

# 1 Economic Policy

## 1.1 Fiscal Policy

Reducing general government deficits and improving the structural parameters of public finances will be the priorities of fiscal policy for the coming period. Preparation and enforcement of a medium-term fiscal strategy, however, is currently complicated by the announcement of elections. The main objective of fiscal policy is thus maintenance of the government deficit in 2010 at 5.3% of GDP and gradual consolidation in subsequent years such that the Czech Republic eliminates the excessive deficit by 2013.

Other objectives of the government in the fiscal area are:

- Limiting the negative impacts of economic development in 2009 on general government finances through the adoption of measures to reduce the deficit,
- Reducing the administrative burden and tax distortion by simplifying the tax system,
- Increasing the effectiveness of government expenditures.

The measures adopted by the Chamber of Deputies toward reducing the deficit in 2010 are focused, in particular, on the revenue side of public budgets, and especially in the area of indirect taxes. On the expenditure side, a compromise in the form of a temporary reduction of certain social benefits was adopted in the Chamber of Deputies. The government at the same time decided to cancel unfilled administrative positions in the general government and subsequently to freeze the volumes of funds for wages of civil servants as well as for 2010 pensions.

In accordance with the requirements of the excessive deficit procedure, the government also prepared and approved a consolidation strategy for the following years of the outlook. In contrast to the measures for 2010, greater emphasis is placed on the expenditure side of public budgets. This approved strategy guarantees reduction of the general government deficit to 4.2% of GDP in 2012.

The simplification of the tax system and the transparent and business-friendly tax administration are the main factors improving the quality of public finances and supporting economic growth. Despite the economic decline, funding for education, support for science and research, and financing of investments that support economic growth remain government priorities. This policy is reflected in expenditure cuts in individual chapters which were carried out selectively with regard for the government's priorities.

A precondition for successful fiscal consolidation shall be determination of achievable fiscal objectives by the new government. The main instrument will be thorough implementation of a fiscal targeting regime and upholding the newly approved medium-term expenditure frameworks.

No deadline for achieving the medium-term budgetary target for the general government structural balance has been established as, given the current state of public finances in the Czech Republic, its achievement would extend well beyond the CP horizon. The new government will be able to credibly establish a date for its achievement.

The macroeconomic forecast of the Ministry of Finance upon which this document is based is rather conservative in comparison with the predictions of other institutions (see Chap. 4.4). This provides a good basis for the achieving the estimated levels of tax revenues and achieving the planned financial results in 2010. Nevertheless, current forecasts do not, and cannot, take into account the consolidation of public finances of most EU countries, which in large measure will have occurred only from 2011. Thus, there is a risk that the EU's economic growth will be lower than currently expected. This would of course have a particularly negative impact on the small, open economy of the Czech Republic with corresponding consequences for the amounts of deficits (Chap. 4.3 is devoted to the impact of the growth rate of the external environment on the Czech Republic).

### 1.2 Monetary Policy

The CNB will continue to conduct monetary policy with the help of the inflation-targeting regime. After four years during which the inflation target was at a level of 3% (expressed as annual growth in the consumer price index), a new target of 2% takes effect from 2010. For the new target, as for the previous one, a tolerance band of  $\pm$  one percentage point will be set.

The reduction in the inflation target reflected, in particular, the longer-term perspective for inflation targeting in the Czech Republic due to postponing the euro adoption date beyond the originally envisaged 2010 horizon (see below) and the 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 the first-round effects of such changes and concentrates only on their second-round effects.

The Czech Republic's Updated Strategy for Euro Area Accession, approved by the Czech government in August 2007, and did not set a new target date for accession to the Euro Area. This date will depend on the resolution of problematic areas as part of a fundamental public finance reform and strengthening the flexibility of the Czech economy. In this respect, entry into ERM II 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. The periodic document "Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area", jointly prepared by the Ministry of Finance of the Czech Republic and the CNB and approved by the government on 21 December 2009, states that it is very improbable under current conditions that the Czech Republic will be able to meet all Maastricht convergence criteria in the medium-term horizon. The major barrier for entry into the monetary union will be that the general government deficit is higher than 3%. Equally uncertain is the sustainability and necessary further increase in the achieved degree of alignment of the Czech economy with the euro area in coming years. Given this situation, it is therefore impossible to establish a new target date for accession to the euro area. This also implies that the Czech Republic will not strive for entry to the ERM II mechanism during 2010.

With the economic crisis subsiding and inflation expected to slowly rise during 2010, interest rates can be expected gradually to increase in this period.

### 1.3 Structural Policies

A detailed outline of priorities and measures adopted in the area of structural policies is presented in the Report on Fulfilment of the Czech Republic's National Reform Programme 2008–2010, which was approved by the Czech government on 26 October 2009. In this section, therefore, only a selection of the most important measures is presented.

#### Education, science, research and innovation

In January 2009, the Czech government discussed the “White Book of Tertiary Education”, which provides the basis for the current debate on the objectives and means of the planned reform of university education in the Czech Republic. In addition to the Strategy for Life-Time Learning approved by the Czech government in July 2007, an Implementation Plan for the Strategy for Life-Time Learning was approved in January 2009. The Strategy was supplemented by specific implementing measures through which its objectives will be fulfilled in the period 2009–2015. The Plan proposes a procedure, organisation, responsibility, timetable and financial backing for putting the Strategy into practice.

Future competitiveness must be based on the use of modern technologies in industry, a whole range of services and agriculture, on energy savings and on increasing economic rationality of the use of alternative energy sources. To meeting this goal, precisely targeted promotion of priority areas in fundamental research, experimental research and innovations that ensure competitive advantages to the key branches in the Czech Republic will contribute, together with promotion of international cooperation in science, research and tertiary education, a shift from input-oriented targets to performance-based targets at all levels of education and increasing pressure on the quality of outcomes and effectiveness of education at all levels and in research supported by the state.

Currently, the Reform of the Research, Development and Innovation System is being executed. Its objective is to simplify administration, achieve more effective use of public resources for this area, and increase the benefits of research, development and innovation for the Czech economy. In June 2009, the National Policy on Research, Development and Innovations of the Czech Republic was approved by the Czech government within the aforementioned reform for the years 2009–2015, defining the government's approach to creating an environment of innovation and its further direction. The Czech Republic will focus primarily on improving strategic management and the efficiency of the science, research and innovation system, improving cooperation between the public and private sectors, greater involvement in international cooperation, and ensuring quality human resources.

#### Business environment

One of the most important reforms adopted in the past period is the Act on Free Movement of Services. This legal regulation transposes into the Czech legal system the Directive on Services in the Internal Market of the EU which significantly liberalises the provision of services in the EU. The Act came into force in December 2009.

One of the priorities of the Czech government in terms of improving the business environment is to reduce the administrative burden on businesses. In 2008, the Czech government committed itself to reducing the administrative burden by 20% in the period of 2005–2010. In this connection, the Report on Implementation of Plan of Reducing the

Administrative Burden of Entrepreneurs till 2010 and Its Acceleration was approved in April 2009 and, in accordance with it, future activities will focus on ten norms presenting the greatest burden for companies.

In July 2009, the Act on eGovernment came into force. This act regulates electronic transactions of select public administration authorities and legal entities and establishes a secure data exchange system and authorised conversion of documents.

### **Energy industry and climate change**

At present, a proposal for an update of the State Energy Policy of the Czech Republic is being discussed. The update should ensure for the next 20 years and with an outlook up to 2050 that the Czech Republic has a safe, low-emission energy industry with permanently surplus balances. The proposal allows for greater use of nuclear and renewable sources of energy. Further discussion on this material will be linked with discussion of the proposal for the Climate Protection Policy with the aim of maximum accord between the two documents.

As part of efforts to support renewable energy sources, an amendment to the Act on Excise Duties has been approved that establishes support of first-generation high-percentage biofuels. The amendment took effect in October 2009.

### **Labour market**

Another priority of the government is a flexible labour market, particularly during the ongoing economic recession. The amendment to the Employment Act that came into force in January 2009 focuses on strengthening economic activity by making conditions for granting unemployment benefits more restrictive.