

# Dismantling Socialism

A Preliminary Report

*Václav Klaus*

The John Bonython Lectures

## THE CENTRE FOR INDEPENDENT STUDIES

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THE 1991 JOHN BONYTHON LECTURE

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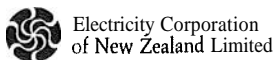
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# Opening Remarks

*Maurice Newman*

Chairman, CIS Executive Board

Your Excellency, Governor-General Mr Bill Hayden, Premier of New South Wales Mr Nick Greiner, Leader of the Opposition in New South Wales Mr Bob Carr, and Mrs Carr, Distinguished Guests, Ladies and Gentlemen,

May I welcome you to this, the eighth John Bonython Lecture. May I also say that it is thanks to your support that the Centre for Independent Studies is this year celebrating its 15th anniversary.

The purpose of the John Bonython Lecture is, and I quote, to 'examine the relationship between individuals and the economic, social and political factors that make up a free society'. When Israel Kirzner gave the first John Bonython Lecture in 1984, we in Australia were uncertain whether the ideas about a free market and a free society that the CIS and its sister organisations around the world had been promoting were going to take root. The miraculous rebirth of those ideas had occurred: was the new infant going to survive? In 1991, we can say that those ideas have been received more deeply and more widely than we ever dared expect. By the mid-1980s we knew that socialism was intellectually on the defensive, for the first time since its birth about a century ago. By the end of the decade, we were witnessing a second miracle: the collapse of the communist regimes of Central and Eastern Europe, which had previously seemed so impregnable.

Years before the CIS came into existence, the groundwork for this change was being laid by young people like Václav Klaus, who, even as their countries were being subjugated by the now-defunct 'Brezhnev doctrine' — the doctrine that the Soviet Union is entitled to intervene to shore up its neighbours' communist systems — were learning about the elements of the free society and preparing to carry them into effect. We are humbled by the dedication, faith and courage shown by Václav Klaus and his fellow-students in those grim days. We are also inspired by them.

And yet, in witnessing the great changes in the communist world, we have perhaps allowed ourselves to drop our guard a little too far. We have been saying for some years now that 'socialism is dead'. If we mean that socialist beliefs have been decisively refuted by experience, then what we say is correct. But socialism persists in the political demands

and preferences of very many people; and as Professor James Buchanan said in last year's Bonython Lecture, disillusionment with big government in the West has not led to any mass enthusiasm for the free market and free society. In dismantling socialism in both the Western countries and the ex-communist ones, we should be prepared for reversals and setbacks. The virus of socialism, in whatever strain, may yet survive.

The Lecture that Dr Klaus will give this evening is named in honour of John Bonython, AO, the first Chairman of the Board of Trustees of the Centre for Independent Studies, and the founder of Santos, the major energy company based in South Australia. Unfortunately, due to poor health, John Bonython cannot be with us this evening. But it is a special pleasure to have the present Chief Executive of Santos, Mr Ross Adler and his wife, with us this evening.

John Bonython has asked me to read this message:

I welcome Václav Klaus to Australia and am honoured to be associated with his lecture. Dismantling socialism is of course a very great part of what the Centre for Independent Studies has been doing in the 15 years since it came into existence, and with much success. But even in Australia the task is a formidable one. I trust Dr Klaus's preliminary report will have some lessons for us all.

As always, the CIS is grateful to the individuals and corporations who have helped to make the Bonython Lecture possible. This year I would like to mention in particular the support of Qantas and of Coca-Cola Amatil, and also the assistance we have received from the Regent Hotel.

I now have great pleasure in inviting Greg Lindsay, the energetic and indefatigable Executive Director and founder of the Centre for Independent Studies, to introduce our guest speaker.



# Introduction

## Greg Lindsay

Executive Director, Centre for Independent Studies

When last year I was thinking through the possibilities for someone to follow Nobel Laureate James Buchanan and present the 1991 John Bonython Lecture, I felt that it would be important for Australians to hear from an individual who had lived through the Communist period in Eastern Europe and who could introduce a very real edge to the underlying reasons for the Lecture and for the Centre's existence. At a conference in Saskatoon in Canada in May 1990, where I was speaking on privatisation in Australia (a short speech, you might say), I asked my friend Albert Zlabinger, head of the Carl Menger Institute in Vienna, who he thought would be the best person that we might invite. He asked if I had heard of Václav Klaus. 'Yes', I responded. He said, 'did you know that he has read Hayek, von Mises, Friedman and most of the rest of those great economists and social commentators with whom we are familiar?' I had an inkling that this was the case. As it has turned out, Albert's suggestion was more than appropriate.

Václav Klaus was born in Prague in 1941 and graduated from the Prague School of Economics in 1963. There he studied international economics and international trade. When he was studying for his doctorate he was allowed to spend six months in Naples. There he read Western economic texts and the more general work of people such as Hayek. By the time he returned home he had a good understanding of the principles of the market. The Prague Spring of 1968 and its political liberalisation gave many cause for hope in Czechoslovakia, including Václav Klaus. But he remained a critic of the so-called 'third way' they pursued in economics. More recently he has become famous for saying that 'the third way leads to the third world'. At the time he was working in the Institute of Economics in the Czechoslovak Academy of Sciences and was meant to criticise non-Marxist economic theories; but he ended up being paid to read more Western economic texts. This seems to turn on its head Lenin's dictum that capitalists would compete to sell the rope from which they would hang!

Though the invasion of 1968 had occurred, the regime took several months to catch up with its critics, So in 1969 Dr Klaus was able to spend the Spring term at Cornell University in New York. During this time he wrote entries for the first Czechoslovakian Encyclopædia of

Economics, including one on John Kenneth Galbraith, whom he dismissed as a social critic rather than a serious economist. He also wrote the section on 'economic liberalism' in which he made a dramatic attack on the role of government.

In 1970 the régime caught up with him, identified him as the leading counter-revolutionary in the Academy and compelled him to leave. At his hearing, it was pointed out that he was the worst counter-revolutionary in the whole place. He was shuffled off to the state bank where he undertook clerical jobs for a while, but in the 1980s the changing climate allowed him to be appointed as an unofficial adviser to the chairman of the bank. In 1986 he returned to the Academy of Sciences as head of the Department for Macroeconomic Policy in the newly-fonned Institute of Forecasting.

Dr Klaus is one of the founders of the Czechoslovak Civic Forum Movement and as its key representative he joined the Government of National Understanding in December 1989. He was appointed the first non-communist Minister of Finance after more than 40 years of communist rule in Czechoslovakia. In June 1990 Dr Klaus was elected a deputy to the Federal Assembly on Civic Forum's ticket and won more votes than any other candidate; in October 1990, he was elected national chairman of Civic Forum with the support of 70 per cent of its delegates. He is now chairman of the Civic Democratic Party, which arose from a break up of Civic Forum earlier this year to become the largest party in the Parliament.

He was asked once in America what kind of economic system he planned for Czechoslovakia. Dr Klaus told the questioner that he obviously didn't fully understand what a market economy was. He said that 'to talk about planning an economic system is to talk in old terms'. He went on to say that 'they often don't realise that they might need a little of a market revolution in their own countries' and that 'what we want [to do] is to establish the rules of a market economy — not to plan its outcome'. To enlarge on this a little, his vision of Czechoslovakia is a society the pillars of which are individual citizens, families, townships, counties, and the state, in that order. Free citizens are the source of political, economic and moral initiative.

Ladies and Gentlemen, it gives me great pleasure to invite Dr Václav Klaus to deliver the 1991 John Bonython Lecture.



*Václav* Klaus



# Dismantling Socialism

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*Václav Klaus*

It is a great honour and also a great pleasure for me to be invited by the prestigious Centre for Independent Studies to deliver the 1991 John Bonython Lecture and to be included among the economists and social thinkers who have used the lecture for expressing important ideas and opinions. They were successful in giving us simple, clear and necessary messages. Without expecting (or even imagining) any contacts with the Centre or the John Bonython Lecture, I have long been using ideas expressed in the various lectures in my essays, editorials, and columns. When discussing the pitfalls of foreign aid for an economy being transformed, one has to quote Peter Bauer<sup>1</sup>. When arguing with our leftist intellectuals, one uses the concept of the 'unconstrained vision' coined by Thomas Sowell<sup>1</sup>. And when warning against state interventionism, redistribution and paternalism, James Buchanan's<sup>1</sup> distinction between socialism and Leviathan is very useful.

For me to speak here tonight is not just an honour; it is at the same time an enormous challenge and responsibility. My country has been for so many years cut off from the rest of the world. We lived not only in an economic autarchy; we lived in an intellectual autarchy as well, which was — probably — even more dangerous, frustrating, and debilitating. We have not had many opportunities to speak abroad anywhere, let alone Australia. Many misconceptions and misunderstandings abound. I shall try to discuss some of them here tonight.

### Dismantling What?

The title of my lecture is somewhat misleading, because we have to distinguish between explicit and implicit socialism, between Soviet-type and welfare-state-type socialism; we have to fully grasp the meaning of last year's Bonython Lecture by James Buchanan, 'Socialism Is Dead But Leviathan Lives On'. It is relatively easy to dismantle a one-party system, to formally liquidate institutions of central planning, to disgrace communist ideologies and irrational and dysfunctional economic policies, and to provide legal guarantees for free speech. It is much more difficult, however, to construct from scratch a stable political system based on several well-defined and transparent political parties, to create

efficient markets in a highly-monopolised and semi-closed economy, to uproot leftist ideologies and distortions in behaviour and the expectations associated with them, to stop deep-rooted government interference in the economy, to block popular redistributive practices, to dissolve dangerous lobbying, rent-seeking, protectionist organisations and pressure groups, and so on.

Creating a new political, social and economic system is a formidable task. It is even more difficult after 40 years of ideological brain-washing, with serious ideological and social prejudices, with lost memories, with unprepared teachers, journalists and 'scribes' of all kinds, and with various wrong signals coming from Western countries. The ideological or psychological side is very important, but the practical, 'material' side is no less demanding. We are confronted with an unavoidable J-curve<sup>2</sup> concerning living standards, industrial and agricultural output, and GDP. Any movement forward requires the elimination of old, inefficient, unsustainable, artificially-promoted economic activities, and the replacement of disguised, hidden, unreported and non-measurable economic and social negative phenomena with visible, measurable and, therefore, reported evils: open unemployment rather than hidden unemployment in the form of labour hoarding, open inflation instead of repressed and hidden inflation, output losses instead of output gains dissipated in unsaleable inventories at home or in frozen assets in various developing countries.

It is common knowledge, embodied in the classical Mises-Hayek arguments, that irrational success indicators used in the planning process, along with distortions in prices, create a wasteful economic system which penalises 'positive' activities and promotes economically, socially and environmentally damaging activities. The latter must (and will) be halted. But the opposition to doing that is enormous and survives the dismantling of the formal institutions of explicit socialism. Most of the countries of Central and Eastern Europe have succeeded in dismantling explicit socialism. But replacing it with a functioning free market system will be our task for the whole decade of the 1990s.

### Two Serious Western Misunderstandings

The implicit assumptions that the East Europeans will lose nothing when the socialist redistributive process is stopped, and that the systemic change is an easily manageable technical task, constitute two serious misunderstandings in the West.

Traditional comparisons of spiritual and material life in Eastern (or rather Eastern European) and Western countries in recent decades give us a somewhat simplified, black-and-white picture, which reinforces an

a *priori* belief that citizens of ex-socialist countries have absolutely nothing to lose and are therefore eager to jump on the 'road to freedom' despite all the suddenly-emerging uncertainties of the transitional period, despite all the potentially unfavourable combinations of success and failure, despite emerging inequalities of income and wealth (and the accompanying envy), and despite the loss of a relatively easily self-arranged leisure, of a strange kind of comfort and of undemanding individual irresponsibility. Susan Marie Szasz put it clearly in the Winter 1991 issue of *Policy*: 'Are they [the people of Eastern Europe and the Soviet Union], in return for true freedom, prepared to give up bread lines for unemployment lines?' (Not that we had bread-lines in Czechoslovakia, though there were queues for many other products.) The answer is far from a simple 'yes'. I have to argue that the 'West' seriously underestimates the relative material 'lightness of being' in countries like Czechoslovakia in the past decades even if it might be — to use the title of the famous novel by Milan Kundera — for many other reasons 'The Unbearable Lightness of Being'.

At the same time, the 'West', basically because of the lack of understanding of the enormous fragility of its own political, social and economic system (as Thomas Sowell reminds us), underestimates the relative difficulties of the transitional period. I am again and again shocked when the same people theoretically harshly criticise the scope of human oppression in communist countries but do not believe that I, like millions of other Czechs and Slovaks, was not allowed to travel abroad between the end of the Prague Spring and the beginning of our Velvet Revolution, which means almost 20 years. I am again and again surprised that distinguished Western Sovietologists, after years of accurately describing the wasteful economic activities of a command economy in their sophisticated, now partly obsolete, textbooks, criticise us for our inability (and, of course, unwillingness) to orchestrate Keynesian, expansionary macroeconomic policies and/or interventionist industrial and sector policies. I have to add that such notions are frenetically applauded by our old central administrators as well as by their intellectual supporters in the academy.

To summarise: the task of transformation is undoubtedly very challenging. We need to obtain and maintain sufficient popular support and cooperation (which we still have in Czechoslovakia) and we have to avoid all the traps of the transitional period. In the remainder of this lecture, therefore, I discuss our basic reform strategy and its first results.

### The Goal of Reform

Given all the intricacies and complexities of the systemic change we are

undergoing, we need to have:

- a clear, straightforward goal and vision;
- a rational, all-embracing and properly structured reform strategy; and
- a pragmatic approach to the sequencing problem and the capacity to control it.

My widely-quoted phrase of last year — 'market economy without adjectives' — was a necessary reaction to repeated attempts in my country and elsewhere to construct and support various 'third way' hybrids as targets of the transformation process. Adjectives like 'social' or 'environmentally conscious' are nothing other than attempts to restrain, limit, block, weaken, dissolve, or make fuzzy the clear meaning of a market economy and to introduce into it non-market elements. I feel I should now advocate the use of adjectives, but adjectives with a totally different meaning. We need an unconstrained, unrestricted, full-fledged, unspoiled market economy, and we need it now. Instead of waiting and prolonging the agony of a post-totalitarian, post-centrally-planned society and economy, instead of looking for partial, temporary, successive targets or subtargets, we have to find a straightforward way, an ideological turnpike which will bring us in an optimal and speedy way to our final target (the so-called turnpike theorem). The turnpike has no room for 'socialism with a human face' associated with the Prague Spring of 1968, for flirtations with the 'market socialist' dreams of Western social democrats, labourists and liberals (I mean liberals in the American sense — see my recent note 'What is Real Liberalism', Fraser Forum, May 1991), or for misleading concepts of *perestroika* prevailing in the Soviet Union these days. Such a strong, theoretical, pro-market conviction is, in my own case, increasingly reinforced by very practical arguments, since our everyday task of masterminding the reforming economy (without planning directives but with very inefficient markets and with still-dominant state ownership) demonstrates how futile, unproductive, and unfounded any direct government intervention is.

### The 'Hard Core' of Reforms

The 'hard core' of necessary reform measures, defining the critical mass for a systemic change, includes several very simple steps:

- early, rapid and massive privatisation;
- price deregulation;
- foreign trade liberalisation and currency convertibility;
- cautious macroeconomic stabilisation policies (monetary and fiscal conservatism).



One can start crossing the Rubicon with any one of the hard-core measures, but the opposite shore can be reached only with all of them together. All of them are self-evident, the words used are self-explanatory, they do not include half-measures or eternally-postponable targets. In Czechoslovakia, they are reflected in crucial parts of our Scenario for Economic Reform, which was approved by the Federal Parliament in September 1990.

Detailed description or analysis of these reform measures is beyond the scope of this lecture. But I will comment briefly on some hotly-debated issues in our part of the world.

Privatisation is the top priority of all truly reforming economies. An overwhelming shift of property rights from government to private hands is essential if these economies are to become market systems. Privatisation must be carried out rapidly; thousands of state enterprises must be denationalised in several months or years. In this respect all comparisons with Margaret Thatcher's achievements, despite my admiration of her personal integrity and her economic policies and political stances, are inapt and misleading. We cannot afford to privatise only a dozen state enterprises in a dozen years. Western consultants (very often highly-paid experts from international institutions), together with domestic opponents, raise objections to rapid privatisation because they are convinced that there exists no suitable basis for evaluating the state enterprises to be privatised in Eastern Europe: that until market forces determine the prices of outputs and inputs, enterprise profitability cannot be correctly evaluated and privatisation should be therefore postponed. As Charles Wolf Jr. aptly argued recently ('Sweepstakes Capitalism', *The Wall Street Journal*, July 12, 1991), 'this objection is spurious. It arises from a misconception about the meaning of privatisation. . . . What is essential is an effective means for shifting ownership from state to private hands'. And I would dare to add, 'and not the maximisation of government revenues from privatisation'. Czechoslovakia did not choose the 'privatisation by randomisation' suggested by the same author (i.e. a sort of national lottery) but invented and tries to realise a non-standard 'voucher privatisation method' which overcomes the valuation problem with a 'free to choose' procedure. The Czechoslovak citizens will receive vouchers (for a nominal price) and will be free to exchange them for shares in denationalised enterprises. This procedure, now being carefully studied by other reforming countries, should help us to achieve our priority reform target swiftly and without unnecessary delays. (A highly competent summary of Privatisation in Eastern and Central Europe is given by Guillermo de la Dehesa, Group of Thirty, Washington, DC, Occasional Paper 34, 1991.)

Price deregulation is correctly understood in reforming economies to be the necessary precondition for a normally-functioning market economy. The problem is to implement such a drastic measure after decades of frozen, administered and disequilibrium prices (or prices formed, in the tricky bargaining process of the planning game, according to the 'planning power' of participating economic agents: see my 'Socialist Economies, Economic Reforms and Economists,' Communist Economies, No. 1, 1990). Price deregulation must take the form of 'shock therapy' because gradualism creates more problems than it solves. Partial deregulation creates new distortions in the price structure that are as bad as the old ones. Price distortions require new subsidies; new subsidies mean renewed government interference in the economy; and back we are with the old game. Price deregulation must therefore be overwhelming, and residual regulatory methods must be rather soft: instructive guidelines for price formation, not direct controls or directives.

Price deregulation results in a dramatic change in relative prices and, somewhat unexpectedly, in large shifts in consumption patterns. The consumer is bewildered at first, but, as a well-behaved homo *oeconomicus*, starts to adjust his purchases very quickly. It leads to large shifts in demand for industrial and agricultural products, and because producers have only a limited capacity to adjust, excess supply appears in many fields. Prices, as always, react faster than quantities and the whole economy is switched, practically overnight, from an excess-demand régime into an excess-supply régime with over-production, excessive inventories, bankruptcies, unemployment, etc. It is easy to liberalise prices, but it is difficult to help firms in trouble because of rapid price deregulation. Basically, you do not want to interfere with market forces but you have to admit that the change came too abruptly and that in many firms and industrial sectors the supply response is necessarily delayed.

Foreign trade liberalisation and currency convertibility are the most effective instruments of competition policy. International competitive pressures form the only feasible demonopolisation procedure because demonopolisation by break-up is a delicate and lengthy task. It necessarily takes time and expertise and is in one specific sense premature: we want to leave all kinds of industrial restructuring to the new owners, which means leaving it until after privatisation. The new owners and managers would do it more efficiently than government bureaucrats. Trade liberalisation and currency convertibility (at least current account convertibility) are the only methods of ensuring that domestic prices reflect international scarcities and availabilities. They

cannot be introduced, however, before a devaluation that brings official exchange rates close to market ones.

Official exchange rates have been for decades close to purchasing power parities, and because of grossly distorted relative prices, large subsidies and low-quality and non-traded goods, they have been very far from viable, defensible market exchange rates. The unavoidable but sizable devaluation has two very unpleasant short-term consequences:

- home-made inflation (after price deregulation) is accelerated by imported inflation. If the country in question (as in the case of Czechoslovakia) imports most of its energy, fuels and other raw materials, imported inflation immediately hits the whole economy and a dangerous inflationary spiral unravels. Cautious, restrictive macroeconomic policy helps to prevent it, but output and employment losses create another problem in need of solution;
- viable exchange rates lead to the emergence of unexpected winners and losers among enterprises and whole industrial branches. New comparative advantages and disadvantages are revealed in this process, very often against a *priori* (mostly technocratic) views of both government and enterprise bureaucrats. More sophisticated products, using skilled labour and based on heavy doses of research and development, and products with higher value-added share lose, and simple products win. It is considered absolutely wrong by those opponents of our radical market-oriented reforms who cannot distinguish between short-term and long-term economic effects and who want to directly secure optimal future economic activities by today's government actions. Devaluation therefore gives another dimension to the call for government industrial policy measures, which is difficult to resist.

Trade liberalisation and currency convertibility cannot be introduced without sufficient hard currency reserves in the vaults of the central banks. Post-communist countries usually have rather negligible domestic reserves and non-negligible external hard currency debts, so that the tricky process of foreign assistance starts to unfold. We are persuaded by experts in international economic and financial organisations, by foreign political leaders and by development economists that we need foreign help. However, the experience of many developing countries teaches us that foreign aid is the 'kiss of death' (to use Milton Friedman's apt phrase) and that the temporary drawings of foreign funds for government purposes should be very limited. Foreign stand-by arrangements, of course indispensable in the short run, cannot be used (or misused) as a substitute for other necessary reform measures,

as they unfortunately so often are. The reforming country must wait for private investment, which will be available immediately an investment climate is created and investment opportunities appear. In the meantime, the best method of foreign assistance is the opening of foreign markets and the promotion of foreign trade, perhaps supplemented with selective technical assistance. As Peter Bauer says, 'better than to give a man a fish is to teach him how to fish'. I hope the reforming countries of Central and Eastern Europe will not fall into the 'foreign aid trap' and will use foreign funds very cautiously.

On the macroeconomic side of the reform, we have to avoid a similar dangerous trap. The macroeconomic task is conceptually simple, but practically very intriguing. Macroeconomic restriction, based on a state budget surplus and on very prudent monetary targeting, is absolutely necessary, since without it a vicious circle of inflation and stagnation will evolve and direct controls will be reintroduced. A restrictive fiscal policy coincides with the declining role of the state and with the cutting of all kinds of subsidies, which makes it easier. But it coincides also with a decreasing overall tax burden, with generous tax holidays and many types of tax exemptions, with growing uncertainty, with increasing unemployment and unemployment benefits, with various forms of wage and income indexation, and so on. Price liberalisation abruptly brings to an end the old macroeconomic and microeconomic relationships, and the budgetary process becomes technically and organisationally very difficult.

The reformers are under heavy pressure to relax their restrictive macropolicies. They are accused of deliberately keeping aggregate demand at an insufficient level, and the well-known arguments in favour of Keynesian expansionary policy are endlessly repeated. We know, however, that the slope and position of our aggregate supply curve do not promise any positive short-term supply response, so that any loosening of demand constraints would be counterproductive and inflationary. But to keep macropolicy on track in a rapidly changing environment is almost impossible. Our task is to minimise errors, not to emit false signals or to reflate the economy.

### Sequencing the Reforms

As for the sequencing and the speed of the economic reform: the lesson I have learned during my 20 months in office is really different from what is usually assumed *a priori* and different from what is suggested in the standard economic literature. We can almost argue that neither the sequencing nor the speed of transition is all that relevant because neither can be really controlled. In my opinion it is wrong to presume

anything else and to attack reformers in Eastern Europe for not being able to control the sequencing aspect of the transformation process. Questions about whether shock therapy is the right way to dismantle a centrally-planned economy are misplaced. In reality there has never been any real shock therapy, because it can never be realised. Fast changes can and must be carried out: in the macroeconomic sphere. You can easily introduce currency reform, liberalise prices, and eliminate import or export restrictions. It will take much longer to change tax and accounting legislation and the business code. You cannot privatise the economy overnight. The speed of the reform has, therefore, several dimensions, each with its own dynamic and pace of progress. This has been clear to me right from the start.'

However, in my keynote address at the World Bank Annual Conference on Development Economics in Washington, D.C. in March 1990 (reprinted in my 'A Road to Market Economy', Prague, 1991) I argued that the art of sequencing constitutes the art of the economic transformation; that incorrect sequencing could cause us to fall into the reform trap. I now see that I was wrong and that it was a false argument. I did not realise sufficiently that in a democratic society neither sequencing nor speed can be exogenously determined. Only an omnipotent monarch, a dictator, or a social engineer operating in a vacuum could exercise full control over the transformation. We live, however, in the real world, which imposes many legitimate constraints that must be accepted and dealt with. Attempts to fine-tune the reform are as misguided as attempts to fine-tune the economy. They stem from the same conceptual mistakes and the same false arguments. Over-stressing the sequencing issue in practical policy-making is nothing other than an attempt to make the world conform to the dreams of ambitious intellectuals, who suppose that the world is based on — to use Hayek's dictum — human design and not on human action. We have to accept modestly that the all-embracing systemic change is a multi-dimensional process with its own dynamics. Our scope for manoeuvring is in reality rather small.

Different reform steps have very different time requirements and it is absolutely impossible to expect that they can somehow be combined and that the perfectly planned reform process can start on a given, prearranged date. But I can suggest the following sequencing guidelines:

- monetary and fiscal restrictions to stop the continuous generation of excess demand and of macroeconomic instability and uncertainty; beginning the subsidy-elimination process in order to reintroduce a hard budget constraint for enterprises and real values for scarce economic goods for all economic agents;

- devaluation to bring an over-valued official exchange rate close to a market one and to stop the black market's use of foreign currencies;
- trade liberalisation, currency convertibility and price deregulation, accompanied by stand-by arrangements with the IMF (and other organisations);
- privatisation as a process of transferring property rights;
- starting a 'take-off' process, based mostly on private initiative, on industrial restructuring, on the deepening of domestic markets, and on full participation in the world economy.

To put it differently: demand measures should precede supply measures, even if temporary costs in terms of growth, output and employment are very high.

This sequence of measures is the one we try to follow but, to be honest, it is exactly the opposite of what our critics would like to see.

#### Czechoslovak Experience Before July 1991

The sequencing outlined above provides a suitable basis for describing our own reform process.

First: We gave a very clear signal to all economic agents in 1990 and followed the same path in 1991. The rate of growth of the money supply has been significantly lower than the rate of growth of nominal income. It was partly the result of deliberate policies introduced by our monetary authorities, partly the unintended consequence of unexpected prudence on the part of new-born commercial banks, which have to operate in a highly uncertain environment. We fear that the monetary squeeze may be too restrictive.

The state budget was in surplus in 1990 and its share of GDP declined by 4 per cent. A similar outcome is envisaged for 1991: in the first half of the year the surplus was even bigger than had been expected and planned. Expenditures have been kept within carefully-prepared budgetary plans, but revenues have been unexpectedly higher. The monopolistic or quasi-monopolistic state-owned firms misused the freedom of price deregulation, set prices too high, and lost considerable sales; but on average their profits increased and so therefore did direct taxes and budgetary revenues. This outcome was only partly expected, but nominal aggregate demand was surprisingly very inelastic and total sales increased. Consumers tried to maintain their previous patterns of consumption; private savings were transferred to firms and indirectly to the government. As a reaction, at the end of June indirect taxes were lowered, various tax concessions were granted and some expenditures were increased to compensate for inflation. But fine-tuning the

budgetary process remains very difficult.

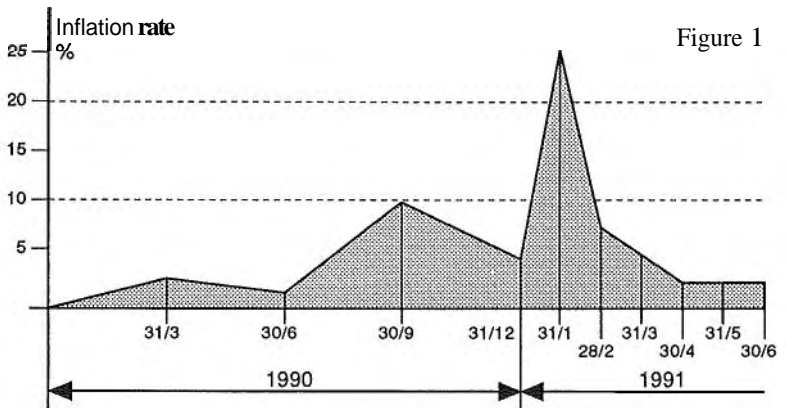
**Second:** Cutting practically all food subsidies in mid-1990 gave a clear signal to both consumers and producers. Revealed price elasticities were not as low as expected; consumption of meat, milk and other products diminished considerably and an excess supply of agricultural products appeared. Agricultural surpluses have been increasing over time, and our ability to deal with them has become the most explosive issue of the moment. All short-term solutions are either extremely costly or they work against the logic of the reform.

All remaining industrial subsidies were abolished when prices were deregulated. To our great regret, important subsidies to energy and fuel prices were not halted until as late as May 1991. The only remaining subsidy is of state-owned flats, whose prices will be deregulated (or at least dramatically increased) at the beginning of 1992.

Third: The Czechoslovak crown was devalued three times in 1990. The current exchange rate (fixed to the basket of five currencies) is very close to the still-existing black market exchange rate and has proved to be viable and defensible. It should play the very important role of a nominal anchor in the very quickly moving sands of all other unstable nominal economic variables. We want to let prices (and wages) adjust gradually to the current exchange rate and find their equilibrium levels; our main strategy is to prevent the emergence of a dangerous spiral of domestic price inflation → devaluation → imported inflation → domestic price inflation. The main instrument is, of course, the very cautious monetary and fiscal policy, as was stressed above.

Fourth: Trade liberalisation and internal currency convertibility were introduced together with price deregulation in January 1991. The devalued crown plus domestic reserves augmented by the IMF and EC stabilisation loans (the SAL agreement with the World Bank is not yet signed) plus inflow of private investments minus unexpected losses of our export markets in the former COMECON countries resulted in a balance-of-payments equilibrium in the first half of 1991 and in a rather small (and slower than expected) increase in foreign indebtedness, which still only amounts to \$US8 billion. The loss of Soviet, East German and other Eastern European markets is visible more in losses of output and employment, and on our estimates it accounts for between one half and two thirds of current output losses (which amounted to about 13 – 15 per cent in the first half of 1991).

Price liberalisation brought about a price shock of unknown proportions because in January prices — on a month-to-month basis — jumped by almost 26 per cent. Price inflation, however, decelerated rapidly, with monthly inflation rates between February and June of 7,



4.7, 2, 1.9, and 1.8 per cent (see Figure 1). Such rapid disinflation is rare; it was achieved mostly by reasonable macroeconomic policies, without anything resembling monetary reform, and only partly by price regulation. Now the task is to keep wages in a quiet state (which will be more and more difficult after the drastic decline in real wages) and not to relax monetary and fiscal policies too much.

Fifth: The privatisation process follows two, relatively separate, paths. Privatisation of small-scale business by public auction continues at an acceptable rate, given the circumstances, and every weekend hundreds of shops, restaurants, hotels, and small firms in wholesaling, in services and even in the industrial and construction sector are privatised. Citizens can see the first fruits of this process in the form of better services, lower prices, a greater variety of products offered, etc. Much more important is the large-scale learning process, involving psychological and attitudinal change.

Large-scale privatisation is and must be slower. Privatisation of large industrial firms proceeds by standard methods (mostly with the active participation of Western investors), but it is still restricted to individual cases because of the tricky valuation problem mentioned earlier (quite apart from other non-trivial organisational issues). We are in the final stage of preparations for the first privatisation wave of several hundred larger scale state owned enterprises, which will be based on vouchers and which will invite all Czechoslovak citizens to participate. The exchange of shares of privatised enterprises for vouchers (very often combined with other privatisation methods) will take the form of a 'silent auction' in a nation-wide computerised auction system (in several iterations or 'rounds'). We face continual pressure, however, to



## DISMANTLING SOCIALISM

postpone privatisation, to start with the restructuring (it would be more accurate to say the bailing-out) of the firms by government bureaucrats, their academic advisers and foreign experts, and to privatise them at an unknown future stage. The privatisation process nevertheless proceeds according to plan and will hopefully be completed on schedule.

Systemic transformation is not a single act. It is a complicated process which needs unceasing involvement, support, defence and explanation, because opposing forces — old-style socialists as well as other irresponsible people who were in the past seduced by decades of comfortable paternalism — are always there waiting for our effort, drive, strength, and enthusiasm to falter. They are waiting for us to make mistakes as well. But we will not give up, we will not let them win, we have to demonstrate that socialism can be dismantled.

### Notes

- 1 Three John Bonython Lectures, published by The Centre for Independent Studies:  
Economic Control or Economic Development?, P.T. Bauer, 1989, [OP27]  
Endangered Freedom, Thomas Sowell, 1988, [OP22]  
Socialism is Dead *but Leviathan* Lives On, James M. Buchanan, 1990, [OP30]  
All lectures are listed on the inside back cover.
- 2 After arriving in Australia, I was interested to learn that the J-curve arguments played an important role in economic policy discussions in the early years of former Treasurer Paul Keating's economic reform program.
- 3 I was struck by the identical reasoning by former New Zealand Finance Minister Roger Douglas (now Sir Roger) who states in his article in *Policy*, Autumn 1990, p4:  
A great deal of technical debate has been aired worldwide about the optimum sequencing of structural reform, and the alleged sequencing errors of governments, both here and elsewhere. Armchair theorists postulate the desirability of tackling the labour market or the tradeable goods market before embarking, for example, on the deregulation of sectors such as finance. At a purely analytical level the debate is entertaining, but no clear-cut answers emerge. Moreover, from my point of view as a practitioner, the question is irrelevant. Before you can plan your perfect move in the perfect way at the perfect time, the situation has already changed. Instead of a perfect result, you wind up with a missed opportunity.  
Some decisions take full effect the date they are made. Others take two to five years hard work before they can be fully implemented. Perfect sequencing is just not achievable. If a window of opportunity opens up for a decision or action that makes sense in the medium term, use it before the window closes.

# Closing Remarks

Dean *Wills*, AM

Chairman and Managing Director, Coca-Cola Amatil Limited

Last May, I was privileged to meet Alexander Dubček in Sydney, and to gain from him a better understanding of the role he and many others played in releasing Czechoslovakia from a repressive yoke and in moving towards freedoms that we take for granted. Fascinating as these events were, they essentially concerned Czechoslovakia's past. Tonight we have heard from Václav Klaus about his vision of that country's future expressed in clear, unequivocal, and even passionate terms. He wants nothing less for his country than freedom for all its citizens to operate within, to use his phrase, an 'unconstrained . . . unspoiled market economy'.

This year's John Bonython Lecture should be compulsory reading for all Australians. It was characterised by clarity of expression, by certainty of purpose, and, most important, by its clear exposition of the means by which Czechoslovakia will reach its goals. The non-use of adjectives is most significant.

Yet Dr Klaus also cautioned those of us in the West not to rush to judgment if the development of a market economy does not seem to be happening overnight. To use another of his phrases, 'systemic transformation is not a single act'. The very nature of the freedom he advocates means that the community must be brought to understand that the best chance for its future prosperity lies in the establishment of a thriving free market. That cannot be done by edict.

It has been enlightening for us all to have heard Dr Klaus's clear and straightforward articulation of his goals for Czechoslovakia. He is clearly impatient to achieve them, but also well aware that, sometimes, where there are winners there are also losers, and that the latter must be brought to an understanding of where a better future lies for all. This is no easy task; and those of us who have not so far given much thought to it are invited now to contemplate it.

You have stimulated us, Dr Klaus, with your thoughtful lecture and 'report' on the dismantling of socialism in Czechoslovakia. We wish you well in your endeavours to institutionalise a market economy in your country. We now have a better appreciation of the difficulties that that entails and of the pain that must be experienced before the gain. I assure you that the good wishes of not only those here tonight but of all thinking Australians go with you. Please join me in thanking Dr Klaus by acclamation.

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# Dismantling Socialism

## A Preliminary Report

*Václav Klaus*

In the eighth John Bonython Lecture, Václav Klaus, Finance Minister of Czechoslovakia, gives an account of his government's attempts to move away from a socialist system towards a free-enterprise system. Originally an advocate of a 'market economy without adjectives', he now calls for 'an unconstrained, unrestricted, full-fledged, unspoiled market economy'. Progress towards this is slowed by opposition from old-style socialists, encouraged by the advice of Western Keynesians and interventionists. 'But we will not give up, we will not let them win, we have to demonstrate that socialism can be dismantled.'

Václav Klaus is Finance Minister of Czechoslovakia. He is one of the founders of the Czechoslovak Civic Forum Movement and as its key representative joined the Government of National Understanding in December 1989. He is now chairman of the Civic Democratic Party, which arose out of Civic Forum in 1991 to become the largest party in the Parliament.

The John Bonython Lecture Series was inaugurated by the Centre for Independent Studies in 1984 to honour the founding Chairman of its Board of Trustees. Each year the Centre sponsors a lecture to examine the relationship between individuals and the economic, social and political factors that make up a free society. The lectures are published in the CIS Occasional Papers series.

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