COUNCIL OPINION

of 10 March 2009

on the updated convergence programme of the Czech Republic, 2008-2011

(2009/C 62/02)

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 ([1]), 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 10 March 2009, the Council examined the updated convergence programme of the Czech Republic, which covers the period 2008 to 2011. The Council notes that the programme submitted in November 2008, including the addendum forwarded in December 2008 appear to be too optimistic in light of the unfavourable macro-economic developments. It also notes that a second package of stimulus measures have been announced on 16 February 2009, which is not covered by this assessment.

(2) Following three years of rapid expansion, growth in the Czech economy moderated in 2008 and is set to slow further in 2009. Weakening external demand resulting from the global financial and economic crisis will act as a significant drag on export growth for the highly open Czech economy. In addition, domestic demand, particularly investment, is softening on the back of falling foreign direct investment, tight credit conditions and a decline in business and consumer sentiment. In response to the slowdown, the government introduced a fiscal stimulus package in the 2009 budget including a range of revenue and expenditure measures. These are geared towards promoting domestic demand and providing support to enterprises through the downturn. From 2010 on, the economy should gradually recover in line with the expected improvement in the external environment. However, growth is not likely to return to the high rates before the crisis. This may have an adverse effect on government finances, which over recent years have benefited from buoyant revenue growth and which despite a relatively low government deficit and debt remain a concern in terms of risks to their long-term fiscal sustainability due to a rapidly ageing population. The Czech National Bank eased monetary policy in the second half of 2008 via successive interest rate reductions (from 3,75 % in July 2008 to 2,25 % in December 2008). The nominal effective exchange rate of the Czech koruna appreciated slightly (by 1,3 %) during 2008.

(3) The macro-economic scenario underlying the programme projects real GDP growth to fall from 4,4 % in 2008 to 3,7 % in 2009 before recovering to an average rate of 4,8 % over the rest of the programme period. Assessed against currently available information ([2]), this scenario appears to be based on markedly favourable growth assumptions in 2009 and 2010, and on favourable ones thereafter, while this has to be seen against the programme cut-off date of 1 October 2008 and the major economic developments that have followed since then.

In particular, in view of the rapid deterioration of the economic outlook for the Czech Republic's main trading partners in recent months, exports are expected to decline much more sharply and their recovery is likely to be more subdued than projected in the programme. Moreover, the swift turnaround of the economy is based on the assumption that potential growth will not be affected by the crisis which appears not very likely in view of the expected decline in investment growth, particularly also of foreign direct investment. The programme's projections for inflation appear realistic.

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

([2]) The assessment notably takes into account the Commission services' January 2009 forecast, but also other information that has become available since then.

(4) For 2008, the general government deficit is estimated at 1,2 % of GDP in the Commission services' January 2009 interim forecast, against a target of 2,9 % of GDP set in the previous update of the convergence programme. The much better than expected outcome is largely due to a better starting position from 2007 and the earlier reform package taken by the government. This was partly offset by less favourable developments in 2008. In particular, while expenditure growth was broadly in line with plan, revenue growth was slightly below target. The increase in the level of collected value added tax has been slightly less than expected due to a slowdown in consumer spending which offset the impact of the increase in the lower band of VAT implemented in 2008, while direct taxes have been more in line with government predictions as the labour market has remained stable.

(5) The target for the general government balance in 2009 is – 1,6 % of GDP, against a projection of – 2,5 % of GDP in the Commission services interim forecast. The estimated net effect on the budget balance of discretionary measures, adopted as part of the fiscal stimulus package and affecting the revenue and expenditure side in roughly equal share, is about 1 % of GDP. These measures are counterbalancing the originally restrictive stance of the convergence programme. In line with the Commission services' interim forecast, this implies a mild expansion of about 0,25 % of GDP. The impact of automatic stabilisers on the deterioration of the budget balance is estimated at around 0,5 % of GDP.

(6) The programme foresees the achievement of the MTO, a structural deficit of 1 % of GDP cyclically adjusted net of one-off and other temporary measures, by 2012 (i.e. not within the programme period). The headline and structural balance are both projected to improve after 2009, as a result of expenditure savings, in particular with respect to intermediate consumption and compensation of employees, projected to fall by more than 0,5 % of GDP per annum over the period 2009-2011.

(7) The budgetary outcomes are subject to downside risks. The macro-economic scenario which underpins the budgetary targets appears markedly favourable. An annual reduction by more than 0,5 percentage point of GDP in intermediate consumption and compensation of employees could entail risks for the overall quality of public services without significant efficiency-enhancing measures. The projected decline in expenditure on social payments does not seem to take into account the likely increase in unemployment benefits due to the expected worsening of the labour market. Furthermore, tax reductions in the fiscal stimulus package may not be offset by future savings. The expenditure targets in the programme are based on ceilings in the medium-term expenditure framework which in the past have been exceeded. Revenues may also be lower than predicted due to the slowdown, while the revenue assumptions in the programme appear to be on the cautious side.

(8) The long-term budgetary impact of ageing is above the EU average according to the projections made in 2005, which are based on the common methodology; the long-term sustainability of the Czech Republic is therefore assessed to be at high risk. Initial phases of pension and health care reforms have been introduced which will reduce expenditure. However, more needs to be done in both areas, taking into account the principles of equity accessibility and sustainability. While the budgetary position in 2008, as estimated in the programme, is markedly improved, it is largely due to a better starting position in 2007 rather than discretionary measures, and still compounds the impact of population ageing. Achieving primary surpluses over the medium term and implementing further structural measures aimed at curbing age-related expenditures would reduce the risks to the long-term sustainability of public finances.

(9) In 2004, the Czech Republic introduced a medium-term budgetary framework which sets annual targets for the State budget over three years. The targets are based on nominal expenditure ceilings and estimated revenue calculated on the basis of projected GDP growth. Since the start of the medium-term budgetary framework, the initial expenditure limits have been exceeded by raising expenditure on a discretionary basis and in the outturns. In 2006 and 2007, outturn expenditure exceeded the initial ceilings by on average 7 %. The Czech Republic is planning several changes aimed at improving budgetary management and enhancing tax collection. Output and target orientated budgeting has been introduced from January 2009. There will be increased integration and simplification of the tax system from January 2010 and there will be modernised administrative support to facilitate the work of the treasury department, for which tenders were launched in 2008. These measures will help to improve budgetary implementation while adhering to expenditure ceilings will depend on further discretion.

(10) In response to the financial crisis, the Czech Republic took a number of measures, including an increase in capital of the Czech Export Bank, the Export Guarantee and Insurance Corporation, the Czech-Moravian Guarantee and Development Bank, totalling CZK 2 billion. The bolstering of the capital of these institutions will help exporting firms, especially SMEs. In addition, the coverage of the deposit guarantee scheme was increased to EUR 50 000.

(11) In line with the EERP agreed in December by the European Council, the Czech Republic adopted a recovery plan consisting of stimulus measures. Within an overall mildly expansionary fiscal stance, these measures are an adequate response to the macro-budgetary situation given the concern for a broader consolidation effort in light of the risks to long-term sustainability from rapid ageing. The stimulus measures taken by the Czech authorities can be regarded as in line with the EERP in that they are timely and targeted.

The decrease of social insurance contributions paid by employees by 1,5 percentage points, which is, though, not easily reversible, will support households' disposable income. This measure will also have a structural impact on the labour market with respect to raising supply and placing downward pressure on gross wages. In addition, the decision to invest in construction and modernization of infrastructure within the State Fund for Transport Infrastructure is likely to help sustain employment and aggregate demand. These measures are related to the medium-term reform agenda and the country-specific recommendations proposed by the Commission on 28 January 2009 under the Lisbon Strategy for Growth and Jobs. In light of the worsened economic outlook, the government announced a second set of measures on 16 February 2009.

(12) The projected fiscal stance is mildly expansionary in 2009 according to the Commission services' January 2009 Interim Forecast, partly due to an exceptional increase granted for public sector wages. The structural balance improves after 2009 mainly thanks to expenditure restraint. The achievement of the fiscal targets may be difficult without further measures, given the programme's favourable macro-economic assumptions, and concrete actions to back-up the planned expenditure reductions.

(13) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data ([1]).

The overall conclusion is that government deficit in the Czech Republic over recent years has been relatively low, while the debt ratio has been below 30 % of GDP, thus clearly below the 60 % reference value. The mildly expansionary fiscal stance, including stimulus measures, appears appropriate in light of the economic downturn and in line with the EERP, however, will affect public finances. Moreover, there are risks attached to the budgetary projections, in particular in view of the favourable growth assumptions, the lack of concrete actions to support the planned expenditure reductions from 2009, and a track record of exceeding expenditure ceilings set in the medium-term budgetary framework. Due to a rapidly aging population, concerns remain regarding the long-term fiscal sustainability. Overall, these risks point to the need for medium-term fiscal consolidation and further efforts in structural reforms.

In view of the above, and also given the need to ensure sustainable convergence, the Czech Republic is invited to:

(i) implement the 2009 fiscal plans, including stimulus measures, in line with the EERP and within the framework of the SGP;

(ii) carry out significant structural consolidation in 2010 and beyond towards the MTO, and back-up the budgetary strategy with specific measures for reducing expenditure in 2010-2011;

(iii) continue with the necessary pension and health care reforms, given the projected increase in age-related expenditures, in order to improve the long-term sustainability of public finances.

([1]) In particular, the data on COFOG for 2011, liquid financial assets and net financial debt with respect to government debt, which have the effect of making the assessment objectively more difficult, are not provided.

Comparison of key macro-economic and budgetary projections

		2007	2008	2009	2010	2011
Real GDP (% change)	CP Nov 2008	6,6	4,4	3,7	4,4	5,2
	COM Jan 2009	6,0	4,2	1,7	2,3	n.a.
	CP Nov 2007	*5,9*	*5,0*	*5,1*	*5,3*	*n.a.*
HICP inflation (%)	CP Nov 2008	3,0	6,4	2,9	3,0	2,5
	COM Jan 2009	3,0	6,3	2,6	2,3	n.a.
	CP Nov 2007	*2,4*	*3,9*	*2,3*	*2,1*	*n.a.*
Output gap [1] (% of potential GDP)	CP Nov 2008	2,7	1,9	0,4	− 0,4	− 0,2
	COM Jan 2009 [2]	3,7	3,4	0,7	− 1,1	n.a.
	CP Nov 2007	*1,8*	*1,4*	*0,7*	*0,5*	*n.a.*
Net lending/borrowing *vis-à-vis* the rest of the world (% of GDP)	CP Nov 2008	− 0,8	− 1,0	− 0,5	0,4	1,2
	COM Jan 2009	− 0,8	− 0,3	− 0,8	− 1,1	n.a.
	CP Nov 2007	*− 2,4*	*− 1,6*	*− 0,4*	*1,5*	*n.a.*
General government revenue (% of GDP)	CP Nov 2008	41,7	41,0	40,6	39,6	39,0
	COM Jan 2009	41,6	40,7	40,7	41,1	n.a.
	CP Nov 2007	*39,8*	*39,5*	*38,1*	*37,1*	*n.a.*
General government expenditure (% of GDP)	CP Nov 2008	42,6	42,2	42,2	41,1	40,2
	COM Jan 2009	42,6	42,0	43,2	43,4	n.a.
	CP Nov 2007	*43,3*	*42,4*	*40,7*	*39,4*	*n.a.*
General government balance (% of GDP)	CP Nov 2008	− 1,0	− 1,2	− 1,6	− 1,5	− 1,2
	COM Jan 2009	− 1,0	− 1,2	− 2,5	− 2,3	n.a.
	CP Nov 2007	*− 3,4*	*− 2,9*	*− 2,6*	*− 2,3*	*n.a.*
Primary balance (% of GDP)	CP Nov 2008	0,2	0,0	− 0,3	− 0,4	− 0,1
	COM Jan 2009	0,2	0,0	− 1,3	− 1,1	n.a.
	CP Nov 2007	*− 2,3*	*− 1,7*	*− 1,3*	*− 1,1*	*n.a.*

		2007	2008	2009	2010	2011
Cyclically-adjusted balance (1) (% of GDP)	CP Nov 2008	− 2,0	− 2,0	− 1,7	− 1,4	− 1,1
	COM Jan 2009	− 2,3	− 2,4	− 2,8	− 1,9	n.a.
	CP Nov 2007	*− 4,1*	*− 3,4*	*− 2,8*	*− 2,5*	*n.a.*
Structural balance (3) (% of GDP)	CP Nov 2008	− 1,7	− 1,9	− 1,7	− 1,3	− 1,1
	COM Jan 2009	− 2,1	− 2,4	− 2,8	− 1,9	n.a.
	CP Nov 2007	*− 4,1*	*− 3,4*	*− 2,8*	*− 2,5*	*n.a.*
Government gross debt (% of GDP)	CP Nov 2008	28,9	28,8	27,9	26,8	25,5
	COM Jan 2009	28,9	27,9	29,4	30,6	n.a.
	CP Nov 2007	*30,4*	*30,3*	*30,2*	*30,0*	*n.a.*

Notes:

(1) Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

(2) Based on estimated potential growth of 4,5 %, 4,5 %, 4,4 % and 4,2 % respectively in the period 2007-2010.

(3) Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0,1 % of GDP in 2008 according to the most recent programme, which were allocated to the normal spending categories on the basis that the components are recurring elements of government expenditure and of a small scale in the Commission services' January interim forecast.

Source:

Convergence programme (CP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations.