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IS THE CZECH ECONOMY READY FOR EUROPEAN UNION ACCESSION?

ABSTRACT

The present economic situation in the Czech Republic may be described as 'a miracle that did not materialise.' It is emphasised that the causes of the present economic difficulties are not related to the systemic transformations implemented, rather they lie mainly in the micro-economic sphere, the inadequacy of the legal framework of the economic reform, and the 'capital concentration process.' Although capital markets have been set up, they lag behind other emerging markets like the Polish and Hungarian, particularly with respect to transparency and credibility.

Key words: Maastricht convergence criteria, market economic, investment funds, economic reforms, legal framework

The Czech Republic and the European Union

Before 1989 the relations between the Czechoslovak Socialist Republic and the European Communities did not exist in the sense of international law. Communist Czechoslovakia nevertheless had bilateral diplomatic relations with all the member states of the European Communities, and trade relations with individual EC countries were also bilaterally based. Before the fall of the Berlin Wall, the turnover of mutual trade was relatively small and political relations were very much influenced by the omnipresent communist ideology. The European Communities were looked upon by communist countries as one of the instruments of transnational corporations for domination of the world economy and as one of the tools of world imperialism. The so-called capitalist integration taking place in Western Europe was seen as a negative and temporary phenomenon, as opposed to the allegedly highly positive socialist integration taking place in the eastern part of the continent. The ideological tensions between the EC and Comecon countries eased somewhat after the start of Gorbachev's Perestroika in 1985, and especially after 1988 when diplomatic relations between the EC and all the individual Comecon members were established.

Shortly after the collapse of communism, most countries in Central and Eastern Europe started to consider membership in the EC as one of the main goals of their foreign policy, and Czechoslovakia was no exception in this respect. Today, 8 years since the beginning of political, economic and social transformation in the CR, accession to the EU together with NATO membership remain the two highest priorities of Czech foreign policy.

The process of integration of the CR into the EU is part of a wider process of integration into European and Euroatlantic structures. Czechoslovakia, and later the CR, has gradually joined the most relevant international and intergovernmental institutions and organizations, such as the IMF, World Bank, Council of Europe, OECD, etc. This process is taking place in the political, economic, legislative, social and even cultural, scientific, ecological and other spheres.

Diplomatic relations between the EU and the CSSR were first established in September 1989 and with the CR in January 1993. The first document regulating the mutual economic relations was the Trade and Cooperation Agreement concluded with the CSFR in 1990 (succeeded by the Interim Agreement). The present contractual relationship between the Czech Republic and the European Union is regulated by the Europe Agreement (EA) which was signed with CSFR in 1991 and the CR on October 4, 1993, and which entered into force on February 1, 1995. In the meantime, the trade related part of this agreement, which aims at creating a free trade area, entered into force on March 1, 1992, in the form of an Interim Agreement. The validity of the Interim Agreement was terminated by the activation of the EA.

The EA is a preferential agreement, of which the trade part aims to establish a free trade area over a maximum period of 10 years, on the basis of reciprocity by the CR and asymmetry by the EU, i.e. more rapid liberalization on the side of the EU. Free movement of goods requires above all a legal regulation of the process of creating a an atmosphere of free competition with the possibility of temporarily using certain protective measures (in order to eliminate serious disproportions on the market and to assure protection of newly established production).

Economic integration requires as a necessary condition not only the creation of certain economic prerequisites but also a respective and approximately identical legal climate, which will involve more or less all fields regulated by the Agreement. This also includes customs law, direct and indirect taxation, business law, protection of inventions and trade marks, environment and safety and technical rules and standards. The EA takes the objective of future membership of the CR into account and provides a framework for the CR's gradual integration into the Union. Besides the objective of future membership, it differs from the association agreements concluded with Turkey, Malta and Cyprus also in the fact that it includes regulations concerning the political dialogue, culture, science and technology.

Before 1990, most of the Czechoslovak foreign trade was oriented towards the Comecon countries, especially the Soviet Union. Since the beginning of the transformation, Czechoslovakia, and later the Czech Republic, has lost a big part of these markets. In 1996, 67.3% of the Czech foreign trade turnover was with developed market economies. With EU countries it was 60.5%. The share was 58.2% for exports and 62.4% for imports. The biggest foreign trade partners from the EU have been Germany, Austria, Italy, France and the United Kingdom.

As far as foreign direct investment (FDI) is concerned, in the period 1990-1996, 7.1 billion USD came to the CR. In 1996 it was 1.4 billion USD. The share of OECD countries in FDI in the CR in the period 1990-1996 was 96.9%; of that, the EU countries' share was 69.1%. In 1990-1996, the biggest investors from the EU were Germany (27%), the Netherlands (14.5%), France (7.8%), Austria (7.3%), and Belgium (3.9%). In 1996 the biggest EU investors were the Netherlands (18.2%), Germany (17.5%), Italy (14.6%), and Austria (6.3%).

As can be seen above, from the point of view of foreign trade and foreign investment, Czechoslovakia and later the Czech Republic has been gradually more and more connected with the EU economy, even without being a full member. Full membership will mean a further increase of trade relations with EU countries, as well as more direct and portfolio capital inflows from the EU to the CR, but also Czech capital outflows to the EU. Moreover, integration effects can be expected in all the other areas of economy.

Two important events that added a new quality to the CR-EU relationship happened in 1996. In January, the Czech government presented its application for EU membership, accompanied by a Memorandum. At the end of July, the Czech government presented detailed answers to the European Commission questionnaire. These answers served as one of the important sources of information for preparing the "avis" - the opinion on the CR as an applicant for membership. These two events resulted in the fact that the CR now finds itself in the pre-negotiation stage.

Shortly after 2000, the EU faces the prospect of its enlargement by a first wave of probably 6 countries (the Czech Republic, Poland, Hungary, Estonia, Slovenia and Cyprus). Later, Romania, Bulgaria, Lithuania, Latvia and Slovakia are expected to follow in the second wave. The December 1997 Luxembourg Summit decided that negotiations will start with only 5 selected CEECs in spring 1998 but no country from the group of ten is excluded from the negotiations in general.

Two stages of integration into the European Union

The process of integration of the Czech Republic and other Central and East European countries into the European Union has two main stages. In the first stage, the associated country is expected to meet the so-called Copenhagen criteria before it can become a full member; in the second stage it is supposed to fulfill the Maastricht convergence criteria before entering the European Economic and Monetary Union and thus accepting the single European currency - the Euro.

As far as the first stage is concerned, following Copenhagen criteria (aside from the political ones) are especially relevant from the point of view of the Czech economy:
- Establishment of a functioning and effective market economy.
- Capacity to cope with competitive pressure and market forces within the Union.

In the Agenda 2000 where an avis on the CR's readiness to enter the EU was expressed, the following evaluation can be found:

"The Czech Republic can be regarded as a functioning market economy. Market mechanisms operate widely, and the role of the state in the economy has been completely changed. Substantial success has been achieved in stabilising the economy. Unemployment is among the lowest in Europe. However, as the recent emergence of macroeconomic imbalances has shown, further progress will need to be made over the next few years, notably in strengthening corporate governance and the financial system... The Czech Republic should be able to cope with competitive pressure and market forces within the Union in the medium term, provided that change at the enterprise level is accelerated. The country benefits from a trained and skilled workforce, and infrastructure is relatively good. Investment in the economy has been high in recent years, with foreign investment also strong. The country has successfully reoriented its trade towards the West. Although the quality of exported goods is improving, their value added is low. The banking sector is dominated by a few, partially state-owned banks and its competitive position is not strong. The main challenge for the Czech Republic is to press on with enterprise restructuring in order to improve the medium term performance of the economy and as a way of redressing the imbalances on the external side."

As far as the second stage is concerned, it should not be too difficult for the CR to qualify once the first stage is successfully achieved. Already in 1995, the CR fulfilled 4 out of 5 Maastricht convergence criteria,[1] with the exception of the inflation rate of 9.1% (the criterion in 1995 was 2.4%); the state budget surplus was 0.4% of GDP (the criterion is a deficit not greater than 3% of GDP); the public debt was 17.5% of GDP (the criterion is a debt not greater than 60% of GDP); the interest rates on long-term government bonds were 8.9% (the criterion was 9.5%); and monetary stability was remarkable: maximum minus divergence CZK/DEM was -4.7% while the required criterion is +-15%. As can be seen, the CR could be able to fulfill relatively early all the convergence criteria after it enters the EU.

Czech Republic and EMU

An essential question is: when will the benefits of participating in the EU prevail over the costs from the point of view of the CR and other CEEcs? In this respect, the fulfillment of convergence criteria is a necessary, but not sufficient condition. The main benefits are lower transaction costs and elimination of the exchange rate risks.

The costs are connected above all with the loss of the exchange rate as an important instrument of monetary policy. The negative consequences of a rapid Monetary Union can be seen on the case of the Eastern part of Germany. Above all, the CR should reach a reasonable level of equilibrium with the current and capital accounts of the balance of payments, which would express a sufficient competitiveness of its exports and its attractiveness to foreign investors. It is also desirable that the exchange rate deviation index (ERDI)[2] show a trend towards a rapid narrowing of the gap between exchange rates and purchasing power parities, and indirectly between domestic and world prices.[3] The USD-based ERDI coefficient was 2.1 in the CR in 1996. For comparison, the ERDI (USD-based) amounted to 1.2 in Portugal in 1995. In the process of structural transformation, a gradual convergence of Czech and EU price levels and relations has been taking place. Generally, the ERDI of any country differs according to the currency which is used as a base, and according to various types of goods and services. In Table 1 the ERDI of GDP in the Czech Republic in 1993 compared to Austria can be seen.

As to interest rates, they are very high as compared to those in most EU countries. This can of course to a large extent be explained by a higher rate of inflation. Once the inflation goes down, so will the interest rates. What is, however, worrying, are the excessively high differences between interest rates from loans and interest rates from deposits. Interest rates from loans are too high and discourage entrepreneurs. On the other hand, interest rates from deposits are often "negative," i.e. they are lower than the inflation rate, and thus they discourage people from having higher savings. A certain cure for this can be a competition from the side of branches of foreign banks. Therefore it can be very beneficial for the whole economy, if their presence in the country significantly increases. Thus far, too many obstacles have existed in this respect. Strong domestic lobbyist groups have naturally feared foreign competition.

Table 1
ERDI (ATS-based) of GDP expenditures in the CR in 1993

	ERDI
GDP total	3.32
Individual consumption by households of which:	3.76
- food, beverages, tobacco	2.81
- clothing and footwear	2.70
- gross rents	10.10
- household equipment and operation	2.54
- personal transport equipment	1.22
Collective consumption by government	3.08
Gross fixed capital formation of which:	2.38
- construction	4.42
- machinery and equipment	1.16

Source: European Comparison Programme 1993.

Table 2:
Comparative price levels in CEE-5 compared to EU-15 and USA in 1995

	EU-15 = 100	USA = 100
Czech Republic	37.6	46.0
Hungary	53.2	64.9
Poland	46.0	56.2
Slovakia	36.4	44.4
Slovenia	73.8	90.1

Source: Czech Statistical Office.

It is no less important that the Czech economy becomes significantly stronger in terms of GDP per capita before it joins the EMU, even though many economists tend to underestimate this factor. In 1996, the Czech GDP per capita was 5,446 USD at exchange rate and 11,266 USD at purchasing power parity, i.e. 59.3% of the EU average (according to the Czech Statistical Office). For comparison, the GDP per capita in PPP in 1996 was 18,910 USD in the EU-15, 20,784 USD in Germany, 12,417 USD in Greece, 12,768 USD in Portugal, 11,161 USD in Slovenia, 6,827 USD in Hungary, and 5,939 USD in Poland (Havlik et al., 1997).

In an interview for the Czech economic daily "Hospodárské noviny" (14.1.1998), when asked about when the CR could become a member of EMU, the chief economist of the Deutsche Bank Group Norbert Walter answered that not before 2005 and more likely around the year 2010. Indeed, this date can be considered as realistic with respect to the readiness of the CR to introduce the Euro with all the consequences that may be related to this step. The EU certainly needs a sufficiently long time-series of relevant data and proof about the consistency of Czech economic policy and sustainable macro-economic stability.

The main transformation steps

Before 1989, Czechoslovakia had a typical Soviet-model centrally planned economy where almost all prices were administratively set, the share of the private sector in the creation of GDP was negligible, the currency was not convertible, there existed a complicated system of multiple exchange rates, the unemployment rate was officially zero as practically no enterprise could go bankrupt in an environment of soft budget constraints, inflation was very low, and above all there was a priority of political decisions over economic considerations. As a whole, the Czech "socialist" economy (the same goes for all the other centrally planned economies) was highly inefficient and ineffective and there were permanent shortages of almost everything. Therefore it was necessary to undertake radical reform and transform the economic system and all its components completely. The main transformation steps in the economic sphere have been the following:

- Macroeconomic stabilization by means of restrictive monetary and fiscal policy.
- Liberalization of prices.
- Small-scale and large-scale privatization and consequent restructuring of the economy.
- Liberalization of foreign trade.
- Internal and external convertibility of the currency.
- Tax reform (e.g. introduction of VAT).
- Establishment of standard market institutions (e.g. commercial and investment banks, stock exchange, pension funds etc.)

Major transformation steps which have been taken so far, have formed, when put together, a very consistent program of economic reform. Looking retrospectively at the whole period 1990-1997, it can be stated that on the one hand, all the basic systemic changes have already been accomplished, but on the other hand none of the transformation steps has been concluded completely. It can be said in a simplified way that radical economic reform is more or less over but the complex transformation process continues and will do so for many years.

According to official data, the share of the private sector in the creation of GDP is around 75%, but a significant proportion of the equity of the four major commercial banks is still owned by state institutions. Given the fact that these banks are holding major stakes in many investment funds which, in turn, hold controlling stakes in many private companies, a large number of allegedly fully privatized large enterprises are still indirectly controlled by the state. These interlocking ownership relations, which often lack transparency, are one of the major obstacles to a quicker restructuring of large Czech firms. While restructuring on the micro-economic level has barely started, a significant restructuring on the macro-economic level has taken place. The structure of the Czech economy according to principal sectors already resembles that of developed market economies as can be seen from Table 3.

Table 3:
Share of sectors in the creation of GDP in 1996

Sector:	Share in %:
Industry	28
Construction	8
Agriculture	5
Services	59

Source: Prague International Securities.

On the other hand, it is fair to admit that small-scale privatization has been to a large extent successful, and has very much contributed to a new and better look of all Czech towns and villages. The sector of services has expanded tremendously since the beginning of 1990 and has improved considerably the living conditions of the Czech population.

In contrast with the macro-sphere, the micro-sphere needs an acceleration of the restructuring process very urgently. It happens very often that financial resources from profitable enterprises end up in semi-state banks, and these banks go on providing loans to loss-making enterprises that are most likely never going to be repaid. Thus profitable enterprises are indirectly subsidizing loss-making enterprises. At the same time, the bankruptcy law is imperfect and not properly enforced. As a consequence, there have been very few bankruptcies of larger enterprises thus far. Under such conditions of soft budget constraints, many large but inefficient and ineffective enterprises have been surviving comfortably, just like in the times of so-called "real socialism." Some Czech politicians and economists call this "banking socialism."

Most prices have already been liberalised, and those which have not form only around 5% of GDP. However, the impact of these still regulated prices on the consumption patterns of households and the behaviour of firms is considerable[4] because they mainly concern rents and energy prices. The deformed structure of these prices has negative impacts on labour force mobility and energy costs of Czech industrial output. They also lead to a waste of energy and environmental pollution as well as to a higher anticipated inflation than would occur under normal circumstances. One negative effect of rent control is a permanent housing crisis (shortage of flats) and a flourishing black market.

As far as currency convertibility is concerned, all current account and most capital account transactions have been liberalised, but Czech corporate entities and private individuals still cannot possess bank accounts abroad or invest in foreign securities unless they get prior approval from the Czech authorities. It is nevertheless important that the Czech Foreign Exchange Act not only meets the requirements set by the Agreement on the International Monetary Fund but even goes beyond them in the case of certain capital operations. The achievement of a nearly full convertibility of the currency together with CR's entry into the OECD on December 21, 1995, are perhaps the greatest successes of the Czech economic transformation. Another important fact worth mentioning has been the remarkable stability of the Czech currency, which lasted from the beginning of 1991, following three devaluations in 1990, until the fall of the crown in May 1997.

The actual economic development

The CR's present economic situation can be described as "a miracle that did not materialize." At the end of 1995, the Czech economy seemed to portend a long period of economic boom ahead. The GDP growth was 5.9%, the industrial growth was 8.7%, the inflation rate reached a single digit figure of 9.1%, the unemployment rate was only 2.9%, the state budget ended in a surplus of 7.2 billion CZK, and there were revaluation tendencies: the current account deficit of 1.36 billion USD was more than offset by a capital account surplus of 8.23 billion USD, the official foreign exchange reserves were 14 billion USD and gross external debt was 16.5 billion USD (which was less than the 17 billion USD of gross forex reserves).

One year later, the whole macro-economic picture looked very different. GDP growth slowed to 4.1%, the industrial growth to 6.4%, unemployment increased to 3.5%, the state budget ended up with a deficit of 1.6 billion CZK, and above all the trade deficit reached 11.5% of GDP and the current account deficit stood at 7.6% of GDP (the current account deficit was 4.29 billion USD and the capital account surplus was only 4.3 billion USD). The gross external debt jumped to 20.8 billion USD and official forex reserves went down to 12.4 billion USD. The situation worsened further in the first half of 1997. The current account deficit climbed to 8.7% of GDP in the first quarter of 1997 and economic growth slowed further.

Together with political instability, this development triggered massive devaluation pressures. On May 27, 1997, the CNB was forced to abolish the fixed exchange rate regime with a fluctuation band of +-7.5% and lost almost 3 billion USD in reserves. With the floating exchange rate the parity jumped from 30.8 CZK to about 33.3 CZK per 1 USD. At the beginning of 1998, 1 USD was close to 36 CZK and it cannot be ruled out that it will be exceeding 40 CZK by the end of the year.

Most estimates of GDP growth for 1997 are around 1%, the inflation rate was 8.5% while the year-on-year consumer price increase was exactly 10%, and the unemployment rate reached 5.2 % at the end of the year. The state budget deficit totalled 15.7 billion CZK at the end of 1997. The foreign trade deficit reached 140.8 billion CZK in 1997, i.e. 8.2% of GDP (in 1996, it was 157.7 billion CZK, i.e. 10.3% of GDP). In order to fight inflation, the interest rates are very high. That, however, undermines economic activity. A forecast of basic macro-economic indicators by one of the prestigious agencies shows the figures in Table 4.

Table 4
Forecast of selected indicators for 1998

Indicator:	1998:
GDP growth, constant prices, %	3.5 (1.6-2.2)*
Industrial output growth, constant prices, %	5.0
Unemployment rate, end of year, %	6.0
Inflation rate, annual average, %	12.0
Trade balance deficit, billion CZK	100.0 (113-123)*
Current account deficit, % of GDP	4.0 (5.0)*
Exchange rate, end of year, CZK for 1 DEM**	21.2

*In the brackets are the estimates of the Czech Statistical Office.

**The exchange rate of 1 DEM was 19.70 CZK on January 12, 1998.
Sources: WoodCommerz, Czech Statistical Office.

After several years of very successful development, the CR now has to cope with an economic crisis. It must be emphasized that the present economic difficulties were not caused by the systemic transformation steps, but lie mainly in the micro-economic sphere and the inadequacy of the legal and institutional framework of the economic reform, and namely the so-called capital concentration process. Capital markets have been established in the CR, but while they have not only not yet reached the standard which is usual in developed market economies, they are in fact lagging behind such emerging markets as the ones in Poland and Hungary, especially from the point of view of transparency and credibility.

The problems of the Czech financial and capital markets

The image of the capital markets as seen from the main financial centres, such as New York, London or Frankfurt is especially important. In this respect, I shall quote the evaluation of the Czech stock market found in the April 1997 edition of the journal Business Central Europe: *"The Czech market has performed badly over the past few years, rising a miserly 17.5% in dollar terms last year. The reasons are simple, if serious: the failure to drive mass privatisation beyond its initial chaos and the complete mismanagement of the exchange itself. Unlike the Poles, who took a gradual and considered approach towards developing an equity market, the Czechs rushed into listing hundreds of companies, including some of the largest in Central Europe. Almost overnight, a multi-billion dollar market was created. This vast amount of capital squashed the totally ill-equipped market, together with the hopes of millions of voucher-owning Czechs. The laissez-faire attitude of the Czech government explained the lack of adequate regulation then. And not much has changed since, although there are now some belated signs of action."*

The April 1997 public opinion polls showed a sharp decline of satisfaction with the work of the government. Czech citizens were dissatisfied with many things (e.g. problems in the housing sphere, health system, etc.), but an increasing number of them were disgusted with the series of financial scandals (around 93% of respondents thought that the government was not able to cope with this problem effectively). In May 1997, as a consequence of both the financial scandals and their reflection in public opinion surveys, a deep crisis within the coalition parties appeared. After opposition parties took advantage of that situation, the greatest general political crisis since the beginning of 1993 started. The combination of political instability and macro-economic disequilibrium (in 1996, the current account deficit reached 8.6% of GDP) together with psychological factors were the cause of strong devaluation expectations. On May 27 the Czech crown fell 12% against the DEM and 10% against the US dollar.

The unwillingness of the government of Václav Klaus to cope in a convincing manner with financial irregularities and its lax approach to legal and ethical aspects of privatization have brought about a growing dissatisfaction both inside the country and abroad. In November 1997, a financial scandal concerning suspicious donations to the Civic Democratic Party (ODS) and the consequent reaction of leading Czech politicians, including several from ODS, forced Václav Klaus to resign. The fall of the Klaus government and the weeks which followed this event were accompanied by turbulence on the Czech foreign exchange and capital markets. At the beginning of 1998, both the political and economic situation in the CR remains unstable and the Asian financial crisis is making the position of the Czech economy even more shaky. It is now almost certain that there will be early parliamentary elections in the CR in 1998. It remains to be seen whether the result of the elections will stabilize the economic situation. It is, however, almost impossible that any probable outcome of the parliamentary elections could weaken the CR's efforts to enter the EU.

The state of the Czech capital markets has contributed to the present unfavourable situation of the Czech economy, especially its external disequilibrium, much more than is widely believed and also much more than the Klaus government was willing to admit. It cannot be denied that the increasing number of scandals connected with the Czech financial markets and the banking sector, and the decreasing ability of the capital account of the balance of payments to compensate for the growing current account deficit did contribute to the political instability and a consequent run of both foreign and domestic speculators on the Czech currency.

Loopholes in legislation (some of them were probably intentional) and insufficient enforcement of the already existing laws was especially harmful in the area of financial markets. The well-known vicious circle "state institutions - four major commercial banks - investment funds - large enterprises" has very much contributed to the fact that problems of the financial sector have had a tremendous impact on the performance of the whole economy, including macro-economic stability.

After the second wave of voucher privatization came to a conclusion at the end of 1994, it became clear that ownership of large enterprises was excessively dispersed and that there was an objective need for the concentration of capital. There was also demand for the establishment of strong domestic capital groups who would be able to compete with foreign institutional investors. However, it was a particular interest of some groups that the capital markets stay as untransparent as possible for as long a time as possible. Unfortunately, they influenced the government to establish such rules of the game that would suit them best, and at the same time almost completely ignore the protection of minority shareholders. These rules were much more "liberal" than is usual in developed economies. Thus they could grab a much bigger slice of the pie, which at the beginning of transformation formally belonged to the whole nation, and was about to be redistributed - shifted from the state to private hands. They saw a big chance that would never again repeat itself. They understood very well that after 40 years of communism, there was only a small number of people in the CR who knew anything at all about the capital markets. They expected that it should not be so difficult to temporarily fool most small voucher shareholders, and their assumption proved to be true. Some of them managed to even fool several experienced foreign institutional investors who naively assumed that more or less standard rules of the game with corresponding legislation had been introduced and at least the most elementary ethical norms would be respected. No wonder some of them were robbed of huge amounts of money.

In this respect, it may be interesting to add a few words by Prof. Andrew M. Weiss from Boston University (December 1996): *"Unless foreign institutions can be persuaded that there is an integrity in the Czech stock market, they will withdraw their money and invest it elsewhere. Because of the Czech Republic's large current account deficit, portfolio outflows could have a disastrous effect on its economy. Potentially it could precipitate capital flight and economic collapse. Substantial capital inflows are necessary to finance the current account deficit, and to offset the export of capital by financial manipulators who wish to put their gains outside of the reach of the authorities."*[5] Needless to say, a country with a stock market lacking credibility can discourage not only portfolio investors, but also potential direct investors.

Much of the property that was formerly nationalised by the Communists was about to be reprivatised, unfortunately according to the laws of the jungle. A few clever insiders took advantage of the situation and have become enormously rich, very quickly and with minimum effort, moreover, at the expense of others and without having created anything positive. They often compensated for lack of experience and theoretical knowledge with close contacts with high government officials, and for some of them, even with the former communist nomenclatura. From this point of view, the process of the so-called third wave of privatization was extremely unfair with respect to millions of small Czech shareholders, because only a relatively small number of people really benefited from it. Primarily, it was unfair in the fact that not everybody had the same access to information. It was bad enough that this type of capital concentration did not accelerate GDP growth in any way, as we can see today. Just the opposite is true. The worst thing about it, however, is that the whole process was accompanied by a large number of unethical and criminal activities which have done a lot of damage not only to the image of the Czech capital markets but also to the reputation of the whole country.

Most scandals were caused by a practice known as "tunnelling," by which investment funds siphon off assets from companies in their portfolio. It usually happened with companies acquired through leveraged privatisations. Since normal dividends were insufficient to service debts, majority shareholders simply dipped into company cash-flows. That has weakened otherwise healthy companies, robbed shareholders of dividends and share-value, and deprived the state of tax receipts. It also happened that large stakes in publicly traded companies were being shifted to individuals as a way to reduce corporate tax. Companies could create an accounting loss by selling the shares to an individual and then repurchasing them six months later when no tax was due. Some individuals have amassed very large holdings like this. Various sophisticated methods of tax evasion have significantly contributed to an alarming increase in the state budget deficit.

The several thousand crowns an average shareholder gained from voucher privatization, he was forced to spend later as a taxpayer for the rescue of the banking sector which had gotten into great trouble as a consequence of the lack of supervision and regulation of the whole financial system. The existing links between the banks and the capital markets through investment funds made the situation dangerous even for ordinary depositors.[6] The existence of universal banks may not be dangerous for well established market economies like the German or Austrian ones, but close links between commercial and investment banking activities without a standard "Chinese Wall" between them which prevents insider-trading, can have disastrous consequences for economies in transition. Much harm for minority shareholders was also caused by a conversion of investment funds into holding companies because these were not liable to supervisory authorities of the capital markets.[7]

It must be noted, however, that the process of voucher privatization was relatively fair at the beginning, because initially, the same rules applied to everybody. The idea was not to give everybody an equal share, but rather the whole process can be compared to a lottery. At the end, some were more lucky and some were less lucky. That would be quite fair unless a group of insiders with privileged information and personal contacts had started to play their own game at the expense of minority shareholders. As a consequence, much of the money acquired in their private game ended up in the Bahamas, Cyprus, Liechtenstein and other off-shore locations, and is about to be invested in Russia, East Asia or Latin America. At the same time, the Czech enterprises remain seriously undercapitalized. Their performance remains poor and they are able to contribute sufficiently neither to economic growth nor to the state budget in the form of taxes.

The big wave of capital concentration which took place in 1995-96 is over, but it has not brought the desired macro-economic effect. Very often, the new owners have been more interested in luxurious private consumption, foreign exchange market speculations or in investing their money abroad, rather than in investing it in the domestic economy.

Before entering the EU, the CR needs standard financial and capital markets with the kind of regulation which is usual in developed market economies. The Czech capital markets must become attractive and cease to be frightening both for investors and primary issuers, if they are to help revive the economy. The first major step in the right direction is the Securities Exchange Commission which is going to be established in April 1998, according to a law which was passed in the parliament.

Productivity of labour and competitiveness of the Czech economy

One of the key problems of the Czech economy is the slow growth of labour productivity. In recent years the average wage has been growing faster than labour productivity, something which is unsustainable. Without any doubt, the hitherto growth rate of the aggregate labour productivity in the CR has been insufficient. In the period 1993-1996 the GDP per one worker increased by 11.0% in real terms, while the increase in real wages (including indirect wage costs) was 27.1%. Thus the real unit labour costs increased by 14.5% in the given period, i.e. by 3.4% per year on average (Vintrová, 1998).

The high difference between the level of labour productivity and wage level in the first years of transformation was a precondition for the high rate of national savings, which was between 28% and 31%. The national savings financed the high rate of fixed investment, which exceeded 30% in a yearly average in the period 1993-1996. In 1996, the share of gross fixed capital formation in the GDP (including the increase of stocks) culminated at 35.6%. For financing such a high investment rate, national savings were insufficient. The use of foreign savings for this purpose has significantly contributed to the external disequilibrium of the Czech economy. The savings rate in the CR decreased to 24.7% in the 1st half of 1997 but it is still high if compared with most transition countries and the EU-15, where it is in the region of 20% (ibidem).

It is important to note that a high proportion of investment was oriented towards public infrastructure, e.g. railway corridors, motorways, telecommunications, etc. at the expense of investments in new technologies in manufacturing. The investment in infrastructure is desirable but its return cycle is very long, while investment in manufacturing could bring much faster returns. It is therefore necessary to find an acceptable ratio between these two kinds of investment.

Table 5
Growth rates of employment, aggregate labour productivity and average wages (in %)

	1993	1994	1995	1996	1.Q-2.Q 1997
Number of workers	-2.3	0.8	1.9	1.2	-0.3
GDP per occupied person*	1.9	1.9	3.9	2.9	1.6
Nominal wages	25.3	18.5	18.5	18.4	13.3
Real wages**	3.7	8.6	8.6	8.4	6.0

*Constant prices of 1994.
**Calculated by means of index of consumer prices.
Source: Czech Statistical Office.

All the years since the beginning of economic transformation, the unemployment rate in the Czech Republic has been very low as compared with most other European countries, both Western and Eastern European ones. One of the main reasons is that the service sector has absorbed many people who were previously employed in industry and agriculture. At the same time, many people in retirement age and married women with children ceased working. Another important reason is a slow restructuring of most large enterprises and the so-called "labour-hoarding."

Table 6
Economic level, labour productivity and average wages in the CR in the period 1995-1996 in relation to the EU-15 (current prices and current parities)

	1995 USD	1995 EU=100	1996 USD	1996 EU=100
GDP per capita:				
- in exchange rate	4.881	21.4	5.446	23.7
- in purchasing power parity (PPP)	10.569	56.8	11.266	59.3
GDP per occupied person in PPP	21.132	44.8	22.141	45.3
Average annual wage:*				
- in exchange rate	4.050	14.7	4.629	16.7
- in PPP	8.793	38.5	9.567	41.1
Unit labour costs	0.25	34.7	0.28	39.2

*According to the methodology of national accounts.
Source: Czech Statistical Office.

As far as the relatively low competitiveness of the Czech economy and only a slow improvement of labour productivity in the CR is concerned, there are many factors which have been influencing this. The most important ones are connected with corporate governance, the ability of management and ownership structures. Others are linked to insufficient skills and a persisting "socialist" working morale of a part of the labour force, the level of technology and organisational structure inherited from the past, insufficient restructuring of enterprises, lack of capital for modernization and some other, less important factors. It is understandable that Czech labour productivity is significantly lower than the same indicator in EU countries. However, it is somewhat worrying that the CR's level is not approaching that of the EU at a sufficiently fast pace. At present, the performance of the economy is below its means, while a large part of the population is living above its means.

As compared with developed market economies, Czech labour costs are very low. This is often considered as an important comparative advantage of the Czech economy. However, given the lower productivity of Czech workers in comparison with their West European counterparts, this "advantage" should not be overestimated.

Table 7
Labour costs per hour in USD in selected countries in 1993

Country	Total labour costs	Direct wage	Other personal costs*
Germany-Western part	32.1	17.6	14.4
Austria	26.1	13.0	13.1
France	19.5	10.8	8.7
USA	17.8	12.7	5.1
United Kingdom	14.4	11.0	3.4
Spain	13.2	n.a.	n.a.
Portugal	6.2	n.a.	n.a.
Czech Republic-foreign firms	4.0	2.5	1.5
Czech Republic-domestic firms	2.7	1.7	1.0

Other personal costs include contribution to social security, health insurance, holiday supplements, etc.
Source: Prague Economic Papers 97/2.

Is the Czech economy ready for EU accession?

At present, the CR is not yet ready to become a full member of the Union. If the CR entered the EU right now, it would have rather unpleasant effects for the whole economy, especially the industrial sphere. Many firms would go out of business and the unemployment rate would increase considerably. Given the actual competitiveness of most sectors of the Czech economy, the costs of accession would certainly by far exceed its benefits. That may, however, change over a period of several years. If the stakes of the state in the four major commercial banks are privatized quickly with credible foreign strategic investors and Czech industry undergoes a rapid and radical restructuring, and at the same time, the banking sector and financial markets start to be regulated properly, the Czech economic level could increase significantly.

Already now, the Czech economy is one of the most open economies in the world. The share of foreign trade turnover on the GDP was 90.5% in current prices in 1996 (in 1995 it was 94.4%). This figure is comparable with a group of countries like Malaysia (162%), Singapore (140%) and Taiwan (80%). On one hand, this makes the Czech economy sensitive to the changes of external conditions, on the other hand, the impact of entry into the EU could be softer than would be the case if the economy were more closed and the economic policy more protectionist.

As far as enlargement costs are concerned, not all applicant countries are similar and the impact on Community resources will differ case by case. E.g. the Czech agricultural sector did undergo profound market reform, it is a transparent and largely privatized sector, and represents only 3.1% of GDP and only 4.6% of the labour force. The CR will accept the Common Agricultural Policy (CAP) in the form that will result from the common activities of the Commission and the member states at the moment of entry. Czech agriculture is less subsidized than that of EU countries, and so the conditions for Czech farmers should become easier rather than harder after the accession.

As to the structural funds, it is still not known what the outcome of discussions on changes in the EU structural policies will be. As a member state, the CR will contribute to the Community budget and will use the available funds, if needed. However, besides the principle of solidarity, there is also a principle of additionality. Every project has to be supported by a previously approved co-financing from the state budget. The use of structural funds has to be justified by specific projects. In order to use the funds a member state first needs to define the region, obtain regional statistical data including regional GDP and also put in place administrative mechanisms to prepare and implement the projects. At present, there are no higher self-governing units in between the 76 districts (with their authorities) and the central government. However, at the beginning of January 2000, 14 regions will be established according to a constitutional law which was passed in the parliament in 1997. Their competencies remain to be clearly defined. That should become a base for seeking aid from the EU structural funds.

The Czech Republic is a country with an advantageous geographic location, an old industrial tradition, a well-educated and highly skilled working force and reasonably good relations with all its neighbors. The country has undergone a radical economic reform that has, to a large extent, been successful. The transformation process is still underway even though it has slowed down. An acceleration of this process is desirable. Major tasks of the continuing transformation process have been identified. Besides economic goals, there remains much to be improved with respect to the judiciary and the state administration.

Despite all the critical remarks in this article, the prospects of the Czech economy in the foreseeable future are good. The Czech government must take some unpopular steps, such as e.g. deregulation of the remaining prices and closing down some unprofitable enterprises which are completely or partly state-owned. Such measures will increase living costs and unemployment is going to rise. Foreign competition will make the life more difficult for domestic commercial banks. Thus the country will have to overcome many difficulties in the coming years. Even if some of the necessary steps require great effort and may create tensions in the social sphere, membership of the CR in the EU by 2005, and in the EMU around 2010 is not unrealistic.

NOTES

[1] In 1997, the CR fulfilled only the two fiscal criteria.

[2] Comparative price levels are defined as ratios of purchasing power parities (PPS) to exchange rate, using costs of an internationally comparable basket of goods and services at national currencies in countries under comparison. They are calculated by means of the Fisher index - i.e. as the geometric average of weights of the respective country, and the country of comparison. The reciprocal value is referred to as the exchange rate deviation index.

[3] According to Czech Statistical Office, the Czech price level was 37.8% of the EU average in 1996 (the estimate for 1997 is 43%).

[4] The regulated prices form at present roughly 21% of the consumption basket of households.

[5] Unpublished material.

[6] At the end, depositors at the banks which crashed had their losses compensated by government resources.

[7] At present, this type of conversion is no longer legal.

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