Convergence Programme of the Czech Republic

(Updated version)

November 2005

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1 Introduction

In accordance with the Stability and Growth Pact set out in Council Regulation (EC) 1466/97, the Czech Republic hereby submits the Convergence Programme for the period of 2006 to 2008. This document has been compiled as a part of the multilateral surveillance procedure set out in Article 99 of the Treaty establishing the European Community and in line with the recommendations of the Integrated Guidelines for Growth and Jobs endorsed by the ECOFIN Council at the meeting of the European Council in Brussels in October 2005. Its strategy respects the decision of the ECOFIN Council of 5 July 2004 on the existence of an excessive deficit in the Czech Republic and the subsequent recommendation[1] with a view to bringing an end to the situation of an excessive government deficit.

From a formal point of view, the Convergence Programme follows the principles defined by the Economic and Financial Committee of the Council in its "*2001 Code of Conduct*" as amended in 2005. In respect to content, the programme is founded on the strategy of fiscal consolidation adopted by the Czech government for eliminating the excessive deficit. The multi-annual programme for the consolidation of public budgets specified in the first Convergence Programme in May 2004 – endorsed by the ECOFIN Council following its decision on the existence of an excessive deficit in the Czech Republic based on the acknowledgement of special circumstances – sets out the medium-term timeframe for eliminating the excessive deficit by 2008. The Czech government continues to follow this strategy of fiscal consolidation so that in 2008 the Maastricht Convergence Criteria can be met in a sustainable manner. The Convergence Programme is in line with the relevant strategic and budgetary documents of the government, such as the Strategy for Economic Growth for the period of 2006 to 2013 and the National Reform Programme, which was drafted in support of the re-launched Lisbon process.

The Convergence Programme is based on the draft of the 2006 state budget as submitted by the government to the Chamber of Deputies of the Parliament of the Czech Republic. It also takes into account the fiscal notification of 1 September 2005, which was submitted to Eurostat and the Directorate General for Economic and Financial Affairs of the European Commission, and the official statistical data of the Czech Statistical Office available in September 2005.

The Convergence Programme was discussed with the representatives of social partners and submitted to the Parliament of the Czech Republic. In February this year, the Czech Parliament was also informed about the Council's opinion on the Convergence Programme from November 2004 and about the Council's recommendation with a view to bringing an end to the situation of an excessive government deficit.

[1] *In accordance with Article 104(7) of the Treaty establishing the European Community*

2 Economic Policy

2.1 Objectives

The economic policy of the Czech government focuses on promoting growth, reducing unemployment and increasing the economy's competitive edge. During 2005, the government adopted two important strategic documents defining the economic policy objectives and priorities for the upcoming years: the Economic Growth Strategy for 2006 to 2013 and the National Reform Programme. In keeping with the re-launched objectives of the Lisbon strategy, which the government has fully endorsed, the reforms are geared to strengthening economic growth and creating jobs.

2.2 Priorities

Fiscal policy

The most important priority of the Czech Republic in the macroeconomic area is the consolidation of public finances. The ongoing process of public finance reform is focused on gradually reducing the Maastricht public deficit to GDP ratio so that a sustainable level of under 3% of GDP may be reached by 2008. During the next three years, the government has committed itself to adopting a strategic decision for stabilising the pension system and the system of healthcare financing.

Monetary policy

Monetary policy, based on the inflation targeting regime formulated in the Long-Term Monetary Strategy of the Czech National Bank (CNB), should help sustain low and stable inflation. For the period starting from January 2006, the inflation target is defined as 3% year-on-year CPI growth with a maximum deviation of one percentage point in either direction. Such an inflation target creates conditions for meeting the convergence criteria for inflation and consequently helps to maintain the desirable space for a positive inflation differential vis-à-vis EU countries.

The Czech Republic is preparing to join the Eurozone in 2010. In the period leading up to this date, it intends to remain in ERM II (Exchange Rate Mechanism II) for the required two-year period. Preparations for membership were already launched formally in 2003 upon adoption of the Czech Republic's Strategy for Eurozone Accession. On the basis of this document, an assessment is made every year on compliance with the Maastricht criteria and on whether the country is prepared for accession.

The recent results of these analyses show that the Czech economy is converging with the economic level of Eurozone countries and that the process of cyclical adjustment has accelerated as well. Interest rates are very close to Eurozone rates, and the exchange rate of the Czech koruna vis-à-vis the euro is relatively stable.

Thanks to close economic relations with the Eurozone, we expect this convergence to develop further. However, the level of economic alignment with the Eurozone is still not high enough for the Czech economy to reap clear benefits from adopting the single currency and common monetary policy.

Structural policies

The microeconomic part of the National Reform Programme is focused on strengthening and increasing the competitive advantages of the Czech economy during sustained use of resources. Thanks to the accelerated growth of macroeconomic labour productivity, this allows the gap to close between the Czech economy and the EU average. The most important reform measures are: creating an environment for stimulating science, research and innovation, including their commercial application; modernisation and development of transportation, information and communication networks; and a quality corporate environment facilitating market entry and promoting new businesses as well as measures relating to termination of business activities and an overall reduction in corporate bureaucracy.

Box 2.1: Improving the business environment

Starting in January 2005, the process of accelerated depreciation of movable property has been speeded up, and the tax support for corporate science and research expenditures has increased. In July 2005, the amount of time for registration in commercial registers has been reduced, which simplifies to a significant extent the process of establishing a company. As mentioned already in previous Convergence Programmes, corporate income taxes will be reduced to 24% starting in 2006.

By the end of 2006, a proposal will be filed for legislative changes leading to another reduction of at least 20% in administrative costs. The obligation to evaluate the impact on businesses relating to all draft acts prepared by the ministries and other state authorities will be introduced in 2007. A system of central registration sites for businesses (i.e. one-stop shops) will be implemented over time. These will assume the issues of entrepreneurs associated with starting up a business or with any eventual changes. Bankruptcy legislation, which has been the subject of justified criticism for many years, will also undergo comprehensive re-codification,. The new legislation will come into effect in 2007.

In research and development, the Czech Republic is significantly behind the EU average in the volume of invested resources as well as the protection of intellectual property rights, innovation and its practical application. Besides the gradual increase in public expenditures for research and development, new tax measures were introduced that should stimulate these private investments. Innovation and innovative infrastructure will be supported by programmes co-financed with EU funds.

Labour market policy

Another priority of economic policy is the labour market and, in particular, increasing market flexibility. By European standards, the Czech labour market is characterised by its somewhat average ability to absorb shocks, its low level of flexibility and low labour force mobility. These factors keep the structural rate of unemployment at a relatively high level.

The National Reform Programme focuses primarily on expanding contractual freedom, reducing statutory non-wage labour costs and increasing the territorial mobility of the labour force. As for labour market inclusion, attention is focused on persons at the start and end of their professional careers. Reforms in the area of education increase the quality of the labour force, increase educational opportunities and support the ability to adapt to demanding conditions on a changing labour market. The new Labour Code, adopted by the government and currently being deliberated in Parliament, should strengthen market flexibility.

Box 2.2: Improving labour market flexibility

As far as reducing labour costs is concerned, ceilings for social security premiums will be introduced and then gradually reduced between 2007 and 2009 (from five times the average wage in 2007 to three times the average wage in 2009). Effective from 2006, taxation for families with low and middle incomes should be reduced by changing the parameters of personal income taxes (reduction in the two lowest rate categories – from 15% to 12% and from 20% to 19%, valorisation of the first tax brackets by about 11%) and replacing the standard deductible entries with tax credits. In addition, measures have been taken to make social benefit payments to the unemployed more stringent, and a reform of the labour legislation is also in preparation. The system of requalification geared to reducing unemployment and strengthening professional mobility will be improved with the help of the European Social Fund, among others. A wider range of short-term and more practical forms of tertiary education contributes to increasing the number of persons attaining higher educational qualifications or university degrees in the Czech Republic. Adoption of the act on lifetime education, computer literacy and the development of an information society should play an important role as well.

3 Macroeconomic Scenario

The macroeconomic scenario was conceived as realistic and conservative and attempts to balance out the positive and negative risks of economic development. A comparison with the previous Convergence Programme is given in Section 5.

3.1 The World Economy and Technical Assumptions

The world economy[2]

The current state of the external environment of the Czech economy can be summarised as follows:

- Growth of developed economies in the first half of the 2005 against the previous year had declined. The dynamics of the global economy are driven by China and other Asian countries.

- Growth of the US economy remains solid despite a slight weakening to 3.6% in the first half of 2005. The ever-increasing current account deficit, which is still accompanied by a high budget deficit, is an exchange rate risk.

- Economic output growth of the EU-25 countries in the first half of 2005 slowed to 1.4%. Net export and investment contributed most to this growth, while household consumption was flat.

- The enlargement process has a positive effect on the EU economy as a whole. The new member states are growing at a faster pace than the EU-15. Important pro-growth factors include liberalised cross-border trading with the new member states, more opportunities for cooperation, increased mobility of the labour force in the enlarged EU and lower saturation of the internal market in the new countries.

- The prices of crude oil in US dollars in nominal terms reached the highest level in history. We expect a peak of over USD 60 per barrel during the first half of 2006. A very slow decline should occur during the following period. The high demand in developing Asian economies is behind this development.

For the upcoming period, 2006 to 2008, we anticipate a gradual increase in GDP dynamics in the EU. The positive impulses coming from EU enlargement should also contribute to this development. Nevertheless, starting up German economic growth will be an important precondition. Economic growth in the EU-25 countries should be in a range of 2% to 2.4% during this period. This should be further driven by net export and investment. Successful structural reforms on the labour market (especially in Germany) should stimulate household consumption growth.

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[2] *For technical reasons, it was not possible to use the "common assumptions on the external environment" in preparing the Convergence Programme according to the Code of Conduct. The Spring EC Forecast, published in April 2005, was already outdated and the assumptions of the Autumn Forecast were not yet known at the time of preparing the programme (September 2005). Therefore, the macroeconomic scenario was supplemented by a sensitivity analysis of certain macro-indicators based on the exogenous variables in Section 5.*

The assumptions of the scenario include the stability of world commodities and financial markets and overall political stability within a wider region, including the absence of unforeseen events with a global impact (e.g. international terrorism).

The most important exogenous assumptions on the external environment up to 2008 are summarised in the following table:

Table 3.1: Assumptions on the external environment

		Year 2004	Year 2005	Year 2006	Year 2007	Year 2008
USD/EUR exchange rate	*(annual average)*	1,24	1,26	1,24	1,24	1,24
EU-25 GDP	*(real GDP growth, y/y, in %)*	2,3	1,5	2,0	2,3	2,4
Germany GDP	*(real GDP growth, y/y, in %)*	1,6	1,0	1,4	1,7	2,0
Oil prices	*(Brent, USD/barrel)*	38,3	55,5	60,5	57,8	54,3

Source: Eurostat, IMF, calculations of the Ministry of Finance

The risks of the scenario include, in particular, another potential rise in oil prices. In the current phase of the cycle, such development would most likely affect the economic performance in Europe more than in other regions. A sensitivity analysis of the exogenous assumptions is presented in Section 5.

As for the impact on the Czech economy, the growing dynamics of GDP, and particularly foreign trade in the previous period, shows that the country has profited from joining the EU common market and from improvements in the institutional environment.

Technical assumptions

The assumptions on short-term interest rates were chosen to be consistent with meeting the CNB’s inflation target.

In the exchange rate area, the scenario is based on the assumption of a continued long-term trend towards real exchange rate appreciation, which continues with practically no interruption throughout the transition process alongside real convergence. From 1998 to 2004, the real exchange rate vis-à-vis the euro (deflated by the GDP deflator) appreciated on average by more than 4% per year. From 2005 to 2008, we expect average real appreciation of around 3% per year, which during low inflation, would tend to cause nominal appreciation of the CZK/EUR exchange rate.

Every year, the outlook for meeting the Czech Maastricht criteria and the alignment level of the Czech economy with Eurozone economies will be assessed. Should positive results be achieved, the Czech Republic could enter ERM II by the end of the monitored period.

3.2 Current Macroeconomic Development

Current macroeconomic developments[3] in the Czech Republic are encouraging.

For the sixth quarter in a row, year-on-year growth of the Czech economy has been in a range over 4%, and reached 5.1% in Q2 2005. From a perspective view, the structure of growth is

[3] *Based on the available data as of 15 September 2005*

favourable. It is driven in particular by an increase in net exports, which has been reflected in foreign trade's positive contribution to GDP growth since 2004.

Growth acceleration is structural as well as cyclical in nature. Thanks in particular to a robust increase in total factor productivity, the growth rate of potential GDP has accelerated systemically, and according to our calculations, reached 4.2% in Q2 2005. The negative output gap has closed as well.

Chart 3.1: Real GDP
y-o-y growth in %

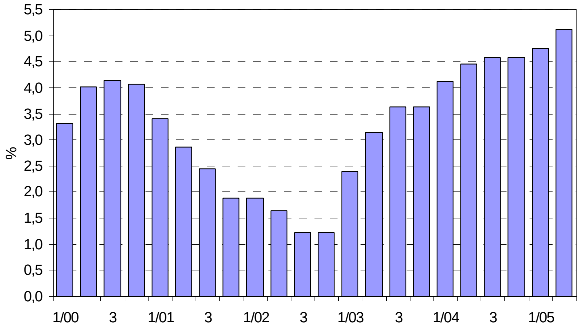
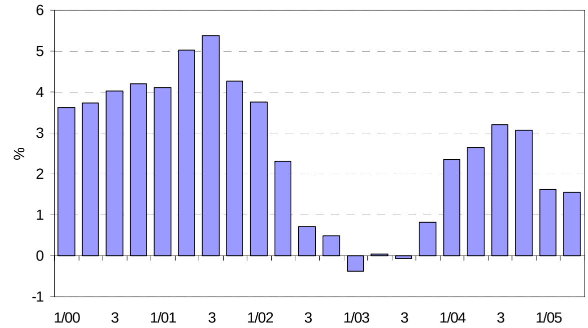


Chart 3.2: Average inflation rate
y-o-y growth in %



Source: Czech Statistical Office

The calm developments seen in consumer prices have continued. Since the beginning of 2005, year-on-year growth has been below 2%, showing 1.7% in August 2005 (HICP 1.4%). The effects of record raw material prices on world markets are partially offset by a strengthening exchange rate. An important role is also played by the high level of competition on the consumer market.

Positive effects have also been apparent on the labour market. After several years of decline, employment (according to a sample labour force survey) began to increase in Q4 2004. In Q2 2005, growth reached 1.1%, while the most significant increases occurred in construction, the manufacturing industry, education and healthcare. The dynamics of labour productivity growth remained around 4% per annum. The unemployment rate after seasonal adjustment reached a peak of 8.4% in Q1 2004 and has been slightly declining since this time. It remains to be seen to what degree cyclical development from the delayed effects of closing the negative output gap has played a role and to what extent it has been affected by improvements in the structural characteristics of the labour market and active employment policy measures.

Chart 3.3: Employment *(sample LFS)*
y-o-y growth in %

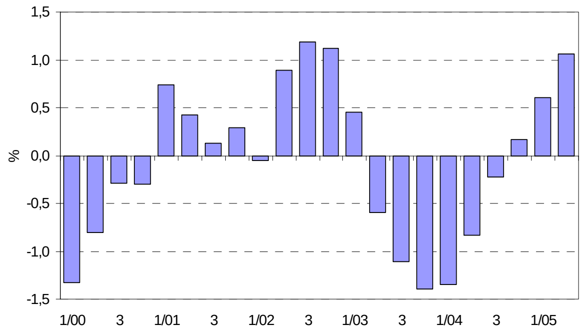
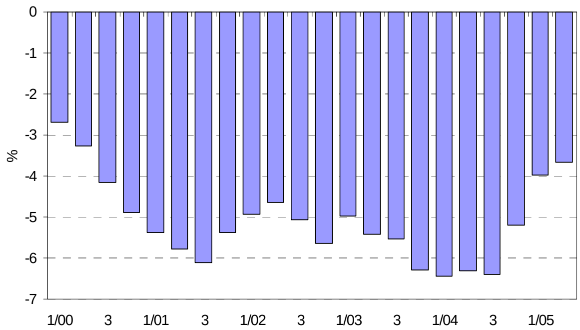


Chart 3.4: Current account/GDP
in %



Source: Czech Statistical Office, Czech National Bank

The external balance, expressed by the ratio of the current account balance to GDP on an annual aggregate scale, has been improving since Q3 2004. In Q2 2005, the current account deficit reached 3.7% of GDP. The main factor behind this development is the unprecedented improvement in the trade balance as a result of simplifying the procedures for foreign trade following EU accession and completion of certain important export-oriented investments. The trade balance, which was still showing a deficit of 2.7% vis-à-vis GDP at the end of 2003, registered a surplus of 1.0% of GDP in Q2 2005, in spite of high oil prices.

3.3 The Medium-Term Scenario

Potential GDP and the position within the economic cycle

According to our estimate based on the Cobb-Douglas production function[4], the growth rate of potential GDP significantly accelerates starting in 2000 (from 1.5% in 2000 to an estimated 4.3% in 2005). The main factor behind this is accelerated growth of the trend components of total factor productivity. In addition, the negative output gap had closed at the beginning of 2005.

Chart 3.5: Output gap

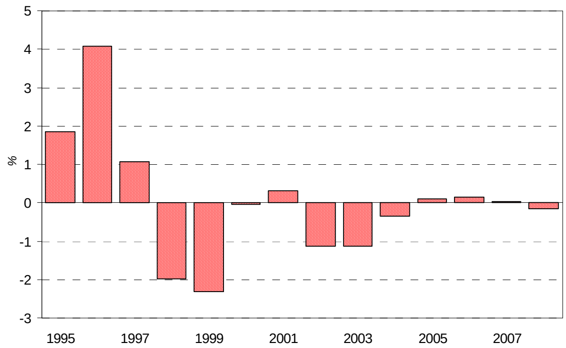
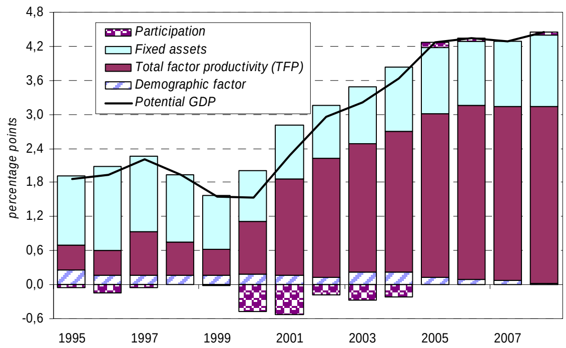


Chart 3.6: Potential GDP growth



Source: Calculations of the Ministry of Finance

In accordance with the precautionary principle, we do not believe that it is possible to maintain such acceleration of potential GDP growth during the monitored period. Therefore, the programme's scenario is based on the assumption that the rate of potential growth will slightly increase and reach 4.5% in 2008 due to higher total factor productivity. Productivity growth should in particular be generated from an improvement in the institutional parameters of the economy and the quality of the business environment as well as from introducing new technology associated with an inflow of foreign direct investment.

The contributions of fixed assets inventories and the labour force have remained stable. The declining benefit of demographic development will be offset by a rising participation rate, supported by the proposed reduction in direct taxes for the low- and medium-income groups.

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[4] *Calculations of potential GDP and the output gap are currently made using the national methodology described in the 2002 Pre-Accession Economic Programme. The main distinction from the European Commission's method, important for interpreting the results, is the use of the clause "zero sum of output gaps over time".*

The growth trajectory of potential GDP implies that the real convergence process will continue towards the economic level of EU countries.

Implementation of the public finance reform and structural policy measures could help to accelerate the growth rate of potential GDP above the projected dynamics. However, there is also a perceptible risk of development in the opposite direction relating to possible long-term complications on the commodities markets or on the markets of our trade partners.

We assume that macroeconomic policies and the functioning of automatic fiscal stabilisers will be so flexible in upcoming years that the economic cycle's high volatility from the 1990s will not be repeated and that the economy will generally be in the range of its potential. With the projected GDP growth rates, a substantial positive output gap should not develop.

GDP and the demand side

Real GDP growth will be in a range of 4.5% in the period up to 2008 with a gradual recovery of domestic demand and a positive, though declining, contribution from the foreign trade balance.

Table 3.2: Economic growth *(CZK billion, increase in %)*

	ESA Code	Year 2004	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008
		level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	2669	4,4	4,8	4,4	4,2	4,3
2. Nominal GDP	B1*g	2750	7,6	5,7	6,7	7,0	7,4
Components of real GDP							
3. Private consumtion expenditure	P3	1343	2,1	2,3	3,5	3,6	3,6
4. Government consumtion expenditure	P3	592	-2,0	-0,6	-0,2	-0,5	-0,5
5. Grossed fixed capital formation	P51	737	7,6	2,8	3,4	4,8	7,5
6. Change in inventories and net acquisition of valuables (% GDP)	P52+P53	9	0,3	-0,4	0,3	0,6	0,7
7. Exports of goods and services	P6	1938	21,9	9,5	10,2	9,8	10,0
8. Import of goods and services	P7	1950	18,4	3,9	8,8	8,9	9,8
Contributions to real GDP growth %							
9. Final domestic demand			2,6	1,8	2,6	2,9	3,6
10. Changes in inventories and net acquisition of valuable	P52+P53		0,1	-1,0	0,6	0,3	0,2
11. External balance of goods and services	B11		1,7	4,0	1,2	1,0	0,6

Source: Czech Statistical Office - quarterly national accounts, calculations of the Ministry of Finance

High oil prices, in particular, and only a slow increase in the most important export markets will have an adverse effect on economic growth. In the upcoming period, the temporary effects associated with the Czech Republic's EU accession will also die out. However, the country's membership in the EU will continue to be a pro-growth factor. We expect the process of economic convergence with the neighbouring advanced EU countries to continue. The Czech Republic's economic level (GDP per capita in purchasing power parity) in comparison with the EU-25 will increase by about seven percentage points against 2004 to ca 77% in 2008 according to this scenario.

Chart 3.7: Decomposition of GDP growth

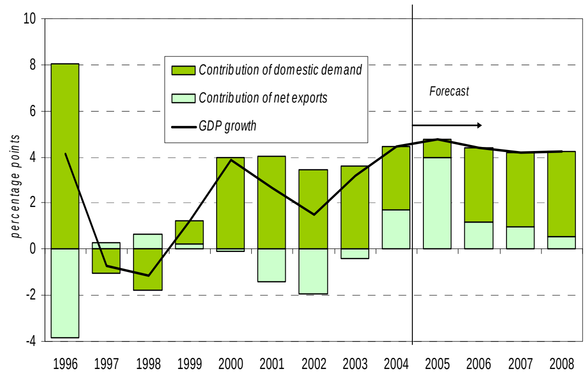
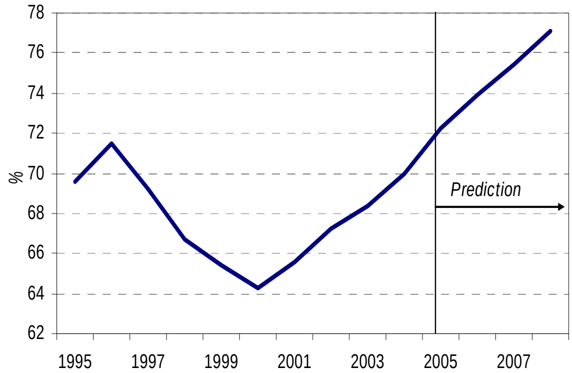


Chart 3.8: GDP in parity per capita
(EU-25 = 100)



Source: Czech Statistical Office, Eurostat, calculations of the Ministry of Finance

Following strong dynamics in 2003 of 4.6%, household consumption growth (including non-profit organisations) slowed significantly in 2004 and 2005 to 2%. Low interest rates support the propensity of households to invest in personal housing needs, which in turn draws on a part of their disposable income. Year-on-year growth in the stock of mortgages of more than one third increases the long-term debt burden of households and reduces the growth rate of expenditures on final consumption. During the upcoming years, household consumption expenditures should increase slightly less than GDP. Slower growth of unit labour costs against growth in the GDP deflator should allow for a rise in economic output in an environment characterised by low domestic inflation pressures and higher profitability in the corporate sphere.

Government consumption in 2004 and 2005 has declined and should be flat or even slightly decrease in the future. The public finance reform will prompt government institutions to behave economically from the standpoint of employment in the government sector as well as in purchasing goods and services.

The peak of investment activity was reached in 2004. Following a certain slowdown in 2005 and 2006, the dynamics should be renewed and exceed the rate of GDP growth primarily due to the continued inflow of foreign direct investment, which reflects the Czech economy's high attractiveness for foreign investors. Foreign owners in the Czech Republic are expected to reinvest a significant part of their profits, and the new capacity will primarily be export oriented. In addition, an increase in the investment activity of domestic companies can be expected. One risk for the rapid recovery of high investment dynamics is any deterioration of the financial situation in the corporate sphere influenced by the high costs of energy input.

In 2007 and especially in 2008, the contributions from structural funds and the Cohesion Fund should significantly increase as a part of the new Financial Perspective. Together with co-financing from public budgets, they will be mainly channelled into infrastructure improvements. In association with this, however, we expect these investments to partially replace projects that would otherwise be financed only by domestic resources.

The contribution of the trade balance for goods and services in constant prices to GDP growth has attained positive figures since 2004. In 2005, it should reach around 4.0 percentage points, which is not only a record figure for the Czech Republic, but also remarkable by international standards. This positive contribution is anticipated to persist up to 2008. The actual extent will depend on meeting the assumptions for the external environment, the launch of new technological complexes and on domestic demand developments.

Prices

The Czech economy has been characterised by low inflation since the end of the 1990s. The inflation targeting regime has had a positive influence on this development and helps to guide the inflation expectations of economic agents.

Since the beginning of 2005, year-on-year consumer price growth has been below 2%. We do not expect any acceleration in inflation until the second half of the year, when in particular the higher prices of petroleum and diesel fuel, an additional adjustment in excise taxes on tobacco products and an increase in regulated natural gas prices should temporarily increase inflation.

Table 3.3: Prices of goods and services

	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008
Percentage changes					
HICP	2,6	1,5	2,2	2,0	2,1
National CPI	2,8	1,9	2,5	2,3	2,5
GDP deflator	3,0	0,9	2,2	2,8	3,0
Consumption of households deflator	2,7	1,5	2,4	2,3	2,9

Source: Czech Statistical Office – price statistics and quarterly national accounts, calculations of the Ministry of Finance

The average inflation rate is estimated to be around 1.9% for 2005. From 2006 to 2008, price growth should be around 2.5%, therefore, undershooting the CNB's inflation target within the range of tolerated deviations.

Chart 3.9: Consumer prices

y-o-y growth in %

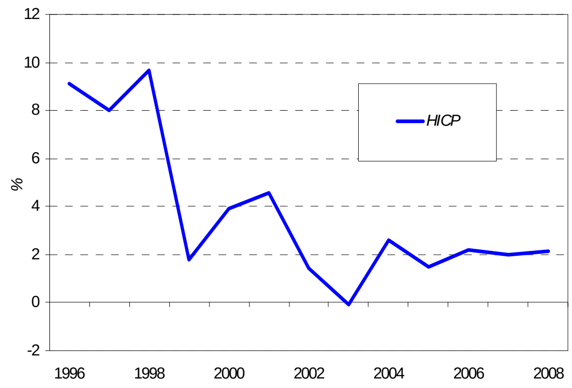
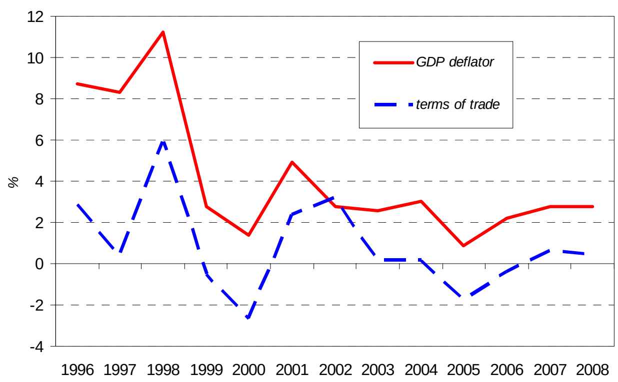


Chart 3.10: GDP deflator and terms of trade

y-o-y growth in %



Source: Czech Statistical Office- price statistics and quarterly national accounts, calculations of the Ministry of Finance

This prediction is based on the above-mentioned exogenous assumptions and continuous non-inflation growth of total unit labour costs. In 2008, inflation should also be affected by the expiration of escape clauses anticipated for excise taxes on cigarettes and VAT. The VAT rate for residential construction still remains open.

The implicit GDP deflator increased in 2004 according to the revised data by 3.0%. From Q3 2004, however, there is a year-on-year decline in terms of trade due to a rise in the prices of imported raw materials, which slows down the growth of the GDP deflator. The estimate for 2005 is around 0.9%, which also shows up in slower nominal GDP dynamics against the 2004 growth rate. In subsequent years, GDP deflator growth should slightly exceed the average inflation rate for consumer prices under the assumption of a decline in Czech koruna oil prices. Terms of trade will then improve thanks to an increase in export prices.

The labour market and wages

On the labour market, the continuous decline in the employment rate came to a halt at the beginning of 2005, and in fact, a slow increase in this indicator can be observed. Similar development has also been seen for the participation rate. A change in the trend for the unemployment rate has also been registered, now showing a slow reduction.

Unemployment, in particular, is of a structural nature, which shows up in an increase in long-term components and regional differences. This has a negative impact on social solidarity as well as on the performance of public budgets.

Table 3.4: Employment and wages

	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008
	Percentage changes				
Employment (LFS)	-0,6	0,9	0,8	0,5	0,4
Compensation of employees	6,5	5,2	5,3	6,0	6,5
Average real gross wage 1)	2,2	1,6	1,9	3,2	3,8
Unit labour costs 2)	0,9	0,4	0,9	1,8	2,1
	Per cent				
Unemployment rate ILO	8,3	7,9	7,4	7,1	6,9
Employment rate 3)	64,9	65,4	65,8	66,0	66,2
Participation rate 4)	70,8	70,9	71,0	71,0	71,1

1) Wage bill per one employee (according to the sample labour force survey) deflated by the CPI
2) Nominal compensation of employees per unit of real GDP
3) Share of total employment in the population 15 to 64 years old
4) Share of the labour force in the population aged 15 to 64 years old

Source: Czech Statistical Office – employment statistics and quarterly national accounts, calculations of the Ministry of Finance

Several reform measures are now being prepared that respond in part to the specified problems. (see Box 2.2).

The demand side of the labour market will still be affected by high economic growth. This has already caused a turn in the employment trend and should generate more jobs in the future through the development of small and medium-size enterprises. Although the number of new jobs created by foreign direct investment inflow is not high enough to cause substantial changes on the labour market, it is important to stress its positive impact in the form of indirect effects associated with engaging domestic firms as sub-suppliers.

The restructuring process will continue to adversely affect the labour market, which puts pressure on increasing labour productivity and is related to terminating ineffective operations. Redundant or laid-off employees on the labour market are then faced with requalification requirements, which create problems of a regional nature as well as in the area of long-term unemployment.

Assuming that relevant structural policy measures are successfully implemented and existing GDP growth still exceeds 4%, a slow increase in employment can be expected[5] connected with a decline in the unemployment rate, which could reach 7% in 2008. Should implementation of these needed reforms be delayed, it could have a negative impact on economic growth due to a lack of flexibility on the labour market.

Chart 3.11: Employment and participation rate

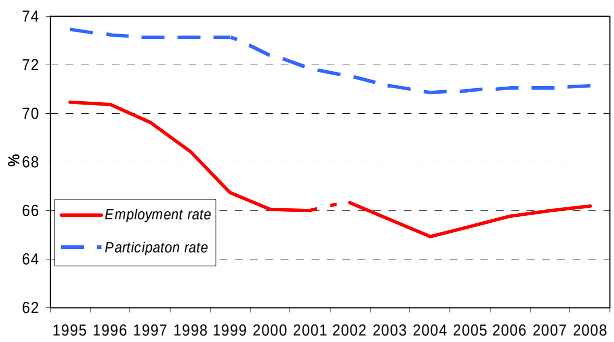
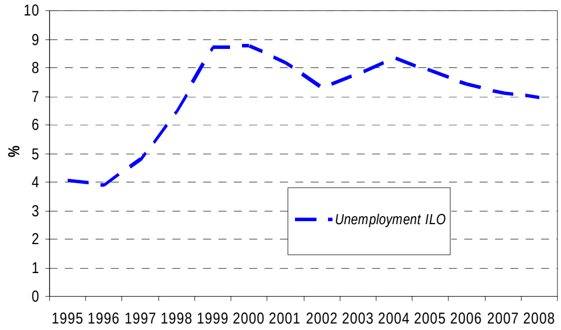


Chart 3.12: Unemployment rate



Note: The employment and unemployment rate from the sample labour force survey is not comparable between 2001 and 2002 due to a change in methodology.

Source: Czech Statistical Office – employment statistics, calculations of the Ministry of Finance

The current wage level copies labour productivity growth and hence does not interfere with the Czech economy's macroeconomic stability. As for wage developments, we anticipate a slow acceleration in average wage growth from 5% to 7%. The growth rate of total unit labour costs should increase from 0.4% in 2005 to 2.1% in 2008, which should not generate wage inflation pressures. During the monitored period, we do not expect any significant changes in the number of working hours per employee. Labour productivity growth should be in a range of 3.6% to 3.9% per annum.

3.4 Foreign relations and sectoral balances[6]

The negative balance of net lending reached its highest level in 2003, i.e. 6.2% of GDP. In 2004, this was reduced to 5.2% of GDP thanks in particular to an improved balance of services.

[5] *The National Reform Programme is, in this aspect, more ambitious and sets a target of 66.4%.*

[6] *In accordance with the rules of the "Code of Conduct", this section is prepared using the methodology of national accounts. On the basis of the relationship between investments and savings, this allows a surplus or deficit in foreign relations to be decomposed into individual economic sectors. This differs from the analogical, ordinarily employed methodology of the balance of payment's current account in the categorisation of some transactions and in the fact that it contains additional items (capital transfers, acquisition of unmanufactured, non-financial assets).*

After reaching its peak in Q2 2001, the goods deficit steadily declined. Following the Czech Republic's EU accession in May 2004, this trend sharply accelerated. In April 2005, the trade balance registered a surplus, despite high and ever-increasing mineral fuel prices. Increasing export performance during slow economic growth in Eurozone countries, especially in Germany where a decisive part of exports end up, demonstrates an improvement in the competitiveness of domestic products. New capacities with a large export potential have had a substantial impact, mainly in the automobile industry, information and communication technology and the substitution of imported intermediate products with domestic products.

Table 3.5: Net lending/borrowing

	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008
	% of GDP				
Balance of goods	-0,8	1,7	2,4	3,6	4,2
- mineral fuels (SITC 3)	-2,6	-3,6	-4,1	-3,5	-3,0
- other goods	1,8	5,3	6,5	7,2	7,2
Balance of services	0,5	0,5	0,4	0,4	0,5
Balance of goods and services	-0,3	2,1	2,8	4,1	4,7
Balance of primary income	-4,9	-5,6	-5,8	-6,0	-6,1
Balance of transfers	0,1	0,8	0,7	0,8	1,0
Balance of primary income and transfers	-4,8	-4,8	-5,2	-5,2	-5,0
Capital transfers	0,2	0,2	0,4	0,7	1,3
Net acquisition of non-produced assets	-0,1	-0,2	-0,2	-0,2	-0,2
Net lending/borrowing vis-a-vis ROW (B.9)	-5,2	-2,6	-2,2	-0,6	0,8
Net lending/borrowing of the private sector	-2,2	2,2	1,6	2,7	3,5
- households	0,5	0,1	-0,2	-0,5	-0,5
- financial and non-financial institutions	-2,7	2,0	1,8	3,2	4,0
Net lending/borrowing of general government	-3,0	-4,8	-3,8	-3,3	-2,7

1) e.g. payments for licences, patents and trademarks

Source: Czech Statistical Office - annual national accounts, calculations of the Ministry of Finance

The tendency towards further improvements in the balance of services will be driven by a surplus in the balance's non-fuel component, which should reach 7% of GDP in 2007. A stable low-inflation environment and wage developments corresponding to the equilibrium appreciation of the real exchange rate will be key for the competitive capabilities of Czech export.

For the balance of services, we anticipate a stable surplus in the share of GDP with continued improvements in the balance for transport and tourism and a decline in "other services".

The most significant negative component in net lending/borrowing is and will continue to be the worsening balance of primary incomes, which reflects, in particular, the increasing flow of foreign investors' repatriated and reinvested profits.

The balance of current and capital transfers, especially in 2007 and 2008, will be affected positively by the balance of financial flows from the EU as a part of the contributions from the structural funds, the Solidarity Fund and for supporting agriculture and regional development.

As a result, we expect the net lending deficit to gradually decline, so that in 2008 the Czech Republic could register a surplus for the first time in history.

As for the specific sector contributions to net lending/borrowing in the economy, the government's position should improve due to the measures described in the following sections. The position of households should show a deficit due to an increase in housing investment, which will be higher than generated savings. The main improvements could be expected in the sector of financial and non-financial institutions.

3.5 The Growth Implications of Structural Reforms

The programme itself contains the assessed effects of the approved reform measures in accordance with the National Reform Programme or the estimated effects of measures that will most likely be approved (e.g. proposal for the new EU Financial Perspective from 2007 to 2013).

The basic structural reforms, as defined in the "Code of Conduct" (especially pension reform and healthcare reform), are currently in the deliberation and discussion phase, so their content, form and timing are not yet known. Therefore, it is not possible to quantify the macroeconomic impact and include it in the programme.

4 General Government Finances – Deficit and Debt

4.1 The Strategy of the Government's Budget Policy

The Czech Republic continues to register excessive budgetary deficits, which are an obstacle on the way to fulfilling the Maastricht criteria. In its new programme declaration, the new government, formed in May 2005, asserted its strategy for reducing the budget deficits and its conscientious compliance with the Convergence Programme.

The public finance reform approved in 2003 and implemented in 2004 contained a set of measures geared to strengthening the income side and to achieving expenditure savings. In accordance with the adopted Conception of Public Finance Reform, the government continues to reduce the public finance deficit so that the consolidated public finance deficit does not exceed 3% of GDP in 2008.

Binding medium-term expenditure frameworks will continue to be an important pillar of the budget policy . These set the maximum volume of expenditures of the central government for a three-year period that corresponds to the established fiscal target. The expenditure frameworks can also help to identify the volume of savings needed to secure the target or to assess the government's success in reducing expenditures.

4.2 The Medium-Term Objective of Budgetary Policy

The Czech Republic will eliminate the excessive public budget deficit within the timeframe of the Convergence Programme. In 2008, the public budget deficit should fall safely below 3% of GDP. This step is the highest priority of all in the area of budgetary policy and government policy. The programme assumes a gradual reduction in the general government deficit to 3.8% of GDP in 2006, 3.3% in 2007 and 2.7% in 2008.

A tool for implementing the fiscal targets should be compliance with the binding expenditure frameworks. Successful compliance with these frameworks will promote expenditure-oriented fiscal consolidation. It will not be in conflict with the built-in stabilisers and will increase the transparency and credibility of the budget process.

Table 4.1: Deficit by sub-sectors

% of GDP	ESA code	Year 2004	Year 2005 (1)	Year 2006 (2)	Year 2007 (2)	Year 2008 (2)
Net lending (B9) by sub-sectors						
General government	S.13	-3,0	-4,8	-3,8	-3,3	-2,7
Central government	S.1311	-3,0	-4,9	-3,5	-3,0	-2,4
Local government	S.1313	-0,1	-0,1	-0,3	-0,3	-0,3
Social security funds	S.1314	0,0	0,1	0,0	0,0	0,0

(1) Estimate
(2) Trend values or period averages
Source: Ministry of Finance

Eliminating the excessive deficit is only the first step towards a medium-term objective consistent with the fiscal regulations of the European Union. The fiscal regulations of the Stability and Growth Pact promote the medium- and long-term focus for public budgets. The Czech Republic will make every effort to quickly reach such a medium-term public finance position. In reaching this goal, the 3% criterion of the Stability and Growth Pact will not be at risk during the cycle from the standard fluctuations of output around its potential level. Year-on-year cuts of 0.5 percentage points in the public budget deficit are seen to be an adequate and reasonable trajectory for reaching the medium-term target.

In accordance with the revised Stability and Growth Pact, the Czech Republic can be categorised as a country with a medium-term public budget deficit target of around 1% of GDP – in view of its above-average economic growth and relatively low level of public debt. The Czech Republic could attain this operative target by 2012. However, budgetary development over the long term will depend on the need to prepare for the process of an ageing population. The trajectory for the medium-term targets could only be disrupted by substantial structural reforms with direct budgetary costs, as could be the case for the pension system reform.

4.3 General Government Finances from 2004 to 2006

2004

Last year's Convergence Programme anticipated a deficit of 5.2% of GDP in 2004, however, according to the latest estimates, the general government deficit was only 3.0% of GDP (CZK 83.5 billion). This development was supported by the legislative change in budgetary rules that allowed for the first time to carry over an unlimited amount for the under-executed budgetary allocations of government organisational units by transferring corresponding funds to their own reserves. This amounted to CZK 29 billion (ca 1.1% of GDP) and the reserves saved could be used for strengthening expenditures in upcoming years. These unexpected and sizeable carry-overs made it difficult to estimate the general government deficit. They had also created the potential for increasing the expenditures and deficit in 2005 above the government's budgetary plans.

The total tax revenues of the consolidated public budgets in 2004 exceeded the budgeted tax revenues by CZK 11.7 billion (0.4% of GDP). Higher tax revenues in combination with overall lower expenditures (as a result of under-executed budgetary allocations from the state budget headings) and reclassification of state guarantee[7] in favour of the CNB from 2004 to1997 accountancy amounting to CZK 22.5 billion (0.8% of GDP) contributed to reducing the deficit from the planned 5.2% of GDP to 3.0% of GDP. Thanks to these extraordinary factors, general government finances finished in a substantially better position than in the original budgetary plans.

2005

The previous Convergence Programme anticipated a deficit of 4.7% of GDP for 2005. The estimate of the deficit was changed to 5.0% of GDP in the March notifications. In the autumn notifications, the Ministry of Finance then estimated a deficit of CZK 140.5 billion (4.8% of

[7] *A Eurostat decision under the notification of the government debt and deficit dated March 2005*

GDP). After adjusting the September government deficit estimate for extraordinary operations (see Box 4.1), which were included in last year's programme, the government deficit would be 1.1 percentage points lower, i.e. 3.7% of GDP. Economic growth accompanied by an increase in tax revenues and slower execution of budgetary expenditures has a positive effect on the budget deficit, which creates space for better deficit outcome than originally targeted..

Box 4.1: Extraordinary public budget operations in 2005[8]

- Recording unrecoverable receivables in Syria amounting to CZK 18.7 billion (0.6% of GDP)
- Supplying military technology for the army as a form of payment on the Russian debt increased the general government deficit by CZK 3.3 billion (0.1% of GDP).
- A change in the accounting for recording the lease of Grippen aircraft, when, after the March government deficit and debt notifications, it was definitely decided to fully record this operation in 2005. As a result, the deficit had increased by CZK 9.6 billion (0.3% of GDP).

Favourable tax performance is influenced in particular by corporate income taxes and excise tax revenues (increasing the excise tax rates on tobacco and improving the administration of excise taxes). Higher-than-budgeted corporate income tax revenues are the result of accelerated economic growth and positive developments for the profits of large corporations. A rise in excise tax revenues is connected with an increase in the transport of goods across the Czech Republic. The anticipated rise in tax collections against planned revenues amounts to approximately CZK 25.5 billion (0.9% of GDP). The estimate of the 2005 tax revenues was complicated by the comprehensive changes in the structure of taxation, the impact of which can be difficult to quantify with adequate precision.

The rise in tax revenues cannot be explained by the economy's cyclical development. During the past two years, tax revenues have structurally increased, and there are two reasons for this. The first reason relates to the fact that the estimate of potential GDP growth was significantly increased. The second reason involves the change in the structure of taxes relating to the range of measures adopted in the public finance reform (see Convergence Programme, November 2004) that increased the overall level of tax revenues above the budgetary plan.

In connection with the 2004 carry-overs, there was a risk on the expenditure side that the expenditure plan for 2005 would be exceeded. The budget headings carried over CZK 24.9 billion to 2005 that could be used for additional expenses. However, the fiscal performance of the state budget shows that the budget headings will not increase their expenditures above the approved 2005 budget. The creation of reserve funds in an expected amount of CZK 20.3 billion will then correspond approximately to the carry-overs from 2004, and the impact on the balance in 2005 will be almost neutral (CZK 4.6 billion, i.e. 0.15% of GDP).

The execution of state budget expenditures for the first three quarters of this year reached about 68.5%of the full year budget, which corresponds more or less to the level drawn down last year. A lower volume of drawn resources is registered, in particular, by debt service. Mixed developments were recorded in the area of social benefits. On the one hand, a lower volume of benefits was executed for government social support benefits and other social

[8] *See the conclusions of Eurostat's EDP mission, August 2005.*

benefits. The savings in this area, however, are offset by higher than budget expenditures for pensions, sickness benefits and social welfare benefits.

2006

The planned public budget deficit for 2006 is 3.8% of GDP. This estimate is based on the continued dynamic growth of the Czech economy. The very favourable structural development of tax revenues supports the consolidation of public budgets and helps to reduce the general government deficit.

In 2006 as well, the Ministry of Finance anticipates a continuation of favourable tax revenue development. The effect of the higher tax base from 2005 will show up, and the autonomous development of taxes will substantially exceed the volume of taxes predicted last year during preparation of the medium-term fiscal framework. In view of the prepared legislative changes for personal income tax (a rate reduction, extending the tax brackets and replacing the deductible entries with tax credits), a reduction in direct taxes can be expected. The compound tax quota should, therefore, decrease after reflecting the active measures.

The structural increase in tax revenues helped to meet the fiscal targets. This development weakened the need of substantial expenditure savings in an election year. The Czech Republic will be capable of fulfilling the objective of the Convergence Programme despite the fact that certain expenditure savings were not implemented. It was not politically feasible to implement all of the expenditure measures proposed by the Ministry of Finance in the previous programme (reducing expenditures for social welfare benefits and state social support, freezing the wages of court officials, judges and members of parliament, and an overall restriction of budget heading expenditures).[9]

Exceeding the expenditure framework of the central government is expected in the draft state budget for 2006 against the expenditure framework approved by the resolution of the Chamber of Deputies. The expenditure framework of the central government was increased by CZK 24.3 billion (0.8% of GDP). However, thanks to higher expected tax collection, the general government deficit that the Czech Republic committed itself to will not be exceeded.

This increase allowed the government to achieve higher valorisation of pensions above the framework considered in the conception of public finance reform. In the area of state social support, an increase in benefits is expected in relation to the planned increase in the minimum subsistence level. The government also plans to increase social benefits paid out to families with children in response to a recovery in the Czech Republic’s birth rate. These measures will lead to an increase in the share of mandatory social expenditures. More resources are also expected for active employment policy, employing disabled persons and environmental protection.

In 2006, downscaling of the number of employees in the central government will continue. Out of approximately 29,000 positions to be eliminated between 2004 and 2006, 13.2% of this total amount will occur during 2006. The number of positions will decline by 3,900 positions

[9] *Convergence Programme of the Czech Republic, autumn 2004, p. 42, table 6.2 – Additional Savings Measures Suggested by the Ministry of Finance*

against 2005 (i.e. by 0.83%).[10] With respect to the overall plan for downscaling the number of positions, a reduction of 16,600 will occur, i.e. about 56% of the planned change.

Table 4.2: General government deficit and debt, by sub-sector

% of GDP	ESA code	Year 2001	Year 2002	Year 2003	Year 2004 (1)	Year 2005 (1)	Year 2006 (2)
Net lending (EDP B9) by sub-sectors							
General government	S.13	-5,9	-6,8	-12,0	-3,0	-4,8	-3,8
Central government	S.1311	-5,6	-6,3	-11,6	-3,0	-4,9	-3,5
Local government	S.1313	-0,3	-0,2	-0,3	-0,1	-0,1	-0,3
Social security funds	S.1314	0,0	-0,2	-0,1	0,0	0,1	0,0

(1) Notification (September 2005)
(2) Trend values or period averages

Source: Czech Ministry of Finance

4.4 The Cyclically Adjusted Budget Balance and Fiscal Stance

During the timeframe of the Convergence Programme, the Czech economy will be close to its potential. The output gap will be slightly positive in 2005 and 2006. A decline in actual GDP below the potential is already assumed in 2008 as a result of acceleration of the potential GDP growth rate. According to expectations, potential growth will be driven by total factor productivity.

The cyclical component of public budgets is very low due to the low absolute value of the output gap from 2005 to 2008. The level of fiscal restriction can be explained the best by a change in the cyclically adjusted primary balance that isolates the effect of an expected rise in interest payments. The decline in the cyclically adjusted primary balance will be on average 0.8 of a percentage point per annum between 2005 and 2008, which can be seen as an adequate tempo that does not conflict with the government's efforts to sustain robust economic growth.

[10] *After offsetting the transfer of the regional school councils. These were transferred during 2005 and incorporated once again into the central government in 2006.*

Table 4.3: Cyclically adjusted balance [(a)]

% of GDP	ESA code	Year 2004	Year 2005 (1)	Year 2006 (2)	Year 2007 (2)	Year 2008 (2)
1. Real GDP growth (%)		4,4	4,8	4,4	4,2	4,3
2. Net lending of general government	**EDP B.9**	-3,0	-4,8	-3,8	-3,3	-2,7
3. Interest expenditure (incl. FISIM)	**EDP D.41**	1,3	1,3	1,3	1,3	1,4
4. Potential GDP growth (%)		3,6	4,3	4,3	4,3	4,5
contributions:						
- labour		0,0	0,2	0,1	0,1	0,1
- capital		1,1	1,2	1,1	1,1	1,2
- total factor productivity		2,5	2,9	3,1	3,1	3,1
5. Output gap		-0,4	0,1	0,1	0,0	-0,2
6. Cyclical budgetary component		-0,1	0,0	0,0	0,0	0,0
7. Cyclically-adjusted balance (2 – 6)		-3,0	-4,8	-3,8	-3,3	-2,7
8. Cyclically-adjusted primary balance (7 – 3)		-1,7	-3,5	-2,5	-2,0	-1,2

(a) Member states can complete rows 4 to 8 using their own figures or the Commission's figures.
(1) Estimate
(2) Trend values or period averages

Source: Ministry of Finance

4.5 Government Debt

At the end of 2004, the general government debt reached 36.8% of GDP. The medium-term fiscal framework assumes only a slight increase in the debt-to-GDP ratio. By the end of 2008, an increase of one percentage point in the government debt is expected against 2004. Hence, the general government debt will increase to 37.8% of GDP in 2008. With current nominal GDP growth, a deficit level that ensures stabilisation of the share of government debt in GDP should be attained in 2008.[11]

The debt projection is based on the assumption that the Czech Consolidation Agency (CKA) will wind up its activities by 2007, and with a reduction in the balance sheet, the volume of its liabilities will also decline. Another assumption is that the government will no longer provide additional risk guarantees. Government guarantees and CKA's accumulated loss will be progressively covered by the state budget. CKA's debt will be reduced from 3.3% to 0% of GDP, and the volume of imputed state guarantees will decrease from 9.2% to 5.4% of GDP. In this way, CKA's liabilities and the imputed state guarantees will be gradually transformed into tradable debt instruments.

[11] *With a nominal GDP growth rate of ca 7% per annum and a debt level of ca 38% of GDP, a deficit of ca 2.5% to 3.0% of GDP will stabilise the share of the debt in GDP.*

Table 4.4: Government debt – share by sub-sector

% of GDP	ESA code	Year 2004	Year 2005 (1)	Year 2006 (2)	Year 2007 (2)	Year 2008 (2)
Gross debt by sub-sectors						
General government	S13	36,8	37,4	37,1	37,9	37,8
Central government	S1311	34,2	34,6	34,3	35,0	34,8
of which: CKA		*3,3*	*1,6*	*1,0*	*0,2*	*0,0*
state guarantees		*9,2*	*8,2*	*7,5*	*6,0*	*5,4*
Local government	S1313	2,6	2,8	2,8	2,9	2,9
Social security funds	S1314	0,0	0,0	0,0	0,0	0,0

(1) Estimate
(2) Trend value or period averages

Source: Ministry of Finance

The growth dynamics of the government debt will gradually diminish after 2005. Nominal GDP growth of 6.0% to 7.5% annually will contribute every year to reducing the debt level by about 2.0 to 2.5 percentage points and thus will offset a substantial part of debt growth due to ongoing deficits. The deficit's contribution to debt accumulation will be reduced over time with gradual fiscal consolidation. In 2005, high revenues from privatisation will contribute to a decline in the debt to 3.5% of GDP. These revenues will not be used entirely to cover the debt in this year, and a certain amount will be available to finance the deficits in 2006 as well. For this reason, we anticipate a decline next year in the share of the government's debt in GDP. In 2007 and 2008, debt dynamics are almost entirely determined by the general government deficit and nominal GDP growth.

Table 4.5: Government debt and related indicators

% of GDP	Year 2004	Year 2005 (1)	Year 2006 (2)	Year 2007 (2)	Year 2008 (2)
Gross debt	36,8	37,4	37,1	37,9	37,8
Change in gross debt	0,0	0,6	-0,3	0,8	-0,1
Contributions to change in gross debt					
Primary balance	1,8	3,5	2,5	2,0	1,2
Interest expenditure (incl. FISIM)	1,3	1,3	1,3	1,3	1,5
Nominal GDP growth	-2,6	-2,0	-2,3	-2,4	-2,6
Stock-flow adjustment	-0,5	-2,3	-1,8	-0,1	-0,2
- Difference between cash and accruals	-0,2	-0,5	-0,1	0,0	0,0
- Net accumulation of financial assets	-0,6	-3,5	0,0	0,0	0,0
of which: Privatisation proceeds	-0,6	-3,5	0,0	0,0	0,0
- Valuation effects and other	0,3	1,8	-1,7	-0,1	-0,1
p.m. implicit interest rate on debt	3,7	3,7	3,8	3,9	4,1

(1) Estimate
(2) Trend values or period averages
Note: The difference between the cash and accrual approach is approximated by the difference between the balance using the national methodology, which is based on the cash principle and more closely correlates to debt development, and the balance using the ESA 95 methodology. Net accumulation of financial assets only contains the decline in assets as a result of privatisation. "Overvaluation and other factors" is a residual term.
Source: Ministry of Finance

As for administering government obligations and drafting a medium-term strategy for financing the central government, the primary focus is on the indebted segments of the general government whose financial security is under the direct responsibility of the Ministry of Finance. The state debt (23.7% of GDP) is the main balance sheet entry of these government obligations. Moreover, this involves obligations arising from covering CKA's expected financial needs from 2006 to 2008 (1.2% of GDP) and risky state guarantees (8.2% of GDP) that, represent for the expenditure side of the state budget a financial risk analogous to the debt structure.

Starting in 2005, the integrated administration of the given three segments was implemented in respect to costs and risks and to planning the strategy of financing and issue activities. In 2006, this portfolio integration should also include state financial assets excluding foreign receivables (6.8% of GDP) allowing for further improvements in the administration of a wider government financial balance.

Managing refinance risk

In relation to its decision to launch regular issues on the foreign market, the Ministry of Finance announced in the first half of 2004 a gradual three-year trajectory for a decline in the share of short-term government debt (with a maturity of one year). The following targets were set for 2004 to 2006: 25% to 30% for 2004, 22.5% to 27.5% for 2005 and 20% to 25% for 2006. By the end of 2004, a value of 25% was reached, exactly at the lower limit of the announced band, which helped to speed up the process of reducing the short-term debt. A target of 24% or less was announced for 2005, and starting at the end of 2006, a target of 20% or less. By the end of 2005, we anticipate a value of around 22%, i.e. meeting the target for this year. By the end of 2006, the ministry should reach the final planned and long-term targeted limit of 20%, which starting from 2007, will become one of the most fundamental limits of risk management in upcoming years.

Another indicator used during refinance risk management is the average period to maturity for the government debt. In December 2004, the ministry announced a target of 5.5 to 6.5 years for the first time in the Strategy for Financing and Management of the State Debt. By the end of this year, a value of around 5.8 years is expected. The Ministry of Finance will continue in its policy of extending the maturity of the state debt in the medium-term horizon as well.

Managing interest rate risk

Interest rate risk remains the most important market risk in managing the state debt. In respect to launching interest rate risk management through financial derivatives, the ministry introduced in 2002 annual targeting of the modified duration of the state debt. This newly defined target, including the effect of financial derivatives, was set at 3.8 years ± 0.4 of a year for 2005. Against 2004 (with a target of 3.3 to 4.3 years), the midpoint target value of duration was sustained while narrowing the band by 0.2 of a year. The ministry does not plan to make any additional increases of a more significant nature in the modified duration during the medium-term horizon, however, as in this year, it will attempt to stabilise it in a narrower band.

The current exposure vis-à-vis a change in interest rates up to one year generated by the structure of the government debt (after including derivative operations), i.e. interest rate refixing up to one year, will be stabilised under 30% starting from the end of Q3 2004.

Table 4.6: Government debt from the standpoint of interest

in %	Year 2002	Year 2003	Year 2004	Year 09/2005
1. Fixed interest rate long-term debt	**57,1**	**64,7**	**75,2**	**76,3**
1a. Of which: due in 1 year or less	*7,2*	*7,9*	*3,7*	*4,5*
2. Variable interest rate long-term debt	**1,1**	**2,4**	**3,5**	**8,8**
3. T-bills	**41,4**	**32,6**	**21,2**	**14,8**
4. Non interest bearing debt	**0,4**	**0,3**	**0,1**	**0,1**
1a. Of which: due in 1 year or less	*0,3*	*0,3*	*0,1*	*0,1*
5. Debt subject to IR re-fixing within 1 year (1a + 2 + 3 + 4a)	**50,0**	**43,2**	**28,5**	**28,2**
6. Including effect of interest rate swaps	**36,8**	**36,4**	**27,0**	**27,9**

Note: The figures in the table include the impact of currency and interest rate derivative operations. The effect of the portfolio derivatives that are not connected to specific debt instruments is given in line 6.

Source: Ministry of Finance

The interest rate sensitivity of the debt portfolio, including derivative operations expressed using modified duration is expected to be in a range of 3.9 to 4 years by the end of 2005 and is situated within the announced targeted band. It can be inferred from the amount of the government debt and its structure from the standpoint of interest that increasing interest rates by one percentage point would increase interest rate payments by about CZK 1.8 billion (0.1% of GDP) within a one-year period when accounting for the effect of derivative operations.

Managing currency risk

The exchange rate exposure of the government debt remains at a negligible level of 0.07% even at the end of the year.[12] The Eurobond issues in 2004 and 2005 were hedged against exchange rate risk by agreement between the Governor of the CNB and the Minister of Finance. The potential market appreciation impact of the single conversion of the issue proceeds of EUR 1.5 billion or EUR 1 billion, respectively, to CZK was also eliminated in this fashion. Higher currency exposure is present in the structure of risky state guarantees (ca 28%).

The risk profile of the state guarantee portfolio

From the standpoint of managing the market risk of the expenditure side of the state budget, not only the structure of the state debt is relevant, but also the structure of the portfolio of state guarantees provided for loans for which the state budget covers principal instalments and interest payments. The Ministry of Finance thus began integrated monitoring of the portfolio of the state debt and risky state guarantees. As a part of managing the government debt, regular monitoring of the state guarantee portfolio was introduced in connection with the strategic goals of the government's debt policy and the ministry's risk management.

[12] *This involves USD bills of exchange issued for the Czech Republic's participation in the EBRD and around EUR 12 million for the principal on Eurobonds from 2005, which remained unhedged against currency risk..*

Table 4.7: Risk profile of the government debt, including state guarantees (end of September 2005)

	Volume	Foreign currency	Variable interest rate	Due in one year	Average maturity	Modified duration
	bil CZK	%	%	%	years	years
State debt	662,6	0,1	4,3	19,4	5,8	3,9
Analyzed state guarantees	95,6	27,9	23,1	27,4	3,9	2,3
Total portfolio	**758,2**	**3,6**	**6,7**	**21,4**	**5,6**	**3,7**

Source: Ministry of Finance

Integrated management of government obligations proved to be effective during the first year of implementation, and over time, it should also lead to further expansion in the direction of integrating the structure of government obligations with the portfolio of government financial assets.

4.6 The Budget Consequences of Important Structural Reforms

The government submitted a package of social legislation to the Chamber of Deputies this year that, if adopted, should strengthen motivation for labour activities and more efforts towards changing the social and economic situation. The changes reinforce the already approved measures in the previous Convergence Programmes (limiting the amount of sickness benefits and state welfare benefits, permitting a combination of proceeds and collection of parental contributions, and entitlement to social benefits conditioned by the duty to accept eight hours of public service work per month).

The newly proposed changes are related to the following areas:

- Minimum subsistence level
- Sickness insurance
- Poverty relief
- Social services
- Social security.

As for the minimum subsistence level and poverty relief, efforts are being made to set the system of social benefits so that citizens are actually motivated to work. The aim is to sufficiently and justly protect citizens from poverty, as well as motivate them to actively seek employment and to even accept lower paid jobs benefiting those who try to increase their income through their own efforts.

Box 4.2: Planned changes in social security

The newly introduced **minimum subsistence level** will be a one-component system. The minimum subsistence amounts needed for securing food and other basic needs will be categorised according to the rank of people in a household, and for unaided children, according to age. The change in the structure of the minimum subsistence level will also affect the amount of government welfare benefits. The amounts expressing the costs of living should be eliminated from minimum subsistence, and housing needs will be resolved in the government welfare system provided by the newly created housing contribution and in the poverty relief system with a housing allowance. The reason behind this step is the substantial differences in housing costs.

In addition, the principle of **reduced subsistence minimum** will be introduced. This will express the costs of the minimum living standards necessary for survival. The reduced subsistence minimum level will guarantee a certain minimum standard of living for poverty-stricken individuals who are not entitled to minimum subsistence support, and in view of their lack of effort to increase their own income, they will receive assistance only at the level of reduced subsistence minimum. The goal of these changes in poverty relief assistance is to prevent long-term dependency on social benefits and to give preferential treatment to recipients of benefits who are active in resolving their own situation.

With respect to **sickness benefits**, wages compensation should be paid by the employer during the first two weeks of work sickness. However, this measure should also be compensated by lowering the premium rate for the employer by 1.9 percentage points (from 3.3% to 1.4%). A positive effect will be associated in particular with preventing rising costs as a result of the increasing occurrence of short-term illnesses. This will no longer affect the sickness insurance system but rather the employer's financial results. With this shift of sickness payments onto the employer, a reduction of CZK 9.2 billion in the state budget expenditures is expected in 2007 and CZK 10.3 billion in 2008. However, the net impact of changes in the area of sickness insurance (after adjusting for the decrease in premiums) will be negative, i.e. CZK –10.7 billion in 2007 and CZK –10.9 billion in 2008.

As a part of the social package, there will also be a change in the payment structure of certain benefits. A fundamental change relates, in particular, to the Social Security Act. With regard to introducing a **care allowance**, the increase in pension for dependent individuals and the care allowance for next of kin or another person will be cancelled. The aim of the care allowance is to aid persons who are dependent on the assistance of other persons and on essential aid from welfare services in particular, due to their adverse social situation. Entitlement to this allowance is based on a system of personal assessment of an individual's ability to care for themselves and their self-sufficiency. The allowance amount is set individually according to the age of the assessed person and to a person's level of dependency on the assistance of others in adverse social situations.

Moreover, a **new definition of the assessment base** is proposed for the state's payment into public health insurance for state-insured individuals (children, pensioners, unemployed, etc.) with the aim of securing its regular valorisation. Although this increases the state budget deficit, it also strengthens the resources of public health insurance. So a negative effect would occur if more resources were used to increase healthcare expenditures.

An adjustment in the premium for social security is anticipated with an amendment to the Act on Sickness Insurance introducing a **maximum assessment** base for employees as well as an adjustment in the maximum assessment base for self-employed persons. A maximum employee assessment base of sixty times the average wage for paying the premium is proposed in 2007, in 2008 forty eight times the average wage, and starting in 2009 thirty six times the average wage. The assessment base of self-employed persons will also be adjusted in a similar fashion[13]. The overall estimated impact of these changes is CZK –22.4 billion in 2006 and CZK –24.2 billion in 2007.

[13] *The proposed maximum assessment base for self-employed persons for the pension insurance premium and the contribution to the government employment policy is CZK 486,000 prior to 2007, sixty times the average wage in 2007, forty eight times the average wage in 2008, and starting from 2009 thirty six times the average wage. These amounts are reduced by CZK 40,500 prior to 2007, by five times the average wage in 2007, by four times the average wage in 2008 and by three times the average wage starting in 2009.*

Table 4.8: Impact of the proposed social legislation

Billion CZK	Year 2007	Year 2008
Impact on revenues		
New Act on Sickness Insurance	-19,9	-21,2
Adjustments in the assesment base	-2,5	-3,0
Overall impact on social contributions	**-22,4**	**-24,2**
Impact on expenditures		
New Act on Sickness Insurance	-9,2	-10,3
Social welfare changes due to new subsistence level	3,6	3,9
New poverty relief benefits	10,0	10,5
Abolishment of social need benefits	-6,4	-6,4
Contribution to placement in healthcare facilities	1,2	2,0
Welfare contribution (new Social Services Act)	8,0	8,3
Abolishment of the increase in pension for dependent individuals and the welfare contribution for next of kin or another person	-3,7	-3,8
Newly defined assessment base for the state's contribution to public health insurance	3,1	3,9
Overall impact on social expenditures	**6,6**	**8,1**

Source: Ministry of Finance

These measures strengthen the motivation for active participation in the labour market and prevents abuse of the social system. The higher demands on citizens will be offset by a rise in expenditures in the social sphere. The overall expenditure impact of all proposed measures in the social package is negative and amounts to CZK 29 billion in 2007 and CZK 32.3 billion in 2008.

This package is being deliberated at this time by the Chamber of Deputies. Approval of the package in its current form would have significant budgetary consequences and presents a risk for meeting the fiscal targets up to 2008. As the government has passed the binding expenditure ceilings for 2007 and 2008, it will be necessary to offset the budgetary effects of the proposed changes by savings in other areas.

5 Comparison with the Previous Convergence Programme and Sensitivity Analysis

5.1 Comparison with the Previous Macroeconomic Scenario

The differences between the macroeconomic scenarios of the current programme and last year's programme are related to the following:

- New observations of the macroeconomic phenomena were included.
- The figures for the annual national accounts for 2003 and the figures for the quarterly national accounts for Q1 and Q2 2004 were updated.
- The assumptions of the programme were changed, primarily for the price of oil.
- The reaction of the economy to external shocks differs from the assumptions of the previous programme in a positive way.

The differences between the expected development of the external environment in both programmes are significant. The assumptions of economic growth in the EU-15 and in Germany were reduced. The largest change occurred in the price of oil where the anticipated dollar price, according to the current forecast, is more than 50% higher for 2005 and even more than 75% higher for 2006 than the assumption for the last Convergence Programme. Both changes are the result of unexpected developments during the spring and summer months of 2005. The differences in the USD/EUR exchange rate are relatively small in comparison.

Table 5.1: Assumptions of the scenario

	CP 2004			CP 2005			Difference		
	2004	2005	2006	2004	2005	2006	2004	2005	2006
GDP growth (%)									
USA	4,4	3,7	4,1	4,4	3,5	3,3	0,0	-0,2	-0,8
EU-15	2,1	2,4	2,8	2,3	1,4	1,9	0,2	-1,0	-0,9
Germany	1,6	1,8	1,9	1,6	1,0	1,4	0,0	-0,8	-0,5
Prices of oil									
(USD / barrel)	36,8	35,9	34,0	38,3	55,5	60,5	1,5	19,6	26,5
Exchange rate									
USD / EUR	1,22	1,21	1,22	1,24	1,26	1,24	0,02	0,05	0,02

Source: Ministry of Finance

Despite the lower economic performance of the EU-15 countries, a shift in oil prices and stronger appreciation of the exchange rate vis-à-vis the euro, the prediction of future Czech economic development has changed in a positive direction.

It has been shown that the dependency of the Czech economy on fuel prices and on the absorption capacity of export markets is limited and that the positive factors associated with EU accession, the subsequent growth of total factor productivity and the competitiveness on world markets prevail.

Table 5.2: Change in the indicators of the macroeconomic scenario

	CP 2004			CP 2005			Difference (p.p.)		
	2004	2005	2006	2004	2005	2006	2004	2005	2006
Growth in real terms (in %)									
GDP	3,8	3,6	3,7	4,4	4,8	4,4	0,6	1,2	0,7
Households consumption	3,6	3,4	3,4	2,1	2,3	3,5	-1,5	-1,1	0,1
Government consumption	-1,2	-0,2	-0,2	-2,0	-0,6	-0,2	-0,8	-0,4	0,0
Gross fixed capital formation	9,3	7,0	5,4	7,6	2,8	3,4	-1,7	-4,2	-2,0
Contribution of domestic demand (pp)	4,6	3,8	3,3	2,7	0,8	3,2	-1,9	-3,0	-0,1
Contribution of foreign trade (pp)	-0,7	-0,2	0,4	1,7	4,0	1,2	2,5	4,2	0,8
Growth (in %)									
HICP	2,7	3,2	2,6	2,6	1,5	2,2	-0,1	-1,7	-0,4
GDP deflator	4,0	3,1	3,0	3,0	0,9	2,2	-1,0	-2,2	-0,8
Employment	-1,0	-0,3	0,1	-0,6	0,9	0,8	0,4	1,2	0,7
Unemployment rate (level in %)	8,3	8,3	8,0	8,3	7,9	7,4	0,0	-0,4	-0,6
Exchange rate CZK/EUR (level)	32,0	31,1	30,5	31,9	29,8	29,2	-0,1	-1,2	-1,3
Balance of goods and services (in % of GDP)	-1,2	-0,7	0,5	-0,3	2,1	2,8	0,9	2,8	2,3
Net lending/borrowing (in % of GDP) [1)]	-6,0	-5,7	-5,3	-5,2	-2,6	-2,2	x	x	x

1) The ratio of the balance of payments current account to GDP was given in the 2004 Convergence Programme.

Source: Ministry of Finance

In the previous programme, however, we did not expect such a significant slowdown in domestic demand for all segments, especially gross fixed capital formation, the change in inventories and household consumption, which is reflected in the predictions for the upcoming period.

Moreover, price development has been substantially calmer than expected. Improved current and future economic performance is also reflected in the basic labour market indicators – higher employment growth and a decline in unemployment.

5.2 Comparison with the Fiscal Framework of the Previous Convergence Programme

The government has committed itself to strict compliance with the programme and the fiscal targets established therein. The fiscal targets for 2006 and 2007 are fully in line with the targets of the previous Convergence Programme. Acceleration of economic growth, which is attributable to the acceleration of potential growth, and favourable development of tax revenues reflecting the implemented tax reform, help in meeting the fiscal targets.

The expected level of government debt in 2006 and 2007 was reduced by about two percentage points. More favourable development of the government debt is the result of the high privatisation revenues collected in 2005 amounting to 3.5% of GDP. Last year's Convergence Programme worked with the assumption of privatisation revenues of 1.8% of GDP. The higher privatisation revenues will not only be used to finance the deficit in 2005, but a significant amount will also help to finance the general government in 2006 (see 4.5 – Government Debt).

Table 5.3: Comparison with the previous Convergence Programme

% of GDP	ESA code	Year 2004	Year 2005 (1)	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)
GDP growth						
previous update		3,8	3,6	3,7	3,8	
latest update		4,4	4,8	4,4	4,2	4,3
Difference		0,6	1,2	0,7	0,4	
Actual budget balance						
previous update	EDP B.9	-5,2	-4,7	-3,8	-3,3	
latest update	EDP B.9	-3,0	-4,8	-3,8	-3,3	-2,7
Difference		2,2	-0,1	0,0	0,0	
Gross debt levels						
previous update		38,6	38,3	39,2	40,0	
latest update		36,8	37,4	37,1	37,9	37,8
Difference		-1,8	-1,0	-2,1	-2,2	

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

Source: Ministry of Finance

5.3 Sensitivity Analysis

The Czech economy is small and open, and to a certain degree, dependent on raw materials. In this respect, the prices of mineral resources are in all probability the largest risk to Czech economic development at this time.[14] Therefore, the sensitivity analysis will be based primarily on various scenarios of oil price development. The adverse development of raw material prices, however, does not only have a negative effect on the Czech economy, but it will most likely affect economic development abroad as well.[15] We have, therefore, decided to supplement the sensitivity analysis with two secondary effects, i.e. the effect of foreign demand and foreign inflation.[16]

We have decided to test the sensitivity of the Czech economy in relation to various developments of the above factors with the help of two scenarios. The optimistic scenario combines positive external supply and demand shocks. It is based on the assumption of a gradual decline in the price of oil, slightly higher foreign demand dynamics, and on the contrary, a lower growth rate for foreign industrial prices. On the other hand, the pessimistic scenario is derived from the assumptions of a higher oil price, lower foreign demand dynamics and acceleration of foreign inflation.

[14] *For a quantitative analysis of the effects of the above factors on Czech economic development, the Ministry of Finance employs a medium-term, quarterly calibrated model. The model is generated by approximately 20 stochastic equations and 50 identities. This model is a standard Keynesian model supplemented with a neoclassical supply side.*

[15] *In our case, we have focused exclusively on the probable impact of oil price fluctuations on the economy of the European Union, our largest trade partner. The simulation results of the MULTIMOD model, set up and managed by the International Monetary Fund, were used to estimate the sensitivity of the European economy.*

[16] *We would like to point out that the scenarios presented below are asymmetric in relation to the baseline forecast of macroeconomic variables.*

Table 5.4: Scenario of exogenous variables

		Year 2004	Year 2005	Year 2006	Year 2007	Year 2008
	UK Brent					
Optimistic	USD/barrel		51,3	49,5	45,8	42,3
Baseline	USD/barrel	38,3	55,5	60,5	57,8	54,3
Pessimistic	USD/barrel		61,8	77,0	75,8	72,3
	GDP EU 15					
Optimistic	y/y in %		1,7	2,3	2,7	2,7
Baseline	y/y in %	1,2	1,5	1,9	2,4	2,5
Pessimistic	y/y in %		1,2	1,3	1,9	2,2
	PPI EU 15					
Optimistic	y/y in %		2,4	0,8	1,2	1,6
Baseline	y/y in %	2,3	3,1	2,0	1,7	1,7
Pessimistic	y/y in %		4,1	3,7	2,4	1,9

Source: Ministry of Finance

Optimistic scenario

The settings of the above scenarios are characterised by the primary nominal and secondary real impact on the Czech economy. Thanks to the assumed decline in the price of oil to around USD 40 per barrel, we can expect a very substantial improvement in the external imbalance measured by the balance of payments current account. A lower price for oil has a very positive income effect. Thanks to the relatively high and, in particular, unchanged energy demands of the Czech economy, firms reduce their production costs, which is reflected positively in lower price dynamics as well as wider profit margins.

Higher foreign demand growth will then have a positive impact on acceleration of the export growth rate and in turn on industrial activity. However, thanks to continued high import demands on the supply side of the Czech economy, the high export dynamics will also be connected to high import dynamics. So the overall positive effect will be partially reduced. The higher dynamics for economic activity, or industrial production, will be associated with higher demand for labour as well as higher labour productivity. Thanks to lower raw material prices and lower foreign price dynamics, relatively positive price and wage development can be expected.[17] Inflation and economic activity (or the output gap) will show contradictory development, however, a lower interest rate than in the baseline scenario can be expected with the current settings of the central bank's reaction function.

Thanks to the expected deceleration of inflation and only a slight increase in GDP dynamics, there will only be a moderate change in the volume of wages and salaries. Hence, the revenue increase for income taxes in our scenario is actually negligible. In addition, even the revenues from consumption (VAT and excise tax) have not really increased due to the composition of economic growth. The expenditure side of the budget assumes nominal rigidity of the expenditure ceilings, and for the given simulations, it has actually not changed. In fact, the positive price development could also be connected with savings on the expenditure side of the budget (e.g. lower valorisation of pensions, social benefits, etc.). Nonetheless, this factor is not accounted for in our simulations, which could cause the deficit or the debt to be overestimated in the scenario. The decline on the expenditure side of the budget is associated

[17] *A substantial decline in the prices of mineral resources could be associated with the asymmetry of monetary policy, especially in the case of low-inflation economies. Despite deflation in the economy, the non-existent ceiling on interest rates does not allow the central bank to reduce short-term nominal interest rates.*

with a decline in debt service, which is affected by a lower level of nominal interest rates and lower expenditures for unemployment benefits. Achieving the optimistic scenario would help improve the performance of public budgets.

Table 5.5: Macroeconomic effects of the optimistic scenario

		Year 2004	Year 2005	Year 2006	Year 2007	Year 2008
	Gross domestic product					
Consumption expenditures	volumes, y/y in %	2,1	2,3	3,5	3,7	3,8
Gross fixed capital formation	volumes, y/y in %	7,6	2,8	3,5	5,0	7,9
Government expenditures	volumes, y/y in %	-2,0	-0,6	-0,5	-0,7	-0,4
Export of goods and services	volumes, y/y in %	21,9	9,5	10,7	10,7	10,8
Import of goods and serivces	volumes, y/y in %	18,4	3,9	9,3	9,6	10,4
Gross domestic product	volumes, y/y in %	4,4	4,8	4,4	4,5	4,9
	Labour market					
Total employment	y/y in %	-0,6	0,9	0,8	0,6	0,6
Unemployment rate	in %	8,3	7,9	7,4	7,0	6,7
Wages and salaries	y/y in %	6,5	5,2	5,2	5,8	6,4
	Prices					
Consumer price index	y/y in %	2,8	1,9	2,3	1,9	2,2
Gross domestic product deflator	y/y in %	3,0	1,1	2,8	2,8	2,7
	Public budget					
Public deficit	in % of GDP	-3,0	-4,8	-3,7	-3,1	-2,4
Gross public debt	in % of GDP	36,8	37,2	36,6	37,1	36,6
	Other indicators					
PRIBOR 3M	in %	2,4	1,9	1,8	2,0	2,3
Current account	in % of GDP	-5,4	-2,4	-1,4	0,2	1,2

Source: Ministry of Finance

Pessimistic scenario

In view of energy demands and raw material dependency, an immediate impact on the external imbalance would be observed should the pessimistic oil price scenario occur. This fact would cause corporate costs to rise and in turn affect the price block.

A secondary effect of high oil prices would be lower foreign demand dynamics, and on the contrary, faster foreign price growth. Lower foreign demand would be reflected in lower export performance and in turn lower GDP dynamics. Higher foreign price growth would put additional pressure on import price growth and production cost growth. Higher price dynamics would also prompt trade unions to accelerate wage bargaining, which would cause production costs to increase again with an effect on prices. Negative inflation pressures are expected to exceed interest in economic growth, and the central bank would then resort to higher interest rates. This fact together with lower corporate profitability will depress investment activity, which will cause economic performance and potential GDP to deteriorate further. Lower economic activity will be connected with lower demand for labour resulting in a slight increase in the unemployment rate.

Higher inflation acceleration than deceleration of real variables (employment, GDP) causes certain tax revenues to increase, even in the pessimistic scenario. However, a higher inflation rate is associated with higher nominal interest rates and thus higher debt service costs. An increase in the drawdown of unemployment benefits would also occur. In addition, it should be pointed out that a higher inflation rate in our scenario is not related to additional valorisation of old-age pensions or other social benefits. This simplification could cause the resulting rise in the deficit or public debt to be underestimated in the pessimistic scenario.

Table 5.6: Macroeconomic effects of the pessimistic scenario

		Year 2004	Year 2005	Year 2006	Year 2007	Year 2008
	Gross domestic product					
Consumption expenditures	volumes, y/y in %	2,1	2,3	3,4	3,4	3,3
Gross fixed capital formation	volumes, y/y in %	7,6	2,8	3,3	4,5	6,9
Government expenditures	volumes, y/y in %	-2,0	-0,5	0,1	-0,3	-0,7
Export of goods and services	volumes, y/y in %	21,9	9,4	9,5	8,4	8,8
Import of goods and serivces	volumes, y/y in %	18,4	3,9	8,1	7,8	8,9
Gross domestic product	volumes, y/y in %	4,4	4,8	4,4	3,8	3,5
	Labour market					
Total employment	y/y in %	-0,6	0,9	0,8	0,4	0,1
Unemployment rate	in %	8,3	7,9	7,4	7,2	7,2
Wages and salaries	y/y in %	6,5	5,2	5,4	6,2	6,6
	Prices					
Consumer price index	y/y in %	2,8	2,9	2,8	2,8	2,9
Gross domestic product deflator	y/y in %	3,0	4,0	1,4	3,0	3,5
	Public budget					
Public deficit	in % of GDP	-3,0	-5,3	-4,0	-3,6	-3,2
Gross public debt	in % of GDP	36,8	38,6	37,6	38,8	39,1
	Other indicators					
PRIBOR 3M	in %	2,4	2,3	2,1	2,9	3,2
Current account	in % of GDP	-5,4	-6,0	-3,7	-2,9	-2,3

Source: Ministry of Finance

Comparison of the sensitivity scenarios

Chart 5.1: GDP (y-o-y, in %)

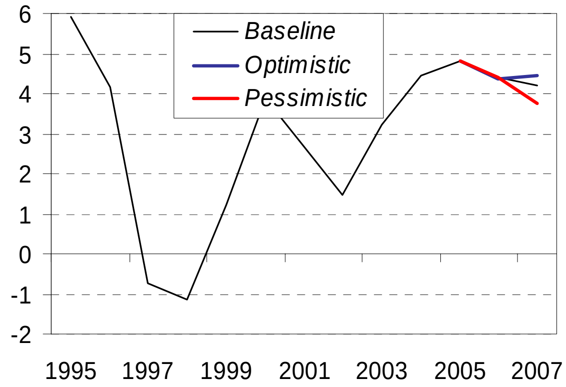


Chart 5.2: Unemployment rate (in %)

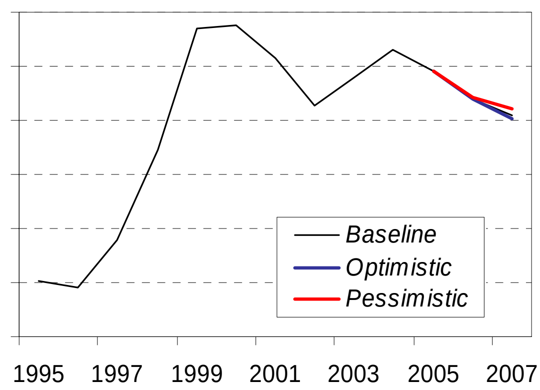


Chart 5.3: Current account (in % GDP)

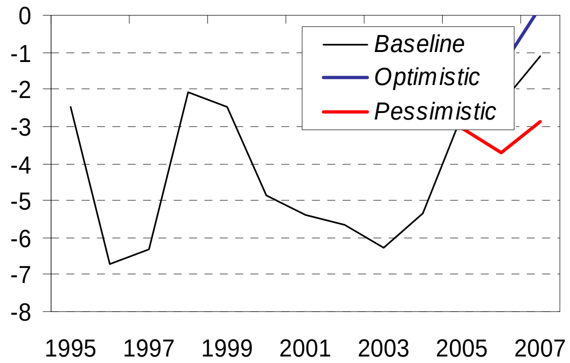
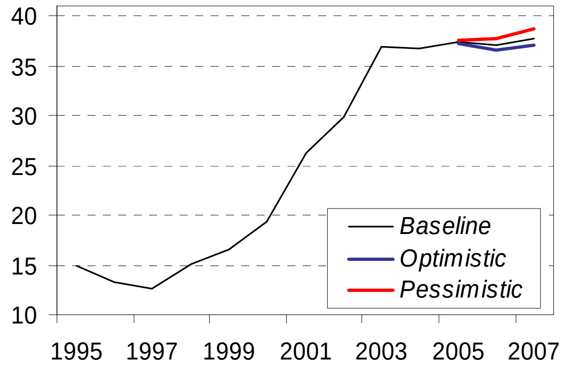


Chart 5.4: Public debt (in % GDP)



Source: Ministry of Finance

6 Quality of Public Finances – Revenues and Expenditures

6.1 The Government's Strategy

Successful fiscal consolidation is a condition for a stable economic environment, and an appropriate structure of public revenues and expenditures can contribute to dynamic economic growth. Therefore, in addition to expenditure savings, fiscal consolidation relies on a change in the structure of tax revenues and expenditure programmes and a change in the social legislation with the goal of promoting a competitive economic environment and increasing motivation to actively participate on the labour market.

The government is working towards strengthening expenditures in the areas covered by the Economic Growth Strategy and the National Reform Programme. In addition, it aims to ensure that expenditures for the government's programme priorities do not exceed the trajectory of the decline in the deficit and that they are not in conflict with the medium-term expenditure frameworks. Resources from the structural funds and the Cohesion Fund will also be used to a large degree to support priorities. The volume of these funds will increase for the new member states with respect to the new financial perspective. The promotion of research and development is even strengthened from the income side of the state budget through legislative changes relating to income tax.

6.2 Public Expenditures

The positive developments in the area of tax revenues have diluted the need for expenditure savings. Thanks to acceleration of economic growth and slowed expenditure growth, the fiscal framework assumes a decline in general government expenditures vis-à-vis GDP. In contrast to the level expected at the end of 2005, the share of government expenditures in GDP will be reduced by about two percentage points. The anticipated rapid launch of projects co-financed from the structural funds and the Cohesion Fund will work against the decline in expenditures. This is reflected in higher gross fixed capital formation and in part current ordinary expenditures. The expected growth of interest rates and a higher government debt level are factors that will work in the direction of expenditure growth for debt service.

Table 6.1: General government expenditures

% of GDP	ESA code	Year 2004	Year 2005 (1)	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)
Components of expenditures						
Collective consumption	P.32	11,3	11,2	11,0	10,6	10,2
Total social transfers	D.62+D.63	23,2	23,1	22,7	22,1	21,6
Social transfers in kind	D.63	11,3	11,3	11,0	10,7	10,5
Social transfers other than in kind	D.62	11,9	11,8	11,7	11,4	11,2
Interest expenditure	EDP D.41	1,3	1,3	1,3	1,3	1,5
Subsidies	D.3	2,2	2,3	2,1	2,0	2,0
Gross fixed capital formation	P.51	5,0	5,2	5,2	5,3	6,1
Other		1,6	2,9	1,7	1,7	2,2
Total expenditures	TE	44,7	45,9	44,0	43,1	43,6
p.m.: Compensation of employees	D.1	8,1	8,0	7,8	7,6	7,3

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

Source: Ministry of Finance

The effect of the austerity measures described in detail in the November 2004 programme has to a large extent already died out. These measures (especially reducing sickness benefits, cancelling the transport benefit, reducing budget heading expenditures, etc.) have lowered expenditures levels in 2004. The measures focusing on stabilisation of the pension system and a gradual reduction in the number of general government employees have a longer-term effect. Reducing the number of employees accompanied by moderate average wage growth (4.5% to 5.0% annually) contribute to reducing compensation to employees by 0.7 percentage points, and in the end, will reduce the expenditures for collective and individual consumption.

Favourable economic development creates assumptions for slower social benefit growth. Therefore, a decline vis-à-vis GDP is expected. Measures strengthening the effectiveness of the social benefits system were adopted in 2004. The austerity measures proposed by the Minister of Finance in the previous Convergence Programme contained proposals for a further reduction in social benefits, but these measures were not implemented. A complex set of social legislation was submitted to the Chamber of Deputies this year (see Section 4.6). The effects of this legislation have not yet been reflected in the fiscal framework, and other important changes could develop during deliberation. Although this legislation increases motivation for more actively resolving the social situation, its anticipated impact on the general government balance is negative. Therefore, adoption of this legislation will require savings in other areas.

Reducing the majority of expenditure entries vis-à-vis GDP created space for increasing gross fixed capital formation. In an international context, this has already reached a high level in the general government, however, with access to the structural funds and the Cohesion Fund, space has been created for an additional increase. Particularly in 2008, gross fixed capital formation will increase to as much as 6.1% of GDP[18] at which time the Czech Republic will gain access to a substantially higher volume of EU funds as a part of the new Financial Perspective. This should substantially speed up the process of developing a transport and ecological infrastructure.

[18] *We expect the Czech Republic to obtain a maximum aggregate allocation of ca 3.6% of GDP per annum.*

6.3 Public Revenues

Restructuring of the revenue side has been taking place now for two years. Tax measures are geared to promoting economic growth and employment. The shift of the tax burden from direct taxes to indirect taxes also continues. The goal is to reduce the distortion effect of direct taxes on economic activity, which is stronger than that of indirect taxes.

Acceleration of economic growth and tax changes implemented during 2004 and 2005 have triggered significant growth in general government revenues above the budgetary plans. From 2005 to 2008, however, we anticipate a decline in the tax quota by about 1.4 percentage points. This is prompted by the planned reduction in income taxes (by ca 0.7 percentage points) and the effect of the GDP growth composition. The dynamics of private and government consumption will stall significantly behind the GDP growth rate. Consequently, VAT and excise tax revenues will fall vis-à-vis GDP.

Total revenues are practically unchanged during the monitored period. This is caused by the increased inflow of EU funds, which is expected in 2007 and especially in 2008 upon adoption of the new Financial Perspective due to a higher drawdown of resources from the structural funds and the Cohesion Fund. Higher drawdown by the general government is adequately reflected on the expenditures side as well.

Table 6.2: General government revenues

% of GDP	ESA code	Year 2004	Year 2005 (1)	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)
Components of revenues						
Total taxes		21,4	21,2	20,4	19,9	20,0
Taxes on production and imports	**D.2**	11,9	11,8	11,9	11,6	11,3
Current taxes on income, wealth etc.	**D.5**	9,5	9,3	8,5	8,3	8,6
Capital taxes	**D.91**	0,0	0,0	0,0	0,0	0,0
Social contributions	**D.61**	15,3	15,2	15,2	15,1	15,0
Property income	**D.4**	0,8	0,5	0,5	0,5	0,4
Other		4,2	4,1	4,1	4,4	5,5
Total revenue	**TR**	41,6	41,1	40,2	39,8	40,9
p.m.: Tax burden		36,7	36,4	35,7	35,0	34,9

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

Source: Ministry of Finance

The tax changes in the first and second stages of the public finance reform presented in the previous Convergence Programme were adopted, though, with several exceptions (e.g. a reduced VAT rate for hotel services and VAT exemption for language schools). These changes will be positively reflected in tax revenues over a period of time.

As for personal income tax, a reduction in the taxation for low- and medium-income groups can be expected starting in 2006 as well as other measures which should significantly increase motivation to actively participate on the labour market (see Box 2.2). The result should increase the disposable income from labour and increase vertical tax equality.

Certain changes have been proposed for corporate income taxes as well and include, for example, cancelling the tax exemption for interest revenues on mortgage bonds, introducing a limited discount on taxes when acquiring cash registers or when tightening conditions for the creation of provisions at banks. The option of deducting 100% of the expenditures invested in research and development from the tax base was also introduced to promote competitiveness.

A decline in revenues can also be expected with VAT. This relates to the adjustment of certain changes adopted in the public finance reform, such as keeping hotel services in the reduced rate category (originally shifted to the standard rate) and VAT exemption for language schools.

In the area of excise taxes, the excise tax rates for tobacco products were adjusted in respect to the Czech Republic complying with the time schedule agreed with the European Union. According to this schedule, gradual steps should be taken up to 2007 to reach the minimum rates valid in the European Union. The amendment to the Excise Tax Act proposes an excise tax rate set over two gradual stages. This consists of a change in the excise tax rates for tobacco products on the effective date of the proposed amendment as well as a change starting on 1 April 2006.

Table 6.3: The impact of tax changes on public budgets [(1)]

% of GDP	Year 2006	Year 2007	Year 2008
Taxes, total	**-0,7**	**-0,7**	**-0,6**
of which: VAT	*-0,2*	*-0,2*	*-0,1*
Excises	*0,2*	*0,2*	*0,2*
CIT	*-0,1*	*-0,1*	*-0,1*
PIT	*-0,7*	*-0,6*	*-0,6*

(1) The impact is expressed on an accrual basis and is given as a deviation from autonomous development.

Source: Ministry of Finance

7 Sustainability of Public Finances

7.1 Introduction

Preparations for the economic consequences of an ageing population have become a priority concern in a number of EU countries, and moreover, this topic is one of the main points on the agenda of the Economic Policy Committee (EPC). The Czech Republic has recognised the urgency of the ageing population issue. Population development in the Czech Republic will be influenced by a strong demographic shock in the form of a growing share of older persons in the total population. An ageing population will not only have an effect on the structure and volume of public expenditures, but it will also affect the labour market and the future development of the standard of living.

The best notion of the extent of demographic changes can be derived from the development of the dependency rate over the next 45 years. Eurostat's population projection (EUROPOP 2004) was used as a source database and is in line with domestic projections from the standpoint of the demographic dependency rate[19].

Chart 7.1: Dependency rate

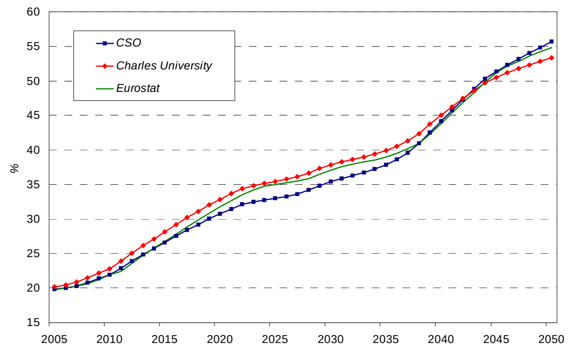
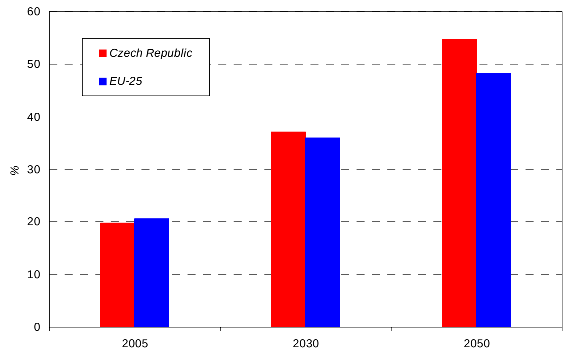


Chart 7.2: Dependency rate in the CR and the EU



Note: The dependency rate is defined as the ratio of the population 65 years of age and older to the population 15 to 64 years old in middle variant demographic projection.

Source: Czech Statistical Office, Faculty of Science at Charles University, Eurostat

Within the context of current European demographics, the Czech population is relatively young. However, very dynamic changes in its structure are expected in the upcoming decades. In fact, the Czech population will be among the oldest in Europe within the next 50 years (Chart 7.2). The reason behind these changes is the rapidly increasing life expectancy accompanied by a low aggregate fertility rate. The Eurostat projection assumes that life expectancy at birth will increase between 2004 and 2050 by 7.3 years for men (from 72.4 to 79.7 years) and by 5.3 years for women (from 78.8 to 84.1 years). The aggregate fertility rate will remain far below the level that ensures simple reproduction (an increase from 1.15 to

[19] Use of this projection permits comparison with the demographic projections in other EU countries. The European Commission will also use Eurostat's projection to assess the long-term sustainability of public finances in member countries. This projection does not deviate significantly from the domestic projections with respect to the dependency rate (Czech Statistical Office, Faculty of Science at Charles University), which indicates the very robust results of the demographic projections (Chart 7.1).

1.5). Even significant growth in the active migration balance (from 4,300 to 20,000 annually) will not prevent an overall decline in the population (from 10.2 to 8.8 million people).

The demographic dependency rate will increase from a current rate of ca 20% to ca 55%, i.e. almost triple. In the absence of reform, the dependency rate would be a very good indicator of future deficit tendencies because it measures the ratio of the number of people in their productive age to those in their post-productive age. To confront such a strong demographic shock, the Czech government is preparing a detailed strategy for dealing with the problems of an ageing population.

7.2 Government strategy

The Czech government continues confront long term challenges by continuation of the public finance reform well planned changes to the pension system and the healthcare system and increasing the overall employment rate. By eliminating the excessive deficit and approaching the medium-term objective, a large portion of the existing fiscal gap can be wiped out. Public finance consolidation, is a necessary condition for renewing long-term fiscal sustainability.

In its programme declaration, the government committed itself to submitting a proposal for the pension system reform by the end of its term in office. In April 2004, an expert political team was created to carefully analyse the current state of the pension system and to assess various proposals for pension reform. For this purpose, the government decided to create an independent Executive Team whose job it would be to prepare the materials used in resolving the pension reform issue. The Executive Team finished its work in June 2005, and the results of this work were published in a Final Report containing a detailed analysis of the situation. It was revealed in the report that the current pension system is financially unsustainable and microeconomically ineffective over the long run. The analysis of the implicit tax revealed that the system does not sufficiently motivate citizens to work soon after reaching the statutory retirement age. The pension system also shows a large degree of redistribution, which is effective in combating poverty for pensioners but which could discourage economic activity and/or the payment of premiums.

Independent expert analyses serve as a foundation for negotiations held with the representatives of the political parties. Currently, agreements are being negotiated on gradually increasing the statutory retirement age, expanding the support for voluntary savings in old age and creating a reserve fund from privatisation revenues and from pension system surpluses relating to pension reform. This involves parametric changes that have a positive impact on the long-term sustainability and equivalence of pensions. The creation of a reserve fund helps generate a financial buffer that would curb the costs of the system reform. However, consensus on the principles of the system reform has not yet been reached.

Short-term stabilisation measures have been adopted in healthcare. These measures focus primarily on strengthening the revenue side of the system, concerning in particular the purchase of irrecoverable receivables from health insurance companies, increasing compensation for persons insured under the state system and full redistribution of the revenues of health insurance companies. It also focuses on better regulation of costs through optimising the network of healthcare services, amending regulations on covering medication, introducing healthcare books or the development of instruments for measuring and assessing the quality of provided healthcare services. A reform strategy for healthcare that would resolve the problem of the system's long-term sustainability is currently in the preparation phase.

As for the participation rate and employment rate, the Czech Republic is one of the more successful countries in the European Union. Nevertheless, it lags behind the leading countries primarily due to its low participation rate for persons between the age of 55 and 64. In recent years, the participation rate has increased in this segment of the population as a result of tightening the conditions for early retirement and a gradual increase in the retirement age. It is anticipated that the pension system reform will be drawn up with respect to an additional rise in the employment of older citizens. Tax changes are intended to support employment in the group of persons with low incomes and qualifications (adjusting the personal income tax parameters).

7.3 The Fiscal Consequences of an Ageing Population – a Long-Term Projection

The European Union devotes a great deal of attention to the long-term fiscal projection and focuses its efforts on the maximum comparability of results between member states. The Czech Republic supports these efforts, and this is why it works as much as possible with the common assumptions and methodology discussed by the EPC's Working Group on Ageing (AWG).

The projections were formed using the following assumptions:

- The population will develop in line with the Eurostat projection (EUROPOP 2004).
- The development of macroeconomic variables up to 2008 is based on national projections. After 2008, the assumptions on labour productivity growth and real GDP growth have been taken from the baseline scenario prepared by the AWG. This assumes gradual convergence to the long-term equilibrium labour productivity growth rate (1.7% per year), a slight increase in the participation rate for men and women and a reduction in the structural unemployment rate to 6.5%.

Table 7.1: Projection assumptions

% of GDP	Year 2000	Year 2005	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050
Labour productivity growth	4,6	3,8	3,4	3,0	2,7	1,9	1,7
Real GDP growth	3,9	4,8	3,6	2,5	1,9	0,4	0,8
Participation rate males (aged 20–64)	86,3	84,3	84,6	87,4	87,1	84,4	85,6
Participation rates females (aged 20–64)	68,9	68,5	70,6	76,4	76,1	72,9	74,0
Total participation rates (aged 20–64)	77,6	76,4	77,6	81,9	81,6	78,7	79,8
Unemployment rate	8,8	7,9	7,3	6,5	6,5	6,5	6,5
Population aged 65+ over total population	13,8	14,0	15,5	20,8	23,6	26,8	31,0

Source: Ministry of Finance

- The pension system projection relies on the national model apparatus. It assumes the validity of current legislative changes, pension valorisation at the level of the mandatory minimum and indexation of the pension model parameters that ensures a stable replacement rate for newly granted pensions.

- The expenditure projection for healthcare and long-term care is based on the assumption of health improvements in the population that fully reflect the increase in life expectancy and the assumption of neutral price development.

- The expenditure projection for education precisely follows the methodology proposed by the AWG. It calculates the expenses per student from the ratio of students to teachers, development of the average wage in the education sphere and the share of other expenditures per student.

- In addition to the above expenditure entries, the development of benefits to families with children and unemployment benefits was also explicitly modelled in order to be consistent with the demographic and macroeconomic scenario.

Age-related expenditures from 2005 to 2050 will increase by about 8% of GDP. The most significant growth factor is expenditures for old-age pensions and healthcare and long-term care. The adverse developments in the pension system and healthcare system will only be reduced to a limited extent by the development of expenditures for education and benefits to families with children.

Table 7.2: Long-term sustainability of public finances

% of GDP	Year 2000	Year 2005	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050
Total expenditure	42,1	45,9	43,0	43,3	45,8	51,2	57,6
of which: **Age-related expenditure**	19,9	20,0	19,0	19,1	21,0	24,5	27,3
Pension Expenditure	8,7	8,3	7,9	8,1	9,2	11,8	13,5
Social security pensions	8,7	8,3	7,9	8,1	9,2	11,8	13,5
Old-age and early pensions	7,7	7,5	7,2	7,4	8,4	11,0	12,8
Other pensions	1,0	0,8	0,7	0,8	0,8	0,8	0,7
Occupational pensions	-	-	-	-	-	-	-
Health care	6,0	6,6	6,5	6,9	7,5	8,3	9,1
Long-term care	0,2	0,3	0,3	0,3	0,4	0,5	0,6
Education expenditure	3,5	3,7	3,2	2,8	2,9	3,0	3,1
Other age-related expenditures	1,4	1,1	1,0	1,0	0,9	1,0	1,1
Interest expenditure	0,9	1,3	1,1	1,3	2,0	3,9	7,5
Total revenue	38,5	41,1	40,9	40,9	40,9	40,9	40,9
of which: **Property income**	0,5	0,5	0,4	0,4	0,4	0,4	0,4
of which: **Pension contributions**	7,9	8,9	8,9	8,9	8,9	8,9	8,9
Pension reserve fund assets	0,0	0,8	4,9	14,2	17,4	3,8	0,0
of which: **Consolidated public pension fund assets**	0,0	0,0	0,0	0,0	0,0	0,0	0,0

Source: Ministry of Finance

A substantial rise in age-related expenditures will cause the primary deficit to worsen, interest rates to increase from the current 1.3% of GDP to 7.4% of GDP and rapid accumulation of government debt. Under these assumptions, Czech public finances would not be compatible with the fiscal criteria defined in the Stability and Growth Pact.

Chart 7.3: Projection of expenditures

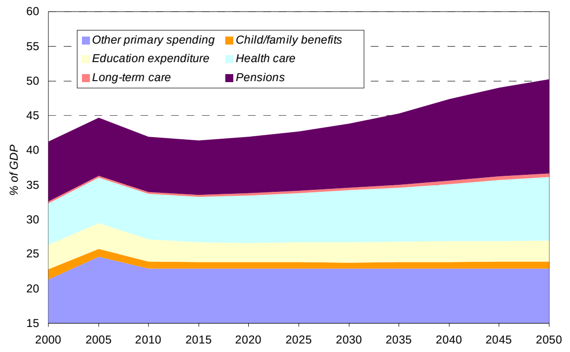
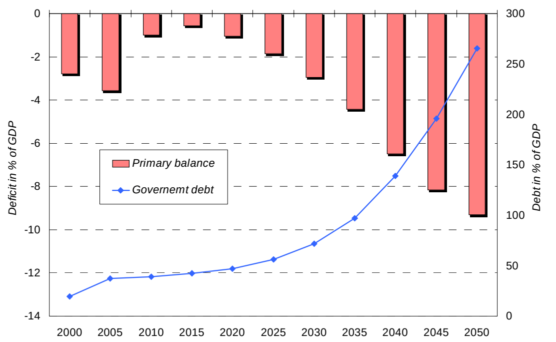


Chart 7.4: Primary deficit and debt



Source: Ministry of Finance

When interpreting the results of the projections, it should be remembered that the projections are created on the assumption of existing policies and do not account for any future reform measures. The aim of this approach is to calculate the level of fiscal correction needed to ensure the long-term sustainability of public finances. In order for the Czech Republic to meet the requirements of the fiscal discipline set in the Stability and Growth Pact between 2008 and 2050, it would be necessary to implement measures that would reduce the share of expenditures or increase the share of taxes in GDP by more than three percentage points in 2008 (i.e. the S1 indicator). This means that the overall public finance balance should register a surplus in 2008 of 0.6% of GDP. In order to ensure the long-term solvency of the general government, a fiscal correction of, in fact, 7.0% of GDP would be needed in 2008 (i.e. the S2 indicator).

Table 7.3: Scope of needed fiscal consolidation

% of GDP	Year 2008	Year 2009	Year 2010
1. Revenues	40,9	40,9	40,9
2. Primary expenditures	42,1	42,0	41,9
3. Primary balance (1-2)	-1,2	-1,1	-1,0
4. Sustainability gap S1 (1)	3,3	3,4	3,5
5. Required primary balance (3+4)	2,0	2,2	2,5
6. Required total balance	0,6	1,1	1,3
Memo:			
Sustainability gap S2 (2)	7,0	7,1	7,2

(1) *Permanent fiscal consolidation (S1) expresses the percentage of GDP needed to permanently increase taxes (from the given year) or reduce expenditures in order to achieve a government debt of 60% of GDP at the end of the projection period.*

(2) *Permanent fiscal consolidation (S2) expresses the percentage of GDP needed to permanently increase taxes (from the given year) or reduce expenditures in order to keep the general government solvent for an indefinite period of time (i.e. meeting the inter-temporal budget restrictions).*

Source: Ministry of Finance

8 Changes in the Institutional Framework for Implementing Fiscal Policy

The public finance reform implemented in 2004 was a fundamental change in the legal and institutional framework of public finances. The government's subsequent steps focus on gradually achieving this according to the time schedule for the institutional part of the reform and preparing additional measures geared to the identified challenges for public finance management.

8.1 Carrying Out the Public Finance Reform

Transformational institutions

In line with the public finance reform and in accordance with the previous Convergence Programme, the process of preparing the steps for terminating the activities of certain "transformation institutions" (sometimes referred to off-budget funds) and selected state extra-budgetary funds has continued. This will not only simplify and increase the transparency of overall budgetary management, but it will also create substantial operational savings.

Preparations for terminating the National Property Fund (execution of privatization) and transferring the remaining activities to the state, under the management of the Ministry of Finance, are coming to an end. During 2006, Česká inkasní will be terminated. This institution was entrusted with the technical implementation of a part of the programme for stabilising and consolidating the banking sector. On 1 January 2006, the State Fund for Soil Fertilisation will be dissolved by law. Its rights, obligations and property will be transferred to the Ministry of Agriculture.

Another step towards increasing the stability and transparency of public finances is to terminate the Czech Consolidation Agency, whose successor will again become the state under the administration of the Ministry of Finance. Preparations are in progress, and according to the adopted timetable, this institution should be terminating without liquidation by 31 December 2007. All of its subsidiaries will be liquidated by this date as well. Moreover, the government decided to terminate the Land Fund (entrusted with privatization and restitution of land) on 31 December 2009. Parliament, though, will still need to approve the agency's termination by law.

Strengthening the role of the medium-term expenditure frameworks

Integration of the government's extra-budgetary funds has also contributed to increasing the transparency and stability of public finances through the medium-term expenditure frameworks and binding expenditure ceilings.[20] To further strengthen the role of the medium-term expenditure frameworks, the binding principles should also be implemented on the heading level of the state budget and state funds, as well as considering the possibility of introducing sanctions for not complying with the expenditure limits of the budget headings.

[20] *For more information, see Act No. 218/2000 Coll., on Budgetary Rules.*

Meeting the fiscal targets also requires compliance with fiscal discipline at the regional level. Therefore, it is necessary to incorporate regional government authorities into the medium-term budgetary process. Closer coordination of the budgetary policy of the central government and regional government authorities, including introducing effective monitoring and assessment of indebtedness and debt service, with the option of penalising municipalities with excessive debts, helps to reduce the level of risk for meeting the set fiscal targets. It is, therefore, important to promote communication between central government and regional government authorities. For this purpose, the Public Finance Committee was established through the advisory body of the Ministry of Finance.[21]

The rules for regional and municipal government administration must ensure more effective disposition with entrusted funds and a sustainable debt position for local governments. The level of fiscal autonomy must also correspond to the scope of responsibility for this level administration. In line with this principle, the level of fiscal autonomy of regional and municipal governments will increase even further. On 1 January 2005, new tax revenue sharing was introduced, through which the dependency of regions and municipalities on subsidies from the state budget was reduced. The measure was conceived as fiscally neutral for the state budget. The impact was offset by reducing the subsidies to local budgets as well as by shifting a part of the sources of the State Fund for Transport Infrastructure from the revenues from mineral oil excise taxes to the state budget.

8.2 New Challenges

Public private partnerships (PPP)

As most transitional economies, the Czech Republic is in the process of preparing its first PPP projects. The Act on Concession Agreements and Concession Management (the Concession Act) is now passing through the Chamber of Deputies. The aim of this act is to create a corresponding legal framework for engaging the private sector in provision of goods that have so far been exclusively provided by the public sector. The government will continue to use its prudent approach to state guarantees and the creation of implicit government obligations, including obligations arising in connection with public private partnerships.

Generally, PPP projects are costly and long-term in nature and therefore may significantly affect the development of the government deficit and debt. A large part of the projects are expected to be implemented on the regional or district level, which could cause a noticeable increase in their liabilities in future years. Along with the Concession Act, other related legislation is being deliberated in the Chamber of Deputies as well, such as an amendment to the Act on Budgetary Rules and on budgetary rules for regional government and municipalities, which extends the mandatory content of the medium-term outlook for monitoring obligations arising from concession agreements throughout their duration.

[21] *The regional government authorities are represented in the Public Finance Committee by the Association of Regions of the Czech Republic and the Alliance of Municipalities and Districts of the Czech Republic. The central body of the Alliance of Regions of the Czech Republic is the Council of the Association of Regions of the Czech Republic made up of the heads of the regions. These regional heads may adopt binding resolutions of a strategic nature after consultation in their regional councils.*

An integrated state treasury system

The government has approved its intention to create a state treasury. The preparation phase of the "Integrated State Treasury System" project is taking place at this time. The aim of this new state treasury system is to create an effective instrument for administering state finances, ensuring the effective management of state financial operations and access to reliable information on state revenues and expenditures in real time. In addition, the budgetary processes and accounting data should be centralised and a fully integrated double-entry accounting system should be introduced globally for the entire general government. The consolidation of data obtained from accounting should be simplified, the controls should be automated, and administration of the government debt and liquidity should be perfected. The project will also introduce a single-account state treasury system. The project aims should be completed in 2011, and the pilot operation of selected sub-projects will most likely be launched during 2006.

Integration of the programming and budgeting of European and national resources

Co-financing from the structural funds and the Cohesion Fund will become an important resource for the National Reform Programme policies[22]. The Czech Republic is preparing additional steps for maximizing absorption of resources from the structural funds and the EU Cohesion Fund, especially increasing the absorption capacity of public administration and effective utilisation of these resources. This allows a transition over to integrated programming of public expenditures and introducing efficient and result-oriented budgeting in state administration along with the related control and assessment mechanisms. This involves, in particular, integrating the programming of European and national funds, including incorporation of the resources of the structural funds and the Cohesion Fund into the national budgetary process.

The Czech Republic has already implemented certain measures for simplifying and speeding up the system of financial flows from the structural funds and the Cohesion Fund to end recipients. It is also preparing a system in which the comprehensive allocation to the end-recipients (i.e. the European and national part) will be paid from state budget after carrying out the relevant controls. The payment authority will then refund the resources corresponding to the European part of co-financing to the revenue account of the state budget headings. This system will be gradually introduced starting from 2006 and should be fully functional on 1 January 2007.

[22] *The National Reform Programme was created to be fiscally neutral, and in this way, its consistency with the Convergence Programme and the Czech Republic's obligations arising from the procedures in respect to an excessive deficit has been secured.*

9 Annexes

9.1 Table annex

Source: Czech Statistical Office, Czech National Bank, Ministry of Finance

Table 9.1: Economic growth *(CZK billion, increase in %)*

	ESA code	Year 2004 level[1])	Year 2004 rate of change	Year 2005 rate of change	Year 2006 rate of change	Year 2007 rate of change	Year 2008 rate of change
1. Real GDP	B1*g	2669	4,4	4,8	4,4	4,2	4,3
2. Nominal GDP	B1*g	2750	7,6	5,7	6,7	7,0	7,4
Components of real GDP							
3. Private consumption expenditure	P3	1343	2,1	2,3	3,5	3,6	3,6
4. Government consumption expenditure	P3	592	-2,0	-0,6	-0,2	-0,5	-0,5
5. Gross fixed capital formation	P51	737	7,6	2,8	3,4	4,8	7,5
6. Changes in inventories and net acquisition of valuables as a % of GDP [2])	P52+P53	9	0,3	-0,4	0,3	0,6	0,7
7. Exports of goods and services	P6	1938	21,9	9,5	10,2	9,8	10,0
8. Imports of goods and services	P7	1950	18,4	3,9	8,8	8,9	9,8
Contribution to GDP growth							
9. Final domestic demand			2,6	1,8	2,6	2,9	3,6
10. Change in inventories and net acquisition of valuables	P52+P53		0,1	-1,0	0,6	0,3	0,2
11. External balance of goods and services	B11		1,7	4,0	1,2	1,0	0,6

1) Real GDP and GDP components level are in prices of previous year
2) From current prices

Table 9.2: Price development *(%)*

	Year 2004 level[1])	Year 2004 rate of change	Year 2005 rate of change	Year 2006 rate of change	Year 2007 rate of change	Year 2008 rate of change
1. GDP deflator	155,4	3,0	0,9	2,2	2,8	3,0
2. Private consumption deflator	146,0	2,7	1,5	2,4	2,3	2,9
3. HICP	108,7	2,6	1,5	2,2	2,0	2,1
4. Public consumption deflator	164,8	5,2	5,3	4,5	4,5	4,4
5. Investment deflator	126,8	1,7	0,3	0,7	0,4	1,2
6. Export price deflator (goods and services)	114,6	1,8	-2,4	-0,3	1,9	2,0
7. Import price deflator (goods and services)	102,1	1,7	-0,6	0,1	1,3	1,6

1) For deflators, 1995=100%, for HICP, 2000=100%

Table 9.3: Labour market development

	ESA code	Year 2004 level	Year 2004 rate of change	Year 2005 rate of change	Year 2006 rate of change	Year 2007 rate of change	Year 2008 rate of change
1. Emloyment, 1000 persons [1])		4849	0,1	0,9	0,8	0,5	0,4
2. Employment, mill. hours worked [2])		9487	0,5	0,9	0,8	0,5	0,4
3. Unemployment rate (%) [3])		8,3	8,3	7,9	7,4	7,1	6,9
4. Labour productivity, persons (1000CZK/person) [4])		567	4,4	3,8	3,6	3,6	3,9
5. Labour productivity, hours worked [5]) (CZK/hour)		290	3,9	3,8	3,6	3,6	3,9
6. Compensation of employees	D.1	1178	5,4	5,2	5,3	6,0	6,5

1) Employed population, domestic meaning of the definition of national accounts
2) Definition according to national accounts
3) Harmonised definition, Eurostat; level
4) Real GDP per employed person
5) Real GDP per hour worked

Table 9.4: Analysis of the change in the net financial position

% of GDP	ESA code	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008
1. Net lending/borrowing vis-a-vis the rest of the world	B.9	-5,2	-2,6	-2,2	-0,6	0,8
	of whith					
-Balance on goods and services		-0,3	2,1	2,8	4,1	4,7
-Balance of primary incomes and transfers		-4,8	-4,8	-5,2	-5,2	-5,0
-Capital account		0,2	0,2	0,4	0,7	1,3
2. Net lending/borrowing of the private sector	B.9	-2,2	2,2	1,6	2,7	3,5
3. Net lending/borrowing of general government	B.9	-3,0	-4,8	-3,8	-3,3	-2,7
4. Statistical Discrepancy		0,0	0,0	0,0	0,0	0,0

Table 9.5: General government budget

	ESA code	Year 2004	Year 2004	Year 2005 (1)	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)
		CZK bill			% of GDP		
Net lending (B9) by sub-sectors							
1. General government	S.13	-83,5	-3,0	-4,8	-3,8	-3,3	-2,7
2. Central government	S.1311	-81,3	-3,0	-4,9	-3,5	-3,0	-2,4
3. State government	S.1312						
4. Local government	S.1313	-2,2	-0,1	-0,1	-0,3	-0,3	-0,3
5. Social security funds	S.1314	-0,1	0,0	0,1	0,0	0,0	0,0
General government (S13)							
6. Total revenue	ESA	1 145,0	41,6	41,1	40,2	39,8	40,9
7. Total expenditure	ESA	1 228,5	44,7	45,9	44,0	43,1	43,6
8. Net lending/borrowing	EDP B.9	-83,5	-3,0	-4,8	-3,8	-3,3	-2,7
9. Interest expenditure (incl. FISIM)	EDP D.41	34,7	1,3	1,3	1,3	1,3	1,5
p.m. : FISIM		0,0	0,0	0,0	0,0	0,0	0,0
10. Primary balance		-71,1	-2,6	-4,1	-3,0	-2,4	-1,7
Components of revenues							
11. Total taxes		588,6	21,4	21,2	20,4	19,9	20,0
11a. Taxes on production and imports	D.2	327,2	11,9	11,8	11,9	11,6	11,3
11b. Current taxes on income, wealth etc.	D.5	260,6	9,5	9,3	8,5	8,3	8,6
11c. Capital taxes	D.91	0,8	0,0	0,0	0,0	0,0	0,0
12. Social contributions	D.61	419,4	15,3	15,2	15,2	15,1	15,0
13. Property income	D.4	22,3	0,8	0,5	0,5	0,5	0,4
14. Other		114,7	4,2	4,1	4,1	4,4	5,5
15. Total revenue	TR	1 145,0	41,6	41,1	40,2	39,8	40,9
p.m.: Tax burden		1 008,0	36,7	36,4	35,7	35,0	34,9
Components of expenditures							
16. Collective consumption	P.32	311,4	11,3	11,2	11,0	10,6	10,2
17. Total social transfers	D.62+D.63	639,2	23,2	23,1	22,7	22,1	21,6
17a. Social transfers in kind	D.63	310,7	11,3	11,3	11,0	10,7	10,5
17b. Social transfers other than in kind	D.62	328,5	11,9	11,8	11,7	11,4	11,2
18. Interest expenditure	EDP D.41	34,7	1,3	1,3	1,3	1,3	1,5
19. Subsidies	D.3	59,3	2,2	2,3	2,1	2,0	2,0
20. Gross fixed capital formation	P.51	138,7	5,0	5,2	5,2	5,3	6,1
21. Other		45,3	1,6	2,9	1,7	1,7	2,2
22. Total expenditures	TE	1 228,5	44,7	45,9	44,0	43,1	43,6
p.m.: Compensation of employees	D.1	222,2	8,1	8,0	7,8	7,6	7,3

(1) Estimate

(2) Trend values or period averages

Table 9.6: General government debt

% of GDP	Year 2004	Year 2005 (1)	Year 2006 (2)	Year 2007 (2)	Year 2008 (2)
1. Gross debt	36,8	37,4	37,1	37,9	37,8
2. Change in gross debt	0,0	0,6	-0,3	0,8	-0,1
Contributions to change in gross debt					
3. Primary balance	1,8	3,5	2,5	2,0	1,2
4. Interest expenditure (incl. FISIM)	1,3	1,3	1,3	1,3	1,5
5. Stock-flow adjustment	-0,5	-2,3	-1,8	-0,1	-0,2
- Difference between cash and accruals	-0,2	-0,5	-0,1	0,0	0,0
- Net accumulation of financial assets	-0,6	-3,5	0,0	0,0	0,0
of which: Privatisation proceeds	-0,6	-3,5	0,0	0,0	0,0
- Valuation effects and other	0,3	1,8	-1,7	-0,1	-0,1
p.m. implicit interest rate on debt	3,7	3,7	3,8	3,9	4,1
Other relevant variables					
6. Liquid financial assets	-	-	-	-	-
7. Net financial debt	-	-	-	-	-

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

Table 9.7: Cyclical development [(a)]

% of GDP	ESA code	Year 2004	Year 2005 (1)	Year 2006 (2)	Year 2007 (2)	Year 2008 (2)
1. Real GDP growth (%)		4,4	4,8	4,4	4,2	4,3
2. Net lending of general government	**EDP B.9**	-3,0	-4,8	-3,8	-3,3	-2,7
3. Interest expenditure (incl. FISIM)	**EDP D.41**	1,3	1,3	1,3	1,3	1,4
4. Potential GDP growth (%)		3,6	4,3	4,3	4,3	4,5
contributions:						
- labour		0,0	0,2	0,1	0,1	0,1
- capital		1,1	1,2	1,1	1,1	1,2
- total factor productivity		2,5	2,9	3,1	3,1	3,1
5. Output gap		-0,4	0,1	0,1	0,0	-0,2
6. Cyclical budgetary component		-0,1	0,0	0,0	0,0	0,0
7. Cyclically-adjusted balance (2 – 6)		-3,0	-4,8	-3,8	-3,3	-2,7
8. Cyclically-adjusted primary balance (7 – 3)		-1,7	-3,5	-2,5	-2,0	-1,2

(a) Member states may complete rows 4 to 8 using their own figures or those of the Commission.
(1) Estimate
(2) Trend values or period averages

Table 9.8: Divergence from the previous update

% of GDP	ESA code	Year 2004	Year 2005 (1)	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)
		GDP growth				
previous update		3,8	3,6	3,7	3,8	
latest update		4,4	4,8	4,4	4,2	4,3
Difference		0,6	1,2	0,7	0,4	
		Actual budget balance				
previous update	**EDP B.9**	-5,2	-4,7	-3,8	-3,3	
latest update	**EDP B.9**	-3,0	-4,8	-3,8	-3,3	-2,7
Difference		2,2	-0,1	0,0	0,0	
		Gross debt levels				
previous update		38,6	38,3	39,2	40,0	
latest update		36,8	37,4	37,1	37,9	37,8
Difference		-1,8	-1,0	-2,1	-2,2	

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

Table 9.9: Long-term sustainability of public finances

% of GDP	Year 2000	Year 2005	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050
Total expenditure	42,1	45,9	43,0	43,3	45,8	51,2	57,6
of which: **Age-related expenditure**	19,9	20,0	19,0	19,1	21,0	24,5	27,3
Pension Expenditure	8,7	8,3	7,9	8,1	9,2	11,8	13,5
Social security pensions	8,7	8,3	7,9	8,1	9,2	11,8	13,5
Old-age and early pensions	7,7	7,5	7,2	7,4	8,4	11,0	12,8
Other pensions	1,0	0,8	0,7	0,8	0,8	0,8	0,7
Occupational pensions	-	-	-	-	-	-	-
Health care	6,0	6,6	6,5	6,9	7,5	8,3	9,1
Long-term care	0,2	0,3	0,3	0,3	0,4	0,5	0,6
Education expenditure	3,5	3,7	3,2	2,8	2,9	3,0	3,1
Other age-related expenditures	1,4	1,1	1,0	1,0	0,9	1,0	1,1
Interest expenditure	0,9	1,3	1,1	1,3	2,0	3,9	7,5
Total revenue	38,5	41,1	40,9	40,9	40,9	40,9	40,9
of which: **Property income**	0,5	0,5	0,4	0,4	0,4	0,4	0,4
of which: **Pension contributions**	7,9	8,9	8,9	8,9	8,9	8,9	8,9
Pension reserve fund assets	0,0	0,8	4,9	14,2	17,4	3,8	0,0
of which: **Consolidated public pension fund assets**	0,0	0,0	0,0	0,0	0,0	0,0	0,0
	Assumptions						
Labour productivity growth	4,6	3,8	3,4	3,0	2,7	1,9	1,7
Real GDP growth	3,9	4,8	3,6	2,5	1,9	0,4	0,8
Participation rate males (aged 20–64)	86,3	84,3	84,6	87,4	87,1	84,4	85,6
Participation rates females (aged 20–64)	68,9	68,5	70,6	76,4	76,1	72,9	74,0
Total participation rates (aged 20–64)	77,6	76,4	77,6	81,9	81,6	78,7	79,8
Unemployment rate	8,8	7,9	7,3	6,5	6,5	6,5	6,5
Population aged 65+ over total population	13,8	14,0	15,5	20,8	23,6	26,8	31,0

Table 9.10: Basic assumptions

	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008
Short-term interest rate *(CZ) (annual average)*	2,4	1,9	-	-	-
Long-term interest rate *(CZ) (annual average)*	4,8	3,3	3,4	3,9	4,0
USD/EUR exchange rate *(annual average)*	1,24	1,26	1,24	1,24	1,24
Nominal effective exchange rate *(2000 = 100)*	116,4	123,5	126,1	128,3	130,5
Exchange rate CZK/EUR *(annual average)*	31,9	29,8	29,2	28,7	28,2
World GDP growth, excluding EU	5,2	4,8	4,6	4,7	4,8
EU GDP growth	2,3	1,5	2,0	2,3	2,4
Growth of relevant foreign markets	7,6	4,3	6,2	5,5	6,6
Growth of world import volumes growth, excluding EU	9,5	8,3	8,0	7,5	7,7
Oil prices *(Brent, USD/barrel)*	38,3	55,5	60,5	57,8	54,3