

# CZECH REPUBLIC 2005



## Year After

An Economic Survey  
Produced by



Center for Economic Research and Graduate Education of Charles University  
& Economics Institute of the Academy of Sciences of the Czech Republic

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Center for Economic Research and Graduate Education

Economics Institute  
Academy of Sciences of the Czech Republic

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## I. GENERAL INFORMATION

### I.1 Fifteen Years on the Road from Communism to the EU

#### A Rocky Road towards the Market Economy

The Czech Republic, despite the break-up of Czechoslovakia in 1993, has awed observers of transition economies. Within three years of the fall of communism, the government liberalized nearly all prices, privatized much of the economy, decentralized wage setting, and opened the country to world trade while maintaining a relatively balanced budget, low inflation, and low unemployment, below 4% until 1995. The Czech GDP per capita level of over five thousand USD, with PPP adjustment factor of about two, was (and remains) high in comparison to other transition countries. Furthermore, the economy appeared to be on an accelerating growth trajectory. By 1995, the initial transformation recession and the negative impact of the split of Czechoslovakia were over and the economy grew by almost 6%. While in 1996 the country recorded robust growth of 5%, in 1997 it was becoming increasingly clear that the macroeconomic success was not based on solid microeconomic foundations. In particular, mass privatization followed a tacit doctrine of economic nationalism as most property was transferred to local owners, either by offering loans to local buyers or through the voucher scheme. Privatization failed to generate sound corporate governance and often resulted in incestuous ownership relations. Large banks remained under government control in order to “fuel” the transition with credit while bankruptcy and foreclosure laws were weak, making

room for lax financial discipline. As a result, while the economy was growing, banks were accumulating nonperforming loans at a distressing rate. While both Hungary and Poland lowered their share of nonperforming loans from about 28% in 1994 to less than 10% in 1998, the Czech share stood at 33% in 1998, comparable to that of Romania.

The local owners of privatized firms were indebted from the start and lacked managerial capital to restructure and operate firms, which faced fierce international competition due to a high degree of openness. Loose access to bank credit coupled with a weak legal and impotent judicial system resulted in massive asset stripping (“tunneling”) of privatized enterprises.

Clearly, privatization was only one method of creating private sector output. Throughout the early transition period new (de novo) private firms were also being created. While early on credit to small firms may have been generous, retained profit was a major determinant of new investment. Small firms were apparently the force behind low Czech unemployment. Survey evidence suggests that small new private firms were responsible for almost all of the vigorous job creation during the early reforms so that five years into transition de novo firms offered more jobs than the state and privatized firms combined.

Weak corporate governance allowed wages to grow two times faster than productivity, which led to higher demand for imports of consumer durables and increasing foreign trade and current account deficits.

## General Information

Year	1998	1999	2000	2001	2002	2003	2004
<b>GDP</b>							
GDP Growth	-1.1	1.2	3.9	2.6	1.5	3.7	4.0
<b>Foreign Trade</b>							
Exports, real y/y %	10.5	5.5	16.5	11.5	2.1	7.3	20.9
Imports, real y/y %	8.4	5.0	16.3	13.0	4.9	7.9	18.5
Trade Deficit as % of GDP	-4.1	-3.3	-5.6	-5.1	-2.9	-2.7	-0.8
<b>Balance of Payments as % of GDP and Its Main Components</b>							
Current Account	-2.1	-2.5	-4.9	-5.4	-5.6	-6.3	-5.2
Inflow of FDI	6.1	10.7	9.0	9.3	11.6	2.8	n.a.
Inflow of FDI (bln. USD)	3.7	6.3	5.0	5.6	8.5	2.5	n.a.
<b>Inflation and Interest</b>							
CPI, y/y %	6.8	2.5	4.0	4.1	0.6	1.0	2.8
PRIBOR 2T	14.2	6.9	5.3	4.7	3.6	2.3	2.2
<b>Labor Market</b>							
ILO Unemployment, %	6.5	8.7	8.8	8.1	7.3	7.8	8.3
Employment, y/y %	-1.4	-2.4	1.3	0.3	0.1	-0.2	-0.4
Real Wages, y/y %	-1.4	6.2	2.4	3.8	5.4	6.5	3.7
<b>Public Finance</b>							
General Government Balance as % GDP	-1.5	-1.5	-2.1	-2.9	-1.9	-4.3	-3.4
<b>Exchange Rates</b>							
CZK per USD	32.3	34.6	38.6	38.0	32.7	28.2	25.7
CZK per EUR	35.8	36.9	35.6	34.1	30.8	31.8	31.9

Sources: CSO, CNB, Ministry of Finance, World Bank

These were financed by an inflow of short-term foreign capital attracted by high interest rates locked in by the fixed exchange rate regime.

Eventually, however, the implicit liabilities of soft loans to large old firms became explicit, and the worsening performance of the economy led to an increase in the public budget deficit. Shortly after the current account deficit ballooned in 1996, the imbalances – both internal and external – were noticed by capital markets and led to an attack on the Czech currency in May 1997. The attack forced the surrender of the fixed exchange

rate regime and the crown depreciated by approximately 10%. The Czech National Bank used high interest rates to stabilize the currency and also strengthened provisioning requirements, leading to a credit crunch. Meanwhile, the government was forced to implement a strict austerity program. All of this naturally sent the economy into recession.

The recession was prolonged with GDP in the red for two consecutive years while other Visegrad countries enjoyed substantial growth. Registered unemployment increased from 3.9% in 1996 to 9% in 1999, and



wage growth slowed down hand in hand with government spending. The recession was driven by a decline in both private spending and investments, while net exports were mostly improving the overall picture – also thanks to the weaker currency.

The downturn shattered the illusion of successful reforms and contributed to the fall of the long-serving coalition governments and resulted in early elections in 1998. These were won by the Social Democrats, who formed a minority government. Since then, the Social Democrats have stayed in power. The party won the 2002 elections and formed a coalition government with two smaller right-centrist parties.

### Recent Economic Development

The Czech Republic entered the EU on May 1st, 2004. Despite the various catastrophic scenarios, no visible change in unemployment or inflation was observed. Also, no flow of Czech workers to old EU member countries occurred. There was a minor visible increase in the percentage of total EU trade turnover and an increase in the percentage of total EU share of imports. Also, as more greenfield investments have started to produce, the trade deficit has improved recently, and the Czech Republic might witness even a small surplus in 2005.

Starting in 1998, the strict monetary policy was relaxed. The new government revived structural reform and privatization, this time relying on strategic foreign partners. Further, in April 1998, the government introduced an investment incentive package for investors bringing more than USD 10 million. Yet, in 1999, GDP remained in the red.

Finally, in 2000 the economy accelerated, most of all thanks to the surge in foreign direct investments (FDIs), but domestic firms

started to invest more as well, and the public deficit started to deteriorate. FDI inflow has continued ever since with privatization peaks around 2001. Moreover, private consumption also accelerated (fueled by real wage growth that reached 4% during 2001). Overall, GDP growth stood at over 3% in 2000 and 2001.

When the economy started to grow in 2000, the trade deficit doubled again and remained high in 2001. The current account now also appears worrisome, reminding one of the 1997 crises. The deficit narrowed from above 6% of GDP in 1997 to below 3% in 1998 and 1999, but in 2000 the deficit worsened to just around 5% of GDP and stayed around this level till 2004. The key difference from the 1997 situation, however, is in the financing of the current account deficit. While it was unstable short-term capital that financed the current account deficit prior to the 1997 crisis, the recent current deficit has been financed by direct investments, which are long-term in nature. The inflow of FDI appears to be able to safely finance the current account deficit.

The one macroeconomic variable that has been under control throughout the whole Czech transition is inflation. Low domestic demand during the 1997–99 recession, combined with relatively strict monetary policy and low commodity prices, lowered the average inflation rate to 2.1% in 1999. It also helped that the government froze the upward adjustment of regulated housing and utilities prices. Later, the revival of domestic demand, higher commodity prices (mainly oil) and several idiosyncratic factors were working to increase inflation, which reached the 4% mark by 2000. Since then, however, the country imported some deflation, and inflation remained close to zero. Even after EU

entry, the major inflation source was the administrative tax change. Another advantage is that commodity prices are nominated in USD and both the fall of the dollar and mild appreciation of the CZK vis-à-vis the Euro eliminated most of the oil price effects.

The main macroeconomic concern of the Czech economy is the large and growing budget deficit. After netting out extraordinary budget items such as privatization receipts and the costs of bank restructuring, the overall balance of the general government mushroomed to 4.8% of GDP in 2000 and grew further in 2001. Excluding extraordinary items, the whole 2001 deficit hovered just below one tenth of GDP. The year 2003 was critical, when new EU methodology required immediate accounting for all future liabilities and the deficit skyrocketed to 11.7%. Contrary to this, the public deficit hit the Maastricht limit and was only 3% in 2004. However, this result is due to faster growth than expected and improvements in other parts than the central budget, as the central government has reduced the state budget deficit only by one fifth compared to 2003 (for example, there were intertemporal shifts in 2005). The concurrent economic recovery made clear that the deficits were not cyclical. Since the fiscal revenue of the Czech government is already high as a fraction of GDP, the adjustment must come on the expenditure side. Yet, most categories of expenditure (including social welfare, housing, and transport) are locked in upward trajectories, even though expenditures on public infrastructure and buildings have already been restricted in recent years. Between 1994 and 1999, social security and welfare expenditures rose by 3.2% of GDP. Public expen-

diture on social welfare persistently exceeds payroll revenues, and the deficit is projected to grow even during the expected years of economic expansion. Worse, these deficits occur while the demographic situation has not yet deteriorated. Towards the end of the new decade, it will. In sum, if there is no change in the fiscal policy, the current debt of the country will increase from 20% and might easily reach 60% of GDP before 2010.

In sum, after 1999, the Czech economy successfully emerged from the recession with GDP growth rates above 3%, with a slow down in 2002. The recovery was driven by private investments, primarily FDI, which also financed the widening trade deficit during those years. While inflation has remained low, real wage growth resumed after the recession and so far has been in line with productivity growth. Unemployment has stayed in the neighborhood of 9%, slowly rising above the psychological level of 10%. The GDP growth of above 3% and high unemployment of around 10% are expected to prevail in the years to come. Yet, the three lost elections of the ruling Social Democrats show that the political pendulum has swung to the other side, and the new government will have to deal with the challenges of the past. In particular, the fiscal deficit and its structure remains the sorest part of the Czech economy, especially mandatory expenditures have to be addressed to achieve substantial improvement. Apart from pension reform, the other main outstanding policy challenges include inefficiency of public administration, much-needed reform of the judiciary system, insufficient use of public tenders by the government, and taming of corruption.

## The Czech Republic – An Economic Summary of 2004

Although the economy of the European Union has not grown very fast, its initial recovery allowed the Czech Republic to experience solid economic growth of 4% in 2004. Yet the Czech Republic ranks low among the newly accessed EU countries based on 2004 GDP growth. Despite economic growth, the unemployment rate has not declined. The Czech Republic witnessed 10.3% unemployment at the end of 2004, as well as a year before when the GDP growth was slightly lower at 3.7%. The last year that closed with an unemployment rate below 10% was 2002 with unemployment at 9.8%. The Czech economy is still ranked high in terms of FDI attractiveness, but the FDI inflow was much lower in 2004, 4.5 billion USD compared to the 8.5 billion USD peak in 2002, yet it is still above the mediocre 2.6 billion a year before when the government had not privatized any major stakes. Continuous massive long-term capital inflow had kept the Czech currency under appreciation pressures in the past. Also, FDI has contributed towards the appreciation pressures. To complete the picture, inflation has risen from null in 2003 to 2.8%, partly due to VAT tax changes in May 2004. However, the generally positive signals about inflation, FDI and growth should be viewed in light of the continuous expansionist governmental fiscal policy. Although the central government has not reduced its deficits much, the overall fiscal deficits just hit the Maastricht 3% criterion, mainly due to higher growth and intertemporal shifts. In 2004, the Czech Republic witnessed a government deficit of 89 billion CZK, a moderate fall from the previous 107 billion CZK. The government had prepared moderate fiscal reforms, but during the course of the year any real reform steps were even further softened as the Social Democrats lost in local, senate and European parliamentary elections. As a result, the prime minister was replaced and reform policies were put aside for the rest of 2004. Moreover, taking into account that the Czech government was not able to fulfill its reform plans last year, the fulfillment of the fiscal criterion in 2004 should not be overrated. In fact, according to the planned fiscal reform, the 3% criterion is expected to be exceeded in future years.

The Czech Republic entered the EU on May 1st, 2004. Despite the catastrophic scenarios, no visible change in unemployment or inflation was observed (note the major VAT legislative change that increased prices). Also, no flow of Czech workers to old EU member countries occurred. There was a minor visible increase in the percentage of the total EU trade turnover and an increase in the percentage of the total EU share of imports.

### Year 2004 in the Czech Republic – Major Political and Economic Events

#### January

- Excise taxes on gas, alcohol and tobacco products increased.
- Unemployment rises to 10.3%.

#### February

- Former Minister of Finance Pilip was selected to the European Investment Bank.
- Bankruptcy corruption was confirmed; suspended Judge Berka was prosecuted for manipulating bankruptcy procedures.

- *Mr. Kužvart, CSSD, was nominated as Czech EU Commissar, however, he later resigned.*
- *Mr. Telička, former ambassador to the EU, was selected to be the first Czech EU Commissar.*
- *Parliament passed a VAT tax amendment needed for EU entry; however, the government also increased tax revenues, which made the law controversial.*

### **March**

- *Unemployment reached 10.9%.*
- *Parliament was not able to approve a new housing law; the old system is still in place, no deregulation of communist-set rents.*
- *The Constitutional Court stopped work on important cases that required plenum decisions as its membership was felt to be below an acceptable level; the mandate of several judges expired and the Senate rejected several candidates.*

### **April**

- *The Senate approved the controversial new VAT tax amendment; however, the president vetoed the law later.*
- *Prime Minister Špidla replaced the minister of health, the new minister was Kubinyi.*
- *The VAT tax amendment was passed; the presidential veto was overruled.*

### **May**

- *The Czech Republic entered the EU, together with nine other countries.*
- *The Czech government forbade exporting radars to China.*
- *The government discontinued the principle of the 13th and 14th salary for state employees.*
- *IMF criticizes the Czech Republic for a lack of fiscal reforms.*

### **June**

- *GDP growth for the last year was only 3.1%, which was the lowest among new EU members.*
- *In the EU parliamentary election, the opposition dominated; the ruling Social Democrats got only two seats out of 24, while the opposition ODS got 9 seats.*
- *Prime Minister Špidla resigned, Gross elected as the new provisional Social Democrat leader and starts negotiations for a new government.*

### **July**

- *Gross elected as the new Prime Minister.*
- *The government replaces EU Commissar Mr. Telička with Mr. Špidla.*

### **August**

- *The new government of the old coalition was appointed and passed the confidence vote.*
- *Mr. Špidla selected as the EU Commissar for Social Affairs.*
- *CNB increased interest rates.*

### **September**

- *GDP growth was 4.1%, which is the highest growth during the last 3 years.*

**October**

- VAT rates for hotels, housing and culture were selected to remain at the lower tax level in 2005.

**November**

- In the regional governmental election, the opposition won by a large margin with 36% of votes, the Communist Party came in second with 20% and third were the Social Democrats with 14% of votes.
- In the Senate elections, the ODS got 18 seats, the Social Democrats none. Three seats went to the Christian Democrats and the remaining six seats at stake were divided among other parties and independents.

**December**

- GDP growth slowed down to 3.6%.
- CME bought back Nova TV.
- The state budget for 2005 passed with a one-vote margin.

## 1.2 History and Geography

The first signs of people living in what is today the Czech Republic are as old as 1.6–1.7 million years and were found near Beroun in Central Bohemia. The first Slavonic people came in the 5th and 6th centuries. The first written references to the Czechs, Prague, and regions of Bohemia appeared in the 8th and 9th centuries. In about the year 870, the Czech prince Bořivoj was mentioned for first time. He came from Prague and belonged to the house of Přemysl, which later became the royal dynasty of Bohemia. This dynasty governed the Czech kingdom until 1306. During the reign of the House of Luxembourg (1310–1436), Bohemia was the center of the so-called Holy West Roman Empire of German People, and Prague became one of the cultural centers of Europe. A short period of elected kings ended in 1526, when the Czech Kingdom (Bohemia, Moravia and Silesia) became a part of Austria, later the Austro-Hungarian monarchy.

In 1918, after World War I, Czechoslovakia emerged from the ruins of the Austro-Hungarian monarchy as a modern democratic state. Czechoslovakia consisted of Bohemia and Moravia, Slovakia and Carpatho-Russia (today a part of Ukraine). In 1939, Slovakia separated from Czechoslovakia and the Czech part of the country was occupied by the German army and incorporated as a special autonomous state into the German Empire. In 1945, Czechoslovakia was liberated by the Soviet and American armies. The Czechoslovak state was restored without Carpatho-Russia, which joined the Soviet Union.

In February 1948, the Communist party gained power (in a formal constitutional way), and Czechoslovakia was under the Soviet sphere of influence until 1989. After the “Velvet Revolution” in 1989, the democratic regime was restored.

In response to the Slovak desire for greater self-determination, a federal constitution was



introduced in 1968. Completely controlled by the Communist Party, the Czechoslovak Federation had not satisfied the legitimate aspirations of the Slovak people. From 1990 on, Czech and Slovak political leaders negotiated the future form of the federation. After two years of unsuccessful negotiation and following the 1992 parliament elections, the country was peacefully divided into the

Czech Republic and Slovak Republic on January 1, 1993. In 1999, the Czech Republic joined NATO; it became an EU member in May 2004.

In terms of its area (76,867 square kilometers), the Czech Republic ranks among the smaller European countries. The Czech Republic shares borders with Germany, Austria, the Slovak Republic and Poland.

## Milestones of the Czech Lands in the 20th Century

- 1918** After the collapse of the Austro-Hungarian monarchy, the First Czechoslovak Republic as a common state of Czechs and Slovaks was established.
- 1920** A democratic constitution was adopted.
- 1938** The Munich agreement, occupation of part of Czechoslovakia by Germany and Hungary; the so-called Second Republic, Czecho-Slovakia, was established with extended Slovak autonomy.
- 1939** The rest of the Czech territory was occupied by Germany, an independent Slovak state was established.

- 1945** Liberation, the Czechoslovak Republic was restored.
- 1948** Communists took over the country, marking the beginning of a 40-year totalitarian regime.
- 1968** Prague Spring, the invasion of Warsaw Pact armies, a federal constitution adopted.
- 1989** The Velvet Revolution, end of the totalitarian regime.
- 1990** The first democratic parliamentary election in 42 years.
- 1991** Last Soviet military troops left the country.
- 1992** The separation of Czechoslovakia, establishment of the Czech and Slovak Republics in 1993.
- 1999** On March 12, the Czech Republic officially joined NATO.
- 2004** In May 2004, the Czech Republic joined the EU.

### I.3 Population

With a population of 10.289 million (2001 census), the Czech Republic is similar in size to Austria, Belgium or Hungary. Its population is ethnically homogeneous with an overwhelming majority of Czechs (94.8%), a Slovak minority (3.1%) and small Polish (0.6%) and German (0.5%) minorities. However, there is also a large and socially segregated ethnic minority of Romanies. The total size of this minority is hard to estimate. The Czech language is a part of the family of west Slavic languages (together with Polish and Slovak). The working age population (15–59 years) accounted for 69% of the total population as of 2000. The prognoses of demo-

graphic development suggest a slow decrease in the population. The population now slowly ages as life expectancy, which is still far behind that in West European countries, increases.

#### Ethnic Minorities in the Czech Republic

	1991		2001	
	census	%	census	%
Slovak	314,877	3.1	193,190	1.8
Polish	59,383	0.6	51,968	0.5
German	48,556	0.5	39,106	0.5
Ukrainian	8,220	0.1	22,112	0.2
<b>Total</b>	<b>488,933</b>	<b>4.7</b>	<b>807,456</b>	<b>7.9</b>

Source: CSO

#### Age Structure of Population (in %)

	1993	1994	1995	1996	1997	1998	1999	2000	2001
0–14	20.0	19.5	18.8	18.3	17.9	17.7	17.0	16.2	15.9
15–64	67.1	67.6	68.0	68.4	68.7	69.0	69.3	69.0	70.3
65+	12.9	13.0	13.1	13.3	13.4	13.6	13.7	13.9	13.8
Average Age	36.6	36.8	37.0	37.3	37.6	37.9	38.3	38.8	39.0
Median Age	35.9	36.0	36.2	36.4	36.6	36.8	37.0	37.6	n.a.
Index of Aging*	64.3	66.8	69.6	72.3	75.3	78.1	80.5	85.5	87.0

Sources: CSO Statistical Yearbook of the Czech Republic 2000, <http://popin.natur.cuni.cz>, CSO

\* Index of aging – number of persons aged 65 or over for 100 children aged 0–14

## II. FIFTEEN YEARS OF POLITICAL TRANSFORMATION

### II.1 Constitutional System

The constitutional system of the Czech Republic consists of the Parliament and the President. The Parliament of the Czech Republic has two chambers: the Lower House (*Poslanecká sněmovna*) and the Upper House (*Senát*). The president is elected by both Houses of Parliament for five year terms and has limited and mostly representative responsibilities. He appoints the Prime Minister and the members of the government, Governor of the Central Bank, ambassadors and the Chief of Staff of the army and signs laws. He can return laws to the Lower House, but his veto can be overridden by an absolute majority of all the members of the Lower House. The current president, Václav Klaus, was elected in February 2003. He replaced Václav Havel, the leader of the Velvet Revolution, who served as the Czechoslovak president from 1989 till 1992 and then as the Czech president from 1993 till 2003.

The Lower House is the most important legislative body. It has the power to pass

laws by a simple majority of the members present during any given session (providing the quorum is met), to cast a no confidence vote against the government, and to override a veto of the President and of the Upper House.

According to stipulations in the constitution, the Upper House has limited legislative action and is only authorized to act upon Lower House legislation. The Upper House has three options when faced with bills approved by the Lower House and must act within 30 days: accept by default (take no action); reject with a suspending veto; or suggest amendments (in both cases by a simple majority). In the latter two instances, the Lower House can vote to either accept or reject the Upper House action by an absolute majority of all members of the Lower House. The Upper House can also initiate legislation. If the Lower House is dissolved, the Upper House assumes its functions until new elections are held.

### II.2 Electoral System

The Lower House of Parliament has 200 members elected for four-year terms. A proportional electoral system is used for the Lower House which discriminates against small parties: to enter the parliament a party has to attain at least 5% of the total number of valid votes cast nationally. The country is divided into 8 voting districts and each party

nominates an ordered list of candidates for the Lower House in each voting district.

In contrast, the Upper House of Parliament uses the majority system (plurality run-off) to elect its 81 members with one representative for each constituency. The Upper House members are elected for six years with a periodic replacement schedule in which 27



members are elected every two years. Each political party can nominate one candidate in each of the 81 constituencies. Also, independent candidates can participate providing they submit a statement of support signed by at least 1,000 eligible voters from the relevant electoral constituency. A candidate is elected

on the first ballot if he/she receives a simple majority of valid votes (at least 50% plus one vote). If no candidate receives a majority on the first ballot, then the two candidates who receive the most votes from the first ballot rerun on the second ballot, and the majority winner on the second ballot is elected.

## II.3 Electoral History of the Czech Republic

Given the proportional system used for the Lower House, Czech governments are either coalition or minority governments or both.

Between 1992–1998, the Czech governments were coalitions of three or four right-centrist parties: the Civic Democratic Party (ODS), the Christian Democratic Party (KDS), the Christian-Democratic Union (KDU-ČSL) and the Civic Democratic Alliance (ODA). At the turn of 1997/1998, a faction of the Civic Democratic Party established a new right-centrist party, the Freedom Union (US). After the 1998 elections, the winning Social

Democrats (ČSSD) were unable to establish a coalition government with just 32% of popular votes. However, they managed to form an unusual “opposition agreement” with the Civic Democrats. The ODS committed itself to tolerating a minority one-party government of the ČSSD in exchange for a dominating role in the Lower and Upper Houses and participation in preliminary consultations on important issues between the ČSSD and ODS.

The last Lower House elections were held in 2002. Social Democrats won with 30.2%

### Composition of the Lower House

Party	Votes	1998			Votes	2002		
		%	Seats	%		%	Seats	%
ČSSD	1,928,660	32.3	74	37.0	1,440,279	30.2	70	35.0
ODS	1,656,011	27.7	63	31.5	1,166,975	24.5	58	29.0
KSČM	658,650	11.0	24	12.0	882,653	18.5	41	20.5
Coalition KDU-ČSL and US-DEU					680,671	14.3	31	15.5
KDU-ČSL	537,013	9.0	20	10.0				
US	513,596	8.6	19	9.5				
Others	675,575	11.3			597,428	12.6		
Total of Valid Votes	5,969,505				4,768,006			
Eligible Voters	8,116,836				8,264,484			
Participation	6,008,926	74.0			4,789,145	58.0		
Not Valid Votes	39,421				21,139			

Source: CSO

of the vote, second came the ODS with 24.5%, third were the Communists with 18.5% and fourth the Coalition (of KDU-ČSL and US-DEU) with 14.3%. A warning sign was the rising number of votes for the Communists: they gained 7.5% percentage points, their best result since 1989, while all democratic parties lost their share of votes. This was in part due to the lowest turnout (58%) in post-communist history.

Coalition building in the Czech Republic is notoriously hard because of the strong position of the extreme-left Communist Party, co-operation with which is naturally a political no-no among the democratic parties. Nevertheless, the ČSSD, KDU-ČSL and US managed to form a government lead by the chairman of the ČSSD, Mr. Vladimír Špidla, with the weakest possible majority of 1 vote. The government consisted of 11 members of the ČSSD (including the prime minister), and has 3 ministers from the KDU-ČSL and US-DEU each. The stability of this coalition was first tested in June 2004 after the Social

Democrat's crushing defeat in the European Parliament elections. Mr. Špidla was forced to resign from his position of party leader and prime minister. He was replaced by 34-year-old Stanislav Gross, one of the most influential and ambitious leaders of the ČSSD. The second test came in March 2005, when the coalition almost broke down after a scandal involving the prime minister's family finances. Mr. Kalousek, the Christian Democratic leader, insisted that Mr. Gross resign. The Christian Democratic ministers left the government, soon followed by some ministers from the Freedom Union. At one point, a government of the ČSSD supported by the Communists in Parliament, appeared to be a highly likely outcome of the coalition break down. In the end, the three coalition parties came to an agreement that involved the resignation of Mr. Gross, reshuffling of a few seats in the government, and the then Minister for Regional Development Jiří Paroubek (ČSSD) becoming the new prime minister.

### Composition of the Upper House

Party	1998		2000		2002		2004	
	Seats	%	Seats	%	Seats	%	Seats	%
KSČM	4	4.9	3	3.7	3	3.7	2	2.5
ČSSD	23	28.4	14	17.3	9	11.1	6	7.4
KDU-ČSL	17	21.0	18	22.2	13	16.0	11	13.6
ODS	26	32.1	21	25.9	25	30.9	35	43.2
ODA (+US)	11	13.6	12	14.8	1	1.2	1	1.2
US-DEU					6	7.4	4	4.9
Independent	n.a.	n.a.	13	16.0	22	27.2	19	23.5
Others					2	2.5	3	3.7
<b>Total</b>	<b>81</b>	<b>100.0</b>	<b>81</b>	<b>100</b>	<b>81</b>	<b>100.0</b>	<b>81</b>	<b>100.0</b>

Source: CSO

## Current Major and Governmental Political Parties

The currently most important political parties are listed below and ordered according to their positions on the traditional “left-right” ideological spectrum.

**Czech and Moravian Communist Party** (*Komunistická strana Čech a Moravy, KSČM*) – an extreme leftist unreformed communist party; opposes Czech membership in NATO and openly advocates the return of the pre-1989 regime; successor to the former Communist Party of Czechoslovakia, which was founded in 1921; has had stable representation since 1989. Current leader: Miroslav Grebeníček.

**Czech Social Democratic Party** (*Česká strana sociálně demokratická, ČSSD*) – a left centrist party of traditional European social-democratic orientation; supports membership of the Czech Republic in NATO; strongly advocates Czech entry into the EU; successor to the former Czechoslovak Social Democratic Party, which was founded in 1878 and forced to merge with the Communist Party in 1948; restored in March 1990; established the minority government in 1998 and is the leader of the current majority coalition government. Current leader: Stanislav Gross.

**Christian and Democratic Union–Czechoslovak People’s Party** (*Křesťanská a demokratická unie–Československá strana lidová, KDU–ČSL*) – a centrist party of Christian-democratic orientation represented in the government from 1990 to 1998 and a member of the current coalition; advocate of a “social market economy;” supports Czech membership in NATO and in the EU; reformed successor of the former Czechoslovak People’s Party, which was founded in 1918. Current leader: Miroslav Kalousek.

**Union of Freedom** (*Unie svobody–Demokratická unie, US–DEU*) – a liberal right-center party established in January 1998 by former members of the Civic Democratic Party who left the party after the governmental crisis in the end of 1997; advocate of radical economic transition with an appropriate legislative framework and of regional self-administration; represented in the government during the first half of 1998 and a current coalition member; currently polls below the 5% threshold for entering the parliament. Current leader: Pavel Němec.

**Civic Democratic Party** (*Občanská demokratická strana, ODS*) – a right-wing conservative party; a dominating member of government coalitions between 1992–1997; the driving force of economic and political transition during the early 1990s; supports Czech membership in NATO; holds a “Euro-skeptic” attitude toward the EU and opposes the European Constitution; founded in April 1991 by long-time former prime minister Václav Klaus, who stepped down at the end of 2002; the leading party in current voter polls. Current leader: Mirek Topolánek.

## II.4 Elections of 2004

**European Parliament.** In June, Czech voters had their first opportunity to choose their 24 representatives in the 732-member European Parliament. A single-district proportional system is used to elect the EP members. The voter turnout was only 28.3%, much lower than in the old EU-15 countries (Austria 42.4%, Netherlands 39.3%), but higher than or comparable to the other accession countries (Slovakia 17%, Poland 20.9, Slovenia 28.3, Hungary 38.5). The content-free campaign may have contributed to the low turnout, as parties were merely labeling themselves as being either “pro-European” or “Euro-skeptic” and were assuring voters that they would protect the “Czech national interests in Brussels.” The election was a debacle for the Social Democrats who received only 8.8% of the vote and gained only 2 seats. The ODS could celebrate with 30% of the vote (9 seats), the Communists were second with 20% of the vote (6 seats) and a pro-European coalition of independent candidates and European Democrats was third with 11% (3 seats).

One-third of the **Upper House** was permutated in the November 2004 elections.

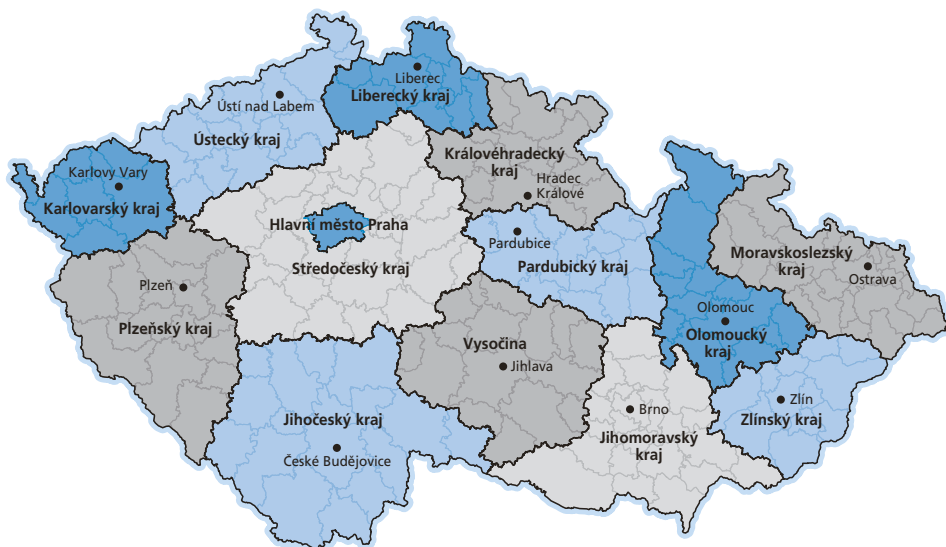
The ODS was highly successful as it won 18 out of 27 electoral districts, and increased its number of seats in the Upper House from 27 to 36. The ČSSD did not win in a single district and therefore lost 3 seats. Participation in the Upper-House elections was notoriously low, reaching 29% in the first round and a meager 18.4% in the second round.

**Regional councils** were elected in all 13 regions except Prague at the same time as the first round of the Upper House elections. The election turned out to be triumphant for the ODS, which was the winning party in 12 out of 13 regions and captured 43% of regional council seats nation-wide. (The Christian Democrats won in South Moravia, their traditional stronghold.) The KSČM came in second with 23.3% of seats and the ČSSD third with 15.6%. It has become almost a rule that Social Democrats fare relatively well in the Lower House national elections, while the ODS and KDU gain strong support in the Upper House and regions. This could prove important in the long-run, since many future national leaders are likely to emerge from regional leaders, and the ČSSD may later find itself lacking regional support.

## II.5 Regional Administration

The local government in the Czech Republic has two layers: 6,234 municipalities and 14 regions (NUTS 3). These are self-administered units; people elect their representatives for municipal and regional councils. The municipalities are responsible for the usual kinds of local public services (elementary schools, local libraries, street cleaning, etc). In addition to that, 205 bigger towns have a special status

of “municipalities with extended jurisdiction.” These also carry out some administrative agendas of the central government (ID cards and passports, social security allowances, special child care, legal protection, driving licenses, etc.) not only for their own residents but also for the residents of nearby smaller municipalities. This arrangement was adopted in 2003, when the 76 county offices of



the central government were abolished and their competences transferred either downstream to the “municipalities with extended jurisdiction” or upstream to the regional governments.

While the division of administrative responsibilities between the regional governments and the central government is clear, the two groups continue to clash over the division of funds, which are still largely controlled by the

<b>Regions</b>					
Number of regions	13 <sup>a)</sup>				
Minimum size (km <sup>2</sup> )	3,163	Minimum population	304,343	Minimum number of municipalities	132
Maximum size (km <sup>2</sup> )	10,057	Maximum population	1,269,467	Maximum number of municipalities	1,048
Average size (km <sup>2</sup> )	5,943	Average population	689,166	Average number of municipalities	473
<b>Municipalities with extended jurisdiction</b>					
Number of municipalities with extended jurisdiction	205				
Minimum size (km <sup>2</sup> )	48	Minimum population	9,500	Minimum number of municipalities	1
Maximum size (km <sup>2</sup> )	1,242	Maximum population	376,172	Maximum number of municipalities	111
Average size (km <sup>2</sup> )	382	Average population	44,200	Average number of municipalities	31

Note: a) Data for capital Prague are excluded from the tables since Prague has a specific status

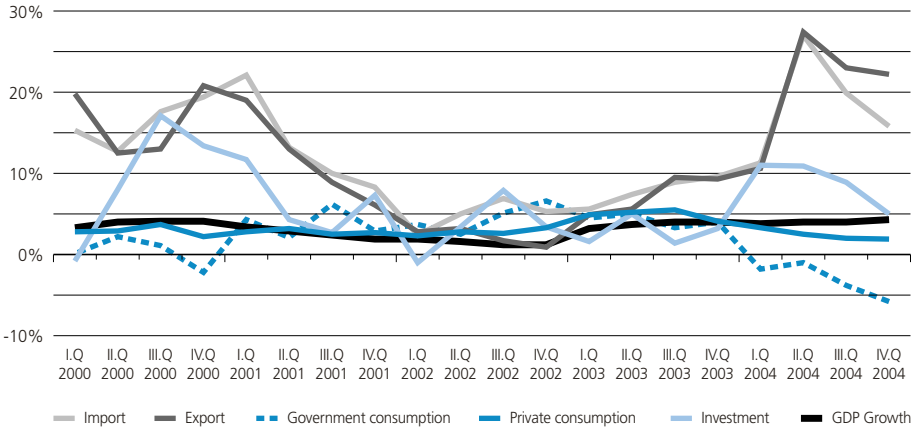
center. The regional offices took over some administrative duties, and, more importantly, hundreds of health, social, and cultural institutions formerly administered by the county offices. These institutions are still financed by grants from the central budget, leaving little freedom for financial management decisions by regional offices. Hospitals in particular were transferred to the regional governments, many in bad financial shape and with large debts, which the regional authorities are unable to cover from their own revenues. Secondary education had already come under the supervision of regional offices in 2002,

but the funds still flow directly from the Ministry of Education. Although the regional offices have been operating for five years, their budgets are still prepared in an ad-hoc manner. A legislation that would set up stable rules for division of tax revenues between the central government and the regions has been under preparation for years. So far, the regions have very limited sources of revenue that they directly control. As much as 86% of their revenue (101.5 billion CZK in 2004) comes as subsidies from the central government, most of which is again tied to specific purpose.

## III. MACROECONOMY

### III.1 Gross Domestic Product

GDP Growth Decomposition



In comparison to previous years, the real Gross Domestic Product has accelerated its growth to 4% in 2004. This acceleration has occurred despite the growing oil price in the world market which was considerably mitigated by the appreciation of the Czech crown with respect to both the USD and EUR. From the demand-side point of view,

the consumption of non-profit organizations and the export of goods and services were the major growth factors. Surprisingly, government spending did not contribute to growth this year, which dropped by 3.2% on a year-on-year basis. From the supply-side point of view, the fishing industry, by its growth of 224%, and the banking and insur-

Decomposition of the real GDP (in bln. of 1995 CZK, s.a.)

Year	2000	2001	2002	2003	2004 Iq	2004 IIq	2004 IIIq	2004 IVq
GDP	1,576.3	1,617.9	1,6	1,7	436.1	440.6	445.1	449.4
Private Consumption	828.0	851.3	874.6	917.6	233.2	234.2	235.2	236.1
Government Consumption	342.5	355.6	371.7	387.3	95.5	94.6	93.2	91.6
Total Investment	502.5	534.3	552.8	568.3	150.1	157.3	158.4	154.1
Net Exports	-127.0	-164.4	-204.7	-229.0	-56.3	-66.2	-60.7	-53.5

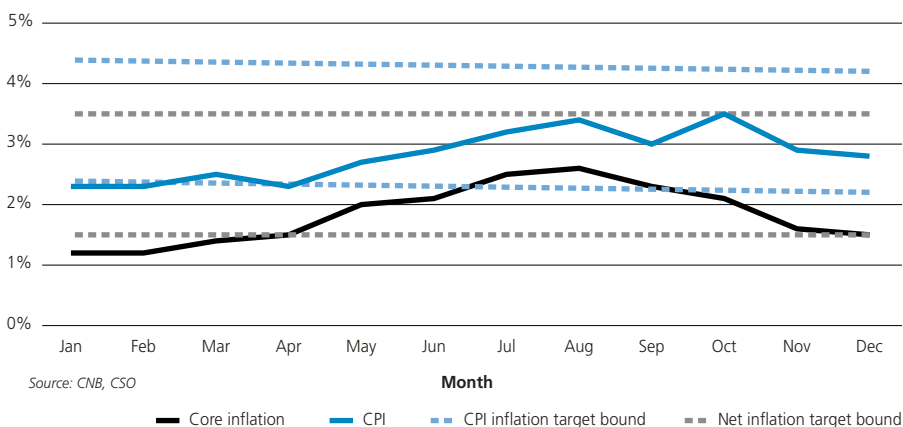
Source: CSO

ance sector, by its 124% growth, were the major contributors to the GDP growth. A slight decline has been registered in the construction industry which has slowed down by 1.4%. Total industrial production grew by about 7%.

There are general expectations for continuing GDP growth of about 4% for 2005. Both the Ministry of Finance and Czech National Bank predict the economy to grow at that rate. The financial sector expects a slightly slower growth in the GDP of 3.8%.

## III.2 Inflation

### Inflation in 2004



The long-term strategy announced by the Czech National Bank for the 2002–2005 period focuses on maintaining sustainable price stability over this period. The strategy is prepared in cooperation with the government to increase the effectiveness of its inflation targeting policy. According to this strategy, the CNB announced its CPI inflation target band of 3–5% starting in 2002, and it should reach 2–4% by the end of 2005. The goal of the CNB is to target CPI inflation and also to set the core inflation band target at 1.5–3.5% for 2004.

After historically low inflation levels in 2003 (-0.4% in the first quarter of 2003),

the year-to-year inflation rate growth that started in the last quarter of 2003 continued over the year 2004 and peaked in August at 3.4%. Since August, inflation declined to 2.8% in December 2004, which is 0.6% less than the third quarter average (1.8% higher than in December 2003). Over the year, to eliminate inflationary pressures, the CNB increased the key interest rates by 0.25% in June and again by 0.25% in August. The actual 2T Repo rate is 2.50%, the discount rate is 1.50% and the Lombard rate is 3.50%. In comparison with the previous year, the CNB managed to meet both of its inflation targets by the end of 2004. These are very

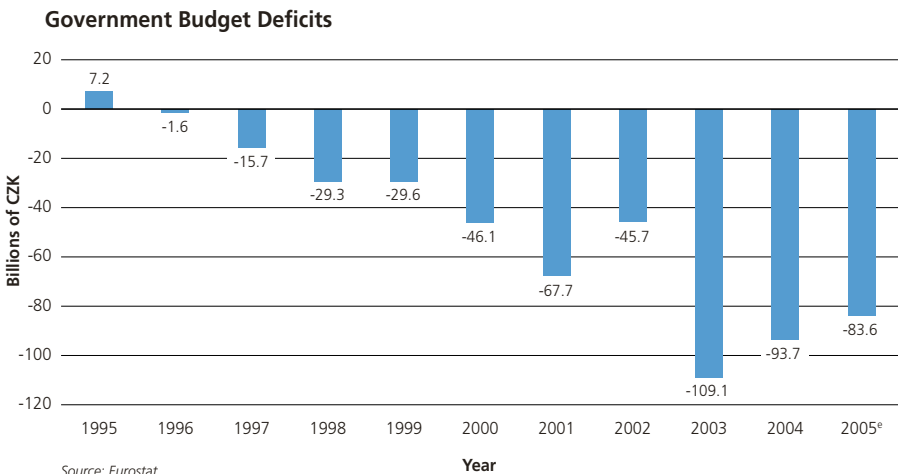


favorable results for future EMU accession. The year-to-year HICP was 2.6%, which is slightly above the estimate of HICP for EU countries (2.3%).

The increase in the CPI in 2004 can be mostly attributed to the increase in regulated prices of natural gas (approximately 11% over the year) and electricity, VAT increases for telecommunication services and tax

increases on fuel, tobacco and alcohol from January 1st. In May 2004, many other services were shifted to a higher VAT class. Increases in prices of crude oil, natural gas and metals (approximately 18.5%) on international markets did not significantly affected inflation since they were mostly absorbed by the further appreciation of the CZK in 2004.

### III.3 Public Budget Deficits

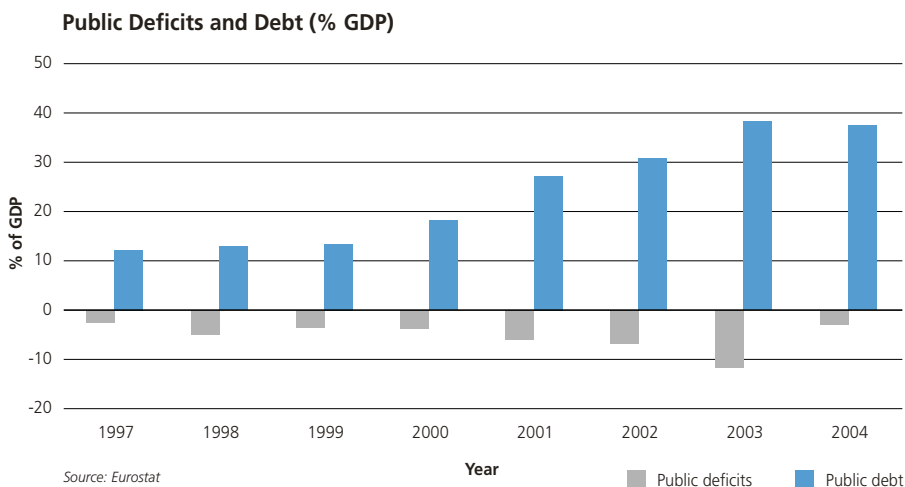


After the period of balanced and seemingly healthy public finances in the first half of the 1990s, the public sector started running regular deficits and accumulating large public debt afterwards. The state budget is plagued by persistent deficits driven largely by exceedingly high mandatory expenditures. There are also many other off-budget accumulated sources of debt.

Last year, however, rather surprisingly, the public deficit was lower than planned for 2004. With 3.0% GDP, the lowest since the

crisis in 1998, the Czech Republic's public finance deficit was the lowest among Visegrad countries. However, all Baltic countries and Slovenia had even lower deficits (with a surplus in the case of Estonia) in 2004. With its public debt of 37.4% of GDP, the Czech Republic still belongs to the EU countries with the best performance in this respect, but again ranks after Slovenia and the Baltic states.

Even though the result for 2004 sounds optimistic, especially when compared to the deficit from 2003, (the planned deficit for



2005 is also promising), it would be misleading to interpret these results as a long lasting tendency in the improvement of the Czech Republic's public finance.

Last year's result was driven mostly by an unexpected increase in revenues in the central government's budget, mainly from the VAT and corporate income tax changes. Also the majority of expenditure items were below the budget plan for 2004, resulting in a slight decrease in the overall growth of government expenditures. However, since there

have not been any serious changes in the public finance policy, the negative trend of public debt is far from broken.

Public finance in the Czech Republic is still predetermined by the high level of mandatory expenditures, especially for the pension system. Therefore, room for the government to make improvements is very limited under the status quo. Without a systemic reform, one cannot expect more than perhaps promising but still unsatisfactory results from last year.

### Consolidated Public Debt (% of GDP)

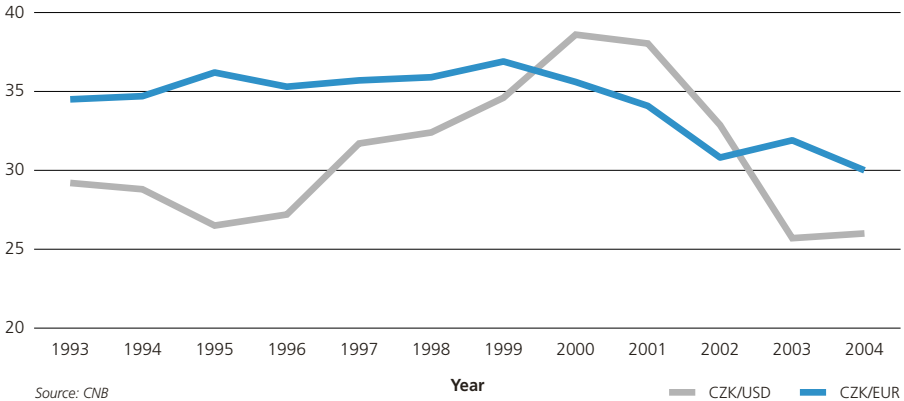
Year	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Public Debt <sup>a)</sup>	17.6	15.3	13.2	12.9	13.0	14.5	16.7	18.7	20.3	24.0	30.6	36.4	41.7
Public Debt with Proposed Reform											29.6	33.9	37.6

Source: Ministry of Finance, Czech Republic

Notes: a) Liabilities of CKA are not fully included (otherwise the public debt would be approximately 28% of GDP in 2002 and 45% of GDP in 2006.)

## III.4 Exchange Rate

Czech Crown Exchange Rate to Euro and US Dollar



At the beginning of the economic transition in the Czech Republic, the exchange rate was used as a nominal anchor of monetary policy. It was tightly pegged to a currency basket, and the level of the nominal peg set in 1991 had not changed until May 1997. The combination of stability with the presence of an inflation differential led to fast real appreciation. The appreciation and the introduction of convertibility meant that the pegged exchange rate could no longer play its stabilization role, and after speculative attacks the crown was allowed to float in 1997. The (lightly) managed floating regime has remained unchanged till now, although changes must be expected as the Czech Republic is going to join the EMU in the future. However, given the skyrocketing budget deficits, the crown is unlikely to join the EMU at the first available date in 2007. It also seems that the Czech National Bank does not want to adopt an exchange rate pegged to the Euro (such as the ERM II regime) too soon and not for longer than necessary.

That's why although the Czech Republic will have to adopt the ERM II regime at least for the two years before it enters the EMU; this reintroduction of a peg is unlikely to occur in the near future.

As far as bilateral exchange rates are considered, the exchange rate of the Czech crown to the U.S. dollar has traditionally been less stable than the CZK/DEM and later CZK/EUR exchange rate: this may be attributed to close trade and investment ties between the Czech Republic and the euro area. During the transition period the exchange rate of the Czech crown to the euro evolved in a relatively stable manner. Differences between points of temporal appreciation and depreciation did not exceed 14% in extreme cases. The largest depreciation occurred during the period following the currency crisis in May 1997, but even the change in the exchange rate during the currency crisis was not as dramatic as those suffered by Asian countries during the same period.

Since 2000, the crown has been steadily appreciating. The appreciation against the USD became extremely dramatic in the last quarter of 2004 because of the evolution of the exchange rate between the euro and the dollar. With the exception of the first quarter, the crown has experienced gradual nominal appreciation against euro in 2004. The exchange rate gradually appreciated from more than 33 CZK/EUR in March to around 31.50 CZK/USD in May and June. Then the crown fluctuated around 31.50 till the beginning of November and experienced another gradual appreciation up to levels around 30.50 CZK/EUR during the last two months of 2004. With respect to the USD, the Czech crown fluctuated in the first nine months around 26 CZK/USD (with a short hike above 27 CZK/USD in March and April). From September on, the CZK/USD exchange

rate has been dominated by the slump of the USD/EUR exchange rate. Consequently, the Czech crown experienced consistent nominal appreciation, and it closed at a historical maximum of around 22.4 CZK/USD at the end of the year.

The long-term trend of gradual real appreciation of the crown, driven by convergence of productivity and institutional characteristics of the economy to the EU level, is likely to continue but at a slower pace than in the previous years. In the near future, the behavior of the CZK nominal exchange rate with respect to the euro will depend on the inflation differential – if inflation remains low, the CZK may even experience mild nominal appreciation. The development of the CZK/USD exchange rate in 2005 will be determined by the development of the EUR/USD exchange rate.

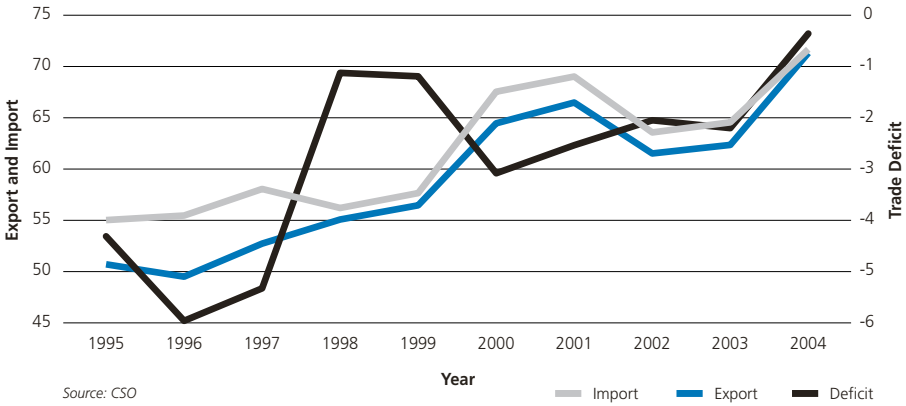
### III.5 Foreign Trade and Balance of Payments

The Czech Republic can serve as a textbook example of a small open economy, in which international trade is an important component of its GDP. The proportions of exports and imports of goods and services to the country's GDP in 2004 amounted to 71% and 72%, respectively (merchandise exports amounted to 62%). The trend in openness shows almost invariably the increasing importance of international trade for the Czech economy. Both exports and imports consistently grew faster than GDP – merchandise exports increased by 25% and imports by 20.5% in 2004 (in CZK and current prices). A trade deficit has been and will be present as well, but in 2004 it decreased in absolute numbers (from 2.47 billion USD to 0.9 billion USD), and the country even experienced a

surplus in the first quarter of 2004. The overall trade development is understandably similar to that of trade in goods and services combined. This trend is likely to continue, and the trade balance is unlikely to cause any problems in near future.

Until 2000, the current account deficit used to be lower than the trade balance deficit because of the positive balance on the services account. While the balance in services remains positive, this positive effect is now dwarfed by a widening deficit in the income balance of the current account. Moreover, this development of the income balance is likely to continue because of the huge inflow of direct investment in recent years (see the next chapter) and consequent increases in profit repatriation by the side

**Foreign Trade, Goods and Services (% of GDP)**

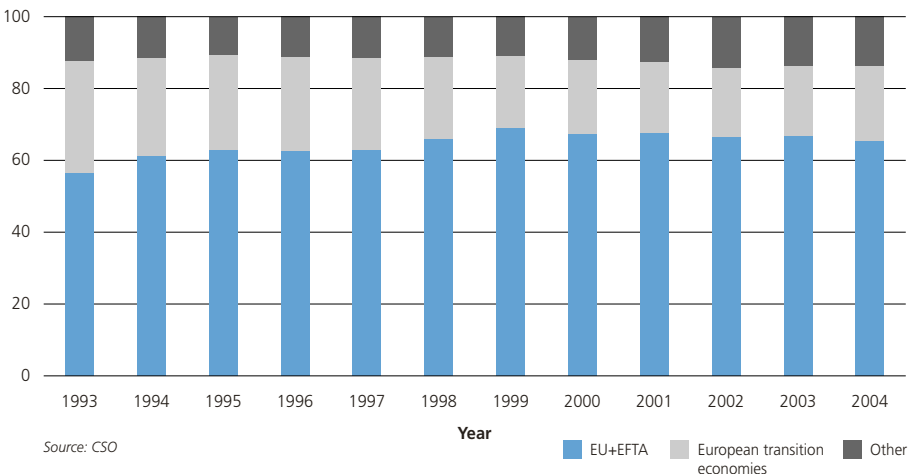


of foreign multinationals. Unlike in previous years, it is therefore the current account deficit that should be watched closely, primarily because of increasing income outflows. However, if we consider the complete balance of payments, there does not seem to be any acute danger. The inflow of capital and the present exchange rate regime (managed

floating) mean that any repetition of balance of payments problems similar to May 1997 remains unlikely.

The EU remains the main trading partner of the Czech economy; its share of total trade turnover reached 79% in 2004 (EU25). This share increased in 2004 because several other European transition economies (Vise-

**Foreign Trade Turnover by Groups of Countries**



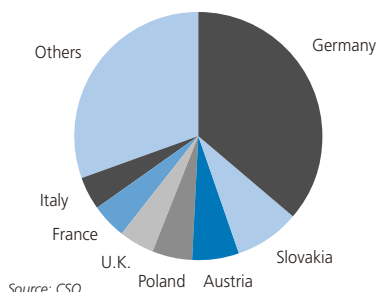
grad countries) that used to be important trade partners of the CR also joined the EU; the share of trade with the original EU15 stagnated (63.4%). If trade with individual countries is considered, then international trade with Germany stands out clearly since it constitutes close to two thirds of the country's trade with the EU and 36% of the overall exports.

The composition of Czech foreign trade has changed dramatically during the transition. Specifically, the share in exports of machinery and transport equipment (SITC 7) has doubled since 1993, while raw materials and semi-finished products have shrunk in similar proportions. This trend continues and it was the increase in exports of machinery and transport equipment that helped to decrease the trade balance deficit in 2004.

The accession to the EU in 2004 did not bring any major shift in aggregate trade patterns since the association agreements had already created a free trade area between the CR and the rest of the EU. Nevertheless,

further increases in foreign trade were evident. However, the accession also means that the CR will have to accept the common trade policy with respect to third countries. This change of trade regime has substantially influenced trade, e.g., trade with China (Czech Republic's fourth biggest trade partner with 5.2% share of Czech imports) as the Czech Republic has together with other EU countries liberalized trade in textiles with China.

**Structure of Exports by Destination (2004)**



## **The Evolution of Foreign Trade in the Czech Republic**

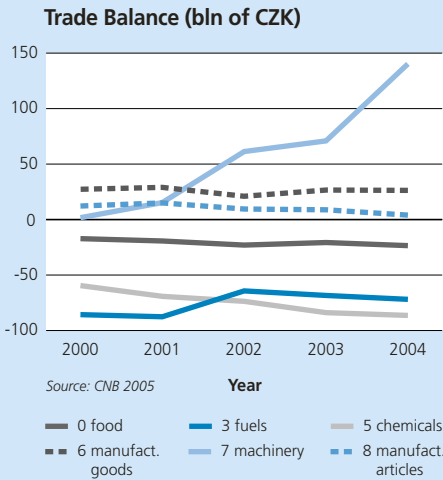
### **Structural changes in foreign trade**

Since 2000, continuous improvement in the foreign trade balance of the Czech Republic has been taking place. This is usually attributed to positive structural changes caused by the inflow of foreign direct investment (FDI) that both enhances and enforces the competitiveness of the Czech economy and its protection against Czech crown appreciation.

Structural changes in Czech foreign trade have become more dynamic since 2000, and these changes were more intensive on the side of exports, culminating in 2002. Since 2002 there has been a decline in the speed of structural changes, yet the concentration of foreign trade remains high.

### **Concentration on commodity groups**

The recent improvement in the trade balance can be attributed to a substantial rise in Commodity Group 7, "machines and vehicles," which traditionally represents a crucial segment



of Czech exports (see graph 2). While in 2000 the trade balance of this group was neutral, in 2004 there was a trade surplus of 140.3 billion CZK. The share of “machines and vehicles” in total exports of goods gradually rose to approximately 50% in 2004.

This does not necessarily mean that producers sold more goods on foreign markets, but rather that part of the production was moved from old EU15 countries to the Czech Republic and sold on guaranteed markets for higher prices. Therefore, this improvement in the trade balance should not be seen as an improvement in competitiveness but rather as a positive structural change in certain industries.

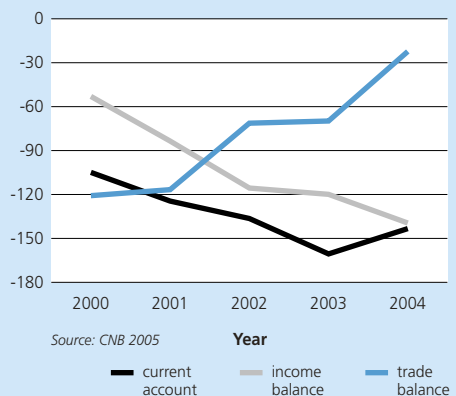
### The effect of ownership

The share of private companies with foreign control increased from 50% in 2000 to 62% in 2004. However, in some sectors like “transportation machines and electronic and optic machines,” it is almost 90%. Therefore, the improved export performance of these industries resulted in higher outflow of profits abroad. Hence, an improvement in the trade balance did not result in an improvement in the current account. The overall current account deficit is expected to remain at about 5% of GDP.

### Conclusion

A structural analysis of Czech foreign trade shows that improvement in the trade balance is caused mostly by a surplus in commodity group “machines and vehicles.” More precisely, the improvement comes from its several subgroups that account for 30% of total exports of goods. However, most of the exports of these subgroups stem from foreign direct investment, which leads to an increasing outflow of profits and that, in turn, offsets the improvement in the country’s current account. The analysis of financial indicators of firms shows that the exchange rate remains an important factor for exporting industries. Especially private firms owned by residents are affected by the recent strong appreciation of the Czech Crown as they have limited options to control for exchange rate risk.

### Current Account and Trade Balance (Bln. of CZK)



## III.6 Foreign Direct Investment

The importance of foreign direct investment (FDI) for the transition economies seem rather obvious: FDIs, among other things, are likely to bring in new capital and new technology, are likely to increase employment and gross domestic product and to improve in the longer run the host country balance of payment. Some of these positive effects of FDI are supposed to be magnified through so-called technological spillovers, which are broadly defined as the indirect positive effects that FDI can have on the rest of the economy, especially on the related upstream and downstream industries. At a bit more subtle level, FDI can have a significant effect on firms' and

industries' restructuring and the change of the structure of the whole economy. Despite the fact that the empirical quantification of the above effects is rather difficult and, at the moment, very incomplete, it can be argued with a high degree of certainty that FDI inflow in the Czech Republic has contributed to all of the above positive effects. However, it is also worth noting that inducing desirable FDI has its social costs in the form of the incentives schemes (investment in infrastructure, tax holidays, financial support for the creation of new jobs, etc.) as well as the costs associated with the displaced domestic firms that cannot survive foreign competitive pressure.

### Some FDI statistics

*According to the Czech central bank's statistics, the cumulative stock of FDI in the Czech Republic amounts to 42,530 billions of USD at the end of 2004. This results in a per capita value of 4,167 USD and places the Czech Republic at the highest position among Central and Eastern European countries in this category. About 80 percent of FDIs come from EU countries with Germany having the strongest position, followed by the Netherlands, Austria, and France. Officially there is relatively little investment from the US and Japan (however the reality may be different as US and Japanese multinationals often establish companies in the Netherlands through which they invest abroad). As for the breakdown by industry, along with massive foreign investment to the services sectors, manufacturing maintained its strong position. The surge in FDI inflows was particularly notable in the period 1998–2001, mainly due to the privatization of large banks and utilities but also due to the established investment incentives scheme in 1998 that in turn boosted the inflow of greenfield FDIs. The latter form has dominated the FDI structure since 2002. The sale of the remaining state share in Czech Telecom, the petrochemical conglomerate Unipetrol, and the national electricity monopoly CEZ in 2005 will be the last big items that would fall under to the title "FDI through privatization." In terms of its influence on the domestic key macroeconomic variables, FDIs (or, equivalently, foreign enterprises) generate about half of the GDP in the Czech Republic although the foreign contribution varies significantly with the sector of the economy. Measured by share in total employment, the highest representation of foreign ownership can be found in the financial services (70%), energy (around 35%), and trade, hotels and manufacturing (around 30%).*



## FDI in Manufacturing

The largest amount of FDI in EU accession countries is generally found in the manufacturing sector and the Czech Republic is no exception. Foreign enterprises account for over 60% of manufacturing output in the Czech Republic, 70% of depreciation of physical capital, and more than three quarters of exports. Moreover, 60% of the total foreign assets (or cumulative FDIs) are concentrated in three manufacturing industries: motor vehicles, food products and tobacco, and non-metallic minerals.

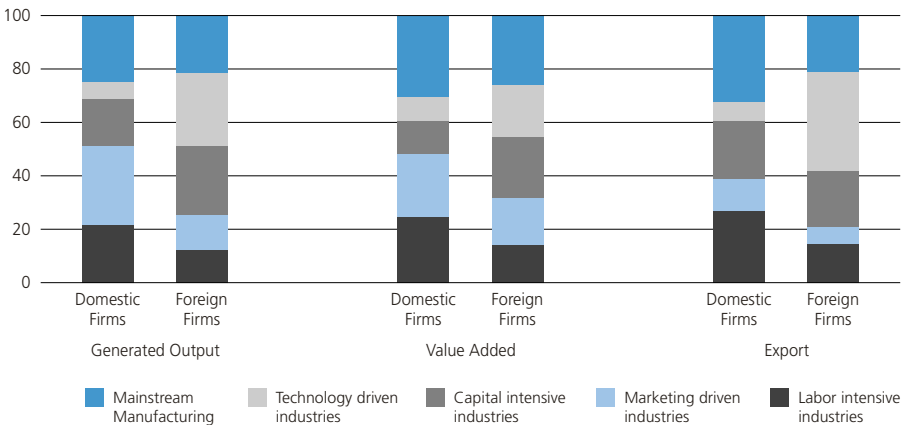
The car industry is the most important production sector of the Czech Republic, generating around 17% of total Czech manufacturing output and 26% of total exports. As such, this industry is an outstanding example of FDI's positive influence on the rest of the economy that occurs through the above-mentioned downstream (or so-called backward) linkages. Such linkage effects, if present, have a profound effect on the structure of the economy, on its long run social welfare and economic growth rate. Namely, if foreign firms established through FDI engage in intensive relations with local suppliers and customers, these foreign firms usually impose discipline and new rules of behaviour. Thus even in the absence of direct involvement on the part of FDI firms, local suppliers are forced to meet demands for higher quality and on-time delivery and to innovate more. Moreover, the foreign firms usually provide technical assistance and training to local suppliers, improving their expertise and human capital, and assist them in purchasing raw materials in order to maintain the quality of intermediate goods. Although there is no exact measure of the importance of the above linkages, it is very likely that they are significant given that in the Czech Repub-

lic there were about 280 manufacturing companies operating in the automotive industry till 2002, more than half of which are foreign owned. Another manufacturing industry that experienced similar effects as the automotive industry is the rapidly growing electronics industry. The break points in its development occurred in the years 1993 and 1996–1997, when several of the world's largest multinational corporations made significant investments in the Czech electronic industry (one of the first investments was made in 1993 by Siemens and amounted to 37 millions USD). The next wave of investments occurred in 1996–1997 when the Asian and North American producers of electronics invested in several greenfield projects.

## FDI and structural change

An important dimension of restructuring that is tightly connected with FDI is the entry process of new firms. The number of enterprises in the Czech manufacturing industry has been steadily increasing since 1993 and has grown dramatically during the last few years. While there were only 190 foreign-owned enterprises out of 3000 manufacturing enterprises in 1993, the number grew to more than 1,300 manufacturing enterprises wholly or partially owned by foreign investors out of 4,700 in the Czech Republic as of 2002. The entry of new firms (either foreign or domestic) is the most important element for fast restructuring of an economy and the most powerful way to sustain economic growth in the long-run. On the other hand, the "old firms" in the transitional countries, which include state enterprises and unstructured privatized firms, cannot compete so well in a market environment and its prolonged support through budgetary subsidies, quasi-fiscal operations, tax offsets and arrears

**Structure of Output, Value Added and Export in the Factor Intensive Industries in 2002**



Sources: CSO, enterprises with 20 and more employees, DBA and COMPET

represents an inefficient use of resources and slows down the economic growth rate. A policy of encouragement for new firms and FDI is, however, not enough. It is essential that policy makers discipline the old sector through the imposition of hard budget constraints, exposure to competition and facilitation of exit procedures. One reason for this is the market for factors that downsizing of old enterprises makes available to new firms. The interaction between old firms and new firms lies at the heart of the growth process.

Another insightful look at the process of restructuring and its directions can be obtained by classifying the manufacturing industries by the usage of their key input and then contrasting this criterion with the domestic (D) with foreign (F) firms' generated output, value added and exports. In this sense, we now rely on the standard taxonomy in the EU, where industries are classified

according to key input usage as: 1) mainstream manufacturing, 2) labor intensive industries, 3) marketing-driven industries, 4) capital intensive industries and, 5) technology-driven industries. The Figure illustrates different pattern of specialization between domestic and foreign firms. Foreign enterprises dominate the *technology-driven* industries and *capital-intensive* industries since more than 50% of the output and exports generated by foreign firms fall into these two categories. On the other hand, *labor-intensive* industries seem unattractive for foreigners since they produce only 10% of their total output. This is consistent with the fact that in the Czech Republic, foreign ownership is negligible in traditional industries, such as textiles, footwear, and machinery, indicating that the main attractor for FDI in the Czech Republic is not cheap labor nor industries that are considered stagnant and non-growing.

## IV. BUSINESS ENVIRONMENT

### IV.1 Privatization and Restructuring

As the communist totalitarian regime came to an end, 95% of Czechoslovakia's GDP was produced by state-owned or co-operative but state-controlled enterprises. Naturally, privatization was the cornerstone of economic transition. The privatization program was carried out in three different schemes: restitution (returning of land, buildings and small businesses expropriated by the communist government back to original owners), small-scale privatization and large-scale privatization. While the first two were completed successfully in the early 1990s, large-scale privatization began in 1991 and was completed in 1995. Most large firms were privatized completely or partially by the voucher method.

Large-scale privatization was later plagued by asset stripping or "looting" and resulted in insufficient restructuring. Many of the old Czech firms continued to receive subsidies hidden as (soft) commercial loans. A state-owned bank (Consolidation Bank) set up to clear non-performing loans from large banks' portfolios in the Czech Republic was transformed from a temporary hospital for bad loans inherited from the communist era to a state-run commercial debt-alleviation agency. The largest banks had long-standing creditor relationships with the voucher-privatized enterprises and also made equity investments in these firms through their voucher investment funds. Such ownership ties served banks as a way of protecting themselves from loan defaults. As a consequence, the actual privatization of many large companies, including banks, was much slower than it appeared –

despite the significant share of these companies distributed among the public via vouchers. In fact, in 1998, most large strategic companies were still under state control – either directly or indirectly through state-owned banks.

Privatization activities were resumed at the beginning of the 2000s. Most importantly, all large banks were sold to foreign investors (Česká spořitelna to the Austrian Erste Bank, Komerční banka to Societé Generale, and ČSOB to Kredietbank of Belgium). IPB, the bank privatized in 1998 to Japanese Nomura, ran into serious financial troubles. The Czech National Bank imposed administration on the bank and quickly arranged the sale of the IPB business to the ČSOB. Both sides (Nomura and the Czech Republic) are now suing each other for the costs of the incident. Recently, a London arbitrage court ruled that the case should be examined within the Czech judicial system. In order to maximize privatization revenues, the government improved the balance sheets of the banks by transferring bad loans to the Consolidation Bank or by providing protection against credit risk. The total cost of bank restructuring is yet to be revealed, but is currently estimated to reach CZK 350–400 billion, of which CZK 100–150 billion will be spent on IPB alone.

By 2004, 80% of Czech national income was generated by private enterprises. However, large-scale privatization is not finished yet and the remaining state-owned enterprises are clustered in the energy, telecommunications and transportation sectors. To

restructure the energy sector, the government is turning to strategic foreign investors. Transgas, the gas distribution company, was sold to German RWE in 2002. The attempt to privatize ČEZ (the main electricity generator with a controlling stake in many regional distributors) was a failure: none of the serious buyers (Enel of Italy and Electricité de France) were willing to meet the government's asking price of 200 billion CZK. The government decided to postpone the privatization of ČEZ beyond the 2006 elections. Likewise, privatization of Czech Airlines and Czech Airports was also postponed until after 2006, the officially stated reason being rising fuel costs and diminishing profit margins. Unipetrol, a large chemical conglomerate, was not sold to the highest bidder (British Roche) but to the second highest bidder of 11.75 billion CZK by domestic Agrofert, which eventually refused to pay the agreed price and returned the company to the government, after having control of the firm for an extended period of time. However, this year the Polish PKN is expected to finalize its purchase of 63% stake in Unipetrol. In March 2004, the government cancelled a tender for coal mining firm Severočeské Doly because of unacceptably low bids. The bids reflected various

restrictions preventing mine closures that were to be imposed on the prospective buyer. A renewed tender for Severočeské Doly is expected in 2005.

Though under preparation for years, postponed and restarted several times, the privatization of the remaining 51.1% stake in Český Telecom (the near-monopolistic provider of fixed-line telecommunications) eventually turned out to be an unexpected success. To increase its attractiveness, the government initiated a restructuring process that moved the firm from a USD 78 million loss in 2003 to a USD 235 million profit in 2004. In February 2005, the government accepted offers from 5 potential investors, and two months later, the government sold the firm to the highest bidder (Telefonica of Spain) without much hesitation. The bid by Telefonica (CZK 82.6 billion) was much higher than what would be implied by the pre-privatization share price. The simplicity and transparency of the sale of Český Telecom was unusual – the government did not keep a golden share and did not even tie any restrictions to the sale. (The only exception being that the government reserved the right to nominate one member to Telecom's supervisory board.)

### Privatization: Do We Always Gain?

*(Based on: Jan Hanousek, Evžen Kočenda and Jan Švejnar (2004): Spinoffs, Privatization and Corporate Performance in Emerging Markets, William Davidson Institute Working Paper 685)*

*One of the central problems facing economies in Central–Eastern Europe in the 1990s was the privatization and restructuring of existing large SOEs and the establishment of effective corporate governance. The process of restructuring and privatizing SOEs could improve the performance of new private firms, yet given the underdeveloped institutional and legal framework, could also be used for tunneling (looting) by their managers. For advanced economies, studies on corporate spin-offs documented improvements in economic efficiency, operational*

performance, investment efficiency. However, for transition and emerging economies the studies are limited and results arguable. The main reasons are the lack of adequate data that does not allow comparing the performance of the spun-off units before and after the spin-off.

Hanousek, Kočenda and Švejnar (2004), in their studies of the effects of spin-offs and privatization on corporate performance in the Czech Republic, have overcome these problems by using a new firm-level data set, which contains indicators of corporate performance for spun-off units both before and after the breakup of the parent enterprise, and data for firms that did not experience spin-offs. This allows them to control for ownership changes while analyzing the spin-off effects and to treat spin-offs and ownership as endogenous variables.

The reported results are complex. On one hand, the spin-offs overall have a positive effect by eliminating the prior inefficiencies of SOEs such as information asymmetries, weak managerial incentives and diseconomies of scale and they increase the firm's indicators of profitability and scale of operations.

On the other hand, the effects of privatization depend on the resulting ownership structure and on whether the firm experienced a spin-off or not. Thus, for firms without spin-offs, a reduction in state ownership does not result in improvements in performance and has a weakly significant positive effect on profitability. Ownership by financial companies or individuals reduces profitability in spun-off firms, increases unit labor cost and reduces sales in firms without spin-offs. This confirms the hypothesis on possible tunneling by managers and/or owners. The ownership by industrial firms reduces the unit labor cost and leaves unchanged or increases the profitability of the firm.

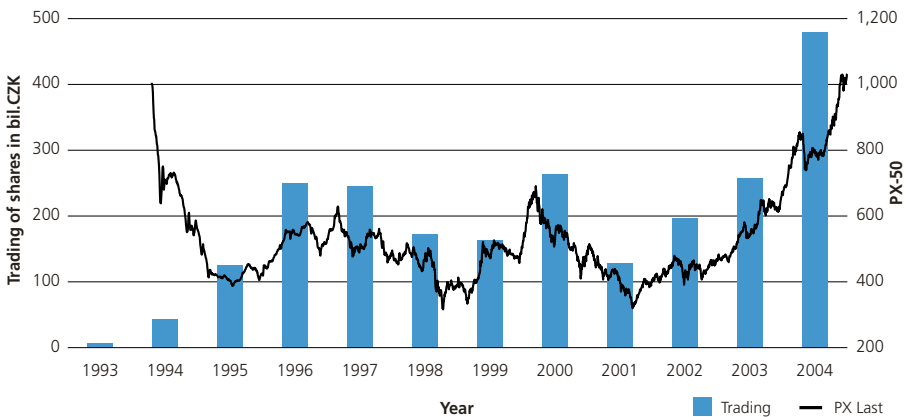
## IV.2 Czech Capital Markets

Development of the Czech capital market has been rather nonstandard due to the mass privatization implemented at the beginning of the transition process. About 1,700 companies were brought to the newly established Prague Stock Exchange (PSE) exchange following privatization. Unfortunately, market forces were not strong enough to cope with such a huge number of illiquid shares, and the expectations of establishing a strong market within a short period of time were not fulfilled. Instead, insider trading, price manipulation, fraud in the investment funds industry, and abuses of minority shareholder rights prevailed in the mid-1990s. The creation of the Czech Securities Commission in 1998 did not

significantly improve the situation because of weak enforcement of the new rules. Moreover, the market was characterized by low transparency as most transactions were not carried out on the centralized, price-setting market, but either outside the PSE or at the PSE but as so-called "block or direct trades" that do not perform a price discovery function. Consequently, investors did not have trust in this market; the liquidity of the market suffered and there was not a single IPO during the 1990s.

The PSE authorities were aware of these problems and responded by dividing the existing equities into three tiers according to capitalization and disclosure obligations, by

### Development of the Prague Stock Exchange PX-50 Index and Trading of Shares (1993–2004)



delisting a huge amount of illiquid shares, introducing a new trading system (SPAD) for blue chips, and prohibiting its members to trade these titles outside of the PSE. Despite all these reforms and harmonization of legislation with the EU, the capital market has not succeeded in fulfilling its primary function of providing capital to enterprises for a long time. However, the development in 2004 has proved that the market is becoming more standard in the sense that companies are starting to use it as a source of capital and investors as a place to invest their money. The evidence is the first successful IPO of Zentiva (a pharmaceutical firm) that took place in June 2004. Zentiva is traded in SPAD; it also became part of the PX-50 index and the value of its shares has almost doubled since its entry. The PSE expects several potential followers of Zentiva (approximately 5–10) within the next year.

Favorable development was also reflected in the behavior of the Prague Stock Exchange PX-50 index (see the graph). In November 2004, it finally conquered its starting value of

1,000 from 1994, and it closed the year at a historical maximum of 1,032 points with a year-to-year increase of 56.6%. Trading volumes have also increased.

These encouraging numbers are in part due to the Czech Republic's entry into the EU, which helped foreign investors "discover" Czech shares. The expectations of growth rates exceeding those of the old EU members together with the prospect of the Czech Republic becoming a part of the EMU further maintain the interest of foreign investors. Investors' confidence is also supported by the international recognition of the PSE. In 2004, it automatically became a regular member of the Federation of European Stock Exchanges (FESE), and the US Securities Commission granted it a "designated offshore securities market" status, which placed it on the list of non-American exchanges safe for American investors.

In spite of the 2004 success, there are still problems to be solved. The number of liquid securities currently traded at the PSE is relatively low, especially for investment funds

activities. These funds are then in fact forced to invest abroad and in this way they indirectly contribute to the growth of foreign economies. Not only would more IPOs help here but so would the privatization of eligible companies through the stock market. Even though the conditions on the market are favorable for privatization nowadays, in the end the decision to privatize depends on the government.

There are also discussions concerning the merging of stock exchanges in Central Europe. These efforts have not produced any specific suggestions so far. Nevertheless, the natural precondition for such development is the consolidation of systems for settlement of trades. This issue is of particular importance for the Czech Republic because a centralized depository still does not exist here.

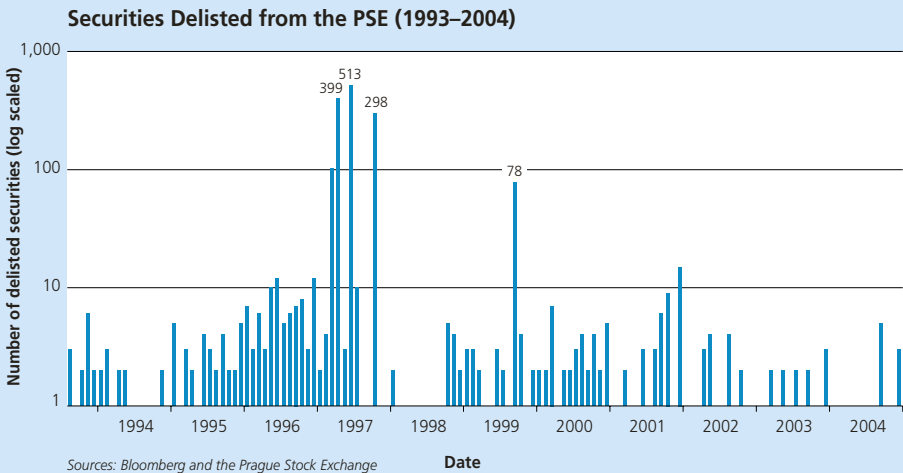
### **Does Delisting Only Mean Fewer Securities Traded?**

*Delisting, i.e., exclusion of shares from public trading, characterized the development of the Czech capital market in the second part of the 1990s. Even though delisting also occurs in the developed economies, the delisting of hundreds of companies within a short period of time from the PSE does not provide a good signal for investors. It points out certain problems in the functioning of capital markets, which can have roots in the way these markets were established. In most countries, these markets emerged gradually as firms were searching for new sources of capital.*

*In the Czech Republic, the capital market was set up by a purely administrative arrangement at the beginning of the 1990s, following the end of the first wave of mass privatization. The shares of privatized companies were put on the market without paying attention to firms' characteristics, their potential to survive there or to the usual listing requirements. It was assumed that more publicly traded companies would generate a more liquid market. However, despite the fact that many companies were listed on the stock exchange and stock market capitalization was relatively high, the majority of these securities were not traded at all or were traded only occasionally. Another unpleasant consequence that resulted from such a huge number of listed securities concerned market supervision – something that would have been problematic even with developed regulatory institutions.*

*Hence, following mass privatization, even companies that if left to their own choice would never have decided to be publicly traded (because of their size or the sector in which they operate) ended up being public. Under such circumstances, the delisting of companies from the stock exchange was only a question of time.*

*The process of delisting can be perceived in two ways. First, delisting of these companies could indicate an effort by the market mechanism to remedy the decision of privatization authorities. It is natural that market forces support the standard evolution of a publicly traded company where companies start as privately owned and only later, when they need to acquire additional capital and fulfill the requirements of the stock exchange, become public. Unfortunately, most companies in transition economies under mass privatization did not follow this process.*



*The second view on delisting is more serious because it indicates a problem with the capital market development. In fact the capital market can hardly develop if there are so many shares just leaving the market. It sends a negative signal to potential investors (see the PX-50 graph; it took ten years to reach its initial value from 1994), not only to foreign institutional investors but also to the small ones who gained shares through mass privatization. Delisting in this case also harms the market as a whole. Investors tend to transfer their money somewhere else, as they no longer have trust in this market and its regulation. Such an unfavorable development may, based on recent empirical studies, hurt a country's further economic growth. Thus, even though the situation on the Czech capital market seems to be improving recently, it is important to realize that resources in the economy would have been used more efficiently if a more careful approach to capital market creation had been adopted.*

### IV.3 Telecommunications Sector

There is hardly an aspect of the telecommunications sector that has not undergone a significant development in 2004, be it changes in the regulatory framework, market structure, or services for end-user.

By May 2005, the set of EU Directives on telecommunications and digital TV broadcasting (forming the so-called "New Regulatory Framework") has been incorporated into

Czech legislation. In theory at least, this should bring a shift in the regulatory approach from "ex post" to "ex ante" regulation. Whereas the current ("ex post") regulation has been focused mainly on regulation of incumbent fixed-line operators in an ad hoc way (by ex post pricing decisions and other regulatory measures) and the creation of a competitive market environment, the New Regulatory



Framework projects an “omniscient regulator” that sets ex ante rules depending on the outcomes of thorough analyses of relevant markets in telecommunications, and thus proactively prevents market distortions. The New Regulatory Framework is also based on the principle of “technological neutrality,” i.e., treating mobile and fixed-line operators in a more similar way. The new framework also envisages a gradual retreat of sector specific regulation and its replacement by general measures enforced by competition offices.

Fixed-line telecommunications have suffered for several years from postponed liberalization, which has enabled Český Telecom (the incumbent monopoly) to maintain a dominant position, and from a very strong fixed-to-mobile substitution effect, which has reduced the scope and scale of Czech fixed-line operators’ activities. Český Telecom remained profitable mainly thanks to revenues from its mobile arm (Eurotel). Its competitors incurred losses on the order of billions CZK during 1999–2004. Inevitable consolidation followed at the end of 2004 when the two largest competitors of Český Telecom – GTS and Aliatel – merged. Other players in the market (Contactel, owned by Teledanmark; CzechOnline, owned by Telekom Austria; and Tiscali) have consolidation plans which are expected to materialize during 2005.

Mobile services are provided by three large operators: Eurotel (41% market share measured by revenue), T-Mobile (38%) and Oskar (21%, bought recently by Vodafone, the world’s biggest operator). No new license has been granted since 1999, despite the rapid growth of the mobile market. The penetration of mobile phones exceeded 90% in 2004, which shows the extreme success

of the Czech mobile industry. This result was achieved due to aggressive and innovative pricing strategies of mobile operators and historically low penetration of fixed-line telephones, but also due to early adoptions of new types of services. This trend is likely to continue from now on under the leadership of Vodafone and T-Mobile group technologies.

The product portfolio of both fixed and mobile operators was changing rapidly in 2004. The spread of high-speed Internet services based on xDSL technology and the development of Voice over IP solutions contributed mostly to the growth of the fixed line market, or more precisely, helped to outweigh the decrease in switched voice and narrow-band Internet services. During 2004, almost 100,000 end-users installed high-speed Internet using their telephone line (xDSL services) or cable TV connections. In a mobile world, high-speed Internet services based on so-called CDMA technology (Eurotel) or EDGE technology (T-Mobile), a part of the so-called 2.5 generation mobile services, emerged and were adopted by tens of thousands of customers. Overall, the gap in penetration of high-speed Internet between the most developed countries (Scandinavian countries, France, Germany, UK, US, South Korea) and the Czech Republic did not further increase for the first time in 2004; however, the penetration of high-speed Internet reached a meager 1.6%, still strikingly low in comparison to other EU countries. The regulation of Internet services and Voice over IP services has not been able to keep pace with the technological development, so these services remain to a large extent unregulated. To find the proper way and extent of regulating IP based fixed-line and mobile services remains a challenge for the next years.

## IV.4 Taxes – Comparison with Other Accession Countries

During 2003, the governments in Central Europe reformed their tax systems in order to harmonize their tax laws with EU laws to make their economies more attractive for foreign investors. In general, the comparison of tax systems across Central Europe shows a weakening of the Czech Republic's competitiveness in the region.

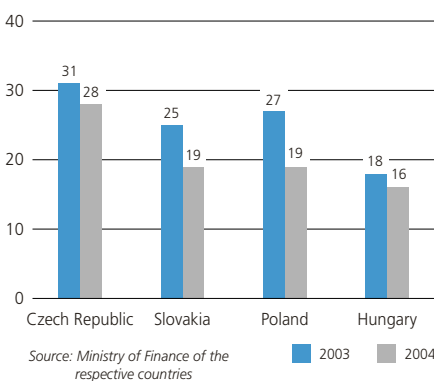
Tax changes in the Czech Republic were quite modest in comparison to other accession countries. Corporate tax will decline from the current rate of 31% to 28% in 2004 and will further drop to 24% by 2006. On the other hand, Hungary cut its corporate tax rate to 16% and Poland to 19%. The Slovak gov-

ernment even introduced a 19% flat tax on both corporate and personal income. In Latvia and Lithuania, the corporate tax rate is 15 percent. In Estonia, the effective rate on distributed profits is 26% and retained earnings are not even subject to taxation. The Czech government changed the value-added tax in two ways in 2004. First, almost all services were moved from reduced to standard rates upon EU accession. At the same time, the standard rate was reduced from 22% to 19%. Thus the Czech value-added tax rates have been 19% (standard) and 5% (reduced) since May 1, 2004.

On the other hand, the Hungarian government proposed an increase in the preferential rates from 0% and 12% to 5% and 15%, respectively. The standard 25% rate remains unchanged. The Slovak VAT went through the greatest change in January 2004. A single 19% VAT rate replaced the reduced and standard rates of 14% and 20%.

As an integral part of the taxation system, social security contributions should be considered. The Czech social security taxes are not only the highest in Central Europe but also in all OECD countries. Thus the social security contributions represented 17.3% of GDP in the Czech Republic, 14.7% in Slovakia, 11.5% in Hungary and 10% in Poland.

### Changes in Corporate Income Tax Rate (in %)



### Individual Income Tax and Value Added Tax in Central European Countries

	Individual income tax <sup>a)</sup>		Value-added tax	
	2003	2004	2003	2004
Czech Republic	15–32	15–32	22, 5	19, 5
Slovakia	16–32	19	20, 14	19
Hungary	20–40	18–38	25, 12, 0	25, 15, 5
Poland	19–40	19–40	22, 3–7	22, 3–7

Sources: Ministries of Finance of the respective countries

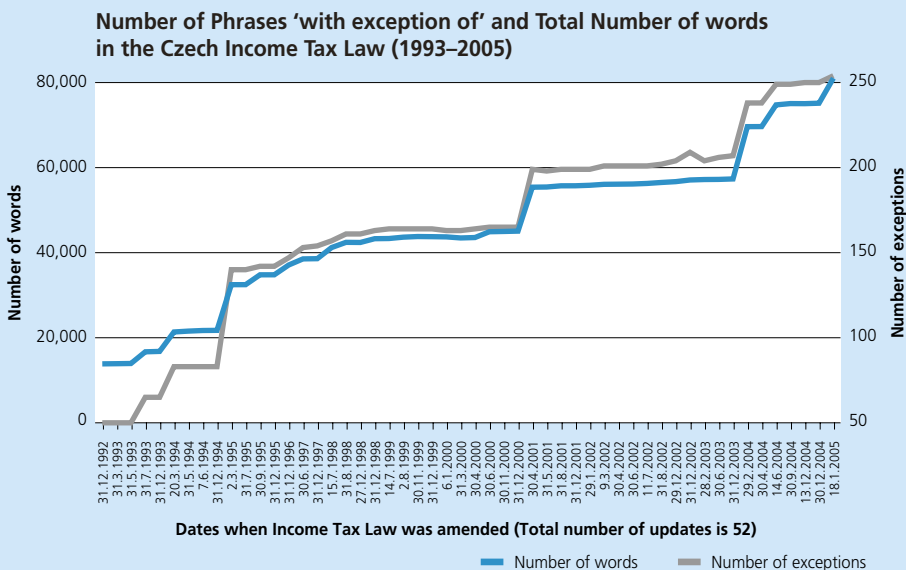
Notes: a) All values are percentages of individual income

## Income Tax Law

The Czech tax system is frequently criticized for its complexity. The Income Tax Act is a prominent example. There were, incredibly, 52 amendments since 1993 – on average more than one modification every quarter. Beside the frequent changes, the income tax law also became more extensive. The first version of the law contained less than 14 thousand words, whereas the last one examined was composed of more than 81 thousand words.

The income tax act modifications were usually introduced to correct previous mistakes, to launch new policies, or to provide special favours to successful interest groups. In addition to the Income Tax Act, there are many regulations issued by ministries that explain certain provisions of the law in more detail. The word count of these regulations is nearly as heavy as that of the income tax law itself. Naturally, as the income tax law increased in size, it allowed for more and more exceptions. In the graph we show the frequency of phrases “with exception of” that appeared in the text of the law. The original income tax law of 1993 mentioned the phrase “with exception of” 50 times; by 2004 the figure more than quintupled to 254. Currently, even tax experts and tax advisors complain that the law is too difficult for them to follow, and that the ordinary public has little chance of grasping it.

Complex and frequent changes in the tax code should pull up the administrative costs of the tax system. The last OECD's survey<sup>1</sup> about tax administration affirms our assumption. The Czech Republic has the highest cost of all OECD countries to collect its tax revenues.



<sup>1</sup> Tax Administration in OECD Countries: Comparative Information Series (2004), OECD, Centre for Tax Policy and Administration; October 2004

The administrative cost represents 2.1% of net revenues in 2002 and are significantly higher than in other CEE economies and are four times higher than in the US.

The markedly simplified Slovak tax system with a flat tax brought higher revenues in 2004. Further, we expect the detailed figures will show a significant decrease in administrative costs. In spite of the above negative results, the current Czech government has not prepared any simplification of the tax system. However, a flat tax is strongly advocated by the Civic Democratic Party (the current leader in opinion polls); hence, there is some chance that this simple tax will actually be implemented by the next government.

### Comparison of Income Tax Administration Costs in 2002

Country	Administrative cost/net revenue collections (%)
Czech Republic	2.08
Hungary	1.35
Poland	1.32
Slovakia	1.46
USA	0.52

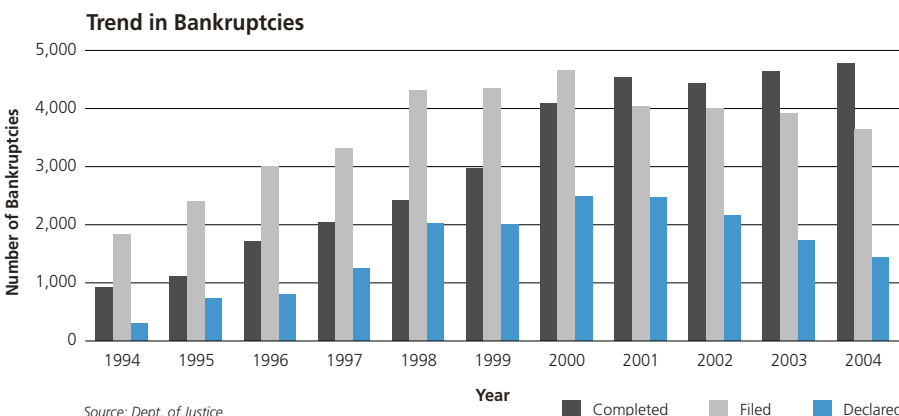
Source: OECD

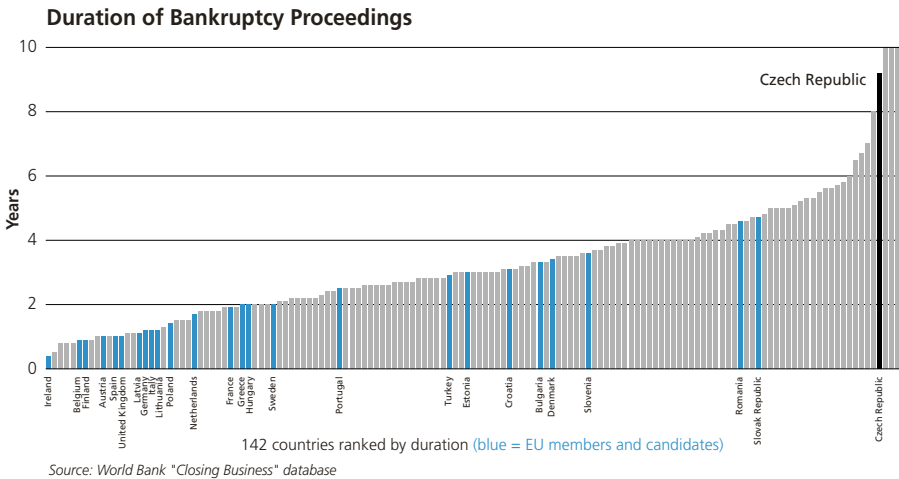
## IV.5 Bankruptcy

Bankruptcy should volley unproductively allocated resources back to productive uses. In the Czech Republic, the number of filed and declared bankruptcies had grown steadily until 2000 when 4,650 bankruptcies were filed and out of these, 2,491 were declared (see graph). The trend reversed in 2001 and by 2004 the numbers reached 3,643 and 1,441,

respectively. The rate of declared/declared bankruptcies was increasing over the nineties to reach its peak of 61% in 2001. Since then it has been steadily falling to only 40% in 2004.

The rapid growth of bankruptcies in the 1990s basically copied the evolution of the legal framework for bankruptcy procedures. Initially, bankruptcy was almost impossible





since the government feared massive layoffs and economic collapse. During the second half of the 1990s it became obvious that bankruptcy legislation needs to be improved so that bankruptcy can serve as a means of enforcing debt repayment and making creditors become more willing to lend. However, several amendments to the Bankruptcy and Settlement Act increased the role of insolvency courts and bankruptcy administrators at the expense of debtors and did not improve the creditors' positions, as courts and administrators still lacked incentives to act in favor of creditors rather than debtors. The decline of the number of bankruptcies after 2001 reflects mostly the end of the recession of the late 1990s.

Nonetheless, what is more important about Czech bankruptcies is their quality rather than quantity. Czech bankruptcy procedures are – still after twenty amendments to the Bankruptcy and Settlement Act – lengthy, costly, and do not protect the insolvent firms' going concern value. As a result, there is a large potential for increasing the creditors' willing-

ness to lend money to enterprises operating in the Czech economy.

Out of all cases pending at the end of 2004, more than 15% had been lasting for more than seven years and another 17% for five to seven years. Moreover, the trend has been negative. This puts the Czech Republic among the worst performing countries in the world in terms of duration of bankruptcy proceedings (see graph).

As a result of lengthy bankruptcy procedures, high administrative costs and weak protection of creditors within bankruptcy, recovery rates to creditors are low. The World Bank's estimates (see the World Bank's database "Closing Business 2004") of how many cents on the dollar claimants (creditors, tax authorities, and employees) recover from an insolvent firm rank the Czech Republic 104th among 142 countries. The estimated 16.8 percent recovery rate for the Czech Republic is by far the lowest within the EU.

The Czech bankruptcy regime is systematically biased towards liquidation. The Czech law defines two types of procedures – *bank-*

*ruptcy* (framework for liquidation) and *settlement* (framework for continuation). Although settlement, being in general more flexible and more debtor-friendly than bankruptcy, represents a faster and less costly solution to insolvency, it is much less frequent, as it requires an agreement on the redesign of property rights over the debtor's assets to be reached between the debtor and the creditors. For example, in 2002, out of all 4,002 bankruptcies declared, only 17 were settlements. Another theoretical possibility of preserving the going concern value of insolvent firms is a sale of the firm as a whole within bankruptcy. However this, too, happens extremely rarely.

The government is now finalizing a new Insolvency Act that will replace the current

Bankruptcy and Settlement Act. The new act is intended to strengthen the rights of creditors, while giving them incentives to keep the firm operating whenever reasonable. Creditors will gain greater influence on the main decisions, such as selection of the procedure, and will be enabled to dismiss a court-appointed bankruptcy trustee and appoint a new one. The new act will introduce a reorganization chapter. Within the bankruptcy chapter, incentives to sell the firm as a going concern are to be promoted. Further, the act will set time limits for some court decisions, give managers incentives to initiate timely bankruptcy proceedings, and limit the discretion of judges in commercial decisions.

## IV.6 Nonprofit Sector

The nonprofit sector (called also voluntary or third) in the Czech Republic came into existence only after the fall of communism. Before, there was a limited number of organizations involved in traditionally nonprofit activities but all were centrally organized and under direct state control (associations of hunters or gardeners, Red Cross, etc.). Since 1989, the sector has exhibited stable and significant growth: the number of non-profit entities (associations, foundations and foundation funds, publicly beneficial and church organizations) grew from 3,000 in 1990 to 60,000 in 2004. These numbers are, however, only the upper limit. Since there is no requirement to announce the dissolution of a nonprofit, it is impossible to identify the number of active organizations. According to an estimate in the current governmental report on nonprofits (2004) approximately one third of the registered nonprofits are no longer active.

Fifteen years after the fall of communism, the sector still differs structurally from its western Europe counterparts: due to the high involvement of the state in education, health and social care, the relevance of nonprofits in these areas remains minor, while nonprofits play more significant roles in culture and sports. Interestingly, discussions erupted in 2004 – following the conversion into for-profits of about 40% of the 200 hospitals in the country – around a proposal suggesting the establishment of nonprofit hospitals across the country that would form a net of hospitals providing necessary care for all patients alike. (These discussions are unlikely to produce tangible results given budgetary constraints.) Discussions heated up after an intriguing alliance of Social Democrats, Communists, and some Christian Democrats pushed through legislation in November that prevents regional offices from converting

their public hospitals into for-profits. It is currently not clear what the factual consequences of these developments will be. It is clear that the current debate about the relative merits of for-profits and non-profit health institutions re-hashes discussions that were led elsewhere twenty years ago. Unfortunately, the current discussions in the Czech Republic seem to be informed by ideological positions rather than what we know empirically about this issue.

The nonprofit sector draws its funds from three main sources: fees and charges, public funding and donations. As elsewhere, donations (which accounted for 14 percent of total income of nonprofits) pale in comparison to fees and charges and public funding whose shares of total income were, as of 2002, 47% and 39%, respectively. Donations, however, represent the involvement of the public at large with the third sector and are therefore an important indicator of social capital. Unfortunately, donations from foreign sources have decreased by 25% during 1997–2002 (an estimate by USAID). Many important foreign foundations moved their programs to places with higher needs (Africa, or Eastern Europe). The sector responded in several ways to find new sources of revenue from domestic sources.

Giving through short text messages, or DMS, sent from mobile phones, turned out to be a very successful fundraising method. Thirty two different causes were funded by DMS during the first year since this project, a joint venture of Donors Forum and three mobile phone operators, was launched. The Tsunami relief project organized by ADRA Foundation received more than 1,350,000 messages in two months (January–February 2005), each representing a gift of 32CZK.

Another initiative by Donors Forum (in cooperation with other organizations in the

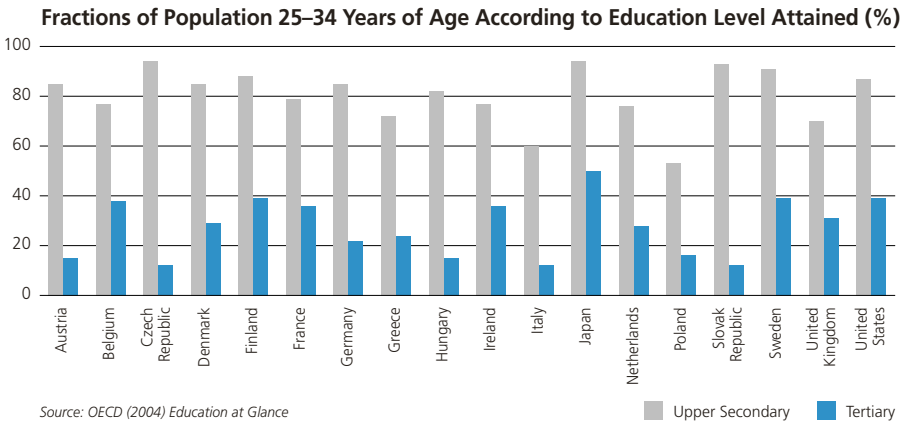
sector) attempted to introduce tax assignation into Czech tax legislation. This provision would give each taxpayer the opportunity to assign one percent of his tax liability to a nonprofit organization of his choice. The legislation is presently being discussed by the government.

Predictably, the year 2004 also brought some accusations of wrongdoing: Bene Factum, a foundation established by a casino, was discovered to be spending its funds not in accordance with its publicly announced beneficial purposes. The problem is likely to be not singular. While casinos, apart from paying taxes, are obliged to support nonprofits (with 30% of their after-tax income), there is no effective enforcement of this requirement (i.e., checks to control what happens to the donated funds are rare, and whatever checks are being conducted have often been found to be hampered by corruption). The problem of nonprofits' lack of transparency and accountability was also evidenced by a recent study by CVNS (a Brno-based nonprofit focused on research in the sector) which found that only 33% of foundations and foundation funds actually do provide their annual reports to the respective courts as required by law.

If foundations, as the formally most accountable nonprofits, display such blatant lackadaisical attitudes toward reporting requirements, it is easy to infer the reporting behavior of other nonprofits. And indeed, there is little evidence that funds going to nonprofits are spent wisely and efficiently. Lackadaisical reporting attitudes and examples of wrongdoing are likely to undermine the trust of the public in nonprofits, and may well be responsible for the recent leveling off of donations in the Czech Republic.

## V. LABOR MARKET

### V.1 Human Capital



The Czech Republic boasts one of the highest upper-secondary school completion rates in the OECD. In 2002, 88% of the Czech population aged 25 to 64 had completed at least upper secondary school. On the other hand, only a very small proportion of the Czech population has completed university: Only 12% of the population aged 25 to 64 has a university degree, compared to an OECD average of 23%.

The structure of the Czech educational and training systems parallels those of other European countries. However, a very high percentage of secondary school students were traditionally enrolled in vocational and apprenticeship programs. For example, in 1995, only 16% of Czech secondary school students were in an academic secondary program, compared with 47% in a typical OECD country. While the size of the general secondary programs has been on the whole administratively fixed

over the last years, the rapidly declining size of the youth cohorts (see section I.3) has allowed an increasing fraction of each cohort to enroll in a general secondary education program and to subsequently enter a university or a lower-tertiary-education program.

Students at the upper-secondary level are tracked into three different school types. Students with the lowest skills are typically enrolled in apprenticeship programs, average-skilled pupils in vocational programs and high-skilled pupils in gymnasia.

While private secondary schools now provide about one fifth of the total of secondary education in the country, public universities and colleges, which are tuition-free by law, continue to dominate the provision of tertiary education and continue being highly over-enrolled. Over the last decade, approximately one half of the applicants to the public tertiary system have been rejected each year.



## V.2 Skills

New insight on the relative standing of the Czech Republic in terms of its human capital endowment has been provided by the results from the PISA 2003 survey of 15-year-old pupils in OECD and other countries. The survey tested pupils' skills in mathematics, science, reading, and problem solving. Czech pupils ranked very high in mathematics and science, well in problem solving and relatively poorly in reading skills. The country clearly outperforms all four neighboring countries. But the results should not be exaggerated.

PISA tested pupils' skills obtained up to the beginning of the upper-secondary level. Little is known about further skills acquired at the upper-secondary and tertiary level. Memorization without understanding key concepts is still the most widespread pedagogical method. While 15-year-old pupils rank high in international comparisons of study achievement in mathematics and sciences, the ability to analyze and process information is relatively low and English language proficiency is very low.

Skills	OECD Countries	European Countries	
	Upper Rank	Lower Rank	Upper Rank <sup>b)</sup>
Reading	14	21	14
Mathematics	9	14	5
Problem-solving	8	14	7
Science	4	18	3

Source: First results from PISA 2003, OECD, Paris 2004.

Notes: a) There were 40 countries participating in the PISA survey and 25 European countries  
b) Rank of a country is reported in confidence interval between upper and lower rank

### Imbalances in Access to Upper-secondary Education

(Based on PISA 2003 data and the author's own computations as part of GAČR project #403/03/340, "Economic, social, and cultural sources of educational inequalities...")

The PISA 2003 survey also provides important evidence on imbalances at the upper-secondary level. Too many pupils who enroll in vocational programs, especially those of apprenticeship type, possess skills which would allow them to enroll into more demanding programs would there be slots available.

Table 1 in column (a) shows the shares of 15 year old apprentices whose skills are higher than the skills of the bottom

**Table 1: Comparison of 15-years Old Pupils in Upper-secondary Education**

		Apprentices vs. Vocational (%)	Vocational vs. Gymnazia (%)
	Municipality size	(a)	(b)
Boys	Small	32	33
	Large	41	40
Girls	Small	15	20
	Large	15	24

Sources: PISA 2003 data, own computations based on GAČR project

25% of pupils in vocational programs. The greatest imbalance is faced by boys in larger municipalities. Fifteen year old boys, compared to equally skilled girls, are much more likely to end-up in apprenticeship programs. Table 2 shows that in the second and third best skill quintile, the share of boys among all apprentices is 88%. This imbalance exists as well in all the lower skills quintiles (78% and 62%). These imbalances should be viewed vis-à-vis the very high incidence of unemployment among apprentice graduates. Finally, boys equally skilled as girls are much less likely to enroll to gymnasia. This is an important phenomenon because the gymnasia curriculum is an important prerequisite for college admission.

**Table 2: Percentage Shares of 15-years Old Boys in Upper-secondary Education by Average Rank in PISA 2003 Testing**

	Skill Quintile Rank	Gymnasia	Vocational	Apprentices
Weak	1	n.a.	26 <sup>a)</sup>	62
	2	14	32	78
	3	19	45	88
	4	33	55	87
Best	5	49	69	n.a.

Sources: PISA 2003 data, own computations based on GACR project

Note: a) 50% represents equal proportions of males and females

### How much Tertiary Education?

There is a fervid ongoing public discussion in the Czech Republic about the magnitude and sufficiency of the recent expansion of its tertiary education system. A hot political issue is the introduction of tuition in public universities. While economists (of education) argue that tuition would improve the motivation of universities to provide high-quality education, lower the very high dropout rate of the public programs, and therefore allow for a further expansion of the system required to meet the globally increasing demand for higher education, the ruling party opposes the idea on ideological grounds. It is therefore important to properly understand the current extent of tertiary education production in the Czech Republic.

The number of students studying in public universities increased from 89 to 236 thousand between 1990 and 2003, but during the same time, the overall demand for tertiary education increased as well and there was a also temporal increase in the cohort of 19-year-olds. The source of standard international comparison, the OECD's Education at a Glance publication, is not useful here because it reports educational attainment only starting with the 25–34 age category, and this category does not yet fully capture the recent expansion of Czech tertiary education provision. However, looking at the ages 20–24, one can compare the fraction of the group enrolled in education programs. In terms of this OECD 27-country comparison, the Czech Republic surpasses only Turkey, Slovakia and Mexico. (The enrollment picture is even bleaker in the age group 25–29.)

In today's Czech Republic, about 60% of each cohort of 19-year olds graduate from a secondary program with the school leaving examination "Maturita" (comparable to the German Abitur exam or the British General Certificate of Education (GCE)). In 2004, 55% of those passing the Maturita exam enrolled in a tertiary program in the same year (including lower tertiary programs). Given that some of these students will not graduate and other Maturita holders will enroll in the tertiary system later, it is likely that about a **third** ( $0.6 \times 0.55$ ) of today's cohorts of 19-year-olds are likely to eventually achieve a tertiary degree, possibly reaching the 2002 OECD all-population average of tertiary education attainment. Here, it is important to note that the simple ratio of all newly enrolled students in tertiary programs to the population of 19-year-olds is much higher than one third because of the backlog demand for tertiary degrees among the older cohorts and because 22% of the newly enrolled in 2004 came from within the tertiary education system, in large part simply switching from one tuition-free public program to another.

### V.3 Employment and Wages

The strongest feature of the Czech labor market is its high employment rate (i.e., the fraction of population employed) in comparison to both EU-8 and EU-15 countries. Even though some EU-8 economies, e.g., Hungary, have lower unemployment rates (the fraction of labor force without work and searching for work), these occur in the context of much lower labor market participation. The structure and level of Czech employment and unemployment is actually very similar to that of a typical EU-15 economy with two important exceptions: there is a high incidence of

- (i) long-term unemployment as about one half of Czech unemployed have been searching for a job for over a year while the relevant fraction in the EU-15 economies is below 40%,
- (ii) youth non-employment: only 30% of Czechs aged 15–24 were employed as of 2003 compared to 40% of the relevant age group in the EU-15 countries.

While the explanation for (ii) may be related to the quite rigid structure of education provision (in particular in the area of vocational programs, see above), the existence of (i) is

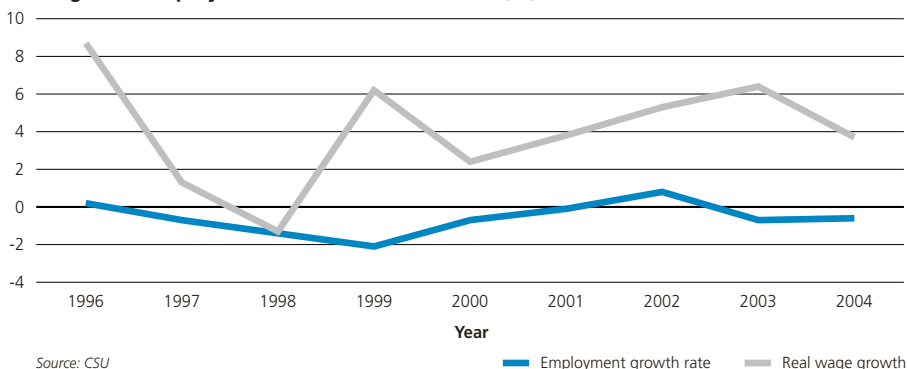
#### Labor Market Indicators in 2003

	Czech Republic	Slovak Republic	Poland	Hungary	EU-8	EU-15
% of population aged 15–64 employed	64.7	57.7	51.2	57.0	55.7	64.3
Full-time-equivalent	64.1	57.4	50.3	56.9	n.a.	58.6
Unemployment rate	7.6	17.2	19.3	5.8	14.3	8.0
% of workers self-employed <sup>a)</sup>	15.3	8.6	28.0	14.6	27.1	15.7
% of workers with limited contracts <sup>a)</sup>	8.1	5.0	11.9	7.5	8.0	13.4

Sources: Eurostat, *Employment in Europe*, World Bank

Note: a) 2001 indicators.

## Wage and Employment Annual Growth Rates (%)



very likely linked to the disincentive effects of the Czech welfare system (see below) and widespread participation of the unemployed in the shadow economy. Finally, the structure of Czech employment also differs from the EU-15 economies in that a high fraction of Czech employment occurs in industry (30% compared to the EU-15 average of 20% as of 2003).

The high employment rates are in large part likely related to the low level of Czech labor costs, relative to productivity, even though this advantage has been shrinking in recent years due to the crown's continuous appreciation resulting in a euro hourly labor cost growth of over 40% between 2000 and 2002. Czech total labor costs (measured in euro using exchange rates) are only somewhat

## Aggregate Productivity, Labor Costs and their Structure

	Czech Republic	Slovak Republic	Poland	Hungary	Germany	Portugal
<b>Labor Costs</b>						
Total hourly labor costs in EUR	5.4	3.6	5.3	4.5	26.9	9.0
<b>Productivity</b>						
GDP per hour worked (EU-15 = 100%, PPS) <sup>a)</sup>	45	50	38		103	59
GDP per worker (EU-15 = 100%, PPS)	57	55	47	62	94	64
<b>Structure of Labor Costs</b>						
Total social security contribution rate, 2003 <sup>b)</sup>	47.5	50.8	45.4	49.6	42.0	34.8
Total tax wedge = contribution rates + income tax rate <sup>c)</sup>	59.1	57.1	51.6	62.6	62.9	40.4

Sources: Eurostat, OECD (Taxing Wages)

Notes: a) Values as of 2002

b) Summation of pension, employment policy, health insurance and other contribution rates

c) Last two rows relate to an average-wage non-married childless production worker

higher than those of most EU-8 economies and continue to be much below the labor costs typical in the EU-15 economies. At the same time, a Czech worker's total output (measured by GDP per worker *in purchasing power standard*) is, thanks to the lower Czech price level, closer to the EU-15 average than the Czech labor cost is. However, according to OECD's Taxing Wages, the structure of labor costs in the Czech lands is very similar to that of the most developed economies and is characterized by high contribution rates and a high total tax wedge. The Czech tax wedge (defined as the ratio of income tax and social security contributions of both employer and

employee to total labor costs) is particularly high in international comparison when calculated not for the average production worker, but for a worker making only two thirds of the average wage. Given the limited downward wage flexibility among low-earners, this tax burden may be work-discouraging for low-educated low-earners. Finally, labor costs in euros have grown not only because of the crown's appreciation but also because of the steady growth of real CZK wages, which continued in 2004 albeit at a slower pace. While real wage growth does not seem to put much pressure on inflation, it may be related to the continuous slight drops in employment.

### Czech Returns to Schooling by District

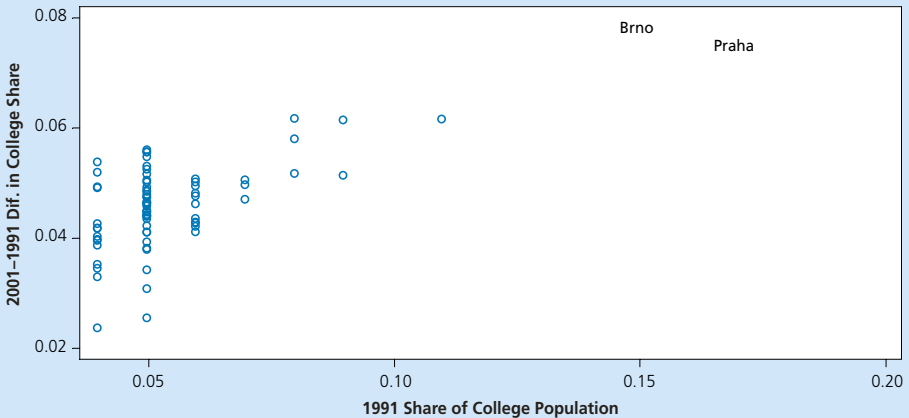
*(Based on Štěpán Jurajda: Are There Increasing Returns to Local Concentration of Skills? Evidence on Wages and Returns to Education in Transition. CERGE-EI Working Paper No. 260, 2005.)*

*There is substantial variation across Czech districts in the share of college-educated labor force. Furthermore, those districts that started the transition process with a higher endowment of college education increased their human capital by more over the first ten years of economic transformation.*

*These differences can be traced to the presence of a public college in the district, which was predetermined from the communist era. District inequality in the endowment of different levels of education is then responsible for about half of the overall district variation in current unemployment rates. Those districts which are hit by a negative overall labor demand shock display disproportionately higher unemployment rates for the less educated, while unemployment rates of the college educated vary little across labor market areas. In contrast, wages of the college educated vary dramatically across districts, while wages of less educated workers are quite equalized across districts, likely thanks to a national level of guaranteed welfare income.*

*The pre-determined part of the variation in college-education endowment can inspire a key question in labor economics: whether there are positive productivity (wage) spillovers from the concentration of highly-educated workers. The empirical results, based on an identification strategy used recently in the US, do not point to significant human-capital spatial externalities. Next, we estimate district-specific college/high-school wage gaps and returns to education and relate these to the relative supply of highly educated workers by area. We find large district variation in the college/high-school wage gap for otherwise comparable workers and confirm*

The Prevalence of College Education in Czech Districts And Its Change Over Time



the intuition of a simple demand-supply framework in those districts relatively abundant in college labor and displaying lower college wage premiums. The results are consistent with a quite elastic long-run relative labor demand curve, where firms with high-skill labor intensive technology are more likely to locate in areas where highly educated labor is more abundant.

## V.4 Labor Market Institutions

Internationally comparable indices of flexibility suggest that the Czech labor market is somewhat more flexible than those of most EU countries and many transition economies. However, this comparison became less favorable during 2003 when neighboring Slovakia introduced a number of flexibility-promoting policies (pro-work structure of support, flexible Labor Code) and when changes in the

Czech Labor Code, championed by the trade unions and their political representatives in the government, limited the use of short-term contracts in the Czech Republic. Laying off a worker due to dissatisfactory effort is also difficult and expensive.

Sick-leave insurance is another problematic institution. Sick leave benefits are quite generous. A worker with earnings somewhat

### Sickness Insurance Benefits as a Share of Net Earnings

Days from the start of sickness	Person 1: with wage 20% below average wage	Person 2: with wage 15% above average wage
1–3 days	30%	27%
4–14 days	83%	75%
>14 days	93%	81%

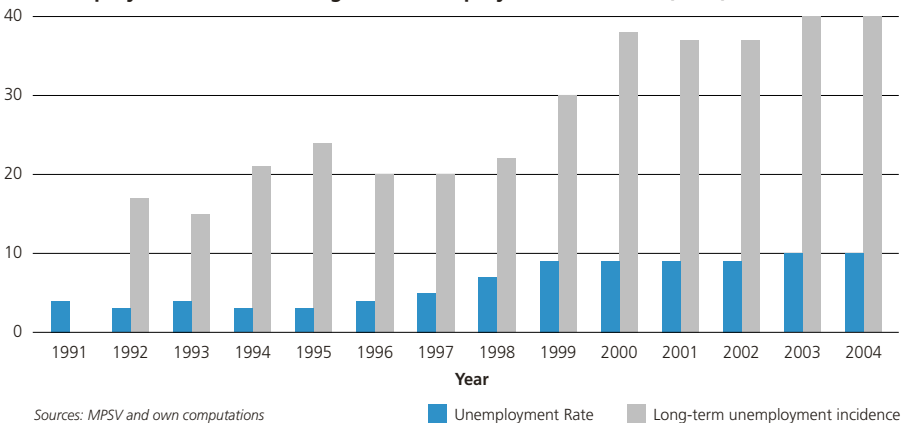
Source: Authors' computation

below average gets 30% of his daily net wage for the first 3 days of sickness, but as much as 93% after the sickness exceeds 14 days. (The system is redistributive across income groups, so that the percentage falls to 56% for workers earning 20,700 a month, and earnings above that level do not increase sick leave benefits.) The system is often abused by both workers (paid work leave) and firms (costless temporary lay-off), while the costs come from the state budget (in 2004, CZK 29.6 billion was paid out in sick leave benefits). Eligibility is weakly scrutinized and misuses are weakly punished. As a result, the

average Czech worker spends much more time on sick leave than workers in neighboring countries. It is also not possible to lay-off an employee who is on sick leave so that the increased duration of sickness and higher outlays of sick leave insurance funds can partly be thought of as unemployment insurance or a temporary layoff subsidy. A reform of the whole system is being prepared. In the new system, sick leave payments should be covered by employers during the first two weeks while payroll tax should be cut accordingly. More stringent supervision and punishments should be introduced.

## V.5 Unemployment

**Unemployment Rate and Long-term Unemployment Incidence (in %)**



Notes: a) Data-series are based on methodology valid until June 2004. Since July 2004, new methodology is used to compute unemployment. It decreases actual unemployment rate by  $-0.9$  pp  
 b) End-year figures

Dynamic economic growth has a positive, but rather limited impact on unemployment, which became clear in early 2005, and there seems to be no effect on unemployment so far. Since December 2004, the unemployment rate has remained below the levels in

corresponding periods of 2003 (a new computation methodology was introduced in July 2004 and decreased the unemployment rate by  $\sim 0.9\%$ ). By the end of April 2005, the unemployment rate dropped to 8.9%. However, the share of long-term unemployed is

growing steadily such that the share of registered unemployed who have been in the registry for over one year reached 41% at the end of the first quarter of 2005.

The ILO unemployment rate based on the labor force surveys reached 8.5% in March 2005. This suggests a growing increase in the misuse of unemployment and welfare programs if individuals who report that they work in the labor force survey are also registered as officially unemployed and are collecting benefits. Finally, the incidence of long-term unemployment (the share of those unemployed for over one year out of the total number of unemployed) also grew steadily in recent years.

(Long-term unemployment is typically higher when based on the ILO definition of unemployment.) Long-term unemployed are often trapped in inactivity by the generous welfare system, rigid housing markets, and their low level of education.

Despite growing regional disparities in unemployment rates, labor mobility across regions remains extremely low. The likely culprits for low mobility are generous welfare benefits and a continuing system of rent control, which pushes up housing prices in large and prosperous urban areas, which in turn mitigates the financial gains from moving to these areas.



## VI. PUBLIC SECTOR

Consolidated expenditures of all levels of government represent 43.7% of GDP, which makes the Czech Republic a country with one of the biggest government sectors in the world. The share of government expenditures in GDP has been growing since 1998, and (with the exception of 2004) has been growing faster than tax revenues, which resulted in deficits reaching 11.7% of GDP in 2003. Since the potential for raising additional revenue is arguably minimal, bringing the budget back to balance requires cuts on the expenditure side. However, 55% of expenditures are so-called mandatory expenditures, pre-determined by existing legislation governing

entitlement programs (pensions, welfare, housing subsidies, etc.). Most of the mandatory expenditures are expected to rise if there is no change in the underlying legislation, as they have been rising since the mid-1990s. The fiscal reform plan of 2003 did make some adjustments to sick leave, construction savings, and welfare, and thus contributed to the reduction in budget deficits. More radical reforms are needed, but are unlikely to happen given the preferences of the ruling Social Democrats. In fact, one could say the approach “if there is a problem, we’ll fix it by pouring in more government money” was major underlying principle for most of their policies.

### Share of Mandatory Expenditures in the State Budget (%)

Year	1995	2000	2001	2002	2003	2004 <sup>a)</sup>
Mandatory expenditures	44.8	53.1	53.5	55.7	55.0	55.5
Quasi-mandatory expenditures	23.0	22.3	26.6	27.9	23.8	22.3
Total share	67.8	75.4	80.1	83.5	78.8	77.8

Source: Ministry of Finance of the Czech Republic

Note: a) Estimate

### VI.1 Pension System

In 2003, problems heightened by the aging population in the Czech Republic resulted in attempts to reform the current pension system. The proposed reform included a switch from a defined benefit system to a defined contribution system, with fictitious notionally defined accounts as implemented in Sweden. The reform would only make benefits more closely related to contributions, but it would not resolve the financial instability inherent in the pay-as-you-go (PAYG) system. Financial instability is caused by projected decreases

in the working population and can only be addressed by at least a partial switch to a fully-funded system. While many professional economists shared this critical view of reform, the proposal initiated discussions about pensions and resulted at least in the government’s acknowledgement of the problem. However, a year later, the Czech Republic is still in need of pension reform.

The current system has two main pillars: “pension insurance,” the main way of providing workers with income after they reach

retirement age and “extra pension insurance,” a way of saving privately for retirement. Pension insurance is obligatory for all earners with benefits guaranteed by the state and is financed by a 28% social security tax on labor and self-employed earnings. It is a defined-benefit, PAYG pension scheme. It provides retirement benefits, income for the disabled, and income for widows and widowers. Of interest is mainly the retirement benefit, which consists of fixed and variable parts. The fixed part is currently CZK 1,400 per month, and the variable part is 1.5% of the pension base for each year of economic activity. The pension base reflects the average salary till 1995 and the tax base for the social security tax since 1996. The average monthly benefit increased by 2.6% to CZK 7,249 mainly due to an inflation adjustment. However, the real pension actually decreased by 0.6%. Before 1996, the retirement age for people paying social security tax for 25 years was 60 years for men and 57 for women without children. The age will be gradually increasing till 2006, when it will be 62 years for men and 61 years for women. Another aspect of the current pension system is its discrimination against elderly workers. If the income from economic activity of a person between 65 and 67 years of age exceeds double the minimum living standard, that person loses the right to collect pension benefits.

The extra pension insurance is a voluntary, individual savings plan. This makes it a private, fully funded, defined contribution plan with no guarantees from the government. The government however contributes up to CZK 150 a month and individuals can deduct up to CZK 12,000 a year (from contributions exceeding CZK 6,000) from their income tax

base. Similarly, tax payers can also deduct up to another CZK 12,000 if they have private life insurance, which is a form of savings. These two saving vehicles complement the current pension system.

Financial instability remains the primary problem of the current Czech pension system. To analyze the issue quantitatively, let us define implicit pension debt (IPD) as the present value of the difference between future benefits and contributions as a portion of GDP. Let us also define the necessary contribution rate (NCR) as the rate which sets IPD to 0 by 2065. The Ministry of Labor and Social Affairs estimates that for the retirement age of 63 for men and 59–63 for women (depending on the number of children),  $IPD=193.9\%$  and  $NCR=38\%$  (compared with the current 28%). If retirement ages were increased to 65 (or 67) years for all, the respective numbers for IPD and NCR are 127.9% (98.2%) and 34.3% (32.8%). What follows is that the retirement age should increase to about 67 years within the framework of the current PAYG system. While some increases in retirement age have already taken place during the 1990s, their positive effects have been more than outweighed by the concurrent introduction of (actuarially unfairly advantageous) early retirement schemes. In 1998, for example, early retirements constituted almost half of all old age retirements.

The Czech Republic is heading for significant demographic aging. The elderly over 65 years will constitute almost one quarter of the total population by 2030. Aging is in part due to extended life expectancy and in part due to the dramatic decrease in fertility during the 1990s when the number of children born per woman decreased from 1.9 to 1.1; aging presents a formidable challenge to the cur-

rent state-guaranteed pay-as-you-go pension scheme. With no changes in the PAYG system, its annual deficit could rise from the current 1% of GDP to about 3% before 2020.

This calls for a major reform. In the long run, the PAYG should be at least in part replaced by a mandatory, fully funded scheme. So far, politicians have not been willing to

take any steps in that direction. In contrast, the recently approved Slovak pension reform allows workers to invest 9% of their gross wage in their privately-owned retirement accounts in pension funds. The missing revenue in the PAYG system is then covered by privatization receipts (currently over 70 billion SKK) put in a lock-box.

## VI.2 Welfare and Other Entitlements

The Czech Republic is fairly generous in handing out cash to the poor (and often times, not-so-poor) households through a variety of welfare and housing subsidy programs. The level of welfare entitlements usually depends on the difference between the household's income and the so-called minimum subsistence level of income. The minimum subsistence depends on the number of adults and children in the household; for example, it is CZK 10,350 for a family of two adults and a child aged 15–26 and CZK 14,700 for a family with 3 children aged between 9 and 14. Every household is guaranteed at least the minimum subsistence. Welfare benefits include the following:

*Child support* is paid to families with children whose income is not more than three times the minimum subsistence. The benefit is decreasing with income, so a family with income at 150% of the minimum subsistence can claim CZK 537 a month per child aged 6 to 10, while a family with income at 300% of the minimum subsistence can claim half as much.

*Maternity leave* of CZK 3,634 a month is paid to a parent who permanently looks after her/his children below the age of four. This benefit is not conditional on total family

income and the child-caring parent is allowed to earn labor income.

The *housing supplement* was initially introduced to help poor families meet the cost of housing, although currently it is not tied to housing per se; it is paid to any family with income below 160% of the minimum living standard and is declining with income.

The *welfare supplement* is an additional child support benefit aimed at families with income at or below 160% of the minimum living standard, and is declining with income.

The *birth benefit* is paid as a lump sum of CZK 8,600 when a mother gives birth to a child (more when twins are born). It does not depend on household income.

A *funeral benefit* of CZK 5,000 is payable upon one's death to the person who covers the cost of the funeral.

Very poor families can obtain *additional welfare assistance*, awarded on a case-by-case basis by social workers. Typically it is paid to families which lose unemployment benefits after 6 months of unemployment.

All together, welfare benefits took CZK 36.9 billion (1.3% of GDP) from the budget. While they do alleviate poverty, they also provide a strong disincentive to work. For poor families, they implicitly levy a 100%

## Earnings and Social Welfare as of 1. 1. 2005

<b>Unemployment Benefits Rules</b>	50% (45%) of previous net wage during first (second) 3 months of unemployment. Max 2.5xMSLI <sup>a</sup>
<b>Sickness Insurance Rule</b>	25% of wage during first 3 days, 69% thereafter up to cca 460 CZK per day including weekends; not taxed; paid from state budget revenues.
<b>Guaranteed Minimum Living Standard (MSLI) net</b>	
a) household 2 adults, 1 child (15–26 years of age)	10,350 CZK
b) household 2 adults, 3 children (9, 12, 14 years of age)	14,700 CZK
<b>Max. household income to be eligible for:</b>	
Housing subsidy	1.6xMSLI
Social allowances	1.6xMSLI
Child benefits	3xMSLI
<b>Minimum Wage (monthly, effective January 2005)</b>	7,185 CZK
<b>Net average wage (4th Q.2004)*</b>	15,373 CZK
Average retirement pension in 2004 (net)	7,256 CZK

Source: <http://www.mpsv.cz/scripts/clanek.asp?lg=1&id=6390>

Note: a) Minimum subsistence level of income

b) Net wage is approximated as 75% of gross average wages (20,498 CZK)

tax on their income. Consider the situation of a family with 2 pre-school children whose mother wants to stay at home. The minimum subsistence income for such a household is CZK 11,300. If the husband does not work, the household collects 16,687 in benefits (the minimum subsistence top-off plus the benefits discussed above). If he goes to work and earns after-tax wage just equal to the subsistence, the household's income actually falls to 14,870 because the top-off is eliminated and some benefits are reduced. Even at the average wage (CZK 20,498 before taxes), the household's income after deducting taxes and adding benefits is just 17,995, not much more than what they could "earn" just by staying at home and collecting benefits.

Another entitlement program that puts a drag on government finances are *construction savings*. They were introduced in the

early 1990s with the official purpose to help households accumulate money for buying or renovating homes. The government adds 15% to the amount that a person puts into a special construction savings account (with a cap of CZK 3,000 per person per year and the restriction that savings must be accumulated for at least six years). After six years, the consumer can take a cheap loan or use the accumulated funds for any purpose. When the subsidy was 25%, these savings accounts became the most popular financial product – 5.9 million people had them by the end of 2004 and the government spent CZK 15.3 billion on the annual subsidy. Probably the main effect of the program is a transfer to the wealthy and the middle classes who, in the absence of the subsidy, would put their savings into a different financial product.

## VI.3 Health Care

Public expenditures represent more than 90% of total expenditures on health care. The major source of income for the sector are revenues from health insurance contributions – in fact a payroll tax of 13.5%, split between employers (9% of gross wages), and employees (4.5%). Every citizen must have health insurance, and the amount of health services received does not depend on the amount of contributions. The government pays a flat rate contribution for the unemployed, the elderly, and children under 18. (Contributions from the government actually represent 22.4% of health-insurance revenue). The contributions are paid to health insurance companies. There are currently 9 health insurance companies – the idea behind this arrangement was to introduce competition into the health care system. In practice, however, the government-owned General Health Insurance Company (VZP) covers 66% of the population and the activities of private insurance companies are heavily regulated. Health care services are provided by both private and public entities. Most of the general practitioners, specialists, and dentists are now private. About 95% of pharmacies have been privatized. On the other hand, 75% of hospitals are still public and are typically owned

by the central government, regional governments and local municipalities.

Medical service providers enter contracts with insurance companies. The reimbursement system is based on evaluating procedures according to their difficulty and cost and then awarding a fixed number of service points. In reality, however, each provider segment – physicians, ambulance specialists, dentists, hospitals, etc. – negotiates separately with insurance companies the precise form of reimbursement for six months in advance. The final agreement is usually a mixture of a fee-for-service and up-front payments.

Health indicators have generally improved since 1990. Life expectancy rose from 71.6 years to 74.8 years in 1999. Infant mortality dropped from 10.8 per 1,000 live births to 4.6 in the year 2000. However, the health care system itself is in serious financial difficulties and periodically requires large injections of funds. So far, there have been numerous reforms proposed by the Ministry of Health Care, but no real reform is in sight. The current Minister of Health Care (Milada Emmerová) proposed yet another reform strategy, which was viewed very critically by the expert public and in all likelihood will not be implemented.

### Which Way in Health Care Reform?

*Every reform needs demand. However, this has not been the case for the Czech health care system for quite a long time. So far, discussion of the shape of the future health care system has always been postponed. Although the old system, inherited from the deep past, was subjected to many changes, some of which were market-oriented, these changes were just partial, targeted to a specific problem, and, definitely, with no conceptual plan. A clear vision has been missing. As a result, the health care sector currently suffers from:*

- systematic financial imbalance (permanently growing debt of both the health-insurance sector and hospitals)
- a gap between demand for health services and supply
- allocation inefficiency – overcapacity and overinvestment into new technologies
- the persistence of great differences in abilities of health care providers
- overconsumption of health care services
- corruption and lack of transparency

*The major cause of all the problems of the system is the crossbreed characteristics of the system – it is a system in which the state plays a dominant role with some quasi-market elements incorporated and combined in a wrong way. The market principles introduced into the system are confronted with harsh (often ad-hoc) interventions and regulation from the state<sup>2</sup>, the roles of the parties within the system are blurred, and the economic incentives faced by the parties lead to waste.*

*In light of the current state of the health care sector, calls for reform are gaining in intensity. In present days, these calls are being materialized in some real proposals. One is currently (April 2005) being composed by the Ministry of Healthcare; the other one is being compiled by Health Reform.cz – an expert group cooperating with the ODS, the major opposition party. However these two proposals are based on completely different approaches and on completely different philosophical views on the provision of health care.*

*The Ministry views the provision of health care as a “public service,” and its highest principles are solidarity, equality and availability. The Ministry seems to be very critical of the presence of market forces, and the use of economic instruments is restricted to the mere generation of funds for the system. The behavior of the participants in the system is to be regulated, rather than driven by the market. The Ministry’s concept claims to solve the financial insufficiency of the sector and regain efficiency in the provision of health services by strengthening the role of the state within the system: to tighten the control over health-insurance companies (which they blame to be incompetent in allocating funds), to maintain influence over health care providers and keep their status as non-profit organizations, and to limit the activities of for-profit entities. (At some stage, the proposal even considered the re-nationalization of many private practices by giving practitioners incentives to “voluntarily” sell their practices back to the government.) Although the concept of the Ministry is straightforward with respect to principles, the specific mechanisms or steps are vague, even absent. Not surprisingly, the majority of the expert public regards the Ministry’s concept as an ideologically backward approach, which is far from being a serious proposal for a workable reform. Fortunately, there is almost zero support for the proposal.*

*A fundamentally different concept has been proposed by the HealthReform.cz. This organization wants to tackle problems of the current Czech health system by introducing market forces which would provide participants with desirable economic incentives. More specifically, health services are to be marketed – both providers and payers (health insurance companies) are expected to behave as regular participants of the market. The extent of health*

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<sup>2</sup> A good example is a contractual process of reimbursement between health-insurance companies and health care providers. Due to permanent interventions of the Ministry of Health, the credibility of the process is severely undermined.

care explicitly covered by compulsory insurance (financed via the health insurance contribution system) is to be limited to about 80 or 70%, and the rest is to be paid by co-payments made by patients (which can be, however, additionally insured) – this measure is to limit excessive consumption of health care services and to stimulate patients to play an active part within the system. The role of the state is to be restricted to supervision and regulation of the system. Even though the idea of the Health Reform.cz is quite revolutionary according to Czech historical standards and maybe too ambitious for many, if designed carefully it might work.

## VI.4 Rent control

The housing market in the Czech Republic is heavily distorted by rent control. The policy of regulating rents below their market levels was inherited from the communist era and none of the post-1989 government was willing to abolish it. In 1992, an amendment of the Civil Code abolished the regulation of rents in new leases; since then an unregulated rental market has gradually evolved. However, the old contracts were grandfathered and remained regulated by the Ministry of Finance, which sets the price per square meter with some adjustment for quality and size of the municipality. (The old contracts are rather administrative decrees giving the tenant an indeterminate right to use an apartment for regulated rent. It is extremely difficult to evict non-paying tenants, and upon death of the tenant, the decree can easily be passed to relatives who may not actually live in the apartment.)

Throughout the 1990s, the regulated rents were being increased faster than inflation, yet the disparity between regulated and unregulated rents remains very large, especially in Prague. While a regulated 70 square meter apartment rents for CZK 2,600, the free market rent is, on average, CZK 12,500 (see table). The regulated rent may be even eight times lower than the free market rent in the most attractive locations. For comparison, the regulated rents in New York City are about 50% below the unregulated rents.

After 1989, the state-owned rental housing stock was either transferred to municipalities or, where possible, returned to the original proprietors or their descendants. Since regulated rents are usually not sufficient to cover maintenance costs, the response of the municipalities was to encourage tenants to purchase “their” apartments. Just between 2000 and 2003, 17% of municipal housing

### Rents in Regulated/Unregulated Flats in Selected Types of Municipalities (CZK/m<sup>2</sup> per month)

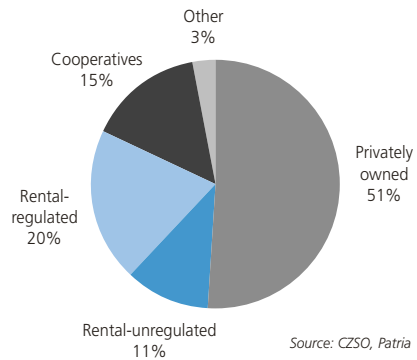
Year	Prague		Municipalities with 10,000–50,000 inhabitants	
	Regulated	Unregulated	Regulated	Unregulated
1999	32.68	226.00	14.46	n.a.
2000	34.28	178.00	15.17	68.60
2001	35.65	168.00	15.78	n.a.

Source: Ministry of Finance, Association of Building Owners

stock was privatized in Prague. As a consequence, the number of apartments subject to rent control has gradually been diminishing.

The standard economic argument holds that rent control reduces the supply of apartments by discouraging construction of new apartments. This does not appear to be the case in the Czech Republic since rent control does not apply to newly constructed units and the vast majority of development projects are built for sale rather than for rent. However, rent control still reduces the supply of apartments and raises prices in the unregulated market since a) it induces many tenants to speculatively hold their apartments even though they physically live elsewhere, b) in attractive locations, many apartments are occupied by poorer households who would choose to live elsewhere in the absence of rent control, and c) it induces richer households to stay in regulated rental apartments

**Housing Units in the Apartment Houses in 2001**



even though they would choose to own their housing in the absence of rent control. A recent study by the Sociological Institute of the Academy of Sciences simulates that rents in Prague would fall by almost 50% if rent control were abolished.

### ***It's Unconstitutional, but Politicians Won't Let It Go***

*In 2000, the Constitutional Court found that the rent control Edict 176/1993 of the Ministry of Finance violated several provisions in the Bill of Rights, namely the requirement that any limitations of fundamental rights must be “non-discriminatory,” must preserve the basic essence of those rights, and must not be misused for purposes other than those for which they were instituted. The court granted the Ministry of Finance the period till December 31, 2001 within which it was expected to enact a new rent control law compatible with the Constitution. No such law was enacted by the Parliament. Instead, the Ministry of Finance substituted the abolished edict with two regulatory orders which were also struck down by the Constitutional Court in 2002. The government responded by freezing rental prices in its Order No. 567/2002, which, again, was found unconstitutional in March 2003. Since then there is no legal document governing rent control, yet rents remain unchanged because according to the Civil Code it is not possible to increase rent without the tenant's agreement.*

*Given the politicians' blatant disregard of the Constitutional Court's rulings, some hope for the abolishment of rent control comes from a February 2005 decision of the European Court for Human Rights, which granted a Polish landlord compensation from the Polish government for losses from rent control which did not allow him to even cover maintenance costs. Czech*



landlords are preparing to sue the Czech government before this Court for similar losses, which may amount up to CZK 40 billion.

Meanwhile, the Ministry for Regional Development has been preparing new legislation which should allow an 8% annual growth of regulated rents. However, the maximum rent should be set at 3% of the corresponding purchase price of the apartment, while in most European countries the rent/price ratio on the free market is about 7%.

The ODS, the main opposition party, rather proposes renegotiation of old regulated rental contracts. In the case the landlord and the tenant do not agree upon the rental price, various notice periods for different age and social categories of tenants are suggested (e.g., 5 years for people over 70 as opposed to a one-year baseline). No additional housing subsidies are intended to be introduced.

## VI.5 Corruption

According to *Mladá Fronta Dnes* (February 22, 2005), 67% of Czechs believe that corruption is an alarming problem in need of a thorough solution. In addition, 20% of Czechs admit giving a bribe in order to speed up procedures at local offices (MFD, December 10, 2004). In light of these numbers, it is hardly comforting that in 2004 the Czech Republic, after years of downward slides, finally managed to move slightly up in the corruption perception index (CPI) rankings reported annually by Transparency International (TI): Specifically, it moved from being ranked 54th (out of 149 countries) in 2003 with a CPI value of 3.9<sup>3</sup> to being ranked 51st (out of 146 countries) in 2004 with a CPI value of 4.2. For comparison, Finland has a 2004 CPI of 9.7.

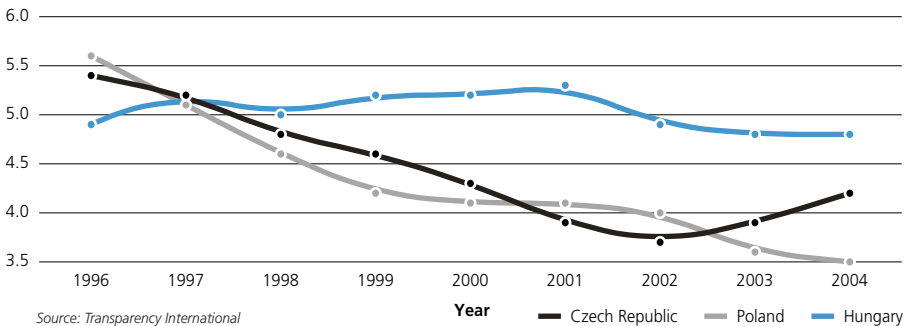
According to a new corruption assessment instrument, the V4 City Corruption Propensity Index, which was conceived by the local branch of TI and implemented in the capitals of the four Visegrad countries (Prague, Bratislava, Budapest, and Warsaw) during winter and spring 2004, Prague City Hall has severe problems in all five areas investigated: how

public procurement tenders are processed, internal audit and audit control mechanisms, codes of ethics, conflict-of-interest regulations and open-information policies. And it does so objectively in terms of insufficient rules and regulations as well as subjectively in terms of various respondent groups' (members of civic associations/businessmen, journalists) perceptions of the level of anticorruption efforts. Clearly, the Czech Republic and Prague City Hall have a lot of catching up to do.

The public's view of corruption as an alarming problem, apart from doubtlessly pervasive personal experiences, was reinforced by several high-visibility affairs. Among them was the apparently wide-spread, and not just recent, bribery of soccer referees documented during spring of 2004. So far, two first league teams were fined CZK 500,000 and deductions of 6 points were imposed on them. Police also charged at least 25 league officials, using phone taps extensively in order to gather evidence. The scandal caused severe damage to the credibility of the game (and did not make sponsors happy).

<sup>3</sup> 10 corresponds to a country with no corruption and 0 to a country with a high level of corruption.

## Corruption Perception Index



The fall of 2004 saw the spectacle of Prime Minister Gross first refusing, and then offering ever changing, and ever more curious explanations for the origin of funds that he and his wife spent on a residence and the real estate business of Ms. Gross. Gross' travails made international news (e.g., a half-page article in the *International Herald Tribune*, March 19, 2005) and unlikely instilled much confidence in the country. The fact that Mr. Gross was eventually forced to resign gives some hopes that Western-style manners are creeping into Czech politics; on the other hand, the fact that the police and prosecutors consistently refused to probe into this affair, despite being provided with ample evidence from investigative journalists that criminal offenses were probably committed, has had a chilling effect on hopes that enforcement agencies will take corruption seriously.

In August 2004, Freedom Union (US-DEU) Member of Parliament Zdeněk Kořistka accused the ODS of offering him CZK 10 million (more than Euro 300,000) in exchange for voting against the coalition in an August confidence vote. The government nearly lost – it was only one vote that made the difference. Not surprisingly, the ODS rejected Kořistka's

accusation. A police investigation into the matter has yet to come to a conclusion.<sup>4</sup>

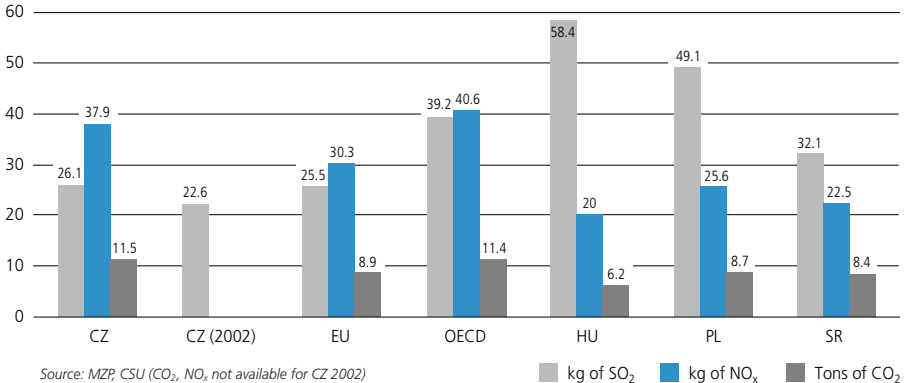
There were numerous other scandals, large and small, involving members of parliamentary parties, policemen, city council members, and others. It is an open question as to what has caused the higher number of cases of corruption currently under investigation (287 in 2004 vs. 155 in 2003; *MFD*, January 25, 2005) but it is likely that – rather than being due to increased corruption or more effective corruption measures – it is just a statistical artifact resulting from the merger of two special units of the state police force into the Office for Corruption and Financial Criminality. That merger, in 2003, had the unfortunate consequence of some very qualified investigators leaving for the private sector and the number of investigations slowed down. There is, in any case, little doubt (see the V4 City Corruption Propensity index results) that tougher legislation and enforcement are needed. It will be interesting to see whether the salary increase that the Gross government pushed through last year will have the intended consequences of making police less susceptible to bribery attempts.

<sup>4</sup> Formal charges against an adviser and former aide to the ODS were dropped in Oct. 2004; however, the investigation continues.

## VII. ENVIRONMENT

### VII.1 The Environmental Success of Transition

Emissions per Inhabitant in 1999



Significant improvements in environmental protection took place during the first decade of pro-market reforms. Not only are the new legal standards comparable to those of the EU, but huge reductions in emissions and significant improvements in environmental quality can be noticed in everyday life.

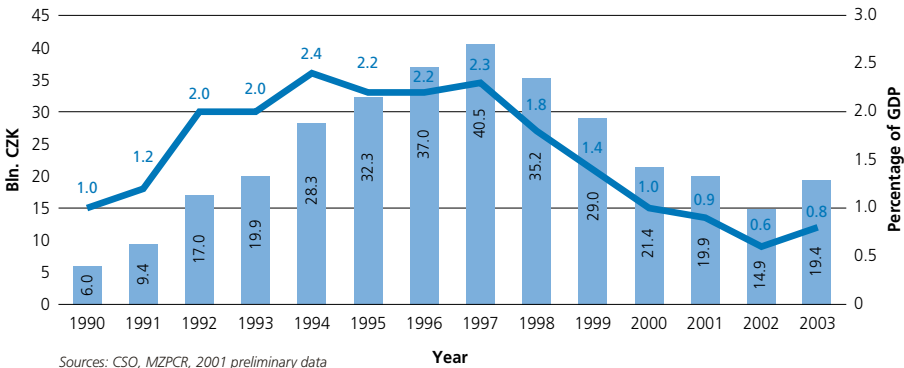
Today's usage of hard fuels is half of what it was in 1989. The unleaded fuel share in gas consumption rose from a mere 1% in 1990 to 81% in 2000. From 2001, the import and sale of leaded gas has been prohibited. In addition, due to new regulations the total share of cars with catalytic converters increased from 1% in 1990 to 32% in 2000; while a significant portion of cars without a catalytic converter were designed to use unleaded fuel.

The Czech Republic is now a signatory of both the Vienna and Montreal treaties on the protection of the ozone layer. Although there was a sharp decline in the emissions of

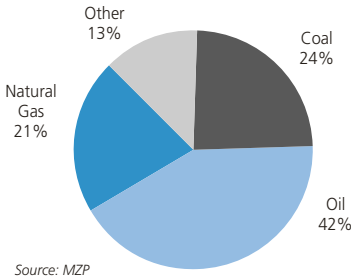
sulphur dioxide and carbon oxides during the last ten years and the current emissions per inhabitant are similar to OECD and EU averages, the emissions per square kilometer are still double that of the EU average and three times higher than the OECD average. In addition, the relative emissions of carbon dioxide are higher than the EU and OECD averages. We should also note the high portion of coal as a primary energy resource. However, the Czech Republic compares favorably in this regard to other Visegrad countries. Unfortunately, the Czech Republic increased its production of nitride oxides because of the increasing number of passenger cars.

Major air pollutants of sulphur and carbon dioxides (e.g., power plants) had a temporary exemption from the emission limits until January 1999. From that time on, all major pollutants have been expected to utilize new technologies. Indeed, sulphur dioxide emis-

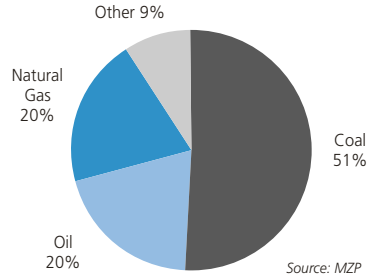
### Investment in Environmental Protection



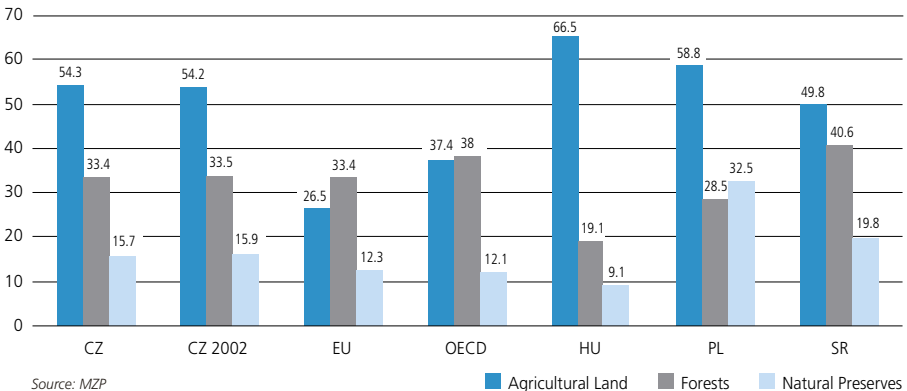
### Primary Energy Resources, OECD, 1999

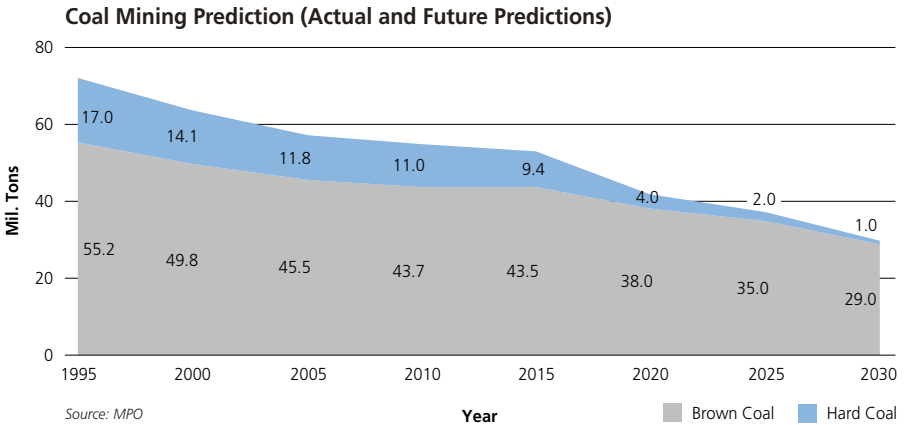


### Primary Energy Resources, Czech Republic, 1999



### Composition of Land Use, 1999 (% of Total Area of the State)





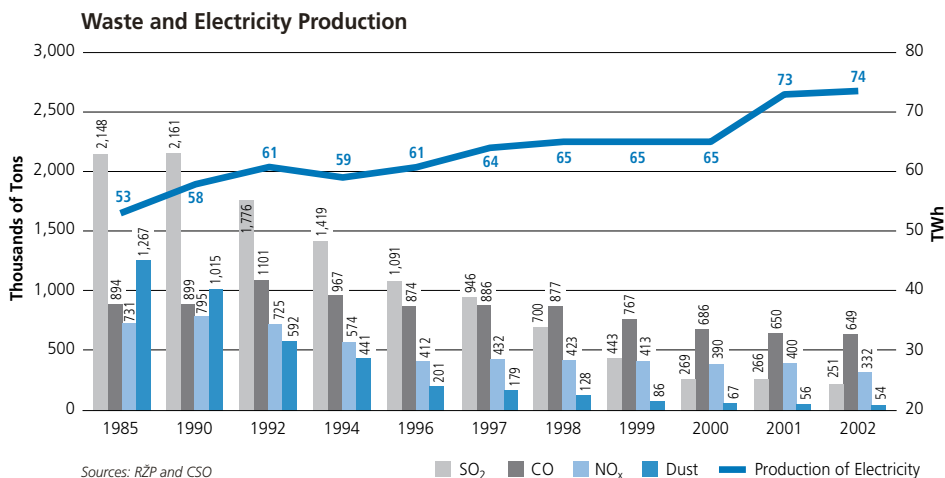
sions dropped to one eighth of the level of the 1980s and even dust emissions were reduced by nineteen times. Moreover, a further reduction is predicted once the newly finished nuclear plant near Temelin is in full operation. The other nuclear power plant in Dukovany currently produces about 20% of the country's total electricity supply. The future share of nuclear energy consumption is estimated to be about 38%, while coal mining should decline.

Noise from transportation is an area where future improvements are necessary. A large portion of the population of the Czech Republic continues to be exposed to excessive noise from transportation. In Prague, almost 40% of the population is exposed to noise levels greater than 65dB during the daytime, in other areas, between 10–30% of the population are exposed to such noise levels. In the Czech Republic, about 4.5% of the population is exposed to health risks due to outdoor noise pollution.

In the Czech Republic, there is approximately the same size of protected areas per one inhabitant as in the other European countries. The Czech Republic has joined all significant international agreements concerning

nature conservation, especially the Convention on Biological Diversity and the Convention on International Trade in Endangered Species of Wild Fauna and Flora (CITES). CITES seeks to control trade in endangered species and their parts as well as products made from such species in order to achieve their protection against complete extinction resulting from merciless commercial activity.

The actual beginnings of legislation concerned with the protection of the environment in the Czech Republic were established after 1989. During a relatively short period of time, not only were laws issued in areas that were formerly not regulated, but most of the former, obsolete regulations were replaced. In recent years, environmental legislation was significantly affected by the process of harmonizing Czech law with the legislation of the European Communities. The Act on Integrated Pollution was an important step towards more uniform environmental legislation. This act lays down a single, integrated procedure for a specified group of installations, which lead to the issuing of a single integrated permit instead of a number of separate permits. One negative consequence of rapid legislation



developments is the lack of interconnection between the legislation in the individual areas of environmental protection. The principles of environmental protection, the institutions of the legislation, procedures, etc., are not dealt with in a uniform manner. The usefulness of and potential for further codification of environmental law is currently under discussion.

The National Ecolabelling Program provides consumers with a guarantee that the labeled product has minimal detrimental impact on the environment and damages it far less than other comparable products. The Ministry of

the Environment of the CR is the guarantor for the program. As of July 30, 2003, a total of 31 Directives had been issued by the Ministry of the Environment with requirements for awarding the environmentally friendly product "Ecolabel" in different product categories (for example, detergents for textiles, water-based coatings, liquid cleaning agents, graph paper made from recycled paper, etc.). There are 63 participating companies, of which 39 are Czech and 24 are foreign companies. There are 300 labeled products on the market.

### Environment Protection Expenditures from Central Sources<sup>a)</sup> (Current Prices, bln. of CZK)

	National Environmental Fund	State Budget	National Property Fund	Total
1998	2.3	4.7	2.2	<b>9.2</b>
1999	2.6	5.5	1.8	<b>9.9</b>
2000	2.9	5.0	2.1	<b>10.0</b>
2001	3.8	4.3	2.7	<b>10.8</b>
2002	4.1	5.0	3.2	<b>12.3</b>
2003	4.6	6.0	2.6	<b>13.2</b>

Sources: SFZP, MF ČR, FNM

Note: a) Excluding expenditures on drinking water since 1998

## Renewable Energy and Greenhouse Gas Emissions

### Renewable energy

In 2002, 12.7% of electricity consumed in the EU came from renewable sources, i.e., hydro plants, wind, solar, geothermal and biomass. Austria, Sweden and Latvia registered the highest shares. The Czech Republic belongs among countries with a relatively low share, in spite of the fact that one of the objectives of the state's environmental policy in the energy sector is to supply energy in a regime of sustainable development. This requires both sound use of non-renewable energy sources and realization of potential savings and increasing the ratio of renewable energy sources to the consumption of primary energy sources.

### An EU-wide "trading scheme" to reduce greenhouse gas emissions

Under the Kyoto Protocol, the EU-15 has agreed to reduce its greenhouse gas emissions by 8% of the 1990 level by 2008–12. In 2002, EU-15 greenhouse gas emissions were around 3% lower than in 1990. Greenhouse gas emissions in the CR were decreasing due to changes in the structure of primary energy sources and an overall transformation of the economy. This trend slowed down in 1993–1997, and since that time greenhouse gas emissions have been slightly varying. For the time being, the present value of emissions is much lower than the value that

was set as the target value on the basis of international agreements. The important component of greenhouse gas emissions is carbon dioxide. An unfavourable indicator is the production of CO<sub>2</sub> per unit of gross domestic product in the Czech Republic; this is much higher than in

### Renewable Energy and Greenhouse Gas Emissions

	Renewable energy (electricity) <sup>a)</sup> % of total	Greenhouse gas emissions <sup>b)</sup> 1990 = 100
EU-15	12.7	97.1
Belgium	2.3	102.1
<b>Czech Republic</b>	<b>4.6</b>	<b>74.3</b>
Denmark	19.8	99.2
Germany	8.1	81.1
Estonia	0.5	44.8
Greece	6.0	126.5
Spain	14.4	139.4
France	13.5	98.1
Ireland	5.4	128.9
Italy	14.3	109.0
Latvia	39.3	36.9
Lithuania	3.2	39.8
Luxembourg	2.8	84.9
Hungary	0.7	69.0
Malta	0	128.5
Netherlands	3.6	100.6
Austria	66.0	108.5
Poland	2.1	67.7
Portugal	20.8	141.0
Slovenia	25.9	98.7
Slovakia	18.7	71.8
Finland	23.7	106.8
Sweden	46.9	96.3
United Kingdom	2.9	85.1

Sources: European Environment Agency, European Topic Center on Air and Climate Change

Notes: a) Share of renewable energy in national electricity consumption  
b) In CO<sub>2</sub> equivalents

*developed countries (in comparison with the average of the EU countries, the Czech Republic produces approximately twice as much CO<sub>2</sub> per unit GDP).*

*The EU has started the first international trading system for CO<sub>2</sub> emissions in the world. The aim is to help EU member states achieve compliance with their commitments under the Kyoto Protocol. It covers some 12,000 installations representing close to half of Europe's emissions of CO<sub>2</sub>. Turning CO<sub>2</sub> into a tradable commodity, i.e., letting participating companies buy or sell emission allowances means that the targets can be achieved with the least costs. The National Allocation Plans determine the total quantity of CO<sub>2</sub> emissions that member states will grant to their companies, which can then be sold or bought by the companies themselves.*



## VIII. THE CZECH REPUBLIC IN THE EUROPEAN UNION – A YEAR AFTER



## VIII.1 A Year After

Last year the Czech Republic along with nine other countries joined the European Union. While the entry marked the culmination of a long accession process, so far EU membership has not dramatically changed the Czech economy. Nevertheless, EU entry gave the country new incentives to strengthen its economic relations with old and new EU members and gave the Czech Republic a full-fledged role in building up a common Europe. The effects of the integration process vis-à-vis the EU countries are already evident and will continue to be so for the foreseeable future. The EU accession has already led to immediate trade liberalization and improved investment climate, which will contribute to further integration and bringing the Czech Republic closer to a moment when it joins the EMU and adopts the euro as its currency.

Joining the EU has also generated high expectations for the general public. Meeting these expectations will not be easy and unless EU membership helps citizens satisfy practical needs, public support for European integration may sooner or later evaporate.

The Czech Republic's first year as an EU member may provide clues as to whether popular support for European integration will persist. The general situation has not changed much since accession. Domestic economic growth has accelerated, as the removal of the remaining trade barriers boosted mutual trade with the Union. Both foreign and domestic investment grew and the trade balance continues to improve further. EU accession had little effect on the Czech labor market and on international labor mobility. Although the current account deficit has remained high, confidence in the Czech crown

strengthened as it continued to gain in value relative to the euro and US dollar. Inflation picked up modestly due to the ongoing harmonization of indirect taxes, though restricted largely by the strong crown and increasingly intense competition on the domestic retail market. Prospects for sustaining domestic economic growth at levels exceeding 4% with stable inflation and moderately declining unemployment seem good for the years to come. So far the Czech Republic has done well within the EU. Looking further ahead many challenges remain although the recent domestic economic record shows few signs of new problems. Upcoming challenges are linked to nominal and real convergence, as "asymmetric shocks" can adversely hit the economy. In this respect, the timing of euro adoption by the new member states has generated the liveliest debate. Beside its general political appeal – related to understanding it either as a promise of further prosperity by the general public or as a vehicle of deeper EU integration on part of the political elite – many practical questions related to the pros and cons of that step, its timing and the country's readiness to take it still remain.

By committing to eventually join the Eurozone, the balance of pros and cons translates into the issue of the most appropriate timing and the readiness for EMU entry of all new member countries. Whereas the readiness question relates more to an "external" assessment based mainly on the Maastricht criteria, considerations of timing have to be based primarily on a "domestic" assessment of conditions and priorities that will serve as a basis for a final political decision.

The convergence process is already under way in the Czech Republic. No fundamental economic obstacles are in sight and the main bottleneck is the unaccomplished fiscal consolidation. Besides that, structural policies aimed at enhancing the flexibility of domestic factor markets, primarily the labor market, would be desirable. The decision about the timing of eurozone entry depends more on domestic political considerations rather than on the existence of major economic weaknesses. However, recently the political and economic landscape of the EU has been changing quite significantly and implications of these changes for the Eurozone are uncertain at the moment. Particularly, the new weakening of the Stability and Growth Pact can hardly be viewed as an argument in favor of early euro adoption, especially given its potentially negative impact on the stability of the single currency area. It can be understood neither as an invitation for new member states, who might present plenty of significant

reasons for more relaxed fiscal policies, nor as a promise that the new currency would necessarily represent a more stable alternative. On the contrary, the appeal of an early euro adoption may be fading particularly for those countries that do not suffer from weak monetary stability.

The recent development in the EU thus opens new questions that have not been yet seriously considered. But they should not overshadow the fact the Czech Republic's EU membership should not be taken as an accomplished deed but rather as a great opportunity to accelerate domestic economic development, to take part in shaping a new, common Europe and in defining and strengthening its common values and foundations. And maybe this is the greatest challenge to be faced: to keep finding and providing evidence that things can be better when there is desire for them to be better and to decide to do what it takes to make them better.

### **Transitory Periods**

*Because of large differences in economic performance and in prices and wages between the current and future member states, there were fears on both sides that enlargement could harm certain markets and social groups. To address these fears, certain transitory periods were required and negotiated. During these periods, the full application of "acquis communautaire" will be postponed. Below is a list of the most important transitory periods and their brief characteristics:*

- *Free movement of workers from the Czech Republic into the EU. For the period of two years there will not be automatic access to the labor markets of the current member states. Under certain conditions, this period can be prolonged for another three years and, under yet further conditions, for an additional two years. After a maximum of seven years no further restrictions are possible. Individual current member states may decide to impose a transitory period or open their labor markets earlier. Five countries, Denmark, Ireland, Netherlands, Sweden and United Kingdom, have promised free access to their labor market from the moment of entry. So far only Ireland, Sweden and United Kingdom have opened their labor markets right away.*

- *A seven-year transitory period for the acquisition of agricultural land and forests in the Czech Republic by current EU citizens. However, no restrictions shall apply to EU-born farmers with permanent residence in the Czech Republic.*
- *Five-year transitory period for the acquisition of secondary residential structures. As of today there are already no restrictions for the acquisition of immovable property by companies registered in the Czech Republic and by the subsidiaries of foreign companies.*
- *Agriculture. Gradual build-up of direct payments to Czech farmers will occur in two stages. In the first stage (2004–2007), direct payments will start at 25% of the EU level in 2004 and will increase by 5 percentage points every year. In the second stage (2008–2013), direct payments will increase by 10 percentage points every year until 2013, when they will reach the EU level. The Czech Republic shall be allowed to make additional payments from its own resources, limited by certain ceilings, above the direct payments from the EU.*
- *Maximum five-year transitory period in road transport, preventing Czech road transport entrepreneurs from offering their services in the current member states. Negotiations are still being held regarding this transitory period, as the Czech Republic opposes its implementation. The major focus is on agreement with Germany, which represents a crucial market for Czech truckers.*
- *Taxes. Permanent exemption enabling the Czech Republic not to require persons subject to VAT to register for this tax if their annual turnover is less than EUR 35,000. A transitory period until the end of 2007 for the application of lowered VAT rate on certain products and services (mainly heating and construction works). A transitory period until the end of 2006 allows for a gradual increase in the excise taxes on cigarettes up to the EU minimum.*
- *Transitory period until the end of 2004 for the liberalization of the gas market. As of this time, the CR should achieve market openness of at least 28%.*
- *Certain transitory periods in the area of the environment: until the end of 2010, for the clearing of municipal wastewater; until the end of 2007, for the reduction of pollution by some pollutants from large combustion facilities; until the end of 2005, for the treatment of packages and packaging waste.*
- *Transitory period of five years for a gradual build-up of contributions to the capital reserves of the European Investment Bank; the first installment shall not occur before mid 2005.*

## VIII.2 A new era in EU politics: Life after the failure of the EU Constitution

The foundations of the current system were laid in the 1950s by the original six member states. Since then, the number of states has increased substantially but, apart from the introduction of direct elections to the European Parliament, the EU's institutional setup has remained essentially unchanged. In May of 2004, membership increased to 25, pushing the EU's boundaries eastwards by hundreds of kilometers and dramatically increasing the disparity in levels of economic development. Given the scale of these changes, European leaders accepted the need for institutional reform in advance of the 2004 enlargement. The discussion of major changes in governance procedures concluded at the Nice conference. The Treaty of Nice enhanced the role of the European Parliament and the Commission and re-distributed power (votes) across member states.

The next step in streamlining EU institutions and governance to cope with the demands of enlargement was to have been the so-called European Constitution. In October 2004, national leaders signed the EU Constitution Treaty in Rome, marking the end of the drafting process which started in 2001. The Constitution would have taken effect November 2006 and would have superseded previous treaties. However, the double defeat of ratification measures by French and Dutch voters killed any hope of adopting the European Constitution in its present form.

### Slamming on the Brakes

Latvia, Hungary, Slovenia and Italy ratified the Constitution by parliamentary votes, and in February 2004, Spain voted overwhelmingly in support in a non-binding referendum.

French voters slammed on the brakes in May 2005, voting "Non" by a 55%–45% margin, even though former French President Giscard D'Estaing was the driving force behind the EU Constitution. Almost all mainstream political parties and figures backed ratification, but leftist voters perceived a strong neo-liberal and pro-market bent to the EU constitution which would constrict generous redistributive policies, and traditional rightist opponents of integration perceived a further loss of sovereignty to Brussels. A few days later Dutch voters handed the EU constitution an even larger defeat in a non-binding referendum. Shortly afterwards, Tony Blair, the British Prime Minister who takes on the EU Presidency for the second half of 2005, said the UK's plans for ratification had been "put on ice." Luxembourg has said it will push on and schedule a ratification vote, and some Polish parties continue to call for a referendum, but these would be merely symbolic gestures.

President Václav Klaus has been a vocal opponent of the European Constitution and wrote an introduction to a Czech translation of an anti-EU publication originally put out by an Irish think tank. The current Czech government maintains a pro-EU stance, though Prime Minister Paroubek has admitted that holding a Czech referendum is now "pointless." Paroubek kept Klaus in check by threatening to restrict the President's official travel unless Klaus respected the government's EU policy.

Proponents of deeper European integration will then have to retreat and rethink. Past grumblings about the EU's "democratic deficit" and the nontransparent and elite-led integration process are coming to the center of

the political debate and old top-down tactics no longer suffice. However, even if the ratification process stalls, the EU will remain a major player both externally and for member states. Especially in former transition countries, the process of harmonizing laws and practices will continue, and lowered trade barriers will continue to drive economic and financial convergence. However, the planned accession of Bulgaria and Romania is not completely certain now. The more controversial long-term possibility of Turkey's entry is another source of friction between the US and UK, which support Turkish entry, and many continental conservatives who see Turkey as too big, too poor and too Islamic.

### **What Would the EU Constitution Have Changed?**

The EU Constitution would have streamlined the EU's governance structure and modified the division of powers between the EU and the member states, continuing the economic and political integration of Europe. Following the addition of 10 new members in 2004, the Constitution would have re-engineered key voting rules to reduce the possibility of organization deadlock and further the process of creating stronger political ties among European countries. Few substantive changes were proposed for the basic structure of the three governing components, the Council of the EU, the European Commission and the European Parliament. Under the Constitution the Council, which directly represents the governments of member states and is thus the most powerful body within the EU, would have used a more stringent qualified majority rule after 2009. Most proposals would have required 55% of votes of states representing

65% of the EU's population of 455 million, or would pass if fewer than four countries oppose it. Proposals involving taxes, social security, foreign policy and defense would still have required unanimity.

This represented a compromise among smaller states, wishing for higher supermajority thresholds, and larger states such as Germany and the UK, which wish to exercise power more in proportion with their population. Despite the streamlined voting rules, blocking coalitions would not have been difficult to construct, given the high degree of consensus required among members.

The Council would have elected a President for a two-and-a-half year term to replace the current scheme in which the Presidency rotates among countries every six months. The Council would have also chosen a EU Foreign Minister to oversee foreign and security policy, when and if member states were able to agree.

The European Commission was slated to shrink from 25 to 18 members after 2014, although an escape clause allowed modification of this number by the unanimous vote of members. The European Parliament would have gained the right to "co-decide" policies with the Council where a qualified majority is needed.

The Constitution would have taken limited but important steps towards expanding the EU's responsibilities by including a Charter of Fundamental Rights and by eliminating national vetoes in critical areas such as law enforcement and judicial cooperation. The Constitution asserted the primacy of EU law over national law in policy areas where the EU has been granted powers; however, this reflects current practice.

## Weighing the Pros and Cons

The principal benefit of the EU has been the expansion of the common market through the lowering of trade barriers. Expanding intra-European trade has raised incomes and competitiveness, providing clear material benefits. The benefits of the introduction of the euro are less obvious, and the Eurozone is not obviously an optimal currency zone. Firms and tourists have avoided millions in currency exchange fees, but growth in the major European economies has remained sluggish since the appearance of the euro.

The Stability Pact, which was added to the Maastricht Treaty at the insistence of Germany, was intended to avoid divergent fiscal policies that might undermine a common monetary policy. Initially the Pact's requirement that government deficits not exceed 3% of GDP provided incentives for fiscal discipline, but the prolonged sluggishness of the French and German economies led those governments to flout the Stability Pact's requirements, much to the dismay of those governments which expended political capital to make painful budget cuts. The uncertain status of the Stability Pact has complicated the planning for expansion of the Eurozone.

Harmonization of national laws has eliminated many non-tariff trade barriers and provided European business with a more standardized set of requirements. Furthermore, harmonization has brought long-needed reforms where reform at the national level had stalled. This harmonization process also created tensions as different nations have different needs and preferences about the right level of regulation. Critics such as Václav Klaus have emphasized the EU's tendency to create new bureaus and regulations. On the other hand French critics argue the Constitution tilts towards neo-liberal competition and economic policy and limits the ability of national governments to maintain a "social economy."

Whether these EU-mandated regulations are good or bad is controversial. For example, EU-mandated regulations now forbid Czech cooks from serving goulash for more than three hours, even as everyone knows it's best after two days. However, this rule closely resembles rarely-enforced 1961 Czech regulations. Most chefs acknowledge that EU food safety regulations and the need to demonstrate that Czech kitchens should meet western standards provided a needed boost in cleanliness and hygiene standards.

Central European farmers are now subject to 80,000 pages of EU regulations on the environment, animal welfare, and sanitation and food quality. Smaller producers unable to meet EU requirements have been going out of business. Czech inspectors closed down 600 out of 4,000 meat and milk processing plants failing to meet EU requirements. The remaining producers stand to gain substantial market shares and will benefit from CAP subsidies as well. While Central European farmers face large compliance costs, they will receive higher prices for many goods. However, although the price gap between new and old EU members has narrowed for some goods, prices for Czech products will fall. In the long run, Czech farmers stand to benefit from lower land and labor costs, although the CAP system will blunt these advantages.

In the first year after accession, the EU is paying only 25% of the level of subsidies paid to western producers, although governments of the new accession states are allowed to top up those payments. EU payments are scheduled to rise to western levels in ten years. However, major budget fights over subsidies will dominate EU politics in the next few years.

### VIII.3 Politics of European Integration

Beyond economic benefits, supporters of European integration have always stressed the need for political integration. The rhetoric of Jean Monnet, whose vision and energy was the driving force behind the founding institutions of European integration, stressed the need to intertwine national economies of former enemy states to make future wars impossible. Politicians with long memories or active imaginations about the distant future emphasize the importance of creating European institutions which would limit the ability of national governments to create division and discord.

Evaluating these claims is at best an exercise in cautious speculation. Certainly Western Europe in the past half century has enjoyed a unique period of peace and prosperity. The contrast with the disappointed optimism of those who considered World War I the “war to end all wars” is complete. No serious analyst foresees any risk of war in Western Europe for the foreseeable future.

Some therefore conclude that the European Unification project has already gone sufficiently far to guarantee peace and security. Critics of further European integration point out that forcing greater conformity among diverse nations is as likely to create as to avoid conflict. For others the horror of another land war in Europe is terrifying enough to require supernational institutions that will dampen nationalist passions.

In the medium term, prosaic and venal concerns will matter more. Accession negotiations for the 2004 enlargement spent much time upon agricultural subsidies and the prospect for other financial transfers. EU accession also promises to pump significant

resources into the new accession economies through improved highways and infrastructure projects. Central European farmers now benefit from the stream of Common Agricultural Fund money from Brussels, while central European consumers have yet to feel the cost of the distortions caused by those subsidies. Many in Western Europe worry that the new accession states have unrealistic expectations of EU subsidies, and hope that the accession states lack the political muscle to expand what they receive in EU structural funds.

The proposed EU Constitution and last year’s accession reflect differing views and hopes of the major member states. States such as the UK hoped that the expansion of the EU would eventually lead to a reconsideration of the Common Agricultural Policy, which takes up about half of the EU’s total budget. If central European farmers were to receive more than a fraction of the benefits available to western European farmers, a major budget crisis would follow, perhaps leading to a sharp across-the-board cut in the level of subsidies. The June 2005 EU summit failed to reach an agreement on the EU 2007–2013 budget because of major disagreements on the CAP and national contributions.

Leaders from net budget beneficiary countries such as France, hoped that a “deepening” of the EU via the proposed constitution would protect the CAP from major reforms for another decade. However, large numbers of French voters feared that further European integration would increase competition from low-wage countries to the East. The far-right French activist Philippe de Villiers stirred up fears that “Polish plumbers” would steal jobs

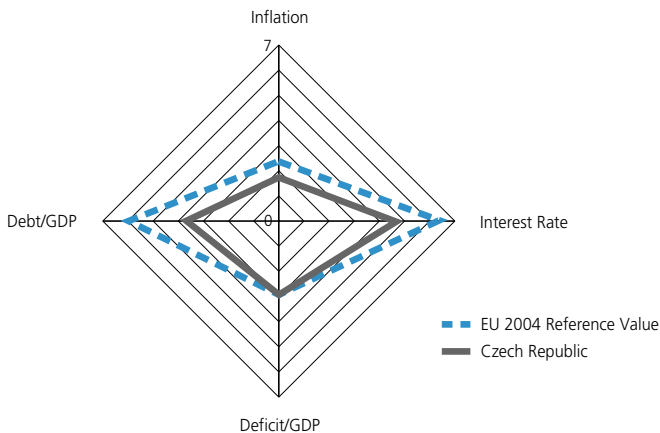


from blue-collar French workers. The French plumbers union's statistics show a deficit of about 6,000 plumbers and a total of about 150 Polish plumbers. One foreign correspondent in Paris noted that French workers asked 10,000 euros to repaint an apartment while Polish workmen in the informal sector asked

800 euros for the same job. If French voters hoped the defeat of the European Constitution would continue their insulation from world market forces, they will be ultimately disappointed. Economic pressure from lower wage countries whose citizens still know how to work hard cannot be infinitely postponed.

## VIII.4 Convergence of the Czech Economy with the Euro Area

Fulfilment of Quantitative Maastricht Criteria in 2004



Once in the European Union, the Czech Republic is obliged to govern its policies with the aim of ultimately joining the euro area and adopting the euro as its currency. Such a step involves giving up independent monetary policy and being governed by monetary policy that is designed for the average country of the euro area. One of the prerequisites to cope well in such an environment is that the economy responds to global economic shocks similarly to the average EU economy and that it has sufficient resilience and reserves to cope

with asymmetric shocks. It is therefore interesting to look at the degree of convergence of the Czech economy to the aggregate EU economy. The Maastricht treaty partly addresses these issues and defines the administrative requirements for entry to the euro area, requiring sufficient price stability, sustainability of government finance, exchange rate stability and the convergence in the long-term interest rates (for more details, see below *“Real, Monetary and Fiscal Convergence: To Worry or Not to Worry?”*).

**Table 1: Compatibility of Legislation and Fulfilment of Convergence Criteria**

	Legal compatibility	Price stability	Government budgetary position	Exchange rates	Long-term interest rate convergence
Czech Republic	no	yes	no	no	yes
Estonia	no	yes	yes	no	–
Cyprus	no	yes	no	no	yes
Latvia	no	no	yes	no	yes
Lithuania	no	yes	yes	no	yes
Hungary	no	no	no	no	no
Malta	no	no	no	no	yes
Poland	no	no	no	no	no
Slovenia	no	no	yes	no	yes
Slovakia	no	no	no	no	yes
Sweden	no	yes	yes	no	yes

Source: European Commission Convergence Report 2004

### Fulfilment of the Maastricht convergence criteria

According to the legislation of the European Union, EU member states must achieve a high degree of convergence as a precondition for joining the euro area. For this purpose, convergence is officially measured by the fulfillment of four criteria: sustainability of price stability observable from inflation developments; long-term sustainability of the government budgetary position as measured by the government deficit and government debt; sustainability of exchange rate stability; and durability of convergence as reflected in the long-term interest rate levels.

The comparison of performance in these criteria based on the European Commission

2004 Convergence Report is presented in Table 1. Disregarding the incompatible legislation in the monetary policy area and the lack of successful functioning in the ERM II for at least two years (two issues yet to be fulfilled for all countries), there is varied progress in the convergence in the three remaining fields. While the criterion of long-term interest rate convergence was accomplished by most countries (the two exceptions being Hungary and Poland), less than a half of them, including the Czech Republic, fulfill the price stability criterion. The government budgetary criterion has been problematic for the Czech Republic as well as for the majority of the new EU members.

The actual figures for the Czech Republic are compared to the corresponding reference

**Table 2: Comparison of Actual and Reference Values of Four Maastricht Criteria**

	Inflation (%) <sup>a)</sup>	Interest rate (%) <sup>a)</sup>	Deficit/GDP (%) <sup>b)</sup>	Debt/GDP <sup>b)</sup>
CR	1.8	4.7	3	0.37
EU 2004 Reference Value	2.4	6.4	3	0.6

Source: European Commission Convergence Report 2004

Notes: a) Inflation and interest-rate criteria are evaluated for a period of twelve months to August 2004.

b) Data for government deficit and debt are for the year 2004.

values in Table 2. Since official reference values for inflation and long-term interest rates are defined as a function of the distribution of the realized values in the EU member states, they are officially reported only in the Convergence Report on a biannual frequency. Therefore, the August 2004 levels of inflation and long-term interest rates are compared. For the fiscal indicators, however, the most up-to-date values (i.e., end-of-year 2004 figures) can be compared because the reference limit values are set in absolute terms. In this regard, the Czech Republic is meeting all the Maastricht criteria except the two mentioned

above. However, this simple comparison fails to demonstrate whether satisfying the convergence criteria is sustainable. While inflation and interest rates have been under control for a long time, public finances have a less positive reputation. The fulfillment of the fiscal criterion in 2004 deserves no celebration. Instead, it should be rather taken as coincidental, as the Czech government was not able to fulfill its spending plans. In fact, plans for 2005 call for pushing public expenditure beyond the convergence criteria limits and sustainable fulfillment of the convergence criteria can only be expected in 2008.

## VIII.5 Economic Alignment with the European Economy

While the Czech economy has gone far in terms of stabilization, important disparities persist between the Czech economy and the economy of the European Union as a whole, or between the Czech economy and the euro area. Some disparities result from the slow convergence of the Czech economy to Western European levels. To illustrate, the Czech per capita income is at 64% of that of the former EU15 and at about 70% of the EU25. This rather large income gap has not changed significantly since the mid 1990s due to relatively slow average economic growth in that period. For serious convergence to take place, there must be a stable and positive differential between the Czech and the EU average GDP growth. For exam-

ple, for the Czech economy to converge to the average EU15 income per capita level in 20 years, the growth differential (adjusted for differences in population growth) would have to well exceed 2% on a sustained basis.

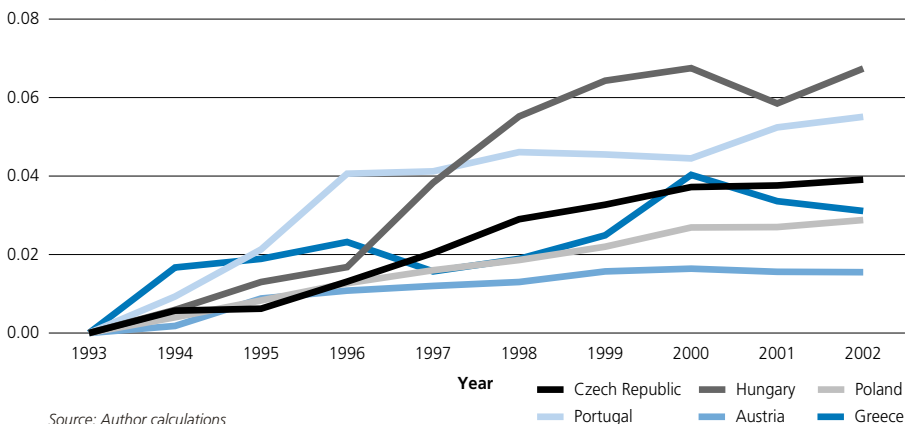
Furthermore, although the link between the opening of EU markets and Czech exports and GDP is indisputable, the Czech business cycle remains out of phase with the cycle of the larger EU countries. A simple correlation of yearly differences of quarterly GDP time series ( $\ln \text{GDPT} - \ln \text{GDPT} - 4$ ) for the period 1995–2003 shows that, in contrast to Hungary and Poland, the GDP growth in the Czech Republic has not moved systematically in parallel with the growth in either the EU as a whole (EU25) or with the euro area.

### Correlation of Economic Growth Rates, 1995–2003

	Czech Republic	Greece	Hungary	Austria	Poland	Slovakia
EU25	-0.38	-0.10	0.69	0.80	0.52	-0.29
Eurozone	-0.26	-0.02	0.68	0.59	0.21	-0.30

Source: Author's calculations

## Change in the Nominal Structure of Exports between 1993 and 2002



Source: Author calculations

The intensity of structural changes is approximated by Landesmann's index

This means that the Czech economy was not speeding up or slowing down at the same time as the EU aggregate, as were other newer EU countries such as Greece. However, two idiosyncratic shocks – the financial crisis in 1997 and the floods in 2002 – probably reduced the correlation between the Czech and aggregate EU business cycles.

On the other hand, both the small-open-economy features and the EU association agreements that have largely opened the European markets enabled the Czech Republic to integrate more into the European economy. The share of foreign trade turnover directed to the European markets has been growing over time and has stabilized at high levels, the last momentum coming from the elimination of the remaining trade barriers

upon entry into the EU in May 2004. During the time of exposure to competitive pressures on western markets, the structure of exports was bound to change. The measurement of structural changes in exports over time using the so-called Landesmann's coefficient confirms that undeniable changes in the export structure have taken place. The total index is computed as a weighted average of the changes in the shares of 65 export-good groups (according to the SITC classification) over time, where weights are the initial shares of these export goods. The coefficient takes values from the interval [0, 1] and increases in the degree of structural changes. Figure above shows, however, that in comparison with other countries this change was not extraordinarily large and was

## Structural Similarity with the Eurozone and EU25, 2003

	Czech Republic	Hungary	Austria	Portugal
Eurozone	0.19	0.08	0.05	0.04
EU 25	0.18	0.08	0.05	0.04

Source: Author's calculations

Note: Landesmann's index of structural difference

comparable to that of Greece or Poland. The change in the structure of Czech exports was mainly driven by growing specialization, where transport vehicles and electric equipment account for major shares of both exports and imports. Currently, the structure of Czech exports closely resembles that of Germany.

Whether high economic integration has reflected also in a high similarity of industrial structure with the European economy is a natural question. Landesmann's coefficient was used again, this time in its spatial specification, to compare the shares of six NACE

production sectors in total value added between selected countries and the European Union. Similarly, the measure ranges between 0 and 1, with low values indicating proximity of economic structure. The degree of similarity of the Czech economy is relatively high though not as high as in Hungary, for instance. The Czech economy differs from the average EU country, principally, in its relatively higher shares of value added concentrated in industry and recently also in trade and somewhat lower share of value added in public services.

### **Real, Monetary and Fiscal Convergence: To Worry or Not to Worry?**

*(Based on Evžen Kočenda, Ali M. Kutan, Taner M. Yigit (2005): "Pilgrims to the Eurozone: How Far, How Fast," CERGE-EI working paper no. 270)*

*In May 2004, ten new members joined the European Union (EU). Eight of them were Central and Eastern European countries namely the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, Slovenia and the other two new members were Cyprus and Malta. For these countries the goal of economic integration is to achieve real per-capita income convergence to the EU average, and, the next necessary step toward integration into the Eurozone is to satisfy the Maastricht criteria. In brief these are: monetary criteria of achieving price stability and convergence of an average nominal long-term interest rate; fiscal criteria of a stable government financial position without an excessive deficit, defined as the ratio of government deficit to GDP not exceeding a reference value of 3% and the ratio of government debt to GDP not exceeding a reference value of 60%; finally, normal fluctuation margins for the exchange-rate mechanism for at least two years without devaluing against the currency of any other EU member country.*

*The empirical literature on real and monetary convergence yields mixed results, which are sensitive to the sample period used, selection of countries, and the methodology employed. Studies on fiscal convergence are scarce. Nevertheless, it is very important to quantify exactly where each of the countries stands in terms of convergence process and specific risks that must be overcome in the process of joining the Eurozone. The background study for this feature article provides comprehensive analyses of real, monetary and fiscal convergence for all recent EU members. It uses an advanced technique that allows the incorporation of structural changes in measured parameters that are due to shifts in economic developments as well as policy steps. The flexibility of this test allows analyzing the absolute convergence in the*

presence of structural breaks in emerging economies, which is very important in drawing correct inferences about convergence as well as the process of “catching up” of the new entrants to the older EU members.

To measure real convergence to the levels of the core EU members, quarterly data on real GDP per capita were employed, and convergence suggests a significant improvement in the standard of living of citizens of the new member-countries. Furthermore, real convergence was measured using not only local currencies but also common currency exchange rates to capture the impact of euro-area aggregate demand changes. The monetary convergence analyses include broad measures of inflation convergence that has significant implications for interim optimal exchange rate and monetary policies before a formal link to the euro. Measures of inflation convergence incorporate two different angles by using two benchmarks: the Maastricht inflation criteria and the European Central Bank price stability approach, which excludes inflation “outliers” when computing the inflation benchmark. ECB’s inflation target test allows inferring whether the new member countries, at least those that adopted an inflation targeting regime (the Czech Republic, Hungary and Poland) are ready to follow ECB’s inflation targeting approach. The results are encouraging.

The analyses of fiscal convergence have particular importance for new EU countries as prudent fiscal performance is the most important condition for the new members to satisfy before adopting the euro. Deterioration of fiscal performance may constrain new member countries from satisfying the Maastricht criteria because large fiscal deficits may create inflationary pressures. Achieving fiscal sustainability is not only necessary but also a sufficient condition for the new EU members to achieve full EMU membership. To investigate fiscal convergence, two fiscal benchmarks of the Maastricht criteria were used at first. Real fiscal performance data were employed as well to test whether the accession countries are performing like the EU core countries; in this case deficit and debt ratios as percentages of the (old) EU GDP were used.

The results of analyses indicate slow but steady per-capita income convergence towards EU standards. Despite the observed widening of the gap between GDP per capita levels in euros, an inspection of growth rates suggests that the faster growth rates of new members will narrow the gap, leading to “catching-up” in the next few decades. There is significant inflation and interest rate convergence. However, progress on fiscal convergence is discouraging, indicating a lack of fiscal sustainability. An important policy implication of the results is that current fiscal practices may delay the new members’ entry into the Exchange Rate Mechanism II (ERM2) and hence their adoption of the euro. Authorities need to better coordinate monetary and fiscal policies to address their reasons for lack of fiscal convergence and, therefore, they should not to rush to enter the Eurozone prematurely.

## EU Enlargement and Exposure to Idiosyncratic Shocks

*(Based on Babetskii, I. (2005): "Trade Integration and Synchronization of Shocks: Implications for EMU Enlargement." Economics of Transition, 2005, 13(1), pp.105–138.)*

The question of sharing a common monetary policy has been on the top agenda since May 2004. Three newcomers – Estonia, Lithuania and Slovenia – entered the Exchange Rate Mechanism II shortly after EU enlargement, by the end of June 2004, thus expecting to adopt the euro in two years. Would it be beneficial for the New Member States in general and for the Czech Republic in particular to become a part of the European Monetary Union (EMU) at their earliest convenience, or to postpone euro adoption for a number of years? The large part of the answer depends on the cost aspects of joining the euro area, namely on the degree of shock asymmetry between the EU and the New Member States.

The issue of shock asymmetry has received particular attention due to the development of the optimal currency area (OCA) theory. According to the classical OCA criteria, two countries or regions would benefit from forming a monetary union if they are characterized by high similarity of business cycles, if they have strong trade links, and if they possess an efficient adjustment mechanism that can mitigate the adverse effects of asymmetric shocks. The first criterion is often considered the key one. Indeed, if the business cycles of two countries are highly synchronized, or in other words if countries are exposed to symmetric shocks and exhibit similar responses to these shocks, a common monetary policy response does not introduce imbalances between them. In other words, higher symmetry of shocks between countries, *inter alia*, implies a lower cost of sharing a common monetary policy. Much interest, therefore, has been focused on estimating the degree of shock asymmetry between countries or regions. As far as the new EU members are concerned, empirical studies have only recently begun to appear as longer time series become available. The still scarce evidence suggests that the New Member States (NMS) have achieved some synchronization of their business cycles with the EU, at least on the demand side. It is commonly stressed, however, that the period of transition/accession is too short to draw robust conclusions.

Along with the measurement issue, another question concerns the link between economic integration and shock asymmetry. There are two opposite views on this subject, usually classified as "The European Commission View" and the "Krugman View." According to the European Commission view, closer integration leads to less frequent asymmetric shocks and to more synchronized business cycles between countries. From the alternative point of view the opposite effect should prevail: international trade increases specialization, making shocks more asymmetric. The overall impact of trade integration on shock symmetry could thus be ambiguous, at least theoretically. Modern formal models do not seem to offer a unique answer either.

Drawing on the evidence from a group of eight central and eastern European NMS, which have experienced an impressive increase in trade openness and economic integration with the European Union during the past decade, this study tries to find out whose argument is supported by the data. Since the trade of these NMS with the EU has significantly increased over the transition period, and since several countries have pegged their currencies to the

*Deutschmark, subsequently replaced by the euro, there is sort of a “natural experiment” for testing the impact of integration on synchronization of macroeconomic shocks between the EU and NMS.*

*Methodologically, a two-step procedure is applied. In the first step, two types of shocks are distinguished and identified: supply shocks and demand shocks. In the second step, after the identification of shocks, there is an analysis of the evolution of shocks over time, in particular the question whether there is convergence of shocks across countries is addressed.*

*The results show that there is convergence of demand shocks and divergence of supply shocks between the NMS including the Czech Republic, on the one hand, and the EU-15 and Germany as alternative benchmarks on the other hand. It is also found that (i) an increase in trade intensity leads to higher symmetry of demand shocks; (ii) a decrease in exchange rate volatility has a positive effect on demand shock convergence and no significant impact on supply shocks.*

*The results for demand shocks can be interpreted in favor of “The European Commission View.” Also, the attempts by some NMS to fix their currencies to the euro contribute to the synchronization of demand shocks. Putting it in practical terms, the results suggest that a policy change (e.g., steps towards forming a monetary union) decreases shock asymmetry for the Czech Republic and other NMS, thus decreasing costs of adopting a common currency.*

*On the supply side, asymmetry of shocks is not necessarily bad from the point of view of EMU membership. Supply shock divergence characterizes the process of catching-up at work: productivity gains in the NMS translate into increases in per capita incomes. Supply shocks can be also interpreted in terms of Schumpeterian “innovations,” which are perceived as an engine of technological progress.*

*Notice that overall implications should be mentioned with caution. The importance of the OCA criteria to the analysis of membership in a monetary union should not be overemphasized. The degree of symmetry of contemporaneous shocks is only one aspect of the costs associated with monetary union membership. There might be other costs of EMU accession of at least the same importance as dissimilarity of shocks.*



## IX. COMPARATIVE STATISTICS

### Comparison of Selected Economic Indicators for CEFTA Countries\*

#### General Characteristics in 2004

	CZ	HU	PL	RO	SK	SL
Surface	78,886	93,030	312,685	238,391	49,034	20,273
Population (in thousands)	10,211.5	10,116.7	38,190.6	21,711.3	5,380.1	1,996.4
Urban share (%)	75	65	63	55	58	49
Economic. active (% , 2003)	64.7	57.0	51.2	57.6	57.7	62.6

#### Level of Development in 2004

	CZ	HU	PL	RO	SK	SL
GDP total (current prices, mln. of EUR)	86,265	80,331	195,206	58,535	33,119	25,895
GDP per capita (EUR)	8,448	7,940	5,111	2,696	6,156	12,971
GDP per capita (EU25=100)	38	35	23	12	27	58
GDP per capita in PPS <sup>a)</sup> (EU25=100)	70	61	47	31,7 <sup>b)</sup>	52	78

Note: a) Purchasing power standard

b) Forecast

#### Real Growth Rates in 2004

	CZ	HU	PL	RO	SK	SL
GDP	4.0	4.0	5.3	8.3	4.6	5.5
Gross fixed capital formation	10.0	10.8	4.2	17.0	8.9	10.0
Industrial production (NACE classification)	9.2	7.5	12.2	5.3	3.8	4.0
Construction	7.2	6.3	-0.7	8.9	2.5	5.6

\* CZ – Czech Republic, HU – Hungary, PL – Poland, RO – Romania, SK – Slovakia, SL – Slovenia

**Unemployment, Wages and Prices in 2004**

	CZ	HU	PL	RO	SK	SL
Unemployment rate	8.3	5.9	18.8	7.1	18.0	6.0
Average gross monthly wage EUR	524.0	567.0	515.0	206.0	395.0	1,118.0
Real growth rate of wages	6.0	7.5	4.1	16.1	12.0	6.8
Consumer Price Index	2.6	6.8	3.6	11.9	7.4	3.6
Producer Price Index	5.7	8.4	7.6	18.5	3.4	4.3

**Government Deficit, Current Account and Debt in 2004**

	CZ	HU	PL	RO	SK	SL
Deficit as % of GDP	-3.0	-4.5	-4.8	-1.1	-3.3	-1.9
Gross government debt as % of GDP	37.4	57.6	43.6	23.6	43.6	29.4
Current account (2003) as % of GDP	-6.1	-9.0	-2.0	-5.7	-0.9	-0.4

**Exports and Imports in 2003**

	CZ	HU	PL	RO	SK	SL
Imports (mln of EUR) <sup>o</sup>	45,239	42,138	60,354	21,201	19,910	12,237
Growth rate of imports	5.2	5.5	3.2	12.3	13.7	5.7
Exports (mln of EUR)	43,027	37,654	47,526	15,614	19,305	11,285
Growth rate of exports	5.8	3.2	9.3	6.4	26.7	2.9
Trade balance (mln of EUR)	-2,212	-4,485	-12,827	-5,588	-606	-952

Source: Eurostat

Note: c) Constant prices

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