August 2004
IMF Country Report No. 04/266

Czech Republic: 2004 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Czech Republic

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2004 Article IV consultation with the Czech Republic, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 25, 2004, 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 22, 2004. 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 August 6, 2004 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its August 6, 2004 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for the Czech Republic.

The documents listed below have been or will be separately released.

Selected Issues Paper
Report on the Observance of Standards and Codes—Fiscal Transparency Module—Update

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

CZECH REPUBLIC

Staff Report for the 2004 Article IV Consultation

Prepared by Staff Representatives for the
2004 Consultation with the Czech Republic

Approved by Susan Schadler and G. Russell Kincaid

July 22, 2004

The 2004 Article IV consultation discussions were held in Prague during May 12–25. The team, headed by Mr. Fernández-Ansola, included Mmes. Krajnyák and van Elkan, and Mr. Sommer (all EUR). Mr. Kiekens (Executive Director) and Mr. Jonas (Advisor to the Executive Director) attended several meetings. The mission met with Governor Tuma of the Czech National Bank (CNB); Minister of Finance Sobotka; other senior officials; and representatives of trade unions, financial institutions, and foreign investors.

The Czech Republic acceded to the European Union (EU) on May 1, 2004. The three-party governing coalition—dominated by the center-left Social Democrats (CSSD)—that came to power in mid-2002 collapsed in June 2004 following a weak showing in the recent European Parliament elections. The next regularly scheduled general election is due in mid-2006. The authorities have announced their intention to adopt the euro in 2009–10.

In concluding the last Article IV consultation on August 22, 2003, Directors commended the economy's solid performance and welcomed plans to correct the regrettable deterioration of public finances in the past few years. Directors welcomed the proactive interest rate cuts since early 2002, which had contributed to halting and then reversing much of the koruna's appreciation. The Czech authorities have responded to some of the policy challenges identified in past Article IV consultations (notably the formulation of a fiscal adjustment plan), but political will to tackle some of the more contentious issues has been lacking.

The mission conducted an update of the Report on the Observance of Standards and Codes (ROSC) module on fiscal transparency. The Czech Republic meets the Special Data Dissemination Standard (SDDS) specifications. Data in this report reflect information available on July 21, 2004.

The Czech Republic's economic data are adequate for surveillance.

The Czech Republic has accepted the obligations of Article VIII, and maintains no restrictions on current transactions.

The authorities released the mission's concluding statement and have expressed their intention to publish the staff report.

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Executive Summary

Background. Growth rebounded to 3.1 percent in 2003, fueled by strong consumption and investment. Inflation has risen gradually after recovering in late 2003 from negative levels, but remains in the lower half of the target range. Unemployment—particularly long-term unemployment—has risen and stands at about 8 percent. Although the trade balance improved, the current account deficit widened marginally to 6¼ percent of GDP primarily due to a secular decrease in the services surplus. Against these mostly favorable developments, the fiscal deficit continued to drift in 2003 and widens further in 2004.

Outlook. Growth is projected to firm modestly in 2004–05, led by rising exports and related investment. Temporary factors should push up inflation to 4 percent (near the top of the CNB's target range) by year's end, before dropping toward the midpoint of the band during the first half of 2005. Thereafter, strengthening demand will lead to rising inflation. The current account deficit should narrow to 5–6 percent of GDP.

Policy Issues and Discussions: Authorities and staff broadly agreed on both the issues and the requisite policies, albeit with nuances on fiscal policy. Namely:

With inflation forecasted to pick up, a tightening cycle has been initiated. As economic growth picks up and the output gap closes, policies will need to be tightened to avoid an increase in underlying inflation. Staff therefore agreed with the CNB's intention to begin to raise interest rates. The ¼ point increase in the repo rate in late June was an appropriate first step, and all agreed that further rate increases should be conditioned on the robustness of growth and exchange rate developments.

Putting a stop to fiscal drift is a priority. Rising deficits and high-risk guarantees will compound fiscal unsustainability brought on by population aging. Staff considers it essential to reverse the widening of the fiscal deficit and implement the 2004–06 fiscal plan. Bringing the deficit close to target in 2004, strictly observing expenditure ceilings, fully identifying measures for 2005–06, and accelerating adjustment to avoid back-loading it to 2006 (a scheduled election year) is key to restoring the plan's credibility. The authorities did not intend additional measures for 2004, but thought that tight budget execution and lower-than-planned spending by extrabudgetary funds would suffice. They saw little scope for accelerating adjustment, but agreed that pension and health reforms were needed for long-term sustainability.

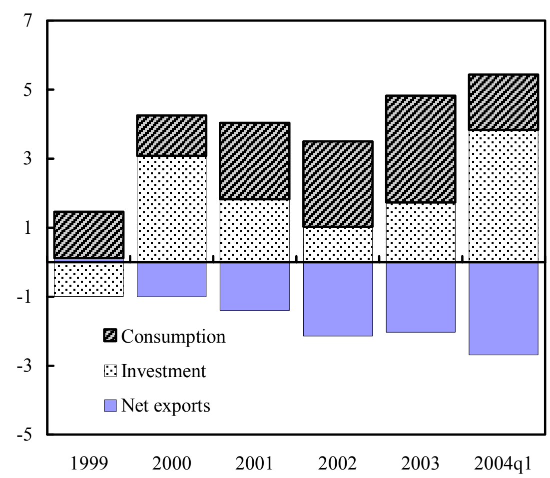
The implementation of a broad structural reform agenda needs to be accelerated. EU accession marks an important milestone for the Czech Republic. But all saw the need to continue and deepen structural reforms to preserve the Czech Republic's position as an attractive destination for FDI and to ensure income convergence. Improving the business-legal environment, keeping the labor market flexible and completing privatization are key, and the authorities were making progress in most areas—albeit at a measured pace.

I. Background

1. **EU accession marks an important milestone for the Czech Republic, allowing attention to shift to the challenges of completing integration with Europe**. Economic performance was solid in recent years, with moderate growth, low inflation, moderate public and external debt, and one of the highest per capita incomes among the new EU members (63 percent of the EU-15 average on a PPP basis). However, problems cloud the outlook: growth remains sluggish—particularly compared with the other central European countries (CECs)—despite relatively high investment (Box 1); government deficits continue to drift upward, led by rising expenditures; adverse demographic trends portend unsustainable pressures on the budget through higher pension and health spending; and long-term unemployment continues to rise and risks becoming entrenched. These trends are shared with many advanced economies. But with its lower per capita income, the Czech Republic cannot afford to delay remedial measures. The authorities' intention to adopt the euro around 2009–10 provides a benchmark against which to judge efforts to meet these challenges.

2. **Rising growth, low inflation, and a narrowing trade deficit characterized recent performance (Table 1 and Figures 1 and 2)**.

Contributions to GDP Growth



Sources: CSO; and IMF staff calculations.

- **GDP expanded by 3.1 percent in 2003 and the first quarter of 2004**. Underpinning the increase in growth—an acceleration from an annual average of less than 2 percent in 1998–2002—was a strong pickup in household consumption reflecting rapid real wage growth (due to unexpectedly low inflation) and robust consumer credit expansion. Investment was also strong in 2003—driven by spending on public infrastructure—and swelled in early 2004 due to one-off influences on private investment associated with EU accession.[1] Rapid investment growth spilled over into imports, leading to a deterioration in the external sector's contribution to growth and the current account balance in early 2004 relative to a year earlier.

[1] The acceleration in investment in early 2004 was due to: (i) a surge in nonhousing construction in advance of a jump in indirect taxes in May; and (ii) stockpiling of imported goods prior to EU accession to avoid possible delays at the border from the switch to a new customs regime and a last opportunity to take advantage of lower tariffs on some non-EU imports.

Box 1. The Czech Growth-Investment Puzzle

The Czech Republic's GDP growth rate lagged the other CECs by about 2 percentage points during 1995–2003. At the same time, the fixed investment-GDP ratio averaged about 4 percentage points higher. This implies that the growth payoff from investment (marginal efficiency of investment) is considerably lower in the Czech Republic than in other CECs (see table).

Relative Marginal Efficiency of Investment
1998-2003 1/ 2/
(In percent)

Czech Republic	77
Hungary	188
Poland	138
Slovenia	171
Slovak Republic	108

Sources: Eurostat; and IMF staff calculations.

1/ Annual growth in real GDP during 1998-2003 divided by average gross-fixed capital formation during 1993-98.
2/ Relative to EU-15.

Several explanations may help to account for the Czech Republic's comparatively weak growth performance: (i) a smaller drop in output at the beginning of transition and a correspondingly shallower subsequent recovery; (ii) a relatively poor business-legal environment; (iii) steeper real appreciation; and (iv) stagnant bank lending to domestic firms since the late 1990s. However, these factors would explain slow growth through lower—not higher—investment.

Explanations for the growth-investment "puzzle" must therefore lie elsewhere. Possibilities include:

- With industry's share in GDP early in transition the highest among the CECs, the production and physical capital structure inherited at the beginning of transition was likely heavily misallocated into nonviable sectors in the Czech Republic. Lax bank lending through the mid-late 1990s—brought about by the delayed restructuring and privatization of the banking sector—probably reinforced this initial structure. Low value added from the unrestructured sectors were a drag on growth; and with a still-incomplete restructuring in some sectors and a high share of industry, this effect may continue.

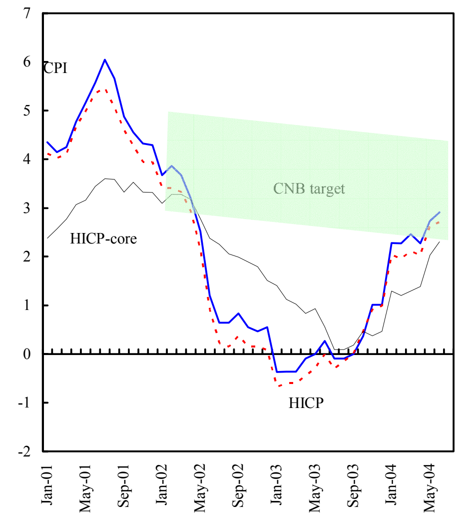
- The higher share of industry suggests that the Czech capital stock was relatively large compared with more agrarian or service-based economies in the region. Replacement of depreciated capital to maintain the net capital stock would therefore absorb a larger amount of investment, but with little net increase in productive capacity.

- Gross fixed investment by the public sector has been relatively high (some 4½ percent of GDP). A significant part (1−2 percent of GDP per year) has been devoted to the environment and does not directly contribute to growth potential. Installation of new electricity-generating capacity has absorbed about 8 percent of GDP, but the plant operates infrequently.

- FDI-financed fixed investment in new machinery has in recent years been associated with high-tech activities, but the domestic component has tended to be of a low value-added, assembly-type nature.

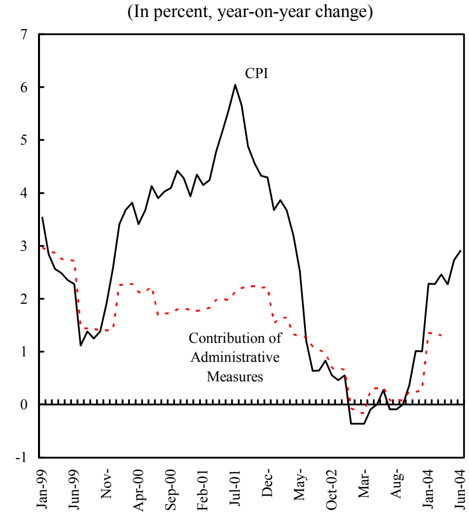
- Measurement issues associated with foreign firms may, in view of the large volume of FDI, play a role. Internal pricing practices of multinationals could understate value added from Czech sources through realization of profits at the point of final sale. Moreover, it may be difficult for multinationals to define value added from support services provided in the Czech Republic in connection with a final product (e.g., logistical services and call centers).

Inflation Developments
(In percent, year-on-year change)



Sources: Czech National Bank; Czech Statistical Office; and Eurostat.

Headline CPI and Contributions of Regulated Prices and Indirect Tax Changes to Inflation
(In percent, year-on-year change)



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

- **Despite solid growth, unemployment—particularly long-term unemployment—has risen and stands at about 8 percent** (Figure 1). While some unemployment is likely to be cyclical and may help contain wage pressures, the sustained increase may signal emerging structural problems.

- **Inflation has risen gradually after recovering in late 2003 from negative levels**. Intense competition in the retail sector (due to growing penetration by large foreign retailers) combined with an earlier appreciation of the koruna generated price declines in most consumption categories during the first half of 2003. But rising consumer demand and more recent depreciation of the koruna brought a small upturn in inflation late in the year. Indirect tax increases in January and May 2004—driven in part by EU harmonization—pushed headline inflation above the bottom of the target band beginning early in the year. However, excluding the effects of administrative measures, underlying inflation has risen only modestly, and remains below the target band.

- **Competitiveness has been improving**. Falling unit labor costs in manufacturing, koruna depreciation, and recovering export prices suggest increases in profit margins and strengthened competitiveness in the manufacturing sector (Figure 2). As a result, the Czech Republic made further inroads into EU-15 markets in 2003—though by less than some other CECs.

- **Notwithstanding a narrowing trade deficit, the current account deficit widened marginally to 6¼ percent of GDP in 2003**. Healthy export volume growth and favorable terms of trade narrowed the trade deficit relative to GDP. But a secular decrease in the services surplus and a one-off drop in current transfers contributed to a widening of the current account deficit in 2003. Reflecting the large stock of FDI and its high profitability, dividends and reinvested earnings accounted for nearly two-thirds of the current account deficit. But with privatization slowing and one-off FDI outflows on account of a change in ownership structure at two large foreign-owned companies, non-FDI flows were the major source of financing for the current account deficit in 2003 (Table 2). However, FDI recovered in early 2004.

3. **With inflation picking up, the CNB has recently raised interest rates to prevent a further decline in real interest rates**. Inflation and inflation expectations fell to very low levels in 2003, and the inflation targeting (IT) CNB cut interest rates sharply through August 2003. This action helped elicit a modest nominal depreciation of the koruna and together resulted in a significant relaxation of monetary conditions (Figure 3). Unchanged policy interest rates combined with the gradual increase in inflation further eased monetary conditions in the first half of 2004. Subsequent to the discussions, the CNB raised the repo rate—which had previously tracked the ECB rate—by ¼ percentage point to 2¼ percent in late June 2004. The CNB has announced that its post-2005 IT framework will shift to a 3 percent point target with a tolerance band of ±1 percent, thereby ensuring continuity with the existing end-2005 target (2–4 percent).

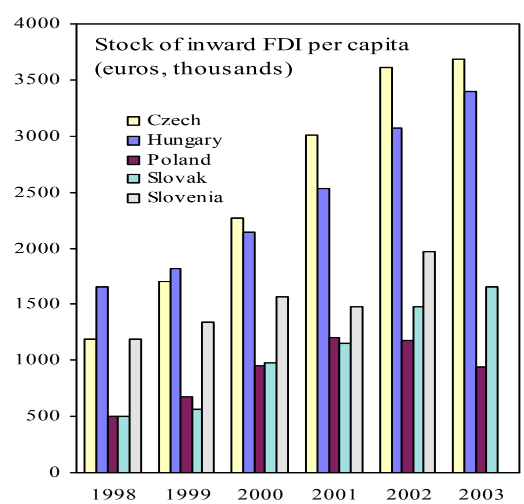
4. **Indicators of banking sector health continue to improve and bank lending to households is dynamic**. The cleanup and privatization of banks (some 95 percent of assets are foreign owned) in the late 1990s reduced nonperforming loans, injected new capital, and raised profitability, but for several years banks remained cautious about lending (text table and Figure 3). However with the retail credit market largely untapped and the perceived lower credit risk of households, banks introduced new mortgage and consumer loan facilities. These new credit instruments combined with low interest rates caused bank lending to households to expand at an annual rate of more than 30 percent during the past two years, while lending to corporates remains stagnant.

Indicators of Banking Sector Size and Soundness, 2001-04

	2001	2002	2003	2004 March
Number of banks	38	37	35	35
Of which: foreign controlled	26	26	26	26
Banking sector assets (in percent of GDP)	106.9	102.8	99.8	109.3
Bank credit outstanding (in percent of GDP)	41.4	38.6	40.4	38.1
Capital adequacy (in percent)	15.4	14.34	14.48	15.17
Classified credits (in percent of total credits)	20.8	15.8	11.2	11.2
Nonperforming loans (in percent of total loan	13.4	8.1	4.9	4.8
Profit from banking activities (in percent of average assets)	3.8	3.7	3.6	3.7

Sources: CNB; and IMF staff calculations.

5. **Foreign investment has made an impressive contribution to the Czech economy**. Among CECs, the Czech Republic has attracted the largest amount of FDI on a per capita basis. Some 20 percent of the FDI stock represented privatization (mostly of banks and network utilities), with the remainder aimed at greenfield and brownfield activities. About half of cumulative FDI has been channeled into services (mainly banking, retailing, transport, and communication), and the rest into industry. Foreign-owned firms account for more than one-third of industrial employment, nearly half of industrial output and value added, and over 70 percent of industrial exports. Foreign industrial firms are also considerably more profitable than



Sources: National Central Banks; and WEO.

their domestic counterparts, with an annual return on equity of about 20 percent (compared with 8½ percent for domestic firms).

6. **In contrast to the favorable conjunctural developments, the fiscal deficit continued to drift in 2003.** The general government deficit—excluding privatization receipts and transfers to the Czech Consolidation Agency (CKA) to cover the costs of managing bad assets—increased in most of the past five years to reach 5 percent of GDP in 2003 (Table 3).[2] Deficit increases occurred in years of both weak and strong economic growth, came despite a significant increase in revenue as a share of GDP, and therefore cannot be explained away as a cyclical phenomenon. That the problem is of a structural nature is also illustrated by the gradual upward creep of government expenditure. The expenditure drift is partly explained by high and rising entitlements, but during 2001–03 expenditures in most other categories also rose. In 2003, in particular, there was higher spending on subsidies, net lending, and investment.

Recent Fiscal Developments, 2001-03 1/

	2001	2002	2003	2001-03 Change
Revenues 2/	36.7	37.5	38.9	2.3
Expenditures, total 3/	41.7	44.2	45.1	3.5
Adjusted expenditures 4/	39.5	41.6	43.9	4.4
Goods and services	7.9	8.6	8.1	0.2
Interest	0.9	0.7	0.8	-0.1
Subsidies 4/	6.8	7.3	8.6	1.7
Of which : to semibudgetary organizations	2.3	2.4	2.7	0.4
Transfers 5/	18.9	19.4	19.9	1.0
Capital expenditure	4.8	5.3	5.5	0.6
Net lending 3/	0.1	0.3	1.0	0.9
Adjusted deficit	-2.8	-4.0	-4.9	-2.2
Memorandum item:				
Transfers to transformation institutions	2.2	2.7	1.2	
General government deficit, ESA95 basis	-6.5	-6.5	-12.9	

1/ In percent of GDP.
2/ Excluding privatization receipts.
3/ Excluding receipts from privatization by the NPF, CLL, and local governments and the sale of Russian debt.
4/ Adjusted for transfers to transformation institutions to cover the costs of managing bad assets.
5/ In 2003, includes one-off transfers abroad of 0.4 percent of GDP.

7. **Fiscal policy drift has now been compounded by political uncertainty**. Public support for the coalition government gradually eroded, in part due to the unpopularity of their medium-term fiscal plan with the electorate (¶19). Following a poor showing of his party in the June European Parliament elections, Prime Minister Spidla resigned, and the President asked Interior Minister Gross to form a new government. Prospects for implementing the previous government's fiscal reform plans are uncertain.

II. Report on the Discussions

8. **Discussions focused on policies to entrench macroeconomic stability and accelerate income convergence, while minimizing fiscal and financial sector risks**. On the fiscal side, strengthening the credibility of fiscal policy plans was the main issue. For

[2] On an ESA95 basis, the inclusion of some high-risk guarantees pushed the 2003 deficit to nearly 13 percent of GDP. The difference mostly reflects accounting for a large guarantee extended earlier, part of which was called. Staff continues to use the cash-based concept when discussing fiscal policy as the calling of guarantees does not affect conjunctural aggregate demand or the fiscal stance, and ESA-based fiscal reporting remains much less timely and frequent than cash-based reporting.

monetary policy, keeping inflation close to the middle of the target range in the face of several one-off influences and the diminishing slack in the economy was seen as the main challenge, while discussions about longer–term issues centered on how to improve the business-legal system, enhance financial sector supervision, and make labor markets more responsive to the changing needs of the economy.

9. **The authorities believed that a gradual strengthening of activity provided an appropriate setting for fiscal adjustment envisaged under the 2004–06 plan**. They considered that meeting the 2004–05 targets was within reach, owing in part to up-front tax measures. Staff cautioned on the vulnerability to policy slippages—particularly giving in to wage and pension demands—and noted that expenditure adjustment envisaged under the plan is back-loaded to a scheduled election year, and requires large spending cuts which would need to be fully identified soon. On monetary policy, staff supported the central bank's intention to enter a tightening cycle, the first step of which has already been taken.

10. **To maintain the edge the Czech Republic has had so far in attracting FDI, the authorities recognized the need for structural reforms**. Therefore they intend to continue improving the efficiency and predictability of the business-legal environment, as well as enhancing labor market flexibility. Further reducing state involvement in the enterprise sector, including by restarting privatization, were seen as important by all for improving resource allocation and for shoring up the fiscal accounts.

A. Economic Outlook

11. **Growth is expected to firm modestly in 2004–05, led by rising exports and related activities** (Table 4). Staff and the authorities agreed that demand would likely shift from household consumption (due to slower growth of real incomes) toward exports and export-related investment on account to stronger global demand and improved external competitiveness. The CNB 's *April 2004 Inflation Report* projected growth in 2004 under the baseline scenario at about 4 percent. However, CNB Board members considered risks to the Inflation Report's growth forecast to be weighted on the downside on account of a somewhat stronger koruna than assumed in the baseline. Staff also projects a more modest 3¼ percent growth rate owing to a faster expected deceleration of consumer demand. For 2005, staff expects the pace of expansion to increase further to about 3½ percent on the back of stronger growth of EU demand. An improving trade balance is expected to contribute to narrowing the current account deficit in 2004–05. Slack in the economy is projected to decrease but fiscal and monetary policy actions should help contain demand pressures. The moderate increase in growth is not expected to yield significant employment gains in the short term as firms continue to focus on improving productivity, and industrial restructuring at remaining state enterprises continues.

12. **Downside risks to near-term growth dominate**. The growth forecast relies heavily on the timing and pace of recovery in EU demand. Should the expected recovery be undermined by continued reluctance of EU households to step up their spending or by renewed euro appreciation against the U.S. dollar emanating from global current account imbalances, Czech growth would be weaker in 2004–05. Moreover, faster improvements in

external competitiveness elsewhere in the region could limit Czech gains in market share. Protracted uncertainty regarding the course of fiscal policy could also slow growth. On the upside, however, bank lending to households remains strong and could moderate the decline in consumer spending growth, and EU recovery may prove to be more dynamic than currently projected.

13. **FDI inflows, especially in skill-intensive activities, will be pivotal to achieving faster long-term growth while containing the buildup in external debt.** Continuing to draw in FDI—albeit at lower levels than previously—and moving both domestic and foreign firms up the technology ladder is the most likely conduit for accelerating total factor productivity (TFP) improvements and maintaining strong capital accumulation. Already a number of technology leaders (including Accenture, IBM, Sun Microsystems, DHL, Honeywell, Olympus, and Dell) have established or committed to operations in the Czech Republic. If TFP were to grow at rates similar to those in the EU-15 catching-up countries (Greece, Ireland, Portugal, and Spain) in the second half of the 1990s, and labor and capital inputs were to rise at rates broadly similar to those recently observed, Czech potential growth would increase to 3¾ percent. Domestic and foreign investment in high-tech machinery would be the impetus to faster TFP growth, and would raise the growth payoff to investment. A sizable fiscal consolidation would help accommodate stronger fixed investment while permitting some narrowing of the current account deficit—and hence the need for foreign saving.

Decomposition of Growth, 1995-2009 1/

	Actual	Potential	
	1995-2003	2004-05	2006-09
GDP growth	2.1	3.1	3.6
Labor	-0.4	0.0	0.1
Capital 2/	1.2	1.5	1.4
TFP	1.4	1.6	2.1

1/ Decomposition is based on spliced GDP and investment data, as these are only available for 2000-03 on the new methodology.
2/ Capital stock data are not available.
The calculations assume a capital-output ratio of 4 and a 35 percent depreciation in 1994.
In the following years, the rate of depreciation is assumed to remain constant at 5.5 percent.

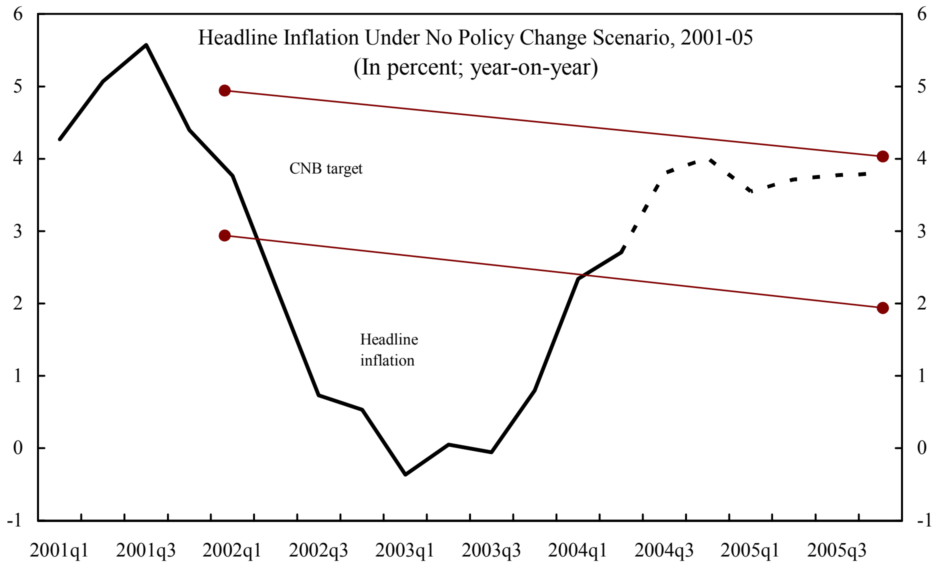
B. Monetary Policy

14. **Expecting temporary factors to drive a rapid rebound in inflation during 2004–mid-2005 while underlying price pressures remained subdued, the CNB decided to keep interest rates on hold through mid-2004.** The authorities and staff agreed that strong retail-sector competition and unused economic capacity would limit the first-round inflationary effect of changes in indirect taxes, regulated prices, and EU-related import duties to about 1½ percentage points in 2004 and early 2005. Owing to low inflation expectations, the CNB saw little risk of significant second-round effects. Staff concurred, and added that a soft labor market could also moderate demands for real wage catch-up. However, staff saw additional sources of pent-up inflationary pressure in previous koruna depreciation, faster growth in wages relative to productivity in the nontraded sector, and rising world prices of oil and raw materials. Staff projections indicate that the realization of these price pressures later this year, combined with the effects of the administrative measures, would temporarily push up inflation to 4 percent (near the top of the CNB's target band) by year's end, before dropping during the first half of 2005 (Box 2). The authorities felt that the prevailing negative output gap would dampen somewhat the inflationary effect of these factors, but agreed that with the gradual closing of the output gap, inflation would begin to pick up again in the second half of 2005.

Box 2. Short-Term Inflation Outlook

Staff estimated a model of Czech inflation that relates consumer prices to exchange rates, commodity prices, productivity-adjusted wages, and economic activity.[1] The model also takes into account the impact of regulated prices and indirect tax changes on inflation.

The forecast of the model under the no policy change scenario, which includes the latest WEO oil-price projections and assumes constant nominal interest rates, sees year-on-year inflation peaking at around 4 percent in late 2004. Inflation is then expected to moderate as the impact of administrative price and indirect tax changes dissipates. Declining slack in the economy, together with growth in wages and commodity prices, will however exert upward pressure on inflation beginning in mid-2005. If monetary conditions are not tightened, year-on-year inflation is projected to lie well above the CNB's point target in 2006.



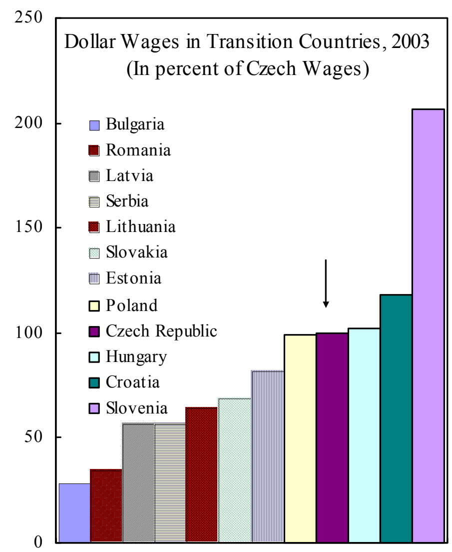
Sources: Czech Statistical Office; and IMF staff calculations.

[1] A background paper discusses the model in more detail.

15. **The authorities thought that current loose monetary conditions and a gradual closing of the output gap called for a measured policy tightening to keep inflation on target over the medium term**. In view of the expected closing of the output gap over the coming year and growing demand-pull inflation pressures, the CNB foresaw the need to initiate a tightening cycle to gradually return real interest rates to levels significantly above zero, with the size and timing of interest rate increases conditioned on exchange rate developments and the robustness of growth. Staff agreed that, with growth expected to rise gradually, monetary conditions were probably too loose to support the inflation target over the next one–two years. Indeed, even after the ¼ percent increase in late June, policy interest

rates remain near historical lows while the depreciation of the koruna also contributes to easier monetary conditions. But staff cautioned that the speed at which the output gap closes would depend on additions to productive capacity, which may have been substantial with the near completion of several large manufacturing investments. A rising pace of potential growth would therefore moderate the size of needed future interest rate increases. Staff also cautioned that the exchange rate—while a key determinant of growth and inflation—had recently been quite volatile and the pace of equilibrium real appreciation uncertain. This suggested that less emphasis be given to short-term exchange rate movements in decision making.

16. **Notwithstanding a modest reopening of the euro-area interest rate gap, the CNB expected exchange rate pressures to remain relatively balanced**. The CNB considered that its ongoing agreement to convert government foreign currency receipts off market and completion of the large initial wave of nonprivatization FDI—while associated dividend outflows were continuing—would help contain the risk of future excessive appreciations. They emphasized that their recent decision to begin selling interest on reserves to limit further accumulation of reserves, although implying an appreciation bias, was not intended to influence the level of the exchange rate.[3] The CNB viewed competitiveness as adequate, pointing to the rise in export growth and the improving trade balance. The staff, however, cautioned that Czech unit labor costs (ULCs)—although declining in recent years—had continued to run ahead of ULCs in several other new EU members, and Czech wages were considerably higher than those of second wave enlargement and other emerging-market countries (Figure 2 and text chart). The authorities expected competitiveness in low-productivity, labor-intensive activities to erode with time, as these activities were gradually supplanted by higher productivity ones. They felt that some slowdown in FDI was to be anticipated even with strong competitiveness, owing to the low capital intensity of higher-tech R&D and strategic services that were expected to comprise the next wave of FDI.



Source: IMF staff estimates.

[3] The CNB sold its first installment of interest on reserves in April 2004 in the amount of US$42 million. On reserves of more than US$26 billion—which provide a high level of coverage of short-term debt and base money (Table 5)—the CNB earned some US$725 million in interest in 2003. Sales will be capped by the volume of current interest income, but to avoid movements in the exchange rate, actual sales may be smaller.

17. **The post-2005 inflation targeting framework provides continuity and a sound anchor for monetary policy during the pre-euro period**. The CNB considered the medium-term inflation target of 3 percent as balancing the goals of inflation convergence and trend productivity catch-up. To capitalize on its acquired credibility, and to avoid a potentially disruptive regime shift, the CNB intends to target inflation through ERM2. CNB officials noted that no regime could resolve the inherent over-determinacy of the Maastricht inflation and exchange rate-stability criteria, and considered it wasteful of reserves to attempt to stabilize the koruna in the event of fluctuations unrelated to fundamentals. Staff supported this pragmatic approach to monetary policy during ERM2, and agreed that the chances of meeting simultaneously the inflation and exchange rate-stability criteria would be enhanced by realizing strong preconditions for ERM2—including credibly reducing the fiscal deficit, improving wage and price flexibility, and strengthening financial sector supervision to reduce risks of financial instability.

C. Fiscal Policy

18. **The consequences of fiscal drift have so far remained manageable but the tolerance margin for policy inaction is steadily shrinking**. Public debt is still moderate (28 percent of GDP) and its financing costs low.[4] However, debt will increase rapidly if significant deficits continue, especially as privatization revenues will soon run out (¶30). It may also jump suddenly if a large amount of guarantees (their total nominal stock is about 20 percent of GDP)[5] were to be called—in fact, public debt is already substantially higher on an ESA95 basis, mostly due to accounting for a large guarantee extended earlier that was partially called. These effects would be compounded by a rapidly aging population, which will sharply increase demands on the public purse. Large financing needs could ratchet up interest rates and crowd out private sector credit. High deficits could also derail plans to adopt the euro over the medium term by moving the Czech Republic farther away from being able to fulfill the Maastricht fiscal criteria. And finally, fiscal inaction would preclude easing the Czech Republic's high tax burden.

19. **The authorities believed that their three-year adjustment plan begins to address these fiscal problems**. The plan aims to achieve a deficit of 4 percent of GDP by 2006 (4.4 percent of GDP on staff's "adjusted deficit" definition that includes nonprivatization net

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[4] The government successfully launched an inaugural euro-denominated bond in June 2004. The € 1.5 billion issue had a spread of 22.5 basis points over a comparable 10-year German bond.

[5] About one-third of the total nominal stock of guarantees (without guarantees for the liabilities to CKA, which are included in public debt) is considered very low risk.

lending; text table), underpinned by annual expenditure ceilings and a rolling three-year fiscal framework.[6] This plan is broadly consistent with the Czech Republic's 2004 Convergence Programme.[7] It combines up-front indirect tax increases with gradual expenditure reductions—focused on public sector wages, discretionary spending, and social expenditures. Despite several tax changes (mostly tax relief) not included in the budget (Box 3), measures so far in 2004 are broadly in line with the plan, but staff noted that post-budget spending decisions breach the expenditure ceiling (¶20). It is unclear whether a new government would follow the fiscal plan.

Deficit Targets of the 2004-06 Adjustment Plan 1/

	2004	2005	2006
Authorities' targeted definition 2/ 3/	5.5	4.8	4.0
Adjusted deficit 2/ 4/	5.8	5.2	4.4
ESA95 deficit 5/	5.3	4.7	3.8

Sources: Ministry of Finance; and IMF staff projections.
1/ In percent of GDP.
2/ Plans formulated based on unrevised GDP.
3/ Excluding privatization receipts, net lending, and transfers to CKA.
4/ Excluding privatization receipts, and transfers to CKA but including nonprivatization net lending.
5/ Based on the Czech Republic's 2004 Convergence Programme, which adjusts the ratios for the effects of GDP revisions.

20. **Staff saw the 2004–06 fiscal plan as a first step in halting—then reversing—the rise in the deficit, but expressed serious concerns regarding implementation**. Under staff's projections—which were slightly more optimistic on growth and revenues than the authorities'—the general government adjusted deficit would widen by over 1 percent of GDP to 6.1 percent of GDP in 2004 (Table 3). Without the help of GDP revisions, it would be even larger, exceeding the target by a significant margin. A drop in nontax revenues played a role in the deficit widening, but loopholes in the coverage and breaches of the expenditure ceilings also contributed. For example, expenditure ceilings exclude subsidies provided by the privatization agency (National Property Fund or NPF) and capital injections through net lending, while some extrabudgetary funds are permitted to exceed their annual expenditure ceiling by the amount of approved spending not undertaken in previous years. In addition, post-budget approval of additional transfers of ⅓ percent of GDP to compensate families and pensioners for the indirect tax hikes appeared to breach the expenditure ceiling.

21. **Staff argued for bolstering the plan's credibility by keeping this year's general government deficit close to its original target and adjusting downward deficit targets relative to GDP in all years to account for the GDP revision**. On current projections, the deficit target would be missed in the first year of the plan. Credibility would require narrowing the headline deficit to meet the original 5.8 percent of GDP target, which becomes

[6] Recent GDP revisions to further harmonize Czech statistics with EU requirements resulted in a 5 percent increase in the level of nominal GDP. This revision lowers the deficit to GDP ratio by about ⅓ percentage point of GDP in 2004–06, but it is yet unclear whether the fiscal targets relative to GDP would be revised downward.

[7] The Convergence Programme's targets relative to GDP have recently been revised, to reflect higher nominal GDP. The Programme envisages reducing the ESA95 deficit to about 3¾ percent of GDP in 2006 and 3¼ percent of GDP by 2007.

5½ percent of GDP after the effect of the GDP revisions (text table). This would call for additional savings of ½ percent of GDP—a cyclically well-timed tightening that should come from reining in expenditures. While the authorities did not plan additional measures, they thought that tight execution of the state budget, and lower-than-planned spending by extrabudgetary funds would make a better-than-projected fiscal outcome likely. Staff also called for adhering to the initial nominal deficit targets for 2005–06, which implies some downward revision of the targets relative to GDP on account of the changes to GDP.

Box 3. Revenue Measures in 2004

The 2004 budget includes:

- EU-mandated increases in excises and shifts of many goods and services (over one-fourth of the consumption basket) from the preferential to the standard VAT category;
- a 3 percentage-point cut in the CIT—the first step in gradually reducing it from 31 to 24 percent.

Subsequent to the budget, several tax measures were legislated or proposed:

- lowering the standard VAT rate from 22 to 19 percent while shifting more goods and services to the standard rate (in effect from May 2004);
- shortening depreciation periods and easing the income tax burden on married couples and families with children with effect from 2005 (with parliament).

The indirect tax changes would raise revenues already in 2004, but revenue reductions from the proposed direct tax amendments would appear only in later years.

Effects of Revenue Measures, 2004-06
(In percent of GDP)

	2004	2005	2006
VAT 1/	1.1	1.5	1.4
Excises 2/	0.5	0.6	0.6
Corporate income taxes	-0.1	-0.3	-0.9
Rate decrease 3/	-0.1	-0.3	-0.5
Shorter depreciation period	0.0	0.0	-0.4
Personal income taxes	0.0	-0.1	-0.2
Total 4/	1.4	1.6	0.9

Sources: Ministry of Finance; and IMF staff estimates.
1/ Net effect of shifting goods and services from the preferential to the standard VAT category; and reducing the standard VAT rate from 22 to 19 percent.
2/ Increases in excises required by EU harmonization.
3/ Phased decline in the corporate income tax rate from 31 to 24 percent.
4/ The increase in the 2004 tax ratio is smaller than the effects of the revenue measures, due mostly to revenue losses from longer collection lags for VAT on imports.

Fiscal Recommendations, 2004-06
(In percent of GDP)

	2003	2004	2005	2006
Adjusted balance based on old GDP 1/	-5.2	-5.8	-5.2	-4.4
Effect of GDP revision 2/	0.3	0.3	0.3	0.2
Adjusted balance 3/	-4.9	-5.5	-4.9	-4.2
Change		-0.6	0.6	0.8
Of which :				
Net impact of EU accession 4/		-1.7	0.1	0.2
Tax measures 5/		1.4	0.1	-0.6
One-offs (net) 6/		-0.7		
Required other adjustment 7/		0.4	0.3	1.2

1/ Corresponds to the deficit path targeted by the authorities' 2004-06 fiscal plan.
2/ Due to methodological changes, nominal GDP increased by about 5 percent.
3/ Path assumes no change in the targeted nominal deficit compared with the plan.
4/ Includes contributions to the EU budget; losses on customs duties and indirect taxes; direct payments and top-off to farmers; and compensation payments. Staff estimates.
5/ Includes the effects of higher excises; a lower standard VAT rate; shifting items from the preferential to the standard VAT rate; reducing the corporate income tax rate; accelerating depreciation for certain assets; and changes to PIT.
6/ One-offs include spending on compensation to a foreign investor in 2003 (+); shifting infrastructure investment spending from 2003 to 2004 (-); and one-off high dividend income in 2003 (-).
7/ Residual to reach the recommended adjusted balance. Measures not yet fully identified.

22. **Reducing the deficit in 2005–06 in line with the plan will require significant additional measures.** The authorities thought that scope for revenue increases had largely been exhausted and further adjustment needed to rely on expenditure reductions. However, the measures underpinning cumulative savings of 1½ percent of GDP in 2005–06 were not yet fully identified. Most of the required expenditure adjustment could be back–loaded to 2006 as only modest savings were needed to meet the 2005 deficit target.[8] The authorities thought these 2005 savings feasible, assuming pressures for increases in wages and pensions were resisted. Delivering the 2006 target appeared more difficult, as it required finding and implementing significant additional savings measures in a scheduled election year. The mission urged the authorities to specify their plans for permanent savings. Identifying the measures early would also make it possible to spread the expenditure cuts more evenly and bring some of the adjustment forward to 2005. Although the authorities agreed that these steps would strengthen the credibility of their deficit reduction plan, and thought that entitlements and social spending had scope for savings, work on systemic reforms was not sufficiently advanced (see below) to allow implementing measures already in 2005.

23. **A stronger fiscal framework could be a useful commitment device to help future policy implementation.** Staff advocated: (i) broadening the coverage of the expenditure ceilings to the widest possible range of spending items and general government units; (ii) strictly adhering to the expenditure targets even when higher revenues would finance a

[8] The back-loading of needed expenditure measures derives from the phased-in reduction in direct taxes that affects the budget in 2006 on a cash basis, but in 2005 on an accrual basis.

spending increase without endangering the deficit target; and (iii) avoiding post-budget spending measures. In response, the authorities explained that although they did not intend to formally broaden the expenditure ceilings, some loopholes would be sealed. Notably, the NPF would be closed by end-2005 and its spending obligations assumed by the state budget, bringing these expenditures under the coverage of the ceiling. The finance minister intended to propose a state budget for 2005 that observed the approved expenditure ceiling, and committed to standing firm against pressures to spend additional revenues.

24. **The authorities recognized that fiscal reforms would need to continue beyond 2006 and that long-term sustainability required pension and health care reform.** Staff recommended targeting a structural deficit of less than 2 percent of GDP by 2008–09. Although by itself this would not be sufficient to deal with long-term fiscal pressures from population aging, it would help keep public debt at a moderate level over the medium term. This target and policy horizon would also support the authorities' euro adoption plans. The authorities intended to continue reducing the deficit beyond 2006, while making room to cofinance EU funds. But they recognized that a restructuring of mandatory expenditures would be necessary to sustainably reduce the deficit. In particular, health care reform could yield near-term payoffs, by reducing excess capacity and raising the financial burden on final users. A reform proposal was expected in the next few months. However, the authorities did not see the urgency regarding pension reform as they expected pension expenditures to remain stable at their current level of about 9 percent of GDP for the next 10–15 years owing to recent measures (including a gradual increase in the statutory retirement age to 63 years and tighter conditions for early retirement). But they agreed that with a projected 6 percentage point increase in pension spending relative to GDP by 2050, long-term sustainability required pension reform, and an expert group was expected to set out the main options by early 2005. Staff argued that the long lags from reforms to their impact on public spending necessitated early action. In addition, there was a risk that labor force participation by older workers may not increase as strongly as envisaged and pension spending would start rising sooner and more steeply than projected, eroding the results of previous fiscal adjustment.

D. Financial Sector Issues

25. **With dynamic growth in bank lending to households, the authorities acknowledged the need for building capacity to monitor new sources of risk**. The authorities recognized the importance of broadening the focus of supervision to systemic sources of risk. However, they considered vulnerabilities from lending to households to be limited owing to banks' fairly low exposure to households (9 percent of assets), low average household indebtedness (18 percent of disposable income), and small share of classified household loans (3 percent of mortgage loans and about 10 percent of consumer loans). Staff countered that bank loans could be highly concentrated, and low average debt burdens and loan carrying costs could conceal pockets of high indebtedness and financial distress. Moreover, while the pace of consumer lending had recently slowed sharply, mortgages continued to grow very strongly (55 percent) in part due to prevailing low interest rates in fixed-then-variable rate contracts. In the event of higher interest rates, banks would be exposed to dual risks of rising loan defaults and declining collateral prices. To better gauge financial conditions of households and implications for the banking sector, staff

recommended collecting data on household debt concentrations, households' nonbank debt, indicators of debt servicing capacity (including disposable income of indebted households), and prices of housing transactions. Staff welcomed progress in developing a stress-testing framework to assess macroeconomic and financial linkages, but urged the authorities to consider credit risk scenarios where the impact of adverse macroeconomic shocks on household loan quality could differ from that on corporate loans.

26. **The planned reorganization of financial supervision should aim to promote a more comprehensive oversight of the sector in the medium term**. To enhance supervision of financial conglomerates, the authorities intend to establish a unified financial market supervisor by 2010. The first stage—to be completed by end-2005—will shift supervision of credit unions to the CNB, and responsibility for insurance and pension funds will move to the Securities and Exchange Commission. Subsequently, a single supervisor will be created, either within the CNB or as a separate public entity. The CNB is also reorganizing its banking oversight functions, and setting up a unit devoted to macrofinancial issues, with responsibility for preparing financial stability reports. Staff welcomed these initiatives as promoting better information flows, but cautioned that organizational changes should not distract from effective oversight. The authorities acknowledged this risk, which had prompted their decision to proceed gradually with the merger of supervisors.

E. Structural Issues

27. **To minimize risks of resource misallocation, staff called for accelerating privatization and reducing state support to public companies and semi-budgetary organizations**. The authorities reported that privatization had been restarted, with the recent sale of the petrochemical company (Unipetrol) and initiation of the process for Czech Telecom. However, the electricity company (CEZ) was likely to remain unsold by the time the NPF was closed. The authorities confirmed their intention to divest all assets of the Czech Consolidation Agency (CKA) and to terminate its activities by end-2007 in order to limit opportunities for future nontransparent bailouts. They also planned to require, with effect from 2006, parliamentary approval for transfers to CKA of bad assets. To limit future drains on the budget and improve allocative efficiency, staff urged that stabilizing the finances of remaining state enterprises—including the railways—be expedited, with state support granted only in the context of restructuring plans aimed at improving long-term viability.

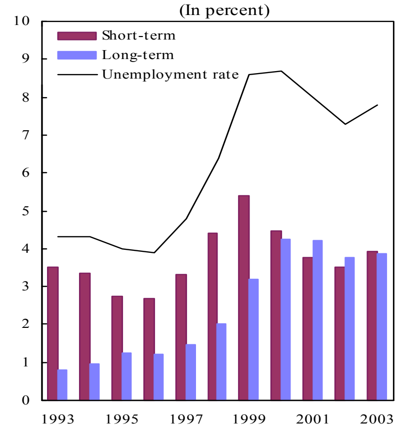
28. **Legal and bureaucratic hurdles risk discouraging future investment by engendering uncertainty and costly delays**. The Czech Republic scores very highly in global surveys as an attractive destination for offshoring, and hosts many large multinational investors.[9] Nonetheless, investor representatives continued to express frustration with the

[9] The A.T. Kearney 2004 Offshore Location Attractiveness Index ranks the Czech Republic fourth in the world (well behind India, but closely trailing China and Malaysia) as a destination for outsourcing based on people skills and availability, business environment, and financial structure. Poland and Hungary rank tenth and eleventh, respectively, in the survey.

business-legal environment, which they considered to fall short of the high standards expected of EU members. In particular, they pointed to weak creditors' rights, excessive discretion of bankruptcy judges, cumbersome and lengthy legal procedures, and unpredictable and time-consuming steps for processing entries into commercial registries. The authorities outlined efforts to enhance the efficiency and predictability of the legal environment, notably progress in drafting comprehensive new legislation on bankruptcy and commercial registers and in preparing standardized forms for expediting entries into the commercial registers. Staff welcomed these steps—crucial for attracting and nurturing small and medium-sized firms and for facilitating bank lending to these firms—but noted the substantial delays until enactment. Staff therefore recommended that, in the interim, amendments to existing legislation proposed by a broad cross-section of parliament, and with support from the business and banking community, be adopted.

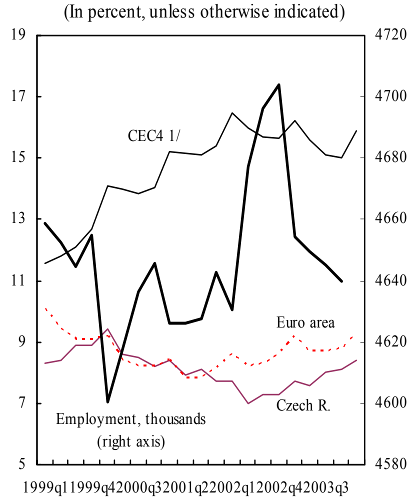
29. **Continuing structural shifts in labor demand, an aging workforce, and a larger role for labor markets in cushioning economic shocks after euro adoption will increase the premium on labor market flexibility.** However, declining employment despite solid GDP growth and significant creation of new jobs in the FDI sector, and rising long-term unemployment with persistent regional differences suggest that labor market flexibility may in fact be eroding.[10] The authorities saw the roots of these trends in inappropriate incentives generated by the benefit system, skill mismatches, and high nonwage labor costs, and have begun to address some of these issues. Tightening unemployment benefit eligibility for school–leavers and plans to reduce benefit withdrawal rates for those leaving unemployment targeted improving work incentives. Staff welcomed these measures but argued for a more comprehensive strategy to create an environment conducive to job-rich growth. In addition to better incentives, avoiding persistent skill-mismatch was also key. The authorities agreed that policies to ensure that school-leavers enter the labor market with sufficient and

Unemployment by Duration
(In percent)



Sources: Czech Statistical Office; Eurostat; and IMF staff calculations.

Employment and Harmonized Unemployment Rate
(In percent, unless otherwise indicated)



Source: Eurostat.
1/ Weighted by PPP-GDP.

[10] A background paper discusses labor market issues in more detail.

marketable skills, and to create adequate possibilities for life-long learning were particularly important and would help preserve the Czech Republic's attractiveness for FDI. Staff noted that other measures—reducing impediments to labor mobility, including through easing rent control, upgrading transport infrastructure, reducing nonwage labor costs, and keeping labor market regulations flexible—could also help.

30. **Stalled structural reforms could prevent a pickup in growth potential and lead to a rapid buildup in public and external debt**. If a less attractive investment climate and reduced FDI inflows cap potential growth at around 2½ percent, risks associated with public and external debt accumulation would increase (Appendix I). On the fiscal side, not only would slower growth make keeping to the planned adjustment path more difficult, it would also complicate bearing the fiscal costs of called guarantees. Moreover, demands for additional bailouts—including of the railways and hospitals—may arise. By pushing up interest rates, wider deficits could further slow growth. In these circumstances, public debt could increase rapidly, to over 50 percent of GDP and its servicing costs could also rise. On the external side, lower FDI would widen the current account deficit through smaller export capacity, notwithstanding a somewhat weaker koruna and slower import growth. Higher external deficits, less nondebt financing and weaker GDP growth would increase the external debt to GDP ratio to some 55 percent of GDP over the medium term.

31. **With EU accession, the Czech Republic adopted the common trade policy**. Bilateral trade agreements were terminated or modified to ensure EU-conformity. Most recent changes occurred in trade relations with third countries, and were expected to be neutral, with relaxation of protection in some sectors (e.g., motor vehicles) and higher tariffs and quantitative restrictions in others, especially for some food items from outside the EU.

III. Staff Appraisal

32. **The performance of the Czech economy has been broadly satisfactory over the past few years and there is reason for optimism on the near-term outlook**. Substantial foreign direct investment has helped raise GDP growth and improve the trade balance. Inflation—after declining sharply in recent years—is expected to stabilize at low levels over the medium term. Public and external debt have so far stayed moderate, and interest rate spreads have been low. Banking sector profitability and capital adequacy are strong, and bank lending has resumed. The upturn in the global economic environment should entrench these favorable developments in the near term.

33. **Although economic fundamentals generally remain strong, continued inaction in key areas could prevent the economy from realizing its full potential.** Looming fiscal unsustainability risks ratcheting up interest rates; structural reforms are needed to maintain the Czech Republic's attractiveness to domestic and foreign investment; and labor markets and the education system should become more flexible. Implementing policies to address these problems would contribute to raising economic growth and furthering income catch-up with new EU partners, and lay the foundation for a successful experience in ERM2 and the euro zone. The Czech Republic's position as one of the most advanced new EU members and

attractions as a platform for FDI may quickly slip if its reforms do not keep pace with those of other countries.

34. **The authorities' multi-year fiscal plan provides a basis for reversing the widening of the deficit, but firm commitment to the spirit as well as the letter of the plan is needed**. The credibility of the plan has been weakened by allowing the general government deficit to expand again in 2004—the first year of the plan. Measures on the spending side are needed to return the deficit to its original nominal target (which implies a small downward adjustment relative to GDP on account of the GDP revision), and the fiscal framework for future years should be strengthened by strictly adhering to the expenditure ceilings and by closing loopholes in their coverage. The government's intention to close the National Property Fund by end-2005 will help in this regard. Deficit targets relative to GDP for 2005–06 should also be revised downward on account of the changes to GDP. Credibility of the plan would also be enhanced by choosing as the targeted fiscal concept the broadest possible and most commonly used measure of the deficit, and by projecting and discussing fiscal performance on this basis. A full shift to standardized European fiscal indicators should be expedited.

35. **To demonstrate commitment to achieving the 2006 deficit target, required expenditure cuts should be identified expeditiously and spread more evenly, resulting in an over-performance of the deficit in 2005.** Yielding to pressures for permanent expenditure increases in 2005 could not only put the 2005 deficit target out of reach, but would add to large required savings in 2006 needed to further reduce the deficit while offsetting the drop–off in tax revenues. The authorities therefore should save any fiscal windfall—whether from higher-than-expected revenues or upward revision of GDP—to reduce the deficit-to-GDP ratio. But this would not eliminate the back-loading of needed expenditure adjustment. To alleviate concerns regarding the feasibility of the 2006 target, shifting forward to 2005 part of the expenditure adjustment is necessary. Nonetheless, the cumulative amount of savings that will need to be found in 2005–06 is substantial; and credible and successful adjustment requires the full and early identification of the necessary measures.

36. **Recognition by the authorities that deficit reduction should continue beyond 2006 is welcome, but reforms of the pension and health systems to sustain the adjustment should be expedited**. A structural deficit below 2 percent of GDP later in the decade is needed to help keep debt moderate and shore up the fiscal position ahead of intensifying budget pressures from population aging. But without pension and health care reforms, population aging will erode the adjustment effort. Significant changes in pension system parameters will be needed, including further raising retirement ages. On health care, greater cost-sharing with final users is required to reduce demand. Long lags from the introduction of these reforms to their impact on public spending warrant early action, and policy measures should be formulated quickly and implemented promptly.

37. **Completing the backlog of structural reforms is crucial for improving the efficiency of resource allocation**. The initial misallocation of capital at the beginning of transition was reinforced through the late 1990s by lax bank lending decisions. This

misallocation is likely to have been a major cause of relatively slow growth during the past decade. Restructuring and privatizing banks and some large state companies has helped ensure that future investment decisions will be made on a market basis. The authorities' intention to reduce the role of the state in the economy by resuming privatization and closing the NPF and CKA will improve the efficiency of resource allocation. Pressures for additional bailouts should be resisted to prevent further increases in public debt and allocation of resources to low value-added uses. In addition, improving the business-legal environment should remain an important priority. Enacting expeditiously a bankruptcy law that enhances creditors' rights and streamlining procedures for entries into commercial registers are long overdue.

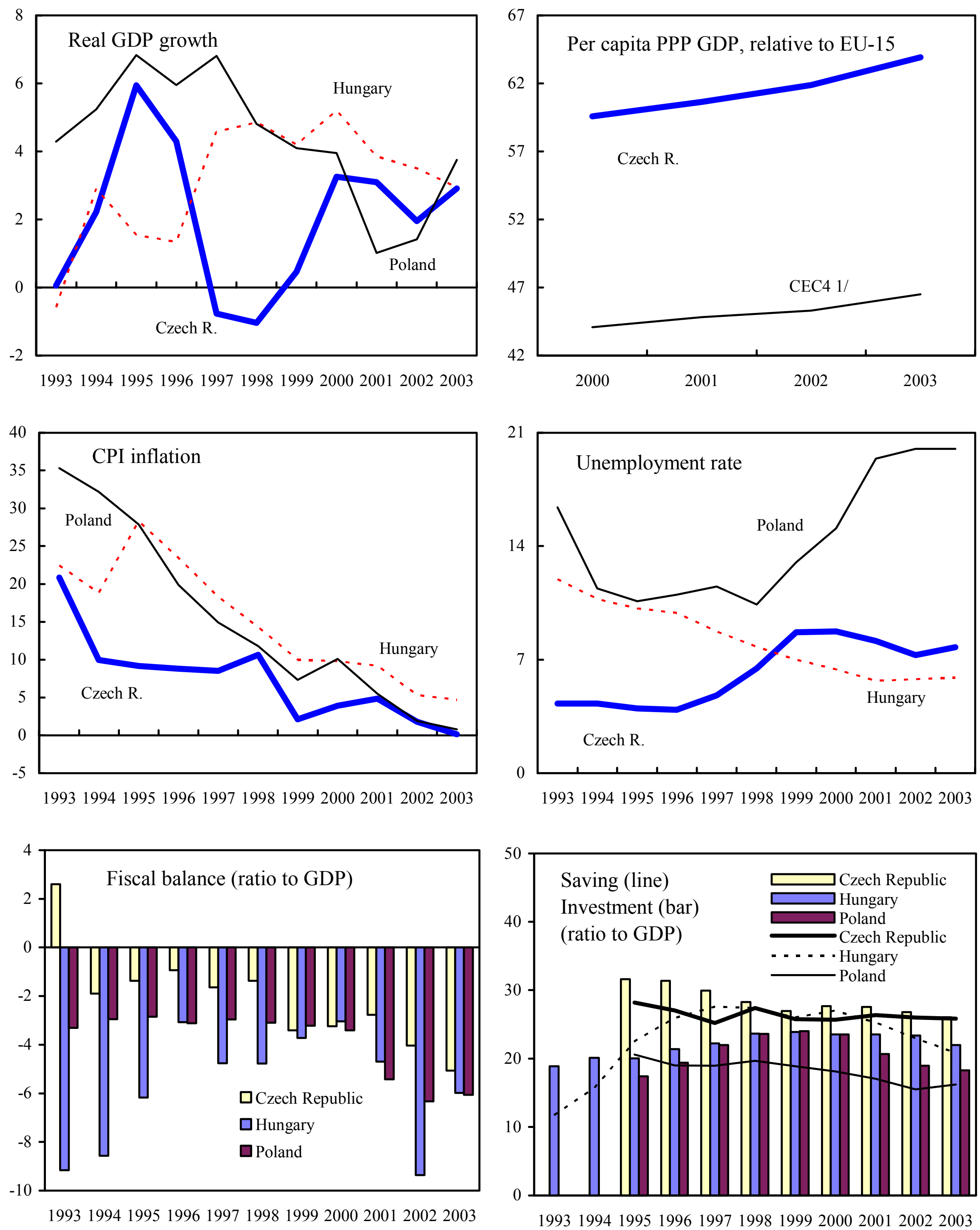
38. **With underlying inflation expected to rise gradually, monetary policy will need to tighten in the period ahead**. Keeping policy interest rates on hold through mid-2004 was appropriate given expectations of subdued underlying inflation. The recent ¼ percentage point increase in the policy rate was needed to prevent any further decline in real interest rates in the context of gradually rising underlying inflation. However, with the expected narrowing of the output gap and pickup in inflation from mid 2005, future interest rate increases will need to outpace inflation in order to tighten monetary conditions. The size and timing of future interest rate increases should be conditioned on evidence of emerging demand-pull pressures which—despite the expected continuing rise in growth—may well be delayed by a faster expansion of potential output.

39. **The Czech inflation targeting framework has provided a transparent foundation for monetary policy and offers continuity through ERM2**. By relying primarily on the interest rate instrument, rather than foreign exchange intervention, the CNB has provided coherent signals to the market about monetary policy intentions. The CNB should continue to pursue a nonintervention strategy during the forthcoming tightening cycle to avoid resisting koruna appreciation driven by rising domestic interest rates. Measured in terms of unit labor costs, competitiveness against several CECs has eroded, but other factors that are more difficult to quantify—including labor quality—are likely to partially compensate.

40. **Bank supervision should adapt to the new risks from rapid growth in lending to households**. The CNB's efforts at improving the analysis of risks from macrofinancial linkages is commendable. But enhancement of supervisory capacity is needed in the area of household credit, and will require data on household indebtedness, debt-servicing ability, and housing transactions. Establishing a single financial sector supervisor should improve information flow, but organizational changes should not distract from effective oversight.

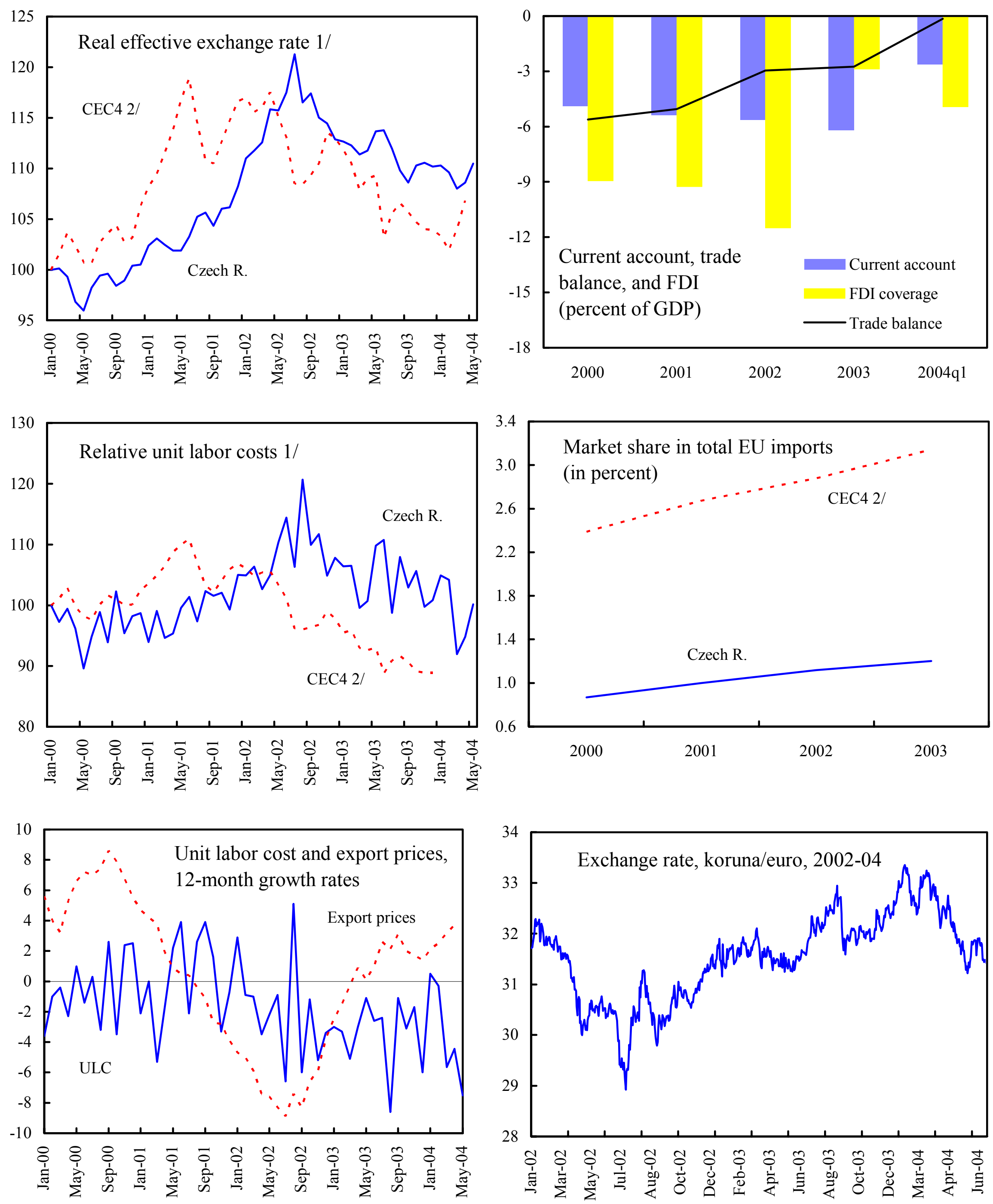
41. The next Article IV consultation with the Czech Republic is expected to be conducted under the standard 12-month cycle.

Figure 1. Czech Republic and Other CECs: Economic Indicators, 1993-2003
(In percent, unless otherwise indicated)



Sources: Eurostat; IMF World Economic Outlook; and IMF staff calculations.
1/ Unweighted average of Hungary, Poland, Slovak Republic, and Slovenia.

Figure 2. Czech Republic: Indicators of External Competitiveness, 2000-04

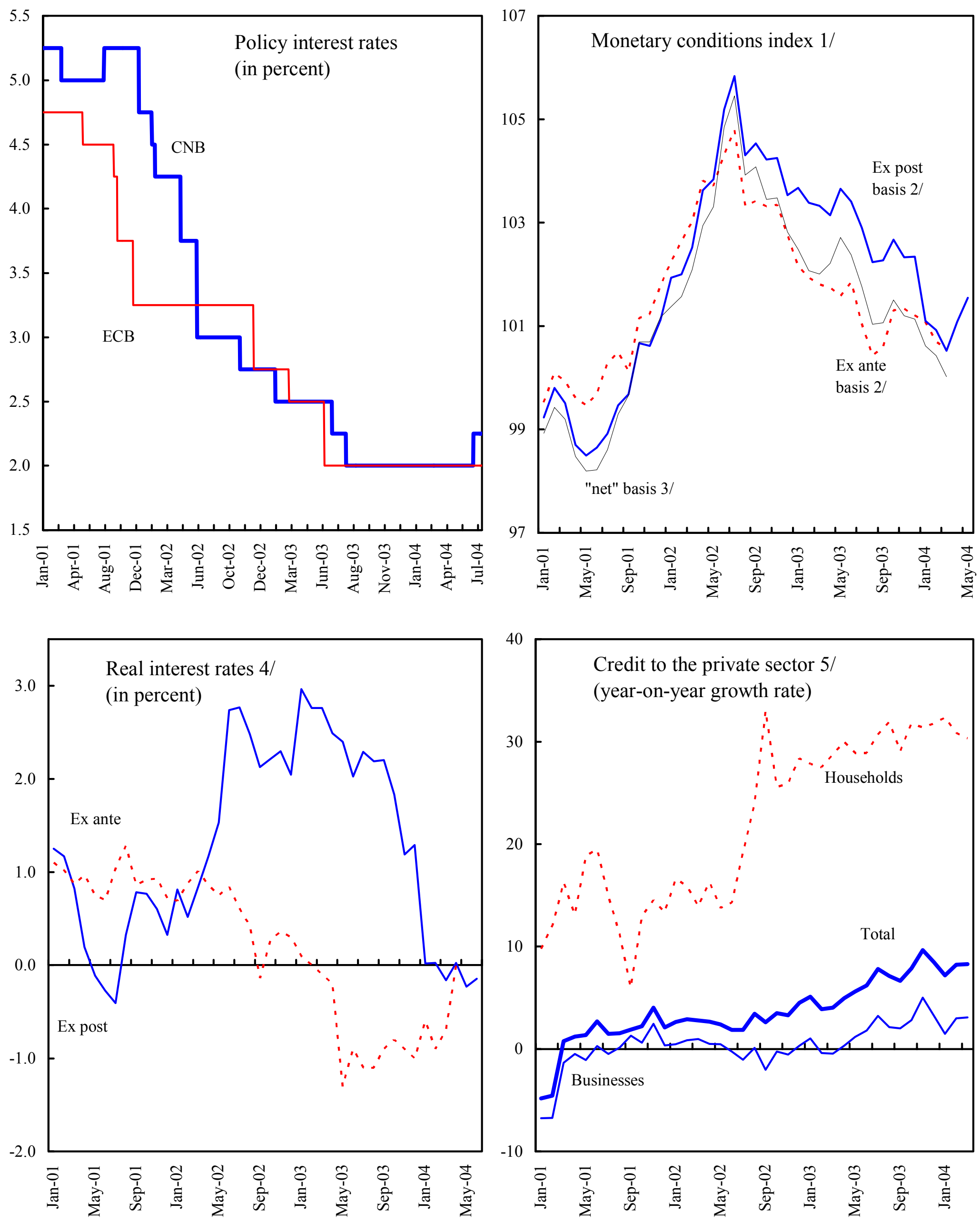


Sources: Czech Statistical Office; Czech National Bank; International Financial Statistics Direction of Trade Statistics; and IMF staff calculations.

1/ Relative to industrial country partners, January 2000=100.

2/ Trade-weighted average of four Central European countries (Hungary, Poland, Slovak Republic, and Slovenia).

Figure 3. Czech Republic: Monetary Policy Indicators, 2001-04



Sources: Czech National Bank; European Central Bank; and IMF staff estimates.

1/ Weighted average of real short-term interest rate and real effective exchange rate (weights: 2/3 and 1/3, respectively).

2/ Based on 1-year PRIBOR deflated by 12-month backward- and forward-looking CPI inflation, respectively.

3/ Based on real interest rate deflated by 12-month backward-looking inflation excluding effects of indirect tax and administered price changes.

4/ Ex post real interest rates are 1-year PRIBOR, deflated by 12-month CPI inflation; ex ante real interest rates are deflated by 12-month inflation expected in a survey conducted by the Czech National Bank Statistical Survey.

5/ Business and total adjusted for loan write-offs and changes in classification of financial institutions.

Table 1. Czech Republic: Selected Economic and Financial Indicators, 2001-04

	2001	2002	2003	2004 1/
Real economy (change in percent)				
Real GDP	2.6	1.5	3.1	3.3
Domestic demand	3.9	3.4	4.5	3.1
CPI (year average)	4.7	1.8	0.1	3.2
PPI (year average)	2.9	-0.5	-0.3	…
Unemployment rate (year average in percent)				
Survey based 2/	8.1	7.3	7.8	7.5
Registered 2/	8.5	9.2	9.9	9.6
Gross national savings (percent of GDP)	23.5	22.3	21.4	22.3
Gross domestic investments (percent of GDP)	28.9	27.9	27.6	27.8
Public finance (percent of GDP)				
General government revenue	36.7	37.5	38.9	38.3
General government expenditure 3/	41.7	44.2	45.1	45.3
General government balance 3/	-5.0	-6.7	-6.2	-7.0
Adjusted to exclude grants to transformation institutions to cover costs related to management of bad assets	-2.8	-4.0	-4.9	-6.1
Adjusted balance excluding net lending 4/	-2.7	-3.7	-3.9	-5.9
General government debt	17.5	18.4	21.9	26.5
Including debt of the Czech Consolidation Agency	22.9	25.5	27.9	31.3
Money and credit (end of year, percent change)				
Broad money 5/	13.0	3.5	6.9	9.0
Private sector credit (percent change, eop) 6/	2.1	4.5	8.5	8.3
Interest rates (in percent)				
Three-month interbank rate (end-of-period) 7/	4.7	2.6	2.1	2.3
10-year government bond 7/	6.3	4.9	4.1	5.0
Balance of payments (percent of GDP)				
Trade balance	-5.0	-3.0	-2.7	-2.6
Current account	-5.4	-5.6	-6.2	-5.5
Gross international reserves (US$ billion)	14.5	23.7	27.0	28.9
Reserve cover (in months of imports of goods and services)	4.1	6.1	5.5	5.1
Fund position (as of May 31, 2004)				
Holdings of currency (percent of quota)			61.9	
Holdings of SDRs (percent of allocation)			n.a.	
Quota (millions of SDRs)			819.3	
Exchange rate				
Exchange rate regime			Managed float	
Koruna per U.S. dollar (July 19, 2004)			CZK 25.12 =US$1	
Nominal effective exchange rate (2000=100) 7/	104.4	116.1	115.6	116.2
Real effective exchange rate (CPI-based; 2000=100) 5/	105.5	116.7	112.6	111.7

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

1/ Staff estimates and projections.
2/ In percent of total labor force.
3/ Excluding privatization revenues of the National Property Fund and the Czech Land Fund, the sale of shares and voting rights by local governments, and the sale of Russian debt.
4/ General government deficit excluding transfer to transformation institutions and net lending. Concept targeted by the authorities.
5/ For 2004, data refer to May.
6/ For 2004, data refer to growth rate from March 2003 to March 2004.
7/ For 2004, data refer to June.

Table 2. Czech Republic: Balance of Payments, 2000-04
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004 1/
Current account balance	**-2,718**	**-3,273**	**-4,166**	**-5,570**	**-5,642**
Trade balance	-3,131	-3,068	-2,179	-2,458	-2,651
Exports	29,052	33,378	38,319	48,599	56,928
Imports	32,183	36,446	40,497	51,058	59,579
Nonfactor services	1,414	1,524	668	469	501
Receipts	6,862	7,090	7,061	7,764	9,266
Payments	5,448	5,566	6,393	7,295	8,765
Factor income (net)	-1,373	-2,197	-3,532	-4,132	-4,631
Transfers	372	467	877	552	1,138
Capital account	**-5**	**-9**	**-4**	**-3**	**-3**
Financial account balance	**3,836**	**4,544**	**10,625**	**5,805**	**6,138**
Direct investment, net	4,943	5,476	8,276	2,351	3,143
Portfolio investment, net	-1,767	916	-1,428	-1,336	-1,336
Financial derivatives, net	-36	-85	-131	137	0
Other investment, net	696	-1,764	3,908	4,654	4,331
Errors and omissions, net	**-295**	**502**	**172**	**225**	**0**
Change in reserves	**-819**	**-1,765**	**-6,627**	**-457**	**-493**
Memorandum items:					
Current account (in percent of GDP)	-4.9	-5.4	-5.6	-6.2	-5.5
Trade balance (in percent of GDP)	-5.6	-5.0	-3.0	-2.7	-2.6
Net foreign direct investment (in percent of GDP)	8.9	9.0	11.2	2.6	3.1
Gross official reserves					
(in months of imports of goods and services)	4.2	4.1	6.1	5.5	5.1
Terms of trade (percentage change) 2/	-2.5	2.3	3.0	1.7	-0.7

Sources: Czech National Bank; and IMF staff projections.

1/ IMF staff projections.
2/ Goods and services.

Table 3. Czech Republic: Consolidated General Government Budget, 2000-04 1/

	2000	2001	2002	2003 2/	2004 3/
	(In percent of GDP)				
Total revenue and grants 4/	36.3	36.7	37.5	38.9	38.3
Total revenue	36.3	36.6	37.4	38.5	37.2
Current revenue	35.8	36.2	37.0	38.0	36.8
Tax revenue	33.5	33.8	34.5	35.3	35.6
Nontax revenue	2.3	2.4	2.5	2.7	1.3
Capital revenue	0.4	0.4	0.5	0.4	0.4
Grants, incl. EU compensation	0.1	0.1	0.1	0.5	1.0
Total expenditure and net lending 5/	40.5	41.7	44.2	45.1	45.3
excl. grants to transformation institutions	39.6	39.5	41.6	43.9	44.4
Total expenditure	40.4	41.6	43.9	44.1	45.0
Current expenditure	35.4	36.7	38.6	38.6	38.7
Goods and services	8.4	7.9	8.6	8.1	7.9
Interest payments	1.0	0.9	0.7	0.8	1.1
Subsidies and other current transfers	26.0	27.9	29.3	29.7	29.7
excluding grants to transformation institutions	25.1	25.7	26.6	28.5	28.8
Transfers to households and nonfinancial enterprises	18.6	18.7	19.2	19.4	18.9
Transfers abroad, incl. EU	0.1	0.1	0.1	0.5	0.8
Subsidies	7.3	9.0	9.9	9.8	10.0
excluding grants to transformation institutions 6/	6.4	6.8	7.3	8.6	9.1
excluding semibudgetary organizations	2.3	2.3	2.4	2.7	3.2
Capital expenditure	5.0	4.8	5.3	5.5	6.3
Net lending (excl. privatization and the sale of Russian debt)	0.1	0.1	0.3	1.0	0.3
Overall balance 5/	-4.2	-5.0	-6.7	-6.2	-7.0
Adjusted to exclude grants to transformation institutions to cover costs related to management of bad assets	-3.2	-2.8	-4.0	-4.9	-6.1
Adjusted balance excluding net lending 6/	-3.1	-2.7	-3.7	-3.9	-5.9
Financing 7/					
Privatization receipts 8/	1.3	2.7	5.3	1.0	1.0
Proceeds from the sale of UMTS licenses	0.0	0.1	0.0	0.0	0.0
Proceeds from the sale of Russian debt	0.0	0.0	0.8	0.0	0.0
Net increase in financial liabilities	2.9	2.2	0.5	5.1	6.0
Memorandum items:					
Grants to transformation institutions to cover costs related to management of bad assets	0.9	2.2	2.7	1.2	0.9
General government debt 9/	15.5	17.5	18.4	21.9	26.5
Including debt of the Czech Consolidation Agency	21.2	22.9	25.5	27.9	31.3
General government balance, ESA95-based	-4.6	-6.5	-6.5	-12.9	-5.3

Sources: Ministry of Finance; and IMF staff estimates.
1/ Includes the state budget, Czech Consolidation Agency, State Financial Assets, National Property Fund, extrabudgetary funds, social security funds, and local governments.
2/ Preliminary estimates.
3/ Staff estimates consistent with the 2004 state budget. Revenue estimates are based on staff's GDP projections. Expenditure estimates include the effects of post-budget spending measures.
4/ Excluding revenues from UMTS license sales.
5/ Excluding privatization revenues of the National Property Fund, the Czech Land Fund, and the sale of shares and voting rights by the local governments.
6/ Concept targeted by the authorities.
7/ IMF staff estimates.
8/ Includes privatization receipts of the National Property Fund, the Czech Land Fund, and the sale of shares and voting rights by local governments.
9/ Includes liabilities of the state budget, extrabudgetary funds, social security funds, and local governments. Staff estimates for 2004.

Table 4. Czech Republic: Medium-term Macroeconomic Scenario, 2001-09

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Real sector				(Percent growth)					
Real GDP	2.6	1.5	3.1	3.3	3.4	3.5	3.6	3.7	3.8
Consumption	3.0	3.3	4.1	2.9	3.0	3.1	3.2	3.2	3.2
Investment	6.3	3.5	5.7	3.7	3.1	2.8	3.4	3.7	4.0
Of which : fixed investment	5.4	3.4	7.4	4.7	3.2	3.5	4.1	4.1	4.2
Exports, goods and services	11.5	2.3	5.9	8.5	7.9	7.9	7.6	7.5	7.6
Imports, goods and services	13.0	4.9	7.9	7.5	7.1	7.0	6.9	6.8	7.0
CPI inflation	4.7	1.8	0.1	3.2	3.0	3.0	3.0	3.0	3.0
GDP deflator	4.9	2.8	1.7	3.6	2.9	2.9	3.0	3.0	2.8
Gross domestic savings 1/	23.5	22.3	21.4	22.3	22.3	22.2	22.0	22.0	21.5
Public	0.3	-0.5	-1.4	-0.3	-1.4	-0.3	0.4	1.4	2.0
Private	23.3	22.8	22.8	22.6	23.7	22.6	21.6	20.6	19.5
Public finances				(In percent of GDP)					
Revenues	36.8	37.5	38.9	38.3	38.6	38.0	37.9	37.9	37.8
Expenditures	41.7	44.2	45.1	45.3	44.5	43.0	41.8	41.1	40.2
Overall balance	-5.0	-6.7	-6.2	-7.0	-5.9	-5.0	-3.9	-3.2	-2.4
Adjusted balance	-2.8	-4.0	-4.9	-6.1	-5.2	-4.4	-3.9	-3.2	-2.4
Cyclically adjusted	-2.7	-3.5	-4.5	-5.9	-5.1	-4.4	-3.9	-3.2	-2.4
Targeted balance (adjusted balance excl. net lending)			-3.9	-5.9	-4.8	-4.0	-3.5	-2.8	-2.0
General government debt	17.5	18.4	21.9	26.5	29.7	32.9	34.8	38.4	38.4
Including debt of the Czech Consolidation Agency	22.9	25.5	27.9	31.3	33.5	35.9	37.6	38.4	38.4
Balance of payments				(In percent of GDP)					
Current account balance	-5.4	-5.6	-6.2	-5.5	-4.9	-4.4	-4.2	-4.1	-4.3
Trade balance	-5.0	-3.0	-2.7	-2.6	-2.1	-1.6	-1.4	-1.4	-1.4
Services balance	2.5	0.9	0.5	0.5	0.5	0.7	0.9	1.2	1.5
Net factor income	-3.6	-4.8	-4.6	-4.5	-4.4	-4.6	-4.8	-5.0	-5.5
Current transfers	0.8	1.2	0.6	1.1	1.1	1.1	1.2	1.2	1.2
Financial account balance	7.5	14.4	6.5	6.0	5.9	4.4	4.2	4.1	4.3
Direct investment, net	9.0	11.2	2.6	3.1	3.6	2.6	2.6	2.6	2.7
Of which : privatization revenue	2.7	5.3	1.0	0.5	1.0	0.0	0.0	0.0	0.0
Portfolio investment, net	1.5	-1.9	-1.5	-1.3	-1.2	-1.1	-1.1	-1.0	-0.9
Financial derivatives, net	-0.1	-0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Other investment, net	-2.9	5.3	5.2	4.2	3.5	2.9	2.6	2.4	2.6
Errors and omissions, net	0.8	0.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves (- increase)	-2.9	-9.0	-0.5	-0.5	-1.0	0.0	0.0	0.0	0.0

Sources: Czech Statistical Office, Czech National Bank; Ministry of Finance; and IMF staff estimates.
1/ In percent of GDP.

Table 5. Czech Republic: Vulnerability Indicators, 1997-2004 1/
(In percent of GDP, unless otherwise indicated)

							Latest Data		
	1997	1998	1999	2000	2001	2002	2003	2004	*Date*
Financial indicators									
Public sector debt 2/	20.0	18.0	21.0	21.2	22.9	25.5	27.9	...	*December-03*
State government guarantees 3/	17.0	17.0	15.3	11.4	13.0	15.0	18.1	...	*December-03*
Broad money (percent change, 12-month basis)	10.8	5.4	7.7	5.6	13.0	3.5	6.9	9.0	*May-04*
Private sector credit (percent change, 12-month basis) 4/	9.4	0.7	-4.7	-4.3	2.1	4.5	8.5	8.3	*March-04*
Domestic credit	66.7	58.7	55.6	49.7	43.7	37.7	42.7	41.6	*March-04*
One-year PRIBOR (end of period, in percent)	17.0	8.9	5.8	5.9	4.6	2.6	2.3	3.0	*June-04*
One-year PRIBOR, real (in percent) 5/	7.0	2.1	3.3	2.0	0.3	2.0	1.3	0.3	*May-04*
Classified credits (percent of total credits)	26.4	26.0	31.9	28.9	20.8	15.8	11.2	11.2	*March-04*
Of which : loss credits	15.0	13.4	13.3	12.9	7.0	3.9	2.3	2.2	*March-04*
External indicators									
Exports G&NFS (percent change, 12-month basis in US$)	-1.2	13.5	-0.6	7.8	12.7	12.1	24.2	25.6	*March-04*
Imports G&NFS (percent change, 12-month basis in US$)	-3.5	4.7	-0.5	10.6	11.6	11.6	24.4	25.0	*March-04*
Terms of trade (percent change, 12-month basis)	1.2	5.0	-0.7	-2.6	2.5	1.7	0.9	1.6	*March-04*
Current account balance	-6.7	-2.2	-2.7	-4.9	-5.4	-5.6	-6.2	-2.6	*March-04*
Capital and financial account balance	2.0	5.1	5.6	6.9	7.5	14.4	6.5	0.6	*March-04*
Of which : inward portfolio investment (debt securities etc.)	2.4	1.9	0.9	0.9	1.3	1.2	1.9	3.5	*March-04*
other investment, net (loans, trade credits etc.)	-2.4	-3.0	-3.2	1.2	-2.9	5.3	5.2	-8.1	*March-04*
inward foreign direct investment	2.5	6.5	11.5	8.9	9.3	11.5	2.9	4.9	*March-04*
Net Foreign Assets (NFA) of commercial banks (in US$ billions)	2.6	4.2	6.3	8.4	11.1	10.3	5.3	7.1	*March-04*
Gross official reserves (in US$ billions)	9.8	12.6	12.8	13.1	14.5	23.7	27.0	27.0	*March-04*
Net International Reserves (NIR) (in US$ billions)	9.8	12.6	12.8	13.1	14.5	23.7	27.0	27.0	*March-04*
Central bank short-term foreign liabilities (in US$ billions)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	*March-04*
Central bank foreign currency exposure (in US$ billions)	9.7	12.6	12.8	13.1	14.5	23.7	27.0	27.0	*March-04*
Short-term foreign assets of commercial banks (in US$ billions)	7.2	9.1	9.3	8.3	9.9	7.1	6.3	5.3	*March-04*
Short-term foreign liabilities of commercial banks (in US$ billions)	4.9	6.5	6.4	6.0	5.3	5.8	8.1	5.4	*March-04*
Foreign currency exposure of commercial banks (in US$ billions)	2.6	4.2	6.3	8.4	11.1	10.3	5.3	7.1	*March-04*
Official reserves in months of imports G&NFS	3.6	4.4	4.5	4.2	4.1	6.1	5.5	5.0	*March-04*
Reserve money to (gross official) reserves (percentage)	67.2	61.0	46.0	45.2	45.9	35.4	39.7	38.5	*April-04*
Broad money to (gross official) reserves (percentage)	348.3	326.9	291.0	288.1	310.5	230.9	254.6	244.4	*April-04*
Total short-term external debt to gross official reserves (percentage) 6/	111.4	104.4	93.4	96.4	83.8	57.1	62.6	52.6	*March-04*
Total external debt	37.7	39.4	38.4	38.8	36.8	36.6	38.9	32.9	*March-04*
Of which : public sector debt 7/	3.6	2.9	2.5	1.9	1.4	2.2	3.0	2.9	*March-04*
Of which : public and publicly guaranteed debt 7/	11.7	13.1	11.9	11.6	9.2	9.3	9.7	8.3	*March-04*
Total external debt to exports G&NFS (in percent)	73.2	72.7	68.6	60.2	55.3	59.5	61.9	49.6	*March-04*
Total external debt service payments to exports G&NFS	15.9	15.3	12.7	12.3	8.6	9.1	6.4	4.7	*March-04*
External interest payments to exports G&NFS	3.0	3.1	3.1	2.4	2.2	2.2	0.3	0.8	*March-04*
External amortization payments to exports G&NFS	13.0	12.2	9.6	9.9	6.4	6.9	5.3	3.9	*March-04*
Exchange rate (per US$, period average)	31.71	32.27	34.60	38.59	38.04	32.74	28.23	26.05	*June-04*
REER appreciation (+) (12-month change; CPI-based)	-0.4	9.5	-0.2	1.2	5.5	10.6	-3.5	-2.8	*May-04*
Financial market indicators (end of period)									
Stock market index (PX-50)	495	394	490	479	395	461	659	807	*June-04*
Foreign currency debt rating (Moody's)	Baa1	Baa1	Baa1	Baa1	Baa1	A1	A1	A1	*June-04*
Domestic currency debt rating (Standard & Poor's)	AA	AA-	AA-	AA-	AA-	A+	A+	A+	*June-04*

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

1/ Starting 2000, GDP data are revised.

2/ Debt of general government and liabilities of transformation institutions.

3/ Includes guarantees provided to CSOB on IPB balance sheet.

4/ Adjusted to account for removal of KoB's banking license in September 2001, exchange rate effects on foreign-currency-denominated loans, loan write-offs, and transfer of IPB loans to CKA (CNB calculations).

5/ Deflated by CPI inflation.

6/ Includes amortization of medium- and long-term debt on a remaining maturity basis. Based on medium- and long-term debt outstanding at the end of the preceding year.

7/ General government and Czech National Bank.

Czech Republic: External and Fiscal Sustainability

Table A1 shows the results of the external debt sustainability framework for the Czech Republic. Under the baseline macroeconomic scenario, the Czech Republic's external debt stock is projected to remain relatively stable at near 40 percent of GDP. The current account deficit is expected to narrow, driven largely by a further reduction in the trade deficit and an increase in the surplus on the services account (reversing its earlier trend). FDI—though slowing from very high levels seen early in the decade—is expected to continue to finance a significant part of the current account deficit. While these factors will mitigate the need for new borrowing, external indebtedness (expressed in U.S. dollar terms) is set to increase significantly. However, the automatic effect of GDP growth and gradual koruna appreciation against the U.S. dollar should stabilize the debt-GDP ratio. While the annual gross external financing need (defined as the sum of the current account deficit, amortization of medium- and long-term debt, and the outstanding stock of short-term debt) is expected to increase in U.S. dollar terms, relative to GDP this ratio is expected to decline due to favorable growth and exchange rate developments.

These conclusions were subjected to several stress test scenarios, including negative shocks to the current account, GDP growth, external interest rates, and a large depreciation of the koruna against the U.S. dollar. In addition, a Czech-specific shock in which FDI falls each year relative to baseline by US$1 billion combined with stagnant GDP growth of 2½ percent was considered (alternative scenario 2 in Table A1). The results indicate that the Czech Republic's debt dynamics remain manageable, with the external debt-GDP ratio remaining under 55 percent in 2009 in all cases.

Turning to fiscal sustainability (Table A2), under the baseline scenario—which assumes that the general government deficit is reduced in line with current plans until 2007, deficit reduction continues at a similar pace in 2008–09, and all of CKA's debt is fully assumed by the government by 2008—the stock of government debt is projected to increase to about 38 percent of GDP. Under the standard adverse shock scenarios, public debt should be sustainable in the medium term, remaining below the Maastricht ceiling of 60 percent of GDP. However, significant risks are associated with contingent liabilities (government guarantees stood at nearly 20 percent of GDP at end-2003).[11] In addition, the possibility of bailouts through CKA remains prior to its planned closure in 2007—recent examples include taking over debt of the railways and of some municipalities. In the country specific risk scenario (consistent with scenario A2 in the external debt sustainability exercise), a substantial share of the currently outstanding contingent liabilities is assumed to fall due in 2006, triggered by weaker growth brought by a drop-off in FDI. Higher fiscal financing needs lead to an increase in domestic interest rates, further slowing annual GDP growth to

[11] About one-third of the total nominal stock of guarantees (without guarantees for the liabilities to CKA, which are included in public debt) is considered very low risk.

about 2½ percent. Slower growth, in turn, impedes public expenditure adjustment. Under this scenario, the stock of public debt is projected to increase to above 50 percent of GDP and could exceed the Maastricht limit in the case of adverse shocks (e.g., higher interest rates).

Table A1. Czech Republic: External Debt Sustainability Framework, 1999-2009
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	1999	2000	2001	2002	2003			2004	2005	2006	2007	2008	2009	
										I. Baseline Projections				Debt-stabilizing noninterest current account 7/
1 **External debt**	38.4	38.8	36.8	36.6	38.9			**38.4**	**39.6**	**39.7**	**39.8**	**39.5**	**39.3**	**-3.3**
2 Change in external debt	-1.1	0.4	-2.0	-0.2	2.3			-0.5	1.2	0.2	0.1	-0.3	-0.2	
3 Identified external debt-creating flows (4+8+9)	-3.1	1.6	-6.4	-10.9	-2.8			0.8	0.0	0.5	0.3	0.1	0.3	
4 Current account deficit, excluding interest payments	0.7	3.3	3.9	4.3	5.1			4.3	3.3	2.7	2.4	2.1	2.3	
5 Deficit in balance of goods and services	1.2	3.1	2.5	2.0	2.2			2.1	1.6	1.0	0.5	0.2	-0.1	
6 Exports	55.9	64.5	66.5	61.5	62.9			64.4	66.2	68.0	69.5	70.9	72.3	
7 Imports	57.1	67.5	69.0	63.6	65.1			66.5	67.8	69.0	70.0	71.1	72.2	
8 Net nondebt creating capital inflows (negative)	-7.0	-5.9	-8.4	-10.1	-2.5			-3.6	-3.7	-2.6	-2.6	-2.6	-2.7	
9 Automatic debt dynamics 1/	3.1	4.2	-1.8	-5.1	-5.4			0.1	0.3	0.4	0.5	0.6	0.6	
10 Contribution from nominal interest rate	1.7	1.5	1.4	1.4	1.1			1.2	1.6	1.7	1.9	2.0	2.0	
11 Contribution from real GDP growth	-0.2	-1.3	-0.9	-0.5	-0.9			-1.1	-1.2	-1.3	-1.3	-1.4	-1.4	
12 Contribution from price and exchange rate changes 2/	1.6	4.0	-2.4	-6.0	-5.6			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	2.1	-1.2	4.3	10.7	5.1			-1.3	1.2	-0.3	-0.2	-0.4	-0.4	
External debt-to-exports ratio (in percent)	68.6	60.2	55.3	59.5	61.8			59.6	59.7	58.4	57.2	55.7	54.3	
Gross external financing need (in billions of U.S. dollars) 4/	13.8	14.8	15.0	16.3	19.6			23.9	24.9	25.4	25.8	26.5	27.5	
In percent of GDP	23.1	26.6	24.6	22.0	21.8	10-Year Historical Average	10-Year Standard Deviation	23.2	22.8	21.7	20.6	19.7	19.1	Projected Average
Key Macroeconomic Assumptions														
Real GDP growth (in percent)	0.5	3.3	2.6	1.5	3.1	2.2	2.3	3.3	3.4	3.5	3.6	3.7	3.8	3.5
GDP deflator in U.S. dollars (change in percent)	-3.9	-9.5	6.5	19.4	18.0	6.4	11.4	10.8	3.0	3.4	3.4	3.4	3.3	4.6
Nominal external interest rate (in percent)	4.3	3.8	4.1	4.5	3.7	4.5	0.7	3.6	4.3	4.7	5.0	5.4	5.5	4.7
Growth of exports (U.S. dollar terms, in percent)	-0.6	7.8	12.7	12.1	24.3	12.0	11.3	17.4	9.5	9.9	9.5	9.2	9.4	10.8
Growth of imports (U.S. dollar terms, in percent)	-0.5	10.6	11.6	11.6	24.5	12.0	12.3	17.0	8.6	8.9	8.7	8.8	8.9	10.1
Current account balance, excluding interest payments	-0.7	-3.3	-3.9	-4.3	-5.1	-3.2	1.9	-4.3	-3.3	-2.7	-2.4	-2.1	-2.3	-2.8
Net nondebt creating capital inflows	7.0	5.9	8.4	10.1	2.5	5.7	2.6	3.6	3.7	2.6	2.6	2.6	2.7	3.0
A. Alternative Scenarios														**Debt-stabilizing noninterest current account**
A1. Key variables are at their historical averages in 2005-09 5/								**38.4**	**37.6**	**35.6**	**33.8**	**32.0**	**30.2**	**-5.5**
A2. Country-specific shock from 2005, with reduction in GDP growth and FDI (relative to baseline)6/								**38.4**	**42.2**	**44.4**	**46.7**	**49.2**	**52.2**	**-5.3**
B. Bound Tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006								**38.4**	**40.1**	**40.7**	**40.8**	**40.4**	**40.3**	**-3.3**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**38.4**	**41.7**	**44.2**	**44.0**	**43.4**	**42.9**	**-3.7**
B3. Change in U.S. dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006								**38.4**	**47.9**	**58.1**	**57.0**	**55.5**	**54.1**	**-4.9**
B4. Noninterest current account is at historical average minus two standard deviations in 2005 and 2006								**38.4**	**43.2**	**47.5**	**47.4**	**47.0**	**46.7**	**-3.4**
B5. Combination of 2-5 using one standard deviation shocks								**38.4**	**46.0**	**52.3**	**52.4**	**51.9**	**51.7**	**-4.2**
B6. One time 30 percent nominal depreciation in 2005								**38.4**	**56.8**	**58.3**	**57.4**	**56.0**	**54.8**	**-4.6**

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both noninterest current account and nondebt inflows in percent of GDP.

6/ Relative to baseline, FDI declines by US$1 billion and GDP growth stabilizes at 2.5 percent. Consistent with the alternative scenario in Table A2.

7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and both noninterest current account and nondebt inflows in percent of GDP) remain at their levels of the last projection year.

Table A2. Czech Republic: Public Sector Debt Sustainability Framework, 1999-2009
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	1999	2000	2001	2002	2003			2004	2005	2006	2007	2008	2009	
								I. Baseline Projections						**Debt-stabilizing primary balance** 11/
1 **Public sector debt** 1/	13.4	15.5	17.5	18.4	21.9			**26.5**	**29.7**	**32.9**	**34.8**	**38.4**	**38.4**	**-0.2**
Of which foreign-currency denominated	1.6	1.5	1.4	2.0	2.8			4.3	5.4	6.4	7.2	7.8	8.4	
2 Change in public sector debt	1.3	2.1	2.0	0.9	3.5			4.6	3.2	3.2	1.8	3.6	0.0	
3 Identified debt-creating flows (4+7+12)	0.8	2.4	1.2	0.5	4.0			4.7	3.2	3.2	1.8	1.0	0.0	
4 Primary deficit	2.6	3.2	4.1	6.0	5.3			5.9	4.6	3.4	2.0	1.1	0.2	
5 Revenue and grants	35.8	36.3	36.7	37.5	38.9			38.3	38.6	38.0	37.9	37.9	37.8	
6 Primary (noninterest) expenditure	38.3	39.5	40.8	43.6	44.3			44.2	43.3	41.3	40.0	39.0	38.0	
7 Automatic debt dynamics 2/	0.9	0.5	-0.3	-0.3	-0.3			-0.3	-0.3	-0.2	-0.2	-0.1	-0.2	
8 Contribution from interest rate/growth differential 3/	0.5	0.4	-0.2	-0.1	0.0			-0.3	-0.3	-0.2	-0.2	-0.1	-0.2	
9 Of which contribution from real interest rate	0.6	0.8	0.1	0.2	0.5			0.4	0.5	0.8	0.9	1.1	1.2	
10 Of which contribution from real GDP growth	-0.1	-0.4	-0.4	-0.2	-0.5			-0.7	-0.8	-1.0	-1.1	-1.2	-1.3	
11 Contribution from exchange rate depreciation 4/	0.4	0.1	-0.1	-0.2	-0.3			...	...	...	...	...	...	
12 Other identified debt-creating flows	-2.6	-1.3	-2.7	-5.3	-1.0			-1.0	-1.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	-2.6	-1.3	-2.7	-5.3	-1.0			-1.0	-1.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	0.5	-0.3	0.8	0.5	-0.6			0.0	0.0	0.0	0.0	2.6	0.0	
Public sector debt-to-revenue ratio 1/	37.3	42.6	47.6	49.1	56.2			69.3	77.0	86.8	91.7	101.3	101.4	
Gross financing need 6/	9.7	11.0	20.7	15.8	13.7			16.1	15.7	16.9	15.7	16.0	15.5	
in billions of U.S. dollars	5.8	6.1	12.6	11.7	12.3			16.6	17.2	19.8	19.7	21.5	22.3	
Key Macroeconomic and Fiscal Assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	0.5	3.2	2.6	1.5	3.1	2.2	2.3	3.3	3.4	3.5	3.6	3.7	3.8	3.5
Average nominal interest rate on public debt (in percent) 7/	8.1	7.6	6.0	3.9	4.8	7.3	2.1	5.4	5.0	5.9	6.0	6.3	6.2	5.8
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	5.2	6.5	1.1	1.1	3.1	1.7	2.9	1.9	2.1	3.0	3.0	3.4	3.3	2.8
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-17.0	-4.9	4.3	20.3	17.5	2.0	14.8	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	3.0	1.1	4.9	2.8	1.7	5.7	3.8	3.6	2.9	2.9	3.0	3.0	2.8	3.0
Growth of real primary spending (deflated by GDP deflator, in percent)	4.9	6.4	5.9	8.4	4.8	4.1	3.2	3.1	1.2	-1.1	0.1	1.2	1.1	0.9
Primary deficit	2.6	3.2	4.1	6.0	5.3	2.6	2.3	5.9	4.6	3.4	2.0	1.1	0.2	2.9
A. Alternative Scenarios								**II. Stress Tests for Public Debt Ratio**						**Debt-stabilizing primary balance** 11/
A1. Key variables are at their historical averages in 2005-09 8/								**26.5**	**27.9**	**30.3**	**32.7**	**37.9**	**40.2**	**-0.3**
A2. Primary balance under no policy change in 2005-09 12/								**26.5**	**30.7**	**36.1**	**40.7**	**48.1**	**52.7**	**-0.2**
A3. Country-specific shock in 2006, with reduction in GDP growth (relative to baseline) of one standard deviation 9/								**26.5**	**29.8**	**45.7**	**48.7**	**54.1**	**56.4**	**0.2**
B. Bound Tests														
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006								**26.5**	**31.1**	**35.6**	**37.4**	**41.0**	**41.0**	**-0.2**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**26.5**	**33.9**	**44.3**	**51.1**	**59.9**	**64.5**	**-0.4**
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006								**26.5**	**32.2**	**39.1**	**40.9**	**44.5**	**44.5**	**-0.3**
B4. Combination of 2-4 using one standard deviation shocks								**26.5**	**31.5**	**37.8**	**39.6**	**43.4**	**43.3**	**-0.3**
B5. One-time 30 percent real depreciation in 2005 10/								**26.5**	**31.8**	**35.0**	**36.8**	**40.4**	**40.4**	**-0.2**
B6. 10 percent of GDP increase in other debt-creating flows in 2005								**26.5**	**39.7**	**42.9**	**44.7**	**48.2**	**48.1**	**-0.3**

1/ General government gross debt.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ The 2008 jump in government debt is associated with closing CKA and taking over its remaining obligations. For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium- and long-term public sector debt, plus short-term debt at end of previous period.
7/ Derived as nominal interest expenditure divided by previous period debt stock.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ Assumes that 90 percent of public guarantees are called in 2006 and GDP growth stabilizes at 2.5 percent. Consistent with the alternative scenario in Table A1.
10/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
11/ Assumes that key variables (real GDP growth, real interest rate, and primary balance) remain at the level in percent of GDP/growth rate of the last projection year.
12/ Assumes that the primary general government balance (excluding CKA transfers) remains at its 2004 level as a share of GDP.

Czech Republic: Fund Relations
(As of May 31, 2004)

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

II. **General Resources Account**

	SDR Million	% Quota
Quota	819.30	100.00
Fund holdings of currency	506.91	61.87
Reserve position in Fund	312.40	38.13

III. **SDR Department**:

	SDR Million	% Allocation
Holdings	0.00	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	0.00

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. In the 2003 edition of the *Annual Report on Exchange Arrangements and Exchange Restrictions,* the exchange rate regime of the Czech Republic was classified as managed floating with no pre-announced path for the exchange rate. On July 19, 2004, the exchange rate of the Czech koruna stood at CZK 25.12 per U.S. dollar.

VIII. **Last Article IV Consultation**:

The last Article IV consultation with the Czech Republic was concluded on August 22, 2003. The staff report and PIN were published on January 9, 2004.

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

X. **Implementation of HIPC Initiative**: Not Applicable

XI. **Safeguards Assessments:** Not Applicable

Czech Republic: Technical Assistance, 1991–2004

Department	Timing	Purpose
FAD	Dec. 1991–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
MFD	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
	April 1997	Banking legislation
	February–June 1999	Monetary research—inflation targeting
	June 1999	Integrated financial sector supervision (with WB)
RES	September 1999	Inflation targeting (financed by MFD)
	June–August 2000	Inflation targeting (financed by MFD)
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
	May 2002	Monetary and financial statistics
	February 2003	Implementing GFSM 2001

Czech Republic: Statistical Issues

1. Data on core surveillance variables are available to the Fund regularly and with minimal lags (reporting to STA is less current, especially for foreign trade and the national accounts). Exchange rates and interest rates set by the Czech National Bank (CNB) are published daily with no lag. Gross and net international reserves are reported on a monthly basis with a one-week lag, as well as on a 10-day basis (with the CNB's balance sheet) with a one-week lag. Consumer prices, reserve money, broad money, borrowing and lending interest rates, central government fiscal accounts, and foreign trade are reported monthly with a lag of one–four 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 two to three months. Since 2003, the main balance of payment components are also available on a monthly basis. 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 two- to three-month lag.

2. Data quality is generally adequate, and the authorities are taking steps to eliminate deficiencies. EU accession has brought some further changes in data collection methodologies, particularly for trade data.

- National accounts data were revised in the second quarter of 2004, to bring them into line with Eurostat requirements. As a result, nominal GDP was revised up by 5–8 percent in 2000–03. The most significant adjustments were undertaken to: (i) estimate the stock and consumption of fixed capital at replacement cost; (ii) calculate imputed rent on the basis of user cost; and (iii) estimate the effect of business units not included in the business register. Both real and nominal data at the annual and quarterly frequencies have been revised.

- With entry to the EU, data on intra-EU trade (which accounts for about 80 percent of the total) will be derived from surveys, not customs information. Large firms and some small- and medium-sized companies will be surveyed monthly. Some nonresponse is expected and, with no overlapping period where both methodologies are used, a break in the trade data is expected. Moreover, significantly longer lags in release of data (25 days compared with 16 days earlier) will occur. 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.

- Although there are some differences with the *IFS* presentation, monetary survey data provided to the European 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. In 2002, the CNB implemented the European Central Bank (ECB) framework for monetary data. It also initiated reporting of monetary accounts that meet the *IFS* as well as the ECB requirements. The same set of accounts also forms the basis of monetary statistics published in the CNB's bulletins and on the website, which are thereby effectively harmonized with the monetary statistics published in *IFS*.

3. The Czech Republic is in observance of the Special Data Dissemination Standard (SDDS) and meets the SDDS specifications. Statistical metadata are posted on the Fund's Dissemination Standards Bulletin Board on the internet.

4. Czech economic data can be obtained from the following websites:

Czech Statistical Office	http://www.czso.cz/eng/redakce.nsf/i/home
Czech National Bank	http://www.cnb.cz/en/index.php
Czech Ministry of Finance	http://www.mfcr.cz/vlfinsta_en.php

Information and documentation on economic statistics can also be found at the Special Data Dissemination Standard website of the IMF's SDDS

http://dsbb.imf.org/Applications/web/sddscountrycategorylist/?strcode=CZE

Czech Republic: Core Statistical Indicators
(As of July 21, 2004)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	External Debt/ Debt Service	Central Government Balance	GDP
Date of latest observation	7/21/04	6/30/04	7/10/04	7/10/04	5/31/04	7/21/04	6/04	5/04	Q1 2004	Q1 2004	5/04	Q1 2004
Date received	7/21/04	7/7/04	7/21/04	7/21/04	6/30/04	7/21/04	7/8/04	6/24/04	6/4/04	6/30/04	6/25/04	6/10/04
Frequency of data	Daily	Daily	10 days	10 days	Monthly	Daily	Monthly	Monthly	Quarterly	Quarterly	Monthly	Quarterly
Frequency of reporting	Daily	Monthly	10 days	10 days	Monthly	Daily	Monthly	Monthly	Quarterly	Quarterly	Monthly	Quarterly
Source of update	CNB 1/	CNB	CNB	CNB	CNB	CNB	CSO 2/	CSO	CNB	CNB	MoF 3/	CSO
Mode of reporting	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet
Confidentiality	No	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	Quarterly	Monthly	Quarterly

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

Statement by the IMF Staff Representative
August 6, 2004

1. This statement contains factual information that has become available since the Staff Report was circulated to the Executive Board on July 23, 2004. This information does not materially alter the thrust of the staff appraisal.

2. A new government—identical in composition to the previous coalition—was formed in early August 2004, and is headed by former Interior Minister Gross. The government holds 101 of the 200 parliamentary seats. A coalition agreement, which sets out the priorities of the government until the 2006 elections, includes in the economic sphere gradually reducing the fiscal deficit to below 3 percent of GDP by 2008, adopting the euro by no later than 2010, preparing reforms of the pension and health care systems, reducing work disincentives in social benefits, and supporting families and the establishment of small- and medium-sized enterprises.

3. The Czech National Bank (CNB), in its July inflation report, forecasts economic growth for 2004 at 3.6–4.0 percent (down marginally from its April prediction) and 3.5–4.9 percent for 2005 (up by ¼ percentage point from its previous forecast). The CNB sees current inflation rising more slowly than previously forecast, and accordingly left interest rates unchanged at its most recent monetary policy meeting.

4. The Ministry of Finance (MoF) revised its fiscal projections for 2004. The updated forecast shows an adjusted general government deficit of about 5¾ percent of GDP, about ¼ percentage points narrower than MoF estimates at the time of the discussions, mostly on account of higher projected nontax revenues. This is still some ¼ percentage points higher than the authorities' original target (based on revised GDP). For 2005, the MoF prepared a draft budget that is consistent with the deficit target of the medium-term fiscal plan. Discussions on the budget will resume when the new government is fully installed.

Public Information Notice (PIN) No.04/93
FOR IMMEDIATE RELEASE
August 17, 2004

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

IMF Concludes 2004 Article IV Consultation with the Czech Republic

On August 6, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Czech Republic.[1]

Background

EU accession marks the formal completion of the Czech Republic's transition to a market economy. Despite a solid performance in recent years—moderate growth, low inflation, moderate public and external debt, and one of the highest per capita incomes among the accession countries—stubborn problems cloud the outlook. Growth remains sluggish compared with the other accession countries; fiscal deficits continue to drift upward, led by rising expenditures; adverse demographic trends portend unsustainable pressures on the budget; and long-term unemployment continues to rise. These trends are shared with many advanced economies. But with its lower per capita income, the Czech Republic cannot afford to delay remedial measures.

Rising growth, low inflation, and a narrowing trade deficit characterized recent performance. GDP expanded by 3.1 percent in 2003 and the first quarter of 2004, mainly supported by household consumption (reflecting rapid real wage growth and robust consumer credit expansion). Investment was also strong in 2003—driven by spending on public infrastructure—and swelled in early 2004 due to one-off influences associated with EU accession. But

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[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 and this PIN summarizes the views of the Executive Board.

unemployment—particularly long-term unemployment—has risen and stands at about 8 percent. Despite strong import growth, favorable terms of trade helped narrow the trade deficit; competitiveness remains strong and the Czech Republic's share in EU markets continued to increase.

Since late 2003, inflation has been recovering from negative levels. Intense competition in the retail sector and an earlier appreciation of the koruna generated price declines during the first half of 2003. But rising consumer demand and a more recent depreciation brought a small upturn in inflation late in the year, and indirect tax increases in January and May 2004—driven in part by EU harmonization—pushed headline inflation above the bottom of the Czech National Bank's (CNB) inflation target band. However, excluding the effects of administrative measures, underlying inflation has risen only modestly, and remains below the target band.

Notwithstanding an improving trade balance, the current account deficit widened marginally to 6¼ percent of GDP in 2003. A secular decrease in the services surplus and a one-off drop in current transfers contributed. With privatization slowing and one-off Foreign Direct Investment (FDI) outflows on account of a change in ownership structure at two large foreign-owned companies, non-FDI flows were the major source of financing for the current account deficit in 2003. In early 2004, however, FDI rebounded.

Monetary conditions eased throughout 2003 owing to a cumulative 75 basis point cut in policy interest rates and a 5½ percent nominal depreciation of the koruna against the euro through January 2004. But with inflation forecasted to pick up, the inflation targeting (IT) CNB raised the repo rate by 25 basis points to 2.25 percent in late June 2004 to prevent a further decline in real interest rates. The CNB recently announced the parameters of its post-2005 IT framework, which shifts to a 3 percent point target with a tolerance band of ±1 percent, thereby ensuring continuity with the existing end-2005 target (2-4 percent).

The fiscal deficit continued to drift upward in 2003. The general government deficit—excluding privatization receipts and transfers to the Czech Consolidation Agency to cover the costs of managing bad assets—widened relative to GDP by about 1 percentage point to near 5 percent of GDP in 2003. The increase reflected mainly higher spending on subsidies, net lending, and investment. Nonetheless, public debt is still a moderate 28 percent of GDP and can be financed with ease, as the success of the recent inaugural eurobond issue illustrates.

Foreign investment has made an impressive contribution to the Czech economy. Among central European countries, the Czech Republic has attracted the largest amount of FDI on a per capita basis. Some 20 percent of the FDI stock represented privatization (mostly of banks and network utilities), with the remainder aimed at greenfield and brownfield activities. Foreign-owned firms account for more than one-third of industrial employment, nearly half of industrial output and value added, and over 70 percent of industrial exports. Foreign industrial firms are also considerably more profitable than their domestic counterparts.

Indicators of banking sector health continue to improve and bank lending—led by credit to households—is rebounding. The cleanup and privatization of banks in the late 1990s reduced nonperforming loans, injected new capital, and raised profitability, but for several years banks remained cautious about lending. Following the introduction of new mortgage and customer loan facilities into a largely untapped market, bank lending to households has risen at an annual rate of more than 30 percent for about two years, while lending to corporates remains stagnant.

Executive Board Assessment

Executive Directors welcomed the Czech Republic's accession to the European Union on May 1, which marks the symbolic end of the full transformation of the Czech economy into a market economy, and sets the stage for further convergence to EU income levels. They also commended the authorities for the solid economic performance over the past few years. The near-term outlook remains favorable, with growth expected to firm, based on robust exports and export-related investment.

While economic fundamentals generally remain strong, Directors emphasized the need for decisive action by the new government in key policy areas to enable the Czech economy to realize its full potential, and strengthen the foundation for a successful experience in ERM2 and the euro zone. In particular, fiscal policy implementation will need to be strengthened decisively to resist spending pressures, prepare for population aging, and cope with potential calls on government guarantees. Moreover, structural reforms need to be reinvigorated to sustain the Czech Republic's attractiveness as an investment destination, increase the flexibility of labor markets, and better tailor the education system to evolving skills demands.

Directors called for a strengthened commitment to the full implementation of the multi-year fiscal plan, the credibility of which has been weakened already in its first year. They urged the authorities to make strong efforts toward adhering to the expenditure ceilings, closing loopholes, and returning to the original nominal deficit target. To strengthen the credibility of the fiscal plan, Directors recommended a shift to a comprehensive fiscal measure—preferably the standardized European Union definition. Credibility would also be enhanced by building public support for the measures contemplated under the plan.

Looking ahead, Directors noted that considerable expenditure savings will be needed to fulfill the medium-term objective of the fiscal plan, and they urged the authorities to identify and implement the measures expeditiously. Directors cautioned against yielding to pressures for permanent expenditure increases in 2005, and urged bringing forward part of the expenditure savings needed to achieve the 2006 target. Any fiscal windfall from higher-than-expected revenues should be saved to support deficit reduction.

With the effects of population aging expected to impact public finances within 10-15 years, Directors considered that ambitious expenditure reforms will be needed to ensure long-term fiscal sustainability. They urged the authorities to expedite the reforms of the pension and health systems given the lags between the introduction of these reforms and their impact on public spending. They agreed that the reforms will need to encompass significant changes in pension system parameters, including a further rise in the retirement age and greater cost-sharing with final users of health care in order to contain demand. Timely implementation of these measures would help lower the deficit to well below Maastricht norms later in the decade in the run-up to joining the euro.

Directors underscored that reforms to strengthen the private sector and the attractiveness for foreign direct investment inflows will be key to raising longer-term growth. They welcomed the authorities' plans to resume privatization, through transparent and open procedures, and to close the National Property Fund and the Czech Consolidation Agency, and they urged them to resist pressures for additional bailouts. It will also be important to improve the business-legal environment, including through enactment of a bankruptcy law that enhances creditors' rights. Directors noted that external competitiveness measured by relative unit labor costs had improved during the past year, although by less than in several other central European countries. While the high quality of Czech labor may have helped support competitiveness, efforts should also be made to improve labor market flexibility. In this regard, Directors saw the need to further reduce non-wage labor costs and welcomed intentions to tighten the rules governing the eligibility for unemployment benefits. Efforts to improve the quality of education and training, as well as research and development activities, will also be important.

Directors saw the recent move to tighten monetary policy as an appropriate response to the changing economic circumstances. With the output gap projected to narrow, and in view of the negative real interest rates, Directors expected that monetary conditions will need to tighten further to keep inflation close to target, with decisions on the size and timing of rate increases carefully taking into account demand and cost push developments. Directors agreed that the flexible exchange rate regime has served the Czech Republic well. They commended the authorities' continued policy of nonintervention in the foreign exchange market, with the interest rate instrument providing markets with coherent and transparent signals about monetary policy intentions. Looking ahead, Directors generally saw continued implementation of inflation targeting as a sound anchor for monetary policy during the pre-euro period. They welcomed the authorities' gradual approach toward monetary integration, with emphasis on the need for further up-front progress on fiscal consolidation and structural reform.

Directors welcomed the continued improvement in the broad indicators of banking sector health. They commended the authorities' improved risk analysis, but stressed the need for enhanced supervisory capacity in the area of household credit, including through the collection of relevant data and enhanced stress-testing. Directors welcomed the planned consolidation of financial sector supervision within a single institution, but cautioned that organizational changes should not distract them from effective oversight.

Directors commended the Czech Republic's commitment to transparency and standards, as evident most recently from its participation in an update of the fiscal transparency module. They also welcomed the progress made by the authorities in aligning their national accounts and financial sector statistics with European standards.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2004 Article IV Consultation with the Czech Republic is also available.

Czech Republic: Selected Economic and Financial Indicators, 2001-03

	2001	2002	2003
Real economy (change in percent)			
Real GDP	2.6	1.5	3.1
Domestic demand	3.9	3.4	4.5
CPI (year average)	4.7	1.8	0.1
PPI (year average)	2.9	-0.5	-0.3
Unemployment rate (year average in percent)			
Survey based 1/	8.1	7.3	7.8
Registered 1/	8.5	9.2	9.9
Gross national savings (percent of GDP)	23.5	22.3	21.4
Gross domestic investments (percent of GDP)	28.9	27.9	27.6
Public finance (percent of GDP)			
General government revenue	36.7	37.5	38.9
General government expenditure 2/	41.7	44.2	45.1
General government balance 2/	-5.0	-6.7	-6.2
Adjusted to exclude grants to transformation institutions to cover costs related to management of bad assets	-2.8	-4.0	-4.9
Adjusted balance excluding net lending 3/	-2.7	-3.7	-3.9
General government debt	17.5	18.4	21.9
Including debt of the Czech Consolidation Agency	22.9	25.5	27.9
Money and credit (end of year, percent change)			
Broad money	13.0	3.5	6.9
Private sector credit (percent change, eop)	2.1	4.5	8.5
Interest rates (in percent)			
Three-month interbank rate (end-of-period)	4.7	2.6	2.1
10-year government bond	6.3	4.9	4.1
Balance of payments (percent of GDP)			
Trade balance	-5.0	-3.0	-2.7
Current account	-5.4	-5.6	-6.2
Gross international reserves (US$ billion)	14.5	23.7	27.0
Reserve cover (in months of imports of goods and services)	4.1	6.1	5.5
Fund position (as of May 31, 2004)			
Holdings of currency (percent of quota)			61.9
Holdings of SDRs (percent of allocation)			n.a.
Quota (millions of SDRs)			819.3
Exchange rate			
Exchange rate regime			Managed float
Koruna per U.S. dollar (July 19, 2004)			CZK 25.12 =US$1
Nominal effective exchange rate (2000=100)	104.4	116.1	115.6
Real effective exchange rate (CPI-based; 2000=100)	105.5	116.7	112.6

Sources: Czech Statistical Office; Czech National Bank; Ministry of Finance; and IMF staff projections.
1/ In percent of total labor force.
2/ Excluding privatization revenues of the National Property Fund and the Czech Land Fund, the sale of shares and voting rights by local governments, and the sale of Russian debt.
3/ General government deficit excluding transfer to transformation institutions and net lending. Concept targeted by the authorities.

Statement by Willy Kiekens, Executive Director for the Czech Republic and Jiri Jonas, Senior Advisor to Executive Director
August 6, 2004

On behalf of our authorities, we would like to thank the staff for the valuable policy discussions. The EU accession on May 1 marks the symbolic end of transition of the Czech Republic from a centrally planned to a market economy. The Czech economy is now officially recognized as a well-functioning market economy. However, this does not mean that the task of bringing the economy on a path of increasing prosperity is done. Far from it. But the nature of challenges that need to be addressed to ensure solid economic growth over the long run has changed. As the staff note, Czech policy makers now face similar challenges as policy makers in the more advanced economies.

The staff report notes that the resignation of the government of Prime Minister Spidla and the formation of new government led by the former Interior Minister Gross has increased political uncertainty and the risk of further fiscal drift. It also observes that the unpopularity of the medium-term fiscal plan with the electorate has contributed to the erosion of public support for the previous coalition government.

We would add two observations. First, it is too early to say how the previous government's fiscal plans will be implemented under the new government. As the staff's supplemental statement informs us, the coalition agreement includes a gradual reduction of fiscal deficit below 3 percent of GDP by 2008, supported by structural reforms, including pension and health care reform. The new government is expected to present its program to Parliament in late August. Second, voters' opposition to fiscal reforms may have contributed to the fall of the previous government, but we would argue that this was not the most important reason. As the staff note, fiscal consolidation has not yet begun in earnest. It would not augur well for future fiscal developments if even a plan of a relatively moderate fiscal adjustment would bring down the government.

Recent developments

The latest economic data broadly confirm the picture of a moderate recovery outlined in the staff report, driven by robust domestic demand, particularly private investment demand.

Real GDP grew by 3.1 percent in the first quarter of 2004, with fixed capital formation growing by 9.5 percent and household consumption by 3.9 percent. To a large extent, the rapid growth of investment demand reflected a sharp increase in building investment prior to the May change in the VAT. The solid growth of consumer demand was supported by growth of incomes and continued widespread use of consumer and mortgage credit. Net exports and government consumption contributed negatively to real GDP growth.

In the period January-May 2004, industrial production and sales both grew by about 10 percent, driven mainly by strong export sales. However, it is interesting to note that the gap between the growth of direct export sales and domestic sales is gradually diminishing, suggesting the growing role of domestic demand in supporting output growth. It is encouraging to note that despite the relatively fast growth of domestic demand, January-May 2004 trade deficit remained broadly unchanged from the same period last year. Both export and import growth accelerated, and it is expected that the EU entry will contribute to the continuation of this trend.

Inflation continues to rise gradually. In June consumer prices rose 2.9 percent y/y, while producer prices increased by 6.2 percent. While increase in consumer prices was affected mainly by changes in indirect taxes, and rise in food and oil prices, the increase in commodity prices was the main driving force of the increase in producer prices.

The latest Ministry of Finance macroeconomic forecast projects a somewhat faster real GDP growth in 2004 and 2005, by 3.1 and 3.2 percent respectively (compared to the previous forecast of 2.8 and 3.1 percent). In contrast, the CNB has revised downwards its earlier growth projection for 2004 (made last April) from 3.8-4.2 percent to 3.6-4 percent. In 2005, it projects an acceleration of real GDP growth to 3.5-4.9 percent, driven mainly by a more robust demand in the European Union. The CNB has also revised the projected consumer price inflation somewhat downward compared to its April 2004 forecast. Inflation is now projected to be 2.2-3.6 percent in June 2005 and 2.3-3.7 percent in December 2005.

Monetary and exchange rate policy

In response to the accelerating inflation, the CNB has increased interest rates from 2 to 2.25 percent. Markets expected that further interest rate increases will follow. However, there is some uncertainty how fast and how far this increase will go. Markets are pricing a further increase of 75 basis points by the end of 2004, even though some market analysts point to muted underlying inflation and suggest that the increase could be more gradual.

In considering the arguments for a further interest rate increase, the CNB will, *inter alia*, take into account the fact that real interest rates are presently negative. In the absence of a large negative output gap, a prolonged period of negative interest rates may not be optimal in an economy where actual growth exceeds potential growth. Moreover, continued elevated oil prices suggest that the risk of secondary effects of these developments on inflation expectations and inflation cannot be underestimated.

On October 13, 2003, the government approved a document prepared jointly with the CNB called "Czech Republic's euro adoption strategy." This document stipulates that under the assumption of successful observation of the Maastricht criteria, particularly the consolidation of public budgets, and under the assumption of a sufficient degree of real convergence and progress in structural reforms, the adoption of euro could be expected in 2009-10.

Regarding the successful functioning within the ERM2 framework, the document emphasizes the need for a sufficient alignment of the Czech economy with the euro area in real and financial sectors, as well as further progress in structural reforms and increased flexibility of labor market. However, even if these conditions are met, the CNB does not consider participation in the ERM2 as risk-free. In order to minimize there risks, it has recommended the shortest possible stay.

As part of the strategy of the euro adoption, the CNB has clarified the monetary policy framework for the period 2005-2010. The CNB has decided that in the period after 2005 when the present policy strategy expires, it will continue to implement an inflation targeting framework. Specifically, the CNB will aim at keeping inflation at 3 percent plus/minus 1 percentage point. The CNB thinks that this objective is sufficiently ambitious to allow stabilization of inflation at a level that would allow it to meet the Maastricht inflation criterion, but at the same time, it takes into account the specific needs of the converging economy.

Fiscal policy

Fiscal policy remains the most difficult challenge. While some progress has been achieved in addressing the deterioration in public finance, it is clear that the measures implemented thus far are not sufficient to ensure a long-term sustainability of public finance.

In recent years, there has been a continued increase in general government deficits. This deterioration has continued even as real GDP growth doubled in 2003 compared with 2002. This clearly suggests that the budget deficits are mainly of a structural and not cyclical nature. To a large extent, increasing budget deficits reflect the rapid growth of mandatory spending. However, the deterioration of public finance also reflects transformation-related costs and the costs related to the EU accession. In recognition of the unsustainable trends in public finance, the government has approved in June 2003 a reform of public finance. Expenditure and revenue measures are supposed to reduce the general government deficit to below 4 percent of GDP in 2006.

It is encouraging to note that the reform measures adopted thus far have already brought some positive -though limited- results. Tightening of eligibility for sickness benefits contributed to a decline of these benefits in January-May 2004 by CZK 2.7 billion relative to the same period of the previous year. In contrast, other categories of social spending where no reform has been implemented continued to grow in 2004. The number of public sector employees has been reduced by over 9000, and total wage spending has remained largely unchanged, despite the increase in average salary by 9 percent.

The staff welcomed the adopted measures, but at the same time, have raised valid concerns. First, the staff note the insufficient coverage and enforcement of expenditure ceiling. Second, the upward revision of the GDP level means that budget deficit targets in terms of GDP could be met with higher nominal deficits. The staff call for adhering to original nominal targets. Third, the staff note that significant additional measures – mainly expenditure reduction - will be required to reduce the deficits in 2005-06 as originally planned. However, delivering spending cuts as the election scheduled for 2006 approaches could be difficult.

The Minister of Finance remains committed to keep the public finance reform on track, enforce the spending ceilings, and avoid using any potential excess revenues to increase budget spending, as prescribed by the budgetary rules. Moreover, it should be noted that fiscal policy of the new government will have to be guided by the May 2004 convergence program.

From the longer-term perspective, it is now widely recognized by the political representatives and the public that a more fundamental reform of public finance will be needed to ensure their long-term sustainability. New demographic projections released by the Czech Statistical Office at the end of 2003 point to significant medium- and long-term pension and health care spending pressures. To address this problem, all parliamentary parties have established a commission of experts to formulate alternative proposals for pension reforms. Similarly, work is underway on a comprehensive reform of the health care system. However, legislative steps are unlikely before the next election.

Structural issues

The staff has correctly identified high unemployment as another serious problem that needs to be tackled urgently. Not only does unemployment remain high, but also the share of the long-term unemployed is increasing, suggesting serious problems hampering the efficient functioning of the labor market. Reform of the labor market is desirable for several reasons: (1) to stimulate employment and increase economic growth that would also support faster reduction of fiscal deficit; (2) to prevent the creation of a large number of difficult-to-employ persons; and (3) to increase the flexibility of the economy and to prepare it better for euro adoption.

It is encouraging that recently, the growth of unemployment has stopped and the unemployment rate has even declined from 10.2 to 9.9 percent. Nevertheless, the main problems of the Czech labor market –skill and regional mismatch exacerbated by disincentives for some categories of unemployed to search more actively for jobs– are structural and cannot be addressed by higher growth.

These mismatches and disincentives require different policy responses and can bring positive results with different time lags. Reducing disincentives to search for jobs can bring the fastest results. In autumn, tighter rules for unemployment support should come into force. Persons unemployed for more than one year will be required to participate in public works to remain eligible for social benefits. Reducing regional mismatches would require a deregulation of rents, thus stimulating the housing market. This, too, can bring relatively quick results. As for skills mismatches, this could take more time to address, because it requires far-reaching changes in the education system.