The Czech Fiscal Council

OPINION OF THE CZECH FISCAL COUNCIL

of 4th March 2020, No. 1/2020

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

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

Basic economic situation

In the last quarter of 2019, the year-on-year growth of the Czech economy slowed to 1.8%, which was below the original estimates of both the market and the Czech Ministry of Finance. Also, all-year growth lagged behind estimates, having reached 2.4%. Economic growth was driven solely by domestic demand. Household consumption, based on the still strong labour market, retained a solid pace in Q4 2019 and increased by 2.9% in a year-on-year comparison. Investment demand presented a positive surprise, with its dynamics having revived to 3.6%. On the other hand, exports dropped by 1.6% year on year, due to the influence of weak foreign demand.

Industrial production in the fourth quarter of 2019 dropped by 2.3% year on year, with an all-year drop of 0.5%. In the last quarter, revenues in the service sector declined slightly (by 0.7%). February expectations of industrialists improved slightly; nevertheless, they continue to be weak and are approximately at the level of the second half of 2013. Furthermore, the expectations of entrepreneurs in the sphere of services are worsening. And even hitherto relatively optimistic households expressed more substantial concerns in January and February about the worsening of the overall economic situation and their financial situation. As of yet, households are not perceiving the risk of unemployment more intensively, unlike their concerns of further price hikes, which naturally reflects the higher than three per cent inflation rate measured in the last two months of 2019, which reached 3.6% in January 2020.

The economy thus clearly continues in deceleration, weakened by foreign demand. The adverse, nevertheless trend, is virtually absent in the sectors of the economy that have not yet been struck by reduced exports (e.g., IT and other services). There is now substantial uncertainty as to the scope of the slow-down for all of 2020. Decisive for all-year development will be whether foreign demand will recover in the upcoming quarters. The hitherto expected growth of around 2% has been, nevertheless, struck by many uncertainties and risks triggered by the outbreak of the coronavirus epidemic. The disease has intensely affected industrial regions in China and is now spreading in Europe, as well.

Problems in China's economy will have an impact on the Czech economy primarily on two levels, through trade and production links. The weakening, of the Chinese economy is affecting Czech exports secondarily, via weaker demand in European countries that export to China. These include, in particular, Germany, which is China's second most important export partner.

With a view to China's importance in global production chains, the Czech economy may also be harmed by outages in the deliveries of subcomponents for domestic production, whether intended for the domestic market or export. Substitution of these subcomponents will probably be more expensive than their imported Chinese counterparts, although their limited availability may also cause the growth of their prices. Increased costs of domestic producers may, therefore, result in a further increase in domestic prices and reduced competitiveness of local producers in foreign markets.

Imports from China account for 11% of total Czech trade inflows, with consumer goods having a dominant impact. This factor may add to the already existing domestic inflation pressures, because, as in the case of subcomponents' production , substitutes from more expensive destinations will again rise since the vast majority of the developed world is in a similar situation. The faster the epidemic in China and other countries is over, the weaker will be the influence of the risks on the domestic economy mentioned above. However, even with China's recovery in the second or third quarter of 2020, all-year growth of Czech GDP cannot be expected to reach the presently estimated level of 2%. In the event of a longer-term and more robust impact on the economy, estimates will need to be further revised in the months ahead.

The labour market is responding to the weakened economic performance with a lag. It is still marked by a surplus of available jobs over the number of unemployed, which continues to result in significant pressure on wage growth. It is, however, only a matter of time that the slow-down of the economy reflects in the labour market, as well, and weakens the dynamism of wages. Nevertheless, wage growth of around 5% can still be expected in 2020. Real consumption will, however, be restricted by continued price growth, as the inflation rate will remain close to3% throughout all of 2020.

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

The tax income estimates, upon which the year's state budget is based, already reflect the gradual slow-down of the Czech Republic's economic growth to 2%. The collection of the fiscally most important taxes and social security contributions in the first two months of 2020 developed either identically to, or slightly more favourably than, the same period last year. Compared to 2017 and 2018, when the Czech economy noted high growth, the rate of collection is lower. Personal income tax from dependent activity continues to maintain a very high year-on-year rate of growth, exceeding 10%.

It can, however, be expected that the slow-down of the economy will adversely influence general government sector finances in 2020. The reduction of foreign demand and exports can gradually spill over into the domestic market and, in turn, weaken the year-on-year rate of growth in tax revenues. The revenue side of the state budget will also be adversely influenced by the likely shortfall of the digital tax this year (approximately CZK 2 bn), the form and collection start date of which will probably differ from the assumptions underlying the state budget parameters. This occurrence confirms the necessity of adhering to the principle that a draft budget should respect only those laws which are already in force[1].

A shift in the date of 5G network frequency auctions may bring about a further shortfall of the state budget, amounting to around CZK 7 bn[2].

The set-up of fiscal policy for 2020 is neutral, which can be considered appropriate given the current position in the economic cycle, the situation on the labour market, and the development of the inflation rate.. The CFC does maintain, however, that the situation abroad should be monitored closely, primarily the impact of the coronavirus epidemic on the economic growth of Czech trade partners. With a view to preliminary prudence, the government should have at its disposal a set of measures to be used to stabilise aggregate demand, should the situation abroad or domestically deteriorate significantly. Such measures should meet several criteria. Above all, their potential implementation should be relatively fast and aim to strengthen demand in labour-intensive sectors. The CFC does not consider the preparation of such stimulatory measures to be an act of panic or that it could harm the expectations of economic entities. On the contrary, the CFC believes that, in the present, very uncertain environment, this would be a responsible approach that could help stabilise expectations as well as future economic development.

Furthermore, it is CFC's opinion that resolution of short-term issues should not overpower persisting long-term imbalances in public finance arising from ongoing demographic change. Discussions about a potential adaptation of the pension system should continue. It is, however, necessary for other topics to be addressed with intensity, aside from a change in pension calculation structures, in particular the issue of future income of the pay-as-you-go system and reform of the third pillar aimed at making it more effective. In this context, the CFC considers it necessary to again draw attention to the relation between long-term public finance imbalances and the value of the medium-term budget objective (MTO)[3]. Unless the pension system is modified, i.e. the pension valorisation rate continues to be higher in the coming years than would correspond to the basic formula given by the Pension Insurance Act, there is a high likelihood of a tightened medium-term budget objective: specifically, from the present level of -0.75% GDP to -0.25% GDP from 2023. This event would involve a significant reduction of the space for potential fiscal stimulation in the future.

[1] See Opinion of the Czech Fiscal Council of 4 December 2019, No. 8/2019 concerning the development of public sector finances and the set-up of fiscal and budgetary policy.
[2] https://www.mfcr.cz/cs/aktualne/tiskove-zpravy/2019/statni-rozpocet-na-rok-2020-miri-do-druh-36438
[3] The MTO sets the limit of the structural deficit of the public institutions sector.