Czech Republic

Country note, July 2018

Key messages:

- **The Czech economy is overheated with positive cyclical effects for the public finance**
- **The level of debt should approach 30 % of GDP in 2021, i.e. close to the pre-crisis level**
- **Strong economic growth would require restrictive fiscal stance but the policy remains pro-cyclical**

Macroeconomic outlook

Growth of the Czech economy has been continuing for the fifth year in a row, currently 4.4 % y-o-y in the first quarter of 2018. Current main drivers of the growth are household consumption and firms´ investment. The economy clearly operates above its potential with unemployment at record low levels and rising wages at more than 8 % y-o-y. Monetary policy interest rate was gradually raised to 0.75 % with further increases possible this year given weaker than expected exchange rate of the Czech koruna. Despite the phase of the economic cycle and strong wage growth, inflation rate remains close to the 2% target of the central bank.

Short-term fiscal outlook

Overheating of the economy is reflected in record general government surplus of 1.6 % of GDP in 2017 with expected 1.5 % of GDP for this year. The surpluses are due to local governments as the central government is running a deficit both this and next year. The expenditure side of the public finance will be influenced by higher increases in old-age pensions which will be even more generous in 2019. Rather fast growth of wages of public employees will further reduce the surplus. A packet of social measures together with a state-compensated reduction of fares for students and elderly persons will amount to additional 0.2 % of GDP in expenditures. The fiscal policy will be expansionary both this and next year with estimated fiscal impulses of 0.4 % of GDP and 0.3 % of GDP, respectively. However, given the state of the economy a restrictive stance would be appropriate.

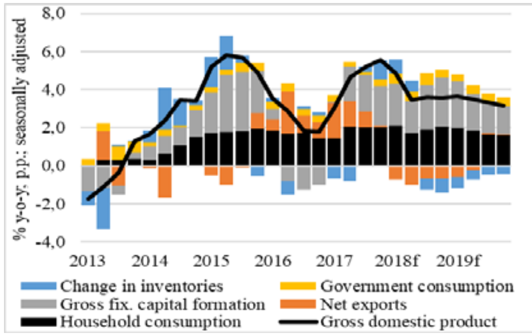
Medium-term fiscal outlook

The structural balance will worsen given the growth of expenditures but it should remain positive and it should be about 0.2 % of GDP in 2019–2021. General government balances are supposed to be about +1 % of GDP till 2021 as it is supposed that the economy will continue to operate above its potential bringing a positive cyclical component of roughly 0.8 % of GDP every year. Given the surpluses, the debt to GDP ratio will continue to decline and it should drop below 30 % in 2021, which would make the Czech Republic one of the least indebted countries within the EU. Average time to maturity was too low given the previous period of low borrowing costs and stability. In the near future, interest rates will increase.

Fiscal framework and national fiscal rules

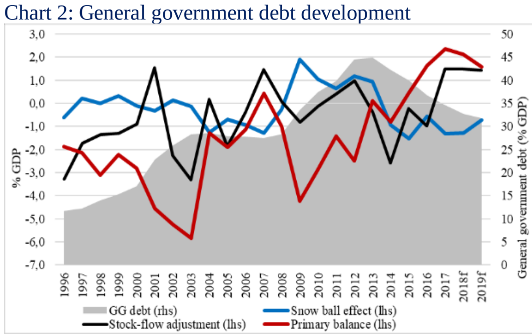
The Czech Fiscal Council was set up in January 2018 and it has gradually started to fulfill its goals and duties. In April 2018, it published its evaluation of the fiscal frameworks of the state budget and state funds for 2019–2021. In its evaluation, the Council recommended to set the expenditures at levels lower than the fiscal frameworks would enable because their full utilization would lead to a fiscal expansion, which is not desirable given the current state of the business cycle as it could further worsen macroeconomic imbalances. By incomplete drawing of the fiscal frameworks, on the contrary, there will be room for active fiscal policy in case of unexpected deterioration of economic development. Besides the Council, a new Committee for Budgetary Forecasts was established in spring this year. Its main objective is to serve as an expert body, which evaluates macroeconomic and fiscal projections of the Ministry of Finance. The Committee should already evaluate projections, which will be used for the 2019 state budget.

Chart 1: Annual GDP growth structure



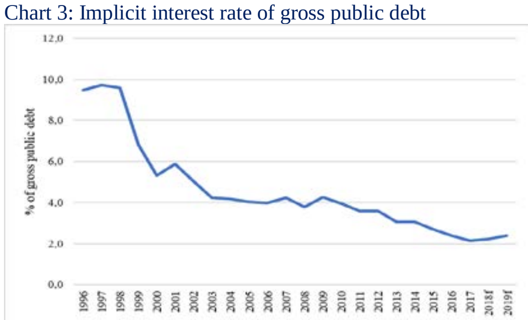
Source: Czech National bank

Chart 2: General government debt development



Source: AMECO

Chart 3: Implicit interest rate of gross public debt



Source: AMECO

Key indicator forecast

		2016	2017	2018 f	2019 f	2020 f	2021 f	Source
Real GDP growth rate	[% y-to-y]	2,6	4,4	3,6	3,3	2,6	2,4	1
Output gap	[%]	0,5	1,4	2,1	2,5	2,4	2,2	1
GG balance	[% of GDP]	0,7	1,6	1,5	1,1	1,0	0,9	1
GG debt	[% of GDP]	36,8	34,6	32,9	31,6	30,7	29,9	1
Cyclical budgetary component	[% of GDP]	0,2	0,5	0,7	0,9	0,8	0,8	1
Cyclically-adjusted primary balance	[% of GDP]	0,2	1,8	1,5	0,9	0,9	1,0	1
Structural balance	[% of GDP]	0,5	1,1	0,8	0,2	0,2	0,2	1

Sources: 1 - Ministry of Finance of the Czech Republic

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