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Statement by the Hon. **PAVEL MERTLIK**,
Governor of the Bank for the **CZECH REPUBLIC**,
at the Joint Annual Discussion

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Transparency: The Importance for the Economic Growth

Fifty-six years ago in Bretton Woods, Czechoslovakia was one of the founding member countries of the IMF and the World Bank. At that time, our country was ranked one of the top 10 economies of the world. More than that, in pre-World War II, Czechoslovakia was also one of the few democracies on the European continent, and the only one in Central Europe. Yet in 1948, the country experienced a Communist revolution, followed by over 40 years of the grand Communist experiment, economic isolation, and the abolishment of private property.[1] Forty years were long enough to bring the once-admired economy down to the fourth or fifth ten among the world's economies—a striking change that normally happens as a result of violent conflicts. Eleven years of transition caused tremendous costs to the society and a lot of pain to the Czech people. It will still take many years for the Czech economy to make it back to the very first league. This striking illustration should serve as a strong memento to any other nation or society that would like to take on a similar hazardous economic experiment, or to any small economy that would favor isolation over integration in the global economy.

While the years of Communism did not at all destroy—not even affect—the high level of literacy and education of the population, the confrontation with the ultimate social state and with the complex and multifaceted legacy of Communism under circumstances of abolished private institutions significantly altered the perceptions, norms, and standards of the society, affected ethics and, most important, market skills. It has proved to be much more difficult to transform the human capital, even if assets provide a fair economic base. Market skills and the market literacy of individuals are not inherited, "given from God," intrinsic to human beings. Market skills are learned by experience; individuals and societies absorb them as they grow and mature, in the way that we breathe the air. Market skills are tacit knowledge that does not stay with the society, they can diminish, if the society suppresses the market mechanism as the ruling force of economic development. This is the one aspect that crucially and fundamentally distinguishes the challenges of transition from the challenges of bringing developing countries out of poverty and up on the development path.

The Czech experience of transition is revealing. The first generation reforms, i.e., the initial liberalization of trade and prices and the subsequent macroeconomic stabilization, had not been politically easy to implement, but became admired by the world for the speed and the smooth way of achieving macroeconomic stability, and for the ambitious and unprecedented pace of transferring property from the state to private hands via the

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[1] Only 3 percent of the total national income of Communist Czechoslovakia was created by private property before the political changes of 1989.

innovative process of voucher privatization. Speed of privatization was declared the critical factor. The privatization distributed ownership—via a fair, relatively transparent, and highly sophisticated and competitive mechanism, to a vast majority of the adult Czech population. It was obvious, and had been so perceived, that secondary trading in shares would have to take place in order to create concentrated structures of ownership in the privatized companies, which would provide a potential for effective corporate governance and corporate restructuring. Underestimated, however, were the requirements of the financial and legal systems, of auditors, of the information disclosure agencies, of the regulation of capital markets and transparency of the corporate sector, and of incentives for and accountability of managers, that would be necessary for such massive secondary trading to avoid any abuse.

A highly competitive market structure, with over a thousand financial intermediaries was allowed to grow in order to facilitate financial intermediation. The experience showed that in the absence of the relevant legislation enforcing prudential behavior, information disclosure, protection of investors' and creditors' rights, in the absence of proper skills of supervision agencies, there is a clear trade-off between the benefits resulting from a highly competitive market structure and the risks of an inability to properly motivate and supervise such complex market structures in an environment entirely lacking relevant information and benchmarks.

The Czech experience showed that the first-generation reforms can be implemented relatively quickly and through relatively uniform economic policies, which may be transferable from one country to another. It, however, also illustrated that the first-generation reforms do not make the transition complete and that the speed of privatization is not the single criterion, not even the most relevant one.

The real critical aspect of the transition is the second-generation reforms, namely building of the institutional underpinnings of a market economy under the circumstances of a lack of market skills and experience, of attitudes and perceptions different from those prevailing in countries with a long and uninterrupted experience of a market economy. If the structural and institutional reforms have not been completed, the macroeconomic stability is not sustainable. It is not difficult to create institutions of a market economy *in the nominal terms*—i.e., laws, codes, and organizations that *look like* the ones in traditional market economies or carry identical names. The challenge is to create institutions that *function like* in stable market economies, that produce the same, predictable outcomes. It should be a lesson for the Bretton Woods institutions, too: fulfilling institutional conditions in the nominal terms (such as approval of certain laws or the foundation of institutions of a certain name) does not automatically mean that from the first day, the society will benefit from outcomes that could be expected from such institutions in traditional market economies.

The experience of transition also clearly demonstrated **the critical importance of the legal system and the financial sector for the functioning of a market economy.** The legal (and tax) systems must protect private property and provide incentives for value creation, rather than to leave room for drifting, or even asset stripping or looting. The financial system must channel funds to the most effective uses; since late last century and the first decades of this century, the world has known that this function critically requires **having a broad range of information available to the public.** In this one aspect, the lesson from transition is not different from the lessons learned during the crises of the early 1900s, from the financial crises of the 1980s or of the mid-1990s.

Among all aspects that challenge the building of institutions and of the capacity and can skyrocket the costs of transition, **the one most critical seems to be the moral hazard issue.**

Among economists, the moral hazard[2] issue, together with the adverse selection problem, is one of consequences of information asymmetry. The moral hazard problem may involve both behavior that is intentionally undesirable from the point of view of the economic or social efficiency (such as management entrenchment, bankruptcy for profit, expropriation of value through transfer pricing, stealing of assets, involvement in high-risk projects, or excessive management compensation), as well as the behavior that is driven by the lack of experience, lack of market incentives, or the lack of care and efforts.

In most markets, asymmetric information in both the adverse selection and moral hazard varieties is present and pervasive. For a number of reasons, it is particularly true about transition countries.

- The information asymmetry is extremely high, due to the magnitude of the change of the whole society, as well as to the magnitude of the transfer of resources.
- The historical information on reputation within the society or on past economic performance loses most of its relevance. As the rules of the game change, in most cases the past performance of individuals and firms no longer matter, making any due diligence and risk assessment difficult or impossible.
- Relevant market economy skills are scarce or absent, thus making the behavior hard to predict and the outcomes often inefficient or harmful. This is true for both individuals and business firms, as well as for financial intermediaries *and* their supervisors.
- The binding norms within the society are weak; the old laws lose their relevance and need to be replaced by hundreds of new codes. The effects of the new codes need to be just tested, due to the fact that any outcome of the law, a code, or a norm depends on the

[2] The moral hazard concept comes from the agency theory, which refers to situations, where the principal relies on the agent to act on his behalf, but cannot fully assess the agent's effort and results due to the stochastic nature of the world. The principal and the agent sign a contract that specifies what exactly the agent is supposed to do in the best interest of the principal. Ideally, they would sign a complete contract specifying the agent's desired behaviour in all states of the world. Due to the stochastic, not fully predictable, nature of the world, however, complete contracts are not feasible. The situation when the agent acts in a way that is undesirable for the principal is referred to as the moral hazard problem.

interaction with the general experience, perceptions, and attitudes of those to be regulated, as well as on the context of other norms and on the enforcement and a broader institutional framework.

- The old Communist ethic loses its legitimacy and cannot substitute for the weak laws.
- Alternative norms, which could fulfill the role of the substitute—such as civic moral, religion, or family norms—may not be developed or widely shared in each and every society.
- The past experience of the ultimate social state causes a belief in bailouts and in the paternal role of the state, and the propensity to push on them.
- Time horizons of managers, new owners, and financiers are often very short, providing them with a weak or no incentive to build a good reputation.
- The government, the parliament, and the judiciary system are not immune from moral hazard, which may affect their willingness to introduce a proper institutional framework and increase the vulnerability of the state to administrative corruption (taking bribes), or even worse, to the state's capture by vested interests.

The existence of moral hazard may have fatal consequences for economic efficiency or even for social cohesion in *any* market economy. In transition economies, however, due to the nature of the transition, the risk of moral hazard is likely to be always higher and more prevailing than in stable, evolutionary market economies. This fact makes it essential to have the moral hazard issue always in mind while designing economic policies in transition, and to try to mitigate it in the institutional design. For example, a too liberal approach to the proper-fit test of managers of financial intermediaries may turn extremely costly for the creditors, minority investors, and/or taxpayers. Too complex institutional structures and a too fast pace, combined with a huge magnitude of transfers, increase the risks that adequate supervision will be simply impossible.

The most important factor of reducing the moral hazard risk is, however, to combat the information asymmetry itself, to shed light on what is actually happening in firms and financial intermediaries, and on what managers, as well as politicians, are doing. Transparency and accountability, in my view, should be a high priority in every society in the best benefit of efficiency, of social cohesion, of the ownership of the economic policies by the broad society, and of economic growth. For all the reasons above, the need to make transparency a high priority is particularly important in transition economies and societies. As a minimum, the lack of transparency increases the costs of transition and slows down economic growth. In the worst case, it may make reforms impossible due to the capture of the state by vested interests, to the loss of credibility of the country's leadership, to the loss of social cohesion and willingness to take the burden of reforms, or due to a violent conflict. Transparency and accountability as a high priority should be promoted, in each and every way, by the country's leadership, encoded in *enforceable* laws, and given much visibility in law enforcement. Transparency refers to both the public sector, including public finance or the judiciary, as well as businesses. Transparency does not come easily, but should be an ever-sought goal.

Broad inclusion is automatically an inevitable part of the requirement of transparency.

In the transition of the Czech economy and society, the full recognition of transparency as a high priority did not come easily and was bought out by much higher fiscal costs than needed. The fiscal burden, which was at least partly unnecessary, and the slow-down of transition of my country in 1996–1999 makes me now a strong promoter of transparency and inclusion.

As the Governor of the World Bank for the Czech Republic, I strongly welcome the endeavor of the Bank to be one of leaders in transparency and inclusion among all multilateral public agencies. I believe that the Bank has achieved this position, which makes it credible when promoting transparency and inclusion among other fora as well as within national governments. The improvement of transparency and inclusion and the promotion of them is, however, a never-ending goal. While it is unrealistic to believe that the Bank—or any public agency—can meet each and every interest, as interests are not homogenous—transparency is, in my view, the best proxy for making such an agency "owned" and trusted by most of the population. Moreover, the strong focus on transparency and inclusion adds to the Bank's legitimacy to intermediate the exchange of information and knowledge, including the due diligence type of information on economies and economic phenomena. Collecting, analyzing, and sharing information, and promoting its qualified use, is a very important public good, one of those that have to be taken up on the global level in order to enable as broad a population as possible to use the benefits, rather than to bear the costs of globalization. We believe that the Bank has a very strong role and a competitive advantage in this area. We strongly support the Bank's going in this direction, even though we realize that it would confront us with difficult issues to resolve with respect to its operational and financial adaptation.

I strongly welcome the proposals for the Bank to open itself even more. As the financial theory teaches us, the leader in openness and transparency always bears the short-term negative costs, but I believe that in the benefit of the medium- and long-term benefits, promotion of transparency is still the way to go.

Finally, I firmly believe that the requirement of transparency as a high priority refers to everyone who wants to be part of the economic and social interaction in this interconnected world. While the pressures on the transparency and accountability of public agencies, including the World Bank and the IMF, from civil society are legitimate and needed, as a feedback, I would like to believe that civil society will soon apply on a broader scale the same criteria to itself. Interests will not be homogenous, but transparency, the disclosure of interests that are represented, and the credibility achieved through openness are critical preconditions for real partners to sit down to a table and have a constructive discussion on any controversial issue.