



Czech Republic: Staff Concluding Statement of the 2018 Article IV Mission

May 16, 2018

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or ‘mission’), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under [Article IV](#) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

The Czech economy is growing strongly; the challenge is to sustain stable growth through the cycle and over the long term. Monetary policy will contribute by focusing on price stability. For financial stability, additional macroprudential measures are advisable to insure against household financial vulnerabilities. The economy is already hitting the limits of supply, and demographic changes imply a shrinking and aging pool of labor. In such an environment, fiscal and structural policies play a key role. Changes to tax and spending policies and coordinated planning for infrastructure and life-long learning could raise productivity and encourage the most efficient use of resources.

Job-rich growth and its limits

The economy has been doing very well, with high growth spread across almost all sectors. Employment growth has been particularly strong, and the unemployment rate is the lowest in the EU. So far, there are no major imbalances: wages have been increasing rapidly, but this is a natural adjustment to the strong demand for labor; otherwise, inflation remains close to the target, credit growth is broadly in line with the growth of nominal GDP, the banking system is well capitalized and funded, and fiscal policy has been conservative. The economy runs a surplus with the rest of the world.

We expect the economy to continue to perform strongly, projecting growth of 3.7 percent this year. But supply constraints are biting; hence, we expect growth rates to fall, to 3.2 percent next year and about 2½ percent over the medium term. As always, there are uncertainties around the outlook. The same openness that benefits the Czech economy by linking it into

global supply chains also exposes it to the risk of a downturn in world demand, especially if trade protectionism were to increase. Domestic labor market pressures could result in higher inflation than currently expected, but imported disinflationary pressures could yet increase.

The challenge: sustained and stable growth

The main challenge for policy is to maintain sustained and stable growth over a prolonged period—this means setting policies to avoid overheating at this stage of the cycle and boosting the potential growth rate of the economy now and over the long term. Boosting capacity is made harder—and more important—by demographic changes that are already underway: the working age population is shrinking, and the share of older workers is increasing. Hence, all macroeconomic policies have an important role to play in navigating the path to sustained and stable growth.

Monetary policy: steady but ready

Since moving off the koruna floor early last year, the exchange rate has appreciated and prices of imported goods have fallen. The Czech National Bank has appropriately taken a cautious approach to raising policy rates, and has signaled a gradual approach to future rate increases. In the current situation, in which there is a risk that disinflationary pressures could increase while policy rates are still close to zero, this is the right approach. That said, given the strength of domestic inflation, the CNB should continue to communicate its readiness to raise rates earlier than currently projected if needed to fulfil its mandate.

Financial policies: insure against financial vulnerabilities

With the prospect of relatively low interest rates needed to meet the inflation target, it becomes important for other policies to insure against potential financial vulnerabilities. Real estate prices have been increasing very strongly, especially in Prague, boosted by strong household confidence. Already, some households are already borrowing at high multiples of their incomes.

Macroprudential policies can play a key role in preventing vulnerabilities in household finances from escalating. The CNB has already responded with recommendations on the maximum ratio of Loans To the Value of housing, and LTV ratios have decreased. But multiples of loans to incomes remain high. The CNB should be given binding powers over Debt-To-Income, Debt-Servicing-To-Income, and LTV ratios—such tools are increasingly standard and are used by other central banks in Europe. In the meantime, for insurance against further increases in financial vulnerabilities, the CNB should introduce recommendations on DTI and DSTI ratios now. The use of these measures puts great demands on data—for example, to be fully sure of compliance, the CNB needs access to comprehensive loan-by-loan data.

Introducing macroprudential tools to insure against risks to borrowers does not remove the need for strong supervision of lenders. The CNB should continue to actively monitor banks. Intensive inspection of banks' practices, such as evaluation of the appropriateness of their risk management systems, including foreign exchange lending, should continue.

Macroprudential measures by themselves cannot fix underlying problems caused by insufficient supply and other policies that boost demand for real estate. Bottlenecks in planning and permits slow the ability of developers to meet demand. The tax environment adds to housing demand. Without attention to such problems, stresses on the housing market are likely to remain high.

Similarly, although good monetary and financial policy decisions can help the economy avoid overheating during the cycle and can contribute to investor confidence, they cannot themselves raise growth rates permanently, or deal with the needs of an aging population. That is the main challenge that should direct fiscal and structural policy decisions.

Fiscal policy: set incentives for the best use of resources

The fiscal position is sound, with surpluses expected this year and over the medium term, and low debt. Some spending has increased. Many of these increases—for example, more resources for education and investment—are justified, especially given the need to boost productivity. But the government should be careful that future expenditure and tax changes do not significantly add to the pressure the economy is already experiencing to meet demand.

Challenges to the budget will increase over the longer term. Stresses on the pension system are manageable with increases in retirement age. But increased demand for health care as the population ages will stress the public finances. Decisions will have to be made to ensure that health care resources are used well and spending is well targeted—re-introducing co-payments, for example, would deter overconsumption of health care resources. Given that the Czech Republic is increasingly well-off compared to other European countries, it is likely to receive less EU funding in the next EU budget, and should accordingly plan alternative sources of finance for long-term projects.

Other spending should also be reviewed to see whether it is providing a good return for the economy. In practice, most grants and tax concessions are still given to large firms in manufacturing—the criteria for providing support should be redesigned to facilitate the best use of resources across the economy, and help the spread of technology and best practices.

Tax policies play a major role in shaping incentives. Property taxation is very low compared with other countries—increased revenues from property taxation could be used to lower other taxes, such as the high labor tax wedge. We encourage moving toward recurrent taxes, rather than transaction taxes. In addition, mortgage interest deductibility encourages households to

take on debt to own a property and should be eliminated on a steady and predictable schedule.

Employment has risen very strongly, to rates now above the EU average. But policies can encourage further increases in participation of underrepresented groups. Further increases in retirement age would mitigate the decline in the working age population. Female labor participation could be boosted: for example, the tax expenditure on the non-working spouse benefit could be used for funding public child care, especially as many parents are currently being denied places in child care facilities because of lack of space.

Several changes to taxation are underway, and further changes are proposed by political parties. In view of the distortions already present from existing taxes, we recommend evaluating such proposals as part of a comprehensive review of the whole tax system, to provide a stable tax environment that provides the right incentives for best use of resources.

Structural policies: coordination and strategy

Ultimately, ensuring convergence to higher living standards comes down to raising productivity growth. Government can play a key role. A single plan for public infrastructure, coordinated across all branches of government, would be an important contribution. Likewise, the framework for life-long learning should be enhanced, given an aging workforce that will be retiring later in life.

Government can also raise the efficiency with which it provides its own services, and this can have big spillover effects to the rest of the economy. A good example comes from initiatives currently underway to bundle all information concerning planning applications into a single “e-binder” that is shared across all agencies responsible for planning approval. This could considerably improve efficiency, by facilitating parallel processing of applications, in turn speeding up the planning process and reducing pressures on supply, especially in the real estate market. Such initiatives in “e-government” are welcome and to be encouraged more broadly.

Discussions for the 2018 Czech Republic Article IV consultation took place in Prague from May 2-16. The mission would like to thank the authorities and other interlocutors for the constructive dialogue and kind hospitality.