



# CZECH REPUBLIC

## STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

July 31, 2014

### KEY ISSUES

**Context.** Growth is gaining momentum, led by strong external demand while domestic demand is also picking up. The central bank's foreign exchange intervention policy has helped stem deflationary pressures but inflation is still well below target. Following substantial fiscal adjustment over the past three years, an easing of the fiscal stance is underway and the new government's medium-term fiscal plans have not yet been fully elaborated. The financial system is sound and resilient to shocks, and improvements in the regulatory and supervisory architecture are ongoing. The challenge for the authorities is to create the conditions for strong and sustainable growth while maintaining macroeconomic stability.

**Policy recommendations.** Policies should aim at comprehensively addressing obstacles to strong, sustained growth; and maintaining buffers.

- **Fiscal policy.** Adopt a growth-friendly fiscal strategy. Support the nascent recovery through an increase in capital spending financed by a slight relaxation of the fiscal stance over the near term. Adopt a medium-term fiscal framework that helps anchor fiscal policy, enhance predictability, and avoid pro-cyclicality.
- **Monetary policy.** Continue to focus on inflation targeting. Keep the exchange rate floor in place until deflation risks recede, and the inflation forecast and inflation expectations become entrenched around the inflation target.
- **Financial sector.** Remain vigilant and be ready to address possible risks to financial stability.
- **Structural reforms.** Advance structural reforms aimed at increasing labor market participation, enhancing investment in human and physical capital, and improving the business climate.

Approved by  
**Philip Gerson and  
 Bob Traa**

Discussions took place in Prague during June 18–30, 2014. The staff team comprised Messrs. Christou (Head), Dalgıç, Lian, and Omoev, and Ms. Mordonu (all EUR). Messrs. Prader and Kollár (both OED) attended some meetings. Mmes. Chen and Moraes Rego (both EUR) assisted in the preparation of the staff report. The staff team met with Czech National Bank Governor Singer, Vice Governor Tomšik, Deputy Ministers of Finance Gregor and Pros, other senior officials, and representatives from the private sector, trade unions, and think tanks. Czech Republic is an Article VIII country (Informational Annex: Fund Relations). Data provision is adequate for surveillance (Informational Annex: Statistical Issues).

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## CONTEXT

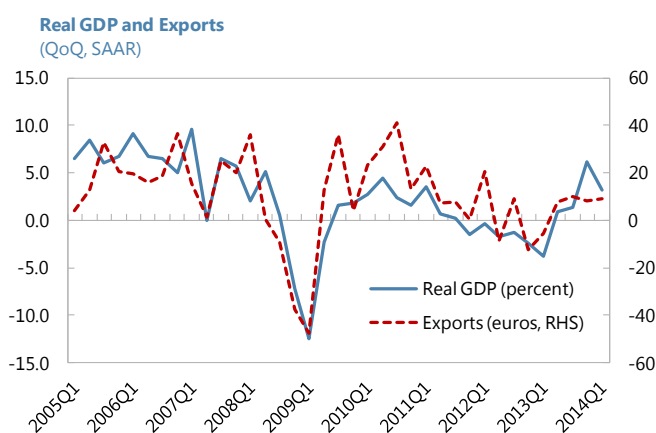
### 1. The Czech economy has gained momentum, but policymakers still face challenges.

Following a prolonged period of stagnation which was exacerbated by significant fiscal consolidation that went beyond what was necessary under the Excessive Deficit Procedure (EDP), the economy has turned a corner, driven by strong external demand and a pickup in domestic demand. An easing of the fiscal stance is now envisaged, although the authorities' fiscal policy agenda is yet to be clearly elaborated. With the policy rate at the zero lower bound, the central bank's foreign exchange intervention policy has helped stem deflationary pressures but inflation remains well below target.

**2. A new pro-European, but ideologically-diverse, coalition government took office in January 2014.** In contrast to the previous right-wing and euro-skeptic coalition, the new government—a coalition of the Social Democrats, a new center right party (ANO), and the Christian Democrats—is friendlier to the EU policy agenda. It already endorsed the Fiscal Compact and stated that euro adoption is a possibility before 2020, albeit not within its current mandate. However, the new government is ideologically diverse. Its overall orientation is toward more activist social welfare-enhancing policies, as evidenced by the decision to increase the minimum wage and introduce a lower VAT rate for some items, and the promise to resume full pension indexation (to a mix of inflation and wage growth). On the other hand, ANO has pledged not to increase taxes.

## BACKGROUND AND RECENT DEVELOPMENTS

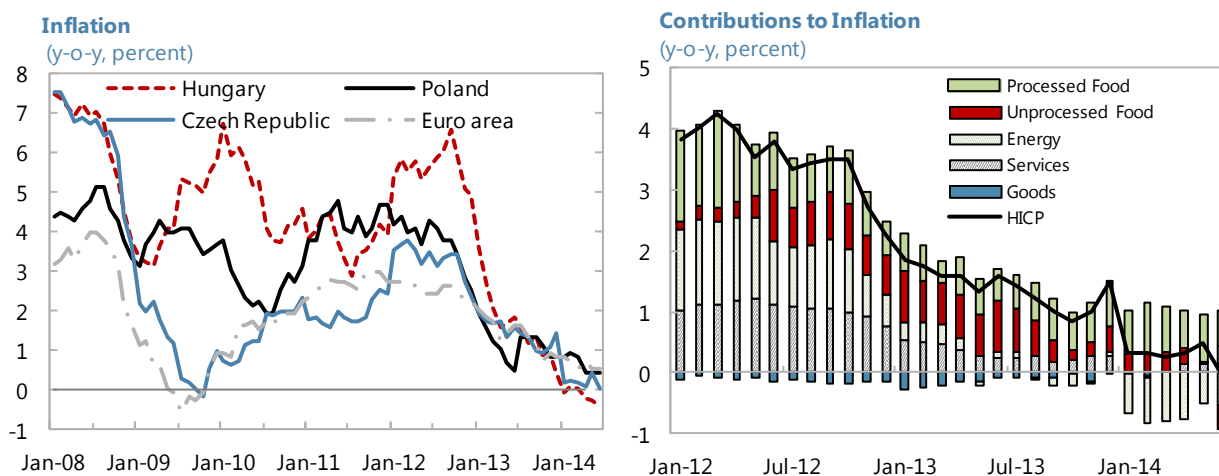
**3. The Czech economy exited the recession in 2013.** Notwithstanding an average annual decline of 0.9 percent in real GDP, quarter-over-quarter growth turned positive in 2013:Q2 and accelerated throughout last year. The recovery was triggered by exports (mainly of automobiles and machinery), but has been increasingly supported by domestic demand, with a strong contribution from investment in 2013:Q4. Household consumption has also buttressed the recovery, underpinned by improvements in labor income. As a result, year-over-year growth reached 2.9 percent in 2014:Q1. Moreover, high frequency indicators, such as industrial production and sentiment surveys, suggest that growth has remained strong in recent months.



**4. The labor market is poised for a recovery.** Unemployment entered a gradually declining path in 2013 on the back of gains in employment, and reached 6.6 percent (seasonally adjusted) in 2014:Q1 compared with 7.2 percent a year earlier. While these employment gains were coupled

with lower hours worked per employee and declining real wages through 2013, this trend was reversed in 2014:Q1 with real wages recording a solid increase.

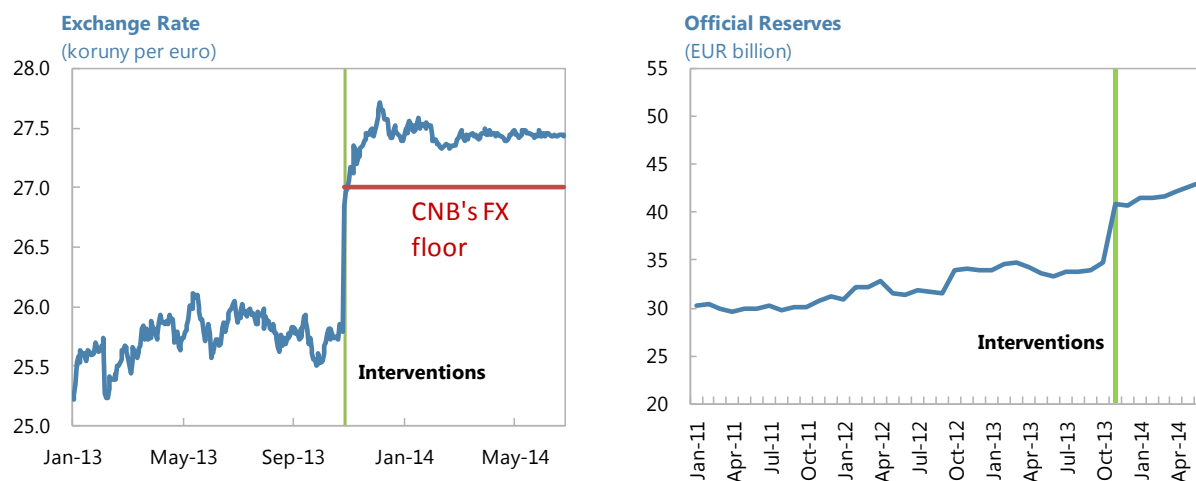
**5. Inflation has been falling, but is still in positive territory aided by the weaker exchange rate.** Headline inflation declined from its September 2012 peak of 3.4 percent to zero in June 2014, in tandem with inflation in the euro area and in regional trade partners. About two thirds of the decline was accounted for by a moderation of food and energy prices. The decline in inflation has been mitigated by the exchange rate depreciation, which had a rapid pass-through to tradables prices—non-energy goods inflation (HICP basis) increased from -0.6 percent in November 2013 to 0.7 percent in June 2014, turning positive for the first time since 2008—and helped keep inflation at an average of 0.2 percent year-over-year in the first half of 2014. Various core inflation indicators also exhibit a trend towards normalization; inflation excluding indirect tax changes and fuels reached 1 percent, its highest level since 2011. Moreover, inflation expectations, as measured by analyst surveys, have also increased following the exchange rate move.



**6. A sharp fiscal adjustment led to an exit from the EDP and kept debt levels contained, but exacerbated the recession.** The adjustment was driven mainly by a compression of capital expenditure, partly due to implementation bottlenecks, while an increase in VAT rates helped boost revenue. The fiscal stance continued to improve, with the structural deficit narrowing by 1.3 percentage points of GDP on the heels of a cumulative 2.4 percentage point consolidation during 2011–12. The decline in the headline deficit, from 4.2 percent of GDP in 2012 to 1.5 percent in 2013, was even more pronounced due to one-off factors in 2012, which had elevated that year's deficit. The European Council abrogated the EDP in June 2014.

**7. Constrained by the zero lower bound, the Czech National Bank (CNB)—an inflation targeter—resorted to foreign exchange intervention to avoid deflation, consistent with Fund advice.** The koruna had been strong in 2012–13, not responding significantly to the weak economy in the last few years, partly buoyed by strengthening capital flows since 2011. In November 2013, facing the zero lower bound for its policy rate and the risk of a persistent undershoot of its inflation target, the CNB decided to use the exchange rate as an additional instrument for inflation targeting and announced its commitment “to prevent excessive appreciation of the koruna below CZK27 per €

by intervening in the foreign exchange market”, implying a 6 percent depreciation that was expected to bring inflation to target in the monetary policy horizon.<sup>1</sup> The exchange rate is currently around CZK27.5 per €, and there has been no intervention in the foreign exchange market since November 2013. In the last Article IV consultation, the Fund recommended foreign exchange intervention as preferable over purely quantitative easing through purchases of domestic financial assets given the systemic liquidity surplus in the banking system, scarcity of private financial assets to purchase, and the very low long-term interest rates for government bonds.



**8. The banking sector remains strong, but credit provision is lackluster.** Banks have improved their already strong capital position reaching a capitalization ratio of 16.5 percent at end-2013 compared with 15.6 percent in 2012. Profits moderated somewhat as net interest income was compressed, but banks continue to enjoy strong asset quality, low non-performing loans, and stable and cheap local deposit funding. At the same time, credit growth was subdued at 3.0 percent, mainly due to weak demand from corporates.

**9. Creditworthiness remains high.** Czech Republic is rated investment grade with a stable outlook. Five-year credit default swaps have been remarkably stable at around 50 basis points. Bond yields increased somewhat in the second half of 2013 in line with global trends, but have recently approached historical lows: the 10-year bond yielded an average of 1.5 percent in June.

**10. The current account deficit is on a moderate narrowing trend.** It remained broadly stable at 1.4 percent of GDP in 2013, as a growing income deficit balanced out the improvement in the trade balance. The improving trend of the latter is expected to continue this year supported by robust export growth, thus contributing to a narrowing of the current account deficit to 0.2 percent

<sup>1</sup> As a result, the de facto exchange rate arrangement has been reclassified from *free floating* to *other managed*, effective November 7, 2013.

of GDP, a level staff assesses to be in line with fundamentals, including the output gap and still weak domestic demand.

### 11. Staff's assessment is that the real exchange rate is broadly in line with fundamentals.

Estimates based on the EBA methodology yield mixed results for the Czech Republic. Specifically, the Current Account Balance approach suggests that the current account deficit is still somewhat wider than the cyclically-adjusted norm of 0.4 percent of GDP deficit, indicating an overvaluation of about 5 percent in 2013. Benchmarked against the 2 percent of GDP deficit that would stabilize the net foreign asset position, the 2013 outturn suggests a very slight undervaluation. While the multilateral REER approach finds an 18 percent overvaluation, this appears too high in view of the current account-based assessment, and needs to be treated with caution as it may not capture factors such as an initial undervaluation, and rapid quality and productivity improvements. Other considerations also point to the absence of evident imbalances in the external position (Box 2) or of significant shortcomings in non-price competitiveness indicators (Figure 6). Overall, staff assesses the exchange rate to be in broad equilibrium, and the confidence level of this assessment has increased with the koruna now 6 percent weaker than the 2013 average.

## OUTLOOK AND RISKS

**12. Economic activity is expected to strengthen further.** The projected euro area recovery, supportive fiscal and monetary policies, and substantial slack in the economy will underpin growth performance over 2014–15. Staff projects growth at 2.5 percent this year, with one third and two thirds contributions from foreign and domestic demand, respectively—the latter is expected to turn positive for the first time since 2010. Investment will be supported by higher capacity utilization, greater clarity about the economic environment, foreign direct investment inflows, and greater take-up of European Union funds, whereas consumers will benefit from gains in labor income as well as improving confidence. At the same time, strong export performance (exports are projected to grow 7 percent in real terms this year) will be underpinned by positive trends in traditional markets (mainly the euro area) and products (mainly automotive and machinery). The effects of the depreciated exchange rate and recovering demand conditions are expected to push inflation gradually toward the 2 percent target. Over the medium term, output growth is set to stabilize at around 2 percent driven by domestic demand, as the current account stabilizes around a small deficit of ½ percent of GDP.

Czech Republic: Key macroeconomic indicators, 2012-19

(in percent of GDP, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019
					Projections			
Real GDP growth (percent)	-1.0	-0.9	2.5	2.5	2.4	2.3	2.1	2.1
Inflation (period average, percent)	3.3	1.4	0.6	1.9	2.0	2.0	2.0	2.0
General government overall balance	-4.2	-1.5	-1.2	-1.4	-1.2	-1.1	-1.1	-1.0
General government gross debt	46.2	46.0	44.3	44.3	44.1	43.5	42.9	42.3
Current account	-1.3	-1.4	-0.2	-0.3	-0.4	-0.4	-0.4	-0.4
Reserves (in billions of dollars)	45	56	58	61	63	66	70	73
Gross external debt	52.2	56.1	54.4	52.0	49.8	48.1	46.9	46.1

Sources: Czech authorities, and IMF staff projections

**13. Risks to the outlook are balanced.** The ongoing recovery in Czech Republic's trade partners, domestic slack, supportive macroeconomic policies, and the improving automotive cycle point to upside risks to growth. On the downside, escalation of geopolitical tensions in the region could affect exports and also create uncertainty regarding energy security (Box 3). Moreover, if the euro area recovery falters, the Czech economy will be negatively affected mainly through the trade channel. The impact would be larger if low growth turns self-reinforcing through low investment in physical and human capital (see Risk Assessment Matrix).

### Authorities' views

**14. The authorities broadly agreed with the near-term outlook, medium-term prospects, and the balance of risks.** Against a relatively upbeat baseline, they saw mostly externally-driven downside risks. They were somewhat concerned about re-emergence of financial stress in the euro area, possibly related to the outcomes from the Asset Quality Review and stress tests, as well as risks from potential geopolitical tensions in the region. On the whole, the authorities saw these risks as a reason to sustain or even strengthen policies that are supportive of domestic demand. Finally, they saw the need to boost potential growth as a key element for future prosperity and the convergence process.

## POLICY DISCUSSIONS

*Policies should be geared toward ensuring a sustainable recovery and macroeconomic stability, while creating the conditions for higher potential growth. Discussions thus focused on the need to adopt a comprehensive growth strategy that would encompass a growth-friendly medium-term fiscal strategy and structural reforms, with monetary policy continuing to play a stabilizing role. Such a strategy would contribute to a higher level of investment and growth.*

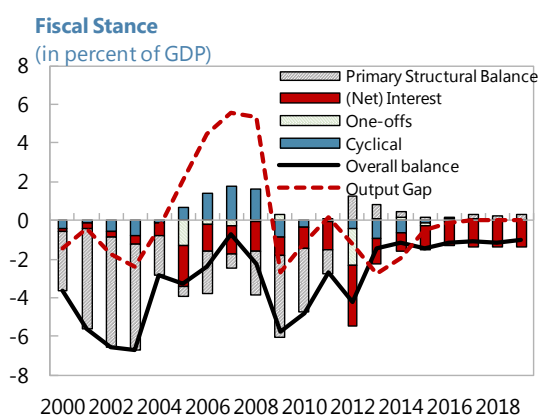
### A. Fiscal Policy

**15. The authorities are committed to the medium-term objective of a 1 percent of GDP structural deficit, which will need to be embedded into a clear medium-term fiscal framework, enshrined in legislation.** The Ministry of Finance has prepared an updated draft Fiscal Framework Reform (FFR) and plans to submit it to Parliament for discussion and approval later this year. The draft includes expenditure ceilings derived from the medium-term objective, a debt brake rule starting at 55 percent of GDP, and a Fiscal Council (Box 4). The proposed structural deficit rule strikes the right balance between reducing debt and creating fiscal space. It would also help eliminate the pro-cyclical bias of fiscal policy and would be consistent with EU fiscal framework requirements. While the debt brake has the potential to introduce a pro-cyclical bias, the current debt level provides an adequate buffer against this risk. Finally, an independent Fiscal Council with sufficient analytical and institutional capacity would further strengthen the fiscal framework. Staff urged the authorities to move expeditiously with the approval of the FFR to help anchor fiscal policy.

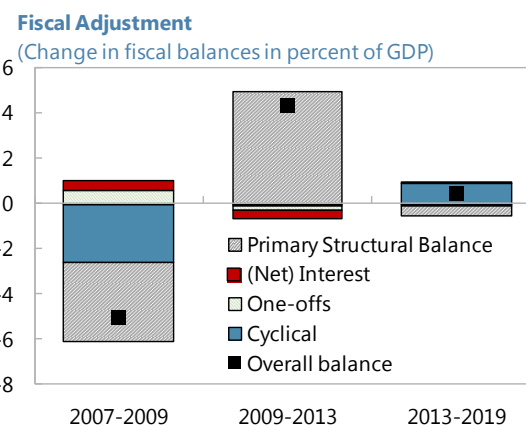


**16. The authorities are still elaborating the timeline for reaching the medium-term fiscal objective and underlying policies. Latest official projections as published in the Convergence Programme (CP) are subject to sizeable upside risks on the revenue side, while expenditure pressures exist in several areas. Near-term policies thus carry some degree of uncertainty.**

- **The fiscal stance is projected to remain neutral in 2014.** On the expenditure side, the budget foresees a sharp increase in capital spending to the pre-2013 levels, while other expenditure remains broadly unchanged as a share of GDP. Possible shortfalls in capital spending would be broadly neutral due to EU financing. However, the budget includes conservative revenue projections as they are based on an older vintage of macro assumptions. All in all, the CP includes a 1.8 percent of GDP projection for the headline deficit. However, in light of strong revenue performance so far this year and consistent with staff's baseline macroeconomic framework, as long as the approved expenditure ceilings are respected, the general government deficit is projected at 1.2 percent of GDP in 2014. This would imply a broadly neutral fiscal stance.



Source: IMF staff calculations.



- **Fiscal plans for 2015 are still being elaborated.** The CP includes a 2.3 percent of GDP projection for the headline deficit, although the actual target is likely to be lower. However, there is uncertainty regarding the structure of the budget and the deficit target, as the coalition partners' priorities are still being elaborated. The government has approved a lower VAT rate for pharmaceuticals, books, and infant food, and promised to abolish the reduced pension indexation—both effective next year. Based on staff's baseline macroeconomic framework and assuming that the expenditure allocations included in the CP are respected, the general government deficit is projected at 1.4 percent of GDP, thus implying a moderate structural easing of ½ percentage point.
- **The CP includes a structural deficit of 1.7 percent of GDP in 2017 and reiterates the government's commitment to the medium-term deficit objective.** This fiscal path implies that public debt would decline to about 42 percent of GDP by 2019, thus reinforcing Czech Republic's strong fiscal position (Appendix II).

**17. Staff welcomed the authorities' commitment to the medium-term deficit objective, but noted the need for more clarity regarding the fiscal targets and underlying policies.** Staff noted that, pending adoption of a medium-term fiscal framework by Parliament, fiscal targets should be consistent with the medium-term objective of a 1 percent of GDP structural deficit, ensuring that the chosen fiscal path strikes a balance between sustaining the economic recovery and creating space for addressing the country's infrastructure needs. To this end, staff supported an increase in capital spending financed by a modest increase in the structural deficit to 1¼ percent of GDP during 2014–15. Moreover, staff recommended that better-than-expected tax revenues not to be channeled to re-current spending.

**18. Staff emphasized the need to improve the efficiency of capital expenditure.** Higher utilization of EU funds should be the first step. Eliminating obstacles in planning and implementation of public projects without compromising governance would help in this respect. Within the envelope of a 1 percent of GDP structural deficit, increases in capital spending can also be financed through rationalizing re-current spending and stepped-up efforts to improve tax administration. In this connection, staff noted that the introduction of a new lower VAT rate was a much less efficient way to address social priorities than a more targeted measure would be, and also an unwelcome complication for tax administration.

### **Authorities' views**

**19. The authorities reaffirmed their commitment to the medium-term fiscal objective, but not to a particular timeline to achieve it.** They acknowledged upside risks to revenue that, were to materialize, would lead to a 2014 fiscal outturn better than the one projected in the CP. In fact, at end-July they revised their deficit projection to 1.5 percent of GDP. As for the medium term, the draft Fiscal Framework Reform foresees the medium-term objective of 1 percent of GDP structural deficit being reached in 2020. As of now, the authorities saw the 3 percent of GDP headline fiscal deficit threshold (i.e., the EDP limit) as the only binding requirement for fiscal policy. They noted that they would elaborate their position on the path and timeline for reaching the medium-term objective in the course of the preparation of the 2015 budget. To this end, they expected detailed discussions in the fall at which time coalition partners would have to agree on the government's priorities. They admitted though that there were expenditure pressures in several areas, which may lead to an increase in expenditure ceilings. In particular, the authorities highlighted that the recent episode of fiscal consolidation has led to an undue compression of public investment and a resulting infrastructure deficit in several areas such as transportation and energy. They also saw benefits from a slight fiscal expansion in terms of insurance against downside macroeconomic risks. Finally, the authorities noted that the approval of the new fiscal framework by Parliament could take time, despite the government's commitment to move expeditiously.

## **B. Monetary Policy**

**20. Under the baseline scenario, with the economic recovery gathering momentum, inflation is set to rise gradually toward the central bank's target.** While headline inflation

remains very low—weighed down by administered prices (e.g., gas and electricity) and food—core measures and demand-sensitive components of inflation are generally stronger and exceed headline inflation (Box 5). Demand for durables is strengthening, suggesting that the tail risk of a self-fulfilling deflationary spiral has been averted. Labor income growth is gaining momentum, underpinning solid consumption trends. Under staff’s baseline scenario, the effects of the weaker exchange rate and recovering demand conditions are expected to push inflation gradually toward the central bank’s 2 percent target over the monetary policy horizon. Moreover, inflation expectations have increased following the exchange rate move and CNB’s stated commitment to maintain the exchange rate floor into early 2015 as an instrument for achieving the inflation objective. In fact, inflation expectations have matched the CNB’s inflation forecast for a slight overshoot of the inflation target in the first half of 2015, before moderating to 2 percent by end-2015.

**21. With these considerations in mind, staff recommended that the CNB continue to focus on inflation targeting, and maintain the current supportive monetary conditions for now.**

There are still risks to the recovery mostly from external developments; the output gap is still sizable; and inflation remains very low, including in wage agreements. Therefore, staff suggested keeping in place the exchange rate floor for now, even though it has not been binding. However, staff recommended a return to a floating exchange rate once deflation risks recede, and the inflation forecast and inflation expectations, as well as wage developments, become entrenched around the central bank’s target. The pre-existence of a consistent monetary policy and inflation targeting framework, and a credible and transparent central bank, make the exit easier than in the case of traditional pegs. Moreover, the current monetary and exchange rate settings are consistent with broad macroeconomic equilibrium. In this context, staff recommended abolishing the exchange rate floor in one step rather than gradually. This is likely to be the first stage in the normalization of monetary policy, with interest rate hikes following in due course.

### **Authorities’ views**

**22. The authorities broadly agreed with the inflation outlook and noted their commitment to inflation targeting, while for now continuing to use the foreign exchange intervention policy as an instrument for achieving their inflation objective.** They were generally satisfied with the results of the intervention policy, and noted the underlying positive trends in the inflation data, which were overshadowed by still-low headline inflation. However, relative to their pre-intervention forecasts, negative price shocks have been more pronounced, and the hoped-for overshoot of inflation relative to target—to decisively break the inertia in inflation expectations—is now unlikely. As a result of a lower inflation profile, the authorities have decided to maintain the intervention policy as an instrument for achieving their inflation objective for longer, announcing in June that the policy will be in place until at least the second quarter of 2015. Nevertheless, once the conditions for exiting from the intervention policy were in place, they would return to a floating exchange rate. In this connection, the central bank would consider exit modalities in detail in the fall of this year.

## C. Financial Sector

**23. The financial sector is sound and resilient.** Czech banks, which are largely owned by euro area banking groups, are self-financed with a low system-wide loan to deposit ratio and strong capital and liquidity buffers. Profitability moderated somewhat on the back of still-weak credit growth, but still helped to further strengthen banks' capital to above 16 percent. Recent CNB stress tests indicate that aggregate bank capitalization would remain above 13 percent, significantly better than the regulatory minimum of 8 percent, even in a severe stress scenario with a large output drop and protracted stagnation. Many Czech bank parents are going through the ECB's comprehensive risk assessment, but their Czech subsidiaries are self-funded and net creditors vis-à-vis abroad, and should thus be relatively resilient to shocks to parents.

**24. Credit growth is likely to be boosted by the recovery.** Despite healthy bank balance sheets and moderate debt levels in the non-financial sector, credit growth remains subdued due to a combination of low credit demand and somewhat tighter lending standards. However, with healthy balance sheets in the financial and non-financial sectors, this is mostly expected to be a cyclical phenomenon—in fact, lending surveys suggest banks are turning cautiously optimistic, with the July lending survey showing that credit standards to corporates were eased for the first time since 2011. Approval rates for most loan categories remain high, and banks noted lack of fixed investment activity and financing from internal resources as limiting corporate credit demand, but they also saw initial signs of a recovery.

**25. Improvements in regulations and the supervisory architecture are continuing.** Building on last year's progress toward implementing FSAP recommendations,<sup>2</sup> supervisory resources have been increased for on-site inspections. Moreover, a draft law on credit unions—a small but problematic sector of credit providers—has been prepared, and would help reduce reputation risks to the financial system. The implementing law of the EU Directive on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms has been approved by Parliament, and systemic banks have already been notified of upcoming capital buffer requirements, with which they would be largely in compliance at current capital levels. Finally, work on the EU-wide initiative for unified resolution schemes and deposit insurance framework is continuing.

### Authorities' views

**26. The authorities shared staff's assessment of a healthy financial sector.** They saw a domestic balance sheet recession as the main risk to the financial system, but attached to this a smaller likelihood than before. They also highlighted the ongoing follow-up on FSAP recommendations and supranational regulatory initiatives. Finally, the authorities are considering

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<sup>2</sup> See Annex II of the Staff Report for the 2013 Article IV Consultation.

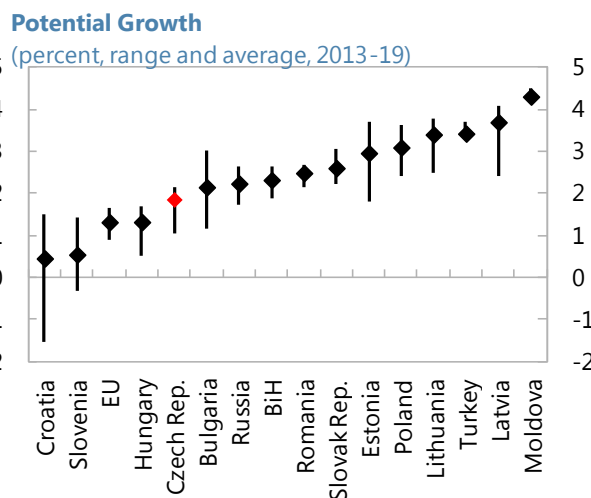
the pros and cons of opting into the euro area banking union ahead of euro adoption, and a detailed study is being prepared to be discussed in the fall.

## D. Structural Policies

### 27. Improving the Czech Republic's growth prospects remains a key challenge.

Staff estimates current potential output growth at 1.6 percent, as the capital stock increases slowly and total factor productivity gradually recovers after several years of stagnation. While potential growth is projected to increase over the medium term due to catching up with more advanced economies, diminishing low-base effects and demographic headwinds will constrain growth to 2 percent over the medium term (Appendix I). This is well

below the level necessary to facilitate convergence of Czech per capita output to the level of other advanced European economies. The employment rate is expected to remain stable, but with declining working age population, the economy would require wider sources of labor supply.<sup>3</sup> Moreover, labor force participation of some demographic groups is low, there are skill mismatches, and investment in research and development (R&D) is low. Although such labor market constraints may not be binding at this stage, they could impede the country's medium-term growth prospects.



**28. Renewed structural reform momentum is needed to put the Czech Republic on a higher growth trajectory.** Important steps have been taken to reduce labor market rigidities, including more flexible employment arrangements, strengthened public employment services, affordable high-quality child-care facilities, and increased rental housing availability. However, labor participation in some segments of the population—e.g., women with young children—remains low<sup>4</sup>, thus calling for targeted policies. Consideration could be given to upgrading skills and addressing skill shortages in the technical fields by education and training of less-advantaged populations (e.g., through apprenticeship programs), vocational training in close cooperation with businesses, and improved incentives in the education system to better match workforce needs. Moreover, reducing uncertainty regarding tax policies, simplifying compliance with taxation requirements, and combating corruption in line with the authorities' 2014 National Reform Programme should help enhance the business environment. Finally, strengthening R&D, improving infrastructure, and

<sup>3</sup> Working age population is projected to decline by 0.36 percent per annum during 2010-50, while total population is projected to grow by 0.15 percent per annum over the same period (based on the medium fertility scenario in UN's World Population Prospects: The 2012 Revision).

<sup>4</sup> Overall labor force participation is around 73 percent, which is above the OECD average, and the authorities' 2011 reform strategy aims at 75 percent by 2020.

facilitating SMEs' expansion and better integration into the international value chain would support stronger growth.

### Authorities' views

**29. The authorities agreed that this is an opportune time to undertake structural reform.**

They broadly shared the mission's assessment regarding impediments to stronger growth, and also noted the lack of part-time job arrangements as a barrier for increasing female labor force participation, the need to have more cooperation between the industry and schools to address the decline in the number of students majoring in technical fields, and the importance of higher public investment. To this end, they pointed to the steps in their National Reform Programme to stimulate growth, including investment in infrastructure, strong efforts to improve the absorption capacity for EU funds, development of child care services, support for vocational education, and co-operation between schools and employers. They felt confident that all these steps in the context of an improving external environment would help boost investment and growth.

## STAFF APPRAISAL

**30. The Czech economy is strengthening but continues to face challenges.** The economy has emerged from the prolonged recession, growth is gaining momentum, and unemployment has been falling. The recovery was triggered by exports, but has been increasingly supported by domestic demand. Despite these positive developments, inflation is still well below target, the new government's medium-term fiscal plans are yet to be clearly elaborated, and potential growth is well below the level necessary to facilitate convergence of Czech per capita income to the level of other advanced European economies.

**31. Following a sharp fiscal consolidation over the last three years, a growth-friendly fiscal strategy along with a clear medium-term fiscal framework is needed.** On account of the need to sustain the nascent recovery and improve infrastructure, an increase in capital spending financed by a slight relaxation of the fiscal stance in the near term would be appropriate. At the same time, using revenue over-performance to ratchet up re-current expenditure should be avoided. The authorities' commitment to a medium-term objective for the structural deficit is welcome, and it will need to be backed by a clear strategy on the underlying fiscal targets and policies. In addition, the medium-term deficit objective should be cast in a medium-term fiscal framework—enshrined in legislation—that would also include a debt brake rule, and an independent Fiscal Council, thus helping anchor fiscal policy, improve policy predictability, and contain pro-cyclicality.

**32. The central bank should continue to focus on inflation targeting and maintain the current supportive monetary conditions for now.** The effects of the depreciated exchange rate and recovering demand conditions are expected to push inflation gradually toward the central bank's target. At the same time, though, there are still risks to the recovery, the output gap is still sizeable, inflation remains very low, and inflation expectations are not yet well-anchored around the inflation target. These considerations argue for keeping the exchange rate floor in place for now.

Nevertheless, the central bank should continue to focus on inflation targeting and return to a floating exchange rate once deflation risks recede, and the inflation forecast and inflation expectations become entrenched around the inflation target.

**33. The financial system is sound and resilient; continued vigilance will help sustain its health.** The banking sector has strong capital and liquidity buffers, which make it resilient to shocks. Moreover, bank supervision has been enhanced by strengthening supervisory resources and legislative changes. Still, proactive supervision would be necessary along with gradual improvements in the supervisory architecture in line with the European and global initiatives.

**34. Unleashing Czech Republic's full growth potential requires renewed structural reform momentum.** Implementation of structural reforms aimed at enhancing investment in physical and human capital, and improving the business environment is critical to support Czech Republic's advancement in the international value chain and support stronger growth. Efforts to increase labor participation should continue, and greater emphasis should be placed on strengthening research and development, and upgrading skills in the technical fields.

**35. It is recommended that the next Article IV consultation with the Czech Republic be held on the standard 12-month cycle.**

Czech Republic—Risk Assessment Matrix <sup>1/</sup>

Source of Risks		Relative Likelihood	Impact if Realized	Policy Response
Global	<i>Surges in global financial market volatility</i>	<b>High</b> Uncertainty regarding the pace of UMP exit and possible change in risk perception may lead to increases in volatility of global yields and exchange rates.	<b>Low</b> Czech sovereign and banks are not reliant on external borrowing to any significant extent, but rising yields can dent growth, especially if the Czech recovery lags the global one.	Maintaining accommodative monetary conditions, while loosening the fiscal stance would allow absorbing the shocks through the trade channel.
	<i>A sharp increase in geo- political tensions surrounding Russia/Ukraine</i>	<b>Medium</b> Regional spillovers through trade, financial and confidence channels. Re-pricing of risks and heightened volatility in the financial markets.	<b>Medium</b> Disruption of gas supply and increase in gas prices would adversely affect production. A shift in risk perception could also increase borrowing costs.	An easing bias would be appropriate provided supply constraints do not become binding.
	<i>Protracted period of slower growth in advanced and emerging economies</i>	<b>High</b> External demand would wane, slowing the Czech Republic's main engine of growth.	<b>Medium</b> Weaker export growth would delay the recovery from the crisis along with a setback in the recovery of domestic demand.	Policies supporting domestic demand, as well as diversifying trade partners and specialization could help cushion the impact on the economy.
	<i>Bond market stress from reassessment in sovereign risk in euro area</i>	<b>Low</b> Sovereign stress re-emerges due to incomplete reforms, unanticipated outcomes from the asset quality review and stress tests in the absence of fiscal backstop.	<b>High</b> Through strong trade and financial ties with Europe, could lead to a significant economic slowdown. Banks, while sound, may turn conservative and limit credit provision. Households and firms can postpone spending as experienced in 2011–12.	Maintaining accommodative monetary conditions, while loosening the fiscal stance would allow absorbing the shocks through the trade channel. Closer monitoring of the Czech subsidiaries of euro area parent banks would be necessary to avoid financial spillovers, such as excessive transfer of liquidity and capital out of the country.
Domestic	<i>Permanently lower potential growth</i>	<b>Medium</b> If the current recovery falters again, hysteresis effects can reduce potential growth further. Structural reforms needed to boost potential growth could be delayed due to lack of political appetite.	<b>Medium</b> Potential growth may remain low for extended periods, and may even lead to long-term output losses	Advancing structural reforms and safeguarding public investment would help mitigate risks of further reductions in potential growth.

<sup>1/</sup> The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks at the time of discussions with the authorities.



### Box 1. Response to Past Fund Policy Advice

Policy implementation has been broadly consistent with IMF advice with the fiscal stance being an exception.

<b>Key recommendations</b>	<b>Implemented policies</b>
Further pro-cyclical fiscal policy should be avoided until the economic recovery gains strength.	Not implemented. The structural balance continued to improve in 2013; however, much of this improvement was due to an inability to execute spending, especially in the investment area, owing to political and legal bottlenecks.
Adopt a fiscal rule which has wide coverage, is easy to monitor, incorporates a debt brake, and is monitored by an independent Fiscal Council.	Not yet implemented. A new proposal by the Ministry of Finance, broadly in line with these recommendations, is under discussion.
If a persistent and large undershooting of the inflation target is in prospect, foreign exchange interventions could be employed to help guide inflation expectations toward the target.	Implemented. As it became clear that inflation will remain below target for a significant period of time, and facing risks that inflation expectations will become unanchored, the Czech National Bank intervened in the foreign exchange market in November 2013.
Continue improving the financial sector supervisory architecture.	Implemented. Supervisory resources have been boosted to intensify on-site supervision. Financial sector regulation is being modified in line with EU-wide initiatives. Stricter regulation of credit unions is under preparation.

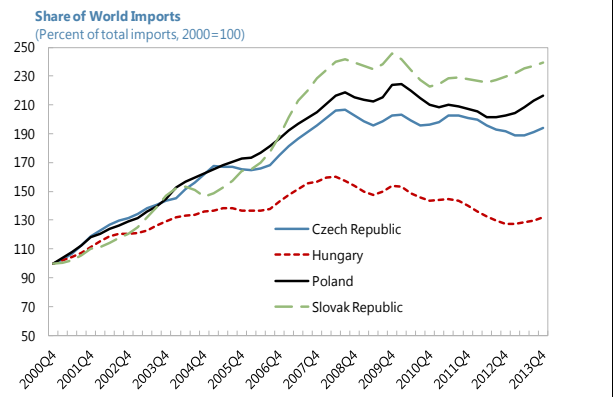
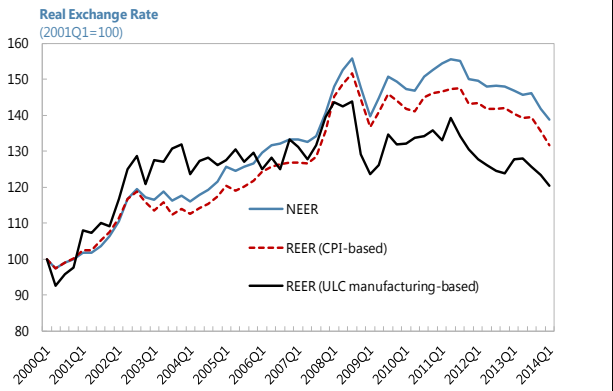
### Box 2. Competitiveness Assessment

**The koruna has depreciated moderately since mid-2011 against the background of financial turmoil in the euro area.** This trend has mitigated the lingering real appreciation from the 2007–08 spikes in the exchange rate, with an additional impetus from the CNB intervention in November 2013 to ease monetary conditions. While the CPI-based real exchange rate remains higher than its 2006 level, the recent favorable wage productivity dynamics has helped the Czech Republic preserve its competitive position—the real exchange rate deflated by unit labor costs in the manufacturing sector is now slightly lower than its historical average.

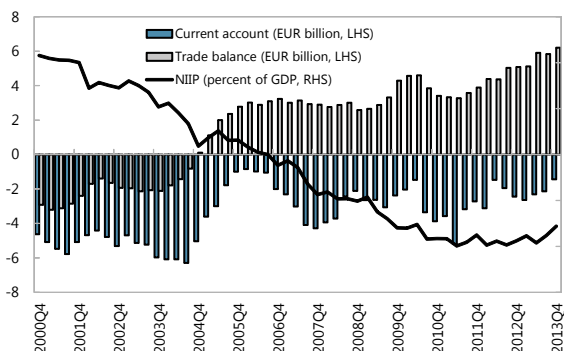
While the CPI-based real exchange rate remains higher than its 2006 level, the recent favorable wage productivity dynamics has helped the Czech Republic preserve its competitive position—the real exchange rate deflated by unit labor costs in the manufacturing sector is now slightly lower than its historical average.

**Despite the recent exchange rate depreciation, the Czech export market share has not yet increased.** Following earlier robust gains, the export market share has been broadly stagnant in the post-crisis period with some evidence of underperformance since 2011. While part of the explanation is the weak relative performance of the main Czech export market, the euro area, export performance has also lagged the one of Slovakia, which has a similar industrial structure and is oriented towards the same export markets.

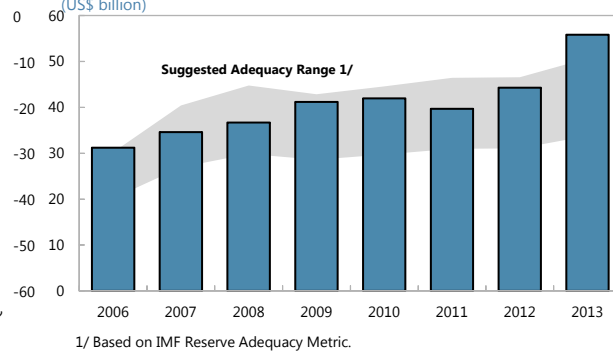
**Current account deficits have been largely financed by FDI inflows, the net international investment position (NIIP) has stabilized, and reserves are strong.** Reflecting the high FDI stock, Czech Republic has traditionally had a large income deficit that outweighs the trade surplus to produce moderate current account deficits. However, these deficits have been largely financed by FDI flows that are underpinned by foreign earnings reinvested in the country, as well as new investments. The accumulated external deficits over the years have led to a moderate negative NIIP of about 45 percent of GDP, but the NIIP has stabilized in recent years. Excluding the FDI stock, the NIIP is positive reflecting low external indebtedness and a strong reserve position. In fact, foreign exchange reserves are well above the suggested adequacy range, providing ample cushion against external shocks.



Current Account and International Investment Position



Czech Republic: Reserves (US\$ billion)



### Box 3. The Czech Republic's Links with Russia and Ukraine

*Real sector links with Russia and Ukraine, except for energy imports, are limited; and direct financial links are negligible.*

**Czech Republic's dependency on Russia and Ukraine is mainly through indirect supply chain links.**

Direct trade links are moderate. Russia is Czech Republic's 8<sup>th</sup> largest export market with 3.2 percent of Czech exports going to Russia, and the 6<sup>th</sup> largest importer, with 5 percent of imports originating from Russia. Czech exports to Ukraine are about 1 percent of total exports and imports from Ukraine represent 0.8 percent of total. Moreover, the share of Russian value added embodied in Czech gross exports is somewhat above 5 percent only in two industries. However, final demand from Russia, in particular for automobiles produced in the Czech Republic and supplied indirectly through the German-Central European Supply Chain, is an important driver for exports, and thus lower growth in Russia could lower Czech exports.

**The Czech Republic has a significant dependency on Russia and Ukraine for its energy imports.** The share of Russian gas in the Czech Republic's total gas consumption is 80 percent—the third largest share after Finland and Belarus. In addition, as the entire region is heavily dependent on energy imports from Russia, lengthy disruptions in gas supply would adversely affect production in the Czech Republic also through the impact on other countries. Nevertheless, there is scope for re-routing gas imports through other countries and, with seasonally-low demand, the Czech Republic could overcome short-lived disruptions.

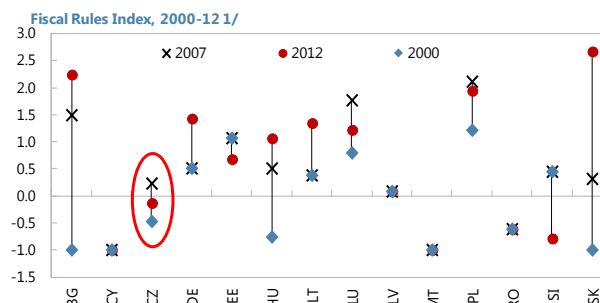
**Direct financial linkages are negligible.** However, there is a risk of contagion through confidence effects.

**There is significant reliance on tourism from Russia.** The number of Russian tourists to the Czech Republic increased sharply in recent years, and now is the second largest only after the one of tourists from neighboring Germany.

### Box 4. The Fiscal Framework

#### The current fiscal framework lacks a medium-term fiscal anchor and contributes to a pro-cyclical bias.

It consists of a medium-term fiscal target within the medium-term budgetary framework (MTBF) introduced in the 2004 Public Finance Reform. The MTBF is a three-year rolling framework that converts general government balance targets into expenditure ceilings, currently the only binding numerical fiscal constraint for the state budget and six state funds. In practical terms, the framework provides an effective constraint only on next year's budget, thus lacking a proper medium-term fiscal anchor. Moreover, there is no enforcement mechanism or corrective actions and the coverage is limited to less than 60 percent of general government spending. As a result, the Czech Republic stands relatively low in the European Commission's (EC) ranking of fiscal rule strength.



Source: European Commission.

1/ Compiled by the European Commission, the Fiscal Rules Index is higher, when the numerical fiscal rules are stronger. Based on: (i) the statutory base of the rule, (ii) room for setting or revising its objectives, (iii) the body in charge of monitoring respect and enforcement of the rule, (iv) the enforcement mechanisms relating to the rule, and (v) the media visibility of the rule.

**The proposed fiscal framework aims at addressing these weaknesses.** It encompasses a structural balance rule, a debt brake supplemented with a debt restriction on local governments, and a deficit constraint on social security funds. The debt brake starts to apply when public debt, adjusted for the Ministry of Finance's liquid reserves, exceeds 55 percent of GDP. The debt brake and the structural balance rule incorporate escape clauses applicable in cases of serious economic downturns, natural disasters, or emergency.

**According to the debt brake, several automatic procedures would be launched when debt exceeds 55 percent of GDP.** In such a case, the state budget as well as budgets of public health insurance companies and local governments must target a balance or surplus. Any new state guarantee would be provided only after a majority approval (by both Chambers of Parliament). While the debt brake has the potential to introduce a pro-cyclical bias, the current debt level provides an adequate buffer against this risk.

**The proposed structural balance rule foresees a limit of 1 percent of GDP for the structural deficit,** identical to the medium-term objective agreed between the previous government that the EC. Adoption of a structural balance rule would also be in line with the Fiscal Compact.

**The proposed framework is to be implemented by a Constitutional Law and an Act on Rules of Fiscal Responsibility.** The former incorporates the debt brake, Fiscal Council, and local governments' debt rule and requires a super majority in both chambers of Parliament to be modified. The latter specifies the practical implementation of the Constitutional Act including the structural balance rule and requires a simple majority in both chambers of Parliament to be modified.

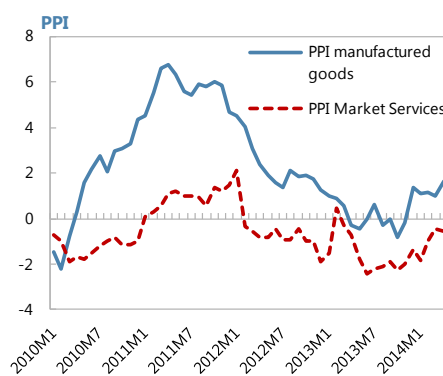
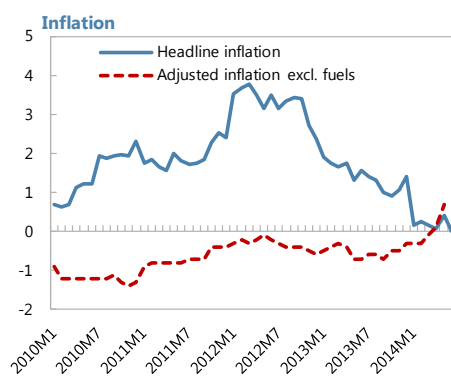
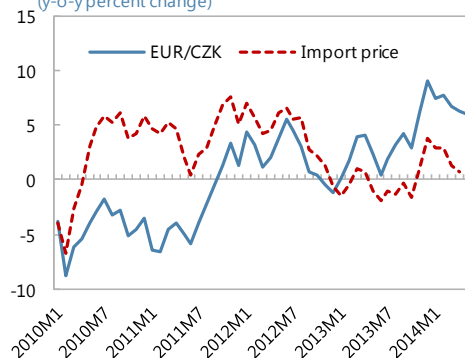
**Transparency and accountability would be enhanced with the introduction of a Committee for Budgetary Forecasts and an independent Fiscal Council.** The Committee would assess government forecasts and could require their revision if deemed optimistic. At the same time, more demanding and regular reporting criteria will be introduced, along with annual reports including on tax expenditures and contingent liabilities. The establishment of an independent Fiscal Council, with sufficient institutional and analytical capacity, would further enhance transparency and accountability of fiscal operations.

### Box 5. Inflation Developments

While headline inflation remains low, driven by administered prices (much of it energy-related) and food price inflation, positive underlying trends in a number of indicators suggest that risks of a deflationary spiral have begun to recede.

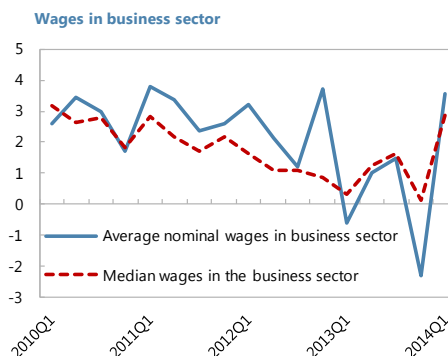
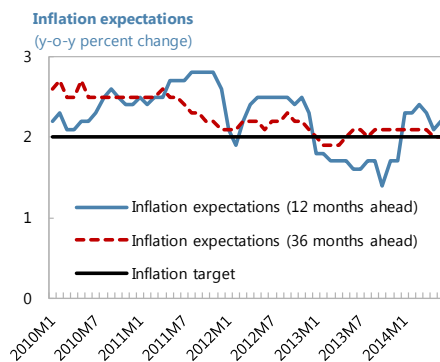
**Indicators of core inflation are supported by currency weakness and economic recovery.** Import prices spiked in late-2013 as a result of the exchange rate depreciation, while producer price indices of manufactured goods and market services have also been exhibiting upward trends. Inflation excluding regulated prices and fuel turned positive for the first time in five years in April 2014.

Import price and exchange rate  
(y-o-y percent change)



Source: Czech Statistical Office, Czech National Bank, Haver.

**Inflation expectations are on target.** Analyst forecasts have converged toward the central bank's 2 percent inflation target for the 12-month horizon, as market participants tuned down expectations of undershooting observed last year and overshooting expectations this year.

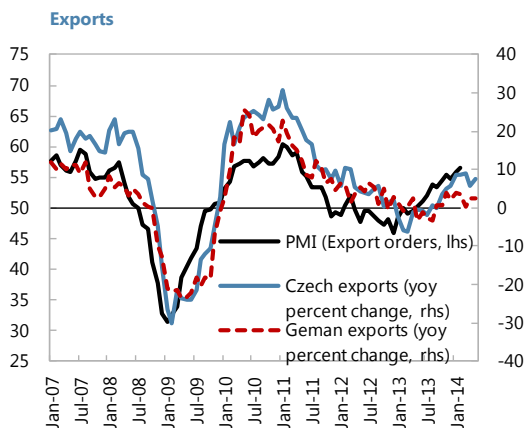


Source: Czech Statistical Office, Czech National Bank, Haver.

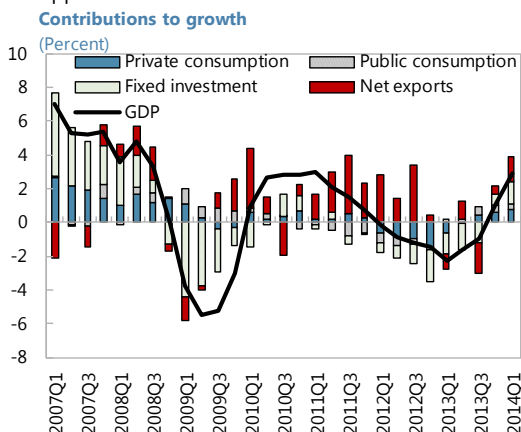
**Wages are recovering.** Nominal wages in the business sector performed strongly in the first quarter of 2014 following a bout of very weak performance. While some of the strength in average wages is due to the shifting of bonuses during the calendar year, even adjusted for this effect, private sector wage dynamics seem to have turned the corner.

**Figure 1. Czech Republic: Macroeconomic Developments**

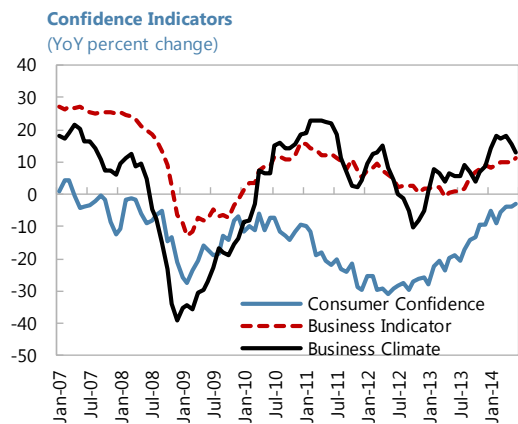
Exports triggered the recovery...



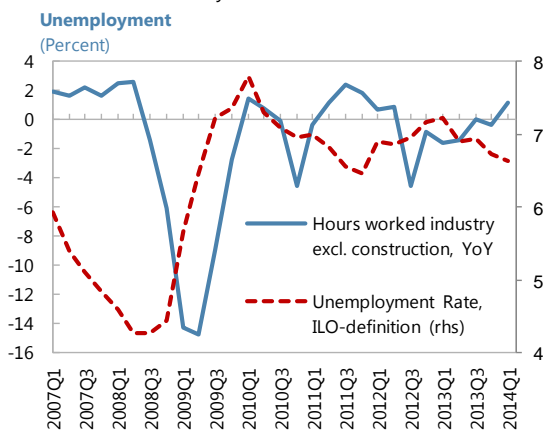
...but domestic demand is increasingly playing a supportive role...



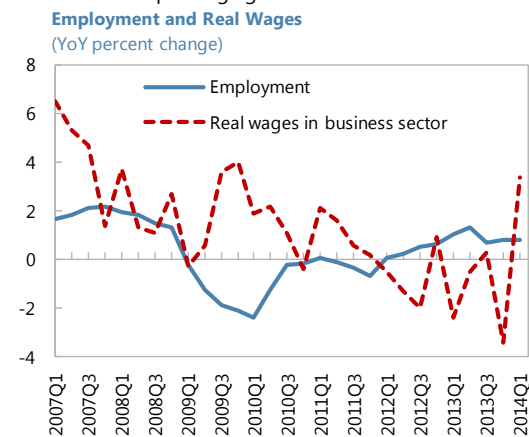
...as confidence indicators approach post-crisis highs.



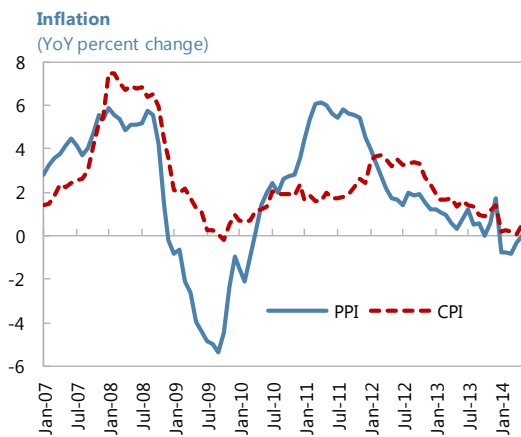
Unemployment has been declining, but aggregate hours worked is very subdued.



Real wages in 1Q were boosted by low inflation and one-off effects, but going forward, employment gains should underpin wage growth.



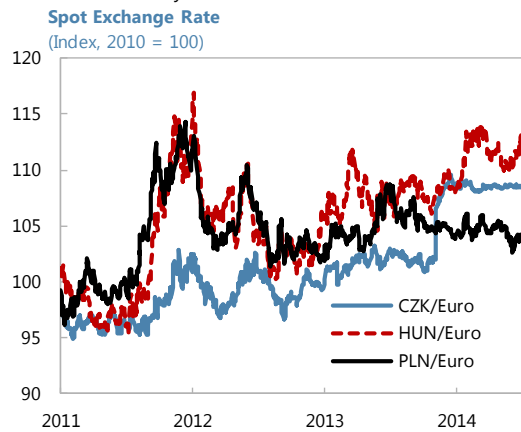
Economic slack and lower administered and energy prices continue to suppress inflation.



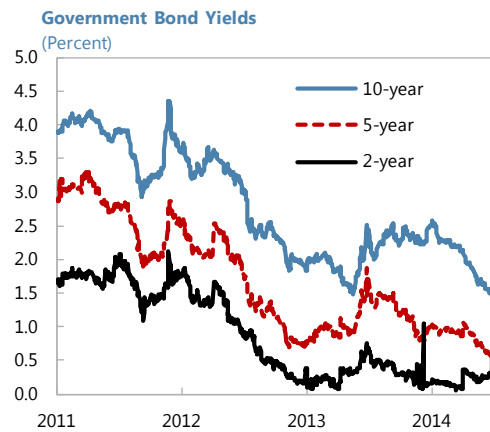
Sources: Haver; Eurostat; EMED; and IMF staff calculations.

**Figure 2. Czech Republic: Financial Markets**

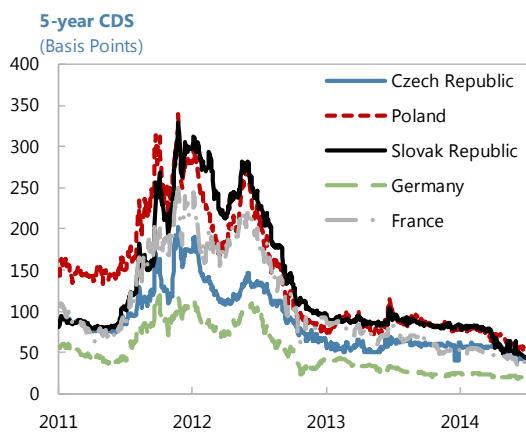
The koruna has overperformed regional currencies, with less volatility, until the CNB's intervention.



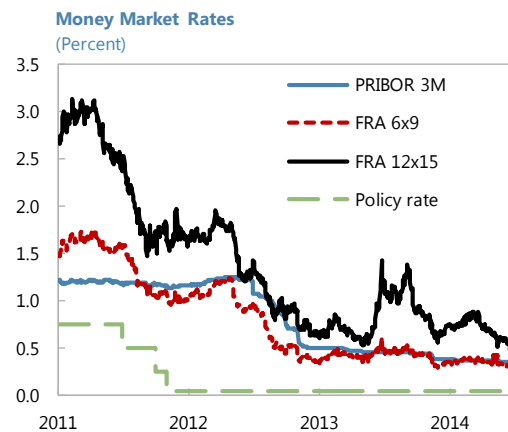
Bond yields are close to their record lows...



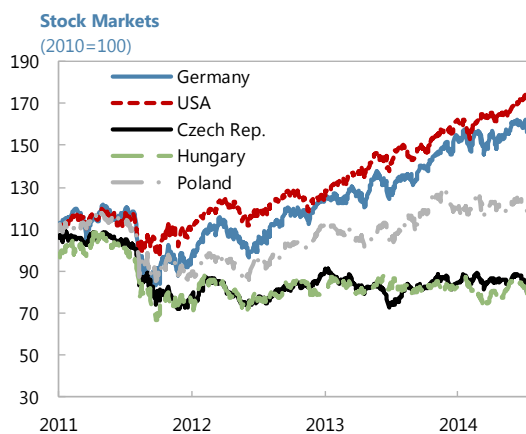
...thanks to low credit risk...



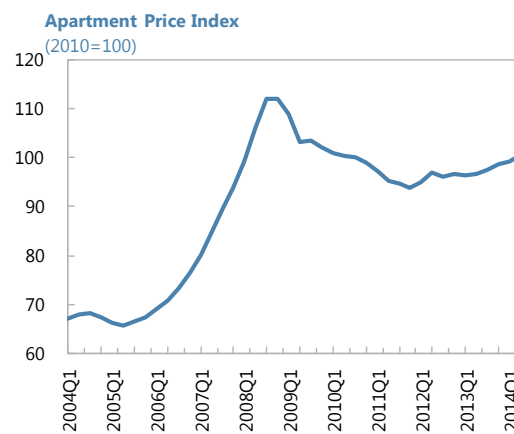
...and expectations of continued easy monetary policy.



Equities have underperformed most regional and global markets...



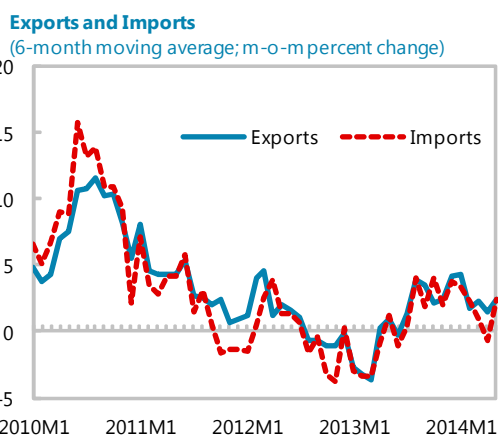
...while real estate prices are in a modest recovery trend.



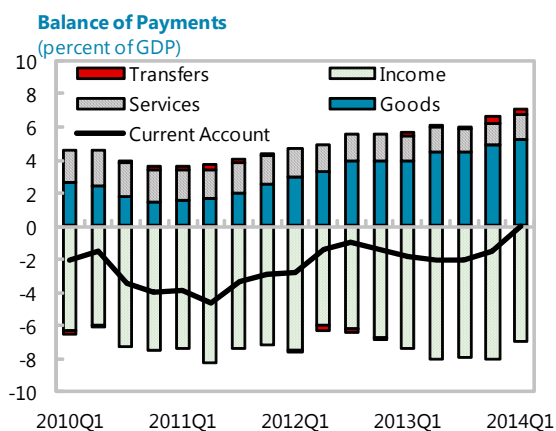
Sources: Bloomberg; Dealogic; Haver; BIS; and Global Insight.

**Figure 3. Czech Republic: External Sector**

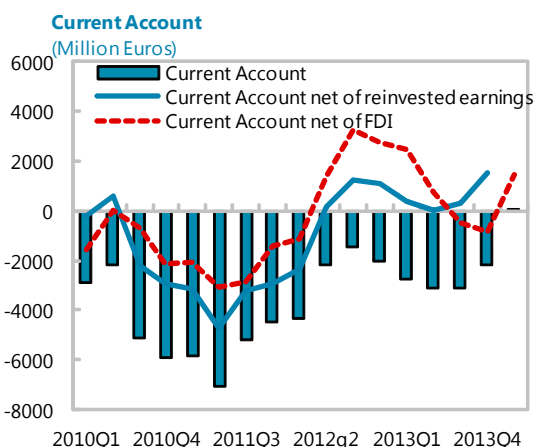
Export momentum remains positive...



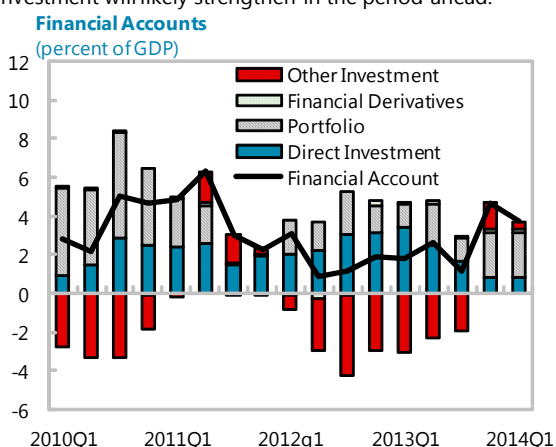
...and current account approached balance on improving trade surplus and narrowing income



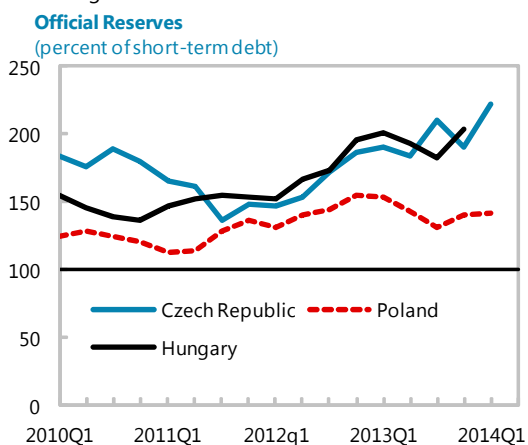
Income deficit has a significant counterpart in retained earnings.



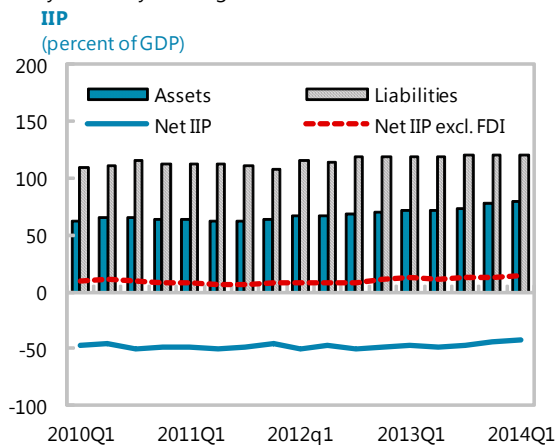
Financial account has been boosted by intervention-related inflows that are likely to reverse, but direct investment will likely strengthen in the period ahead.



Stock vulnerabilities are limited, with adequate reserve coverage...



...and a net international investment deficit that is mainly driven by the large FDI stock.



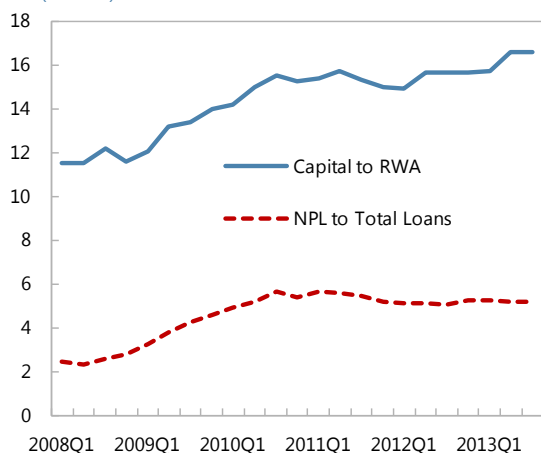
Sources: Czech Statistical Office, Czech National Bank, and IMF staff estimates.



**Figure 4. Czech Republic: Evolution of Bank Credit**

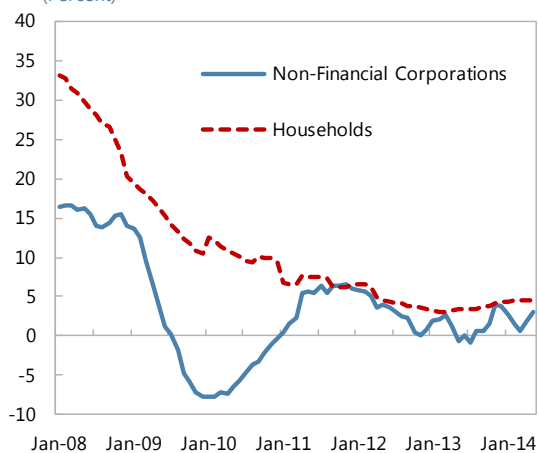
Banks are financially sound...

**Financial Soundness Indicators**  
(Percent)



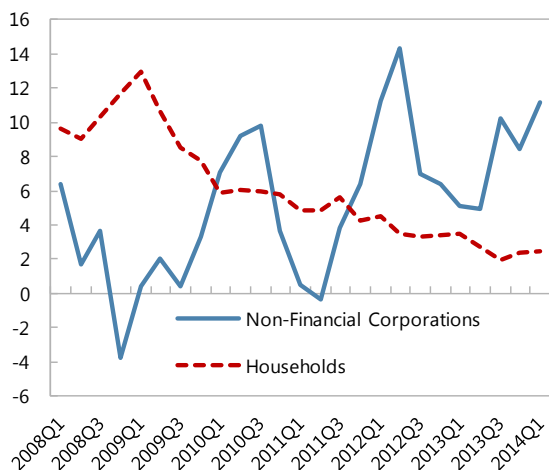
...but credit growth has been weak...

**Credit Growth by Selected Categories**  
(Percent)



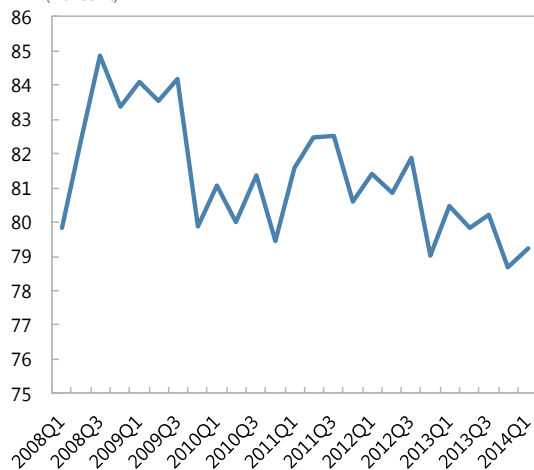
...outpaced by deposit growth...

**Deposit Growth by Selected Categories**  
(Percent)



...underpinning record low loan to deposit ratios.

**Household and Non-Financial Corporations  
Loan to Deposit Ratio**  
(Percent)

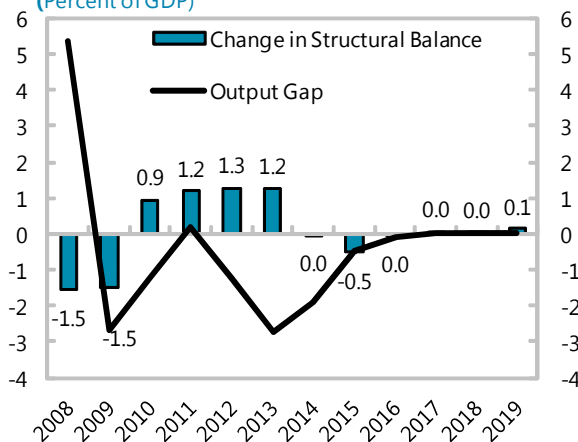


Sources: Haver; CNB; and IMF staff calculations.

**Figure 5. Czech Republic: Fiscal Developments and Prospects**

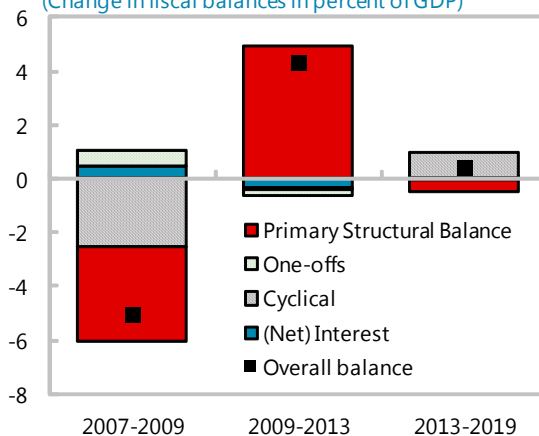
Fiscal policy stance has been pro-cyclical since the onset of the 2009 recession.

**Fiscal Stance**  
(Percent of GDP)



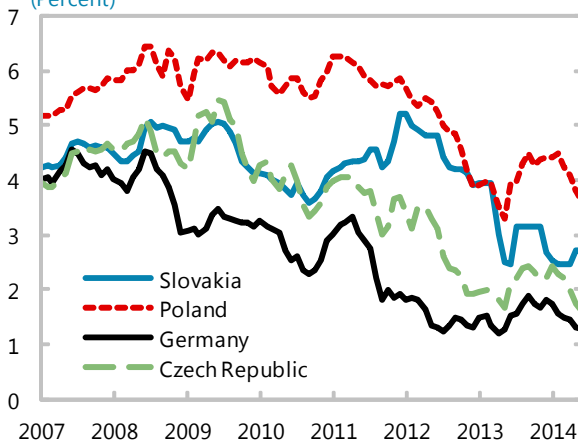
Stimulus in 2008-09 was followed by a large consolidation in 2010-12.

**Fiscal Adjustment**  
(Change in fiscal balances in percent of GDP)



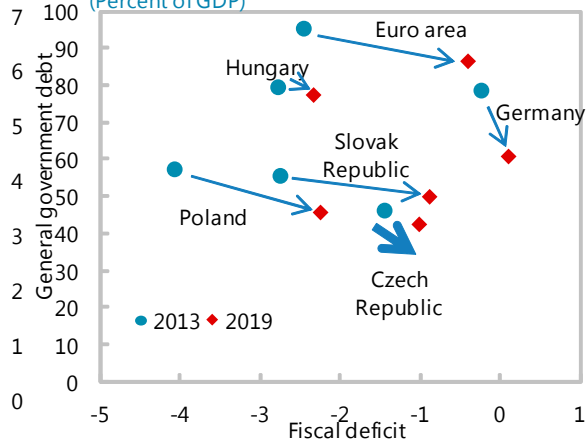
However, low financing costs augur well for...

**10-Year Government Bond Yields**  
(Percent)



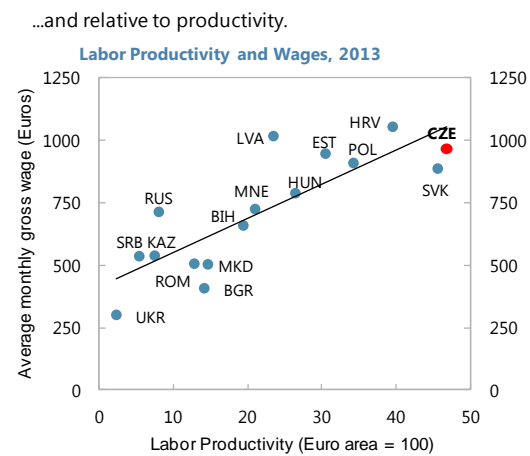
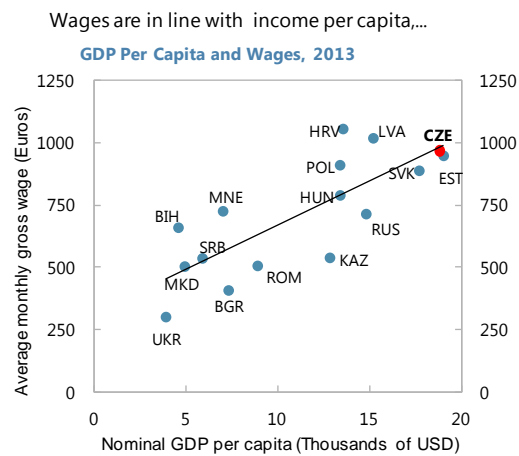
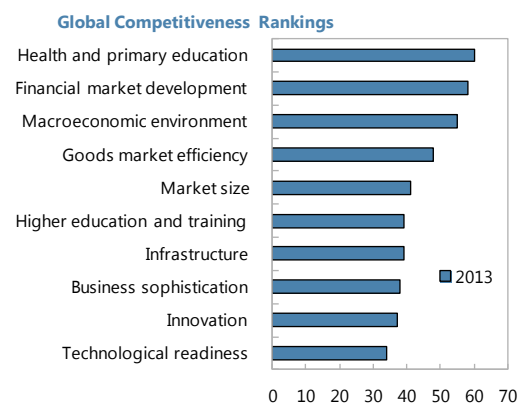
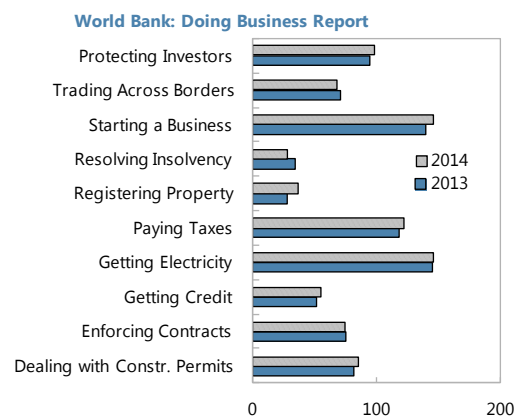
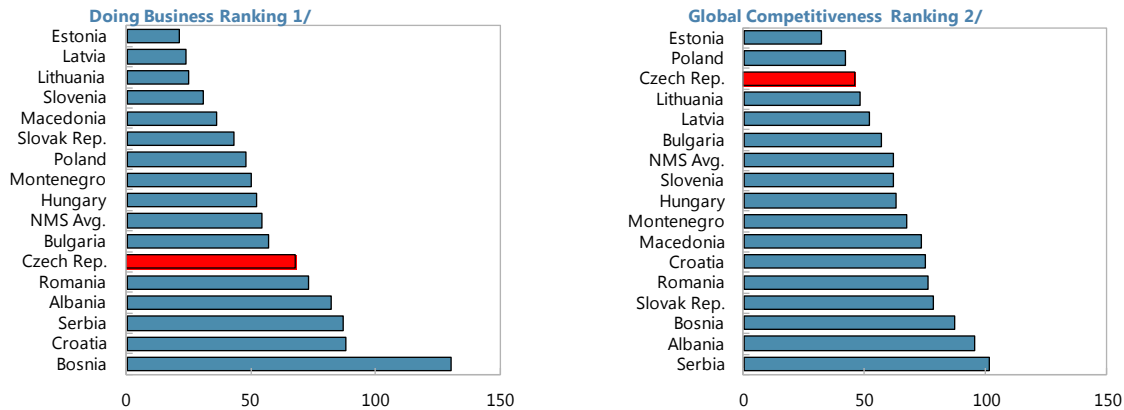
...the Czech public debt and fiscal deficits to come down further from relatively low levels by 2019.

**Fiscal Position**  
(Percent of GDP)



Sources: Haver; National Authorities; and IMF staff calculations.

Figure 6. Czech Republic: Competitiveness Indicators



Sources: Czech Republic authorities; Haver; OECD; World Bank, *Doing Business Indicators*; IMF, *IFS*; *DxTime*; IMF, *World Economic Outlook*; and IMF staff estimates and calculations.

1/ Covers the period June, 2013. Rank out of 189 countries.

2/ Rank for 2013–14. Ranking out of 148 countries.

Table 1. Czech Republic: Selected Economic Indicators, 2008–16

	2008	2009	2010	2011	2012	2013	2014	2015	2016
	Staff Proj.								
Nominal GDP (USD billions)	225.4	197.2	198.5	216.1	196.4	198.4	200.0	208.9	216.7
Population (millions)	10.3	10.4	10.5	10.5	10.5	10.5	10.5	10.6	10.6
GDP per capita (USD)	21,794	18,913	18,973	20,603	18,699	18,871	18,985	19,796	20,511
Real economy (change in percent, unless stated otherwise)									
Real GDP	3.1	-4.5	2.5	1.8	-1.0	-0.9	2.5	2.5	2.4
Domestic demand	2.2	-5.4	2.0	-0.1	-2.9	-0.8	1.8	2.9	2.8
Private consumption	2.8	0.2	0.9	0.5	-2.1	0.1	1.3	2.5	2.5
Investment	1.9	-20.2	5.4	0.8	-5.0	-4.4	3.0	4.4	4.0
Exports	4.0	-10.9	15.4	9.5	4.5	0.2	7.2	5.0	4.0
Imports	2.7	-12.1	15.4	7.0	2.3	0.6	7.0	5.8	4.6
Output gap (percent of potential output)	5.4	-2.7	-1.2	0.2	-1.3	-2.7	-1.9	-0.5	-0.1
CPI (average)	6.3	1.0	1.5	1.9	3.3	1.4	0.6	1.9	2.0
PPI (average)	4.5	-3.1	1.3	5.5	2.1	0.8	...	...	...
Unemployment rate (in percent)	4.4	6.7	7.3	6.7	7.0	7.0	6.4	6.0	5.6
Gross national savings (percent of GDP)	26.8	21.4	21.0	21.6	22.0	20.8	22.2	22.4	22.5
Gross domestic investments (percent of GDP)	28.9	23.8	24.8	24.5	23.3	22.3	22.4	22.7	22.9
Public finance (percent of GDP)									
General government revenue	38.9	38.9	39.1	40.0	40.3	40.9	41.3	40.7	40.0
General government expenditure	41.1	44.7	43.7	43.2	44.5	42.3	42.5	42.2	41.1
Net lending / Overall balance	-2.2	-5.8	-4.7	-3.2	-4.2	-1.5	-1.2	-1.4	-1.2
Structural balance	-3.9	-5.1	-4.3	-3.2	-1.9	-0.6	-0.6	-1.2	-1.2
General government debt	28.7	34.6	38.4	41.4	46.2	46.0	44.3	44.3	44.1
Money and credit (end of year, percent change)									
Broad money (M3)	13.6	0.2	1.9	2.8	4.8	5.8	...	...	...
Private sector credit	16.1	0.8	3.0	5.5	2.6	3.7	...	...	...
Interest rates (in percent, year average)									
Three-month interbank rate 1/	4.0	2.2	1.3	1.2	1.0	0.5	0.4	...	...
Ten-year government bond 2/	4.6	4.8	3.9	3.7	2.8	2.1	2.0	...	...
Balance of payments (percent of GDP)									
Trade balance (goods and services)	2.7	4.3	3.4	4.2	5.5	6.2	7.0	6.9	6.9
Current account balance	-2.1	-2.5	-3.8	-2.9	-1.3	-1.4	-0.2	-0.3	-0.4
Gross international reserves (US\$ billion)	37.0	41.6	42.5	40.3	44.9	56.2	57.9	60.8	63.4
(in months of imports of goods and services)	3.2	4.5	4.0	3.2	3.7	4.6	4.5	4.4	4.3
Exchange rate									
Nominal effective exchange rate (index, 2005=100)	121.6	116.2	118.7	122.4	117.7	115.7	...	...	...
Real effective exchange rate (index, CPI-based; 2005=100)	125.6	120.5	122.5	125.1	121.3	118.8	...	...	...

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

1/ Offer rate. 2014 entry is January-June average.

2/ 2014 entry is January-June average.

Table 2. Czech Republic: Balance of Payments, 2008–19

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
	Staff Projections											
	(percent of GDP)											
Current account balance	-2.1	-2.5	-3.8	-2.9	-1.3	-1.4	-0.2	-0.3	-0.4	-0.4	-0.4	-0.4
Trade balance	0.8	2.3	1.4	2.5	3.9	4.8	5.5	5.2	5.1	4.9	4.7	4.6
Exports	55.5	50.3	57.4	64.1	67.5	68.3	73.1	75.2	76.6	78.1	79.7	81.2
Imports	54.7	48.0	56.0	61.7	63.7	63.5	67.6	70.0	71.5	73.2	74.9	76.7
Nonfactor services	1.9	2.0	2.0	1.7	1.6	1.4	1.6	1.7	1.8	1.9	2.0	2.2
Receipts	9.7	9.9	10.5	10.7	11.6	11.3	11.1	11.3	11.4	11.6	11.7	11.8
Payments	7.8	7.9	8.6	8.9	10.0	9.9	9.6	9.6	9.6	9.7	9.7	9.7
Factor income (net)	-4.7	-6.7	-7.5	-7.2	-6.7	-8.0	-7.5	-7.5	-7.5	-7.5	-7.5	-7.4
Transfers	-0.1	-0.1	0.2	0.1	-0.1	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Capital account	0.7	1.4	0.8	0.4	1.4	1.9	1.5	1.5	1.5	1.5	1.5	1.6
Financial account	2.4	4.0	4.6	2.4	1.9	4.8	-0.2	-0.2	-0.1	-0.1	-0.2	-0.2
Direct investment, net	1.0	1.0	2.5	2.0	3.1	0.9	2.0	2.0	2.0	2.1	2.1	2.2
Portfolio investment, net	0.0	4.4	3.9	0.2	1.4	2.4	0.7	0.7	0.6	0.6	0.6	0.6
Other investment and financial derivatives, net	1.4	-1.4	-1.7	0.3	-2.9	1.5	-2.9	-2.8	-2.8	-2.8	-2.9	-3.1
Errors and omissions	0.1	-1.3	-0.5	-0.3	0.1	-0.4	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves	-1.1	-1.6	-1.0	0.5	-2.1	-4.9	-1.0	-1.0	-1.0	-1.0	-0.9	-0.9
Memorandum items:												
Gross official reserves (US\$ billions)	37.0	41.6	42.5	40.3	44.9	56.2	57.9	60.8	63.4	66.4	69.7	73.1
in months of the current year's imports	3.2	4.5	4.0	3.2	3.7	4.6	4.5	4.4	4.3	4.3	4.3	4.4
as a ratio to the short-term debt	100.1	131.6	137.2	123.4	158.6	159.6	170.3	179.1	187.9	197.3	207.1	217.7
External debt, percent of GDP	37.4	45.3	47.5	43.6	52.2	56.1	54.4	52.0	49.8	48.1	46.9	46.1

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

**Table 3. Czech Republic: The Statement of Operations of General Government, 2008–19 1/**  
(in billions of Koruny)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
	Staff Projections											
<b>Revenue</b>	<b>1,498.6</b>	<b>1,462.1</b>	<b>1,481.1</b>	<b>1,528.4</b>	<b>1,551.0</b>	<b>1,588.4</b>	<b>1,658.5</b>	<b>1,706.6</b>	<b>1,744.6</b>	<b>1,814.4</b>	<b>1,886.1</b>	<b>1,968.9</b>
Taxes	714.4	686.7	685.2	719.8	744.8	766.8	785.4	803.2	828.7	864.1	896.8	938.6
Personal income tax	142.4	136.0	131.7	142.8	145.2	150.1	154.1	157.0	161.5	168.0	174.7	183.7
Corporate Income tax	161.9	132.3	127.4	129.0	127.5	130.0	134.9	139.9	144.3	149.9	156.1	162.6
VAT	254.8	254.0	258.8	265.2	281.1	298.0	310.4	320.6	334.8	349.2	363.6	378.7
Excise	126.1	137.3	138.4	149.8	151.7	149.7	146.5	146.9	148.3	157.0	160.7	170.2
Other taxes	29.1	27.1	28.8	33.0	39.2	38.9	39.5	38.8	39.7	40.0	41.6	43.4
Social contributions	599.2	559.7	577.8	592.3	600.0	606.4	626.9	655.6	683.8	712.6	741.7	772.3
Grants	48.8	77.5	85.7	82.9	71.2	75.0	104.7	101.5	80.0	79.5	82.8	86.3
Other revenue	136.2	138.3	132.4	133.4	135.1	140.2	141.4	146.3	152.2	158.2	164.9	171.8
Property income	30.3	31.3	30.6	28.1	28.4	34.3	31.9	32.1	33.1	34.1	35.5	37.0
Sales of goods and services	102.9	104.1	98.7	102.4	103.3	103.9	107.5	112.1	117.0	121.8	127.0	132.4
Other revenue	2.9	2.9	3.0	2.8	3.4	1.9	2.0	2.1	2.2	2.3	2.4	2.5
<b>Expenditure</b>	<b>1,583.5</b>	<b>1,678.9</b>	<b>1,658.2</b>	<b>1,650.4</b>	<b>1,711.7</b>	<b>1,644.7</b>	<b>1,705.8</b>	<b>1,766.4</b>	<b>1,796.5</b>	<b>1,865.0</b>	<b>1,940.5</b>	<b>2,020.1</b>
<b>Expense</b>	<b>1,407.4</b>	<b>1,487.1</b>	<b>1,497.8</b>	<b>1,513.0</b>	<b>1,588.7</b>	<b>1,536.6</b>	<b>1,566.6</b>	<b>1,616.8</b>	<b>1,661.3</b>	<b>1,725.9</b>	<b>1,795.9</b>	<b>1,869.5</b>
Compensation of employees	279.6	292.9	286.0	279.6	286.0	293.4	299.0	307.8	314.0	328.4	342.0	356.2
Use of goods and services	227.9	238.3	234.8	223.8	210.6	215.6	223.6	230.7	235.1	245.9	257.1	268.7
Interest	39.4	47.4	51.1	52.5	56.0	53.9	54.5	56.2	58.2	59.6	59.9	60.5
Subsidies	62.3	74.0	70.3	78.8	76.4	77.3	79.8	81.4	83.0	85.5	89.1	92.8
Grants	36.2	34.1	32.9	36.8	34.8	22.4	23.2	23.9	24.3	24.9	25.9	27.0
Social benefits	675.4	728.3	740.2	754.6	766.9	778.0	810.6	834.6	860.6	890.8	927.5	966.0
Other expenses	86.6	72.1	82.5	86.9	158.1	96.1	75.9	82.2	86.0	90.7	94.4	98.3
<b>Net acquisition of nonfinancial assets</b>	<b>176.1</b>	<b>191.8</b>	<b>160.4</b>	<b>137.4</b>	<b>123.0</b>	<b>108.1</b>	<b>139.2</b>	<b>149.6</b>	<b>135.2</b>	<b>139.1</b>	<b>144.6</b>	<b>150.6</b>
<b>Gross Operating Balance</b>	<b>91.2</b>	<b>-24.9</b>	<b>-16.7</b>	<b>15.5</b>	<b>-37.7</b>	<b>51.7</b>	<b>91.9</b>	<b>89.8</b>	<b>83.3</b>	<b>88.6</b>	<b>90.2</b>	<b>99.5</b>
<b>Net lending/borrowing (overall balance)</b>	<b>-85.0</b>	<b>-216.7</b>	<b>-177.1</b>	<b>-121.9</b>	<b>-160.7</b>	<b>-56.4</b>	<b>-47.3</b>	<b>-59.8</b>	<b>-51.9</b>	<b>-50.5</b>	<b>-54.4</b>	<b>-51.1</b>
<b>Net financial transactions</b>	<b>-85.0</b>	<b>-217.4</b>	<b>-180.7</b>	<b>-121.9</b>	<b>-161.7</b>	<b>-59.8</b>	<b>-46.9</b>	<b>-59.5</b>	<b>-50.5</b>	<b>-49.4</b>	<b>-53.8</b>	<b>-50.3</b>
<b>Net acquisition of financial assets</b>	<b>41.8</b>	<b>0.1</b>	<b>-22.6</b>	<b>15.2</b>	<b>-34.6</b>	<b>38.8</b>	<b>0.0</b>	<b>-20.9</b>	<b>-21.5</b>	<b>-4.5</b>	<b>0.0</b>	<b>0.0</b>
<b>Net incurrence of liabilities</b>	<b>126.8</b>	<b>217.5</b>	<b>158.1</b>	<b>132.4</b>	<b>126.5</b>	<b>95.2</b>	<b>46.9</b>	<b>38.6</b>	<b>29.0</b>	<b>45.0</b>	<b>53.8</b>	<b>50.3</b>
<i>Adjustment and statistical discrepancies 1/</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>-4.8</i>	<i>-0.6</i>	<i>-3.4</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>
<b>Memorandum item:</b>												
General government debt	1,104.3	1,299.3	1,454.4	1,583.3	1,775.1	1,788.2	1,780.0	1,855.9	1,927.0	1,980.9	2,033.7	2,085.9
Primary balance	-45.5	-169.3	-126.1	-69.4	-104.7	-2.5	7.2	-3.5	6.3	9.1	5.6	9.4
Cyclically adjusted primary balance	-119.2	-147.4	-123.4	-80.6	-96.3	26.8	27.3	-2.6	2.9	3.6	-0.1	4.1
Change in cyclically adjusted primary balance	-53.2	-28.1	24.0	42.8	-15.7	123.0	0.5	-29.9	5.5	0.7	-3.7	4.2

Sources: Ministry of Finance and IMF staff estimates and projections.

1/ Adjustments for cash-accrual differences, valuation changes and other discrepancies.

**Table 4. Czech Republic: The Statement of Operations of General Government, 2008–19 1/**  
(in percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
									Staff Projections			
<b>Revenue</b>	<b>38.9</b>	<b>38.9</b>	<b>39.1</b>	<b>40.0</b>	<b>40.3</b>	<b>40.9</b>	<b>41.3</b>	<b>40.8</b>	<b>40.0</b>	<b>39.9</b>	<b>39.8</b>	<b>39.9</b>
Taxes	18.6	18.3	18.1	18.8	19.4	19.7	19.6	19.2	19.0	19.0	18.9	19.0
Personal income tax	3.7	3.6	3.5	3.7	3.8	3.9	3.8	3.8	3.7	3.7	3.7	3.7
Corporate Income tax	4.2	3.5	3.4	3.4	3.3	3.3	3.4	3.3	3.3	3.3	3.3	3.3
VAT	6.6	6.8	6.8	6.9	7.3	7.7	7.7	7.7	7.7	7.7	7.7	7.7
Excise	3.3	3.7	3.7	3.9	3.9	3.9	3.6	3.5	3.4	3.5	3.4	3.5
Other taxes	0.8	0.7	0.8	0.9	1.0	1.0	1.0	0.9	0.9	0.9	0.9	0.9
Social contributions	15.6	14.9	15.2	15.5	15.6	15.6	15.6	15.7	15.7	15.7	15.7	15.7
Grants	1.3	2.1	2.3	2.2	1.9	1.9	2.6	2.4	1.8	1.7	1.7	1.7
Other revenue	3.5	3.7	3.5	3.5	3.5	3.6	3.5	3.5	3.5	3.5	3.5	3.5
Property income	0.8	0.8	0.8	0.7	0.7	0.9	0.8	0.8	0.8	0.8	0.8	0.8
Sales of goods and services	2.7	2.8	2.6	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Other revenue	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Expenditure</b>	<b>41.1</b>	<b>44.7</b>	<b>43.7</b>	<b>43.2</b>	<b>44.5</b>	<b>42.3</b>	<b>42.5</b>	<b>42.2</b>	<b>41.1</b>	<b>41.0</b>	<b>41.0</b>	<b>41.0</b>
<b>Expense</b>	<b>36.6</b>	<b>39.6</b>	<b>39.5</b>	<b>39.6</b>	<b>41.3</b>	<b>39.6</b>	<b>39.0</b>	<b>38.6</b>	<b>38.0</b>	<b>37.9</b>	<b>37.9</b>	<b>37.9</b>
Compensation of employees	7.3	7.8	7.5	7.3	7.4	7.6	7.4	7.4	7.2	7.2	7.2	7.2
Use of goods and services	5.9	6.3	6.2	5.9	5.5	5.6	5.6	5.5	5.4	5.4	5.4	5.4
Interest	1.0	1.3	1.3	1.4	1.5	1.4	1.4	1.3	1.3	1.3	1.3	1.2
Subsidies	1.6	2.0	1.9	2.1	2.0	2.0	2.0	1.9	1.9	1.9	1.9	1.9
Grants	0.9	0.9	0.9	1.0	0.9	0.6	0.6	0.6	0.6	0.5	0.5	0.5
Social benefits	17.5	19.4	19.5	19.7	19.9	20.0	20.2	19.9	19.7	19.6	19.6	19.6
Other expenses	2.3	1.9	2.2	2.3	4.1	2.5	1.9	2.0	2.0	2.0	2.0	2.0
<b>Net acquisition of nonfinancial assets</b>	<b>4.6</b>	<b>5.1</b>	<b>4.2</b>	<b>3.6</b>	<b>3.2</b>	<b>2.8</b>	<b>3.5</b>	<b>3.6</b>	<b>3.1</b>	<b>3.1</b>	<b>3.1</b>	<b>3.1</b>
<b>Gross Operating Balance</b>	<b>2.4</b>	<b>-0.7</b>	<b>-0.4</b>	<b>0.4</b>	<b>-1.0</b>	<b>1.3</b>	<b>2.3</b>	<b>2.1</b>	<b>1.9</b>	<b>1.9</b>	<b>1.9</b>	<b>2.0</b>
<b>Net lending/borrowing (overall balance)</b>	<b>-2.2</b>	<b>-5.8</b>	<b>-4.7</b>	<b>-3.2</b>	<b>-4.2</b>	<b>-1.5</b>	<b>-1.2</b>	<b>-1.4</b>	<b>-1.2</b>	<b>-1.1</b>	<b>-1.1</b>	<b>-1.0</b>
<b>Net financial transactions</b>	<b>-2.2</b>	<b>-5.8</b>	<b>-4.8</b>	<b>-3.2</b>	<b>-4.2</b>	<b>-1.5</b>	<b>-1.2</b>	<b>-1.4</b>	<b>-1.2</b>	<b>-1.1</b>	<b>-1.1</b>	<b>-1.0</b>
<b>Net acquisition of financial assets</b>	<b>1.1</b>	<b>0.0</b>	<b>-0.6</b>	<b>0.4</b>	<b>-0.9</b>	<b>1.0</b>	<b>0.0</b>	<b>-0.5</b>	<b>-0.5</b>	<b>-0.1</b>	<b>0.0</b>	<b>0.0</b>
<b>Net incurrence of liabilities</b>	<b>3.3</b>	<b>5.8</b>	<b>4.2</b>	<b>3.5</b>	<b>3.3</b>	<b>2.5</b>	<b>1.2</b>	<b>0.9</b>	<b>0.7</b>	<b>1.0</b>	<b>1.1</b>	<b>1.0</b>
<i>Adjustment and statistical discrepancies 1/</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>-0.1</i>	<i>0.0</i>	<i>-0.1</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>
<b>Memorandum item:</b>												
General government debt	28.7	34.6	38.4	41.4	46.2	46.0	44.3	44.3	44.1	43.5	42.9	42.3
Primary balance	-1.2	-4.5	-3.3	-1.8	-2.7	-0.1	0.2	-0.1	0.1	0.2	0.1	0.2
Structural balance	-3.7	-5.2	-4.3	-3.1	-1.9	-0.6	-0.7	-1.2	-1.2	-1.2	-1.1	-1.0
Cyclically adjusted primary balance	-3.1	-3.9	-3.3	-2.1	-2.5	0.7	0.7	-0.1	0.1	0.1	0.0	0.1
Change in cyclically adjusted primary balance	-1.3	-0.8	0.7	1.1	-0.4	3.2	0.0	-0.7	0.1	0.0	-0.1	0.1
Output gap	5.4	-2.7	-1.2	0.2	-1.3	-2.7	-1.9	-0.5	-0.1	0.0	0.0	0.0
Nominal GDP (billions of Koruny)	3,848	3,759	3,791	3,823	3,846	3,884	4,015	4,186	4,366	4,550	4,736	4,931

Sources: Ministry of Finance and IMF staff estimates and projections.

1/ Adjustments for cash-accrual differences, valuation changes and other discrepancies.

**Table 5. Czech Republic: Medium-Term Macroeconomic Scenario, 2008–19**

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
<b>Real sector</b>	(percent change, unless stated otherwise)											
Real GDP	3.1	-4.5	2.5	1.8	-1.0	-0.9	2.5	2.5	2.4	2.3	2.1	2.1
Private consumption	2.8	0.2	0.9	0.5	-2.1	0.1	1.3	2.5	2.5	2.3	2.2	2.2
Public consumption	1.2	4.0	0.2	-2.7	-1.9	1.6	1.2	2.0	2.0	1.9	1.9	1.9
Investment	1.9	-20.2	5.4	0.8	-5.0	-4.4	3.0	4.4	4.0	3.9	3.5	3.5
Fixed investment	4.1	-11.0	1.0	0.4	-4.5	-3.5	3.3	4.4	4.0	3.9	3.5	3.5
contribution of inventories (percent)	-0.5	-2.9	1.1	0.1	-0.1	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Exports, goods and services	4.0	-10.9	15.4	9.5	4.5	0.2	7.2	5.0	4.0	4.0	4.0	4.0
Imports, goods and services	2.7	-12.1	15.4	7.0	2.3	0.6	7.0	5.8	4.6	4.6	4.6	4.6
contribution of net exports (percent)	1.0	0.3	0.8	2.4	2.0	-0.3	0.9	-0.1	-0.1	-0.1	-0.1	-0.2
Inflation (CPI, percent)	6.3	1.0	1.5	1.9	3.3	1.4	0.6	1.9	2.0	2.0	2.0	2.0
Unemployment (percent of labor force)	4.4	6.7	7.3	6.7	7.0	7.0	6.4	6.0	5.6	5.4	5.1	5.0
Output gap 1/	5.4	-2.7	-1.2	0.2	-1.3	-2.7	-1.9	-0.5	-0.1	0.0	0.0	0.0
Gross domestic savings (in percent of GDP)	26.8	21.4	21.0	21.6	22.0	20.8	22.2	22.4	22.5	22.7	22.9	23.2
Public	13.1	9.9	10.5	11.7	12.4	13.2	13.2	13.5	13.7	14.1	14.1	14.2
Private	13.7	11.5	10.5	9.8	9.6	7.7	9.0	8.9	8.8	8.6	8.8	9.0
Gross capital formation	28.9	23.8	24.8	24.5	23.3	22.3	22.4	22.7	22.9	23.1	23.4	23.6
<b>Public finances</b>	(in percent of GDP)											
Revenues	38.9	38.9	39.1	40.0	40.3	40.9	41.3	40.8	40.0	39.9	39.8	39.9
Expenditures	41.1	44.7	43.7	43.2	44.5	42.3	42.5	42.2	41.1	41.0	41.0	41.0
Net lending	-2.2	-5.8	-4.7	-3.2	-4.2	-1.5	-1.2	-1.4	-1.2	-1.1	-1.1	-1.0
Structural balance 1/	-3.7	-5.2	-4.3	-3.1	-1.9	-0.6	-0.7	-1.2	-1.2	-1.2	-1.1	-1.0
General government debt	28.7	34.6	38.4	41.4	46.2	46.0	44.3	44.3	44.1	43.5	42.9	42.3
<b>Balance of payments</b>	(in percent of GDP)											
Current account balance	-2.1	-2.5	-3.8	-2.9	-1.3	-1.4	-0.2	-0.3	-0.4	-0.4	-0.4	-0.4
Trade balance	0.8	2.3	1.4	2.5	3.9	4.8	5.5	5.2	5.1	4.9	4.7	4.6
Services balance	1.9	2.0	2.0	1.7	1.6	1.4	1.6	1.7	1.8	1.9	2.0	2.2
Net factor income	-4.7	-6.7	-7.5	-7.2	-6.7	-8.0	-7.5	-7.5	-7.5	-7.5	-7.5	-7.4
Current transfers	-0.1	-0.1	0.2	0.1	-0.1	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Capital account balance	0.7	1.4	0.8	0.4	1.4	1.9	1.5	1.5	1.5	1.5	1.5	1.6
Financial account balance	3.1	5.4	5.4	2.7	3.3	6.7	1.2	1.3	1.3	1.4	1.4	1.4
Direct investment, net	1.0	1.0	2.5	2.0	3.1	0.9	2.0	2.0	2.0	2.1	2.1	2.2
Portfolio investment, net	0.0	4.4	3.9	0.2	1.4	2.4	0.7	0.7	0.6	0.6	0.6	0.6
Other investment & derivatives, net	1.4	-1.4	-1.7	0.3	-2.9	1.5	-2.9	-2.8	-2.8	-2.8	-2.9	-3.1
Errors and omissions, net	0.1	-1.3	-0.5	-0.3	0.1	-0.4	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves (- increase)	-1.1	-1.6	-1.0	0.5	-2.1	-4.9	-1.0	-1.0	-1.0	-1.0	-0.9	-0.9

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

1/ In percent of potential GDP.



**Table 6. Czech Republic: Financial Soundness Indicators**  
(in percent unless indicated otherwise)

	2009	2010	2011	2012	Sep-13
<b>Capital</b>					
Regulatory capital to risk-weighted assets	14.0	15.3	15.0	15.6	16.6
Regulatory Tier 1 capital to risk-weighted assets	12.6	13.9	13.9	15.2	16.3
Capital to assets	6.1	6.5	6.5	6.9	7.5
<b>Profitability</b>					
Return on assets	1.4	1.3	1.2	1.4	1.3
Return on equity	26.4	19.7	18.3	20.4	17.9
Interest margin to gross income	55.8	63.1	64.5	60.7	60.1
Noninterest expenses to gross income	42.0	46.8	47.2	46.9	46.6
Trading income to total income	9.5	4.6	4.1	8.9	9.0
Personnel expenses to noninterest expenses	40.5	39.7	41.0	41.2	41.9
<b>Liquidity</b>					
Liquid assets to total assets	27.1	29.4	29.9	32.6	32.0
Liquid assets to short-term liabilities	70.0	71.1	72.2	71.4	62.4
Customer deposits to total (noninterbank) loans	128.2	129.6	126.0	133.1	128.1
Foreign-currency-denominated loans to total loans	21.2	21.6	22.2	20.9	25.2
Foreign-currency-denominated liabilities to total liabilities	14.2	14.3	15.0	14.1	17.7
<b>Sensitivity to market risk</b>					
Net open position in foreign exchange to capital	0.5	0.4	-3.2	5.1	1.1
Gross asset position in financial derivatives to capital	54.0	43.2	57.5	46.5	28.4
Gross liability position in financial derivatives to capital	50.9	41.2	53.5	40.5	24.9
Net open position in equities to capital	8.3	8.1	9.3	7.8	6.8
<b>Memo item</b>					
Nonperforming loans to total gross loans	4.6	5.4	5.2	5.2	5.2

Source: Czech National Bank

## Appendix I. Potential Growth

### Raising Czech Republic’s potential growth faces significant challenges.

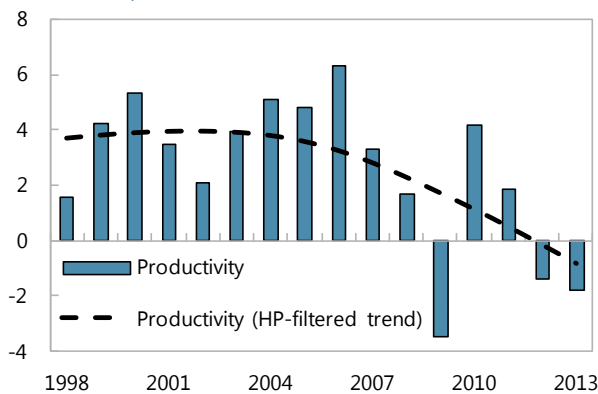
After important gains in the years prior to the 2008 global financial crisis, labor productivity improved only very little during 2008–13 (Figure 1). Moreover, as the working age population (ages 15–64) is projected to decline by 0.4 percent annually during 2010–50, medium-term growth will have to rely on a bounce back of labor productivity growth and higher labor force participation.

Czech Republic: Potential growth

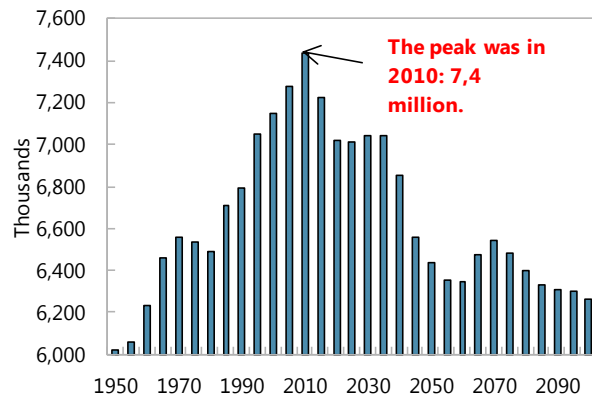


Figure 1 Productivity Growth and Demographic Changes in the Czech Republic

Productivity Growth and The Underlying Trend (YoY, Czech Republic 1998 - 2013)



Adult Population (Ages 15 - 64) (Czech Republic 1950 - 2100)



Sources: Eurostat, World Population Prospects, and IMF Staff Calculations.

**The slowdown in labor productivity may not be just cyclical.** Aggregate employment declined during 2008–13 and aggregate output dropped even more, thus suggesting a possible role of labor hoarding—firms underutilizing productive employees and hence tending not to actively hire new ones—and that the slowdown in labor productivity may be cyclical. However, sectoral level data do not fully support this: e.g., the employment drop in manufacturing and real estate was larger than the output drop in the respective sector. Service sectors, such as finance and insurance, and information and communication expanded significantly, which is perhaps inconsistent with labor hoarding. Finally, sectors whose change in labor productivity seems not to be explained by labor hoarding account for more than 80 percent of the total labor force. This suggests that a slowdown in labor productivity may be more entrenched than being purely cyclical.

**The Czech growth model may be facing increasing constraints.** The current growth model of the Czech Republic relies on a strengthening of the economy's position in the German-Central European Supply Chain (GCESC) by attracting FDI and relying on relatively cheap and high-skilled labor. However, this model may increasingly be facing limits, especially as the income convergence has substantially reduced unit labor cost differentials with Germany. Moreover, increased competition from other countries in the region creates additional headwinds.

**Trends in total factor productivity (TFP) and unit labor costs (ULC) seem to be the main drivers of growth in countries with an income level higher than the Czech Republic's.** To assess the Czech growth potential, we analyze the experience of OECD countries with per capita income above the one of the Czech Republic.<sup>1</sup> Figure 2 depicts the relationship between per capita GDP growth and the gap with US income level, ULC growth, TFP growth, and gross fixed capital formation. For each country, we define the time when the country's real purchasing power<sup>2</sup> started to exceed the Czech Republic's 2014 level as time 0. We then compute per capita GDP over US per capita GDP and real ULC growth<sup>3</sup> in the five years before time 0; and TFP growth and gross fixed capital formation over GDP in the five years after time 0. This analysis suggests that higher per capita real GDP growth is positively associated with: (i) a higher gap from the US income level; (ii) more moderate historical ULC growth; (iii) higher TFP growth; and (iv) higher capital formation. Moreover, strong TFP growth and moderate ULC growth seem to be the main drivers of growth.

**The importance of TFP and ULC growth is confirmed by regression analysis.** We examine the whole period between time 0—the time when each country's real purchasing power started to exceed the 2014 level of the Czech Republic—and year 2013 and divide the period into five year intervals. Then, we conduct a pool-OLS regression analysis<sup>4</sup> over these country-five year interval pairs, with the dependent variable being per capita real GDP growth in the five years, and the explanatory variables of the average ratio of per-capita GDP over the US per capita GDP and ULC growth in the previous five years, TFP growth and the average ratio of investment to GDP in the five years, as well as the world trade stock growth in the five years, the FDI stock growth, services share in export, and export share in GDP in the previous five years. The results of the regression analysis (Table 1) broadly support the observations made above. For example, a 1 percent increase in annual ULC growth implies a 0.1 percent decline in the annual per-capita GDP growth; while a 1 percent increase in annual TFP growth would lead to a 0.7 percent increase in annual per-capita GDP

<sup>1</sup> These countries include (the years in the parentheses are the time when each country's per-capita GDP in PPP US\$ deflated by the US GDP deflator started to exceed the Czech Republic's 2014 level): Australia (1989), Austria (1987), Belgium (1989), Canada (1989), Denmark (1985), Finland (1997), France (1989), Germany (1989), Greece (2003), Iceland (1986), Ireland (1997), Israel (2000), Italy (1991), Japan (1988), Korea (2007), Luxembourg (1976), Netherlands (1988), New Zealand (2003), Norway (1976), Slovenia (2006), Spain (1999), Sweden (1988), Switzerland (1969), United Kingdom (1995), and the United States (1976).

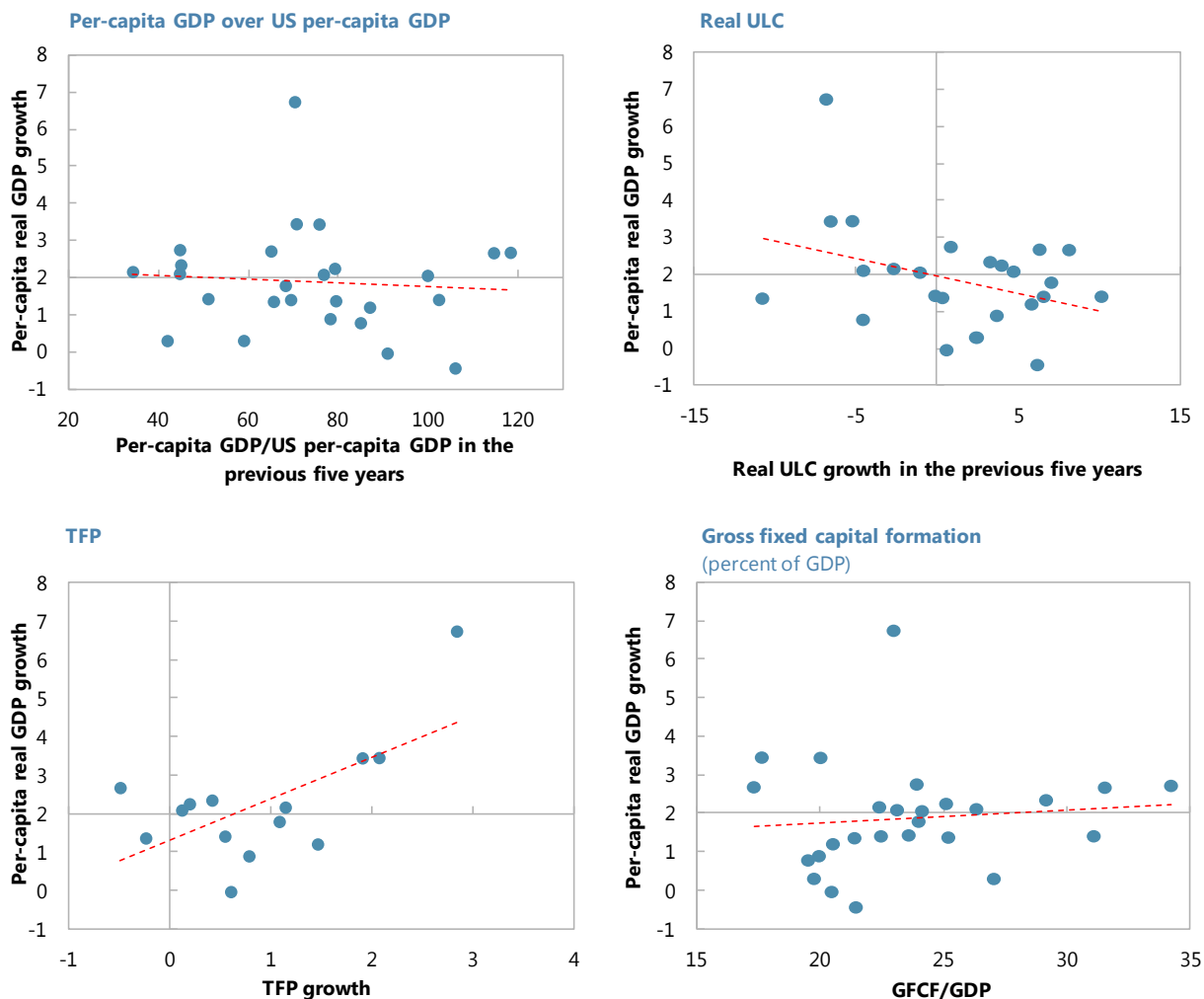
<sup>2</sup> Real purchasing power is defined as per-capita GDP in PPP US\$ deflated by the US GDP deflator.

<sup>3</sup> Real ULC is defined as ULC in manufacturing in US\$ deflated by the US GDP deflator.

<sup>4</sup> We choose not to do a panel analysis because of a small sample size. The regression results are robust to various specifications. If we drop FDI stock growth, we will have around 80 observations, and results are largely unchanged.

growth. Interestingly, the coefficients of the FDI stock growth, services share in export, and export share in GDP are all insignificant.<sup>5</sup>

**Figure 2. Growth Factors and Per-Capita Real GDP Growth**



<sup>5</sup> This may not be driven by the small sample size, as the simple regression of per-capita real GDP growth on FDI stock growth is also insignificant.

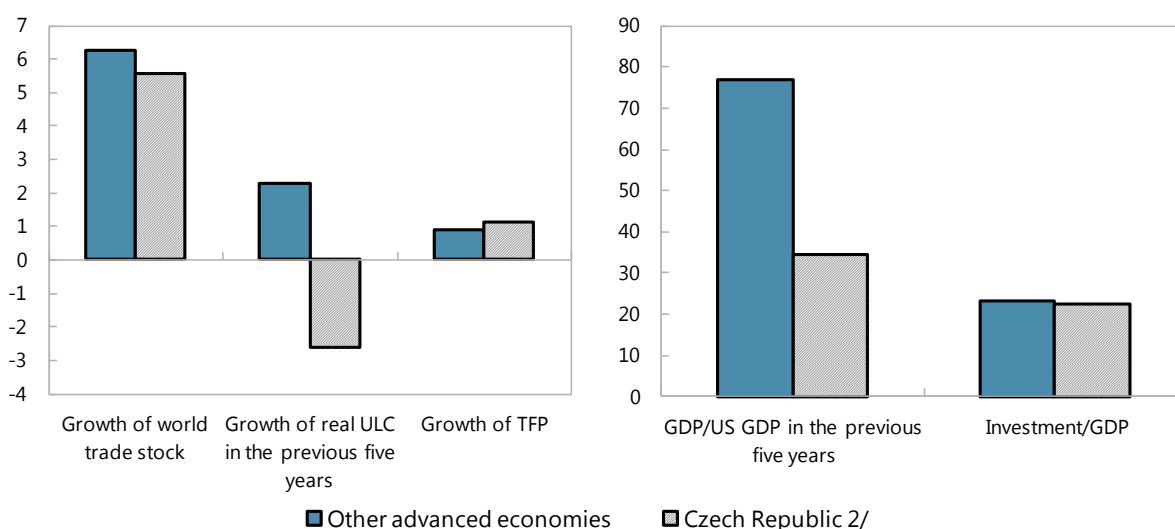
**Table 1. Regression Results**

Dependent variable: per-capita real GDP growth in 5 years			
GDP/GDP of US	-0.0110* (0.00556)	Investment over GDP in 5 years	0.0970** (0.0396)
Growth of ULC in the previous 5 years	-0.0762** (0.0323)	Services share in export in the previous 5 years	0.00464 (0.0152)
Growth of TFP in 5 years	0.696*** (0.120)	Export share in gdp in the previous 5 years	0.00320 (0.00629)
Growth of world trade stock in 5 years	0.170** (0.0693)	Constant	-1.466 (1.037)
Growth of FDI stock in the previous 5 years	0.0213 (0.0148)	Observations	47
		R-squared	0.798
Standard errors in parentheses			
*** p<0.01, ** p<0.05, * p<0.1			

**This analysis suggests a potential GDP growth of around 2½ percent for the Czech Republic.**

The model-predicted per capita real GDP growth for the Czech Republic over 2014–19, based on the regression coefficients and estimations/projections for the explanatory variables is 2.6 percent (Figure 3). However, this figure could be slightly over-estimated for two reasons. First, 0.7 percentage point growth comes from the Czech Republic's per capita GDP being on average 34 percent of the US per capita GDP in 2008–13. Such growth due to relatively low initial income level may be better seen as potential for catch up rather than as an actual projection. Second, 0.15 percentage point growth comes from negative real ULC growth during 2009–14, which, however, should be largely attributed to the 2008 global financial recession and not necessarily imply gains in competitiveness. Considering these factors, the average potential real GDP growth of 2.2 percent over 2014–19 assumed in the staff's baseline scenario is in line with what this analysis suggests.

**Figure 3. Growth Drivers During the Five Years after the Per-Capita Purchasing Power of Countries Started to Exceed the Czech Republic's 2014 Level**



Note: 1/ Median of other advanced economies in the five years after the real purchasing power of the country started to exceed the Czech Republic's level in 2014, or in the previous five years, depending on the variable definitions.

2/ The average during 2008-13/2014-19 depending on the variable definitions.

Sources: WEO, IMF Staff Calculations.

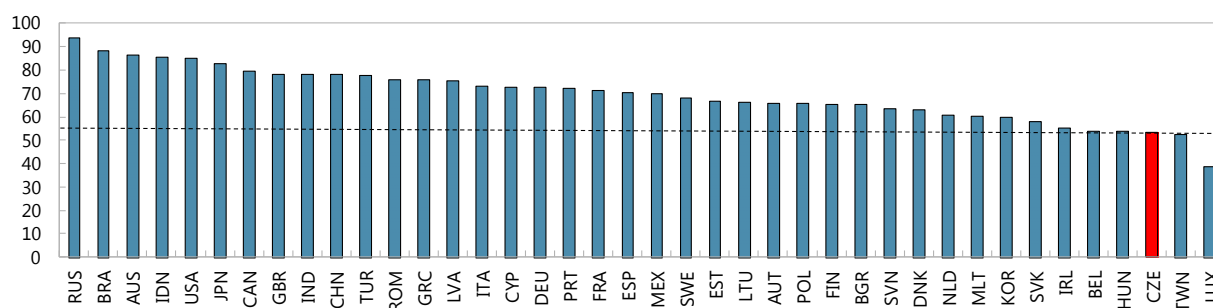
**These results point to the importance of investment in research and development (R&D).** R&D spending of the Czech Republic stood at 1.8 percent of GDP in 2011, significantly lower than the OECD average of 2.4 percent. The mission's discussions with private sector representatives suggest that this could be to a large extent due to the lack of co-operation between businesses, universities, and the government; e.g., the government's funding support tends to favor projects in the basic research and large companies which already have sufficient funding for innovation. If that is the case, there could be room for government support to strengthen R&D in the private sector, in a way that can help strengthen technology spillovers from the Germany-Central Europe Supply Chain<sup>6</sup> to the domestic economy.

**Accelerating TFP growth should also entail enhancing domestic value-added in exports.** The domestic value added of Czech exports stood at around 55 percent in 2012, substantially lower than in other advanced economies. On the one hand, the low domestic content in export may reflect the fact that the Czech Republic is exporting highly sophisticated products, whose intermediate inputs

<sup>6</sup> Largely due to the participation in the GCESC, data suggest that the export sophistication (measured using the method developed by Hatzichronoglou, T. (1997) "Revision of the high-technology sector and product classification", OECD Science, Technology and Industry Working Papers, 1997/02, OECD Publishing.) of the Czech Republic was higher than most advanced economies with similar or smaller population sizes in 2012, with notable exceptions of Ireland and Switzerland. This implies a large potential for technology spill-over in the Czech Republic.

tend to be produced by more than one country. On the other hand, recent OECD studies<sup>7</sup> point out two other explanations: first, intermediate goods produced in the Czech Republic are relatively little used in Czech exports or as intermediate inputs in global production; and second, services sectors are poorly integrated into the supply chain, and the services content in Czech exports is the lowest among OECD countries. These explanations suggest room for the Czech Republic to enhance the integration of its domestic firms into the international value chain, which can be important for the TFP growth of the Czech Republic, as studies (Eaton & Kortum, 1999<sup>8</sup>) show that international technology spill-over plays a large role even for the TFP growth of advanced economies.

**Figure 4. Domestic Value Added in Export**



Sources: World Input and Output Table, IMF Staff Calculations.

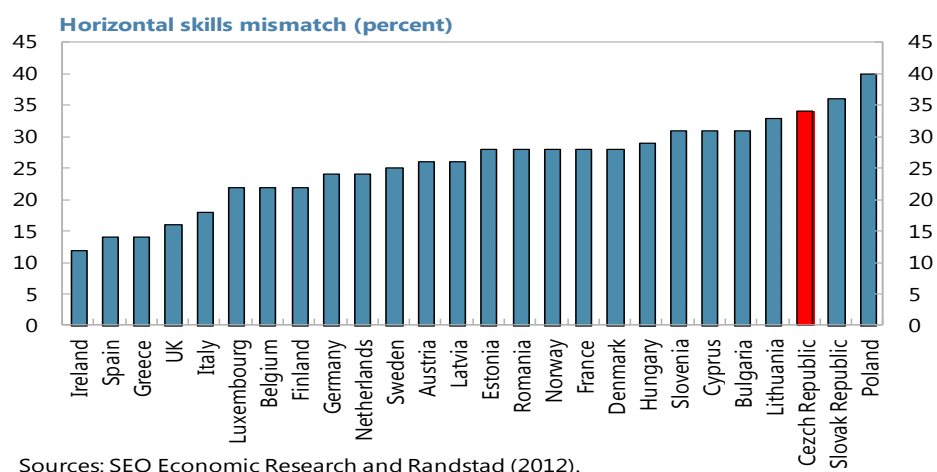
**Addressing skill mismatches in the labor market is also important.** Demographic headwinds may lead to labor shortages, with segments of skill mismatch suffering most, so the resulted upward pressure in the ULC will hamper growth. The Czech Republic has done relatively poorly in aligning its fields of study with job requirements (horizontal mismatch, Figure 5). Various interlocutors of the mission pointed to potential lack of workers trained in technical fields down the road as increasingly more students choose social science as their majors, since compensation is similar or even higher, and completion of such degrees may be less challenging. Coming to the underlying causes, it has been suggested that there are insufficient incentives for the education system to shift focus on the market needs when training students, as the university funding is based on the number of students rather than on their job market performance. To this end, recent OECD analysis<sup>9</sup> suggests a need for the Czech Republic to improve tertiary education quality, including publicizing information on labor market outcomes by field of study and education institutions, and developing accreditation criteria for tertiary education accordingly. Adopting measures to address skill mismatch and improve labor force skills will not only help contain ULC growth but also accelerate TFP growth.<sup>10</sup>

<sup>7</sup> OECD economic surveys: Czech Republic. March, 2014.

<sup>8</sup> Eaton, J. and Kortum, S. (1999) "International technology diffusion: theory and measurement", *International Economic Review* 40, 537-570.

<sup>9</sup> OECD economic surveys: Czech Republic. March, 2014.

<sup>10</sup> There are two reasons for this: first, we do not control for quality of labor when estimating the TFP, and strengthening the labor skill naturally increases the TFP as defined in the current context. Second, highly-skilled labor force can increase the capacity for firms to absorb new technologies, and hence facilitate technology spill-over.

**Figure 5. Fractions of Respondents Reporting Horizontal Skills Mismatch**

**Finally, it is important to further develop the services sector and enhance labor force participation.** The services sector in the Czech Republic hired 60 percent of the labor force in 2013, compared with, e.g., 70 percent and 80 percent in Germany and the UK, respectively. There is evidence that services industries, which tend to hire more women, are less-developed in the Czech Republic. For example, the top five sectors in the share of female employees (namely, health and social work, education, accommodation and food services, finance and intermediation, and administrative support) in Germany belong to the services sector and hired around 30 percent of the total labor force in 2013, while the same industries hired 38 percent in the UK and only 22 percent in the Czech Republic. In the same year, only 74 percent of employed women were working in the services sector in the Czech Republic compared with 83 percent and 91 percent in Germany and the UK, respectively. This evident suggests that the less-developed state of the services sectors may have contributed to the relatively low female labor force participation, by offering fewer attractive job opportunities. Moreover, a number of studies (e.g., Dabla-Norris et al., 2013<sup>11</sup>) show that a higher dependency ratio leads to a larger value-added share of the services sector in the total economy. Given the aging of the population, the services sector could perhaps play a more prominent role in the Czech Republic. Therefore, reducing domestic entry barriers in the services sectors and enhancing competition could help further develop these sectors and achieve a dual goal of enhancing women labor force participation and better preparing for the aging society.

<sup>11</sup> Dabla-Norris, E., Thomas, A., Garcia-Verdu, R. and Chen, Y. (2013) "Benchmarking structural transformation across the world", *IMF Working Paper*.



## Appendix II. Czech Republic: Debt Sustainability Analysis

Public debt has stabilized at around 46 percent of GDP, as the effect of narrowing structural deficits was counterbalanced by economic contraction in 2012–13. Provided the expenditure ceilings as specified in the Convergence Programme are respected, public debt is projected to stay on a downward path reaching 42 percent of GDP by 2019 on the back of the economic recovery and strong revenue collection. Public debt and gross financing needs are relatively resilient to isolated shocks to key variables, but a combination of shocks to real GDP growth, interest rate, exchange rate, and revenue shortfalls could lead to a significant ratcheting up of the debt level.

### Baseline and Realism of Projections

**The baseline scenario assumes a structural relaxation from a deficit of 0.6 percent of GDP in 2012 to 1.2 percent in 2015 with structural balances staying close to a 1 percent of GDP deficit over the medium term.** It is underpinned by the following assumptions:

- **Expenditure ceilings:** The baseline assumes that the expenditure ceilings set forth in medium term budget framework for the 2014–17 period will be respected. The small structural relaxation is mostly due to the increase in the capital expenditures from 2.8 percent of GDP in 2013 to 3.6 percent in 2015.
- **Growth and inflation:** Underpinned by a recovery in domestic demand and exports, real GDP is projected to increase by 2.5 percent in 2014 and 2015, with medium-term growth converging close to 2 percent. The inflation rate is forecast to converge to the 2 percent target by end-2015.

**The outlook for the fiscal path is benign under the baseline.** Staff projects that the debt-to-GDP ratio will decrease from 46 percent in 2013 to 44.4 percent in 2014–15, before starting to steadily decline to 42.3 percent in 2019. The temporary stabilization in 2015 at 44.4 percent in part reflects the scheduled government structural stimulus to aid the nascent recovery. Gross financing needs are projected to stay below 9 percent of GDP throughout the projection period.

### Shock and Stress Tests

**A combination of macro-fiscal shocks is the main risk to debt sustainability.** Assuming that shocks to real GDP growth, the primary balance, the real exchange rate and the real interest rate would occur simultaneously, public debt would increase sharply and stabilize around 62 percent of GDP. Gross financing needs would also climb to 14 percent of GDP in 2019.

## Czech Republic: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

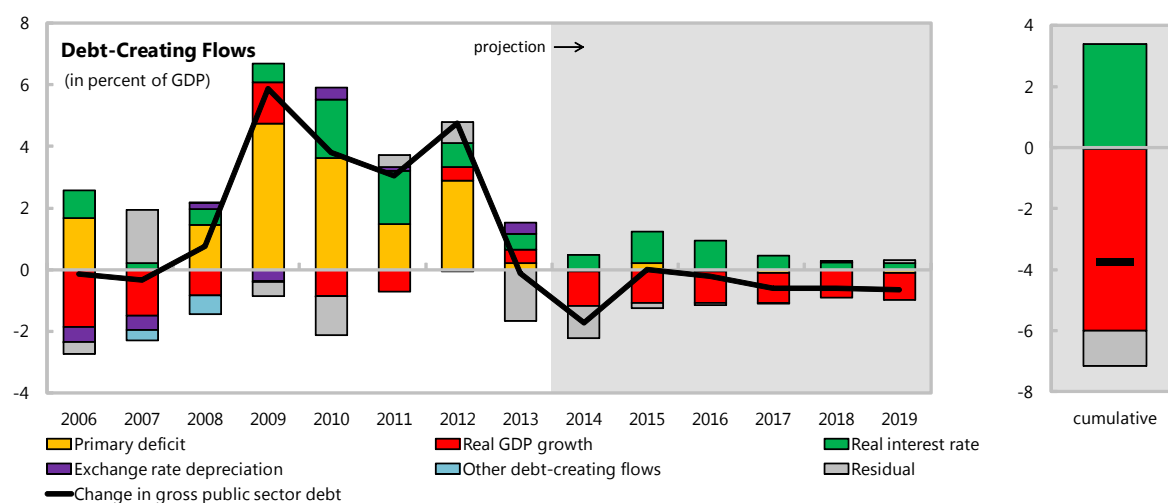
(in percent of GDP unless otherwise indicated)

### Debt, Economic and Market Indicators <sup>1/</sup>

	Actual			Projections						As of May 21, 2014		
	2006-2011 <sup>2/</sup>	2012	2013	2014	2015	2016	2017	2018	2019	Sovereign Spreads		
Nominal gross public debt	33.2	46.2	46.0	44.3	44.3	44.1	43.5	42.9	42.3	EMBIG (bp) <sup>3/</sup>	268	
Public gross financing needs	3.1	4.2	1.5	5.5	7.1	7.4	8.1	8.6	8.4	5Y CDS (bp)	51	
Real GDP growth (in percent)	2.6	-1.0	-0.9	2.5	2.5	2.4	2.3	2.1	2.1	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	0.9	1.6	1.9	0.9	1.7	1.8	1.9	1.9	2.0	Moody's	A1	A1
Nominal GDP growth (in percent)	3.5	0.6	1.0	3.4	4.3	4.3	4.2	4.1	4.1	S&Ps	AA-	AA
Effective interest rate (in percent) <sup>4/</sup>	4.0	3.5	3.0	2.0	4.1	4.1	3.0	2.6	2.5	Fitch	A+	AA-

### Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance <sup>9/</sup>
	2006-2011	2012	2013	2014	2015	2016	2017	2018	2019		
Change in gross public sector debt	2.2	4.7	-0.1	-1.7	0.0	-0.2	-0.6	-0.6	-0.6	-3.7	
Identified debt-creating flows	2.2	4.1	1.5	-0.7	0.2	-0.1	-0.6	-0.6	-0.7	-2.6	
Primary deficit	2.2	2.9	0.2	0.0	0.2	0.0	-0.1	0.0	-0.1	0.0	
Primary (noninterest) revenue and grant	39.3	40.1	40.7	41.1	40.6	39.8	39.8	39.7	39.8	240.8	
Primary (noninterest) expenditure	41.5	43.1	41.0	41.1	40.8	39.8	39.7	39.7	39.7	240.7	
Automatic debt dynamics <sup>5/</sup>	0.2	1.2	1.3	-0.6	-0.1	-0.1	-0.5	-0.6	-0.7	-2.5	
Interest rate/growth differential <sup>6/</sup>	0.2	1.2	0.9	-0.6	-0.1	-0.1	-0.5	-0.6	-0.7	-2.5	
Of which: real interest rate	1.0	0.8	0.5	0.5	1.0	0.9	0.5	0.3	0.2	3.4	
Of which: real GDP growth	-0.7	0.4	0.4	-1.1	-1.1	-1.0	-1.0	-0.9	-0.9	-5.9	
Exchange rate depreciation <sup>7/</sup>	-0.1	0.0	0.4	...	...	...	...	...	...	...	
Other identified debt-creating flows	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
General government net privatization	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes <sup>8/</sup>	0.0	0.7	-1.7	-1.1	-0.2	-0.1	0.0	0.0	0.1	-1.2	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as  $[(r - \pi(1+g) - g + ae(1+r)] / (1+g+\pi+g\pi)$  times previous period debt ratio, with  $r$  = interest rate;  $\pi$  = growth rate of GDP deflator;  $g$  = real GDP growth rate;  $a$  = share of foreign-currency denominated debt; and  $e$  = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as  $r - \pi(1+g)$  and the real growth contribution as  $-g$ .

7/ The exchange rate contribution is derived from the numerator in footnote 5 as  $ae(1+r)$ .

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

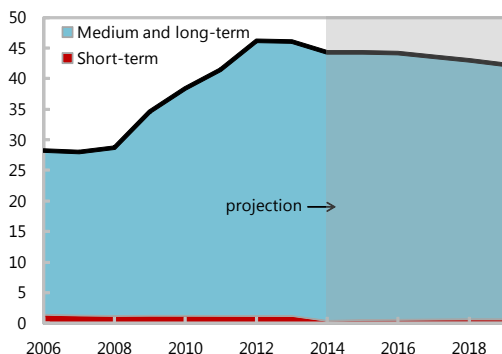
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

## Czech Republic: Public DSA – Composition of Public Debt and Alternative Scenarios

### Composition of Public Debt

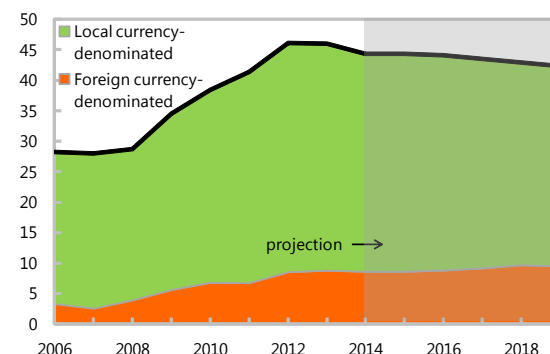
#### By Maturity

(in percent of GDP)



#### By Currency

(in percent of GDP)



### Alternative Scenarios

— Baseline

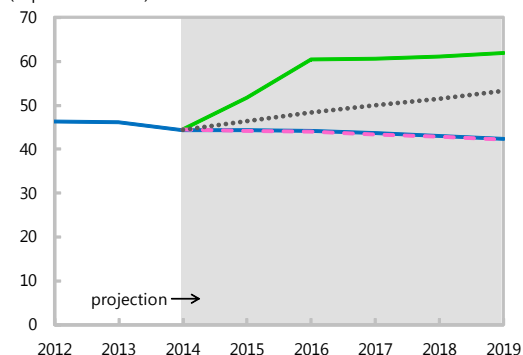
..... Historical

— Combined Macro-Fiscal Shock

— Constant Primary Balance

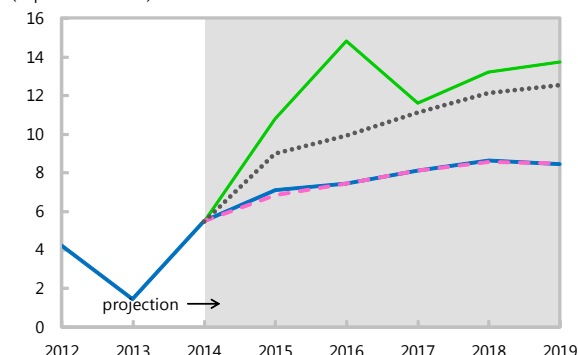
#### Gross Nominal Public Debt

(in percent of GDP)



#### Public Gross Financing Needs

(in percent of GDP)



### Underlying Assumptions

(in percent)

	2014	2015	2016	2017	2018	2019
<b>Baseline Scenario</b>						
Real GDP growth	2.5	2.5	2.4	2.3	2.1	2.1
Inflation	0.9	1.7	1.8	1.9	1.9	2.0
Primary Balance	0.0	-0.2	0.0	0.1	0.0	0.1
Effective interest rate	2.0	4.1	4.1	3.0	2.6	2.5
<b>Constant Primary Balance Scenario</b>						
Real GDP growth	2.5	2.5	2.4	2.3	2.1	2.1
Inflation	0.9	1.7	1.8	1.9	1.9	2.0
Primary Balance	0.0	0.0	0.0	0.0	0.0	0.0
Effective interest rate	2.0	4.1	4.1	3.0	2.6	2.6
<b>Combined Macro-Fiscal Shock</b>						
Real GDP growth	2.5	-1.2	-1.3	2.3	2.1	2.1
Inflation	0.9	-0.2	-0.1	1.9	1.9	2.0
Primary Balance	0.0	-3.3	-5.4	0.1	0.0	0.1
Effective interest rate	2.3	4.2	4.8	4.6	4.9	5.3

	2014	2015	2016	2017	2018	2019
<b>Historical Scenario</b>						
Real GDP growth	2.5	2.5	2.5	2.5	2.5	2.5
Inflation	0.9	1.7	1.8	1.9	1.9	2.0
Primary Balance	0.0	-2.1	-2.1	-2.1	-2.1	-2.1
Effective interest rate	2.1	4.1	4.3	3.5	3.3	3.4

Source: IMF staff.



# CZECH REPUBLIC

## STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 31, 2014

Prepared By

European Department

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## FUND RELATIONS

(As of June 30, 2014; unless specified otherwise)

**Membership Status:** Joined 01/01/1993; Article VIII

### General Resources Account

	SDR Million	Percent of Quota
Quota	1,002.20	100.0
Fund Holdings of Currency	624.85	62.35
Reserve position in Fund	377.35	37.65
Lending to the Fund		
Borrowing Agreement	113.37	

### SDR Department:

	SDR Million	Percent Allocation
Net Cumulative Allocation	780.20	100.0
Holdings	751.39	96.31

**Outstanding Purchases and Loans:** None

### Financial Arrangements:

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

### Projected Payments to Fund:

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2013	2014	2015	2016	2017
Principal					
Charges/Interest	0.01	0.03	0.03	0.03	0.03
Total	0.03	0.03	0.03	0.03	0.03

**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  $\pm 0.5$  percent to  $\pm 7.5$  percent around the central rate. On May 27, 1997, managed floating was introduced. Between 2002 and 2013, the CNB has not engaged in direct interventions in the foreign exchange market, and the de facto exchange rate regime was classified as a free float. In November 2013, facing zero lower bound for policy rates and a persistent and large undershooting of its inflation target, the CNB intervened in the market to weaken the currency, and announced its commitment to resist any appreciation beyond CZK 27 per euro. As a result, the de facto exchange rate regime was reclassified as 'other managed'. The de jure exchange rate arrangement remains floating. On June 30 2014, the exchange rate stood at CZK 27.45 per euro and CZK 20.10 per U.S. dollar.

The Czech Republic has accepted the obligations of Article VIII and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. The Czech Republic maintains exchange restrictions for security reasons, based on UN Security Council Resolutions and Council of the European Union Regulations that have been notified to the Fund for approval under the procedures set forth in Executive Board Decision No. 144-(52/51).

**Last Article IV Consultation:**

The last Article IV consultation with the Czech Republic was concluded on July 24, 2013. The staff report and the press release were published on August 2, 2013.

**FSAP Participation and ROSCs:**

An FSAP was carried out in late 2000/ early 2001. The Financial System Stability Assessment was considered by the Executive Board on July 16, 2001, concurrently with the staff report for the 2001 Article IV Consultation. An FSAP update was carried out in 2011. ROSCs on: banking supervision; data dissemination; fiscal transparency; securities market; and transparency of monetary and financial policies were published on the Fund's external website on July 1, 2000.

**Technical Assistance:** See attached table.

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

**Implementation of Multilateral Debt Relief Initiative (MDRI):** Not Applicable.

**Implementation of Post-Catastrophic Debt Relief (PCDR):** Not Applicable.

**Safeguards Assessments:** Not Applicable.

<b>Czech Republic: Technical Assistance, 1991–2014</b>		
<b>Department</b>	<b>Timing</b>	<b>Purpose</b>
FAD	December 1991– September 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
	MCM	February 1992
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
April 1994		Foreign exchange laws (jointly with LEG) and external liberalization
January 1995		liberalization
May 1995		Monetary operations
May 1995		Banking system reform
May 1996		Economic research
April 1997		Banking legislation
February–June 1999		Monetary research—inflation targeting
June 1999		Integrated financial sector supervision (with WB)
RES		September 1999
	June–August 2000	Inflation targeting (financed by MFD)
	February–March 2005	Inflation targeting (financed by MFD)
STA	May 1993	Money and banking statistics
	February 1994	Balance of payments
	April 1994	Government finance
	November 1994	Money and banking statistics
	January–February 1999	Money and banking statistics
	May 2002	Monetary and financial statistics
	February 2003	Implementing GFSM 2001
	November 2006	GFSM 2001 Pilot Project GFSM 2001 implementation

## STATISTICAL ISSUES

**1. Data provision is adequate for surveillance.** The Czech Republic subscribed to the Special Data Dissemination Standard in April 1998, and metadata and annual observance reports for 2006–09 are posted on the Fund’s Dissemination Standards Bulletin Board.

**2. Data on core surveillance variables are available to the Fund regularly and with minimal lags. Interest rates set by the Czech National Bank (CNB), and exchange rates are reported daily with no lag.** Gross and net international reserves are reported on a monthly basis with a one week lag, as well as on a 10-day basis (with the CNB’s balance sheet) with a one-week lag. Consumer prices, reserve money, broad money, borrowing and lending interest rates, central government fiscal accounts, and foreign trade are reported monthly with a lag of between one and four weeks. Final monetary survey data are available with a lag of about one month. GDP and balance of payments data are made available on a quarterly basis with a lag of two to three months. Since 2003, the main components of the balance of payments are also available monthly. 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 state budget accounts and are available with a two- to three-month lag.

**3. While data quality is generally high, some deficiencies remain in certain areas,** and the authorities are taking measures to improve data accuracy.

- National accounts data are subject to certain weaknesses. Value added in the small scale private sector is likely to be underestimated, as the mechanisms for data collection on this sector are not yet fully developed and a significant proportion 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 by respondents. Large swings in individual components of spending and the overall GDP from quarter to quarter bring into question the reliability of the quarterly data and hamper business cycle analysis. The Czech Republic is adopting the *European System of Accounts 2010 (ESA 2010)* in September 2014. The transition from the *ESA 1995 (ESA95)* requires a revision of national accounts data. New data sources will also be incorporated in the new estimates which are due to be published in September/October 2014.
- Recently, revisions 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 fixed base price indices for exports and imports; these indices are currently presented on the basis of the same month of the previous year. Starting in 2014, external sector statistics are compiled according to the *Balance of Payments and International*



*Investment Position Manual, sixth edition (BPM6)* and in accordance with legal requirements of the ECB and Eurostat.

- Monetary survey data provided to the European Department are generally adequate for policy purposes. However, large variations in the interbank clearing account float, especially at the end of the year, require caution in interpreting monetary developments. The CNB has made a major effort to identify the causes of these variations and adjust the data. In 2002, to meet EU statistical conventions, the CNB implemented the European Central Bank's (ECB) framework for collecting, compiling, and reporting monetary data. The data published in *IFS* are based on monetary accounts derived from the ECB's framework. The same set of accounts also forms the basis for monetary statistics published in the CNB's bulletins and on the website, which are thereby effectively harmonized with the monetary statistics published in *IFS*, although the presentation in *IFS* differs somewhat from the CNB's.
- Annual and quarterly fiscal data are compiled on *ESA95* basis by the Czech Statistical Office, including non-financial accounts, financial accounts, and financial balance sheets. Starting from September 2014, GFS data will be based on *ESA 2010* methodology which is likely to include revisions of the general government deficit and debt levels from 1995 onwards. The Ministry of Finance uses the *ESA* methodology for the Convergence Program targets. Some adjustments are to be done when converting data from the national (fiscal targeting) methodology to the *ESA* based fiscal accounts. The differences relate mainly to the coverage of the institutions classified in the general government sector, exclusion of financial transactions, different classification of some specific government transactions (for example, called guarantees) and the time of recording of government transactions (*ESA* records transactions on accrual basis).

**Czech Republic: Table of Common Indicators Required for Surveillance**  
(As of July 18, 2014)

	Date of Latest Observation	Date Received	Frequency of Data <sup>7</sup>	Frequency of Reporting <sup>7</sup>	Frequency of Publication <sup>7</sup>
Exchange Rates	current	current	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities <sup>1</sup>	May 2014	Jun. 2014	D	M	M
Reserve/Base Money	May 2014	Jun. 2014	M	M	M
Broad Money	May 2014	Jun. 2014	M	M	M
Central Bank Balance Sheet	Jun. 2014	Jun. 2014	M	M	M
Consolidated Balance Sheet of the Banking System	May 2014	Jun. 2014	M	M	M
Interest Rates <sup>2</sup>	current	current	D	D	D
Consumer Price Index	May 2014	Jun. 2014	M	M	M
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – General Government <sup>4</sup>	2012	May 2014	A	A	A
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – Central Government	May 2014	Jun. 2014	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt <sup>5</sup>	2014 Q1	Jun. 2014	Q	Q	Q
External Current Account Balance	Mar. 2014	Jun. 2014	M	M	M
Exports and Imports of Goods and Services	Mar. 2014	Jun. 2014	M	M	M
GDP/GNP	2014 Q1	Jun. 2014	Q	Q	Q
Gross External Debt	2014 Q1	Jun. 2014	Q	Q	Q
International Investment Position <sup>6</sup>	2014 Q1	Jun. 2014	Q	Q	Q

<sup>1</sup>Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

<sup>2</sup>Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

<sup>3</sup>Foreign, domestic bank, and domestic nonbank financing.

<sup>4</sup>The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments. Data for the state budget are available with monthly frequency and timeliness, while data on extra budgetary funds are available only on an annual basis.

<sup>5</sup>Including currency and maturity composition.

<sup>6</sup>Includes external gross financial asset and liability positions vis-à-vis nonresidents.

<sup>7</sup>Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).

**Statement by the IMF Staff Representative on the Czech Republic**  
**August 27, 2014**

This statement provides information that has become available since the staff report was finalized. This information does not alter the thrust of the staff appraisal.

The Board of the Czech National Bank (CNB) extended its timeline for using the exchange rate as an additional monetary policy instrument to end-2015. This decision was underpinned by a new quarterly macroeconomic forecast, which foresees achievement of the inflation target conditional on continuation of current market interest rates and the use of the exchange rate as a monetary policy instrument for inflation targeting until 2015:Q3. The CNB Board assessed the risks to the new forecast as being to the downside, mainly from very low euro area inflation, and therefore extended its guidance for using the exchange rate as a monetary policy instrument. While staff supports the view that it is appropriate to keep the exchange rate floor in place for now, the central bank should continue to focus on inflation targeting with a view to exiting the intervention policy as soon as conditions allow (as emphasized in the staff appraisal). Following the decision, the koruna entered a slight depreciation trend, and, as of August 21, was about 2 percent weaker than the level prevailing at end-July and about 4 percent weaker than the CNB's floor of 27 koruny per euro.

The latest national accounts data confirmed the economy's growth momentum, notwithstanding one-off effects from stocks. Preliminary estimates suggest that real GDP grew 2.6 percent year-over-year in the second quarter of 2014. Compared to the first quarter, real GDP remained unchanged mainly due to the impact of continued destocking of tobacco products following the excise tax hike.

Inflation picked up somewhat. Headline inflation increased to 0.5 percent year-on-year in July from 0 percent year-on-year in June, mainly due to a slight acceleration of food price inflation. Inflation excluding regulated prices, indirect price changes, food, and fuels remained unchanged at 0.7 percent year-on-year in July.



INTERNATIONAL MONETARY FUND



Press Release No. 14/xx  
FOR IMMEDIATE RELEASE  
[Month, dd, yyyy]

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

## **IMF Executive Board Concludes 2014 Article IV Consultation with the Czech Republic**

On August 27, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation<sup>1</sup> with the Czech Republic.

The Czech economy exited the recession in 2013. The recovery was triggered by exports, but has been increasingly supported by domestic demand, with contributions from investment and household consumption. Moreover, high frequency indicators suggest that growth has remained strong in recent months. Unemployment entered a gradually declining path in 2013 on the back of gains in employment. Exports are performing very well, and the current account deficit is likely to narrow and approach balance this year. Inflation has been falling and is fluctuating just above zero, but this is mainly due to administrative prices and energy prices, while core indicators are on a moderate upwards trend.

A sharp fiscal adjustment led to an exit from the EDP and kept debt levels contained, but exacerbated the recession. The adjustment was driven mainly by a compression of capital expenditure, partly due to implementation bottlenecks, while an increase in VAT rates helped boost revenue. As a result, but also owing to one-off factors, the overall fiscal deficit narrowed from 4.2 percent of GDP in 2012 to 1.5 percent in 2013. The fiscal stance continued to improve, with the structural deficit narrowing by 1.3 percentage points of GDP on the heels of a cumulative 2.4 percentage point of GDP consolidation during 2011–12.

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<sup>1</sup> 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.

The Czech National Bank (CNB)—an inflation targeter—resorted to foreign exchange intervention to avoid deflation, consistent with Fund advice. In November 2013, facing the zero lower bound for its policy rate and the risk of a persistent undershoot of its inflation target, the CNB decided to use the exchange rate as an additional instrument for inflation targeting and announced its commitment “to prevent excessive appreciation of the koruna below CZK27 per € by intervening in the foreign exchange market”, implying a 6 percent depreciation that was expected to bring inflation to target in the monetary policy horizon.

The financial sector remains strong and financial market volatility is low. Banks have improved their already strong capital position reaching a capitalization ratio of 16.5 percent at end-2013 compared with 15.6 percent in 2012. Credit growth is currently low, mainly due to weak demand, but is likely to recover gradually given strong balance sheets in both financial and non-financial sectors. Bond yields increased somewhat in the second half of 2013 in line with global trends, but have recently approached historical lows again.

### **Executive Board Assessment<sup>2</sup>**

Executive Directors welcomed the recent strong and broad-based rebound of the Czech economy, with falling unemployment and more robust domestic demand. These notwithstanding, inflation remains well below target, and potential growth is still below the level necessary to facilitate convergence of Czech per capita income to that of other advanced European economies. Meanwhile, external uncertainties, including about growth prospects and geopolitical tensions in the region, continue to cloud the near-term outlook. In this light, Directors stressed the importance of a comprehensive growth strategy that includes supportive macroeconomic policies and accelerated structural reforms.

Directors underscored the need for a growth-friendly fiscal strategy, anchored in a clear medium-term framework. They generally supported the prudent easing of the fiscal stance in the

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<sup>2</sup> 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. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

near term, geared toward increasing capital investment, particularly in infrastructure. At the same time, they encouraged the authorities to continue to improve tax administration, combat tax evasion, and use revenue over-performance for priority expenditures and debt reduction.

Directors welcomed the authorities' commitment to the medium-term structural deficit target, and looked forward to the adoption of a new medium-term fiscal framework, comprising fiscal rules, a debt brake, and an independent fiscal council.

Directors noted that while inflation is projected to rise gradually toward the central bank's target, there remain a sizable output gap and considerable risks to the economic recovery. They therefore saw merit in maintaining the current accommodative stance by keeping the exchange rate floor in place while considering modalities for a timely exit. Directors agreed that the central bank should continue to focus on inflation targeting and return to the floating exchange rate once deflation risks recede and the inflation forecast and inflation expectations become entrenched around the inflation target.

Directors observed that the financial system is sound and resilient, with banks maintaining strong capital and liquidity buffers. They encouraged the authorities to remain vigilant, conduct proactive supervision, and improve the supervisory architecture in line with the European and global initiatives, building on recent progress in implementing the FSAP recommendations. Directors welcomed the authorities' consideration of the pros and cons of joining the euro-area banking union ahead of euro adoption.

Directors called for renewed momentum in structural reform to boost potential growth, especially in light of demographic challenges. They recommended that priority be given to increasing investment in physical and human capital, removing labor market rigidities, and improving the business environment more broadly. They also encouraged further steps to promote labor participation, advance research and development, and upgrade technical skills.

## Czech Republic: Selected Economic Indicators, 2008–16

	2008	2009	2010	2011	2012	2013	2014	2015	2016
	Staff Proj.								
Nominal GDP (USD billions)	225.4	197.2	198.5	216.1	196.4	198.4	200.0	208.9	216.7
Population (millions)	10.3	10.4	10.5	10.5	10.5	10.5	10.5	10.6	10.6
GDP per capita (USD)	21,794	18,913	18,973	20,603	18,699	18,871	18,985	19,796	20,511
Real economy (change in percent, unless stated otherwise)									
Real GDP	3.1	-4.5	2.5	1.8	-1.0	-0.9	2.5	2.5	2.4
Domestic demand	2.2	-5.4	2.0	-0.1	-2.9	-0.8	1.8	2.9	2.8
Private consumption	2.8	0.2	0.9	0.5	-2.1	0.1	1.3	2.5	2.5
Investment	1.9	-20.2	5.4	0.8	-5.0	-4.4	3.0	4.4	4.0
Exports	4.0	-10.9	15.4	9.5	4.5	0.2	7.2	5.0	4.0
Imports	2.7	-12.1	15.4	7.0	2.3	0.6	7.0	5.8	4.6
Output gap (percent of potential output)	5.4	-2.7	-1.2	0.2	-1.3	-2.7	-1.9	-0.5	-0.1
CPI (average)	6.3	1.0	1.5	1.9	3.3	1.4	0.6	1.9	2.0
PPI (average)	4.5	-3.1	1.3	5.5	2.1	0.8	...	...	...
Unemployment rate (in percent)	4.4	6.7	7.3	6.7	7.0	7.0	6.4	6.0	5.6
Gross national savings (percent of GDP)	26.8	21.4	21.0	21.6	22.0	20.8	22.2	22.4	22.5
Gross domestic investments (percent of GDP)	28.9	23.8	24.8	24.5	23.3	22.3	22.4	22.7	22.9
Public finance (percent of GDP)									
General government revenue	38.9	38.9	39.1	40.0	40.3	40.9	41.3	40.7	40.0
General government expenditure	41.1	44.7	43.7	43.2	44.5	42.3	42.5	42.2	41.1
Net lending / Overall balance	-2.2	-5.8	-4.7	-3.2	-4.2	-1.5	-1.2	-1.4	-1.2
Structural balance	-3.9	-5.1	-4.3	-3.2	-1.9	-0.6	-0.6	-1.2	-1.2
General government debt	28.7	34.6	38.4	41.4	46.2	46.0	44.3	44.3	44.1
Money and credit (end of year, percent change)									
Broad money (M3)	13.6	0.2	1.9	2.8	4.8	5.8	...	...	...
Private sector credit	16.1	0.8	3.0	5.5	2.6	3.7	...	...	...
Interest rates (in percent, year average)									
Three-month interbank rate 1/	4.0	2.2	1.3	1.2	1.0	0.5	0.4	...	...
Ten-year government bond 2/	4.6	4.8	3.9	3.7	2.8	2.1	2.0	...	...
Balance of payments (percent of GDP)									
Trade balance (goods and services)	2.7	4.3	3.4	4.2	5.5	6.2	7.0	6.9	6.9
Current account balance	-2.1	-2.5	-3.8	-2.9	-1.3	-1.4	-0.2	-0.3	-0.4
Gross international reserves (US\$ billion)	37.0	41.6	42.5	40.3	44.9	56.2	57.9	60.8	63.4
(in months of imports of goods and services)	3.2	4.5	4.0	3.2	3.7	4.6	4.5	4.4	4.3
Exchange rate									
Nominal effective exchange rate (index, 2005=100)	121.6	116.2	118.7	122.4	117.7	115.7	...	...	...
Real effective exchange rate (index, CPI-based; 2005=100)	125.6	120.5	122.5	125.1	121.3	118.8	...	...	...

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

1/ Offer rate. 2014 entry is January-June average.

2/ 2014 entry is January-June average.

**Statement by Johann Prader, Executive Director for Czech Republic  
and Miroslav Kollar, Second Alternate Executive Director  
August 27, 2014**

The Czech economy has recovered from the negative growth of the last two years and is experiencing a strong and balanced recovery. Households' consumption growth has resumed and is beginning to contribute meaningfully to economic growth. With stronger growth in the euro area over the last twelve months, the external environment has been positive for Czech exports. After graduating from the EU's Excessive Deficit Procedure, fiscal policy is no longer a drag on the economy. Private and public sector investments are picking up as demand continues to improve, and the execution of projects from EU funds has improved.

The authorities expect the real GDP to grow in the order of 2.7 - 2.9 percent this year and in the order of 2.5 - 3 percent next year. Risks to the forecast stem from the speed in EU funds absorption, a continuation of the positive consumer sentiment, disinflationary risks in the euro area, the development of global commodities prices, and geopolitical risks in Ukraine and Iraq. The unemployment rate is projected to decline from its peak of 7 percent in 2013, to 6.4 in 2014, and then 6.1 in 2015. The current account is expected to reach a surplus of 0.4 percent of GDP in 2014 (for the first time since 1993) and remain balanced in 2015.

The Czech economy has weathered last summer's pullback of capital flows from emerging markets well. Since 2008, the current account and fiscal deficits have decreased significantly and the economy has become less reliant on foreign capital. As a result, and faced with decelerating inflation, monetary policy has continued with easing, and fiscal policy can use the acquired fiscal space to provide targeted support to the economy this year.

### **Monetary policy stance**

The Czech National Bank (CNB) reached the zero interest rate bound in November 2012, but the economy continued to experience weakness throughout 2013, households' consumption was weak, fiscal consolidation was ongoing and weak demand and economic uncertainty weighed negatively on investment. Inflation slowed down rapidly over 2013 towards zero, with households starting to postpone consumption as prices were falling.

Faced with the risks of a deflationary spiral, missing its inflation target, and the continued low-inflation environment in the euro area, the CNB launched foreign exchange interventions in the fall of 2013 in order to further ease monetary conditions to bring inflation to its 2 percent inflation target. The CNB adopted the commitment to intervene in the foreign exchange market to weaken the koruna so as to maintain the exchange rate close to CZK 27 to the euro. The CNB only intervened during the first few days after its announcement; the exchange rate adjusted accordingly and has been above this level without significant fluctuations. The CNB communicated that further changes to its exchange rate floor towards the greater weakening of its exchange rate would be warranted only if economic conditions and the medium-term outlook were to change significantly. The CNB is an inflation-targeting central bank and foreign



exchange interventions are used only as a tool to further ease monetary conditions in order to reach the inflation target in situations when monetary policy interest rates have reached the zero bound.

The fact that inflation was still only 0.5 percent in July (well below the lower boundary of the tolerance band around the CNB's inflation target) despite the slightly weaker exchange rate (27.8 CZK/EUR as of August 22) and in an environment where growth is picking up strongly suggests that the output gap could have been even deeper than expected and the extent of households' savings glut even greater than anticipated. Therefore, foreign exchange interventions have been successful in averting the threat of a deflationary spiral.

The current CNB forecast sees more downside inflation risks than in the previous quarter, and inflation gradually returning to the target from its presently very low levels in the second half of 2015, as wage growth in the business sector picks up. The Bank Board therefore decided to continue using the exchange rate as a monetary policy instrument at least until 2016 (originally the beginning of 2015), on the condition that there is sufficient certainty after the exit from foreign exchange interventions that inflation would not immediately fall below its target again. The Bank Board continues to discuss the exit strategy, and exchanging views with Fund staff during the June Article IV mission was very helpful in this regard. An exit from foreign exchange intervention will not imply the appreciation of the exchange rate to the level recorded before the CNB began to intervene, as the weaker exchange rate will in the meantime pass through to the price level and other nominal variables.

## **Government policies**

The new government took office in January 2014, aiming for more pro-growth policies and emphasizing social policy priorities, while adhering to overall budgetary responsibility.

### *Fiscal policy*

The Czech Republic exited the EU's Excessive Deficit Procedure this year after considerable fiscal consolidation that brought down the fiscal deficit from its peak of 5.8 percent of GDP in 2009 to 1.5 percent of GDP in 2013, primarily due to the increase in VAT rates and a reduction in public investment. The government expects the fiscal deficit to reach 1.5 percent of GDP in 2014. In 2014, the government's fiscal policy strategy expects to utilize this newly-created fiscal space to support the domestic economy's fragile recovery in the short term, with a neutral effect in the medium term. Government investment (mainly as a result of the increase in investment financed from EU sources) and government current spending (primarily on social benefits) are projected to pick up this year, while there are only relatively moderate discretionary tax measures planned for this year. The wage bill in the state administration was approved to increase by 2 percent this year. Tax revenues are expected to improve in 2014 on the back of the strengthening economy.

The gross government debt is expected to decline from 46.2 percent of GDP in 2012 to 46 percent of GDP in 2013, then 44 percent of GDP in 2014 (currently among the lowest in the EU). The net financial government debt is estimated at 29.9 percent of GDP in 2014. Government

debt denominated in foreign currency is estimated at 14 percent of total debt (or 4.1 percent of GDP, adjusted for collateral and assets). Expenditures on interest payments remain low and yields on government bonds remain at a historical low, due to the stable debt development, the country's economic stability, and the favorable situation on global financial markets.

As to the modification of the tax legislation, the Lower House of Parliament already approved an increase in the rates on the excise duty on tobacco products in line with EU requirements, particularly due to the currency depreciation. As of January 1, 2015, the government plans to amend the personal income tax legislation, including by increasing tax credits for children and reintroducing tax discounts for pensioners; to introduce a second, reduced VAT rate of 10 percent on drugs, books, and essential infant nutrition; and to abolish fees for prescription and outpatient treatment.

The government is committed to the medium-term structural deficit objective of 1 percent of GDP by 2020 and the headline deficit below 3 percent. In the medium term, the government expects to reach a headline fiscal deficit of 1.7 percent of GDP in 2017, and plans changes in the area of direct and indirect taxation. The government's priority is to increase the effectiveness of tax collection and more successfully fight against tax evasion. The rationalization of expenditure and savings in the government sector's current expenditure are also among the key priorities. The wage bill in the state administration is expected to grow by 1 percent in the medium term, and the wages of medical doctors should increase in 2015 and 2016. A larger amount of funding will be directed to the healthcare sector, as public and private spending on health care is below the OECD average. The gross fixed capital formation of the government sector is expected to be around 3 percent annually in the medium-term outlook horizon until 2017. The structural deficit is expected to deteriorate to 1.7 percent of GDP by 2017 as a result of the reduced emphasis on public sector consolidation. Government debt is projected to increase only slightly by 2017, in view of the expected recovery of GDP growth.

The government committed to adopt the Fiscal Compact of the EU. Furthermore, the government continues its work on the Constitutional Act on Fiscal Responsibility with the government's aim of enacting it in 2015. The Act will introduce numerical fiscal rules, a debt break, and a fiscal council. Based on the agreement between the Government and the two political parties in the parliamentary opposition, the new Civil Service Act is to be approved with a view to entering into force on January 1, 2015.

### *Structural policies*

In line with staff recommendations to increase labor force participation, a draft Act to introduce a new type of service to provide childcare was adopted by the Lower House of the Parliament. The government also aims to create suitable conditions for long-term sustainable employment, based on a targeted active employment policy and by modifying the investment incentive system to improve employers' motivation to invest in regions with an above-average unemployment rate. The government will also start implementing measures to reduce entrepreneurs' administrative and regulatory burden. The minimum wage should be increased annually in order to reflect the socio-economic environment and to raise it over time to 40 percent of the average wage.

The government is returning to the pre-2012 rules for the indexation of pensions to allow for its indexation based on the CPI index and real wage growth. From 2015, the average, independently paid old-age pension will increase by at least 1.8 percent annually. The main goal is to stop the decrease of the real value of pensions and to prevent the decrease of the standard of living of pensioners.

With the measures from 2011 introducing increases in the retirement age, the average period of pension payments was stabilized for the long term, in accordance with the expected future demographic development and changes in life expectancy. However, being aware of the uncertainty regarding demographic forecasts, the current government considered the possibility to implement standardized procedures of regular revisions to the retirement age increase rate.

In line with the Policy Statement of the Government, an expert committee has been established to propose changes to the current pension system with a view to bringing a long-term stable setup of the system, enhancing the sustainability of its funding, and the adequacy of the provided benefits. The Government also mandated the expert committee to submit a proposal for termination of Pillar II of the pension system on January 1, 2016.

## **Financial sector**

The Czech banking sector remains stable and sound. Czech banks follow a traditional banking model, are well-capitalized (17.1 percent capital adequacy ratio) and continue to be some of the most profitable in the region (18.4 percent return on equity). Bank lending is predominantly financed by domestic deposits (a loan-to-deposit ratio of 74 percent, among the best in EU) and foreign exchange loans to households are virtually non-existent. Banks operate in an environment of excess liquidity. The net external position of the Czech banking sector is positive. Non-performing loans are leveling up at 6.5 percent of total loans while non-performing loan provisioning remains flat at 48 percent. Credit growth remains moderate, with growth in loans to households being low and growth in loans to the non-financial corporate sector stagnating due to weak domestic demand.

The CNB's most recent bank stress tests again showed that the banking sector is sufficiently resilient to even very unfavorable shocks, owing to its profitable business model, and strong capital and liquidity position. The insurance sector also showed sufficient resilience to the adverse scenario on account of its large capital buffer. The pension management company sector (pillar III) remains sensitive to a rise in yields on securities holdings.

The Czech Republic transposed the EU Capital Requirements Directive (CRD IV) into Czech law as of June this year, with selected parts taking effect in 2015 and 2016, and banks are already in compliance with the new regulation. The EU Directive establishing a framework for the recovery and resolution of credit institutions and investment firms (BRRD) is expected to be transposed into Czech law in 2015. The Czech authorities continue to address the weaknesses in the non-systemic sector of credit unions, following up on the recent FSAP recommendations, by closing down unviable businesses and strengthening the regulation for the sector. In line with FSAP recommendations, the CNB also increased staff in financial sector supervision.

The Czech authorities thank the Article IV team for a constructive exchange of views during its mission.