

# Czech Republic Special

10 May 2006

## Elections on 2-3 June

### Election Schedule

2-3 June 2006	Chamber of Deputies of the Parliament
Oct-Nov 2006	Municipalities
Oct-Nov 2006	1/3 of seats in the Senate

Source: Raiffeisen RESEARCH

### Key political parties, figures, events

#### Leading figures in Czech politics

Function	Name	Party affiliation
President	Vaclav Klaus	ODS
Prime Minister	Jiri Paroubek	CSSD
Finance Minister	Bohuslav Sobotka	CSSD
CNB Governor	Zdenek Tuma	non-partisan
Speaker of the Chamber of Deputies	Lubomir Zaoralek	CSSD
Speaker of the Senate	Premysl Sobotka	ODS

#### Political parties

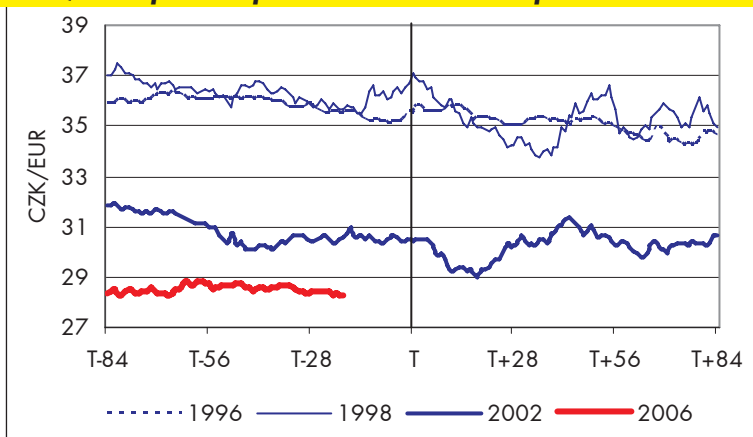
Name	Party leader	Political orientation
CSSD	Jiri Paroubek	socialist
ODS	Mirek Topolánek	nationalist/conservative
KDU-CSL	Miroslav Kalousek	christian democratic
SZ	Martin Bursik	green
KSCM	Vojtech Filip	communist

Source: Raiffeisen RESEARCH

### Highlights

- The ruling Social Democrats, who have led a government coalition with the Christian Democrats and the liberal US-DEU since the 2002 elections, managed to recover from a mid-term slump after a couple of changes at the Prime Minister's post, but are still trailing the national-conservative ODS party founded by current President Vaclav Klaus.
- Finding a stable majority in Czech parliament has been difficult due to the relatively strong position of the non-reformed Communists, a party that has so far been shunned by the other parties as a potential political partner. The rise of the Greens party, which overtook the Christian Democrats to take up the fourth place with a support of more than 10% in the latest polls, could add new options for potential coalitions.
- One of the key economic issues at stake is the eventual course towards the Euro. The Czech Republic could probably meet all criteria required for entering the Eurozone in 2010 - the official target of the country, but would have to enter the ERM II by mid 2007. However, an eventual ODS-led government would almost certainly mean a postponement of the Czech Republic's Eurozone entry.
- Regarding the development of the CZK there has been only a moderate weakening ahead of previous elections (see graph below) and hardly any weakening before the elections in 2002, while there was an appreciation trend in the first 28 days after all three previous elections.

### CZK/EUR pre- & post-election developments



Source: CNB, Raiffeisen RESEARCH

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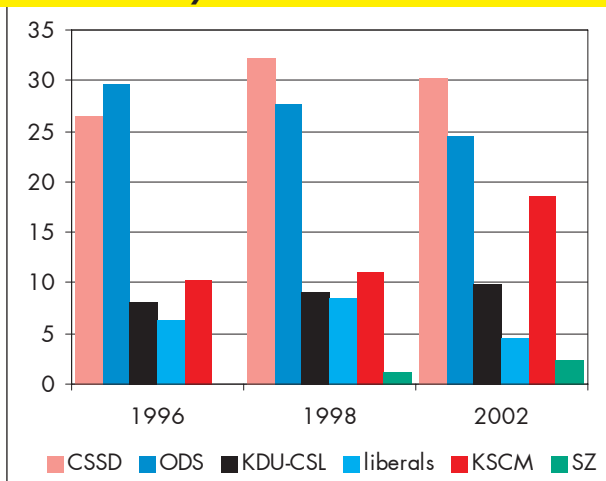


**Raiffeisen  
RESEARCH**  
RZB Group

## Current situation

The Czech Republic is a parliamentary republic with a two-chamber Parliament consisting of the Chamber of Deputies and the Senate. The Chamber of Deputies has a four-year electoral period and 200 seats. The electoral system is proportional with 5% entry threshold. The Chamber of Deputies gives and rejects confidence to the cabinet, and elects the President for a five-year tenure. The role of the President is mostly representative, but he or she also has some important executive powers including appointment of the Governor of the Czech National Bank (CNB) and members of the CNB Board. The Senate consists of 81 Senators elected in two-round majority elections for six years. Every two years one third of the Senate is elected. The senate does not control the cabinet and the state budget so its role in day-to-day political life is comparable to the Chamber of Deputies limited.

## Parliamentary elections 1996-2002



Note: Liberals - 1996 ODA, 1998 US, 2002 US-DEU; 2002 - electoral coalition of KDU-CSL and US-DEU, US-DEU and KDU-CSL votes recalculated according to mandates

Source: Czech Statistical Office, Raiffeisen RESEARCH

**Consolidation:** The political scene in the Czech Republic had over time been consolidating and the number of political parties in the Chamber of Deputies has fallen over the last 15 years. By 1998, the number of parties represented in the Chamber of Deputies fell to 5, and since 1996 two parties - ODS and CSSD - have played the dominant role. The smaller parties - liberal and/or Christian Democrats - often play the role of 'index hand', balancing the power dominance of the two strong players. Besides ODS, CSSD and the rather centrist smaller parties, a considerable role in the Chamber of Deputies is also played by the extrem-

ist parties - the Communists, and in the period 1992 -1998 also the extreme right Republicans. None of them is, however, an acceptable partner for the non-extremist parties for coalition agreements. A reduction in the number of parties elected to the Chamber of Deputies to 4 in the upcoming elections is not excluded.

## Political structure

	Number of parties	Mandates of ODS	Mandates of CSSD	Mandates of extremist parties*
1992	8	76	16	49
1996	6	68	61	40
1998	5	63	74	24
2002	5	58	70	41

\*Note: KSCM, republicans (in the Chamber of Deputies in 1992 and 1996)

Source: Raiffeisen RESEARCH

**Political structure:** Czech parliamentary political parties have a standard 'Western' ideological profile - there are the socialists, conservatives, liberals, Christian Democrats, communists, and environmentalists. Certain specific political groups of local flavor disappeared by 1996. The important fact is that, with the exception of the first democratic elections in 1990 that rather than standard elections had the nature of a referendum on communism, the main political parties have so far never got the support of more than one third of voters. Consequently, forming a coalition is the key point in post-election politics.

**Weak governments:** Since 1996, the Czech Republic has never had a strong majority government. The 1996 - 1998 ruling coalition led by ODS (with the Christian Democrats and liberals) was a minority one, dependent on the tolerance of the Social Democrats as the leading opposition party. The center-right coalition broke under the pressure of the 1997 monetary turbulence and subsequent recession, and the country had early elections in 1998. After these elections, a minority single-party Social Democrat government with tolerance of ODS as the opposition leader was formed. The outcome of the next elections in 2002 was a center-left coalition government of CSSD with Christian Democrats and liberals, with a narrow majority of one seat (101 seats out of 200). The cabinet had to act during the whole electoral period often effectively as a minority one because it could not rely in all cases on the votes of all of its deputies, and therefore the electoral period was marked by several government crises. Three cabinets with three Prime

Ministers changed during this electoral period. Nevertheless, the political fragility of the country is not excessive, at least compared to some notorious countries with almost permanent government shake-outs.

### Government coalitions

	Composition	Mandates (out of 200)
1992	ODS - KDU-CSL - liberals	105
1996	ODS - KDU-CSL - liberals	99
1998	CSSD	74
2002	CSSD - KDU-CSL - liberals	101

Source: Raiffeisen RESEARCH

**Consensus:** Finding consensus is hence a must in Czech policymaking. Particularly as regards fiscal and welfare reforms, broad public discourse and political negotiations across the whole Parliament are the prerequisites for arriving at a broadly acceptable decision. The content of reforms is in consequence full of compromise and as a rule rather solid and firm. That's why the Czechs prefer to practice gradual, incremental political and economic changes rather than some bold 'shock therapy'. And, last but not least, this is the reason why political changes as a rule do not have a strong and longer-lasting market influence.

## Political parties in the Czech Republic

**CSSD:** The Czech Social Democratic Party is the oldest Czech political party established in 1878. After the Communist coup in 1948 the CSSD was disbanded by the Communists but continued to work in exile. The party was restored inside the country in 1989. During the first half of the 1990-ies the CSSD strengthened and underwent a modernization process that gradually increased its credibility and popularity. In 1998 and 2002 the CSSD won the elections and formed the cabinets. In 2005 it however was heavily defeated in the European Parliament elections. Its track record in regional, local and Senate elections is also rather poor. CSSD has practiced policies of moderate modernization based on deregulation and privatisation, support of foreign direct investment and a gradual decrease of direct taxes compensated by an increase in indirect taxation with a stable overall tax burden at about 35 - 37% of GDP, gradual improvements in the fiscal balance, and a focus on maintaining a low level of poverty, low income dis-

parities and social cohesion. The CSSD is strongly pro-European and supports entry into the Eurozone in 2010. It has, similarly as with most European socialist parties, good relations with the trade unions, and its core electorate comes from lower income groups, voters with secondary school (rather than university) education, living outside most prosperous big cities, and rather but not exclusively the older generation. The CSSD however also struggles to attract middle-income liberal urban voters, similarly as with the ODS and the Greens.

The CSSD has always had different factions and a high degree of internal plurality. The permanent clashes between its leftist and liberal wings have had at times a detrimental effect on the party's credibility. The resolution of the party congress embargoes CSSD government coalitions with the Communists.

The election platform of the party basically promises to continue in the successful policies of 1998-2006. It offers moderate taxation reforms, pension reform based on notional defined contributions (NDC) pension system ("the Swedish model"), and a moderate increase in co-payments for healthcare combined with optional private co-insurance with a dominance of network of public hospitals as regards healthcare provision inspired by the model of Austria. CSSD strictly opposes the flat rate of taxation advocated by ODS and the ODS proposals of welfare reforms (flat welfare benefit, decrease of social insurance contributions by one quarter, flat pensions). Its recent populist proposal regarding increases of birth grants made during the electoral campaign is inconsistent with its electoral platform as well as with the current and future fiscal situation of the country.

**ODS,** the Civic Democratic Party, had been the ruling party in the Czech Republic between 1992 and 1998, and today is the major opposition party with an ambition to win the June parliamentary elections. The ODS dominates the Senate (Parliament's upper house), thirteen out of fourteen regional governments, most major cities, and its founder and long-term chairman Vaclav Klaus has been since 2003 the Czech President (with a rather representative capacity - the Czech Republic is a republic of the parliamentary type). ODS is a conservative party with a certain nationalist accent which in the European Parliament joins the British Conservatives in their parliamentary faction ("European Democrats"). ODS has published its electoral platform only in the beginning of May and its programme proposals in economic and social area are partway inconsistent (e.g. the concept of "flat pensions" versus the proposal of joint social security contributions of husbands or the concept of "flat



welfare benefit" versus the proposal of food stamps). More importantly, their proposals are also by no means consistent from fiscal point of view and would lead to huge fiscal deficits.

ODS is embedded particularly in the business environment and has strong ties with managerial circles. It has well-functioning local chapters and strong positions in boroughs. Its appeal is towards the younger generation, which in the 1990ies was strong but is today partly eroded, as well as its influence on liberal urban professionals. Its electorate is nevertheless typically rather affluent and better educated.

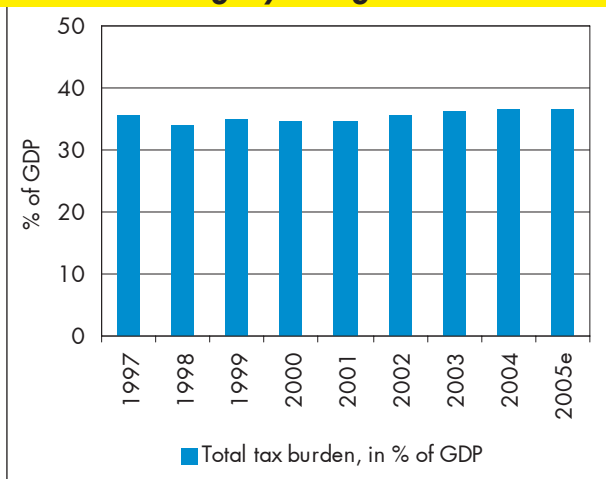
ODS' main electoral lure is its radical tax reform. It should consist of a Slovak-inspired 15% flat tax on corporate profit and personal income combined with a 15% single-rate VAT. The original ODS' proposal to cancel most existing welfare benefits and substitute them with a single, subsistence level defined "flat benefit" (of about EUR 170 per month for an adult) for which most citizens will be eligible is in the electoral platform markedly subdued, similarly as the planned degree of reduction of the social insurance contributions (they should have decrease by about 25% according to earlier ODS' statements) and the proposal of the "flat pensions". The pension reform should be according to ODS based on PAYG "flat pension" that will pose about 42% of average wage. ODS rejects the idea of the "second pillar" - according to the ODS' view saving should be private decision of each person and people should not be forced to it by the government and its mandatory pension savings programme. ODS however supports private pension savings, i.e. the "third pillar". The overall tax burden should decline according to ODS to about 30% of GDP (i.e. by some 7 percentage points).

The tax and welfare reforms are expected to significantly increase the fiscal deficit (the ODS however so far failed to deliver any quantification) which the ODS promises to curb down to balanced budget in seven years. This means that in case the reforms are accomplished the Czech Republic would not fulfil the 3% Maastricht threshold as regards fiscal deficit over GDP, and the ODS intentionally postpones a Eurozone entry to an unspecified future beyond 2010. The ODS is famous for its Euroskepticism and rejection of deepening of the EU. Also, the ODS plans to abandon the inward FDI supporting investment incentive scheme and replace the investment incentives by the generally improved business environment, and lowered taxation (the 15% corporate income tax and lower social insurance contributions).

**KDU-CSL** or Christian Democratic Union - Czechoslovak People's Party is another "historical" party originating in 1894 - 1896. During the Communist era the party cooperated with the Communists and was part of the Czechoslovak political establishment. In 1989 it had outcast its "collaborationist" past and reorganized itself again as a democratic party linked to conservatism and Christianity (namely Catholicism). The party is rooted in several rural Catholic regions (parts of Southern and Eastern Moravia, to lesser extent Eastern Bohemia) and its relevance in other regions of the country is limited, as well as its attractiveness for the non-religious urban majority of the Czech population. The mid-1990ies attempt of the party to modernize according to the model of the German CDU was not very successful and the party today again appeals overwhelmingly to its traditional (and ageing but very stable) rural electorate that constitutes some 5 - 6 % of the voters.

The party has participated in all Czechoslovak and Czech cabinets since 1918 except for the Social Democratic minority cabinet of 1998 - 2002, and is famous for its ability to compromise and simultaneously to gain maximum political profit from its role as the junior coalition member. It focuses on family values and on the development of the countryside. It is pro-European. Its electoral platform is a centrist platform based on moderate tax and welfare reforms. Namely, KDU-CSL wants to converge the basic and lowered VAT rate (to 18% and 9% from the contemporary 19% and 5%), and to cut the corporate profit tax to 19% (from contemporary 24%). As regards the pension scheme, KDU-CSL wants the "opt-out", i.e. to introduce the freedom to choose between the traditional PAYG system and the "second pillar", which KDU-CSL wants to establish, for up to about one third of the mandatory social security contributions (which should remain in total unchanged).

## Tax burden slightly rising



Source: Eurostat, 2005: estimate of Raiffeisen RESEARCH

**SZ:** The spring of 2006 saw an impressive rise of the non-parliamentary Green Party. The Greens are the rising stars of the electoral campaign as they are substituting the non-existent credible liberal party the liberal affluent urban voters are looking for. They however are not yet a well-constituted political party with a clear-cut profile and ideas but rather heterogeneous group of (often respected) individuals with strong but diverse views. Their electoral platform is however well done and consistent, with a focus on environmental tax reform. They are rather centrist, not leftist party, with strictly anticommunist background. In case that they qualify to the Chamber of Deputies internal clashes between their "Fundis" and "Realos" with limited predictability of their political behaviour can be expected, what decreases their value as a coalition partner. They oppose the ODS's flat tax reform plans as well as the CSSD's "social conservatism" as regards the traditional "corporatist" view of CSSD on the labour market that opposes its flexibility. The Greens advocate the "second pillar" - based pension reform (mandatory capital-based pension funds), similarly (but more radically) as the Christian Democrats and unlike the Social Democrats and ODS. They are also in favour of moderate increases in patient's co-payments in healthcare.

The Greens are pro-European and welcome deeper European integration. They strongly appeal to young voters to whom they are offering apart of the environmental values an extensive educational reform based on the idea of open and free university education without entry exams available for any applicant holding GCE. Of course, they advocate a broad fiscally neutral environmental tax reform (introduction of excise taxes for fuels, energy, and most waste-producing items). The overall tax burden should according to the Greens remain about constant at 35% of GDP.

**KSCM:** Unlike all other Central European countries, the Czechs do not have only an "authentic" Social Democracy with uninterrupted political and legal continuity from the times of the Hapsburg Empire, but also a strong "authentic" unreformed Communist party. The Communist Party of Bohemia and Moravia however an outlaw of the Czech parliament - is an unacceptable partner for any other major political party on the central government level as all other parliamentary parties perceive the Communists as an undemocratic political power (they however sometimes cooperate with them on the municipal level). The electoral base of the KSCM consists chiefly of elderly "Ostalgotists" and distressed low-educated protest voters. There is a growing demand in a part of CSSD to break the

non-cooperation rule as regards Communists and to form a CSSD - KSCM "leftist coalition", but the influential anticommunist wing in CSSD was so far always strong enough to prevent such political development. A CSSD-lead minority cabinet dependent on Communist support is however not a ruled out option.

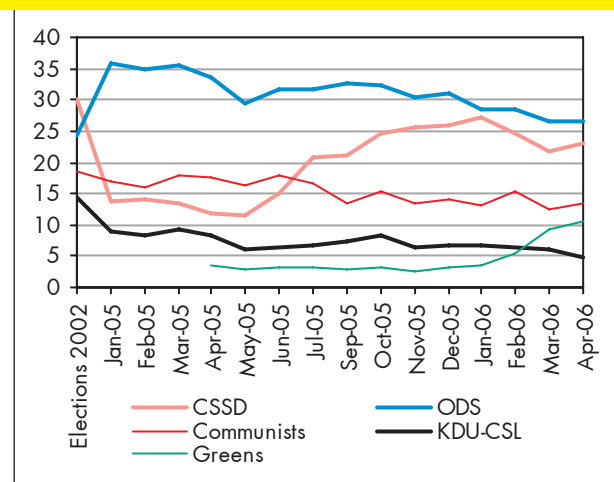
The economic part of the electoral platform of KSCM is socially conservative, based on parametric changes of the existing PAYG pension scheme and corporatist labour market protectionism. They are in favour of tax increases focusing on higher income and property groups, including introduction of property taxes and taxation of luxuries, in order to finance welfare benefits of all kinds that should generously grow. These radical ideas are on the Czech parliamentary scene isolated, even if the leftist wing in the Social Democratic party shares part of them (namely to increase the progression of the personal income tax, and to introduce moderate property taxes).

**US-DEU:** The Freedom Union - The Democratic Union, i.e. the liberal party that is the junior member of the existing CSSD-led government coalition, has according to all opinion polls no chance to reach the 5% threshold to qualify to the next Chamber of Deputies.

## What do the opinion polls say?

ODS has led the opinion polls for more than three years. In January the margin between CSSD and ODS narrowed to 1 p.p., but since then CSSD has been losing. In March, the difference had widened to 4.5 - 5 p.p. While the approval rates of the Communists and the Christian Democrats tend to be rather stable, a new phenomenon of the pre-election period is the rise of the Green Party.

### Polls - Greens on the rise



Note: In 2002 KDU-CSL and US-DEU formed an election coalition  
Source: Reuters, STEM

The Greens crossed the 5% margin in February and in March they reached a 10% approval rate. The skyrocketing rise of the Greens is, however, unstable according to political analysts and their qualification to the Chamber of Deputies is uncertain. The reason is that the Greens - unlike the Christian Democrats with their stable electoral core in some regions of the rural countryside - do not have a broader stable electoral base. Virtual opinion poll votes for them are typically virtual votes of so-called 'non-radical urban protest voters' - mainly from Prague - who in all previous elections supported the liberals. The rise of the Greens is seen as the result of the fact that there is currently no credible liberal alternative available on the Czech 'political market', and that the Greens are substituting for it. Their current supporters may, however, at the moment of the actual elections split between ODS and CSSD, and some of them may perhaps even turn to KDU-CSL.

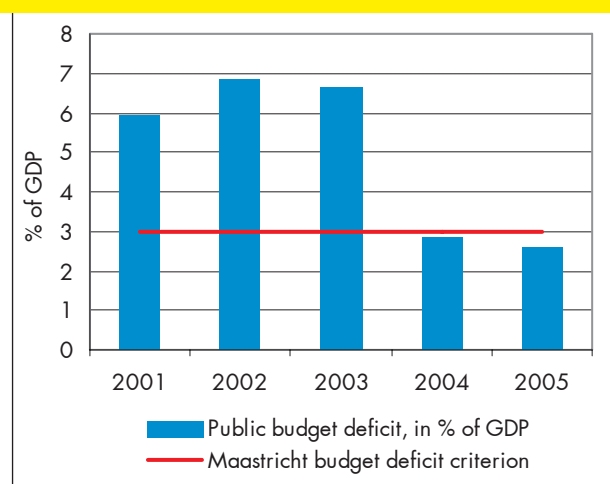
### Possible government coalitions and consequences for the markets

**ODS - KDU-CSL, or ODS - KDU-CSL - SZ:** The coalitions that may appear in the case of a strong ODS electoral victory, which would bring the combined CSSD and KSCM mandates below 50%. The first alternative would be put into life if the Greens do not qualify to the Chamber of Deputies while the second in case they do. A coalition with the Greens will be much more vulnerable than an ODS-led coalition without them due to the expected low consistency and predictability of the eventual parliamentary caucus of the Greens. Also, the party programmes and electoral platforms of ODS and KDU-CSL are significantly closer to each other than to the electoral platform of the Greens, and so the priorities of a coalition government which would include the Greens would have differ in several important points. Particularly the educational (namely university) reform will be hardly possible, because while the Greens prefer free university education for everyone (no entry exams and numerus clausus), ODS advocates university tuition fees and the implementation of a supportive financial infrastructure for students. On the other hand, a compromise in the tax and pension areas should be easily manageable - ODS may accept the idea of a "second pillar" while KDU-CSL and the Greens may accept the concept of a flat income tax (and ODS will swallow a moderate environmental tax reform).

An ODS victory and the formation of an ODS-led government is a welcome result according to the financial markets' perception. This however is

based rather on the right-wing ideological profile of ODS than on an assessment of the ODS policy plans. ODS wants to radically reduce overall taxation, but at the cost of increases in fiscal deficits significantly beyond 3% of GDP for several years and postponing Eurozone entry to beyond 2010. Also, ODS wants to disestablish or significantly downplay the investment incentives scheme that is beyond the performance of the Czech economy during this decade - its economic growth, improving trade balance, and a strong financial account surplus. The junior party(s) in the government coalition would definitely calm ODS' fiscal radicalism down, but the risk of deterioration of the Czech fiscal position due to ODS' radical fiscal plans is serious. We hence expect that the boost which may be given to CZK due to an eventual ODS electoral victory would be rather short-lived while the increases in fiscal deficits planned by ODS may have a longer-term adverse effect on CZK.

### Fiscal deficit below Maastricht threshold

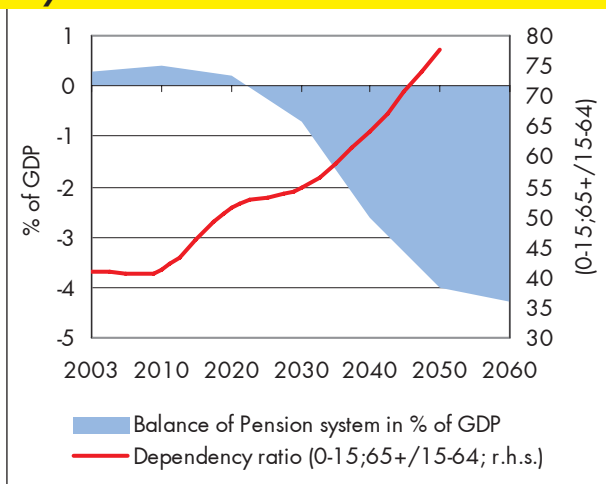


Source: Ministry of Finance

**CSSD:** A CSSD minority cabinet supported by KSCM is an option in case the combined mandates of CSSD and KSCM exceed 50% of the seats in the Chamber of Deputies. CSSD would, if this alternative comes true, try to maintain its policies of moderate reforms combined with macroeconomic stability and incremental fiscal improvements. The unknown variable of this coalition is naturally the behaviour of the Communists. They would certainly try to guarantee a left-leaning profile of the government, namely as regards further increases in welfare benefits and blocking pension and healthcare reforms. The risk of this option is that it will perhaps retain status quo as regards the short-term and medium-term priorities of the economic policy of the

current government, but the necessary long-term oriented reforms opposed by the Communists will not take place. And, of course, without deep pension reform, the Czech fiscal system is not sustainable in the long run, and serious problems could come soon after 2010. Apart from that, the political stability of such a Communist-backed CSSD minority government would be permanently exposed to difficult political challenges as KSCM would try to introduce the radical points of its social and economic agenda, which for CSSD are not acceptable. In case this option takes place, it will also be difficult for the government to gain international credibility - both on the part of foreign governments and on the part of international financial markets. A communist-backed minority Socialist government in a post-communist country would always be suspicious. CZK would react negatively to its appointment as well as - in the longer perspective - to its instability and political fragility. Its failure to bring necessary systemic reforms (namely the pension reform) could undermine the long-term fiscal sustainability and hence overall economic stability of the country, which would inevitably cause further negative economic consequences.

## Pension system is to fall into deep deficit beyond 2020

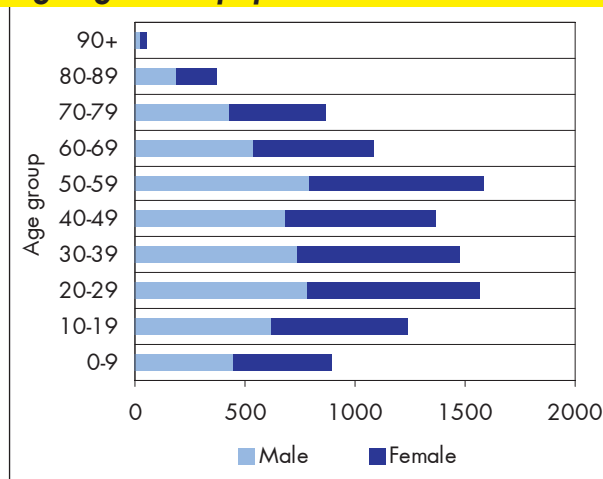


Source: Government commission for pension reform, Czech Statistical Office

**CSSD - KDU-CSL - SZ:** Probably the optimum solution from the point of view of fiscal stability and reform drive. This government would, we assume, maintain both reasonable short-term and medium-term fiscal deficits and provide systemic reforms as regards the pension system and healthcare. This option is, however, politically not very likely - not only would a significant increase in the political

attractiveness of CSSD against its current approval rates be necessary but the other problem is that KDU-CSL currently clearly prefers ODS to CSSD as a possible coalition partner. Similarly, a significant part of CSSD prefers a KSCM-backed minority cabinet to further cooperation with KDU-CSL, which is, after a four years of controversial experience, highly unpopular inside CSSD.

## Ageing Czech population



Source: Czech Statistical Office

**ODS - CSSD or CSSD - ODS:** A "grand coalition". Economically, this could be a good eventuality - as mentioned above, the upcoming 2006-2010 electoral period should be a period of pension reform (and some other important systemic reforms) and a joint effort of the two most important political parties, particularly provided that the cabinet is rather "technical", i.e. consisting of party-affiliated professionals rather than top party politicians, could be good for the credibility and political stability of the reform process. It could also bring stability and credibility to the external perception of Czech political and economic policy developments. However, neither ODS nor CSSD want to launch a "grand coalition". Both parties are afraid that such controversial alliance would put at risk their political credibility and they would consequently suffer in the next elections. Moreover, the two alternatives to the "grand coalition" differ politically - it is important who the senior coalition partner is and who the junior is. Also, from the point of view of the EU agenda, it would be very difficult for both ODS and CSSD to find a compromise between the Euro-scepticism of ODS and the pro-European stance of CSSD. Summed up, we can almost rule out the two "grand coalition" alternatives. They are seen by both ODS and CSSD as a last resort option.

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## Abbreviations

### Currencies and countries

BAM Bosnian Marka  
 BGN Bulgarian Lev  
 CSD Serbian Dinar  
 CZK Czech Koruna  
 EKK Estonian Kroon  
 HRK Croatian Kuna  
 HUF Hungarian Forint  
 LVL Latvian Lats  
 LTL Lithuanian Litas  
 PLN Polish Zloty  
 RON Romanian Leu  
 RUB Russian Rouble  
 SIT Slovenian Tolar  
 SKK Slovak Koruna  
 TRL Turkish Lira  
 UAH Ukrainian Hryvnia

CE Central European countries - Poland, Hungary, Czech Republic, Slovakia, Slovenia  
 SEE South East European countries - Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, Serbia  
 CIS European CIS (Commonwealth of Independent States) countries - Russia, Ukraine, Belarus  
 RTSI incl.: MTS, Vimpelcom and Golden Telecom  
 excl.: Bashneft, IRKUT, Lebedyansky, Nizhny Tagil Iron & Steel Pl, Novatek, Novolipetsk, Purneftegaz, Ritek, Seventh Continent, Severstal-Avto, Tatneft, Transneft Pref., Uralkaliy, Ufa Engine Plant, YUKOS

### Economic abbreviations

avg average  
 yoy year on year  
 LCY Local Currency  
 GDP Gross Domestic Product  
 C/A Current Account  
 T/B Trade Balance  
 FDI Foreign direct investments  
 CPI Consumer price index  
 PPI Producer price index  
 FX Foreign Exchange  
 ULC Unit Labour Costs  
 %chg Percentage change  
 (not in percentage points)

### Stock Exchange Indices

BET Romanian stock index  
 BUX Hungarian stock index  
 PX 50 Czech stock index  
 RTSI Russian stock index  
 WIG 20 Polish stock index

### Equity related

DY Dividend yield  
 EG Earnings growth  
 LTG Long term (earnings) growth  
 P/E Price earnings ratio

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