

# Czechs Fall From Their Ivory Tower

*Fed for years on a diet of constant success, the Czechs have recently discovered that all is not as it seemed and some belated belt-tightening is in store*

by Jiri Pehe

"T he economic transformation is over," Czech Prime Minister Vaclav Klaus proclaimed at the end of 1995. In his words, the Czech Republic was out of surgery and was flexing its muscles in a rehabilitation center. Western investment banks rated the country as the safest place in the post-communist world to invest money. And Western economists spoke of "the Czech economic miracle," describing the country as an "East European tiger." The Czechs were led to believe that they were indeed uniquely lucky among the post-communist nations. Their country seemed like a well-run corporation destined to churn out positive results. The pain

of transition was almost unbearably light.

A year and a half later, the Czech Republic is experiencing a profound political crisis and faces major economic problems. What has gone wrong?



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*The minority government of Premier Vaclav Klaus, left, is relying more than ever on courting the parliament's few independents, such as ex-Social Democrat Jozef Wagner, right, and on backstage deals with individual deputies.*

The roots of the Czech Republic's fall from grace can be traced to 1992, when Klaus's Civic Democratic Party (ODS) won the parliamentary elections by a large margin. The party's victory marked the end of a protracted struggle between two wings of the Civic Forum, a broad umbrella of anti-communist forces. The "technocrats," led by Klaus, felt that economic reforms needed to be completed quickly. They considered laws that would protect the privatization process from abuse an unnecessary hindrance. First, they argued, you need to create a market, and its "invisible hand" will then take care of the rest. The defeated wing, represented by Jiri Dienstbier's Civic Movement, was in favor of reforming the economy at a slower pace but within as perfect a legal framework as possible.

In the next four years, Klaus's right-of-center coalition—which also included the neoliberal Civic Democratic Alliance (ODA) and the Christian Democratic Union (KDU-CSL)—ruled basically unopposed. The coalition enjoyed a comfortable majority in the parliament, where it faced a fragmented leftist opposition. The government was able to speed up and complete the privatization process, whose main pillar was the voucher scheme that was launched in the fall of 1991 when Klaus was still the Czechoslovak finance minister. The voucher privatization proved to be a smashing success with the public, as some 6 million Czechs, in a nation of 10 million, bought vouchers. In theory, everyone benefited. The state was basically giving away its property for symbolic fees, allowing its citizens to benefit economically and dramatically shifting the ownership structure of the economy in the process.

Klaus's tight budgetary and fiscal policies, introduced after the "velvet divorce" with Slovakia, brought positive macroeconomic results: the inflation rate dropped below 10 percent in 1994; the country had a balanced budget for several years in a row; and the unemployment

rate, hovering around 3 percent, was the lowest in the region. Arguments that such low unemployment could point to a lack of restructuring at the company level were rejected by the increasingly confident Klaus.

#### THE OWNERSHIP MUDDLE

In reality, the voucher scheme was above all a political project. It made a large number of Czechs personally tied to or directly dependent on Klaus's reforms. The jury is still out on whether it was good for the economy. Some 400 investment funds that emerged at the end of 1991 quickly managed to buy the majority of vouchers from the population by promising huge returns. Most funds were set up by state-owned banks and insurance companies. The privatization process thus traveled a circle: people bought vouchers from the state, only to sell them to investment funds that were in many cases controlled by state-owned banks.

Suggestions that, under such conditions, commercial banking should be separated from investment banking were rejected. Klaus argued that the best way was to let the market sort things out. In theory, market forces should have started working to their full potential when shares of many companies privatized under the voucher scheme began trading on the Prague Stock Exchange in the spring of 1993. But there were at least two serious problems. First, the unclear rules of trading on the stock exchange did not ensure sufficient transparency in deal-making, and the government did little to improve them. Second, the voucher scheme resulted in no-

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minal privatization, and a large number of Czech companies still do not have clearly defined owners.

Typically, several investment funds—meaning several banks and other financial groups that control the funds—vie for control of a single company. To make things more complicated, banks have come to be

partly owned by investment funds. The resulting ownership muddle leaves room for managers—often members of the old nomenklatura—to run the companies at their own whim.

Obtaining shares in enterprises appeared to be a good business for banks, at least initially. But that has also removed the incentive for banks to

start bankruptcy proceedings against unprofitable companies in which they held ownership stakes.

Unclear ownership relations and an imperfect legal framework have facilitated outright fraud. Managers in some smaller banks arbitrarily lent money to friends running dubious companies or conspired to enrich themselves.

Twelve banks have collapsed in the last three years. Some of them, as well as some investment funds and companies, were “tunneled out” through deliberately arranged disadvantageous deals. Billions of crowns have been siphoned out of banks and investment funds by sophisticated fraud artists. Owing to legal loopholes and benefiting from the nonchalant approach of the Klaus administration in this area, some of the fraudulent schemes did not become apparent for years.

## POLITICAL OSSIFICATION

The Klaus government could have prevented much of the fraud had it followed the initial wave of reforms with appropriate changes in legislation and with the privatization of banks. And it was then, during its first term, that the government had the public support to move ahead with potentially unpopular health-care, housing, and energy-sector reforms. Instead, in 1993 and 1994, the government began slowing down. The governing parties prematurely began thinking about the next elections, scheduled for 1996. Opinion polls repeatedly showed a huge lead for the ODS and the coalition, so postponing unpopular measures, such as energy-price and rent hikes, until the next electoral term appeared increasingly sensible.

In the absence of a strong opposition, the coalition parties soon began to grow together with the state. President Vaclav Havel had warned in 1994 that Czech political parties engaged in excessive partisanship and that the government parties behaved as if they “owned the state.” But Havel’s calls for supporting civic initiatives and groups whose activity would somewhat offset such phenomena were rejected by Klaus. The premier criticized the proponents of a civil society as people who wanted to introduce unnecessary layers between the state and the free individual. Klaus also repeatedly rejected the decentralization of the country into regions, warning against what he called the “unraveling” of state administration.

As a result, the political process in the country has remained confined to the central level. Beneath the surface of smoothly functioning democratic mechanisms and institutions, there has been a degree of hollowness. Civic activism and active political participation have been quite limited. The Czech Republic has resembled a relatively well-run corporation, rather than a multilayered democratic society.

The first visible signs of trouble emerged in 1994, when the coalition parties, confident of their joint victory in the upcoming elections and

used to ignoring the weak opposition, gradually stopped communicating with the public. This breakdown in communication has never been successfully repaired.

### WE ARE NUMBER ONE

For four years, the country was fed the diet of constant success. The Klaus government repeatedly stressed that the Czech Republic was the front-runner in economic and political reforms and should be treated as such by international institutions and Western countries. The positive macroeconomic indicators made it possible for Klaus to argue that the country was in the same league with some European Union nations rather than with its post-communist neighbors.

Czechs sabotaged the so-called Visegrad grouping, arguing against any institutionalization. The Czech government felt that closer cooperation with Poland, Slovakia, or Hungary could only hinder the country's march to Europe.

Even the European Union was not safe from criticism. Klaus repeatedly spoke out against political integration in Europe, warning against sacrificing Czech national interests. He also repeatedly spoke of the need to develop a Czech national identity in the wake of the disintegration of Czechoslovakia. Dissolving a newly formed national identity in the sea of united Europe was deemed undesirable.

But national identity was being built on shaky ground. The ideology of permanent success—the notion that the Czech Republic was the region's star performer and that it was able to reform without economic pain—was bound to backfire at the first sign of economic trouble. Moreover, Czech politicians shunned any open discussion of the country's difficult past. Issues such as Czechoslovakia's surrender to Hitler, the collaboration of many Czechs with the Nazi occupying forces, the expulsion of 3 million Sudeten Germans from the country after World War II, and the active collaboration of many Czechs with the communist regime have re-

mained complete or partial taboos. Isolated from their own past [and, therefore, unable to learn from it] and fed on illusions of their uniqueness in the post-communist period, the Czechs were bound to crash.

At the end of 1995, some six months before the parliamentary elections, Klaus announced that the transformation process was basically over. The prime minister apparently hoped that that assertion would secure his government another four years. Instead, it created a crisis of expectations. Many people began asking themselves whether they, under such circumstances, should not have personally benefited more from such a successful reform process. Many also began thinking that with the country out of the transformation tunnel, they could look around for alternatives to the ruling coalition parties.

### KLAUS'S TROUBLE WITH COLOR

Klaus showed real leadership only as long as the country faced a reality that appeared to be black and white. But in his "post-transformation period," things by definition became more colorful. Klaus and other coalition leaders (particularly those from his ODS) were, however, unable to abandon their black-and-white vocabulary. Any suggestions that certain things could be handled differently were often dismissed as attacks on the very foundations of the post-1989 system. As a result, many people began to regard the coalition politicians as arrogant.

According to opinion polls, the perceived arrogance of ODS leaders cost the coalition dearly in the June 1996 parliamentary elections. The ODS remained the strongest party, but the opposition won 101 seats in the 200-member lower chamber. Klaus, nevertheless, formed a minority government. But, unused to governing under pressure, the coalition found it almost impossible to make decisions. It opted for confrontation, waging major battles over trivialities. Big reform projects in the housing, banking, energy, and health-care sectors were put on hold.

The lack of a developed civil society or au-

onomous politics on the local and regional level allowed Czech politics to slide even further into mindless partisanship. Political debates became highly personalized. The longstanding personal rivalry between Milos Zeman, leader of the largest opposition party, the Social Democrats (CSSD), and Klaus intensified, causing many a political debate to degenerate to the level of personal insults.

By November 1996, when the first-ever Senate elections were held, opinion polls were showing that most voters were disgusted with politics and politicians. Only 30 percent of the voters bothered to turn out to vote for senatorial candidates.

Earlier, in the summer, a number of banking and other financial scandals had broken out. In the changed political situation, under the watchful eye of the opposition, the Klaus government was no longer able to sweep charges of corruption and fraud under the carpet. For the first time since 1992, commentators began openly talking about how the ruling coalition had neglected the rule of law, failing especially to ensure that proper rules governing capital markets and decent anti-corruption laws were in place. And the media began looking for culprits.

#### FALLING INTO A 'FOUL MOOD'

Instead of openly admitting its mistakes and promising quick remedies, the coalition tried to play down the importance of proliferating scandals. The Social Democrats also did not act in a constructive way. Rather than offering economic and political alternatives to the increasingly paralyzed coalition, the largest opposition party manufactured more charges, some of which it was later unable to substantiate. Zeman also began flirting with populism, aiming to woo voters of the two other opposition parties—the extreme-right Republicans and the unreformed Communists.

The behavior of the Social Democrats had a devastating effect on Czech politics. Under normal circumstances, many of the voters who were

increasingly unhappy with the paralyzed and unrepentant coalition would cross over to the democratic opposition camp. But CSSD's radicalism and populism made this alternative unappealing. As a result, an increasing number of people found themselves in a political no-man's land. By early spring, opinion polls showed that a large majority of people were dissatisfied with the political situation in the country. Even worse, an increasing number of people began expressing doubts about the democratic system.

Fault lines began to appear within the coalition and individual coalition parties. The Christian Democrats, whose program is in many ways a social-democratic one, began to distance themselves from the two civic parties within the coalition. The ODS then attempted to start an internal debate, but it quickly discovered that it was, above all, Vaclav Klaus's party. Most ODS leaders and members realized that without Klaus at the helm the ODS would probably disintegrate. The ODA, the smallest of the three coalition parties, changed its leadership in the spring of 1997, which has prompted conflicts within the party between the ascendant pragmatists and the defeated conservatives.

These political developments took place against the backdrop of increasing economic problems. Until April, the paralyzed government had been unable to react to the rapidly growing trade and budget deficits or to the growth of wages that outpaced the growth of labor productivity. When it finally decided to act, it announced a set of austerity measures and plans to improve the legal system, but the package came too late and did not go far enough. Moreover, the coalition again failed to assume any political responsibility for the long list of economic failures it finally conceded.

The failure to accompany the austerity package with a reshuffle of the government was probably the most important reason why the announced measures failed to generate any fresh political dynamism. The popularity of the government quickly plummeted to an all-

time low. Calls for the government to resign began to proliferate.

### THE CROWN'S TUMBLE

In May, currency speculators, prompted by the mounting political and economic troubles of the country, attacked the Czech crown. The central bank attempted to defend the 15 percent band in which the crown had been allowed to fluctuate, but it gave up after spending some \$3 billion. The surrender, as well as the subsequent decline in the crown's value, represented the worst blow for Klaus to date, as the stable crown had been a chief tenet of his policy.

In an attempt to prevent the crown from plunging even further, the coalition leaders came up with a second package of austerity measures at the end of May. In many ways, the announced measures represented the kind of belt-tightening that the country should have adopted several years ago. For the first time, Klaus had to admit the country was living far above its means.

This was unpleasant news on many counts. Czechs were being asked to tighten their belts almost eight years after the revolution and only a year after they were told by Klaus the transformation process was over. And Czechs were told that Hungary and Poland had succeeded where the Czech Republic had failed because those two countries had more courage to face reality.

The Czech Republic plunged into what Havel described as a "foul mood." For the first time since 1989, opinion polls began to indicate that almost half of the population thought the pre-1989 system was better than the new democratic order. Many analysts and commentators agreed that probably the best solution under the circumstances would have been the resignation of the Klaus government and the naming of a new government, without Klaus at the helm. But ODS leaders resolutely opposed replacing Klaus. They were caught in a dilemma: their party could no longer afford to go on with Klaus but, at the same time, it could not afford to go on without Klaus—yet. In the end, the

coalition decided to replace two ministers and subsequently asked the parliament for a vote of confidence. It passed by one vote—that of a former CSSD deputy who had been expelled from the party.

### NO GUTS

Any government that enjoys such fragile parliamentary support and the confidence of only a fifth of the population would find it extremely difficult to implement highly unpopular austerity measures. The Czech ruling coalition is, moreover, severely disjointed. Any outbreak of labor unrest or another attack on the crown could bring the Klaus government down.

In June, the KDU-CSL was on the brink of letting the Klaus government fall. The coalition leaders opted for a compromise that kept the government alive. Many Czech politicians as well as signatories of petitions sent to Klaus before the vote of confidence admitted that the situation in the country was bad but warned that alternatives could be even worse.

Such a "velvety" way of doing things may work in some situations. In the process of transformation or in times of political crises, however, bolder political decisions—such as those that the Poles or Hungarians were willing to adopt on certain occasions—may be more appropriate. The fact that the Czechs, traditionally prone to being overcautious, do not have enough courage to make such decisions is probably the chief reason why they cannot hope to assume a leading role in the region any time soon. ♣

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The currency's recent tumble represented the worst blow for Prime Minister Klaus to date.