1. Economic conditions and policy challenges

Membership of the European Union has marked the end of the Czech Republic's transition to a market economy. Institutions, policies and, in broad terms, the role of the state in markets and the structure of economic activity now differ little from many other OECD countries. Furthermore, an impressive record of low inflation has been maintained. With such positive developments a strong process of catch-up would normally be expected. Czech GDP per capita is considerably below the more affluent OECD countries and under the right conditions the economy should have a healthy margin of growth on high-GDP-per-capita countries. The reasonably strong growth of recent years is a welcome sign that catch-up is underway, though a weak long-term record warns against complacency. There is broad support in the current political climate to tackle the basic economic challenges, though pushing reforms through has to date often been hampered by political complexities (Box 1.1).

Growth has picked up

Growth in recent years has been relatively strong, in 2003 it was 3.1 per cent and virtually the same in terms of GDP per capita – population growth is currently close to zero.[1] The pace of GDP increase is expected to be greater for this year and to continue at least through to 2006, driven by an encouragingly strong pick-up in investment and exports. The OECD's autumn 2004 projection expects growth of 3.9 per cent in 2004 and projects growth of 4.2 per cent and 4.1 per cent in 2005 and 2006 respectively (Box 1.2). This is echoed in other projections, for instance the Central Bank's quarterly *Inflation Report* for July 2004 also projects growth of close to 4 per cent for 2004 and 2005 (Czech National Bank, 2004). The Ministry of Finance's October 2004 projection expects annual growth of 3.8 per cent for 2004 and 3.6 per cent in 2005, reflecting a tradition of conservative projections by the Ministry.

However, the long-run average rate of growth is more modest and there is a risk that the encouraging recent performance will not be sustained. Average annual growth in GDP per capita between 1995 and 2003 was under 2 per cent, a little below that in the euro area and United States and close to 2 percentage

Box 1.1. **The political situation**

Following the elections to the European Parliament in June (where coalition parties only won 4 out of the 24 seats), changes in leadership took place both in the Czech Social Democratic Party (CSSD) and the Freedom Union. In late June, Vladimir Spidla resigned, both as Prime Minister and the Head of CSSD, and the government resigned formally on 1 July – the main reason was the low confidence of the CSSD in the coalition government. Stanislav Gross (former Deputy Chairman of CSSD and Minister of Interior) became the new leader of CSSD, and the President appointed him to the position of Prime Minister on 26 July 2004. Gross launched negotiations to form a cabinet with the previous centre-right coalition members, the Christian Democratic Party (KDU-CSL) and the Freedom Union. A new cabinet was appointed by the President on August 4 comprising 12 members nominated by the CSSD, 3 by the KDU-CSL and 3 by Freedom Union. There are some notable changes in the composition of Deputy Prime Ministers, the Minister of Finance is not longer included as a Deputy Prime Minister and Martin Jahn, formerly head of Czech-Invest, has been appointed to cover economic affairs. The new government won a vote of confidence from the Parliament on 24 August, though it will again be supported by only a very narrow majority (of 101 out of 200 in the lower house).

The main priorities of the new government have as yet only been expressed in broad terms but reflect in many respects those of the previous government – including, importantly, a focus on fiscal consolidation. The new coalition also broadly supports market-oriented and liberal economic reform and the main opposition party has a similar outlook. However, though the general direction of change is agreed on by many, political positioning can make agreement on precise actions difficult, both within the government and when proposals are put before Parliament. The narrow majority in Parliament means that government often has to seek consensus with opposition parties for legislation to have a strong chance of parliamentary approval – the setting up of a multi-party committee on pension reform by the previous coalition government earlier this year bears witness to this.

points below that in neighbouring Hungary, Poland and Slovakia (Figure 1.1). To some extent this performance can be explained by special circumstances. The Czech experience with soft loans and the subsequent banking and economic crisis brought negative growth in 1997 and 1998 whose severity was not matched in the other Visegrad countries. In addition, efforts to bring inflation down have been more vigorous in the Czech Republic and this may have damped growth. Despite these caveats, the long-run rate of growth suggests that the stronger

Box 1.2. The OECD's autumn 2004 economic projection

Demand, output and prices

	2001	2002	2003	2004	2005	2006
	Current prices billion CZK	Percentage changes, volume (1995 prices)				
Private consumption	1 192.3	2.8	4.9	3.5	3.6	3.6
Government consumption	513.0	4.5	2.2	–0.4	–0.2	0.5
Gross fixed capital formation	638.6	3.4	7.4	9.5	7.2	6.0
Final domestic demand	2 343.9	3.3	4.9	4.1	3.7	3.6
Stockbuilding[1]	30.0	0.1	–0.4	0.6	0.0	0.0
Total domestic demand	2 374.0	2.8	4.2	4.5	3.7	3.6
Exports of goods and services	1 539.3	2.7	6.2	16.7	12.0	10.5
Imports of goods and services	1 598.0	4.9	7.8	17.3	11.2	9.6
Net exports[1]	–58.7	–2.2	–2.2	–2.7	–0.9	–0.6
GDP at market prices	2 315.3	1.5	3.1	3.9	4.2	4.1
GDP deflator		2.8	1.7	4.1	1.5	1.6
Memorandum items	–					
Consumer price index	–	1.8	0.1	3.0	3.1	3.0
Private consumption deflator	–	0.7	–0.7	2.1	2.5	2.4
Unemployment rate	–	7.3	7.8	8.4	8.3	8.2
General government financial balance[2, 3]	–	–6.8	–12.6	–4.3	–4.6	–4.0
Current account balance[2]	–	–5.6	–6.2	–6.5	–6.6	–6.4

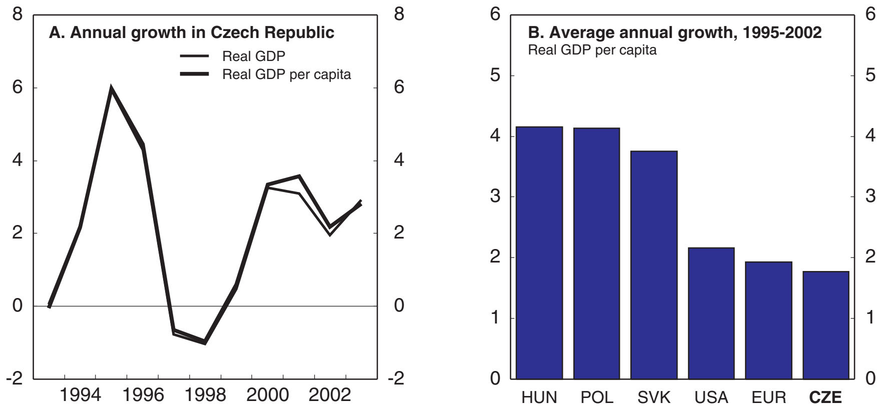
1. National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see OECD *Economic Outlook* Sources and Methods, (*www.oecd.org/eco/sources-and-methods*).
2. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
3. As a percentage of GDP.
4. Since the change in methodology in 2004, high-risk state guarantees are classified as capital transfers as soon as they are called for the first time. In 2003, the activation of guarantees issued mainly for the banking sector accounted for about 7.7 percentage points of the deficit.

Source: OECD Economic Outlook 76 database.

performance of recent years can only be ensured with a broad range of policy measures.

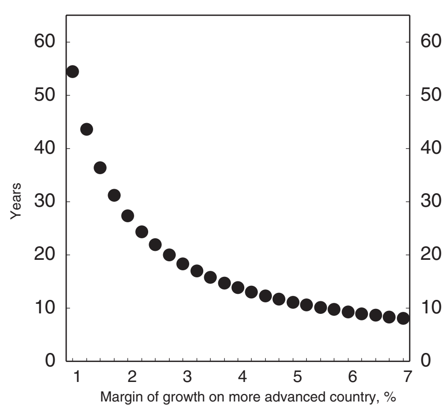
If the current pace of growth is sustained, or preferably bettered, then real convergence can get properly under way. For example, if growth in GDP per capita in the euro area remains around 2 per cent then 3 per cent growth in the Czech Republic will bring close-to complete real convergence in about 50 years. If Czech growth can be sustained at 4 per cent, the period of catch-up would roughly be halved (Figure 1.2).

Figure 1.1. **Output growth**
Per cent



Source: OECD, Annual National Accounts Database.

Figure 1.2. **Years required for catch-up**[1]



1. Estimates are based on a simple compound growth formula. It is assumed that the initial ratio of GDP per capita (more advanced:CZE) is 1.7 and the annual growth of GDP per capita of the more advanced country is 2 per cent.

Source: OECD; UN, *World Population Prospects 1950-2050* (the 2002 revision).

Monetary conditions are good

The Czech Republic has had relatively stable and low inflation in the process of economic transition. Price increases after initial liberalisation steps were large but inflation was kept below 10 per cent thereafter, contrasting sharply with Poland and Hungary which have taken longer to tackle high inflation. During 1998 inflation made a level shift downwards and has remained below 5 per cent since then (Figure 1.3). Real interest rates are now also low indicating that financial markets expect inflation to stay low.

The most striking feature of monetary conditions over the past couple of years is that inflation spent a prolonged time below the target band set in the Central Bank's inflation-targeting regime. In part this was caused by regulated prices movements, where increases were expected to contribute to about 1 to 1.5 percentage points to CPI but in fact prices declined. In addition, exchange rate appreciation and large domestic harvests contributed to strong falls in agricultural prices. These exogenous factors aside and with the benefit of hindsight, the Central Bank admits overestimating the downward stickiness of prices. The Bank has since increased the sensitivity of some areas of pricing to a negative output gap in its modelling system.

Fiscal policy and public expenditure reform

The fiscal position needs improving

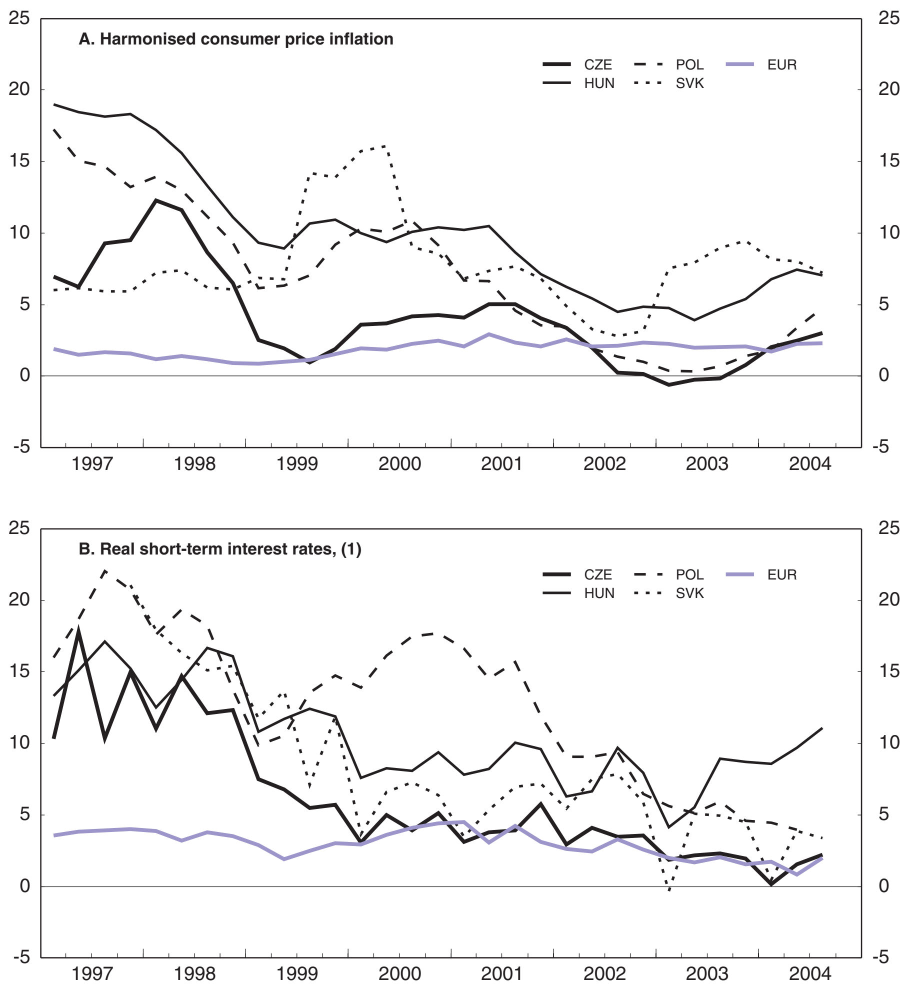
Fiscal conditions have deteriorated and improving them through sustainable fiscal consolidation is a key policy challenge. Through much of the 1990s, the unwinding of state involvement in the economy brought decline in government spending relative to GDP. However, since 1999 spending has increased. According to the Ministry of Finance's adjusted-cash account, general government spending was close to 40 per cent of GDP in 1998 and rose to over 45 per cent by 2003 (Figure 1.4). The increase lies primarily in current expenditures (both in the provision of services and transfers), rather than capital spending or debt-servicing costs. The latter remain relatively low thanks to the low interest rates and, as yet, a moderate level of debt (see below).

The growing general-government deficit is essentially reflected in a growing state-budget deficit. As seen in Figure 1.4, the general and state budget deficits are closely correlated. In other words, the deficit has not – at least in an accounting sense – been primarily driven by rising deficits in the social-insurance funds, extra-budgetary funds or by deficits in regional and municipal governments' accounts. However, transfers from the state budget are sometimes used to cover losses in other government entities such as public health insurance. Therefore, to some extent, deficits are generated in accounts outside the state budget but end up recorded in this budget anyway.

As might be expected, the deficit increases have often been unplanned. In 1997 and 1998 the state-budget deficit outcome turned out worse than the

Figure 1.3. **Inflation and interest rates**

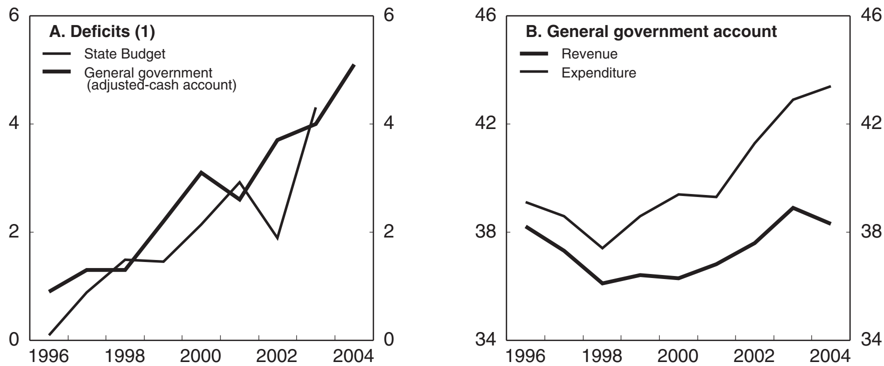
Per cent



1. Three month interbank rates deflated by the quarterly harmonised consumer price inflation rate. For Hungary, 90 day Treasury bill yield. For the euro area, weighted average of national rates before 1999, EUR 11 up to 2000 and EUR 12 from 2001 onwards.

Source: OECD, *Main Economic Indicators*.

Figure 1.4. **Trends in government deficit, expenditure and revenue**
Per cent of GDP



1. The general government deficit is from the cash-based GFS account adjusted by the Ministry of Finance. The state budget deficit is from the cash-based GFS account voted by Parliament.

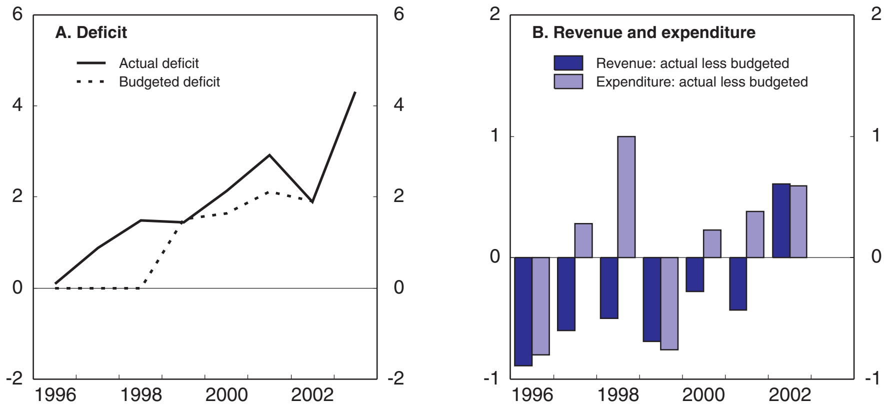
Source: Czech Statistical Office.

zero-deficit budget plans, with budgeted revenues being over-estimated and expenditures under-estimated (Figure 1.5). In 1999, the authorities appear to have abandoned budgeting for a zero deficit and adopted more realistic budgeted deficits. Nevertheless, 2000 and 2001 saw repetition of over-estimation in revenue and under-estimation in expenditure. In 2002, the deficit came out as expected though growth in both revenues and expenditures was greater than expected in the budget. The 2003 budget outcome was shaped by unexpected outcomes in VAT revenue and surprise expenditures arising from a court case and from flood damages (a detailed account of the outcome is in Chapter 2).

The revenue shortfalls underscore a weak capacity for tax-raising measures. The tax wedge on labour, including the large employer and employee social contributions, is already fairly high (Figure 1.6). A fresh increase would push up labour costs further and might prompt adverse reactions, such as shifts into the already sizeable grey economy. In addition, concerns for international competitiveness dissuade revenue increases in corporate taxation. Indeed, at 28 per cent the corporate tax rate is already high in comparison to other countries in the region (this issue is discussed further in Chapter 2).

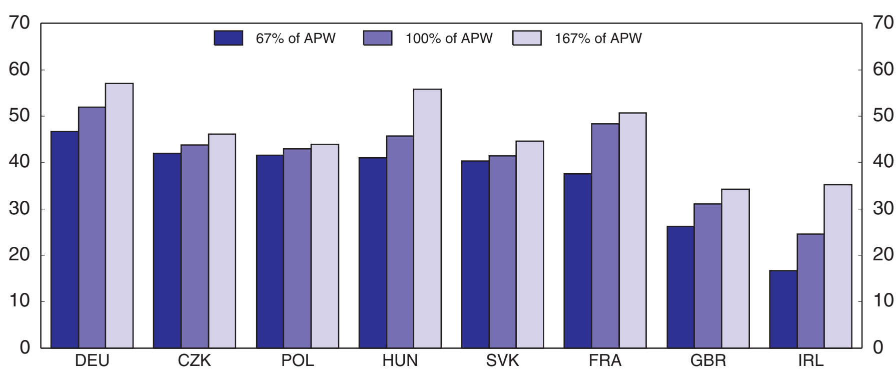
Despite the deficit increases, debt levels have yet to reach alarming levels. The general-government debt-to-GDP ratio was just under 22 per cent in 2003 according to GFS86 accounts, though a higher figure of close to 40 per cent is recorded in

Figure 1.5. **Budgeted and actual deficits in the State Budget**
Per cent of GDP



Source: Czech Statistical Office.

Figure 1.6. **Average tax wedge for a single person, 2003**[1]
Per cent of labour costs



1. The tax wedge is the ratio of income tax plus employee and employer social security contributions less cash benefits as a percentage of labour costs. The tax wedges have been calculated at different percentages of the average production worker wage (APW). Data are ranked by the wedge for 67 per cent of the average wage level.

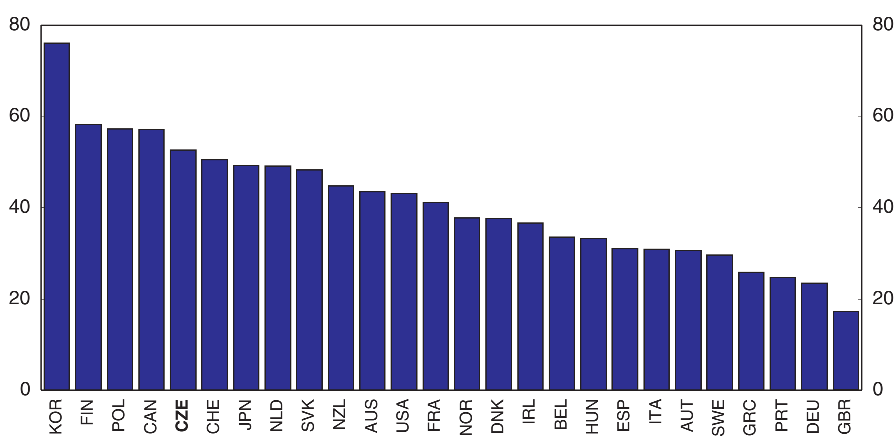
Source: OECD, *Taxing Wages 2002-2003*.

ESA95 accounts (approximately 10 percentage points of the ESA figure is attributable to state guarantees). While many other OECD countries have to undergo a painful consolidation process to reach sustainable debt levels during the coming period of population decline, the Czech Republic is in a much more comfortable position though this should not be put at risk through postponing necessary fiscal reforms (Chapter 2).

Ageing is adding to fiscal challenges

Ageing has already advanced further in the Czech Republic than in most other European OECD countries and is set to present an increasing headwind against increases in GDP per capita. Within the next few years the working-age population will be shrinking by about ½ a percentage point faster than the total population and this figure is set to rise rapidly further into the future. So, any given level of growth in GDP per capita will have to be achieved by faster growth in output per head of the working-age population, either through a wider and more active working-age population or through additional productivity gains. Ageing populations bring, of course, specific challenges for public budgets. By 2020, the old-age dependency ratio will have risen by over 50 per cent, one of the largest increases in the OECD, raising questions about the sustainability of state-pension and health systems (Figure 1.7). Ageing also raises broad questions about

Figure 1.7. **Percentage increase in old-age dependency ratios by 2020**[1]



1. Calculated as the percentage increase between 2004 and 2020 in the ratio of the population aged 60 and above to that aged 20 to 59 years.

Source: UN, *World Population Prospects 1950-2050* (the 2002 revision).

how to design family policy and whether migration policy can be used as a tool to mitigate the ageing process (Chapter 6).

Policy for a smooth entry to the euro area

The long-term gains from euro-area membership are potentially large

For the Czech Republic the main long-run gains from euro-area membership will come from the removal of exchange-rate risks from much of its large trade and capital flows as well as increased transparency in international comparisons of costs and prices. Aside from removal of day-to-day hedging costs, membership would reduce the risk of periods of monetary turbulence and instability in the financial sector due to sharp fluctuations in the exchange rates arising from large capital movements. Membership would also add pressure for sustainable fiscal consolidation.[2]

Indeed, the gains from entering common currency areas look now to be larger than many had previously thought. Until recently it was commonly thought that the removal of exchange-rate risk does not boost trade by much. However research results emerging over the past few years suggest that the effect of common currencies on trade may be quite considerable.[3] Micco *et al.* (2003) for instance look at the 12 countries that joined EMU and conclude that a common currency boosted trade by about 15 per cent above the level of trade which would be expected on the basis of growth in demand and other factors.

But entering the euro-area presents challenges for macroeconomic policy

The conditions for euro-area membership present significant challenges for monetary and fiscal policy, involving difficult decisions on the timing and strategy for entry. There are four interrelated challenges which are addressed in Chapter 3:

– Ensuring that fulfilment of the Maastricht fiscal criteria is made through sustainable fiscal consolidation. As the preceding section underscores, keeping momentum on fiscal reform going is the major macroeconomic policy challenge that needs to be addressed to improve growth prospects. Therefore, meeting the Maastricht criteria needs to come about through permanent spending cuts and efficiency improvements in public services, not through temporary measures.

– The process of achieving the inflation criterion for entry should not interfere with the business cycle. For example, untimely damping of the real side of the economy to meet the criterion could inflict an unnecessary entry cost in terms of real output. The presence of a significant inflation differential of catching-up economies (Balassa-Samuelson effect) presents a further complication.

– The currency has to lock into the euro at an appropriate exchange rate. In particular, entry at an exchange rate significantly above that suggested by economic fundamentals can do lasting damage to exports: domestic prices then have to adjust downwards relative to those of trading partners, and this can be painfully slow if prices are sticky.

– There has to be sufficient cyclical convergence with the euro area economy on entry so that euro-area monetary policy is appropriate for economic conditions. There are some subtleties in this issue. While joining the euro without full cyclical convergence risks incongruent monetary policy, it is also the case that being a member of the euro area can help convergence.[4] So the "optimal" time to enter from this perspective probably lies some time before full convergence is achieved.

Improving policy towards business

Business-sector productivity growth is key to catch-up

Increases in business-sector productivity growth have to do most of the work in the process of catch-up. Though Czech GDP per capita is about 70 per cent of that across the EU25, it is considerably below that in the high-GDP-per-capita countries, both within the EU and elsewhere. For example, Czech GDP per capita is estimated to be only a little above 40 per cent of that in the United States.[5] This gap can only partially be closed through increased labour utilisation. There may be room for increasing the employment rate by about 10 per cent (see below), implying only about one fifth of real convergence can be achieved through the increased mobilisation of labour resources. The rest of the gap has to be closed through productivity increase, and the business sector has to fulfil the major role. In this process, export-driven manufacturing firms are likely to continue playing a key role by bringing in more high-productivity plants but also through exposing the domestic sector to competition and international best practice (Box 1.3).

And significant weaknesses in the business environment need to be addressed

A host of policies influence business-sector productivity growth. Good framework conditions are essential; here much work is of course performed by macroeconomic policies in influencing general price conditions, interest rates and exchange rates.[6] Inflexibilities in the labour market are also relevant in the Czech Republic (see below). In addition, more immediate policy influences on businesses are of importance. Chapter 4 looks at the following key areas of policy:

– **The legal and administrative environment for business.** Legislation and regulations for business have long-since been criticised as dealing inefficiently with non-viable firms. In addition, the time and energy required to fulfil registration and other requirements for setting up a business has also long been recognised as excessive. The cumbersome nature of regulations is probably also contributing to the Czech

Box 1.3. The structure of Czech business

Similar to other countries in the region, there are sharp divides between foreign and domestic controlled enterprises. Foreign operations are generally large scale and are backed by big multi-national enterprises. The large domestic enterprises have often struggled in the process of transition and the large number of the many small and medium-sized enterprises are not strongly exposed to foreign competition or advanced business models.

In the manufacturing sector, large foreign-owned and export-oriented manufacturing operations have spearheaded the introduction of new capital and business techniques, and have been responsible for a significant proportion of growth in productivity. There are also some large domestic manufacturing firms that have successfully weathered transition to become international players, albeit often with significant foreign capital and expertise (*e.g.* Skoda). Exports and FDI developments illustrate the significant growth in large-scale manufacture (the value of exports is now equivalent to over 65 per cent of GDP). Total annual FDI inflows have been equivalent to between 9 and 12 per cent of GDP over the past few years (with the exception of 2003 when privatisation receipts were very low), with manufacturing-sector FDI representing between 1½ and 4 percentage points of the total.

Alongside the successful manufacturing operations, some traditional large-scale enterprises have not weathered the economic transition process easily. The most notable examples are coal mining and steel production. These sectors have been supported by considerable subsidy in the past. Concern about the consequences of severe and typically highly localised economic collapse, combined with active political support have both contributed to sustaining the subsidies. At the same time, however, a network of domestic manufacturing firms (typically small and medium-sized enterprises) has emerged that supplies the new large-scale manufacturing plants. This has been helped by policies to bring foreign firms and domestic suppliers together.

In some private-sector services, notably in retailing and banking, big international players are already playing a significant role in domestic markets, bringing new competition through large-scale operations and leading-edge business models. In addition, a demand for outsourced services has brought opportunities in some other sectors, also bringing them into contact with international business practices. In other services sectors, the scale of operations is typically small and economic efficiency relies on there being strong local competition.

Republic's disappointing image for corruption by increasing the incentives to break rules and to short-cut official procedures.

– **Business taxation and targeted support.** Corporate taxation and special support schemes are the main focal points of efforts to attract large investors. Targeted support to small business includes measures to develop links between small domestic firms and the large FDI-based enterprises as well as general measures to encourage entrepreneurship in the economy.

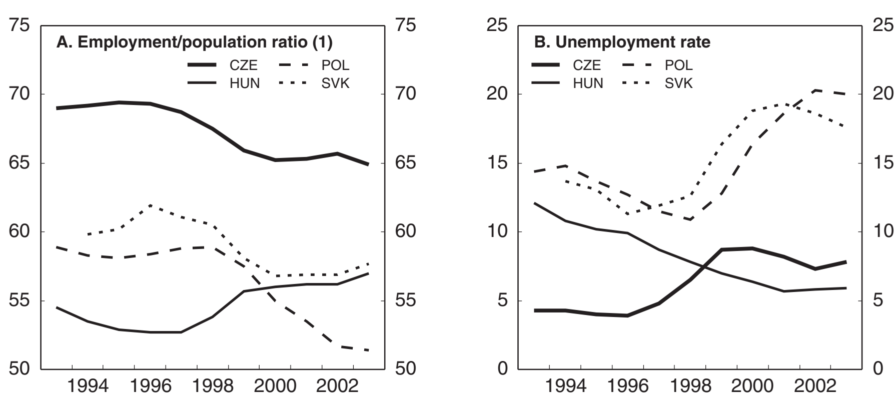
– **Regulation and administration of network industries.** The Czech Republic has gone some way in privatising energy and communications, and developed a regulatory framework to encourage competition. However, as is often the case elsewhere, this process has not yet resulted in strongly competitive markets. As a result, businesses and households can face relatively high prices and poor quality services.

Improving the reallocation of labour

Structural unemployment has emerged

Weak labour utilisation and labour-market inefficiencies have become increasingly apparent in recent years. Over the 1990s, the employment rate remained relatively high and unemployment low (Figure 1.8). This was initially interpreted as a sign that either the Czech Republic was in need of less labour-market restructuring than other transition countries, or that restructuring was much smoother than elsewhere. This view has since been proved wrong, high employ-

Figure 1.8. **Labour utilisation**
Per cent



1. Employment and population aged 15-64 years.
Source: OECD Employment Outlook.

ment and low unemployment were in fact reflecting too slow labour-force adjustment. To some extent this was a reflection of a somewhat slow process of reform and adjustment in the economy as a whole. But also, the slow labour-market adjustment was reflecting serious problems within the labour market itself. Since the macroeconomic crisis of the late 1990s, the unemployment rate has roughly doubled and the latest OECD projection estimates over 8 per cent unemployment for 2004. There are now many long-term unemployed, the share of those unemployed for more than one year has risen to more than 50 per cent, one of the highest shares in OECD countries.

Much of the labour shed from declining, non-viable activities effectively leaves the workforce, either through long-term unemployment or early retirement. This is partly because of generous benefits with light eligibility conditions. But labour-market inflexibilities are also to blame, notably stringent rules on dismissals. These not only reduce job-openings for the unemployed but also make it more difficult to increase productivity. In addition, the high tax wedge on labour constrains labour demand and encourages tax evasion, either through cheaper legal alternatives to labour contracts, or through grey-sector activity. Many of those on welfare benefits are also engaged in the grey economy, the result of light checks on income tests and job search requirements. The recently passed employment act aims to address this issue through stricter conditions on the provision of benefits (Chapter 5).

Weak labour mobility is also contributing to high unemployment and exit from the labour market. This is reflected in large unemployment black-spots in previously industrialised areas. Unemployment is highest in Northern Moravia and North-Western Bohemia, generated by significant downsizing and closures in mining, metallurgy and heavy manufacturing. Most notably, since late 1990s, the subregions of Moravskoslezský and Ústecký face unemployment rates above 13 per cent – more than three times that in Prague. The persistence of these large differences in regional unemployment rates suggests those made redundant from restructuring have weak incentives to go to where employment prospects are better. Indeed, according to surveys, Czechs are not keen on migrating for work.[7] Chapter 5 looks at the key role that low-rent housing is playing in this problem.

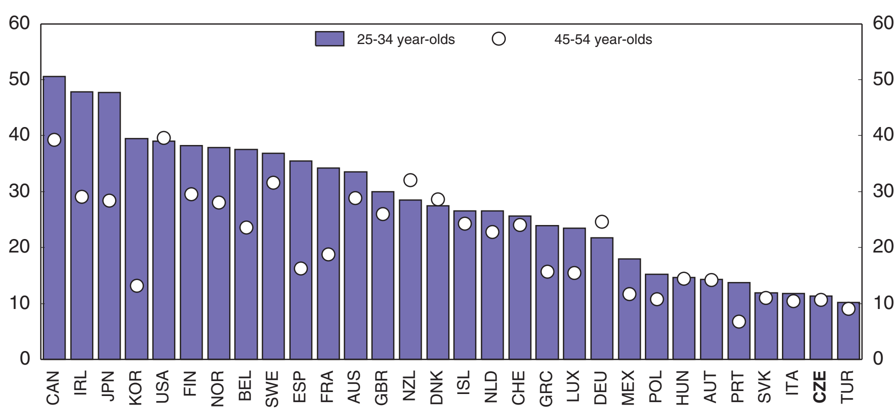
Attachment to the labour force is weakest at the younger and older ends of the working-age population. Since 1995 the employment rate for 55 to 59 year-olds has risen from 55 per cent to over 56 per cent, providing some good news on the labour-market attachment of older cohorts. However youth unemployment rates are high. Though increasing numbers go into higher education, those that do enter the labour market face high unemployment rates with long unemployment spells.[8] The unemployment rate among 15 to 19 year-old for men is about 30 per cent and over 40 per cent for women (2002 figures) – both figures are very high in international comparison.[9]

How much scope is there for increasing labour utilisation in the Czech labour market? Recent OECD calculations suggest perhaps 10 percentage points of the working-age population could be mobilised through reduction in unemployment and increases in labour force participation rates (OECD, 2003b).[10] About half of the reserves are among those aged 55 to 64, highlighting the need for reforms that extend the standard age of retirement and reduce early retirement.

There are structural mismatches in skills

Structural mismatch between the skills of the labour force and the demands of employers also hampers the labour market. Shortages in skilled labour are frequently reported by employers and in the press. A recent study by Czech researchers confirms this (National Employment and Education Observatory and the National Training Fund, 2003). The study finds skill-shortages among companies employing highly-qualified blue-collar workers as well as among IT specialists, programmers, managers, and engineers.[11] To some extent labour shortages are part and parcel of economic restructuring. But they also reflect issues in the level and mix of educational attainment and weaknesses in the education system. Low educational attainment is particularly striking in tertiary qualifications (Figure 1.9) partly reflecting that enrolment in tertiary education has only

Figure 1.9. **Percentage of the population that has attained tertiary education, 2001**[1]



1. Countries are ranked in descending order of the percentage of 25-34 year-olds who have attained tertiary education.
Source: OECD, *Education at a Glance*.

recently reached levels comparable with other OECD countries (Chapter 5). It should however be noted that though the level of degree-level tertiary education attainment is low, the education system has a strong focus on non-degree-level post secondary courses and enrolment in this regard is relatively high in the Czech Republic. In addition degree-level education has, until recently, focussed on providing master's level degree courses rather than shorter ordinary level courses.

Economic and social problems continue for the Roma

The Roma population is generally thought to be less numerous in the Czech Republic than in other Central and Eastern European countries, but nevertheless an important ethnic minority. There are no precise population estimates as many Roma do not identify themselves in census questionnaires; for example, only 11 000 persons declared Roma ethnicity in the 2001 census. Expert assessments put the population at between 100 000 and 200 000 (*i.e.* between 1 and 2 per cent of the total population).[12]

The Roma face major integration problems and often suffer from poverty and social exclusion.[13] With low education levels and typically with low-skilled jobs, the Roma were hard hit by economic transition, in particular from the downsizing and closure of state-owned firms. Re-entry to the labour market has proved difficult for many Roma and long-term dependency on welfare benefits is common. Linked to these problems are inadequate housing, a lack of access to social and public services (notably health), and a long history of discrimination and limited communication with the majority of the population (Ringold *et al.*, 2003). These policy issues are examined in greater depth in Chapter 5.

Immigrants play an increasing role in the labour market

Immigrants are playing an increasing role in the Czech labour market, and policy issues raised by this are getting more attention alongside migration issues raised by EU membership. A special agreement on labour movement with Slovakia means the countries effectively share the same labour market and this has helped smooth out imbalances, the Czech Republic typically being a net recipient of workers. In addition, high-skilled foreign workers have played an important role in management and specialist positions in FDI-based firms. At the same time, relatively good wage and employment conditions are attracting increasing numbers from further east, notably the Ukraine, typically to fill jobs at the lower end of the labour market. To date, Czech immigration policy has been conservative, with a work permit system that focuses on giving out job-based permits, rather than general permits. In addition, opportunities to become a permanent resident or a citizen are limited, requiring very long periods of residence even by European standards. One basic challenge is to construct a more comprehensive system of immigration that copes better with the increasing role of immigrants. In addition, the conservative approach to immigration is not necessarily optimal given the Czech Republic's declining and ageing population. These policy issues are examined in a special chapter on migration (Chapter 6).

Other policy challenges: the environment

Issues in air pollution and greenhouse-gas emission are discussed in Chapter 7 – as part of country-by-country reviews of sustainable development issues. The air quality in the Czech Republic was poor at the start of the transition to a market economy in the early 1990s. Although significant improvements have taken place since then, emission levels of some pollutants remain high in international comparison, notably in sulphur dioxide and nitrogen dioxide, and are continuing to contribute to problems relating to soil acidification, smog and ozone in some regions. Similarly, greenhouse gas emissions have come down considerably but remain high by international standards, though official estimates suggest Kyoto target levels will nevertheless be achieved.

Notes

1. Note that Czech GDP data has recently been revised. The revision has resulted in quite large changes in nominal GDP, but the changes in real GDP growth are relatively small (Annex 1.A1).
2. For some other countries, joining the euro area has brought real interest rates down because of reduction in the level and volatility of inflation. However, in the Czech case, inflation is already quite low and real interest rates very close to those in the euro area, so further substantial gains to a low inflation environment are not likely.
3. The recent research on the link between common currency and trade has been led by Andrew Rose (Berkeley) whose initial work suggested that small economies who have adopted a major foreign currency, such as the US dollar, British pound, French Franc, have about three times the amount of trade of those that have not. The initial results were regarded with some scepticism but the major lines of criticism have not seriously challenged the basic finding. And, similar results (though not usually as dramatic) have been observed in other cases where common currencies have been adopted. Andrew Rose has recently published a review of the empirical results (Rose and Stanley, 2004).
4. Such a hypothesis has been found in line with empirical observations for Austria (Hochreiter and Winckler, 1995).
5. The latest Cardiff Report assessment of the Czech economy estimates that Czech GDP per capita will come out at 69.9 per cent of average GDP across the EU25 in 2004 (European Commission, 2004). OECD calculations using purchasing-power parities indicate Czech GDP per capita to be 59 per cent of that in the euro area and 42 per cent that of the United States.
6. The importance of macroeconomic stability for investment flows is illustrated in a recent CNB Working Paper that makes an econometric examination of the determinants of FDI flows (Kral, 2004).
7. According to one cross-country survey, only 16 per cent of Czechs are willing to migrate if they have no job in their present residence and were offered one elsewhere, compared to 19 per cent of Hungarians, 25 per cent of Dutch and 39 per cent of British (Flek and Vecernik, 2004).
8. Since 1993 the number of unemployed 15-19 year-olds has in fact remained roughly constant while employment has shrunk considerably. More than half of 15-24 years old unemployed have been unemployed for more than six months.
9. For older cohorts of youth, the unemployment situation is less exceptional in international comparison. For instance, the unemployment rate is 13-14 per cent for 20 to 24 year-olds, which is about the OECD average.

10. The OECD calculations of potential labour resources assume that unemployment rates can be brought down to 5 per cent and that labour force participation rates can be brought up to the third-highest rate in the OECD labour market (OECD, 2003b).
11. The analysis of job shortages in the study by the National Employment and Education Observatory and the National Training Fund combines information from surveys of employers, labour offices and private labour agencies, analysis of job announcements, and a survey carried out by CzechInvest among Czech and foreign investors in the manufacturing industry.
12. During the communist era, the population censuses did not include questions on ethnic origin, but data collectors used to tick off forms filled by people "looking or living as Gypsies". In 1980, 89 000 persons were counted as Roma, or 0.9 per cent of the population.
13. The original "Czech" Roma community (about 5 000 persons) was almost wiped out during the Second World War. After the war, many Roma came, often involuntarily, from Hungary, Romania and eastern Slovakia to the evacuated Czech border area and throughout the industrial areas of Bohemia and Moravia. Another migratory movement from eastern Slovakia took place in the 1960s.

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Annex 1.A1

Recent revision of GDP data

The authorities have recently revised the national accounts to harmonise them with EU legislation. Revised real GDP and components on a quarterly and annual basis for 2001 onwards were released in late spring of this year and further backdates were released over the summer.

In the revised series, nominal GDP is about 6 to 8 per cent greater than in the previous series. Among the changes made, a user-cost method in the calculation of spending on dwelling services has been introduced. And there has been a shift in method regarding consumption of fixed capital in non-market services, *e.g.* road-transport assets, that uses a replacement cost method, rather than historic cost in the calculation method. In addition, the revision included the results of an updated business register that recorded more active units than would have been recorded under the previous register.

In terms of overall growth in real GDP the revised figures differ little from previous ones, but there are changes in composition. The new data show somewhat weaker consumption growth and stronger investment growth over the past year or so than was previously recorded.

Glossary of acronyms

AETR	Average Effective Tax Rates
ALMP	Active labour market policy
ARP	Agency for Business Development
a.s	Joint stock company
CEEC	Central and eastern European countries
CEZ	Czech Power Company
CKA	Czech Consolidation Agency
CLRTAP	Convention on Long-Range Transboundary Air Pollution
CNB	Czech National Bank
CPI	Consumer Price Index
CSSD	Czech Social Democratic Party
CzechIndustry	Agency for Development of Industry
CzechInvest	Agency for Foreign Investment
CZSO	Czech Statistical Office
ECB	European Central Bank
EIA	Environmental impact assessments
EMS	European Monetary System
EPL	Employment Protection Legislation
ERM II	Exchange Rate Mechanism II
ESA95	European Standard Accounting
EURES	European Employment Services
FDI	Foreign Direct Investment
FNM	National Property Fund
GFS	Government Finance Statistics
GHG	Greenhouse gas
ICT	Information and communication technology
IT	Information technology
KDU-CSL	Christian Democratic Party
KOB	Consolidation Bank
MLA	Adult minimum subsistence allowance
MLS	Minimum Living Standard
MTEF	Medium-term expenditure framework
NDC	National Defined Contribution pension scheme
NGO	Non-governmental Organisation
PIRLS	Progress in Reading Literacy Study
PISA	Programme for International Student Assessment
PPP	Purchasing power parities
R&D	Research and Development
RILSA	Research Institute for Labour and Social Affairs

Roma NGOs	Roma non-governmental organisations
SDVR	The proposed new medium-term budgeting framework
SEA	Strategic environmental assessments
SMEs	Small and medium enterprises
SNA	System of National Accounts
SZDC	Railway Infrastructure Administration
VAT	Value-added tax
VOCs	Volatile organic compounds

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BASIC STATISTICS OF THE CZECH REPUBLIC, 2003

LAND

Area (1 000 km^2)	79	Major cities, 31.12.2002 (1 000 inhabitants)	
Agriculture, 2002 (%)	54	Prague	1 187
Forest, 2002 (%)	34	Brno	387
		Ostrava	315

PEOPLE

Population (1 000)	10 211	Employment (1 000)	4 698
Inhabitants per km^2	129	Agriculture (%)	5
Natural increase in population (1 000)	–18	Industry (%)	40
Net immigration (1 000)	26	Services (%)	56

GOVERNMENT

Public consumption (% of GDP)	24	Chamber of Deputies, as at March 2003	Seats
General government total revenue (% of GDP)	42	Social Democratic Party	70
Public debt, national accounts definition (% of GDP)	37	Civic Democratic Party	58
		Communist Party	41
		Freedom Union/Christian Democratic Union – People's Party Coalition	31
		Total	200

PRODUCTION

GDP, current prices (billion CZK)	2 551	Origin of value added (%)	
GDP per capita (USD, current prices)	8 864	Agriculture	3
Gross fixed investment (% GDP)	27	Industry	38
		Services	59

FOREIGN TRADE

Exports of goods and services (% GDP)	62	Imports of goods and services (% GDP)	65
Main exports (% of total merchandise)		Main imports (% of total merchandise)	
Machinery and transport equipment	50	Machinery and transport equipment	43
Manufactures	35	Manufactures	31
Chemicals	12	Chemicals	11

CURRENCY

Monetary unit: Czech koruna		Currency units per euro	
Currency units per \$, 2003	28.13	Year 2003	31.84
		Aug 2004	31.63

Note: An international comparison of certain basic statistics is given in an annex table.

Executive summary

Following accession to the European Union the big issue for the Czech Republic is to strengthen growth prospects. Growth potential at present is somewhat above 3 per cent, implying a moderate pace of catch-up to living standards in the EU and elsewhere. There is room for greater ambition in growth performance, and it is welcome to see this reflected in the programme of the new Czech government. This *Survey* underscores four main challenges.

Fiscal consolidation

Fiscal consolidation is the dominant challenge for macroeconomic policy, and is not only necessary to cope with ageing and to bring down the tax burden but is also needed to fulfil euro-area entry conditions. A welcome programme of fiscal reform has begun, including proposals for a system of multi-year aggregate spending ceilings and significant expenditure cuts. However, to date, mainly revenue-raising measures have been implemented while the full impact of expenditure measures is yet to be realised. The attempt to secure broad political consensus on pension reform is commendable, but it must be underscored that whatever reform is finally implemented, it will have to bring considerable fiscal savings. Health-care reform also has to deliver savings, but concrete proposals have yet to be made. To facilitate assessment of the true fiscal position, extra-budgetary funds need to be more fully integrated in mainstream government budgeting procedures. Also, with the further decentralisation of public services, the need for good budgeting practices and accountability in regional and municipal governments is all the more important.

A successful entry into the euro area

The Central Bank and the Ministry of Finance have formulated a transparent strategy for entering the euro area, that foresees minimising the time spent in the Exchange Rate Mechanism (ERM II). Annual reports will assess the economic conditions in relation to the Maastricht Criteria and a request to enter ERM II will only being made if the probability of a positive first assessment by the EU authorities is high. The choice of a 3 per cent inflation target for the run-up to euro entry is justifiable on medium-term grounds. However there may be some difficulty communicating the consistency of this target with the Maastricht criterion for price stability. The Czech authorities should therefore pay *close attention to how the Maastricht criteria are interpreted and applied by the European Commission and the ECB and adjust their communication strategy accordingly.*

Making the environment for business more growth-friendly

Most of the catch-up in living standards will have to come from boosting productivity growth. This means swifter re-allocation of resources across firms as well as stronger in-firm productivity growth. While the Czech Republic is a strong competitor for attracting foreign direct investment, policy towards poorly performing firms and business start-ups has problems, slowing down the exit and entry of firms. Bankruptcy procedures are cumbersome, often long and usually end up in liquidation, with asset stripping not uncommon. Reforms have long-since been planned, and it is welcome that new legislation looks finally set to go ahead. The legislation aims at strengthening the role of creditors, speeding up proceedings and allowing composition to play a bigger role. Likewise, efforts to streamline business registration are welcome and should be implemented as soon as possible. The general business climate is also damaged by issues in network-industry competition, as some services, notably Internet, are expensive in international comparison.

Improving the functioning of the labour market

Mobility between jobs and regions is weak. Administrative extensions of collective wage agreements, strict employment protection legislation (EPL) on individual dismissals, rent control, severe poverty traps (particularly for families) and a high tax wedge have contributed to considerable long-term unemployment. The Roma population is hit especially hard in this respect. Migration is to some extent mitigating the labour-market rigidities with Slovaks filling skilled vacancies and other eastern Europeans (mainly Ukrainians) taking up unskilled jobs that are unattractive for locals. Tackling the unemployment problem requires measures across a wide front, but most notably social benefit reform is needed along with reduction in the tax wedge as well as easing of EPL. The widespread social and economic exclusion of the Roma needs more attention, particularly in the education system. A more open immigration policy is needed to address immediate issues such as the inconsistency between granting work permits as well as for better alignment of immigrants' skills with those needed on the Czech labour market.

This Survey is published on the responsibility of the Economic and Development Review Committee *of the* OECD, *which is charged with the examination of the economic situation of member countries.*

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The economic situation and policies of the Czech Republic *were reviewed by the* Committee *on* 11 October 2004. *The draft report was then revised in the light of the discussions and given final approval as the agreed report by the whole* Committee *on* 28 October 2004.

•

The Secretariat's *draft report was prepared for the Committee by* Philip Hemmings, Ann Vourc'h, Dana Hajkova *and* Boris Cournede *under the supervision of* Andreas Wörgötter.

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