COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 11.1.2005
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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 updated 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. 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 do not participate in the single currency, but are required to fulfil in due time the convergence criteria, including the one on the sustainability of the government financial position, in order to qualify for the adoption of the euro. In view of a general government deficit of 12.6% of GDP (including a major one-off operation of about 7% of GDP) recorded in 2003, the Council decided on 5 July 2004 that the Czech Republic was in excessive deficit and recommended that the excessive deficit be corrected by 2008 at the latest in line with the May 2004 convergence programme. In particular, the Czech Republic was requested to take effective action regarding the measures to achieve the 2005 deficit target. It was also recommended to implement with vigour the measures envisaged in the May 2004 convergence programme, in particular to cut the wage bill of central government and to reduce spending of individual ministries. Furthermore, the Czech Republic was invited to allocate higher-than-budgeted revenues to deficit reduction, to introduce fiscal targeting based on medium-term expenditure ceilings, to design effective rules to reduce the risk of increasing indebtedness of regions and municipalities, to undertake the reform of the pension and healthcare systems to improve the long-term sustainability of the public finances and to minimise the negative budgetary impact of the operations of the Czech Consolidation Agency. In its Communication of 22 December 2004 the Commission concluded that the Czech government had taken effective action regarding the measures envisaged to achieve the 2005 deficit target[2].

The Member States which joined the EU on 1 May 2004 committed themselves to submitting their convergence programmes by 15 May 2004 and a first update thereof towards the end of 2004. The first convergence programme of the Czech Republic, covering the period 2004-2007, was submitted on 13 May 2004 and assessed by the Council on 5 July 2004. The Czech Republic submitted an update of its convergence programme on 1 December 2004. The Commission services have carried out a technical evaluation of this update, taking into account the results of the Commission services Autumn 2004 economic forecasts, and having regard to the code of conduct[3], the commonly agreed methodology for the estimation of potential output, the recommendations in the broad economic policy guidelines for the period 2003-2005 and the principles laid down in the Communication from the Commission to the

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 SEC(2004) 1630 final, 22.12.2004.

3 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.

Council and the European Parliament of 27 November 2002 on strengthening the coordination of budgetary policies[4]. This evaluation warrants the following assessment:

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

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

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

- The programme aims at reducing the deficit from 5.2% of GDP in 2004 (including one-off expenditures of about 1.2% of GDP) to below the 3% of GDP reference value in 2008, in line with the Council recommendation under Article 104(7). The programme targets a cut in the general government deficit by 1.9 percentage points between 2004 and 2007 and a cut in the primary deficit by 2.3 percentage points over the same period. However, excluding the impact of two one-off operations in 2004, the improvement in the nominal deficit is around 0.7 percentage points. The adjustment is foreseen to be gradual, by about 0.5% of GDP annually, except in 2006, when the cut is planned to be almost 1% of GDP.

4 COM(2002) 668 final, 27.11.2002.

Both revenues and expenditures are planned to fall over the programme period (as a percentage of GDP), with public investment the only expenditure item expected to increase, from 4.2% of GDP in 2003 to 4.6% of GDP in 2007, well above the EU-average (2.4% of GDP in 2004). The deficit reduction path in the convergence programme is broadly in line with that in the pre-accession economic programme of August 2003. When compared to the May 2004 programme, there is no change of the deficit targets for 2005-2007 as percentage of GDP, although GDP growth has been revised upwards considerably and the estimated outcome for the 2004 deficit (excluding one-offs) is better than expected.

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

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

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

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

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

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

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007
Real GDP (% change)	**CP December 2004**	**3.8**	**3.6**	**3.7**	**3.8**
	COM	3.8	3.8	4.0	n.a.
	CP May 2004	*2.8*	*3.1*	*3.3*	*3.5*
HICP inflation (%)	**CP December 2004**	**2.7**	**3.2**	**2.6**	**2.2**
	COM	2.8	3.1	2.9	n.a.
	CP May 2004	*2.8*	*2.6*	*2.2*	*2.2*
General government balance (% of GDP)	**CP December 2004**	**-5.2**	**-4.7**	**-3.8**	**-3.3**
	COM	-4.8[1]	-4.7	-4.3	n.a.
	CP May 2004	*-5.3*	*-4.7*	*-3.8*	*-3.3*
Primary balance (% of GDP)	**CP December 2004**	**-4.0**	**-3.3**	**-2.3**	**-1.7**
	COM	-3.6[1]	-3.3	-2.9	n.a.
	CP May 2004	*-4.1*	*-3.4*	*-2.4*	*-1.7*
Government gross debt (% of GDP)	**CP December 2004**	**38.6**	**38.3**	**39.2**	**40.0**
	COM	37.8[1]	39.4	40.6	n.a.
	CP May 2004	*38.4*	*39.7*	*41.0*	*41.7*

[1] The Commission services forecast for 2004 did not include the imputed state guarantee of 0.8% of GDP.

Sources:
Convergence programme (CP); Commission services autumn 2004 economic forecasts (COM)

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the updated 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 updated 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:

(1) On [18 January] 2005 the Council examined the updated convergence programme of the Czech Republic, which covers the period 2004 to 2007. The programme complies partly with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes". In particular, in spite of a revision in the data provided after the submission of the update, the expenditure and revenue ratios are not fully consolidated in line with ESA95 statistical standards. Accordingly, the Czech Republic is invited to achieve compliance with the data requirements.

(2) The programme contains different scenarios for the macroeconomic and budgetary projections: a "baseline" scenario, an "optimistic" scenario and a "pessimistic" scenario. The "baseline" scenario is considered as the reference scenario for assessing budgetary projections, because, on the basis of currently available information, it seems to reflect plausible growth assumptions. This scenario expects real GDP growth to be 3.8% in 2004. In 2005, real GDP is forecast to reach 3.6% and to accelerate slightly later on, reaching 3.8% in 2007. The programme's projections for inflation appear realistic.

(3) On 5 July 2004, the Council decided that an excessive deficit existed in the Czech Republic and recommended that this be corrected by 2008.

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.

(4) The programme aims at reducing the deficit from 5.2% of GDP in 2004 (including one-off expenditures of about 1.2% of GDP) to below the 3% of GDP reference value in 2008, in line with the Council recommendation under Article 104(7). The programme targets a cut in the general government deficit by 1.8 percentage points between 2004 and 2007 and a cut in the primary deficit by 2.3 percentage points over the same period. The adjustment is foreseen to be gradual, by about 0.5% of GDP annually, except in 2006, when the deficit improvement is planned to be almost 1% of GDP. Both revenues and expenditure are planned to fall over the programme period (as a percent of GDP), with public investment is the only expenditure item expected to increase, from 4.2% of GDP in 2003 to 4.6% of GDP in 2007, well above the EU-average (2.4% of GDP in 2004). In comparison with the May 2004 convergence programme, there is no change in the deficit targets for 2005-2007 although GDP growth has been revised upward and the budgetary outcome for 2004 (excluding one-offs) is better than expected.

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

(6) The debt ratio is estimated to have reached 38.6% of GDP in 2004, well below the 60% of GDP Treaty reference value. The programme projects the debt ratio to increase by 1.4 percentage points over the programme period.

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

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

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

Key projections from the updated convergence programme of the Czech Republic

	2003	**2004**	**2005**	**2006**	**2007**
Real GDP growth (%)	3.1	3.8	3.6	3.7	3.8
HICP inflation (%)	-0.1	2.7	3.2	2.6	2.2
General government balance (% of GDP)	-12.6	-5.2	-4.7	-3.8	-3.3
Primary balance (% of GDP)	-11.3	-4.0	-3.3	-2.3	-1.7
Government gross debt (% of GDP)	37.8	38.6	38.3	39.2	40.0