Statement by Ibrahim Canakci, Executive Director for Czech Republic and Miroslav Kollar, Senior Advisor to the Executive Director
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Economic developments

The Czech Republic continued to enjoy robust and balanced economic growth in 2015, which was fueled by a combination of factors. These included easy monetary conditions and increased growth in government investment, reflecting the effort towards maximal absorption of resources from the EU structural funds from the EU multi-year programming and budgetary framework "The Financial Perspective" for the period of 2007-2013. The economy was also stimulated by a positive supply shock due to low oil prices.

As a result, the economy accelerated considerably in 2015 and real GDP increased by 4.2 percent. Improving household incomes, growing employment with low inflation and increasing consumer confidence led to an acceleration of household consumption growth. In 2016, the authorities expect a slowdown in real GDP growth to around 2.3 to 2.5 percent, given the decline in gross fixed capital formation after the expiration of the factor related to the EU funds. On the other hand, growth in economic activity will continue to be supported by easy domestic monetary conditions, low oil prices and rising external demand. The strong economic activity will manifest itself in continued growth in employment.

Consumer price inflation reached 0.3 percent in 2015. The Czech National Bank expects inflation at 0.4 percent in 2016, and to reach the 2-percent target in mid-2017. Unemployment has been declining and stood at 5.1 percent in 2015. The authorities expect an unemployment rate of 4.4 percent in 2016 with a continued downward trend going forward. Average real monthly wages grew by 3.1 percent in 2015, and are expected to grow by 3.4 percent in 2016. The external position of the Czech economy should remain balanced. The current account recorded a surplus of 0.9 percent of GDP in 2015, and is expected to reach a surplus of 2 percent of GDP in 2016 owing to a very strong trade balance.

Government policies

Fiscal policy

The government is committed to ensuring that the general government deficit will remain at a safe level below the reference value of 3 percent of GDP. The medium-term budgetary objective of the government is a structural deficit of no more than 1 percent of GDP. In the area of fiscal policy, the government's main objectives include the improved collection of taxes, more

effective and transparent government expenditures and an enhanced absorption and drawdown of resources from EU funds.

For 2015, the general government sector deficit of 0.4 percent of GDP and government debt of 41.1 percent of GDP were notified. In 2015, the Czech Republic over-performed in meeting its medium-term budgetary objective when the structural balance reached a deficit of 0.3 percent of GDP. The authorities' forecast estimates the general government sector deficit at 0.6 percent of GDP in 2016 with a subsequent decrease to 0.5 percent of GDP in the whole horizon of the outlook until 2019. The structural balance should decrease to a deficit of 0.6 percent of GDP in 2016, and stay at a deficit of around 1 percent of GDP, i.e. at the level of the medium-term budgetary objective, until 2019.

In 2016, the authorities expect a stabilization of the general government debt-to-GDP ratio on the 2015 level and a decrease in general government debt to around 39 percent of GDP by 2019. The Czech Republic is still one of the least indebted countries in the EU. The debt-to-GDP ratio is at a safe distance both from the debt reference value given by the Maastricht Convergence Criteria and the Stability and Growth Pact, and below the limit of the proposal of the national debt rule included in the government act on budgetary responsibility rules.

The biggest contribution to growth on the revenue side in 2015 stemmed from the accrual of capital transfers from EU funds, which increased by more than 84 percent compared to 2014. The development was caused by the successful effort to draw down the remaining resources from the 2007–2013 Financial Perspective. 2015 was also characterized by a high increase in tax revenues, including social contributions. The record-low yields on Czech government bonds also contributed positively to the budget outturn.

Investment activity of the general government sector increased by approximately 30 percent in 2015 and reached the highest value since 1995. In particular, the increase in investment went to EU projects and it was therefore possible to generate a substantial fiscal impulse for the economy with relatively small costs for Czech public finances.

For 2017-2019 the authorities expect a systematic increase in investment activity with annual growth of approximately 4.5 percent due to the expiration of the financial resources provided under the 2007-2013 Financial Perspective at the end of 2015 and the gradual introduction of the new Financial Perspective. Aside from the EU funds, the authorities also expect growth in investment financed from national resources.

Measures in the social area aimed at increased expenditures of health insurance companies and growth in social benefits. In 2015, the government carried out an extraordinary indexation of

pension benefits by 1.8 percent as compensation for the cuts of previous governments. Since January 1, 2016, the indexation formula has reverted to the total sum of full consumer price growth and one third of real wages growth. In February 2016, a one-off benefit was paid out to each pensioner due to the low increase in pensions given by the calculation of the indexation formula in which the low inflation is reflected. In February 2016, the government further approved a change in the pension indexation system, partially returning the possibility of discretion to the government, reacting to the currently very low inflation values and subsequent low indexations. Now the government will be able to adjust indexation up to 2.7 percent, if the indexation amount is lower according to the standard rule. Another aspect of the expenditure policy is an increase in the wage bill in the general government sector, where the government estimates the salary compensation of employees to increase by approximately 4 percent in 2016.

At present, measures aimed at increasing the effectiveness of tax collection are being introduced. The electronic VAT reporting came into effect on January 1, 2016, and fiscalization of cash payments will be implemented at the end of 2016. Both aforementioned measures should result in an improvement of the revenue side that should enable the financing of government priorities on the expenditure side or reduce the tax burden in the future. In 2016, revenues should decrease due to the reduced use of funding from the EU. Nevertheless, the decrease will be mitigated by incomes from taxes and social security contributions. Indirect tax revenues should increase in 2016, mainly due to VAT collection resulting from the newly introduced electronic VAT reporting. Work is also under way on the new act on income taxes.

In terms of quality of public finances, the government is focusing on the rationalization and effectiveness of expenditures in the general government sector. Meeting these objectives is shown, for example, by the introduction of the central register of contracts or in the draft act on the monitoring and management of public finances. In the area of tax policy, one of the main priorities is the fight against tax evasion and increasing tax collection efficiency.

In February 2015, the government approved proposals for regulations in the area of fiscal responsibility. These proposals are being submitted for approval by the Chamber of Deputies of the Parliament of the Czech Republic. One of the proposals, the so called "Act on Rules of Fiscal Responsibility" will introduce among others: (i) an independent expert Committee for Fiscal Forecasts; (ii) an independent National Budgetary Council; (iii) an expenditure fiscal rule for the general government; (iv) and debt rules for local governments and the general government. As an interim measure (before the new Act is implemented), the Ministry of Finance has its macroeconomic forecasts assessed by independent experts. These assessments are transparently published and attached to key fiscal and budgetary documents.

Structural policies

The government is committed to enforcing an economic program based on support for business, an effective labor market, a functioning and transparent state administration, a long-term sustainable pension scheme, investment in education, science and research. The priority is to identify and implement growth-supporting measures across different spheres of the economy.

In line with the 2016 National Reform Program, the government will continue its focus on proper implementation of recently adopted measures aimed at combatting tax evasion and stabilizing public administration. Ongoing activities are also aimed at further improving the labor market (including by improving labor mobility and protecting the vulnerable groups), improving the infrastructure, introducing a new construction law and increasing the quality of primary and higher education. The government will also continue its efforts to strengthening the cooperation between research institutions and the business sector, implementing measures to establish a favorable investment environment, and digitizing the economy.

The measures and reforms to support the government's structural policy goals that have already been taken or are being prepared also include a decrease in the tax burden on the labor of pensioners and families with children, or relaxing the conditions for providing material support for creating new jobs in the investment incentive system. The Act on Public Procurement which was approved by the Parliament on April 19, 2016, will increase transparency and reduce the administrative requirements of the procurement process. A draft long-term budget (until 2021) for national expenditure on research, development and innovation is currently prepared.

After seeking to address the long-term sustainability of the pay-as-you-go public pension system by adjusting the parameters of the pension insurance system in 2011, measures have been taken in the area of pension security and the public health insurance system, primarily aimed at short- or medium-term consolidation of public finances. Also, since 2010, the penalty for early retirement has been increased, thus reducing the attractiveness of retiring before reaching the statutory retirement age. The Pillar II of the pension system was cancelled as of January 1, 2016 and the winding up process will last until the end of 2016. The pension insurance system is regarded as sustainable with respect to stabilization at the end of the forecast horizon 2060. The government also continues with its efforts to improve the cost effectiveness of the health care system and its management, including reforms of the public health insurance system.

Monetary policy

The Czech National Bank's (CNB) monetary policy rate has been at "technical zero" (0.05 percent) since November 2012. Since November 2013, the CNB has been using the exchange

rate as an additional instrument within its inflation-targeting framework for easing the monetary conditions. At its last monetary-policy meeting on May 5, the CNB Bank Board decided unanimously to keep interest rates unchanged at technical zero. The Bank Board decided to continue using the exchange rate as an additional instrument for easing the monetary conditions and confirmed the CNB's commitment to intervene on the foreign exchange market if needed to weaken the koruna so that the exchange rate is kept close to 27 koruna to the euro. The asymmetric nature of this exchange rate commitment, i.e. only to intervene against appreciation of the Czech koruna below the announced level, remains unchanged.

The latest CNB staff forecast assumes that market interest rates will be flat at their current level and the exchange rate will be used as a monetary policy instrument until mid-2017. Consistent with the forecast is an increase in market interest rates thereafter. According to the forecast, sustainable fulfilment of the inflation target, which is a condition for a return to conventional monetary policy, will occur from mid-2017. The Bank Board therefore stated that the CNB will not discontinue the use of the exchange rate as a monetary policy instrument before 2017 and considers it likely that the commitment will be discontinued in mid-2017.

The return to conventional monetary policy will not result in the exchange rate appreciating sharply to the slightly overvalued level recorded before the CNB started intervening, among other things because the weaker exchange rate of the koruna is in the meantime passing through to the price level and other nominal variables. At the same time, the Bank Board stated that exchange rate appreciation following the discontinuation of the exchange rate commitment would be dampened by hedging of exchange rate risks by exporters during the existence of the commitment, by the closing of koruna positions by financial investors and by possible CNB interventions to mitigate exchange rate volatility.

The Bank Board assessed the risks to the forecast at the monetary policy horizon as being slightly anti-inflationary. In this context, the Bank Board pointed out that the CNB stands ready to shift the exchange rate commitment to a weaker level if there were to be a systematic decrease in inflation expectations manifesting itself in nominal variables, especially wages.

In connection with the need to maintain easy monetary conditions, the Bank Board also discussed the possibility of introducing negative interest rates, as stated in the published minutes of the Bank Board meeting on May 5. The prevailing view was that negative rates were not an appropriate tool for additionally easing monetary conditions and hence for influencing inflation directly, although negative interest rates could serve effectively as a tool for defending the exchange rate commitment. However, negative interest rates could be an appropriate complementary tool if the level of the exchange rate commitment were to be moved.

Financial stability and macroprudential policy

The performance of the banking sector in 2015 was positively affected by the strong economic recovery. This was reflected in an increase in profitability and sustained high capitalization and favorable liquidity. Deposits continued to increase despite a continuing decline in deposit interest rates. The domestic banking sector has long been independent of foreign sources of funding. Credit risk has decreased. The structure of non-performing loans has also improved. The provisions created by banks at the aggregate level seem to be sufficient to cover the current expected loss given default. Insurance companies are well capitalized and most of them are maintaining stable profitability even in the current period of low interest rates. The pension management companies sector remains stable.

The Czech economy continues to be in a growth phase of the financial cycle. In December 2015, the CNB reacted to rapid credit growth, increasing household debt relative to income and growth in residential property prices by setting the countercyclical buffer rate at 0.5 percent of exposures located in the Czech Republic with effect from January 2017. As there has been no significant change in cyclical risks indicating growth in systemic risk this year, the Bank Board decided at its meeting on financial stability issues in May 2016 to leave the buffer rate at the current level for the time being. However, if credit growth remains high, credit standards ease further and investor optimism continues to grow, the CNB will stand ready to increase this buffer rate further.

The new Financial Stability Report issued on June 14, 2016, pays increased attention to the property market and the provision of house purchase loans. The CNB does not assess the trends in the area of house purchase loans as an acute market overheating giving rise to direct risks to financial stability. However, it considers credit standards to be highly relaxed and has identified the taking on of higher risks by some institutions.

The combination of exceptionally low interest rates and easy access to house purchase loans is creating conditions for growth in residential property prices above levels consistent with fundamentals. Consequently, on June 14, 2016 the CNB announced that it is tightening its current Recommendation introduced in June 2015 on the management of risks associated with the provision of retail loans secured by residential property as of October 2016, mainly by lowering the maximum LTV levels. In particular, the current upper LTV limit of 100 percent will be reduced to 95 percent as of October 2016 and to 90 percent as of April 2017. The current recommended limit of 10 percent of new loans with an LTV of 90 percent to 100 percent will change to a limit of 10 percent of new loans with an LTV of 85 percent to 95 percent as of October 2016. The limit will be set at 15 percent of new loans with an LTV of 80 percent to 90 percent as of April 2017. The CNB has also issued a new recommendation that institutions

should use all available information to determine whether a loan is being used to finance owner-occupied housing or as an investment. If they find that an application for an investment loan shows a combination of characteristics with a higher risk level, they should apply an LTV of 60 percent at most. If the domestic property market were to show increasing signs of overheating in the years ahead, the CNB would tighten the conditions further or, where appropriate, use other instruments defined by law.

In accordance with ESRB recommendations, the CNB will also seek enactment of the power to set risk parameters for loans for house purchase. They include the option to set binding LTV, LTI and DSTI limits as well as other risk parameters for loans for house purchase. Such powers would enable the CNB to respond effectively to emerging risks to financial institutions and consumers which might arise from excessive softening of credit standards. The alternative would be strong measures in the area of institutions' capital, which could be costlier from the perspective of the national economy.

The latest stress test results demonstrate that the banking sector remains highly resilient to adverse scenarios. The Adverse Scenario, whose probability is very low, assumes a strong recession and a fall of the economy into deflation. The banking sector has a large capital buffer which enables it to withstand highly adverse shocks and maintain its overall capital adequacy sufficiently above the regulatory threshold of 8 percent even in the Adverse Scenario. The banking sector is also highly resilient to short-term liquidity risk.

The CNB also conducted a stress test of public finance. Its results indicate that the current fiscal situation does not represent a threat to the stability of the banking sector, which holds a large part of the Czech government debt. Consequently, the CNB will not apply additional capital requirements to credit institutions at the three-year horizon.

Pursuant to the Recovery and Resolution Act, the CNB is the resolution authority in the Czech Republic. As of January 2016, this law vested the CNB, among other things, with exclusive power to create plans for resolution of banks, credit unions and some investment firms.

The Czech authorities thank the Article IV team for a constructive exchange of views during its mission.