Czech Transformation Strategy and its Economic Consequences: A Case of an Institutional Failure (or the Economic Consequences of Mr. Klaus)[1]

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Introduction

This paper is concerned with selected institutional aspects and problems connected with the Czech 'neo-liberal' transformation strategy[3] that was implemented in the Czech Republic during the 1990s. Transformation should create conditions for economic and social development, for the overall modernization of the national economy and society, and for a catching-up process resulting in the closing of the economic performance gap between a post-Soviet economy and developed market economies. To fulfil this task, the transformation should create an adequate institutional framework. However, even after twelve years of transformation of Czech society and economy, private property is not guaranteed enough due to an inadequate legislation and court system. The voucher privatization scheme and a trial to re-create a Czech entrepreneurial elite with an important stake in the national

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3 Taking into account that this transformation strategy was implemented with considerable neglect to its legal framework, we can question its neoliberal nature in the European traditions of classical liberalism and neoliberalism.

economy resulted in serious complications and hurdles for the process of modernization. This situation has been getting better only after 1998 due to EU pressure and the acceptance of EU legislation that has served as an institutional anchor.

1. May We Speak about an Institutional Failure in the Case of the Czech Transformation?

Due to an advantageous starting position for transformation in comparison with the majority of other Soviet-type societies, expectations of rapid and successful transformation prevailed in the Czech Republic after the November Revolution of 1989.[4] During the first half of the 1990s, the Czech Republic was frequently considered as a case of successful transformation and rapid institutional transformation. Selected favourable macroeconomic data were used to support this assessment. At that time we could only find a small number of Czech social scientists and politicians who doubted the Czech 'neo-liberal' transformation strategy and its effects. However, since at least 1997, it was quite clear that the Czech transformation strategy was in some important respects mistaken and that it should be fundamentally corrected if we required it to push the Czech economy into a sustainable growth trajectory.

There were important institutional drawbacks, and the macroeconomic performance of the Czech economy was unsatisfactory as well. During the period 1990-2000, the Czech economy was unable to increase its economic performance. The gap in productivity that separated it from the economy of the European Union was increasing. In the case of the Czech economy, an average rate of growth of more than 4 per cent is necessary for decreasing the gap between its performance and the average performance of the European Union. However, during 1993-2000 the Czech economy reached an average rate of growth of only 1.4 per cent (*Studie*, 2001: 35; calculation of indicators based on *CESTAT Sta-*

4 There was, however, one important drawback. Until 1990 almost no private property existed in the Czechoslovak economy.

tistical Bulletin, 1997-2000), and if we tried to include the period 1990-1993 it would be even worse due to the transformation recession.

We may rightly speak about almost ten years of stagnation of the Czech economy on the basis of its macroeconomic performance during the 1990s (Table 1). The relative position of the Czech economy in comparison with the EU average worsened. In 1990 the Czech GDP per capita in purchasing power parity was about 69 per cent of the EEC average (at that time the GDP per capita of Greece was about 59 per cent of the EEC average and the Portuguese GDP per capita about 62 per cent of the EEC average). After ten years of transformation, the Czech GDP per capita in purchasing power parity decreased to 59 per cent of the EU average GDP per capita (the Greek increased to 67 per cent and the Portuguese to 74 per cent) (*Studie*, 2001:143, indicators based on *OECD* 2000).[5]

Table 1. Main Macroeconomic Indicators in the Czech Republic

Indicator	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Real GDP (rate of growth, %)	0.6	2.2	5.9	4.3	-0.8	-1.0	0.5	3.3	3.1	2.0
Inflation (CPI, average in %)	20.8	10.0	9.1	8.8	8.5	10.7	2.1	3.9	4.7	1.8
Rate of unemployment (average in %)	3.5	3.2	3.0	3.9	4.8	6.5	8.7	8.8	8.9	9.8
Net FDI Inflow % of GDP	–	–	4.9	2.4	2.5	4.6	11.4	9.8	9.6	11.9
Gross foreign debt % of GDP	–	–	33.1	36.7	40.8	42.7	42.0	42.1	37.6	34.0

Source: Czech Statistical Office, Czech National Bank.

Taking into account the original ambitious aims and the economic potential of the Czech Republic, we can seriously speak about a considerable failure of the 'neo-liberal' transformation

5 Comparing the statistical figures before and after the transformation of a Soviet-type economy, we should be cautious as there used to be an extensive vicious circle of 'production for production', huge shortages and a very low quality of goods.

strategy. Processes of transformation and social and economic development are very complex, and it is impossible to separate the impact of different factors. There is no direct method of measuring their effects, and existing trials to quantify transaction costs do not seem very persuasive. Anyway, as I argue in this paper, it can be clearly seen that institutional factors played a very important role in those unsatisfactory results. On the basis of macroeconomic indicators, and facts about microeconomic development and the quality of the legal framework and its enforcement in the Czech Republic, we can clearly conclude an institutional failure of the Czech 'neo-liberal' transformation strategy.

2. Transformation as institutional change

In any theoretical perspective, the institutional structure of the 'former' and 'transformed' society and economy play a very important role in transformation strategies. Hundreds of new formal institutions and organizations have to emerge during the transformation process.

A completely new legal system has to be created. A system of independent courts, civic and commercial law with 'standard' institutes of contract, penalties for their violation, and so forth have to be instituted. Assets in state ownership have to be privatized, and a genuine 'green-lawn' private sector and ownership transparency in public sector have to be created. An efficient internal revenue service with a new tax and fiscal system has to be instituted. The public welfare system has to be reformed. Money and capital market institutions and organizations must be formed.

According to institutional economics, institutions are understood as generally accepted and embedded rules, regularities or routines of social life and behaviour, and not as formal institutions only (see Hodgson, 1993). Institutional economics distinguishes formal and real institutional change. Formal institutional change is the process of deliberate change of institutional settings. Real institutional change includes the functioning of the new institutional setting and its efficiency. In this connection, social acceptance of formal institutions and informal social identification with them is crucial. Real institutional change may be considered complete when the new institutions form a part of everyday life or are internalized by the majority of the population.

The institutional framework encompasses the legal framework, the distribution of property rights, government regulatory bodies, various self-regulatory market institutions and organizations representing the interests of different social groups, and so forth. In the Czech Republic, progress in creating a new formal institutional setting and new organizations in the process of 'creative destruction' of the Soviet-type institutional and organizational setting cannot be questioned as such. From this point of view, the main reform steps were carried out during the first half of the 1990s. Hundreds of new acts were passed, the whole structure of government bodies and agencies changed, new public agencies were created, a large part of the national economy was privatized in one small-scale privatization and two subsequent waves of large-scale privatization, and a significant genuine private sector has emerged, a two-tier banking system was established, and money and capital markets emerged. What should be questioned, however, is the quality of the new legislation and its enforcement. Even taking into account that the processes of internalization of formal institutions are, by their nature, time consuming, progress in real institutional change was much slower. In many respects we may speak about important institutional failures or about very incomplete and inefficient enforcement of formal institutions.

According to a very novel Czech economist, Lubomír Mlčoch, a Soviet-type economy may be in reality considered a kind of very specific market economy, based on informal 'entitlements' connected with 'coalitions of control groups consisting of the top managers, party leaders and external members from the upper strata of the planning and managing machinery'. These 'entitlements' were very loosely defined and their execution was often connected with physical coercion, but they formed a natural nucleus of the property rights structure under so-called socialist ownership. Taking this into due account, the proper sense of transition may be seen in 'the substitution of informal entitlements (existing under the conditions of the Soviet-type economic system) by the legal system of property rights, and further in the task of improving the existing markets – till now inefficient, rigid, non-competitive, monopolistic and discriminating – into markets more efficient, more open and more competitive' (Mlčoch, 1993: 5).

In 1990 the central planning system of administrative allocation of capital and labour was abolished but market allocation mechanisms were arising only very slowly, and were not able to adjust by themselves in a comparatively short time span to the huge structural deformations created by the Soviet-type economic system. At the beginning of the 1990s, the Czech economy functioned in a considerable institutional and organizational systemic vacuum which was in a reactive and quite unsystematic way filled up by government interventions (we may even speak about a non-admitted industrial policy). The concept of systemic vacuum does not mean that there were no institutions and organizations but that the society lacked some important formal institutions and organizations or that these institutions had the nature of 'empty shells' or their enforcement was weak. Under such conditions, informal institutions, an important part of which was the heredity of the informal institutional setting of the former Soviet-type economy and its black market component, played a very important role.

The relative failure of the Czech 'neo-liberal' transformation strategy may be considered to be the result of the peculiar combination of the neo-liberal theoretical framework of the 'Washington Consensus' adopted as a basis of the Czech transformation strategy. It resulted in a mistaken economic policy, an ideologically conditioned aversion to any kind of active state role in the economy, and to an active industrial or structural policy. But the major mistake of this strategy was without any doubt the neglect and inadequate development of the legal and institutional framework because this is the very basis of the transformation processes. In combination with an insufficient enforcement of the law, the Czech transformation innovations (the voucher privatization scheme, and a trial to re-create an important Czech entrepreneurial elite) led to the marked failure of the Czech 'neo-liberal' transformation strategy.

Czech large-scale privatization with its important voucher privatization component created hurdles in the process leading to an efficient structure of property rights in an important sector of Czech industry. Together with an inadequate legal framework, these innovations created suitable conditions for speculative and predatory behaviour connected with a massive redistribution of assets. Voucher privatization[6] together with leveraged buy-out privatization connected with a trial to resuscitate the Czech entrepreneurial elite should be considered the biggest mistake in the Czech case.[7] Moreover, the trial to resuscitate the Czech national entrepreneurial elite and to guarantee for it an important stake in the Czech national economy should be considered a move against the stream from the point of view of the major tendencies of globalization and integration in the contemporary world economy.

The fundamental principles of the transformation strategy elaborated by Václav Klaus and his collaborators were based on the Washington Consensus measures – deregulation, price liberalization, foreign trade liberalization, privatization and support for private-sector development, reform of the legislative system, and a restrictive macroeconomic stabilization policy based on monetarist theories. The authors of the Czech transformation strategy did not take into account recent developments in institutional and post-Keynesian economics. The Washington Consensus was the usual blueprint for transformation and it also played an important role in the transformation of other post-Soviet societies. These principles were applied with the above mentioned 'Czech' innovations such as the voucher privatization method and an important endeavour to create a strong Czech national entrepreneurial

6 Institutional failure was not the result of technical aspects of the voucher privatization scheme as such. It was the effect of the way in which this scheme was implemented under the existing conditions of badly functioning or non-existent legal and regulatory frameworks.

7 Certainly it was without any doubt a short-run political success of Václav Klaus and his Civic Democratic Party. However, economic consequences were largely negative, which can be seen clearly in the medium and long run. Large-scale privatization winners have created an important group of supporters of Václav Klaus till today which may explain his political success even after the 1997 political crisis.

elite in the national economy using leveraged buy-outs. The authors of the Czech transformation strategy followed, probably even more rigorously than the other Central and Eastern European Countries undergoing transformation, the model of economic transformation developed by Jeffrey Sachs. According to this approach, which is nothing else but a variation on the Washington Consensus theme, 'standard' economic conditions should be created by privatization and completed by the liberalization of markets and the liberalization of foreign trade, and capital movements would lead in a short time to equalization of the level of economic development with developed market economies. The Washington Consensus was based on an implicit supposition that the transition should 'naturally' evolve into a kind of modern capitalist society and economy of the Western type.

However, after more than ten years of 'deliberately building' a capitalist society in the Czech Republic, we must acknowledge that private property is not guaranteed sufficiently and certain economic crimes cannot be legally prosecuted (*e.g.*, the case of Viktor Kožený or other cases of 'tunnelling' assets), minority shareholders rights are not respected, and so forth. In the following text I will concentrate on the Czech privatization strategy, especially on voucher privatization and leveraged buy-outs as privatization methods which led to serious problems and heavily burdened the development of the Czech economy during the 1990s.

3. Voucher privatization and its consequences

The fate of transformation efforts is critically conditioned by successful creation of a market economy based on private ownership. This idea is based on the historical evidence of the developed market economies. Without creating a strong private sector in the national economy, it is impossible to form an efficient competitive economic structure compatible with the economies of Western Europe and able to compete in international markets. The process of creating the underlying structure of property rights consists in the evolution of a newly re-emerging private sector (especially small and medium firms) and in massive privatization.

Financial and institutional support of newly born small and medium-sized private firms has been one of the commitments of the Czechoslovak (and Czech) government after 1989. In October 1991, an Information and Consulting Centre for Small and Medium Firms was established, and in January 1992, the Czech Guarantee and Development Bank was founded. Unfortunately, the government policy has not been systematic enough and financial resources devoted to this goal have been quite restricted, and accordingly progress has been very slow.

Under the communist regime, the state sector (together with the cooperative sector) was the completely dominant sector of the national economy. Even at the beginning of 1991, the state sector and cooperative sector produced almost 98 per cent of the Czechoslovak GDP, and almost all industrial assets were in state hands.

Privatization on such a large scale represented a serious problem in many respects. It was a crucial issue in the transformation process in every Central and Eastern European country. The difficulties encountered during privatization in Poland and Hungary, the countries where the process of transformation started, demonstrate well the different conditions and dimensions that privatization in post-communist countries had in comparison with Great Britain or other developed Western countries.

In Czechoslovakia, as well as in other post-communist countries, there was a significant shortage of domestic capital that could be used to privatize large state-owned enterprises. Even from the technical point of view, privatization under these conditions represented a highly complex task if we take into account that thousands of state-owned enterprises had to be privatized in a relatively short time. According to the government aims the main bulk of these enterprises (70 per cent of state owned assets) had to be privatized in three years.

The existing legal norms presupposed three methods of privatization against payment: direct sale, public auction, and public tender. These methods are usually called standard methods of privatization. Due to the above-mentioned shortage of national capital, doubts about large-scale foreign capital admission, and some reluctance of foreign capital to enter the process because of many uncertainties, it seemed clear that the standard methods would not be able to guarantee rapid privatization. For this reason, nonstandard methods of privatization, the methods of free-of-charge transfer of state-owned property into the private hands of Czechoslovak citizens were implemented. The voucher (or coupon) privatization scheme in the large-scale privatization was used as one of the main privatization methods. The fourth important method of privatization was restitution of state-owned property to the former owners.

The majority of the state-owned enterprises were privatized in accordance with the Large-Scale Privatization Act. This act referred to the privatization of several thousand large state-owned enterprises by standard and nonstandard methods in as short a time as possible. The major part of the large-scale privatization process was divided into two waves that took place during 1991-1994. To manage this process, new government agencies were created (Czech and Slovak Ministries for Privatization and Administration of the National Property and Funds of National Property).

The implementation of the process was based upon individual privatization projects prepared by or for the state-owned enterprises. The management of the state-owned enterprises selected for privatization was legally obliged to submit its individual privatization project, but any other physical or legal person could do it as well. The Ministry for Privatization and Administration of the National Property had to choose between two or sometimes more privatization projects for the same enterprise. The individual privatization project stated the privatization method or methods used in the individual case and decided the proportion of the book value of the property to be privatized by any method used.

According to law, privatization could be performed using direct sale, sale in public competition, sale in auction, transfer to municipalities and other public institutions or creation of a joint stock company (or some other type of business company) and its subsequent privatization via sale of its shares, placing its shares in voucher privatization or/and transfer of its shares, without payment, to municipalities or other bodies. These methods could be combined.

Before the actual privatization of a state-owned enterprise could be executed, the property was transferred into a respective National Property Fund (until January 1, 1993, the date of the split of Czechoslovakia, there were Federal, Czech and Slovak Funds). These funds were created to take care of the privatized national property. They were not a part of the state budget and were allowed to operate only in the way stated by the law. These funds were to satisfy restitution claims, obligations of the enterprises which were to be privatized, and so forth. Because of the complexity and very tight time schedules, the process of approval could be, in the main, only formal control of the feasibility of the project, without any possibility of real evaluation and without checking the tendencies represented by existing management to take as much advantage from the operation as possible. The Ministries for Privatization were under great pressure, and cases of fraud and bribery were not unusual under such conditions.

According to the official statistics, the fixed capital value of the state property at purchase book value was evaluated at about 3.6 thousand billion CZK on January 1, 1988. Property to be privatized in the large-scale privatization process was estimated at about 2.8 thousand billion CZK. We should take into account capital consumption and the large indebtedness of the then existing state-owned enterprises (in February 1992 estimated at around 200 billion CZK). But even if we subtract the capital consumption estimated for recent years, the remaining figure is still too large compared to available household savings, which amounted to nearly 332 billion CZK at the end of 1992.

Accounting value, especially in a post-communist economy does not say much about the real value of the property and the importance of such information should not be exaggerated. However, it was very difficult, and sometimes even impossible, to evaluate the market value of this property based on the standard pricing methods used in developed market economies. This was done only in cases of selling the property to foreign capital where a market evaluation, usually elaborated by a foreign consulting firm, is required.

The above-mentioned figures make it clear why the government decided to implement the voucher privatization scheme – because it could in this way very easily overcome the problem of national capital (or household savings) shortage. The political motivation of creating a broad popular base for the support of the transformation process was probably the most important incentive, but the possibility of very rapid privatization without the necessity of evaluating state-owned enterprises at market values was also tempting.

Since the end of 1991, when the share of private sector in GDP creation was about 8.4 per cent, the Czech Republic made an enormous step forward, and after two waves of large- and small-scale privatization its share approached 80 per cent of GDP in 1995. Unfortunately an important part of privatized state-owned enterprises using the voucher method was privatized only formally. Voucher privatization resulted in very peculiar property rights structures connected with very inefficient corporate governance. An important part of the national economy was privatized in a strange way ending up in the hands of privatization investment funds, the majority of which were controlled by the big Czech banks. These banks were controlled by the Fund of National Property and this structure, sometimes called 'banking socialism', probably had to serve as a kind of 'safety catch' or 'fuse' in case of unexpected adverse developments. The very difficult and costly process of the privatization of these banks (in the medium run the costs may surpass very significantly the proceeds and the 'solution' of the Investment and Post Bank crisis alone is estimated to have cost at least 120 billion CZK) started after the crises of 1997, gained momentum in 1999-2000 under the social democratic government and was crowned by the privatization of the 'Komerční banka' (Commercial bank). The solution of the bank sector crisis was rather costly. By 2000 the financial stabilization of Czech banking required over 260 billion CZK (that is over 14 per cent of annual Czech GDP), but even higher estimates up to 400 billion CZK can be found. The relative importance of different privatization methods used during the Czech large-scale privatization can be clearly seen from Table 2.

The voucher privatization can be considered formally rapid. But in reality it was a quite slow method of privatization. In its initial stage voucher privatization had the character of more or less formal privatization (or commercialization). Efficient property rights structure could develop on its basis only gradually, if at all.

Table 2. Privatization in the Czech Republic (Act on the Large-Scale Privatization from February 1991)

	billion CZK	%
Value of assets privatized during 1990-1998	780	100.0
Voucher privatization	333	42.7
Direct sales	237	30.4
Assets transferred without payment to municipalities	121	15.5
Reserve funds of joint stock companies		
Newly founded from former SOE	64	8.2
Restitutions (Fund of Nat. Property)	25	3.2

Source: Češka (2000): 13.

For a long time, the Fund of National Property held a large direct share position in former state-owned enterprises privatized using the voucher method and, together with 'banking socialism', the role of the Czech state remained quite high in the Czech economy until the end of the 1990s. E. Kočenda and J. Valachy are right in stating that 'the voucher scheme did not fulfill its main mission to cut ownership links among the state and firms since a large potential control of the state persisted over [a] substantial part of [the] economy' (Kočenda and Valachy, 2002: 258). Due to this, voucher privatization resulted in a significant postponement of the restructuring of enterprises, protracting in this way the inefficient use of 'frozen' resources. The restructuring of former state-owned enterprises was deliberately left to their future private owners (which in some cases led to the necessity of government help in restructuring them after privatization). In some cases, the quality of assets deteriorated during this period, and the possibility of successful privatization was definitively over. The process of reallocation of property rights born by the voucher scheme began in 1995 and was very intensive during 1996, sometimes being called the third wave of privatization. But it has still not been finished, and we may have many doubts about the efficiency of its results (Kočenda and Valachy, 2002: 255-258).

In an attempt to avoid an excessive fragmentation of ownership in voucher privatization, the government allowed the creation of privatization investment funds which were to serve as institutional investors (as mutual funds) and as active shareholders. These institutions were completely new, and their management did not have the experience and abilities to fulfil such tasks. Anyway these privatization investment funds were able to acquire more than 70 per cent of vouchers. There was an excessive uncertainty about the behaviour of the largest privatization investment funds resulting several times in capital drain of newly privatized enterprises. The largest privatization investment funds experienced serious difficulties in executing their property rights over the management and financial restructuring of enterprises in their portfolios.

Because of the Czech privatization strategy in which an important role was played by the non-standard voucher method, the transition from formal private ownership to real private ownership of firms remained for a long time a serious problem. It was connected with some important risks. In the short and medium runs there was a problem of fragmentation of shareholdings, uncertainty about the behaviour of the 16 most important privatization investment funds (PIFs), and developments in newly created capital markets. The lack of domestic capital resources, which had to be overcome by the voucher scheme, was expressed among other factors in the quite unsatisfactory functioning of the Czech capital market during the 1990s.

Voucher privatization could not bring any new financial resources to privatized enterprises. It was an attempt to create artificial capital and was connected with a long ownership vacuum lasting three to four years in the Czech state-owned enterprises privatized in the first and second waves of voucher privatization. This created suitable conditions for spontaneous privatization. The Czech state in fact ceased to execute property rights in state-owned enterprises and left them to enterprise managers in spite of the fact that these enterprises were not yet handed over to private owners. The process of 'tunnelling' assets from state-owned enterprises started. Restructuring and investment in these enterprises were frozen as the uncertainty of managers led them to follow their short-run interests, which were quite frequently personal. During this stage, state-owned enterprises adapted to changing market conditions mostly passively. In many cases these enterprises decreased the output but without an adequate reduction of employment, and their indebtedness was increasing (this was one of the important factors in the later banking crises). The quality of assets held by these enterprises was decreasing step by step and some of their managers transferred the assets from the state-owned enterprises into their hands using many semi-legal and illegal methods. This peculiar situation resulted in postponing the inflow of foreign direct investments and the real and financial restructuring of the sector of big industrial enterprises. This phase shift can be clearly seen when comparing statistical data of FDI inflow for the Czech Republic, Hungary and Poland. Some of the former big state-owned enterprises could have been privatized by the standard privatization methods instead, and on this basis they could have escaped bankruptcy.

The term 'banking socialism' depicts some special cross-ownership structures (see Mertlík, 1995) resulting from the Czech large-scale privatization. During the process of large-scale privatization, the Czech state banks created their privatization investment funds which had in their portfolios the shares of many big Czech enterprises whose performance was inadequate and which resulted in huge losses. In order to help them, banks continued to provide credit links and a vicious circle of badly performing or classified credit accounts and secondary indebtedness plagued the economy.

The results of the leveraged buy-outs privatization were even worse. This privatization method burdened former state-owned enterprises with privatization debts which were not repayable, and most such ‘industrial empires in Czech hands’ ended up in major financial difficulties or bankruptcy (Poldi Kladno, Chemopetrol Group and Škoda Plzeň being the most important cases).

4. Supply-Side Non-Adaptability Due to Slow Restructuring and Modernization

Erroneous privatization strategy together with very limited real support for small and medium scale private firms resulted in a very slow and only partial restructuring and modernization of the Czech economy during the 1990s. Instead of trying to privatize large state-owned enterprises via standard methods, and preferably by foreign capital where possible, a combination of methods with a very large share of voucher privatization and managerial leveraged buy-outs (with the hope of creating a strong sector of firms in Czech hands) was used.

During the 1990s the Czech economy developed a dual structure which can be observed at least by 1994. A sector of rapidly growing enterprises, the majority of which were owned by foreign capital, can be clearly distinguished. These enterprises are highly productive and profitable. Their growing performance is based on modernization and restructuring and this sector is highly competitive in internal and foreign markets. In 1997 its share in the production of manufacturing was estimated at about 26 per cent, but in exports more than 42 per cent. The share of this development pole was rapidly growing due to a massive inflow of foreign direct investments after 1997, and during 1999-2000 it reached a share of over 40 per cent in employment in manufacturing, and about 47 per cent in exports.

On the other hand, there was an important ‘pole of decline’ formed by enterprises that were highly indebted, making losses and sometimes with a negative equity value. These enterprises, frequently privatized by leveraged buy-outs or with an important share of voucher privatization, were unable to restructure and modernize and their bad performance was the major cause of an enormous secondary indebtedness (estimated still at about 180 billion CZK at the end of the 1990s), and created a very big share of non-performing loans or so-called classified loans (estimated at about 27 per cent of all bank credits in 1998). This sector of 'dying' enterprises threatened by bankruptcy was formed by almost one third of all manufacturing firms, and in 1999 its share in the labour force employed in manufacturing still exceeded 38 per cent.

Since 2000 the social-democratic government has launched an active policy of restructuring selected enterprises of this sector and has been trying to find foreign investors for them, but this operation has been rather costly and the results have been problematic. Czech manufacturing has still been in the midst of important Schumpeterian processes of creative destruction, and the dynamics of the growing pole has become a major cause of increased macroeconomic performance of the Czech economy during the period 2001-2002. An important lagging behind in productivity and an extraordinary differentiation of profitability were still the most outstanding features of Czech manufacturing at the beginning of the new century.

Taking into account the results of a comprehensive overview of the characteristics of the structural changes (factor input, technology intensity, product differentiation, market concentration, and labour skills) in selected Central and East European countries during the 1990s based on multi-criteria analysis (Kadeřábková and Srholec, 2001), structural change intensity in the Czech Republic can be considered as medium-high. Especially comparing the changes of qualitative positions at the end of the period, a striking difference between Hungary and the Czech Republic arises. The Czech economy so far exhibits weaker capacity for closing the technology gap and a weaker capacity for taking the opportunity of technology catch-up as the base for improving growth and export performance. According to the authors, their comparative study leads to an interesting comparison between Hungarian and Czech relative positions. Development tendencies in Hungary point more to a structure with a dominant share of high technology intensive industries (as in Ireland) whereas the Czech economy seems imbedded more in the industrial phase of development with a dominant share of medium-high technologies, and shows stronger similarity to the economic structure of Germany (Kadeřábková and Srholec, 2001: 344).

In the short run the Czech Republic had to rely mostly on existing export patterns, with a bias for cheap labour and labour-intensive, relatively standardized products. The advantages of low wages and cheap labour as the basis of the country's specialization and competitiveness should, however, be qualified. The cost and price dimensions of competition dominate the markets for standardized products. For heterogeneous, more sophisticated and higher value added products, factors such as goodwill, reliability and quality standards, advertising, after-sale service and the ability to meet special consumer requirements are crucial. An important part of Czech firms is still unable to meet these requirements. For almost all such firms, there is only one possible way to meet them. This is to attract foreign capital, to look for reliable foreign partners, strong enough and competitive in international markets. It is a pity that such a systematic strategic policy was not followed since the very beginning of transformation in the Czech Republic. Fourteen years after 1989 we could have more 'development poles' similar to Škoda Mladá Boleslav. Under present conditions it will be more difficult but there is no viable alternative. The other alternative comes only with a high probability of bankruptcy for many former big state-owned enterprises.

Conclusions

The Czech 'neo-liberal' transformation strategy is connected with an important institutional failure. Its privatization efforts using a significant degree of non-standard methods of privatization became in reality a long process causing a three to four year delay in financial and real restructuring of an important part of the Czech economy, and in some cases caused deterioration of the quality of assets. In effect it created important hurdles to the development and modernization of the Czech economy during the 1990s. Its neglect of the quality of the legal framework and its adequate enforcement, created conditions for 'tunnelling' of assets, fraud and bribery, and in some respect it questioned the very basis of the capitalist economy – private property.

As Jan Mládek put it clearly in his critical assessment of the Czech large-scale privatization, 'Coalition governments (formed by Václav Klaus) succeeded in proving that forms of private ownership existed which were worse than state ownership' (Mládek, 2002: 126). This trial to create a Czech 'national capitalism' had very negative effects for the development and modernization of the Czech economy, and it was a very expensive experiment for the Czech taxpayers as well. However, its true overall costs will never be exactly counted.

Since 1999 the pace of transformation and macroeconomic performance of the Czech economy has been predominantly influenced by the effects of accession to the European Union. There are important implications in the pre-accession period as well connected with the processes of harmonization of Czech law with European Union law and with the efforts to prepare the Czech economy for new conditions. The processes of harmonization that gained momentum since 1998 serve as an institutional anchor for the institutional and legal framework of the Czech economy. Step by step harmonization will help to solve major drawbacks in the Czech institutional and legal structures. The pressure of the European Union may help in reforming and making more efficient the government administration and the public sector.

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