Office of the Czech Fiscal Council

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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 framework 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 regularly, on a quarterly basis, has informed the public about its conclusions.

Macroeconomic background

The performance of the Czech economy, measured by GDP, rose by 3.3% in 2021, after a fall of 5.8% in 2020. In the last quarter alone, the economy grew by 3.6% year on year. Throughout 2021, economic growth was supported by domestic demand, whereas exports were still plagued by problems with production finalisation related to disruptions in supply chains. This was manifest in the declining performance of the manufacturing industry by 1.6% in the second half of the year. Exports in the second half of 2021 were down by 3.9%, whereas household consumption was up by 7.9%.

The second half of 2021 was significantly marked by unexpected growth in inflation. The year-on-year growth in consumer prices went above the CNB tolerance band in July 2021. The outlook for rising inflationary pressure led the central bank to increase its main two-week repo rate to 3.75% in December 2021. Average inflation in the second half of 2021 exceeded 5% and year-on-year inflation in January 2022 attacked the 10% mark, which is why the CNB raised its two-week repo rate to 4.5% in early February 2022.

Nevertheless, the outlook for the Czech economy for 2022 remained relatively positive in January 2022, with both MoF and CNB estimates of economic growth ranging about 3% and average inflation estimates being around 8.5%. The invasion of Ukraine by the Russian Federation army has, however, encumbered the future with an immense measure of risk and uncertainty. The main scenario is a downward risk for economic growth and an upward risk for inflation.

In addition to the sharply rising fuel and energy prices, inflationary pressure can be further enhanced by nervousness on the FX market, which is, in line with short-term predictions, causing at least a temporary weakening of the CZK exchange rate and is thus not acting as a damper of price shocks from abroad, but rather as their accelerator. In order to dampen excessive fluctuations in the exchange rate and the weakening of the crown, the CNB has started to intervene on the Foreign exchange market.

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

The current development of public budgets has been significantly influenced by the fact that the act on the state budget for this year has not been approved, meaning the application of a provisional budget. This does ensure the basic functioning of the state, but it also involves restrictions in the launch of large investment projects, the calling of new subsidy programmes, and the exercise of claims for unspent expenditure. All that has, thus far, partially limited the scope of public expenditure.

As at the end of February, the balance of the state budget was a deficit slightly above CZK 45 bn (net of the impact of revenues and expenditures related to projects supported by the EU, the deficit was slightly more favourable – CZK 44.5 bn. With the exception of personal income tax, where the comparison (the year-on-year decrease) has been influenced by adjustments in the tax base and an increase in the basic taxpayer credit in 2021 and 2022, all major taxes and compulsory insurance contributions have grown.

In February, the government presented a draft of the state budget with a deficit of CZK 280 bn, which is CZK 97 bn lower than the value proposed by the previous government. The Council considers the draft to be the first step in the process of the consolidation of public finances, which have reached a level that is unsustainable in the medium-term. At the same time, the Council sees a risk that that may cause, that the actual scope of the change of the year-on-year improvement of the balance of public budgers will be less favourable than envisaged by the plan (the level to which reduced budgetary expenditure will be offset by the drawing of claims to unspent expenditures, a possible shift of the imbalance to the public health insurance sub-system, and, in particular, the war conflict in Ukraine – see below). The Council maintains that the budget should be approved as soon as possible (naturally, while respecting all of the requirements of the legislative process) in order to end the use of the provisional budget as soon as possible.

Not only the development of the economy but also the development of public finance has been and will continue to be significantly influenced by the Russian Federation army invasion on the territory of Ukraine. The Council naturally understands that the dramatically changing security and geo-political situation caused by the attack constitutes additional challenges for domestic fiscal policy. It is not just the impact of the conflict on the prices of energy commodities, and hence also overall inflation in the Czech Republic, that may necessitate additional compensation for households or the business sector. The conflict may result in movements in the already overheated labour market, which may not necessarily stabilise it, but may, at least temporarily, sway it even further out of balance. A stronger refugee wave may pose an unexpected and unpredictable burden on public budgets in the short- and perhaps even in the medium-term. Furthermore, the order of public sector strategic priorities on the central government level will change, relatively logically so from the Council's point of view. Greater priority will be given to the security and defence sectors, with respect to which the Council understands the argument that this area has been underfinanced in the long-term and not meeting allied commitments in the long-term (expenditure of 2% of GDP), which are the only ones to efficiently ensure the country's security and defence.

Furthermore, the Council points out that the method of financing military investment purchases must be changed, which differ significantly in nature from investment purchases of other organisational units of the state. The current method of financing through the Ministry of Defence chapter does not offer adequate stability and predictability of sources, which is key in this sector. The establishment of a special fund for strategic purchases the income of which would be ensured by a regular and statutorily set contribution of funds from the government budget at a level derived from GDP would seem to be an appropriate solution. Inspiration in this case may be drawn from the system operating during the First Republic under Act No. 240/1926 Coll.

The change in prioritisation will also concern the sphere of energy security, where dependence on the hitherto dominant gas supplier – Russia – must be clearly reduced. On the other hand, the Council warns against using the worsened geo-political situation for an uncontrollable stream of ad hoc compensations from public budgets for everyone who will declare that they have been, in one way or another, financially affected by the conflict. No public budget can fully compensate for the impact of such an extensive security and geo-political shock, and it is not only unthinkable, but it is also not desirable. Furthermore, the risks linked to doing business in the Russian Federation or trading with entities whose owners are from that country have been obvious, at least since the occupation of Crimea in 2014. It must be stressed that public budgets should – even in a situation as difficult as this – retain fundamental manageability and sustainability that will be the basis of prosperity for the entire economy once the conflict ends.

Furthermore, the Council states that the extent of the impact of the ongoing conflict on public budgets cannot be seriously quantified at this point, as everything will be influenced by its duration and intensity, the number of refugees, the scope of sanctions imposed, and the level of participation of European funds. It seems premature to ask, at this time, as to what extent the state budget that is currently in the approval process, and in particular, the fundamental parameter of deficit, will need to be adjusted.