COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 24.6.2004
SEC(2004) 829 final

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 9
of Council Regulation (EC) No 1466/97 of 7 July 1997

On the convergence programme of the Czech Republic, 2004-2007

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1] stipulates that non-participating Member States, that is, those which have not adopted the single currency, have to submit convergence programmes to the Council and the Commission for the purpose of multilateral surveillance at regular intervals under Article 99 of the Treaty.

In accordance with Article 9 of this Regulation, the Council has to examine each convergence programme based on assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). On the basis of a recommendation from the Commission and after consulting the Economic and Financial Committee, the Council is required to deliver an opinion, following its examination of the programme. According to the Regulation, Member States need to submit annual updates of their convergence programmes, which may also be examined by the Council in accordance with these same procedures.

The ten countries that joined the EU on 1 May 2004 have a derogation and thus do not yet participate in the single currency. They committed themselves to submitting their convergence programmes by 15 May 2004 and a first update thereof towards the end of 2004.

The Czech Republic's convergence programme covering the period 2004-2007 was submitted on 13 May 2004. The Commission services have carried out a technical evaluation of this programme, taking into account the results of the Spring 2004 forecasts and having regard to the Code of Conduct[2] and the principles laid down in the Communication from the Commission to the Council and the European Parliament of 27 November 2002 on strengthening the co-ordination of budgetary policies[3]. This evaluation warrants the following assessment:

> 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.
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> The Czech programme complies only partly with "the code of conduct on the content and format of stability and convergence programmes"[4]. 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.

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1 OJ L 209, 2.8.1997. All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

2 Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the ECOFIN Council on 10.7.2001.

3 COM(2002) 668 final, 27.11.2002.

4 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.

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 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: 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)

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the convergence programme of the Czech Republic and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the convergence programme of the Czech Republic, 2004-2007

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[5], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [5 July] 2004, the Council examined the convergence programme of the Czech Republic, which covers the period 2004 to 2007. The programme complies only partly with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes". In particular, 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 budgetary strategy underlying the programme aims at gradual reduction of the general government deficit to 3.3% of GDP in 2007 from 12.9% in 2003 (5.9% of GDP excluding a major one-off operation related to imputed state guarantees). The programme further mentions that the proposed path of deficit reduction indicates that the elimination of the excessive deficit would be completed by 2008. This goal is set to be achieved by fiscal consolidation measures adopted to a large extent in 2003 and 2004. The programme envisages that the fall in the general government revenue-to-GDP ratio is more than offset by the cut in the general government expenditure ratio. On the revenue side, the programme constitutes a shift from direct to indirect taxation. On the expenditure side, the programme foresees a decrease in transfers and subsidies and in government consumption. The programme envisages a slight increase in public investment expenditures as a share of GDP.

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5 OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

The macro-economic scenario underlying the programme reflects cautious growth assumptions, i.e. growth of 2.8% in 2004 and an acceleration thereafter, reaching 3.5% in 2007. This scenario is taken as the reference scenario for assessing budgetary projections. The projection for inflation appears realistic.

The programme foresees the deficit to be reduced to 3.3% of GDP in 2007 and to fall further thereafter, with the following intermediate targets: 5.3% of GDP in 2004, 4.7% of GDP in 2005, and 3.8% of GDP in 2006. 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 budgetary stance in the programme seems sufficient to reduce the deficit to the 3% of GDP deficit threshold by 2008.

The debt ratio increases by 4.1 percentage points over the programme period, reaching 41.7% of GDP in 2007. The evolution of the debt ratio may be less favourable than projected, given possible developments affecting the stock-flow adjustment, in particular lower future privatisation proceeds.

The Czech Republic faces serious risks of budgetary imbalances in meeting the cost of an ageing population. Making progress towards securing an adequate primary surplus is essential to ensure that the public finances are on a sustainable footing. 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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On [5 July] 2004, on the basis of recommendations from the Commission, the Council decided that an excessive deficit existed in the Czech Republic in accordance with Article 104(6) of the Treaty and made recommendations under Article 104(7) to the Czech Republic with a view to bringing that situation to an end, in which the Council expresses its policy advice.

Key projections from the convergence programme of the Czech Republic

	2003	**2004**	**2005**	**2006**	**2007**
Real GDP growth (%)	2.9	2.8	3.1	3.3	3.5
Employment growth (%)	-0.7	-0.8	-0.3	0.0	0.1
HICP inflation (%)	-0.1	2.8	2.6	2.2	2.2
General government balance (% of GDP)	-12.9	-5.3	-4.7	-3.8	-3.3
Government gross debt (% of GDP)	37.6	38.4	39.7	41.0	41.7