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# **ŠIK'S REFORM IN MONETARY ECONOMY IN CSSR**

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### ***Abstract***

*The study analyzes economic reform prepared in 1964-65 and carried out in stages through 1968 and focuses on the banking sector. The economic reform was regarded as comprehensive and particular opinions on it were developed gradually. The reform was unambiguously aimed at abandoning the Soviet type centrally planned economy and transitioning to a market economy with a dominant role of state and indicative planning. Banking and financial sector was not a significant part in Šik's reform, since the real economy was more significant. However, the rehabilitation of functions of money forced the managing centre to create an adequate institutional environment. In the banking system the concept of separate central and commercial banking was enforced, nevertheless the framework of monetary policy instruments was not put in practice. This situation was comparable with the transformation to market economy at the beginning of the 1990s but there were stronger internal and external political limitations in the 1960s. Šik's reform concerning banking could not have been carried out thoroughly because of the Soviet external intervention in August 1968 and subsequent change in home affairs. Despite, the banking sector was one of the industries where the pursued reform changes endured to a certain extent, and they became a basis for attempts at autonomous monetary policy and activation of money in the 1970s and 1980s.*

***Keywords: Czechoslovakia, economic reform, centrally planned economy, banking***

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## 1. INTRODUCTION

The Czechoslovak attempt at reforming the centrally planned economy reform in the second half of the 1960s was and still is a relatively frequent object of scientific concern. However, most of specific literature deals with the general concept, main features in the context of social movement in the second half of 1968. Historians has been paid their attention to, the partial especially, historical topics so far. Indeed, the sphere of banking sector is satisfactorily depicted already (for example Vencovský et al., 1999; Vencovský, 2003), however it is only part of a wider summary containing banking sector development in the area of today's Czech Republic.

The reform in the second half of the 1960s still offers a wide range of unanswered questions or less explored and problems. Either it is the question if the banking sector represented a significant reform component, or if the genuine intension of reform efforts consisted of separation of the issuing and monetary policy from commercial banking and financial services. The Czech economic thought of that time was naturally reflected in discussions, the theoretic approaches separated gradually from rigid Stalinist theory wielding the Czechoslovak economic thought from the end of the 1940s. To what extent the Czechoslovak economists absorbed the newest knowledge of current world economics was a matter of controversy as well. The aim of the study is, besides the analysis of pragmatic issues in contemporary discussions on banking sector reform, to show the level and development of contemporary economic thought with an eye on subsequent progress. Authors are convinced that, in spite of forced termination of reform efforts and reintroduction of a centralistic model, the banking sphere got into a new development phase which did not imply an entire return to pre-reform status despite the numerous limits. Accordingly, it applies to financial theories as well.

Failure of the third economic plan led to increased criticism of existing economic and political system and a low living standard not only by common people, but also by the economic elite and some members of management of the Communist Party. Likewise, as in the 1950s at that time opinions about modifying the contemporary socialist economy started to appear. From a few initial alternatives the next (the second in the course)<sup>1</sup> concept of economic reform was put forward (called Šik's economic reform afterwards). Introducing the market elements in the centrally planned economy was essential. After adaptations and approval by the Communist Party in 1965<sup>2</sup> a draft of the economic reform was gradually implemented and became economic reality. Principles were as follows: the market should have been the primary mechanism

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<sup>1</sup> The first attempt at the reform of the centrally planned economy in Czechoslovakia was carried out from 1958 to 1962 and is known under the name of Kurt Rozsypal, the contemporary deputy director at the State Planning Office, which led the team conceiving the reform.

<sup>2</sup> For more information on conflicts referred to the concepts of reform and their assertion see Šik, 1990 or Kosta, 2005.

determining the firms' and consumers' behavior, economic subjects (firms) should have been more responsible for their development and its results (e. g. investments should have been financed from their own resources); economic plans ought to play rather a role of orienting goals and not to coordinate economic activities.<sup>3</sup>

The fourth five-year plan in 1966-70 partly reflected these new fundamentals. As a part of the plan, the firms were to concentrate on fulfillment of wider objectives rather than strictly quantified aims. Primarily, conditions for economic competition and for higher autonomy of enterprises in establishing the supplier-customer relations should be provided. New market features were brought into the directly managed economy. Aims of economic plans mirrored economic development and during their specification, the economic prognoses were incorporated. The companies were to be more motivated with market-conformed (not administrative – directly planned) tools to achieve the aims of the plan. It was intended to set up employees' councils, which could participate in firms' decision-making (Pravda, 1973). The next important change consisted in support of small business and entrepreneurship.

However, the reform process progressed in its dynamics and the original concept was modified and concretized gradually during the second half of the 1960s. The major principles became clearer and predictable. Although the reform was stopped as a consequence of Soviet intervention, it is possible to paint a quite clear-cut picture of its final outcomes if we do not take into account the risks and pitfalls adherent to the reform<sup>4</sup> continuance and possible reactions to them from the implementers' side.

Introduction of the market mechanism is connected with value (monetary) categories, as price, wage, profit, income and interest. Their effect can not be separated from the role of money. Recovery of an active role of money in the economy would be one of its significant effects but also one of the prerequisites of economic reform. Money and other value categories had a specific status and significance in a Soviet type economy, which was different from those in a market economy or contemporary economic theory.

## **2. THE ROLE OF MONEY IN THE CENTRALLY PLANNED ECONOMY**

Architects of the centrally planned economy<sup>5</sup> endeavored to suppress the monetary role as much as possible. Its functions were to be limited only to a unit

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<sup>3</sup> For other aims of the new economic model see for example Šik, 1965 or Urbanek, 1968.

<sup>4</sup> The risk of discontent based on a loss of some social safeties guaranteed by centrally planned economy that could endanger the reform was pointed out also by contemporary western economists, for example Staller, 1968.

<sup>5</sup> A comprehensive theoretic analysis of the Soviet type economic system including functioning of money was given in Šulc, 2004, or Kýn, 1970.

of account. The reasons were ideological and also pragmatic—because money enables relatively independent and subjective action which could negate the intents of the centre. Material proportions were used primarily, but huge amounts of goods and services in natural distribution needed a common equivalent, so it was not possible to avoid this function of money. Money in the centrally planned economy served as its foremost function, as a unit of account, and it wasn't to have any direct impact on real processes.<sup>6</sup> Regardless of its universality, the time and space character of real processes led to a situation when money carried out some of the other economic functions. However, this fact distorted functionality of the centrally planned economy. The serious consequences resulted also from the fact that whilst money was secondary in the production and served only for accounting and evaluation of material transactions determined by the state plan, in consumption it was not so. People were forced to behave economically rationally under the pressure because they felt the budget restraint more strongly.

Separation of monetary circles went hand in hand with separation of price circles. Effects of the next value tool – price – were significantly deformed and the effective and rational allocation of sources was not enabled. The price on the particular market was not set by market relations of supply and demand but by the costs, that corresponded to the Marxist theory in the 19<sup>th</sup> century. In the price circle relating final consumption, the prices were created moreover according to political and social preferences of the centre. If money was not the full-scope tool influencing the economic life, monetary policy carried out in the modern developed countries did not make sense. Likewise, central distribution of financial resources declassed banks on entire intermediaries of assigned sources and on supervisors over their usage in firms (so-called supervision by crown). The two-level banking system was not necessary. Systems with centrally planned economies were characterized by a one-level banking scheme, where all banking functions were affiliated under one banking institution (monobank).<sup>7</sup>

### 3. MONETARY POLICY INSTRUMENTS

“Monetary policy” instruments corresponded to the Socialist approach to money. Monetary equilibrium was understood as having a non-inflationary amount of cash in circulation. Currency came into circulation mostly through paid wages and salaries, in other words, through drawings from savings accounts or drawings on credit at people and firms. The currency was retracted by payments of revenues from retail business to affiliates of the State Bank of Czechoslovakia

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<sup>6</sup> Functions of money in the Soviet type of economy relating to market economy as well as to Marxist theory are described in Itoh, 1996.

<sup>7</sup> The Czechoslovak banking sector was never covered by only one bank. Besides the dominant State Bank of Czechoslovakia and several banks in liquidation (for example Poštovní banka), there existed also Investiční banka and Živnostenská banka, but they were of marginal significance and served only a partial market segment. Similarly Československá státní spořitelna dealt with current accounts of people. In 1965 Československá obchodní banka was established for business with foreign currencies.

(Státní banka Československá, the SBČS or the State Bank). This also matched the scheme of plans covering this area in terms of state plan as main instruments of “monetary policy” in the centrally planned economy.

A cash plan referred to circulation of cash money. It was regulated through determinants of demand and supply of short-term and long-term consumption. On the demand side there were earnings of the population. Another plan was the credit plan. On the resource side of this plan there were the savings of the population, disposable firms’ money and state budget balances. With the separation of production and consumption, the covering became fictional. The actions predicted by the central plan were financed by credit, when there were no other financial sources (own finances of firms, or more often finances distributed by the state budget). It must be noted, the major part of finances was allocated centrally through the state budget – especially investments. The distribution system existed de facto in the financial relations. Naturally, the system needed neither monetary nor capital markets as they were known in contemporary market economies. On the subject of the distribution system, it is apparent that monetary policy (credit policy more specifically) was not a monopoly of the SBČS, but the Ministry of Finance affected it markedly.<sup>8</sup> The Ministry of Finance was responsible for drawing an aggregated financial plan and in cooperation with the Ministry of Foreign Trade and the State Planning Office guaranteed drawing a plan for the national economy. Operative instruments were price and wage regulation.

The question of interest is compelling. The interest had in the centrally planned economy different relevance than in the market economy. The interest rate did not carry out the allocation function, but it was a check and vindicatory instrument that should have forced enterprises to meet the plan targets and to a certain efficiency in relation to the current economic system. From the point of households’ view the interest rate ought to have motivated them to higher savings. Of course interest rate impacts on these subsectors were limited.

#### **4. IMPLEMENTATION OF THE REFORM AND THE BANKING SECTOR**

The first part of reform was approved by the Central Committee of Communist Party of Czechoslovakia at its meeting in January 1965. This was to lead to a bigger independence of enterprises of the state direction and was meant to settle the structure of relative prices so as to become a basis for effective economic decision making. The banking sector wasn’t mentioned yet. The same applies to the Outline of Theses to Improve the System of Planned Management

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<sup>8</sup> The State Bank of Czechoslovakia was directly subordinated to the Ministry of Finance until 1965. Nevertheless the superiority of other state administration bodies (government, State Planning Office) remained afterwards.

of the National Economy written by a collective headed by Ota Šik and Zdeněk Vergner.<sup>9</sup> The document considered a real economy, i.e. several systematic elements such as implementation of market relations and position of enterprise in relation to state and plan (Šulc, 1998). Nevertheless, discussions concerning banking and monetary issues were held among people working in this industry and on the pages of technical papers.

However, changes in the status of the SBČS were done very early after the January meeting. They were pronounced in the State Bank of Czechoslovakia Act in 1965 which got the Bank to get rid of its subordination to the Ministry of Finance. The result of a long term process of changes in the Czechoslovak banking since the mid fifties was embodied in it as well. There were discussions on the role of credit, especially as an active instrument, which should enhance the efficiency of enterprises concurrently with the start of the reform (Daněček, 1964). This led to the removal of enterprises' own resources for financing their current assets and replacing them with credit in 1966 (Holešovský, 1968). The intention was to equalize the starting conditions for all enterprises before the rebuilding of wholesale prices. This step increased the influence of the SBČS on enterprises because the Bank had settled the conditions of providing credit. Strengthening of the role of investment credit was also a subject of debate. It was later expressed in Principles of the Credit Policy of the SBČS for the Year 1967. The function of both types of credit was still tributary to the existing centrally planned system, i.e. credit had to be straight, planned, returnable, special, and backed with resources.

First contributions on the division between monetary and commercial functions appeared in technical papers in 1965, for example, the paper written by Eugen Löbl (1965), a high official of the SBČS. He described the monetary impacts on banking activity and concluded that a greater focus on monetary stability by the SBČS would have been necessary. He also realized the trade off between an effort for monetary stability and commercial activity of the Bank. Nevertheless, the institutional division of both activities appeared to him as an ultimate solution. „*We must not neglect that commercial and monetary functions will trade off. (...) Organizational structure of the bank is necessary to define so that this interest could not influence the independent decision making of monetary section, i.e. to violate the monetary function of the Bank. If it does not come off in practice, it could lead to a split of the State Bank of Czechoslovakia into a separate monetary bank and a separate commercial bank.*“ (Löbl, 1965, p. 603).

Original ideas did not include a division between monetary institution and the set of several independent commercial banks, but an internal division within the SBČS only. Especially, the headquarters of the SBČS was defending it even in 1968. Following words of Václav Zahálka, the SBČS deputy illustrated it: „*Immediate institutional rebuilding of the banking system adequately to projections – moreover to very imperfect and often simplified projections - of*

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<sup>9</sup> Zdeněk Vergner was the director of the Research Institute of Economic Planning at that time.

*future market function would be a step too ill-considered.” Or “If we afford a certain advance it should be only after we are quite sure about the trend of future development and when we are sure about the adequacy of organizational form. (...) From this point of view I count, namely concrete recommendation, which appeared in the works of some theorists, as hardly applicable. I recommend to create a network of special commercial banks or to transform regional affiliates of the State Bank to commercial banks.” (Zahálka, 1968c, pp. 220-221). He himself preferred creating of a set of instruments which would have made effective monetary policy possible according to actual conditions. After that he was for solving institutional arrangement.*

Further he outlined his idea of the future form of the State Bank's organizational structure. He suggested internal division into three sections; monetary, commercial and service for the banking industry (for example clearing, account administration for the public sector, etc.). The latter one had to manage the property of the State Bank therewith „*the service group provides its outputs for a consideration only*”. This had to lead to internal increase in productivity of the bank, i.e. to operational cost efficiency. The head of the SBČS did not confirm the separation of monetary and commercial functions but it insisted on the principle of „*integrated organizational framework*“, where „*independent groups of the bank, in fact independent banks are covered by a unifying element impersonated by a representative of the State Bank of Czechoslovakia.*“ (Zahálka, 1968c, p. 225). It was generally considered that this representative would be a governor and the declarations of Otakar Pohl, the general director of State Bank, confirmed it: „*The importance of monetary policy (...) requires the building of the banking sector as an independent economic industry. This is connected partly with integration of the banking system and concentration of monetary policy management to the State Bank and partly with a deeper democratization and decentralization inside the bank.*“ (Pohl, 1968, p. 4). This formulation however, includes another substantial fact. It shows a distinct shift in the position of the State Bank relative to the state plan and other bodies of state administration responsible for the economic policy of the state. The concept, where the State Bank had been subordinated to the state plan and had thus been responsible only for its fulfillment in the financial area while the key decisions (on wages, prices or exchange relations) that had been made in other state bodies, was now abandoned.

Discussions on economic reform and thus banking reform as its part accelerated during the Prague Spring in 1968. The concept, aimed at a division of the State Bank into separate institutions according to monetary and commercial functions, prevailed step by step. These opinions gained support not only among theoretical economists and high officials of the State Bank but also among officials in other state bodies responsible for economic and financial policy making, especially the Ministry of Finance. This trend could be documented by both technical papers discussions and by government acts, especially after the new government headed by Oldřich Černík was established at the beginning of

April 1968. For example, the government report to the presidium of the National Assembly, regarding the prepared arrangements for the betterment of governmental work in March 1968, notes on the State Bank issue the following: „*Especially monetary and commercial activity will be thoroughly internally separated into organizational units (groups) whereas monetary activity is more important than commercial activity.*“ (Felcman et al., 2000, p. 133). If we compare these words with the words from the Task Schedule for the Government of Oldřich Černík resulting from its statement of policy from the beginning of April 1968: „*To elaborate on the proposal of the new banking system organization securing a separation of monetary and commercial activities. To organize the banking system in a way that it will make functioning of the monetary institution and commercially based credit institutions possible.*“ (Felcman et al., 2000, p. 222).

The State Bank had to conform to the new conditions, so in May 1968 it changed its view and agreed with institutional separation of monetary and commercial activities. The monetary institution and two commercial institutions, one in Prague and the other in Bratislava had to be established. The latter two would have worked besides already existing banks (Živnostenská banka [Trade Bank], Československá obchodní banka [Czechoslovak Merchant Bank], Investiční banka [Investment Bank]). Česká spořitelna [Czech Savings Bank] which specialized in households' savings only had to become a bank, too. The possibility of establishing new banks was taken into account. There were proposals to establish some special banks, such as a bank for agriculture or a cooperative bank in newspapers but the state bodies did not support it.

## 5. THE BANKING SECTOR AND FEDERATION

The Communist Party's Action Program was released on 5<sup>th</sup> April 1968. Although it did not mention either the banking sector or monetary policy, it raised another substantial theme: the Czecho-Slovak rectification. „*The necessities to respect the advantage of the socialist federative organization as a distinguished and proven form of a state organization for coexistence of two equal nations in a common state arise with all seriousness. It is therefore needed to elaborate and to pass the constitutional law.*“ (Rok šedesátý osmý v usneseních a dokumentech ÚV KSČ, 1969, p. 120). This question belonged to the more complicated questions which had been discussed within the frame of this problem of central bank organization.

On one hand, the Ministry of Finance and management of the State Bank promoted one central bank and a single monetary policy. This may be documented by the statement of the State Bank's first deputy Zahálka who pronounced the intentions of the State Bank most often. „*I consider proposals to build two separate central banks and to coordinate their activities by a central body as unacceptable. The autonomy of national monetary institutions would be then fictive or two currencies would be established in our state.*“ (Zahálka,

1968b, p. 4). Minister of Finance Bohumil Sucharda talked in a similar way on 15<sup>th</sup> August 1968: „*I find it necessary to abandon the idea of three separate central banks and to think about only one federal central bank, which would respect the principle of national parity and its bodies in national republics would be endowed with corresponding competences.*“ (Felcman et al., 2000, p. 293). On the other hand, Slovak economists proposed two central banks and one federal board which would have coordinated monetary policy and set its principles. They argued that there were different economic levels in the two respective countries and also that monetary stability in each of the republics would have assured global monetary stability. In addition, they objected that only two alternatives were possible. They referred to the example of the Federal Reserve System in the USA.<sup>10</sup>

It would be difficult to prevent money flows from one part of the state to another, for example because of different interest rates within a single economic and thus monetary area. Historian Karel Půlpán gives another risk factor. The central system could make the transfer of resources from a more developed part of country to the less developed invisible. Transfer of resources made through monetary emission would be hardly controllable. This transfer flowed through a state budget only until now which was essentially more transparent and also, the transfer was of a final amount (Vencovský et al., 1999, p. 429). The system of two central banks would lead to massive inflation and monetary disruption. A compromise was reached at the end. Two national banks, Česká národní banka [Czech National Bank] and Slovenská národní banka [Slovak National Bank], and one federal (SBČS) central bank were established. This concept was embodied in the Act on Czechoslovak Federation passed on 28<sup>th</sup> October 1968. According to this act, the SBČS consisted of federal bank as the top monetary body and of national banks of the two republics. This Act, however, presupposed the existence of other special acts governing the central bank and the banking sector in greater detail, but they were still in preparation.

Regarding the incipient new organization of the economy the existing instruments, especially of administrative character, were used for regulation of monetary development. Tools fitting new conditions as credit contingencies, interest rates or compulsory minimal reserves should have been in exclusive power of the issuing bank after mid-1969. Likewise, the market relations on the microeconomic level, i.e. bank-company relations, with the large range of bank instruments regulating the business sphere should have been established since 1969. It could be illustrated by the reactions of central institutions, for example, the SBČS, to disequilibrium development in years 1967-1970. Another problem consisted in non-existence of the money and capital markets, thus impossibility of inter-branch and inter-company carry-over of capital unlike that of the state budget.

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<sup>10</sup> This controversy was revived in 1989 during the debate on arrangement of constitutional law. Both parties of this controversy used the same arguments as in 1968 (see Dědek et al., 1997).

## 6. MONETARY POLICY AND ECONOMIC DEVELOPMENT

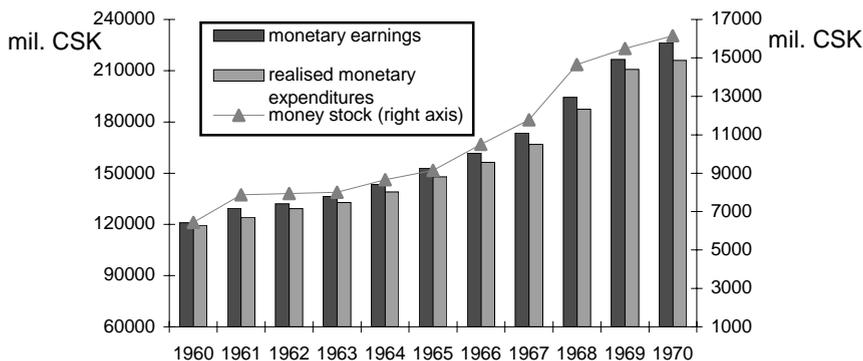
Although it was intended next year the reconstruction of wholesale prices was put into practice by the government in early 1967. Prices were divided into three categories – one part was strictly regulated (food and goods important for population), another part was limited, and the third part was unregulated (selected consumer goods). The goal was not only to bring monetary indicators into the economy, but even to involve the companies in generating their revenues and profits, which could be used for financing the investments from internal company funds subsequently. Prices, partly influenced by the market, should have illustrated the profitability of particular industries as well, and in relation to it also served as a guide to direct larger amounts of investments. It arose from an opinion that the stable price level should not be one of social economic fundamentals, but changes in prices should react to a situation in the market and to scarcity of a particular good and service. Although it was anticipated that the prices could rise up to 19 %, the hurried procedure of reform showed up in a sharp increase of wholesale prices (in industry) by more than 29 % year on year in 1967 (Graph 1). Higher prices in wholesale did not carry over to more notable rise in retail prices. The separation of price circles was still apparent. Whereas there was some liberation in wholesale prices, retail prices remained administratively controlled. In retail trade, prices rose by 1.5 % which was the second highest growth rate in the second half of the 1960s. The “consumer” prices rose more significantly only in 1969.

The firms' profits increased by a higher multiple than was expected thanks to higher prices.<sup>11</sup> Thus companies gained more money for their investments, but there was no pressure to spend efficiently. By virtue of wage ceiling abolition, a more significant nominal wage increase appeared, and together with oversized investments, it resulted in a higher inflation rate. An accelerating inflation rate caused the government to start to control the recently unregulated wages and prices again in September 1967. Besides more strict regulation of wages especially since 1969 (during the return to a directive economic model), there were also other instruments used. They were foremost credit restrictions stemming not only from raised interest rates and their differentiation in favor of long term saving but also from tighter investment credit conditions. For example, the system of competition for credit was introduced. In an effort to siphon off the excessive liquidity in companies, the issuing of bank obligations was intended in 1968. Understandably several items of the state budget were cut, especially expenditures on capital construction. Endeavors to handle disequilibria with these instruments were not very successful.

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<sup>11</sup> The rise in prices redistributed national income in the economy as well. About 16 billion CSK was directed from the central funds to profits of enterprises (Kýn, 1970).

If prices were controlled henceforth<sup>12</sup>, the economic and monetary disequilibria must have shown up somewhere else. People started to save more than before as is illustrated by the development of realized expenditures of the population in Graph 1. The money earnings rose by 4.8 % and realized money expenditures by 4.3 % on average per year in the first half; it was 8.2 %, and 8 % in the second half of the 1960s. The gap must have shown up in an increased rate of deposit consignment on the households' accounts. In comparison of the third and the fourth plan the stock of money in circulation increased markedly in the fourth five-year plan. Whereas the stock of money growth reached 7.6 % per year on average from 1961 to 1965, it was 12.3 % from 1966 to 1970. In the context of reconstruction of prices in 1967, the growth of money among people reached the most rapid rate of 24.4 % compared to 1966. Aggravated stock of money (owing to a wage increase) glanced off in consignment of redundant liquidity. Explanation can be dual. Either the part of savings was forced (and inflationary) in virtue of poor supply, or the propensity to save rose because of previous saturation of consumer demand. Both are possible to observe in that time.



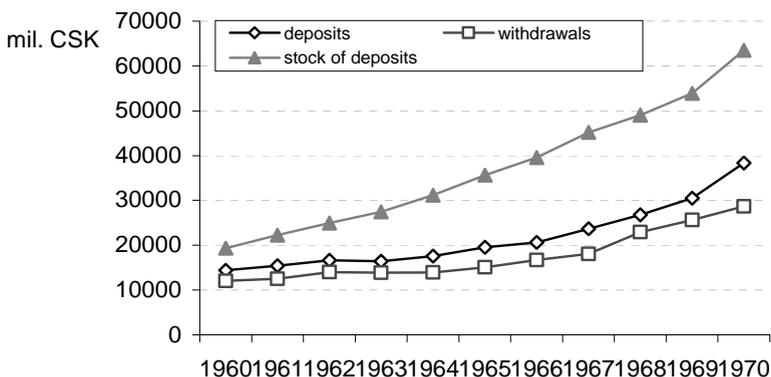
Source: Československý statistický úřad, 1971, p. 460, Federální statistický úřad, 1985, pp. 350-351

Graph 1. Money earnings and realized monetary expenditures of population, stock of money in circulation (mil. of CSK)

This hypothesis is supported by the development of deposits on bank books, which represented a saving instrument for people in Czechoslovakia (Graph 2). If the rise of deposits on bank books developed at an average rate of 6.4 % per year in 1961-65, in the second half of the 1960s it was more than twice

<sup>12</sup> Since 1967 and foremost since mid-1968 the discussions about interconnection of retail and wholesale price circles were held (namely about decreasing of number of sales tax rates). This measure should have created greater pressure on the companies and mitigated disequilibrium gradually. Regarding the disequilibrium and monopoly structure of the economy this step must have been connected inevitably with a fierce rise in prices in retail trade. Then economists were aware of it and they tried to split it into several stages over time.

as high (14.6 %). The maximum growth was reached in 1970 - almost 26 %. Although the deposits rose quite markedly year on year, overall deposits did not rise at the same rate as in the first half of the 1960s. The cause consisted in a higher increase of deposits withdrawals from bank accounts. As withdrawals increased by 4.7 % in 1961-65, in 1966-1970 it accelerated to 13.9 %.



Source: *Československý statistický úřad, 1971, p. 460, Federální statistický úřad, 1985, p. 143*

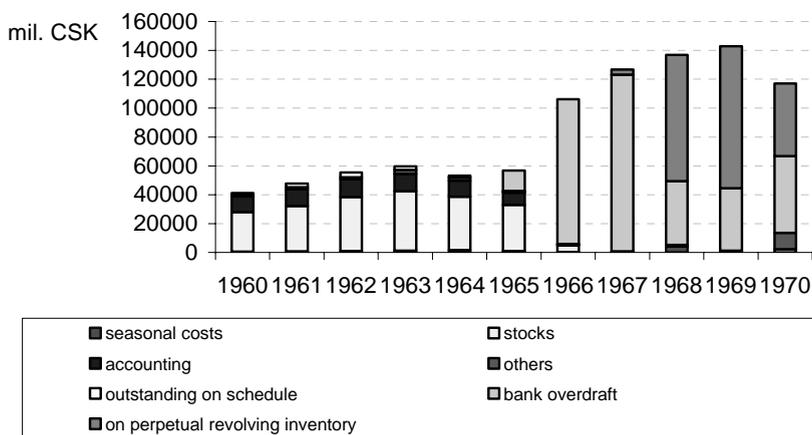
Graph 2. Deposits on bank books including charged interest, withdrawals from bank books, stock of deposits towards the end of the year (mil. of CSK)

## 7. CREDITING BUSINESS AND RESTRICTIVE LENDING POLICY

A year before the reconstruction of prices the turnover funds of companies were transferred to the state budget and they were displaced by operational credit granted by the SBČS. An aim was to provide the companies the equivalent starting conditions, when the most efficient enterprises would survive, they would be able to pay off operational credit and to increase the pressure on efficient utilization of short-term assets (especially inventories). It resulted in significant increase of operational credits (Graph 3). The measure should have been only provisional; operational credit should have been repaid subsequently because enterprises would have had their own financial resources. At the same time, the overdraft facility was introduced in which credit on short-term assets and residual companies' finances were included. The overdraft facility was divided again in 1968 – the credits on perpetual revolving inventories became isolated – they were a long-term financial resource and credit on seasonal costs and inventories were affiliated (but it referred to several industries). The reason was that enterprises used their own resources for covering the short-term assets and efficiency of this instrument was considerably lower in relation to more rational utilization of short-term assets than it was expected.

The reconstruction of prices the beginning of 1967 evoked further rising in operational credit and the centre was forced to establish anti-inflationary and restrictive credit policy in May 1967. Graph 3 illustrates that the policy was not successful – credit rose constantly. The restrictions were imposed hand in hand with reentry regulation of wages and prices. The problem also consisted in the fact that the restrictions could not have been carried out without tightening of some direct (directive) instruments as for example central limits on credit volumes. Independence of the SBČS affiliates was hampered in this area. The profound fall in operational credit from the SBČS became obvious no sooner than in 1970 when the credit restrictions started to manifest themselves again because of pressure on the higher prices.

Restrictive policy influenced the investments more oppressively. The reform assumed decentralization of investments through the larger share of own enterprises' resources on investment activities and enhancement of the role of investment credit. Besides the cut in investments in state plan, new policy also brought about competition for investments, which were organized by the SBČS, and the central bank provided credit on them. Within the allocation of state finances for firms' investments the principle of partial coverage with own assets was asserted additionally. Simultaneously the effort to emphasize the role of interest in credit policy showed up, however interest was never too important according to prior application of direct instruments.



Source: *Československý statistický úřad, 1967, p. 151, Československý statistický úřad, 1971, p. 197*

Note: In 1969 operational credit on seasonal costs and on stocks was compounded. In the graph this consolidated item is represented by stocks.

Graph 3. Structure and value of operational credit provided by the SBČS (mil. of CSK)

## 8. CURRENCY AREA AND FOREIGN TRADE

External relations, from the monetary point of view were connected with exchange regulation. The exchange rate and its relation to balance of payments were the reform priorities. The reason was an attempt to increase the impact of world prices on the domestic economy. The world prices should have been a measure and an instrument to set domestic relative prices right and they would also represent pressure for changes in the structure of the Czechoslovak economy. There were no notions on foreign trade and exchange relations, except the necessity to stimulate more the exporting sectors in the Outline of Theses from 1964. Nevertheless, this area had been highly focused on since 1965. The Act No. 117/1965 Coll. strengthened the competencies in treatment with foreign-exchange in favor of the State Bank and at the expense of the Ministry of Finance and the Ministry of Foreign Trade. The State Bank set the exchange rate in bank operations abroad.<sup>13</sup> In addition, the establishment of Československá obchodní banka [Czechoslovak Merchant Bank] which provided the system of external payments, broke the exchange monopoly of the state.

Suggestions aiming to the abolishment of the rationing system in the area of the exchange rate and suggestions to the gradual establishment of internal and external convertibility of the Czechoslovak crown began to appear in 1967. The actual system isolated the economy from the world market. It was rather complicated and based on multiple exchange rates. Efforts of the reform had at least three goals - to reduce the rationing system gradually, to set the single exchange rate and to establish internal convertibility of currency. Yet certain regulatory arrangements stemming from a special law would have continued. The State Bank should have been responsible for the whole field of external monetary relations and its competency would have been limited only by exchange law (Felcman et al., 2000, p. 225). The Ministry of Finance opposed this intention and the letter of Minister of Finance Bohumil Sucharda to Gustáv Husák, head of the expert commission for preparation of federation, from 15<sup>th</sup> August 1968 showed it very clearly. In connection with the negotiation on Czechoslovak federation he wrote: „*I think therefore, that setting of relations between the government and the central bank (...) should be based on task division and coordination (...) and that the central bank should not receive any tasks belonging to the competence of executive state power, for example in currency adjustment or exchange rate arrangement or in foreign exchange reserves etc., under its exclusive competence.*“ (Felcman et al., 2000, p. 293).

The question of currency convertibility was tied to the development of the real economy. Its intended consequence was to spread the process of establishment currency convertibility within a longer period, preferably within five or seven years (Podlaha, 1968; Zahálka, 1968a). The problem of external

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<sup>13</sup> Setting of this exchange rate was made according to the act which determined golden parity of the Czechoslovak crown. It is necessary to point out that the Bretton-Woods monetary system based on connection of single currencies to gold through American dollar still existed.

convertibility had to be divided into relations to non-socialist, especially capitalist countries and to relations to socialist countries. This included a problem of international monetary systems compatibility. The currency convertibility in non-socialist countries was based on clear rules, at least on Article VIII of Articles of Agreement on IMF<sup>14</sup>, while socialist countries had a different and more complicated system. There had been an agreement on multilateral clearing, where the transferable ruble was a common unit of account since 1963. This agreement was valid for trade payments whereas there was no such agreement for non-trade payment, therefore full convertibility of the Czechoslovak crown depended on further negotiations with other countries within the Council of Mutual Economic Assistance (CMEA) whether they would have supported such a system of mutual convertibility or not. Statements of many responsible state officials and economists documented that optimism did not prevail on this question at all (Podlaha, 1968; Zahálka, 1968a). In connection with the currency convertibility a foreign loan was taken into account.

In context of reconstruction of prices foreign trade represented another canal for economic disequilibrium in ČSSR, through which the surplus purchasing power of both households and firms could have been used. In 1967 the releasing of a rationing system for devices was initiated, however it lasted only till 1970. Czechoslovak companies could have obtained so-called internal repayable or non-repayable device loans, but the companies had to guarantee the loans with their exports. At the same time, the control of imports was lowered moderately. This fact can be traced out in trade balance and balance of payments in several aspects. Similar to exports, in imports the capitalist countries also enforced itself more significantly in the course of the 1960s. The share of countries from CMEA in exports lowered to 57 % in 1969, whilst in the first half of the 1960s their average share was 73 %. The share of imports from CMEA decreased from 72% to 71 % as well in comparing the first and the second half of the 60s.

The export on turnover of foreign trade ratio was lowering. The balance of trade deteriorated successively, though the average growth of exports heightened from 6.9 % to 7.2 % in the second half of the 1960s. The trade deficit was exhibited in particular with capitalist countries in the long term; the imports from these states in volume significantly exceeded the exports from ČSSR there. The commodity structure of imports also changed - the share of machinery and equipment and share of consumption goods rose.<sup>15</sup> This fact supported inflationary pressures in the Czechoslovak economy at the end of the 1960s, thus

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<sup>14</sup> Re-accession to the International Monetary Fund and the World Bank was considered at that time. Czechoslovakia was a member of these institutions from 1945 to 1954. In the case of new accession, Czechoslovakia would have been considered as a new member. The basic condition of membership was subscription amounting to 125 mld. USD (900 mil. CSK) that could be profitably repurchased afterwards.

<sup>15</sup> The imports of consumption goods excluding food increased to 46.5 % year on year in 1968, next year it was 25.7 % and 15.1 % in 1970. The share of imports of consumption goods rose from 5.8 % in 1966 to 8.5 % in 1970.

the disproportion between demand of households and domestic supply of final consumption goods. The higher share of consumption goods in imports explains at the same time why the consumption expenditures could lag behind the abnormal incomes.<sup>16</sup>

Increased restrictions on foreign trade and return to the directive system at the beginning of the 1970s influenced the external relations. On account of cumulative difficulties in international trade the government decided that exchange policy, foreign currency control and elaboration of the exchange plan would be fully in power of the State Bank on the one hand and implementation of rationing system on foreign exchange on the other hand. The foreign exchanges were distributed only for imports that were sufficiently justified by companies and their availability and importance for increment of future investments or enlargement of export capacities must have been proven in advance.

## **9. DEVELOPMENT AFTER INVASION IN AUGUST 1968**

Implementation and further preparations of the reform were not stopped after the invasion in August 1968. The Monetary System Act, Banking Industry Organization Act and Foreign Exchange Act were in progress since mid-1968 and they were considered to be applied since 1<sup>st</sup> July 1969. Some concepts of prospective banking industry arrangements that were included in the acts in question can be found for example in the publication of Czech national bank released in May 1969 (for example Vencovský, Zahálka, et al., 1969). Federal Central Bank had to guarantee integrated monetary policy and the representative of the state in monetary field, too. Currency emission, making of monetary policy principles which National Central Bank had to respect, choosing instruments of this policy and also external relations as exchange rate setting and representing the state at international financial and monetary negotiations belonged to its competences.

Federal Central Bank relation to the state was important too. The bank board, the top body of the bank had to be subordinated to the Federal Assembly. If the development had tended to plural democracy, the State Bank would have gained a great deal of independence. National central banks would have been responsible to the Board of the Federal Bank and to national parliaments too. The concepts of commercial banking organization were embodied in the Act on banking industry organization (Vencovský, et al., 1999; Vencovský, 2003). In the mean time, the organizational changes were carried out in the SBČS. The banking sector should have been prepared for a transition to a two-level model of banking. Regional branches of the SBČS were closed and new affiliates for monetary,

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<sup>16</sup> For more information about Czechoslovak foreign trade see for example Michal, 1968, Metcalf, 1993.

commercial, and investment function were established. In addition to, there was intensive work on founding national banks.

Situation in political area developed step by step in abandoning the reform. A meeting of the Central Committee of Communist Party of Czechoslovakia in April 1969 where Alexander Dubček was replaced by Gustáv Husák is considered a beginning of so-called normalization. It soon appeared in the banking sector, too. General Director of the State Bank Otakar Pohl was replaced by Svatopluk Potáč on 3<sup>rd</sup> October 1969. He began to drive the State Bank and whole banking sector back in the centrally planning system in the spirit of a decision of the Central Committee and the government in October 1969, which defined the State Bank as a central economic body, which has rigorous centralized structure and should enforce central plan's intents and aims through direct economic relations to industry units and companies. But the development of the Czechoslovak economy in the second half of the 1960 left lasting changes in the banking sector. The State Bank did not represent only a „gearing-level“ in the state plan mechanism anymore. It became a prominent and relatively independent institution within the institutional economic framework. It was most visible in the area of foreign exchange.

## 10. CONCLUSIONS

Initially, the banking sector did not play a dominant role in the reform: the real economy was the priority. Rehabilitation of money forced the centre to create a corresponding institutional and system framework. This implies that reform of the banking sector was considered in complexity and concepts developed and gradually refined. The example of the banking sector shows significant dynamics of the reform process which included a certain radicalism going beyond what was possible in the last period of the reform and also hesitation, which harmed the reform. The last proposals suggest further development of the reform very clearly. This unambiguously would have aimed at abandoning the Soviet type of the economy and at the transition to the type existing in some countries in Western Europe – the market system with a strong role of the state and with indicative planning, in that times, if Soviet Union and its allies had not invaded Czechoslovakia. It is possible to say that this reform was the first attempt of a transition from a centrally planned economy to a market economy. The reform of the banking sector corresponded to this trend because its main element was a two-stage banking system with a separate central bank. An appropriate set of monetary policy instruments had to be created simultaneously. These instruments were not developed yet in the initial phase of the reform so the centre had to rely on direct administrative instruments to manage monetary policy.

Theoretical discusses fully reflected Czechoslovak conditions and the development of the reform and increasing awareness of Western economic theories by Czechoslovak economists. The topics which are of intense interest can

corroborate the perception of mainstream economic theory. Besides the problems of market or prices, there is a research on inflation and its admission even in the socialist economy, for example. But main source of inspiration for Czechoslovak economists came from reformatory economic thought in Soviet Union which they further developed and enriched. It is worth to point out the fact, that interest of Czechoslovak economists was primarily determined by practical problems of the centrally planned economy which differed from a market economy. This corresponded to the extent which various currents and fields of economic science were developed in Czechoslovakia. For example econometrics and mathematical economy were not too developed at this time. So the reform of the 1960s opened the door to adoption of modern economic theory by Czechoslovak economists.

This point of view suggests a comparison with economic transition after 1989.<sup>17</sup> Focusing on money and banking it is obvious that the situation was very similar. A separation of monetary functions from commercial functions was prepared even before November 1989 and in the spirit of development in the late 1960s, i.e. organizational and institutional division of the State Bank. A debate on organizational arrangement and functioning of the central bank went in a similar way.

The banking sector was one of those where changes made within Šik's economic reform lasted in subsequent decades and then became a base for independent monetary efforts and thus efforts to activate a role of money in the 1970s and the 1980s despite the fact that the system of centrally planned economy doomed them to permanent failures.

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<sup>17</sup> Comparison of reforms in 1960s and 1990s is included in *Otakar Turek, Šikova reforma po čtyřiceti letech. Listy XXXVIII, No. 4, pp. 18-24, Olomouc, 2008*. For brief information about development in the first years of economic transition see *Josef C. Brada, The Economic Transition of Czechoslovakia From Plan to Market. The Journal of Economic Perspectives, Vol. 5, No. 4 (Autumn, 1991), pp. 171-177*.

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**ŠIKOVA REFORMA MONETARNE EKONOMIJE U  
ČEHOSLOVAČKOJ****Sažetak**

*U radu se analizira gospodarska refoma pripremljena u periodu od 1964 do 1965 koja je provedena u fazama tijekom 1968, s fokusom na bankovni sektor. gospodarska reforma je bila sveobuhvatna, a mišljenja o njoj su se postepeno gradila. Jasni cilj reforme bio je napuštanje centraliziranog gospodarstva sovjetskog tipa i prijelaz na tržišno gospodarstvo s dominantnom ulogom države i indikativnim planiranjem. Bankarstvo i finacijski sektor nisu bili važan dio Šikove reforme budući da je realna ekonomija bila važnija. Ipak, zbog ponovnog oživljavanja funkcije novca, centar upravljanja je morao stvoriti odgovarajuće institucionalne uvjete. U bankovnom sustavu primijenjeno je odvojeno centralno i komercijalno bankarstvo, ali instrumenti monetarne politike nisu provedeni. Ta situacija se može porediti s prijelaskom na tržišno gospodarstvo početkom 1990ih, ali 1960ih unutarnja i vanjska politička ograničenja bila su jača. Šikova reforma bankovnog sustava nije se mogla provesti u potpunosti zbog vanjske intervencije Sovjetskog saveza u kolovozu 1968. i zbog promjena u unutarnjoj politici. Unatoč tome, bankovni sektor je bio jedna od gospodarskih grana u kojoj su reforme izdržale do određene mjere, i postale su osnovom za pokušaj stvaranja autonomne monetarne politike i aktivaciju novca 1970ih i 1980ih.*

**Ključne riječi:** *Čehoslovačka, gospodarska reforma, centralizirani gospodarstvo, bankovni sektor.*

**JEL classification:** E42, E52

