Economic Trends

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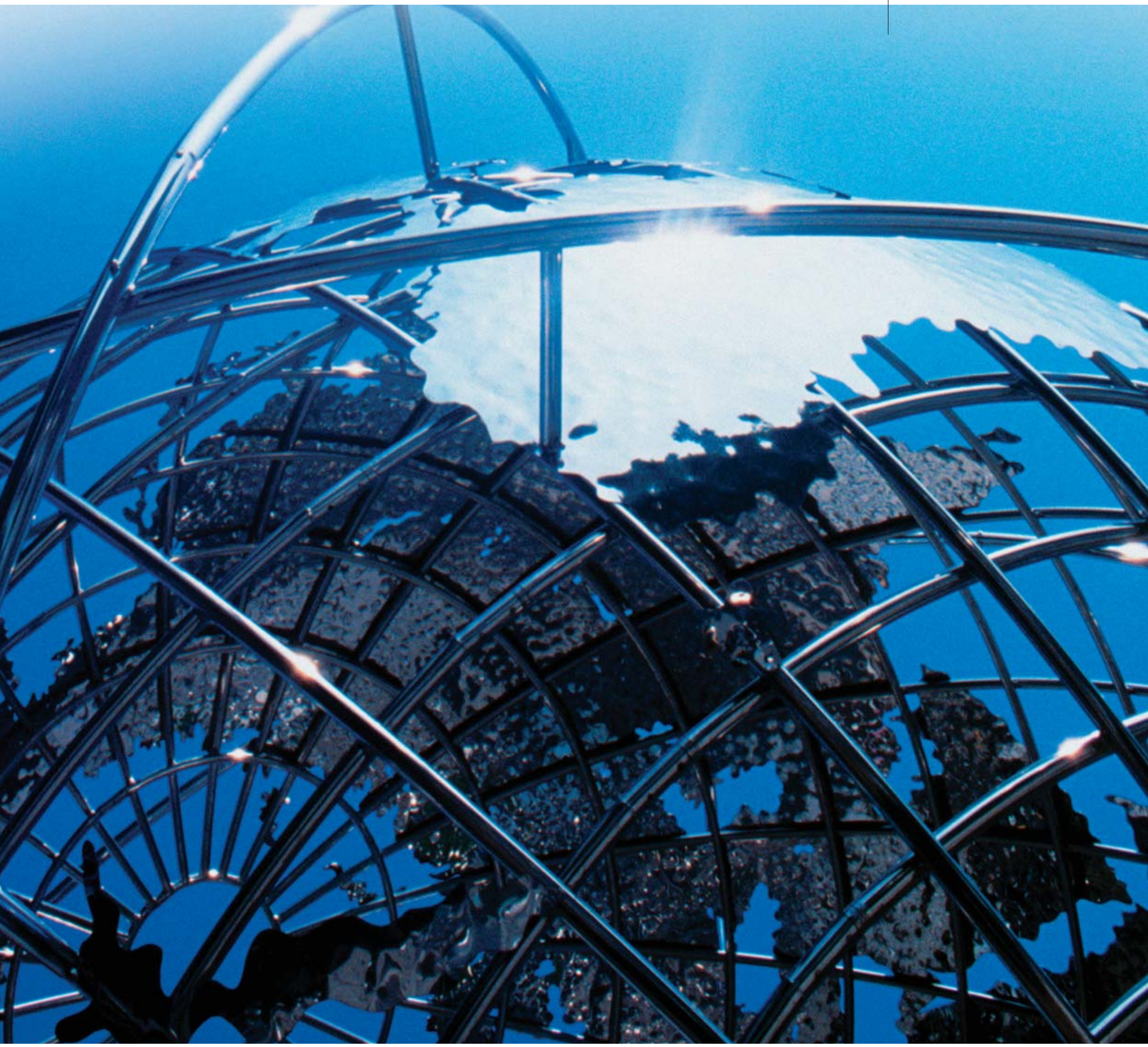

CONTENTS

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CZECH ECONOMY IN EARLY 2010: FRAGILE STABILISATION

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1. Economic Dynamics

Czech economy shrank considerably during the last quarter of 2009 according to flash estimates of the Czech Statistical Office, after two quarters of a weak growth in quarter-on-quarter perspective. During the fourth 2009's quarter, gross domestic product slumped by 4.2% y/y, quarter-on-quarter development returned to red numbers with a fall of 0.6%. The preliminary results on fourth quarter surprised the markets negatively when consensus forecast pointed to a quarter-on-quarter growth of 0.8% and year-on-year fall of 2.8% only. The Czech National Bank also expected a lower year-on-year drop at 2.7% only. Previous quarter-over-quarter turnaround seems, therefore, rather fragile in the light of recent data. Nevertheless, detailed structure will be published in March together with final GDP results, which may revise the flash estimates substantially. Overall in 2009, the economy was 4.3% down compared to previous year.

Technically, the data on the third quarter confirmed the end of Czech economic recession. After growing 0.3% q/q in the second quarter, real GDP was 0.8% q/q up in the third quarter. Compared with the last recession of late 1990s, the 2008/2009 downfall lasted shorter but its scope was much larger. Still, the turnaround was rather poor so far – the average quarter-on-quarter growth during the previous period of economic expansion in 2005–7 amounted to strong 1.6%. Moreover, growth rates reflect the effect of previous periods' comparative bases – weakening performance since late–2008 tends to technically improve recent results.

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Table 1: Main Macroeconomic Indicators

		2007	2008	10/09	11/09	12/09	*01/10*	*2009F*	*2010F*
Inflation	%, y/y, eop	5.4	3.6	-0.2	0.5	1.0	0.7	1.0	*1.9*
	%, m/m	–	–	-0.2	0.2	0.2	1.2	–	*–*
	%, 12m average	2.8	6.3	1.6	1.3	1.0	0.9	1.0	*1.4*
Industrial prices	%, y/y, eop	5.3	-0.2	-4.6	-2.4	-0.8	-1.5	-0.8	*1.5*
	%, m/m	–	–	-0.2	0.4	0.1	0.5	–	*–*
	%, 12m average	4.1	4.5	-2.8	-3.1	-3.1	-3.2	-3.1	*1.5*
Unemployment rate	%, eop.	6.0	6.0	8.5	8.6	9.2	9.8	9.2	*9.8*
	%, 12m average	6.6	5.4	7.6	7.9	8.1	8.4	8.1	*9.8*
Industrial production	%, real	10.8	-1.5	-7.2	-0.1	1.8	*2.0*	-13.4	*4.0*
Construction output	%, real	7.1	0.0	-1.1	5.9	3.5	*-4.5*	-1.0	*1.0*
Retail sales	%, real	10.0	2.8	-4.7	-4.9	-1.9	*-3.0*	-4.3	*1.0*
State budget	CZK bill.	-66.4	-19.4	-138.1	-169.4	-192.4	13.1	-192.4	*-165.0*
Trade balance	CZK bill.	85.0	67.2	17.5	14.5	2.8	*0.0*	153.2	*80.0*
FOREX reserves	USD bill.	34.9	37.0	41.4	42.5	41.5	41.1	41.5	*44.0*
PRIBOR 3M	% average	3.1	4.0	1.9	1.8	1.6	1.6	2.2	*1.9*
CZK/EUR	Average	27.8	24.9	25.8	25.8	26.1	26.1	26.4	*25.6*
CZK/USD	Average	20.3	17.0	17.4	17.3	17.8	18.3	19.1	*18.0*
				Q1/09	Q2/09	Q3/09	*Q4/09*		
GDP	%, y/y	6.1	2.3	-4.2	-4.7	-4.1	*-4.2*	*-4.3*	*1.5*
Current account	USD bill.	-3.3	-6.6	1.1	-1.4	-1.1	*0.0*	*-1.3*	*-3.3*
	% of GDP	-1.8	-3.1	-3.3	-2.5	-2.3	*-0.7*	*-0.7*	*-1.5*
Financial account	USD bill.	4.9	8.9	-0.3	1.3	1.9	*0.3*	*0.9*	*1.4*
	% of GDP	2.7	4.1	4.4	3.2	2.9	*0.5*	*0.5*	*1.0*

Source: Czech National Bank, Czech Statistical Office, Ministry of Finance of the CR, forecasts by Komercni banka marked red, italics

2. Structure of Growth

During the third quarter of 2009, the negative trend in Czech economic performance was mainly determined by the lasting slump of manufacturing industry production in year-over-year perspective. The drop reached considerable 9% in the third quarter, which is somewhat less compared to the previous one, but still does not give a favourable picture of the situation in Czech industry. Further drops were registered in energy sector, mining and quarrying and trade; milder negative tendencies were recorded in construction and services of hotels and restaurants. On the other hand, agriculture, financial intermediation and healthcare exhibited positive development. In quarter-on-quarter view, manufacturing industry production returned to red numbers after a favourable result of the second quarter; similar negative development was registered in energy sector. In contrast, positive contribution was brought in by financial intermediation, construction, transport, trade and services.

Demand side structure concerning the third quarter confirmed trends from previous period and, furthermore, revealed the expected contraction of consumer demand, resulting from unfavourable labour market situation. Although the year-on-year dynamics sustained in black numbers (+1.3%), household expenditure tumbled 0.6% compared to previous quarter. Government consumption increased considerably (+5.3% y/y, +2.2% q/q) mainly on account of healthcare expenditure pickup. In contrast, the data show a lasting drastic curb in firms' investment as a result of adverse economic development and uncertain future outlook. Gross capital formation shrank by 23.8%, when gross fixed capital formation fell by 9.5%. Therefore, the most pronounced slump happened in stock of inventories which cut off 3.4 percentage points from overall GDP growth. Relatively solid growth of net exports was dampened by the negative effect of terms of trade and ended up in a 2.7% y/y real increase of active trade balance. This is considerably better outcome than in the previous quarter, mainly due to the effect of foreign fiscal stimulation programmes. In the third quarter, foreign trade represented a stabilization element of economic development.

Detailed structure of the fourth quarter's results has not been published yet. However, the statistical office indicated that in quarter-on-quarter view, the negative trend in Czech economic performance was mainly determined by the slump in taxes on products reaching 6.9%, mainly due to high comparable basis of previous quarter. On the contrary, total gross value added reported a 0.2% growth mainly as a result of positive contribution of industry. Nevertheless, drop in trade, business services and construction pulled the economy down. Given the development of foreign trade in late–2009, we may expect that foreign trade represented a factor driving the economic performance in the last quarter.

2.1. Industrial Production

Czech industrial sector continued to suffer from adverse developments that started already in late 2008. Total year-on-year slump of the industrial production during 2009 reached 13.4%. The growth dynamics was negative in all the 2009's months but December, which registered a negligible positive growth. The dynamics of the industrial production slump hit the bottom in April and May and consequently decelerated, largely being driven by falling comparative bases of the previous year. Moreover, overall industrial development in 2009 was also substantially stimulated by foreign scrapping premia, largely supporting automotive industry and following sectors. Month-over-month development sustained in red numbers in eight months of 2009 (positive growth was registered in March, June, August and October only), which also does not indicate any stable turnaround in a more favourable direction. Forward-looking indicators of confidence, despite showing a weak improvement, confirm the uncertain outlook of the sector.

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The 2009's fall in industrial production was to major extent caused by a drop in manufacture of machinery and equipment (-27.2%), manufacture of metal structures and fabricated metal products (-21.8%) and manufacture of motor vehicles, trailers and semi-trailers (-10.2%). Furthermore, huge declines of output exceeding 20% were recorded in manufacture of basic metals and fabricated metal products, manufacture of other non-metallic mineral products and in manufacture of electrical equipment. The only positive development was registered in manufacture of food, beverages and tobacco (+5.3%). Some stabilisation of the development (although the considerable effect of lower comparative bases must be still in mind) was recorded during the last quarter, when automotive and other industries greatly profited from foreign fiscal stimuli (manufacture of motor vehicles, manufacture of rubber and plastic products, etc.). Moreover, chemical industry and manufacture of paper also exhibited a positive dynamics.

New industrial orders give some signs of improvement for the future: November and December witnessed an increase of industrial orders, foreign orders growth even exceeded the one of the domestic orders. As regards the development in particular sectors, the worst situation persists in manufacture of basic metals and fabricated metal products. On the other hand, manufacture of machinery and equipment and manufacture of electrical equipment started to pick up by the year-end, despite the huge slump during the year. On the contrary, new orders kept growing throughout the last quarter in manufacture of motor vehicles and other transport equipment and in manufacture of chemical products.

In 2009, sales in the industry went down even more than did the output, by 15.1%, reflecting the drop in industrial producer prices. The gap between development of output and sales indicates that financial situation of businesses remains rather poor and profit margins have been reduced substantially. Real direct export sales declined relatively less compared with domestic sales and December even witnessed a recovery in export sales growth, resulting from weak rebound of foreign demand.

The fall of employment in industry (enterprises with more than 50 employees) accelerated over the year (reaching 12.9% y/y in December) and averaged on 11.3% in 2009. The largest reductions were recorded in manufacture of textile and manufacture of other non-metallic mineral products. Nominal wages increased 3.6% y/y despite the unfavourable labour market situation mainly as a result of reduction of less-qualified and low-wage labour.

2.2. Construction Output

Czech construction sector was heavily affected by economic downturn through the rapidly falling demand for its production: firms curb their investment and household demand for new flats slumps considerably. The deteriorating labour market situation and tight credit market play considerable roles. In 2009, real construction output dropped by 1.0% y/y. The development was partially affected by two missing working days compared to previous year; adjusted for this influence the construction gets to a milder decline of 0.6% y/y. Civil engineering recorded a solid growth of 14.3%; on the contrary, building construction output dropped by 7.0%. The largest slump of total construction output was recorded during the first quarter of 2009, when it contracted by 11.5% y/y (mainly due to a slump of building construction at 15.9% and a weaker growth of civil engineering that added 6.3%).

The end of 2009 witnessed a temporary rebound in performance of the construction sector (November +5.9% y/y, December +3.5%). This was mainly a result of two factors. In November, extraordinarily favourable climatic conditions enabled continuation of all types of construction works which is not a common seasonal feature. In December, certain shift in finishing of already started constructions towards the year-end was registered due to the January 2010's hike in the VAT. Indeed, building construction confirmed its return to black numbers after thirteen months of drops in a row, when it increased by 4.6% y/y in December.

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In 2009, the average number of employees in construction enterprises with 50 or more employees fell by 0.2% compared with 2008. After a stable growth during the beginning of the year (with an exception of February) employment contracted substantially during four last months of the year – the drop averaged on 0.9%. Larger enterprises considerably profited from the boom in civil engineering, orders of which are not usually available to smaller firms. Still, companies with less than 20 employees account for two-thirds of total employment in the sector and a sharper employment decline might be expected given their greater involvement in building construction. Nevertheless, data from labour force surveys show a stable growth of employment in the sector during first three quarters of 2009, which refers to small enterprises and household trades as well. We assume that larger reduction of labour stock in the sector took place during the last 2009's quarter and will continue in 2010 as well, bearing in mind the poor demand for construction production from households and firms; we do not expect as sharp reduction in demand of public sector. Average monthly nominal wage increased by 5.5% in 2009.

Certain weak turnaround was registered in development of the forward-looking indicator of business confidence in the sector, the dynamics of which hit its bottom in November after the lasting huge slump during the whole 2009, and consequently begun to turn around. Still, the data do not point towards favourable future perspectives of the sector. Statistics on housing construction in the fourth quarter of 2009 still show a negative trend: number of dwellings started was 21.2% down compared to 2008. In contrast, construction of already started dwellings moderately revived: dwellings completed were 2.6% up compared to 2008. Granted building permits declined 6.0% y/y, when approximate value of these constructions grew 15.4% y/y. New orders contracted by 35.3% y/y.

3. Labour Market

The situation on Czech labour market sharply deteriorated during 2009. Number of unemployed persons far exceeded the symbolic threshold of half million and the registered unemployment rate went up from 6.8% in January to 9.2% in December. In average, the unemployment rate raised to 8.1% (while it stood at 5.4% in 2008 only). January 2010's development continued in negative trend of 2009. Besides the unfavourable effect of economic climate, the development was also negatively influenced by termination of seasonal works in construction, agriculture etc. and termination of fixed-term contracts. The number of registered unemployed persons went up to 574.2 thousand in January and the unemployment rate jumped to 9.8%, which corresponds with the level reached for the last time in January 2005. Men unemployment rate soared to 9.3% and its pace of growth accelerated much more strongly than the unemployment of women, that reached 10.6% in January 2010. The fall in demand for labour stopped in January 2010 when the number of offered vacancies grew by weak 2% m/m reaching 31.6 thousand. Still, this represents a very low level and a year-on-year drop of almost one half. Overall, the figures recently jumped to 18.2 unemployed per vacancy, which is the new record high in history of the Czech Republic. The ratio increased considerably when it averaged on 6.8 in Q1 2009 only.

The situation on Czech labour market sharply deteriorated during 2009. Number of unemployed persons far exceeded the symbolic threshold of half million and the registered unemployment rate went up from 6.8% in January to 9.2% in December. In average, the unemployment rate raised to 8.1%.

Regardless of the soaring unemployment, average real wage exhibited a solid growth in Q3 (4.7%; average 2.4% in Q1–Q3 2009), mainly as a result of reduction in employment of least-qualified low-wage workers, which are the easiest to replace. In contrast, firms hesitate to lay off high-qualified employees, as these would be hard to hire back once the production and demand for labour rebounds. The industrial and agricultural sector was hit the most so far, although recently a cut down in employment has started in construction and services as well. In 2009, the largest growth in number of unemployed was registered in occupations supplying to industrial sector: particularly craft and related trades workers and plant and machine operators and assemblers. These categories account for almost one third of all the unemployed. As regards the age structure of unemployed, relatively largest increases were registered in age group 20–25 years and, to lesser extent, also in age group 26–40 years. On the other hand, the share of unemployed older than 40 and, particularly, older than 50 has been continuously falling. Besides the potential effect of early retirement, this might be considered an evidence of the above-described rational behaviour of firms.

With the overall GDP slump estimated at 4.3% in 2009, the drop in demand for labour is an inevitable reaction of firms coping with the falling demand for their production and trying to cut down costs. Still, number of employed fell back below the 5 million threshold, where it stood before Q1 2008 and narrowed by 1.4% only in 2009, far less than was the respective fall in output. Negative trend in output was cushioned by certain labour market adjustment. While the number of employees narrowed, number of self-employed in main job slightly increased. Number of part-time workers grew by 10.1% during Q1–Q3 2009 and the growth has been accelerating, reaching 12.2% in Q3. Similarly, number of work hours in main job shrank by 1.5% in average during Q1–Q3 2009, with certain acceleration of the decline (it amounted to -2.3% in Q3).

4. Household Consumption

Household consumption weakened substantially during 2009. The key factors dragging the consumer demand down were soaring unemployment, limited wage growth and tight credit market, resulting in uncertain future financial situation of households and highly cautious behaviour of households. This effect was mainly reflected in purchases of long-term consumption goods, investment goods and luxurious goods. On the contrary, necessary goods such as foods or pharmaceuticals kept a relatively stable position.

Situation in retail trade confirms the substantial weakness of domestic consumer demand. Czech retail sales fell 4.3% in average during 2009, while they did not reach the previous year's level in a single month and kept in negative territory over the whole year. The falling dynamics accelerated in the third quarter and consequently slowed down in December. In contrast with real development, the index of consumer confidence improved from its February's low of 74.2 to 95.3 in December which represents a positive signal, although its balance still stays in red numbers. However, January 2010 witnessed a drop in consumer confidence again.

The biggest drag on the retail sector development was a huge drop in sale and repair of motor vehicles (-11.1%). Retail sales excluding the automotive segment went down in average by 1.4% y/y during 2009. Sales of non-food goods generally pulled the retail trade down when they declined by 2.9% y/y. In detail, sales reduction was recorded in all the surveyed product groups but pharmaceutical and medical goods, which added 3.5 %. Sales of fuel declined by 1.7%. In contrast, sales of food kept a relatively stable position and increased by 0.9%. Particularly, a considerable slump was reported in sale of food, beverages and tobacco in specialized stores. On the contrary, positive growth figures were recorded in non-specialized stores with food, beverages and tobacco predominating; among these stores the group of enterprises employing more than 100 employees (including mainly big chain stores) profited the most.

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The more cautious behaviour of households manifested itself strongly in a considerable slowdown in dynamics of loans. Volume of households' loans by monetary and financial institutions amounted to CZK 983.3 bill. in December 2009 and grew in average by 16.3% y/y during 2009 with a huge deceleration of growth from 20.3% y/y in January to 12.1% y/y in December. The dynamics of housing loans and consumer loans almost equalised. Alongside, household saving growth tended to decelerate due to worsened financial situation of households.

By the end of 2009, household indebtedness approached 31% of GDP, which represents a milder growth than was expected mainly due to recession. The level of household indebtedness stays relatively low in an international comparison and still does not represent any serious economic threat, unlike the situation in public indebtedness. Nevertheless, adverse economic developments curb the households' ability to repay the debt and push the default rate up. There was registered a slight increase in proportion of classified loans to households in 2009, from 5.4% in January to 7.0% in December.

5. Foreign Trade and External Balance

Situation in Czech foreign trade was seriously affected by economic recession, both in domestic and global point of view. The exports relatively profited from foreign demand stimulation by scrapping bonuses and other expansionary measures, while poor domestic demand together with lower world commodity prices pulled down the imports. Overall, foreign trade balance during period January–December 2009 reached strong CZK 153.2 bill. (i.e. record high in the Czech history and by CZK 85.9 bill. more compared to 2008's outcome). The exports of goods dropped by 14.1% y/y, and the imports slumped by 18.1% in average.

Generally compared with 2008, trade surpluses increased in trade with miscellaneous manufactured articles, in trade with manufactured goods classified chiefly by material and in trade with crude materials. Deficit in trade with mineral fuels and chemical products shrank. The surplus of trade with machinery and transport equipments moderately declined compared with 2008, mainly due to the huge export contraction during the first half of the year, which was not completely offset in the second half despite its solid results.

Trade with the EU–27 ended up in a surplus of CZK 498.5 bill., representing a year-over-year gain of CZK 1.9 bill. An improvement was recorded in trade with main trading partner, Germany (+CZK 48.5 bill; effect of scrapping bonuses), while the surplus in trade with the second most important partner, Slovakia, somewhat narrowed (-CZK 4.1 bill.). The trade shortfall with the non-EU countries amounted to CZK 345.3 bill., i.e. CZK 84.1 bill. less than in 2008. The largest deficits were produced by China (CZK 174 bill.) and Russia (CZK 56.3 bill.). Czech trade registered a considerable reduction of these deficits compared to the previous year mainly due to falling value of imports of oil and fuels (Russia) and machinery imports (China).

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Foreign trade year-on-year dynamics stabilised in the last quarter of 2009 even with a turnaround into black numbers registered on the export side after thirteen months of a slump in row. Despite considerable stabilisation of its falling trend, the imports are low as a reflection of weak domestic demand of firms and households. The December's development of both foreign trade components registered the most favourable values since September 2008. However, this was largely a result of falling comparative bases of 2008, month-over-month growth rates remained rather poor with an exception of November. Despite the sluggish dynamics, foreign trade outcomes during the last quarter of 2009 were favourable; December's trade balance was even positive for the first time in history of the CR. These huge trade surpluses were considerable affected by a growth of surplus in trade with machinery and transport equipment (where the Czech export largely profited from foreign fiscal stimulation programmes) and reduction of deficit in trade with mineral fuels (given by low prices and weak demand).

Overall, external balance of the economy remains favourable despite the stormy economic development. Positive foreign trade balances and underlying factors were also reflected in developments of the balance of payment. In 2009, current account deficit considerably improved on year-over-year basis reaching CZK 25.4 bill., which is the lowest figure in the history of the Czech Republic and by CZK 88.5 bill. less than it was in 2008. The figures indicate current account deficit on 0.7% of GDP in 2009, being almost outweighed by the surplus on financial account amounting to 0.5% of GDP. Financial account ended up in a surplus of CZK 16.3 bill. in 2009. The data mainly reflect a positive effect of substantial improvement in foreign trade, weakening outflows of income abroad resulting from falling profitability of domestic firms, and, finally, sluggish investment activity as a consequence of global recession.

6. Exchange Rate

During late 2009 and early 2010, the koruna's exchange rate has been largely driven by general sentiment towards CEE markets. Domestic macroeconomic fundamentals or political development played a rather minor role in this setting. After hitting its 2009's record high of 25.09 CZK/EUR in mid-September, Czech koruna depreciated and returned back towards the 26 CZK/EUR threshold by the year-end. Generally similar development was registered with respect to the US dollar, although the fluctuations were much more pronounced: while the variation coefficient of CZK/EUR exchange rate in Q4 2009 amounted to 1.2% (0.5% in January–mid February 2010), the same figure for the CZK/USD exchange rate reached twofold value of 2.4% (2.0% respectively). The CZK/USD exchange rate dynamics was driven by the development of the underlying EUR/USD rate (correlation period in period 1/2009/1/2010 stands at -0.97), reflecting the shifts of sentiment between these two huge markets. Presently the euro has been largely loosing on account of Greece's poor fiscal situation. Concerns over Greece's ability to rein in its spending and to service its heavy debt have continued to haunt the markets, putting pressure on the euro and even prompting speculation that Greece could be forced out of the euro area. Meanwhile, weaker euro supports economic growth in the euro area and consequently also in the Czech Republic.

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7. Inflation

Inflationary pressures in the Czech economy were marginal during the whole 2009 (with an exception of January) – lasting drop in agricultural producer prices did not push towards a growth in food prices, wage driven inflation was minimal, foreign development together with stronger koruna did not favour imported inflation either. Consumer inflation was very low during the year and second half of the year witnessed even four months of price level fall in month-over-month horizon (July–October). In year-on-year perspective, the bottom of the price slump was registered in October (-0.2%) and inflation and started to pick up afterwards. Overall in 2009, average inflation reached weak 1.0% (it stood at 6.3% in 2008), which is the second lowest figure in the Czech history. It was influenced by the high comparative basis and by a general pressure towards price decline as a result of domestic and global recession. Inflation has been under the Czech National Bank's target (3% in 2009) throughout the whole 2009. Prices of foods and non-alcoholic beverages fell 3.9%, prices of alcohol and tobacco added 6.5%. Prices in transport category declined by 5.8% (automotive fuels -11.8%, cars -9.2%), opposite development was recorded in housing category (+7.2%). Market prices fell 0.7%, regulated prices increased by 8.1%.

During the last quarter of 2009, consumer price level fell or stagnated month-on-month in categories post and telecommunication, recreation and culture. The major effect towards growth in price level stemmed from clothes and footwear and food and non-alcoholic beverages, affected by seasonality. The year-over-year CPI development was generally driven by a growth in prices of transport, where growth of automotive fuel prices accelerated mainly as a result of low comparative bases. A considerable price increase was registered in housing category, due to an increase in prices of electricity, heat and hot water, water supply and net actual rentals (mainly as concerns dwellings with regulated rentals, while market rentals picked up relatively less, being held down by deteriorating financial situation of households). In contrast, prices of natural gas were falling. The price decline in foods and non-alcoholic beverages, clothing and footwear, post and telecommunication and recreation and culture further dampened the overall price growth.

Consumer price development in January 2010 largely reflected the effect of a hike in indirect taxes and regulated rents. Yet, the pickup was lower than stood market expectations: this factor remained subdued due to weak consumer demand disabling more pronounced shifts of higher tax burden to final consumer prices. Instead, firms were forced to further cut down their profit margins to preserve demand for their production. The most significant month-over-month growth was recorded in regulated rents, fuels and alcohol. In contrast, the effect on other consumption goods and cigarettes has been rather limited so far.

Industrial producer prices followed a negative trend throughout the whole 2009 when compared with the previous year. After reaching the bottom of its year-on-year slump at -5.4% in September after six months of falls in a row, the dynamics started to slow down. Yet, these figures represented the largest annual falls of industrial prices since 1991. On average, industrial producer prices were 3.1% down compared to 2008. In month-over-month view, prices started to pick up by the end of the year, following the development of world commodity and oil prices. The general result was continuously pulled down by a substantial drop of producer prices in manufacturing (-5.6% y/y) and raw materials (-3.9% y/y). On the other hand, the PPI in electricity and gas production increased (+10.9% y/y), as did prices of water producers (+6.9% y/y). Among the manufacturing industries, substantial drops were recorded in prices of metals (-10.8% y/y) and foods (-4.5% y/y). After thirteen months of slumps in a row, prices of coke and refined oil products went up substantially in December, but still averaging on -29.1% y/y in 2009 as a whole. In contrast, prices of machinery and equipment and transport equipment slightly increased (+1.7% and +0.5% y/y, respectively).

Consumer inflation was very low during the year and second half of the year witnessed even four months of price level fall in month-over-month horizon (July–October). Overall in 2009, average inflation reached weak 1.0% (it stood at 6.3% in 2008), which is the second lowest figure in the Czech history.

Agricultural prices witnessed even a more stormy development compared with the industrial sector. The overall 2009's price downfall in this segment reached huge 24.8% y/y and the dynamics sustained in red numbers through the whole year. Prices have been declining on year-over-year basis already since September 2008. However, after hitting its low in May 2009, the falling trend tended to decelerate. The drop was mainly attributable to fall in prices of crop products; growth in animal products prices was not as pronounced. The crucial factor holding the price level low was weak (both domestic and foreign) demand. Falling agricultural producer prices tended to drive the decline in food prices and to hold the consumer price inflation low. Yet, certain turnaround in this respect was registered in December 2009 and January 2010, when agricultural prices increased by 1.2% and 4.2% m/m, respectively, indicating future pressures on food prices.

8. Monetary and Fiscal Policy

The Czech National Bank proceeded to further loosening of monetary conditions in late 2009. After it had been cut down for seven times in a row since August 2008, the basic 2W repo rate hit its new historical minimum of 1% in December 2009. This step was mainly seen as a support of economic growth as the country recovers from a recession and was preceded by the November's quarterly report on inflation, assuming lower interest rates without any actual cut being made by that time. Yet, published macroeconomic figures (weaker koruna, faster wage growth, higher than predicted inflation, GDP development and looser state budget) represented rather pro-inflationary factors and pointed in favour of continuing stability of the repo rate. The December's cut put the Czech rate level with the main ECB's refi rate.

On its next monetary-policy meeting in February 2010, the Bank Board confirmed the inflationary risks being balanced without any change made in the rate settings. In their public announcements, several Board members claimed that the repo has already reached its bottom. Governor Tůma announced that the CNB expected stability of interest rates in the first half of the year and a gradual growth afterwards. The rates will tend to normalize from their current record lows along with monetary-policy inflation creeping up the targeted level of 2% in Q2 2011 (actual inflation predicted at 2.1%). The CNB's inflation forecast stands at 2.1% for Q3 2010 and 2.6% Q4 2010.

Basic 3M PRIBOR roughly traced the repo rate dynamics, amounting to 1.6% in December 2009 and 1.5% in January 2010. Nevertheless, banks stay highly cautious in credit granting (in both tighter credit granting conditions and higher risk premia). While the interest rates on loans by firms registered a moderate declining trend, interest rates on household loans headed in an opposite direction. This is a reflection of the fact that while the corporate sector is expected to rebound slowly, the major deterioration of the households' financial situation is yet expected to come.

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Fiscal policy switched from expansionary stance of previous year to a more restrictive approach in 2010 in a weak attempt to put the Czech financial house in order. The package of several legislative measures aimed at reducing the 2010's deficit mainly consisted of hikes in taxes (the VAT, excise duty on fuel, alcohol and cigarettes etc.) at the expense of larger cuts in expenditure. In 2009, state budget deficit jumped to a record high of CZK 192.4 bill. (and exceeded the 2009's result ten times). The state debt soared to CZK 1178.2 bill. by December 2009, meaning a huge jump of 17.9% y/y. This development partly reflects the inevitable drop in tax revenues alongside the falling economic activity and pressures towards larger expenditure on social provisions. Yet, the figure also shows the unsustainable situation of expenditure side of the state budget, suffering from a huge mandatory share.

Till the moment, no consensus was found as regards any systemic reform to mandatory expenditure that are seriously threatening the future economic development of the country. Apart from shifting the realistic date of euro area entry beyond 2016, there exists a substantial risk of worsening the country's assessment by the rating agencies. Such a step might in turn represent even a larger burden fort the budget due to increased risk premia on government bonds. Unfortunately, there is only a small chance to hope for any considerable change in 2011's budget as it will be mainly prepared by the present caretaker government, with no political support to introduce necessary–and unpopular–measures. Overall situation of public finance will be in 2010 negatively impacted by scheduled May's elections to Chamber of Deputies.

The 2010's stabilisation will be very fragile and domestic economic development will be largely affected by two factors in 2010: fiscal instability magnified by political uncertainty, pulling the economy down, and economic development of the euro area countries, potentially representing the main growth driver during the year.

9. Outlook

Data on the GDP development in 2009's last quarter show that, despite some stabilisation in macroeconomic figures, the situation remains highly vulnerable. Previous weak quarter-on-quarter economic dynamics returned to negative territory and year-over-year slump does not give a positive picture in spite of falling comparative bases. The 2010's stabilisation will be very fragile and domestic economic development will be largely affected by two factors in 2010: fiscal instability magnified by political uncertainty, pulling the economy down, and economic development of the euro area countries, potentially representing the main growth driver during the year. We expect a consolidation of general economic conditions during next quarters with a return of the year-over-year growth into black numbers by the beginning of 2010. Generally, certain deceleration of year-over-year economic dynamics might occur in mid-2010 (partly also as a result of raising comparative bases), resembling the development tracking the asymmetric W-shape. Still, a prompt return to the past growth dynamics is not realistic and recent turnaround has to be considered highly fragile so far.

Domestic consumption remains very weak and, given the expected continuing deterioration of labour market situation and 2010's fiscal restriction, we can certainly not expect any strong growth in this segment until mid-2010 at least. Financial situation of firms determined by falling profit margins and tight credit conditions does not allow for any considerable growth in investment either. A factor that is promising is the expected gradual recovery of stock of inventories, both in the Czech Republic and abroad. Foreign trade was stimulated by foreign scrapping premia and other fiscal measures in 2009. Still, we cannot rely on this factor in 2010 anymore and the crucial question stands whether the slowly reviving foreign demand will be able to compensate for this shortage. Still, the most important factor, potentially pushing the Czech economy up in 2010, is a sustainable recovery of foreign demand, particularly the demand of the euro area.

During last months, eurozone countries have showed some signs of stabilisation and certain sluggish improvement of economic conditions. This development was reflected in several upward revisions of economic forecasts for the Czech Republic as well. In its November's economic outlook, OECD expects the 2010's Czech economic growth rather high at 2%, i.e. 0.6 percentage point more than five months ago. Presumably, the main driver of these expectations is Germany, whose 2010's economic dynamics was raised to 1.4%. Consequently, fast spillover to Czech industry and exports is expected. Recent turnaround of Czech foreign industrial orders' dynamics partly confirms this view. Nevertheless, recent foreign figures indicate substantial fragility of the positive tendencies, being largely driven by fiscal and monetary stimuli rather than improving economic fundamentals.

A moderate improvement in economic sentiment was recorded also domestically. Composite indicator of economic sentiment exhibited an increasing trend after hitting its low in February 2009, with the consumers' component growing slightly more than the business' component. Czech purchasing managers' index reached 53.1 in January 2009, overgrowing the threshold between contraction and expansion. In reaction to the signs of stabilisation, domestic institutions revised their economic forecasts as well. In November 2009 the Czech National Bank improved the projected GDP growth for 2010 from 0.7% to 1.4%; 2009's figure was raised to 3.9% in February 2010. Similarly, Ministry of Finance in January 2010 revised the 2009's economic slump upwards from original 5% to 4% and the 2010's recovery from 0.3% to 1.3%. We expect a mild growth of the GDP around 1.5% in 2010.

December's moderate growth of industrial production was largely determined by the low comparative basis and the continuing effect of foreign scrapping bonuses. The effect of fiscal stimulation is to disappear soon, as has already been indicated by cuts in domestic automotive companies' production. Improvement of the situation in other industrial branches has only been very weak so far (mainly concerns food industry, pharmaceuticals and chemistry). In month-over-month view, industry is expected to slowly return to black numbers, although a sustainable stabilisation cannot be expected earlier than in the second half of 2010. In 2010, we expect a mild growth of industrial production of about 4%.

The data from the last months point to certain stabilisation of situation in Czech construction, particularly when compared to industrial sector. Still, certain attenuation of construction production is expected in the future. In 2009, construction production was being pushed up by large investment actions in civil engineering mainly, which will remain the driver of the sector in 2010 as well. We expect continuation of unfavourable trends due to limitation of building construction production as a consequence of the uncertain economic development and poor economic activity, although with a weaker intensity. By the beginning of the year, the growth figures will be improved by positive effect lower comparative bases of the previous periods. Certain attenuating effect might stem from the increased VAT in 2010 that partly led to a shift towards finishing already started constructions in 2009. Statistics on housing construction in the third quarter of 2009 still show a negative trend. Stagnation or a negligible growth of construction output not exceeding 1% y/y is expected in 2010.

Czech labour market development reflects the unfavourable economic situation. Weak economic activity pushes the firms towards cuts in costs and reduction of the labour stock. The most dynamic growth of unemployment already took place at the beginning of 2009. The sharp increase in number of unemployed registered in December 2009 and January 2010 reflects the unfavourable situation of Czech firms and, to a large extent, also the effect of seasonal factors, which will support the labour market with coming spring. The registered weak turnaround in development of supplied vacancies need not reflect a beginning of a new trend, but rather a short-term fluctuation. Labour market follows the overall economic dynamics with a substantial lag; we expect a continuation of the recent trends in the first half of the year and a potential turnaround not earlier than in second half of 2010. We expect an ongoing deterioration of the labour market situation in coming months as was also indicated by the beginning fall of activity in services and trade. We expect the unemployment rate to hover under 10% in average; nevertheless, this threshold might be beaten during the first half of the year. The unemployment rate will be around 9.8% by the year-end.

Labour market follows the overall economic dynamics with a substantial lag; we expect a continuation of the recent trends in the first half of the year and a potential turnaround not earlier than in second half of 2010. We expect the unemployment rate to hover under 10% in average; nevertheless, this threshold might be beaten during the first half of the year. The unemployment rate will be around 9.8% by the year-end.

Household demand will be very weak also in 2010, mainly due to the negative labour market development. The high unemployment and limited real wage growth will, together with fiscal restrictions, tend to limit purchasing optimism of households. These factors will be reflected in continuing adverse development of retail trade, although the year-over-year growth rates might be positively influenced by low comparative bases, leading to a turnaround to black numbers. Consumer demand, which represented a stabilising factor dampening the overall GDP downturn during the first half of 2009, declined in the third quarter when compared to the second quarter and no growth can be expected in the last quarter of 2009 and in 2010 either. We expect a mild growth of retail trade of about 1% in 2010.

Despite the strong surpluses of Czech foreign trade in 2009 indicating a good external balance of the economy, sustaining such a trend in 2010 as well is unlikely. The main factors determining the 2009's situation in foreign trade were low commodity prices, weak domestic demand and fiscal stimulation packages of our main trading partners. In 2010, one can not rely on any of these but poor domestic demand and revival of foreign demand in case it survives after the fiscal stimulation edges away; commodity prices have been already increasing. Yet, foreign trade will represent the main driver of domestic economic growth in 2010. We expect the full-year trade surplus around CZK 80 bill. in 2010 (about half of 2009's figure).

The situation of Czech balance of payment is stable and sustainable; Czech economy is not largely dependent on external financing. Current account deficit will be deepened by narrowing trade balances in 2010. On the other hand, negative balance of incomes will be further attenuated by lower profits of firms that will decrease the volume of money transfers abroad. Financial account will reflect the lasting cautiousness of foreign investors in 2010, foreign direct investment will be rather limited. However, the situation might begin to change by the end of the year with 2011 bringing a more positive outlook. The koruna's exchange rate will be further crucially affected by global sentiment during 2010. Moreover, domestic political development after the May's elections might also influence the development. Besides these factors, gradual trend appreciation of the currency is expected. We expect the CZK/EUR exchange rate averaging on 25.6 in 2010 with the CZK/USD exchange rate averaging around 18.0.

Sharp deterioration of world and Czech economic activity has and will have a dampening effect on commodities prices as well as on prices of final goods. Price growth will gradually accelerate during 2010 due to the effect of several factors: rebound in commodity prices, reviving foreign demand, and extremely low comparative basis of 2009. Yet, the CNB's inflation target should not be threatened. In 2010, we expect the year-over-year CPI growth around 1.9% by the year-end, average inflation will stay low, around 1.4%. Czech producer prices remain still rather low. Despite certain deceleration of year-over-year declines of industrial PPI, inflationary pressures in the Czech economy are not an issue so far. Producer price decline will be further reflected in lower consumer inflation as well. We expect a stabilization of producer prices development by the beginning of 2010 with a return into black numbers in the second quarter of 2010. In average, we expect industrial producers PPI to grow around 1.5% in 2010.

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KOMERČNÍ BANKA IN THE TRANSFORMING CZECH ECONOMY 1990–2001[1)]

Kamil Janáček

1. Komerční banka was founded on January 1, 1990 on the basis of the 158/1989 Act that split the monobank – Czechoslovak State Bank – into the central bank (SBČS) and two commercial banks – Komerční banka (KB), to be active in the Czech Republic, and Všeobecná úverová banka, for Slovakia. That was the start of a standard, two-tier banking system in Czechoslovakia. At the same time, universal licence was granted to the already existing but specialized banks: ČSOB, Investiční banka, Živnostenská banka, Česká spořitelna and Slovenská spořitelna.

2. The start of transition toward a standard market economy brought an enormous outburst of new businesses (the number of firms increased from under 19 thousand to over one million between 1990 and 1993). That meant an exponential increase of business demand for bank services. Also, the number of private persons demanding bank service grew rapidly. On the supply side, there stood the existing banks, strongly undercapitalized, with inexperienced staff (as to modern bank methods, modern products, and risk management), and with a completely inadequate IT equipment (both hard- and software). This was characteristic also of Komerční banka at the start of its existence, in 1990.

3. Komerční banka started with 84 branches on the territory of Czech Republic, all together having 7 900 employees, and 10 personal computers. At the same time, the bank "inherited" from the monobank a volume of CZK 325 billion credits previously granted to the state-own and co-operative firms, without any collateral. By present standard criteria, 85% of these credits were doubtful or loss.

Komerční banka strived to cope with the growing demand for bank services by an extensive enlargement of the branch net (from 84 branches in 1990 to more than 400 in 1992). The lack of modern information technology was compensated by growing staff (from 7.900 in 1990 to 14.600 in 1992).

Undercapitalization was partly solved in 1991 by an increase of the basic capital by CZK 0.8 billion. In 1992, Komerční banka was transformed into a Joint Stock Company, to be ready to be the subject of the first wave of coupon privatization. In this first privatization phase of KB, the ownership share of the state (represented by the Fond of National Property and by the Restitution Investment Fund) was down to 52% at the start of 2003, with the rest owned by private investors, both institutional and individual.

4. Transformation of the economy altered the role of banks, and of the banking sector, in a fundamental way. Banks are the backbone of modern market economy, playing a key role in allocation of free financial means. Here, the role of banks was massively complicated by the fact that the transition, and the outbreak of private businesses, went on in a strongly undercapitalized economy. Bank credit had to be amply used in privatization. During the so-called large-scale privatization, banks took on the risks which in a standard economy are borne by risk capital. Czech banks obtained their share of the positive effects of economic transition (jump of demand for bank services, good interest margins) – but they also had to carry part of the negative effects (extremely risky credits, collapses of clients, slow enforcement of law, etc.).

5. Komerční banka, of course, could not avoid these problems. Proliferation of new and privatized businesses led to less prudence in granting credit; this tendency was strengthened by critical statements by the government, and by business representatives, about "lack of cooperation on the part of banks", insufficient credit support of the real economy, and too high interest rates. Risk management was underdeveloped, there was little experience in evaluating projects, collateral, and debtors. The share of risky and loss loans in the portfolio of Komerční banka increased; in the special case of this bank, situation was aggravated by the large packet of bad credits inherited from the "socialist planned economy".

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The role of banks was massively complicated by the fact that the transition, and the outbreak of private businesses, went on in a strongly undercapitalized economy. Bank credit had to be amply used in privatization.

[1)] Paper prepared for conference "20 Years of Financial and Banking Reforms in the Czech Republic", November 11th, 2009, Prague

Czech Government had to react to the sharp deterioration of financial condition of the three large banks in which the state owned a majority share. One of the last decisions of the second government of Václav Klaus was the decree No. 732/1997 (of November 11, 1997), to prepare the selling of state shares in Komerční banka, Česká spořitelna, and Československá obchodní banka.

During preparations for the sale of the state-owned share in Komerční banka, it became more and more apparent that it will be unsaleable (or, saleable only on miserable conditions, at practically zero price), unless the bank´s portfolio is rid of doubtful and loss loans, and the staff is reduced. Both steps were required by the potential investors, discreetly of semi-officially.

Although the share of non-standard, doubtful or loss credits in the portfolio of KB was much higher (about three times) than in normal market economies, the bank was able not only to create a sufficient volume of reserves to cover them, but even showed profits and paid dividends in 1991–1997 – with capital adequacy (Basel I) kept slightly above 8%. Rapid growth of the economy in 1994-1996, big demand for bank services, and good interest margins enabled these positive results, in spite of large write-offs of bad loans.

6. Situation turned dramatically in 1977. In August 1966, Czech National Bank increased the rate of mandatory minimum reserves from 8.5% to 11.5% of all primary deposits. Unlike in other countries, mandatory minimum reserves paid no interest, so that they represented a special form of implicit tax imposed on commercial banks. Banking costs increased, and banks had to raise interest rates on new loans. As economic growth slowed down in the same period, higher interest rates had fatal effects on banks´ corporate clients – who, at the time, were fully dependent on bank credit. Many clients of Komerční banka lost the ability to repay loans; the share of doubtful and loss credits in the portfolio was growing fast (to over 25%), and the need for reserves jumped up. In 1998, reserves against non-performing and loss loans reached almost CZK 21 billion. At the same time, KB for the first time showed a loss of CZK 9.5 billion (after a 0.5 billion profit in 1977) in IAS terms.

In August 1998 the situation was further aggravated by the next step of Czech National Bank who ordered that bad loans (loans more than 360 days in delay) covered by real-estate collateral must, in addition, be covered by reserves to 100%. In Komerční banka, 60% of the credit portfolio were granted against real estate collateral (coverage by securities, cash-flow and other was in minority). Economic results of Komerční banka further deteriorated, as reserves had to be increased massively (in 1998 this caused two thirds of KB´s loss). The above-described steps of Czech National Bank – as such theoretically rational – were introduced in a shock-inducing way, at the least convenient time, during recession of the Czech economy. Bank clients were in troubles, banking costs soared, and credit creation practically stopped. Czech economy entered a credit crunch.

As a final blow, Czech National bank in 1999 increased the requirements on consolidated balances of banks, arguing that Czech norms must reach compatibility with international ones (EU, Basel Committee). Again, this step was taken without any regard to the current situation of corporate clients and banks. Bank losses grew, credit creation froze.

7. Over 1999, losses of Komerční banka were aggravating. The bank also had to cope with three waves of (fortunately, moderate) outflow of deposits – in October 1998, May 1999, and October 1999. Capital adequacy was endangered, so that in May 1999, it was decided to increase the basic capital by CZK 9.5 billion. As a result, the ownership share of the state (the Fond of National Property) increased from 49% to the 60% later offered for privatization. The increase of basic capital was completed in January 2000 (when the court rejected an appeal of a minority stock-owner to block the capital increase).

8. Czech Government had to react to the sharp deterioration of financial condition of the three large banks in which the state owned a majority share. One of the last decisions of the second government of Václav Klaus was the decree No. 732/1997 (of November 11, 1997), to prepare the selling of state shares in Komerční banka, Česká spořitelna, and Československá obchodní banka. The government crisis and early elections in 1998, however, postponed the full privatization of Komerční banka. Only on March 10, 1999, another government decree (No. 194) brought new steps toward privatization (Government consent with the sale of state share owned by the Fond of National Property). The privatization tender was published in Hospodářské noviny and Financial Times on August 10, 1999. Goldman Sachs International was Government´s advisor. Another Government decree (No. 696 of July 12, 2000) stated an adjusted time schedule for privatization, and conditions for dealing with selected investors. Goldman Sachs sent a marketing letter to 32 potential investors; fifteen of them asked to be forwarded an Information Memorandum.

9. During preparations for the sale of the state-owned share in Komerční banka, it became more and more apparent that it will be unsaleable (or, saleable only on miserable conditions, at practically zero price), unless the bank´s portfolio is rid of doubtful and loss loans, and the staff is reduced. Both steps were required by the potential investors, discreetly of semi-officially. Hence the majority owner decided to respond with several measures.

a) In May 2000, new bank board was appointed, with the task to prepare privatization, and implement crisis management in KB. The pre-privatization program, realized in the second half of 2000, contained the following main steps:
   - one-off reduction of the staff by more than 2 700, i.e. by 20%;
   - introduction of strict control of costs, and cost management;
   - forming of a special division for loss credits;
   - splitting risk management from the sales division, and strengthening its position within the bank.

b) Loss credits were transferred to the (state-owned) Konsolidační banka in two steps (in 1999 and 2000), in nominal value of CZK 83.1 billion. Costs of this operation for the public finance amounted to CZK 49.6 billion, as Komerční banka was only paid 60% of the nominal value (40% being covered from KB reserves).

c) The Government approved a guarantee of CZK 20 billion for possible future losses resulting from the low-quality credit portfolio as to the day of sale. At the same time, very strict conditions were set for the new owner, forcing him to prefer the restructuring of loss loans, rather than reaching for the Government guarantee. This reflected recent bad experience with generous conditions of Government guarantees that had been granted to Česká spořitelna, or Investiční a poštovní banka (IPB).

10. During autumn 2000, Goldman Sachs International obtained answers declaring interest to buy Komerční banka from five financial institutions: Crédit Agricole, Bayerische Hypo- und Vereinsbank, Société Générale, Unicredito Italiano, AIG New Europe Fund. The Government by decree No. 1208 of November 11, 2000 chose the first four of the above institutions, and enabled them to start a due diligence process in Komerční banka.

On May 11, 2001 all four institutions submitted their first bids. Crédit Agricole announced on May 29 that it would not further participate, due to a change in its strategy and priorities. The other three institutions were on June 7, 2001 called to submit their final offers. On June 25, HVB decided not to make the final bid. Final offers by Unicredito and Société Générale were submitted on June 27, 2001. On June 28, 2001 the Government by decree No. 661 confirmed the sale of 60% of Komerční banka to Société Generale who offered the highest price, CZK 40.1 billion. The contract was signed on July 13, 2001. In September 2001 Société Generale paid the price and ownership rights and stocks were transferred.

11. Many pages have been written on the costs of revitalization of the Czech banking system. Estimates of total costs vary, and mostly are dubious, in the least. But there are publicly available data that make it possible to quantify the costs and benefits for the state from the pre-privatization period of Komerční banka, and from its privatization (covering the period 1990–2004).

The figures are as follows:

Costs

1) Increases of basic capital (1991 and 1999)	CZK 7.7 billion
2) Transfers of bad loans to Konsolidační banka, later Konsolidační agentura (1992, 1999, 2000)	CZK 57.4 billion
3) Government guarantees paid to the new owner (2004)	CZK 5.1 billion
Total costs	**CZK 70.2 billion**

Benefits

1) Price paid for the 60% share in KB by Société Générale	CZK 40.1 billion
2) Dividends paid to the state (1991–1997)	CZK 6.4 billion
3) Income from the sale of loans transferred to Konsolidační banka, later Konsolidační agentura (average return 10% of the nominal CZK 92.2 billion)	CZK 9.2 billion
Total Benefits	**CZK 80.3 billion**
Net income of the state from owning and selling the KB	**CZK 10.1 billion**

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This sum is much lower than the CZK 40.1 billion paid by the new owner of Komerční banka in 2001. The question remains whether it would have been better to sell KB with portfolio not cleared of the bad loans, and what the profit from such operation would have been. The returns from sale by Société Générale of bad loans covered by Government guarantees were 37%, while in the case of Konsolidační agentura the figure was below 11% (which proves the different behaviour of private and Government institutions). But the cardinal question is: had it been possible to find any buyer at all for the bank, without cleaning its credit portfolio?

12. What conclusions can be drawn from the analysis of 12 years of existence of Komerční banka as a state-owned and half-state-owned bank?

a) The start, and the successful completion, of transition toward a standard market economy (and, especially, the large-scale privatization) would have been impossible without a decisive participation of Czech banks. The strongly undercapitalized firms were fully dependent on bank credit, and bank loans also supported the bulk of privatization cases.
b) As different from Poland and Hungary where hyperinflation practically wiped off the enterprise debts from the communist era, in Czechoslovakia the large state-owned banks "inherited" these debts in full amounts, with all their low quality, and without any guarantees or collateral. That was a big burden for bank balances during the whole decade of 1990s.
c) Transformation of the economy, and the building of a standard banking system, inevitably was a process of trial and error. To criticize now, almost twenty years later, the low use of foreign capital, the slow adoption of experience of advanced market economies, or the reluctance to take over ready-made legal, entrepreneurial and managerial models, means to ignore the historical dimension of the transition:
   – It was not possible to "import" tens of thousands of bankers and managers to lead the local firms and financial institutions;
   – It was not possible to privatize to 100% (or massively) with the help of foreign capital. Foreign investors, in privatization, always concentrated on strictly selected firms – and, till the end of the 1990s, large state-owned banks were not in their sphere of interest.
d) Transformation had indisputable benefits – fast formation of a standard market economy with all the needed institutions, birth and growth of a well-functioning banking and financial sector, and start of economic growth after the period of unavoidable "transformation recession". At the same time, there were costs, carried to a significant degree also by the banking sector. However, compared to other post-communist countries, in the Czech Republic the transformation costs were among the lowest, if not the lowest of all.

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LABOUR MARKET FLEXIBILITY AND ECONOMIC DOWNTURN

Kamila Fialová

1. Introduction

Year 2008 brought along a severe economic recession in most countries of the developed world. The sharp reduction in economic activity hit the bottom in 2009 and since the end of this year, signs of stabilisation and improvement of the economic climate could be observed. Partly as a consequence of very low comparative bases of previous periods, year-on-year growth rates of real economic indicators decelerated their slumps and in some cases even turned to positive territories both in the European Union and the United States. Market sentiment generally improved and stock markets indices wiped out large parts of their substantial losses registered during the previous financial crisis period. Recently, economic forecasts for 2010 and 2011 have been generally revised upwards. Yet, main drivers behind the present economic stabilisation were huge expenditures of governments, intervening hard to fight the recession. Were not for these fiscal stimuli, economic situation around the world would give a very different picture. Sustainable economic revival and consequent stable growth is tightly connected to labour market situation.

Sharp contraction in economic activity resulted in a drop of demand for labour. However, the reduction of employment was far less pronounced than the respective fall in output in Europe. Partly, this might be connected with the fact that labour markets follow the reduction in economic activity with a substantial lag, usually perceived at about four to six quarters.

Table 1 – Labour Market Flexibility: Institutional Setups Applied in Selected Countries

	Employment Protection Legislation Index	Statutory Minimum Wage (% of wage median)	Trade Union Density (%)	Collective Bargaining Coverage*** (%)	Total Tax Wedge (% of total labour costs)	Active Labour Market Policies* (% GDP per percentage point of unemployment)	Pasive Labour Market Policies* (% GDP per percentage point of unemployment)
Austria	2.41	x	31.7*	95+	48.8	0.15	0.28
Belgium	2.61	0.51	52.9	90+	56.0	0.17	0.27
Czech Republic	2.32	0.35	21.0*	25+	43.4	0.05	0.04
Denmark	1.91	x	69.1	80+	41.2	0.34	0.39
Finland	2.29	x	70.3	90+	43.5	0.12	0.21
France	2.90	0.63	7.8	90+	49.3	0.11	0.15
Germany	2.63	x	19.9	68	52.0	0.09	0.19
Greece	2.97	0.53	23.0**	n.a.	42.4	n.a.	n.a.
Hungary	2.11	0.47	16.9	30+	54.1	0.04	0.05
Ireland	1.39	0.53	31.7	n.a.	22.9	0.13	0.20
Italy	2.58	x	33.3	80+	46.5	0.08	0.12
Luxembourg	3.39	0.40	41.8**	60+	35.9	0.11	0.13
Netherlands	2.23	0.43	19.8	80+	45.0	0.34	0.43
Norway	2.65	x	53.7	70+	37.7	0.22	0.17
Poland	2.41	0.45	14.4*	40+	39.7	0.05	0.05
Portugal	2.84	0.47	n.a.	80+	37.6	0.07	0.13
Slovak Republic	2.13	0.43	23.6*	50+	38.9	0.02	0.03
Spain	3.11	0.45	14.6*	80+	37.8	0.10	0.17
Sweden	2.06	x	70.8	90+	44.6	0.18	0.11
United Kingdom	1.09	0.46	28.0	30+	32.8	0.06	0.03
United States	0.85	0.34	11.6	14	30.1	0.03	0.07
European average	2.40	0.47	33.9	68+	42.5	0.13	0.17

Note: * figure concerns year 2007; ** figure concerns year 2006; *** figure concerns year 2000; x statutory minimum wage not introduced; n.a. data not available. European average gives an unweighted average for the twenty selected European countries. Source: OECD database, own calculations

Further, part-time working and falling number of hours of work in main job prevented even larger job-losses. Finally, negative trend in output was cushioned by barriers to flexible labour market adjustment.

So far the unemployment rate has been rising steadily since the end of 2008 and it is expected to peak in 2010 in Europe in general while in the United States the recovery might be faster with an improvement of labour market conditions generally expected already during 2010. Major reason of the diverging development in this field is the degree of labour market flexibility given by institutional framework. This article aims to assess the institutions affecting labour market flexibility in the Visegrad countries (the Czech Republic, Slovakia, Hungary, and Poland), selected European countries and the United States. Consequently, it deals with potential impact of the institutional background on labour market performance during economic recession and consequent recovery process.

Sharp contraction in economic activity resulted in a drop of demand for labour. However, the reduction of employment was far less pronounced than the respective fall in output in Europe. Partly, this might be connected with the fact that labour markets follow the reduction in economic activity with a substantial lag, usually perceived at about four to six quarters. Further, part-time working and falling number of hours of work in main job prevented even larger job-losses. Finally, negative trend in output was cushioned by barriers to flexible labour market adjustment.

2. Institutional Framework and Labour Market Flexibility

The diversity of labour market institutions is huge; countries differ extensively in their use of labour market institutions resulting in different degree of flexibility. Germany and North European countries have tightly regulated labour markets, in which the institutions' predominant concern is protecting existing jobs. Anglo-Saxon countries are more often associated with labour institutions that rely on markets and favour job creation (and destruction) rather than protection. Denmark adopted the flexicurity approach, combining higher flexibility with the accent on social security and active labour market policy.

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Institutions evolve over time and their effects may change as well. Moreover, the same institutions may have different effects in different countries or in different periods. Consequently, the flexibility of the labour market determined by the institutional framework is not easily quantifiable. Recent research usually uses a set of institutional indicators, as there is no single measure of labour market flexibility. These institutional environments have been compared to labour market performance to assess real labour market flexibility and rigidity.[2] This article adopts the same approach, focusing on five areas: employment protection legislation (EPL), wage-setting frameworks (trade unions and minimum wage), taxation systems, and labour market policies. Table 1 offers the comparison of selected indicators describing the particular areas as described below. The source of the data is the OECD and figures refer to year 2008 unless indicated otherwise.

Employment Protection Legislation

EPL aims to improve workers' employment conditions and enhance their welfare. Apart from its effect on worker welfare resulting from higher job security, employment protection stabilizes the employer–employee relationship and might stimulate the firm's investment in the human capital of workers, leading to higher productivity. On the macroeconomic level, it might smooth labour market adjustment to adverse shocks. Yet, the regulation mainly restricts the employers' freedom to dismiss workers and, thus, reduces the flows into, but also out of, unemployment. Consequently, there might be significant negative side effects to worsening the firms' flexibility in changing economic conditions, and widening of the distance between labour market insiders and outsiders. In this sense, EPL might contribute to labour market rigidity and higher unemployment.

We follow the OECD methodology for measuring the strictness of employment protection.[3] As follows from Table 1, there is a large heterogeneity as regards employment protection in the selected countries. Southern European countries have the toughest regulation, whereas the rules relax as one moves north. English-speaking countries enjoy the most liberal EPL, with the US representing the most flexible labour market in this perspective. In contrast, Luxembourg applies the toughest employment protection. Visegrad countries find themselves somewhat under the European average, the Czech Republic and Poland being about comparably rigid and Slovakia with Hungary slightly more flexible, although the differences are not pronounced. The Czech practice is close to the one of Austria, while Germany exhibits a more regulated employment protection.

Minimum Wage Setting

Policies aimed at increasing low incomes from employment are a common practice in almost all the developed countries in the world. Advocates of the minimum wage argue that

[2] See, e.g., Blanchard, O.; Wolfers, J. (2000): "The Role of Shocks and Institutions in the Rise of European Unemployment: The Aggregate Evidence". The Economic Journal, Vol. 110, No. 462, Conference Papers, pp. C1-C33; or Nickell, S. (1997): "Unemployment and Labour Market Rigidities: Europe versus North America". The Journal of Economic Perspectives, Vol. 11, No. 3, pp. 55-74.

[3] The OECD developed a system of indicators including a single overall composite indicator. As many as twenty-one measures describing various aspects of EPL, covering regular and temporary contracts and collective dismissals, were aggregated into a summary indicator using a set of weights. EPL index we use refers to version 3 of the OECD EPL indicators. It reaches values from 0 to 6: a low index indicates flexible legislation and a liberal hiring and firing environment, whereas stricter protection is reflected in a higher value. For details see www.oecd.org/employment/protection.

it decreases poverty, reduces income disparities, and protects and motivates least productive workers. However, a minimum wage might not effectively promote these goals, as it can increase the incomes only of those individuals who work. Moreover, minimum wage might represent a large burden for employers of workers, whose productivity cannot support the wage; in response, firms might decide to fire workers or not to employ them in the first place. To the extent that these negative consequences occur, potential benefits for the working poor would be limited. The adverse effects are usually stronger for particular groups of workers with the lowest productivity.

In this article we focus on real economic impact of the minimum wage as measured by its ratio to median wage in the economy–the higher the ratio, the larger share of labour force might be impacted by the measure. All the four Visegrad countries have introduced a legally binding minimum wage. Among them, the lowest ratio exhibits the Czech Republic (35%); all the remaining three countries are closer to the European average of 47%. Within Europe, minimum wage exceeds 50% of the median in three countries: France, Greece, Ireland and Belgium. The United States employs a significantly lower minimum wage tariff when compared with the wage median. Yet, the system of sub-minimum wage tariffs for young and disabled, largely applied in Europe, might partially mitigate potential negative effects on the most threatened groups of workers affected by higher minimum wage.

Collective Bargaining and Trade Unions

Trade unions influence wage formation, the determination of labour costs, and the flexibility of firms in collective-bargaining processes, and in most European countries, they are an important factor to consider. Their power was traditionally measured by trade union density, the share of workers who were trade union members. However, even if the density is rather low in some countries, it is a common practice to extend trade union agreements to nonunionized workers, covering a large share of employees in the economy. Thus, the degree of collective bargaining coverage – the share of all salary earners whose wage is actually determined by a collective agreement in a legal extension of bargained wage rates to nonunionized workers – might be a more reliable indicator of real economic consequences. The level of union coordination and centralization is also important.[4] Theory suggests that the trade unions generally tend to raise wages and thus influence unemployment. The more workers the unions cover, the greater this effect, which, in reality, might be offset by the extent to which unions or firms coordinate their wage determination.

Table 1 summarizes the key features of collective bargaining processes in surveyed European countries and the U.S. Clearly, trade union density is much lower in the Visegrad countries and Anglo-Saxon countries (United Kingdom, United States), and also in France, Germany, Netherlands and Spain. In the last four of the mentioned, collective bargaining coverage exceeds the European average despite low union membership, indicating a larger degree of unions influence on the wage determination. Yet, stronger union power given by high collective bargaining coverage might be in most cases at least partly offset by a higher degree of centralization and coordination compared to countries with weaker trade unions. The poorest coordination and the lowest degree of centralization were registered in the Czech Republic, Hungary, Poland, United Kingdom and the United States as of 2000. Unfortunately, no comparable data covering recent period is available.

System of Labour Taxation

Taxes on labour are expected to influence labour markets negatively, as they drive a wedge between the labour cost to the employer and the take-home wage for the employee. The larger the wedge, the more pronounced is the negative effect on the labour market. In this respect, it is irrelevant whether we analyze income taxes or social security contributions, as the highly redistributive nature of most social security programs separates their contributions from entitlements.

Labour taxes in Europe are generally very high – the highest in the world. Their microeconomic effects can be approximated by a tax wedge. As tax systems are progressive in all EU countries, the tax wedge differs for different income groups. For average wage earners, it reaches more than 50% in Belgium, Germany, and Hungary; Austria and France are very close to this threshold. Ireland and the United Kingdom emerge as the low-tax countries, with labour taxes' share resembling the very low one of the United States. As regards the rest of the Visegrad group, the Czech Republic lies

[4] Coordination refers to the ability to coordinate bargaining among various unions and employer organizations; centralization refers to the level of bargaining and the role of the government. A high degree of centralization does not necessarily have to mean close coordination.

As follows from presented data, English-speaking countries (United Kingdom, United States and Ireland) represent the most flexible labour market environments among the examined countries. Moreover, in certain aspects, Slovakia and Poland might be also classified into this group. The Czech Republic exhibits low minimum wage, collective bargaining coverage and LMPs expenditure, but with its EPL and taxation of labour it ranks among more rigid labour markets. On the other hand, the least flexible institutional setups can be observed in large European economies: Germany, France and Italy, and also in Belgium and Portugal. Denmark and Sweden apply a mixed system of liberal employment protection combined with higher taxation, larger active LMPs spending and stronger trade unions.

Although the U.S. was hit by the economic downturn earlier than Europe, the decline was not as pronounced and was reflected in more significant rise of unemployment which soared to levels registered for the last time in 1980s. In contrast, Europe generally returned back to levels of about four years ago. Taken generally, the labour market reaction in the US was much stronger. Faster adjustment and reduction of redundant labour stock enabled considerable productivity gains in the U.S.; labour productivity picked up 1.3% in 2008 while the average figure ended up in red numbers in Europe. In 2009, the US productivity gain even amounted to solid 2.9% y/y.

slightly above the European average, Slovakia and Poland apply a somewhat lower tax burden on labour.

Labour Market Policies

Labour market policies (LMPs) may have ambiguous effects on unemployment and labour market performance. Active LMP aims to enhance human capital and sustain the employability of their participants and, consequently, to improve the efficiency of the job-matching process. Although negative effects occur, empirical studies often find overall positive effects of these provisions on unemployment. In contrast, passive LMP may decrease the job search intensity and lower the economic costs of unemployment, raise the employees' wage claims, and, thus, might push up overall unemployment. At the same time, it might increase the effectiveness of the matching process. The generosity of the unemployment insurance system is of particular importance: the more generous the system, the larger the adverse effects. The negative consequences of a generous unemployment insurance system and high passive LMP spending might be offset partly by suitable active LMP measures aimed at returning the unemployed back to work. The final effect of the LMP is then given by the relative scope of these programs and their features.

Examining the data, there exist very significant differences among the countries. Visegrad countries together with the United Kingdom and the United States spend a relatively small amount of resources on LMPs. This spending represents less than 0.1% GDP per percentage point of unemployment in these countries both for active and passive measures. Moreover, Germany, Italy and Portugal also fall into this low-expenditure group as regards active labour market policies, putting a relatively larger accent on the passive measures. In contrast, the Czech Republic, Norway, Sweden and the United Kingdom spend relatively more on active LMP. The greatest expenditure on LMPs exceeding 0.3% GDP per percentage point of unemployment was registered in the Netherlands and in Denmark.

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As follows from presented data, English-speaking countries (United Kingdom, United States and Ireland) represent the most flexible labour market environments among the examined countries. Moreover, in certain aspects, Slovakia and Poland might be also classified into this group (mainly as regards weak trade unions, low minimum wage and LMPs expenditure). The Czech Republic exhibits low minimum wage, collective bargaining coverage and LMPs expenditure, but with its EPL and taxation of labour it ranks among more rigid labour markets. On the other hand, the least flexible institutional setups can be observed in large European economies: Germany, France and Italy, and also in Belgium and Portugal. Denmark and Sweden apply a mixed system of liberal employment protection combined with higher taxation, larger active LMPs spending and stronger trade unions.

3. Labour Market Performance

Labour market situation deteriorated in 2009 in all the surveyed countries in reaction to fading economic activity. While the gross domestic product contracted by 3.2% y/y in the U.S. and by average 4.7% y/y in selected European countries during first three quarters of 2009, the respective reduction of employment reached 3.8% and 1.4% respectively. That means, while in the U.S. employment declined even more than the output, Europe witnessed only a moderate employment drop compared to the development in real economy. Similarly, number of hours worked in main job subtracted 1.7% in the U.S. and 0.6% in Europe in average in the same period. Part-time employment increased in both regions, but the rise in the U.S. was again greater (+8.1% y/y) compared with Europe (unweighted average of +5.1% y/y was considerably biased by the huge pick up in the Visegrad countries, enabled by their very low levels of part-time employment; weighted average reached +0.8% only).

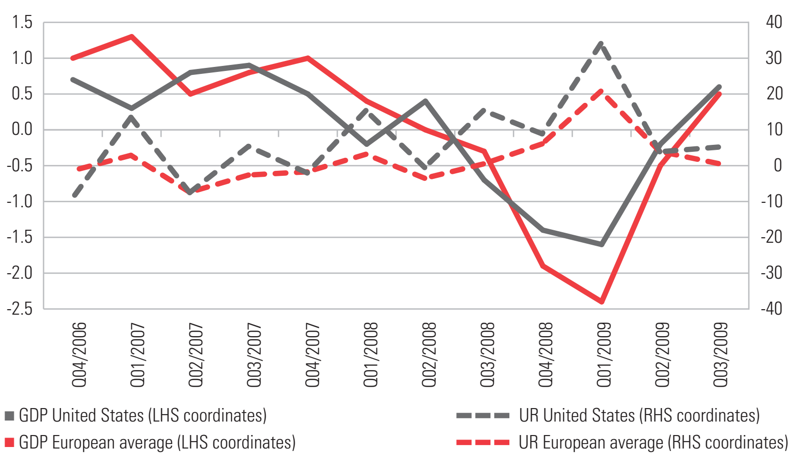
The unemployment rate started to grow considerably in late 2008, this trend lasted through the whole 2009 and it is expected to continue in 2010, or, particularly, in the first half of the year at least. Figure 1 shows the quarter-on-quarter change of the GDP and the unemployment rate in the United States and the mean for selected European countries. Although the U.S. was hit by the economic downturn earlier than Europe, the decline was not as pronounced and was reflected in more significant rise of unemployment which soared to levels registered for the last time in 1980s. In contrast, Europe generally returned back to levels of about four years ago. Taken generally, the labour market reaction in the US was much stronger. Faster adjustment and reduction of redundant labour stock enabled considerable productivity gains in the U.S.; labour productivity picked up 1.3% in 2008 while the average figure ended up in red numbers in Europe. In 2009, the US productivity gain even amounted to solid 2.9% y/y.

This discrepancy was largely affected by different degree of labour market flexibility. In the U.S., firms were able to cut down labour stock and sustain productivity and financial stability. In contrast, this was not the case in Europe. In Germany, for instance, government introduced the Kurzarbeit programme, temporarily reducing the number of work hours that allowed maintaining the employment levels. Although the governments bore certain parts of these programmes' expenses of maintaining jobs, rigid institutions generally burdened firms with substantial costs, undermining their financial situation and competitiveness. Generally, besides saving the jobs, rigid employment protection disabled smooth labour market adjustment. Consequently, future economic recovery in Europe will be limited by the inconvenient starting position of the corporate sector and the rebound will be much slower. This effect might be partly compensated for by a more stable situation of European households, which have not suffered so much from labour market fluctuations and even if they have, they have been supported by relatively generous state assistance.

As regards the development in particular surveyed countries, the situation is described in Table 2. The group of countries with the most flexible institutional framework (United Kingdom, United States, and Ireland) enjoyed higher employment rates and low unemployment during the pre-recession period of 2001–2007, but the consequent adjustment during the recession was rather strong. By their labour market outcomes during these two periods, Denmark and Sweden might be ranked together with the more flexible group of countries. In contrast, Poland and Slovakia registered lower employment and higher unemployment during the pre-recession period and the subsequent reaction was not as strong (in case of Poland, the downturn was not as pronounced and the country was the only European economy that did not fell into recession). The situation of the last group of countries is not as straightforward: the unemployment rates hovered around the European average and the employment rates were rather varied during the pre-recession period (while Portugal exhibited higher employment, Belgium and Italy registered the opposite). Further, neither employment nor unemployment data indicate a larger deterioration during the recession period, with an exception of Italy and Portugal, which recorded a considerable drop in employment.

To estimate the effect of various institutional setups and their changes to major labour market performance indicators we ran a regression analysis on panel data covering nineteen European countries in 1999 and 2004.[5] Our results indicate that high taxes increase unemployment whereas active labour market policies tend to reduce it. Moreover, stricter employment protection, higher taxes, and a larger economic burden represented by the minimum wage significantly decrease the employment rate.

Figure 1: Change in the GDP and Unemployment Rate, % q/q, 2006–2009



Note: European average gives an unweighted average for the twenty selected European countries described in the text above.
Source: Eurostat, own calculations

[5] The sample covered Belgium, Czech Republic, Denmark, Germany, Greece, Spain, France, Ireland, Italy, Hungary, Netherlands, Austria, Poland, Portugal, Slovakia, Finland, Sweden, United Kingdom, and Norway. The regression coefficients were estimated using the standard random effects generalized least square estimation procedure. The regression equation had the following form:
$\ln X_{ti} = \alpha + \beta_1 EPLti + \beta_2 MWti + \beta_3 CBCt + \beta_4 TAXti + \beta_5 ALMP_{ti} + \beta_6 UBRRti + \beta_7 INFL_{ti} + \beta_8 LEFT_{ti} + \varepsilon_{ti},$
where X takes the form of UR and ER in consequent regressions. The independent variables were the EPL index (EPL); minimum wage (MW) as a cluster variable constructed according to minimum wage levels and their relative share of median wages in the economy; the trade unions' power represented by the collective bargaining coverage (CBC); total tax wedge on labour (TAX); the replacement rate (UBRR); expenditure on active LMP (ALMP), active labour market policy expenditure is instrumented. We use the actual rate of unemployment in our regressions, but labour market institutions affect the equilibrium unemployment. To reflect this, we use an additional variable in the model: the change in the annual rate of inflation (INFL). This variable captures the influence of the economic cycle and also may be considered to indicate macroeconomic policy stance. Finally, unemployment might be influenced by the political preferences of governments and conflicts of interest over power resources; to account for these political factors, we add one more variable in the regression model: the government orientation with respect to economic policy. The variable LEFT is a dummy with a value of 1 for left-wing parties used with a one-year lag. For details see Fialová, K.; Schneider, O. (2009): "Labour Market Institutions and Their Contribution to Labour Market Performance in the New EU Member Countries". Eastern European Economics, May–June 2009, Vol. 47 No. 03, pp. 57–83.

4. Conclusions

Institutional framework might significantly alter the labour market outcomes of countries and the degree of flexibility or rigidity given by particular institutional mixes might considerably impact adjustment processes. Indeed, the evident unemployment gap between (continental) Europe and the United States led many observers to argue that the more flexible U.S. institutions were at the root of the superior performance. During the 2008-9 economic recession, flexible labour markets (for instance of the Anglo-Saxon countries) enabled smooth employment reaction that consequently improved the starting position for the coming economic recovery. In contrast, higher levels of rigidity (for instance Germany, France, Italy) burdened firms with substantial costs and economic revival will reflect consequences of this fact. Recent predictions of different economic performance of the two groups of countries (despite being highly affected by many other factors as well) tend to confirm this view.

The presented data evidence regarding the particular case of the Czech Republic indicates a relatively higher degree of employment protection (yet, it can not be compared with the substantial rigidity of Southern European countries) and a larger tax burden on labour. In contrast, relatively low minimum wage and weak real power of trade unions presently do not constitute a considerable barrier to functioning of the labour market in general (while significant negative consequences on micro level may occur). Although a slight easing of the employment protection was registered following from the new labour code effective as of 2007, lasting low flexibility of hiring and firing conditions might represent a considerable obstacle to economic adjustment during the recent downturn. The case of Denmark shows that even the potential negative impact of flexible employment protection for the employees might be offset by suitable active labour market policies and strict social provisions to the unemployed, leading to higher employment levels and reducing unemployment. The question is, whether the Czech Republic could afford such an expensive system under current fiscal situation (although it would bring substantial economic gains in the future) and whether such an institutional framework would be socially acceptable and feasible. Nonetheless, current system is apparently far from being effective, motivating (both for employees and firms) and long-term sustainable.

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The presented data evidence regarding the particular case of the Czech Republic indicates a relatively higher degree of employment protection and a larger tax burden on labour. In contrast, relatively low minimum wage and weak real power of trade unions presently do not constitute a considerable barrier to functioning of the labour market in general.

Table 2: Labour Market Outcomes under Different Institutional Setups, 2001–2007, 2009

	Employment rate (%)	Unemployment rate (%)	Employment	Unemployment rate
	Average 2001–2007		Q1–Q3 2009, % y/y	
More rigid labour market				
BELGIUM	60.5	7.8	-0.7	12.1
GERMANY	66.3	8.4	-0.2	2.0
FRANCE	63.6	8.9	-0.6	23.4
ITALY	57.0	7.8	-1.5	14.0
PORTUGAL	68.1	6.6	-2.7	22.9
Average	*63.1*	*7.9*	*-1.2*	*14.9*
More flexible labour market				
UNITED KINGDOM	71.5	5.0	-1.6	39.0
UNITED STATES	71.8	5.2	-3.8	66.9
SLOVAKIA	58.0	16.4	-1.8	13.6
POLAND	53.2	16.9	0.8	10.8
IRELAND	66.9	4.4	-8.9	113.4
Average	*64.3*	*9.6*	*-3.0*	*48.7*
Flexicurity approach				
DENMARK	76.2	4.7	-2.0	77.4
SWEDEN	73.2	6.8	-2.0	34.7

Source: OECD and Eurostat database, own calculations

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