CZECH REPUBLIC 2003/2004

Entering the EU

An Economic Survey
Produced by

CERGE-EI

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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Early Transition Policies and Outcomes

The Czech Republic 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 1996 recorded still a robust 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" 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 on all 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 the managerial capital to restructure and operate firms, which faced fierce international competition due to a high degree of openness. The 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 Czech job creation during early reforms so that five years into transition de novo firms offered more jobs than the state and privatized firms combined.

General Information

Year	1997	1998	1999	2000	2001	2002	2003
GDP							
GDP Growth	-0.8	-1.0	0.5	3.3	3.1	2.0	2.9
Foreign Trade							
Exports, real y/y %	9.2	10.0	6.0	17.0	11.9	6.1	9.3
Imports, real y/y %	8.1	6.6	5.4	17.0	13.6	4.2	8.8
Trade Deficit as % of GDP	-8.3	-4.4	-3.4	-6.3	-5.5	-3.1	-3.0*
Balance of Payments as % of GDP and Its Main Components							
Current Account	-6.7	-2.2	-2.7	-5.3	-5.7	-6.4	-6.6*
Inflow of FDI	2.4	6.6	11.9	9.3	8.7	13.4	2.8*
Inflow of FDI (bln. USD)	1.3	3.7	6.3	4.6	4.9	9.3	2.3*
Inflation and Interest							
CPI, y/y %	10.0	6.8	2.5	4.0	4.1	0.6	0.1
PRIBOR 2T	18.1	14.2	6.9	5.3	4.7	3.6	2.3
Labor Market							
ILO Unemployment, %	4.8	6.5	8.7	8.8	8.1	7.3	7.8
Employment, y/y %	-2.0	-1.4	-2.4	-0.2	0.3	-0.4	-1.1*
Real Wages, y/y %	1.3	-1.3	6.2	2.4	3.8	5.3	6.4*
Public Finance							
General Government Balance as % GDP	-1.2	-1.5	-0.6	-3.7	-3.2	-3.9	-6.2*
Idem, Excluding Extraordinary Items	-2.0	-1.5	-3.0	-4.3	-5.1	-6.7	-7.0*
Exchange Rates							
CZK per USD	31.7	32.4	34.6	38.6	38.0	32.7	28.3
CZK per Euro	18.3	18.3	18.9	18.2	34.1	30.8	31.8

Source: CSO, CNB, Ministry of Finance, World Bank, (*) CERGE-EI estimates.

The Currency Crisis and Recession of 1997

The 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. 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 of 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 red numbers 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 of 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 government headed by Václav Klaus' Civic Democrats and the resulting early elections of 1998. Further, following party finance scandals, a significant number of Civic Democrats established a new liberal right-center party. The early elections of 1998 were won by Social Democrats, who formed a minority government. Since then, Social Democrats stayed in power. The party won the 2002 elections and formed a coalition government with two smaller centrist parties.

Recent Macroeconomic Development

Starting in 1998, the strict monetary policy of the currency crisis was relaxed by the central bank. Facing recession, the new government revived structural reform and privatization, this time relying on strategic foreign partners. Further, in April 1998 the government introduced an aggressive FDI incentive package for manufacturing investors bringing more than USD 10 million. Yet, 1999 GDP remained in red numbers.

Finally, in 2000 the economy accelerated. Investments started to grow, most of all thanks to the surge of foreign direct investments (FDI), but domestic firms started to invest more as well. FDI inflow continued at similar strength during 2001, thanks to both the incentive package and the expected accession of the Czech economy into the EU. 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 crisis. The deficit narrowed from above 6% of GDP in 1997 to below 3% in 1998 and 1999, but 2000 saw worsening to just around 5% of GDP and this trend continued through 2003. The key difference from the 1997 situation, however, is in the financing of the current account deficit. While it was the unstable short-term capital, which financed the current account deficit prior to the 1997 crisis, the recent current deficit was 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 prices of housing and utilities. Later, the revival of domestic demand, higher commodity prices (mainly oil) and several idiosyncratic factors had been working to increase inflation, which reached the 4% mark by 2000. Since then, however, the country has imported some deflation and inflation remains close to zero.

The main macroeconomic concern of the Czech economy is the high 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 concurrent economic recovery made clear that the deficit was not merely cyclical. Since 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 severely restricted in recent years. Between 1994 and 1999, social security and welfare expenditures rose by 3.2% of GDP. Public expenditure 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% to almost 42% of GDP between now and 2006 and reach the magic 60% of GDP before 2010.

In sum, after 1999, the Czech economy successfully emerged from the recession with GDP growth rates around 3%. The recovery was driven by private investments, primarily FDI, which also financed the widening trade deficit. While inflation was low, real wage growth resumed after the recession and was so far in line with productivity growth. Unemployment stayed in the neighborhood of 9%. The GDP growth of around 3% and high unemployment of around 10% are expected to prevail in the years to come. The fiscal deficit remains the sorest part of the Czech economy and the government's unwillingness to cut mandatory expenditures does not offer much hope for substantial improvement. Among the other main outstanding policy challenges (also voiced in the annual pre-accession EU reports) are the inefficiency of public administration, the much-needed reform of the judicatory system, the insufficient use of public tenders by the government, and the taming of corruption.

The Czech Republic – An Economic Summary of 2003

Despite the EU slowdown, during 2003, the Czech Republic experienced moderate economic growth of about 3%. Growth was driven primarily by domestic consumption, but investment and exports also helped from the third quarter of the year. The significant FDI inflow of the past continued, although the record level of the 9 billion USD the Czech economy received in 2002 will not be matched as there was no significant privatization this year; the 2003 FDI inflow figure should be at most about 5 billion USD. The continuous massive long-term capital inflow continues to keep the Czech currency under appreciation pressures. To complete the picture, inflation fell also and is expected to be almost exactly 0%.

Yet, despite the moderate economic growth, the employment decline of 2002 continued and registered unemployment reached double-digit levels at the end of 2003. Furthermore, the moderately positive aggregate signals cannot be correctly interpreted without noting the continuous expansionist governmental fiscal policy. The price of the moderate growth is high: the state budget deficit skyrocketed from 46 billion CZK in 2002 to 109 billion in 2003 so that the central government deficit alone constituted almost 5 percent of GDP, with little improvement projected for 2004. The government has prepared – at most – moderate fiscal reform but during the course of the year the real reform steps were even further softened and postponed. The optimistic aim of the reforms is to bring the deficit down to 4% by 2006.

The Czech Republic held a referendum on EU accession in June. The vote was strongly in favor of entering the EU in May 2004 (77.3%), although the turnout was only just above 55%. The European Commission's last pre-accession annual report on the Czech Republic was favorable. It should be noted that the Czech Republic has reached a high level of alignment with the acquis in most policy areas.

Year 2003 in the Czech Republic – Major Political and Economic Events

January

- *The President was not elected in the first round of the presidential election; the final two candidates were Mr. V. Klaus and Senator P. Pithart.*
- *The ČSU announced a major revision of foreign trade figures due to errors made (the deficit was reduced from 94 billion CZK to 55 billion).*
- *Parliament failed to elect the President in the second round of the presidential election; the final two candidates were Mr. V. Klaus and Senator J. Moserova.*
- *CNB cut rates by 0.25%, unemployment surpasses 10% to 10.2%.*

February

- *Vaclav Havel's presidential term ended.*
- *The President of the CSO Ms. M. Bohata stepped down.*
- *Union Bank got into trouble; later is closed down.*
- *On the last day of February Mr. Vaclav Klaus was elected President of the Czech Republic; the final two candidates were Mr. V. Klaus and university professor J. Sokol.*

March

- *The government asked for a confidence vote. It got 101 votes for, 99MPs were against.*
- *The Czech Republic lost a 10-billion CZK court dispute with CME for failure to protect its investment in private TV channel Nova.*
- *The Iraqi war started. The Czech Republic supported the Allied forces with its chemical brigade in Kuwait and a field hospital in Basra.*
- *The government cancelled a suspicious contract to build the highway to Ostrava.*

April

- *The EU parliament approved EU enlargement by 10 countries. In the case of the Czech Republic 489 votes were in favor, 39 against and 37 abstained.*

May

- *The Minister of Justice stepped down as he was elected to the Constitutional Court.*
- *The Minister of Defense resigned.*

June

- *University teachers went on strike complaining about their salaries and financing of education.*
- *In a referendum on June 13th and 14th on EU accession in May 2004 the vote was 77.3% in favor, although the participation rate was only 55.2%.*
- *Government announces the need of fiscal cuts of 200 billion over three years.*

July

- *President vetoed the VAT increase of services (form 5% to 22%), his veto was later over-ruled by Parliament.*

August

- *CNB cuts discount rate to 2%.*
- *A major travel agency, Fisher, went bankrupt; the following reorganization was successful.*

September

- *Teachers went on strike during the first day of the school year complaining about their salaries.*

October

- *Liechtenstein refused to sign the enlargement treaty of European Economic Area because of restitution claims against the Czech Republic; the treaty is signed later.*
- *CSO re-calculated the Czech GDP level using ESA methodology; the Czech Republic GDP level is at 64% of EU average.*

November

- *The smallest coins (10 and 20 heller) are abolished.*
- *The final pre- accession EU report on the Czech Republic is published.*

December

- *The Lower House approves the government budget for 2004 with a record deficit of 115 billion CZK.*

I.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 the 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 army. 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, a 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 will become 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 leave the country.

1992 The separation of Czechoslovakia, establishing the Czech and Slovak Republics in 1993.

1999 On March 12, the Czech Republic officially joined NATO.

2004 In May 2004, the Czech Republic joins 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 demographic 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 census	%	2001 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
Total	**488,933**	**4.7**	**807,456**	**7.9**

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

Aging of the Czech Population

Czech demographic development is not positive. During the nineties, the population of the Czech Republic stagnated, and even decreased (in 1990 10.363 million; in 1999 10.283 million; the last census taken in the first quarter of 2001 recorded 10.298 million).

The main factors influencing the demographic development have affected it in different ways: the number of deaths steadily sinks, from 129.2 thousand in 1990 to 109.0 thousand in 2000; the infant mortality rate of 4.6 is, together with Slovenia, the lowest among EU candidate countries; the net migration is positive. But the number of births is declining very quickly (the number of live births in 1990 was 130,564, but since that year it constantly decreased

Age Structure Development and Projection (% of Total Population):

Age	1980	1991	1995	2000	2010	2010	2030
0–14	23.5	20.6	18.3	16.2	13.7	13.7	12.4
15–64	63.2	66.6	68.4	69.0	70.2	64.7	63.5
65+	13.3	12.8	13.9	13.9	16.1	21.6	24.1

Source: Czech Republic Population Development (CSO, 2001), Projection: Statistical Yearbook 2000, CSO, middle variant

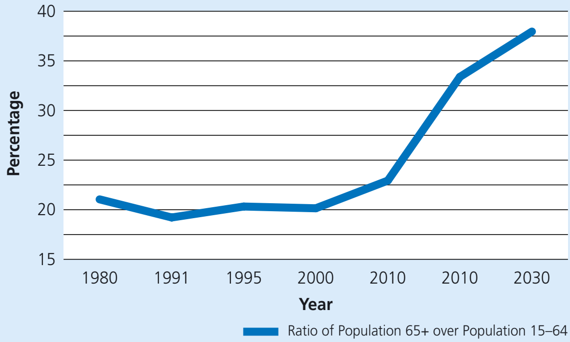
until 1999, when it sank to 89,471. In 2000 the number of live births increased to 90,910 and in 2001 this positive tendency seemed to continue. Nevertheless, the birth rate is very low. In 1992 it was 12.6 births per 1000 inhabitants, while in 2000 only 8.9. This will influence the aging of the population in the future.

Together with individual aging, i.e. steadily increasing life expectancy, the share of the population in older age groups has grown and shapes the dependency ratio, the share of the population aged 65+ on the group of "working age" population aged 15 to 64 – the standard indicator of population aging. Even if at present the share of the elderly in the Czech Republic is lower than in most European countries (in 1998, the average share of people aged 65 and over reached 16.2% in the EU–15, but only 13.7% in the Czech Republic), demographic projections show a high increase of this share in the future.

Demographic factors of aging influence deeply the number of people who benefit from age-related social programs, especially pensions. This is why many countries are advocating reforms that would modernize pension systems and strengthen private pensions savings. On the other hand, life expectancy will be increased by better living conditions of the elderly. This is the true reason for prolonging the eligibility of pension age. These facts call for an active policy of offering to the elderly schooling programs, half time employment, etc. (In the Czech Republic there has already existed for many years a "university of the third age," with more than 30 branches of tuition, which is still not fully exploited by this generation in comparison with other countries).

Also the birth rate will begin to grow in those societies where many families have decided to postpone their first child for some years. The postponement should last about seven years in the Czech Republic. And for those families who decide to have fewer children or none at all, the adults will have relatively more means of providing for their own old age.

Old Age Dependency Ratio Development Projection



Source: Czech Republic Population Development (CSO, 2001), Projection: Statistical Yearbook 2000, CSO, middle variant