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CZECH ECONOMY AT THE BEGINNING OF 2004

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Economic Growth

In the course of 2003, the Czech economic growth accelerated. GDP grew by 2.4 % in the first two quarters of the year followed by an increase of 3.4 % in the third quarter. The main factor of this acceleration was massive household consumption increasing by record 7.3 % in the third quarter of 2003. At the same time, a revival of fixed capital formation observable as of second 2003 quarter supported economic growth: in Q3 2003, fixed capital investments increased by 3.9 %. The recovery of investment demand was supported both by strong domestic consumer demand and by increasing demand for exports. The average growth of consumer demand thus increased by 6 %, while investment demand grew by 2.2 %, in the first three quarters of 2003. Gradual narrowing of the gap between consumer and investment demand was one of major achievements of 2003, supporting the long-term sustainability of Czech economic growth.

As in 2002, external sector continued to contribute adversely to economic growth. Trade with goods deteriorated by CZK 8 bill., while trade with services worsened by CZK 10 bill., in the first three quarters of 2003. This negative contribution was mainly due to the developments of prices in foreign trade because the real trade deficit in current prices improved by CZK 4 bill., January – September 2003.

Low inflation, rapid growth of real incomes combined with all types of consumer loans were the main factors of strong consumer demand and an acceleration in retail trade. The growth of retail sales reached 4.9 %, January – November 2003. Boom in retail trade was concentrated to summer months due to massive

car sales which grew by 10 %, June – September 2003. At the same time, sales of food increased by 4.6 % while non-food items showed an under-average growth of 3.4 %. Growth in retail trade was the main factor of growth in services; sales in services increased by 6 %, in the third quarter of 2003. Also growth of GDP in services accelerated in the third quarter of 2003, amounting to 2.3 % – up from 0.9 % in the first half of the year.

In 2003, industry continued in solid growth without significant fluctuations, the industrial output increasing by 5.6 %, January to November 2003. Industry was the most important sector in GDP growth: GDP in manufacturing industry increased by 3.3 %. Growth of GDP in manufacturing accelerated strongly in Q3 2003 when the growth of 5.1 % was almost double in comparison with the second quarter. Having in mind that the growth of output in manufacturing amounted to 6.1 % in Q3 2003, narrowing of the gap between output and value added seems to be an favourable change caused especially by continuing restructuring and pressures on cost reductions.

Similar tendency has been observed in construction. After a long-term decline of GDP in construction, in Q3 2003 an upturn was achieved, GDP in construction increasing by 6.9 %. This change is most probably supported by increasing importance of housing which has been producing higher share of value added in total output than large infrastructural and business projects. Housing construction has been driven by boom of mortgages due to low interest rates combined with easier access to mortgages and housing loans. Construction showed a strong boom in the second half of 2003, driven especially due to prospects of an increase of VAT in construction, effective as of January 2004. Therefore, construction has shown double digit growth rates of output since June 2003, while construction output stagnated until May. In 2003, construction output increased by 8.9 %.

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Foreign Trade and Exchange Rate

The full-year 2003 trade deficit remained at the same level as in 2002, amounting to CZK 71 bill. At the same time, the trade deficit will most probably decline under 3 % of GDP in 2003. Considering acceleration of Czech economic growth in 2003, stagnating level of deficit is favorable. Also, the ratio between imports and exports in 2003 increased to 95.1 %, up from 94.6 % in 2002. High import intensity of Czech exports and economic growth has thus been slowly declining.

In 2003, both imports and exports accelerated, increasing by 8.8 % and 9.3 %, respectively. As in 2002, exports to EU were above average, being pulled predominantly by activities of foreign controlled companies. In 2003, the trade with EU produced an surplus of CZK 103 bill., the trade deficit was concentrated to former Soviet Union states and China (deficits amounting to around CZK –60 bill. with each of them).

In 2003, the average exchange rate of CZK against EUR amounted to 31.84 CZK/EUR. Compared to 2002, the average exchange rate weakened by 3.3 %. The depreciation was concentrated especially to the third quarter of the year when the CZK against the EUR depreciated by 6 %. The weakening of the Czech currency was – to a high degree – provoked by low interest rates during the whole year. Foreign investors assessed the Czech currency less attractive compared to forint or zloty. Also, there were no big FDI deals pushing the currency up (as it was the case in previous year).

The developments of the CZK to the USD were quite different. CZK appreciated on average by 14 % against the USD and yearly average stood at 28.23 CZK/USD. The movements of the CZK/USD exchange rate were not primarily affected by domestic factors but predominantly by the depreciation of USD against the EUR.

In the first three quarters of 2003, the balance of payments was roughly balanced: financial account showed a surplus of CZK 106.5 bill, while current account deficit amounted to CZK –104.8 bill, almost the same level as in Q1 – Q3 2002 (CZK – 106 bill.).The main source of current account deficit was anew the income balance with the deficit of CZK –89.5 bill., remaining thus the most significant long-term risky factor for the Czech external balance.The trade deficit amounted to CZK –36.5 bill. Services produced a small surplus of CZK 10.4 bill. The foreign direct investments reached CZK 111.1 bill. The first three quarters of 2003 proved that the FDI inflow amounting to at least USD 1 bill. each quarter seems to be a mid-term potential after the end of the privatisation in the Czech Republic.

Inflation

After a slight weakening of deflation tendencies in the third quarter of 2003, last quarter of the year confirmed a resurgence of inflation. In the fourth quarter of 2003, yearly indices of consumer prices were above zero, the year on year headline inflation standing at 1 % at the end of 2003. The average CPI was only slightly above zero, amounting to 0.1 %.

The unique situation of 2003 was caused by combination of several benign factors. First, food prices were unusually low in the first half of the year, and started to grow only in the second half of the year – from August 2003, when domestic and import prices went up after a weak crop. Second, fierce competition among big retail chains kept consumer prices low. Third, the appreciation of the exchange rate of the CZK to USD compensated for price increases of metals and other raw materials on the world market, at least in the first three quarters of the year.

Producer prices showed similar developments as the consumer ones. PPI was in the deflation range until the last quarter of the year, an upturn being registered in November 2003 – after 21 months of continuous decline.

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The year on year PPI stood at 0.9 %, in December 2003, almost the same level as CPI. The twelve-months average declined by 0.3 % against the 2002 PPI average.

The Czech National Bank decided three times to cut basic rates by 25 basis points. The first cut occurred on January 30, 2003, placing the basic Repo rate to 2.5 %, 25 basis points under the ECB’s basic rate. The second cut followed on June 25, reducing the basic Repo rate to 2.25 %, the same level as the ECB refi rate. Also, the last cut from July 31 followed the step of ECB, placing the repo rate to the record low of 2 %.

Unemployment

In December 2003, the unemployment rate reached 10.3 %. In the course of 2003, the unemployment rate thus increased by 0.5 percentage point, up from 9.8 % in December 2002. The rate of unemployment is by 1.5 percentage points above the unemployment rate in the Eurozone. The number of unemployed amounted to 542 thousands in

December 2003, up from 514 thousands in December 2002. At the same time, 40 thousands of vacancies were registered at the end of 2003, almost the same number as a year before.

Restructuring of Czech industry has been the main factor behind massive layoffs of labour force: employment in industry declined by 43 thousands persons (year on year) in November 2003. Level of unemployment is kept high also due to structural factors, especially by differences between structure of vacancies and skills of the unemployed. Therefore, long-term unemployment has been rapidly increasing, representing approximately 40 % of Czech unemployment.

In this respect, qualification and education is playing an important role. While the share of long-term unemployment exceeds 70 % in the group of unemployed with basic education, it is only 30 % in the group of unemployed with completed secondary education. Increasing costs of long-term unemployment calls for new measures in employment policy.

Table 1: Main Macroeconomic Indicators

		2000	2001	2002	2003	10/03	11/03	12/03	2004F
Inflation	%, y/y	3.9	4.1	0.6	1.0	0.4	1.0	1.0	3.0
Inflation	%, m/m	–	–	–	–	0.1	0.5	0.2	–
Industrial prices	%, y/y	5.0	0.8	–0.7	0.9	–0.1	0.4	0.9	2.0
Industrial prices	%, m/m	–	–	–	–	0.6	0.4	0.2	–
Unemployment rate	%, eop.	8.8	8.9	9.8	10.3	9.9	9.9	10.3	9.8
Industrial production	%, real	5.1	6.8	4.8	5.5	5.2	4.8	5.5	5.5
Construction output	%, real	5.3	9.6	2.5	9.0	12.1	14.3	8.9	4.0
Retail sales	%, real	4.6	4.3	2.7	5.0	3.4	1.0	5.5	3.5
State budget	CZK bill.	–46.1	–67.7	–45.7	–109.1	–82.9	–92.2	–109.1	–130
Trade balance	CZK bill.	–120.8	–119	–71.3	–71.2	–6.6	–8.3	–19.8	–65
FOREX reserves	USD bill.	13.1	14.8	23.7	27.0	25.6	26.0	27.0	27.0
PRIBOR 3M	% average	5.36	5.2	3.55	2.3	2.06	2.07	2.08	2.8
CZK/EUR	Average	35.6	34.1	30.81	31.84	31.98	31.97	32.13	31.5
CZK/USD	Average	38.6	38.0	32.74	26.32	27.35	27.34	26.32	26.0
GDP	%, y/y	3.3	3.1	2.0	3.0	–	–	–	3.3

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

External Environment

The world economy is finally recovering. Moreover, the recovery is stronger than it was expected several months ago. In the US, after 3.1 % growth in 2003, the economic expansion appears to accelerate to 4.5 % growth rate in 2004. Also growth in Asia looks impressive and Latin America can expect a solid economic expansion. Only Euroland is lagging behind: strong euro and weak domestic demand will lead to a lacklustre recovery in 2004 with the growth rate of 1.8 %.

Among high-income countries, growth is led by the US, when Canada, Australia and UK follow behind. Then come Japan (forecast to grow by 2.1 % in 2004) and eurozone in the last place. The major factor behind these differences is productivity growth: while the productivity growth in the US rose from 1.2 % a year between 1990 – 1994 to 2 % in the period of 1995 – 2002, productivity growth in the eurozone slowed from 2.6 % a year in the first half of 1990s to 1.4 % between 1995 and 2002. For this reason, Japan and eurozone stopped to catch up US in GDP per head and are slowly slipping behind.

Despite the structural weaknesses, the eurozone is starting to benefit from the upsurge in world economic activity. Nevertheless, the economic dynamics will be limited due to slow pace of structural reforms and only gradually recovering domestic demand. Also, the fiscal policies in core euroland countries (France, Germany, the Netherlands) will be restrictive in the aftermath of the clash about the Stability and Growth Pact.

The risks to the global economic recovery are lower than in 2003. First, geopolitical risk are somewhat lower despite remaining instability in Iraq, Afghanistan and situation in the Middle East. Second, the risks of global deflation have lessened. Third, despite the very low US personal savings rate and the large US borrowing requirements, the investors continue

to find the US a relatively attractive place – at least in the short term.

Outlook

In 2004, the growth of domestic consumer and investment demand will be more closer than was the case in 2003. Consumer demand will somewhat slow while recovery of fixed capital investment will continue. The negative impact of external sector to GDP growth is expected to be roughly the same as in 2003. The long awaited revival of the EU economy will push Czech exports. On the other hand, we cannot await any immediate impact of EU entry (May 2004) on economic growth. The full year GDP growth will be slightly above 3 %.

In 2004, Czech exports will be favourably affected by recovery of economic activity in the EU. Due to slow but ongoing decline of import intensity of exports, Czech trade balance will moderately improve in 2004. The trade deficit will thus amount to CZK 60 – 65 bill. However, the trade balance does no longer represent the main cause of current account deficit which is estimated to fall to 5 % of GDP, down from expected 6 % of GDP in 2003. This level of current account deficit does not represent significant macroeconomic risk and will be to a high extent covered by FDI inflows which are estimated around USD 4 bill. in 2004.

Industry will continue to grow at the pace similar to that of 2003, i.e. around 5 %. As in recent years, the growth in industry will be more and more pulled by foreign-owned companies, with close business ties to EU countries. Growth in construction will continue in 2004 due to planned infrastructure projects and by persisting boom in housing construction. The growth rates will be favourably affected by low comparative bases from 2003 until May, later on slowdown will take place due to double-digit statistical bases from 2003. In 2004, we expect the growth of construction output around 4 %.

The retail sales will show a slight slowdown in 2004. The boom in car sales (which accelerated

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retail sales in 2003) is – with high probability – over. Therefore, in the first half of 2004, retail sales will grow by 3 – 4 %, slowing to 2 – 3 % in the second half of the year. In 2004, we expect the average growth in retail trade to reach approximately 3 %.

After a year of practically zero inflation, the consumer prices in 2004 will grow rather dynamically. Two waves of tax increases (January and May 2004) will push the CPI to the level of 3 %. Also, CZK/EUR exchange rate stopped to keep import prices at a low level – at least of manufactured consumer goods and foods.

Acceleration of domestic investment demand combined with recovery of world economy and increase of world raw material prices support our expectations that also Czech producer prices will show growth in the course of 2004. Anyway, the growth of producer prices will be lower than that of consumer ones : at the end of 2004, year on year growth of PPI will reach 2 %.

In 2004, several main factors will act on the labour market. Recovering foreign demand and accelerating domestic investment demand will support new job opportunities, ongoing restructuring in the Czech industry, however, will increase numbers of job-seekers. Due to demographic development, the new wave of graduates entering the labour market should be weaker than in the past several years, but, at the same time, higher inflow of workers from abroad must be expected.

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Monetary policy of the Czech National Bank will be influenced by two factors: monetary policy of ECB and development of domestic inflation.

In the course of 2004, we expect regular seasonal developments. Regular January increase will be followed by the decline of the unemployment rate under the 10 % level in spring. Later on, increase in summer months (as a consequence of school-leavers entering the labour market) will be replaced by slight autumn decline. The rate of unemployment will be slightly over the 10 % level at the end of 2004.

For 2004, we expect different developments of the exchange rate of the CZK against EUR and USD. As far as USD is concerned, the Czech currency will follow the appreciation trend of the EUR towards US dollar. The prospects of the development of the CZK/EUR exchange rate are more unclear. On the one hand, the low interest rates will continue to keep CZK/EUR in the interval of 32.50 – 33.0. On the other hand, the entry of the Czech Republic into the EU could be followed by the appreciation of the currency. Summing up, we expect the average level of CZK/EUR at 31.50 – 32.0.

Monetary policy of the Czech National Bank will be influenced by two factors: monetary policy of ECB and development of domestic inflation. While ECB – with high probability – will keep its refi rate unchanged till the last quarter of 2004, domestic inflation could push CNB to increase the interest rates.

CZECH REPUBLIC AND EMU ENTRY: SOME REFLECTIONS

Kamil Janáček

After the Czech Republic has entered the European Union on May 1, 2004, discussion can start about our another obligation – joining the European Monetary Union (the eurozone). According to EU legislation, eurozone entry should follow after EU accession – with Czech Republic having to fulfil the Maastricht convergence criteria¹ before applying for the euro. As different from Great Britain and Denmark, there is no "opt-out clause" for the new member countries with respect to eurozone, which implies that the Czech Republic, in future, will be obliged to join.

Discussion about the time horizon of eurozone entry is very important for the Czech economy – as it is catching up with EU countries, undergoing fundamental structural change, and at the same time adapting to the, often very complicated, conditions following from "acquis communautaire".

Eurozone: an Optimal Currency Area?

The European Monetary Union has been implemented at three stages based on the Maastricht Agreement. Most important was the third phase when, since 1999, in 11 member states (later, 12), euro was introduced for non-cash transactions, and the common monetary policy of European Central Bank began to function. The process of monetary integration was then formally completed by introducing the euro for cash transactions in January 2002.

Economic theory states as prerequisite for a successful monetary union that the relevant countries represent an optimum currency area. Conditions for the optimum currency area (OCA) are as follows:

- mobility (or, a high degree of it) of labour, goods, capital and services;
- close synchronisation of economic cycles of the member countries;
- symmetry of external economic shocks, or of reaction to shocks;
- existence of a sufficiently strong fiscal compensating mechanism (or, a common fiscal policy).

As Prof. Bofinger writes, "OCA theory... seems to be almost generally accepted as the main touchstone of the advantages of EMU and as the theoretical basis for all empirical tests in this area".²

Does, then, the European Monetary Union in its present form, fulfil the OCA criteria?

- The EU common market, so far, enables a free movement of goods. In free movement of services, there are still very strong barriers, which the EU has started to remove (gradually, slowly and with problems) for financial services, telecommunications and energies. Complicated national licensing conditions prevent a free over-the-border movement of many services (legal, marketing, real-estate, architects', etc.).
- Free movement of labour is also regulated, and will be more so after the accession of new members on May 1, 2004.
- Economic cycle within the eurozone is not yet fully synchronised, although evidence here is not conclusive. As to symmetry of shocks, the same applies.
- Common monetary policy is not supported by common fiscal policy, the latter remaining the domain of individual EMU countries. The Stability and Growth Pact defining some boundaries for national fiscal policies collapsed in November 2003, after the two largest (and founding) EU members – Germany and France – had violated its rules for several years.

The present European Monetary Union thus is very distant from fulfilling the OCA parameters. The main reason is that at the end of the 1980s and

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The common currency – after five years of its existence – has not fulfilled the original optimistic expectations of faster economic growth.

The new member countries are obliged to join the eurozone, but the accession agreements do not state a strict term. The new members are also expected to follow, in their fiscal policy, the Stability and Growth Pact; however, not complying with the Pact does not (so far) entail any sanctions for them.

during 1990s, "the driving force behind European monetary unification has been strictly political, not economic... Euro has always been considered to be a useful instrument for creation of the European political union."³ This fact has been confirmed by leading EU representatives. European Commission's President Romano Prodi stated: "The introduction of the euro is not economic at all. It is a completely political step... The historical significance of the euro is to construct a bipolar economy in the world."⁴

Thus the common currency – after five years of its existence – has not fulfilled the original optimistic expectations of faster economic growth. And it has to be underlined that the twelve EMU members are – not identical economies – but countries with very similar economic levels. That cannot be said of the new EU members, who are to join the eurozone.

It may also be noted that economic literature shows that it took the U.S.A. whole 150 years to become a homogenous monetary union – i.e. it lasted that long before the benefits of monetary union started to outweigh its costs. With high probability, in today's globalised world, homogenisation will not take that long for the European Monetary Union – but the period will certainly be longer than one decade.

EMU and New Member States

As mentioned above, the new member countries are obliged to join the eurozone, but the accession agreements do not state a strict term. The new members are also expected to follow, in their fiscal policy, the Stability and Growth Pact; however, not complying with the Pact does not (so far) entail any sanctions for them.

The attitudes of the Central-European new member countries (Poland, Hungary, Slovakia, Czech Republic) toward eurozone membership have passed through some modifications.

In the second half of the last decade especially Poland and Hungary were talking about immediate EMU entry, if possible, right after EU accession. Some Polish economists (including government ones) were even seriously considering the idea of a unilateral adoption of euro, without complying with the nominal convergence criteria and without undergoing the required two years of ERM II membership. Only the strict attitudes of the ECB and the European Commission – against unilateral "euroization" – curbed such tendencies.

At that time, Slovakia did not make statements as to the timing of EMU entry, as the country was not yet definitely included in the "first wave" of accession countries. Later, Slovakia's attitudes approached those of Poland and Hungary, now the official standpoint also being "EMU entry as soon as possible".

Official attitudes of central banks of the above three countries toward an early EMU entry have one inward-oriented dimension which should not be overlooked: they serve as a tool of pressure of central banks on governments – to speed up structural reforms and to lower the large public finance deficits. The proclaimed aims are to fulfil the Maastricht criteria by 2006 (Slovakia) and 2006 or 2007 (Poland, Hungary) – and to join the EMU in 2008. Leszek Balcerowicz, governor of the Bank of Poland, expressed this position most clearly: "Targeting the earliest possible date of entry into the EMU is the best strategy for the accession countries."⁵

Official position of the Czech Republic had long not been known – except for general statements of some politicians. On the board of Czech National Bank, two opinion groups formed – one supporting a fast EMU entry, the other taking a more reserved standpoint. For several years, discussion in the CR was led predominantly on academic level.

³ Klaus, Václav: "The Future of Euro: A View of a Concerned Outsider", lecture at the Cato Institute, Washington, D.C., November 20, 2003 (www.klaus.cz).

⁴ Interview on CNN, January 1, 2002.

⁵ "EU Enlargement and Catching Up". Paper presented at a conference for new member states "From Accession to Adopting the Euro", Warsaw, November 21, 2003.

Only after the completion of accession negotiations and signing the accession treaty (in April 2003) did the dialogue accelerate between the government, or the Czech Ministry of Finance, and the Czech National Bank. This resulted on September 30, 2003 in adoption of a joint government and CNB document "Strategy for Accession of the Czech Republic to the Eurozone". The material states that "assuming fulfilment of the Maastricht criteria, including a successful consolidation of public finance, reaching a sufficient degree of real convergence, and a corresponding progress of structural reforms ensuring a sufficient economic harmonisation with EU countries, eurozone accession can be expected within the horizon of 2009–2010."

Czech Republic thus takes a more reserved and more realistic position among the Central-European new member countries, as to the date of possible eurozone accession. Its strategy weighs the benefits as well as possible risks of entry, and pays strong attention to fiscal consolidation as a necessary condition for the adoption of common currency.

The joint government and CNB strategy paper also mentions (though only briefly) one vital economic problem which has up to now lacked broader attention of both the academic circles, and the media. It is the problem of setting a correct central parity of CZK to euro on entering the ERM II – and of fixing the exchange rate at a proper level on the moment of joining the eurozone.

This really is a vital problem, with grave economic consequences – either beneficial or fatal. This will not be the first time of having to establish the parity of the national currency toward a foreign one. Setting the exchange rate of Czechoslovak koruna (CSK) toward the USD was a similar case – at the end of December 1990, before the start of economic reforms, before liberalisation of prices and of external trade, etc. At that time, the federal minister of finance Václav Klaus (then legally responsible for exchange rate policy) did not yield to the populist proposals of some economists, and to pressures from part of the media and the public,

to set the exchange rate of CSK at an unrealistic level of 10 or 14 CSK/USD. Setting the exchange rate at 28 CSK/USD has since then proved as correct – such exchange rate assessed realistically the position of the currency, and supported exports, without unduly impeding Czech imports. Best proof is the fact that after 13 years, the fluctuations of Czechoslovak and, later, Czech koruna never exceeded $\pm 25\%$ toward the USD and $\pm 15\%$ toward the DEM or EUR. The long-term stabilising effect of the exchange rate supported economic growth and gradual catch-up with more advanced European countries.

ECB's and EU Commission's Stance

The stance of ECB and EU Commission on the speed of EMU entry of new member states is more nuanced and complex. At first – before the third stage of EMU was started – it seemed that EU institutions, on the whole, agreed with the declared intentions of Poland, Hungary, and, later, Slovakia (and the Baltic countries) to adopt the euro as soon as possible.

That stance however changed in the last year. From both institutions, opinions abound that EMU entry must not be hurried. Representatives of the ECB and of European Commission stress more and more often that, in addition to nominal convergence criteria, in assessing the preparedness of countries for the euro also real criteria will have the same weight (such as relative economic level, unemployment, productivity, competitiveness, etc.) It is apparent that stressing the real convergence criteria amounts to a special "coverspeak" – a form how to say that the new member countries will not be accepted soon into the eurozone.

Also the discussions which fluctuation band is to be used within the ERM II for new candidates of EMU membership, express the unwillingness to admit the new EU members into the eurozone within the next years. In case of applying the narrow $\pm 2.25\%$ fluctuation band (instead of the usual $\pm 15\%$), it is evident that hardly any of the new member countries could fulfil this condition within the nearest decade.

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The European Monetary Union is formed by 12 countries which, though far from being identical, enjoy more-or-less comparable levels of economic development. The Czech economy is characterised by a completely different economic level.

Giving up prematurely the option of country-specific monetary policy (setting interest rates), and of exchange rate flexibility would be unreasonable and potentially harmful to long-term economic growth. The new members of European Union – including the Czech Republic – will need a maximum of flexibility for fostering growth and catch-up with the "old" members.

Following the "don't hurry" policy for euro surely would be beneficial for a long-term catch-up process of the Czech Republic. Use of country-specific monetary policy is indispensable for real convergence – which is no less important, if not more important than nominal convergence.

The ECB's position "don't hurry" was most openly expressed by J.C.Trichet, the new president of ECB, who described the strategic position of Czech Republic – to adopt the euro around 2010 – as a "balanced and reasonable stance". The 12 EMU members will now be tackling problems arising from the de facto collapse of Stability and Growth Pact. Establishing new conditions for a long-term sustainability of public finance will not be a task for one or two years. Under this situation, accession of new members could only exacerbate the instability within eurozone. Eurozone's readiness to accept new members from among the Central – or Eastern-European countries thus, in all probability, shifts toward or beyond the year 2010.

Why Hurry toward the Euro?

Proponents of an early accession of Czech Republic to the European Monetary Union stress the following benefits:

- eurozone entry will finalise the integration process, Czech Republic will be able to participate fully in forming and implementing the common monetary policy;
- elimination of exchange rate risk will be beneficial for Czech firms trading with eurozone countries;
- the risk of monetary crises and turbulences will diminish;
- Czech Republic will be able to profit from lower interest rates in the eurozone (though this factor – due to recent trends – is losing in importance).

The argument that obligation to fulfil the conditions of the Stability and Growth Pact would increase the public finance discipline has lost much of its value. Not all value: as the Stability Pact crisis has shown, small countries (Portugal, Ireland) were forced to comply with the Pact strictly, while large countries (France, Germany) can afford to violate its criteria over a long period without sanctions. There are equals and more equals also in the club named European Union.

An early eurozone accession can however also bring considerable new risks and costs. In the nearest period, the costs would probably highly outweigh the above mentioned benefits. The European Monetary Union is formed by 12 countries which, though far from being identical, enjoy more-or-less comparable levels of economic development. The Czech economy is characterised by a completely different economic level. The country is in process of catch-up with the EMU-12, and undergoing fundamental structural change. Its economic cycle is not synchronic with the cycles of majority of eurozone countries, its response to exogenous shocks is and will not be symmetric with their response.

Giving up prematurely the option of country-specific monetary policy (setting interest rates), and of exchange rate flexibility would be unreasonable and potentially harmful to long-term economic growth. The new members of European Union – including the Czech Republic – will need a maximum of flexibility for fostering growth and catch-up with the "old" members. The example of Ireland in the 1990s proves that intelligent use of country-specific monetary policy can support fast economic growth.⁶ It would be naive to believe that the problems which some EMU countries have with ECB's "one size fits all" monetary policy would not apply, with much higher intensity, to the economically weaker and structurally more vulnerable new EU members from Central and Eastern Europe.

We can conclude that following the "don't hurry" policy for euro surely would be beneficial for a long-term catch-up process of the Czech Republic. Use of country-specific monetary policy is indispensable for real convergence – which is no less important, if not more important than nominal convergence.

⁶ Coughlan, A.: Some Reasons why Joining the Euro has been a Mistake for the Republic of Ireland, The European Journal, Vol. 10, No. 8, July 2003.

CZECH ECONOMY BEFORE THE EU ACCESSION

Eva Zamrazilová

Fifteen years after the beginning of the transition process, the Czech Republic approaches final step for reintegration into developed economic West-European community. The 1993 Copenhagen Summit of the EU set political, economic and institutional criteria of membership for associated Central European countries: stability of the institutions guaranteeing democracy and the rule of law, functioning market economy and ability to cope with competitive pressures within the international market. Reforms accomplished within last period in fact fulfilled these criteria to a sufficient degree. Transition process was a great challenge for macroeconomic policy arising many opened questions during its course. Leaving aside political and institutional aspects, let us shortly remind the macroeconomic history of the Czech Republic focusing on most important moments of the last decade.

Post-transformation Recovery

The crucial point of transformation, reorientation and catching-up processes has been undoubtedly sustainable economic growth non-provoking imbalanced tendencies. In the case of small economy with limited raw material sources, external sector necessarily plays the key role in the whole transformation process. Therefore, looking for sound proportion between economic growth and external stability was one of the crucial points of integration into the developed economic community.

After the break of the COMECON, the Czech orientation of Czech foreign trade shifted quite quickly towards developed market economies, especially those of the EU. Due to the optimal geographic location combined with good catching-up prospects, foreign investors were highly

interested in placing all kinds of investments to the Czech economy. After the liberalisation of the capital account, this inflow became very massive.

At the same time, first wave of the posttransformation economic recovery was driven both by consumer and investment demand. Naturally, strong domestic demand could not yet be met by domestic supply. Growth of demand was thus satisfied by rapidly growing imports and financed predominantly by massive inflow of foreign debt capital (during 1994 – 1995 the inflow of debt capital exceeded CZK 200 bill.). Export efficiency was still low and exchange rate appreciated, so that foreign trade deficits were rapidly increasing since 1994. Since the second half of 1996, it has been quite evident, that the current account deficit has reached the levels threatening macroeconomic stability. May 1997 monetary crisis was a natural consequence of increasing imbalance combined with late reaction of CNB with the change of exchange rate regime.

Following Economic Slowdown

The recession hitting the Czech economy until the second half of 1999 was mainly the price for external consolidation. However, an overdosed monetary restriction from mid-1996 was, undoubtedly, one of the factors that deepened and pro-longed the recession. On the other hand, tight monetary policy was one of the factors that were helpful for pressing inflation down.

In the period 1993 – 1997, Czech inflation stayed at the level of around 10 %. At this time, reduction of inflation by each percentage point seemed to be a heroic and at least mid-term task for monetary policy. Later on, inflation was falling sharply during 1998 from initial 13.1 % to 6.8 % at the end of the year, the decline in inflation even deepening in the following year. In July 1999, a record low level of CPI since the price liberalisation was achieved, i.e. 1.1 %. In 1999, Czech Republic was able – for the first time in its history to meet the Maastricht inflation criterion (which amounted to approximately 2 % in 1999 while Czech average inflation stood

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at 2.1 %). Price developments in the Czech economy gave even arise concerns about possible deflation risks. In 1998 and 1999, price developments were caused by mix of domestic and external factors. The main reasons for the low inflation were slow developments of prices abroad, low prices of raw materials on world markets, and the Czech economic recession, which began to abate slowly in the second half of 1999.

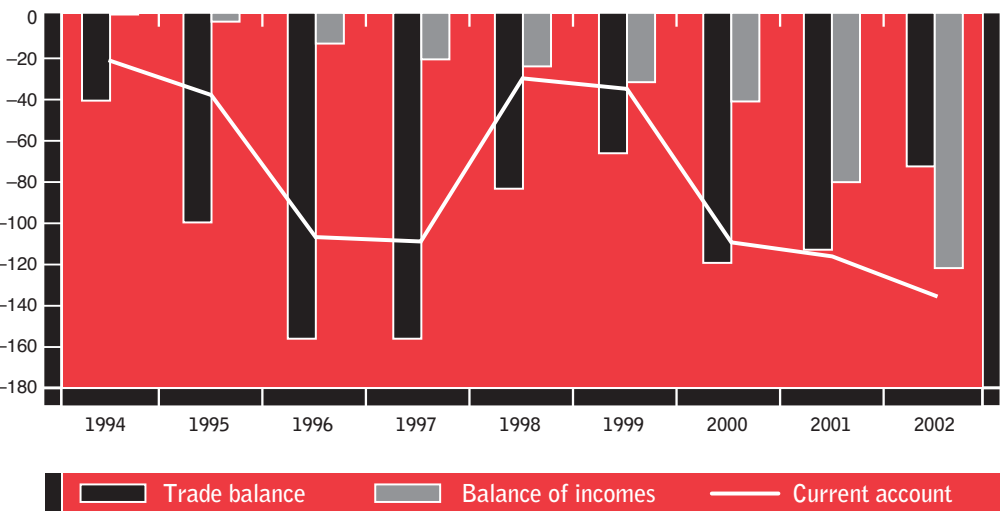
Improving Macroeconomic Conditions

Gradual consolidation of external imbalance at the end of the Nineties was accompanied by improving adaptation of the Czech exporters to advanced markets. It becomes more and more obvious that FDI inflows from the past combined initially with massive imports of modern machinery and technologies were – with a time lag of several years – followed by ongoing restructuring, rise in productivity and export performance. It became clear that foreign owners bring not only capital but also know-how, managerial experience and better access to developed markets, with ongoing effects on restructuring, competitiveness and export performance of domestic companies.

2000 economic recovery was first driven by increasing foreign demand. As of second quarter of 2000, domestic demand has taken over the major pro-growth role. At that time, major macroeconomic question was whether the newly acquired economic growth would be based on more healthy background on supply side or whether new wave of imbalances could emerge.

Following years have shown that restructuring of supply side really progressed to such an extent that new round of high trade deficits did not come; new macroeconomic problems, however, emerged. As of 2000, Czech economy continues in growth without provoking neither deepening of trade imbalance nor inflationary pressures. The current account deficits have been persisting quite high, the structure of the current account, however, changing significantly within previous few years. While until 2000, the trade balance was the major source of current account deficits, balance of incomes has produced the highest deficits in the last year (See Figure 1).

Figure 1: Current Account, Trade Balance, Balance of Incomes (CZK bill.)



Source: Czech National Bank

The balance of incomes represents a sort of feedback between current and financial account. Reinvestments of profits driven by previous massive inflows of FDI have been gaining on importance since 1998 or 1999. These reinvestments have been amounting to CZK 40 – 60 bill., each year since 2000, accounting for approximately half of the incomes balance deficits. Though, at first sight, the figures of current account deficits do not look favourable, high levels of reinvestments do not in fact threaten the external stability. The deficit of the current account in last two years was not provoked by growing imports as it was in the Nineties, but has been predominantly the price for the massive FDI inflows in the past decade.

The year 2000 may be depicted as the year of a turnover, when the shock from adaptation to EU markets was overcome. High integration into the trade with EU thus gave arose serious concerns about the impact on Czech economy after first sign of economic slowdown appeared in mid-2001. The West-European slowdown caused a part of slowdown of Czech economic growth in 2002. However, the negative impact was less significant than expected, most probably due to the flexibility of the exporters, among which especially companies under foreign control have been the most progressive ones. During the slowdown from 2001 up to the end of 2003, Czech exporters were able to shift their activities from countries hit most by economic slowdown (especially Germany – Czech major trade partner) to those which

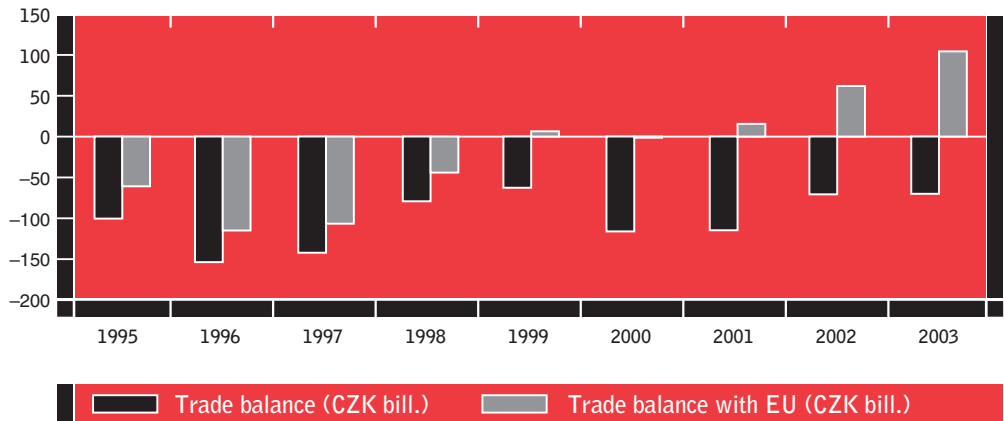
suffered less and showed better economic performance. The surplus in trade with EU 14 (that is EU without Germany) amounted to CZK 32 bill. in 2002 and to CZK 66 bill. in 2003, up from CZK –54.7 bill. in 2000.

Major Macroeconomic Progresses of Recent Years

Full trade integration into the Single market accompanied by improving export performance to EU countries is one of the biggest progresses of recent three years. While in the beginning of transition process, high imports from developed countries necessary for restructuring of the economy created high trade balance deficits, in recent two years Czech foreign trade was able to achieve increasing surpluses in the trade with the EU. At the same time, EU accounts for 60 % of Czech imports and for 70 % of Czech exports, showing extremely high level of trade cooperation.

Price stability achieved during previous two years was not determined only by mix of favourable external factors combined with strong exchange rate which was pressing down the import prices but has been also a consequence of strong domestic competition. As of 1999, the effects of great retail chains on domestic consumer prices have been increasing. Price stability is thus another proof of functioning market economy. Also monetary policy in previous years has been more accommodative, responding to macroeconomic developments to a greater extent than before.

Figure 2: Trade Balance (CZK bill.)

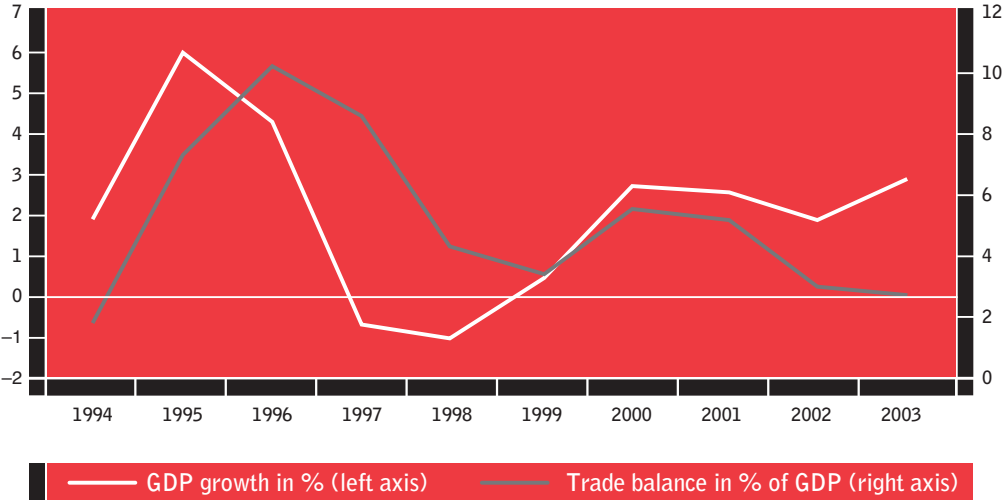


Source: Czech Statistical Office

In the Nineties, high import intensity of exports and also import intensity of domestic demand resulted in a very high import intensity of Czech economic growth. This has changed during previous two years. Both the import intensity of exports and economic growth have been gradually declining

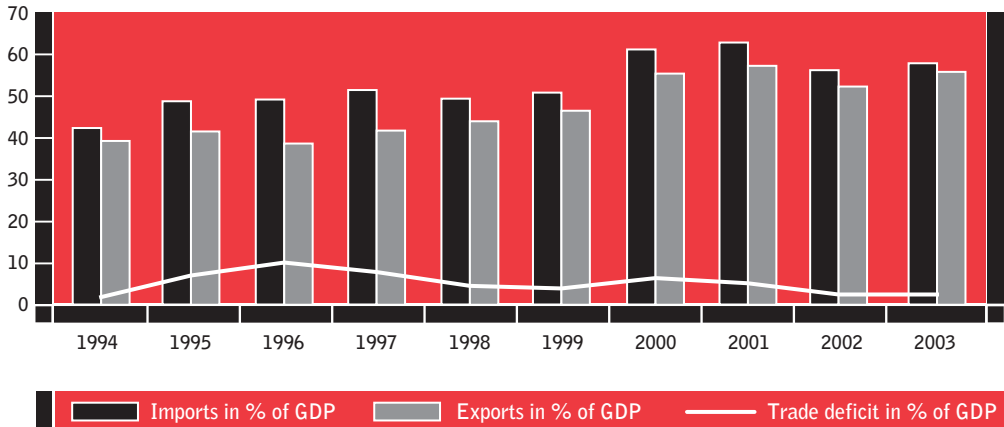
(see Figures 3 and 4). While trade deficit amounted to 10 % of GDP in 1996, it declined under 3 % in 2002 and 2003. Progress in restructuring and improved structure of the supply side of the economy have started to support the sustainability of economic growth.

Figure 3: GDP Growth and Trade Deficit



Source: Czech Statistical Office

Figure 4: Imports, Exports and Trade Deficit (in % of GDP)



Source: Czech Statistical Office

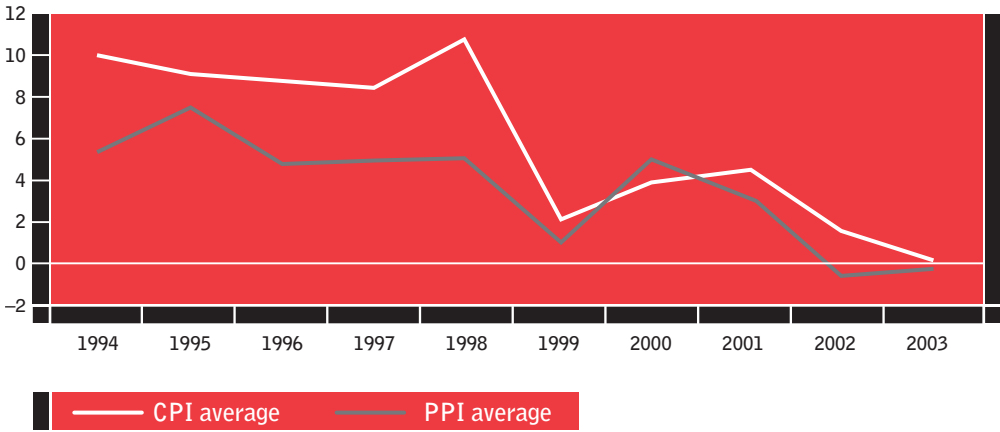
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Figure 5: Consumer and Producer Prices



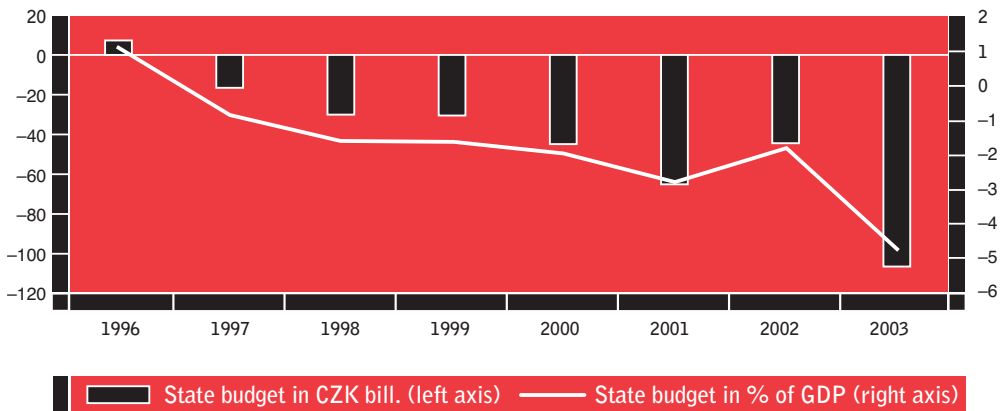
Source: Czech Statistical Office

Major Weaknesses of the Czech Economy
Public Finance

Stability of public finance has been representing one of the main economic problems since 1997. Originally, the deficiency in public finance was not perceived as a structural problem, since the fiscal tension in 1996 – 1998 was caused by deficits on the revenue side due to economic recession. While the economy was in a recession, the widening of

state budget deficit could be assessed as a normal operation of automatic stabilizers. A breakthrough into this idea happened in 2000: though the economic growth accelerated, state budget and public finance experienced deepening deficits, showing that the main reason of deficiency has been the structural part of the deficit. Therefore, it has become evident that the problems of the Czech state budget will not be solved automatically with higher economic growth.

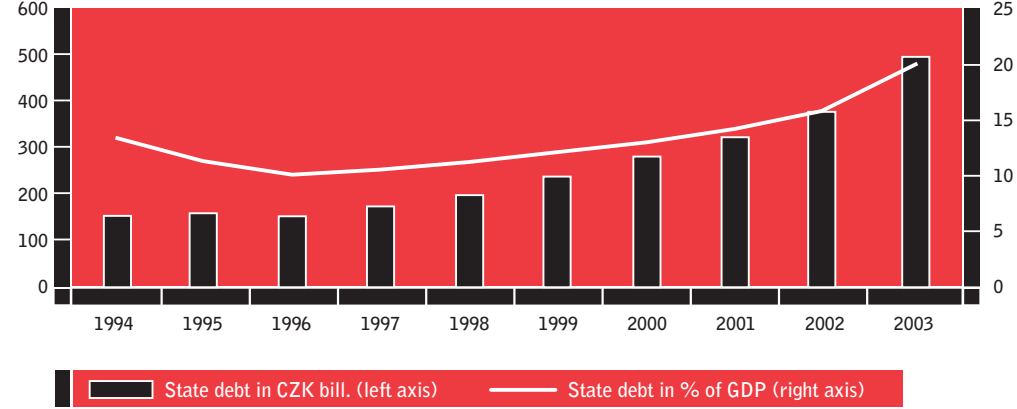
Figure 6: State Budget



Source: Ministry of Finance

However, the reform proposal does not represent a systematic reform but rather a parametric tuning of the present system.

Figure 7 : State Debt



Source: Ministry of Finance

Since 1999, state budgets have been set-up as deficit ones. In 2003, deficit of state budget amounted to approximately 5 % of GDP, while the state debt exceeded 20 % of GDP. The two figures are alarming enough to illustrate the acceleration of adverse tendencies. In mid-2003 some progress has been achieved, Czech fiscal reform starting. However, the reform proposal does not represent a systematic reform but rather a parametric tuning of the present system. Parametrical changes may stabilize public finance in the short run but cannot represent sufficient solution for longer-term horizon. In the case of small and highly opened Czech economy, fiscal tightening is also desirable to retain higher flexibility to respond to possible external shocks. Moreover, present pro-cyclical character of fiscal policy hampers the use of public expenditures to promote economic growth in the periods of cyclical slowdown.

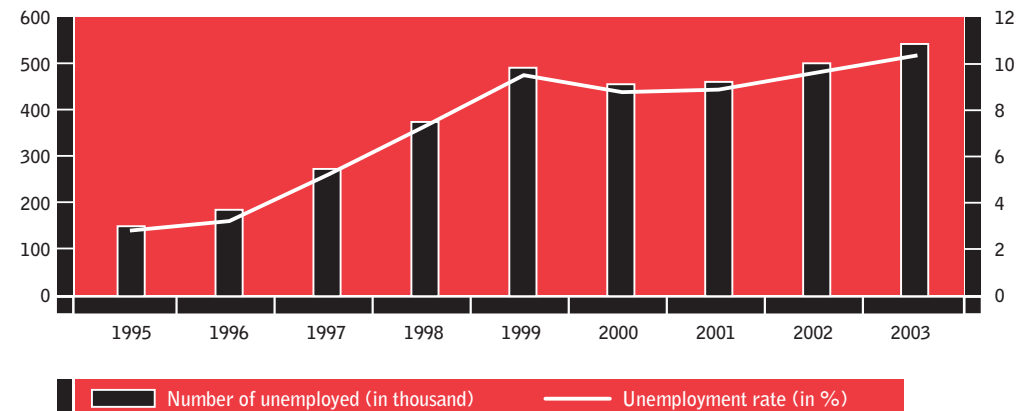
Since the reform of public finance has already attracted focus of government and political representatives, we limit ourselves to outline of major points that should be respected for the success of the reform of public finance:

- transparency of public finance
- sustainability of revenue and income
- sound macroeconomic forecast behind set-up of planned revenue and income
- built-in reserves.

Labour Market

Until 1997, the unemployment rate was low – around 3 %. The main factors behind low rate of unemployment in the first half of the Nineties were: shifts in the structure of employment, significant changes in property rights, relatively favourable qualification structure of labour force, high propensity of population to entrepreneurship and self-employment.

Figure 8: Unemployment



Source: Ministry of Labour and Social Affairs

Following years have proved that unique advantage of the Czech Republic will not persist in the longer horizon. Year 1997 was a turning point in the development of Czech unemployment. Economic growth slowed down and general economic situation deteriorated. Moreover, monetary and fiscal restriction hit the entrepreneurial sector. Economic recession in 1998 led to decrease of vacancies and general rise of unemployment. The most sharp increase in the unemployment rate occurred in 1999, from 7.5 % at the end of 1998 to 9.4 % at the end of 1999. After a slight decline in 2000 and stagnation in 2001, the unemployment rate exceeded 10 % at the beginning of 2003, ending at 10.3 % in December 2003, 1.5 percentage points above the unemployment rate in the eurozone.

Restructuring of Czech industry has been one of the main factors behind increasing unemployment in recent years. Employment in industry started to decline in the last quarter of 2001, the number of employed declining by almost 100 thousands during 2002 and 2003. Strong pressures on the labour market still preserve due to mainly structural reasons. Even those companies demanding new labour force cannot find workers with appropriate qualification. Almost three quarters of unemployed have only basic (or unfinished secondary) education.

At present, the number of unemployed amounts to more than half million thousands persons, approximately one third of which are entitled to unemployment benefits, the other two thirds receiving social benefits. As in other developed European countries, the most pressing problem has become the long-term unemployment. While the share of long-term unemployment (over 1 year) represented 20 % until 1997, it has increased up to almost 50 % in recent months.

The chance to form active employment policy as a preventive programme and to use wide experience of market economies has unfortunately been wasted in the Czech Republic. Flexibility of labour market is very low and the improvement may come only in longer time horizon. In this respect, comprehensive measures focused on human factor is the only way how to increase the flexibility of labour force. Employment policy and the system of education must force people to permanent improvements or changes in skills and qualification during the whole period of economic activity. Also, the system of health care should be better focused on the responsibility for own health and ability to work. At the same time, functioning market with housing is sine qua non for increasing labour force mobility and thus flexibility of the labour market.

Naturally, the EU membership will not be the end of transition process. Reforms will have to continue – especially in public administration and business environment – if the Czech Republic is to be competitive in the Single market. Small and highly opened Czech economy remains strongly vulnerable to external shocks and changes in external environment. The robustness of the economy may be increased with the help of functional institutional framework and strong financial sector. Anyway, improving the institutional framework is a permanent, never-ending story in all market economies. The enlarged EU will represent the largest single market in the world and itself will be a subject for transition to a more effective and competitive region within the world economy.

Restructuring of Czech industry has been one of the main factors behind increasing unemployment in recent years.

As in other developed European countries, the most pressing problem has become the long-term unemployment.

Flexibility of labour market is very low and comprehensive measures focused on human factor is the only way how to increase the flexibility of labour force.

The robustness of the economy may be increased with the help of functional institutional framework and strong financial sector.

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