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**The Economic Transformation of the Czech Republic:  
Challenges Faced and Lessons Learned**

by Václav Klaus

The collapse of communism in the Czech Republic (then Czechoslovakia) in 1989 produced an extraordinary euphoria among the Czech people. It created an unusually great unity in the whole country. As reformers, we knew then that that unity was explicitly negative. The people were united “against something,” not “in favor of something.” Fortunately, that was enough to allow us to look for the way forward. It seems almost unimaginable today, but for the majority of people the alternative to communism in our country was not capitalism. A utopian “third way” was being sought and promoted.

Proponents of the third way opposed the establishment of political parties, defended so-called nonpolitical politics, and claimed an exceptional role for intellectual and cultural elites in the running of the country. Theirs was a neocollectivist vision of society that rejected liberal democracy. In essence, promoters of the third way advocated “postdemocracy.”

The proponents of the third way did not want to change the existing economic system; they wanted merely to deepen perestroika. They wanted to realize the 1960s’ idea of convergence of the economic systems of socialism and capitalism. They did not trust the market. Instead, they believed in an enlightened economic center, which would, with the aid of the Internet and popular managerial pamphlets, wisely

organize the economy. They wanted to privatize only small businesses and give the larger ones to their employees. They feared selling “the family silver” abroad, and so on.

When it came to foreign policy, the proponents of the third way intended to make the Czech Republic a bridge between the East and the West and create a new world that would eliminate the faults of both. They wanted to abolish the Warsaw Pact and the North Atlantic Treaty Organization at the same time. They were idealists without a realpolitik understanding of foreign policy who mocked the long-term national interests of the Czech Republic.

It is necessary to remember that the conflict at that time was not between authentic reformers on the one hand and apologists for the old order or former communist officials on the other. The communists knew very well that they had lost, and for that reason they had no, or only very small, political ambitions—at least in the short run. The communists did not have any influence on the discussion at the time the Czech economic transformation began.

Those who hindered a thorough overhaul of the Czech economic system belonged to two influential groups. The first group consisted of the communist reformers of the 1960s, who were expelled from the Communist Party after the Soviet invasion in 1968. Their wish was to implement their 20-year-old reform agenda. The second group consisted of the anti-communist dissidents from the cultural and intellectual sphere. Led by Václav Havel, my predecessor as president of the Czech Republic, the group wanted to create something new—something without the faults of either liberal democracy or communism. The world, they reasoned, was supposed to be governed by a chosen few. They considered market forces *demeaning*. It is not an accident that Mr. Havel recently said that “the invisible hand commits various clearly visible crimes.”<sup>1</sup>

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## Promoting Democratic Capitalism

A different, relatively small, group of people was not afraid to say that the goal of transformation in the Czech Republic was capitalism and a parliamentary democracy. That group knew that it was necessary to say where they wanted to go, outline how to get there, and convince the Czech public to move in that direction. That group, of which I was a part, pushed for the adoption of the Scenario for Economic Reform by the Federal Parliament of the then-Czechoslovakia in the fall of 1990. A compromise document, the Scenario for Economic Reform, contained the main policies needed for the liquidation of the institution of the centrally planned economy, not just the partial adjustments that were advocated by others. Those policies included annulling thousands of orders and bans, allowing Czech and foreign subjects to enter the market, liberalizing prices and foreign trade, and privatizing state enterprises.

All the while, we kept in mind the two indispensable preconditions for the success of economic transformation: macroeconomic stability and gradual creation of the infrastructure needed for the functioning of the market. All of us who were thinking about economic reforms at that time knew that it was necessary to take all of those steps simultaneously. We did not consider any of them less important than the others. However unbelievable it might sound today, we had to fight hard over every sentence in the Scenario for Economic Reform.

We knew that there was nothing to wait for, because the euphoria that followed the collapse of communism would not provide us with unlimited time and room for unpopular and painful steps. We knew that it was necessary to take advantage of the temporary weakening of all the various interest groups, which, as Mancur Olson explained, would under normal circumstances obstruct change, and promote their own special interests. We knew that any fundamental change in a free democratic society is, not an exercise in applied economics, but a real social process, which cannot be designed and gradually implemented by constructivists. (Thus, the advice given by Joseph Stiglitz—that we should have made our transformation more gradual as the Chinese have done—is laughable.) Also, we had to avoid partial reform because partial reform creates new disequilibria that harm the economy as a whole. It was, therefore, essential to take a big step and create a “critical mass” of reforms that signaled that there would not be a return to the past.

We also knew that we could not destabilize the economy and with it millions of people’s lives. We had to minimize inflation as well as the unavoidable losses of output—some of which, unfortunately, was irretrievably lost. We tried to achieve the best possible shape of the proverbial J-curve. If we were to create our own “Tobin’s” index showing the losses suffered by the Czech economy because of transformation, I am confident that it would be the most favorable such measure among all the transforming countries.

The key to minimization of transformation losses was a cautious fiscal policy—in particular a surplus budget in 1990—and a cautious monetary policy. That allowed us to avoid the risks resulting from price and foreign trade liberalization, a price-wage spiral, and an exchange rate spiral. It

can be said that we did avoid them even though—especially when we were looking for the correct rate of devaluation of the Czechoslovak crown at the end of December 1990—we did not sleep for a few nights.

## The Critics and Our Accomplishments

In the end, we did only what we were allowed to do by the social and political consensus of that time. But it was far from being all that we dreamt about and that we considered correct. Other evolutionary, but not revolutionary, changes would follow, and the system would be fine-tuned in the future and within the framework of the intricate process of parliamentary democracy. (I believe that much concerning the challenges we faced was not understood by those who criticized us then and is still not understood by those who criticize us today.)

Over the years, we were criticized for price liberalization in a monopolistic economy. But we knew that that monopolistic structure was the main reason for parallel liberalization of foreign trade. Essentially, we had to “import” competition. The results bore out our hypothesis, and our country had the lowest rate of inflation of all countries where prices had been liberalized.

We were also criticized for the extent of the crown’s devaluation, but our rate of devaluation secured our main aim—equilibrium of the balance of payments. We also won our fight with the International Monetary Fund when we refused to accept the even greater devaluation that the IMF advocated. The exchange rate survived at the level chosen by us in December 1990 for six long years.

We accepted the dominant doctrine at that time that argued in favor of a fixed exchange rate as the only possible anchor of a sharply fluctuating transformation economy—even though I feared that measure. We wanted to liberalize prices and trade and fix the exchange rate afterwards. It came out well. Unfortunately, after a couple of years, we missed the moment when we should have left the fixed exchange rate. That mistake was partly responsible for the exchange rate problems of 1997. (I consider amusing a recent criticism that I promoted the fixed exchange rate at that time but today do not want to fix our exchange rate by accepting the euro. In 1990 the fixed exchange rate was a key element in the stabilization of our economy, whereas today it would lead to our economy’s destabilization.)

Moreover, we pushed for privatization of businesses as we found them and not, as some of our critics wanted, after first bailing them out financially. If we were to wait for the financial bailouts to happen, transformation would be stopped. Calls to postpone the beginning of transformation until the economic institutions and the rule of law were perfect (and they never are) were similarly wrongheaded. We knew that institutions and legislation are endogenous rather than exogenous. We knew, therefore, that they would have to evolve gradually. We recognized that the faster that happened, the better, but we also recognized that institutions and the rule of law cannot be created in the offices of a few reformers.

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## Note

1. Václav Havel, *Questions of Václav Moravec: Part 1*, Czech TV1, January 1, 2006.