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

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

Recent Developments

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

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

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

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

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

Structural Reforms

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

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

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

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

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

Fiscal Policy

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

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

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

Monetary Policy and Central Bank Autonomy

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

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

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

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