August 2000
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Czech Republic: Staff Report for the 2000 Article IV Consultation

As required under Article IV of its Articles of Agreement, the International Monetary Fund conducts periodic consultations with its member countries. In the context of the 2000 Article IV consultation with the Czech Republic, the following documents have been released and are included in this package:

- the staff report for the 2000 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 9, 2000,** with the officials of the Czech Republic on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on July 11, 2000.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **July 26, 2000**, updating information on recent economic developments.

- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during the July 26, 2000, Executive Board discussion** of the staff report that concluded the Article IV consultation.

- a statement by the authorities of the Czech Republic.

Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports and PINS allows for the deletion of market-sensitive information.

The Article IV staff report is published—both in hard copy and on the IMF's website (http://www.imf.org)—as part of a pilot project. To assist the IMF in evaluating the pilot project for release of Article IV staff reports, reader comments are invited prior to October 5, 2000, and may be sent by e-mail to Pilotproject@imf.org.

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INTERNATIONAL MONETARY FUND

CZECH REPUBLIC

Staff Report for the 2000 Article IV Consultation

Prepared by the Staff Representatives for
the 2000 Consultation with the Czech Republic

Approved by C. M. Watson and Leslie Lipschitz

July 11, 2000

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SUMMARY AND KEY ISSUES

Background: The severe recession that started in 1997 has come to an end, and a recovery is emerging. The recovery has been based primarily on robust exports, reflecting growing demand from EU member countries. A substantial amount of foreign direct investment is flowing in, and partly because of this, fixed capital investment is expected to rebound after declining three years in a row. However, the growth of domestic demand components is likely to be modest. The ongoing banking and corporate sector restructuring, and the associated increase in unemployment, are putting downward pressure on private investment and consumption and acting as a drag in the short run. As a result, the pace of recovery is expected to be moderate, and some downside risks still remain, although these are gradually receding over time. Inflation has come down considerably, and is expected to remain low. Nominal wage growth has decelerated, suggesting stable inflationary expectations. The strong capital inflows imply that upward pressure on the koruna is likely to continue, although substantial outflows are also taking place. The external current account deficit is expanding in value terms, primarily because of increases in imported oil prices, but it still remains well within the range that can be covered by expected net capital inflows.

Policy Issues: Macroeconomic policies need to sustain the pace of recovery, but continued improvements in economic conditions should allow the authorities to gradually shift their focus to medium-term policy objectives. For the Czech economy to achieve robust growth over the medium term, it is imperative that structural reforms proceed without delay. Some progress has been made, but there still is a considerable way to go.

- On **fiscal policy**, the 2000 budget is appropriately supportive. The authorities should implement expenditures as planned to let the automatic stabilizers operate fully. As for the plans for the 2001 budget, it is difficult as yet to assess their macroeconomic impact with precision, but there are several concerns. First, the current budget plan includes no fundamental fiscal reform measures, so that lasting progress toward consolidation is unlikely to occur in 2001. Second, two new extrabudgetary funds have recently been introduced, partially funded by privatization revenues, and will become fully operative from 2001, running counter to fiscal transparency and posing a threat to fiscal sustainability. In sum, medium-term policy objectives should be better articulated, and more vigorously pursued, on the fiscal front.

- **Monetary policy** is also appropriately supportive, and the medium-term objectives of the Czech National Bank (CNB) were clearly signaled by its announcement in April of the end-2001 inflation target. While the current interest rate policy is broadly consistent with the new target, the CNB needs to respond flexibly to changes in future economic conditions. In particular, a significant appreciation of the koruna should be resisted through intervention and, if necessary, further interest rate cuts, until the recovery is firmly established. It is essential that the CNB's ability to forecast inflation be strengthened to enhance its credibility. The amendments to the CNB Act, currently under discussion in Parliament, weaken central bank independence and are a source of concern.

- On **structural reforms**, three of the four major state-owned banks have been privatized, and the last one is to be sold by early next year, which is a welcome development. However, one of the privatized banks was recently placed under forced administration after a major run on its deposits, raising questions about banks' governance. In the process of bank privatization, a large amount of nonperforming assets have been transferred to the state-owned "consolidation" bank. Disposing of these assets is a major remaining task, closely related to corporate sector restructuring. The Revitalization Agency has started to operate, and the market-based approach chosen so far is welcome. The Agency should continue to operate without political interference. A legal environment conducive to banking and corporate restructuring is necessary, and steps are being taken in this direction as well, though there is further room for improvement. The sharp rise in unemployment over the past few years is worrisome. To prevent unemployment from becoming structural, the authorities should implement measures that increase the flexibility of the labor market.

I. Introduction

1. The 2000 Article IV discussions with the Czech Republic were held in Prague during April 25–May 9, 2000.[1] The mission met with Prime Minister Zeman, Finance Minister Mertlík, Czech National Bank (CNB) Governor Tošovský, several members of the CNB Board, senior officials in government ministries, the CNB, and the Czech Statistical Office, members of Parliament, labor unions, financial market representatives, and the EU delegation. Messrs. Kiekens (Executive Director) and Jonas (Advisor to the Executive Director) participated in many of the meetings.

2. At the conclusion of the 1999 Article IV consultation with the Czech Republic on July 21, 1999, Executive Directors commended the authorities for maintaining a prudent macroeconomic policy, which had allowed the Czech economy to maintain a strong external position and relatively low inflation during the turmoil in emerging markets in the preceding year. They observed, however, that deep-rooted problems in the banking and enterprise sectors, compounded by the tight policy stance, had sent the Czech economy into a severe recession. They agreed that the easing of fiscal and monetary policies that had begun toward the end of 1998 was appropriate, but stressed that to ensure the sustainability of growth in the longer term, as well as to prepare for EU accession, it was crucial to address the underlying structural weaknesses in the banking and enterprise sectors.

3. The economy hit bottom in the first quarter of 1999, and has gradually recovered since then. The discussions focused on the strength of the emerging recovery, and on policies necessary for the recovery to develop into robust, sustainable, and non-inflationary growth. In addition, the mission looked into banking and corporate sector restructuring, labor market issues, and legal reforms, and also followed up on the medium-term fiscal framework and the Report on the Observance of Standards and Codes (ROSC) exercise.[2]

4. Since mid-1998, the Social Democratic Party has ruled as a minority government, with tacit support from the Civic Democrats. The approval of the 2000 budget was delayed repeatedly while the two parties renegotiated the terms of their "opposition agreement," and was finally passed in March 2000. Most observers believe it is now likely that the current government will remain in power until the next legislative elections, which are due by mid-2002.

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[1] The mission team comprised Messrs. Takeda (head), Lutz, Tzanninis, Ms. van Elkan (all EU1), and Mr. Song (MAE). Mr. Nord, the regional representative in Central Europe, participated in a part of the mission.

[2] The medium-term fiscal framework was developed last year with technical assistance from the Fund. The ROSC was also conducted last year, and the report was published in September 1999.

5. The Czech Republic accepted the obligations under Article VIII of the Articles of Agreement as of October 1, 1995, and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. The Czech Republic notified the Fund on April 21, 2000 of its approval of the Fourth Amendment to the Articles of Agreement. The Czech Republic has announced its participation in the pilot project for publication of Article IV staff reports, and hence the present report will be published.

II. Background

A. Origin of the Recession

6. **After initial success in stabilization and transition towards a market economy, the Czech Republic experienced growing economic imbalances in the mid-1990s, culminating in a currency crisis in May 1997.** Weak corporate governance, resulting not least from the dispersion of ownership following the voucher-type privatization, fueled excessive wage increases, leading to persistent inflation. Imprudent lending by commercial banks, which remained largely in state hands, contributed to the absence of an effective budget constraint on the corporate sector. Meanwhile, large capital inflows, which reached 16 percent of GDP in 1995, complicated monetary management and led to a continued appreciation of the real exchange rate which, coupled with sluggish productivity growth, contributed to a decline in competitiveness. As the current account deficit widened, reaching 7½ percent of GDP in 1996, the economy became increasingly vulnerable to changes in investor sentiment. The currency attack in the spring of 1997 reflected a sudden reversal in market sentiment, and the CNB was forced to abandon the currency band and float the koruna.

7. **Macroeconomic policies were tightened sharply after the attack to stop the slide of the currency, and remained tight until late 1998, partly because of fears that the Czech economy might be adversely affected by the crisis in Russia in the summer of 1998.** In hindsight, the tempo of subsequent loosening was too slow, which made the recession longer and deeper than necessary. Domestic banks and firms faced serious balance sheet problems resulting from earlier excesses, making it imperative to introduce some far-reaching restructuring measures. Moreover, the currency attack was followed by a period of political uncertainty, with an interim government, early elections, and a new minority government coming to power in mid-1998. Many structural reforms thus began only in 1999.

8. **Real GDP growth was negative from 1997 through 1999, in sharp contrast with Poland and Hungary, which achieved 4–5 percent growth during the same period.** Whether, and how, the Czech Republic can return over the medium term to a growth path comparable to these countries is one of the important questions the mission examined. While tight macroeconomic policies contributed to the length and depth of the recession, the fundamental cause of the recession was the structural problems in the banking and enterprise sectors. Looking ahead, addressing these problems is key to achieving high and sustainable medium-term growth comparable to some of the neighboring countries.

B. Economic and Policy Developments over the Past Year

9. **The economy began to recover during 1999: output contracted sharply in the first quarter, but growth turned modestly positive in each of the following three quarters.** The modest recovery was headed by a rebound in household consumption, underpinned by strong real wage growth, and the recovery of demand in EU trading partners (Figure 1 and Table 1). However, investment continued to fall as banking and corporate sector restructuring proceeded. Lagging somewhat output trends, the unemployment rate continued to rise sharply during 1999, reaching 9½ percent by end year, before declining to 8¾ percent during the first five months of 2000, on account of seasonal factors (Figure 2). The unemployment rate remains about 5 percentage points above the level that prevailed at the beginning of the recession in late 1996.[3]

10. **Inflation remains subdued, and a modest pickup in recent months reflects mainly temporary factors**. Headline consumer price inflation was 3¾ percent in May 2000, up from a low of 1 percent in July 1999 (Figure 3, upper panel). Inflation trends over the course of 1999 were driven primarily by a sizable fall in food prices—partially attributable to a structural change in the retail sector—and, to a lesser extent, weak import prices, notably oil.[4] The recent pickup was mainly due to the rebound of oil prices and an increase in regulated prices in January 2000, notwithstanding the continued weakness in food prices. Net inflation, the CNB's target, has also picked up modestly to just over 2 percent in May 2000, following a negative trend observed during most of the past year.[5]

11. **Both nominal and real wages rose in 1999, despite growing unemployment** (Figure 3, lower panel). After declining two years in a row in real terms, public sector salaries were adjusted substantially upward in 1999, with real wages in the sector rising in excess of 10 percent. Private sector wage settlements were more moderate, but the sharp deceleration of inflation resulted in 3¼ percent real wage growth in this sector as well. The continued decline in employment together with the recovery of industrial production (Figure 4) led to an improvement in labor productivity, which moderated the rise in unit labor costs. The

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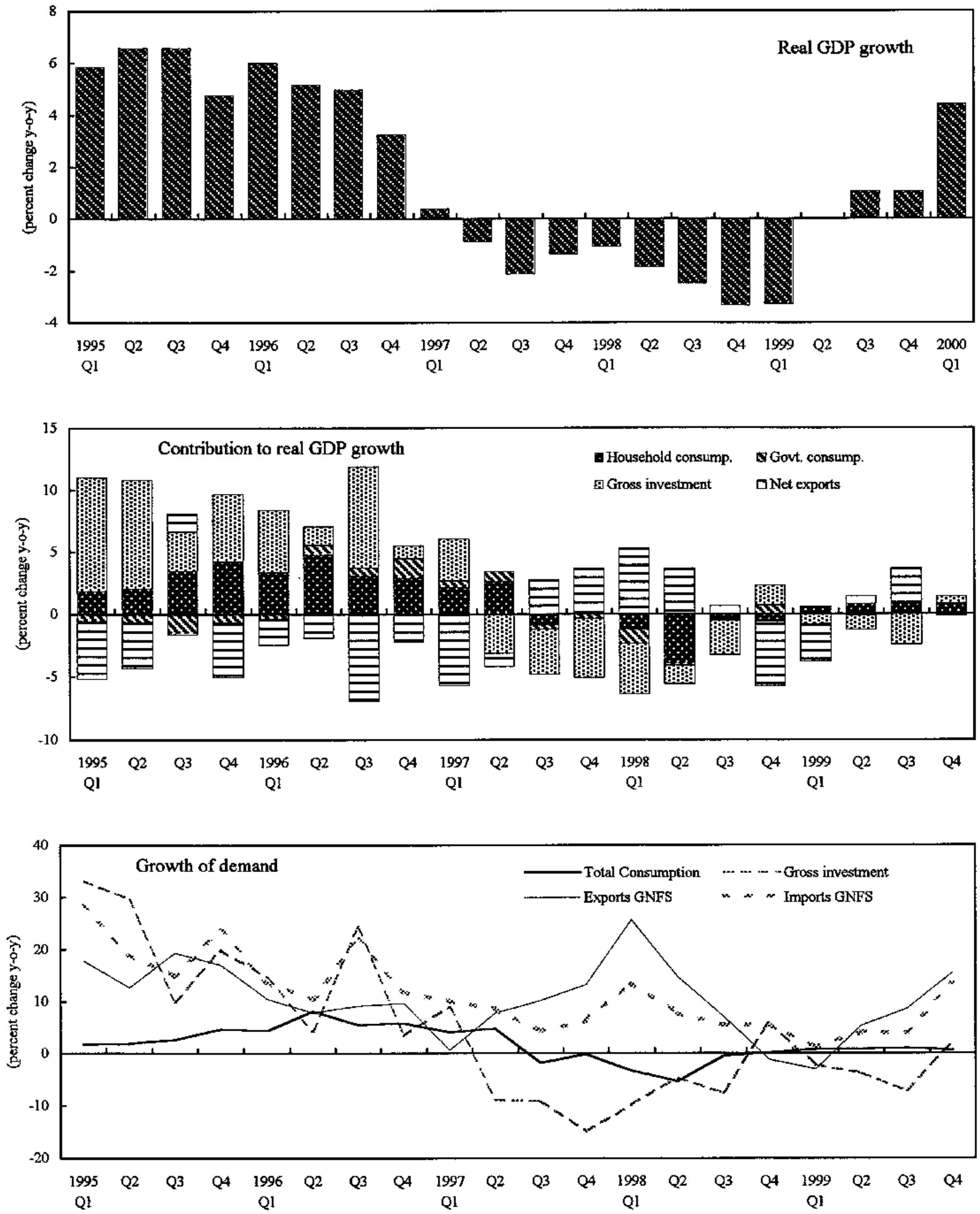
[3] High unemployment has been coupled with large regional disparities, with the unemployment rates in some regions that are heavily dependent on steel, mining, and agriculture being much higher than elsewhere. The sharp increase in unemployment and its regional pattern are explained in part by the ongoing corporate sector restructuring, in which excess labor is being released from industries facing financial difficulties.

[4] Increased competition in the domestic retail sales sector—following the establishment of supermarket chains selling food at discount prices—contributed to the decline in food prices over the past year.

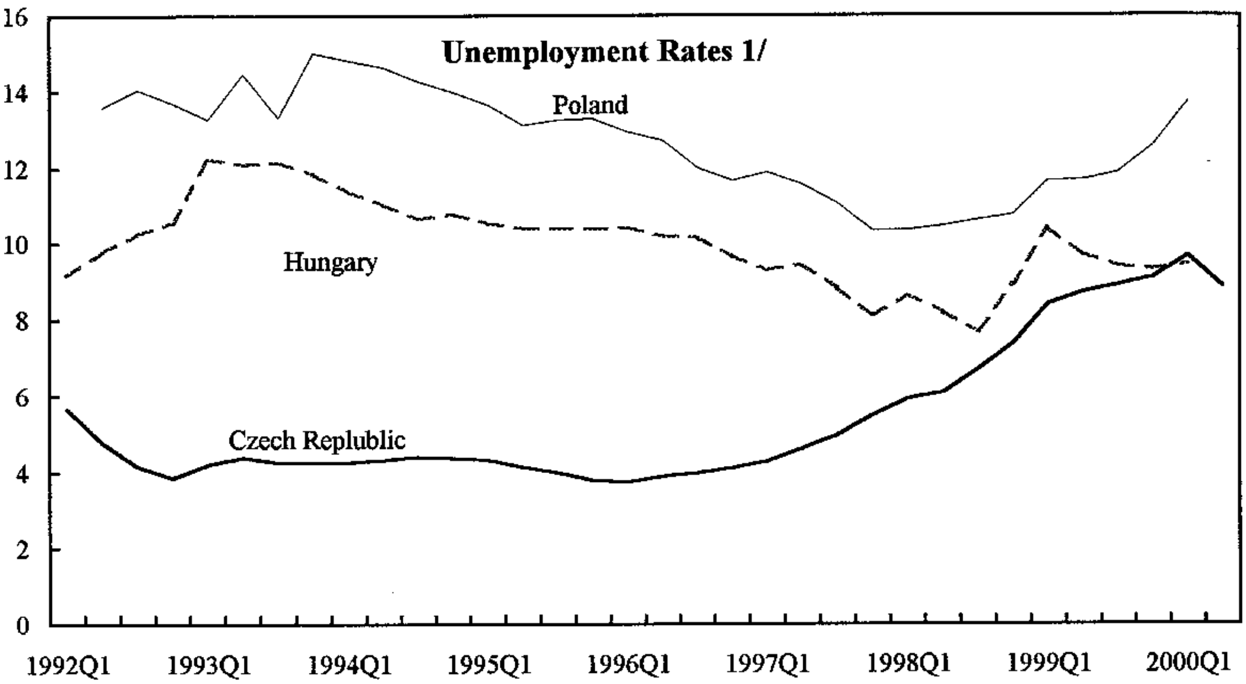
[5] Net inflation excludes regulated prices and changes in indirect taxes from the headline rate.

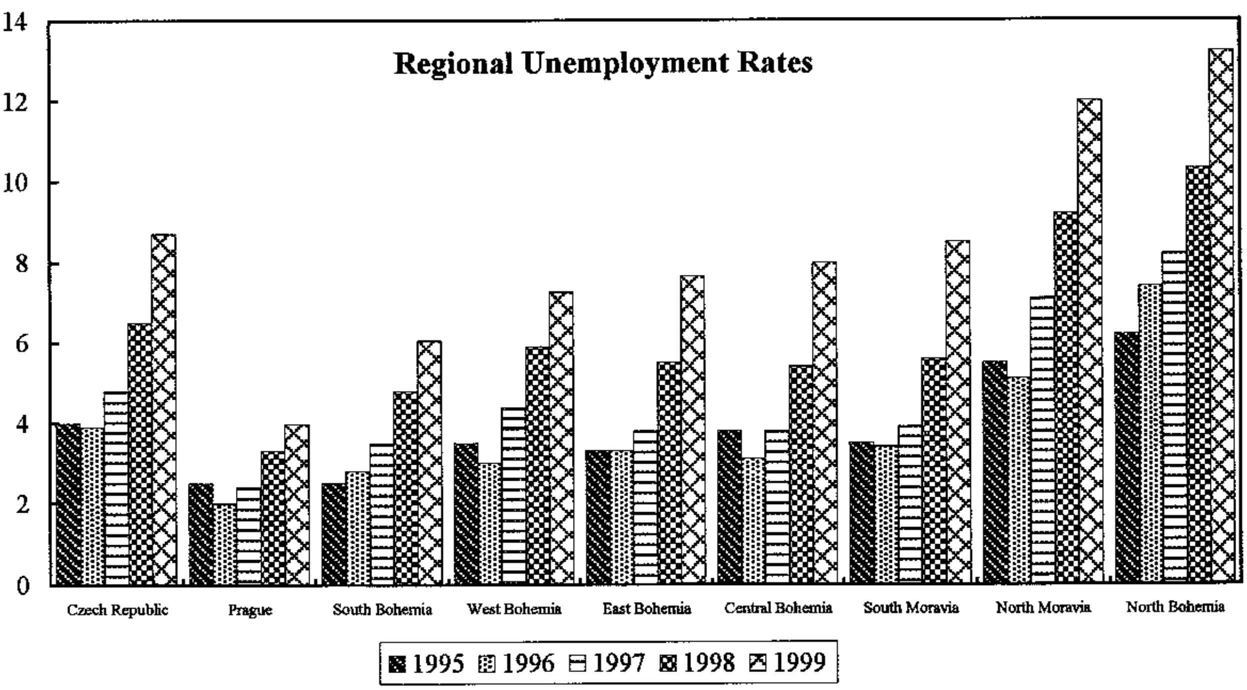
Figure 1. Czech Republic: Developments in GDP, 1995-2000



Sources: Czech Statistical Office; and Fund staff calculations.

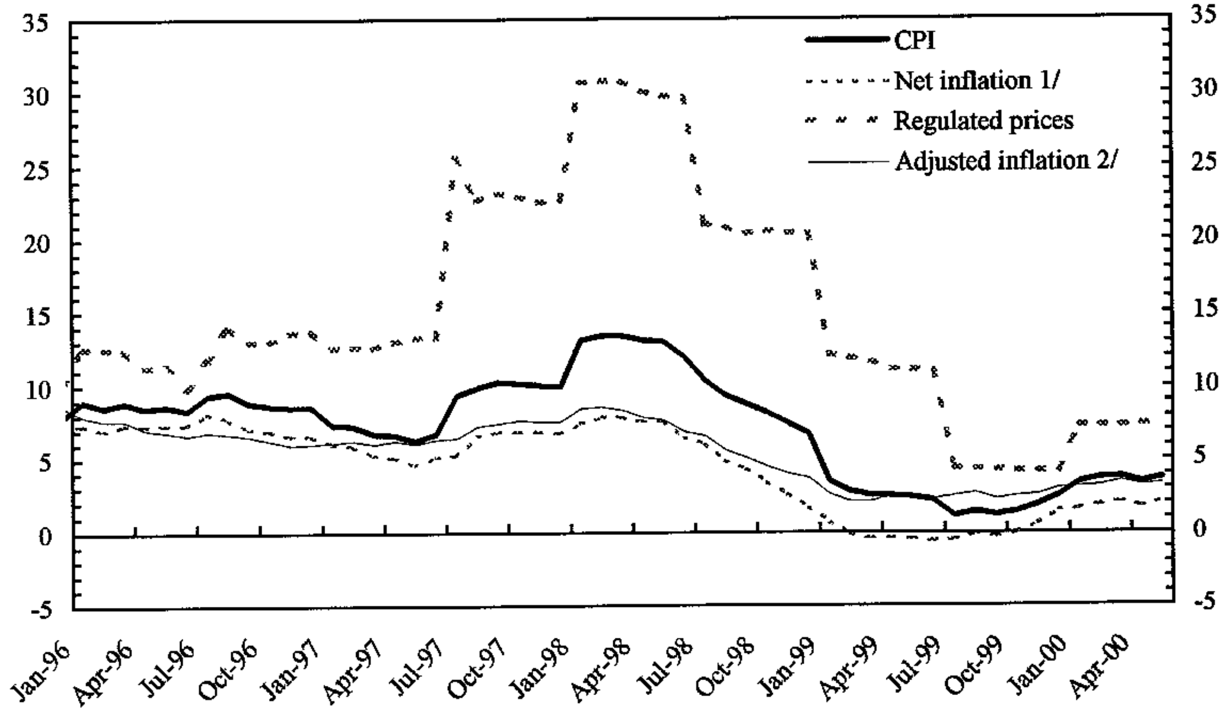
Figure 2. Czech Republic: Unemployment Rates, 1992-2000

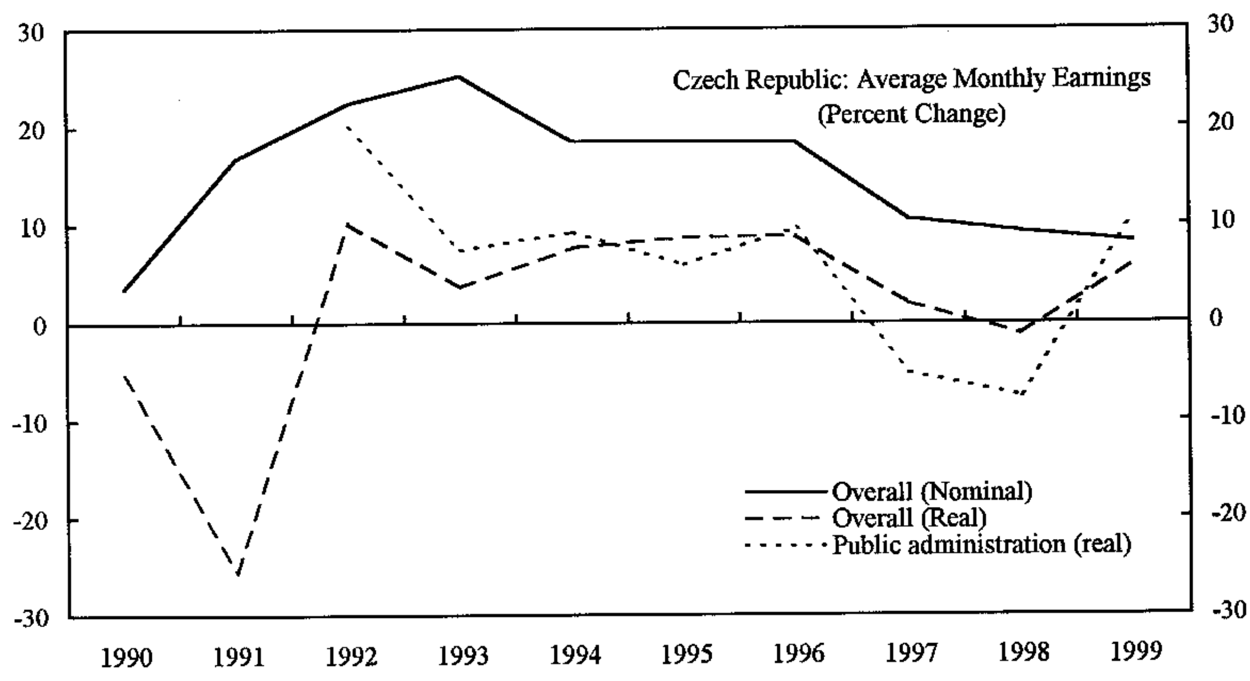




Source: Czech Statistical Office; OECD.
1/ In the top panel, data for the 2nd quarter for the Czech Republic are through May.

Figure 3. Czech Republic: Price and Wage Developments, 1990-2000
(In percent; 12-month rate)



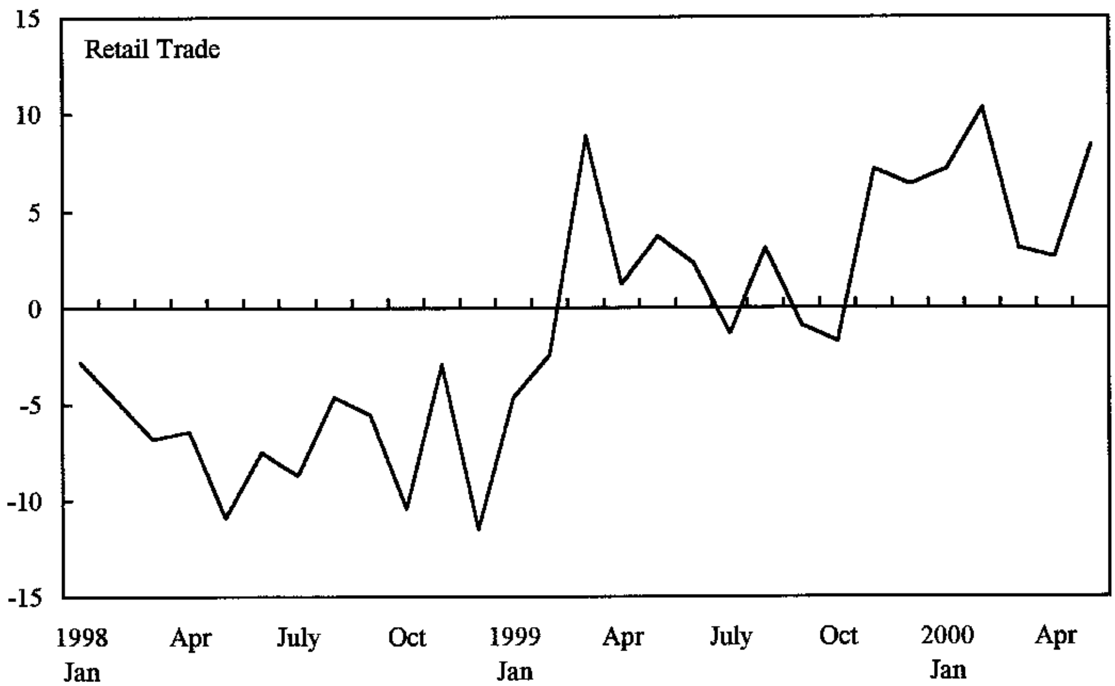


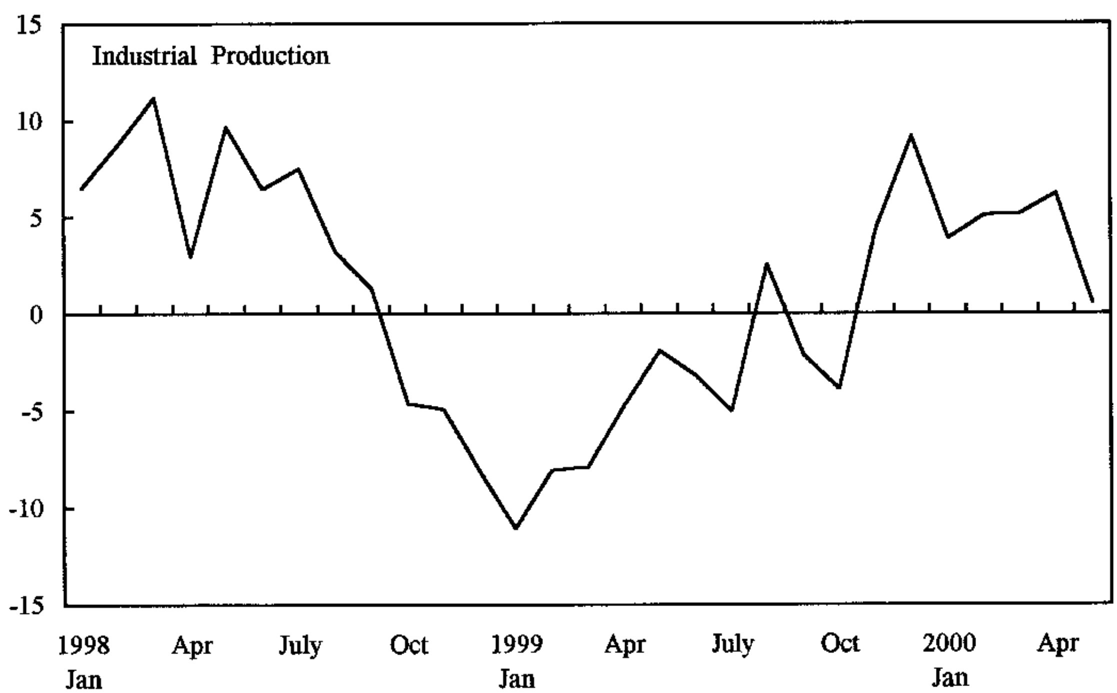
Sources: Czech National Bank; and Czech Statistical Office.

1/ Net inflation is CPI inflation excluding effects of changes in regulated prices and indirect taxes.

2/ Adjusted inflation is net inflation excluding effects of changes in food prices.

Figure 4. Czech Republic: Retail Trade and Industrial Production, 1998-2000
(Year on year growth; in percent)





Source: Czech Statistical Office.

government froze public sector nominal wages in 2000,[6] while private sector wages have been settled at a range broadly in line with expected inflation.

12. **The external current account deficit in 1999 was US$1.1 billion (2 percent of GDP), slightly lower than in the previous year** (Figure 5 and Table 2). The trade deficit declined by US$0.5 billion, against the background of vigorous export growth, reflecting a strengthening of partner country demand, and subdued domestic demand, which limited the growth of imports. Toward the end of the year and in early 2000, imports grew robustly, partly due to the higher oil prices and a high import content of expanding exports, but also suggesting a pickup of domestic demand. As a result, the trend of shrinking trade deficits (relative to the previous year) has been reversed since the fourth quarter of 1999.

13. **Capital inflows surged in the second half of the year, and the 1999 total (US$2.5 billion or 4¾ percent of GDP) was more than double the current account deficit**. Foreign direct investment (FDI) inflows rose sharply to an historical high (Figure 6 and Box 1), partly explained by the privatization of a major bank, but also by substantial amounts of reinvestments and greenfield FDI. Somewhat more than one-half of capital inflows were offset by increases in claims held by commercial banks against nonresidents, as banks financed indirectly a part of incoming FDI. Net portfolio investment outflows were recorded for the first time in 1999, as households and enterprises readjusted their portfolios in reaction to lower domestic returns relative to those abroad. The issuance of international bonds continued to be subdued over the past year; there were only two issues in1999, compared with three in1998 (none of them sovereign). Reflecting a relatively high country rating (Baa1 by Moody's and A– by Standard and Poor's), spreads on Czech international bonds are generally quite low among emerging market issues.[7]

14. **Strong FDI flows have put upward pressures on the koruna**. Following a depreciation in early 1999, the koruna gradually strengthened (vis-à-vis the euro as well as in nominal effective terms), owing to the subsequent surge in FDI (Figure 7). In an effort to mitigate the impact of FDI inflows, the CNB and the government agreed earlier this year to

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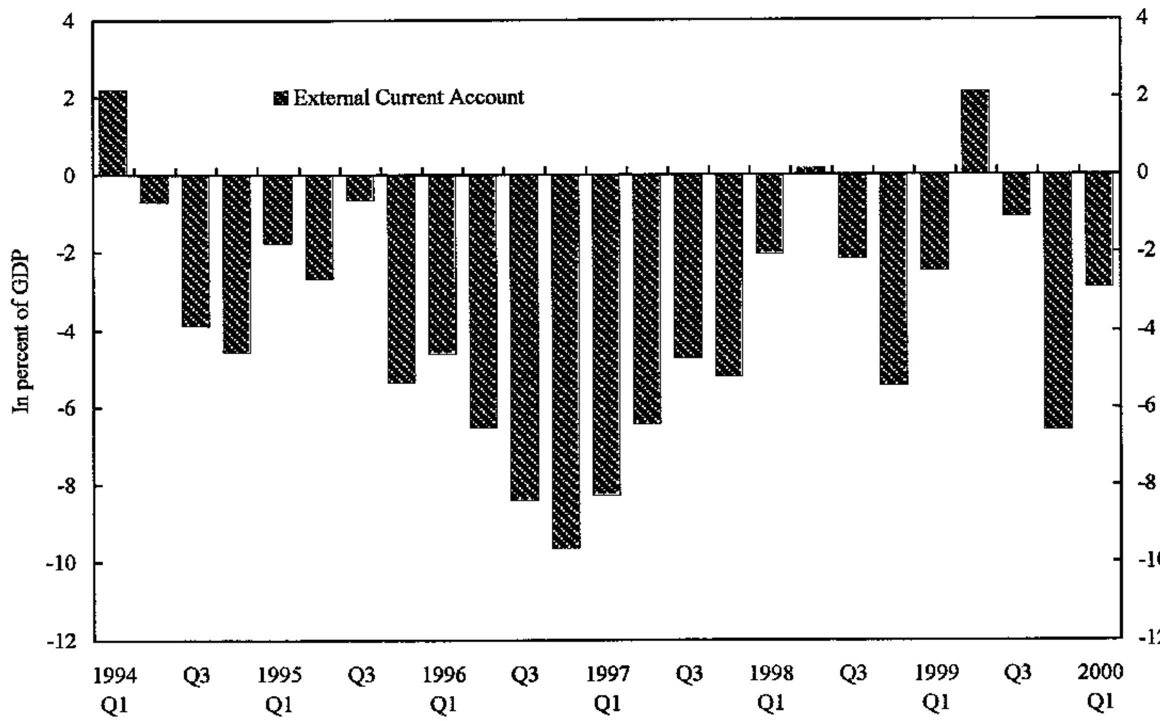
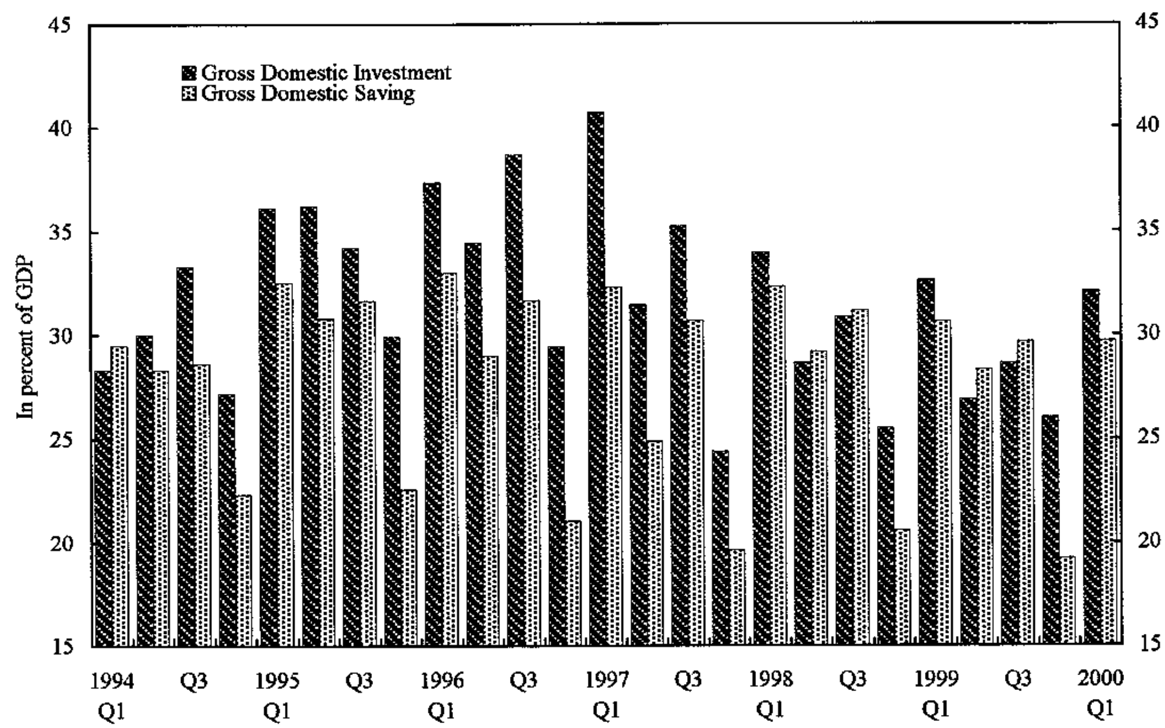
[6] Government sector nominal wages were frozen from mid-1997 through 1998, a period during which CPI inflation exceeded 10 percent. In order to compensate for their decline in real terms, a discrete upward adjustment took place in 1999, when inflation was decelerating sharply. This sent a poor signal to private sector wage negotiations. The government-sector wage freeze in 2000 follows the same backward-looking pattern, though the moderation of inflation has made it much less distortive this time.

[7] Czech interest rate spreads, currently about 130 basis points, lie above those of Hungary (80 basis points) and Poland (95 basis points), but this difference partly reflects the greater riskiness of corporate, as compared with sovereign, bonds.

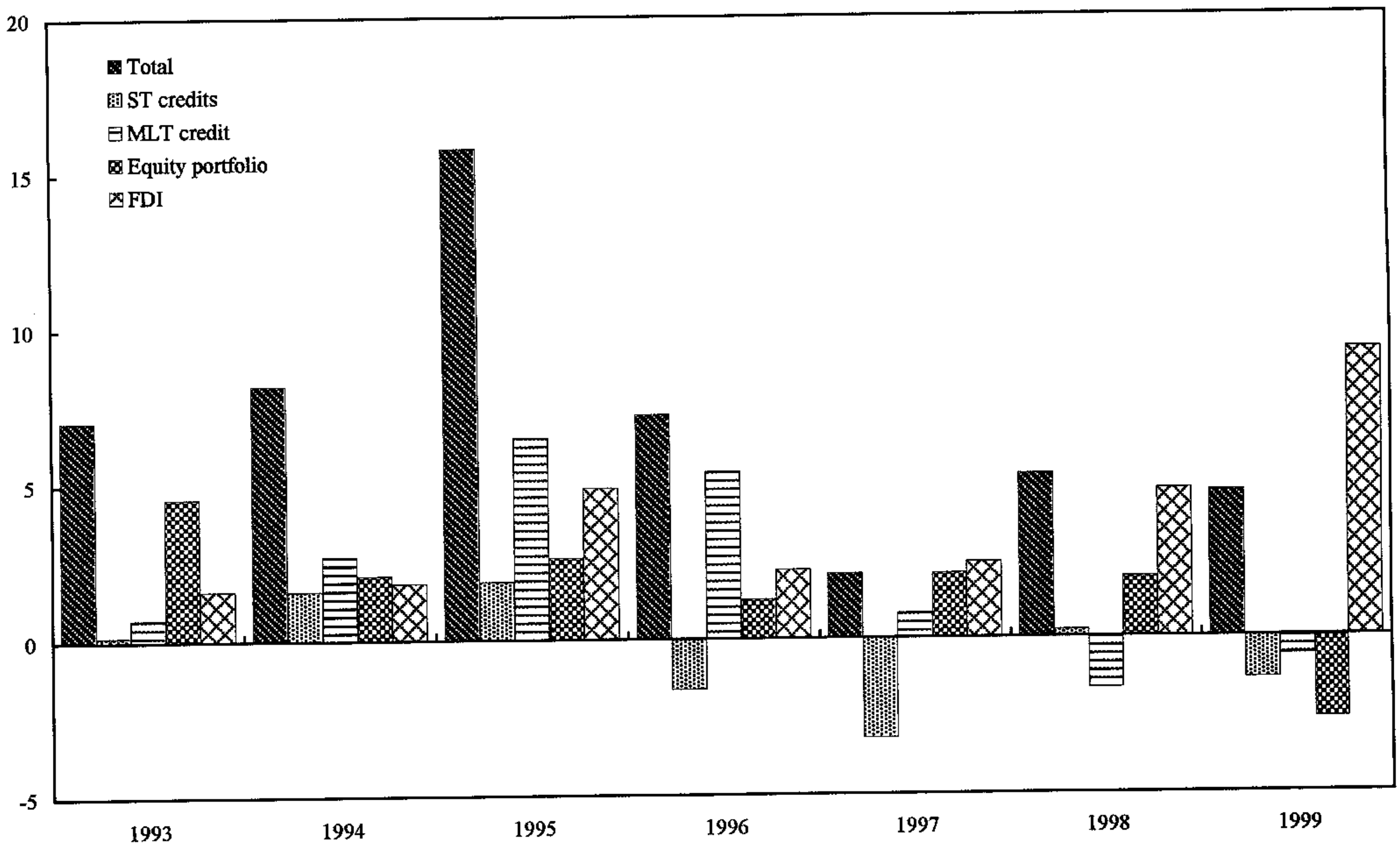
Figure 5. Czech Republic: External Current Account, Saving and Investment, 1994-2000
(In percent of GDP)





Sources: Czech National Bank; Czech Statistical Office; and Fund staff calculations.

Figure 6. Czech Republic: Net Capital Inflows, 1993-99
(In percent of GDP)



Sources: Czech National Bank and Fund staff estimates.

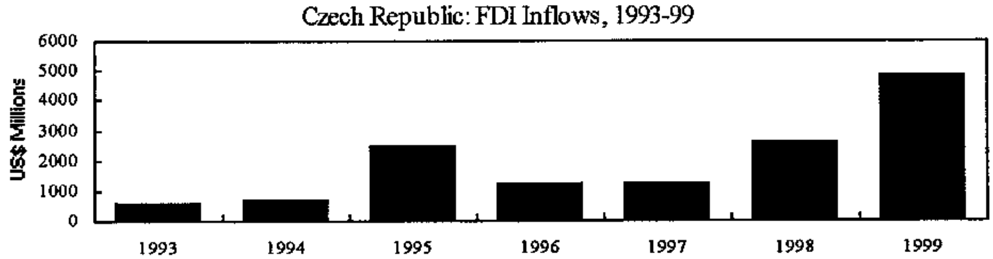
Box 1. Foreign Direct Investment Inflows—Will the Flood Continue?

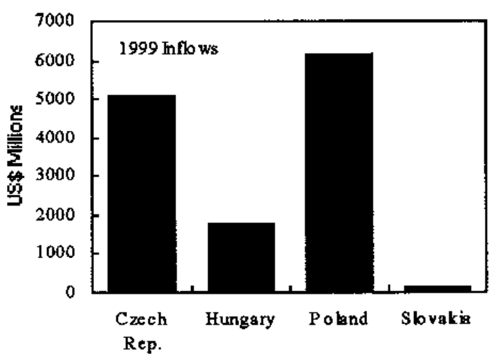
The pace of foreign direct investment inflows has markedly increased in the Czech Republic in recent years. While the annual flows into the economy were small relative to such flows into Hungary and Poland through 1997, reflecting in part differences in the method of privatization, these flows increased dramatically thereafter. They totaled some US$5 billion in 1999, compared to a current account deficit of about US$1 billion. As a result, the cumulative stock of inflows now roughly equals that in Hungary, and exceeds that in Poland on a per capita basis.

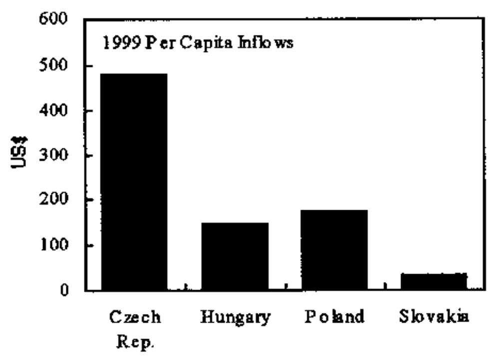
Investment to date has been economically quite diverse, with financial services accounting for 16 percent of all capital (largely the result of bank privatizations), wholesale trade for 14 percent, and nonmetallic manufacturing, post and telecommunications, motor vehicles, and food processing each accounting for 5–8 percent of total investments. In sharp contrast, the location of these investments has been quite concentrated, with 47 percent of invested capital linked to entities having their registered address in Prague (especially financial institutions and telecommunications).

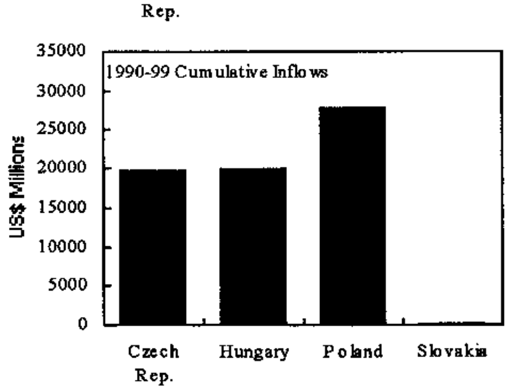
A number of factors suggest that future FDI flows, for at least the next few years, could remain at levels close to or above that experienced in 1999. First, the government intends to privatize substantial amounts of state-owned assets, including the state telecom company and the largest bank among the Central European transition economies in terms of assets. Second, since May 2000 a new law providing for investment incentives (including income tax reductions, job creation and training grants, and the provision of low-cost land and/or infrastructural support) has been in force, replacing a previous case-by-case incentive scheme. A number of sizable new investments have been made in response to these incentives.

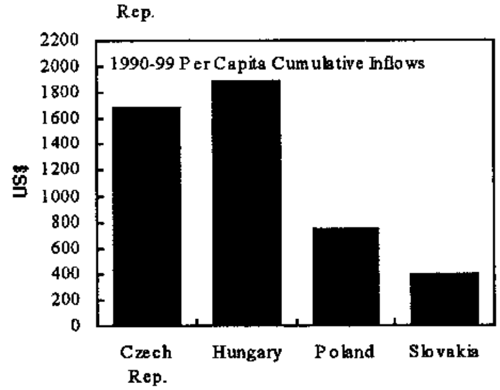
Czech Republic: FDI Inflows, 1993-99





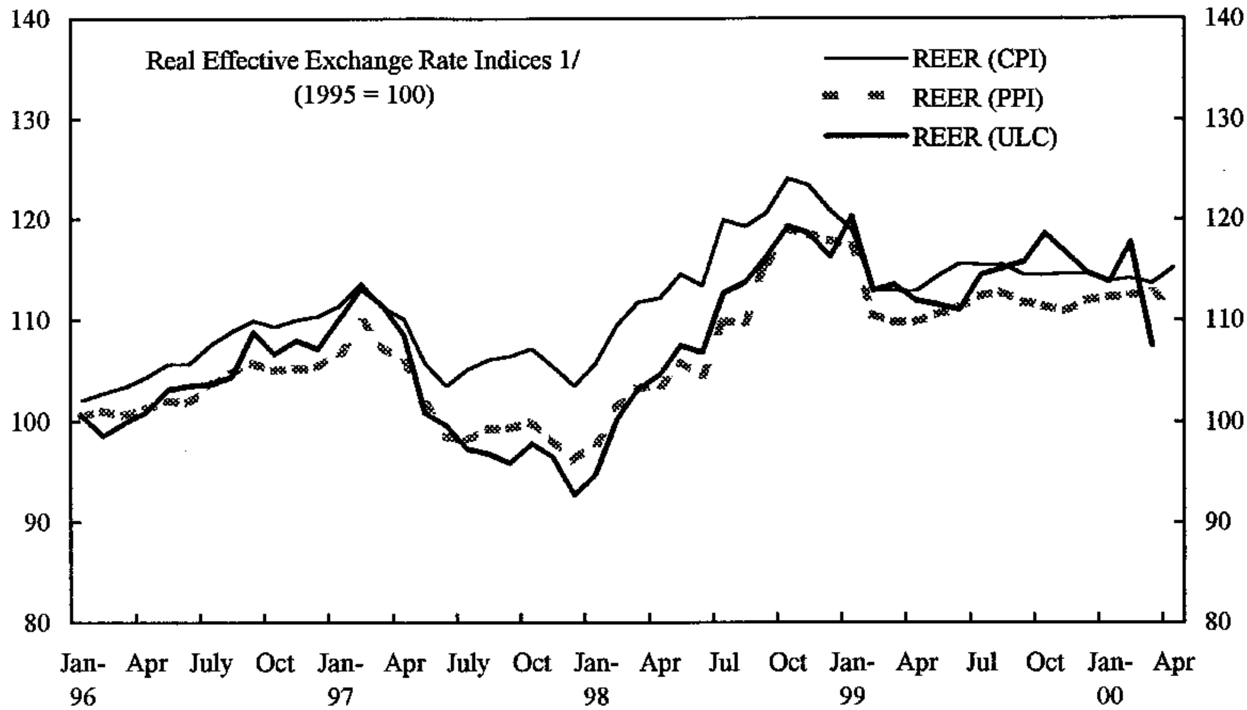


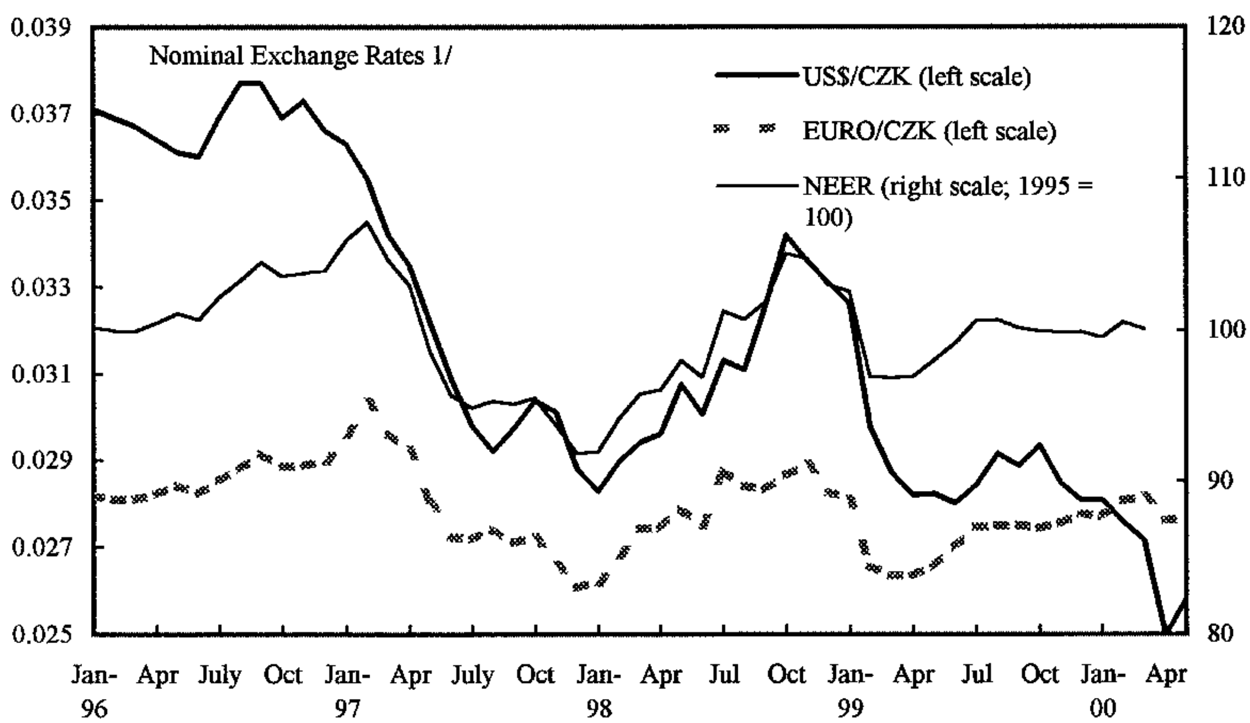




Sources: Czech National Bank; Vienna Institute of Comparative Economic Studies, 2000, as provided by Czech Invest.

Figure 7. Czech Republic: Exchange Rate Indicators, 1996-2000





Sources: Czech National Bank; Fund staff estimates.
1/ Upward movement denotes appreciation.

set up a special foreign exchange account in which privatization proceeds from abroad will be deposited. In the meantime, the authorities sought to stem the upward pressure on the koruna by intervening in the foreign exchange market on three occasions since October 1999, most recently in March 2000, and have successfully resisted the pressures. As a result of the CNB's intervention, official foreign exchange reserves increased to US$ 12.9 billion at end-May 2000 (equivalent to 5¼ months of imports, or close to 1½ times the stock of short-term debt on an original maturity basis) from US$ 11.9 billion a year before.[8]

15. **As the economy weakened, the authorities allowed the fiscal deficit to widen significantly in 1999, and a further loosening is envisaged for 2000.** The general government deficit (excluding privatization receipts and grants to transformation institutions) increased to 3¼ percent of GDP in 1999 from 2 percent of GDP in the previous year, reflecting increased transfers to households and greater support to nonfinancial enterprises through subsidies and policy-related lending (Figure 8 and Table 3). A further increase in the deficit to 4¼ percent of GDP is envisaged for 2000, particularly owing to a reduction in corporate and personal income tax rates and increased transfers to households.[9] However, in view of the widening output gap during 1999–2000, the expansion in the structural deficit was more modest than suggested by the headline measure. Specifically, the structural deficit is estimated to have increased by ½ percent of GDP in 1999, and by less than ¼ percent of GDP in 2000.

16. **The CNB cut interest rates aggressively from July 1998 through November 1999.** The key policy interest rate (two-week repo rate) was reduced 18 times, from 15 percent in July 1998 to 5¼ percent in November 1999. However, with inflation decelerating sharply and the koruna gradually appreciating during 1999, it is estimated that the monetary conditions index did not ease significantly (Figures 9 and 10). Moreover, the credit channel of the monetary policy transmission mechanism was clogged owing to banking sector problems, which tended to weaken the effectiveness of interest rate policy. The CNB's net inflation forecast consistently overshot actual inflation, and end-1999 net inflation was 1½ percent compared with the target range of 4–5 percent.

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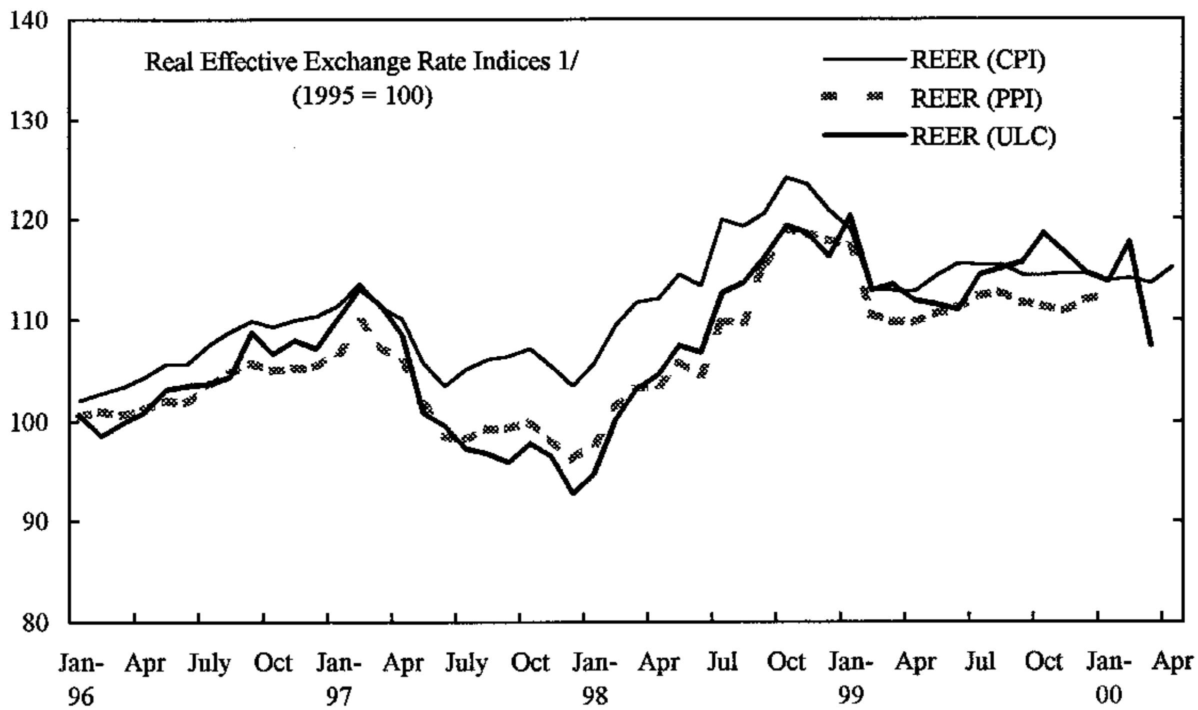
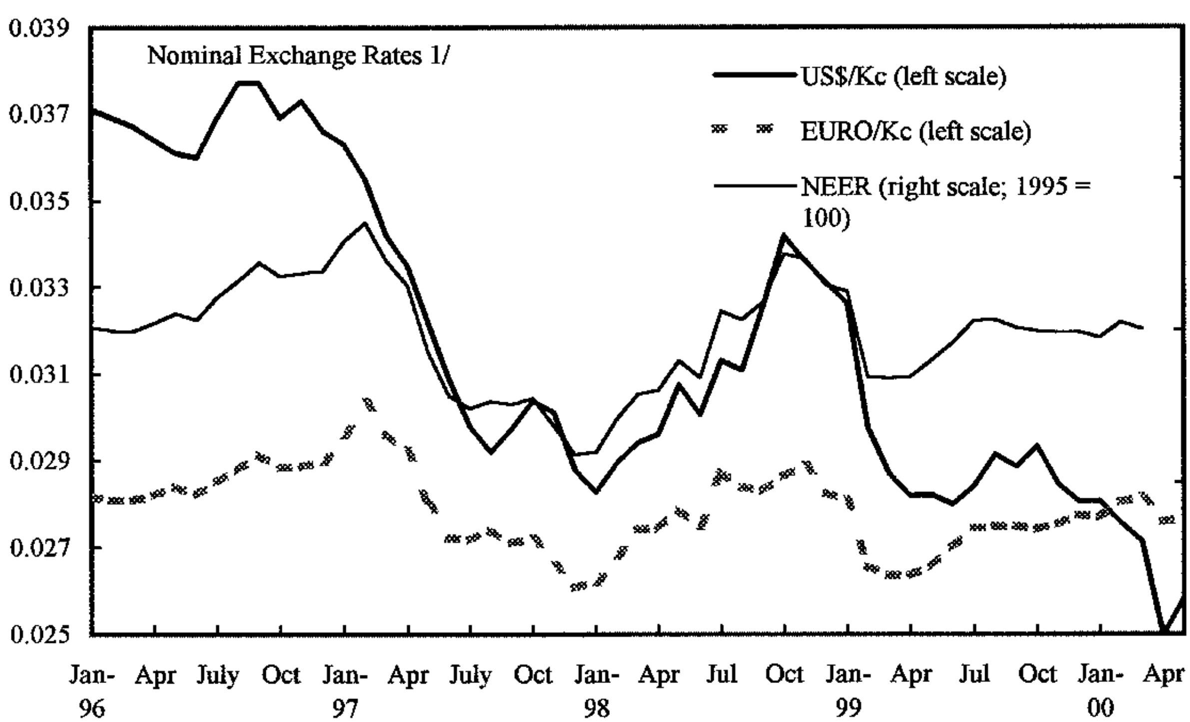
[8] The CNB's foreign currency liabilities are very small (somewhat less than $0.4 billion).

[9] Grants to off-budget transformation institutions—primarily to cover the cost of cleaning up banks' portfolios—declined from 1 percent of GDP in 1998 to less than ½ percent in 1999. However, they are expected to reach nearly 3 percent in 2000, owing to the assumption of CZK 36 billion in nonperforming loans (net of provisions) from a state-owned bank and the need to cover losses accumulated during 1998 and 1999.

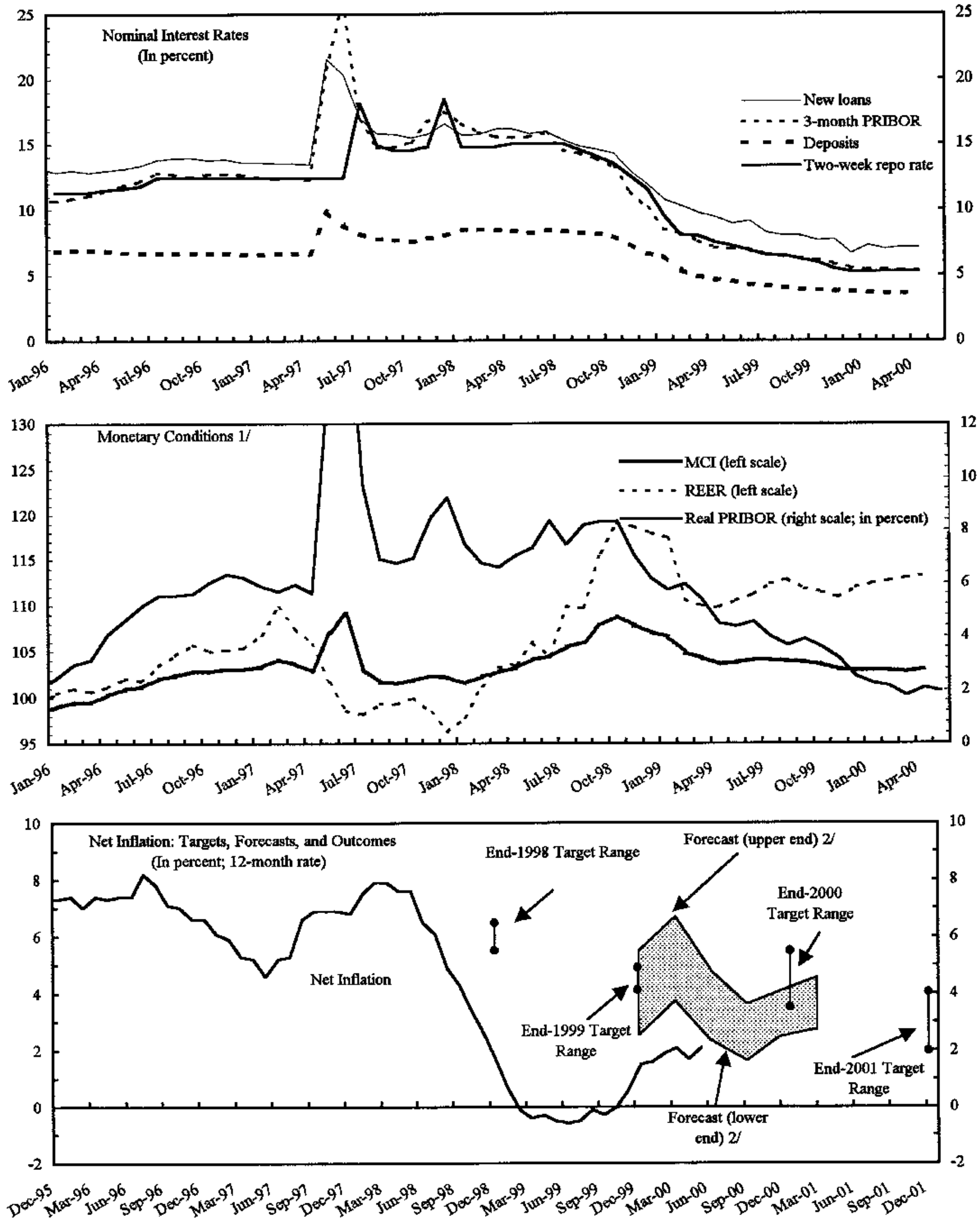
Figure 8. Czech Republic: Exchange Rate Indicators, 1996-2000





Sources: Czech authorities; Czech National Bank; and staff estimates.
1/ Upward movements denote appreciation

Figure 9. Czech Republic: Interest Rates, Monetary Conditions, and Net Inflation, 1996-2001

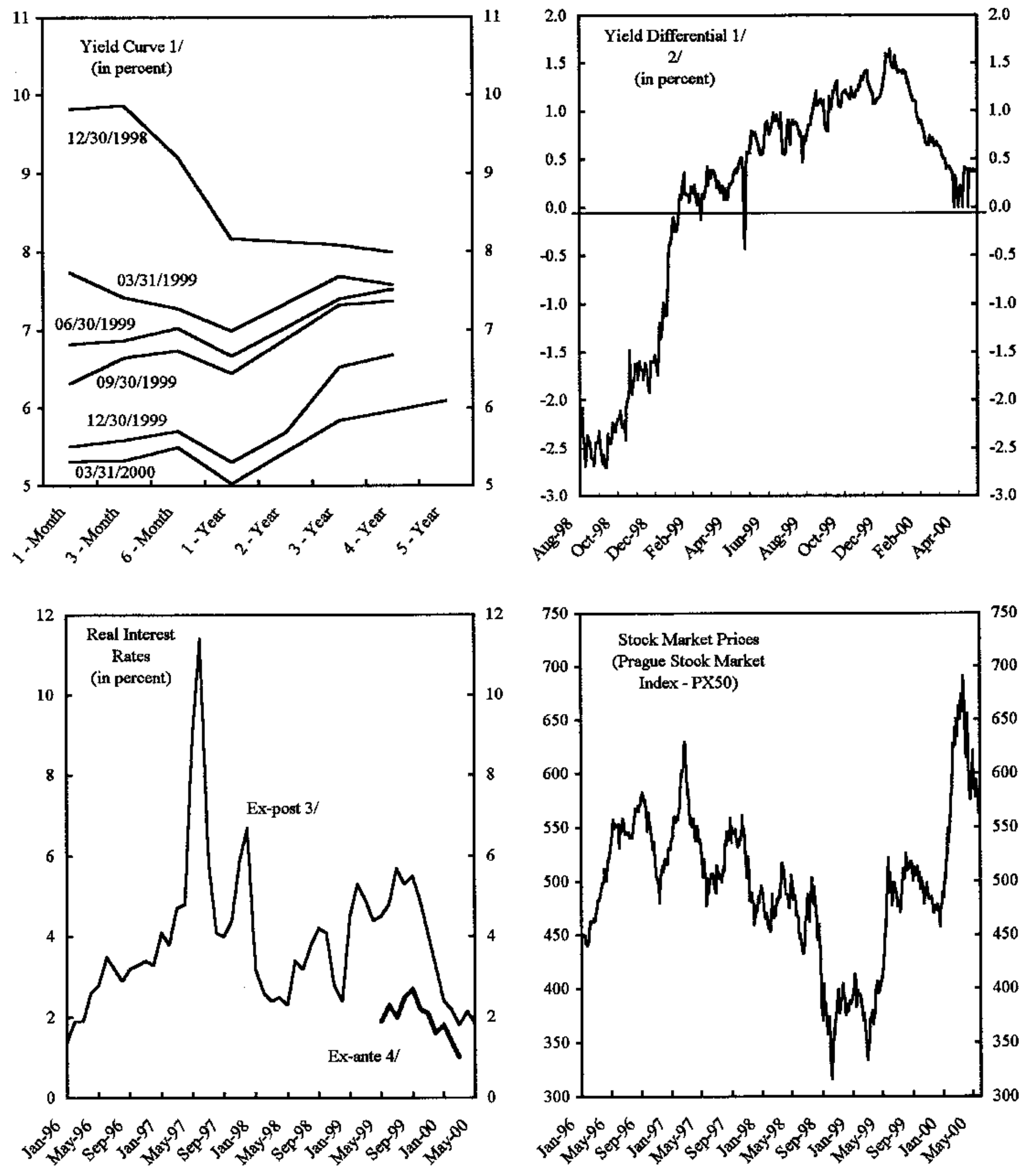


Sources: Czech National Bank; and Fund staff estimates.

1/ Real interest rate used is 3-month PRIBOR deflated by contemporaneous adjusted inflation. REER used is PPI based (Jan. 1995=100). The change in the Monetary Conditions Index (MCI) is defined as two-thirds of the change in the real interest rate (in percentage point terms), and one-third of the change in the PPI-based REER (in percent).

2/ CNB's twelve-month-ahead forecast. Forecasts shown were produced 12 months prior to the reference period.

Figure 10. Czech Republic: Selected Financial Market Indicators, 1996-2000



Sources: Bloomberg; Czech National Bank; and Fund staff calculations.

1/ Secondary market yields of government securities.

2/ Difference between 4-year government bond yield and 3-month Treasury bill yield. Upward movements indicate a steeper yield curve.

3/ One-year PRIBOR less ex-post CPI.

4/ One-year PRIBOR deflated by inflation expected by selected economic sectors according to the CNB Statistical Survey.

17. **On the structural front, banking sector woes continued over the past year, but steady progress has been made in privatization.**[10] The performance of the large commercial banks was poor, weighed down by the deteriorating quality of loan portfolios (Text Table 4, below). A further tightening of loan provisioning requirements exerted additional pressure on the balance sheets of the major state-owned banks.[11] In mid-1999, the government sold its majority share in CSOB, the country's fourth largest bank, to the Belgian KBC. In early 2000, the sale of Česká Spořitelna (CS), the national savings bank, to Austria's Erste Bank was agreed. Prior to the agreement, a large share of nonperforming assets were transferred to Konsolidační banka (KoB), which functions as the national "bad" bank. Moreover, the deal included a ring-fencing arrangement, which allows the buyer to rid itself of further

Table 4. Classified Bank Credit, 1996-2000

(End of period)

	Classified Credits 1/	
	In CZK billions	Share in total bank credits (in percent)
1996	258	29.3
1997	266	27.0
1998	262	26.7
1999	291	32.1
March 2000 2/	244	28.3

Source: Czech National Bank

1/ Excludes Konsolidační banka. The Czech definition of classified credits includes loans under watch.
2/ The decline in classified credits in the first quarter of 2000 is due to the transfer of bad assets from Komerční banka to Konsolidační banka.

[10] For a full description of the structural problems facing the Czech banking and corporate sectors, see the 1999 Article IV consultation documentation (SM/99/150 and SM/99/157) and the latest OECD report (OECD, *Economic Surveys: The Czech Republic* (Paris, 2000)).

[11] Reflecting the difficulty in the Czech legal environment to seize real estate pledged as loan collateral, the CNB issued a regulation in July 1998 requiring commercial banks to fully provision against loss loans (overdue over one year) collateralized by real estate. Because of its sharp impact on banks' balance sheets, the CNB phased in the requirement over three years.

bad assets if any loan misclassifications at the time of the sale are identified subsequently. The sole remaining state-owned commercial bank, Komerční banka (KB), is slated to be privatized by early 2001. A large share of its bad loan portfolio was transferred to KoB in early 2000, and KB's management was replaced to prepare for privatization.[12]

18. **The authorities have also begun to address difficulties in the corporate sector, by improving the legal framework governing economic transactions and by intervening directly in a limited number of key enterprises.** To support the latter, the state-owned Revitalization Agency (RA) initially selected eight large industrial companies for financial and organizational restructuring.[13] However, progress has been relatively slow, reflecting the difficulty in getting shareholders and creditors to agree to share the financial burden. In selected cases, KoB has provided new financing to support the required restructuring, but its availability has been made strictly conditional on agreement to the RA's restructuring plan.

III. Policy Discussions

19. **The discussions focused on the appropriate policy responses to the emerging, but still tentative, recovery.** There were two main questions:

- First, how can the economy maintain and strengthen the momentum of recovery, and thereby close the output gap created over the course of the recession? As long as the recovery is still modest, fiscal, monetary, and exchange rate policies should remain supportive. However, continued improvements in economic conditions should allow the authorities to gradually shift their focus to medium-term policy objectives. This consideration is particularly relevant for the government's fiscal position, which requires decisive action in order to achieve long-term sustainability. A second reason for fiscal prudence is the risk of strong and persistent capital inflows as the recovery gathers further momentum.

- Second, how can the economy achieve robust and non-inflationary growth over the medium term? This requires a strengthening of the supply side of the economy, and hence structural reforms. Banking and corporate sector restructuring is key to this process, but for this to proceed smoothly, legal reforms that tighten firms' budget constraints and improve corporate governance play an important role. Corporate sector restructuring may

[12] In 1999, KoB took over assets from CS and KB totaling CZK 56 billion, bringing KoB's total assets to close to CZK 200 billion (about 11 percent of GDP), though its market value is significantly less. Since the beginning of this year, a further CZK 60 billion in bad assets was taken over from KB for a price of CZK 36 billion; the actual value is likely to be much lower.

[13] The RA was established in April 1999 as a subsidiary of KoB to formulate and implement restructuring programs for selected major, deeply indebted, Czech companies. In November 1999, a contract was signed with a consortium of two international investment banks chosen to manage the RA.

aggravate the already quite serious unemployment problem. In order to prevent unemployment from becoming structural, labor market reform is also necessary. A flexible labor market not only improves growth potential, but in the medium term also helps reduce unemployment and poverty, and hence has a beneficial impact on the fiscal position.

A. Macroeconomic Prospects

20. **The authorities and the staff agreed that signs of recovery were evident, but that the recovery in 2000 would be modest.** The staff found that several elements conducive to growth were in place: a strengthening recovery in the EU, the Czech Republic's major trading partner; a sharp increase in FDI, reflecting both privatization and greenfield investment; and low inflation and inflationary expectations. However, ongoing restructuring of the banking and traditional corporate sectors would in the short run act as a drag on the economy by restraining credit growth and contributing to unemployment. As a result, the staff expects growth of 2–2½ percent in 2000, with a pickup to 3–3½ percent in 2001 as these negative factors recede. Cost pressures, especially rising oil prices in the first half of 2000, are expected to raise inflation to 3½ percent at end-2000, despite the sizable slack remaining in the economy. Inflation is expected to rise further to around 5 percent in 2001 as domestic demand gradually recovers. The latter factor is also expected to contribute to a modest deterioration in the external current account. The authorities concurred with this assessment, and most private sector analysts shared the staff's tempered view of near-term growth prospects.

21. **The main, albeit moderate, stimulus to economic activity is expected to come from fixed capital formation, while consumption would grow at a more modest rate and net external demand would exert a slightly positive influence.** There was broad agreement that, after three years of successive declines, gross capital formation would turn around to grow by 2½–3 percent in 2000, with a further acceleration in 2001. This reflected an increase in greenfield investment and upgrading of the capital stock in previously privatized, foreign-owned companies. More extensive application of investment incentives is expected to contribute to investment growth by increasing the attractiveness of the Czech Republic as an FDI destination.[14] Among Czech-owned firms, however, investment is expected to remain weak owing to the low level of profits and the continuing stagnation of bank credit.

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[14] The incentives consist of full corporate tax holidays for a period of ten years (in newly established firms) or a partial discount for five years (in already existing legal entities), job-creation grants, training grants, and the provision of low-cost land and/or infrastructure support. Incentives were first introduced in 1998, and granted by government decree on a case-by-case basis to investment projects exceeding US$ 25 million (as from December 1998, US$ 10 million). Effective May 1, 2000, a new law replaced the past decrees, reduced the minimum investment to CZK 175 million (approximately US$ 5 million) for specified regions where unemployment is particularly high, and expanded the scope of tax incentives to investments by already existing entities.

22. **Low growth in the real wage bill and higher precautionary savings are expected to retard household consumption growth,** which is forecast to increase by 1–1½ percent in 2000, similar to the rate in 1999, with a higher increase in 2001. Renewed enterprise restructuring is expected to lead, after a pause early in the year, to a further rise in the unemployment rate, to 10½ percent by end-2000 and 11 percent by end-2001. Concerns about the employment effects of ongoing enterprise restructuring are expected to induce higher precautionary savings, thereby constraining consumption expenditure.

23. **Inflation is expected to remain subdued, reflecting the considerable slack in the economy as well as a moderation of wage demands.** In view of this outlook, the CNB recently revised downward its net inflation forecast for end-2000 to 2.2–3.5 percent, which points to an undershooting of its net inflation target (of 3.5–5.5 percent) for the third year in a row.[15] The authorities and the staff agreed on the inflation outlook, which is consistent with a mild pickup in domestic demand, modest nominal wage growth in 2000, and a broadly stable exchange rate.

24. **Export performance is expected to remain strong, increasing the external sector's contribution to growth in the near term.** External competitiveness has been maintained by labor shedding and modest wage growth, while EU demand is projected to strengthen further, both suggesting that the favorable export performance will continue (Box 2). However, owing to the effect of higher oil prices on import values and the spillover of increased investment demand to imports, the current account deficit is expected to expand from 2 percent of GDP in 1999 to 3½ percent this year. Given the continuing FDI inflows, the increase in the current account deficit poses no threat to the balance of payments. Some further modest outflows of short-term capital may take place, but they are not expected to be so large as to jeopardize the external position. Reserves are expected to remain comfortable in 2000 at around five months of merchandise imports, covering more than 50 percent of total external debt.

B. Fiscal Policies for 2000 and 2001

25. **The authorities targeted an appropriately supportive fiscal stance in 2000, but there are risks that it may not be as supportive as envisaged.** Staff endorsed the modest increase in the structural deficit (after deducting privatization receipts and transfers to transformation institutions) envisaged for 2000, but noted that budget execution during the first quarter had been somewhat restrictive. The authorities agreed that the state budget, which accounts for about two-thirds of consolidated general government expenditure, would overperform in 2000 if trends in the first quarter were to persist.[16] While they expected the

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[15] The earlier forecast was 2.5–4.1 percent.

[16] The strong showing of the state budget in the first quarter was attributed to robust collections of indirect taxes. Also, expenditures on a pro-rated basis were low, reflecting cautious spending in the period prior to the approval of the state budget in March.

Box 2. Export Performance and Competitiveness

The modest strengthening of the koruna against the euro—and in nominal effective terms—since March 1999 has raised concerns that Czech exports may have become less competitive. The staff's analysis suggests that there is limited justification for these concerns.

Export performance

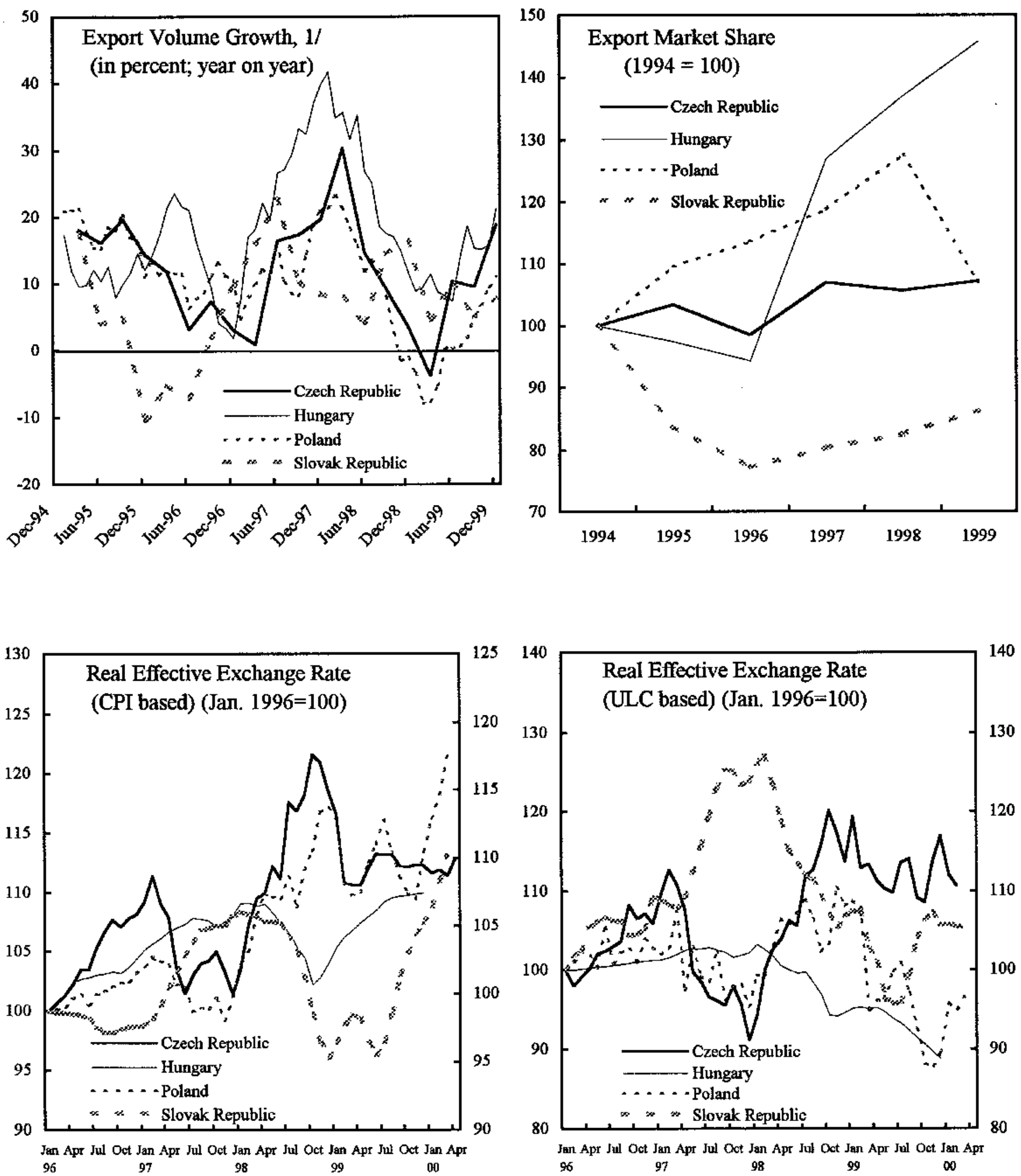
The strengthening of the koruna does not appear to have hurt Czech exports. Czech exports have remained strong in real terms in 1999, with no visible signs of loss of market share (Figure 11). In addition, the performance of Czech exports compares favorably to that of other transition economies in the region. Export performance of these economies appears to be driven primarily by demand developments in Western Europe (the transition economies' main trading partner).

The robust performance of Czech exports has not been broad based, as structural factors have impacted exporters in an uneven way. The strength of exports derives mainly from manufactured goods as well as machinery and transport equipment. These sectors have benefited from the presence of foreign-owned firms, which have better overall competitive structure and access to credit. By contrast, a number of traditional sectors have experienced declining exports in recent years, most notably food and animal products, crude materials and minerals, and chemicals. These sectors need fundamental restructuring if they are to regain competitiveness.

Real effective exchange rate (REER)

The appreciation of the koruna by over 6½ percent vis-à-vis the euro since March 1999 did not translate to a loss in price competitiveness: both the CPI-based and the unit-labor-cost (ULC)-based REER are at about the same levels as those in March 1999. The main contributing factors have been the decline in Czech inflation and ULCs over the same period relative to partner countries. Over a longer period, the appreciation of the koruna has been moderate in real effective terms, and has been in line with the appreciation of the currencies of other transition economies in the region.

Figure 11. Czech Republic: Regional Comparison of Export Performance and Real Effective Exchange Rates, 1994-2000



Sources: Information Notice System; World Economic Outlook; and Fund staff estimates.

1/ Based on monthly customs data (three month moving average) for Poland and Hungary. Based on quarterly national account data (exports of goods, constant prices) for the Czech Republic and the Slovak Republic.

deficit to be on target if revenues come in as budgeted, they noted that higher-than-budgeted revenues would be used for deficit reduction, whereas if economic activity were to weaken and revenues came in below expectations, corresponding cuts in current discretionary spending would be implemented in order to achieve the deficit target. The staff argued that in order to allow automatic stabilizers to operate fully, deviations in revenue from forecast levels attributable to changes in economic activity should not be offset by adjustments to expenditure, and for this purpose, stressed the importance of implementing expenditures as planned.

26. **For 2001, the government is targeting a reduction in the state budget deficit of about ¾ percent of GDP, which could translate into a cut in the deficit of about ½ percent of GDP at the general government level.**[17] Although measures to achieve the reduction in the state budget deficit have not been finalized, the authorities indicated that some expenditures would be shifted to two new extrabudgetary funds (EBFs), for transport infrastructure and housing development, generating a net "improvement" in the state budget of about ¼ percent of GDP, and—ceteris paribus—the overall general government deficit (including EBFs) would decline by some ½ percent of GDP. The staff noted that a cut of this size would be on the restrictive side if GDP increased by only 3–3½ percent, namely, broadly in line with potential, and that, at a minimum, the automatic stabilizers should be allowed to operate fully if downside risks materialize. However, given the uncertainties attaching to the recovery and the very limited information available on the budgetary measures and on the planned activities of the EBFs and local governments for 2001, the overall fiscal stance for 2001 is as yet difficult to ascertain.

27. **Of more concern, however, is the fact that fiscal consolidation seems likely to be based on a generalized compression of discretionary spending, rather than on fundamental reforms.** The authorities expressed their reluctance to modify the existing system of social benefits and contributions ahead of a change in the institutional organization of the social welfare system planned for 2002. The staff emphasized that reform of mandatory expenditures was necessary in view of the inflexibility of budgetary expenditures and the need to accommodate EU-accession-related spending, and that failing to reduce entitlement spending raised doubts about the sustainability of whatever deficit cuts might be achieved in 2001.[18] The authorities responded that proposals for 2001 to eliminate incentives for early retirement and raise contributions of self employed to levels comparable to those applicable to employees, which together would significantly improve the finances of the social security system, had not received support within the government.

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[17] The state budget deficit target for 2001 is part of the "opposition agreement" which, inter alia, specifies the path for reducing the state budget deficit from CZK 35 billion in 2000 to zero (balanced budget) in 2003.

[18] See paragraph 36 below for the staff's view on specific measures needed to improve the fiscal position over the medium term.

28. **Considerable progress has recently been made in improving fiscal transparency and accountability, but the creation of the new EBFs runs counter to this trend.** New rules for budget implementation and execution, with effect from January 2001, are aimed at enhancing fiscal transparency, and the authorities viewed them as a way to attenuate pressures to spend unexpectedly large privatization receipts.[19] As to the new EBFs, the authorities confirmed that they would be fully integrated into the general government accounts and that they would be required to submit an annual budget to parliament for its approval. However, staff noted that segmentation of the budget and the exemption of the new EBFs from the budgetary rules would weaken transparency, while earmarking revenue sources could perpetuate certain types of expenditures. In addition, since the funds will be permitted to borrow—apparently without legal limit—and will receive part of their financing from privatization receipts, their existence may jeopardize fiscal sustainability. The authorities responded that shifting expenditures to the EBFs—over which the government would have considerable discretion in practice—and financing a part of their operations with privatization receipts would reduce the risk that one-off revenues would be used to finance government consumption. They stressed that investments by the EBFs were critical for facilitating growth, especially in economically depressed regions, and that they intended to dissolve the transport fund in 3-4 years, although the housing fund was expected to be a more permanent institution.

C. Monetary Policies for 2000 and 2001

29. **The upturn in inflation and signs of economic recovery prompted the authorities to refrain from further interest rate cuts since November 1999, and they saw limited scope for further cuts in interest rates.** With the recovery likely to strengthen, the authorities were reassessing monetary conditions against the prospective pickup in demand. Although they acknowledged the absence of major inflationary threats and the need to support the recovery, they generally expressed reluctance to cut interest rates further, mainly out of concern that the CNB could fall behind the curve in judging the economic turnaround. The staff supported the CNB's current monetary policy, which is sufficiently accommodative, but looking forward, emphasized the need for flexibility. The staff cautioned that downside risks still remained and, given that no major threat to medium-term price stability was in sight, the current accommodative stance should be maintained until the recovery was firmly established, if necessary through further interest rate cuts in the event of upward pressure on the koruna.

30. **The authorities indicated their intention to preserve the disinflation gains achieved over the past year, and did so publicly by announcing a new inflation target.** In late April, the CNB announced a net inflation target of 2–4 percent for end-2001, which was interpreted by market participants as a signal that the CNB would "lock in" the current low level of inflation (around 2 percent), rather than try to hit the end-2000 target (3.5–5.5 percent). The credibility of the inflation targeting framework was enhanced by the government's endorsement, for the first time, of the CNB's inflation target, reflecting the

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[19] See Appendix III for the details of the new budget rules.

close coordination between the CNB and the Ministry of Finance. The staff considered the target appropriate and welcomed its "lock-in" implications. However, the staff noted that medium-term inflationary expectations might have been pinned down more firmly if the target had been announced somewhat earlier. The authorities argued that the current level of interest rates was consistent with the new inflation target, so that both inflation and (nominal) interest rates would be kept relatively stable in the near term.

31. **There is a need to improve the CNB's inflation forecasting ability** (Box 3). The undershooting of the inflation targets over the past two years adversely affected the CNB's credibility, and the staff advised the authorities to step up efforts to improve its inflation forecasting ability to facilitate forward-looking policy-making. While recognizing the fundamental difficulties involved in forecasting Czech inflation, including data limitations, the staff offered various suggestions for improving inflation forecasts.

32. **Since the last interest rate cut in November 1999, the authorities have relied on limited foreign exchange market intervention to prevent appreciations of the koruna that could have been detrimental to the recovery.** They noted that although there were persistent upward pressures on the koruna due to FDI-related inflows, countervailing outflows prompted by the relatively low level of interest rates were also taking place, attenuating the pressures. Also, some of the pressures were based on market sentiment rather than actual inflows. In their view, these factors explained the success of recent interventions in spite of their relatively small amounts. The staff wondered how durable the effect of intervention unaided by monetary policy action would be, and noted that in the event that the upward pressures could not be contained by intervention alone, it might be necessary to combine it with further interest cuts, unless and until the recovery was strong enough to absorb the deflationary impact of the koruna's appreciation. At the same time, the staff cautioned against creating the false impression that the CNB had an implicit exchange rate target, because public statements made by some CNB officials had often been interpreted by market participants as attempts to defend a certain target exchange rate. The staff also welcomed the agreement between the CNB and the government to establish a special foreign exchange account for sterilizing the government's privatization revenues.[20] The authorities argued that maintaining external competitiveness was key to sustainable growth, and were concerned that the koruna's appreciation could pose a threat. The staff acknowledged the risk, but argued that competitiveness seemed adequate at this juncture (see Box 2). Moreover, a lasting, long-term improvement in external competitiveness hinged on the success of the

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[20] The account, initially proposed by the CNB, can be replicated by the CNB's intervention that fully offsets the government's sales to the market of its foreign exchange receipts from privatization. Thus, one could argue that it would add little to what had been available before the account. However, the creation of the account sent a signal to the market that the CNB and the government were closely cooperating with each other in limiting upward pressures on the koruna. There is no concern at this point that the account could be misused, and thus hindering the CNB's conduct of foreign exchange policy.

Box 3: Why Has It Been So Difficult to Forecast Inflation in the Czech Republic?

The authorities have so far had very limited success both in meeting their intermediate inflation targets and in forecasting inflation. The CNB missed its net inflation targets in 1998 and 1999, and—beginning with the publication in January 1999 of its 12-month-ahead net inflation forecasts—has consistently overestimated net inflation (see Figure 9). Moreover, headline CPI and the net inflation index have followed different paths over the past couple of years, owing mainly to the relatively high inflation of regulated prices (see Figure 3). This has complicated efforts to communicate the intentions of monetary policy to the public. In recognition of this, the CNB announced for the first time its end-2001 net inflation target in conjunction with a corresponding headline inflation range.

Main factors behind the forecasting problems

The CNB's weak forecasting record reflects primarily two factors: (i) the impact of unforeseen developments (such as sharp changes in oil and food prices); and (ii) its difficulty in formulating a reliable inflation forecasting model. The latter, in turn, is due to two main complications:

- **The inclusion of food prices in the net inflation measure complicates modeling and forecasting.** Food prices are very volatile, and largely determined outside the Czech Republic—which makes them fairly unresponsive to changes in domestic economic variables and monetary policy instruments—and thus are difficult to forecast. In fact, the principal reason for undershooting the 1999 net inflation target was the higher-than-expected drop in food prices.

- **The available data set is small and has limited information content.** The Czech data set consists of observations of relevant variables that in some cases are only available beginning in January 1995, thus making it difficult to model long-term relationships. Moreover, the information content of the data has been skewed by the recession years of 1997–99, which span most of the available observations. In addition, ongoing reforms and problems in the banking system have made it increasingly difficult to pin down structural coefficients.

Reflecting those limitations, the CNB does not have a very good handle on what drives inflation in the Czech Republic or to what extent, and with what lags, its instruments affect inflation. While efforts have been made to improve inflation-modeling techniques, including work supported by technical assistance from the Fund, the principal challenge remains to produce more accurate inflation forecasts given the limitations described above.

Looking forward

Repeated undershooting of the inflation targets runs the risk of undermining the CNB's credibility, an important prerequisite for the effective implementation of inflation targeting. While continuing its efforts to improve its forecasting ability, the CNB should explore various "core" inflation concepts that remove or reduce the impact of volatile food prices. However, simply excluding food prices from the targeted measure would result in too narrow a target, because they account for about one-third of the overall CPI, and close to 40 percent of net inflation.

An alternative way to reduce the impact of volatile food prices is to switch to headline inflation targeting. The staff recommended this to the authorities because, first, the CNB's record at modeling and forecasting headline inflation has been more robust than that of net inflation. Second, headline inflation has more intuitive appeal to the general public, and hence increases transparency of monetary policy. One drawback is the possible need to tighten monetary policy in response to upward revisions in administered prices, which could discourage price deregulation by the government. However, this problem can be alleviated through increased coordination between the CNB and the government in setting the inflation target. A first step in this direction has already been taken in the context of the end-2001 target.

ongoing banking and corporate sector restructuring, and could not be achieved through maintaining a particular level of the nominal exchange rate through intervention or interest rate cuts.

33. **The Czech parliament is considering amendments to the National Bank Act that weaken its independence (Box 4).** There was intense debate among the authorities and parliamentarians on this issue, and their views varied on whether the proposed amendments posed a threat to the independence of the CNB. Many of them expressed concerns that the proposed amendments could potentially weaken the CNB's independence, and were thus inconsistent with EU norms. However, some thought that the proposed amendments would not jeopardize the CNB's independence, and argued that the amendments could help increase financial accountability of the CNB without threatening its operational independence. While interpretations hinge in part on the imprecise wording of some of the amendments—which is itself problematic—the staff viewed the amendments as weakening independence, and argued that independence of the CNB, especially operational independence, would be necessary for sustained good macroeconomic performance.

D. Medium-Term Macroeconomic Policy Framework

34. **Strong capital inflows attracted by improving economic prospects and EU accession could pose substantial challenges for the conduct of macroeconomic policy over the medium term.** While capital inflows have accelerated over the past year, the weak cyclical position of the Czech Republic has so far spared it from the policy dilemma currently facing Hungary and Poland, which are more advanced in the cycle. In these countries, where buoyant domestic demand and rising oil prices have reversed the downward trend of inflation since the second half of 1999, the monetary authorities have had to choose whether to ease (to discourage capital inflows) or tighten (to stop the acceleration of inflation). The Czech monetary authorities acknowledged the seriousness of this future risk, but noted that net foreign exchange inflows would likely continue to be much lower than gross inflows. They also recognized that monetary policy alone could not protect against a continued strengthening of the koruna coming from sustained inflows. In order to mitigate overheating pressures and contain excessive expansion of external deficits, they saw a need for rebalancing the mix of macroeconomic policies, giving a major role to fiscal consolidation, while structural reforms would also be necessary to enhance external competitiveness. However, some of them expressed their doubts that fiscal policy would be tightened adequately and in a sufficiently timely manner to shoulder its share of the policy burden.

35. **Concerns about medium-term fiscal sustainability and the need to reduce upward pressures on the real exchange rate call for the consolidation of the fiscal accounts.** Following a strong performance through the mid-1990s, the underlying Czech fiscal position has deteriorated in recent years, and pressures on the budget are expected to rise further in the coming years, reflecting EU membership (which will impact the budget both before and after accession), the realization of government contingent liabilities, population

Box 4. Amendment to the CNB Act and Central Bank Independence

As a part of the ongoing process of harmonizing the Czech legal system with EU norms, the CNB Act has to be amended.[1] The government, after careful consultations with the CNB and the ECB, prepared a set of draft amendments and submitted them to Parliament. The Budgetary Committee, entrusted to examine the draft amendments, introduced a large number of additional amendments, many of which were aimed at increasing the scrutiny over the CNB by the government and Parliament. The Committee's version of the amendments was approved in early May, and was sent to the plenary session. The plenary session started the discussion of the amendments in late-June.

The proposed amendments have raised concerns in many quarters, including the CNB itself, the ECB, international organizations, and market participants, as undermining central bank independence. The most controversial among the proposed amendments include the following.

- The CNB is to submit a report on monetary developments at least twice a year. The lower house may either approve, acknowledge, or reject the report. In the case of rejection, the lower house recommends remedial measures. The CNB is then to re-submit within six weeks a more accurate and complete report in compliance with the recommendations.

- The President of the Czech Republic may recall a member of the CNB Board if: he fails to perform his function for a period of longer than six months; he damages in a serious manner the dignity of his function; or he is disloyal to the mission ensuing from the duties of member of the CNB Board.

- The CNB is to consult with the government on matters of significant monetary and political importance and to submit reports to it upon request.

- The CNB's budget is to be approved by the lower house. If rejected, the CNB is to re-submit within six weeks a more accurate and complete budget in compliance with the recommendations made by the lower house at the time of rejection. The CNB is to submit its annual profit and loss statement to the lower house. The lower house may either approve, acknowledge, or reject the statement. If rejected, the same process as above will be required.

- Salaries, allowances, etc. of the Governor, Vice Governors, and other Board members are to be the same as those of the Prime Minister, the Deputy Prime Minister, and government ministers, respectively. The pay conditions of the CNB's other employees are to be set by the CNB Board, taking into account the legal regulations for salaries of state employees.

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[1]Necessary amendments include, for example, removing an article that allows the CNB to provide temporary credit to the government.

aging, and a drying up of privatization receipts.[21] The ability to restrain expenditures in other areas to offset new spending pressures, while also achieving the authorities' general government deficit target of 3 percent of GDP from 2003, is limited by the fact that nearly half of general government expenditure is devoted to mandatory transfers to households in the form of pensions and other entitlements.

36. **In order to assess medium-term fiscal trends under different macroeconomic scenarios, and with a view to identifying emerging pressures, the authorities have developed a quantitative fiscal framework.** Under the "structural reform" scenario, GDP growth is assumed to increase gradually to some 5½ percent by 2005 which, together with large cuts in transfers to households and enterprises, leads to a drop in the general government deficit—to less than 1 percent of GDP—in 2005 and to a stabilization of debt, at about 21 percent of GDP. In contrast, the "slow growth" scenario assumes little progress with structural reform, leading to 2 percent GDP growth in the medium term and a continued rise in unemployment. As a result, the deficit stabilizes at about 5½ percent of GDP from 2003, with public debt more than doubling by 2005. The mission that visited Prague in October 1999 viewed both of these projections for the medium-term budget deficit, given the growth assumptions, as too optimistic and argued that fiscal sustainability required: (i) lowering the generosity of the pension system; (ii) reducing enterprise subsidies; (iii) increasing excise taxes to EU levels and shifting some goods and services to the higher VAT category; and (iv) improving the efficiency of the health care system, including through copayments. These remain the policy requirements if the Czech Republic is to regain firm control of its public finances.

37. **Unfortunately, no substantive progress has been made in articulating fundamental fiscal reforms to address medium-term fiscal sustainability.** The authorities indicated their intention to separate the social security system from the state budget in 2002 and to capitalize it with CZK 50 billion (2½ percent of GDP) in privatization receipts. The mission noted that since no reduction in benefits or further increase in retirement ages would be introduced, the change would not ameliorate fiscal strains arising from demographic pressures. The authorities responded that some improvement would be achieved by eliminating incentives for early retirement, but agreed that the underlying strains on the public pay-as-you-go system would not be resolved. They acknowledged that fundamental changes in funding sources and benefit levels would be needed in the future, but that planning was still at a very preliminary stage.[22]

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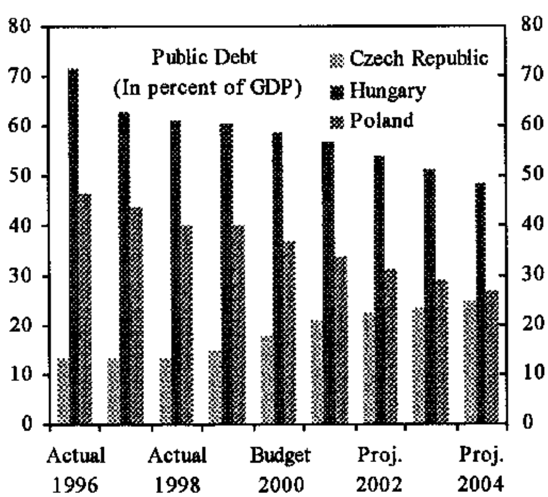
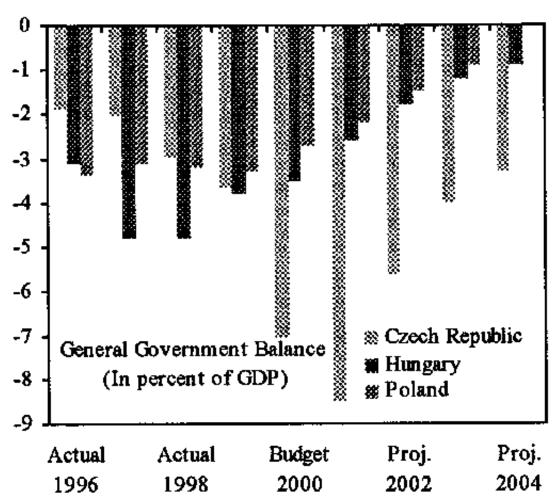
[21] This stands in sharp contrast with the fiscal positions of Hungary and Poland (Box 5).

[22] The World Bank, in the context of a Public Expenditure Review (PER), is assisting the government in reforming the fiscal accounts. The PER, which is expected to be completed by May 2001, is focusing on restructuring mandatory expenditures and strengthening the medium-term budget planning process.

Box 5. Medium-Term Fiscal Performance: A Cross-Country Perspective

The expected evolution of the Czech fiscal situation may be compared with that of Hungary and Poland. Public debt in Hungary and Poland in 1999, at 61 percent and 40 percent of GDP, respectively, was well above the level in the Czech Republic, reflecting not only large debt inherited prior to the transition, but also the fact that Hungary and to a lesser extent Poland have already incurred the fiscal costs of restructuring their banking and enterprise sectors, while this process is ongoing in the Czech Republic. During the next five years, the general government balance (excluding privatization) in Hungary and Poland is expected to improve steadily from a deficit of 3–4 percent of GDP in 1999. While the starting position of the general government deficit (excluding privatization) in the Czech Republic is similar to that in Hungary and Poland, its projected future path is quite different, even though all three countries share a similar target date for EU entry and their fiscal sectors are expected to bear accession-related costs of a comparable magnitude. In order to make room for these costs, Hungary and Poland have initiated reforms to reduce other expenditures, including reform of their pension systems. In contrast, the Czech Republic has made little headway with fiscal expenditure reform which, in the absence of future progress in this area, would lead to persistent and sizable deficits even after abstracting from expenditures related to bank and enterprise restructuring. Small deficits in Hungary and Poland financed in part by privatization inflows are expected to generate a reduction in the public debt ratio of about 10 percentage points of GDP over the next five years. For the Czech Republic, however, public debt is expected to *rise* by almost 10 percentage points of GDP, even with robust GDP growth. In the absence of expenditure reform, the longer-term fiscal outlook in the Czech Republic is likely to deteriorate further as a sharp increase in the dependency ratio beginning in the latter part of the decade will place a heavy burden on the finances of the pay-as-you-go pension system.





Sources: National authorities; current Fund staff projections for the Czech Republic and Hungary, and staff projections from the Staff Report on Poland (SM/00/36).

E. Structural Reforms

38. **Recent structural reforms have proceeded along three major tracks, namely, bank restructuring, corporate sector restructuring, and legal reforms.** There are close links among these reforms. Bank and corporate restructurings reinforce each other, while the legal reforms should provide an environment conducive to the smooth progress of the overall restructuring process. It is therefore important that efforts be made to strengthen reforms in all three areas.

39. **Having completed the sale of Česká Spořitelna (CS) early in 2000, the authorities expressed their determination to act expeditiously to privatize the remaining major state-owned bank, Komerční banka (KB).** The authorities argued that the best way to restructure troubled state-owned banks was to find strategic investors strongly committed to the long-term management of the banks they purchase. The staff agreed and commended the government's efforts to sell CS speedily, but expressed reservations about the extensive ring-fencing that had been agreed to, which could prove to be quite costly for the government.[23]

40. **The authorities acknowledged the need to improve the overall performance of the banking sector. They noted that not all privatized banks were soundly managed and that some were burdened with sizable nonperforming loans (NPLs).** In this context, the authorities explained that the regulatory framework for bank supervision had been strengthened over the past year; that some ingredients of consolidated supervision had been introduced; and that the capital adequacy requirement had been reinforced, incorporating market risk. While welcoming these developments, the staff argued that additional actions were needed to facilitate the disposal of NPLs, including expanding tax deductibility of specific provisions on classified loans and accrued interest on NPLs. Also, to the extent that the legal changes that are intended to facilitate the seizure and sale of real estate collateral prove to be effective (see paragraph 45), there should be a relaxation of the current provisioning rule that prohibits the deduction of such collateral from required provisions.

41. **Recent financial difficulties in Investiční a Poštovní banka (IPB) illustrate that privatization alone cannot solve banking sector problems (Box 6).** To minimize disruptions, the authorities explored the possibility of finding a new strategic investor that would take over the bank as a going concern, but before their efforts bore fruit, a major run took place in mid-June. They announced a blanket guarantee on deposits to contain the run, but the share price plummeted, and interbank lines were cut, at which point the CNB had to resort to forced administration. Fortunately, financial markets reacted favorably to this news,

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[23] According to the agreement, the buyer can sell to KoB any loans on the books which were classified as standard as of end-1999, but whose correct classification is later found to be below substandard. The agreement also covers some off-balance-sheet contingent liabilities. However, extensive safeguards have been put in place to avoid abuse of ring-fencing.

the spread of the problem to other banks was avoided, and a strategic investor (Československá obchodní banka, which is owned by Belgian KBC) was found promptly. However, the government will have to bear a substantial cost to clean up IPB's balance sheet.

Box 6. The Source of the IPB Problem

IPB, the third largest bank in the Czech Republic, was privatized in 1998 to Nomura Securities' subsidiary in London, the first to be privatized among the four major state-owned banks. As of end-April 2000, it accounted for 22 percent of household deposits in the Czech banking sector, and its share in total banking sector assets was 13 percent. The amount of client deposits held with IPB exceeded 10 percent of GDP.

Unlike the current privatization of state-owned banks, the government did not clean up the balance sheet of IPB prior to its sale, nor did it provide a "ring-fencing" arrangement. Therefore, a considerable amount of bad assets were left with IPB after privatization.

However, there were two other important factors that led to the eventual collapse of IPB. First, corporate governance at IPB was weak following its privatization; Nomura saw itself as a portfolio investor, not as a strategic owner. Second, the bank's situation was exacerbated by the deep recession in 1998 and 1999, which contributed significantly to a deterioration of asset quality. Thus, IPB's problem is partly inherited and partly acquired, perhaps with a larger weight on the latter.

42. **An important question that could remain after the completion of bank restructuring (including IPB's) is how to dispose of the large amount of NPLs that have been accumulated on KoB's books.** The transfer of NPLs to KoB itself is simply a reorganization of the problem. However, the transfer has been a prerequisite for privatization, and hence for real reform. Also, the evolving role of KoB from administering bad loans to recovering asset value is a positive step. The authorities explained their efforts to speed up the disposal of NPLs held by KoB, using various methods such as sales (including on-line sales), bankruptcy proceedings, court settlements, and claim capitalization. They cited inadequacies in the Czech legal framework and generally slow court procedures as major obstacles to the effective recovery and restructuring of assets. They expressed the hope, however, that recent legal changes would improve the situation and contribute to better recovery (see paragraph 45 below).

43. **The authorities argued that progress had also been made in the restructuring of the corporate sector.** Much of it was spontaneous: tighter budget constraints had led to increased bankruptcies and also voluntary debt restructuring. The Revitalization Agency (RA) had taken some time to set up, but a strong team was now in place. The government was supportive of its work, and had approved all the restructuring plans proposed by the RA to

date. The RA was hopeful that over the coming year, several large enterprises could be restructured, placed on firmer financial footing, and sold to strategic investors. The staff welcomed the progress, although it had been long in coming. A number of concerns raised by the staff last year—including the risk of political interference, which could result in the RA being forced to expand its scope by bailing out unviable enterprises—thus far seemed to have been largely avoided.

44. **Legal reforms have important implications for the proper functioning of the economy, for banking and corporate sector restructuring, and for the Czech Republic's accession to the European Union.** In contrast to relatively slow progress in earlier years, the pace in adopting the EU's *acquis communautaire* accelerated markedly this year. The staff welcomed this development, as it should facilitate the implementation of reforms that would be needed in their own right to improve economic efficiency and growth prospects.

45. **The potential contribution of legal reforms to banking and corporate sector restructuring is substantial.** The April 2000 amendment of the Bankruptcy Act represents a shift toward stronger creditor rights, and aims at reducing the often long delays in the bankruptcy process. A key provision allows creditor committees to dismiss court-appointed trustees, and it will become more difficult for small creditors to delay the bankruptcy process. Most observers agreed that this was a step in the right direction. However, the Act still has a number of shortcomings, including the vague definition of circumstances under which a creditor can initiate bankruptcy proceedings, the absence of the right of creditors to appoint the bankruptcy administrator, the power of the court to dismiss the creditors' committee, and the limitation of the value that can be recovered by secured creditors to 70 percent of realized assets. By facilitating the seizure of collateral, the new Law on Public Auctions, which became effective May 1, 2000, should help creditors (commercial banks in particular) that hold large amounts of nonperforming loans secured by real estate. However, there remains some legal uncertainty regarding a conflict of this law with provisions of the Executions Act, which could require an ex ante stipulation of the debtor's agreement to forgo rights to the pledged collateral—hence negating some of the shift toward creditors' rights. Moreover, in the case of both Bankruptcy and Public Auctions Laws, much will depend on the manner and speed with which they are interpreted by the courts and it is too early to tell to what extent they have improved the business environment.

46. **Laws concerning the operations of securities markets are being amended as well, including the Commercial Code and acts dealing with securities, bonds, accounting, and the Stock Exchange.** These represent a welcome, if overdue, step toward improving the business environment by clarifying the rules of the game, strengthening minority shareholder protection, and providing a basis for the development of Czech capital markets. They also move the Czech Republic closer to internationally accepted standards in these areas (see Appendix III with an update of the Czech Republic's Observance of Standards and Codes).

F. Labor Market and Unemployment Problems

47. **A notable feature of the recession over the past few years has been the sharp rise in unemployment, which reversed earlier tendencies to labor hoarding.** Over the past five years, real wages in the industrial sector rose by more than 25 percent, compared with a GDP increase of only 7 percent (both cumulative). This implies a sharp compression of profit/entrepreneurial income on average, which is clearly an unsustainable situation. While the cyclical downturn has exacerbated increases in joblessness, there has also been a major structural element—namely, corporate and banking sector restructuring—that has resulted in sizable labor shedding. The unemployment consequences of these reforms have been accentuated by other distortions in the economy, such as generous social assistance and rent controls that discourage labor mobility.

48. **The authorities shared the staff's concerns that the ongoing enterprise restructuring could result in continued, or even increasing, levels of unemployment.** The government's macroeconomic forecast predicts that the unemployment rate would continue to rise in spite of accelerating GDP growth, and would reach a peak of close to 12 percent in 2002. This implies that more than 100,000 additional workers (totaling some 610,000 workers) would be dependent on government support. Partly in response, a system of investment incentives was instituted in May 2000 that would, inter alia, provide grants and subsidies to job creation and retraining in regions of high unemployment. The authorities acknowledged that the number of new jobs initially created by greenfield FDI would be far less than those lost through restructuring, but argued that the former would generate additional employment possibilities over time, including those generated from local demand for parts and services. The staff noted that major factors hampering the efficient functioning of the labor market were high social benefits relative to average wages,[24] a mismatch between redundant workers' skills and the demands of new job opportunities, and limited labor mobility.[25] In order to alleviate this risk, the staff suggested that social benefits be modified to increase incentives for job search, and that rent controls be relaxed to promote labor mobility (with assistance to low-income households). The authorities responded that further efforts at fostering mobility, such as worker relocation assistance, were in initial stages of discussion, and should be considered in the broader social policy context.

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[24] The replacement ratio for an unemployed married couple with two children exceeds 80 percent, with respect to both unemployment insurance, which is available for six months after termination of employment, and subsequent social assistance.

[25] For a comprehensive discussion of the current situation in the Czech labor market, see the OECD *Economic Surveys: The Czech Republic* (Paris, 2000).

IV. Staff Appraisal

49. **Although still weighed down by a belated hardening of budget constraints on the banking and corporate sectors, the Czech economy is beginning to see significant improvements in a number of important areas.** The long recession is now over and recovery underway. The external environment has improved dramatically, resulting in rising foreign demand and FDI. The disinflation process is substantially complete and the Czech economy can enjoy the fruits of low inflation and low inflationary expectations. Long-delayed privatization and structural reforms are now proceeding (though slowly in some areas), contributing to the overall positive sentiment toward the country. However, in spite of this favorable turn of events, the tempo of recovery is generally expected to be only moderate. In the near term, this is because ongoing banking and corporate sector restructuring will continue to exert a negative impact on domestic investment and consumption. In the longer term, growth will continue to be held back unless substantial progress in reforming key segments of the economy is achieved.

50. **Macroeconomic policies need to both sustain the pace of recovery and begin to place greater weight on achieving medium-term policy objectives. As regards fiscal policy, the aim should be to maintain a supportive stance in 2000 and 2001, but with steps being taken to reform the structure of expenditure and revenue so as to set the stage for an improved medium-term fiscal outlook.** In this regard, uncertainties about the prospect of recovery have left concerns that the envisaged tightening of the 2001 state budget might be premature, although evolving economic developments after the consultation have somewhat mitigated them. It would be important to allow, at a minimum, for the operation of the automatic stabilizers in the event that downside risks materialized. The increasing recourse to EBFs is also of concern, representing a step back from transparency and good practice. Privatization receipts should be used primarily to cover pre-privatization costs of bank and enterprise restructuring. The 2001 budget is also a timely opportunity to take a step in the direction of the fiscal reform needed over the medium term. However, the authorities' medium-term fiscal strategies for 2001 and beyond have not been fully elaborated. Clearly, major policy decisions that have a tangible impact on the medium-term fiscal position are more difficult to come by, because they require broad political consensus. But precisely because of this, the authorities need to formulate plans now so that they can implement them in a timely manner.

51. **As regards monetary and exchange rate policies, the staff considers the current policy stance broadly appropriate.** Should the recovery falter, the CNB would need to resist a significant appreciation of the koruna through intervention and, if necessary, with further interest rate cuts. However, with recovery seemingly in prospect, policies should shift increasingly to ensuring price stability for next year and beyond. The CNB's announcement, and its endorsement by the government, of the end-2001 inflation target is welcome: it has sent a clear signal that the authorities are aiming at medium-term price stability. The CNB's task is to stay on this course, consolidating the gains of disinflation. In order to ensure that the CNB will be able to carry out this task without undue political interference, as well as to keep

the CNB on a par with EU norms and global best practices, the CNB's independence, especially operational independence, is of critical importance. The staff is therefore concerned about several of the proposed amendments to the CNB Act that could subordinate the CNB to Parliament and the government.

52. **The acceleration of overdue structural reforms is welcome, but there is still a considerable way to go.** The staff welcomes the progress in bank privatization and urges the authorities to proceed expeditiously with the sale of the one remaining state-owned bank. At the same time, a sound and efficient banking system will not appear overnight, and further improvements in the legal and regulatory framework, in particular, will be necessary to strengthen banks' governance. The recent episode of IPB illustrates this point most clearly. These issues, together with various standards in the financial sector, will be examined in depth in the context of the Financial Sector Assessment Program over the coming year. Corporate restructuring is finally underway, and the staff welcomes the market-based approach chosen so far. Provided that the Revitalization Agency can implement its restructuring plans without political interference, the prospects for a stronger corporate sector are good. Here, too, reforms would benefit from a clear legal framework that strengthens creditor rights and provides for a rapid and predictable judicial process.

53. **Looking further into the future, persistent, large-scale capital inflows could pose a significant challenge for macroeconomic policy**. Strong FDI-related capital inflows could continue for some years, and sterilizing their effect by the CNB's action alone would be neither possible nor desirable. The policy mix would have to be rebalanced to ease the burden on monetary policy, and to this end again, fiscal consolidation would become necessary to avoid an overheating of the economy and an unsustainable expansion of the external current account deficit. Exchange rate flexibility would be a necessary requirement for attenuating inflows as well as for preventing inflation. Moreover, to avoid misallocation of incoming capital, it would be necessary to remove major distortions in relative prices and incentives. Progress in corporate restructuring should improve the competitiveness of Czech firms, and thereby mitigate the adverse effect of a secular appreciation of the exchange rate. The financial sector supervisory authorities should be vigilant in their enforcement of prudential regulations to prevent severe disruptions to financial markets in the event of temporary reversals of capital flows.

54. **The staff welcomes the Czech authorities' observance of international standards and the progress made since the last assessment.** The Czech Republic remains in observance of the SDDS's prescriptions for data coverage, periodicity and timeliness, and for the dissemination of advance release calendars. The authorities began publishing in April 2000 international reserve and foreign currency liquidity data according to the new template. Their data provision to the Fund is also sufficient. Fiscal transparency has benefited from the introduction of new budgetary rules, which will improve the accountability of the fiscal authorities and curb the scope for accumulating contingent fiscal liabilities. Some progress was made in bank supervision, through the limited introduction of consolidated supervision

and a measure of market risk. Finally, the legal and regulatory framework in the securities' markets has also been strengthened.

55. **In sum, developments since the last Article IV consultation are positive, but the authorities' continued efforts in reforming the basic structure of the economy and managing the associated fiscal costs will be required to accelerate the current recovery and help it become sustainable over the medium term.**

56. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. Czech Republic: Selected Economic and Financial Indicators, 1995-2000

	1995	1996	1997	1998	1999	2000 Proj. 1/
			(Percent change)			
Real sector						
Real GDP	5.9	4.8	-1.0	-2.2	-0.2	2.3
CPI inflation						
Period average	9.1	8.8	8.5	10.7	2.1	3.9
12-month change	7.9	8.6	10.0	6.8	2.5	3.8
Net inflation, 12-month change 2/	7.3	6.6	6.8	1.7	1.5	2.9
Real wages (industry), period average	8.5	8.1	3.2	-0.2	4.6	1.0
Registered unemployed, per. average (percent of labor force)	3.0	3.1	4.3	6.1	8.6	9.8
			(In percent of GDP)			
Fiscal sector 3/						
Revenues	41.9	40.4	39.7	39.3	41.4	39.9
Expenditures	41.5	40.6	40.9	40.8	42.0	43.6
Balance	0.3	-0.4	-1.2	-1.6	-0.6	-3.7
Excluding privatization revenues	-2.1	-2.1	-1.9	-3.0	-3.7	-7.1
Excluding privatization revenues and grants to transformation institutions	-1.4	-0.9	-1.7	-2.0	-3.3	-4.2
Gross debt	14.1	13.3	12.8	13.4	15.0	18.0
Loan guarantees outstanding	...	...	15.0	15.6	14.0	...
			(12-month change in percent)			
Money and credit (end-of-period)						
Broad money	22.0	7.8	8.7	5.2	8.1	...
Credit to enterprises and households	13.2	10.6	9.4	-3.5	-3.9	...
Net foreign assets	60.3	-9.5	20.1	25.6	33.2	...
Velocity (percentage change, end-of-period)	-4.3	5.6	-2.3	2.4	-5.6	...
			(In percent)			
Interest rates						
Average lending rate	12.8	12.5	13.2	12.9	8.7	...
Average deposit rate	7.0	6.8	7.7	8.1	4.5	...
			(In billions of U.S. dollars)			
Balance of payments						
Merchandise exports	21.5	21.7	22.8	26.4	26.9	26.5
Volume change (in percent)	17.0	6.2	13.7	13.7	8.7	8.1
Merchandise imports	25.1	27.6	27.3	28.9	28.9	29.2
Volume change (in percent)	27.0	12.5	10.7	8.0	6.0	6.4
Trade balance	-3.7	-5.9	-4.5	-2.6	-2.1	-2.7
Current account	-1.4	-4.3	-3.2	-1.3	-1.1	-1.7
(Percent of GDP)	-2.6	-7.4	-6.1	-2.4	-2.0	-3.4
Non-debt capital inflows (percent of GDP)	6.7	3.4	3.3	7.1	9.9	...
Gross official reserves (end-of-period)	14.0	12.4	9.8	12.6	12.9	...
(In months of merchandise imports)	6.6	5.4	4.3	5.2	5.3	...
(In months of current payments)	5.3	4.1	3.3	4.0	4.1	...
(In percent of short-term debt by residual maturity)	...	...	87.7	98.2	...	...
External debt in convertible currencies (end-of-period)	16.5	20.8	21.4	24.0	22.6	...
(Percent of GDP)	31.8	36.2	44.3	39.9	44.3	...
Short-term debt (convertible currencies, end-of-period)	5.0	6.0	7.1	9.1	8.8	...
External debt service ratio in convertible currencies						
(Percent of exports of goods and nonfactor services)	9.3	10.9	15.7	15.1	12.5	...
			(Percent change)			
Exchange rate (period average)						
Nominal effective	-0.9	1.0	-3.7	-0.6	-3.6	...
Real effective (ULC-based)	3.9	5.8	-0.4	8.1	-0.7	...
Memorandum item:						
GDP in nominal terms						
(In US$ billions)	52.0	57.9	52.6	55.7	53.1	...
(In CZK billions)	1,381	1,572	1,669	1,798	1,836	1,944

Sources: Czech authorities; and staff estimates and projections.

1/ Staff projections.
2/ Net inflation excludes regulated prices and changes in indirect taxes.
3/ General government operations and debt; central government guarantees.

Table 2. Czech Republic: Medium-term Balance of Payments, 1996-2004
(In millions of U.S. dollars)

	1996	1997	1998	1999 Prel.	2000 Proj.	2001 Proj.	2002 Proj.	2003 Proj.	2004 Proj.
Current account balance	**-4,292**	**-3,211**	**-1,336**	**-1,058**	**-1,717**	**-1,784**	**-2,056**	**-2,100**	**-2,523**
Trade balance	-5,877	-4,540	-2,554	-2,060	-2,743	-2,766	-3,028	-3,012	-3,222
Exports	21,691	22,777	26,351	26,846	26,465	28,556	31,141	34,130	37,459
Imports	27,568	27,317	28,905	28,906	29,208	31,322	34,169	37,142	40,681
Nonfactor services	1,923	1,763	1,793	1,230	991	1,028	1,119	1,188	1,112
Receipts	8,179	7,162	7,494	6,926	6,716	7,205	7,857	8,585	9,366
Payments	6,256	5,399	5,701	5,696	5,725	6,176	6,738	7,397	8,254
Factor income (net)	-723	-791	-983	-739	-453	-563	-708	-886	-1,077
Current transfers	385	357	408	511	488	517	561	610	664
Financial account balance	**4,184**	**1,082**	**2,923**	**2,484**	**2,703**	**4,968**	**3,665**	**3,527**	**3,369**
Direct investment, net	1,276	1,275	2,641	4,912	4,551	6,910	5,715	5,702	5,688
Portfolio investment, net	726	1,086	1,069	-1,395	-872	-916	-967	-1,026	-1,094
Other investment, net	2,183	-1,279	-787	-1,033	-977	-1,026	-1,083	-1,149	-1,225
Errors and omissions, net	**-721**	**352**	**351**	**228**	**0**	**0**	**0**	**0**	**0**
Change in reserves (- increase)	**828**	**1,767**	**-1,941**	**-1,651**	**-986**	**-3,184**	**-1,609**	**-1,427**	**-846**
Memorandum items: 1/									
Current account (share of GDP)	-7.4	-6.1	-2.4	-2.0	-3.4	-3.3	-3.5	-3.3	-3.7
Foreign direct investment (share of GDP)	2.2	2.4	4.7	9.3	9.0	12.9	9.8	9.0	8.3
Gross official reserves (in months of imports of goods and services)	4.4	3.6	4.4	4.4	4.5	5.1	5.2	5.2	5.0
Total external debt/GDP ratio	36.8	44.9	40.4	44.8	47.1	49.0	50.4	51.5	52.3

Sources: Czech National Bank; and Fund staff projections.

1/ All figures in percent unless otherwise indicated.

Table 3. Consolidated General Government Budget, 1998-2000

	1998 Actual	1999 Actual	2000 Budget	1998 Actual	1999 Actual	2000 Budget
	(in billions of koruny)			(in percent of GDP)		
Total revenue and grants	696.9	730.1	763.1	38.8	39.8	39.3
Total revenue	696.8	729.8	763.1	38.8	39.7	39.3
Current revenue	696.6	729.6	762.6	38.7	39.7	39.2
Tax revenue	650.5	682.1	715.3	36.2	37.1	36.8
Direct taxes	162.2	165.4	170.3	9.0	9.0	8.8
Individual	94.9	95.3	99.7	5.3	5.2	5.1
Corporate	67.3	70.1	70.6	3.7	3.8	3.6
Social security contributions	262.9	270.6	284.1	14.6	14.7	14.6
Property taxes	10.4	11.1	11.3	0.6	0.6	0.6
Goods and services	200.9	222.7	238.4	11.2	12.1	12.3
VAT	119.4	138.3	149.9	6.6	7.5	7.7
Excises	67.8	73.1	77.6	3.8	4.0	4.0
Other	13.8	11.3	10.9	0.8	0.6	0.6
International trade	13.6	12.1	11.2	0.8	0.7	0.6
Other taxes	0.5	0.2	0.0	0.0	0.0	0.0
Nontax revenue	46.1	47.5	47.3	2.6	2.6	2.4
Capital revenue (excluding privatization)	0.3	0.3	0.5	0.0	0.0	0.0
Grants	0.0	0.3	0.0	0.0	0.0	0.0
Total expenditure and net lending	750.0	797.4	900.7	41.7	43.4	46.4
Total expenditure	749.6	790.6	899.3	41.7	43.1	46.3
Current expenditure	655.5	687.9	782.4	36.5	37.5	40.3
Goods and services	148.6	156.4	168.1	8.3	8.5	8.6
Wages and salaries	62.6	69.5	71.5	3.5	3.8	3.7
Employer contributions	0.0	0.1	0.0	0.0	0.0	0.0
Other goods and services	85.9	86.8	96.6	4.8	4.7	5.0
Interest payments	21.2	19.6	20.4	1.2	1.1	1.1
Subsidies and other current transfers	485.8	512.0	593.9	27.0	27.9	30.6
Subsidies	139.1	139.1	190.7	7.7	7.6	9.8
to nonfinancial public enterprises	82.1	95.0	95.3	4.6	5.2	4.9
to financial institutions	27.2	10.0	50.3	1.5	0.5	2.6
to other enterprises	29.8	34.1	45.1	1.7	1.9	2.3
Transfers to households & nonprofits	345.0	370.4	400.3	19.2	20.2	20.6
Transfers abroad	1.7	2.4	2.9	0.1	0.1	0.1
Capital expenditure	94.1	102.7	116.9	5.2	5.6	6.0
Acquisition of fixed capital	60.1	66.0	73.2	3.3	3.6	3.8
Capital transfers	34.0	36.7	43.7	1.9	2.0	2.2
Net lending (excluding privatization)	0.3	6.8	1.4	0.0	0.4	0.1
Lending	12.5	21.5	8.7	0.7	1.2	0.4
Repayments (excluding privatization)	12.1	14.7	7.3	0.7	0.8	0.4
Overall Balance	-53.1	-67.3	-137.6	-3.0	-3.7	-7.1
Excluding grants to transformation institutions	-35.2	-60.0	-80.9	-2.0	-3.3	-4.2
Memorandum items						
Privatization receipts	25.0	56.7	66.5	1.4	3.1	3.4
o/w local governments	9.5	30.6	13.1	0.5	1.7	0.7
Grants to transformation institutions (KoB, CI, CF)	17.9	7.3	56.7	1.0	0.4	2.9

Sources: Ministry of Finance and Fund staff estimates.

1/ Includes the State budget, State Financial Assets, National Property Fund, Czech Land Fund, Extrabudgetary funds, Social funds, and local governments.

Table 5. Czech Republic: Vulnerability indicators
(In percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	Latest Data 2000	Date
Financial indicators						
Public sector debt 1/	13.3	12.8	13.4	15.0	...	
Broad money (percent change, 12-month basis)	7.8	8.7	5.2	8.1	7.7	*April*
Private sector credit (percent change, 12 month basis)	10.6	9.4	-3.5	-3.9	-5.7	*April*
Domestic credit	65.5	68.2	61.7	59.7	56.8	*March*
1 year bond yield at issue (annual average)	8.4	10.3	13.8	7.4	5.2	*May*
1 year bond yield at issue, real (annual average) 2/	1.8	3.5	12.1	5.9	3.1	
External Indicators						
Exports G&NFS (percent change, 12-month basis in US$)	6.0	0.2	13.0	-0.2	13.8	*March*
Imports G&NFS (percent change, 12-month basis in US$)	12.7	-3.3	5.8	0.0	13.3	*March*
Terms of Trade (percent change, 12 month basis)	-1.3	-5.6	1.0	-1.0	-9.8	*March*
Current account balance	-7.4	-6.1	-2.4	-2.0	-2.9	*March*
Capital and financial account balance	7.2	2.1	5.3	4.7	8.3	*March*
o/w: Inward portfolio investment (debt securities etc.)	1.3	2.4	2.0	0.9	1.6	*March*
Other investment, net (loans, trade credits etc.)	3.8	-2.4	-1.4	-1.9	3.1	*March*
Inward foreign direct investment	2.5	2.5	4.9	9.6	8.8	*March*
Net Foreign Assets (NFA) of commercial banks (in US$ billions)	-1.2	2.6	4.2	6.3	6.2	*April*
Gross official reserves (in US$ billions)	12.4	9.8	12.6	12.8	12.9	*May*
Net International Reserves (NIR) (in US$ billions)	12.4	9.8	12.6	12.8	12.9	*May*
Central Bank short-term foreign liabilities (in US$ billions)	0.0	0.0	0.0	0.0	0.0	*May*
Central Bank foreign currency exposure (in US$ billions)	12.4	9.7	12.6	12.8	...	
Short term foreign assets of commercial banks (in US$ billions)	4.7	7.2	9.1	9.3	...	
Short term foreign liabilities of commercial banks (in US$ billions)	3.7	4.9	6.5	6.4	...	
Foreign currency exposure of commercial banks (in US$ billions)	0.9	4.4	6.6	7.6	7.3	*April*
Official reserves in months of imports G&NFS	4.4	3.6	4.4	4.4	4.2	*May*
Reserve money to (gross official) reserves (percentage)	33.3	26.5	22.1	5.7	4.1	*April*
Broad money to (gross official) reserves (percentage)	325.4	312.5	299.1	300.1	282.1	*April*
Total short term external debt to gross official reserves (percentage)	48.4	72.2	72.0	68.4	...	
Total external debt	36.8	44.9	40.4	44.8	...	
o/w: Public sector debt 3/	3.9	3.8	2.4	2.4	...	
Total external debt to exports GS (in percent)	70.9	72.2	71.9	67.7	...	
Total external debt service payments to exports G&NFS	10.9	15.7	15.1	12.5	...	
External interest payments to exports G&NFS	3.4	2.9	3.1	3.1	...	
External amortization payments to exports G&NFS	7.4	12.8	12.1	9.5	...	
Exchange rate (per US$, period average)	27.14	32.06	32.19	34.87	37.64	*May*
REER depreciation (-) (12 month basis; CPI-based)	8.4	-6.3	16.9	-5.2	2.1	*April*
Financial Market Indicators (end-year)						
Stock market index	530	488	386	490	579	*May*
Foreign currency debt rating (Moody's)	...	...	...	...	Baa1	*June*
Spread of benchmark bonds (basis points) 4/	...	...	...	104	130	*July*

1/ General government, excluding government guarantees, which amounted to 14 percent of GDP at end 1999.

2/ Deflated by net inflation.

3/ General government and the central bank.

4/ Yield spread on bond issued by the Czech Export Bank.

Table 6. Czech Republic: Macroeconomic Framework, 1996-2004

	1996	1997	1998	1999	2000 Proj.	2001 Proj.	2002 Proj.	2003 Proj.	2004 Proj.
					(In percent of GDP)				
Foreign saving 1/	7.4	6.1	2.4	2.0	3.4	3.3	3.5	3.3	3.7
Gross national saving 2/	27.5	26.7	27.3	26.5	24.7	24.9	25.2	25.7	25.8
Gross domestic saving 3/	28.0	26.3	28.3	26.9	24.6	25.0	25.4	26.2	26.4
Nongovernment	21.4	20.9	24.2	23.8	21.4	22.2	22.3	22.2	22.1
Government	6.5	5.4	4.1	3.1	3.2	2.8	3.2	3.9	4.4
Gross domestic investment	34.9	32.8	29.7	28.5	28.1	28.2	28.7	29.0	29.5
Nongovernment	29.9	27.3	23.3	21.7	22.0	22.0	22.3	22.6	23.2
Government	5.0	5.5	6.4	6.8	6.0	6.3	6.5	6.4	6.3
					(Percent change in real terms)				
Memorandum items:									
Consumption expenditure	6.0	1.6	-2.2	0.8	1.4	2.7	3.7	3.4	4.1
Nongovernment	6.9	1.9	-2.6	1.2	1.4	3.0	3.6	3.9	4.8
Government	3.5	0.8	-0.9	-0.1	1.1	1.8	3.8	2.2	2.2
Gross capital formation	11.8	-5.9	-4.9	-3.0	2.2	3.9	5.6	5.4	6.5
Nongovernment	12.4	-8.5	-10.5	-5.7	2.1	3.1	5.5	6.0	7.8
Government	8.0	9.6	23.3	6.9	2.6	6.7	5.9	3.4	2.6
Fixed capital investment	8.2	-2.9	-3.9	-5.5	2.7	4.2	6.0	5.8	7.0
GDP	4.8	-1.0	-2.2	-0.2	2.3	3.2	3.7	4.2	5.0
Nominal GDP (In CZK billion)	1,572	1,669	1,798	1,836	1,944	2,089	2,244	2,414	2,603
Net inflation (percent change) 4/	7.4	6.8	1.7	1.5	3½–5½	2–4	...	...	...

Sources: Data provided by the Czech Statistical Office; and Fund staff projections.

1/ External current account deficit (+).
2/ Equal to gross domestic investment (excluding statistical discrepancy) less foreign saving.
3/ Equal to gross national saving less net factor income and transfers from abroad.
4/ Authorities' target range for 2000 and 2001.

Table 7. Medium-Term General Government Accounts, 1999-2004
(In percent of GDP)

	1999 Actual	2000 Budget	2001 Proj.	2002 Proj.	2003 Proj.	2004 Proj.
Revenue 1/	39.8	39.3	39.3	38.8	38.5	38.2
of which:						
Total Current Revenue	39.7	39.2	38.6	38.2	37.9	37.6
of which:						
Tax Revenue	37.1	36.8	36.3	36.0	35.8	35.6
of which:						
Indirect Taxes	12.8	12.8	12.9	12.8	12.9	12.8
Direct Taxes	9.0	8.8	8.6	8.5	8.4	8.3
Social Security Contributions	14.7	14.6	14.3	14.1	14.0	13.9
Expenditure and net lending						
excluding privatization receipts	43.4	46.3	47.8	44.5	42.6	41.4
Current expenditure	37.5	40.2	41.3	36.8	36.3	35.2
Goods and services	8.5	8.6	8.5	8.3	8.1	7.9
Transfers and subsidies	27.9	30.5	31.6	27.0	26.5	25.8
of which:						
Transfers to households	13.4	13.4	13.4	13.4	13.4	13.5
Transfers to transformation institutions (TIs)	0.4	2.9	4.7	0.4	0.3	0.0
Interest payments	1.1	1.1	1.2	1.5	1.6	1.5
Capital Expenditures	5.6	6.0	6.2	6.2	6.1	6.0
Net lending 1/	0.4	0.1	0.3	1.5	0.2	0.2
General government balance	-3.7	-7.1	-8.5	-5.6	-4.0	-3.3
General government balance						
excl. grants to TIs and calls on guarantees	-3.2	-4.0	-3.6	-3.8	-3.6	-3.1
Primary balance	-2.1	-3.0	-2.4	-2.3	-1.9	-1.5
Memorandum items						
Privatization receipts	3.1	3.4	4.1	2.9	1.2	0.4
General government debt	15.0	17.8	20.9	22.3	23.5	24.7

Sources: Czech Ministry of Finance and Fund staff projections.
1/ Excluding privatization receipts.

Czech Republic: Fund Relations
(As of May 31, 2000)

I. **Membership Status**: Joined 1/01/1993; Article VIII

II. **General Resources Account**:	SDR Million	% Quota
Quota	819.30	100.0
Fund holdings of currency	819.29	100.0

III. **SDR Department**:	SDR Million	% Allocation
Holdings	0.15	n.a.

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	3/17/1993	3/16/1994	177.00	70.00

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangement**:
The currency of the Czech Republic is the Czech koruna, created on February 8, 1993 upon the dissolution of the currency union with the Slovak Republic, which had used the Czechoslovak koruna as its currency. From May 3, 1993 to May 27, 1997, the exchange rate was pegged to a basket of two currencies: the deutsche mark (65 percent) and the U.S. dollar (35 percent). On February 28, 1996, the Czech National Bank widened the exchange rate band from ±0.5 percent to ±7.5 percent around the central rate. On May 27, 1997, managed floating was introduced. On July 12, 2000, the exchange rate of the Czech koruna stood at CZK 37.24 per U.S. dollar.

VIII. **Last Article IV Consultation**:
The last Article IV consultation with the Czech Republic was concluded on July 21, 1999.

IX. **Technical Assistance**: See attached table.

X. **Resident Representative Post**: The post in Prague was closed in December 1995. A regional office covering the Czech Republic and Hungary was opened in January 1999 when Mr. Nord assumed the post, based in Budapest.

Czech Republic: Technical Assistance, 1991-2000

Department	Timing	Purpose
FAD	Dec. 1991 to Sept. 1993	Regular visits by FAD consultant on VAT administration
	March 1993	Public financial management
	September 1993	Follow-up visit on public financial management
	November 1993	Follow-up visit on public financial management
	January 1994	Follow-up visit on public financial management
	July 1994	Follow-up visit by FAD consultant on VAT administration
	May 1995	Follow-up visit on public financial management
	June 1995	Follow-up visit by FAD consultant on VAT administration
	June–July 1999	Medium-term fiscal framework
MAE	February 1992	Monetary management and research, foreign exchange operations, and banking supervision
	June 1992	Monetary research
	July 1992	Long-term resident expert assignment in the area of banking supervision (financed by EC-PHARE; supervised by the Fund)
	December 1992 and February 1993	Bond issuance and monetary management
	November 1993	Follow-up visit on bond issuance and monetary management and management of cash balances
	April 1994	Data management and monetary research
	January 1995	Foreign exchange laws (jointly with LEG) and external liberalization
	May 1995	Monetary operations
	May 1995	Banking system reform
	May 1996	Economic research

Department	Timing	Purpose
	April 1997	Banking legislation
	February–June 1999	Monetary research—inflation targeting
	June 1999	Integrated financial sector supervision (with World Bank)
RES	September 1999,	Inflation targeting (financed by MAE)
	June-August 2000	Inflation targeting (financed by MAE)
STA	May 1993	Money and banking statistics
	February 1994	Balance of payments
	April 1994	Government finance
	November 1994	Money and banking statistics
	January–February 1999	Money and banking statistics

Czech Republic: Relations with the World Bank

1. The Czech Republic became a member of the World Bank on January 1, 1993, by joint succession with the Slovak Republic to the membership of the Czech and Slovak Federal Republic.

2. A Structural Adjustment Loan (SAL) of US$450 million, concluded in June 1991 with Czechoslovakia, has been fully disbursed. The Czech and Slovak Republics have assumed repayment obligations in the ratio of 2:1. The SAL was cofinanced by the Japanese Export-Import Bank in the amount of US$200 million. A Power and Environmental Improvement Loan of US$246 million was assumed completely by the Czech Republic which has been fully disbursed.

3. In April 1996, the Czech Republic paid the outstanding balance (US$10.3 million) of a telecommunications loan approved by the World Bank for US$80 million in September 1993. The government continues to pursue a very prudent borrowing strategy thereby limiting its recourse to credits from international financial institutions, including the World Bank.

4. The Bank's renewed program with the Czech Republic includes several analytical pieces as well as technical assistance: A Capital Market Report was completed (in red cover) in June 1999; an EU-focused Country Economic Memorandum, the first for the Czech Republic, was finalized in September 1999, broadly distributed and presented in Prague in October 1999 to a diverse audience that included EU representatives; technical assistance in the area of quality of fiscal adjustment, focused on contingent liabilities and fiscal sustainability framework, was provided during 1998-99; support to the National Energy Efficiency Study was also provided in 1998. Work on EU related environmental issues (water) is being done with the cross support from EU member states. Most recently, the Bank has launched a Public Expenditure Review that will be completed by the Spring of 2001. The PER will focus primarily on public expenditure management issues and make an assessment of the efficiency and effectiveness of public expenditures in the Czech Republic.

5. The International Finance Corporation (IFC) has made loans and equity investments in industrial and financial companies. Total IFC exposure to the Czech Republic as of May 31, 2000 amounted to US$311.12million. The IFC has also provided advisory assistance in a number of privatization deals.

Status of Bank Group Operations in the Czech Republic
Operations Portfolio
As of May 31, 2000

	Number	(In millions of US$)
Active projects	0	
Closed projects	5	
Total disbursements (IBRD)		511.7
Of which has been repaid		186.0
Total outstanding		325.7
Total undisbursed		0.0

Source: IBRD

Czech Republic
STATEMENT OF IFC's
Current Exposure
As of 31-May-2000
(In millions of US dollars)

FY Approval	Company	Loan	Equity	Quasi	Partic
1992	CM Cement	0.00	0.00	0.00	0.00
1992	Zivnostenska	0.00	5.42	0.00	0.00
1994	Autokola	6.92	0.00	0.00	1.70
1994	Beronit	2.41	0.00	0.00	0.00
1995	Plzensky	0.00	0.00	7.10	0.00
1995	Sumperk	1.57	0.00	1.05	0.00
1997	Kladno	36.23	0.00	15.00	20.13
1997/98	Nova Hut	67.18	0.00	0.00	146.02
1998	DCR Czech Rating	0.00	0.39	0.00	0.00
	Total Portfolio:	114.31	5.81	23.15	167.85

		Approvals Pending Commitment			
		Loan	Equity	Quasi	Partic
1999	CSOB	0.00	77.74	0.00	0.00
	Total Pending Commitment:	0.00	77.74	0.00	0.00

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES
CZECH REPUBLIC—AN UPDATE[1]
JUNE 2000

This note provides a factual report on developments since the September 1999 "Experimental Report on the Observance of Standards and Codes—Czech Republic." For a full description of institutions and practices, it should be read in conjunction with the original report.[2]

A. Data Dissemination

The Czech Republic is a subscriber and meets the specifications of the Special Data Dissemination Standard (SDDS) for the coverage, periodicity, and timeliness of data, as well as for advance release calendars. Since the September 1999 ROSC, it has put in place a National Summary Data page, which is linked to the IMF's Dissemination Standards Bulletin Board and provides actual economic data corresponding to the SDDS requirements in a common format. Since April 2000, the Czech Republic has been releasing detailed information on international reserves and foreign currency liquidity that conforms with the required data template.

B. Fiscal Transparency

Substantial progress has been made to address the issues identified in the September 1999 fiscal ROSC module. A new *Law on Budgetary Rules* has been approved by Parliament, which addresses many of the previous shortcomings (see below). In addition, the new *Public Administration Reform Act* and amendment of the *Law on Municipalities* aim at clarifying the roles and responsibilities of different levels of government.

The new budgetary rules comprise five main changes:

- **Expost changes in the State Budget will be strictly limited.**[3] Unanticipated revenue can no longer be spent without Parliamentary assent and the approved expenditure thus

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[1] Prepared by Mr. Nord (European I Department), in consultation with the Czech authorities.

[2] The report was issued to the Executive Board as EBS/99/158, Supplement 5 (9/1/99) and is available on the IMF website as http://www.imf.org/external/np/rosc/cze/index.htm.

[3] The new *Law on Budgetary Rules* covers only the operations of the State Budget. However, together with the new *State Property Law*, it stipulates that any extrabudgetary funds must be created by separate laws, which themselves must be in conformity with the new *Law on Budgetary Rules*.

represents an overall cap.[4] Within a budgetary chapter, increases in individual spending lines (votes) may not exceed 10 percent, even if the overall chapter ceiling is observed. Across budgetary chapters, the government's discretion is limited to 5 percent additional spending, but only if equivalent savings are realized elsewhere.

- **Rules on government guarantees are tightened substantially.** Each individual guarantee must now be approved in a separate law, either at the time of the budget submission or separately.

- **All spending must be executed by institutions approved by law**. Past practice of establishing spending institutions by ministerial decree will be discontinued.

- **Budgetary presentation and monitoring will be made more transparent and accountable**. The presentation of the state budget must include a medium-term outlook covering two years beyond the budget under consideration.[5] Moreover, the quarterly reports to Parliament will become more timely and user-friendly, with a semiannual focus on budget deviations and proposed remedies. These reports must also cover the operations of the extrabudgetary funds.

- **The government can no longer operate on the basis of an unapproved budget.** Under current rules, the budget provisorium is the proposed budget, even if it has been rejected by Parliament. Under the new rules, the Czech practice will be brought in line with that in many other countries: the government will need to limit total monthly expenditure to 1/12 of the previous year's spending until the new budget is approved.

C. Transparency of Monetary and Financial Policies

In early 2000, there was a wave of bankruptcies in the credit union (kampelicka) sector, and a large number of credit unions were placed under forced administration. The guarantee fund maintained by the credit unions does not suffice to cover all insured deposits and the government has proposed to step in to indemnify all depositors 80 percent of their deposits, up to a maximum of CZK 100,000. The credit union sector is regulated by a separate

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[4] There are a few small, and well-defined exceptions. For example, if certain mandatory expenditures are running above expected levels (for example, unemployment benefits because of a higher-than-anticipated number of unemployed) then the government is not obliged to call for a halt in payments. Also, if expenditures are linked to precise additional financing such as EU funds, then they do not fall under the ceiling.

[5] However, the medium-term framework required by law can remain quite general; it does not require, for example, medium-term projections of individual spending items or even budgetary chapters, but only broad revenue and expenditure magnitudes.

legislative act, which assigns the responsibility of supervising to the *Office for Credit Union Supervision.*

D. Compliance with Basel Core Principles for Effective Banking Supervision

A new regulation was issued in July 1999 regarding **consolidated supervision**, stipulating that from April 2000 the capital adequacy ratio (CAR) on credit risk and large exposure limits should be calculated both on a solo and a consolidated basis (only once a year on a consolidated basis). However, this does not cover cases where the bank is a subsidiary of a nonbank holding company, as required by EC directives.[6] This would require an amendment of the *Act on Banks*, which is under consideration.

The CNB has introduced a requirement for a capital charge for **market risk**, designed to contribute to the effective supervision of off-balance-sheet transactions. This is assessed on a solo basis, however. The CNB is considering extending it to a consolidated basis by 2002/03. The CNB has also introduced a market value accounting standard for the derivative transactions of banks starting in January 2000 in accordance with the international accounting standards. Conditional upon the amendment of the Accounting Act (see below), starting January 1, 2001, market value accounting will also be introduced for the securities portfolios held by banks.

E. Transparency and the Securities Market

Since the August 1999 report, a number of changes are now being made to the regulatory framework governing the securities market, with the overall objective of bringing Czech legal and regulatory practice closer to international standards and harmonizing Czech law with EU law.[7] All amendments listed below are due to enter into force on January 1, 2001.

The *Commercial Code* is being amended. Key elements of the amendment are: (i) a strengthening of minority shareholders' rights, including the disclosure requirements of large shareholdings and mandatory buy-outs in case of take-overs;[8] (ii) a clarification of other

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[6] Under the Agreement on Cooperation with the Ministry of Finance and the Securities Commission, the CNB has the possibility of acquiring information from other domestic financial market regulators and, under certain circumstances, the possibility of requiring on-site examinations; however, the Czech legal system hampers a full exchange of information.

[7] Draft laws have been submitted to Parliament and, in some cases, approved. Before entering into force, they must also be approved by the Senate and signed by the President.

[8] A buyer is required to make an offer to minority shareholders if its purchase results in a shareholding exceeding 40 percent of outstanding equity. This compares with levels of 25-30 percent in many other market economies.

take-over rules and providing the Czech Securities Commission with regulatory powers in this area; and (iii) a clarification of the responsibilities of boards of directors. Overall, the amendment is intended to accord with the OECD's Principles of Corporate Governance.

The *Securities Act* is being amended. A key feature of the amendment concerns tightening disclosure requirements to be listed as a publicly tradable company and standardizing the requirements in all public exchanges. With few exceptions, the amendment aims to incorporate all relevant EU directives.

The *Accounting Act* is being amended. It is intended to align Czech accounting standards with international standards. It allows corporations to choose to publish accounts on either Czech standards or IAS. It also gives the stock exchange the power to require either Czech standards or IAS.

The *Bonds Act* is being amended. The amendment provides for enhanced disclosure requirements, streamlines the approval process for issuing bonds, and provides for the formation of creditors' committees aimed at strengthening the position of creditors.

Finally, the *Stock Exchange Act* is being amended, aimed at strengthening the supervisory powers of the Securities Commission and introducing several technical changes to ensure more transparency in trading.

Later this year, the preparation of an amendment of *Securities Commission Act* will begin, with the objective of improving the ability of the Securities Commission to regulate capital markets and enforce existing regulations. This amendment would likely enter into force in December 2001.

Meanwhile, the Securities Commission has recently submitted for public discussion a draft of principles of best practice in securities markets. The goal is to establish general rules of behavior for market participants and their basic responsibilities. The principles are grounded in the Commission's authority to demand compliance with best practice in the Czech capital market, and to set market standards that would meet EU standards. The Commission intends to publish this proposal in the form of a recommendation whose principles should be obeyed by all market participants. The proposal is based on the Best Practice Principles published by the International Organization of Securities Commissions (IOSCO). Its aims are to increase trust in the Czech capital market, educate the investing public, protect investors, and fight against financial crime.

Czech Republic: Statistical Issues

1. Data on core surveillance variables are provided to the Fund regularly and with minimal lags (reporting to STA is less current, especially for foreign trade and the national accounts). Data on exchange rates and basic interest rates set by the Czech National Bank (CNB) are reported on a daily basis with no lag. Data on gross and net international reserves are reported on a monthly basis with a one-week lag, as well as on a ten-day basis (with the CNB's balance sheet) with a two-week lag. Data on consumer prices, reserve money, broad money, borrowing and lending interest rates, central government fiscal accounts, and foreign trade are provided monthly with a lag of 1–5 weeks. Final monetary survey data are available with a lag of about one month. GDP and balance of payments data are made available on a quarterly basis with a lag of 2–3 months. Annual data published in the Government Finance Statistics Yearbook cover all operations of the general government, including the extrabudgetary funds excluded from the monthly data. These annual data are available on a timely basis. Monthly fiscal data published in *International Financial Statistics (IFS)* cover central and local budget accounts and are available with a 2–3 month lag.

2. All data are promptly released by the Czech authorities to the Fund and news services, and are also published regularly in various monthly and quarterly statistical publications as well as being posted on the internet. Information on exchange rates and basic interest rates is available daily through Reuters and Bloomberg. The quality of financial variables is high, and improvements have been made in the processing of foreign trade statistics. However, national accounts data suffer from a number of weaknesses (see below).

3. In the national accounts, the value added in the small-scale private sector is likely to be underestimated as the mechanisms for collection of data on this sector are not yet fully developed. It is also believed that a large volume of unrecorded activity stems from tax evasion. Discrepancies between GDP estimates based on the production method and the expenditure method are large, and are subsumed under change in stocks. Quarterly estimates of national accounts are derived from quarterly reports of enterprises and surveys. The estimates are subject to bias because of nonresponse (while annual reporting of bookkeeping accounts is mandatory for enterprises, quarterly reporting is not) and lumping of several expenditure categories in particular quarters. Large swings in individual components of spending and the overall GDP from quarter to quarter also raise serious questions on reliability of the data.

4. Revisions in recent years to procedures for processing export data have brought external trade statistics close to the practice in the EU. However, a continued weakness of foreign trade statistics is the unavailability of price indices for exports and imports with a fixed base; these indices are currently presented on the basis of the same month of the previous year. Also, there continues to be some discrepancies in the current account data published by the CNB and the statistical office. Progress has been made towards implementing the methodology in the fifth edition of the Balance of Payment Manual.

5. Although there are some differences with the *IFS* presentation, monetary survey data provided to the European I Department are generally adequate for policy purposes. However, large variations in the interbank clearing account float, especially at the end of the year, require caution in interpreting monetary developments. The CNB has made a major effort to identify the causes of these variations and adjust the data. An STA mission (January-February 1999) provided recommendations regarding valuation, accrued accounting, and treatment of financial derivatives in monetary statistics. The mission also reviewed and updated the system of reporting data to IFS which has resulted in some changes to published monetary statistics.

6. The Czech authorities have subscribed to the Special Data Dissemination Standard (SDDS), and the metadata have been posted in the Fund's Dissemination Standards Bulletin Board. The authorities have committed to meeting all the requirements of the SDDS by the end of the transition period (March 2000).

Czech Republic: Core Statistical Indicators
(As of June 12, 2000)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Central Govern-ment Balance	GDP
Date of latest observation	6/12/00	5/31/00	5/31/00	5/31/00	4/00	6/12/00	5/00	4/00	00 Q1	5/00	Q4 2000
Date received	6/12/00	6/17/00	6/6/00	6/6/00	5/31/00	6/12/00	6/8/00	5/23/00	6/5/00	6/1/00	3/22/00
Frequency of data	Daily	Daily	10 days	10 days	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly
Frequency of reporting	Daily	Monthly	10 days	10 days	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly
Source of update	Reuters	CNB 1/	CNB	CNB	CNB	CNB	CSO 2/	CSO	CNB	MOF 3/	CSO
Mode of reporting	Electronic	Electronic	Mail/ Electronic	Mail/ Electronic	Mail/ Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic
Confidentiality	No	No	No	No	No	No	No	No	No	No	No
Frequency of publication	Daily	Monthly	10 days	10 days	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly

1/ CNB = Czech National Bank.
2/ CSO = Czech Statistical Office.
3/ MOF = Ministry of Finance.

Statement by the IMF Staff Representative
July 26, 2000

1. This statement contains information which has become available since the staff report (SM/00/159) was issued. This information does not modify the thrust of the staff appraisal.

2. **Recent data continue to signal a solidifying economic recovery.** Real GDP expanded by 4.4 percent year-on-year in the first quarter of 2000 (up from 1 percent in the last quarter of 1999), although this partly reflected special factors including the leap-year effect and the low level of activity in the base period. Adjusting for additional working days, real GDP growth is estimated to have been a more moderate 2.9 percent. While all major demand components contributed to growth, the external sector made the largest contribution (nearly two-thirds) as export volumes surged ahead of imports. Private consumption grew modestly and, in contrast to previous quarters, fixed capital formation also expanded. Industrial production increased by 4.8 percent (year-on-year) in the first five months of 2000, with the fastest growth among large firms and companies with foreign strategic investors. However, activity in other sectors, including agriculture and construction, is subdued. The unemployment rate was unchanged in June from the previous month at 8.7 percent, but was slightly lower on a seasonally adjusted basis. Retail sales grew 8.4 percent and 6.1 percent (both year-on-year), in May and the first five months of this year, respectively.

3. **Rising oil prices boosted inflation and expanded the trade deficit during the first half of the year**. Sharply higher oil prices pushed inflation at the consumer level to 4.1 percent in the 12 months to June from 3.7 percent in May, while net inflation (excluding regulated prices and changes in indirect taxes) jumped half a percentage point to 2.6 percent. Also on the back of sharply higher oil prices, and notwithstanding strong growth in export volumes, the trade deficit rose substantially in May, bringing the cumulative trade deficit for the first five months of 2000 to CZK 31.6 billion (1.6 percent of annual GDP). The external current account deficit increased to 0.7 percent of annual GDP in the first quarter of 2000.

4. **On the monetary policy area, the CNB has indicated that the recent activity and inflation data as well as the continued strength of the koruna vis-á-vis the euro have not significantly changed its short-term outlook for the Czech economy**. It has thus kept its key two-week repo rate unchanged at 5.25 percent, and its most recent monetary policy meeting at the end of June noted that the exchange rate was "at a tolerable level." However, more recently, a senior official of the CNB made a public comment that the strengthening of the koruna vis-á-vis the euro was disturbing, and did not rule out intervention in the foreign exchange market.

5. **On fiscal policy, the 2000 state budget remains on track, with less risk of overperformance than at the time of the mission.** Good VAT revenue growth has balanced shortfalls elsewhere, but there are signs that VAT collections have begun to moderate. In

addition, the strength of the U.S. dollar and payments for drought relief are expected to raise overall spending by about ¼ percent of GDP in 2000.

6. **Plans for the 2001 state budget are firming and include measures that would bring about a durable—albeit modest—improvement in public finances**. Cabinet approved two measures that, if agreed by parliament, would permanently improve the fiscal outlook. First, several items currently taxed at the 5 percent VAT rate would be transferred to the standard 22 percent category, which would yield an additional CZK 6.5 billion (⅓ percent of GDP) in revenues in 2001 and help align the tax system with EU requirements.[1] Second, lifetime pension benefits for early retirees are to be reduced below the level of benefits for those who retire at the normal retirement age, while benefits for late retirees will be raised. Although this reform would save only a small amount in the short run, it signals the authorities' willingness to begin to reform pension finances. Also in the area of pension reform, a proposal passed its first reading in parliament, which sets aside CZK 200 billion (10 percent of GDP) in privatization revenues to cover the shortfall in contributions to the existing PAYG system that would arise from setting up a system of private pension funds. However, this was opposed by the government, which plans to allocate CZK 40 billion to bolster the state-run PAYG system. A parliamentary commission to study pension reform was created in early July and is expected to present its recommendations by end-2001.

7. **Regarding the financial difficulties in Investiční a Poštovní banka (IPB), the rapid sale to a Belgian strategic investor—which was done without a competitive tender—has drawn fire from the opposition**. In a nearly unanimous vote, the lower house of parliament decided to form a special commission to investigate the events at IPB from the time of its establishment in the early 1990s until its sale in June 2000. The commission has been given one year to complete its report. According to estimates presented in a joint government-CNB report on the events at IPB, the impact on the Czech economy of an outright failure of the bank, as opposed to the chosen method of forced administration, would have been a drop in GDP of 2–4 percent.

8. **The lower house of parliament approved a number of amendments to the CNB Act on July 14.** Major changes include: (i) shifting the CNB's policy objective from currency stability to price stability; (ii) subjecting the CNB's operating budget (but not the budget to cover activities related to achieving its primary objective) to parliamentary approval; (iii) giving the government an exclusive power to nominate the CNB governor, vice-governors, and board members (whereas their appointment is made by the president as before); (iv) calling on the CNB to consult with the government when setting inflation targets and the exchange rate regime; and (v) aligning salaries of CNB employees with those of civil

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[1] However, other items, including telecommunications, construction and energy for heating, which are currently taxed at the preferential rate, are required by the EU to be taxed at the higher rate.

servants. Proposals that would have required the CNB to consult with the cabinet on significant monetary policy decisions and permitted parliament to reject the CNB's monetary report were voted down, which reduced the concern expressed in the staff report to a certain extent. However, some of the approved amendments could potentially constrain the CNB's operational independence. The bill must be sent to the Senate and then the president for final approval.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with Czech Republic

On July 26, 2000, the Executive Board concluded the Article IV consultation with Czech Republic.[1]

Background

Following a severe and protracted recession, a modest economic recovery has taken hold in the Czech Republic owing to the relaxation of macroeconomic policies and an acceleration of structural reforms. The underlying cause of the recession was inadequate restructuring of the corporate and banking sectors which impaired the supply side of the economy and led to a burgeoning external current account deficit in 1996. The recession was compounded by contractionary monetary and fiscal policies in response to a series of currency attacks during the first half of 1997, and policies remained tight until late 1998 partly out of concern about contagion from the Russian crisis. Tight macroeconomic policies—together with favorable temporary factors—succeeded in bringing down inflation and reducing the current account deficit, but at a heavy toll in terms of economic activity. A subsequent loosening of policies and advances with structural reform, including bank and enterprise restructuring, have underpinned the return to positive economic growth. However, the pace of expansion is expected to remain weak in comparison to other advanced transition economies until substantial progress has been made in reducing the backlog of structural reforms.

Economic growth turned modestly positive after the first quarter of 1999, headed by a rebound in household consumption and a recovery of demand in European Union (EU) trading partners. However, investment remained weak owing to banking and corporate sector restructuring. Inflation continued to decline during the first half of 1999 to reach very low levels but subsequently picked up modestly due to adjustment of administered prices and rising world oil prices. Net inflation, at 1½ percent at end-1999, undershot the Czech National Bank's (CNB) target range of 4–5 percent.

[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. In this PIN, the main features of the Board's discussion are described.

Cyclical and structural factors led to sharply higher unemployment during 1999; nonetheless, real wages also rose strongly partly due to the unexpectedly large drop in inflation.

Subdued domestic demand and strong export growth narrowed the external current account deficit to some 2 percent of GDP in 1999 and exports expanded by 9 percent in volume terms. Foreign direct investment (FDI) related capital inflows surged in the second half of the year, and net inflows reached a level that was more than double the current account deficit, leading to upward pressure on the koruna. The CNB intervened on a few occasions beginning in the fourth quarter of 1999 to resist the appreciation of the currency.

In response to weak economic activity, the authorities allowed a significant widening of the fiscal deficit while official interest rates were cut aggressively. The general government deficit (excluding privatization and grants to transformation institutions) increased to 3¼ percent of GDP in 1999 from 2 percent of GDP in the previous year, with a further expansion to 4¼ percent of GDP envisaged for 2000. However, in view of the widening output gap, the structural deficit is estimated to have increased by ½ percentage point of GDP in 1999 with a more modest increase expected for 2000. The CNB reduced its key policy interest rate (the two-week repo rate) by nearly 10 percentage points from mid 1998 to November 1999, but the sharp deceleration in inflation and strengthening of the koruna reduced the implied easing of monetary conditions.

On the structural front, banking sector woes continued, but steady progress was made in privatizing banks, improving the legal framework governing economic transactions and restructuring several key enterprises. Two large state-owned banks were sold during 1999-2000, and the sole remaining large state-owned bank is slated for privatization by early 2001. In preparation for their sale, a large part of their non-performing loans was transferred to the state-owned "consolidation" bank. Weak management and imprudent lending contributed to the decapitalization of a major privatized bank, which was placed under CNB administration and subsequently resold in June 2000. A number of legal reforms, including a revised Bankruptcy Act, were recently introduced which aim at increasing the transparency of the business environment, strengthening creditors' rights and reducing the often long delays in the resolution of legal claims. Their effectiveness will, however, depend on the manner and speed with which they are applied by the courts. The state-owned Revitalization Agency selected eight large industrial companies for organizational and financial restructuring, but progress has been hindered by difficulties in getting shareholders and creditors to share the financial burden.

The economic recovery is expected to continue, supported by strengthening demand in the EU, a sharp increase in privatization and greenfield FDI, and low inflation and inflationary expectations. However, ongoing restructuring in the banking and traditional corporate sectors will in the short run act as a drag on the economy by restraining credit and contributing to unemployment, As a result, growth will reach a modest 2–2½ percent in 2000, with a pickup to 3–3½ percent in 2001 as these negative factors recede. The main stimulus to economic activity is expected to come from fixed capital formation, while consumption would grow at a more modest rate and net external demand would exert a slightly positive influence as foreign demand strengthens further. However, due to higher oil prices and the spillover of increased investment demand onto imports, the external current account deficit is expected to rise to 3½ percent of GDP in 2000. Renewed enterprise restructuring is expected to lead, after a pause early in the year, to a further rise in the unemployment rate to 10½ percent by end-2000 and 11 percent by end-2001.

Executive Board Assessment

Executive Directors were encouraged by signs that economic recovery was now underway, and commended the authorities for the prudent and coherent macroeconomic policies that had contributed to this result. They noted that a number of elements conducive to growth were in place, including a better external environment, low inflation and inflationary expectations, a viable and competitive external position, and some progress with structural reforms. However, they observed that there are still reasons to be cautious about the strength of the recovery, as the ongoing banking and corporate sector restructuring could continue to act as a drag on domestic investment and consumption. These uncertainties might best be alleviated through a more decisive specification and implementation of the authorities' medium-term fiscal and structural objectives.

Directors agreed that macroeconomic policies needed to strike a balance between sustaining the pace of recovery and making progress toward achieving medium-term policy objectives. As regards fiscal policy, they thought that the current policy setting was broadly appropriate to support the recovery and considered that automatic stabilizers should be allowed to operate if downside risks materialized. At the same time, Directors also noted that, if the recovery gathered further momentum, a stronger fiscal position would become necessary, as was, indeed, already envisaged for the 2001 state budget. This would be all the more necessary if capital inflows remain strong, since monetary policy alone may not be sufficient to cope with a rising exchange rate and inflationary pressures stemming from a sustained strengthening of activity. Directors stressed that the authorities should focus on achieving medium-term fiscal sustainability. In this regard, reforming the pension and healthcare systems was critical, and they urged the authorities to formulate fundamental reforms expeditiously. There was also a call for greater efforts to deal with tax arrears.

Directors welcomed the new budget rules, which would improve fiscal transparency and accountability. However, they expressed concern about the establishment of new extrabudgetary funds (EBFs), and cautioned that the EBFs could become entrenched and pervasive, thereby undermining fiscal transparency and accountability. They called on the authorities to ensure the transparency of these funds and a prudent approach to their financing, scope, and timely termination, once the stated policy objectives had been achieved.

Directors considered that the stance of monetary and exchange rate policies has been suitably supportive of activity at the time when inflation was exceptionally low. Directors indicated that until the recovery was firmly established, the current accommodative stance should be maintained. At the same time, they suggested that the authorities should keep a watchful eye on the evolution of the economy and, as the recovery proceeds, they should be ready to adjust the monetary stance as needed to ensure price stability for the coming year and beyond. In this regard, Directors welcomed the Czech National Bank's (CNB's) end-2001 net inflation target, which signaled the intention to maintain the disinflation gains achieved so far. Directors encouraged the authorities to improve the inflation targeting framework, including forecasting. They also welcomed the government's endorsement of the target, which strengthens accountability and credibility. Directors expressed concerns, however, about some of the proposed amendments to the CNB Act currently under discussion in parliament, which could undermine the CNB's operational independence. Directors expressed the hope that the ongoing discussion would result in an Act that would ensure the independence of the Central Bank, on par with EU norms and international best practices.

Directors noted that the continued strong FDI inflows suggested that the upward pressure on the koruna would continue, and encouraged the authorities to take the necessary measures, including further intervention in the foreign exchange market, and on the fiscal side, to prevent excessive appreciation. Some Directors considered, however, that allowing the exchange rate to appreciate would be appropriate in light of the effects of structural reforms on productivity and economic efficiency.

Directors encouraged the authorities to accelerate structural reforms. In this regard, the recent privatization of a major state-owned bank, the plan to sell the remaining bank, the market-oriented approach to restructuring several large enterprises, and legal reforms including improvements in bankruptcy procedures, were steps in the right direction.

Directors noted some progress made in the regulatory framework for bank supervision, such as the incorporation of market risk into the capital adequacy requirement. However, the recent failure of IPB demonstrated the need to strengthen bank governance and the importance of further strengthening banking supervision. In this context, they welcomed the authorities' decision to participate in the Financial Sector Assessment Program later this year. Directors noted that legal impediments still tended to slow the recovery of claims against debtors and hence the overall speed of banking and corporate sector restructuring. While acknowledging the difficulties the authorities were facing in this regard, they noted the synergies among the various structural policy measures, and underscored the importance of moving forward on all fronts in order to achieve maximum results.

One consequence of the structural reforms, however, has been increased unemployment, which has risen to a high level over the past few years. Directors were concerned about the risk of unemployment becoming structural, and recommended that the authorities take steps to increase the flexibility of the labor market, notably by reforming the system of social benefits.

Directors recognized the high quality of economic statistics in the Czech Republic and noted that data provision to the Fund for surveillance is adequate. In particular, they noted the observance of the SDDS's prescriptions for data coverage, periodicity and timeliness, and for the dissemination of advanced release calendars. They welcomed the publication, since April 2000, of international reserve and foreign currency liquidity data according to the new template.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. As part of a pilot project, the staff report for the 2000 Article IV consultation with Czech Republic is also available.

Czech Republic: Selected Economic Indicators, 1995-2000

	1995	1996	1997	1998	1999	2000 Proj. 1/
	(Percent change)					
Real sector						
Real GDP	5.9	4.8	-1.0	-2.2	-0.2	2.3
CPI inflation						
Period average	9.1	8.8	8.5	10.7	2.1	3.9
12-month change	7.9	8.6	10.0	6.8	2.5	3.8
Net inflation, 12-month change 2/	7.3	6.6	6.8	1.7	1.5	2.9
Real wages (industry), period average	8.5	8.1	3.2	-0.2	4.6	1.0
Registered unemployed, period average (percent of labor force)	3.0	3.1	4.3	6.1	8.6	9.8
	(In percent of GDP)					
Fiscal sector 3/						
Revenues	41.9	40.4	39.7	39.3	41.4	39.9
Expenditures	41.5	40.6	40.9	40.8	42.0	43.6
Balance	0.3	-0.4	-1.2	-1.6	-0.6	-3.7
Excluding privatization revenues	-2.1	-2.1	-1.9	-3.0	-3.7	-7.1
Excluding privatization revenues and grants to transformation institutions	-1.4	-0.9	-1.7	-2.0	-3.3	-4.2
Gross debt	14.1	13.3	12.8	13.4	15.0	18.0
Loan guarantees outstanding	...	...	15.0	15.6	14.0	...
	(12-month change in percent)					
Money and credit (end-of-period)						
Broad money	22.0	7.8	8.7	5.2	8.1	...
Credit to enterprises and households	13.2	10.6	9.4	-3.5	-3.9	...
Net foreign assets	60.3	-9.5	20.1	25.6	33.2	...
Velocity (percentage change, end-of-period)	-4.3	5.6	-2.3	2.4	-5.6	...
	(In percent)					
Interest rates						
Average lending rate	12.8	12.5	13.2	12.9	8.7	...
Average deposit rate	7.0	6.8	7.7	8.1	4.5	...
	(In billions of U.S. dollars)					
Balance of payments						
Merchandise exports	21.5	21.7	22.8	26.4	26.9	26.5
Volume change (in percent)	17.0	6.2	13.7	13.7	8.7	8.1
Merchandise imports	25.1	27.6	27.3	28.9	28.9	29.2
Volume change (in percent)	27.0	12.5	10.7	8.0	6.0	6.4
Trade balance	-3.7	-5.9	-4.5	-2.6	-2.1	-2.7
Current account	-1.4	-4.3	-3.2	-1.3	-1.1	-1.7
(Percent of GDP)	-2.6	-7.4	-6.1	-2.4	-2.0	-3.4
Non-debt capital inflows (percent of GDP)	6.7	3.4	3.3	7.1	9.9	...
Gross official reserves (end-of-period)	14.0	12.4	9.8	12.6	12.9	...
(In months of merchandise imports)	6.6	5.4	4.3	5.2	5.3	...
(In months of current payments)	5.3	4.1	3.3	4.0	4.1	...
(In percent of short-term debt by residual maturity)	...	...	87.7	98.2	...	...
External debt in convertible currencies (end-of-period)	16.5	20.8	21.4	24.0	22.6	...
(Percent of GDP)	31.8	36.2	44.3	39.9	44.3	...
Short-term debt (convertible currencies, end-of-period)	5.0	6.0	7.1	9.1	8.8	...

External debt service ratio in convertible currencies						
(Percent of exports of goods and nonfactor services)	9.3	10.9	15.7	15.1	12.5	...
			(Percent change)			
Exchange rate (period average)						
Nominal effective	-0.9	1.0	-3.7	-0.6	-3.6	...
Real effective (ULC-based)	3.9	5.8	-0.4	8.1	-0.7	...

Sources: Czech authorities; and IMF staff estimates and projections.

1/ Staff projections.
2/ Net inflation excludes regulated prices and changes in indirect taxes.
3/ General government operations and debt; central government guarantees.

Statement by Willy Kiekens, Executive Director and Jiri Jonáš, Advisor for the Czech Republic
July 26, 2000

1. After three consecutive years of negative growth, the Czech economy seems finally to be recovering just in time to ensure a more cheerful reception for the many guests who will come from all over the world to attend the IMF/World Bank Annual Meeting in Prague. Nearly every scrap of new data indicates that the recovery is strengthening, but the Czech authorities agree with the staff that the fundamentals must be consolidated to ensure that the strengthening continues until it becomes self-sustaining. There are still many challenges to be surmounted, the most serious involving fiscal adjustment and the restructuring of the banking and corporate sectors. An incipient recovery is not a reason to relax adjustment efforts; it is rather a signal to intensify such efforts because it proves that measures that are difficult and even painful will pay off by bringing stronger economic growth.

Recent Developments

2. Initially the recovery was driven mostly by strong growth in the euro area, which is by far the Czech Republic's most important export market. Now, however, there are encouraging signs that domestic demand growth is also beginning to take off. A strong increase in retail sales in May, of 8.4 percent in real terms, suggests that consumer demand is recovering. Since the growth of wages and other incomes has been relatively subdued, the new strength of consumer demand could be taken to indicate that increasing consumer optimism is making precautionary savings less attractive than it has been in recent years. In addition, the first quarter national account data show that fixed investment has reversed its decline, growing be 2.2 percent; and construction is also gradually beginning to recover.

3. The recovery in economic activity appears to have arrested, at least for the time being, the growth of unemployment, which earlier this year had reached a historic level for the Czech Republic, although not really higher than the unemployment peaks of other transition economies. But even though the accelerating recovery will promote employment growth, the continued restructuring of enterprises will continue to cause labor shedding and could push the unemployment rate higher. In any case, the earlier projections that had unemployment significantly higher than 10 percent by the end of this year now look a bit too pessimistic.

4. The Czech economy's long recession contributed to a significant slowing of inflation. But as activity resumes and some temporary factors that restrained inflation have weakened, inflation has begun to creep up once more. Headline CPI rose from a low of 1 percent in June 1999 to reach 4.1 percent in June 2000. The same period saw net inflation rise from -0.6 percent to 2.6 percent. Producer prices grew even faster due to the effect of higher oil prices.

5. The gradual recovery of donmestic demand combined with the higher price of imported oil to weaken the trade and current account balances. However, export growth

remains robust in spite of the continued tendency of the Czech koruna to appreciate. The strength of export growth reflects not only strong demand in Western Europe, but also improved competitiveness resulting from enterprise restructuring and growing inflows of FDI. This is why the expectation of some widening of the current account deficit this year is not a cause for concern. The expected large inflows of FDI should make the deficit easy to finance without creating additional debt, even if outflows of short-term capital continue, driven by the low interest rates on koruna deposits.

Structural Reforms

6. For some time the banking sector was a weak spot in the Czech economy. This was partly due to factors that have caused trouble in other transition economies, such as the difficulty of ensuring that bank supervision and regulation can keep up with the growing numbers of banks and other financial institutions and the rapid development of banking services. There were also factors peculiar to the Czech Republic that contributed to problems in the banking sector. For example, in the early years of the transition, the level of monetization and debt remained high, instead of being reduced by inflation as in some other transition countries. This meant that the banks had a relatively large (in GDP terms) amount of savings requiring to be allocated. But the mechanism and incentive structures guiding this allocation did not ensure the avoidance of bad loan problems later on. The causes included delays in bank privatization, the use of credit to finance the acquisition of nonfinancial companies during the voucher phase of privatization, and less than arm's length relations between banks and their corporate clients which interfered with appropriate assessments of the creditworthiness of loan applicants.

7. As long as economic growth was strong, the problems in the banking sector appeared manageable. But in 1997, the recession and the tighter financial conditions imposed to reduce an unsustainable current account deficit brought these latent problems suddenly to the surface. In a highly monetized economy, where companies depend largely on bank credit to finance both investment and some current expenditures, any problems in the banking sector will have serious consequences for economic activity, which is one of the reasons why the Czech economy performed so poorly at a time when other advanced transition economies were experiencing rapid growth.

8. Fortunately, financial crisis and banking sector problems have given the Czech authorities a strong incentive to react quickly to privatize the four large state-owned banks by selling them to strong foreign investors. Two of these banks, the CSOB and CS, are already sold, and the authorities are in the process of selling the largest, the KB, which will likely be completed early next year. Problems have developed with the fourth bank, IPB, purchased by Nomura Securities in 1998. Unfortunately, Nomura turned out to be a weak owner and behaved more like a portfolio investor. As a result, IPB's management remained weak, its risk management inadequate, and its bad loans continued to grow. By the end of June, when the auditors' report showed a serious capital inadequacy, the authorities responded quickly. Given IPB's systemic importance, it was considered too costly to close it. The authorities therefore imposed forced administration, wrote the value of the equity down to zero, and then

resold the IPB as a going concern to the CSOB. This solution made it possible to avoid the disruptive economic effects of closing IPB, while the provision of strong ownership created favorable conditions for finally putting the Czech banking sector on a sounder footing.

9. The banking sector problems were not the economy's only structural weakness. Restructuring the banks without acting to solve the remaining problems in the nonfinancial sector would not have created all the conditions needed for a resumption of rapid growth. Accordingly, the authorities are also addressing the problems of several large enterprises, some of them still state-owned, through financial and operational restructuring, and will then sell them to private investors. The goal is not to prop up inefficient companies that cannot survive competition, but to restructure their debt burdens, streamline their operations, and make them durably viable under market conditions. The entire restructuring operation is being guided by economic considerations and protected from political pressure.

Fiscal Policy

10. The problems of the banking sector were not without effect on the public finances. Fortunately, the low public debt and relatively prudent fiscal policies that marked the transition's early years had provided a cushion sufficient to absorb the costs of restructuring the banking sector without serious risk of financial destabilization.

11. Nonetheless, our authorities agree with the staff that there are still structural problems in the fiscal area which it is urgent to resolve to keep the public debt from swelling to levels that threaten financial stability. The staff correctly notes that not much real progress has been made in addressing the underlying fiscal problems. But this does not mean the authorities are doing nothing. First, they are in the process of improving fiscal transparency and accountability and will impose new budgetary rules in 2001. They are aware of the staff's concern that the creation of two new extrabudgetary funds seems to undermine this effort, but they intend these funds as temporary vehicles to prevent the use of one-time privatization receipts to finance recurrent consumption expenditures by directing them instead to investment projects with high social value.

12. An even stronger motivation is the great urgency felt across the entire political spectrum for ensuring the Czech Republic's early membership in the European Union. The prospect of EU membership imposes a powerful discipline on all phases of economic policy, and especially on fiscal policy. And although the current political constellation may not be the best environment for making important decisions about fundamentally reforming of the social security system, both our authorities and the Czech public are acutely aware that the present system is unsustainable and that it will require a thorough overhaul to ensure its long-term viability.

Monetary Policy and Central Bank Autonomy

13. The rapid weakening of growth and the later, repeated undershootings of the Czech National Bank's (CNB) inflation target has provoked a lively debate about whether monetary

policy in 1998 and 1999 was or was not too tight. With the benefit of hindsight the staff notes that the monetary easing was too slow. This may be true, but as the staff already explained in detail during last year's Board discussion, if there was a need to relax monetary policy faster and more decisively, it was certainly not obvious *ex ante*. An important question, which arises as a result of lower than targeted inflation, is whether to lock in the unexpected disinflation gain. The CNB has opted to do so because it thinks that locking in lower inflation is still compatible with a monetary policy stance that is supportive to economic recovery. This means that the end-2000 inflation target will likely be somewhat undershot, but as far as monetary policy in concerned the end of 2000 is already past. The CNB is now focusing on 2001, and has announced a 2-4 percent net inflation target for that year to confirm that low inflation is here to stay. And to further enhance the credibility of its own commitment to low inflation, the government has publicly endorsed this inflation target.

14. Strengthening signs of economic recovery, together with a noticeable pick-up in both headline and core inflation, has persuaded the CNB to refrain from further cuts in interest rates. They consider current interest rates to be adequately supportive of recovery. The CNB also agrees with the staff that the recent acceleration of inflation is mainly due to external factors and that domestic inflation pressures remain low. At the same time, however, the authorities have expressed some concern about the recent strength of the koruna. But the rapid recovery of demand in Western Europe, productivity-enhancing restructurings, and strong FDI inflows indicate that some appreciation will not necessarily lead to undue loss of competitiveness. Looking into the future, the projected large inflows of FDI suggest that the upward pressure on the koruna is likely to continue for some time. The authorities are monitoring exchange rate developments closely, and are ready to take any measures needed to prevent excessive appreciation from undermining the nascent recovery.

15. The lively public debate on monetary policy was accompanied by an equally lively discussion of the desirable degree of CNB autonomy and accountability. Partly to bring the CNB Law into line with EU norms, and partly to correct an alleged absence of accountability, Parliament recently amended the CNB Law. Some of the originally proposed changes did not survive the final reading, but the amendment still introduces some significant modifications. While not directly attacking the CNB's independence in conducting monetary policy, this amendment could provide an opening for exerting political pressures on the CNB. The amendment still has to be approved by Senate before it can become effective.