THE COMPLEXITIES OF ECONOMIC TRANSITION: LESSONS FROM THE CZECH REPUBLIC AND SLOVAKIA

Rita O. Koyame-Marsh, Ph.D
Florida Memorial University
School of Business
15800 NW 42nd Avenue, Miami Gardens, FL 33054
United States of America

Abstract

This study examines two decades of economic transition as experienced by Czech Republic and Slovakia between 1989 and 2009. We examine the impact of historical background, initial conditions, and reform policies on the economy of both countries. We found that both Czech Republic and Slovakia experienced a transitional recession in the early 1990s right at the start of the transition and a tremendous one-time increase in the inflation rate. Both countries also saw a rise in income inequality during the transition. To correct some of the shortcomings of initial reform policies, Czech Republic and Slovakia instituted second generation reform policies that improved their economic conditions in the mid-1990s and led to sustained growth. Unlike previous studies, this paper ascertains the critical role that second generation reform policies play in a successful transition.

Keywords: Transition Economies; Economic Growth; Macroeconomics, Czech Republic, Slovakia.

JEL Classification Codes: O40; P21; E1

1. INTRODUCTION

The transformation of an economy from a command economy to a market oriented economy (capitalism) is a dynamic and difficult process that involves several stages of transformation. Transitioning countries experience these transition stages differently based on their political and socio-economic background. When researching this topic, I found that the term “economies in transition” refers not only to countries that may be emerging from a socialist-type command economy towards a market-based economy but also to countries that might be moving from a heavily regulated economy or a post-dictatorship to a democratic and capitalist society. Assessing the progress of countries in transition in any area is a complex undertaking. However, Havrylyshyn and Wolf (1999) note that output growth seems to be a unifying theme in assessing economic progress because of, among other things, the importance policymakers put on it and its impact on the immediate welfare of people in these countries. In addition, the stages of transition are just stages and do not have to be experienced in a certain order or with a certain speed in their implementation for a successful transition.

According to Donnorummo (2006), three of the main factors that affect the relative success of a transition process are the impact of historical background and conditions confronted by each country at the start of the transition, Government reform policies undertaken during the transition, and the presence or absence of military conflicts. The historical background and conditions refer to variables such as cultural traits and values, geography, relative levels of wealth, and economic structures at the start of the transition. These variables have a strong impact on the transition process but mostly in the beginning of the transitioning period. For instance, the industrial structure at the start of transition is an important determinant of initial output growth. Being located close to a larger and developed market is great for trading and output growth. Military conflicts, internal or external, also lead to complications and to delayed transition.

Indeed, military conflicts usually put a financial strain on government’s coffer and have a potential weight on fiscal policies because government’s policies and budget for the financing of the war often take precedent over macroeconomic policies. Economic reforms, such as free trade and exports expansion, often cannot be implemented due to war. Moreover, wars lead to loss in human and physical capital and cause transportation networks to become ineffective. These outcomes of wars are very detrimental to economic reforms and to the overall success of transition. Policies undertaken by government officials to reform the economy and the full commitment of reforming elites toward a market economy are also crucial to the success of the transition. Delayed reforms lead to delayed transition.

Reform policies that countries in transition can undertake include among other things trade and price liberalization, macroeconomic stabilization, privatization, legal and judicial reform, reform of public sector institutions, reform of the tax system, and restructuring of public expenditures. This study examines two decades of economic transition as experienced by Czech Republic and Slovakia. We discuss the impact of the initial socio-economic conditions at the start of the transition and that of reform policies undertaken during the transition on real GDP growth, inflation, employment, and income equality in the two countries. Our focus on reform policies is on liberalization, privatization, and macroeconomic stability. We conclude with a summary of lessons of transition as learned from this study and from the World Bank's 2002 study of economies in transition. There are two separate periods in the study of the transition of Czech Republic and Slovakia: the period between 1989 and 1993 during which the two countries were part of one country called Czechoslovakia Federation and the period after 1993 when Czechoslovakia was divided into two countries Czech and Slovak Republics. Czech Republic and Slovakia (Slovak Republic), thus, have the same transition experience before 1993 and a separate one after 1993. However, data published by international organization such as the World Bank and United Nations are done separately for Czech Republic and Slovakia even prior to 1993.

We found that Czech Republic and Slovakia, like most of the Central Eastern European countries, experienced a transitional recession and an enormous one time increase in inflation rate in early 90s. The output recession had more to do with the initial conditions at the start of the transition than with other factors, while the one time increase in inflation stemmed from price liberalization reform. The unemployment also went up in Slovakia during the 1991-1992's recession but remained stable in Czech Republic. Nevertheless, reform policies of early 90s (first generation reforms), even though not perfect, were helpful in boosting output growth in mid-90s. Second generation reform policies enacted in late-90s by the government of the two countries to correct some of the mistakes and shortcomings of the first generation reforms led to sustained economic growth in second decade of transition. Finally, both Czech Republic and Slovakia experienced a rise in income inequality during their transition period. Second generation reform policies in the two countries were heavily influenced by European Union (EU) membership requirements.

The next section of the paper examines the literature on transition economies in general and of Czech and Slovak transition in particular and found that most of the countries in transition experienced a transition recession earlier in their transition journey. Section 3 examines the initial conditions at the start of transition which are similar in the two countries because they were part of one country at the time. Section 4 discusses the reform policies undertaken at the start of transition and those undertaken later to correct the shortcomings of the earlier reforms. Section 5 and 6 examine the impact of reform policies on income inequality and economic growth. Section 7 states some of the lessons of transition learned from this study and from the World Bank's study of transition of Eastern European countries and the former Soviet Union (World Bank, 2002). The conclusion is presented in Section 8.

2. LITERATURE REVIEW

This literature review looks at both the theoretical and empirical studies of transition in general and the transition experiences in Czech Republic and Slovakia in particular. Among the theoretical studies, Shafik (1993) examined the speed , equity, and corporate governance of mass privatization program in Czechoslovakia and found that the entire program took 14 months to complete and had transferred claims on assets worth $10.7 billion from 1,491 enterprises to 85 million citizens who participated in the privatization scheme. For equity purpose and for the sake of transparency, the government of Czechoslovakia distributed to all the participants equal amount of claims worth approximately $1,250 per person. Shafik also found that after the division of Czechoslovakia, enterprises that ended up in the Czech Republic were characterized by a greater concentration of shareholdings, while those in Slovakia had ownership structures that were more diffuse.

The World Bank's 1996 World Development Report titled "From Plan to Market," examines the state of countries in transition after 5 years of transition. In this report, the World Bank recognized that while initial conditions are important at the start of the transition, decisive and sustained reforms are critical for recovery of growth and should be accompanied by social policies designed to protect the most vulnerable groups until growth takes hold. The World Bank also highlighted the need to create institutions in support of markets, and the importance of investing in people which are all critical to growth. Djankov and Pohl (1997) examined the restructuring of large firms in Slovakia by documenting the ownership changes and restructuring actions of firms based on detailed financial information of 21 firms for 1991-96 period, and interviews with top management.

Most of the 21 firms included in the sample were firms initially classified as nonviable loss makers. The authors showed that even in the absence of foreign investors and government-led restructuring programs, the majority of large Slovak enterprises were able to successfully restructure. In addition, large industrial firms in Slovakia have restructured more rapidly than expected, including firms regarded as nonviable only a few years ago. Rapid privatization is an important determinant of successful restructuring. The method of privatization and the type of owner appear to play only a minor role. Privatization to insiders, through management-employee buyouts, did not hamper restructuring in Slovakia because the new owners (old managers) invested heavily in new technology, laid off a substantial part of the workforce, sought foreign partnerships, and were prepared to sell controlling stakes to outsiders in return for fresh financial resources. They concluded that mass privatization program did not lead to weak corporate governance because of it was followed by a rapid consolidation of ownerships during which large investment funds bought out individual investors and smaller investment funds causing a substantial number of firms to be earned by large investment funds. Moreover, their findings support the belief that speedy transformation of ownership should be the main objective of privatization and not the choosing of perfect owners.

In 2002, the World Bank decided to examine once again the transition process by looking at the transition experiences of countries in Eastern Europe and the former Soviet Union after 10 years of transition from 1991 to 2000. Data collected during this ten-year of transition in these countries show that the differences in growth performance across countries had intensified. Poverty and income inequality in some countries have increased to levels not foreseen earlier. In many countries, reform efforts that started in the early 1990s have been interrupted and in some cases even stalled. The resulting effect was a sharp reverse in output recovery in some of the transition countries during the second half of the 1990s. This study also establishes that while the initial conditions played a big role in the decline of output at the beginning of transition, they did not have much impact on the variability in the recovery of output thereafter. The latter is mainly due to the reform policies instituted by each country. This study also determines that the entry and growth of new firms, especially small and medium size ones, plays a big role in creating employment and in producing economic growth. Therefore, the policymakers should use an encouragement strategy that focuses on encouraging entry of new firms in new sector of the economy.

Donnorummo (2006) provided a general framework and insights into the transition from authoritarian socialism to democracy and capitalism that started in 1989 in Eastern Europe and 1991 in the former Soviet Union. The study examined the transition from command economy to capitalism and democracy in about 28 countries. He argues that privatization is necessary but it does not have to be done all at once and that there is no model which dictates how much must be privatized. In addition, there is no single specific model of capitalism. The basics components of capitalism must exist and be dominant, but the precise shapes that these basic elements assume should be determined by the prevalent culture values, relative strength of civil society, existing economic structures, level of economic development, and security needs of each individual state/society." Most of the empirical studies on transition use cross-country statistical analysis that examines the effects of reform policies on growth. These studies found that better policies are associated with higher annual output growth even when controlling for the effects of initial conditions and external economic shocks. Aslund, Anders, Peter Boone, and Simon Johnson (1996) examined the impact of different determinants of output on growth during 1989–95. They found no significant relation between output and policy reforms while liberalization and inflation had a significant impact on end-of-period output level.

De Melo, Martha, Cevdet Denizer, and Alan Gelb (1996) and De Melo, Martha, Cevdet Denizer, Alan Gelb, and Stoyan Tenev (1997) are two empirical papers that introduced the measures of policy reform and initial conditions most widely used in the literature. The first paper introduced the Liberalization Index, defined as a weighted average of policy reforms in three areas: internal markets, external markets, and privatization and private sector entry. The focus of this paper's empirical analysis was on patterns of transition and not on models of policy response and statistical test of hypotheses. The second paper estimates a model where growth is explained by initial conditions, policy reforms as measured by the aggregate Liberalization Index or its cumulative value, and a war dummy variable during 1992-95 periods. The authors also estimate a simultaneous equations model for growth and the Liberalization Index. They found that both the initial conditions and the Liberalization Index are quite significant in the growth equation. Berg, Andrew, Eduardo Borensztein, Ratna Sahay, and Jeromin Zettelmeyer (1999) did an extensive exploration of the issues in growth model specification with annual data for 26 countries from 1991 to 1996 (different period for a few countries).

They found among other things that most of the variability in growth is associated with differences in policies rather than initial conditions. Campos, Mauro F., and Fabrizio Coricelli (2000) used contemporaneous Liberalization Index and its components on their regression of growth. They found that inflation had a significantly negative effect on growth and so did the presence of an International Monetary Fund program. The impact of Institutional variables such as the rule of law and quality of bureaucracy on growth are significant and positive.

3. INITIAL CONDITIONS

This section examines the historical background and the socio-economic conditions at the start of the transition and their impact on the economy of Czech Republic and Slovakia. As mentioned earlier, these initial conditions include factors such as cultural traits and values, geography, macroeconomics and social conditions. These factors vary considerably across countries. However, since Czech Republic and Slovakia were part of the same country at their starting point in 1990, they have the same historical and socio-economic background. It is worth mentioning that, while the impact of cultural values in the transition process is often rejected by some political scientists and some economists, they cannot be ignored. Donnorumo (2006) strongly believes that economic development starts with a change in people's culture or way of thinking. Indeed, the success of new market oriented policies and reform might require changes in some of the long standing traditions in countries in transition. For instance, societies whose dominant traits are more compatible with private ownership and open market should have an initial advantage in the transition process compared with those whose value system is controlled by powerful clan based loyalties or whose economy is dominated by informal practices. The suggestion here is not that clan based values are bad, but that countries with values that might conflict with economic structures of market-oriented societies will face more challenges in their transition process especially in the beginning.

The World Bank (2002) determined that the initial conditions of geography, history, and price and output distortions at the start of transition were only significant during the initial period of declines in Gross Domestic Product (GDP) during 1990-1992 periods rather than throughout the full ten years of transition. This was true in most of the countries in transition even after accounting for differences across countries in policy reform and the effect of external economic shocks. Thus, countries' market-oriented reform policies were not only key in alleviating the effects of the transitional recession but also in speeding up economic recovery and promoting growth in the medium term and not the initial conditions (World Bank 2002, Overview xvi).

Czech Republic and Slovakia, both former members of communist bloc countries of Europe and of Czechoslovakia Federation, started their economic transition after the collapse of the Berlin Wall in November 1989. Consequently, these two countries have the same cultural traits and values and the same historical and economic background that are shaped by about 45 years of communism. Experiencing communism for 45 years constitute a distinct advantage for Czech Republic and Slovakia when compared to other communist bloc countries of Europe which experienced 75 years of communism that ended with the implosion of the Soviet Union. Indeed, the longer an economy functions under the principles of a command economy, the more severe the handicaps in building a market-oriented economy. Geographically, Czech Republic and Slovakia are located close to Germany and the markets of European Union which gives them an advantage in trading especially when it comes to transportation cost.

Czech Republic and Slovakia also had the same economic structures at the start of the transition as part of Czechoslovakia. In 1993, Czechoslovakia federation dissolved into two independent Republics, Czech Republic and Slovakia. For more on the Chronology of key transition events in Czechoslovakia see Myant (2003). After they split in 1993, Czech Republic ended up with better economic structures than Slovakia. Czech Republic had a powerful tourism industry, especially in Prague, that kept unemployment low. In addition, Czech Republic inherited relatively medium sized industries that traded efficiently with the neighboring European Union (EU) markets. These were all positive factors that helped Czech Republic in its trade liberalization reform and in its recovery from recession of the early 1990s. Slovakia, on the other end, inherited much of the heavy and arms industries of former Czechoslovakia, a relatively unattractive industrial structure made of large industries such as steel, armaments, and chemicals that could not successfully trade in the competing markets of EU (Donnorumo, 2006). The economic conditions in the two countries at the start of the transition were quite similar even though as mentioned earlier, some of the existing macroeconomic variables are measured separately by the World Bank for the two Republics during the time when they were still part of Czechoslovakia Federation.

The per capita GDP in 1990 was $3,594.71 in Czech Republic and $3,125.00 in Slovak Republic and inflation rates was around 7 percent in the two Republics. Real GDP growth rate which was about 4.5 percent in 1989 in the two republics fell in 1991 to about -11.6 percent in Czech Republic and to -14.5 percent in Slovakia showing a deeper early recession in the later than in the former. The unemployment rate was also higher in Slovakia than in Czech Republic earlier in the transition. In 1993, Slovakia had an unemployment rate of about 14.7 percent compare with about 3.8 percent in Czech Republic (United Nations, National account, 2010). Thus, earlier in the transition, Slovakia was more concerned with higher unemployment than with the establishment of market-oriented reforms.

4. REFORM POLICIES

Reform policies undertaken at the start of the transition in early 90s are referred to here as first generation reform policies and the ones undertaken in late 90s as second generation reform policies. According to the World Bank (2002), there is a broad consensus that reforms should include the following policies even if their specific design, sequencing, and speed of implementation are still subject to debate: Macroeconomic stabilization, Price and trade liberalization, Imposition of hard budget constraints on banks and enterprises, Privatization, Reform of the tax system and restructuring of public expenditure, Legal and judicial reform, and Reform of public sector institutions. How fast and in what order should a country in transition implements these reforms is not that critical when compared to the level of commitment and the tenacity of the reformers. Indeed, there was not much theoretical guide to lead reformers on how to implements the above reform policies. So countries learned as they go, making mistakes along the way but remaining committed to the process. The impact of reform policies on transition could be strong or weak depending on whether the transitioning country is led by concerned and committed reformers who have the best interest of the people in mind or by rent seeking elites who buy political clout to prevent or delay market reforms (Aslund, 2002).

Donnorumo (2006) added that civil societies have a role to play when it comes to the commitment in the implementation of reform policies. Indeed, the strength of the civil society at the start of the transition makes a big difference because they provide a system of check and balance right from the start. A strong civil society, which do not solely rely on the political elites, help provide a sense of semi-independence from government authorities which in turn can foster political attitudes and activities that often become the driving force for change. Czech Republic showed more independence from the political elites with its voucher privatization program and commitment of its reformers to market oriented goals than Slovakia. Sequencing particular sets of reforms during the transition process might also be important as stressed in Joseph Stiglitz (2002). For instance, to build a market-oriented economy, prices must first be liberalized in order to put in place a well functioning market. Reform policies should also be implemented at the start of the transition because they have a critical role to play otherwise output growth will be solely determined by initial conditions and external economic shocks.

Respect of private property right, attraction of FDI, and the development and regulatory institutions should be an integral part of reform policies. Reform policies have a range of possible outcomes, depending on whether liberalization was implemented, hard budget constraints were imposed, and an enabling business environment was promoted and in what order and how vigorously. Softer budget constraints and hence less discipline prevailed for a long time in Czech Republic and Slovakia (World Bank 2002, overview xviii). The impact of good governance on a country's transition is just as important as the rule of law and the effective legal infrastructure that protects property rights. There is a clear correlation between good governance (laws), property rights, and economic growth (Desoto, 2000). We believe that the government has a role to play even so limited in establishing and enforcing the rules of the market. However, this paper main focus is on privatization, liberalization, and macroeconomic stability.

4.1. Price Liberalization and Privatization

Price liberalization and privatization of state-owned enterprises in Czech Republic and Slovakia happened right at the start of the transition in Czechoslovakia. As expected, price liberalization led to a one time enormous rise in inflation rate in 1991. Inflation rate as measured by GDP deflator increased to about 36 percent in Czech Republic and 34 percent in Slovak Republic (See Chart 1 below). To contain this high inflation the government of Czechoslovakia had to institute a strong tight monetary policy. Privatization of state-owned enterprises was done in steps starting with mass privatization and other methods afterward. The three common privatization methods in the literature are management-employee buy-outs (MEBOs), mass privatization, and direct sales to outside owners (see Caves, 1990; Carlin et al., 1995, and Djankov & Pohl, 1997).

Each privatization approach is different and thus leads to different results. MEBOs and mass privatization often lead to speedy change in ownership but are inferior to direct sales when it comes to the efficiency in corporate governance and better access to capital and skills. Efficient governance is usually the case when enterprises are sold to foreign owners who are more able than the locals to implement deep restructuring of the firms.

Insert Chart (1) about here

Since Czech Republic and Slovakia started their transition as part of Czechoslovakia they inherited the voucher privatization scheme of state-owned firms that started in Czechoslovakia. However, after the dissolution of Czechoslovakia each country was independent and able to pursue separate privatization policies. Czech Republic continued with the voucher privatization while Slovakia abandoned it and experimented with MEBOs and direct sales to outsiders.

4.1.1 Czech Republic

After its independence from Czechoslovakia, Czech Republic continued with voucher privatization program. However, the rapid privatization through the voucher system was counter-productive to sustained economic growth because it resulted in enterprises that lacked capital to upgrade technology and in the dispersion of ownership among small shareholders. These small voucher owners later sold their shares to big investment funds which ended up owning seventy percent of the vouchers. Unfortunately, seven of the ten largest investment funds were being held by state-owned banks with poor management skills (Donnorumo, 2006). See Myant (2003) for the chronology of reform policies in Czech Republic. Czech Republic led all the transition countries in the level of private sector as percentage of GDP which was about 2 percent of GDP in 1990 increase to about 70 percent of GDP in 1995 and reached about 80 percent of GDP by the end of 1997 (World Bank, 1999). Extensive and rapid privatization accounted for much of this shift. Strong growth in new small and medium start-up firms, with a fair amount of this coming from FDI, accompanied privatization and contributed greatly to the explosive growth in private sector share in GDP. Czech FDI increased from about 2 percent of GDP in 1993 to about 5 percent of GDP in 1995 (See Chart 2 below).

Insert Chart (2) about here

The mass privatization program was able to reallocate a large amount of property into private hands; however, it did not help introduce the needed fundamental changes in management behavior and corporate governance to a large and important segment of the business sector. Weak corporate governance allowed wages to grow above productivity increases causing a rise in production costs and erosion of competiveness abroad. In addition, a significant part of privatization in Czech Republic was leveraged, thus generating firms that had no capital but large debts. Moreover, the banking sector continued to be dominated largely by state-owned banks which were not operating efficiently and did not impose the needed hard budget constraints on the business sector.

The inefficiency of state-owned banks and the inability of legislative reform to set the proper conditions for the use of market based solutions were detrimental to enterprise restructuring. Consequently, between 1996 and 1997, Czech Republic introduced a package of reforms (second generation reform) that attended to a number of the more costly mistakes and shortcomings of first generation reforms. Indeed, there was still a great deal to be done in terms of enterprise and bank restructuring, improving productivity, employing financial and policy mechanisms that will encourage market-led restructuring, improving the regulatory and legal environment under which firm operate, and attending to measures required to bring Czech industry in line with EU requirements. Czech Republic was working toward its ascension to EU membership.

The example of Czech Republic shows that early reforms are not as important as the overall commitment to capitalism and to working hard in combating the agenda of rent seeking elites. Czech Republic overall commitment to market oriented economy resulted in strong economic growth by mid-90s and thereafter in spite of the early transition recession that it experienced. In his address to the boards of governors during the joint annual discussion of the 2000 annual meeting, the Honorable Pavel Mertlik, Governor of the bank of Czech Republic stated among other things these facts about Czech Republic 11 years of transition to capitalism (Mertlik, 2000):

- "It has proven to be much more difficult to transform the human capital, even if assets provide a fair economic base. Market skills and the market literacy of individuals are not inherited, given from God, or intrinsic to human beings. Market skills are learned by experience; individuals and societies absorb them as they grow and mature, in the way that we breathe the air.

Market skills are tacit knowledge that does not stay with the society; they can diminish if the society suppresses the market mechanism as the ruling force of economic development. This is the one aspect that crucially and fundamentally distinguishes the challenges of transition from the challenges of bringing developing countries out of poverty and up on the development path.

- The Czech experience of transition is revealing. The first generation reforms, i.e., the initial liberalization of trade and prices and the subsequent macroeconomic stabilization, had not been politically easy to implement, but became admired by the world for the speed and the smooth way of achieving macroeconomic stability, and for the ambitious and unprecedented pace of transferring property from the state to private hands via the innovative process of voucher privatization. Speed of privatization was declared the critical factor.
- Underestimated, however, were the requirements of the financial and legal systems, of auditors, of the information disclosure agencies, of the regulation of capital markets and transparency of the corporate sector, and of incentives for and accountability of managers, that would be necessary for such massive secondary trading to avoid any abuse.
- The Czech experience showed that the first-generation reforms can be implemented relatively quickly and through relatively uniform economic policies, which may be transferable from one country to another. It, however, also illustrated that the first-generation reforms do not make the transition complete and that the speed of privatization is not the single criterion, not even the most relevant one.
- The real critical aspect of the transition is the second-generation reforms, namely building of the institutional underpinnings of a market economy under the circumstances of a lack of market skills and experience, of attitudes and perceptions different from those prevailing in countries with a long and uninterrupted experience of a market economy. If the structural and institutional reforms have not been completed, the macroeconomic stability is not sustainable.
- The experience of transition also clearly demonstrated the critical importance of the legal system and the financial sector for the functioning of a market economy. The legal (and tax) systems must protect private property and provide incentives for value creation, rather than to leave room for drifting, or even asset stripping or looting. The financial system must channel funds to the most effective uses; since late last century and the first decades of this century, the world has known that this function critically requires having a broad range of information available to the public.
- Among all aspects that challenge the building of institutions and of the capacity, and can skyrocket the costs of transition, the one most critical seems to be the moral hazard issue."

4.1.2. Slovakia

Slovakia experimented with all three privatization methods: mass privatization, direct sales to domestic outside investors, and management-employee buy-outs (MEBOs). Slovakia's privatization started in Czechoslovakia with the first wave of mass privatization through the voucher program. However, after its independence, Slovakia decided to abandon the voucher privatization in favor of direct sales through auction. Partial privatization to foreign investors was carried out and was later followed by MEBOs that led to a majority inside ownership. Slovakia did not push for the voucher privatization again until 1998. For the chronology of privatization in Slovakia see Djankov and Pohl (1997).

According to Djankov and Pohl (1997), the use of MEBOS did not hamper firm restructuring in Slovakia because the new owners invested heavily in new technology, laid off substantial part of their workforce, and sought foreign partnerships. However, Miroslav (2010) on the other end remarks that privatization to domestic investors in Slovakia was challenging because it was not accompanied by strong restructuring or by strong ability to capture new markets and to grow. In addition, the banking system was still owned by the state and was politically managed causing misallocation of capital. Consequently, in 1998, Slovakia started a rigorous industrial restructuring with the consolidation and privatization of large state-owned banks and many utilities. The privatization of Slovak electrical company was the largest sale between 2002 and 2006. The restructuring and privatization was expanded to the transportation sector that included the Kosice Airport and bus companies. In addition, new manufacturing accelerated during the same time period and FDI as of percent of GDP doubles from about 1 percent in 1997 to 2.5 percent in 1998. FDI as percent of GDP reached its highest level of 16.8 percent in 2002 (see chart 2 above).

4.2. Macroeconomic Stability

Here we look at reform policies undertaken by the government of Czech Republic and Slovakia in order to attain fiscal and monetary stability during their transition process. Czech Republic and Slovakia inherited the overall macroeconomic stability of the communist Czechoslovakia with fiscal and monetary prudence. The restrictive monetary and fiscal policies continued at the start of reform in 1990 and led to a rapid fall in inflation after the initial one-time jump caused by price liberalization. Czechoslovakia also introduced a stable pegged exchange rate in 1991 that helped the country control the generated inflation.

4.2.1. Czech Republic

Czech Republic continued a fiscal policy of prudence that it inherited from Czechoslovakia. In addition, the dissolution of Czechoslovakia freed Czech Republic from the implicit liability of fiscal transfers to Slovakia. Due to its tight fiscal policy, Czech government was able to achieve close to a balanced budget from the start of the transition until 1998 when fiscal deficit rose above 2 percent of GDP. Indeed, the fiscal stance in Czech Republic became less restrictive in 1999 when the parliament approved a state budget with a deficit of 2 percent of GDP implying a deficit for the general government of about 3 percent of GDP (World Bank, 1999, p. 5). The easing of fiscal policy resulted in a soaring fiscal deficit that reached its highest level of about 6 percent of GDP in 2002 (see Chart 3 below).

Insert Chart (3) about here

Czech Republic like most of the countries in transition was impacted by the Asian regional financial crisis of 1997 that turned into a Russian and global crisis in 1998.[1] Czech Republic coped very well with regards to the financial crisis and had no appreciable long-term effect on its financial markets. There were, however, some short term effects, for instance, inflation rate which was on the downward trend increased from 8 percent in 1997 to 11 percent in 1998 (See chart 1 above) and real GDP growth rate fell by about 1 percent during 1997-1998 period (see chart 4 below). Czech Republic also decided to float the *koruna* in May of 1997.

Insert Chart (4) about here

To combat the recession of 1997-1998 and the growing inflation, the central bank of Czech Republic decided to pursue a new monetary policy in early 1998 that targeted net inflation, a narrow definition of inflation. Net inflation is a corrected Consumer Price Index (CPI) inflation that excludes the impact of changes in regulated prices and indirect taxes. The target for net inflation was set at a range between 5.5 and 6.5 percent in 1998. Net inflation declined to 1.7 percent by December 1998 well below the set target because of not only the tight monetary policy, but also the fall in domestic demand and commodity prices, including food and oil during 1998 (World bank 1999, P.11). At the same time the broad inflation rate started to decline and reached the rate of about 2.85 percent in 1999 (see Chart 1 above). Czech unemployment, however, remained very low between 3 percent and 4 percent until after the 1997 Asian crisis when it reached about 6 percent in 1998 and continued to rise attaining 9 percent during 1999-2005 periods (Chart 5 below). Czech Republic also had to tighten its fiscal policy in early 2000s to comply with the EU requirement of a budget deficit of no more than 3 percent of GDP as it worked toward its ascension to the EU membership. Fiscal deficit fell from about 6 percent of GDP in 2002 to about 3 percent of GDP in 2004 (see Chart 3 above). Czech Republic became member of EU in 2004.

Insert Chart (5) about here

4.2.2. Slovakia

Like Czech Republic, Slovakia inherited the overall macroeconomic stability of the communist Czechoslovakia with fiscal and monetary prudence. However, within the two years of its independence, Slovakia decided to abandon its tight macroeconomic policy by increasing expenditures through extensive infrastructural investment and real wage increase in order to stimulate the economy. This expansionary fiscal policy resulted in a rise in fiscal deficit from around 5 percent to about 10 percent of GDP between 1996 and 1998 (Miroslav, 2010, p. 4). The Russian crisis of 1998 also negatively impacted Slovakia by causing Slovak businesses and households to heavily speculate against the pegged exchange rate.

[1] Russian government faced with unsustainable market pressure, decreasing international reserves and a sizable amount of short-term debt payments decided in 1998 to abandon its pegged exchange rate regime. Simultaneously, it announced a 90-day moratorium on private external obligations, a restructuring of domestic government debt, and the imposition of foreign exchange controls.

As a result Slovak central bank decided to let the currency float in the market causing a widespread collapse of the industrial sector, an increase in unemployment, and a sharp economic slowdown. Unemployment rose from 14 percent in 1998 to 18 percent in 1999 (see Chart 5 above). While real GDP growth rate fell from about 5 percent in 1998 to 0 percent in 1999 (see Chart 4 above). New policies of stabilization and rapid structural reforms were introduced in late 90s (second generation reforms) by the Slovak government to alleviate some of the fiscal imbalances and to comply with EU membership requirements since Slovakia was planning to join the EU. By early 2000, macroeconomic stability was restored together with strong economic growth rate. Fiscal deficit declined from 8.2 percent of GDP in 2002 to about 2.7 percent of GDP in 2003, while GDP growth rate rose to reach about 4.8 percent in 2003 (see Charts 3 and 4 above). Slovak government also embarked in ameliorating its legal system by revamping laws on bankruptcy and corporate governance while progressively cutting corporate income tax from 40 percent in 1998 to 25 percent in 2002 (Miroslav, 2010).

It is worth noting that Slovak planned ascension to EU membership in 2004 influenced its fiscal policy of late 90s and early 2000s while its planned Euro adoption in 2009 critically affected its fiscal policy of mid-2000s. Indeed, Slovakia's objective of fulfilling the Maastricht criteria (Euro convergence criteria) for Euro Zone entry became the guiding mantra of economic policy-making of mid-2000s.[2] Slovakia joined the EU in 2004 and the Euro Zone in 2009. Second generation reform policies also resulted in the improvement in FDI, output growth and employment. The inflows of FDI in Slovakia, especially in the automobile, electronics and engineering industries and the EU funding after 2004 led to a sharp increase in productive capacities and in real GDP in Slovakia. Real GDP grew at an average rate of 6.6 percent between 2002 and 2008 and unemployment rate fell during the same time period to reach about 7.6 percent in 2008, its lowest level since the start of the transition. Inflation also declined to about 3 percent in 2008 (see Charts 1 and 5 above).

5. INCOME INEQUALITY

Czech Republic and Slovakia had lower level of income inequality at the start of transition with a Gini coefficient of about 0.20 in the 1987-90 time periods. However, the Gini coefficient in both countries rose to around 0.25 in the 1996-99 time periods (World Bank 2002, Box 1) and to 0.26 during 2000-2004 time period (CIA-World Factbook, 2010, 2005 Estimate). The rises in the Gini index show increases in income inequality in the two countries during the transition. According to the World Bank (2002), the increases in income inequality during the transition had little to do with reforms and liberalization and more to do with positive developments such as rising returns to education, decompressing wages, and emerging returns to risk taking and entrepreneurship, especially in countries of the Baltic and Central and Southeastern Europe like Czech Republic and Slovakia. The rises in income inequality in Czech Republic and Slovakia showed progress because they stem from factors which proved that the market was functioning better and was rewarding skills and efforts just like in more mature market economies. Indeed, despite the rise in income inequality, per capita real GDP has increased over time in the two countries implying an improvement in people's standard of living (see Chart 6 below).

Insert Chart (6) about here

6. ECONOMIC GROWTH

"*It is the effectiveness of reform policies in disciplining the old sector and encouraging the new that holds the key to understanding why growth has been better in some transition economies than in others.*" (World Bank 2002, Overview xvi) Both Czech Republic and Slovakia experienced an early transitional recession during 1990-1992 period resulted in a cumulative decline in real GDP of about 13 percent in Czech Republic and 23 percent in Slovakia (see Chart 4 above). These significant falls in output were not only due to the internal shocks resulting from transition, but also to the collapse of Czechoslovakia's main external markets, especially East Germany, the Soviet Union, and other CMEA countries of Central and Eastern Europe. Output decline was more severe in Slovakia than in Czech Republic because the industry located in Slovak Republic's side of Czechoslovakia was more dependent on CMEA markets. After the transitional recession, Czech GDP growth rebounded to positive rates between 1994 and 1996 just to fall again to negative rates in 1997 and 1998.

[2] Maastricht criteria required that inflation rate be no more than 1.5 percentage points higher than the average of the three lowest inflation rates among member states of the EU, that government deficit as percent of GDP not exceed 3 percent, that candidate country join the exchange rate mechanism of the European Monetary System for two consecutive years prior to the adoption of Euro, and that the nominal long-term interest rate be no more than 2 percentage points higher than the average of the three lowest inflation members states.

This second recession in Czech Republic, which resulted not only from the 1997 Asian Regional crisis but also from the 1996 recession in its main export markets in the West, especially Germany, was very mild. Czech officials had to institute new (second generation) reform policies to curb the recession and to continue restructuring their economy. Slovak economy, on the other end, which was able to capitalize on the revitalization of its key export markets for intermediate manufacturing inputs and goods with the EU and Czech Republic had a sustained growth from the end of 1993 and thereafter. Slovak real GDP grew at a rate of about 2 percent in 1993 to about 6 percent during 1994-1998 periods (see Chart 4 above). Even though the 1996 economic slowdown in Western Europe did not have much impact on Slovak output growth, the Russian crisis of 1998 affected it significantly due to the economic ties between the two countries. Slovak real output slowed down to a rate of about 0 percent in 1999 and 1 percent in 2000 (see Chart 3 above). By 2001 Slovak economy began to recover and output rose by about 3 percent as a result of fiscal responsibility and the restructuring of state-owned banks and utilities from the second generation reform policies that started in 1998. Slovakia had stronger growth than Czech Republic and its output growth has been more sustained than in Czech Republic during the 20 years of transition. Indeed, real GDP in Slovakia grew by an average yearly rate of about 5 percent between 1993 and 2008 while Czech real GDP grew by an average yearly rate of about 1.8 percent during the 1993-1998 periods and about 4 percent during the 1999-2008 periods. Slovak economy was one of the fastest growing economies of the E.U countries between 2005 and 2008, with a real GDP growth rate of around 8 percent. However, due to the global recession of 2008, both Slovak and Czech Republic real GDP declined by about 5 percent in 2009 respectively (see Chart 4).

7. LESSONS OF TRANSITION

The following are some of the lessons of transition from this study and from the World Bank (2002, overview p. xxvii-xxix). Countries that plan to move from either a command economy or a heavily regulated economy or a post-dictatorship towards a market-based economy or a capitalist society must understand that:

- In order to have a market-oriented economy, price must first be liberalized.
- Price liberalization, however, has the potential of causing higher inflation especially when it is instituted. Policymakers must use tight fiscal and monetary policy to curb inflation, otherwise it will become pervasive.
- While the initial conditions that prevailed at the start of transition are critical in explaining output decline early in the transition, market-oriented policy reforms have played a significant role in promoting subsequent economic growth.
- Civil societies have a role to play when it comes to the commitment in the implementation of reform policies. A strong civil society, which do not solely rely on the political elites, help provide a sense of semi-independence from government authorities which in turn can foster political attitudes and activities that often become the driving force for change.
- Policymakers cannot postpone the pain of liquidating and restructuring the old sector until the cushion provided by new enterprises is in place.
- Where direct sales of state assets to strategic investors - a preferred method of privatization - is not feasible, policymakers face a difficult choice between (i) privatization to ineffective owners in a context of weak corporate governance, with the risk of expropriation of assets and income of minority shareholders by those who gained control over the enterprise, and (ii) continued state ownership in the face of inadequate political commitment to transparent privatization outcomes and limited institutional capacity to prevent asset stripping by incumbent enterprise managers.
- Policymakers must create an environment that disciplines old enterprises into releasing assets and labor and encourages new enterprises to absorb those resources and undertake new investment, without tilting the playing field in favor of any particular type of enterprise. This is the encouragement strategy that is vital to economic growth.
- Breaking out of low-level equilibrium traps in which the immediate beneficiaries of liberalization and privatization have captured the state and oppose measures of encouragement such as competition and free entry that would reduce their rents is very important.
- In cases where small, medium-sized, new enterprises and second-tier businesses suffer because of uneven playing field, fiscal policy should redirect support away from ailing enterprises toward worker training and severance payments, and divest social assets such as housing, child care, and health facilities from enterprises to governments.

- External economic shocks should be expected to occur and to disrupt growth. Policymakers should take necessary measures to correct the effects of external shocks without delay.
- The practice of allowing old (state-owned) and large enterprises to avoid paying taxes and social security contributions and to avoid repaying bank debts should be avoided otherwise it will cause painful macroeconomic crises.
- Adopting second generation reform policies is necessary in order to correct any mistakes or shortcomings of early reform policies. New enterprises stand to gain from further reform.
- Developing legal and regulatory institutions to oversee enterprise management, though time-consuming, is important.

Financial system must channel funds to the most effective uses. This requires disclosure of a broad range of information to the public in order to avoid the moral hazard risk. Indeed, transparency and accountability should be high priority in transition economies for the benefit of efficiency, social cohesion, and of economic growth. A minimum lack of transparency increases the costs of transition and slows down economic growth.

8. CONCLUSION

We found that Czech Republic and Slovakia, like most of the Central Eastern European countries, experienced a transitional recession in early 90s and an enormous one time increase in inflation rate. The early output recession had more to do with the initial conditions at the start of the transition than with reform policies while the rise in inflation stemmed from price liberalization. The unemployment also went up in Slovakia during the 1991-1992's recession but remained stable in Czech Republic. Both Czech Republic and Slovakia had a rise in income inequality during their transition period. Nevertheless, second generation reform policies undertaken by the governments of the two countries to correct the shortcomings of the first generation reforms resulted in sustained economic growth in mid-90s and thereafter. Both countries' growth was affected by external economic shocks such as the Asian regional financial crisis of 1997 and the global recession of 2008.

Czech Republic and Slovakia had the same initial conditions at the start of the transition as members of Czechoslovakia Federation. They also started with the same reform policies until they split in 1993. The post 1993 macroeconomic policies in the two countries were heavily influenced by the EU membership requirements since the two countries were planning to join the EU. After 20 years of transition, Czech Republic and Slovakia's economies achieved significant economic growth. Real GDP grew by about 37 percent in Czech Republic and by around 60 percent in Slovakia during the two decades. Per Capita GDP also grew tremendously in the two countries by about 485 percent in Czech Republic changing from $3,594.71 to $21,036 and by about 463 percent in Slovakia changing from $$3,125.46 to $17,585.26 between 1990 and 2008. The two countries have also experienced an increase in their FDI in the past two decades. FDI as percent of GDP more than double during the transition rising from about 2 percent in 1993 in both countries to above 4 percent in Slovakia and above 5 percent in Czech Republic in 2007.

While unemployment followed similarly shaped paths in both countries, the difference in levels is striking. Being very low before the transition, the Slovak unemployment rate reached 14.7 percent in 1993 while Czech unemployment rate stayed low at about 4 percent during the same year. The unemployment rate in Czech Republic was strangely low when compared with all CEE countries which had unemployment rate exceeding 10 percent. One of the reasons for the persistently low jobless rate in Czech Republic was the fact that labor costs expressed in dollar terms were low enough to prevent some of the painful lay-offs. However, such relative low labor cost was not unique to Czech Republic, yet only Czech Republic unemployment remains at such low level (World Bank, 1999).

After two decades of transition, both Czech Republic and Slovakia experienced tremendous growth in their economies, however, by 2009 Czech Republic's GDP as share of world output grew to be twice as big as that of Slovakia. Czech GDP as share of world output in 2009 was 0.37 percent compared with 0.15 percent in Slovakia. In addition, the IMF ranked Czech Republic in 39th place and Slovakia in 59th place out of 181 countries based on their 2009 GDP measured in current U.S$ (IMF, 2010). This shows that Czech Republic is doing much better economically than Slovakia. In addition, Czech Republic was listed in 2009 as an emerging economy by the Economist magazine and the Wall Streets Journal while Slovakia was not (Global Edge, 2009). Should we, thus, say that Czech Republic transition is over? The answer is yes if based on the above arguments. Nevertheless, the general question still lingers. When can we really say a country's transition is over? What are the factors that signal the end of transition one might ask?

According to the World Bank, a country is at the end of its transition odyssey when the wide dispersion in the productivity of labor and capital that existed across different types of enterprises at the onset of transition vanishes and the differences between old and new sectors fades away during reform. Indeed, enterprises in a typical transitional economy can be distinguished by history, that is, if they are new, restructured, or old. They can also be distinguished by economic performance: are they productive? Since history and performance are related, new enterprises are expected to be more productive than restructured enterprises, which are expected to be more productive than old enterprises. As markets develop and resources are allowed to flow to their most valued uses, the role of history progressively weakens, and disparity in productivity amongst the different categories of enterprises also tends to disappear. When a country reaches this point, it can consider the transition to be over. The economic issues and problems policymakers must deal with at that point would no longer be specific to transition (World Bank, 2002, overview xix).

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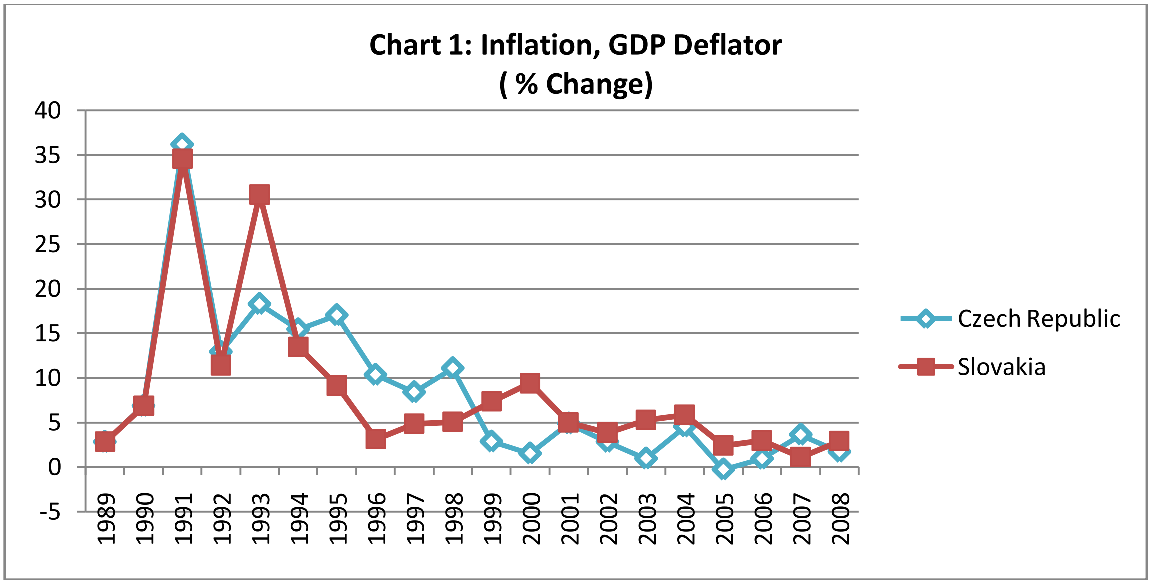
Figures



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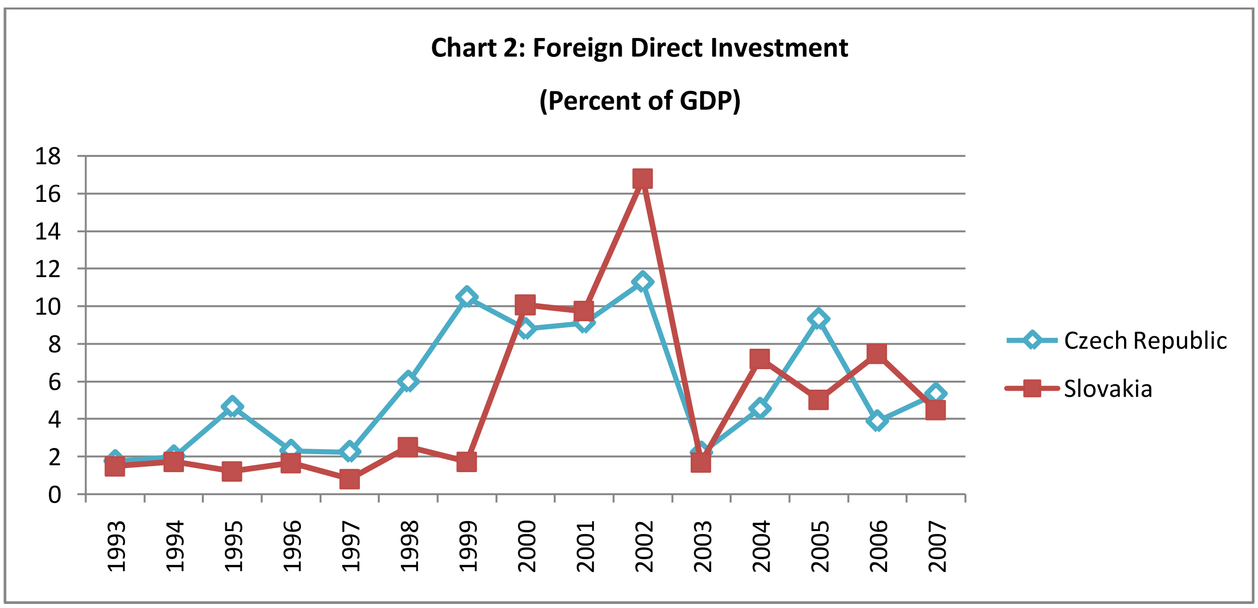

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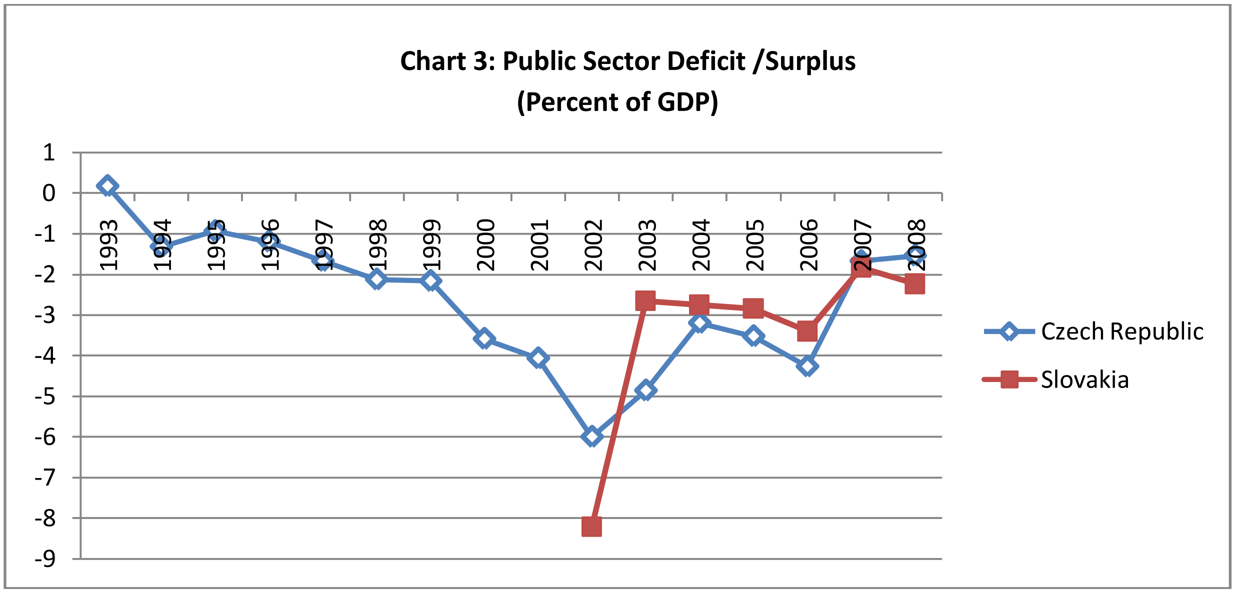

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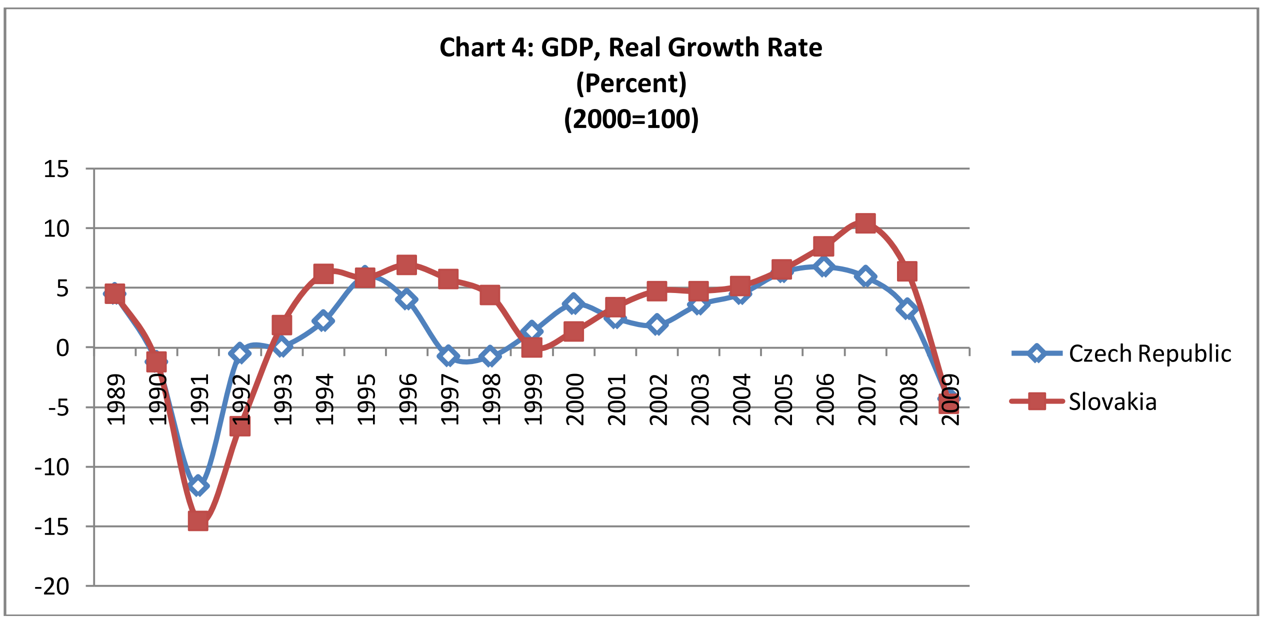

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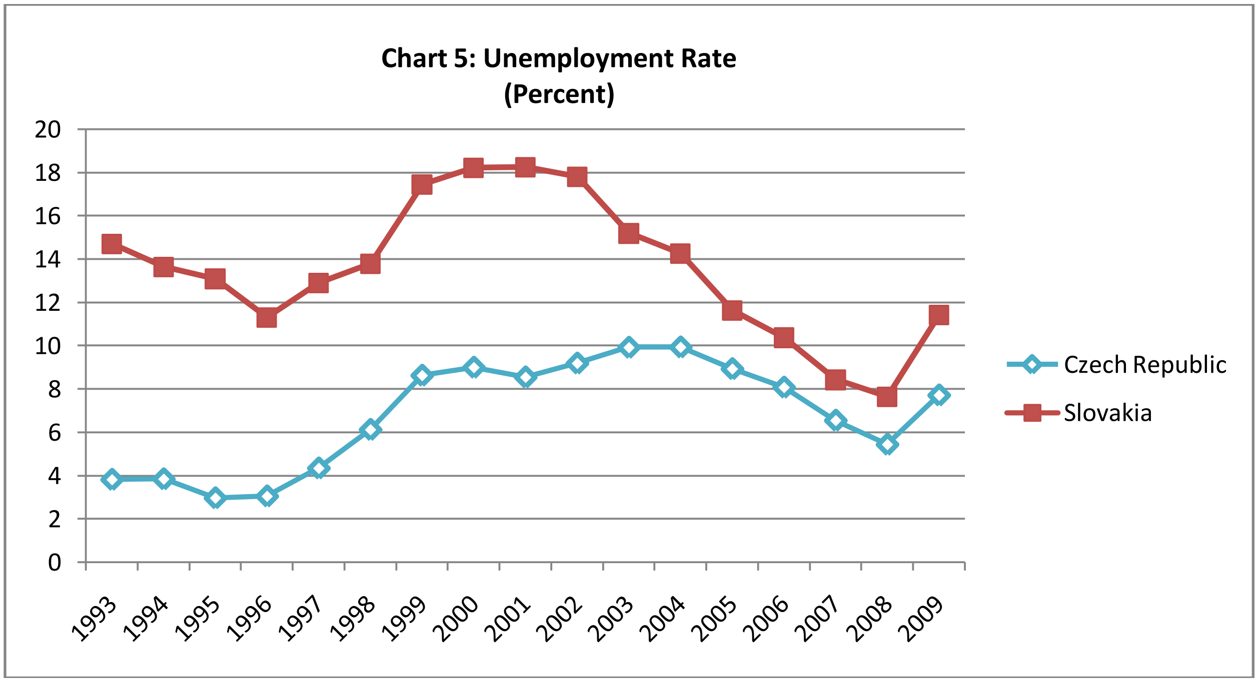

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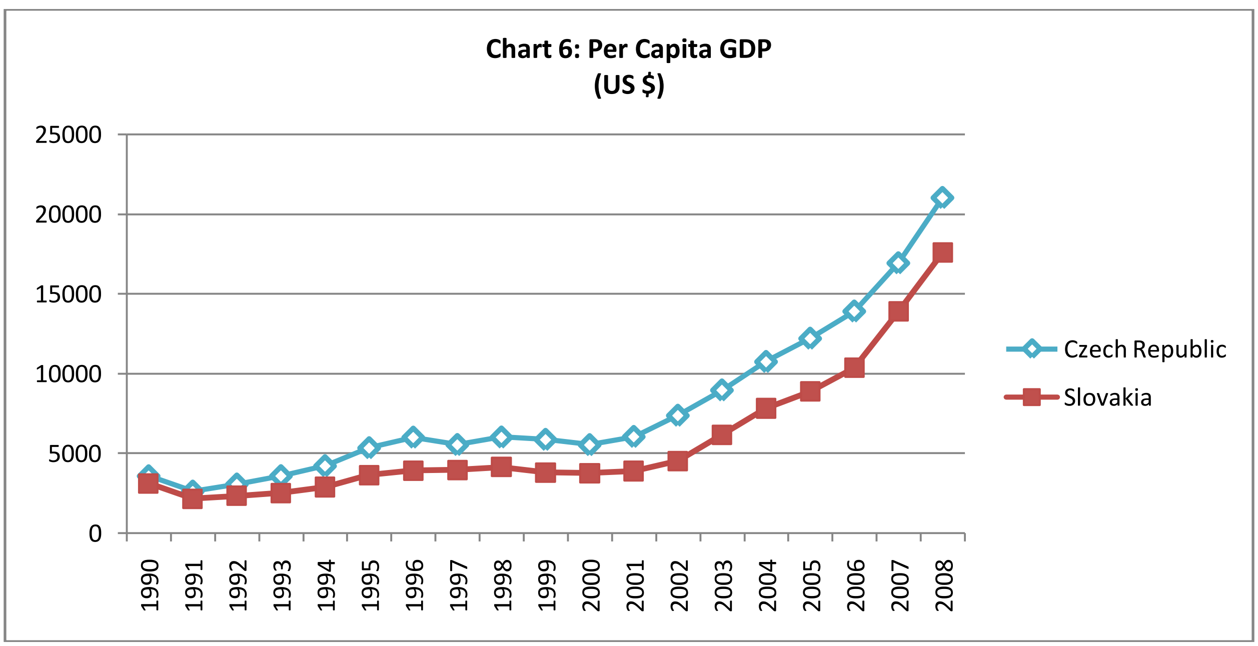

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