský is married and has two daughters.

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1977 *The International Monetary System in Operation.* Lectures by Wilfried Guth and Sir Arthur Lewis.

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1974 *Steps to International Monetary Order.* Lectures by Conrad J. Oort and Puey Ungphakorn; commentaries by Saburo Okita and William McChesney Martin (Tokyo).

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1971 *International Capital Movements: Past, Present, Future.* Lecture by Sir Eric Roll; commentaries by Henry H. Fowler and Wilfried Guth.

1970 *Toward a World Central Bank?* Lecture by William McChesney Martin; commentaries by Karl Blessing, Alfredo Machado Gómez, and Harry G. Johnson (Basle).

1969 *The Role of Monetary Gold over the Next Ten Years.* Lecture by Alexandre Lamfalussy; commentaries by Wilfrid Baumgartner, Guido Carli, and L.K. Jha.

1968 *Central Banking and Economic Integration.* Lecture by M.W. Holtrop; commentary by Lord Cromer (Stockholm).

1967 *Economic Development: The Banking Aspects.* Lecture by David Rockefeller; commentaries by Felipe Herrera and Shigeo Horie (Rio de Janeiro).

1966 *The Role of the Central Banker Today.* Lecture by Louis Rasminsky; commentaries by Donato Menichella, Stefano Siglienti, Marcus Wallenberg, and Franz Aschinger (Rome).

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