International Monetary Fund

2003 Article IV Consultation Mission with the Czech Republic

Preliminary Conclusions of the Mission

May 27, 2003

1. **During the past year the Czech economy has been resilient.** Growth, while well below that during the recovery in 2000-01 and indeed most estimates of potential, has remained at a respectable 2 percent, despite slowing demand in export markets. Certainly an unsustainable fiscal stimulus has played a role. But export market penetration, thanks largely to success in addressing structural weaknesses and the post-crisis pick-up in private investment, has also been important. Sustaining this strength over the short to medium term will require effort. Confidence effects and, over time, financial support from EU accession will be sources of strength. But stemming the increase in public debt, finding the balance between adequate social safety nets and competitive market discipline, and creating legal and institutional conditions that support private investment will be as essential as they are politically demanding. All of this will need to be carried out during what may prove to be a period of relatively weak external growth and increasing competition in Europe.

2. **Alongside these efforts, a course should be charted for achieving full integration in Europe by adopting the euro.** A central question at this stage is how quickly this goal should be pursued. The answer will rest on the expected scale of benefits for business efficiency and the growth of trade, the value of retaining an independent monetary policy, and the costs of diverging significantly from the timing decisions in neighboring countries. Most analyses suggest that euro adoption will bring significant gains from greater efficiency and tighter market linkages. Questions remain on whether euro-area monetary policy is likely to be optimal for domestic conditions. But even here, recent experience suggests rather little room for pursuing a significantly divergent monetary policy given similar goals for inflation and the need to avoid substantial changes in the real value of the koruna. Pending final views on this issue, moving deliberately to meet the Maastricht criteria—particularly the fiscal ones which will be the most challenging—is advisable. It will put the Czech Republic in a position of strength for any decision on timing and also will be consistent with the fiscal adjustment needed from a purely domestic standpoint. Similarly the post-2005 monetary policy framework will need to meld the economy's immediate needs with a strategy for participation in ERM2, once the requirements for that period are made clear.

Economic Outlook

3. **For the short term, we are sanguine about growth prospects, although risks on the downside are significant.** Assuming a fairly strong rebound in Western European demand, we expect GDP growth to be slightly below 2 percent in 2003, rising to about 3 percent in 2004. Private consumption—buoyed by rising incomes, bank credits to households, and actual and lagged effects of the 2002-03 fiscal stimulus—and exports should be the sources of strength.

While we envisage some pick-up in private investment growth, it is likely to remain subdued pending greater clarity on prospects for export markets. The current account deficit should remain in the range of 5-6 percent of GDP, mostly financed by FDI. A still sizable output gap and continuing effects from last year's appreciation should keep inflation low, even with some pick-up in 2004 due principally to tax changes. The significant downside risks to growth reflect the possibility of a substantial delay in the recovery projected for Western Europe.

4. **We are also bullish on medium term prospects.** Much depends on the political will to deliver fiscal consolidation and institutional reform. But assuming reasonable success on these fronts, potential growth of 3.5-4 percent seems feasible. Certainly this would require containing cost increases to attract FDI, raise productivity, and sustain rapid export growth. Concerted efforts to improve infrastructure would also be needed. Yet, with the planned restraint on current fiscal expenditure, it should be possible to make room for infrastructure spending and moderate private consumption growth without straining the current account position.

Fiscal Policy

5. **Fiscal developments during the past few years have been unsustainable.** Three specific aspects of underlying fiscal trends stand out. First, the rise in the general government deficit (excluding transfers to transformation institutions) from about 3 percent of GDP early in the decade to about 6.5 percent in 2003 has been the direct reflection of burgeoning fiscal transfers and subsidies (again excluding those to transformation institutions) principally channeled through nonfinancial enterprises. While we cannot track precisely the nature of some of these increases, we strongly recommend that they be assessed in order to fully understand the roots of the current fiscal problem. Second, the Czech Republic's advantage in starting its transition with low public debt is being eroded. With debt rising rapidly—on account of large deficits and hidden liabilities—the urgency of fiscal adjustment is stark. Third, demands of a rapidly aging population will, without further changes to the pension system, result in punishingly high contribution and tax rates.

6. **We welcome the mobilization of political will in the past few months to address the fiscal problem.** The broad outlines of the current reform proposals are a significant first step in what will have to be a sustained effort requiring broad-based political and economic sacrifices. We strongly support the intention to reduce the general government deficit to 4 percent of GDP in 2006 and, in view of the already high taxation, to place the largest burden of the adjustment on expenditure restraint. Indeed, the proposal to reduce the corporate income tax rate will help keep the Czech Republic competitive with neighboring countries. Many of the expenditure measures under discussion also push in the right direction: revisions to sickness benefits, parametric changes to the pension system, increases in social security contributions of the self-employed and limits on the growth of social benefits and agricultural subsidies. Beyond these direct deficit reducing steps, the proposals include important institutional reforms. Plans to embed annual budgets in rolling three year fiscal plans, to incorporate extra-budgetary funds in responsible ministries' expenditure ceilings, to limit and properly account for new state guarantees, and to make fiscal effects of CKA operations more transparent would contribute to rational fiscal adjustment and accountability.

7. **For all their positive aspects, however, the measures under discussion will need to be augmented to fully stabilize the fiscal position and make sufficient progress toward the Maastricht deficit limit of 3 percent of GDP.** Among the proposed measures, some may only temporarily restrain spending and push the true burden of adjustment to later years. For example, delaying the planned civil service reform and compressing operational spending, while helpful in meeting 2004 targets, may produce catch-up spending in 2005-06. Targeting additional expenditure items might augment permanent savings. In this vein, closer identification of the sources of the increase in subsidies and transfers through nonfinancial enterprises during 2000-02, might reveal scope for significant savings. And the proposals should go further in addressing population aging problems. In this connection we would advise more aggressive efforts to build on recent pension system reforms, for example by further increasing the statutory retirement age, extending the minimum contribution period for full-pension eligibility, and indexing benefits to the CPI. Agreeing on measures now that will comfortably secure the 2006 target will be important to permit the reprioritization of spending to meet EU accession related obligations and avoid the difficulties of securing support for follow-up measures as the election cycle progresses.

Monetary and Exchange Rate Policy

8. **The inflation targeting (IT) framework has served the Czech Republic well over the past year.** Faced with a strong appreciation of the koruna in 2002, the Czech National Bank (CNB) cut interest rates aggressively and purchased foreign exchange. The result was a partial reversal of the appreciation and a welcome improvement in competitiveness to what seems a broadly appropriate level. Fortunately, with inflation falling below the target band, interest rate cuts were fully consistent with the inflation objective.

9. **But tensions for near-term interest rate decisions are arising from the expected increase in consumer price inflation while prospects for growth remain uncertain.** Holding the present level of the policy rate may appear inconsistent with preventing any overshooting relative to the band. But we agree that because the prospective price increase largely reflects the once-off effect of tax changes, rather than underlying inflation pressures, action to counter it is not necessary. Moreover, in the face of considerable uncertainty about growth prospects at home and in Western Europe, low core inflation, and a sizable output gap, the downside risks for inflation must be taken seriously. And a further cut in ECB interest rates could renew pressure on the koruna. A continuation of the current wait-and-see approach, with a willingness to move the rate in either direction as the outlook becomes clearer therefore seems advisable.

10. **Foreign exchange market intervention sits uneasily in an IT framework.** The intervention in 2002 appears to have contributed to minimizing and even reversing an episode of exchange rate overshooting. Nevertheless, we remain of the view that, in an IT framework, the interest rate is the primary policy instrument for influencing the inflation rate and indirectly even the exchange rate. For this reason and to ensure transparency and clarity in communications with the market, intervention is best restricted to exceptional circumstances.

11. **The post-2005 monetary policy framework will need to be formulated in the next year amidst lingering uncertainty about the timing and conditions for euro adoption.** Particularly in light of your understandable reluctance to spend more than two years in ERM2, it is likely that the new monetary policy parameters will be in place outside the ERM2 framework at least through end-2006. It therefore seems reasonable to continue inflation targeting at least during this period, possibly changing the existing framework to target a point within a symmetric $\pm$1 percent band. The inflation target need not be set to conform strictly to the present expected Maastricht inflation limit, but should not deviate far from it. Concretely, a point target in the range of 2.5-3 percent would provide room for stability of both inflation and the nominal exchange rate as the effects of real convergence on relative prices take place. By solidifying market expectations, such nominal stability should help avoid undue real appreciation—a development that could prove difficult to reverse and would increase the risk of entering ERM2 at an overvalued rate.

Banking Sector Issues

12. **Broad indicators of banking system health and the supervisory framework have improved.** In the wake of the large-scale transfer of non-performing loans to the CKA and the completion of bank privatization, capital adequacy ratios (CARs) are strong, bank profits have improved, and non-performing loan indicators continue to strengthen. Although a medium-sized bank was found insolvent and closed, the event had no systemic implications. In light of this experience, the CNB's ongoing efforts to increase the efficacy of prompt corrective action and bank licensing practices are important. At the same time, steps to enable consolidated supervision of banks and set rules on risk management practices have strengthened supervisory capabilities. The CNB's recently-completed second self-assessment of the Basel Core Principles revealed improved overall compliance. The CNB should undertake to become fully compliant with all core principles in a timely manner.

13. **Rapid changes in the structure of bank lending are raising new questions.** In the past year, as outstanding credit to enterprises has been flat, credit to households has risen at unprecedented rates. In many senses this is unsurprising. Banks, recovering from large losses on loans to enterprises, were naturally searching for a client base perceived as less risky. They found it in households, where previous exposure was negligible and potential demand was strong owing to rising incomes and historically low interest rates. Banks' current exposure to households remains low, but the pace of change is rapid. The highest priority should, therefore, be given to collecting data to monitor developments in household indebtedness, housing and property prices, and banks' aggregate and individual exposure to households. Also, given the pace of household credit growth, supervisors will need to monitor closely banks' ability to assess the risk of this new and dynamic class of credit.

Structural Issues

14. **Progress with institutional reform continues, but the pace of change remains frustrating to many market participants.** Completing the new bankruptcy law is a priority, both to promote enterprise restructuring and to revive bank lending to enterprises. In addition,

more timely court decisions and improved accuracy and transparency of firms' financial statements are key to providing an appropriate framework for sustained growth. Stronger efforts to improve the functioning of Commercial Registries are also needed.

15. **Restructuring needs to continue.** We are encouraged that sales of CKA's assets are proceeding expeditiously. Sustaining the pace of privatization, particularly moving ahead with Czech Telekom and Unipetrol, is equally important. Pockets of the economy where restructuring is at an early stage also need attention. In particular, Czech Railways remains a sizable potential drain on the budget and improvements in its efficiency should be pursued vigorously.

16. **Rising unemployment during the last year has heightened the urgency of measures to ensure flexibility of the labor market.** Much of the increase is undoubtedly cyclical, but structural factors are also at work. And, in some other transition countries similar trends began a cycle of distressingly high and persistent unemployment rates. It is important to examine key aspects of the labor market now to prevent the emergence of long-term problems. Structures of unemployment benefits and social assistance need to be tailored to help the truly needy but not demotivate job search. For restructuring enterprises that are downsizing, the state must balance the costs and benefits of early retirement/ severance payments and retraining/ job placement assistance. Plans for reducing impediments to labor mobility must move ahead, even if, as in the case of rent controls, they could involve fiscal costs. And making room to reduce non-wage labor costs, a persistent drag on labor demand, should be a medium term fiscal objective. Such measures will be key to preserving the current high labor force participation rate—a major strength for the Czech Republic as it strives to secure robust growth and provide for an aging population.

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In conclusion we would like to thank all our interlocutors, in both the private and public sectors, for their warm welcome and generous cooperation.