EUROPEAN COMMISSION

Brussels, 11 November 2009

Czech Republic - Commission assessment in relation to the Commission recommendation for a Council decision and recommendation under Articles 104(6) / 104(7) of the Treaty[1]

1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn in 2008/09. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be timely, targeted and temporary and differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which have impacted on the debt position or constitute a risk of higher deficits and debt in the future[2], although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to initiate the excessive deficit procedure (EDP) whenever the deficit of a Member State exceeds the 3% of GDP reference value. The amendments to the Stability and Growth Pact in 2005 aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation, and thereby ensuring long-term sustainability of public finances.

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1 Excerpt from the explanatory memorandum of the Commission recommendation for a Council decision and recommendation under Articles 104(6) and 104(7) adopted by the Commission on 11.11.2009

2 See the Eurostat decision of 15 July 2009 on the statistical recording of public interventions to support financial institutions and financial markets during the financial crisis, Eurostat News Release No 103/2009.

2. PREVIOUS STEPS IN THE EXCESSIVE DEFICIT PROCEDURE

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure"[3], which is part of the Stability and Growth Pact.

According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 104(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".

On the basis of the data notified by the Czech authorities in April 2009[4] and taking into account the Commission services' spring 2009 forecast, the Commission adopted a report under Article 104(3) for the Czech Republic on 7 October 2009[5].

Subsequently, and in accordance with Article 104(4), the Economic and Financial Committee formulated an opinion on the Commission report on 27 October 2009.

3. THE EXISTENCE OF AN EXCESSIVE DEFICIT

According to data notified by the Czech authorities in April 2009, the general government deficit in the Czech Republic was planned to reach 3.9% of GDP in 2009, thus exceeding the 3% of GDP reference value. The Commission report under Article 104(3) considered that the planned deficit was not close to the 3% of GDP reference value but that the planned excess over the reference value could be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact, on the basis of the information available at the time of the

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[3] OJ L 209, 2.8.1997, p. 6. Account is also taken of the Opinion of the Economic and Financial Committee on the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005, available at: http://ec.europa.eu/economy_finance/other_pages/other_pages12638_en.htm

[4] According to Council Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notifications of the Czech Republic can be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/procedure/edp_notification_tables.

[5] All EDP-related documents for the Czech Republic can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

report. Furthermore, the planned excess over the reference value could not be considered temporary.

According to more recent data notified by the Czech authorities in October 2009 the general government deficit in the Czech Republic is now planned to reach 6.6 % of GDP in 2009, thus remaining above and not close to the 3% of GDP reference value. Based on the Commission services' autumn 2009 forecast, the planned excess over the reference value still qualifies as exceptional within the meaning of the Treaty and the Stability and Growth Pact. In particular, it results, among other things, from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. The Commission services' autumn 2009 forecast predicts negative annual real GDP growth of 4.8% in 2009 compared to positive growth of 2.5% in 2008, largely reflecting the impact of the global economic crisis. While the headline deficit started to increase only in 2008, the structural deterioration started earlier when the economy was still in good times. Furthermore, the planned excess over the reference value cannot be considered temporary, since the Commission services' autumn 2009 forecast projects the general government deficit to reach 5.5% of GDP in 2010 and, based on the no-policy-change assumption, 5.7% of GDP in 2011. The forecast takes into account the effect of anti-crisis measures that will still be in place in 2010 (two measures amounting to approximately 0.7% of GDP are permanent), as well as the fiscal consolidation package for 2010 adopted by the Czech authorities in October 2009. Overall, the deficit criterion in the Treaty is not fulfilled.

According to data notified by the Czech authorities in October 2009, the general government gross debt remains well below the 60% of GDP reference value and is planned to stand at 35.5% of GDP in 2009. According to the Commission services' autumn 2009 forecast, the debt ratio is set to increase rapidly, reaching 44% of GDP in 2011 under the no policy change assumption.

In line with the provisions in the Treaty and the Stability and Growth Pact, the Commission also analysed in its report "relevant factors". According to the Stability and Growth Pact, these can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the deficit satisfies the double condition of closeness and temporariness. In the case of the Czech Republic, the double condition is not met. Considered on their own merit, the relevant factors in the current case on balance present a mixed picture.

The opinion of the Economic and Financial Committee in accordance with Article 104(4) of the Treaty is consistent with the assessment in the Commission report under Article 104(3).

The Commission, having taken into account its report under Article 104(3) and the opinion of the Economic and Financial Committee under Article 104(4), is of the opinion that an excessive deficit exists in the Czech Republic. This opinion, adopted by the Commission on [11 November 2009], is herewith addressed to the Council according to Article 104(5). The Commission recommends that the Council shall decide accordingly, in conformity with Article 104(6). In addition, the Commission is submitting to the Council a recommendation for a Council recommendation to be addressed to the Czech Republic with a view to bringing the situation of an excessive deficit to an end according to Article 104(7).

4. RECOMMENDATIONS TO END THE EXCESSIVE DEFICIT SITUATION

According to Article 3(4) of Council Regulation (EC) No 1467/97, the Council recommendation under Article 104(7) has to establish a deadline of six months at most for effective action to be taken by the Member State concerned as well as a deadline for the correction of the excessive deficit, which "should be completed in the year following its identification unless there are special circumstances". Article 2(6) of the Regulation implies that the "relevant factors" considered in the Commission report under Article 104(3) of the Treaty have to be taken into account in deciding whether special circumstances exist. Article 3(4) of the Regulation specifies that the Council has to recommend that the Member State achieves a "minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation".

In the case of the Czech Republic, special circumstances are considered to exist. In particular, the global economic and financial crisis has caused a very severe recession in the Czech Republic. The economic environment deteriorated sharply already in the last quarter of 2008. The deterioration continued in the first half of 2009 when real GDP contracted by 5% year-on-year. The collapse of external demand, which has been the main channel through which the global crisis has impacted on the Czech economy, has triggered a double-digit contraction of Czech exports and industrial production in the first half of 2009. In parallel, tighter credit conditions coupled with worsening output prospects have dragged down investment, which fell by more than 7% in the first half of 2009. According to the Commission services' 2009 autumn forecast, real GDP is projected to contract by 4.8% in 2009. A sluggish recovery is expected in 2010 with real GDP growth reaching 0.8%.

The Commission services' autumn 2009 forecast projects that the government deficit reaches 6.6% of GDP in 2009 and 5.5% of GDP in 2010. In response to the global crisis and in line with the EERP, the Czech authorities adopted stimulus measures amounting to approximately 2.1% of GDP in 2009 which have helped stabilise the economy. However, together with revenue shortfalls and rising social expenditure, these measures are expected to result in a government deficit of 6.6% of GDP in 2009, also according to the latest notification. The worsening budgetary situation prompted the Czech authorities to adopt in October 2009 a fiscal consolidation package in the context of the budget for 2010. According to the Commission services' autumn 2009 forecast, the consolidation package, estimated at approximately 1½% of GDP, will reduce the general government deficit to around 5.5% of GDP in 2010. The main measures include an increase in VAT, excise duties and real estate tax, and, withdrawal of some previously adopted anti-crisis measures, such as higher unemployment benefits, higher child allowances and temporary reductions in social security contributions. Under the no policy change assumption, the Commission services' autumn 2009 forecast projects the general government deficit to reach 5.7% of GDP in 2011 as some consolidation measures on the expenditure side will expire at the end of 2010.

Considering the special circumstances and the EERP framework, an average annual structural budgetary adjustment is recommended. The required adjustment should take into account the fiscal room for manoeuvre which is assessed on the basis of all factors relevant for achieving the fiscal policy objectives, starting with the level of the general government deficit and gross debt as well as other indicators, such as the current account position, the level of contingent liabilities of the financial sector, interest payments, risk premia and the expected change in age-related expenditure in the medium term. In calculating the average annual adjustment, the 2011 deficit in the Commission services' autumn 2009 forecast is taken as the starting point.

The total structural adjustment needed to reach the nominal deficit target of 3% by the deadline is then calculated by assuming a gradual closure of the output gap by 2015.

Against this background, it is appropriate to consider the correction of the excessive deficit for the Czech Republic in a medium-term framework with a deadline for the correction of 2013. In particular, in view of the size of the 2009 deficit, and of the economic outlook for the Czech Republic, a credible and sustainable adjustment path would require the Czech authorities to implement the deficit reducing measures in 2010 as planned in the draft budget law for 2010. In order to bring the deficit below 3% of GDP in 2013, an average annual structural budgetary adjustment of 1% of GDP over the period 2010-2013 has to be ensured. The Czech authorities should specify the measures that are necessary to achieve the correction of the excessive deficit by 2013 cyclical conditions permitting and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected.

According to data notified by the Czech authorities in October 2009, the general government gross debt remains well below the 60% of GDP reference value and is planned to stand at 35.5% of GDP in 2009. According to the Commission services' autumn 2009 forecast, the debt ratio is set to increase rapidly, reaching 44% of GDP in 2011 under the no policy change assumption.

In 2004, the Czech Republic introduced a medium-term budgetary framework which sets annual ceilings for nominal expenditure, for the state budget over three years; however, under the current set-up, the expenditure ceilings have been breached since 2006 compared to the originally planned ceiling. In light of this track record, it is important to enforce more rigorously the medium-term budgetary framework and improve the monitoring of the budget execution throughout the year to avoid expenditure overruns compared to budget and multi-annual plans.

As regards the long-term sustainability of public finances, the budgetary impact of ageing in the Czech Republic is above the EU average, mainly as a result of unfavourable demographic developments. Initial phases of pension and health care reforms have been introduced which will reduce expenditure. In 2008 parametric changes to the pay-as-you-go pension system were introduced, in particular an increase in retirement age from 62 to 65. First steps of a healthcare reform program included the introduction of fees for basic medical services. However, further progress in both areas is necessary to reduce the risk as defined by the Commission Communication[6] on 'Long-term sustainability of public finances for a recovering economy' and endorsed by the ECOFIN Council[7] on 10 November 2009.

Enhanced surveillance under the EDP, which seems necessary also in view of the deadline for the correction of the excessive deficit, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy to ensure the correction of the excessive deficit. In this context, a separate chapter in the updates of the Czech stability programme which will be prepared between 2010 and 2012 could usefully be devoted to this issue.

In general, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy. In particular, the Czech

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[6] Available at: http://ec.europa.eu/economy_finance/publications/publication15996_en.pdf

[7] Available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/111025.pdf

Republic should improve the efficiency and effectiveness of public spending. Moreover, the Czech authorities should continue with the necessary pension and healthcare reforms, with reforms aimed at raising labour supply and skill levels, as well as with reforms increasing the amount and effectiveness of public R&D.

Key macroeconomic and budgetary projections

	2007	**2008**	**2009**	**2010**	**2011**
Real GDP (% change)	6.1	2.5	-4.8	0.8	2.3
Output gap[1] (% of potential GDP)	6.6	5.6	-1.8	-2.9	-2.5
General government balance (% of GDP)	-0.7	-2.1	-6.6	-5.5	-5.7
Primary balance (% of GDP)	0.5	-1.0	-5.2	-3.9	-4.1
Cyclically-adjusted balance[1] (% of GDP)	-3.1	-4.1	-6.0	-4.5	-4.8
Structural balance[2] (% of GDP)	-3.1	-4.1	-6.3	-4.7	-4.9
Government gross debt (% of GDP)	29.0	30.0	36.5	40.6	44.0

Notes:
[1] Based on estimated potential growth of 3.8%, 3.4%, 2.4%, 2.0% and 2.0% respectively in the period 2007-2011.
[2] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures amount to 0.3%, 0.2% and 0.1% of GDP in 2009, 2010 and 2011 respectively according to the Commission services' autumn 2009 forecast.
Source:
Commission services' autumn 2009 forecasts (COM); Commission services' calculations.