INTERNATIONAL MONETARY FUND

CZECH REPUBLIC: Staff Concluding Statement of the 2019 Article IV Mission

May 14, 2019

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

The economy is doing well but is running at full capacity. Now is the time for a durable policy agenda to boost potential growth over the long term.

The Czech economy has been doing well. Wages are higher. Unemployment rates have reached record lows, being the lowest in the EU. Nonetheless, it is widely recognized that more will be needed to maintain strong growth.

It is particularly important to act now. The workforce is already just about fully employed—currently, for every person seeking work, there is more than one job available. The economy is slowing—we expect growth of 2½ percent in 2019—and could slow more if the external environment worsens. And holding a steady 2½ percent annual growth rate over the medium term will require high employment and productivity growth as the population ages and the workforce shrinks.

Needed: a durable and coordinated policy agenda

Sound and coordinated policies that encourage innovation and efficiency are crucial for staying on a path of increasing living standards. After consulting with industry, the government has published an ambitious strategy to boost innovation over the next decade with efforts in R&D, skills, and infrastructure. This plan could make a valuable contribution to boosting potential growth—but only if it is implemented. So the first step is to ensure that strategies are practical and carried through.

There are other bottlenecks—such as the labor force, infrastructure, and housing—that need attention. Exporters cite incomplete transport networks that make moving goods expensive. Construction companies cite long delays in planning and getting construction approval for improvements and new buildings. A new Act that is being prepared that aims to simplify the construction code would be a step in the right direction, if it is delivered. More generally, coordination across government—among ministries, and across the layers of central, regional, and municipal bodies—needs improvement, so that plans are implemented effectively.

Nor should the emphasis be only on glamorous innovations, such as digitalization. The demand for employee cards—which grant work permits for up to two years to migrant workers who have employment offers—often exceeds the limited capacity to process applications. A sustainable medium-term immigration strategy that makes it easier for firms to fill vacancies—under discussion—would pay for itself many times over.

Implications for fiscal policy

The focus should be on spending and revenue choices that are as friendly as possible to raising growth. Investment in public goods that boosts productive potential should be preferred—subject to the fiscal rules—especially given that public debt, already low, will decrease further over the next few years and the costs of funding such investment are still low. This investment includes not just major physical structures—roads, for example—but resources such as child care and "intangibles" such as education and training.

Hard choices will also need to be made over social spending. As the population ages, demands on healthcare will increase, and there will be fewer people working to pay for the pensions of those retired. Of options to ensure pension sustainability, reducing pensions themselves could create hardship, and firms and workers already pay substantial contributions into the system. Hence, raising the statutory retirement age as life expectancies increase will be needed.

Otherwise, policy should seek efficiency gains. Some spending could be trimmed without harming social outcomes—through better gate-keeping of healthcare resources, for example. Some spending could be redirected to better outcomes—at a time when unemployment is so low, direct job subsidies (unless for disadvantaged groups such as the disabled) would be better directed toward training the workforce.

It can be tempting to target extra taxes at particular sectors, such as banks or foreign companies. Caution is needed: such taxes are often easily evaded, and they can lead to "double taxation" and distort incentives. Applied extensively, they could damage the attractiveness of the Czech economy as a place for foreign firms to invest. The IMF supports internationally-coordinated reform to corporate income taxes to address tax avoidance by multinational enterprises, including digital companies. But unilateral actions by countries might only succeed in harming the economy, for little in the way of extra revenues.

The role of the financial system

Underpinning growth will be a well-functioning financial system. The banking system is stable, well capitalized, and well placed to direct credit toward investment. Recent cases of money laundering in several EU countries, however, have revealed weaknesses in Anti-Money Laundering/Combatting the Financing of Terrorism (AML/CFT) regimes across Europe, heightening concerns about cross-border flows. The authorities should therefore continue their AML/CFT efforts, monitoring financial flows coming into and going out of the Czech Republic, especially those associated with non-resident accounts, and identifying sources of foreign funds. Regarding the real estate sector, the authorities should also continue to monitor money laundering risks, including by enhancing data collection on non-residents and beneficial owners.

Navigating the near term

While the domestic economy has been growing strongly, uncertainty has persisted about the outlook for many of the Czech Republic's trading partners. The Czech National Bank has balanced domestic pressures and external risks with gradual increases in interest rates. With the economy slowing, and the threats of disruption to trade still present, a pause in interest rate increases—as indicated by the Czech National Bank—is the right approach.

More challenging is the pressure on housing, which is very striking in Prague. So-called "macroprudential" measures can help insure that households do not take on too much debt. To this end, the Czech National Bank has recommended that banks limit mortgages and mortgage interest servicing according to the incomes of borrowers. These will support existing recommendations on the maximum amounts households can borrow relative to the value of the property. The values of these new caps are not tight by international standards and might yet have to be adjusted, but, as with interest rates, should be assessed after they have had some time to pass through fully to lending conditions. It would be better if the Czech National Bank had legal powers to set these limits, to ensure that conditions are the same across all lenders.

However, macroprudential policies cannot "solve" the problems in the housing market. Housing demand has consistently exceeded supply for many years, owing not just to the high growth in the economy, but also changes in demographics and preferences for type and location of housing. Construction firms have struggled to meet demand, because of labor shortages and lengthy planning and construction permit processes. As noted above, this is a crucial bottleneck that needs to be addressed. Lack of action on policies to raise the numbers of houses—especially of affordable rental accommodations—would particularly exclude those from poorer regions, by restricting their ability to move to where incomes are higher.

Meanwhile, with the supply of housing so inflexible, introducing extensive exemptions to macroprudential limits to "support" people to get on the housing ladder risks creating a generation of households burdened by high debt.

Discussions for the 2019 Czech Republic Article IV consultation took place in Prague from April 29 to May 14. The mission would like to thank the authorities and other interlocutors for the constructive dialogue and kind hospitality.