STATEMENT OF THE CZECH FISCAL COUNCIL

of 6 March 2019, No. 1/2019

on the development of general government sector finances and on the setting of fiscal and budgetary policies

Pursuant to Section 21 (2) a) of Act No. 23/2017 Coll., on the Rules of Budgetary Responsibility, the Czech Fiscal Council monitors the development of sector of general government finances. Under this activity, it also seeks to identify risks and threats that could negatively affect the stability of public budgets in the short, medium and long term. As of September 2018, the Czech Fiscal Council regularly informs the public of its conclusions each quarter.

Initial Economic Conditions

The Czech economy grew by 3% last year, but economic growth fluctuated below this level from the second quarter. Household consumption slowed steadily throughout the year to 2.2% in the last quarter, which was in stark contrast to rapidly growing wages and employment. The slowdown in the dynamics of household consumption was partly due to rising inflation and partly due to concerns about deterioration in the economy, as confirmed by the February consumer survey. At the same time, a slight downturn in the rate of growth of retail sales was also seen in 2017 and 2018. Investment activity remained strong in the second half of 2018, largely driven by labour market tensions, resulting in companies increasing their efforts to replace manual labour with machines. Investment activity was also supported by government spending last year.

GDP growth of 2.8% in the last quarter was somewhat more encouraging than expected by the market, Czech Ministry of Finance and Czech National Bank. This was mainly due to solid export growth of around 5% associated with the recovery of the manufacturing industry at the end of the year. In the context of weaker performance of the German economy in the second half of 2018, these results can be viewed positively.

In light of developments in the last quarter of 2018, growth of around 2.5% expected by the Ministry of Finance of the Czech Republic in 2019 seems realistic. However, the growth outlook is subject to an unusually high degree of uncertainty. Most risks stem from the external environment and are concentrated on foreign demand for Czech manufacturing production, especially in the automotive industry. The potential for investment activity will continue to develop based on export performance. The main domestic source of uncertainty is the labour market, especially with regard to the development of wages and inflation. Employment increased by 1.5% at the end of 2018 and the volume of wages and salaries increased by 8.2%.

General government sector finances and setting fiscal policy in the coming years

Current macroeconomic predictions show that this year’s economic growth will be slower than expected at the time the state budget for 2019 was approved. However, it should be noted that expected y-o-y GDP growth of around 2.5% in 2019 and 2020 is likely to ensure the economy remains above the potential output level, albeit the positive output gap will become smaller. In terms of the impact on public budgets, the rate of growth of tax revenues is likely to slow against previous expectations. Nevertheless, public budgets will continue to benefit from the high rate of growth in wages, i.e., the base with the highest burden of taxes and social contributions. As a result, tax revenues and social contributions as a percentage of GDP[1] will continue to grow. However, the cyclic contribution in public revenues brought about by the economic boom, which reached roughly CZK 20 billion in 2018 at state budget level and significantly improved the final balance of the state budget, will gradually decrease.

Based on the above, the Czech Fiscal Council believes the economy does not require significant fiscal stimulation in the foreseeable future, as the gradual slowdown in GDP growth points to a gradual return to potential output and not a sharp fall due to a radical decline in aggregate demand. At the same time, the Czech Fiscal Council believes the government should not resort to significant fiscal restrictions and that fiscal policy should be neutral in 2020 and 2021. Greater intervention through fiscal policy would only be needed on the materialisation of certain external risks (hard Brexit, outbreak of trade wars, etc.) that significantly affect the growth of the Czech Republic's key export partners.

Nevertheless, in terms of the medium-term stability of public budgets, there appears to be a need to reduce the rate of growth of some expenditure items (against last year's plans) and limit the scope of newly considered measures, especially in the area of current expenditures, in order to meet planned state budget balances in 2020 and 2021. The Czech Fiscal Council believes that an audit of individual public sector activities and their reduction in cases where their effect proves to be inadequate is the way forward. However, this activity should be carried out on an ongoing basis and not only in the context of slowing economic growth.

In the statement of the Czech Fiscal Council, the reduction in the rate of growth should not affect those expenditures that lead to higher growth in potential output. This particularly concerns investments whose volume is still below the long-term average[2] and which must be increased to a higher level in order to close the infrastructure gap between the Czech Republic and old EU Member States. On the other hand, the Czech Fiscal Council points out that growth in investment spending should be gradual, as the situation in the construction industry does not allow a significant increase in production volume due to the tense circumstances on the labour market.

In terms of future growth in investment expenditure, municipalities and regions should also be encouraged to increase their activity, as their investment activity has been below the long-term average for a number of years. At the same time, these government units show a steady increase in funds on their cash accounts[3]. Low investment activity is therefore unlikely to be the result of a lack of funding but is rather due to other factors such as administrative barriers to the implementation of individual projects.

The Czech Fiscal Council also believes that measures should not be taken at central government level to reduce tax burdens or increase spending that would jeopardise meeting planned state budget deficits in 2020 and 2021. Although the Czech Fiscal Council does not consider this trajectory suffi-

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[1] This share was 34.6% in 2016; the Ministry of Finance expects an increase to 36.2% in 2018. MF CR: Fiscal Outlook (November 2018). Given the high wage dynamics expected in 2019 and 2020, this indicator can be expected to continue to grow.

[2] The Czech Ministry of Finance expects the overall level of investment by the general government sector to reach 3.9% of GDP in 2019 according to its Fiscal Outlook of November 2018. The long-term average for 2008 to 2017 was 4.5% of GDP.

[3] The volume of funds on the current accounts of municipalities and regions increased from CZK 87.7 billion at the end of 2014 to CZK 156.7 billion at the end of 2018.

ciently ambitious, compliance with deficits of CZK 40 billion represents the minimum for maintaining medium-term sustainability of the Czech Republic's public finances.