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I. Recent economic developments

As with other countries in the region, the Czech Republic continues to face far-reaching structural transformations, which bear directly on macroeconomic performance. The economy has not yet reached a level at which a business cycle is firmly established. Potential output is not yet following a regular trend, but continues to reflect to a larger extent the impact of restructuring efforts in the wake of legal reforms and ownership changes.

What distinguishes the economic policy challenges in the Czech Republic from other transition countries? Firstly, the full opening to strategic investors and foreign direct investment incentives took place only toward the end of the last decade, generating highly synchronised capital inflows. These put strong upward pressures on the currency and create specific tensions in the labour market. Secondly, the exit of low-productivity and loss-making enterprises inherited from the planned economy has also been much delayed¹ and islands of economically non-viable employment and capital stocks remain entrenched. This emerging dualism in the economy increases pressures on the social benefit and welfare system while expected adjustments in the low productivity sector, accelerated by recent currency appreciation, create risks of additional shocks to output and employment.

Current economic developments result from a combination of these structural influences, the spillover from the international downturn, the impact of the summer 2002 floods and a massive fiscal impulse. The tension arising from this interaction of supply and demand factors is preventing the Czech economy from growing faster and better exploiting its prime location in an enlarged European Union.

Output

Gross domestic product grows at a slower pace

Output growth started slowing from the last quarter of 2001, following the international slowdown. Exports of goods and services represent 60 per cent of GDP – and 70 per cent of them are directed to EU markets (40 per cent to Germany

alone) – so that foreign market weakening exerted important first and second round impacts. Initially, the contribution of net exports to GDP became strongly negative; then all export-induced domestic activities, in particular investment and demand for intermediate imports, decelerated. Following the ensuing slowdown of the private business investment, equipment imports were also sharply reduced, the trade deficit narrowed and the net contribution of external sector became positive through 2002. Floods in August, provoking a collapse in tourism revenues, turned the contribution of the external sector negative again (Table 1 and Figure 1).

Growth in both public and private consumption has tempered the slowdown. Government consumption kept growing strongly, partly as a result of election-driven spending (general elections were held in summer 2002). Increases in public sector wages, pensions and transfers ahead of the elections also kept household revenues growing. Private consumption continued to grow on the back of strong real income growth and the reluctance of private firms to fire workers in structurally tense labour markets. A contrast therefore arose between sharply decelerating exports, slower investment growth and associated de-stocking² on the one hand, and the strength of private and public consumption on the other. The extent to which this development can carry over beyond 2002 and allow the emergence of a larger role for domestic demand in supporting growth will be determined by the success in closing the productivity gap with the EU. Such a progress would stimulate investment and exports again, and help rebalance the demand structure.

The shift in the composition of demand was reflected in the evolution of the output structure. Output of the goods-producing sectors, which supply export markets and provide inputs to domestic exporters, decelerated earlier and more rapidly than in the service industries catering to local demand (Table 2). At the same time, local manufacturers of consumption goods, which were penalised by rising unit labour costs (under wage increases and currency appreciation – see below lost competitiveness and faced acute international competition and increased import penetration). Textiles, clothing, leather and shoe manufacturing industries recorded absolute falls in production.

These developments reversed the closing of the output gap that had been initiated in 2000 and 2001 as growth decelerated below trend in 2002. Figure 2 represents two estimates of the potential output and gap, the sources of potential output, and the productivity and employment components of GDP in international comparison. The wedge between actual and potential output widened in spite of a trend rate of growth which is considerably lower than in other transition countries.³

The main factor behind the low trend growth rate is the low productivity of employed resources, which is a consequence of delayed and incomplete reforms

Table I. Quarterly gross domestic product

	2000					2001					2002		
	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Q1	Q2	Q3 ¹
Year-over-year percentage change at 1995 prices													
GDP ²	3.3	3.3	3.1	2.8	3.9	3.3	3.6	3.5	3.3	2.7	2.8	1.9	1.5
Household consumption expenditure	2.5	2.3	2.3	3.2	2.0	3.9	3.1	4.0	4.0	4.4	4.1	5.1	5.3
Government consumption (incl. NPISH)	-1.0	-2.2	0.6	0.2	-2.3	0.3	-0.4	-1.8	0.6	2.5	4.9	9.4	3.7
Gross fixed capital formation ³	5.3	3.4	5.9	7.3	4.7	7.2	6.0	8.9	6.8	7.2	3.4	-0.7	0.9
Change in inventories ⁴	1.3	-0.6	0.6	2.7	2.6	0.7	2.9	0.2	0.4	-0.5	-2.1	-1.4	..
Exports	17.0	20.7	13.2	13.3	21.3	12.3	21.1	13.3	9.4	6.7	5.5	3.8	-2.7
Goods	20.0	26.2	15.9	15.9	22.6	14.6	24.1	15.1	11.4	9.0	5.3	7.0	1.1
Services	5.7	-0.6	2.0	4.7	16.1	2.2	6.4	5.3	2.2	-3.5	6.2	-12.3	-17.9
Imports	17.0	15.9	13.2	18.3	20.0	13.6	23.0	14.1	10.6	8.5	4.2	4.0	3.6
Goods	20.2	19.8	17.0	22.2	21.8	15.3	25.7	15.4	12.1	9.9	3.4	4.8	3.9
Services	1.2	-2.7	-4.9	1.7	10.2	3.8	7.2	6.5	2.9	-0.3	9.9	-1.5	1.6
Net exports ³	-1.0	2.1	-0.6	-4.1	-1.1	-2.0	-2.6	-1.3	-1.7	-2.6	0.8	-0.4	-5.6

1. Data were substantially revised in January 2003 due to the correction of export data for the period July to November 2002.

2. ESA95.

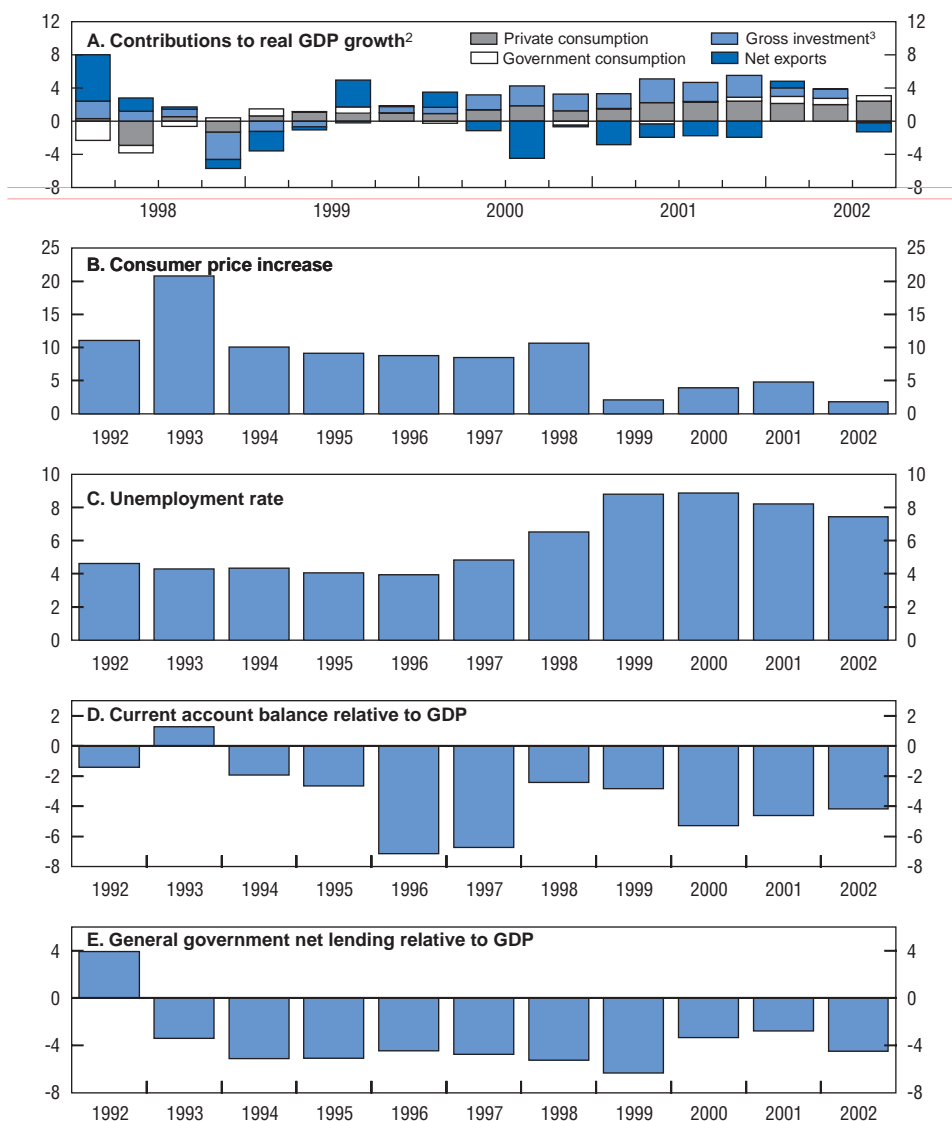
3. Includes large purchases of military aircraft in 2001; similar purchases were recorded as government consumption in 2002.

4. Contribution to GDP growth calculated as the change in the variable as a percentage of the previous period's GDP.

Source: OECD Quarterly National Accounts.

Figure 1. Macroeconomic performance¹

Per cent



1. Data for 2002 are estimates in Panels C to E.

2. Contribution to GDP growth calculated as the change in the variable as a percentage of the previous year's GDP.

3. Includes government investment.

Source: OECD – *Economic Outlook*, *Main Economic Indicators*.

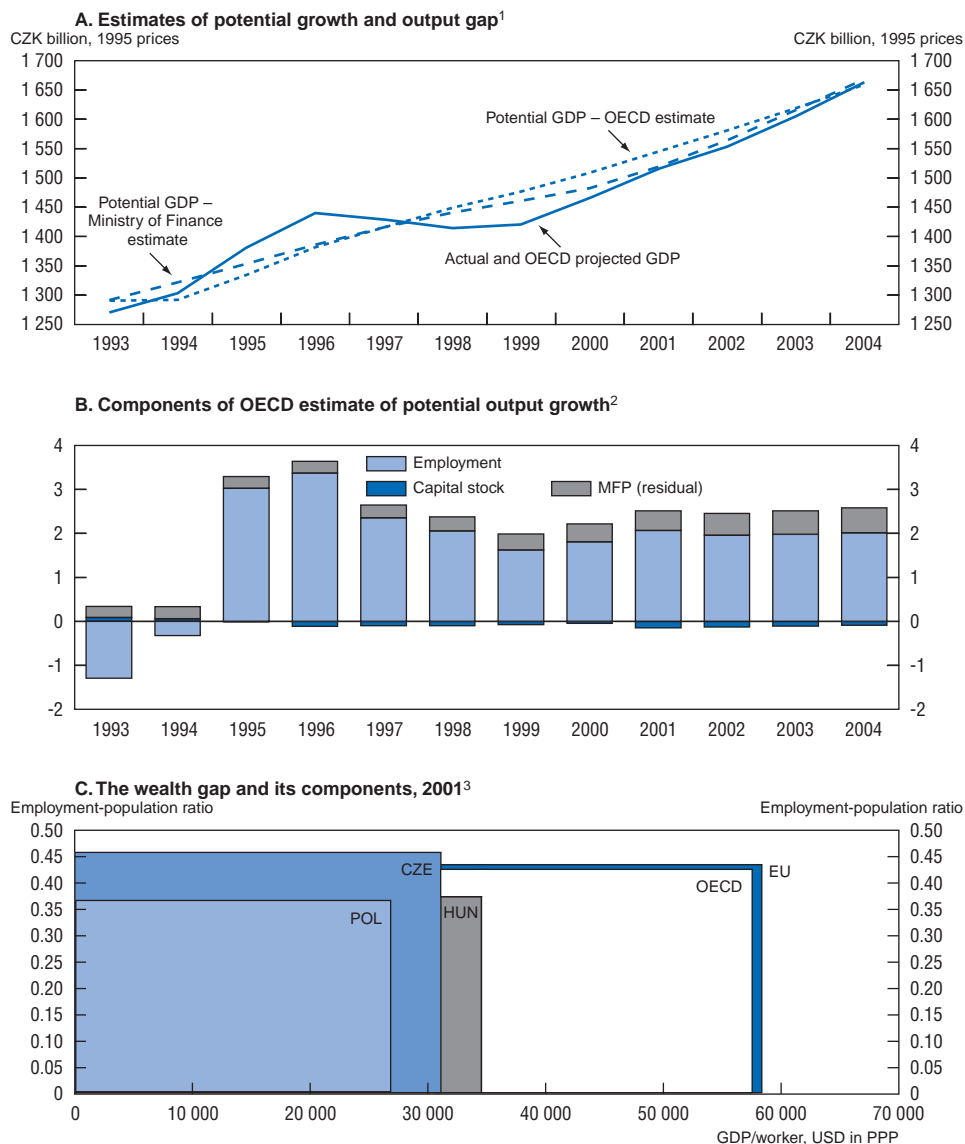
Table 2. Quarterly gross domestic product by sector

	Average share in gross value added 2000-2001	2000					2001					2002											
		Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Q1	Q2										
		Per cent												Year-over-year percentage change at 1995 prices									
Gross value added ¹		3.4	3.3	3.1	2.8	4.5	3.7	3.9	4.0	3.7	2.9	2.9	2.3										
Agriculture, fishing and forestry	6	-1.4	3.0	1.6	-6.1	0.5	-5.4	-4.5	-3.0	-6.7	-6.2	-3.5	3.5										
Industry	37	9.3	6.7	10.8	9.7	10.2	1.8	4.9	1.6	2.7	-2.1	2.0	-2.0										
Manufacturing	30	8.0	6.6	8.4	3.6	13.7	2.6	5.4	0.9	4.2	0.1	4.0	-0.6										
Construction	5	-6.3	-6.1	-16.0	-3.2	0.3	-1.2	2.3	2.0	-2.5	-5.0	-5.6	-2.0										
Services	59	0.8	1.7	0.0	0.5	1.3	6.4	3.3	6.4	7.5	8.3	5.5	5.4										
Trade, repairs,	15	-0.8	0.7	-4.1	-2.3	2.8	7.8	4.0	9.9	6.8	10.1	11.6	10.9										
Hotels, restaurants	2	15.6	-11.6	21.3	31.7	15.1	-1.8	9.6	4.2	-5.3	-13.5	-1.9	-12.2										
Transport and community services	10	8.2	10.3	6.7	11.2	4.8	11.5	5.2	10.7	13.6	16.8	10.8	15.2										
Financial services	7	-9.3	2.7	-12.7	-11.5	-16.5	15.9	-1.8	14.3	26.2	29.8	0.9	-2.5										
Real estate, business services	13	7.6	5.6	8.8	3.8	11.8	5.4	6.6	5.4	6.6	3.5	4.6	-0.1										
Other services	12	-5.4	-5.9	-5.1	-5.7	-4.9	-1.6	-0.3	-3.4	-1.8	-0.7	-2.1	3.9										

1. ESA95. Gross value added is the sum of the component in the table minus financial intermediation services indirectly measured.

Source: Czech Statistical Office.

Figure 2. Potential growth



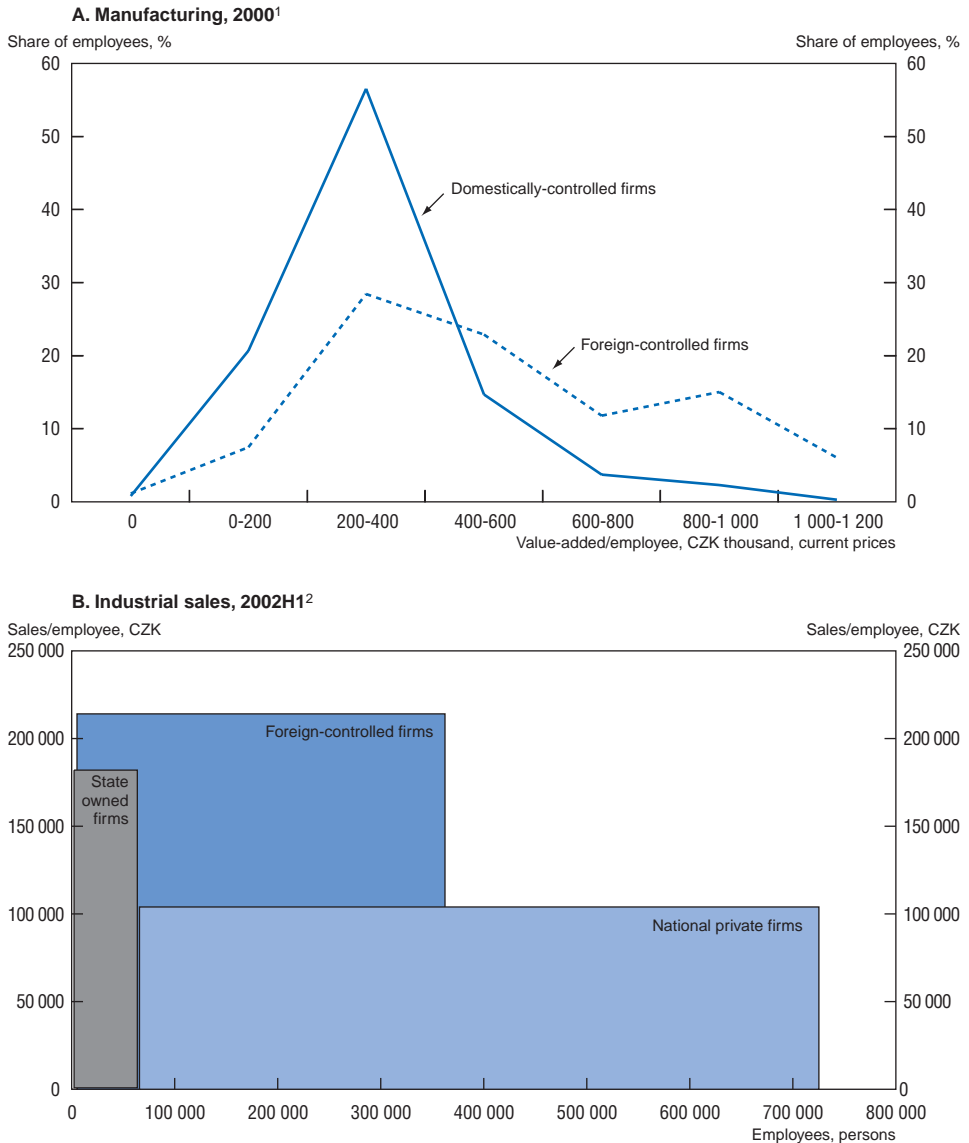
1. Output gap is deviation of actual from potential GDP.

2. Capital stock depreciation rate is assumed to be 11% for 1991 to 1993, 7% for 1994-95 and then 8%.

3. Area of rectangle is GDP/capita, USD in PPP.

Source: OECD; Ministry of Finance.

Figure 3. Labour productivity and sales by type of enterprise



1. Confidentiality prevents publication of higher productivity categories. The residual for foreign-controlled enterprises is about 3% (compared to 0.5% to 1.4% for the other categories).

2. For firms with 20 or more employees.

Source: Czech Statistical Office.

in the first years after transition.⁴ Following the full liberalisation and encouragement of foreign capital inflows since 1998, the restructuring of the supply side of the economy gained pace with the aid of FDI firms in manufacturing, trade and banking sectors. The ongoing liberalisation and privatisation of network industries also results in stronger performance by energy and telecommunication firms (see Annex IV). An emerging dualism between labour productivity performance in the foreign-controlled and domestically-controlled segments of the manufacturing sector is discernible (Figure 3). This indicates that the short-term strength and resilience of the economy and its growth potential depend to a considerable extent on foreign business investment, while the restructuring of domestic firms with low-productivity does not make enough progress.⁵ The ongoing slump in investment – in particular by foreign firms – will slow down restructuring and prevent a more resolute recovery in 2003.

Efforts to strengthen the supply potential should aim at preserving the remarkably high labour force participation and employment rates, which are well above other countries in the region. While high employment is partly an outcome of

Box 1. **The economic impact of the floods**

Exceptionally severe floods in August 2002 contributed to the weakening of economic performance, reducing the nation's capital stock by an amount that is probably equivalent to 4-6 per cent of GDP. The floods temporarily paralysed part of the productive infrastructure (a supply shock) and discouraged foreign tourists (a demand shock), resulting in negative macroeconomic impacts before the positive impulse associated with reconstruction kicks in. Such output losses, without offsetting employment and wage cost adjustments, eroded the profitability of the business sector. Furthermore, profits were squeezed by uninsured losses which were significant in some regions, especially in the domestically-owned business sector. In addition to financing public infrastructure repairs, the government agreed to subsidise private housing reconstruction. The reconstruction of the housing stock and transportation infrastructure hit by floods is likely to boost public investment spending in 2003, providing a stimulus to final demand.

Insurance firms estimate that flood-related payouts will sum up to some CZK 32 billion (about \$1 billion or 1½ per cent of GDP). This payout will have reduced profits of the financial sector only in part because foreign re-insurers compensated a sizeable portion of claims. However, insurance companies hiked up premiums immediately and started to refuse coverage to households and firms that are located in endangered areas. The government's decision to provide relatively generous assistance to households has created a moral hazard problem. Authorities should therefore enforce stricter building and zoning rules in order to minimise future budgetary losses from flood events.

the survival of low performance firms, it has the potential of becoming an additional source of growth if resources can be switched into higher productivity activities.

Employment and wages

The registered unemployment rate is high but effective labour reserves are smaller

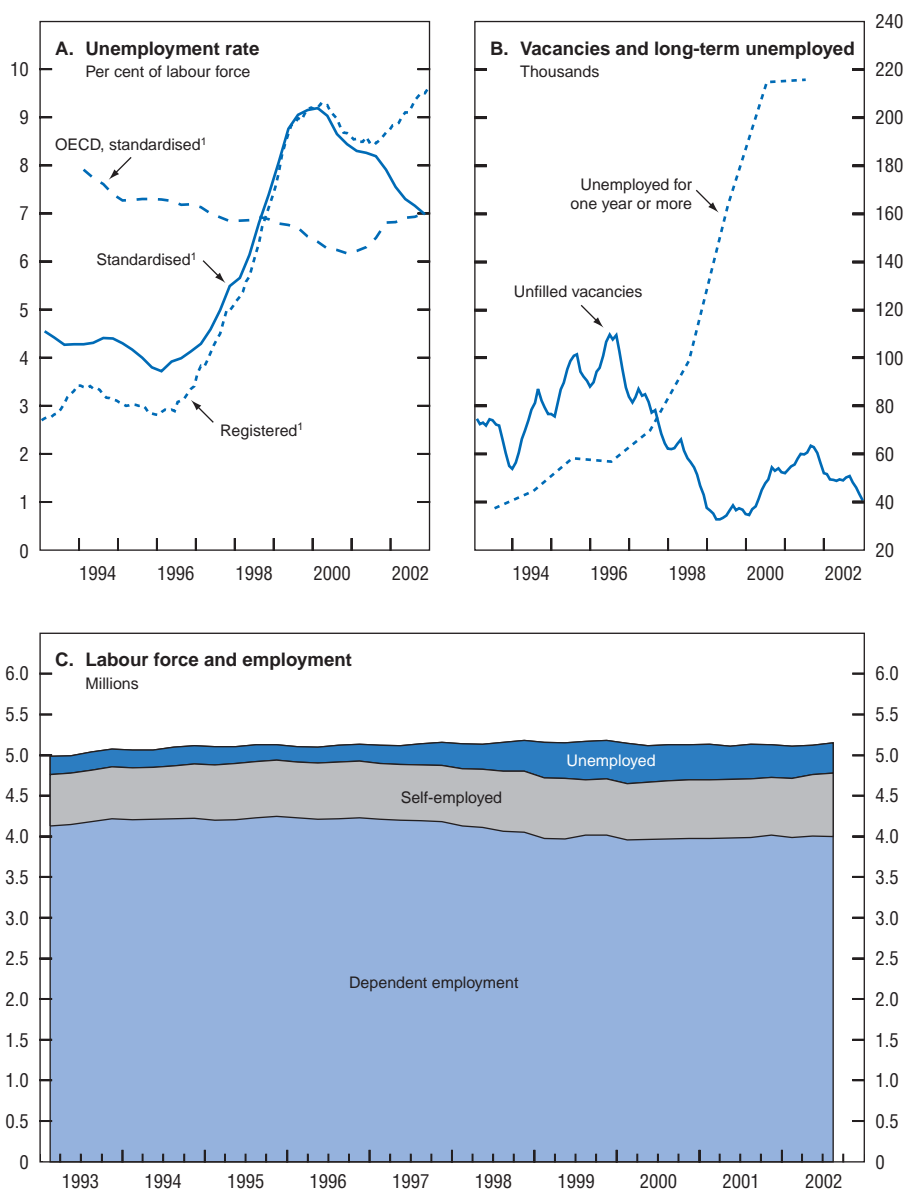
In the standardised labour force surveys, unemployment rate declined below the 8 per cent mark for the first time since 1998, converging towards the OECD average (Figure 4). Simultaneously, the rate of registered unemployment shot up toward 9½ per cent, creating a growing wedge between the two measures, reflecting the impact of weak work incentives: following the tightening of the rules governing early retirement, a growing number of elderly unemployed take advantage of the generous welfare system that requires them to remain in the unemployment register, without actually seeking jobs.⁶ On the demand side, vacancies for low-skilled labour were also dampened by cumbersome employment protection procedures and high payroll taxes. The geographical mobility of the labour force is low and local labour market areas remain narrow, as a result of rigidities in transport infrastructure and housing markets. Part-time and temporary contracts also remain rare, due to unclear regulations.⁷

In this environment of low labour mobility, there are signs of acute labour shortages in specific geographical and sectoral labour markets. Unemployment rates remain low in the rapidly growing regions of Prague, the wider Prague area (central Bohemia), and south-western and north-eastern Bohemia.⁸ The Economic Chamber interviewed a number of large companies in May 2002 and reported that 57 per cent face hiring difficulties in the areas of business management, marketing, finance and engineering.⁹ Higher turnover of company-trained personnel is also reported, revealing heightened competition between companies for skilled workers. Growing mismatches between demand and supply of labour could indicate that the share of structural unemployment in total unemployment might be higher than commonly thought. If so, effective labour reserves may indeed be much lower than the apparent level indicated by survey or registered unemployment.¹⁰ This would represent a heavy constraint on output growth in the longer term.¹¹

Wage growth exceeds productivity in spite of the slowdown...

Dependent employment in the business sector has decreased during the slowdown, but job losses have been offset by rising self-employment and government employment, so that aggregate employment has slightly increased (Figure 4). Within the business sector, the number of unfilled vacancies dropped over the year. Wage pressures have nevertheless remained important and have resulted in average wage growth exceeding labour productivity by a large margin (Table 3). Wage hikes in the public sector also played a role, especially before the elections when they exceeded

Figure 4. Employment, unemployment and the labour force



1. Seasonally adjusted by the OECD.

Source: OECD: Main Economic Indicators, Quarterly Labour Force Statistics; Ministry of Labour and Social Affairs.

Table 3. **Wage developments**

	1994	1995	1996	1997	1998	1999	2000	2001	2002 Q1	2002 Q2	Estimated 2002
	Year-over-year percentage change										
Overall nominal wage	18.5	18.5	18.4	10.5	9.4	8.2	6.6	8.5	7.0	7.4	7.4
Business sector	18.2	19.2	17.7	11.7	11.0	7.1	7.8	8.2	7.2	6.4	6.7
Non-business sector	19.8	17.0	20.7	5.8	3.9	13.1	2.8	10.0	6.5	11.7	11.3
Overall real wage	7.7	8.7	8.8	1.9	-1.2	6.0	2.6	3.6	3.1	5.0	6.7
Business sector	7.4	9.2	8.2	2.9	0.3	4.9	3.8	3.3	3.3	4.0	6.0
Non-business sector	8.9	7.3	10.9	-2.5	-6.1	10.8	-1.1	5.1	2.7	9.2	10.5
Productivity in the business sector	1.5	5.4	4.4	-0.5	0.4	3.0	4.4	2.8			
Unit labour costs in the business sector	15.4	11.3	12.4	8.4	4.6	1.9	2.8	5.2			

1. Data refer to all registered employees and exclude payroll taxes.

Source: Czech Statistical Office.

11 per cent, because of their demonstration effects on wage setting in the business sector. When combined with strong currency appreciation through 2002, these wage developments generated a significant increase in relative unit labour costs.

A minimum wage increase in January 2003, not accompanied by any reductions in labour taxes, has worsened the employment prospects of the unskilled workers whose unemployment rate is already above 20 per cent. The government raised the minimum gross wage by 9 per cent, from CZK 5 700 to CZK 6 200,¹² following controversial assessments of impacts of this measure.¹³ Although only 2 per cent of all workers earned the minimum wage in 2002, some sectors, such as glass and shoe manufacturing, will be affected more than others. This follows the government-imposed “administrative extension” of the collective agreements reached with unionised enterprises in the construction industry, machine building, textiles, leather and shoe manufacturing to all enterprises of these sectors in 2002. The key adverse impact of these labour cost increasing measures will be on labour-demand incentives at the low end of the labour market. This calls for offsetting measures to reduce the hiring costs of employers, such as social security contribution reductions or granting in-work benefits rather than mandatory wage increases. In the longer term it will be necessary to make sure that there is a corresponding increase in the productivity of these workers (see Chapter IV).

Within the business sector, FDI firms responded promptly to deteriorating conditions, increasing wages less and adjusting employment faster than their domestic counterparts. The responsiveness of foreign firms to business circumstances is striking and contrasts with inertial wage growth and lesser employment flexibility in the domestic sector. Consequently, the part of the export sector controlled by multinational corporations (MNCs) preserved its competitiveness better than the domestic sector. Moreover, given the high import content of production in MNCs, the overall effect of massive appreciation was less unfavourable than for less import-intensive domestic producers.

The poorer adaptability of domestic corporations was reflected in the rapidly rising number of distressed non-financial firms and vulnerable jobs¹⁴ (Table 4). Both statistical data and *ad hoc* surveys confirm the feared accentuation of a growing divide.

Table 4. **Vulnerable jobs**

	1999	2000	2001	2002 ¹
Industry	323.2	214.5	208.1	231.9
Construction	17.5	12.0	9.7	30.7
As per cent of dependent employment	8.6	5.9	5.6	6.8

1. First quarter.

Source: Ministry of Industry and Trade, Czech Statistical Office.

A credit rating survey in October 2002 found that both the proportions of highly robust and highly vulnerable firms in the survey sample have increased in parallel.¹⁵

Inflation

Inflation declined below the Central Bank's target...

Headline inflation (CPI) has been dominated by favourable one-off factors that monetary policy did not influence directly (Figure 5). Therefore, inflation declined well below the Central Bank's target, as in 1999. CPI growth has remained below the OECD and eurozone averages since the second quarter of 2002 (Panel A). Prices of food and energy, reflecting both declining prices of imports and the gradual liberalisation of network industries, declined significantly, pulling down overall inflation. The underlying inflation measure excluding food and energy prices exceeded the overall CPI growth by 1-2 percentage points throughout 2002 (Panel B). The 10 per cent effective appreciation of the currency contributed significantly to the benign impact of tradables on overall inflation (Panel C). Trade prices of manufactured goods plummeted until the middle of the year when their rate of decline slowed and the faster deflation of import prices implies improving terms of trade for the Czech Republic (Panel D). Inflation remained stronger in the non-tradables, at 4-5 per cent, reflecting the remaining endogenous cost pressures not disciplined by international competition.

... but remaining tensions may translate into higher inflation in the future

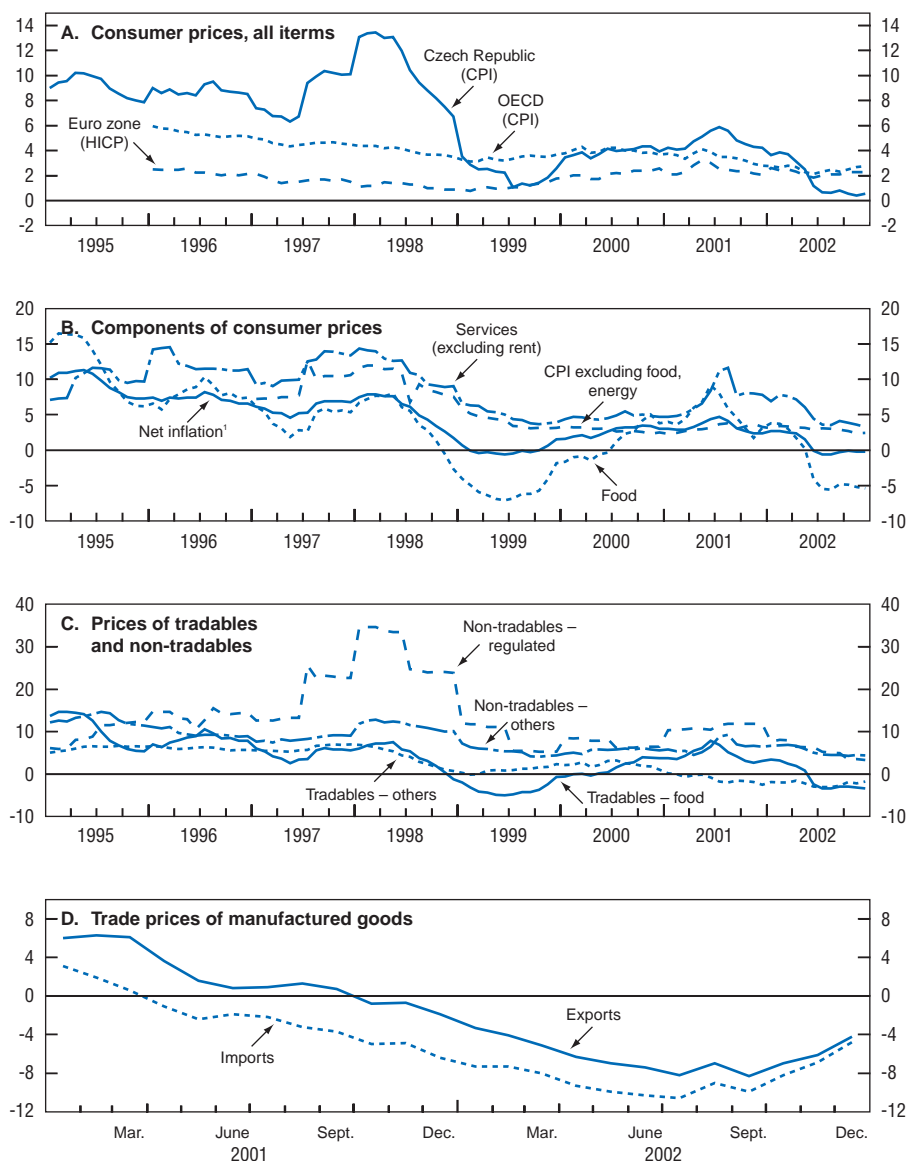
The undershooting of the inflation target created real wage surprises in 2002. The credibility of the *ex ante* tripartite wage bargaining process as a wage anchor for employers and employees alike is now tested. Unless central wage guidelines start including an explicit real wage adjustment clause, nominal wage flexibility may prove insufficient in this disinflationary environment and it may be difficult to prevent real wage growth from overshooting labour productivity gains again. Alternatively firms will have to offset the real wage surprises by not paying the customary (but not statutory) 13th and 14th monthly salaries in the final quarter of the year. In the longer term, a switch to fully decentralised bargaining at enterprise level¹⁶ could enhance the wage flexibility and contribute to the swifter absorption of labour market imbalances.

External balance

Strong currency appreciation has compounded the competitiveness losses...

The adverse impact of excessive wage growth on relative unit labour costs has been reinforced by strong currency appreciation in 2002, lifting the Czech average wage to one-quarter of the corresponding German level (Figure 6). While

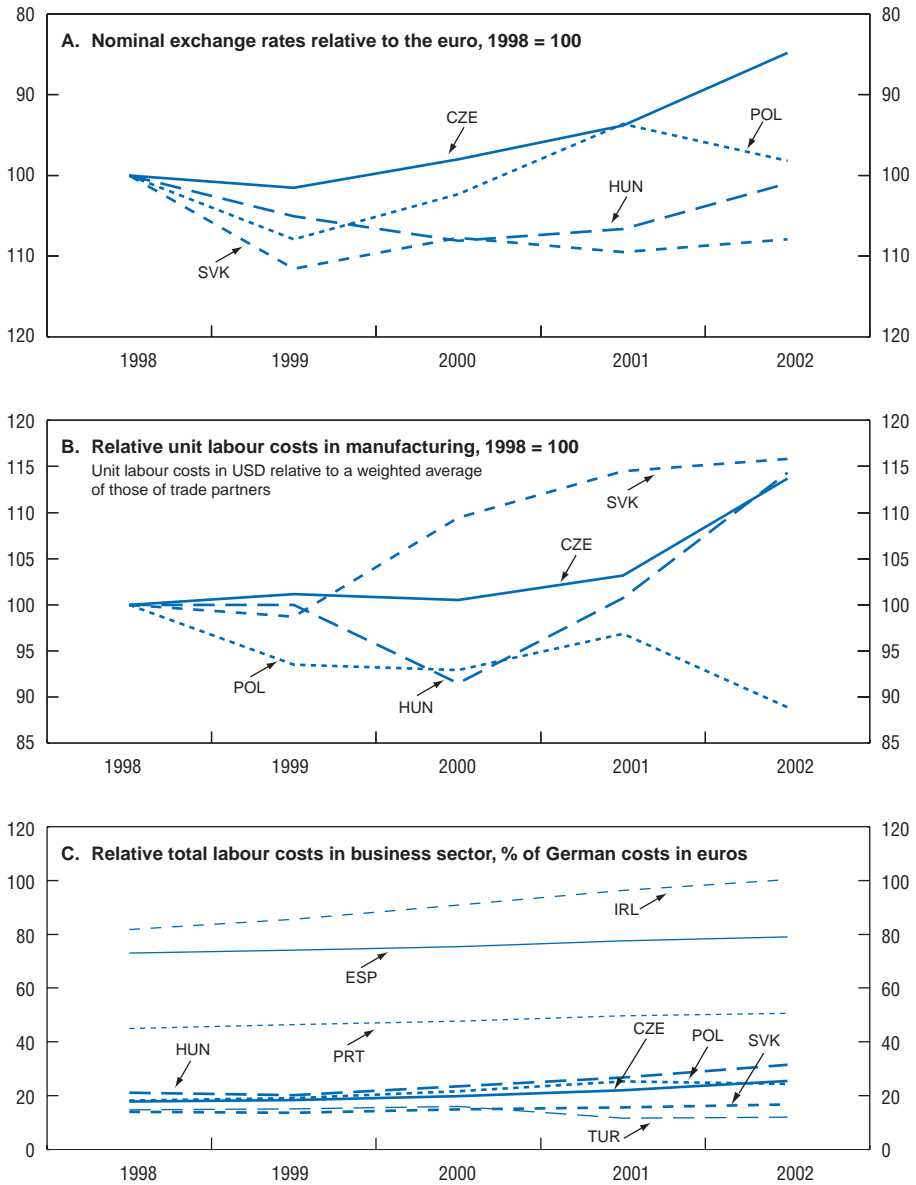
Figure 5. **Price developments**
Year-on-year percentage change



1. Net inflation refers to consumer prices adjusted for the direct impact of changes in indirect taxes and administered prices.

Source: Czech National Bank; Czech Statistical Office; OECD *Main Economic Indicators*.

Figure 6. Competitiveness¹



1. Estimates for 2002.
Source: Eurostat, OECD.

this is still well below the wage level in the less advanced EU countries such as Portugal, the continuation of massive wage increases in euro terms threatens to induce outflows of labour-cost sensitive production activity from the Czech Republic to countries with significantly lower wages. The recent departure of a major multinational company (Flextronics) entailing a loss of over 2 000 Czech jobs and its apparent relocation to a Ukrainian free-trade zone provides an early-warning signal. As long as the country maintains a large pool of low-skilled workers, loosing such workplaces has economic and social costs. To improve competitiveness and encourage job creation, the authorities may want to consider a labour cost-reducing shift in taxation and cut significantly the very high social-security charges. The Secretariat has estimated that, to the extent that labour demand responds to these cuts, such reforms may be self financing (see Box 2 below).

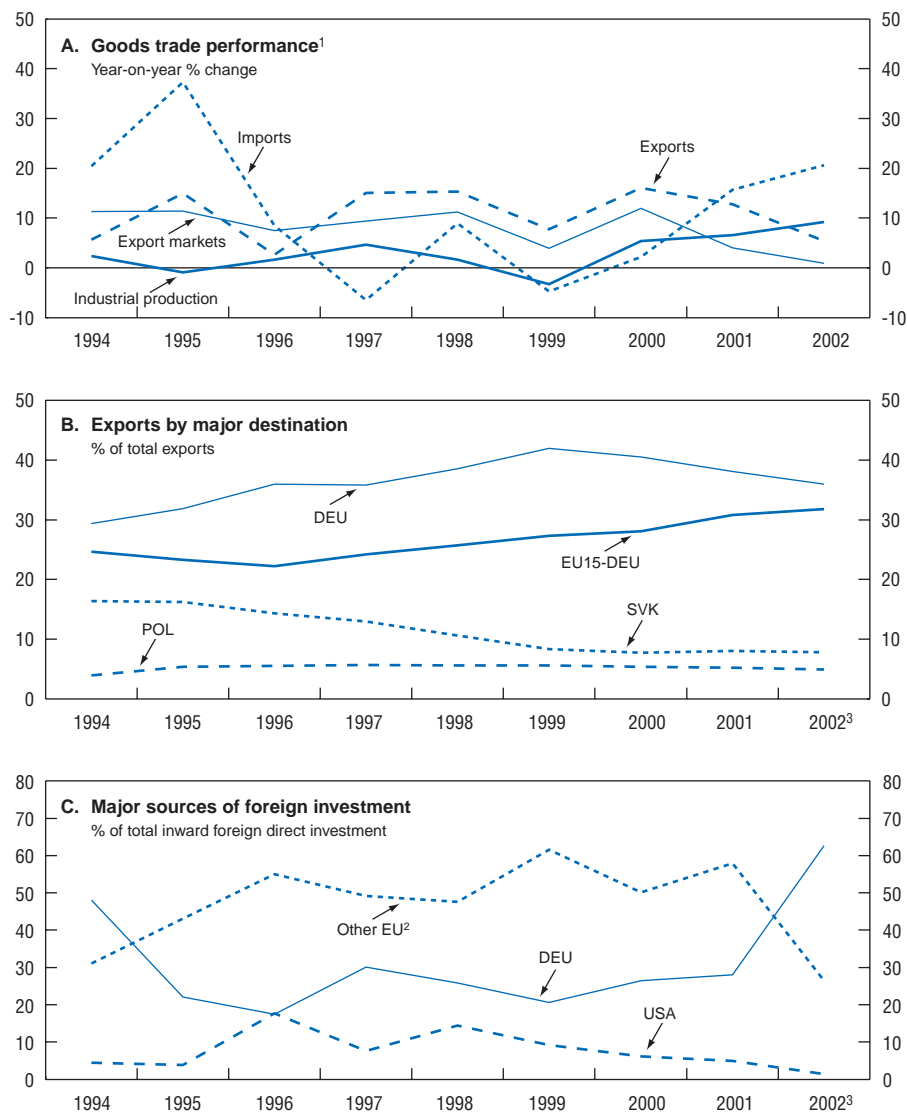
The principal external sector developments are shown in Figure 7. The well-established correlation between export market growth, exports, industrial production and imports has recently weakened, apparently as a result of the domestic demand stimulus and competitiveness losses. Competitiveness deterioration shows more in the import penetration of the domestic consumption good markets, rather than in the international market share losses – even if a deceleration of trade gains is visible and a lagged decline of orders to local producers within FDI subcontracting networks is reported.

Balance of payments data show that the composition of current account deficit keeps changing (Table 5). The trade deficit has fallen, reflecting the rising surplus in transactions with the EU area, declining equipment imports and the lower value of the energy bill induced by strong currency appreciation. At the same time, the deficit in the income balance has increased as reinvested earnings of FDI firms and dividends paid to foreign investors kept growing. Overall, the current account deficit declined below 5 per cent of GDP in 2002. This deficit was more than offset by a surplus on the financial account, exceeding 10 per cent of GDP, resulting from massive privatisation inflows. Consequently, official reserves increased considerably. The prominence of reinvested earnings as well as the potential for profit repatriation is likely to increase in the future. The funding of the current account deficit will then rely less on one-off operations and more on permanent arbitrages by large numbers of international investors. The role of official capital transfers should also increase, with EU co-funding a larger share of infrastructure investment.¹⁷

... while non-privatisation FDI inflows decline

Massive FDI flows continued in 2002, mainly from the privatisation of large utilities while investment associated with greenfield projects appears to have

Figure 7. International trade and capital inflows



1. Export markets are a weighted average of import volumes in the exporting markets of the Czech Republic. Trade calculations use data in USD and 1995 prices. Industrial production excludes construction. Estimate for 2002.
 2. AUT, BEL, DNK, FRA, ITA, NLD, SWE, GBR.
 3. Panel B, Jan. to Oct.; Panel C, Q1 to Q3.
 Source: OECD; Czech National Bank.

Table 5. Balance of payments¹

	1997	1998	1999	2000	2001	2001	2002
						Q1 to Q3	Q1 to Q3
Euro billion							
A. Current account	-3 187	-1 134	-1 379	-2 960	-2 930	-2 229	-2 233
Trade balance ²	-4 353	-2 335	-1 797	-3 409	-3 434	-2 317	-1 319
Exports	19 757	23 063	24 651	31 509	37 271	27 352	30 132
Imports	24 110	25 398	26 448	34 918	40 705	29 669	31 451
Services balance	1 545	1 713	1 130	1 536	1 706	1 246	780
Transport (net)	606	612	718	736	791	582	646
Travel (net)	1 119	1 766	1 558	1 847	1 919	1 460	1 109
Other services (net)	-180	-666	-1 146	-1 048	-1 004	-797	-976
Income balance	-701	-973	-1 265	-1 490	-1 726	-1 486	-2 007
Current transfers (net)	322	461	552	403	524	329	314
B. Capital account	10	2	-2	-6	-10	-2	-3
Credits	14	13	17	6	3	1	6
Debits	5	11	19	12	13	4	9
Total, Groups A to B	-3 178	-1 132	-1 381	-2 966	-2 940	-2 231	-2 771
C. Financial account	1 003	2 594	2 915	4 178	4 525	2 515	10 116
Direct investment	1 118	3 193	5 879	5 356	5 397	3 453	7 583
Abroad ³	-24	-113	-84	-47	-107	-102	-144
In the Czech Republic	1 142	3 305	5 963	5 403	5 505	3 555	7 727
Portfolio investment	910	954	-1 336	-1 922	1 028	551	548
Equity securities (net)	355	1 069	-1 229	-560	970	415	-527
Debt securities (net)	555	-115	-107	-1 363	58	136	1 075
Financial derivatives	0	0	0	-39	-97	-28	-117
Assets	0	0	0	-126	-280	-91	-534
Liabilities	0	0	0	87	184	62	417
Other investment	-1 025	-1 553	-1 629	783	-1 803	-1 460	2 101
Long-term (net)	411	-1 766	-693	-162	105	-86	634
Short-term (net)	-1 436	213	-936	946	-1 908	-1 374	1 467
Total, Groups A to C	-2 175	1 462	1 534	1 212	1 585	284	7 344
D. Net errors and omissions	638	248	32	-328	413	410	-394
Total, Groups A to D	-1 537	1 710	1 566	885	1 998	695	7 486
E. Change in reserves (-increase)	1 537	-1 710	-1 566	-885	-1 998	-695	-7 486

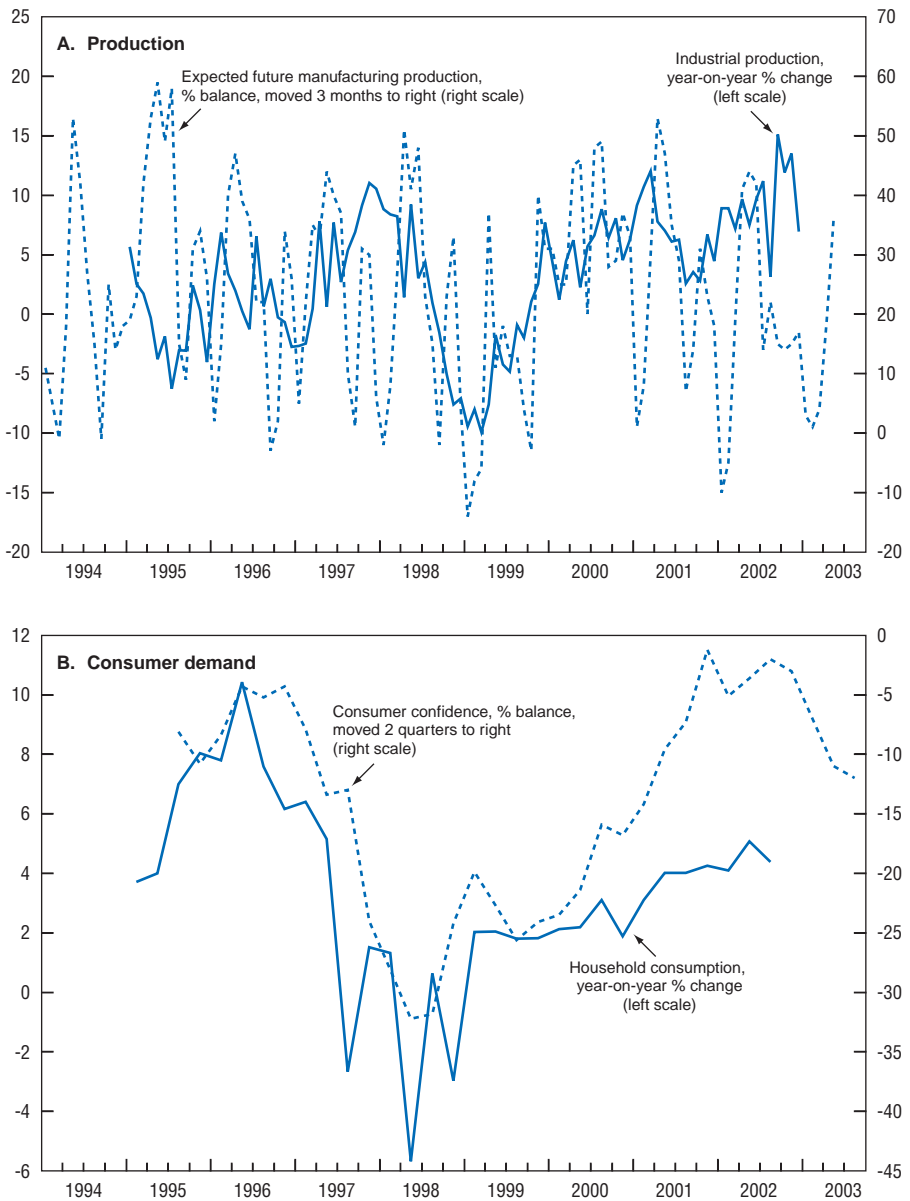
1. Based on the 5th edition of the *Balance of Payments Manual* (IMF 1993).

2. Based on data published by the Czech Statistical Office: 1996-1998 according to methodology for customs statistics in effect from 1.1.1996; 1999-2000 according to revised methodology for customs statistics in effect from 1.7.2000.

3. Adjusted outflow of direct investment capital (based on the results of a survey of the corporate sector).

Source: Czech National Bank, ARAD database (http://wdb.cnb.cz/cnbeng/docs/ARADY/HTML/index_en.htm).

Figure 8. Private sector sentiment



Source: OECD, *Main Economic Indicators, Quarterly National Accounts*.

declined somewhat. However, this slowdown may be short-lived as large investment projects in the automotive and electronics sectors are scheduled to come on stream in 2003 and 2004. If these projects are implemented in full size, the slowdown will have been temporary, coinciding with the subdued expectations in the second half of 2002 and the disruption caused by the floods. Expectations of manufacturers are consistent with an improvement in both production levels and exports in the final quarter of 2002, while consumer expectations remain stable (Figure 8).

The outlook

In cyclical terms, strengthening recovery in western Europe and the expected resurgence of FDI should result in an export-driven rebound, with GDP growth picking up to over 3 per cent in 2003 and 2004. This would be consistent with a reduction of the output gap by almost 1 percentage point in 2003 and its disappearance in 2004 (Table 6). Risks concern competitiveness of the supply side, already hit by the strength of the koruna, but which could be further affected. Export risks could be exacerbated by a delayed recovery in western Europe.

Structurally and in a longer-term perspective, the Czech economy could follow either of three stylised paths. In a baseline scenario where the present microeconomic foundations of growth, notably the determinants of productivity growth and labour costs, are preserved, a moderate sustained growth could be obtained, prolonging the existing trends and permitting a slow catch-up to EU income levels. In this scenario employment growth would be moderate within a stagnating labour force, as new job creation would be largely offset by job losses in the downsizing and exit of lower productivity enterprises. The registered unemployment rate would remain at relatively high levels and continue to call for large social transfers. In a second scenario, worse outcomes could arise if exits of low performance activities are accelerated, no other activities replace the lost ones and the economy sees its employment rate fall toward regional averages. In this scenario productivity for the economy overall would rise more rapidly, because of the more selective survival of better performing firms. Finally, a radically different path is also possible, if microeconomic reforms significantly enhance entrepreneurship, investment and incentives to hire labour and take up work. Such a path was followed by several OECD countries during periods of high employment growth. Even though this scenario implies smaller productivity increases,¹⁸ output growth would be stronger and the national wealth might well increase more rapidly. These three prospective scenarios faced by the Czech economy are further discussed in Box 2.

Table 6. Short-term projections

	1999 current prices CZK billion	2000	2001	2002	2003	2004
	Annual percentage change Volume, 1995 prices, except where otherwise indicated					
Private consumption expenditure ¹	1 019	2.5	3.9	4.5	3.3	3.7
Government consumption	373	-1.0	3.0	2.8	2.5	1.0
Gross fixed investment	528	5.3	5.8	2.1	3.8	4.1
Final domestic demand	1921	2.8	4.4	3.4	3.3	3.4
Stockbuilding, contribution to GDP ²	6	1.3	0.7	-0.4	0.0	0.0
Total domestic demand	1927	4.0	4.9	3.0	3.3	3.4
Exports of goods and services	1 153	17.1	12.3	3.7	7.0	10.0
Imports of goods and services	1 177	17.0	13.6	4.1	6.6	9.2
Net exports , contribution to GDP ²	-24	-1.0	-2.0	-0.8	-0.3	-0.1
GDP at 1995 prices		3.3	3.3	2.5	3.3	3.5
GDP implicit deflator		1.1	5.3	2.6	2.8	3.3
GDP	1 902	4.3	8.7	5.1	6.2	7.0
<i>Memorandum items:</i>						
Private consumption deflator		2.9	3.7	1.2	1.8	2.5
Consumer price index		3.9	4.8	1.8	2.3	3.0
Unemployment rate (per cent of labour force)		8.9	8.2	7.4	7.4	7.4
General government financial balance, per cent of GDP ³		-3.4	-2.8	-4.5	-5.8	-5.7
Current account balance, per cent of GDP		-5.3	-4.6	-4.2	-4.3	-4.2

1. Includes NPISH.

2. Purchases of military aircraft in 2001 were transferred from fixed investment to government consumption to improve intertemporal comparability.

3. Change as a per cent of real GDP in previous year, actual amount in the first column.

4. OECD estimate which adjusts official data so as to improve international and intertemporal comparability.

Source: OECD.

Box 2. Three catch-up scenarios

According to OECD (2002d), Czech productivity measured by per worker GDP in purchasing power parities reached 45 per cent of the US level in the early 2000s. The OECD medium-term reference scenario indicates that the catch up will continue slowly, with output growth averaging 2.9 per cent until 2008. This is consistent with labour productivity growth of 2.7 per cent per annum, a trend decline in participation rate from 71.5 per cent in 2002 to 70.6 per cent, and the unemployment rate falling gradually to the non-accelerating inflation level of 6.8 per cent.

In the second (accelerated exits) scenario, the Czech participation rate remains consistent with the baseline while there is a net loss of three quarters of the vulnerable jobs (see Table 4) that are not replaced.* The unemployment rate hits 10 per cent by 2008 but productivity growth is stronger.

In the third (high employment growth) scenario, labour-market reforms described in Chapter IV are implemented and result in employment increases averaging 20 000 workers per annum until the end of the projection period when unemployment falls to 5 per cent, while the rate of productivity growth is slower. In this third scenario more low-skilled and older, *i.e.* less productive, workers enter employment. However, as the level of GDP depends on both productivity and employment, this scenario is superior in terms of per capita GDP (Table 7). Although the increase in employment in the high employment growth scenario may appear to be too optimistic, it is not greater than the increase implied by the government's long-term projections.

Table 7. **Alternative medium-term projections**

Scenario	Employment			Productivity			Per capita GDP		
	I	II	III	I	II	III	I	II	III
2002	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
2003	100.0	98.9	100.4	103.3	103.8	102.9	103.3	102.7	103.4
2004	100.0	98.3	100.8	107.1	107.7	105.9	107.1	105.9	106.9
2005	100.2	97.9	101.5	109.7	111.6	109.0	109.9	109.3	110.6
2006	100.4	97.6	102.0	112.4	115.6	112.1	112.8	112.9	114.4
2007	100.5	97.3	102.6	115.2	119.6	115.2	115.8	116.5	118.3
2008	100.7	97.3	103.2	118.1	123.7	118.4	118.9	120.4	122.3

1. Scenario I is the OECD medium term reference scenario. Scenario II assumes that three-quarters of vulnerable jobs disappear successively over the period projected and catch-up parameter of 2 per cent. Scenario III assumes increasing employment and catch up parameter of 1.2 per cent.

Source: OECD.

Box 2. Three catch-up scenarios (*cont.*)

This *Survey* argues that it is important to strengthen the incentives for the supply of and demand for low-skilled labour. If microeconomic and labour market reforms, including adjustments in welfare benefits and employment costs and regulations can help retain a higher proportion of older and less skilled workers in labour force and employment, the third (high employment growth) scenario may become feasible.

* Two alternative productivity catch-up paths were estimated with the aid of the following model that measures labour productivity by GDP per worker: $H(t) = (1 + \alpha) \cdot H(t - 1) + \beta \cdot [A(t - 1) - H(t - 1)]$, where H and A denote productivity in the Czech Republic and the US respectively, α is the trend growth rate of productivity of 1½ per cent per annum, t indexes time and β refers to a specific catch-up parameter. In the accelerated exits scenario, the catch-up parameter is set to 2 per cent. In the high employment growth scenario, it is set to 1.2 per cent.

Notes

1. As a result of the corporate governance shortcomings of the unconventional privatisation and banking strategies, such as voucher privatisation and government-controlled banking (“banking socialism”).
2. Inventory movements in national accounts also include an error term.
3. According to available estimates, the trend growth rate of the economy is currently around 4 per cent in Hungary, 3½ per cent in Poland and only 2¾ per cent in the Czech Republic.
4. The recently completed OECD research project on the sources of long-term growth found that the real increase in capital stock has been the single most important source of growth in OECD economies in the past decades (OECD, 2002a). The Czech economy has already an incremental capital stock/GDP ratio higher than in most other countries; however, this includes large portions of capital of undetermined economic value. Massive suboptimal capital allocation in the 1990s, both as reinvested earnings within firms subject to loose corporate governance, and investment projects financed by loans granted by state-controlled institutions outside conventional banking disciplines, helped build-up largely irrelevant capital stocks. The estimation of their share in the total capital stock is impossible but may represent a lion's share of investment effected in the 1990s.
5. The problem is less acute in the financial services industry where foreign banks already control over 95 per cent of assets. The weight of FDI firms in manufacturing has increased less rapidly but is nevertheless impressive in OECD standards; they account for about one-third of employment, one-half of sales and two-thirds of exports. However, the unfinished restructuring within the nationally controlled manufacturing subsector is large and keeps reducing the aggregate productivity level significantly (see Annex IV).
6. According to the current legislation, able-bodied welfare recipients ought to look actively for work but authorities have been unable to enforce this provision effectively.
7. These features of the labour market institutions are described and analysed in more detail in Chapter IV.
8. The unemployment rates in these four regions in the first half of 2002 were respectively 3.4 and 4.9 per cent in Prague and the surrounding area and 5.3 per cent in south-western and north-eastern Bohemia.
9. See Czech Republic Today, Intellinews, 18 July 2002.
10. Those unemployed for more than one year represent 50 per cent of the total unemployed population which is high in international comparison. A group of older job seekers that were unsuccessful in finding employment for more than four years

account for 12 per cent of involuntary unemployment. These high proportions of the long-term unemployed suggest that the skills and/or location of a sizeable portion of the unemployed need to be upgraded, if they were to be given a chance of finding jobs at present labour cost levels. In contrast, the participation of persons over 30 years in the formal education system remains close to nil, while retraining courses are dominated by the employed. See Chapter IV.

11. Structural unemployment estimates are in the neighbourhood of 7 per cent. The OECD medium-term projections use a non-accelerating inflation rate of unemployment (NAIRU) of 6.8 per cent for the Czech economy. Assertive reforms in labour markets, notably labour tax cuts re-activating the demand for low-skilled labour, and regional reforms making high unemployment areas better accessible to outside investment and facilitating outward labour mobility, would lead many unemployed to move back to effective labour reserves. The Czech Republic has already improved the accessibility of many of its lower employment regions to foreign direct investment and needs to carry on these efforts. Effective training policies on a larger scale would also help (see Chapter IV).
12. Approximately from \$190 to \$210 – *e.g.* within the range of minimum wages in Poland and Hungary.
13. According to press reports, the Minister of Industry and Trade had advocated a more limited increase of 3.5 per cent, employers wanted no change while trade unions had demanded a 15 per cent hike.
14. Vulnerable jobs refer to employment in loss-making firms. Due to lack of statistical data on employment in the entire population of such firms, vulnerable employment is approximated by the number of jobs in larger loss-making industrial firms employing more than 100 workers. They account for some 7 per cent of dependent employment in the Czech Republic. For more details, see Chapter IV.
15. According to the latest Dun & Bradstreet credit rating survey completed in October 2002, the number of perfectly creditworthy (Category 1) enterprises in the total population of 4 987 rose to 422 (8.5 per cent, a jump doubling their share compared to May) while at the same time those “in jeopardy” (Category 4) also increased to 350 (6.9 per cent, also almost doubling from May). According to past records, 74 per cent of these vulnerable firms are expected to stop activities in 2003.
16. At present centrally-bargained wage guidelines are re-negotiated and implemented at enterprise level.
17. In earlier accession countries such as Greece and Portugal these EU transfers represented up to 4 per cent of GDP in certain years. However, full utilisation of these funds requires domestic participation in the funding of projects, which may be constrained by fiscal strains (see Chapter II).
18. This would happen because a second-tier of workers with below average human capital is made economically productive.
19. FDI and its positive consequences for the Czech supply structure also play a role.
20. As most of the required catch-up in regulated prices due to better cost-recovery is already completed in the Czech Republic – notably in energy and telecommunications – there is limited “repressed” inflationary pressures in this section of the consumer basket, as a difference from other countries in the region. Future pressures are nevertheless expected in pharmaceutical and housing prices (see Chapters III and IV).
21. This safeguard did not need to be exerted to date.

22. See Kovacs (2003).
23. Given some legal aspects of the second requirement of the agreement, which were refined in May 2002, the obligation of the collection of 20 per cent of all privatisation proceeds started to be enforced only from June 2002 (after the Transgas privatisation). In other words, only the conversion part of the agreement has been implemented in 2002.
24. By the end of 2002, this agreement was actually implemented only as regards the conversion channel (*i.e.* off-market, bi-lateral transactions) while the bulk of the privatisation receipts were actually converted, the government paying CNB the agreed fees and CNB sterilising the growth in monetary base through its two-weeks repo facility.
25. Monetary authorities estimate that the trend real appreciation rate has decreased and is closer to 4 per cent per year. This deceleration may be explained by the maturation of the first wave of post-transition shocks and the possible narrowing of productivity differentials between manufacturing and service sectors. Even if the precise calculation of an equilibrium appreciation rate is elusive, CNB uses several indicators to diagnose the gap between actual and equilibrium appreciation – including mark-ups and competitive performance in the enterprise sector.
26. The unadjusted credit supply kept falling due to the impact of exchange rate and one-off factors related to the earlier restructuring of bank credit portfolios.
27. The interest rate channel in the monetary transmission mechanism in the Czech Republic works through CNB basic rates via interbank market interest rates (PRIBOR) to credit and deposit interest rates for clients. This relation is verified econometrically for the period of the big interest rate slow-down (in the period July 1998-December 2002, the two weeks CNB repo rate declined from 18.30 to 2.75 per cent, one year PRIBOR from 15.8 to 2.6 per cent, interest rates for newly granted credit from 16.0 to 2.6 per cent and for deposit from 11.0 to 2.2 per cent). Controlling for other factors, CNB estimated that a decrease in nominal short-term interest rates by 25 basis points induces a rise in inflation four quarters later of 0.3-0.4 percentage points.
28. Net aggregate outcomes of restructuring do not only depend on the rate of exits of low productivity firms, capital and employment, but also on their pace of recycling into higher productivity activities.
29. ERM II excludes the current free floating regime without a mutually agreed central rate, it re-establishes the exchange rate as an operational target. If the Bank were to choose the “right” reference rate, then it could remain fixed until the country joined the euro-zone.
30. The real rate of appreciation of the currency is driven by the catching up process, but the combination between inflation and nominal appreciation to achieve it depends on the monetary and exchange rate regime selected. Like other transition and EU accession countries the Czech Republic is at this stage implementing a low inflation target and floating (and appreciating) currency, but its future participation in the ERM II and subsequently in the EMU will reduce the room for appreciation. The additional margin remaining for higher inflation will also be limited by EMU rules but at that stage the natural (equilibrium) appreciation rate will be further reduced and can be more easily accommodated. Any brisk appreciation in the course of this adjustment path may take the rate of appreciation above equilibrium, with unwelcome consequences for the real sector if firms do not exhibit sufficient downward price and wage flexibility.
31. The authorities use the GFS86 methodology for fiscal policy evaluation because cash-based government accounts are available promptly and the national budgetary classi-

fication is compatible with them, allowing for quick inter-temporal comparisons of expenditures and revenues (see Annex I). In contrast, the ESA95 framework that is fully compatible with Czech national accounts is more suitable for the fiscal policy stance assessment but is more demanding in terms of statistics, economic analysis and accounting.

32. The previous OECD *Economic Survey of the Czech Republic* (2001, p. 112) included a special chapter on fiscal spending reforms. Its main recommendations included budgetary reform, systematic programme evaluation and improved transparency.
33. This Fund was included in the general government sector since 2001. An act passed in 2000 has changed its main activity to distribution of subsidies. Up to 2000 the Agriculture Fund was included in the non-financial corporations sector because its main activity consisted of market intervention operations.
34. Fourteen elected regional governments were created by a new Law on Territorial Government. District offices, which represented the central government but were part of local governments until 2000 were phased out by the end of 2002, and part of their assets and personnel were transferred to the regional governments.
35. International fiscal reports exclude these privatisation-related expenditures and revenues from the scope of the fiscal stance, treating them "below the line" (see Annex I).
36. With regard to its income per capita level.
37. Hanousek and Palda (2002) suggest that the total tax burden may be resented by large segments of the population and tax avoidance and tax evasion may have increased. However, there is no further evidence on this issue.
38. And a registered unemployment rate of 9.9 per cent, inflation rate of 2 per cent and wage growth of 5.5 per cent.
39. This figure does not include a pending investment loan by the European Investment Bank for flood reparations and the related government spending. The transaction will be included in the general government accounts when approved by Parliament.
40. OECD projection.
41. Such as foreign and domestic private business investment.
42. On the basis of last decade's records, the elasticity of general government deficit to GDP expressed as a percentage of potential GDP may be estimated at between 0.7 and 0.9 per cent. However, this estimation is fragile because of lack of sufficiently stable cyclical GDP and fiscal records (see Table 12).
43. Outstanding liabilities of CKA for bank cleaning purposes are estimated at around 10 per cent of GDP, in addition to a similar amount that has already been disbursed.
44. Act on Budgetary Rules (218/2000). Only transfers to local governments are included.
45. With the exception of "environmental guarantees", which remain non-transparent in this document.
46. The medium-term budgetary outlook was introduced for the first time in 2001 and this practice continued in 2002, this latest outlook covers the time period 2003-05.
47. The medium-term outlook includes information on the yearly balance of the pension system but no estimates of the present value of longer-term PAYG deficits. Projections by the OECD Secretariat (see Box 5 and Chapter III) point to the likelihood of a total social-security deficit amounting to 6-8 per cent of GDP over the coming decades if entitlements or contributions are not modified. This is a tremendous fiscal challenge which begs for policy response. Generational pension accounts were introduced in the

United States in 1993, followed by Germany, New Zealand, Norway, Sweden and the United Kingdom. Governments of Australia and Canada estimate implicit liabilities stemming from their public pension systems on a regular basis. In Hungary, since the late 1990s the annual state budget includes an attachment with a 50-year pension projection.

48. By contrast, domestic political pressures for fiscal consolidation have been rather slight.
49. Such a reform would help restore the financial sustainability of the public pension system and if it were implemented, the consolidated deficit could fall below 4 per cent of GDP by 2005 (see Box 5). The previous *Survey* described how actual pension expenditure exceeded the minimum amounts implied by indexation rules. See OECD (2001).
50. The responsiveness of health care services to society's preferences determines their allocative efficiency, and their capability to minimise costs at given quality their technical efficiency.
51. Health services and products funded from private sources and excluded from the scope of social insurance will be labelled, through this chapter, "complementary services". This includes services or comfort elements, which are not considered as medically necessary (and therefore not reimbursed) and medically necessary services which are demanded outside the public health system for non-medical reasons (such as convenience of access, preference for certain technologies, etc.). Services considered as "complementary" in many other countries are in the Czech Republic either categorised as "medically necessary" or altogether banned – as there is practically no free market for privately funded health care.
52. Relatively small interregional differences in life-expectancy may be related to differences in environmental, working and living conditions – for instance northern Bohemia has suffered from intensive combustion of poor quality coal. Improvements in health status seem to benefit to all age groups and there is no evidence of noticeable inequalities across social groups, other than the discriminating influence of education. There are symptoms of health status differences according to ethnic origin (the Roma minority might be disadvantaged) but no study has checked if differences remain after controlling for education.
53. Even in these areas however, mortality rates are less than proportional to incidence rates in international comparison – possibly pointing to the ability of care providers to deal with the detected cases. Improvements may also be due to the availability of modern technologies and drugs following liberalisation.
54. During 1919-24, the newly independent Czechoslovak Republic was one of the first countries to extend obligatory health insurance to the entire wage-earning population. In 1966, the Czechoslovak law on health services promised full and free health care services on the basis of citizenship alone (and not according to employment status and employer affiliation as in other socialist countries). The "Basic Charter of Citizen Rights" of 1990, which is a part of the post-transition Constitution, re-asserted the principle of free and equal health care. Article 31 declared: "Everybody has the right to the protection of his/her health. Citizens are entitled under public insurance to free medical care and to medical aids under conditions set by law." Health insurance entitlements are therefore defined by law and not by government policies and regulations.
55. It must be admitted that the health status of the population depends only partially on the quality of health services. It is equally influenced by factors such as income levels,

education, nutrition, working conditions etc. Diets have considerably improved, compared to the late 1980s when the Czech population had a very low consumption of fruits and vegetables, 37 per cent of the population smoked, and the levels of blood cholesterol were the highest in Europe. In 2000 by contrast, the Czechs consumed 155 kg of fruits and vegetables per capita against 132 kg in 1993, the largest improvement in OECD countries. Nonetheless, the upgrading of treatments (including emergency interventions and surgeries) and medication (including the administration of more effective drugs) had major effects, in particular in the area of circulatory diseases.

56. For example, the losses incurred by the two large Prague hospitals equalled their annual turnover. In the course of the big payments crisis some providers refused to offer services without direct cash payments by patients, a big step back from social insurance.
57. Capitation payments follow service flows to the extent each physician provides a "coverage service" to a variable pool of patients and is paid in proportion.
58. Only certain over-the-counter drugs, categories of aesthetic surgery, in-vitro fertilisation, sophisticated dental care and certain medical devices are paid out-of-pocket, under maximum price regulations. They make up only a small share of health expenditures (8.6 per cent).
59. The "equilibrium" amount of health care resources remains unknown, as markets for privately-funded services are not authorised. With demand for health care by certain population groups being highly income elastic, additional demand is likely to develop in an environment of liberalised transactions.
60. This is confirmed formally in the annual report of the General Health Insurance Fund, 2000.
61. After eliminating the outliers, and referring to the third most stringently endowed region in each medical speciality as a benchmark for others.
62. The approach adopted here fails to control for the special status of the Prague area as a medical excellence centre, necessarily a more intensive employer of sophisticated human and technological resources. Yet anecdotal evidence reveals that the region, beyond its technological sophistication, also suffers from mainstream excess capacity.
63. Leaves of absence are compensated from the very first day, at a "social income" rate calculated as a percentage of the minimum wage. This income may assure a replacement rate superior to 100 per cent for low wage earners, as it is also paid during weekends and holidays. Large numbers of low-income workers take sick leave for weekend periods (when they do undertake undeclared work, including on the surrounding Fridays and Mondays). Sick leaves are also utilised to postpone job cuts by declining firms.
64. The Czech social-security administration employ physicians who check sick-leave claims on a random basis. However, the low number of such controllers and the frequent collusion between the sick-leave claimants and their physicians preclude any detection of massive fraud.
65. Two factors underlie the higher health spending for older cohorts. First, a large proportion of health expenditures are incurred at the end of the life cycle. This effect concerns therefore only the oldest cohorts, and not the generations below them, even if they are also ageing. Secondly, older and frailer population groups generally recourse to more frequent services and many health technology innovations cater to their needs.

66. Since 1998 the General Health Insurance Fund has foregone annual government subsidies of CZK 800 million to be (partly) freed from such funding responsibilities.
67. An EU-sponsored co-operation programme with Netherlands aims at transferring recent experience and know-how in the area of integrated community care.
68. Newly introduced or more widely provided care includes, hip and knee endoprostheses, advanced pacemaker implantations and bone marrow transplantation.
69. All screening tests have also a certain share of false positive results, *i.e.* subjects with a positive test but no disease, so that all positives have to undergo additional and often expensive testing.
70. Vecernik, 2001b.
71. Citizens have at present access to complementary services and products in a small number of markets in stomatology, artificial incubation, esthetical surgery and, unrestrictedly, in pharmaceutical markets where drugs with additional attributes (in addition to the fully reimbursed reference product in each therapeutic group) are paid out of pocket. In care markets *stricto sensu*, such commercial differentiation of services, including more convenient and comfortable and therefore more expensive hospital wards and examination techniques are not developed. Commercial development of such services is banned, but quality differences which naturally arise within existing capacity are arbitrated through out-of-market means, notably under-the-table payments to parties controlling access to such resources and by superior information of the elite groups who know which specialists to consult.
72. Except for “child GPs”, a well-established Czech speciality. An individual paediatrician follows a baby from birth to up to 18 years of age, providing a range of testing, preventive and referral-to-specialist services. This surveillance was compulsory before the transition and continues to be voluntarily used by large numbers of parents.
73. PPP exchange rates equalise the price of a representative basket of consumption goods and services in domestic and international markets. This adjustment does not suffice to equalise the price of health services and products to their level in partner countries, because local health prices are lower than the other domestic prices. This concerns principally physicians' and health personnel's salaries and to a lesser extent medical product prices.
74. Physicians' and other medical professions' wage claims are reinforced by the growing international standardisation and transferability of their skills, and their emigration prospects after EU accession. The Czech Medical Chamber has been energetically contesting the government intervention in medical professions' wage and fee negotiations with health insurers since 2000. Pharmaceutical producers also request faster price increases and threaten to discontinue production of the most “price repressed” products, notably generic drugs.
75. Service sector prices tend to converge internationally in proportion to productivity and wage growth across sectors (the so-called Balassa-Samuelson effect). Health sector prices will in principle converge internationally only when productivity and wage catch-up between countries will be completed. Higher labour mobility in the health sector may however accelerate this process more than in other sectors.
76. The methodology utilised in these projections is inspired by the approach taken in OECD, *New Directions in Health Policy*, 1995, which is now refined for more elaborate projections in the framework of the OECD Health Project. A similar but less detailed approach was utilised in the special chapter on health care reform of the 2000 *Economic Survey of Hungary*. Annex III provides a summary of this methodology.

77. All mandatory health insurance expenditures (even if funds are not formally in the public sector) and direct health-related spending from the state budget have been aggregated as general government expenditures. This approach is consistent with recommended national accounts principles.
78. Projected in the framework of the growth scenarios of Chapter I, Box 2.
79. This is a conservative assumption, not allowing for any “superior good” character for health care services (which would imply an above-unity elasticity of health service demand to income, at macroeconomic level). It also implies a relatively limited aggregate impact from ageing, in line with lower Czech elderly spending coefficients.
80. This is a conservative price evolution path because it projects only a domestic price equilibration process, without any direct catching up to international and European prices.
81. The Minister for Health has changed once a year from 1990 to 2001, and none of the many draft Health Acts prepared has been adopted by the government and submitted to Parliament. Health policy is a contentious area within the winning coalition since the June 2002 elections and only a very short general statement on health policies has been made by the new government.
82. It may be argued that health insurance funds are purchasing agents on behalf of the entire population. However, as health care coverage is a formal constitutional liability of the general government, health insurance funds operate as the spending agents of the general government.
83. Their boards and executives have been in charge for longer periods than government ministers. The CEO of the largest fund (VZP) has not changed since 1991.
84. The important role that they played in the 1997 “capacity norm” exercise has been a significant contribution. In line with the Ministry of Health recommendations and following this assessment VZP refused to conclude new contracts with 176 providers and terminated contracts with 130 others (Czech Association of Health Services Research, 1998). Health insurance funds have also contributed knowledge and been a negotiation party in the settlement of reimbursement rates in the DRG experiment.
85. These attempts have not been always successful. HIFs are not entitled to refuse contracts to providers except under rare circumstances and face political and regulatory difficulties in enforcing quality, performance and other standards. They nevertheless act in this direction.
86. Legal and regulatory rules and political influences do not always facilitate the utilisation of the available information. On the providers' side, information on the efficacy of treatments and the performances of alternative (and competing) providers cannot be made public on grounds of “privacy of information”. On the other hand, HIFs are entitled to present and recommend the best performing suppliers to their enrolees. HIFs also follow the drug prescription behaviour of physicians and inform them yearly on their prescription behaviour, in comparison to colleagues of same disciplines. On the patients' side, the most blatant area of waste, namely sick leaves, the identity of the physicians involved in granting the needed certificates cannot be traced by HIFs as benefits are handled by another social security agency.
87. True competition is lacking but there are strong incentives for risk selection. While 60 per cent of the premia collected are centralised in a compensation fund, risk equalisation is based on age and grouped only into two categories – ordinary enrolees and enrolees older than 65 – without regard to differences in morbidity.

88. The incentives and decision rights that the DRG system will create for hospital managers and physicians will need to be monitored. Hospital managers, now exposed to hard budget constraints, will see their governance rights strengthened. Physicians will remain less driven by financial considerations and are expected to continue to act as quality agents. Tensions between the two parties (*i.e.* between a previously secondary and previously omnipotent party) would be counterproductive and should be avoided.
89. The 11 university and teaching hospitals, which represent around 23 per cent of acute bed capacity are not affected by this law and will be managed by the Ministry of Health.
90. Regulatory safeguards will be necessary to ensure the transparency of such operations. Private investors need also to demonstrate, and financially guarantee, their ability to run these essential facilities in the public interest.
91. Hospitals had managed to obtain changes in payment mechanisms in late 1990s, shifting their financing away from FFS and restoring quasi-budget funding on the basis installed capacity. See above.
92. Labour-intensive care strategies and technologies are penalised when hospitals do not need to amortise capital and depreciation costs but need to fully fund current costs including labour and pharmaceutical inputs.
93. The Czech Republic's position in the IMD World Competitiveness Scoreboard moved from the 40th place among the 49 economies assessed in 2000 to the 29th place in 2002. See IMD (2002). The latest available comparison based on the economic freedom index and comparing 123 countries, ranks the Czech Republic in the 38th position, second to Estonia (35th position) among the transition economies. See Gwartney and Lawson (2002).
94. For instance, the three-year old government's pro-growth strategy recognised the need to improve the legal environment for doing business, corporate governance, industrial restructuring, and liberalisation of network industries and professional education. However, it has not addressed the need to improve significantly the efficiency of the public sector and work incentives.
95. Productivity growth over the 1990s was also considerably faster in Poland than in the Czech Republic. See Landesmann and Stehrer (2002).
96. For instance, a former high official appointed to implement the government's anti-corruption drive in the Ministry of Foreign Affairs was taken into custody in July 2002 and charged with embezzlement, arranging a contract killing of an investigative journalist and other crimes.
97. The 2002 corruption perceptions index for the Czech Republic has the value of 3.7 points (on the scale of 0 to 10 points between the poles of extreme corruption and its complete absence), well below 4.9 points awarded to Hungary (33th place), 6 points for Slovenia (27th place) and 9.7 points for Finland (1st place). See Transparency International (2002).
98. See Djankov *et al.* (2000). According to the data provided to the Secretariat by the authorities, the Czech performance improved considerably since late 1990s, with the average entry time declining from 97 to 67 days, the number of procedures falling from 11 to 10, and the cost of entry falling from 25 to 4 per cent of per capita GDP. The entry time can be reduced by 34 days if the applicant obtains relevant documents from the Criminal Register in Prague and the registering court personally rather than by mail;

however, this option increases the entry cost for the entrepreneurs not residing in the capital.

99. Even in case of a purchase of a pre-registered company, the records must be updated in the Commercial register with names and addresses of new owners, directors, etc. Reliable data in the publicly accessible Register improve transparency of the business environment.
100. In mature market economies with creditor-oriented bankruptcy rules such as Germany and the United Kingdom, the number of successful compositions represents about 1 per cent of bankruptcies. In contrast, the incidence of compositions is significantly higher in the debtor-oriented bankruptcy systems of the United States or France.
101. The truck maker *Tatra Kopřivnice* was sold to the US-based SDC financial group, the tractor producer *Zetor* to a Slovak entity (HTC holding), and the integrated steel mill *Nová Hul'* to the LNM holding controlled by Ispat International, the 8th largest steel producer in the world. The prospects for the sale of the second state-controlled steel mill (*Vítkovice Steel*) and its principal supplier of coke (OKD) are unclear, while a domestic group owns the remaining integrated steel mill.
102. Sales of two other firms participating in the revitalisation programme (*Vítkovice Steel and ČKD Holding*) as well as the residual part of the *Škoda* engineering group remain to be completed.
103. Each of these vulnerable firms employs more than 100 workers. See Ministry of Industry and Trade (2002).
104. For a description of the IPB collapse and its subsequent sale to CSOB, see OECD (2001), p. 144.
105. CKA is not allowed to resell bad loans to the original owners of distressed firms. According to numerous press articles, these owners are sometimes able to buy back discounted claims on their firms through a chain of transactions following the CKA block sales. See *e.g. Hospodářské noviny*, 20 November 2002.
106. Unipetrol was created by consolidating both profitable and loss-making firms in the petrochemical industry with the aim to minimise post-privatisation job losses. Provisions of the public tender for privatisation of this artificial conglomerate included clauses limiting the right of the prospective new owner to close unprofitable parts of the conglomerate for a period of eight years. Low bids reflected the impact of such restrictions.
107. Despite a simplification of customs procedures in July 2002, border crossings for trucks appear to have remained congested.
108. These dominant operators are either fully controlled by a foreign conglomerate (natural gas industry) or partly state controlled (major telecom firm) or fully state controlled (largest electricity producer and distributor).
109. Technical assistance provided by the Spanish telecommunications authority as part of an EU programme helped to somewhat offset this handicap by upgrading skills of the current CTO staff. Moreover, the government created a working group of representatives of the regulatory agencies and the respective line ministries to address the problem; this group started to meet in November 2002.
110. A subsidiary of the FNM purchased 51 per cent while the Ministry of Labour and Social Affairs acquired 15 per cent of the high-voltage grid. The latter transaction is supposed to provide the yet to be established Social Security Agency with initial funding.

111. The partial separation of the grid is insufficient to ensure neutrality as long as CEZ keeps exercising management control on the basis of its minority share.
112. The linkage between the domestic price of coal and the regulated price of natural gas appears to be unique in the OECD area.
113. CEZ makes it clear that this is the maximum price cut it considers acceptable, regardless of the price decision of the regulator. See *Profit*, 5 August 2002.
114. The energy regulator plans to remove this distortion within two years.
115. See Hájková, (2002).
116. See *Trend*, 31 July 2002, p. 6.
117. If these negotiations result in a rescue plan, the competition authority will have to assess its terms and approve the bailout only if it conforms to the state aid rules of the European Union.
118. Government-appointed administrators run two credit unions while 29 have been subjected to bankruptcy proceedings. Another 51 credit unions have been liquidated while some 90 000 clients received up to 90 per cent of their savings from a guarantee fund financed mainly by the state budget.
119. For principal features of the KCP corporate governance code, see OECD (2001), p. 149.
120. For a description of the Czech voucher privatisation and its unfavourable impact on the capital market and industrial sector, see the 1998 and 2000 *Economic Surveys*.
121. The largest bankruptcy of this kind took place a year ago, resulting in losses of CZK 2.2 billion to some 30 000 clients of the KTP Quantum brokerage. Its chief executive has been in custody since May 2002. See *Respekt*, 16 December 2002.
122. See Hanousek and Podpiera (2002).
123. According to the labour force survey data, the group of registered unemployed who are either unable or unwilling to work grew from 35 to 57 thousand persons between the first quarters of 2001 and 2002, *i.e.* by 60 per cent.
124. At the same time, delayed retirement was made more attractive by increased benefit levels.
125. This initiative appears to have been inspired by the UK programme for unemployed school leavers.
126. In addition to the MLS benefit paid by the state, welfare recipients also qualify for housing and other benefits provided by local authorities. Therefore, the incentive to accept a minimum wage job is quite weak.
127. Another 100 000 foreigners work in the Czech Republic legally. Over one-half of them are Slovak citizens who need no work permit, given the bilateral labour-market agreement between the Czech and Slovak Republics.
128. The government has submitted recently to Parliament an amendment to the Act on Social Needs (No. 4821/1991) that regulates welfare benefit levels. The amendment stipulates that only 70 per cent of earned income should count in the calculation of the welfare benefit, motivating recipients to seek low-paying jobs. While the amendment would somewhat improve work incentives, it is unclear whether Parliament will adopt it.
129. The poor maintenance of housing estates has already resulted in growing transfers on an *ad-hoc* basis.

130. "Rent control is so effective a means to devalue collateral that on the eve of execution or bankruptcy debtors frequently have been renting out their property." Schönfelder (2001), p. 414.
131. The estimated increase of employment (50 000) persons would generate budget savings that are equivalent to 1 per cent of GDP. *Prague Business Journal*, 2-8 December 2002, p. 5.
132. The sickness insurance scheme is also available on voluntary basis to self-employed persons.
133. The experience of Flextronics, a multinational manufacturer of electronic products, provides a good illustration of the problem. Once the firm announced that it would close its plant in Brno (the second-largest Czech city), the incidence of sick leave increased so drastically that labour had to be imported from neighbouring Slovakia at higher cost, in spite of high local unemployment in Brno.
134. The number of non-unionsed employees affected by administrative extension of sectoral agreements increased from 173 000 in 2000 to almost 270 000 per annum in 2001 and 2002 (i.e. 8½ per cent of the dependent employment registered in the business sector).
135. At the same time, self-employment is promoted by artificially low social-security contributions that remain below the levels paid by minimum-wage earners.
136. See ([http://pisa.oecd.org/Docs/Download/PISA2001\(english\).pdf](http://pisa.oecd.org/Docs/Download/PISA2001(english).pdf)).
137. Growing because the fertility rate of the Roma minority and its age structure imply a much faster population growth than that of the non-Roma majority. See Kalibová (1999).
138. According to feedback received by the CzechInvest agency, some secondary and post-secondary education programmes have become increasingly divorced from labour-market realities, resulting in growing numbers of graduates with irrelevant skills and shortages of those whose technical skills and language abilities are needed in the private business sector.
139. Some measures to remedy the problem are to be provided in the draft of a new Act on Teaching Staff that is to be submitted to Parliament in the first half of 2003.
140. The number of employees in the public administration sector increased steadily from 132 675 in 1993 to 182 358 persons in 2001.
141. In a limited way the European Union also provides some funding (ISPA and optionally SAPARD for local infrastructure).
142. Apart from road tax, a percentage of the excise duties on hydrocarbon fuels and lubricants, and user fees on some motorways.
143. The current law provides for a 10 per cent cost advantage for domestic bidders that may result in unnecessarily high project costs.
144. While the Czech Republic's tax to GDP ratio is only a little higher than the OECD average, it exceeds by 5 percentage points the average of the low-income group of member countries that includes Hungary, Greece, Korea, Mexico, Poland, Portugal, Spain, Turkey and Slovakia. This finding is consistent with a recent study of the World Bank on taxation in transition economies (Mitra and Stern, 2002).
145. The planned changes in VAT and excise duties are driven by the need to harmonise Czech tax regulations with those of the EU. The Finance Ministry's medium-term revenue projections indicate that these changes will not generate enough revenues to allow deep cuts in profit and social-security taxes.

Glossary

AUT	Austria
AUS	Australia
BEL	Belgium
CAN	Canada
CHE	Switzerland
CEZ	Czech Power Company
CKA	Czech Consolidation Agency
CNB	Czech National Bank
CSO	Czech Statistical Office
CZE	Czech Republic
CZK	Czech koruna
DEU	Germany
DNK	Denmark
ESP	Spain
EUR	Euro
FDI	Foreign Direct Investment
GBR	United Kingdom
GFS	Government Finance Statistics
GRC	Greece
FIN	Finland
FRA	France
HUN	Hungary
HIF	Health Insurance Fund
IMF	International Monetary Fund
IRL	Ireland
ISL	Island
ITA	Italy
JPN	Japan
KCP	Czech Securities Commission
KOR	Korea
LUX	Luxembourg
MEX	Mexico
MoF	Ministry of Finance
NOR	Norway
NLD	Netherlands
NZL	New Zealand
POL	Poland
PRT	Portugal
SNA	System of National Accounts

SVK	Slovakia
SWE	Sweden
TUR	Turkey
USA	United States
VZP	General Health Insurance Fund of the Czech Republic

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BASIC STATISTICS OF THE CZECH REPUBLIC¹

THE LAND

Area (sq. km)	78 864	Population of major cities (thousands) (1.1.2000)	
Arable land (sq. km)	42 798	Prague	1 186.9
		Brno	383.6
		Ostrava	321.2
		Plzeň	167.5

THE PEOPLE

Population (thousands, 31 December 2001)	10 206	Civilian employment by sector	
Number of inhabitants per sq. km	129.4	(% of total, 2001)	
Annual population growth, 1996-2001 (%)	-0.02	Agriculture	4.8
Employment (thousands, 2001)	4 707	Industry	40.4
		Services	54.8

THE PARLIAMENT

Chamber of Deputies, as at March 2003 (number of seats)

Social Democratic Party	70	Freedom Union/Christian Democratic Union	31
Civic Democratic Party	58	and People's Party Coalition	
Communist Party	41	Total	200

THE PUBLIC SECTOR²

% of GDP, 2002

Current receipts	40.9	Total expenditure excluding net lending	46.2
Direct taxes	9.8	Government consumption	21.7
Indirect taxes	10.3	Subsidies to enterprises	2.4
Social security contributions	16.1	Social security benefits	13.5

PRODUCTION

GDP (\$ million, 2001)	56 754	Structure of production (% of GDP, 2001)	
GDP per capita (\$, 2001)	5 561	Agriculture	4.2
Gross fixed investment (% of GDP, 2001)	28.3	Industry	40.0
		Services	55.8

FOREIGN TRADE

Exports of goods and services (2001)		Imports of goods and services (2001)	
(\$ billion)	40.5	(\$ billion)	42.0
(per cent of GDP)	64.9	(per cent of GDP)	68.2
Main merchandise exports (% of total, 2001)		Main merchandise imports (% of total, 2001)	
Machinery and transport equipment	47.4	Machinery and transport equipment	42.2
Manufactures	24.3	Manufactures	20.2
Chemicals	6.4	Chemicals	10.9
Other	21.9	Petroleum products	9.1
		Other	17.6

THE CURRENCY

Monetary unit: Czech koruna		Currency units per \$	
		Year 2001	38.0
		Year 2002	32.7
		Feb. 2003	29.4

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

2. Data are based on the OECD-adjusted general government accounts which differ from but are based upon the Czech Ministry of Finance data produced in accordance with the IMF's Government Financial Statistics.

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•

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•

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