CZECH REPUBLIC

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

April 19, 2012

KEY ISSUES

Context. The recovery stalled in the second half of 2011 mainly because of deteriorating external conditions. With the euro area recession constraining Czech exports and affecting consumer and business sentiment, economic activity is expected to remain flat in 2012 and gradually pick up in 2013. Risks are to the downside and closely related to euro area developments.

Fiscal policy. The authorities are committed to fiscal consolidation and meeting the headline deficit targets in 2012–13. They are planning additional procyclical measures under the weakening growth outlook. With public debt at 41.5 percent of GDP, the Czech Republic has the fiscal space to let automatic stabilizers work; in staff's view, this is a preferable policy option. After consistent progress in tackling medium-term fiscal challenges during 2011, the authorities are revamping the fiscal framework and planning to enshrine a fiscal rule in legislation.

Monetary policy. With the policy rate at 0.75 percent, monetary conditions are appropriately supportive of economic activity. However, with inflation expected to be at target next year, risks tilted to the downside, and fiscal policy constrained, there is merit in adopting an easing bias.

Financial sector. Financial system stress in the euro area could spill over to otherwise sound Czech banks via the extensive parent-subsidiary relationships, despite being, on average, net creditors to their parents. To mitigate the spillover risks, the CNB has enhanced bank reporting requirements, intensified monitoring of transactions, and begun implementing recommendations of the recent FSAP mission.

Structural reforms. The government adopted a comprehensive strategy to boost potential growth. It includes infrastructure development, strengthening institution and governance, reforming education sector, increasing labor market flexibility, and improving business climate. The challenge now is implementation.

Approved By
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Mission dates: February 15–27, 2012.

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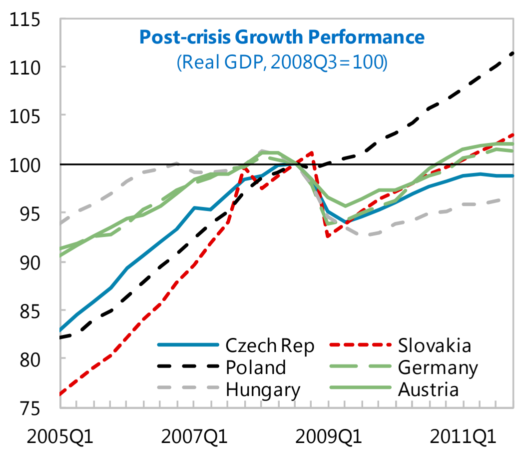
CONTEXT

A. Recent Developments

1. **The post-crisis recovery stalled in the second half of 2011 as exports lost momentum**. The expansion since the 2009 recession was almost exclusively driven by exports, whereas domestic demand stagnated and currently stands about 7 percent below its peak. Labor market improvement has been weak and a moderate output gap remains. As export growth slowed, real GDP declined in the last two quarters of 2011, albeit marginally. As a result, GDP growth for the whole year declined to 1.7 percent from 2.7 percent in 2010.



2. **Inflation has risen and was above the target at end-2011, despite subdued demand conditions.** Inflation hovered slightly below the 2 percent target during most of 2011, but increased towards the end of the year and spiked to 3.7 percent in early 2012, buoyed by the one-off impact of the VAT adjustment and food and energy prices. Real wages increased by a modest ¼ percent in 2011, implying largely stable unit labor costs.

Main Indicators

	2011Q1	2011Q2	2011Q3	2011Q4	Latest obs.	Date
Real GDP (SA, QoQ)	0.5	0.3	-0.1	-0.1	...	...
Domestic Demand (SA, QoQ)	-1.5	0.9	1.1	-2.7	...	...
Net exports (contribution to growth, QoQ)	1.8	-0.5	-1.1	2.4	...	...
Industrial production (QoQ, SA)	2.2	0.8	-0.6	1.5	-0.5	Feb-12
Inflation (same period prev. year)	1.7	1.8	1.7	2.4	3.7	Feb-12
Real wage (percent year-over-year)	0.5	0.5	0.6	-0.4	...	...
Unemployment (percent)	6.9	6.8	6.6	6.5	...	...
Exchange Rate (CZK per EUR, eop)	24.5	24.3	24.8	25.8	24.8	28-Mar
10 year bond yield (eop)	4.1	3.8	3.0	3.6	3.5	28-Mar

Source: Haver

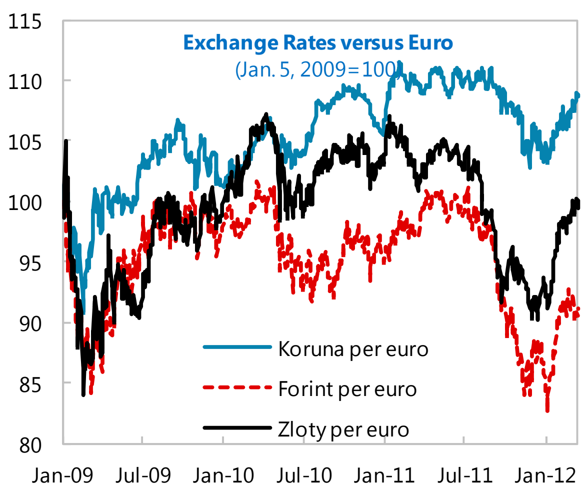
3. **The external current account deficit has remained contained.** The combination of robust export performance and restrained imports kept the external deficit unchanged from the previous year at 3 percent of GDP in 2011. The trade surplus increased by about 1 percent of GDP. This was largely offset by an increase in the income deficit, which reflects mostly accrued profits on the existing stock of inward direct investment and reached a record 7.3 percent of GDP. Financing of the current account deficit has not been an issue, with two thirds covered by direct investment, mainly comprising retained earnings of foreign-owned firms.

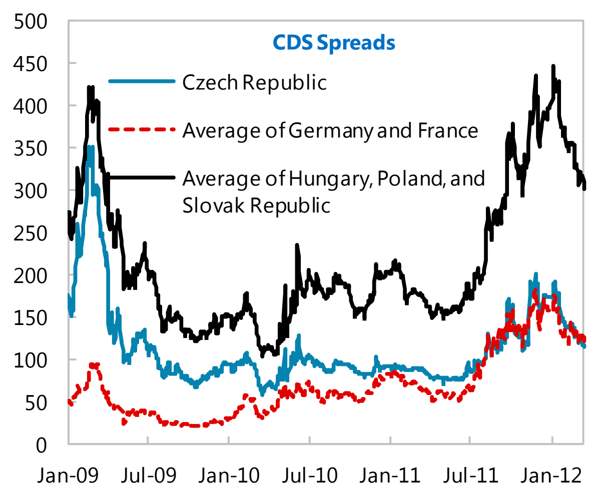
4. **The fiscal consolidation has continued apace.** The overall deficit in 2011 is estimated at 3.8 percent of GDP, better than previous year's 4.8 percent. The structural balance also improved by about one percentage point, mainly reflecting expenditure measures such as reductions in the central government wage bill and better targeting of social assistance. The public debt to GDP ratio at 41.5 percent at end-2011 remains manageable and attests to a strong fiscal position. Policies continue to be geared towards additional structural consolidation with a 0.8 percent of GDP improvement

planned for 2012, led by a VAT adjustment and expenditure restraint.

5. Monetary conditions have been appropriately supportive of economic activity. The policy rate was cut aggressively during the 2009 crisis, and has remained at 0.75 percent since May 2010. Despite the recent spike in inflation, expectations remain well-contained, while the yield curve is consistent with a stable policy rate in the next few months. The floating exchange rate remains the main shock absorber. The koruna traded in line with the currencies of neighboring countries in 2011, albeit with lower volatility, and depreciated moderately during the fourth quarter of last year, before recovering in 2012.

6. Heightened global risk aversion has not led to dislocations in domestic markets. The sovereign risk premium increased somewhat in the second half of 2011, but remained well below the highs seen during the 2009 crisis, and compares favorably with regional peers as well as most euro area countries. Reflecting the strong fiscal position, long-term government bond yields in local currency have remained below 4.5 percent even during the episode of global risk aversion in late 2011, and have averaged 3.5 percent in March.





B. Outlook and Risks

7. Economic activity is expected to remain flat in 2012 and gradually gain momentum in 2013. The projected recession in the euro area will constrain exports in 2012. Low confidence indicators, coupled with the impact of fiscal consolidation, suggest that domestic demand will remain anemic in the short run. Unemployment is expected to increase marginally, as the output gap widens somewhat. As external conditions, in particular in the euro area, improve from the second half of 2012, activity is expected to pick up, with a balanced composition. Improving external demand will be accompanied by better confidence which will underpin a moderate domestic demand recovery. Inflation is forecast to average slightly above 3 percent in 2012, but below the 2 percent target in 2013. The current account deficit will remain well-contained.

8. The main risks are spillovers from the euro area. Thanks to sound policies and strong fundamentals, the Czech economy appears well positioned to withstand most downside risks (Annex I, Risk Assessment Matrix). However, the close integration with the euro area implies a high risk of spillovers via trade and bank channels. A deeper recession in the euro area and a decline of foreign demand would further depress the export dependent economy (exports to the EU accounted for about 83 percent of all exports and 59 percent of Czech GDP in the last two years). A potential intensification of the sovereign debt crisis in Europe also entails a risk of abrupt deleveraging by (or failures in) euro area banks, which could adversely affect domestic credit conditions and the health of the banking sector at large through parent-subsidiary relationships. Other risks include commodity price shocks and the real estate market cycle.

POLICY DISCUSSIONS

Discussions centered on the appropriate policies to address medium-term fiscal challenges, to ensure financial stability amid challenging external conditions, to safeguard the successful monetary policy framework while keeping policy flexibility, and to enhance the growth potential

Box 1. The Authorities' Policies and Past IMF Policy Recommendations

The policies implemented in 2011 were broadly consistent with previous IMF advice. In particular, significant progress in reaching medium-term fiscal targets was achieved, while the pension reform helped address longer-term challenges.

Key Recommendations	Implemented Policies
Define additional fiscal consolidation measures, including structural savings in expenditures.	Laws on the unification of VAT, as well as pension, healthcare, and social benefits reforms were passed.
Maintain accommodative monetary policy in the face of economic slack.	Policy rates have been maintained at historically low levels.
Pursue productivity enhancing structural reforms.	The government adopted a strategy for enhancing international competiveness.
Continue to monitor risks to the banking system from credit portfolios and foreign parents.	Monitoring of transactions with foreign parent banks was intensifed.

A. Fiscal Policy

9. Since the last Article IV consultation, significant progress has been made in tackling medium-term fiscal challenges and improving the structural balance. During the crisis and its aftermath, the Czech economy experienced a 2.7 percent of GDP increase in the structural fiscal deficit and a 13½ percent of GDP public debt spike from admittedly low levels. Policies since 2010 have aimed to address these developments through higher VAT and excise rates, social assistance reforms, and changes to the pension system, as well as restraint of current expenditure (Box 2). With these policies, the authorities achieved a sizable reduction of the fiscal deficit in 2011, while they remain committed to meeting the general government headline deficit target of below 3 percent of GDP in 2013, as agreed with the European Commission (EC) in the context of the Excessive Deficit Procedure (EDP). As an intermediate step towards this goal, the authorities intend to reduce the headline deficit to 3.5 percent in 2012.

10. However, the economic outlook has weakened, requiring additional measures to counter deteriorating revenue prospects. Since the 2012 budget was formulated based on a more favorable outlook, the authorities are increasingly concerned about missing the fiscal target. In order to make up for possible revenue shortfalls, they announced an expenditure freeze in late February, which would yield an improvement of 0.6 percent of GDP in the 2012 budget result. They intend to reassess the necessary amounts later in the year.

General Government Balance and Debt: 2010-13
(Percent of GDP, unless otherwise noted)

	2010	2011	2012	2013
	Actual	Prelim.	Staff proj.	
General government balance	-4.8	-3.8	-3.5	-3.4
Structural balance	-3.9	-3.1	-2.3	-2.2
Real GDP growth (percent)	2.7	1.7	0.1	2.1
General government debt	37.6	41.5	43.9	45.4
Memorandum				
General government balance (budget target) 1/	-5.3	-4.6	-3.5	-2.9

1/ From the corresponding year's budget law, except 2013, which is from the 2012 budget.
Source: Czech Republic authorities; and IMF staff projections

11. Staff argued that procyclical tightening in addition to the already ambitious consolidation would unnecessarily undermine short-term growth, and recommended letting automatic stabilizers operate fully. Staff agreed on the need for further gradual structural consolidation, but argued that the Czech Republic has the fiscal space to allow automatic stabilizers to work around the baseline outlined in the medium-term budget framework. Under staff projections, the Czech Republic will still be able to meet the budget target in 2012 without further expenditure cuts. Staff recommended, and would have preferred, letting the 2012 budget be executed as is, even if this would result in missing the target. Staff also argued that, if the outlook worsens significantly, the authorities should consider re-pacing the structural consolidation. Of course, this would depend on the continuation of benign financing conditions and any changes should be clearly communicated to the public and carefully fitted into the context of the European Union (EU) commitments.

12. While mindful of staff arguments, the authorities disagreed and considered adhering to preannounced targets as necessary based on financial risks and political commitments. They argued that the fiscal multiplier is very small, given a large demand leakage to imports—a view shared by the staff. More importantly, they stressed that reducing the fiscal deficit below 3 percent in 2013 as originally agreed with EU to exit the EDP, and therefore meeting the 2012 target midway, was critically important for preserving market confidence and keeping bond yields low in a challenging environment. The authorities also noted that the current government had been elected on a platform of fiscal rectitude and the long-term sustainability of public finances, and not meeting the headline targets could be construed as going against these commitments.

13. Consolidation is set to continue in the medium term. The government policy statement of 2010 envisaged a balanced budget in 2016. In this context, the authorities are considering new additional measures in 2013 and 2014, mainly on the revenue side. These include further adjustment of the VAT rates and a personal income tax increase. Staff considered that if the defined contribution component of the pension system (the second pillar) is introduced as planned in 2013 with associated revenue shortfalls for the budget (Box 2), the unchanged nominal target defined by the EDP could imply an overly tight fiscal stance that year constituting a total structural adjustment of 0.5 percent of GDP. Authorities took notice, but noted the need to weigh the short-term impact against the longer-term benefits of instituting the second pillar, e.g. giving workers more control over their retirement plans.

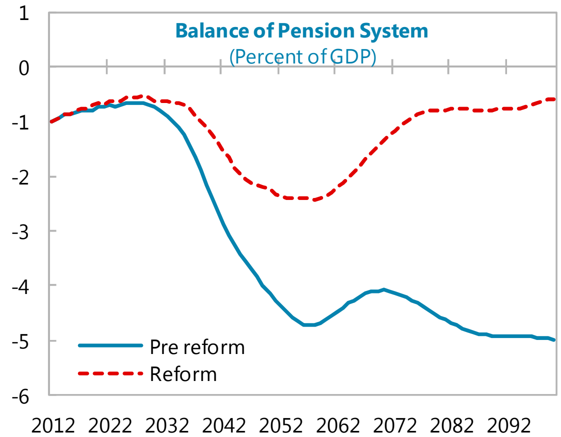
Measures under consideration (2012-14)	Estimates of savings (percent of GDP)
Readjusting VAT rates	0.35 - 0.45
Introducing a new PIT bracket for high incomes	0.08 - 0.10
Increase in PIT rate	0.30 - 0.40
Introducing a carbon tax	0.05 - 0.10
Temporarily change in pension indexation formula	0.30 - 0.50

Source: Authorities' plans and estimates.

14. The authorities are revamping the fiscal policy framework in the context of the new Stability and Growth Pact (SGP). The authorities are considering various options for a fiscal rule to be enshrined in the constitution. Staff suggested a structural fiscal balance rule for the general government with a debt brake in the form of compensatory corrections for ex post deviations from the target. Such a rule would comprehensively guide fiscal policy and be fully consistent with the new SGP (Box 3). The proposal currently under consideration by the government would serve the same broad objectives, though with additional complexity and fragmentation that could complicate an effective implementation of the rules. A fiscal council, also under consideration, would contribute to the transparency and accountability of the framework. The authorities' strong commitment to long-term fiscal sustainability does not conflict with what is stipulated in the "Fiscal Compact", which the Czech Republic has not signed due to legal considerations, specifically the reference to EU institutions in a treaty outside the EU framework.

Box 2. Fiscal Implications of the Pension Reform

Parametric changes in the pension system have improved its sustainability considerably. The reform adopted in 2011 increased the statutory retirement age, reduced disability pensions, curtailed the rate of progressivity in the assessment of contributions, and extended the insurance period required for accessing a full pension. These and other changes to the pay-as-you-go (PAYG) system have cut its long-term deficits from 4-5 percent to around 2 percent of GDP in 2040-60, and to less than 1 percent of GDP from 2070.



Source: Czech authorities.

The reform will also introduce a voluntary defined-contribution "second pillar" of the pension system. For those who volunteer to participate, 3 percentage points of the current public social security contribution of 28 percent of wages will be diverted to personal accounts, implying lower budgetary revenues. Each insured person will have to add to this an additional 2 percentage points from his/her own funds. The fiscal impact of this in terms of the PAYG deficit is estimated to be CZK 10 billion in 2013 (about ¼ percent of GDP), and additional CZK 5 billion for both 2014 and 2015, although there is significant uncertainty around these estimates as they depend on behavioral assumptions.

Box 3. The Current Fiscal Framework of the Czech Republic and Options for a Fiscal Rule

The current fiscal framework contains several standard elements necessary for effective medium-term planning, but it also has some weaknesses. The medium-term budget framework (MTBF), which is a three-year rolling budget for the general government, is the main source of guidance for the annual budget preparation. Through the MTBF, the nominal expenditure ceilings for the central government budget and six state funds are derived. While the expenditure ceilings do not cover local governments and social security funds explicitly, local governments are usually expected to prepare a balanced budget. However, the framework has important weaknesses, notably lack of a durable fiscal anchor, weak enforcement and independent monitoring, and limited coverage.

The authorities are in the process of revamping the fiscal framework. The authorities' ongoing discussion on the overhaul of the fiscal framework, which gained urgency from the new EC directive regarding the public finances, provides a good opportunity to introduce an effective mechanism to safeguard fiscal sustainability, to mitigate the procyclical bias of fiscal policy, and to ensure compliance with the new EC fiscal framework.

Staff views a structural balance rule with a debt brake and an escape clause as an appropriate option for the Czech Republic. This rule would help achieve the twin goals of fiscal policy by striking a balance between fiscal sustainability and cyclical flexibility. Under this rule, fiscal sustainability will be ensured through a close alignment of the medium-term fiscal target with the ultimate objective of debt stabilization, as well as the automatic correction mechanism (debt brake) for past unanticipated deviations. The structural balance rule can also allow full operation of automatic stabilizers, and it would be fully in line with the supranational rules that the Czech Republic is committed to. While estimating the output gap in a transparent and robust manner will be the key challenge in implementing this rule, the strong institutional and analytical capacity of the Czech government would support this.

The Ministry of Finance currently considers a framework with multiple targets, all of which will be enshrined in a constitutional act. The current proposal under consideration envisages imposing separate numerical constraints for general government, central government, local government, and health insurance funds. While these rules appear to be sensible individually, there is a significant risk of a budget fragmentation, by which rules could complicate the annual budget process with mutually inconsistent targets. The complexity of the proposal would also be detrimental to the transparency and accountability of the fiscal framework.

The effective implementation of the fiscal rule will also depend on its transparency and accountability. In this regard, broader reforms are highly warranted, including to provide stronger legislative support, effective monitoring and enforcement mechanism, and clear understanding of roles and responsibilities. Specifically, a constitutional amendment to outline the principles of debt stabilization, together with an introduction of new ordinary laws that define the operational details of the fiscal rule, would confer more stability to the fiscal framework. A borrowing constraint on local government budget would be useful to make local fiscal policy fully in line with the overall national goals. A fiscal council that monitors compliance with the rule and produces independent forecasts would also contribute to greater transparency and accountability of the framework.

B. Monetary Policy

15. **Historically low rates remain appropriate in the context of the forward-looking inflation targeting framework and the negative output gap, and an easing bias may usefully complement this stance. Inflation is projected to overshoot the inflation target of 2 percent in 2012 and reach 3.5 percent.** However, this is mostly

due to the VAT adjustment, which is beyond monetary policy's influence. Commodity prices are the main source of inflation in the period ahead. There are no signs of demand-side inflation pressures, and wage growth is subdued against still high unemployment. Medium-run inflation expectations have continued to converge towards the target. Staff projects that inflation will fall slightly below the target in 2013, and euro area developments and fiscal tightening highlight further downside risks. Against this background staff sees merit in shifting to an easing bias to sustain the benefits of a strongly expansionary monetary policy.

16. **The Czech National Bank (CNB) sees risks to inflation as broadly balanced and maintains a neutral bias.** The consensus view of the CNB at the time of the discussions was that the current high rate of inflation and the koruna posed upside risks, while the negative output gap posed downside risks. Individual Board members saw the balance of risks in slightly different shades. Since the discussions, the koruna has appreciated and is no longer seen as an upside risk for inflation, but commodity prices have risen rapidly in the same period to emerge as a short-term inflationary factor. The authorities agreed that there are no emerging macroprudential risks associated with the low rates, as lending remains subdued across categories and asset prices remain within historical norms. The authorities reiterated the benefits of a flexible policy stance, including the possibility of further easing if downside risks intensify.

17. **Given the low policy rate, staff discussed with the authorities options for unconventional policy measures in the context of disinflationary adverse scenarios.** The options include a commitment to keeping policy rates low for an extended period, quantitative easing, and intervening in the foreign exchange market. Staff argued that the principal considerations in choosing among the instruments are their effectiveness and the ease of return to the standard inflation targeting framework, which served the economy very well. A systemic liquidity surplus in the banking system and already low long-term rates suggest that the first two tools are likely to be limited in effectiveness. Given the importance of the exchange rate channel for the economy, staff suggested the possible use of regular and preannounced foreign exchange interventions, in particular, in case the exchange rate fails to fully respond to negative shocks. Reserves are adequate but not high by the standard metrics and can accommodate such interventions. Unsterilized interventions can both expand the monetary base and limit currency appreciation. The authorities broadly agreed with these considerations, while noting that they saw the likelihood of such a disinflationary environment rather low.

18. **The free floating exchange rate regime continues to function as a factor of support for macroeconomic stability.** The exchange rate has functioned as the main absorber of external shocks, and together with limited foreign exchange mismatches, it has facilitated the implementation of an independent and effective monetary policy. Staff and the authorities agreed that the koruna exchange rate is broadly in line with its fundamentals. This is confirmed by a stable market share in world markets, a moderate current account deficit, a relative price level that is consistent with the country's income level, as well as the estimates based on the CGER methodology (Box 4). The government has not announced a target date for euro adoption.

Box 4. External Sector Assessment

- **The koruna has continued on a long-term appreciation trend.** Following the large swing in 2008-09, the koruna has sustained a moderate appreciation trend in both nominal and real terms, with fluctuations around this path coming from global risk sentiment. ULC-based real exchange rate growth has been more subdued suggesting that a large part of the appreciation is absorbed by favorable wage productivity dynamics.

- **Despite the long-term appreciation trend, Czech Republic's price level seems to be in line with what would be expected given its income level.**

- **Exports grew at a sufficient pace to keep market share stable in the last three years.** Following earlier robust gains, market share of Czech exports has broadly stabilized in the last three years.

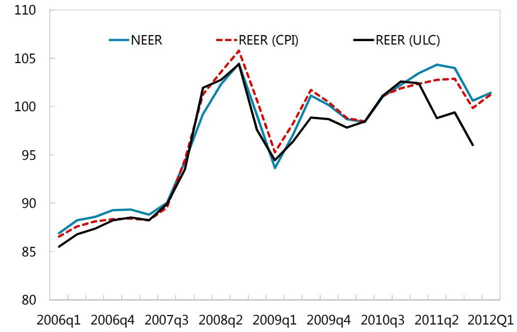
- **Persistent current account deficits have led to a deteriorating net foreign asset position.** Despite consistent trade surpluses, large income transfers on the stock of direct investment lead to a moderate current account deficit. In recent years, NFA has deteriorated under the influence of current account deficits, but not at a pace or scale that would suggest competitiveness problems. In addition, NFA excluding the direct investment stocks is positive, which mitigates the vulnerabilities associated with the external position.

- **Staff estimates based on the CGER methodology suggest the koruna is broadly around equilibrium value as well.**

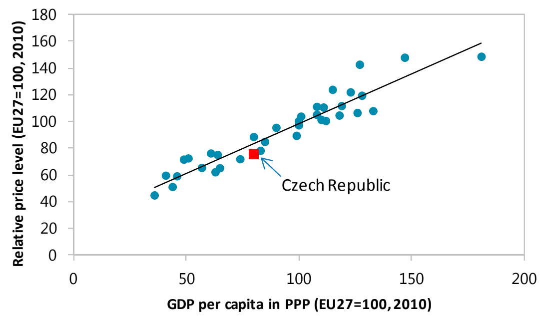
Estimates of REER Misalignment, 2011

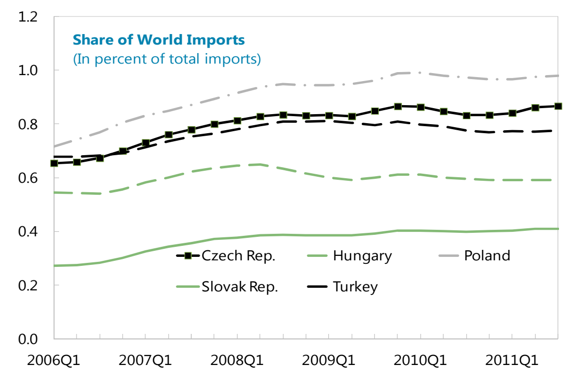
Macroeconomic Balance Approach	-3%
External Sustainability Approach	-5%
Equilibrium Real Exchange Rate Approach	9%
Overall Assessment (Fall 2011)	About 0%

Source: IMF staff estimates.

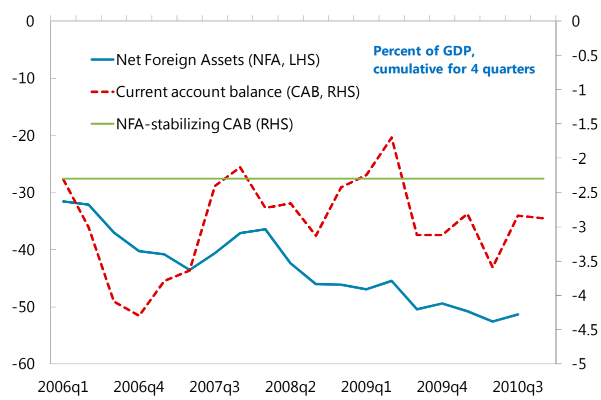


Source: Haver, and IMF staff estimates.





Sources: IMF Direction of Trade Statistics



Sources: CNB and IMF staff estimates

C. Financial Sector

19. Czech banks are highly profitable and self-financed with low loan-to-deposit ratios and strong capital and liquidity buffers. The banks can comfortably satisfy current and future supervisory standards, specifically Basel III and CRD4. Non-performing loans have increased after the 2009 crisis, but remain manageable at 5.5 percent. Subdued credit growth is mostly due to prudence in both demand and supply sides of the credit market. Consumers and corporates are not overly indebted by international comparison and banks continue to expand in profitable lending activities, all of which bodes well for future deepening of the financial sector. Recent events in the euro area financial system have not changed this broad picture. Domestic credit growth increased to about 5½ percent in 2011, lending margins declined, and loan growth outpaced deposit growth, suggesting little deleveraging. Moreover, comfortable liquidity and very limited currency mismatches in final borrowers' balance sheets suggest that the system is robust. Sharp property price falls could pose a risk, but the recent moderation of price declines and the fact that a large part of the increase in recent years is undone suggest the likelihood of such an outcome is low. An increase in new mortgage loan volumes is also supportive of the real estate market.

Key Characteristics of the Czech Banking System

	2008	2009	2010	2011
Number of banks	37	39	41	44
of which foreign controlled	30	32	33	36
Assets (percent of GDP)	105.1	109.5	111.0	117.5
of which large banks	60.5	63.2	64.4	67.3
Client loans to deposits (percent)	80.9	77.8	78.0	79.4
of which large banks	71.3	66.7	65.6	68.6
Net interest income (percent of assets)	2.49	2.51	2.52	2.53

Source: Czech National Bank

Financial Soundness Indicators
(percent)

	2008	2009	2010	Sep-11
Regulatory capital to risk-w eighted assets	11.6	14.0	15.3	15.3
Return on equity	20.7	26.4	19.7	18.7
Liquid assets to total assets	25.8	27.1	29.4	30.5
Provisions to nonperforming loans	57.4	49.7	47.9	49.4
Nonperforming loans to total gross loans	2.8	4.6	5.4	5.5

Source: Czech National Bank

20. Despite solid fundamentals, the Czech financial system is confronted with a number of risks mainly from external spillovers. With banks largely owned by euro area parent groups, the main risks to the sector stem from negative developments in the euro area, which would affect the Czech subsidiaries. The Czech banking system has a net external creditor position, which reduces the risks of rapid deleveraging[1]. Group-wide capital scarcity could set a higher threshold for new lending in terms of profitability and risk taking. Funneling capital and liquidity out from the Czech subsidiaries to parent group banks is another plausible scenario, but only under extreme stress and uncertainty, as the stakes in the Czech subsidiaries carry significant value on a stand-alone basis. The CNB is aware of these risks, and has tightened the reporting requirements on transactions between parents and subsidiaries. A range of stress tests run during the FSAP mission found that the system would be resilient against these key risks, using simulated shocks including a large drop in GDP (about twice the magnitude of the 2009 crisis), a protracted stagnation, and failures in parent banks. Only when a large GDP drop and

[1] The BIS statistics indicate that foreign banks have a small net creditor position vis-a-vis the Czech banks of about 3% of Czech banks' balance sheet. However, this arises mainly from a limited geographic coverage.

parent bank failures[2] are combined, does the system-wide capitalization fall below the regulatory limit—a shortfall of about 2 percent of GDP.

21. The authorities are aware of these risks, and have adequate facilities to address them. In the last few years, the CNB has strengthened macroprudential supervision by setting up a separate department and allocating more resources as a first defense against systemic risks, including external spillovers. The authorities have strengthened the liquidity provision framework since the 2009 crisis with a standing collateralized liquidity window, and stand ready to take bank-specific prudential measures, should the need arise.

22. The FSAP exercise confirmed the underlying soundness of the Czech financial system and institutional framework, but made several recommendations aimed at further improvements. Staff found the CNB to be an effective integrated supervisor overall, but highlighted the need for more intensive supervision. It also recommended operationalizing the bank resolution framework, strengthening the macro-prudential policy framework to ensure that warning signals would be translated into policy actions quickly, and broadening the mandate of the CNB (Box 5).

23. The authorities welcomed the mission's recommendations, and have already begun implementation in many areas. The amendments to the CNB Law broadening the CNB's mandate have been sent to the parliament and are expected to be adopted later in 2012. Legal amendments regulating the activities of credit unions are also under preparation. The limit on banks' exposures to parent groups are planned to be reduced from 100 percent to 50 percent of bank capital from July 2012. Work is also ongoing to strengthen the macro-prudential policy framework and stress testing.

[2] The Czech banks have exposures to their parents equivalent to about half of their capital. Stress tests were run using an assumption of system-wide write-offs of 40 percent on these exposures.

Box 5. FSAP Main Findings and Recommendations

While the Czech financial institutions were found resilient to the effects of ongoing global crisis, it was also identified that several elements of the financial policy framework need strengthening.

CNB mandate. The legal setting for the CNB financial stability mandate should be strengthened. Elevating the financial stability mandate beyond a supporting element of achieving the price stability will establish a stronger accountability framework for all of these functions.

Prudential requirements. The decision of the CNB to introduce extraordinary reporting requirements of liquidity position and exposures between Czech banks and their foreign parents was a welcome development. In the event of a material deterioration in the condition of foreign parent banks, the CNB should consider deploying firm-specific prudential measures, such as increased capital and liquidity requirements, pre-approval of significant intra-group transactions, and reducing the intra-group limits.

Supervisory resources. The regulatory and supervisory framework was found generally sound. The assessment of the Basel Core Principles for Effective Banking Supervision noted that the regulation and supervision of banks has been markedly strengthened since the 2001 FSAP. A few weaknesses that were identified related mainly to inadequate resources of the CNB.

Macro-prudential policy framework. Several recommendations were made in order to strengthen the macro-prudential policy framework, particularly by formalizing the decision-making mechanism on macro-prudential policy issues.

Crisis management and bank resolution. Several elements of the crisis management and resolution framework need strengthening. In particular, the deposit insurance fund should be enlarged, its payout triggers should be clarified, and the use of public funds to provide exceptional support to banks should be further operationalized.

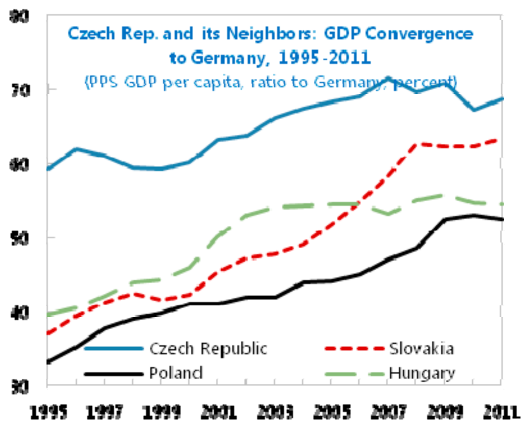
D. Structural Issues

24. Accelerating structural reforms is critical for boosting potential growth. Convergence of Czech per capita output towards Germany, an appropriate benchmark, has stalled in recent years. While it is difficult to distinguish this phenomenon from the cyclical factors at this stage, structural factors could also be playing a role. Earlier rapid convergence, underpinned by trade integration, technology transfer, and an inexpensive and skilled labor force, produced a competitive economy with a strong export-oriented manufacturing sector. However, as the economy nears the technology frontier and labor costs converge to Western European levels, it becomes more important to be proactive in seeking new growth areas while monitoring and addressing any growth bottlenecks.

25. Several areas emerge as the key priorities in that regard. International competitiveness surveys and OECD reports highlight cumbersome business regulations, problems with the education system and human capital, persistent rigidities in the labor market, technology and scientific infrastructure weaknesses, low quality of institutions and governance issues as the key obstacles to growth.

26. The government adopted a comprehensive reform strategy to address

these challenges. It sets an ambitious goal of making the Czech economy one of the 20 most competitive economies in the world by 2020. The strategy outlines concrete plans for developing infrastructure, strengthening institutions and governance, reforming the education sector, further increasing labor market flexibility, and improving the business climate (Box 6).



27. **Implementation will be a challenge.** Many line ministries are involved in the strategy, and enhancing cooperation among the ministries and providing centralized monitoring would be pivotal in implementing the reform plans. The authorities also view coordination with the corporate sector as well as universities as critical for implementation.

Box 6. Structural Reform Strategy

The reform strategy adopted by the government in September 2011 calls for result-oriented reforms and empirical evaluation of government policies. To guide the reforms, the strategy authors developed concrete proposals ("scorecards") for more than 40 projects in the nine main areas ("pillars") of the strategy. These pillars are innovation, financial markets, labor markets, education, healthcare, macroeconomics, infrastructure, institutions, and enterprise and the market for goods and services. The scorecards set time-tables and assign responsibilities for the key reform measures. Their implementation will be monitored by the inter-ministerial Competitiveness Council.

In late 2011, the government developed a new export strategy targeting diversification of products and markets. The new strategy aims to reduce the reliance on the core European markets, and limit concentration of exports in several key products and large firms. Twelve priority markets for exports have been selected, which comprise Brazil, China, India, Iraq, Kazakhstan, Mexico, Russia, Serbia, Turkey, Ukraine, the United States, and Vietnam. In parallel, the strategy calls for strengthening the export-financing institutions to support small and medium-sized exporters.

STAFF APPRAISAL

28. Since the last Article IV consultation, significant progress has been made in tackling medium-term fiscal challenges. Staff welcomes the authorities' resolute implementation of the pension reform, including the retirement age increase and other parametric changes to the PAYG system, which was accompanied by raising the preferred VAT rate from 2012 as an intermediate step towards the unification of the two rates in 2013. Continuation of pension, health, and tax reforms is important for securing long-term sustainability of the public sector.

29. Short-run fiscal policy needs to strike a balance between consolidation and avoiding an overly contractionary stance. Staff believes that letting automatic stabilizers operate fully in 2012 to accommodate any cyclically driven revenue shortfalls is appropriate. Moreover, if the outlook worsens significantly, the planned fiscal consolidation could be repaced as well, particularly in 2013. If the defined contribution component of the pension system (the second pillar) is introduced as planned in 2013 with associated revenue shortfalls for the budget, the unchanged nominal targets as defined by the EDP could imply an overly tight fiscal stance.

30. The government's plan to introduce a fiscal rule is a welcome step for safeguarding long-term sustainability. Given the current manageable level of public debt and sound institutional capacity in the Czech Republic, consideration could be given to a structural balance rule for the general government, augmented with a debt brake. Such a rule would ensure fiscal sustainability while avoiding unwarranted procyclicality, and would be consistent with the new EU fiscal framework. Other types of rules, including the one currently under consideration, may achieve the same broad objectives. However, it is essential for any rule to have an appropriately wide coverage, provide clear guidance to the annual budgeting process, and be consistent with supranational rules. An independent fiscal council would foster an effective implementation of the fiscal rule.

31. Monetary policy is appropriate, although an easing bias could be considered. Consistent implementation of the inflation targeting framework continues to serve the economy well, and inflation expectations remain well-anchored. The policy rate at 0.75 percent for almost two years coupled with market expectations for a continuation of the low rates have provided needed support to the economy without excessive risk taking in any particular financial market segment. Despite some upside risks arising from commodity prices, in view of the likely downside disinflationary effects and the fiscal policy constraints, there is a case for an easing bias.

32. With the already low policy rate, it is important to have strategies for coping with the zero-bound constraint. Given the limited room for conventional monetary policy, the use of unconventional tools may need to be contemplated for scenarios of significant undershoot of the inflation target. Key criteria in deciding among the potential actions should include effectiveness against disinflationary pressures, as well as the ease of reversing them. Given the importance of the exchange rate channel for the economy, foreign exchange interventions may be considered in this regard, in particular, in case the exchange rate fails to fully respond to negative shocks.

33. The Czech financial system has proved resilient to the effects of the global crisis, but spillover risks remain elevated. Despite slow GDP growth at home and financial strains abroad, the banks show good performance, with strong capitalization, solid profits, and ample liquidity. This resilience, which has been confirmed by the FSAP stress tests, reflects to a large extent a relatively conservative structure of bank balance sheets (particularly low loan-to-deposit ratios) and relatively low indebtedness of the corporate and household sectors. Nevertheless, the financial system is facing a number of risks, particularly related to the macroeconomic and financial developments in the euro area, where the parents of major Czech banks are based.

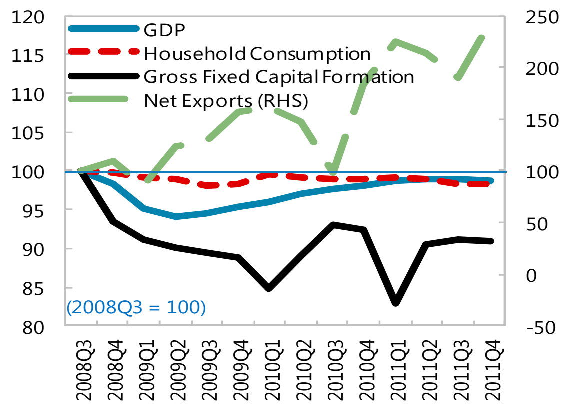
34. The authorities' efforts to strengthen the financial stability policy framework are encouraging. The CNB has already started to improve bank reporting requirements, to intensify monitoring of transactions between parents and subsidiaries, and to implement many of the FSAP recommendations. It would be important to implement all FSAP recommendations, particularly in the areas of bank supervision and crisis management.

35. Steady implementation of the structural reforms is critical to boost potential growth. The government's comprehensive reform strategy is a welcome first step for improving international competitiveness. Reinvigorating the "Competition Council" is another important step in the right direction. Implementation of these plans requires sustained efforts.

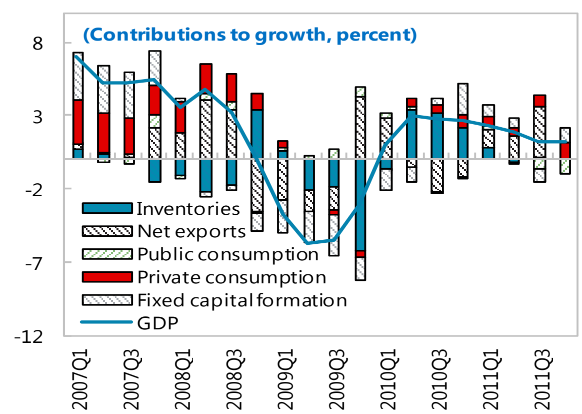
36. It is recommended that the next Article IV consultation with the Czech Republic be held on the usual 12-month cycle. The Czech Republic is an Article VIII country, and its data provision is adequate for surveillance (Informational Annex).

Figure 1. Czech Republic: Macroeconomic Developments, 2007-12

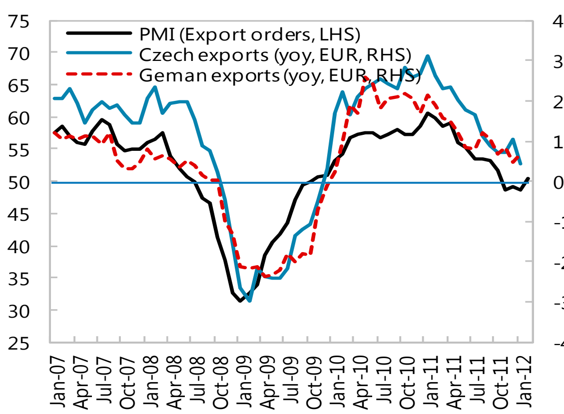
Activity has recovered to close to its pre-crisis peak, mainly thanks to net exports.



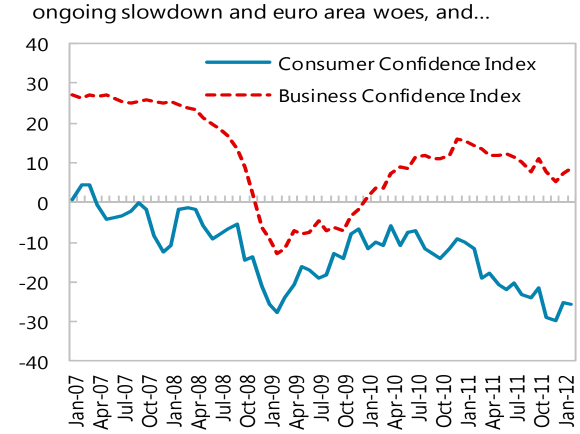
But the recovery has lost impetus, as the anemic domestic demand...



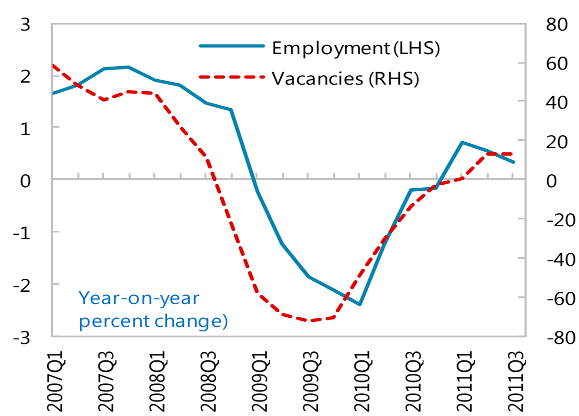
...was combined with a slowdown in exports.



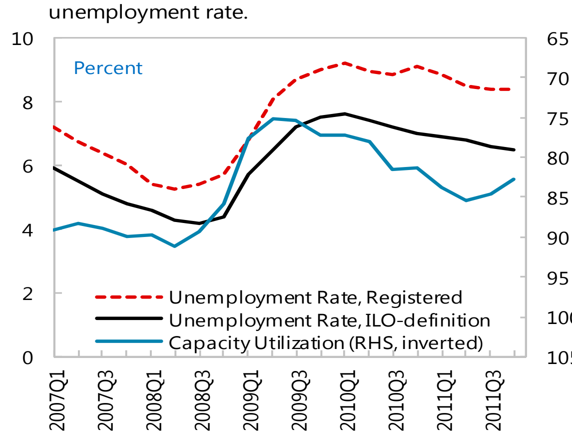
Confidence has weakened under the influence of the ongoing slowdown and euro area woes, and...



...while employment has increased slightly...

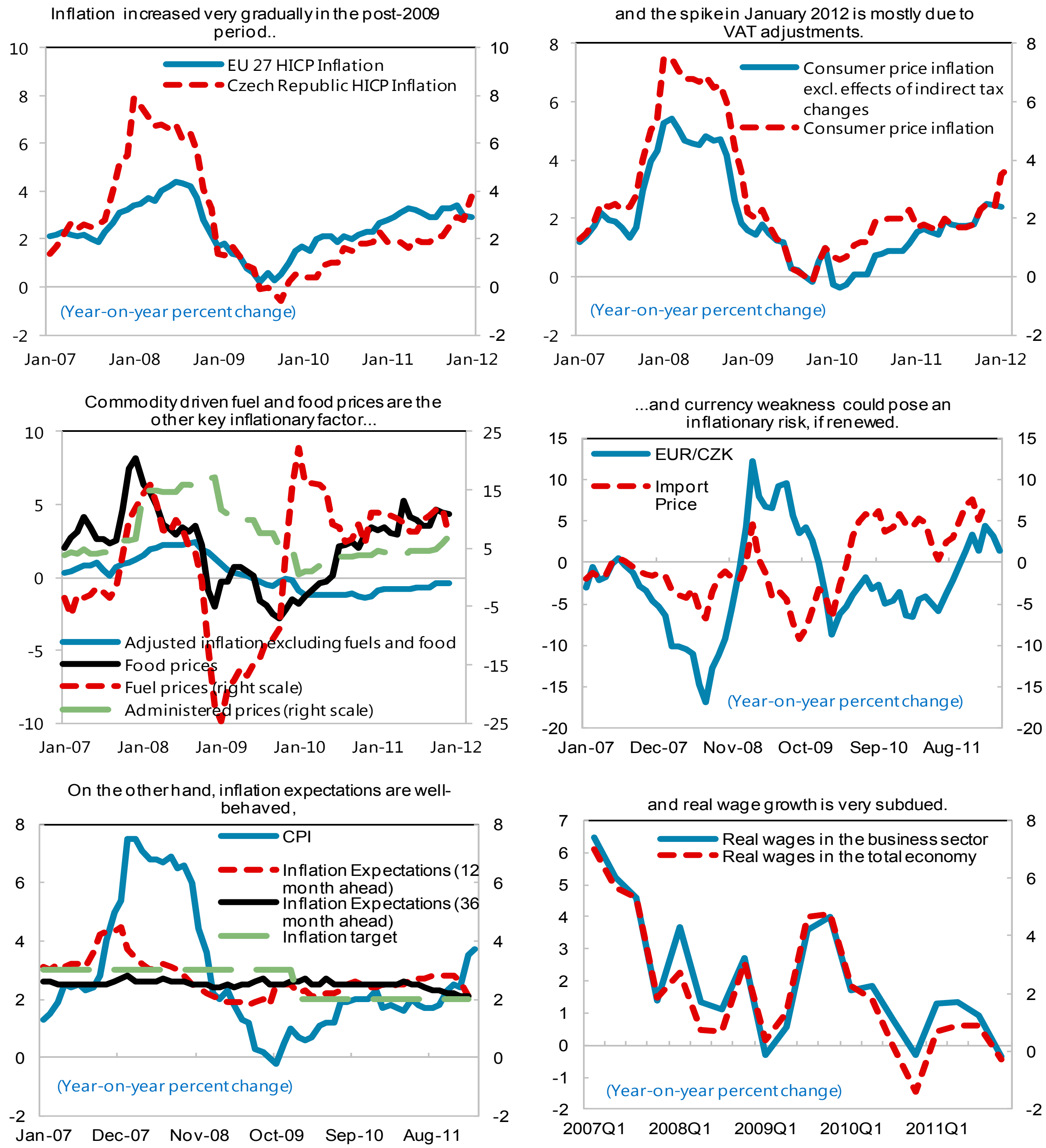


...it has made only a small dent in the unemployment rate.



Sources: HAVER, Eurostat, EMED, and IMF staff calculations.

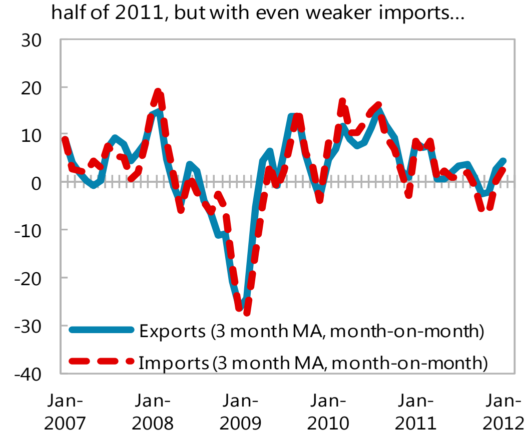
Figure 2. Czech Republic: Inflation Developments, 2007-12



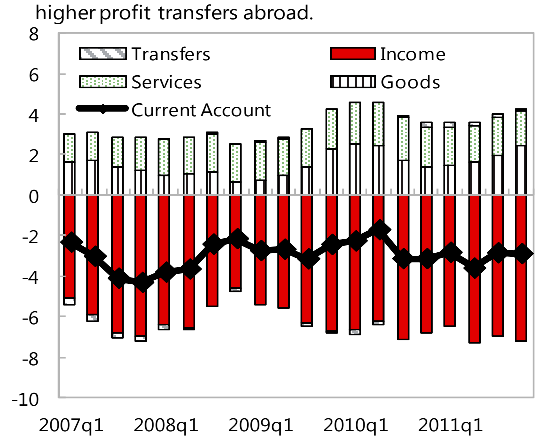
Sources: Czech Statistical Office, Czech National Bank, Haver.

Figure 3. Czech Republic: External Sector Developments, 2007-12

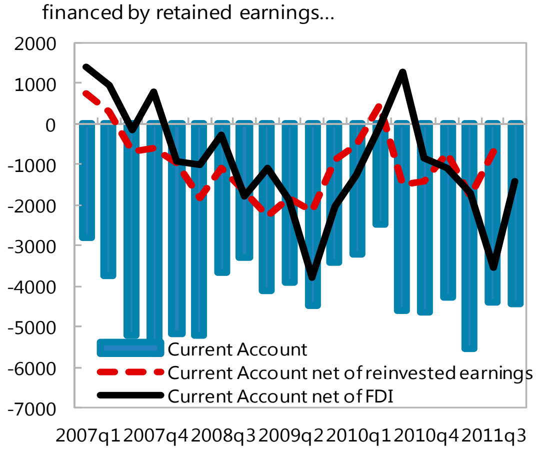
Exports slowed down significantly in the second half of 2011, but with even weaker imports...



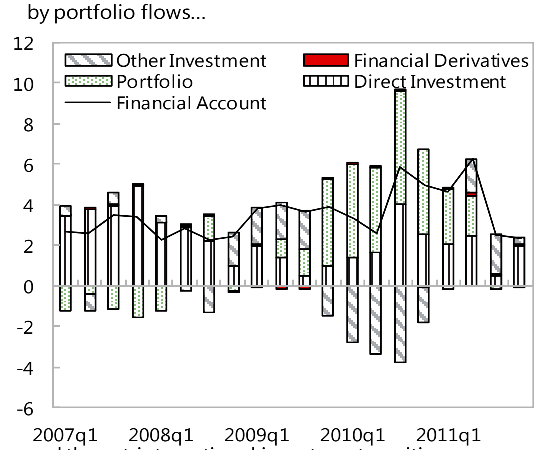
...the trade surplus increased, counterbalanced higher profit transfers abroad.



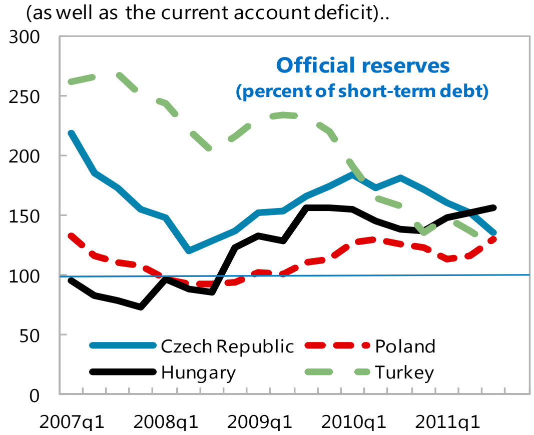
Most of the current account deficit can be financed by retained earnings...



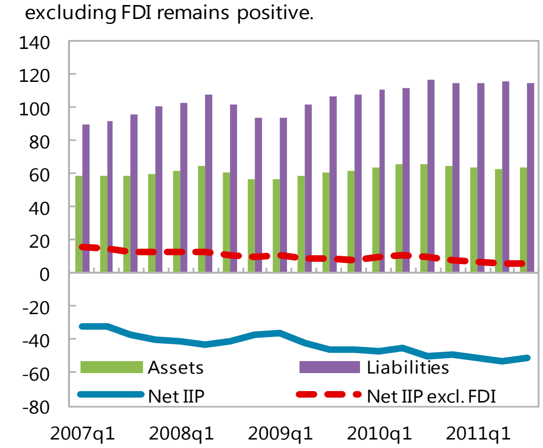
...and while capital inflows slowed in late 2011, led by portfolio flows...



...official reserves comfortably cover the short-term debt. (as well as the current account deficit)..



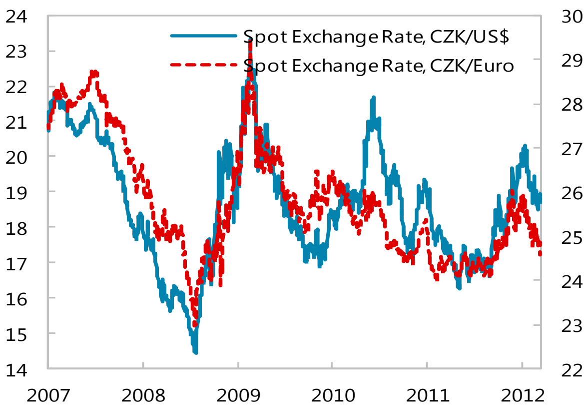
...and the net international investment position excluding FDI remains positive.



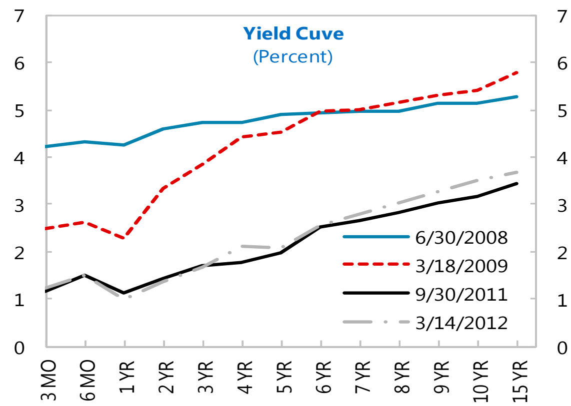
Sources: Czech Statisical Office, Czech National Bank, and IMF staff estimates.

Figure 4. Czech Republic: Financial Markets

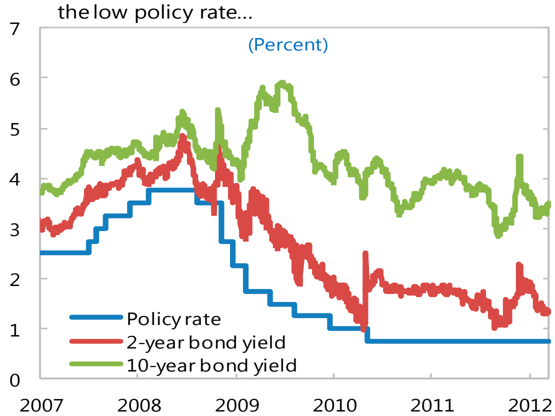
The koruna has depreciated moderately against the euro in the last six months, as risk aversion spiked...



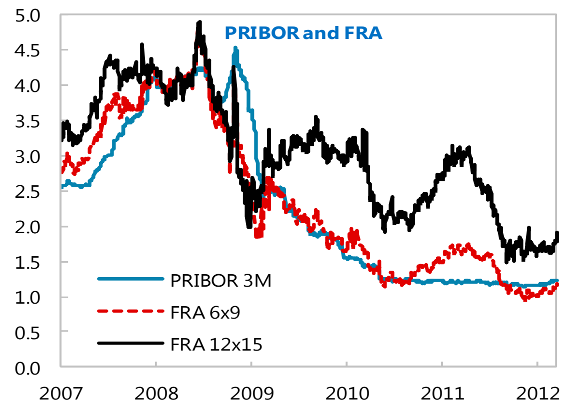
...and bond yields increased slightly from their historical lows.



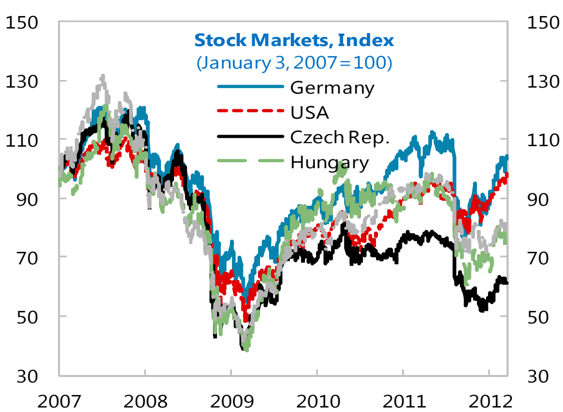
The short end of the yield curve is anchored by the low policy rate...



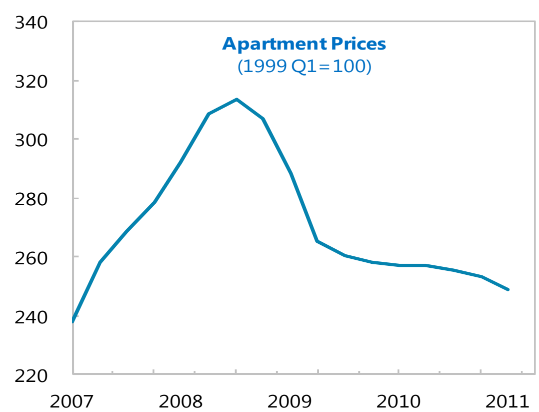
...that the markets expect to persist.



Equities have fallen sharply, but the limited size of the market ensures that wealth effects are small...



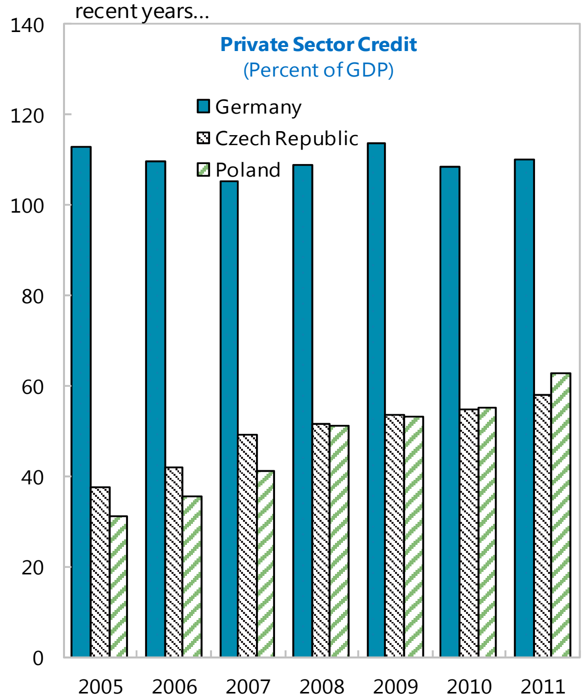
...in contrast to the keenly-watched housing, where prices continued to retreat gradually through 2011.



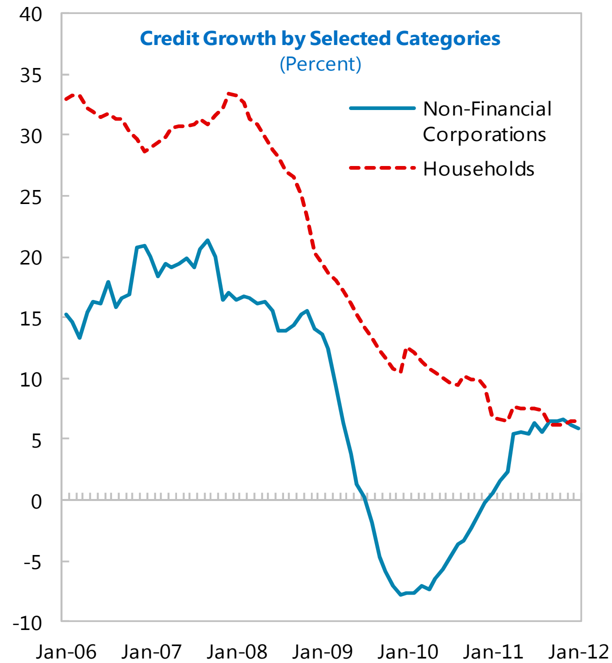
Sources: Bloomberg, Haver, and the Czech National Bank.

Figure 5. Czech Republic: Bank Credit, 2005-12

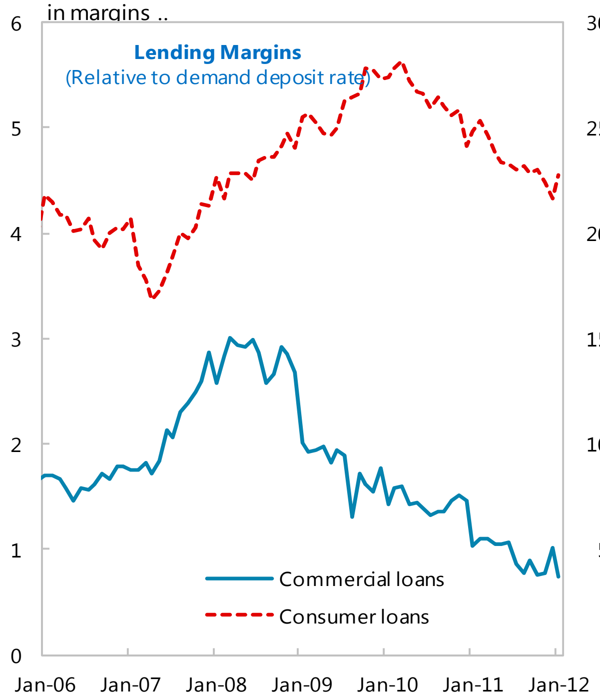
The pace of credit deepening has been very slow in recent years...



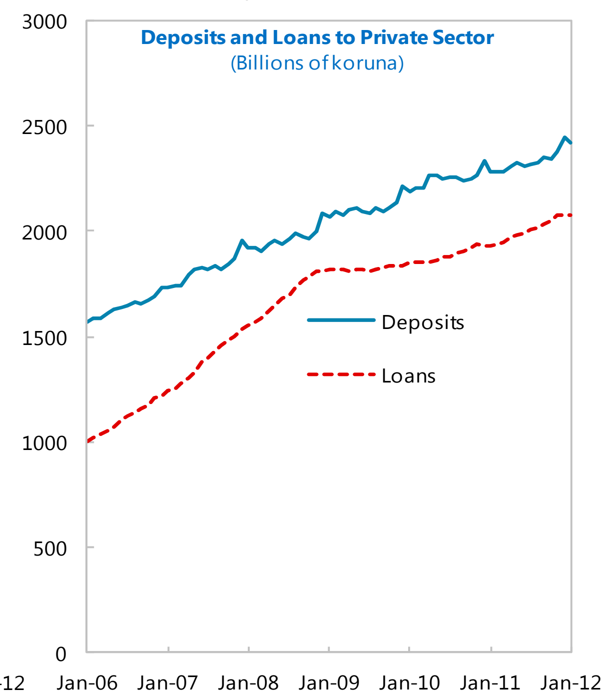
..as credit growth was negatively affected by the crisis...



There is little evidence of ongoing deleveraging in margins ..

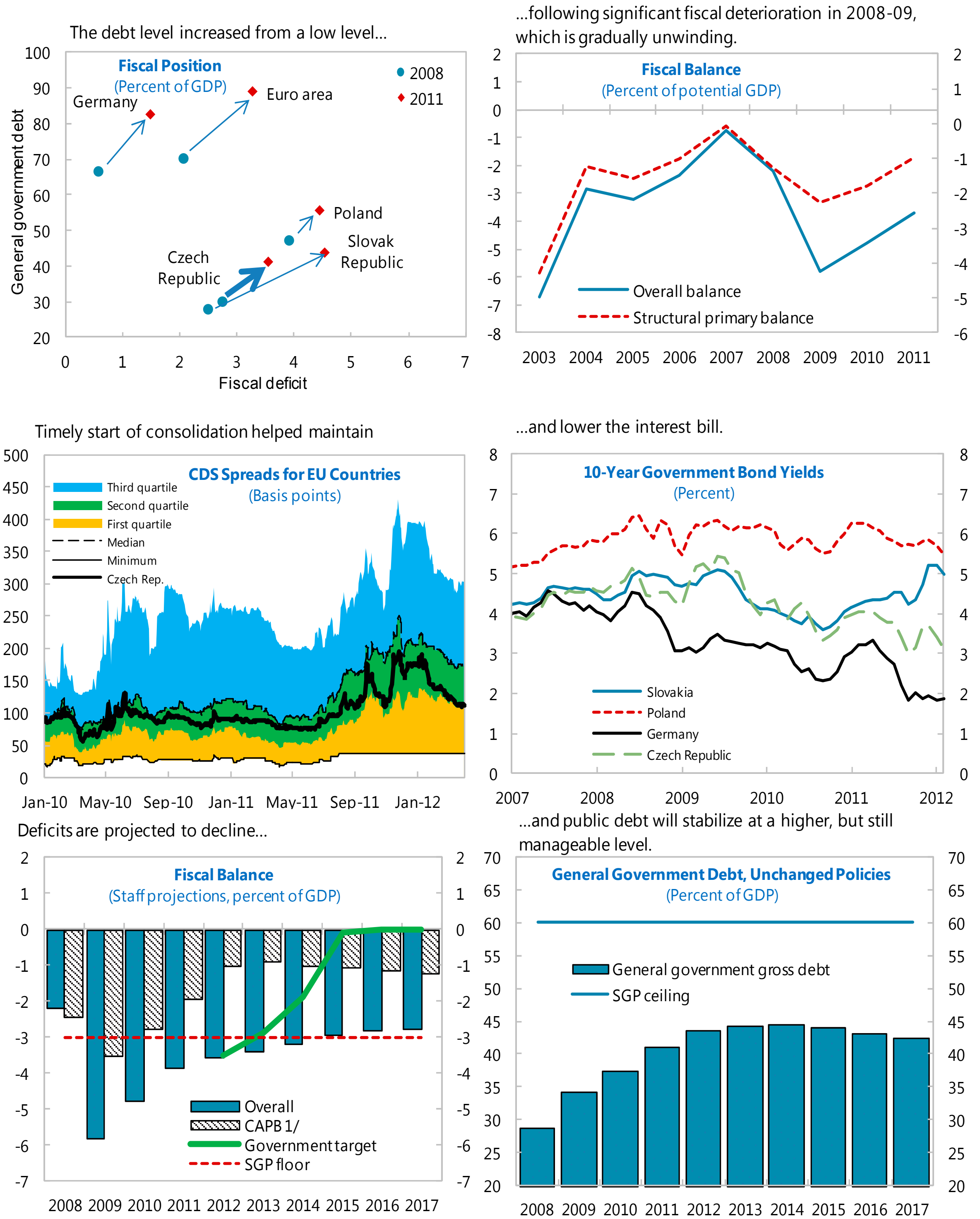


...or loan to deposit ratio.



Sources: CNB and IMF staff calculations.

Figure 6. Czech Republic: Fiscal Developments and Prospects



Sources: Eurostat; Bloomberg, and IMF staff estimates.
1/ Cyclically-adjusted primary balance.

Table 1. Czech Republic: Selected Economic Indicators, 2007-13

	2007	2008	2009	2010	2011	2012	2013
					Prelim.	Staff Proj.	
Nominal GDP (USD billions)	180.5	225.4	196.2	197.7	215.3	206.0	213.6
Population (millions)	10.3	10.4	10.5	10.5	10.5	10.6	10.6
GDP per capita (USD thousands)	17,544	21,715	18,739	18,814	20,444	19,515	20,196
Real economy (change in percent, unless stated otherwise)							
Real GDP	5.7	3.1	-4.7	2.7	1.7	0.1	2.1
Domestic demand	6.6	2.2	-5.9	2.0	-1.0	-1.4	1.4
Private consumption	4.2	2.8	-0.4	0.6	-0.5	-0.3	1.2
Investment	15.5	1.9	-20.8	5.9	-1.6	-3.7	2.7
Exports	11.2	4.0	-10.0	16.4	11.0	-1.2	6.0
Imports	12.8	2.7	-11.6	16.0	7.5	-3.2	5.7
Ouput gap (percent of potential output)	3.1	2.8	-3.6	-2.5	-1.9	-3.5	-3.2
CPI (average)	2.9	6.3	1.0	1.5	1.9	3.5	1.9
PPI (average)	4.1	4.5	-3.1	1.3	5.5	...	...
Unemployment rate (in percent)	5.3	4.4	6.7	7.3	6.7	7.0	7.4
Gross national savings (percent of GDP)	25.4	26.8	21.6	22.1	21.5	21.3	21.8
Gross domestic investments (percent of GDP)	29.8	28.9	24.0	25.1	24.5	23.4	23.7
Public finance (percent of GDP) 1/							
General government revenue	40.3	38.9	39.1	39.3	40.7	41.3	41.2
General government expenditure	41.0	41.1	44.9	44.1	44.5	44.9	44.6
Net lending / Overall balance	-0.7	-2.2	-5.8	-4.8	-3.8	-3.5	-3.4
Primary balance	0.4	-1.2	-4.6	-3.4	-2.4	-2.0	-1.8
Structural balance	-1.8	-3.2	-4.5	-3.9	-3.1	-2.3	-2.2
General government debt	28.0	28.7	34.3	37.6	41.5	43.9	45.4
Money and credit (end of year, percent change)							
Broad money (M3)	16.1	13.6	0.2	1.9	2.7	...	...
Private sector credit	26.6	16.1	0.8	3.0	5.5	...	...
Interest rates (in percent, year average)							
Three-month interbank rate	3.1	4.0	2.2	1.3	1.2	...	...
Ten-year government bond	4.3	4.6	4.7	3.7	3.5	...	...
Balance of payments (percent of GDP)							
Trade balance (goods and services)	2.9	2.7	4.3	3.4	4.2	5.0	5.2
Current account balance	-4.4	-2.1	-2.5	-3.0	-2.9	-2.1	-1.9
Gross international reserves (US$ billion)	34.9	37.0	41.6	42.5	40.3	42.9	44.9
(in months of imports of goods and services)	3.5	3.2	4.5	3.9	3.2	3.8	3.9
(in percent of short term debt, remaining maturity)	113.5	100.1	131.6	132.6	122.8	133.5	135.9
Exchange rate							
Nominal effective exchange rate (index, 2000=100)	108.1	121.6	116.3	118.7	122.4	n.a.	n.a.
Real effective exchange rate (index, CPI-based; 2000=100)	108.8	125.5	120.5	122.5	125.0	n.a.	n.a.

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

1/ Assumes unchanged policies

Table 2. Czech Republic: Balance of Payments, 2007–13

	2007	2008	2009	2010	2011	2012	2013
					Est.	Staff proj.	
				(billions of US$)			
Current account balance	-7.9	-4.8	-4.8	-6.0	-6.3	-4.4	-4.0
Trade Balance	2.2	1.7	4.6	2.8	5.3	6.0	6.5
Exports	106.5	125.1	99.1	116.7	138.5	123.0	127.2
Imports	104.3	123.4	94.6	113.9	133.2	117.1	120.7
Nonfactor Services	2.9	4.4	3.9	3.9	3.8	4.3	4.7
Receipts	17.4	21.9	19.4	20.9	23.1	21.3	23.1
Payments	14.5	17.5	15.5	17.0	19.3	17.1	18.5
Factor Income (net)	-12.7	-10.6	-13.2	-13.2	-15.6	-14.8	-15.3
Transfers	-0.4	-0.3	-0.2	0.5	0.2	0.1	0.2
Capital account	1.1	1.6	2.7	1.7	0.8	1.2	1.2
Financial account	6.4	5.4	7.8	9.5	5.1	5.2	4.7
Direct investment, net	9.0	2.3	2.0	5.0	4.2	3.3	2.7
Portfolio investment, net	-2.7	0.0	8.6	8.1	0.4	0.3	0.3
Other Investment and Financial derivatives, net	0.1	3.2	-2.7	-3.4	0.7	1.6	1.8
Errors and omissions	1.3	0.2	-2.6	-3.1	-0.6	0.0	0.0
Change in reserves 1/	-0.9	-2.4	-3.1	-2.1	1.0	-2.0	-2.0
Memorandum items:							
Current account, percent of GDP	-4.4	-2.1	-2.5	-3.0	-2.9	-2.1	-1.9
Trade balance, percent of GDP	1.2	0.8	2.3	1.4	2.5	2.9	3.1
Foreign direct investment, net, percent of GDP	5.0	1.0	1.0	2.5	2.0	1.6	1.3
Terms of trade (% change)	0.8	-1.4	1.4	-2.5	-2.3	-0.5	0.0
Gross official reserves	34.9	37.0	41.6	42.5	40.3	42.9	44.9
in months of the current year's imports	3.5	3.2	4.5	3.9	3.2	3.8	3.9
as a ratio to the short-term debt 2/	114	100	132	133	123	133	136
as percent of GDP	19	16	21	21	19	21	21
External debt, percent of GDP	42.2	37.4	45.5	48.3	47.7	48.7	48.6

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

1/ Changes in reserves reflect off-market conversion of large privatization receipts, EU transfers, eurobond issuance, and sales of accumulated interest.

2/ Remaining maturity basis.

Table 3. Czech Republic: The Statement of Operations of General Government, 2007-14 1/

(In billions of Koruny)

	2007	2008	2009	2010	2011	2012	2013	2014
				Est		Proj.		
Revenue	**1,476.4**	**1,498.6**	**1,462.0**	**1,484.5**	**1,550.7**	**1,612.4**	**1,669.0**	**1,749.3**
Taxes	725.9	714.4	686.7	688.6	738.0	779.6	814.8	857.3
Personal income tax	155.9	142.5	136.0	135.2	151.3	145.9	151.0	158.5
Corporate Income tax	171.1	161.8	132.3	127.2	130.9	132.3	145.6	152.9
VAT	226.8	254.8	254.0	258.8	271.9	304.6	314.0	331.5
Excise	142.5	126.1	137.3	138.4	147.3	150.9	156.6	164.5
Other taxes	29.5	29.1	27.2	28.9	36.7	45.8	47.5	49.9
Social contributions	576.7	599.2	559.7	577.8	587.6	601.1	613.7	639.5
Grants	38.2	48.8	77.5	85.6	91.4	91.0	94.4	99.1
Other revenue	135.7	136.2	138.1	132.4	133.6	140.8	146.1	153.4
Property income	27.1	30.3	31.3	30.7	31.0	33.7	35.0	36.7
Sales of goods and services	95.2	102.9	104.0	98.7	99.6	104.0	107.9	113.3
Other revenue	13.4	2.9	2.9	3.0	3.0	3.1	3.2	3.4
Expenditure	**1,503.1**	**1,583.5**	**1,679.7**	**1,665.2**	**1,697.0**	**1,750.9**	**1,806.9**	**1,884.2**
Expense	**1,350.3**	**1,407.4**	**1,487.9**	**1,500.7**	**1,532.0**	**1,579.2**	**1,629.1**	**1,699.5**
Compensation of employees	268.6	279.6	292.9	285.6	280.0	291.5	301.6	313.4
Use of goods and services	218.7	227.9	238.4	234.9	239.4	249.2	257.8	267.9
Interest	39.8	39.4	47.4	51.2	55.0	61.2	66.2	71.2
Subsidies	60.8	62.3	74.7	71.3	78.0	81.2	84.0	87.3
Grants	37.0	36.2	34.1	32.9	33.5	34.9	36.1	37.5
Social benefits	643.5	675.4	728.3	743.5	760.0	791.1	818.7	850.7
Other expenses	82.0	86.6	72.1	81.3	86.2	70.2	64.7	71.5
Net acquisition of nonfinancial assets	**152.8**	**176.1**	**191.8**	**164.5**	**165.0**	**171.8**	**177.7**	**184.7**
Gross Operating Balance	**126.1**	**91.2**	**-25.9**	**-16.2**	**18.7**	**33.3**	**39.9**	**49.8**
Net lending/borrowing (overall balance)	**-26.7**	**-85.0**	**-217.7**	**-180.7**	**-146.3**	**-138.5**	**-137.9**	**-134.9**
Net financial transactions	**-26.7**	**-85.0**	**-217.7**	**-180.7**	**-146.3**	**-138.5**	**-137.9**	**-134.9**
Net acquisition of financial assets	**75.8**	**32.7**	**-1.5**	**-32.0**	**7.7**	**7.9**	**0.0**	**0.0**
Currency and deposits	76.1	75.3	-57.8	-30.1	....	....	....	....
Debt securities	3.6	1.9	3.7	-0.6	....	....	....	....
Loans	-9.7	-3.0	0.1	2.1	....	....	....	....
Equity and investment fund shares	-17.3	-23.2	-8.8	0.7	....	....	....	....
Other financial assets	23.1	-18.3	61.3	-4.2	7.7	7.9	0.0	0.0
Net incurrence of liabilities	**97.1**	**126.8**	**216.3**	**145.0**	**161.7**	**134.7**	**125.7**	**126.4**
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt securities	86.7	78.5	164.9	148.0	161.7	134.7	125.7	126.4
Loans	-6.7	0.0	22.0	5.7	....	....	....	....
Other liabilities	17.1	48.3	29.3	-8.7	....	....	....	....
Adjustment and statistical discrepancies 2/	*-5.4*	*9.2*	*0.1*	*-3.7*	*7.6*	*-11.7*	*-12.1*	*-8.5*
Memorandum item:								
General government debt	1,023.8	1,104.9	1,282.3	1,417.7	1,579.4	1,714.1	1,839.8	1,966.2
Primary balance	13.1	-45.5	-170.3	-129.5	-91.3	-77.3	-71.7	-63.6
Structural balance 3/	-65.6	-122.3	-168.5	-146.3	-119.7	-89.5	-90.9	-101.6
Structural primary balance 3/	-39.5	-93.0	-131.5	-104.0	-73.5	-40.1	-36.9	-42.6
Output gap 3/	113.7	109.4	-133.4	-96.1	-74.0	-136.2	-130.7	-93.5

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

1/ Assumes unchanged policies.

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

3/ Staff estimates of output gap.

Table 4. Czech Republic: The Statement of Operations of General Government 2007-14 1/

(In percentage of GDP)

	2007	2008	2009	2010	2011	2012	2013	2014
				Est		Proj.		
Revenue	**40.3**	**38.9**	**39.1**	**39.3**	**40.7**	**41.3**	**41.2**	**41.1**
Taxes	19.8	18.6	18.4	18.2	19.4	20.0	20.1	20.2
Personal income tax	4.3	3.7	3.6	3.6	4.0	3.7	3.7	3.7
Corporate Income tax	4.7	4.2	3.5	3.4	3.4	3.4	3.6	3.6
VAT	6.2	6.6	6.8	6.9	7.1	7.8	7.8	7.8
Excise	3.9	3.3	3.7	3.7	3.9	3.9	3.9	3.9
Other taxes	0.8	0.8	0.7	0.8	1.0	1.2	1.2	1.2
Social contributions	15.7	15.6	15.0	15.3	15.4	15.4	15.2	15.0
Grants	1.0	1.3	2.1	2.3	2.4	2.3	2.3	2.3
Other revenue	3.7	3.5	3.7	3.5	3.5	3.6	3.6	3.6
Property income	0.7	0.8	0.8	0.8	0.8	0.9	0.9	0.9
Sales of goods and services	2.6	2.7	2.8	2.6	2.6	2.7	2.7	2.7
Other revenue	0.4	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Expenditure	**41.0**	**41.1**	**44.9**	**44.1**	**44.5**	**44.9**	**44.6**	**44.3**
Expense	**36.9**	**36.6**	**39.8**	**39.8**	**40.2**	**40.5**	**40.2**	**40.0**
Compensation of employees	7.3	7.3	7.8	7.6	7.4	7.5	7.4	7.4
Use of goods and services	6.0	5.9	6.4	6.2	6.3	6.4	6.4	6.3
Interest	1.1	1.0	1.3	1.4	1.4	1.6	1.6	1.7
Subsidies	1.7	1.6	2.0	1.9	2.0	2.1	2.1	2.1
Grants	1.0	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Social benefits	17.6	17.5	19.5	19.7	20.0	20.3	20.2	20.0
Other expenses	2.2	2.3	1.9	2.2	2.3	1.8	1.6	1.7
Net acquisition of nonfinancial assets	**4.2**	**4.6**	**5.1**	**4.4**	**4.3**	**4.4**	**4.4**	**4.3**
Gross Operating Balance	**3.4**	**2.4**	**-0.7**	**-0.4**	**0.5**	**0.9**	**1.0**	**1.2**
Net lending/borrowing (overall balance)	**-0.7**	**-2.2**	**-5.8**	**-4.8**	**-3.8**	**-3.5**	**-3.4**	**-3.2**
Net financial transactions	**-0.7**	**-2.2**	**-5.8**	**-4.8**	**-3.8**	**-3.5**	**-3.4**	**-3.2**
Net acquisition of financial assets	**2.1**	**0.8**	**0.0**	**-0.8**	**0.2**	**0.2**	**0.0**	**0.0**
Currency and deposits	2.1	2.0	-1.5	-0.8	....	....	....	....
Debt securities	0.1	0.0	0.1	0.0	....	....	....	....
Loans	-0.3	-0.1	0.0	0.1	....	....	....	....
Equity and investment fund shares	-0.5	-0.6	-0.2	0.0	....	....	....	....
Other financial assets	0.6	-0.5	1.6	-0.1	0.2	0.2	0.0	0.0
Net incurrence of liabilities	**2.7**	**3.3**	**5.8**	**3.8**	**4.2**	**3.5**	**3.1**	**3.0**
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt securities	2.4	2.0	4.4	3.9	4.2	3.5	3.1	3.0
Loans	-0.2	0.0	0.6	0.2	....	....	....	....
Other liabilities	0.5	1.3	0.8	-0.2	....	....	....	....
Adjustment and statistical discrepancies 2/	*-0.1*	*0.2*	*0.0*	*-0.1*	*0.2*	*-0.3*	*-0.3*	*-0.2*
Memorandum item:								
General government debt	28.0	28.7	34.3	37.6	41.5	43.9	45.4	46.2
Primary balance	0.4	-1.2	-4.6	-3.4	-2.4	-2.0	-1.8	-1.5
Structural balance 3/	-1.8	-3.2	-4.5	-3.9	-3.1	-2.3	-2.2	-2.4
Structural primary balance 3/	-1.1	-2.4	-3.5	-2.8	-1.9	-1.0	-0.9	-1.0
Output gap 3/	3.1	2.8	-3.6	-2.5	-1.9	-3.5	-3.2	-2.2
GDP at current market prices (billions of Koru	3,662.6	3,848.4	3,739.2	3,775.2	3,809.3	3,902.9	4,049.8	4,252.6

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

1/ Assumes unchanged policies.

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

3/ Staff estimates of output gap.

Table 5. Czech Republic: General Government Financial Balance Sheet, 2007–10

(In billions of Koruny)

	2007				2008			2009			2010		
	Opening balance	Trans-actions	OEF	Closing Opening balance	Trans-actions	OEF	Closing Opening balance	Trans-actions	OEF	Closing Opening balance	Trans-actions	OEF	Closing Opening balance
Net worth and its changes	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**
Nonfinancial assets	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**
Net Financial Worth:	**376.6**	**-21.3**	**219.4**	**574.6**	**-94.1**	**-222.6**	**257.9**	**-217.8**	**60.0**	**100.1**	**-177.0**	**-9.0**	**-85.9**
Financial Assets	**1,469.2**	**75.8**	**165.0**	**1,710.0**	**32.7**	**-161.4**	**1,581.3**	**-1.5**	**56.2**	**1,635.9**	**-32.0**	**-9.6**	**1,594.3**
Currency and deposits	317.8	76.1	1.5	395.4	75.3	2.6	473.3	-57.8	0.4	415.8	-30.1	7.4	393.2
Debt securities	18.2	3.6	-2.0	19.7	1.9	-0.9	20.8	3.7	-0.2	24.2	-0.6	2.2	25.8
Loans	60.7	-9.7	0.6	51.7	-3.0	-8.7	39.9	0.1	-0.9	39.0	2.1	-5.6	35.5
Equity and inv. fund shares	793.7	-17.3	215.3	991.7	-23.2	-162.1	806.4	-8.8	59.6	857.1	0.7	-10.7	847.1
Other financial assets	278.8	23.1	-50.4	251.6	-18.3	7.7	241.0	61.3	-2.6	299.7	-4.2	-2.9	292.6
Liabilities	**1,092.7**	**97.1**	**-54.4**	**1,135.4**	**126.8**	**61.2**	**1,323.4**	**216.3**	**-3.8**	**1,535.8**	**145.0**	**-0.7**	**1,680.1**
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt securities	790.4	86.7	-2.3	874.8	78.5	2.2	955.5	164.9	-4.1	1,116.3	148.0	-2.6	1,261.7
Loans	159.7	-6.7	-0.5	152.5	0.0	0.6	153.2	22.0	-0.3	174.9	5.7	-4.1	176.5
Other liabilities	142.5	17.1	-51.5	108.1	48.3	58.3	214.7	29.3	0.6	244.6	-8.7	6.0	241.9
Memorandum items:													
Net financial worth (in % of GDP)	11.2			15.7			6.7			2.7			-2.0
Financial assets (in % of GDP)	43.8			46.7			41.1			43.8			37.5
Liabilities (in % of GDP)	32.6			31.0			34.4			41.1			39.5
o/w foreign liabilities (%)	28.4%			28.4%			29.4%			30.3%			33.8%
GDP nominal prices	3,352.6			3,662.6			3,848.4			3,739.2			4,252.6

Source: Ministry of Finance

Table 6. Czech Republic: Medium-term Macroeconomic Scenario, 2007–17

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Real sector	(change, percent, unless stated otherwise)										
Real GDP	5.7	3.1	-4.7	2.7	1.7	0.1	2.1	3.3	3.6	3.6	3.5
Private Consumption	4.2	2.8	-0.4	0.6	-0.5	-0.3	1.2	3.5	3.8	3.8	3.6
Public Consumption	0.4	1.2	3.8	0.6	-1.4	-1.4	0.2	1.1	1.5	1.5	1.5
Investment	15.5	1.9	-20.8	5.9	-1.6	-3.7	2.7	3.6	3.9	3.9	3.9
o/w fixed investment	13.2	4.1	-11.5	0.1	-1.2	-3.1	2.7	3.6	3.9	3.9	3.9
contribution of inventories (percent)	0.9	-0.5	-3.0	1.4	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Exports, goods and services	11.2	4.0	-10.0	16.4	11.0	-1.2	6.0	5.2	5.2	5.2	5.2
Imports, goods and services	12.8	2.7	-11.6	16.0	7.5	-3.2	5.7	5.2	5.2	5.2	5.2
contribution of net exports (percent)	-0.5	1.0	0.6	1.2	3.2	1.4	0.8	0.6	0.6	0.6	0.6
CPI inflation	2.9	6.3	1.0	1.5	1.9	3.5	1.9	2.0	2.0	2.0	2.0
GDP deflator	3.3	1.9	1.9	-1.7	-0.7	2.3	1.7	1.6	1.7	1.7	1.7
Unemployment (percent of labor force)	5.3	4.4	6.7	7.3	6.7	7.0	7.4	6.9	6.0	5.5	5.5
Output gap 1/	3.1	2.8	-3.6	-2.5	-1.9	-3.5	-3.2	-2.2	-1.2	-0.6	0.0
Gross domestic savings (in percent of GDP)	25.4	26.8	21.6	22.1	21.5	21.3	21.8	21.9	21.8	21.8	21.9
Public	14.4	13.1	10.0	10.6	11.8	12.2	12.2	12.2	12.3	12.4	12.5
Private	11.0	13.7	11.6	11.5	9.7	9.1	9.6	9.6	9.6	9.4	9.4
Gross capital formation	29.8	28.9	24.0	25.1	24.5	23.4	23.7	23.6	23.6	23.6	23.6
Public finances 2/	(in percent of GDP)										
Revenues	40.3	38.9	39.1	39.3	40.7	41.3	41.2	41.1	41.1	41.1	41.1
Expenditures	41.0	41.1	44.9	44.1	44.5	44.9	44.6	44.3	44.0	43.9	43.9
Net lending	-0.7	-2.2	-5.8	-4.8	-3.8	-3.5	-3.4	-3.2	-2.9	-2.8	-2.8
Cyclically-adjusted deficit 1/	-1.8	-3.2	-4.5	-3.9	-3.1	-2.3	-2.2	-2.4	-2.5	-2.6	-2.7
General government debt	28.0	28.7	34.3	37.6	41.5	43.9	45.4	46.2	46.6	46.9	47.1
Balance of payments	(in percent of GDP)										
Current account balance	-4.4	-2.1	-2.5	-3.0	-2.9	-2.1	-1.9	-1.8	-1.8	-1.8	-1.8
Trade balance	1.2	0.8	2.3	1.4	2.5	2.9	3.1	3.1	3.1	3.0	3.0
Services balance	1.6	1.9	2.0	2.0	1.8	2.1	2.2	2.2	2.3	2.3	2.3
Net factor income	-7.0	-4.7	-6.7	-6.7	-7.2	-7.2	-7.2	-7.2	-7.2	-7.2	-7.2
Current transfers	-0.2	-0.1	-0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Capital account balance	0.6	0.7	1.4	0.8	0.4	0.6	0.6	0.6	0.6	0.6	0.6
Financial account balance	4.2	3.1	5.4	5.7	2.8	2.1	1.9	1.8	1.8	1.8	1.8
Direct investment, net	5.0	1.0	1.0	2.5	2.0	1.6	1.3	0.6	0.3	0.3	0.3
Portfolio investment, net	-1.5	0.0	4.4	4.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Other investment & derivatives, net	0.0	1.4	-1.4	-1.7	0.3	0.8	0.8	1.3	1.7	1.6	1.6
Errors and omissions, net	0.7	0.1	-1.3	-1.6	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves (- increase) 3/	-0.5	-1.1	-1.6	-1.1	0.5	-1.0	-0.9	-0.9	-0.9	-0.8	-0.8

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

1/ In percent of potential GDP.

2/ Assumes unchanged policies. On ESA-95 basis.

3/ Changes in reserves reflect off-market conversion of large privatization receipts, EU transfers, Eurobond sales and sales of accumulated interest.

Table 7. Czech Republic: Monetary Indicators, 2005-11
(billions of koruny)

	2005	2006	2007	2008	2009	2010	2011
Monetary Aggregates							
M2	1992	2189	2478	2641	2753	2845	2994
M1	1087	1240	1439	1545	1662	1911	2042
Quasi Money	905	949	1040	1096	1091	934	953
Net Domestic Assets	916	1216	1508	1666	1750	1830	2001
Net Domestic Credit to the Government Sector	99	136	72	23	166	225	335
Domestic Credits to the Rest of the Economy	1068	1286	1628	1890	1905	1962	2070
Net Foreign Assets	1076	973	970	975	1003	1015	993
Central Bank Accounts							
Currency in Circulation	264	295	324	366	354	358	378
Net Foreign Assets	725	659	633	720	770	799	805
Credit							
Private Sector	938	1166	1451	1700	1723	1809	1923
Corporations	525	635	743	848	782	780	828
Households	413	531	708	851	940	1028	1095
Foreign Currency	94	119	128	157	147	146	160
Corporations	93	118	127	156	146	144	159
Households	1	1	1	1	1	1	2
Deposits							
Private Sector	1525	1695	1904	2031	2162	2274	2384
Corporations	448	520	614	591	611	633	673
Households	1077	1174	1290	1440	1551	1642	1711
Foreign Currency	158	179	187	191	185	183	188
Corporations	92	118	128	125	118	121	128
Households	66	61	58	66	67	62	60
Interest Rates (percent)							
Discount Rate	1.0	1.5	2.5	1.3	0.3	0.3	0.3
Lombard Rate	3.0	3.5	4.5	3.3	2.0	1.8	1.8
Repo Rate - 2 Weeks	2.0	2.5	3.5	2.3	1.0	0.8	0.8
PRIBOR - 1 Week	2.0	2.5	3.6	2.8	1.3	0.8	0.8

Source: Czech National Bank.

Table 8. Czech Republic: Financial Soundness Indicators (2008-11)

(in percent unless indicated otherwise)

	2008	2009	2010	Mar-11	Jun-11	Sep-11
Capital						
Regulatory capital to risk-weighted assets	11.6	14.0	15.3	15.4	15.7	15.3
Regulatory Tier 1 capital to risk-weighted assets	11.1	12.6	13.9	13.8	14.4	14.2
Capital to assets	5.5	6.1	6.5	6.5	6.8	6.5
Profitability						
Return on assets	1.1	1.5	1.3	1.6	1.3	1.2
Return on equity	20.7	26.4	19.7	23.9	19.8	18.7
Interest margin to gross income	65.0	55.8	63.1	62.5	64.2	64.3
Noninterest expenses to gross income	51.2	42.0	46.8	44.9	46.4	46.6
Trading income to total income	-4.8	9.5	4.6	6.9	4.6	3.8
Personnel expenses to noninterest expenses	40.2	40.5	39.8	41.8	41.4	41.4
Liquidity						
Liquid assets to total assets	25.8	27.1	29.4	31.4	31.4	30.5
Liquid assets to short-term liabilities	70.3	70.0	71.1	76.4	75.9	74.4
Customer deposits to total (noninterbank) loans	125.6	128.2	129.6	129.6	127.7	127.1
Foreign-currency-denominated loans to total loans	21.8	21.2	21.6	20.6	20.2	21.4
Foreign-currency-denominated liabilities to total liabilities	16.4	14.2	14.3	14.8	14.9	15.4
Sensitivity to market risk						
Net open position in foreign exchange to capital	3.9	0.5	0.4	2.3	0.6	-0.1
Gross asset position in financial derivatives to capital	98.4	54.0	43.2	38.0	38.2	54.7
Gross liability position in financial derivatives to capital	93.9	50.9	41.2	35.2	34.5	48.8
Net open position in equities to capital	15.7	8.3	8.1	8.8	9.3	9.6
Memo item						
Nonperforming loans to total gross loans	2.8	4.6	5.4	5.6	5.6	5.5

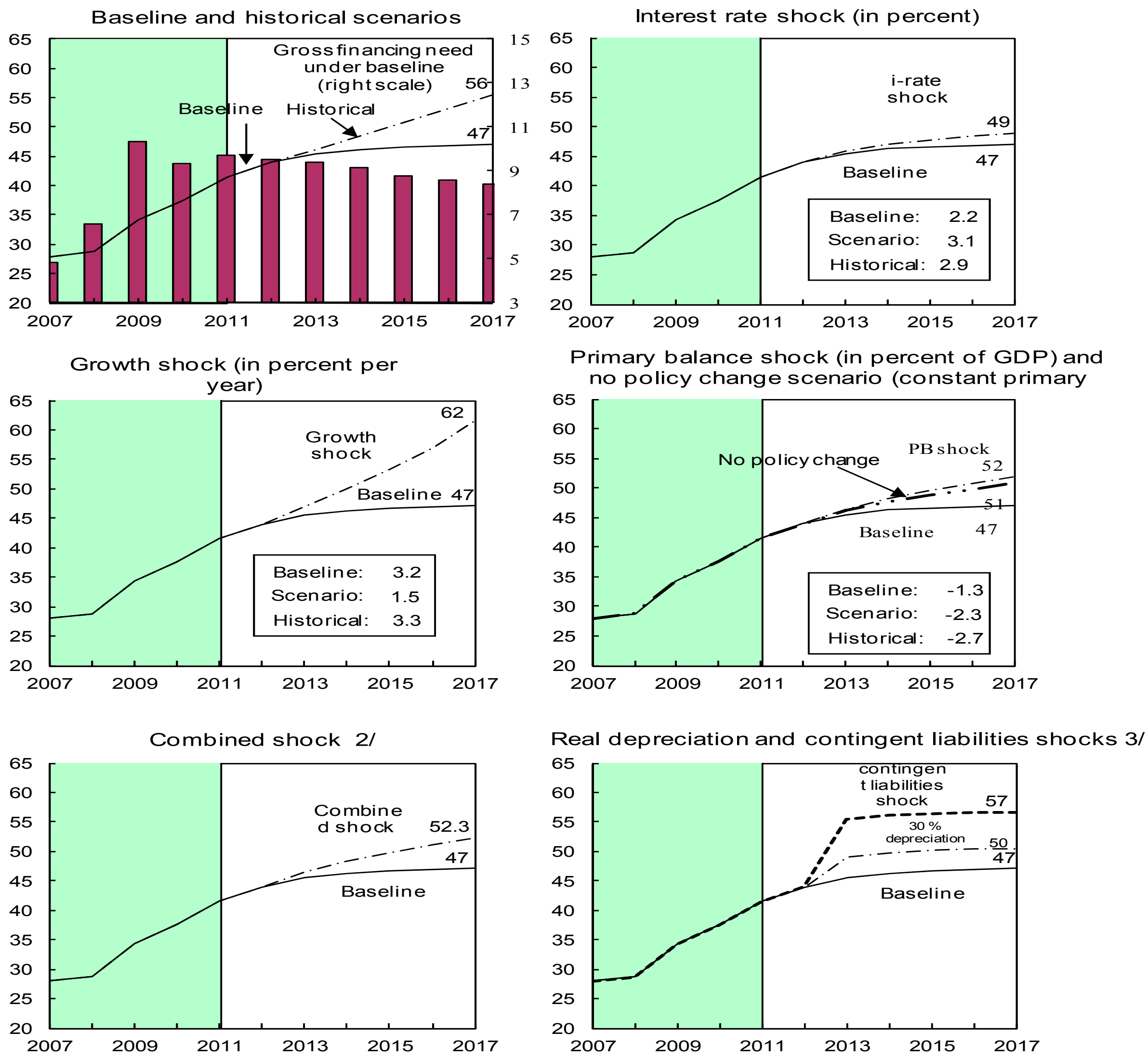
Source: Czech National Bank

Annex I - Risk Assessment Matrix

Czech Republic: Risk Assessment Matrix		
Shock	**Likelihood**	**Expected Impact**
Intensification of euro area crisis	**Medium**	**High** Lower export demand from the euro area, the market for two thirds of all exports, will negatively affect growth in the Czech Republic. Potential disruptive deleveraging, funneling capital and liquidity out from the Czech subsidiaries, and (at the extreme) outright failures can harm the Czech financial system severely. The stock of portfolio capital is limited on account of small and less liquid asset markets, but rollovers of short-term debt of banks and corporates can become more difficult.
Gradual deleveraging by euro area banks	**Medium** It is possible that even without an intensification of the euro area crisis, euro area parent banks will reduce cross-border lending activities.	**Low** Czech subsidiaries are largely self-reliant in their funding and are profitable. Compared with other host countries, the impact on the Czech Republic should be smaller.
Rapid increases in commodity prices	**Medium**	**Low** Well-anochored inflation expectations, the negative output gap, and labor market slack should help keep inflationary spikes from turning into sustained wage price spirals.
Sharp falls in property prices	**Low** Property price declines subsided for the most part, but a renewed decline is still possible, though not very likely. Unsold inventory continue to pressure prices, but mortgages are performing very well thanks to prudent LTV ratios and low interest rates.	**High** The financial system has high exposure to the real estate market through mortgages as well as credit to developers. Widespread losses on these portfolios could lead to financial instability.
Safe-haven inflows to Czech assets	**Low** The low indebtedness of the Czech Republic may make Czech assets look attractive to those seeking stability. However, the real economy is so tightly linked to the euro area that financial decoupling is an unlikely prospect. In addition, the local asset markets are quite small and not very liquid.	**High** A sharp appreciation would hurt Czech exports, and, under current demand conditions, would lead to a severe disinflationary environment.

Annex II - Debt Sustainability Analysis

Figure 1. Czech Republic: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



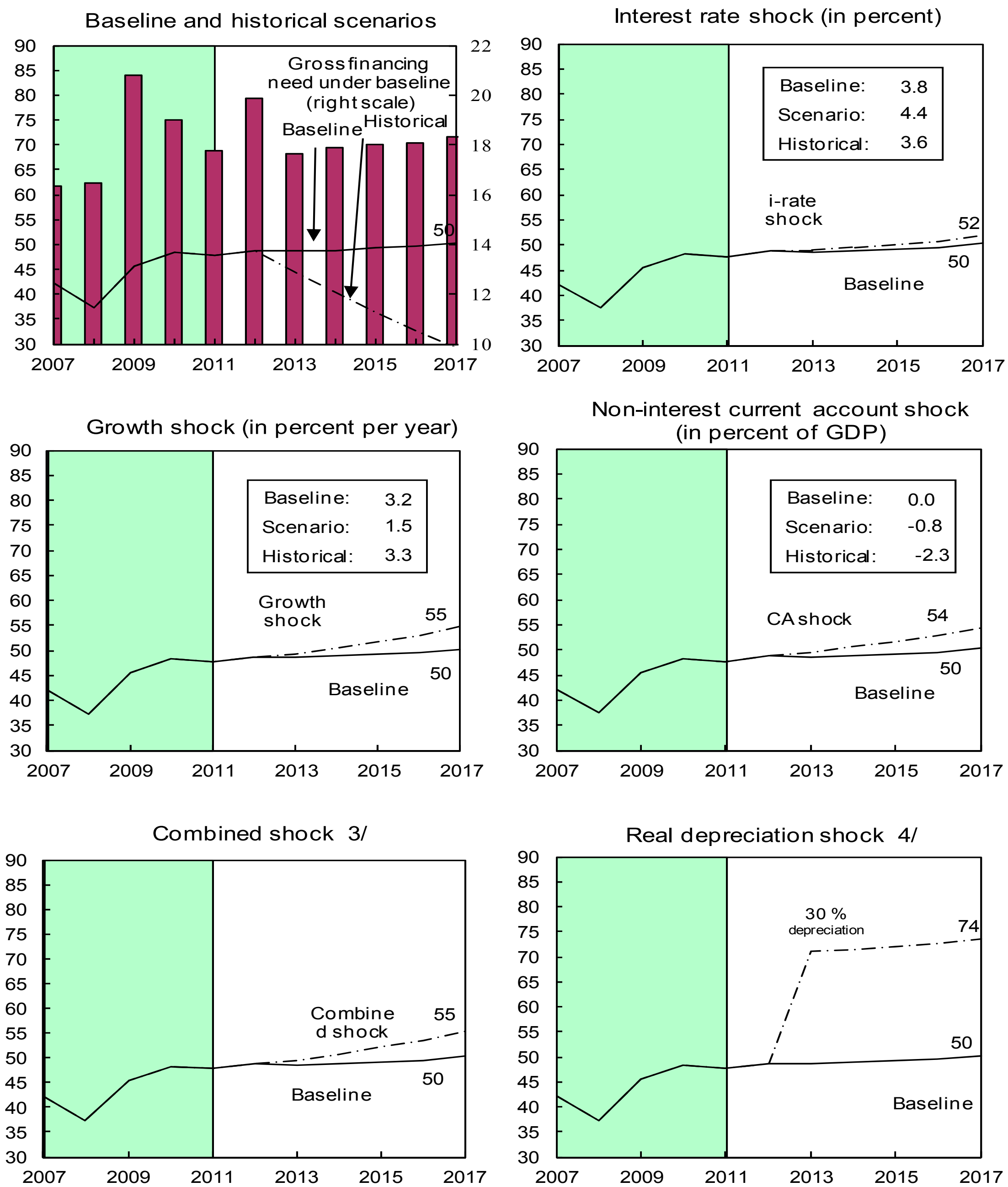
Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 1. Czech Republic: Public Sector Debt Sustainability Framework, 2007-2017
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	28.0	28.7	34.3	37.6	41.5	**43.9**	**45.4**	**46.2**	**46.6**	**46.9**	**47.1**	**-0.2**
o/w foreign-currency denominated	2.6	4.0	5.6	6.7	7.4	7.9	8.1	8.3	8.3	8.4	8.4	
Change in public sector debt	-0.3	0.8	5.6	3.3	3.9	2.5	1.5	0.8	0.4	0.2	0.2	
Identified debt-creating flows (4+7+12)	-0.5	1.1	5.7	5.6	4.1	3.1	2.3	1.1	0.7	0.6	0.6	
Primary deficit	-0.4	1.2	4.6	3.4	2.4	2.0	1.8	1.5	1.2	1.1	1.0	
Revenue and grants	40.3	38.9	39.1	39.3	40.7	41.3	41.2	41.1	41.1	41.1	41.1	
Primary (noninterest) expenditure	40.0	40.1	43.7	42.8	43.1	43.3	43.0	42.6	42.3	42.2	42.1	
Automatic debt dynamics 2/	-1.8	-0.1	1.7	1.4	1.2	0.6	0.0	-0.5	-0.6	-0.6	-0.6	
Contribution from interest rate/growth differential 3/	-1.3	-0.3	2.1	1.0	1.1	0.6	0.0	-0.5	-0.6	-0.6	-0.6	
Of which contribution from real interest rate	0.2	0.5	0.7	2.0	1.7	0.6	0.9	0.9	0.9	1.0	1.0	
Of which contribution from real GDP growth	-1.5	-0.8	1.4	-0.9	-0.6	0.0	-0.9	-1.4	-1.6	-1.6	-1.6	
Contribution from exchange rate depreciation 4/	-0.5	0.2	-0.4	0.4	0.1	...	...	...	...	...	...	
Other identified debt-creating flows	1.7	0.0	-0.6	0.8	0.5	0.5	0.5	0.1	0.1	0.2	0.2	
Privatization receipts (negative)	-0.3	-0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	
Other (specify, e.g. bank recapitalization)	1.8	0.4	-0.8	0.5	0.2	0.2	0.2	-0.3	-0.3	-0.2	-0.2	
Residual, including asset changes (2-3) 5/	0.1	-0.3	-0.1	-2.4	-0.2	-0.6	-0.8	-0.3	-0.3	-0.4	-0.4	
Public sector debt-to-revenue ratio 1/	69.3	73.7	87.7	95.5	101.9	106.3	110.2	112.4	113.5	114.0	114.4	
Gross financing need 6/	4.8	6.6	10.4	9.3	9.7	9.6	9.4	9.1	8.8	8.6	8.4	
in billions of U.S. dollars	8.7	14.8	20.3	18.4	20.9	19.7	20.1	20.2	20.2	20.5	20.6	
Scenario with key variables at their historical averages 7/						**43.9**	**46.2**	**48.5**	**50.9**	**53.2**	**55.6**	**0.2**
Scenario with no policy change (constant primary balance) in 2012-2017						**43.9**	**46.3**	**47.6**	**48.7**	**49.8**	**50.9**	**-0.3**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	5.7	3.1	-4.7	2.7	1.7	0.1	2.1	3.3	3.6	3.6	3.5	
Average nominal interest rate on public debt (in percent) 8/	4.2	3.9	4.3	4.0	3.9	3.9	3.9	3.9	3.9	3.9	4.0	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.9	1.9	2.3	5.7	4.6	1.5	2.2	2.2	2.2	2.2	2.2	
Nominal appreciation (increase in US dollar value of local currency, in percent)	16.5	-7.4	9.2	-6.2	-1.7	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	3.3	1.9	1.9	-1.7	-0.7	2.3	1.7	1.6	1.7	1.7	1.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	3.3	3.5	3.7	0.6	2.5	0.6	1.3	2.5	2.8	3.4	3.4	
Primary deficit	-0.4	1.2	4.6	3.4	2.4	2.0	1.8	1.5	1.2	1.1	1.0	

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.

Figure 2. Czech Republic: External Debt Sustainability: Bound Tests 1/ 2/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2012.

Table 2. Czech Republic: External Debt Sustainability Framework, 2007-2017
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	42.2	37.4	45.5	48.3	47.7	**48.7**	**48.6**	**48.9**	**49.3**	**49.6**	**50.3**	**0.4**
Change in external debt	3.6	-4.9	8.1	2.8	-0.5	1.0	-0.1	0.3	0.4	0.3	0.7	
Identified external debt-creating flows (4+8+9)	-5.5	-6.4	6.7	0.0	-3.0	0.4	-0.4	-0.5	-0.3	-0.3	-0.3	
Current account deficit, excluding interest payments	3.0	0.8	1.6	2.2	2.2	1.1	0.4	0.0	0.1	-0.2	-0.3	
Deficit in balance of goods and services	-2.9	-2.7	-4.3	-3.4	-4.2	-5.0	-5.2	-5.3	-5.3	-5.3	-5.3	
Exports	68.6	65.2	60.5	69.6	75.1	70.1	70.4	71.9	73.0	74.2	75.2	
Imports	65.8	62.5	56.1	66.2	70.9	65.1	65.2	66.5	67.7	68.9	69.8	
Net non-debt creating capital inflows (negative)	-3.0	-0.2	-1.4	-2.6	-2.0	-1.7	-1.3	-0.7	-0.4	-0.3	-0.3	
Automatic debt dynamics 1/	-5.5	-7.1	6.4	0.5	-3.2	1.0	0.5	0.2	0.0	0.3	0.3	
Contribution from nominal interest rate	1.4	1.3	0.9	0.8	0.7	1.1	1.5	1.7	1.7	2.0	2.0	
Contribution from real GDP growth	-1.8	-1.0	2.0	-1.2	-0.7	-0.1	-1.0	-1.6	-1.7	-1.7	-1.7	
Contribution from price and exchange rate changes 2/	-5.0	-7.4	3.6	0.9	-3.2	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	9.1	1.6	1.5	2.7	2.5	0.6	0.3	0.8	0.7	0.6	1.0	
External debt-to-exports ratio (in percent)	61.5	57.3	75.3	69.3	63.6	69.5	69.0	68.0	67.4	66.8	66.9	
Gross external financing need (in billions of US dollars) 4/	29.5	37.1	40.8	37.6	38.2	41.0	37.7	39.5	41.2	43.1	44.9	
in percent of GDP	16.3	16.4	20.8	19.0	17.8	19.9	17.6	17.9	18.0	18.1	18.3	
Scenario with key variables at their historical averages 5/						**48.7**	**44.4**	**40.2**	**36.3**	**32.6**	**29.1**	**-5.8**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	5.7	3.1	-4.7	2.7	1.7	0.1	2.1	3.3	3.6	3.6	3.5	
GDP deflator in US dollars (change in percent)	15.0	21.2	-8.7	-1.9	7.1	-4.4	1.6	0.2	0.2	0.2	-0.8	
Nominal external interest rate (in percent)	4.4	3.9	2.0	1.8	1.6	2.1	3.1	3.6	3.7	4.2	4.2	
Growth of exports (US dollar terms, in percent)	24.2	18.6	-19.3	16.0	17.5	-10.7	4.2	5.6	5.5	5.5	4.1	
Growth of imports (US dollar terms, in percent)	25.0	18.7	-21.9	18.9	16.6	-12.1	3.8	5.6	5.7	5.6	4.2	
Current account balance, excluding interest payments	-3.0	-0.8	-1.6	-2.2	-2.2	-1.1	-0.4	0.0	-0.1	0.2	0.3	
Net non-debt creating capital inflows	3.0	0.2	1.4	2.6	2.0	1.7	1.3	0.7	0.4	0.3	0.3	
B. Bound Tests												
B1. Nominal interest rate is at historical average plus one standard deviation						**48.7**	**48.9**	**49.5**	**50.2**	**50.8**	**51.9**	**0.7**
B2. Real GDP growth is at historical average minus one standard deviations						**48.7**	**49.4**	**50.5**	**51.7**	**52.9**	**54.6**	**1.3**
B3. Non-interest current account is at historical average minus one standard deviations						**48.7**	**49.4**	**50.5**	**51.7**	**52.9**	**54.5**	**0.4**
B4. Combination of B1-B3 using 1/2 standard deviation shocks						**48.7**	**49.5**	**50.8**	**52.2**	**53.5**	**55.4**	**1.1**
B5. One time 30 percent real depreciation in 2006						**48.7**	**71.0**	**71.5**	**72.0**	**72.5**	**73.6**	**0.5**

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) 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, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) 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.

INTERNATIONAL MONETARY FUND

CZECH REPUBLIC

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

April 19, 2012

Prepared By | European Department

CONTENTS

FUND RELATIONS

(As of February 29, 2012; unless specified otherwise)

I. **Membership Status**:

Joined 1/01/1993; Article VIII

II. **General Resources Account**

	SDR Million	Percent Quota
Quota	1,002.20	100.0
Fund holdings of currency	684.45	68.29
Reserve position in Fund	317.75	31.71
Lending to the Fund		
Borrowing agreement		128.10*

* out of the committed EUR1.03 billion

III. **SDR Department**:

	SDR Million	Percent Allocation
Net cumulative Allocation	780.20	100.00
Holdings	750.5	696.20

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 Payments to Fund**:

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

	Forthcoming				
	2012	**2013**	**2014**	**2015**	**2016**
Principal					
Charges/Interest	0.04	0.05	0.05	0.05	0.05
Total	0.04	0.05	0.05	0.05	0.05

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 a free 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 February 28, 2012, the exchange rate of the Czech koruna stood at CZK 18.479 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 April 4, 2011. The staff report and PIN were published on April 7, 2011.

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

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

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

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

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

XIV. **Safeguards Assessments:** Not Applicable

Czech Republic: Technical Assistance, 1991–2010		
Department	**Timing**	**Purpose**
FAD	Dec. 1991–Sept. 1993	Regular visits by FAD consultant on VAT administration
	March 1993	Public financial management
	September 1993	Follow-up visit on public financial management
	November 1993	Follow-up visit on public financial management
	January 1994	Follow-up visit on public financial management
	July 1994	Follow-up visit by FAD consultant on VAT administration
	May 1995	Follow-up visit on public financial management
	June 1995	Follow-up visit by FAD consultant on VAT administration
	June–July 1999	Medium-term fiscal framework
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

STATISTICAL ISSUES

1. **Data provision is adequate for surveillance.** The Czech Republic subscribed to the Special Data Dissemination Standard in April 1998, and metadata and annual observance reports for 2006–9 are posted on the Fund's Dissemination Standards Bulletin Board.

2. **Data on core surveillance variables are available to the Fund regularly and with minimal lags (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.

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

- National accounts data are subject to certain weaknesses. Value added in the small-scale private sector is likely to be underestimated, as the mechanisms for data collection on this sector are not yet fully developed and a significant proportion of unrecorded activity stems from tax evasion. Discrepancies between GDP estimates based on the production method and the expenditure method are large and are subsumed under change in stocks. Quarterly estimates of national accounts are derived from quarterly reports of enterprises and surveys. The estimates are subject to bias because of nonresponse (while annual reporting of bookkeeping accounts is mandatory for enterprises, quarterly reporting is not) and lumping of several expenditure categories in particular quarters by respondents. Large swings in individual components of spending and the overall GDP from quarter to quarter bring into question the reliability of the quarterly data and hamper business cycle analysis.

- 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 April 12, 2012)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	4/16/12	4/17/12	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Mar. 2012	Apr. 2012	D	M	M
Reserve/Base Money	Mar. 2012	Apr. 2012	M	M	M
Broad Money	Mar. 2012	Apr. 2012	M	M	M
Central Bank Balance Sheet	Mar. 2012	Apr. 2012	M	M	M
Consolidated Balance Sheet of the Banking System	Mar. 2012	Apr. 2012	M	M	M
Interest Rates[2]	4/16/12	4/17/11	D	D	D
Consumer Price Index	Mar. 2012	Apr. 2012	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2010	Jun. 2011	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Feb. 2012	Apr. 2012	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2011 Q4	Mar. 2012	Q	Q	Q
External Current Account Balance	Feb. 2012	Apr. 2012	M	M	M
Exports and Imports of Goods and Services	Feb. 2012	Apr. 2012	M	M	M
GDP/GNP	2011 Q4	Mar. 2012	Q	Q	Q
Gross External Debt	2011 Q4	Mar. 2012	Q	Q	Q
International Investment Position[6]	2011 Q4	Mar. 2012	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).

INTERNATIONAL MONETARY FUND

CZECH REPUBLIC

April 30, 2012

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—SUPPLEMENTARY INFORMATION

Approved By **Rodrigo Valdés and Vivek Arora**

The Ministry of Finance of the Czech Republic published an update of the Convergence Program on April 25. Earlier in April, the coalition partners in the government agreed on new fiscal consolidation measures for 2013–15, which are incorporated in the program. [1] *The new information does not affect the thrust of the staff appraisal.*

1. The update of the Convergence Program provides a medium-term fiscal projection where the general government deficit gradually declines through 2015.

General Government Balance and Debt: 2011-15
(percent of GDP, unless otherwise noted)

	2011	2012	2013	2014	2015
	Est.	Authorities' plans			
General government balance	-3.1	-3.0	-2.9	-1.9	-0.9
Cyclially adjusted balance	-2.8	-2.4	-2.3	-1.4	-0.8
Real GDP growth (percent)	1.7	0.2	1.3	2.2	2.8
General government debt	41.2	44.0	45.1	44.8	43.4
Memorandum:					
General government balance (budget targets) 1/	-4.6	-3.5	-2.9	-1.9	...

1/ From the corresponding year's budget law for 2011 and 2012, and from the November 2011 Fiscal Outlook for 2013-14.
Source: Convergence Programme, April 2012

- **The fiscal balance was better than expected in 2011.** The general government deficit in 2011 is now estimated to be 3.1 percent of GDP, significantly lower than the budget target of 4.6 percent and the staff projection at the time of the mission

[1] Since the agreement, the structure of the three party coalition (ODS - the Civic Democratic Party, TOP09, and VV-Public Affairs) has changed. The smallest party (VV) was replaced by a new group formed by its ex-members. The government of the new coalition won a vote of confidence in the parliament on April 27.

of 3.8 percent. Relative to the staff projection, the difference is mainly due to the lower-than-expected public investment.

- **The authorities now plan to contain the deficit to 3 percent of GDP in 2012.** At the time of the mission discussions, the authorities expressed the concern that the 3.5 percent budget target could be missed in 2012, and announced a freeze of expenditures equivalent to 0.6 percent of GDP. The deficit figure in the program of 3.0 percent of GDP reflects this freeze.
- **The authorities intend to continue the fiscal consolidation in 2013 and onwards.** In the scenario described in the program, the general government deficit will be brought below 3 percent in 2013 as required by the excess deficit procedure (EDP), with further deficit reductions foreseen for 2014–15. Additional measures are already envisaged to ensure this consolidation path.

2. The coalition partners agreed on a package of consolidation measures to achieve the fiscal targets. These measures are geared towards the revenue side. The two VAT rates, which were to be unified at 17.5 percent in 2013, are now planned to be increased by one percentage point each to 15 and 21 percent in 2013. The personal income tax rate will be hiked by one percentage point to 20 percent, while several exemptions and tax credits will be abolished. On the expenditure side, the bulk of savings are expected to come from changing the pension indexation formula and streamlining public expenditures.

New Consolidation Measures
(percent of GDP)

	2013	2014	2015
Total of all measures	1.5	2.9	3.2
Revenue measures	0.9	1.9	1.8
VAT rate increase	0.4	0.4	0.4
Personal income tax changes	0.2	0.9	0.8
of which 1 pp rate hike	0.0	0.3	0.3
Excise increases	0.1	0.2	0.3
Other revenue measures	0.2	0.3	0.3
Expenditure measures	0.6	1.0	1.4
Change in pension indexation	0.2	0.4	0.5
Expenditure streamlining	0.0	0.3	0.6
Carry over from the 2012 expenditure freeze	0.3	0.3	0.3
Other expenditure measures	0.1	0.1	0.1

Source: Convergence Programme, April 2012

3. The thrust of the staff appraisal does not change. The authorities' projection suggests that the previous 3.5 percent budget deficit target in 2012 can be met without further expenditure cuts. Staff remains of the view that short-run fiscal policy could let automatic stabilizers operate fully to strike a better balance between consolidation and avoiding overly contractionary stance.

Public Information Notice (PIN) No. 12/xx
FOR IMMEDIATE RELEASE
May, dd, 2012

International Monetary Fund
700 19th Street, NW
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IMF Executive Board Concludes 2012 Article IV Consultation with the Czech Republic

On May 4, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Czech Republic.[1]

Background

The post-crisis recovery stalled in the second half of 2011 as exports lost momentum. The expansion since the 2009 recession was almost exclusively driven by exports, whereas domestic demand stagnated and remains about 7 percent below its peak. Economic activity is expected to remain flat in 2012 and gradually gain momentum as external conditions improve. Inflation has risen, and is expected to overshoot the target in 2012 before coming down in 2013, buoyed by the one-off impact of the VAT adjustment and food and energy prices. The combination of robust export performance and restrained imports kept the external deficit unchanged from the previous year at 3 percent of GDP in 2011 despite an increase in the income deficit.

The fiscal consolidation has continued apace. The overall deficit in 2011 is estimated to be 3.1 percent of GDP, significantly better than the previous year. The structural balance also improved by about one percentage point, mainly reflecting expenditure measures such as reductions in the central government wage bill and better targeting of social assistance. The

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

public debt to GDP ratio at 41.2 percent at end-2011 remains manageable and attests to a strong fiscal position.

Monetary conditions have been appropriately supportive of economic activity. The policy rate was cut aggressively during the crisis, and remains at 0.75 percent since May 2010. Despite the recent inflation spike, inflation expectations remain well-contained, while the yield curve is consistent with a stable policy rate in the next several months. The floating exchange rate remains the main shock absorber.

The Czech financial system has proved resilient to the effects of the global crisis. Czech banks do not depend on wholesale or external funding (rather, the Czech banking sector is a net external creditor); credit growth is funded mainly by domestic deposits with the loan-to-deposit ratio of around 70 percent.

Heightened global risk aversion has not led to dislocations in domestic markets. The sovereign risk premium increased somewhat in the second half of 2011, but remained well below the highs seen during the 2009 crisis, and compares favorably with regional peers as well as most euro area countries. Reflecting the strong fiscal position, long-term government bond yields in local currency have remained below 4.5 percent even during the episode of global risk aversion in late 2011, and have averaged 3.5 percent in March.

Executive Board Assessment

Executive Directors noted that the Czech economy is well positioned in the current global economic climate, underpinned by prudent policies and strong fundamentals. Directors commended the significant progress made in consolidating public finances and the authorities' strong commitment to long-term fiscal sustainability. Against the backdrop of an uncertain external environment, Directors encouraged the authorities to remain vigilant to the growth outlook, continue to strengthen the policy framework for financial stability, and accelerate structural reforms to enhance competitiveness and potential growth.

Directors discussed the appropriate fiscal policy stance in light of the weaker economic outlook for 2012. A number of Directors emphasized the importance of adhering to the fiscal targets to preserve the credibility of economic policies and market confidence, while not ruling out the role of automatic stabilizers if the situation deteriorates further. Other Directors saw merit in allowing automatic stabilizers to operate fully in 2012, and in the event that the growth outlook worsens significantly, in repacing the fiscal consolidation path without jeopardizing the medium-term objectives. Directors welcomed the government's plan to improve the fiscal framework, including through introducing a fiscal rule and an independent fiscal council. They encouraged further efforts to reform the pension, health care, and tax systems, with a view to safeguarding the long-term sustainability of public finances.

Directors broadly agreed that the current monetary policy stance is appropriate and that the inflation-targeting framework continues to serve the economy well. A number of Directors considered that risks to inflation are broadly balanced, warranting a neutral bias. Directors welcomed the monetary authorities' intention to remain flexible. A few Directors, noting that inflation expectations are well anchored, saw scope for adopting a more accommodative policy stance in light of deteriorating growth prospects. Additional policy options could be explored to prepare for a possible disinflationary scenario.

Directors observed that the Czech financial system remains profitable and resilient, reflecting a conservative structure of bank balance sheets and the low indebtedness of the corporate and household sectors. They welcomed recent steps to strengthen the macroprudential framework and reporting requirements for banks' liquidity positions and intra-group exposures. Directors looked forward to further progress in implementing the FSAP recommendations, particularly on bank supervision and crisis management.

Directors stressed that steady implementation of structural reforms is key to boost potential growth. The government's comprehensive reform strategy is a welcome step toward improving international competitiveness. Key priorities include developing infrastructure, improving labor market flexibility, and strengthening institutions and governance.

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.

Czech Republic: Selected Economic Indicators, 2007–13

	2007	2008	2009	2010	2011	2012	2013
					Est.	Staff	Proj.
Real economy (change in percent, unless stated otherwise)							
Real GDP	5.7	3.1	-4.7	2.7	1.7	0.1	2.1
Domestic demand	6.6	2.2	-5.9	2.0	-1.0	-1.4	1.4
CPI (average)	2.9	6.3	1.0	1.5	1.9	3.5	1.9
PPI (average)	4.1	4.5	-3.1	1.3	…	…	…
Unemployment rate (in percent)	5.3	4.4	6.7	7.3	6.7	7.0	7.4
Gross national savings (percent of GDP)	25.4	26.8	21.6	22.1	21.5	21.3	21.8
Gross domestic investments (percent of GDP)	29.8	28.9	24.0	25.1	24.5	23.4	23.7
Public finance (percent of GDP) [1/]							
General government revenue	40.3	38.9	39.1	39.3	40.7	41.3	41.2
General government expenditure	41.0	41.1	44.9	44.1	44.5	44.9	44.6
Net lending / Overall balance	-0.7	-2.2	-5.8	-4.8	-3.8	-3.5	-3.4
General government debt	28.0	28.7	34.3	37.6	41.5	43.9	45.4
Money and credit (end of year, percent change)							
Broad money (M3)	16.1	13.6	0.2	1.9	2.7	…	…
Private sector credit	26.6	16.1	0.8	3.0	5.5	…	…
Interest rates (in percent, year average)							
Three-month interbank rate	3.1	4.0	2.2	1.3	1.2	…	…
Ten-year government bond	4.3	4.6	4.7	3.7	3.5	…	…
Balance of payments (percent of GDP)							
Trade balance (goods and services)	2.9	2.7	4.3	3.4	4.2	5.0	5.2
Current account balance	-4.4	-2.1	-2.5	-3.0	-2.9	-2.1	-1.9
Gross international reserves (US$ billions)	34.9	37.0	41.6	42.5	40.3	42.9	44.9
Reserve cover (in months of imports of goods and services)	3.5	3.2	4.5	3.9	3.2	3.8	3.9
Exchange rate							
Nominal effective exchange rate (index, 2000=100)	108.1	121.6	116.3	118.7	122.4	n.a.	n.a.
Real effective exchange rate (index, CPI-based; 2000=100)	108.8	125.5	120.5	122.5	125.0	n.a.	n.a.

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

[1/] Public finance numbers reflect data available at the time of the Article IV Consultation mission. After the mission, the authorities have published the new estimates of net lending/ overall balance of 3.1 percent, and general government debt of 41.2 percent for 2011.

Statement by Willy Kiekens, Executive Director for Czech Republic
and Miroslav Kollar, Senior Advisor to the Executive Director
May 4, 2012

The Czech authorities thank the Article IV and the FSAP teams for constructive exchange of views during their missions.

Economic development and outlook

Strong exports drove the economic recovery in 2010 and continued in 2011 when real GDP growth reached 1.7 percent. However, towards the end of 2011, the Czech economy entered into a mild recession in tune with similar developments in the euro area, which is the Czech Republic's main trading partner. Fiscal consolidation and the conservative and cautious consumer behavior of Czech households contributed to the slowdown. As external demand picks up, real GDP growth should resume in 2013. For this year, the Czech authorities expect growth in the order of 0 - 0.2 percent of GDP and in the order of 1.3 - 1.9 percent in 2013, when the loss in absolute real GDP due to the crisis is expected to be recovered.

Employment creation reflects sluggish growth and the uncertainty about developments in the euro area. Unemployment may gradually rise from 6.7 percent in 2011 to 7.2 percent in 2013. This will be a drag on household consumption.

The current account deficit is projected to shrink by 0.6 percent of GDP to about 2.3 percent in both 2012 and 2013. While the trade and services account is in surplus, the income account contributes to the overall deficit mainly because of dividends on foreign direct investments paid to non-residents (of which 1/3 is reinvested in the Czech Republic). The current account deficit should remain at a sustainable level.

At the end of 2011, the net international investment position was -49 percent of GDP. Foreign direct investment liabilities of the Czech Republic accounted for 56 percent of total external liabilities. The Czech Republic's external debt was 49.2 percent of GDP, equally divided between public and private debt.

Monetary policy and exchange rate

Credible inflation-targeting monetary policy, flexible exchange rate as well as integrated financial sector supervision within the CNB served the country well during the crisis. The CNB did not have to rely on any unconventional monetary policy measures during this crisis period.

The macro-financial panel established within the CNB to integrate monetary policy analysis, supervision and macroprudential analysis ahead of each monetary-policy meeting of the CNB Bank Board serves the policymakers well in informing them about broader financial sector developments in the economy.

Annual changes in monthly headline inflation increased from close to zero levels at the end 2009 to 3.8 percent year-on-year in March 2012. Monetary-policy-relevant inflation, i.e. inflation adjusted for the first-round effects of changes to indirect taxes, also rose slightly to 2.7 percent in March 2012 and is thus in the upper half of the tolerance band around the inflation target (i.e. 2 percent headline inflation with tolerance band of ± 1 percent).

The main sources of inflation are administered prices (mostly natural gas prices) and food prices – reflecting first-round effects of the hikes in VAT rates – as well as fuel prices and the gradual pass-through of the depreciated exchange rate to prices. However, core inflation remains slightly negative consistent with the disinflationary development of the domestic economy.

The forecast assumes that headline inflation will be just above 3 percent for most of 2012 owing to the VAT increase and will fall below the CNB target (i.e. below 2 percent) in 2013. Consistent with well-anchored inflation expectations, the CNB's forecast expects stability of market interest rates in the near future and a modest decline thereafter, and the exchange rate to appreciate gradually against the euro from its currently weakened level.

The CNB considers the level of foreign exchange reserves as adequate, amounting to 22 percent of GDP, covering 43 percent of all external debt liabilities of domestic entities, 23 percent of total banking sector assets, and 3.6 months of imports.

Czech banking sector

The Czech banking sector proved highly resilient throughout both the U.S. subprime crisis and the euro area crisis, mainly thanks to sound fundamentals prior to the crisis. Czech banks follow a traditional banking model. Their assets do not include substantial amounts of structured products. The share of foreign-exchange denominated loans is very low. Czech banks are primarily funded from local deposits. The Czech banking sector operates in an environment of excess liquidity. During this crisis, Czech banks – which are largely subsidiaries of euro area banks – served as net creditors to their parent banks in euro area. The loan-to-deposit ratio of the Czech banking sector is 73 percent, among the lowest in the European Union. In recent years, the Czech banking sector has been the most profitable and stable in the Central and Eastern Europe, with ROE above 20 percent, and CAR around 15 percent. The share of non-performing loans in total loans is leveling up at 6.4 percent. Almost 60 percent of non-collateralized loans to households and corporations are provisioned. The largest Czech banks substantially exceed the EBA 9 percent Tier 1 ratio recommendation. There have been no signs of loan deleveraging driven by recapitalization needs of the euro area parent banks.

The FSAP's stress tests in November-December 2011 highlighted the resilience and profitability of the Czech banking sector. Even in the scenario of a severe recession in Europe accompanied by losses of the subsidiaries on their exposures to their euro area parents, the banking sector as a whole would remain only slightly undercapitalized, potentially requiring only a small amount of fiscal resources. Even in this scenario the banks would recover these small capital losses in as soon as two years thanks to the profitable business model.

The resilience of the Czech banking sector to severe stress was also confirmed by the most recent February 2012 stress tests by the CNB. The capitalization of the entire sector would remain above the regulatory minimum of 8 percent even in a significantly adverse stress scenario combining negative developments in the domestic and external economy and renewed uncertainty in financial markets caused by an escalation of the debt crisis in the indebted euro area countries.

Since 2009, there is close cooperation between the CNB, the Ministry of Finance and the Deposit Insurance Fund.

FSAP update

The Czech authorities welcome the positive assessment of the Czech regulatory and supervisory framework. They acknowledge the extensive work done by the assessment team, who delivered very well elaborated documents. Generally, the CNB appreciates the recognition of the resilience and stability of the Czech financial system as well as the statement that compliance with the Basel Core Principles for Effective Banking Supervision has improved markedly since the previous assessment and after the integration of the supervision of the whole financial sector into the CNB. The CNB values the recommendations provided by the FSAP team and works closely with the Ministry of Finance on following-up on these recommendations.

Fiscal policy

The Czech Republic was one of the first European countries to start fiscal consolidation in 2010. The fiscal deficit trajectory is to reach 3.0 percent of GDP in 2012; 2.9 percent in 2013 and 1.9 in 2014. This will bring the general government deficit below 3 percent of GDP by 2013 as required by the EU Excessive Deficit Procedure (EDP). The budget should be balanced by 2016.

Given the low public debt ratio (gross general government debt in 2011 was 41.2 percent of GDP, among the lowest in the EU), the medium-term budget objective for the Czech Republic under the Stability and Growth Pact is a structural deficit not exceeding 1 percent of GDP. This objective is likely to be reached by 2016.

The general government deficit improved significantly during the last 3 years and reached 3.1 percent of GDP in 2011. The bulk of the measures in 2011 consisted of expenditure cuts, particularly of reduction in salaries of public sector employees (excluding teachers and doctors), reduction of selected social benefits and non-mandatory current expenditures. With fiscal revenues weakening due to the slowdown, additional measures are needed to reach a deficit of 3.0 percent of GDP in 2012. To this end, the government intends to freeze the budget expenditures by CZK 23.6 billion. The expenditures of the Ministry of Education are expected to be cut by the least, in order to keep the focus on education, science and R&D intact. Also, the government adjusted the value added tax rates since January 2012. The reduced rate was increased by 4 percentage points from 10 percent to 14 percent.

Although the staff recommends allowing the automatic stabilizers to operate and to re-pace the planned fiscal consolidation if economic outlook worsens significantly, the government's preferred fiscal policy stance is maintaining the trajectory of fiscal consolidation even in temporary unfavorable economic conditions.

The trust of the market in the continuation of the fiscal consolidation is reflected in low funding costs for the public debt. Government bond yields have been decoupling downwards from its regional peers since the beginning of 2011. Standard & Poor's upgraded the credit rating of Czech Republic in August 2011 by two notches to AA- (stable outlook) based on the authorities' strong commitment to fiscal consolidation and a prudently managed economy.

On April 11, 2012, the government approved a set of measures to secure the implementation of the planned fiscal consolidation. The expenditure measures include rationalization of the public administration, cuts in renewable energy subsidies, or temporary lowering of indexation of pensions for the next three years. The revenue measures include a VAT hike by 1 percentage point for both rates to 21 percent and 15 percent for the next three years, a 1 percentage point increase in PIT for all income segments, a 7 percentage points additional PIT surcharge for high-income earners, tax hikes on tobacco, introduction of tax on non-sparkling wine and a carbon tax, cancellation of oil tax subsidy for agriculture producers, a 1 percentage point increase in tax on real estate transfers, and the inclusion of the revenues of the state-owned forestry to the general budget.

In order to smooth the impact of the fiscal consolidation on economic growth, the government intends to come up with a package of growth-enhancing measures by mid May. These could include more effective drawing of EU funds, lowering the administrative burden for businesses, promotion of exports, support for innovations and more effective use of state assets.

On April 11, 2012, the government outlined its plans for a constitutional fiscal responsibility act to be adopted by the end of 2012. The act will (i) establish an independent fiscal council which would assess the fiscal impact of new legislation, conduct debt-sustainability analysis and monitor and evaluate how governments meet their fiscal goals, (ii) introduce a debt ceiling and a list of measures to be initiated when the debt approaches the ceiling, (iii) introduce fiscal rules for all levels of the government, including municipalities.

On April 25, 2012, the government coined the consolidation path and the changes to fiscal institutions as approved on April 11, 2012 into its Convergence program for the period 2011-2015. The Convergence program is submitted to the European Commission and the Council as a fulfillment of the commitments stemming from the European semester.

Structural reforms

Pension reform

The new pension system will be based on three pillars. The pay-as-you-go pillar will remain the core of the pension system. The reform will introduce the second fully-funded defined-contribution pillar, which will involve the possibility to optionally transfer (opt-out) a part of social contributions from the first pillar together with additional private contributions from net income to chosen private pension fund(s). Investing in private funds will be optional, but irreversible; workers can choose to continue heading full pension payments to the first pillar only. The third pillar which enables additional contributions to private pension funds with state subsidy will remain almost unchanged by the reform. The pension reform is primarily aimed at people younger than 35, but older people can also voluntarily enter the second pillar. The estimated shortfall of revenues from social security contribution stemming from the introduction of the second pillar is already included in the fiscal outlook of the Ministry of Finance. The pension reform is planned to take effect in 2013.

Health care reform

The first phase of the health care reform increases patients' participation in health care and introduces so-called above-standard care. The reform came into effect on 1 December 2011.

The second phase of the health care reform regulates the rights and obligations of medical personnel and patients and stipulates the conditions for providing emergency medical service. The reform took effect on April 1, 2012.

The third phase of the health care reform will unify the conditions for health insurance and improve the competition among health insurance companies as well as improve the effectiveness of health care providers. Reform is currently being prepared.

The Social benefit reform simplifies the social security system, reduces administrative burdens for users of services and improves the targeting and needs calculation of social benefits. The reform came into effect on 1 January 2012.

Other

In March 2012, the government approved its 2020 export strategy to increase the share of non-EU markets (currently only less than 20 percent of total exports) as well as improving the state’s role as a partner for Czech exporters.