July 2001
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Czech Republic: 2001 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Authorities of 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 2001 Article IV consultation with the Czech Republic, the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **April 18, 2001**, 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 June 28, 2001.** 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 supplement of **July 13, 2001,** updating information on recent economic developments.
- a Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during its July 16, 2001, discussion** of the staff report that concluded the Article IV consultation.
- a statement by the authorities of the Czech Republic.

The document(s) listed below have been or will be separately released.

Financial Sector Stability Assessment
Report on Observance of Standards and Codes—An Update
Selected Issues and Statistical Annex

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

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INTERNATIONAL MONETARY FUND

CZECH REPUBLIC

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the
2001 Consultation with the Czech Republic

Approved by Jacques Artus and Leslie Lipschitz

June 28, 2001

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I. Introduction

1. The 2001 Article IV consultation discussions with the Czech Republic were held in Prague during April 5–18, 2001.[1] The mission met with Czech National Bank (CNB) Governor Tuma, outgoing Finance Minister Mertlik, several members of the CNB Board, senior officials in government ministries, the CNB, and the Czech Statistical Office, members of parliament, labor unions, financial market representatives, the European Union (EU) delegation, and senior managers in a large foreign-owned and in a large state-owned company. Mr. Jonaš (Advisor to the Executive Director) participated in the discussions. The Czech Republic had its financial sector stability assessed in a Financial Sector Assessment Program (FSAP), and FSAP missions took place in November 2000 and February 2001.

2. The Czech Republic has accepted the obligations under Article VIII, Section 2(a), 3, and 4 as of October 1, 1995, and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. The Czech Republic meets the Special Data Dissemination Standard (SDDS) specifications for coverage, periodicity, and timeliness of the data (see Appendix III on statistical issues). In general, data quality is adequate for assessing the macroeconomic situation. The Czech Republic ratified the 1997 OECD Convention Against the Bribery of Foreign Public Officials in International Business Transactions on January 21, 2000, and the Convention came into force on March 21 of the same year. In March 2000, the OECD evaluated the Czech Republic's record in implementing the Convention and concluded that legislation was missing in only one area, namely the absence of criminal responsibility of legal entities (such as corporations) for criminal acts of bribery.[2]

3. In concluding the 2000 Article IV consultation on July 26, 2000, Executive Directors commended the Czech authorities for the prudent and coherent set of macroeconomic policies that contributed to the economic recovery. But they noted that, for the future, policies would need to strike a balance between sustaining the recovery and achieving medium-term objectives, notably fiscal sustainability. They recommended maintaining the accommodative stance of monetary policy while inflation was still low and until the recovery was firmly established, but called for a stronger fiscal position, should the recovery gather

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[1] The team comprised Mr. Takeda (head), Ms. van Elkan, and Mr. Tzanninis (all EU1), and Mr. Nord, the Fund's Regional Resident Representative in Central Europe; Messrs. Petersen (MAE) and Rocha (World Bank) participated in a part of the mission to conduct discussions on the Financial Sector Assessment Program.

[2] In the Czech Republic, as in several other OECD countries, criminal liability extends only to natural persons; not legal persons. The government is currently preparing a new Criminal Code, which will, among other things, incorporate criminal liability for legal persons, as required by several international treaties.

momentum. Directors also advised accelerating the pace of structural reform, including bank privatization, legal reform, and implementing a market-oriented approach to restructuring a few large enterprises.

4. The political situation remains fragile, with the Social Democratic (CSSD) minority government continuing to rely on an agreement with the main opposition party (ODS) that the latter will refrain from casting a no-confidence vote in exchange for key parliamentary posts and policy concessions. Lower house elections are scheduled to take place in mid-2002, which makes politically sensitive reforms more difficult and popular spending plans more tempting in the near term. Mr. Tuma, formerly Deputy Governor at the CNB, was appointed as the new Governor in November 2000. During the mission, Finance Minister Mertlik resigned and was replaced by Mr. Rusnok, who previously held the post of Deputy Minister of Labor and Social Affairs.

II. Background

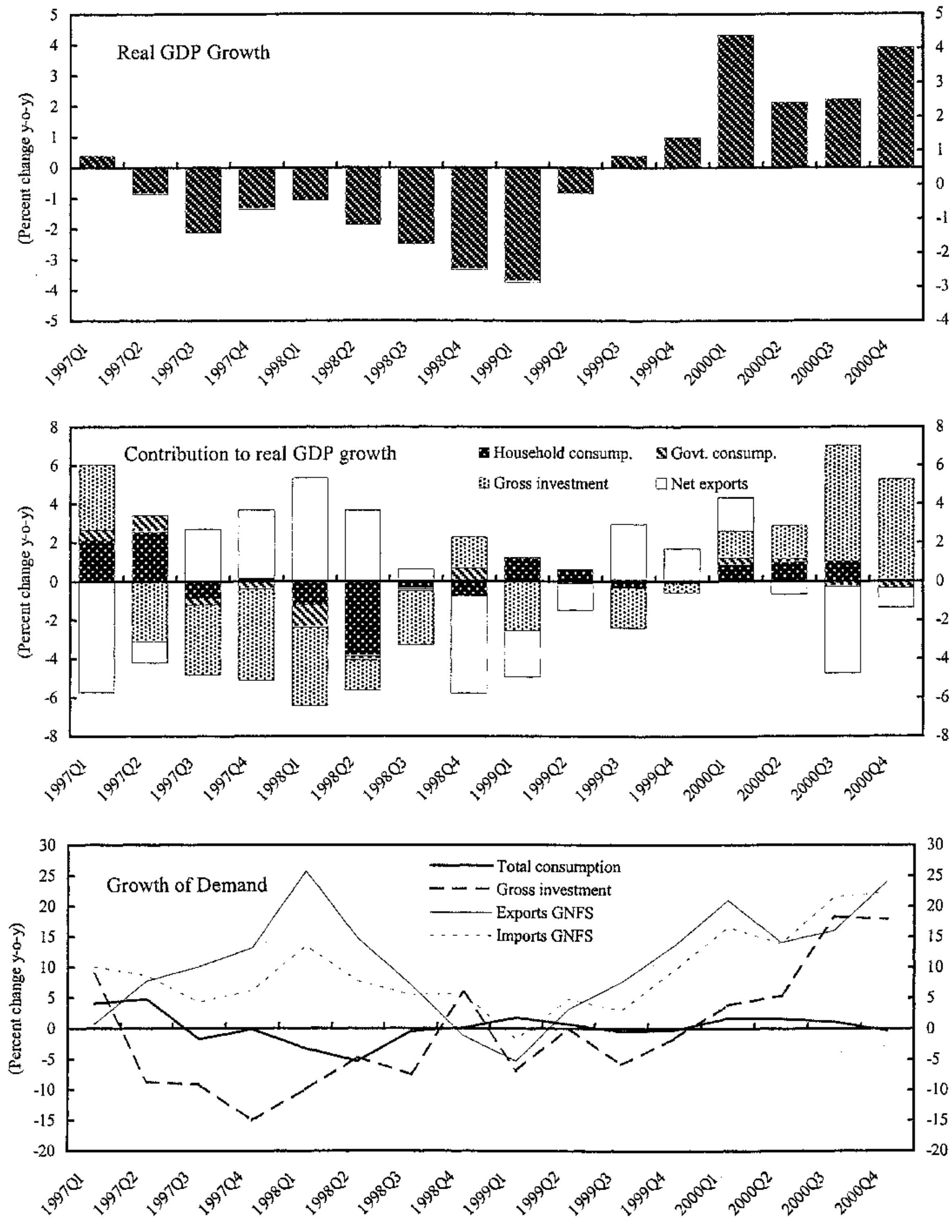
A. Recent Economic Developments

5. **Following a recession dating back to the currency crisis in 1997, a recovery in the Czech Republic began in 1999** (Figure 1 and Table 1). Growth of real GDP registered a moderate 3.1 percent in 2000, and activity remained strong in early 2001, with industrial production and construction output in the first four months of the year rising by 10 percent and 15 percent, respectively, compared with the previous year (Figure 2). Growth has been supported by a revival of investment reflecting strong foreign direct investment (FDI), and moderate real wage growth underpinned a modest increase in household consumption. Demand from the EU led to strong export growth, but imports (primarily of investment goods) grew even faster, generating a negative contribution from the external sector.

6. **The expansion has been uneven.** Vibrant, export-oriented firms with foreign participation are leading the recovery, benefiting from better organization and technology as well as access to credit and markets abroad. They are the source of high export growth (see paragraph 9), and are gradually strengthening the economy's competitiveness. At the same time, a large number of less dynamic firms in the traditional enterprise sector are in need of restructuring and continue to face losses and overdue debt service. However, the base of growth is broadening, as an increasing number of local companies are beginning to benefit—primarily as suppliers of components—from the presence of foreign-owned companies.

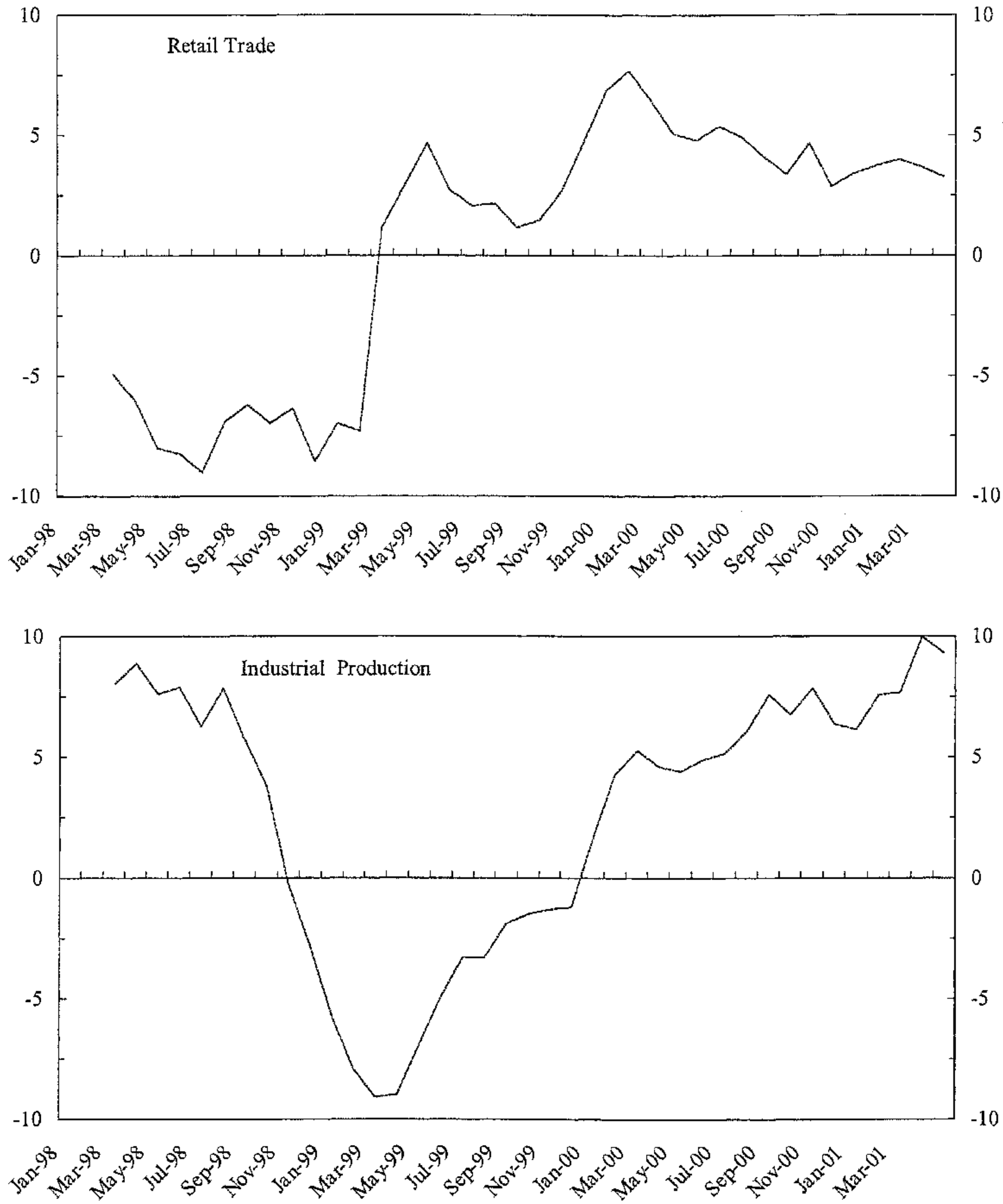
7. **The uneven nature of the expansion has dampened the recovery in employment.** Employment began to increase from the second quarter of 2000, as new job creation outweighed layoffs from enterprise restructuring; however, employment remains below the average level for 1999. The rise in employment and a drop in labor force participation reduced the unemployment rate, but only marginally from a seasonally adjusted peak of 9½ percent at end-1999 to about 8¾ percent in early 2001, a level still close to historical

Figure 1. Czech Republic: Developments in GDP, 1997-2000



Sources: Czech Statistical Office; and Fund staff calculations.

Figure 2. Czech Republic: Retail Trade and Industrial Production, 1998-2001
(3-month moving average, year-on-year growth in percent)



Sources: Czech Statistical Office; and Fund staff calculations.

highs (bottom panel of Figure 3).[3] This has helped restrain wage demands well within productivity growth.[4] While all regions have recently experienced a drop in the unemployment rate, large regional disparities in unemployment remain, owing to the low mobility of labor. As a result, tight labor market conditions have emerged in some areas, while in many other areas, unemployed persons greatly outnumber job openings.[5]

8. **Absent major domestic inflationary pressures, a modest pickup of inflation has been due mostly to external factors.** Consumer price inflation ended 2000 at 4 percent (12-month rate), 1.5 percentage points higher than in the previous year, owing to temporary external factors such as higher imported fuel costs and a strong U.S. dollar (see top panel of Figure 3). The recent pickup was mainly due to the rise in fuel and food prices. Domestic price pressures continued to be generally weak due to strong competition in the retail sector and moderate wage demands. Net inflation targeted by the CNB (which excludes administered prices and the impact of indirect tax changes) was 3 percent at end-2000, below the CNB's target range of 3.5–5.5 percent, and has remained moderate so far in 2001.

9. **Deteriorating terms of trade and strong imports of capital equipment led to a significant widening of the trade and external current account deficits in 2000, but this has been amply financed by FDI inflows.** The current account deficit expanded from 3 percent of GDP in 1999 to 4.8 percent of GDP in 2000, as the trade deficit doubled to 6.6 percent of GDP, despite export volume growth of nearly 20 percent (Figure 4 and Table 2). Higher oil costs are estimated to have added about 1.5 percentage points of GDP to the import bill, while in volume terms, imports of capital goods and intermediate products grew strongly in 2000, with capital goods imports growing even faster in the first four months of 2001. FDI inflows continued to dominate the financial account. Incoming FDI reached 9 percent of GDP in 2000—following inflows of about 12 percent of GDP in 1999. On a net basis, though, inflows were more subdued, as a capital account liberalization measure and the narrowing of the interest rate differential between koruna- and euro-denominated assets led to a pickup in residents' outflows. Consequently, the koruna has strengthened only modestly since early 2000 vis-à-vis the euro as well as in nominal effective terms.

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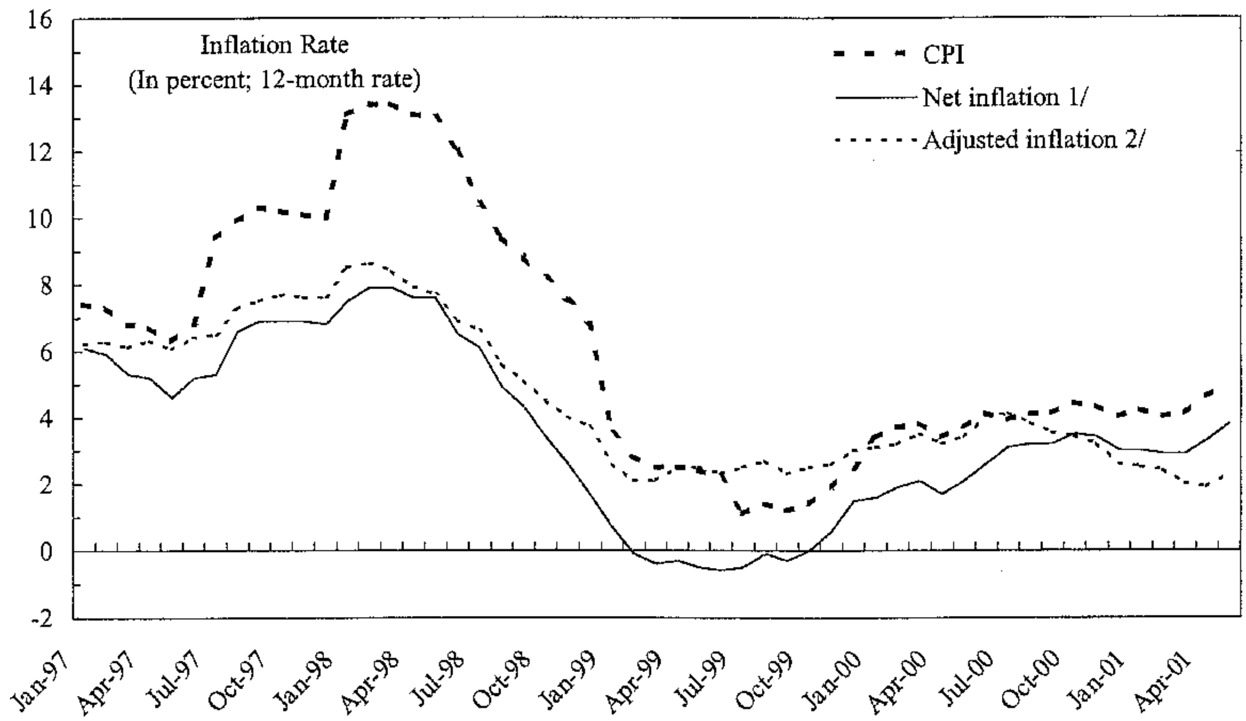
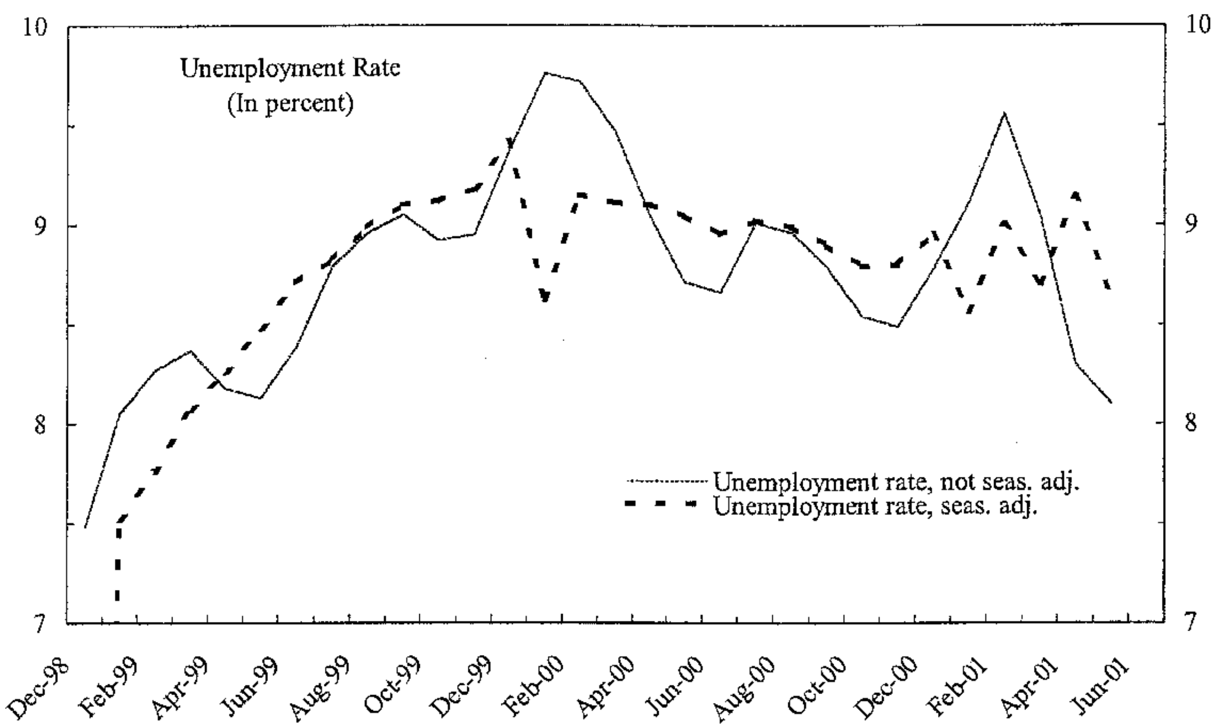
[3] The decline in labor force participation reflects in part a shift by older workers to early retirement ahead of a change in the pension system in 2001 that reduced the generosity of benefits for early retirees.

[4] Labor productivity in industry (in constant prices) grew 8 percent in 2000 and was rising by 8.3 percent in the first four months of 2001, more than twice the rate of growth of real wages.

[5] In April 2001, Prague-West had an unemployment rate of 2.3 percent compared with 20.9 percent in the north-western region of Most.

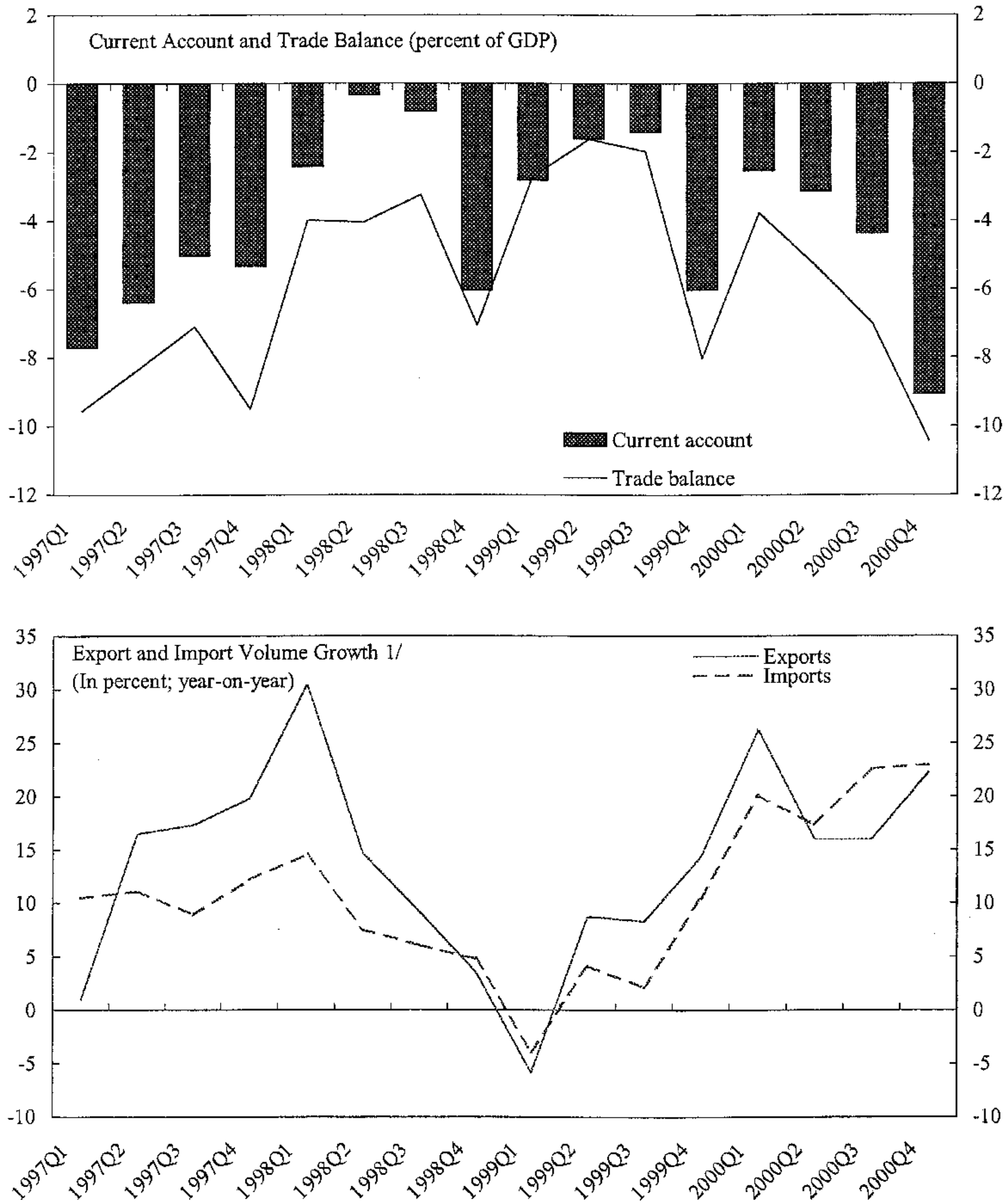
Figure 3. Price and Unemployment Developments, 1997-2001





Sources: Czech National Bank; Czech Statistical Office; and Fund staff calculations.
1/ Net inflation is CPI inflation excluding administered prices and the effects of changes in indirect taxes.
2/ Adjusted inflation is net inflation excluding effects of changes in food prices.

Figure 4. Czech Republic: External Current Account and Trade Developments, 1997-2000



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

1/ Based on quarterly national accounts data (exports and imports of goods at constant prices).

10. **Monetary conditions have been broadly constant, with a decline in real interest rates offsetting the appreciation of the koruna in real effective terms** (Figures 5 and 6). Against the background of subdued underlying inflation, the CNB reduced its two-week repo rate (the key policy rate) from 5.25 percent, where it had remained since November 1999, to 5 percent in February 2001. Market interest rates tracked the cut in the policy rate (Figure 7). Still, the low interest rate environment and the pickup of economic activity have yet to be accompanied by a resumption of credit growth. Adjusted credit to the nongovernment sector declined by 0.3 percent in 2000 and was still contracting by 0.6 percent (year-on-year) at end-April 2001.[6] This reflected the chilling effect on lending activity of efforts by management of newly or soon-to-be privatized large banks to consolidate loan portfolios. It is also notable that credit to households and enterprises under foreign ownership rose in 2000, in contrast to declining credit to the traditional enterprise sector. With the privatization and the restructuring process of the banking system nearing completion, modest credit growth is expected in 2001, with a further pickup thereafter. In addition, ongoing efforts to strengthen creditor rights (see paragraph 13) should help banks resume broad-based credit activities.

11. **Fiscal policy has been expansionary.** Against the background of a still nascent recovery, the general government deficit—adjusted to measure more closely its aggregate demand impact and hereafter called the "adjusted" deficit—increased by nearly 1 percentage point to 4.1 percent of GDP in 2000, imparting a fiscal stimulus (see Text Table below).[7, 8] With tax revenues rising in line with nominal GDP, the increase in the deficit-to-GDP ratio reflected the rapid growth of expenditures, particularly transfers to nonfinancial

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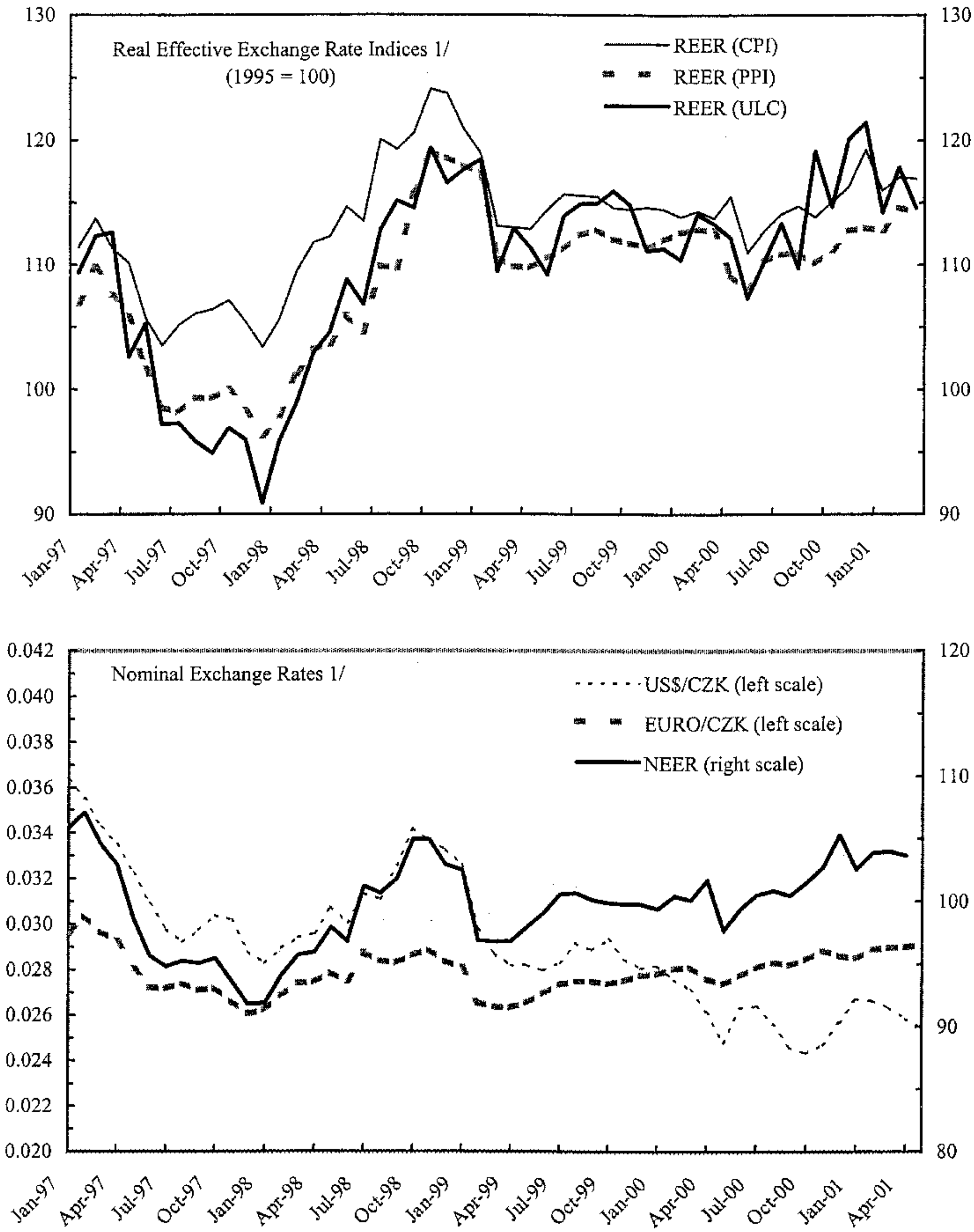
[6] Adjusted credit takes into account loan write-offs and operations linked with restructuring of loan portfolios.

[7] The "adjusted" deficit is defined as the deficit measured according to GFS methodology (the concept used by the MoF), less privatization receipts and proceeds from the sale of UMTS licenses, plus grants to transformation institutions.

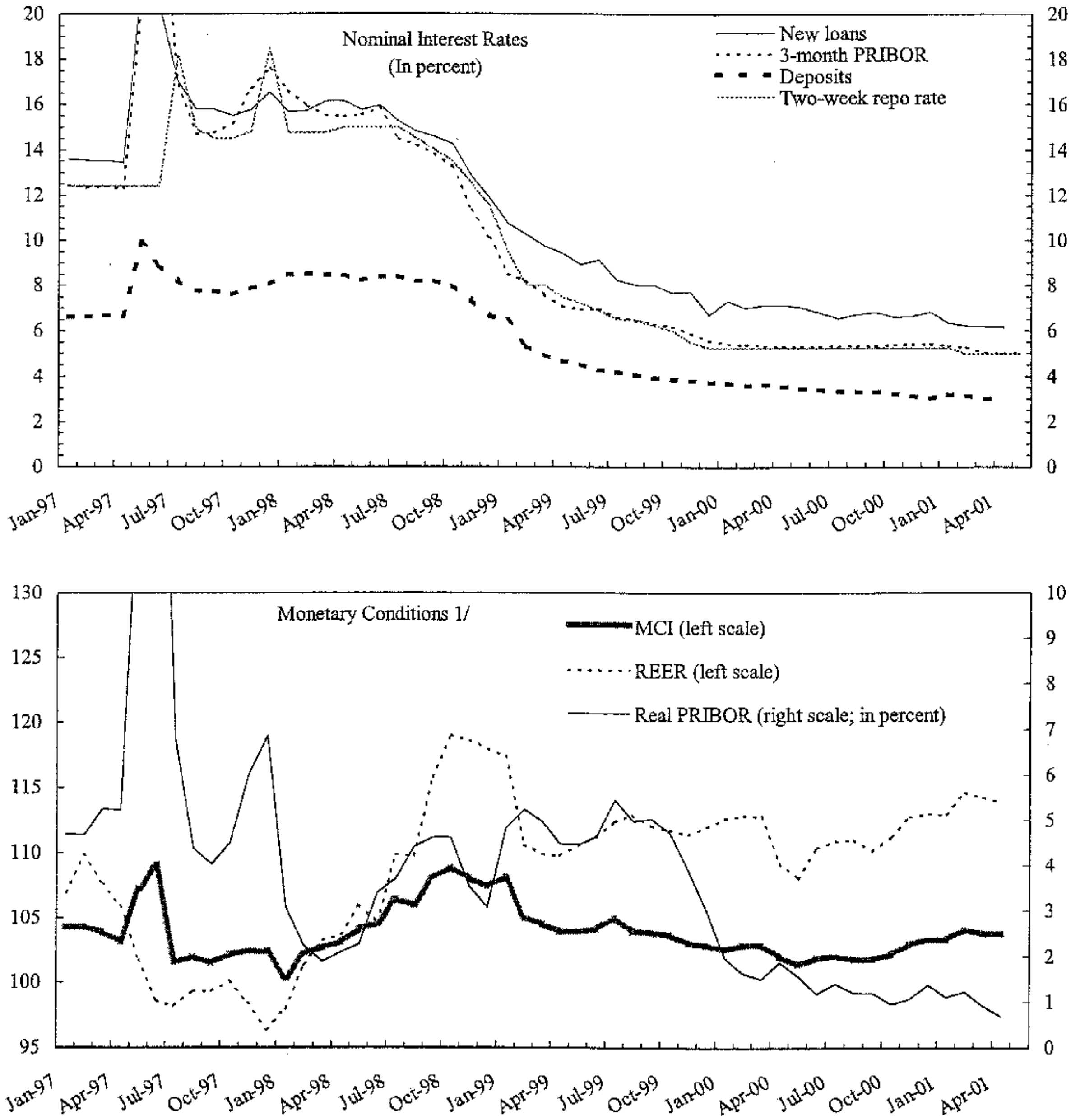
[8] Evaluation of the cyclically adjusted impact of fiscal policy ultimately relies on estimates of potential output and of the output gap. The ongoing restructuring of the traditional enterprise sector and the rising FDI inflows—which are raising productivity levels in the dynamic sector of the economy—make it particularly difficult to estimate potential growth or the output gap from data. The staff considers that potential growth is, at present, somewhat above the actual-growth forecast of 3–3.5 percent for this year, and hence, the output gap will widen, albeit slightly. This implies that the 1.6 percentage point expansion in the adjusted fiscal deficit expected in 2001—see Text Table in this paragraph—translates into a somewhat smaller deficit expansion on a cyclically adjusted basis. A sizable, though declining, unemployment rate suggests that the extent of the output gap remains considerable.

Figure 5. Czech Republic: Exchange Rate Indicators, 1997-2001



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

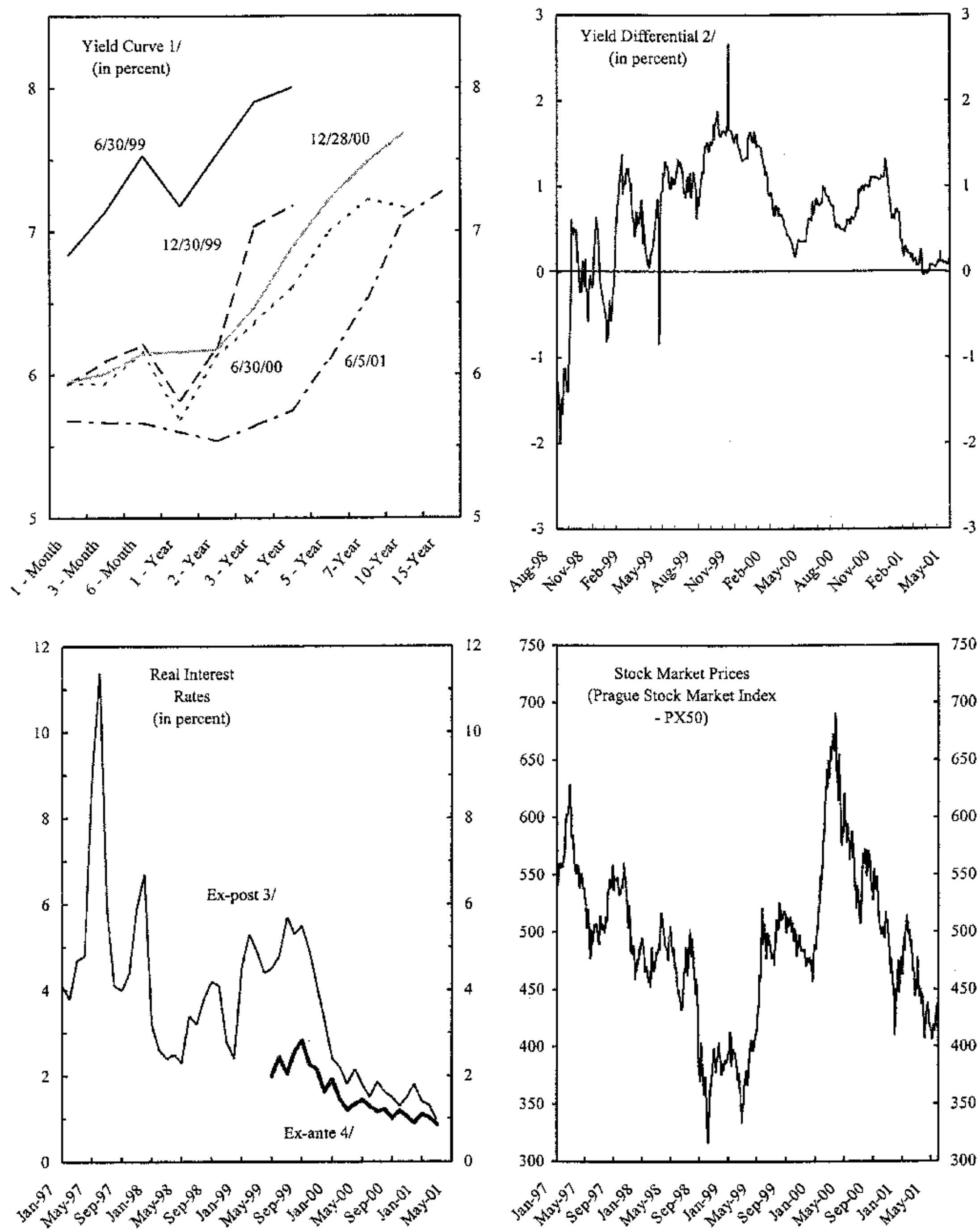
Figure 6. Czech Republic: Interest Rates and Monetary Conditions, 1997-2001



Sources: Czech National Bank; and Fund staff estimates.

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

Figure 7. Czech Republic: Selected Financial Market Indicators, 1997-2001



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

1/ Secondary market yields on government securities.

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

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

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

Text Table. Adjustments to the Ministry of Finance's Presentation of the Fiscal Data, 1998–2001

	1998	1999	2000	2001 MoF proj.
(In billions of CZK)				
Overall general government balance (MoF data)	-28.2	-10.5	-62.7	-20.5
(in percent of GDP)	-1.6	-0.6	-3.3	-1.0
Privatization (-)	24.9	56.6	33.8	200.4
National Property Fund	15.5	26.0	20.5	168.9
Local governments	9.5	30.6	13.3	11.5
Proceeds from sale of UMTS licenses	0.0	0.0	0.0	20.0
Headline fiscal balance	-53.1	-67.2	-96.5	-220.9
(in percent of GDP)	-3.0	-3.7	-5.1	-10.8
Grants to transformation institutions (+)	18.4	7.7	17.3	104.8
Adjusted fiscal balance	-34.7	-59.4	-79.1	-116.1
(in percent of GDP)	-1.9	-3.2	-4.1	-5.7

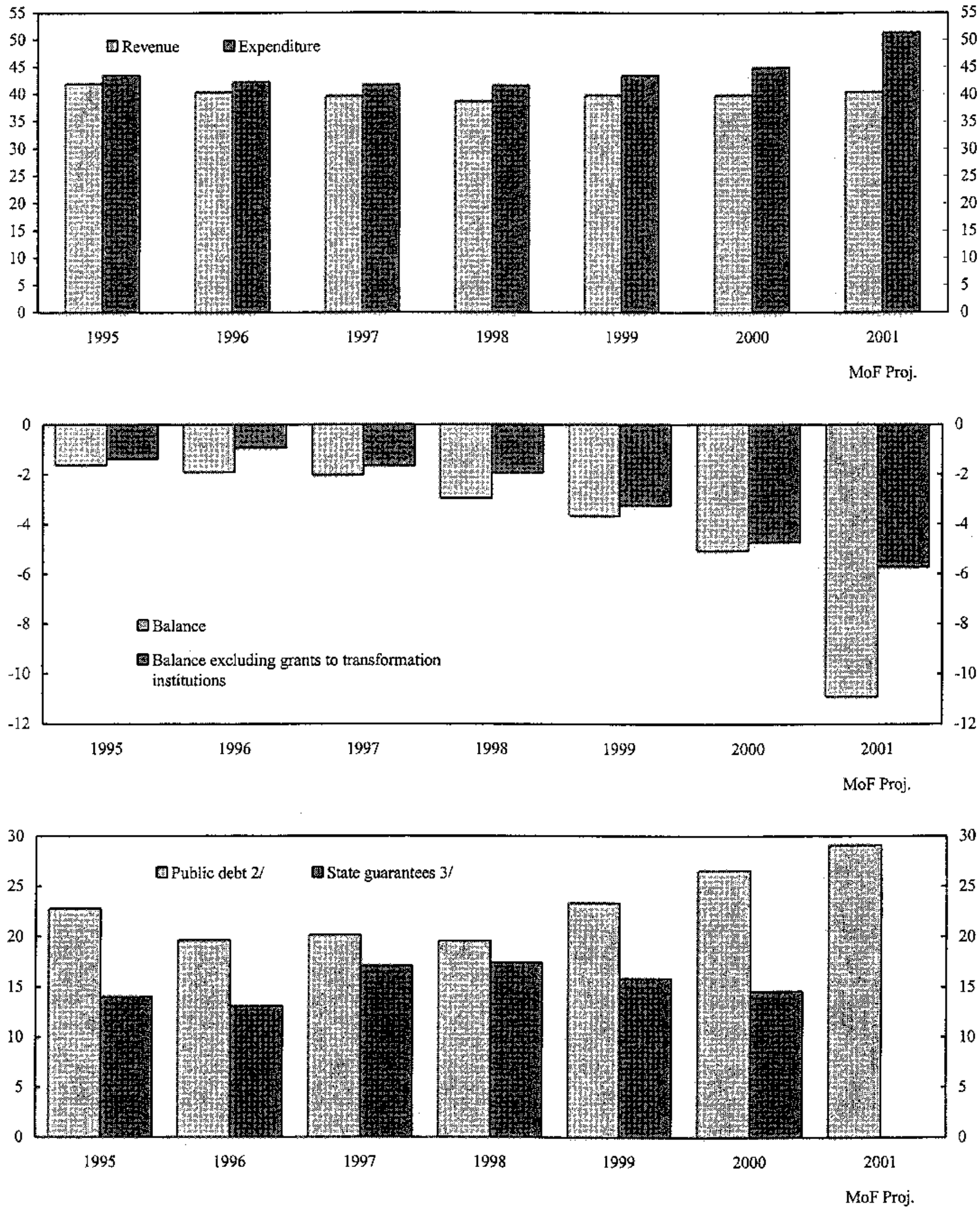
Sources: Ministry of Finance; and Fund staff calculations.

enterprises, social benefits, and capital expenditures (Figure 8 and Table 3). In addition, grants to transformation institutions—primarily designed to cover bank restructuring costs—added a further 1 percentage point to the headline (unadjusted) deficit.

12. **On the structural reform front, progress has been mixed.** Legislative reform has continued apace, and the European Commission's (EC's) 2000 Regular Report noted a significant acceleration in the rate of alignment with the EU's *acquis communautaire.* The Czech Republic has provisionally closed 19 of 29 negotiating chapters, and is considered to be among the front-runners toward EU accession. With the imminent privatization of Komerčni banka (KB), the last major state-owned bank, the banking sector will soon be largely foreign owned. Nevertheless, cleaning up the banks resulted in the accumulation of a very large stock of nonperforming assets in the portfolio of Konsolidačni banka (KoB), the state work-out bank, and the pace of their disposal has been slow.[9] Further large-scale

[9] The FSAP mission estimated that the remaining fiscal cost—including guarantees related to KB and IPB, the latter of which was put under forced administration by the CNB in June 2000—could reach some CZK 300 billion (just under 15 percent of 2001 GDP), to be paid out during 2001–05.

Figure 8. Fiscal Operations of the General Government, 1995-2001 1/
(In percent of GDP)



Sources: Czech Ministry of Finance; and Fund staff estimates.
1/ Excluding privatization revenues.
2/ Debt of general government and liabilities of transformation institutions. For 2001, assumes liabilities of transformation institutions are unchanged from 2000.
3/ Includes a CZK 33 billion guarantee maturing in 2002 that is not included in official reported statistics. Excludes guarantees of the NPF.

privatization is slated for the coming two years, concentrated in the telecom and energy sectors. The state of international markets may delay this process, however.

13. **Creditor rights have been strengthened, but there remain areas of weakness.**[10] The amendment to the Bankruptcy Act in May 2000 has introduced some positive changes, including more equitable rules regarding the appointment and operation of the bankruptcy administrator. Nonetheless, secured creditor rights appear weakened by the requirement that 30 percent of net recoveries from enforcement of collateral lose priority and fall into the general creditor pool, contrary both to international best practice and to the incentives and goals of stimulating bank lending. Also, the possibility for the courts to dissolve the creditors' committee without well-founded reasons effectively threatens the creditors and weakens their control over the choice and the actions of the liquidator. Moreover, enforcement of existing laws and regulations is also often unsatisfactory, introducing delays and uncertainty into the judicial process.

14. **Corporate restructuring is proceeding—albeit slowly.** Corporate sector financial performance has begun to improve, with the return on assets increasing significantly in the first half of 2000, while leverage ratios declined. But a large segment of the corporate sector—accounting for the bulk of bad assets that have been, or will be, transferred to KoB—continues to generate losses and remains highly indebted. Bankruptcy proceedings have been initiated against some of these enterprises, but progress is very slow. Accelerating the sale of KoB's bad assets is expected to foster the restructuring of viable enterprises. To address some of the largest enterprises, the government introduced a Revitalization Program in 1999, under the auspices of KoB, to facilitate restructuring.[11] Out of the original nine enterprises in the Program, two have been sold and privatization is advancing in a further four. However, difficulties in convincing other creditors to restructure their claims has slowed the process.

B. Prospects

15. **Despite favorable dynamics in the domestic economy, the staff projects that economic growth will not accelerate substantially in 2001, owing to the deterioration in global economic conditions.** A positive medium-term outlook for the economy is expected to sustain strong investment demand (largely from foreign sources) in 2001, which will continue to be the main driving force of growth. The momentum of consumption is expected to build further this year as total employment expands and real wages continue to rise

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[10] "Czech Republic—Completing the Transformation of Banks and Enterprises," Country Study, World Bank (Washington, November 2000).

[11] Initially, the responsibility for the formulation and the implementation of the Revitalization Program fell in the hands of the state-owned Revitalization Agency (RA), which was established in 1999 as a subsidiary of KoB. In early 2001, the RA was abolished and the execution of the Program is now the direct responsibility of the KoB.

modestly. With weakening demand in the EU though, export growth is expected to slow. As a result, the pace of intermediate goods imports will decline, but imports of capital equipment will remain buoyant, resulting in a negative growth contribution from the external sector. On balance, the staff expects this year's real GDP growth rate to be around 3–3.5 percent, but with an acceleration next year if the external environment improves. Given the likely increase in potential growth that occurred as a result of past FDI, a growth rate of 3–3.5 percent this year would imply some further widening of the output gap.

16. **With external price pressures waning, inflation will remain moderate, while the weaker external environment will preclude a reduction in the current account deficit.** Slowing external demand, lower world oil prices, and under-utilized factors of production (particularly labor) are expected to moderate price pressures resulting from higher domestic demand, helping to keep headline inflation around 4 percent in 2001. The outlook for 2002 is for inflation to rise somewhat, to 4–5 percent, as the moderating influence of those factors dissipates and domestic demand gathers momentum. On the external current account, growing household consumption and a slowdown in trading partner countries are expected to balance the effect of lower oil prices, a weaker U.S. dollar, and a boom in FDI-related provision of services to foreign investors, to keep the deficit near 5 percent of GDP. The current account deficit is expected to be amply financed by FDI inflows, which could exceed US$8 billion (about 15 percent of GDP) this year if the government's privatization plans are fully realized. Some further modest outflows of short-term capital may take place, depending on the interest rate differential between the Czech Republic and abroad, but these would not be expected to jeopardize the external position. The reserve position is expected to remain comfortable in 2001 at around four months of imports.

17. **The baseline macroeconomic scenario for 2001 is subject to considerable uncertainty associated with the prospects for external demand, a principal driving force behind growth in the Czech Republic.** A deeper or more protracted slowdown in Europe could result in a sharper-than-envisaged decline in export growth, and could temporarily slow incoming FDI, thereby reducing investment demand and financing of the current account deficit;[12] in this case, the growth rate this year could fall somewhat below 3 percent. Nevertheless, vulnerability indicators—including external debt and international reserves ratios—and recent improvements in the structure of the real economy suggest that the Czech Republic is now more resilient than it was in the mid-1990s to cope with a temporary shock of this sort (Table 4). Should the slowdown in external demand be short-lived or its effects not fully felt in the Czech economy, though, growth in 2001 could surpass 3.5 percent.

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[12] As a small open economy with strong trade and investment links with the EU, the Czech Republic is susceptible to conditions in its western neighbors, particularly Germany, which absorbs 40 percent of Czech exports and supplies more than a third of FDI.

III. REPORT ON THE DISCUSSIONS

18. **With the recession behind them, the Czech authorities can turn their attention fully to the task of securing EU accession at an early date.** Having made virtually no progress since the mid-1990s toward the target of income convergence, the authorities are now keen to get a jump start on the process, and the discussions focused on how to achieve a steady and sustainable growth path. The two main themes were:

- The appropriate policies to sustain and extend the recovery in private sector demand, in light of the need to put public finances on a sustainable footing and given a likely slowdown in external demand; and

- Ways to enhance the supply side of the economy and maintain external competitiveness over the longer run in order to facilitate rapid convergence of real incomes to EU levels.

A. Fiscal Policy[13]

19. **The 2001 general government budget implies that financing needs will increase sharply, primarily reflecting transitory items, to be covered by large privatization receipts.** Costs associated with EU accession (estimated by the MoF at about 2 percent of GDP) and enterprise sector reform are budgeted to boost the adjusted fiscal deficit by some 1½ percentage points, to 5.7 percent of GDP. In addition, grants to transformation institutions to cover bank restructuring costs will add over 5 percent of GDP to the headline deficit. The authorities are relying on privatization proceeds of some 9.8 percent of GDP to cover most of the financing requirement.

20. **The mission's discussions with the authorities revealed that fiscal policy in 2001 might be more expansionary than envisaged in the budget.** A more realistic assessment of tax revenue would lower revenue forecasts this year by about 1 percent of GDP relative to the budget (see Table 1).[14] In addition, some risk of additional spending exists under the auspices of a government plan to boost near-term growth and reduce regional income disparities, known as the "Big Bang" plan (Box 1). A number of other factors may mitigate the headline deficit, including smaller-than-expected bank restructuring costs to be covered by the state budget this year and one-time revenue from the sale of Russian debt. However, these factors do not influence the budget's impact on aggregate demand. It is nevertheless

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[13] The Minister of Finance resigned several days into the mission, and this report partly reflects discussions in Washington with the new Finance Minister subsequent to the mission.

[14] The budget assumes that value-added tax (VAT) revenues will increase by more than 17 percent in 2001 (against the authorities' projection of nominal consumption growth of 6½ percent), with no changes in tax rates. This reflects in part unrealistic expectations of yields from strengthened tax administration.

Box 1. "Big Bang" Stimulus Plan

Minister of Industry and Trade Gregr proposed in February 2001 (after parliament approved the 2001 budgets) a plan to spend CZK 100 billion (5 percent of GDP) and CZK 165 billion (8 percent of GDP) in 2001 and 2002, respectively, with the aim of boosting GDP growth to 4 percent this year and 5-6 percent in 2002, while reducing regional income disparities. The package, known as the "Big Bang" plan, would direct spending to economically depressed regions through construction of infrastructure and housing (7¾ percent of GDP) and the restructuring of state-owned mining and metallurgy enterprises and heavily-indebted industrial firms (3½ percent of GDP). The plan relies heavily on privatization receipts as its ultimate funding source.

For 2001, at least two-thirds of planned expenditures are a repackaging of already approved programs. The additional spending is intended to be used to stabilize and restructure heavily indebted firms. The new budgetary rules introduced this year grant the government very little flexibility to increase spending levels without seeking parliamentary approval – which is unlikely to be forthcoming in the current political context.[1] Moreover, implementation bottlenecks and, ultimately, a constraint on available financing from privatization receipts—offer some reassurance that additional spending will not take place this year, although intense lobbying in the run-up to next year's general elections can be expected.

The bulk of the Plan's increase in spending in 2002 is intended to be directed to construction of housing and transport infrastructure. The budgetary framework for 2002 embodied in the political understanding between the minority government and the largest opposition party envisages substantial fiscal consolidation and would make it very difficult to expand spending along the lines of the Big Bang Plan. However, spending controls outside of the central government State Budget are less rigorous, and there are risks of unanticipated spending, especially from privatization receipts. Therefore, the plan could result in considerable fiscal risks in 2002.

[1] See the Report on the Observance of Standards and Codes—Update (SM/01/193, 6/28/01).

possible that the revenue shortfalls, together with financing difficulties (see paragraph 22), could compel the government to introduce some expenditure cuts.

21. **The Ministry of Finance officials were not concerned about the expansionary nature of the 2001 budget, and argued that it was unrealistic to think that lasting deficit cut measures could be introduced in the near future.** From a cyclical point of view, staff considered the envisaged fiscal stimulus to be unnecessary, given the improving cyclical position of the economy and the accommodative monetary policy stance. Moreover, failing to scale back the structural deficit during cyclical upturns could reduce the availability of fiscal policy as a counter-cyclical instrument, should growth falter in the future. The staff therefore argued that the government should introduce fiscal reforms that would have a lasting effect on deficit reduction, which would not only reduce the fiscal stimulus this year, but would also attenuate the problem of medium-term fiscal sustainability stemming from the country's demographic problem (see paragraph 24). Ministry of Finance officials saw no strong need to reduce deficits for cyclical reasons, but concurred with the staff that the medium-term fiscal outlook was worrisome. Still, they noted that fiscal reform could not commence ahead of the 2002 elections, owing to the politically sensitive nature of many of the proposed reforms.[15] They argued that the increase in the fiscal deficit over the past few years reflected the recognition of hidden quasi-fiscal liabilities that they had inherited from previous governments, and hence considered it unfair that they were being criticized for them or held responsible for finding ways to reduce the resulting larger deficits. They noted, though, that reforms that would yield durable savings were being prepared so that they could be implemented after the elections.

22. **Claims on expected privatization receipts have more than exhausted reasonable estimates of the amount that could be realized, raising the prospect of additional government borrowing.** In view of concerns about the unsustainability of public finances, the staff advised that large one-off receipts from privatization not be used as an opportunity to increase expenditures (or reduce revenues) unduly. The authorities responded that it was appropriate to use resources generated by the privatization of industrial firms to strengthen infrastructure and to restructure the corporate sector. The staff noted that using these receipts to cover enterprises' bad debts to banks—in the context of a well-defined restructuring plan—also met this criterion. Regarding the prospect of achieving the targeted amount of privatization this year, a significant shortfall was likely, owing to delays (primarily in the energy sector) as well as permanent shortfalls (including in the telecom sector). The staff was concerned that this could result in a large build up in debt, as spending plans for individual ministries and extrabudgetary funds had already been approved. However, the MoF saw the situation as manageable through a combination of spending cuts and postponements (including those from implementation bottlenecks), as well as some short-term bridge

[15] In addition to pension system reform (see paragraph 24), these include introducing tuition and healthcare user fees and rationalizing social benefits, which were among the measures suggested by the World Bank in its 2001 Public Expenditure Review of the Czech Republic.

financing. They assured staff that privatization shortfalls would not lead to additional long-term borrowing, as parliament was unlikely to approve any such increase in debt (or government guarantees).

23. **A number of uncertainties relate to fiscal policy in 2002, now in an early stage of formulation.** The MoF is bound by an agreement between the ruling party and the main opposition party, which requires a state budget deficit of CZK 10 billion for 2002 (excluding the losses of KoB). This would require a substantial adjustment relative to a no-policy-change budget, on the order of 3½ percent of GDP. To this end, the MoF is proposing to cut inefficient expenditures by some 1½ percent of GDP, guided by the recommendations of the World Bank's Public Expenditure Review. Further adjustment would require severe cuts in entitlement programs or other sensitive areas, which are likely to be difficult in the run-up to next year's elections. Owing to the constraints on the state budget, the Big Bang plan is not expected to increase state budget expenditures. Outside the state budget, the plan calls for additional spending on the order of 3 percent of GDP in excess of this year's level. The staff responded that this would lead to a net increase in government spending and in the adjusted deficit next year, thus adding to the procyclicality of fiscal policy and likely contributing to a further widening of the current account deficit.[16] However, members of the parliamentary budget committee doubted that these expenditures would be approved by parliament and predicted a very lengthy and difficult debate over the 2002 public budgets.

24. **The authorities agreed with the staff that it was imperative to address the implications of the looming demographic problem well before it becomes manifest in expanding deficits later in the decade, but some difference of opinion existed about the need for an urgent response.** The pay-as-you-go (PAYG) pension system is already running an annual deficit of 1 percent of GDP, and the breakeven contribution rate is 3 percentage points above the current 26 percent statutory rate. With the pension system dependency ratio expected to drop from 2 workers per pensioner in 2000 to fewer than 1.2 workers per pensioner in 2030, the staff urged the authorities to introduce necessary reforms at an early stage, given the long delays before significant payoffs can be realized. However, the authorities considered the current pension system imbalance to be due in part to low statutory retirement ages and the prevalence of early retirement, both of which are being corrected through recent reform steps. They also viewed the country's low birth rate as providing the budget with several years of breathing space, as savings on education and child allowances and health care could more than compensate for higher old age expenditures through the end of the decade. The staff questioned whether significant savings would be realized in practice since, for example, the number of primary-age children had already declined, yet capacity in primary education had not been scaled back significantly. Within the context of a planned strengthening of the role of voluntary private schemes in the provision of pension benefits

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[16] The net increase in government spending and in the adjusted deficit next year is confirmed by the authorities' projections included in their Czech Republic's Pre-Accession Economic Program (PEP); see Section IV.

(Box 2), the authorities conceded that further changes in the basic parameters of the PAYG system would be needed to raise contributions relative to benefits.

B. Monetary and Exchange Rate Policy

25. **Inflation is expected to remain moderate, creating an environment conducive to maintaining the current accommodative monetary policy stance.** The CNB's latest forecast of net inflation for end-2001 stands at 2.5 percent (within the end-year target range of 2–4 percent), and for headline inflation at 3.8 percent.[17] Beyond 2001, the CNB is expecting a modest pickup of inflation, consistent with domestic demand gathering momentum—bolstered by stronger consumer spending—and a gradual elimination of the output gap. The authorities and the staff agreed on the inflation outlook, but acknowledged that the recent emergence of unfavorable trends in international oil prices could pose a risk.

26. **Following 15 months of leaving the key policy interest rate unchanged, the CNB in February 2001 cut its repo rate by 25 basis points.** With the koruna gradually appreciating in real effective terms in the months leading to the rate cut, the policy change reversed a gradual tightening of monetary conditions (see Figure 6 and the bottom left panel of Figure 7). Although the CNB's action took many observers—who expected the next move to be a tightening one—by surprise, the authorities argued that a downward shift of the long end of the yield curve prior to the rate cut meant that market participants had already factored in an action by the CNB. They also noted that the CNB was ready to take an action flexibly, either tightening or loosening, as necessary. The staff agreed that in an environment of subdued inflationary prospects the rate cut was appropriate, and that, in light of uncertainty about the strength of domestic and external demand, monetary policy should remain flexible.

27. **The CNB—in formal agreement with the government as required under the new CNB Act—announced a new inflation targeting framework in April.** The main changes involve: (i) the introduction of a continuous target band, rather than year-end targets; (ii) the specification of a target band not only for 2002 but also through 2005; and (iii) a switch to targeting headline inflation (Box 3). The new framework will increase the transparency of the inflation concept being targeted, while the longer horizon of the target and the specification of an intra-year band will help to better pin down short and medium-term inflation expectations. Also, the CNB officials pointed out that, with the disinflation process that had been initiated a few years ago largely completed, the targeted path of headline inflation from 3–5 percent in January 2002 to 2–4 percent at end-2005 represented the CNB's desire to preserve hard-won disinflation gains.

28. **However, there are disadvantages in the new framework as well, and its operational aspects need to be carefully examined.** Unlike the existing framework, the

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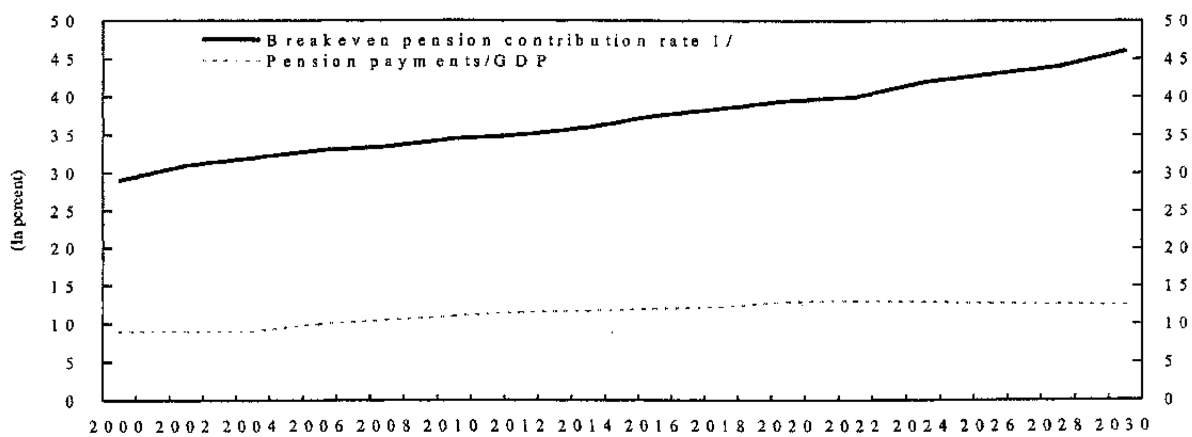
[17] Inflation modeling and forecasting issues are discussed further in the Selected Issues and Statistical Appendix, accompanying this report.

Box 2. Pension System Reform: Need and Plans

The Czech pension system consists of two pillars: a mandatory pay-as-you-go (PAYG) defined benefit scheme within the state budget that is financed largely by taxation of labor, and a voluntary private scheme, which is expanding rapidly (from a very low base), owing to generous state copayments and the tax deductibility of contributions.

Total benefit expenditures of the PAYG pension system (including old age, disability, and survivors benefits) were equivalent to 9 percent of GDP in 2000, with old age pensions accounting for about 7 percentage points (similar to the level in the UK). Social security contributions to the "pension account" of the state budget equaled 8.9 percent of GDP which, together with administrative costs, resulted in a pension system deficit of about 1 percent of GDP in 2000.

The public pension system is ill equipped to cope with an expected increase in the system dependency ratio beginning later this decade. According to calculations by the Ministry of Labor and Social Affairs—and assuming an unchanged average gross replacement rate (the ratio of average old-age pension benefits to gross wages) of 45 percent and real GDP growth of 3 percent—pension payments should increase only gradually to a still-modest 13 percent of GDP by 2030; however, owing to the fall in the number of contributors per beneficiary from 2 in 2000 to fewer than 1.2 in 2030, the breakeven contribution rate on gross wages would need to rise steadily from 29 percent in 2000 (compared with a statutory rate of 26 percent) to more than 45 percent in 2030 (see figure below).



Source: Ministry of Labor and Social Affairs.
1/ Contribution rate needed to balance PAYG pension system revenue and expenditures. As a percent of gross wages.

The government is proposing a number of changes to the pension system that would affect primarily the structure of the system, rather than its financial stability. These changes include: (i) adding a voluntary private employer-based scheme which, together with the existing private scheme, would be expected to eventually provide pensioners with one quarter of their income; and (ii) separating the PAYG mandatory scheme from the state budget in 2002 or 2003 (however, the state budget would still be required to cover any system deficit so that, absent fundamental reforms, this would not improve the fiscal outlook).

In the near term, the government is introducing or proposing several steps that would generate some modest reduction in the PAYG system deficit. These include: (i) from July 2001, the elimination of incentives for early retirement; and (ii) a proposal to raise the minimum assessment base for calculating premiums on the self employed. Over the longer term, the government has committed to adjust the parameters of the PAYG system to shore up its financial stability, possibly within the context of a shift from a defined benefit to a notional defined-contribution scheme.

Box 3. New Inflation Targeting Framework

In April 2001, the CNB announced changes to its inflation targeting framework. Under the existing framework, the CNB has an end-year target range for net inflation (i.e., headline CPI excluding administered prices and the impact of indirect tax changes) which is announced about 20 months in advance. The new framework shifts to targeting headline inflation and specifies a continuous linear and declining target band from January 2002 through end-2005. The changes were primarily motivated by the desire to increase the transparency of monetary policy and help better anchor inflation expectations. The target band for headline inflation was specified at 3–5 percent in January 2002, declining to 2–4 percent in December 2005 (Figure below). This range is consistent with the CNB's medium-term target for net inflation of 1–3 percent announced in 1999, and is based on the assumption that the impact on headline inflation of changes in administered prices will not exceed 1.5 percentage points at any point in time. Should the effect of changes in administered prices exceed the amount assumed, the CNB intends to invoke escape clauses. The CNB has yet to announce details of the operational aspects of the new framework, including the design and use of escape clauses.

The new framework is broadly in line with practices in most other countries targeting inflation. Most countries have intra-year targets or checkpoints rather than a single end-year target (Table below), though many of them have already achieved price stability so that they have a flat target band, unlike the Czech Republic. Most emerging market countries target headline inflation, while the choice of target varies in industrial countries. Most countries with relatively low and stable inflation employ a band width of 2 percentage points or less, and some countries prefer to accompany the target band with a mid-point to help focus expectations in the middle of the targeted range. Finally, few countries include escape clauses as part of their inflation targeting framework; many countries prefer to accommodate shocks to inflation through wider bands, owing to concerns that escape clauses could undermine the credibility of monetary policy.

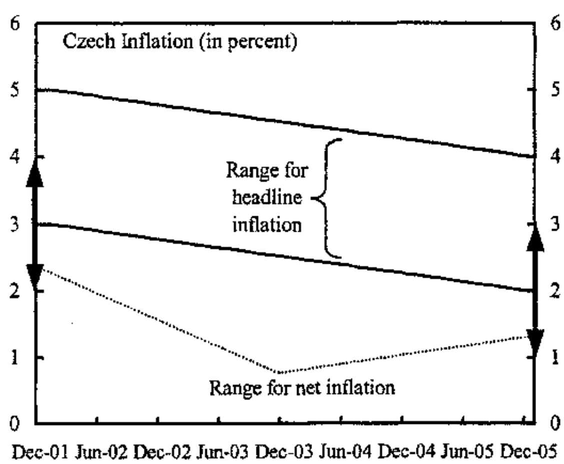


Table. Inflation Targeting Frameworks in a Range of Countries 1/

Targeted measure	
Headline inflation:	Australia, Brazil, Chile, **Czech Republic**, Israel, New Zealand, Poland, Spain, Sweden
Core/underlying inflation:	Canada, Finland, South Africa, UK
Checkpoints	
Intra-year:	Australia, Brazil, Canada, Chile, **Czech Republic**, Finland, New Zealand, Sweden, UK
End-year:	Israel, Poland
Escape clauses	
Yes:	Canada, **Czech Republic**, New Zealand, South Africa
None:	Australia, Brazil, Chile, Finland, Israel, Poland, Spain, Sweden, UK

Source: Schaechter, A., M. R. Stone, and M. Zelmer, 2000, "*Adopting Inflation Targeting: Practical Issues for Emerging Market Countries*," IMF Occasional Paper 202 (Washington: International Monetary Fund).

1/ The information on Finland and Spain pertains to the period prior to their entry into the euro zone.

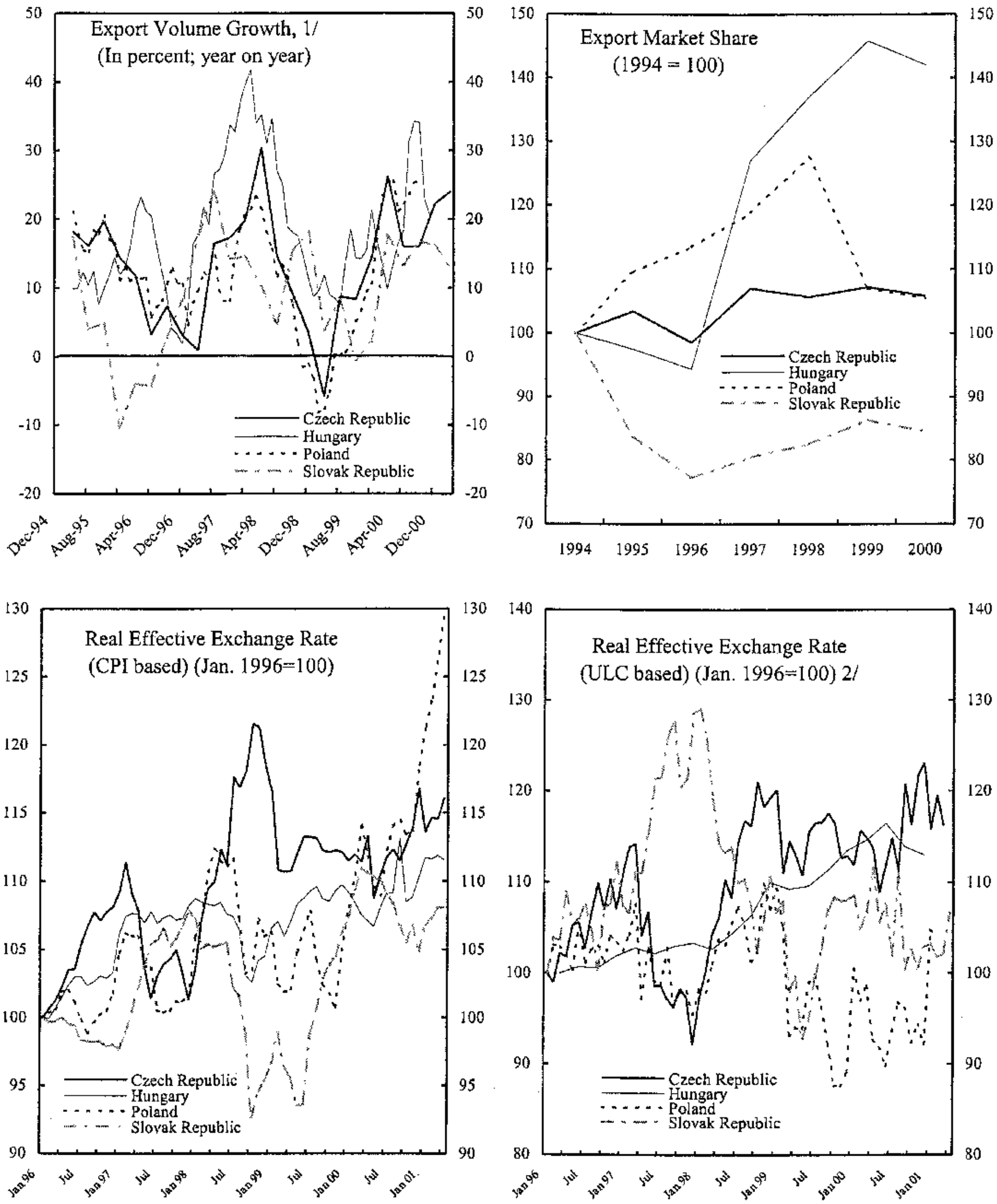
new framework will entail no clearly specified time horizon on which the CNB will focus; instead, the focus is to be on a continuous path well into the future, which might make it difficult for the public to understand the time horizon of the CNB's policy actions: namely, whether the CNB is aiming to keep inflation within the target band 12 months ahead, or 18 months ahead, and so on. In addition, administered price adjustments and the envisaged large indirect tax changes could make headline inflation very erratic.[18] With details of the new framework yet to be announced, the staff cautioned that it would be important to give due consideration to a range of operational issues to enable the CNB to firmly establish the conduct of monetary policy under the new framework. These include: (i) how to produce and communicate to the general public the CNB's inflation forecasts; (ii) how to develop optimal procedures concerning the communication and understanding between the CNB and the government with respect to administered price and indirect tax adjustments; and (iii) how to design and use escape clauses. The CNB officials agreed with the staff on the need to enhance accountability and preserve the CNB's credibility—especially with regard to the proper design and use of escape clauses—and assured the staff that every effort would be made to achieve these objectives. Moreover, they explained that the CNB was planning to include in its quarterly Inflation Reports its headline inflation forecast path up to 18 months ahead as a way of signaling to the public that it would be aiming at controlling inflation more than a year ahead.

29. **The authorities were not seriously concerned about a loss of external competitiveness stemming from the nominal appreciation of the koruna vis-à-vis the euro over the past several months.** In their view, the exchange rate was broadly in line with its fundamentals, as evidenced by the stable market share of Czech exports to the EU during a period of nominal appreciation of the koruna (Figure 9). The competitiveness of Czech exports has benefited from FDI, which has introduced new, efficient technologies and management practices in the country. The competitiveness of the Czech economy will likely continue improving, reflecting the increasing role of foreign-owned firms (Figure 10). In light of the expectation of continued strong FDI inflows over the medium term, the authorities were willing to accommodate a gradual nominal appreciation of the koruna, resorting to foreign exchange market intervention only to moderate large fluctuations in the exchange rate. Consistent with this, the authorities explained that, should sizable privatization-related inflows occur this year or next, they would try to moderate their immediate impact on the market through a bilateral transaction between the government and the CNB.

30. **Looking further ahead, the Czech Republic's steps toward the eventual entry into the euro zone becomes an increasingly relevant issue.** Some officials cited the need for the economy to achieve a higher degree of convergence, as well as the need to improve

[18] The new inflation targeting framework will be based on the assumption that the contribution of administered price adjustments will not exceed a certain amount (around 1.5 percentage points) per year; beyond that the CNB will likely invoke escape clauses.

Figure 9. Czech Republic: Regional Comparison of Export Performance and Real Effective Exchange Rates, 1994-2001

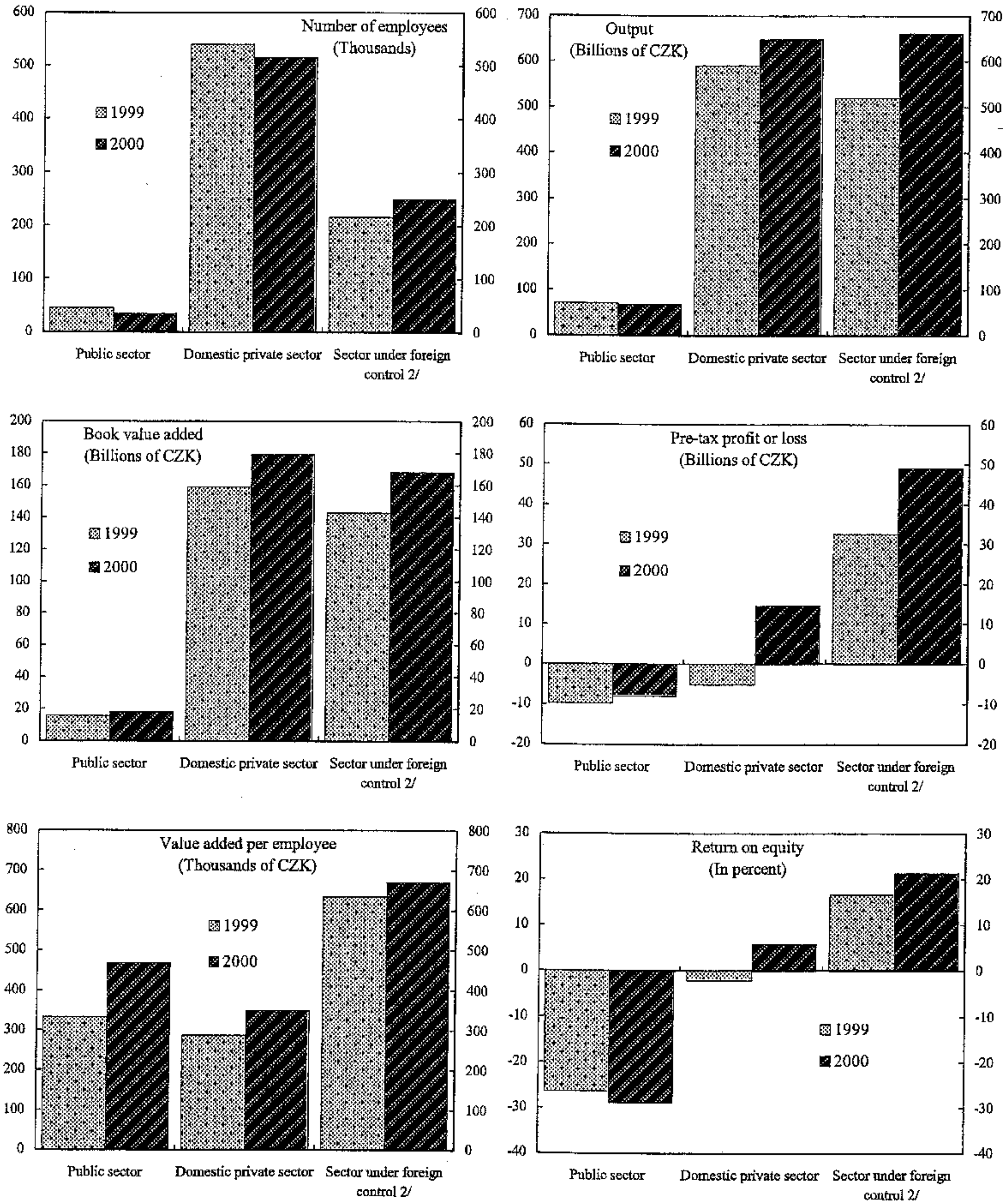


Sources: Information Notice System; World Economic Outlook; and Fund staff estimates.

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

2/ Hungarian data are quarterly.

Figure 10. Czech Republic: Manufacturing Industry by Sectors, 1999-2000 1/



Source: Czech Statistical Office.

1/ Enterprises with 100 or more employees.

2/ Foreign equity in excess of 50 percent.

public finances, before the country requests admission to ERM-II. They agreed with the staff that there might be a possible tension—arising from Balassa-Samuelson effects—between the ultimate inflation goal of 2–4 percent and the constraint imposed on the nominal exchange rate under ERM-II.[19] They noted, though, that various uncertainties—including the extent of future capital inflows—would make it difficult to draw any definitive conclusion at this point regarding the timing of their participation in ERM-II.

31. **The authorities are not currently considering issuing foreign-currency-denominated government debt, although this continues to be a future option.** In the CNB's view, which the MoF shared, ample liquidity existed in the domestic banking system that could accommodate new issues of government debt without crowding out the private sector. The relatively high premium associated with a euro bond issue, the cost of hedging the exchange rate risk, and the impact on the exchange rate were not deemed justified in the current circumstances where the proceeds would be used domestically rather than paying off obligations in foreign currency.

C. Financial Sector Stability

32. **The FSAP report, presented in Prague by a combined IMF/World Bank team, was very well received by the authorities** (Box 4). The authorities had no major disagreements concerning the report and expressed their desire to move speedily to adopt most of the recommendations as circumstances permit. They pointed to progress made in restructuring the banking sector as evidence of their determination to address the structural impediments and vulnerabilities in the Czech financial system. A main recommendation of the report dealt with the issue of adopting consolidated and risk-based supervision. The authorities acknowledged the need to extend supervision to financial conglomerates and to move toward risk-based supervision, but they indicated that this might be a long process. In addition, they noted their intention to address the issues of insolvency and creditor rights that had been constraining the proper functioning of the banking system.

33. **Restructuring of the banking sector is nearing completion.** The government has received bids on the sale of the last remaining large state-owned bank (Komercni banka), and the sale is expected to be completed this year. The parliament recently adopted a law transforming KoB from a bank to a nonbank agency, responsible primarily for asset disposal and consolidation. Although no major changes are expected in its activities, the new agency will be more limited in its ability to extend new financing to ailing enterprises. The staff noted that the transformation was an important step in the final chapter of restructuring the bank and corporate sectors if indeed the agency were to focus its efforts on disposing of bad assets, and argued that active corporate restructuring, currently limited to a handful of

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[19] See the Board paper, "Monetary and Exchange Rate Regimes in the Central European Economies on the Road to EU Accession and Monetary Union," accompanying this text.

enterprises originally placed under the Revitalization Agency (see paragraph 36), should be kept to a minimum.

34. **The legal system continues to slow the process of asset recovery.** The KoB management explained that, in spite of the recent legal changes purported to facilitate sales of collateral, asset recovery through this channel was still plagued by delays due to legal

Box 4. Main Findings of the Czech FSSA[1]

Following an acute crisis phase, the Czech financial system has undergone a fairly rapid phase of restructuring and reform. Considerable progress has been made in improving the legislative and regulatory framework. Institutional strengthening has been accompanied by enhanced prudential oversight, extensive carve-out of bad assets, privatization of large banks to foreign strategic investors, and a significant consolidation of banks and nonbank financial institutions. After the completion of the sale of the last large state bank (Komerčni banka) later this year, about 90 percent of the banking sector will be owned by strategic foreign investors.

Little residual risk appears to remain in the banking system, as the level of non-performing loans that will be left after the carve-out of bad assets appears manageable given current provisioning levels. Stress tests indicated that the Czech banking system is only moderately vulnerable to risks. The effects of market risks appear quite limited and while the banking system will still face pockets of vulnerability to credit risk, these would not appear to add up to systemic risk at present. These results are qualified, however, by being based on the current structure of bank exposures. Although banks remain currently reluctant to extend new credit to any but top quality corporate borrowers, they are under profit pressures that may prompt them to assume new kinds of market and credit risk.

Ongoing restructuring in the corporate sector bodes well for resolution of its long-standing problems. The sector's financial performance has started to improve, and the regulatory framework affecting corporate governance has been substantially upgraded, but it has yet to be tested. There are still many enterprises that continue to generate losses and are highly leveraged. Nevertheless, most of them are probably classified debtors which have been or are in the process of being transferred to the workout institutions.

The non-banking financial sector is quite small compared to the banking sector, and its weaker segment—namely the credit unions—is not systemically important. The insurance sector is currently adequately capitalized and profitable; however, insurance supervision is weak. In the securities markets, regulation and supervision are fairly transparent, but the supervisory capacity needs to be strengthened further. Consolidation has reduced the number of pension funds, but their performance has been modest reflecting mainly their investment in low-yielding securities. Credit unions have recently experienced a major crisis, and the deposit protection agency for credit unions is facing pressures from claims. However, credit unions remain a very small part of the Czech financial system and thus they are not systemically important.

Despite improvements in the legal and regulatory framework for the Czech financial and corporate sectors, critical challenges remain. Enforcement has been unsatisfactory, and better enforcement will require a strong build up of supervisory capacity, a more proactive approach by self-regulatory organizations, and improvements in the court system. Coordination and cooperation between supervisory agencies requires urgent attention. Supervisory objectives should be strongly oriented towards monitoring the soundness of financial institutions on a consolidated and risk basis.

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[1] The Czech Republic—Financial System Stability Assessment, (SM/01/189).

challenges by debtors. They argued that because of this, pooled sales were a much faster and more efficient way of disposing of bad assets. The staff welcomed the sale of a large pool of bad assets in early 2001. Although the sales price reached only 7 percent of the original face value of about CZK 19 billion (11 percent of the value booked by KoB), the sale is likely to benefit both the KoB, by reducing the volume of its bad assets, and the Czech economy, by promoting the financial restructuring of many small and medium-sized enterprises. The staff therefore argued that further pooled sales should be sought, along with all other methods available to the KoB, to achieve quick asset recovery. The managers of KoB indicated that scope remained for further pooled sales. However, they noted that the strategy of pooled sales was not uncontroversial within the government and they did not exclude that it could be politically difficult to implement.[20] The authorities and the staff agreed that a successful workout program would require further improvements in the legal framework, such as insolvency, that would expedite enterprise restructuring and would likely also imply a better price in the auction of bad assets.

35. **The authorities have estimated the cost of cleaning up bank balance sheets at about 20 percent of 2001 GDP.** About a fourth of these costs have already been incurred and the rest are expected to burden the state budget over the course of the next four years. The authorities stressed that the total clean up cost would likely change, pending the completion of the review of the loan portfolio of IPB and the conclusion of the disposal of bad assets. A large stock of nonperforming loans—as much as 25 percent of GDP, including the "ring-fenced" part to be kept on the balance sheet of banks—remains to be worked out, a considerable part of it with KoB.

36. **The government's role in corporate restructuring may expand to cover small and medium-sized enterprises (SMEs).** The intention of the original Revitalization Program was to limit the government's involvement only to selected large firms, leaving the disposition of heavily indebted SMEs in the hands of the private sector. However, the slow court system and banks' reluctance to actively engage in corporate restructuring have resulted in many SMEs being left in limbo. Ministry of Industry and Trade officials noted that many viable SMEs could be revived if the government offered some help. This motivated them to include in the Big Bang plan a program called "exit and balance sheet," which appears to be an expansion of the Revitalization Program to SMEs. The staff questioned the government's ability to distinguish viable and non-viable firms correctly, and advocated pooled sales of bad debts that would let the private sector decide whether to close or revive individual debtor firms.

[20] After the mission, the head of KoB—who was in favor of pooled sales—was dismissed by the government.

IV. Medium-Term Fiscal Issues

37. **In the context of the Czech Republic's Pre-accession Economic Program (PEP), the authorities prepared a medium-term fiscal framework that achieves a moderate reduction in the deficit through a combination of higher taxes and expenditure reductions** (Tables 5 and 6).[21] The authorities are forecasting a decline in the general government deficit (excluding privatization and grants to transformation institutions) by 1.8 percent of GDP over three years to 3.9 percent of GDP in 2004. Excluding interest payments, the amount of adjustment over the same period increases to 2.5 percentage points of GDP. General government debt is projected to rise by 10 percentage points to about 30 percent of GDP.[22]

38. **The Program's objective is to reduce the structural deficit over the medium term in order to limit upward pressure on interest rates and the current account deficit, and to create room for the automatic stabilizers to operate symmetrically.** This is to be achieved through a higher burden of taxes and a gradual reduction in expenditures that is afforded by the completion of programs related to transition and EU accession. On the revenue side, taxes will be harmonized with EU requirements (excluding some specific areas where transition periods will be requested).[23] When fully in place, tax changes are expected to add 2.8 percent of GDP to total revenue in 2004. On the expenditure side, the authorities see the potential for decisive action limited by inherited and other one-off obligations, a large share of mandatory expenditures, and the need to accommodate priority construction investments. However, they envisage savings in social transfers owing to a change in the pension system introduced in July 2001, which no longer favors early retirement, and plans to tighten eligibility for, and better target, social benefits. Wage costs are expected to rise by more than ½ percent of GDP, reflecting primarily a new civil service pay scale, part of an EU-required reform of the civil service. Subsidies to enterprises are expected to remain stable in real terms, while transfers to transformation institutions for managing bad assets and

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[21] During the mission, staff did not have access to the PEP document submitted to the European Commission on May 1, 2001. Therefore, there were no detailed discussions on the Program between the authorities and staff. The document was subsequently published, on which the description of the Program in this section is based.

[22] Lower-than-expected privatization receipts and higher bank restructuring costs would lead to a larger increase in the debt ratio. Staff has estimated that a primary deficit of 2–3 percent of GDP over the next few years would be sufficient to stabilize the debt ratio, provided that privatization receipts arrive as planned.

[23] Changes include: (i) reducing the standard VAT rate from 22 percent to 20 percent and raising the preferential rate from 5 percent to 10 percent; and (ii) shifting a number of goods and services to different tax categories, including moving telecommunications and nonresidential construction from the preferential to the standard rate.

supporting the restructuring process will drop sharply. General government-financed investment will grow in real terms, but this excludes sizable off-budget investment expenditure covered by loans from the European Investment Bank.

39. **The Program would—if realized—represent at best a modest step forward in the process of fiscal consolidation.** A large part of the adjustment in expenditure comes about without any policy actions, owing to the termination of one-off fiscal spending initiatives. In addition, the staff sees risks regarding the achievement of expenditure restraint in other areas, notably in support to enterprises and transfers to households, since the mechanisms for containing these expenditures are unclear. Moreover, it would appear that significant fiscal activity will take place outside the general government budget, but this will nonetheless add to aggregate demand pressures and to public sector debt. Given that the envisaged expenditure reduction plans are not ambitious, the staff would have preferred to see the balance of adjustment shifted further in the direction of expenditure retrenchment (Box 5).[24] A large part of the fiscal consolidation is driven by tax reforms. However, the tax burden is already quite heavy in the Czech Republic, and raising tax rates is a movement in the opposite direction from trends in other accession candidate countries.

V. Staff Appraisal

40. **Over the past year, the economic expansion has gained a broader footing.** The staff believes that with an appropriate macroeconomic policy mix and a steadfast pursuit of structural reforms, the Czech Republic should be able to raise its medium-term growth rate to levels that would ensure convergence with its partners in the EU within a reasonable time frame. FDI is improving productivity and international competitiveness, and is laying the foundation for strong, sustainable growth. With the completion of the privatization of the last major state-owned bank and the speedy disposal of bad loans, the banking sector will be able to operate on a sounder basis in the coming years, while ongoing restructuring in the corporate sector bodes well for the resolution of its long-standing problems.

41. **Against this background, the staff considers that the appropriate macroeconomic policy mix is accommodative monetary policy and tighter fiscal policy.** Although inflation has recently edged up, domestic inflationary pressures are broadly under control. Hence, barring unexpected exogenous shocks, there is no need for monetary policy to deviate substantially from its current accommodative stance. However, the main concern is on the fiscal side. Specifically, fiscal policy should refrain from adding demand stimulus to the growing economy by further expanding the deficit. With the global economy decelerating, such a policy could result in an unsustainable widening of the current account deficit and undermine medium-term growth. Careful preparation of fundamental fiscal

[24] The staff estimates that this rebalancing of the composition of fiscal adjustment could be largely achieved by reducing the standard VAT rate to less than 20 percent, and shifting the basis of pension indexation to consumer prices.

Box 5. Size of Government in the Czech Republic

The size of government in the Czech Republic has expanded rapidly since the latter part of the 1990s, and general government expenditure is expected to exceed 51 percent of GDP in 2001. Moreover, the government plays a larger role in the Czech economy than in the economies of other advanced transition countries (see table below). This is most apparent on the expenditure side of the budget, where the share of government spending in GDP exceeds that in Hungary by more than 7 percentage points. Some 5 percentage points of this difference reflects one-off bank restructuring costs, helping to reduce the expenditure ratio closer to levels prevailing in the more mature EU economies. However, fiscal data for the EU are more comprehensive than those compiled by the transition countries, implying that, if measured on a comparable basis, spending ratios for the transition countries would likely be significantly higher than those currently reported.[1]

Size of Government in Selected Countries 1/
(In percent of GDP)

	Revenue	Expenditure	Observation Year
Czech Republic	40.1	50.9	2001 (budget)
Excluding grants to transformation institutions		45.7	
Hungary	39.8	43.2	2001 (budget)
Poland	39.6	43.2	2001 (budget)
Slovenia	43.1	44.1	2001 (proj.)
Slovakia	35.4	39.3	2001 (budget)
EU-15 average	47.0	45.7	2000 (actual)
EU-12 average	47.0	46.7	2000 (actual)

Source: Staff estimates.
1/ General government data.

In the context of its 2001 Public Expenditure Review (PER) of the Czech Republic, the World Bank recommended measures to reduce government spending—in both the short- and medium-term.[2] Reforms that would have an immediate impact on expenditure include: (i) indexing pensions by no more than the minimum legal requirement; (ii) expanding user co-payments for health services; (iii) reducing and rephasing road and rail corridor investments; (iv) scaling back subsidies on household saving (so-called construction savings accounts); (v) increasing transport user fees; and (vi) terminating the preferential VAT treatment of residential construction. Over the longer term, opportunities exist in a number of areas—especially the mandatory pension system—for increased cost savings as a result of more fundamental reforms. Improved fiscal management and budgeting practices, including greater use of cost-benefit analyses to screen government projects and longer time horizons for budgeting purposes, would also be expected to yield considerable savings.

[1] For example, measured government expenditure in the EU includes depreciation of public fixed capital, which may exceed several percentage points of GDP.
[2] World Bank, "Czech Republic: Enhancing the Prospects for Growth with Fiscal Stability," March 2001.

reform measures should be among the authorities' top priorities, so that they are able to implement them expeditiously. Structural reforms, especially banking and corporate sector restructuring, should proceed without delay, with a minimum of government intervention.

42. **The staff's concern about fiscal policy is shared by some in the government and parliament, but not by all.** With lower house elections in 2002 looming, policymakers are facing an increasing temptation to loosen fiscal discipline and postpone necessary reforms. High unemployment rates in certain regions, as well as a large number of firms still struggling under a heavy debt burden, provide additional reasons for the government to use fiscal policy to offer relief. Moreover, many of the structural problems that the government is facing right now were either inherited from previous governments (such as the need for banking and corporate sector restructuring, which resulted from the excesses in the mid-1990s) or are beyond the control of any government (such as the consequences of demographic changes). It is nonetheless incumbent on the current government to take necessary actions to ensure that fiscal policy does not jeopardize macroeconomic stability. The recent turn of events, including the emergence of the Big Bang plan, should not work against putting public finances on a sustainable path or result in interventionist industrial policy. Achieving privatization in an open and transparent way is another important task for the current government.

43. **The staff welcomes the new inflation targeting framework, but at the same time, considers that the CNB has set for itself a more difficult task.** Under the continuous target band as from January 2002, the CNB's performance could be judged practically every month. Failing to keep inflation within the band for several months in a row might put pressure on the CNB to use monetary policy for a quick result. Yielding to such pressure would make the CNB's policy horizon inappropriately short. It is therefore important to establish a clear distinction between the use of the target band for ex post performance evaluation and its use for forward-looking policymaking. In this regard, the CNB should explain clearly the reasons for inflation being contemporaneously outside the target range; however, when it comes to policymaking, the relevant target period is not today, but at least 12-18 months ahead. The Czech Republic's status as a country in transition poses an additional challenge. The CNB may face erratic movements in inflation due to changes in administered prices and indirect taxes, which could complicate the task of forecasting inflation, and the CNB must decide to what extent it should react to such exogenous price changes.

44. **A critical challenge for the authorities is how to plan for the Czech Republic's eventual participation in the euro zone.** Toward this end, it is important for the Czech Republic to achieve a smooth progression through the wide bands of ERM-II. To avoid exchange rate turbulence during this critical phase, it is desirable to achieve further progress in a number of areas before joining ERM-II, including real convergence, financial sector stability, and a sound fiscal position. Falling behind neighboring countries in the accession process risks an economic cost, providing yet another reason to accelerate reforms in these areas.

45. **Banking sector restructuring has come a long way, and the staff commends the authorities on their achievements and determination to complete the process.** Their efforts are starting to bear fruit; the staff's discussions during the mission with major banks have shown that some of the larger banks are gradually becoming more receptive to increasing their lending activities, which should provide support to viable firms. Positive findings by the FSAP team are encouraging, and its recommendations will help the authorities better focus on the areas where additional steps are needed. While there is relatively less room for—hence less risk of—backtracking, the staff's major concern is regarding the method and pace of disposing of bad assets held by, or soon to be transferred to, KoB. Here again, a call for the government to restrain interventionist policies is warranted.

46. **Legal and regulatory reforms continue to be a pressing issue.** Shortcomings in the legal framework have contributed significantly to the problems of the Czech Republic during the 1990s, and progress so far has been insufficient. A further amendment of the bankruptcy regime is currently under consideration. But possibly even more important is better enforcement of existing laws and regulations, which will require a strong buildup of supervisory capacity, a more proactive approach by self-regulatory organizations, and improvements in the court system.

47. **In sum, developments since the last Article IV consultation are generally positive, and attest to the Czech economy's potential for a speedy catch-up with EU countries.** What is required of the authorities is to avoid weakening this momentum by pursuing short-term policy objectives.

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

Table 1. Czech Republic: Selected Economic and Financial Indicators, 1996–2001

	1996	1997	1998	1999	2000	2001 Proj. 1/
			(Percent change)			
Real sector						
Real GDP	4.8	-1.0	-2.2	-0.8	3.1	3.0-3.5
CPI inflation						
Period average	8.8	8.5	10.7	2.1	3.9	4.0
12-month change	8.6	10.0	6.8	2.5	4.0	4.0
Net inflation, 12-month change 2/	6.6	6.8	1.7	1.5	3.0	2-4
Real wages (industry), period average	8.1	3.2	-0.2	4.6	1.0	2.0
Registered unemployed, per. average (percent of labor force)	3.1	4.3	6.1	8.6	9.0	8.7
			(In percent of GDP)			
Fiscal sector 3/						
Revenues	40.4	39.7	39.2	41.5	40.6	40.6
Expenditures and net lending (including privatization and bank restructuring costs)	40.6	40.9	40.8	42.1	43.8	42.3
Balance	-0.4	-1.2	-1.6	-0.6	-3.3	-1.7
Excluding privatization revenues	-2.1	-1.9	-3.0	-3.7	-5.1	-11.5
Excluding privatization revenues and grants to transformation institutions to cover costs related to bad asset management	-0.9	-1.7	-1.9	-3.2	-4.1	-6.4
Gross debt	13.3	12.8	13.3	15.0	17.3	...
Loan guarantees outstanding 4/	...	17.0	17.4	15.8	14.6	...
			(12-month change in percent)			
Money and credit (end-of-period)						
Broad money	7.8	8.7	5.2	8.1	6.5	8.4
Credit to enterprises and households	10.6	9.4	-3.5	-3.9	-3.3	3.0
Net foreign assets	-9.5	20.1	25.6	33.2	20.0	19.5
Velocity (percentage change, end-of-period)	5.6	-2.3	2.4	-5.7	8.9	...
Interest rates						
Average lending rate	12.5	13.2	12.9	8.7	6.9	...
Average deposit rate	6.8	7.7	8.1	4.5	3.0	...
			(In billions of U.S. dollars)			
Balance of payments						
Merchandise exports	21.7	22.8	26.4	26.3	29.0	32.2
Merchandise imports	27.6	27.3	28.9	28.2	32.3	36.2
Trade balance	-5.9	-4.5	-2.6	-1.9	-3.3	-4.0
Current account	-4.3	-3.2	-1.3	-1.6	-2.4	-2.8
(Percent of GDP)	-7.4	-6.1	-2.4	-3.0	-4.8	-5.1
Nondebt capital inflows (percent of GDP) 5/	3.5	3.3	6.8	10.7	9.7	14.8
			(In billions of U.S. dollars)			
Reserves and external debt						
Gross official reserves (end-of-period)	12.4	9.8	12.6	12.8	13.1	13.6 6/
(In months of imports of goods and services)	4.4	3.6	4.4	4.5	4.1	3.9 6/
Total external debt (end-of-period)	21.2	21.6	24.3	22.9	21.5	22.0
(Percent of GDP)	36.8	44.9	40.4	44.9	42.6	40.5
Short-term debt (convertible currencies, end-of-period)	6.0	7.1	9.1	8.8	9.0	9.5
External debt service ratio in convertible currencies (Percent of exports of goods and nonfactor services)	10.9	15.7	15.1	12.8	12.2	10.1
			(Percent change)			
Exchange rate (period average)						
Nominal effective	1.9	-3.5	0.7	0.2	1.6	...
Real effective (ULC-based)	3.3	-2.3	8.5	3.4	0.6	...
Memorandum item:						
GDP in nominal terms						
(In US$ billions)	57.9	52.6	55.7	53.0	49.5	...
(In CZK billions)	1,572	1,669	1,798	1,833	1,911	2,060

Sources: Czech authorities; and staff estimates and projections.

1/ Staff projections.
2/ Net inflation excludes administered prices and the effects of changes in indirect taxes. Authorities' target range for 2001.
3/ General government operations and debt; central government guarantees. Revenues and expenditures include privatization receipts.
4/ Includes a CZK33 billion government guarantee not included in official reported statistics.
5/ Inflows for direct investment (equity capital and reinvested earnings) and equity securities. Includes privatization-related FDI.
6/ Excludes privatization proceeds to be deposited in the special account for privatization-related FDI.

Table 2. Czech Republic: Balance of Payments, 1997-2005
(In millions of U.S. dollars)

	1997	1998	1999	2000	2001 Proj.	2002 Proj.	2003 Proj.	2004 Proj.	2005 Proj.
Current account balance	**-3,211**	**-1,336**	**-1,567**	**-2,369**	**-2,776**	**-2,961**	**-3,158**	**-3,171**	**-3,326**
Trade balance 1/	-4,540	-2,554	-1,903	-3,285	-4,024	-4,416	-4,420	-4,285	-4,211
Exports	22,777	26,351	26,265	29,034	32,171	35,452	39,310	44,078	49,358
Imports	27,317	28,905	28,167	32,320	36,195	39,868	43,731	48,363	53,569
Nonfactor services	1,763	1,793	1,102	1,396	2,004	2,335	2,353	2,455	2,490
Receipts	7,162	7,494	6,928	7,245	8,315	9,119	9,724	10,595	11,541
Payments	5,399	5,701	5,826	5,849	6,311	6,784	7,371	8,140	9,051
Factor income (net)	-791	-983	-1,277	-764	-1,051	-1,185	-1,406	-1,668	-1,943
Current transfers	357	408	511	285	295	305	315	326	337
Capital account balance	**10**	**2**	**-2**	**-5**	**-8**	**1**	**1**	**1**	**1**
Financial account balance	**1,208**	**3,006**	**3,224**	**3,359**	**5,773**	**7,908**	**5,043**	**5,157**	**5,414**
Direct investment, net 2/	1,275	3,591	6,234	4,477	8,178	10,078	6,464	6,245	6,223
Portfolio investment, net	1,212	1,152	-1,251	-1,767	-760	-757	-642	-567	-294
Financial derivatives, net	--	--	--	-47	0	0	0	0	0
Other investment, net	-1,279	-1,737	-1,759	696	-1,646	-1,414	-778	-521	-516
Errors and omissions, net	**226**	**268**	**-3**	**-166**	**0**	**0**	**0**	**0**	**0**
Change in reserves 3/ (- increase)	**1,767**	**-1,941**	**-1,651**	**-819**	**-2,989**	**-4,948**	**-1,886**	**-1,987**	**-2,088**
Memorandum items:									
Current account (in percent of GDP)	-6.1	-2.4	-3.0	-4.8	-5.1	-5.2	-5.1	-4.8	-4.6
Net foreign direct investment (in percent of GDP) 2/	2.4	6.4	11.8	9.0	15.0	17.6	10.5	9.4	8.6
Gross official reserves									
(in months of imports of goods and services) 3/	3.6	4.4	4.5	4.1	3.9	3.9	4.0	4.0	4.1
Total external debt (in percent of GDP)	44.9	40.4	44.9	42.6	40.5	40.1	40.1	40.3	40.5

Sources: Czech National Bank; and Fund staff projections.

1/ Beginning in 1999, trade data are compiled following the revised methodology for trade statistics, according to which, only the value added during servicing of goods imported or exported for upgrades and repairs is captured in the trade statistics.
2/ Includes privatization-related FDI.
3/ Figures from 2001 onward exclude privatization proceeds to be deposited in the special account for privatization-related FDI.

Table 3. Consolidated General Government Budget, 1998-2002 1/

	1998 Actual	1999 Actual	2000 Prelim	2001 MoF Proj.	2002 MoF Proj. 2/	1998 Actual	1999 Actual	2000 Prelim	2001 MoF Proj.	2002 MoF Proj. 2/
	(In billions of koruny)					(In percent of GDP)				
Total revenue and grants	695.2	729.8	761.6	820.0	872.7	38.7	39.8	39.9	40.1	39.6
Total revenue	695.2	729.5	760.4	820.0	872.7	38.7	39.8	39.8	40.1	39.6
Current revenue	694.9	729.2	760.1	818.1	868.9	38.6	39.8	39.8	40.0	39.5
Tax revenue	648.2	682.7	710.7	759.9	808.7	36.0	37.2	37.2	37.1	36.7
Direct taxes	162.5	165.4	169.5	174.2	182.7	9.0	9.0	8.9	8.5	8.3
Individual	94.9	95.3	98.3	102.2	108.4	5.3	5.2	5.1	5.0	4.9
Corporate	67.6	70.1	71.2	72.0	74.3	3.8	3.8	3.7	3.5	3.4
Social security contributions	263.1	271.3	287.4	300.0	318.1	14.6	14.8	15.0	14.7	14.5
Property taxes	10.4	11.1	10.4	12.1	13.1	0.6	0.6	0.5	0.6	0.6
Goods and services	198.5	222.7	228.1	261.4	294.8	11.0	12.2	11.9	12.8	13.4
VAT	119.4	138.3	145.9	170.3	184.6	6.6	7.5	7.6	8.3	8.4
Excises	67.8	73.1	70.9	77.4	79.8	3.8	4.0	3.7	3.8	3.6
Other	11.4	11.3	11.3	13.7	30.4	0.6	0.6	0.6	0.7	1.4
International trade	13.6	12.1	13.6	12.2	...	0.8	0.7	0.7	0.6	...
Other taxes	0.1	0.2	1.7	0.0	0.0	0.0	0.0	0.1	0.0	0.0
Nontax revenue	46.7	46.5	49.4	58.2	60.2	2.6	2.5	2.6	2.8	2.7
Capital revenue (excluding privatization)	0.3	0.3	0.3	1.9	3.8	0.0	0.0	0.0	0.1	0.2
Grants	0.0	0.3	1.2	0.0	0.0	0.0	0.0	0.1	0.0	0.0
Total expenditure and net lending	748.3	797.0	858.1	1,040.9	1,090.5	41.6	43.5	44.9	50.9	49.5
(excluding transfers to transformation institutions)	730.0	789.3	840.8	936.1	1,010.9	40.6	43.1	44.0	45.7	45.9
Total expenditure	748.1	790.3	858.4	1,035.9	1,078.7	41.6	43.1	44.9	50.6	49.0
Current expenditure	654.0	687.2	744.3	910.4	948.4	36.4	37.5	39.0	44.5	43.1
Goods and services	146.8	155.7	161.3	190.7	217.0	8.2	8.5	8.4	9.3	9.9
Wages and salaries	62.6	69.4	70.1	79.5	101.0	3.5	3.8	3.7	3.9	4.6
Other goods and services	84.1	86.2	91.1	111.2	116.0	4.7	4.7	4.8	5.4	5.3
Interest payments	21.4	19.5	21.2	24.8	28.5	1.2	1.1	1.1	1.2	1.3
Subsidies and other current transfers	485.9	512.0	561.8	694.9	702.9	27.0	27.9	29.4	33.9	31.9
Subsidies	139.2	139.2	159.5	262.6	243.3	7.7	7.6	8.3	12.8	11.1
to nonfinancial public enterprises	76.2	87.6	94.2	102.9	163.7	4.2	4.8	4.9	5.0	7.4
to financial institutions	33.2	17.5	26.8	108.4	79.6	1.8	1.0	1.4	5.3	3.6
to other enterprises	29.8	34.1	38.5	51.3	...	1.7	1.9	2.0	2.5	...
Transfers to households & nonprofits	345.0	370.4	399.6	428.3	459.6	19.2	20.2	20.9	20.9	20.9
Transfers abroad	1.7	2.4	2.7	4.0	...	0.1	0.1	0.1	0.2	...
Capital expenditure	94.1	103.0	114.1	125.5	130.3	5.2	5.6	6.0	6.1	5.9
Acquisition of fixed capital	60.1	66.3	76.9	76.6	79.5	3.3	3.6	4.0	3.7	3.6
Capital transfers	34.0	36.7	37.2	48.9	50.8	1.9	2.0	1.9	2.4	2.3
Net lending (excluding privatization)	0.3	6.7	-0.3	5.0	11.8	0.0	0.4	0.0	0.2	0.5
Lending	12.5	21.5	9.9	14.5	...	0.7	1.2	0.5	0.7	...
Repayments (excluding privatization)	12.2	14.8	10.2	9.5	...	0.7	0.8	0.5	0.5	...
Overall Balance	-53.1	-67.2	-96.5	-220.9	-217.8	-3.0	-3.7	-5.1	-10.8	-9.9
Excl. grants to transformation institutions to cover costs related to management of bad assets	-34.7	-59.4	-79.1	-116.1	-138.2	-1.9	-3.2	-4.1	-5.7	-6.3
Financing	53.1	67.2	96.5	220.9	217.8	3.0	3.7	5.1	10.8	9.9
Privatization receipts	24.9	56.6	33.8	200.4	70.0	1.4	3.1	1.8	9.8	3.2
Net increase in financial liabilities	27.4	10.4	62.7	20.5	147.8	1.5	0.6	3.3	1.0	6.7
Memorandum items										
Primary balance	-31.7	-47.6	-75.3	-196.1	-189.3	-1.8	-2.6	-3.9	-9.6	-8.6
Privatization receipts of local governments	9.5	30.6	13.3	11.5	10.0	0.5	1.7	0.7	0.6	0.5
Proceeds from sale of mobile phone licenses	...	...	...	20.0	...	...	...	...	1.0	...
Grants to transformation institutions (KoB, CI, CF) to cover costs related to management of bad assets	18.4	7.7	17.3	104.8	79.6	1.0	0.4	0.9	5.1	3.6
General government debt 3/	240.0	274.6	331.2	413.5	561.6	13.3	15.0	17.3	20.2	25.5
Liabilities of transformation institutions	112.0	153.0	176.0	...	...	6.2	8.3	9.2	...	...
State government guarantees 4/	313.4	290.3	278.7	...	...	17.4	15.8	14.6	...	...
Risk-adjusted guarantees 5/	139.6	130.8	126.4	...	...	7.8	7.1	6.6	...	...

Sources: Ministry of Finance and Fund staff estimates.

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

2/ From the authorities' Pre-Accession Economic Program, May 2001.

3/ Includes liabilities of the state budget, National Property Fund, Health Insurance Fund, and local governments.

4/ Includes a CZK 33 billion guarantee due in 2002 that is not included in the MoF's published guarantee data.

5/ Expected government payout on guarantees. Based on the average default risk estimated by the World Bank. Excludes environmental and other guarantees of the NPF which, on a risk adjusted basis, stood at CZK 33.5 billion at end 2000.

Table 4. Czech Republic: Vulnerability Indicators
(In percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	Latest Data 2000	2001	Date
Financial indicators							
Public sector debt 1/	19.6	20.1	19.6	23.3	26.5	...	*December-00*
Broad money (percent change, 12-month basis)	7.8	8.7	5.2	8.1	6.5	9.2	*April-01*
Private sector credit (percent change, 12-month basis)	10.6	9.4	-3.5	-3.9	-3.3	-2.0	*April-01*
Domestic credit	65.5	68.2	61.7	59.7	56.9	56.2	*April-01*
One-year bond yield at issue (annual average)	8.4	10.3	13.8	7.4	5.9	4.9	*April-01*
One-year bond yield at issue, real (annual average) 2/	1.8	3.5	12.1	5.9	2.9	1.6	*April-01*
External Indicators							
Exports G&NFS (percent change, 12-month basis in US$)	6.0	0.2	13.0	-1.9	9.3	...	*December-00*
Imports G&NFS (percent change, 12-month basis in US$)	12.7	-3.3	5.8	-1.8	12.3	...	*December-00*
Terms of Trade (percent change, 12 month basis)	0.9	0.3	5.2	-0.5	-2.9	...	*December-00*
Current account balance	-7.4	-6.1	-2.4	-3.0	-4.8	...	*December-00*
Capital and financial account balance	7.2	2.1	5.3	5.8	6.8	...	*December-00*
o/w: Inward portfolio investment (debt securities etc.)	1.3	2.4	2.0	0.9	1.0	...	*December-00*
Other investment, net (loans, trade credits etc.)	3.8	-2.4	-1.4	-3.3	1.4	...	*December-00*
Inward foreign direct investment	2.5	2.5	4.9	11.9	9.3	...	*December-00*
Net Foreign Assets (NFA) of commercial banks (in US$ billions)	-1.2	2.6	4.2	6.3	8.6	9.2	*April-01*
Gross official reserves (in US$ billions)	12.4	9.8	12.6	12.8	13.1	13.1	*April-01*
Net International Reserves (NIR) (in US$ billions)	12.4	9.8	12.6	12.8	13.0	13.0	*April-01*
Central Bank short-term foreign liabilities (in US$ billions)	0.0	0.0	0.0	0.0	0.1	0.1	*April-01*
Central Bank foreign currency exposure (in US$ billions)	12.4	9.7	12.6	12.8	13.0	...	*December-00*
Short term foreign assets of commercial banks (in US$ billions)	4.7	7.2	9.1	9.3	8.3	...	*December-00*
Short term foreign liabilities of commercial banks (in US$ billions)	3.7	4.9	6.5	6.4	6.0	...	*December-00*
Foreign currency exposure of commercial banks (in US$ billions)	0.9	4.4	6.6	7.6	8.6	9.2	*March-01*
Official reserves in months of imports G&NFS	4.4	3.6	4.4	4.5	4.1	4.1	*April-01*
Reserve money to (gross official) reserves (percentage)	73.4	67.2	61.5	45.8	44.9	42.0	*April-01*
Broad money to (gross official) reserves (percentage)	325.4	359.6	340.0	300.1	299.5	304.0	*April-01*
Total short term external debt to gross official reserves (percentage) 3/	66.3	111.4	104.4	101.6	92.2	...	*December-00*
Total external debt	36.8	44.9	40.4	44.8	42.6	...	*December-00*
o/w: Public sector debt 4/	3.9	3.8	2.4	2.4	1.7	...	*December-00*
Total external debt to exports G&NFS (in percent)	70.9	72.2	71.9	68.9	59.3	...	*December-00*
Total external debt service payments to exports G&NFS	10.9	15.7	15.1	12.8	12.2	...	*December-00*
External interest payments to exports G&NFS	3.4	2.9	3.1	3.1	2.4	...	*December-00*
External amortization payments to exports G&NFS	7.4	12.8	12.1	9.6	9.8	...	*December-00*
Exchange rate (per US$, period average)	27.14	32.06	32.19	34.87	38.81	39.94	*May-01*
REER depreciation (-) (12 month basis; CPI-based)	8.4	-6.3	16.9	-5.2	4.1	2.6	*March-01*
Financial Market Indicators (end of period)							
Stock market index	530	488	386	490	479	427	*June-01*
Foreign currency debt rating (Moody's)	...	...	...	...	Baa1	Baa1	*June-01*
Spread of benchmark bonds (basis points) 5/	...	...	...	98	125	83	*February-01*

Sources: Czech Statistical Office, Czech National Bank, Ministry of Finance, and Fund staff calculations.

1/ Debt of general government and transformation institutions; excludes government guarantees, which amounted to 14.2 percent of GDP at end 2000 and guarantees of the National Property Fund.

2/ Deflated by net inflation.

3/ Includes amortization of medium and long-term debt on a remaining maturity basis. Based on M&LT debt outstanding at the end of the preceeding year.

4/ General government and the central bank.

5/ Yield spread on a 5-year, U.S. dollar-denominated bond issued by the Czech Export Bank. This bond is quite illiquid, trading only once during February and mid-June 2001.

Table 5. Medium-Term Fiscal Scenarios, 2001–2004
(in percent of GDP)

	2001	2002	2003	2004
Authorities' Pre-Accession Economic Program (PEP)				
Overall general government balance (MoF definition)	-1.0	-6.7	-4.2	-4.3
Headline balance (excluding privatization)	-10.8	-9.9	-6.2	-4.6
Revenue	40.1	39.6	41.1	40.9
Expenditure	50.9	49.5	47.4	45.6
Interest payments	1.2	1.3	1.8	1.9
Grants to transformation institutions (TIs)	5.1	3.6	1.5	0.7
Other expenditure	44.5	44.6	44.0	43.0
Financing	10.8	9.9	6.2	4.6
Privatization	9.8	3.2	2.1	0.3
Net increase in financial liabilities	1.0	6.7	4.2	4.3
Adjusted balance	-5.7	-6.3	-4.7	-3.9
Adjusted primary balance	-4.5	-5.0	-2.9	-2.0
General government debt	20.2	25.5	27.9	30.3
Memorandum item:				
Revenue excluding tax reforms	40.1	38.9	38.5	38.2
Alternative scenario: Authorities' PEP with Reduced Privatization and Higher Cost of Bank Restructuring				
Overall general government balance (MoF definition)	-3.5	-7.9	-5.0	-4.7
Headline balance (excluding privatization)	-11.3	-10.4	-6.6	-5.0
Revenue	40.1	39.6	41.1	40.9
Expenditure	51.4	50.0	47.7	45.9
Interest payments	1.2	1.5	2.0	2.2
Grants to TIs	5.6	4.0	1.7	0.8
Other expenditure (primary expenditure excl. TIs)	44.5	44.6	44.0	43.0
Financing	11.3	10.4	6.6	5.0
Privatization	7.8	2.5	1.7	0.3
Net increase in financial liabilities	3.5	7.9	5.0	4.7
Adjusted balance	-5.7	-6.4	-5.0	-4.2
Adjusted primary balance	-4.5	-5.0	-2.9	-2.0
General government debt	22.7	29.0	31.9	34.4

Sources: Ministry of Finance; and staff calculations.

Table 6. Czech Republic: Macroeconomic Framework, 1997-2005

	1997	1998	1999	2000	2001 Proj.	2002 Proj.	2003 Proj.	2004 Proj.	2005 Proj.
				(In percent of GDP)					
Foreign saving 1/	6.1	2.4	3.0	4.8	5.1	5.2	5.1	4.8	4.6
Gross national saving 2/	26.7	27.3	25.6	25.6	25.5	25.4	25.2	25.3	25.2
Gross domestic saving 3/	26.3	28.3	27.0	26.6	26.9	26.9	27.0	27.2	27.4
Nongovernment	33.2	35.5	34.5	34.3	35.4	35.3	33.2	32.5	32.3
Government	-6.8	-7.1	-7.5	-7.7	-8.5	-8.4	-6.2	-5.3	-4.9
Gross domestic investment	32.8	29.7	28.5	30.4	30.6	30.6	30.4	30.0	29.8
Nongovernment	27.3	25.5	22.4	24.4	24.2	24.1	24.1	24.0	24.0
Government	5.5	4.1	6.1	6.1	6.4	6.5	6.3	6.0	5.8
Government balance 4/	-2.3	-1.9	-2.8	-3.9	-5.4	-5.7	-4.2	-3.5	-3.1
			(Percent change in real terms, unless noted otherwise)						
Memorandum items:									
Consumption expenditure	1.6	-2.2	0.4	0.9	3.8	3.7	3.2	3.6	3.6
Nongovernment	1.9	-2.6	0.5	1.4	1.8	2.2	3.0	3.5	3.9
Government	0.8	-0.9	-0.1	-0.2	9.2	7.3	3.6	3.9	3.0
Fixed capital investment	-2.9	-3.9	-4.4	5.2	6.1	4.7	3.6	3.7	3.8
Nongovernment	-5.1	0.2	-13.3	5.2	4.7	4.8	4.5	4.7	5.0
Government	8.7	-23.1	49.7	5.0	10.8	4.6	0.6	0.1	-0.6
GDP growth	-1.0	-2.2	-0.8	3.1	3.3	3.9	4.3	4.8	5.0
Nominal GDP (in CZK billion)	1,669	1,798	1,833	1,911	2,060	2,216	2,378	2,554	2,743
CPI inflation (12-month change)	10.0	6.8	2.5	4.0	3.8	...	...	...	...

Sources: Data provided by the Czech National Bank; Czech Statistical Office; Ministry of Finance; and Fund staff projections.

1/ External current account deficit (+).
2/ Equal to gross domestic investment (excluding statistical discrepancy) less foreign saving.
3/ Equal to gross national saving less net factor income and transfers from abroad.
4/ Based on MoF data and projections, excluding grants to TIs, privatization receipts, and other net lending.

Czech Republic: Fund Relations
(As of May 31, 2001)

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

II. **General Resources Account**:	SDR Million	% Quota
Quota	819.30	100.0
Fund holdings of currency	770.96	94.1

III. **SDR Department**:	SDR Million	% Allocation
Holdings	0.24	n.a.

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

V. **Financial Arrangements**:

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

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

VII. **Exchange Rate Arrangement**:
The currency of the Czech Republic is the Czech koruna, created on February 8, 1993 upon the dissolution of the currency union with the Slovak Republic, which had used the Czechoslovak koruna as its currency. From May 3, 1993 to May 27, 1997, the exchange rate was pegged to a basket of two currencies: the deutsche mark (65 percent) and the U.S. dollar (35 percent). On February 28, 1996, the Czech National Bank widened the exchange rate band from ±0.5 percent to ±7.5 percent around the central rate. On May 27, 1997, managed floating was introduced. On June 26, 2001, the exchange rate of the Czech koruna stood at CZK 39.34 per U.S. dollar.

VIII. **Last Article IV Consultation**:
The last Article IV consultation with the Czech Republic was concluded on July 26, 2000. The staff report and PIN were issued on August 9, 2000.

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

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

Czech Republic: Technical Assistance, 1991–2001

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

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

Czech Republic: Relations with the World Bank

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

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

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

4. Early in 1998 the Czech authorities initiated a new program of collaboration with the World Bank which has included several analytic reports as well as technical assistance. The first round of work in 1998-99 began with a Report on Capital Markets, completed (in red cover) in June 1999, following broad dissemination in Prague. A Country Economic Memorandum, focussed on issues related to EU accession, was finalized in September 1999, and was also broadly distributed and presented in Prague in October 1999 to a diverse audience that included EU representatives. Technical assistance on contingent liabilities and fiscal sustainability was provided during 1998-99, as was support to the National Energy Efficiency Study. Work on EU related environmental issues (water) was done with the cross support from EU member states while work related to EU accession issues in energy is being pursued jointly with the EC. During the second round of work in 2000/01, the Bank completed two major follow-up reports, the Public Expenditure Review (PER) and a report on Completing the Transformation of Banks and Enterprises. Both were presented at public seminars and have been published in Czech by the journal Okonom as well as in red cover versions by the Bank. In addition, as a spin-off of the PER, the Bank will publish a separate report on Intergovernmental Fiscal Relations, which will be discussed at another public seminar in Prague in June 2001. During the coming year, the Bank will follow-up the PER with more detailed technical assistance on pension reform as well as follow-up technical assistance on bankruptcy legislation, insolvency and creditors rights.

5. The International Finance Corporation (IFC) has made loans and equity investments in industrial and financial companies. Total net IFC exposure to the Czech Republic as of April 30, 2001 amounted to US$219.04 million. The IFC has also provided advisory assistance in a number of privatization deals.

Table. Status of Bank Group Operations in the Czech Republic—
Operations Portfolio

As of April 30, 2001

	Number	(In millions of US$)
Active projects	0	
Closed projects	5	
Total disbursements (IBRD)		511.7
Of which has been repaid		234.1
Total outstanding		273.8
Total undisbursed		0.0

Source: IBRD.

Table. Czech Republic: Statement of IFC's Current Exposure

As of April 30, 2001

FY Approval	Company	Loan	Equity	Quasi	Partic.
	(In millions of US dollars)				
1994	Autokola	3.15	0.00	2.29	0.00
1994	Beronit	2.05	0.00	0.00	0.00
1995	Plzensky	0.00	0.00	6.88	0.00
1995	Sumperk	1.14	0.00	1.02	0.00
1997	Kladno	33.43	0.00	14.16	18.24
1997/98	Nova Hut	77.12	0.00	0.00	143.99
1998	DCR Czech Rating	0.00	0.04	0.00	0.00
1999	CSOB	0.00	77.74	0.00	0.00
Total Portfolio:		116.89	77.78	24.35	162.23
		Approvals Pending Commitment			
		Loan	Equity	Quasi	Partic.
2001	Konsolidacni banka	0.00	2.50	20.00	0.00
Total Pending Commitment:		0.00	2.50	20.00	0.00

Czech Republic: Statistical Issues

1. Data on core surveillance variables are provided to the Fund regularly and with minimal lags (reporting to STA is less current, especially for foreign trade and the national accounts). Data on exchange rates and basic interest rates set by the Czech National Bank (CNB) are reported on a daily basis with no lag. Data on gross and net international reserves are reported on a monthly basis with a one-week lag, as well as on a ten-day basis (with the CNB's balance sheet) with a one-week lag. Data on consumer prices, reserve money, broad money, borrowing and lending interest rates, central government fiscal accounts, and foreign trade are provided monthly with a lag of 1–4 weeks. Final monetary survey data are available with a lag of about one month. GDP and balance of payments data are made available on a quarterly basis with a lag of 2–3 months. Annual data published in the Government Finance Statistics Yearbook cover all operations of the general government, including the extrabudgetary funds excluded from the monthly data. These annual data are available on a timely basis. Monthly fiscal data published in *International Financial Statistics (IFS)* cover central and local budget accounts and are available with a 2–3 month lag.

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

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

4. Revisions in recent years to procedures for processing export data have brought external trade statistics close to the practice in the EU. However, a continued weakness of foreign trade statistics is the unavailability of price indices for exports and imports with a fixed base; these indices are currently presented on the basis of the same month of the previous year.

5. Although there are some differences with the *IFS* presentation, monetary survey data provided to the European I Department are generally adequate for policy purposes. However, large variations in the interbank clearing account float, especially at the end of the year,

require caution in interpreting monetary developments. The CNB has made a major effort to identify the causes of these variations and adjust the data. An STA mission (January-February 1999) provided recommendations regarding valuation, accrued accounting, and treatment of financial derivatives in monetary statistics. The mission also reviewed and updated the system of reporting data to IFS which has resulted in some changes to published monetary statistics.

6. The Czech Republic has subscribed to the Special Data Dissemination Standard (SDDS), meets the SDDS specifications, and its metadata are posted on the Fund's Dissemination Standards Bulletin Board on the internet.

Czech Republic: Core Statistical Indicators

(As of June 25, 2001)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Central Govern-ment Balance	GDP
Date of latest observation	6/25/01	5/31/01	5/31/01	5/31/01	5/01	6/25/01	5/01	5/01	Q1 2001	4/01	Q1 2001
Date received	6/25/01	6/7/01	6/6/01	6/6/01	6/13/01	6/25/01	6/8/01	6/22/01	6/5/01	6/4/01	6/25/01
Frequency of data	Daily	Daily	10 days	10 days	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly
Frequency of reporting	Daily	Monthly	10 days	10 days	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly
Source of update	Reuters	CNB 1/	CNB	CNB	CNB	CNB	CSO 2/	CSO	CNB	MOF 3/	CSO
Mode of reporting	Electronic	Electronic	Mail/ Electronic	Mail/ Electronic	Mail/ Electronic	Electronic	Electronic	Electronic	Electronic	Mail/ Electronic	Electronic
Confidentiality	No	No	No	No	No	No	No	No	No	No	No
Frequency of publication	Daily	Monthly	10 days	10 days	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly

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

INTERNATIONAL MONETARY FUND

CZECH REPUBLIC

Staff Report for the 2001 Article IV Consultation
Supplementary Information

Prepared by the European I Department

(In Consultation with the Policy and Review Department)

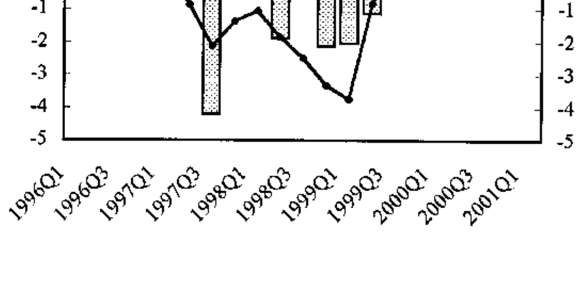
Approved by Masahiko Takeda and Leslie Lipschitz

July 13, 2001

1. This supplement contains information on recent economic developments in the Czech Republic that has become available since the circulation of the staff report for the Article IV consultation (SM/01/195, June 28, 2001). This information does not alter the general thrust of the staff appraisal.

I. Macroeconomic Developments

2. **Economic activity continued to be strong in the first quarter.** GDP grew by a somewhat-better-than-expected 3.8 percent (year-on-year) in the first quarter, on the back of brisk investment demand (7.3 percent over Q1 of 2000) and rising household consumption expenditure (3.9 percent over Q1 of 2000). However, the outcome does not alter the staff's forecast of 3–3.5 percent growth in 2001, which is based on a slowdown in the remainder of the year. On the supply side, activity in the manufacturing sector was particularly strong (12.1 percent, year-on-year). The Czech Statistical Office announced substantial revisions to the GDP series for 1996–2000. The revised series showed that the 1997–99 recession was somewhat shorter and not so deep as originally thought (see Figure). As for 2000, growth of real GDP was revised downward from 3.1 percent to 2.9 percent.



3. **The external current account deficit widened in the first quarter** to US$708 million (5.6 percent of first quarter GDP), from US$336 million in the same quarter

of 2000, reflecting a growing trade deficit driven primarily by buoyant imports of capital equipment. Substantial foreign direct investment (US$915 million) and portfolio investment inflows (US$252 million) provided the necessary financing. External debt at end-March was unchanged from the end-2000 level of US$21.4 billion (over 42 percent of GDP). The koruna has been less affected than other regional currencies by the recent turmoil in emerging markets, recovering to its previous level vis-à-vis the euro after a brief dip, reflecting in part the absence of large long koruna positions subject to liquidation. Concerns about the prospects for privatization of the Czech telecom company as well as negative sentiment worldwide have weighed on Czech equities. The Prague Stock Exchange index has lost about 5 percent of its value since late June.

4. **Inflation has edged up, but underlying inflation remains subdued.** Consumer price inflation rose to 5.5 percent (year-on-year) in June, from 5.0 percent in May. The rise reflected primarily higher food prices, which have shot up 9.1 percent (year-on-year) and have contributed 2.6 percentage points to annual inflation. Excluding food items and administered prices, 12-month inflation was 2.4 percent in June. Commenting on these developments, the Czech National Bank (CNB) noted (i) the influence of the volatile food component on recent inflation trends and (ii) the general absence of price pressures in the other components of the consumption basket. Looking ahead, the CNB sees price pressures rising, as demand factors are expected to play a more dominant role.

5. **The government recently approved a scaled-down version of the Big Bang plan,** which envisages total spending of CZK 166 billion (about 8 percent of 2001 GDP) during 2001–02, compared with CZK 265 billion under the original plan. This spending will be split about evenly across the two years. According to the government, the revised plan will not have any net budgetary or macroeconomic impact in 2001 since all expenditures proposed for this year are already included in approved budgets. As for next year, while the level of expenditures under the plan will be smaller than originally envisaged, the macroeconomic effects of the plan remain unclear at this stage. The Big Bang plan—and the general government budget more generally—continues to rely on privatization receipts as its main source of financing. The authorities have reduced their privatization forecast for 2001 by CZK 20 billion (nearly 1 percent of GDP) to CZK 180 billion (8.8 percent of GDP), of which CZK 50 billion has already been, or is soon to be, realized.[1] As regards budget execution, indications are that shortfalls in tax revenue and privatization receipts, together with implementation delays, have restrained the pace of discretionary spending (especially capital expenditure) in the state budget and by the Housing Fund. Further savings (CZK 15 billion) could come this year from smaller-than-budgeted bank restructuring costs.

II. Structural Measures

6. **Bank privatization is nearing completion with the recent announcement of the sale of Komerční banka (KB) to Société Générale.** The purchase price of CZK 40 billion

[1] This forecast includes privatization revenues received by the National Property Fund and local governments, and the proceeds from the sale of UMTS licenses.

(US$1 billion, or close to 2 percent of 2001 GDP) was about what the government was expecting to raise. The government announced that the deal with Société Générale did not involve any additional guarantees on the assets of KB. Prime Minister Zeman announced that half of the proceeds would be used to pay down the national debt; however, most of the remainder would be used to support the activities of the infrastructure and housing funds.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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July 25, 2001

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

IMF Concludes Article IV Consultation with the Czech Republic

On July 16, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Czech Republic.[1]

Background

After three years of recession, the economy grew by 2.9 percent in 2000, supported by a revival of investment in primarily foreign-owned firms and a modest increase in household consumption. Economic growth strengthened to 3.8 percent in the first quarter of 2001, as investment continued to expand briskly and household consumption rebounded. However, the expansion has been uneven, with vibrant, export-oriented firms with foreign participation leading the recovery and raising the economy's competitiveness, while a large number of less-dynamic firms are in need of restructuring and continue to generate losses. Nonetheless, the base of growth has broadened as local firms have begun to benefit from the presence of foreign-owned companies—primarily as suppliers of components. Strong demand from the European Union led to rapid export growth, but imports (primarily of investment goods) grew even faster, generating a negative contribution from the external sector.

New job creation has outweighed layoffs from enterprise restructuring only since mid-2000 and the unemployment rate has declined only slowly to a seasonally-adjusted 8.5 percent in mid-2001, which helped contain wage demands well within productivity growth. Low mobility of labor has led to large regional disparities in unemployment rates.

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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. This PIN summarizes the views of the Executive Board as expressed during the July 16, 2001 Executive Board discussion based on the staff report.

Consumer price inflation ended 2000 at 4 percent, 1.5 percentage points higher than in the previous year, owing to temporary factors including higher imported fuel costs and a strong U.S. dollar. However, net inflation targeted by the Czech National Bank (CNB) (which excludes administered price and indirect tax changes) was 3 percent at end 2000, below the CNB's target range. Headline inflation edged up to 5.5 percent in June 2001, but underlying inflation remains subdued due to strong competition in the retail sector and restrained wage demands.

Deteriorating terms of trade and strong imports of capital equipment led to a sharp widening of the external current account deficit in 2000 to 4.8 percent of GDP, which was amply financed by foreign direct investment (FDI) inflows. The trade deficit doubled to 6.6 percent of GDP in 2000, despite rapid export volume growth, reflecting effects of higher oil prices and strong imports of capital goods and intermediate products. Incoming FDI reached 9 percent of GDP in 2000. On a net basis, capital inflows amounted to 6.8 percent of GDP. These trends continued in the first quarter of 2001, with the external current account deficit reaching 5.6 percent of GDP, while FDI and other capital inflows remained strong. The koruna has strengthened modestly since early 2000 vis-à-vis the euro and in nominal effective terms, and has been relatively unaffected by recent turmoil in emerging markets.

Monetary conditions have remained supportive, with a decline in real interest rates offsetting the real effective appreciation of the koruna. The CNB lowered its key policy interest rate in February 2001 to 5 percent from 5.25 percent. While market rates tracked the decline in official interest rates, aggregate bank lending to the private sector has remained subdued. Nonetheless, credit to households and to enterprises under foreign ownership did expand in 2000 and early 2001, while credit to the traditional enterprise sector continued to decline.

Against the background of a still nascent recovery, fiscal policy was expansionary in 2000, with the general government deficit (excluding privatization receipts and bank restructuring costs) increasing by nearly 1 percentage point to 4.1 percent of GDP. For 2001, the general government deficit is budgeted to expand by a further 1.6 percentage points to 5.7 percent of GDP. In addition, bank restructuring costs could add up to 5 percent of GDP to the government's total financing requirement. The authorities plan on privatization proceeds of some 8.8 percent of GDP to cover most of this need.

On the structural front, an amendment to the Bankruptcy Act was passed to strengthen creditor rights, but creditors continue to express dissatisfaction with the enforcement of bankruptcy procedures. With the recent privatization of Komercni banka, the last major state-owned bank, the banking sector is now largely foreign owned. Cleaning up the banks shifted a large stock of nonperforming assets to the state work-out bank, but the pace of their disposal has so far been slow. Large-scale enterprise privatization is slated for this year and next, but the state of international markets could result in delays. Corporate profitability is increasing, but restructuring of a large segment of enterprises is proceeding slowly. These enterprises continue to generate losses and remain highly indebted. The Revitalization Program for nine large enterprises has led to several privatizations, but restructuring plans for a number of other companies have been frustrated by inadequacies in the legal system and a lack of support from other creditors.

Looking ahead, economic growth is expected to reach 3–3.5 percent in 2001, propelled by strong investment demand and a building momentum in household consumption. However, with weakening demand in the EU, export growth will slow and the pace of intermediate goods imports will decline while imports of capital equipment should remain buoyant, resulting in a negative growth contribution from the external sector. Despite a weakening of external price pressures, inflation is forecast to rise somewhat above 4 percent, as domestic demand factors begin to exert a greater influence on price formation. Growing household consumption and the slowdown in trading partner demand are expected to balance the effect on the external current account of lower oil prices and a weaker U.S. dollar, which should keep the deficit near 5 percent of GDP this year.

Executive Board Assessment

Directors observed that the economic expansion had gained a broader footing, and commended the authorities for having installed a set of macroeconomic and structural policies that had so far contributed to this outcome. Directors noted the key role that foreign direct investment had played in improving productivity and international competitiveness, thereby laying the foundation for strong, sustainable economic growth. They considered that the challenge was to ensure fiscal sustainability and to maintain the momentum of structural reform in order to hasten the Czech economy's convergence with the European Union.

Directors considered that, in the period ahead, it would be critical to find the right balance of policies to ensure that the ongoing recovery would not stall while maintaining the long-term sustainability of public finances. They agreed that the appropriate policy mix would be an accommodative monetary policy and a tighter fiscal policy. Directors noted that fiscal policy should refrain from adding demand stimulus; any further expansion in the fiscal deficit could result in an unsustainable widening of the external current account deficit, particularly with export markets weakening, which could undermine medium-term growth. Also, government privatization receipts may be lower than expected, making it all the more imperative to resist spending pressures. Directors noted that extrabudgetary funds are non-transparent and complicate fiscal management. They cautioned, in particular, against recent initiatives, such as the "Big Bang" plan, which could work against the achievement of sustainable public finances. While Directors recognized that the authorities face political constraints, they urged them to prepare carefully, and implement expeditiously, fiscal reform measures to place public finances on a sound, medium-term footing.

Directors noted that flexibility in the conduct of monetary policy is key to ensuring that inflation remains under control. They saw no need for monetary policy to deviate substantially from its current accommodative stance, provided that domestic inflationary pressures remain broadly under control. Directors welcomed the new inflation-targeting framework, which would improve the transparency of monetary policy. However, they noted that the new framework would require the CNB to establish a clear distinction between the use of the target band for forward-looking policymaking, on the one hand, and for ex post performance evaluation, on the other, where the authorities are expected to explain clearly the reasons why inflation was outside the band. Directors considered that the authorities should examine carefully some of the operational aspects of the framework, especially how to handle administrative price and indirect tax adjustments, as well as the design and use of escape clauses.

The exchange rate was considered to be broadly in line with fundamentals, and it was agreed that intervention should be limited to moderating large fluctuations in the exchange rate, without attempting to influence productivity-driven medium-term trends. Looking further ahead, an important challenge for the authorities is to plan for the Czech Republic's eventual participation in the euro zone. In order to achieve a smooth progression through the wide bands of ERM-II and avoid exchange rate turbulence during this critical phase, Directors saw a need for further progress in a number of areas, including real convergence, financial sector stability, and a sound fiscal position.

Directors noted that recent improvements in productivity and international competitiveness indicate that structural reforms are bearing fruit. They noted that further progress is needed to expand the productive capacity of the economy in order to reduce regional disparities and enhance the Czech Republic's ability to compete effectively within the EU. In particular, legal and regulatory reforms, corporate sector restructuring, and reform of the pension system should proceed without delay. Directors considered it necessary to improve enforcement of existing laws and regulations—a step that would require a strong build-up of supervisory capacity, a more proactive approach by self-regulatory organizations, and improvements in the court system.

Directors welcomed the considerable progress in banking sector restructuring, and commended the authorities for their achievements and determination to complete the process. They were encouraged by the positive findings of the Financial System Stability Assessment and indications that some of the banks are now more receptive to expanding their lending activities. However, some concern was expressed about the slow pace of bad asset disposal, and the authorities were encouraged to refrain from disposal methods that would increase government intervention in the enterprise sector.

Directors observed that the Czech Republic meets the Special Data Dissemination Standard (SDDS) specifications for coverage, periodicity, and timeliness of the data, and that the quality of data is adequate for the purpose of surveillance.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The staff report for the 2001 Article IV Consultation with the Czech Republic is also available.

Table 1. Czech Republic: Selected Economic and Financial Indicators, 1996–2001

	1996	1997	1998	1999	2000	2001 Proj. 1/
			(Percent change)			
Real sector						
Real GDP	4.3	-0.8	-1.2	-0.4	2.9	3.0–3.5
CPI inflation						
Period average	8.8	8.5	10.7	2.1	3.9	4.0
12-month change	8.6	10.0	6.8	2.5	4.0	4.0
Net inflation, 12-month change 2/	6.6	6.8	1.7	1.5	3.0	2–4
Registered unemployed, per. average (percent of labor force)	3.1	4.3	6.1	8.6	9.0	8.7
			(In percent of GDP)			
Fiscal sector 3/						
Revenues	40.4	39.7	39.2	41.5	40.6	40.6
Expenditures and net lending (including privatization and bank restructuring costs)	40.6	40.9	40.8	42.1	43.8	42.3
Balance	-0.4	-1.2	-1.6	-0.6	-3.3	-1.7
Excluding privatization revenues	-2.1	-1.9	-3.0	-3.7	-5.1	-11.5
Excluding privatization revenues and grants to transformation institutions to cover costs related to bad-asset management	-0.9	-1.7	-1.9	-3.2	-4.1	-6.4
Gross debt	13.3	12.8	13.3	15.0	17.3	...
Loan guarantees outstanding 4/	...	17.0	17.4	15.8	14.6	...
			(12-month change in percent)			
Money and credit (end-of-period)						
Broad money	7.8	8.7	5.2	8.1	6.5	8.4
Credit to enterprises and households	10.6	9.4	-3.5	-3.9	-3.3	3.0
Net foreign assets	-9.5	20.1	25.6	33.2	20.0	19.5
Velocity (percentage change, end-of-period)	5.6	-2.3	2.4	-5.7	8.9	...
Interest rates						
Average lending rate	12.5	13.2	12.9	8.7	6.9	...
Average deposit rate	6.8	7.7	8.1	4.5	3.0	...
			(In billions of U.S. dollars)			
Balance of payments						
Merchandise exports	21.7	22.8	26.4	26.3	29.0	32.2
Merchandise imports	27.6	27.3	28.9	28.2	32.3	36.2
Trade balance	-5.9	-4.5	-2.6	-1.9	-3.3	-4.0
Current account	-4.3	-3.2	-1.3	-1.6	-2.4	-2.8
(Percent of GDP)	-7.4	-6.1	-2.4	-3.0	-4.8	-5.1
Nondebt capital inflows (percent of GDP) 5/	3.5	3.3	6.8	10.7	9.7	14.8
			(In billions of U.S. dollars)			
Reserves and external debt						
Gross official reserves (end-of-period)	12.4	9.8	12.6	12.8	13.1	13.6 6/
(In months of imports of goods and services)	4.4	3.6	4.4	4.5	4.1	3.9 6/
Total external debt (end-of-period)	21.2	21.6	24.3	22.9	21.5	22.0
(Percent of GDP)	36.8	44.9	40.4	44.9	42.6	40.5
Short-term debt (convertible currencies, end-of-period)	6.0	7.1	9.1	8.8	9.0	9.5
External debt service ratio in convertible currencies						

(Percent of exports of goods and nonfactor services)	10.9	15.7	15.1	12.8	12.2	10.1
			(Percent change)			
Exchange rate (period average)						
Nominal effective	1.9	-3.5	0.7	0.2	1.6	...
Real effective (ULC-based)	3.3	-2.3	8.5	3.4	0.6	...

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

1/ Staff projections.
2/ Net inflation excludes administered prices and the effects of changes in indirect taxes. Authorities' target range for 2001.
3/ General government operations and debt; central government guarantees. Revenues and expenditures include privatization receipts. Projections for 2001 based on the April 2001 discussions with the authorities.
4/ Includes a CZK33 billion government guarantee not included in official reported statistics.
5/ Inflows for direct investment (equity capital and reinvested earnings) and equity securities. Includes privatization-related FDI.
6/ Excludes privatization proceeds to be deposited in the special account for privatization-related FDI.

Statement by Jiri Jonáš, Advisor to Executive Director for the Czech Republic
July 16, 2001

Recent developments

Since the last Article IV discussion, the economic situation in the Czech Republic has significantly improved. After three years of negative growth, real GDP growth finally picked-up in 2000, to 2.9 percent, and even more robust growth continues this year. Real GDP has increased by 3.8 percent in the first quarter of 2001, and the rapid growth of industrial production and construction in the second quarter suggest that the growth momentum is sustained.

It is particularly encouraging that growth is accelerating despite the marked slowdown in the EU. This does not mean that the Czech economy is immune from the adverse external environment. If growth in the EU had not weakened, it is likely that the recovery in the Czech Republic would be even faster. However, the relative resistence to weakness in the EU shows that the recovery is quite broad-based, supported by solid domestic demand growth.

The economic recovery is accompanied by a welcome decline in the unemployment rate, which fell from a peak of 9.8 percent in January 2000 to 8.1 percent in June of this year. The accelerated creation of new jobs augurs well for the continued drop in unemployment, though large regional differences remain a serious problem. Stronger economic activity has been accompanied by accelerating inflation, which had fallen to a very low level during the recession years. In June, consumer prices jumped by 1 percent, bringing the 12-month consumer price increase to 5.5 percent, the highest since December 1998.

Future outlook

Reduced import demand in Germany and other large trading partners is already causing some deceleration in exports, and it is likely that this effect will be felt even more strongly in the future. Because domestic demand in the Czech economy is expected to remain strong, it is likely that import growth will continue to outpace export growth, and the trade deficit could widen further. The current account deficit has widened in the first quarter of 2001 to 5.6 percent of GDP, from 4.6 percent of GDP in 2000, but it continues to be more than fully financed by direct foreign investment. For the time being, large projected privatization revenues and greenfield investment projects are expected to provide sufficient financing in the future as well. However, should privatization and foreign direct investment slow down, a further widening of the current account deficit could become a source of vulnerability, particularly in the present unsettled situation in international capital markets.

With respect to the long-term sustainability of the recovery, it is particularly encouraging that economic growth is led by dynamic growth in investment, while consumption growth remains relatively moderate. Qualitatively, economic growth in 2001 is very different from that in the period before the 1997 turbulence. At that time, it was mainly driven by a rapid wage growth in excess of productivity growth which fueled rapid growth of consumption. Presently, real wage growth remains relatively moderate, lagging behind growth in labor productivity. This has beneficial effects on competitiveness and exports.

Monetary policy

It could seem that in the Czech Republic, the conduct of monetary policy has been recently somewhat uneventful. Between November 1999 and now, the Czech National Bank (CNB), has changed its policy rate only once, in February 2001 when it cut the two-week repo rate from 5.25 to 5 percent. However, the long period of stability in policy interest rates masks important shifts in the setting of monetary policy that took place during that period. Most importantly, inflation risks have gradually increased.

In 1998, 1999 and 2000, the CNB repeatedly undershot its inflation target, as weak domestic demand and deflationary external shocks combined to push headline inflation to as low as 1.1 percent two years ago. However, with economic recovery accelerating and the temporary factors that kept inflation down disappearing, both headline and net inflation have begun to rise. In recent months, inflation has exceeded the CNB's forecasts. June inflation figures were particularly surprising. The CNB is analyzing the situation carefully. It does not want to tighten monetary policy prematurely, partly in view of the strong koruna and worsening external outlook, but it does not want to be left behind the curve and allow inflation to get out of control, thus threatening its inflation targets. The recent higher-than-expected increase in inflation can be ascribed mainly to the faster growth of traditionally volatile foodstuff prices and oil prices (on account of the strong dollar). Prices of other items in the consumer basket did not increase much, suggesting little demand pressure on prices thus far. The CNB is well aware, however, that as economic recovery gathers strength, room for demand-pulled inflation pressure will increase, and it could become more difficult to dampen such cost-pushed inflation impulses. The CNB will analyze carefully these opposite forces that will shape the inflation outcome in the future, and adjust monetary policy accordingly.

As the staff notes, in April the CNB modified its inflation targeting framework. Instead of net inflation, it is now targeting headline inflation. This shift was made possible because of the progress in reducing the uncertainties regarding price deregulation. Headline inflation is generally better understood by markets, trade unions and other agents, and this shift should enhance the CNB's ability to affect inflation expectations. Of course, the risk of missing the headline inflation target on account of factors not related to monetary policy increases, which puts a premium on the CNB's clear and persuasive communication strategy.

Fiscal policy

My authorities generally share the staff's assessment and recommendations concerning fiscal policy. The staff has correctly identified medium-term fiscal prospects as the main risk to the economic outlook and the most important policy challenge. As a result of resolution of nonperforming loans in the banking sector, public deficits and public debt will have increased rapidly, though from a very low level. At the same time, weak economic activity in the previous years prompted my authorities to seek ways to stimulate the economy. In line with the IMF recommendations expressed during previous missions and Board meetings, they used fiscal policy as an instrument for short-term demand stimulus.

Clearly, as economic recovery gathers strength, the need of procyclical fiscal policy diminishes, and the task of consolidating public finance becomes the order of the day. As the staff explains, fiscal policy will likely remain expansionary in 2001 as well. As output growth is likely to remain below potential, however, my authorities do not see an immediate need to reduce the public deficit for cyclical reasons. Moreover, while the authorities may have somewhat overestimated the ability to increase tax revenues, they expect that this shortfall could be to a large extent compensated by higher-than-budgeted social security contributions. A payment to cover last year's Konsolidacni Banka losses that is smaller than budgeted would also help this year's budget. My authorities also expect that they will be able to complete the privatization of Telecom and Ceske Radiokomuniakce this year. They do not assume that additional long-term borrowing will be needed to finance the 2001 budget deficit. In fact, they do not exclude a budget outcome better than originally projected, which would allow them to finance a 2000 state deficit larger than originally approved without additional long-term borrowing, which is opposed by Parliament.

Presently, budget deficits are largely financed using privatization revenues, which are one-time revenues, and their timing and size are uncertain. My authorities recognize that this creates a significant risk to financial stability. Partly in response to the difficult situation in public finance, the Government has recently decided to scale down the so-called "Big Bang" project, from the original CZK 265 billion to CZK 166.4 billion. For 2001, this project does not imply any new demand on budget financing, and it is very unlikely that there will be any large claims next year.

Given the worrisome medium-term public finance outlook, the authorities will face some difficult choices in deciding how to put public finance on a sustainable path. The implementation of a successful strategy to deal with the fiscal problems will require a broad political consensus, which is unlikely to be reached before next year's parliamentary election. However, the staff at the Ministry of Finance, with the helpful assistance of the World Bank and the IMF, is working hard so that reforms of public finance can start as soon as possible after next year's election.

Structural reforms

Serious problems in the banking sector were an important factor behind the poor growth performance after the 1997 monetary turbulence. In recent years, however, the Czech banking sector has undergone dramatic changes. With the sale of Komercni Banka two weeks ago, all major banks now have private foreign owners. In the short-term, this could create some funding problems for less creditworthy borrowers. In the longer term, however, economic performance should benefit from this change in the ownership structure.

This year, the Czech Republic took part in the FSSA project, and my authorities have expressed strong satisfaction with the work of the joint IMF/World Bank team. The FSAP team has not only provided a very thorough analysis of developments and risks in the Czech financial sector, but has offered the Czech authorities many useful recommendations as to where further improvements are needed. My authorities intend to pursue these recommendations vigorously.

Both the Article IV Report and the FSSA Report note that problems remain in the area of creditors' rights, and that it is difficult to initiate bankruptcy proceedings. Given the relatively large role of bank financing in the Czech economy, this is a serious problem which deserves attention. As the staff notes, a new amendment to the Bankruptcy Law is being prepared. In addition, the Law on Court Executioners should enter into force in September, and it is expected to significantly strengthen creditors' position vis-à-vis debtors.

Conclusion

The Czech Republic has made significant progress in addressing the problems that contributed to the 1997 financial turbulence and subsequent weak growth performance. The benefits of this progress are obvious: growth in the Czech Republic has accelerated even at a time when global economic activity has weakened significantly. Of course, no country is isolated from what happens elsewhere. But continued progress with privatization of nonfinancial enterprises, resolution of remaining structural problems and, later on, implementation of a resolute strategy to deal with fiscal problems should ensure that the long-needed recovery in the Czech Republic will continue.