Czech Republic

Country note, July 2019

Key messages:

- **The Czech economy has probably reached its peak of the economic cycle in 2018…**
  …forecasts point to the onset of the downward part of the cycle.
- **Fiscal rules are likely to be observed over the next few years,…**
  …however, under current set policies and population aging their fulfillment is not sustainable in the long run.

Macroeconomic outlook

The Czech Republic reported annual GDP growth of 2.9% and the output gap reached 1.7% of GDP in 2018. Potential product grew at roughly the same pace as GDP. Aggregate factor productivity dominantly contributed to its growth (1.9 p.p.). On the demand side the gross fixed capital formation was the main driver of GDP growth (2.6 p.p.). In addition, expenditure on final consumption of households (1.5 p.p.) and general government (0.7 p.p.) contributed to growth too. The contribution of external trade balance and changes in inventories had a negative effect. The Ministry of Finance of the Czech Republic (MoF) expects lower real GDP growth for 2019–2022 (see Table). Also, a positive output gap is expected to close for the following years 2020–2022. Our calculations indicate the easing of monetary conditions in 2019, mainly due to lower real interest rates of the three-month PRIBOR (Prague Interbank Offered Rate). In the following period, the growth of the 3M PRIBOR can be expected, as well as an apreciation of the real effective exchange rate, i.e. the tightening of monetary condition (see Chart 1).

Short-term fiscal outlook

This favorable economic environment was reflected in the Czech general government sector´s balance and debt. In 2018, the sector reached a surplus of 0.9% of GDP. The cyclically-adjusted balance was 0.3% of GDP and structural balance was 0.4% of GDP. General government debt reached 32.7% of GDP in 2018 (see Table).

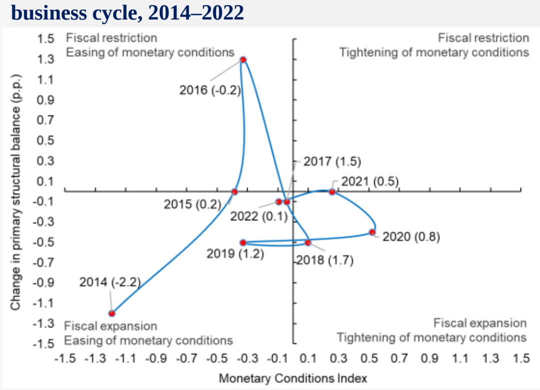
Medium-term fiscal outlook

Due to macroeconomic outlook, the sector's cyclical budgetary component will decline to zero for the last year of the MoF's forecast (i.e. 2022). At the same time, as a result of the expansionary fiscal policy stance this and next years, the structural balance will decrease from a surplus of 0.4% of GDP in 2018 to a deficit of 0.5% of GDP in 2020 and beyond (2021 and 2022). On the one hand, the debt of the public sector will fall from 31.5% to 29.7% of GDP between 2019 and 2022. On the other hand, it is not expected that the debt-to-GDP ratio will decline significantly as in previous years, mainly due to lower GDP growth and lower primary balances (see Table).

Fiscal framework and national fiscal rules

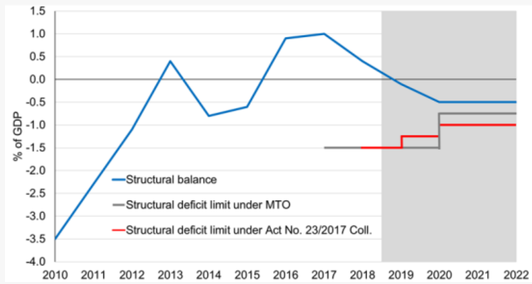
In the period 2019–2022 the forecasted structural balance and general government debt will not probably reach the limits set by the Act No. 23/2017 Coll., on the rules of budgetary responsibility (the "Act"), i.e. structural deficit limit 1% of GDP (Section 10 of the Act) and debt limit 55% of GDP (Section 14 of the Act), see Chart 2 and 3. At the same time, due to the deterioration of the aging component of the long-term sustainability indicator S2, the medium-term budgetary objective (MTO) was tightened from –1.5% of GDP to –0.75% of GDP (see Chart 2). However, compliance with fiscal rules will be a challenge in the long term, at least according to our projection. Due to the current set of tax and expenditure policies and, in the long run, mainly due to aging, the current MTO limit will be breached around 2030 and the limit under the Act will be broken around 2032. The 55% of GDP debt threshold is likely to be exceeded around 2047.

Chart 1: Monetary and fiscal policy in the context of the business cycle, 2014–2022



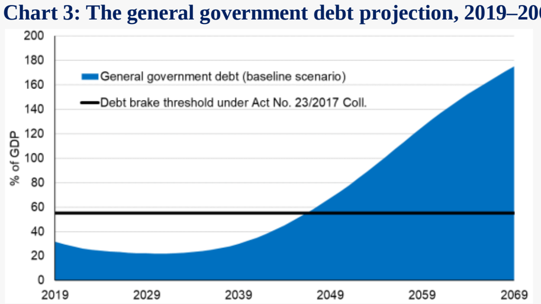
Source: MoF, Czech National Bank, IMF, Eurostat, forecast: 2019–2022 The output gap in % of GDP is shown in parentheses.

Chart 2: The general government structural balance, 2010–2022



Source: MoF, forecast 2019–2022.

Chart 3: The general government debt projection, 2019–2069



Source: Czech Fiscal Council calculation

Key indicator forecast

		2015	2016	2017	2018	2019f	2020f	2021f	2022f	Source
Real GDP growth rate	[% y-to-y]	5.3	2.5	4.4	2.9	2.4	2.4	2.3	2.2	1
Output gap	[% of pot. GDP]	0.1	0.5	1.4	1.7	1.2	0.8	0.5		2, 3
GG balance	[% of GDP]	-0.6	0.7	1.6	0.9	0.3	-0.2	-0.3	-0.5	1, 3
GG debt	[% of GDP]	40.0	36.8	34.7	32.7	31.5	30.8	30.2	29.7	1, 3
Cyclical budgetary component	[% of GDP]	0.1	-0.1	0.5	0.6	0.4	0.3	0.2	0.0	1, 3
Cyclically-adjusted balance	[% of GDP]	-0.7	0.8	1.0	0.3	-0.1	-0.5	-0.5	-0.5	1, 3
Cyclically-adjusted primary balance	[% of GDP]	0.4	1.7	1.8	1.0	0.6	0.3	0.2	0.2	1, 3
Structural balance	[% of GDP]	-0.6	0.9	1.0	0.4	-0.1	-0.5	-0.5	-0.5	1, 3

Sources:

1) Macroeconomic Forecast (April, 2019), MoF
2) Convergence program of the Czech Republic, MoF (April 2016, 2017, 2018)
3) Convergence program of the Czech Republic, MoF (April 2019)

f = forecast

GG = General Government

jan.kubicek@unrr.cz

www.rozpoctovarada.cz

+420 774 281 741