INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No.
FOR IMMEDIATE RELEASE
[xx, August, 2005]

International Monetary Fund
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Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with the Czech Republic

On August 1, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Czech Republic.[1]

Background

Recent accession to the EU and gains in growth performance reinforced the Czech Republic's position as one of the most open and developed economies among the new member states. Thanks to substantial foreign direct investment, its manufacturing sector is closely integrated into cross-border production networks, and foreign-owned firms now account for most of industrial exports.

Nothwithstanding a recent spurt, growth potential remains constrained by impediments to the geographical mobility of workers and skills mismatches, and weaknesses in the business-legal environment. Adverse demographic trends presage unsustainable pressures on the budget and weakening economic prospects. Despite initial steps in some areas and the development of a medium-term strategy, overall progress in alleviating structural impediments to growth has been slow. Implementing the requisite policies has become all the more imperative for the Czech Republic to maintain its

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the August 1, 2005 Executive Board discussion based on the staff report.

relatively favorable position among new member states and keep pace with quickly catching up peers.

Accession to the EU combined with a cyclical recovery accelerated growth last year. GDP expanded by 4.4 percent in 2004, with net exports gradually replacing investment as the main source of growth. Household consumption grew only modestly, as lagging employment weighed on disposable incomes. Unemployment—of which more than half is long-term—remained at about 8 percent. With favorable terms of trade, an export boom narrowed the trade deficit. Although appreciation and rising unit labor costs unwound competitiveness gains achieved in 2003, market shares remained broadly stable.

Despite a pickup in growth, inflation stayed low, as a soft labor market, expanding productive capacity, and strong productivity growth kept core inflation down. Excluding the effects of administrative price changes related to EU accession, underlying inflation has risen only modestly, remaining on average below 2 percent. Headline inflation is about 1½ percent, below the CNB target band.

The trade deficit narrowed to less than 1 percent of GDP in 2004, turning into a surplus in the first quarter of 2005. The current account deficit declined to 5¼ percent of GDP, in 2004, with rising profit and dividend repatriations offsetting the narrower trade deficit. The current account deficit was largely financed by greenfield and brownfield FDI, which rebounded to 3⅔ of GDP, despite the lack of major privatizations.

Monetary conditions tightened during 2004, owing to a cumulative 50 basis point increase in policy interest rates in the summer of 2004 and a 6 percent nominal appreciation of the koruna against the euro during the year. A strengthening of the koruna led the inflation-targeting (IT) CNB to reassess the inflation outlook and reduce the main policy rate by cumulative 75 basis points to 1¾ percent by April 2005.

The fiscal deficit declined in 2004. The general government deficit—excluding privatization receipts and transfers to the Czech Consolidation Agency (CKA) to cover the costs of managing bad assets—narrowed relative to GDP by about 1¾ percentage point to near 3¼ percent of GDP in 2004. The decline mainly reflected changes in the budgetary rules that allowed line ministries to carry over unspent allocations to future years, as well as a reduction in sickness benefits and public employment. Tax revenues remained strong, given a pickup in growth and harmonization of indirect taxes with the EU. Public debt is still a moderate 24 percent of GDP and can be financed with ease, as the success of the recent Eurobond issues illustrates.

Banking sector indicators are positive, and bank lending—led by credit to households—continues to rebound. Past restructuring and improved risk management have strengthened banks, and the authorities' stress testing suggests that the banking system is resilient to moderate macroeconomic shocks. As banks introduced new mortgage and consumer loan facilities into a largely untapped retail market, bank lending to households has risen at an annual rate of 20–30 percent for about three years, outpacing lending to corporates by a wide margin.

Executive Board Assessment

Executive Directors commended the authorities for the Czech Republic's strong economic performance in the first year of EU membership. Moreover, the near-term outlook has brightened, in part because significant foreign investments have expanded capacity, lowered inflationary pressures, and contributed to a robust export performance.

At the same time, Directors noted that the Czech Republic's continuing attractiveness to foreign and domestic investors may be affected by rigidities in the labor market and weaknesses in the business-legal environment. In addition, primary fiscal deficits are large, and population aging could slow growth and undermine fiscal sustainability. Directors emphasized that sustaining the good economic performance will require an integrated policy response to these challenges.

Directors considered that robust economic growth offers the authorities the opportunity to advance the pace of deficit reduction and implement in full the reforms under the medium-term fiscal adjustment plan. Substantial budgetary savings will be needed to achieve the medium-term fiscal targets. Directors therefore encouraged the authorities to sustain the consolidation gains made in 2004 and to approve quickly the expenditure-reducing measures identified for 2006 and beyond, which would also bolster the credibility of the medium-term plan.

Directors called for a further strengthening of the fiscal framework to address existing institutional weaknesses and contain the risk of fiscal drift. The budget approval process for extrabudgetary activities should be integrated with that for the state budget, and expenditure ceilings should be extended to cover carryover spending and extrabudgetary activities. Enhancing fiscal policy transparency will require the timely reporting of spending from extrabudgetary funds and a shift to a comprehensive fiscal definition—preferably the standardized European Union definition.

Directors stressed that, to deflect the adverse effect that population aging is expected to have on the public finances, ambitious expenditure reforms will be needed to ensure a sound long-term fiscal position. They welcomed the progress made in evaluating pension reform proposals, and noted the need to build a political consensus for such a reform. They cautioned that delays in health care reform and repeated bailouts of health insurance companies increase moral hazard and raise contingent liabilities for the budget. They saw an urgent need to create incentives for containing costs and allowing greater burden-sharing of costs with final users.

Directors commended the authorities for having achieved low inflation. The inflation-targeting framework has gained well-deserved credibility and is a sound anchor for inflationary expectations. Given the benign inflation outlook, Directors supported the recent interest rate cuts. Looking ahead, the absence of demand pressures justifies an accommodative monetary policy stance. However, uncertainties about fiscal policy, in particular, call for a cautious approach to future interest rate cuts. Directors underscored that, while the Czech Republic's near-term competitiveness is not in question, a

continued rise in unit labor costs relative to trading partners would be a cause for concern. Directors welcomed the authorities' continued policy of non-intervention in the foreign exchange market and their commitment to use the interest rate instrument to achieve price stability. They also welcomed recent efforts by the Czech National Bank to improve public communication of its monetary policy decisions, and encouraged it to seek further refinements.

Directors welcomed the indications of strong banking system soundness and the ongoing improvements in banking supervision. At the same time, given the rapid increase in credit to households, continued supervisory vigilance is needed in this sector, including through improved collection of data on household loan portfolios and better evaluation of household loan quality. Directors also noted the need to promote policies that encourage long-term savings, to prepare for the demands of an aging population and the expected transfer of financial risks from the public sector to households.

Directors observed that a more flexible labor market will be needed to deal with the implications of the decline in the number of active labor market participants as the population ages. Greater flexibility will also be important given that the labor market will have to play a larger role in cushioning economic shocks after the euro is adopted. Directors called on the authorities to speed up the adoption of legislation to tighten benefit entitlements, encourage retraining, and increase geographical mobility. They particularly encouraged the authorities to focus on reforming the social benefit system to reduce disincentives to work and increase labor force participation. Efforts to improve the quality of education, as well as research and development activities, will also be important.

Directors considered that bolstering the role of the private sector would be key for raising productivity in the economy and long-term growth. They welcomed the resumption of privatization, but noted that slow reforms of bankruptcy procedures hinder the restructuring of poorly performing enterprises. They urged swift approval of new bankruptcy legislation.

Directors felt that euro adoption can bring considerable economic gains provided that the appropriate flexibility of the economy is achieved and the right policies are in place. They stressed that adhering to the current timetable for euro adoption will require securing an early agreement on, and building public support for, sustainable fiscal consolidation and structural reforms.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Czech Republic: Selected Economic and Financial Indicators, 2002-04

	2002	2003	2004
Real economy (change in percent)			
Real GDP	1.5	3.2	4.4
Domestic demand	2.7	3.4	2.9
CPI (year average)	1.8	0.1	2.8
PPI (year average)	-0.5	-0.3	5.7
Unemployment rate (in percent) 1/			
Survey-based	7.3	7.8	8.3
Registered 2/	9.2	9.9	9.2
Gross national savings (percent of GDP)	22.3	21.0	22.4
Gross domestic investments (percent of GDP)	27.9	27.1	27.6
Public finance (percent of GDP)			
General government revenue	37.5	38.6	38.4
General government expenditure 3/	44.1	44.6	42.5
General government balance 3/	-6.6	-6.0	-4.0
Adjusted to exclude grants to transformation institutions to cover costs related to management of bad assets	-3.9	-4.8	-3.3
Targeted: adjusted balance excluding net lending 4/	-3.7	-3.9	-2.8
General government debt	18.4	21.7	24.0
Including debt of the Czech Consolidation Agency	25.5	27.7	27.8
Money and credit (end of year, percent change)			
Broad money	3.5	6.9	4.4
Private sector credit (percent change, eop)	4.5	8.5	8.4
Interest rates (in percent)			
Three-month interbank rate	3.5	2.3	2.4
Ten-year government bond	4.6	4.0	4.3
Balance of payments (percent of GDP)			
Trade balance	-3.0	-2.7	-0.8
Current account	-5.6	-6.2	-5.2
Gross international reserves (US$ billion)	23.7	27.0	28.4
Reserve cover (in months of imports of goods and services)	6.1	5.5	4.4
Fund position (as of May 31, 2005)			
Holdings of currency (percent of quota)			71.13
Holdings of SDRs (percent of allocation)			n.a.
Quota (millions of SDRs)			819.3
Exchange rate			
Exchange rate regime			Managed float
Koruna per U.S. dollar (June 28, 2005)			CZK
Nominal effective exchange rate (2000=100)	115.8	117.0	119.4
Real effective exchange rate (CPI-based; 2000=100)	116.6	114.2	115.8

Sources: Czech Statistical Office; Czech National Bank; Ministry of Finance; and IMF staff estimates and projections.

1/ In percent of total labor force.
2/ The methodology for calculating the registered unemployment rate changed in 2004. Under the old methodology, the registered unemployment rate in 2004 is estimated at 10.2 percent.
3/.Excluding privatization revenues of the National Property Fund and the Czech Land Fund, the sale of shares and voting rights by local governments, and the sale of Russian debt.
4/ General government deficit excluding transfer to transformation institutions and net lending. Concept targeted by the authorities.