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Initial Par Values - Czechoslovakia

Prepared by Gertrud Lovasy
Research Department

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Conclusions

After the first world war, Czechoslovakia quickly established itself as a strong and important trading country. Throughout the 1920's the country had an export surplus. The difficulties arising from the depression were overcome with the help of exchange control and two devaluations of the crown and shifting exports from its central and eastern European trading partners which utilized clearing agreements, toward the western "free exchange" countries.

The Czechoslovak economy is now in the process of reconstruction and adjustment to changed internal and external conditions. During that period it will prove difficult to balance its international payments without substantial credits from abroad. Production and exports are being restored, but are still below the pre-war level.

Although the Czechoslovak crown is now overvalued on the basis of relative prices, this has not been a significant factor affecting the country's exports. The limit on Czechoslovak export trade is still the relatively low level of production and disrupted transportation system outside the country. Continuation of trade controls and the restriction of non-essential imports would appear to be necessary under present conditions.

As reconstruction proceeds, physical limitations of supply will gradually be overcome; but competition for export markets will increase when present scarcities end. If overvaluation of the crown persists, Czechoslovakia's position on foreign markets will be weakened. There are however indications that overvaluation of the crown may gradually disappear; a marked change is already noticeable in the last few months. The gradual rise in productivity of labor with improving production facilities may further reinforce that trend.

1. Prewar Trade and Balance of Payments

When, in 1918, Czechoslovakia emerged as an independent state from the breakdown of the Austro-Hungarian Monarchy, the country found itself equipped with a highly-developed industry and valuable natural resources. Its industry had, before the separation, supplied the monarchy with a

large variety of manufactured goods, and had a considerable share in its export trade. About half of Czechoslovakia's working population was engaged in industry and trade and 38 per cent in agriculture. While well supplied with domestic foodstuffs and rich in coal, the country was highly dependent on imports of other raw materials for its finishing industries, especially textiles, iron and steel, and other metal trades. Raw materials made up some 60 per cent of total imports while about 70 per cent of exports consisted of manufactured goods.

In spite of the difficulties caused by severe shortage of raw materials and disruption of transportation facilities after the war, trade was quickly expanded. By 1920, a sufficient export surplus was developed and maintained through the 1920's, to cover other expenditure abroad, including interest and amortization payments on the moderate foreign debt. Exports in 1926-29 amounted to some 20 per cent of total national income, and about 25 per cent of total industrial output was exported.

The world depression of the early 1930's caused a sharp decline in Czechoslovakia's foreign trade and had severe repercussions on the whole economy of the country.

Economic Activity in Czechoslovakia, 1932-37

	Imports (value)	Exports (value)	National Income	Industrial Production	Employment in Industry
		(1929 = 100)			
1932	38	36	65	64	83
1933	29	29	59	60	75
1934	32	36	62	67	75
1935	34	32	65	70	77
1936	40	40	66	80	82
1937	55	60	74	96	90

The depth of the depression was reached in 1933, when national income and production had fallen to less than two-thirds and trade to less than one-third of 1929 levels.

In the autumn of 1931, after the devaluation of sterling and the breakdown of the Austrian "Creditanstalt," Czechoslovakia followed most other countries in that area and introduced exchange control to prevent capital flight and to protect the crown. Subsequently trade with Central and Eastern Europe was placed under a system of clearing agreements on a strictly bilateral basis. Although the balance of Czechoslovakia's total trade remained favorable, except for a small deficit in 1932, a serious balance-of-payment problem arose because the export surplus resulted almost exclusively from trade with clearing countries.1/

1/ Trade was carried out on a clearing basis with Austria, Germany, Rumania, Yugoslavia, Italy, Hungary, Bulgaria, Greece and Turkey.

Czechoslovak Trade Balance, 1933-37
(million crowns)

	Trade Balance with Clearing Countries	Trade Balance with All Other Countries
1933	+ 155	- 132
1934	+ 1.031.	- 133
1935	+ 586	+ 93
1936	+ 311	- 212
1937	+ 749	+ 257

In view of the difference in the type of imports from the two groups of countries, it was not possible to shift their source from the free exchange countries to the clearing countries. The only way to overcome the difficulties was to expand exports toward free exchange countries sufficiently to reverse the unfavorable trade balance with that group. And that was the course adopted by Czechoslovakia. In February, 1934, the crown was devalued to adjust the price level which, as a consequence of the devaluation in the sterling area and in the United States, had got out of line with prices in those markets. In the following year, exports to free exchange countries exceeded imports by 93 million crowns. The devaluation was not sufficient (a deficit appeared in 1935) and the crown was further devalued late in 1936. In 1937, exports rose steeply, partly as a consequence of the revival of world trade, and a surplus of 257 million crowns in trade with the free exchange group was achieved.

From 1933 to 1937, exports to free exchange countries increased by 130 per cent while exports to clearing countries rose by only 75 per cent. As a result, exports to clearing countries amounted to 36 per cent of the total as compared with 45 per cent in 1933 and 55 per cent in 1929. The shift in geographical distribution of Czechoslovakia's exports was achieved without a major change in its composition: manufactured goods made up about 70 per cent of the total, with textiles first, iron and steel manufactures second, glass and glassware third.

Total trade with all countries in 1937 had reached its highest level since 1929; unemployment had considerably decreased and industrial production had almost reached its 1929 level.

2. Post-War Problems

The war resulted in considerable impairment of Czechoslovakia's productive resources. Coal mines had been heavily exploited, forests had suffered from over-cutting, agricultural yield had heavily declined. The transportation system was disrupted, with rolling stock depleted and in poor condition. Industrial equipment had deteriorated through excessive use and lack of replacement and repair. Raw material stocks were exhausted.

The difficult problem of reconstruction is aggravated by a severe labor shortage, to some extent a legacy of war, occupation and slave-labor, but mainly due to the transfer of three million Germans from Czechoslovak territory. The exodus will be felt throughout the economy, but primarily in the textile, glass and ceramic industries, which before the war accounted for about 35 per cent of total exports. The Government intends to replace the Germans by its own nationals, and may also encourage immigration of foreign labor. The retraining of labor will take time, and it will hardly be possible to replace all that go. Some shift in the structure of Czechoslovakia's industry will be inevitable.

A further factor to be taken into account in the reorientation of Czechoslovakia's economy is the changed economic pattern in post-war Europe. With the decline of Germany's role in international trade, Czechoslovakia has lost its most important trading partner (15 per cent of exports, 17 per cent of imports, in 1937). Other sources of supply and other markets will have to be found. On the other hand, Germany's exports to her former markets will have to be replaced, and that may offer great opportunities to Czechoslovakia's export industries.

Since the liberation of the country in May, 1945, the Government has taken vigorous action to reconstruct and adjust the economy, and considerable progress has already been made. In November, 1945, the currency in circulation was recalled and exchanged for the new Czechoslovak crown and note circulation was reduced by about 60 per cent. An even greater reduction was made in deposits. The exchange rate for the new crown was fixed at 2.0 cents against the previous rate of 3.35 cents. Nationalization of a large sector of the country's industries, mines and banking institutions was provided for by decree of October 24, 1945. More than half of industrial production has been brought under direct control of the Government. Recently a two-year development plan was adopted to come into effect by January 1, 1947. Production goals at the end of 1948 have been set some 10 per cent above 1937 levels. Special emphasis is laid on expansion of capital goods and of mass-produced consumer goods industries.

The ordinary budget for 1946 shows a deficit of 7.5 billion crowns, about four-fifths of expenditure being covered by ordinary revenue. The extraordinary budget provides for total expenditures of 25 billion crowns chiefly for reconstruction purposes, of which only 6.5 billion does not involve new borrowing. Outlays in the extraordinary budget are not mandatory and will be undertaken only to the extent that funds become available from sources mentioned in the budget--largely proceeds from the sale of UNRRA supplies--or from credit operations.

At the beginning of 1946, total economic activity was about 50 per cent of pre-war and considerable improvement has been reported since. Harvest results for 1946 were satisfactory: wheat production is about 95 per cent of pre-war, while other crops are reported at two-thirds to three-fourths of that level. Progress in industrial recovery is unevenly spread, reflecting specific shortages in skilled labor equipment and raw materials. Production of textiles (including clothing), in the middle of 1946, was only 40 per cent of the pre-war volume. Steel production in June, on the other hand, reached 75 per cent of the 1937 volume.

With the gradual revival of industrial production and restoration of the transportation system both within and outside of the country, foreign trade is steadily recovering.

Czechoslovak Trade in the First Seven Months of 1946
(in millions of current U.S. dollars)

	Exports	Imports (excl.UNRRA)	UNRRA Supplies	Ratio of exports to imports (excl. UNRRA)	Ratio of exports to imports (incl. UNRRA)
January	6.7	6.5		103	
February	8.7	5.5		158	
March	11.8	10.7		110	
April	14.2	11.4		124	
May	18.6	14.5		128	
June	18.5	15.3		121	
July	27.6	15.2		182	
TOTAL, January to July	106.1	79.1	80.1	134	67

Exports have been increasing much faster than imports, accounting for the steeply rising export surplus (excluding UNRRA supplies). In July, the volume of exports reached about half of the pre-war monthly average. Comparison of exports and imports in the first half of 1946 with the corresponding breakdown for 1937 shows a large change, at least for the present, in the composition of trade.

	Exports 1937	Exports 1946*	Imports 1937	Imports 1946*
	(per cent of total)			
Foodstuffs (including live animals)	8	20	13	30
Materials raw or partly manufactured	20	25	57	47
Manufactured Articles	72	55	30	23

The increased proportion of foodstuff imports--30 per cent of total (other than UNRRA) against 13 per cent in 1937--is not likely to persist. When domestic agriculture is restored, food imports can be expected to return to pre-war levels, while with an increase in aggregate imports, their proportion will decline. On the export side, manufactured goods

*First six months of 1946; does not include UNRRA supplies.

goods show the sharpest decrease--55 per cent against 72 per cent in 1937.

With the recovery in industrial production, manufactured goods are likely to regain their former share in Czechoslovakia's export trade. But the future pattern within the broad group of manufactured goods will probably be different. Iron and steel manufactures, now 18 per cent of manufactured exports, will in all likelihood remain the largest item. Textiles and clothing, formerly 35 per cent of manufactured exports, will be second at best. The share of glass, glassware and pottery, formerly 12 to 14 per cent of manufactured exports, will also be reduced. There may also develop a shift within the textile, glassware and pottery industries from luxury goods to mass-produced utility goods.

Percentage Distribution of Trade in 1937 and 1946

	Exports		Imports	
	1937	1946*	1937	1946*
1. USSR	.8	12.9	1.1	15.7
2. Danubian countries	15.4	15.3	11.4	25.5
3. Other Eastern European countries	9.0	4.8	8.4	7.1
4. Germany	15.0	2.4	17.3	5.6
5. Switzerland	3.8	24.6	3.3	10.1
6. Northern and Western European countries	15.7	25.2	17.5	25.0
7. Great Britain	8.7	2.3	6.3	3.6
8. U. S. A.	9.3	9.2	8.8	1.6
9. All Others	22.3	3.3	25.9	5.8
	100.0	100.0	100.0	100.0

* First six months of 1946

Group 2: Austria, Hungary, Rumania, Bulgaria.
Group 3: Poland, Yugoslavia, Greece, Turkey.
Group 6: Sweden, Denmark, Netherlands, France, Belgium, Norway.

The most remarkable feature of the change in the geographic distribution of trade has been -- apart from the decline of trade with Germany -- the large increase in the share of the USSR, the Danubian countries (on the import side) and of Switzerland. Whether the new pattern will persist cannot be foreseen as yet. In view of her geographic position, it would appear that Czechoslovakia is best suited to replace Germany as a supplier of industrial goods to that area. The announced intention to expand production of capital goods and of mass-produced consumer goods would favor such a development. It is not impossible, however, that production of specialty goods will also be restored in order to raise exports to Western markets to pre-war levels. We shall proceed under the assumption that though a larger proportion of trade may be directed toward Eastern Europe, there will be considerable interest in retaining trade with Western Europe and overseas countries.

3. Price Levels and the Rate of Exchange

Recent developments on the exchange rate, note circulation and prices are shown below:

	Exchange Rate (price of dollar)	Note Circulation	Wholesale Prices	Wholesale Prices in U.S.A.
		(1937 = 100)		
1945 October	104	715	159	123
1946 January	175	359	277	124
March	175	400	285	126
June	175	440	287	131
July	175	440	290	144
August	175	468	303	150

The sharp upward movement of prices following the monetary reform in November, 1945, did not result from growing scarcities, but reflects the deliberate policy of the Government to adjust prices.1/ The rise in wholesale prices in the last two months is almost entirely due to the sharp rise in the prices of imported raw materials. Prices for domestic goods were almost stable and wages remained unchanged. A recent resolution passed by the Central Planning Commission proposes measures to reduce prices whenever possible.

Purchasing power parities of the crown and the U.S. dollar were computed, taking 1937 and 1938, each separately, as a base. Both 1936 and 1939 are inappropriate because of the devaluation in the former and political events in the latter year. The results seem to suggest some overvaluation, highest in terms of cost of living and almost negligible in terms of wage rates.2/ Developments in the first eight months of 1946 show, however, a tendency toward closing the gap between relative prices and wage levels in Czechoslovakia and the United States.

1/ It is interesting to note that the upward movement of controlled prices was accompanied by a drop of black market quotations. The percentage change for a number of food prices is shown below:

	Prices in March 1946 (October 1945 = 100)	
	Official Price	Black Market Price
Wheat flour	157	46
Meat (beef)	252	60
Fat (pork)	340	38
Eggs	288	59
Coffee (in Prague)	260	19

2/ If family allowances paid to workers in Czechoslovakia but not reflected in the wage rates used for comparison are taken into account, overvaluation in terms of the latter would be somewhat higher.

Percentage Overvaluation of the Crown

	1937 Base				1938 Base			
	1945	Mar.46	June 46	Aug.46	1945	Mar.46	June 46	Aug.46
Wholesale prices	39	30	25	15	29	21	17	7
Cost of living	50	57	53	42	42	48	45	33
Wage rates	13	9	6	3	14	8	6	2

The adequacy of these comparisons for determining the precise degree of overvaluation is highly questionable even in normal times. Czechoslovakia's own experience may be recalled in basing devaluation of the crown in 1934, which soon proved insufficient, on relative movements of world prices and Czechoslovak prices. Present conditions add to the inadequacy of the method.

Another approach is provided by the so-called "travel rates" applying for notes only (Notenkurse im Reiseverkehr) quoted, for a number of currencies, on the Swiss market. Such quotations are of little significance. The following table compares official rates of the crown for Swiss francs and for U.S. dollars with the rates for notes in May and September, 1946:

	Swiss francs per 100 crowns		U.S. dollars per 100 crowns	
	Buying Rate	Selling Rate	Buying Rate	Selling Rate
Official rate	8.57½	8.67½	2.00	
Travel rate:			(calculated cross rates)	
May 10	3.25	4.50	1.00	1.35
Sept. 6	4.00	5.00	1.20	1.50
Sept. 20	4.50	5.50	1.35	1.65
Sept. 27	4.00	5.00	1.20	1.50

4. Balance of Payments Problems in the Transition.

It seems convenient to divide the discussion into two parts, considering first the period of reconstruction, estimated in the Government's forthcoming plan at about two years, and then to turn to the later period.

As already pointed out earlier, the expected equilibrium in foreign payments for 1946 is mainly afforded by the large UNRRA supplies which heavily supplement ordinary imports. The balance of payments for 1947 (shown in the recent UNRRA report) has been estimated by the Czechoslovak Government, as follows:

(in millions of U.S. dollars)

	Receipts	Payments	Balance
Food		128	
Clothing		108	
Medical Supplies		10	
Agricultural Rehabilitation		34	
Industrial Rehabilitation		210	
Total merchandise	237	499	- 262

Based on the development of trade in the last months, a revision of estimated exports from 237 to 350 million dollars appears justified. Taking into account other items of the current balance not included in the Government's estimate, we arrive at the following figures:

(in millions of current U.S. dollars)

	Receipts	Payments	Balance
Merchandise, including reconstruction material	350	500	- 150
All other items1/			- 50
			- 200

No estimate for the balance of payments for 1948 or later years has been made, but it may be assumed that the carrying out of the Government's development plan will still require a deficit on current account. It seems reasonable to assume, however, that the deficit in 1948 will be smaller than that expected for 1947 and will further decline in 1949. By 1950, equilibrium on current account should be attained. Increased agricultural production will reduce the need for food imports and exports will expand with rising output and improved transportation facilities. The Czechoslovak Government has asked for a reconstruction loan of 350 million dollars which with other credits under negotiation would cover the estimated import surplus necessary to carry out the Government's development plan.

Although it may be hoped that multilateralism will be widely restored, Czechoslovakia's trade with Eastern Europe is likely to continue on a bilateral or, at best, on a regional basis, in inconvertible currencies. If, as was the case in the 1930's, Czechoslovakia has an export surplus from its trade with that area, she would still be unable to use the surplus to meet the deficit in free exchange. The credits needed by Czechoslovakia will, therefore, exceed the net deficit. Foreign exchange reserves are small and can have little effect on the need for credits. Even if the gold taken by Germany is recovered, total gold and foreign exchange reserves at the disposal of the Central Bank would amount to barely 70 million dollars.

If the deficit of the next few years cannot be met by borrowing abroad, it will prove necessary to adjust export and/or imports in order to narrow the gap. Would depreciation be helpful for this purpose? The steep increase of Czechoslovakia's exports--from 8 billion crowns in 1936 to nearly 12 billion in 1937--after the devaluation in November, 1936, even allowing for effects of the revival of world trade in 1937, seems

1/ Including freight, commissions, tourist expenditure, emigrant remittances, government expenditure abroad, debt service. We have estimated net payment of 20 million dollars for freight, assuming rates three times their 1937 level. In that year, freight constituted a net receipt, due to extensive transit trade through Czechoslovakia. We assume those receipts diminish to a small fraction.

to support the view that Czechoslovak exports respond sharply to relatively lower prices. Before basing any conclusions on the development in 1937, when unemployment and other unused capacity allowed for quick expansion of output in the export industries, we shall briefly examine the probable effects of a cheapening of Czechoslovakia's exports under present conditions.

Under conditions of unused capacity, the increased demand in response to relatively lower export prices would lead to an expansion of production in the export industries and improvement in the balance of payments. Presently the country is faced with a severe labor shortage and limited raw material supplies. Apart from these internal shortages, expansion of Czechoslovak trade is seriously hampered by scarcity of transportation facilities outside the country. Under these conditions, it seems rather questionable whether the volume of exports could be sufficiently expanded to meet even part of the increased demand. It is indeed quite possible that, except by shifting production away from urgent domestic needs, the volume of exports could not even be raised to a level where it would make up for the cheapening of the price. In that case, total value of exports would be less and the deficit in the balance of payments would be widened. Stimulating demand by lowering prices, as long as the volume of exports is limited by physical factors, cannot increase their value.

Developments in Czechoslovakia's foreign trade during the first half of 1946 seem to suggest that there is sufficient potential demand for her exports, even at current prices, to allow for expansion of trade if only the goods can be produced and moved. The sharp increase in Czechoslovakia's exports points in that direction. The trade with Switzerland--exports in the first six months of 1946 amounted to 968 million crowns--is an indication of the large markets for Czechoslovak exports in Western countries if production and transport problems can be solved.

Some other corrective will be needed to close any remaining gap in Czechoslovakia's balance of payments in the next two years. Given the physical limitation to expand exports much beyond the estimated figures, imports may have to be reduced below the planned level. But that can be achieved without accepting the deterioration in the terms of trade necessarily connected with devaluation. In a country where trade is controlled by the Government, and where a preponderant sector of industry is Government-owned, it appears likely that the necessary adjustment will be made through import controls.

5. The Post-Transition Prospects.

It is difficult to make any predictions as to the balance of payments after the transition. We do not know what Czechoslovakia's future markets will be and the composition of her future trade can only be surmised. Metal manufactures, including machinery, will probably be the leading items. It is possible that the better textile and glass products will regain an important share in the country's export trade. That will largely depend on the ability to secure the skilled labor needed. The Government plans to open training schools for textile workers. But it will take time to replenish the reservoir of skilled labor and competition may develop from similar industries across the border.

Even more difficult is any forecast of the direction of Czechoslovak trade. If much of it is with Eastern Europe, the exchange of goods in that direction may in large part be by agreement between governments, in which case exchange rates as such would be of less significance. But a good deal of trade, perhaps most, will continue with other countries on a basis under which exchange rates, prices and costs are important factors in determining trade. In such trade, competition to secure markets for industrial output will be keen and it seems realistic to assume that the price at which the goods can be offered will again play a decisive role.

What are the chances that after reconstruction the price level in Czechoslovakia will be in line with world prices? There are two factors which may work in that direction. First, the Central Planning Commission intends to take measures to bring prices down. A downward trend was already discernible in the late spring, but further and more drastic reductions may be carried out under the Commission's plan. Second, the productivity of labor, at present still greatly impaired because of inadequate equipment and shortages, is bound to increase and labor cost per unit of output will be brought down. There is, on the other hand, the danger that wages, especially for skilled labor, will have to be raised in order to achieve the necessary shifts and render the planned training worthwhile for the worker. That may counteract the effects of increased productivity and labor costs may not come down.

Which of those tendencies will be stronger cannot be predicted. Some measure to adjust the price level may prove necessary and lowering of the exchange rate may have to be considered. In view of the adverse effects discussed above, it would not be advisable to anticipate the possible necessity of a later adjustment by lowering the exchange rate of the crown at the present time.

Summary

The foregoing discussion may be concluded with a brief survey of the main factors affecting Czechoslovakia's balance of payments after the transition.

Strongest on the favorable side is the country's ability, proved in the past, of quickly adapting its economy to changing conditions. The decline of Germany's role as the chief supplier of industrial goods for Europe's markets offers great opportunities for Czechoslovakia's export industries and may more than offset the loss of Germany itself as a major export market. Czechoslovakia's foreign debts are of moderate size, and the debt service, even if increased through additional borrowing in the next few years, is not likely to be a heavy burden. Prices and wages in the country seem to be in hand and there is a good chance that the present overvaluation of the crown may gradually decline and disappear.

On the adverse side there is the shortage of labor, raw materials and equipment, which may seriously hamper and delay the expansion of export industries. The labor shortage and the need to shift labor to other industries may also make it difficult to avoid an increase in the wage level. Foreign exchange reserves are small and cannot contribute much toward financing reconstruction. Unless foreign loans can be secured, reconstruction will be slower and will require more sacrifices than anticipated. Finally, the fact that a large proportion of Czechoslovakia's export trade is directed toward "inconvertible currency" countries may result in a shortage of free exchange even if aggregate accounts show a surplus.

All in all, it would not seem unreasonable to expect that overvaluation of the crown will be overcome and economic impediments to the balancing of Czechoslovakia's international payments, at the present rate of exchange, will be removed.