April 2009
IMF Country Report No. 09/122

Czech Republic: 2008 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Czech Republic

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2008 Article IV consultation with the Czech Republic, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 24, 2008, with the officials of the Czech Republic on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 9, 2009. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff statement of February 6, 2009, updating information on recent developments.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 6, 2009 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for the Czech Republic.

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

CZECH REPUBLIC

Staff Report for the 2008 Article IV Consultation

Prepared by the Staff Representatives for the 2008 Consultation with the Czech Republic

Approved by Juha Kähkönen and Alan MacArthur

January 9, 2009

Contents Page

This report is based on discussions held in Prague during November 13-24, 2008. The mission team comprised Mr. Subhash Thakur (head), Ms. Sònia Muñoz (EUR), Ms. Li Lian Ong (MCM), and Ms. Anita Tuladhar (FAD). Messrs. Willy Kiekens (Executive Director) and Stanislav Polak (Senior Advisor to the Executive Director) also joined the discussions. The mission met with Minister of Finance Miroslav Kalousek, Czech National Bank Governor Zdeněk Tůma, other senior officials, as well as representatives of the Parliament, financial and business sectors, academia, and the media.

Political Background: A three-party center-right coalition, ruling since January 2007 with a very thin majority, faces elections in 2010. The Czech Republic assumes the rotating EU Presidency from France in January 2009.

Exchange Rate Regime: The exchange regime is classified as an independent float (Informational Annex). The Czech Republic has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.

STAFF APPRAISAL AND SUMMARY

1. **Following three years of rapid growth, the economy is set to slow sharply in 2009.** Growth is projected at 1½ percent, a far cry from the average growth of 6 percent recorded during 2005-2007. Even then, risks remain on the downside, stemming primarily from tighter credit conditions that could hold back domestic spending, and a deeper recession in the eurozone than now expected.

2. **With inflation likely to fall below the Czech National Bank's (CNB) target of 3 percent, scope exists for further monetary easing.** Falling commodity prices and weakening demand are projected to help bring inflation down to 2½ percent in 2009. Recent cuts in the policy rate are appropriate. It will be important that the CNB communication strategy ensures that expectations are well anchored to the new target of 2 percent from January 2010.

3. **Export competitiveness is adequate and the external position has remained strong.** The modest current account deficit is expected to be comfortably financed by direct investment inflows. In the staff's view, the koruna is broadly in line with fundamentals and consistent with external stability.

4. **The financial sector has come under increasing pressure.** Liquidity has tightened considerably in interbank markets, and trading in the government bond market froze temporarily in October. The country's large presence of foreign banks with significant exposure to emerging Europe has also given rise to uncertainty about the risk of cutbacks in lending. Meanwhile, credit risk, especially in the corporate sector, has risen significantly amid the worsening outlook for economic activity.

5. **The authorities have moved to maintain confidence and ensure financial stability.** Measures to improve liquidity have been implemented. Further steps could be taken to support the smooth functioning of markets, such as widening the range of instruments acceptable as collateral in the interbank market, and taking measures to mitigate perceptions of rising counterparty risks and promote greater transparency in the government bond market. Financial supervisors also need to remain vigilant and ensure that their toolkit is sufficient to address any emerging weakness. Strengthening financial safety nets and crisis preparedness is crucial, including proactive collaboration with financial authorities and governments in home countries of foreign subsidiaries.

6. **Fiscal policy should aim at supporting growth, but be cognizant of potential financing constraints and medium-term fiscal goals**. Recent strengthening of the fiscal position and the authorities' commitment to the nominal expenditure ceilings have created room for countercyclical policy in the turbulent times ahead. For 2009, automatic stabilizers should be allowed to operate fully. This would imply a deficit of about 2½ percent of GDP,

higher than currently budgeted (1.6 percent of GDP). With low government debt and limited macroeconomic imbalances, there would be room for a discretionary fiscal stimulus under a more adverse scenario. Stimulus measures need to be temporary and well targeted. Faster implementation of EU-funded projects could help boost demand while safeguarding the long-run fiscal position.

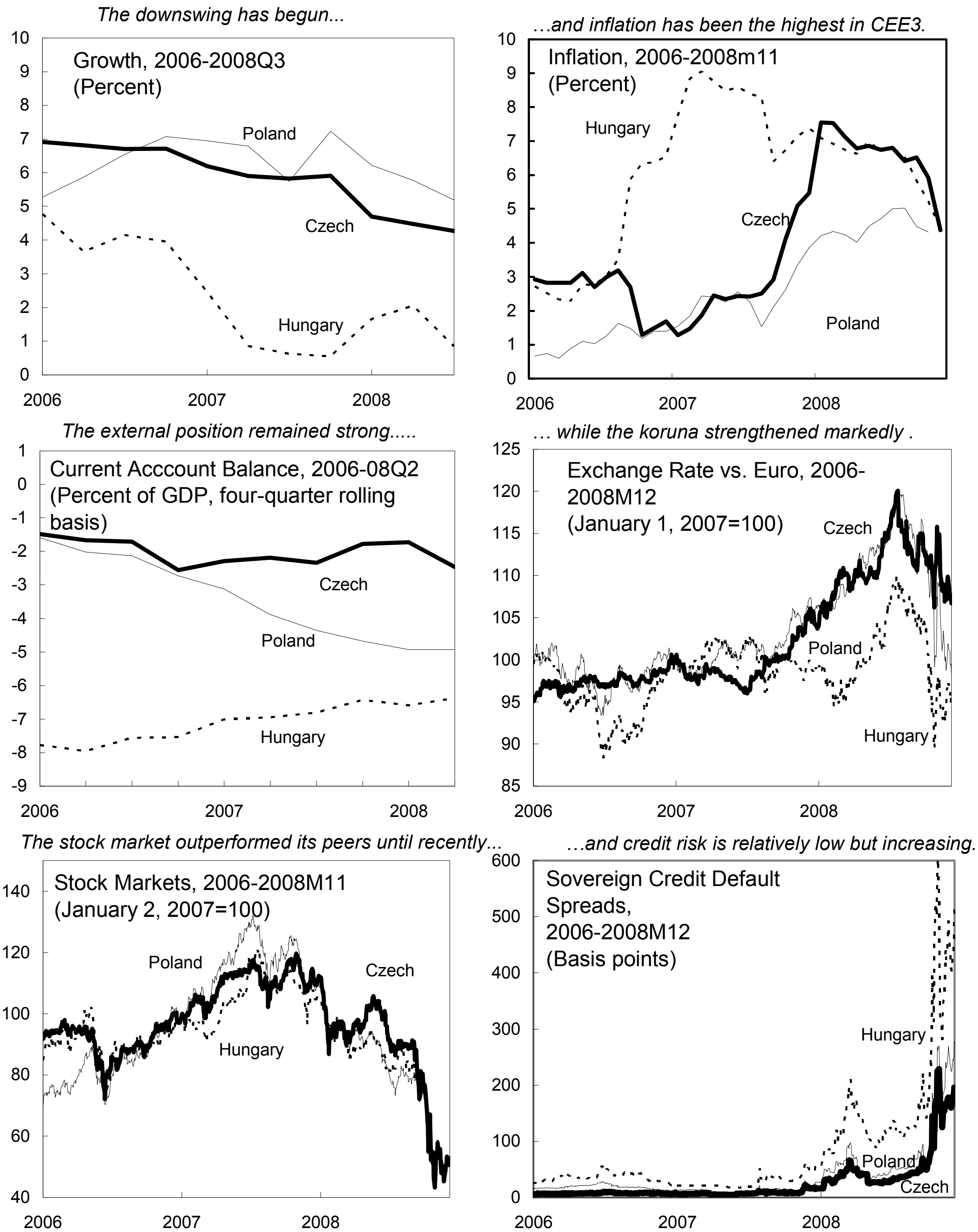
7. **Over the medium term, the momentum of reforms will need to be restored to address long-term challenges and raise potential growth**. Fiscal space will need to be created to cope with the demographic transition through greater efficiency in public spending. Recent health and parametric pension reforms should help reduce fiscal pressures and increase labor force participation. Scope exists for improving incentives to work through reforms of the labor market and the tax-benefit system. The beneficial effects of such structural reforms should reinforce each other, promoting economic stability and sustained growth.

I. Introduction

8. **Generally strong fundamentals have helped the Czech economy weather the global financial crisis until late 2008.** Robust productivity growth, improved fiscal performance, and a comfortable external position supported by inflows of foreign direct investment placed the economy in a relatively favorable position. Reflecting these strengths, the adverse effects on activity and risks in the banking system remained contained, as compared with the regional peers (Figure 1 and Table 1).

9. **Nonetheless, the economy has begun to be buffeted by strong spillover effects from the global crisis.** The financial sector has come under increasing pressure, given its rapid integration with the rest of Europe and the very high level of foreign ownership of banking assets (97 percent). The prospect of a sharp slowdown in economic growth in 2009 is also weighing on the outlook for the financial sector. The speed and enormity of the global financial market turmoil and the depth of the downturn pose a challenge for policy-making to preserve financial stability and mitigate the risk of a hard landing.

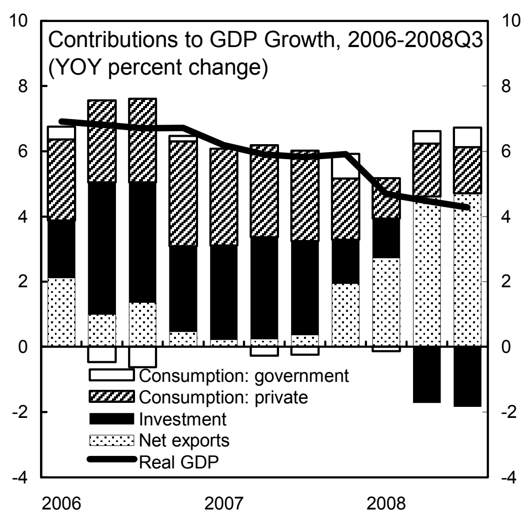
Figure 1. Czech Republic: Background, 2006-08



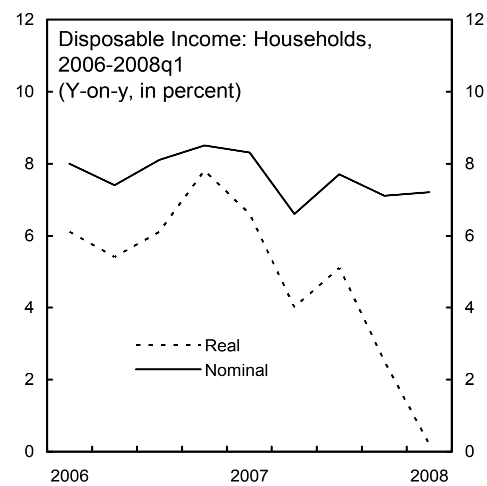
Source: Bloomberg, EMED, and Haver.

II. THE SETTING

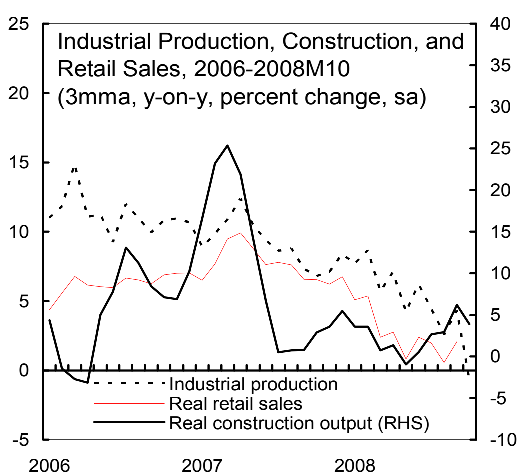
10. **Following three years of exceptionally rapid expansion, a downturn is under way.** The slowdown in growth in 2008 to 4 percent of GDP has been led by domestic demand, and especially private consumption, as high oil and food prices and an increase in the value added tax dented growth in household real disposable incomes. A tight labor market and falling export profit margins due to a strong koruna held back fixed investment. The gathering recession in the advanced economies has started to slow growth in the last quarter of 2008, reflecting the economy's high trade openness. Forward-looking indicators of domestic demand suggest that the downturn is continuing to deepen. While the output gap remains positive, capacity constraints have eased.



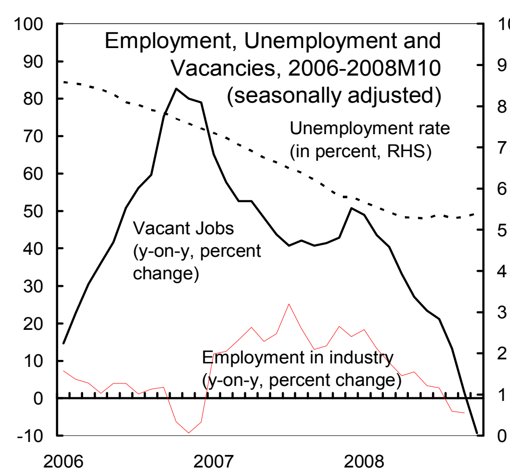
Source: Czech Statistical Office; and IMF staff calculations.



Source: Czech National Bank.

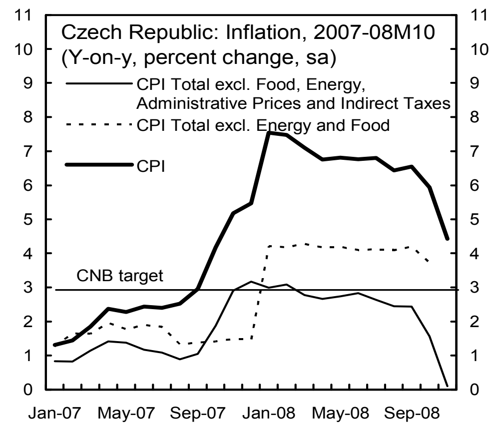


Source: Czech Statistical Office; and IMF staff calculations.



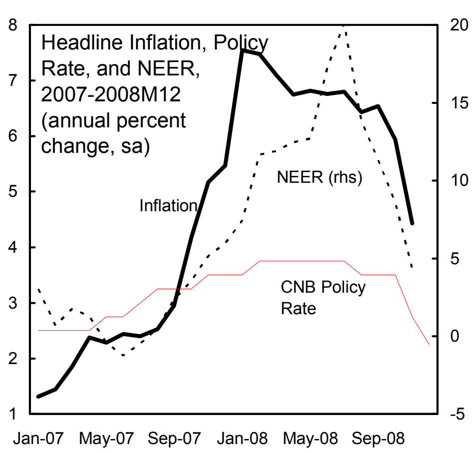
Source: Czech Statistical Office; and IMF staff calculations.

11. **Inflation has started to recede rapidly, after having risen sharply since late 2007.** Headline inflation accelerated to above 6 percent, well above the central bank's target of 3 percent, fuelled by oil and food price increases, higher indirect taxes and demand pressures. Regulated prices and indirect taxes accounted for more than 60 percent of the rise in inflation. Underlying inflation also rose in the first half of the year, despite the dampening effect of the strong koruna, reflecting the tight labor market and strong credit growth. Since September, inflation started to decline following the fall on global commodity prices.

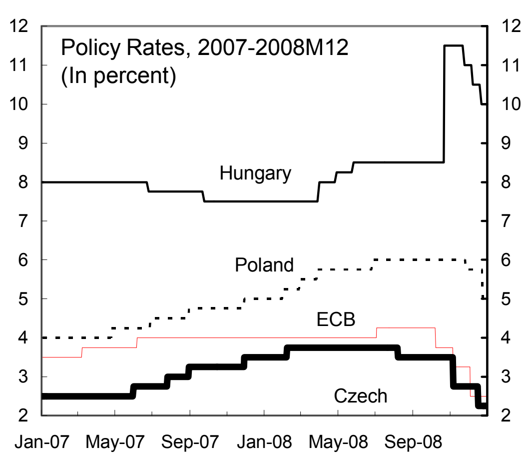


Source: Czech Statistical Office; Eurostat; and IMF staff calculations.

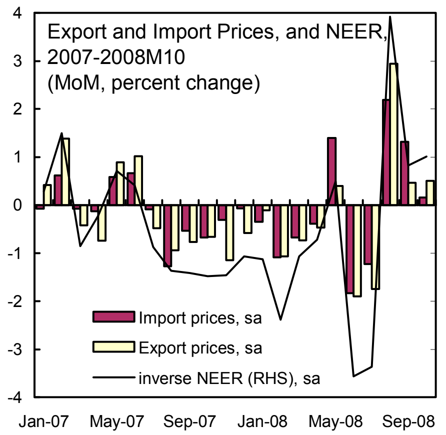
12. **Receding inflation pressures in recent months created room for monetary easing.** The koruna, up 12 percent through July, helped keep monetary conditions tight, partially offsetting the impact of negative real interest rates. After raising its policy rate throughout 2007 and in February 2008 by a total of 125 basis points to 3¾ percent, the CNB cut it by 25 basis points in August—the first central bank in Europe to reverse the tightening cycle—citing concerns that the excessively strong koruna could hamper economic activity. As the ripple effects of the global financial crisis began to impact the economy, the CNB acted aggressively, cutting the policy rate in early November by 75 basis points, exceeding market expectations. A further 50 basis point cut in mid-December brought the policy rate to 2¼ percent.



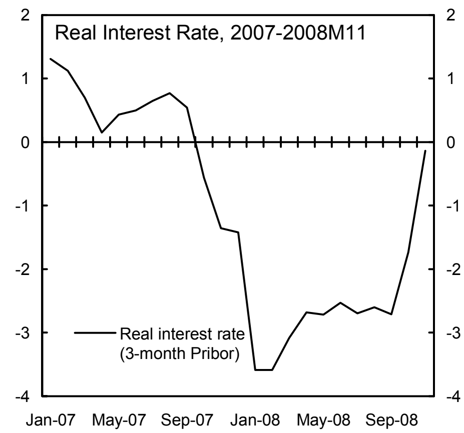
Source: Czech Statistical Office; Eurostat; and IMF staff calculations.



Source: Bloomberg.



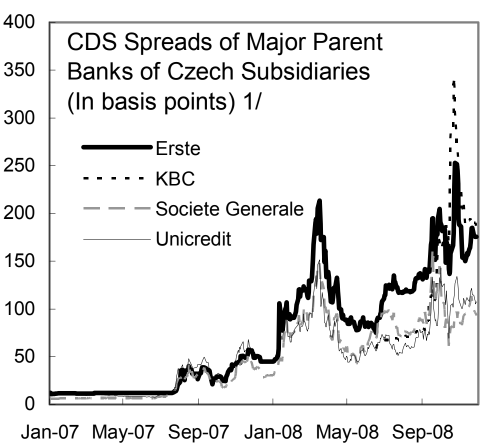
Source: Czech Statistical Office; Eurostat; and IMF staff calculations.



Source: Czech National Bank; and IMF staff calculations.

13. **Czech financial markets and institutions have come under increasing pressure, as the global financial turmoil spilled into local markets:**

- **Concerns about the health of the banking sector have intensified.** These have been manifest in temporary withdrawals by depositors, contributing to a further tightening in liquidity conditions. At the same time, market concerns over the health of Western European parents of Czech subsidiaries and their exposures to emerging Europe have risen. In mid-October, the authorities raised the deposit guarantee to cover 100 percent of deposits up to € 50,000—in line with the EU agreement—from the previous coverage of 90 percent up to € 25,000. Banks' exposures to sub-prime securities and their involvement in structured financial products appear to be insignificant. However, off-balance sheet liabilities appear to be high relative to on-balance sheet assets.[1]

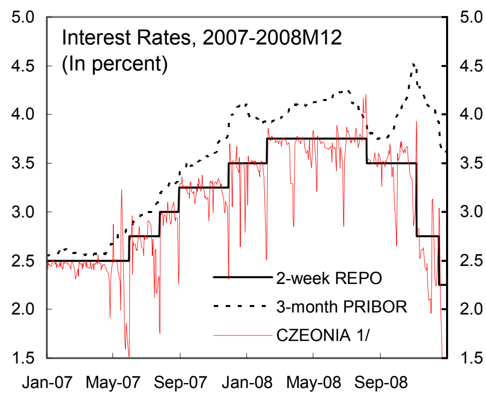


Source: Bloomberg.
1/latest observation Nov. 28, 2008

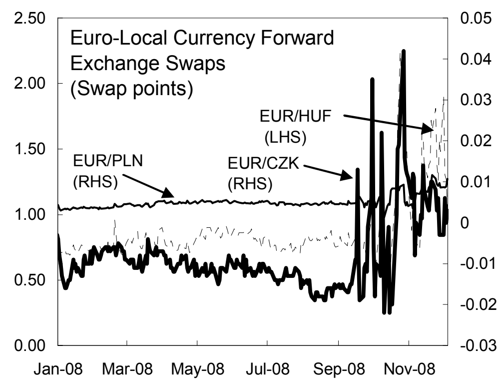
- **The interbank market has tightened considerably.** Counterparty risk is perceived to have risen, as evidenced by the rising PRIBOR and the widening spreads in its term structure.

[1] Off-balance sheet liabilities include derivatives transactions (more than 80 percent of the total and equivalent to 3 times on-balance sheet assets) and assets under custody (10 percent of the total); contingent liabilities in the form of commitments, guarantees and pledges given are equivalent to one-fifth of on-balance sheet assets.

Banks holding surplus koruna liquidity are reluctant to lend beyond the overnight market. The CNB's aggressive cut in the policy rate in early November was aimed, in part, at easing conditions in the interbank market. Activity in the foreign exchange swap market has also reportedly declined amid tightening conditions, although foreign exchange liquidity has not been an issue.

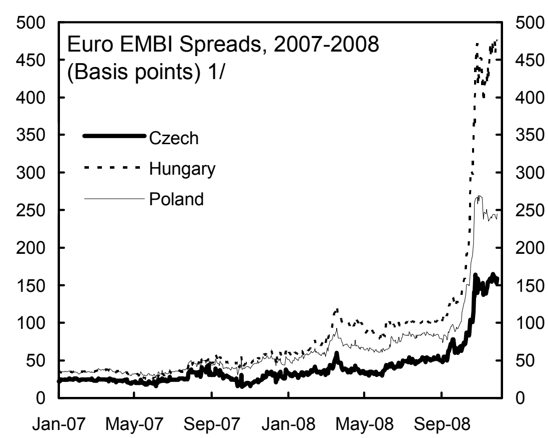


Source: Bloomberg.
1/ Czech Overnight Index Average.



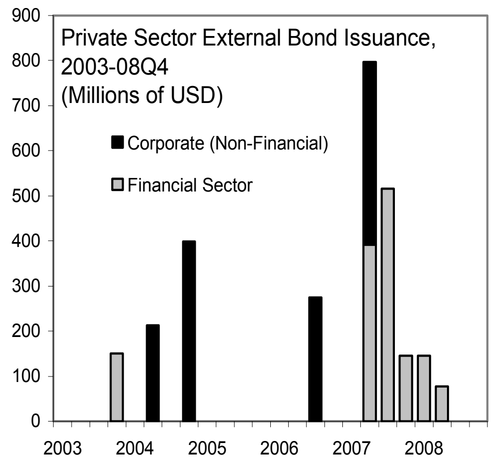
Source: Bloomberg.
1/ Last observation Dec.4, 2008

- **The government bond market came under severe stress.** Trading came to a virtual standstill in mid-October as liquidity disappeared amid continued global deleveraging, forcing the cancellation of planned bond issuances. In an effort to revive the bond market, the CNB introduced a two-week repo facility in October and the government shifted to issuing floating rate treasury bonds;[2] in November, a three-month repo facility was also made available. Some liquidity has reportedly returned to the market. The government and the private sector, notably financial entities, were able to issue bonds in foreign currency over the past year, although issuances appear to have fallen off in recent months.

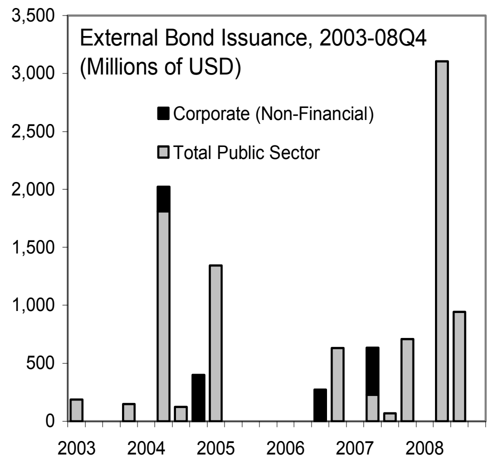


Source: Bloomberg.
1/ Latest observation Nov. 28, 2008

[2] The CNB has routinely used repo transactions as a monetary policy tool, but until recently, they were used to reduce a chronic liquidity surplus in the market.

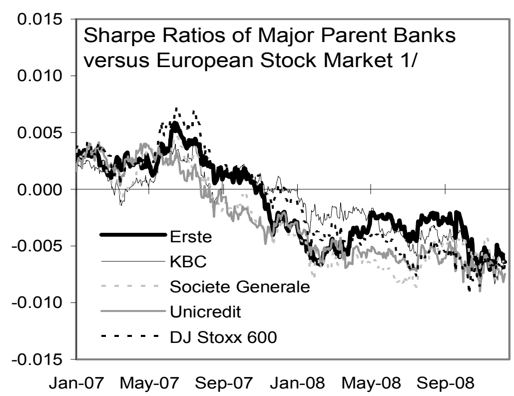


Source: Dealogic, BEL database.



Source: Dealogic, BEL database.

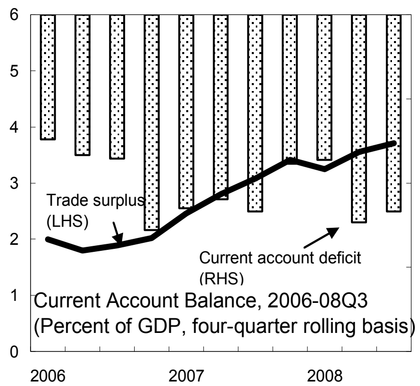
- **The equity market fell sharply**, converging with its regional peers, after outperforming many European markets for most of 2008.[3] The Sharpe ratios (risk-adjusted returns) of major parent banks have been largely in line with other European stocks.



1/ Latest observation Dec. 8, 2008.

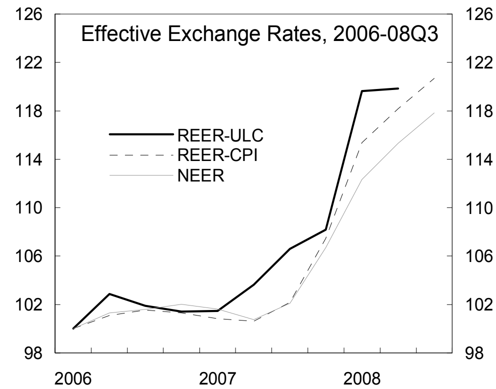
14. **The external position remains strong**, **despite the sharp real appreciation.** The current account deficit narrowed further to 1.8 percent of GDP in 2007, reflecting continued solid export growth. Although it widened to 2.3 percent of GDP in the third quarter of 2008 due to declining exports and a large dividend outflow, it remained comfortably financed by direct investment inflows. At 43 percent of GDP at end-2007, external debt remained low, although short-term debt rose to $23 billion. International reserves rose modestly to $34 billions, covering about 3 months of imports.

[3] With the five largest companies accounting for almost 90 percent of market capitalization at end-2007, the Czech market is the most highly concentrated in emerging Europe.



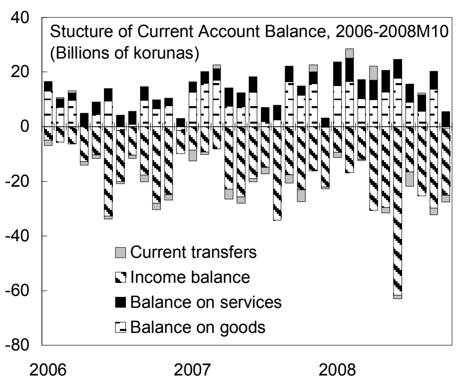
Current Account Balance, 2006-08Q3
(Percent of GDP, four-quarter rolling basis)

Source: Czech Statistical Office; and Czech National Bank.



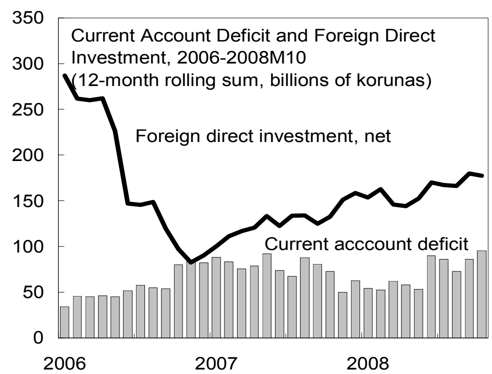
Effective Exchange Rates, 2006-08Q3

Source: Staff calculations.



Stucture of Current Account Balance, 2006-2008M10
(Billions of korunas)

Source: Czech Statistical Office; and EMED.



Current Account Deficit and Foreign Direct Investment, 2006-2008M10
(12-month rolling sum, billions of korunas)

Source: Czech Statistical Office; and EMED.

15. **The fiscal position has strengthened considerably**. Strong revenue gains and spending discipline led to a significant narrowing of the general government deficit to 1 percent of GDP (on ESA-95 basis) in 2007.[4] For 2008, the authorities project a deficit of 1¼ percent of GDP—less than half that initial budgeted. This primarily reflects the strong fiscal outturn in 2007, but also streamlining of social spending implemented under a fiscal reform package (Box 1) and buoyancy of corporate tax revenues, despite sizeable tax cuts. With the recent rapid slowdown in activity expected to hamper the growth of revenues, staff projects a deficit of 1½ percent of GDP, implying a small fiscal stimulus.

Box 1. Key Measures of the 2007 Fiscal Reform Package (Fiscal Impact in 2008)

Revenues (0 percent of GDP)
- Introduction of flat Personal Income Tax rate of 15 percent
- Phased reduction of Corporate Income Tax rate to 19 percent
- Increase in lower VAT rate to 9 percent
- Introduction of ceiling on social security contributions

Expenditures (1/2 percent of GDP)
- Reduction of sickness benefits
- Deindexation of social benefits
- Introduction of user fees in health care

[4] The Czech Republic was removed from the European Commission's Excessive Deficit Procedure earlier this year.

Fiscal Stance, ESA-95, 2005-08 (In percent of GDP)

	2005	2006	2007	2008	
	Actual	Actual	Actual	Auth Proj.	Staff Proj.
Revenue	41.3	41.1	41.6	41.0	41.2
Expenditure	44.8	43.8	42.6	42.2	42.7
General Government Deficit	-3.6	-2.7	-1.0	-1.2	-1.5
Cyclically Adjusted Deficit 1/	-3.0	-2.8	-1.7	-1.8	-2.1
Cyclically Adjusted Primary Deficit	-1.9	-1.7	-0.5	-0.5	-0.8
Change (Fiscal Impulse)	1.5	-0.1	-1.2	0.0	0.3
Memo:					
Output Gap 1/	-1.7	0.6	1.9		1.6
General Government Debt	29.7	29.6	28.9	28.8	29.3

Source: Ministry of Finance and staff estimates.
1/ Assumes staff estimates of output gap.

16. **The economy will slow sharply in 2009 amid a gathering recession abroad and tightening credit at home.** With growth already moderating in 2008, staff project a severe slowdown in 2009 to around 1½ percent. The shrinking demand from the euro area, and especially Germany, will curtail exports and direct investment inflows. Tightening credit conditions at home and shrinking profit margins will weigh on capital spending, offsetting the stimulus from the new automobile plant and rising inflows of EU funds.[5] Household consumption is expected to grow only modestly as plummeting confidence and rising unemployment overshadow the favorable impact of declining inflation on real disposable incomes. The downturn should ease labor market and wage pressures. Even if the recent reversal of the koruna appreciation were to continue for some time, falling commodity prices and weakening demand should reduce both core and headline inflation, with the latter expected to decline to 2½ percent in 2009.

Comparison of Growth and Inflation Forecasts, November
(In percent)

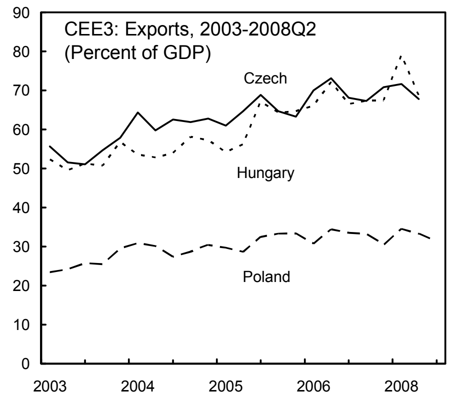
	2008	2009
	GDP Growth	
IMF	4.0	1.5
Consensus	4.2	2.6
OECD	4.4	2.5
European Commission	4.4	3.6
MOF	4.4	3.7
CNB	4.5	2.9
	Inflation, avg	
IMF	6.7	2.6
Consensus	6.5	2.7
OECD	6.6	2.0
European Commission	6.6	3.1
MOF	6.4	2.9
CNB	6.6	2.5

Sources: Consensus Forecasts, OECD, European Commission, Czech authorities, and IMF staff estimates.

17. **Risks to the baseline projection are clearly tilted to the downside**. The downward phase of the cycle has coincided with a possible credit crunch that could hold back spending by corporations and households, and a deeper-than-projected recession in the eurozone. The main risks center on weaker than projected global growth and financial market uncertainty across the eurozone. As a result, foreign direct investment, an important driver of recent

[5] The Hyundai car plant is expected to start production in November 2008 with an initial annual capacity of 200,000 cars.

growth, could suffer. Bank profitability, largely driven by consumer and mortgage lending, could also worsen in light of the weakening economic outlook, further depressing prospects for growth. In a more adverse scenario, a prolonged credit squeeze could result in an even deeper downturn than in the baseline (Box 2 and 3).

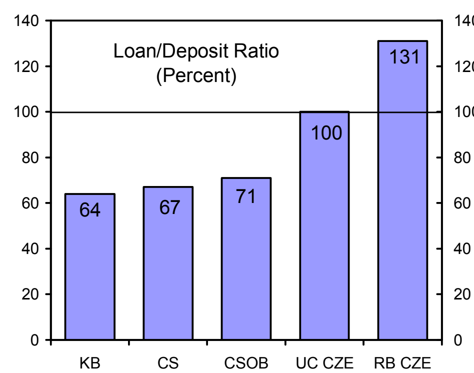


III. THE MAIN POLICY CHALLENGES

18. **The consultation centered on how policies could be calibrated to ensure financial stability and facilitate a smooth landing.** Against the backdrop of a deepening European downturn and a banking system overwhelmingly under foreign ownership, the discussions focused on a) the macrofinancial and regulatory implications of the financial crisis and b) the policy options for preserving macroeconomic stability by ensuring a soft landing and keeping inflation on a downward path.

A. Rising Risks to the Financial Sector

19. **Banks have enjoyed strong profits and comfortable liquidity.** Driven by consumer and mortgage lending, interest income has contributed the largest—and growing—share of net income. The Czech banking sector as a whole remains liquid, in contrast to the shortages seen in some European countries during the current turmoil, due in large part to the major banks' access to a large deposit base, with loan-to-deposit ratios averaging 70–80 percent.



Source: Banks' presentations, 2008H1 data.

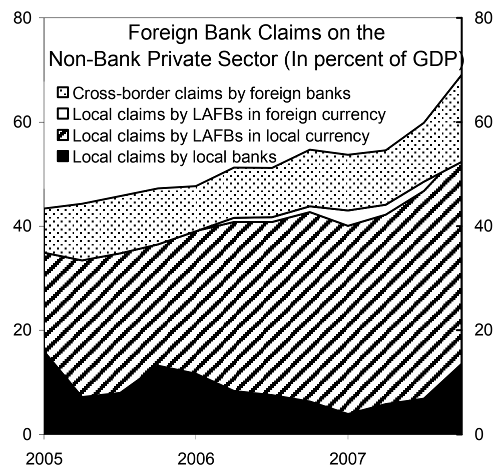
20. **However, financial system risks have increased significantly in recent months, reflecting the effects of the global crisis and in anticipation of a sharp slowdown:**

- ***Liquidity risk is rising.*** Banking system liquidity has been declining gradually as a result of the rapid growth in bank lending. Liquidity risk at the smaller banks has increased markedly, given their reliance on their foreign parents—which have reportedly set liquidity limits for their foreign operations—and the interbank market. In this context, foreign bank ownership has come under closer scrutiny, as any sharp retrenchment of funds could have a significantly negative impact on financial intermediation and economic activity (Box 2).[6] Although officials noted that there has been little evidence so far of any significant repatriation of funds to foreign parents, staff expect some shrinking of subsidiaries' balance sheets. Meanwhile, more volatile short-term lending, which the authorities attribute to parent lending to branches, is rising as a proportion of total loans to banks.

Box 2. Foreign Banks in the Czech Republic: Rewards and Risks

The Czech Republic represents one of the most important host countries in emerging Europe, accounting for 11 percent of total foreign claims on the emerging European region as of end-2007. The presence of foreign banks has typically been considered a positive development in emerging market countries, as they drive financial innovation and improve operational efficiency. Additionally, strong ownership brand is seen to provide banks with a second line of defense—after own financial strength—against potential shocks.

However, as the current credit crisis demonstrates, even the major international banks could be exposed to the risk of mispricing and a sudden reversal in the credit cycle. Thus, the vulnerability of the Czech banking system to any deleveraging by foreign parents may have increased. Claims by foreign banks on the non-bank private sector amounted to about 56 percent of Czech GDP at the end of 2007, of which one-third is attributable to more volatile short-term claims.[1]



Sources: BIS; IFS, IMF; and Maechler and Ong (2009).

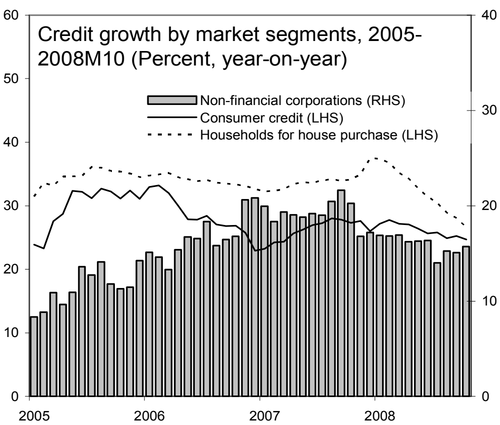
A key mitigating factor is that lending by the major foreign subsidiaries to the Czech economy is predominantly in local currency, and is largely financed by local deposits. Most of these banks have not had to rely on parent financing for their lending activities, thus reducing the rollover risk and limiting indirect credit risk from any depreciation in the koruna. Koruna liquidity remains high, although liquidity risk at smaller banks has nudged upwards in recent months.

[1] See Maechler, A. and L.L. Ong, "Foreign Banks in the CESE Countries," IMF Working Paper, forthcoming.

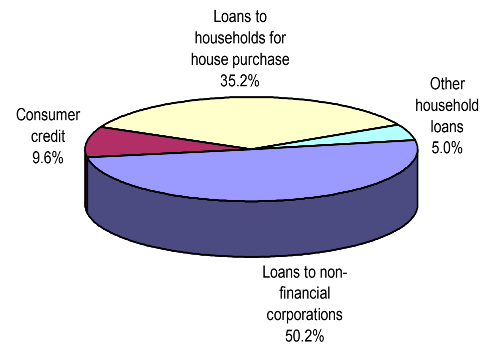
- ***Credit risk, especially to the corporate sector, has increased significantly.*** Credit quality is generally considered the biggest risk to the outlook for the banking sector. The rapid rise in property prices and housing construction have increased the possibility that a reversal in the property market would affect the credit risk of both households and corporates, especially

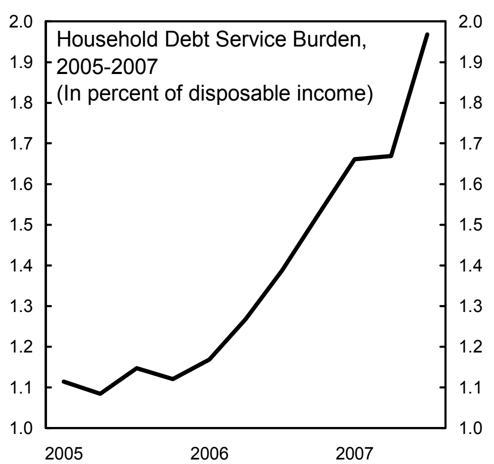
[6] The four largest banks, all foreign-owned, account for 60 percent of total banking assets, 55 percent of loans and 64 percent of deposits. They comprise CS (Erste Bank, Austria), CSOB (KBC Bank, Belgium) and KB (SG, France), and Unicredit Bank (Unicredit, Italy).

since the real estate sector is the main driver of corporate credit growth. The worsening outlook for the corporate sector is weighing heavily on small and medium enterprises due to the likely trickle-down effects of a sharp slowdown in activity by large companies. Moreover, given the strong competition among lenders, loans may not have been adequately priced to cover credit risks which have yet to be tested through a full economic cycle.

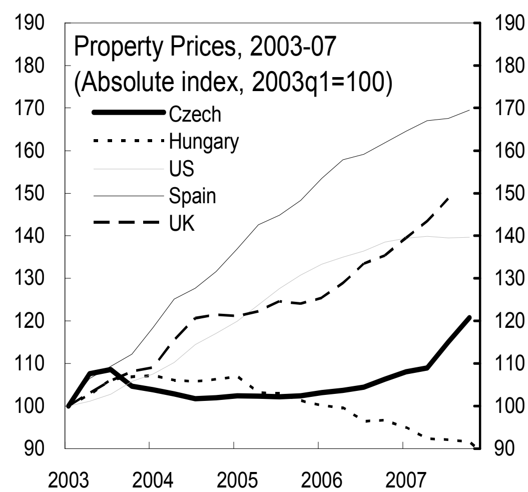


Source: CNB.





Source: National Accounts for Households Sector, CZSO.



Source: Czech National Bank, Magyar Nemzeti Bank, and BIS.

21. **The authorities concurred that prompt measures needed to be taken to maintain confidence in the financial system and to ensure its stability.** In addition to steps already taken by the CNB to ease the tightness in money and bond markets, staff suggested further measures, viz.: (i) widening the range of instruments acceptable as collateral in the interbank market, in addition to government bonds; if this proved insufficient, steps to mitigate perceptions of rising counterparty risks ; (ii) ensuring greater transparency in the government bond market by, for example, adhering strictly to the announced size of bond issuances, to enable accurate pricing by dealers; and taking into account the need for developing the local market when determining the types of issuances. Additional measures to improve the demand

for government securities consistent with staff discussions have since been implemented. Supervisors also need to be vigilant about the extent of the contingent liabilities of the banking system, and to ensure that banks have the capacity to cover these liabilities, should they materialize.

22. **The toolkit of financial supervisors must be sufficiently versatile to address weaknesses as they arise.** The authorities have implemented a system to monitor the liquidity positions of banks on a daily basis, to collect up-to-date information on the transfer of liquidity by banks overseas and monitor the exposures of foreign subsidiaries to their parent banks. The supervisors will also soon implement a framework for systemic assessment to help review the potential effects of a crisis. Since any decision to intervene would likely be discretionary, a consistent approach would need to be established among the relevant authorities from the outset. Staff also recommended that the modalities for the application of Pillar II of Basel II be put in place as soon as possible, to ensure that banks remain well-capitalized.

23. **Staff emphasized that, in the current uncertain environment, strengthening financial safety nets and crisis preparedness measures was crucial.** The CNB has supervisory tools in place to preserve the continuity of access to key banking functions in systemically important banks. These measures should be continually enhanced, and where discretion is required, supervisory response should be prompt. Thus, the features of the Deposit Insurance Fund should be calibrated to ensure transparency and credibility. In the context of the pending revision of the relevant legislation, staff suggested a clarification of the capacity and features of the scheme to help maintain confidence.[7] Domestic crisis management arrangements between the CNB and the Ministry of Finance have been established and tested. Similar formal arrangements with the private sector could be considered. In view of the importance of cross-border bank linkages for the Czech Republic, a major host country to subsidiaries of Western European banks, there was agreement that proactive collaboration with financial authorities and governments in home countries was essential.

B. The Scope for Monetary Easing

24. **The monetary policy stance shifted in mid-year in view of the changing balance of risks between inflation and growth**. CNB officials explained that in the first half of 2008, inflation risks were viewed as serious, especially in the context of possible second-round effects of food and energy prices and a tight labor market. Falling commodity prices and weakening demand led to a reversal of the tightening cycle. Recent signs of weakness in the labor market have begun to allay concerns about wage inflation.

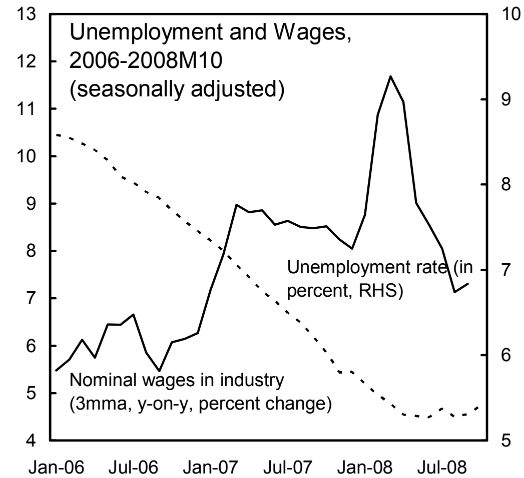
---

[7] Despite the increase in the deposit guarantee coverage, some of the weaknesses noted in the 2001 FSAP remain.

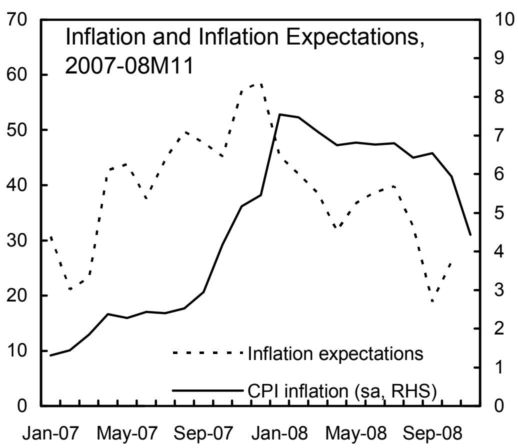
Response of Core Inflation to Shocks to Domestic Food and Energy Price Inflation (Percentage Points) 1/ 2/

	Domestic food price inflation shock 3/	Domestic energy price inflation shock 3/
Bulgaria	0.6	-
Czech Republic 4/	**1.4**	**-**
Estonia	1.3	-
Latvia	1.2	-
Lituania	2.4	1.2
Macedonia	1.2	0.5
Romania	3	-
Serbia	-	0.7
Slovenia	2.5	-
Turkey	-	2.7
Ukraine	-	1

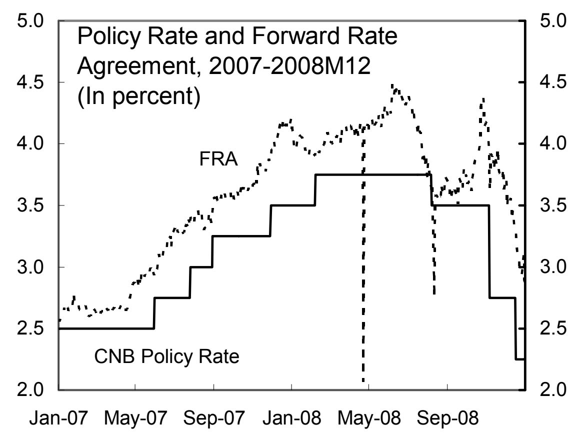
Source: REO, Europe, Dealing with Shocks, October 2008.
1/ Results reported for countrires for which responses are significant at 95 percent level
2/ Size of the shock: 10 percentage points in domestic food and energy price inflation.
3/ Maximum response within 12 months.
4/ Similar results were obtained by using core inflation excluding administrative prices and indirect taxes.



Source: Czech Statistical Office; and IMF staff calculations.



Source: Czech Statistical Office; and DG ECFIN (Price trends over next 12 months).



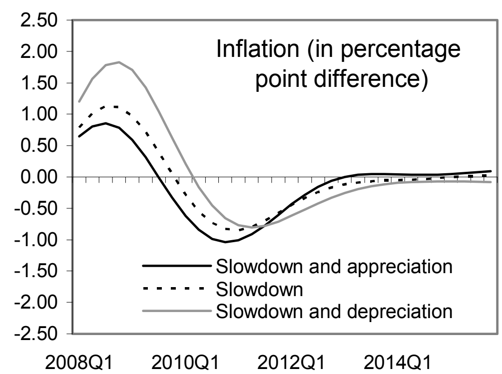
Source: Bloomberg.

25. **With inflation likely to fall below the CNB's target of 3 percent amid a sharp slowdown, scope exists for further easing.** Under the baseline, staff as well as the CNB expect inflation to drop below the target of 3 percent in 2009, driven by weaker domestic demand, the lagged impact of the currency appreciation, and falling commodity prices. The pace and the magnitude of the easing would have to take into account movements in the koruna and the extent of weakness in demand (Box 3). The latter could be worse than the baseline, if a credit crunch were to materialize (Box 2). While CNB officials regarded the chances of a credit crunch as low, they and the staff were in agreement on the risks and the options for monetary policy. As for the risk of deflation, CNB officials considered a short period of falling prices possible under an adverse scenario, but not likely to pose a substantive policy challenge.

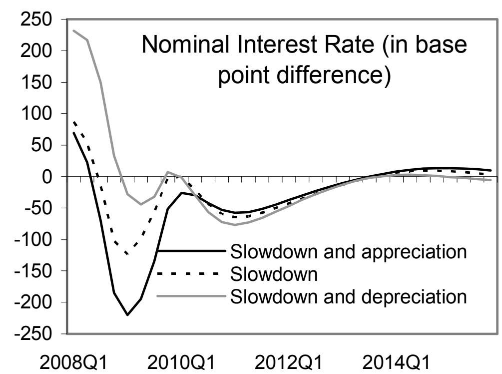
Box 3. Challenges Facing Monetary Policy

The pace and the magnitude of the monetary policy response to the global shocks will be shaped by important uncertainties: the extent of the slowdown of the world economy (and especially Germany) and the volatility of the koruna. Staff simulations, based on the IMF's Global Integrated Monetary and Fiscal model, suggest—assuming that the lower inflation target from 2010 is fully credible—that a substantial cut in the policy rate may be needed.

The sharp slowdown is likely to lead to rapid disinflation, dampening any inflationary impact of lower interest rates. A strong adverse shock to the euro area, hitting Czech exports, would require an additional cut in the policy rate, depending on the behavior of the exchange rate. If monetary-relevant inflation is initially elevated owing to the past global supply shocks and tight labor markets, the shock could result in rapid disinflation and a fall in growth by 2-3 percentage points.



The path of the koruna, a key disinflationary influence for the past two years, would remain important. The appreciation played a key role in keeping inflation under check during the surge in commodities prices and the increase in the VAT. Simulation results suggest that the response to exchange rate shocks are likely to be swamped by the impact of the slowdown in activity.



26. **The effectiveness of the traditional channels of monetary policy transmission has become more uncertain.** Accordingly, CNB officials were aware of the need to act with particular agility. Staff stressed that communication strategy should ensure that expectations were well anchored to the new inflation target of 2 percent from January 2010.[8] In this context, officials noted that the recent decision to publish a forecast exchange-rate path beginning in 2009 was a technical fine-tuning of the inflation targeting framework and should not be interpreted as giving greater weight to the exchange rate.

[8] See Allard, C. and S. Muñoz (2008), "Challenges to Monetary Policy in the Czech Republic—An Integrated Monetary and Fiscal Analysis," IMF Working Paper 08/72.

C. Maintaining Competitiveness

27. **Competitiveness is adequate but under incipient pressure**. Export volumes enjoyed double-digit growth for the greater part of the year, with market shares continuing to expand. Staff and the authorities shared the assessment that the koruna was broadly in line with fundamentals, a view supported by estimates based on the CGER methodology (Box 4), despite some recent erosion of competitiveness due to the lagged effects of the earlier appreciation and rising unit labor costs. The authorities had expressed concerns about the damaging effects on activity of an excessively strong koruna, although these have been assuaged to some extent by the recent reversal of the appreciation. Looking ahead, the planned privatization of the remaining state-owned assets, estimated at about 1.9 percent of GDP, and the expected large inflows of EU funds in coming years could put upward pressure on the koruna. In this context, the CNB has renewed its 2002 agreement with the government to limit any appreciation in the event of large privatization revenues or inflows of EU fund. CNB officials acknowledged that this policy was likely to pose challenges for reserve management, especially in view of the sizeable losses already incurred by the CNB.[9]

28. **Although euro adoption remains an important policy objective, no target date for entry has been set.** The authorities continue to strive to meet the Maastricht criteria for euro entry in a sustainable manner. The CNB's decision to reduce the inflation target to 2 percent from 2010 will align it with the ECB's inflation target.

D. Supporting Growth and Preserving Fiscal Sustainability

29. **The immediate challenge for fiscal policy is to support growth while protecting the hard-won gains from recent fiscal consolidation.** In the face of stronger-than-expected fiscal outturns in recent years of rapid growth, the authorities have sought to lower deficit targets while adhering to the nominal expenditure ceilings, thereby affirming their commitment to the medium-term objective of a deficit of 1 percent of GDP by 2012. As the growth outlook worsens, these early savings have helped create room for automatic stabilizers to operate and allowed for a cyclical margin to stay within the SGP limit of 3 percent of GDP. These savings have also helped support the government's liquidity position, relieving near-term financing pressures in a tight financial market. However, officials felt that the rising pressure for stimulus is testing fiscal discipline and could put at risk the achievements of earlier reforms.

[9] Accumulated losses were 26 percent of total assets at end-2007.

Box 4. Exchange Rate Assessment

Staff analysis suggests that the koruna is broadly in line with fundamentals and consistent with external stability. The real exchange rate, adjusted for either relative consumer prices or unit labor costs, appreciated by around 10 percent in the first half of 2008. The surge in the koruna may have been driven by its "safe-haven" status in a period of enhanced uncertainty. Since October, however, heightened risk aversion towards emerging market assets and a possible correction from earlier high levels weakened it by almost the same amount.

Estimates of REER Misalignment, 2008 (In percent)

	Reference period 1/	November average
Macroeconomic Balance Approach	5	2
External Sustainability Approach	3	0
Equilibrium Real Exchange Rate Approach	6	3
Average	5	2

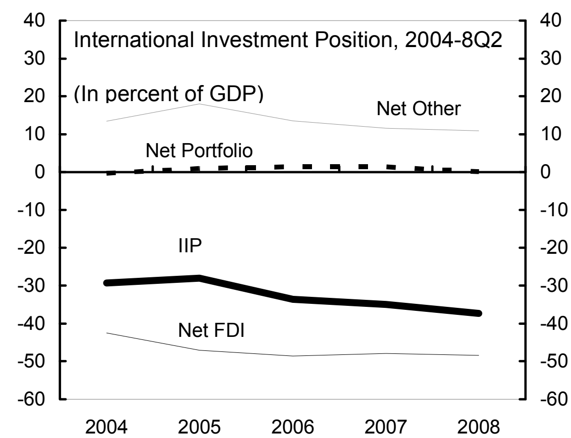
Source: Staff estimates.
1/ August 18-September 15, 2008.

The balance of payments is consistent with external stability. The gap between the actual and the underlying current account is not considered significant, suggesting that the rise in the deficit reflects cyclical and transitory factors. Moreover, the underlying current account is broadly in line with its equilibrium level.

Analysis of the Current Account Balance, 2008
(Percent of GDP)

Current account balance	-2.2
Adjustments	0.87
Domestic output gap	1.77
Foreign output gap	0.29
Lagged effects of exchange rate changes	-1.19
Underlying current account balance	-1.3
Equilibrium current account balance	
NFA-stabilizing current account	-2.2
Current account norm	-2.2

Source: WEO, INS, IMF Occasional Paper 167, and staff estimates.



30. **With the rapid worsening of the near-term outlook, the fiscal deficit in 2009 is likely be higher than budgeted.** In October, the authorities' projected a deficit of 1.6 percent of GDP, assuming growth of 3.7 percent, which implied a neutral fiscal stance. Cuts in the corporate income tax and social security contribution rates are largely offset by the tightening of the wage bill and social transfers under the 2007 fiscal reform package. Staff agreed that a neutral stance struck an appropriate balance between the goal of supporting growth and the countervailing pressures of financing risks (Paragraph 13, bullet 2). With the growth assumption in the budget looking increasingly unrealistic, automatic stabilizers will need to be allowed to operate. In staff's view, this would be consistent with a higher deficit of around of 2½ percent of GDP, mainly reflecting lower revenue collections.

31. **The authorities believed that fiscal policy, while trying to support growth, needed to be mindful of potential financing constraints and medium-term fiscal goals**. If the outlook for growth were to worsen even further, they would be prepared to consider a discretionary stimulus package, given low public debt and limited macroeconomic imbalances. However, the recent freezing of the government bond market that led to cancellation of bond issuances underscored potential financing risks. Staff welcomed the authorities' readiness to shift to a more expansionary fiscal stance as needed. It also suggested measures which would boost demand while safeguarding medium-term deficit objectives such as more rapid implementation of EU-funded projects and temporary measures that are well targeted to vulnerable groups. Permanent tax cuts, however, should be avoided, especially given the low tax-wedge already in place following the tax reform plan approved in 2007.

32. **Over the medium term, the authorities plan important structural reforms to ensure fiscal sustainability**.[10] Following the introduction of user fees in the health care sector, a voluntary supplementary health insurance system is being proposed. Reform of tax administration by integrating it with customs and social contribution systems is being planned, for which a comprehensive modernization program is needed. Regulatory reforms in private pensions are being implemented while a voluntary partial opt-out to funded pension is being considered. The authorities noted, however, that these steps remained politically difficult in the near term. Staff supported these efficiency-enhancing measures and reiterated the scope for reforms in the tax-benefits system and labor market to enhance incentives to work, generate fiscal savings and raise potential growth.[11]

---

[10] See Botman, D. and A. Tuladhar (2008), "Tax and Pension Reform in the Czech Republic: Implications for Growth and Debt Sustainability," IMF Working Paper 08/125.

[11] See Dalsgaard, T. (2008), "Tax and Welfare Reforms in the Czech Republic: Structural Implications and Challenges," IMF Working Paper 08/52.

Table 1. Czech Republic: Selected Economic Indicators, 2003-09

	2003	2004	2005	2006	2007	2008	2009
						Staff Proj.	
Real economy (change in percent)							
Real GDP	3.6	4.5	6.3	6.8	6.0	4.0	1.5
Domestic demand	4.1	3.2	1.3	5.4	5.1	2.5	1.5
CPI (year average)	0.1	2.8	1.8	2.5	2.8	6.7	2.6
PPI (year average)	-0.3	5.7	3.0	1.6	4.0	n.a.	n.a.
Unemployment rate (in percent)							
Survey-based 1/	7.8	8.3	7.9	7.1	5.3	4.0	5.1
Registered 1/	9.9	9.8	8.9	8.1	6.6	5.3	6.3
Gross national savings (percent of GDP)	21.1	22.4	24.3	23.9	24.8	22.9	22.7
Gross domestic investments (percent of GDP)	27.4	27.6	25.7	26.5	26.5	25.1	25.2
Public finance (percent of GDP) 2/							
General government revenue	40.7	42.2	41.3	41.1	41.6	41.1	40.8
General government expenditure	47.3	45.1	44.8	43.8	42.6	42.6	43.3
Net lending	-6.6	-2.9	-3.6	-2.7	-1.0	-1.5	-2.5
General government debt	30.1	30.4	29.7	29.6	28.9	29.3	30.1
Money and credit (end of year, percent change)							
Broad money 3/	6.9	4.4	8.0	9.9	13.2	8.1	n.a.
Private sector credit (percent change, eop) 3/	11.8	15.3	20.8	21.6	27.3	22.7	n.a.
Interest rates (in percent, year average)							
Three-month interbank rate 4/	2.1	2.6	2.2	2.6	4.1	4.5	n.a.
Ten-year government bond 3/	4.8	4.0	3.6	3.7	4.7	4.4	n.a.
Balance of payments (percent of GDP)							
Trade balance	-2.7	-0.5	2.0	2.0	3.4	2.6	1.5
Current account	-6.2	-5.2	-1.3	-2.6	-1.8	-2.2	-2.5
Gross international reserves (US$ billion)	27.0	28.4	29.6	31.5	34.9	38.4	43.7
Reserve cover (in months of imports of goods and services)	5.5	4.5	4.1	3.6	3.2	2.7	3.0
Exchange rate							
Nominal effective exchange rate, pa (2000=100) 3/	116.8	118.0	125.3	131.7	135.6	153.5	n.a.
Real effective exchange rate, pa (CPI-based; 2000=100) 3/	116.8	118.3	125.3	132.3	136.8	159.1	n.a.

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

1/ In percent of total labor force.
2/ On ESA-95 basis.
3/ For 2008, data refer to September.
4/ For 2008, data refer to October.

Table 2. Czech Republic: Balance of Payments, 2003-09

	2003	2004	2005	2006	2007	2008	2009
						Proj.	
			(In millions of U.S. dollars)				
Current account balance	-5785	-5751	-1662	-3640	-3085	-4691	-5201
Trade balance	-2519	-530	2522	2843	5909	5490	2991
Exports	48701	67239	77973	95147	122697	160868	159087
Imports	51221	67768	75451	92304	116788	155378	156097
Nonfactor services	470	636	1548	2058	2781	2780	1904
Receipts	7789	9646	11769	13941	17166	20744	20094
Payments	7319	9010	10220	11883	14385	17965	18191
Factor income (net)	-4285	-6094	-5975	-8104	-11031	-12391	-9225
Transfers	548	236	326	-579	-886	-570	-871
Capital account	-3	-603	196	380	1025	1748	3631
Financial account balance	5620	7041	6379	4204	4913	4691	9206
Direct investment, net	1814	3941	11630	4043	7930	9152	8547
Portfolio investment, net	-1181	1988	-3390	-1132	-2501	1207	-342
Financial derivatives, net	143	-146	-112	-282	55	0	0
Other investment, net	4844	1259	-1748	1575	-571	-5667	1001
Errors and omissions, net	609	-426	-1033	-852	-1984	0	0
Change in reserves 2/	-441	-261	-3879	-92	-868	-1748	-7636
Memorandum items:							
Current account (in percent of GDP)	-6.2	-5.3	-1.3	-2.6	-1.8	-2.2	-2.5
Trade balance (in percent of GDP)	-2.8	-0.5	2.0	2.0	3.4	2.6	1.5
Net foreign direct investment (in percent of GDP)	2.0	3.6	9.3	2.8	4.6	4.3	4.2
Gross official reserves							
(in months of the following year's imports of goods and non-factor services)	4.6	4.3	3.6	3.2	2.8	2.5	2.8
(as a ratio to the short-term debt by remaining maturity)	1.5	1.2	1.3	1.4	1.3	1.1	1.2
Terms of trade 3/	0.4	1.2	-1.7	-1.3	1.1	-3.0	-1.9

Sources: Czech National Bank; and IMF staff projections.

1/ IMF staff estimates or projections.
2/ Changes in reserves reflect off-market conversion of large privatization receipts, EU transfers, and sales of accumulated interest.
3/ Goods and services.

Table 3. Czech Republic: Consolidated General Government Budget, 2003-09 1/
(on ESA-95 basis)

	2003	2004	2005	2006	2007	2008	2009
						Proj.	
			(In percent of GDP)				
Total revenue	40.7	42.2	41.3	41.1	41.6	41.1	40.8
Current taxes on income, wealth, etc	9.6	9.6	9.1	9.2	9.3	8.4	8.1
Personal income tax	4.9	4.8	4.6	4.2	4.3	3.9	3.9
Corporate Income Tax	4.6	4.7	4.5	4.8	4.8	4.4	4.0
Social contributions	15.1	16.1	16.1	16.3	16.3	16.4	15.9
Taxes on production and imports	11.1	11.5	11.4	10.9	10.9	11.0	11.1
VAT	6.4	7.2	7.0	6.5	6.4	6.6	6.8
Excise	3.4	3.5	3.7	3.7	3.8	3.6	3.6
Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Property income	1.0	0.8	0.7	0.8	0.8	1.0	0.8
Other	4.0	4.1	3.9	3.9	4.3	4.4	4.8
Total expenditure	47.3	45.1	44.8	43.8	42.6	42.6	43.3
Final consumption expenditure	23.4	22.1	22.0	21.3	20.4	20.1	20.3
Collective consumption	11.9	10.5	11.0	10.6	10.1	9.8	9.7
Individual consumption	11.5	11.5	11.0	10.6	10.3	10.3	10.7
Social transfers in kind	5.8	5.7	5.6	5.3	5.3	5.4	5.7
Transfers of individual non-market goods or services	5.7	5.8	5.4	5.3	5.0	4.9	5.0
Social benefits other than social transfers in kind	12.2	12.8	12.6	12.7	12.9	12.6	12.9
Interest	1.1	1.2	1.1	1.1	1.1	1.2	1.2
Subsidies	2.6	2.1	1.8	1.9	1.8	1.8	1.9
Gross fixed capital formation	4.5	4.8	4.9	5.0	4.7	4.9	5.1
Other expenditure	3.3	2.1	2.4	1.8	1.8	1.9	1.8
Net lending	-6.6	-2.9	-3.6	-2.7	-1.0	-1.5	-2.5
Financing	6.6	3.0	3.6	2.7	1.0	1.5	2.5
Net change in financial assets 2/	3.0	-0.6	1.0	0.2	-1.9	-0.9	1.0
Currency and deposits	0.2	-1.1	-3.9	0.5	-2.1	-1.9	-1.4
Securities other than shares	0.4	-0.2	-0.1	0.0	-0.1	0.0	0.0
Loans	2.6	0.4	1.6	0.2	0.3	0.4	0.4
Shares and other equity	0.3	0.2	3.6	0.1	0.5	0.7	2.0
Other financial assets	-0.5	0.1	-0.2	-0.6	-0.4	0.0	0.0
Total adjustment 4/	0.8	0.7	1.5	0.5	0.9	0.4	0.1
Change in debt	2.8	2.8	1.1	2.0	1.9	1.9	1.4
Memorandum items:							
General government debt	30.1	30.4	29.7	29.6	28.9	29.3	30.1
Government deposits	...	...	11.3	9.8	11.1	...	...
Primary balance	-5.5	-1.8	-2.4	-1.6	0.2	-0.2	-1.3
Cyclically adjusted balance 3/	-4.6	-1.4	-2.9	-2.7	-1.7	-2.1	-2.2
Cyclically adjusted primary balance 3/	-3.6	-0.2	-1.8	-1.6	-0.5	-0.8	-0.9
Output gap 3/	-4.1	-3.5	-1.4	0.3	1.9	1.6	-0.7

Sources: Ministry of Finance and Fund staff estimates.
1/ On accrual basis. Includes financial transations and broader coverage of institutions (such as the Czech Consolidation Agency and the Railways) that is excluded from the GFS-86 fiscal accounts.
2/ (+) sign means financing through decrease in assets.
3/ Staff estimates of output gap.
4/ Adjustments for cash-accrual differences, valuation changes and other discrepancies.

Table 4. Czech Republic: Selected Vulnerability Indicators

	2003	2004	2005	2006	2007	2008 1/	Latest Observation
Key Economic and Market Indicators							
Real GDP growth (in percent)	3.6	4.5	6.3	6.8	6.0	4.0	Proj
CPI inflation (period average, in percent)	0.1	2.8	1.8	2.5	2.8	6.7	Proj
Short-term (ST) interest rate (in percent) 2/	2.1	2.6	2.2	2.6	4.1	4.5	Oct-08
EMBI secondary market spread (bps, end of period) 3/	...	14.0	22.0	22.0	33.0	159.0	Nov-08
Exchange rate NC/US$ (end of period)	25.7	22.4	24.6	20.9	18.1	19.0	Oct-08
External Sector							
Exchange rate regime			Free floating				
Current account balance (percent of GDP)	-6.2	-5.2	-1.3	-2.6	-1.8	-2.2	Proj
Net FDI inflows (percent of GDP)	2.0	3.6	9.3	2.8	4.6	4.3	Proj
Exports (percentage change of US$ value, GNFS)	24.0	35.7	17.1	21.2	28.0	30.4	Proj
Real effective exchange rate (2000 = 100)	116.8	118.3	125.3	132.3	136.8	159.1	Sep-08
Gross international reserves (GIR) in US$ billion	27.0	28.4	29.6	31.5	34.9	38.4	Proj
GIR in percent of ST debt at remaining maturity (RM)	169.5	126.1	122.0	133.2	161.9	118.8	Proj
Total gross external debt (ED) in percent of GDP	38.2	41.3	37.3	40.2	42.9	40.3	Proj
o/w ST external debt (original maturity, in percent of total ED)	40.1	34.0	31.4	26.9	31.3	32.7	Proj
ED of domestic private sector (in percent of total ED)	92.2	85.0	80.0	79.1	79.7	78.5	Proj
ED to foreign official sector (in percent of total ED)	9.6	8.6	9.4	9.2	7.6	7.4	Proj
Total gross external debt in percent of exports of GNFS	61.8	59.0	51.7	52.6	53.6	47.3	Proj
Gross external financing requirement (in US$ billion) 4/	19.8	27.1	25.0	25.8	22.5	34.1	Proj
Public Sector (PS) 5/							
Overall balance (percent of GDP)	-6.6	-2.9	-3.6	-2.7	-1.0	-1.5	Proj
Primary balance (percent of GDP)	-5.5	-1.8	-2.4	-1.6	0.2	-0.2	Proj
Debt-stabilizing primary balance (percent of GDP) 6/	...	...	...	-1.2	-1.6	-0.5	Proj
Gross PS financing requirement (in percent of GDP) 7/	15.5	13.3	9.8	11.5	6.8	10.4	Proj
Public sector gross debt (PSGD, in percent of GDP)	30.1	30.4	29.7	29.5	28.9	29.3	Proj
Financial Sector (FS) 8/							
Capital adequacy ratio (in percent)	14.5	12.6	11.9	11.5	11.5	12.9	Sep-08
NPLs in percent of total loans	4.9	4.1	4.3	3.6	2.7	3.1	Sep-08
Return on average assets (in percent) 9/	1.2	1.3	1.4	1.2	1.3	1.3	Sep-08
Return on equity (in percent) 10/	23.8	23.3	25.2	22.5	24.4	23.7	Sep-08
FX deposits held by residents (in percent of total deposits)	10.5	10.2	10.6	10.8	10.9	9.1	Sep-08
FX loans to residents (in percent of total loans)	14.1	13.4	13.0	13.6	12.9	13.1	Sep-08
Credit to private sector (percent change)	11.8	15.3	20.8	21.6	25.9	22.7	Sep-08
Memo item:							
Nominal GDP in billions of U.S. dollars	91.4	109.5	124.5	142.3	174.0	213.2	Proj

1/ Staff estimates, projections, or latest available observations as indicated in the last column.
2/ Three-month interbank offer rate (PRIBOR), average.
3/ JPMorgan Euro EMBI Global Government Spread.
4/ Current account deficit, amortization of medium and long term debt, plus short-term debt by remaining maturity.
5/ On ESA-95 basis. Public sector covers: general government.
6/ Based on averages for the last five years for the relevant variables (i.e., growth, interest rates).
7/ Overall balance plus debt amortization.
8/ Financial sector includes: commercial banks.
9/ A ratio of net profit to average assets.
10/ A ratio of net profit to average capital.

Table 5. Czech Republic: Medium-term Macroeconomic Scenario, 2003–2013

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Real sector					(percent growth)						
Real GDP	3.6	4.5	6.3	6.8	6.0	4.0	1.5	2.3	4.5	4.5	4.5
Consumption	6.3	1.0	2.6	3.7	3.9	2.0	1.7	1.9	3.2	3.2	3.2
Investment	-1.2	8.7	-1.2	10.5	8.4	1.7	1.1	2.3	6.4	6.1	5.8
o/w fixed investment	0.4	3.9	1.8	6.5	6.7	3.2	1.0	2.5	5.6	5.6	5.6
Exports, goods and services	7.4	21.0	11.6	15.9	15.1	10.8	3.4	4.6	10.8	11.5	11.9
Imports, goods and services	8.0	17.9	5.0	14.2	14.2	9.4	3.5	4.4	10.7	11.4	11.8
CPI inflation	0.1	2.8	1.8	2.5	2.8	6.7	2.6	2.0	2.0	2.0	2.0
GDP deflator	0.9	4.5	-0.3	0.9	3.6	1.8	1.1	1.4	1.7	1.8	1.8
Gross domestic savings 1/	21.1	22.4	24.3	23.9	24.8	22.9	22.7	22.7	23.3	23.5	24.4
Public	-0.7	0.9	-0.6	0.3	2.7	1.5	1.6	1.5	2.4	2.8	2.8
Private	21.9	21.5	24.9	23.6	22.0	21.4	21.1	21.2	20.9	20.7	21.6
Gross capital formation 1/	27.4	27.6	25.7	26.5	26.5	25.1	25.2	25.4	25.7	26.1	26.4
Public finances 2/					(in percent of GDP)						
Revenues	40.7	42.2	41.3	41.1	41.6	41.1	40.8	40.8	40.9	41.1	40.8
Expenditures	47.3	45.1	44.8	43.8	42.6	42.6	43.3	43.3	42.6	42.6	42.5
Net lending	-6.6	-2.9	-3.6	-2.7	-1.0	-1.5	-2.5	-2.5	-1.7	-1.5	-1.7
General government debt	30.1	30.4	29.7	29.5	28.9	29.3	30.1	30.9	30.2	29.9	29.9
Balance of payments					(in percent of GDP)						
Current account balance	-6.2	-5.2	-1.3	-2.6	-1.8	-2.2	-2.5	-2.7	-2.4	-2.6	-2.1
Trade balance	-2.7	-0.5	2.0	2.0	3.4	2.6	1.5	1.2	1.5	1.8	2.1
Services balance	0.5	0.6	1.2	1.4	1.6	1.3	0.9	0.7	0.6	0.5	0.5
Net factor income	-4.7	-5.6	-4.8	-5.6	-6.3	-5.8	-4.5	-3.8	-3.6	-4.0	-3.7
Current transfers	0.6	0.2	0.2	-0.4	-0.5	-0.3	-0.4	-0.8	-0.9	-1.0	-0.9
Financial account balance	6.1	6.3	5.2	3.0	2.8	2.2	4.5	2.7	2.4	2.6	2.1
Capital transfers	0.0	-0.6	0.2	0.3	0.6	0.8	1.8	1.2	1.2	1.3	1.3
Direct investment, net	2.1	3.6	9.4	2.8	4.5	4.3	4.2	2.5	2.8	3.4	3.3
o/w privatization revenue	0.9	0.5	0.8	0.0	0.0	0.0	2.0	0.0	0.0	0.0	0.1
Portfolio investment, net	-1.4	1.9	-2.7	-0.8	-1.5	0.6	-0.2	-0.2	-0.1	-0.1	-0.1
Financial derivatives, net	0.1	-0.1	-0.1	-0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.4
Other investment, net	5.3	0.9	-1.4	1.0	-0.2	-2.7	0.5	0.4	-0.2	-0.7	-1.0
Errors and omissions, net	0.6	-0.3	-0.9	-0.6	-1.1	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves (- increase) 3/	-0.5	-0.2	-3.1	-0.1	-0.4	-0.8	-3.7	-1.2	-1.2	-1.3	-1.4

Sources: Czech Statistical Office, Czech National Bank, Ministry of Finance, and IMF staff estimates.
1/ In percent of GDP.
2/ On ESA-95 basis.
3/ Changes in reserves reflect off-market conversion of large privatization receipts, EU transfers, and sales of accumulated interest. The projected increase in reserves in 2008-12 is based on the expected increase in EU-fund transfers and the level of absorption of these transfers.

Table 6. Czech Republic: External Debt Sustainability Framework, 2003-2013
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	38.2	41.3	37.3	40.2	42.9	**40.3**	**43.0**	**44.9**	**45.5**	**46.0**	**46.3**	**-3.3**
Change in external debt	2.3	3.1	-4.0	2.9	2.7	-2.6	2.7	1.9	0.7	0.5	0.3	
Identified external debt-creating flows (4+8+9)	-2.4	-4.1	-11.2	-4.8	-9.1	-3.8	-2.2	-0.2	-1.5	-1.4	-2.0	
Current account deficit, excluding interest payments	4.7	3.7	0.1	1.4	0.3	0.8	0.9	1.0	0.6	0.8	0.2	
Deficit in balance of goods and services	2.2	-0.1	-3.3	-3.4	-5.0	-3.9	-2.4	-1.9	-2.1	-2.3	-2.6	
Exports	61.8	70.2	72.1	76.7	80.4	85.2	87.4	89.8	95.2	101.6	108.9	
Imports	64.1	70.1	68.8	73.2	75.4	81.3	85.0	87.9	93.1	99.3	106.3	
Net non-debt creating capital inflows (negative)	-2.4	-3.0	-7.6	-2.7	-3.6	-4.5	-4.1	-1.9	-2.0	-2.0	-2.2	
Automatic debt dynamics 1/	-4.7	-4.8	-3.7	-3.5	-5.8	0.0	0.9	0.7	-0.1	-0.1	-0.1	
Contribution from nominal interest rate	1.6	1.5	1.3	1.2	1.5	1.4	1.6	1.7	1.8	1.8	1.9	
Contribution from real GDP growth	-1.1	-1.4	-2.3	-2.2	-2.0	-1.4	-0.6	-0.9	-1.9	-1.9	-1.9	
Contribution from price and exchange rate changes 2/	-5.2	-4.9	-2.7	-2.4	-5.4	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	4.8	7.2	7.2	7.7	11.9	1.1	4.9	2.1	2.1	1.8	2.4	
External debt-to-exports ratio (in percent)	61.8	58.8	51.8	52.4	53.3	47.3	49.2	50.0	47.8	45.3	42.6	
Gross external financing need (in billions of US dollars) 4/	19.8	27.1	25.0	25.8	22.5	34.1	39.5	42.3	46.2	51.6	55.4	
in percent of GDP	21.6	24.8	20.1	18.1	12.9	16.0	19.2	19.8	20.2	21.1	21.1	
Scenario with key variables at their historical averages 5/						**40.3**	**36.4**	**32.9**	**29.7**	**26.4**	**23.7**	**-7.2**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	3.6	4.5	6.3	6.8	6.0	4.0	1.5	2.3	4.5	4.5	4.5	
GDP deflator in US dollars (change in percent)	17.1	14.7	7.0	7.0	15.4	17.8	-5.3	2.0	2.3	2.4	2.4	
Nominal external interest rate (in percent)	5.6	4.7	3.5	3.7	4.5	4.1	3.8	4.1	4.2	4.3	4.4	
Growth of exports (US dollar terms, in percent)	24.0	36.1	16.7	21.6	28.2	29.9	-1.3	7.2	13.5	14.2	14.7	
Growth of imports (US dollar terms, in percent)	24.2	31.2	11.6	21.6	25.9	32.1	0.5	7.9	13.3	14.1	14.6	
Current account balance, excluding interest payments	-4.7	-3.7	-0.1	-1.4	-0.3	-0.8	-0.9	-1.0	-0.6	-0.8	-0.2	
Net non-debt creating capital inflows	2.4	3.0	7.6	2.7	3.6	4.5	4.1	1.9	2.0	2.0	2.2	

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

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

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

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

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

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

Table 7. Czech Republic: Public Sector Debt Sustainability Framework, 2003-2013
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	30.1	30.4	29.8	29.6	28.9	**29.4**	**30.2**	**30.9**	**30.2**	**30.0**	**29.8**	**-0.6**
o/w foreign-currency denominated	2.7	2.4	2.3	2.3	2.3	3.5	5.3	6.5	7.2	8.0	8.9	
Change in public sector debt	1.6	0.3	-0.6	-0.2	-0.7	0.5	0.8	0.8	-0.7	-0.3	-0.2	
Identified debt-creating flows (4+7+12)	4.1	-0.5	-1.5	-0.4	-0.9	0.7	0.8	0.8	-0.7	-0.3	-0.2	
Primary deficit	5.5	1.8	2.4	1.6	-0.2	0.2	1.2	1.3	0.5	0.3	0.4	
Revenue and grants	40.7	42.2	41.4	41.2	41.6	41.2	40.9	40.9	41.0	41.2	41.0	
Primary (noninterest) expenditure	46.2	44.0	43.8	42.7	41.5	41.5	42.1	42.2	41.5	41.5	41.3	
Automatic debt dynamics 2/	-0.4	-1.7	-0.3	-1.4	-1.8	-0.4	0.5	0.1	-0.6	-0.6	-0.6	
Contribution from interest rate/growth differential 3/	-0.1	-1.4	-0.6	-1.0	-1.5	-0.4	0.5	0.1	-0.6	-0.6	-0.6	
Of which contribution from real interest rate	0.9	-0.1	1.2	0.8	0.1	0.7	1.0	0.8	0.7	0.7	0.7	
Of which contribution from real GDP growth	-1.0	-1.2	-1.8	-1.9	-1.6	-1.1	-0.4	-0.7	-1.3	-1.3	-1.3	
Contribution from exchange rate depreciation 4/	-0.3	-0.3	0.2	-0.3	-0.3	...	...	...	...	...	...	
Other identified debt-creating flows	-1.0	-0.5	-3.6	-0.5	1.1	0.9	-1.0	-0.6	-0.6	0.0	0.0	
Privatization receipts (negative)	-1.0	-0.5	-3.6	0.1	-0.5	-0.7	-2.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	-0.6	1.6	1.5	1.0	-0.6	-0.6	0.0	0.0	
Residual, including asset changes (2-3) 5/	-2.5	0.8	0.9	0.2	0.2	-0.2	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	73.8	72.0	71.9	71.9	69.4	71.3	73.8	75.6	73.8	72.8	72.7	
Gross financing need 6/	21.1	15.6	11.5	10.6	7.7	9.1	10.3	10.3	9.3	8.0	8.0	
in billions of U.S. dollars	19.3	17.0	14.3	15.0	13.3	19.4	21.2	22.0	21.4	19.7	21.0	
Scenario with key variables at their historical averages 7/						**29.4**	**31.1**	**33.1**	**35.2**	**37.7**	**40.2**	**-0.7**
Scenario with no policy change (constant primary balance) in 2008-2013						**29.4**	**29.0**	**28.8**	**27.9**	**27.6**	**27.3**	**-0.6**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	3.6	4.5	6.3	6.8	6.0	4.0	1.5	2.3	4.5	4.5	4.5	
Average nominal interest rate on public debt (in percent) 8/	4.2	4.2	4.0	4.0	4.2	4.5	4.5	4.2	4.2	4.3	4.3	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.2	-0.3	4.3	3.1	0.6	2.7	3.4	2.8	2.5	2.5	2.6	
Nominal appreciation (increase in US dollar value of local currency, in percent)	17.5	14.7	-9.0	17.8	15.5	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	0.9	4.5	-0.3	0.9	3.6	1.8	1.1	1.4	1.7	1.8	1.8	
Growth of real primary spending (deflated by GDP deflator, in percent)	6.2	-0.5	6.0	4.1	2.8	4.0	3.2	2.5	2.7	4.6	4.1	
Primary deficit	5.5	1.8	2.4	1.6	-0.2	0.2	1.2	1.3	0.5	0.3	0.4	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

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

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

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.

INTERNATIONAL MONETARY FUND

CZECH REPUBLIC

Staff Report for the 2008 Article IV Consultation—Informational Annex

Prepared by the European Department

January 9, 2009

Contents | Page

Appendix I. Czech Republic: Fund Relations
(As of November 30, 2008; unless specified otherwise)

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

II. **General Resources Account**	SDR Million	% Quota
Quota	819.30	100.0
Fund holdings of currency	714.33	87.19
Reserve position in Fund	104.98	12.81

III. **SDR Department**:	SDR Million	% Allocation
Holdings	13.76	N/A

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

V. **Financial Arrangements**:

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

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

VII. **Exchange Rate Arrangement**:

The currency of the Czech Republic is the Czech koruna, created on February 8, 1993 upon the dissolution of the currency union with the Slovak Republic, which had used the Czechoslovak koruna as its currency. From May 3, 1993 to May 27, 1997, the exchange rate was pegged to a basket of two currencies: the deutsche mark (65 percent) and the U.S. dollar (35 percent). On February 28, 1996, the Czech National Bank widened the exchange rate band from ±0.5 percent to ±7.5 percent around the central rate. On May 27, 1997, managed floating was introduced. In the *Annual Report on Exchange Arrangements and Exchange Restrictions,* the de facto exchange rate regime of the Czech Republic is classified as an independent float. Since 2002, the CNB has not engaged in direct interventions in the foreign exchange market. International reserves have been affected by the off-market purchases of large privatization receipts and EU transfers and the sales of the accumulated interest. On December 8, 2008, the exchange rate of the Czech koruna stood at CZK 19.895 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).

VIII. **Last Article IV Consultation**:
The last Article IV consultation with the Czech Republic was concluded on January 23, 2008. The staff report and PIN were published on January 28, 2008.

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

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

XI. **Safeguards Assessments:** Not Applicable

Czech Republic: Technical Assistance, 1991–2005

Department	Timing	Purpose
FAD	Dec. 1991–Sept. 1993	Regular visits by FAD consultant on VAT
	March 1993	administration
	September 1993	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 on public financial management
	May 1995	Follow-up visit by FAD consultant on VAT
	June 1995	administration
	June–July 1999	Follow-up visit on public financial management
		Follow-up visit by FAD consultant on VAT
		administration
		Medium-term fiscal framework
MCM	February 1992	Monetary management and research, foreign exchange operations, and banking supervision
	June 1992	Monetary research
	July 1992	Long-term resident expert assignment in the area of banking supervision (financed by EC-PHARE; supervised by the Fund)
	December 1992 and February 1993	Bond issuance and monetary management

	November 1993	Follow-up visit on bond issuance and monetary management and management of cash balances
	April 1994	Data management and monetary research
	January 1995	Foreign exchange laws (jointly with LEG) and external liberalization
	May 1995	Monetary operations
	May 1995	Banking system reform
	May 1996	Economic research
	April 1997	Banking legislation
	February–June 1999	Monetary research—inflation targeting
	June 1999	Integrated financial sector supervision (with WB)
RES	September 1999	Inflation targeting (financed by MFD)
	June–August 2000	Inflation targeting (financed by MFD)
	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

Appendix II: Statistical Issues

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 and 2007 are posted on the Fund's Dissemination Standards Bulletin Board.

Data on core surveillance variables are available to the Fund regularly and with minimal lags (reporting to STA is less current, especially for foreign trade and the national accounts). Exchange rates and interest rates, set by the Czech National Bank (CNB), are 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.

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.

- 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.

- 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 fiscal data on ESA-95 basis has been prepared by the Czech Statistical Office. Quarterly data for non-financial accounts have also been compiled and quarterly financial accounts are being prepared. The Ministry of Finance uses the ESA-95 methodology for the Convergence Program targets. The ESA-95 methodology differs from the national (fiscal targeting methodology) in terms of the coverage of the institutions (for example, the Czech Consolidation Agency is included in the central government under ESA definition) and inclusion of financial transactions and other accrual items (for example, called guarantees). The Ministry of Finance participated in the Fund's pilot project to transition to the statistical methodologies outlined in *Government Finance Statistics Manual, 2001*.

Czech Republic: Table of Common Indicators Required for Surveillance
As of October 27, 2008

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	9/30/08	9/30/08	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Sep. 2008	10/10/08	D	M	M
Reserve/Base Money	8/01/08	9/15/08	10 days	10 days	10 days
Broad Money	Aug. 2008	10/21/08	M	M	M
Central Bank Balance Sheet	8/01/08	9/15/08	10 days	10 days	10 days
Consolidated Balance Sheet of the Banking System	Aug. 2008	10/21/08	M	M	M
Interest Rates[2]	9/30/08	9/30/08	D	D	D
Consumer Price Index	Sep. 2008	10/16/08	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Dec. 2007	Jan. 2008	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	July 2008	Sep. 2008	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	July 2008	Sep. 2008	A	A	A
External Current Account Balance	2008 Q2	Sep. 2008	Q	Q	Q
Exports and Imports of Goods and Services	June 2008	Sep. 2008	M	M	M
GDP/GNP	2008 Q2	Sep. 2008	Q	Q	Q
Gross External Debt	2008 Q2	Sep. 2008	Q	Q	Q
International Investment Position[6]	2008Q2	Sep 2008	Q	Q	Q

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] 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.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).

Statement by the IMF Staff Representative
February 6, 2009

This statement provides information on economic developments since the staff report was issued. The new information does not alter the thrust of the staff appraisal.

1. **The downturn in demand and activity accelerated sharply and inflation slowed further.** Industrial production fell by 17 percent in the year to November 2008, led by a sharp decline in the automobile sector, and retail sales dropped by over 6 percent over the same period. Exports fell by almost 18 percent, led by vehicles and machinery, while imports declined by 13 percent. Indicators of consumer and business confidence fell further in January 2009. Consumer price inflation declined to 3.6 percent in the year to December 2008, a 15-month low, driven by prices of food and fuel.

2. **Staff has lowered its projection for growth in 2009 to -1¼ percent from 1½ percent.** The sharp downward revision reflects the deepening recession in the euro area, especially Germany, as well as deteriorating prospects for domestic demand. While investment is set to slow down markedly, especially in the key automobile sector, private consumption is projected to weaken further, reflecting dimmer prospects for employment and lower household confidence.

3. **The authorities have lowered their projection for growth as well.** The Ministry of Finance now forecasts growth of 1.4 percent in 2009, down from 3.7 percent. The sharp downward revision is driven by exports of goods and services, which are expected to fall by close to 1 percent. The Czech National Bank (CNB) is due to publish its latest assessment of economic prospects on February 5. Based on public statements of CNB officials, market participants expect a sharp downward revision in the forecast for growth and a further cut in the policy interest rate.

4. **In light of the worsened outlook for growth, the authorities revised the budget for 2009 in late January.** The Ministry of Finance raised its projection for the fiscal deficit to 3 percent of GDP from 1.6 percent of GDP (on ESA-95 basis). The higher deficit reflects primarily lower revenues, and is to be partially financed through a drawdown of reserves. With the deficit outturn for 2008 better than expected at around 1¼ percent of GDP due to lower capital spending, the revised budget implies a slightly expansionary fiscal stance for 2009.

5. **The koruna continued to depreciate, in line with the trend in the regional currencies.** Against the euro, the koruna fell by 4.1 percent during January, following a decline of 6 percent in December 2008.

Table 1. Czech Republic: Selected Economic Indicators, 2003-10

	2003	2004	2005	2006	2007	2008	2009	2010
						Staff Est.	Staff Proj.	
Real economy (change in percent)								
Real GDP	3.6	4.5	6.3	6.8	6.0	4.0	-1.3	1.4
Domestic demand	4.1	3.2	1.3	5.4	5.1	2.5	-0.1	1.3
CPI (year average)	0.1	2.8	1.8	2.5	2.8	6.3	2.1	2.0
PPI (year average)	-0.3	5.7	3.0	1.6	4.0	4.4	n.a.	n.a.
Unemployment rate (in percent)								
Survey-based 1/	7.8	8.3	7.9	7.1	5.3	4.0	5.3	5.6
Registered 1/	9.9	9.8	8.9	8.1	6.6	5.3	6.5	6.9
Gross national savings (percent of GDP)	21.1	22.4	24.3	23.9	24.8	22.9	22.4	22.6
Gross domestic investments (percent of GDP)	27.4	27.6	25.7	26.5	26.5	25.1	25.5	25.9
Public finance (percent of GDP) 2/								
General government revenue	40.7	42.2	41.3	41.1	41.6	41.2	41.1	41.1
General government expenditure	47.3	45.1	44.8	43.8	42.6	42.5	44.4	44.5
Net lending	-6.6	-2.9	-3.6	-2.7	-1.0	-1.2	-3.3	-3.4
General government debt	30.1	30.4	29.7	29.6	28.9	29.2	31.4	33.1
Money and credit (end of year, percent change)								
Broad money 3/	6.9	4.4	8.0	9.9	13.2	7.9	n.a.	n.a.
Private sector credit (percent change, eop) 3/	11.8	15.3	20.8	21.6	27.3	19.0	n.a.	n.a.
Interest rates (in percent, year average)								
Three-month interbank rate	2.1	2.6	2.2	2.6	4.1	3.6	n.a.	n.a.
Ten-year government bond	4.8	4.0	3.6	3.7	4.7	4.1	n.a.	n.a.
Balance of payments (percent of GDP)								
Trade balance	-2.7	-0.5	2.0	2.0	3.4	2.6	1.0	0.5
Current account	-6.2	-5.2	-1.3	-2.6	-1.8	-2.2	-3.1	-3.3
Gross international reserves (US$ billion)	27.0	28.4	29.6	31.5	34.9	38.3	44.4	47.2
Reserve cover (in months of imports of goods and services)	5.5	4.5	4.1	3.6	3.2	2.7	3.0	3.0
Exchange rate								
Nominal effective exchange rate, pa (2000=100)	116.8	118.0	125.3	131.7	135.6	140.6	n.a.	n.a.
Real effective exchange rate, pa (CPI-based; 2000=100)	116.8	118.3	125.3	132.3	136.8	148.5	n.a.	n.a.

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

1/ In percent of total labor force.
2/ On ESA-95 basis.
3/ For 2008, data refer to November.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 09/46
FOR IMMEDIATE RELEASE
April 14, 2009

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

IMF Executive Board Concludes 2008 Article IV Consultation with the Czech Republic

On February 6, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation with the Czech Republic.[1]

Background

Generally strong fundamentals helped the Czech economy weather the global financial crisis until late 2008. Robust productivity growth, improved fiscal performance, and a comfortable external position, supported by inflows of foreign direct investment, placed the economy in a relatively favorable position. Reflecting these strengths, the adverse effects on activity and risks in the banking system remained contained, as compared with the regional peers. Inflation started to recede rapidly, after having risen sharply in the first half of 2008. As the ripple effects of the global financial crisis began to impact the economy, the Czech National Bank acted aggressively, cutting the policy rate by a total of 200 basis points.

Growth is projected to slow sharply in 2009 amid a gathering recession abroad and tightening credit at home. The shrinking demand from the euro area, and especially Germany, will curtail exports and direct investment inflows. Tightening credit conditions at home and shrinking profit margins will weigh on capital spending. Household consumption is expected to grow only modestly as plummeting confidence and rising unemployment overshadow the favorable impact of declining inflation on disposable income. Risks to this growth outlook are clearly tilted to the downside. The downward phase of the cycle has

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

coincided with a deeper-than-projected recession in the euro area, and tighter credit conditions at home.

The financial sector came under increasing pressure in the latter part of 2008. Liquidity tightened considerably in interbank markets, and trading activity in the government bond market froze temporarily in October. Meanwhile, credit risk, especially in the corporate sector, rose amid the worsening outlook for economic activity.

Competitiveness was adequate but under incipient pressure. Export volumes enjoyed double-digit growth for the greater part of the year, with market shares continuing to expand. The koruna was broadly in line with fundamentals despite some recent erosion of competitiveness due to the lagged effects of the earlier appreciation and rising unit labor costs.

In the face of stronger-than-expected fiscal outturns in recent years of rapid growth, the authorities have sought to lower deficit targets while adhering to the nominal expenditure ceilings, thereby affirming their commitment to the medium-term objective of a deficit of 1 percent of GDP by 2012. Streamlining of social spending under the 2007 fiscal reform package and buoyancy of corporate tax revenues resulted in a fiscal outturn in 2008 of less than half that initially budgeted. With the rapid worsening of the near-term growth outlook, the fiscal deficit in 2009 is likely to be higher than the budgeted 1½ percent of GDP.

Executive Board Assessment

Executive Directors praised the generally strong fundamentals that have helped the Czech economy weather the initial spillover effects of the global financial crisis relatively well. Directors noted, however, that the Czech economy, highly open to trade and investment flows, has begun to be adversely affected by the global crisis. Given the prospect of a sharp economic downturn in 2009, it will be important to preserve financial stability and mitigate the impact of the downturn, using the flexibility gained from past sound policies. At the same time, the authorities should remain mindful of their medium-term fiscal and inflation objectives.

While welcoming the resilience of the Czech banking sector, Directors noted that financial system risks have increased. They supported the authorities' measures to maintain confidence and ensure financial stability, and encouraged further steps to support the smooth functioning of markets and to promote greater transparency in the government bond market. Financial supervisors need to remain vigilant and ensure that their toolkit is sufficient to address any emerging weakness. Directors also called for the strengthening of financial safety nets. Although it is reassuring that the lending by the subsidiaries of foreign banks is predominantly in local currency and is largely financed by local deposits, Directors considered that, in view of the dominant presence of these foreign banks, proactive collaboration with their financial authorities in home countries is warranted.

Directors supported the Czech National Bank's recent decisions to cut the policy interest rate. With inflation projected to fall below the target of 3 percent and a sharp slowdown in prospect, there is scope for further prudent easing depending on movements in the koruna and the extent of weakness in demand. Directors considered that the central bank's communication strategy should ensure that expectations are well anchored to the revised inflation target of 2 percent, effective January 2010.

Directors viewed competitiveness to be adequate and the external position to remain strong. They noted the staff's assessment that the koruna exchange rate is broadly in line with fundamentals. Concerns about the excessively strong koruna in the first half of 2008 have been eased by the recent significant reversal of the appreciation.

Directors welcomed the authorities' intention of supporting economic activity in the face of a sharper than expected downturn. They also agreed that fiscal policy needs to give due weight to financing constraints and to preserving the hard-won gains in fiscal consolidation. The recent strengthening of the fiscal position and the authorities' commitment to the nominal expenditure ceilings have created room for countercyclical policy, including the full operation of automatic stabilizers. Directors welcomed the revised budget for 2009, which implies a slightly expansionary stance. Should the downturn prove deeper than expected, they saw room for some further discretionary stimulus, given the relatively low government debt and limited macroeconomic imbalances. Any such stimulus measures, however, should be temporary and well targeted.

Directors commended the authorities' commitment to press ahead with essential structural reforms over the longer term. They welcomed the ongoing reforms in pensions and health care, which should help ensure fiscal sustainability. Looking ahead, creating fiscal space to cope with the demographic transition through greater efficiency in public spending will be important. Directors also reiterated the scope for reforms in the tax-benefits system and labor markets to enhance incentives to work, generate fiscal savings, and raise potential growth.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2008 Article IV Consultation with the Czech Republic is also available.

Czech Republic: Selected Economic Indicators, 2003-10

	2003	2004	2005	2006	2007	2008	2009	2010
						Staff Est.	Staff Proj.	
Real economy (change in percent)								
Real GDP	3.6	4.5	6.3	6.8	6.0	4.0	-1.3	1.4
Domestic demand	4.1	3.2	1.3	5.4	5.1	2.5	-0.1	1.3
CPI (year average)	0.1	2.8	1.8	2.5	2.8	6.3	2.1	2.0
PPI (year average)	-0.3	5.7	3.0	1.6	4.0	4.4	n.a.	n.a.
Unemployment rate (in percent)								
Survey-based 1/	7.8	8.3	7.9	7.1	5.3	4.0	5.3	5.6
Registered 1/	9.9	9.8	8.9	8.1	6.6	5.3	6.5	6.9
Gross national savings (percent of GDP)	21.1	22.4	24.3	23.9	24.8	22.9	22.4	22.6
Gross domestic investments (percent of GDP)	27.4	27.6	25.7	26.5	26.5	25.1	25.5	25.9
Public finance (percent of GDP) 2/								
General government revenue	40.7	42.2	41.3	41.1	41.6	41.2	41.1	41.1
General government expenditure	47.3	45.1	44.8	43.8	42.6	42.5	44.4	44.5
Net lending	-6.6	-2.9	-3.6	-2.7	-1.0	-1.2	-3.3	-3.4
General government debt	30.1	30.4	29.7	29.6	28.9	29.2	31.4	33.1
Money and credit (end of year, percent change)								
Broad money 3/	6.9	4.4	8.0	9.9	13.2	7.9	n.a.	n.a.
Private sector credit (percent change, eop)	11.8	15.3	20.8	21.6	27.3	16.0	n.a.	n.a.
Interest rates (in percent, year average)								
Three-month interbank rate	2.1	2.6	2.2	2.6	4.1	3.6	n.a.	n.a.
Ten-year government bond	4.8	4.0	3.6	3.7	4.7	4.1	n.a.	n.a.
Balance of payments (percent of GDP)								
Trade balance	-2.7	-0.5	2.0	2.0	3.4	2.6	1.0	0.5
Current account	-6.2	-5.2	-1.3	-2.6	-1.8	-2.2	-3.1	-3.3
Gross international reserves (US$ billion)	27.0	28.4	29.6	31.5	34.9	38.3	44.4	47.2
Reserve cover (in months of imports of goods and services)	5.5	4.5	4.1	3.6	3.2	2.7	3.0	3.0
Exchange rate								
Nominal effective exchange rate, pa (2000=100)	116.8	118.0	125.3	131.7	135.6	140.6	n.a.	n.a.
Real effective exchange rate, pa (CPI-based; 2000=100)	116.8	118.3	125.3	132.3	136.8	148.5	n.a.	n.a.

Sources: Czech Statistical Office; Czech National Bank; Ministry of Finance; and IMF staff estimates and projections.
1/ In percent of total labor force.
2/ On ESA-95 basis.
3/ For 2008, data refer to November.

Statement by Willy Kiekens, Executive Director for the Czech Republic and Stanislav Polak , Senior Advisor to Executive Director February 6, 2009

The Czech authorities thank the staff for the useful discussions in preparation of the 2008 Article IV Consultation report.

Macroeconomic outlook

After an average growth of 6.4 percent during the period 2005–2007, growth in 2008 isestimated to have declined to around 4 percent. In 2009, the highly open Czech economy is set to slow down further due to the deteriorating outlook in its main trading partners.

In its January outlook update, the Czech Ministry of Finance revised the October forecast for output growth in 2009 from 3.7 percent to 1.4 percent. This is in line with the January 2009 Interim Forecast of the European Commission which anticipates growth of 1.7 percent. However, both outlooks point to downside risks.

Macroeconomic forecasts and their risk assessments are currently fraught with unprecedented uncertainty. Continuous revisions to the global and Euro zone economic outlook make it difficult to assess the impact of exogenous variables on the Czech economy. Weakening external demand will weigh on export and investment activities despite the current depreciation of the Czech koruna. Weaker business activity will slow down employment growth, which in turn will moderate domestic demand. The consensus forecast for 2009 has dropped from 4.4 percent in August 2008 to 0.3 percent in the January 2009 survey.

Policy challenges

The Czech Republic has entered the current global crisis without significant macroeconomic imbalances and with a sound financial system. Nevertheless, macroeconomic management is facing significant challenges because of uncertainty about the economic contraction in main trading partners. The authorities are aware that the Czech economy is heavily dependent on exports, concentrated in a few sectors and towards a few countries. Therefore, in the short term, domestic demand should be boosted with fiscal stimulus measures, while in the medium to long term, structural reforms to improve the competitiveness and flexibility of the economy will make the economy more resilient to adverse external shocks. National policy choices of a small open economy have a limited impact on the current global conditions. In a small open economy, demand-stimulating measures, significantly leak to external economies. Therefore, the Czech authorities support a coordinated international approach in reversing the current global slowdown.

On December 2, 2008, the Czech Government announced its “Strategy of Preparedness and Growth Acceleration” to mitigate risks related to the global financial crisis. Early this year, the National Economic Council was established to identify measures to minimize the impact of the unfavorable external cyclical conditions, while preserving long-term objectives. A comprehensive set of structural reforms is well-identified to improve the economy and will be implemented when a broader political consensus across ruling and opposition political parties can be reached on the detailed nature and sequence of particular reforms.

(i) Public finances and fiscal stimulus

The general government deficit has been reduced from 2.7 percent of GDP in 2006 to 1 percent in 2007. For 2008, this deficit was broadly stable at 1.2 percent, despite less favorable economic growth, thanks to the beneficial effects of the January 2008 fiscal measures.

The 2009 budget, adopted last October, targeted a deficit of 1.6 percent of GDP. However, as automatic stabilizers will be allowed full play, and because of the fiscal stimulus plan, the deficit is now expected to be at 3 percent. Assuming adherence to the spending ceilings outlined in the medium-term budget, the deficit should be 2.9 percent of GDP in 2010 and 2.5 percent in 2011.

As part of the European Economic Recovery Plan, the Czech government announced the following stimulus measures, equivalent to about 1 percent of GDP:

- Cuts in employees' social security contributions with a net budget cost of CZK 18.4 billion;
- CZK 14.4 billion contribution to construction and modernization of infrastructure within the State Fund of Transport and Infrastructure;
- Increase of salaries in the government sector by CZK 2.7 billion following a decrease in public sector salaries in real terms in 2008;
- Increase of capital of the Czech Export Bank (CEB) and other export promoting institutions by some CZK 2 billion;
- Increase in the capital of Supporting Guarantee Agricultural and Forestry Fund by CZK 0.3 billion;
- CZK 0.6 billion investment incentives for technology centre projects;
- CZK 0.5 billion for environment related projects, which are co-financed by EU Funds.

The government is determined to cut, in 2009, expenses for CZK 15 billion, or 0.4 percent of GDP. If approved by the parliament, these cuts will create budget room to absorb the cost of additional structural measures to boost the domestic economy.

Resources from EU funds are expected to have an expansionary effect, without affecting the general government balance.

(ii) Financial sector resilience

It is important to assess each country on its own merits and to avoid associating a country with the problems in the region when this is not justified. The Czech Republic has managed to avoid contagion from the financial turmoil. The main financial institutions remain sound, well-capitalized and profitable. A comfortable level of local currency deposits shields these institutions from liquidity strains and provides them with stable financing at reasonable costs compared to other volatile external sources.

Although the Czech financial sector is not immune to the global financial crisis, its healthy conditions have helped avoid financial distress. The Czech financial system was comprehensively restructured and consolidated during the last decade. An independent central bank conducted successfully monetary policy aimed toward maintaining price stability. Financial regulation and supervision, covering the entire financial sector, was the responsibility of the central bank which encouraged sound financial practices. This setting has enabled domestic interest rates to be lower than in the eurozone, making foreign currency loans not attractive for households and corporate borrowers.

The strengths of the Czech financial system, which is mainly foreign owned, are: (i) growth opportunities in traditional banking and their reasonable profitability, (ii) negligible share of structured credits, not exceeding 1 percent of total assets, and (iii) stable funding by local deposits rather than by foreign funds. In the Czech Republic, the deposit to loan ratio is double the average ratio in the original members of the European Union.

The Staff Report concludes that *"concerns about the health of the banking sector have intensified. Temporary withdrawals by depositors, contributing to a further tightening in liquidity conditions…"*. This was most likely a temporary episode stemming from neighboring countries announcing more generous deposit insurance schemes. After the alignment of the deposits guarantee scheme with the EU agreement in mid-October 2008, covering 100 percent of deposits up to euro 50,000, withdrawal of deposits stopped. The staff have also expressed concern about the high off-balance sheet liabilities. The Czech authorities remain vigilant and monitor these developments. They would appreciate it if the staff could provide a more detailed analysis and comparison with similar economies.

The staff caution against the quick and significant reduction of exposures of foreign banks in the region. We would like to draw attention to the difference between a parent bank withdrawing existing funds and not extending new financing. Subsidiaries of foreign banks, with funding from local sources, as is mainly the case in the Czech Republic, are in a more stable condition than subsidiaries and branches that rely on foreign currency funding from the parent bank. In addition, the allocation of liquidity by a subsidiary to its foreign parent bank is constrained by the prudential regulation limiting risk concentration on counterpart to 20 percent of own capital. Nonetheless, the CNB monitors the situation of the main financial institutions daily in order to react without delay if appropriate. The banking law might be amended to strengthen the supervisory system as needed.

(iii) Euro adoption prospects

The Czech authorities annually assess the extent to which economic conditions, in particular, nominal and real convergence, are sufficiently aligned with the euro area. The Czech Republic has been improving its sustainable macroeconomic convergence with the euro area in all traditional indicators. Also, the government's financial position is no longer a barrier to fulfilling the Maastricht criteria, now that the excessive deficit procedure has been terminated. Since the one-off inflationary effect that caused a temporary hike in inflation in 2008 has subsided, inflation in 2009 is expected to allow fulfillment of the price stability criterion. The criterion on long-term interest rates has been and will continue to be fulfilled.

The Czech Republic does not participate in ERM II and, thus, does not fulfill the exchange rate criterion. In addition, the present global financial crisis has increased the volatility of the exchange rate, so fulfillment of the exchange rate criterion within ERM II could be difficult and costly. Given the current assessment and the uncertain near-term outlook, the Ministry of Finance and the CNB have recommended that the government should not set a target date for adopting the Euro.