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DECEMBER 2004 UPDATE
OF THE CONVERGENCE PROGRAMME OF THE CZECH REPUBLIC
(2004-2007)
AN ASSESSMENT

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SUMMARY AND CONCLUSIONS¹

The first update of the Czech Republic's convergence programme, covering the period 2004-2007, was submitted on 1st December 2004. The programme broadly complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes".² In particular, in spite of a revision in the data provided after the submission of the update, the expenditure and revenue ratios are not fully consolidated in line with ESA95 statistical standards. Accordingly, the Czech Republic is invited to achieve compliance with the data requirements. In addition, the programme only broadly follows the model structure of Annex 2 of the "code of conduct on the content and format of stability and convergence programmes".

The baseline macroeconomic scenario presented in the programme expects real GDP growth to be 3.8% in 2004. In 2005, real GDP is forecast to reach 3.6% and to accelerate slightly later on, reaching 3.8% in 2007. This is below the Commission services autumn 2004 forecasts for the years 2004-2006, which project an average growth rate of 3.8% in 2004 and 2005 and 4% in 2006. For the year 2007, the programme's estimate of potential output growth is slightly above the estimate of the autumn forecast. On the basis of currently available information, the baseline scenario in the programme can thus be considered as plausible and is therefore treated as the reference scenario for assessing budgetary projections. Two alternative scenarios presented in the programme assume different developments of three key exogenous variables: foreign demand, the exchange rate, and oil prices.

Following deflation for most of 2003, price changes turned positive again and inflation returned inside the central bank target band in 2004. The updated programme expects HICP inflation to reach 2.7% on average in 2004. The Czech koruna depreciated by some 11% against the euro between July 2002 and March 2004, partly compensating for the strong appreciation experienced in the previous period. The koruna has been appreciating since April 2004 and despite a temporary stabilisation in the summer months, it gained some 4.5% against the euro in the first eleven months of 2004. Following a period of government bond yields below euro area levels in the first half of 2003, the spread started to slowly increase in October 2003, peaked at some 100 points in September 2004, before decreasing again in the fourth quarter of the year. The Czech Republic intends to join the euro area around 2009-2010 and to pursue inflation targeting until then. As of 1 January 2006, a steady inflation rate of 3% will be targeted with a tolerance of ± 1 percentage point. The authorities plan to limit the period of participation in ERM II to two years.

¹ This technical analysis, which is based on information available up to 22 December 2004, accompanies the recommendation by the Commission for a Council opinion on the update of the convergence programme, which the College adopted on 11 January 2005. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to Marek Mora (Marek.Mora@cec.eu.int).

² Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, document EFC/ECFIN/404/01 - REV 1 of 27.06.2001 endorsed by the ECOFIN Council of 10.07.2001. Compared to the Commission assessment (available at http://europa.eu.int/comm/economy_finance/about/activities/sgp/year/year20042005_en.htm), the evaluation of compliance follows a reclassification of the degree of compliance into four categories (namely "fully complies", "complies", "broadly complies" and "partly complies"), replacing the previous three-way classification ("complies", "largely complies" and "partly complies").

The programme aims at reducing the deficit from 5.2% of GDP (including one-off expenditures of about 1.2% of GDP) to below the 3% of GDP reference value in 2008, in line with the Council recommendation under Article 104(7). The programme targets a cut in the general government deficit by 1.9 percentage points between 2004 and 2007 and a cut in the primary deficit by 2.3 percentage points over the same period. However, excluding the impact of two one-off operations in 2004, the improvement in the nominal deficit is around 0.7 percentage points. The adjustment is foreseen to be gradual, by about 0.5% of GDP annually, except in 2006, when the cut is planned to be almost 1% of GDP. Both revenues and expenditures are planned to fall over the programme period (as a percentage of GDP), with public investment the only expenditure item expected to increase, from 4.2% of GDP in 2003 to 4.6% of GDP in 2007, well above the EU-average (2.4% of GDP in 2004). The deficit reduction path in the convergence programme is broadly in line with that in the pre-accession economic programme of August 2003. When compared to the May 2004 programme, there is no change of the deficit targets for 2005-2007 as percentage of GDP, although GDP growth has been revised upwards considerably and the estimated outcome for the 2004 deficit (excluding one-offs) is better than expected.

The risks to the budgetary projections in the programme appear broadly balanced. On the one hand, the relatively cautious macroeconomic scenario suggests that revenues could be better than expected and that expenditures could be lower than budgeted. Moreover, further risks to the budgetary targets linked to state guarantees and debt assumption appear to be limited. On the other hand, important expenditure cuts, particularly regarding government consumption, still have to be adopted in order to meet legally binding expenditure ceilings in 2006 and 2007. The implementation of expenditure ceilings is subject to a risk ahead of the next parliamentary elections scheduled for June 2006. In view of this risk assessment, the budgetary stance in the programme seems sufficient to reduce the deficit to below 3% of GDP by 2008 as envisaged in the programme.

The programme foresees the debt ratio to increase from 37.8% of GDP in 2003 to 40% of GDP in 2007, well below the 60% of GDP reference value. Between 2003 and 2006, the debt ratio is expected to increase by 1.4 percentage points, less than in the Commission services forecasts which project a higher primary deficit in 2006 and a more moderate impact of the stock-flow adjustment. In particular, the Commission services forecast did not include privatisation proceeds in 2005, which contribute to a temporary and slight fall in the debt ratio in 2005. The debt ratio is expected to rise further in 2006-2007, but at a much slower pace as activities of transformation institutions are planned to be phased out. The main driving force of the growing debt ratio continues to be the primary deficit, but its contribution is decreasing in line with fiscal consolidation.

The reduction in the general government deficit over the programme period should be achieved by a cut in the expenditure ratio (by about 3.7% of GDP) which more than compensates the planned reduction in the revenue ratio (by 1.8% of GDP). In addition to the decline of the weight of the government in the economy, the fiscal consolidation strategy plans to change the structure of both revenues and expenditures. On the expenditure side, cuts in transfers and subsidies are projected to contribute most to the expenditure reduction, in particular at the level of the central government. On the revenue side, the major structural change is the shift of the tax burden from direct to indirect taxation. The programme also envisages an end of the operation of the transformation institutions, in particular of the National Property Fund (by end-2005) and of the Czech Consolidation Agency (by end-2007).

The Czech Republic appears to be at serious risk with regard to the long-term sustainability of the public finances, on grounds of the very important projected budgetary costs of an ageing population. In particular, the strategy of fiscal consolidation outlined in the programme needs to be complemented with additional reforms to reduce the sustainability risks associated with the projected increase in pension and health-care expenditures.

Overall, the economic policies outlined in the update are partly consistent with the country-specific broad economic policy guidelines in the area of public finances. On the one hand, the programme is in line with the reduction of the general government deficit recommended by the Council and the reduction is based on legally binding medium-term expenditure ceilings. On the other hand, the implementation of the recommended cuts of the wage bill of central government envisaged in the May convergence programme is proving difficult and the programme does not present sufficient measures to control the deficits and debt of regional governments and municipalities. In addition, the programme does not present concrete steps to safeguard the long-term sustainability of public finances, specifically through the implementation of pension and healthcare reforms.

In view of the above assessment and in the light of the recommendations made by the Council under Article 104(7), the Czech Republic is recommended to allocate higher-than-budgeted revenues to deficit reduction and adhere strictly to the medium-term expenditure ceilings for central government, which become legally binding from 2006. Furthermore, the Czech Republic is invited to step up the pension reform and to undertake the reform of the healthcare system to improve the long-term sustainability of the public finances.

Table: Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007
Real GDP (% change)	CP December 2004	3.8	3.6	3.7	3.8
	COM October 2004	3.8	3.8	4.0	n.a.
	CP May 2004	2.8	3.1	3.3	3.5
HICP inflation (%)	CP December 2004	2.7	3.2	2.6	2.2
	COM October 2004	2.8	3.1	2.9	n.a.
	CP May 2004	2.8	2.6	2.2	2.2
General government balance (% of GDP)	CP December 2004	-5.2	-4.7	-3.8	-3.3
	COM October 2004	-4.8 ¹	-4.7	-4.3	n.a.
	CP May 2004	-5.3	-4.7	-3.8	-3.3
Primary balance (% of GDP)	CP December 2004	-4.0	-3.3	-2.3	-1.7
	COM October 2004	-3.6 ¹	-3.3	-2.9	n.a.
	CP May 2004	-4.1	-3.4	-2.4	-1.7
Government gross debt (% of GDP)	CP December 2004	38.6	38.3	39.2	40.0
	COM October 2004	37.8 ¹	39.4	40.6	n.a.
	CP May 2004	38.4	39.7	41.0	41.7
<u>Note:</u>					
¹ The Commission services forecast for 2004 did not include the imputed state guarantee of 0.8% of GDP.					
<u>Sources:</u>					
Convergence programme (CP); Commission services economic forecasts (COM)					

1. INTRODUCTION

The first update of the Czech Republic's convergence programme, covering the period 2004-2007, was submitted on 1 December 2004, following approval by the government on 24 November. The programme was also sent to the Parliament of the Czech Republic. It is based on the 2005 draft state budget and on expenditure ceilings of the central government for 2006 and 2007.

The programme broadly complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes". In particular, the expenditure and revenue ratios are not fully consolidated in line with ESA95 statistical standards. The programme broadly follows the model structure of Annex 2 of the "code of conduct on the content and format of stability and convergence programmes".³

2. MACROECONOMIC DEVELOPMENTS

The macroeconomic scenario presented in the programme expects real GDP growth to be 3.8% in 2004. In 2005, real GDP is forecast to reach 3.6% and to accelerate slightly later on, reaching 3.8% in 2007. This is below the Commission services autumn 2004 forecasts for the years 2004-2006 and, for 2005, also below the forecast by a panel of fourteen independent forecasters set up by the Ministry of Finance. For the year 2007, the programme's estimate of potential output growth is slightly above the estimate of the autumn forecast. The short-term growth assumption underlying the programme can thus be considered as plausible (tilted towards caution) and the medium-term growth assumptions as plausible.

In line with the Commission services autumn forecast, inflation is expected to increase to some 3.2% in 2005, mainly on account of higher net inflation,⁴ while the contribution of administrative measures is expected to subside. In 2006 and 2007, the programme expects inflation to decrease to 2.6% and 2.2%, respectively, which appears relatively low in view of the Commission services autumn forecast, which foresees average inflation in 2006 at 2.9%.

The external assumptions behind the programme's macro-economic scenario are slightly more optimistic than those used in the Commission services autumn 2004 economic forecasts.⁵ In particular, the programme assumes a more favourable development of oil prices.⁶

³ Fiscal data in the original version of the updated convergence programme differed from those in the fiscal notification of September 2004. This was due to the lack of coordination between the Ministry of Finance and the Czech Statistical Office which led to serious data problems already in the May convergence programme. Upon the request of the European Commission, a new version of the programme with consistent data was submitted on 13 December 2004.

⁴ The growth of prices in the unregulated part of the consumer basket adjusted for changes in indirect taxes and for abolition of subsidies.

⁵ The external assumptions of the Commission services autumn forecast could not be fully used due to their late availability.

⁶ This partly explains the relatively low inflation forecast. Other assumptions differ from the Commission services autumn forecasts as well. As concerns the exchange rate, it is assumed that the Czech koruna will appreciate nominally to reach 30 CZK/EUR in 2007. The annual real appreciation vis-à-vis the

The programme presents three scenarios for the macro-economic projections. The baseline scenario, presented in Table 1, is considered as the reference scenario for assessing budgetary projections, because it reflects plausible to cautious assumptions. The two alternative scenarios assume different developments of three key exogenous variables: foreign demand, the exchange rate and oil prices. The “optimistic” macroeconomic scenario assumes a gradual oil price decrease from 36.8 USD per barrel in 2004 to 25 USD in 2007 and an acceleration of EU-15 real GDP growth to 3% a year. On the other hand, the “pessimistic” scenario assumes an increase in oil prices to 41 USD per barrel in 2007 and weaker growth performance in EU-15.

Table 1: Comparison of macroeconomic developments and forecasts

	2004		2005		2006		2007
	COM	CP	COM	CP	COM	CP	CP
Real GDP (% change)	3.8	3.8	3.8	3.6	4.0	3.7	3.8
<i>Contributions:</i>							
- Final domestic demand	6.0	4.0	5.2	3.6	4.7	3.1	3.1
- Change in inventories	0.7	0.6	0.1	0.2	-0.2	0.1	0.1
- External balance on g&s	-1.9	-0.7	-1.5	-0.2	-0.4	0.4	0.6
Employment (% change)	-0.9	-1.0	-0.1	-0.3	0.1	0.1	0.2
Unemployment rate (%)	8.3	8.3	8.2	8.3	8.0	8.0	7.8
HICP inflation (%)	2.8	2.7	3.1	3.2	2.9	2.6	2.2
GDP deflator (% change)	4.8	4.0	3.1	3.1	2.7	3.0	3.2
Current account (% of GDP)	-6.1	-6.0	-6.0	-5.7	-5.7	-5.3	-4.8
<i>Sources:</i>							
<i>Commission services autumn 2004 economic forecasts (COM); convergence programme update (CP)</i>							

Table 2: Sources of potential output growth

	2004		2005		2006		2007
	COM	CP ³	COM	CP ³	COM	CP ³	CP ³
Potential GDP growth ¹	3.3	3.3	3.3	3.2	3.5	3.2	3.1
<i>Contributions:</i>							
- Labour	0.1	0.1	-0.1	-0.2	0.0	-0.2	-0.4
- Capital accumulation	2.3	2.3	2.4	2.3	2.4	2.2	2.2
- TFP	0.8	0.9	1.0	1.0	1.1	1.2	1.3
Output gap ^{1,2}	-0.6	-1.3	-0.2	-0.9	0.3	-0.4	0.3
<i>Notes:</i>							
¹ based on the production function method for calculating potential output growth							
² in percent of potential GDP							
³ Commission services calculations on the basis of the information in the convergence programme update							
<i>Sources:</i>							
<i>Commission services autumn 2004 economic forecasts (COM); Commission services calculations</i>							

The estimate of potential output based on Commission services calculations according to the commonly agreed methodology and consistent with the programme’s macro-economic scenario is somewhat below the estimate of potential output of the Commission services autumn 2004 forecast. According to the autumn forecast, the output gap becomes positive already in 2006, whereas the Commission services calculations

euro is assumed to be 3%, compared to the constant real effective exchange rate assumption in the Commission services forecasts. As regards 2007 which is not covered in the Commission services autumn forecasts, the convergence programme assumes a slight growth upturn in the EU (and in particular in Germany) and stability in commodity and financial markets.

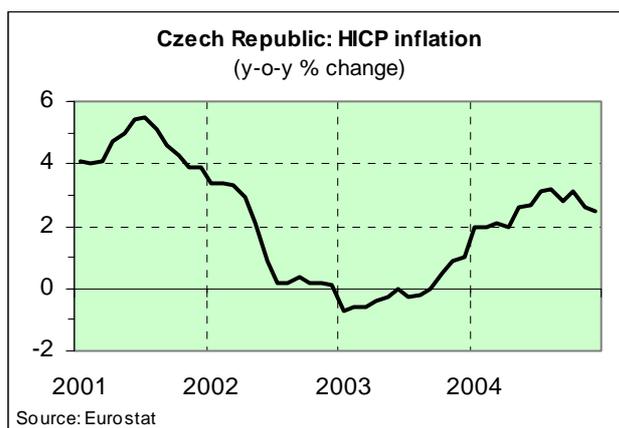
based on the commonly agreed methodology applied to the programme's data suggest a positive output gap one year later. This supports the view that the programme's macroeconomic scenario is relatively cautious.

Since 1999, the current account deficit has been widening, exceeding 6% of GDP in 2003. This is the combined result of declining surpluses on the service balance and of large and increasing deficits on the income balance (mostly due to the increase in repatriated profits).⁷ The trade deficit has diminished and reached around 3% of GDP in 2003, despite a strong appreciation of the Czech koruna and an economic slowdown in major trade partners in recent years. This positive trend has continued in the course of 2004.

Although the programme projects the current account deficit to decrease from 6.2% of GDP in 2003 to 4.8% of GDP in 2007, the expected catching-up process in the Czech economy is likely to lead to an acceleration of private investment and consumption. This could further deteriorate the net private savings balance and add pressures on the current account deficit. Such pressures could be eased by an improvement of the general government balance.

3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY

Czech monetary policy continues to combine inflation targeting with a managed float of the exchange rate. The Czech National Bank (CNB) targets year-on-year CPI inflation within a continuous band that is gradually decreasing from 3-5% in January 2002 to 2-4% in December 2005. As of 1 January 2006, a steady inflation rate of 3% will be targeted with a tolerance of ± 1 percentage point. The Czech Republic intends to pursue inflation targeting until it joins the euro area.



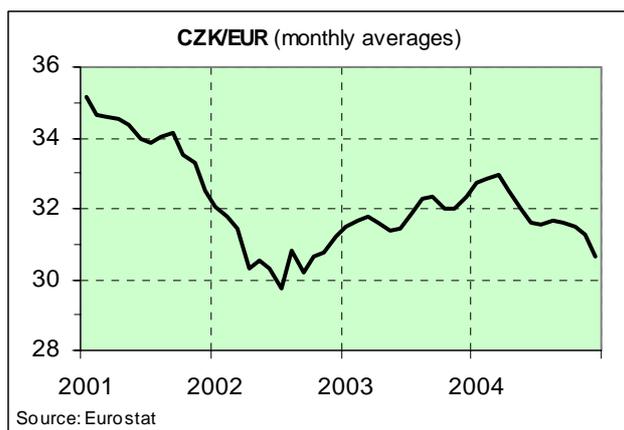
The updated convergence programme maintains the expected date for euro area membership at around 2009-2010. Following an assessment of the fulfilment of the Maastricht convergence criteria and of the degree of synchronisation of the Czech economy with the euro area, the Ministry of Finance and the CNB have re-confirmed their earlier recommendation to the government to postpone participation in ERM II.

Following deflation for most of 2003, price changes turned positive again and inflation returned inside the central bank target band in 2004. The updated programme expected HICP inflation to reach 2.7% on average in 2004⁸, under a combined impact of a slight

⁷ Although a large part of repatriated profits has been reinvested, the share of reinvested profits seems declining.

⁸ According to the latest available data, average HICP growth in 2004 was 2.6%.

increase in net inflation (mainly on account of food prices) and of a contribution of administrative measures (increases in indirect tax rates and in some regulated prices).



The Czech koruna depreciated by some 11% against the euro between July 2002 and March 2004, partly compensating for the strong appreciation experienced in the previous period. The koruna has been appreciating since April 2004 and despite a temporary stabilisation in the summer months, it gained about 6% against the euro in the year as a whole. This is above the programme's assumption of some

2% annual appreciation foreseen for the period until 2007.

Against the backdrop of low inflation, Czech money market interest rates moved at or below euro area levels between July 2002 and May 2004, when they started to increase on market expectations of a monetary policy tightening. Following two successive hikes of policy rates (by 25 basis points each) in June and August 2004, short-term rates have stabilized at around 2.5% in the fourth quarter of the year, reflecting market views that no further increases of policy rates should be expected in the short term.

Following a period of government bond yields below euro area levels in the first half of 2003, the spread started to slowly increase in October 2003 and peaked at about 100 points in September 2004, before decreasing again in the fourth quarter of the year. While the increase of the spread reflected the rise of headline inflation from very low levels, the generally low level of government bond yields continues to echo the stable macroeconomic environment prevailing in the Czech Republic.

4. BUDGETARY IMPLEMENTATION IN 2004

According to the programme, the deficit is projected to fall to 5.2% of GDP in 2004 (from 12.6% of GDP in 2003, including a major one-off operation of about 7% of GDP). The Commission services autumn 2004 economic forecasts expect a deficit of 4.8% of GDP. The programme's 2004 estimated deficit outcome of 5.2% of GDP includes two major one-off operations, the second of which was not included in the autumn forecast: (i) a capital injection of almost 13 billion CZK (about 0.5% of GDP) to the state-owned company Aero, linked to the exit of the strategic partner Boeing; and (ii) an imputed capital transfer of 22.5 billion CZK (about 0.8% of GDP) in relation to guarantees granted to the banking sector in the mid-1990s, which the Czech government has decided to impute already in 2004 in the light of a better-than-expected budgetary outcome and of an increasing likelihood that this guarantee will be fully called by 2007. Without these two one-off operations, the 2004 deficit would be about 4% of GDP, i.e. much better than originally expected.

The better-than-expected outcome for the 2004 deficit (excluding the one-off expenditures) is due to better-than-foreseen economic developments and to the reform measures introduced in the course of 2003 and 2004 in order to consolidate the Czech public finances. The central government, in particular the state budget contributed substantially to the better-than-expected outcome. In cash terms, the annual deficit

reached 93.5 billion CZK, i.e. only 81% of the full year target (115.7 billion CZK), and was by 15.6 billion CZK lower than in 2003. The deficit projection in the Commission services forecast did not include the imputation of the capital transfer of 0.8% of GDP (because the government decided on this after the finalisation of the autumn 2004 forecast) and was based on less favourable assumptions on the execution of the 2004 state budget. The better-than-expected central government deficit is partly due to higher-than-planned revenues and partly due to some lower-than-budgeted expenditures, in particular due to underspending of some state funds (see Box 3 below). Note, however, that in ESA95 terms, the reduction of the general government deficit in 2004 is estimated to have been achieved mainly through an increase in the revenue ratio (by 0.5% of GDP), which more than compensated for the slight increase in the expenditure ratio (by 0.1% of GDP).⁹

5. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

5.1. Evolution of budgetary targets in successive programmes

The updated programme foresees a gradual reduction of the general government deficit from 5.2% of GDP in 2004 to 3.3% of GDP in 2007 (the end of the programme period) and to reduce the deficit to below the 3% of GDP reference value in 2008. The deficit reduction path in the update is broadly in line with that in the pre-accession economic programme of August 2003. When compared to the May 2004 programme, there is no change of the deficit targets for 2005-2007 (as a percent of GDP), although GDP growth was revised upwards considerably.¹⁰ The 2005 deficit target of 4.7% of GDP appears high compared to the estimated 2004 deficit of about 4% of GDP (without the two one-off operations). The fiscal consolidation path seems also slow in the absence of fundamental reforms in social expenditures.

Table 3: Evolution of budgetary targets in successive programmes

		2003	2004	2005	2006	2007
General government balance (% of GDP)	CP December 2004	-12.6	-5.2	-4.7	-3.8	-3.3
	CP May 2004	-12.9	-5.3	-4.7	-3.8	-3.3
	<i>PEP August 2003</i> ¹	-7.6	-5.9	-4.8	-4.0	<i>n.a.</i>
Real GDP (% change)	CP December 2004	3.1	3.8	3.6	3.7	3.8
	CP May 2004	2.9	2.8	3.1	3.3	3.5
	<i>PEP August 2003</i>	2.4	2.8	3.2	3.6	<i>n.a.</i>
Note:						
¹ Data in the August 2003 pre-accession economic programme do not take account of the extraordinary revision of national accounts in April 2004, according to which GDP was revised upwards by some 5-8%.						
Sources:						
<i>Convergence programmes (CP); pre-accession economic programme (PEP)</i>						

⁹ In this comparison, the 2003 expenditure ratio does not include the expenditure-increasing one-off operation of 7% of GDP. If one abstracts from the two one-off expenditures in 2004 as well, the 2004 expenditure ratio would fall by 1.2% of GDP.

¹⁰ The more favourable growth profile is partly due to methodological changes in the calculation of real GDP growth. Those changes were for the first time fully reflected in the December 2004 update.

Box 1: The excessive deficit procedure for the Czech Republic

On the basis of a general government deficit of 12.6% of GDP in 2003, above the 3% of GDP reference value, the Council decided on 5 July 2004 that the Czech Republic had an excessive deficit and recommended that this be corrected by 2008 at the latest. In particular, the Czech Republic was recommended to take effective action regarding the measures envisaged to achieve the 2005 deficit target by the deadline of 5 November and to implement with vigour the measures envisaged in the May 2004 convergence programme, in particular to cut the wage bill of central government and to reduce spending of individual ministries. Furthermore, the Czech Republic was invited to allocate higher-than-budgeted revenues to deficit reduction, to introduce fiscal targeting based on medium-term expenditure ceilings, to design effective rules to reduce the risk of increasing indebtedness of regions and municipalities, to undertake the reform of the pension and healthcare systems to improve the long-term sustainability of the public finances and to minimise the negative budgetary impact of the operations of the Czech Consolidation Agency.

On current information and on the basis of the measures detailed in the 2005 budget it appears that the Czech government has taken effective action regarding the measures envisaged to achieve the 2005 deficit target, by the deadline of 5 November, in response to the recommendation under Article 104(7) to correct the excessive deficit by 2008 at the latest.

5.2. Budgetary targets in the updated programme

The updated programme aims at reducing the deficit to below the 3% of GDP reference value in 2008, in line with the Council recommendation under Article 104(7). The programme targets a cut in the general government deficit by 1.9 percentage points between 2004 and 2007 (around 0.7 percentage points excluding the one-offs in 2004) and a cut in the primary deficit by 2.3 percentage points over the same period (by about 1.1 percentage points excluding the one-offs). The adjustment is foreseen to be gradual, by about 0.5% of GDP annually, except in 2006, when the deficit reduction is planned to be almost 1% of GDP. Recently introduced expenditure ceilings are key to achieve the fiscal targets (see Section 7 below).

The reduction in the general government deficit should be achieved by a cut in the expenditure ratio (by about 3.7% of GDP, around 2.5% of GDP excluding the one-offs in 2004) which more than compensates the planned reduction in the revenue ratio (by 1.8% of GDP). The fiscal consolidation strategy plans to change the structure of both revenues and expenditures (see Section 7 below).

The risks to the budgetary projections in the programme appear broadly balanced. On the one hand, the relatively cautious macroeconomic scenario suggests that revenues could be better than expected and that expenditures could be lower than budgeted. On the other hand, important expenditure cuts, particularly regarding government consumption, still have to be adopted in order to meet the expenditure ceilings in 2006 and 2007. The implementation of expenditure ceilings remain subject to a political risk, even though they are legally binding from 2006. In particular, spending pressures might arise ahead of the next parliamentary elections scheduled for June 2006 (extra social spending was introduced already before the European elections in July 2004). The Commission services autumn 2004 forecast projects a 2005 deficit that is in line with the target set in the budget and the convergence programme. As regards 2006, the expenditure ceilings for 2006 were not taken into account in the autumn forecast and the 2006 deficit was projected to be 4.3% of GDP under the no-policy-change assumption, ½ percentage point above the target. However, if expenditure ceilings were adhered to strictly, the deficit

targets could be over-achieved against the backdrop of the expected strong economic performance.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2003	2004	2005	2006	2007	Change: 2007-2004
Revenues	41.9	42.4	41.1	40.9	40.6	-1.8
<i>of which:</i>						
- Taxes & social security contributions	37.1	37.0	35.9	35.8	35.4	-1.6
- Other (residual)	4.8	5.4	5.2	5.1	5.2	-0.2
Expenditure	54.5	47.6	45.8	44.7	43.9	-3.7
<i>p.m. excluding one-off operations</i>	47.5	46.4				-2.5
<i>of which:</i>						
- Primary expenditure	53.2	46.4	44.4	43.2	42.3	-4.1
<i>of which:</i>						
Gross fixed capital formation	4.2	4.3	4.4	4.5	4.6	+0.3
Consumption	23.8	22.9	22.4	22.0	21.8	-1.1
Transfers other than in kind & subsidies	15.4	15.1	14.4	14.0	13.5	-1.6
Other (residual)	9.8	4.0	3.1	2.7	2.5	-1.5
- Interest payments	1.3	1.2	1.4	1.5	1.6	+0.4
Budget balance	-12.6	-5.2	-4.7	-3.8	-3.3	+1.9
<i>p.m. excluding one-off operations</i>	ca. -5.6	ca. -4				ca. +0.7
Primary balance	-11.3	-4.0	-3.3	-2.3	-1.7	+2.3
<i>p.m. excluding one-off operations</i>	-4.3	-2.8				+1.1
<i>Sources:</i>						
<i>Convergence programme update; Commission services calculations</i>						

Box 2: The budget for 2005

After the 2004 budget, the 2005 budget is the second one based on the medium-term expenditure ceilings for the central government. The government applied the 2005 expenditure ceiling voluntarily (the ceiling will become legally binding as of 2006) which may be a reason why the original ceiling, set in 2003 was exceeded, albeit marginally (by 2.5 billion CZK, i.e. about 0.2% of the overall state budget expenditure).

Unlike in 2004, 2005 revenues are budgeted to fall, mainly due to a shortening of depreciation periods for investment, tax allowances for R&D (up to 10% of the company's tax base), joint income taxation for married couples (lowering average taxable income) and replacing tax-deductible child allowances with tax credits. The overall impact of these measures on the 2005 budget outcome is estimated at -0.6% of GDP. However, it is likely that second-round positive growth effects will follow due to higher investment and labour market participation with favourable consequences for the budget. Moreover, the fall in revenue is expected to be more than compensated by a decrease in expenditure.

Despite broadly respecting the expenditure ceiling for 2005, the 2005 state budget does not respect the recommendation in the Council recommendation for the correction of the excessive deficit to cut the wage bill of central government. In contrast to this recommendation, the 2005 budget proposes an increase in salaries of some groups of central government employees (in the original budget draft of the government, the envisaged increase was substantial in the case of the armed forces). Also the implementation of the planned decrease of employment in central government by 2% annually (presented in the May 2004 convergence programme) is proving difficult.

The risk linked to the transformation costs of the economy and to state guarantees should be limited. According to the programme, the imputed capital transfer of 22.5 billion CZK

in 2004 is the last one linked to the transformation process. The remaining guarantees of 0.5% of GDP bear low risk. Nevertheless, the programme spells out further fiscal operations and risks which might negatively affect the ESA95 general government balance in the future. First, there are outstanding liabilities of the National Property Fund associated with removing of ecological damage in privatised companies. After the Fund will be dissolved in 2005, those liabilities will be taken over by the Ministry of Finance. The amount of these liabilities is difficult to quantify. Second, there is uncertainty about the accounting treatment of the lease of 14 Gripen fighters. The annual lease instalments will be paid over the period 2005-2015, and, until 2007, they have already been included in the expenditure ceilings. However, it cannot be excluded that the cost of the fighters may have to be imputed to 2005, which would substantially increase the 2005 deficit. Third, the deficit will be negatively affected by an alleviation of debt of some heavily-indebted poor countries. Fourth, although the health care insurance companies currently show only moderate deficits, there is financial pressure in the area of public healthcare.

The impact of EU accession on the fiscal balance is estimated in the programme at -0.6% of GDP in 2004, increasing afterwards to almost -1.5% of GDP in 2007. On the revenue side, the Czech authorities consider budgetary compensations agreed in December 2002 in Copenhagen for 2004-2006 and the drop of customs duties from trade with the EU countries. On the expenditure side, they include payments of to EU budget and top-up subsidies to farmers. However, the authorities' analysis of the impact of EU accession on the Czech budget should be qualified. First, top-up subsidies to farmers, though agreed in the Accession Treaty, were to a large degree discretionary and decided domestically. Second, there have been some extra tax revenues generated by EU accession as a part of increased VAT and excise duties revenues was due to the harmonisation with EU legislation. Third, it is up to the discretion of the national authorities to what extent they compensate for co-payments on EU funds by savings on other expenditures in the budget or to what extent they draw on EU-funds, which require co-payments, at all.

Taking account of the balance of risks to the budgetary targets, the Czech Republic seems on track to correct its excessive deficit by the deadline set by the Council (2008) through a deficit reduction path that conforms to that specified by the Council. This is also consistent with the country-specific broad economic policy guidelines in the area of public finances for the Czech Republic.

Table 5: Budgetary targets and output gaps

	2003		2004		2005		2006		2007	Change: 2007-2004
	COM	CP ¹	COM	CP ¹	COM	CP ¹	COM	CP ¹	CP ¹	CP ¹
Budget balance ²	-12.6	-12.6	-4.8	-5.2	-4.7	-4.7	-4.3	-3.8	-3.3	1.9
Output gap ^{1,3}	-1.1	-1.8	-0.6	-1.3	-0.2	-0.9	0.3	-0.4	0.3	1.6
Notes:										
¹ Commission services calculations on the basis of the information in the convergence programme (CP)										
² in percent of GDP										
³ in percent of potential GDP										
Sources:										
<i>Commission services autumn 2004 economic forecasts (COM); Commission services calculations</i>										

5.3. Sensitivity analysis

As indicated in Section 2 above, sensitivity analysis is presented in the programme in the form of two alternative scenarios – an optimistic and a pessimistic one – to the baseline macroeconomic framework. In the optimistic scenario, the general government deficit declines to 3% of GDP in 2007, while in the pessimistic scenario, the deficit would be 3.6% of GDP.

6. EVOLUTION OF THE DEBT RATIO

In the past five years, the debt-to-GDP ratio almost tripled, reaching 37.8% of GDP in 2003. The steep increase in the debt ratio since 2002 has been due to a combination of high fiscal deficits (including capital transfers to the Czech Consolidation Agency, CKA, and debt assumptions of considerable contingent liabilities) and a drop in privatisation proceeds. However, the snowball effect has been mitigated by a reduction in the implicit interest rate on government debt. This is because a part of government debt (about 10% of GDP), in particular some of the imputed government guarantees, bears no interest. These guarantees were already recorded as government debt given the expectation that the government will have to honour these commitments.

Table 6: Debt dynamics

	average 2000-2003	2004		2005		2006		2007
	COM	COM	CP	COM	CP	COM	CP	CP
Government gross debt ratio	27.5	37.8 ¹	38.6	39.4 ¹	38.3	40.6 ¹	39.2	40.0
Change in debt ratio (1 = 2+3+4)	5.4	0.1	0.8	1.6	-0.3	1.2	0.9	0.8
<i>Contributions:</i>								
- Primary deficit (2)	6.0	3.6 ¹	4.0	3.3	3.3	2.9	2.3	1.7
- “Snow-ball” effect (3)	0.1	-1.8	-1.6	-1.1	-1.0	-1.1	-0.9	-1.0
- Interest expenditure	1.2	1.2	1.2	1.4	1.4	1.5	1.5	1.6
- Real GDP growth	-0.6	-1.3	-1.3	-1.3	-1.3	-1.5	-1.3	-1.4
- Inflation (GDP deflator)	-0.6	-1.7	-1.5	-1.1	-1.1	-1.0	-1.1	-1.2
- Stock-flow adjustment (4)	-0.7	-1.7	-1.6	-0.7	-2.6	-0.6	-0.5	0.1
- Cash/accruals	-0.5							
- Accumulation of financial assets	-2.0							
- of which: Privatisation proceeds	-2.4	-1.0	-1.0	0.0	-1.8	0.0	0.0	0.0
- Valuation effects & residual adj.	1.8							
<u>Note:</u>								
The change in the gross debt ratio can be decomposed as follows:								
$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$								
where t is a time subscript; D , PD , Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the “snow-ball” effect.								
¹ The Commission’s forecast for 2004 did not include the imputed state guarantee of 0.8% of GDP.								
<u>Sources:</u>								
Convergence programme update (CP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations								

The updated programme foresees the debt ratio to increase from 37.8% of GDP in 2003 to 40% of GDP in 2007. Between 2003 and 2006, the debt ratio is expected to increase by 1.4 percentage points. This is below the Commission services forecasts which project a higher primary deficit in 2006 and a more moderate impact of the stock-flow adjustment. In particular, the Commission services forecast did not include privatisation proceeds in 2005, which, according to the programme, contribute to an interruption of the steady upward trend in the debt ratio in 2005. The debt ratio is expected to resume its upward trend in 2006-2007, but at a much slower pace as activities of transformation institutions are planned to be phased out. The main driving force of the growing debt ratio will be the primary deficit, but its contribution is expected to decrease from 4.0% in 2004 to 1.7% in 2007 as a result of fiscal consolidation. The negative contribution of slightly increasing interest outlays should be more than offset by the continuation of high nominal GDP growth.

About 90% of consolidated public debt is made up by state debt. The interest rate risk is currently the most important risk. The government follows a strategy to lower the risk from interest rate shocks through increasing the share of fixed-yield medium- and long-term treasury bonds and decreasing the share of T-bills (which are planned to account for less than 20% of total state debt by the end of 2006). In 2004, the Ministry of Finance issued the Eurobond of 1.5 billion EUR. This operation was fully hedged so that there is no currency risk exposure of the Czech public debt.

7. STRUCTURAL REFORM AND THE QUALITY OF PUBLIC FINANCES

As highlighted above (Section 5.2) the reduction in the general government deficit over the programme period should be achieved by a cut in the expenditure ratio (by about 3.7% of GDP) which more than compensates the planned reduction in the revenue ratio (by 1.8% of GDP). In addition to the decline of the weight of the government in the economy, the fiscal consolidation strategy plans to change the structure of both revenues and expenditures.

On the expenditure side, cuts in transfers and subsidies are projected to contribute most to the expenditure reduction, in particular at the level of the central government. Among primary expenditure, spending on gross fixed capital formation is planned to be the only growing item. Public investment is expected to increase from 4.2% of GDP in 2003 to 4.6% of GDP in 2007, well above the EU-average (2.4% of GDP in 2004). On the revenue side, the major structural change is the shift of the tax burden from direct to indirect taxation. This is expected to have a positive effect on both economic growth and labour market participation of the low-income labour force. There is also a notable reduction in the tax burden, particularly in 2005.

The recently adopted amendment to the Law on Budgetary Rules introduced fiscal targeting based on medium-term expenditure ceilings for central government. Expenditure ceilings are expected to make a significant contribution to the reinforcement of aggregate fiscal discipline and to the deficit reduction. The binding expenditure ceilings for 2006 and 2007 and, to a large extent, the 2005 state budget have been prepared according to the new rules. The medium-term orientation of the budgetary procedure has been reinforced by an amendment of the Rules of Government Procedures. They stipulate that all proposals submitted to the government must contain an evaluation of their impact on public finances, over a period of at least three years. However, the adherence to the expenditure ceilings might be hindered by a separate voting on the central government budgets (see Box 3).

Box 3: The central government budget - components and adoption procedure

The central government is the only sub-sector of general government subject to fiscal targeting through medium-term expenditure ceilings, introduced in 2004 by the new Law on Budgetary Rules. Expenditure ceilings apply both to the state budget and to seven state “extra-budgetary” funds (State Fund of Environment, State Fund for Land Fertilization, State Fund of Culture, State Fund for Czech Cinematography Support and Development, State Fund of Transport Infrastructure, State Fund of Housing Development, State Agriculture Intervention Fund).

Despite this important progress, the state funds are not under the direct control of the Ministry of Finance, but of the spending ministries. They are presented both in the government and in the parliament not only separately from the state budget, but often also individually. The separate decisions on the state budget and the individual state funds prevent their consideration in the context of the overall central government budget. As the state funds’ budgets are usually passed without significant opposition, their managers can bid for high budget allocations. High budget allocations tend to result in underspending. In the case of the biggest fund – State Transport Infrastructure Fund – this happened several times.

If the Ministry’s of Finance estimates of central government expenditures are based on inaccurate spending, it might not only create problems for budget planning, but it also might lead to difficulties when fulfilling expenditure ceilings. Furthermore, if budget allocations are unrealistically high, it creates difficulties for the assessment of progress towards the fiscal targets.

Voting on the central government budget *en bloc* would help enhance the transparency of the budgetary procedure by making the trade-offs between individual spending items more explicit. It would also better match the requirements of the central government expenditure ceilings.

The programme also envisages an end of the operation of the transformation institutions. The operation of the two privatisation funds, the National Property Fund and Land Fund of the Czech Republic, will end by law by end-2005 and by end-2009, respectively. The Czech Consolidation Agency (CKA) is expected to be closed by end-2007. Moreover, the new Law on Budgetary Rules restricts the possibility of transferring non-performing assets to the CKA portfolio under non-market conditions.

In 2004, the Czech Republic disclosed another state guarantee which was imputed as a capital transfer into the general government deficit. As mentioned in Section 5.2, the updated programme is explicit about other sources of potential risks (the environmental “guarantees”, the accounting of the Gripen fighters, the alleviation of debt) and it admits financial pressure in the area of public healthcare. The disclosure of contingent liabilities and of other sources of fiscal risks is a commendable step towards higher transparency.

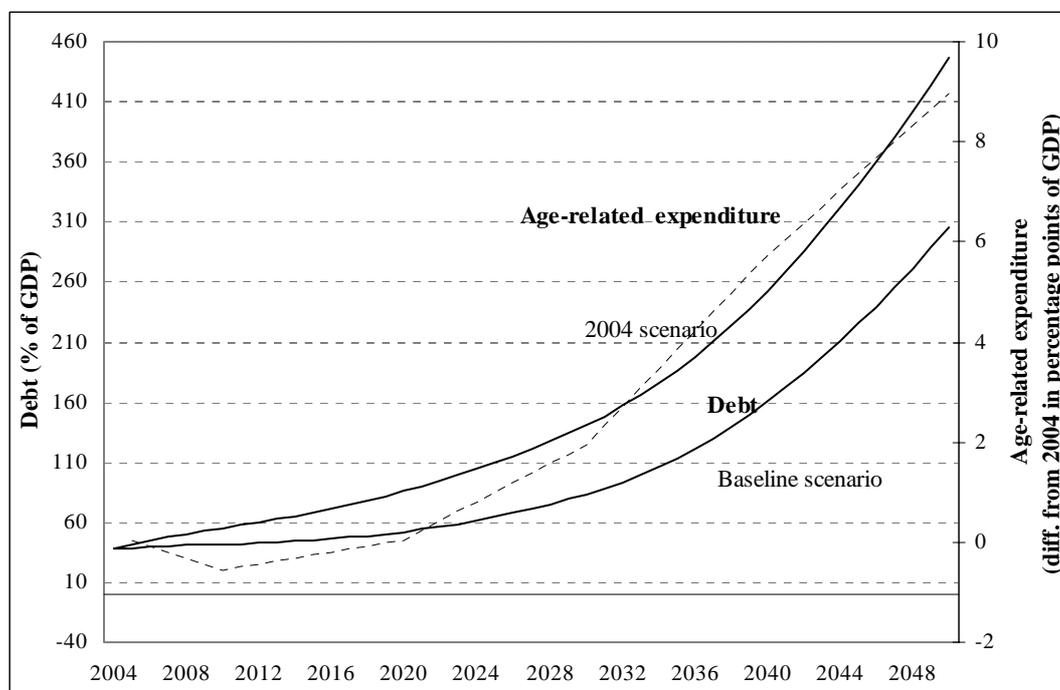
The process of decentralisation could lead to increasing borrowing requirements of local governments, in particular since joining the EU, with regions and municipalities co-financing EU funded projects. As a result, the indebtedness of regions and municipalities could rise because local governments will not be subject to fiscal targeting and legal constraints on their indebtedness may not be sufficient to discourage them from high deficits and debt.

8. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of the Czech public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The

quantitative indicators project gross debt developments according to two different scenarios, to take into account different budgetary developments over the medium term. The “programme” scenario (baseline) assumes that the medium-term objective set in the programme is actually achieved, while the “2004” scenario assumes that the underlying primary balance remains throughout the programme period at the 2004 level.

Long-term sustainability: summary results



Sustainability indicators

	S1*	S2**	RPB***
Baseline scenario	4.3	7.5	6.1
2004 scenario	6.7	10.0	6.2

Notes:

* Required change in tax revenues as a share of GDP over the projection period to reach a debt to GDP ratio of 60% of GDP in 2050.
 ** Required change in tax revenues as a share of GDP to respect the intertemporal budget constraint, i.e., equates the actualized flow of revenues and expenses over an infinite horizon to the debt at the outset of the projection period.
 *** Based on S2, the Required Primary Balance (RPB) indicates the average minimum required cyclically adjusted primary balance as a share of GDP over the first five years of the projection period that guarantees the respect of the intertemporal budget constraint of the government.

The graph above presents gross debt development according to the two different scenarios. On the basis of the programme, age-related expenditure is foreseen to increase by 9.3% of GDP between 2008 and 2050 (see Annex 2 for a breakdown of different age-related expenditures). This trend already includes the impact of the parametric changes legislated this year. Age-related expenditures may continue to increase thereafter as a consequence of the still ongoing ageing process. Gross debt is projected to increase continuously as a consequence of the strong increase in age-related expenditures and the forecasted primary deficit at the end of the programme period.¹¹ The debt dynamics

¹¹ It should be recalled that, being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of likely outcomes and should not be taken at face value.

would significantly worsen if the expected consolidation path in the programme period does not materialise.

On the basis of the debt projections, it is possible to calculate a set of sustainability indicators to measure the gap between the current policies and a sustainable one. The S1 indicator shows the permanent change in the primary balance that is required to have a debt ratio in line with the 60% of GDP reference value in the very long run (year 2050).¹² S2 shows the gap between the current tax policies and those that would ensure respect of the intertemporal budget constraint given the future impact of ageing on public expenditure, namely the change in the tax ratio that would equate the present discounted value of future primary balances to the current stock of gross debt.¹³ According to the latter, in order to tackle the cost of ageing entirely through a budgetary strategy, the Czech Republic should increase its tax ratio permanently by at least 7.5 percentage points, depending on the profile in the medium term. This would lead to a negative debt ratio by the middle of this century. The budgetary effort over the first 5 years of the projections (i.e. after the end of the programme period) to respect the intertemporal budget constraint requires a primary surplus of about 6.1% of GDP on average, compared with a primary deficit of 1.7% of GDP forecasted for the last year of the programme period.

These results confirm the ones presented by the Czech authorities of explosive debt dynamics. Assumptions in the convergence programme underlying the projected long-term sustainability are cautious (from two independent demographic scenarios officially available, the programme uses the less favourable one) and the long-term budgetary projections can be considered as credible.

Given the necessity of a high permanent increase in the primary balance to keep the debt dynamics under control, the needs for investment to catch-up and also considering the already high tax burden, additional reforms in the pension and health care system should be pursued. The government recognises this and is committed to tackle the problem of long-term sustainability within the so-called second stage of the public finance reform. However, concrete progress has so far been very limited. It is important that the Czech government takes further steps, also taking advantages of the work of the “Executive Team for Pension Reform”.¹⁴

¹² The respect of the underlying debt path does not ensure sustainability over an infinite horizon, but only that debt remains below 60% up to 2050. In most cases, this would imply an increasing trend and possible unbalances after the end of the projection period.

¹³ Formally, the intertemporal budget constraint assumes that the present discounted value of the ratio of the primary balance to GDP is equal to the negative of the current level of the debt to GDP ratio.

¹⁴ The “Executive Team for Pension Reform” is led by a central bank specialist on pension policy and includes experts from the Ministry of Labour and Social Affairs and from the Ministry of Finance. The main objective of this team is to carry out calculations of pension reform proposals put forward by political parties currently represented in the Chamber of Deputies of the Parliament. The proposals are: i) a parametric reform of the current PAYG system (Communist Party), ii) a shift towards a notional defined contribution PAYG system (Social Democrats), iii) an introduction of a flat-rate pension (Civic Democrats), iv) a parametric reform of the PAYG system and a possibility to opt-out partially to a fully funded system (Christian Democrats, Liberals). To safeguard its non-partisan mission, the team consults pension specialists from all the political parties (in particular on the assumptions). The team should present the results in the first half of 2005. The government promised to choose one of the reform proposals and to decide on it before the end of its mandate in June 2006.

Annex 1: Summary tables from the December 2004 convergence programme

Table 1. Growth and associated factors

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

Table 2. General government budgetary developments

% of GDP	2003	2004	2005	2006	2007
Net lending by sub-sectors					
1. General government	-12.6	-5.2	-4.7	-3.8	-3.3
2. Central government	-12.2	-4.9	-4.4	-3.5	-3.0
3. State government					
4. Local government	-0.3	-0.3	-0.3	-0.3	-0.3
5. Social security funds	-0.1	-0.1	0.0	0.0	0.0
General government					
6. Total receipts	41.9	42.4	41.1	40.9	40.6
7. Total expenditures	54.5	47.6	45.8	44.7	43.9
8. Budget balance	-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	21.3	21.9	20.8	20.6	20.2
12. Social contributions	15.2	15.1	15.1	15.2	15.2
13. Interest income	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	41.9	42.4	41.1	40.9	40.6
Components of expenditures					
16. Collective consumption	12.0	11.5	11.2	10.9	10.7
17. Social transfers in kind	11.8	11.4	11.2	11.1	11.1
18. Social transfers other than in kind	12.6	12.1	11.7	11.5	11.2
19. Interest payments	1.3	1.2	1.4	1.5	1.6
20. Subsidies	2.8	3.0	2.7	2.5	2.3
21. Gross fixed capital formation	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	54.5	47.6	45.8	44.7	43.9

Table 3. General government debt developments

% of GDP	2003	2004	2005	2006	2007
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	1.3	1.2	1.4	1.5	1.6
Nominal GDP growth	-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
<i>Of which: Privatisation receipts</i>	-1.0	-1.0	-1.8	0.0	0.0
<i>p.m. implicit interest rate on debt</i>	4.8	3.5	3.9	4.1	4.3

Table 4. Cyclical developments

% of GDP	2003	2004	2005	2006	2007
1. GDP growth at constant prices	3.1	3.8	3.6	3.7	3.8
2. Actual balance	-12.6	-5.2	-4.7	-3.8	-3.3
3. Interest payments	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

Table 5. Divergence from previous update

% of GDP	2003	2004	2005	2006	2007
GDP growth					
Previous update	2.9	2.8	3.1	3.3	3.5
Latest update	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	-12.9	-5.3	-4.7	-3.8	-3.3
Latest update	-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

Table 6. Long-term sustainability of public finances

% of GDP	2003	2005	2010	2020	2030	2050
Total expenditure	54.5	45.8	40.9	41.6	43.4	47.2
Old age pensions	6.4	6.5	6.3	6.5	7.4	9.9
Health care (including care for the elderly)	6.3	6.4	6.5	7.0	7.7	8.5
Interest payments	1.3	1.4	1.7	2.5	4.0	7.8
Total revenues	41.9	41.1	39.7	39.7	39.7	39.7
<i>Of which: from pension contributions</i>	8.3	9.0	9.0	9.0	9.0	9.0
National pension fund assets (if any)						
Assumptions						
Labour productivity growth	3.8	3.9	3.4	2.8	2.5	1.8
Real GDP growth	3.1	3.6	3.9	2.3	1.7	0.6
Participation rate males (aged 20-64)	84.8	84.7	84.9	85.7	84.5	83.6
Participation rates females (aged 20-64)	67.6	67.6	68.1	71.5	72.3	73.9
Total participation rates (aged 20-64)	76.2	76.1	76.5	78.6	78.4	78.8
Unemployment rate	7.8	8.3	7.9	6.5	6.5	6.5

Table 7. Basic assumptions

	2003	2004	2005	2006	2007
Short-term interest rate (annual average)	2.3				
Long-term interest rate (annual average)	4.1	4.9	5.3	5.4	5.5
United States: short-term (three-month money market)	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/€exchange rate (annual average)	1.13	1.22	1.21	1.22	1.22
Nominal effective exchange rate (euro area)	11.8	4.2	-0.2	-0.1	-0.1
Nominal effective exchange rate (EU)	12.8	6.9	-1.1	-0.9	-0.9
CZK/€exchange rate (annual average)	31.8	32	31.1	30.5	30.2
World GDP growth, excluding EU	4.4	5.2	4.8	5	5
United States, GDP growth	3	4.4	3.7	4.1	4.6
Japan, GDP growth	2.5	4.5	2.8	3.3	4
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)	7.1	18.5	-3.1	-2.4	-3.3

Annex 2: Indicators of long-term sustainability

Main assumptions - baseline scenario (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Total age-related spending	18.8	18.6	19.2	21.1	24.9	28.1	9.3
Pensions	8.6	8.5	8.8	10.0	13.0	15.2	6.6
Health care	6.5	6.5	7.0	7.7	8.5	9.3	2.8
Education	3.8	3.6	3.4	3.4	3.4	3.6	-0.2
Total primary non age-related spending*	23.3						
Total revenues*	40.6						

* constant

Results (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Baseline scenario							
Gross debt	40.6	41.4	52.1	83.2	160.9	305.8	265.2
i + 0.5*	40.8	41.9	54.7	89.1	174.1	335.2	294.4
2004 scenario							
Gross debt	49.9	54.8	85.8	140.8	253.0	447.1	397.1
i + 0.5*	50.2	55.5	89.6	150.2	274.2	493.2	443.0

* i + 0.5 represents the evolution of debt under the assumption of the nominal interest rate being 50 basis points higher throughout the projection period.

