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An Analysis of External Economic Stability
in the Czech Republic

Abstract of Diploma Thesis

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Souhrn

Vnější ekonomická rovnováha je jedna ze základních ekonomických otázek otevřené ekonomiky. Závažnost posouzení vnějšího prostředí je důležitá, neboť nerovnost vnějších vztahů slouží jako varovný signál nadcházející měnové krize. V této práci je analyzována vnější ekonomická rovnováha podle příslušných měřítek s přihlédnutím na specifika tranzitivní ekonomiky, kterou je Česká Republika. Důraz je kladen zejména na platební bilanci jako nejvýznamnější indikátor celkového ekonomického růstu dané země. Dále jsou analyzovány dvě úzce související měřítka externí stability – investiční pozice a zahraniční dluh.

Klíčová slova: vnější ekonomická rovnováha, platební bilance, běžný účet, investiční pozice, zahraniční dluh

Summary

External economic stability is one of the key economic issues of an open economy.

The relevance of external environment assessment is due to the fact that imbalances of external relations serve as early warning signals of upcoming monetary crisis. In this work the external stability is analysed according to respective measures considering the specifics of transition economy of the Czech Republic. Emphasis is put on the balance of payments as an indicator of major importance for the overall economic growth of a country. Moreover, analysed are also two closely related benchmarks – international investment position and external debt.

Keywords: external economic stability, balance of payments, current account, international investment position, external debt

ABSTRACT

One of the key macroeconomic issues that are taken into account for an open economy is internal and external economic stability. In regard of stability it is used for analytical purposes namely for keeping track of economic transactions and prognosis on future economic growth of a country which is in point of fact an important source for foreign investors and business partners. Macroeconomic openness in trade of goods, services, capital and labour as well as the Czech Republic's accession to the European Union, eligibility for euro currency are the main reasons behind the argument for an increasing importance of external environment analysis. In order to measure the external stability economists usually study the balance of payments. There is an assumption that long-term negative results of individual external balances of the balance of payments may indicate an upcoming monetary crisis. The main viewpoint is that the external current account balance of the balance of payments is a focal point for the overall economic growth. However, to determine whether the imbalances are economically sound it is essential to take into consideration the state in which an economy in question is, what are the affecting factors of external imbalances and how are they converted. Furthermore, there is a broad consensus that external economic stability contains also examination of other indicators such as international investment position and external debt due to their close interconnection with the balance of payments.

For a transition economy such as the Czech Republic terms of external stability are undoubtedly connected with the current account that mirrors the catching-up process and is of major importance for the overall economic development. Therefore, the most important goal of this work is the current account analysis and in relation to this it is assessed whether any potential external threat in the Czech Republic is posed. Furthermore, international investment position and mainly the terms of external debt development and its assessment according to various thresholds are carried out.

The proposed structure of the diploma thesis is according to the three main subparts covering the literature review, analysis of external economic stability in the Czech Republic and an econometric model of the current account of the Czech Republic. The following methods are used: description, global analysis, structural analysis, comparative analysis, quantitative analysis and consultation with supervisor of this diploma thesis. Description is used in the first part that focuses on the literature review. Global analysis of the balance of payments issues is supplemented in the second part of this paper taken into account the

external relations of the period under review. Structural analysis is presented in the next part and it focuses on individual subsets of economic transactions that are entered in the balance of payments. Comparative analysis is aimed at four other post-transition countries' trade balances. The studied period is 2000 – 2009 and data are in CZK millions. By using methods of quantitative analysis it is attempted to suggest the relationship between the current account and its determinants. Quantification of the defined variables is conducted by the ordinary least squares method. In regard of data there are used quarter time series of the period under review because in case of annual modelling the range of time series would be very limited and negatively influence the accuracy of estimated values of coefficients.

It has to be put forward that the Czech economy underwent a remarkable development over the observed period. Several conclusions arose from the analysis of external relations. Firstly, the global analysis showed that a phenomenon of the Czech external relations were the current account deficits which were offset by the financial account in the period under review. Relatively large current account deficits may be seen as a natural phenomenon of the catching-up process of a post command economy and therefore as a consequence of high investment. The current account balance decomposition was related to the trade balance as the main deficit burden in the period before the accession into the European Union. The current account deficit registered a structural change as the main deficit burden has been generated by the income balance since 2005. Rise in income balance deficits is the side-effect of inward FDI flows into the Czech Republic. The foreign investors started to recapture the return on investment which is entered as a debit on the direct investment income account. By having a closer look on the current account to GDP ratio alerting or even unsustainable values were entered in the period of 2001 to 2004. Calculated ratios were slightly higher than the threshold values that are set by Czech National Bank. It was the strong economic growth and an increase in domestic demand that resulted in higher than threshold values. Nevertheless, those deficits of the current account in this period were covered by foreign direct investment. Apart from the current account balance the basic balance is of major importance especially in regard of transition economy as it is in case of the Czech Republic where there was a shortage of own capital and the Czech Republic was characterized by inflow of foreign direct investment. Furthermore, the basic balance is a very complex one so for the external economic assessment of the Czech Republic the current account balance and the basic balance are important.

The closely integrated stock benchmark of the balance of payments – international investment position showed a rise in investment position stocks over the examined period due to the openness of the Czech economy on the current and financial accounts. The chief factor

behind the negative figure of international investment position of the Czech Republic was attributed to capital inflow in the form of foreign direct investment inward flows. One of the main policy issues for foreign investors is the monitoring of external debt ratios of a prospect country. For a small open economy such as the Czech Republic higher foreign debt is a natural result of intensifying relations with other countries in trade. There is no consensus among economists as to which sustainability indicator of external debt is the sole one; however a set of debt burden indicators for assessment of external sustainability was calculated. Commonly used indicator is the external debt to GDP ratio. In the last two years of the period under review there were higher values than the threshold. The potential determinants of the current account as a focal point for assessment of the external position were verified and estimated by the ordinary least squares method. The income balance deficit was the main deficit burden of the current account in the last years of the period under review. However, the model suggests that the negative side-effect of foreign direct investment was outweighed by the raise in export. Therefore, the net international investment position has an ambiguous impact on the current account surplus. From the tested determinants in terms of average elasticities Germany's GDP proved the biggest influence on the current account from the tested determinants. As for the model, the relevance of those findings is limited due to the short time series. In addition, other influencing factors may be found.

In conclusion, the presented analysis indicates that the Czech Republic is not in danger of external economic imbalance and there is no starting cause that monetary crises may trigger. Current account dynamics is a natural result of the catching-up process. The current account deficits were a reflection of effective allocation of resources in the analysed period. As for the econometric analysis, the situation on the current account of the Czech Republic is not as threatening especially the effect of the net international investment position that was in the model used as proxy of foreign direct investment.

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