Convergence Programme

of the Czech Republic

May 2004

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1 Introduction

The Czech Republic hereby submits its first Convergence Programme in accordance with the Council Regulation No. 1466/97, which establishes for non-participating Member States the obligation of presenting a Convergence Programme. It is elaborated within the multilateral surveillance framework procedure laid down in Article 99 of the Treaty establishing the European Community and in line with the country-specific recommendations of the BEPGs as proposed by the Commission early this year. The Czech Republic expresses its interest in proceeding further with its conservative euro-strategy which was specified in the joint strategic document of the Czech Government and the Czech National Bank The Czech Republic's Euro-area Accession Strategy" of October 2003. According to this strategy, the Czech Republic can be expected to join the euro-area around 2009-2010.

From the formal point of view the Convergence Programme respects fully the format defined by the European Commission in its "2001 Code of Conduct". However, with respect to the factual content the Czech Government has so far not been able to satisfy either the reference fiscal deficit set by the Protocol on Excessive Deficit Procedure, or the requirements of the Stability and Growth Pact for the medium-term objective of a budgetary position close to balance or in surplus, due to the current fiscal situation and fiscal burden. These problems will be solved by the Government through a multi-annual programme of fiscal consolidation.

The Convergence Programme is based on external assumptions given by the European Commission and on the State Budget for 2004. It also takes into account the fiscal notification of February 2004, which was submitted to the Commission, and official statistical data from the Czech Statistical Office available up to March 2004. The Convergence Programme prolongs and updates the August 2003 Pre-Accession Economic Programme.

2 Overall Policy Framework and Objectives

2.1 Government Objectives and Priorities

The main economic objectives of the Czech Government are to promote growth and employment by stimulating productivity and competitiveness and to get public finances under sustainable development. The aim is to accelerate the process of catching-up with the "old" EU Member States, without neglecting environmental and social issues.

Achieving high growth dynamics is also a prerequisite for reversing the declining trend of employment in the Czech Republic. The key to this strategy is to improve the entrepreneurial culture and business environment, together with measures aimed at increasing flexibility of the supply side of labour market (e.g. through adjustments to the social benefit scheme, reform of the education system, through promotion of professional training and implementation of lifelong learning schemes), including encouraging R&D and innovations[1]. All these measures have to be in accordance with principles of sustainable development.

A precondition of the stated priorities is maintenance of a stable macroeconomic environment by applying an optimal economic policy mix. Satisfying this goal is a prerequisite also for subsequent accession to the eurozone. Due to the unavoidable lags in implementation, the economic policy will already concentrate on creating conditions for effective integration of the Czech Republic into European monetary structures. The timing of this process will depend, however, on the speed of real convergence and structural reforms, on nominal convergence, and especially on consistent fiscal consolidation.

The economic policy will focus on speeding up economic convergence and increasing the adaptability of the economy in order to reduce the risk of an economic slowdown caused by asymmetrical shocks. Although, since the beginning of transformation, the characteristics of the Czech economy have approached those of EU countries, a certain degree of economic misalignment and structural differences will persist even after eurozone accession. Crucial for ensuring sufficient responsiveness of the economy are stabilising fiscal policy, labour market flexibility and effectively functioning financial markets.

Fiscal reforms will prevent the public finances from becoming a barrier to full participation in the eurozone because of excessive deficits and also due to insufficient structural adjustment, notably on the expenditure side. Fiscal policy must fulfil its macroeconomic stabilisation function and be - at the same time - consistent with other structural policies promoting the competitiveness of the Czech economy on the single market.

The Government is fully aware that completing the reform of public finances is a precondition for achieving compliance with the Maastricht criteria. Excessive budget deficits and unfavourable debt trends have been, unfortunately, obvious negative side effects of the enormous transformation burden, new requirements on infrastructure, environmental protection and the need for catching-up. Fiscal consolidation will be carried out step-by-step within an appropriate time period and in a sustainable manner.

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[1] *The National Innovation Strategy was approved by the Czech Government in March 2004, and innovation has been declared one of its top priorities. A medium-term oriented document called National Innovation Policy will be elaborated by the end of this year.*

In line with the above-mentioned ambitions and in accordance with the Lisbon strategy, the Government has set the following priorities[2] for 2004:

- promotion of growth and competitiveness,
- employment,
- public finances reform,
- sustainable development.

2.2 Monetary and Exchange Rate Policy

The main objective of the Czech National Bank's (CNB) monetary policy is to ensure price stability[3]. The establishment and maintenance of a low-inflation environment is a prerequisite of balanced and long-term sustainable growth.

Monetary Policy and Inflation Targeting

The current monetary-policy regime of the central bank is based on direct inflation targeting. As of January 2002 the central bank moved to continuous band-targeting of total year-on-year inflation[4]. The inflation-targeting band has consistently decreased from 3-5 percent in January 2002 to 2-4 percent in December 2005. In line with the CNB Monetary Strategy document, the CNB set in March 2004 its inflation target for the period starting January 2006 and thus created, sufficiently in advance, a framework for monetary policy decision-making with impacts on inflation from the start of 2006, and also anchored long-term inflation expectations. The CNB hereby announced that the inflation target for the period starting January 2006 is a year-on-year consumer price index (CPI) change of 3 %. The CNB will at the same time endeavour to ensure that actual inflation outturn does not differ by more than one percentage point in either direction from this target. The inflation target will be in force continuously until the Czech Republic joins the euro-area.

The declared inflation target does not institute any acceleration in targeted inflation and follows smoothly on the end of the previous steadily descending target band. Given the low-inflation environment, the target is set in horizontal form. The inflation target is at the same time a good starting point for future fulfilment of the convergence criteria, corresponds to the long-term inflation expectations of the financial markets, and also conforms to the limitations stemming from statistical overvaluation in measuring inflation. The target also takes into account the zero nominal interest rate limit and the potential downward inflexibility of wages.

The inflation target has been set slightly above the price stability level declared by the ECB[5]. This small inflation differential reflects the long-term real convergence of the Czech economy

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[2] *These priorities, although in rather different ranking, reflect principally the recommendation of the BEPGs as the European Commission proposed them for the CR in early 2004.*

[3] *This objective was codified in 2002 by an Amendment of the Act on the Czech National Bank and an Amendment of the Constitution of the Czech Republic, replacing the previous objective, which was monetary stability, in order to harmonise the aforementioned legislation with that of the EU.*

[4] *For more information see the Pre-Accession Economic Programme from August 2003.*

[5] *The ECB declared price stability for the euro-area in terms of year-on-year change in the harmonised index of consumer prices (HICP), which is "below but close to 2%".*

with the euro-area average, which will continue for some time after the Czech Republic's accession to the euro-area.

Role of Monetary Policy in Preparation for Euro-Area Accession

The Czech Republic's strategy for the single currency's adoption was formulated in the joint document of the Czech Government and the CNB adopted in October 2003.

The preparedness of the Czech Republic for ERM II participation and euro-area accession will be assessed each year, not only with respect to fulfilment of the formal entry criteria, but also by means of detailed economic analyses. Specifically, during the drafting and discussing of the Convergence Programmes, the Government will, each autumn and at the latest by the end of December, receive an assessment of the Czech economy's current and expected fulfilment of the Maastricht convergence criteria and an assessment of the degree of the Czech economy's alignment with the euro-area. On the basis of this assessment, the CNB and the Ministry of Finance will propose to the Government a position on whether to initiate the procedure that will take the koruna into ERM II. Given the intention to participate in ERM II for the obligatory two years only, the decision to join ERM II will also predetermine the projected date for euro-area entry, i.e. the introduction of the euro in the Czech Republic.

Until the monetary integration process has been completed, independent Czech monetary policy will continue to be implemented by means of an inflation-targeting strategy. The participation in ERM II can be perceived only as a prerequisite for joining the euro-area and the central bank does not consider a longer-than-necessary stay in ERM II to be desirable. The Czech Republic should enter ERM II only after conditions have been established for successful fulfilment of convergence criteria. Afterwards the Czech Republic could introduce the euro and benefit from its introduction.

Provided that the Maastricht criteria are fulfilled, including a successful consolidation of public finances, and provided that a sufficient level of real convergence is achieved and adequate progress has been made with structural reforms guaranteeing sufficient economic alignment with the EU Member States, the Czech Republic can be expected to join the euro-area around 2009–2010.

2.3 Fiscal Policy

Sustainability of public finances is a fundamental requirement for adopting the single European currency. To reduce the current excessive budget deficit, the Government has adopted a strategy aimed at consolidation of public finances. According to this document, the general government deficit should not exceed 4.0 % of GDP in 2006 and 3.5 % in 2007. This would bring an average reduction in the general government deficit of approximately 0.7 percentage points annually during the period 2004 – 2007. This speed of fiscal consolidation should not lead to a significant drop in domestic demand or threaten social cohesion. We expect fiscal policy to be slightly demand-restrictive and make room for a more accommodating monetary policy. Together with reducing the deficit, the Government has also decided to change the structure of tax revenues and government expenditures. The aim is to stimulate the supply side of the economy and to create conditions for acceleration of the potential output growth rate.

Changes in the tax system have been introduced as part of the 2nd stage of public finance reform, which will help increase competitiveness. The most significant change is decreasing the standard VAT rate from 22 % to 19 % while maintaining the reduced tax rate at 5 %. With the aim of supporting entrepreneurship, the Government adopted a programme of significantly decreasing corporate taxation. The statutory tax rate is gradually decreasing[6]. According to available forecasts, the effective tax rate will decline even more radically in future, especially as a result of faster depreciation in the first three depreciation groups, and because of enhancing the promotion of R&D via increasing the limit regarding tax deduction in relation to gifts given for scientific and research purposes to 10 % of the income tax base. In the medium term, the effective corporate tax rates will be roughly comparable with the neighbouring countries, as well as with the tax rates the "old" EU countries applied when they were at a similar stage of economic development (for more information on fiscal policy see chapters 4 – 7).

2.4 Structural Policies

Improvement of Business and Investment Environment

In February 2003, the Government approved a document Proposals for Improvements of the Business and Investment Environment, which identified significant barriers to the development of entrepreneurial and investment activities in the Czech Republic.

In January 2004, the Investment and Business Development Agency CzechInvest started its operations after a merger of three agencies – the Czech Agency for Foreign Investment (CzechInvest), the Business Development Agency (BDA) and the Industry Development Agency (CzechIndustry). The main intention is to make the system of business support more effective and to simplify access to financial sources from the EU Structural Funds. The newly created agency has also set up 13 regional offices. In February 2004, the Business Environment Development Council was established, whose members are both from a public and a private background. The Council will mainly concentrate on tax issues, legislation regulations of entrepreneurship, improvement of infrastructural conditions for businesses, support of entrepreneurship and trade/export, the labour market and the education system.

Box 2.1: Structural Characteristics of the Czech Economy

As regards the sectoral breakdown of GDP (expressed as a % of gross value added incl. FISIM in current prices) no significant changes occurred in 2003 in comparison with the previous year. The share of the service sector increased from 57.9 % in 2002 to 58.3 % in 2003 and that of construction from 6.6 % to 6.9 %. Contrary to this development, the share of industry decreased from 31.8 % to 31.4 % and that of agriculture from 3.7 % to 3.4 %.

Economic development in industry has been driven mainly by strongly performing private companies under foreign control (representing roughly half of total revenues, more than a third of direct exports and a third of total employment in 2003). This favourable influence stems from launch of new productive capacities in new industrial zones and from the recovery of production in the traditional mining and machinery sectors.

Supported by investment incentives, the Czech Republic registered enormous increase in FDI inflows in the last four years and in the long run it belongs – from the standpoint of international comparison – among those

[6] *This rate was decreased from 31 % in 2003 to 28 % in 2004 and is to be further reduced to 26 % in 2005 and finally to 24 % in 2006.*

considered to be credible recipients of foreign capital. From 1993 to the end of 2003, the Czech Republic gained in total CZK 1,288 bn in FDI. However, in 2003 FDI inflow to the Czech Republic decreased (y-o-y) by almost 74 % to CZK 72.9 bn (or ca USD 2,583 mil.).*)

Nearly two fifths of these investments were channelled into industry, approximately one third went into manufacturing (especially to the production of machines, electrical and optical equipment and transport means).

In the service sector, one fifth of FDI was directed into the banking and insurance industry, nearly 18 % into real estate services and ca 13 % into trade and maintenance.

By the end of 2003, the Cabinet had discussed and approved the investment plans of 28 companies, which were interested in being granted support in connection with the creation of 20 technological centres and 8 centres for strategic services. These companies plan to invest more than CZK 8 bn and employ more than 6,000 persons over the next five years.

In the course of 2003 the former CzechInvest Agency mediated 60 investment projects (41 of them submitted a request for investment incentives) with an expected inflow of FDI amounting to approx. CZK 35.8 mil. and creating more than 7,000 new jobs. As many as 11 industrial zones were prepared over the same period of time.

The number of bankruptcy and settlement proposals has decreased for the third year running (in 2003 y-o-y by 2.1 %). 4,639 bankruptcy proceedings have been finalised since 1992.

In the labour market, a mild annual decrease in total employment and an increase in the average rate of registered unemployment to 9.9 % mainly resulted from the continuing process of structural changes in the national economy and lasting labour market rigidities. Industry in particular witnessed a decrease in the number of workers, resulting in an increase in labour productivity and competitiveness. In contrast to this development, the service sector (still with a lower share of the total workforce than observed in standard market economies) is an area where employment may continue to rise in future. So far, however, its absorption capacity cannot compensate for the loss of jobs due to production restructuring.

*) *The decrease in 2003 FDI was caused partially by very low privatization activity, combined with outflow of capital due to Cesky Telecom´s acquisition of a 49 % share in the Eurotel Praha company from Atlantic West B.V. (at sale price of USD 1.05 bn) and with the high reference level of 2002 (sale of Transgas).*

The current system of investment incentives in the Czech Republic is regulated by the Act on Investment Incentives, effective since May 2000. Its second amendment, which came into effect on 1 May 2004, has ensured full compatibility with EU law. The crucial measures include a transfer of powers previously exercised by the Office for the Protection of Competition of the Czech Republic, with respect to the evaluation of applications for investment incentives, to the Ministry of Industry and Trade. Where the incentive would exceed the limit determined by relevant legislation, these powers have been transferred to the European Commission. Furthermore, the minimum volume of investment giving rise to eligibility for investment incentives has been reduced from CZK 350 mil. to CZK 200 mil. (from EUR 10.9 mil. to EUR 6.2 mil.). A new Framework Programme for the Support of Technology Centres and Centres of Strategic Services was approved in December 2003. It should enhance the international competitiveness of the Czech Republic and contribute to creation of employment opportunities for highly skilled personnel.

The Government pays close attention to the sector of small and medium-sized enterprises (SMEs), which represent an important segment of the Czech economy. SMEs stimulate the competitive dynamics of the economy by compelling, both directly and indirectly, large enterprises to increase effectiveness and to support innovation. Therefore the Government is preparing a strategic document focussed on the support of small and medium enterprises. The medium-term objectives of this strategic document will be as follows:

- to increase SME’s contribution to economic growth, export performance, reduction in unemployment and economic recovery of structurally weak regions;

- to improve the competitiveness of SMEs and to create conditions for their successful integration within the Internal Market and successful long-term survival in this market;
- to facilitate the setting-up of private businesses;
- to adjust the existing institutions and instruments aimed at the support of entrepreneurship, so that they would be compatible with the rules to the use of EU funds focussed on overcoming the negative impact of structural changes, particular economic weaknesses of individual regions and enhancement of the general cohesion of EU Member States;
- to develop human resources by specifically targeted development of infrastructure, reflecting the needs of the business sector, municipalities and regions, with particular focus on technical education and information and communication technologies, providing for professional training and lifelong education that will enable the workers to stay abreast of new information and knowledge, thus improving their career prospects.

The Government is already trying to support SMEs, notably to increase their share in total production and employment. At present, small and medium-sized enterprises receive assistance within the framework of 11 programmes created specifically for this purpose. State support is also aimed at the introduction of new technologies, including the re-qualification of employees, and enhancing access to information and communication technologies.

Promotion of R&D also contributes to the increasing competitiveness of the Czech economy. The first National Research and Development Policy was adopted in January 2000. At the beginning of this year the Government adopted a new National Research and Development Policy for 2004 – 2008. The main aim of this document is to establish the right conditions for an improvement in the economy's performance and eventual achievement of the Barcelona objectives, while taking into account the limited resources of the Czech state. In the area of research and development, the priorities are based on the Act in Support of Research and Development, implemented through a National Research Programme (which builds on priorities set out in 2000 and will be in place until 2009). The following areas were selected as system priorities: human resources, international cooperation in R&D, regional aspects thereof, practical use of R&D results and evaluation of research.

Full integration of Czech markets into the Internal Market will not only bring swifter progress in terms of market liberalisation (thus increasing competition), but it will also speed up the harmonisation of technical regulations, standards and procedures for the assessment of product conformity, which will in turn facilitate the access of Czech exporters to EU markets.

As far as the legislative framework is concerned, the following draft acts are to be submitted before the end of this year: new Commercial Code; new Bankruptcy Act (which is to do away with the lengthiness of procedures and introduce a differentiated approach to debtors, depending on the character of the debtor and on the number of his creditors, thereby helping to preserve the healthy parts of bankrupt companies); an amendment of the Code of Civil Procedure and draft legislation aimed at simplifying and accelerating registration in the Commercial Register.

When it comes to bureaucracy related to setting up and running of businesses, the Government is planning to introduce so-called one-stop-shops, i.e. offices where companies could get registered and also sort out all the other formalities related to their existence. The

Economic Chamber of the Czech Republic is working on establishing information centres for both Czech and foreign entrepreneurs. One central, 75 regional and 25 sectoral centres were set up in 2003. Regional centres provide information on the Internal Market and on public programmes focused on support of SMEs. They can also facilitate communication between entrepreneurs and institutions providing specialised services and information tailored to the specific needs of individual entrepreneurs. In cooperation with the Economic Chamber, the CzechTrade Agency, by means of its 15 regional representations, provides consulting and assistance services to support export. The possibility of on-line submission of tax returns and other forms of electronic communication with the state administration will also contribute to lessening the administrative burden for businesses.

In addition to these selective support measures and changes in legislation, the Government has adopted a programme of significant reductions in corporate income tax rates (see the sections devoted to fiscal policy).

Increasing Labour Market Flexibility and Employment

Relatively low labour force mobility and flexibility are typical of the Czech labour market, as they are of other EU Member States. Improving the adaptability of the labour market is conditional upon the adoption of measures aimed at greater flexibility of the labour market and real wages (not only in the institutional setting but also in other areas such as transport infrastructure or housing market).

The ratio of economically active population to total population has been decreasing over recent years and the sectoral structure of employment has been approaching that of the EU countries. However, a number of structural shortcomings persists, which results in increasing unemployment rates, especially when it comes to long-term unemployment. Significant regional disparities in unemployment and high unemployment rates of vulnerable groups, notably young and older workers, are other consequences of the above-mentioned structural shortcomings. The key structural problems include in particular the low regional and professional mobility of workers, a "soft" system of social benefits[7], high taxes on labour and non-existence of any universal lifelong learning scheme.

Box 2.2: Structural problems of the labour market

The rate of economic activity, i.e. the ratio of employed and unemployed to total population between the ages of 15 – 64, declined from 73.5 % in 1994 to 71.1 % in 2003. Increasing the retirement age does not influence the rate of economic activity to any significant extent, due to a growing number of other groups of non-active persons.

As a result of ongoing structural changes and increasing labour productivity the number of employees working on a full-time basis in the economy in 2003 declined (on a year-on-year basis) by 31,700 people, i.e. by 0.7 %, to 4.7 mil. people. Annual average employment in the primary sector (agriculture, forestry, fishery) declined by 6.5 % and in the secondary sector (industry, construction) by 1.3 %. The drop in employment in industry was partly offset by higher employment in the area of construction. Employment in the tertiary sector increased by 0.3 %, with different developments in different sectors of services. The highest increase in the number of employees was noted in the area of real estate and rental, while the most significant decrease was observed in the

[7] *Work on a draft act on poverty and social inclusion, which a.o. aims at motivating the workers to prefer active work over reliance on social benefits, has been initiated. This act should come into force as of January 1, 2006.*

field of education. The service sector's share of total employment in the Czech Republic is 56.2 %. Services are the only sector where a further increase of employment can be expected.

The number of job seekers increased (on a year-on-year basis) by 28,000 to 542,400 (at the end of 2003), while the number of vacancies slightly decreased by 500 to 40,200 vacancies. This means that there were 13.5 job seekers per vacancy (as compared to 12.7 job seekers in 2002). As for the structure of job seekers, there was a year-on-year increase of job seekers older than 50 years, those with lower education and the disabled. The number of long-term unemployed (i.e. those remaining unemployed for longer than one year) increased year-on-year by 27,000 to 218,300, i.e. to 40.3 % of all unemployed.

On average, 55,500 graduates and young persons were registered as job seekers in 2003, i.e. there was a year-on-year decrease of 3,500. This group represents 10.6 % of all job seekers. The number of graduates entering the labour market regularly increases between June and September, while it gradually decreases during the rest of the year. A year-on-year increase in unemployment has particularly affected higher age groups. The highest year-on-year increase in the number of job seekers was in the age group over 50 (by 12,800 to 112,700 persons). The ratio of this group to all the job seekers has been persistently growing over recent years. As for the job seekers under 25 years, who represent 23.8 % of all job seekers, a slight year-on-year decrease (1.5%) was recorded. The average age of job seekers increased, in comparison with the previous year, from 35.8 to 36.3 years.

Regional disparities in unemployment, expressed as a ratio of standard deviation to the average unemployment rate, declined (in a year-on-year comparison) by 0.9 percentage points to 41.1%, according to Ministry of Industry and Trade calculations.

The above-mentioned facts hint at the structural character of current labour market problems, which would therefore persist even if the country achieved economic growth higher than its potential growth.

With the aim of addressing these structural weaknesses, a number of steps was taken as part of the 2nd stage of the public finance reform. The retirement age is being gradually increased and the eligibility criteria for early retirement tightened up. This should lead to an increase in the employment of older workers. Another measure adopted with the same objective in mind provides retired people with the possibility of topping up their pensions by an unlimited level of earnings (either from employment or from entrepreneurial activity). Apart from a positive impact on the employment of older workers, this will also reinforce the revenue side of the pension system. On the other hand, some negative consequences may occur, such as a certain increase in the unemployment rate and social transfers.

Certain changes were also focused on legislation regulating the functioning of the labour market, in order to increase its flexibility. These changes included an Amendment of the Labour Code (in effect as of February 1, 2004) and the Employment Act (which is expected to come into force in mid-2004). The purpose of these changes is to create conditions for the successful functioning of private, profit-based labour agencies, which can lease workers to other firms. On the other hand, with the aim of increasing the protection of employees, the Amendment of the Labour Code restricts repeated use of work contracts for a definite duration. As for other measures, the eligibility criteria for unemployment benefits will be stricter and better cooperation with labour offices will be required from the unemployed.

The Government also stresses the necessity of developing active labour market policies. Apart from already existing instruments (socially beneficial or publicly useful jobs, etc.), some new measures are to be implemented[8]. All these steps should shorten the period of job search and

[8] *This applies in particular to offering the possibility of participating in re-qualification courses even to persons who are still employed but expect to lose their job in the foreseeable future.*

thus reduce the rate of frictional unemployment. To reduce regional disparities in unemployment, financial support for creating new jobs will be increased for those investors who decide to place their investments in regions with an unemployment rate of more than 14 %.

Labour market reforms will be followed by reforms of the educational system. A new four-year development programme Removal of Disproportions in Regional Educational Portfolios focuses on improving the responsiveness of educational schemes to labour market needs. Support is provided particularly for innovative training in technical areas, where substantial changes occurred in recent years. With some of the legislative barriers to the development of lifelong learning schemes already identified, the issue of lifelong learning, the search for alternative ways of education and identification of difficulties related to the implementation of these alternative options remain on the Government agenda. Establishment of a transparent national system of qualifications and introduction of so-called professional profiles (reflecting the needs of the labour market) will mark another crucial step for the development of lifelong learning.

Nevertheless, in view of certain implementation delays and ongoing restructuring, we cannot expect any immediate effects of the measures adopted so far or any swift changes in the labour market trends.

3 Macroeconomic Scenario

The expected development of the Czech economy can be illustrated using a quantitative macroeconomic scenario. The preparation of this scenario was motivated by an effort to be as cautious and realistic as possible[9] and to assess both the upside and downside risks in a very balanced way. The scenario was arrived at by a combination of formal (economic modelling) and not so formal methods of economic forecasting. Its plausibility was verified by a formalised survey of opinions held by the representatives of Czech public and private institutions dealing with macroeconomic forecasts (see Annex 9.1). A sensitivity analysis of some macroeconomic indicators in dependence on exogenous variables is described in Chapter 5.3. A comparison with macroeconomic scenario of the PEP (August 2003) is in Chapter 5.1.

3.1 Assumptions on External Environment

This scenario – in line with the mission of the Convergence Programme – is based on assumptions on the economic environment given in Economic Forecasts (Spring 2004) of the European Commission.

The assumptions having relevance for the macroeconomic forecast of the Czech Republic are summarized in the table below.

Table 3.1: Assumptions on External Environment

		Year 2003	Year 2004	Year 2005	Year 2006	Year 2007
USD/EUR exchange rate	*(annual average)*	1.13	1.25	1.24	1.23	1.23
EU-15 GDP	*(real GDP growth, y/y, in %)*	0.8	2.0	2.4	2.8	2.6
Germany GDP	*(real GDP growth, y/y, in %)*	-0.1	1.5	1.8	2.0	2.2
Oil prices	*(Brent, USD/barrel)*	28.8	31.1	28.9	27.2	26.9

Source: EC

The main features of this adopted external development scenario are as follows:

- The worldwide recovery gets stronger but growth is still uneven. While U.S. economic growth was over 3 per cent in 2003, and Japan’s growth was approaching 3 per cent, growth in the EU-15 economy, particularly the euro-zone, lags far behind. The steep appreciation of the euro vis-à-vis the US dollar has stopped recently, while oil prices are still soaring.

- Robust recovery in the U.S. should reach its peak in 2004. However, the growth in consumption can be expected to slow as the effect of tax cuts fades away. The immediate risk is presented in the increasing current account deficit accompanied by a steep increase of the budget deficit. This twin deficit may bring higher interest rates that would hurt economic growth. Interestingly, USD depreciation has not caused a lower U.S. current account deficit.

[9] *For instance, the growth scenario is located roughly in the lower quarter of the variation of the macroeconomic forecasts issued by other relevant domestic institutions. It is also slightly lower compared to estimates of international and foreign institutions. (See Annex 9.1)*

- Recovery in the EU is weak at present. Nevertheless, a gradual recovery is expected. An upsurge in domestic demand is imperative, since growth in the EU is highly dependent on exports. The German economy, which is the largest Czech trading partner, will continue to lag behind the EU average (and will show the greatest downside deviation from potential growth).

- EU enlargement may influence the Union positively in several respects. The acceding countries' growth rates are considerably above those of the EU-15; lower saturation of their markets might enhance internal demand within the EU. Despite initial constraints, enhanced labour mobility in the enlarged EU-25 may act as a pro-growth factor.

This scenario should be considered rather optimistic. If the assumptions concerning stabilisation of the USD/EURO exchange rate and the gradual decrease in oil prices fail to be borne out, EU growth rates will be below forecast levels. Further appreciation of the euro (say above the level of 1.30 USD per euro) and the continuing increase of oil prices create a significant risk that the recovery may be derailed. Moreover, increased geopolitical risks (including increased dangers in the Middle East region and bomb attacks in Spain) aggravate the situation again. Heightened tensions could endanger growth in Europe, which is sensitive to oil and gas price shocks, as well as export opportunities.

For the period 2006-2007 – not mentioned in the European Commission's Forecast – we assume a slight growth upturn in the EU, which will be amplified by the impetus stemming from EU enlargement. Growth in the EU over this period we expect to be between 2.6 % and 2.8 %. This scenario requires, however, stability in the commodity (with the oil price around 27 USD/barrel from 2006 on) and financial markets, political stability in our region and the absence of unpredictable accidents which might have a global impact (e.g. acts of international terrorism).

It is not likely that EU enlargement would mean a turning point in the development of macroeconomic indicators. It is more likely to manifest itself by a gradual accentuating of trends which began in pre-accession period. The Czech economy will enjoy the merits of joining a common market and an improved institutional framework.

3.2 Economic Output

This evaluation and forecast of the economic output of the Czech Republic, is based on the data available.

Box 3.1: Extraordinary Revision of National Accounts

Present situation

According to Eurostat requirements the Czech Statistical Office published in October 2003 selected variables from the ongoing review of annual national accounts in current prices for the years 2000 to 2002. The aim of the review is the full harmonization of national statistics with ESA 95 standards. The Czech Statistical Office simultaneously included within the revised figures the effect of an update of the statistical register based on the register of income tax payers. The issued figures are preliminary. The definitive time series of annual national accounts in current prices for the period 1995 to 2002 were published on April 30, 2004.

Planning schedule for the next review steps:

The time series of annual national accounts in constant prices using 2000 as the base year (using the method based on the conversion of segmented variables into the previous year's prices and their subsequent linking) for the same period should be completed by June 30, 2004.

The time series of annual national accounts in current and constant prices for the period 1990 to 1994 should be published by the end of 2004.

The quarterly national accounts have not been revised yet.

Revised quarterly time series for the years 2000 to 2003 in current and constant prices should be published in June 2004 together with the estimates of GDP for the 1st quarter 2004. The revised time series in current and constant prices for the previous years should be published in September 2004.

Consequences for the Convergence Programme

The usability of published revised figures is so far extremely limited, because:

- The revised time series of annual national accounts includes only 3 observations (for 2003 only a preliminary estimate of GDP at current prices is available).
- The variables in constant prices are not available. Therefore an analysis of real economic developments is impossible.
- The quarterly series of national accounts has not been revised yet. Those variables are the basis for most analytical and forecasting methods.

Therefore it is impossible yet to create a macroeconomic forecast based on the revised variables. Under the assumption that the planning schedule of revisions is met, the Autumn Convergence Programme submitted within the standard deadline will be already based on the revised time series.

Economic growth accelerated to 2,9 % in 2003. Growth was triggered on the demand side particularly by the high dynamics of household consumption. It was supported by high levels of growth in wages and disposable income, stable levels of consumer prices and low interest rates. Some recovery was also observed in the area of investment expenditure. The shift in the trigger of economic growth from consumption to investments, which took place at the end of 2003, may be evaluated as positive because it creates conditions for an acceleration in potential growth. The growth of domestic demand was partly compensated for by an increase in the foreign trade deficit (in constant prices). The deficit slowed GDP growth by 1.6 percentage points.

From the sectoral point of view, the value added grew mainly in the service sector, especially in the retail trade, hotels and restaurants, in transport and communication. Industrial growth was approximately proportional to GDP growth. The value added in the agricultural sector declined.

Table 3.2: Economic Growth

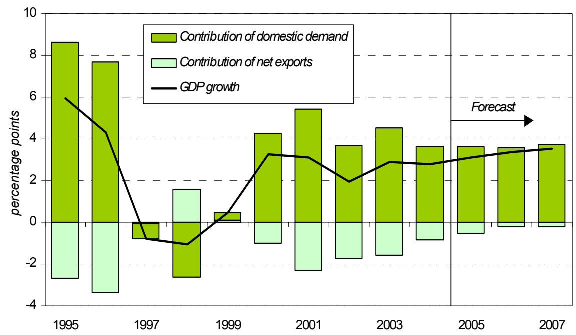
	ESA code	Year 2003	Year 2004 (1)	Year 2005 (1)	Year 2006 (2)	Year 2007 (2)
GDP growth at constant market prices (7 + 8 + 9)	B1g	2.9	2.8	3.1	3.3	3.5
Sources of growth: percentage changes at constant prices						
1. Private consumption expenditure	P3	5.4	2.9	3.1	3.4	3.4
2. Government consumption expenditure	P3	0.0	-0.2	-0.2	-0.2	-0.1
3. Gross fixed capital formation	P51	3.7	4.8	4.7	4.3	4.5
4. Changes in inventories and net acquisition of valuables as a % of GDP	P52+P53	2.6	2.8	3.0	3.1	3.1
5. Exports of goods and services	P6	6.7	8.0	7.9	7.8	7.8
6. Imports of goods and services	P7	7.6	7.9	7.5	7.1	7.1
Contribution to GDP growth						
7. Final domestic demand		4.3	3.3	3.4	3.4	3.5
8. Change in inventories and net acquisition of valuables	P52+P53	0.3	0.3	0.3	0.1	0.2
9. External balance of goods and services	B11	-1.6	-0.8	-0.5	-0.2	-0.2

Source: MoF CR

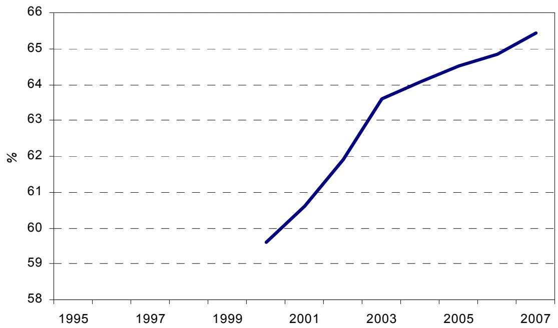
We expect the Czech economy to move on a trajectory of economic growth by somewhere between 2.8 % and 3.5 %, accelerating gradually. The intensity of acceleration will depend on the recovery enjoyed by our main trading partners and on the results of ongoing fiscal consolidation and structural reforms. In addition, we expect positive effects following the accession of the Czech Republic to the EU to come on stream.

Economic policy measures (described in Chapter 2) and the continuing inflow of foreign investments can have a positive effect on the supply side of the economy, encouraging both potential and real economic growth. Pursuant to this scenario, the gap between the Czech economy and the EU-15 will be reduced by about 2 percentage points by 2007 when compared to 2003, which will take Czech GDP per capita (in terms of PPP) to 65.5 % of the EU-15 average.

Graph 3.1: Decomposition of the Rate of Growth of GDP



Graph 3.2: GDP in Parity per capita *(EU-15 = 100)*



Sources: CSO, MoF calculations

The Demand Side

The extremely rapid growth of consumption by households (including NPISH) was a one-off episode in 2003. It should grow approximately in proportion to GDP in years to come. This will be conditional upon adequate and stable growth of average wages. The slower growth of unit labour costs in comparison with GDP deflator growth will lead to an increase in economic output in an environment characterised by low domestic inflation pressures and improving economic circumstances in the business sector.

Government consumption should stagnate or mildly decrease. The reform of public finance will lead to economical behaviour on the part of government institutions, both in employment terms and where the purchase of goods and services is concerned.

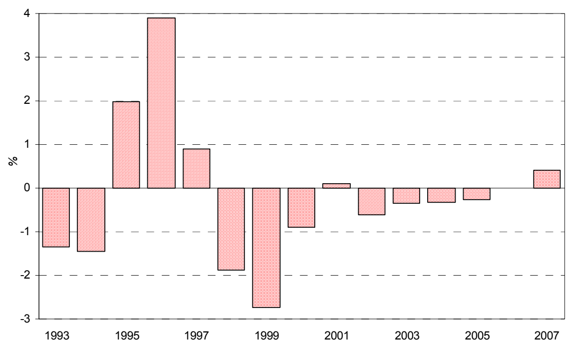
Gross fixed capital formation should continue to grow faster than GDP in years to come. Investment growth should be stimulated by low real interest rates, the improving situation in the corporate sphere, better export prospects connected with EU accession and recovery in partner countries. This investment wave should lead to new highly competitive export capacities, which will contribute to an improvement in the trade balance.

The negative contribution to GDP growth of the balance of trade in goods and services (in constant prices) should decrease in the coming years and could approach zero in 2007. It will depend on the materialisation of assumptions concerning the development of the external environment, the coming on stream of new technologies and on growth in domestic demand development, especially in investment. Otherwise, there is a risk of further increases in the difference between real exports and imports, because of the gap between domestic and foreign technological standards where equipment is concerned, and the fact that Czech production is highly import-intensive.

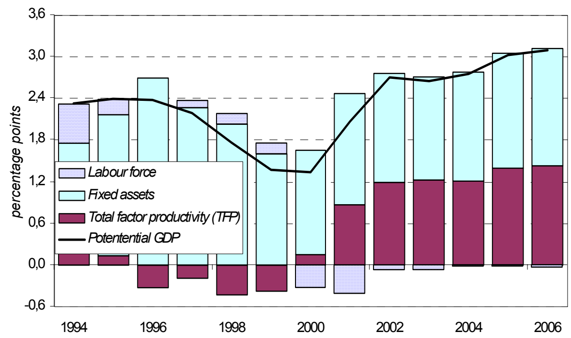
The Czech Republic's Position in the Business Cycle

According to our estimates, based on the Cobb-Douglas production function[10], the Czech economy had a small negative production gap amounting to 0.4 % of potential product in 2003. We assume that macroeconomic politics will be elastic enough to prevent repetition of the volatility in the economic cycle which characterised the late 1990s.

Graph 3.3: Output Gap



Graph 3.4: Growth Rate of the Potential Product



Source: MoF CR

Concerning the period up to 2007, we expect the implementation of public finance reform and structural policy measures to help speed up the present pace of potential product growth (which we estimate at 2.7 %), bringing it up to 3.0 %. If GDP grows at the projected pace, no significant positive output gap should be created. At the same time the growth trajectory of

[10] The potential product and output gap is calculated using a national methodology for the present. This methodology is described in PEP 2002. The main difference from the EC methodology proposal, important for the interpretation of results, is the zero-sum clause. Due to the use of this clause, the Czech economy has a negative gap which is 1 to 2 percentage points lower than would be the case if the other methodology were used, while the potential product growth rate remains roughly the same.

potential output implies a continuation of real convergence with the economic level of EU member states.

The growth of potential product should be driven in particular by increases in the total factor productivity. This should stem from improvements of the economy's institutional parameters in particular, not to mention the quality of the business environment and the introduction of new technologies related to the inflow of foreign direct investment.

Gross fixed capital formation, supported by FDI inflow, will also raise the economy's potential productive capacity. This will reflect both productive investment and investment in infrastructure (highway construction, railway corridor construction, telecommunications network construction etc.), often supported by use of Structural and Cohesion Funds.

Provided no change in the present unfavourable tendencies occurs, the situation in the labour market could endanger growth rates of potential product. The falling participation rate (ratio of the labour force to the number of people of productive age) prevents the economy from using the growing number of older people who are still capable of economic activity.

3.3 Prices

The Czech economy can be described as a low-inflationary one. This is a result of the positive impact of the inflation targeting regime on expectations concerning inflation on the part of economic players. The consumer price level was almost stable in 2003. The national average inflation rate reached only 0.1 %, while average HICP even decreased by 0.1 %.

Price stability was brought about mainly by cost factors. Both the decrease of prices of food and of imported goods, due to the strong appreciation of CZK vis-à-vis USD and strong competition on the domestic consumer market, prevented the price level from rising. Moreover, stagnation in regulated prices and an absence of other administrative measures contributed to very low CPI growth. Price developments were also influenced by the fact that economic output has been below its potential for a rather long time.

Nevertheless, the influence of these factors was fading out at the end of 2003. Year-on-year depreciation of the exchange rate against the euro started to manifest itself. Agricultural producer prices started to rise, leading to higher consumer prices of vegetable foodstuffs.

Table 3.3: Prices of Goods and Services

	Year 2003	Year 2004	Year 2005	Year 2006	Year 2007
Percentage changes					
HICP	-0.1	2.8	2.6	2.2	2.2
CPI	0.1	3.1	2.8	2.5	2.5
GDP deflator	2.9	3.5	3.3	3.2	3.4
Consumption of households deflator	0.1	3.2	2.8	2.5	2.5

Source: MoF CR

The inflation scenario for 2004 – 2007 is based on evaluating the impact of administrative measures, inflationary expectations and momentum and the output gap, foreign prices of imported commodities and nominal exchange rate developments.

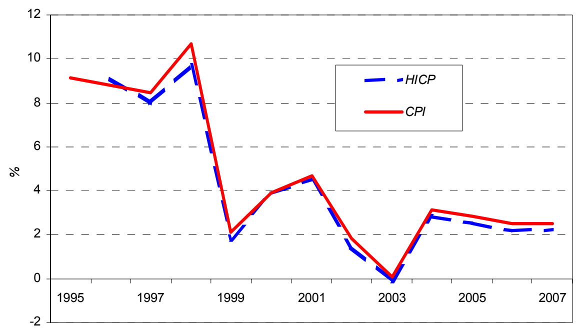
Inflation in 2004 will be greatly determined by an increase in the contribution of administrative measures to approx. 1.5 percentage points. This contribution will be a result of the tax harmonisation of excise duties and VAT within the public finance reform and of a higher increase in regulated prices. In subsequent years the inflationary contribution of administrative measures should stabilise below 1 p.p.[11]

Accelerated economic growth, motivated by loosened real monetary conditions and by foreign recovery, could gradually generate demand pressures in the economy, which may take over the role of main inflationary factor from the administrative measures in 2005. On the contrary, an acceleration in inflation should be prevented by import prices, whose growth should be curbed mainly by the expected nominal appreciation of the CZK vis-à-vis the euro and the dollar.

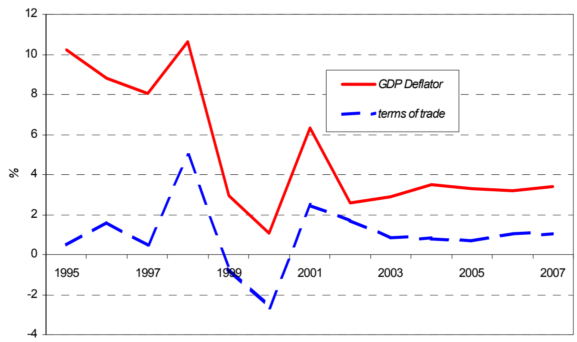
The gradual closing of the negative output gap in 2005 – 2007, together with inflationary persistence and expectations, which should partly reflect the administrative measures in 2004, should prevent inflation from a marked deceleration after one-off measures cease having an effect. On condition that there is not any distinct supply shock (oil, prices of food etc.), inflation in these years should stabilise around or closely below the CNB inflation target.

GDP deflator growth should be reaching higher levels than CPI because of continuous improvement in the terms of trade. The hike in indirect taxes in 2004 and higher inflation in construction investments may be other factors at work.

Graph 3.5: Consumer Prices



Graph 3.6: GDP Deflator and Terms of Trade



Source: CSO, MoF CR calculations

3.4 Labour Market and Wages

Medium-term analysis of the time series dealing with labour market developments has been significantly hampered by methodological changes in the Labour Force Survey (LFS).

[11] *The regulation of consumer prices of utilities (electricity, gas and telecomunications) is based on approved costs, technologies and the level of competition in the markets evaluated by independent regulators. The situation in the other important item – regulated rents – is not clear because of the absence of any legislative norm preparing a path for deregulation.*

Box 3.2: Statistical description of employment and unemployment

There are two non-negligible breaks in levels and year-on-year comparability in the LFS time series for the years 2001 and 2002.

1. The year 2001 has been presented twice in the LFS time series – according to results of the Population Censuses in 1991 and in 2001. The difference between both sources amounts to 41,000 persons for population and 22,000 for employment. An interpretation of calculations dealing with levels (eg. level of labour productivity) in 2001 may be misleading.
2. A harmonisation of the questionnaire was carried out in the first quarter of 2002. The question of whether a person had worked for pay or other remuneration for at least one hour during the monitored period, was put before the question on economic activity. The psychological effect of this change has caused a shift of some people from unemployment to employment resulting in a growth in employment (mainly self-employed people) and decrease in unemployment. On the other hand, the registered unemployment rate climbed by 0.7 pp. As a result, those two essential indicators describe unemployment in such a way that each is at variance with the other.

Therefore, when analysing unemployment in a time context, the national indicator of the registered unemployment rate is preferred to the internationally comparable LFS indicator.

Unemployment, and particularly its prevailing structural character, is considered to be a possible risk to future macroeconomic developments. With employment falling (see Box 2.2), fairly dynamic economic growth has been driven solely by an increase in labour productivity. Spontaneous job creation has been insufficient and rigidities in both the demand and supply sides of the labour market have prevailed.

All this results in a decrease in the labour force, which is contrary to demographic developments, and in high and still increasing levels of unemployment with very negative social and economic consequences, not only for those who are unemployed but for the overall fiscal balance.

According to our estimates, given the current setting of parameters of the labour market, economic growth of 1 p.p. above potential growth would be needed in order to curtail the growth in unemployment.

The low professional, qualification and geographical mobility of the labour force, together with insufficient job creation and low motivation for working when compared to living off social benefits, are the main causes for this situation.

Table 3.4: Employment and Wages

	Year 2003	Year 2004	Year 2005	Year 2006	Year 2007
y/y percentage changes					
Employment	-0.7	-0.8	-0.3	0.0	0.1
Gross wages and salaries	5.8	5.6	6.2	6.4	6.6
Average real gross wage	7.9	3.3	3.7	4.0	4.0
Unit labour costs	2.9	2.8	3.1	3.0	3.0
in per cent					
Unemployment rate ILO	7.8	8.5	8.7	8.7	8.5
Rate of unemployment reg.	9.9	10.5	10.7	10.6	10.5
Employment rate	65.6	64.6	64.2	64.0	63.9
Participation rate	71.1	70.7	70.3	70.1	69.8

Source: MoF CR

A reversal of unfavourable tendencies would depend on greater flexibility in the labour market and on the effectiveness of structural policies described in Chapter 2.

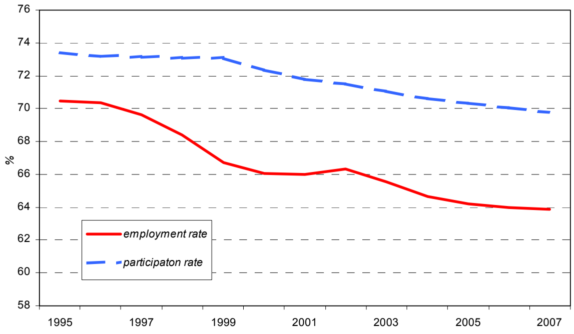
On the supply side, this will call in particular for an enhancement of the professional and qualification mobility of the labour force and its ability to respond to changing economic conditions. Some public finance reform measures leading to a more active participation in the labour market (e.g. withdrawal of social benefits from long-term unemployed people who refuse to take part in public works, abolition of temporarily reduced early retirement pensions, removal of a ban on work for some people on benefits, tax discounts for parents etc.) could help increase motivation for work.

Increasing computer literacy and the development of the information society should play a substantial role. Last but not least, higher geographical mobility resulting from the liberalisation of the housing market and increasing availability of housing should help produce improvement.

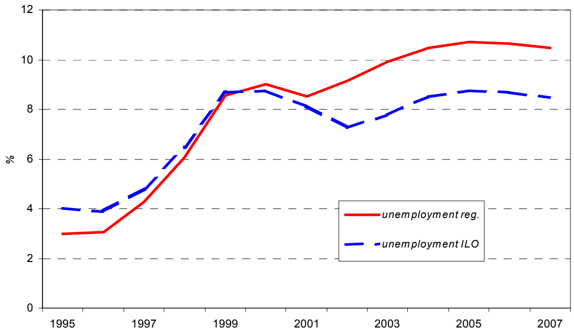
On the demand side, employment will be boosted in particular by economic growth and by the expansion of small and medium-sized businesses generating new job opportunities. The inflow of foreign investment in new locations will result only in a limited number of new jobs (which is due to the fact that this type of investment will focus on high-tech activities with high labour productivity) but it will have indirect positive effects on employment due to the co-operation of domestic firms. A marked positive effect might be obtained by lowering the tax burden on labour and by creating more flexible conditions for work contracts.

On the other hand, the ongoing restructuring process will result in higher pressure for labour productivity growth, involving a further removal of unviable operations, a tendency to trim workforces and changes in qualification requirements. Finding new jobs for employees thus made redundant, solving the relevant regional problems and addressing the issue of long-term unemployment, will remain challenges to be met on the way towards a functioning labour market as well as providing a measure of the effectiveness of structural policies.

Graph 3.7: Employment and Participation Rates



Graph 3.8: Unemployment Rate



Sources: CSO, MoL, MoF calculations

The unfavourable situation on the labour market has been contributing to stable wage developments by eliminating the opportunity for extreme wage claims. We expect a stable growth rate in average wages by around 6.5 % (3.5 – 4.0 % in real terms), which should keep the growth of unit labour costs below the growth of the GDP deflator.

Should the relevant structural policy measures be implemented, this should mitigate or stop the fall in participation levels and instead a stabilisation in employment levels could be expected. After reaching a peak below 11 %, the average registered unemployment rate might decline slightly. Without these measures there is a risk that the labour market could become a limiting factor in relation to economic growth.

3.5 Balance of Payments

The scenario for the balance of payments is based on assumptions on the development of exchange rates, which are different from the assumptions in the EC Spring Forecast. We consider the requirement of real exchange rate stability with respect to the euro for the Czech economy as being too rigid. It would mean the interruption of the long-term tendency towards real appreciation, which has cohabited with the procedure of real convergence almost continuously during the whole process of transformation. The real exchange rate with respect to the euro (deflated by GDP deflators) appreciated on average by 5 % yearly from 1998 to 2003.

That is why the scenario was based on the assumption of a gradual and mild nominal appreciation with a value of 30 CZK/EUR and average real appreciation of 3 % yearly up to the end of 2007. The sensitivity analysis of the influence of different values of the exchange rate on macroeconomic development is mentioned in part 5.3.

Table 3.5: Current Account of the Balance of Payments

	Year 2003	Year 2004	Year 2005	Year 2006	Year 2007
	pct of GDP				
Balance of trade	-2.9	-2.3	-1.7	-1.4	-1.0
- mineral fuels (SITC 3)	-2.8	-2.7	-2.3	-1.9	-1.8
- others	0.0	0.3	0.6	0.5	0.8
Balance of services	0.5	0.6	0.7	0.7	0.6
Balance of income	-4.8	-5.2	-5.7	-5.8	-5.8
Balance of transfers	0.6	0.8	0.7	0.7	0.6
Current account	-6.5	-6.2	-6.0	-5.8	-5.5

Source: MoF CR

We expect a continuation in the tendency to amend the balance of trade in the current account structure, in the context of the launch of new production oriented towards exports (mainly in branches of the car industry and ICT) and with improvement in the terms of trade. The non-fuels part of the balance of trade should enjoy a permanent and growing surplus. The growth of exports should more than compensate for the high intensity of investment activity, which is demanding where the import of machinery and equipment is concerned. A stable low-inflation environment will be crucial for the competitiveness of Czech exports. The same holds for the development of salaries, which should correspond to the steady appreciation of the real exchange rate.

The deciding factor in the current account deficit is and will be the worsening balance of income, where increasing flows of the repatriated and reinvested profits of foreign investors are projected. The balance of transfers will be slightly positively influenced by financial flows from the EU.

The current account deficit should be covered more than adequately by the surplus in the financial account. The deciding item will be the inflow of foreign investments, connected on the one hand with "green field" investments and the enlargement of existing capabilities, and on the other hand with the completion of the process of privatization. The inflow of debt capital will be influenced mainly by the necessity of financing general government.

As a result we expect a stabilization and gradual lowering of the current account deficit of the balance of payments within a range from approx. –6.5 to –5.5 % of GDP and a mild drop in the ratio of foreign debt to GDP.

4 General Government Finances - Deficit and Debt

4.1 Policy Strategy

At present the Czech Republic reports an excessive deficit, which poses an obstacle on the road towards compliance with convergence criteria. In order to restore a sound fiscal position, the Government of the Czech Republic has adopted a strategy of public finance consolidation that will ensure a gradual reduction in the budgetary deficit. Public sector deficit should not exceed 4.0 % of GDP in 2006 and in 2007 it should not be higher than 3.5 % of GDP. Compared to the level of the budgetary deficit in 2004, this represents an annual fall of almost 0.7 percentage points on average. The Government intends to pursue a pace of fiscal consolidation that will not slow down domestic demand excessively and will not jeopardise social harmony. Apart from the obligation to reduce the deficit, the Government has taken up changing the structure of taxes and government expenditure with the aim of strengthening the supply side of the economy and of establishing conditions for the acceleration of potential growth.

Public finance reform was laid out in two stages. During the first stage the emphasis was put on bringing the deficit trend to a halt and on slowing down the dynamics of public debt increases. The proposed measures focused on raising tax revenues and restraining the growth of social transfers and government consumption (see PEP 2003). In the second half of 2003 the Parliament gradually passed laws that put measures proposed during the first stage of the public finance reform into practice.

Currently the second stage of public finance reform, which is aimed at promoting economic growth and strengthening the long-term sustainability of public finances, is being prepared. As part of the second stage of public finance reform, a tax package for the enhancement of economic growth was drawn up. Tax measures were designed to promote investment activity, research and development and to reinforce incentives for low-income parents to participate more actively in the labour market. These policies will be financed by means of raising indirect taxation.

Tax and spending reforms are accompanied by changes in the institutional framework of the budgetary process. The most important change is the introduction of fiscal targeting, a part of which is the binding medium-term expenditure ceilings (see Chapter 8). In the first half of this year an Amendment to the Budgetary Rules Act, that provides conditions for presenting the medium-term expenditure frameworks, is to be approved. It can be expected that the introduction of medium-term expenditure ceilings will contribute to strengthening the medium term orientation of the budgetary process and to fostering fiscal discipline. It will also restrain discretionary spending and strengthen control over mandatory spending.

4.2 Overview of Public Finances in 2003 and 2004

Assessment of outcomes in the government sector is affected by several methodological changes that were carried out by the Czech Statistical Office on the basis of Eurostat recommendations (see Annex 9.2). Taking account of these changes, the deficit in the government sector reached 13.6 % of GDP in 2003 and for 2004 a decline of the deficit to 5.6 % of GDP is expected[12]. The outcome in the government sector was most significantly influenced by the change in treatment of high-risk state guarantees. The largest guarantees in terms of future obligations were issued to deal with the transformation problems of the banking sector. State guarantees are now reported as a capital transfer at the moment when the guarantee is called for the first time. This results in a rise in expenditure equal to the total amount of the guarantee, irrespective of when the remaining part of the guarantee is called. Thus, besides operations of the Czech Consolidation Agency (CKA), non-standard state guarantees represent another way in which the transformation costs impact expenditures, deficit and debt in the government sector. In 2003 the capital transfers reflecting the called state guarantees accounted for as much as 7.7 % of GDP. If adjusted by the one-off impact of the realized state guarantees, the deficits would amount to 6.0 % and 5.4 % of GDP in 2003 and 2004 respectively.

If expenditures and deficit were reported net of the called state guarantees in 2003, the deficit would be lower compared to what was expected during the previous year (PEP 2003). The deficit is almost 2 percentage points lower, despite the higher than expected capital transfer in the books of CKA (CZK 37.9 bn against CZK 29.5 bn). The more favourable outcome can be explained by the higher growth in tax revenues (especially indirect taxes) and non-tax revenues (dividends) and by lower spending in the area of extra-budgetary funds. Compared to their budget intentions, state and privatization extra-budgetary funds (especially Infrastructure Fund and National Property Fund) substantially reduced their spending.

In 2004 public finance reform was launched and the state budget and budgets of state extra-budgetary funds for 2004 were prepared so as to be conducive to making savings. The deficit net of state guarantees will be reduced by 0.8 percentage points. However, to ensure full comparability it would be necessary to exclude not only the impact of state guarantees but also all the other transformation costs, including operations of transformation institutions. The deficit, when adjusted by all these costs, will remain at the 2003 level of 4.4 % of GDP. The stagnation of the deficit adjusted by the full impact of transformation costs will be brought about by the expected fiscal impact of EU accession, which is to reach 0.6 % of GDP[13] in 2004. On a comparable basis (net of transformation costs and the fiscal impact of EU entry) the deficit to GDP ratio will fall by 0.6 percentage points. The sector of central government subject to fiscal targeting – i.e. the state budget and state funds – will contribute most to deficit reduction.

Revenues in the government sector will rise in 2004, due to higher tax revenues reflecting tax law changes approved in the first stage of the public finance reform and due to budgetary compensations received from the EU. Expenditure in the government sector (net of guarantees provided) will come down slightly in terms of GDP, in spite of the rise in some of the expenditure, especially fixed capital formation and current transfers (as a result of own

[12] *The 2003 deficit is a preliminary estimate and is fully consistent with the data provided in the March notification. Unlike the March notification, the deficit-to-GDP ratio was calculated on the basis of the non-revised GDP for 2003 (see Box 3.1). 2004 data come out from approved budgets but, unlike the March notification, it incorporates expected budgetary implications of tax changes and compensatory social benefits prepared at the second stage of the public finance reform. The main differences vis-à-vis the March notification result from tax changes drawn up at the second reform stage (+0.2 % of GDP), approved social compensations (-0.3 % of GDP) and the precise specification of the accrual impact of tax changes from the first reform stage (+0.4 % of GDP).*

[13] *Differences between budgetary compensations (CZK 10.6 bn) on the one hand, and payments of own resources (CZK – 17.4 bn),the drop in revenues due to the elimination of custom duties in trade with the EU countries (CZK – 3.5 bn) and top-up subsidies to farmers (CZK –5.8 bn) on the other hand.*

resources payments to the EU budget). However, the 2004 outcome is not free from risks. The risks stem primarily from the accuracy of estimates of proceeds from tax changes and possible additional budgetary claims.

In 2004 several tax changes will coincide and therefore the impact of the tax changes on the behaviour of economic agents and government revenues can only be quantified within wide margins of uncertainty. A risk of expenditure overruns appeared as early as at the beginning of this year. This is a result of higher indexation of pensions, pressure to raise the wage bill of government sector employees and a potential rise in the cost of debt servicing. The closing balance of measures prepared at the second stage of the public finance reform and affecting the budget of 2004 is also not risk-free for the budget.

Central government contributes most to the overall budgetary deficit, since it absorbs all the costs linked to transformation of the Czech economy (operations of transformation institutions, banking state guarantees). By way of contrast, the contribution of local governments will fall from the level of 0.2 percent of GDP to 0.0 percent of GDP. The finances of health insurance companies will be close to balancing.

Table 4.1: Deficit and Debt by Sub-sectors

% of GDP	ESA code	Year 2000	Year 2001	Year 2002	Year 2003 (1)	Year 2004 (2)
Net lending (B9) by sub-sectors						
General government	S13	-4.9	-6.9	-6.8	-13.6	-5.6
Central government	S1311	-4.7	-6.1	-6.1	-13.2	-5.8
Local government	S1313	-0.4	-0.8	-0.5	-0.2	0.0
Social security funds	S1314	0.2	0.0	-0.2	-0.2	0.1
Gross debt by sub-sectors						
General government	S13	19.7	26.9	30.6	39.7	40.5
Central government	S1311	18.1	25.1	28.5	37.1	37.7
Local government	S1313	1.6	1.8	2.0	2.6	2.8
Social security funds	S1314	0.0	0.0	0.0	0.0	0.0

(1) Notification
(2) Compared to March notification data were adjusted to reflect the latest development (impact of tax changes prepared at the second stage of the public finance reform, compensatory social benefits and adjustment of accrual impact of tax changes from the first reform stage).

Source: MoF CR

Government debt level was subject to substantial revisions due to changes in the classification of issued state guarantees. The debt at the end of 2003 amounted to 39.7 % of GDP and it is expected to exceed the threshold of 40 % of GDP in 2004. Of this amount state guarantees account for approximately 10 percent of GDP. The stock of default state guarantees included within government debt is not fully reflected in the particular debt instruments and therefore it does not have an immediate adverse impact on the level of interest rates and debt servicing costs. Considering that the repayment calendar is extended till 2028 for some guarantees, the part of the debt that is in form of guarantees will gradually be transformed into particular debt instruments, as the Government will be forced to finance the payments related to state guarantees, which have been called.

If the guarantees included in the debt were to be excluded, the debt level would be one percentage point lower at the end of 2003 and another 3.5 percentage points lower in 2004 compared to expectations from the previous year (see PEP 2003). This outcome can be explained by the lower deficit (adjusted for the flow of state guarantees). As the highest deficit is run up by central government, the debt of central government accounts for the largest part of total debt and amounts to 93 % of total debt. The rest is made up almost exclusively by the debt of local governments, which is not expected to rise any further in terms of its ratio to GDP.

4.3 Medium-term Fiscal Framework

Last year the Government committed itself to reduce the government sector deficit to 4.0 % of GDP in 2006. This target remains unchanged and was extended also to the year 2007. In 2007 the deficit should not exceed the 3.5 % GDP threshold. In comparison with the level of government sector deficit in 2004, this represents an average annual decrease of 0.7 p.p. In 2005 and 2006 the deficit reduction is expected to be faster. In 2005 the faster deficit reduction will be facilitated by the fact that transformation costs will be phased out and there are no plans to issue additional state guarantees. In 2007 the rate of deficit reduction will slow to 0.5 p.p. The proposed path of deficit reduction indicates that the elimination of excessive deficit would be completed by 2008.

As the budgetary impacts of tax law changes, drawn up at the first and second stage of public finance reform, are concentrated in the year 2004, it will be the increase in tax revenues that will contribute most significantly to deficit reduction in this year. However, the influence of tax changes will diminish gradually in subsequent years and the tax-to-GDP ratio will decline, mainly due to the lowering of income taxes. From as early as 2005 more weight will be laid on expenditure savings to deliver deficit reduction. Except for government investments all important expenditure items are expected to fall in terms of their ratio to GDP. Interest payments alone will increase, due to government debt progression and moderate growth of interest rates.

Binding medium-term expenditure ceilings, which limit the volume of expenditure of the state budget and state funds within the 2004 to 2007 horizon, serve as the fundamental tool for meeting fiscal targets. Hence central government will be the major contributor to deficit reduction. Local government budgets are assumed to show only moderate deficits. Local governments (municipalities and regions) are unlikely to restrain the volume of provided public goods at a time when resources from the EU will become available for their financing. Apart from indirect instruments, central government does not have at its disposal any means that could restrict deficit financing on the part of local government bodies. The possibility of limiting the debt servicing costs of local governments is currently under discussion, but the proposed level of limits will not effectively restrict the room for borrowing of the majority of municipalities. Health Insurance Companies are expected to run balanced budgets within the projected horizon.

Table 4.2: Deficit by Sub-sectors

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (1)	Year 2006 (2)	Year 2007 (2)
Net lending (B9) by sub-sectors						
1. General government	**S13**	**-13.6**	**-5.6**	**-4.9**	**-4.0**	**-3.5**
2. Central government	**S1311**	**-13.2**	**-5.8**	**-4.7**	**-3.8**	**-3.2**
3. State government	**S1312**					
4. Local government	**S1313**	**-0.2**	**0.0**	**-0.2**	**-0.2**	**-0.2**
5. Social security funds	**S1314**	**-0.2**	**0.1**	**0.0**	**0.0**	**0.0**

(1) Projection
(2) Forecast

Source: MoF CR

The fiscal framework is based on expectations of a slightly accelerating growth of real GDP and stable wage and price development. The output gap in 2004 and 2005 is projected to be slightly negative. The actual growth rate of GDP should somewhat exceed the growth rate of potential GDP during 2005 to 2007. The output gap will be closed in 2006 and in 2007 it will turn out moderately positive. Considering the low level of difference in both the level and the growth rate of actual and potential GDP, tax revenues will move close to their structural level and the cyclical component of budget balances will be almost negligible.

In 2004 the cyclically adjusted deficit will reach a level of 5.5 % of GDP. As a result of fiscal reform implementation it will fall to 4.0 % of GDP in 2004 and will continue to decline to 3.6 % of GDP in 2007. With regard to the expected growth of interest payments, the extent of fiscal restriction gauged by the drop in the cyclically adjusted primary balance will be greater than the total balance would indicate. A decrease in the cyclically adjusted deficit will be achieved particularly through public expenditure reduction and partly through a temporary rise in the tax-to-GDP ratio. Austerity measures will be implemented at a time of stable economic growth and should not considerably decelerate the growth of domestic demand. On the other hand, only a decrease in the cyclically adjusted deficit and its stabilization at low levels will create conditions for letting automatic fiscal stabilizers operate freely during the economic cycle.

Table 4.3: Cyclically Adjusted Budget Balance

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (2)	Year 2006 (2)	Year 2007 (2)
1. GDP growth at constant prices	**B1g**	2.9	2.8	3.1	3.3	3.5
2. Actual balance	**B9**	-13.6	-5.6	-4.9	-4.0	-3.5
3. Interest payments	**D41**	1.3	1.3	1.3	1.5	1.7
4. Potential GDP growth		2.6	2.7	3.0	3.1	3.1
5. Output gap		-0.4	-0.3	-0.3	0.0	0.4
6. Cyclical budgetary component		-0.1	-0.1	-0.1	0.0	0.1
7. Cyclically-adjusted balance (2 – 6)		-13.5	-5.5	-4.9	-4.0	-3.6
8. Cyclically-adjusted primary balance (7 – 3)		-12.2	-4.2	-3.5	-2.5	-1.9

(1) Projection
(2) Forecast

Source: MoF CR

4.4 Public Debt and Debt Strategy till 2007

As from 2004 gross government debt will exceed the threshold of 40 % of GDP and will reach the level of 44.0 % by the end of 2007. Due to the inclusion of transformation institutions within the government sector and a change in the treatment of state guarantees, the Czech Republic has moved from the group of countries with low debt levels to the group of countries with average debt levels. In order to put an end to the growth of the debt ratio, it would be necessary to push the deficit below 3.0 % of GDP. It is obvious from the fiscal framework that conditions for the reduction of the debt ratio will not be fulfilled before 2007. The Government is striving to comply with convergence criteria by 2008, which is why the increase in debt ratio is not likely to be brought to a halt before then.

In recent years the growth of public debt was to a large extent brought about by the costs of the transformation of the economy and stabilization of the banking sector. Debt projection is based on the assumption that activities of transformation institutions (the CKA in particular) will be phased out and their losses financed from the state budget and the budget of the NPF. Another assumption is that the Government will not provide any additional high-risk guarantees. State guarantees that have been called will be gradually paid, but guarantee payments will impact budgetary balance on a cash basis only. As a result, liabilities of the CKA and called state guarantees will be gradually transformed into the state debt and negotiable debt instruments. The total amount of the debt remains unchanged. Only the structure of the debt will change.

Table 4.4: Structure of Public Debt by Sub-sectors

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (2)	Year 2006 (2)	Year 2007 (2)
		Gross debt by sub-sectors				
General government	**S13**	**39.7**	**40.5**	**41.8**	**43.2**	**44.0**
Central government	**S1311**	**37.1**	**37.7**	**39.0**	**40.3**	**41.0**
of which: CKA		*6.0*	*4.0*	*2.3*	*1.3*	*0.6*
state guarantees		*10.5*	*9.8*	*8.7*	*7.9*	*7.3*
Local government	**S1313**	**2.6**	**2.8**	**2.8**	**2.9**	**2.9**
Social security funds	**S1314**	**0.0**	**0.0**	**0.1**	**0.1**	**0.1**

(1) Projection
(2) Forecast

Source: MoF CR

The fiscal framework implies a gradual deceleration of the growth in government debt. High debt increments, which amounted to 5 p.p. of GDP annually between 2000 and 2004, are expected to come down below 1 p.p. annually. Apart from methodological reasons, the deceleration in government debt growth is a direct result of the public finance reform, which leads to primary deficit reduction. As a result, the contribution of the primary deficit to the growth of the debt ratio falls from 4.3 % GDP in 2004 to 1.8 % GDP in 2007. The relatively high growth of nominal GDP approaching 7 % annually will contribute to a decrease in the debt-to-GDP ratio of about 2.5 p.p. and the relevance of this factor will slightly augment over time.

The size of interest payments, which will increase due to the expected growth of both interest rates and debt levels, will also adversely affect the debt ratio. In spite of considerable state shares in power companies, the fiscal framework does not include any additional revenues from privatization after 2004, as the detailed privatization plan has not been published yet. Any future privatization revenues will thus favourably influence the government debt level. The distinction between the accrual and the cash impact of tax changes (CIT) in 2005 will be reflected in "other factors influencing the debt ratio". The fall in revenues on a cash basis will be registered in 2006 and it will therefore have to be financed one year later.

Table 4.5: General Government Debt Developments and Other Indicators

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (2)	Year 2006 (2)	Year 2007 (2)
Gross debt level		39.7	40.5	41.8	43.2	44.0
Change in gross debt		9.1	0.8	1.4	1.4	0.8
Contributions to change in gross debt						
Primary balance		12.3	4.3	3.6	2.5	1.8
Interest payments	**D41**	1.3	1.3	1.3	1.5	1.7
Nominal GDP growth	**B1g**	-1.7	-2.4	-2.5	-2.6	-2.8
Other factors influencing the debt ratio		-2.8	-2.4	-1.1	0.0	0.1
Of which: **Privatisation receipts**		-1.0	-1.0	0.0	0.0	0.0
p.m. **implicit interest rate on debt**		4.6	3.6	3.5	3.8	4.1

(1) Projection
(2) Forecast

Source: MoF CR

From the debt management point of view, special attention is paid to the state debt, which comprised 89 % of total consolidated government debt (excluding state guarantees and liabilities of the CKA) at the end of 2003. State debt is almost exclusively denominated in CZK and the exposure to currency risk is zero at present. From the second quarter of 2004 the issue of treasury bonds will be launched on the basis of a decision by the Ministry of Finance. These bonds will be denominated in euros and will be issued on the European capital markets. The issues will be hedged against exchange rate fluctuations, so as not to increase excessively exposure to currency risks.

Both refinancing and interest rate risks are currently the most important risks for government financing. These risks are crucial subjects for risk management and are taken account in the preparation of the debt and issue strategy. The medium-term target of refinancing risk management is to restructure the debt portfolio through decreasing the share of T-bills and increasing the share of fixed-yield medium and long-term treasury bonds. The first step is to reduce the share of short-term state debt maturing within one year, from the current level of 40 % to the band of 25 to 30 %. By the end of the year 2006 the short-term debt should fall below the limit of 20 %.

A new target band for the modified duration of state debt, in a range of 3.3 to 4.3 years, was announced for the purposes of interest rate management. Compared to 2003, there is a symmetrical shift of the band by 0.3 years upwards. Considering the high levels of growth in state debt and increasing nominal exposure to interest risks, the strategy of extending the duration seems to be an optimal strategy for the coming years too.

Table 4.6: State Debt in Terms of Interest Rates

in %	Year 2001	Year 2002	Year 2003
1. Fixed interest rate long-term debt	**44.8**	**57.1**	**64.7**
1a. Of which: due in 1 year or less	*4.6*	*7.2*	*7.9*
2. Variable interest rate long-term debt	**0.7**	**1.1**	**2.4**
3. T-bills	**54.1**	**41.4**	**32.6**
4. Non interest bearing debt	**0.4**	**0.4**	**0.3**
5. Debt subject to IR re-fixing within 1 year (1a + 2 + 3 + 4)	**59.7**	**50.0**	**43.2**
6. Including effect of interest rate swaps	**59.7**	**47.0**	**36.8**

Source: MoF CR

It is apparent from the structure of state debt in terms of interest rates that exposure to interest rate risk continues to be high. More then 40 % of the debt portfolio is exposed to unexpected changes in interest rates within one year. Gradual reduction of interest rate risk will be achieved through decreasing the share of T-bills, issuing fixed-yield treasury bonds on both domestic and soon also foreign capital markets. Since 2002 this has also been achieved through active utilization of interest rate swaps. Thanks to swap operations, the interest rate risk has approached the medium-term target, according to which the share of state debt exposed to re-fixing of nominal interest payments within one year should not exceed 30 %. This target should be met preferably by the end of 2004, but no later than by 2006.

At the end of 2003 the modified duration reached the value of 3.3 years, which is in line with the target defined for this year. From the point of view of a debt manager, duration expresses the average time period in which the current change of market interest rates will be absorbed in payment flows from the current debt portfolio structure. It can be deduced, from the level of state debt and its interest rate structure, that a 1% increase in interest rates will increase interest payments within a one-year horizon by 1.8 billion CZK (0.1 % of GDP), taking account of the effect of interest rate swaps.

5 Comparison with PEP 2003 and Sensitivity Analysis

5.1 Comparison with PEP 2003 Macroeconomic Framework

The differences between PEP 2003 and CP 2004 macroeconomic scenarios can be explained in terms of the following factors:

- New data based on the monitoring of macroeconomic developments have been included,
- Assumptions have changed (in particular ones concerning the development of the external environment),
- The response of the economy to external shocks differs from PEP 2003 assumptions.

The development of the external environment in 2003 and its expected development in 2004 and 2005 differ from the assumptions retained in PEP 2003. The recovery in the EU-15 was considerably weaker in 2003 (in particular the downturn in Germany was unexpected). Moreover, the expectations of dynamic GDP growth in 2004 and 2005 had to be moderated.

The biggest difference arose in terms of oil prices, where the dollar price expected in 2004 is 32 % higher according to CP 2004 than that expected in PEP 2003. Fortunately, this rise was largely compensated for by the depreciation in the USD vis-à-vis euro.

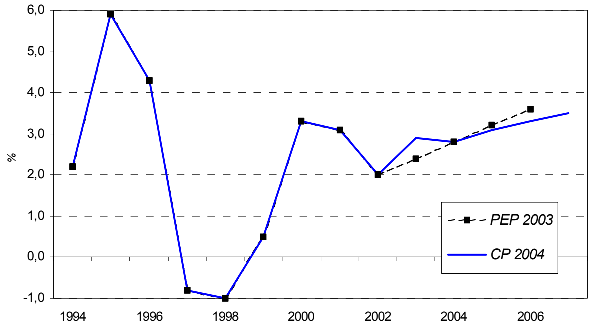
Table 5.1: Comparison with the Previous Macroeconomic Framework

	PEP 2003			CP 2004			Difference		
	2003	2004	2005	2003	2004	2005	2003	2004	2005
GDP growth (%)									
USA	2.3	3.2	3.8	3.1	4.2	3.2	0.8	1.0	-0.6
EU-15	1.3	2.4	2.8	0.8	2.0	2.4	-0.5	-0.4	-0.4
Germany	0.3	1.5	2.0	-0.1	1.5	1.8	-0.4	0.0	-0.2
Prices of oil									
(USD / barrel)	26.2	23.5	23.5	28.8	31.1	28.9	2.6	7.6	5.4
Exchange rate									
USD / EUR	1.14	1.12	1.10	1.13	1.25	1.24	-0.01	0.13	0.14

Source: MoF CR

Despite considerable changes in assumptions concerning the scenario, the changes in expectations about the Czech economy are rather limited. The economy has been developing relatively well and has increased its positive growth differential vis-à-vis the EU-15. In view of the downside risks concerning future developments in the external environment, the CP 2004 forecast has been formulated more cautiously compared with PEP 2003.

Graph 5.1: Comparison of GDP Forecasts



Source: MoF CR

The acceleration in household consumption was caused by an unexpected decrease in inflation. The forecast for 2004 (similarly to PEP 2003) reflects a decrease in the dynamics of household consumption expected from the proposed public finance reform. A similar decrease is expected in the area of government consumption.

Graph 5.2: Comparison of Growth in Household Consumption

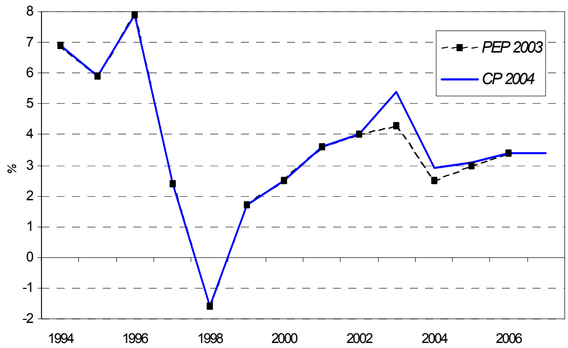
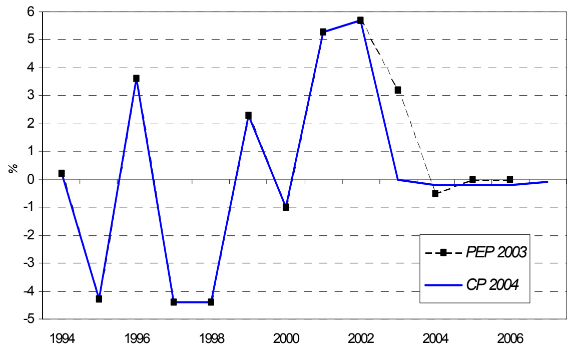


Chart 5.3: Comparison of Growth in Government Consumption

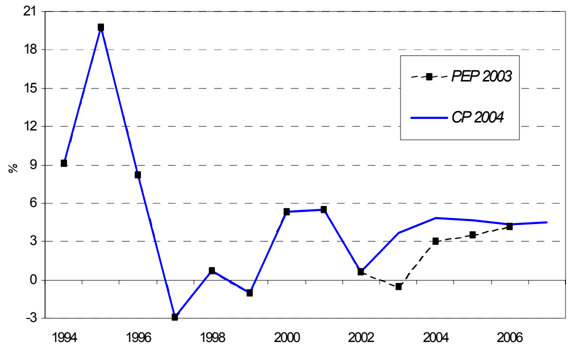


Source: MoF CR

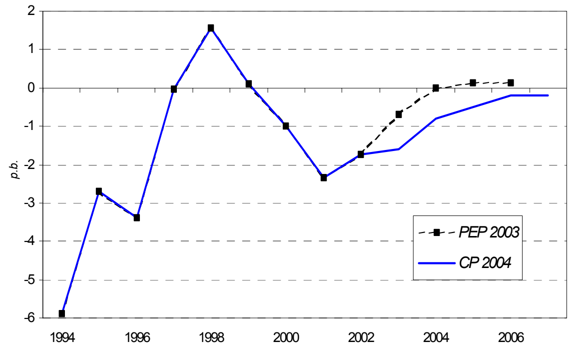
The forecast showed that stagnation in the dynamics of gross fixed capital formation was limited to the year 2002. In the next period the growth trajectory is expected to pick up again in association with our EU accession, which could also boost the growth of potential product.

When it comes to the contribution of foreign trade in goods and services to GDP growth, in parallel with higher export dynamics (which in our view demonstrates the competitiveness of Czech exporters) higher than expected import demands were also to be observed. That is why the assumption that the foreign trade contribution will be close to zero was postponed to 2006.

Graph 5.4: Comparison of Growth of Gross Fixed Capital Formation



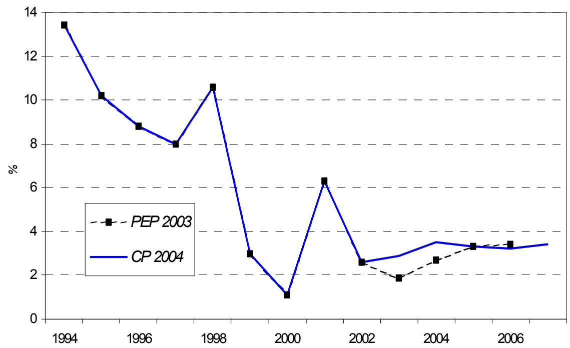
Graph 5.5: Comparison of Contributions of Foreign Trade in Goods and Services to GDP Growth



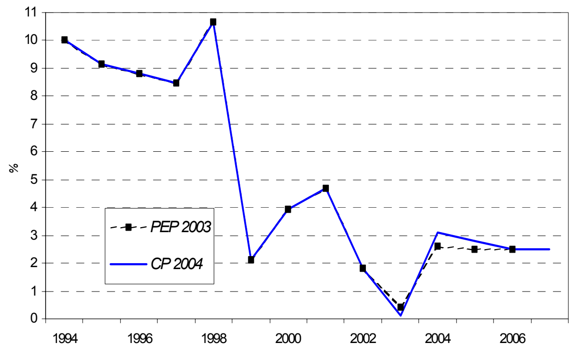
Source: MoF CR

Non-inflationary development in 2002 and 2003, combined with a lower than expected impact of administrative measures, has resulted in achieving almost zero inflation in 2003. Furthermore, the perception of the risk of a price leap caused by EU accession seems to be negligible and the contribution of harmonising measures in the area of VAT and excise duties towards the growth of prices has stabilised near the level expected in PEP 2003.

Graph 5.6: Comparison of the the GDP Deflator



Graph 5.7: Comparison of the Growth in Average Rate of Inflation

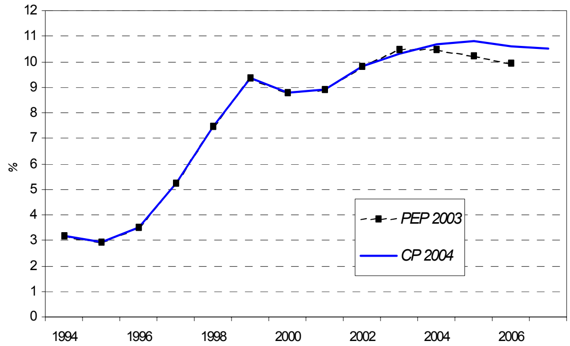


Source: MoF CR

As for unemployment registered by the Labour Offices, we have revised our forecast upwards once again. The inflow of foreign capital does not seem to generate a sufficient number of new jobs to reduce the unemployment rate, while economic growth oscillates around 3%.

Graph 5.8: Comparison of the Unemployment Rate

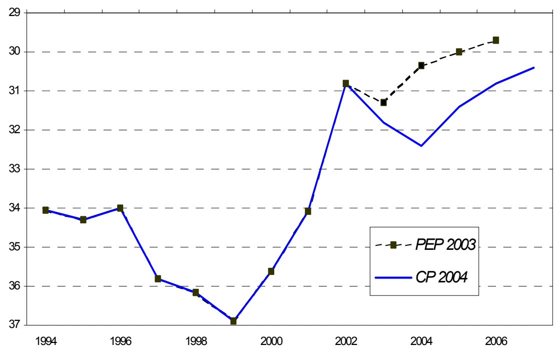
(registered unemployment rates at the end of the year)



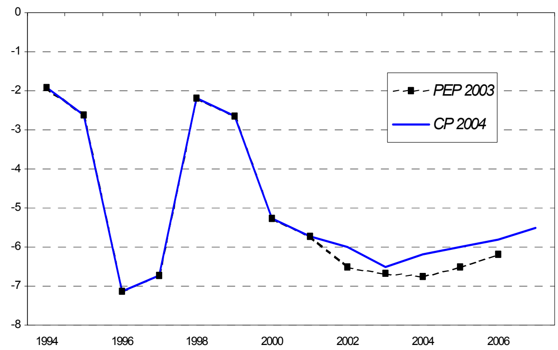
Source: MoF CR

The correction of excessive appreciation of the koruna in 2002 has been longer and deeper than PEP 2003 had expected. However, according to our scenario we anticipate a renewed tendency for the koruna to appreciate. The slight improvement in the current account forecast will reflect this exchange rate development.

Graph 5.9: Comparison of the Exchange Rate CZK/EUR (ECU)



Graph 5.10: Comparison of Current Account as per cent of GDP



Source: MoF CR

5.2 Comparison with the Fiscal Framework of PEP 2003

The fiscal framework was not subject to any major revisions, because substantial changes occurred neither in macroeconomic performance nor in the fiscal base, adjusted for extraordinary one-off effects. Government sector deficit is expected to decline to 4.9 % of GDP in 2005 and to 4.0 % of GDP in 2006. The deficit reduction trend as an indicator of the nominal convergence process will continue in 2007 and the deficit will fall further to 3.5 % of GDP. However, the structure of fiscal consolidation has changed to a certain extent. As opposed to last year's forecasts, neither the tax ratio nor the revenue ratio is expected to rise in the medium-term. That results from reducing the CIT rate and supplementing fiscal reforms with a tax package conducive to economic growth, which will decrease government sector revenues in the medium term. This development will be offset by additional expenditure savings.

As no substantial deviations in deficit level should appear, the dynamics of government debt do not change substantially. Increase in the public debt will reach 1.4 p.p. of GDP on average between 2004 to 2006 compared to 2.6 p.p. in the previous PEP. A slower rise in the debt level is partially attributable to higher nominal GDP growth. However, the level of public debt is substantially different. Due to methodical changes it exceeds the debt level from the previous Programme by 4.0 p.p.

Table 5.2: Comparison with PEP 2003

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (1)	Year 2006 (2)	Year 2007 (2)
			GDP growth			
previous update	**B1g**	2.4	2.8	3.2	3.6	-
latest update	**B1g**	2.9	2.8	3.1	3.3	3.5
Difference		0.5	0.0	-0.1	-0.3	-
			Actual budget balance			
previous update	**B9**	-7.6	-5.9	-4.8	-4.0	-
latest update	**B9**	-13.6	-5.6	-4.9	-4.0	-3.5
Difference		-6.0	0.3	-0.1	0.0	-
			Gross debt levels			
previous update		30.5	34.2	37.7	39.4	-
latest update		39.7	40.5	41.8	43.2	44.0
Difference		9.2	6.2	4.1	3.9	-

(1) Projection
(2) Forecast

Source: MoF CR

5.3 Sensitivity Analysis

The Czech economy can be characterized as a small, open and energy-intensive economy. From this point of view it is possible to define a set of key exogenous variables influencing strongly the performance of the Czech economy. These factors are the following – foreign demand, foreign prices, exchange rates and raw material prices[14].

[14] *The medium-term quarterly simulation model is used for quantitative analysis of risk factors at the Ministry of Finance of the Czech Republic. This model can be characterized as a standard Keynesian model extended by a*

The central macroeconomic framework presented in the Convergence Programme is associated with several dangers, the realisation of which can cause important deviations from the central scenario. For the sake of sensitivity analysis, we take into consideration just three fundamental risks. The first one is instability on the raw materials market, which results in substantial fluctuations of oil and gas prices. The second one is the performance of the European economy, the biggest trade partner of the Czech Republic. The last factor is represented by exchange rate fluctuations, CZK vis-à-vis EUR in particular.

The sensitivity analysis of Czech economic performance vis-à-vis the above-mentioned risk factors was carried out in terms of two scenarios. These scenarios – the optimistic and the pessimistic one – are compared with the central scenario derived from the assumptions of the European Commission Spring Forecast. The optimistic scenario allows for a combination of positive demand and supply shocks and rests on the assumptions of a gradual oil price decrease to the level of 22 USD per barrel, a stable exchange rate CZK/EUR and acceleration of EU-15 real GDP growth to more than 3.5 % a year. On the other hand, the pessimistic scenario employs the assumptions of higher oil prices, appreciation of CZK/EUR exchange rate and deceleration of annual EU-15 economic growth.

In practice, macroeconomic scenarios are usually computed using symmetrical deviations of risk factors from the baseline scenario. However, we believe that this approach need not be appropriate since it does not take proper account of either the economic context or risk perception on part of policy makers. This is the reason why we have decided to define, partly on the basis of estimates and partly on the basis of expert judgement, asymmetrical scenarios[15] for the development of oil prices and foreign economic growth (see Table 5.3).

Table 5.3: Scenarios of Key Exogenous Variables

		Year 2003	Year 2004	Year 2005	Year 2006	Year 2007
	UK Brent					
Optimistic	USD/barrel		**28.8**	**24.6**	**22.5**	**22.2**
Baseline	USD/barrel	**28.8**	**31.1**	**28.9**	**27.3**	**27.0**
Pessimistic	USD/barrel		**32.7**	**31.7**	**30.4**	**30.2**
	GDP EU 15					
Optimistic	y/y in %		**2.4**	**3.2**	**3.6**	**3.4**
Baseline	y/y in %	**0.7**	**2.0**	**2.4**	**2.8**	**2.6**
Pessimistic	y/y in %		**1.3**	**1.2**	**1.6**	**1.4**
	CZK/EUR					
Optimistic			**33.0**	**33.0**	**33.0**	**33.0**
Baseline		**31.8**	**32.4**	**31.4**	**30.8**	**30.4**
Pessimistic			**31.7**	**30.1**	**29.3**	**28.9**

Source: MoF CR

Neoclassical supply side. It consists of approximately 20 stochastic equations and 55 identities and contains standard blocks, such as households, firms, labour market, prices, foreign trade and a block of fiscal and monetary policy.

[15] *It is now a widely accepted fact that e.g. the business cycle has asymmetrical development – short but more profound recession phases are followed by longer but less intense phases. Probability estimates of the asymmetrical evolution of oil prices and foreign demand are based on this fact. For instance, the EU's average annual growth rate is approximately 2.3 % during last 15 years, which roughly corresponds to the central scenario (2.5 %). From the analysis of cyclical components we can find that there is a higher probability of lower EU GDP growth than is suggested in the central scenario.*

Optimistic Scenario

Higher economic growth in EU will primarily work through the acceleration of exports and industrial activity. Moreover, the assumption about the stable exchange rate of the CZK would also mean stable price competitiveness for domestic exporters and this will be reflected in the positive development of foreign trade. The still high import intensity of Czech exports will, however, trigger the acceleration of import growth. The overall positive effect of stronger external demand will be thereby reduced.

Higher economic activity and industrial production will be translated into additional demand for labour and also higher labour productivity growth. These factors together with a higher inflation rate will manifest themselves in higher nominal wage growth. Higher inflation and a positive output gap are likely to force the monetary authority to raise short-term nominal interest rates. Monetary restriction will be briefly reflected in long-term interest rates that will adversely affect investment activity and most probably also household consumption. A number of stabilization mechanisms will be put in place and GDP growth, wage and price development will be gradually stabilised.

A strong upturn in the external balances in terms of the current account balance can be expected due to an assumed fall in oil price levels to 22 USD per barrel. Lower oil price levels have a strong positive effect on income, since - given the relatively high and unchanged energy intensity of the Czech economy – firms' production costs will be reduced by these price falls to a great extent. It is important to point out that this fact will, according to this scenario, reduce the effectiveness of monetary policy interventions[16].

Robust economic growth, accompanied by higher growth in wages and profits, will boost general government revenues. Social security contributions, personal income and corporate income tax in particular will rise buoyantly. Taking into account the composition of higher economic growth, indirect taxes (VAT and excise duties) will not be much affected. As government expenditure is in principle defined by medium-term nominal expenditure ceilings, general government expenditure remains largely unaffected by this development. However, in reality an acceleration in the inflation rate would very likely result in higher spending (indexation of pensions, social benefits and so on). This fact was neglected in our simulations. A very slight increase in expenditure is caused exclusively by higher costs of debt servicing resulting from higher interest rates. To sum up, should all the assumptions of the optimistic scenario be satisfied, fiscal outcomes would be significantly more favourable.

[16] *We assume a validity of price rigidity, which means that a strong fall in oil price will lead to broadening of profit margins in the short term. Moreover, due to the fact that 70 % of private gross fixed capital formation is financed from retained profits, the effects of monetary policy on stabilisation of the economic development are likely to be seen only slowly and in longer time horizon.*

Table 5. 4: Macroeconomic Impacts of the Optimistic Scenario

		Year 2003	Year 2004	Year 2005	Year 2006	Year 2007
	Gross domestic product					
Consumption expenditures	volumes, y/y in %	**5.4**	**2.9**	**3.2**	**3.5**	**3.4**
Gross fixed capital formation	volumes, y/y in %	**3.7**	**4.8**	**5.4**	**5.0**	**5.0**
Government expenditures	volumes, y/y in %	**0.0**	**-0.2**	**-0.2**	**-0.2**	**-0.3**
Export of goods and services	volumes, y/y in %	**6.7**	**8.7**	**10.8**	**11.4**	**11.3**
Import of goods and serivces	volumes, y/y in %	**7.6**	**8.2**	**9.4**	**9.9**	**10.1**
Gross domestic product	volumes, y/y in %	**2.9**	**3.2**	**4.3**	**4.2**	**4.1**
	Labour market					
Total employment	y/y in %	**-0.7**	**-0.8**	**-0.1**	**0.3**	**0.3**
Unemployment rate	in %	**7.8**	**8.5**	**8.5**	**8.3**	**7.9**
Nominal wages	y/y in %	**6.6**	**6.9**	**7.2**	**6.4**	**5.6**
	Prices					
Consumer price index	y/y in %	**0.1**	**3.2**	**3.3**	**3.3**	**3.4**
Gross domestic product deflator	y/y in %	**2.9**	**3.4**	**3.2**	**3.5**	**4.0**
	Public budget					
Public deficit	in % of GDP	**-13.6**	**-5.5**	**-4.4**	**-3.1**	**-2.4**
Gross public debt	in % of GDP	**39.7**	**40.3**	**40.8**	**41.3**	**41.5**
	Other indicators					
PRIBOR 3M	in %	**2.6**	**2.4**	**3.5**	**4.9**	**5.4**
Current account	in % of GDP	**-6.5**	**-5.9**	**-5.0**	**-4.3**	**-3.3**

Source: MoF CR

Pessimistic Scenario

Slower growth of foreign demand, along with faster appreciation of the CZK against the EUR when compared to the central scenario, will adversely affect the export performance of the Czech economy. It is necessary to add to this the price effect resulting from higher oil and gas prices. The two factors will primarily lead to a worsening of the external imbalance. A secondary effect will be decreasing profitability of firms with subsequent impact on their investment activity. Weaker export performance, accompanied by lower gross fixed capital formation, will adversely affect the growth of domestic GDP.

Interestingly, the pessimistic scenario displays relative price stability, for the inflation effect on raw materials is covered by both exchange rate appreciation and labour productivity. Lower economic activity will also impact on the labour market in the form of a continuing fall in employment and higher unemployment rate. Lower labour productivity, moderate price increases and higher unemployment rate will trigger the gradual deceleration of nominal wages growth.

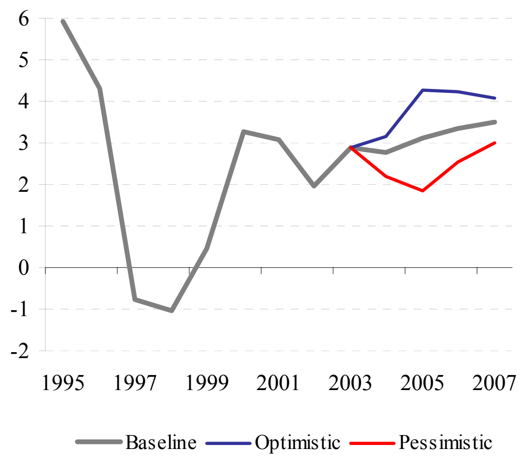
More slowly rising wage bill will also have an impact on the revenue side of the government sector. Declining social security contributions and income taxes should be expected. VAT yield will diminish as a result of the slower growth of private consumption measured at current prices. Should this scenario come to pass, it would lead to considerable deviation from the Government's intention to consolidate public finances. In such circumstances additional austerity measures would most probably be implemented and they would reinforce the adverse implications of the pessimistic scenario for the real economy.

Table 5.5: Macroeconomic Impacts of Pessimistic Scenario

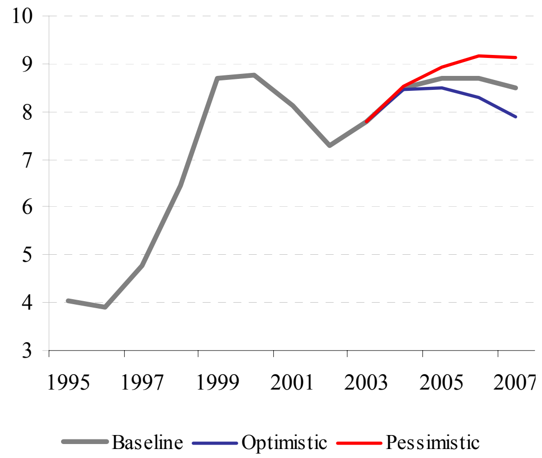
		Year 2003	Year 2004	Year 2005	Year 2006	Year 2007
	Gross domestic product					
Consumption expenditures	volumes, y/y in %	**5.4**	**2.9**	**3.1**	**3.4**	**3.3**
Gross fixed capital formation	volumes, y/y in %	**3.7**	**4.6**	**4.0**	**3.6**	**4.1**
Government expenditures	volumes, y/y in %	**0.0**	**-0.2**	**-0.3**	**-0.1**	**0.1**
Export of goods and services	volumes, y/y in %	**6.7**	**6.9**	**4.0**	**3.2**	**2.8**
Import of goods and serivces	volumes, y/y in %	**7.6**	**7.3**	**5.0**	**3.5**	**2.9**
Gross domestic product	volumes, y/y in %	**2.9**	**2.2**	**1.8**	**2.5**	**3.0**
	Labour market					
Total employment	y/y in %	**-0.7**	**-0.9**	**-0.6**	**-0.2**	**-0.1**
Unemployment rate	in %	**7.8**	**8.5**	**8.9**	**9.2**	**9.1**
Nominal wages	y/y in %	**6.6**	**6.7**	**6.2**	**4.9**	**3.9**
	Prices					
Consumer price index	y/y in %	**0.1**	**3.0**	**2.2**	**1.8**	**2.0**
Gross domestic product deflator	y/y in %	**2.9**	**3.7**	**3.4**	**2.8**	**2.9**
	Public budget					
Public deficit	in % of GDP	**-13.6**	**-5.7**	**-5.4**	**-5.0**	**-4.7**
Gross public debt	in % of GDP	**39.7**	**40.7**	**42.9**	**45.2**	**46.7**
	Other indicators					
PRIBOR 3M	in %	**2.6**	**3.7**	**3.7**	**4.5**	**4.9**
Current account	in % of GDP	**-6.5**	**-6.5**	**-7.1**	**-7.5**	**-7.7**

Source: MoF CR

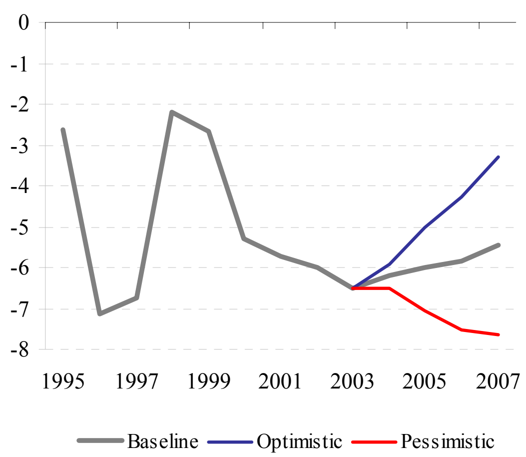
Graph 5.11: GDP *(growth in %)*



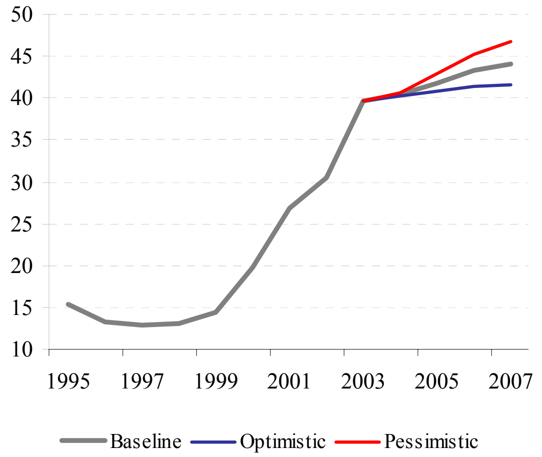
Graph 5.12: Unemployment Rate *(in %)*



Graph 5.13: Current Account *(% of GDP)*



Graph 5.14: Public Debt *(% of GDP)*



Source: MoF CR

6 Quality of Public Finances – Government Revenues and Expenditures

6.1 Policy Strategy

The Government has set out on a comprehensive programme of public finance reform, which aims not only to decrease the budgetary deficit but also to improve the quality of public finances. The first and the second phase of the reform will result in a change of the structure of tax revenues and of the structure of government expenditure. The principle that in the process of deficit reduction expenditure savings will prevail over tax changes was adopted right from the first drafts of the reform. Taking into account all tax measures up to the year 2007, the overall tax burden should not increase significantly. In the end it should even be slightly lower than in 2003.

Fiscal consolidation is focused mainly on making the pensions and health insurance system more efficient, getting the growth in the government wage bill under control and controlling the other expenditure categories in such a way that the growth of central government expenditure does not go beyond the levels defined in the medium-term expenditure framework. Expenditure reforms approved during the last year will facilitate reduction of social transfers and government consumption growth. Our assumption is that government investments will continue to be at relatively high levels. The above-mentioned measures should result in improving the quality of public expenditure – increasing the efficiency of the government sector, restricting social transfers contributing to better functioning of the labour market, and raising the value of government investments that bring growth, particularly in the case of countries at a relatively low level of economic development.

Tax changes promoted at the first and the second stage of public finance reform aim for similar goals. These changes diminish the share of income taxes and raise the importance of indirect taxes. They re-direct taxation from the taxation of labour and profit that negatively affects production factor markets towards consumption taxation. During the first phase there has been rise in the effective rate of VAT, realised by shifting certain goods and services from the lower rate to the standard one. In addition, there has been a rise in excise tax rates. Higher consumption taxation will be accompanied by a gradual decrease in the statutory corporate income tax rate. The second phase of the reform will continue in the same direction, as the effective CIT rate will be further reduced. This reduction will be compensated for by a further increase in the effective VAT rate. Modifications in the CIT scheme are directed to promoting investment activities and R&D. Next to that the second phase of the reform aims to support families with children by implementing the common taxation of married couples and by the introduction of tax credits for couples with children. Tax credits will increase the income of parents with taxable incomes and strengthen incentives for a more active participation in the labour market.

6.2 General Government Expenditure

The fiscal framework assumes a gradual decrease in the government expenditure-to-GDP ratio. During the next three years this ratio is to be lowered by three percentage points. Reduction in government expenditure will be attained even if the rise in expenditure following from entry to the EU is taken into account. Fiscal consolidation will affect nearly all expenditure items; government consumption, social transfers and subsidies will experience the most significant decline. Only investments will elude austerity measures, since infrastructure development and modernization of the economy are among major government priorities. There will also be a possibility of funding additional investments by means of resources from the Structural Funds and the Cohesion Fund. Due to an increase in government debt, our debt servicing costs will continue to rise in years to come.

A decline in government consumption will be attained due to measures approved in the first phase of the reform of public finances (see Box 6.1). These are mainly steps leading to a decrease in government sector employment and containment of average wage growth in the government sector. Together with the reduction of the government sector wage bill, it is possible to expect a decrease in intermediate consumption, in particular operational expenditures.

From 2004 on the adoption of reforms is expected to deliver a growth rate in social transfers that will be lower than the growth in GDP. Consequently, the proportion of social transfers to GDP will fall. A number of measures limiting the growth in social expenditure will have positive effects for the labour market. A tightening of early retirement schemes and further increase of the retirement age will contribute to a rise in the participation rate of people at the age of 55-64. If the efforts to make the labour market more flexible succeed, the growth in the labour force will lead to higher employment levels and higher levels of potential output. It can be expected that the lowering of sickness benefits will, besides expenditure savings, increase labour efficiency, mainly in terms of hours worked.

Starting from 2004, the system of state social support is to become more efficient. Measures implemented will not generally result in direct budgetary savings, but will step up incentives for active job seeking. The motivation for more active participation in the labour market should be particularly strengthened by lifting the ban on drawing certain benefits simultaneously with labour income. The idea of promoting efficiency is also behind the proposed measure that people unemployed for more than one year have to carry out eight hours of public works each month, so as to preserve their eligibility for social benefits. Apart from these steps, the overall level of benefits paid will be reduced as a consequence of the abolition of transport benefit and the lower indexation of benefits in general.

After the enforcement of the first stage of public finance reform, fiscal policy priorities have shifted towards the stimulation of economic growth. Reforms on the expenditure side strengthen incentives for higher labour participation and thus supplement the tax changes contained in a tax package for the enhancement of economic growth. Acceleration of the real convergence process will be also supported by the anticipated high ratio of government investment to GDP.

Table 6.1: General Government Expenditures

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (2)	Year 2006 (2)	Year 2007 (2)
Components of expenditures						
Final consumption expenditure	**P3**	21.5	21.2	20.8	20.3	19.7
Social transfers other than in kind	**D62**	13.3	13.1	12.7	12.5	12.2
Interest	**D41**	1.3	1.3	1.3	1.5	1.7
Subsidies	**D3**	2.5	2.7	2.4	2.3	2.3
Gross fixed capital formation	**P51**	3.8	4.0	4.1	4.2	4.2
Other		21.1	13.3	13.1	12.6	12.4
Total expenditures	**ESA**	63.6	55.6	54.4	53.4	52.6

(1) Projection
(2) Forecast

Source: MoF CR

Box 6.1: Spending Reforms in the First Stage of Public Finance Reform

The state budget for 2004 contains considerable savings. It was facilitated by the approval of a series of laws and measures curtailing public spending. Although the primary objective of these measures was to accomplish budgetary savings, many of the measures improve economic incentives, contribute to increased use of the labour force and strengthen the supply side of the economy. Among measures with such effects can be included the increase in retirement age, substantial tightening of early retirement schemes, reduction in generosity of sickness benefits and abolition of the restrictions on earning while drawing some social benefits.

To provide an overview of the reform steps, this box summarises all the important spending measures approved by the first stage of public finance reform.

Parametric changes of the pension system

- Abolition of early retirement schemes with only temporarily reduced pension benefits;
- The statutory retirement age will continue to rise beyond 2007 at the same pace as it has been rising, till the target age of 63 years for men and childless women is reached;
- Indexation of pension benefits will be kept to the statutory minimum (corresponding to consumer price inflation and a third of the real growth in average wages);
- Restriction of study years after reaching 18 years recognised as contributory periods and acquired before January 1, 1996;
- Cancellation of the restriction on drawing pension benefits simultaneously with earnings exceeding double the minimum subsistence level in the first 2 years following retirement.

System of sickness benefits

- Lowering the level of sickness benefits for the first three calendar days of sick-leave from 50 % to 25 % of the daily assessment basis;
- Reduction of the assessment basis from 100 % to 90 % for the first 14 days of sick leave;
- Freezing of the current reduction caps for defining the assessment basis;
- Extension of the decisive period for the assessment basis from 3 to 12 months.

System of state social support

- Abolition of the transportation benefit that proved ineffective;
- Removal of the upper limit on the earnings of parental allowance recipients;
- When assessing the eligibility of self-employed persons for benefits, it will be presumed that they earn a minimum notional income of 50 % of the average wage;
- The level of the subsistence minimum decisive for eligibility for benefits and the level of benefits will be increased only by the minimum required by law (i.e. on the basis of CPI growth for the entire household).

Wages and employment in the government sector

- A decrease in the number of employees at the level of central government with the goal of reducing their number by 6 % (approximately 29 thousands posts) in the period 2004 to 2006;
- Introduction of the 16-class salary tariff in a form that will significantly limit the fiscal impact of this step;
- Freezing of salaries of MPs and government officials, judges, state attorneys and similar officials at their 2003 level throughout the period 2004 – 2006.

Other measures and discretionary changes

- Reduction in the state subsidy for housing savings schemes;
- Lower military spending;
- Lower subsidies to businesses;
- Reduction of the operating costs of individual ministries.

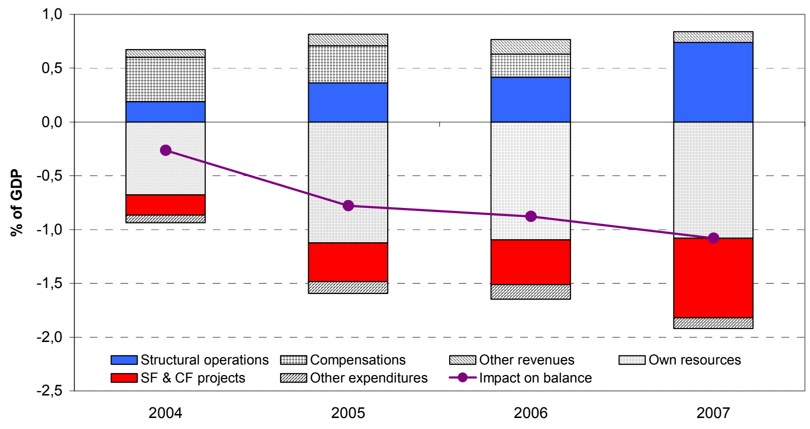
In recent years (up to 2004) government expenditure has been strongly influenced by the costs of economic transformation. These costs take the form of capital transfers, emerging due to transfers of poor performing assets at prices below market ones to transformation institutions (Group of the CKA and the CI) and due to the provision of non-standard bank guarantees. However, as the restructuring of the banking sector is over and asset transfers to the CKA will be subject to stringent authorization procedures (see section 8), no other capital transfers due to the CKA's operations are expected to come within the fiscal framework.

At the end of 2003 the stock of state guarantees amounted to 12.1 % of GDP. During the period 1995 to 2003, state guarantees amounting to 10.5 % of GDP were included within the expenditure, deficit and debt of government sector. There is potential room for additional increases in government expenditures due to existing state guarantees at the level of 1.5 % of GDP. As the vast majority of existing guarantees are risk-free, the fiscal outlook does not anticipate any deficit increase due to realisation of these guarantees. Assumptions about the development of state guarantees and about operations of transformation institutions explain the significant decrease in other expenditures compared to 2003 (see Table 6.1).

As of 2004 general government expenditure will be affected by EU entry. In many cases the Structural Funds and the Cohesion Fund will provide financing for such projects, where the Government will be the final recipient of the funds.[17] Consequently, expenditure in the area of social and economic cohesion will be increased. This will also show itself at the level of government investments. The Czech Republic will contribute to the EU budget by approximately 1.1 % of GDP and this expenditure is to be reflected in the increase in current transfers. Receipts from the EU budget directed to the government sector (Structural Funds, Cohesion Fund, internal policies), will not contribute to any improvement in the government sector balances during the given period. These resources are earmarked for particular projects and due to the additionality principle they will increase expenditure in the government sector. Yet in the longer term government savings may be expected. Since these funds will accelerate development in the area of social and economic cohesion and the need to finance these areas from domestic resources will be reduced. In the short run EU admission will result in a deterioration of the government sector deficit of about 0.3 – 1.0 % of GDP.

[17] *It is assumed that the projects financed by the Cohesion Fund will be carried out almost exclusively by the government sector, while both government and private sectors are to be final recipients of the funds from the Structural Funds. We assume the share of government projects to be about 75 – 80 %.*

Graph 6.1: Main Impact of EU Accession on Government Expenditures and Revenues



Source: MoF CR

6.3 General Government Revenues

The ratio of public revenues to GDP is to fall slightly until 2007. The overall development masks many distinct factors with potentially contrary effects. On the one hand, taxes on production and imports will increase due to the rise in indirect taxation; on the other hand taxes on income will fall down. The above-mentioned trends result from the impact of the tax changes, assuming that all measures proposed at the second stage of public finance reform will be implemented together with changes from the first stage. The ratio of social contributions to GDP will rise slightly. Income from interest payments is expected to drop. Next to debt accumulation, the volume of financial assets will decline and consequently the income from interest payments is likely to decrease.

Other current and capital revenues will increase in terms of GDP. After a one-off increase in 2003 due to dividend income, the rise in this item is brought about by the start of financial flows from EU. These flows will raise revenues in the government sector by approximately 0.5 to 1.0 % of GDP in each year covered by the fiscal framework. Starting from 2004, general government revenues will be higher, particularly due to budgetary compensations. In the course of time their level will decrease and the resources from the Structural Funds and the Cohesion Fund will gradually replace compensation payments.

Table 6.2: General Government Revenues

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (2)	Year 2006 (2)	Year 2007 (2)
Components of revenues						
Taxes on production and imports	**D2**	11.9	12.6	13.0	12.8	12.5
Current taxes on income and wealth	**D5**	10.1	9.9	9.0	9.0	9.0
Social contributions	**D61**	16.0	16.0	16.1	16.2	16.2
Interest income	**D41**	0.6	0.3	0.2	0.2	0.2
Other		11.3	11.1	11.2	11.2	11.2
Total receipts	**ESA**	49.9	50.0	49.5	49.4	49.1

(1) Projection
(2) Forecast
Source: MoF CR

Many legislative changes in the field of taxation have been implemented since 2004. These changes will have an important impact on the total amount of tax receipts between 2004 and 2007. The individual measures realized at both stages of public finance reform are summarized in Box 6.2. The format of the tax measures adopted during the first stage of the reform was predetermined by the effort to consolidate public finances and by the requirement to harmonize tax legislation in line with EU regulations. To start up the process of public finance consolidation, VAT and excise duty modifications were used to raise tax revenues. Apart from the harmonization of indirect taxation, changes were made in the field of corporate income tax, property tax and taxation of the self-employed.

The statutory CIT rate will gradually be reduced to 24 %. The tax rate reduction is an important measure to maintain the competitiveness of the Czech Republic in the Central European region, as many other countries including Poland, Hungary and Slovakia have already slashed CIT rates to attract foreign investors. The planned cuts, together with the measures proposed for the second stage of the reform, will reduce the effective CIT rate to a level comparable with neighbouring countries joining the EU.

Box 6.2: Tax Changes at the First and Second Stage of Public Finance Reform

The common denominator of the changes contained in the two tax packages put forth at the first and the second stage of public finance reform, is the reinforcement of indirect taxes compensated for by a fall in income taxes. The first tax package pursued mainly fiscal motives and was drawn up in the context of the obligation of the CR to harmonise its tax legislation with the appropriate EU directives. On the other hand, the second tax package is perceived as an instrument of structural reforms and strives to promote potential growth in the Czech economy.

The most important changes approved at the first stage of public finance reform are the following:

VAT:

- In accordance with EU regulations selected goods and services were transferred from the reduced (5 %) to the standard rate (22 %). The change took place in two steps – a part from 1 January 2004 (e.g. telecommunications) and the remaining items from 1 May 2004 (e.g. construction);
- From 1 October 2003, the turnover threshold for obligatory VAT registration was reduced from CZK 3 mil. to CZK 2 mil. a year and from 1 May 2004 further to CZK 1 mil. a year;
- The VAT law will contain provisions regulating intracommunity trade between EU Member States.

Excises:

- The excise duties on commodities where Czech rates were lower have been raised to the level of the minimum rates applied in the EU. From January 1, 2004 excise duty on mineral fuels was raised. The tax burden on the most frequently purchased type of cigarettes will be gradually increased to reach 57 percent or 60 € per 1000 cigarettes by 31 December 2006;
- A rise in the excise duty on spirits and tobacco products will be accompanied by measures aimed at the prevention of tax evasion (stamping of spirits, restrictions on stand selling);
- A new regulation on excise duties, which will introduce changes concerning duty suspension arrangements through so-called tax warehouses, is being prepared at the moment.

Income taxes:

- The amended Income Tax Act introduces a common system of taxation for parent companies and subsidiaries from different Member States and a common system of taxation applicable to mergers, transfers of assets and exchanges of shares concerning companies from different Member States;
- The corporate income tax rate was reduced to 28 % from 1 January 2004 and will be further reduced to 26 % as of 1 January 2005, and finally to 24 % as of 1 January 2006;
- Self-employed persons have to pay at least a minimum amount of tax corresponding to a notional income at the level of 50 percent of the average wage.

Real estate transfer tax:

- The real estate transfer tax was cut by 2 p.p. (from 5 % to 3 %) from 1 January 2004, and the tax is payable within the deadline for filing one's tax return.

Social contributions:

- A gradual rise in the assessment base of the self-employed between 2004 and 2006 from the current 35 % to 40, 45 and eventually 50 % of the difference between revenues and costs, whereby this difference may not fall below 50 % of the average wage;
- A budgetarily neutral rearrangement of social contributions – a decrease in the contribution for the active employment policy compensated for by a 2 p. p. increase in pension contributions.

At the second stage of the public finance reform following measures have been proposed:

VAT:

- From 1 May 2004, the standard rate was reduced by 3 percentage points (from 22 % to 19 %). The reduced rate remains unchanged and is maintained for socially sensitive goods (food, medicaments, construction works for housing purposes, heating).

Income taxes:

- PIT – introduction of joint income taxation for married couples in order to support families with children and replacement of tax-deductible allowance for a child by a tax credit;
- CIT – shortening of depreciation periods in the first three depreciation groups (e.g. computers, means of transport, machinery), increase in tax-deductible allowances for financial donations in the area of R&D up to 10 per cent of tax base.

In order to increase the horizontal fairness of the tax system, the taxation of the self-employed has been modified, since the self-employed were unduly favoured when it came to paying taxes and contributions. The most significant measure is the introduction of a minimum assessment base for income tax and social security contributions. At the same time, the assessment base for social security contributions of self-employed has been broadened.

The first stage of the public finance reform has started the re-shuffling of the tax burden from income taxation, which impairs economic activity significantly, towards indirect taxation. The second stage of the reform will continue in the same direction by launching a tax package for bolstering economic growth. The further reduction in effective taxation of corporate profits is the most significant measure and it will be achieved by the acceleration of depreciations and by an increase in the R&D allowance. Whereas the lowering of the statutory CIT rate approved at the first stage will increase the rate of return on capital and promote the attractiveness of entrepreneurship in general, the acceleration of depreciations will endorse investment activity and strengthen the supply side of the economy. Similar effects are expected in relation to the R&D allowance. The support of families with children is another objective of the intended measures. The abolition of child allowance and its replacement by the tax credit is to have a positive impact. Lower income families with children, who have some taxable income, will benefit from this measure. Consequently, financial benefit should bring incentives for a more active participation in the labour market.

The measures enhancing economic growth and supporting families with children will be financed by an increase in indirect taxes. The majority of goods and services currently taxed by the reduced VAT rate will be taxed by the standard rate. This shift will come into effect on 1 May 2004. The standard VAT rate will not be applied on socially sensitive items only. To mitigate the price impact of shifting most goods and services to the standard rate, the standard rate will be lowered by 3 percentage points as of 1 May 2004.

Table 6.3: The Impact of Tax Changes on Public Budgets [1]

% of GDP	Year 2004	Year 2005	Year 2006	Year 2007
The first stage of public finance reform				
Taxes, total	**0.9**	**0.9**	**0.7**	**0.6**
of which: VAT	*0.7*	*1.0*	*1.0*	*1.0*
Excises	*0.5*	*0.6*	*0.7*	*0.6*
CIT	*-0.2*	*-0.5*	*-0.8*	*-0.9*
PIT	*0.0*	*0.0*	*0.0*	*0.0*
Social contributions	**-0.1**	**0.0**	**0.1**	**0.1**
The second stage of public finance refom				
Taxes, total	**0.2**	**-0.3**	**-0.1**	**0.0**
of which: VAT	*0.2*	*0.4*	*0.4*	*0.4*
CIT	*0.0*	*-0.5*	*-0.3*	*-0.1*
PIT	*0.0*	*-0.2*	*-0.2*	*-0.2*

(1) The impact is expressed in accrual terms and indicated as a deviation from a no-policy-change scenario.

Source: MoF CR

The first stage of the tax changes will raise government sector revenues by less than one percentage point of GDP. The changes in excise duties and VAT will contribute most to the increase in revenues. They will generate additional revenues of approximately 1.6 % of GDP. On the other hand, the adjustment of the statutory CIT rate will bring a tax relief of 0.9 % of GDP for companies. The overall effect of tax changes drawn up at the second stage of public finance reform is in general close to being neutral. Since VAT adjustments precede changes in income taxation, there is an increase in tax revenues in 2004. In the following years the tax support of investments and families with children will take effect and thus tax revenues will decrease. The effect of higher depreciations on total tax revenues will fade away gradually and tax revenues will remain nearly unchanged in the medium term.

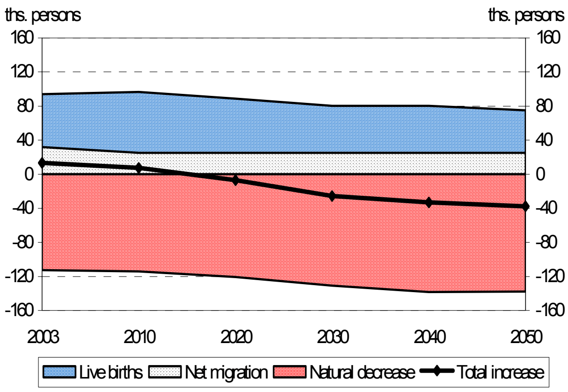
The measures, which have been carried out during the first stage of the reform, will lead to an increase in revenues of the government sector. Thus, the measures are likely to have a rather restrictive impact on the economy through a reduction in aggregate demand. Nevertheless, the short-term impact on demand will be compensated for by the long-term stimulation of the supply side of the economy. These effects are expected to be delivered by the cut in the statutory CIT rate, the accelerated depreciation of resources and equipment used in the production process and the introduction of tax credits for families with children.

7 Sustainability of Public Finances

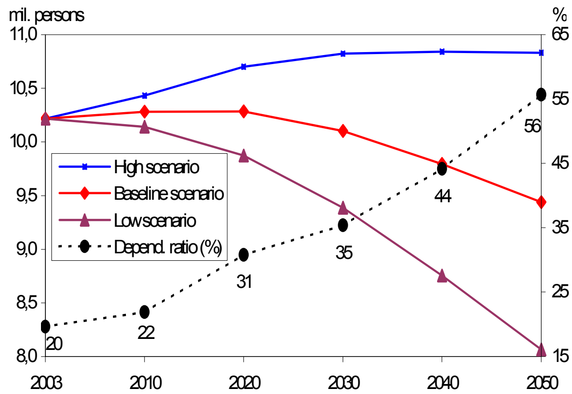
A substantial part of public expenditure consists of spending programmes, an analysis of which requires a long-term perspective. Current decisions on these programmes affect spending patterns not only in the immediate future but also after several decades and often much more intensively. On these grounds and due to coming shifts in the demographic structure, an interest in long-term fiscal projections has gained in importance, despite the wide margins of uncertainty surrounding long-term projections. Shifts in demographic structure, that are already predetermined in their main outlines, represent the most important factor driving fiscal outcomes over coming decades. Public expenditure will not be the only variable affected by demographic shifts. Population ageing will impact on the labour market and productivity growth too.

At present, there are two recent demographic projections for the Czech Republic available. They were produced by the Czech Statistical Office (CSO) and the Faculty of Science of the Charles University respectively. Both projections agree in forecasting that the proportion of elderly people will rise rapidly. This will have serious effects on the sustainability of spending programmes, which are targeted at those age groups. For reasons of objectivity the fiscal projection was based on the CSO forecast, as it foresees more adverse consequences in terms of the fiscal costs of an ageing population than the other one.

Graph 7.1: Structure of Demographic Development



Graph 7.2: Population Development and Dependency Ratio



Source: CSO

Note: The dependency ratio is defined as a ratio of the number of people aged over 65 to the number of people aged between 15 and 64 in the baseline demographic scenario.

In spite of the fact that there are significant differences in the size of population in the respective demographic scenarios, their dependency ratios differ only marginally. The process of population ageing represented by the dependency ratio peaks approximately 20 years later in acceding countries than in most other EU countries.[18] Nowadays, the Czech Republic belongs to those countries which have a rather young population when compared to the EU - 15 average, but viewed from the end-point of the demographic forecast (2050), its share of the

[18] *According to the forecast of the Faculty of Science of the Charles University, which extends up to 2065, the dependency ratio continues to rise until the middle of the 2050s.*

elderly will then substantially exceed the EU-15 average. Its pace of population ageing is unambiguously one of the fastest compared with the EU-15's.

The release of the above-mentioned demographic projections at the end of last year was the main reason for updating the projections of the fiscal implications of population ageing. Along with the revision of demographic assumptions, the underlying database was brought up to date and the simulation models were also partially adjusted. Macroeconomic assumptions concerning the participation rate, unemployment rate, and productivity growth are compatible with those applied by international institutions.[19] Compared to last year's PEP the latest update also takes into account all the important reform measures that were adopted before the projections exercise and that will strongly impinge on the sustainability of public finances.

In 2003 the Government initiated public finance reform, the aim of which is to contribute to long-term sustainability and to mitigate adverse demographic prospects. Its first stage in particular included measures that have the potential to curtail the magnitude of the long-term fiscal imbalance. The second stage, which was launched at the end of last year, has focused largely on implementing structural reforms, including reform of the pension and health care system. But up to now a political consensus on the shape of these measures has not been reached. Hence further reform challenges lie ahead.

Under the first stage of public finance reform the retirement age was raised to 63 years, which was an important step towards the medium-term stabilisation of the pension system. The level of 63 years will be reached in 2016 for men and 2019 for women; the retirement age will, however, be kept differentiated for women, depending on the number of their children. Yet another measure was aimed at increasing the effective retirement age – the Government decided to curtail one of the two early retirement schemes. One scheme, which is linked to unemployment, will be phased out by 2006. The other, which is being used to a greater extent, remained nevertheless unaffected. The expenditure side of the pension system will furthermore profit from the restriction of study years recognised as contributory periods.

On the revenue side of the pension system, steps have been undertaken that will bring the effective pension contributions of the self-employed up to those of employees and will thus bring in additional revenues to the pension system. The abolition of a condition, which allowed only a limited (relatively low) employment-related level of income for those drawing the old-age pension, will strengthen public sector revenues too. Furthermore, a proportion of the state employment policy contributions will be diverted to the pension system, which will be fiscally neutral, but will positively impact on the pension account balance.

At the second stage of public finance reform, discussions on a thoroughgoing pension reform have been initiated across all parliamentary parties. This resulted in an agreement to establish an expert committee in April 2004, which would assess various pension reform proposals. Reform suggestions cover parametric changes of the current defined benefit system, transition towards a defined contribution system financed on a pay-as-you-go basis (the Swedish model, or NDC), and also the option of a partial, voluntary reallocation of individual contributions into private pension funds (contracting out).

Concerning the heath care sector, a number of short-term stabilising measures were put in place and the health insurance contributions of the self-employed were increased in a similar

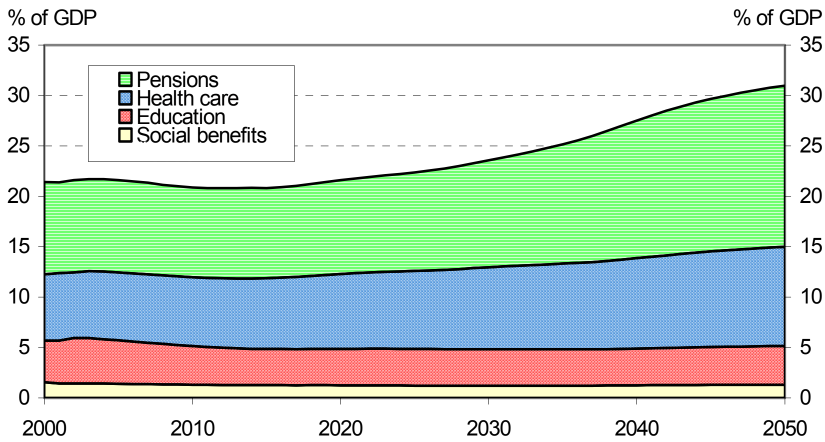
[19] *The Czech Republic has participated in two OECD fiscal projection exercises (Fiscal Implication of Ageing, 2001 and Projections of Health Care, 2002) and recently took part in activities of the Ageing Working Group attached to the EU Economic Policy Committee.*

manner to the pension contributions. Work on a comprehensive health care reform has been under way during this year but has not yet been concluded. The health care system hence remains, after the pension system, the second most important source of risks for the long-term sustainability of public finances.

Important measures were initiated in the education system. The new Act on Education is aiming at enhancing flexibility in education programmes and should boost change in terms of the structure of educational achievements, leading towards an increased number of people with completed tertiary education and a lower number of people with narrowly (technically) focused secondary education. Fiscal projections take this into account and consequently assume a gradual increase in the number of students at the tertiary level towards the OECD average. This will decelerate the rate of decrease in education expenditure which would otherwise originate from demographic changes. This means that such changes will not allow education expenditure to fall far below 4 percent of GDP.

Last but not least, long-term sustainability will profit from reducing the general government primary balance from a recent level of almost 5 percent of GDP to just below 2 percent, which results from higher revenues and curtailed expenditure in the public sector.

Graph 7.3: Old-age Public Expenditures



Source: MoF CR

Obviously, a substantial increase of pension and health care expenditures occurs in the second quarter of the 21st century. Advances in life expectancy will be the most important driving force; the one for men being particularly striking. Initially, pension and health care outlays will partly be compensated for by low fertility rates that will restrain child-related expenditure in the educational area and social benefits for families with children. Nevertheless, this factor exhausts itself in about twenty years and from that time on we project the growth of these expenditures to recur. Care should be take when interpreting the projection results, as long-term projections are inevitably susceptible to both under- and over-estimates and they presume a continuation of present policies regardless of any future (and very likely) reforms.

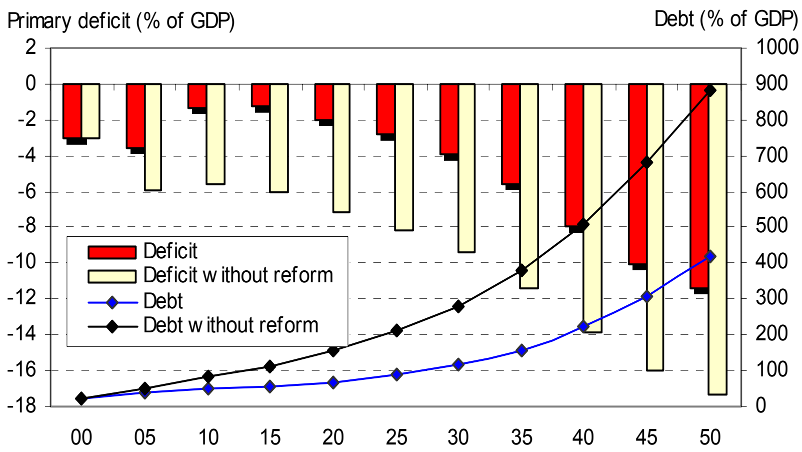
Table 7.1: Long-term Sustainability of Public Finances

% of GDP	Year 2003	Year 2005	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050
Total expenditure	62.2	53.1	50.4	51.1	53.1	57.0	60.5
Old-age pensions	6.8	6.8	6.6	6.9	7.8	10.4	12.5
Other pensions	2.4	2.4	2.3	2.4	2.8	3.2	3.5
Education	4.5	4.3	3.8	3.6	3.6	3.6	3.8
Healthcare (including care for the elderly)	6.7	6.7	6.8	7.4	8.1	9.0	9.8
Interest payments	1.3	1.3	1.8	2.6	4.3	8.2	15.6
Total revenues	49.9	49.5	49.1	49.1	49.1	49.1	49.1
***of which:* from pensions contributions**	8.8	9.5	9.5	9.5	9.5	9.5	9.5
National pension fund assets (if any)							
	Assumption						
Labour productivity growth	4.3	2.9	3.4	2.8	2.5	1.8	1.8
Real GDP growth	2.9	3.1	3.9	2.3	1.7	0.6	1.1
Participation rate males (aged 20–64)	84.8	84.7	84.9	85.7	84.5	83.6	83.9
Participation rates females (aged 20–64)	67.6	67.6	68.1	71.5	72.3	73.9	77.2
Total participation rates (aged 20–64)	76.2	76.1	76.5	78.6	78.4	78.8	80.6
Unemployment rate	7.8	8.7	7.9	6.5	6.5	6.5	6.5

Source: MoF CR

To evaluate the long-term impact of public finance reform, we compared our calculations with those reflecting the estimated evolution of revenues and spending without the consolidation measures of 2003 and 2004. The latter projection simply preserves all the unfavourable budgetary trends from the past and translates them forwards. The impact of consolidation on the primary deficit of the structural balance and public debt is shown in Graph 7.4.

Graph 7.4: Primary Deficit and Public Debt



Source: MoF CR

Despite positive effects brought about by public finance reform, it is apparent that public finances still lack sustainability. In the absence of additional consolidation measures, the boom in expenditure would have to be backed up by a higher tax burden imposed on both recent and future taxpayers. Otherwise the level of government spending programmes for those generations would have to be restrained. Reaching a sustainable fiscal position necessitates further, long-lasting consolidation efforts concentrated in the areas of pensions and health care. The sustainability, manageability and quality of public finance would otherwise be jeopardized.

Should the Czech fiscal and budgetary policy have to comply after EU entry with the fiscal discipline requirements imposed by the Stability and Growth Pact, measures to curtail the expenditure ratio or to boost the revenue ratio by more than 5 percentage points of GDP would be required in 2008 (the so-called sustainability gap). If translated into the aggregate general government balance, a sustainable fiscal target would be a surplus of 1.8 % of GDP in 2008. The following table compares the two abovementioned projections, with and without public finance reform, in terms of overall budgetary figures and supports the evidence that the public finance reform has substantially reduced the risks posed by population ageing. This finding should, however, be interpreted with caution, for it results to a significant extent from delaying the expansion of pension spending and from reducing the initial level of general government deficit. This generally improves the results regardless of worrisome demographic developments. Current reform efforts should definitely not be dampened by the fact that the current debt level still provides some breathing space before the limit of 60 percent of GDP is reached. As one can see from the following table, delaying necessary reforms represents the most important short-term risk to fiscal sustainability. Each additional year by which the budgetary consolidation is delayed incurs extra costs (of about 0.3 to 0.4 percentage points of GDP) in terms of restoring a sustainable fiscal position.

Table 7.2: Long-term Requirements for Public Finances

% of GDP	Year 2008	Year 2009	Year 2010
1. Revenues *(forecasts)*	49.1	49.1	49.1
2. Expenditures *(forecasts)*	50.7	50.6	50.4
3. General government primary balance (1-2)	-1.6	-1.4	-1.3
4. Sustainability gap (1)	5.1	5.3	5.4
5. Required primary balance (3+4)	3.5	3.8	4.1
6. Required total balance	1.8	2.1	2.3
7. Sustainability gap without public finance reform	10.9	11.2	11.6

(1) The sustainability gap reflects the size of a long-lasting tax increase or expenditure cut (in terms of GDP in a given year) that is necessary in order for the Czech Republic to comply with the Stability and Growth Pact.

Source: MoF CR

8 Changes in the Institutional Framework

The basic instruments for ensuring the achievement of fiscal targets specified in the Conception of Public Finance Reform are included in an Amendment of the Act on Budgetary Rules, which is being discussed in the Parliament at present and which is expected to be approved in mid-2004. The Amendment will significantly change the institutional framework for the performance of fiscal policy, as it introduces fiscal targeting based on binding medium-term expenditure limits. With a view to increasing the effectiveness of expenditure limits, further institutional changes are envisaged (audit of state budget expenditure, programme-oriented budgeting, inclusion of the expenditure incurred by extra-budgetary state funds within the medium-term expenditure limits etc.). These institutional changes are aimed especially at improving aggregate fiscal discipline, ensuring a more efficient allocation of budgetary resources and better "operational" efficiency of government-controlled organisations. These changes will help the Czech Republic to catch up with states with modern budgetary systems.

Pursuant to the aforesaid Amendment the medium-term expenditure frameworks will be defined on the basis of the so-called sliding principle, always for a period of three years (the year of the state budget plus the following two years). The expenditure limits will be firstly discussed by the Cabinet and then approved by the Parliament as a resolution on the governmental draft of the State Budget Act. Any later review will be limited to highly specific situations, namely to situations where real price development will significantly diverge from the forecast or where legislative changes modify the allocation of expenditure authority to individual levels of government. The expenditure limits can also be increased by the amount of expenditure co-financed by the EU. In practice, adherence to approved expenditure frameworks will depend on the government's will and self-discipline, because, as in a number of other countries, the breach of aggregate expenditure limits cannot be sanctioned. The binding character of expenditure frameworks, together with the fact that they will be somewhat shielded from the impact of cyclical or even one-off fluctuations on the revenue side, should create conditions for a better and more effective functioning of automatic fiscal stabilisers.

The process underlying the provision of state guarantees was tightened in 2001, making any new guarantee subject to approval by the Chamber of Deputies and thus reducing the total volume of guarantees. Owing to these aforesaid measures, only three state guarantees - totalling CZK 5.9 bn were provided over the period of 2002-2003.

The Amendment of the Act on Budgetary Rules lays substantially higher emphasis on the need to enhance the commitment and discipline of the budgetary chapters' administrators, while strengthening their managerial authority. The budget chapters' administrators will have the right to roll over the entire amount of unspent revenues earmarked for investment and operational financing into the following years. The sanctions for breach of budgetary discipline are also laid down in more detail and - to a large extent - also more fairly. These measures add a medium-term outlook to the – previously strictly annual - state budget. The draft 2005 state budget as well as the binding medium-term expenditure frameworks for 2005-2007 will be already prepared on the basis of the approved Amendment of the Act on Budgetary Rules. Individual stages of the budgetary process should be defined more precisely in terms both of factual content and of time schedule than has been the case up to now.

Another substantial change is the fact that the State Environment Fund and the State Fund for Transport Infrastructure will be obliged to earmark a part of their budgets for programmes and projects co-financed from the EU Structural Funds and Cohesion Fund. The provision on medium-term outlook was also amended, providing for expenditure for programmes and projects, co-financed from the EU budget, to be structured by budgetary chapters and state funds.

The Amendment of the Act on Budgetary Rules comprises a considerable restriction of the possibility of further transfers of non-performing assets to the balance of the CKA under non-market conditions. Additional transfers of such assets to the CKA at non-market prices should be subject to the approval of the government and – for amounts over CZK 1 bn a year (EUR 31 mil.) - to the approval of the Chamber of Deputies of the Parliament of the Czech Republic.

With a view to reducing the fragmentation of public budgets, limiting the autonomous expenditure centres and reducing medium-term fiscal risks, the reform plans include a proposal for ending the operation of privatization funds[20]. The operation of the National Property Fund (NPF) will be ended by law, once the NPF has fulfilled its role as a temporary state privatization agency. Since the NPF has almost completed its role as a transformation institution and has finalised the privatization of the vast majority of state property, its operation should be concluded without liquidation by the end of 2005.

The state, represented by the Ministry of Finance, is expected to become the legal successor to the NPF. All property of the NPF, whether intended for privatization or used for operational purposes, will be transferred to the Ministry of Finance. This will also apply to all equity stakes of the Fund in entrepreneurial activities of business companies that have not been privatised yet and all securities in the possession of the NPF. The ways of managing the property, disposing of it and further privatization after the ending of the NPF's activities will also be defined in the relevant legislation, which is currently being prepared. The bank balances of NPF and all its receivables and obligations will also be transferred to the Ministry of Finance.

The objective of these measures is to create conditions for a smooth completion of the privatization of state property earmarked for privatization but still left in state hands at the end of 2005. The closing down of the privatization funds will be completed by the conclusion of the Land Fund's activities (by its transformation). The remaining tasks of the Fund will probably be assumed by the Land Settlement Offices (which represent an organisational unit of the state) and the number of extra-budgetary funds will thereby be reduced further.

The Ministry of Agriculture is preparing the conclusion of the activities of the State Fund for Land Fertilisation, which should be carried out by the end of 2006. Conditions for the operations of the remaining state funds will be brought in line with the conditions applicable to the state budget. The funds´ expenditures will be included in the medium-term expenditure framework and their expenditure will be under as strict a control as state budget expenditure.

Proposed measures concerning the CKA are also closely linked to the efforts aimed at increasing the transparency of public finance and thus preventing any circumvention of expenditure frameworks. On the basis of the government's resolution the CKA should conclude its operation without liquidation by December 31, 2007. The above-mentioned

[20] *For the purposes of Czech budgetary practice, the privatisation funds are the National Property Fund (NPF) and the Land Fund (LF).*

provision of the Amendment of the Act on Budgetary Rules, which substantially restricts the transfer of poor-quality assets to the CKA, is also closely related to this decision. Before CKA´s operations are concluded, the state will have to find a way of settling CKA´s receivables vis-à-vis the state budget. These were accrued due to the accumulation of unsettled losses from previous years. The settlement of CKA´s receivables will be solved by a special state bond programme for the years 2004 – 2007. The aim of this programme is to enable CKA's obligations to be absorbed by the state budget as efficiently as possible.

9 Annexes

9.1 CP Macroeconomic Framework – Feasibility Verification Based on a Consensual Forecast

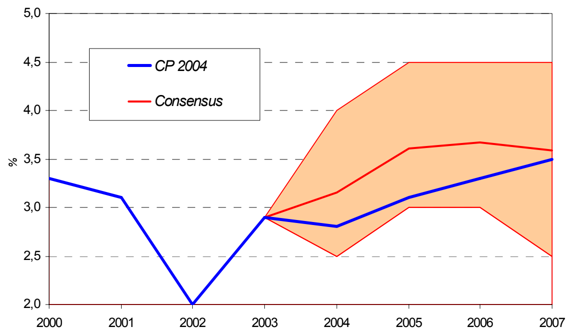
As was the case last year, the feasibility of the CP macroeconomic framework has been verified by means of a consensual forecast.

A consensual forecast has been a standard part of the preparation of a macroeconomic budgetary framework in the Czech Republic since 1996. The Ministry of Finance has been organising a semi-annual Colloquium, i.e. a meeting of the representatives of both public and private institutions involved in macroeconomic forecasting. Participating analysts are invited to fill in a questionnaire in the form of a formalised table focused on their expectations of the future development of basic macroeconomic indicators, and the consensual forecast is computed as the arithmetic average of individual forecasts. Normally this exercise involves developments expected in the current year and the year after. For the purposes of CP, the timescale has been extended to provide in addition a reference forecast for the following two years.

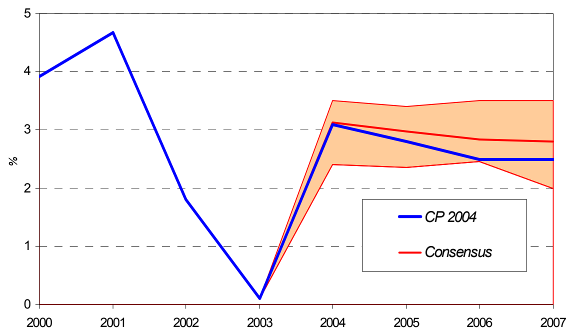
The Colloquium has been attended by 19 institutions, and provisional forecasts for 2006 and 2007 have been presented by 12 respondents. The participating institutions include state administration bodies, the Czech National Bank, domestic banks, branches of foreign banks, investment companies and research institutes. The circle of respondents participating in the exercise has stabilised over the years. In an international context, the number of institutions preparing their own macroeconomic forecasts is fairly high.

By and large we can state that the main trends of the CP macroeconomic framework correspond to the consensual forecast. The respondents mostly expect a favourable and smooth development, without any significant demand or supply shocks.

Graph 9.1: Comparison of GDP Forecasts



Graph 9.2: Comparison of Forecasts of Average Inflation Rate



Source: MoF CR

As for the growth of GDP and its individual components, the CP forecast is slightly more conservative than the consensual forecast (evenly in all its components of demand). What is remarkable is the agreement with respect to the expected average rate of inflation for 2004 (probably due to a similar perception of risks connected with the “harmonising” amendment of the VAT Act). In the next few years the respondents predict a slight relaxation of inflation within the tolerance band of the Czech National Bank's inflation target. The variance of inflation rate forecasts is rather small, which means probably that the inflation targeting regime has been successful in influencing expectations.

The CP scenario also reflects the risks in the labour market more strongly, while private institutions' forecasts systematically underestimate future unemployment rates.

Table 9.1: Comparison of Consensual Forecasts with the CP Macroeconomic Framework

			Year 2003	Year 2004	Year 2005	Year 2006	Year 2007
Gross domestic product	growth in %	Minimum		2.5	3.0	3.0	2.5
		Consensus	**2.9**	**3.2**	**3.6**	**3.7**	**3.6**
		Maximum		4.0	4.5	4.5	4.5
		CP 2004	**2.9**	**2.8**	**3.1**	**3.3**	**3.5**
Private consumption	growth in %	Minimum		2.5	3.1	3.0	3.0
		Consensus	**5.4**	**3.2**	**3.6**	**3.7**	**3.4**
		Maximum		4.5	4.1	4.9	4.0
		CP 2004	**5.4**	**2.9**	**3.1**	**3.4**	**3.4**
Government consumption	growth in %	Minimum		-0.5	-2.0	-1.5	-2.0
		Consensus	**0.0**	**0.5**	**0.3**	**0.5**	**0.1**
		Maximum		2.5	2.5	3.0	2.0
		CP 2004	**0.0**	**-0.2**	**-0.2**	**-0.2**	**-0.1**
Gross fixed capital formation	growth in %	Minimum		3.3	3.5	3.5	2.5
		Consensus	**3.7**	**4.7**	**5.1**	**4.6**	**4.4**
		Maximum		8.0	8.0	7.2	6.0
		CP 2004	**3.7**	**4.8**	**4.7**	**4.3**	**4.5**
National inflation rate	growth in %	Minimum		2.4	2.4	2.5	2.0
period average		**Consensus**	**0.1**	**3.1**	**3.0**	**2.8**	**2.8**
		Maximum		3.5	3.4	3.5	3.5
		CP 2004	**0.1**	**3.1**	**2.8**	**2.5**	**2.5**
GDP deflator	growth in %	Minimum		2.0	1.7	2.0	2.0
		Consensus	**2.9**	**3.3**	**3.2**	**3.2**	**3.1**
		Maximum		3.7	3.5	5.0	4.0
		CP 2004	**2.9**	**3.5**	**3.3**	**3.2**	**3.4**
Employment	growth in %	Minimum		-1.5	-0.8	-0.5	-0.5
		Consensus	**-0.7**	**-0.5**	**-0.1**	**0.2**	**0.2**
		Maximum		0.0	1.0	1.0	1.0
		CP 2004	**-0.7**	**-0.8**	**-0.3**	**0.0**	**0.1**
Registered unemployment rate	in %	Minimum		10.1	9.4	9.0	8.2
end of period		**Consensus**	**10.3**	**10.5**	**10.1**	**9.8**	**9.4**
		Maximum		11.1	11.0	10.8	10.7
		CP 2004	**10.3**	**10.7**	**10.8**	**10.6**	**10.5**
Trade balance (current prices)	bill. CZK	Minimum		-80	-85	-85	-90
		Consensus	**-69**	**-64**	**-60**	**-57**	**-51**
		Maximum		-50	-35	-20	-10
		CP 2004	**-69**	**-60**	**-47**	**-40**	**-30**
Current account / GDP	% of GDP	Minimum		-6.5	-6.5	-7.0	-6.3
		Consensus	**-6.5**	**-5.9**	**-5.5**	**-5.4**	**-5.0**
		Maximum		-4.0	-4.2	-4.5	-4.0
		CP 2004	**-6.5**	**-6.2**	**-6.0**	**-5.8**	**-5.5**

Source: MoF CR

9.2 Methodological Changes

The differences in data on the level of government deficit and debt in the years 2002 – 2004 published in PEP 2003, when compared to those in the Convergence Programme, were not caused by impaired government sector management. They arose in particular from methodical changes carried out by the Czech Statistical Office (CSO) on the basis of Eurostat recommendations. The biggest impact has been made by the following methodological changes:

- Reclassification of high-risk state guarantees as government debt and deficit in line with the ESA 95 methodology;
- Extension of the definition of general government sector (inclusion of the Viticulture Fund (Vinarsky fond), Railway Infrastructure Administration (Sprava zeleznicni dopravni cesty, s. o.), CKA subsidiaries, Ceska inkasni), in line with the recommendations of Eurostat.

Transformation of High-risk State Guarantees into Government Deficit and Debt in Line with the ESA 95 Manual on Government Debt and Deficit

First of all the financial situation of entities that received state guarantees in the past had to be analysed, in order to identify high-risk state guarantees, i.e. guarantees related to debtors unable to honour their obligations. **In accordance with the ESA 95 methodology, high-risk state guarantees were fully transformed into government deficit and debt by means of a capital transfer since 1994**. The guarantees were incorporated into the government sector in the year in which the guarantee was called for the first time, i.e. when the state had to pay instead of the debtor, whether the payment amounted to repayment of principal or merely payment of interest. **The capital transfer, the amount of which corresponds to the total volume of guarantee provided, increased the government deficit and debt in that year.** In 2004, those state guarantees expected to be called have also been newly classified as deficit and debt and expenditure related to these guarantees is already included in the approved state budget for 2004. In subsequent years, these expenditures will affect the level of government deficit and debt in the following way: principal repayments will represent (from the point of view of national accounts) only a financial operation that reduces the level of imputed debt, with the government deficit increased only by interest payments. The debt resulting from the reclassification of these transfers has not been covered by any debt instruments as yet.

Box 9.1 Classification of State Guarantees

State guarantees transformed into government debt can be subdivided into two groups, based on the purpose for which they were provided:

- *"standard guarantees"* – those guarantees related in particular to loans for the development of infrastructure. If the debtor does not fulfil his or her obligation, the state will have to take over the debt service, i.e., in abeyance with the conditions laid down in the contract, to settle the principal and – where applicable - also to pa the interest instead of the debtor.
- *"non-standard guarantees"* – guarantees related to other types of operations

The highest increase in the government debt and deficit occurred in 2003. This was due in particular to the reclassification of the following two non-standard guarantees concerning the banking sector:

- **Guarantees for CNB related to the IPB case**

On the basis of a government resolution, the Ministry of Finance provided CNB with a guarantee covering the losses from unrecorded liabilities of the former Investicni a postovni banka, a. s. (IPB) resulting from the Agreement on Indemnification of the Strategic Investor (CSOB a. s.) concluded by and between the CNB and CSOB a. s. Pursuant to the above-mentioned Agreement, the resulting state liability is limited both in terms of the maximum amount (CZK 160 bn) and in terms of duration (it expires in 2016). The final cost of this guarantee is to a great extent dependent on the results of arbitration. In 2003, the Ministry of Finance paid, in connection with the issued state guarantee and in compliance with the above-mentioned Agreement, an advance payment amounting to CZK 2 bn to CNB. For the year 2004 an amount of CZK 2.7 bn is budgeted for this purpose.

- **Guarantee to CSOB related to Slovenska inkasni, s. r. o. (SI)**

On the basis of a government resolution the Ministry of Finance of the Czech Republic, the Ministry of Finance of the Slovak Republic and Ceskoslovenska obchodni banka, a. s. (CSOB) concluded a framework agreement defining the basic principles of the 2nd stage of CSOB´s transformation. In line with this agreement, CSOB transferred, i.e. sold, a range of non-performing assets to so-called payment-collection units established by the Ministry of Finance of the Czech Republic and the Ministry of Finance of the Slovak Republic. Both these units were established for the purpose of enforcing and collecting irrecoverable claims. Both are refinanced by CSOB and CSOB´s resulting losses are to be covered by the state. Pursuant to the above-mentioned framework agreement, the Czech Ministry of Finance provides compensation for the losses of Ceska inkasni, s. r. o. Unlike its Czech counterpart, the Ministry of Finance of the Slovak Republic did not cover the losses of Slovenska Inkasni, s. r. o., which resulted in a claim of CSOB vis-à-vis this company. In 1997, CSOB initiated an arbitration against the Slovak Republic at the International Centre for the Settlement of Investment Disputes (ICSID) in Washington, which is still pending. In order to eliminate the danger of CSOB´s financial destabilisation, the Ministry of Finance of the Czech Republic concluded a “Stabilisation Agreement” with CSOB, stipulating that the Ministry of Finance of the Czech Republic undertakes to pay 90 % of the nominal value of outstanding claims by December 31, 2002. As the arbitration proceedings became long drawn out, the payment date for this claim totalling CZK 22 bn was - by way of an Amendment to the aforesaid Stabilisation Agreement - postponed till December 31, 2004, with the possibility of postponement by three more days, i.e. until January 3, 2005. In 2003, an amount of CZK 0.57 bn was paid on the basis of this guarantee.

Changes in the Definition of the General Government Sector (Inclusion of Additional Institutions)

- subsidiary companies of CKA (Konpo, Ceska financni, Prisko) – since 2002
- Ceska inkasni – since 2002
- Viticulture Fund - since 2002
- Railway Infrastructure Administration – since 2003

On the basis of a recommendation received from the Eurostat mission, the Czech Statistical Office has decided to include additional entities within the government sector. This applies to institutions whose management and functioning is not fully in line with the principles of market economics and is strongly linked with other parts of the government sector (more than 50 % of their activities are state-funded). At the same time these institutions manage some state property. **The government sector was extended to include the subsidiaries of the Czech Consolidation Agency (CKA) and Ceska inkasni[21], with retroactive effect as of 2002.** Their activities are similar to those of the CKA and consist in active administration and subsequent sale of non-performing assets transferred to them during the transformation process, mainly from commercial banks. **Furthermore, the Viticulture Fund was included within the government sector in 2002. It is responsible in particular for promoting**

[21] Before 2002 these institutions were included within the sector of financial institutions (S. 12)

further development of viticulture in the Czech Republic and its primary source of income is levies paid by wine producers.

In 2003, the state organisation of Czech Railways (Ceske drahy, s. o.) was (by a specific law) divided, creating two independent entities, Czech Railways (Ceske drahy, a. s.), a state-owned joint stock company, and the Railway Infrastructure Administration (Sprava zeleznicni dopravni cesty, s. o., SZDC), established as a state organization. The SZDC manages state property and provides for the operation and development of the railway infrastructure. Moreover, it manages the liabilities and receivables of the former Czech Railways (a state organisation), which were by law transferred to the SZDC. The expenditure of the SZDC is partly covered by revenues from the leasing of railway network routes to railway operators, with the remaining more than 50 % financed by loans and state subsidies. That's why the CSO included the SZDC within the government sector as of the day of its establishment, i.e. as of January 1, 2003.

The SZDC has assumed almost all the liabilities of the former Czech Railways, s. o., but the state guarantees these liabilities[22]. So far as guarantees are concerned, the debt portfolio of the SZDC can be divided into the following two groups:

- investment loans guaranteed by the state;
- non-guaranteed investment loans, which acquired a guarantee on the basis of the Act concerning the Joint Stock Company of Czech Railways and the SZDC, s. o.

This includes obligations resulting from loans taken out and used for the development of infrastructure, for which the state provided guarantees in previous years[23], as well as outstanding investment and operational loans that were not guaranteed by the state before 2003.

SZDC may take out loans that are guaranteed by the state on the basis of the above-mentioned law. For this purpose, the specification of the credit framework lies within the remit of the Ministry of Transport.

Compliance with Eurostat's requests resulted in the incorporation of the impact of all liabilities assumed in previous periods into the government debt and deficit. This practice has led to the creation of a more objective reference basis for the assessment of fiscal developments in the Czech Republic. The impact of these changes on government debt and deficit is quantified in the following tables.

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[22] *The cost of the building and modernization of railway network routes is guaranteed by the state only if a special act provides for such a guarantee.*

23 *State guarantees provided for these loans were transformed into government debt in line with ESA 95, i.e. the entire amount was reflected in government debt for the year in which the state guarantee was first called. These loans were excluded from the debt of the SZDC in order to avoid duplication. The other liabilities transferred to the SZDC from the former Czech Railways (state organisation) were officially incorporated into government debt as of the day of the SZDC's inclusion within the general government sector, i.e. as of January 1, 2003.*

Table 9.2: General Government Balance *(in bn CZK)*

	ESA code	Year 2000	Year 2001	Year 2002	Year 2003	Year 2004
1. State budget and State extrabudgetary funds		-28.5	-51.6	-111.9	-51.0	-81.5
2. Other central government bodies except 3, 4, 5, 6		-55.4	-58.9	-53.0	-39.1	-46.8
3. Czech Consolidation Agency (CKA)		x	-1.6	13.6	-31.5	-3.8
4. Subsidiaries of the CKA and Czech inkasni		x	x	12.9	-0.5	-0.4
5. Railway Transport Administration		x	x	x	-12.6	-2.7
6. Vine-culture Fund		x	x	0.0	0.0	0.0
7. State guarantees		-8.4	-19.9	-1.5	-184.7	-12.9
8. Central government (1 + 2 + 3 + 4 + 5 + 6 + 7)	S.1311	-92.3	-132.0	-139.9	-319.2	-148.2
9. Local government	S.1313	-8.2	-17.4	-10.7	-5.5	0.4
10. Social security funds	S.1314	3.8	-0.4	-4.0	-3.8	3.7
11. General government (8 + 9 + 10)	S.13	-96.7	-149.8	-154.6	-328.5	-144.1

Source: CSO, MoF CR

Table 9.3: Nominal Value of the General Government Gross Consolidated Debt *(in bn CZK)*

	ESA code	Year 2000	Year 2001	Year 2002	Year 2003	Year 2004
1. State budget and State extrabudgetary funds		285.0	341.5	395.5	488.0	606.9
2. Other central government bodies except 3, 4, 5, 6		14.3	0.3	0.6	0.8	1.0
3. Czech Consolidation Agency (CKA)		x	126.8	170.2	144.9	102.1
4. Subsidiaries of the CKA and Czech inkasni		x	x	6.9	5.1	4.7
5. Railway Transport Administration		x	x	x	1.3	0.3
6. Vine-culture Fund		x	x	0.1	0.1	0.0
7. State guarantees		60.0	77.8	75.7	253.4	251.3
8. Central government (1 + 2 + 3 + 4 + 5 + 6 + 7)	S.1311	359.2	546.5	649.0	893.6	966.3
9. Local government	S.1313	31.5	38.9	46.5	62.4	71.3
10. Social security funds	S.1314	0.4	0.2	0.2	0.2	0.1
11. General government (8 + 9 + 10)	S.13	391.1	585.5	695.6	956.2	1 037.8

Source: CSO, MoF CR

9.3 Tables

Table 9.4: Growth and Associated Factors

	ESA code	Year 2003	Year 2004 (1)	Year 2005 (1)	Year 2006 (2)	Year 2007 (2)
GDP growth at constant market prices (7 + 8 + 9) *in %*	**B1g**	2.9	2.8	3.1	3.3	3.5
GDP *level* at *current* market prices *in bn CZK*	**B1g**	2410	2563	2730	2911	3114
GDP deflator change *in %*		2.9	3.5	3.3	3.2	3.4
HICP change *in %*		-0.1	2.8	2.6	2.2	2.2
Employment growth *in %* (3)		-0.7	-0.8	-0.3	0.0	0.1
Labour productivity growth *in %* (4)		3.6	3.6	3.4	3.3	3.5
Sources of growth: percentage changes at constant prices						
1. Private consumption expenditure	**P3**	5.4	2.9	3.1	3.4	3.4
2. Government consumption expenditure	**P3**	0.0	-0.2	-0.2	-0.2	-0.1
3. Gross fixed capital formation	**P51**	3.7	4.8	4.7	4.3	4.5
4. Changes in inventories and net acquisition of valuables as a % of GDP	**P52+P53**	2.6	2.8	3.0	3.1	3.1
5. Exports of goods and services	**P6**	6.7	8.0	7.9	7.8	7.8
6. Imports of goods and services	**P7**	7.6	7.9	7.5	7.1	7.1
Contribution to GDP growth						
7. Final domestic demand		4.3	3.3	3.4	3.4	3.5
8. Change in inventories and net acquisition of valuables (= 4)	**P52+P53**	0.3	0.3	0.3	0.1	0.2
9. External balance of goods and services	**B11**	-1.6	-0.8	-0.5	-0.2	-0.2

(1) Forecasts
(2) Trend values or period averages.
(3) Occupied population, domestic concept, persons, national accounts definition.
(4) Growth of GDP at market prices per person employed at constant prices.

Source of tables 9.4-9.9: MoF CR

Table 9.5: General Government Budgetary Developments

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (1)	Year 2006 (2)	Year 2007 (2)
Net lending (B9) by sub-sectors						
1. General government	S13	-13.6	-5.6	-4.9	-4.0	-3.5
2. Central government	S1311	-13.2	-5.8	-4.7	-3.8	-3.2
3. State government	S1312					
4. Local government	S1313	-0.2	0.0	-0.2	-0.2	-0.2
5. Social security funds	S1314	-0.2	0.1	0.0	0.0	0.0
General government (S13)						
6. Total receipts	ESA	49.9	50.0	49.5	49.4	49.1
7. Total expenditures	ESA	63.6	55.6	54.4	53.4	52.6
8. Budget balance	B9	-13.6	-5.6	-4.9	-4.0	-3.5
9. Net interest payments		0.7	1.0	1.1	1.3	1.5
10. Primary balance		-12.9	-4.6	-3.9	-2.8	-2.0
Components of revenues						
11. Taxes	D2+D5	22.0	22.5	22.0	21.7	21.5
12. Social contributions	D61	16.0	16.0	16.1	16.2	16.2
13. Interest income	D41	0.6	0.3	0.2	0.2	0.2
14. Other		11.3	11.1	11.2	11.2	11.2
15. Total receipts	ESA	49.9	50.0	49.5	49.4	49.1
Components of expenditures						
16. Collective consumption	P32	10.8	10.6	10.4	10.1	9.8
17. Social transfers in kind	D63	10.7	10.5	10.4	10.2	10.0
18. Social transfers other than in kind	D62	13.3	13.1	12.7	12.5	12.2
19. Interest payments	D41	1.3	1.3	1.3	1.5	1.7
20. Subsidies	D3	2.5	2.7	2.4	2.3	2.3
21. Gross fixed capital formation	P51	3.8	4.0	4.1	4.2	4.2
22. Other		21.1	13.3	13.1	12.6	12.4
23. Total expenditures	ESA	63.6	55.6	54.4	53.4	52.6

(1) Forecasts
(2) Trend values or period averages

Table 9.6: General Government-Debt Developments

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (2)	Year 2006 (2)	Year 2007 (2)
Gross debt level		39.7	40.5	41.8	43.2	44.0
Change in gross debt		9.1	0.8	1.4	1.4	0.8
Contributions to change in gross debt						
Primary balance		12.3	4.3	3.6	2.5	1.8
Interest payments	D41	1.3	1.3	1.3	1.5	1.7
Nominal GDP growth	B1g	-1.7	-2.4	-2.5	-2.6	-2.8
Other factors influencing the debt ratio		-2.8	-2.4	-1.1	0.0	0.1
Of which: **Privatisation receipts**		-1.0	-1.0	0.0	0.0	0.0
p.m. **implicit interest rate on debt**		4.6	3.6	3.5	3.8	4.1

(1) Forecasts
(2) Trend values or period averages

Table 9.7: Cyclical Developments

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (2)	Year 2006 (2)	Year 2007 (2)
1. GDP growth at constant prices	**B1g**	2.9	2.8	3.1	3.3	3.5
2. Actual balance	**B9**	-13.6	-5.6	-4.9	-4.0	-3.5
3. Interest payments	**D41**	1.3	1.3	1.3	1.5	1.7
4. Potential GDP growth		2.6	2.7	3.0	3.1	3.1
5. Output gap		-0.4	-0.3	-0.3	0.0	0.4
6. Cyclical budgetary component		-0.1	-0.1	-0.1	0.0	0.1
7. Cyclically-adjusted balance (2 – 6)		-13.5	-5.5	-4.9	-4.0	-3.6
8. Cyclically-adjusted primary balance (7 – 3)		-12.2	-4.2	-3.5	-2.5	-1.9

(1) Forecasts
(2) Trend values or period averages

Table 9.8: Divergence from Previous Update

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (1)	Year 2006 (2)	Year 2007 (2)
	GDP growth					
previous update	**B1g**	2.4	2.8	3.2	3.6	-
latest update	**B1g**	2.9	2.8	3.1	3.3	3.5
Difference		0.5	0.0	-0.1	-0.3	-
	Actual budget balance					
previous update	**B9**	-7.6	-5.9	-4.8	-4.0	-
latest update	**B9**	-13.6	-5.6	-4.9	-4.0	-3.5
Difference		-6.0	0.3	-0.1	0.0	-
	Gross debt levels					
previous update		30.5	34.2	37.7	39.4	-
latest update		39.7	40.5	41.8	43.2	44.0
Difference		9.2	6.2	4.1	3.9	-

(1) Forecasts
(2) Trend values or period averages

Table 9.9: Long-term Sustainability of Public Finances

% of GDP	Year 2003	Year 2005	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050
Total expenditure	62.2	53.1	50.4	51.1	53.1	57.0	60.5
Old-age pensions	6.8	6.8	6.6	6.9	7.8	10.4	12.5
Other pensions	2.4	2.4	2.3	2.4	2.8	3.2	3.5
Education	4.5	4.3	3.8	3.6	3.6	3.6	3.8
Healthcare (including care for the elderly)	6.7	6.7	6.8	7.4	8.1	9.0	9.8
Interest payments	1.3	1.3	1.8	2.6	4.3	8.2	15.6
Total revenues	49.9	49.5	49.1	49.1	49.1	49.1	49.1
***of which:* from pensions contributions**	8.8	9.5	9.5	9.5	9.5	9.5	9.5
National pension fund assets (if any)							
	Assumption						
Labour productivity growth	4.3	2.9	3.4	2.8	2.5	1.8	1.8
Real GDP growth	2.9	3.1	3.9	2.3	1.7	0.6	1.1
Participation rate males (aged 20–64)	84.8	84.7	84.9	85.7	84.5	83.6	83.9
Participation rates females (aged 20–64)	67.6	67.6	68.1	71.5	72.3	73.9	77.2
Total participation rates (aged 20–64)	76.2	76.1	76.5	78.6	78.4	78.8	80.6
Unemployment rate	7.8	8.7	7.9	6.5	6.5	6.5	6.5

Table 9.10: Basic Assumptions

	Year 2003	Year 2004	Year 2005	Year 2006	Year 2007
Short-term interest rate *(CZ) (annual average)*	2.3				
Long-term interest rate *(CZ) (annual average)*	4.2	4.8	5.0	5.5	5.5
United States: short-term *(three-month money market)*	1.2	1.2	1.7	1.7	1.8
United States: long term *(10-year government bonds)*	4.0	4.2	4.6	4.6	4.8
USD/EUR exchange rate *(annual average)*	1.13	1.25	1.24	1.23	1.23
Nominal effective exchange rate *(euro area, %change)*	11.8	4.2	-0.2	-0.1	-0.1
Nominal effective exchange rate *(EU, % change)*	12.8	6.9	-1.1	-0.9	-0.9
Exchange rate CZK/EUR *(annual average)*	31.8	32.4	31.4	30.8	30.5
World GDP growth, excluding EU	4.4	5.1	4.7	5.0	4.8
United States, GDP growth	3.1	4.2	3.2	4.0	4.0
Japan, GDP growth	2.7	3.4	2.3	3.0	3.0
EU-15 GDP growth	0.8	2.0	2.4	2.8	2.6
Growth of relevant foreign markets					
World import volumes, excluding EU	7.3	9.7	8.5	8.1	7.5
World import prices *(goods, in USD)*	8.8	6.4	0.7	1.5	2.0
Oil prices *(Brent, USD/barrel)*	28.8	31.1	28.9	27.2	26.9
Non-oil commodity prices *(in USD, % change)*	6.6	15.6	-2.6	-0.5	1.0

Source: EC