

ECONOMIC TRENDS 32

CZECH ECONOMY: SPRING 2002

Kamil Janáček

Eva Zamrazilová

The Czech economy grew steadily in 2001 despite overall economic slowdown both in the United States and in the European Union. The GDP growth reached 3.6 %. The main pro-growth factor was domestic demand.: fixed capital investment grew by 7.0 % and private consumption by 3.7 %. Government consumption fell by 1 %. Anew, net exports affected GDP growth adversely.

As for supply side, the major contributor to value added growth was manufacturing (CZK 13.0 bill.), transport and telecommunication (CZK 12.2 bill.) and commercial services (CZK 7.1 bill.). Dynamic growth of private consumption of households was financed both by increase of disposable incomes (7.2 %) and by growing use of various forms of credits (consumer, mortgage, leasing).

Strong growth of domestic demand did not provoke deterioration in external imbalance. The current account deficit negligibly dropped to CZK 101 bill. (USD 2.65 bill.) which represents 4.7 % of GDP. Again, this deficit was comfortably covered by continuing inflow of foreign direct investments which amounted to USD 4.9 bill. Although foreign direct investments were the most significant part of capital inflows again, the area of portfolio investments registered an improvement showing a net inflow of around USD 1 bill. This was both due to declining purchases of Czech subjects on foreign markets and growing investment activities of foreign investors in the Czech Republic.

The slowdown in Western Europe has continued to affect the Czech economy also in the first months of 2002. The demand for Czech exports has been weak so far, nevertheless, the slowdown of imports was even more pronounced. The outpace of exports seems to be a mid-term tendency: the imports grew by 6.7 % and the exports increased by 8.8 % in previous 12 months. The effect of strong exchange rate of CZK is more significant on the part of imports, moreover, the imports have been – so far - affected also by low world raw material prices.

The slow growth of exports affected also the growth in industry and construction. The growth rates in these two sectors do not and will not reach the levels of growth from 2001. Weaker demand observable in the main sectors of the Czech economy in recent months has been visible also on the labour market. The Czech companies are very cautious in hiring new labour force which can be proved by decline in vacancies from the beginning of 2002. Growing pressures on the Czech labour market strongly correlate with the slowdown in the Czech industry experienced since August 2001.

In the first months of 2002, no inflationary pressures emerged in the Czech economy. Price deregulations had only limited effect on CPI increase in January and February, while producer prices fell into deflation (on yearly basis) in February 2002. Favourable developments of producer prices and moderate growth of prices in construction represent a very favourably factor for consumer prices : at least for the first half of 2002, the consumer prices will not be pushed by producer prices.

The Czech currency continued to strengthen against EUR in the first quarter of 2002. The open market intervention of the Czech National Bank had only limited and short-term effects. The Czech currency is pushed up by

continuing inflow of foreign direct investments and favourable assessment of the financial markets about the prospects of the Czech economy.

Outlook.

We forecast that full-year figure for GDP growth will be around 3.0 %. The domestic demand will continue to be the main pro-growth factor in 2002. Slow growth of prices in industry, construction and agriculture combined with still low world material prices is giving favourable consumer prices prospects. The CPI index will decline to the level close to 3 - 3.5 % in the mid-year and then will start again to grow above 3.5 % level. In the second half of the year due to growing foreign and domestic demand and uncertain prospects for oil prices, the consumer prices will start to grow, again. Headline inflation will increase by 3.8 % y/y in December 2002.

Fixed capital investments will be enhanced by continuing inflow of foreign direct investments. Private consumption will be robust in 2002, as well. We also expect that the revival of EU economy will help to boost the Czech manufacturing and help to accelerate the Czech exports in the second half of 2002.

In 2002, the growth in industry will be approximately the same as in the second half of 2001, amounting to 4 %. The growth will be slower in the first half of the year and then – following the acceleration of exports – will speed up in the second half of 2002. The improvement of economic climate in the second half of the year will have only limited effect on the labour market, having in mind that the major part of Czech unemployment is a structural one. We expect

only slight decrease of the unemployment rate under the 9 % level at the end of the year.

In the first half of 2002, the trade balance will continue to be affected by still low demand in the EU countries and strong exchange rate of CZK. In the second half of the year, the revival of exports to the EU can be expected. The full-year trade deficit for 2002 will be around CZK 100 bill. In 2002, the current account deficit will reach approximately the same level as in 2001 (CZK 100 bill.). Under the assumption of 3 % growth of GDP the current account deficit will decline to roughly 3.5 % of GDP. The financial account should register surplus of CZK 120 bill.(at least) concentrated to FDI, again, so that the current account deficit will be comfortably covered. Moreover, structure of the FDI indicates that the inflow will not strongly decline even after the end of Czech privatisation.

Table 1: Main Macroeconomic Indicators

| | | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002f |
|-----------------------------------|------------|--------|--------|-------|-------|--------|------|-------------|
| GDP growth | %, real | 4.3 | -0.8 | -1.2 | -0.4 | 2.9 | 3.6 | 3.0 |
| Industrial sales | %, real | 6.8 | 6.1 | 0.6 | -0.5 | 8.4 | 5.5 | 5.0 |
| Industrial production | %, real | 2.0 | 4.5 | 1.6 | -3.1 | 5.8 | 6.8 | 4.0 |
| Construction output | %, real | 4.8 | -3.9 | -7.0 | -6.5 | 5.6 | 9.6 | 7.0 |
| Retail sales | %, real | 11.4 | 1.9 | -7.2 | 2.1 | 4.6 | 4.3 | 4.5 |
| Inflation | %, average | 8.8 | 8.5 | 10.7 | 2.1 | 3.9 | 4.7 | 4.4 |
| Inflation | %, e.o.p. | 8.6 | 10.0 | 6.8 | 2.5 | 3.9 | 4.1 | 3.8 |
| Net inflation* | %, e.o.p. | 6.6 | 6.8 | 1.7 | 1.5 | 3.0 | 2.4 | - |
| Industrial producer prices | %, e.o.p. | 4.4 | 5.7 | 2.2 | 3.4 | 5.0 | 0.8 | 2.0 |
| Nominal wages | %, average | 18.4 | 10.5 | 9.3 | 8.2 | 6.6 | 8.5 | 8.0 |
| Unemployment rate | %, e.o.p. | 3.5 | 5.2 | 7.5 | 9.4 | 8.8 | 8.9 | 8.5 |
| Exports | %, nom. | 6.6 | 20.0 | 17.7 | 9.2 | 23.3 | 13.1 | 12.0 |
| Imports | %, nom. | 13.0 | 15.3 | 7.5 | 7.5 | 28.2 | 11.7 | 10.0 |
| Trade balance | CZK bill. | -155.8 | -151.2 | -76.3 | -69.9 | -126.8 | -119 | -100 |
| Current account | USD bill. | -4.3 | -3.2 | -1.0 | -1.1 | -2.4 | -2.4 | -2.2 |
| Current account | % of GDP | -7.4 | -6.1 | -1.9 | -2.0 | -4.8 | -4.3 | -3.5 |
| Financial account | USD bill. | 4.3 | 1.1 | 2.6 | 2.5 | 3.4 | 4.0 | 3.5 |
| Financial account | % of GDP | 7.4 | 2.1 | 4.8 | 4.7 | 6.8 | 7.2 | 5.3 |
| State budget | % of GDP | -0.1 | -1.0 | -1.6 | -1.6 | -2.4 | -3.3 | -2.2 |
| Gross foreign debt | USD bill. | 21.2 | 21.6 | 24.3 | 22.9 | 21.5 | 22.0 | 21.0 |
| Official FOREX reserves | USD bill. | 12.4 | 9.8 | 12.6 | 12.9 | 13.1 | 14.5 | 18.0 |

| | | | | | | | | |
|------------------|------------|-------|-------|-------|-------|------|------|-------------|
| M2 growth | %, e.o.p | 9.2 | 10.1 | 5.2 | 8.1 | 6.5 | 12.4 | 10.0 |
| PRIBOR 3M | %, average | 12.02 | 16.00 | 14.33 | 6.85 | 5.4 | 5.2 | 5.0 |
| CZK/EUR** | Average | 35.32 | 35.75 | 35.85 | 36.88 | 35.6 | 34.1 | 31.5 |
| CZK/USD | Average | 27.14 | 31.71 | 32.27 | 34.60 | 38.6 | 38.0 | 36.0 |

Source: Czech National Bank (CNB), Czech Statistical Office, forecasts by Komerční banka (bold figures)

Note: *) target indicator of the CNB; consumer price inflation net of administered prices; **) until 1998 the CZK/DEM exchange rate converted by 1 EUR = 1.95583 DEM; n.a. = not available

Czech Republic and European Union: Convergence in Economic, Price and Productivity Levels

Stanislava Janáčková
Kamil Janáček

A. Convergence of economic levels („real“ convergence)

European Union accession is a priority for the Czech Republic, as for the other Central-European transition countries. Successful accession requires further convergence of economic, productivity, and price levels toward the EU. This catch-up process has already started in the first half of 1990s, with the start of economic transformation. Presently, in 2001, Czech economic level (measured by GDP per head at PPP) is at 62 % of EU average. Price level is estimated at about 43 %, and productivity level slightly above 50 % of EU average. Convergence of economic levels is the primary process, accompanied by price level convergence. For both, productivity increase is a fundamental condition.

From the standpoint of the Czech Republic's readiness to enter the EU and the EU's willingness to accept the Czech Republic, economic performance will be more important than relative price level. Formally, real convergence has never been declared as a pre-condition for accession. The Copenhagen criteria, rather, state that the candidate country must have a solid market framework, and be able to cope with competitive pressures within the Single Market. However, without some degree of economic strength, measured by GDP per head, withstanding the competitive pressures would be very difficult, if not impossible. The Maastricht treaty underlines the necessity to reach stable

macroeconomic conditions, which can indirectly be interpreted as a condition of EU membership.¹

In the past, the least advanced EU countries - Spain, Greece, Ireland and Portugal - entered the EU with relative economic levels (GDP per head at PPP) of 70%, 64%, 57%, and 52% of EU average, respectively. After 13 years of EU membership, at 1999, Spain reached 82 %, Portugal 73%; Greece, after 19 years, reached 68% of EU average. Ireland was the best performer: after 27 years of EU membership, its economic level lies at 110 % of EU average.

A relatively low economic level in a candidate country provokes the EU's fear of high costs of structural and regional policies, with the accompanying need to reduce aid to the existing „poorest“ EU countries as new members are admitted. Also, there are concerns about an inflow of cheap labour and about so-called sensitive goods that may be advantageously produced by new members who have both low wages and social expenditures. There is also the fear that the newly accepted countries will not become markets fast enough for EU products, or, quite the opposite, that their lack of competitiveness will make them a burden to the EU.

If we accept that Czech per capita GDP was 62 % of the EU average in 2001, than to achieve a level of 70 % at the start of 2010 would require the Czech Republic to achieve a 1.5 % per year growth differential during 2002-2009. It is true that we are dealing with income levels measured in PPP terms, so that the required growth differential can be some combination of measured growth in GDP per capita and improvements in quality and innovation in the Czech economy. This however does not diminish the importance of achieving

¹ This opinion was clearly expressed by Pedro Solbes, EU Commissioner, at the ELEC Monetary Panel meeting in Frankfurt on December 6, 2001.

rapid economic growth because the possibilities for quality improvements and for innovation depend critically on new investments and without economic growth they are very limited. With a declining or stagnant GDP, we cannot expect rapid growth of productivity or a high level of innovation in the future. From this point of view, relatively rapid Czech GDP growth in 2000 and 2001 is a very positive sign of a renewed catch-up process.

B. Convergence of Price Levels

As indicated above, the relative price level of the Czech Republic toward EU average is significantly lower than its relative economic level. Some Czech experts see this as the main problem of our smooth accession to the European Union. They shift the real side of convergence into the background. However, both sides of convergence cannot be strictly separated, as they both are based on the same economic process - productivity increase which has to be faster than in the EU.

Convergence of the Czech price level to EU average will be a gradual and long-time process. In the past, the poorest EU members acceded with relative price levels higher than that of Czech Republic today: Portugal 55 % (in 1986), Spain 76.9 % (1986), Greece 83.3 % (1981). Today, differences in price levels among EU members still reach ± 30 % around the average. However, real convergence of the former poorest EU members has been accompanied by convergence of their relative price levels - albeit slower in some countries.

For individual groups of goods, big differences occur even in the tradeable-goods sector, and they exist also inside the euro area. Even in tradeables, the law of one price does not fully manifest itself, and international competition fails to equalise their prices among countries. The sources of

differences lie, e.g., in different taxes and tariffs, transport costs, and before- and after-sale service. „Indeed, in a small number of cases, the differences between high and low prices for particular commodities can be observed to exceed 50 %. The differences across countries are far higher than those which are typically found within individual countries.“ (ECB Monthly Bulletin, October 1999, p. 38.).

Convergence of price levels is predominantly a spontaneous trend, originating in the micro-sphere. In principle, there are two economically measurable processes, through which price level convergence may occur: inflation differentials, and nominal exchange rate appreciation. Another source of convergence is harder to measure: micro-structural change, product innovation, and quality improvements. The engine of price level convergence in tradeables is international competition. Limits of the speed of convergence are given by the effort of individual countries to preserve their price competitiveness.

Price convergence will be a differentiated, segmented process. First, due to the well-known Balassa-Samuelson effect, there tends to be a difference in price level convergence between tradeables and non-tradeables. But, even within the tradeables sector, different segments can be observed. Now, in the Czech economy, one could distinguish at least three segments:

a) Tradeables, traded at world prices (priced at parity). Here, further price changes should, in principle, follow the developments of prices of our main trade partners.

b) Tradeables, traded at lower than world prices. In this segment, two groups of goods can again be distinguished:

- Goods where lower price is connected with lower quality. We have in mind quality differences observed and judged by consumers, which cannot be fully

reflected in the construction of price indices. In future, thanks to quality improvements, this group should shrink, and prices will approach the world level.

- Equal quality goods that however are traded, even internationally, for lower prices. Lower price can be based on lower domestic costs - lower wages, or other cheaper domestic inputs. Or, lower price can indicate that the local producer is willing to accept a lower profit margin than his foreign competitors. In this group of tradeables, there is the largest room for future price convergence.

c) Tradeables not traded internationally. Goods that so far are unable to find other than domestic buyers but still avoid competition by imported substitutes. The existence of such goods is based on local habits, consumers preference for lower price even if it means lower quality, or, in other cases, by high costs of international trading. Price level convergence in this segment will only be gradual.²

The reasons presented for the existence of categories „b)“ and „c)“ partly explain why there is not yet complete price convergence between the Czech Republic and its partners even in the tradeable goods area. What matters is that behind many price differences are quality differences. Another part of the explanation is that the Czech economy entered the transition process with significant distortions in relative prices, which also applies for tradeables. While the process of correcting relative prices is already advanced, it is not yet complete. Gaps between prices in the non-tradeable sector will narrow more slowly than in the tradeables.

c. Price convergence and competitiveness

² For more detail, see Janáčková (2000), pp. 81-82.

Convergence of the Czech price level toward EU average occurs in two ways which in practice are combined: first, through nominal appreciation of the koruna toward the euro; second, via faster inflation than EU average, i.e. positive inflation differentials. Both ways together form the process known as real appreciation of the currency.³ Limits to the speed of real appreciation are set by the need to preserve competitiveness of the economy.

One of the main causes of the long-term difference in price levels between the EU and the Czech Republic is the significant difference in productivity. Because the Czech Republic cannot close this gap rapidly, it also cannot afford a substantial sudden real appreciation of its currency. The loss of competitiveness would endanger the current account and lead to a devaluation, which again would push the price levels further apart.

Therefore, the key to the price level convergence lies in factors that can ensure that real appreciation does not adversely affect price competitiveness. For looking at such factors, it is useful to regard separately positive inflation differentials and the nominal appreciation of exchange rate.

a) Positive inflation differentials. It is often argued that to preserve competitiveness, the entire inflation differential should be offset by faster productivity growth in the tradeables sector. This is a rather simplistic view, as there are two ways of increasing competitiveness: technological innovation and product innovation.

Technological innovation is indeed reflected in measured productivity growth. It reduces the volume of inputs per unit of output. As inflation raises the

³ If the Czech Republic in future enters the eurozone and gives up its own currency, one can no more speak about currency real appreciation but the ongoing process of price level convergence will result in real appreciation of domestic assets.

price of inputs in the tradeables sector, including labour, reducing the volume of inputs per unit of output preserves price competitiveness. In this case, inflation in the economy can be higher than abroad but it is segmented. It occurs mainly in the non-tradeable sector, while in tradeables, especially in goods that are priced at parity, there may be an inflation differential in input prices but not in the price of outputs. To follow such segmented inflation statistically is difficult because of the lack of segmented price indices. One signal can be the situation when CPI-based real exchange rate appreciates significantly faster than PPI-based real exchange rate.

Product innovation and quality improvement are non-price factors of competitiveness. In this case, the mechanism of compensating inflation is much harder to quantify. With new or improved products, there is no comparable base to measure productivity increase - or to measure price increase. Theoretically, new products should enter into real GDP measurement at current prices, and thus increase the aggregate measured productivity. Instead, in practice an entire group of products, including new ones, is deflated by a price index based on price increase of previously existing goods. Thus, the introduction of new and better-quality products is not reflected in productivity figures; instead, it falsely appears as a price increase, as spurious inflation. From the competitiveness point of view, such inflation is offset by non-price factors, even without a measured increase in productivity.⁴

b) Nominal appreciation of the exchange rate. In case of nominal appreciation, the economy again needs to maintain competitiveness by productivity growth and quality improvement that are faster than abroad. Nominal exchange rate appreciation is less selective than inflation - it leads to

⁴ Developed economies assume that new products and quality improvements can lead to a spurious inflation rate of 1,5-2 % annually. Assuming that in the catching-up Czech economy product innovation and quality improvement can be even faster, we could downgrade our inflation differential accordingly in considerations about preserving competitiveness.

an overall increase of foreign prices of exported goods. Compensation requires either a negative inflation differential in tradeables - or product innovation and quality increase ensuring that exported goods will be competitive even at higher prices.

D. Catch-up in economic levels, monetary policy and exchange rate

The reason for discussing the sustainable speed of price level convergence is that catch-up in economic levels tends to provoke real appreciation, both in the form of positive inflation differentials and of nominally appreciating exchange rate. The Czech economy cannot converge toward the average EU level of GDP per head, and at the same time enjoy low inflation and a stable nominal exchange rate. The same problem is faced by all the candidate countries, and it is especially hard for those that would aim to join the eurozone soon after EU accession.

Real appreciation will be a process stemming from more than one source. For one, there is a need for more frequent change in relative prices in a transitive economy, first to absorb the full effect of price deregulation and later to ease fast structural change, technological catch-up, and product improvement. As prices are generally less flexible in the downward direction, faster relative price change, as a rule, requires higher inflation. The low relative price level itself will also press for faster inflation, part of which will be spurious, as competition forces Czech producers to improve the quality and higher quality allows for higher price. Rapid productivity increase, being the main condition of catch-up in economic levels, also provokes inflation differentials, via the well-known

Balassa-Samuelson effect.⁵ This effect will probably be the main long-term source of real appreciation, as is confirmed also by analyses of a number of foreign experts.⁶

The overall speed of real appreciation has to be seen as a combined result of all the sources - faster relative price change, product innovation and quality improvement, and the Balassa-Samuelson effect. Monetary and exchange rate policy can influence the shares of inflation differentials and nominal exchange rate appreciation in the overall real appreciation process, and it can also slow the whole process down, through strict disinflation policies. However, policies aimed at preventing real appreciation, as their side effect, also tend to slow down the whole catch-up process in GDP per head.

This is why the process of real appreciation, meaning higher inflation than abroad and/or an appreciating nominal exchange rate, must not be seen as harmful - as long as it does not undermine the competitiveness of Czech producers. In fact, on condition that competitiveness is preserved, real appreciation is a very positive process, reflecting increased wealth of the economy. Convergence in economic levels and of price levels go hand-in hand. Real appreciation means that both households and companies can, for their incomes in CZK, buy more foreign products. That again increases the production potential of the economy.

⁵ In catching-up economies productivity must ex-definitione grow faster than in more advanced countries. Productivity increase occurs mainly in tradeables, while in non-tradeables (services), as a rule, it is much slower. However, wages in non-tradeables tend to follow those in tradeables, and, not being underpinned by fast productivity increase, lead to higher inflation of non-tradeables prices. That again leads to an overall (CPI) inflation differential against more advanced countries.

⁶ Begg, D., Eichengreen, B., Halpern, L., von Hagen, J. Wyplosz, C. (forthcoming), see Doyle, P. and others (2001); Noyer, Ch. (2001); Fidrmuc and Schardax (2000), p. 42-44.

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APPENDIX

Table 1: Hypothetical Convergence Scenarios (Czech GDP Level in % of EU Average)

| Czech economic growth at: | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---------------------------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|
| 3.5 % | 62 | 62 | 62 | 63 | 63 | 64 | 65 | 65 | 69 | 66 | 67 | 67 | 68 | 68 | 69 |
| 4.0 % | 62 | 62 | 63 | 64 | 64 | 65 | 66 | 67 | 68 | 69 | 70 | 71 | 72 | 73 | 74 |
| 4.5 % | 62 | 63 | 64 | 65 | 66 | 67 | 68 | 70 | 71 | 72 | 74 | 75 | 77 | 78 | 80 |
| 5.0 % | 62 | 63 | 65 | 66 | 67 | 69 | 71 | 72 | 74 | 76 | 78 | 80 | 82 | 84 | 86 |

Source: Eurostat, computations by Komerční banka

Note: Average EU growth rate is assumed at 2.5 %.

Recent Developments on the Czech Labour Market

Eva Zamrazilová

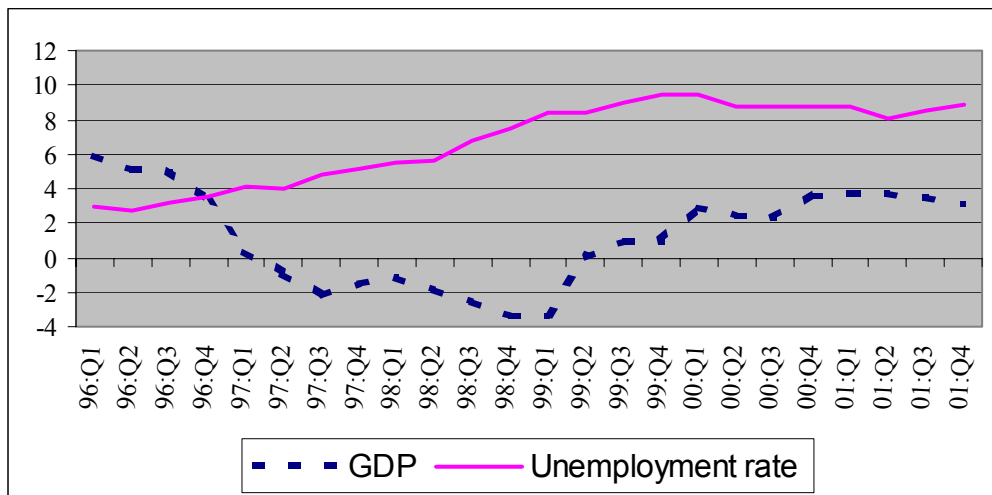
Business Cycle and Restructuring Processes

The developments on the labour market in past five years showed strong dependency between the economic growth and the level of unemployment. In the period of recession, during 1998 – 1999, the unemployment rate grew very rapidly from moderate level of 3.5 % at the end of 1996 to 9.4 % at the end of 1999. Along with economic recovery at the beginning of 2000, the unemployment rate started to decline. Economic growth stopped another deterioration of the unemployment rate which was expected by many analysts to reach almost 12 % for the end-year of 2000.

An upturn occurred in the second quarter of 2000 when the unemployment rate started to decline. The recovery of economic growth was more robust against overall expectations, main factors of economic growth changing at the same time. Until second quarter of 2000, foreign demand was the main factor helping to recover the Czech economy, while as of second quarter of 2000 on, domestic demand has started to play major role. Strengthening domestic demand boosted vacancies and increased absorption capacity of the economy. The unemployment rate continued to decline until June 2001 to the relatively low level of 8.1 %. Anyway, this decline was not so significant as was the previous growth of unemployment, therefore the unemployment rate did not

fall to previous pre-recession low figures. This discrepancy has been witnessing predominantly for growing importance of structural factors on Czech labour market.

Figure 1 Economic Growth and the Unemployment Rate



Source: Czech Statistical Office

Restructuring of the Czech economy speeded up in the period of recession when lack of finance resources deepened the division between performing and non-performing companies. Restructuring speeded also along with massive inflow of foreign direct investments: new management started with far-reaching restructuring inside newly acquired companies. The employment grew in the industries which had been able to export, especially in some manufacturing ones during 2000 (automotive industry, electrical and optical appliances). The employment grew also in some services, especially in retail trade towards which a significant part of foreign direct investments was oriented. On the other hand, employment declined in mining and quarrying and also in some badly performing manufacturing industries.

Structural character of demand deepened structural character of Czech unemployment. Both foreign and domestic demand has been concentrated to industries with higher value added which demanded qualified labour force. Also the vacancies created due to foreign direct investments demanded qualified labour force which still has been in shortage in the Czech Republic.

The quite favourable picture of the Czech labour market somewhat changed in second half of 2001 as a result of the overall West-European slowdown. During the second half of 2001, the unemployment rate increased from 8.1 % in June to 8.9 % at the year-end.

Unemployed and Vacancies

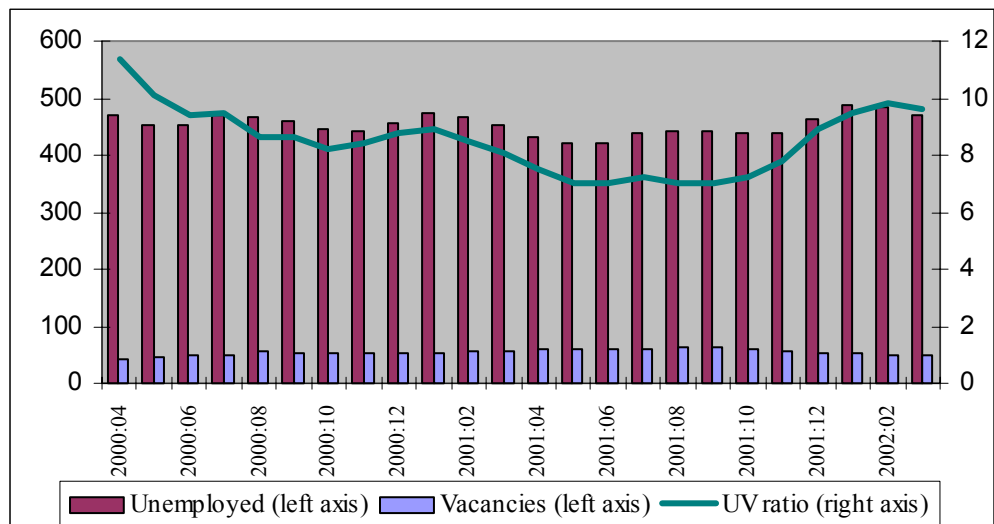
In the period before economic recession, the ratio between unemployed or job-seekers and vacancies (the so-called UV ratio) was very low, only 2 – 3 people falling upon one vacancy. During the recession the UV ratio deteriorated very rapidly amounting to 10.3 at the end of 1998. The record high of this indicator was reached in January 2000, 15 people falling upon one vacancy. In January 2000 also the number of unemployed reached its record high level in the history of the Czech republic amounting to 508 thousands people. At the same time also the number of vacancies reached its record low, with only 34.7 thousands free jobs.

In the course of 2000, both the number of unemployed declined and the number of vacancies increased. Since January to August 2000, the number of vacancies increased by 50 % witnessing for strong demand for labour on the Czech labour market. As of second quarter of 2001, a slower growth of

vacancies started to be visible. Weakening foreign demand led with some delay also to slight decline of domestic demand: weakening both of foreign and domestic demand did not allow domestic companies to hire additional labour force and create new vacancies.

December 2001 was the first month with year on year decline in vacancies, after 22 months of continuous yearly growth. At the same time, in December 2001 the year on year growth in job-seekers increased after 14 months of continuous decline. Following months proved both these changed tendencies. As a consequence of developments of unemployed and vacancies, the ratio between unemployed and vacancies showed a deterioration since September 2001 after year and a half of improvement. In September this ratio amounted to 6.9, first quarter 2002 data indicating stabilisation around the level of 9-10 people falling upon one vacancy.

Figure 2: Ratio between unemployment and vacancies



Source: Czech Statistical Office

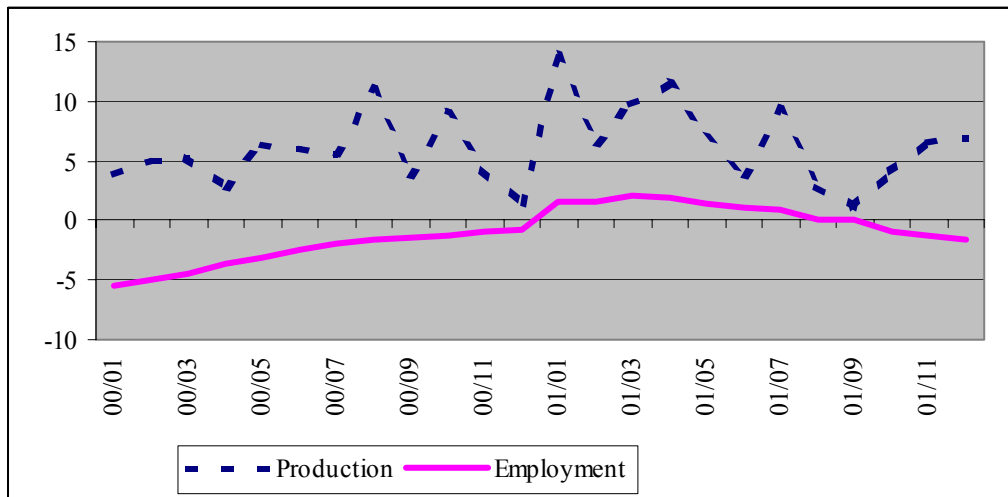
Industrial Slowdown

Growing pressures on labour market strongly correlate with signs of slowdown of demand for the Czech industrial exports, especially on the part of the Czech main trading partner, Germany which have been visible since August 2001. Czech industry still preserved major sector of Czech employment. Manufacturing industry employed 27 % of Czech labour force in the first quarter of 2002. At the same time, manufacturing industries have been responsible for decisive part of the Czech exports. Therefore it is only natural that the overall changes for demand for industrial products are – with a certain time lag – strongly felt on the general labour market.

Figure 3 illustrates that the employment in industry has followed the rates of growth in industrial production in the past two years. Econometric computations showed that a growth of manufacturing industrial production by 1 percentage point caused a growth by 0.2 – 0.3 of percentage points in industrial employment in the period of 1999 – 2001. Different models brought

up different results, but the interval of 0.2 to 0.3 percentage points seemed to be the most reliable and exact one. Mining and quarrying industries were left out from this analysis due to government decided and controlled attenuation carried out in these industries.

Figure 3: Production and Employment in Industry (Growth rates in %)



Source: Czech Statistical Office

Post-recession Changes on the Labour Market

Increasingly structural nature of the Czech unemployment correlates strongly with increase of long-term unemployment in the Czech Republic. Long-term unemployment (unemployment over 1 year duration according to the ILO definition) stabilised around the level of 20 % in 1994 - 1998. Economic recession combined with deepening restructuring led to a significant increase of long term unemployment as of 1998.

Economic theory calls this recession increase in long-term unemployment with following post-recession persistence of higher shares of long-term unemployment as the hysteresis effect. The experience with hysteresis effect in West European countries showing that the share of long-term unemployment usually has even increased after the recession was thus fully confirmed in the case of the Czech Republic. The hysteresis effect is caused by the fact that the recession makes the duration of unemployment longer. After the recession, the position of unemployed being out of work during the recession is more complicated than the position of people newly entering labour market or short-term unemployed. Recession is thus responsible for partial loss of human capital.

More than one third of long-term unemployed people are people with primary or low secondary education which supports again the statement about the structural factors behind growth of long-term unemployment. The importance of good requalification programmes must be therefore stressed again, having in mind that the chances of low qualified people on the labour market are poor. On the other hand, the position of people which have passed through some training and requalification programme improves, the rate of training success ranging between 50 to 75 % .

Table 1: Long-term Unemployment in the Czech Republic

| Year | Rate of unemployment | Over 6 months | Over 1 year |
|-------------|-----------------------------|----------------------|--------------------|
| | | % | % |
| 1995 | 2.9 | 39.5 | 23.7 |
| 1996 | 3.5 | 35.4 | 20.1 |
| 1997 | 5.2 | 37.5 | 19.6 |
| 1998 | 7.5 | 53.0 | 31.6 |
| 1999 | 9.4 | 64.7 | 41.0 |

| | | | |
|------|-----|------|------|
| 2000 | 8.8 | 70.3 | 50.7 |
| 2001 | 8.9 | 71.0 | 53.0 |

Source: Ministry of Labour and Social Affairs, Czech Republic

The recession put the Czech labour market closer to standard West European labour markets. The unemployment rate being very close to the unemployment rate in the EU seems to be a non-comittant feature of the Czech economy. International comparisons show that the Czech long-term unemployment share is similar to Germany, France and other West European countries. The developments on the Czech market in the next months will be strongly dependent on timing and intensity of recovery in Western Europe.

Domestic companies will be very cautious about demanding new labour force in the first half of 2002. In the second half of the year, first signs of world economic recovry could be felt also on the Czech labour market. Foreign direct investments are expected to reach even higher level then in 2000 and 2001 what is giving brighter prospects to the developments of vacancies. With strengthening both domestic and foreign demand in the last quarter of 2002 the absorption capacity of the labour market should increase, again. The improvement of economic climate in the second half of the year will have only limited effect on the labour market, having in mind that the major part of Czech unemployment is a structural one. We expect only slight decrease of the unemployment rate under the 9 % level at the end of the year.

Slovakia: Catching Up on the Way Towards European Union

Kamil Janáček

Despite a slowdown in Western European markets, the Slovak GDP grew by 3.3 % in 2001, from 2.2 % a year earlier. Surging domestic demand helped sustain economic growth and overplayed weakening demand for Slovak exports. Domestic demand rose by almost 7 %, driven by revival of private consumption (4 %) and 11.6 % growth of fixed capital investment.

Sharp increase in fixed capital investment followed a 1 % decline in 2000. Investment grew predominantly in companies under foreign ownership; this was combined with government investment for road construction. Investment activities led to growth of public consumption by 5.2 % in 2001.

Rising consumer confidence and increasing real wages supported an increase in private consumption of households by 4 % – after two years of

decline. Smaller increases in administered prices and lower oil prices helped slow inflation to 6.4 % at the end of the year (cf. Table 1). The trend of declining inflation continues in the first quarter of 2002: at the end of March, CPI dropped to 3.6 %, y/y.

Table 1: Main Macroeconomic Data

| | 1999 | 2000 | 2001 | 2002F |
|--|------|------|------|-------|
| GDP (growth in %) | 1.9 | 2.2 | 3.3 | 2.7 |
| Industry (growth in %) | -3.4 | 9.1 | 6.3 | 6.0 |
| Inflation (% , end of period) | 14.2 | 8.4 | 6.4 | 5.5 |
| Unemployment rate (%) | 16.2 | 18.6 | 18.6 | 19.0 |
| Employment (growth in %) | -4.0 | -3.0 | 1.0 | 0.5 |
| Nominal incomes(growth in %) | 7.2 | 6.5 | 7.8 | 7.5 |
| State Budget Balance (% of GDP) | -1.8 | -3.1 | -5.2 | -5.0 |
| M2 (growth in %) | 11.4 | 15.4 | 11.9 | 11.0 |

Source: Slovak Statistical Office, IIF, forecasts by Komerční banka

Boosting domestic demand with slower growth of exports led to a sharp increase in current account deficit- it reached a dangerous level of 9.1 % of GDP. The current account deficit was primarily due to a record deficit of trade balance (SKK 103.2 bill.), the service balance recorded a surplus of SKK 20 bill. – the same amount as in 2000. The FDI were unable to cover the gap and the Slovak government was obliged to borrow at home as well as abroad (cf. Table 2).

Table 2: Trade, Balance of Payments and Exchange Rate

| | 1999 | 2000 | 2001 | 2002F |
|---|-------------|-------------|-------------|--------------|
| Trade Balance (USD bill.) | -1.1 | -0.9 | -2.0 | -2.5 |
| Current Account (in % of GDP) | -4.2 | -3.2 | -9.1 | -9.0 |
| Reserves (USD bill.) | 3.4 | 4.0 | 4.4 | 5.5 |
| External Debt (USD bill.) | 10.5 | 10.8 | 11.8 | 13.1 |
| External Debt (% of GDP) | 53.4 | 56.3 | 57.0 | 54.0 |
| PRIBOR 3M (end of period) | 12.6 | 8.0 | 7.7 | 8.5 |
| SKK/EUR (end of period) | 42.5 | 43.6 | 42.6 | 43.5 |
| SKK/USD (end of period) | 42.1 | 48.6 | 47.9 | 49.0 |
| SKK/CZK (end of period) | 1.18 | 1.25 | 1.26 | 1.26 |
| Real Effective Exchange Rate (1995 = 100, end of period) | 114 | 115.8 | 122.4 | - |

Source: Slovak Statistical Office, IIF, forecasts by Komerční banka

The wider external deficit was accompanied by an increase of deficit in public finances: state budget deficit increased to 5.2 % of GDP (from 3.1 % in 2000) and public budget deficit stood almost at 7.5 %, as a result of tax cuts, bank restructuring costs and increased off-budget spending. Financing pressures have been accommodated by monetary easing , by revenues from privatisation of two large banks and by bank's eagerness to lend to the government instead of to corporate sector. As a consequence of this crowding-out effect, the companies preferred to lend abroad (if possible). Net foreign borrowing both by companies and banks rose significantly in comparison with recent years.

During 2001, structural reforms progressed pushed by the preparations for the EU accession (Slovakia's bid to join the European Union has the strong support among the population). The government have advanced bank restructuring and privatisation; progress on other structural reforms remained more modest. Public enterprise restructuring has begun only recently and is proceeding only slowly despite a much improved legal framework due to weak implementation. Unreformed pension and health care systems, a poorly targeted and administered social safety net and tax collection deficiencies led to strong fiscal pressures and imbalances.

Bank privatisation progressed significantly with the sale of 87 % stake of Slovenská sporiteľňa (Slovak biggest bank) in January 2001 to the Austrian Die Erste Bank , and the sale of 95 % of Všeobecná úverová banka – in June – to Italian IntesaBCI. In 2002, the sale of the remaining large bank – Investičná a rozvojová banka – will be finished, as well as the privatisation of 49 % of gas company SPP and biggest insurance company, Slovenská poisťovňa. It is only unclear, if the privatisation of these companies will be completed before or after the parliamentary elections due in September 2002.

Expectations of privatisation related capital inflows helped to appreciate the SKK against EUR in 2001 (cf. Table 2), but the concerns about the widening current account deficit kept the appreciation of the Slovak crown in reasonable limits. Slovak currency continued in slight depreciation against the Czech crown reflecting the better assessment of the Czech economy by the international markets.

The employment grew by 1 %, but due to demographic development (43 thousands new entrants on the labour market, out of which 20 000 found a job and 23 000 increased the number of unemployed), the unemployment rate stagnated at a high level – 18.6 % at the end of the last year. The 12 years of the transformation of the Slovak economy are characterised by a high degree of unemployment rate and one of the weakest results of the present government is an inability to cope effectively with this economic and social problem.

As it was mentioned above, the trade balance registered a record deficit in 2001 – 103.2 bill SKK, which represents 10.7 of GDP. Export growth slowed significantly due to low demand on the West European markets and due to the fact, that the significant part of Slovak export is composed by steel and chemical semiproducts , items highly sensitive on the development of the world business cycle. On the other hand, imports accelerated due to substantial increase of imports consumption and investment goods, particularly technology imports related to foreign direct investments. This trend continue in the first month of 2002.

Outlook

Relatively strong growth of domestic demand will keep the rate of growth of GDP at a solid level: we expect that GDP will rise by 2.7 % in 2002. But the financial stability will be under increasing risk having in mind the twin deficits of current account and public finances. Fiscal policy is likely to ease ahead of the election, widening the state budget deficit and keeping the current account deficit outsized as export growth continues to be slow in response to weaker

foreign demand. The wider fiscal deficit is unlikely to threaten financial stability in the short run, however, if large privatisation receipts materialise in 2002 as expected.

Due to pre- and post election periods, structural reforms will continue, albeit more slowly. Fiscal policy is likely to be tightened in 2003, but not enough to reduce the current account deficit. At least the minimum of institutional and structural reforms needed to advance EU accession is likely to be enacted. The corporate sector will increase the pressure to advance reforms not only to speed EU accession, but to assure the access to international capital markets needed to finance the large fiscal and external deficits once privatisation proceeds decline sharply in 2003 and cease thereafter.

The need to finance both a wider fiscal deficit and continuing strong growth of fixed capital investments should increase net external borrowing in 2002 to 1.2 bill. USD (25 % increase in comparison with 2001) and this trend will continue in 2003, as well. Borrowing needs of this magnitude leave Slovakia at risk of a sharp reversal of capital flows should external (or internal) circumstances turn abruptly in unfavourable. This risk will increase if the authorities fail to advance structural reforms and proceed with the medium-term fiscal consolidation as agreed under the staff-monitored program with the IMF.

This situation put Slovak National Bank on alert. Despite declining inflation rate, SNB is pursuing neutral monetary policy and will not cut the interest rates in the near future. On the contrary, if the current account and budget deficits continue to widen, central bank is prepared to rise interest rates.

For this reason we expect that BRIBOR will rise during the 2002 and that the Slovak crown will slightly depreciate both against EUR and USD (cf. table 2).

| | | |
|------------------------|-----------------|-------------------------|
| <u>Authors:</u> | Kamil Janáček | ### +420-2-24214666 |
| | Chief Economist | ✉ kamil_janacek@koba.cz |
| | Eva Zamrazilová | ### +420-2-24436633 |

Senior Analyst

✉ eva_zamrazilova@koba.cz

FAX + 420-2-24222839

Stanislava Janáčková

<na přední předsádku>

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Tel.: + 420 - 2 - 24 21 46 66

Fax: + 420 - 2 - 24 22 28 39

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