Czech Republic – 2017 Article IV Consultation
Concluding Statement of the IMF Mission
Prague, May 15, 2017

The Czech economy is doing well. Growth is solid and the unemployment rate is low. Inflation is back at the target level. The public finances are in good condition, and the banking system is liquid and profitable. However, policy makers face important challenges: household financial vulnerabilities appear to be increasing; labor—especially skilled labor—is in short supply; and several aspects of public administration and processes need improvement. Addressing these and other issues will require a well calibrated combination of monetary, macroprudential, financial, structural, and fiscal policies.

Outlook and Risks

1. **Strong growth is expected this year, but supply constraints will bite.** Real GDP growth is projected to increase to 3 percent in 2017, largely driven by domestic demand. Consumption is supported by strong real wage growth, employment security, and low interest rates. Investment is projected to rebound as EU funds absorption picks up after falling last year. But labor shortages are expected to constrain growth to about 2½ percent over the medium term. Given the tight labor market and demand pressures, inflation is expected to reach 2.3 percent this year, before falling to the 2 percent inflation target.

2. **This broadly positive forecast has notable uncertainties.** The future path of the exchange rate now that the euro:koruna floor has been removed is highly uncertain. The projection assumes that the koruna appreciates modestly each year, and that interest rates increase gradually, which would rein in demand and inflation. But unwinding of large financial positions built up by foreign investors ahead of the floor's removal could cause the exchange rate to be erratic. Another important risk to the forecast is the sustainable growth rate: a significant increase in labor productivity is assumed in the face of a shrinking workforce. As firms are already facing labor shortages, these productivity gains are crucial to ensure wages can increase without putting undue pressure on competitiveness.

Monetary Policy

3. **The time was right for leaving the exchange rate floor.** Headline inflation is at the target, external deflationary pressures have faded, and the real exchange rate remains moderately below equilibrium, even with an increase in the price level. In addition, the economy is running slightly above capacity, labor markets are tight, and credit growth is high, adding to price pressures.

4. **The mission agrees with a gradual, data-driven approach to raising interest rates.** Letting the exchange rate find its natural value and waiting to see how the economy reacts to the transition off the floor is appropriate. Ex post, inflation might turn out to be higher than expected, but that is preferable to tightening policy rates too early. If market conditions become disorderly,

some moderate foreign exchange intervention could be valid. However, foreign exchange interventions should not be used to counter the natural structural adjustment of the exchange rate.

Macroprudential Policy

5. **Rapid credit growth raises concern that some households are becoming overstretched.** Although average household debt is relatively low, it has been increasing rapidly, and some households have been borrowing high amounts to finance house purchases, especially in comparison to their incomes. These borrowers are particularly vulnerable to falling house prices or incomes or increases in interest rates.

6. **These developments warrant a wider range of tools than currently employed.** Experiences from other countries suggest that a wide range macroprudential tools should be applied to safeguard household finances. Although the CNB has been steadily restricting loan-to-value limits, it lacks the full range of tools it needs to target household vulnerabilities, in particular the high multiples of lending to income.

7. **To this end, it is crucial that the CNB be given binding powers over loan-to-value, debt-to-income, and debt-servicing-to-income ratios.** Such tools are increasingly standard for central banks, including those in advanced economies with inflation targets. Legislation providing powers over LTV, DTI and DSTI ratios should be put in place shortly without being watered down further—the tools should not be thought of as substitutes for each other, and prudential tools (such as bank capital requirements) are not well suited to addressing borrower vulnerabilities.

8. **Removing supply distortions and changing the tax treatment of housing could reduce price pressures.** House prices fluctuations are amplified by complex permits processes that limit the ability of supply to respond quickly to demand. Introducing value-based property taxation, with a suitable phase-in period, could also help dampen the cycle.

Financial Policy

9. **The banking system is liquid and profitable.** Banks are typically funded mainly through deposits, and have ample access to liquidity. Profitability is high, in terms of returns both on equity and assets.

10. **Vigilance is needed to prevent vulnerabilities.** So far, there are no signs of significant system-wide weaknesses in the banking system. However, the acceleration of credit growth raises concern that lending standards may slip. To this end, rigorous stress tests will be important; the CNB should continue to increase frequency of on-site inspections. Supervision needs to be backed up by more granular data, such as on real estate and household debt. The increase in foreign exchange lending to corporates warrants close attention.

Structural Reforms

11. Labor market incentives should be revised to boost labor force supply and quality. Reducing the relatively high tax wedge and marginal tax disincentives to enter the workforce could increase labor force participation further. Similarly, incentives could be changed to deter early retirement. Female labor participation is notably low for women with small children, limiting not just the labor force but lifetime female earnings. This necessitates attention to a tax system that penalizes women for reentering the labor force and limited affordable childcare services and flexibility with part-time contracts that limit their ability to do so. Skill mismatches are relatively high; strengthening vocational training systems, including apprenticeships and other in-work and life-long learning schemes, could help upgrade the labor force skill level.

12. There is space to improve the regulatory environment. The Czech Republic ranks well on competitiveness and product market regulation indicators overall. However, processes for obtaining planning and building permits are widely perceived to be cumbersome, opaque, and inconsistent, substantially contributing to supply problems in real estate markets and slowing implementation of infrastructure spending. The mission recommends a thorough review, benchmarking to best practices, to simplify procedures, reduce administrative burdens on start-ups, and foster competition.

13. Investment in physical and digital infrastructure will help boost potential growth. Infrastructure coverage and quality in the Czech Republic remains below the EU average. Improved efficiency in the absorption of public funds, whether the EU or national ones, could be instrumental in addressing infrastructure needs.

Fiscal Policy

14. The fiscal framework is being improved. A new fiscal law establishes an independent fiscal council to assess compliance with the fiscal rules and evaluate the long-term sustainability of the public finances. The law also sets fiscal limits, not only for general government but also for local government. Strict targets at the local level are important to ensure fiscal sustainability.

15. Public finances are in good condition and projected to remain so on current policies. Strong economic growth and better revenue collection mean a surplus of 0.4 percent of GDP is expected for 2017, despite increases in public sector wages and social spending. If conservative spending policies remain in place, these combined with improved tax collection would imply continued small surpluses from 2018. These surpluses and steady nominal growth would bring the public debt to around 26 percent of GDP by 2022.

16. Given the relatively low public debt ratio, the mission recommends that fiscal policy prioritize raising growth potential via modestly higher investment in physical and human capital. There is no need for sizeable short-term stimulus, given that the economy is operating slightly above capacity. But the authorities should consider adjustments to fiscal policy to boost potential output and maintain competitiveness—with debt already low and interest

rates at historic lows, surpluses could be used to finance spending on infrastructure and skills, rather than to necessarily reduce debt, while nevertheless leaving some margin to take into account uncertainty about future revenues, given questions about the sustainable growth rate and availability of EU funds after 2020. The composition of tax and expenditure policies could also be adjusted: rationalizing healthcare spending, ensuring pension system sustainability through gradual increases in the retirement age, and better targeting of direct taxation and social security contributions could create additional room for public investment in infrastructure and skills, and also to reduce tax distortions affecting the labor force.

17. Public investment spending lacks a medium- and long-term strategy. No single ministry is responsible for coordinating planning for all infrastructure, including not just transport but also energy and connectivity. Low EU funds absorption led to a sharp contraction in public investment in 2016. The mission thus recommends an assessment of public investment management with a view to establishing a unified and transparent plan for infrastructure over a long horizon.

18. The debt management framework should be improved. The current debt management strategy puts a high weight on short-term outcomes. The authorities should instead lock in low rates for longer while the opportunity remains. 10.5 percent of state debt is exposed to foreign exchange risk. The mission therefore recommends that debt management pursue a strategy of minimizing costs and risks over the medium term, including complete hedging of foreign exchange rate risks, and that the authorities consider how to achieve suitable operational independence.

The mission is grateful to the Czech authorities for their excellent cooperation and warm hospitality, and would like to thank them and representatives from the private sector, social partners, and academic institutions for candid and constructive discussions.