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IMF Executive Board Concludes 2011 Article IV Consultation with Czech Republic

On April 4, 2011 the Executive Board of the IMF concluded the Article IV consultation with the Czech Republic, and considered and endorsed the staff appraisal without a meeting.[1]

Background

The Czech economy has recovered from the downturn owing to its strong fundamentals and the global recovery. Low public debt, a comfortable external position, absence of pre-crisis asset bubbles, and a stable financial sector led to a relatively moderate decline in output in 2009 and a subsequent rebound of domestic demand. Deep economic integration with the euro area allowed the Czech economy to benefit from the recovery in trading partner countries. Overall GDP grew by 2.3 percent in 2010. Confidence has improved, spare capacity has been reduced, and the fall in employment has abated.

The recovery is expected to slow down in line with developments in the euro area. Staff projects GDP growth of 1.7 percent in 2011, with output reaching its pre-crisis level by year-end. Net exports and fixed investment are expected to drive growth, while consumption expansion should be modest given slow improvements in unemployment and fiscal consolidation. Downward risks in the short-term outlook stem in part from sovereign and banking sector risks in the euro area periphery spreading to core Europe. In the medium term growth is expected to remain below 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.

pre-crisis levels, reaching around 3 percent beyond 2011, with output gap forecast to close around 2014.

The 2010 budget delivered a significant fiscal consolidation, largely based on revenue measures. These measures, interest costs savings, and the improving economy helped reduce the deficit to an estimated 4.9 percent of GDP in 2010, from 5.8 percent in 2009, and yielded significant credibility gains. General government debt reached about 40 percent of GDP and was easily financed, mostly through issuance of domestic bonds.

Despite accommodative monetary policy, inflationary pressures remained subdued until the recent surge in commodity prices. After temporarily becoming negative in late 2009, headline CPI inflation largely stayed below the 2 percent target since mid-2010. This increase reflects growth in regulated prices, indirect tax hikes and lately global commodity prices inflation. But with large negative output gaps, core inflation remains low. In this environment, the Czech National Bank (CNB) has maintained policy interest rates at record low levels.

The virtually foreign-owned banking sector has been stable throughout the crisis. Banks' liquidity is comfortable and structurally sound, and capital adequacy ratios have strengthened on the back of retained earnings. The main risks stem from possible further worsening of credit quality under an adverse scenario and potential contagion from foreign parent banks. However, CNB's stress tests indicate that the banking system is well prepared to absorb losses of severe adverse shocks without threatening financial stability.

Executive Board Assessment

In concluding the 2010 Article IV consultation with the Czech Republic, Executive Directors endorsed the staff's appraisal, as follows:

The Czech Republic has rebounded from the downturn, but faces a number of policy challenges. Large structural deficits together with demographic trends are creating fiscal pressures and, under unchanged policies, would imply a rising public debt burden. Climbing world commodity prices complicate monetary policy in a situation of still nascent recovery and low core inflation. Sustaining robust productivity and GDP growth will require significant policy efforts. The authorities have prepared an ambitious policy agenda to tackle the challenges, but implementation of the necessary reforms may not be easy.

An accommodative monetary policy remains appropriate in the presence of a large negative output gap and fiscal consolidation. Appreciation of the koruna and the sizeable output gap are likely to offset the effects of rising commodity prices. Thus a gradual increase in policy interest rates should commence once the output gap starts closing at a significant pace, though a rise in inflation expectations or a rapid improvement in labor markets would warrant earlier action. Interest rate differentials against other advanced economies need to be also taken into consideration to avoid sharp changes in capital flows, which affect the exchange rate and inflation in the highly open Czech economy.

Wide-ranging structural reforms are needed to buttress growth. To close the productivity and income-per-capita gap vis-à-vis EU-15 countries, policies should focus on: increasing labor participation and labor market flexibility; enhancing efficiency in higher education, research and development, and the public sector; and further improving the business climate.

Following initial efforts to reign in the fiscal deficit last year, the 2011 budget is a welcome further step towards consolidation of public finances. The largely expenditure-based focus of the consolidation is adequate and, given the high degree of openness of the Czech economy, is expected to have a limited negative impact on growth.

The authorities' medium-term fiscal targets are appropriate, since balancing the budget by 2016 would reverse the rising trend of public debt. However, to achieve these targets additional reforms need to be specified and implemented rapidly. Efforts should focus primarily on reducing the high level of entitlement spending and rationalizing the generous welfare state, while the pension reform should ensure long-term sustainability of the pay-as-you-go finances and introduce a second pillar without additional accumulation of debt. A broad-based consensus will be necessary to ensure full and successful implementation and durability of these reforms.

The banking sector is stable and well supervised, though possible risks warrant close monitoring. The Czech banks' high capital and liquidity buffers as well as their domestic retail business orientation helped them weather the financial crisis well. Nevertheless, risks of further worsening of credit portfolios and potential contagion from parent banks cannot be precluded, and require continued close monitoring and cross-border supervisory co-operation.

Czech Republic: Selected Economic Indicators, 2006–12

	2006	2007	2008	2009	2010	2011	2012
					Est.	Staff Proj.	
Real economy (change in percent)							
Real GDP	6.8	6.1	2.5	-4.1	2.3	1.7	2.9
Domestic demand	5.4	5.2	1.2	-3.7	2.6	1.0	2.2
CPI (year average)	2.5	2.9	6.3	1.0	1.6	2.0	2.0
PPI (year average)	1.5	4.1	4.5	-3.1	1.3	…	…
Unemployment rate (in percent)	7.1	5.3	4.4	6.7	7.3	7.1	6.9
Gross national savings (percent of GDP)	24.3	23.7	24.7	20.6	19.9	20.7	20.9
Gross domestic investments (percent of GDP)	26.8	27.0	25.3	21.7	22.3	22.4	22.1
Public finance (percent of GDP)							
General government revenue	41.1	41.8	40.2	40.2	40.8	41.0	40.8
General government expenditure	43.7	42.5	42.9	45.9	45.7	44.7	44.4
Net lending / Overall balance	-2.6	-0.7	-2.7	-5.8	-4.9	-3.7	-3.6
General government debt	29.4	29.0	30.0	35.4	39.6	41.7	43.4
Money and credit (end of year, percent change)							
Broad money (M3)	12.9	16.1	13.7	0.2	1.2	…	…
Private sector credit (percent change, eop)	20.5	26.6	16.1	0.8	3.0	…	…
Interest rates (in percent, year average)							
Three-month interbank rate	2.3	3.1	4.0	2.2	1.3	…	…
Ten-year government bond	3.8	4.3	4.6	4.7	3.7	…	…
Balance of payments (percent of GDP)							
Trade balance (goods and services)	3.4	4.8	4.7	5.7	4.6	5.7	6.3
Current account balance	-2.5	-3.3	-0.6	-1.1	-2.4	-1.8	-1.2
Gross international reserves (US$ billion)	31.5	34.9	37.0	41.6	43.7	46.2	48.7
Reserve cover (in months of imports of goods and services)	3.6	3.2	2.8	4.1	3.8	3.9	4.1
Exchange rate							
Nominal effective exchange rate (index, 2000=100)	105.2	108.1	121.6	116.3	118.7	n.a.	n.a.
Real effective exchange rate (index, CPI-based; 2000=100)	105.6	108.8	125.5	120.4	122.1	n.a.	n.a.

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