

# 1 Economic Policy

## 1.1 Fiscal Policy

Improving the structural parameters of public finances and reducing further the general government deficit continues to be an important priority for the upcoming period. Achieving this target, however, will be complicated by the expected slowdown in the Czech Republic's economic growth, which is related in particular to the cooling of the European and world economies and the crisis in the financial markets. At the same time, the government is committed to continue with reforms that will ensure the long-term sustainability of public finances.

The primary objectives of the government in the fiscal area are:

- Complying with the approved expenditure limits, which should result in achieving a general government deficit of 1.6% in 2009 and 1.5% in 2010. A new fiscal target of -1.2% was approved for 2011, along with its corresponding expenditure limit.
- Lowering tax burden and limiting administrative burden and tax distortion by simplifying the tax system.
- Reducing dynamics of government expenditures in proportion to nominal GDP growth and increasing their effectiveness.
- Continuing to reform the pension and health care systems.

Measures towards reducing the deficit are focused, in particular, on savings on the expenditure side of public budgets, especially in the area of mandatory expenditures, the reduction of which was made possible by the adoption of stabilising measures in 2007. These steps will further increase the effectiveness of the social system and strengthen motivation with respect to economic activity.

On the revenue side, tax burden will be gradually lowered and tax system will be simplified. Reduced personal and corporate taxation along with transparent and business-friendly tax administration are the main factors supporting economic growth. In coming years, growth in tax revenues will decelerate due to a cooling of the Czech economy.

A precondition for successful fiscal consolidation is a thorough implementation of the fiscal targeting regime and upholding the approved medium-term expenditure frameworks.

Reducing the general government structural deficit to 1% of GDP by 2012 continues to be a medium-term budgetary objective.

With regard to the negative fiscal impact of an ageing population, the government is committed to continue with the reforms of the pension and health care systems that were initiated in 2007.

### 1.2 Monetary Policy

The Czech National Bank (CNB) will continue to conduct monetary policy via the inflation-targeting regime. The inflation target valid since January 2006 is set for annual CPI inflation at a level of 3% with a maximum deviation of one percentage point in either direction. In March 2007, the CNB announced a new inflation target of 2% for annual CPI inflation (with a tolerance band of  $\pm$  one percentage point), effective from January 2010. In addition, the CNB announced that it would allow a gradual reduction in inflation to the level of the new inflation target far enough in advance so that inflation would be close to the target by the time the targets is effective.

The reduction in the inflation target reflects, in particular, longer-term perspective for inflation targeting in the Czech Republic due to postponing the euro adoption date beyond the originally envisaged horizon of 2010 (see below) and current low-inflationary environment of the Czech economy, exhibited in inflation expectations anchored at low levels. Lower inflation in the Czech Republic in line with the new target further increases the chances of meeting the Maastricht price stability criterion in the future. The CNB continues to view its inflation targets as medium-term in nature, and real inflation may temporarily deviate from them as a result of exogenous shocks. Changes to indirect taxes are one such shock. Monetary policy does not react to first-round effects of such changes and concentrates only on their second-round effects.

The Czech Republic's original Strategy for Eurozone Accession has not been fulfilled, and the originally envisaged date for euro adoption in the Czech Republic of 2009/2010 is no longer realistic. The Czech Republic's Updated Strategy for Eurozone Accession, approved by the Czech government in August 2007, states that the main obstacle to meeting the Maastricht criteria is still the unconsolidated state of public finances. This, along with the low flexibility of the Czech economy, and especially of the labour market, is also a risk to Czech economic performance in the Eurozone and prevents it from reaping the benefits associated with adopting the euro. The euro adoption date will, therefore, be linked to resolving these problematic areas with a fundamental public finance reform and strengthening the flexibility of the Czech economy. In this respect, ERM II entry is still viewed as only a necessary condition for adopting the euro, and hence, the amount of time spent in ERM II should be kept at a minimum. A periodic document "Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Eurozone", jointly prepared by the Ministry of Finance and the CNB and approved by the government at the end of 2007, stated that, to date, insufficient progress had been made toward creating the conditions necessary for adopting the euro to be able to assign a target date for accession to the Eurozone. It recommended that the Czech Republic, for the time being, should not set a target date for accession to the Eurozone. This also implies the recommendation that it should not strive for entry to the ERM II mechanism in 2008.

With the expected waning of inflation pressures associated with the subsidence of one-off expenditure shocks dating from the turn of 2007 to 2008, the economic decline from the peak in the economic cycle, and the impacts of this year's accelerated strengthening in the CZK exchange rate, interest rates can be expected to fall in the very near future and remain roughly stable thereafter.

### 1.3 Structural Policies

A detailed outline of the priorities and approved measures in the area of structural policies is presented in the Czech Republic's National Reform Programme 2008–2010, which was approved by the government in October 2008. In this section, therefore, we present only a selection of some of the measures.

In March 2008, the government commenced its reform of the research, development and innovation system. The objective of the complete package of measures is to simplify administration, improve the quality of the system, and increase the benefits of research, development and innovation for the Czech economy. Public financial resources for research and development are being gradually increased such that they will represent 1% of GDP by 2010.

Currently under preparation, the “White Book of Tertiary Education” will provide the foundation for tertiary educational system reform. The concept of the reform consists in the elimination of obstacles to access to tertiary education, changes in the structure of the tertiary education, and a change in the financing system. The Czech Strategy for Lifelong Learning was already approved by the government in July 2007. The Czech Republic is currently preparing an Implementation Plan for the Strategy, wherein individual proposals will be elaborated into concrete projects.

The government is also actively engaged in improving the quality of the business environment, in particular by reducing the administrative burden. In April 2008, the “Plan to Reduce the Administrative Burden on Businesses by 2010” was approved. This document establishes binding procedures for reducing the burden by 20% over the period 2005–2010. In July 2008, Czech POINT extended its services for entrepreneurs and an amendment to the Trade Licensing Act entered into effect. This has brought about the abolishment of trade licenses and certificates, abolishment of territorial jurisdiction of trade licensing offices, limiting of the notification duty, introduction of a single unregulated licence, and a complete restructuring of trades. Furthermore, act on E-Government was approved. This covers electronic transactions of select public administration authorities and legal entities, as well as of a secure data exchange system, and it introduces into the legal order authorised conversion of documents. The act will become effective as of July 2009. A comprehensive reform of the tax system is currently being prepared.

Reducing the energy and material demands of the Czech economy is important for increasing its competitiveness and protecting the environment. Starting in January 2008, the Czech Republic launched the first phase of its ecological tax reform by implementing Directive 2003/96/ES. The aim is to shift taxation away from labour and towards products and services, production or consumption of which have negative impacts on the environment while maintaining the principle of revenue neutrality. The Czech Republic also supports renewable sources of energy and the use of combined electricity and heat production by means of redemption prices and contributions toward the price of electricity.

The Schedule for the Construction of Transport Infrastructure 2008–2013 is an initial document for the further expansion of transportation infrastructure, which was approved by the Czech government in September 2007. The main priority is to complete the backbone network of motorways and railway corridors.

Another priority of the government is a flexible labour market. In January 2009, an amendment to the Employment Act entered into effect that significantly revises assistance and benefits for the unemployed and introduces a “green card” for foreign workers. An amendment to the Labour Code is also currently being prepared.