



Economic Trends 41

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CZECH ECONOMY IN 2004

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1. Economic Growth

In the first quarter of 2004, the Czech GDP grew by 3.1 %, the same growth rate as in 2003. Although the Czech economic growth has been considerably higher than the average of the Eurozone, this figure was the lowest one among the Central European new EU member states. The main growth factor of GDP in the first quarter of 2004 was fixed capital formation with growth of 9.5 %, followed by household consumption increasing by 3.9 %. Investment demand was under the dominant influence of building investments where the impact of the May change in VAT was dominant. Government consumption fell by 1.6 %.

Despite higher inflation and persistent high unemployment, the Czech households continued in buying spree – supported by growth of income and use of consumer and mortgage credits. However, consumer demand has been more and more oriented toward services as indicated by the difference between growth of retail sales and sales of services (1.4 % and 5.6 %, respectively).

Again, the external sector continued to contribute adversely to economic growth: the growth of imports (11.3 %) exceeded significantly the growth of exports (8.3 %). Trade with goods deteriorated by CZK 13 bill., while trade with services worsened by CZK 2 bill., in the first quarter of 2004.

In the first five months of 2004, growth in industry accelerated, the growth of industrial output increasing by 9.9 % and industrial sales by 10.4 %. Industry continued to be driven predominantly by the exports, the direct export sales increasing by 12.0 %. However, the gap between the growth of export sales and domestic

sales seems to be narrowing, which indicates that the role of domestic demand as a pro-growth factor of industrial output has been gaining on importance. It must be stressed that – as for domestic investment demand – especially strong activity in construction observed in previous months was a strong growth-supporting factor.

Again, the exports were realised predominantly by the foreign controlled companies. Nevertheless, domestic companies seem to be able to use the advantage of catching-up, the gap between the dynamics in the domestic and foreign controlled sector gradually diminishing. Growth of industrial output was strongly driven by the metal industry which has been supported by rapid growth in construction and by strong demand for metal products in Asia (in particular by the Chinese one).

At the beginning of 2004, Czech construction witnessed an extraordinary boom with growth of 22.9 %, January-May 2004. Extremely high growth rates in March and in April (when the construction output increased by 62.4 %) were affected by May 2004 change in VAT rate (from 5 % to 19 %). April 2004 was the last month with the possibility of invoicing construction works under the lower rate. Therefore a large amount of construction works was most probably pre-invoiced as confirmed by the May decline of output by 2.4%.

2. Foreign Trade and Exchange Rate

January – May 2004, the trade deficit amounted to CZK 12.6 bill., which represents a year on year stagnation. With the respect to rapid growth both of exports and imports (19.2 and 18.5 % y/y, respectively), stagnation of the cumulative deficit represents quite a positive signal for foreign trade prospects. The exports were driven by machinery and transport equipment which account for approximately half of Czech exports and which increased by more than 30 %, in the first five months of 2004.

The main growth factor of GDP in the first quarter of 2004 was fixed capital formation with growth of 9.5 %, followed by household consumption increasing by 3.9 %.

In the first five months of 2004 growth in industry accelerated, the growth of industrial output increasing by 9.9 %. The role of domestic demand as a pro-growth factor of industrial output has been gaining on importance.

Domestic companies seem to be able to use the advantage of catching-up, the gap between the dynamics in the domestic and foreign controlled sector gradually diminishing.

January to May 2004, the exchange rate of CZK/EUR oscillated in the range of 32.3 to 33.0 CZK/EUR (26.0 – 27.0 CZK/USD). In the first half of June, due to favourable macroeconomic fundamentals, the Czech currency started to appreciate reaching, 31.3 CZK/EUR in mid-June. Later on, following the disaster results of coalition parties in the European elections and subsequent government crisis, the Czech crown depreciated till the level of 32 CZK/EUR. The period of negotiations about the new Czech government will be accompanied by higher volatility of the Czech currency, both against the EUR and USD.

Current account deficit amounted to CZK 16.7 bill. The main source of current account deficiency remains the incomes balance with the deficit of CZK 19 bill. However, one third of expenditure of the incomes balance has been generated by the reinvestments of profits which do not represent real financial flows and therefore do not threaten the external stability of the country. The inflow of foreign direct investments in Q1 2004 reached CZK 30 bill.

3. Inflation

As expected, inflation continued to grow in the first five months of 2004, year on year index of consumer prices reaching 2.9 % in June 2004. The first increase in consumer prices came as early as in January, 2004 due to changes in indirect taxes. Another change in taxes affected inflation in May 2004, although only moderately. Other factor of consumer prices growth was the rise of food and fuel prices. The average twelve-months inflation rate thus reached 1.4 % in June 2004.

The increase of producer prices was faster than that of consumer ones, year on year PPI standing at 4.9 % in May 2004. The growth of Czech PPI was pulled predominantly by world raw material prices which were by 20 % higher than a year before. World oil prices increased by 46.6 % y/y, and metal prices were by 28 % higher than a year before. The oil price hike was caused by high demand for oil in the USA and China, metal prices were driven in particular by East Asian demand.

Table 1: Main Macroeconomic Indicators

		2000	2001	2002	2003	03/04	04/04	05/04	2004F
Inflation	%, y/y	3.9	4.1	0.6	1.0	2.5	2.3	2.7	3.0
Inflation	%, m/m	-	-	-	-	0.1	0.0	0.4	-
Industrial prices	%, y/y	5.0	0.8	-0.7	0.9	2.1	3.7	4.9	4.0
Industrial prices	%, m/m	-	-	-	-	0.8	0.8	0.8	-
Unemployment rate	%, eop.	8.8	8.9	9.8	10.3	10.7	10.2	9.9	10.0
Industrial production	%, real	5.1	6.8	4.8	5.8	15.3	10.1	12.7	8.5
Construction output	%, real	5.3	9.6	2.5	8.9	21.4	62.4	-2.4	14.0
Retail sales	%, real	4.6	4.3	2.7	5.0	2.9	2.6		3.0
State budget	CZK bill.	-46.1	-67.7	-45.7	-109.1	-7.8	-38.1	-45.4	-130
Trade balance	CZK bill.	-120.8	-119	-71.3	-71.2	-4.2	-10.8	-0.9	-60
FOREX reserves	USD bill.	13.1	14.8	23.7	27.0	27.0	26.3	26.6	27.0
PRIBOR 3M	% average	5.36	5.2	3.55	2.3	2.05	2.06	2.16	2.3
CZK/EUR	Average	35.6	34.1	30.81	31.84	32.98	32.51	31.97	32.0
CZK/USD	Average	38.6	38.0	32.74	26.32	26.90	27.12	26.63	26.5
GDP	%, y/y	3.3	3.1	2.0	3.1	-	-	-	3.3

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

As expected, inflation continued to grow in the first five months of 2004, year on year index of consumer prices reaching 2.7 % in May 2004. The average twelve-months inflation rate thus reached 1.2 % in May 2004.

On June 24, 2004, the Czech National Bank decided to increase basic rates by 25 basis points. This step placed the basic repo rate to 2.25 %, 25 basis points above the ECB's basic rate.

4. Unemployment

Unemployment, especially the long-term one, remains one of the main macroeconomic bottlenecks of the Czech economy. However, April and May labour market figures indicate that the deterioration on the labour market does not continue. Seasonal factor – i.e. new job opportunities in construction, agriculture and some services – acted with above-average intensity in 2004 due to strong domestic demand combined with the recovery of the foreign one. In June 2004, the unemployment rate declined to 9.9 %.

Labour market does not continue to deteriorate also due to first signs of stabilisation in industry. Employment in industry continues to decline. Nevertheless, the intensity of decline has been diminishing. The main part of the effects of restructuring in industry on labour market thus seems to be over.

5. External Environment

The world economy appears to accelerate: in the US, after 3.1 % growth in 2003, the economic expansion accelerated to 3.9 % in Q1 of 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 1.5 %.

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 continue to be neutral or restrictive in the aftermath of the clash about the Stability and Growth Pact.

6. Outlook

In 2004, we expect that the domestic demand (both household consumption and investment demand) will continue to grow. Also the revival of the EU economy will push the Czech economy up. Consumer demand will somewhat slow while growth of fixed capital investment will continue. While Czech exports will keep solid growth, the negative impact of external sector to GDP growth will be roughly the same as in 2003. Although any immediate impact of EU entry on economic growth cannot be expected, from long-term point of view, the catch-up process will accelerate. We continue to keep our forecast of GDP growth for 2004 at 3.3 %.

Czech exports will continue to be favourably affected by the recovery of economic activity in the EU. Due to the slow but ongoing decline of import intensity of exports, the Czech trade balance will moderately improve in 2004 to around CZK 60 bill. However, the trade balance no longer represents the main cause of current account deficit which is estimated to fall to 5.5 – 6.0 % of GDP, down from 6.5 % of GDP in 2003. Though this level of current account deficit could seem at first sight to be high, it must be stressed that the major part of this deficit belongs to the incomes balance. One third of expenditures of the incomes balance are formed by reinvested profits which do not represent real financial flow and therefore cannot threaten Czech macroeconomic stability. Therefore 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 3.5 - 4 bill. in 2004.

Despite the structural weaknesses, the Eurozone is starting to benefit from the upsurge in world economic activity.

In 2004, we expect that the domestic demand will continue to grow. Also the revival of EU economy will push the Czech economy up.

Czech industry will continue to be driven by strong domestic demand and also by recovery in the Eurozone countries. In 2004, growth in industry will amount to 7 – 8 %.

The Czech industry will continue to be driven by strong domestic demand and also by recovery in the Eurozone countries. Industry will continue to be driven in particular by foreign-owned companies, with close business ties to EU countries. The metal industry will most probably show a moderate slowdown due to the expected weakening of construction activity, as of May 2004; nevertheless, this slowdown will be a moderate one, because the main factor of growth in the metal industry – strong Asian demand – will persist, though with lower intensity. In 2004, growth in industry will amount to 8.0 – 8.5 %.

Extraordinary double-digit growth in construction in the first four months of 2004 will not continue in the rest of the year. A strong drop in construction output must be expected for the following months – as compensation for the extraordinary April figure. As of June, also high bases for comparison will play some role in construction output growth figures. On the other hand, growth in construction will be supported by planned infrastructure projects and by the persisting boom in housing construction. Anyway, for the time being, the forecast is rather uncertain and risky. The full-year growth in construction should not exceed 12 – 15 %.

The first four months of 2004 registered a slowdown in retail sales against the previous year, predominantly as a consequence of a drop in the automotive segment which was the main driving force of the retail trade boom in second and third quarter of 2003. The high basis for comparison in the automotive segment from 2003 will continue to reduce growth rates in the forthcoming months. Also, high prices of fuel will hit the retail sales. In 2004, we expect the average growth in retail trade to reach approximately 3 %.

In the following months, high oil prices will be pushing the Czech CPI up. For the rest of the year we also expect moderate growth of food prices. The lagged effects of VAT changes from May 2004 will influence the price level, as well. We continue to expect both the year-end headline

inflation and average inflation to be around 3 %, in 2004.

Recent stabilisation of world metal prices and decline in oil prices indicates future stabilisation of producer prices in domestic industry. We expect that the year on year PPI will amount to 4 %, at the end of 2004.

In 2004, several main factors will influence 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 fresh 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.

In 2004 we expect regular seasonal developments on labour market. After a slight improvement in second quarter of 2004, in summer months an increase of the unemployment rate must be expected due to new graduates entering the labour market. However, favourable tendencies on labour market should preserve with only a slight increase of unemployment in the third quarter. In this case the employment rate will move around 10 % 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. The entry of the Czech Republic into the EU could be followed by the appreciation of the currency. On the other hand, the political instability will weaken the Czech crown. Summing up, we expect the average level of CZK/EUR at 32.0.

The first four months of 2004 registered a slowdown in retail sales against previous year, predominantly as a consequence of drop in automotive segment which was the main driving force of retail trade boom in second and third quarter of 2003. In 2004, we expect the average growth in retail trade to reach approximately 3 %.

EASTERN EUROPE – IMPEDIMENTS TO SUCCESS IN ACCESSION ¹

Kamil Janáček

1. Starting Position of New Central European Member States

On May 1, 2004, four Central-European post-communist countries became new members of the European Union, within a biggest enlargement wave since the foundation of EU. This enlargement differs significantly from previous ones, new member states being on a substantially lower economic level than the “old” EU-15.

On the other hand, as Table 1 indicates, the Central-European accession countries are characterised by higher growth rates, and faster productivity increase.

The Czech Republic, Slovakia, Poland and Hungary are fighting with high public budget deficits, and fast-growing public debt (though none of them has reached the 60 % bar set by the Maastricht criteria – see Table 2). Slovakia is the only country that started a fundamental reform of public finance, with the aim to bring the public budget deficit under 3 % till 2006. The others are only playing with the idea of reducing public expenditures, and to reform the tax system. It is not by chance that in all three countries, weak central-left governments are at power, that are either unable or unwilling to part with the old socialist ideas of the omnipotent state.

Table 1: Main Macroeconomic Indicators

	2000	2001	2002	2003
Czech Republic				
GDP (growth in %)	3.3	3.3	2.0	2.9
Inflation (average)	3.9	4.7	1.8	0.1
Current Account (% of GDP)	-5.3	-5.7	-6.0	-6.5
Slovakia				
GDP (growth in %)	2.2	3.3	4.4	4.0
Inflation (average)	12.0	7.1	3.3	8.5
Current Account (% of GDP)	-3.6	-8.4	-8.0	-0.5
Poland				
GDP (growth in %)	4.0	1.0	1.4	3.7
Inflation (average)	10.2	5.5	2.0	0.8
Current Account (% of GDP)	-6.3	-4.0	-3.6	-1.9
Hungary				
GDP (growth in %)	5.2	3.8	3.5	2.9
Inflation (average)	9.8	9.1	5.3	4.7
Current Account (% of GDP)	-8.7	-6.3	-7.1	-8.8
Eurozone				
GDP (growth in %)	3.5	1.6	0.9	0.4
Inflation (average)	2.3	2.5	2.3	2.1
Current Account (% of GDP)	-0.9	-0.2	0.9	0.4

Source: National Statistical Offices; Eurostat

On May 1, 2004, four Central-European post-communist countries became new members of the European Union, within a biggest enlargement wave since the foundation of EU.

¹Based on paper presented at the Annual Meeting of the International Conference of Commercial Bank Economists held in Chicago, USA, July 7-10, 2004

Table 2: Budget Deficit/Surplus and Public Debt (% of GDP)

	2000	2001	2002	2003
Czech Republic				
Public Budget	-4,5	-6,4	-6,4	-12,9
Deficit/Surplus	18,2	25,2	28,9	37,6
Public Debt				
Slovakia				
Public Budget	-2,3	-6,0	-5,7	-3,6
Deficit/Surplus	49,9	48,7	43,3	42,8
Public Debt				
Poland				
Public Budget	-1,8	-3,5	-3,6	-4,1
Deficit/Surplus	36,6	36,7	41,2	45,4
Public Debt				
Hungary				
Public Budget	-3,0	-4,4	-9,3	-5,9
Deficit/Surplus	55,4	53,5	57,1	59,0
Public Debt				
Eurozone				
Public Budget	0,2	-1,6	-2,3	-2,7
Deficit/Surplus	69,7	69,4	69,2	70,4
Public Debt				

Source: Eurostat

As is well-known, all fresh EU members lag behind the "old" EU-15 in relative economic levels. The four Central-European countries are no exception, although they are better placed than the Baltic countries. Among the four, the Czech Republic has the best relative economic position against both the EU-15 and the new EU-25 (See Tables 3 and 4). Yet, seeing that in

2002, the Czech Republic was at 62 % of EU-15 level of GDP per head, Hungary at 53 %, Slovakia at 47 %, and Poland at 41 %, it is clear that the catching-up will take several decades. It is obvious in the case of the largest of the four countries – Poland, where the GDP lag is combined with obsolete agriculture having a 25 % share on economically-active population.

Table 3: GDP per head in EU 15 and New CE Member States in 2002

EU	100
Germany	100
France	105
Spain	86
Portugal	71
Greece	71
Ireland	125
Finland	102
Austria	111
Average of 10 New Member States	47
Czech Republic	62
Slovakia	47
Hungary	53
Poland	41

Source: Eurostat

Table 4: GDP per head in EU25 and New CE Member States in 2003

EU	100
Germany	108
France	113
Spain	95
Portugal	75
Greece	79
Ireland	131
Finland	111
Austria	121
Eurozone	107
Czech Republic	69
Slovakia	51
Hungary	61
Poland	46

Source: Eurostat

All fresh EU members lag behind the "old" EU-15 in relative economic levels. It is clear that the catching-up will take several decades.

2. Impediments on New Member States Side

Barriers of faster catch-up on the part of new member states can be divided into institutional, economic, and psychological. Of course, in reality they are intertwined, interacting and mutually reinforcing.

a) Institutional Barriers

- Poor functioning of public administration, both on national and local levels. Example can be the Czech Republic where the public sector is sucking in additional staff, yet its efficiency is not visibly improving.

- Lower professional qualities of staff in public administration comparing to private sector (including language skills). This is one of the heaviest burdens of the communist past. Public servants have not yet realised that they are there to serve the public – typical is a patronising, disparaging or unhelpful behaviour.

- Problems in justice: insufficient enforcement of law, inexperienced judges, long delays in the commercial register, lengthy bankruptcy procedures, weak protection of creditors' rights. Improvement comes very slowly. Solution of this problem is of cardinal importance.

- Big bureaucratic obstacles in creating new businesses: according to World Bank, founding a new firm lasts 98 days in Slovakia, 88 days in the Czech Republic, 65 days in Hungary, and 43 days in Poland (compared to: 4 days in Denmark, 12 in Ireland, 18 in UK or 29 in Austria).

b) Economic Barriers

- Persistent public budget deficits and growing public debt represent the biggest barrier to fast catch-up. Only Slovakia – due to the vast reform of public finance - will be able to cut public budget deficit to around 3 % by 2006. The other three countries can aspire to fulfil this Maastricht criterion around 2008, at the earliest.

- Low level of GDP and productivity per head, compared to EU-15 (see Part 1 above). Big differences in economic level impede the full use of advantages of economic integration – due to differences in economic structures and in vulnerability to external shocks, or due to diverse economic cycles, etc.

- High degree of unemployment (with the exception of Hungary) – around 20 % in Poland and Slovakia, 10 % in the Czech Republic. Fast productivity increase in manufacturing is labour-saving. Labour intensive service sector is unable to fill the gap.

- Insufficient infrastructure (railroads, highways) mainly in Poland and in the eastern parts of Slovakia and Hungary. Telecommunications infrastructure (use of internet) is underdeveloped in all four Central-European fresh EU members.

- Low mobility of labour force (with the exception of university-educated people and the young, skilled generation). This problem is aggravated by non-existent or ill-functioning housing markets.

c) Psychological Barriers

- After fifty years of totalitarian regimes, society in Central European new member states still remains closed. People are suspicious of foreigners and new ideas coming from abroad.

- Low social mobility, again with exception of university educated people and young skilled generation.

- Low practical knowledge of foreign languages (English, German, French). All the four discussed countries being small (or, in case of Poland, medium-sized), their citizens have to accept the necessity to master foreign languages, and use them in economic activities.

3. Impediments on EU Side

- Obligation to implement all parts of "acquis communautaire" immediately – or with very

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Big differences in economic level impede the full use of advantages of economic integration – due to differences in economic structures and in vulnerability to external shocks.

short transition periods – will burden the economy of new Central-European member states and hinder faster catch-up. The costs of adopting the “acquis communautaire” are fairly high for the new member states, given their relative economic levels.

- The conditions of access to EU funds for new member states are much stricter than for the members of EU-15: new members are eligible only for 25 % of direct payments in Common Agricultural Policy, compared to the EU-15, etc. Promises that EU accession will be for the new member states as beneficial as it was in previous enlargements are, in this respect, misleading.

- Limitations for the next 7 years in free movement of labour from the new members further decreases the mobility of their labour force, and the flexibility of labour markets in the whole EU-25.

- Due to complex and rather opaque decision making of the European Commission, the inexperienced new member states will be – for some time – in position of junior members, unable to participate fully in (and make use of) the decision taking within EU.

- Permanent efforts of Germany (supported by France and Sweden) to “harmonise” corporate taxes – i.e. to increase them to the German level, if successful, would hit severely the new member states and could undercut their competitiveness.

- The necessity – before adopting the euro – to spend two years in ERM II will expose the currencies of countries with floating exchange-rate regimes (Poland, Slovakia, Czech Republic and finally also Hungary with its dirty float) to the danger of speculative attacks.

4. Pros and Contras of Early Entry to EMU ²

The new member countries are obliged to join the European Monetary Union, but the accession agreements do not state a strict term. The decision when to enter the eurozone will be of vital importance for all four countries discussed here.

Main potential benefits of an early adoption of euro for the new EU members are as follows:

- Eurozone entry will finalise the integration process, new members will be able to participate in forming and implementing the common monetary policy;

- Elimination of exchange risk will be beneficial for their firms trading with eurozone countries;

- The risk of monetary crises and turbulences will diminish.

- New members will be able to profit from lower interest rates (though this factor – due to recent trends – is losing in importance).

On the other side, there are well-known risks and costs of an early accession:

- Economic cycles of new member states are not synchronic with the cycles of EMU countries.- Their response to exogenous shocks will not be symmetric with that of EMU members.

- Giving up prematurely the option of a country-specific monetary policy, and of exchange rate flexibility, would be harmful to long-term economic growth.

We can conclude that following the “don’t hurry” policy (discreetly recommended also by the ECB) would be beneficial for the long-term catch-up process in the new member states. Use of country-specific monetary policy is indispensable for real convergence – which is no less important, if not more important than nominal convergence.

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Following the “don’t hurry” policy would be beneficial for the long-term catch-up process in the new member states. Use of country-specific monetary policy is indispensable for real convergence.

² For more detail, see Kamil Janáček: Czech Republic and EMU entry: Some reflections, Economic Trends 39, Komerční banka, February 2004.

ECONOMIC SLOWDOWN IN THE EU: LESSONS FOR THE CZECH REPUBLIC

Eva Zamrazilová

In the course of recent years, economic growth in Western Europe registered a considerable slowdown, though the developments were different in individual countries. Slowdown was most profound in Germany, France, Italy and the Netherlands. On the other hand, United Kingdom, Sweden, Spain and Greece performed better and

have kept up quite solid growth. The weakening of growth in the Eurozone was thus significantly affected by the strong slowdown in the countries accounting for major part of the Eurozone product. Germany, France and Italy have been creating about 70 % of the Eurozone GDP. In 2003, only United Kingdom, Spain, Greece and Luxembourg kept economic growth above 2 % within EU – 15.

Figures in Table 1 also show that the economic growth in Western Europe and particularly in the Eurozone has been lagging behind economic performance in the USA. The comparison of GDP per capita is somewhat less unfavourable for the Eurozone: the growth in the USA remains higher

Table 1: GDP Growth (in %, constant prices)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
EU 15	2.7	2.4	1.6	2.5	2.9	2.9	3.5	1.6	1.0	0.7
EU 12	2.4	2.2	1.4	2.3	2.9	2.8	3.5	1.6	0.9	0.4
Germany	2.3	1.7	0.8	1.4	2.0	2.0	2.9	0.8	0.2	-0.1
France	2.1	1.7	1.1	1.9	3.4	3.2	3.8	2.1	1.2	0.5
Italy	2.2	2.9	1.1	2.0	1.8	1.7	3.0	1.8	0.4	0.3
Spain	2.4	2.8	2.4	4.0	4.3	4.2	4.2	2.8	2.0	2.4
The Netherlands	2.9	3.0	3.0	3.8	4.3	4.0	3.5	1.2	0.2	-0.7
Belgium	3.2	2.4	1.2	3.5	2.0	3.2	3.8	0.6	0.7	1.1
Austria	2.6	1.6	2.0	1.6	3.9	2.7	3.4	0.8	1.4	0.7
Greece	2.0	2.1	2.4	3.6	3.4	3.4	4.4	4.0	3.9	4.3
Finland	3.9	3.4	3.9	6.3	5.0	3.4	5.1	1.1	2.3	1.9
Ireland	5.8	9.9	8.1	11.1	8.6	11.3	10.1	6.2	6.9	1.4
Portugal	1.0	4.3	3.5	4.0	4.6	3.8	3.4	1.7	0.4	-1.3
Luxembourg	3.8	1.4	3.3	8.3	6.9	7.8	9.0	1.3	1.7	2.1
UK	4.4	2.8	2.7	3.3	3.1	2.8	3.8	2.1	1.6	2.3
Sweden	4.2	4.1	1.3	2.4	3.6	4.6	4.3	0.9	2.1	1.6
Denmark	5.5	2.8	2.5	3.0	2.5	2.6	2.8	1.6	1.0	0.4
USA	4.0	2.5	3.7	4.5	4.2	4.4	3.7	0.5	2.2	3.1

Source: Eurostat

Table 2: GDP Growth in the Eurozone and the USA (in %, constant prices)

GDP growth:	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
EU - 12, USA										
EU - 12	2.4	2.2	1.4	2.7	2.9	2.8	3.5	1.6	0.9	0.4
USA	4.0	2.5	3.7	4.5	4.2	4.4	3.7	0.5	2.2	3.1
difference	1.6	0.3	2.3	1.8	1.3	1.6	0.2	-1.1	1.3	2.7
GDP per capita growth: EU-12, USA										
EU - 12	2.1	1.9	1.1	2.1	2.7	2.5	3.1	1.1	0.4	0.3
USA	3.0	1.5	2.4	3.2	3.1	2.9	2.6	-0.8	1.3	2.0
difference	0.9	-0.4	1.3	1.1	0.4	0.4	-0.5	-1.9	0.7	1.7

Source: Eurostat, IMF

In the course of recent years, economic growth in Western Europe registered considerable slowdown, though the developments were different in individual countries.

The economic growth in the Western Europe and particularly in the Eurozone has been lagging behind economic performance in the USA.

More rapid economic growth in the USA is partly a consequence of faster growth of population and labour force in the USA in comparison with Western Europe.

against the growth in the Eurozone countries. However, the growth differential slightly diminishes. More rapid economic growth in the USA is thus partly a consequence of faster population growth and labour force in the USA in comparison with Western Europe.

It is therefore evident that the demographic development has been one of the factors adversely affecting the economic growth in Western Europe in recent years.

Demographic Factor

Birth rates have been falling continuously since the post-war boom, to reach the current average of 1.5 children per woman in EU-15. In many West European countries, births have been below the replacement level for several years. Lower fertility combined with higher life expectancy has led to the ageing of the European population. The share of the EU population over 65 has increased for almost 3 percentage points – from 14.5 % to 17.5 % - during the last decade (see Figure 1). In the United States, the demographic developments are more favourable than in Europe, with the percentage of population over 65 around 15 %.

Ageing of population has many of intertwined consequences. Ageing population has been producing less but consuming more. Also, increasing risk aversion as well as an aversion to all kinds of reforms is common to an aging population. The increase in the percentage of older age groups naturally reflects in growing political importance of conservative attitudes. An aging of population is thus one of the factors why it is so difficult to reduce public expenditures. Figure 2 illustrates that – after a couple of successful years due to the efforts to fulfil the Pact of Stability and Growth conditions – as of 2000, a growth of public expenditures was restored in the Eurozone.

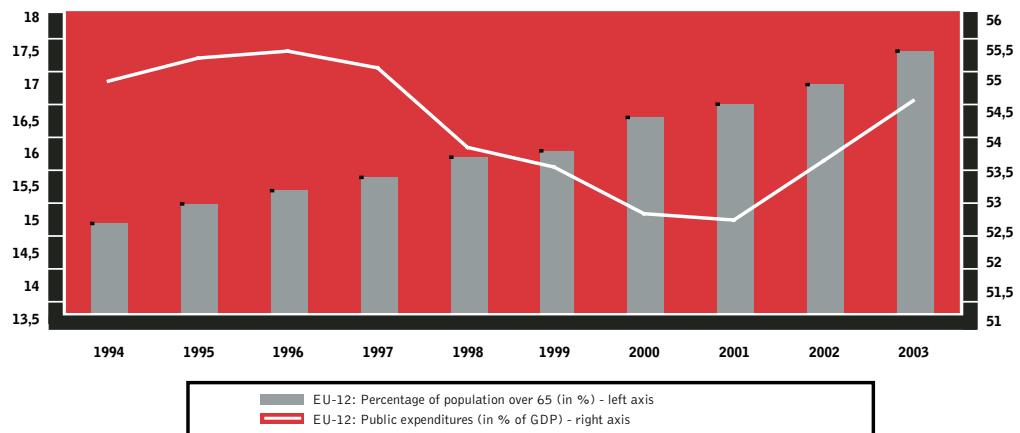
Public Expenditures

Restored growth of public expenditures has been most probably also one of the reasons behind the slowdown of economic growth in the Eurozone countries. In the period of stricter fiscal discipline, the Eurozone performed better than in latter years. Figure 2 illustrates quite well the relationship between the acceleration of public expenditures and the slowdown of economic growth in the Eurozone after the weakening of fiscal discipline.

Lower fertility combined with higher life expectancy has been leading to ageing of European population.

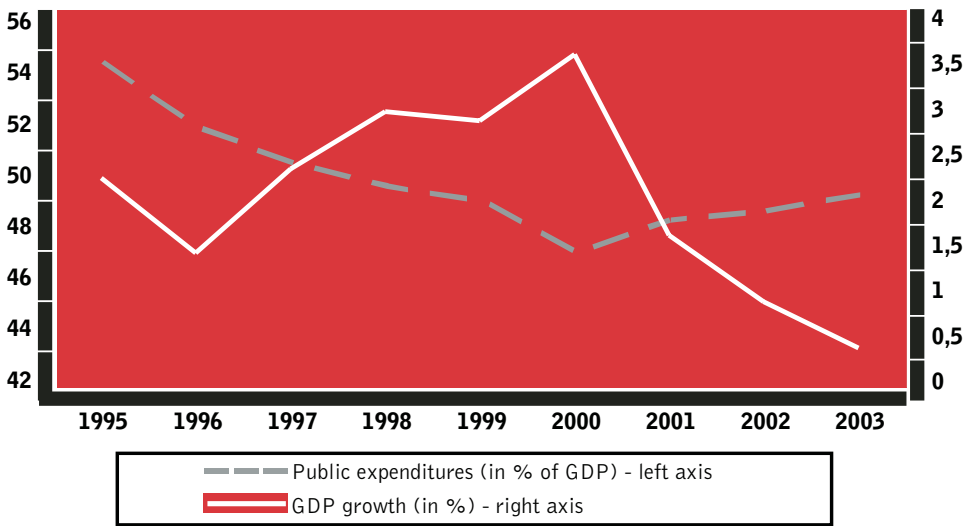
Restored growth of public expenditures has been most probably also one of the reasons behind slowdown of economic growth in the Eurozone countries.

Figure 1: Eurozone: Post-productive Population and Public Expenditure



Source: Eurostat

Figure 2: Eurozone: Developments of Public Expenditures and GDP



Ageing of population has not been the only reason for the weakening of fiscal discipline. Unfavourable developments on labour markets in most of West European countries have been hampering the fiscal prudence efforts. Labour markets in most West European countries are highly inflexible and are in urgent need of fundamental reforms. On the demand-side, labour markets are over regulated, partly due to the strong power of trade unions that have been asserting both high wages and protection of workers against dismissals. On the supply-side, a large volume of people accustomed to social comfort and unable to adapt to a rapidly changing profession and qualification demands of modern economy, has been hitting the

flexibility of West European labour markets. The efforts to adapt have been undermined by relatively generous social benefits.

Weakening of fiscal discipline thus reflects the difficulties with the adoption of reforms, especially when addressing pension systems and labour market. West European population has accustomed to relatively high social comfort and has not yet fully adopted the idea of necessary changes.

As for differences in growth between individual countries, the impact of fiscal discipline intensity seems to be a relevant factor. In 1996 -1997, which were the years when the fiscal discipline

Table 3: Public Expenditure (in % of GDP)

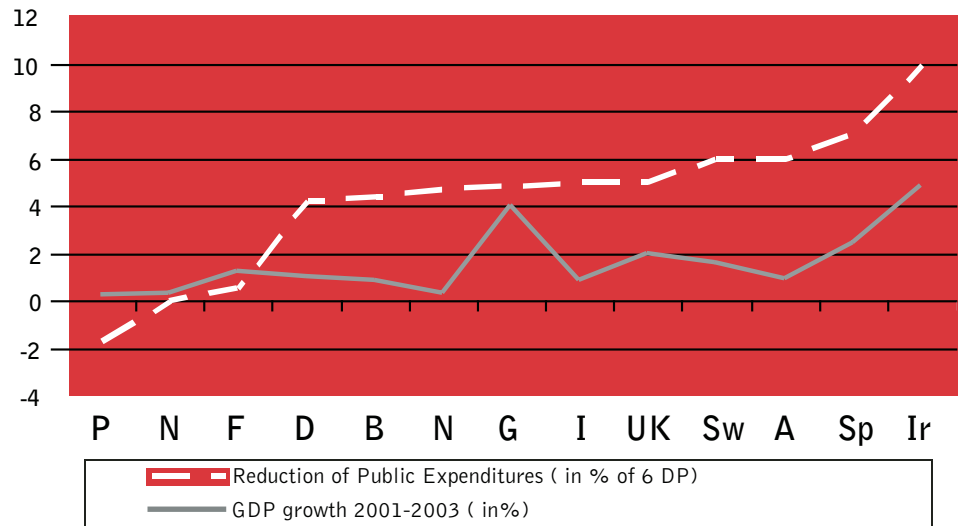
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
EU 15	n.a.	53.4	51	49.3	48.3	47.7	46.1	47.1	47.5	n.a.
EU 12	n.a.	54.1	51.6	50.2	49.3	48.9	47.1	48.2	48.5	49.1
Germany	49	56.1	50.3	49.3	48.8	48.7	45.7	48.3	48.5	48.9
France	54.9	55.2	55.4	54.9	53.7	53.4	52.6	52.5	53.5	54.5
Italy	54.6	53.4	53.2	51.1	49.9	48.9	46.9	48.7	48	49
Spain	n.a.	45	43.7	41.8	41.4	40.2	40	39.6	39.9	39.5
The Netherlands	53.6	56.4	49.6	48.2	47.2	46.9	45.3	46.6	47.5	48.9
Belgium	53.4	52.9	52.9	51.4	50.7	50.1	49.4	49.5	50.5	51.3
Austria	57.4	57.1	56.6	53.9	54	54	52.3	51.6	51.3	51.2
Greece	49.9	51	49.2	47.8	47.8	47.6	49.9	47.8	46.8	47.2
Finland	62.9	59.6	59.7	56.4	52.8	52.1	49.1	49.2	50.1	50.6
Iceland	44.3	41.5	39.6	37.1	35	34.6	32.1	33.8	33.3	35.2
Portugal	46	45	45.8	44.8	44.1	45.3	45.2	46.3	45.9	47.7
Luxemburg	44.5	45.5	45.6	43.3	42	41.3	38.5	39.1	44	46.4
UK	45	44.6	43	41.1	39.8	39.1	39.3	40.2	40.7	41,0
Sweden	70.9	67.7	65.3	63	60.7	60.3	57.3	57.1	58.3	58.3
Denmark	n.a.	60.3	59.8	58	57.6	56.3	54.8	55.3	55.8	56.1

Labour markets in most West European countries are highly inflexible and are in urgent need of fundamental reforms.

Weakening of fiscal discipline reflects the difficulties with the adoption of reforms especially when addressing the areas of pension systems and labour market.

Source: Eurostat

Figure 3: Change in Public Expenditures and GDP Growth



Source: Eurostat

efforts started due to expected introduction of the Euro, individual Eurozone countries disposed with different initial position for the level of public expenditures. In 1997, the public expenditures in the EU-12 amounted to 50 % of GDP. Finland, France and Austria were the "leaders" with public expenditures amounting to 56.4 %, 55 % and 54 % of GDP, respectively. On the other hand, Ireland and Spain showed the lowest relative level of public expenditures: 37 % and 42 %.

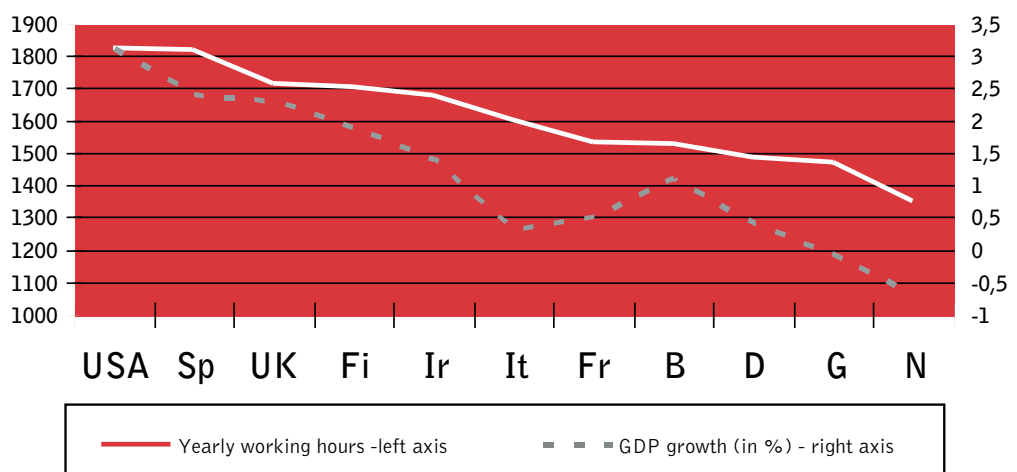
The fiscal consolidation efforts has reached different intensity in individual countries. Figure 3 shows quite clearly that the countries that succeeded to cut the relative level of public expenditures by more than 5 percentage points are the winners in economic growth in recent years.

In the case of Western Europe, lower number of working hours compared to the USA has been also one of the factors of slower economic growth, confirming again the negative role of social comfort. Figure 4 shows that the difference between the yearly working hours in the USA and Germany (which belongs to countries with lowest working hours) amounted to more than 350 hours in 2002. The developments both of working hours and growth of GDP presented in Figure 4 thusly raised a question whether reduction in working hours in some West European countries was not too excessive and did not contribute to slowdown in economic growth. Within the West European countries, Germany and the Netherlands were the countries with the lowest number of working days; at the same time, these countries registered most profound slowdown in economic growth in recent years.

The countries which succeeded to cut the relative level of public expenditures are the winners in economic growth in recent years.

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Figure 4: GDP Growth and Yearly Working Hours



Source: OECD

To sum up: main reasons of slowdown of economic growth in most countries of Western Europe in recent years may be outlined as a combination of unfavourable demographic developments and excessive or at least unsustainable social comfort. In other words: the economic growth in Western Europe has been undermined by the imbalance between the economic and political goals. The factor of imbalance between economy and politics has been acting among others in particular in the areas of social insurance and labour market. In the end, also the adoption of the Euro was primarily a political matter.

It is only natural that, to push through the necessary reduction of social comfort is very difficult as the political preferences are derived from preferences of an aging and reform-unfriendly population. Also, finding a better balance between politics and economics is complicated due to different time horizons which are taken into account by politicians and economists, the time horizon of the politicians being much shorter. However, finding political courage for realising the necessary reforms in the area of public expenditures and labour market is of vital importance for most European countries, especially due to the demographic outlook.

Outlook: Population and Potential Product

The demographic outlook for Europe is rather alarming. At the same time, contrary to the majority of economic forecasts, the demographic ones are quite reliable and exact. The ageing of West European population will begin to accelerate around 2010. By 2050, the percentage of population over 65 will increase to about 30 %. The aging trend is not uniform among West European countries. The most profound trend is found in Spain, Italy and Greece, where also lower labour participation

rates have been observable up to now. Ageing has been least apparent in Ireland and the Netherlands, France and Germany being close to the average. The situation is more favourable in the USA, where the population is also expected to age significantly, but higher fertility and immigration should lead to slower progress in the population ageing. Therefore, the proportion of the US population over 65 should flatten between 2030 and 2050 at 20 % of the population.

Ageing of population will mean that the proportion of economically active people in the population will fall and the scope of the dependents will increase which will have fundamental affect on public expenditures and potential product. If adequate reforms are not realised, the demographic factor will depress economic growth with potential growth falling from the present rate of about 2 % to 1 % in 2030. The USA should continue to enjoy a potential growth rate of 2.5 % over the next 50 years. Due to the decline of potential growth in Western Europe, its relative importance in the world economy should also be declining along with the decline of its share on world production.

Among EU-15, there have been wide differences in the preparedness and sustainability of the population ageing. According to the European Commission, countries which appear to be best placed are Denmark, the Netherlands, Finland, Sweden and the United Kingdom. Those have been the most progressive countries in public expenditure reforms. On the other hand, Greece and Spain are the countries that are expected to face most serious problems, followed by Germany, France and Austria, especially due to increasing pension costs.³ Anyway, countries which will be able to realise the necessary steps now still have a good chance to address the challenge of ageing.

The economic growth in Western Europe has been undermined by the imbalance between the economic and political goals. The factor of imbalance between economy and politics has been acting among others in particular in the areas of social insurance and labour market.

If adequate reforms are not realised, the demographic factor will depress economic growth with potential growth falling from the present rate of about 2 % to 1 % in 2030. The USA should continue to enjoy a potential growth rate of 2.5 % over the next 50 years.

Table 4: The Estimate of Potential Product for EU-15 and the USA

	2000	2010	2020	2030
EU-15	2,0	1,7	1,5	1,0
USA	3,0	2,8	2,7	2,4

³The credit rating agency Standard and Poor's identifies Germany, France, Poland and the Czech Republic as the European countries particularly at risk of downgrading at the end of this decade, due to aging-related spending.

All the above said indicates, that adoption of necessary reforms addressing public finance and labour markets is really an urgent issue. This issue is of high political sensitivity and time factor press for the reforms due to the ageing of population and thus increasing power of those age groups of voters which have higher aversion to all kinds of reforms. It is also obvious that the sooner the reforms are adopted, the better for future economic prospects. Also, the sooner the reforms are realised, the sooner the positive impacts of the reforms may appear. However, it is necessary to stress again, that the positive effects may appear in the longer horizon that is the political cycle of individual politicians.

However, the positive examples of United Kingdom and some Scandinavian countries have shown that it is possible to adopt necessary measures even under preserving the social peace. Those countries have been nowadays reporting higher economic growth than most of West European countries and their economic prospects are better. On the other hand, the economic situation seems to be the worst in Germany which is the country where the factor of political preferences over the economic ones has been most profound, in particular after the re-unification of the country.

Lessons for the Czech Republic

The above outlined problems are common not only for most countries of the former EU –15 but also for new EU member states, including the Czech Republic. The birth rate in the Czech Republic has been one of the lowest in the world, falling from 2.25 in mid-Seventies to 1.1 at present. As in other countries, low fertility combined with increasing life expectancy has been leading to ageing of population, the share of population above 65 increasing by 1.5 percentage points during last decade - to 14.2 %. Contrary to fiscal discipline in the Eurozone, public expenditures in the Czech Republic registered considerable increase in the last years, reaching 54 % of GDP at present. Among

EU-15 this figure is higher only in Sweden (58%) and Denmark (56%).

In the case of labour market, the Czech Republic has not taken the advantage of using the West European experience. While in the first years of transition, the Czech labour market seemed to perform as a very successful one, later it became clear that serious institutional, structural and policy shortcomings were overlooked in the past, labour market becoming one of the main macroeconomic bottlenecks of the Czech economy. Both the unemployment rate and the scale of long-term unemployment reached levels usual in Western Europe. The chance to use West European experience to avoid at least some mistakes in labour market policies has been missed, Czech economy facing labour market problems very similar to the West European ones.

It is therefore evident that adopting necessary reforms addressing public finance and labour market is at least of the same urgency for the Czech Republic as for West European countries. The demographic outlook for the Czech Republic is not more favourable than for West Europe. Also, the temporary estimated level of potential product around 3 % does not give the Czech economy good prospects for catching up the Eurozone. Although, the Czech Republic has the best relative position among the Central European new member states against the EU-15 at the time of entry, the economic growth has started to lag behind those Central European countries. Therefore, declining level of potential product and real economic growth due to aging of population (if no public finance and labour market reforms were realised) would cause not only slowdown of catching-up process but also lagging behind new EU member states.

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