International Monetary Fund

Czech Republic—2007 Article IV Consultation

Concluding Statement

November 19, 2007

1. **Over the past year, the Czech economy has maintained the momentum of rapid growth and made further strides toward convergence with the EU-15**. A robust export expansion and, more recently, rising consumption demand have underpinned growth, and a strong koruna has helped keep inflation below target. Generally strong fundamentals have seen the economy tide over an extended political gridlock and the recent financial market turmoil. However, sustaining this success through a less benign global environment and tighter supply constraints at home calls for agile macroeconomic management. Above all, steadfast political commitment is needed to ensure fiscal sustainability by addressing major challenges in the areas of pensions, healthcare and labor market reforms.

2. **The economy is currently at a fairly advanced stage of a strong cyclical upswing and a slowdown in growth is likely in 2008**. Rapid growth —expected to be close to 6 percent in 2007 for the third year in a row—has begun to stretch the limits of productive capacity. With unemployment at its lowest level this decade, shortages of labor are emerging in many sectors, both headline and underlying inflation are on the rise, and the current account deficit is expected to widen as well. We expect economic growth to slow in 2008 as the recent fiscal measures weigh on consumption and growth in the euro area weakens. At about 4½ percent, growth will nevertheless remain solid on the back of continued strong domestic demand. Output is likely to remain above its potential level and unemployment

low. The risk to this central forecast are mainly on the downside, stemming primarily from fragility of growth in major export markets.

3. **Inflation is set to rise sharply against a backdrop of demand and wage pressures as well as rising food and energy prices and increases in indirect taxes**. Headline inflation is forecast to rise above 5 percent in 2008, well above the upper margin of the Czech National Bank's tolerance band around the target of 3 percent, mainly on account of the first round effects of increases in VAT and excises. Core inflation is also expected to rise in the face of a positive output gap and a tight labor market. Following a lengthy period of low inflation, there is a risk of such a rapid doubling of headline inflation feeding into inflation expectations. A slower pace of koruna appreciation could also remove a recent significant anti-inflationary influence, making the task of monetary policy more onerous.

4. **To keep inflation expectations firmly anchored to the target, monetary policy would need to remain on a continued path of tightening**. With core inflation expected to rise and the risk that high headline inflation could get embedded in expectations, a steady tightening would be in order. In deciding the precise pace of tightening, the CNB will need to weigh factors such as the developments in the koruna, recent evidence of fragility in European growth and the stance of fiscal policy. The upcoming wage round for 2008 will be a key test of the level of inflation expectations. Further ahead, the downward shift in the inflation target to 2 percent from 2010 onwards would call for deft policy management and clarity of communication so as to preserve the CNB's high policy credibility. In this context, the recent decision to publish a forecast-consistent interest-rate path, which is consistent with best international practice, should enhance transparency and communication in the transition period to a lower inflation target.

5. **The external competitive position remains comfortable and vulnerabilities limited**. The real effective exchange rate, both measured by consumer prices and by unit labor costs, has been broadly stable over the past year. Trade performance has remained robust, with double-digit growth in exports volume, rising export market shares in both the EU and world markets, and strong profitability of large exporters. The current account deficit is moderate and comfortably financed by direct investment inflows. These indicators suggest that the koruna has been broadly in line with fundamentals and consistent with external stability.

6. **Financial stability indicators suggest that risks are contained**. The Czech financial markets have remained largely unscathed by the recent turmoil in advanced financial markets, reflecting limited reliance on cross-border bank borrowing and virtual absence of securitization. Capital adequacy ratios have remained comfortably above the minimum regulatory thresholds despite a slight decline in 2005-06 reflecting rapid asset growth and record-high dividends. Bank profitability also remains healthy. Non-performing loan ratios, although lagging indicators, have been broadly stable and loan-to-value ratios indicate that banks are well collateralized. Sensitivity and stress test results, albeit limited to only the first-round impact of shocks, indicate that banks would be able to withstand the risk of sizeable defaults without jeopardizing capital positions. While these indicators appear comfortable, in an environment of rising interest rates and property prices, close supervisory vigilance is therefore needed to ensure that household credit risks are not building up, particularly for low-income borrowers.

7. **Public finances are benefiting from the effects of the strong cyclical expansion, resulting in a more favorable fiscal outturn in 2007 than budgeted**. Buoyed by the

strength in household incomes, consumption and corporate profits, strong growth of tax revenues is likely to keep the general government deficit (on ESA-95 basis) close to 3 percent of GDP, fortuitously offsetting the large increase in spending on social benefits stemming from pre-election commitments. Upside risks remain from end-of-year wasteful spending which should be avoided. With a widening positive output gap, the fiscal stance for 2007 is nevertheless expected to be once again expansionary, albeit only mildly.

8. **The tax and welfare reform recently passed by Parliament promotes a number of desirable modifications to the structure of the tax regime**. The shift from taxation of income to taxation of consumption is likely to contribute to enhancing savings and investment in the medium-term. The introduction of excises on energy consumption will discourage pollution and carbon emissions. The planned cut in the corporate income tax rate will help maintain the attractiveness of Czech Republic as an investment location. However, given the advanced cyclical position of the economy and the need to strengthen public finances, the tax cut could have been phased in more gradually.

9. **Regrettably, the fiscal reform package is insufficient to advance the critical task of fiscal consolidation in the medium-term**. The package, set for implementation in 2008, will help rein in demand pressures in the short term. However, while the tax reform is expected to be broadly revenue-neutral in 2008, revenues are expected to decline in 2009-10. On the spending side, while steps are taken to improve targeting of benefits, the compression of public sector wages and some of the measures taken to contain social spending are likely to yield only short-term reductions in spending. Overall, the reform package is thus likely to add to long-term fiscal pressures since the proposed tax cuts are permanent and well-defined,

while some of the offsetting spending measures are of a temporary character and as yet undefined.

10. **Against this backdrop, it is imperative to avoid slippages in the implementation of the 2008 budget as proposed.** A lower deficit than the budgeted 2.9 percent of GDP should be attainable if the fiscal adjustment implied by the reform package is not offset by additional discretionary spending. This would ensure that cyclical gains from 2007 are saved rather than spent. Such prudence is all the more advisable in view of the risk of breaching the 2009-10 fiscal targets, since specific expenditure restraint measures to attain them are yet to be identified. With a tightening monetary policy cycle underway and the need for anchoring inflation expectations in the face of sharply rising headline inflation, a tight fiscal stance would also be important to ensure a balanced policy mix.

11. **Fiscal consolidation needs to be sustained beyond 2008 to meet the challenges posed by the aging population and to ensure smooth euro entry**. Public debt which has been low and stable in recent years owing to strong growth and the use of privatization revenues for financing, is projected to rise faster than regional peers. An annual consolidation of at least ½ percent of GDP would help stabilize debt over the medium term, provide a safety margin in respecting the Stability and Growth Pact limit of 3 percent of GDP under more adverse cyclical conditions, and help create fiscal space for accommodating age-related spending. However, despite having one of the most rapidly aging population in the European Union, the Czech Republic remains one of the few countries that has yet to start reforming its pension system. Correspondingly, the fiscal gap that needs to be filled in order to ensure long-term sustainable public finances is one of the largest in the EU. In order to prepare for

the inevitable spending pressures associated with this demographic transition, a multi-pronged strategy is urgently required.

12. **Durable fiscal consolidation calls for a strategy that strikes a careful balance between spending and revenue measures**. Priority should be given to efficiency-enhancing expenditure rationalization. The IMF and others have previously analyzed public spending and pointed to areas where higher efficiency might be achieved, including in health care, social transfers and benefits. Absent expenditure restraint, the Czech Republic can ill afford tax cuts and may even have to countenance tax increases as part of a more sharply defined strategy to set fiscal priorities. Possible options include raising the low VAT rate further, reducing corporate loopholes, pruning personal tax credits, and increasing environmental taxes.

13. **Pension and healthcare reforms should clearly be key pillars of the medium-term fiscal strategy**. They should be implemented sooner rather than later, given the long lags with which especially pension reforms have their impact. Raising the retirement age to 65 years is welcome, but unlikely to restore pension viability. Complementary reforms to increase the effective retirement age and reliance on private pensions will also be needed. Creation of pension reserves will help avoid undue burden on future generations, but will require adequate safeguards in its governance. In health care, the introduction of co-payments marks an important step towards containing excess demand pressures and enhancing efficiency of health care spending. Early efforts are needed to better link hospital financing to the cost of service and reduce distortions in the system.

14. **Labor market reform can help alleviate fiscal adjustment**. The recent fiscal package fails to fully offset the adverse impact of the pre-election increase in social benefits on incentives to work. As a result, significant unemployment and low wage traps—caused by the combined effects of income tax, social security contributions and withdrawal of social benefits—remain in place. These act as barriers to enter the labor market and seek better-paid jobs for those on low pay. The substantially enhanced tax credits are not targeted and their effects on labor supply uncertain at best. Reforms to facilitate higher labor market participation and lower structural unemployment would help reduce unemployment benefit payments and social transfers and raise tax revenues, reducing the necessity of spending cuts. This could be achieved through more effective and targeted active labor market policies, less rigid regulations regarding hiring and dismissals, and an improved design of the tax-benefit system. Indeed, the experience of the Netherlands and the Nordic countries demonstrates how effective labor market reform can ease long-term fiscal adjustment. More flexible labor markets would also help position the Czech economy for a smoother entry into the euro.