Czech Republic: Concluding Statement of the 2015 Article IV Mission

May 20, 2015

The economy is gaining momentum on account of improving domestic demand and strong exports. Fiscal policy has been supportive of the recovery and the central bank's use of an exchange rate floor to achieve its inflation objective has helped stem deflationary pressures. But more is needed to sustain the recovery. A growth-friendly medium-term fiscal strategy, enshrined in legislation; structural reforms to encourage investment and enhance productivity; and continued efforts to preserve financial stability and achieve the central bank's inflation target are the top priorities.

Economic outlook and risks

1. **The Czech economy is growing strongly.** Both exports and domestic demand are performing well, and the recovery in domestic demand is broad-based. Employment continues to grow and unemployment to decline, reaching its lowest rate since the onset of the crisis and contributing to a welcome recovery in real wages. Output growth is projected to accelerate to 3 percent in 2015, mainly driven by domestic demand, and to stabilize at around 2¼ percent over the medium term. Inflation has been hovering just above zero, mainly on account of lower imported energy and food prices, and is expected to remain low this year, before rising gradually toward the central bank's 2 percent target in 2016.

2. **Risks to the outlook are broadly balanced.** On the upside, the positive effects from lower oil prices, supportive macroeconomic policies, the ongoing recovery in Czech Republic's trade partners, and ECB's quantitative easing could turn out to be larger than currently forecast. On the downside, if the euro area recovery were to falter the Czech economy would be negatively affected through the trade channel. The impact would be larger

still if low growth turned self-reinforcing through low investment. Moreover, an escalation of geopolitical tensions in the region or the reemergence of sovereign stress in Europe could affect exports and also create negative confidence effects.

Anchoring fiscal policy

3. **Fiscal policy has been supportive of the recovery.** Following substantial fiscal adjustment during 2011-13, the fiscal stance eased by about 1 percentage point of GDP last year. It is projected to loosen by a further ¼ percentage point this year especially on account of higher capital spending. This slightly expansionary policy stance is appropriate, given the remaining output gap, low inflation, and the fact that monetary policy is at the zero lower bound. However, should growth turn out to be faster than projected, the authorities should allow the automatic stabilizers to operate and use any higher-than-expected revenues to reduce the deficit. Likewise, should growth prove slower, the authorities should not tighten policy further but instead tolerate a higher deficit.

4. **The government's medium-term fiscal objective is appropriate, but needs to be supported by accompanying legislation.** The Convergence Program envisages gradual fiscal consolidation over 2016-18 aimed at reaching the medium-term objective of a 1 percent of GDP structural deficit. The mission welcomes the authorities' commitment to this objective, which will put the debt ratio on a gradual downward path while allowing adequate space for current fiscal policy priorities. Reaching the 1 percent of GDP objective would require only modest and very gradual fiscal consolidation over the next few years. However, the deficit objective should be incorporated in fiscal framework legislation and supported by expenditure ceilings to guide spending, a debt brake rule to gradually correct deficit overruns, and a Fiscal Council to promote transparency. Timely adoption of such legislation would help anchor fiscal policy and guard against pro-cyclical tendencies in policymaking.

5. **There is scope to improve the budget composition, with higher capital spending to address infrastructure needs offset by efficiency gains in current spending and improved revenue administration.** Although total government spending is somewhat below the advanced economy average, spending on social benefits is relatively high and has been rising. Expansion of means testing and adherence to the indexation rules for the adjustment of social benefits would help contain spending pressures. Moreover, by international standards, health spending is high relative to outcomes, suggesting room for efficiency gains. Conversely, sizeable transport infrastructure gaps push transportation costs above the OECD average, pointing to spending needs in this area. On the revenue side, the authorities' efforts to strengthen tax administration through the introduction of electronic VAT reporting and electronic cash registers are welcome, but budgeted revenue gains should remain conservative to avoid putting pressure on deficit outturns.

Achieving the inflation target

6. **Inflation will remain low this year, but gradually rise towards the central bank's (CNB) target in 2016.** The positive impulse from the exchange rate floor was counteracted by the slump in energy and other commodity prices, as well as by low core inflation throughout Europe. Nevertheless, domestic inflation adjusted for food, fuel, and indirect taxes remains stable at around ½ percent, wage agreements and inflation expectations do not show evidence of large second-round effects, and as base effects from the energy shock are dissipated and strong growth starts to boost wages, inflation is expected to start moving gradually towards the 2 percent target. These projections are conditioned on current policies, including the exchange rate floor, remaining in place through the middle of 2016, in line with official announcements.

7. **Supportive monetary conditions should be maintained until deflation risks recede and inflation expectations become entrenched around the inflation target.** Given the only gradual closing of the projected output gap and asymmetric risks at the zero lower bound, monetary policy would likely need to remain supportive for some time even after abolishment of the exchange rate floor. The mission assesses the current level of the exchange rate to be broadly in line with fundamentals, and there is little economic reason to expect large moves in the exchange rate after the exit. The pre-existence of a consistent monetary policy framework, and CNB's continued transparent communication strategy—appropriately emphasizing the priority of the inflation objective, and the temporary role of the exchange rate policy as an instrument to achieve it—should facilitate a smooth exit. Finally, the CNB has sufficient tools to counter any unintended tightening of monetary conditions.

Safeguarding financial stability

8. **The financial system is resilient and well-regulated.** Czech banks are self-financed with a low system-wide loan-to-deposit ratio and strong capital and liquidity buffers. Recent stress tests confirm that even extreme recessionary and deflationary scenarios would be manageable, mainly thanks to high initial capitalization levels. The CNB has recently allocated more resources for on-site supervision, and started utilizing the macroprudential toolkit of the CRD-IV by requiring an across-the-board "conservation buffer", supplemented by a "systemic buffer" targeted at the largest banks.

9. **However, credit growth remains slow.** This is despite the healthy financial sector and generally strong corporate and household balance sheets. On the corporate side, in addition to still-low investment levels, this appears to be due to corporates' tendency to utilize internal resources for investment and, to a lesser extent, other financing sources such as corporate bonds, rather than problems with access to credit. Household credit growth has been stable at a slightly higher level, mainly driven by continued demand for mortgages. At

the same time, recent lending surveys point to easing lending standards and gradually rising demand for credit, suggesting that credit growth will likely gradually rise going forward.

Boosting potential growth

10. **Ambitious structural reforms could put the Czech Republic on a higher growth trajectory.** Growth is constrained by demographic headwinds, structural weaknesses in the labor market, and slow productivity improvements. Low labor participation rates among women with young children and low-skilled workers call for further progress in providing affordable childcare, and raising the effectiveness and scope of job search assistance and training services. It would also be important to upgrade labor skills and reduce skill mismatches in the high technology sectors, including by strengthening education, training, and apprenticeship programs. Further steps to enhance the business environment are needed, including simplifying tax compliance and other administrative procedures. Finally, improving transport infrastructure, and strengthening research and development to facilitate moving up in the value chain, would also support faster potential growth.

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