CZECHOSLOVAKIA: REFORM AND PRIVATIZATION

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Czechoslovakia is a nation consisting of two different republics. The Czech and Slovak republics, though close in proximity, are vastly different because of their separate histories. The Czech's have historically been greatly influenced by the intellectually and culturally advanced societies of Austria and Germany while the Slovak's have been mainly controlled by the underdeveloped society of Hungary. These influences, along with those of the communist rule, have enabled Czechoslovakia to be the most successful of the former communist Eastern European nations in introducing a capitalist economy into its society.

Since the fall of the communist regime, Czechoslovakia has undergone radical changes to try to improve the quality of life for its people. There has been some opposition to the radicals in the government due to a few of the negative short-term effects of the transition from communism to capitalism, such as unemployment and scarcity of consumer goods, but the foreseen long-term benefits of capitalism are acknowledged by the majority of the people. With the privatization of business and price liberalization, plans are developing for more investment from foreign countries furthermore, the Czech and Slovak people are expecting better lives in the future what they experienced under communist rule.
The recent events in Eastern Europe have caused many changes. Aside from the social and political changes, economic change has been one of great interest. One of these Eastern European nations, Czechoslovakia, has been more successful than the others in moving to a free market economy. Even though the differences between the two republics of this nation have torn them apart, economic reforms such as privatization, price liberalization, banking system and currency changes have been very effective. Relations and trade with the West have also improved and have been important in helping Czechoslovakia in its reform process.

HISTORY OF CZECHOSLOVAKIA

The Federal Republic of Czechoslovakia was formed in 1918 by two peoples, the Czechs and the Slovaks, who are closely related yet have some very different historical experiences. To fully understand the recent developments in Czechoslovakia, one must first get acquainted with the history of these two groups. The ancestors of the Czechs and the Slovaks were once united in the Great Moravian Empire in the ninth century which is the basis of the bond between the two peoples. Soon after, the two groups went their separate ways when the Hungarians conquered Slovakia in the late ninth century.

In their search for independence, both groups of people struggled against powerful neighbor countries. The Czechs have had much more success with self-rule than their counterparts.
From the tenth to the fifteenth century, the Czech-inhabited Bohemian Kingdom was politically and militarily powerful. When many Germans began immigrating into Bohemia, tension was created between the Czechs and the Germans. In 1403, the Czechs challenged papal authority and the incident turned into a national struggle for political and ecclesiastical independence. Czechs maintained political self-rule for over two centuries thereafter.

Soon after the Czech acceptance of a Hapsburg ruler as a monarch, in 1526, the Hapsburgs overtook the Bohemian Kingdom. In 1620, at the Battle of White Mountain, the Hapsburgs defeated the resisting Bohemian estates. The Czech leaders were either killed or went into exile and Czech lands were incorporated into Austria.

During the nineteenth century industrial revolution, the peasant Czech nation was transformed into a society that included industrial workers, a middle class, and an elite group of intellectuals. With the influence of the Enlightenment and romanticism, the Czechs revived their culture and national consciousness. By the mid-nineteenth century, Czechs were making political demands of independence. Austria's parliamentary system allowed them to legalize a language decree putting Czech equal to German in Bohemian administration and law. They were almost allowed to reinstate the historic rights of the Bohemian Kingdom but were stopped by strong disapproval from Germany and Hungary.

The Slovaks had a much more difficult history than the
Czechs. In the tenth century, they were incorporated into the Kingdom of Hungary and reduced to being serfs of Hungarian overlords.

Over the years, the Slovaks had some contact with the Czechs. For a short period of time in the fifteenth century, Czech Hussite armies occupied parts of Slovakia. And in the sixteenth century, Czech Protestant literature circulated in Slovakia and the Czech language became the literary language of educated Slovaks.

Until the end of the nineteenth century, when Slovakia became industrialized, the Slovak people remained rural serfs led by a small group of intellectuals. After determining the nature of the Slovak identity, the Slovaks made an attempt at establishing cultural institutions and demanding some political rights, but were stopped by the ruling Hungarian aristocracy.

At the beginning of World War I, a Czech leader, Tomas Masaryk, promoted the idea of reuniting the Czechs and Slovaks into one political entity. The Slovaks were then struggling to keep their newly found national identity and quickly agreed to the joining of the two countries. The Czechs and Slovaks formed a new political state in 1918 called the Czechoslovak Republic. The government consisted of a parliamentary democracy and, though surrounded by hostile neighbors, thrived for twenty years.

Pressure from within by dissatisfied German minorities and from aggressive neighbors caused the break up of the newly formed nation. Tension was great in the Sudetenland where many Germans
lived. Hitler came to power in Germany in 1933 and demanded annexation of that highly industrialized area of Czechoslovakia. Britain and France, Czechoslovakia's major allies, wanted to avoid a war with Germany and, therefore, signed the Munich Agreement in 1938, giving the Sudetenland to the Third Reich. Soon after that, Nazi troops invaded and occupied all of Czech lands and the Slovaks declared independence.

After World War II, Czechoslovakia was reconstituted as an independent nation but was faced once more with the threat of the very powerful neighboring state, the Soviet Union. The president of Czechoslovakia made some major concessions to the Communist Party of Czechoslovakia by letting them gain control over some of the important ministries of the government such as information, internal trade, finance, and interior. His attempt to satisfy the Soviet Union while, at the same time, trying to keep Czechoslovakia's democratic, pluralistic political system failed and the communists overthrew the government in 1948. The country was quickly forced to accept Soviet rule and became a victim of Stalinization. Since that time, Czechoslovakia's democratic tradition was suppressed but not destroyed. The people have had reformist tendencies toward a more democratic form of socialism, but were quickly quieted by the anti-reformist government of the Soviet Union. The strongest reform movement which took place in 1968, and even included support from within the Czechoslovak Communist Party, ended with an invasion by the Warsaw Pact military forces of the country.¹

In November 1989, as a result of the break up of the Soviet
Union, Czechoslovakia was given the opportunity to elect its government and to redesign its economy. Before 1989, the country had no legal base for a market economy, virtually no private sector, economic activity that was concentrated in large units, prices that were completely controlled, and heavy dependency on other communist nations for its foreign trade. In deciding to change to a market economy, the leaders of the country had to develop a major structural reform program that included price liberalization, privatization of industry, and banking system and currency changes. Fortunately, Czechoslovakia has so far been the most successful of the three previously communist Central European nations to adopt such policies. Even with the break up of the Czech and Slovak republics in January 1991, the two areas plan to have a prosperous future with the changes that are occurring.

COMMUNIST LEFT-OVERS

Even though it seems as if Czechoslovakia is getting a fresh start at rebuilding its economy, there are many structural problems that exist in the country due to previous communist rule. Reversing these problems to improve the economy will take much work. The Eastern European economies did fairly well in the first decade of communist rule but started doing badly when they could not advance with the rest of the world by improving productivity, absorbing new technologies, making a wider range of products, and making them better. Czechoslovakia's income
per capita was comparable to that of France and Austria in the 1950's, but could not keep up in the 1960's and fell further back in the 1970's. One cannot discern exactly how the economies of Eastern Europe have been affected by communism because official statistics were rarely issued. When they were issued, they were unrealistic. Now one of these countries, Czechoslovakia, must face that its currency is practically worthless, prices are too high, telecommunications are terrible, the railroad is deteriorating, and there is a severe shortage of consumer goods. There is also a critical problem with overmanning which the communists produced so that jobs could be maintained for all people.4

All of these economic problems directly affect the average Czechoslovak citizen. In introducing a market economy, the people will face even more problems during the transition period than they did under communist rule until prices and wages stabilize. Right now, people still must accept a very low standard of living where the average monthly wage is $100-150 at the current exchange rate of 28 crowns per dollar, and the prices of most goods are so high that the average person can only afford to buy necessities. Some basic items like bread, milk, meat, and public transportation were kept under subsidies until just recently.4 Even though Czechoslovakia produces everything needed by the people, supplies are so low that people must spend hours in queues every day to get the items they need, and the quality of the products is so low that people would rather pay higher prices for imports.5
It can be easily deduced that the big problem is the inefficiency of production. The country needs to increase output per worker, increase quality, and, at the same time, keep prices low. The problem with trying to increase efficiency in production is that jobs must be cut and the general public is not in favor of rising unemployment.

This particular problem is very evident in Slovakia, where most of the country's arms factories are located. When the communists took over, this area was changed from a mainly agricultural society to an industrial one producing mostly weapons. Now, there is a plan to get rid of the unwanted armaments industry by changing the products that those factories produce to heavy equipment like bulldozers. Even though the Slovakian economy would no longer be dependent on selling arms to such countries as Iraq and Syria, trade unions are reluctant to change because of the fear of losing jobs. The people of Czechoslovakia are pulled in one direction by the job security that communism provided and in another direction by the hope for a better life that a market economy could give them.

RADICALS VS. GRADUALISTS

Since the end of the communist control in Czechoslovakia, the government has enthusiastically agreed that the change to a market economy would benefit the country. After the decision of what changes to make, leaders ceased to agree. Government officials have been split on the issue of the pace of reforms.
The radicals say that "social and economic pain is more likely to be accepted if it is concentrated in the immediate aftermath of the post-communist revolution, rather than dragged out." In firm opposition, the gradualists are afraid of the effects that might be caused by "shock therapy."

The two men around whom this controversy centers are Czech Premier Vaclav Klaus and the Slovak Premier Vladimir Meciar. Klaus follows the belief of the well-known economist Milton Freidman that the immediate introduction of free market policies is crucial to the success of the switch from communism to a market economy. This means the prompt removal of government control on prices, exchange rates, wages, and government monopolies. With these changes, the radicals do not expect to see benefits immediately, but assure that with patience, the wealth and the living standards of the population will increase over the next few years. They claim that the public should be prepared to make sacrifices, at first, in order to reap the benefits of a free market economy.

The gradualists like Meciar do not believe that the public is prepared to make those sacrifices. They feel that radical changes in economic policy will cause more harm than good leading to massive unemployment and high prices. According to them, changes should be made slowly so as not to disrupt economic stability. Not all gradualists are former communists like Meciar, who turned nationalist after the Velvet Revolution. He has led the Slovak movement to stop the economic reform and the privatization program that Klaus developed as Finance
Minister of the country. It was this controversy which delayed the introduction of many reform laws and, eventually, led to the splitting of the two republics into independent countries. Meciar wanted more autonomy from Prague to set a slower pace of reform for Slovakia, but no compromises could made. The split was inevitable. On January 1, 1993, the two republics separated. Only time will tell which pace of reform is the most successful.

RESOURCES

In order to develop the Czech and Slovak economies, the country must depend on the productive utilization of its resources. The country has several natural resources. Its principal crops consist of wheat, barley, potatoes, sugarbeets, and hops. Its energy resources include coal which is mined on a large scale, hydro-electric and nuclear power. Other important natural resources include forestry, copper, zinc, and gold. Compared with the rest of Eastern Europe, Czechoslovakia is one of the most industrialized countries with a well developed industrial infrastructure. Czechoslovak industry, which made up 66% of national income and 36% of employment in 1990, has five major components: engineering (22% of total industry); food industry (13.9%); chemicals (11.9%); electro-technical and metalworking (10.4%); and steel (9.5%). One of the country's most important resources is its people. Czechoslovakia has a
strong tradition in engineering and manufacturing and the capability of producing quality products. Most Czechs believe that forty years of communism is not enough to destroy their history of highly successful, highly skilled workers. It is precisely this history that can help Czechoslovakia overcome the economic struggle it is facing. There are several traditional Czechoslovak industries that require the use of skilled workers such as glass cutters, jewelry makers, brewers, and porcelain producers. These people are being used to produce high quality, skilled labor intensive goods that are in great demand in the West. There are also a great number of unskilled workers who have the capability of increasing productivity with the right training and management.

RECENT ECONOMIC STATISTICS

Overall, the economic outlook for Czechoslovakia is good considering the stress that an economic transition can cause. Following the turmoil of the Velvet Revolution, the country's net material product fell only 1.1% and there was a decrease in real wages of only 5.7%. In spite of the wage decrease, domestic demand rose, as did consumption, in anticipation of the devaluation of the crown.

With the effects of many policies enacted in 1991, the economy took a downturn. The GDP dropped by 16%, real wages decreased 25%, and unemployment rose to a yearly average of 4.17%. Most of this was due to financial difficulties that
businesses were facing because of the devaluation of the crown in December 1990 that made raw material imports more expensive. Decreasing subsidies, and privatization of some 25,000 small businesses also caused difficulties. In addition to government subsidies being reduced form 16% of GDP in 1989 to 4.6% in 1991, the deregulation of prices began in 1991. Price regulation was reduced from 85% of GDP under regulation in 1991 to only 13-16% in January of 1991 and decreased to a small 5-6% by October of 1991. This caused prices to increase 49.2% in the first half of 1991, but they steadied during the summer for a 53.6% change in prices for the entire year. Prices are estimated only to have risen 10-15% in 1992. The reason that such changes could be made while keeping economic stability was the tight monetary and fiscal policies used by the government.2

Unemployment is expected to increase slightly as privatization of inefficiently-run businesses continues, but this privatization will also bring new investment to the country. Economic conditions that may result from the split of the Czech and Slovak republics are unknown, but a big economic difference can already be seen between the two with 5% unemployment in the Czech Republic, as of March 1992, and 13% in the Slovak Republic.13

**BANKING SYSTEM AND CURRENCY**

The banking system in Czechoslovakia consists of a central bank freed from government control in January 1990. The central
bank has the responsibility of regulating the money supply and the commercial banking sector and implementing fiscal and monetary policy. Since reforms began, 36 commercial banks have been established and representative offices have been opened by over forty foreign banks. Banking activities still are severely segmented and there is a lack of competition, but with further development and experience, competition is sure to improve. With the liberalization of access to foreign exchange in January 1991, most foreign exchange controls were abolished. An active interbank market in foreign exchange has, therefore, developed due to a growth in foreign currency deposits. The State Bank is responsible for setting the discount rate and overall reserve ratios for banks. In March 1992, it abolished interest rate ceilings and considered ending credit limits. The State Bank, instead, continued setting lending limits because of the uncertainty of the relationship of the two republics. Credit ceilings in 1992 were slightly increased to support growth in the private sector.

Czechoslovakia formerly had two different exchange rates for the crown; a commercial rate and a tourist rate. Since the tourist rate of exchange was much higher at 30 crowns per dollar than the commercial rate (14.25 crowns), an opportunity for black market exchange was present. On January 1, 1991, the country instituted a new foreign exchange regime which creates one rate and implements internal convertability of the crown. The exchange rate is set daily using a market value and floats against the dollar within a set band.
convertability allows businesses to freely convert crowns into foreign currency for current account transactions. In addition, all foreign currency receipts held within the country must be offered to the State Bank for crowns. Bank accounts denominated in foreign currency are only allowed for paid in capital by the foreign shareholder. There are some controls on the exchange of foreign currency, to keep the exchange rate and reserves stable, but for the most part, currency can be exchanged freely.

**PRIVATIZATION OF BUSINESS**

The decision on how to privatize formerly state-owned businesses has been one of the most important choices the government has had to make in planning for the transition to a market economy. The process of shifting 120,000 small and medium-sized enterprises and more than 4,000 large enterprises to the private sector is a complex task. Preparation for privatization involved the passage of several laws detailing the procedures for restitution and privatization, the first of which were enacted at the beginning of 1991.

The small-scale privatization started in 1991 as local committees throughout Czechoslovakia auctioned off small businesses. By the end of March 1991, a total of 17,621 small businesses in the Czech Republic and 8,536 in the Slovak Republic had been privatized yielding approximately $750 million and $375 million respectively. In addition, it is estimated that 100,000 small and medium sized businesses were returned to
former owners or their heirs to undo some of the
nationalizations which occurred under communist rule.

The first wave of the large-scale privatization, which
would put one-third of Czechoslovak industry in private hands,
began in 1992. Under the large-scale program, each large
enterprise must submit a privatization plan to its founding
ministry for approval. Other interested parties, including
foreign investors can submit competing plans. Except for
setting aside 3% of shares for a fund to cover restitution
claims, there is great flexibility to tailor plans to an
enterprise's needs. Enterprise shares can go to foreign
investors, be sold to domestic investors, distributed to
employees, retained by the state, etc.

Enterprises can also designate some or all of their shares
to be sold through the "voucher method" designed by the
Czechoslovak government. Each citizen over the age of 18 is
allowed to purchase books of vouchers for 1030 crowns which can
then be used to bid for shares in enterprises or invested in
mutual funds. Public interest in the voucher system developed
quickly when several mutual funds sprung up offering ten to
thirty times the initial cost of the vouchers. About 8.5
million citizens bought and registered voucher books for the
first round. The government plans to privatize 95% of large
enterprises by the end of 1993.19

It is estimated that 70-80% of Czechoslovakia's enterprises
are technically bankrupt. After the transfer to private
ownership, it is expected that private shareholders will start
to restructure, sell, or liquidate their companies and that many enterprises will fail. Many citizens participating in the voucher system will find that they own a piece of nothing, but they will be warned by the government of this from the beginning.

Privatization of the agricultural sector poses a different set of problems, because agriculture has been controlled by cooperatives which are not technically state enterprises. Laws have been passed restoring land to the original owners. In the Spring of 1992, land owners and cooperative members from each cooperative voted to form a committee which would develop plans to dispose of property and to reorganize or dissolve the cooperative.

The loss of Slovakia from the Federation could prove to be a benefit for the privatization of Czech enterprises. The Slovak government and people have been reluctant to participate in the privatization plan from the beginning. Most of the country's unwanted armaments industry is located in Slovakia, also. Without Slovakia to hold it back, the Czech Republic will be quicker at privatizing enterprises and probably more successful in the long-run.

PRICE LIBERALIZATION

Price liberalization, along with privatization, is one of the major steps required of Eastern European nations wanting a market economy. Many skeptics argue that liberalization of
prices and wages will lead to heavy inflation. Because the seller of a product is able to set the price of the product, inflation may be caused in the short term. But if the price of a product if too high, consumers will not buy much of the product. Eventually, the seller will be forced to decrease the price in order to sell an adequate amount of the product. It is this concept that many communists have difficulty in understanding. The seller of a product has a desire to make a profit, but if too few items are sold, the profit is very low.

The definition of price is misunderstood in the former communist countries. People say that, in Eastern Europe, goods are cheap, but you cannot find them. The nominal price may be low in these countries, but when one must stand in line for hours to buy an item, the time one spends becomes part of the real price. Considering the time that Czechoslovak citizens spend shopping for goods, the real price that they pay for the items they purchase is much more than they realize.

On January 1, 1991, a price liberalization program was introduced in Czechoslovakia covering most goods and services. As a result, prices increased by 49.2% during the first half of the year, but quickly stabilized thereafter. In autumn of 1991, price controls were removed from previous heavily subsidized bread, milk, and meat. Granulated sugar was left as the only major food product still subject to price control.22 To protect the economy from a wage-price spiral, the government has formed an agreement with employers and trade unions allowing modest wage increases. Even with this allowance, wages have not
increased much because many enterprises cannot afford to pay higher wages. This also helps facilitate the strict monetary policy to keep the crown stable.

FOREIGN INVESTMENT AND TRADE

Opening up to the world has been one of Czechoslovakia's goals since it decided to adopt a free market economy. Restructuring the country's economy will require a large amount of capital which must come from outside sources. Recognizing this fact, the Czechoslovak government has made some radical changes in its laws and regulations governing foreign investment and trade.

Joint ventures have been legal in Czechoslovakia since 1986, but were then strictly controlled by the government. Now, foreign investors can invest in an existing Czechoslovak enterprise, establish a new business with a domestic partner, or set up a 100% foreign owned company. Since April 1991, foreign investments could be made without any formal approval from the federal, Czech, or Slovak ministries of finance, except when it is done through the large privatization program. To promote foreign investments, the government has dropped restrictions on the repatriation of profits and developed tax incentives. According to reports from the State Bank, in 1991, direct foreign investment was about $600 million. Foreign investment is expected to increase as privatization progresses. The majority of foreign investment has occured in the Czech Republic where investors have committed $5 billion to privatization
projects which would be $490 per capita investment.

Czechoslovak trade with other countries has decreased over the last few years due to the collapse of eastern markets, but trade with the West is increasing. The current account went from a $400 million surplus in 1989 to a $1.1 billion deficit in 1990 because of a sharp rise in imports. That deficit was financed entirely by reserves. Concern about the stability of the crown prompted the government to introduce an import surcharge of 20%, applied mainly to consumer goods, in December of 1990. In 1991, there was a trade surplus of $300 million due more to a drop in imports by 20.5% than an increase in exports. Total exports actually fell 9.8% that year, but exports to Western developed countries rose by one percent. The devaluation of the crown in December of 1990 helped develop exports to Western countries. The lack of imports in 1991 may have harmed consumers because of a lack of consumer goods to protect them from domestic monopolies. A rise in exports to developed countries in 1992 will help the Czechoslovak economy by building up foreign currency reserves which will give the country a better ability to purchase more imports in the future.

The government has adopted several new policies in the last few years to promote trade. Since April 1991, any Czechoslovak-registered company which lists foreign trade as one of its activities can take part in foreign trade without having to register with the Federal Ministry of Foreign Trade. Areas that are of concern for national security, such as armaments and drugs, still require government authorization.
revolution, Czechoslovakia joined the International Monetary Fund and the World Bank and began negotiations with the EC. Association agreements have been signed with both the EC and EFTA which provide for the removal of trade barriers. A free trade agreement is being negotiated with Hungary and Poland, and other trade agreements have been made with most of the former Soviet states. Czechoslovakia has also signed bilateral investment treaties with 26 countries to attract foreign investment.25

INTERNATIONAL AID

Of all the difficulties that can occur during economic reform, financial hardships are the most challenging to solve. It is with the help of bilateral and multilateral foreign assistance that countries such as Czechoslovakia, Poland, and Hungary are able to overcome these financial problems and focus on making reforms. Czechoslovakia has been offered the least amount of commitments for foreign assistance ($1,303,200,000) of the three Central European countries. Commitments have been offered for various purposes such as the environment ($38 mil.), training ($10 mil.), agriculture ($0.2 mil.), non-project assistance ($733.4 mil.), export credits ($87 mil.), and private investment ($0.5 mil.).26 Much of the assistance bears near-market terms of interest, but Czechoslovakia, having very low foreign debt prior to its revolution, should accumulate a net positive inflow of $1-2 billion during 1990-1991.27
The World Bank is signing structural adjustment loans to Central Europe for the purposes of enterprise reform and privatization, financial sector restructuring, trade liberalization, assistance to unemployed workers, and balance of payments assistance. The EC has developed a program to aid these nations in five specific areas: 1) improving access to Western markets; 2) providing humanitarian and food aid; 3) providing technical training; 4) establishing programs for environmental protection and rehabilitation; and 5) extending loans for economic and investment restructuring.

The OECD lowered Czechoslovakia's status from a "low debt" to a "moderately indebted country" due to financial assistance it has received in the last few years. Even so, the country has a greater flexibility in borrowing abroad than Poland and Hungary who are tightly constrained by their existing debts. If Czechoslovakia can improve its trade with other countries, its debt ratio is sure to improve.

IMPLICATIONS FOR THE FUTURE

Because the two republics have such different economic backgrounds, reforms and the severing of the Federation will cause different effects in both areas. Slovakia tends to have more large, monopolistic and inefficient state enterprises, a higher unemployment rate, less foreign investment, and depends more on trade with other Eastern European countries than the Czech Republic. The Slovaks, being enthusiastic about the break
up of the country, plan to slow down privatization, give the
government greater control over the economy, and use subsidies
to keep ailing state enterprises running. This slowing down of
reforms will most likely give Slovakia problems in integrating
itself with Western nations. Some foreign businesses have
already complained that the Slovak government is not cooperative
in approving investment proposals. This rejection of the West
and of free market concepts may slowly widen the gap between the
standard of living in the two republics.

The Czech Republic has so far proved that it is quickly on
its way to becoming a free market economy. Now that Slovakia has
decided to go its separate way, the Czech Republic will probably
find that additional reforms are made quicker, smoother, and
more successful without the two republics disputing. The Czech
people must accept the fact that this transition will require
hard work from everyone involved and that benefits will not be
seen overnight. The Czech government has done a wonderful job
keeping the bad effects of reform, like inflation and
unemployment, under control, but needs to keep planning very
carefully to avoid future problems.

The U.S. and the Western European countries will also
benefit from the transition of the Czech Republic. Through
trade and investment, these countries can take advantage of the
inexpensive goods and labor present in the country. At the same
time, these more developed countries can help speed up
development in the Czech Republic by giving management and
technical expertise and foreign currency, and by further opening
Western markets to trade with Eastern Europe.
END NOTES


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