Economic crisis - CMKOS view[1]

CMKOS Study Analysing the Present Economic Crisis

Summary

The study analyses the risks stemming from strengthening of economic restriction connected with reduction of taxes and social security contributions and points out the non-existence of budgetary reserves for alleviating economic and especially social repercussions of the economic crisis in the Czech Republic.

The study analyses the risks that direct taxes and social security contributions (i.e. a guaranteed budgetary source) will be reduced and the budgetary loss connected with this reduction will be substituted by higher taxation rates for consumption (VAT and excise tax). Already in 2008 this assumption did not materialise and given the expected slowdown or a downright halt of economic growth, this “compensation effect” will be non-existent. At the same time, there will be a considerable shortfall at the income side of the budget as the tax revenue will not come up.

The process of “decapitalisation” of State assets, which is already under way, will accelerate and so will gradual reduction of public activities both in the social sphere (social transfers - pensions, sickness benefits, family benefits, unemployment benefits, etc.), and in public services (such as health and education, etc). This process tends to open the way for “private initiatives” undertaken by companies and actual privatisation of these areas. The current economic crisis will thus become a useful opportunity and a pretext for implementation of privatisation plans conceived long ago. Further reduction of direct taxes and social security contributions, which the present Government plans to enforce as quickly as possible (calling it a tool to challenge the crisis) is an immediate threat to the viability of public budgets and narrows the room of manoeuvre for implementing genuine active policy measures of the Government designed to eliminate or alleviate social impacts of the crisis and for active measures to support economic growth. In a situation of economic growth slowing down there will not be enough money for either of these measures. The growing budgetary deficit and the insistence on the current policy intentions would leave the Government only with one option, as already was already signalized to the IMF mission, namely “to reduce the rates of taxation for businesses and those for social security contributions still further and try to offset the shortfall in revenue by making more stringent policies related to the volume of wages and social transfers”.

Two different processes can be distinguished in the Czech economy: the proper economic crisis imported from abroad by means of the export and banking channels and the impact of measures undertaken within the public finance reform. These two processes are of the same direction and are mutually supportive, and tend to cause a slowdown of domestic demand. For this reason, no measure designed to continue and even to accelerate the current reform and thus leading to a further slowdown of demand will be able to combat the crisis. On the contrary, it will enhance the outside adverse impact.

The study makes an analysis of the major key areas hit by the crisis: the financial sector (growing indebtedness of businesses and households, incl. ensuing risks); reduced performance of manufacturing (which lost the capacity to supply complete industrial plants and equipment); the construction sector (including the situation of developers hit by the crisis). Also analysed are implications of the privatisation of Czech banks, which are now owned by foreign parent companies. The study analyses the risk that the Czech economy is on the verge of a crisis, which cannot be compared with any previous downturns, including the slump of 1997-1998. The latter was caused by mismanagement of economic transformation at the beginning of the nineties and by faulty economic policies pursued by the Government (as well as by

[1] The first version of this paper was prepared and distributed to CMKOS leaders and affiliated unions on 10 December, before the adoption of the State budget. This paper dated 13 January 2009 represents the second version. The present document takes account of the approved State budget 2009, creation of the National economic council - a consultative body to advise the Prime minister, and, of course, the worsening situation of the Czech economy. The document represented a basis for proposals submitted by CMKOS at a special meeting of the supreme tripartite body, which was convened to deal with the economic crisis.

a wrong response made by the central bank), an additional factor being an internal political crisis. Thus the fundamental causes emanated “from within” and to start economic recovery it was sufficient to revise the Government's economic policy. In contrast to this, the present crisis is of global nature, crisis of overproduction affecting the whole world. It is a crisis caused by excess demand, which was based on speculative transactions on financial markets. This resulted in undermining the confidence in the whole financial sector, which led to a rapid collapse of financial markets and, as a consequence, to subsequent slump of demand and production.

Given the fundamental causes of the present crisis and the existing structure of the Czech industry, patterns of exports and high dependence on external demand, the possibilities to challenge the impact of the crisis by domestic measures are considerably limited. Any short-term effect can only be expected from measures designed to promote domestic demand, for example by promoting the household consumption, or infrastuctural investment from public budgets.

Long-term remedies to assist the Czech industry should be directed, in particular, towards the development of sophisticated products, support to research and development in the sector of industry as well as towards close co-operation of the capacities of higher education with industrial companies. This would bring about a more direct and rapid transfer of research results into practical implementation. For the same reason it would be sensible to provide greater support to higher education in selected technical branches and to the development of natural sciences at university level with a view of increasing the number of graduates. High priority has to be given to the development of the entire educational system, including vocational training.

At the same time, it is necessary to strengthen the diversification of Czech exports in order to reduce the present high concentration on specific territories (and thus their vulnerability). To this effect supported should be diplomatic efforts with a special attention to the export of Czech technologies.

The Government should direct its economic policies, in particular:

- to direct all measures towards strengthening economic growth and, to the maximum possible extent, towards moderating the social impact of the crisis;
- to strengthen measures assisting growth and not to resort to economic restriction;
- to prevent wasting of public resources and stop with the non-sense across the board reduction of taxes and social security contributions;
- to create strong budgetary reserves to deal with the solution of both economic and social repercussions of the crisis;
- to get rid of sentimentality and immediately reassess all the so-called “reform measures”, which have nothing in common with the primary objective of alleviating the economic and social impact of the present crisis. Rather, the measures planned under the “reform” are bound to aggravate the crisis (the planned pension reform based on the “opt-out” system, the tax reform involving a great risk of great reduction of tax and social security contributions revenue, health reform involving the risk of reducing the present health care standards);
- to co-ordinate more closely the budgetary and monetary policies with the Czech National Bank;
- to immediately stop the process of privatisation of public property (in the first place in the energy, transport infrastructure and health sectors) as well as privatisation plans in the area of social transfers and public services (pensions, health and social systems);
- to closely co-operate with social partners when developing recovery packages.

According to the study the precondition for effectiveness of any measures is a close involvement and co-operation of major stakeholders - the Government, employers and workers, both at home and at EU level.

It is necessary “to unfold a social safety net”. In this area, key measures include the following:

- Increasing social benefits and extending the period of their payment. This applies mainly to unemployment benefits, sickness and family benefits (social assistance benefits) and allowances providing relief in acute distress situations. Equal attention should be paid to living conditions of pensioners, considering possible extraordinary valorisation of pensions.

- Resolutely rejected should be the policy of reducing public expenditure in the area of social transfers, which is the basis of the public finance reform implemented by the Government. Large groups of the population are likely to be affected by the expected increase of unemployment, including long-term unemployment. These workers cannot be treated as individuals who refuse to work and opt for being supported by social benefits and allowances. It is not possible to tolerate that these workers, hit by the crises for which they are not responsible, would become impoverished, together with their families. One should also consider the ensuing possible increase of crime.
- Fieldwork in the social area has to be considerably strengthened. It should be aimed at a systematic identification of persons who are in need of assistance (individuals with specific handicaps, older persons, etc.). In major cities, which are threatened by emergence of slums, social support centres should be established to counter emergence of ghettos of low-income people with all accompanying adverse phenomena observed already in some places. This would require a change of principle in the existing social systems. The policy followed by the Government was designed for a period of prosperity and has been aimed mainly at reducing public expenditure across the board.
- Needed is also a change in the framework of housing regulations including regulation of rents. It is necessary to promote the systems of social housing and to redefine the concept of usury. A new system of refinancing of mortgages should be developed with a view of dealing with situations where, due to the crisis, people are unable to repay their debt.
- In addition to regulation of rents the Government should consider the introduction of regulation of prices for items of basic needs, in particular the prices of fuel and energy.
- Additional allocation of resources should also be directed at active labour market policies and employment policy as a whole.

However, a precondition for feasibility of the measures and policies referred to above is to immediately stop the present wasting of money on across the board reduction of taxes and social security benefits. Further reduction of taxes and of the consolidated tax quota, as proposed by the Government, must not be continued. It would be sensible to stabilise the tax system at 2007-2008 levels, i.e. to abolish all already approved but not yet implemented tax and social security contributions cuts and reject any further proposals in this direction.

The study invites the Czech Government to adopt the objectives formulated by the European economic recovery plan submitted by the European Commission. This is a plan developed jointly at international level, which has to be followed, sooner or later, by all Member States, unless the Governments concerned intend to digress from the main stream of social and economic developments in the European Union.

This is also the reason why CMKOS supports the requirements formulated by the European Trade Union Confederation, the heart of which is a plan in the volume of 2% GDP designed to stimulate investment in people, innovation and sustainable development.

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CMKOS Study Analysing the Present Economic Crisis

Motto:

„The top priority must be to protect Europe's citizens from the worst effects of the financial crisis. They are the first to be hit, whether as workers, households or entrepreneurs. In addressing the employment and social impact of the financial crisis, Member States should actively involve social partners" (Communication from the Commission to the European Council: A European economic recovery plan, COM (2008/800).

I. Introduction

In his address of 2nd December 2008 to the Deputy Chamber of the Parliament entitled "Information on the world financial crisis " the Prime Minister of the Czech Republic, Mirek Topolánek presented his " Strategy of readiness and acceleration of growth". This was the first Czech "long-term comprehensive plan describing the response to the world financial and economic crisis". Undoubtedly, this was positive news. After months of disparaging the growing symptoms of crisis and systematic criticism of anti-crisis measures adopted by developed EU countries, the Czech government finally admitted that the crisis might have an impact on the Czech Republic and that this impact could be much heavier than previously thought.

Whereas in developed European countries, or at the level of EU bodies, it is self-evident that social partners are called upon to be involved in the solution of crisis situations, any move in this direction on the part of social partners in the Czech Republic is bound to meet with suspicion and distrust. This is particularly true of proposals submitted by trade unions. During the whole year of 2008 the CMKOS called attention to the trends in the global economic developments and the risks involved and challenged the Czech government to follow other governments and start to develop scenarios including measures designed to meet the crisis. Instead, precious time was lost by shallow disputes whether the crisis existed or not. Exclusion of representatives of groups of citizens, who are most vulnerable to the impact of financial crisis, from co-operation aiming at adoption of adequate measures, cannot lead to restoring mutual confidence (which is the most important in this crisis situation).[2]

Already in Spring last year, the CMKOS started to repeatedly call attention to threats resulting from the economic restrictive measures gradually introduced by the Government (restrictive packages)[3] and referred to wasting of resources due to nonsensical reductions of taxes and social security contributions[4]

[2] The Prime Minister Topolánek was very frank on the subject when commenting the creation of the „National economic council" when he said: „I am not under impression that a milkmaid or a mother of three children is missing in the composition of this body".

[3] At a special meeting of the supreme tripartite body (RHSD) during the discussion of the State budget in mid-September, the Minister of Finance responded to the trade union warnings by saying that, in the event of a lower economic growth, adequate response would follow and would be directed at the expenditure side of the budget with the view of safeguarding the planned budget deficit. (This of course meant cutting expenditures.) This intention amounted to a deadly attitude for any attempt to maintain any economic growth and the Minister of Finance continued to hang on it until the second decade of November. It appears that only following the conclusions made by the IMF mission, which proposed to use adequate stabilisers (i.e. higher deficit of public finances at the level of 2,5 per cent as proposed by IMF, compared with 1,6 per cent included in the budget), the latent threat originating from restrictive packages was put somewhat aside (but not completely abandoned because even the IMF stated that "the reduction of taxes for businesses and lower social security contributions should be offset by restrictions achieved within the volume of wages and social transfers"). This trend is confirmed by signals received from the work on the so-called realistic budget 2009, which is currently developed by the Ministry of Finance. In accordance with the information released by the minister of Finance to the press, this should include expenditure cuts amounting to approx. CZK 15 billion.
In addition to it, the existing budget is highly problematic, is based on wrong numbers and includes major structural problems, which narrow the room of manoeuvre for finding appropriate solutions of the social and economic impact of the crisis. (We refer to the proposed further considerable tax cuts, non-existence of budget reserves to finance anti-crisis measures, etc., which will be dealt with later).

[4] The approved budget includes a reduction of social security contributions paid by employees by 1,5 %. This measure is, de facto, the third stage of reducing social security contributions. Already earlier, the government adopted the intent to reduce contributions paid by employers by 1 percentage point in 2009 and by further 0,9 percentage points in 2010. Since beginning of 2008 a ceiling was introduced for the amount of paid contributions. This time, the reduction of contributions was used as an argument to compensate the fact that the rate of income tax of natural persons and the amounts of tax deductions are now proposed to remain unchanged at the 2008 level. The impact of the shortfall of social security contributions levied from employees' wages (1,5%) will amount to CZK 18 billion in 2009. If the reduction of the rate for employers is added, the summary impact on the systems of sickness and unemployment insurance will amount to CZK 32 billion. If we consider the effect of the contribution ceiling, as adopted already last year, it becomes evident that the existing Coalition Government plans to dismantle public social security systems in these tow areas.

and to a non-existence of budgetary reserves needed for solution of the economic and especially the social impact of the crisis. Similar observations were made in autumn during the regular evaluation of the National reform programme (Lisbon strategy) and the discussion of the Convergence programme.

The present paper is to be understood as an attempt to resume a dialogue with the Government concerning measures aiming at combating the impending economic crisis.

II. The current reform of public finances and its real impact

If we analyse the results of macro-economic forecasts made by the Ministry of Finance during the last two years, we have to ask whether the repeated mistakes were due to misjudgement or whether they were intentional. We are afraid that the second assumption is true.

The strange "distortion of numbers" began already last year. Even if we disregard the fact that basic assumptions and the whole set of arguments advanced by the Government in favour of the public finance reform stem from purposefully manipulated ***estimates of deficits for the period 2006-2007***, we have to call attention to the artificially low ***estimates of the 2008 inflation.*** These estimates were made by the ministry of Finance (3,2% in April, 3,4% in July, 3,8% in October) were primarily **used for "refuting" the concerns of the trade unions and the public at large of the real impact of the "reform package".[5]**

The Government drew a double advantage from this misleading estimate. In addition to creating a basis for the above arguments the underestimated inflation led to creation of the latent budgetary reserve in the amount of CZK 20 billion. This operation concealed (to a certain extent) the problems at the income side of the budget caused by the public finance reform.

Contrary to official expectations adverse processes have taken place. When comparing the expected budgetary income with actual revenues in 2008, marked contradictions emerge. First of all, contrary to budgetary assumptions there was a strong decrease of revenue from VAT and excise taxes. The shortfall in VAT was CZK 14 billion, that in excise tax CZK 9 billion. (Here, one could observe a marked yearly decrease of revenue in absolute terms.) This shortfall occurred in a situation where the average tax rate substantially increased: the VAT rate for items of basic needs rose from 5 to 9%, the excise tax rates were also increased and environmental taxes were introduced for fuels and energy.

This shortfall of indirect taxes was, for the most part, offset by higher revenue from the income tax (both from natural and juridical persons) where the actual revenue was by CZK 14,5 billion higher than expected. This was due to good economic performance. This result makes it possible to reassess optimistic expectations of those who conceived the public finance reform and call attention to its true nature.

The reform (and the 2008 budget based on it) assumed that reduction of direct taxation and social security contributions (safe sources of the budget revenue), and the shortfall connected with such reduction, would be offset by an increase of revenue from indirect taxes (VAT and excise tax). As shown by the 2008 figures, somebody failed to communicate this reasoning behind the budget construction to the general public. It was clearly demonstrated that indirect taxes were unable to compensate any shortfalls in direct taxation. As for the actually achieved higher revenue from income tax this was mostly due to a strong economic growth in 2007.

In a situation of slowdown or complete halt of the growth this "compensator" will disappear. On the contrary considerable problems can be expected on the income side of the budget. The last year's shortfall of income from taxes (during a period of a relatively sound growth both in the volume of wages and in particular company profits) was the first reminder of the existing problem. Unfortunately, this problem - the problem of insufficient revenue of public budgets - will manifest itself much more strongly in the near future.[6] As it is, there will be a marked reduction of public transfers and a marked reduction of

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In its declared position, CMKOS rejected these reductions and voiced justified concerns with reference to the impending destruction of the systems.

[5] By end of August 2007, CMKOS put its estimate for the 2008 inflation at 5,5%. Having considered the impact of the introduction of patients' direct payments in the heath sector (representing 0,6% according to the Czech Statistical Office), CMKOS increased its inflation estimate to 6%. **The real increase of the consumer prices index in 2008 was 6,3%.**

[6] Incidentally, this confirms concerns repeatedly expressed by CMKOS concerning the public finance reform. CMKOS repeatedly argued that it was entirely irresponsible to decide on any further reduction of tax rates unless one knows the impact on budget revenues caused by previous tax reductions.

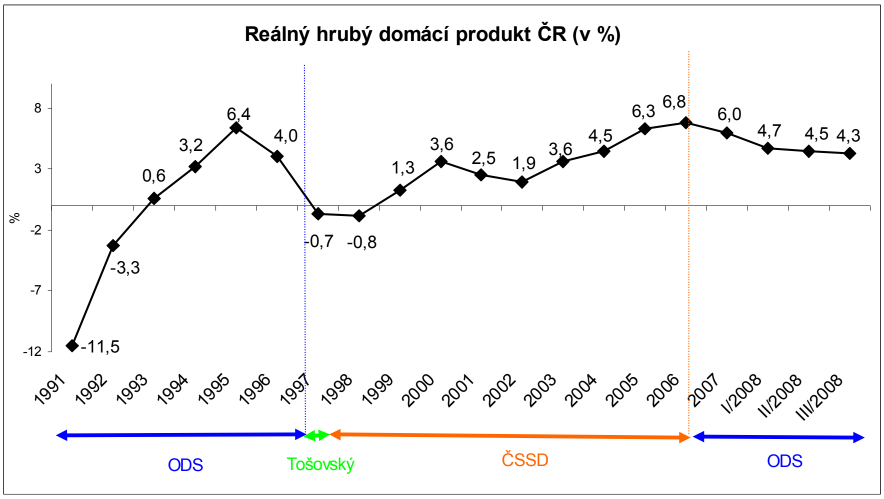
both public functions in the social area (social transfers - pensions, sickness benefits, family benefits, unemployment benefits, etc.) and of public services (in particular in the health and education sectors). This, in turn, will open the way for "private initiatives" undertaken by various companies, which might lead to partial privatisation of the areas concerned. Judging from a number of statements made by government officials it has become clear that the economic crisis would provide an opportunity and a welcomed pretext for the implementation of privatisation plans conceived long ago.

Unfortunately under the euphoria elicited by a massive PR campaign in respect of achievement of a "marked decrease of the public finance deficit in 2008" (combined with commendations addressed to the minister of finance) the Government omitted to state the facts. The decrease was achieved in a situation of failure to collect planned budgetary revenues and the real cause of the "achievement" was the existence of latent budgetary reserves and substantial reductions in the planned use of reserves by individual ministries. Contrary to statements made by the so-called "independent analysts" to the effect that, thanks to the public finance reform, the year of 2008 was marked by more realistic financial flows, in fact the opposite was true.

The budgetary results of 2008 confirmed the concerns voiced by the CMKOS already at the time when the reform proposals were under consideration. This Government and this Minister of Finance will not be remembered as those who achieved higher budgetary revenue but rather as those who made extensive cuts in budgetary expenditures.

Given the fact that we can expect a period of economic problems and a marked slowdown of economic growth, it has become clear that a further reduction of taxes and social security contributions, as proposed by the present Government (allegedly in order to confront the impending crisis) would represent a real threat to a sound operation of public budgets. At the same time, it would narrow the room, which is available for active Government policies aimed at elimination or moderation of the social impact of crisis and at supporting economic growth. As it is, the Government will be short of money needed to support these two objectives.

Then the Government will be left with only one alternative. In spite of the ever growing deficit it will carry on with its present intentions, as already communicated to the IMF representatives, that is to say **"it will reduce the rates of taxes for businesses and those for social security contributions still further and try to offset the shortfall in revenue by stringent policies regarding the volume of wages and social transfers".**[7]



Practically the same appears to be this years' gross ***mistake in the GDP estimate for 2009***. Already at the origin of the evidently overestimated GDP estimate (what other government would dare to forecast acceleration of GDP for the next year in July 2008?) the real purpose was "to solve a difficult arithmetic operation" - how to propose a budget with a low deficit in conditions where further reductions of taxes and

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[7] IMF, Czech Republic 2008, Article IV, Consultations, Final statement, 24 November, 2008.

social security contributions are planned. This could not be achieved without a higher GDP growth. (Moreover, the Government announced that this artificial acceleration of economic growth was the first positive result of the reforms under way.)

The permanent inflow of ever more pessimistic news about symptoms of an impending world economic crisis was interrupted in November by an official statement on a surprisingly positive **development of the Czech GDP in the third quarter 2008.** Most independent analysts agreed that under existing circumstances these figures had to be considered as being very positive but warned that, given the overall situation in the world, the trend was unlikely to be maintained.[8] In this respect they were not mistaken but real GDP development was different - the announced third quarter figures did not hold. In December, the Czech Statistical Office announced that real growth for this period was not 4,7% but 4,3%.

Let us consider this figure, which confirms a relatively rapid loss of the rate of GDP growth when compared with 2007. If one takes into consideration the trends of economic development in neighbouring countries and the time lag in the area of economic flows, it seems to be clear that GDP trends within the first three quarters of 2008 were not substantially influenced by the impending economic crisis.

What then was behind the rapid slowdown of GDP rate of growth? It is our firm belief that the main factor was nothing other than the public finance reform implemented by the present coalition Government.

In reality, the GDP growth rates during the first three quarters 2008 were not positive but rather negative news. Compared with previous years a slowdown of economic growth was registered - nearly by 2 percentage points. The so-called public finance reform has certainly to be credited for this "achievement". This should be taken into account when considering the constant flow of bad news from the economic world. It should not be forgotten that the public finance reform is to be blamed for a CZK 70 billion' loss of GDP growth in 2008. It is highly probable that these squandered billions will be missing when trying to combat the crisis that comes "from outside". Repeated statements made by the Prime Minister Topolánek to the effect that the Government is not responsible for the crisis cannot be accepted.

This rather extensive "excursion into the past" served one single purpose - to describe the **specific situation of the Czech Republic. Two different processes can be distinguished in the Czech economy: the proper economic crisis imported from abroad by means of the export and banking channels (see next chapter) and the impact of measures undertaken within the public finance reform. In spite of repeated claims made by Government representatives these two factors are of the same direction and are mutually supportive, and are adversely influencing one key area - a slowdown of domestic demand. For this reason, no measure designed to continue the current reform and leading to a further slowdown of demand will be able to combat the crisis. On the contrary, it will enhance the outside adverse impact.**

III. An analysis of key trends in selected economic sectors and possible further prospects

In spite of the fact that most analysts kept denying the existence of crisis, it has become evident that many sectors of the Czech economy are already bearing its impact. Those who now already admit its existence, immediately add that the Czech banking sector will be spared because it is alleged to be sound because it has learned the lessons of the nineties, when it was bailed out by hundreds of billions Crowns. In accordance with these views the crisis will be felt only in the real economy.

These arguments can hardly be accepted. If we consider certain open symptoms of the crisis and its expected development it seems to be clear that the crisis will affect both the financial sector and the real economy.

1. Threats and risks for the financial sector

Threats and risks for the financial sector can be observed in several areas. One of these is ***rising indebtedness of households***. Until recently the volume of debt rose by more than one-third a year. The present volume of household debt is more than CZK 1,000 billion, of which CZK 850 billion are loans

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[8] Their growth estimates for 2008 are now around 2-3% and these figures tend to be gradually reduced. As already mentioned there exist some forecasts of a "positive zero", or even a decline, IMF and CNB estimates are 1,5% and 2,0%, respectively. At present the Ministry of Finance announced three possible estimates but failed to say, which is "the correct one". The budget expected acceleration to 4,8%, the October estimate was a slowdown to 3,7%, the Minister of Finance told the press that growth would be around 3% but, more recently, he admitted that it might be less than 2%.

awarded by the banking sector. Most of it falls upon mortgages. In addition to it the population is indebted by CZK 150 billion to non-banking institutions - these are mostly different forms of instalment transactions.

Very problematic are certain forms of loans offered to the population by non-banking institutions. Certain of these offer conditions that widely exceed the accepted standards. In certain cases, interest rates exceed 50% a year. Strangely enough, in accordance with the Czech law this is permissible, it is not considered to be usury. (In other EU countries this practice would hardy be tolerated.) Given these interest rates, many individuals can rapidly find themselves in financial difficulties, especially those that are not well-versed in financial matters. If the overall economic situation worsens this - for the present relatively small - segment of the population would be in trouble and would need assistance.

However, the main problem is the rapidly increasing volume of debt in the housing sector. It can be reasonably assumed that groups of population, which cannot rely on high incomes, are among those who participate in the indebtedness. It follows that under economic recession it will be very difficult for them to repay their debt.

In addition to it, the total value of real estates burdened by mortgages is problematic. Most mortgages were accorded in a period when the prices were very high and forecasts existed that they would increase still further. The present and foreseeable future will certainly be marked by falling real estate prices. This will be accompanied by changing attitudes of banks - imposition of more severe conditions for debtors. This will be primarily true for cases where loans were accorded for the whole amount of the value of the real estate. Given the probable slowdown and fall of prices in the housing sector the banks will probably seek higher security for pending loans and they will also raise their requirements in connection with the award of new loans. This impact will certainly be very significant for individuals, in particular in certain regions, but the impact on the overall situation in the financial sector will be rather limited.

Already during 2008 the ever growing volume of loans in the housing sector started gradually to slow down due to the fact that banks became more prudent.

In spite of this slowdown the total volume of loans accorded to the population in 2008 has probably increased by a further 20% to reach the total of CZK 1,200-1,250 billion. At the same time, the average increase of total savings of the populations in the two recent years was roughly one-tenth a year (before the rate was half of it) and by end of 2008 the savings are expected to reach CZK 1,500 billion.

When considering the growth of total economic demand, we can see that, in recent years, private consumption was driven by the rapidly increasing volume of indebtedness of individuals. It follows that any slowdown will be reflected in lower performance of the economy.

The slowdown in awarding loans in the housing sector will have a very significant impact on the real estate market, in particular on the activities undertaken by larger developers. Clear signs could be observed already in recent years that the market was already overheated. The proposed projects required ever growing amounts of money and it was apparent that certain of them did not guarantee expected results. This can be demonstrated by erection of commercial centres in Prague where, several months since opening, there appear to be not enough customers. Leaseholders are leaving because their expectations did not materialise. Many such constructions cannot guarantee the return of investment.

This also concerns certain housing estates where the price for a unit of space exceeds reasonable limits. The developers can hardly expect sufficient demand because they targeted only the narrow segment of the very rich and most of these people have already solved their housing problems.

The differentiation process in the real estate sector has already started and will further expand.[9] Even if only few examples of this process are emerging, it is apparent that the crisis in the construction industry has already started, especially in the sector affected by speculation and by untenable expectations related

[9] This can be demonstrated by the situation of a major developer, the Orco company. In August last year this company announced big projects, for example development of one of the Prague old railway stations (Bubny) in the total value of CZK 100 billion. However, in mid-November the most important owner of the company was expropriated by the creditor bank, which sold the shares used by it as security for awarded loans. Apparently, the bank did so in order to prevent further losses and opt out of the transaction. The value of shares of the Orco company fell to reach only 5% of the original value of 2007. Similarly, in mid-November a bankruptcy of a large construction company" Průmyslové stavitelství Brno" (with a yearly turnover of CZK 2 billion) was announced. Hundreds of millions of unpaid debt remained. It has become obvious that the value of the property is insufficient and that many contractors and sub-contractors will be severely hit. These examples represent only an illustration. Possibly they are not typical, but they are not isolated events and other similar cases are looming large.

to many development projects. Its repercussions are already felt in other parts of the economy. It has also become obvious that this crisis will inevitably adversely affect the financial institutions involved.

One cannot entirely disregard views expressed by some observers of the real estate market that the number of real estate operators will shrink to one half, or even one third during the period 2009-2010. This might be due to reduced demand, decreased volume of housing construction and fewer development projects.

The present trends are considerably influenced by changed attitudes towards funding new projects. Whereas in the first half of 2008 banks actively searched for opportunities in this sectors and offered favourable conditions, at present more stringent conditions are imposed for awarding new loans and banks concentrate their attention on management of ongoing projects in order to prevent possible losses.[10]

The examples referred to above demonstrate that the flow of money to this segment of the market is drying up and that it is not possible to expect continuation of the past rate of growth in the foreseeable future. By the end of 2009 we will surely register a fall of output in the construction sector. The decline might be estimated at 10%, but this is surely not the end of the story.

Significant in this connection is published data on ***output in the construction industry***. The construction industry as a whole registered only a slowdown of growth - a growth of less than 1% in constant prices in 11 months of 2008. However the result for the whole year will surely be decline in output. There is only one sector of this industry which appears to be sound - engineering projects. This is due to the fact that they are funded by budgetary means (even here a slowdown can be registered). Compared with 2007, road building reported a decline in constant prices by 10%. All this leads to the conclusion that clear crisis symptoms are already present in the construction industry and the situation will likely worsen in 2009.

The reason for this assumption is that declining rate of growth (combined with new reduction of tax rates) will inevitably lead to lower revenue of the budget and thus to reduced volumes of funding for investment projects, including engineering and infrastructure projects. Until now, these were the driving forces in the construction industry and they will cease fulfilling this role. Information coming from spokesmen of development groups suggests that certain projects might be postponed because of lack of funding. The construction boom, which was present in recent years, is over because the flow of money based on debt financing is now exhausted. Inevitably, the coming period will be marked by seeking a new balance with the side effect of getting rid of spare capacity, which in turn will cause the release of redundant workers.

Investment banking will surely be another area where restructuring can be expected. Even if this sector is not highly developed in the Czech Republic, as it is the case in highly developed countries, similar problems will arise. Investment banking can be characterised as borrowing money in a bank with the intention to invest it in shares of selected companies. After implementing restructuring and similar operations, these companies are then sold with a view of achieving profit, or they can be used as a vehicle to implement certain projects. Profitability of these transactions in times of general prosperity tends to be relatively high. The standard technique may be that the investment company acquires a firm promising a sound perspective on the market, implements a number of measures (as a rule leading to reduction of costs, improvement of marketing, etc.) with a view of achieving a higher profit. The new company is then more attractive for other investors, because it promises higher profitability and thus can be sold with profit.

However, this scenario can operate only in times of a booming economy, a sufficient number of those who want to invest their money in this way, and if banks are ready to fund such projects. This does not hold at times when the economy is hit by crisis. Thus it can be expected that the present crisis will adversely affect numerous projects and that expectations of possible future profits will diminish. This may be a more favourable outcome. The less favourable scenario is that there will be no demand for existing projects and that no banks will be ready to finance acquisition projects.

Certain Czech investment companies have already partially implemented such projects - some of them are development projects in the construction sector. These can now become source of instability for

[10] Example of this may be failure of the municipality of Hradec Králové to find funding for the planned construction projects. Municipality officials have pointed out that in Spring 2008 many banks showed active interest. However, when the tender was finally formulated, no bank presented the corresponding bid. This in spite of the fact that risk involved in funding such projects is relatively low because security is granted by the municipality budget.

funding institutions. The banks must seek ways and means how to eliminate or reduce impending losses. Most of these projects are based on the assumption that the ultimate investor will be a foreign institution (as a rule a fund). Under the constraints of the present crisis these institutions are limited in their operational capacity and they will be hardly interested to invest their money in Czech projects, especially in a situation of surplus of similar projects across the whole Europe. In particular, the volume of money available for these transactions has considerably diminished.

At a margin it can be added that the poor performance of the Czech stock market can become another adverse factor. One of the practices used for investment was a pledge of shares of profitable companies against the granted loan. The growing Czech stock market made it possible to widen the scope of credit, because the value of the shares involved was on the rise. The present slump at the stock market makes it impossible to use this vehicle. On the contrary there is a pressure to repay the debt as quickly as possible.

It can be concluded that the Czech market can expect that investment companies will experience difficult times. This is true in particular of companies with shortage of disposable assets, which had to rely on raising capital from banks for funding their projects. In our view it is also highly improbable that the current problems experienced by European investment companies would not have repercussions on the Czech market. Possibly there will be a time lag before full impact is felt.

The **Czech banking sector** as a whole will also not be immune to problems. Foreign banking groups own practically all the most important Czech banks. At present, all theses groups, without exceptions, were severely hit by the world financial crisis. They were forced to appeal for State bailout, because they incurred substantial losses in speculative transactions. Directly or indirectly, this situation will have an impact on their Czech subsidiaries.

Therefore, one can expect a particularly prudent attitude to granting new loans, a policy of avoiding risks and great efforts to get rid as quickly as possible of all high-risk projects. This may aggravate problems in companies, which rely on long-term financing from banks. This means that all those, who do not have their own resources, are vulnerable. Also, the general lack of confidence on the financial market has led to a substantial reduction of the volume of transactions among banks.

The beginning of this year was marked by significant changes on the Czech banking market. A number of banks have reduced the volume of credit available to their clients by one fifth or by one forth. In addition to that, and in spite the reduction of the consolidated rate of interest, the rates charged by banks to most clients were increased. We are afraid that this was done on a great scale and that the financial situation of many companies will be undermined. These new policies adopted by all banking institutions will inevitably tend to aggravate the present crisis, because many companies are short of resources for financing their operations and are burdened by additional costs. Also they have to increase the volume of collaterals, which further reduces their means of operation.

All this indicates that the Czech banking sector is under great influence exercised from abroad and that banks will not be prepared - and being part of international groups they will not be allowed - to change the present policies. For this reason, we do not believe that these policies could be influenced by any government economic measures, unless the Government is prepared to provide massive State guarantees. One must be rather afraid that the resources available to Czech banks will be used to partially alleviate the problems of parent banks.

We can also expect a reduction of activities in the sector of leasing operations because insufficient resources will be available. Similarly, this might apply to various forms of instalment plans. Overall, this will lead to making it more difficult to seek access to financial services including more stringent conditions for making available new financial resources. In this situation, the reduction of the consolidated rate by the Central bank seems to be of little impact. Feasibility of specific projects will largely depend on availability of the investor’s own resources and on availability of collaterals.

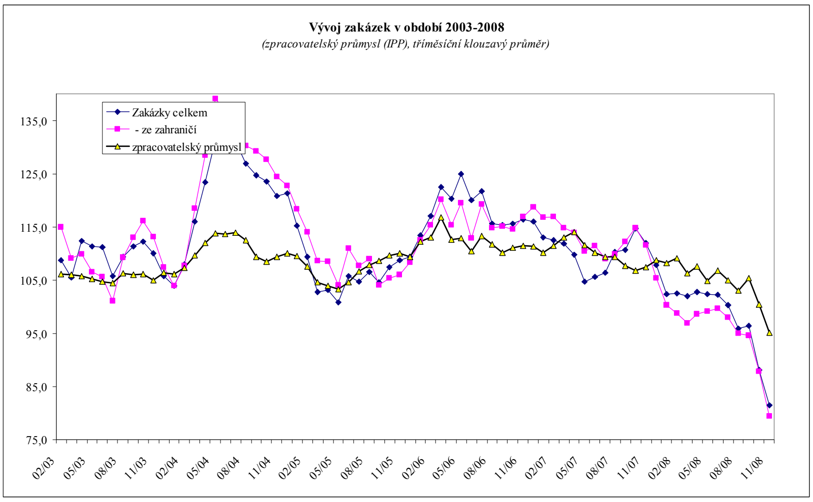
2. Crisis in the sector of industry

Crisis symptoms are already highly visible in the sector of industry. Virtually every day we can register news about which new companies have been hit by the crisis, by how much their output will be reduced and how many workers will become redundant.

Official data on trends of industrial output indicate a clear tendency to decrease. Due to time lag in respect of published figures one can assume that the actual situation is worse than available data might indicate.

Even so the fall in industrial output, as registered in October and November 2008, is unprecedented when compared to figures from any period within the last fifteen years. Its depth and speed suggests that the Czech industry is on the verge of an unprecedented squeeze, even on the verge of economic disaster.

Volume of orders (2003-2008)
manufacturing industry running average of three-month' output
aggregate volume of orders
orders from abroad
manufacturing industries



This chart illustrates the trend of the industrial output index in the manufacturing industry and thus the trends of industrial output, adjusted for price fluctuations. For the sake of transparency the index is conversed to average data for three previous months. The chart also includes data concerning the volume of orders - again in three-month averages - with breakdown for the total and orders from abroad.

Since mid 2008 there is a clear tendency of fall of industrial output. In the last three months the index of industrial output has been below 100. The fall of industrial output reached 18% in November 2008. If this figure were adjusted to take account of the number of working days the fall would still amount to 10%. This is nearly a double of average in the EU area where industrial output fell by 5%. It seems to be clear that the crisis has hit Czech companies with greater intensity compared to companies in neighbouring countries.

Also the trends of incoming orders in the sector of industry are rather unfavourable. The growth of their volume is slowing down since the beginning of 2008 and this predetermines the expected volume of output in the months to come. The volume of orders started to fall in June 2008 and the biggest fall was registered in November where the index fell by one third compared with 2007.

Here, too, we can observe the greatest ever-recorded monthly falls of these indicators when considering the whole period for which these indicators are available.

When analysing these indicators the most important source of concern stems from the rapidity of their fall within a very short period of time. This suggests a sudden loss of markets, sudden decrease of demand and there are no means how to compensate this deficit. Therefore, an early similar impact can be expected on related indicators, in particular on employment.

Perhaps most disturbing is the fact that the Czech economy has never been in a situation of a sudden fall in sales and output. All this puts new demands on the Government for taking adequate action to moderate the impact of the crisis.

It has also become clear that this development will have a strong impact on the patterns of industrial production. The greatest share in the overall index falls on manufacturing industries - nearly 90% of the total.[11] Within the manufacturing industry the biggest share falls on three industries - foodstuffs, production and processing of metals and automobiles and car accessories. These three industries represent around 45% of total industrial output. If two other industries were added - machines and electrical appliances, then the total share would reach around 60%. These data make it possible to assess possible future developments, in particular the possible impact of crisis. It seems to be evident that the data on the patterns of industry do not raise any hopes that the Czech industry might avoid the impending problems.

Production of foodstuffs: Already since the beginning of 2008 we can register halt of growth and rather moderate decline in most months. The possibilities for expansion to new markets can be considered to be very limited. This is not only because of the fact that most of the existing capacities are part of transnational companies and thus subordinated to their export strategies. In addition to that, both in this country and abroad, the volume of sales depends on the willingness of big sales chains to buy. In these circumstances placement of new products is very difficult. For these reasons the volume of output is essentially dependent on the demand on internal market.

Production of metals: assumes the biggest share in the total output. It is well known that there was a boom in this industry in recent years, which was accompanied with price increases and surplus of demand. By mid-2008 there was a sudden change of the market situation, the industry was hit by the world crisis and it is now confronted with sales problems. We have learned from the media that the largest world producers (for example Arcelor/Mittal) are reducing output and the impact on Czech companies cannot be avoided. Prospects for an early recovery of markets - where for example China was one of the main clients - are very remote. Existing data convincingly indicate that the crisis has already hit the sales of this sector. The output fell by 20% in the last two months (the volume of orders in November was lower by one third).

The production of automobiles and car accessories: The development has so far been uneven. On the one hand, a new automobile plant Hyundai started its operation in Autumn 2008, which was considered to be a positive sign for future increase of the overall output, including new opportunities for subcontractors. Certain politicians already announced this as a great contribution towards GDP growth.[12] However, after two months from launching full operation the company announced reduction of output. On two occasions last year, the most important Czech car producer, Škoda, announced a reduction of output and this need not be end of the story. The third automobile group TPCA has seemingly so far been spared of problems. The reason for this may be that it produces small cars where considerable demand still exists.

Much more serious is the situation of suppliers to the automobile industry. As a result of the crisis in the European automobile industry the sales of Czech companies, which supply also other leading European car companies, fell by 10%, and in certain cases even more. These companies already announced reduction of employment, which is a clear signal that they do not believe in an early recovery. All this can only be considered to be preliminary symptoms: full impact on employment will be substantially more important and its volume will only be visible towards the end of 2009.

As to prospects for the future, a decisive factor is the volume of orders. With the slump by one third in the two recent months there are little hope for an early improvement in this sector.

When considering ***prospects for the Czech manufacturing industries,*** and taking into account possible action with a view of alleviating the impact of the world crisis, we have to say that the room of manoeuvre is extremely limited. This is due to a number of factors. In the first place, the Czech industries are heavily depending on exports and on the developments on foreign markets. The Czech export relies

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[11] When considering individual industries, account has been taken of weights in the index of industrial output. If shares of individual industries were considered taking account of sales, the data would be different. In accordance with the 2007 figures the share of the automotive industry, including accessories, amounted to 22% of total sales in constant prices, the figures for production of metals, machinery, electrical machines and appliances and foodstuffs being 10%, 9%, 16,5% an 7,4%, respectively.

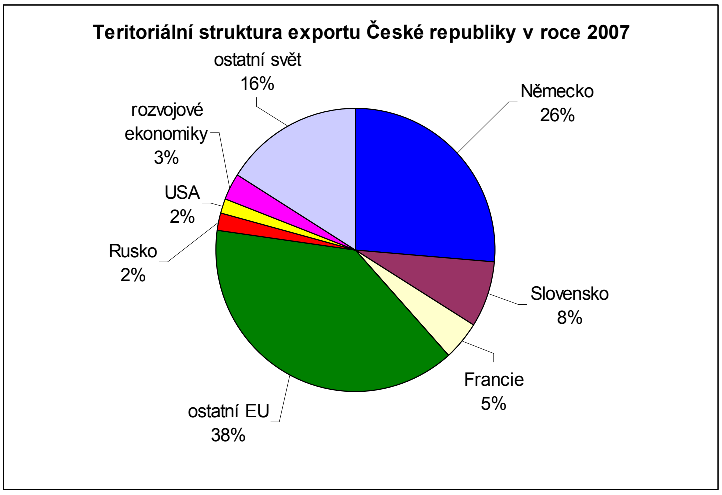
[12] When discussing Government support for the Hyundai company it is said that the Government was submitted a study, which stated that the operation of the new plant will contribute by 1,5% to the GDP growth. (See. http://czekonomika.asp?=A060126_ekonomika_ven

by more than 50% on export of machines and equipment (including automobiles), by 20% on export of intermediate products (including products of the iron and steel industry) and by 10% on export of consumer goods. This means that the bulk of exports (more than 80%) is supported by the output of the manufacturing industries.

As to territorial breakdown, 85% of our export is directed to EU countries. Most of it is exported to Germany, more than 30% to neighbouring countries (Slovakia, Austria and Poland, 10% each). 0,5% of the Czech export falls on the Chinese market and roughly 2,5% on the Russian market. Thus the participation of these two big markets in the total volume of the Czech export is insignificant.

Export of the Czech Republic in 2007: territorial patterns

Germany, Slovakia, France, rest of EU, Russia, US, developing countries, rest of the world



Source: CSO

The importance of these data lies in that they unequivocally demonstrate a high degree of dependence of the Czech industry on the situation in developed countries. This dependence is further accentuated by the fact that a significant number of Czech companies and industrial units is owned by firms from the countries of destination and thus Czech producers have to rely on orders received from the parent companies. The dependence on these markets is therefore overwhelming.

The weight of this dependence is demonstrated by recently released data, which make it possible to draw a picture of the volume of impact on the Czech companies. Compared with the same period in 2007, the Czech export of machines dropped by 15% in the period October-November 2008, of which by 20% in November. Usually, these two months are a period with strong export performance. Halt in the growth of industrial production in October and November has also been announced by Slovakia, a country of destination for 10% of our exports. These are clear signals of the likely future impact on Czech companies. Also, a number of companies decided to terminate their 2008 operations long before Christmas and to start activities only in mid-January as they tried to respond in this way to the existing lack of orders.

Last but not least we can refer to indicators of confidence ensuing from recent inquiries. The index of confidence drawn from responses made by industrial companies has dropped and is now similar as it was during the crisis period 1997-1998. Extremely warning is the rapidity of this drop not registered in any past period. Companies have little confidence in future development and their concerns are mounting.

The recent data have shown that the Czech industry, and together with it the whole Czech economy, is on the road to full crisis and that this development proceeds more rapidly than could be expected some months ago. Before long, full impact will be felt, including production stoppages, bankruptcies, and redundancies.

When considering the likely impact of the crisis experienced by the highly developed countries on the Czech industry, we can conclude that this impact will be very immediate. **Given the dependence described above, it follows that substantial improvement of the situation cannot be essentially**

achieved by any measures designed within the Czech economy. Improvement will be possible only after export markets have recovered and the demand for Czech industrial products has been restored. Possible measures undertaken by the Czech Government can have only very limited impact and can only slightly contribute towards certain alleviation of the crisis.

These considerations have to take account of two additional factors. The first is the nature of the Czech industrial output. During the recent twenty years the patterns of the Czech industry were essentially shaped under influence of the German industry, which is the most important world supplier of machines and equipment. The capacities, of which the Czech industry disposed, are now used to complement deliveries of capital equipment by German final assembly suppliers. The Czech companies mostly supply parts, intermediate products and accessories. German companies supply complete industrial plant and equipment using deliveries from Czech subcontractors. Thus many Czech firms are highly dependent on the performance of German firms on the world markets.

In the course of recent years the Czech industry essentially lost its capacity to deliver capital equipment for crude oil or sugar refineries, chemical processes or power plants, as well as railroad and city transport vehicles, sophisticated machine tools, etc. Such capacity existed in the past. Missing is not only adequate production capacity but, above all, capacity of design and assembly, i.e. capacity not only to manufacture the sophisticated equipment but also to guarantee its operation.

Thus the Czech industry must settle for being a subcontractor who has to wait until his foreign partner needs its services. There is only a limited capacity for creating demand and for active marketing activities. Deliveries of complete industrial plant and equipment usually promise a higher profitability and loss of the capacity to deliver is therefore a major setback.

The existing territorial concentration of the Czech export can also be considered a major disadvantage. The Czech industry is essentially absent from markets that are generally considered as fast growing, such as Russia and China, where the Czech economy has little to offer. The same applies to the markets of developing countries, in particular India, or Latin America, or Vietnam, which has been a traditional partner.

Therefore, the sales crisis can hardly be solved by “redirecting” export flows to other markets where the loss of demand has so far not been felt to such an extent as in developed countries. It is therefore doubtful if measures as for example export subsidies in the form of Government export guarantees or award of Government sponsored export credits can bear immediate fruit.

In the short-term, these measures cannot have any substantial effect and to believe that they may be implemented within short amounts to wishful thinking. They are unable to solve the industrial and economic crisis in the near future. Nevertheless, they can be considered as sound and useful, if meant as a long-term policy.

Possible elimination of the impact of crisis in the Czech industry is complicated by the fact that, in recent years, a number of new plants were erected on the basis of investment incentives. These plants now provide a substantial number of jobs. There is a risk, that these production capacities can be abandoned and wounded up in a situation of general crisis. This concerns in particular simple assembly plants based on semi-skilled manpower, cable harness, plastic injection moulding operations, etc. Neither other more sophisticated recently erected production plants employing skilled workers are immune to such risks. Erection of these production plants was based on the existence of several favourable factors, such as relatively cheap skilled labour, good infrastructure, access to EU markets and tax and other subsidies, which were promised to be provided for periods up to 10 years. In certain cases, these subsidies have already been “used” and relocation of the capacities further to the East or to the Balkan countries cannot be excluded, nor averted. This process has already started.

From what has been referred to above - and this surely is not an exhaustive account of problems - it follows that there is no easy way out of the crisis, which the Czech industry has only started to experience. Above all, it is necessary to realise that the adverse impact is bound to be substantial, in particular due to the patterns of production and sales. At present, more than one million workers are employed in the Czech manufacturing industry.[13] More than 700 thousand of them are in industries representing the major share in total production, as mentioned earlier. More than 600 thousand are employed in major export industries, such as production of transport equipment, machines and electrical appliances, production and

[13] This is an average of full-time workers. If part-time workers were added then the number would rise to 1,3 million.

treatment of metals. Considering a possible 10% decline of production output and supposing maintenance of present productivity, then 60-70 thousand of workers might lose their jobs in the industrial sector in 2009, and maybe more.[14]

This would cause an increase of total unemployment by 2-percentage points. Such substantial increase would be accentuated by the fact that this might not be a short-term unemployment. We are also concerned with the fact that the shrinkage of employment will considerably affect migrant workers, in particular agency workers. Some of them came from countries as distant as Mongolia and a question arises, how to solve the problems related to their return to home countries or provision of social assistance and shelter in this country. Some of them might create additional problems (for example illegal working or crime).

From what has been said above we have to draw an important conclusion. The Czech industry, and the whole Czech economy, is on the verge of a crisis, the scope of which is much greater than all slumps experienced in the past. The impending crisis cannot be compared with the slump of 1997-1998, which was caused by mismanagement of economic transformation at the beginning of the nineties. The crisis of that period was caused by faulty economic policies pursued by the Government (as well as by a inadequate response of the Central Bank), an additional factor being an internal political crisis. Thus the causes emanated "from within" and to start economic recovery it was sufficient to revise the Government economic policy.

In contrast to this the impending crisis is of global nature, affecting the whole world, a crisis caused by excess demand, which was based on speculative transactions on financial markets. This resulted in undermining of confidence in the whole financial sector, which led to a rapid collapse of financial markets and, as a consequence, to the slump of demand and production.

It can be expected that the Czech industry will be sharply hit by the present crisis, in particular due to loss of demand on the principal markets in the neighbouring countries. Considering the analogy of past crises we can assume that the crisis in countries with similar industry and export patterns as the Czech Republic, would start to manifest itself later than the crisis on principal markets. Also, it might take more time to surmount the crisis and restore recovery. We have to reconcile ourselves with the fact that the Czech economy will experience serious difficulties during the whole year of 2009, at a minimum.

Given the causes of the crisis, the structure of the Czech industry and the patterns of exports, as well as the high dependence on the demand coming from abroad, available measures for alleviating the impact of the crisis are limited. A short-term effect can only be expected from measures to enhance domestic demand, for example supporting domestic consumption or investment from public budgets.

Long-term remedies to assist the Czech industry should be directed, in particular, to the development of sophisticated products, support to research and development in the sector of industry as well as to close co-operation of the capacities of higher education with industrial companies. This would bring about a more direct and rapid transfer of research results to practical implementation. For the same reason it would be sensible to provide greater support to higher education in the technical branches and to the development of natural sciences at university level with a view of increasing the number of graduates.

At the same time, it is necessary to strengthen the diversification of Czech exports in order to reduce the present high concentration on specific territories (and thus vulnerability). To this effect supported should be diplomatic efforts with a special attention to the Czech export of technologies.

IV. Economy to assist affected workers

The analyses and considerations referred to above convincingly argue that the impact of the crisis will neither be short, nor negligible. It is necessary to assess the impact and concentrate on adequate response. In our view it is indispensable to start with a thorough and impartial analysis of causes and the

[14] One could remind that, already in Autumn 2008, the representatives of the automobile industry estimated, that due to the sales crisis it would be necessary to make redundant at least 14 thousand of workers (or around one tenth of the total).

nature of the crisis and its repercussions on the Czech economy. There will be no easy or simple solutions but we are convinced that adoption of partial measures to mitigate the impact of crisis is much better than doing nothing.

More than ever before, this situation requires the Government to behave in the areas of economic policy in the same way as a other Governments in both neighbouring and distant countries do. In particular:

- to direct all measures towards strengthening economic growth and, to the maximum possible extent, towards moderating the social impact of the crisis;
- to strengthen measures assisting growth and to limit economic restriction;
- to prevent wasting of public resources and stop with the non-sense flat reduction of taxes and social security contributions;
- on the contrary to create strong budget reserves to deal with the solution of both economic and social repercussions of the crisis;
- to get rid of sentimentality and immediately reassess all the so-called “reform measures”, which have nothing in common with the primary objective of alleviating economic and social impact of the present crisis. Rather, the measures planned under the “reform” are bound to aggravate the crisis (the planned pension reform based on the “opt-out” system, the tax reform involving a great risk of great reduction of tax and social security contributions revenue, health reform involving the risk of reducing the present health care standards);
- to co-ordinate more closely the budgetary and monetary policies with the Czech national bank;
- to immediately stop the process of privatisation of public property (in the first place in the area of the energy, transport infrastructure and health sectors) as well as privatisation plans in the area of social transfers and public services (pensions, health and social systems)[15];
- to closely co-operate with social partners when developing recovery packages. Above all, the crisis is related to a large extent to a general loss of confidence; without close involvement of major stakeholders - the Government, employers and workers - it is not possible to deal with the crisis effectively[16];

In our view, the key precondition for the effective performance of any measures is close co-operation and co-ordination at EU level. As already extensively argued above, any chance to get out of the crisis is closely related with the success of responses at EU level. It is not possible to allow the Czech Government to continue in implementing present policies, which include the tendency to criticise all measures currently adopted by individual EU Member States (where the symptoms of the crisis are already more pronounced) and to reject all proposed joint efforts and measures implemented at EU level. (Mentioned can be recent rejection of the European plan of economic recovery proposed by the European Commission.)

Already now it is obvious that getting out of the crisis will not be easy, or speedy. Measures have to be adopted and a comprehensive plan has to be developed for dealing with the social impact of the crisis

[15] Within the population at large little attention has been paid to the fact that gradual privatisation of the social transfers’ systems need not mean their immediate transfer to private operators. No less important for the development of private business in this sector (in certain cases more dangerous for the future) is a gradual “pullout from the market” by means of reducing the State transfers to the population based on public resources. Where reasonable needs of the population fail to be met by the corresponding public systems the citizens are left with only one option - to opt for private insurance in the areas of sickness, unemployment, pensions, education of children, etc. This of course opens the way for private businesses and insurance companies and pension funds are already looking forward to new lucrative opportunities.

[16] In October 2008, the European Council, with reference to the growing financial crisis and a general loss of confidence, called upon all actors within the financial system, in particular the banks, to accept their respective shares of responsibility. It emphasised that bonuses paid to top manager have to correspond to their actual performance and that this principle has to be applied to the severance pay (the “golden parachutes”) which should correspond to the past contribution of the manager concerned towards economic results of the company. At the same time, it was necessary to observe the rule that the promises of stock options and bonuses would not lead to acceptance of excessive risks, or concentration on short-term objectives, especially in the financial sector. The Council called upon Member States to promote implementation of these principles and invited the Economic and Social Committee to report on this by the end of 2008. The corresponding account of measures adopted by individual Member States was submitted a 28 November 2008. It is symptomatic that the Czech Republic is absent from this account. (ECOFIN582/DRS76, Brussels, 28 November 2008 - Remuneration of top managers: Overview of measures adopted by the Commission and by the Member States since the October meeting of the European Council).

while creating sufficient reserves in the system of public budgets for funding the plan. It is necessary "**to unfold a social safety net".**

- A key for countering adverse social impact is to increase social benefits and extend the period of their payment. This applies mainly to unemployment benefits, sickness and family benefits (social assistance benefits) and allowances providing relief in acute distress situations. Equal attention should be paid to living conditions of pensioners, considering possible extraordinary increases corresponding to rising living costs. We should resolutely reject the policy of reducing public expenditure in the area of social transfers, which is the basis of the public finance reform implemented by the Government. Large groups of the population are likely to be affected by the expected increase of unemployment, including long-term unemployment. These workers cannot be treated as individuals who refuse to work and opt for living on the basis of social benefits. It is not possible to tolerate that these workers, hit by the crises for which they are not responsible, would become impoverished, together with their families. One should also consider the ensuing possible increase of crime and social unrest.
- Social work in the field has to be considerably strengthened. It should be aimed at a systematic identification of persons who are in need of assistance (individuals with specific handicaps, older persons, etc.). In major cities, which are threatened by emergence of slums, it is necessary to provide temporary social centres to counter emergence of ghettos of low-income people with all accompanying phenomena observed in similar situations. This would require a change of principle in the concept of social systems, which were created for other situation and the aim of which was primarily to save financial means.
- Needed is also a change in the framework of housing regulations including regulation of rents. It is necessary to promote the systems of social housing and to redefine the concept of usury. A new system of refinancing of mortgages should be developed with a view of dealing with situations where, due to the crisis, people are unable to repay their debt.
- In addition to regulation of rents the government should consider the introduction of regulation of prices for basic needs, in particular prices of fuel and energy.
- Additional allocation of resources should also be directed at active labour market policies and employment policy as a whole.

However, a precondition for feasibility of the measures and policies referred to above is immediate halt to wasting money for across the board reduction of taxes and social security benefits. Further reduction of taxes and of the comprehensive tax quota, as proposed by the Government, must not be continued. This means to stabilise the tax system at 2007-2008 levels, i.e. to abolish all already approved but not yet implemented tax and social security contributions cuts and reject any further proposals in this direction.

Continuation in the policy of massive tax and social security contributions cuts, which the present coalition Government started under cover of "redress of public finances" and now is proposed to continue under the pretext of "combating the crisis", would be very dangerous. There is an acute risk that the across the board cuts would not been effective in respect of restoring economic growth and rather cause insurmountable problems in the area of public finances. Due to such inroads there will be shortage of money for any expenditure in the public sector, in particular for creation of a safety social net, which would ensure decent living conditions to affected families and save them from destitution.

There is no guarantee that the proposed tax and social security contributions cut, which has been much discussed recently, would be beneficial, for example in promoting investment activities. One must be rather afraid that these additional means will flow abroad in the form of dividends, as we have already witnessed in recent past. (The Czech Republic will then be left with the destruction of existing social systems.)

One has to realise that the present crisis is a crisis stemming from excessive output, surplus of production capacities and investment. What is missing is adequate demand. When studying the papers that are meant to be a basis for the "**Strategy to promote and accelerate growth**" (SPAR) to be announced by the Government, we do not find much emphasis on supporting the demand. Even the considered increase of pensions (no mention by how much) to be based on an "analysis of pensioners' health expenditures", or a more specific idea of "increase of the volume of wages in the public sector, is always conditioned with words like "possibly, eventually", etc. If such "mist" amounts to formulation of proposals by the Government with a view of strengthening the demand, this will be of little assistance for the Czech economy.

The lack of measures proposed on the demand side sharply contrasts with bold proposals on the supply side: to reduce taxes for juridical persons to the level of 15%, to reduce social security contributions paid by employees, to reduce “collateral labour costs” (which is euphemistic terminology meaning further reduction of social security contributions), to “accelerate further reforms in the labour market by amending the Labour Code” (meaning nothing other than making further inroads into the working conditions standards). It is quite evident that proposals included in this strategy amount to continuation of the policies, which the present Government coalition embarked since the beginning of its mandate. In this light we can understand another euphemistic expression “re-examining, possibly regrouping priorities in the area of expenditures”.

The submitted SPAR strategy has to be assessed not only in accordance of what it includes, but also in accordance with what is missing. There is not a single word about co-operation or policy co-ordination with other countries at EU level, which seems to be essential for combating the crisis, nor a single word about co-operation with social partners. Missing is also an analysis of the real economy, an analysis of the likely impact and costs and benefits of the proposed measures. As such, the strategy amounts to mere outlining possible suggestions, or perhaps titles of chapters for describing a future package of proposals. To what extent are these more detailed proposals developed one can only guess (written in the middle of January 2009).

We are convinced that the Czech Government ought to adopt the objectives formulated by the European economic recovery plan submitted by the European Commission. This is a plan developed jointly at international level, which has to be followed, sooner or later, by all Member States, unless the Governments concerned intend to digress from the main stream of social and economic developments in the European Union.

This is also the reason why we support the requirements formulated by the European Trade Union Confederation, the heart of which is a stimulation plan consisting in investment in people, innovation and sustainable development in the volume of 2% GDP.

ETUC suggests that the European recovery plan should be based on measures aimed at preventing the impending collapse of the EU economy. To keep the economy running, it is necessary to implement, on a large scale, labour market policies in the order of 1% of GDP. The objective is to provide more security to workers in general and, at the same time, to provide adequate support to those who are most in need. Depending on labour market patterns in individual Member States, the “investment in people programmes” in the order of 1% GDP can assume different forms and combinations:

a. **Strengthening of the unemployment benefit systems -** in Member States, where unemployment benefits are low, the periods of payment are short and conditions for entitlement are stringent, structural strengthening of the benefit system should become a priority.

b. **Increased security for flexible workers -** the crisis has demonstrated one again that European labour markets are already highly flexible. Since economic activity has started to slow down, massive restructuring of employment has already been implemented. However, the dimension of security is missing. Economic slowdown has adversely affected mainly workers with fixed and short-term contracts and agency workers. At the same time, these workers do not enjoy full social security rights and, mostly, they have little or no access to company retraining programmes. It would be only just to award a one-off compensation for their flexibility. This payment could be considered as an “employment bonus” that the unemployed workers could use for expenses involved in the search of a new job.

c. **Support for internal flexicurity** - where companies do not have recourse to releasing redundant workers in periods of slowdown they assume that they will enjoy competitive advantage in the next period of recovery when skilled and educated workforce will be readily available. These models of internal flexicurity are to be looked at as effective systems of job protection and, for this reason, financing of such “technical unemployment” from social security means is fully warranted. In these cases workers do not lose their jobs, they work shorter working hours for reduced wages that are supplemented by unemployment benefits. Member States opting for these measures could direct part of their investment in the labour market (1% GDP) into introduction or strengthening of measures of internal flexicurity support.

d. **Investment into skills and life-long learning -** the systems of unemployment benefits should be complemented by programmes aimed at retraining and improvement of the skill base of the unemployed. In this way, the period of unemployment would be effectively used for human capital improvement. Such policy would prevent emergence of bottlenecks that typically come up with the start of economic recovery.

e. **A job-support programme in the social economy sector -** in addition to the training of unemployed workers there is another way how to maintain contact with the labour market and prevent a degradation of human capital. It is introduction of a job programmes in the social economy sector. Creation of jobs in such Government sponsored programmes would respond to social needs that merit special attention, such as care of older people, childcare institutions, personal assistants of the handicapped, etc.

f. **Enlargement of the European globalisation fund -** the above measures at national level have to be supplemented by action at European level. The present globalisation fund has to be strengthened and rebuilt into a fund that would provide support and assistance to all workers threatened by job losses irrespective of whether this threat comes from globalisation or the present crisis in the European economy. More resources should be made available and social partners should be fully involved.

A programme construed to achieve the above objectives would surely be instrumental for combating the worst impact of the impending crisis. It would provide a meaningful assistance to all those who are likely to be adversely affected in the near future.

The current casual approach of the Czech Government to the solution of the likely impact of the crisis is highly visible, in particular when compared with measures that are adopted by other world countries.

Prague, January 2009