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CONVERGENCE PROGRAMME OF THE CZECH REPUBLIC (2004-2007)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The first Czech convergence programme covering the period 2004-2007 was submitted on 13 May 2004. The convergence programme spells out the intention to join the euro area around 2009-2010 provided that the Maastricht criteria are met and a sufficient level of real convergence is achieved. The authorities plan to limit the period of participation in ERM II to two years.

The Czech programme complies only partly with "the code of conduct on the content and format of stability and convergence programmes"[2]. In particular, the ESA95 statistical standards are not entirely met and the quality of ESA95 data on revenues and expenditures of both the functional sub-components and the sub-sectors of the general government needs to be further improved.

The general government deficit increased to 12.9% of GDP in 2003 (5.9% of GDP excluding a major one-off operation related to imputed state guarantees), above the 3% of GDP Treaty reference value. The Commission initiated the excessive deficit procedure for the Czech Republic on 12 May 2004, with the adoption of a report in accordance with Article 104(3) of the Treaty. The Economic and Financial Committee issued its opinion on this report on 24 May. On 5 July 2004, the Council is expected, on the basis of two Commission recommendations, to decide that an excessive deficit exists in the Czech Republic and to make recommendations to the Czech Republic to bring this situation to an end.

The macroeconomic scenario presented in the programme expects real GDP growth to reach 2.8% in 2004 and to accelerate slightly later on, reaching 3.5% in 2007, which is slightly above potential output growth estimated by the Czech authorities. This is below the Commission Spring 2004 forecasts for the years 2004-2005 and below the forecast for the years 2004-2007 by a panel of independent forecasters set up by the Ministry of Finance. The macroeconomic scenario underlying the programme can thus be considered as cautious. Growth is projected to be driven mainly by investment and private consumption. The programme also presents two alternative scenarios which assume different developments of three key exogenous variables: foreign demand, the exchange rate, and oil prices. The baseline scenario is considered as the reference scenario for assessing budgetary projections because it reflects cautious growth assumptions.

Inflation fell from above 10% in January 1998 – when inflation targeting was introduced – to levels approaching zero in mid-2002. Prices were falling for most of 2003 and started to rise again in 2004. Recent VAT changes and increases in regulated prices are expected to contribute to a rise in HICP inflation which is expected to reach 2.8% for the year as a whole. Between January 1999 and mid-2002, the koruna was appreciating against the euro. This trend was temporarily reversed between mid 2002 and beginning of 2004. In line with the drop in inflation, money market interest rates and bond yields

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1 This assessment has been carried out on the basis of information available as of 16 June 2004.

2 For nominal GDP levels, the convergence programme did not use the most recent data as contained in the fiscal notification of March 2004, reflecting a lack of coordination between the Ministry of Finance and the Czech Statistical Office. Updated tables with new GDP data were sent on 2 June 2004 and the assessment of the programme is based on the updated data.

fell substantially between 1998 and 2003. Long-term bond yields even temporarily dropped below EU levels in 2002 and 2003. The Czech monetary policy combines inflation targeting with a managed float of the exchange rate. The Czech National Bank announced a change of the inflation target as of 1 January 2006 – from a gradually decreasing band towards a target of 3% ± 1 percentage point.

The programme targets a gradual reduction of the general government deficit from 5.9% of GDP in 2003 (without the major one-off operation) to 3.3% of GDP in 2007. It further mentions that the proposed path of deficit reduction indicates that the elimination of the excessive deficit would be completed by 2008. The fiscal consolidation is planned to be achieved by a cut in the expenditure ratio (by about 3.5 percentage points) which more than compensates the decline in the revenue ratio (of about 0.8 percentage points). Central government will contribute most to the deficit reduction. To be put into practice in 2004 some of the measures required legal action. The Parliament passed gradually the necessary laws in the second half of 2003 and in April 2004, for instance the law on changes in the VAT and in the excise duties, the laws introducing savings in pension and sickness expenditures. The measures were applied in the 2004 budget. Other measures, particularly those to stimulate growth are being prepared by the government to be adopted as of January 2005. No concrete decisions have been taken on other envisaged measures, in particular those that aim at combating tax evasion and at improving the long-term sustainability of public finances, such as a reform of the pension and healthcare system.

Within the outlined macroeconomic framework, the budgetary adjustment appears to be credible. The risks to the budgetary projections appear broadly balanced. On the one hand, the cautious macroeconomic scenario suggests that revenues could be better than expected and that expenditures could be less than budgeted. On the other hand, the impact of the numerous coinciding tax changes in 2004 on the behaviour of economic agents remains uncertain. In addition, important savings measures, particularly regarding government consumption, still need to be agreed upon. The adjustment path is not very ambitious in the absence of fundamental reforms in social expenditures and taking account of the projected recovery.

Reforms of expenditures and revenues are accompanied by the creation of a new institutional framework for budgetary planning. The new rules are expected to be adopted in summer 2004 and the government plans to prepare already the 2005 budget according to these new budgetary rules. The major institutional innovation is the introduction of fiscal targeting based on medium-term expenditure frameworks for central government. With each annual budget for year *n*, the Parliament will approve nominal expenditure ceilings for years *n+1* and *n+2*. Any later review of the ceilings is allowed only in situations explicitly mentioned in the law on Budgetary Rules (for instance the limits can be increased by the amount of expenditure co-financed by the EU).

The programme projects the debt-to-GDP ratio to increase from 37.6% of GDP in 2003 to 41.7% of GDP in 2007. The main driving force of the growing debt ratio will be the primary deficit, but its contribution is expected to decrease from 4.1% in 2004 to 1.7% in 2007 as a result of the budgetary consolidation. Between 2003 and 2005, the debt ratio is expected to increase by 2 percentage points. This is 2.8 percentage points below the Commission forecasts which project higher primary deficits and a more moderate impact of the stock-flow adjustment due to a less optimistic view on future privatisation proceeds.

The programme reviews the government’s structural reform programme which focuses on the improvement of business and investment environment and on increasing labour market flexibility and employment. It also outlines measures which largely reflect the Broad Economic Policy Guidelines recommendations in those fields.

The Czech Republic faces serious risks of budgetary imbalances in meeting the cost of an ageing population. In particular, unfavourable demographic developments will result in high increases of pension and healthcare expenditures. Policy measures outlined in the programme aiming at containing these risks include mainly parametric changes of the pension and healthcare systems, which may be insufficient to secure the long-term sustainability of public finances. In a situation of rapidly increasing government debt, achieving and maintaining primary surplus is essential to ensure long-term sustainability. Furthermore, the budgetary strategy based on a gradual consolidation over the programme period needs to be complemented by measures that address directly the expected surge in age-related expenditures, including a comprehensive reform of pension and healthcare systems.

Table 1: **Comparison of key macroeconomic and budgetary projections**

		2003	**2004**	**2005**	**2006**	**2007**
Real GDP (% change)	**CP**	**2.9**	**2.8**	**3.1**	**3.3**	**3.5**
	COM	2.9	2.9	3.4	n.a.	n.a.
	PEP	*2.4*	*2.8*	*3.2*	*3.6*	*n.a.*
HICP inflation (%)	**CP**	**-0.1**	**2.8**	**2.6**	**2.2**	**2.2**
	COM	-0.1	2.8	2.8	n.a.	n.a.
	PEP	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
General government balance (% of GDP)	**CP**	**-12.9**	**-5.3**	**-4.7**	**-3.8**	**-3.3**
	COM	-12.9	-5.9	-5.1	n.a.	n.a.
	PEP	*-7.6*	*-5.9*	*-4.8*	*-4.0*	*n.a.*
Primary balance (% of GDP)	**CP**	**-11.7**	**-4.1**	**-3.4**	**-2.4**	**-1.7**
	COM	-11.7	-4.6	-3.8	n.a.	n.a.
	PEP	*-6.0*	*-4.6*	*-3.2*	*-2.4*	*n.a.*
Government gross debt (% of GDP)	**CP**	**37.6**	**38.4**	**39.7**	**41.0**	**41.7**
	COM	37.6	40.6	42.4	n.a.	n.a.
	PEP	*30.5*	*34.2*	*37.7*	*39.4*	*n.a.*
Sources: Convergence programme (CP); August 2003 Pre-accession economic programme (PEP); Commission services Spring 2004 forecasts (COM)						

1. INTRODUCTION

The first Czech convergence programme, covering the period 2004-2007, was submitted on 13 May 2004, following approval by the government on 12 May. The programme was also sent to the Parliament of the Czech Republic. It includes measures incorporated in the 2004 budget as well as additional measures agreed in spring 2004. In particular, it reflects the so-called second stage of public finance reform which further shifts the tax burden from direct to indirect taxation and which includes growth-enhancing measures (see Box below). The convergence programme complies only partly with the "code of conduct on the content and format of stability and convergence programmes". In particular, the ESA95 statistical standards are not entirely met and the quality of ESA95 data on revenues and expenditures of both the functional sub-components and the sub-sectors of the general government needs to be further improved. Due to the incomplete revision of Czech national accounts, the data for nominal GDP levels used in the convergence programme are different from those in the fiscal notification of March 2004, reflecting a lack of coordination between the Ministry of Finance and the Czech Statistical Office. However, an update of the tables of Annex 1 of the Code of Conduct with revised GDP data compatible with the fiscal notification was sent by the Czech authorities on 2 June 2004. The assessment of the programme is based on these updated data.

The budgetary strategy in the programme targets a path of declining general government deficits in the period 2004-2007 towards a deficit of 3.3% of GDP in 2007. This goal should be achieved by fiscal consolidation measures adopted in 2003 and 2004. About three-quarters of the overall adjustment are planned to take place on the expenditure side. Public debt is expected to increase from 37.6% of GDP in 2003 to 41.7% of GDP in 2007. The programme mentions that the proposed path of deficit reduction indicates that the elimination of excessive deficit would be completed by 2008.

2. MACROECONOMIC DEVELOPMENTS

2.1. Macroeconomic scenario

The macroeconomic scenario expects GDP growth of the Czech economy to reach 2.8% in 2004 and to accelerate slightly later on, reaching 3.5% in 2007, which is slightly above potential output growth estimated by the Czech authorities. The growth forecast is below the Commission Spring 2004 forecasts for the years 2004-2005 and below the forecast of the panel of independent forecasters set up by the Ministry of Finance for the period 2004-2007 which verified the plausibility of the programme's macroeconomic framework. For the years 2005-2006, the convergence programme also revises downwards the macroeconomic outlook of the 2003 pre-accession economic programme. Therefore, the macroeconomic scenario underlying the Czech convergence programme can be considered as cautious.

Growth is projected to be driven mainly by investment and private consumption. Assumptions on the external economic environment were taken from the Commission Spring 2004 forecasts[3]. While the inflation forecast is broadly in line with the

[3] However, exchange rate assumptions differ from the Commission Spring forecasts. It is assumed that the Czech koruna will appreciate nominally to reach 30 CZK/EUR in 2007. The annual real

Commission Spring 2004 forecasts, the programme's forecast for current account developments is slightly more optimistic, mainly due to different exchange rate hypotheses. The unemployment rate reached 7.8% in 2003 and the programme forecasts a further increase by 0.7 percentage points by 2007. For the period 2004-2005, the unemployment forecast is slightly above the Commission forecasts, due to a weaker growth perspective compared to the Commission outlook.

Table 2: Comparison of macroeconomic developments and forecasts

	2003		2004		2005		2006		2007	
	COM	**CP**	**COM**	**CP**	**COM**	**CP**	**COM**	**CP**	**COM**	**CP**
Real GDP (% change)	2.9	2.9	2.9	2.8	3.4	3.1	n.a.	3.3	n.a.	3.5
Contributions:										
- Final domestic demand	4.3	4.3	3.5	3.3	3.9	3.4	n.a.	3.4	n.a.	3.5
- Change in inventories	0.3	0.3	0.2	0.3	0.1	0.3	n.a.	0.1	n.a.	0.2
- External balance on g&s	-1.6	-1.6	-0.7	-0.8	-0.6	-0.5	n.a.	-0.2	n.a.	-0.2
Employment (% change)	-0.7	-0.7	-0.4	-0.8	-0.2	-0.3	n.a	0.0	n.a.	0.1
Unemployment rate (%)	7.8	7.8	8.2	8.5	8.2	8.7	n.a.	8.7	n.a.	8.5
HICP inflation (%)	-0.1	-0.1	2.8	2.8	2.8	2.6	n.a.	2.2	n.a.	2.2
GDP deflator (% change)	2.9	2.9	3.1	3.5	3.0	3.3	n.a.	3.2	n.a.	3.4
Current account (% of GDP)	-6.5	-6.5	-6.8	-6.2	-6.6	-6.0	n.a.	-5.8	n.a.	-5.5
Sources: *Convergence programme (CP); Commission services Spring 2004 forecasts (COM)*										

The baseline macroeconomic framework was subject to sensitivity analysis based on two alternative scenarios – an optimistic and a pessimistic one. Both alternative scenarios assumed different developments of three key exogenous variables: foreign demand, the exchange rate, and oil prices. The optimistic scenario assumes a gradual oil price decrease to the level of 22 USD per barrel, a stable nominal exchange rate of 33 CZK/EUR and an acceleration of EU-15 real GDP growth to more than 3.5% a year. On the other hand, the pessimistic scenario assumes higher oil prices, appreciation of the CZK/EUR nominal exchange rate and a deceleration of annual EU-15 economic growth. In the optimistic scenario, the general government deficit declines to 2.4% of GDP in 2007, while in the pessimistic scenario, the deficit would remain at 4.7% of GDP. The baseline scenario is considered as the reference scenario because it reflects cautious growth assumptions.

2.2. External accounts

The current account deficit has been increasing since 1998 and is currently above 6% of GDP. 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). 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. The increasing current account deficits have been accompanied by increasing general government deficits.

Although the current account deficits have been more than covered by surpluses in the financial account, leading to an accumulation of international reserves, the structure of

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appreciation vis-à-vis euro is assumed to be 3%, compared to the constant real effective exchange rate assumption in the Commission forecasts. As regards the period 2006-2007, which is not covered in the Commission Spring forecasts, the convergence programme assumes a slight growth upturn in the EU and stability in commodity and financial markets.

the financial account surplus has changed. The financial account surplus in 2003 was mainly due to inflows of portfolio capital; FDI inflows dropped from a very high 13% of GDP in 2002 to around 3% of GDP in 2003.

The programme expects the current account deficit to decrease slightly, from 6.5% of GDP in 2003 to 5.5% of GDP in 2007. However, the expected catching-up process in the Czech economy is likely to lead to the acceleration of private investment and consumption. This could further deteriorate the net private savings balance and add pressures on the current account deficit. Such developments could be eased by an improvement of the general government balance.

Different scenarios could be considered for the current account development and the underlying domestic savings-investment balances, including the analysis of the composition of capital inflows, domestic credit growth, foreign debt dynamics and associated macroeconomic and financial stability issues. In this context, it would also be useful to examine the broader ramifications of growth, interest rate or exchange rate shocks on fiscal and external sustainability and the soundness of the financial sector.

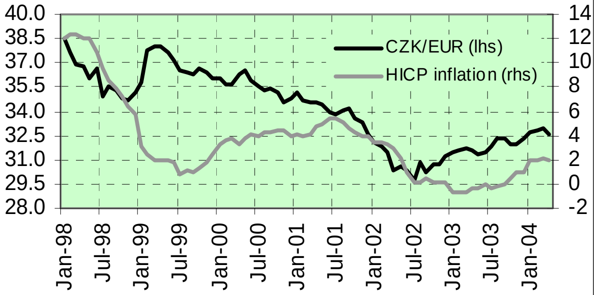
3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY

Czech monetary policy combines inflation targeting with a managed float of the exchange rate. Since early 2002, the Czech National Bank has targeted year-on-year CPI inflation within a band that is gradually decreasing from 3-5% in January 2002 to 2-4% in December 2005. As of 1 January 2006, an inflation rate of 3% ± 1 percentage point will be targeted.

Inflation fell from above 10% in January 1998 – when inflation targeting was introduced – to levels approaching zero in mid-2002. In line with the reduction of inflation expectations, policy rates were lowered from 15% at the beginning of 1998 to 2% in August 2003, where they have since remained. Prices fell for most of 2003 as the development of food and regulated prices was more benign than expected and the dampening effect of the earlier appreciation of the koruna worked its way through. Price changes turned positive again in 2004, and recent VAT changes and increases in regulated prices are expected to contribute to HICP inflation reaching 2.8% for the year as a whole. Inflation is expected to remain between 2.2 and 2.6% for the rest of the forecasting period.

Between January 1999 and mid 2002, the koruna appreciated some 33% against the euro against the backdrop of substantial FDI inflows and positive market sentiment. Assisted by the drop in interest rates and intervention by the authorities, the trend was temporarily reversed and the currency depreciated by some 14% until the beginning of 2004, when it resumed a path of gradual appreciation. The Convergence Programme expects the nominal appreciation to continue at a rate of around 2% a year.

CZK/EUR* (monthly averages) and HICP inflation (monthly figures, y-o-y % change)



*CZK/ECU before Jan-99

Source: ECB, Eurostat

In line with the drop in inflation, money market interest rates fell substantially between 1998 and 2003. Credible monetary policy and stable inflation perspectives led to a progressive convergence of long-term government bond yields with the EU 15, with Czech bond yields dropping temporarily below EU levels in 2002 and 2003.

The Convergence Programme spells out the intention to join the euro area around 2009-2010 provided that the Maastricht criteria are met and a sufficient level of real convergence is achieved. The authorities plan to limit the period of participation in ERMII to two years.

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

4.1. Budgetary developments until 2003

Since the end of the 1990s, the general government deficit has been widening from about 4% of GDP in the late 1990s, reaching 12.9% of GDP in 2003. The steady widening of the deficit since the end of the 1990s has been heavily affected, first, by the operations of transformation institutions, in particular, the financial group of the Czech Consolidation Agency (CKA)[4], second, by a rapid increase of social expenditures of the central government, and third, by an inclusion of state guarantees[5].

The CKA has been used to improve the performance of the banking sector, in particular to prepare it for consolidation and privatisation, and to help with the restructuring of the business sector. Through the CKA, the Czech state has taken over many bad assets and explicit and implicit guarantees which caused the rapid deterioration of the deficit in recent years. For instance, the 2002 deficit of 3.9% of GDP notified in April 2003 was revised upwards in August (in the 2003 pre-accession economic programme, thereafter PEP) to 6.7% of GDP reflecting the operations of the CKA. The consequent rapid increase in public debt was partly mitigated by high privatisation revenues.

Social expenditures (pensions, sickness benefits, family allowances, etc.) have displayed the highest growth dynamics among all expenditure items. A significant fiscal consolidation package in 1997 and 1998 targeted the government-sector wage bill and capital spending but left entitlement programmes untouched. As a consequence, the discretionary cut in spending was offset by increases in social expenditures. In the period 1995-2001, social expenditures almost doubled, rising twice as fast as total general government expenditures. Social expenditures, for the most part mandatory, have been basically crowding out other types of expenditure. Rapidly increasing mandatory and quasi-mandatory expenditures have contributed to the widening of the deficit, also when the economic recovery took hold in 1999.

Table 3: General government balance and debt, 1998-2003 (% of GDP)

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4 The financial group of the CKA was officially established on 1 September 2001 as a successor to the former Konsolidacni Banka. The most important part of the whole group is the Czech Consolidation Agency itself. The rest of the group is composed of the CKA's subsidiaries – Ceska financni, Konpo, Sanakon, Prisko and the Revitalisation Agency (the last three being negligible in financial terms). Apart from the CKA, other important transformation institutions are the National Property Fund and the Ceska Inkasni.

5 In accordance with ESA95 methodology, the Czech authorities imputed high-risk state guarantees provided by the government after 1994 as capital transfers into the general government deficit and debt figures. The 2003 pre-accession economic programme estimated state guarantees at about 13% of GDP. According to the programme, most of them (12.1% of GDP) have been included in the debt figures. The full set of revised national account data for government sector should be available in August 2004.

	1998	1999	2000	2001	2002	2003
General government balance	-4.7	-3.7	-4.5	-6.4	-6.4	-12.9
General government gross debt	13.7	14.3	18.2	25.2	28.9	37.6
Source: *Commission services*						

The budget planning for the year 2003 took place after parliamentary elections in June 2002 and the transition to a new government. The 2003 PEP targeted the general government deficit to increase from 6.7% in 2002 to 7.6% of GDP in 2003 (in ESA95 terms)[6]. However, due to the one-off imputation of state guarantees to ESA95 general government expenditure, the 2003 deficit reached 12.9% of GDP[7]. Without the imputed state guarantees, the deficit would have been about 6% of GDP, i.e. lower than expected in the 2003 PEP, in spite of additional one-off spending related to arbitration proceedings against the CME[8] and expenditure for repair works after the 2002 floods (reflected in a modification of the budget in September 2003).

The better-than-expected outcome of the general government deficit in 2003 at around 6% of GDP (without the imputed state guarantee) was mainly due to the rigorous execution of the state budget which is the biggest component of the general government. On the revenue side of the state budget, tax receipts were 2.5% higher than expected in the budget presented in December 2002. To this result contributed in particular VAT receipts (3.6% higher than expected), and excise duties (8% higher than expected) related to high household consumption in the second half of the year. On the expenditure side, unemployment benefits and capital expenditure were substantially higher than planned, by 10.3% and 9.2% respectively, but overall, total expenditures were only 1.6% higher than foreseen in the budget.

Apart from the state budget, lower-than-planned spending of extra-budgetary funds and higher-than-expected revenues of the National Property Fund also contributed to the better-than-expected outcome of the 2003 general government budget[9].

Despite the positive developments in 2003, the upward trend in social spending was not reversed and the deficit, even when adjusted for the one-off imputation, remains high.

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6 Based on the old (lower) GDP figures.

7 The guarantee is related to the prevention of possible negative impacts and financial instability stemming from the IPB (Investicni a Postovni Banka, a.s.) collapse and the consequent takeover by the CSOB (Ceskoslovenska Obchodni Banka, a.s.) in June 2000.

8 In 1993, CME (Central-European Media Enterprises Group) bought the first Czech private TV broadcaster NOVA. CME sued the Czech Republic for not protecting its investment. In 2003, the Czech Republic lost the case before the arbitration court in Stockholm, forfeiting almost 0.5% of GDP (about 320 mil. EUR).

9 Apart from the state budget, the central government sector in the Czech Republic includes 7 so called 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), and two privatisation funds (National Property Fund, Land Fund of the Czech Republic). Besides their specific laws, the state funds are governed by the Act on Budgetary Rules. Under this act, the funds are obliged to fulfil the same information duty to the Ministry of Finance as ministries and other state bodies (organizational components of the state), i.e. to submit a budget of revenues and expenditures classified according to the budget structure including funding. Their budgets are then approved by the Parliament. Both privatisation funds are an exception: they are not subject to this act and have their own accounting systems.

4.2. Programme overview

The programme targets a reduction of the general government deficit to 3.3% of GDP in 2007. It further mentions that the proposed path of deficit reduction indicates that the elimination of excessive deficit would be completed by 2008. The deficit reduction path in the convergence programme is broadly in line with that in the pre-accession economic programme of August 2003. The debt-to-GDP ratio is forecast to increase from 37.6% of GDP in 2003 to 41.7% of GDP in 2007.

Table 4: Comparison with 2003 pre-accession economic programme and Commission forecasts (% of GDP)

	2003	2004	2005	2006	2007
		General government balance			
CP	**-12.9**	**-5.3**	**-4.6**	**-3.8**	**-3.3**
COM	-12.9	-5.9	-5.1	n.a.	n.a.
*PEP**	*-7.6*	*-5.9*	*-4.8*	*-4.0*	*n.a.*
		General government expenditure			
CP	**60.3**	**52.7**	**51.6**	**50.6**	**49.9**
COM	57.9	50.9	49.2	n.a.	n.a.
*PEP**	*50.0*	*49.7*	*48.2*	*46.8*	*n.a.*
		General government revenues			
CP	**47.4**	**47.4**	**46.9**	**46.8**	**46.6**
COM	45.0	45.0	44.1	n.a.	n.a.
*PEP**	*42.4*	*43.8*	*43.4*	*42.7*	*n.a.*

* The PEP data are based on the old (lower) GDP figures.
<u>*Sources:*</u>
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services Spring 2004 forecasts (COM)

The programme targets a cut in the general government primary deficit by about 3% percentage points between 2003 and 2007. The adjustment is foreseen to be gradual, by about 0.7% of GDP annually, except in 2006, when the cut is planned to be 1% of GDP. The reduction in the general government deficit should be achieved by a cut in the expenditure ratio (by about 3.5% of GDP) which more than compensates the planned reduction in the revenue ratio (by 0.8 percentage points). The Central government sector will contribute most to the deficit reduction. The adjustment path is not very ambitious in the absence of fundamental reforms in social expenditures and taking account of the projected recovery. Nevertheless, within the outlined macroeconomic framework, the adjustment can be considered as broadly credible. However, a major source of risk for the adjustment process are the next Parliamentary elections, planned for June 2006.

Table 5: Composition of the budgetary adjustment (% of GDP)

	2003*	2004	2005	2006	2007	Change: 2007-2003*
Revenues	47.4	47.4	46.9	46.8	46.6	-0.8
of which:						
- Taxes & social security contributions	36.1	36.5	36.0	35.9	35.8	-0.3
- Other (residual)	11.3	10.9	10.8	10.8	10.8	-0.5
Expenditure	60.3 (53.3)	52.7	51.6	50.6	49.9	-10.4 (-3.4)
of which:						
- Primary expenditure	58.9 (51.9)	51.5	50.3	49.3	48.3	-10.6 (-3.6)
of which:						
Gross fixed capital formation	3.6	3.8	3.9	4.0	4.0	+0.4
Consumption	20.4	20.1	19.6	19.2	18.7	-1.7
Transfers & subsidies	14.9	15.0	14.3	14.1	13.8	-1.1
Other (residual)	20.0 (13.0)	12.6	12.5	12.0	11.8	-8.2 (-1.2)
- Net interest payments	0.7	1.0	1.0	1.2	1.4	+0.7
Budget balance	-12.9 (-5.9)	-5.3	-4.6	-3.8	-3.3	+9.6 (+2.6)
Primary balance	-11.7 (-4.7)	-4.1	-3.4	-2.4	-1.7	+10.0 (+3.0)

Note:
* The figures in parentheses exclude imputed state guarantees estimated at 7% of GDP in 2003.
Sources:
Convergence programme; ECFIN calculations

4.3. Targets and adjustment in 2004

The target for the general government deficit in 2004 is 5.3% of GDP, about 0.6 percentage points better than the 2003 outcome if one excludes imputed state guarantees. The Commission Spring 2004 forecasts project a worse deficit than the Czech government (5.9% of GDP). The Commission forecasts reflected fiscal risks stemming mainly from the remaining state guarantees which have in the meantime been included in the historical budgetary data. The risks to budgetary projections appear broadly balanced. On the one hand, the cautious macroeconomic scenario suggests that revenues could be better than expected and that expenditures could be less than budgeted. On the other hand, the impact of the numerous coinciding tax changes in 2004 on the behaviour of economic agents remains uncertain.

To be put into practice in 2004 some of the measures required legal action. The Parliament passed gradually the necessary laws in the second half of 2003. All those laws are a part of the so-called first stage of the fiscal reform (see Box). These measures were applied in the 2004 budget.

On the revenue side, higher VAT and excise duties are expected to more than compensate for the fall in the corporate income tax rate from 31% to 28%. The overall budgetary impact of these tax changes on the general government balance is projected to be 0.9% of GDP. As of the 1 of May 2004 value added taxation was effectively increased (see Box) which is expected to increase further tax revenues. However, the overall revenue ratio in 2004 is expected to remain at the level of 2003 because other revenues are declining.

On the expenditure side, additional measures (not mentioned in the Box) were taken as of June 2004 to mitigate the social consequences of the higher VAT burden. They include permanent as well as one-off additional social spending for retirees and for families with children[10].

Box: The two stages of the public finance reform in the Czech Republic

1. First stage

Many fiscal consolidation measures covering the period 2004-2006 were agreed in 2003. They resulted in a series of measures and laws which have already been adopted by the Parliament. The focus of the measures was expenditure savings which deliver about three-quarters of the total consolidation, with the remainder generated by increased revenues.

a) Expenditure side

The three major expenditure-side measures include a reduction in sickness benefits and in social assistance, a cut in the wage bill of the central government administration and a reduction in discretionary spending of individual ministries. Some additional savings come from parametric changes in the pension system, including reductions in early-retirement pensions, minimal indexation of pension benefits and a further increase of the statutory retirement age.

b) Revenue side

There is a shift in the structure of budget revenues: a decrease in corporate income tax should be more than offset by an increase in VAT and in excise duties. Higher VAT revenues are expected to result from a broadening of the tax base (a lower limit for obligatory VAT registration) and the application of the standard (22%) rather than the reduced (5%) VAT rate to some goods and services. The corporate income tax rate will be reduced in 3 steps from current 31% in 2003 to 24% in 2006. There are additional measures which aim at increasing tax revenues (for instance, a modernisation of the tax and customs administration and an increase in the base for levying social contributions by self-employed persons to 50% of the difference between revenues and costs).

2. Second stage

In late 2003 it was decided that further measures would be taken, focusing on combating tax evasion and promoting economic growth. As of then, measures decided in 2003 are referred to as “the first stage” of the public finance reform and measures decided in early 2004 as “the second stage”. A part of the second stage of the public finance reform was adopted in May 2004 (a decrease of the standard VAT rate from 22% to 19% and a further shift of goods and services from the reduced VAT rate (5%) to the standard one). The growth-stimulating measures are being prepared by the government to be adopted as of January 2005. They are likely to decrease tax revenues.

In addition, the second stage of the public finance reform aims at improving the long-term sustainability of public finances, in particular through a reform of the pension and healthcare system. So far, however, no concrete decisions have been taken.

The impact of EU accession on the fiscal balance is estimated in the programme at -0.6% of GDP in 2004. On the revenue side, the Czech authorities consider budgetary compensations agreed in December 2002 in Copenhagen and the drop of customs duties from trade with the EU countries. On the expenditure side, they include the payments of own resources and top-up subsidies to farmers. However, the authorities’ analysis of the impact of the EU accession on the Czech budget should be qualified. First, top-up

10 These social expenditures are planned to be higher than the additional VAT revenues so that the net effect on the general government balance is expected to be slightly negative in 2004 (0.1% of GDP).

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 the EU accession as a part of increased value added taxation was due to the harmonisation with the EU legislation.

4.4. Targets and adjustment in 2005 and beyond

The programme foresees an improvement of the primary balance by 2.4% of GDP between 2004 and 2007. The largest deficit reduction is expected in 2006 (1 percentage point) while annual adjustments of 0.7 percentage points are planned in 2005 and 2007. The phasing out of transformation costs of the economy and the limitation of the issuance of new state guarantees will impact favourably on the budget. On the other hand, 2006 – when the major reduction of the fiscal deficit should take place, based on spending reforms introduced in 2004 and 2005 – is a year for which the next regular Parliamentary elections are envisaged.

The general government deficit reduction will mainly be a result of measures adopted already in 2003 and early 2004, although the government plans to adopt additional measures as of 2005, in order to decrease tax evasion and to stimulate growth. In addition, important savings measures, particularly regarding government consumption, still need to be agreed upon.

To combat tax evasion, the government plans to implement measures like stamping of spirits and restrictions on stand selling. Growth should be stimulated by shortening depreciation periods for investment and making tax-deductible donations for R&D up to 10% of the tax base. This means a fall in the effective corporate income tax rate. Personal income tax revenues are planned to decline due to a joint income taxation for married couples (lowering the average taxable income) and due to a replacement of tax-deductible allowance for a child by a tax credit. This is expected to lead low-income households to quit the social support system and participate in the labour market.

The first-round impact on the budget of the fall in the effective corporate tax rate and in personal income taxation is estimated to be negative but to diminish (-0.7% of GDP in 2005, -0.5% of GDP in 2006, and -0.3% of GDP in 2007). 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.

Measures for budgetary consolidation in 2005 and beyond are well-directed and within the macroeconomic framework can be considered as credible.

4.5. Debt ratio

In the past five years, the debt-to-GDP ratio almost tripled, reaching 37.6% of GDP in 2003. The steep increase in the debt ratio since 2002 is due to a combination of high fiscal deficits (including capital transfers to the CKA and debt assumptions of considerable contingent liabilities) and a drop in privatisation proceeds[11]. 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, 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.

[11] In 2003, the share of the Czech Consolidation Agency in the total general government debt was 15%, the share of state guarantees was almost 27%.

The programme foresees the debt ratio to increase from 37.6% of GDP in 2003 to 41.7% of GDP in 2007. Between 2003 and 2005, the debt ratio is expected to increase by 2 percentage points. This is below the Commission forecasts which project higher primary deficits and a more moderate impact of the stock-flow adjustment due to the Commission's less optimistic view on privatisation proceeds in 2004. 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 will be the primary deficit, but its contribution is expected to decrease from 4.1% 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.

Table 6: Debt dynamics

	2003		2004		2005		2006	2007
	COM	CP	COM	CP	COM	CP	CP	CP
Government gross debt ratio	37.6	37.6	40.6	38.4	42.4	39.6	41.0	41.7
Change in debt ratio (1 = 2+3+6)	8.8	8.7	3.0	0.8	1.7	1.3	1.3	0.7
Contributions:								
- primary deficit (2)	11.7	11.7	4.6	4.1	3.8	3.4	2.4	1.7
- snow-ball effect (3 = 4+5)	-0.2	-0.2	-0.9	-1.0	-1.2	-1.0	-1.1	-1.1
- interest expenditure (4)	1.3	1.3	1.3	1.3	1.3	1.3	1.4	1.6
- nominal GDP growth (5)	-1.5	-1.5	-2.2	-2.3	-2.5	-2.3	-2.5	-2.7
- stock-flow adjustment (6)	-2.7	-2.7	-0.7	-2.3	-0.9	-1.1	0.0	0.1

Note:
The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} + \frac{SF_t}{Y_t}$$

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

Sources:
Convergence programme (CP); Commission services Spring 2004 forecast (COM); ECFIN calculations

The programme refers to the level of outstanding state guarantees in 2003 at 1.5% of GDP. The majority of these guarantees are considered as risk-free and not expected to increase the general government deficit and debt. Moreover, the issuance of new state guarantees has been limited[12].

About 90% of consolidated public debt is made up by state debt. State debt is almost exclusively denominated in domestic currency which means that there is no exposure to exchange rate risk[13]. The interest rate risk is currently the most important risk. The government follows a strategy to lower this risk 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).

[12] The provision of new state guarantees was restricted in 2001 when any new state guarantee was made subject to approval by the Chamber of Deputies. Hence, only three state guarantees were issued in 2002-2003, totalling to 5.9 billion CZK (about 0.2% of 2003 GDP).

[13] On 14 June 2004 the government issued 1.5 billion Eurobond, which is hedged in order to limit exchange rate risk. Originally, the Ministry of Finance planned a 1.0 billion Eurobond issue. The increased issue size is expected to lead to reduced issuance of T-bill in the domestic market.

5. THE QUALITY OF THE PUBLIC FINANCES

The overall revenue and expenditure ratios are expected to fall by about 0.8 and 3.4% of GDP respectively over the programme period. 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, the programme foresees a decrease in transfers and subsidies (from 15% of GDP in 2004 to 13.8% of GDP in 2007) and in government consumption (from 20.1% of GDP in 2004 to 18.7% in 2007). Government consumption should decline, first, by a decrease in government sector employment and a containment of average wage growth in the public sector, and second, by a cut in the operational expenditures of individual ministries. The programme envisages a slight increase in public investment expenditures as a share of GDP, from 3.8% of GDP in 2004 to 4.0% of GDP in 2007[14]. The fall of "other" expenditures from 20.0% of GDP in 2003 to 11.8% of GDP in 2007 mainly reflects the reduction of capital transfers to transformation institutions and the end of the process of imputation of state guarantees.

The major structural change on the revenue side is the shift of the tax burden from direct to indirect taxation. A reduction in corporate income tax should be more than offset by an increase in VAT and in excise duties. This is expected to have a positive effect on both economic growth and labour market participation of the low-income labour force. Furthermore, the motivation for active participation in the labour market should be enhanced by changes in the pension system (limitation of early retirement) and in the social support system (lifting the ban on drawing certain benefits simultaneously with labour income). The ratio of social contributions to GDP is expected to slightly increase.

The programme also envisages an end of the operation of the transformation institutions. The operation of the National Property Fund will end by law by December 2005. The Czech Consolidation Agency is expected to be closed by the end of 2007.

Reforms of expenditures and revenues are accompanied by the creation of a new institutional framework for budgetary planning. The new rules are expected to be adopted in summer 2004 and the government plans to prepare already the 2005 budget according to these new budgetary rules. The major institutional innovation is the introduction of fiscal targeting based on medium-term expenditure frameworks for central government. With each annual budget for year *n*, the Parliament will approve nominal expenditure ceilings for years *n+1* and *n+2*. Any later review of the ceilings is allowed only in situations explicitly mentioned in the law on Budgetary Rules (for instance the limits can be increased by the amount of expenditure co-financed by the EU)[15]. Furthermore, the state extra-budgetary funds will be submitted to controls as strict as those applying to state budget expenditure. Finally, the effectiveness of expenditure ceilings should be enhanced by an audit of state budget expenditures and programme-oriented budgeting.

In 2003, regions and municipalities have been entrusted with important responsibilities for providing many public services. This could lead to increasing borrowing requirements, in particular after EU accession when regions and municipalities will need

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[14] Figures might change after the revision of national accounts is completed.

[15] Adherence to approved expenditure ceilings will always depend on the government's self-discipline. No sanctions are foreseen when the ceilings are breached, nor a higher Parliamentary majority to change the ceilings.

to co-finance EU funded projects. As a result, the indebtedness of regions and municipalities could rise because local governments will not be subject to fiscal targeting, but their borrowing rules which are not well defined have been discussed by the Government and changes are in preparation.

6. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The programme includes a section on the sustainability of public finances which presents demographic and macroeconomic assumptions as well as national projections for public expenditures on old-age and other pensions, health-care and education until 2050.

Given the current demographic structure in the Czech Republic, the country belongs to the group of EU countries with a rather young population. In the period up to 2050, however, this is expected to change radically as the demographic projections suggest a rapid worsening of the old-age dependency ratio (almost tripling from 20% in 2003 to 56% in 2050) and, consequently, an increase in age-related expenditures.

Improving the prospects for long-term sustainability of public finances is one of the objectives of the public finance reform. Its first stage included mainly parametric measures (see Box above). *Inter alia*, this consisted of increasing the retirement age, phasing out one of the two early retirement schemes, alignment of effective pension contributions of the self-employed with those of employees and reallocating a proportion of the state employment policy contributions to the pension system. In addition, several reform measures targeted the labour market and social care (reduction in sickness benefits), which should, in addition to the planned improvement in the education system, lead to higher productivity growth in the future and indirectly, to enhanced sustainability of public finances. The second stage aims at a thorough reform of the pension and healthcare system. However, apart from a few short-term stabilising measures related to the latter, the most important steps of the reform process do not seem to be planned before the end of the convergence programme period, thus further delaying steps towards containment of the budgetary risks related to populationageing.

The programme foresees overall age-related expenditures to increase by 9.4 percentage points of GDP, from 20.2% of GDP in 2005 to 29.6% of GDP in 2050. Particularly high increases are projected in pension and health care expenditures (6.8 percentage points of GDP and 3.1 percentage points, respectively), while education expenditures are expected to decrease marginally, reflecting the strategic efforts of increasing the number of students at the tertiary level towards the OECD average. Especially significant, are the projected dynamics in pension and health care expenditures in the period 2020–2050 when the impact of ageing will be particularly felt.

The risk to long-term sustainability of public finances increases if the objectives set in the convergence programme fail to be achieved. Negative dynamics in the government debt-to-GDP ratio during the recent years have resulted mainly from high general government imbalances and the assumption of considerable contingent liabilities. The stabilisation of the government debt-to-GDP ratio is conditional on the planned budgetary consolidation.

As regards the long-term sustainability, the Czech Republic faces serious risks of budgetary imbalances in meeting the cost of an ageing population. In particular, unfavourable demographic developments will result in high increases of pension and healthcare expenditures. Policy measures outlined in the programme aiming at containing these risks include mainly parametric changes of the pension and healthcare systems, which may be insufficient to secure the long-term sustainability of public finances. In a situation of rapidly increasing government debt, achieving and maintaining a primary surplus is essential to ensure long-term sustainability. Furthermore, the budgetary strategy based on a gradual consolidation over the programme period needs to be complemented by measures that address directly the expected surge in age-related expenditures, including a comprehensive reform of pension and healthcare systems.

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ANNEX: SUMMARY TABLES FROM THE 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)	2.9	2.8	3.1	3.3	3.5
GDP *level* at *current* market prices, CZK bn.	2541	2703	2879	3070	3283
GDP deflator	2.9	3.5	3.3	3.2	3.4
HICP change	-0.1	2.8	2.6	2.2	2.2
Employment growth [3]	-0.7	-0.8	-0.3	0.0	0.1
Labour productivity growth [4]	3.6	3.6	3.4	3.3	3.5
Sources of growth: percentage changes at constant prices					
1. Private consumption expenditure	5.4	2.9	3.1	3.4	3.4
2. Government consumption expenditure	0.0	-0.2	-0.2	-0.2	-0.1
3. Gross fixed capital formation	3.7	4.8	4.7	4.3	4.5
4. Changes in inventories and net acquisition of valuables as a % of GDP [3]	2.6	2.8	3.0	3.1	3.1
5. Exports of goods and services	6.7	8.0	7.9	7.8	7.8
6. Imports of goods and services	7.6	7.9	7.5	7.1	7.1
Contribution to GDP growth					
7. Final domestic demand (1+2+3)	4.3	3.3	3.4	3.4	3.5
8. Change in inventories and net acquisition of valuables (=4)	0.3	0.3	0.3	0.1	0.2
9. External balance of goods and services (5-6)	-1.6	-0.8	-0.5	-0.2	-0.2

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

% of GDP	**2003**	**2004**	**2005**	**2006**	**2007**
Net lending by sub-sectors					
1. General government	-12.9	-5.3	-4.7	-3.8	-3.3
2. Central government	-12.6	-5.5	-4.4	-3.6	-3.1
3. State government					
4. Local government	-0.2	0.0	-0.2	-0.2	-0.2
5. Social security funds	-0.1	0.1	0.0	0.0	0.0
General government					
6. Total receipts	47.4	47.4	46.9	46.8	46.6
7. Total expenditures	60.3	52.7	51.6	50.6	49.9
8. Budget balance	-12.9	-5.3	-4.7	-3.8	-3.3
9. Net interest payments	0.7	1.0	1.0	1.2	1.4
10. Primary balance	-12.2	-4.4	-3.7	-2.6	-1.9
Components of revenues					
11. Taxes	20.9	21.3	20.8	20.6	20.4
12. Social contributions	15.2	15.2	15.2	15.3	15.4
13. Interest income	0.6	0.3	0.2	0.2	0.2
14. Other	10.7	10.6	10.6	10.6	10.6
15. Total receipts	47.4	47.4	46.9	46.8	46.6
Components of expenditures					
16. Collective consumption	10.3	10.1	9.8	9.6	9.3
17. Social transfers in kind	10.1	10.0	9.8	9.6	9.4
18. Social transfers other than in kind	12.6	12.4	12.0	11.9	11.6
19. Interest payments	1.3	1.3	1.3	1.4	1.6
20. Subsidies	2.3	2.6	2.3	2.2	2.2
21. Gross fixed capital formation	3.6	3.8	3.9	4.0	4.0
22. Other	20.0	12.6	12.5	12.0	11.8
23. Total expenditures	60.3	52.7	51.6	50.6	49.9

Table 3. General government debt developments

% of GDP	**2003**	**2004**	**2005**	**2006**	**2007**
Gross debt level	37.6	38.4	39.7	41.0	41.7
Change in gross debt	8.7	0.8	1.3	1.3	0.7
Contributions to change in gross debt					
Primary balance	11.7	4.1	3.4	2.4	1.7
Interest payments	1.3	1.3	1.3	1.4	1.6
Nominal GDP growth	-1.5	-2.3	-2.3	-2.5	-2.7
Other factors influencing the debt ratio	-2.7	-2.3	-1.1	0.0	0.1
Of which: Privatisation receipts	-1.0	-1.0	0.0	0.0	0.0
p.m. implicit interest rate on debt	4.6	3.6	3.5	3.8	4.1

Table 4. Cyclical developments

% of GDP	2003	2004	2005	2006	2007
1. GDP growth at constant prices	2.9	2.8	3.1	3.3	3.5
2. Actual balance	-12.9	-5.3	-4.7	-3.8	-3.3
3. Interest payments	1.3	1.3	1.3	1.4	1.6
4. Potential GDP growth	2.6	2.7	3.0	3.1	3.1
5. Output gap	-0.4	-0.3	-0.3	0.0	0.4
6. Cyclical budgetary component	-0.1	-0.1	0.0	0.0	0.1
7. Cyclically-adjusted balance (2-6)	-12.9	-5.3	-4.6	-3.8	-3.4
8. Cyclically-adjusted primary balance (7-3)	-11.6	-4.0	-3.4	-2.4	-1.8

Table 5. Divergence from previous update

% of GDP	2003	2004	2005	2006	2007
GDP growth					
Previous update	2.4	2.8	3.2	3.6	-
Latest update	2.9	2.8	3.1	3.3	3.5
Difference	0.5	0.0	-0.1	-0.3	-
Actual budget balance					
Previous update	-7.6	-5.9	-4.8	-4.0	-
Latest update	-12.9	-5.3	-4.7	-3.8	-3.3
Difference	-5.3	0.6	0.1	0.2	-
Gross debt levels					
Previous update	30.5	34.2	37.7	39.4	-
Latest update	37.6	38.4	39.7	41.0	41.7
Difference	7.1	4.1	2.0	1.7	-

Table 6. Long-term sustainability of public finances

% of GDP	2003	2005	2010	2020	2030	2050
Total expenditure	59.0	50.3	47.8	48.5	50.3	54.1
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	1.3	1.7	2.5	4.0	7.8
Total revenues	47.4	46.9	46.6	46.6	46.6	46.6
Of which: from pension contributions	8.3	9.0	9.0	9.0	9.0	9.0
National pension fund assets (if any)						
Assumptions						
Labour productivity growth	4.3	2.9	3.4	2.8	2.5	1.8
Real GDP growth	2.9	3.1	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	8.7	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)	4.2	4.8	5.0	5.5	5.5
United States: short-term (three-month money market)	1.2	1.2	1.7	1.7	1.8
United States: long term (10-year government bonds)	4.0	4.2	4.6	4.6	4.8
USD/€ exchange rate (annual average)	1.13	1.25	1.24	1.23	1.23
Nominal effective exchange rate (euro area)					
Nominal effective exchange rate (EU)					
CZK/€ exchange rate (annual average)	31.8	32.4	31.4	30.8	30.5
World GDP growth, excluding EU	4.4	5.1	4.7	5.0	4.8
United States, GDP growth	3.1	4.2	3.2	4.0	4.0
Japan, GDP growth	2.7	3.4	2.3	3.0	3.0
EU-15 GDP growth	0.8	2.0	2.4	2.8	2.6
Growth of relevant foreign markets					
World import volumes, excluding EU	7.3	9.7	8.5	8.1	7.5
World import prices (goods, in USD)	8.8	6.4	0.7	1.5	2.0
Oil prices (Brent, USD/barrel)	28.8	31.1	28.9	27.2	26.9
Non-oil commodity prices (in USD)	6.6	15.6	-2.6	-0.5	1.0