The Czech Fiscal Council

STATEMENT OF THE CZECH FISCAL COUNCIL

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On the development of public sector finances and the set-up of fiscal and budgetary policy

Pursuant to Act No. 23/2017 Coll., on budget responsibility rules, Section 21 (2) (a), the Czech Fiscal Council monitors the development of public sector finance. Within the framework of that work, it also strives to identify risks and threats that may have an adverse impact on public budget stability in the short-term, medium-term, and long-term. Since September 2018, the Czech Fiscal Council regularly, on a quarterly basis, informs the public about its conclusions.

Basic economic situation

In Q3 2019, the Czech economy grew by 2.5% year on year, which was, in principle, in accordance with the expectations of the Ministry of Finance of the Czech Republic as well as those of the market. The structure of year-on-year growth remained similar to that in the first half of the year, with the predominant impact of household consumption, supported by government expenditure. Investment demand was down by 0.3%; however, capital generation overall was prevented from a year-on-year drop by a growth in inventory stock, which is, at this stage of the economic cycle, rather a warning signal evidencing weaker domestic as well as foreign absorption. Furthermore, investment is driven by the construction and housing sector, whereas the year-on-year drop in investments in machines and equipment continued to deepen. Export dynamics have been slowing down since the beginning of the year and, in Q3 alone, real exports were up by just under 2% year on year. The contribution of foreign trade to growth did remain positive, but it was, above all, due to the stagnation of imports of goods, reflecting weak investment demand in the domestic economy.

The overall picture of a decelerating economy is supplemented by the quarter-on-quarter dynamics. Household consumption stagnated in a quarter-on-quarter comparison; exports declined in real terms as compared to Q2. Exports have clearly been hit by weak foreign demand, whose uncertain outlooks are also reflected in terms of worsened expectations, not only among domestic entrepreneurs, but also consumers. Industrialists' expectations are the weakest since mid-2013, to which correspond the six quarters of weakening rates of industrial growth – gross added value in the processing industry was up by exactly 1% in Q3. The situation in services and the construction business is somewhat better. Hence, the growth of the economy was driven primarily by services, where household demand is supported by the strong employment market, while in the business sector, the effect of digitisation is felt. Overall, growth in the service sector is also driven by the still relatively strong real estate market.

The last quarter of 2019 can be expected to bring similar developments, with GDP for the full year growing by 2.5%. According to the expectations of the Czech Ministry of Finance, as well as of the market, the economy will further decelerate next year, to approximately 2%, which will still be a very good result in the European context. This outlook is, however burdened by uncertainty. A negative surprise has come primarily in the form of new data on household consumption, which, however, only confirmed the weakening of consumer sentiment that has been continuing for many months. On the other hand, despite the continuing foreign risks, leading indicators abroad have recently been improving, but this has not yet been reflected in the expectations of Czech businesses.

The labour market responds to weakened economic performance with a lag and is still marked by an excess of available positions over the number of job applicants, which continues to present significant pressure on wage growth. In a quarter-on-quarter comparison, however, employment only grew in public administration, IT, and on the real estate market. It is only a matter of time before the slowing down of economic performance reflects on the labour market and weakens the dynamism of wages. For 2020, however, wage growth of around 5% can be expected. Real consumption will, however, be restricted by continuing price increases, with inflation remaining above 2% in 2020, as well.

Public sector finances and the set-up of fiscal and budgetary policy for upcoming years

In the sphere of public finance, the gradual slowing of economic growth in 2019 started to manifest in the rates of growth of certain tax incomes, which are not as high as in previous years. The results of government budget performance at the end of November 2019 indicate that the planned values will probably not be achieved in VAT and social security insurance, but only in terms of CZK billion in single digits. The aggregate difference between taxes collected and the planned values at the end of the year can be expected not to exceed 1% of planned tax income. The overall balance of the government budget will depend primarily on the scope of capital expenditure draw-down, which may exceed the planned values if claims from unconsumed expenditures are involved to a significant degree, as they were last year.

In its November macroeconomic prediction, the Ministry of Finance assumed that fiscal policy will be of a neutral nature in 2020[1], which the CFC considers optimal in macroeconomic terms. The CFC continues to hold that, even though there is a gradual slowdown in the rate of GDP growth, and this trend will continue in 2020 according to most macroeconomic predictions, the Czech economy will still be slightly above the potential product. Any fiscal stimulation would thus encounter a shortage of disposable resources, especially on the labour market, where the unemployment rate reaches extremely low values. The value of fiscal multipliers is thus probably low, and any fiscal stimulus would have only a limited impact on the rate of GDP growth and, rather, would contribute to a strengthening of inflation pressures. On the other hand, the CFC does not deem it appropriate to perform any fiscal restrictions at this time, as they may have an adverse impact on the expectations of economic entities.

Maintaining the dynamism of economic growth at around 2% is conditioned on the non-materialisation of foreign risks (in particular the introduction of barriers limiting international trade) which would affect primarily the domestic industrial sector. Hence, the CFC is of the opinion (as in its September 2019

[1] See MF ČR: Macroeconomic prediction, November 2019, information about fiscal efforts on p. 11, or MF ČR: Fiscal outlook, November 2019, p. 11.

opinion) that the government should prepare a specific form of fiscal stimulation for the economy, in the event that extreme risks materialise along with a further loss in the dynamism of economic growth.

Furthermore, the CFC deems it necessary to point to problematic aspects in the approval of the 2020 government budget, as the budget bill counts on certain income the attainment of which is conditioned on the enactment of other acts (known as the tax package). But those had not been approved at the time of deliberations on the government budget and, given the duration of the legislative process, there is a risk that they will not come into force as at 1 January 2020. Hence, the government budget may be approved counting on income that will, in the end, not be collected, as the relevant acts might not be enacted, or changes made during the deliberations may have a negative impact on the expected collection. It is also important to mention the adverse effect on taxpayers who are exposed to uncertainty with respect to their obligations starting from 1 January 2020 and do not have sufficient time to prepare for the new conditions.

The CFC draws attention to the fact that this year is not the first in which such problems occur. Hence, from its point of view, it seems appropriate to adopt such a regulation of this part of the budget process as would ensure that the draft budget only operate with tax income that is based on already applicable laws. Inspiration may be sought in other EU states where this issue is dealt with for example by approving tax changes at the time of deliberations on the draft budget (Sweden) or by motioning tax changes with sufficient advance notice (United Kingdom).

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