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Foreign trade and exchange rate in Czechoslovakia: Challenges of the transition and economic recovery[1]

In 1992 the key issue facing Czechoslovakia, as well as some of the other transition economies in Central Europe, is the revival of economic development. Following the first phase of transition in the period 1990-1991, which was dominated by macroeconomic stabilization and liberalization measures, the current phase of transition is aimed at privatization, factor markets development and mass restructuring.

The by-product of the stabilization effort was a deep structural recession aggravated by an abrupt collapse of the former institutional framework, both domestic and international. The main challenge of the current phase of the transition has therefore become the restoration of positive growth rates.

This paper examines the external dimensions of economic recovery. Section 2 deals with the trends in the Czechoslovak integration into the world economy, sections 3 evaluates the impact of the divergence between the external and domestic purchasing power of the Czechoslovak currency.

1 Implied Conditions for Revival of Economic Growth

The revival of economic development in the former centrally planned economies is conditioned both by the legacy of past development as well as by the impact of the transition strategy and policies followed in individual countries.

1.1 Initial conditions for transition: legacy of the centrally planned economy

– In macroeconomic terms, the Czechoslovak economy of the 1980s was certainly in considerably better shape than the Polish economy, and in most

[1] This paper was written during the stay in the Bank of Finland in summer 1992. My thanks are due to the Bank of Finland for generous hospitality and to the colleagues from the Unit for Eastern European Economies for a stimulative environment. The paper benefited from the comments by Kari Pekonen, Pekka Sutela, Terhi Kivilahti, Jouko Rautava and participants of the seminar held at the Unit. In the course of my stay I have profited from conversations also outside the Unit, in particular I should acknowledge my debts to Pentti Pikkarainen of the Central Bank Policy Department.
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respects, notably regarding foreign indebtedness, also in comparison with Hungary.

– However, in microeconomic and institutional terms Czechoslovakia maintained the relatively rigid framework of a centrally planned economy up until as late as 1989. Unlike in Hungary and Poland, there was almost no private sector, neither in services nor in agriculture. Foreign trade and foreign exchange activity were subject to rigid state monopolies, and foreign trade was one-sidedly oriented toward the CMEA markets. The changes made in the legal framework, institutions and banking system toward a market environment were only marginal compared to Hungary and Poland.[2]

1.2 Results of the first phase of transition

– During the two and half years since the Velvet revolution of November 1989 substantial progress has been achieved in Czechoslovakia in closing the "institutional gap" with respect to Hungary and Poland. Along with macroeconomic stabilization measures, domestic prices as well as foreign trade and foreign exchange were abruptly liberalized, "internal" currency convertibility on current account was introduced, banking reform was effected, the stock exchange was established, the legal framework was entirely overhauled and a major tax reform was prepared for the beginning of 1993. Moreover, both the small- and large-scale privatization processes have been launched. Thanks to a comprehensive privatization programme, including a non-standard voucher scheme, Czechoslovakia now appears to be ahead even of Hungary and Poland in the privatization "race".

– Notwithstanding relatively favourable initial macroeconomic conditions and progress in making institutional changes towards a market environment as emphasized above, the results of the first phase of transition appeared to be rather controversial.

In macro terms, the results appeared favourable and encouraging on the financial side:

– The current account showed an increasing surplus in the course of the period discussed (instead of an envisaged deficit of US $ 2.5 billion for 1991, there was a surplus of US $ 0.3 billion)

– Foreign exchange reserves increased continually

– The price level was successfully stabilized in the course of 1991 (even though the January 1991 price jump of 25.8 % following price liberalization was higher than expected)

[2] For a discussion of initial "stock" and "flow" conditions for transition in Czechoslovakia see Hrncir M. – Klacek J.(1991).

– General government budgets were maintained basically in a programmed balance.

At the same time, however, the "real" results, in the level of economic activity in particular, were much less favourable and worse than expected (GDP decreased by 15.9 % in 1991 compared to the government forecast of a decline in the range of 5–6 %). The data reflecting trends in the real sphere (see table 1) thus imply un unexpectedly (and apparently unnecessary) high costs of the stabilization phase, given the relatively favourable initial macroeconomic conditions in Czechoslovakia.

Table 1. **Main macroeconomic indicators, %**

		1989	1990	1991
GDP	Czechoslovakia	1,4	- 0,4	- 15,9
	Hungary	0,2	- 4,3	- 7,5
	Poland	0,3	- 11,9	- 8,0
Inflation rate (CPI, average)	Czechoslovakia	1,4	10,0	58,7
	Hungary	17,0	28,9	35,0
	Poland	251,0	586,0	70,0
Unemployment rate (end of period)	Czechoslovakia	..	1,0	6,6
	Hungary	0,4	1,7	7,5
	Poland	0,3	6,1	11,4
Real wages (average)	Czechoslovakia	0,9	- 5,6	- 24,0
	Hungary	-	- 2,1	- 7,5 [1)]
	Poland	11,6	- 27,4	3,7 [1)]
External debt (as % of GDP)	Czechoslovakia	15,7	18,2	26,8
	Hungary	71,3	65,0	71,0 [1)]
	Poland	52,0	76,7	53,0 [2)]
Fiscal balance (General government as % of GDP)	Czechoslovakia	- 2,7	1,4	- 2,0
	Hungary	- 2,5	- 0,7	- 1,5 [1)]
	Poland	- 5,2	2,5	- 4,3

[1)] Preliminary
[2)] Reflects the 1991 Paris Club agreement

Source: International Financial Statistics,
National Statistics.

Despite an endeavour to speed up the privatization process and institutional change in general, it is now clear that to make them effective will be more complicated and time-consuming than initially expected. The restructuring of economic agents, which is the very core of any successful transition, has progressed rather slowly. Consequently, it can hardly be claimed in mid-1992 that a change in the micro regime is an accomplished fact.

The rather high cost of the stabilization effort in terms of lost output and a severe drop in real wages appears to be the price paid for an asymmetry that has been developing between the implementation of macroeconomic stabilization and liberalization measures on the one hand and the delayed progress in the microeconomic and institutional dimensions on the other. This is not surprising, as institutional and behaviour changes are, unlike stabilization and liberalization measures, long-term issues " by definition". A certain gap between developments in the macro- and micro- dimensions of the transition is therefore inevitable.

A matter open to discussion, however, is to what extent the type of transition strategy adopted and the policies followed contributed to the mentioned gap or, at least, failed to narrow it in a significant way. In a comprehensive examination of the reform programmes of Central and East European countries by the staff of the UN Economic Commission for Europe the questions are raised such as "too much stabilization?" and "what went wrong?" (Economic Bulletin for Europe, 1992).

As argued in more detail elsewhere (Hrncir, 1992) the Czechoslovak strategy followed the "conventional wisdom" of stabilization programmes in the other parts of the world economy, particularly in Latin America under conditions of hyperinflation. Under the conditions prevailing in the CSFR, given the lack of market agents and market institutions, this approach was a misplaced therapy: too much was expected in the way of the curative effects of restrictive macroeconomic policies.[3] It also suggests an explanation as to why the data on the Czechoslovak "real" performance in the stabilization phase are hardly better than those for Hungary (compare table 1) and more or less resemble the Polish case, in spite of more favourable initial macroeconomic conditions.

It may be claimed that in the case of the CSFR the importance of purposeful policy support of the restructuring of existing firms and of the entry of new firms, as well as of an early development of factor markets and market institutions, has not been duly accounted for or, more precisely, it has been recognized only after considerable delay. Government policies, premised on quick progress in privatization, left aside the issues of control and incentive schemes for state and public firms in the interim period. Consequently, a kind of management and control vacuum developed in the state sector: agents found themselves to be without principals. There was also a lack of determination to cope in a definite way with the legacy of the past, including in particular increasing inter-enterprise debt and non-performing loans on the balance sheets of commercial banks.

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[3] R. Portes has asserted with reference to the transition in Eastern Europe in general: " The main difference between Eastern Europe and Latin America was the initial absence of markets, hence huge distortions and supply side failures. The Latin American experience and analogy, though instructive, has brought undue emphasis on macroeconomics for Eastern Europe". (R. Portes, 1991 p. 7).

1.3 The existing environment for economic revival

Both the legacy of the centrally planned economy and the results of the "stabilization phase" of transition affected the present environment in the economies of Central Europe. Consequently, some features still distinguish them from the comparable market economies, whereas others separate them from their own past development. In evaluating the prospects and conditions for economic recovery in transition economies, three groups of new or specific factors appear to be of particular importance in determining what policies should be pursued:

1.3.1 Structural character of the current recession

The transition economies suffered a rather severe decline in economic activity and real incomes.[4] Czechoslovakia, despite its relatively stabilized initial macroeconomic conditions, experienced a 16% decrease in its GDP and 24% decrease in real wages in 1991 (see table 1). Along with the drop in consumer demand, estimated at 33%, aggregate demand was substantially depressed due largely to the fall in investment activities. The volume of investment decreased by 33.8% in 1991 from the previous year (data includes investment activities of private and small firms). Such a deterioration in macroeconomic performance exceeds by far the worst recession recorded in any comparable market economy over a period of several decades.[5]

The extent of the recession experienced is therefore a distinguishing feature, but not the primary one. The factors responsible for the fluctuations in economic activity in developed market economies are mostly of a cyclical nature, even though they are often associated with external shocks. On the other hand, the present recession in Czechoslovakia, is an outcome of a broader range of interrelated factors. The impact of external shocks (implied in an abrupt collapse of CMEA markets and institutions in particular) is mixed with the impact of restrictive policies aimed at maintaining macroeconomic stability in the course of the liberalization process. The institutional and ownership changes underway are only gradually replacing the former patterns of behaviour and modes of coordination in the economy, and the allocation and reallocation of resources in accordance with the newly appearing profitability ratios and comparative advantage is constrained by a number of inherent rigidities. The current recession

[4] The causes, consequences and policy implications of the unexpectedly deep contraction of Eastern European economies are a topic of increasing interest and study. A joint IMF-World Bank conference held in Washington on June 4-5, 1992 focused on this particular issue. (See IMF Survey, July 6, 1992).

[5] Two qualifying arguments to the disposable data on economic performance of transition economies could be raised. Due to the ongoing institutional and ownership changes, the statistical data tended to underestimate the real performance, particularly that of small firms and of the newly arising private sector. The second argument claims that a certain part of the former economic activity was in fact of no use and was ultimately largely lost in unsaleable stocks. Even if these arguments appear at least to some extent justified, the information available on Czechoslovakia does not indicate that they are highly significant. The corrective estimates made by the Statistical Office showed that the implied unrecorded activities were only marginal in magnitude, although significant somewhat with respect to construction and local services.

in transition economies, in contrast to market economies, is therefore predominantly of a structural nature, with cyclical factors playing a less significant role.

The above conclusion points to the limitations of traditional anti-cyclical policies in the context of transition economies and underlines the importance of the coordination problem in coping with the current recession. As indicated particularly by an extremely sharp decline in investments, mentioned above with respect to Czechoslovakia, "downward expectations" dominated the decision-making of economic agents. A reversal of these expectations - by itself a necessary precondition for an economic revival - is constrained by a rather imperfectly competitive environment in the domestic economy. The incentives to invest and the prospects for any investment to turn profitable are conditioned by the parallel behaviour of other investors. Of crucial importance for achieving a reversal in existing expectations is therefore a feasible and efficient solution of the implied coordination problem under the conditions prevailing in transition economies.[6]

1.3.2 An open economy framework

While the structural character of the recession distinguishes the situation in transition economies from that in the developed market economies, the increasing openness of these economies, on the other hand, is a dramatic departure from their own past.

Within two years, Czechoslovakia has turned into a fairly liberalized economy on current account items:

- Any registered economic agent can engage in foreign trade, with access to foreign exchange for current account transactions at the official exchange rate

- Any physical person can maintain foreign exchange accounts

- Apart from a few specific items, there are virtually no quotas or quantitative restrictions applied,and tariff incidence is less than 6 %, which implies a rather liberal regime even by international standards.

Capital flows remain regulated for the most part. Although, for example, borrowing abroad by domestic firms beyond a certain ceiling is subject to central bank approval, the forming of joint ventures and foreign direct investment are already substantially deregulated, even with respect to profit and capital repatriation.

The achieved stage of openness to the outside world and the continuation of this trend in the near future is a highly desirable development, assuming success

[6] The importance of this "economy wide" externality was underlined by R. Dornbusch when confronting the IMF model with the lessons of Latin America in the 1980s. His conclusion that market forces alone could hardly resolve the problem appears even more relevant to present conditions in the transition economies of Central and Eastern Europe. Compare R. Dornbusch, 1990.

for the entire transition process. At the same time, however, the implied role of the balance-of-payments constraint becomes more sensitive and more demanding. Unlike in the past, any set of policies must be devised with due consideration given to their impact on foreign exchange flows. This also means that any revival of domestic activities could be made sustainable only if an adequately growing export potential matches the increasing import over the medium-term horizon.

1.3.3 Uncertainties involved

The multi-dimensional character of the transition process, involving parallel changes in economic, institutional, social, legal, political and other fields, inevitably results in a substantial amount of uncertainty. Just in the economic sphere, there can hardly be any "established" macroeconomic ratios given ex ante for the course of the transition. Evidently, even less stable and predictable are the microeconomic behaviour responses and elasticities.

The issues of supply side response to transition policies with respect to both intensity and timing are clearly of prime importance to policy makers. The progress in enterprise restructuring, a condition for a positive supply side response, is in fact the key success indicator for the entire transition. At the same time, however, this affords a striking example of the high degree of uncertainty involved: the expectations thus far have deviated substantially from the reality, being too optimistic.

The main impetus for the unleashing of supply side responses in the current stage is being associated in all the transition economies with the progress of privatization and with the hoped-for increased flows of foreign direct investment (FDI). By this reasoning, Czechoslovakia might be expected to be heading for an efficiency and performance "leap" in the near future. Though still the late 1980s the economy was almost entirely "socialized", with no private sector and negligible foreign investment, the situation has recently reversed in both respects.

However, a number of factors may substantially alter the outcome. While privatization is now proceeding on a mass scale, the implied risks of adopted schemes, of the voucher scheme in particular, as well as of the impact of almost 450 newly established investment funds and societies, may be realized. In spite of all the effort to speed up the process, privatization is proving to be a long-term matter. Further time lags between "nominal" and "real" privatization are likely to arise, with the unpredictable consequences of the "pre-privatization agony" of state firms resulting in a drastic drop in the level of their investment.

There has recently been a promising trend in FDI in Czechoslovakia, but it fell short of that in neighbouring Hungary (see table 2)[7].

[7] It is estimated that in 1991 about 60% of all FDI in Eastern Europe was in Hungary; in cumulative terms, the volume of FDI in Hungary is estimated at USD 3 billion, i.e. roughly 1/3 of all funds invested in Eastern Europe. The difference as compared to Czechoslovakia record is even more pronounced in per capita terms: USD 150 in Hungary and less than USD 4O in Czechoslovakia in 1991.

Table 2. **Foreign direct investment in Czechoslovakia and Hungary**
(in million USD)

	1989	1990	1991	I/1992
Czechoslovakia	256	181	600	230
Hungary	..	900	1.500	..

Source: State Bank of Czechoslovakia
National Bank of Hungary.

The likely forthcoming split of Czechoslovakia, along with other factors, may increase the country risk for potential investors and dampen the incoming flow of funds, at least in the short run.

2 Trends in the Czechoslovak integration into the world economy

The Czechoslovak transition from the very beginning encompassed simultaneous liberalization in both the domestic and external sectors.

A sweeping liberalization of foreign trade and foreign exchange associated with the introduction of "internal" currency convertibility for registered businesses on current account transactions was implemented at the beginning of 1991, together with a package of measures aimed at macroeconomic stabilization and the liberalization of domestic prices.

As all legal and physical persons became entitled to enter into international business, the numbers of those engaged in foreign trade mushroomed:

Table 3. **Firms engaged in foreign trade**

	End 1989	September 1990	End 1991
Total	203	2.317	8.706 in exports 13.812 in imports

Source: CSFR in the World Economy, March 1992, Prague.

Re-integration into the European and world economy became a priority goal of the Czechoslovak authorities. The radical opening of the economy was considered a pre-condition for the success of the entire transition. An early move towards the liberalization of trade and foreign exchange was expected to:

– Provide the discipline of foreign competition and a countervailing power to the monopoly practises of domestic producers and traders

– Contribute to a more rational price structure through "importing" price ratios from the world markets

– To initiate a reallocation of resources reflecting the terms of an open economy.

2.1 The trends prior to transition

In evaluating the legacy of past development, the following trends are relevant and/or specific for Czechoslovakia:

- Czechoslovakia's long-run declining share of the world's exports, coupled with the increasing replacement of higher value-added products by lower value-added ones, such as raw materials, intermediate products and standard consumer goods, in its exports to the convertible currency markets. In the period 1975–1989 the Czechoslovak share of imports of OECD countries fell from 0.28 % to 0.18 %. Its share of machinery imports fell even more drastically, from 0.21 % to 0.07 %. (Source: OECD Trade Statistics).

- An increasingly pronounced tendency toward a "dual" structure of export flows to the former "socialist" and developed market economies. Manufactures (SITC 6–8) accounted for 87 % of exports to former socialist countries in 1990, but for only 66 % in exports to market economies. (Source: Facts on Czechoslovak foreign trade, 1991).

- One-sided concentration of its trade with the CMEA partners, the share being second highest among the CMEA members (behind Bulgaria only), coupled with one-sided dependence on Soviet oil and gas supplies.

- Unlike Poland and Hungary, Czechoslovakia accumulated only a moderate foreign debt in convertible currencies, both on volume and per capita bases.

Table 4. **External debt in 1989**
(gross debt in convertible currencies)

	bill. USD	percent of exports for convertible currencies
Czechoslovakia	7,9	104
Hungary	20,6	319
Poland	40,6	486

Source: Statistical Yearbook of Czechoslovakia.

Per capita, the Czechoslovak gross debt amounted to USD 444. It can be concluded that in the case of Czechoslovakia the balancing of foreign exchange flows did not turn into a pressing constraint at any time in the entire postwar period.

2.2 Developments in the course of transition

The relative inertia of both the domestic and external environments ended abruptly at the beginning of 1990s. According to M. Landesmann (1991), the CSFR may have been hardest hit by the trade shocks (due to the collapse of CMEA trade and institutions in particular) of all the Central and East European countries. The impact of external factors interacted with institutional changes initiated in the domestic economy and with a parallel severe contraction of domestic demand.

2.2.1 Trends in the volume of foreign trade

The volume of foreign trade decreased in absolute terms throughout the period examined, thus accelerating a long term decline in Czechoslovakia's shares of world markets. Between 1989 and 1991 its share of world exports dropped from 0.46 % to 0.33 %.

In 1991 imports were 20 per cent lower than in 1990 (reflecting a deep domestic recession), while exports declined by 7 %, recovering in the second half of the year. A further decline in the trade volume is expected to take place in 1992, due particularly to the continued decrease in trade flows with the former USSR and decreasing imports of oil.

The above figures suggest a deep contraction in the volumes of trade flows. However, the foreign trade results seem to be in line with the rate of decrease in macroeconomic indicators of domestic activities (see table 1).

2.2.2 Balance of payments, foreign exchange reserves and foreign debt

Unlike the volume of trade flows, the current account balance in convertible currencies has substantially recovered after a sharp deterioration in 1990, with surpluses steadily increasing in the course of 1991 and the first half of 1992 as well. Correspondingly, the foreign exchange reserves also recovered.[8] (See the tables 5 and 6).

[8] The foreign exchange reserves increased to the end of June 1992 to USD 4.7 billion., the highest level since the end of World War II.

Table 5. **Balance of payments in convertible currencies**
(in USD million)

	1985	1989	1990	1991	I/1992
Current account	789	439	- 1105	356,5	295,0
- Trade balance	695	419	- 785	- 447,4	153,1
- Service balance	336	218	37	827,4	203,7
- Income balance	- 203	- 163	- 316	- 65,4	- 75,7
- Transfers	- 40	- 35	- 40	41,8	13,9
Capital account	- 825	326	326	47,0	168,8
- Direct foreign investment	..	256	181	592,4	230,0
- Other long term capital	- 753	- 53	718	1.731,7	262,3
- Short term capital, net	- 72	123	- 573	-2.277,1	- 323,5
Errors and omissions	- 76	- 197	- 324	494,4	- 105,8
Changes in reserves (increase = –)	112	- 569	1102	- 897,9	- 358,0

Source: State Bank of Czechoslovakia.

Table 6. **Foreign exchange reserves and foreign debt**
(in million USD)

	Dec 1989	Dec 1990	Dec 1991	May 1992
Gross foreign exchange reserves of which:	2.309,5	1.207,1	3.290,0	4.364,1
official reserves of the State Bank	956,2	353,6	1.351,5	1.949,2
Gross debt in convertible currencies	7.915,0	8.085,0	9.365,0	9.025,0

Source: State Bank of Czechoslovakia.

The outcomes in current account balance have tended to be much more favourable than predicted by the authorities and IMF staff: in 1991 a surplus of USD 0.3 billion was achieved instead of an envisaged deficit of USD 2.5 billion; and again in 1992, a predicted deficit of USD 0.6 billion has been revised at mid-year to an expected surplus of USD 1.5 billion.

The forecasted levels of aggregate economic activity, on the other hand, tended to err in the opposite direction: instead of the predicted fall in GDP of 5–6 %, the outcome in 1991 was – 16 %. It is obvious that the mentioned forecasting errors in opposite directions are interrelated: because of a much deeper recession, the current account turns out better than expected.

Compared to the past when merchandise trade flows were dominant, a tendency to an increased share of various services, tourist trade and income transfers is clearly surfacing and contributing to favourable changes in the current account (compare table 5).

2.2.3 Changes in the regional distribution of Czechoslovak trade

Whereas up to 1989 the share of former centrally planned economies (CMEA countries) was dominant in Czechoslovak foreign trade, substantial shifts have subsequently taken place, particularly in 1991 (see tables 7 and 8). Some selective evidence seems to suggest, however, that the main factors behind the shift were external (collapse of CMEA markets in particular) rather than firms' endogenous incentives to restructure and re-direct their trade.

Table 7. **Territorial direction of Czechoslovak trade**
(percent share, derived from values in CSK, current prices and foreign exchange rates)

	Exports				Imports			
	1985	1989	1990	1991	1985	1989	1990	1991
Former CPEs	62,3	60,8	49,0	39,3	67,2	62,3	51,2	42,8
former CMEA	54,7	54,9	43,4	32,8	59,9	56,1	44,4	39,5
former USSR	33,1	30,5	25,2	19,4	36,2	29,7	21,6	31,8
Market economies	37,7	39,2	51,0	60,6	32,8	37,7	48,8	57,1
Developed	25,8	31,2	42,4	51,9	26,0	31,1	42,6	48,9
EC	15,0	18,2	26,5	40,7	14,6	17,8	23,8	33,0
Developing	11,9	8,0	8,6	8,7	6,8	6,6	6,2	8,2

Source: Facts on Czechoslovak foreign trade,
Foreign Trade in 1991, Federal Statistical Office.

Table 8. **Recent changes in territorial pattern of Czechoslovak trade**
(percent share, current prices and foreign exchange rates)

	Exports		Imports	
	I/1991	I/1992	I/1991	I/1992
Developed market economies	52,7	65,1	38,6	50,7
Developing economies	9,7	12,7	8,1	5,0
Transition economies	36,2	21,6	51,3	44,0
State trading economies	1,4	0,5	2,0	0,3

Source: Federal Statistical Office.

As seen in table 7, the share of market economies increased sharply, due to a rising proportion of trade with the EC countries. Germany became Czechoslovakia's dominant trade partner: its export-share was the highest (25.1 %), and its import-share second highest (20.3 %) in 1991. Germany's share of total Czechoslovak trade with the EC amounted to 61.6 % in 1991, followed by Italy with 10 %.

2.2.4 Commodity composition of Czechoslovak trade

Shocks and discontinuities experienced in both the domestic and external environment have had a decisive effect on the commodity composition of trade flows in 1989–1992. The collapse of CMEA trade interacted with a substantial contraction of domestic demand. The immediate impact on the pattern of export flows, judging by the implied changes in the aggregate figures, was unfavourable: the trend towards an increasing share for raw materials and intermediate products in total Czechoslovak exports became even more pronounced.

According to the data in tables 9 and 10, the share of relatively higher value-added products, especially of machinery & transport equipment (SITC 7), in total exports decreased dramatically in the period examined: from 44.7 % in 1989 to 27.9 % in 1991, i.e. by 17 percentage points. Data in table 10 indicate the continuation of the trend in 1992.

Table 9. **Product composition of the Czechoslovak foreign trade**
(percent share, SITC classification)

	Total		EC		Former USSR	
	1989	1991	1989	1991	1989	1991
Exports						
Food and beverages (0+1)	5,0	8,6	12,3	10,0	1,0	4,5
Crude materials, excluding fuels (2+4)	3,8	5,5	6,9	7,1	2,6	0,4
Fuels (3)	5,2	4,2	6,9	4,6	1,1	1,5
Chemicals (5)	7,6	10,6	14,1	13,1	3,5	8,3
Manufactured goods (6+8)	32,1	43,2	48,1	47,2	26,1	41,5
Machinery and transport (7)	44,4	27,9	13,9	18,1	61,3	43,8
Imports						
Food and beverages (0+1)	7,6	6,9	8,1	7,4	8,9	0,5
Crude materials, excluding fuels (2+4)	9,1	9,5	7,9	7,1	7,3	10,8
Fuels (3)	17,3	29,8	0,2	1,8	51,7	76,5
Chemicals (5)	9,3	9,8	20,8	17,0	3,1	2,6
Manufactured goods (6+8)	16,6	15,9	17,8	20,1	6,9	5,0
Machinery and transport (7)	37,0	28,1	44,3	46,4	28,8	4,6

Source: Facts on Czechoslovak trade.

Table 10. **Recent developments in product composition of Czechoslovak foreign trade**
(percent share, SITC classification)

	Exports		Imports	
	I/1991	I/1992	I/1991	I/1992
Food and beverages (0+1)	7,4	6,4	4,0	7,3
Crude materials, excluding fuels (2+4)	5,1	6,9	10,2	8,2
Fuels (3)	3,5	4,1	41,5	33,5
Chemicals (5)	14,0	11,4	8,3	9,4
Manufactured goods (6+8)	39,2	50,7	13,5	14,3
Machinery and transport (7)	30,8	20,3	22,5	27,3

Source: Federal Statistical Office.

In evaluating these trends, however, it must be recognized that they developed in spite of a very remarkable increase of machinery exports to developed market economies of more than one-third in 1990–1991. It follows that the main reason behind them is the collapse of CMEA markets, of the former USSR in particular, associated with the legacy of the "dual" structure of Czechoslovak trade. The growth of machinery exports to developed market economies could not compensate in the given time frame for the losses in the former CMEA markets.[9]

The data showing the pattern of export and import flows with EC countries highlight the degree of qualitative imbalance in Czechoslovak trade with developed market economies. While the share of SITC 5 & 7 (chemicals, machinery & transport equipment) in Czechoslovak imports amounted to 63–64 % in the period examined, their share in exports was only 28–31 %.

Though being a legacy of the past, the above mentioned qualitative imbalance has been fostered also by recent developments.

The industries hardest hit by the present recession are largely in manufacturing. In 1991 substantial declines were experienced in electrical products (– 39 %), engineering (– 30 %), metal (– 33 %), glass and porcelain (– 26 %), textile (– 35 %), clothing (– 40 %) and leather (– 37 %).

In the heavy industries, on the other hand, the respective declines have been modest, particulary in the energy and fuel industries.

Trade data reflect parallel tendencies in exports. Raw materials, intermediary products and construction materials could find new export markets relatively more easily, especially in the short run. As their sales are conditioned mostly on costs

[9] To illustrate the orders of magnitude involved, the cumulative increase of "western" machinery exports amounted to USD 255 million, while the respective losses in "eastern" exports were calculated for 1990 and 1991 in the range of USD 4.9 billion. Even if this "loss" figure is evidently inflated, both because of a higher price level in the former CMEA markets and the exchange ratio applied (1 USD=1 XTR), the volume differences are substantial.

and price competitiveness, the CSK's depreciated exchange rate (after three devaluations in 1990) evidently contributed to the ensuing trends.

The identified impacts of the domestic and external factors on the production and export patterns were evidently mutually interacting in the present recession, fostering one another.

A longer-term challenge for the industrial and export promotion programmes and policies are the findings showing that a significant share of industry sectors have a negative value added at world prices in the production and export pattern of Czechoslovakia and other transition economies as well (Hughes – Hare, 1992).

2.3 Terms of access to world markets and the capacity to penetrate them

The prospects for success of any export-led revival strategy are conditioned by both the external and domestic environment: by the terms of access to world markets along with the capacity of domestic firms to adjust and to penetrate those markets, i.e. to make use of the implied conditions for entry.

2.3.1 Czechoslovak exports: conditions and barriers

The export performance of Czechoslovak manufacturing enterprises in Western markets has deteriorated for at least last two decades. At the same time, the export performance of individual firms within a given sector or industry tended to be rather uneven.

According to a survey analysis, the export deliveries to market economies did not in 342 cases (of a total of 866 surveyed firms, i.e. in almost 40 per cent of cases) exceed
1 per cent of their total deliveries (Kolanda – Kubista, 1990). This implies that four out of every ten firms had almost no contact with world markets and had no idea what real competition actually means.

The existence of prior contacts with foreign markets already now appears to be an important distinguishing factor: the firms with some previous experience are as a rule much more successful in reorienting and expanding their trade on world markets.

As mentioned above, with the dismantling of the foreign trade monopoly, the number of firms trying to enter international trade is mushrooming. The role of private sector is significantly greater here than it is in production: in the first quarter of 1992 private firms accounted for more than 40 % percent of exports.

Compared with their Western counterparts, the conditions for entry into world markets are far from being favourable for Czechoslovak firms, even assuming that trade-partner countries' external barriers are further dismantled.

Along with the lack of experience and know-how on the functioning of world markets they lack mainly comparable
up-to-date banking, credit, insurance and marketing services. As newcomers, they lack goodwill, distributional networks and contacts with the established domestic firms.

Progress along those lines seems to be much more important for the penetration of world markets than the technical qualities of the products alone, particularly with respect to higher value-added products where the non-price aspects of competition dominate.

2.3.2 Terms for entry into world markets

While in the past Czechoslovakia was one-sidedly oriented towards the CMEA block, the markets of integrating Europe already are, and undoubtably will remain by far the most important for Czechoslovak trade.[10]

Czechoslovakia was one of the founding parties to the GATT and participated in all the rounds of negotiations that took place in the postwar period. Its framework of a centrally planned economy was, however, not consistent with the market logic of the GATT rules. As a reaction to its state trading system, Czechoslovakia faced considerable trade barriers and less favourable treatment in world markets. Apart from higher tariffs, Czechoslovak exports were often subjected to quotas and other non-tariff barriers, particularly for "sensitive" items like textiles, rolled material and steel. The records also reveal a substantial number of anti-dumping actions initiated against Czechoslovak exporters in the past, especially in chemical products.

After the start of transition to a market type economy in 1990, the external environment for Czechoslovak firms also began to change.[11] By far the most important change has been the "European type" Association Agreement signed with the EC in December 1991 and a similar agreement with EFTA concluded at the beginning of 1992.

[10] This notwithstanding, the turnover with some other parts of the world economy may be more dynamic in the forthcoming period, because of much lower initial trade volumes. This applies particularly to the trends in trade with the US and with the Far-East Asian countries like Korea, Singapore, Taiwan.

[11] In April 1990 a new trade agreement based on the MFN principle was signed with the United States and in May 1990 an agreement was made with the EC on trade and economic cooperation, granting higher steel and textile quotas. Since January 1991 Czechoslovakia has enjoyed GSP treatment in the EC, except for exports of "sensitive" products.

2.4 The Association Agreement with the EC – good enough for Czechoslovakia?

The Association Agreement establishes the framework for a gradual adjustment of the Czechoslovak economy and society to European standards, which is a necessary pre-condition for accession to the EC at a later stage:

– With regard to trade, the main goal envisaged is the establishment of a free trade area

– The Association Agreement, however, extends far beyond free trade, covering investment, legal framework, competition rules, financial cooperation, as well as the human and cultural dimensions

– The adoption of EC conditionality obliges the present as well as any future government authorities of Czechoslovakia to adhere to the strategy of a market type economy and to the corresponding policies.

The Association Agreement is perhaps the most far-reaching one concluded by Czechoslovakia since World War II. From the point of view of Czechoslovakia's prospects it, however, also has "weaker" aspects and even drawbacks:

– Unlike in some other cases, the agreements with Hungary, Poland and Czechoslovakia do not stipulate any explicit commitment of the EC to their full membership, i.e. no explicit link is set up between the association and the potential accession

– Of the four" basic freedoms" the Association Agreement provides only for the gradual establishment of free movement of goods, whereas there is virtually no commitment to the free movement of labour

– Even though the agreed schedule for the establishment of a free trade area is in principle based on the non-reciprocity principle, which implies "positive asymmetry" in the implementation of tariff reductions and in the elimination of quantitative and other non-tariff restrictions, the other factors conditioning a competitive dominance of EC firms in mutual trade, particularly in higher value-added manufactures, were not tackled

– For the "sensitive" products, like textiles, steel, coal and agricultural products, the establishment of free trade is envisaged by means of special arrangements and protocols (excepting agricultural products, where an approach of mutual concessions is to be applied), implying only gradual elimination of tariffs and quotas. Those sensitive products were, however, dominant in Czechoslovak exports to EC countries and are evidently the items for which Czechoslovakia has some comparative advantage, at least in the short and medium run.

Their shares of total Czechoslovak exports to the EC in 1990 were estimated as follows (Rollo, 1992):

– agricultural products	8.1 %
– textiles	11.5 %
– iron and steel	16.3 %
– coal	2.5 %
– products with tariff ceilings and quotas	19.2 %

This indicates that these products accounted for over 50 % of total Czechoslovak exports to the EC. Even if a restructuring of the export pattern is likely in the forthcoming period, the time factor is crucial. To overcome the current deep recession and to initiate an export-led revival, Czechoslovakia would need more favourable access to the EC markets for "sensitive" products immediately, not just at sometime in the future.

– Some safeguards and anti-dumping provisions may become obstacles to the exploitation by Czechoslovak firms of the cost advantages entailed in relatively low labour costs and a devalued exchange rate. Hence, they would likely be treated as the state-owned firms that they used to be, with all the inertia that this implies.

The Association Agreement with the EC is evidently a compromise. On the one hand, it points out the interest of the EC in supporting the transition towards a market economy and political democracy; on the other hand, it shows limits of this endeavour. The EC was apparently not ready for any commitments which might result in additional costs to and/or constraints on the prospects for the closer economic and political integration of the present EC members. Such a cautious approach is understandable in the context of the broader issues relating to Europe's position in the world economy (the Far East Asian challenge in particular) and the resulting "deepening-versus-enlarging" debate.

At the same time, however, the support provided by the EC to Czechoslovakia, Poland and Hungary through association agreements is apparently not meeting the needs of the latter in their present stage of transition.These countries in fact remain "outside" the main integration processes in Europe. They cannot benefit from such institutional developments as the EEA, nor from structural funds and from the prospective EC cohesion funds for relatively less developed regions.

We cannot rule out the possibility - in fact the rather likely possibility, it would seem - that the existing gap between the economic level of EC members and reforming countries of Central and Eastern Europe will widen further in the medium term.[12]

With deepening integration, the pace of economic development and technical progress in Western Europe is likely to advance substantially in the near future. Consequently, however controversial it may appear, even if there is a successful adjustment of the institutional framework towards a market type economy, the transition economies may in a few years find themselves even further from

[12] According to a World Bank, assessment the countries of Central and Eastern Europe are not likely to reestablish their 1989 level of economic activity (aggregate output) before 1996.

European standards than they are at present. The tendency towards a further "peripherization" of the countries of Central and Eastern Europe is not highly unlikely.

In conclusion, given the unprecedented scope and dimensions of the issues these countries face in the context of transition, the granting of more liberalized access to its markets seems to be the least costly course of action for the EC. At the same time, it is a course of action that would help the entire region of Central and Eastern Europe to get out of its present structural recession.

A more liberal and speedy opening of the EC markets to exports from the associated countries of Central Europe would evidently imply some additional costs and possibly conflicting interests. Those costs to EC countries should, however, be balanced against the potential benefits implied, given the growing markets and more stable political and social developments in Central and Eastern Europe.

The alternative to economic recovery and self-sustained development is a long-lasting structural recession with increasing instability, social unrest and mass migration. The markets of Central and Eastern Europe could become a new and increasingly important sphere of interest for EC exporters and investors, but only providing the initial conditions are created for their stability and self-sustained growth.

It seems clear that these medium and long term economic interests, along with the political ones, should outweigh the generally short term costs entailed in the granting of relatively free market access to the exports of the Central and Eastern European countries.

3 Divergence between the external and domestic purchasing power of the Czechoslovak currency

A common feature of the former centrally planned economies was a wide gap between the domestic and external values of their currencies. The implied external "price" of a given currency was as a rule substantially lower than its domestic purchasing power.

In the case of Czechoslovakia, the gap widened further in nominal terms at the very beginning of the transition. The changeover to limited currency convertibility and foreign trade liberalization was paid for by the three consecutive devaluations of the CSK vis-a-vis convertible currencies in the course of 1990.[13]

Referring just to the costs of the considerably increased gap between the domestic purchasing power and foreign exchange rate of the CSK resulting from the devaluations, a number of observers criticized the move towards a radical opening of the Czechoslovak economy as ill-timed, pre-mature and too costly (Pick, 1991).

The above-mentioned currency gap reflects, however, a "quality" gap between Czechoslovakia and the outside developed world. The extent, changes and possible solutions of the divergence between the external and domestic purchasing power are therefore related to the fundamentals of the national economy and, consequently,to the economic strategy and policies followed.

3.1 Why a discussion of purchasing power parity in the context of transition economies?

The answer seems obvious: just because transition is a reality. The ratios maintained in the former centralized framework were discontinued and new ones are to be established. In a situation dominated by dislocations and disturbances, information on purchasing power parity is looked upon as a potential point of departure.

This situation is in fact parallel to past periods of increased interest in the purchasing power parity doctrine: it was increasingly discussed after World War I, then again in the forties and fifties after World War II, and again in the early seventies, i.e. in periods of substantial discontinuities and disturbances in the world economy.

There are, however, well established limits to the purchasing power parity doctrine. Its explanatory capacity, both in the strong (absolute) and weak (relative) versions, is subjected to a number of qualifications. (For a discussion of structural as well as transitory departures from PPP, see the critical survey by R.

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[13] The CSK was devalued by 16.6% on January 8, by 55.3% on October 15, and by 15.98 on December 28. The cumulative depreciation in the course of 1990 was substantial: after the third devaluation at end-December 1990, the exchange rate changed to 28 CSK per USD, as compared to 14.29 CSK per USD end-December 1989.

Dornbusch, 1987). Those qualifications are evidently even more relevant with respect to the former centrally planned economies.[14]

Consequently, neither in developed market economies, nor in transition economies can the purchasing power parity be relied upon as a direct benchmark for the establishment of the exchange rate and/or for its adjustment. It does, however, provide useful information for evaluating the deviation of the current exchange rate from the level which would correspond to the fundamentals of the given economy.[15]

The relevance of purchasing power parity reasoning in terms of transition economies is underlined by the extent of the implied gap vis-a-vis the current exchange rate level which tended to be wider than in comparable economies elsewhere. By the same token, given the magnitude of the issue,the implied distortions in the price data of transition economies and the inconsistencies vis-a-vis price series of market economies do not appear to be highly significant.

3.2 The extent of the gap between domestic and external values of the currency in Czechoslovakia as compared to Hungary and Poland

With the implied qualification that any assessment of domestic purchasing power of a currency is liable to some margin of error, it can be claimed that most expert studies, including our own, identified the domestic PPP of the CSK at the beginning of 1990, i.e. at the start of the transition, in the range of 7–8 CSK per USD.

Using the midpoint of the interval, i.e. 7.50 CSK/USD, as a benchmark, the resulting development of the PPP in the course of transition is presented in the chart 1 (for the data see table 11).

[14] This is due particulary to the legacy of their institutional framework. Domestic price ratios were generally kept fixed for a "planning" period and changed only in the context of administratively effected price reforms. The supply-demand ratios as well as the quality of goods and services could therefore be reflected in the applied prices only in a very distorted way, with substantial differences both across time and individual product groups. Furthermore, widely differentiated subsidies and taxes distorted the price pattern even more.

In a parallel way, the implied exchange rates were widely diversified. The "official" exchange rate was as a rule too high, while on the other hand various black and parallel market rates tended to unrealistically depress the external value of the currency.

[15] The concept of the real exchange rate, calculated and extensively applied by both international and national institutions, is in fact based on the purchasing power parity reasoning. Changes in real exchange rate values, based as a rule on GDP deflators or wholesale prices, are considered to reflect changes in the given country's external competitiveness.

Table 11. **Exchange rate, purchasing power parity rate and parallel market exchange rate for the CSK in 1989–1992**

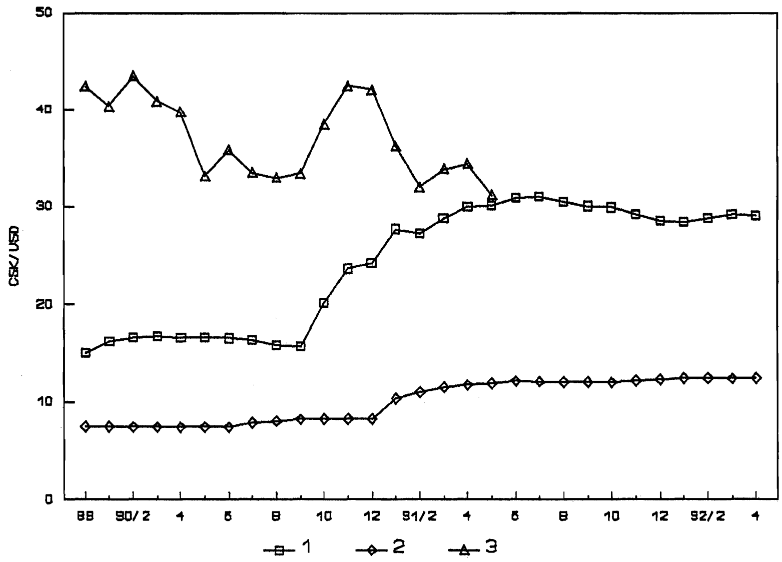
(CSK per USD, average per period)

	1	2	3	4
1989	15,05	7,50	2,01	42,39
1990/1	16,29	7,50	2,17	40,39
2	16,60	7,46	2,22	43,46
3	16,72	7,42	2,25	40,88
4	16,67	7,44	2,24	39,81
5	16,64	7,45	2,23	33,20
6	16,58	7,43	2,23	35,88
7	16,37	7,88	2,08	33,55
8	15,89	8,05	1,97	32,99
9	15,71	8,23	1,91	33,42
10	20,18	8,26	2,44	38,52
11	23,63	8,26	2,86	42,45
12	24,19	8,27	2,93	42,10
1991/1	27,65	10,34	2,68	36,34
2	27,24	11,04	2,47	32,02
3	28,74	11,54	2,49	33,88
4	29,94	11,75	2,55	34,43
5	30,12	11,96	2,52	31,19
6	30,89	12,13	2,55	..
7	31,00	12,11	2,56	..
8	30,53	12,06	2,53	..
9	30,03	12,05	2,49	..
10	29,89	12,02	2,49	..
11	29,15	12,17	2,39	..
12	28,55	12,31	2,32	..
1992/1	28,36	12,42	2,28	..
2	28,78	12,44	2,31	..
3	29,16	12,40	2,35	..
4	29,06	12,46	2,33	..

1 = Exchange rate
2 = Purchasing power parity (PPP rate)
3 = Exchange rate/PPP rate ratio (1:2)
4 = Parallel market rate

Chart 1. **Purchasing power parity rate, nominal exchange rate and parallel market exchange rate for the CSK in 1989–1992**

(CSK per USD, average per period)



1 = Exchange rate
2 = Purchasing power parity
3 = Parallel market rate

The identified decrease in the implied purchasing power of the CSK with respect to the USD from 7.50 CSK in January 1990 to 12.46 CSK in April 1992 reflects Czechoslovakia's inflation differential, as measured by ratios of respective CPIs for the given period.

The study by PlanEcon (PlanEcon Report 16–17, 18, 1992) evaluated the PPP of the CSK at the beginning of 1990 even more favourably, 6.20 CSK/USD in January 1990 and 10.30 CSK/USD in May 1992. While diverging from the initial level, the resulting rate of change for the examined period coincides with the above estimates.

Chart 1 shows the development of the domestic purchasing power of the CSK compared to the two options for its external value: the nominal effective exchange rate (NEER)[16] (in 1989 referred to as "commercial" rate) and a parallel market

[16] While expressed in terms of the CSK per USD, it reflects the ratio towards the basket of five currencies to which CSK is pegged. Both the composition of the basket and relative weights of individual currencies are revised in year's period. The respective shares in 1991 were as follows: DEM 45.52%, USD 31.34%, ATS 12.35%, CHF 6.55%, GBP 4.24%. The revised composition as of May 1992 is following: USD 49.07%, DEM 36.15, ATS 8.07%, CHF 3.79%, FRF 2.92%.

rate (alternatively called black market rate)[17]. A striking feature of the comparisons is the inertia of divergence between the domestic purchasing power and the nominal exchange rate of the CSK, while the gap between the parallel market rate and nominal rate almost disappeared around May 1991. Since then there have been a few periods in which the CSK's nominal rate was stronger by several points.

As can be seen in chart 1 (data in table 11), the disparity between the domestic purchasing power rate and the CSK's exchange rate culminated towards the end of 1990 (after effected devaluations and a sweeping liberalization of domestic prices only forthcoming). In December 1990 the implied exchange rate/PPP ratio amounted to 2.93, since then it decreased continuously to the level of 2.33 in April 1992.

The study by PlanEcon (1992) gave this ratio for other former centrally planned economies also. According to it, the ratio for the Hungarian forint was 2.15 in January 1990 and for the Polish zloty 3.88. The ratio decreased to 1.62 and 1.70 respectively in May 1992. Comparing these findings for Hungary and Poland with the above results for Czechoslovakia, the following conclusions may be drawn:

- Both the initial wide disparity between the current exchange and PPP rates, and a tendency afterwards towards its gradual narrowing in the course of the stabilization phase were common to all three transition countries

- The extent of the disparity, as identified for Czechoslovakia, Poland and Hungary at the beginning of 1990, appeared to be significantly wider than in comparable market economies[18, 19]

- Unlike in Hungary and Poland, the exchange rate/PPP ratio for the CSK fell only modestly up to mid-1992. This implies that the CSK has been kept relatively undervalued with respect to convertible currencies, and in the course of the recent period this has become the case with respect to the Polish zloty and the Hungarian forint.

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[17] The parallel market rate was based on unofficial quotations on the CSK outside Czechoslovakia, in Austria and Switzerland in particular. Being a domestic, inconvertible currency, with officially prohibited flows outside and inside the country, the level of the parallel market rate of the CSK was inevitably rather depressed and gave a distorted picture of existing real ratios. The trends and changes of those rates in the course of time, however, provided valuable information on a market-like evaluation of the currency.

[18] That proposition would not hold in the case of the former GDR. But due to adopting the DEM as its own currency in the context of monetary union, the GDR represents a very special case.

[19] According to Summers-Heston the respective ratios (ERDI coefficient) for comparable European economies in 1985 were as follows: Spain 1.81, Ireland 1.34, Greece 1.70, Portugal 2.28, Turkey 2.99. (See Summers R. - Heston A., 1988).

3.3 Factors responsible for the divergence between the domestic and external purchasing power of the CSK

The existence of a gap between the domestic and external values of a currency is itself hardly an exceptional phenomenon. Countries at a relatively low level of development inevitably face productivity and efficiency gaps with respect to their higher developed partners. B. Balassa developed the argument on the "productivity bias" of the PPP, implying that divergent productivity levels lead to systematic trend deviations from PPP (Balassa, 1964). The implications of this have been extensively dealt with in the realms of both economic theory and policy making (see e.g. Hillman, 1991).

Nonetheless, the size of the gap in the case of former centrally planned economies suggests that specific factors are involved. Moreover, the exchange rate/PPP ratio was considerably higher in Czechoslovakia than e.g. in Poland (2.33 to 1.70 in April 1992), whereas the productivity ratios and income levels would imply the reverse. The issue thus raises a number of questions which deserve a more thorough examination:

- What are the specific factors involved in the case of former centrally planned economies

- Is the Czechoslovak development path really different, or just lagged with respect to Hungary and Poland

- What are the consequences of a wide divergence between domestic and external purchasing power of the currency.

3.3.1 The factors responsible for the wide divergence of external and domestic purchasing power in the former centrally planned economies

While official exchange rates tended to overvalue and black market rates to undervalue the currencies of centrally planned economies, their "real" external purchasing power was increasingly reduced by features inherent to the centralized framework:

- The concept of "balanced" domestic development and the "homeward" orientation of the policy failed to create environment and incentives for the expansion of specialized export-oriented industries

- In the traditional state firms the lack of internal incentives to strive for the improvement of product standards and quality co-existed with the lack of determination to strive for the best possible terms in marketing abroad

- The "soft budget" constraint was interrelated with a "soft" exchange rate regime. The implied exchange rate value was adjusted ex-post, almost as in a free float, without having any significant impact on the behaviour and efficiency of domestic firms.

Besides the "real" factors, the external purchasing power of the currency was also weakened by a number of "nominal" factors: due to a higher share of direct taxes in total budget's revenues, compared to market economies, the tax burden on the domestic firms was in general substantially higher. The very fact of strict administrative regulation of foreign exchange and currency inconvertibility itself also depressed the external value of the currency.

Unlike in market economies, with the administrative regulation and a differentiated system of levies and subsidies, a rather wide range of "implied" exchange rates developed. The "real" external value inevitably tended to reflect the least favourable rates.

On the other hand, there was persistent effort to artificially keep the domestic consumer price level stabilized (subsidizing, among others, foodstuffs, rents, transport and some other services).

Summing up, unlike in the other parts of the world economy, the disparity between the exchange rate level and the PPP rate in the former centrally planned economies was due not only to their technical and technological gaps with respect to developed market economies, but also to the institutional, systemic and policy peculiarities of their development. Consequently, the ensuing exchange rate/PPP disparity tended to be higher than warranted by technical and technological factors alone and, as a result, higher than in other countries at a similar level of development.

3.3.2 The impact of transition policies

As shown above, in the course of transition, the exchange rate/PPP ratio tended to narrow in all examined countries, though with differences in speed, intensity and time horizon. Does this imply that the tendency of exchange rates to move towards the PPP rate, a proposition claimed to hold at least in the long-run in monetary theory, started to assert itself also in the case of the former centrally planned economies once they opted for a market type economy?

Chart 2 reveals the implied trends in the case of Czechoslovakia (for the data see table 12).

Table 12. **Effective exchange rates of the CSK**

Indexes (January 1990 = 100)

	CSK/USD[1]	1	2	3	4
1990/1	16,29	100,00	100,00	100,00	100,00
2	16,60	98,13	100,00	100,43	97,71
3	16,72	97,43	100,00	100,69	96,76
4	16,67	97,72	100,40	100,87	97,26
5	16,64	97,90	100,70	101,09	97,52
6	16,58	98,25	101,00	101,35	97,91
7	16,37	99,51	107,50	101,52	105,37
8	15,89	102,52	110,90	102,07	111,39
9	15,71	103,69	114,30	102,64	115,47
10	20,18	80,72	115,50	103,31	90,25
11	23,63	68,94	115,60	103,26	77,17
12	24,19	67,34	115,70	103,32	75,41
1991/1	27,65	58,92	145,60	103,99	82,49
2	27,24	59,80	155,80	104,22	89,40
3	28,74	56,68	163,10	104,24	88,69
4	29,94	54,41	166,30	104,59	86,51
5	30,12	54,08	169,70	104,91	87,48
6	30,89	52,74	172,60	105,39	86,37
7	31,00	52,55	172,60	106,01	85,55
8	30,53	53,36	172,50	106,15	86,71
9	30,03	54,25	173,00	109,80	85,47
10	29,89	54,50	172,90	106,67	88,34
11	29,15	55,88	175,60	107,09	91,63
12	28,55	57,06	177,70	107,18	94,60
1992/1	28,36	57,44	179,50	107,50	95,92
2	28,78	56,60	180,40	108,06	94,49
3	29,16	55,86	180,90	108,52	93,12
4	29,06	56,06	181,79	108,73	93,72

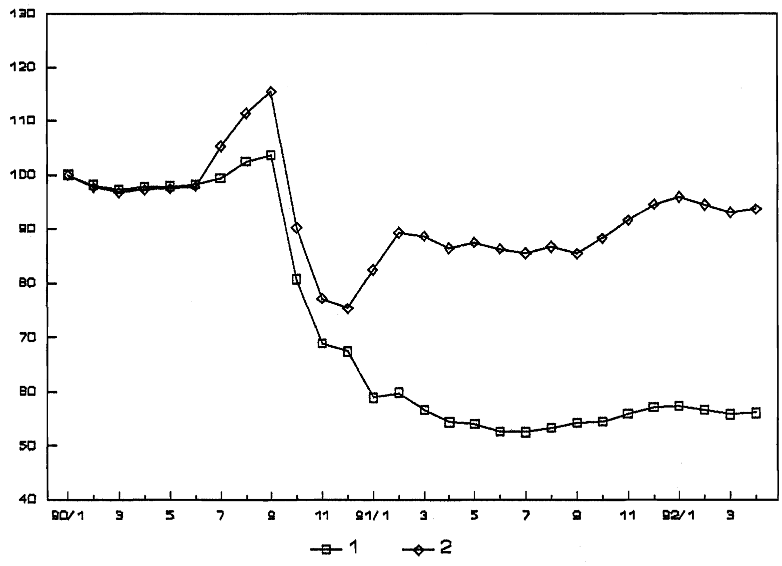
Indexes (May 1990 = 100)

	CSK/USD[1]	1	2	3	4
1991/5	30,12	100,00	100,00	100,00	100,00
6	30,89	97,51	101,71	100,45	98,73
7	31,00	97,16	101,71	101,06	97,79
8	30,53	98,66	101,65	101,19	99,11
9	30,03	100,30	101,94	104,69	97,67
10	29,89	100,77	101,89	101,68	100,97
11	29,15	103,33	103,48	102,08	104,74
12	28,55	105,50	104,71	102,17	108,13
1992/1	28,36	106,21	105,77	102,47	109,63
2	28,78	104,66	106,31	103,01	108,01
3	29,16	103,29	106,60	103,45	106,44
4	29,06	103,65	107,12	103,64	107,13

[1] Monthly average values
1 = Nominal effective exchange rate of CSK
2 = Consumer prices of Czechoslovakia
3 = Consumer prices of basket countries
4 = Real effective exchange rate of CSK

Chart 2. **Effective exchange rates of the CSK**[20]

Chart 2a. January 1990 = 100

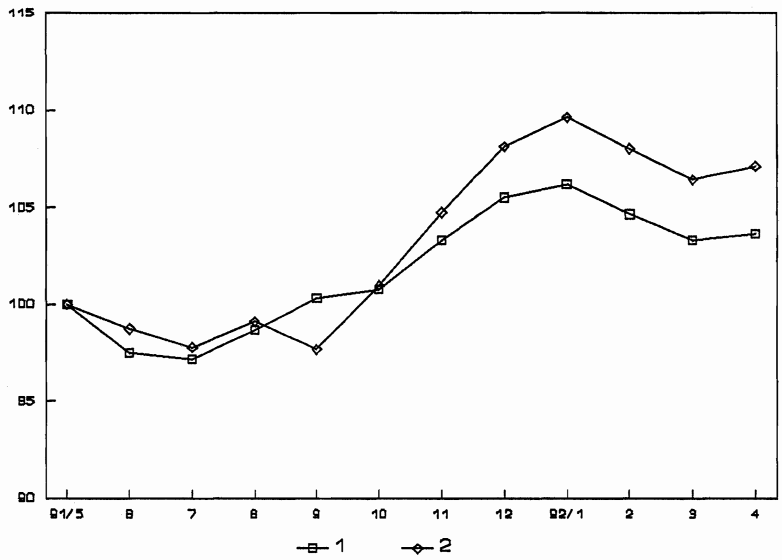


1 = Nominal effective exchange rate of the CSK
2 = Real effective exchange rate of the CSK

In the period January 1990 - April 1992 (chart 2a) the nominal effective exchange rate (NEER) of the CSK depreciated to 56 % of its value, as a result of devaluations vis-a-vis convertible currencies in January, October and December 1990. However, the real effective exchange rate (REER), calculated on the basis of the CPI, depreciated as well. In spite of a high inflation differential in the examined period (more than 70 % against the countries of basket currencies), the level of the REER was in April 1992 still below its January 1990 base, though only by a few percentage points.

[20] The effective exchange rate of the CSK is expressed in terms of CSK/USD, reflecting, however, the development with respect to basket of five currencies (DEM, USD, ATS, CHF, GBP) to which CSK is pegged.
The real effective rate calculations are based on consumer price indexes of Czechoslovakia and of basket currencies countries. Greater value than 100 signifies appreciation and less than 100 depreciation.

Chart 2b. May 1991 = 100



1 = Nominal effective exchange rate of the CSK
2 = Real effective exchange rate of the CSK

Source: State Bank of Czechoslovakia,
International Financial Statistics.

However, as is apparent especially from chart 2b, the CSK's REER has tended to appreciate in recent times. Along with a marginal appreciation of the nominal exchange rate, CSK's REER appreciated by 7% in the year ending April 1992.

The table 13 presents parallel data on nominal and real effective exchange rates for Hungary and Poland.[21]

[21] The data on the REER for Hungary and Poland, taken from the IFS are not strictly consistent with those presented by us for Czechoslovakia. Calculations of REER for Hungary and Poland are made by the IMF staff, while no parallel data are published in the IFS for Czechoslovakia. Besides the difference in base year, the calculations for Hungary and Poland apparently use industrial price indices.

Table 13. **Exchange rates and consumer prices in Hungary and Poland**
(1985=100, period averages)

	1985	1986	1987	1988	1989	1990	1991
Nominal effective exchange rates							
Hungary	100	90,7	80,9	79,6	82,1	78,9	71,6
Poland	100	72,5	45,1	29,5	17,1	1,8	1,7
Consumer prices							
Hungary	100	105,3	113,9	132,5	155,0	198,7	..
Poland	100	117,7	147,4	236,1	828,9	5.684,3	9.680,2
Real effective exchange rates							
Hungary	100	89,7	80,7	83,0	83,7	85,2	95,9
Poland	100	78,2	56,9	52,0	58,5	48,2	73,8

Source: International Financial Statistics.

While the nominal exchange rate of the Polish zloty depreciated between 1989 and 1992 much more than the CSK exchange rate, the Hungarian forint, on the other hand, depreciated significantly less.

Those diverging trends reflect the difference in strategies adopted. In Poland at the beginning of 1990, and in Czechoslovakia a year later, the move to a limited currency convertibility was associated with a substantial devaluation. Moreover, the authorities in both cases opted for a deliberate overshooting of devaluation, setting the exchange rate close to a parallel market or a "marginal" rate.[22]

Hungary, on the other hand, followed a more gradual path of liberalization, accompanied by repeated, but relatively modest, devaluations of the forint.

A substantially different conclusion follows, however, from a comparison of REERs over the examined period since the end of 1989. While the level of the

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[22] With the advantage of hindsight, it can be claimed that the extent of overshooting was in both countries unnecessarily large. In the Polish case e.g., the adopted rate "survived" a 250% inflation rate in 1990 (December 1989 to December 1990) without any adjustment being necessary. A number of observers criticized the extent of the devaluation as an evident policy mistake.

It must be admitted, however, that the authorities faced a considerable degree of uncertainty while setting a new exchange rate. Given the sweeping changes taking place with the start of the transition and given the proclaimed target of maintaining the exchange rate as a nominal anchor for a specified period (in the case of Poland) or at least to avoid any further devaluation in the near future (in the case of Czechoslovakia), the selection of a proper rate seemed to be more a question of the "art of policy making" than of rational calculation.

CSK's REER was in May 1992 still below its January 1990 base, in both Hungary and Poland the REERs appreciated in 1990 and 1991; in Poland the appreciation was much sharper (compare table 13). Parallel calculations based on the CPI indicate that the forint's REER appreciated by 32 % and the zloty's by 140 % between January 1990 and May 1992, compared to a 6% real depreciation of the CSK in the same period.

The divergent trends in nominal and real effective exchange rates across the individual reforming countries are conditioned by substantial differences in their inflation records.

In Czechoslovakia, apart from a price jump in January 1991 following the sweeping price liberalization (CPI increased by 25.8 % in January 1991), inflation was well under control through the entire examined period, with the monthly average at 0.6 % for the year ending May 1992. The Czechoslovak inflation record was thus more favourable than that of Hungary, and certainly much more favourable than Poland's (compare table 14).

Table 14. **Consumer prices in Czechoslovakia, Hungary and Poland 1986 - 1991**
(1985 = 100, average annual percentage changes over the previous year)

	1986	1987	1988	1989	1990	1991
Czechoslovakia	0,5	0,1	0,2	1,4	10,0	58,7
Hungary	5,3	8,6	15,5	17,0	28,9	35,0
Poland	17,7	25,0	60,0	251,0	586,0	70,0

Source: International Financial Statistics.

To conclude, the path taken by Czechoslovakia diverged from those taken by Poland and Hungary. Due to a substantial devaluation of the CSK's nominal exchange rate associated with a relatively modest increase in the domestic price level since the start of transition, the implied exchange rate/PPP ratio decreased much less than in Hungary and Poland. Consequently, the CSK continues to be relatively undervalued at mid-1992.

3.4 Consequences of the built-in disparity between the external and domestic purchasing power of the CSK

As follows from the discussion above, a wide gap between the external and domestic value of the CSK seems to be a "built in" longer-term factor in the case of Czechoslovakia. With the start of transition it was accentuated by a substantial nominal devaluation of the CSK, while the domestic price level inflated relatively modestly across the transition period.

What are the consequences of the given situation, leaving aside the issue of whether there were other options available to the policies followed since the beginning of transition in order to secure the competitiveness of Czechoslovak exports.

Under the given terms, the comparative advantages tend to be based on cost advantages, provided by low labour costs.[23]

The potential benefits of the implied cost advantages include:

- A basis is provided for export expansion and for improved competitiveness in the world markets. It was particularly important in the period when sustained export growth to convertible-currency markets was considered crucial in order to offset at least partially the sharp contraction of trade to the former CMEA and to finance the potentially quickly growing imports of western technology and products.

[23] The average wage rate of a qualified worker amounted to USD 200 per month at the beginning of 1992, a rather low level among comparable countries of Western Europe.

– Low labour costs along with prospective capital gains via future appreciation of the CSK should attract foreign investors who want to exploit the opportunities provided (particularly since the labour force is well educated and qualified).

There are, however, strong reservations concerning the claimed benefits:

a) Cost advantages provide a basis for export expansion of those items where the costs and price dimensions of competition dominate. These are " by definition" standard, mostly lower-value added, products. By the same token, the firms are not induced to develop all possibilities to innovate, to launch and to market new products of higher quality and technical standards, which is certainly more demanding and more risky longer-term option.

Comparative advantages derived from "cheap labour" were thus likely to foster a shift towards lower value-added sectors in production and export patterns, thus accentuating the longer-run trends to "regressive specialization" present in Czechoslovakia. As argued in section 2, there is some evidence that this has actually been the case recently.

The negative implications of moving to lower value-added products include the risks of a brain-drain and of an increasing gap vis-a-vis world technological standards. By contrast, successful examples of revitalization elsewhere have been based on the narrowing of this gap.

In spite of some short-run gains, it appears hardly prospective for Czechoslovakia, given its resource pattern and income level, to base present restructuring on low labour costs and to shift even further to lower value-added products. From a medium and long term point of view, the desirable trend is evidently the reverse.

b) A parallel qualification relates to cost advantages as an incentive for foreign direct investments. As supported by data in table 2, comparing the Czechoslovak and Hungarian experiences, factors other than cost ratios are evidently more important to foreign investors. Moreover, the low-labour-cost "advantage" tends to affect accordingly the pattern of foreign investments. A relatively high proportion of funds invested e.g. in the construction materials sector (cement works in particular) seems to support the argument.

c) A persistently wide disparity between the external and domestic purchasing power of the CSK has some other side effects:

– it provides an advantage for foreign currency holders, implying a biased redistribution of wealth to foreign investors via windfall gains

– even the proceeds from tourist trade, which is under "standard" conditions the most favourable trade option for domestic agents, are likely to be relatively small in the real terms.

To conclude, maintaining the disparity between domestic and external values of the CSK was a viable way of securing the competitiveness of Czechoslovak exports in the short run. At the same time, however, that type of solution - if maintained - is likely to work against their competitiveness in the medium and long run. Consequently, the open issue is how, and in what time frame, to cope with the above-mentioned "built-in" gap.

Tables

Charts

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