Monetary and fiscal policy interactions in the wake of the pandemic: the case of the Czech Republic

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Abstract

In this note we describe the impact of the Covid-19 pandemic on the Czech economy and the measures adopted by the Czech National Bank (CNB) and the Czech government in the areas of monetary, macroprudential, microprudential and fiscal policies. We review the formal rules of interaction between government and central bank policies which are important for successful macroeconomic stabilisation and the country's experience before and during the Covid-19 crisis. We then summarise the existing evidence on de jure and de facto CNB independence which are important elements of the interactions between monetary and fiscal policies. We provide a qualitative update of the indicators of central bank independence up to 2020 by assessing the recent changes to the Act on the CNB in the case of de jure independence, and by using the Binder methodology on political pressure on central banks in the case of de facto independence. Finally, we discuss the potential constraints on monetary policy emanating from the sustainability of public finance.

Keywords: Monetary policy, fiscal policy, central bank independence, Covid-19 pandemic.

JEL classification codes: E52, E58, E61, E62.

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1. Introduction

Like the majority of countries, the Czech Republic was affected by the Covid-19 pandemic. The first positive cases were recorded in March 2020. In response to the outbreak of the disease, the government declared a state of emergency on 12 March and introduced containment measures. During the first lockdown in spring 2020, the number of daily cases per capita was very low by international comparisons, yet the measures introduced had significant negative impacts on economic activity. Since the escalation of the second wave of the pandemic in September 2020, the Czech Republic has ranked globally among the countries which have been most negatively hit by the pandemic.

The Czech government and the Czech National Bank (CNB) have responded to the pandemic by providing unparalleled stimulus and support to the corporate, household and financial sectors. In Section 2, we describe the impact of the pandemic on the Czech economy, contrasting its effects with the macroeconomic indicators and the public finance stance in the period preceding the pandemic. We summarise the measures introduced by the CNB and the government in the areas of monetary, macroprudential, microprudential and fiscal policies. In Section 3, we outline the Czech experience of interactions between government and central bank policies which are crucial to successful macroeconomic stabilisation. In Section 4, we describe the evidence on de jure and de facto independence of the CNB and assess the recent changes which could potentially affect the CNB´s independence and hence the institutional arrangement of interactions between the CNB and the Czech government. In the final part we discuss the potential constraints on monetary policy stemming from the sustainability of public finance and the likely outlook for interactions between CNB and government policies.

2. Before and during the pandemic: the initial situation and the policy measures adopted

Until 2019, the Czech Republic had experienced robust economic growth, while the unemployment rate was at levels which were among the lowest in the EU. The inflation rate was close to the CNB’s 2% inflation target and accelerated to 2.8% on average in 2019. Market interest rates had been on the rise since 2017, reaching 2.1% in 2019. The exchange rate appreciated from 2017, reaching CZK 25.7 to the euro in 2019 (Table 1).

Since the onset of the pandemic in March 2020, the negative impact on the economy has been unprecedented. GDP growth saw a double-digit decline in the second quarter, followed by a slight rebound since Q3 2020 as containment measures were gradually lifted. The unemployment rate remained at astonishingly low levels throughout 2020, mainly due to government measures aimed at maintaining employment. The inflation rate remained above the upper bound of the 2% target for most of the year, reflecting a combination of demand and supply factors.

Key macroeconomic indicators								Table 1
	2017	2018	2019	2020	Q1 2020	Q2 2020	Q3 2020	Q4 2020
GDP growth (y-o-y, %)	5.4	3.2	2.2	-5.6	-1.8	-10.8	-5.1	-4.8
Unemployment rate (%)	2.9	2.3	2.0	2.6	2.0	2.5	2.8	3.0
Inflation rate (%)	2.5	2.1	2.8	3.2	3.6	3.1	3.3	2.6
3M PRIBOR (%)	0.4	1.3	2.1	0.9	2.1	0.6	0.3	0.4
Exchange rate (CZK/EUR)	26.3	25.6	25.7	26.5	25.6	27.1	26.5	26.7

PRIBOR = Prague Inter Bank Offered Rate

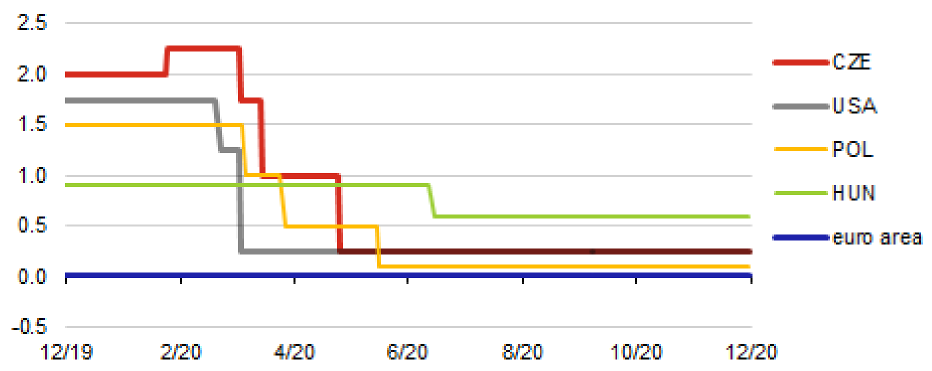
Average values except for GDP growth.

Source: Czech National Bank Monetary Policy Report, Spring 2021.

Before the outbreak of the pandemic, the Czech authorities had ample room for manoeuvre in the event of unfavourable economic conditions.[2] The two-week repo interest rate, the CNB's main monetary policy instrument, stood at 2.25% in February 2020, well above the levels observed in other countries (Graph 1). The fiscal position in terms of government debt to GDP and the budget balance was at a favourable level in 2019 in comparison to many EU countries (Graph 2, left-hand panel). In 2019, the general government balance was slightly positive at 0.3% of GDP, while the debt to GDP ratio was 30.3%.

Monetary policy interest rates

In % Graph 1



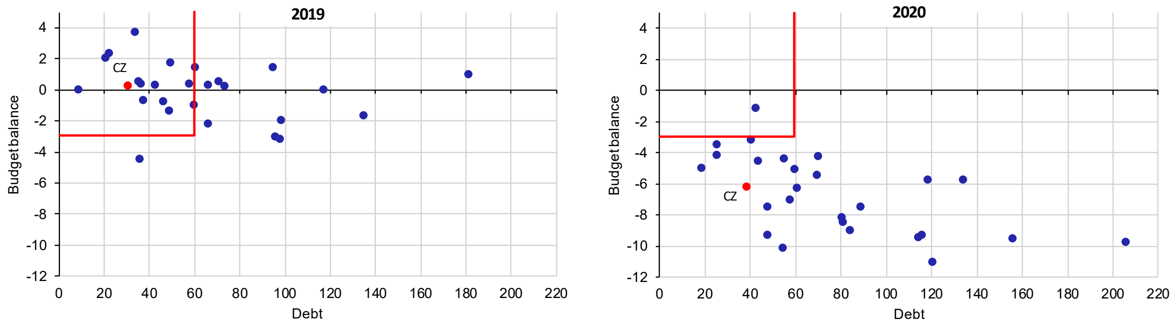
CZE = Czech Republic; HUN = Hungary; POL = Republic of Poland; USA = the United States.

Source: Czech National Bank (2020)

[2] Rusnok (2018) points to the importance of the room for public finance manoeuvring in the context of the post-GFC experience in advanced economies.

Fiscal positions in the EU-27

In % of GDP Graph 2

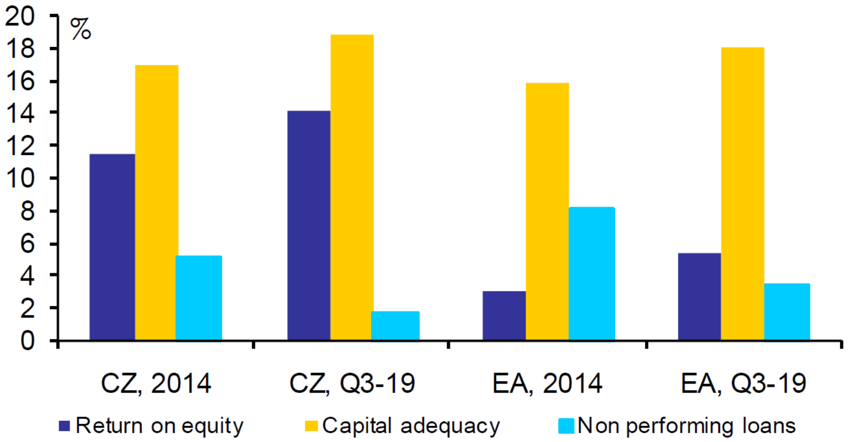


CZ = Czech Republic.

Source: Eurostat.

The capitalisation of Czech banks was robust before the Covid-19 pandemic and has remained so during the pandemic owing to capital requirements and voluntary capital surpluses, which have enabled the banking sector to cope with adverse economic developments. In terms of return on equity, capital adequacy and non-performing loans, the Czech banking sector was performing better before the pandemic than the banking sector in the euro area (Graph 3).

Selected banking sector soundness indicators Graph 3



CZ = Czech Republic; EA = euro area. Q3 2019 return on equity is calculated over the previous four quarters.

Source: European Commission (2020).

Both the CNB and the Czech government responded to the pandemic by applying measures to mitigate its negative effects on the economy. The purpose of the measures was to help Czech financial institutions and the corporate and household sectors to withstand the unfavourable economic conditions better.

The CNB applied a combination of monetary, macroprudential and microprudential tools. The CNB lowered the key interest rates twice in March and once in May, by 200 basis points in total, with the two-week repo rate standing at 0.25% since May 2020 (Graph 1). These interest rate cuts were immediately reflected in market interest rates and, with some delay, also in interest rates on loans and deposits. The exchange rate depreciated markedly to 27.1 CZK/EUR in the second quarter of 2020 (Table 1), easing the monetary conditions further, so that the exchange rate worked as a natural stabiliser.

Other CNB measures were implemented to support the liquidity of the Czech financial market and the capital position of Czech banks. Although the Czech interbank market has exhibited a sizeable aggregate surplus, and no liquidity shortage is observed, the rules for monetary operations have been modified for preventive reasons. Since 18 March 2020, the frequency of the liquidity-providing repo operations has been increased from once per week to three times per week at a fixed rate equal to the two-week repo rate. In addition to these amendments, liquidity-providing operations with three-month maturities were added to the CNB's liquidity management tools in May 2020. In March 2020, the CNB initiated an amendment to the Act on the CNB. After it came into effect in April 2020, it allowed the CNB to introduce further preventive measures by extending the scope of open market operations. Since 18 May, non-bank financial institutions (insurance, pension management and management companies) have been allowed to obtain short-term liquidity from the CNB. The collateral requirements for obtaining such credit are the same as the standard collateral of banks which take part in monetary operations, ie mainly Czech government bonds. The CNB also broadened the range of eligible collateral accepted from credit institutions (banks, foreign bank branches and credit unions) to include mortgage bonds. As a further measure to preserve liquidity on the market and strengthen the capital position of individual institutions, the CNB called on banks, insurance companies and pension management companies to refrain from making dividend payouts or taking steps that might jeopardise the resilience of their institutions.

The Czech National Bank also introduced a number of macroprudential measures. The CNB lowered the countercyclical capital buffer (CCyB) as economic activity started to decline significantly which might have an adverse impact on the quality of loan portfolios. In March 2020, the CNB cancelled its decision from the previous year to raise the CCyB rate to 2% and left it at 1.75%. Later, the CNB lowered the rate to 1% with effect from 1 April and to 0.5% from 1 July 2020. The CNB also modified the lending rules on the mortgage market. As the CNB expected that the banks themselves would be rather cautious regarding the provision of new mortgage loans, the CNB relaxed the limits on the credit ratios used by banks to assess applications for new mortgage loans in several steps (Table 2). As of 1 April 2020, the loan-to-value (LTV) ratio was increased from 80% to 90%, the debt-service-to-income (DSTI) ratio was raised from 45% to 50% and the debt-to-income (DTI) ratio was abolished. As of 8 July 2020, the LTV ratio remained at 90%, while the DSTI limit was abolished. The LTV ratio reflects the persisting overvaluation of housing prices.

Recommended mortgage lending ratios Table 2

	Before 1 April 2020	From 1 April to 7 July 2020	From 8 July 2020
LTV (loan-to-value)	80%	90%	90%
DTI (debt-to-income)	Eightfold	No limit	No limit
DSTI (debt-service-to-income)	45%	50%	No limit

In order to protect firms, the self-employed and households against early insolvencies, the CNB in cooperation with the Ministry of Finance, initiated a loan moratorium. The law, which was passed in April 2020, allowed borrowers who had suffered a negative economic impact from the pandemic to withhold repaying their debt obligations for three to six months. The moratorium allowed repayments to be postponed quickly and simply, while also making it unnecessary for banks to increase their provisions due to such postponement.

Crucial measures were introduced by the Czech government to mitigate the economic and social impact of the recession caused by the Covid-19 pandemic, mainly through fiscal policy. On the revenue side of public budgets, the measures included, inter alia, waiving the advance payments of health insurance and social security contributions, a compensation bonus for the self-employed and a reduction in the VAT rate from 15% to 10% for selected services. Policies on the expenditure side encompassed, for example, compensation of wage costs, an increase and extension in care benefits, bonuses in the healthcare sector and a one-off contribution to pensions. The government introduced several programmes for firms in selected sectors which were eligible for subsidies and loan guarantees. In terms of labour market supports, a programme was launched to partially reimburse employers for payroll costs (antivirus programme). This was made available to employers who were in economic difficulty, had to stop operating or to those who had to quarantine their employees. The programme helped to keep the unemployment rate low throughout 2020 (Table 1). Table 3 shows the CNB's calculation of fiscal discretion expressed as a percentage of GDP.

Discretionary fiscal measures

As % of GDP Table 3

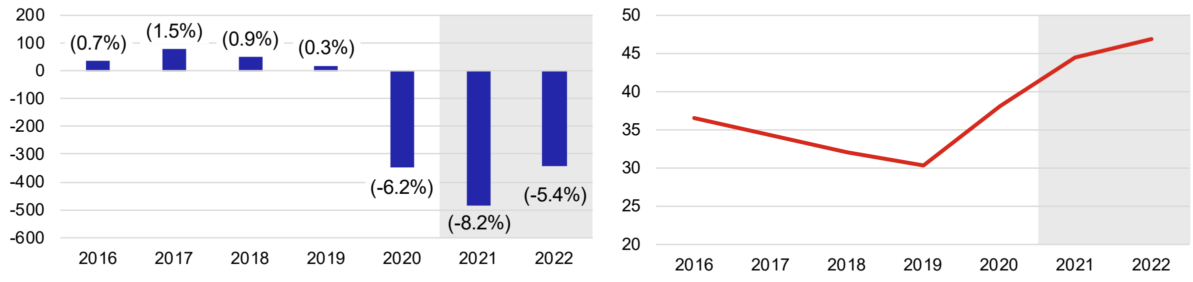
	2020	2021	2022
Cancelling of social and health contributions for self-employed	0.25	-	-
Increase in a care benefit	0.22	0.05	-
Wage subsidies for companies (antivirus programme)	0.47	0.40	-
One-off benefit for persons that are self-employed, partners of small ltd., or employed in short-term contracts	0.43	0.53	-
Increase in healthcare and security corps expenditure	0.54	0.54	-
Postponement of electronic records of sales	0.06	0.08	-
Loss carry back	0.00	0.22	0.21
Covid-19 - rent	0.04	-	-
Abolition of real estate transfer tax	0.24	-	-
Cancelling of social and health contributions for employers	0.24	-	-
VAT reduction on accommodation, cultural and sports services	0.02	0.04	-
Covid-19 - spa/accommodation/culture/sport	0.06	0.03	-
Other measures, 1st wave	0.06	-	-
Targeted support for areas in decline, 2nd wave (culture, sports, rent etc)	0.12	0.50	-
One-off increase of pension	0.27	-	-
Tax package II*	-	2.12	0.37
Increase in a child benefit and in a sickness benefit during quarantine	-	0.06	0.03
VAT exemption for vaccines, tests and respirators	-	0.04	0.01
Total measures	**3.03**	**4.62**	**0.62**

*2021 tax reform: abolition of the super-gross wage, increase in tax deductible items for taxpayers, abolition of the threshold on tax deductible items for children, changes in amortisation of assets, introduction of a flat tax rate on meal tickets, changes in excise duties rates etc.

Source: CNB.

Discretionary crisis policies adopted by the government together with automatic stabilisers resulted in a significant deterioration of public finances (Graph 4). In 2020, the general government balance reached a deficit of 6.2% of GDP and the debt to GDP ratio climbed to 38.1%. Nevertheless, the fiscal position of the Czech Republic remained at a relatively favourable level in 2020 compared to most other EU countries (Graph 2, right-hand panel). According to the CNB forecast, the general government deficit will also remain relatively high in 2021 and 2022, which will result in a substantial increase in general government debt (Graph 4, right-hand panel).

General government budget balance (on the left in CZK billion; percentage of GDP in parentheses) and government debt (on the right as % of GDP) Graph 4



Source: CNB Monetary Policy Report, Spring 2021.

The government and the CNB reacted swiftly to ease the negative impacts of the Covid-19 pandemic on the Czech economy. Fiscal measures are more suitable for dealing with such a crisis, as they are targeted at vulnerable groups and, unlike monetary policy, their impact is immediate. The CNB's measures were complementary, providing the necessary easing of monetary policy and the appropriate financial stability measures. Thanks to the available monetary policy space, the CNB was able to use monetary policy interest rates without the need for the deployment of unconventional monetary policy tools. The government had ample room for expansionary policies owing to the relatively low level of public debt before the pandemic.

3. Monetary and fiscal policy interactions

Formal rules and past experience

The framework of interactions between the CNB and the government is set by law. The CNB is defined by the Czech Constitution and the Act on the Czech National Bank as a strictly independent body. In line with the provisions of the EU Treaty and the Statute on the European System of Central Banks (ESCB) and the European Central Bank (ECB), the CNB is not allowed, or even expected to be involved in, any formal coordination of policies with the Czech fiscal authority, and it is forbidden for the CNB to take instructions from the government. This does not preclude interactions. The CNB, as one of the most transparent central banks (see Dincer and Eichengreen (2014)), uses a wide range of communication channels to present its monetary policy decisions to various stakeholders, including fiscal authorities. In this way, the CNB contributes to a stable economic environment, which in turn helps to shape expectations and prices, including interest rates.

The formal procedures for setting the interactions between the CNB and the government are defined in the Act on the CNB. The CNB and the government inform each other about the principles and measures concerning monetary, macroprudential and economic policy. The CNB has observer status in several government expert groups and committees. These platforms enable the sharing and exchange of views on economic issues at different working levels. The Minister of Finance, or an authorised member of the government, may attend CNB Board meetings. He or she is allowed to submit proposals for discussion and has an advisory vote. However, participation in the CNB's Board meetings is not an established practice and the right to attend meetings has been used very rarely in the past (the last such case was in 2017). On the other hand, the CNB is involved in drafting relevant economic legislation submitted by the government, and the governor or deputy governor can attend government meetings. This happens only rarely. The purpose of their participation is to be involved in discussions about topics related to the CNB's activities. The CNB also submits quarterly reports on monetary developments to the Chamber of Deputies of Parliament. On these occasions, the Governor of the CNB attends the plenary sessions.

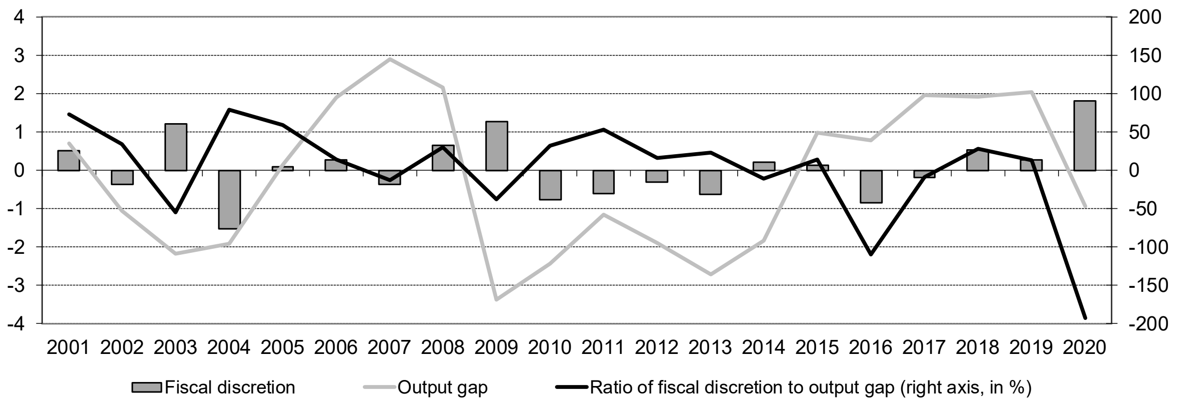
Another rule specified in the Act on the CNB sets the conditions under which the CNB's profit is transferred to the state budget. The CNB is required to use its profit to finance past losses or to deposit it in its reserve fund, which is expected to cover possible future losses. Only after the reserve fund is full, can the remaining profit be transferred to the state budget. This has happened only once – in 1993. Due to sizeable foreign exchange reserves and the appreciating currency, the central bank has recorded persistent losses in most of the period since the early 1990s, so that profit transfers to the state budget are not common practice in the Czech Republic and the state budget does not rely on the CNB's profits. However, the economic developments in the last decade and CNB's policies have had a bearing on the probability of CNB profit transfers to the state budget. In particular, the amount of foreign currency reserves accumulated significantly in the period 2013–2017 (it is currently at around €135 billion or two thirds of GDP) as a consequence of the CNB's monetary policy at that time. As long as economic convergence and the related real appreciation of the domestic currency are expected, any transfers of the CNB's profit to the state budget will be postponed further into the future.

The CNB's independence does not preclude the bank from analysing the steps taken by the government. The CNB analyses fiscal policy and uses its own projections of fiscal policy in its macroeconomic forecasts (see, for example, Tomšík (2012) for a brief overview). Fiscal policy is incorporated into the forecast as an exogenous factor. In the forecasting process, CNB staff assess discretionary fiscal policy measures and their impact on GDP and its expenditure components. Proposed fiscal measures, which have not yet been approved by the parliament, are not part of the baseline forecast scenario. They are instead taken into consideration when discussing risks to the forecast. The CNB calculates general government revenue, expenditure and balance, as well as general government debt and debt service costs. The CNB's fiscal forecasts are thus fully consistent with the CNB's macroeconomic projections.

The Czech fiscal authority is constrained by fiscal rules which are defined in the Act on Budgetary Responsibility Rules. The law defines a debt brake which is activated when government debt exceeds 55% of GDP. In such a case, the government is obliged to submit the state budget and the budgets of state funds which ensure the long-term sustainability of public finances. In addition, the proposed budgets of health insurance funds must be balanced. Another rule stipulates a structural government deficit ceiling of 1% of GDP. In view of the ongoing coronavirus pandemic, the general escape clause of the Stability and Growth Pact was activated at the EU level for both 2020 and 2021. This has allowed the Czech government to adopt a further loosening of the budgetary rules. The last approved amendment to the rules of budgetary responsibility from December 2020 essentially creates de facto unlimited space for the fiscal stimulation of the Czech economy in 2021. From 2022, the annual consolidation of the structural government budget balance in the amount of 0.5 percentage points of GDP will be required, with the year 2021 being the starting point for determining the level from which the consolidation of public finances will take place in the following years.

Although the CNB and the government responded in tandem in 2020 so that their policies counteracted the unfavourable economic conditions caused by the pandemic, operating in the same countercyclical direction cannot be taken for granted. Automatic fiscal stabilisers mitigate the impact of the business cycle through public finance revenues and expenditure, but the available evidence suggests that the discretionary fiscal measures adopted by the government were only rarely countercyclical in the years before the Covid-19 pandemic. Updating the estimates in Ambriško et al (2012), Graph 5 shows that fiscal discretion was used frequently by the government and was large in several years between 2001 and 2020. However, the ratio of fiscal discretion to the output gap was positive in most of the period, indicating the discretionary fiscal policy measures were more procyclical than countercyclical. This fiscal policy sometimes made it complicated for the CNB to fulfil its price stability mandate.[3]

Impact of fiscal discretion on the GDP and the output gap (as % of GDP) Graph 5



Fiscal discretion is the average value of several measures based on Ambriško et al (2012). Positive values indicate fiscal expansion; negative values signal fiscal restriction. Output gap is the yearly average output gap estimated using the production function and the Kalman filter. The ratio of fiscal discretion to output gap indicates procyclical (countercyclical) fiscal discretion when it is above (below) the zero line.

Source: Czech National Bank's calculations based on Ambriško et al (2012).

Experience in the Covid crisis

The formal cooperation processes and procedures between the CNB and the government have not changed since the onset of the Covid-19 pandemic, but the interaction between the two has intensified. On 11 March 2020, the CNB Bank Board discussed the possible economic scenarios facing the country, due to the Covid-19 crisis, with the prime minister and government representatives. After the meeting, the Bank Board declared its willingness and readiness, together with the government, to take all the necessary steps and measures in its area of competence and to use all the measures in its toolkit to fulfil its price stability and financial stability mandate. The CNB Governor took part in several government meetings, mainly related to new

[3] Rusnok (2018) points to the procyclical effects of Czech fiscal policy from 2010 to 2013 which transferred the burden of adjustment to monetary policy.

legislation which affected the CNB (the amendment to the Act on the CNB, the Act on the Deferment of Loan Repayment). However, no formal interactions between the CNB and the government contradict the Act on the CNB.

After the CNB lowered its key two-week repo interest rate to 0.25% in May 2020 and interest rates approached zero, the CNB started internally discussing its preparedness to use unconventional monetary policy should there be a need for a further easing of monetary conditions. The CNB has already used the exchange rate as an additional monetary policy tool to ease monetary policy conditions in order to avoid the risk of deflation and a protracted economic recession. In November 2013, the CNB committed to preventing the exchange rate from appreciating below 27 CZK/EUR. The exchange rate commitment had been in place until 2017 when the conditions for sustainable fulfilment of the 2% inflation target on the monetary policy horizon had been met. Hence, the CNB is ready, in principle, to use the exchange rate as an unconventional monetary tool for monetary policy easing.

The CNB has not ruled out other unconventional monetary policy options, including negative interest rates, yield curve control and quantitative easing. On the other hand, Board members spoke in their public statements against the use of "helicopter money", as it was mostly a theoretical concept and was in fact in the remit of government policy. Some doubts were also raised about funding for lending which would not have been efficient given the structural surplus on the interbank liquidity market.

The amendment to the Act on the CNB, which came into effect in April 2020, extends temporarily (until the end of 2021) the range of CNB instruments and counterparties for open market operations, as well as their maturity to beyond 12 months. The amendment was approved to allow the CNB to tackle the Covid-19 crisis more effectively. However, the CNB has been striving since 2016 for a permanent extension of its open market operations toolkit, which would enhance the CNB's operational independence to the level necessary for fulfilling its legal mandate of price and financial stability. During the parliamentary discussions on extending the range of CNB instruments, some doubts were raised about their potential misuse by the CNB, and the violation of market neutrality, when buying corporate bonds. The proposed comprehensive amendment also allows the CNB to apply legally binding lending rules to the mortgage market which have so far been used by the CNB in the form of recommendations (see Table 2). This amendment to the Act on the CNB has already been approved and took effect in August 2021.

4. Measurement of the CNB's independence: de jure and de facto views

So far we have discussed monetary and fiscal policy interactions from the perspective of recent lessons learned. The relationship between the monetary and fiscal authority is driven by the institutional arrangement which may be expressed in terms of de jure (legal) and de facto (actual) central bank independence.

Mas et al (2020) show that traditional indices of central bank independence do not indicate a deterioration in de jure independence of central banks after the global financial crisis. To assess whether actual central bank independence has changed more recently, they collected information from news reports and other official sources related to pressure exerted by governments and changes in central bank practices in 13 central banks in 2018 and 2019. Their results suggest that actual independence may have deteriorated in almost half of the sample. In a similar vein, Binder (2021) constructed a dataset for political pressure put on 118 central banks in the period between 2010 and 2018. She finds that about 10% of central banks allegedly came under political pressure in an average year, usually in the direction of looser monetary policy.

Table 4 shows central bank independence indices for the Czech Republic reported in the literature. The results indicate no change in de jure central bank independence from the global financial crisis until 2014. To assess the potential changes in these indices since 2015, we investigate updates of the Act on the CNB which would have a bearing on the CNB's independence. As there have been no amendments which would affect the factors used in the calculation of the indices in Table 4, we conclude that the CNB's de jure independence did not change until 2020.

Central bank independence indices for the Czech Republic — Table 4

Source	Index	2002	2010	2012	2014
Dincer and Eichengreen (2014)	LVAW		0.66		
Dincer and Eichengreen (2014)	CBIW	0.64	0.64		
Bodea and Hicks (2015)	LVAW	0.73	0.73	0.73	0.73
Garriga (2016)	LVAW	0.83	0.83	0.83	

LVAW is the Legal Variables Aggregated Weighted index calculated using the methodology proposed in Cukierman et al (1992). The CBIW index augments the LVAW index by adding other aspects of central bank independence.

As for the evidence on de facto central bank independence, Binder (2021) reports that between 2010 and 2018, the CNB came under political pressure to tighten monetary policy three times (in Q3 2015, Q4 2015 and Q1 2016), with calls for the replacement of the Governor, but the CNB did not succumb to the pressure. In the earlier literature, Geršl (2006) analysed political pressure on the CNB using the same methodology as Binder (2021) and found that the CNB came under considerable pressure from the government to ease monetary policy between 1997 and 2005, which was comparable to the pressure on the Board of Governors of the Federal Reserve System and slightly higher than the pressure on the Bundesbank, but resisted the pressure. More importantly, Geršl (2006) did not find any systematic impact of political pressure on either the direction of monetary policy or the uncertainty under which CNB Board members made their decisions, as measured by the degree of disagreement when voting on monetary policy.

We updated the evidence on the CNB's de facto independence between 2019 and 2020. We used the same approach as Geršl (2006) and reviewed the articles in the Czech daily newspaper Hospodářské noviny and in social media between 2019 and 2020 for any calls by government officials for weaker or stricter monetary policy. We found two mentions (23 February 2020 and 15 April 2020) demanding lower interest rates. The number of signs of political pressure per year is one, which is much lower than the 5.2 reported by Geršl (2006) for the period 1997–2005. This suggests that political pressure from the government was substantially lower between 2019 and 2020 than between 1997 and 2005.[4] However, we do not believe that these rare public statements affect the conduct of the CNB's monetary policy or the CNB's independence.

5. Looking ahead

At the time of writing this note (February 2021, updated in June 2021), the CNB does not see any significant constraints on monetary policy in the short- to medium-term stemming from the sustainability of public finances, although the Covid-19 crisis constitutes a major risk to the fiscal position in 2021 and the years to come. The risk of fiscal dominance is low, as the debt level is relatively low compared to other EU countries, and the CNB considers it to be sustainable if interest rates were to rise in the medium term. The currently favourable maturity structure of Czech government debt and the Ministry of Finance's strategy to exploit the currently favourable bond market conditions, including low yields and ample demand for Czech government bonds, have so far mitigated the vulnerability of public finances to a possible rise in interest rates. Furthermore, due to the relatively low number of government bonds denominated in foreign currency, exchange rate developments do not pose a significant risk to the sustainability of government debt.

Nevertheless, we prefer to avoid strong conclusions on future constraints on monetary policy. Confidence in the sustainability of Czech public finances has been robust so far, reflected by favourable ratings and a stable outlook by rating agencies. However, a sharp rise in government debt, followed by a moderate public finance consolidation, could lead to rating downgrades,[5] adverse sentiment on the bond market and portfolio reallocation mainly by non-residents, resulting in higher interest costs for new issues of Czech government bonds. As an institution with a forward-looking perspective, the CNB is aware that fiscal consolidation will be crucial for keeping Czech public finances on a sustainable track.

Looking ahead, we do not foresee significant changes in the interactions between CNB and government policies. Despite some turbulence linked to the depreciation of the Czech koruna and the introduction of the exchange rate commitment in November 2013, the CNB is considered to be one of the most trusted public institutions. Moreover, there have not been any amendments to the Act on the CNB, or any significant political pressures put on the CNB in recent years, which would weaken the CNB's independence and negatively affect the ability of the CNB to fulfil its mandate.

4 Binder (2021) found three signs of political pressure between 2010 and 2018 which would indicate an even lower number of incidents of pressure on the CNB per year. She reviewed articles about the CNB in country reports published by the Economist Intelligence Unit and Business Monitor International. Political pressure could thus be underestimated in comparison with the approach based on national sources.

5 When confirming the Czech Republic's rating as Aa3 in February 2021, Moody's cited a slowdown in government debt through sensitive fiscal consolidation as a condition for this rating to be maintained in subsequent years.

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