Economic Trends

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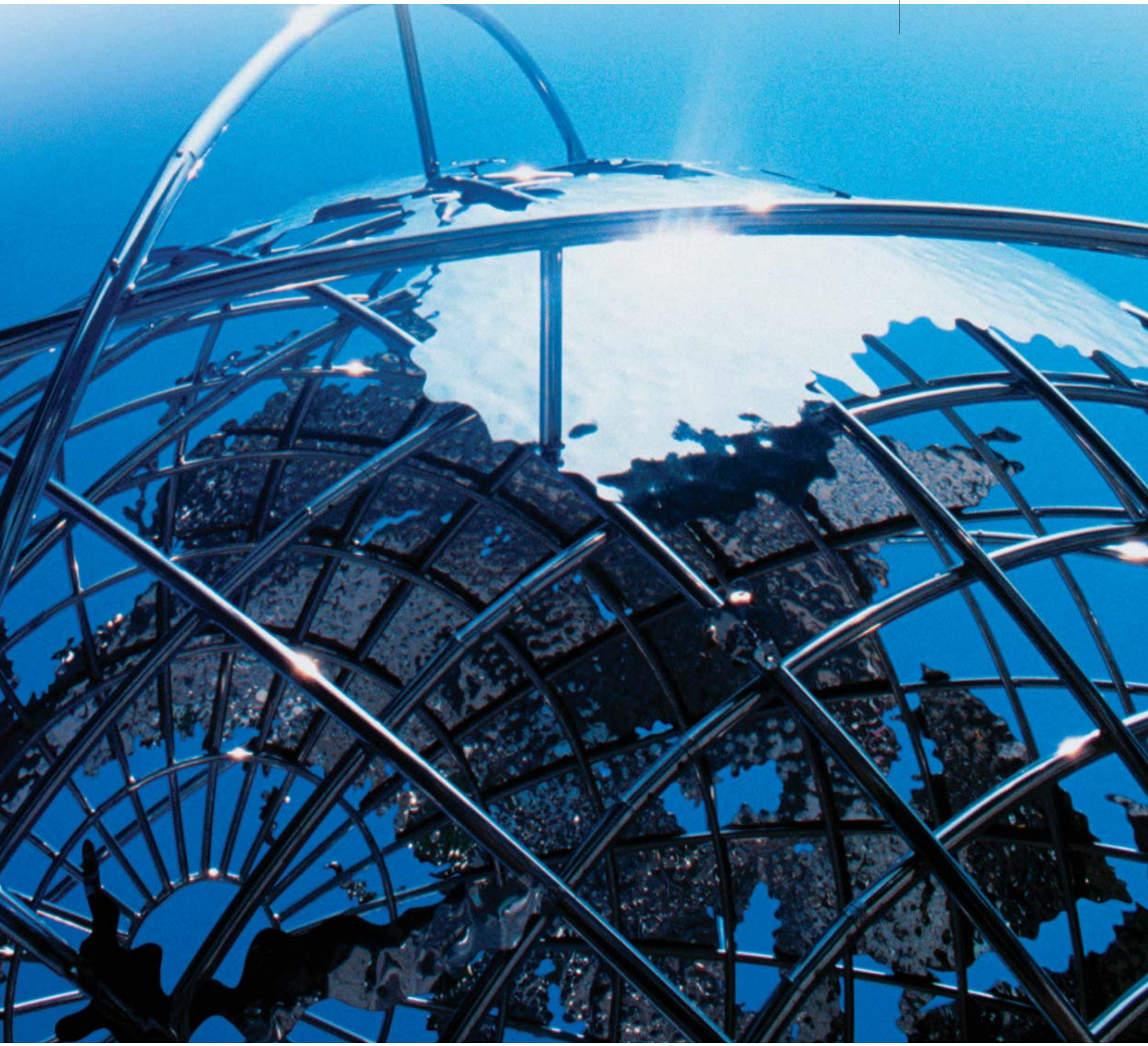

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CONTENTS

FOREWORD **2**
CHIEF ECONOMIST UNIT **3**
15 YEARS OF THE CZECH ECONOMY THROUGH THE LENS OF ECONOMIC TRENDS **4**
Eva Zamrazilová: Public Finance: A New Threat to Macroeconomic Stability? 4
Kamil Janáček: Ten Transition Years: Some Reflections 5
Tomáš Holub, Martin Čihák: Relative Price Convergence to the EU: An Understated Problem 7
Marie Frýdmanová: Myths on the Czech Labour Market 10
Kamil Janáček, Vladimír Tomšík: Development of the Banking and Financial Institutions in the Czech Republic 12
Kamil Janáček, Eva Zamrazilová: Floods: The Impact on the Czech Economy 16
Kamil Janáček: Unemployment in the Czech Republic: Present State and Outlook 18
Eva Zamrazilová: Risks of the Inflationary Pressures after the Emu Entry 19

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CHIEF ECONOMIST'S FOREWORD

Dear Reader,

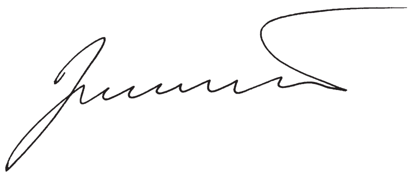
lit has been already 15 years since Komerční banka started to offer you Economic Trends. With the current issue, the number of Economic Trends has reached 61.

During the last 15 years, we have analyzed transformation of the Czech economy, monetary and fiscal policy, and various aspects of the catch-up process. Comparisons were made regularly with other Central-European countries, with special regard to Slovak economy.

Specific topics of our interests were, also, development of the Czech banking sector, costs and benefits of future Eurozone entry, impact of FDI on the Czech economy and Czech labour market, etc.

In the current No. 61 of Economic Trends, we would like to refresh the readers´ memory, offering some parts of the best contributions over the whole 15 years. It is worth to recall the key moments of the route passed by the Czech economy, and show what failures and successes laid the foundation for the present and the future.

At this occasion, I would like to thank personally to all my colleagues who participated in forming Economic Trends over the whole period. Below, the reader will find their photos, with times of their stay in the Chief Economist Unit team, and with their present positions. My thanks also go to all assistants, for their valuable technical contribution.



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15 YEARS OF THE CZECH ECONOMY THROUGH THE LENS OF ECONOMIC TRENDS

ECONOMIC TRENDS NO. 20, APRIL 1999, PP. 7–8

EVA ZAMRAZILOVÁ: **PUBLIC FINANCE: A NEW THREAT TO MACROECONOMIC STABILITY?**

Quo Vadis, Public Finance?

The state budget deficit reached 1.6% of GDP in 1998; for general assessment the ratio between consolidated budgets and GDP is important. This ratio exceeded 2% in 1998, and another increase in 1999 is almost sure. Another problem is so called "shadow deficit" concerning quasi-fiscal institutions (Konsolidační banka, Česká inkasní, Česká finanční, National Property Fund); total debt accumulated in these transformation institutions was estimated by the Government to reach about 1.9% of GDP in 1998.

The 1999 state budget was approved with the revenue of CZK 574 bill. and the expenditure of CZK 605 bill., i.e. that the budget was supposed to operate with a planned deficit of CZK 31 bill. Anyway, even such a considerable deficit does not seem very realistic. The discrepancy between the budget macroeconomic assumptions and reality will emerge, again. The 1999 budget was prepared under the assumptions of GDP growth by 1.8%, unemployment rate of 8.7% and average inflation reaching 7.8%. In reality, one cannot expect GDP growth higher than 0.5%, inflation will move around 5% and unemployment is sure to exceed 9%. There can exist the only result of the differences outlined above: real budget revenue will be lower than the planned one.

Macroeconomic forecast of Ministry of Finance changed immediately after the budget being approved (decline of GDP by 0.2%, unemployment 9.5%, inflation 5.1%). Moreover, budget did not account for reduction of personal income tax and it remains an open question, whether Parliament will pass the increase of some excise tax proposed by the Government. The revenue concerning sale of state stake in CSOB (CZK 5.8 bill.) cannot be taken for granted, too. The expenditure side can be hit by unplanned expenditures as well. Like in 1997 and 1998, the 1998 loss of Konsolidační banka could be included to the 1999 state budget, privatisation of big Czech banks can cause another expenditures.

If the Government does not reduce expenditure, the real deficit of the state budget in 1999 could reach CZK 40-50 bill. which is very close to the Maastricht criterion (3% of GDP, which represents approximately CZK 55 bill. for the Czech Republic in 1999). The consolidated deficit, which is decisive for total assessment, will thus very probably exceed the Maastricht criterion.

Risky Development of Public Finance

The planned deficit of state budget was approved to provide Czech economy with pro-growth incentives. Undoubtedly, the recovery of economic growth is the priority for 1999 and 2000. Any activities with the aim to revive economic growth should however not initiate unmanageable imbalances. And that is exactly what threatens if the 1999 state budget deficit amounts to the estimated level (CZK 45–55 bill.): such a high deficit represents a significant risk for the Czech economy. Moreover, revelation of other debt items in the non-transparent system of public finance cannot be excluded.

The experience of West European economies trying hard to achieve and to sustain the Maastricht criteria, bring quite reliable evidence: deficit spending will not bring long-term sustainable economic growth. Moreover, the recovery of demand via deficit spending is quite dangerous for the Czech economy, until the structure of supply remains unchanged.

The reaction of foreign investors – growing cautiousness and changes in rating – following deterioration of domestic imbalance is well predictable. The currency crisis of 1997 represents a very precious experience in this respect, since the price for consolidation of external imbalance was very high. Keeping of imbalanced tendencies within manageable limits is a very important issue.

In years to come at least three rules should be respected, so that the macroeconomic stability would not be threatened:
- macroeconomic forecast for next year (the year for which the state budget is prepared) must be realistic, otherwise public revenue is lower against assumptions,
- public finance should be transparent,
- the deficit of public finance for the respective year should be kept within the limit of 3% of GDP.

15 YEARS OF THE CZECH ECONOMY THROUGH THE LENS OF ECONOMIC TRENDS

ECONOMIC TRENDS NO. 22, OCTOBER 1999, PP. 3–5

KAMIL JANÁČEK: **TEN TRANSITION YEARS: SOME REFLECTIONS**

The oncoming tenth anniversary of the start of fundamental social and economic change has triggered a wave of interest in analyzing transformation – the process that was and is difficult, stormy, and often painful for Czech citizens. Beyond any doubt, the Czechs have lived through more political, economic and social change in the last decade, than the average West-European encountered during the whole post-war period.

Evaluation of the past decade will, of course, differ according to the political and economic background of individual analysts. One should however avoid the attitude frequent among part of the economists: neglecting the facts, and failure to see them in the context of historical time. To look at the problems of 1991 through the eyes, and experience, of 1999 is, modestly expressed, misleading. This fact is all the more important that the failure to respect the historical dimension of transformation has recently become a rule rather than an exception. The following reflections will therefore comment on the basic transition steps under this special focus.

Privatization: was it too hasty?

Both among Czech economists and in international economic circles, a dispute exists on privatization. Privatization was one of the main pillars of transformation. Was it correct to privatize fast, and to start privatization before a standard institutional framework of the market economy was established? Lately, it was Joseph Stiglitz, Chief Economist of the World Bank, who cast doubt on one of the pillars of the so-called Washington Consensus (the basic IMF and World Bank recommendations to the post-communist transition economies, stating that transition toward a market economy must include macroeconomic stabilization, liberalization of prices, trade, and capital movements, as well as mass privatization). The critics – with the benefit of hindsight – now argue that the transforming economies should have concentrated their effort, first, on building and strengthening the basic institutions of the market economy and the legal system. Only afterwards, mass (and fast) privatization was to be started. The slogan is „Regulation and institutions prior to privatization".

Let us leave aside the problem whether it is at all possible (except in the virtual reality of a theoretical concept) to start building a market economy without its main constituting element, i.e. private property, or privately-owned firms.[1] In the light of this problem, the only realistic view is to discuss the adequate speed of privatization in the transition from a centrally-planned system toward a market economy.

However, even here, the critics of the adopted way of privatization can find no strong evidence. Two recently published studies[2] have come to two fundamental conclusions:

– in spite of all problems, privatization in transition economies can be seen as a success. Countries that did a fast and massive privatization (e.g. Poland, Hungary, Czech Republic, Slovenia, Estonia) have substantially better macroeconomic figures than those who hesitate to privatize, hoping that the state-owned firms can survive (e.g. Ukraine, Belarus, Russia).
– any privatization is better than none, because in general, private firms in transition economies are much more efficient, more profitable, they export more, and restructure faster.

It is of course true that there has been a week point – the problem of efficient management, and effective corporate governance in general. Discussing the Czech way of fast privatization, the coupon method which helped to solve the problem of lacking capital at the start of privatization (and helped to gain support of most citizens for radical economic transformation), suffers from this weak point. Insufficient or wrong enforcement of ownership rights then can, in some cases, lead to inefficient functioning of firms, and to non-ethical or illegal behaviour of the owners. However, the social and economic costs of waiting for a well-established institutional market framework would have been much higher than the costs of fast privatization – as experience of some other countries in the last decade shows.

Foreign Capital – How Much Was Available?

Critics of the Czech way of privatization recognize the indisputable fact that Czech economy was undercapitalized during the transition period. They however say that the optimum solution was not coupon privatization but mass privatization by foreign capital.

[1] To refresh the memory, let me remark that in 1988, the share of state-owned (public) sector in Czechoslovakia's GDP was almost 98%.

[2] Nellis, John: Time to Rethink Privatization in Transition Economies? IFC Discussion Paper No. 38, 1999. Havrylyshyn, Oleg – McGettian, Donal: Privatization in Transition Countries: A Sampling of the Literature. IMF Working Paper WP/99/6.

The basic, well known and very correct argument against this opinion is that one could not expect the Czech Republic being able to attract, within two to three years, 30 or 40 billion USD – and that foreign capital would not be interested in the whole range of privatized firms. If confronted with actual figures on the cumulative foreign direct investment inflows, the idea of mass privatization by foreign capital is clearly unrealistic.

There is however another fact which was even more important at the time when decisions on the form and speed privatization were taken: the then prevailing attitudes of political parties and lobbyist groups (entrepreneurs, trade unions). In the years 1991 to 1993 (the years decisive for choosing the principle ways of privatization), entrepreneurs' interest groups, trade unions, and most of the general public supported the slogan „Czech firms into Czech hands". Even some very liberal economists backed the idea that the so-called family silver must remain in the hands of Czech capital. In this prevailing social climate, it was a success that the government pushed through the principle of equal access for everybody – that is, no discrimination of, but no big advantages for foreign capital.

Only the visible economic success of most foreign-owned firms changed the prevailing attitude. It became clear that foreign owners bring not only capital but know-how, managerial experience, access to markets, and employment opportunities. Yet, in spite of all that, it would be a heroic and naive abstraction to think that the bulk of privatization in any transition economy can be based on foreign capital.

Macroeconomic Policy: Achievements and Failures

Macroeconomic stability has been an indisputable success of the mix of fiscal and monetary policies. Stability was preserved in the period when prices and foreign trade were being liberalized, and even later, when Czechoslovakia broke in two states, and currencies were being separated (the latter events, moreover, fell together with the introduction of a new tax system). Keeping inflation at two-digit levels after price liberalization, and its reduction to around 10% where it stayed during 1992-1998, was a remarkable success in the context of Central-European transition countries. This achievement preserved, for households, most of the purchasing power of their savings. It however had one perverse effect. Unlike in Poland and Hungary, where hyperinflation practically wiped off all enterprise debt (as well as household savings), Czech firms and banks entered the phase of microeconomic restructuring with a substantial burden of past debt. This is a problem with which the Czech economy is struggling till today, and it will preoccupy us for several years to come.

Ten years of transformation have also learned us a lesson on the difficulty of reaching political consensus for economic policy, and on the existence of the so-called „political economic cycle". A recent proof has been the dissolution of budget surplus from 1995 in the election year of 1996 – which started the turn of government budgets from surpluses to latently growing deficits.

Creating and improving the institutional framework of market economy is a permanent, unending task. Implementing the laws takes time and requires numbers of competent experts. This process can be speeded up in some aspects, but it cannot be „solved" in a short horizon (and once for ever). Yet it has to be said that in this sphere, too, more could have been done to the benefit of private enterprise – by making the activities of some government organs more efficient and transparent, and providing more support to small and medium-sized firms. I do not mean financial support – which exists since several years – but consultancy on the process of founding a firm, on accounting, on preparing entrepreneurial projects, etc. In this respect, experience of some EU countries remained untapped.
Analyzing monetary policy, one can also find some weaknesses – it failed to respect sufficiently the specific situation of a transforming economy, and it hesitated too long to take some needed steps. An overdosed monetary restriction in mid-1996 was, undoubtedly, one of the factors that deepened the recession which hit the Czech economy in the following two years. Introducing some regulations instantly and in full, rather than gradually over some time (for example, the requirement of 100% provisions against real estate collateral in banks, or the rule about consolidated bank balances), destabilized, in the short run, the economic situation of Czech banks, instead of making them sounder. Another example is the minimum reserve requirement, which was lowered to standard European levels as late as two years after the introduction of direct inflation targeting (where the institute of minimum reserves has no sense). The high reserve requirement needlessly increased the costs of commercial banks, and resulted in wider interest margins, putting additional cost on bank clients.

Another problem was the hesitation to change the exchange rate regime. The fluctuation band for Czech koruna was introduced too late (five months after full liberalization of capital flows); the same is true of the change to managed floating. Had this step been taken in 1997, at the time of the so-called first austerity package of the government, the attack on Czech currency in May 1997 could have had less serious short-run consequences.

In fact, the forming of economic policy in the transition period often was a trial-and-error process – and could be nothing else. The analysis of achievements and failures thus should primarily serve for learning from past mistakes, and for finding a better mix of fiscal and monetary policy – not for a misleading, superficial search for culprits.

When Will Transformation Be Finished?

The answer to this question has two dimensions. If one takes the basic transformation steps – liberalization, stabilization, and privatization – they all have been taken. In this sense, that phase of transformation lies behind us. If, however, one talks about a full-fledged market economy, about structural change, about well-functioning legal and administrative institutions, then transformation is still in progress, and by far not over. It is very difficult to speculate on the time dimension of this second phase of transition. Very generally, one can say that transformation will be finished when the Czech economy will have all features of a standard, advanced market economy – and will face only problems typical for such economies. In the last ten years, we have undoubtedly covered a substantial part of our way to a standard market economy. Now it is necessary – with the same determination as in the fist years of transformation – to accomplish the remaining part of our way.

15 YEARS OF THE CZECH ECONOMY THROUGH THE LENS OF ECONOMIC TRENDS

ECONOMIC TRENDS NO. 22, OCTOBER 1999, PP. 14–18

TOMÁŠ HOLUB, MARTIN ČIHÁK: **RELATIVE PRICE CONVERGENCE TO THE EU: AN UNDERSTATED PROBLEM**

In the first half of 1999, the Czech National Bank (CNB) announced its „Long-Term Monetary Strategy", in which it set an inflation target of 2±1% from 2005 onwards. As a result, the problem of the low Czech price compared to the EU and its implications for future inflation have recently come back to the forefront of economic debate. It is a major point of disagreement between the CNB on the one side, and the government on the other side. The government stresses the necessity of price level convergence to the EU, and warns against the potential risk of a price jump after our EU accession. On the other hand, the central bank argues that the price level convergence is not a matter of monetary policy, that it will be a result of a productivity catch-up with the EU. The price level convergence then does not have to be carried out by higher domestic inflation, but instead by a gradual appreciation of the nominal exchange rate.

The above discussion, however, misses the main points, as concentrating on the average price level is rather confusing. A more detailed analysis shows that the problem consists rather in the relative price convergence to the price relations usual in the advanced countries. Given the relative downward stickiness of prices, this relative price convergence will push on higher inflation. There is no way this process could be substituted for by a simple macroeconomic solution, such as a nominal exchange rate appreciation. The CNB realises this problem to some extent, as its long-run inflation target allegedly „reflects the fact that the probable extent of the distortion of price indices due to changes in the quality and range of goods and services, as well as to the more intense adjustment of relative prices in the still transforming Czech economy, will continue to be larger than in eurozone countries." We may ask, however, if the CNB's target really reflects the necessary relative price adjustments fully, or whether it is too low. To answer this question, we must look at the problem of relative price convergence in more detail.

Differences in Relative Prices

The international comparison of average price levels may be a good first view of the issue, but at the same time it may lead us to oversimplified conclusions that a solution can be found in the macroeconomic field, for example in a higher domestic inflation or/and appreciating nominal exchange rate.

The problem is rather microeconomic than macroeconomic, and we thus have to concentrate above all on the structure of relative prices. Relying on the average price level may be quite misleading, because the average figure disguises the substantial differences among individual goods (or groups of goods). For example, the prices of accommodation (i.e. rents, water, energy etc.) reach less than 30% of their German levels, while the prices of household equipment already exceed 60% of what they are in Germany.

We can find even greater differences if we look at more detailed data. On the one extreme, there are rents and the prices in education and healthcare reaching less than 20% of their German values; on the other extreme, there are prices of cars and shoes that are almost the same as in Germany. By no means is it the case, however, that the prices of tradeables are already equalised with the advanced countries, and the price differences can be found solely in nontradeables. The cars and shoes are sooner an exception than a rule. A great majority of tradeables' prices (e.g. most of foodstuffs, non-alcoholic beverages, tobacco, clothing, carpets, household appliances etc.) still lies between 45% and 65% of the German levels. The distribution of individual price groups according to their (real) shares in household consumption is very dispersed (and far from „standard normal").

This means, however, that the relative prices (i.e. the price of shoes vs. rents, or the price of cars compared to bread etc.) in the Czech Republic differ substantially from the relative prices in advanced countries. To measure the importance of this problem, we have defined the so called coefficient of relative price differences, which captures the degree of deviations of relative prices in the Czech Republic (and other countries) from the relative price system in our benchmark country, i.e. Germany. This coefficient is calculated as a weighted standard deviation of comparable price levels of individual goods in the Czech Republic in ratio to the average Czech price level (for more detail see Economic Trends, Komerční Banka, Prague, No. 11, pp. 24–25). The higher is the value of the coefficient, the higher is the average percentage difference of our relative prices compared to foreign relative prices.

When calculating the coefficient of relative price differences, the main problem is the choice of suitable weights. One possibility is to use the structure of nominal expenditures of consumption outlays by households (i.e. to use nominal weights). There is one difficulty with this approach, however: if a commodity has a lower price, it has lower nominal share on consumption. Regulation of rents in the Czech Republic, for instance, lowers the nominal share of „gross rents and water supply" to only 12% (while in Germany it is 19%). Nominal weights therefore tend to underestimate the importance of rents, which biases the coefficient of relative price differences downwards. Another possibility is to „impute" internationally comparable prices of the individual commodities, from which we can calculate „real" weights of the respective commodities. The real share of „gross rents and water supply" on consumption, calculated this way, is roughly 25%. The calculation of „real shares" is artificial to some extent, since there is obviously no guarantee that the real structure of consumption in the Czech Republic will not change as relative prices will change.[3)] Nevertheless, we consider this approach to be better than to use nominal weights, and in the following text we focus on the coefficient of relative price differences with real weights. We however calculated also the coefficient based on nominal weights; but the results were not qualitatively different.

Coefficients of relative price differences in the most developed EU countries are below 20%. Yet even in the least developed EU countries, they are not higher than 35%. In the Czech Republic, the value of the coefficient of relative price differences was 65% in 1993, and it declined to 56% in 1996 and to 50% in 1998. It means that in spite of the positive development in the last years, in the area of relative price convergence, Czech Republic still has a significant a significant gap vis-a-vis even the least developed EU countries. Only a partial consolation can be found in the fact that out of all the transition countries with the exception of Slovenia, relative prices in the Czech Republic are the closest to the EU price structure.

Consequences for Inflation

Prices and wages in nominal terms (CZK-terms) are not very flexible downwards, so that most of relative price adjustments have the form of increases in some CZK-denominated prices. This was how the decline in the coefficient of price deviation happened in the last years. None of the comparable prices of individual consumption items in the Czech Republic (compared again to Germany) declined in 1993-1998 period. Those prices, which were relatively the closest to the developed countries already in 1993, tended to grow at the slowest rate in the period afterwards, while the most underpriced commodities tended to show the highest price growth. This negative correlation can be well described by a hyperbolic-shaped curve.

A similar type of relative price convergence is implicitly assumed also in the existing inflation targeting regime, introduced by the Czech National Bank since 1998. The target variable is the so-called net inflation, which is inflation adjusted for changes in regulated prices and taxes. The implicit assumption is that regulated prices and taxes will grow relatively to other prices. The aim of the central bank should not be to offset this growth by a corresponding decline in non-administered prices (since it would lead to costs in the form of decline in production), but only to stop the effects of these administrative changes to spill over to the rest of the economy. It is therefore reasonable to exclude such items from the targeted price index. In our view, however, the same type of adjustment is not the distinctive characteristics of regulated prices, but it concerns relative price adjustment in general. It is still an open question, to what extent this problem was reflected when the Czech National Bank was setting up its long-term inflation target for the year 2005.

We therefore tried to calculate an estimate of the inflationary pressure stemming from the adjustment of relative price differences to the level of the least developed EU countries, i.e. to the 35% level of coefficient of price deviation. We started from the extreme assumption that all adjustments of the relative price structure will have the form of increases in nominal CZK prices and that the structure of consumption will not change. The assumption that the adjustment of relative prices will have the form of increases in individual nominal prices, is not completely unrealistic: our analysis confirms that in the last five years, all commodity groups experienced increases in prices.[4)]

In our calculations, we assumed that price growth in each individual commodity group (according to the classification in the international comparison project) would be roughly proportional to the respective price gap of this group vis-a-vis the EU. One can easily imagine other assumptions on the possible concrete mechanism of price adjustments, but this one seemed to be simple enough and provided a useful first approximation. Moreover, past data were consistent with this assumption: the fastest price growth was seen in the relatively „cheapest" groups, like rents, health care or education, while the relatively „most expensive" groups, like cars or shoes, experienced only a very slight price increases, basically in line with inflation in the EU.

Given these rather extreme assumptions we arrived at the conclusion that the decline of relative price deviations to the level of the least developed EU countries would be connected to the increase in the price level by 55%.[5)]

We tried to find out, how sensitive this result is to various changes in our assumptions. It was revealed that if one sticks to the assumption that a significant majority of relative price adjustments has the form of a price growth, then slight alterations of the relative price adjustment mechanism have no substantial impact on the final result. Far more important is the assumption that the real structure of consumption will not change during the price convergence. When we used nominal weights instead of real ones, the estimate of the resulting increase in the price level was 30%. When using weights from the current official consumer basket, published by the Czech Statistical Office, we can reach even a lower number (20%). We already argued that the problem of real weights is that we ignore the possible shifts in the real structure of consumption that may be due to the changes in relative prices. The official CSO weights, on the other hand, are from 1994 and therefore do not reflect the real structure of household consumption. It is therefore reasonable to rule out both extreme variants of our calculations. We can conclude that the adjustment of relative price structure vis-a-vis EU will tend to increase the Czech price level by 25–50%.

This pressure on increases in the price level will obviously continue even after the eventual entrance of the Czech Republic to the European Union. If the adjustments of relative prices at least to the level of the least developed EU countries are to happen till 2010, yearly inflation rate would be 2-4 percentage point higher than if there were no adjustments

[3)] As the relative price of a commodity will grow, people will try to substitute its consumption with other commodities. In other words, the structure of consumption will tend to shift towards those commodities whose prices grow the slowest. On the other hand, there will be also income effects: the growth of wealth does not lead to a proportional growth of consumption of all commodities. It tends to increase more consumption of luxurious items.

[4)] The short period of price decline in some commodity groups in the beginning of 1999 is probably a one-off phenomenon, due to both the positive – but unfortunately only temporary – external supply shock, and the deep economic recession.

[5)] The advantage of our approach – compared to approaches deriving inflation from the adjustment of price levels to the EU – is the fact that we do not need any assumption concerning the exchange rate, e.g. the stability of the exchange rate.

in relative prices. The official headline inflation rate would probably be on the lower end of this interval, since official price indices underestimate the real weight of regulated items, like rents.

The calculations above covered only those „natural“ inflationary pressures acting in addition to other inflationary pressures that are present also in EU countries. Most economists seem to agree that price stability in developed countries is equivalent to yearly inflation of 1–2%. This is due to the inability of official inflation indices to capture continuing improvements in product quality. There is no reason to think that Czech Republic is a exception in this respect. We should therefore add these 1–2 percentage points of „price stability“ to our estimate. We can therefore arrive to the conclusion that the sum of all natural inflationary pressures in the next 10 years will increase yearly inflation to the interval of 3–6% (the lower end of this interval being more likely for official inflation indices).

Our calculations are consistent with the hypothesis that in transition countries like the Czech Republic, there is a one-digit, non-zero "natural" rate of inflation. The determination of such a natural inflation rate must always be a result of comparison of welfare costs and benefits of inflation. There seems not to be many doubts concerning the costs of inflation. Yet inflation also has its benefits, and they can be even more important than costs for one-digit rates of inflation. One of the benefits was demonstrated in this article: under the conditions of downward inelastic nominal prices and wages, inflation can be the most acceptable way of adjustment of the distorted relative price structure.[6)]

The existence of a non-zero natural rate of inflation is not a result of a "need to narrow the price level gap between the Czech Republic and the European Union". There is no such an abstract need, since without a corresponding convergence in productivity a political pressure to converge in price levels would only increase the risk of external imbalance. The pressure towards higher inflation stems from the gradual adjustment of relative prices (i.e. prices of bread in the Czech Republic vis-a-vis butter in the Czech Republic) under conditions of low downward flexibility of nominal prices and wages, rather than from the adjustment of price level as such (i.e. the price of bread in the Czech Republic vis-a-vis bread abroad). Moreover, this type of price adjustment can not be substituted by an alternative approach, like the nominal adjustment of exchange rate.

Our estimates suggest also a conclusion regarding the debates about the long-term monetary strategy of the Czech National Bank. We have showed that inflation pressures connected to the adjustment of relative prices can lead to the yearly headline inflation of 3-6 percent in the next decade. These results can not be applied directly to the long-term monetary policy target, which the Czech National Bank has set in terms of „net inflation“ (2±1% since 2005). Nevertheless, the CNB also says in its long-term monetary strategy document that since 2005 net and headline inflation should be basically equal, since also adjustments of regulated prices and taxes will have been done by that time. We however do not think this is a realistic scenario. If the Czech National Bank's related its long-term target (2±1%) to headline inflation, it would lead to a slower adjustment in relative prices. It is a legitimate target to decrease inflation to 2±1%, but there seems to be a trade-off between disinflation and the speed of relative price adjustment. It is correct to point out that Czech National Bank's main target according to the law is to take care for "monetary stability", so that the CNB can argue that the speed of relative price adjustment is not something of primary importance. Nevertheless, our calculations show that a rapid disinflation in a transition country such as the Czech Republic can lead to a substantial slowdown in natural adjustment processes.

[6)] In the case of transition countries, the distortion is mainly due to historical reasons, but important distortions can be introduced also institutionally. A typical example can be the ratio of minimum (or average) wage to social payments. This ratio can be called the relative price of work compared to leisure. In the Czech Republic, this price is distorted by the excessively high social payments. It is not realistic to assume that the adjustment of this relative price could take the form of nominal decrease of social payments. It seems to be politically more feasible that there will be inflation accompanied by a growth in nominal wages, which will enable to sustain or even slightly increase nominal level of social payments, and at the same time to erode their real value.

15 YEARS OF THE CZECH ECONOMY THROUGH THE LENS OF ECONOMIC TRENDS

ECONOMIC TRENDS NO. 24, APRIL 2000, PP. 9–10

MARIE FRÝDMANOVÁ: **MYTHS ON THE CZECH LABOUR MARKET**

In the last ten years the labour market has been affected by many political and economic changes and has gradually acquired the characteristics considered normal for market economies. Some of the major factors have been the fall in economic participation, the changing structure of employment by sector and branch, and the emergence of open unemployment. However, the assessment of the past and future development of the labour market is not always in accordance with the facts.

At the beginning of the Nineties unemployment was regarded as a possible neuralgic point of the transformation process. Its growth was feared by the public and successive governments alike. After 1989, however, most forecasts for the development of unemployment were highly exaggerated while the medium-term forecasts from 1992 to 1996 were generally underestimated. In the last three years the real extent of unemployment has recorded lower figures than those predicted by the annual forecasts. Government and other professional estimates of its future development have scarcely ever been accurate. The forecasting of this important macro-economic indicator is however for many reasons extremely important as spending on employment policy and other facultative social benefits connected with unemployment constitute a significant part of the state budget. The last ten years represent a sufficiently long period for it to be possible firstly to analyse the factors responsible for the imprecision in the forecasts and secondly to recall some of the erroneous conclusions about the Czech labour market.

Why were the forecasts of the extent of unemployment inaccurate

The newly-created market environment and the emerging labour market themselves created obstacles to the accurate forecasting of the development of the rate of unemployment. The course and extent of the transformation changes were difficult to estimate and neither were the impacts of the individual forms of privatisation quantifiable in advance. At the beginning of the decade it was assumed, on the one hand, that the emergence of a competitive environment together with the change in the forms of ownership would lead to an increase in the pressure to implement structural changes, which would be linked to the eradication of over-employment. The influence of the external environment on our economy in the medium-term was likewise an unknown quantity. These were all reasons for the high estimates for the rate of unemployment. It was expected that the Czech labour market would swiftly adapt to the advanced market economies not only as concerned its basic characteristics but primarily in the unemployment rate, whereas the actual rate of unemployment in the Czech Republic up to 1996 fluctuated below the level of the natural rate of unemployment. The voucher privatisation in particular did not result in the desired ownership relations and the responsibility of owners or company management which was to have ensued therefrom. The pressure to restructure the corporate sector was not sufficient. Much management did not regard the company's prosperity as their primary goal and this situation was exacerbated by the corporate sector's relatively easy access to credit. Large-scale reductions in the workforce did not therefore occur. The initial fall in production was far quicker than the fall in employment. Many experts, however, assumed that structural changes were taking place as major shifts occurred in the labour market between 1990 and 1994. Such beliefs influenced not only the evaluation of the labour market but of the whole economy.

Labour market flows and structural changes

Significant movement on the Czech labour market has actually been one of its chief characteristics in the course of the last decade. With the exception of the years 1993 to 1996 there has been a reduction in employment, which, with greater or lesser intensity has been reflected in the development of unemployment. Although the labour market in many respects began to adapt to market conditions and some of its features were similar to advanced market economies a significant difference between the fall in production and the non-corresponding development in unemployment was not registered on continuing over-employment and slow structural changes in the micro-sphere. This fact, however, was not regarded as convincing, with the counter-argument being the massive shifts in the area of employment. The major shifts between specific sectors and branches, which occurred chiefly between 1990 and 1994 (and particularly the absorption capacity of the tertiary sector: the proportion of employed in the tertiary sector rose by more than 12 percentage points during the decade, a shift which in its rapidity has no parallel in post-war Europe) were regarded as evidence of the extensive structural changes in the economy as a whole. With the recovery of economic growth in 1994 the demand for labour grew, which temporarily deferred the need to restructure the corporate sector. This need became pressing with the overall deterioration in the macro-economic situation in 1997.

The belief in the occurrence of structural changes derived purely from data on the flows on the labour market is one of the erroneous and in recent years highly publicised conclusions. Studies exist, however, which with the aid of detailed statistical analyses of flows on the labour market disprove the theory of massive structural changes in the early years of transformation.[7)] These analyses concluded that partial structural changes had taken place but that these were far less extensive than had been assumed. The question still remains whether the flows on the labour market can serve as a measure of structural changes. These changes should not be understood (even in a transitional economy) as merely the eradication of over-employment, but as an integrated process, the result of which should have been not only a change in the structure of the economy connected with shifts in employment, but also major changes connected with the introduction of new production and technology and ultimately also in the organisation of labour. All this should (even given a certain delay) have been reflected in the performance of the economy, which should have been the main indicator of the success of the structural changes. Nevertheless, the really erroneous reflections on the realisation of structural changes in the early period of transformation were due to the low level of medium-term forecasts for the development of the rate of unemployment, whereas the majority of published annual forecasts during the past five years (with the exception of 1997) were exaggerated. The year 2000 will be no exception. It is obvious that with economic revival the total absorption capacity of the economy will increase slightly and that the expected rise in direct foreign investment will act against an increase in the rate of unemployment. Most other forecasts certainly proceed from these assumptions. However, they overestimate (or underestimate) certain factors which at first glance have a different weight than is the case upon closer inspection – statistically speaking. In our opinion, one of the main such factors is the underestimation of the demographic influence of development and the exaggeration of the influence of employment in industry on the development of unemployment.

[7)] Gottvald, J.: „Flows on the Czech Labour Market between 1993 and 1998". Material for Discussion Seminar No. 2, Department of Economic Policy of the Faculty of National Economy, University of Economics, Prague.

15 YEARS OF THE CZECH ECONOMY THROUGH THE LENS OF ECONOMIC TRENDS

ECONOMIC TRENDS NO. 26, OCTOBER 2000, PP. 5–10

KAMIL JANÁČEK, VLADIMÍR TOMŠÍK:

DEVELOPMENT OF THE BANKING AND FINANCIAL INSTITUTIONS IN THE CZECH REPUBLIC

Development of the Banking and Financial System

Development of the Banking Sector in Czechoslovakia (1991–1992)

The Czechoslovak banking system underwent rapid development in 1991. While in 1990 there were only fourteen commercial banks (including savings banks) in the CSFR, in 1991 twenty-five new banks were authorized. From the standpoint of capital origin we can divide these banks as follows:
a) 8 state financial institutions
b) 15 banks in hands of Czechoslovak capital
c) 7 banks with joint foreign capital participation
d) 9 banks in 100% foreign ownership.

In 1991 the state-owned financial institutions played a decisive role in credit and deposit markets, representing 50% of the total basic capital of the banking sector, and over 80% of the granted credits. However, new private Czech and Slovak banks were emerging (aproximately 40% of banking capital). Also foreign-owned banks and banks with foreign capital participation were active in the Czechoslovak market (the remaining 10% of capital).

During 1991, conditions for the establishment of new banks became more demanding, both from the point of view of minimum amount of basic capital required, and of information to be provided about the bank´s founder, the origin of capital, business plans of the bank, its management, etc. The principal change in this respect came in April 1991, when the central bank (SBČs – Czechoslovak State Bank) decided to increase the minimum capital required for the establishment of a bank from CZK 50 to 300 million (USD 10 mil.).

By the end of 1991, a total of 39 banking licenses had been issued in Czechoslovakia. Additional 22 licenses were issued in 1992, bringing the total number of granted licenses as of December 31, 1992, to 61, of which 11 banks had not as yet begun operations.

On December 31, 1992, at the moment of split-up of the federal Czechoslovakia, the structure of the Czechoslovak banking sector was as follows:
a) 4 state banking institutions (Consolidation Bank Prague, Consolidation Bank Bratislava, Slovak State Savings Bank, Slovak Guarantee Bank)
b) 33 joint stock companies, wholly Czechoslovak-owned
c) 11 joint stock companies with foreign capital participation
d) 8 joint stock companies, wholly foreign-owned
e) 5 foreign bank branches.

Further Development and Consolidation of the Czech Banking Sector

In January 1993, when the Czech Republic originated as an independent state, its banking system could be predominantly characterized as that of universal banking. Specialized banks were Konsolidační banka, Českomoravská záruční a rozvojová banka, and four building societies. The growth of the number of banks decelerated over 1993, compared to previous years. Only eight banks were granted licences, of which four were branch offices of Austrian and German banks and two were building societies. In general, 10 banks started to operate in 1993.

The structure of the banking system as of December 31, 1993, was as follows.
a) 24 commercial banks, joint stock companies without foreign participation
b)12 commercial banks, joint stock companies with foreign participation
c) 10 commercial banks, joint stock companies in 100% foreign ownership
d) 10 foreign bank branch offices
e) 1 state-owned financial institution (Konsolidační banka).

Rapid development of the private business sector, where the number of firms multiplied during the first transformation years, led to a huge increase of demand for banking services. The gradual progress of the banking sector, including the development of its branch office networks, led to further improvements in its nation-wide structure. In response to increased demand for banking services, and in the absence of sufficient new technological equipment, the number of bank employees in 1993 increased by about 30% against 1992. At the end of 1993, there was one banking employee for every 194 inhabitants. In addition to basic banking activities such as accepting deposits, granting credits and ensuring payments, banks gradually developed other activities to satisfy the demands of their clients. In 1993 it was, in particular, securities trading, management of securities portfolio, and others.

The main problems facing the majority of Czech banks, especially those which emerged in 1990–1992, were the low quality of credit portfolios and the unbalanced time structure of claims and commitments of banks. The causes were not only objective, connected with the transformation of the Czech economy, but also the lack of experience of banking management and staff, plus an improper bank organisation. In 1993, the number of risky credits further increased. Some banks had difficulties with liquidity, which were overcome with the help of the central bank (the CNB, Czech National Bank). The only bank in serious problems was Kreditní a průmyslová banka where conservatorship was imposed effective September 30, 1993, and later on, bankruptcy proceedings were started.

During 1994, the increase in the number of banks in the Czech Republic slowed down further. The number of banks which had obtained a licence to operate as a bank or as a foreign bank branch reached 58 by 31 December 1994. As a consequence of emerging problems in the banking sector, the evaluation of new applications for bank licences became much stricter, and only two building and loan associations were licensed. Of the total number of 58 banks, one was under conservatorship (Kreditní a průmyslová banka) and one undergoing liquidation (Banka Bohemia).

Structure of the banking sector as of 31 December 1994 was as follows:
a) 16 commercial banks without foreign participation
b) 14 commercial banks with foreign participation
c) 11 commercial banks in 100% foreign ownership
d) 10 foreign bank branches
e) 6 building and loan societies with foreign participation
f) 1 state-owned financial institution (Konsolidační banka)

Situation in the banking sector as a whole was still influenced primarily by the activities of the major banks (Česká spořitelna, Komerční banka, Investiční a Poštovní banka, Československá obchodní banka and Agrobanka). These banks held a share of about 80% in the market, and more than 90% in reserves and reserve funds. However, the share of foreign banks and foreign bank branches was increasing, thanks to their positive evaluation of economic development in the Czech Republic.

The reasons for placing the Banka Bohemia under conservatorship (on 31 March 1994) were the issuance by this bank of Prime Bank Guarantees and Bank Guarantees by which it violated the Foreign Exchange Act, the Act on Banks and the Act on Accounting. Clients of this bank were subsequently given the option of transferring their deposits to Československá obchodní banka (ČSOB). An extraordinary general meeting of Banka Bohemia´s shareholders held on 28 June 1994 decided to liquidate the bank.

On 11 May 1994, the CNB initiated administrative procedures to withdraw AB banka´s licence to operate as a bank due to its inability to meet its commitments. At the same time, all its assets and liability transactions were frozen. Clients were given the possibility to transfer all deposits below CZK 100 mil. to Česká spořitelna and 92% of them took advantage of this offer. An extraordinary general meeting held on 24 August 1994, decided to decrease AB banka´s basic capital and that Česká spořitelna would subsequently increase the capital, thus becoming AB banka´s major shareholder.

In 1995, the banking sector developed in favourable conditions of robust GDP growth. This was based on increasing productivity, a decrease in inflation, and a low unemployment rate. In the international context, the prestige of the Czech Republic increased, particularly in connection with its OECD entry and EU association, and, last but not least, with a favourable rating by leading world rating agencies, which gradually granted the Czech Republic investment grade ratings. This, together with the development of the capital and money markets, adoption of a new Foreign Exchange Act, and introduction of currency convertibility in the sense of Article VIII of IMF, gradually created an environment allowing the banking sector to expand its activities and to get access to international markets.

The trend towards stabilization and consolidation of individual banks and the banking sector as a whole, started in 1994, continued. At the same time, due to an increased competition both home and abroad, the individual groups of Czech banks further differentiated. The weakness of some smaller banks, originating in their starting conditions and deepened by lack of experience, and by the risky environment of the transformation process in general, led to their deteriorating financial situation. On the other hand, the large, and some medium-sized banks, received favourable ratings from foreign rating agencies, in most cases just one grade below the sovereign rating.

Long-term performance problems generated mostly by a non-prudential credit policy (often, granting credit to the bank´s own shareholders) and ill-management, which led to liquidity problems and insolvency, were reasons for revoking the licences of Česká banka and AB banka at the end of 1995. At the same time, the conservatorship of Kreditní a průmyslová banka was ended with the revocation of its licence. A deposit insurance system, introduced in 1994, allowed Česká banka´s clients to be compensated by the Deposit Insurance Fund. At the beginning of 1996, a decision was made to start liquidation procedures against both banks.

As of 31 December 1995, 55 banks and foreign bank branches actively operated in the Czech Republic. Four banks left the banking sector in 1993–1995, of which three were under liquidation and one ceased to exist.

During 1995, in compliance with the policy of giving priority to the consolidation of the banking sector over a further rise in the number of banks, only Česká exportní banka was granted a licence to operate as a state institution specialising in export promotion. The licensing activity concentrated particularly on mortgage banking, permitted by the adoption of the relevant laws in 1995. Licences were extended in this connection to four banks (Českomoravská hypoteční banka, Komerční banka, Vereinsbank CZ, a.s., Česká spořitelna).

The structure of the Czech banking sector as of 31 December 1995 was as follows:
a) 13 commercial banks without foreign participation
b) 14 commercial banks with foreign participation
c) 11 commercial banks in 100% foreign ownership
d) 10 foreign bank branches
e) 6 building and loan societies with foreign participation
f) 1 state-owned financial institution (Konsolidační banka)

The activity of the Czech banking sector was still primarily influenced by the major banks which accounted for 72% of total assets as of 31 December 1995 (see below, Table 4). However, this proportion was decreasing, mainly to the benefit of foreign banks and foreign bank branches which were gradually intensifying their activities.

Banking sector development in 1996 was characterised by consolidation in the subsector of small banks. Performance among the various categories of banks had been increasingly differentiated since 1995. Major and foreign banks, which represented approximately 90% of the banking market, had continued to develop in a stable and prudent manner, leading to favourable credit ratings from the leading rating agencies especially for large banks. On the other hand, in the subsector of small banks, representing approximately 4–5% of the Czech banking sector, a significant worsening of problems began to occur in late 1995 and 1996, arising mainly in connection with poor-quality loan portfolios from the beginning of the bank´s operations. In this context, at the beginning of 1996 the CNB undertook a comprehensive programme of consolidation of the subsector of small banks, with the aim of assessing the further prospects of these banks and cleansing the banking sector of those which did not display the prerequisites for future stable, prudent operations.

As a result of the consolidation programme, První slezká banka and Kreditní banka had their licences revoked and were forced to close, and five banks were placed under conservatorship (Ekoagrobanka, which was subsequently taken over by Union banka and taken out of conservatorship at the end of the third quarter of 1996; COOP banka; Podnikatelská banka; Realitbanka and Velkomoravská banka). At the same time the equity capital of the banks under conservatorship was reduced in order to replenish funds for covering losses.

In other banks, stability was bolstered through new equity injections from existing or new shareholders, through changes in the shareholder structure and the management of the banks, through pressure to increase the quality of management system, or by integrating certain banks into stronger groups (for example the take-over of Ekoagrobanka, Evrobanka and Bankovní dům Skala by Union banka).

In 1996, after a moratorium of over two years on the issuing of new licences, two new banks were allowed to begin operations: a subsidiary of Westdeutche Landesbank and a branch of the British Midland Bank, neither of which expected to begin client operations before 1997.

As regards the type and extent of foreign participation, at the end of 1996 the banking sector consisted of (excluding banks under conservatorship):
a) 10 banks without foreign participation
b) 10 banks with foreign participation
c) 13 wholly (100%) foreign-owned banks
d) 10 branches of foreign banks
e) 6 building societies with foreign participation
f) 1 state financial institution.

In 1997, the Czech banking sector was significantly affected by negative internal and external economic influences, and by stricter regulation of banking sector activities. Consolidation of the subsector of small banks during 1996 had led to a principal change in its structure. Banks which, according to the auditor´s statement and an analysis by the banking supervision, were insolvent, had been excluded from the banking sector. However, the consolidation process was accompanied by a decline in public confidence in the banking sector. Small banks experienced a gradual deposit outflow which, being undercapitalized, they would not be able to face very long. To prevent the risk of a liquidity crisis in the small bank subsector, and the possibility of an overall destabilisation of the banking sector, the Czech government adopted in its provision of October 16, 1996, as a systemic solution, a programme for strengthening the banking sector stability, designed for the 13 small banks existing at that time.[8] Six banks showed interest in participating in the voluntary stabilisation programme (Banka Haná, Pragobanka, Universal banka, Moravia banka, Foresbank, Expandia banka). They submitted their specific stabilisation programmes, and gradually during 1997, started to sell their poor-quality receivables to Česká finanční. At the same time, most of the banks increased their initial capital in order to meet the stabilisation parameters.
At the end of 1997, fifty banks were operating in the Czech banking sector. No new entity was granted a banking licence during 1997; the number of banks with a licence dropped by four as a result of revoking the licences of three banks (Ekoagrobanka, Banka Skala, Evrobanka) which were taken over by Union banka, and of the bankruptcy of Realitbanka. Conservatorship continued in four banks: COOP banka, Podnikatelská banka, Velkomoravská banka and Agrobanka.

One of the two banks granted a licence in 1996, the Midland Bank branch, started operations in May 1997; the second one, West Deutsche Landesbank, had its licence revoked, because it had not commenced operations. The Oesterreichische Volksbanken branch changed its legal form and from January 1, 1997, became the subsidiary, Volksbank Prague.

1997 was also the year when the Czech koruna, in May, faced a currency crisis that was faced with increased interest rates and a general liquidity squeeze imposed by the central bank. The liquidity squeeze was continued all over the year, and during the first half of 1998, contributing to economic recession. High interest rates, both nominal and real, represented a significant burden for bank clients, often turning good credits into bad ones.

In 1998, this unfavourable situation continued. The deep economic recession in the business sector had a significant negative impact on the banking sector. High interest rates, the high credit burden of businesses, their inability to obtain funds from the capital market or other cheaper financial sources, and the declining economic activity meant that no room was created for improvement in their performance and their ability to repay funds. The worsening financial situation of businesses placed credit risk at a level which banks could no longer accept. The situation was characterized by the autumn 1998 IMF mission as that of a credit crunch.

[8] The consolidation programme of the Czech banking sector was prepared especially by the Czech National Bank but it was also completed with some measures adopted by the Czech government.

As of 31 December 1998, there were 45 banks and foreign bank branches operating in the Czech banking sector, i.e. five less than a year before. The COOP banka, Velkomoravská banka, Agrobanka and Pragobanka had their licences revoked after failing to meet the prudential regulations. In 1998, several foreign bank subsidiaries operating in the Czech Republic were merged following amalgamations of their parent banks. Bank Austria and Creditanstalt merged to form Bank Austria Creditanstalt Czech Republic, and HYPO-BANK and Vereinsbank became HypoVereinsbank CZ. In 1998, one new banking licence was granted: to GE Capital Bank, which took over part of Agrobanka´s activities.

Another change in the banking sector structure in 1998 was the termination of conservatorship at Podnikatelská banka and the sale of the bank to a new foreign investor.

The stabilisation programme which six small banks signed up to in 1997 continued in 1998. Under the programme, Česká finanční s.r.o. (which was set up for this purpose) purchased these banks´ poor-quality receivables for a period of seven years. During that time, the banks were obliged to create reserves sufficient to cover the repurchase of those receivables that would not be repaid by debtors when the programme comes to an end.

In 1999, the credit crunch continued, leading to a further deterioration of the position of the Czech banking sector as a whole. The overall share of bad credits kept increasing, as businesses were less and less able to cope with the combination of deep recession and high real interest rates. Serious problems were not limited to small banks; more and more, the major Czech banks were getting into a situation when the growing provisions against bad loans brought their final economic results into red figures. Situation was aggravated by steps taken by the bank supervision. In principle, the requirement for banks to create 100% provisions against bad loans guaranteed by real estate collateral was a step in the right direction. But its timing was questionable, as it came in the trough of the recession, and it was not spread over a sufficient time. As it was, it destabilized the banking sector rather than making it sounder. The solution is now sought in finalizing the privatization of the major banks, selling the state-owned shares into the hands of strong foreign strategic partners. Full privatization of large Czech banks is to be achieved during 2000–2001.

As of December 1999, there were 42 banks and foreign bank branches operating in the banking sector, i.e. three less than a year before. Universal banka and Moravia banka had their licences revoked after failing to meet the prudential regulations. Foresbanka by itself decision finished its activity; the majority of its banking activity was delegated to Union banka. In July 1999, the privatization process in one of the biggest bank in the CR (Československá obchodní banka) finished: the Czech government sold its share in ČSOB (65.7%) to Belgian KBC bank. The price was CZK 10.05 bill. (USD 1.11 bill.). In 1999, also the privatization process in Česká spořitelna has been prepared: at the beginning of 2000 the Czech government sold its share in Česká spořitelna (45.0%) to Austrian Erste Bank Sparkassen. Continuing privatization of state shares in the Czech biggest banks has changed a share of domestic and foreign capital in the Czech banking sector: in 1999, the share of foreign capital in the ownership of the Czech banks increased and amounted to 48.4% (as of December 1999). Taking into account the privatization of Česká spořitelna (in 2000) and coming soon privatization of Komerční banka (probably at the end of 2000 or early in 2001) it is supposed that the share of foreign capital in the Czech banking sector will increase.

Summing up, the banking sector has undergone very dynamic development in the decade since 1989. Part of the newly established banks were unable to cope with the strong competition and risky conditions associated with economic transformation, and were forced to terminate their operations. The tightening of the conditions for setting up new banks restricted the entry of new entities into the sector, particularly since 1996. Recently, the structure of the banking sector has been affected by mergers of individual banks, leading to a concentration in the sector. Between 1989 and the end of 1999, a total of 63 banking licences were granted and 20 revoked. Of these, 16 were revoked because of the relevant bank's poor financial situation and failure to meet the prudential rules, 3 as a result of mergers, and 1 because the bank did not start its operations within the allotted legal period.

15 YEARS OF THE CZECH ECONOMY THROUGH THE LENS OF ECONOMIC TRENDS

ECONOMIC TRENDS NO. 34, OCTOBER 2002, PP. 4–5

KAMIL JANÁČEK, EVA ZAMRAZILOVÁ:

FLOODS: THE IMPACT ON THE CZECH ECONOMY

Floods, which hit approximately one fourth of the territory of the Czech Republic, will have contradictory effects on the Czech economy both in the short and in the medium term horizon. The effect on national wealth will be clearly negative, the official estimate of the damage amounts to CZK 80 bill. Nevertheless, the net effect on economic growth will differ both across sectors and time.

Gross Domestic Product

The drop in production in the flooded territories will lead to weaker economic growth for the third quarter of 2002. Reconstruction and renewal works, however, will lead both to an increase in the growth rate of investment in fixed capital, and to growth in the public consumption as of the last quarter of 2002. We expect that the total household demand will be – more than expected – supported by the necessity to replace the destroyed durable and non-durable goods in affected areas and by the higher use of different types of credits.

In the fourth quarter, a slight acceleration of economic growth can be expected; nevertheless, the floods are expected to cause drop in the GDP growth rate by 0.3 percentage point in the second half of 2002. Moreover, the slow recovery in the EU will also decelerate the GDP dynamics. Therefore, we cut our full-year GDP forecast from 3.0% to 2.5%. The effect on the GDP growth in the next one or two years, however, is likely to be slightly positive, amounting to 0.1–0.2 percentage points.

Industry and Construction

The preliminary estimate of losses of industrial companies amounts to CZK 6 bill. Around forty big industrial companies were directly hit by the floods. Approximately two thirds represent direct damage, one third is estimated drop in industrial production. Current situation fully confirms both foreign and domestic experience that the drop in industrial production is usually only temporary and that especially large and medium-size industrial firms are able to re-establish normal levels of production during the couple of months. In majority of hit companies, normal functioning was restored until the beginning of October.

In a longer horizon, the removal of the damage will result in an enhancement of reconstruction and modernisation in at least one part of the companies. The after-flood renewal will also accelerate exits of ineffective companies from the industry, especially in decaying industries (textile, leather, etc.). We keep our 2002 forecast of industrial output growth at 4%.

The after floods reconstruction will be clearly a pro-growth impulse for construction, both for large and small firms. However, the impact for GDP growth will be only limited. Even in the period of strong boom in construction, the direct effect on GDP growth was neutral or even negative due to high share of intermediate product in this sector. Although, the construction output grew very rapidly, the value added in construction was declining. On the other hand, the indirect effect of construction boom concentrated to supplying manufacturing industries can be expected with some time-lag (one to two quarters).

The impact of floods might partly offset the decline of fixed capital investments observed as of the second quarter 2002. We expect the full-year construction output growth around 4%.

State Budget

Approximately one third of total damage will be paid by the state budget, i.e. CZK 25 -30 bill. The cover of flood damages will affect the state expenditures not only in the second half of 2002, but also in 2003 and 2004. We can expect use of some privatisation receipts, revenues from previously issued bonds and increase of some taxes, especially indirect ones. It is clear if the Czech government missed this unique opportunity to start the necessary structural reforms to reverse the long-term tendency of public finances towards chronical deficits.

Inflation and the Exchange Rate

Preliminary estimates indicate that the pressures on the food prices will be only very limited and will concern very narrow range of food products. The floods only cut the expected agricultural overproduction and therefore we can await the normal seasonal increase of agricultural prices in the rest of the year. The autumn's rise of inflation will be provoked predominantly by the rise in world oil prices. The year-end inflation will amount to/or slightly below 2%. Present halt of rapid appreciation of CZK will be temporary only; in a medium and longer term horizon, a further appreciation of CZK is to be expected, albeit at a slower pace.

Labour Market

The increase in unemployment due to closing of companies in the flooded regions will be higher than the increased demand for labour force in construction. At the same time, the main reason for growing pressures on the labour market – weak foreign demand – will preserve. Therefore, the unemployment rate at the end of 2002 will be close to 10 %.

External Sector

We expect an increase in imports, especially of technologies, but also of some raw materials and food products. Nevertheless, the trade deficit will not exceed the upper limit of our previous forecasts, that is CZK 80 bill. On the other hand, the decline in incomes from tourism will cut the surplus on balance of services by 10 – 15 CZK bill., which will increase the current account deficit to CZK 80 – 90 bill. The ratio of current account deficit on GDP will be thus by half percentage point higher than our pre-flooding estimate, reaching 3.6%.

Banking Sector

In short-term horizon, flooding will promote demand for consumer loans and mortgages by households. At the same time, the increase of the types of property insurance covering the flooding is to be expected as well as related insurance costs.

Also in the corporate sector, the demand for credit will increase. The problem will be the economic and financial conditions of some companies asking for new loans, as well as the collaterals. As for the clients hit directly by floods or indirectly by their consequences, one can await the wave of demands for postponement of previously granted loans and a higher degree of bankruptcies in the rest of 2002 and in the first half of 2003.

15 YEARS OF THE CZECH ECONOMY THROUGH THE LENS OF ECONOMIC TRENDS

ECONOMIC TRENDS NO. 38, OCTOBER 2003, PP. 14–15

KAMIL JANÁČEK: **UNEMPLOYMENT IN THE CZECH REPUBLIC: PRESENT STATE AND OUTLOOK**

Unemployment in the Czech Republic has remained just under 10% over the last five years. This means that, permanently, half a million Czechs are jobless. The unemployment rate stays at this level, whether the economy is in recession (1998–1999), or growing (2000–2003). Evidently, Czech unemployment is not cyclical but structural.

There are strong regional differences in the rate of unemployment: on the one hand, there is Prague and surroundings, where unemployment is around 3% (a level practically bordering on full employment); on the other, some regions in North Bohemia and North Moravia have unemployment hovering around 20%. Situation in those regions is all the more difficult that strongly above-average unemployment has been typical here for more than a decade.

As the relatively high unemployment rate is a persistent phenomenon, its cutting to a level considered as socially acceptable (around 4%) will be a several-years task. The condition is to pursue a set of policies aimed at making the labour market more flexible, and fostering new job creation. Such policies have a broader character, and exceed the single powers of the Ministry of Labour and Social Affairs.

1. The notion that economic growth in itself will automatically push unemployment down has not proved to be true. Revival of economic growth at the start of the present decade was accompanied by continuing restructuring within Czech firms. The effect of faster growth was compensated, in relation to labour market, by a trend of downsizing in privatized firms. Moreover, the technological and organizational know-how brought by foreign investors is mainly labour-saving, not labour-intensive.

2. The relative "softness" and generousness of the social safety net means that people are not forced to seek new jobs actively. Weak control mechanisms also make it possible to work in the shadow economy, drawing at the same time unemployment benefits or social allowances. It is vital to shed all the pseudo-social considerations, and to set much stricter rules for obtaining social allowances and unemployment benefits. Slovakia which – in spite of a strong resistance by part of the public – was not afraid to introduce stricter rules, is now getting first positive results: during the first 8 months of 2003, unemployment rate has declined by 4.5 percentage points (with economic growth unchanged).

3. A more flexible labour market requires also a more flexible concept of labour contracts. Legislation should only set some basic standards, on a certain level. Other conditions must be left to be agreed between the employers and employees (full- or part-time jobs, flexible working hours, level of lay-off compensations, time-limited work contracts, etc.). Proposals – which await codification – to regalement the number of hours worked go exactly against a de-regulated labour market.

4. Minimum wage must not be too high, and the tax burden on labour should not be further increased. A high minimum wage prevents hiring of less-skilled or unskilled labour. And, if the proportion between minimum wage and average wage exceeds some level (OECD empirical data suggest that the limit is 40%), it blocks hiring of exactly those groups that are most hit by unemployment. No less devastating for the labour market is the high burdening of jobs with taxes and other payments by employers. Comparison of countries with high and low indirect wage costs shows a positive correlation between high costs for employers, and unemployment. Lowering this burden has a positive impact both on competitiveness of exports, and on creation of new jobs.

5. Support of business activity, especially of small- and medium-sized firms – which should include lower taxes, free consulting services, easier access to credit (credit guarantees), support of exports, and less bureaucratic barriers for upstarts – has direct effect in new job creation. Experience of some countries (USA, Canada) shows that this supports especially new high-skilled jobs, created mostly in services. Newest steps of the Czech government, within the reform of public finance, however go against this trend. Measures in the fields of taxation and social insurance will create new burdens for the self-employed, and will force part of them to lay off workers, or even shut down their businesses.

6. Changes of the education system. Even in regions with higher-than-average unemployment, employers have problems to find workers of some professions, mainly for jobs requiring secondary or university education. It is necessary to end with over-specialization of secondary schools, and to create school leavers with broader backgrounds, capable of flexible adaptation and re-training. The same is true of university education – students should get a broader, more general basis, to be ready for re-training within the so-called life-cycle education. It is evident that Czech education system only partly meets these requirements.

7. Co-ordination of policies, seeking a synergy effect. Changes in legislation must guarantee that social allowances go only to those in need, not to the free-riders. Economic policy should create a business-friendly environment for everyone – not just for selected groups. Tax support should be available also for those who by themselves organize and finance such activities that are, within various government programs, financed by public money.

To conclude, business-friendly economic policy, less regulatory and more growth-oriented, can secure faster economic growth over the long run, creation of new jobs, and lower unemployment. As experience of OECD countries shows, there is no other recipe for cutting unemployment.

15 YEARS OF THE CZECH ECONOMY THROUGH THE LENS OF ECONOMIC TRENDS

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EVA ZAMRAZILOVÁ: **RISKS OF THE INFLATIONARY PRESSURES AFTER THE EMU ENTRY**

After two years after the EU entry, the Czech Republic faces another crucial milestone – the EMU entry. The sine qua non for the EMU entry will naturally be the fulfilment of the Maastricht criteria. At the same time, the discussion among domestic economists has been more and more focused on the evaluation of costs and benefits of the adoption of the euro, on the timing of the entry and on the setting of the appropriate exchange rate level.

In the previous two years, the Czech economy was in a very good condition – accelerating economic growth under the low inflation and improving external balance. The year 2006 will most probably have the same label. There is a question, whether rapid economic growth and low inflation will persist after the eurozone entry. This paper is focused on the possible inflationary pressures that may follow after fixing of the currency (ERM II) and the EMU entry. The recent developments of inflation have put aside the fears from the inflationary pressures. But why is the inflation in the Czech Republic so low?

Factors of Low Inflation

Strong competitive pressures, appreciating currency and sound monetary policy – these have been major factors preventing emerging demand inflationary pressures and enabling good absorption of cost inflationary pressures. High openness of the economy with steady increase of the share of imported goods on both consumption and production makes the role of the exchange rate increasingly important in taming the inflationary tendencies.

In 2005, import prices rose by mere 0.3%, y/y, in spite of record high world prices of fuels. According to the analyses carried out by the Czech Statistical Office, the increase of import prices would be much more significant, if it had not been for the exchange rate appreciation. Note that the CZK appreciated by 6.6% on average with respect to the EUR and by 6.8% against the USD. The import prices of foods declined by 0.8%, y/y, import prices of machinery fell by 4%, y/y, prices of consumer goods dropped by 7.3%, y/y. The weakening of the Czech currency against the USD in the last quarter of 2005 was immediately seen in the inflation figures.

Strengthening competition and appreciating currency have thus been major factors behind ability of the Czech Republic to fulfil the Maastricht inflation criterion in previous years. There is a question whether this will be the case after the fixing of the currency. Let us remind that the Maastricht criteria should be sustainable in the long-term horizon.

Low Relative Price Level

The risks of inflationary pressures after the EMU entry are stemming not only from the fact that the appreciating currency prevents inflationary pressures but also from the fact that the Czech relative price level is very low. According to the Eurostat, the relative price level (of final consumption of households) is approximately at 55% of the EU 25 average. This is one of the lowest price levels in the EU 25, similar to Poland, Latvia, and Slovakia (52%, 55%, 55% of the EU 25 average, respectively). Low relative price level represents the most significant deviation within the framework of the real convergence to the eurozone. Even the less developed members of the eurozone did not have such a low relative price level at the moment of EMU entry – the lowest price level of 75% of the EU average belonged to Portugal. Anyway, this was by approximately 20 percentage points higher than the today's Czech reality.

Some economists may not consider the problem of low price level of so great importance, pointing to the fact that considerable differences between the price levels persist within the EMU itself. However, in the case of the Czech economy, the problem of low price level is accompanied by the discrepancy between the price level and the relative GDP level (level of economic development). Some difference between GDP (in terms of PPP) and relative price level is typical for small and opened economies; relatively high differences being observed also for Belgium, the Netherlands, Austria, and Ireland. However, the relative price level in these economies is not lower than in EU 25. The relative price levels in Poland, Slovakia and Hungary are very close to the GDP (PPP based) level.

In the period 1999–2004, the Czech relative price level increased by 10 percentage points. The convergence of price levels may be based on two channels: inflation differential or nominal appreciation of the currency. Regarding the fact that in this period the average Czech inflation was roughly the same as in EU 25, the increase in relative price level was driven by the nominal appreciation of the currency. The importance of the exchange rate is thus stressed again. What will happen after the fixing of the exchange rate? The scenario of increased inflationary pressures will be highly probable.

Key Role of the Exchange Rate

To sum up, the importance of the exchange rate is stressed at least by two circumstances:
– appreciation of the currency prevents inflationary pressures,
– appreciation of the currency is the main channel of the convergence of the Czech price level to eurozone.
If the exchange rate is fixed too early, the channel of the price convergence via nominal appreciation of the currency will be closed and the threat of its spillover to the price channel will be imminent. The scenario of increasing inflation, weakening of economic activity and slowdown in the process of real convergence is realistic. At the same time, the convergence of the price level based on the nominal appreciation of the exchange rate is the best way because it does not threaten domestic price stability. Therefore, it is not reasonable to close the nominal appreciation channel too early.

Since 2001, the process of real convergence of the Czech economy accelerated – both the GDP (PPP based) level and the relative price levels have come significantly closer to the EU average. Czech economy followed the trajectory of accelerating economic growth under low inflation. Premature entry to the eurozone may change this picture dramatically. The case of the Irish economy may serve as an interesting example.

The Irish Case

Although the Irish economy is much more developed than the Czech one, there have been some similar features as small size and high openness of the economy. In addition, the positive effects of foreign direct investments were the main driving force of strong economic growth in the nineties. Moreover, the exchange rate of the Irish pound has been appreciating in this period. Until 1998, that is until fixing the exchange rate, strong growth was accompanied by low inflation (lower than the EU average). However, this picture has changed after the EMU entry: inflation increased, followed by slowdown in economic growth. In recent two years, the inflation was pressed down by restrictive economic policy; nevertheless, the economic growth has also been considerably lower than in the nineties.

With respect to the developments of inflation in recent years and taking into account persisting existence of very low relative price level, the most reasonable policy is to wait with the fixing of the exchange until the appreciation of the currency does not stop. The appreciation of the exchange rate has been connected with the real convergence of the Czech economy towards more developed market economies. If the exchange rate was fixed too early, the exchange rate channel of the price convergence would be closed. Consequently, inflationary pressures would emerge, followed (with high probability) by slowdown of economic growth and slowdown of the real convergence processes. In addition, the increase of inflation may lead to exceeding the Maastricht inflationary criterion. This could lead to prolongation of the ERM II period, which is consensually considered to be quite dangerous for the Czech economy.

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