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CZECH ECONOMY IN THE BEGINNING OF 2007

Kamil Janáček, Eva Zamrazilová

1. ECONOMIC GROWTH

Quarterly figures on GDP in 2006 have indicated that the peak of the business cycle is over. In the third quarter of 2006, GDP increased by 5.8 %, y/y, after the revised growth of 6.4 % and 6.0 %, in Q1 and Q2, respectively. The cumulative growth for the first three quarters amounted to 6.1 %. Year 2006 witnessed the change in structure of economic growth: domestic demand became the main driving factor.

Fixed capital investments reported highest growth of all the demand items, increasing by 6.7 %, y/y, in Q1 – Q3 2006. The GDP growth was notably fuelled by the consumption of households, which kept the trajectory around 4 %, in the course of the whole year (the growth was exactly at 4 %, y/y, in Q1 –Q3). The only declining component of GDP was government consumption, which registered decrease of 0.7 %, y/y.

Foreign trade did not keep the role of the leader (exports rose by 13.5 %, y/y, imports grew by 12.6 %, y/y) due to two reasons. Firstly the trade balance in current prices did not continue in strong improvement observed in 2005, and secondly, the terms of trade registered an upturn from decline to growth in Q3 2006.

Although the Q3 figure was somewhat below the results of previous quarters, it is still very solid growth in the European context – it is roughly double than the growth in EU 25 (2.9 %, y/y) and eurozone (2.7 %, y/y). Therefore, the process of real convergence towards the most developed market economies proceeds at a satisfactory pace.

The biggest contributor to GDP growth in the Q1 – Q3 was manufacturing with record-high growth of value added by almost 15 %. Out of services, trade reported most dynamic growth of 10.4 %, y/y, correspondingly to strong consumer demand. Financial services increased by 6.8 %, y/y.

Industrial output accelerated in the beginning of the year (14.8 %, y/y in Q1 2007), with a slowdown to around 8 % in the forthcoming quarters. The full year growth in industry amounted to 9.7 %, y/y. The fastest growing industries – cars (20.6 %, y/y), electrotechnics (16.3 %, y/y), rubber and plastics (14.6 %, y/y), general machinery (18 %, y/y) show similar features: high shares of direct export sales on total sales and high penetration of foreign controlled companies. In the case of car industry the share of export sales exceeds 70 %, in the case of electrotechnics and general machinery the respective share amounts to approximately two thirds.

Generally, the importance of direct export sales increases. At the same time, the share of foreign controlled companies on total sales has been increasing as well as the tendency of these companies to export. The share of export sales on total sales amounted to 48.5 %, in 2006. The share of foreign controlled companies on total sales amounted to 56.3 %, in December 2006 (up from 52.1 %, in December 2005), the share of exports on sales in the segment of foreign controlled companies further increased to 73.9 % (up from 71.1 %, in December 2005). Therefore, the companies under foreign control account for approximately 90 % of direct export sales, while their share on purely domestic sales is much lower – approximately one quarter.

Manufacturing keeps favourable proportion between growth of productivity and real wages. In 2006, the productivity increased by 9.2 %, y/y, real wage rose by 3.4 %, y/y. Due to this favourable discrepancy, the producers are still able to keep costs under control. The growth of employment in industry has been slowing down, in the second half of 2006. Manufacturing industries registered an increase in employment amounting to 1.5 %, in 2006.

Although the growth in construction accelerated in 2006, growth of output amounting 6.6 %, y/y (up from 4.2 %, in 2005), signs of saturation have been felt in the course of the whole year. Firstly, hiring of new employees almost stopped, secondly, growth of construction permits declined over the whole year. The only part of construction reporting growth of permits and continuous boom was housing construction. The figures on housing confirm large scope of projects under construction. The developers prefer starting rather than completing of new

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projects and they report insufficiency of special building capacities for finalizing works. In 2006, construction of 43.7 thousands dwellings was started, i.e. by 8.3 % more year-on-year, while 30.2 thousands flats were completed, which was by 8.1 % less than in 2005. There were 168.8 dwellings under construction, i.e. by 8.7 % more year-on-year.

The main factors behind growth of housing construction remain the same: booming mortgage market, growth of loans from construction savings (both supported by low interest rates), demographic factors, solid growth of real incomes and expected changes in the VAT rate for housing construction. Mortgage market has kept dynamic growth between 40 and 50 %, y/y, in 2006, with a slowdown observable in Q4 2006.

From the beginning of 2006, retail sales have been growing significantly over longer-term path, increasing by 6.4 %, y/y, in 2006. The shift to higher growth trajectory showed low volatility and has corresponded well with the acceleration of households' consumption. In 2006, retail sales rose by roughly the same pace like nominal incomes; this has been enabled by the fact that prices in retail sales stagnated year over year (price deflator was thus strongly below the overall CPI). In addition, retail sales were strongly supported by consumer credits.

The major drivers have been consumer goods and cars, increasing by 7.7 % and 7.1 %, y/y, respectively. Spending has been promoted by a shift towards more expensive goods with higher quality, because of increasing living standard. This has been very pronounced in the case of food sales; even though the growth of their sales (4.8 %, y/y) was under the overall growth, foods registered a notable change in trend up from previous long-term path around 3 %.

2. FOREIGN TRADE AND EXCHANGE RATE

In 2006, the exports increased by 14.6 %, y/y, the imports rose by 14.4 %, y/y. The trade surplus amounted to CZK 47.3 bill., which was an improvement of CZK 8.7 bill. in comparison with 2005. At the same time, this was the best result in the history of the Czech Republic. The dynamics of foreign trade strongly accelerated in 2006; at the same time, the average growth of imports was almost the same like the growth of exports due to two reasons. Firstly, strong domestic demand promoted the imports and secondly, high world fuel prices pushed up the growth of imports in current prices.

In 2006, machinery, fuels and chemistry continued to be the key items for the trade balance. Machinery produced a surplus of CZK 276.9 bill., which was an increase of CZK 64.6 bill. against 2005. Cars accounted for approximately two thirds of the machinery surplus (CZK 185.7 bill.). Fuels represented the highest burden for the trade balance, producing a deficit of CZK 138.9 bill, followed by chemistry (deficit of CZK 89.7 bill.). High world fuel prices hit strongly the trade balance in 2006 and deteriorated the developments of terms of trade.

The trade with EU 25 ended in a surplus of CZK 330.5 bill. (year over year improvement of CZK 58.5 bill.). The highest surpluses were generated in the trade with Germany (CZK 86.9 bill.) and Slovakia (CZK 70.3 bill.). The highest deficits were produced by China (CZK 118.8 bill.) and Russia (CZK 83.4 bill.). Both these countries registered deterioration of the trade balance. While the deficit with Russia increased only in a small extent (by CZK 12.4 bill.), the deterioration of deficit with China was significant (by CZK 31.9 bill.).

Czech currency continued in appreciation trend during the whole year 2006. The appreciation was interrupted for a short time in July 2006 (as a consequence of an unclear result of parliamentary elections); the appreciation however accelerated in November and December 2006. On average, CZK appreciated by 4.8 % against the EUR and by 5.6 % against the USD, yearly averages amounting to 28.3 CZK/EUR and 22.6 CZK /USD. Therefore, the unstable political situation after the elections did not affect the Czech currency at all.

After the two increases of basic interest rates in the third quarter of 2006, the CNB is keeping the repo rate at 2.5 %, the lowest rate among EU 25 and 100 basis points under the refi rate of ECB. Due to this reason, 3M PRIBOR was at the end of 2006 by more than 100 basis points under 3M EURIBOR. Due to low inflation and appreciating currency, CNB can keep the low level of rates also in the near future. At the same time, there seems to be a discrepancy between inflation developments on the one side and the inflation target (and the CNB inflation forecast) on the other one, which indicate relative prudency of Czech monetary policy

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and existing space for rates cuts. However, in the context of a small and open Czech economy the room for the rate cuts is very limited, if non-existent.

3. INFLATION

Year over year growth of CPI in the first three quarters was slightly below 3 % (i.e. the CNB inflation target) – merely two months (May and August 2006) witnessed inflation over 3 % - but only negligibly - at 3.1 %, y/y. Last quarter of 2006 dramatically changed the inflation picture. Along with the decline of oil prices, the competition on internal market kept the prices of goods at a low level. The year over year CPI was, at the end of 2006, at 1.7 %, y/y, visibly under the lower band of CNB inflation target (3 % with tolerable limits plus minus 1 %). CNB acknowledged (tacitly) the undershooting of the target and, at the end of January 2007, changed the inflation forecast for December 2007 from 3.2 – 4.6 % to 2.4 – 3.8 %.

After a very modest growth of PPI in Q1 2006, the PPI gradually rose quarter by quarter until the end of the year, the year on year PPI standing at 2.6 %, y/y, at the end of 2006. The average growth of PPI in 2006 amounted to 1.6 %, y/y, which was the lowest average growth within previous three years.

At the end of 2006, producer prices in manufacturing (2.1 %, y/y) were below the overall growth. Automotive industry registered decline of PPI (by 1.5 %, y/y), PPI of coke and refined oil products stagnated, food industry registered moderate growth of 0.5 %, y/y. On the other hand, PPI in metal industry rose by 5.3 %, y/y, driven by expensive metals. World prices of metals were by 42.9 % higher than a year before, in December 2006, while oil prices were by 8.1 % higher, y/y.

Strong competition and strong currency continue to be the main factors preventing producer cost inflationary pressures. The growth of PPI in CR was significantly below the EU 25 average (in November 2006, the EU 25 average stood at 3.7 %, y/y, the respective figure for CR was at 2 %, y/y).

4. UNEMPLOYMENT

At the end of 2006, the unemployment rate stood at 7.7 %, that is notably below the year-end 2005 figure (8.9 %). The year over year decline of the unemployment rate was thus double than in 2005. The number of unemployed (448.5 thousands) was by 62 thousands lower than in December 2005. The decline of unemployment has been driven by strong economic activity, which promoted new jobs. The growth of vacancies was rapid, during 2006. In December 2006, Labour Offices reported 93.4 thousand of vacancies, which was by 80 % more than a year before.

According to our analyses, the regions with

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The regions with above average stock of FDI dispose with above-average offer of vacancies. However, these regions do not have significantly lower unemployment rates. This reflects the fact that foreign investors often have not been able to find enough qualified and skilled domestic workers.

Table 1: Main Macroeconomic Indicators

		2002	2003	2004	2005	2006	10/06	11/06	12/06	2007F
GDP	%, y/y	1.9	3.6	4.2	6.1	5.8	–	–	–	4.8
Inflation	%, y/y	0.6	1.0	2.8	1.9	1.7	1.3	1.5	1.7	2.0
Inflation	%, m/m	–	–	–	–	–	-0.5	-0.1	0.2	–
Industrial prices	%, y/y	-0.7	0.9	7.7	-0.3	2.6	1.9	2.0	2.6	2.2
Industrial prices	%, m/m	–	–	–	–	–	0.0	-0.2	0.0	–
Unemployment rate*	%, eop.	9.8	10.3	9.5	8.9	7.7	7.4	7.3	7.7	7.0
Industrial production	%, real	1.9	5.5	9.6	6.7	9.7	12.6	7.6	3.0	8.5
Construction output	%, real	2.5	8.9	9.7	4.2	6.6	7.1	7.7	15.4	5.0
Retail sales	%, real	3.0	4.9	2.5	4.0	6.4	8.9	6.5	4.4	4.5
State budget	CZK bill.	-45.7	-109.1	-93.5	-56.4	-97.3	-12.7	-30.9	-97.3	-95
Trade balance	CZK bill.	-70.8	-69.8	-26.4	39.5	47.3	4.4	6.4	-3.2	60
FOREX reserves	USD bill.	23.7	27.0	28.4	29.5	31.3	30.8	31.6	31.3	32.5
PRIBOR 3M	% average	3.6	2.3	2.4	2.0	2.3	2.65	2.64	2.56	2.7
CZK/EUR	Average	30.81	31.84	31.9	29.78	28.34	28.29	28.03	27.78	27.5
CZK/USD	Average	32.74	26.32	25.7	23.95	22.61	22.43	21.75	21.02	21.5

Source: Czech National Bank, Czech Statistical Office, forecasts by Komercni banka

*Note: As of July 2004, the unemployment rate is published according to the new methodology

For 2007, we expect that GDP will grow around 5 %, i.e. at a slightly lower pace than in 2006. The main reason of this mild deceleration of growth is the expected slowdown of dynamics in core eurozone countries, especially in Germany.

The growth in industry will continue to be driven by the sector of foreign controlled companies, the penetration of which gradually increases. The main drivers should not witness any significant structural change. The main driving force will continue to be the automotive industry and electronics.

Even under the improving trade balance, the current account deficit will further increase up above 4 % of GDP due to continuous deterioration of the incomes balance. This is caused by increasing profitability of foreign controlled companies and their increasing number which has led to increasing transfers of profits abroad as well as reinvestments of profits.

above average stock of FDI dispose with above-average offer of vacancies. However, these regions do not have significantly lower unemployment rates. This reflects the fact that foreign investors often have not been able to find enough qualified and skilled domestic workers. Therefore, the decline of the unemployment has been driven by cyclical factors, structural problems of the labour market preserving.

This is confirmed also by the developments of long-term unemployment. While the overall unemployment developments have been favourable, the share of long-term unemployment continues in growth. In Q4 2006, the share of long – term unemployment rose to 54.5 %, up from 53.4 %, a year before. Low educated groups of unemployment are the main source of increasing long-term unemployment. The share of long-term unemployment in the group of people with basic education is around 70 %; in the group of people with unfinished secondary education, the share of long-term unemployment exceeds one half.

5. OUTLOOK

For 2007, we expect that GDP will grow around 5 %, i.e. at a slightly lower pace than in 2006. The main reason of this mild deceleration of growth is the expected slowdown of dynamics in core eurozone countries, especially in Germany. In addition, the growth of private consumption above 4 % is not sustainable in the long run; for 2007, we forecast the private consumption growth at 3.5 %. The same applies for fixed capital investments, the growth will moderate from roughly 7 % to approximately 5 %, in 2007. The impact of foreign trade will not depend only on the development of trade balance, but also on the developments of terms of trade, i.e. prices of exports and imports. We thus expect marginal impact of net exports to GDP growth.

The growth in industry will continue to be driven by the sector of foreign controlled companies, the penetration of which gradually increases. The main drivers should not witness any significant structural change. The main driving force will continue to be the automotive industry and electronics. The expected slowdown in Germany, mentioned above, will be seen in the industrial activity, causing most probably a very moderate slowdown to approximately 8 - 9 %, y/y. Therefore, also in 2007, industry will be the general leader of Czech economic growth.

The construction will also experience a slight deceleration of growth trend as indicated by the results of 2006. This will apply especially to the segment of infrastructure, the construction of which will continue, however, by a slightly lower pace than in 2006. Also new projects of foreign investors are expected (e.g. Hyundai) but not to the extent of previous years. On the other hand, 2007 will be another year of boom in housing construction before the expected VAT change. Therefore, the mortgage market will continue in rapid growth, but a slowdown in growth is expected, too. Given high volumes of mortgages granted in previous years, growth rates above 40 %, y/y, are not sustainable. Some slowdown to about 30 %, y/y, must be expected for 2007. To sum up, we expect the growth in construction to reach approximately 5 %, in 2007.

In 2007, the retail sales continue to be driven by industrial consumer goods and cars, with the increase of sales not as record-high as in 2006. Similar to the mortgages, the dynamics of consumer credits showed a slowdown in the second half of 2006. Therefore, we cannot await the growth of consumer credits growth over 30 %, y/y, but rather around 20 %, y/y, in 2007. At the same time, similarly to 2006, the retail sales will continue to be supported by stable dynamics of incomes and low inflationary environment. Positive impact of strong currency will preserve, as well, making the imported goods cheaper and very competitive. Generally, the full-year growth of retail sales will be around 4.5 %.

The exports will continue in solid growth, driven by the machinery exports, in particular by the automotive industry, computers and other machinery. At the same time, the exports will continue to be concentrated in the sector of foreign controlled companies. However, the improvement of the trade balance with machinery is expected to be slightly lower than in 2006, since the exports of the car industry is close to full capacity for the time being (before the new factory Hyundai is finished). The prices of fuels will not represent such a burden for the trade balance as it was the case in 2006 – oil shocks excluded. Therefore, the growth of imports will be slightly below the dynamics of exports. Under these circumstances, the full-year trade surplus will amount to approximately CZK 60 -70 bill.

Even under the improving trade balance, the current account deficit will further increase up above 4 % of GDP due to continuous deterioration of the incomes balance. This is caused by increasing profitability of foreign controlled companies and their increasing number which has led to increasing transfers of profits abroad as well as reinvestments of profits. Both these items represent expenditures of the incomes balance of the current account.

In January 2007, there was the biggest increase in regulated prices over the last six years – and this will affect the 2007 figures. On the other hand, one can await the decline of petrol prices. Part of cost inflationary pressures will be absorbed by strong competition; strong currency will have favourable effect, as well. For 2007, we expect end-of-year inflation at 2.0 %, and average inflation in the range 1.5 – 2 %.

As for PPI, two key factors will play major role in 2007: world prices of oil and metals. The outlook for world oil prices is more or less stabilised, while metal prices will continue in growth driven by strong global demand. Under the assumption that significant shocks on the oil market will not occur in 2007, the year over year PPI is expected between 2 and 2.5 %, in December 2007. Average PPI will therefore move in the interval of 1.5 – 2 %, y/y.

The CZK will keep the path of moderate appreciation during the whole year. The average appreciation of the Czech currency in 2007 will be around 3 % in respect with EUR and 4 % vis-à-vis USD. The average 2007 exchange rate is expected at 27.5 CZK/EUR and 21.5 CZK/USD.

CNB will keep 100 basis points differential between its repo rate and refi rate of European Central Bank. Having in mind the moderate inflation development and the strength of the Czech currency, CNB will not raise repo rate in the first half of 2007. For this reason, the 3M PRIBOR will continue to be almost 90 basis points below 3M EURIBOR.

In 2007, we expect the improvement on the labour market to continue, however, in a lower extent than in 2006. The decline of the unemployment has been mostly cyclical one and will probably encounter the structural barrier. Structural problems of the labour market – large scope of long-term unemployment, strong regional disparities and low flexibility of the labour market remain main challenges for the government policy.

In the course of the year, we expect regular seasonal developments. Spring months will register declining unemployment rate due to seasonal jobs in construction, agriculture and some services. The unemployment rate will decline to or slightly below 7 % in June 2007. Third quarter will register increase of the unemployment rate as a consequence of fresh school leavers entering the labour market, which will be only moderate this year due to demographic developments. Regular autumn decline will be replaced by seasonal December increase due to finishing seasonal jobs and term contracts. At the end of 2007, we expect the unemployment rate around 7 %.

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SLOVAK ECONOMY: STRONG GROWTH CONTINUES

Kamil Janáček

1. MACROECONOMIC PERFORMANCE

The Slovak economy continues in fast – spectacular in European context – growth. In 2006, Slovakia has again taken the first position among the four Central-European EU countries (ahead of Czech Republic, Hungary, and Poland). GDP growth achieved in 2006 will be around 8 %, which meant a substantial speed-up against 2005. Growth is driven by exports (which grew by almost 20 %) but also by strong household consumption (more than 6 % growth) and fixed capital investment (11 % growth).

Large current account deficit (7.5 % of GDP) does not create a big threat, being a logical consequence of massive foreign investment inflows. These are followed by imports of technology and materials, and sub-supplies for new capacities, especially in car production. Hence it may be expected that in future, after the new capacity has been fully put in use, growth of exports will help to cut the current account deficit, bringing it below the "magical limit" of 5% of GDP.

What are the factors behind such a dynamic growth of the Slovak economy in recent years?

First, opening of the economy to direct foreign investment brings results. "Greenfield" plants are beginning to produce – and export – at full capacity. Privatized firms have gone through the necessary restructuring, and are speeding up their production and exports. Public administration has been improved, tax system simplified, and, together with a friendly attitude of past governments toward foreign capital, this starts to bring visible effects.

Second, the reforms of public finance undertaken in 2001-2003 are only now starting to be "visible" – after some period ("implementation delay" in words of economic theory). The flat tax has really benefited the vast majority of Slovak households, which found a positive reflection in their consumption expenditures. Reduction of social benefits, together with stricter rules, forced the unemployed to seek new jobs fast, or to accept work in the framework of public projects. The result is that in Slovakia – where, for more than a decade, unemployment rates were between 14 % and 17 % - for the first time unemployment went below 10 % in the fourth quarter of 2006.

Third, in spite of the populist rhetoric before elections, the new central-left government of Prime Minister Fico has not changed anything substantial on the reforms introduced by the previous Dzurinda government. The entrepreneurial environment has not deteriorated, and Slovakia remains an attractive location for both foreign and domestic firms.

2. MONETARY POLICY

Slovak koruna is in the ERM II system since November 25, 2005, in accordance with the plan of the (previous) Slovak Government, and the National Bank of Slovakia, to introduce the euro in 2009. Central parity of

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Table 1: Main Macroeconomic Indicators, 2005-2007

	2005	2006F	2007F
GDP (growth in %, const.pr.)	6.0	8.2	7.5
Industrial Output (growth in %)	3.9	9.9	12.5
Inflation (average, in %)	2.7	4.5	2.5
Unemployment Rate (average)	11.6	10.4	9.5
Current Account (as % of GDP)	-7.8	-7.5	-4.0

Source: Slovak Statistical Office, forecasts by Komerční banka

Table 2: Main Financial Indicators, 2005-2007

	2005	2006	2007F
BRIBOR 3M (average)	3.0	4.3	5.1
SKK/EUR (average)	38.6	37.2	36.5
Public Budget Deficit (as % of GDP)	-2.9	-3.2e	-2.8
Public Debt (as % of GDP)	33.7	35.5e	35.0

Source: National Bank of Slovakia, Slovak Ministry of Finance, forecasts by Komerční banka

the Slovak koruna was set at 38.455 SKK/EUR, which means that the permitted exchange rate interval is from 44.22 SKK/EUR to 32.69 SKK/EUR.

During the whole second half of 2006 Slovak koruna was appreciating, with a speed-up in December 2006 when it appreciated by almost 10 % against the central parity. While the NBS Governor Šramko was denying any need for a central parity revaluation during autumn of 2006, at the end of the year he already admitted that revaluation is theoretically possible. Whether this "oral intervention" will have any lasting influence and stop the currency appreciation, is not sure.

One thing however is sure: a strong koruna has undeniable anti-inflation effects; so it can be expected that the NBS will not hurry with an increase of the repo rate from the present 4.75 % (if it undertakes an increase at all in the first half of the year). As different from 2006, in 2007 there will be no substantial increase of regulated prices, so that inflation may go under the 3 % level, ensuring the fulfilment of the Maastricht inflation criterion.

3. OUTLOOK

Strong GDP growth will continue in 2007. Achieving of full capacity in the Peugeot and KIA plants will foster the growth of industrial output, as well as exports (in spite of a growth slowdown in the Eurozone). Household demand and fixed capital investment will grow, too, though somewhat slower than in 2006.

After some hesitation, the Fico Government has declared to keep the goal of adopting the euro in 2009. For this goal, the year 2007, and the start of 2008, will be decisive. Slovakia can be expected to push the public finance deficit under 3 % in 2007 – faster growth will also mean higher public budget incomes. The level of public debt and the long-term interest rates represent no problems. Thus inflation is and will remain the only problematic Maastricht criterion.

The Maastricht criterion evaluates inflation as a moving average of the 12-month inflation rate, which is then compared with the average of three "best performers", i.e. three countries with lowest inflation among the – now 27 – EU members.[1] Inflation of the country in question may not exceed the average of the three best performers by more than 1.5 percentage points. Nevertheless, the strong Slovak koruna, and the outlook that energy prices will not increase (gas price has been cut by 4 %), give a chance that Slovakia can fulfil the inflation criterion at the start of 2008 (thus avoiding the fate of Lithuania).

To sum up, the probability of Slovakia entering the eurozone on January 1, 2009 is above 50 %, and if sudden external shocks are excluded, one can set it at 75 %.

[1] By "best performing", the ECB usually means the lowest inflation rate which is still positive.

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CZECH PUBLIC FINANCES: INTERNATIONAL COMPARISON

Eva Zamrazilová

Czech public finances represent the weakest point in the macroeconomic picture of the Czech Republic. There is a widespread consensus among the economists that a crucial reform of the Czech public finance is inevitable, however, its realization depends on the consensus among politicians, which had not been reached yet. Moreover, in the long –term perspective, the ageing population will lead to a much worse situation than is the present reality. The paper will focus on selected issues related to the public finances in the framework of the international comparison within the EU 25.

Table 1: Structure of Public Incomes in EU 25

		Public Incomes (% of GDP), 2005				
		Total	Indirect taxes	Direct taxes	Health and social contributions	Others
Belgium	BE	49.9	13.2	17.1	13.9	5.7
Germany	DE	43.5	11.8	10.2	16.7	4.8
Greece	EL	41.6	12.6	9.3	12.1	7.6
Spain	ES	39.4	12.1	10.9	12.2	4.2
France	FR	50.9	15.6	11.4	16.4	7.5
Ireland	IE	35.2	13.3	12.3	4.8	4.8
Italy	IT	44.0	14.2	13.3	12.6	3.9
Luxenbourg	LU	42.2	13.2	14.0	10.8	4.2
The Netherlands	NL	45.2	12.6	11.6	13.1	7.9
Austria	AT	48.3	14.4	12.9	14.6	6.4
Portugal	PT	41.7	15.1	8.7	11.3	6.6
Slovenia	SI	45.8	16.1	9.3	14.8	5.6
Finland	FI	52.6	13.9	17.5	12.1	9.1
Denmark	DK	57.4	17.7	30.5	2.1	7.1
Estonia	EE	35.5	13.2	7.1	10.4	4.8
Cyprus	CY	41.2	16.9	9.3	8.3	6.7
Latvia	LV	36.2	12.6	8.0	8.5	7.1
Lithuania	LT	33.0	11.2	9.1	8.3	4.4
Hungary	HU	42.1	15.5	9.0	12.3	5.3
Malta	MT	44.2	15.7	11.8	7.2	9.5
Poland	PL	40.9	13.6	7.0	13.7	6.6
Slovakia	SK	33.9	12.7	6.1	10.9	4.2
Sweden	SE	59.0	17.0	19.9	13.9	8.2
United Kingdom	UK	40.8	12.7	16.2	7.8	4.1
CR	CZ	40.4	11.6	9.3	15.1	4.4
EU-12		44.8	13.4	11.7	14.4	5.3
EU-25		45.1	13.5	12.8	13.0	5.8

Source: ECFIN

STRUCTURE OF PUBLIC INCOMES AND EXPENDITURES

Table 1 presents a more detailed structure of public incomes in the EU 25; the position of the Czech economy as for the individual important items show Figures 3 and 4.

It is obvious that the position of the Czech economy as for the share of public revenues on GDP (40.4 %) is below the average of eurozone and EU 25. The same applies for the tax quota; the Czech tax quota amounted to approximately 36 % in 2005, placing the CR to the eleventh position within the EU 25 and below the average for the eurozone and EU 25 (39 %). The tax quotas of major eurozone economies range from 40 – 50 %. The lowest tax quotas were registered in Lithuania, Latvia, Slovakia and Ireland. On the other hand, there are also countries with tax quota above 50 % of GDP - Denmark and Sweden. However, the less favourable part of the story is that the Czech tax quota has been steadily increasing during previous years (Figure 2).

Another problem is that the Czech Republic has one of the lowest shares (32 %) of indirect taxation on overall taxation (and one of the highest shares of direct taxation, respectively) see Figure 3. At the same time, the share of indirect taxes does not increase in time. Accordingly, the share of indirect taxation on GDP in the Czech Republic (11.6 % in 2005) was the lowest

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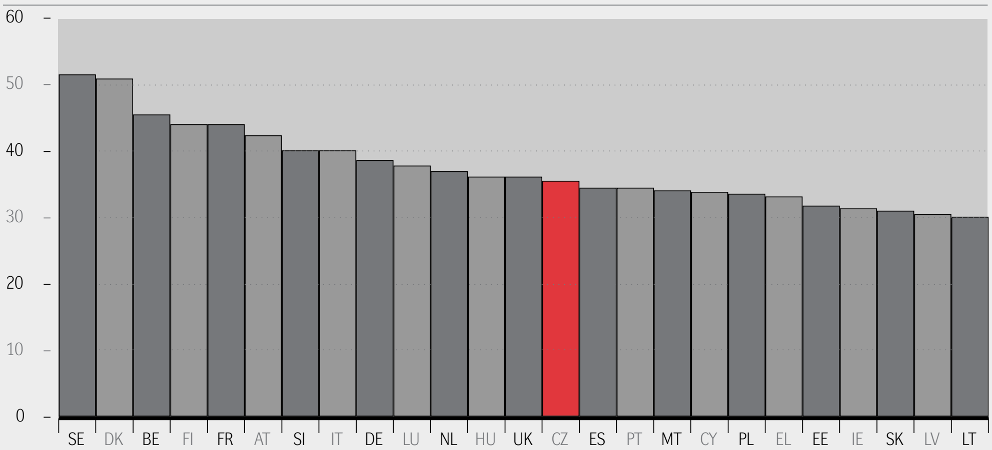
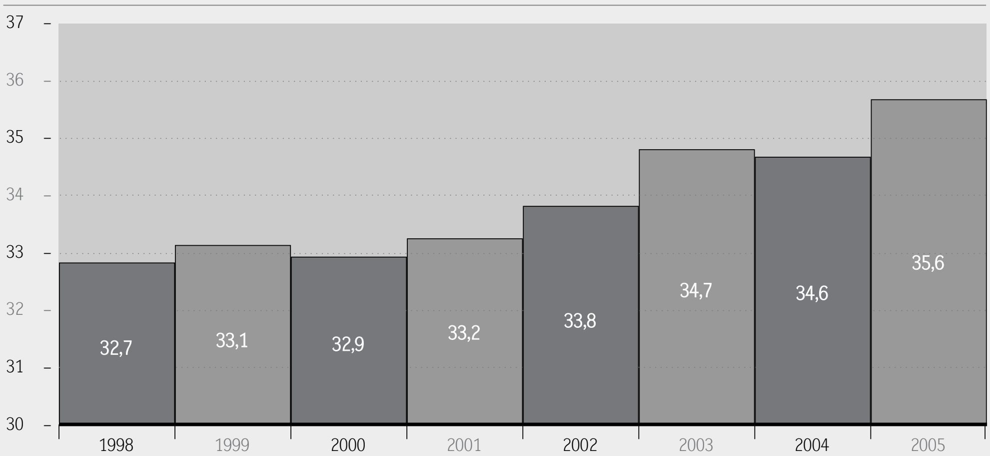
The Czech tax quota has been steadily increasing during previous years.

Figure 1: Tax Quotas in EU 25 (% of GDP, 2005)



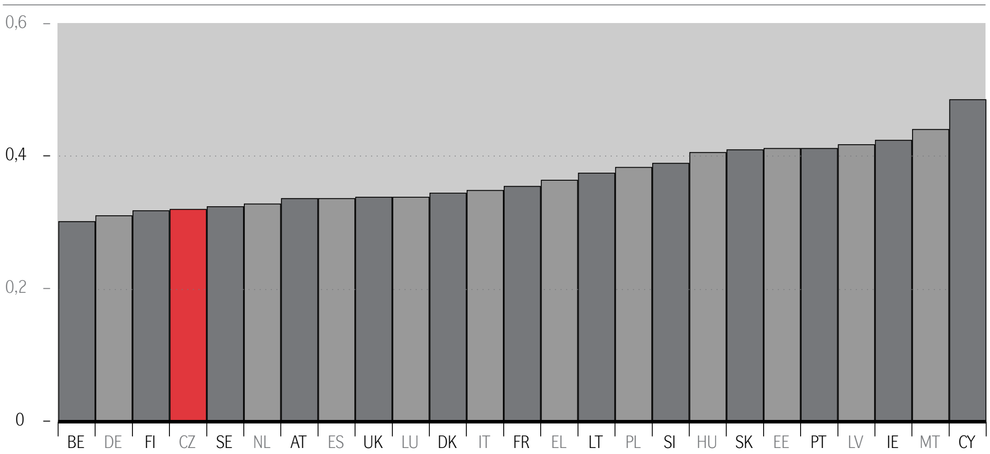
Source: ECFIN

Figure 2: Tax Quota in the CR (% of GDP, 1998–2005)



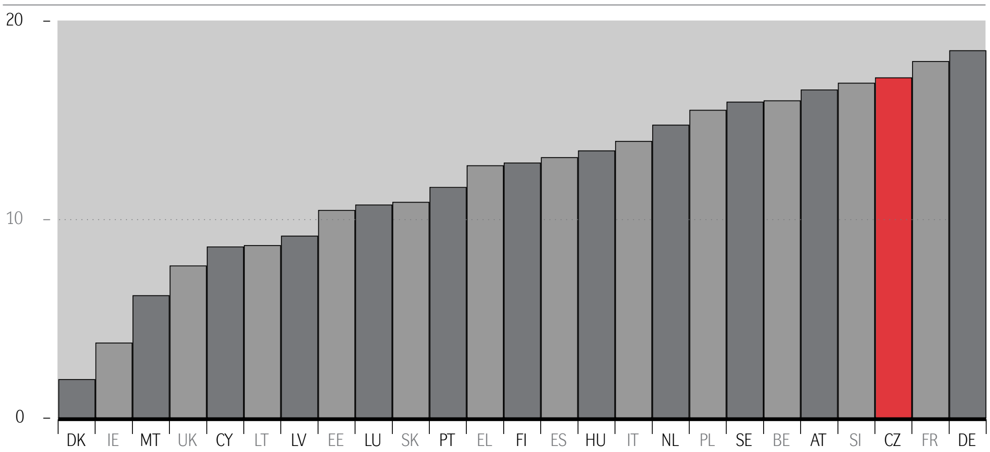
Source: Ministry of Finance

Figure 3: The Share of Indirect Taxation on Overall Taxation (in %, 2005)



Source: ECFIN

Figure 4: The Level of Health and Social Contributions (% of GDP, 2005)



Source: ECFIN

The Czech Republic has one of the lowest shares (32 %) of indirect taxation on overall taxation. The share of indirect taxation exceeds 40 % in countries with progressive tax systems. The share of indirect taxation on GDP in the Czech Republic (11.6 % in 2005) was the lowest among the EU 25 countries.

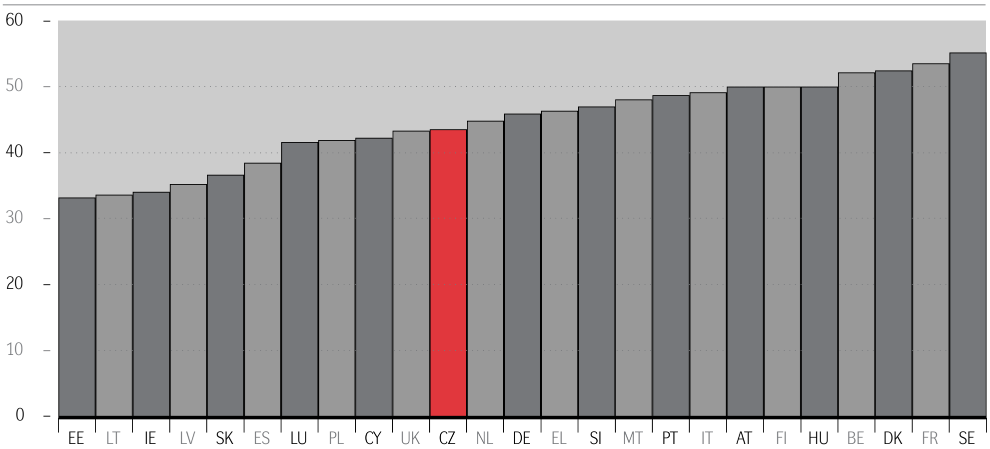
The major problem is the level of contributions to health and social care, which amounts to 15 % of GDP in the Czech Republic, i.e. third highest level (after Germany and France).

among the EU 25 countries (See Table 1). In majority of EU countries, the share of direct taxes has been declining; therefore, the tax burden has shifted to the indirect taxation. Along with the economic theory and empirical findings, the higher share of indirect taxation promotes economic activity and economic growth. The share of indirect taxation exceeds 40 % in countries with progressive tax systems.

Going into a more detail, the major disadvantage is not the share of direct taxes like personal income tax or corporate income tax – the share of these taxes on GDP amounts to 9.3 % of GDP, which is below the EU 25 average of 12.8 % (or eurozone average of 11.7 % of GDP). The major problem is the level of contributions to health and social care, which amounts to 15 % of GDP in the Czech Republic, i.e. third highest level (after Germany and France) – see Figure 4. The share of these contributions is very high also due to non-existence of the upper limits unlike in majority of developed countries.

Looking at the share of public expenditures on GDP, the position of the Czech Republic is not unfavourable, with 44 % of GDP. This is by 3 percentage lower level than the EU 25 average of 47 %. Anyway, this means that almost half of the GDP has been still distributed through the system of public finances. The countries with lowest shares of public expenditures on GDP (between 30 – 40 % of GDP) are the same countries with the lowest tax quotas,

Figure 5: Public Expenditures in EU 25 (in % of GDP)



Source: ECFIN

Table 2: Czech Republic and the Maastricht Criterion of Public Finances

	2002	2003	2004	2005	2006F	2007F
Government Deficit (% of GDP)	6.8	6.6	2.9	3.6	3.5	4.0
Government Debt (% of GDP)	28.5	30.1	30.7	30.4	30.6	31.7

Source: Czech National Bank

i.e. Estonia, Latvia, Lithuania, Ireland and Slovakia. At the same time, these are the countries with most progressive structure of public incomes as for the shares of direct and indirect taxation.

To sum up, the main problems of the Czech public finances are following: increasing tax quota combined with unfavorable structure of taxation, with relatively low share of indirect taxation and the excessive share and level of social contributions. At the same time, the shares of both public revenues and expenditures on GDP are not far enough from the most developed EU countries with high living standards. This is not appropriate to the economic level of the CR (approximately 75 % of the EU 25) and does not give a good background to the catching-up process.

CZECH REPUBLIC AND THE MAASTRICHT CRITERION OF PUBLIC FINANCES

The Maastricht criterion of sustainability of public finances consists of two parts: the criterion of general government deficit and the criterion of government debt. Both parts of this criterion must be in acceptable limits to fulfill the Maastricht public finances criterion. The first part of the criteria is the annual general government deficit (under the ESA 95 national accounts methodology) and the critical level is 3 % of GDP. This part of criterion is focused on sustainability of public finances in short and mid-term horizon. The second part of the Maastricht criterion of public finances is the level of government debt, with the limit of 60 % of GDP. This part of criterion monitors the sustainability of public finances from a longer-term perspective.

The Czech Republic's current public finance parameters prevent it from satisfying the government deficit criterion in sustainable manner and ensuring anti-cyclical fiscal policy. Fiscal developments confirm that the transitory decline of the deficit to just below 3 % of GDP in 2004 was due to extraordinary factors and was not sustainable in the following years. The state budget for 2007 confirms the deteriorating trend in public finances and hence the Czech Republic's failure to comply with the consolidation strategy that is pledged to implement on joining the EU. It also means a breach of its

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commitment to the EU to reduce its government deficit in a sustainable and credible manner below 3 % of GDP by 2008 (a commitment ensuing from the excessive deficit procedure).

Given its low initial level of government debt, the Czech Republic has no problem fulfilling the second part of the criteria, i.e. the criterion of public debt. The ratio of government debt to GDP was stabilized in the recent years. The annual government deficits were not accumulated in the public debt (see Table 2) because the nominal increase of GDP highly exceeded the interest rates appropriate for the public debt interests payments. However, this situation may change in the future and the dynamics of the public debt may accelerate if the nominal growth of GDP registers a slowdown. Moreover, not even a successful fiscal consolidation will be able to stabilize the government debt level in a sustainable manner if the fiscal system is not prepared for the expected effects of population ageing. This must be ensured by implementing fundamental reforms of the pension system and health care system, which will be discussed in a more detail in the concluding section.

Figures 6 and 7 show that the level of government deficit in 2005 was the fourth highest within the EU 25. On the other hand, the level of government debt was the eighth lowest one.

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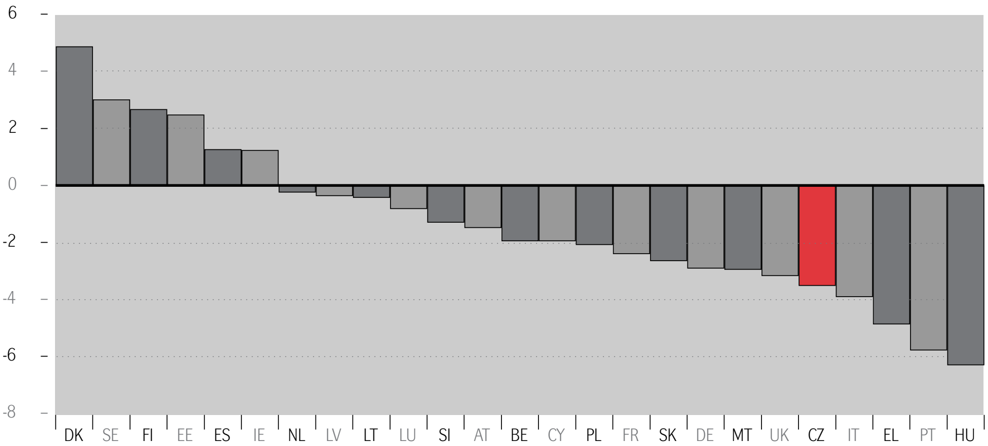
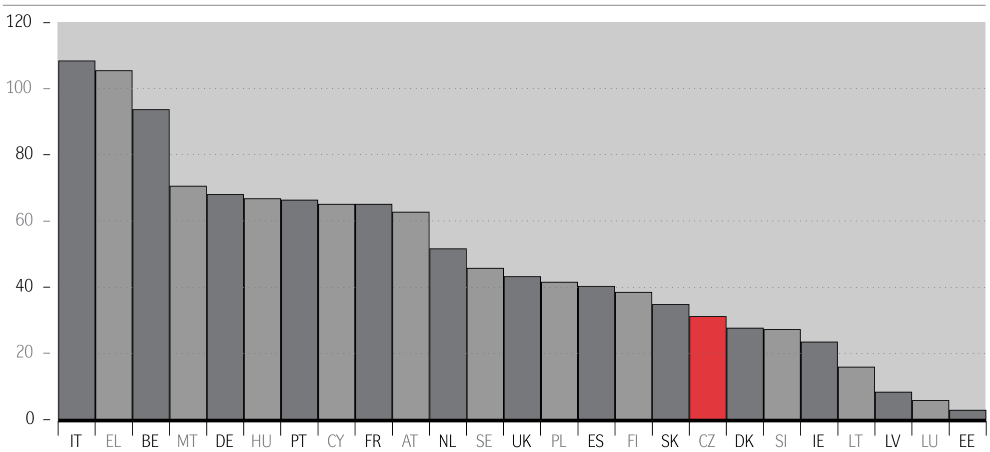
Figure 6: General Government Deficit (in % of GDP, 2005)



Source: ECFIN

Figure 7: Government Debt (in % of GDP, 2005)



Source: ECFIN

Table 3: Czech Government Deficit – Cyclical and Structural Part

	1999	2000	2001	2002	2003	2004	2005	2006F	2007F
Government Deficit (% of GDP)	-3.7	-3.7	-5.7	-6.8	-6.6	-2.9	-3.6	-3.5	-3.6
Cyclical Part	-1.3	-0.6	-0.6	-1.1	-1.1	-1.1	-0.3	-0.1	0.5
Structural Part	-2.4	-3.1	-5.1	-5.7	-5.5	-1.8	-3.3	-3.6	-4.1

Source: ECFIN

THE CYCLICAL AND STRUCTURAL PART OF THE GOVERNMENT DEFICIT

After the eurozone entry, the fiscal policy will remain the most important part of macroeconomic policy and thus the stabilization function of the public finances will gain on importance. But, for the time being, the fiscal policy is a pro-cyclical one and cannot ensure the anti-cyclical stabilization effect. The government deficit increases even under strong economic growth observed during previous years. This can be explained by dividing the government deficit into two parts: cyclical and structural. This is rather a complicating task, presuming to estimate the potential output and the elasticities of the revenues and expenditures. The economy, with its real output at the level of potential output does not produce cyclical part of the deficit (or the budget saldo). The estimates of public institutions (Ministry of Finance, ECFIN) indicate that the Czech economy has been close to its potential. Table 3 presents the estimates of the structural and cyclical part of the Czech government deficit in recent years including forecasts for 2006 and 2007.

It is obvious that the cyclical part of the deficit in 2005 and 2006 is negligible and that the main part of the government deficit is created by structural factors. Structural character of the government deficit has been the reason behind high deficits in the period of rapid economic growth and it is also the reason for which the fiscal policy could not be able to stabilize the economy, if needed. The tendency to produce the deficit is build-in the scheme of revenues and expenditures of the public finance and has nothing to do with the business cycle. The reform of the public finances is therefore the biggest homework of the Czech economy before the eurozone entry, or better before the entry to ERM II.

A partial reform of public finances started in 2003, with the aim to press down the government deficit below 3 % in 2008. However, the reform was breached on the expenditure side, due to social expenditures that were approved before the elections in 2006 (across the political spectrum). These expenditures are estimated at CZK 50 bill. in 2007. Nevertheless, this reform was not the real fundamental reform of the architecture of public finances. This partial reform did not include the necessary pensionary reform, nor the reform of the health care system. These areas will gain on importance in the future due to continuous ageing of the Czech population.

AGEING OF POPULATION AND THE SUSTAINABILITY OF PUBLIC FINANCES

The long-term budgetary projection of the CR based on the demographic forecast is one of the worst in the whole Europe. Ageing of population leads to the slowdown of economic growth on the one hand and to the increase of the ageing-related expenditures on the other one. According to the estimates of the ECFIN, the Czech economy is projected to experience a slowdown of economic growth over the coming decades, from 3.5 % until 2010 to 2.6 % in 2011 – 2030 and a further decline to 0.8 % in 2031 – 2050, influenced by an ageing population and an assumed slowdown in the productivity growth. The projected increase in age-related spending in the CR (7.2 % of GDP between 2004 – 2050) is strongly above the EU average. Most of the expected increase during this period will be due to the rise in pension expenditures. Similar conclusions were outlined by the Czech Ministry of Finance (see Table 4). It is obvious that the age-related expenditures would account for bigger and bigger part of GDP if the reform had not been realized.

The government deficit increases even under strong economic growth observed during previous years.

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The long-term budgetary projection of the CR based on the demographic forecast is one of the worst in the whole Europe.

Table 4: Long-term Budgetary Projection (% of GDP)

	2005	2010	2020	2030	2040	2050
Total Expenditures	**44.0**	**42.5**	**43.3**	**46.2**	**52.0**	**59.2**
Age-related Expenditures	19.9	18.5	18.9	20.9	24.5	27.7
Pensions	*8.4*	*7.7*	*8.3*	*9.5*	*12.1*	*14.2*
Health Care	*6.5*	*6.4*	*6.7*	*7.3*	*8.1*	*8.9*
Long-term care	*0.3*	*0.3*	*0.3*	*0.4*	*0.5*	*0.6*
Education	*3.6*	*3.1*	*2.7*	*2.8*	*2.9*	*3.0*
Others	*1.1*	*1.0*	*0.9*	*0.9*	*0.9*	*1.0*

Source: Ministry of Finance

Table 5: Long-term Sustainability of Public Finances

High risk:	Czech Republic, Greece, Cyprus, Hungary, Portugal, Slovenia
Middle risk:	Belgium, Germany, Spain, France, Ireland, Italy, Luxenbourg, Malta, Slovakia, United Kingdom
Low risk:	Denmark, Estonia, Latvia, The Netherlands, Austria, Poland, Sweden, Finland

Source: ECFIN

The initial budgetary position constitutes a risk to sustainable public finances even before considering the long-term budgetary impact of ageing.

The economic prosperity of the individual countries will crucially depend on the preparation for the ageing of population. In this respect, the Czech Republic is assessed to be in the most risky group of countries within the EU 25.

The necessity of the public finances reform has not been driven only by the planned eurozone entry but rather by specific risky factors such as increasing tax quota under increasing government deficits, high tendency to structural deficit and the inevitable threat of ageing population.

The initial budgetary position constitutes a risk to sustainable public finances even before considering the long-term budgetary impact of ageing. Consolidating the public finances further than is currently planned together with the implementation of structural reforms would be key in view of reducing risks to the sustainability of the public finances in the long run. The economic prosperity of the individual countries will crucially depend on the preparation for the ageing of population. In this respect, the Czech Republic is assessed to be in the most risky group of countries within the EU 25, which is illustrated by Table 5 (based on the assessment of the ECFIN).

Therefore, the necessity of the public finances reform has not been driven only by the planned eurozone entry but rather by specific risky factors such as increasing tax quota under increasing government deficits, high tendency to structural deficit and the inevitable threat of ageing population. In this respect, the CR missed the opportunity to realize the unpopular steps without high social pressures during a relatively long period of solid economic growth in recent years.

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