The Ten Commandments of Systemic Reform

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Mr. Klaus is the Prime Minister of the Czech Republic. The material presented in this paper is the text of an address to the Group of Thirty at its Spring 1993 Plenary meeting in Vienna, Austria. The ideas presented in this paper are the author’s. Publication does not imply that the Group of Thirty endorses the views expressed therein.

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Introduction

The goal of my presentation is to say a few words about the prospects for the Czech Republic, drawing upon the lessons learned in the first three years of our radical economic reform. It is sufficient to say only a few words because, as most observers of the reform process know, the Czech Republic has been experiencing the fastest, most radical, and the most consistent and comprehensive economic and social transformation in the whole post-communist world.

In addition to this economic transformation, the Czech Republic has been successful in creating a standard, pluralistic political system. In last year’s parliamentary elections, the country provided a workable majority to market-oriented, democratic and liberal political leaders. For all these reasons, prospects for the Czech Republic are positive, despite the repeated negative impact of exogenous, external factors, and the country’s overall situation is stable both in economic and social terms.

Given these results, I would like to discuss basic lessons from the first three years of our “velvet revolution” that may be of interest to other reforming countries. The presentation is in the form of “Ten Commandments” for profound, fundamental, structural reform—or in our preferred terminology, systemic reform.
I – There Is No Pure Economic Solution

In such a fundamental change of an entire society, there can be no pure economic solution. The dreams of social engineers to organize or to mastermind the whole process of a systemic transformation are wrong, misleading, and dangerous. The theoretical analysis of optimal sequencing of individual reform steps that may be found in sophisticated economic journals is of academic interest only, because the reality is and will always be different. Unavoidable time lags, political and social pressures of various vested interests groups, human failures, and the unimaginable complexities of the whole transformation process make it impossible to centrally plan the origin and rise of a market economy.

II – The Role Of Foreign Aid Will Be Marginal

The role of foreign aid in the transformation process is marginal at best. First, the reform must be accomplished at home. Second, we have come to understand that asking for foreign aid in the increasingly egoistic and protectionist world of the last decade of the twentieth century is a useless activity. My everyday experience with the ambiguities of foreign assistance in the last three years confirms the worst arguments of the standard textbook criticism of development aid.

III – An Economic Shock Is Inevitable

There is absolutely no way to avoid the transformation shakeout of non-viable economic activities based on subsidized prices, artificial demand, and sheltered markets. No amount of skillful macroeconomic management, either fiscal or monetary fine-tuning, can prevent a GDP decline, an increase in unemployment, a once-and-for-all price jump after price deregulation, or a drastic devaluation before liberalization of foreign trade. Rational macroeconomic policy can, however, avoid permanent galloping inflation, repeated devaluations, state budget deficits, and growing foreign indebtedness.
IV – Dramatic Action Is Required To Restrict Macroeconomic Policy, Liberalize Prices And Foreign Trade, And Establish A Process For Privatization

Although detailed preorganized sequencing of reform measures cannot work in the real world, several basic macrorules should be followed. In describing them, I will disregard political and social factors for the sake of simplicity.

Our experience shows that reform must start with a heavy dose of restrictive macroeconomic policy. This prepares the ground for price and foreign trade liberalization and, by cutting subsidies, announces the dramatic change of the whole economic climate. A reforming country that does not implement this crucial measure exactly at this early moment inevitably falls into what I call the “reform trap.” This is a vicious circle of high inflation or even hyperinflation, repeated devaluations, growing foreign indebtedness, budget deficits, and the like. I would argue that the country that deliberately—without IMF pressure—and most vigorously implemented this unpopular step was undoubtedly Czechoslovakia.

The second, unavoidable step is a merciless price and foreign trade liberalization. This unlocks the markets, returns proper “values” to economic assets and all goods and services, changes past demand patterns, creates economic equilibrium and market clearing, and gives necessary signals to the still mostly unreconstructed economic agents operating on the supply-side of the economy. The exchange rate must become a solid nominal anchor, the point of Archimedes of the whole economic system and the only stable, unchanging nominal variable. Because of huge structural defects of the economy reflected in balance of payments deficits, it must be, however, very far from purchasing power parity level. Price liberalization must be complete, or at least overwhelming, otherwise new price distortions will be created. Wage regulation should be soft, based on indicative guidelines, or nonexistent. Foreign trade liberalization must be accompanied by wide-ranging internal convertibility of the devalued currency.

Having withstood requests for help, for bailing out, for protected markets, for subsidies, and for modernization and de-monopolization of state-owned firms, the government must initiate a rapid and comprehensive privatization process as a precondition for further changes; as a mechanism for finding real and, therefore, responsible and rationally behaving owners; and as a final blow to the ambitions of government bureaucrats to control the economy.
Other reform measures, such as tax reform, perfecting legislation, improvements of market structures, and creation of financial intermediaries and other market institutions, can be done any time they are prepared and ready for implementation.

These basic sequencing rules are neither original nor innovative. Such ideas may only seem original because they were so often forgotten or ignored.

V – Macroeconomic Policy Must Be Sustained

The most delicate task is to find the right moment for the shift in macroeconomic policy from a restrictive one to a neutral or, perhaps, even an expansionary one. This judgment is complicated by the fact of a fully independent central bank and by the rapid changes in both the velocity of money and the demand for money. The economy, undergoing such a radical transformation process, is far from being homogeneous. The turning point of the aggregate supply curve from the horizontal to the vertical segment of the curve is, therefore, very sharp and is located far below the full employment level.

The populist pressures to inflate the economy are very strong, but they must be resisted. We spent the first two years, before and immediately after price liberalization, in a restrictive policy regime with a budget surplus, then we moved into a neutral, balanced budget policy regime and continue to follow this course. It seems to me that no transforming economy has reached the stage at which it would be appropriate to release fiscal and monetary controls and to start Keynesian-like, demand-expanding policies.
VI – The Price Shock Must Be Vigorously Defended And Survived

The inevitable price shock that follows price deregulation must be preannounced, preexplained, defended, and “survived.” The original price increase reflects the inherited size of macroeconomic disequilibrium—small in Czechoslovakia but huge in Poland, Russia, and other ex-Soviet dominated countries—whereas the post-deregulation price dynamic reflects the degree of restrictiveness of the current fiscal-monetary mix. In the case of Czechoslovakia, the initial price increase in the first month was “only” 25 percent. The following three months’ rates of inflation were 7 percent, 4.5 percent, and 2 percent, respectively, and in the following 20 months, until the introduction of the value added tax at the beginning of 1993, the rate of inflation never exceeded 1 percent per month. In other reforming countries, in which inflation has fluctuated greatly, there were repeated inflation peaks and troughs reflecting inconsistencies in actual macroeconomic policy.

Two debilitating vicious circles must be avoided if the reform is to succeed: price-wage and price-exchange rate spirals. Our experience tells us that the appearance of both is directly attributable to the unnecessary failure of macroeconomic policy. In the period of the restrictive policy regime of 1990 and 1991, wages in our country were growing more slowly than prices. In the “neutral” macroregime of 1992 and 1993, wages have been growing slightly faster but the dangerous range has not yet been reached, and the wage variable has been moving consistently with other linked economic variables.

The same holds for the price-exchange rate nexus. Reforming countries usually simultaneously face a high degree of macro-disequilibrium making huge price increases unavoidable; an overvalued currency, with zero hard currency reserves and with large balance of payments deficits; and budget deficits because of loose macroeconomic policies. Nevertheless, the typical reforming country does not devalue its currency sufficiently. As a result, rising domestic prices tend to discourage exports and encourage imports; the balance of payments deteriorates; a new devaluation is necessary; imported inflation caused by the devaluation pushes prices upward; and the dangerous vicious circle unavoidably results.

In Czechoslovakia the situation was and is different. The original macroeconomic disequilibrium was relatively small, macropolicy was cautiously restrictive, and devaluation was sufficiently deep. The high rate of devaluation created enough room for necessary price and other cost increases and the exchange rate has, therefore, been stable for 28
months in spite of 75 percent price inflation that occurred in the same period. In addition, hard currency reserves have been permanently growing. This demonstrates that the vicious circle can be avoided, provided rational economic policy is followed.

VII – Economic Restructuring Requires Comprehensive Privatization

The economy cannot be restructured without a comprehensive shift in the property rights structure. To expect a change in economic agents’ behavior without privatization is unwarranted; it never happens. The perestroïka style of economic thinking, reaching the most sophisticated form in the pamphlets of Janos Kornai, suggests that the shift from a soft budget constraint to a hard one can be achieved and economic behavior changed by macroeconomic measures only. This is wrong and misleading. Rational macroeconomic policy represents a necessary but not a sufficient condition for the desired change of economic behavior.

The reforming country needs to organize a rapid and massive privatization, which can be achieved only when the government follows several nontraditional rules:

• Standard, and therefore, slow privatization methods must be accompanied by much faster nonstandard ones.

• The aim of privatization must be to find new, private owners not to maximize the government’s revenue originating from the sale of government assets.

• Privatization must start at the microlevel, not at the government level. A special government agency should perform procedural functions only. Planning, organizing, modernizing, restructuring, dividing, and de-monopolizing functions should not be initiated from above. The German Treuhandanstalt is an extreme case of such an approach.

• Foreign capital involvement is beneficial but should not be treated preferentially vis-à-vis domestic capital. The role of foreign advisors and consultants should be minimized.

The Czechoslovak voucher privatization method was extremely successful and should be tried in other countries. At the same time, I have to admit that it is difficult to restrict the activities of government privatization agencies and especially their bureaucratic attempts to control and distort the privatization process.
VIII – Transformation Costs Must Be Widely Shared

The basic reform strategy should be based on a maximum degree of sharing of non-trivial transformation costs. The concept of sharing is necessary for social reasons—to make it possible to defend and justify inevitably growing income and property disparities—as well as for economic reasons—to make it possible to bear jointly the inherited burden of excessive inventories of unsaleable products; of old, bad loans; of unfinished investment projects; of unreturnable, frozen assets in foreign countries, etc. The problem is that a tendency prevails to shift the transformation costs on to the government, which becomes the residual agent of “last resort.” Its degree of freedom to make positive, “autonomous” decisions and financial outlays, becomes smaller and smaller and its involuntary, induced expenditures dominate the state budget.

IX – Successful Transformation Requires Open Markets Abroad

The crucial role of domestic factors in the transformation process and the limited impact of foreign aid and advice has already been mentioned. The external dimension is, however, extremely significant in another respect. What we really need from the rest of the world is not aid but trade and exchange. By exchange I mean symmetrical relations based on the principles of equality.

We do not need one-way transfers because they are usually not taken seriously on either side. They tend to be misused, misdirected, or misplaced. However, we do need exchange of people, of ideas, and, most important, exchange of goods organized in such a way that both sides of the deal benefit.

That is why we are so critical of the discriminatory and protectionist measures that have greeted any success of our exports in Western markets. This phenomenon demonstrates, paradoxically, that the transformation of the post-communist countries in Europe represents a very important external challenge for Western Europe as well. It has become evident that the collapse of the Iron Curtain does not require restructuring and transformation only on its eastern side. The western side needs to adjust as well, and the necessity of doing so is no less urgent. Attempts to postpone this painful economic and social process by protectionism and by trade discrimination against former communist countries can only worsen problems on both sides.
X – Successful Transformation Requires Successful Politicians

It is absolutely necessary for the reformers to believe in the success of the reforms, to succeed in inspiring their fellow citizens, and to create broad pro-reform coalitions. Reform is not an academic problem. It is a political issue, and it is vitally important to win sufficient political support for it.

We understood at the very beginning of our transformation that building a political base is an indispensable component of reform activities. We succeeded in creating the only conservative party in the former communist world that is able to address the people and get wide political support. It required enormous political and human effort—hundreds of political rallies and endless meetings with thousands of people. In other words, it required, and still requires, permanent campaigning.

Telling the truth was a major weapon that helped us to win elections and to create a basic consensus supporting reform. A credible program, not populism; realism, not false promises; optimism and self-confidence, not pessimism, doomsday scenarios, and dreams of state paternalism. These are the preconditions for success. We hope we will have it.
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