COMMISSION OF THE EUROPEAN COMMUNITIES

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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, 2005-2008

(presented by the Commission)

EXPLANATORY MEMORANDUM

Background

The Stability and Growth Pact, which entered into force on 1 July 1998, is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. In 2005, the Pact was amended for the first time. The reform acknowledged the Pact's usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). The first convergence programme of the Czech Republic was submitted in May 2004. In accordance with the Regulation, the Council delivered an opinion on it on 5 July 2004 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

In these programmes, Member States need to specify their medium-term objective for the budgetary position and set out the policy measures to achieve and maintain it, including the accompanying economic assumptions. Following the reform of the Pact, the medium-term objective should be differentiated for individual Member States in the light of the economic and budgetary heterogeneity in the Union, including as regards the fiscal risk to sustainability. Other elements of the reform are that a more symmetrical approach to fiscal policy over the cycle through enhanced budgetary discipline in economic good times should be achieved, while "major structural reforms" with a verifiable impact on long-term sustainability should be taken into account for a temporary deviation from the medium-term objective or the adjustment path towards it.

Taking into account the Commission services' autumn 2005 forecast, the code of conduct[2], the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and the broad economic policy guidelines, included in the integrated guidelines for the period 2005-2008, the Commission has examined the recently submitted update of the convergence programme of the Czech Republic and, based on its assessment below, has adopted a recommendation for a Council opinion on it.

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1 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). 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 Opinion of the Economic and Financial Committee on the " Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

Assessment

(1) The second update of the Czech Republic's convergence programme, covering the period 2005-2008, was submitted on 24 November 2005. The programme broadly follows the model structure for stability and convergence programmes specified in the new code of conduct and provides all compulsory and most optional data prescribed by the new code of conduct.

(2) On 5 July 2004 the Council decided that the Czech Republic was in excessive deficit. According to the Council recommendation under Article 104(7) of the same date, the excessive deficit has to be corrected by 2008. In its opinion of 18 January 2005 on the previous update of the Czech Republic's convergence programme covering the period 2004-2007, the Council recommended the Czech Republic "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 was 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."

(3) After achieving progress in economic reforms and in stabilisation by mid-1990s, the Czech Republic experienced macroeconomic imbalances, leading to a foreign-exchange crisis in May 1997 and to an economic recession in 1997-1999. Comprehensive structural reforms in the financial and enterprise sectors helped the economy to recover from 2000. Since then, real annual GDP growth has averaged about 3%, compared to an average annual growth rate of 1.7% in the EU.

(4) The programme presents three scenarios for the macro-economic projections: a "baseline", an "optimistic", and a "pessimistic" scenario. The "baseline" scenario is considered as the reference scenario for assessing budgetary projections. It expects annual real GDP growth to be 4.8% in 2005 and 4.4% in 2006 followed by a slight decrease to 4¼% in 2007-2008. This is broadly in line with the Commission services autumn 2005 forecasts for the years 2005-2007. For the year 2008, growth is somewhat above the Commission services' estimate of potential growth. The growth assumptions underlying the programme can thus be considered as plausible, tilted to favourable in the outer year. Due to possible overestimation of potential growth, cyclical conditions are likely to be more favourable than implied by the programme's projections. Inflation is expected to increase from 1.5% in 2005 to 2.2% in 2006 and to slightly decrease to 2.0% in 2007, which appears relatively optimistic.

(5) After a depreciation of the koruna/euro exchange rate by almost 15% between July 2002 and February 2004, the Czech currency joined in a regional trend of sustained appreciation until March 2005 and regained some 12% against the euro. This trend was temporarily reversed by a depreciation in March-April 2005, but the koruna resumed its appreciation trend in June 2005. Czech long-term interest rates remain low. Following their easing in the second half of 2004, the spread against the euro area fluctuated between 0 and 40 basis points for most of 2005. The convergence programme specifies that the Czech Republic is preparing for joining the euro area in 2010 and reconfirms that ERM II participation should be limited to the minimum required period. An indicative calendar for achieving full euro area membership recently published by the Ministry of Finance suggests a possible ERM II entry in the second half of 2007.

(6) The general government deficit for 2005 is estimated at 3.2% of GDP, based on the Commission services' autumn 2005 forecasts, against a targeted deficit of 4.7% of GDP in the previous update. The deficit outcome is expected to be influenced mainly by the budgetary performance of the central government, in particular of the state budget, which recorded (on a cash basis) higher-than-planned tax revenues and an under-execution of expenditures of about 1.5% of GDP.

(7) This update aims at reducing the general government deficit to below the 3% of GDP reference value in 2008, in line with the Council recommendation under Article 104(7). In particular, it projects the deficit to be cut by over 2 percentage points of GDP between 2005 and 2008 and the primary deficit by 2.3 percentage points. However, excluding the impact of two one-off expenditures in 2005, the improvement in the nominal deficit over the period is only 1 percentage point of GDP. The deficit reduction mainly reflects a cut in the expenditure ratio (by 2.3 percentage points of GDP) over the programme period, while revenues are broadly unchanged (-0.2 percentage point). Public consumption and social transfers are the expenditure items that are planned to decline most as a percent of GDP. Public investment is foreseen to rise strongly, from 5% of GDP in 2004 to over 6% of GDP in 2008, well above the EU average (2.5% of GDP in 2005). Compared with the previous programme, the November 2005 update broadly confirms the planned adjustment, although the underlying macroeconomic scenario is considerably stronger.

(8) Based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the structural balance is planned to improve only slightly over the programme period (by ½ percentage point of GDP). The planned fiscal effort is back-loaded and concentrated in years in which the output gap is projected to be positive. Indeed, in 2006 the fiscal position is expected to deteriorate. The update identifies a medium-term objective (MTO) for the budgetary position as meant in the Stability and Growth Pact of a structural balance of "around -1% of GDP", which it expects to achieve by 2012.

(9) As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1½% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO is at an appropriate level because it adequately reflects the debt ratio and average potential output growth in the long term.

(10) The risks to the budgetary projections in the programme appear broadly balanced. On the one hand, the track record of cautious budgetary planning indicates that outcomes could be better than targeted (as was the case in 2004 and is expected by the Commission services also for 2005). The growth assumptions underlying the budgets have usually been realistic and the assumptions about tax elasticities cautious. Moreover, budgeted expenditures have not always been fully executed, mainly due to the possibility to carry over unspent funds from previous budgetary years. On the other hand, the programme refers to several (proposed) measures in the area of social spending which would increase expenditure under this heading rather than decrease it, as projected in the programme. Moreover, expenditure carryovers of more than 1% of GDP were accumulated in 2004 and Commission services expect their volume to further increase in 2005. If these sizeable carryovers were spent in addition to all budgeted expenditures – which cannot be excluded especially in the election year 2006 – budgetary outcomes could be worse than targeted, in particular in 2006.

Furthermore, the growth assumption in the final year of the programme seems favourable.

(11) In view of this risk assessment, the budgetary stance in the programme seems consistent with a correction of the excessive deficit by 2008 as recommended by the Council, which is the end-year of the programme. However, the envisaged adjustment path in structural terms could be strengthened, especially when the possibility of a much better outcome in 2005 and the upward revision of growth prospects are taken into account.

(12) Between 2005 and 2008, government debt is expected to increase by ½ percentage point of GDP and reach almost 38% of GDP in 2008, well below the 60% of GDP reference value. The negative effect of the primary deficit is projected to be to a large extent compensated by a positive snowball effect whereby the negative contribution of a slightly increasing implicit interest rate should be more than offset by the continuation of high nominal GDP growth. The stock-flow adjustment is also expected to have a mitigating impact on the rise in debt.

(13) With regard to the sustainability of public finances, the Czech Republic appears to be at high risk on grounds of the projected budgetary costs of ageing populations. While the debt ratio is currently relatively low in an EU perspective, the high deficit contributes to a rising debt ratio in the long-term projections until 2050, which increases the risk to debt sustainability. At the same time, the projected high increases of pension expenditure over the projection period are expected to put a significant burden on the public finances. A rigorous implementation of the planned consolidation of public finances over the medium term and a further strengthening of the budgetary position together with additional structural reforms to contain the increase in age-related expenditures, in particular on pensions and health care, appear to be of key importance in order to mitigate the risks to public finance sustainability[3].

(14) The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, the programme foresees the correction of the excessive deficit in line with the Council's recommendations. It also presents measures to promote a growth- and employment-oriented allocation of resources, in particular by decreasing the weight of the public sector in the economy and by shifting the tax burden from direct to indirect taxation. However, while the government is aware of the problem of the long-term sustainability, the programme does not present concrete steps to address it.

(15) The National Reform Programme of the Czech Republic, submitted on 14 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies long-term sustainability as the main challenge with implications for public finances. The budgetary implications of the limited number of concrete reform measures specified in the National Reform Programme are reflected in the budgetary projections of the convergence programme. The measures in the area of public finances envisaged

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[3] Details on long-term sustainability are provided in the technical assessment of the programme by the Commission services, to be published at the website:http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

in the convergence programme are in line with the actions foreseen in the National Reform Programme. In particular, the convergence programme outlines measures to support jobs and growth by changes in the revenue and expenditure structure (especially a shift of the tax burden from direct to indirect taxation and a cut in government consumption and transfers) and by making public investment a spending priority, but it does not present any concrete reform steps to address the problem of long-term sustainability. The programme further envisages a strengthening of the role of the medium-term expenditure ceilings by implementing the binding principles on the headings of the state budget and of the state funds and by inclusion of local governments in the budgetary planning process.

In view of the above assessment and in the light of the recommendations made by the Council under Article 104(7) of 5 July 2004, it would be appropriate for the Czech Republic to:

(i) strengthen the effort in the structural budgetary adjustment, in view of the small margin below the reference value targeted for 2008 (which is the deadline for the correction of the excessive deficit) and in order to fully take advantage of the upward revision of growth prospects compared to those underlying the Council recommendations;

(ii) enhance the quality of budgetary planning, in particular by analysing causes of significant expenditure carryovers and reinforcing the medium-term expenditure ceilings;

(iii) improve the long-term sustainability of the public finances, in particular by accelerating the pension reform and undertaking the reform of the healthcare system.

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, 2005-2008

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[4], 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 [24 January 2006] the Council examined the updated convergence programme of the Czech Republic, which covers the period 2005 to 2008. The programme broadly follows the model structure for stability and convergence programmes specified in the new code of conduct and provides all compulsory and most optional data prescribed by the new code of conduct.

(2) After achieving progress in economic reforms and in stabilisation by mid-1990s, the Czech Republic experienced macroeconomic imbalances, leading to a foreign-exchange crisis in May 1997 and to an economic recession in 1997-1999. Comprehensive structural reforms in the financial and enterprise sectors helped the economy to recover from 2000. Since then real annual GDP growth averaged about 3%, compared to an average annual growth rate of 1.7% in the EU. The programme contains three different scenarios for the macroeconomic and budgetary projections: an “optimistic” scenario, a “baseline” and a “pessimistic” scenario. The “baseline” scenario is considered as the reference scenario for assessing budgetary projections because, assessed against currently available information, it appears to be based on plausible growth assumptions, tilted to favourable in the outer year. It envisages that real GDP growth will slightly decrease from 4.8% in 2005 to 4.3% on average over

[4] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, 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 rest of the programme period. Due to possible overestimation of potential growth, cyclical conditions are likely to be more favourable than implied by the programme's projections. The programme's projections for inflation appear to be on the low side.

(3) On 5 July 2004, the Council decided that the Czech Republic was in excessive deficit. According to the Council recommendation under Article 104(7) of 5 July 2004, the excessive deficit has to be corrected by 2008. In its opinion of 18 January 2005 on the previous update of the Czech Republic's convergence programme covering the period 2004-2007, the Council recommended the Czech Republic "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 was 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".

(4) The general government deficit for 2005 is estimated at 3.2% of GDP, based on the Commission services' autumn 2005 forecasts, against a targeted deficit of 4.7% of GDP in the previous update. The deficit outcome is expected to be influenced mainly by the budgetary performance of the central government, in particular of the state budget, which recorded higher-than-planned tax revenues and an under-execution of expenditures of about 1.5% of GDP.

(5) This update aims at reducing the general government deficit to below the 3% of GDP reference value in 2008, in line with the Council recommendation under Article 104(7). In particular, it projects the deficit to be cut by over 2 percentage points of GDP between 2005 and 2008 and the primary deficit by 2.3 percentage points. However, excluding the impact of two one-off expenditures in 2005, the improvement in the nominal deficit over the period is only 1 percentage point of GDP. The deficit reduction mainly reflects a cut in the expenditure ratio (by 2.3 percentage points of GDP) over the programme period, while revenues are broadly unchanged (-0.2 percentage point). Public consumption and social transfers are the expenditure items that are planned to decline most as a percent of GDP. Public investment is foreseen to rise strongly, from 5% of GDP in 2004 to over 6% of GDP in 2008, well above the EU average (2.5% of GDP in 2005). Compared with the previous programme, the November 2005 update broadly confirms the planned adjustment, although the underlying macroeconomic scenario is considerably stronger.

(6) Over the programme period, the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to improve by ½% of GDP. The programme sets the medium-term objective (MTO) for the budgetary position at a structural deficit of "around" 1% of GDP, which it does not aim to achieve within the programme period. As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1½% of GDP), its achievement should fulfil the aim of providing safety margin against the occurrence of an excessive deficit. The programme's MTO is at an appropriate level because it adequately reflects the debt ratio and average potential output growth in the long term.

(7) The risks to the budgetary projections in the programme appear broadly balanced. On the one hand, the track record of cautious budgetary planning indicates that outcomes could be better than targeted (as was the case in 2004 and is expected by the

Commission services also for 2005). The growth assumptions underlying the budgets have usually been realistic and the assumptions about tax elasticities cautious. Moreover, budgeted expenditures have not always been fully executed, mainly due to the possibility to carry over unspent funds from previous budgetary years. On the other hand, the programme refers to several (proposed) measures in the area of social spending which would increase expenditure under this heading rather than decrease it, as projected in the programme. Moreover, expenditure carryovers of more than 1% of GDP were accumulated in 2004 and Commission services expect their volume to further increase in 2005. If these sizeable carryovers were spent in addition to all budgeted expenditures – which cannot be excluded especially in the election year 2006 – budgetary outcomes could be worse than targeted, in particular in 2006. Furthermore, the growth assumption in the final year of the programme seems favourable.

(8) In view of this risk assessment, the budgetary stance in the programme seems consistent with a correction of the excessive deficit by 2008 as recommended by the Council, which is the end-year of the programme. However, the envisaged adjustment path in structural terms could be strengthened, especially when the possibility of a much better outcome in 2005 and the upward revision of growth prospects are taken into account.

(9) The debt ratio is estimated to have reached 37.4% of GDP in 2005, well below the 60% of GDP Treaty reference value. The programme projects the debt ratio to increase by ½ percentage point over the programme period.

(10) With regard to the sustainability of public finances, the Czech Republic appears to be at high risk on grounds of the projected budgetary costs of ageing populations. While the debt ratio is currently relatively low in an EU perspective, the high deficit contributes to a rising debt ratio in the long-term projections until 2050, which increases the risk to debt sustainability. At the same time, the projected high increases of pension expenditure over the projection period are expected to put a significant burden on the public finances. A rigorous implementation of the planned consolidation of public finances over the medium term and a further strengthening of the budgetary position together with additional structural reforms to contain the increase in age-related expenditures, in particular on pensions and health care, appear to be of key importance in order to mitigate the risks to public finance sustainability[5].

(11) The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, the programme foresees the correction of the excessive deficit in line with the Council's recommendations. It also presents measures to promote a growth- and employment-oriented allocation of resources, in particular by decreasing the weight of the public sector in the economy and by shifting the tax burden from direct to indirect taxation. However, while the government is aware of the problem of the long-term sustainability, the programme does not present concrete steps to address it.

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5 Details on long-term sustainability are provided in the technical assessment of the programme by the Commission services, to be published at the website:http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

(12) The National Reform Programme of the Czech Republic, submitted on 14 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies long-term sustainability as the main challenge with implications for public finances. The budgetary implications of the limited number of concrete reform measures specified in the National Reform Programme are reflected in the budgetary projections of the convergence programme. The measures in the area of public finances envisaged in the convergence programme are in line with the actions foreseen in the National Reform Programme. In particular, the convergence programme outlines measures to support jobs and growth by changes in the revenue and expenditure structure (especially a shift of the tax burden from direct to indirect taxation and a cut in government consumption and transfers) and by making public investment a spending priority, but it does not present any concrete reform steps to address the problem of long-term sustainability. The programme further envisages a strengthening of the role of the medium-term expenditure ceilings by implementing the binding principles on the headings of the state budget and of the state funds and by inclusion of local governments in the budgetary planning process.

In view of the above assessment and in the light of the recommendations under Article 104(7), the Council is of the opinion that the Czech Republic should:

(i) strengthen the effort in the structural budgetary adjustment, in view of the small margin below the reference value targeted for 2008 (which is the deadline for the correction of the excessive deficit) and in order to fully take advantage of the upward revision of growth prospects compared to those underlying the Council recommendations;

(ii) enhance the quality of budgetary planning, in particular by analysing causes of significant expenditure carryovers and reinforcing the medium-term expenditure ceilings;

(iii) improve the long-term sustainability of the public finances, in particular by accelerating the pension reform and undertaking the reform of the healthcare system.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP (% change)	**CP Nov 2005**	**4.4**	**4.8**	**4.4**	**4.2**	**4.3**
	COM Nov 2005	4.4	4.8	4.4	4.3	n.a.
	CP Dec 2004	*3.8*	*3.6*	*3.7*	*3.8*	*n.a.*
HICP inflation (%)	**CP Nov 2005**	**2.6**	**1.5**	**2.2**	**2.0**	**2.1**
	COM Nov 2005	2.6	1.7	2.9	2.6	n.a.
	CP Dec 2004	*2.7*	*3.2*	*2.6*	*2.2*	*n.a.*
Output gap (% of potential GDP)	**CP Nov 2005**[1]	**-1.9**	**-0.8**	**-0.1**	**0.3**	**0.8**
	COM Nov 2005[5]	-1.4	-0.2	0.6	1.2	n.a.
	CP Dec 2004[1]	*-1.3*	*-0.9*	*-0.4*	*0.3*	*n.a.*
General government balance (% of GDP)	**CP Nov 2005**	**-3.0**	**-4.8**	**-3.8**	**-3.3**	**-2.7**
	COM Nov 2005	-3.0	-3.2	-3.7	-3.3	n.a.
	CP Dec 2004	*-5.2*	*-4.7*	*-3.8*	*-3.3*	*n.a.*
Primary balance (% of GDP)	**CP Nov 2005**	**-1.8**	**-3.5**	**-2.5**	**-2.0**	**-1.2**
	COM Nov 2005	-1.8	-1.9	-2.3	-1.9	n.a.
	CP Dec 2004	*-4.0*	*-3.4*	*-2.4*	*-1.7*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP Nov 2005**[1]	**-2.4**	**-4.5**	**-3.8**	**-3.4**	**-3.0**
	COM Nov 2005	-2.5	-3.1	-3.9	-3.8	n.a.
	CP Dec 2004[1]	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Structural balance[2] (% of GDP)	**CP Nov 2005**[3]	**-1.9**	**-3.4**	**-3.8**	**-3.4**	**-3.0**
	COM Nov 2005[4]	-2.0	-2.0	-3.9	-3.8	n.a.
	CP Dec 2004	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**CP Nov 2005**	**36.8**	**37.4**	**37.1**	**37.9**	**37.8**
	COM Nov 2005	36.8	36.2	36.6	36.9	n.a.
	CP Dec 2004	*38.6*	*38.3*	*39.2*	*40.0*	*n.a.*

Notes:
[1] Commission services calculations on the basis of the information in the programme.
[2] Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.
[3] One-off and other temporary measures taken from the fiscal notification (0.5% in 2004) and from the programme (1.1% in 2005); both deficit-increasing.
[4] One-off and other temporary measures taken from the Commission services' autumn 2005 forecast (0.5% of GDP in 2004, 1.1% in 2005; both deficit-increasing).
[5] Based on estimated potential growth of 3.5%, 3.5%, 3.6% and 3.7% respectively in the period 2004-2007.

Source:
Convergence programme (CP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations.