Czech Republic—2016 Article IV Consultation
Concluding Statement of the IMF Mission
Prague, May 16, 2016

Czech economic performance has been impressive, with output growing strongly and unemployment declining steadily. Growth is projected to slow this year, however, and to remain moderate over the medium term. The challenge for the authorities is to create conditions for a sustained increase in potential growth and to maintain macroeconomic stability. To this end, the mission recommends (i) anchoring fiscal policy in a medium-term framework enshrined in legislation that would ensure long-term fiscal sustainability and enhance policy predictability; (ii) maintaining accommodative monetary conditions while setting the stage for the eventual normalization of monetary policy; (iii) remaining vigilant toward financial sector risks; and (iv) improving the efficiency of EU fund utilization, increasing participation of certain segments of the labor force, and enhancing investment in human and physical capital.

Economic outlook and risks

1. **Following an impressive growth performance last year, output growth is expected to slow sharply in 2016.** Supportive macroeconomic policies, along with a favorable external environment and high EU fund utilization, contributed to a 4.2 percent expansion last year. Solid employment growth helped reduce the unemployment rate to below pre-crisis levels and contributed to a welcome pick up in real wage growth. However, output growth is projected to decline to 2.2 percent this year, owing to the slow start of investment projects financed from the next EU-fund cycle. Headline inflation is expected to reach the central bank's (CNB) 2 percent target next year, as base effects from lower import prices fade and domestic demand pressures pull inflation up.

2. **Risks to the outlook are broadly balanced.** Weaker-than-projected external demand, notably from the euro area but also from emerging markets, would weigh on exports. An escalation of the refugee crisis in Europe or a decision by UK voters to leave the EU could increase market uncertainty, and affect trade and economic activity. Moreover, global financial market turbulance could generate capital inflows that would contribute to appreciation pressures, while a prolonged period of low interest rates could—absent effective macro prudential measures—lead to overvaluation of asset prices that could threaten financial stability. On the upside, the positive effects from supportive macroeconomic policies, improved economic sentiment, and ECB's quantitative easing could be larger than currently forecast.

Fiscal policy

3. **The envisaged fiscal stance is appropriate.** Robust tax revenues and spending discipline helped narrow the headline fiscal deficit from 1.9 percent of GDP in 2014 to 0.4 percent last year. However, the main driver was a sizeable under-execution of

domestically-financed capital projects, as spending units focused on EU-funded projects. The envisaged 0.2 percentage point of GDP widening of both the headline and the structural fiscal deficits this year is appropriate, in light of the expected growth slowdown and with inflation well below target.

4. **The authorities should resist pressures to reduce taxes and increase current spending in the run-up to next year's elections.** Efforts to reduce tax avoidance, including through electronic VAT reporting and the envisaged rollout of online cash registers, are welcome. Although the unification of VAT rates for restaurants aims at simplifying tax administration, further shifting of items to lower rates should be avoided. On the expenditure side, although the mission understands the rationale for increasing public wages following their prolonged freeze after the 2008 crisis, increases beyond those already budgeted should be avoided. Moreover, the introduction of discretion in the automatic pension indexation mechanism could undermine the long-run sustainability of the system. The mission thus urges the authorities to refrain from pension adjustments beyond what is implied by the standard rule, and from putting an ex-ante limit on the maximum retirement age, which is being increased gradually but remains below the EU average.

5. **Fiscal policy should be anchored by a medium-term fiscal strategy enshrined in legislation.** With the structural deficit (at ½ percent of GDP) already below the 1 percent medium-term objective, there is space for maneuver and for increasing investment in much-needed public infrastructure to support faster medium-term potential growth. Nevertheless, the mission re-iterates its recommendation for speedy adoption of fiscal framework legislation to anchor fiscal policy, reduce pro-cyclicality, and enhance policy predictability.

6. **It is important to strengthen the capacity to absorb EU funds and improve the efficiency of their use.** The absorption rate was stepped up significantly in 2015, but despite better planning for the new program period, the start of projects is very slow partly due to the incompatibility of Environmental Impact Assessments of large infrastructure projects with revised EU standards. The mission urges the authorities to take all necessary measures to ensure compliance with EU requirements, with a view to launching those projects as soon as possible. Furthermore, there is a need to systematically follow up and correct the systemic shortcomings identified in the Supreme Audit Office's audits of utilization of EU Structural and Cohesion Funds.

Monetary policy

7. **With the balance of risks for inflation remaining on the downside, monetary policy should remain accommodative.** The exchange rate floor has so far been able to mitigate deflationary pressures. Core inflation remains stable at above 1 percent, one-year inflation expectations have moved closer to the target, while three-year inflation expectations remain well-anchored at 2 percent. Moreover, the positive dynamics of the real economy and labor markets suggest that a scenario involving damaging second-round effects of low inflation has become less likely. However, the positive price impetus from domestic demand

and the tight labor market continues to face anti-inflationary headwinds from declining import prices, thus requiring continued monetary accommodation.

8. **The CNB should continue to focus on inflation targeting and set the stage for monetary policy normalization.** The exchange rate floor was introduced as a temporary additional instrument in the inflation targeting regime. With inflation projected to start moving toward the target, the central bank should begin to prepare for the eventual exit from the floor. In the run-up to this point, and the return to a fully floating exchange rate, the CNB could employ other tools to counter an undesirable tightening of monetary conditions. To this end, the bank should be ready to use discretionary interventions to prevent excessive appreciation and to reduce interest rates to a negative level if needed to mitigate the pace of speculative capital inflows. The timing and extent of such measures would depend on developments in inflation, the size of capital inflows, and the magnitude of appreciation pressures. To mitigate the impact on the net margin of banks, negative deposit interest rates could be applied in tiers. Finally, clear communication about the CNB's focus on inflation targeting would be important for guiding expectations and reinforcing the credibility of the framework.

Financial stability

9. **The financial system is stable and resilient to shocks.** Czech banks are self-financed with a low system-wide loan-to-deposit ratio and strong liquidity buffers. The sector has a large capital buffer which should enable it to absorb adverse shocks under recessionary and deflationary scenarios. The Bank Recovery and Resolution Directive was transposed into local law, making the CNB a designated resolution authority. The new harmonized resolution framework should allow the authorities to resolve financial institutions without taxpayer exposure to loss from solvency support.

10. **Credit growth remains robust**. Credit standards were further eased last year on the back of easy monetary conditions, increasing competition among banks, and improving market sentiment. Mortgage rates are at historic lows and have boosted lending to a 10-year high, putting upward pressure on prices. Moreover, some deterioration in the affordability-of-housing indicators has taken place recently.

11. **Continued vigilance will be needed to prevent a buildup of vulnerabilities.** The mission welcomes CNB's recommendations to tighten mortgage lending standards, but for them to be effective, they need to become legally binding. To this end, it is important for the CNB to be able to issue binding macroprudential regulations. Going forward, continued vigilance will be needed and, if current trends in the mortgages segment continue in the coming months, the macroprudential stance should be further strengthened. This should be done with targeted measures, including raising risk weights on mortgages, lowering LTV limits with possible regional differentiation, and issuing clear guidance on maximum debt-to income limits.

Structural reforms

12. **Ambitious structural reforms remain essential for increasing potential growth.** Consideration should be given to measures to enhance investment in physical and human capital, and promote innovation.

- **Labor market.** Labor participation of the low-skilled remains low, the labor force is projected to decline, and skill shortages could become binding, thus making it difficult to attract more knowledge-intensive industries and raise productivity. To this end, improving (tertiary) education and vocational training is important; while consideration should be given to introducing a dual vocational education system and providing incentives to boost labor mobility.

- **Innovation**. The *National Research, Development and Innovation Policy for 2016-20* includes important measures to improve the coordination and prioritization of R&D spending, and cooperation between research centers and business. Steadfast implementation would help the Czech Republic move up the value chain.

- **Business environment.** Although the Czech Republic ranks highly overall in business climate indicators, it lags behind competitors in business regulation and quality of institutions. There is thus a need to improve the predictability of policy and regulation, reduce the administrative burden, and increase the efficiency of judicial procedures, including the framework for formation, restructuring and liquidation of firms.

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