



Convergence Programme of the Czech Republic

(updated version)

November 2004

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1 Introduction

The Czech Republic hereby submits its first regular autumn Convergence Programme, by which it updates the extraordinary Convergence Programme submitted to the European Commission in May 2004. The document was elaborated in accordance with Council Regulation No. 1466/97, which imposes an obligation to present convergence programmes upon the Member States that do not participate in the euro area. The Convergence Programme was elaborated within the multilateral surveillance framework procedure laid down in Article 99 of the Treaty establishing the European Community and in line with the country-specific recommendations of the BEPGs and with their update for the Czech Republic, as adopted by the ECOFIN Council during the European Council meeting in June 2004 in Brussels. It also respects the ECOFIN Council Decision of July 5, 2004, on the existence of an excessive deficit in the Czech Republic and the ensuing Recommendation¹ to the Czech Republic, concerning remedial measures related to the excessive deficit.

From the formal point of view the Convergence Programme fully respects the principles defined by the European Commission in its “2001 Code of Conduct”. As far as its contents are concerned, the Czech government has not been able so far to meet either the reference value of the fiscal deficit set by the Protocol on Excessive Deficit Procedure, or the requirements of the Stability and Growth Pact regarding the medium-term target of budgetary balance or surplus. This is due to the current fiscal situation and fiscal burden, both of which problems the government is striving to solve by means of a multi-annual programme of fiscal consolidation.

The Excessive Deficit Procedure was initiated with the Czech Republic after its accession to the EU. Based on the acknowledgment of the existence of special circumstances, the Council decided to allow the excessive deficit situation to be remedied within a medium-term framework. The recommended strategy of fiscal consolidation was approved in accordance with the Convergence Programme submitted by the Czech Republic in May 2004. According to this, the general government deficit should not exceed 5.3 % of GDP in 2004 and 4.7 % in 2005; it should not be higher than 3.8 % of GDP in 2006 and than 3.3 % of GDP in 2007, so that the Maastricht reference criterion would be reliably and sustainably met in 2008. The updated Convergence Programme also reacts to other Council recommendations.

The Convergence Programme is based on the 2005 Draft State Budget as it was submitted by the government to the Chamber of Deputies of the Parliament. It also takes into account the fiscal notification of September 1, 2004, which was submitted to the Commission, and official statistical data from the Czech Statistical Office available in September 2004.

¹ Pursuant to Article 104 (7) of the Treaty Establishing the European Community

2 Economic Policy

In August 2004 a new Czech government was created and installed in office. The government confirmed in its Programme Declaration that it will follow up on the economic policy of previous governments, focussed in particular on promoting economic growth, reducing the unemployment rate and improving the competitiveness of the Czech economy, and will persist in the reform efforts that had been initiated. A new position of Deputy Prime Minister was established for the purpose of better coordination of economic policy and an Economic Council will be created, as an advisory and coordinating body to assist the government. An updated medium-term economic strategy will be prepared in the first half of 2005, relying on the following two basic pillars: the reduction of public finances deficit and effective promotion of economic growth.

The economic policy will in the following period aim first and foremost at the acceleration of economic growth and at the reduction of unemployment. The government will concentrate on improving the legislative and institutional environment for entrepreneurship in the Czech Republic, both for domestic and foreign entities, and on preparation of the labour force to be able to withstand global competition. To ensure long-lasting and sustainable prosperity, this aim will be incorporated into the final stages of public finance reform, so as to create the conditions for economic convergence with developed countries. Financing of joint programmes of the EU and the CR and promotion of expenditures on R&D and education have been made the budgetary priorities for 2005.

The economic policy of the government remains based on the 2004 update of the Broad Economic Policy Guidelines for the period 2003 – 2005 specified for the Czech Republic².

2.1 Government Objectives and Priorities

The government determined the following economic priorities in its Programme Declaration:

- Stabilization of public budgets and improvement of the effectiveness of public expenditure, with the aim of joining the euro area by 2010;
- Reduction of unemployment by creating better conditions for businesses, active employment policy (particularly in regions affected by structural imbalance) and enforcement of equal opportunities;
- Improvement of the legal environment for entrepreneurship, particularly in the area of bankruptcy legislation, shortening of waiting times for registration in the Commercial Register, introduction of measures aimed at reducing the administrative burden for entrepreneurs and simplifying the communication between entrepreneurs and state institutions; strengthening of law enforcement and continuation of the fight against the shadow economy;

² The 2004 update of BEPGs specified the following main challenges for the Czech Republic:

- Urgently ensure a further reduction of the general government deficit on a sustainable basis and the long-term sustainability of public finances;
- Continue to address the structural problems in the labour market;
- Improve conditions for accelerated productivity growth;
- Promote entrepreneurship and SMEs.

- Improvement of targeting and implementation of government programmes aimed at the promotion of entrepreneurship, so that these would effectively encourage investment in production and services with high value added, creation of new jobs and economic growth based on innovations, investments in modern technologies and on support of small and medium-sized enterprises;
- Support of science, research and education through the development of a knowledge-based society, wider access of the population to lifelong learning and increased government investment in research and development;
- Development of transport infrastructure, including the construction of a high-capacity transport infrastructure and the promotion of public passenger transport;
- Support of families with children through the creation of a favourable social and economic environment;
- Improvement of conditions for a better quality of life in rural areas and respect for the environment;
- Preparation and submission of draft reform of the pension system.

A prerequisite for meeting the said priorities is maintenance of a stable political and macroeconomic environment by applying an optimal economic policy mix. Economic policy is focused on speeding up the process of economic convergence and increasing the adaptability of the economy, in order to reduce the risk of an economic slowdown caused by asymmetrical shocks. Since the beginning of transformation, the characteristics of the Czech economy have moved much closer to those of EU countries, but a certain degree of economic misalignment and structural differences still persist and will persist even after joining the euro area. Stabilisation of fiscal policy, flexibility of the labour market and effective functioning of the financial markets will be crucial for making the Czech economy sufficiently responsive to changes.

Fiscal reforms will prevent the public finances from becoming a barrier to full participation in the euro area (due to excessive deficits and insufficient structural adjustment, notably on the expenditure side). The government is fully aware that completion of public finance reform is a basic prerequisite for achieving compliance with the Maastricht criteria.

2.2 Monetary and Exchange Rate Policy

As far as this area is concerned, all facts mentioned in the 2004 spring Convergence Programme remain valid. The main objective of the Czech National Bank's (CNB) monetary policy is to maintain price stability³, which is a prerequisite for balanced and long-term sustainable growth.

Monetary Policy and Inflation Targeting

Monetary policy is managed by direct inflation targeting. The inflation-targeting band has consistently decreased from 3-5 percent in January 2002 to 2-4 percent in December 2005. In

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

March 2004 the CNB set, sufficiently in advance, its inflation target for the period starting January 2006, defined as a 3 % year-on-year increase in the value of the consumer price index (CPI). The CNB will at the same time endeavour to ensure that actual inflation does not differ from this target by more than one percentage point in either direction. Inflation targets will remain in force until the Czech Republic joins the euro area. The small inflation differential between the inflation target set by the CNB and the price stability level proclaimed by the ECB⁴ reflects the necessity of long-term real convergence of the Czech economy with the euro area average.

Monetary Policy in the Period before the Single Currency's Adoption

The government and the CNB closely cooperate in the area of implementing the national Eurostrategy, formulated in the material *The Czech Republic's Strategy for the Adoption of the Single Currency*, jointly prepared by the government and the CNB in October 2003.

In accordance with conclusions of this document, analytical background papers for an annual assessment of the Czech economy's current and expected fulfilment of the Maastricht convergence criteria and an assessment of the degree of the Czech economy's alignment with the euro area were elaborated. The assessment was, together with the updated Convergence Programme, submitted to the Czech government and became a basis for the timing of the accession of the Czech Republic to ERM II and subsequent adoption of the single European currency. The results of an assessment of the fulfilment of the Maastricht convergence criteria and an assessment of the degree of the Czech economy's alignment with the euro area led the Ministry of Finance and the CNB to recommend the Czech government to postpone participation in ERM II for the moment. The expected date for the Czech Republic to join the euro area, as mentioned in the 2004 spring Convergence Programme (around 2009–2010).

The CNB also continuously updates the material *Future Steps in the Process of Preparation for the Introduction of the Single Currency in the Czech Republic* aimed at drafting specific measures to be taken by the central bank in institutional, technical-organizational and legislative areas, when the Euro is introduced.

2.3 Fiscal Policy

In the following period, fiscal policy will be based on a process of fiscal consolidation and gradual reduction of the current excessive deficit. This process was launched by the public finance reform approved in 2003⁵ and has become one of the main priorities of the new Czech government. According to this strategy, the general government deficit should not exceed 3.8 % of GDP in 2006 and 3 % in 2008. The adopted system of fiscal targeting is based on two pillars that anchor the budgetary process - on legally binding medium-term nominal expenditure ceilings for central government and on the policy of earmarking any higher-than-budgeted revenues for swifter deficit reduction. Measures carried out during the first stage of public finance reform were primarily aimed at reversing the inbuilt deficit tendencies of public finance and reducing the growth dynamics of general government deficit.

⁴ The ECB's declared target in the area of price stability in the euro area is a year-on-year difference in the harmonised index of consumer prices of slightly less than 2 %.

⁵ The approved fiscal consolidation strategy was described in detail in the Convergence Programme of the Czech Republic of May 2004; for more details see also Chapter 4.

In the next stage of public finance reform the Czech authorities will focus on neutralizing the fiscal impact of current economic policy priorities, i.e. of measures aiming to support the supply side of the economy and create conditions for faster growth of potential output, and on fiscal policy measures aiming for long-term sustainability of the fiscal targets achieved.

Current economic results show that in the years to come the economy will be operating close to its potential⁶, both in terms of its performance and the rate of growth. The fiscal framework approved by the government during the preparation of the draft 2005 state budget and the approved expenditure framework for 2006-2007 are based on expectations of an average annual decrease in central government deficit by 0.6 p.p. At a time of stronger growth, this will provide for the required extent of fiscal restriction and - together with automatic fiscal stabilisers - will contribute to a smoothing out of the economic cycle.

2.4 Structural Policies

Alongside fiscal consolidation, one of the main current challenges in the area of economic policy is the need to create suitable conditions for entrepreneurship and for the functioning of the labour market. These areas are crucial for accelerating potential growth, enhancing the competitiveness of the Czech economy and thus providing for faster convergence of the Czech Republic. Just like the area of fiscal policy (or rather the stabilising function of public finance) the labour market has to undergo such reforms as will be able to provide for an effective adaptation of the economy to external shocks.

Improving the Business and Investment Environment

As for structural reforms, the government pursues the policy described in detail in the spring Convergence Programme and in this year's National Report on Reforms on Product and Capital Markets. This includes an approved programme of tax burden reduction for the business sphere (see Subchapter 6.3), support of research and development (R&D) and programmes oriented towards small and medium-sized enterprises (SMEs) and towards support of technological and business centres.

Among the most criticised aspects of the business environment in the Czech Republic belongs the institutional and legislative framework of corporate bankruptcy, excessive delays in the registration of new companies (despite a recent shortening of waiting times) and corruption.

Therefore the government has made it to its priority to complete a full recodification of the bankruptcy legislation by the end of 2004⁷, in order to strengthen the role of creditors, reduce the interest of various parties in prolonging bankruptcy procedures and make it possible for viable parts of bankrupt businesses to be salvaged. An amendment to the Civil Procedure Code, aimed at improving the organisation of the Commercial Register to noticeably shorten the time needed for the setting up of a business particularly by shortening of waiting times for registration in the Commercial Register, is currently being debated by the Chamber of Deputies of the Parliament.

⁶ Under these circumstances the tax revenues will not significantly differ from their structural level and the cyclical component of budget deficit will be negligible (see Chapter 4).

⁷ The amendment should take effect as of January 1, 2006.

A project of setting up central registration offices within the existing network of Trade Licensing Offices is about to be launched. A new information system will be introduced at the Trade Licensing Offices, which provides for a centralised execution of state administration in this area. Furthermore, the system will allow for an exchange of information between relevant administrative authorities and particularly for communication with the Commercial Register. The existing network of information points for entrepreneurs, which are administered by the Economic Chamber of the Czech Republic, is another supporting element of the system. Based on this network, a fully-fledged service system for entrepreneurs, the so-called one-stop-shops, will be created.

A new integrated Public Administration Portal <http://portal.gov.cz> was set up, which includes - among other information - links to the servers of a range of public institutions that facilitate electronic communication between entrepreneurs and public administrative bodies. There is in particular the possibility of submitting tax returns for most types of taxes and customs declarations via the Internet. Although the number of electronically submitted tax returns is not very high as yet, it is growing at a rapid pace. In the first half of 2004 the number of all electronic submissions increased on a year-on-year basis by 7,263 submissions to 10,124 (i.e. by more than 250 %); 74 % of all submissions are signed with advanced electronic signature. Similarly, entrepreneurs can submit their social security premium electronically.

The government is preparing a range of measures aimed at improving the conditions for the establishment of stronger links between universities and research institutions acting in the area of R&D on the one side and business entities on the other side, and at integrating Czech companies more widely into the R&D activities of the EU.

Besides efforts aimed at reducing the tax burden imposed on the business sphere, the government is also preparing measures aimed at simplifying the tax legislation and making it more transparent.

Labour Market

The labour market in the CR is characterised by rather low flexibility, in particular by low mobility and flexibility of the labour force. The low flexibility results, among other things, in high unemployment rate, which is mainly of a structural nature. Therefore the government, when formulating its policies, focuses primarily on addressing the main causes of structural unemployment.

Box 2.1. Current Situation on the Labour Market

A persistently declining employment rate, accompanied by a stagnating unemployment rate, which fluctuates between 7.3 % and 8 %*, is a defining feature of the Czech labour market. Unemployment is mainly of a structural nature and the factors causing the low level of flexibility can be found on both sides of the labour market. The structural nature of unemployment can also be illustrated by the high proportion of long-term unemployed (the proportion of long-term unemployed has been around 50 % in recent years). There remain significant differences in regional unemployment rates (Prague, the capital - 3.9 % compared with the region of Moravia-Silesia - 14.5 %)**. The rate of economic activity declined from 73.5 % in 1994 to 71.1 % in 2003. Increasing the retirement age does not influence the rate of economic activity to any significant extent, due to a growing number of other groups of non-active persons.

However, the unfavourable situation of the labour market contributes to stable wage development and eliminates potentially extreme wage claims. This fact is also supported by the decentralisation of wage bargaining to the level of individual companies, with only about 25 – 30 % of employees covered by collective wage bargaining.

The key structural shortcomings of the Czech labour market include in particular low regional and professional mobility of workers, untransparent system of social benefits with low frequency of assessing the social situation of individual claimants, high taxes on labour especially for low-income groups of citizens, a complicated process of dismissals of individual workers for employers and the non-existence of any universal lifelong learning scheme. From the institutional point of view, the rigidities of the labour market are encouraged by a limited use of legislation for fixed-term contracts and the remaining regulation of housing prices.

**) according to ILO*

***) according to ILO, in the 2nd quarter of 2004*

With the aim of increasing the flexibility of the supply side of the labour market, a new Act on Poverty and an amendment to the Minimum Subsistence Amount Act, expected to come into effect as of January 1, 2006, are being prepared at present. The changes proposed to the system of social protection of citizens would mean first of all that the minimum subsistence amount would be construed on the basis of one component only (instead of the two components currently used for its calculation). The protection in the area of housing will be solved in an independent way by introduction of two new benefits, that ensure specific circumstances of individual families and the price of housing in different regions to be taken into account more strongly than in the past. In the minimum subsistence amount the ranking of members in numerous families should be newly cater and it should also reflect the so-called “savings from numbers”. A new concept of the minimum subsistence amount is about to be introduced to increase motivation of adult persons who have got into material poverty; the concept should increase their activity on the labour market by using bonuses to raise the minimum subsistence amount. Abolition of the ban on the simultaneous drawing of selected social benefits and earned income should also strengthen the motivation for higher participation in the labour market.

The purpose of proposed changes is to prevent the system of social benefits from being misused, increase its efficiency and motivate persons living on social benefits to seek and keep a job. Introduction of the proposed changes will increase the difference between income from labour and social benefits. This will result in a mitigation of the non-activity trap, particularly for low-income groups of citizens. Moreover, the tax-deductible child allowance has been replaced by a tax credit (including non-wastable tax credit) in order to support families with children, as of January 1, 2005. The above-mentioned measures should increase the flexibility of the labour market and bring down the unemployment rate. Furthermore, the proposed changes should help to slow down the growth of expenditure on state social support, which will facilitate compliance with planned expenditure frameworks in the area of state social support and contribute to a relative decrease in the weight of mandatory expenditure in the state budget.

The same aim of increasing flexibility in the supply side of the labour market is being pursued by the new Act on Employment, which came into effect as of October 1, 2004. The most important changes include the creation of an institutional framework that allows for the successful functioning of private, profit-based, labour agencies and introduction of several new tools of active employment policy that are to reduce the frictional unemployment. The new act also increases requirements imposed on the long-term unemployed (those who remain unemployed for more than one year). They have to agree to carry out eight hours of community-useful jobs a month, in order to keep their entitlement to social benefits.

A new programme of subsidies for employers approved by the government is aimed at promoting the creation of new jobs in regions that are worst affected by unemployment, should contribute to the reduction of regional disparities in unemployment.

The government also focuses also on eliminating skills mismatches between labour supply and demand at a time when the structure of the economy and the structure of employment change rapidly (especially on a regional scale), while the system of labour force education and training is only capable of gradual adaptation⁸. New legislation, which covers primary and secondary education (at the level ISCED 0-4), as well as the new Higher Education Act and Act on Continuing Education which are currently in preparation, is aimed at increasing the flexibility of graduates to suit the needs of a quickly changing society and quickly changing labour market requirements. The objective of this act is also to create an open system of continuing education, which should restrict neither the providers of education nor those who want to be educated. The aim is to strengthen the links between initial and continuing education. This should make it possible for everyone (regardless of age) to attain a certain level of education, insofar as they demonstrate an appropriate level of competence, knowledge and skills.

⁸ This has already been reflected e.g. in the extension of the average length of education, which reached 16.7 years in 2004.

3 Macroeconomic Scenario

Expected development of the Czech economy can be illustrated by means of a quantitative macroeconomic scenario. Scenario's preparation has been motivated by an effort to apply conservative and realistic approach assessing positive and negative risks of the economic developments in a balanced way. The scenario has been arrived at by a combination of formal (economic modelling) and less formal methods of economic forecasting. Changes compared to the previous Convergence Programme scenario made in May 2004 are summed up in Chapter 5.1. Sensitivity analysis of some macroeconomic indicators in dependence on exogenous variables is described in Chapter 5.3. Feasibility of the scenario has been verified by a formalised survey among representatives of both the Czech government agencies and private organizations engaged in macroeconomic forecasting (see Chapter 9.1).

3.1 Recapitulation of the Current Developments

Current Czech macroeconomic developments can be characterized as favourable.

A rise in economic growth dynamics can be observed (to 4.1 per cent in the second quarter of 2004 in year-on-year terms), driven by a higher investment activity and, recently, also by a leap in the economy's export performance. Growth acceleration is of both structural and cyclical character. Pace of potential product growth is increasing mainly thanks to robust growth of total factor productivity, closing, at the same time, a negative output gap.

Since early 2004, year-on-year growth of consumer prices has been accelerating (to 3.5 per cent in October 2004). It reflects impacts of administrative measures (especially harmonization in excise taxes and VAT), growth of food prices and increasing commodity prices on the world markets.

Fall in employment still persists (by 0.8 per cent in the second quarter of 2004 in year-on-year terms) and so dynamic economic growth is generated exclusively by rising labour productivity. Rate of seasonally adjusted registered unemployment peaked in March 2004, stagnating or slightly falling since then.

External balance expressed by means of current account deficit to GDP ratio is worsening slightly (-6.4 per cent at the end of the first half of 2004). It results from ongoing deepening of balance-of-income deficit; on the other hand, trade balance has been improving in spite of high oil prices.

3.2 Assumptions on External Environment

Assumptions on development of the external environment's key indicators having relevance for the macroeconomic forecast of the Czech Republic are summed up as follows:

Table 3.1: Assumptions on External Environment

		Year 2003	Year 2004	Year 2005	Year 2006	Year 2007
USD/EUR exchange rate	<i>(annual average)</i>	1.13	1.22	1.21	1.22	1.22
EU-15 GDP	<i>(real GDP growth, y/y, in %)</i>	0.9	2.1	2.4	2.8	2.9
Germany GDP	<i>(real GDP growth, y/y, in %)</i>	-0.1	1.6	1.8	2.0	2.4
Oil prices	<i>(Brent, USD/barrel)</i>	28.8	36.8	35.9	34.0	33.0

Source: EC

Main features of the scenario of the Czech economy's external environment can be summed up as follows:

- World economy recovery is strengthening. It is led by the US economy, which grew by 3 per cent in 2003 and whose growth in this year is estimated at some 4.5 per cent, and also by Japan's economy, developing in a similar way. The growth momentum seen in EU-15 and especially in the euro area is lagging behind but the first-half year data point to strengthening recovery. The steep appreciation of the euro against the US dollar stopped in the second and third quarters of 2004 while oil prices are still soaring.
- US economy growth should reach its maximum in 2004. With the effect of tax cuts fading away, growth of consumption will probably slow down as suggested by the second-quarter of 2004 results. Rising current account deficit accompanied by growing budget deficit is seen as the biggest risk for the economy's growth. This twin deficit is one of the causes of higher interests, which will result in hindering the economy. Weakening of the US dollar has had no impact on external imbalance of the US economy so far.
- Recovery in EU-15 is strengthening, albeit only moderately. It is conditioned by a rise in domestic demand, as growth of EU-15 countries is extremely dependent on exports. The German economy, which is the largest Czech trading partner, keeps growing below the EU average in the long run and will show the greatest downside divergence from its potential.
- The enlargement may influence the Union's performance positively in several respects. The acceding countries including four Central European countries display a considerably higher growth than EU-15. Also lower saturation of their internal markets will enhance demand within the EU. Despite initial constraints, enhanced labour mobility in the enlarged EU-25 may act as a pro-growth factor.
- Dollar oil prices reached USD 41.5 per barrel in the third quarter and keep growing at present; however, they are expected, in our scenario, to peak over the last quarter of 2004. Also growth of world prices of non-fuel commodities, especially metals, which are soaring at present, should stop (there are indications in October data that boom of metal prices has already peaked). Possible further growth of prices on commodity markets could endanger recovery in the EU and partially also hinder the Czech economy's dynamics.

We regard the presented scenario as slightly optimistic. Its risks are seen in possibility of further strengthening of the euro and, mainly, in further rise in oil prices (or even in prices remaining at the present high level). Also increased geopolitical risks re-emerge, shown

mainly in aggravation of the Middle East situation. Further escalation of this development would obviously hit European growth mainly as it is both sensitive to changes in export opportunities and dependent on oil and gas imports.

For the period 2006 to 2007 further, even if moderate, acceleration of EU GDP dynamics is expected. It will be amplified by the impetus stemming from EU enlargement. Growth in the EU-15 over this period is expected at some 2.8 per cent. This scenario is based on assumptions of stability of world commodity prices and financial markets, political stability in broader region and absence of further unpredictable events, which might have a global impact (e.g. acts of international terrorism).

EU accession will manifest itself in gradual underlining of trends and tendencies, which began in the pre-accession period, as shown also by growing GDP dynamics. The Czech economy will gradually start enjoying the benefits of joining the common market and an improvement of institutional environment.

3.3 Economic Output

The Czech Statistical Office has made a revision of national accounts, which are the key database for macroeconomic analyses and forecasts.

Box 3.1: Extraordinary Revision of National Accounts

National accounts of the Czech Republic and aggregates based on them are going through an extraordinary revision. In the period from October 2003 to September 2004 the Czech Statistical Office released revised time series of annual and quarterly data in current and constant prices for 1995 – 2003.

Changes compared with the previous data can be summed up in three points:

1. Harmonization with ESA 1995 standards has been made. The adjustment has covered a review of estimate of fixed capital consumption, now based on reproduction prices, with new inclusion of fixed capital formation used for providing of non-market services (roads, motorways, water supply, sewerage etc.). Further, changes have been made in calculation of imputed rents for households living in their own houses or flats, estimates of wages in kind and given tips have been revised and other changes of minor importance have been made.
2. Some economic entities have been additionally included in statistical register, inaccuracies have been removed and newly identified facts have been taken into account.
3. The CSO has proceeded to a change in a method of GDP in constant prices calculation. Estimate derived from base-year prices has been replaced by a method based always on average prices of the previous year. Time series in constant prices is constructed by means of chaining of year-on-year increases.

Advantage of the method based on average prices of the previous year and subsequent chaining consists in providing a better reflection of the current price and volume structure of the economy while results are not influenced by change in GDP structure compared with the selected reference year. On the other hand, the final data in constant prices are not fully additive ones and methodical discrepancies appear (e.g. between the size of GDP and a sum of its individual components of use).

Level of gross domestic product in current prices has increased after the revision; by CZK 122 bn, i.e. 5.1 per cent, to be explicit. Due to it, values of ratios related to GDP have changed.

As regards expenditure components, the revision has increased gross fixed capital formation and government consumption most (by 16.2 per cent, i.e. CZK 84 bn and 7.8 per cent, i.e. CZK 49 bn, respectively). Household

consumption has increased by 1.5 per cent i.e. CZK 19 bn. Change in inventories and valuables has fallen by CZK 30 bn. Balance of foreign trade in goods and services has not been affected by the revision.

Economic growth accelerated to 3.1 per cent in 2003. On demand side, growth was driven by high dynamics of household consumption mainly. Investment spending recovered visibly, too. In the first half of 2004, growth continued accelerating, reaching 3.8 per cent. Economic dynamics shifted from consumption toward investments, which may be evaluated bluntly as positive as conditions for acceleration of potential growth are thus created.

Table 3.2: Economic Growth

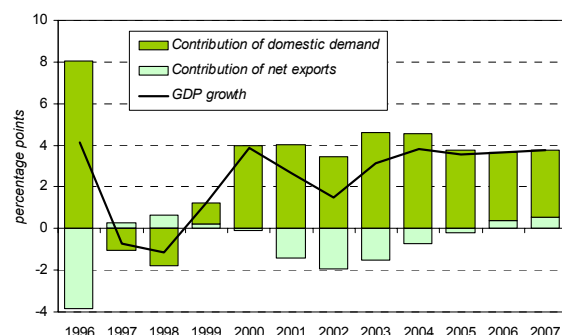
	ESA code	Year 2003	Year 2004 (1)	Year 2005 (1)	Year 2006 (2)	Year 2007 (2)
GDP growth at constant market prices (7 + 8 + 9)	B1g	3.1	3.8	3.6	3.7	3.8
Sources of growth: percentage changes at constant prices						
1. Private consumption expenditure	P3	4.9	3.6	3.4	3.4	3.6
2. Government consumption expenditure	P3	2.2	-1.2	-0.2	-0.2	-0.1
3. Gross fixed capital formation	P51	7.4	9.3	7.0	5.4	5.0
4. Changes in inventories and net acquisition of valuables as a % of GDP	P52+P53	1.2	1.9	2.1	2.2	2.3
5. Exports of goods and services	P6	6.2	16.5	11.1	7.9	8.0
6. Imports of goods and services	P7	7.8	16.8	11.1	7.3	7.3
Contribution to GDP growth						
7. Final domestic demand		5.0	4.0	3.6	3.1	3.1
8. Change in inventories and net acquisition of valuables	P52+P53	-0.4	0.6	0.2	0.1	0.1
9. External balance of goods and services	B11	-1.5	-0.7	-0.2	0.4	0.6

Source: CSO, MoF calculations

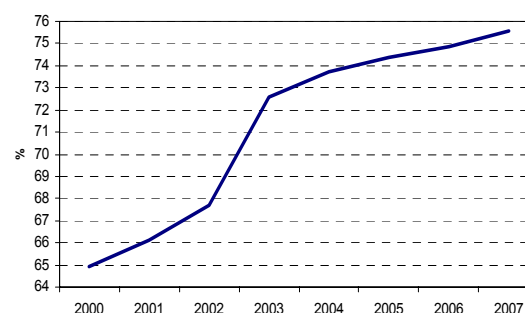
Within the horizon to 2007, the Czech economy growth is expected to oscillate in the range between 3.5 – 4.0 per cent. The dynamics is grounded on potential output acceleration based on the assumption of positive benefits of structural policies. Intensity of growth will also depend on the level of recovery enjoyed by our main trading partners, ongoing inflow of foreign investment, and results of fiscal consolidation under way. Besides, we expect positive effects following the accession of the Czech Republic to the EU to come on stream.

Process of real convergence will continue. Economic level of the Czech Republic (PPP-adjusted GDP p.c.) against the EU-25 will, under this scenario, increase by some 3 percentage points to approximately 76 per cent in 2007 compared with 2003.

Graph 3.1: Decomposition of the Rate of Growth of GDP



Graph 3.2: GDP in Parity per Capita (EU-25 = 100)



Sources: CSO, Eurostat (Structural indicators) – preliminary data, MoF calculations

Demand Side

As regards domestic demand, extremely fast growth of household consumption (including NPISH) by nearly 5 per cent in 2003 was a one-off episode, conditioned by low inflation, high growth of real wages and low interest rates. In the years to come, household expenditures on consumption should grow approximately in proportion to GDP growth provided that growth of average real wage is adequate and stable. Slower growth of unit labour costs in comparison with GDP deflator growth should enable an increase in economic output in an environment characterized by low domestic inflationary pressures and improved economic situation of the business sector.

Government consumption should stagnate or fall slightly in real terms. Public finance reform will lead to economical behaviour on the part of government institutions in terms of both government sector employment and purchases of goods and services.

Economic growth is based, first of all, on high rate of investment activity. A lead of growth of gross fixed capital formation, ranging from 5 to 9 per cent, on growth of GDP should continue in the coming years too. Growth of investment should be boosted by means of improving financial situation of the business sphere and promising export prospects connected with EU entry and growth in partner countries. This investment wave should lead to enhancement of new highly competitive export capacities, which will accelerate tendency to improve the trade balance.

Contribution to GDP growth on the part of trade balance in goods and services in constant prices should thus start reaching positive values from approximately 2006. It will depend on fulfilment of assumptions concerning developments of the external environment, start-up of new technological units and developments of domestic demand.

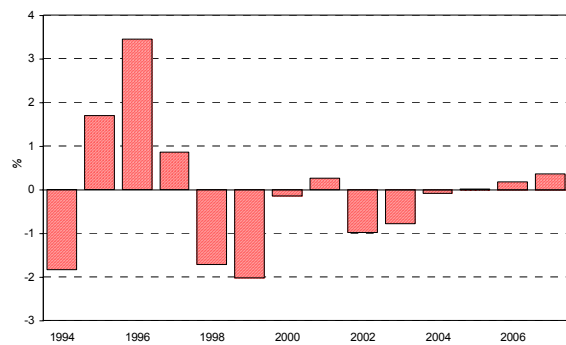
External environment is still seen as risk for economic growth, especially as prices on commodity markets are concerned. If gradual cuts in the deficit fail to be enforced in conformity with the fixed schedule, public finance imbalance would remain the most serious problem in the medium term.

Position within the Economic Cycle

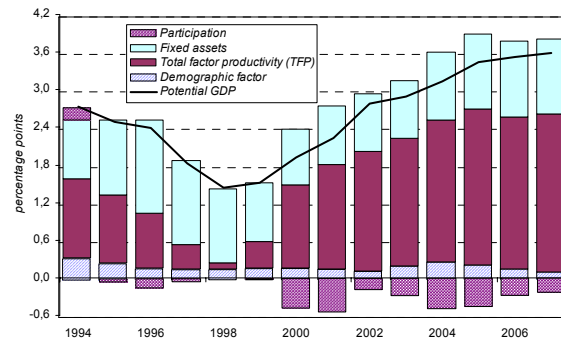
In our estimate, based on the Cobb-Douglas production function⁹, negative output gap has closed in the first half of 2004. It is assumed that macroeconomic policies will be flexible enough in the following years so that the extreme volatility of the economic cycle in the nineties would not repeat and the economy would get close to its potential.

⁹ *The potential product and the output gap have been calculated using a national methodology for the present. This methodology was described in PEP 2002. The main difference from the EC methodology proposal, important for the interpretation of results, is the "zero sum of output gaps over time" clause. Under this clause, and with similar growth rates of potential product, output gap of the Czech economy comes 1 to 2 percentage points higher.*

Graph 3.3: Output Gap



Graph 3.4: Growth of Potential Product



Source: MoF

As regards period to 2007, implementation of public finance reform and structural policy measures are expected to help speed up the current pace of potential product growth (estimated at some 3 per cent), bringing it above 3.5 per cent. If GDP grows at the projected pace, no significant positive output gap should appear. At the same time, growth trajectory of potential product implies a continuation of real convergence process to economic levels of EU states.

Growth of potential product should continue to be driven in particular by increases in total factor productivity. The latter should stem mainly from improvements in the economy's institutional parameters and level of the business environment and from introduction of new technologies related to the inflow of foreign direct investment.

Robust growth of gross fixed capital formation supported by inflow of foreign direct investment will also increase production potential of the economy. This will reflect both "productive investments" and investments in infrastructure (construction of highways, railway corridors, telecommunications network etc.), often carried out by means of Structural and Cohesion Funds.

If structural policy measures under preparation fail through, labour market functioning might endanger acceleration of potential product growth. Falling participation rate prevents the economy from using the ever-growing number of people who are still capable of economic activity.

3.4 Prices

The Czech economy can be described as a low-inflationary one. This is a result of positive impact of the inflation-targeting regime, affecting inflationary expectations of economic agents.

Price stability in 2003 was brought about mainly by cost factors. Price growth was counteracted by decrease of food and import prices with strong appreciation of the CZK against the USD and strong competition on the domestic consumer market. Stagnation of regulated prices and absence of other administrative interventions contributed to very low values of consumer price growth, too. Price developments were also influenced by the fact that economic output was below its potential for quite a long time.

However, influence of these factors faded away in late 2003. Year-on-year depreciation of the exchange rate against the euro started to be seen, and turnaround in agriculture producer prices occurred, which reflected in prices of vegetable food mainly. In 2004 these developments have been further amplified by a rise in indirect taxation and growth of world oil prices with expected average national CPI inflation rate reaching 2.9 per cent (HICP 2.7 per cent).

Table 3.3: Prices of Goods and Services

	Year 2003	Year 2004	Year 2005	Year 2006	Year 2007
Percentage changes					
HICP	-0.1	2.7	3.2	2.6	2.2
National CPI	0.1	2.9	3.3	2.8	2.5
GDP deflator	1.7	4.0	3.1	3.0	3.2
Consumption of households deflator	-0.7	1.9	2.3	1.8	1.5

Source: CSO, MoF calculations

Inflation scenario to 2007 is based on evaluating impacts of administrative measures, inflationary expectations and persistency, and developments of output gap, foreign prices and nominal exchange rate. Average rate of inflation should be at about 3 per cent with slightly downward tendency.

Inflation in 2004 is strongly determined by 1.6 p.p. increase in the contribution of administrative measures to price level growth. This contribution results from tax harmonisation changes in excise duties and VAT under the public finance reform, and acceleration of regulated price growth. In the following years the inflationary contribution of administrative measures should stabilize at approx. 1 p.p.¹⁰

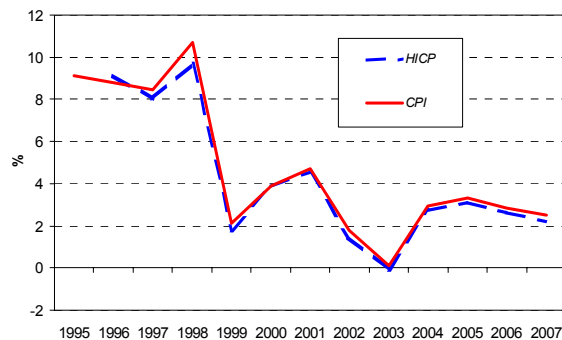
With real monetary conditions loosened, accelerating economic growth could gradually generate certain demand pressures in the economy, which in 2005 might follow up on impact of administrative measures, taking over the role of the main factor determining price developments. Acceleration of inflation on account of domestic demand environment should be counteracted by import prices, whose dynamics will be pushed down mainly by expected nominal appreciation of the exchange rate CZK/EUR and, implicitly, CZK/USD.

Zero or slightly positive output gap in 2005 to 2007 together with effects of persistency and inflationary expectations, which will partially reflect acceleration of inflation in 2004 due to administrative measures, will prevent inflation from decelerating more significantly after one-off effects fade away. Provided that no major supply shock appears (oil, prices of foodstuffs etc.), inflation in these years should stabilize near the centre of CNB's inflation target or slightly below it.

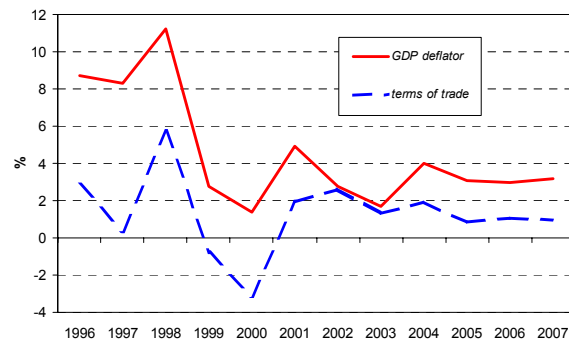
Growth of GDP implicit deflator for 2004 is estimated at 4.0 per cent. When the above-given assumptions materialize, its growth should roughly imitate the average rate of consumer price inflation in the following years.

¹⁰ As regards regulated prices, a significant group of network industries (electricity, gas and telecommunications) is influenced by developments in costs, technologies and level of competition on the market, with the role of final arbiter played by independent regulators. Other important item – regulated rents – is connected with considerable uncertainties due to an absence of any legislative norm preparing a path for deregulation.

Graph 3.5: Consumer Prices



Graph 3.6: GDP Deflator and Terms of Trade



Sources: CSO, MoF calculations

3.5 Labour Market and Wages

Decline in employment is seen as the current dominant trend on the labour market. Dynamic economic growth is assured exclusively by rising productivity of labour.

Unemployment, and particularly its prevailing structural character, is considered a potential risk to future macroeconomic developments. Spontaneous job creation has been insufficient even with the current growth and inflow of foreign investment. Existing bottlenecks (see 2.4) persist also due to relatively easy availability of welfare benefits.

All this results in a decline in labour force, which is in contradiction with the demographic developments, and high unemployment (especially the long-term one) with very negative social and economic consequences not only for the unemployed but for overall fiscal balance as well.

Table 3.4: Employment and Wages

	Year 2003	Year 2004	Year 2005	Year 2006	Year 2007
Percentage changes					
Employment	-0.7	-1.0	-0.3	0.1	0.2
Gross wages and salaries	5.6	5.3	6.2	6.4	6.6
Average real gross wage	7.7	3.0	3.2	3.7	4.0
Unit labour costs	2.6	1.6	2.6	2.7	3.0
Per cent					
Unemployment rate ILO	7.8	8.3	8.3	8.0	7.8
Rate of unemployment reg.	9.9	10.3	10.3	10.0	9.8
Employment rate 1)	65.6	64.6	64.1	63.9	63.9
Participation rate 2)	71.1	70.4	69.9	69.5	69.3

Source: CSO, Ministry of Labour and Social Affairs, MoF calculations

A reversal in the direction of unfavourable tendencies will depend on greater flexibility of both sides of labour market and on effectiveness of structural policies.

On the supply side, mainly an enhancement of the professional and qualification mobility of the labour force and its ability to respond to changing economic conditions are important.

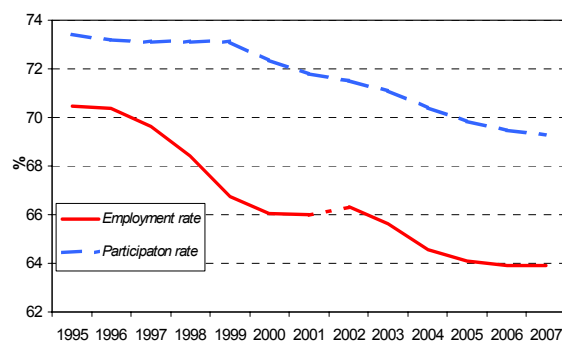
Some measures of public finance reform leading to a more active participation in the labour market (e.g. planned withdrawal of social benefits from the long-term unemployed who refuse to take part in public works, abolition of temporarily reduced early retirement pensions, removal of a ban on combination of some benefits with earnings, tax discounts for parents etc.) should help increase motivation to work.

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

On the demand side, higher employment will be boosted in particular by economic growth and by expansion of small and medium-sized businesses generating new job opportunities. Admittedly, foreign investment inflow creates only a limited number of new jobs (in view of the fact that these are more of investments in high-tech and high-productivity activities) but it will have indirect positive effects thanks to cooperation of domestic firms. A marked positive effect could be also obtained by reducing the tax burden on labour and by creating more flexible conditions for work contracts.

On the other hand, the ongoing restructuring process will result in higher pressure on productivity growth including closing down of non-efficient plants, a tendency to cut employment and changes in qualification requirements. Finding new jobs for employees thus made redundant together with solving the existing problems of regional character and long-term unemployment is and will be the main challenge for labour market functioning and a measure of structural policies effectiveness.

Graph 3.7: Employment¹¹ and Participation Rate



Graph 3.8: Unemployment Rate



Note: Rate of employment and of unemployment under LFS is incomparable between 2001 and 2002 due methodical changes.

Sources: CSO, Ministry of Labour and Social Affairs, MoF calculations

Unfavourable situation on the labour market has been contributing to stable wage developments by eliminating the possible extreme wage claims. A stable growth of average wages at about 6.5 per cent (3.0 – 4.0 per cent in real terms) is expected, which should keep the pace of growth of unit wage costs below the growth of GDP deflator.

Should the relevant structural policy measures be enforced, mitigation or stoppage of fall in participation rate should be observed with stabilization of employment and average rate of

¹¹ Rate of employment is defined as a ratio of all employed people to the number of population aged 15 to 64.

registered unemployment¹² starting falling after having peaked in 2004 and 2005 to 10.5 per cent. Failing that, there is a risk that the labour market will become a limiting factor of economic growth.

3.6 Balance of Payments

Deficit of the current account of balance of payments related to GDP has not changed significantly since the end of 2000. Process of improvement of the trade balance has been compensated by rising deficits of balance of income due to higher volume of reinvested and repatriated profits. These conflicting tendencies have resulted in current account deficit at 5.0 per cent to 6.5 per cent of GDP.

Under the customs statistics, trade balance deficit has been falling almost smoothly since reaching its maximum in the second quarter of 2001. Rising export performance, despite not too dynamic growth in EU states and in particular in Germany, documents improvement in domestic producers' competitiveness. Start-up of new export-oriented capacities, mainly as regards information and communication technologies, shows itself significantly.

Table 3.5: Current Account of the Balance of Payments

	Year 2003	Year 2004	Year 2005	Year 2006	Year 2007
pct of GDP					
Balance of trade	-2.7	-1.8	-1.4	-1.0	-0.6
- mineral fuels (SITC 3)	-2.7	-2.8	-2.8	-2.0	-1.6
- others	0.0	1.0	1.4	1.1	1.0
Balance of services	0.5	0.6	0.7	0.8	0.9
Balance of income	-4.6	-5.3	-5.7	-5.9	-6.0
Balance of transfers	0.6	0.5	0.7	0.8	0.9
Current account	-6.2	-6.0	-5.7	-5.3	-4.8

Source: CNB, CSO, calculations of the MoF

Scenario for the balance of payments is based on the assumption of ongoing long-term tendency toward real appreciation of the exchange rate, which is under way simultaneously with advancement of real convergence almost continuously for the whole period of transformation process. The real exchange rate against the euro (deflated by GDP deflators) appreciated on average by approximately 5 per cent yearly from 1998 to 2003. Gradual slight appreciation of the exchange rate against the euro should be heading for some 30 CZK/EUR by the end of 2007 with average real appreciation reaching some 3 per cent a year. Sensitivity analysis concerning the influence of different values of the exchange rate on macroeconomic developments is given in part 5.3.

Within the horizon of macroeconomic framework, export performance of the economy should further improve. In 2004 trade balance deficit will be noticeably below the level of 2003, as

¹² Over 2004, the Ministry of Labour and Social Affairs has been introducing new methodology of calculation of registered unemployment rate. Macroeconomic framework is based on time series under the original approach. The new way of calculation does not change neither the economic substance of the phenomenon nor the system of welfare benefit granting and as such will have no fundamental impact on the social transfer bill implied by the forecast of unemployment.

improvement of balance of non-fuel commodities will be more intensive than impact of high oil prices.

Tendency to cut the deficit of the trade balance will be connected with start-up of export-oriented productions (especially as regards the car industry and production of information and communication technology products) and improvement of terms of trade. Non-fuel part of balance of trade should run a permanent surplus. Growth of exports should more than compensate high intensity of investment activity, which is intensive as regards imports of machinery and equipment mainly. A stable low-inflationary environment and such development of wages, that would correspond to the balanced appreciation of real exchange rate, will be crucial for the Czech exports' competitiveness.

As regards balance of services, gradual moderate rise in surplus is expected depending on improvement of the situation in the global economy.

Worsening balance of income is and will be the key factor of the current account deficit where increasing flows of the repatriated and reinvested profits of foreign investors are reflected. Balance of transfers will be slightly positively influenced by financial flows from the EU.

The current account deficit should be covered more than sufficiently by the surplus in the financial account. Inflow of foreign direct investments, connected on the one hand with „green-field“ investments and expansion of the existing capacities and on the other hand with completion of the privatisation process, will be the crucial item. Inflow of debt capital will be influenced mainly by the necessity to finance the general government deficit.

As a result, stabilization and subsequent slight lowering of the current account deficit of the balance of payments to some 5.0 per cent of GDP in 2007 and a mild drop in the ratio of external debt to GDP are expected.

4 General Government Finances – Deficit and Debt

4.1 Policy Strategy

The Czech Republic is currently reporting an excessive deficit, which poses an obstacle on the way towards compliance with convergence criteria. Public finance consolidation and gradual budgetary deficit reduction are the main government priorities. The recently formed government (in August 2004) accepted the budgetary deficits reduction strategy from the May 2004 Convergence Programme. According to this strategy, public sector deficit should not exceed 3.8 % of GDP in 2006 and in 2008 it should not be higher than 3 % of GDP. The government intends to pursue a pace of fiscal consolidation that will not slow down domestic demand excessively and will not jeopardise social harmony. Apart from the commitment to reduce the deficit, the government has taken up changing the structure of taxes and government expenditure, with the aim of strengthening the supply side of the economy and of establishing conditions for the acceleration of potential growth.

Public finance reform was laid out in two stages. During the first stage¹³ measures were adopted with the aim of bringing the deficit trend to a halt and of slowing down the dynamics of public debt increases. As a part of the second stage of public finance reform, a fiscally-neutral tax package for the enhancement of economic growth was drawn up. Tax measures were designed to promote investment activity, research and development and to reinforce incentives for low-income parents to participate more actively in the labour market. The new government committed itself to prepare both pension and health care reform.

The budgetary deficit reduction strategy was implemented by means of binding medium-term expenditure frameworks. In summer 2004 the Parliament approved an Amendment to the Budgetary Rules Act that prescribes their extent, form and deadlines for submission. Medium-term expenditure frameworks quantify the maximum expenditure volume of central government against a 3-year horizon in order to meet the fiscal target. Expenditure frameworks simultaneously allow one to analyse the degree of government success in expenditure reduction and to identify the volume of savings essential for meeting the targets. The importance of medium-term expenditure frameworks as an anchor of the budgetary process and an effective tool for deficit reduction has been demonstrated during the preparation of the 2005 state budget proposal.

4.2 Overview of Public Finances in 2004 and 2005

2004 was the first year of public finance reform. The expected budgetary deficit in 2004 is 5.2 % of GDP¹⁴ and this corresponds to a 7.4 p.p. reduction compared to the year 2003. After

¹³ Expenditure measures were specified in the Pre-Accession Programme (2003) in detail and they are summarized in box 6.1. Tax reforms were discussed in the Pre-Accession Programme (2003), the spring Convergence Programme (2004) and the total summary is mentioned in Box 6.2.

¹⁴ Year 2004 represents the expected outcome. In comparison to the August notification the nominal deficit increased by 22.0 billions of CZK due to the state guarantee provided to the Czech National Bank in 1997 and to higher than projected tax revenues. This guarantee was for the first time called in October 2004 with payment amounting to 0.5 billion CZK.

adjustment for state guarantees and transformation costs, the deficit will remain unchanged. This is caused by the additional costs of EU accession. The budgetary deficit in 2004 deepened by 0.6 % of GDP as a result of the direct costs of EU accession¹⁵. The budgetary deficit will decrease by 0.1 p.p. compared to the estimated deficit in the spring Convergence Programme. However, the state guarantee provided to the Czech National Bank increased the expenditures by 22.5 billion CZK (0.8 % of GDP)¹⁶ compared to the spring Convergence Programme. The deficit would improve by 0.8 p.p. if we excluded this guarantee. The central government expenditure increase due to the realization of state guarantees will be almost fully offset by the deficit reduction of NPF (8.7 billion CZK), improvement in the management of SZDC (10.7 billion CZK), KONPO (5.1 billion CZK) and centrally managed semi-budgetary organisations (9.1 billion CZK). On the other hand, a worsening in the management of local government (by 8.5 billion CZK) and social security funds (6.1 billion CZK) is expected.

Expected state budget compliance on both the revenue and expenditure sides is influenced by legal changes approved in 2004. Expected tax revenues exceed the level budgeted for by 7.6 billion CZK by the end of October. From the structure of tax revenues point of view, the highest increase manifested the VAT compared to the forecast (approximately 6 %). This result is due to the legislative changes approved after the state budget was adopted. Income taxes are in line with the budget. On the other hand, property taxes will probably deviate from the projections. The estimated increase in social contribution revenues by 1.5 billion CZK is the result of wage growth in the economy and some legislative changes (the rise in the social contribution of the self-employed in particular). Due to the measures adopted a rise in the tax quota by 0.6 p.p. in 2004 is expected.

On the expenditure side the budget will be exceeded in the social expenditure chapter. The rise in social expenditure is the result of the disbursement of social compensations which were additionally approved to mitigate the impact of increased living costs resulting from the tax changes (lump-sum allowances for pensioners and families with children, parental allowance). It will be possible to offset part of these extra expenditures by savings in other areas of social expenditure. The total expected increase in social expenditure is 4.7 billion CZK above the approved budget level. Due to higher tax revenues the state budget deficit will be reduced below the approved level.

The general government deficit for the year 2005 should reach 4.7 % of GDP¹⁷ and this corresponds to the value planned in the spring Convergence Programme. According to the ESA methodology the general government total deficit will decline by 0.5 p.p. year on year. The state budget is the main contributor to the deficit reduction. The 2005 state budget was approved with a cash deficit of 2.9 % of GDP (83.6 billion CZK), i.e. the deficit is substantially lower, compared to the previous one (115 billion CZK).

¹⁵ *These are only the direct financial costs of EU accession i.e. excluding costs of additional necessary administrative capacities and costs resulting from accepted obligations (environment, public health regulations, etc.).*

¹⁶ *According to previous information the guarantee should not have been executed before 2007. Due to both a higher probability that the guarantee will have to be settled and to better expectations in the area of government sector deficit in 2004, the discussion with CNB resulted in an earlier settlement of the guarantee. This is the last risk guarantee to be imputed in the deficit and debt.*

¹⁷ *In 2005 the leasing of military airplanes amounting to a total value of 19.7 billion CZK will begin. As this will be operational leasing, government sector expenditure will include the annual payments of this leasing. In 2005 the aforesaid payments will amount to 1.6 billion CZK. The instalments are allocated till 2015 and their average annual amount equals 2 billion CZK. It has to be pointed out that Eurostat currently does not provide for a clear classification of military equipment purchases.*

4 General Government Finances – Deficit and Debt

The 2005 state budget is the second economical budget in a row to be in line with the concept of public finance reform. The increase in expenditures will lag behind the increase in revenues and will amount to 6.8 % (transformation costs excluded). Both in terms of expenditure and revenues the state budget marked a moderate increase compared to the medium-term outlook. The total state budget revenues will increase by 9.4 % of GDP and the tax revenues by 8.6 % of GDP. The increase on the revenue side is linked to the update in the tax forecast, to the inclusion of revenues from the budget of the European Union earmarked for the financing of joint programs and to the shift of revenues from the EU (earmarked for market regulation) from the State Agricultural Intervention Fund to the state budget. The increase in state budget expenditure (by 12 billion CZK compared to the medium-term framework) is not in conflict with the reform objectives, as it either does not increase consolidated government sector expenditure (transfer of responsibility for individual tasks) or it is in line with budgetary rules (this applies to the increase in the estimated revenues from the EU). The expenditure framework was exceeded only marginally (by 2.5 billion CZK). For successful fiscal consolidation it is significant that the higher-than-expected tax revenues (by 5 billion CZK) were used for a greater-than-planned deficit reduction.

From as early as the preparation phase of the state budget for the year 2005, the importance of medium-term expenditure frameworks became completely obvious. Within the framework of the preparation of the state budget and updating the medium-term framework, expenditure exceeding the expenditure ceiling for last year was identified. The fact that the expenditure exceeded the approved framework was due to the adoption of certain laws that had not been taken into account when the public finance reform was being prepared (i.e. laws increasing the salaries of the armed forces, introducing higher social benefits and prescribing higher spending in the area of infrastructure) and to an unexpected increase in certain expenditure items (interest payments). Additional savings measures concerning social expenditure, public-sector wages and other expenditure items of individual chapters (with savings amounting to approximately 10 billion CZK) were required to offset the above-mentioned expenditure requirements.

Central government continues to be the most significant contributor to the overall general government deficit. Within the central government sector the most important contributors are the state budget and state funds. This explains why the consolidation efforts of the government are focused in particular on those segments of public finance that are under the government's direct control. Local government contribution to the general government deficit amounted to 0.3 % of GDP in 2004. The same contribution is expected in 2005. Despite mounting pressure in the area of public healthcare, the Health Insurance Companies show only moderate deficits.

4 General Government Finances – Deficit and Debt

Table 4.1: Deficit and Debt by Sub-Sector

% of GDP	ESA code	Year 2000	Year 2001	Year 2002	Year 2003 (1)	Year 2004 (1)	Year 2005 (2)
Net lending (B9) by sub-sectors							
General government	S13	-3.7	-5.9	-6.8	-12.6	-5.2	-4.7
Central government	S1311	-3.8	-5.6	-6.3	-12.2	-4.9	-4.4
Local government	S1313	0.0	-0.3	-0.2	-0.3	-0.3	-0.3
Social security funds	S1314	0.2	0.0	-0.2	-0.1	-0.1	0.0
Gross debt by sub-sectors							
General government	S13	18.2	25.3	28.8	37.8	38.6	38.3
Central government	S1311	16.7	23.6	26.9	35.3	36.0	35.4
Local government	S1313	1.5	1.7	2.0	2.4	2.6	2.9
Social security funds	S1314	0.0	0.0	0.0	0.0	0.0	0.0

(1) Notification

(2) Forecast

Source: MoF CR

The nominal level of government debt expected at the end of 2004 has increased from 1037.8 billion CZK to 1054.5 billion CZK. In comparison to the spring Convergence Programme government debt will increase by 0.2 p.p., reaching a level of 38.6 % of GDP. The contribution of imputed guarantees to the government debt amounts to 10.0 % of GDP. The balance of default state guarantees included within the government debt is not fully reflected in the specific debt instruments. Considering that the repayment calendar for certain guarantees extends until 2028, the part of the debt that is in the form of guarantees will be converted into specific debt instruments gradually, as the government is forced to finance the payments related to the state guarantees that have been called.

By the year 2005 the debt-to-GDP ratio could slightly decline to a level of 38.3 % of GDP. This expectation concerning a reduction in government debt is based on the assumption that the government will manage to privatise its stakes in companies for the equivalent of 1.8 % of GDP and that CKA (the Czech Consolidation Agency) will successfully continue to reduce its balance, including its debt liabilities).

4.3 Medium-Term Fiscal Framework

The government appointed in summer 2004 declared in its Programme Declaration that it would carry on reducing the government sector deficit, so that it would be lower than 4.0 % of GDP in 2006. In 2008 the deficit should not exceed 3 % of GDP. This government declaration confirms the fiscal targets laid down in the spring Convergence Programme. The current fiscal framework assumes that the government deficit will be reduced to 3.8 % of GDP in 2006 and to 3.3 % of GDP in 2007. In comparison with the level of government sector deficit in 2004, this represents an average annual decrease of 0.7 p.p. Thus the elimination of an excessive deficit would be completed by 2008.

Binding medium-term expenditure ceilings, which limit the volume of expenditure of the state budget and state funds within the period 2005-2007, serve as the fundamental tool for ensuring compliance with fiscal targets. The original expenditure framework for the period until 2006, which was still approved by the previous government, was – during the preparation of the 2005 state budget and in line with the budgetary rules- extended to cover

4 General Government Finances – Deficit and Debt

2007 too. The deficit in the following years will be dependent on developments in both the economic situation and budgetary revenues, since the fiscal policy implemented by the government reflects the medium-term expenditure frameworks and the government has declared itself ready to use any higher-than-expected revenues for swifter deficit reduction. Positive growth shocks and higher-than-expected revenues would therefore lead to a faster reduction in the government sector deficit.

Significant reduction in transformation costs and an increase in tax revenues will make the most significant contribution to deficit reduction in 2004. Due to the lowering of income tax levels the tax-to-GDP ratio will moderately decline from 2005 onwards. Starting in 2005 more weight will be laid on expenditure savings to deliver deficit reduction. Except for government investment, all important expenditure items are expected to decline in terms of their ratio to GDP. Only interest payments will increase, due to the growth in government debt and expected moderate growth in interest rates.

The consolidation effort is primarily aimed at central government, because central government is the major deficit contributor. So far local governments have shown only moderate deficits and the Programme assumes this trend will remain unchanged. Despite this trend the government intends to strengthen the monitoring of debt development, in order to prevent local governments from accumulating excessive debts. For this purpose the so-called “debt service indicator” was introduced (together with the rule that interest payments combined with instalments repaying the principal should not exceed 30 % of revenues). Local governments have a reporting duty concerning the level of their debt. If local governments exceed the aforesaid indicator, they are obliged to explain their position and adopt remedial measures. The Health Insurance Companies are expected to run balanced budgets throughout the period of time covered by the outlook.

Table 4.2: Deficit by Sub-Sector

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (2)	Year 2006 (2)	Year 2007 (2)
Net lending (B9) by sub-sectors						
General government	S13	-12.6	-5.2	-4.7	-3.8	-3.3
Central government	S1311	-12.2	-4.9	-4.4	-3.5	-3.0
Local government	S1313	-0.3	-0.3	-0.3	-0.3	-0.3
Social security funds	S1314	-0.1	-0.1	0.0	0.0	0.0

(1) Projection

(2) Forecast

Source: MoF CR

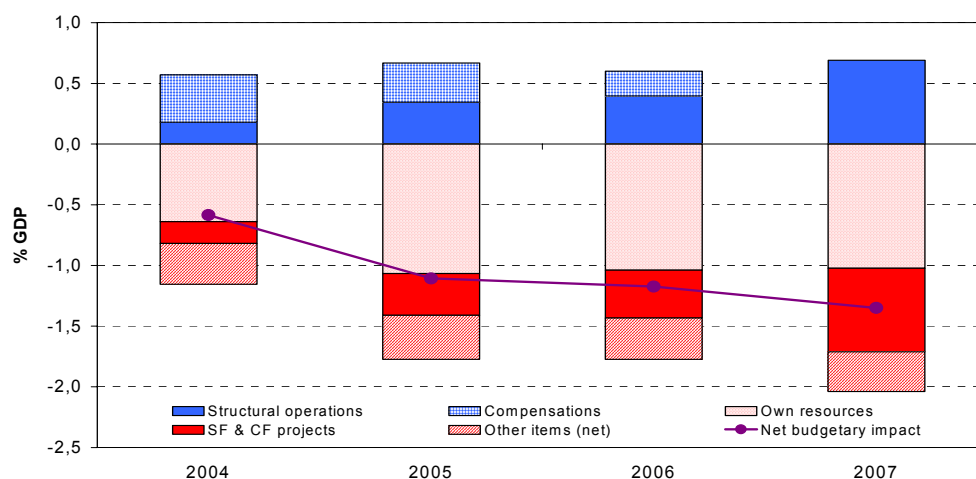
From 2004 onwards, the revenues, expenditures and government sector deficit will be influenced by budgetary relations between the Czech Republic and the EU. On the revenue side this means the negative effect of the reduction in revenues from custom tariffs and the positive effect of the inflow of revenues from structural funds and the Cohesion Fund and – temporally - also the receipt of budgetary compensations. In the case of many projects, the government sector¹⁸ will be the main recipient of resources from structural funds and the Cohesion Fund. These resources are intended for specific projects in the area of social and

¹⁸ It is assumed that projects financed from the Cohesion Fund will be carried out almost exclusively by the government sector. On the other hand, resources from structural funds will be received by both the government sector (75-80 %) and the private sector.

4 General Government Finances – Deficit and Debt

economic cohesion and will therefore increase government sector expenditure correspondingly. The expenditure side will be further burdened by the outflow of own resources, exceeding 1.0 % of GDP. An increase in direct payments to farmers can also be considered to constitute a part of the direct costs of accession. In the short run, EU accession will exacerbate the government sector deficit by more than 1.0 % of GDP annually.

Graph 4.1: Direct Impact of EU Accession on Government Sector Deficit



Source: MoF CR

The Czech economy will operate near its potential throughout the period covered by our projections. Considering the low level of difference in both the level and the growth rate of actual and potential GDP, tax revenues will move close to their structural level and the cyclical component of budget balances will be almost negligible. In 2005 the cyclically adjusted deficit will reach a level of 4.7 % of GDP. It will fall to 3.8 % of GDP in 2006 and will continue to decline to 3.3 % of GDP in 2007. With regard to the expected growth in interest payments, the extent of fiscal restriction measured by the reduction in the cyclically adjusted primary balance will be greater than the change in the cyclically adjusted total balance would indicate. Fiscal restriction will be brought into effect during a period of strengthening economic growth and together with automatic fiscal stabilizers it will contribute to a smoothing out of the economic cycle.

Table 4.3: Cyclically Adjusted Budget Balance

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (2)	Year 2006 (2)	Year 2007 (2)
1. GDP growth at constant prices	B1g	3.1	3.8	3.6	3.7	3.8
2. Actual balance	B9	-12.6	-5.2	-4.7	-3.8	-3.3
3. Interest payments	D41	1.3	1.2	1.4	1.5	1.6
4. Potential GDP growth		2.9	3.1	3.5	3.6	3.6
5. Output gap		-0.8	-0.1	0.0	0.1	0.3
6. Cyclical budgetary component		-0.2	0.0	0.0	0.0	0.0
7. Cyclically-adjusted balance (2 – 6)		-12.4	-5.2	-4.7	-3.8	-3.3
8. Cyclically-adjusted primary balance (7 – 3)		-11.1	-4.0	-3.3	-2.3	-1.8

(1) Projection

(2) Forecast

Source: MoF CR

4.4 Public Debt and Debt Strategy till 2007

The medium-term fiscal framework predicts a moderate increase in government debt. The expected increase in government debt over the next three years is 1.5 p.p. Government sector debt will rise from 38.6 % of GDP by the end of 2004 to 40.0 % of GDP in 2007. However, within the period covered by the projection, the deficit will not be reduced to a level that would provide for a stabilisation of the debt-to-GDP ratio¹⁹.

In the past the sudden growth of public debt was to a large extent brought about by the conversion of conditional liabilities associated with economic transformation and banking sector stabilisation (state guarantees and guarantees for the liabilities of transformation institutions) into explicit liabilities²⁰. The volume of these liabilities reached almost 20 % of GDP. Debt projection is based on the assumption that activities of transformation institutions (the CKA in particular) will be gradually dampened and the volume of their liabilities will fall simultaneously with the decrease of the total balance. Another assumption is that the government will not provide any additional high-risk guarantees. State guarantees that have been called and the loss of CKA will be gradually paid, but such payments will impact budgetary balance on a cash basis only. As a result, liabilities of CKA and called state guarantees will be gradually transformed into the form of negotiable debt instruments.

Table 4.4: Structure of Public Debt by Sub-Sector

% of GDP	ESA code	Year	Year	Year	Year	Year
		2003	2004 (1)	2005 (2)	2006 (2)	2007 (2)
Gross debt by sub-sectors						
General government	S13	37.8	38.6	38.3	39.2	40.0
Central government	S1311	35.3	36.0	35.4	36.2	36.9
<i>of which: CKA</i>		<i>5.7</i>	<i>3.7</i>	<i>2.1</i>	<i>1.2</i>	<i>0.5</i>
<i>state guarantees</i>		<i>10.0</i>	<i>10.0</i>	<i>8.9</i>	<i>8.1</i>	<i>7.3</i>
Local government	S1313	2.4	2.6	2.9	3.0	3.1
Social security funds	S1314	0.0	0.0	0.0	0.0	0.0

(1) Projection

(2) Forecasts

Source: MoF CR

The dynamics of government debt should gradually become more subdued after 2007, as is illustrated by the diminishing debt increments. The deceleration in the growth of government debt will be facilitated by falling primary deficits. The contribution of the primary deficit to the growth of the debt ratio will fall from 4.0 % GDP in 2004 to 1.7 % GDP in 2007. The relatively high growth-rate of nominal GDP approaching 7 % a year will contribute to a decrease in the debt-to-GDP ratio of about 2.4 p.p. and will exceed the contribution of interest payments to debt accumulation throughout the period covered by the projections. The internal dynamics of the debt remains favourable. In 2005 privatisation revenues, corresponding approximately to 1.8 % of GDP, should also contribute to debt reduction. At that point the

¹⁹ Assuming that the current nominal GDP growth is maintained, a deficit between 2.5 and 3.0 % of GDP would provide for a stabilization of the debt-to-GDP ratio. According to the public finance consolidation plan, this value should be reached in 2008.

²⁰ In 2001 CKA became part of the government institution sector and in that year its liabilities increased the government debt. The state guarantees were included in the deficit and debt gradually, as it became evident that the state would have to pay the liabilities stemming from the said guarantees. By now, the majority of guarantees provided have been fully included in the debt.

potential of privatisation revenues will have been practically exhausted, with the exception of revenues from the privatisation of the energy industry.

Table 4.5: Development of Government Debt and Related Indicators

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (2)	Year 2006 (2)	Year 2007 (2)
Gross debt level		37.8	38.6	38.3	39.2	40.0
Change in gross debt		8.9	0.8	-0.2	0.9	0.8
Contributions to change in gross debt						
Primary balance		11.3	4.0	3.3	2.3	1.7
Interest payments	D41	1.3	1.2	1.4	1.5	1.6
Nominal GDP growth	B1g	-1.3	-2.8	-2.4	-2.4	-2.6
<i>Other factors influencing the debt ratio</i>		-2.4	-1.7	-2.5	-0.5	0.1
Of which: Privatisation receipts		-1.0	-1.0	-1.8	0.0	0.0
p.m. implicit interest rate on debt		4.8	3.5	3.9	4.1	4.3

(1) Projection

(2) Forecast

Source: MoF CR

From the debt management point of view, special attention is paid to the state debt, which represented 89 % of total consolidated government debt (excluding state guarantees and liabilities of the CKA) at the end of 2003. When it comes to developing the medium-term debt-management and issuing strategy, the greatest attention is devoted to refinancing and interest-rate risks, which are currently the most important risks related to government financing. Exposure to currency risk is still negligible, despite the fact that the first issue of Eurobonds took place this year.

Refinancing Risk

When it comes to the management of refinancing risk, the main target is a reduction of the short-term debt below the 20 % limit by the end of 2006. At the end of the third quarter of 2004 the intermediate goal of reducing the short-term debt to a level of 25 - 30 % was met. By the end of the third quarter of 2004 the share of short-term debt fell to 28.7 % of total state debt (the share of T-bills decreased to 24.9 %). This confirms that – at a time when the Czech Republic is on the verge of becoming a part of the integrated European financial market - the structure of state debt is quickly becoming very similar to the structure of government portfolios in the Eurozone Member States.

The first Eurobond issue contributed considerably to the mitigation of refinancing and interest-rate risk. In June 2004 the Czech Republic issued bonds to a nominal value of 1.5 billion EUR and yielding 4.654 % p.a. in the European financial market. This yield, lying 12 basis points above mid-swap, approaches the Czech Republic to Italy and Greece, i.e. countries that have a better rating. Not only did this issue mitigate the refinancing risk, but it also helped to optimise the costs of debt servicing. The issue was successful in attracting a broad range of investors, whereby the geographical distribution of investors was also very favourable. As of the end of June 2004 the share of non-residents holding the Czech state debt increased to 16.2 %, i.e. by 8.2 p.p. when compared to the end of 2003. The share of domestic financial institutions and corporations fell by 8.5 p.p., to 62.8 %. This has mitigated the dependence of the Czech government on the domestic market. The debt strategy is based on

the assumption that the Czech Republic will strengthen its presence in the European market by further benchmark-sized issues of additional Eurobonds, to be released at least once a year.

Interest Rate Risk

Modified duration (including derivative operations) reached a value of 3.69 years at the end of the third quarter and thus got very close to the medium level of the 2004 band (3.3 to 4.3 years). Interest rate risk still remains the most important market-related risk for state debt management. As far as interest rates are concerned, as of the end of the third quarter of 2004 the structure of state debt generates exposure to changes in short-term nominal interest rates (below 1 year) corresponding to 29.9 % of the state debt. The decline of this exposure below 30 % means that the reference threshold defined in the Convergence Programme of May 2004 has been complied with. In view of the main target in this area – i.e. minimisation of the cost of servicing the state debt - this level of exposure to interest rate risk is acceptable.

Table 4.6: State Debt in Terms of Interest Rates

in %	Year 2001	Year 2002	Year 2003	Year 06/2004
1. Fixed interest rate long-term debt	44.8	57.1	64.7	72.2
<i>1a. Of which: due in 1 year or less</i>	4.6	7.2	7.9	3.7
2. Variable interest rate long-term debt	0.7	1.1	2.4	2.8
3. T-bills	54.1	41.4	32.6	24.9
4. Non interest bearing debt	0.4	0.4	0.3	0.2
<i>1a. Of which: due in 1 year or less</i>	0.3	0.3	0.3	0.1
5. Debt subject to IR re-fixing within 1 year (1a + 2 + 3 + 4a)	59.7	50.0	43.2	31.5
6. Including effect of interest rate swaps	59.7	47.0	36.8	29.9

Source: MoF CR

When compared to the end of 2003, the effect of CZK interest rate swaps which have been carried out on a reduction of interest rate risk has decreased. This is due to the hedging of the Eurobond issue against FX impacts. Virtually the entire portfolio of interest rate swaps carried out since November 2002 was used for fixing the Eurobond coupon in the Czech currency. In the first three quarters of 2004, debt with interest rate re-fixing within 1 year was reduced by 11.7 p.p. (excluding derivative operations). From the level of state debt and its interest rate structure we can deduce that – allowing for the effect of interest rate swaps - a 1 % increase in interest rates would increase interest payments within a one-year period by approximately 1.8 billion CZK. Despite the reduction in relative exposure to interest rate risk by 6.9 p.p. since the end of 2003, absolute exposure has remained virtually unchanged due to the increase in the total volume of state debt.

Currency Risk

As of the end of the third quarter of 2004, state debt FX exposure remained at a negligible level of 0.016 %²¹. Based on an agreement between the Governor of the Czech National Bank and the Minister of Finance, the Eurobond issue was fully hedged against currency risk. This eliminated the potential appreciation that could be caused by the one-off conversion of the issue revenue amounting to 1.5 billion EUR into CZK. Derivative operations led to the conversion of 1.5 billion EUR into the Czech currency, namely 48.8 billion CZK. This corresponds to the effective exchange rate of 32.55 CZK/EUR, fixed for both the principal

²¹ Bills of Exchange denominated in USD issued to finance the participation of the Czech Republic in EBRD.

value and the coupon of the Eurobond issue until 2014. The average effective cost of FX hedging (undiscounted) amounts to 253 million CZK over a period of ten years.

Risk Profile of the State Guarantee Portfolio

When it comes to management of market-related risks regarding the expenditure side of the state budget we must allow both for the structure of state debt and for the structure of the portfolio of state guarantees covering loans where both principal and interest are paid from the state budget. In accordance with the ESA 95 methodology the risk guarantees have already been transferred into government debt but as yet they are not considered a part of it for the purpose of state debt management. In 2004 the Ministry of Finance began with an analysis of the refinancing, term, currency and interest-rate structure of state guarantees, so that the relevant risk management methods could be applied to the integrated portfolio of state debt and state guarantees from 2005 onwards. By the end of the third quarter of 2004 the preliminary analysis had covered guarantees amounting approximately to 110 billion CZK²².

Table 4.7: Risk Profile of State Debt, including State Guarantees

	Volume	Foreign currency	Variable interest rate	Due in one year	Average maturity	Modified duration
	bil CZK	%	%	%	years	years
State debt	589.3	0.0	2.8	28.7	5.0	3.7
Analysed state guarantees	110.4	55.7	55.0	5.2	5.0	2.5
Total portfolio	699.7	8.0	10.2	25.0	5.0	3.5

Source: MoF CR

Preliminary analyses have shown that the risky state guarantees analysed so far have a positive effect (from the refinancing point of view) because they reduce the share of short-term liabilities (thereby contributing to the achievement of the medium-term target in this area) and at the same time do not reduce the average maturity. On the other hand, state guarantees have a negative effect on the level of market risk, because the state guarantee portfolio includes a high percentage of debt instruments in a foreign currency and with variable interest rates. It is important to mention that the integration of both portfolios has not led to any significant deviations, when it comes to parameters for which some quantitative criteria have been set (i.e. share of short-term debt and modified duration).

Specific guarantees with an unknown term and volume structure of future payments have been left aside for the moment. The government pays increased attention to the monitoring of all fiscal risks with a potential impact on public finance. The potential risks identified so far are summarised in the following box.

Box 4.1: Potential Liabilities and their Possible Impact on Public Finance

- **State guarantees – differences between the Convergence Programme (May 2004) and this autumn Convergence Programme**

Following a reassessment of its risk level, a non-standard state guarantee provided to CNB in 1997 in association with the consolidation and stabilisation of the banking sector has been reflected in the government debt and deficit. The total volume of this guarantee amounts to 22.5 billion CZK; the first payment

²² Excluding specific guarantees where the schedule and volume structure of future payments remain unknown. This applies to the IPB guarantee (160 billion CZK) and the guarantee provided to CNB (22.5 billion CZK).

under this guarantee amounted to 0.5 billion CZK and was made in October 2004. Contrary to our previous expectations, this guarantee will have to be paid to its full extent. Compared to the August notification, the government sector deficit has therefore increased due to this operation by 22.5 billion CZK, with the government debt increasing by 22 billion CZK.

The potential increase in future government expenditure from so far issued state guarantees after the inclusion of this guarantee in deficit and debt is estimated at 0.5 % of GDP.

▪ Other potential liabilities

Within the framework of the rules of the privatisation process it was decided that the state would take over the cost associated with remedying any subsequently ascertained ecological damage related to privatised property. This means that the state has to provide compensation for the cost related to the removal of any inherited ecological burden concerning privatised property and caused by the activities of privatised companies prior to privatisation. **The costs associated with the liquidation of ecological damage are gradually defrayed from the privatisation revenues of NPF, pursuant to specific legislation.** The expected value of compensations is specified on the basis of continual updates and at the moment we cannot reliably quantify the total value of such compensations or the number of years over which they will continue to be paid. So far, the Czech Statistical Office has classified these payments as subsidies. Payments of ecological liabilities are not included in the deficit of the year in which the given liability was quantified by NPF but only when the NPF is obliged to pay out the said compensation. **Compensations are paid by NPF in regular instalments, based on the progress of individual projects, whereby the total corresponds to the actual costs and not merely to their estimate. This way the ecological liabilities are gradually reflected in government deficit.**

The government of the Czech Republic signed a **contract concerning the lease of 14 Gripen fighter planes**, covering the period until 2015, with a Swedish partner. Over the years 2005 - 2015 the lease will be paid in the form of annual instalments, which have been (for the period until 2007) included in the expenditure frameworks. The ESA 95 methodology does not include clear instructions concerning the classification of long-term contracts for the lease of military equipment and the relevant specific regulation is currently being prepared and discussed. For these reasons the impact of this transaction on government debt and deficit (amounting to a total of 19.6 billion CZK) has not been classified in accordance with the ESA 95 methodology as yet.

Issues concerning the above-mentioned potential liabilities will be discussed between the Czech Statistical Office and Eurostat, in order for the impact of such liabilities to be adequately reflected in the next Convergence Programme.

▪ Other factors with a possible impact on the amount of government deficit in line with the ESA 95 methodology

The Czech Republic respects the common EU policy concerning the **issue of irrecoverable receivables of individual Member States vis-à-vis heavily indebted poor countries**. However, as yet the Czech Republic has not made a final decision on the quantification of the volume of such receivables and on the timing of their inclusion in government deficit pursuant to ESA 95.

This also applies accordingly to the de-blocking of low-quality receivables of the Czech Republic concerning certain other countries.

For the aforementioned reasons it would be rather difficult to quantify the impact of factors that might have some effect on the deficit in accordance with ESA 95.

5 Comparison with Previous Convergence Programme and Sensitivity Analysis

5.1 Comparison with the Previous Macroeconomic Scenario

Differences between the macroeconomic scenarios of the current autumn Convergence Programme (CP) and the past spring CP can be explained as follows:

- New data on macroeconomic phenomena have been included,
- Results of national accounts revision have been included (see Box 3.1),
- CP assumptions have partially changed, in particular prices of oil,
- Response of the economy to external shocks differs slightly from the previous CP assumptions.

Expected development of external environment in 2004 and 2005 is nearly identical with the spring CP assumptions as regards forecasts of economic growth in EU-15 and in Germany. Differences concerning the USD/EUR exchange rate are also small. Conversely, the biggest change is connected with the price oil forecast where the current forecast of expected oil price is higher by 18.3 per cent for 2004 and by as much as 24.2 per cent for 2005 in comparison with the previous CP assumptions. Fortunately, this factor has been partially compensated for by strengthening of the CZK against the USD.

Table 5.1: Scenario Assumptions

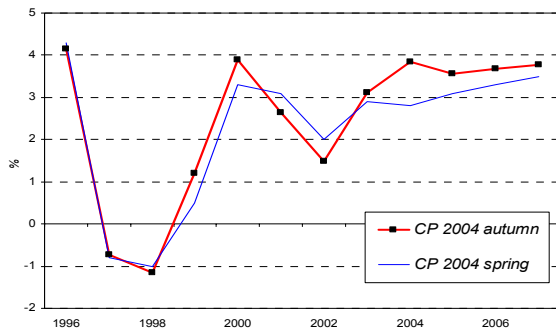
	CP 2004 - spring			CP 2004 - autumn			Difference		
	2003	2004	2005	2003	2004	2005	2003	2004	2005
GDP growth (%)									
USA	3.1	4.2	3.2	3.0	4.4	3.7	-0.1	0.2	0.5
EU-15	0.8	2.0	2.4	0.9	2.1	2.4	0.1	0.1	0.0
Germany	-0.1	1.5	1.8	-0.1	1.6	1.8	0.0	0.1	0.0
Prices of oil									
(USD / barrel)	28.8	31.1	28.9	28.8	36.8	35.9	0.0	5.7	7.0
Exchange rate									
USD / EUR	1.13	1.25	1.24	1.13	1.22	1.21	0.00	-0.03	-0.03

Source: MoF CR

Despite a shift in oil prices, the expected future development of the Czech economy takes the positive course. It is obvious that dependency of the Czech economy's dynamics on the fuel prices is limited and that positive factors connected with growth of total factor productivity and competitiveness on the world markets prevail.

5 Comparison with Previous Convergence Programme and Sensitivity Analysis

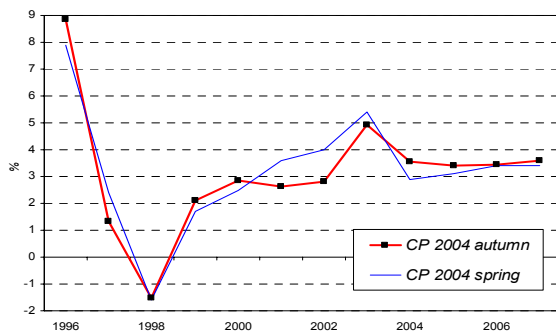
Graph 5.1: Growth of GDP



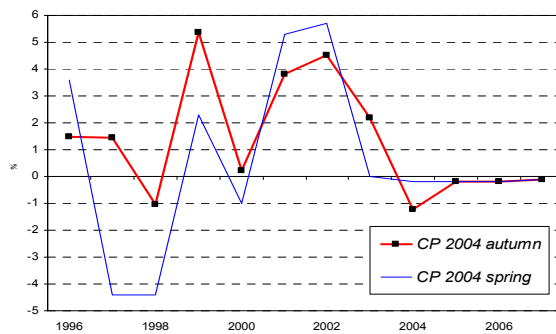
Source: MoF

Acceleration of household consumption in 2003 was caused by an unexpected fall in inflation. Forecast for the following years (similarly as in the past CP) reflects a fall in dynamics due to faster growth of consumer prices and to some measures of public finance reform. As regards government consumption, big divergences in dynamics were identified in the past due to data review while forecast for 2005 to 2007 does not change.

Graph 5.2: Growth of Household Consumption



Graph 5.3: Growth of Government Consumption

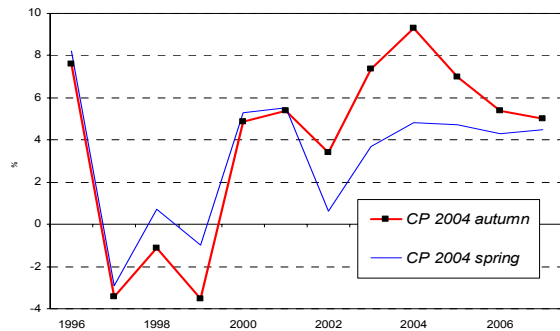


Source: MoF

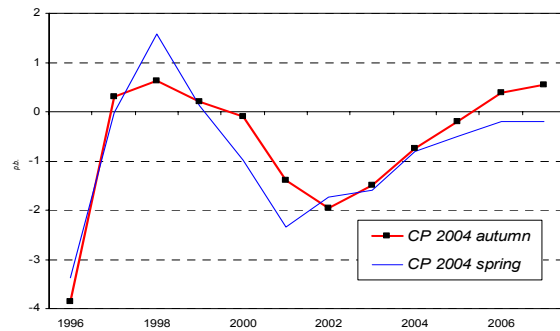
Given the significant increase in dynamics of gross fixed capital formation in 2002 and 2003 after the national accounts revision, and the first-half of 2004 developments, predicted paces have substantially moved up as compared with the previous CP. As regards the contribution of the foreign trade in goods and services, the current CP is more optimistic assuming that trade balance might be able to contribute positively to GDP growth as soon as from 2006.

5 Comparison with Previous Convergence Programme and Sensitivity Analysis

Graph 5.4: Growth of Gross Fixed Capital Formation



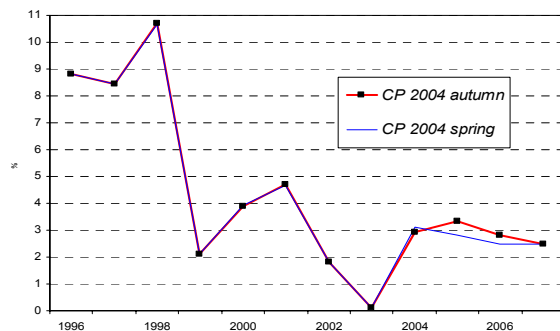
Graph 5.5: Contributions of Foreign Trade in Goods and Services to GDP Growth



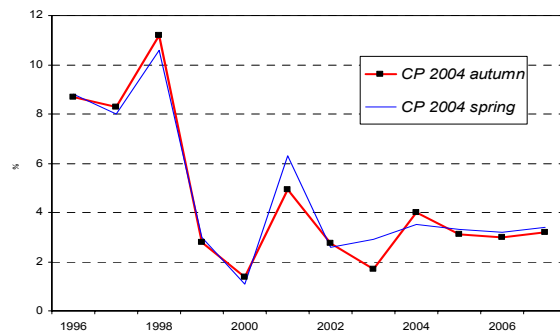
Source: MoF

Changes in expected inflationary development as compared with the spring CP are minimal. A slight increase in the forecast can be attributed to higher oil prices. Also forecast of GDP deflator is changing only negligibly.

Graph 5.6: Average Rate of Inflation



Graph 5.7: Growth of GDP Deflator

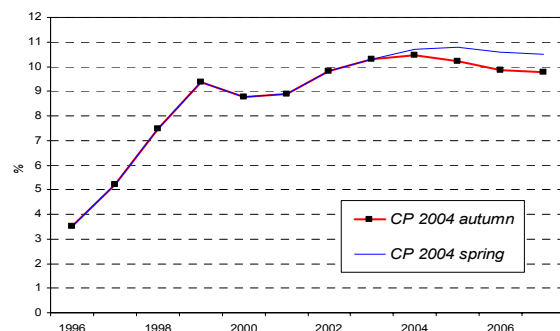


Source: MoF

As regards unemployment registered with the employment agencies, the forecast has been decreased due to higher economic growth. However, perception of labour market problems does not change compared with the previous CP.

Graph 5.8: Rate of Unemployment

(Registered unemployment at the end-year)

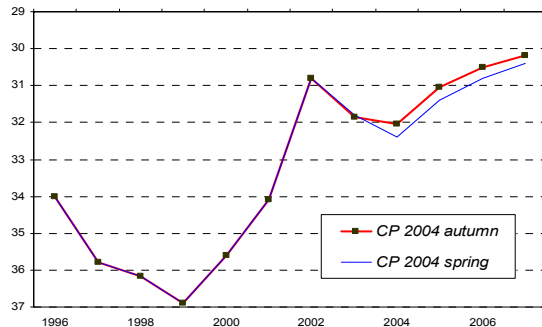


Source: MoF

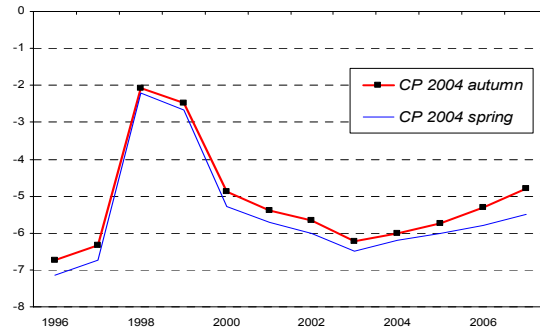
5 Comparison with Previous Convergence Programme and Sensitivity Analysis

CZK/EUR exchange rate is assumed to tend to appreciation in the future. A shift in the forecast stems from the 2004 developments up to now. Also the expected tendency of the current account of the balance of payments to improve slightly does not change: movement in the ratio of the current account to GDP in the past and future results from an increase in denominator (nominal GDP) related to the national accounts revision.

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



Graph 5.10: Ratio of the Current Account to GDP



Source: MoF

5.2 Comparison of Fiscal Frameworks

The differences in fiscal frameworks described in the spring and autumn Convergence Programme are negligible because the interval between the preparation of these two documents was very short. The government has approved the fiscal targets for the years 2005 – 2007, which correspond to the confirmed medium-term expenditure frameworks. Insofar as the deficits are concerned, there are no differences between the spring and autumn versions of the Convergence Programme. The expected acceleration of GDP growth has not led to any change in the fiscal targets, because the growth will be driven in particular by foreign demand and investment activity. The forecast of tax revenues has remained unchanged in the horizon 2005 -2007 and therefore there is no change in the deficit target of the government either.

The expected level of government debt has decreased by 1.5 % approximately. This is due in particular to the privatisation revenue expected in 2005 and corresponding approximately to 1.8 % of GDP. This expected privatisation revenue was not included in the spring version of the Convergence Programme. Despite the higher dynamics of real GDP, the growth rate of nominal GDP has not significantly changed. When compared to the spring version of the Convergence Programme, the debt dynamics has not changed and higher growth of real GDP has had practically no impact.

5 Comparison with Previous Convergence Programme and Sensitivity Analysis

Table 5.2: Comparison with the Previous Programme

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (1)	Year 2006 (2)	Year 2007 (2)
GDP growth						
previous update	B1g	2.9	2.8	3.1	3.3	3.5
latest update	B1g	3.1	3.8	3.6	3.7	3.8
Difference		0.2	1.0	0.5	0.4	0.3
Actual budget balance						
previous update	B9	-12.9	-5.3	-4.7	-3.8	-3.3
latest update	B9	-12.6	-5.2	-4.7	-3.8	-3.3
Difference		0.3	0.1	0.0	0.0	0.0
Gross debt levels						
previous update		37.6	38.4	39.7	41.0	41.7
latest update		37.8	38.6	38.3	39.2	40.0
Difference		0.1	0.2	-1.3	-1.8	-1.7

(1) Estimate

(2) Forecast

Source: MoF CR

5.3 Sensitivity Analysis

The Czech economy can be characterized as small and open and from this point of view it is possible to define a set of key exogenous variables influencing strongly the performance of the Czech economy. These factors are the following – foreign demand, foreign prices, exchange rates and raw material prices²³. At the moment, the biggest risk factor is probably the development of prices of raw materials, especially the prices of oil and natural gas. For this reason the following sensitivity analysis is primarily based on several different scenarios of oil price development. It is necessary to note that an unfavourable development in the area of prices of raw materials would hamper economic development both in the Czech Republic and global economy²⁴. That is why two secondary effects, foreign demand and foreign inflation, were included in our sensitivity analysis²⁵.

We decided to analyse the sensitivity of Czech economic performance to the above-mentioned risk factors on the basis of two different scenarios. The optimistic scenario allows for a combination of positive demand and supply shocks and assumes a gradual reduction in oil prices to a level of 25 USD per barrel, slight acceleration of foreign demand and

²³ For the purposes of quantitative analysis assessing the impact of the aforesaid factors on the economic development in the Czech Republic the Ministry of Finance of the Czech Republic uses the calibrated medium-term quarterly simulation model. This model can be characterized as a standard Keynesian model extended to include Neoclassical supply side. It consists of approximately 20 stochastic equations and 55 identities.

²⁴ We focussed exclusively on the possible impact of oil price fluctuation on the economy of the EU-15, our biggest trading partner. For the purpose of executing a sensitivity analysis of the EU we used MULTIMOD, the simulation model of the IMF.

²⁵ Empirical results obtained so far have shown that the correlation between GDP dynamics and oil price is negative, but also asymmetric. The economic recovery brought about by a fall in oil prices is not comparable to the economic slow-down brought on by the equivalent increase in oil prices. The asymmetry can be explained partly by the existence of nominal rigidities in the economy and partly by the asymmetry of monetary policy. Insofar as prices are concerned, there is a positive correlation between the dynamics of inflation and changes in the prices of raw materials.

5 Comparison with Previous Convergence Programme and Sensitivity Analysis

deceleration of foreign inflation in the form of industrial prices (when compared to the baseline scenario). On the other hand, the pessimistic scenario employs the assumptions of higher oil prices, lower dynamics of foreign demand and acceleration of foreign inflation.

Table 5.3: Development Scenarios of Key Exogenous Variables

		Year 2003	Year 2004	Year 2005	Year 2006	Year 2007
UK Brent						
Optimistic	USD/barrel		36.8	28.0	25.9	25.0
Baseline	USD/barrel	28.8	36.8	35.9	33.9	33.0
Pessimistic	USD/barrel		36.8	43.8	41.9	41.0
GDP EU 15						
Optimistic	y/y in %		2.1	2.7	3.0	3.0
Baseline	y/y in %	0.9	2.1	2.4	2.8	2.9
Pessimistic	y/y in %		2.1	2.0	2.3	2.7
PPI EU 15						
Optimistic	y/y in %		2.0	0.6	0.6	0.7
Baseline	y/y in %	0.8	2.0	1.7	1.1	0.7
Pessimistic	y/y in %		2.0	3.4	1.8	0.8

Source: MoF CR

Optimistic Scenario

The above-mentioned scenarios are characterized by a primary nominal effect and secondary real effect on the Czech economy. Thanks to the expected decrease in the price of oil (to the level of 25 USD per barrel) we can expect a very substantial improvement of the external imbalance (measured by the current account balance). A lower oil price has a very positive income effect because – in view of the relatively high and stable energy intensity of the Czech economy – it brings about a significant reduction in production costs, which will in turn be reflected in lower price dynamics and an increase in profit margins.

Higher growth of foreign demand will have a positive effect, accelerating the growth rate of export volume and therefore also growth rates of industrial production. However, due to the fact that the Czech supply side is still very import intensive, a higher dynamics of exports will be accompanied by a higher dynamics of imports. The overall positive effect of stronger foreign demand will thereby be significantly reduced. Higher growth in economic activity and industrial production will be translated into additional demand for labour and also higher labour productivity. Thanks to a favourable oil price development and lower dynamics of foreign prices, we can expect a relatively positive development in the area of prices and wages²⁶. Inflation and economic activity (or rather the output gap) are likely to move in the opposite direction and - in view of the current set-up of the central bank's reactions – this is likely to lead to lower interest rates (when compared to the baseline scenario).

The expected deceleration of domestic inflation, combined with a very slight acceleration of GDP growth, will result in only very slight changes in wages and salaries. Because of this, the scenario does not include any additional income tax revenues (when compared to the baseline

²⁶ A substantial decrease in raw material prices can be connected with the asymmetry of monetary policy, especially in low-inflation economies. Despite deflation tendencies, the zero ceiling of interest rates does not enable the central bank to cut the nominal short-term interest rates.

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scenario). Besides, taking into account the composition of economic growth, revenues from indirect taxes (VAT and excise duties) will not be significantly increased either. As government expenditure is in principle defined by medium-term nominal expenditure ceilings, general government expenditure remains largely unaffected by this development. We assume that the nominal value of the expenditure side of the budget is rigid and therefore remains virtually constant for the purpose of our simulations. However, in reality a positive price development could be accompanied by savings on the expenditure side of the budget (e.g. lower indexation of pensions, social benefits etc.). This factor was not taken into account in our simulations and that can result in an overvaluation of the budget deficit or debt. This scenario includes a certain decrease in expenditure, linked to lower costs of debt servicing resulting from lower nominal interest rates and lower unemployment-related costs. All in all, should all the assumptions of the optimistic scenario be satisfied, it would have a certain positive effect on the state of public finances.

Table 5.4: Macroeconomic Impacts of the Optimistic Scenario

		Year 2003	Year 2004	Year 2005	Year 2006	Year 2007
Gross domestic product						
Consumption expenditures	volumes, y/y in %	4.9	3.6	3.4	3.6	3.8
Gross fixed capital formation	volumes, y/y in %	7.4	9.3	7.1	5.6	5.2
Government expenditures	volumes, y/y in %	2.2	-1.2	-0.2	-0.1	0.0
Export of goods and services	volumes, y/y in %	6.2	16.5	11.5	8.6	8.7
Import of goods and services	volumes, y/y in %	7.8	16.8	11.4	7.9	7.9
Gross domestic product	volumes, y/y in %	3.1	3.8	3.7	3.9	4.0
Labour market						
Total employment	y/y in %	-0.7	-1.0	-0.3	0.2	0.3
Unemployment rate	in %	7.8	8.3	8.3	7.9	7.6
Wages and salaries	y/y in %	5.6	5.3	6.1	6.3	6.6
Prices						
Consumer price index	y/y in %	0.1	2.9	3.1	2.4	2.2
Gross domestic product deflator	y/y in %	1.7	4.0	3.8	3.0	3.0
Public budget						
Public deficit	in % of GDP	-12.6	-5.3	-4.5	-3.5	-3.0
Gross public debt	in % of GDP	37.8	38.6	37.8	38.6	39.3
Other indicators						
PRIBOR 3M	in %	2.3	2.3	2.6	2.6	2.9
Current account	in % of GDP	-6.2	-6.0	-4.6	-3.9	-3.4

Source: MoF CR

Pessimistic Scenario

With respect to the energy intensity and commodity dependency of the Czech economy, realisation of the pessimistic scenario of oil price development would lead to an immediate and substantial worsening of external imbalances. This fact would result in an increase in the costs of the corporate sector, which would subsequently be reflected in higher prices.

One of the secondary effects of high oil prices would be a lower dynamics of foreign demand and a higher dynamics of inflation. A lower dynamics of foreign demand would negatively affect the dynamics of Czech exports and consequently also the entire GDP dynamics. Higher foreign inflation will mean additional pressure towards higher import prices and higher

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production costs. A higher price dynamics would also stimulate trade unions to accelerate their wage requirements, which would result in a further growth in production costs that would need to be reflected in prices. It can be assumed that in the context of an inflationary development, the need to deal with inflation will win over the wish to promote economic growth and the Czech National Bank will raise interest rates. This measure, together with lower profitability in the corporate sector, will probably dampen investment activity, which will result in a further worsening of economic performance and potential product. Lower economic activity will have a negative impact on demand for labour, resulting in a slight increase in unemployment.

The fact that the acceleration of inflation would be higher than the deceleration of real indicators (unemployment, GDP) would mean that even the pessimistic scenario would lead to an increase in revenues from certain taxes. However, a higher inflation rate is accompanied by higher nominal interest rates and these would also increase the cost of debt service. Furthermore, there would be greater need for funds in the area of unemployment benefits. It is also necessary to emphasise that the scenario presented does not include sufficient indexation of retirement pensions or other social transfers. This simplification can lead to an undervaluation of public finance deficit or debt.

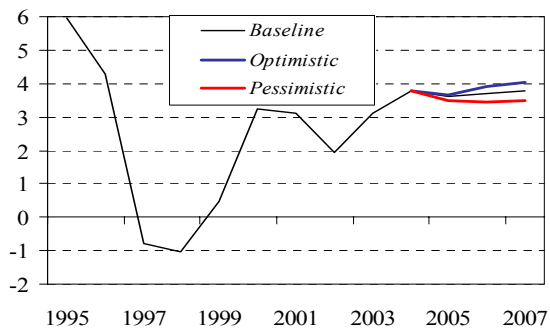
Table 5.5: Macroeconomic Impacts of the Pessimistic Scenario

		Year 2003	Year 2004	Year 2005	Year 2006	Year 2007
Gross domestic product						
Consumption expenditures	volumes, y/y in %	4.9	3.6	3.3	3.2	3.3
Gross fixed capital formation	volumes, y/y in %	7.4	9.3	6.9	5.2	4.7
Government expenditures	volumes, y/y in %	2.2	-1.2	-0.2	-0.3	-0.3
Export of goods and services	volumes, y/y in %	6.2	16.5	10.6	6.9	7.0
Import of goods and services	volumes, y/y in %	7.8	16.8	10.7	6.4	6.4
Gross domestic product	volumes, y/y in %	3.1	3.8	3.5	3.4	3.5
Labour market						
Total employment	y/y in %	-0.7	-1.0	-0.3	0.0	0.0
Unemployment rate	in %	7.8	8.3	8.3	8.1	8.1
Wages and salaries	y/y in %	5.6	5.3	6.3	6.5	6.6
Prices						
Consumer price index	y/y in %	0.1	2.9	3.5	3.2	2.9
Gross domestic product deflator	y/y in %	1.7	4.0	2.5	3.1	3.5
Public budget						
Public deficit	in % of GDP	-12.6	-5.3	-4.9	-4.0	-3.6
Gross public debt	in % of GDP	37.8	38.6	38.8	39.8	40.7
Other indicators						
PRIBOR 3M	in %	2.3	2.3	2.8	3.3	3.7
Current account	in % of GDP	-6.2	-6.0	-6.8	-6.7	-6.3

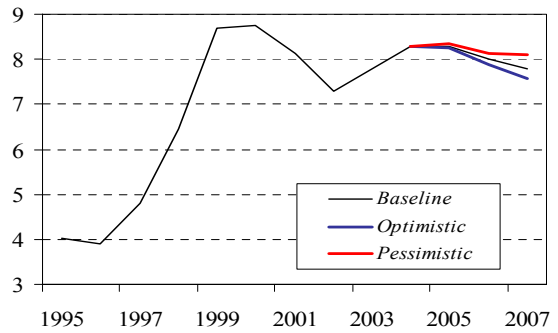
Source: MoF CR

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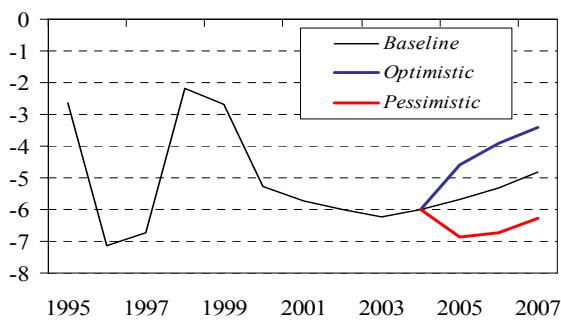
Graph 5.11: GDP growth (in %)



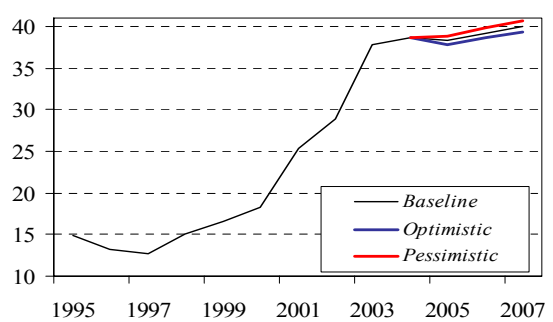
Graph 5.12: Unemployment Rate (in %)



Graph 5.13: Current Account (% of GDP)



Graph 5.14: Public Debt (% of GDP)



Source: MoF CR

6 Quality of Public Finances – Government Revenues and Expenditures

6.1 Government Strategy

In 2004 the government set out on a reform of public finances, which is aimed not only at gradually reducing the budgetary deficits but also at improving the quality of public finances. The new government has confirmed these objectives in its Programme Declaration. The government's declared expenditure priorities are as follows:

- Research and development
- Education
- Transport infrastructure
- Programmes co-financed from the EU budget.

The government will strive to restructure public expenditure in a way that will strengthen the areas mentioned above, while ensuring that spending on the government's priorities will not endanger the approved expenditure frameworks. Higher expenditure in priority areas will be financed from savings combined with a reassessment of other expenditure, including mandatory expenditure. Further opportunities for the financing of these priorities arise thanks to the savings measures approved last year and implemented in the 2004 state budget.

Furthermore, certain tax changes were approved towards the end of 2003 and have been effective since the beginning of 2004. These tax changes reduce the role of income taxes and raise the importance of indirect taxes. This means a shift from the taxation of labour and profit (which has a negative effect on the markets of production factors) towards the taxation of consumption. This autumn brought the beginning of a debate focussed on changes in income taxes, with special focus on the promotion of investment activity, research and development, as well as support of families with children.

6.2 General Government Expenditure

The preparation of public finance reform was based on the principle that in the process of deficit reduction expenditure savings should prevail over tax changes. Over the next three years the ratio of general government spending to GDP will drop by almost 4 p.p. Fiscal consolidation will affect almost all expenditure items; government consumption, social transfers and subsidies will experience the most significant decline. Starting in 2005, the government will no longer be burdened by transformation costs. In accordance with government priorities, government investment will increase. It will also be possible to fund additional investments from the Structural Funds and the Cohesion Fund. Expected growth in interest rates and a higher level of government debt may lead to increased debt service expenditure.

Table 6.1: General Government Expenditure

% of GDP	ESA code	Year	Year	Year	Year	Year
		2003	2004	2005	2006	2007
			(1)	(2)	(2)	(2)
Components of expenditures						
Final consumption expenditure	P3	23.8	23.0	22.4	22.0	21.7
Social transfers other than in kind	D62	12.6	12.1	11.7	11.5	11.2
Interest	D41	1.3	1.2	1.4	1.5	1.6
Subsidies	D3	2.8	3.0	2.7	2.5	2.3
Gross fixed capital formation	P51	4.2	4.3	4.4	4.5	4.6
Other		9.8	4.0	3.1	2.7	2.5
Total expenditures	ESA	54.5	47.6	45.8	44.7	43.9

(1) Projection

(2) Forecast

Source: MoF CR

The set of economic measures approved last year (Box 6.1) is focused on increasing the efficiency of the pension and health insurance systems, on controlling the growth in wage expenditure and on the management of other expenditure categories, so that the growth in central government expenditure would not exceed the values defined in the medium-term expenditure framework. These measures should result in an increase in the quality of government expenditure – in higher efficiency of the government sector, in reduction of social transfers contributing to better functioning of the labour market and in the freeing of funds for higher investment in government priorities.

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

Starting from 2004, the system of state social support is to become more efficient. Measures implemented do not always result in direct budgetary savings, but increase incentives for active job seeking (see 2.4). Measures that should result in a lower volume of social expenditure include the abolition of transportation benefits and lower indexation of subsidies.

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

In 2004 a number of legislative measures focused on rationalising public expenditure came into force. Although the primary objective of these measures was to accomplish budgetary savings, many of these measures improve economic incentives, contribute to a greater use of the labour force and strengthen the supply side of the economy. Among measures with such effects can be included the increase in the retirement age, substantial tightening of early retirement schemes, reduction in the generosity of sickness benefits and abolition of the restrictions on earning while drawing some social benefits.

To provide an overview of the reform steps, this box summarizes all important spending measures that affect public expenditures as of 2004.

6 Quality of Public Finances – Government Revenues and Expenditures

Parametric changes in the pension system:

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

System of sickness benefits

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

System of state social support

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

Wages and employment in the government sector

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

Other measures and discretionary changes

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

During the preparation of the state budget for 2005 and updating of the medium-term expenditure framework for 2006 and 2007, it became obvious that approved spending reforms would not be sufficient for preventing a breach of this medium-term expenditure framework. In the budget proposal for 2005 this issue was resolved by discretionary cuts in certain categories of expenditure. In 2006 and 2007 it will be necessary to supplement these discretionary measures (reduction of wage growth, global reduction in all expenditure categories) with additional systemic reforms (new law on subsistence minimum and poverty).

Table 6.2: Additional Savings Measures Suggested by the Ministry of Finance

bill. CZK	Year 2005	Year 2006	Year 2007
Reduction of social benefits expenditures	1.0	2.0	2.0
Reduction of state social support benefits	0.5	1.0	1.0
Reduction of expenditures on passive employment policy	1.0	2.0	2.0
Reduction of sickness benefits expenditures	2.0	2.0	2.0
Deferral of State Employees' Service Act	0.0	0.0	8.5
Elimination of the valorization mechanism and reduction of severance pay and retirement pay for members of army and police forces	0.0	4.0	5.8
Prolongation of freezing the salaries of constitutional officials, MP's, judges and state attorneys beyond the year 2006	0.0	0.0	1.5
Reduction of expenditure categories implemented in the state budget for 2005	2.5	2.5	2.5
Reduction of selected expenditure categories and global cut of 4 % in the state budget for 20	0.0	15.4	14.3
Total	7.0	28.8	39.6

Source: MoF CR

On the contrary, in the period 2006 to 2007 we assume that expenditure will increase even by CZK 11.0 billion (i.e., 0.3 % of GDP), especially as a consequence of identified higher expenditure on transport infrastructure (due to the completion of highways currently under construction). However, when facing the situation of increased expenditure the government will do its best to achieve the adopted fiscal targets and not to divert from them.

6.3 General Government Revenues

The development of government revenues is affected by the ongoing tax reform. By 2007 the ratio of public revenues to GDP will fall by 1.8 p.p. in comparison to 2004. In comparison to 2003, taxes on production and imports will increase, due to a rise in value added tax and excise duties. On the other hand, taxes on income will be falling, in accordance with the government strategy of lowering the taxation of production factors. The ratio of social contributions to GDP will increase slightly. Apart from these developments, we can expect a fall in the income from interest payments. Due to continuing use of deficit financing, the volume of the government's general financial assets will decline and this will lead to a decrease in the volume of income from interest payments.

The development of the tax quota between 2004 and 2007 reflects both the impact of tax changes and the composition of GDP growth. Tax receipts in relation to GDP will rise in 2004 only by 0.3 p.p., despite the fact that the increase of VAT and excise duties (amounting to 1.4 p.p.) is concentrated in this year. The reason for this lies in the sources of GDP growth. Nowadays the growth is driven mainly by investment and in future a significant source of growth will be net exports. Both these sources of growth do not directly lead to large tax incomes. Therefore the tax quota will show a significant tendency towards autonomous decline until 2007.

Table 6.3: General Government Revenues

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (2)	Year 2006 (2)	Year 2007 (2)
Components of revenues						
Taxes on production and imports	D2	11.4	12.3	12.3	12.1	11.7
Current taxes on income and wealth	D5	9.8	9.6	8.5	8.5	8.5
Social contributions	D61	15.2	15.1	15.1	15.2	15.2
Interest income	D41	0.7	0.5	0.4	0.4	0.3
Other		4.8	4.9	4.8	4.8	4.8
Total receipts	ESA	41.9	42.4	41.1	40.9	40.6

(1) Projection

(2) Forecast

Source: MoF CR

Many legislative changes in the field of taxation have been implemented in 2004. Individual measures executed at both stages of public finance reform are summarized in Box 6.2. The format of the tax measures adopted during the first stage of the reform was predetermined by the effort to consolidate public finances and by the requirement to harmonise tax legislation with EU requirements. To start up the process of public finance consolidation, VAT and excise duty modifications were used to raise tax revenues. Changes were also made in the fields of corporate income tax, property taxes and taxation of the self-employed.

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

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

Value Added Tax

- In accordance with EU regulations selected goods and services were transferred from the reduced (5 %) to the standard rate. The change took place in two steps – a part from 1 January 2004 (e.g. telecommunications) and the remaining items from 1 May 2004 (e.g. construction works);
- From 1 October 2003, the turnover threshold for obligatory VAT registration was reduced from CZK 3 mil. to CZK 2 mil. a year and from 1 May 2004 further to CZK 1 mil. a year;
- The VAT law will contain provisions regulating intracommunity trade between EU Member States.
- From 1 May the standard VAT rate was reduced by 3 percentage points (from 22 % to 19 %). The reduced rate remains unchanged and it covers only a narrowly defined list of socially sensitive commodities (food, drugs, construction works for housing, heat etc.)

Excises

- The excise duties on commodities where Czech rates were lower have been raised above the level of the minimum rates applied in the EU. From January 1, 2004 excise duty on mineral oils was raised. The tax burden on the most frequently sold type of cigarettes will be gradually increased to reach 57 % or at least 60 € per 1000 cigarettes by January 1, 2007;
- A rise in the excise duty on spirits and tobacco products will be accompanied by measures aimed at the prevention of tax evasion (stamping of spirits, restrictions on stand selling);
- A new regulation on excise duties, which will introduce changes concerning duty suspension arrangements through so-called tax warehouses, has been accepted.

Income taxes

6 Quality of Public Finances – Government Revenues and Expenditures

- The amended Income Tax Act introduces a common system of taxation for parent companies and subsidiaries from different Member States and a common system of taxation applicable to mergers, transfers of assets and exchanges of shares concerning companies from different Member States;
- The corporate income tax rate was reduced to 28 % from 1 January 2004 and will be further reduced to 26 % as of 1 January 2005, and finally to 24 % as of 1 January 2006;
- Faster depreciation of items listed in the first three amortisation groups (e.g. computers, selected means of transport, machinery).
- Increased R&D allowance amounting to up to 10 % of the tax basis.
- Self-employed persons have to pay at least a minimum amount of tax corresponding to a notional income at the level of 50 % of the average wage.
- Joint taxation of married couples became effective, serving as a tool to support families with children and replacing child allowance by tax credit, including tax bonus.

Social contributions

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

Real estate transfer tax

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

The first stage of the public finance reform started the re-shuffling of the tax burden from income taxation, which impairs economic activity significantly, towards indirect taxation. The second stage of the reform continues in the same direction by launching a tax package for bolstering economic growth. The most significant measure is further reduction in effective taxation of corporate profits and it will be achieved by the acceleration of depreciations and by an increase in the R&D allowance. Whereas the lowering of the statutory CIT rate approved at the first stage will increase the rate of return on capital and promote the attractiveness of entrepreneurship in general, the acceleration of depreciations will endorse investment activity and strengthen the supply side of the economy. Similar effects are expected from the increased tax allowance for R&D.

The support of families with children is another objective of the intended measures. The abolition of child allowance and its replacement by tax credit, including tax bonus, is to have a positive impact. Lower-income families with children and with some taxable income will benefit from this measure. The resulting financial benefit should be stimulating to a more active participation in the labour market. Joint taxation of married couples is also being introduced, in particular with a view to helping young families with children, as this taxation option will mitigate the negative impact of progressive income tax.

The measures enhancing economic growth and supporting families with children will be financed by an increase in indirect taxes. The majority of goods and services previously taxed by the reduced VAT rate became taxed by the standard rate. The major shift came into effect on 1 May 2004, when the standard VAT rate also began to apply to the goods and services for which this change had already been agreed at the first stage of the reform. Only socially sensitive items are still excluded from the standard VAT rate. To mitigate the price impact of shifting most goods and services to the standard rate, the standard rate was lowered by 3 percentage points as of 1 May 2004.

Table 6.4: The Impact of Tax Changes on Public Budgets⁽¹⁾

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

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

Source: MoF CR

Tax changes implemented in 2004 raised government revenues by approximately 1.0 % of GDP. The changes in excise duties and VAT will contribute most to the increase in revenues. They will generate additional revenues of approximately 1.4 % of GDP; the target level is close to 2 % of GDP. On the other hand, the adjustment of the statutory CIT rate is about to bring a tax relief of 0.9 % of GDP for companies. The overall effect of tax changes prepared for the second stage of public finance reform is designed to be close to being neutral. Since VAT adjustments precede changes in income taxation, there is an increase in tax revenues in 2004. In the following years the tax support of investments and families with children will take effect and thus tax revenues will decrease. The effect of faster depreciations on total tax revenues will fade away gradually and tax revenues will remain nearly unchanged in the medium term.

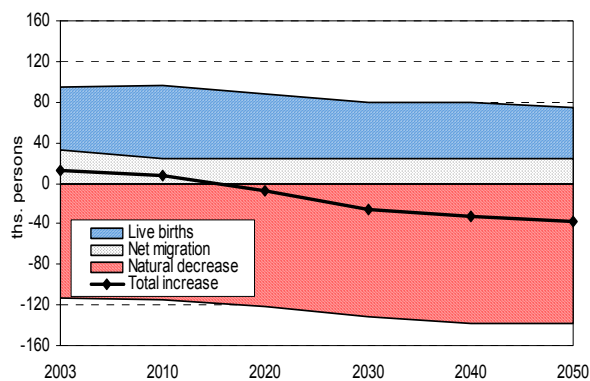
The measures that have been carried out during the first stage of the reform will lead to an increase in revenues for the government sector. Thus, the measures are likely to have a rather restrictive impact on the economy through a reduction in aggregate demand. Nevertheless, the short-term impact on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

7 Sustainability of Public Finances

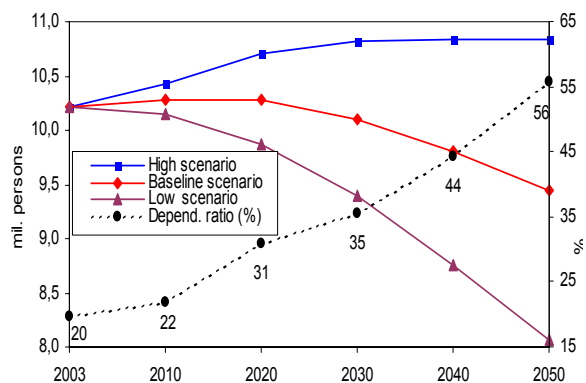
A substantial part of public expenditure consists of spending programmes, an analysis of which requires a long-term perspective. Current decisions on these programmes affect spending patterns not only in the immediate future but also after several decades and often much more intensively. On these grounds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

At present, there are two recent demographic projections for the Czech Republic available, both dating from 2003. They were produced by the Czech Statistical Office (CSO) and the Faculty of Science of the Charles University, respectively. Both projections agree in forecasting that the proportion of elderly people will rise rapidly. This will have serious effects on the sustainability of spending programmes that are targeted at those age groups. For reasons of objectivity the fiscal projection was based on the CSO forecast, as it foresees more adverse consequences in terms of the fiscal costs of an ageing population than the forecast of the Faculty of Science.

Graph 7.1: Structure of Demographic Development



Graph 7.2: Population Development and Dependency Ratio



Source: CSO

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

In spite of the fact that there are significant differences in the size of population in the respective demographic scenarios, their dependency ratios differ only marginally. The process of population ageing represented by the dependency ratio peaks approximately 20 years later in acceding countries than in most other EU countries.²⁷ Nowadays, the Czech Republic belongs to those countries which have a rather young population when compared to the EU - 15 average, but viewed from the end-point of the demographic forecast (2050), its share of the

²⁷ According to the forecast of the Faculty of Science of the Charles University, which extends up to 2065, the dependency ratio continues to rise until the middle of the 2050s.

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

In quantitative terms this chapter of the programme is identical to the version prepared in May 2004, when the database and demographic projections were updated and some minor changes were made in the models for the calculation of individual expenditure items. Since the release of the Convergence Programme of May 2004 there has been neither a substantial review of evaluation of the macroeconomic situation nor measures significantly influencing the sustainability of public finances in the Czech Republic.

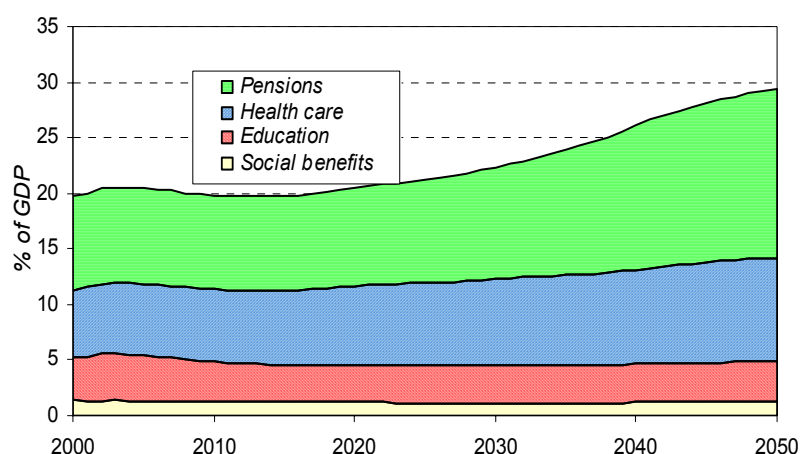
The public finance reform, launched in 2003, remains one of the priorities of the government. Mainly during the first phase of the reform, certain measures were approved in order to reduce the level of long-term fiscal imbalance. Among the most important measures are the changes in the pension system: gradual increase of the retirement age to 63 both for men and women, curtailing of one of the two early retirement schemes and reduction of the time of study that can be recognised for the purposes of pension insurance. On the revenue side of the pension system, steps have been undertaken that will bring the effective pension contributions of the self-employed up to those of employees and will thus bring in additional revenues to the pension system.

The government's keynote address includes a pledge to present a proposal of pension system reform to the Chamber of Deputies before the end of the election period. Nowadays there is a discussion among all parliamentary parties about the reform. In April 2004, a group of experts and politicians was set up in order to serve as an institutional platform for discussion and to scientifically assess various pension reform options. The government has decided to establish an independent "Executive Team for Pension Reform" that will compare individual reform options on the basis of pre-defined evaluation criteria and will carry out all the necessary calculations. Members of the team are experts in the area of pension systems from the Czech National Bank, Ministry of Labour and Social Affairs and Ministry of Finance. The currently discussed options range from parametric changes of the current system, through transition towards a defined contribution system financed on a pay-as-you-go basis (NDC system) and obligatory or optional partial reallocation of individual contributions into private pension funds, to proposals introducing a unified level of pension benefits.

The health care sector has become one of the main priorities for the government's legislative activity. An important step towards a reform of the current system of providing and funding healthcare was the consultations with experts from the World Bank that took place in May 2004 under the patronage of the Minister of Finance. The key conclusion of the World Bank mission was that any reform in this area should be focused on designing a balanced and long-term sustainable format of the involvement of public resources in the health care system and on optimising and modernising the network of health care providers. The reform efforts should also concern other issues, such as the funding and provision of long-term care and creation of a market of complementary insurance covering auxiliary services in the health care sector. All measures should be in line with the requirement for long-term fiscal sustainability.

Last but not least, long-term sustainability of public finances in the Czech Republic will be helped by the reduction of the primary deficit from a recent level of almost 5 % of GDP to just below 2 %, which will result from the increases in public sector revenues and decreases in expenditure to be achieved between now and 2007 within the framework of public finance reform.

Graph 7.3: Development of Individual Age-Dependent Expenditure Items



Source: MoF CR

A substantial increase in the area of pension and healthcare expenditure can be expected in particular in the second quarter of the 21st century. Advances in life expectancy will be the most important driving force; where men are concerned, the increase in life expectancy will be particularly significant. Initially, pension and healthcare outlays will be partly (but far from entirely) compensated for by low fertility rates that will result in lower expenditure in the areas of education and social benefits for families with children. Nevertheless, this factor will have exhausted itself in about twenty years and after that we expect these types of expenditure to start growing again. The projection results should be interpreted very carefully, as long-term projections are inevitably susceptible to both under- and over-estimates and they presume a continuation of present policies regardless of any future (and very likely) reforms.

Table 7.1: Long-Term Sustainability of Public Finance

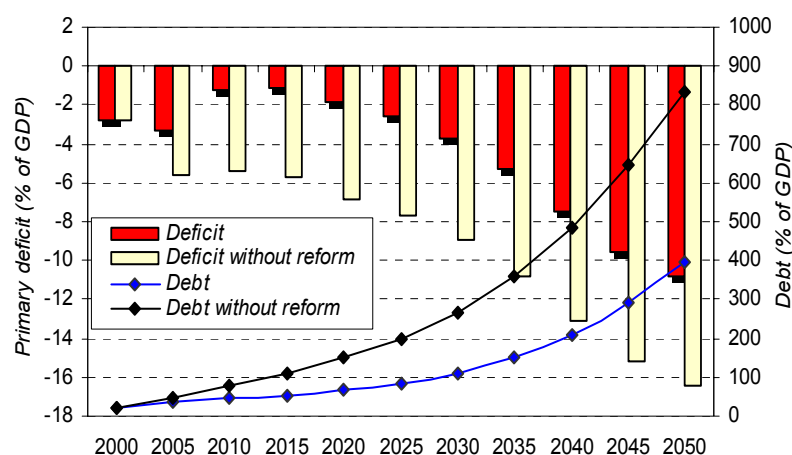
% of GDP	Year 2003	Year 2005	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050
Total expenditure	54.5	45.8	40.9	41.6	43.4	47.2	50.5
Old-age pensions	6.4	6.5	6.3	6.5	7.4	9.9	11.8
Other pensions	2.2	2.2	2.2	2.3	2.6	3.1	3.4
Education	4.2	4.1	3.6	3.4	3.4	3.4	3.6
Healthcare (including care for the elderly)	6.3	6.4	6.5	7.0	7.7	8.5	9.3
Interest payments	1.3	1.4	1.7	2.5	4.0	7.8	14.8
Total revenues	41.9	41.1	39.7	39.7	39.7	39.7	39.7
of which: from pensions contributions	8.3	9.0	9.0	9.0	9.0	9.0	9.0
National pension fund assets (if any)							
	Assumption						
Labour productivity growth	3.8	3.9	3.4	2.8	2.5	1.8	1.8
Real GDP growth	3.1	3.6	3.9	2.3	1.7	0.6	1.1
Participation rate males (aged 20–64)	84.8	84.7	84.9	85.7	84.5	83.6	83.9
Participation rates females (aged 20–64)	67.6	67.6	68.1	71.5	72.3	73.9	77.2
Total participation rates (aged 20–64)	76.2	76.1	76.5	78.6	78.4	78.8	80.6
Unemployment rate	7.8	8.3	7.9	6.5	6.5	6.5	6.5

Source: MoF CR

In order to evaluate the long-term fiscal impact of public finance reform, we compared our calculations with those reflecting the estimated evolution of revenues and spending without the consolidation measures of 2003 and 2004. The latter projection simply preserves all the unfavourable budgetary trends from the past and extrapolates them into the future. The impact

of consolidation on the primary deficit of the structural balance and public debt is shown in Graph 7.4.

Graph 7.4: Primary Deficit and Public Debt



Source: MoF CR

Despite positive effects brought about by the consolidation measures adopted to date, it is apparent that public finances have not reached a sustainable level as yet. In the absence of additional consolidation measures, the expected boom in expenditure would have to be backed up by a higher tax burden imposed on both current and (in particular) future taxpayers. Otherwise the level of government spending programmes for those generations would have to be restricted. With a view to achieving a sustainable fiscal position and inter-generational justice, further, long-lasting consolidation efforts will be needed, concentrated in the areas of pensions and healthcare. These will have to be aimed at improving the sustainability, manageability and quality of public finance.

Should the Czech fiscal and budgetary policy have to comply after EU entry with the fiscal-discipline requirements imposed by the Stability and Growth Pact, measures to curtail the expenditure ratio or to boost the revenue ratio by more than 5 percentage points of GDP would be required in 2008 (the so-called sustainability gap). Translated into aggregate general government balances, a sustainable fiscal target would be a surplus of 1.8 % of GDP in 2008. The following table compares the two above-mentioned projections, with and without public finance reform, in terms of overall fiscal outcome and illustrates the fact that public finance reform has substantially reduced the risks posed by population ageing. This finding should, however, be interpreted with caution, for the apparent risk reduction is to a significant extent due to a postponement of the expansion in pension spending and to a reduction of the initial level of primary deficit. This generally improves the results regardless of worrisome demographic developments. As one can see from the following table, further delays in necessary reforms represent the most important short-term risk to fiscal sustainability. Each additional year by which the budgetary consolidation is delayed incurs extra costs (of about 0.3 to 0.4 percentage points of GDP) for restoring a sustainable fiscal position.

Table 7.2: Scope of Necessary Fiscal Consolidation

% of GDP	Year 2008	Year 2009	Year 2010
1. Revenues (forecasts)	39.7	39.7	39.7
2. Expenditures (forecasts)	41.2	41.0	40.9
3. General government primary balance (1-2)	-1.5	-1.4	-1.3
4. Sustainability gap ⁽¹⁾	4.8	5.0	5.1
5. Required primary balance (3+4)	3.3	3.6	3.9
6. Required total balance	1.7	1.9	2.2
7. Sustainability gap without public finance reform	10.3	10.6	11.0

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

Source: MoF CR

8 Changes in the Institutional Framework

A significant step towards the achievement of fiscal targets defined in the Public Finance Reform Concept is the recently adopted amendment to the Act on Budgetary Rules²⁸. The complex of measures introduced by this amendment will make a significant contribution to the reinforcement of aggregate fiscal discipline, improvement of allocation efficiency of public budgets and the so-called operational effectiveness of government-controlled organisations.

The most important change lies in the introduction of fiscal targeting, based on medium-term fiscal outlooks, applicable both to the state budget and state funds, and binding medium-term expenditure frameworks based on the mentioned outlooks. The binding medium-term outlooks are a new tool in this area.

The act defines exhaustively the minimum scope of the medium-term fiscal outlook for the state budget²⁹ and state funds, the time scope of such a fiscal outlook (based on the “n + 2” principle) and the link to fiscal expenditure frameworks. Furthermore, it specifies the individual phases of the budgetary process more precisely than before, both in terms of their content and time scope.

Similarly, the act explicitly defines the medium-term expenditure frameworks on the basis of the so-called sliding principle, comprising the total expenditure on the state budget and state funds for each year of the medium-term outlook³⁰. The act also specifies the types of expenditures that are excluded from the expenditure frameworks³¹ and the manner in which the limits for medium-term expenditure frameworks are to be determined (including the provision for their subsequent adjustments). The procedure for the preparation of the draft state budget for the following year, on the basis of amounts specified in the medium-term expenditure framework, is also defined therein. The medium-term expenditure frameworks represent a positive shift towards budgeting over several years rather than a single year. The expenditure frameworks are debated by the government and subsequently approved by the Chamber of Deputies in the form of a resolution regarding the draft act on the state budget. The government is bound by the medium-term expenditure framework and insofar as it deviates from this framework, it has to justify such a deviation.

²⁸ Act No. 482/2004 on Budgetary Rules, effective as of September 7, 2004

²⁹ The government's expectations and intentions concerning revenues, expenditure and balance of the state budget and state funds (in particular intended changes of laws and other legal regulations), expected total revenues and expenditure of the state budget (subdivided by chapter) and state funds for individual years, programme expenditure and participation of the state budget in their funding and expenditure needed for programmes or projects co-financed from the EU budget (subdivided into individual chapters of the state budget and state funds).

³⁰ The figure for the medium-term expenditure framework for the 1st year of the medium-term outlook is based on the medium-term expenditure framework for the same year and may be adjusted for selected expenditure items. This way the figure for the 2nd year of the medium-term outlook becomes the figure for the 1st year of the outlook.

Once adjusted to include the cost of called state guarantees, refundable financial assistance and – where applicable – the expenditure incurred due to unforeseen circumstances, the level of total expenditure specified in the resolution of the Chamber of Deputies becomes the level of state budget expenditure, as specified in the draft act on the state budget.

³¹ State guarantees approved before April 30, 2004, with the exception of the cost of state guarantees to creditors of the Railway Infrastructure Administration (Sprava železniční dopravní cesty, a state organisation) and refundable financial assistance.

The medium-term principle of the budgetary process has also been reinforced by an amendment of the Rules of Government Procedure. This amendment stipulates that any and all proposals submitted to the government must also contain an impact evaluation of proposed changes on public budgets, at least over a period of three years (i.e. an estimate of future expenditure and the proposed source of financing).

The draft state budget for 2005 and the binding medium-term expenditure frameworks for 2006-2007 have already been prepared on the basis of the recently adopted amendment to the Act on Budgetary Rules.

A significant measure aimed at improving budgetary management is the restriction of the possible use of extraordinary revenues of the state budget for extraordinary expenditure. At the moment, such a use of extraordinary revenues is conditional upon the Parliament passing an amendment to the State Budget Act.

The amendment to the Act on Budgetary Rules also lays substantially higher emphasis on the need to enhance the commitment and discipline of the budgetary chapters' administrators, while strengthening their managerial authority. The budget chapters' administrators will have the right to roll over the entire amount of unspent revenues earmarked for investment and operational financing into the following years. The sanctions for breach of budgetary discipline are also laid down in more detail. The amended budgetary rules require the administrators of individual chapters to carry out continual monitoring and assessments of the efficiency, effectiveness and purposefulness of all expenditures in their chapters. The same approach is applied to individual organisational entities of the state and to semi-budgetary organisations established by the administrators of individual chapters. Results of the said monitoring and assessments are to be published in the form of annual reports³².

The Ministry of Finance is to publish quarterly and biannual reports with an assessment of the performance of the state budget and the final state account, both in electronic form.

In accordance with the Public Finance Reform Concept, measures are being prepared that will conclude the activities of individual privatisation funds³³ and other extra-budgetary agencies and funds of the state.

The National Property Fund (NPF) has nearly fulfilled its role as a transformation institution (privatisation fund) and has finalised the privatisation of the vast majority of state property. Therefore its operation should be concluded without liquidation by the end of 2005. The State, represented by the Ministry of Finance, will be appointed the legal successor to the NPF by law. All property of the NPF, balances of its accounts and all receivables and liabilities will be transferred to the Ministry of Finance. The ways of managing the property, disposing of it and further privatisation after the ending of the NPF's activities will also be defined in the relevant legislation, which is currently being prepared. The objective of these measures is to create conditions for a smooth completion of the privatisation of state property earmarked for privatisation but still left in state hands at the end of 2005.

³² Annual reports are prepared by the state's organisational units, semi-budgetary organisation and state funds, whereby the reports treat of these units and organisations, their activities and in particular their management of resources.

³³ The privatisation funds are the National Property Fund and Land Fund.

Another step aimed at concluding the privatisation process is the termination of the activities (or rather the transformation) of the Land Fund of the Czech Republic, planned to take place at the end of 2009. The remaining tasks of the Fund will probably be assumed by the Land Settlement Offices (which represent an organisational unit of the state).

Proposed measures concerning the CKA³⁴ are also closely linked to efforts aimed at increasing the transparency of public finance and thus preventing any circumvention of expenditure frameworks. On the basis of the government's resolution the CKA should conclude its operation without liquidation by December 31, 2007. The above-mentioned provision of the amendment to the Act on Budgetary Rules, which substantially restricts the transfer of poor-quality assets to CKA, is also closely related to this decision. Pursuant to the relevant legislation, it will be no longer possible to transfer any non-performing loans into the CKA portfolio as of January 1, 2006. Before CKA's operations are concluded, the state will have to find a way of settling CKA's receivables vis-à-vis the state budget. These were accrued due to the accumulation of unsettled losses from previous years. The settlement of CKA's receivables is solved with a special state bond programme for the years 2004 – 2007, approved by the Chamber of Deputies.

Insofar as the efforts aimed at decreasing the number of extra-budgetary funds are concerned, the Chamber of Deputies has approved an act on the conclusion of the activities of the State Fund for Land Fertilisation that should take place as of January 1, 2006.

³⁴ *In the context of the termination of CKA's activities (expected in 2006) the amendment to the Act on Budgetary Rules comprises a considerable restriction of the possibility of further transfers of non-performing assets to the balance of the CKA under non-market conditions. Additional transfers of such assets to CKA at non-market prices should be subject to the approval of the government and – for amounts over CZK 1 bn. a year - to the approval of the Chamber of Deputies of the Parliament of the Czech Republic.*

9 Annexes

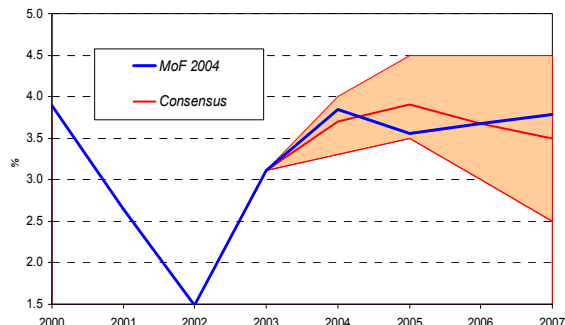
9.1 Verification of Macroeconomic Scenario by Means of Consensus Forecast

As usual, feasibility of macroeconomic scenario of the Convergence Programme has been verified by means of a consensus forecast.

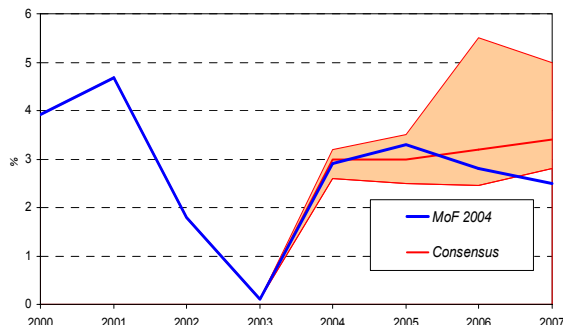
A consensus forecast has been a standard part of preparation of the State Budget's macroeconomic framework in the Czech Republic since 1996. Based on it, the Ministry of Finance organizes twice a year a Colloquium i.e. a meeting of representatives of relevant public and private institutions. The consensus forecast is computed as an arithmetic average of forecasts collected by means of a survey carried out in the form of standardized questionnaires. Normally this exercise involves developments expected in the current year and the year after. For the purpose of this scenario, the perspective of the survey has been extended by short-term outlook for the next two years to 2007.

Fourteen institutions took part in the 18th Colloquium, while nine respondents presented short-term outlooks for 2006 to 2007. They were state administration bodies, CNB, domestic banks, branches of foreign banks, investment companies and research institutes.

Graph 9.1: Forecasts of Economic Growth



Graph 9.2: Forecasts of Average Rate of Inflation



Source: MoF

It can be generally stated that the consensus forecast for 2004 to 2005 is very close to the macroeconomic scenario with minimal differences, in most cases below the precision limit for statistical surveys. Some divergences can be seen as regards the longer horizon 2006 to 2007³⁵ but underlying trends are identical. Participants of the Colloquium mostly expect favourable and smooth developments without substantial demand- or supply-side shocks.

Average forecast level of GDP growth in the macroeconomic scenario is similar to that in the consensus forecast. Regarding the individual components of use, this scenario is slightly more conservative for household consumption (in 2005 and 2006) and government consumption but it expects better results of the balance of trade in constant prices.

³⁵ Reliability of the consensus forecast for 2006 to 2007 is somewhat limited due to a smaller number of respondents.

Expected average rate of inflation in 2006 to 2007 is slightly lower with downward tendency in macroeconomic scenario. The cause can be seen in different views on whether factors, accelerating growth of consumer prices at present, are one-off or permanent.

The scenario perceives more intensively structural risks on the labour market, in particular as regards unemployment.

The current account forecast corresponds to the consensus forecast but the macroeconomic scenario expects a more marked improvement in the trade balance and worsening of the balance of income.

Table 9.1: Verification of the Macroeconomic Scenario by Consensus Forecast

			Year 2003	Year 2004	Year 2005	Year 2006	Year 2007	
Gross domestic product	growth in %	Minimum		3.3	3.5	3.0	2.5	
		Consensus	3.1	3.7	3.9	3.7	3.5	
		Maximum		4.0	4.5	4.5	4.5	
		CP 2004	3.1	3.8	3.6	3.7	3.8	
Private consumption	growth in %	Minimum		3.2	3.2	3.0	2.5	
		Consensus	4.9	3.6	3.9	4.0	3.5	
		Maximum		5.0	6.0	5.0	4.0	
		CP 2004	4.9	3.6	3.4	3.4	3.6	
Government consumption	growth in %	Minimum		-1.9	-2.0	0.0	-1.0	
		Consensus	2.2	-0.5	0.3	0.8	0.5	
		Maximum		2.5	2.5	3.0	2.5	
		CP 2004	2.2	-1.2	-0.2	-0.2	-0.1	
Gross fixed capital formation	growth in %	Minimum		7.0	4.5	3.5	2.8	
		Consensus	7.4	9.7	7.3	5.6	5.2	
		Maximum		13.5	11.0	7.5	6.5	
		CP 2004	7.4	9.3	7.0	5.4	5.0	
National inflation rate	growth in %	Minimum		2.6	2.5	2.5	2.8	
		period average	Consensus	0.1	3.0	3.0	3.2	3.4
		Maximum		3.2	3.5	5.5	5.0	
		CP 2004	0.1	2.9	3.3	2.8	2.5	
GDP deflator	growth in %	Minimum		3.5	2.5	3.1	2.8	
		Consensus	1.7	4.0	3.4	3.7	3.7	
		Maximum		4.8	4.5	5.5	5.0	
		CP 2004	1.7	4.0	3.1	3.0	3.2	
Employment	growth in %	Minimum		-1.0	-0.5	-0.3	-0.2	
		Consensus	-0.7	-0.8	0.1	0.1	0.2	
		Maximum		-0.5	1.0	0.5	0.5	
		CP 2004	-0.7	-1.0	-0.3	0.1	0.2	
Registered unemployment rate	in %	Minimum		10.1	9.6	9.0	8.2	
		end of period	Consensus	10.3	10.3	10.0	9.7	9.4
		Maximum		10.8	10.8	11.0	10.5	
		CP 2004	10.3	10.4	10.2	9.8	9.8	
Trade balance (current prices)	bill. CZK	Minimum		-70	-75	-63	-55	
		Consensus	-69	-57	-51	-52	-46	
		Maximum		-48	-38	-40	-35	
		CP 2004	-69	-50	-40	-30	-20	
Current account / GDP	% of GDP	Minimum		-7.0	-6.6	-6.7	-6.1	
		Consensus	-6.2	-6.1	-5.6	-5.3	-4.8	
		Maximum		-4.6	-4.3	-3.1	-3.0	
		CP 2004	-6.2	-6.0	-5.7	-5.3	-4.8	

Source: MoF

9.2 Overview of Guarantees

Information about the reclassification of state guarantees as a part of the government deficit and debt and the quantification of their impact on the government deficit is provided in Table 9.2. This applies to high-risk guarantees provided by the state in the past, in particular for the purposes of modernisation and development of the railway and road infrastructure and stabilisation of the banking sector. In view of the debtors' inability to meet their obligations, resources for debt servicing have been repeatedly provided from the state budget.

Table 9.2: Reclassification of State Guarantees and their Inclusion in the State Deficit in Individual Years

	mill. CZK	year of provision	percentage of GDP (%)
1994 Mitas, a. s.	219	1990	
PBS Brno, a. s.	874	1990	
Total	1093		0.1
1995 Konax, a. s.	74	1991	
Mesit, a. s.	53	1990	
Total	127		0.0
1996 Improvement of the state of roads - EI (EIB loan)	2 034	1996	
Total	2034		0.1
1997 Healthcare providers	537	1995	
Chepos	3 416	1995	
Total	3953		0.2
1998 Česká spořitelna (payment for AB Banka)	4 063	1995	
MDS investment (ČS loan)	1 580	1998	
D5 Highway (EIB loan)	5 778	1997	
flood relief project(EIB)	7 004	1998	
ČD, s. o. (modernisation of carriages - CLB)	500	1997	
ČD, s. o. (modernisation of carriages - CSOB)	1 100	1996	
ČD, s. o. (I.corridor - KfW loan)	447	1996	
ČD, s. o. (I.corridor - 2nd KfW loan)	1 125	2000	
ČD, s. o. (I.corridor - EBRD)	556	1996	
ČD, s. o. (I.corridor - 1st EIB loan)	4 378	1996	
ČD, s. o. (I.corridor - 2nd EIB loan)	2 627	1997	
ČD, s. o. (I.corridor - JEXIM)	3 117	1996	
ČD, s. o. (II.corridor- KfW)	3 572	1998	
ČD, s. o. (II.corridor - EIB)	7 004	1997	
Total	42851		2.2
1999 Czech Highways A (EIB loan)	8 310	1998	
Total	8310		0.4
2000 MATRA - Integrated rescue system	4 000	2000	
MDS loan (ČSOB loan)	1 082	1999	
Repairs of I. and II. class roads and highways (EIB loan)	3 334	2000	
Total	8416		0.4
2001 Water-management programme (EIB loan)	3 198	2000	
Improvement of E II roads (EIB loan)	3 198	2000	
ČD, s. o. (ČSOB - pendolino)	865	2000	
ČD, s. o. (ČSOB - investment)	900	1999	
ČD, s. o. (ČS - I.corridor)	2 125	2000	
ČD, s. o. (KB- revitalisation of carriages)	2 500	2000	
ČD, s. o. (KB- I.corridor)	2 000	2000	
ČD, s. o. (EIB - II.corridor)	5 117	2000	
Total	19903		0.9
2002 SEVAC	600	1996	
ČD, s. o. (ČSOB - replacement of carriages - series 471)	930	2002	
Total	1530		0.1
2003 FN Motol	412	1997	
VFN Praha	805	1997	
SŽDC, s. o. (KfW - I.corridor - extension)	1 491	2002	
ČNB - guarantee for IPB	160 000	2000	
ČSOB - guarantee for Slovenská inkasní	22 000	1997	
Total	184708		7.3
2004 Aero, a. s. production of L 159 planes (revolving credit)	7 719	1998	
Aero, a. s. - production of L 159 planes (bonds)	5 146	1998	
State guarantee for ČNB	22 500	1997	
Total	35366		1.3

Loans denominated in foreign currencies have been translated into CZK on the basis of the exchange rate applicable on December 31, with the exception of the year 2004, for which the exchange rate applicable on January 2, 2004, was used.

Table 9.3 lists guarantees that do not represent any major source of fiscal risk for the state, because the debtors have been duly repaying their loans, including the interest. Apart from these, the provision of three new state guarantees is currently being debated (see Table 9.4).

Table 9.3: Provided State Guarantees that Remain Untransformed into Government Deficit and Debt (low-risk guarantees)

	level of guarantee on 31. 12. 2004 (mill. CZK)	year of provision
A. State Guarantees Provided Pursuant to Acts No. 576/1990 Coll. and 218/2000 Coll.		
Project ENERGY I	1 319	1992
Nuclear Power plant Temelín - automated steering system	2 721	1996
Project TELECOMMUNICATIONS I	760	1993
Project TELECOMMUNICATIONS II (supplementary loan)	502	1995
Municipal development project - MUFIS (1st tranche)	1 031	1995
Municipal development project - MUFIS (2nd tranche)	562	1997
Municipal development project - MUFIS (3rd tranche)	597	1998
Pendolino carriages for Czech Railways (ČD a.s.) - ČSOB loan	2 932	2003
Carriages for Czech Railways (ČD, a. s.) from EUROFIMA	478	2003
Congress Centre Prague - completion and renovation	1 782	1999
<i>Total A.</i>	<i>12 684</i>	
B. Special Guarantees		
Guarantee for airlines	0	2001
C. Solidarity Guarantees (from the times of Czechoslovakia)		
	824	1993
Total A. + B. + C.	13 508	

Table 9.4: Expected Provision of New Guarantees

Investment Project	Total Value of Guarantee (mill.)
IV. corridor: Prague-Č.Budějovice-Horní Dvořiště	10 000 CZK
III. corridor: Cheb-Prague-Č.Třeb.-Mosty u Jablunkova	14 500 CZK
carriages for Czech Railways (ČD, a. s.) from EUROFIMA	45 EUR

9.3 Gender Budgeting

Gender budgeting is a new principle to be integrated within the budgetary process in the Czech Republic. Gender budgeting³⁶ is based on providing for equal access to financial resources by both genders, i.e. both men and women. This is the application of gender mainstreaming³⁷ to the budgetary process. The favourable impact of this approach may take the form of positive feedback from the electorate, economic growth or more favourable demographic development. Analyses have also confirmed that a budget prepared in line with the principles of gender equality leads to higher productivity and promotes GDP growth. Principles of gender budgeting can be applied throughout the budgetary process. Their use does not require any radical changes or high costs; it merely requires the introduction of gender equality as another criterion relevant to the budgetary process. The initial phase of the introduction of gender budgeting should be focused on the expenditure side of public budgets, as this side is more easily influenced (this applies in particular to local government budgets). However, it is also suitable to apply these principles to the revenue side of budgets (e.g. the impact of tax advantages on men and women, depending on their family status). An important source of data for the purposes of gender budgeting is statistics that differentiate between genders (statistics concerning healthcare, education, labour and salaries, social security, justice and criminality, participation in public affairs and decision-making processes, family and household). The government has adopted a resolution asking the Czech Statistical Office to publish such statistics at regular intervals. Gender budgeting can be implemented at two basic levels, i.e. the level of state administration (state budget) and that of local government (budgets of individual regions and municipalities).

In future it will be necessary to develop the existing methods, analyse the processes used for the implementation of this approach and assessment of expenditure (revenues) in this area, but also to look for new methods suitable for this area. The first step in this direction was the publication of *Informative Methodology of Gender Budgeting*³⁸, an item of material supposed to provide information about this approach to public servants as well as elected representatives involved in the preparation and execution of public budgets. One of the aims of this material is to provide assistance with the implementation of this approach and to help provide information about gender budgeting to the public at large.

The Czech Republic undertakes to provide for equal opportunities of women and men in particular in accordance with the annually updated *Government Priorities and Procedures Concerning the Promotion of Gender Equality*³⁹. Furthermore, the Czech Republic is obliged to respect gender equality as a signatory of the *UN Convention on the Elimination of All Forms of Discrimination against Women* and the *Beijing Platform for Action*. Very recently the rules of gender equality have been also reflected in the amended Labour Code and amended Act on Employment. By acceding to the EU the Czech Republic also endorsed the fundamental principles promoted by the EU, including the principle of equal opportunities for women and men. Furthermore, there is a *Framework Strategy on Gender Equality*.

³⁶ Also “budgeting based on equality of men and women”.

³⁷ *The process of organising, improving, developing and evaluating the political processes in a manner that will provide for the inclusion of the gender-equality principle at all levels and stages, enlisting all players and entities normally involved in political decision-making.*

³⁸ *Published by the Ministry of Finance and Ministry of Labour and Social Affairs.*

³⁹ *Government Resolution No. 453 of May 12, 2004.*

9.4 Tables

Table 9.5: Growth and Associated Factors

	ESA code	Year 2003	Year 2004 (1)	Year 2005 (1)	Year 2006 (2)	Year 2007 (2)
GDP growth at constant market prices (7 + 8 + 9) in %	B1g	3.1	3.8	3.6	3.7	3.8
GDP level at current market prices in bn CZK	B1g	2532	2735	2920	3118	3339
GDP deflator change in %		1.7	4.0	3.1	3.0	3.2
HICP change in %		-0.1	2.7	3.2	2.6	2.2
Employment growth in % ⁽³⁾		-0.7	-1.0	-0.3	0.1	0.2
Labour productivity growth in % ⁽⁴⁾		3.8	4.9	3.9	3.6	3.6
Sources of growth: percentage changes at constant prices						
1. Private consumption expenditure	P3	4.9	3.6	3.4	3.4	3.6
2. Government consumption expenditure	P3	2.2	-1.2	-0.2	-0.2	-0.1
3. Gross fixed capital formation	P51	7.4	9.3	7.0	5.4	5.0
4. Changes in inventories and net acquisition of valuables as a % of GDP	P52+P53	1.2	1.9	2.1	2.2	2.3
5. Exports of goods and services	P6	6.2	16.5	11.1	7.9	8.0
6. Imports of goods and services	P7	7.8	16.8	11.1	7.3	7.3
Contribution to GDP growth						
7. Final domestic demand		5.0	4.0	3.6	3.1	3.1
8. Change in inventories and net acquisition of valuables	P52+P53	-0.4	0.6	0.2	0.1	0.1
9. External balance of goods and services	B11	-1.5	-0.7	-0.2	0.4	0.6

(1) Forecasts

(2) Trend values or period averages.

(3) Occupied population, domestic concept, persons, national accounts definition.

(4) Growth of GDP at market prices per person employed at constant prices.

Source of tables 9.5-9.10: MoF CR

Table 9.6: General Government Budgetary Developments

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (1)	Year 2006 (2)	Year 2007 (2)
Net lending (B9) by sub-sectors						
1. General government	S13	-12.6	-5.2	-4.7	-3.8	-3.3
2. Central government	S1311	-12.2	-4.9	-4.4	-3.5	-3.0
3. State government	S1312					
4. Local government	S1313	-0.3	-0.3	-0.3	-0.3	-0.3
5. Social security funds	S1314	-0.1	-0.1	0.0	0.0	0.0
General government (S13)						
6. Total receipts	ESA	41.9	42.4	41.1	40.9	40.6
7. Total expenditures	ESA	54.5	47.6	45.8	44.7	43.9
8. Budget balance	B9	-12.6	-5.2	-4.7	-3.8	-3.3
9. Net interest payments		0.7	0.7	1.0	1.1	1.2
10. Primary balance		-11.9	-4.5	-3.7	-2.7	-2.1
Components of revenues						
11. Taxes	D2+D5	21.3	21.9	20.8	20.6	20.2
12. Social contributions	D61	15.2	15.1	15.1	15.2	15.2
13. Interest income	D41	0.7	0.5	0.4	0.4	0.3
14. Other		4.8	4.9	4.8	4.8	4.8
15. Total receipts	ESA	41.9	42.4	41.1	40.9	40.6
Components of expenditures						
16. Collective consumption	P32	12.0	11.5	11.2	10.9	10.7
17. Social transfers in kind	D63	11.8	11.4	11.2	11.1	11.1
18. Social transfers other than in kind	D62	12.6	12.1	11.7	11.5	11.2
19. Interest payments	D41	1.3	1.2	1.4	1.5	1.6
20. Subsidies	D3	2.8	3.0	2.7	2.5	2.3
21. Gross fixed capital formation	P51	4.2	4.3	4.4	4.5	4.6
22. Other		9.8	4.0	3.1	2.7	2.5
23. Total expenditures	ESA	54.5	47.6	45.8	44.7	43.9

(1) Forecasts

(2) Trend values or period averages.

Table 9.7: General Government-debt Developments

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (2)	Year 2006 (2)	Year 2007 (2)
Gross debt level		37.8	38.6	38.3	39.2	40.0
Change in gross debt		8.9	0.8	-0.2	0.9	0.8
Contributions to change in gross debt						
Primary balance		11.3	4.0	3.3	2.3	1.7
Interest payments	D41	1.3	1.2	1.4	1.5	1.6
Nominal GDP growth	B1g	-1.3	-2.8	-2.4	-2.4	-2.6
Other factors influencing the debt ratio		-2.4	-1.7	-2.5	-0.5	0.1
Of which: Privatisation receipts		-1.0	-1.0	-1.8	0.0	0.0
p.m. implicit interest rate on debt		4.8	3.5	3.9	4.1	4.3

(1) Forecasts

(2) Trend values or period averages.

Table 9.8: Cyclical Developments^(a)

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (2)	Year 2006 (2)	Year 2007 (2)
1. GDP growth at constant prices	B1g	3.1	3.8	3.6	3.7	3.8
2. Actual balance	B9	-12.6	-5.2	-4.7	-3.8	-3.3
3. Interest payments	D41	1.3	1.2	1.4	1.5	1.6
4. Potential GDP growth		2.9	3.1	3.5	3.6	3.6
5. Output gap		-0.8	-0.1	0.0	0.1	0.3
6. Cyclical budgetary component		-0.2	0.0	0.0	0.0	0.0
7. Cyclically-adjusted balance (2 – 6)		-12.4	-5.2	-4.7	-3.8	-3.3
8. Cyclically-adjusted primary balance (7 – 3)		-11.1	-4.0	-3.3	-2.3	-1.8

(a) Member States can fill-in lines 4–8 using either own figures or Commission figures.

(1) Forecasts

(2) Trend values or period averages.

Table 9.9: Divergence from Previous Update

% of GDP	ESA code	Year 2003	Year 2004 (1)	Year 2005 (1)	Year 2006 (2)	Year 2007 (2)
GDP growth						
previous update	B1g	2.9	2.8	3.1	3.3	3.5
latest update	B1g	3.1	3.8	3.6	3.7	3.8
Difference		0.2	1.0	0.5	0.4	0.3
Actual budget balance						
previous update	B9	-12.9	-5.3	-4.7	-3.8	-3.3
latest update	B9	-12.6	-5.2	-4.7	-3.8	-3.3
Difference		0.3	0.1	0.0	0.0	0.0
Gross debt levels						
previous update		37.6	38.4	39.7	41.0	41.7
latest update		37.8	38.6	38.3	39.2	40.0
Difference		0.1	0.2	-1.3	-1.8	-1.7

(1) Forecasts

(2) Trend values or period averages.

Table 9.10: Long-term Sustainability of Public Finances⁽¹⁾

% of GDP	Year 2003	Year 2005	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050
Total expenditure	54.5	45.8	40.9	41.6	43.4	47.2	50.5
Old-age pensions	6.4	6.5	6.3	6.5	7.4	9.9	11.8
Other pensions	2.2	2.2	2.2	2.3	2.6	3.1	3.4
Education	4.2	4.1	3.6	3.4	3.4	3.4	3.6
Healthcare (including care for the elderly)	6.3	6.4	6.5	7.0	7.7	8.5	9.3
Interest payments	1.3	1.4	1.7	2.5	4.0	7.8	14.8
Total revenues	41.9	41.1	39.7	39.7	39.7	39.7	39.7
of which: from pensions contributions	8.3	9.0	9.0	9.0	9.0	9.0	9.0
National pension fund assets (if any)							
Assumption							
Labour productivity growth	3.8	3.9	3.4	2.8	2.5	1.8	1.8
Real GDP growth	3.1	3.6	3.9	2.3	1.7	0.6	1.1
Participation rate males (aged 20–64)	84.8	84.7	84.9	85.7	84.5	83.6	83.9
Participation rates females (aged 20–64)	67.6	67.6	68.1	71.5	72.3	73.9	77.2
Total participation rates (aged 20–64)	76.2	76.1	76.5	78.6	78.4	78.8	80.6
Unemployment rate	7.8	8.3	7.9	6.5	6.5	6.5	6.5

(1) Information in this table, if provided, should be updated at least every three years.

Table 9.11: Basic Assumptions

	Year 2003	Year 2004	Year 2005	Year 2006	Year 2007
Short-term interest rate (CZ) (annual average)	2.3				
Long-term interest rate (CZ) (annual average)	4.1	4.9	5.3	5.4	5.5
United States: short-term (<i>three-month money market</i>)	1.2	1.6	2.4	3.0	3.0
United States: long term (10-year government bonds)	4.0	4.5	5.0	5.0	5.5
USD/EUR exchange rate (annual average)	1.13	1.22	1.21	1.22	1.22
Nominal effective exchange rate (euro area, %change)	11.8	4.2	-0.2	-0.1	-0.1
Nominal effective exchange rate (EU, % change)	12.8	6.9	-1.1	-0.9	-0.9
Exchange rate CZK/EUR (annual average)	31.8	32.0	31.1	30.5	30.2
World GDP growth, excluding EU	4.4	5.2	4.8	5.0	5.0
United States, GDP growth	3.0	4.4	3.7	4.1	4.6
Japan, GDP growth	2.5	4.5	2.8	3.3	4.0
EU-15 GDP growth	0.9	2.1	2.4	2.8	2.9
Growth of relevant foreign markets	5.4	6.5	7.7	8.0	8.0
World import volumes, excluding EU	7.3				
World import prices (goods, in USD)	8.8				
Oil prices (Brent, USD/barrel)	28.8	36.8	35.9	34.0	33.0
Non-oil commodity prices (in USD, % change)	7.1	18.5	-3.1	-2.4	-3.3

Source: EC