EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 23 May 2018

Assessment of the 2018 Convergence Programme for the Czech Republic

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

This document assesses the 2018 Convergence Programme for the Czech Republic (hereafter called the Convergence Programme), which was submitted to the Commission on 30 April 2018 and covers the period 2018-2021. It was approved by the government on 30 April 2018. Additionally, it was 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 7 March 2018 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 2018 spring forecast. The following section presents the 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 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.

2. MACROECONOMIC DEVELOPMENTS

The macroeconomic scenario in the Convergence Programme projects a slight deceleration in GDP growth, from 4.4% in 2017 to 3.6% in 2018 and 3.3% in 2019 (Table 1). GDP growth is expected to be driven by domestic demand in both years, while net exports are expected to produce a small negative contribution. Private consumption is estimated to be the main contributor to domestic demand growth, supported by growing real disposable income and a declining savings rate. Investment is projected to follow the recovery initiated in 2017 and underpin growth in 2018 and 2019, encouraged by the tight labour market. The external sector is expected to maintain its dynamics, but imports are likely to outpace exports in both years.

Compared to the previous 2017 Convergence Programme, GDP shows a significant upward revision in both years; from 2.5% to 3.6% in 2018 and from 2.4% to 3.3% in 2019. The main reasons for these revisions are better-than-expected growth in 2017 (1.9 percentage points above the outlook of last year's programme) and the current dynamism of household consumption and investment. The forecast for HICP inflation did not change significantly: it was revised from 1.8% to 1.9% in 2018 and remained unchanged at 1.9% in 2019.

The Commission 2018 spring forecast expects GDP growth to reach 3.4% in 2018 and 3.1% in 2019, which is slightly lower than the Convergence Programme's forecast. Both forecasts project strong private consumption growth to continue, although rates in the programme are higher, with 4.3% in 2018 and 4.1% in 2019, as compared to 3.9% and 3.1%, respectively, in the Commission forecast. Investment is expected to growth firmly, but the Programme predicts a more marked slowdown in 2019. As for net exports, both the Commission and the Programme scenario expect a small negative contribution to GDP growth in 2018, narrowing to zero in 2019. The programme scenario does not include the impact of any structural reforms.

The Convergence Programme and Commission forecast both expect a tight labour market marked with a low unemployment rate and rapid wage inflation. Both forecasts point to the unemployment rate falling to 2.4% in 2018 and remaining broadly unchanged in 2019. Wage growth rates are very similar in both documents, though marginally higher in the Programme. As for prices, the Commission expects a slightly higher HICP inflation in 2018 (2.1%, 0.2 percentage point above the programme) but marginally lower in 2019 (1.8%, 0.1 percentage points below the Programme). The Commission forecasts a significantly higher GDP deflator (2.7%) than the Convergence Programme (1.5%) in 2018. The difference changes and gets smaller in 2019: 1.5% according to the Commission forecast, and 1.8% according to the Programme.

The Convergence Programme presents alternative macroeconomic scenarios on the grounds of three main risks for the Czech economy: slower economic growth in the EU, higher oil prices, and an excessive tightening of monetary policy resulting in additional rises in domestic interest rates. The programme identifies signs of overheating in the labour market with implications for further economic growth.

Table 1: Comparison of macroeconomic developments and forecasts

	2017		2018		2019		2020	2021
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	4.4	4.4	3.4	3.6	3.1	3.3	2.6	2.4
Private consumption (% change)	4.0	4.0	3.9	4.3	3.1	4.1	2.9	2.6
Gross fixed capital formation (% change)	5.4	5.4	5.4	5.7	4.8	4.4	3.0	2.8
Exports of goods and services (% change)	6.5	6.5	4.8	5.2	4.7	4.9	4.6	4.4
Imports of goods and services (% change)	5.8	5.8	5.6	6.0	5.1	5.4	4.8	4.5
Contributions to real GDP growth:								
- Final domestic demand	3.5	3.5	3.6	3.9	3.1	3.4	2.5	2.3
- Change in inventories	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	1.0	1.0	-0.2	-0.2	0.0	-0.1	0.1	0.2
Output gap[1]	0.9	0.7	1.2	1.1	1.4	1.1	0.7	0.2
Employment (% change)	1.6	1.6	0.7	0.7	0.2	0.2	0.2	0.1
Unemployment rate (%)	2.9	2.9	2.4	2.4	2.4	2.4	2.3	2.3
Labour productivity (% change)	2.8	2.8	2.6	3.0	2.9	3.2	2.5	2.3
HICP inflation (%)	2.4	2.4	2.1	1.9	1.8	1.9	1.8	1.7
GDP deflator (% change)	1.4	1.4	2.7	1.5	1.5	1.8	1.7	1.9
Comp. of employees (per head, % change)	6.7	6.7	6.8	7.0	6.2	6.3	5.3	5.3
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.0	1.0	0.8	0.4	0.2	0.4	0.6	1.0

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 2018 spring forecast (COM); Convergence Programme (CP).

The output gaps, as recalculated by the Commission based on the information in the Convergence Programme following the commonly agreed methodology, are in positive territory throughout 2017–2019. They are expected to widen from 0.7% of potential GDP in 2017 to 1.1% in 2018 and 2019. In comparison, the output gaps in the Commission 2018

spring forecast are slightly larger, increasing from 0.9% of potential GDP in 2017 to 1.2% in 2018 and 1.4% in 2019. This difference is explained by a higher potential growth rate in the Programme, resulting from larger gains in factor productivity compared to the Commission forecast.

Overall, the Convergence Programme macroeconomic scenario is based on plausible macroeconomic assumptions. The Programme projections for household consumption growth and productivity growth in 2018-2019 are more favourable than the Commission forecast, whereas the projections for investment growth in 2019 are more prudent.

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT DEVELOPMENTS IN 2017 AND 2018

The 2017 fiscal outcome was significantly higher than the target in the previous 2017 Convergence Programme: 1.6% of GDP instead of 0.4% of GDP. This surplus was supported by tax-rich growth on the back of a strong labour market. Investment growth fell short of previous expectations, which also contributed towards a higher surplus. Other notable developments were the marked increase of wage scales for public employees and falling debt service payments.

Overall, in 2017 total revenues grew by 6.5% and total expenditure by 4.2%, as compared to 2016. It contrasts with the last year's Convergence Programme, which expected revenue growth of 4%. The difference was mainly caused by better underlying macroeconomic developments, which boosted taxes and social security contributions; e.g. value added tax grew by 9.5% compared to the authorities' past expectation of 4.9%. On top of the favourable macroeconomic situation, measures aimed at curbing tax evasions increased the tax intake as well. While total expenditure growth was similar to the authorities' forecast, the composition was rather different, with significantly stronger wage growth (10.2% compared to 5.2%), offset by lower investment growth and declining interest payments.

Taken at face value, the headline balance for 2018 was predicted at 0.3% of GDP a year ago, while the current 2018 Convergence Programme estimates 1.5% of GDP. When comparing the current forecast for 2018 with the previous Convergence Programme, the most visible difference is higher total revenues (up by 5%). Higher expenditure on wages and also slightly higher investments partially compensate the stronger revenue side. A better-than-expected growth performance, a more favourable starting point and a slower pick-up of public investment explain much of the difference for the 2018 headline balance projection.

In 2018, the general government surplus is expected to be around 1.4% of GDP in the Commission 2018 spring forecast. While tax growth moderates marginally, public investment activity and intermediate consumption are forecast to pick up pace after the muted performance in 2017. Interest payments are expected to start increasing after three consecutive years of decline, in line with rising interest rates. Public wages are likely to continue growing by around 8% annually and pensions are being bolstered by a stronger indexation.

The Convergence Programme includes temporary expenditure items of around 0.1% of GDP, arising from a state guarantee claim for a power plant construction in Turkey. This is not considered a one-off measure in the Commission 2018 spring forecast since recurrent

guarantees for a loss-making project are economically similar to a capital injection.[1] The Commission 2018 spring forecast does not include any one-off measures beyond 2016.

3.2. MEDIUM-TERM STRATEGY AND TARGETS

The Czech Republic's Convergence Programme aims at continuing to meet its medium-term objective (MTO) – a structural deficit of 1% of GDP – throughout the forecast period. Based on the information in the Convergence Programme, the general government balance is forecast to be in surplus throughout 2019-2021. Specifically, the Convergence Programme expects a headline surplus of 1.1% of GDP in 2019, which already includes two measures passed by the government – namely increases in pensions and the regional education financing reform (see Section 3.3).

The 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), from 1.1% of GDP in 2018 to 0.6% of GDP in 2019, before changing trend and slightly increasing toward 2021. The Commission 2018 spring forecast expects the structural balance to be closing more rapidly, from a peak level of 1.2% of GDP in 2017 towards 0.2% of GDP in 2019.

The Convergence Programme assumes total revenues of 40.6% of GDP in 2019, which is broadly in line with the Commission 2018 spring forecast, with social security contributions on the slightly more positive side. The expenditure forecast is roughly the same, with small differences for interest expenditure and wages (Table 2).

In terms of the sectoral composition of the headline balance, municipalities were responsible for over half of the surplus in 2017, while the central government's balance turned positive for the first time in history. According to the authorities forecast, the strong trend of accumulation of surpluses at the municipal level is likely to become more pronounced in 2018, before starting to decline in 2019.

The headline balance targets over the forecast horizon are significantly more positive than in the 2017 Convergence Programme (Figure 1), stemming from improved macroeconomic assumptions. The MTO reflects the objectives of the Pact and is more stringent than the minimum MTO.

[1] The construction of the power plant was severely delayed and additional funding is needed to make it operational. The Czech company building the project became insolvent and the power plant was nationalised in 2016 by the Turkish government. The Czech export insurance bank, financing the project, made provisional reserves already in 2016. More recently, the state transfer to cover the potential losses was further increased from CZK 2.8 billion to CZK 4.7 billion in 2018.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2017	2018		2019		2020	2021	Change: 2017-2021
	COM	COM	CP	COM	CP	CP	CP	CP
Revenue	**40.4**	**40.3**	**40.9**	**40.4**	**40.6**	**40.5**	**40.4**	**0.0**
of which:								
- Taxes on production and imports	12.5	12.2	12.3	12.0	12.0	11.9	11.8	-0.7
- Current taxes on income, wealth, etc.	7.7	7.8	7.8	7.8	7.8	7.8	7.8	0.0
- Social contributions	15.0	15.2	15.4	15.4	15.5	15.7	15.9	0.8
- Other (residual)	5.2	5.1	5.4	5.1	5.2	5.1	5.0	-0.2
Expenditure	**38.8**	**38.9**	**39.4**	**39.5**	**39.5**	**39.5**	**39.5**	**0.7**
of which:								
- Primary expenditure	38.1	38.2	38.6	38.8	38.8	38.7	38.7	0.6
of which:								
Compensation of employees	9.1	9.3	9.3	9.6	9.7	9.7	9.8	0.7
Intermediate consumption	5.8	5.7	5.7	5.6	5.6	5.6	5.5	-0.4
Social payments	14.9	14.8	14.9	15.0	15.0	15.0	14.9	0.0
Subsidies	2.2	2.1	2.2	2.1	2.1	2.1	2.1	-0.1
Gross fixed capital formation	3.3	3.6	3.6	3.7	3.7	3.8	3.9	0.6
Other (residual)	2.7	2.7	2.9	2.7	2.6	2.6	2.5	-0.1
- Interest expenditure	0.7	0.7	0.7	0.7	0.8	0.8	0.8	0.1
General government balance (GGB)	**1.6**	**1.4**	**1.5**	**0.8**	**1.1**	**1.0**	**0.9**	**-0.7**
Primary balance	**2.3**	**2.1**	**2.2**	**1.6**	**1.8**	**1.8**	**1.7**	**-0.6**
One-off and other temporary	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**1.6**	**1.4**	**1.6**	**0.8**	**1.1**	**1.0**	**0.9**	**-0.7**
Output gap[1]	0.9	1.2	1.1	1.4	1.1	0.7	0.2	-0.5
Cyclically-adjusted balance[1]	1.2	0.9	1.0	0.2	0.6	0.7	0.8	-0.5
Structural balance[2]	**1.2**	**0.9**	**1.1**	**0.2**	**0.6**	**0.7**	**0.8**	**-0.5**
Structural primary balance[2]	2.0	1.6	1.9	1.0	1.3	1.5	1.6	-0.4

Notes:

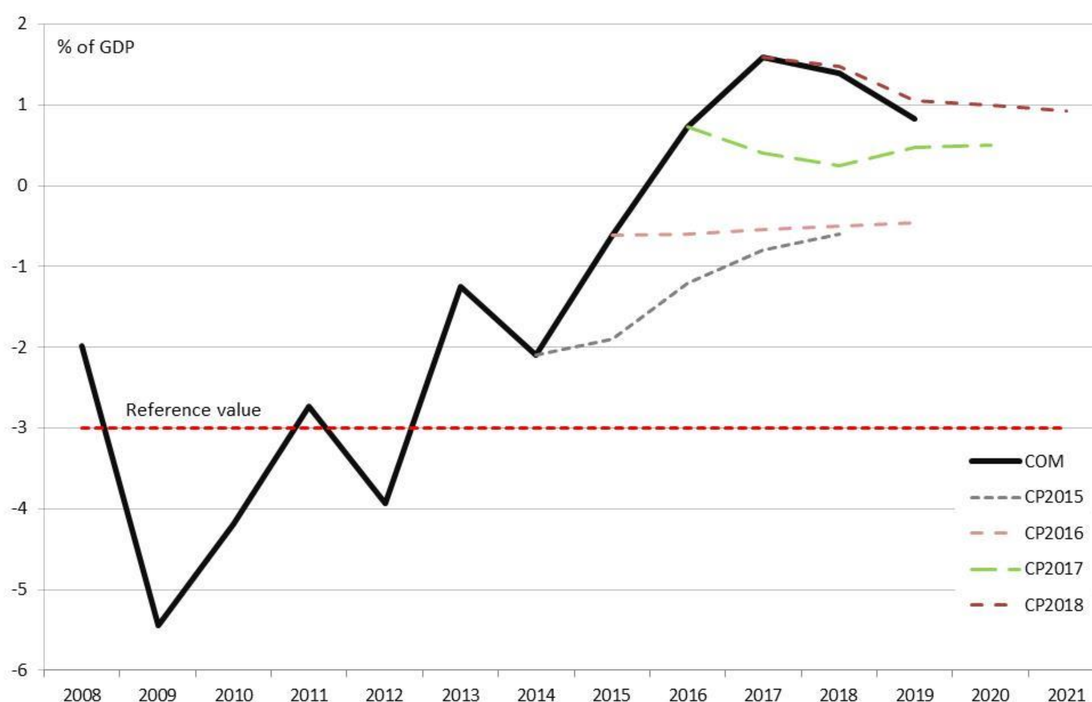
[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

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

Source :

Convergence Programme (CP); Commission 2018 spring forecasts (COM); Commission calculations.

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



Source: Commission 2018 spring forecast; Convergence Programmes

3.3. MEASURES UNDERPINNING THE PROGRAMME

Aggregate discretionary measures, presented in the Convergence Programme, are predominantly on the expenditure side, with an overall negative impact on the headline balance to the tune of 0.8% in 2018 and 0.3% of GDP in 2019. The table below sets out an overview of measures between 2017 and 2019, as presented in the Convergence Programme. The envisaged fiscal targets are in general supported by plausible estimates of measures.

For 2017, the government adopted mainly expenditure measures. These were primarily driven by an overall increase of the public wage scale of 10%, with teachers receiving a 15% increase (as of November 2017). Other measures include higher healthcare expenditure (0.2% of GDP) and subsidies for renewable energy sources (0.1% of GDP).

Going forward, in 2018 the wage bill is forecast to increase for a broad range of public employees, among others in the healthcare sector (0.4% of GDP). Cash social benefits are expected to increase due to various changes to social allowances, such as the parental allowance or child benefits, to the tune of around 0.2% of GDP. Social transfers in kind are also increasing because of higher regulatory healthcare limits (via the reimbursement decree). Year 2019 is expected to be influenced by an additional hike in pensions, as the government proposes to increase the basic pension as well as pensions above the age of 85, with total costs amounting to 0.2% of GDP. Another envisaged measure is the harmonisation of wages across regions for teachers, as part of the regional education financing reform (0.2% of GDP). A smaller measure relates to higher transport subsidies for students and pensioners for ticket prices, with estimated costs of 0.1% of GDP spread between 2018 and 2019.

Main budgetary measures

Revenue	Expenditure
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 of 2.7% (0.1% of GDP) • Increase in healthcare expenditure (0.2% of GDP) • Subsidies for renewable energy sources (0.1% of GDP)
2018	
• Additional revenues from electronic evidence of sales (0.1% of GDP)	• Increases in public sector wages (0.4% of GDP) • Higher expenditures for social policies (0.2% of GDP) • Higher social transfers in kind (0.2% of GDP)
2019	
	• Lump-sum increase in basic pension and higher pensions for older pensioners (0.2% of GDP) • Regional education financing reform (0.2% 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

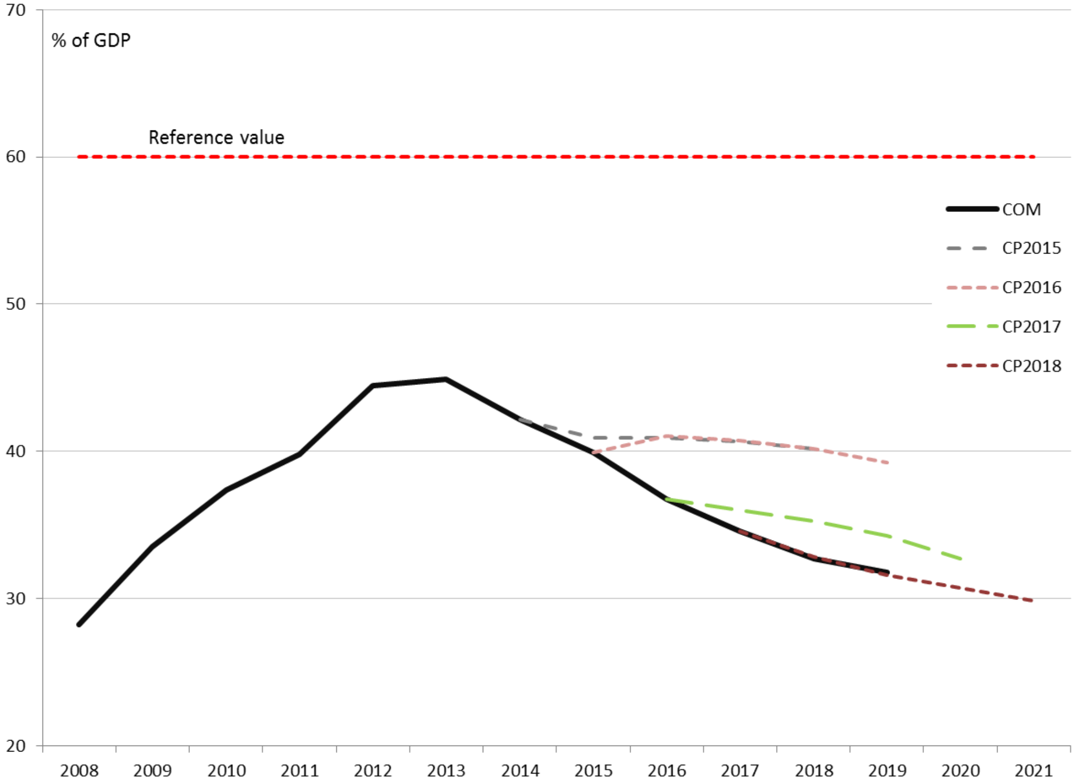
Gross general government debt declined to 34.6% of GDP in 2017 (Table 3), 2.2 percentage points lower as compared to 2016. Net financial debt[2] represented 19.6% of GDP in 2017. The primary balance and the strong nominal GDP growth (denominator effect) drove the decline of the debt-to-GDP ratio, which was offset by a sizable stock-flow adjustment related to the government issuing debt securities and depositing them on their accounts. The issuance of short-term treasury bills increased in 2017, which brought in cash revenues due to the negative yields of those debt instruments[3]. Additionally, a broadly balanced state budget contributed to lower financing needs. The average maturity of the state debt portfolio declined further to 5 years and the government outlook to reach the medium-term target of 6 years has been postponed to 2020.

[2] Net financial debt is defined as the difference between gross debt and liquid financial assets (monetary gold, Special Drawing Rights, currency and deposits, securities other than shares, shares and other equity quoted in stock exchange).

[3] Around 15% of the cash state debt in 2017 had negative interest rates.

Overall, the debt dynamics in the Commission 2018 spring forecast are broadly comparable to those in the Convergence Programme. The debt-to-GDP of 32.7% in 2018 is slightly lower than the Programme estimate (32.9%), while the opposite is true for 2019. Differences emerge from a higher primary balance in the Commission forecast in both years and from a higher GDP deflator in 2018, which reduced the debt level more than in the Convergence Programme. Taking a longer view, past debt forecasts from the convergence programmes had a tendency towards more conservative debt projections (Figure 2).

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



Source: Commission 2018 spring forecast; Convergence Programmes

The Convergence Programme expects a decline of the debt-to-GDP ratio by around 1.5 percentage points between 2018 and 2021 on average, resulting in debt falling below 30% of GDP by 2021. The Programme predicts strongly positive stock-flow adjustments over the years 2018-2021, stemming from net accumulation of financial assets that averaged 1.4 percentage points. Lower stock-flow adjustments are a positive risk which could translate into lower debt levels. Interest expenditure reached their bottom as a percentage of GDP in 2017 and is projected stabilise around 0.8% of GDP as of 2019.

Table 3: Debt developments

(% of GDP)	Average 2012-2016	2017	2018		2019		2020	2021
			COM	CP	COM	CP	CP	CP
Gross debt ratio[1]	**41.7**	**34.6**	**32.7**	**32.9**	**31.8**	**31.6**	**30.7**	**29.9**
Change in the ratio	-0.6	-2.2	-1.9	-1.7	-0.9	-1.2	-0.9	-0.8
Contributions[2] :								
1. Primary balance	**0.2**	**-2.3**	**-2.1**	**-2.2**	**-1.6**	**-1.8**	**-1.8**	**-1.7**
2. "Snow-ball" effect	**-0.2**	**-1.3**	**-1.2**	**-1.0**	**-0.7**	**-0.8**	**-0.5**	**-0.4**
Of which:								
Interest expenditure	1.2	0.7	0.7	0.7	0.7	0.8	0.8	0.8
Growth effect	-0.7	-1.5	-1.1	-1.2	-1.0	-1.0	-0.8	-0.7
Inflation effect	-0.6	-0.5	-0.9	-0.5	-0.5	-0.6	-0.5	-0.5
3. Stock-flow adjustment	**-0.6**	**1.5**	**1.5**	**1.5**	**1.4**	**1.4**	**1.4**	**1.4**
Of which:								
Cash/accruals diff.				0.0		0.0	0.0	0.0
Acc. financial assets				1.5		1.3	1.4	1.4
Privatisation				0.0		0.0	0.0	0.0
Val. effect & residual				0.0		0.1	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 2018 spring forecast (COM); Convergence Programme (CP), Comission calculations.

3.5. RISK ASSESSMENT

The Convergence Programme's targets for the headline budget balance, (recalculated) structural balance and debt are broadly in line with the Commission 2018 spring forecast. Both the Commission and the Czech authorities expect the cycle to continue, as approximated by the widening positive output gap. A sudden and abrupt slowdown of the economic cycle over the forecast horizon represents a downside risk.

The most idiosyncratic macroeconomic risks stemmed from the Commission 2018 spring forecast are associated with the labour market shortages, which are fuelling wage rises. While economic convergence might have stimulated wage growth, mounting wage pressures could contribute to an overheating of the economy via higher private consumption demand, harm business competitiveness, increase inflationary pressures and reduce the capacity of firms to react to potential adverse shocks. The current dynamics in the labour market could also deter future foreign direct investment, particularly in the manufacturing industry. Wage inflation is also seen as a risk for the competitiveness of the Czech economy in the Convergence Programme, which also points to signs of overheating in the labour market. Other macroeconomic risks reported in the Programme and the Commission 2018 spring forecast are linked to the external environment and the monetary conditions.

An important recurrent risk is the development of public investment, which is strongly linked to the EU funds cycle. Given the contraction by around 30% in 2016, investment was forecast to substantially rebound in 2017, which, however, did not fully materialise. The need to utilise potentially de-committed[4] EU funds in 2018 could give rise to higher investment expenditure, which is factored into the baseline forecast. The past track record of back-loaded investment, coupled with high volatility, constitutes a downside risk for the investment forecast in 2018.

Considering the ongoing government-formation discussions[5], implementation risks persist in view of possible changes in government priorities. The Convergence Programme also refers to a forthcoming tax reform, which seems to have been postponed to 2020. According to the initial proposal from February 2018 the overall costs were estimated at around 0.5% of GDP, while the Convergence Programme does not include a financial impact.

The assumptions for the additional revenues from the electronic evidence (recording) of sales changed due to a constitutional court decision which led to a postponement of the last two phases[6]. The government is currently proposing an amendment to the respective act which should address the concerns raised by the court. The measure represents a positive risk, as the impact is not part of the baseline scenario.

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 did not address a SGP-related recommendation to the country in 2017.

The general government balance registered a surplus of 1.6% of GDP in 2017 (see Section 3.1 for detailed information). 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 surplus is set to decrease to 1.1% and 0.6% of GDP, in 2018 and 2019 respectively. Beyond that, the structural balance is forecast to slightly increase towards 0.8% of GDP. Overall, the structural balance is to stay well above the MTO - defined as a structural balance of -1% of GDP –over the forecast period.

The Commission 2018 spring forecast also projects the country to remain above its MTO in both years. After the peak of the structural balance in 2017 (1.2% of GDP), the fiscal position is expected to loosen to 0.9% of GDP in 2018 and further to 0.2% of GDP in 2019. This development is driven by a worsening of the headline balance and a widening positive output gap. Taking into account these developments, the Czech Republic is expected to comply with the requirements of the preventive arm of the Pact in both 2018 and 2019 as the MTO continues to be met with a positive margin.

[4] It relates to EU funds for projects in 2015, which according to the N+3 rule have to be spent by 2018.

[5] Parliamentary elections were held in October 2017. The ANO party emerged as the strongest party, but lacked the majority in parliament where it lost a confidence vote in January 2018. Now the government is in a caretaker position and seeks partners to form a coalition.

[6] It was originally launched in 2016 and was planned to be implemented in four phases until 2018. The constitutional court questioned among others procedural aspects of the adoption of the law and granted an exemption of cashless payments in e-shops. The overall effect of the electronic evidence of sales is expected in the order of 0.4% of GDP on a cumulative basis over the four waves.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2017	2018		2019	
Initial position[1]					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance[2] (COM)	1.2	0.9		0.2	
Structural balance based on freezing (COM)	0.8	0.9		-	
Position vis-a -vis the MTO[3]	At or above the MTO	At or above the MTO		At or above the MTO	
(% of GDP)	**2017**	**2018**		**2019**	
	COM	**CP**	**COM**	**CP**	**COM**
Structural balance pillar					
Required adjustment[4]	Compliance				
Required adjustment corrected[5]					
Change in structural balance[6]					
One-year deviation from the required adjustment [7]					
Two-year average deviation from the required adjustment [7]					
Expenditure benchmark pillar					
Applicable reference rate[8]					
One-year deviation adjusted for one-offs[9]					
Two-year deviation adjusted for one-offs[9]					
PER MEMORIAM: One-year deviation [10]					
PER MEMORIAM: Two-year average deviation [10]					

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 2017) is carried out on the basis of Commission 2018 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 2018 spring forecast (COM); Commission calculations.

5. FISCAL SUSTAINABILITY

The Czech Republic does not appear to face fiscal sustainability risks in the short run.[7]

Based on Commission 2018 spring forecasts and a no-fiscal policy change scenario beyond the forecast horizon, government debt, at 34.6% of GDP in 2017, is expected to decrease steadily to 25.6% of GDP in 2028, thus remaining well below the 60% of GDP Treaty threshold. Over this horizon, government debt peaks in 2017. Sensitivity analysis shows similar risks.[8] Overall, this highlights low risks for the country from debt sustainability analysis in the medium term. The full implementation of the Convergence Programme would put debt on a slightly more swiftly decreasing path, reaching 22% of GDP by 2028, also well below the 60% of GDP reference value.

The medium-term fiscal sustainability risk indicator S1[9] is at -2.9 percentage points of GDP, primarily thanks to the low debt level and the favourable initial budgetary position, indicating low risks in the medium term. The full implementation of the Convergence Programme would put the sustainability risk indicator S1 at -4.4 percentage points of GDP, leading to even lower medium term risk. Overall, risks to fiscal sustainability over the medium-term are considered 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 4.2 percentage points of GDP. In the long term, the Czech Republic appears to face therefore medium fiscal sustainability risks, primarily related to the projected ageing costs (contributing 4.7 percentage points of GDP). Full implementation of the programme would nonetheless put the S2 indicator at 3.5 percentage points of GDP, leading to a lower long-term value, but remaining in the medium risk category.[10]

Updated age-related budgetary projections point to pension expenditure rising from 8.2% of GDP in 2016 to 10.9% of GDP in 2070. This expected higher increase in pension expenditure mainly reflects the capping of retirement age at 65 years. The alignment of life expectancy with statutory retirement age is not automatic; instead, the cap is to be reviewed every five years by the government, starting in 2019. Since it is left to the government's discretion, the current pension expenditure projections prepared on a no-policy-change basis, do not take into account these retirement age reviews. Besides the retirement age cap, the indexation of pensions became more generous, taking into account 50% of real wage growth rather than the previous 33% applied previously. Moreover, new policy measures - such as an increase in the basic pension amount and higher pensions for older pensioners - are bound to increase costs further and worsen the S2 sustainability indicator by 0.2-0.3 percentage points of GDP (authorities' calculations).

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[7] This conclusion is based on the short-term fiscal sustainability risk indicator S0. See the note to Table 5 for a definition of the indicator.

[8] Sensitivity analysis includes several deterministic debt projections, as well as stochastic projections (see Debt Sustainability Monitor 2017 for more details).

[9] See the note to Table 5 for a definition of the indicator.

[10] The projected costs of ageing used to compute the debt projections and the fiscal sustainability indicators S1 and S2 are based on the updated projections, endorsed by the EPC on 30 January 2018, and to be published in the forthcoming Ageing Report 2018.

Table 5. Fiscal Sustainability Assessment
Czech Republic

Time horizon				Commission 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]			-2.9	LOW risk	-4.4	LOW risk
	of which						
		Initial Budgetary Position		-1.7		-2.4	
		Debt Requirement		-2.2		-2.7	
		Cost of Ageing		0.9		0.8	
		of which					
			Pensions	0.1		0.1	
			Health-care	0.2		0.2	
			Long-term care	0.2		0.2	
			Other	0.4		0.3	
Long Term				**MEDIUM risk**		**MEDIUM risk**	
	S2 indicator [4]			4.2		3.5	
	of which						
		Initial Budgetary Position		-0.6		-1.2	
		Cost of Ageing		4.7		4.7	
		of which					
			Pensions	2.2		2.2	
			Health-care	0.8		0.8	
			Long-term care	1.1		1.1	
			Other	0.7		0.6	

Source: Commission services; 2018 stability/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 2018 forecast covering until 2019 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 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 2032. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2020 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 2015 and Debt Sustainability Monitor 2017.

6. FISCAL FRAMEWORK

The new fiscal responsibility law (Act on Fiscal Responsibility Rules No. 23/2017), in place since the beginning of 2017, has strengthened the Czech fiscal framework. This long-delayed reform addressed the main weaknesses of the fiscal framework and paved the way for establishing an independent fiscal institution, while also transposing provisions of the Six-pack's Directive on the requirements for the budgetary frameworks (Council Directive 2011/85/EU). A draft law on independent audits is currently in inter-service commenting procedure and aims to address the outstanding transposition of the Six-pack's Directive. The National Budgetary Council (NBC), tasked to independently evaluate compliance with fiscal rules, became operational in spring 2018. Its main tasks are to assess compliance with the expenditure framework and to assess the sustainability of public finance. Among others, the NBC also assesses in how far the Ministry of Finance complies with a debt ceiling of 55% of GDP (based on outturn data for 2017, the debt rule is currently not constraining as public debt reached 34.6% of GDP). Another aim of the new fiscal framework is to strengthen expenditure ceilings by directly linking the country-specific MTO with the national budgetary methodology. These ceilings are based on a cyclically-adjusted revenue forecast. As of 2018, municipal and regional governments are subject to more stringent debt rules overseen by the Ministry of Finance. If their debt level reaches 60% of the four-year average revenues, local governments have to decrease it by 5% of this excess. Based on older 2016 data, some 6.5% of municipalities breached this threshold, while all regional governments complied with it. 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.

The NBC is currently setting-up the Committee for budgetary forecasts, which will replace the previously used expert forecasting panel. This Committee should evaluate the robustness of macroeconomic and fiscal forecasts underlying the budgetary process and will comprise experts from the main public and private sector institutions. Immediately after the Ministry of Finance releases the forecasts, the Committee should publish an assessment of the macroeconomic and budgetary projections.

The Czech government pledged on 14 February 2018 to ratify the intergovernmental Treaty on Stability, Coordination and Governance in the EMU (TSCG). This is the second attempt of the Czech Republic to adopt the TSCG, following the approval by the previous government in 2014 and its unsuccessful passage through Parliament. The key element of the treaty, the Fiscal Compact, is not binding for non-euro area countries and the Czech government does not intend to adhere to it voluntarily.

7. SUMMARY

In 2017, the Czech Republic overachieved the MTO, with a structural surplus of 1.2% of GDP and was hence compliant with the requirements of the preventive arm of the Pact.

According to the Convergence Programme, the (recalculated) structural balance is expected to somewhat worsen until 2019, but nevertheless to remain positive. This is also confirmed by the Commission 2018 spring forecast, where the fiscal position is expected to loosen in 2018 and 2019, reaching a structural balance of 0.2% of GDP in 2019. With regards to the MTO, the Commission forecast predicts the structural balance to be well above the MTO over the forecast period. On this basis the Czech Republic is assessed to be compliant with the requirements of the preventive arm of the Pact in both 2018 and 2019.

8. ANNEXES

Table I. Macroeconomic indicators

	2000-2004	2005-2009	2010-2014	2015	2016	2017	2018	2019
Core indicators								
GDP growth rate	3.5	3.4	1.1	5.3	2.6	4.4	3.4	3.1
Output gap [1]	0.1	3.2	-1.8	-0.3	-0.4	0.9	1.2	1.4
HICP (annual % change)	2.5	2.7	1.7	0.3	0.6	2.4	2.1	1.8
Domestic demand (annual % change) [2]	3.7	2.3	0.5	5.9	1.5	3.7	3.9	3.4
Unemployment rate (% of labour force) [3]	8.1	6.3	6.8	5.1	4.0	2.9	2.4	2.4
Gross fixed capital formation (% of GDP)	29.4	28.3	25.9	26.5	25.0	25.2	25.3	25.6
Gross national saving (% of GDP)	26.1	25.8	23.3	26.4	26.2	26.9	26.8	26.4
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-4.9**	**-2.6**	**-2.8**	**-0.6**	**0.7**	**1.6**	**1.4**	**0.8**
Gross debt	**24.5**	**29.0**	**41.7**	**40.0**	**36.8**	**34.6**	**32.7**	**31.8**
Net financial assets	**12.6**	**6.6**	**-14.5**	**-19.8**	**-18.3**	**n.a**	**n.a**	**n.a**
Total revenue	39.2	39.1	40.4	41.1	40.2	40.4	40.3	40.4
Total expenditure	44.2	41.8	43.2	41.7	39.4	38.8	38.9	39.5
of which: Interest	1.0	1.1	1.3	1.1	0.9	0.7	0.7	0.7
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-0.9**	**-2.4**	**-0.7**	**-0.1**	**-1.5**	**-1.7**	**-1.5**	**-1.6**
Net financial assets; non-financial corporations	**-96.3**	**-92.9**	**-86.9**	**-77.1**	**-71.5**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**-1.4**	**-5.2**	**-2.2**	**-1.5**	**-2.6**	**n.a**	**n.a**	**n.a**
Gross capital formation	19.8	19.0	16.8	17.6	17.9	18.2	18.2	18.4
Gross operating surplus	28.0	29.5	28.9	31.1	30.5	29.9	30.2	30.3
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**1.9**	**1.8**	**2.4**	**2.0**	**1.4**	**1.1**	**1.0**	**0.9**
Net financial assets	**68.8**	**60.3**	**71.6**	**79.2**	**81.2**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	29.8	30.0	31.0	30.7	31.3	32.0	32.5	33.0
Net property income	3.9	3.7	3.3	3.3	3.0	3.2	3.1	2.9
Current transfers received	16.5	16.5	17.9	17.4	17.2	17.4	17.5	17.7
Gross saving	6.2	6.5	6.4	6.4	5.9	5.6	5.3	5.2
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.9**	**-3.3**	**-1.1**	**1.2**	**0.4**	**1.0**	**0.8**	**0.2**
Net financial assets	**16.4**	**31.4**	**32.4**	**19.4**	**11.3**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-1.0	2.7	4.8	6.0	7.5	7.2	7.3	6.7
Net primary income from the rest of the world	-3.2	-6.1	-6.8	-6.8	-6.4	-5.6	-5.8	-5.9
Net capital transactions	0.3	0.8	1.7	2.8	0.6	0.5	0.5	0.5
Tradable sector	53.9	52.3	51.1	52.4	52.5	52.3	n.a	n.a
Non tradable sector	37.3	38.2	39.0	37.6	37.4	37.5	n.a	n.a
of which: Building and construction sector	5.8	5.9	5.4	5.1	4.9	4.7	n.a	n.a
Real effective exchange rate (index, 2000=100)	73.9	93.1	98.5	89.6	92.8	98.5	105.9	107.5
Terms of trade goods and services (index, 2000=100)	101.5	101.1	99.2	100.9	102.0	101.0	102.2	101.8
Market performance of exports (index, 2000=100)	66.8	92.4	104.8	109.2	109.4	110.8	109.7	109.5

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 2018 spring forecast