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Biographical Notes

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The Czech Republic: A Review of the Eastern European Economy with the Lowest Unemployment Rate

by Rafael Pampillón and José Luis Jiménez

Introduction

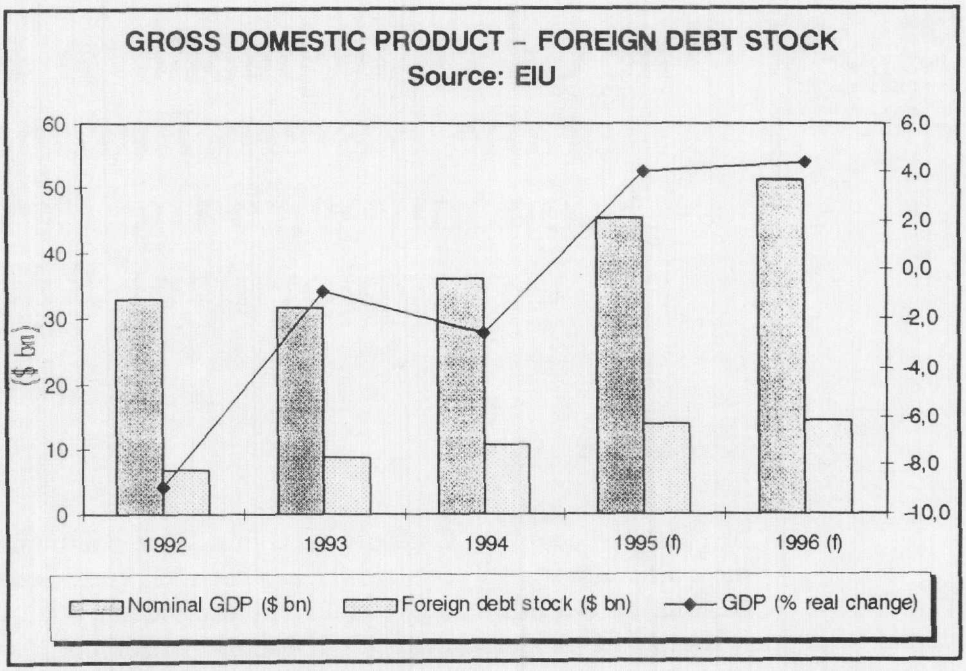
In 1989, the people of Czechoslovakia ousted the communists from government after almost fifty years of rule, in a peaceful process known as the Velvet Revolution. An IMF-backed stabilisation programme was launched in 1991. It comprised some liberalisations, a sharp devaluation of the currency and the unification of the exchange rate. In 1992, the Czechs and Slovaks decided to separate, in what was known as the Velvet Divorce. The separation of the Czech and Slovak Republics officially took place the 1st of January 1993 without political and social crisis.

The state of the economy of the Czech Republic at the end of 1991, was as follows:

Gross Domestic Product	$32,2 billion
GDP per capita	$2,129
GDP growth	-14.7%
CPI (% change av.)	57.8%
Unemployment rate	6.6%
Source: EIU (1995).	

At the helm of government in the Czech Republic, was President Vaclav Havel, a playwright and dissident in the communist days, and Prime Minister Vaclav Klaus, a free-market reformer, who used to read his Milton Friedman under his desk in the communist days.

Due to the new economic situation GDP of the Czech Republic registered a negative growth of -8,9% in 1992, 0.9% in 1993, 2.6% in 1994, and for 1995, the estimate is 4.0% (See Table 1). Per capita this figure rose from $2,712.8 in 1991 to $4,375.8 (estimate) in 1995. Adjusting it for purchasing power parity (PPP), Czech per capita GDP is estimated at $8,200 (See Table 2). This is the second highest in Eastern Europe, behind Slovenia's $9,000 per capita (PPP).



Fiscal Policy

After 1992 deficit of 1.8% of GDP, the Czechs maintained a balanced budget, registering a perfect balance in 1993 and a surplus of 2 Billion Czech crowns in 1994. In percentage of GDP, 1994 registered a surplus of 1%, and by November 1995, the surplus was also 1% of GDP. The components of the budget are shown in Table 3. Among twelve former communist countries, only the Czech Republic, Estonia and Latvia achieved a balance or a surplus in their budgets. The balance in the budget was achieved, largely by increase in tax collection, including the introduction of the VAT (value-added-tax) in 1993.

CPI and Monetary Indicators

The liberalisation of 90% of prices and of the foreign trade, inflation average rose to 57.8% in 1991. But after this sharp acceleration and the introduction of value added tax in 1993, inflation was brought under control dropping to 10.0% in 1994 and 9.0% (estimate) in 1995.

The prices increases (% change av.) by sector for the year 1994 was as follows:

Consumer prices	18.0
Food	13.2
Non-Food	18.0
Public Catering	21.9
Services	25.3
Industry	11.4
Building Industry	25.9
Transport (all types)	29.5
Communication services (sales)	28.9
Agricultural products	6.2
Source: Ministry of Industry and Trade, Czech Republic.	

Due to inflation is largely a problem in the supply side, the Czech National Bank has pursued a policy of continuous reduction of interest rates on domestic credits (loans) in order to promote economic growth. The Prague Interbank Offered Rate (PRIBOR) has steadily declined as is shown below.

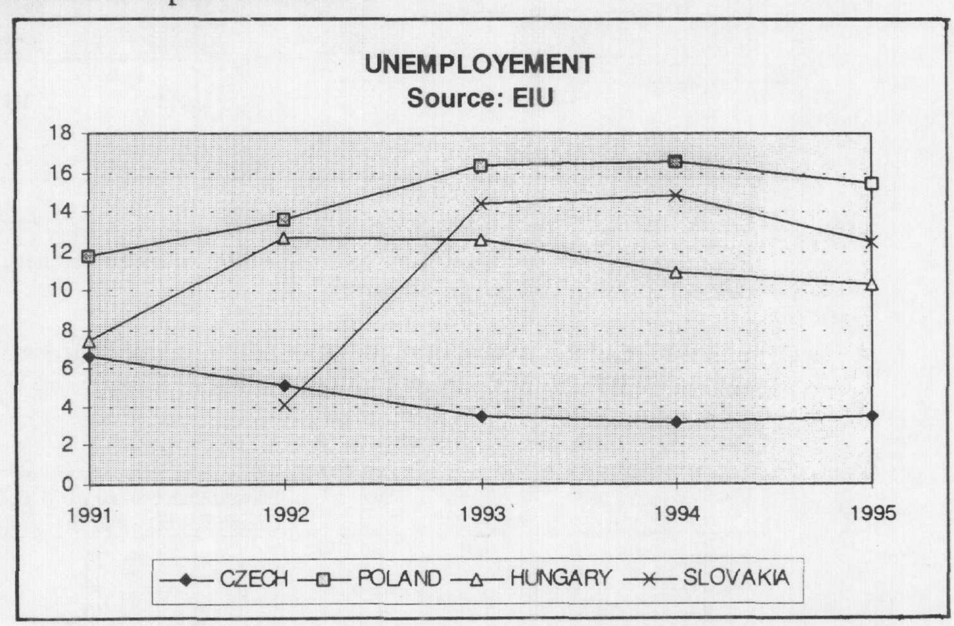
Average interbank rate of interest from deposits (PRIBOR)

No. of days	1992	1993	1994	(IQ)	IIQ	IIIQ
7 days	10.50	10.74	7.97	7.31	7.58	
90 days	13.80	13.15	9.08		8.43	8.40
180 days	14.60	13.95	9.21		8.64	8.56
Source: Ministry of Idustry and Trade, Czech Republic						

Labor Policy

The Czech goverment maintains a policy of not allowing wages to rise by more than five percent (5%) above the CPI. The wages have, therefore, been kept low, relative to European Union rates. The average wages for general workers for 1995 were $315/month. Compared to German wages, the wages of Czech workers were, on the average, 10% of German wages. (See Table 4.)

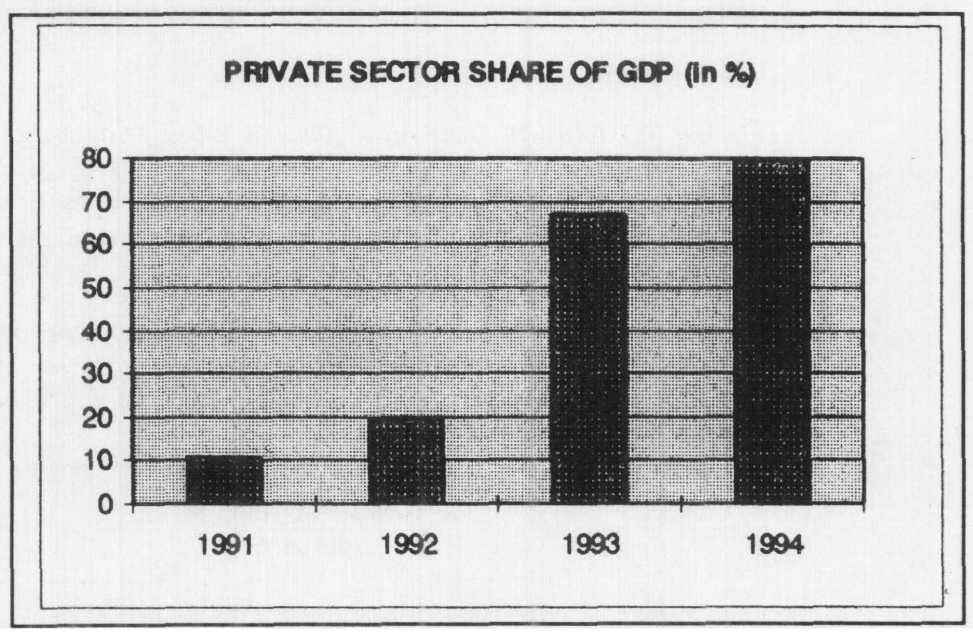
Unemployment in the Czech Republic has been kept low, with rates of 2.6%, 3.5%, 3.2% and 3.2% for the years 1992, 1993, 1994 and 1995 respectively. Czech unemployment rates are one of the lowest among the Eastern European countries.



Although the Czech Republic has achieved low unemployment rates, there is a hidden structural defect in the economy. As Dirk Damrau, Director of Salomon Brothers International points out, the investors in the privatised companies of the Czech Republic are passive investors. They have not done the restructuring required, which would lead to downsizing to make the Czech companies more competitive (Central European Economic Review, September 1995, p. 6). This may explain why Czech industrial output is not as high as that of Poland and Hungary, which have undergone restructuring.

Privatisation

The intensive process of privatisation represented the most important feature of the Czech economy. In 1993 small-scale privatisation was practically completed, with 24,359 companies privatised by means of auctions by the end of 1993. This provided the government with 31 Billion Czech crowns in revenues. In the industrial sector, 13,500 companies were privatised, realizing for the government, 19 Billion Czech crowns in revenues.



All told, privatisation realized 212.5 Billion Czech crowns for the year 1992, and for 1993, total revenues amounted to 155 Billion, of which 87.8 Billion represent industrial property.

As a result of privatisation, the share of the private sector in GDP formation reached 80.0% in 1994, from a low of 10.6% in 1990.

Comparative progress in transition in eastern Europe:

Country	Private sector share of GDP. Mid-94 in % (rough EBRD estimate)
Albania	50
Bulgaria	40
Croatia	40
Czech Republic	65
Hungary	55
Poland	55
Romania	35
Slovak Republic	55
Slovenia	30

Investment

Total Foreign Direct Investment (FDI) in the Czech Republic from 1990 to Nov. 1995 has reached a total of $5.27 Billion. The distribution of the investments by country and sector are as follows:

Country	1993	1990-1994
Germany	82	790
USA	255	651
France	34	339
Belgium	32	188
Austria	55	201
Others	103	530
TOTAL (in million US$)	567	2699
Source: Ministry of Industry and Trade, Czech Republic		

Foreign Direct Investment by sector (in million US$)

Consumer industry	244	605
Automobile industry and transport facilities	10	469
Building	65	382
Banking and insurance	55	344
Foodstuff industry	35	283
Other sectors	152	616
Source: Ministry of Industry and Trade, Czech Republic		

The foreign investments come in three forms, direct purchase of Czech companies, portfolio investments by investment funds in the form of shares of stock and other securities bought in the Prague Stock Exhange, and financial credits obtained by Czech companies from sources abroad.

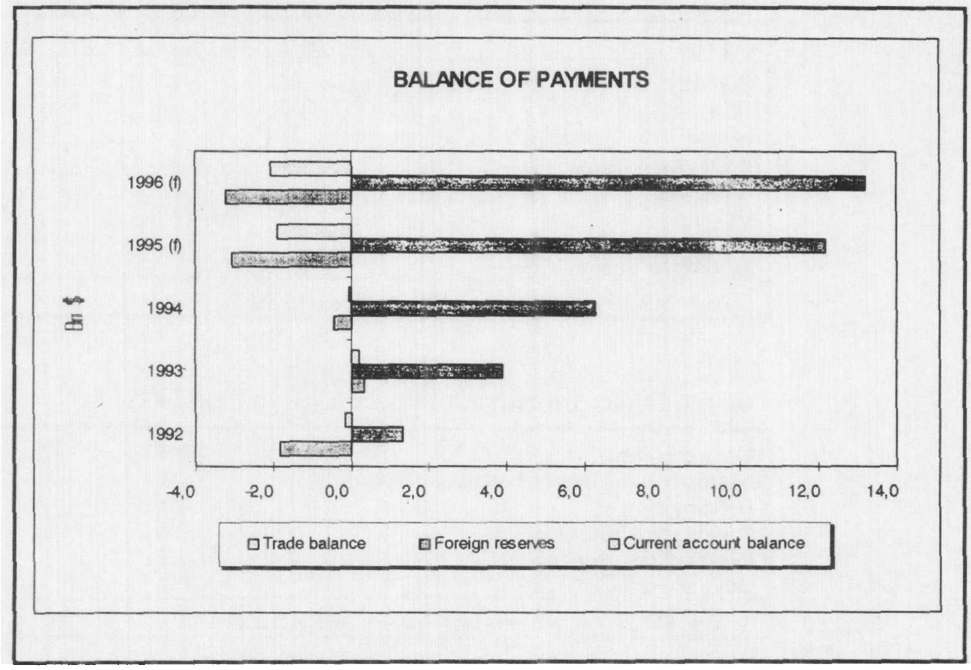
Investment in shares and securities quoted in the Prague Stock Exchange reached $350 Million in 1993. Financial credits to Czech companies were $300 Million and $800 Million for 1992 and 1993 respectively.

The stable political conditions and a relatively low inflation rate have maintained investor confidence in the Czech Republic. This confidence is reflected in the upgrading by Standard and Poor's of Czech risk rating from BBB+ to A.

Balance of Payments

The Czech Republic has registered deficits in the trade balance since 1991 except for 1993. The current account balance has followed the same way, registering a $201 million superavit in 1993 and -50 million in 1994, due to the balance of services (transfer of gas and tourist industry) and transfers and remittances of foreign exchange by both individuals and corporations. Table 6 compares Czech trade balances with other Eastern European countries.

As we have pointed out above, the tourism industry is a vital component in the Czech Republic's balance of payments. Tourist arrivals in 1994 reached 17 million, generating revenues of $1.97 Billion. This figure is equivalent to 14% of export receipts and 5.6% of GDP.



The number of tourist arrivals and revenues generated for the years 1992 - 1994 as compared to other countries are as follows:

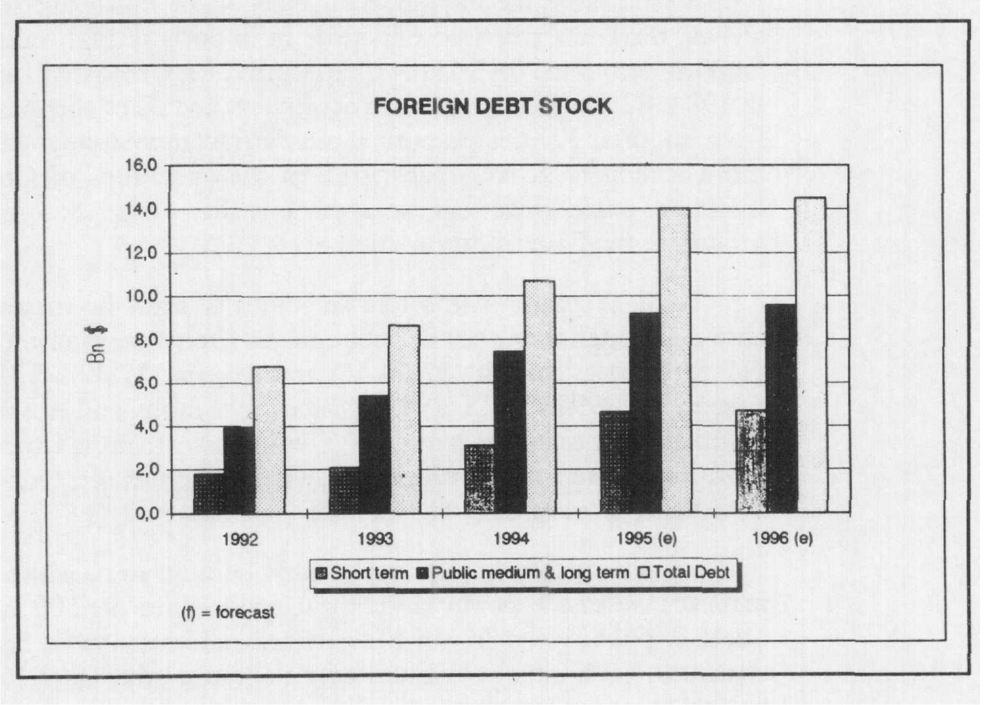
	Rank by receipts		
Country	(85)	(94)	1994 receipts ($ B)
USA	1	1	57.10
France	4	2	25.00
Austria	6	6	13.16
Poland	74	15	6.15
Czech Republic	54	31	1.97
Hungary	56	39	1.44
Source: World Trade Organization			

	Rank by arrivals		
	(85)	(94)	1994 arrivals (m)
France	1	1	60.64
USA	3	2	46.43
Hungary	11	5	21.43
Austria	5	8	17.89
Poland	22	9	17.60
Czech Republic	16	10	17.00
Source: Ministry of Industry and Trade, Czech Republic			

The key objective of the maintenance of a stable koruna followed by the monetary authorities it could not be easy to follow in the future. After an initial sharp devaluation at the start of the reform in 1991, the rate was fixed to a basket of western currencies (65% D-mark and 35% $US). Despite it has been stable in nominal terms, due to the inflation differential with this countries and high capital inflows, in real terms it has risen significantly since then. This situation is making a policy dilemma to the goverment because it has no much sense to maintain an appreciated currency with trade and current account deficit, as IMF has pointed out recently.

External Debt

During the 80'S, the prudent management of the external debt by the czech authorities (they did not apply for external debt to resolve their domestic problems), has permitted the country to confront the changes to a market economy without a high mortgage. In 1991, In 1991, gross external debt stood at 7.2 $ bn. (22% of GDP) and the foreign debt service reached $1,1 bn. (less than 10%). At the end of 1995, total external debt represented $14 billions (31% of GDP), while the debt service reached $2 billions (9.9% of export). These figures are well below from Poland and Hungary where the total stock debt represented (36,7% and 68,4% of GDP) respectively.



Conclusion:

All indications for 1995 show that the Czech Republic has managed its economy above average. Estimates for 1995 show that GDP could reach $45.2 billion. GDP per capita could reach $4,375.8, and growth could be about 4.0%. Inflation is a single digit 9.0% and unemployment would continue to be low (3.2%).

The success of the Czech economy can be seen from the fact that it has been admitted recently to the Organization for Economic Cooperation and Development. Although admission to the OECD does not bring economic advantages like admission to the EU, it does bring prestige, and indicates that the Czechs have been accepted into the supposed rich boys' club of the nations of the world.

Some challenges have to be met, however, if the Czech Republic intends to maintain its good economic performance.

First, they must continue with structural reforms, giving to the private sector an increasing role. A full restructuring must be made of Czech industry, which is still outmoded and inefficient by European standards. The industrial output, which is in a decline, should be benefit from this. Growth in the Czech industrial output for 1995 (Jan. To Nov.) does not compare favorably with that of Slovenia (12.0%), Poland (14.9%), Hungary (7.9%) and even Bulgaria (5.3%), which are all experiencing increases in industrial output.

Second, the Czech economy must also endeavor to produce more high-value-added products, not only for the domestic market, but for export, if it wishes to achieve the high growth levels of the Asian tigers. But as Table 7 shows, there is a worrisome increase in imports of high-value-added goods. Imports accounted for 94% of total demand for Czech demand for computers in 1994. 82% of communication equipment and 62 of chemicals were sourced from imports. For this purpose, it must attract more foreign investors who are more willing to actively participate in the operations of Czech companies, instead of passive investors, who only buy shares of stock to benefit from the growth in the Eastern European markets.

Third, revenues in the tourism industry must be increased. As shown above, although the Czech Republic hosted almost the same number of tourists (17 Million) as Poland (17.60 M) and Austria (17.89 M), Poland's tourist receipts for 1994 ($6.15 B) were three times more, and Austria's ($13.16 B) six times more than Czech receipts. This indicates that the Czech Republic host more backpackers than businessmen, who on the average, spend twice as much as ordinary tourists.

To achieve this, infrastructure must be improved, which would require massive investment. For instance, the telephone lines per 100 inhabitants in the Czech Republic is very low by EU standards, and even low by Eastern European standards. Without telecommunications advances, the Czech Republic will not be able to attract the high-spending business tourists.

Another area for improvement is roads, which have been overburdened by traffic. A Berlin executive, for instance, travelling to Dresden, would spend half the time it takes to travel to Prague, even though the distance from Berlin to Dresden is 1.5 times the distance from Berlin to Prague.

The factors that led to the success of the Asia "tigers" are export-oriented growth, high domestic savings, low inflation, high foreign investments, and low labor costs (Pamillon 1995) The Czech Republic has been able to achieve low inflation rates and has attracted high foreign investments. It has been able to play the game of low wages played by the Asian economies. What is lacking in this menu, however, is high growth led by exports.

The Czech GDP growth is only one-half the growth rate of the Asian tigers, which they have maintained for more than ten years. Czech exports are low, and its trade balance has been negative since 1991. If these two components can be added (high exports and high growth), perhaps we shall see the emergence of the firtst Eastern European tiger.

Table 1
Key Czech Economic Indicators

	1992	1993	1994	1995 (est.)
GDP ($ Billion)	28.0	31.2	36.0	45.2
GDP per capita ($)	2,712.8	3,023.9	3,486.5	4,375.8
GDP (annual growth)	-6.4%	-0.9	2.6	4.0
CPI (% change av.)	11.1	20.9	10.0	9.0
Unemployment rate	2.6%	3.5%	3.2%	3.2%
Current Account ($B)	-0.3	0.1	0.0	-1.9
Current Account (% of GDP)	-1.1	0.3	0.0	-4.2

Source: OECD

Table 2

Country	GDP/capita at PPP (1994)
Slovenia	$9,800
Czech Republic	$8,200
Estonia	$7,000
Slovaki	$6,800
Hungary	$6,600
Poland	$5,600
Croatia	$5,000
Latvia	$4,800
Russia	$4,600
Bulgaria	$4,000
Lithuania	$3,400
Romania	$3,100

Source: Business Central Europe

Table 3

The State Budget for 1994

	Basic structure of the state budget revenues in billion Czech Korunas)		1993		1994	
A.	Revenues from taxes		223.6		237.3	
B.	Revenues from social security		107.5		120.1	
C.	Revenues other than taxes		22.2		24.4	
TOTAL REVENUES				353.3		381.8
LOCAL BUDGET REVENUES						
A.	Revenue from taxes		33.7		39.0	
B.	Revenues other than from taxes		14.5		25.1	
	Total own revenues		48.2		77.1	
C	Transfer from state budget	26.1		25.1		
TOTAL REVENUES				74.3		77.1
STATE BUDGET EXPENSES						
A.	Ordinary current expenses		314.8		336.7	
	non-investment subsidies to corporations		29.8		28.0	
	transfer to households		121.4		139.6	
	public consumption - population		63.6		68.2	
	public consumption - state		64.1		81.1	
	debt service		15.6		0.0	
	transfers to foreign countries		0.9	0.9		
	housing policy		2.2	4.7		
	allocations (subsidies) to local budgets		17.0		14.0	
B.	Capital expenses	31.5		35.9		
	subsidies to corporations	5.8	6.4			
	subsidies to public sector	25.7		29.5		
C.	Government credits/loans	7.3			7.4	
TOTAL EXPENSES			353.3		379.8	
Source: Ministry of Trade and Industry, Czech Republic						

Table 4
Wage Costs (as % of German gross wages, 1994 levels)

Country	
Slovenia	31.0%
Hungary	13.0%
Poland	10.5%
Czech Republic	10.3%
Slovakia	8.5%
Source: J. P. Morgan	

Table 5
Trade surplus/deficits in milion ($)

	1993	1994	1995
Czech Republic	705	-1170	-660
Poland	-1340	-4430	-4040
Slovakia	-140	-255	-750
Source: Investmentbank Austria			

Table 6 Import Penetration in the Czech Republic (% of sectors provided by imports, 1994)	
Computers	94%
Communication equipment	82%
Optical, medical equipment	74%
Chemicals	62%
Machinery	54%
Furniture	48%
Cars, trailers	42%
Leather, shoes	41%
Oil, Coal	36%
Tobacco	36%
Metal	34%
Electrical machines	33%
Textiles	28%
Wooden products	24%
Printing and Publishing	18%
Foodstuffs	18%
Source: Czech Statistical Office	

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