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Assessment of the 2017 convergence programme for

Czech Republic

(Note prepared by DG ECFIN staff)

CONTENTS

1. INTRODUCTION 3
2. MACROECONOMIC DEVELOPMENTS 3
3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS 5
3.1. DEFICIT DEVELOPMENTS IN 2016 AND 2017 5
3.2. MEDIUM-TERM STRATEGY AND TARGETS 5
3.3. MEASURES UNDERPINNING THE PROGRAMME 8
3.4. DEBT DEVELOPMENTS 9
3.5. RISK ASSESSMENT 11
4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT 12
5. LONG-TERM SUSTAINABILITY 14
6. FISCAL FRAMEWORK 16
7. SUMMARY 16
8. ANNEX 17

1. INTRODUCTION

On 28 April 2017, the Czech Republic submitted[1] its April 2017 convergence programme (hereafter called convergence programme), covering the period 2017-2020. The government approved the programme on 24 April.

The Czech Republic is currently subject to the preventive arm of the Stability and Growth Pact (SGP) and should preserve a sound fiscal position which ensures compliance with the medium term objective.

This document complements the Country Report published on 22 February 2017 and updates it with the information included in the convergence programme.

Section 2 presents the macroeconomic outlook underlying the convergence programme and provides an assessment based on the Commission 2017 spring forecast (hereafter Commission forecast). The following section presents recent and planned budgetary developments, according to the convergence programme. In particular, it includes an overview on the medium term budgetary plans, an assessment of the measures underpinning the convergence programme and a risk analysis of the budgetary plans based on the Commission forecast. Section 4 assesses compliance with the rules of the SGP, including on the basis of the Commission forecast. Section 5 provides an overview of long-term sustainability risks and Section 6 reviews recent developments and plans regarding the fiscal framework. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

The macroeconomic scenario in the convergence programme projects GDP growth to increase slightly from 2.4% in 2016 to 2.5% in 2017 and 2018. In both years, GDP growth is driven mainly by domestic demand. Private consumption is projected to be the main contributor, supported by low unemployment and wage increases. After a decrease in 2016, investment is projected to be another key element of economic activity in 2017 and 2018. The scenario projects also a small positive contribution from net exports in both years, as external demand is likely to remain robust.

Compared to the 2016 convergence programme, GDP growth in 2017 was revised slightly downward from 2.6% to 2.5%, but was increased slightly from 2.4% to 2.5% in 2018. These changes took place in the context of a stable economic outlook but higher inflation in 2017; the latter was revised up from 1.5% in last year's programme to 2.4% in the current programme.

The Commission forecast expects GDP growth of 2.6% in 2017 and 2.7% in 2018, which is somewhat higher than the programme's forecast. Both forecasts project strong private consumption growth to continue. The programme expects investment to rebound somewhat stronger in 2017 but to slow down in 2018, while the Commission forecast expects the momentum to continue in 2018. The contribution from net exports to GDP growth is projected to be small and positive in 2017, both according to the programme and the Commission forecast. However, for 2018 the programme projects a further positive contribution, while in the Commission forecast it narrows to zero. The programme scenario does not include the impact of any structural reforms.

[1] The convergence programme was submitted both in Czech and English.

The convergence programme and Commission forecast both expect a tight labour market marked by strong wage growth, though at slightly higher rates in the programme than in the Commission forecast. Moreover, the programme projects the unemployment rate to decrease from 4.0% in 2016 to 3.4% in 2017 and 3.3% 2018, which is marginally lower than the 3.5% expected for both years in the Commission forecast. The programme and Commission forecast inflation projections are similar, with slightly higher rates in the Commission forecast. The risks identified in the programme stem from the external environment, exchange rate developments and the real estate market in the context of low interest rates.

The output gaps as recalculated by the Commission based on the information in the programme following the commonly agreed methodology are in positive territory at 0.3% of potential GDP throughout 2016–2018. In comparison, the output gaps in the Commission 2017 spring forecast are more positive and increasing in 2017 and 2018. This difference is explained by the combination of slightly higher potential growth and somewhat lower actual GDP growth in the programme compared to the Commission forecast.

Overall, the convergence programme macroeconomic scenario is based on plausible macroeconomic assumptions. The programme assumption for overall investment in 2018 appears cautious, whereas the assumption for employment growth in 2018 is higher than the Commission forecast.

Table 1: Comparison of macroeconomic developments and forecasts

	2016		**2017**		**2018**		**2019**	**2020**
	COM	**CP**	**COM**	**CP**	**COM**	**CP**	**CP**	**CP**
Real GDP (% change)	2.4	2.4	2.6	2.5	2.7	2.5	2.4	2.3
Private consumption (% change)	2.9	2.9	2.4	2.4	2.6	2.7	2.2	2.1
Gross fixed capital formation (% change)	-3.7	-3.7	3.5	3.8	4.2	3.0	3.0	3.0
Exports of goods and services (% change)	4.3	4.3	4.5	3.0	4.8	4.1	4.3	4.3
Imports of goods and services (% change)	3.2	3.2	4.5	3.1	5.2	4.1	4.1	4.2
Contributions to real GDP growth:								
- Final domestic demand	0.6	0.6	2.3	2.4	2.7	2.3	2.1	2.0
- Change in inventories	0.7	0.7	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	1.1	1.1	0.3	0.2	0.0	0.2	0.4	0.3
Output gap[1]	0.2	0.3	0.5	0.3	0.9	0.3	0.3	0.2
Employment (% change)	1.8	1.8	0.3	1.1	0.0	0.3	0.3	0.3
Unemployment rate (%)	4.0	4.0	3.5	3.4	3.5	3.3	3.2	3.1
Labour productivity (% change)	0.6	0.6	2.4	1.5	2.7	2.2	2.1	2.0
HICP inflation (%)	0.6	0.7	2.5	2.4	2.0	1.8	1.9	1.8
GDP deflator (% change)	1.1	1.1	1.6	1.1	1.7	1.8	1.9	1.9
Comp. of employees (per head, % change)	3.9	3.9	4.6	4.4	4.6	4.4	4.1	3.9
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	0.8	0.8	0.5	0.3	0.3	0.6	1.2	1.9

Note:

[1] In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:

Commission 2017 spring forecast (COM); convergence programme (CP).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT DEVELOPMENTS IN 2016 AND 2017

The general government balance turned positive in 2016, with an outturn of 0.6% of GDP, compared to a government balance of -0.6% of GDP in 2015. This implies a considerable overachievement of the target of the previous convergence programme, which expected an unchanged balance of -0.6% of GDP in 2016. The improvement was mainly due to higher-than-expected tax revenues and lower capital expenditure. Firstly, tax and social security revenues increased by 5.8% year-on-year. Secondly, total expenditure decreased due to the slow roll-out of the new programming period for EU funds, with public investment dropping by ⅓ from the peak in 2015. In terms of the sectoral breakdown, municipalities recorded a significant surplus, while the central government more than halved its deficit. The headline balance was mildly impacted by one-off measures related to auctions of mobile frequencies and the retroactive implementation of the 2014 Own Resources Decision regarding EU budget contributions[2].

For 2017, the convergence programme sets the headline balance at 0.4% of GDP, with total revenues forecast to outpace expenditure. The 2016 convergence programme projected broadly the same revenue ratio, but the expenditure ratio was expected to be around 1 pp. higher. As a result, the 2016 convergence programme reported a general government balance of -0.5% of GDP in 2017 (see Figure 1). Specifically, the current vintage of the convergence programme predicts higher tax revenues (in particular social security revenues and current taxes on income) and lower capital and interest expenditure than a year ago.

Looking at the factors behind the surplus in 2017, the dynamics of tax revenues remain a strong driver of the favourable fiscal position. VAT receipts are forecast to be buoyant, with new measures being gradually phased-in. Offsetting this is a decrease in excise duties on mineral oils and tobacco products. Public wages are set to increase as a result of discretionary measures (see Section 3.3). Interest expenditure is expected to follow a downward path on the back of favourable issuance conditions in financial markets.

The convergence programme includes some temporary items (amounting to around 0.1% of GDP for both revenues and expenditure), which are not sufficiently specified due to non-disclosure agreements, but their net effect on the budget balance is negligible.

3.2. MEDIUM-TERM STRATEGY AND TARGETS

The Czech Republic's convergence programme aims at continuing to meet its medium-term objective (MTO) and pursuing an improvement in the state budget deficit in cash terms. To this end, the general government balance is forecast to be in surplus throughout the forecast horizon and to stabilise at 0.5% of GDP from 2019 onwards. According to the convergence programme, the budgetary targets include specified measures with a cumulative negative impact of around 0.6% by the end of the forecast horizon.

[2] This relates to a correction in contribution for the EU budget following the adoption of the 2014 Own Resource Decision by the European Council on 24 May 2014. This measure is not recorded as a one-off measure in the convergence programme.

The convergence programme assumes revenues at 40.6% of GDP in 2018, which is in line with the Commission forecast. Expenditure is set to increase slightly, reaching around 40.3% of GDP. The Commission forecast shows a somewhat different expenditure composition, with compensation of employees and social payments slightly below the programme's expectations, but with higher capital transfers and higher public investment. The underlying assumption is that EU co-financed investment projects are set to continue gaining momentum in 2018.

The convergence programme expects a declining structural balance, as recalculated by the Commission on the basis of the information in the programme according to the commonly agreed methodology (hereafter recalculated structural balance), which is expected to reach 0.1% of GDP in 2018. The structural balance targets over the forecast horizon are significantly more positive than in the 2016 convergence programme, mainly due to revised headline figures. In contrast, the Commission forecast expects already a structural deficit of 0.2% of GDP for the same year. The reason for this difference is mainly the widening of the output gap to 0.9% of potential GDP in the Commission forecast, while the programme expects it to remain stable at 0.3% of GDP. Beyond 2019 the convergence programme projects a rising structural surplus, reaching 0.4% by the end of the programme's horizon in 2020. Czech Republic's MTO is specified as a structural balance of -1% of potential GDP and reflects the objectives of the Pact.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2016	2017		2018		2019	2020	Change: 2016-2020
	COM	**COM**	**CP**	**COM**	**CP**	**CP**	**CP**	**CP**
Revenue	**40.5**	**40.5**	**40.6**	**40.6**	**40.6**	**40.4**	**40.1**	**-0.4**
of which:								
- Taxes on production and imports	12.6	12.4	12.4	12.4	12.3	12.1	11.9	-0.6
- Current taxes on income, wealth, etc.	7.5	7.4	7.5	7.5	7.6	7.6	7.6	0.1
- Social contributions	14.9	15.0	15.2	15.1	15.3	15.3	15.3	0.4
- Other (residual)	5.5	5.5	5.5	5.6	5.5	5.4	5.3	-0.2
Expenditure	**39.9**	**40.2**	**40.2**	**40.5**	**40.3**	**39.9**	**39.6**	**-0.3**
of which:								
- Primary expenditure	38.9	39.3	39.3	39.6	39.5	39.2	38.9	-0.1
of which:								
Compensation of employees	8.9	9.0	9.0	9.0	9.1	9.1	9.00	0.09
Intermediate consumption	6.2	6.1	6.1	6.0	6.1	6.0	5.9	-0.2
Social payments	15.5	15.4	15.4	15.4	15.5	15.4	15.2	-0.2
Subsidies	2.4	2.4	2.4	2.4	2.4	2.3	2.3	-0.1
Gross fixed capital formation	3.4	3.7	3.7	4.0	3.8	3.8	3.9	0.5
Other (residual)	2.6	2.8	2.5	2.9	2.7	2.6	2.5	-0.1
- Interest expenditure	0.9	0.9	0.9	0.8	0.8	0.8	0.8	-0.2
General government balance (GGB)	**0.6**	**0.3**	**0.4**	**0.1**	**0.3**	**0.5**	**0.5**	**-0.1**
Primary balance	**1.5**	**1.1**	**1.3**	**0.9**	**1.0**	**1.2**	**1.3**	**-0.3**
One-off and other temporary	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**0.6**	**0.3**	**0.4**	**0.1**	**0.3**	**0.5**	**0.5**	**-0.1**
Output gap[1]	0.2	0.5	0.3	0.9	0.3	0.3	0.2	0.0
Cyclically-adjusted balance[1]	0.5	0.0	0.3	-0.2	0.1	0.3	0.4	-0.1
Structural balance[2]	**0.505**	**0.043**	**0.2**	**-0.237**	**0.1**	**0.3**	**0.4**	**-0.1**
Structural primary balance[2]	1.5	0.9	1.1	0.6	0.9	1.1	1.2	-0.3

Notes*:*

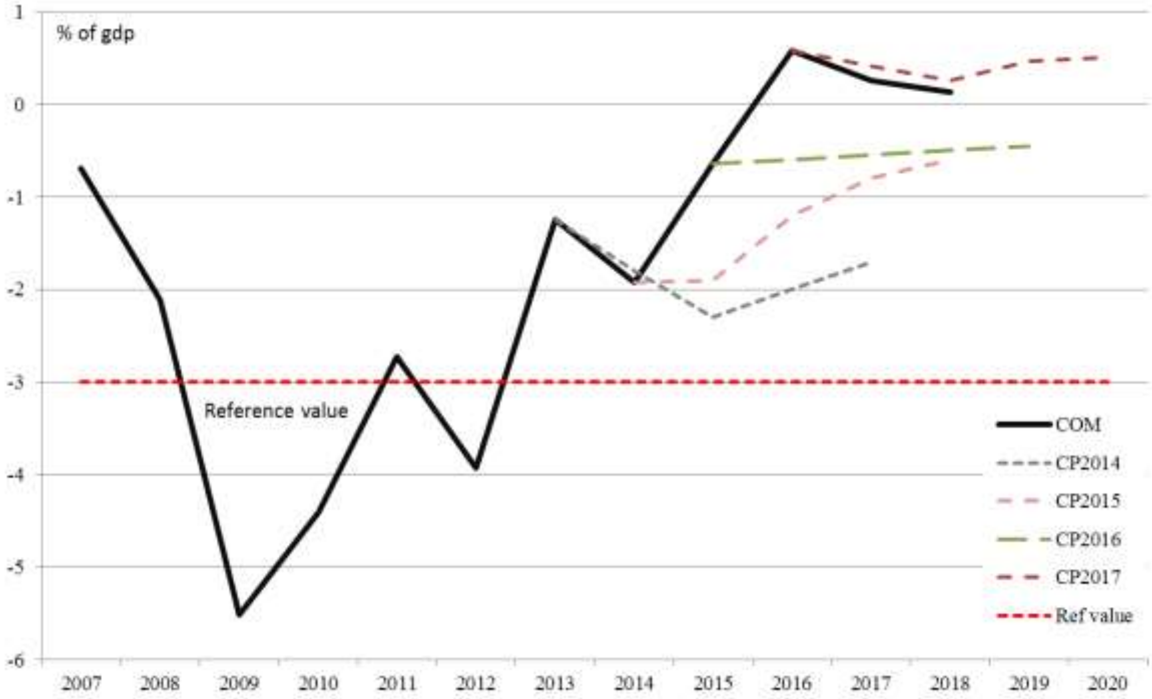
[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source *:*

convergence programme (CP); Commission 2017 spring forecasts (COM); Commission calculations.

Figure 1: Government balance projections in successive programmes (% of GDP)



Source: Commission 2017 spring forecast and convergence programmes.

3.3. MEASURES UNDERPINNING THE PROGRAMME

The convergence programme reports the main revenue and expenditure measures, which are summarised in the table below. Aggregate discretionary measures, presented in the convergence programme for 2017 to 2020, are predominantly on the expenditure side. The Commission forecast does not include any one-off measures for the years 2017 to 2020.

On the revenue side, the authorities estimate that the VAT control statement yielded additional revenues of around 0.3% of GDP in 2016. Excise duties on tobacco products are planned to rise repeatedly between 2016 and 2018. The electronic evidence of sales started in December 2016, and is phased in gradually among different categories of businesses until June 2018. The overall effect of electronic evidence of sales is expected in the order of 0.5% of GDP on a cumulative basis, spread across all tax and social security items. On the expenditure side, the main increases relate to public sector wages and social policies. Public wages in 2017 are set to increase mainly for state administration employees, in the education and healthcare sector, and for security forces. The minimum wage was increased in early 2017 by 11%, although this had a relatively minor direct effect on government expenditure. A larger social package is planned for 2018, reflecting increases in pensions[3] and other social allowances, such as parental allowance or child benefits. The overall package is expected to cost around 0.3% of GDP in 2018.

[3] Changes in pension expenditure include an increase in indexation of pensions due to rising wage growth and inflation – as stipulated by law – and a proposed amendment to use a higher contribution of wage growth for pension indexation purposes. For details see Section 5.

Main budgetary measures

Revenue	Expenditure
2016	
• Introduction of VAT control statement (0.3% of GDP) • Increase in tobacco products taxation (0.1% of GDP)	• Increase in public sector wages for public employees and doctors (0.3% of GDP) • Lump-sum increase in pensions by a fixed amount (0.1% of GDP) • Increase in healthcare expenditure (0.1% of GDP) • Subvention for renewable energy sources (0.1% of GDP)
2017	
• Implementation of electronic evidence of sales (0.3% of GDP)	• Increase in public sector wages (0.4% of GDP) • Introduction of minimum pension indexation at 2.7% (0.1% of GDP) • Increase in healthcare expenditure (0.2% of GDP) • Subvention for renewable energy sources (0.1% of GDP)
2018	
• Additional revenues from electronic evidence of sales (0.2% of GDP)	• Higher expenditures for social policies (parental allowances, increase of child benefits, etc.) (0.1% of GDP) • Increase in sickness benefits (0.1% of GDP) • Increase in pension insurance benefits (0.1% of GDP) • Changing the pension indexation formula (0.1% of GDP)

Note: The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.

3.4. DEBT DEVELOPMENTS

The Czech Republic's gross debt ratio stood at 37.2% of GDP in 2016, decreasing by 3.1 pps. year-on-year and staying well below the 60% of GDP reference value. In the years 2013 to 2015, debt reduction was accompanied by an increase in liquidity buffers of the state treasury system. This trend continued in 2016, as health insurance companies were included in the state treasury as mandatory clients. In 2016 debt developments were shaped mainly by the state budget surplus, which contributed to lower financing needs. The authorities sold mostly short-term and medium-term bonds[4] in 2016 to take advantage of the negative yields for koruna-denominated bonds. While this allowed decreasing interest expenditure, it also decreased the average maturity of state debt to the lowest value since 2004 (at 5.1 years).

The debt ratio, as reported by the convergence programme, is forecast to follow a downward path throughout the forecast horizon, reaching 36% of GDP in 2017 and 35.3% of GDP in 2018. This is broadly in line with the Commission forecast, which expects debt levels of

[4] 53% of all treasury bonds issued in 2016 had a maturity up to 3 years.

36.2% and 35.6% of GDP, respectively. In 2017, a higher debt ratio in the Commission forecast is explained by a lower primary balance and higher stock-flow adjustment expectations. This is partly offset by a stronger snow-ball effect than in the convergence programme, driven mainly by higher inflation. In 2018, the debt dynamics are virtually the same. The convergence programme predicts positive stock-flow adjustments over the years 2017-2020, which are, however, not explained in detail.

The 2016 convergence programme assumed somewhat different debt dynamics, with gross debt converging to 40% of GDP by the end of 2018 (see Figure 2), rather than 35% as in the current convergence programme. Among the reasons for the downward revision were higher primary surpluses of local governments and the unexpected cash state budget surplus, which supported decreasing debt levels.

Table 3: Debt developments

(% of GDP)	Average 2011-2015	2016	2017		2018		2019	2020
			COM	CP	COM	CP	CP	CP
Gross debt ratio[1]	**42.3**	**37.2**	**36.2**	**36.0**	**35.6**	**35.3**	**34.3**	**32.7**
Change in the ratio	0.4	-3.1	-1.0	-1.2	-0.6	-0.7	-1.0	-1.5
Contributions[2] :								
1. Primary balance	**0.8**	**-1.5**	**-1.1**	**-1.3**	**-0.9**	**-1.0**	**-1.2**	**-1.3**
2. "Snow-ball" effect	**0.1**	**-0.4**	**-0.7**	**-0.5**	**-0.7**	**-0.7**	**-0.7**	**-0.6**
Of which:								
Interest expenditure	1.3	0.9	0.9	0.9	0.8	0.8	0.8	0.8
Growth effect	-0.6	-0.9	-0.9	-0.9	-0.9	-0.9	-0.8	-0.8
Inflation effect	-0.5	-0.4	-0.6	-0.4	-0.6	-0.6	-0.6	-0.6
3. Stock-flow adjustment	**-0.5**	**-1.1**	**0.8**	**0.5**	**1.1**	**1.1**	**0.9**	**0.4**
Of which:								
Cash/accruals diff.				0.0		0.0	0.0	0.0
Acc. financial assets				0.5		1.1	0.9	0.4
Privatisation				0.0		0.0	0.0	0.0
Val. effect & residual				0.0		0.0	0.0	0.0

Notes:

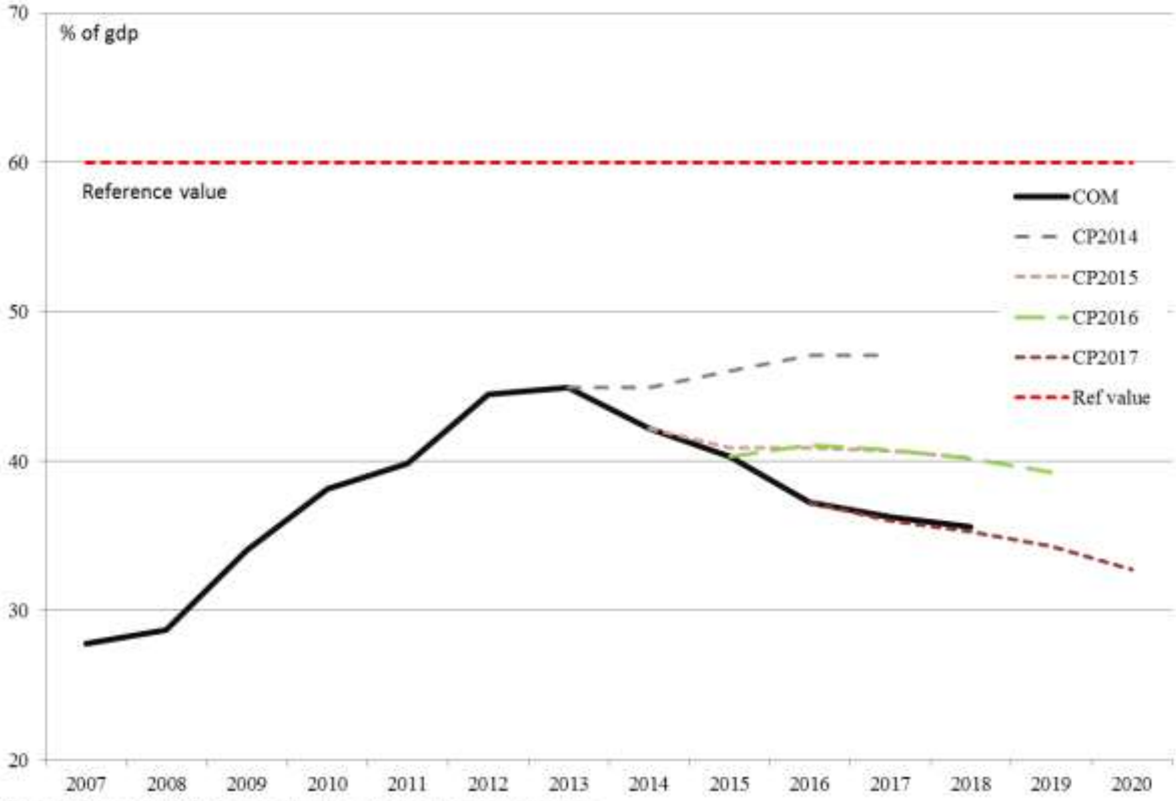
[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source :

Commission 2017 spring forecast (COM); convergence programme (CP), Comission calculations.

Figure 2: Government debt projections in successive programmes (% of GDP)



Source: Commission 2017 spring forecast and convergence programmes.

3.5. RISK ASSESSMENT

Overall, the convergence programme's targets in terms of headline budget balance, (recalculated) structural balance and debt are broadly in line with the Commission 2017 spring forecast. The headline budget surplus differs marginally in 2017 and by 0.2 pps. in 2018. As a result, the (recalculated) structural balance deteriorates somewhat further in the Commission forecast, reaching a value of -0.2% in 2018. The underlying macroeconomic outlook in the convergence programme is more cautious on GDP growth with 2.5% in both years, while the Commission forecast expects 2.6% in 2017 and 2.7% in 2018.

The main risks stem from the pronounced contraction in public investment in 2016, linked to the slow start of investment at the beginning of the new EU funds cycle. Considering the high volatility of investment and its strong link to EU funding, public investment represents both an upside and downside risk. There are reasons to believe that construction works for certain strategic infrastructure projects[5] will begin in the fourth quarter of 2017. However, delays have been rather frequent in the past and further postponements could occur due to disputes with landowners over purchase of land. With regards to anti-tax evasion measures, higher revenues could entail an upside risk for the Commission forecast.

[5] Nine strategic projects were subject to an accelerated Environmental Impact Assessment procedure to ensure timely implementation of projects. This was facilitated by an amendment of the Environmental Impact Assessment Act, which entered into force in April 2016.

Implementation risks in view of upcoming elections could lead to higher current expenditure. Moreover, a sizeable social package is expected for 2018 (see Section 3.3). Beyond the measures presented in the convergence programme, the government recently approved the differentiation of social insurance rates according to the number of children.

Increased uncertainty is connected to the floating of the koruna-euro exchange rate since 06 April 2017. Market reactions to the policy change have so far been limited, but a slight appreciation is anticipated by major institutions by the end of the year. A mild appreciation would have a limited impact on the economy in the short term. Although exporting firms are likely to be directly affected by the currency fluctuation, they are expected to have prepared for the event by hedging their exposure to currency risk.

Finally, Eurostat is currently discussing a potential reclassification of the Czech Railways into the general government sector, but the likely impact cannot be assessed at the present moment.

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

The Czech Republic is subject to the preventive arm of the SGP. The Council has not addressed a SGP-related recommendation to the country in 2016.

The general government balance registered a surplus in 2016 and the convergence programme indicates that surpluses are planned to be maintained throughout the programme horizon. According to the programme, the (recalculated) structural surplus is set to decrease to 0.1% of GDP in 2018, after which it is forecast to slowly improve towards 0.4% of GDP by 2020, thus remaining well above the MTO, defined as a structural balance of -1% of GDP

The outturn data confirm a structural surplus of 0.5% for 2016, which implies that the Czech Republic remained above its MTO. The Commission 2017 spring forecast projects the country to remain above its MTO in 2017 and 2018. More specifically, the structural balance is forecast to deteriorate slightly to 0.1% of GDP in 2017, reaching a deficit of -0.2% of GDP in 2018 on the back of a widening positive output gap. Despite these developments, the Czech Republic is expected to comply with the requirements of the preventive arm of the Pact in both 2017 and 2018, and the MTO is met with a positive margin.

Table 4: Compliance with the requirements under the preventive arm

<table>
<tr><td>(% of GDP)</td><td>2016</td><td colspan="2">2017</td><td colspan="2">2018</td></tr>
<tr><td colspan="6">Initial position[1]</td></tr>
<tr><td>Medium-term objective (MTO)</td><td>-1.0</td><td colspan="2">-1.0</td><td colspan="2">-1.0</td></tr>
<tr><td>Structural balance[2] (COM)</td><td>0.5</td><td colspan="2">0.0</td><td colspan="2">-0.2</td></tr>
<tr><td>Structural balance based on freezing (COM)</td><td>0.5</td><td colspan="2">0.0</td><td colspan="2">-</td></tr>
<tr><td>Position vis-a -vis the MTO[3]</td><td>At or above the MTO</td><td colspan="2">At or above the MTO</td><td colspan="2">At or above the MTO</td></tr>
<tr><td rowspan="2">(% of GDP)</td><td>2016</td><td colspan="2">2017</td><td colspan="2">2018</td></tr>
<tr><td>COM</td><td>CP</td><td>COM</td><td>CP</td><td>COM</td></tr>
<tr><td colspan="6">Structural balance pillar</td></tr>
<tr><td>Required adjustment[4]</td><td colspan="5" rowspan="17">Compliant</td></tr>
<tr><td>Required adjustment corrected[5]</td></tr>
<tr><td>Change in structural balance[6]</td></tr>
<tr><td>One-year deviation from the required adjustment [7]</td></tr>
<tr><td>Two-year average deviation from the required adjustment [7]</td></tr>
<tr><td>Expenditure benchmark pillar</td></tr>
<tr><td>Applicable reference rate[8]</td></tr>
<tr><td>One-year deviation adjusted for one-offs[9]</td></tr>
<tr><td>Two-year deviation adjusted for one-offs[9]</td></tr>
<tr><td>PER MEMORIAM: One-year deviation [10]</td></tr>
<tr><td>PER MEMORIAM: Two-year average deviation [10]</td></tr>
<tr><td>Conclusion</td></tr>
<tr><td>Conclusion over one year</td></tr>
<tr><td>Conclusion over two years</td></tr>
</table>

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2015) is carried out on the basis of Commission 2016 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

[10] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :
Convergence Programme (CP); Commission 2017 spring forecast (COM); Commission calculations.

5. LONG-TERM SUSTAINABILITY

The Czech Republic does not appear to face fiscal sustainability risks in the short run according to the S0 indicator, which captures short-term risks of fiscal stress stemming from the fiscal, as well as the macro-financial and competitiveness sides of the economy.

Based on Commission forecasts and a no-fiscal policy change scenario beyond current forecasts, government debt, at 37.2% of GDP in 2016, is expected to fall to 32.8% in 2027, thus remaining below the 60% of GDP Treaty threshold. Over this horizon, government debt is projected to have peaked in 2016. This highlights low risks for the country a the debt sustainability analysis over the medium term. The full implementation of the convergence programme would put debt on a faster-decreasing path, to a level well below the 60% of GDP reference value in 2027.

The medium-term fiscal sustainability risk indicator S1 stands at -2.3 pps. of GDP, thus indicating low risks in the medium term. While the low debt level and the favourable initial budgetary position act as risk-lowering, projected ageing costs contribute to increasing the S1 indicator. The full implementation of the convergence programme would put the sustainability risk indicator S1 at an even more favourable -4.0 pps. of GDP, leading to the same low-risk assessment in the medium term. Overall, risks to fiscal sustainability over the medium-term are, therefore, low. Fully implementing the fiscal plans in the stability programme would further decrease those risks.

The long-term fiscal sustainability risk indicator S2 (which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path) is at 2.1 pps. of GDP. In the long term, the Czech Republic therefore appears to face medium fiscal sustainability risks, which are primarily related to the projected cost of ageing (contributing 2.3 pps. of GDP to the S2 indicator value). Full implementation of the programme would nonetheless put the S2 indicator at 1.3 pps. of GDP, leading to a lower long-term risk.

Recently-adopted measures on pensions contribute to a deterioration of the long-term budgetary outlook. In 2016 the government approved a cap on the retirement age at 65 from around 2030, thus cancelling the previous approach of continuously increasing the retirement age with no upper limit[6]. Another recent change to the pension system gives the government the option to increase pensions by up to 2.7 % annually if the application of the pension indexation formula would entail a lower increase. Moreover, the Pension Committee has proposed a more generous indexation formula; while pensions were previously indexed by the sum of consumer price index (CPI) and ⅓ of real wage growth, the new proposal would use pensioners CPI[7] and ½ of real wage growth. The precise impact of these proposed changes has not yet been ascertained and is not reflected in the calculations of the aforementioned sustainability indicators. However, changes to the pension system are relatively frequent, and could potentially worsen the long-term sustainability of public finances by increasing pension expenditure.

[6] The new cap is to be reviewed every five years, with the aim being to allow workers to spend around a quarter of their lives in retirement.

[7] The aim is to use the more favourable price index for pensioners. If CPI was higher than pensioners CPI, CPI will be used.

Table 5: Sustainability indicators

Time horizon			No-policy Change Scenario		Stability / Convergence Programme Scenario	
Short Term			**LOW risk**			
S0 indicator [1]			0.2			
Fiscal subindex			0.0	LOW risk		
Financial & competitiveness subindex			0.3	LOW risk		
Medium Term			**LOW risk**			
DSA [2]			LOW risk			
S1 indicator [3]			-2.3	LOW risk	-4.0	LOW risk
of which						
	Initial Budgetary Position		-1.1		-2.0	
	Debt Requirement		-1.9		-2.5	
	Cost of Ageing		0.7		0.5	
	of which					
		Pensions	0.1		0.0	
		Health-care	0.3		0.2	
		Long-term care	0.1		0.1	
		Other	0.2		0.2	
Long Term			**MEDIUM risk**		**LOW risk**	
S2 indicator [4]			2.1		1.3	
of which						
	Initial Budgetary Position		-0.2		-0.8	
	Cost of Ageing		2.3		2.1	
	of which					
		Pensions	0.6		0.5	
		Health-care	0.8		0.7	
		Long-term care	0.5		0.5	
		Other	0.4		0.4	

Source: Commission services; 2017 stability/convergence programme.

Note: the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2017 forecast covering until 2018 included. The 'stability/convergence programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2015 Ageing Report.

[1] The S0 indicator of short term fiscal challenges informs the early detection of fiscal stress associated to fiscal risks within a one-year horizon. To estimate these risks S0 uses a set of fiscal, financial and competitiveness indicators selected and weighted according to their signalling power. S0 is therefore a composite indicator whose methodology is fundamentally different from the S1 and S2 indicators, which quantify fiscal adjustment efforts. The critical threshold for the overall S0 indicator is 0.46. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.36 and 0.49*.

[2] Debt Sustainability Analysis (DSA) is performed around the no fiscal policy change scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections*.

[3] The S1 indicator is a medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to bring the debt-to-GDP ratio to 60 % by 2031. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2019 for No-policy Change scenario and from last available year for the SCP scenario); it must be then sustained, including financing for any additional expenditure until the target date, arising from an ageing population. The critical thresholds for S1 are 0 and 2.5, between which S1 indicates medium risk. If S1 is below 0 or above 2.5, it indicates low or high risk, respectively*.

[4] The S2 indicator is a long-term sustainability gap; it shows the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical thresholds for S2 are 2 and 6, between which S2 indicates medium risk. If S2 is below 2 or above 6, it indicates low or high risk, respectively*.

* For more information see Fiscal Sustainability Report 2015 and Debt Sustainability Monitor 2016.

6. FISCAL FRAMEWORK

In February 2017, the Act on Fiscal Responsibility Rules (Act No. 23/2017) entered into force, following a protracted adoption process. The Act introduces a debt rule for general government, which will be activated once adjusted public debt[8] breaches the 55% of GDP threshold. Additional provisions for municipalities[9] limit debt to 60% of average municipal revenues. An independent fiscal council is to be established, tasked with monitoring public finances and evaluating fiscal rules. As the law only entered into force in early 2017 and has not been fully implemented, an evaluation of the new fiscal framework is not yet possible.

Additionally, one of the aims of the new fiscal law was to strengthen expenditure limits. To this end, the country-specific MTO was directly linked with the national budgetary methodology. The authorities presented a new methodology to calculate expenditure limits in April 2017 in the context of the 'Budgetary Strategy of Public Sector Units'. The strategy outlines how expenditure limits for the state budget and state funds are to be derived from the general government expenditure, taking into account the cyclical position and automatic stabilizers. The methodology also includes a corrective mechanism that lowers expenditure limits in case discrepancies between the outturn and forecast expenditure are larger than 2% of GDP.

Based on the information provided in the convergence programme, the past, planned and forecast fiscal performance in the Czech Republic appears to comply with the requirements of the applicable national numerical fiscal rules.

Since 2016 the macroeconomic forecasts underlying the convergence programme are assessed by an expert forecasting panel. The panel has an advisory function and does not have the power to formally reject the forecast. Out of eight private institutions which replied to the survey, seven assessed the macroeconomic forecast underpinning the programme at hand as realistic. The expert panel is due to be replaced by the Committee for Budgetary Forecasts, which was established by the Act on Fiscal Responsibility Rules. The Committee will be responsible for assessing forecasts used in the preparation of the state budget, budgets of the state funds and health insurance companies.

7. SUMMARY

In 2016, the Czech Republic achieved an improvement in the structural balance of 1.2% of GDP. Since the Czech Republic had already reached its MTO, this improvement provided for further fiscal space vis-à-vis the MTO. The Czech Republic was therefore in line with the requirements of the preventive arm of the Pact in 2016.

According to the convergence programme, a deterioration in the (recalculated) structural balance is expected in 2017 and 2018. Despite these developments, the structural balance is maintained above the MTO in both years. This is also confirmed by the Commission forecast. On this basis the Czech Republic is assessed to be compliant with the requirements of the preventive arm of the Pact in both 2017 and 2018.

[8] General government debt minus liquidity reserves for financing state debt.
[9] Sanctions for municipalities apply as of 1 January 2018.

8. ANNEX

Table I. Macroeconomic indicators

	1999-2003	2004-2008	2009-2013	2014	2015	2016	2017	2018
Core indicators								
GDP growth rate	2.8	5.3	-0.4	2.7	4.5	2.4	2.6	2.7
Output gap [1]	-0.4	3.6	-1.7	-2.1	0.0	0.2	0.5	0.9
HICP (annual % change)	2.3	3.1	1.8	0.4	0.3	0.6	2.5	2.0
Domestic demand (annual % change) [2]	3.3	4.1	-1.2	3.4	4.7	1.4	2.5	2.9
Unemployment rate (% of labour force) [3]	8.1	6.6	6.9	6.1	5.1	4.0	3.5	3.5
Gross fixed capital formation (% of GDP)	29.8	28.6	26.3	25.1	26.3	24.6	24.7	25.0
Gross national saving (% of GDP)	26.5	26.4	22.9	24.6	26.1	26.5	26.3	26.3
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-5.0**	**-2.2**	**-3.6**	**-1.9**	**-0.6**	**0.6**	**0.3**	**0.1**
Gross debt	**21.8**	**28.2**	**40.3**	**42.2**	**40.3**	**37.2**	**36.2**	**35.6**
Net financial assets	**19.8**	**10.7**	**-9.8**	**-20.1**	**-19.8**	**n.a**	**n.a**	**n.a**
Total revenue	38.4	38.8	39.8	40.3	41.4	40.5	40.5	40.6
Total expenditure	43.3	41.0	43.3	42.2	42.1	39.9	40.2	40.5
of which: Interest	1.0	1.1	1.3	1.3	1.1	0.9	0.9	0.8
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-0.4**	**-3.0**	**-0.4**	**-0.1**	**0.6**	**-1.6**	**-1.7**	**-1.7**
Net financial assets; non-financial corporations	**-103.8**	**-95.8**	**-90.9**	**-80.1**	**-76.3**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**0.9**	**-4.6**	**-2.5**	**-0.4**	**-2.0**	**n.a**	**n.a**	**n.a**
Gross capital formation	20.4	20.2	16.6	16.7	16.9	17.8	17.9	17.8
Gross operating surplus	28.2	29.6	28.7	30.7	30.8	30.2	30.2	30.3
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**1.8**	**1.5**	**2.4**	**2.5**	**1.7**	**1.8**	**1.9**	**1.9**
Net financial assets	**71.2**	**60.8**	**68.4**	**77.6**	**78.9**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	29.8	30.0	30.9	31.1	30.8	31.6	31.8	31.9
Net property income	4.1	3.7	3.3	3.5	3.2	3.2	3.2	3.2
Current transfers received	16.6	16.1	18.0	17.7	17.5	16.7	16.6	16.6
Gross saving	6.3	6.1	6.6	6.4	6.3	6.4	6.3	6.2
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.6**	**-3.7**	**-1.6**	**0.5**	**1.9**	**0.8**	**0.5**	**0.3**
Net financial assets	**12.0**	**29.0**	**35.0**	**23.3**	**19.4**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-1.2	2.1	4.3	6.4	6.1	7.4	7.1	6.9
Net primary income from the rest of the world	-2.6	-5.6	-6.9	-6.8	-6.6	-5.9	-5.8	-5.8
Net capital transactions	0.2	0.4	1.8	1.7	3.1	0.6	0.5	0.6
Tradable sector	54.2	53.0	50.7	52.4	52.2	52.3	n.a	n.a
Non tradable sector	37.2	37.7	39.5	38.0	37.7	37.5	n.a	n.a
of which: Building and construction sector	5.9	5.9	5.7	5.0	5.1	4.8	n.a	n.a
Real effective exchange rate (index, 2000=100)	69.8	90.0	99.5	91.6	89.7	92.9	94.3	94.7
Terms of trade goods and services (index, 2000=100)	100.7	101.6	99.5	100.5	100.7	101.6	101.0	101.0
Market performance of exports (index, 2000=100)	62.6	88.6	102.4	108.8	110.9	111.3	111.1	110.9

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.

[2] The indicator on domestic demand includes stocks.

[3] Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.

Source :
AMECO data, Commission 2017 spring forecast