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Assessment of the 2019 Convergence Programme for

Czech Republic

(Note prepared by DG ECFIN staff)

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EXECUTIVE SUMMARY

The Czech Republic is subject to the preventive arm of the SGP. With a gross public debt below 60% of GDP (32.7% in 2018), the country is compliant with the debt criterion.

Strong growth in investment allowed the Czech economy to expand by 2.9% in 2018. According to the Commission 2019 spring forecast, the economic expansion is expected to moderate to 2.6% in 2019 and 2.4% in 2020, broadly in line with estimated potential growth rates. Supported by rising wages across the economy, domestic demand, in particular through private consumption, is likely to remain the main driver of GDP growth, as the external outlook is gradually weakening. Investment growth is expected to moderate compared to the significant rise seen in 2018. In this context, the output gap is expected to narrow from 1.3% of potential GDP in 2018 to 0.3% in 2020. The labour market is expected to remain very tight over the forecast horizon, with an unemployment rate of around 2.2%. As such, the macro-economic scenario included in the Convergence Programme is plausible.

The headline budget surplus reached 0.9% of GDP in 2018, following robust growth in both revenue and expenditure. Gross fixed capital formation had a remarkable growth of around 28%, boosted by domestic investment, whereas the compensation of employees continued to grow at above 10% for the second year in a row. According to the Convergence Programme, the general government budget surplus is set to decrease to 0.3% of GDP in 2019 before moving into negative territory for the rest of the forecast horizon, from -0.2% of GDP in 2020 to -0.5% in 2022. This is significantly below the projections made in the 2018 Convergence Programme and is mainly due to the recently adopted measures to increase pensions and other social benefits, on the back of a more moderate economic growth. In structural terms, based on recalculated output gaps, the budget balance reached 0.4% of potential GDP in 2018, well above the medium-term budgetary objective, a deficit of 1%. However, it is expected to decline to a neutral position in 2019. Between 2020 and 2022 the structural balance is expected to turn negative but remain above the MTO.

Risks to the short-term fiscal outlook mainly come from the macroeconomic side, such as a further deterioration of the external outlook and the lack of growth in employment associated with the fast wage growth. The projected increase in public expenditure on pensions points to a medium risk in long-term sustainability.

Overall, the Czech Republic is expected to remain compliant with the MTO in 2019 and 2020.

1. INTRODUCTION

On 30 April 2019, the Czech Republic submitted its 2019 Convergence Programme (hereafter called Convergence Programme), covering the period 2019-2022, in both Czech and English languages. On 29 April, the government approved the programme, which was also discussed in the respective committees of the Parliament.

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 Budgetary Objective (MTO).

This document complements the Country Report published on 27 February 2019 and updates the information therein 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 2019 spring forecast. The subsequent section presents the recent and planned budgetary developments presented in 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 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 on long-term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework. Section 7 provides a summary of the assessment note.

2. MACROECONOMIC DEVELOPMENTS

The macroeconomic scenario in the Convergence Programme projects a deceleration in real GDP growth, from 2.9% in 2018 to 2.4% in 2019 and in 2020. GDP growth is expected to be driven by domestic demand in both years, notably by household consumption and fixed capital investment, while net exports are expected to bring a negative contribution in 2019 and remain neutral in 2020. Private consumption is estimated to be the main contributor to domestic demand growth, supported by growing real disposable income. Investment, while decelerating to 3.1% in 2019, following the exceptionally high growth in 2018, is projected to remain an important growth driver.

Compared to the previous 2018 Convergence Programme, GDP growth suffered a significant downward revision in 2019 from 3.3% to 2.4%. There was also a slight downward revision in 2020 from 2.6% to 2.4%. The main reasons for these revisions are the lower-than-expected growth in 2018 (0.7 percentage points below the outlook of last year's programme), the global trade uncertainty and deteriorating consumer and business confidence. The forecast for inflation also changed slightly – it was revised upwards in 2019 from 1.9% to 2.1% and downwards in 2020 from 1.8% to 1.5%.

The Commission 2019 spring forecast expects GDP growth to reach 2.6% in 2019 and 2.4% in 2020, a slightly more optimistic scenario when compared to the Convergence Programme. In both forecasts, the growth is driven by domestic demand. There are some small differences in the subcomponents, most notably on the growth rate of investment. While the Convergence Programme expects a 3.1% growth in 2019 and 2.7% in 2020, the Commission's forecast projects investment growth rates of 3.9% in 2019 and 3.1% in 2020. The Commission's assumption for higher rates is based on the strong incentives private companies have to continue investing in automation and digitalisation, on the back of an ever-tightening labour market. On the external side, there are no major differences for 2019 when both forecasts expect imports to grow significantly faster than exports. In 2020, the Commission estimates both exports and imports to have a smaller growth than that put forward in the Convergence Programme. Overall, both forecasts expect net exports to have a negative contribution to GDP growth in 2019, narrowing to zero in 2020. The Convergence Programme scenario does not include the impact of any structural reforms.

The Convergence Programme and the Commission 2019 spring forecast both expect labour market to continue to tighten, with a very low unemployment rate hovering around 2.2%. However, wage growth rates are higher in the Convergence Programme while employment grows slightly faster in the Commission's forecast. As for prices, HICP inflation in 2019 is higher in the Commission's forecast (2.4%) compared to the programme (2.1%) In 2020, the Commission expects a rate of 2.0% whereas the programme projects only 1.5%, despite an expected higher wage growth.

Table 1: Comparison of macroeconomic developments and forecasts

	2018		2019		2020		2021	2022
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	2.9	2.9	2.6	2.4	2.4	2.4	2.3	2.2
Private consumption (% change)	3.2	3.2	3.0	2.9	2.8	2.8	2.5	2.1
Gross fixed capital formation (% change)	10.5	10.5	3.9	3.1	3.1	2.7	2.6	2.9
Exports of goods and services (% change)	4.5	4.5	3.3	3.4	3.1	3.5	3.3	3.2
Imports of goods and services (% change)	6.0	6.0	4.2	4.0	3.5	3.7	3.4	3.5
Contributions to real GDP growth:								
- Final domestic demand	4.8	4.8	3.1	2.7	2.5	2.4	2.3	2.1
- Change in inventories	-1.2	-1.2	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	-0.7	-0.7	-0.4	-0.3	-0.1	0.0	0.1	0.0
Output gap[1]	1.2	1.3	0.8	0.7	0.3	0.3	0.1	0.0
Employment (% change)	1.6	1.6	0.9	0.4	0.7	0.2	0.1	0.0
Unemployment rate (%)	2.2	2.2	2.2	2.2	2.3	2.2	2.3	2.3
Labour productivity (% change)	1.3	1.3	1.7	2.0	1.7	2.3	2.2	2.1
HICP inflation (%)	2.0	2.0	2.4	2.1	2.0	1.5	1.7	1.7
GDP deflator (% change)	2.1	2.1	2.1	3.0	2.0	1.9	1.9	2.0
Comp. of employees (per head, % change)	7.6	7.6	5.0	6.9	4.2	5.7	5.3	5.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.0	1.0	0.6	1.0	0.7	1.2	1.5	1.6

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 2019 spring forecast (COM); Convergence Programme (CP).

The Convergence Programme presents three alternative macroeconomic scenarios based on the highest risks for the economy: slower growth in the EU in 2020, a rise in interest rates and higher oil prices. In all these scenarios, a deviation from the baseline scenario as of the first quarter of 2020 is expected. A rise in interest rates or in oil prices seems to have the highest impact on the government balance but only as of 2021.

Based on the information in the Programme, the output gaps, as recalculated by the Commission, following the commonly agreed methodology, are expected to narrow from 1.3% of potential GDP in 2018 to 0.7% in 2019 and 0.3% in 2020. The output gaps in the Commission 2019 spring forecast are quite similar, decreasing from 1.2% of potential GDP in 2018 to 0.8% in 2019 and 0.3% in 2020.

Overall, the Convergence Programme macroeconomic scenario is based on plausible macroeconomic assumptions. The projections for export performance and productivity growth are more favourable than the Commission forecast, whereas the projections for investment growth are more prudent. On the risk side, the slowing external demand and the extremely tight labour market are seen as major concerns in both forecasts.

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT DEVELOPMENTS IN 2018 AND 2019

The general government balance in 2018 reached a surplus of 0.9% of GDP (Table 2). This was the third year in a row when the overall outcome was positive and the second in a row when all the three subcomponents (central government, local government, social security funds) closed in surplus. Similar to 2017, this was supported by a high growth in tax revenue on the back of a strong labour market and domestic consumption. Nonetheless, due to an exceptionally high increase in investment and a significant acceleration of government final consumption, the surplus almost halved compared to 2017.

Despite remaining in surplus, the fiscal outcome in 2018 was lower than expected in the 2018 Convergence Programme – 0.9% instead of 1.5% of GDP. This was due to worse economic conditions and a higher increase in general expenditure, on the back of a much higher-than-expected increase in gross fixed capital formation and intermediate consumption. By contrast, the outturn of the general government debt was very similar to the projections of the 2017 programme – 32.7% of GDP instead of 32.9%.

Overall, total revenues increased by 8.1% in 2018, whereas total expenditures grew by 10.1%. Both figures were above the expectations of the 2018 Convergence Programme by respectively 2.6 and 3.0 percentage points. On the revenue side, the main difference was a better-than-expected intake of social security contributions – 9.8% compared to the authorities' past expectation of 7.7% - on the back of a higher rate of wage growth in the economy. Apart from social transfers, the growth of the major government expenditure categories was significantly higher than expected in the previous Programme. The difference is notable when looking at: a) compensation of employees (12.7% instead of 7.5%), in particular due to the increases of public wages; b) intermediate consumption (9.7% instead of 3.5%), due to a significant increase of current expenditure in EU-funded projects; and c) gross fixed capital formation (27.7% instead of 14.9%), due to a strong take-off of domestically-funded investment.

The general balance for 2019 was revised downwards significantly compared to the previous Programme – 0.3% instead of 1.1% of GDP. This is due to an upward revision of expenditures growth from 5.5% to 6.5%. The difference is due to the different outturn in 2018 and a further increase in public wages in 2019. On the revenue side, the growth was also revised upwards by around 0.5 percentage points. This was driven mainly by higher expected receipts from the personal income tax and social contributions, in line with the projected wage rise in the economy.

The Commission 2019 spring forecast expects a surplus of 0.2% of GDP (Table 2), slightly below the 2019 Convergence programme projections. While total revenues are expected to grow in line with the nominal GDP at around 5%, total expenditures are forecast to grow by 7%. Both are slightly higher compared to the Programme, particularly on the expenditure side where the authorities project a lower growth of intermediate consumption and cash social transfers. The forecast also expects slightly higher receipts from tax revenues, in line with the more optimistic GDP growth projections for 2019. Thus, the share of both revenue and expenditure to GDP is around 0.5 percentage points above the programme. Neither the Convergence Programme nor the Commission forecast include any one-off measures between 2019 and 2022.

3.2. MEDIUM-TERM STRATEGY AND TARGETS

The Czech Republic's Convergence Programme aims at continuing to meet is medium-term objective (MTO) throughout the forecast period – a structural deficit of 1% of GDP in 2019 and 0.75% of GDP as of 2020 – in line with the updated minimum MTOs for 2020-2022. Based on the information in the Convergence Programme, the general government balance is forecast to be in surplus in 2019 and in slight deficit throughout 2020-2022. The structural balance is expected to follow a similar trend. The MTO reflects the objectives of the Pact.

The structural balance, as recalculated by the Commission, following the commonly agreed methodology, on the basis of the information in the Convergence Programme, is expected to worsen from a neutral stance in 2019 to a deficit of 0.5% of GDP by 2022 (Table 2). The Commission 2019 spring forecast expects the structural balance to remain in deficit in both 2019 and 2020, with values very much in line with the Programme.

The Programme expects total revenues of 41.3% of GDP in 2020, which is slightly below the expectations in the Commission 2019 spring forecast due to expected lower contribution of social contributions. The expenditure forecast in the Programme (41.9% of GDP) is also mildly below the Commission forecast due to some small differences for intermediate consumption, social payments and gross fixed capital formation.

Compared to the 2018 Convergence Programme, the headline balance for 2020-2021 was significantly revised from a surplus of around 1% of GDP to a deficit of around 0.2% of GDP. This is mostly due to a different assumption on the share of total expenditure in GDP –around 39.5% compared to the current 41.5%, i.e. a difference of 2 percentage points. The forecast of the structural balance for 2020-2021 was also revised downwards from a surplus of 0.2% of GDP to a deficit of 0.3 to 0.5% of GDP.

In terms of the sectoral composition of the headline balance, local governments were responsible for around half of the total surplus in 2018 and are currently expected to remain in positive territory up to 2022. On the other hand, the balance of the central government will be negative throughout the period and gradually worsen. The social security funds will also gradually decline to a neutral stance by 2022.

The planned targets in the previous programmes were somewhat more conservative than the outturns, particularly in 2016 and 2017. The only exception was the 2018 Programme, which estimated that the balance would continue to remain in surplus up to 2021. Overall, the MTO reflects the objectives of the Pact.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2018	2019		2020		2021	2022	Change: 2018-2022
	COM	COM	CP	COM	CP	CP	CP	CP
Revenue	**41.7**	**41.9**	**41.5**	**41.7**	**41.3**	**41.2**	**41.2**	**-0.5**
of which:								
- Taxes on production and imports	12.4	12.2	12.2	12.0	11.9	11.7	11.6	-0.8
- Current taxes on income, wealth, etc.	7.9	8.0	8.0	8.1	8.1	8.1	8.2	0.3
- Social contributions	15.7	16.1	15.9	16.2	16.0	16.2	16.3	0.6
- Other (residual)	5.7	5.5	5.4	5.4	5.3	5.2	5.1	-0.5
Expenditure	**40.8**	**41.7**	**41.2**	**41.9**	**41.5**	**41.6**	**41.7**	**0.9**
of which:								
- Primary expenditure	40.0	40.9	40.4	41.1	40.7	40.8	41.0	1.0
of which:								
Compensation of employees	9.8	10.3	10.2	10.5	10.4	10.6	10.8	0.9
Intermediate consumption	6.1	6.1	5.9	6.0	5.9	5.8	5.7	-0.4
Social payments	14.9	15.3	15.2	15.5	15.4	15.4	15.3	0.4
Subsidies	2.3	2.2	2.2	2.2	2.2	2.1	2.1	-0.2
Gross fixed capital formation	4.1	4.2	4.1	4.3	4.2	4.3	4.6	0.4
Other (residual)	2.8	2.7	2.7	2.7	2.6	2.6	2.5	-0.2
- Interest expenditure	0.8	0.8	0.8	0.8	0.8	0.8	0.7	0.0
General government balance (GGB)	**0.9**	**0.2**	**0.3**	**-0.2**	**-0.2**	**-0.3**	**-0.5**	**-1.4**
Primary balance	**1.7**	**1.0**	**1.1**	**0.6**	**0.6**	**0.4**	**0.2**	**-1.4**
One-off and other temporary	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1
GGB excl. one-offs	**0.9**	**0.2**	**0.3**	**-0.2**	**-0.2**	**-0.3**	**-0.5**	**-1.5**
Output gap[1]	1.2	0.8	0.7	0.3	0.3	0.1	0.0	-1.3
Cyclically-adjusted balance[1]	0.4	-0.1	0.0	-0.4	-0.3	-0.4	-0.5	-0.9
Structural balance[2]	**0.4**	**-0.1**	**0.0**	**-0.4**	**-0.3**	**-0.4**	**-0.5**	**-0.9**
Structural primary balance[2]	1.2	0.6	0.8	0.4	0.5	0.3	0.2	-0.9

Notes:

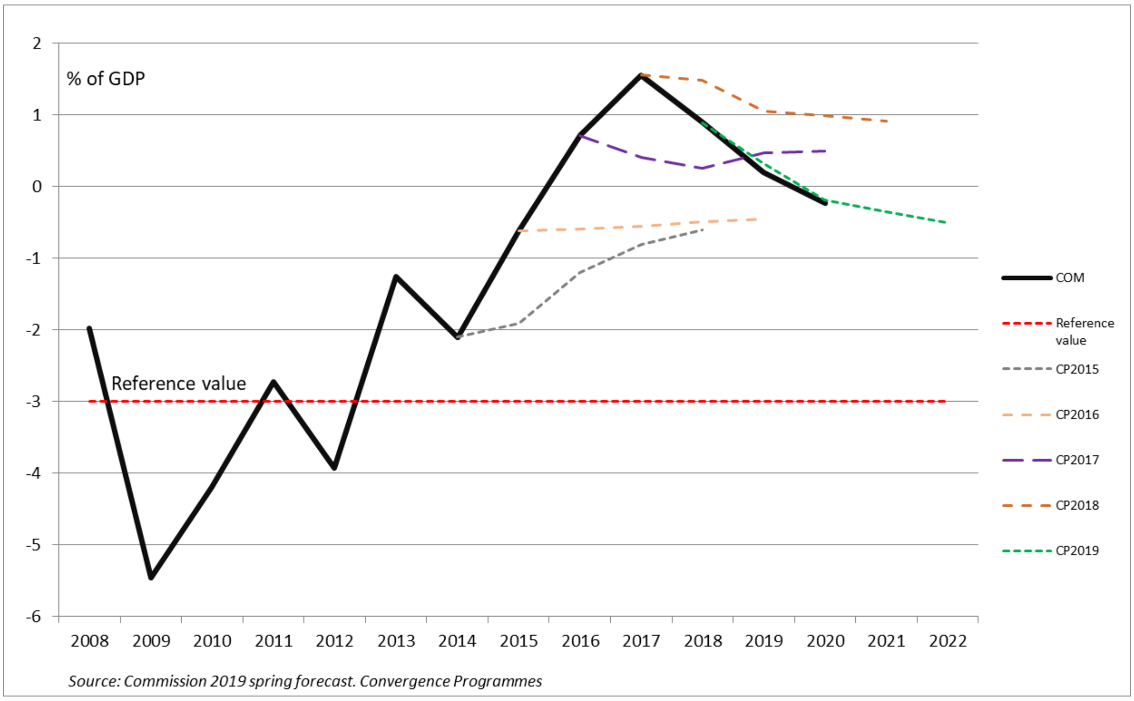
[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

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

Source :

Convergence Programme (CP); Commission 2019 spring forecasts (COM); Commission calculations.

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



3.3. MEASURES UNDERPINNING THE PROGRAMME

The aggregate discretionary measures included in the programme are mostly on the expenditure side. These expenditures are expected to decrease the headline balance by 0.8% of GDP in 2019 and by 0.3% in 2020. The impact of the measures in 2021-2022 is rather minimal. The table below sets out the overview of the measures envisaged by the programme in 2018-2022. The fiscal tagets are in general supported by plausible estimates of measures.

For 2018 the government mainly adopted expenditure measures. The most costly measure, amounting to around 0.6% of GDP, related to the rise of public wages for civil servants, teachers, security forces and doctors. Other measures included higher cash social benefits (0.2% of GDP) and healthcare expenditure (0.2% of GDP).

In 2019 the wage bill will continue to grow at simillar rates as in 2018 (0.5% of GDP), with teachers alone receiving a significant increase of 0.3% of GDP due to salary increases, partly associated with the regional education reform. Pension expenditure is also expected to rise significantly (0.3% of GDP) due to the decision to increase basic pensions as well as pensions for people above 85 years of age. There is also a slight increase in other cash and in-kind social benefits, particularly public transport discounts for students and pensioners.

Year 2020 will witness some developments on the revenue side but the impact will be neutral. While the final phases of the electronic evidence of sales are expected to bring additional revenues of around 0.1% of GDP via improved tax compliance, the expected reduction of VAT for certain goods and service will counterbalance the gains. On the expenditure side, the programme envisages an increase of pensions above the standard indexation formula (0.1% of GDP) and an increase of the standard parental allowance (0.2% of GDP).

Main budgetary measures included in the Programme (% of GDP)

Revenue	Expenditure
2018	
	• Increase in public sector wages (0.6%) • Increase in cash social benefits (0.2%) • Increase in healthcare expenditure (0.2%)
2019	
	• Increase in public sector wages (0.5%) • Increase in the pension flat rate and higher pensions for older pensioners (0.3)
2020	
• Implementation of the final phases of the electronic evidence of sales (0.1%) • Reduction of VAT for certain services and goods (-0.1%)	• Increase in pensions above the indexation formula (0.1%) • Increase in parental allowances (0.2%)

Note: The table refers to the main measures included in the 2019 Convergence Programme that have an incremental budgetary impact over the programme period. 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.

Most of the measures underpinning the programme were also included in the Commission 2019 spring forecast. On the expenditure side, the Commission did not include the temporary expenditure arising in 2018 and 2019 from the state guarantee claim for a power plan construction on Turkey. On the revenue side, the increase in tax collection and social security following the raise of the public wage bill was not deemed to be a discretionary measure. It also did not include some other measures below 0.1% of GDP that were either too small or not sufficiently detailed in the Convergence Programme.

3.4. DEBT DEVELOPMENTS

Gross general government debt declined to 32.7% of GDP in 2018, 2 percentage points lower than in 2017. Net financial debt represented 17.7% of GDP, down from 19.7% in 2017. The decline was mainly driven by the primary balance and impact of real economic growth and inflation, offset by a significant but declining stock-flow adjustment. The average maturity for refinancing debt increased to 5.4 years while the short-term interest fixation debt remained rather constant. The foreign currency exposition of the state debt, out of which around 97% is in relation to the euro, dropped to 3.2% of GDP. Local governments hold only 4% of the general government debt, a figure that has been decreasing due to the headline surplus and, to some extent, the fiscal responsibility rules in place.

Table 3: Debt developments

(% of GDP)	Average 2013-2017	2018	2019		2020		2021	2022
			COM	CP	COM	CP	CP	CP
Gross debt ratio[1]	**39.7**	**32.7**	**31.7**	**31.5**	**31.1**	**30.8**	**30.2**	**29.7**
Change in the ratio	-2.0	-2.0	-1.0	-1.2	-0.6	-0.7	-0.6	-0.5
Contributions[2]:								
1. Primary balance	**-0.7**	**-1.7**	**-1.0**	**-1.1**	**-0.6**	**-0.6**	**-0.4**	**-0.2**
2. "Snow-ball" effect	**-0.7**	**-0.9**	**-0.7**	**-0.9**	**-0.5**	**-0.5**	**-0.5**	**-0.5**
Of which:								
Interest expenditure	1.1	0.8	0.8	0.8	0.8	0.8	0.8	0.7
Growth effect	-1.1	-1.0	-0.8	-0.7	-0.7	-0.7	-0.7	-0.6
Inflation effect	-0.6	-0.7	-0.7	-0.9	-0.6	-0.6	-0.6	-0.6
3. Stock-flow adjustment	**-0.6**	**0.6**	**0.7**	**0.8**	**0.5**	**0.4**	**0.3**	**0.2**
Of which:								
Cash/accruals diff.				0.0		0.0	0.0	0.0
Acc. financial assets				0.8		0.4	0.3	0.2
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.

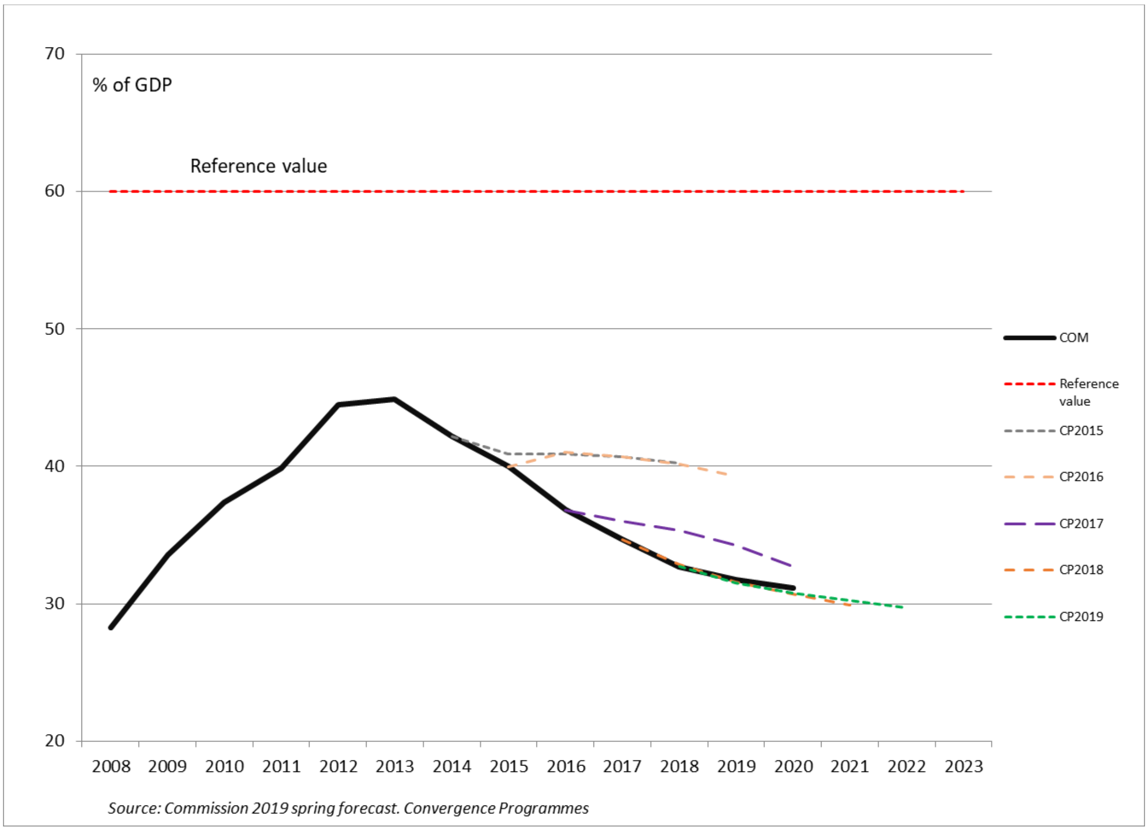
[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets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

Source :

Commission 2019 spring forecast (COM); Convergence Programme (CP), Commission calculations.

The Convergence Programme debt dynamics are very much in line with those in the Commission 2019 spring forecast, which estimates a gross debt ratio of 31.7% of GDP in 2019 and 31.1% in 2020. The Programme estimations are around 0.2 to 0.3 percentage points below the Commission forecast due to a higher primary balance and a different inflation effect in 2019. Between 2019 and 2022, the Convergence Programme sees debt decreasing by around 1.8 percentage points to 29.7% of GDP. Interest expenditure is expected to stabilise to around 0.8% of GDP throughout most years before decreasing to 0.7% towards the end of the forecast horizon. The level of stock-flow adjustment is expected to decrease gradually, on the back of lower accumulation of financial assets. Looking backwards, previous Convergence Programmes had a tendency to be more conservative in their debt projections than the actual outturn (Figure 2).

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



3.5. RISK ASSESSMENT

The Convergence Programme's targets for the headline budget balance, the recalculated structural balance and debt ratio are broadly in line with the Commission 2019 spring forecast. Both the Czech authorities and the Commission agree that in light of the slowing economic growth, the objective is to maintain a stable trajectory of the structural balance and continue to meet the medium-term objective under the preventive arm of the Stability and Growth Pact.

The Commission 2019 spring forecast suggests that the Czech Republic witnessed a significant amount of revenue windfalls[1] in 2018 (above 0.5% of GDP). This is mostly due to the good economic times and the strong wage growth across the economy, generating a significant amont of tax revenues. While the MTO in 2018 would still be achieved when excluding these windfalls, the multi-annual perspective provides a slightly different picture. When cumulated over 2 years, the distance to MTO, excluding the windfalls, turns slightly positive in 2019. Similarly, when cumulated over 3 or 4 years, the MTO appears not to be achieved in 2020 if the windfalls are excluded. Nevertheless, in line with the moderating growth of the economy and a more sustainable wage growth as of 2020, the nature of these windfalls may be temporary and should not threaten the overall achievement of the MTO.

[1] Windfalls (or shortfalls) are defined as the difference between the actual growth of revenues and the revenue growth expected according to nominal GDP growth with elasticity 1, corrected for discretionary revenue measures.

The most idiosyncratic risks steemed from the Commission 2019 spring forecast are associated with the high dependency on the external sector and the continued labour shortages associated with the fast real wage growth in the economy. A slower demand from the country's major trade partners may stiffle the growth rate of exports and detract their contribution to GDP growth. As a small open economy, any escalation in global trade tensions can significantly hold down further growth. While the wage growth has stimulated private consumption, the main driver of growth over the forecast horizon, it may also have started to affect competitiveness. Despite an expected moderation in wage growth dynamics as of 2020, there is little room for further increases in employment with the currently available workforce. In this context, the number of vacancies continues to increase in all sectors and across all skill levels.

On the revenue side, there are on-going discussions at the government level to amend certain tax laws, particularly on gambling, alcohol and tobacco, and impose a new so-called digital tax. Additional tax revenue could also be generated by the introduction of the generalised reverse charge mechanism, which is expected to further increase VAT compliance. All these measures represent a positive risk, as their impact is not part of the baseline scenario.

Investment co-financed from EU funds also adds recurrent uncertainty to expenditure estimates, given its recent volatility. The 2018 Covergence Programme underestimated the increase in absorption in 2018, which has led to different outturns for both intermediate consumption and gross fixed capital formation. The previous track record of back-loaded investment and the high volatility constitute a downside side for the investment forecast over the period covered by the programme.

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

The Czech Republic is subject to the preventive arm of the Stability and Growth Pact. The Council did not address a SGP-related recommendation to the country in 2018. Both the general government balance and the structural balance registered respectively a surplus of 0.9% of GDP and 0.4% of GDP in 2018. Based on the outturn data, the Czech Republic complies with the requirement of the preventive arm of the Stability and Growth Pact.

According to the Convergence Programme, the recalculated structural balance is set to decrease from a surplus of 0.4% of GDP in 2019 to a neutral stance in 2019 and a deficit of 0.3% of GDP in 2020. Beyond that, the structural deficit is forecast to slightly increase to around 0.5% of GDP. Overall, the structural balance is expected to remain above the MTO - a structural deficit of 1% in 2019 and 0.75% of GDP as of 2020 – throughout the forecast period.

The Commission 2019 spring forecast also expects the country to remain above its MTO in both 2019 and 2020 and comply with the requirements of the preventive arm. After three years of staying on the surplus side, the structural balance is expected to move into negative territory, reaching a deficit of 0.1% of GDP in 2019 and 0.4% in 2020. This is driven mostly by the worsening of the headline balance and a still positive output gap.

Table 6: Compliance with the requirements under the preventive arm

(% of GDP)	2018	2019		2020	
Background budgetary indicators[1]					
Medium-term budgetary objective (MTO)	-1.0	-1.0		-0.75	
Structural balance[2] (COM)	0.4	-0.1		-0.4	
Setting the required adjustment to the MTO					
Structural balance based on freezing (COM)	0.9	-0.1		-	
Position vis-à-vis the MTO[3]	At or above the MTO	At or above the MTO		At or above the MTO	
Required adjustment[4]	0.0	0.0		0.0	
Required adjustment corrected[5]	-2.0	-1.9		-0.6	
Corresponding expenditure benchmark[6]	8.9	9.2		6.2	
Compliance with the required adjustment to the MTO					
	COM	**CP**	**COM**	**CP**	**COM**
Structural balance pillar					
Change in structural balance[7]	Compliance				
One-year deviation from the required adjustment[8]					
Two-year average deviation from the required adjustment[8]					
Expenditure benchmark pillar					
Net public expenditure annual growth corrected for one-offs[9]	Compliance				
One-year deviation adjusted for one-offs[10]					
Two-year deviation adjusted for one-offs[10]					
Finding of the overall assessment	**Compliance**				

Legend

'*Compliance*' - the recommended structural adjustment or a higher adjustment is being observed.

'*Some deviation*' - a deviation from the recommended structural adjustment is being observed, but it is below the threshold for a significant deviation.

'*Significant deviation*' - a deviation which has reached or breached the threshold for a significant deviation (i.e. 0.5% of GDP over one year, 0.25% of GDP over two years on average).

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 point 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, 2018 edition, p.38.). In case of a SDP, the requirement corresponds to the Council recommendation when available; otherwise it refers to the Commission recommendation to the Council.

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

[6] 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.

[7] Change in the structural balance compared to year t-1. Expost assessment (for 2018) is carried out on the basis of Commission 2019 spring forecast.

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

[9] Net public expenditure annual growth (in %) corrected for discretionary revenue measures, revenue measures mandated by law and one-offs (nominal)

[10] 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.

Source:

Convergence Programme (CP); Commission 2019 spring forecast (COM); Commission calculations.

5. DEBT SUSTAINABILITY ANALYSIS AND FISCAL RISKS

The Czech Republic does not appear to face fiscal sustainability risks in the short run.[2]

Based on Commission 2019 spring forecasts and a no-fiscal policy change scenario beyond the forecast horizon, government debt, projected at 31.7% of GDP in 2019, is expected to decrease to 29.1% by 2024 and then to increase to 31.6% by 2029, thus remaining well below the 60% of GDP Treaty threshold. Sensitivity analysis shows similar risks. Overall, this highlights low risks for the country in terms of debt sustainability in the medium term.[3] The full implementation of the Convergence Programme would lead to a decline in the debt by 2029, below the 60% of GDP reference value in 2029.

The medium-term fiscal sustainability risk indicator S1[4] is at -2.1 percentage points of GDP, primarily related to the low level of government debt and the favourable initial budgetary position. This indicator thus signals low risks in the medium term. The full implementation of the Convergence Programme would put the sustainability risk indicator S1 at -2.7 percentage points of GDP. Based on the debt sustainability analysis and the S1 indicator, overall medium-term fiscal sustainability risks are, therefore, low. Fully implementing the fiscal plans in the Convergence Programme would further decrease those risks.

The long-term fiscal sustainability risk indicator S2 is at 4.7% of GDP. Therefore, in the long term, the Czech Republic appears to face medium fiscal sustainability risks due to the projected ageing costs, contributing 4.6 percentage points of GDP. Full implementation of the programme would put the S2 indicator at 4.8 percentage points of GDP, leading to a slightly higher long-term risk, while the S2 risk category would remain medium.[5] The debt sustainability analysis discussed higher points to low risks so that, overall, long-term fiscal sustainability risks are assessed as medium for the Czech Republic.

The retirement age was capped at 65 years and the alignment of life expectancy with the statutory retirement age is not automatic. Since changes to the statutory retirement rate are left to the Parliament's discretion, at the government's proposal, the current pension expenditure projections prepared on a no-policy-change basis, do not take into account any possible retirement age reviews. The Ministry of Labour and Social Affairs is expected to submit to the government in June 2019 a report on the pension system that should evaluate the current retirement age and, if considered necessary, adjust it accordingly. Nevertheless, it is unlikely that the report will propose any major changes to the current system since the current government's policy is that all insured people should spend a quarter of their lives in retirement. Recently adopted measures that made pension indexation more generous and increased pensions for older pensioners are not yet reflected in the latest age-related budgetary projections.[6]

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[2] This conclusion is based on the short-term fiscal sustainability risk indicator S0. See the note to Table 7 for a definition of the indicator.

[3] Sensitivity analysis includes several deterministic debt projections, as well as stochastic projections (see Fiscal Sustainability Report 2018 for more details).

[4] See the note to Table 7 for a definition of the indicator.

[5] The projected costs of ageing that are used to compute the debt projections and the fiscal sustainability indicators S1 and S2 are based on the projections of the 2018 Ageing Report.

[6] See the 2019 Country Report for the Czech Republic issued by the European Commission, published on 27 February 2019.

Table 7: Debt sustainability analysis and sustainability indicators

Time horizon				Commission Scenario		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]				-2.1	LOW risk	-2.7	LOW risk
of which	Initial Budgetary Position			-0.9		-0.8	
	Debt Requirement			-2.2		-2.7	
	Cost of Ageing			0.9		0.8	
		of which	Pensions	0.1		0.1	
			Health care	0.3		0.2	
			Long-term care	0.3		0.2	
			Other	0.3		0.3	
Long-term				**MEDIUM risk**			
DSA [2]				LOW risk			
S2 indicator [4]				4.7	MEDIUM risk	4.8	MEDIUM risk
of which	Initial Budgetary Position			0.0		0.2	
	Cost of Ageing			4.7		4.6	
		of which	Pensions	2.2		2.3	
			Health care	0.8		0.7	
			Long-term care	1.1		1.1	
			Other	0.6		0.5	

Source: Commission services; 2019 Convergence Programme.

Note: the 'Commission' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2019 forecast until 2020. 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 2018 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 2033. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2021 for Commission 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 2018.

6. FISCAL FRAMEWORK

The fiscal responsibility law adopted in 2017 strengthened the Czech fiscal framework, while transposing most of the provisions of the Six-pack's Directive on the budgetary framework requirements. The law introduced three fiscal rules: a structural balance of maximum -1% of GDP, a cap of 55% of GDP on the general government debt and a cap of 60% of the 4-year average of revenues for local government's debt. The Ministry of Finance is expected to assess the compliance with this new debt management rule every year. The outstanding transposition on independent audits has been adopted by the Parliament and sent for publication. However, fiscal coordination among the various levels of the general government remains rather low, while a third of public expenditure is outside the general government budget.

The Czech Fiscal Council, operational since early 2018, is tasked to assess compliance with the expenditure framework and the long-term fiscal sustainability. More specifically, it assesses the compliance with the debt ceiling of 55% of GDP (currently not constraining since the gross debt is around 30%) and the setting of total public sector expenditure consistent with a structural balance of maximum -1% of GDP as of 2019. On the long-term sustainability, the Fiscal Council issued their first report and provided more pessimistic projections than the Commission due to a different assumption regarding demographics and the no-policy-change scenario. The Committee on Budgetary Forecasts also became operational and, as of July 2018, started assessing the macroeconomic and fiscal forecasts prepared by the government. The Committee's role is to evaluate the robustness of macroeconomic and fiscal forecasts underlying the budgetary process. It has 11 members from the financial sector, the social partners and academia, and some represent institutions that prepare their own economic forecast.

The Czech authorities notified the Council of the European Union in April 2019 that the Czech Republic is adhering to the Treaty on Stability, Coordination and Governance in the EMU. However, until it joins the euro area, the country is effectively bound only by the governance section of the treaty. The fiscal core of the treaty, namely the Fiscal Compact, which can be binding for non-euro area Member States only on a voluntary basis, was not subject to such a declaration. The Czech Republic was the last Member State to ratify the treaty, except for the United Kingdom.

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.

7. SUMMARY

In 2018, the Czech Republic achieved the MTO, having a structural surplus of 0.4% of GDP. Therefore, it is compliant with the requirements of the preventive arm of the Pact.

According to the Convergence Programme, the recalculated structural balance is expected to gradually worsen and move into negative territory but remain above the MTO. This is confirmed by the Commission 2019 spring forecast, where the fiscal position is expected to loosen in 2019 and 2020, reaching a structural deficit of 0.4% of GDP, above the MTO - a structural deficit of 1% of GDP in 2019 and 0.75% of GDP as of 2020. On this basis, the Czech Republic is assessed to be compliant with the requirements of the preventive arm of the Pact in both 2019 and 2020.

8. ANNEXES

Table I. Macroeconomic indicators

	2001-2005	2006-2010	2011-2015	2016	2017	2018	2019	2020
Core indicators								
GDP growth rate	3.9	2.5	1.7	2.5	4.4	2.9	2.6	2.4
Output gap [1]	0.7	2.3	-1.6	-0.1	1.3	1.2	0.8	0.3
HICP (annual % change)	2.0	2.6	1.6	0.6	2.4	2.0	2.4	2.0
Domestic demand (annual % change) [2]	3.6	2.0	1.3	1.1	3.5	3.9	3.3	2.7
Unemployment rate (% of labour force) [3]	7.9	6.2	6.4	4.0	2.9	2.2	2.2	2.3
Gross fixed capital formation (% of GDP)	29.0	28.1	25.8	24.9	24.8	26.2	26.3	26.2
Gross national saving (% of GDP)	25.9	24.9	24.2	26.1	26.2	26.2	25.7	25.4
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	-4.8	-2.9	-2.1	0.7	1.6	0.9	0.2	-0.2
Gross debt	26.7	30.9	42.3	36.8	34.7	32.7	31.7	31.1
Net financial assets	10.1	3.1	-16.9	-17.2	-12.2	n.a	n.a	n.a
Total revenue	39.6	39.1	40.7	40.2	40.5	41.7	41.9	41.7
Total expenditure	44.4	42.0	42.8	39.5	38.9	40.8	41.7	41.9
of which: Interest	1.0	1.1	1.3	0.9	0.7	0.8	0.8	0.8
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	-0.9	-2.3	-0.5	-1.8	-1.1	-1.0	-0.8	0.0
Net financial assets; non-financial corporations	-94.2	-93.0	-83.8	-76.8	-78.9	n.a	n.a	n.a
Net financial assets; financial corporations	-3.0	-4.9	-1.8	-5.6	-10.2	n.a	n.a	n.a
Gross capital formation	19.4	18.5	17.1	17.5	17.5	16.9	16.7	16.3
Gross operating surplus	28.1	29.5	29.4	30.5	29.9	28.3	28.1	28.3
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	2.0	1.9	2.4	1.6	0.3	1.1	1.2	1.0
Net financial assets	67.0	61.3	74.2	81.7	82.2	n.a	n.a	n.a
Gross wages and salaries	30.0	30.1	31.0	31.3	32.0	33.2	33.5	33.6
Net property income	3.8	3.6	3.3	3.4	3.0	2.8	2.9	2.9
Current transfers received	16.3	16.9	17.8	17.9	17.9	18.1	18.4	18.6
Gross saving	6.1	6.7	6.2	6.2	5.0	5.8	5.9	5.7
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	-3.8	-3.3	-0.2	0.6	0.8	1.0	0.6	0.7
Net financial assets	20.3	33.6	28.5	18.1	19.3	n.a	n.a	n.a
Net exports of goods and services	-0.1	2.9	5.4	7.7	7.5	6.2	5.4	5.2
Net primary income from the rest of the world	-3.7	-6.7	-6.6	-6.5	-6.2	-5.1	-5.0	-4.8
Net capital transactions	0.2	1.2	1.9	0.5	0.5	1.0	1.1	1.3
Tradable sector	53.4	51.8	51.6	52.1	52.2	51.4	n.a	n.a
Non tradable sector	37.5	38.8	38.4	37.8	37.5	38.5	n.a	n.a
of which: Building and construction sector	5.9	6.0	5.2	4.9	4.8	5.2	n.a	n.a
Real effective exchange rate (index, 2000=100)	78.3	96.1	96.5	92.9	98.2	105.8	106.0	106.4
Terms of trade goods and services (index, 2000=100)	102.6	100.7	99.4	102.0	100.9	100.6	100.5	100.5
Market performance of exports (index, 2000=100)	72.4	95.0	106.6	109.1	110.6	111.8	111.8	111.3

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2015 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 2019 spring forecast

Mandatory variables not included in the Convergence Programme

The Convergence Programme contains all mandatory variables.