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Czech Republic: Staff Report for the 2010 Article IV Consultation

The following documents have been released and are included in this package:

- The staff report, prepared by a staff team of the IMF, following discussions that ended on January 25 with the officials of the Czech Republic on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 5, 2010. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff statement.
- A Public Information Notice (PIN).
- A statement by the Executive Director for the Czech Republic.

The document(s) listed below will be separately released.

Selected Issues Paper

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CZECH REPUBLIC

Staff Report for the 2010 Article IV Consultation

Prepared by the Staff Representatives for the 2010 Consultation with the Czech Republic

Approved by Juha Kähkönen and Aasim M. Husain

February 5, 2010

This report is based on discussions held in Prague during January 14–25, 2010. The mission team comprised Ms. Murgašová (head), Ms. Muñoz, Mr. Tchaidze, Ms. Westin (all EUR), and Mr. Giustiniani (MCM). Mr. Kiekens (Executive Director) and Mr. Kollár (Advisor to the Executive Director) also joined some of the discussions. The mission met with Prime Minister Fischer, Czech National Bank Governor Tůma, Deputy Finance Ministers Chrenko, Hájková, Hejduk, and Zídek, Deputy Minister of Education Matesová, and other officials, as well as representatives of the Parliament, financial and business community, academia, and the media.

Political Background: After the ruling three-party center-right coalition lost a nonconfidence vote last March, an interim government headed by Prime Minister Fischer is in power until the general elections in May 2010.

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

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I. STAFF APPRAISAL

The macroeconomic position was very strong before crisis

1. Prior to the global financial and economic crisis, the Czech Republic benefited from integration with the EU, supported by strong macroeconomic policies. Large foreign direct investment inflows (FDI) fostered trade integration, underpinning an export-led expansion. Higher initial standard of living contained consumption convergence pressures. An improved fiscal performance contributed to the comfortable external position. This, combined with credible inflation targeting, resulted in generally low inflation and interest rates. A liquid and conservative banking sector limited the build-up of balance sheet vulnerabilities.

But spillover effects have taken their toll

2. The highly open Czech economy has been significantly affected by the global crisis. A downturn in the euro area—especially in Germany, the main trading partner—depressed exports and output fell by 4⅓ percent in 2009. A drop in FDI and the tightening of domestic banks' lending standards hit the corporate sector, leading to a decline in investment. Private consumption held up in spite of rising unemployment, reflecting a supportive fiscal policy.

3. The external position remained robust despite a sharp decline in capital inflows. The drop in exports was offset by a larger fall in imports, improving the trade balance. FDI more than halved and no longer fully finances the current account deficit, but rising inflows of EU funds filled the gap. The initial depreciation of the Czech koruna was subsequently reversed, and the real exchange rate remains in line with fundamentals. Overall, market sentiment vis-à-vis the Czech Republic remains relatively favorable, reflecting limited vulnerabilities.

4. The Czech banking sector has weathered the global financial turmoil relatively well. Healthy capital and liquidity buffers, strong retail funding, and limited exposure to foreign currency risk eliminated the need for the authorities to undertake bank recapitalization or other exceptional measures to shore up financial sector stability. However, liquidity in the interbank market and trading activity in the domestic bond market remain below pre-crisis levels.

The policy response was adequate

5. Monetary and fiscal easing provided a sizeable stimulus. The Czech National Bank (CNB)—the first central bank in Europe to start easing monetary policy in August 2008—cut the policy rate by a total of 275 basis points through December 2009. Although the effectiveness of the traditional monetary transmission mechanism has weakened, such easing—combined with well-timed verbal interventions—kept inflation largely in positive territory, though well below the target. Automatic stabilizers and fiscal

measures helped cushion the decline in growth, increasing the overall fiscal deficit by some 4 percentage points of GDP.

The short-term recovery will depend on external demand

6. The revival of the Czech economy is expected to be gradual and dependent on the global recovery. GDP is projected to grow by 1½ percent in 2010, supported by exports and a buildup of inventories, while fixed capital formation will likely remain depressed. Consumer spending is expected to decline reflecting still-rising unemployment, a slowdown in wage growth and the unwinding of fiscal stimulus. Risks to the short-term outlook seem balanced.

The monetary policy should shift to tightening once the economy recovers steadily

7. The inflation environment will remain benign in the near future. The recently-approved VAT and excise hikes are expected to push average headline inflation to over 1½ percent in 2010, still below the new inflation target of 2 percent that came into effect in January 2010. The easing cycle of monetary policy seems to have come to an end. The supportive monetary policy stance remains appropriate for now, but should shift to tightening as the recovery gathers momentum.

The crisis has highlighted the urgency of fiscal adjustment

8. The crisis took a major toll on the fiscal position. During the years of rapid economic growth the opportunity for more fundamental fiscal consolidation was missed. The crisis led to a sharp widening of the overall deficit in 2009, a rapid accumulation of debt, and an increase in interest rate spreads. In the absence of additional adjustment measures, the budget deficit is projected to remain above 5 percent of GDP over the medium term, with the level of public debt doubling to 60 percent of GDP in less than a decade. We estimate that a structural adjustment of at least 0.7 percent of GDP per year will be required to achieve a deficit of below 3 percent of GDP in 2013 mandated by ECOFIN. This, however, will not be sufficient to achieve debt sustainability over the long term, in particular given spending pressures of population aging.

9. The 2010 fiscal budget appropriately balances the objectives of fiscal sustainability and supporting economic recovery. With the projected recovery in the trading partners, growth is expected to pick up in 2010 in the Czech Republic. Given very low fiscal multipliers in the highly open Czech economy, additional fiscal stimulus would have limited effect. At the same time, starting fiscal consolidation would help lower borrowing costs and likely aid economic recovery by crowding in private investment. The budget—a first marked step to reverse the deteriorating fiscal position—mostly relies on permanent indirect tax increases and, to a lesser degree, on temporary expenditure cuts that will expire in 2011. In this regard, pressures to approve increases in spending in the pre-election period should be resisted.

10. The government that will be formed after the May general elections will need to propose a credible and durable plan for fiscal consolidation. Broad support among the social and political partners, with a wide range of views on the appropriate strategy, will be crucial for its successful implementation. Fiscal consolidation during 2011–13 should focus on both expenditure and revenue measures. International experience suggests that expenditure-based fiscal consolidations tend to be more durable.

- *Expenditures.* Rationalizing mandatory expenditures and the generous welfare system is unavoidable. Re-organizing public institutions and positions would help reduce the overall wage bill without reducing wage levels. Introducing means-testing would improve targeting of social benefits, yield savings, and enhance work incentives. There is scope for improving efficiency of public services delivery and public procurement.

- *Revenues*. The tax base needs to be expanded by eliminating exemptions and loopholes. VAT rates should be unified at the higher rate and taxation of real estate property be based on market value. While the scope for raising additional revenues from direct taxation is likely to be limited during the nascent recovery, the current corporate income tax rate could be reconsidered as it is below the OECD average. Improving tax administration could improve efficiency of revenue collection.

Demographic trends heighten the need for sustainable pension and health care reforms

11. A longer-term fiscal challenge arises from the projected rapid aging of the Czech population and the related increase in social spending. While the pension and health care systems remain largely unreformed, with limited private participation, the associated spending is expected to increase by 6 percentage points of GDP over the next 50 years, bringing total age-related spending to about one quarter of GDP.

12. Pension reforms should make the public pension scheme sustainable over the long term and promote the development of a complementary sound private pension system. While the significant parametric changes to the current PAYG system effective January 2010 are mostly welcomed, there will be a need for further changes. Additional changes should be aimed at better linking contributions to benefits and further increasing the effective retirement age (for example by moving forward to 2020 the increase in the statutory retirement age to 65 and reducing the period for early retirement back to 3 years). Over the medium term, consideration should be given to moving to a fully funded second-pillar private pension scheme, and to prefunding additional reserves to finance future deficits of the PAYG scheme (or transition deficits if moving toward private pension funds) through upfront fiscal consolidation measures or any privatization revenues.

13. Fundamental health care reforms are equally important. The user fees, introduced in 2008, were a first step in the right direction and could usefully be made means tested.

Given the sheer complexity of health care reform, there is a need to establish a working group with broad representation to lead the reform efforts on:

- *Institutional reform*—reduce the broad coverage of publicly provided and insured services and allow greater scope for private sector provision of health services, in turn introducing more competition among insurers and providers.

- *Financing reform*—introduce voluntary insurance, personal health accounts, and choices in health benefits plans to ensure long-term financial sustainability of the health care system.

Structural reforms are needed to support long-term growth in the post-crisis environment

14. The adverse effects of the crisis are likely to be long lasting. A collapse in investment and slowdown in total factor productivity growth reduced dramatically the growth rate in 2009–10. Looking ahead, growth is not expected to reach pre-crisis levels due to abating convergence process, worsening demographic trends, and uncertainties regarding global long-term growth as a result of the crisis.

15. Against this background, the swift implementation of growth-enhancing structural reforms becomes critical. The focus should be on increasing productivity and labor participation, and improving the quality of the labor force and the business climate to attract foreign direct investment. The array of measures includes further promoting work incentives through changes to the tax-benefit system, improving labor market flexibility and the quality of education, and further reducing barriers to business entry and exit.

Domestic capital markets should be developed further

16. Local bond markets are not functioning in an efficient way and capital markets remain underdeveloped. Despite steps taken by the CNB to improve the liquidity of the local currency government bond market, trading remains thin due to the opaqueness of public debt management. Capital market development is hampered by poorly-targeted subsidies and tax exemptions on certain savings products, and old regulations regarding private pension funds. Further measures should be taken to support the smooth functioning of these markets:

- Enhance the transparency of the government bond market by, for example, adhering to the announced size of bond issuances, to enable accurate pricing by dealers.

- Rationalize subsidies and tax exemptions for deposits in building societies and contributions in voluntary third-pillar pension funds.

- Improve the regulation regarding the third-pillar pension funds.

Credit quality is a challenge, but banks' financial health bodes well for credit recovery

17. The economic downturn has started to take its toll on the banking sector. The share of banks' nonperforming loans is expected to rise, thus exercising pressure on banks' profitability, though the private sector's moderate debt levels and low interest rates may be mitigating factors. High single-borrower concentration in the corporate sector and commercial real estate exposure require high vigilance. Against this background, further improvements in cost efficiency will become key for the Czech banks. The CNB should continue closely monitoring developments in banks' profitability, so as to preserve adequate capital buffers and liquidity positions. Banks' soundness, low loan-to-deposit ratio, and parent banks' commitment to the market bode well for banks' ability to resume lending as the economic outlook improves.

18. The Czech Republic has a sound financial supervisory and prudential framework. The framework was further strengthened by the recent widening of the array of remedial measures to deal with weak credit institutions and systemic risk. Important reforms of the deposit insurance framework, in line with EU agreements, are pending in parliament. Given the shortening of the pay-off period of insured depositors, the timeliness and periodicity of basic information sharing between the CNB and the Deposit Insurance Fund need to be reviewed. The CNB should continue its efforts in: (i) improving macro-prudential analysis by taking into account the interaction among liquidity, market, and credit risks; and (ii) enhancing the integration between macro-prudential analysis and supervision activity.

19. Given the virtually complete foreign ownership of banks, intensive supervisory coordination with cross-border authorities remains crucial.

20. It is recommended that the next Article IV consultations take place on a standard 12-month cycle.

II. Authorities' Views

21. The authorities agreed with most of staff's assessment and recommendations, including the analysis of the crisis impact, prospects for the recovery, the need for fiscal adjustment and structural reforms, the strategy for monetary policy, and the broad assessment of financial sector issues. The authorities' views differed from staff's with respect to the specific strategy for pursuing medium-term fiscal consolidation, the feasibility of proposed pensions and health reforms, and impediments to capital market functioning and development.

Fiscal consolidation

22. While the authorities agreed with the need to design a credible policy for a sustainable medium-term fiscal consolidation, they pointed out that the lack of broad political consensus on the appropriate strategy made developing specific policy proposals difficult. They cautioned that some of the proposed measures, in particular on the unification of the two VAT rates and on the property tax, were unlikely to find support in the near future. They also noted that despite its limited mandate, the current caretaker government was spearheading preparation of an Exit Strategy from the Crisis—an options-based approach for fiscal consolidation combined with other growth-supportive policies. This document could help in the formulation of fiscal strategy by the new government after the May general elections.

Pension and health reform

23. While the problems stemming from population aging and its adverse impact on the future fiscal balances are widely known, the social sensitivity of pension and health issues are likely to limit the scope for reforms of these systems in the foreseeable future. The authorities pointed to the significant parametric changes to the existing first-pillar pension system (PAYG) that are currently being implemented, but agreed that these changes would not be sufficient to ensure the sustainability of the pension system. They thought that having a complementary fully-funded second pillar system was beneficial by creating a more diversified pension system, but expressed concerns that a voluntary opt-out would mainly involve wealthier individuals, thus further worsening the financial situation of the PAYG. The authorities noted that some reserves for funding future pension deficits have already been created, but questioned the feasibility for building up further significant reserves, in particular given that no further privatizations were likely.

Financial sector and capital markets

24. The authorities generally agreed on the imperfect functioning of the domestic government bond market and the need to develop capital markets further. They noted that enhancing transparency of government debt management and improving functioning of the government bond market would be beneficial, but pointed out that the debt management

strategy was clear. The MOF agreed that the system of subsidies and tax exemptions on certain savings products (deposits in building societies and contributions to third-pillar pension funds) created market distortions, and saw them as impediments for capital market development in the Czech Republic. Also, the authorities believed that abrupt elimination of these savings incentives would not be politically feasible and could generate instability in the financial system. Rather, they saw merits in reviewing and gradually rationalizing these incentives. Amendments to the law regulating private pension funds, aimed at making these institutions financially sound in the long term, are pending in Parliament, though their approval was far from certain.

25. The CNB was of the view that high single-borrower concentration in the corporate sector and commercial real estate exposure did not represent a particular source of concern at the current juncture, but agreed that this issue required adequate monitoring and further analysis.

26. The authorities agreed on the need to review the timeliness and frequency of basic information sharing between the CNB and the DIF in light of the shortening of the period for paying off depositors.

27. While supporting closer cooperation and collaboration among home/host supervisors, the authorities expressed concerns about an EU-wide cross-border bank crisis and resolution framework since fiscal responsibilities remain at national levels. Moreover, harmonization of national insolvency and commercial laws would be required.

Table 1. Czech Republic: Selected Economic Indicators, 2005-11

	2005	2006	2007	2008	2009	2010	2011
					Est.	Staff Proj.	
Real economy (change in percent)							
Real GDP	6.3	6.8	6.1	2.5	-4.3	1.7	2.6
Domestic demand	1.3	5.5	5.2	1.1	-5.3	0.6	2.1
CPI (year average)	1.9	2.5	2.8	6.3	1.0	1.6	2.0
PPI (year average)	3.1	1.5	4.1	4.5	-3.1	n.a.	n.a.
Unemployment rate (in percent)							
Survey-based 1/	7.9	7.1	5.3	4.4	7.2	8.8	8.5
Registered 1/	8.9	8.1	6.6	5.4	8.2	9.9	9.6
Gross national savings (percent of GDP)	24.4	24.4	23.8	22.2	20.9	21.0	20.3
Gross domestic investments (percent of GDP)	25.7	26.8	27.0	25.3	23.0	22.7	22.7
Public finance (percent of GDP) 2/							
General government revenue	41.4	41.1	41.9	40.9	38.8	40.7	40.8
General government expenditure	45.0	43.7	42.5	42.9	44.8	45.8	46.1
Net lending / Overall balance	-3.6	-2.6	-0.7	-2.0	-6.0	-5.1	-5.3
General government debt	29.7	29.6	29.0	30.0	34.2	37.9	40.5
Money and credit (end of year, percent change)							
Broad money 3/	8.0	9.9	13.2	6.6	4.3	4.0	n.a.
Private sector credit (percent change, eop) 3/	20.8	21.6	27.3	16.0	2.8	1.5	n.a.
Interest rates (in percent, year average)							
Three-month interbank rate	2.0	2.3	3.1	4.0	2.2	n.a.	n.a.
Ten-year government bond	3.5	3.8	4.3	4.6	4.7	n.a.	n.a.
Balance of payments (percent of GDP)							
Trade balance	2.0	2.0	3.4	2.8	2.9	2.9	3.3
Current account	-1.3	-2.4	-3.2	-3.1	-2.1	-1.7	-2.4
Gross international reserves (US$ billion)	29.6	31.5	34.9	37.0	42.7	45.9	47.5
Reserve cover (in months of imports of goods and services)	4.4	3.5	3.0	3.0	4.3	4.3	4.1
Exchange rate							
Nominal effective exchange rate, pa (2000=100) 3/	125.3	131.7	135.4	142.5	149.5	n.a.	n.a.
Real effective exchange rate, pa (CPI-based; 2000=100) 3/	125.5	132.6	136.8	148.8	155.1	n.a.	n.a.

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

1/ In percent of total labor force.
2/ On ESA-95 basis.
3/ For 2009, data refer to November.

Table 2. Czech Republic: Balance of Payments, 2005-11

	2005	2006	2007	2008	2009	2010	2011
					Est.	Staff Proj.	
	(In millions of U.S. dollars)						
Current account balance	-1,578	-3,558	-5,747	-6,642	-4,122	-3,384	-4,849
Trade balance	2,522	2,843	5,909	6,367	5,745	5,830	6,825
Exports	77,973	95,147	122,697	145,749	108,940	116,937	126,564
Imports	75,451	92,304	116,788	139,382	103,196	111,107	119,740
Nonfactor services	1,548	2,000	2,439	4,852	3,404	2,790	2,270
Receipts	11,769	13,941	16,917	22,240	20,260	20,922	21,442
Payments	10,220	11,941	14,478	17,387	16,856	18,132	19,172
Factor income (net)	-5,975	-7,486	-12,735	-17,285	-12,411	-10,246	-11,830
Transfers	326	-915	-1,360	-576	-861	-1,757	-2,114
Capital account	196	380	1,021	1,818	2,639	1,590	1,743
Financial account balance	6,379	4,204	6,382	8,973	4,122	3,384	4,849
Direct investment, net	11,630	4,043	8,955	8,972	1,735	2,425	3,764
Portfolio investment, net	-3,390	-1,132	-2,688	-42	7,389	2,922	3,022
Financial derivatives, net	-112	-282	28	-804	0	0	0
Other investment, net	-1,748	1,575	86	846	-5,001	-1,963	-1,937
Errors and omissions, net	-1,118	-934	-787	-1,729	0	0	0
Change in reserves 1/	-3,879	-92	-868	-2,419	-2,639	-1,590	-1,743
Memorandum items:							
Current account (in percent of GDP)	-1.3	-2.4	-3.2	-3.1	-2.1	-1.7	-2.4
Trade balance (in percent of GDP)	2.0	2.0	3.4	2.8	2.9	2.9	3.3
Net foreign direct investment (in percent of GDP)	9.4	2.8	5.1	4.1	0.9	1.2	1.8
Gross official reserves							
(in months of the following year's imports of goods and non-factor services)	4.1	3.6	3.2	2.8	4.0	4.0	3.5
(as a ratio to the short-term debt by remaining maturity)	1.3	1.4	1.3	1.3	1.3	1.4	1.3
Terms of trade 2/	-1.7	-1.3	1.1	-1.5	-1.1	-1.8	-0.4

Sources: Czech National Bank; and IMF staff projections.

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

Table 3. Czech Republic: Consolidated General Government Budget, 2005-11 1/
(on ESA-95 basis)

	2005	2006	2007	2008	2009	2010	2011
					Est.	Proj.	
	(In percent of GDP)						
Total revenue	41.4	41.1	41.9	40.9	38.8	40.7	40.8
Current taxes on income, wealth, etc	9.2	9.2	9.4	8.6	7.3	6.9	6.9
Personal income tax	4.6	4.2	4.3	4.0	3.4	3.4	3.4
Corporate Income Tax	4.5	4.8	5.0	4.4	3.9	3.4	3.4
Social contributions	16.2	16.3	16.3	16.2	15.0	15.8	15.8
Taxes on production and imports	11.5	10.9	11.2	11.0	10.9	12.2	12.1
VAT	7.1	6.5	6.4	6.9	6.8	7.3	7.3
Excise	3.7	3.8	4.0	3.4	3.4	4.1	4.1
Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Property income	0.7	0.8	0.8	0.9	0.8	1.0	1.0
Other	3.9	3.9	4.1	4.2	4.7	4.9	5.0
Total expenditure	45.0	43.7	42.5	42.9	44.8	45.8	46.1
Final consumption expenditure	22.1	21.3	20.3	20.4	21.2	21.0	20.6
Collective consumption	11.0	10.6	10.0	10.1	10.3	9.8	9.6
Individual consumption	11.0	10.7	10.3	10.3	11.0	11.2	11.0
Social transfers in kind	5.6	5.4	5.3	5.4	5.7	5.9	5.8
Transfers of individual non-market goods or services	5.4	5.3	5.0	4.9	5.2	5.3	5.2
Social benefits other than social transfers in kind	12.6	12.6	12.8	12.8	13.6	13.9	14.0
Interest	1.2	1.1	1.1	1.1	1.2	1.7	2.1
Subsidies	1.8	1.9	1.8	1.7	1.8	1.7	1.7
Gross fixed capital formation	4.9	5.0	4.7	5.0	5.0	5.5	5.7
Other expenditure	2.4	1.8	1.8	2.0	2.0	1.9	2.1
Net lending	-3.6	-2.6	-0.7	-2.0	-6.0	-5.1	-5.3
Financing	3.6	2.6	0.7	2.0	6.0	5.1	5.3
Net change in financial assets 2/	1.0	0.2	-2.3	-0.6	0.8	-0.8	-0.2
Currency and deposits	-3.9	0.5	-2.2	-2.2	0.4	-1.3	-1.1
Securities other than shares	-0.2	0.1	0.0	0.1	0.0	0.0	0.0
Loans	0.0	-0.1	-0.1	-0.1	0.0	-0.1	-0.1
Shares and other equity	1.6	0.2	0.2	0.4	0.4	0.3	0.4
Other financial assets	3.6	0.1	0.5	0.6	0.0	0.4	0.3
Total adjustment 3/	1.3	0.5	0.9	0.6	0.0	0.5	0.4
Change in debt	1.3	2.0	2.1	2.2	5.2	5.9	5.6
Memorandum items:							
General government debt	29.7	29.6	29.0	30.0	34.2	37.9	40.5
Primary balance	-2.4	-1.5	0.5	-1.0	-4.8	-3.4	-3.3
Cyclically adjusted primary balance 4/	-2.4	-1.6	-0.1	-1.4	-3.3	-2.0	-2.2
Output gap 4/	-0.2	0.2	1.6	1.3	-4.3	-3.7	-3.0

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

Table 4. Czech Republic: Selected Vulnerability Indicators, 2003-09

	2003	2004	2005	2006	2007	2008	2009 1/	Latest Observation
Key Economic and Market Indicators								
Real GDP growth (in percent)	3.6	4.5	6.3	6.8	6.1	2.5	-4.3	Proj
CPI inflation (period average, in percent)	0.1	2.8	1.9	2.5	2.8	6.3	1.0	Proj
Short-term (ST) interest rate (in percent) 2/	2.1	2.6	2.2	2.6	3.1	4.0	1.5	Dec-09
EMBI secondary market spread (bps, end of period) 3/	...	14.7	14.2	19.8	28.5	185.3	83.4	Nov-09
Exchange rate NC/US$ (end of period)	25.7	22.4	24.6	20.9	18.1	19.3	18.4	Dec-09
External Sector								
Exchange rate regime			Free floating					
Current account balance (percent of GDP)	-6.2	-5.2	-1.3	-2.4	-3.2	-3.1	-2.1	Proj
Net FDI inflows (percent of GDP)	2.1	3.6	9.4	2.8	5.1	4.1	0.9	Proj
Exports (percentage change of US$ value, GNFS)	24.0	35.7	17.1	21.2	28.0	19.6	-22.4	Proj
Real effective exchange rate (2000 = 100)	116.8	118.1	125.5	132.6	136.8	148.8	155.1	Nov-09
Gross international reserves (GIR) in US$ billion	27.0	28.4	29.6	31.5	34.9	37.0	42.7	Proj
GIR in percent of ST debt at remaining maturity (RM)	169.6	131.8	120.9	133.3	161.9	117.7	126.6	Proj
Total gross external debt (ED) in percent of GDP	38.2	41.3	37.3	40.1	43.6	37.2	41.9	Proj
o/w ST external debt (original maturity, in percent of total ED)	40.1	34.0	31.4	26.9	29.7	32.1	30.5	Proj
ED of domestic private sector (in percent of total ED)	92.2	85.0	80.0	79.1	80.0	80.9	78.1	Proj
ED to foreign official sector (in percent of total ED)	9.6	8.6	10.1	9.8	8.0	8.3	8.5	Proj
Total gross external debt in percent of exports of GNFS	61.8	59.0	51.7	52.6	54.6	48.3	63.5	Proj
Gross external financing requirement (in US$ billion) 4/	19.8	26.2	25.2	25.8	24.9	36.3	36.9	Proj
Public Sector (PS) 5/								
Overall balance (percent of GDP)	-6.6	-2.9	-3.6	-2.6	-0.7	-2.0	-6.0	Proj
Primary balance (percent of GDP)	-5.5	-1.8	-2.4	-1.5	0.5	-1.0	-4.8	Proj
Debt-stabilizing primary balance (percent of GDP) 6/	...	...	...	-1.3	-1.6	-0.1	1.2	Proj
Gross PS financing requirement (in percent of GDP) 7/	15.5	13.3	9.8	11.5	7.8	11.3	8.2	Proj
Public sector gross debt (PSGD, in percent of GDP)	29.8	30.1	29.7	29.6	29.0	30.0	34.2	Proj
Financial Sector (FS) 8/								
Capital adequacy ratio (in percent)	14.5	12.5	11.9	11.5	11.5	12.3	13.7	Sep-09
NPLs in percent of total loans	4.9	4.0	3.9	3.7	2.8	3.3	5.0	Sep-09
Provisions in percent of NPLs	76.7	71.2	64.5	61.5	70.4	67.5	59.2	Sep-09
Return on average assets (in percent) 9/	1.2	1.3	1.4	1.2	1.3	1.2	1.3	Sep-09
Return on equity (in percent) 10/	23.8	24.6	26.4	23.4	25.4	21.7	23.3	Sep-09
FX deposits held by residents (in percent of total deposits)	9.2	9.3	9.4	9.8	9.1	8.4	7.8	Nov-09
FX loans to residents (in percent of total loans)	11.0	10.2	9.4	9.8	8.6	8.8	8.0	Nov-09
Credit to private sector (percent change)	11.8	15.3	20.8	21.6	25.9	16.0	1.5	Nov-09
Memo item:								
Nominal GDP in billions of U.S. dollars	91.4	109.5	124.5	142.6	174.2	216.1	196.0	Proj

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

Table 5. Czech Republic: Medium-term Macroeconomic Scenario, 2005–15

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Real sector				(percent growth)							
Real GDP	6.3	6.8	6.1	2.5	-4.3	1.7	2.6	3.5	3.5	3.5	3.5
Consumption	2.6	3.9	3.7	2.8	0.8	-0.6	1.8	3.1	3.3	3.2	3.2
Investment	-0.8	9.6	9.4	-2.7	-21.3	4.4	3.1	2.1	5.3	1.6	0.6
o/w fixed investment	1.8	6.0	10.8	-1.5	-10.5	-3.0	2.1	4.6	5.1	5.5	5.5
Exports, goods and services	11.6	15.8	15.0	6.0	-15.8	4.6	6.1	9.3	10.7	11.4	11.4
Imports, goods and services	5.0	14.3	14.3	4.7	-17.1	3.6	5.7	9.0	11.4	11.1	11.1
CPI inflation	1.9	2.5	2.8	6.3	1.0	1.6	2.0	2.0	2.0	2.0	2.0
Gross domestic savings 1/	24.3	24.2	23.9	22.2	20.9	21.0	20.3	21.0	21.3	22.0	22.4
Public	-0.6	0.4	3.1	1.7	-1.0	-0.1	-0.2	0.1	0.7	0.9	0.9
Private	24.9	23.9	20.8	20.5	21.8	21.1	20.6	20.9	20.7	21.1	21.5
Gross capital formation 1/	25.7	26.8	27.0	25.3	23.0	22.7	22.7	23.8	24.3	24.6	24.9
Public finances 2/				(in percent of GDP)							
Revenues	41.4	41.1	41.9	40.9	38.8	40.7	40.8	41.5	41.6	41.6	41.5
Expenditures	45.0	43.7	42.5	42.9	44.8	45.8	46.1	47.0	46.8	46.8	46.8
Net lending	-3.6	-2.6	-0.7	-2.0	-6.0	-5.1	-5.3	-5.5	-5.2	-5.3	-5.3
General government debt	29.7	29.4	29.0	30.0	34.2	37.9	40.5	44.1	46.7	48.6	50.3
Balance of payments				(in percent of GDP)							
Current account balance	-1.3	-2.4	-3.2	-3.1	-2.1	-1.7	-2.4	-2.7	-3.0	-2.6	-2.5
Trade balance	2.0	2.0	3.4	2.8	2.9	2.9	3.3	0.1	-0.6	0.2	0.9
Services balance	1.2	1.4	1.4	2.2	1.7	1.4	1.1	0.9	0.7	0.5	0.2
Net factor income	-4.8	-5.2	-7.2	-7.8	-6.3	-5.2	-5.7	-2.7	-2.1	-2.3	-2.8
Current transfers	0.2	-0.6	-0.8	-0.3	-0.4	-0.9	-1.0	-1.1	-1.0	-0.9	-0.8
Financial account balance	5.2	2.9	3.6	4.1	2.1	1.7	2.4	2.7	3.0	2.6	2.5
Capital transfers	0.2	0.3	0.6	0.8	1.3	0.8	0.8	0.9	1.0	1.0	1.0
Direct investment, net	9.4	2.8	5.1	4.1	0.9	1.2	1.8	1.3	1.3	1.7	1.7
o/w privatization revenue	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Portfolio investment, net	-2.7	-0.8	-1.6	-0.2	3.8	1.5	1.5	1.4	1.3	1.1	1.1
Financial derivatives, net	-0.1	-0.2	0.0	-0.4	0.0	0.0	0.0	0.0	0.5	0.4	0.4
Other investment, net	-1.4	1.1	0.1	0.6	-2.6	-1.0	-0.9	0.0	0.3	-0.3	-0.2
Errors and omissions, net	-0.9	-0.7	-0.5	-0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves (- increase) 3/	-3.1	-0.1	-0.4	-1.1	-1.3	-0.8	-0.8	-0.9	-1.0	-1.0	-1.0

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

Table 6. Czech Republic: External Debt Sustainability Framework, 2005-2015
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2005	2006	2007	2008	2009			2010	2011	2012	2013	2014	2015	Debt-stabilizing non-interest current account 6/
Baseline: External debt	37.3	40.1	43.6	37.2	41.9			**45.2**	**46.2**	**48.1**	**48.6**	**48.3**	**47.9**	**-2.0**
Change in external debt	-4.0	2.8	3.6	-6.4	4.7			3.3	1.0	1.9	0.5	-0.3	-0.4	
Identified external debt-creating flows (4+8+9)	-11.2	-6.4	-9.4	-9.6	5.6			0.6	0.2	0.0	0.2	-0.1	-0.1	
Current account deficit, excluding interest payments	0.0	1.4	1.7	1.8	0.7			0.3	0.9	1.1	1.3	0.9	0.8	
Deficit in balance of goods and services	-3.3	-3.4	-5.0	-5.2	-4.7			-4.4	-4.4	-1.0	-0.1	-0.6	-1.1	
Exports	72.1	76.5	80.3	77.7	65.9			69.6	71.9	78.1	83.6	88.7	94.1	
Imports	68.8	73.1	75.3	72.5	61.2			65.2	67.5	77.0	83.5	88.0	93.0	
Net non-debt creating capital inflows (negative)	-7.5	-4.3	-5.3	-4.2	-0.2			-0.4	-1.0	-1.1	-1.1	-1.1	-1.0	
Automatic debt dynamics 1/	-3.7	-3.5	-5.9	-7.1	5.1			0.7	0.3	0.0	0.0	0.1	0.1	
Contribution from nominal interest rate	1.3	1.2	1.4	1.3	1.4			1.4	1.5	1.6	1.6	1.7	1.7	
Contribution from real GDP growth	-2.3	-2.2	-2.0	-0.9	1.8			-0.7	-1.1	-1.6	-1.6	-1.6	-1.6	
Contribution from price and exchange rate changes 2/	-2.7	-2.5	-5.3	-7.6	2.0			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	7.1	9.2	13.0	3.2	-1.0			2.7	0.8	1.8	0.2	-0.2	-0.3	
External debt-to-exports ratio (in percent)	51.8	52.4	54.4	47.9	63.5			65.0	64.3	61.6	58.1	54.4	50.9	
Gross external financing need (in billions of US dollars) 4/	25.2	25.8	24.9	36.3	36.9			35.4	38.1	41.0	44.2	46.3	49.1	
in percent of GDP	20.2	18.1	14.3	16.8	18.8	10-Year	10-Year	17.9	18.5	19.6	20.2	20.0	20.0	
Scenario with key variables at their historical averages 5/								**45.2**	**39.7**	**34.1**	**28.6**	**23.7**	**19.1**	**-7.3**
						Historical	Standard							
Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation							
Real GDP growth (in percent)	6.3	6.8	6.1	2.5	-4.3	3.4	3.2	1.7	2.6	3.5	3.5	3.5	3.5	
GDP deflator in US dollars (change in percent)	7.0	7.2	15.1	21.1	-5.2	9.4	10.2	-0.6	1.3	-1.7	1.0	2.3	2.3	
Nominal external interest rate (in percent)	3.6	3.7	4.3	3.7	3.4	4.3	0.7	3.4	3.3	3.5	3.6	3.6	3.7	
Growth of exports (US dollar terms, in percent)	16.7	21.6	28.2	20.1	-23.1	15.7	15.9	6.7	7.4	10.5	11.9	12.3	12.4	
Growth of imports (US dollar terms, in percent)	11.6	21.6	25.9	19.5	-23.4	14.5	15.1	7.7	7.5	16.2	13.2	11.7	11.9	
Current account balance, excluding interest payments	0.0	-1.4	-1.7	-1.8	-0.7	-2.5	1.6	-0.3	-0.9	-1.1	-1.3	-0.9	-0.8	
Net non-debt creating capital inflows	7.5	4.3	5.3	4.2	0.2	5.8	3.1	0.4	1.0	1.1	1.1	1.1	1.0	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, 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 $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

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

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

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

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

Table 7. Czech Republic: Public Sector Debt Sustainability Framework, 2005-2015
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	29.7	29.4	29.0	30.0	34.2	**37.9**	**40.5**	**44.1**	**46.7**	**48.6**	**50.3**	**-1.2**
o/w foreign-currency denominated	2.6	2.6	2.4	3.7	5.2	6.9	8.3	9.9	11.2	12.2	13.6	
Change in public sector debt	-0.4	-0.2	-0.5	1.0	4.2	3.7	2.6	3.6	2.6	1.9	1.7	
Identified debt-creating flows (4+7+12)	-1.8	-0.2	-1.1	1.2	5.7	4.2	2.9	3.9	3.0	2.3	2.1	
Primary deficit	2.4	1.5	-0.5	1.0	4.8	3.4	3.3	3.3	3.2	3.2	3.2	
Revenue and grants	41.4	41.1	41.9	40.9	38.8	40.7	40.8	41.5	41.6	41.6	41.5	
Primary (noninterest) expenditure	43.8	42.6	41.4	41.8	43.6	44.1	44.1	44.8	44.8	44.8	44.8	
Automatic debt dynamics 2/	-0.7	-1.2	-1.7	-0.5	1.6	1.7	0.5	1.4	0.0	-0.8	-1.0	
Contribution from interest rate/growth differential 3/	-0.6	-1.1	-1.5	-0.1	1.1	1.7	0.5	1.4	0.0	-0.8	-1.0	
Of which contribution from real interest rate	1.2	0.8	0.2	0.6	-0.1	2.2	1.5	2.8	1.4	0.7	0.6	
Of which contribution from real GDP growth	-1.8	-1.9	-1.6	-0.7	1.3	-0.6	-1.0	-1.4	-1.5	-1.5	-1.6	
Contribution from exchange rate depreciation 4/	-0.1	-0.1	-0.3	-0.4	0.4	...	...	...	...	...	...	
Other identified debt-creating flows	-3.6	-0.5	1.1	0.7	-0.6	-0.9	-0.9	-0.8	-0.1	-0.1	-0.1	
Privatization receipts (negative)	-3.6	0.1	-0.5	-0.6	-2.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	-0.6	1.6	1.3	1.4	-0.9	-0.9	-0.8	-0.1	-0.1	-0.1	
Residual, including asset changes (2-3) 5/	1.4	0.0	0.7	-0.2	-1.5	-0.4	-0.3	-0.3	-0.4	-0.4	-0.4	
Public sector debt-to-revenue ratio 1/	71.7	71.6	69.1	73.3	88.0	93.1	99.3	106.2	112.3	116.8	121.1	
Gross financing need 6/	9.3	9.2	6.1	8.9	13.5	12.2	13.7	14.5	14.4	14.8	15.2	
in billions of U.S. dollars	8.0	8.5	6.2	9.4	14.4	13.1	15.3	16.5	17.3	18.9	20.7	
Scenario with key variables at their historical averages 7/						**37.9**	**39.2**	**40.5**	**42.4**	**44.3**	**46.1**	**-0.7**
Scenario with no policy change (constant primary balance) in 2010-2015						**37.9**	**40.6**	**44.3**	**47.1**	**49.2**	**51.0**	**-1.2**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	6.3	6.8	6.1	2.5	-4.3	1.7	2.6	3.5	3.5	3.5	3.5	
Average nominal interest rate on public debt (in percent) 8/	4.1	4.0	4.2	3.9	4.1	5.1	5.7	5.7	4.9	4.7	4.5	
Average real interest rate (nominal rate minus change in GDP deflator, in p	4.3	2.9	0.9	2.0	-0.7	6.5	4.1	7.0	3.4	1.7	1.4	
Nominal appreciation (increase in US dollar value of local currency, in perc	7.3	6.0	11.3	18.9	-9.9	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	-0.3	1.1	3.4	1.8	4.7	-1.4	1.5	-1.3	1.4	3.0	3.2	
Growth of real primary spending (deflated by GDP deflator, in percent)	6.0	3.9	3.1	3.5	-0.3	2.8	2.6	5.2	3.5	3.5	3.5	
Primary deficit	2.4	1.5	-0.5	1.0	4.8	3.4	3.3	3.3	3.2	3.2	3.2	

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.

III. Background—Staff Analysis

A. Impact of the Global Financial and Economic Crisis

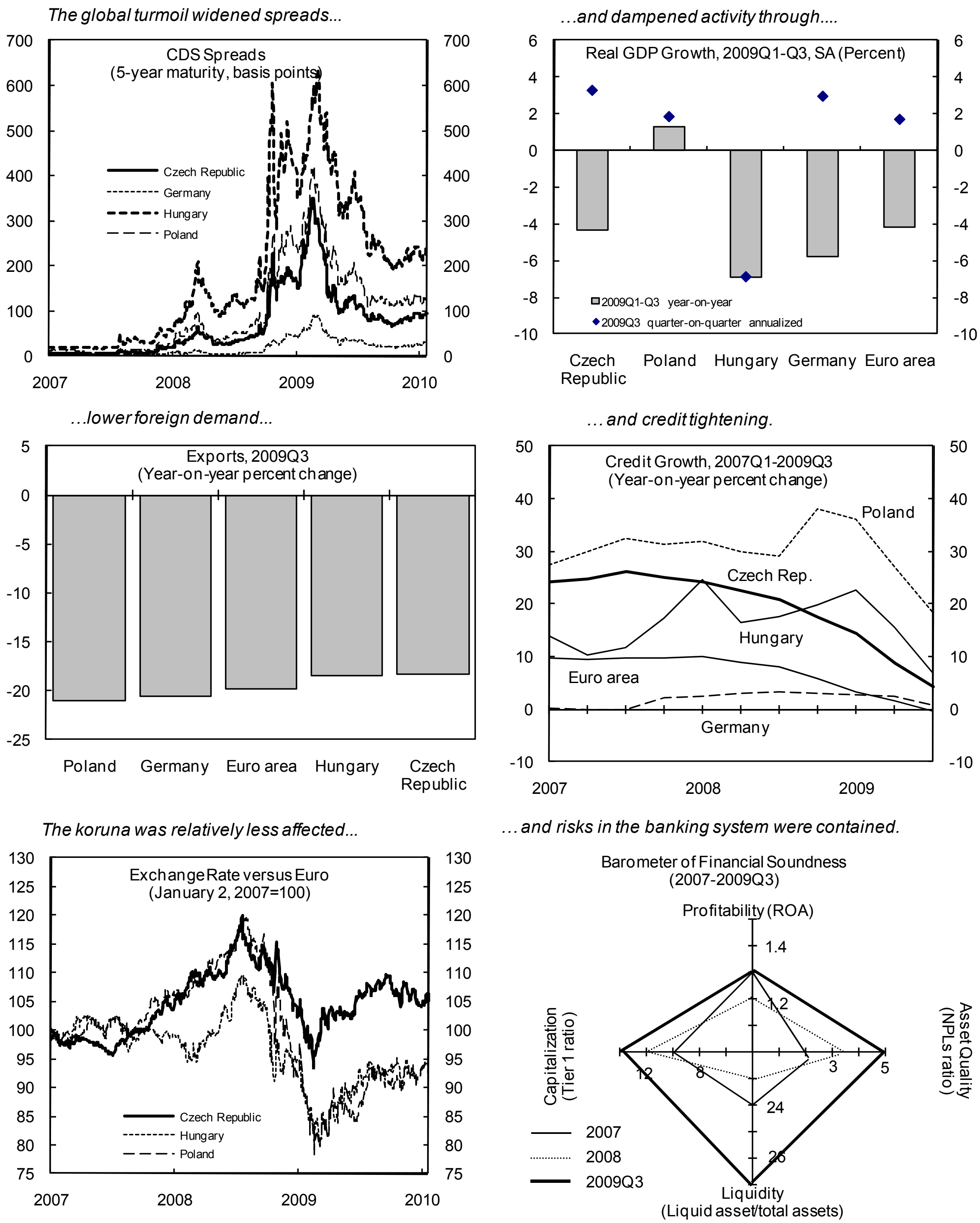
1. **The Czech Republic's macroeconomic position was very strong prior to the global financial crisis.** Growth stood above 6 percent during 2005–07 before slowing in 2008. Large foreign direct investment (FDI) inflows fostered trade integration, underpinning an export-led expansion. Higher initial standard of living than most other countries in the region contained consumption convergence pressures. An improved fiscal performance contributed to the comfortable external position. Credible inflation targeting helped maintain low inflation, with the exception of a short-lived spike in 2008 mainly due to supply shocks and one-off tax increases. With domestic interest rates lower than in the euro area until recently, private sector borrowing in foreign currency has been quite modest. A liquid and conservative banking sector limited the build-up of balance sheet vulnerabilities (Box 1).

2. **Despite its very strong fundamentals, the Czech real economy—highly open to trade and investment flows—has been impacted by spillover effects from the global crisis both through a decline in foreign demand and in overall risk tolerance (Figures 1 and 2).**

- Global recession, and especially in the main trading partner Germany, depressed Czech output by 4⅓ percent largely through falling exports (which account for almost 80 percent of GDP) and FDI-financed investment. Private consumption grew modestly despite rising unemployment, fuelled by low inflation and stable net incomes that benefited from fiscal automatic stabilizers and discretionary measures. High frequency indicators point to a recent stabilization of both investment and exports.

- Escalating global risk aversion at the outset of the crisis led to a considerable liquidity tightening in the Czech interbank market, a slowdown in trading activity in the government bond market, rising funding costs, currency depreciation, and more stringent credit conditions. However, overall market sentiment has largely recovered since then. Risks in the banking system were contained, allowing the economy to tide over an extended political gridlock and the global market turmoil with relatively low banking and exchange rate losses.

Figure 1. Czech Republic: Impact of the Crisis, 2007-10



Source: Haver; EMED; CZSO; Eurostat; and Bloomberg.

Box 1. Why Did the Czech Republic Have Less Financial Vulnerabilities than its Peers?

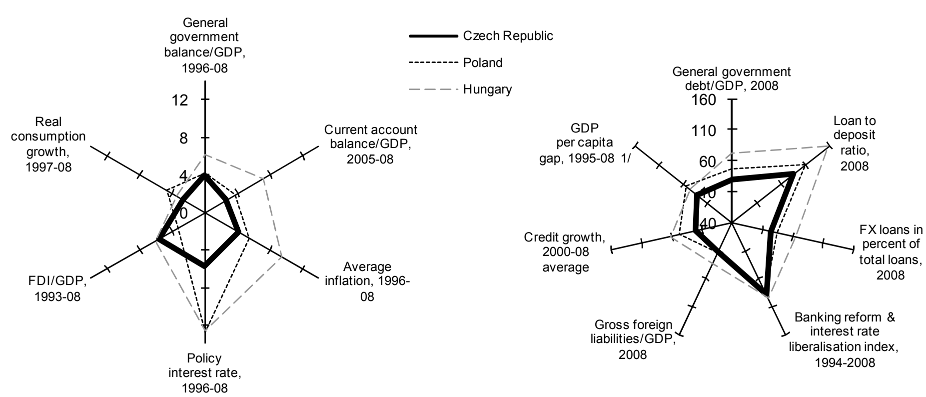
Before the outbreak of the global financial crisis, many economies in Central and Eastern Europe (CEE) experienced an economic boom fuelled by buoyant credit growth to the private sector. Supported by large capital inflows, private sector lending was often denominated in foreign currency, thereby breeding vulnerabilities in both the external and banking sectors. Yet the Czech Republic is an exception in those aspects even compared to its closest CEE peers—Poland and Hungary. A number of factors help explain this difference:

Higher initial income in the early 1990s has led to lower convergence pressures. In terms of per-capita income valued at purchasing-power-parity prices, the Czech Republic had a smaller gap vis-à-vis more advanced European countries (proxied by the euro area). Therefore, the consumption catch-up by households towards European living standards (particularly durable goods) has been less significant than in Poland and Hungary, as reflected in lower borrowing and lower external current account deficits.

The low-inflation and low-interest environment has made borrowing in foreign currencies less attractive. The Czech Republic had no history of hyperinflation, and the monetary overhang in the beginning of the transition period was minor. The early shift to inflation targeting provided a critical anchor to monetary policy, increasing its credibility. Persistent currency appreciation helped achieve a low level of inflation fairly rapidly. Fiscal policy was also prudent, with low deficit and public debt burden. In addition, positive supply-side shocks helped contain inflation. The Czech Republic was one of the first-wave countries in expanding low-cost, high-efficiency retail sector during 1997-2005, which lowered distribution margins (the so-called "Wal-Mart effect"). Overall, the low inflation environment resulted in negative interest spreads vis-à-vis the euro area. This, together with households' risk-adverse attitudes, made foreign currency borrowing less attractive for households compared with the other CEEs, despite the appreciating exchange rate.

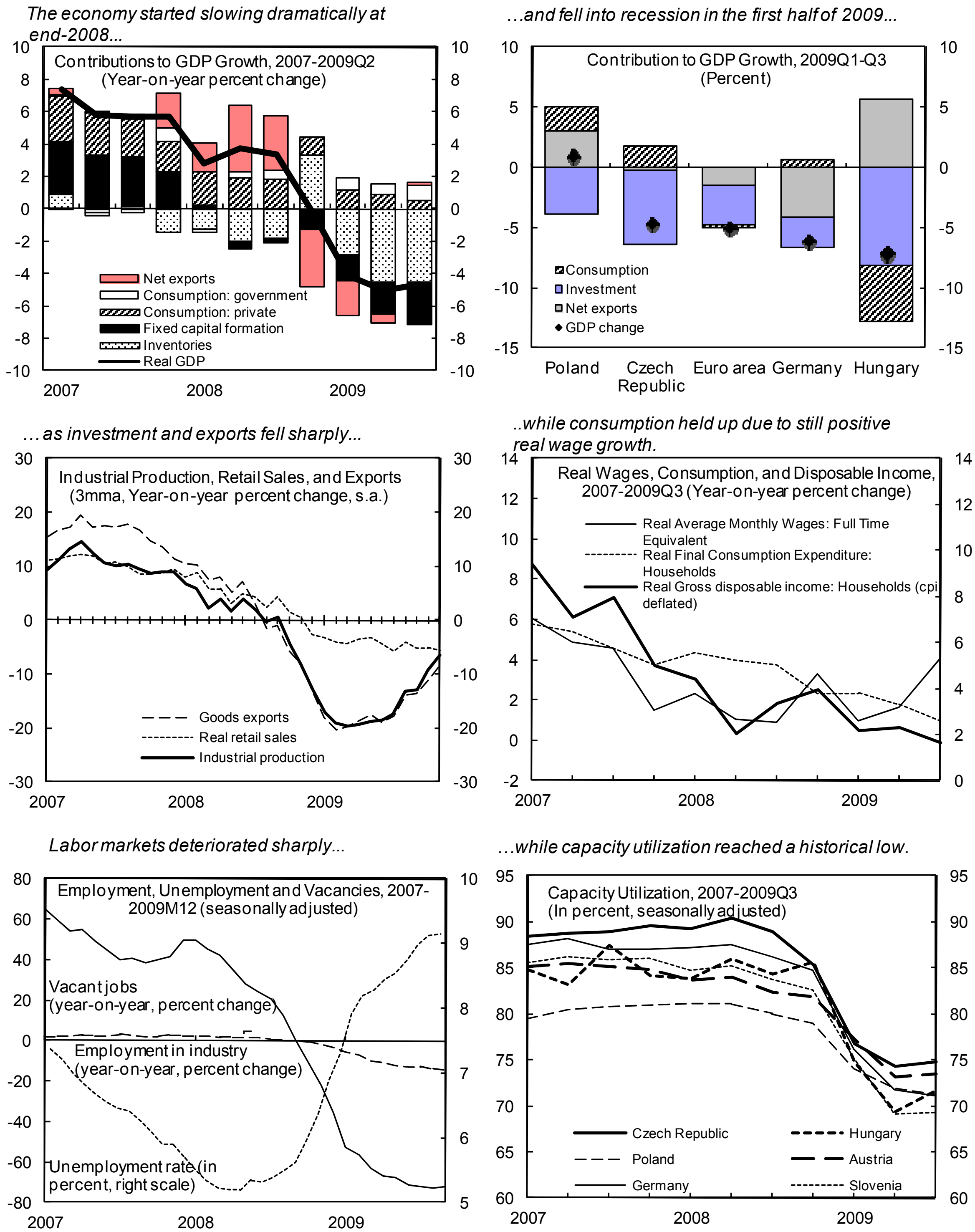
The Czech banking sector is characterized by high liquidity buffers and conservative retail-oriented business model. It is funded domestically and has a low loan-to-deposit ratio. These features are the result of a combination of factors: (i) the bank restructuring process in the late 1990s (which led to the privatization of the sector) removed bad assets from banks' balance sheets and transferred them to a (state-owned) special asset management agency in exchange for government bonds, while preserving the entire depositor base; (ii) large capital inflows in the 1990s added liquidity into the system, which have been partially absorbed by the CNB through regular open-market operations; and (iii) the conservative behavior of households, combined with government incentives to save, helped establish a sound deposit base. More generally, the hard lesson learned during the 1990s banking crisis has led banks to manage the risk-profile of their activities prudently during the boom years (reflected in a relatively low risk-weighted-to-total asset ratio).

Comparison of Financial Sector Indicators
(Percent, unless otherwise indicated.)



Source: Haver; EMED; Eurostat; Bloomberg; and IMF staff calculations.
1/ Difference from Euro Area average in percent of Euro Area GDP per capita.

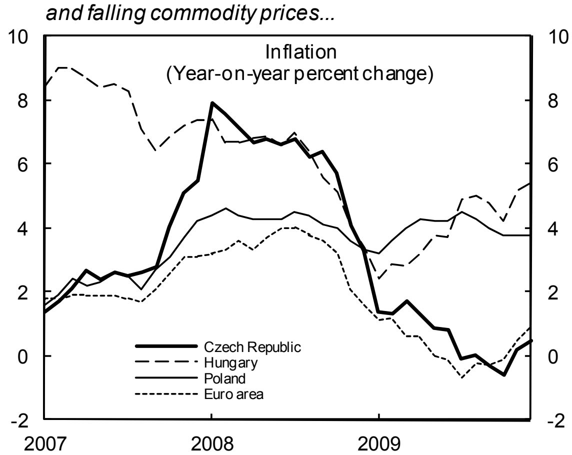
Figure 2. Czech Republic: Real Economic Indicators, 2007-09



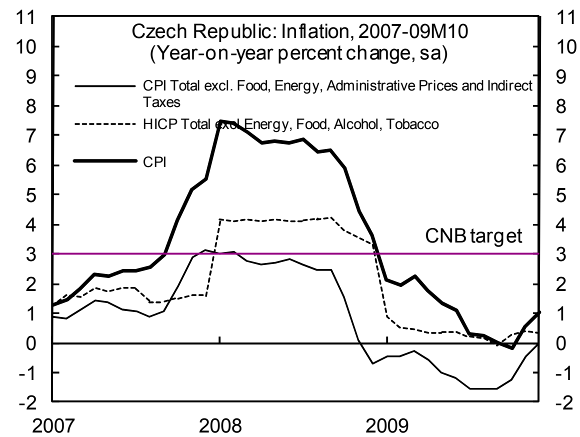
Sources: Haver; EMED; Eurostat; and CSZO.

3. **Inflation remained largely positive in 2009, although well below target.** Against the central bank's target of 3 percent (+/-1 percentage point band), both headline and core inflation fell sharply due to weakening domestic demand and falling commodity prices that more than offset the increases in regulated prices. Moreover, the lagged effects of the rapid appreciation of the koruna in the first half of the year turned inflation negative in October 2009. The disinflation trend was reversed in late 2009.

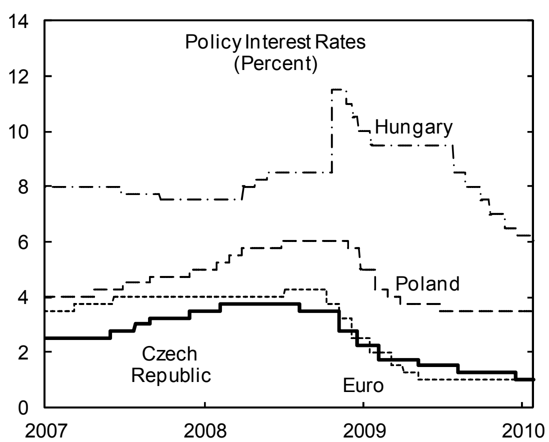
Inflation declined due to collapsing demand and falling commodity prices...



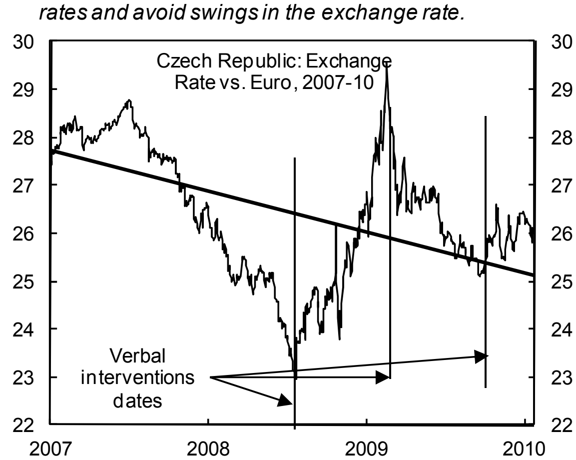
...to well below the central bank's target of 3 percent.



The central bank aggressively cut interest rates...



... and verbally intervened to move down market rates and avoid swings in the exchange rate.



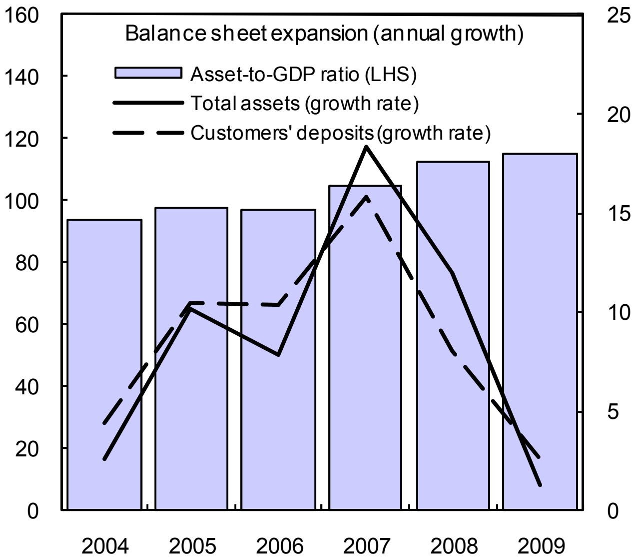
Sources: Bloomberg; and Czech National Bank.

4. **The Czech National Bank (CNB) eased monetary policy significantly through the use of conventional measures.** The CNB, the first central bank in Europe to start the easing cycle in 2008, gradually cut the policy rate by a total of 275 basis points, combined with occasional well-timed verbal interventions. However, the effectiveness of the traditional monetary transmission mechanism has weakened, and market rates have been less responsive to monetary policy than before the crisis. Retail lending rates have not followed the decline in policy rates, especially for the household sector. The CNB considered alternative options for further monetary easing if conventional measures proved insufficient. Although interest

rates are the preferred instrument of monetary policy, direct foreign exchange interventions were seen as the most viable alternative monetary policy option, should the need arise.

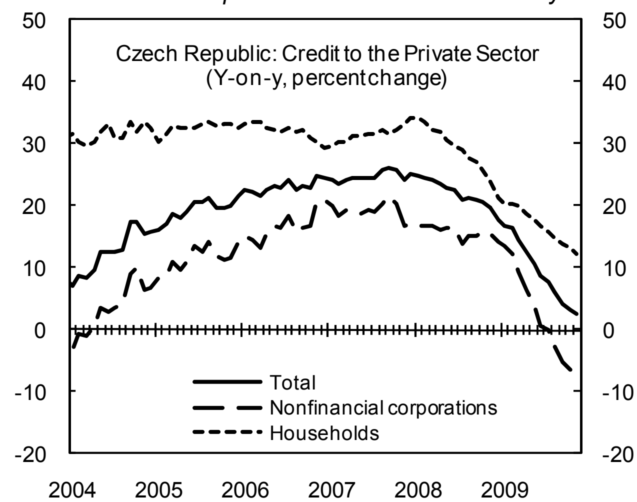
5. **Credit to the economy has decelerated dramatically**. Total private sector credit growth slowed to 1½ percent year-on-year in November from 23 percent the year before, mainly as a result of a contraction of corporate credit. This decline reflects both unfavorable investment sentiment and tighter credit conditions. Household credit, however, continued its double-digit growth but slowed down due to uncertainty about households' future income. Mortgage lending has performed relatively well, but nonperforming loans of the nonfinancial corporations are rising faster owing to declining economic activity.

Banks slowed lending activity broadly in line with deposit deceleration...



Source: Czech National Bank.

...and credit to corporates decreased dramatically



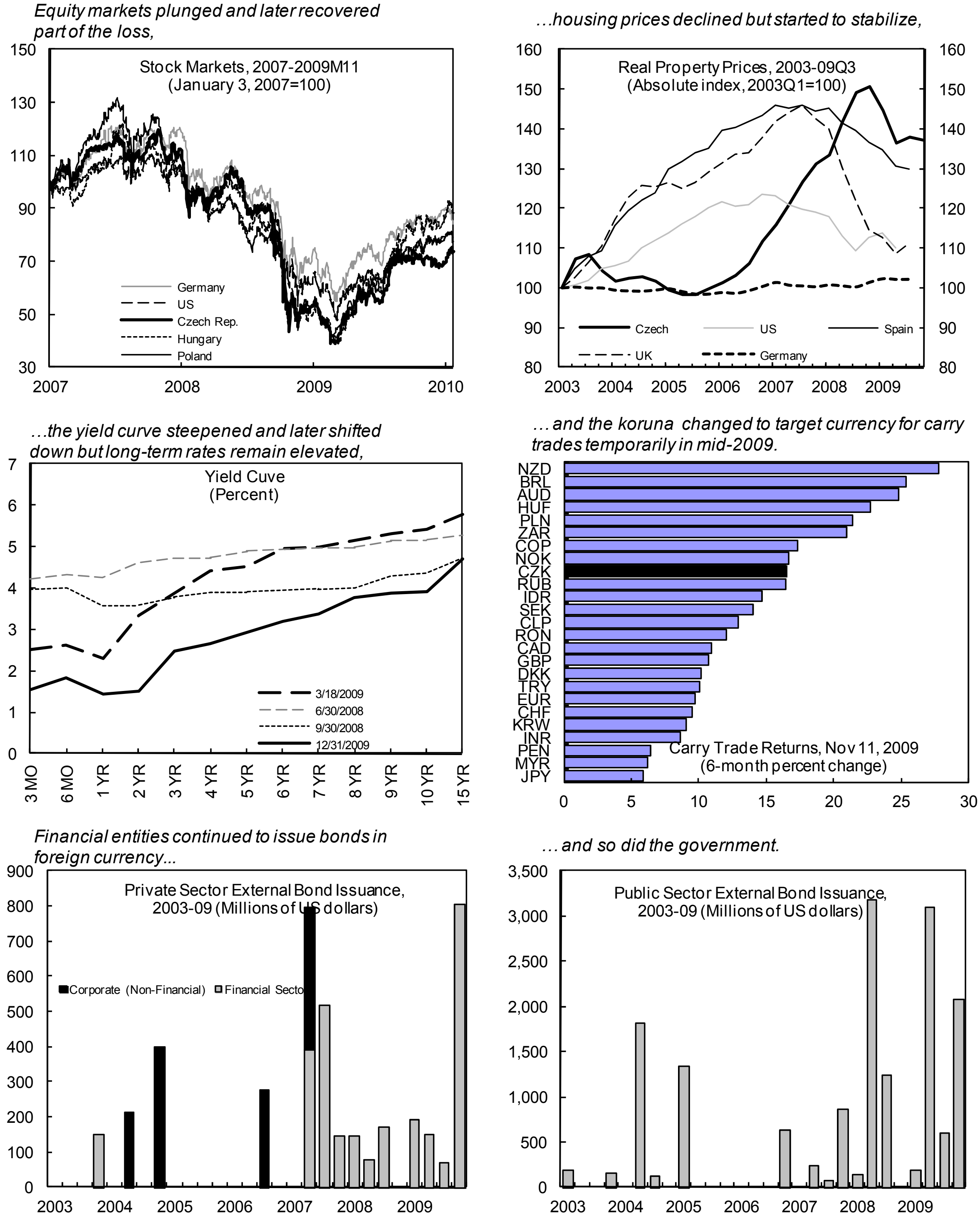
Source: Czech National Bank.

6. **The global financial turmoil also spilled into asset prices, but the resulting second round impact on the real economy was limited (Figure 3).**

- Real housing prices declined by 10 percent in the first half of 2009 but have since stabilized.[1] The impact of the asset price decline on the real economy has been mitigated by the relatively low household indebtedness.

[1] Real housing prices started to grow later than in other advanced European countries, and the sharp increase since 2007 was mostly due to the availability of low-interest mortgage loans and the expected VAT hikes in the construction sector.

Figure 3. Czech Republic: Financial Markets, 2003-09



Sources: Bloomberg; Dealogic; Haver; BIS; and Global Insight.

- Equity markets fell sharply in line with other European stocks through March 2009, partly recovering later. Yet negative wealth effects arising from equity are small since less than 4 percent of households own stocks directly.

- The koruna, historically a funding currency for carry trades, became temporarily a high return currency due to near-zero rates in the US and unwinding of previous positions, contributing to its strengthening in mid-2009. Since late 2009, the koruna was used again as a funding currency towards higher-yield neighboring countries.

- Tightness in money markets started to ease as evidenced by a declining PRIBOR, although term structure spreads remain high.[2] Both financial entities and the government have been able to issue bonds in foreign currency over the last year.[3]

7. **The external position remains solid, even though capital inflows have plunged.** The drop in exports has been accompanied by an even larger fall in imports, improving the trade balance despite the real appreciation. Lower dividend payments reduced the current account deficit. FDI inflows more than halved and no longer fully finance the current account, but rising inflow of EU funds filled the gap. Other investments declined as banks subsidiaries repaid loans to parents abroad, although the flows reversed somewhat in the second half of the year. Portfolio investment, however, increased reflecting the government issuance of the Eurobond. International reserves rose slightly to $41 billion (about 4 months of imports), partly due to the SDR allocation. The real exchange rate remains in line with fundamentals (Box 2). External debt was modest at 37 percent of GDP at end-2008.

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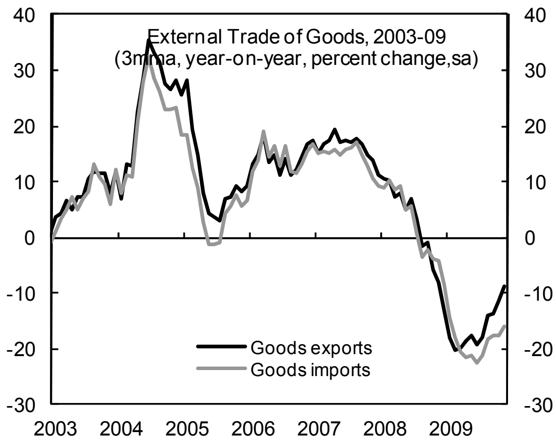
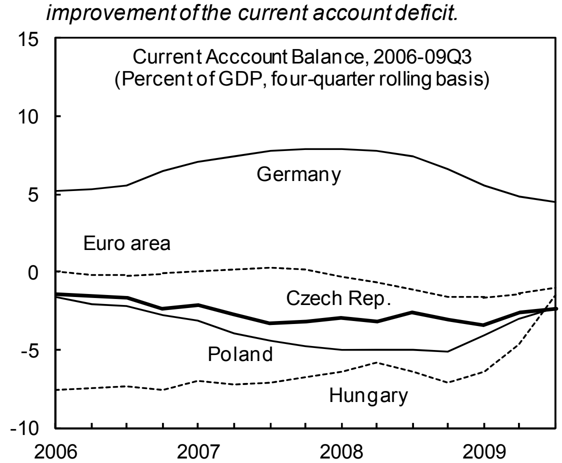
[2] The repo facilities introduced by the CNB in October and November 2008 to improve the distribution of liquidity were not widely used by the banks, partly because of the structural liquidity surplus in the market.

[3] The government issued a €1.5 billion Eurobond on April 28, 2009.

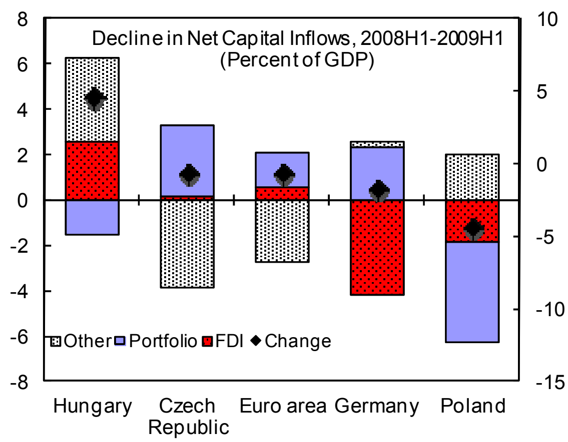
Sharp drop in exports accompanied by an even larger fall in imports...



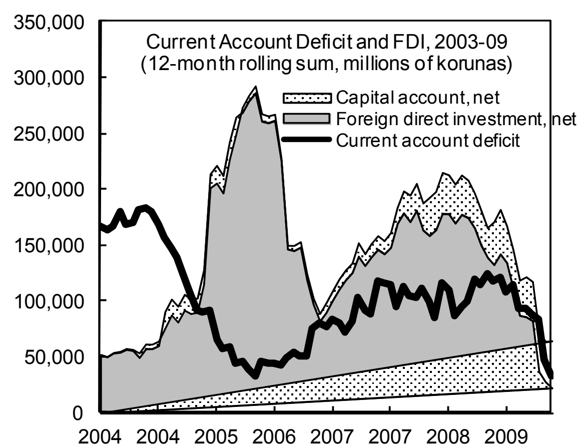
...and lower dividend payments led a slight improvement of the current account deficit.



Capital inflows declined...



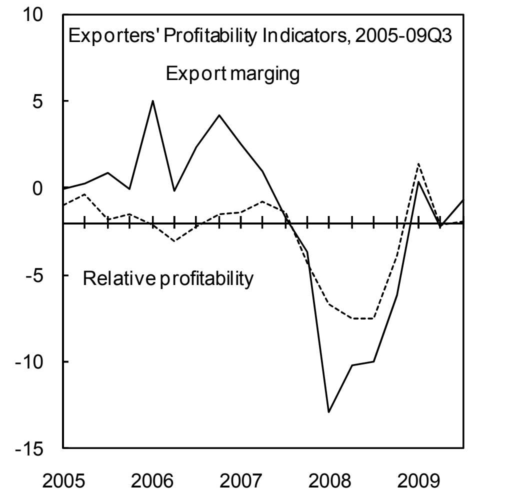
...and current account is no longer fully financed by FDI.



Sources: Haver; EMED; and Eurostat.

Box 2. External Competitiveness Assessment

On the back of the global financial crisis, the real effective exchange rate (REER) depreciated sharply. Rising uncertainty in the foreign exchange markets and weakening cyclical conditions led to REER depreciation of about 11 percent. These trends started to reverse in the second quarter of 2009 due to the improvement in market sentiment towards the region.

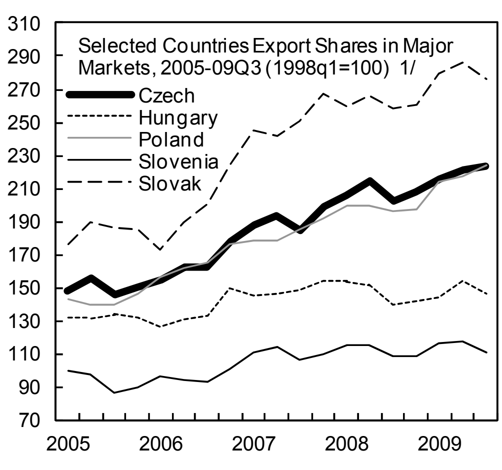


Source: IMF staff calculations.
1/ Export Margin is measured as the difference between the annual growth in exports deflator and manufacturing sector unit labor costs. Relative profitability is measured as the difference between the annual growth rates of exports deflator and GDP

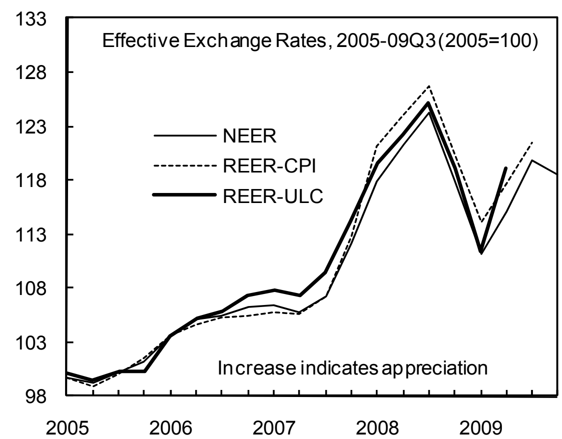
After significant weakening in 2008, export profitability improved. Margins of Czech exporters to its main trading destinations recovered from the erosion of competitiveness in early 2008 caused by the lagged effects of a strong koruna and rising labor costs, but deteriorated again in part due to exporters' over-hedging caused by the uncertainty in exchange rate developments. Export shares, however, have continued to increase after falling in 2008.

Staff believes that the koruna has remained broadly in line with fundamentals as indicated by three CGER methodologies.

Export market shares continue to rise.



1/ Major Czech trading partners include Austria, Belgium, France, Germany, Hungary, Italy, the Netherlands, Poland, Russia, the Slovak Republic, UK, and USA. Data for Belgium starts in 1997.
Source: IMF DOT and IMF staff calculations.



Source: CNB.

Estimates of REER Misalignment, 2009 (Percent)

	Reference period 1/	December average
Macroeconomic Balance Approach	-2	-4
External Sustainability Approach	-4	-6
Equilibrium Real Exchange Rate Approach	6	4
Average	0	-2

Source: Staff estimates.
1/ July 30-August 27, 2009.

8. **The fiscal position has deteriorated sharply with the economic slowdown.** The overall deficit increased by 4 percentage points to 6.0 percent of GDP in 2009. While automatic stabilizers have played a significant role, more than half of the widening reflected discretionary measures, including those from the 2009 Anti-Crisis Package and the impact of the 2007 reforms, which reduced CIT and social contributions rates.

2009 Anti-crisis Measures
(Fiscal impact in 2009, percent of GDP)

Total impact on overall deficit	**-2.0**
(+) Revenue Cuts	**-1.5**
Social security contributions (including the 2007 Reform	-1.0
Decrease in the CIT rate (from 2007 reform)	-0.2
Broadening of the VAT deductions on personal vehicles	-0.1
Other measures	-0.3
(-) Expenditure Increases	**0.6**
Traffic infrastructure	0.2
Provision of transport services	0.1
Guarantees and support of SMEs	0.1
Increase in public sector wages (net impact)	0.1
Support of agriculture entrepreneurs	0.1
R&D and fiscal impact of R&D spending	0.1
Other measures	0.1

Source: Ministry of Finance and IMF staff calculations.

Fiscal Stance, ESA-95, 2007-09 (Percent of GDP)

	2007	2008	2009	
			Staff	Auth. 2/
Revenues	41.9	40.9	38.8	39.5
Expenditures	42.5	42.9	44.8	46.0
Overall Balance	-0.7	-2.0	-6.0	-6.6
Structural Balance 1/	-0.1	-1.4	-3.3	-4.4
Primary Budget Balance	0.5	-1.0	-4.8	-5.3
Change in Primary Balance		-1.5	-3.8	-4.3
(+) Automatic Stabilizers		-0.1	-2.0	-1.4
(+) Change in Structural (= - Fiscal Stimulus)		-1.3	-1.8	-2.9
2007 Reform Package		0.6	-0.4	
(+) Revenue Measures		0.0	-0.7	
(-) Expenditure Measures		-0.5	-0.3	
2009 Anti-Crisis Package			-1.3	
(+) Revenue Measures			-0.8	
(-) Expenditure Measures			0.5	

Source: Ministry of Finance and staff estimates.
1/ Cyclically-Adjusted Primary Balance in percent of potential GDP
2/ As of October 2009.

B. Macroeconomic Outlook: Gradual Recovery, Though with Risks

9. **The revival of the Czech economy is expected to be gradual and closely linked to the global recovery.** Staff projects growth of 1.7 percent of GDP in 2010 driven by the pickup in foreign demand, especially in Germany, that will support exports and inventories. However, fixed capital formation and corporate credit growth are projected to remain depressed, while consumer spending will suffer from a decline in disposable income due to still rising unemployment, low wage growth, and the withdrawal of fiscal stimulus.

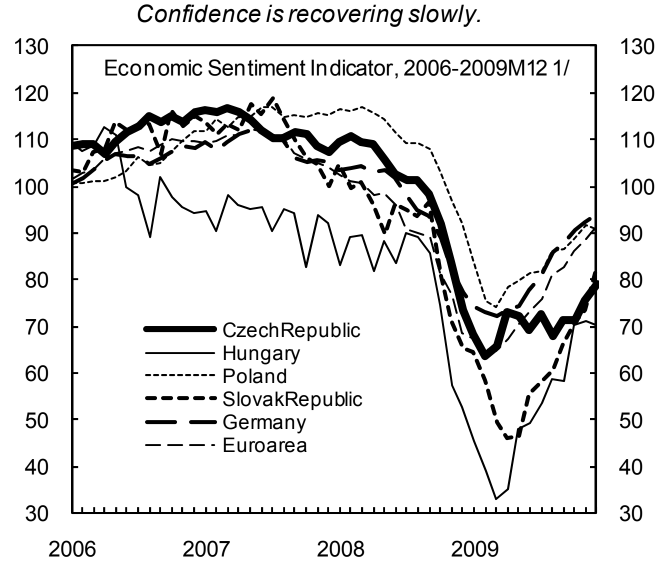
Comparison of Growth and Inflation Forecasts
(In percent)

	2009	2010
	GDP Growth	
IMF (January)	-4.3	1.7
Consensus (January)	-4.2	1.5
OECD (November)	-4.4	2.0
European Commission (October	-4.8	0.8
MOF (January)	-4.0	1.3
CNB (November)	-4.4	1.4
	Inflation, avg	
IMF	1.0	1.6
Consensus	1.1	1.6
OECD	1.1	1.4
European Commission	0.6	1.5
MOF	1.0	2.0
CNB	1.0	1.2

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

10. **The risks to the short-term outlook seem balanced.** The main risk arises from weaker-than-projected export markets and prolonged global financial market strains. Also, the growth momentum in 2010 could temporarily suffer once inventories are rebuilt and car scrapping bonuses expire. On the upside, global recovery could be faster than projected.

Confidence is recovering slowly.



Source: European Comission.
1/ Economic sentiment indicator is a composite of Industrial (40%), Construction (20%), Consumer (20%), and Retail trade (20%) confidence indicators.

11. **The adverse effects of the crisis are likely to be long lasting.** Potential growth has been severely curtailed by the crisis. A collapse in investment and slowdown in total factor productivity growth reduced dramatically the growth rate in 2009–10. Looking ahead, growth is not expected to reach pre-crisis levels due to abating convergence process, worsening demographic trends, and uncertainties regarding global long-term growth.[4] Therefore, there is a need for growth-promoting structural reforms to boost potential output and competitiveness. These reforms should focus on increasing labor participation, productivity, and labor market

[4] See Selected Issues Paper on Estimating Potential Output in the Czech Republic.

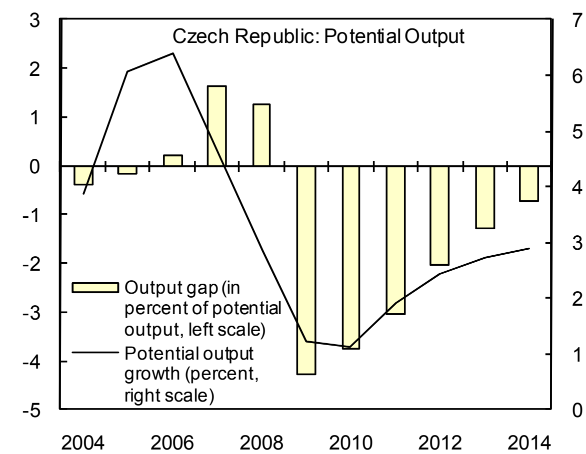
flexibility; enhancing the efficiency of higher education and research and development; and further improving the business climate to attract foreign direct investment.[5]

C. The Main Policy Challenge: How to Ensure a Sustainable Recovery?

Restoring Long-Term Fiscal Sustainability

12. **The main challenge for fiscal policy in the coming years will be to reverse the widening of budget deficits in a sustainable manner (Figure 4).** While the overall fiscal position improved during the boom years, the opportunity for more fundamental fiscal consolidation was missed and the structural deficit[6] barely changed. The recent economic downturn has compounded these problems and led to a sharp increase in the overall deficit, fast accumulation of debt, and widening of interest rate spreads vis-à-vis Germany. With prospects of a moderate recovery over the medium term, staff projects that without consolidation measures the deficit would remain above 5 percent of GDP, with public debt rising to 48 percent of GDP by 2014. The deficit target of below 3 percent of GDP, mandated by ECOFIN, is to be achieved by 2013 and according to staff's calculations will require a structural adjustment of at least 0.7 percent of GDP per year, starting in 2011. This, however, will not be sufficient to achieve debt sustainability over the long term, in particular given spending pressures associated with population aging.

Impact of the crisis on potential growth



Source: IMF staff calculations.

Fiscal Stance with Unchanged Policies, ESA-95, 2009-14 (Percent of GDP)

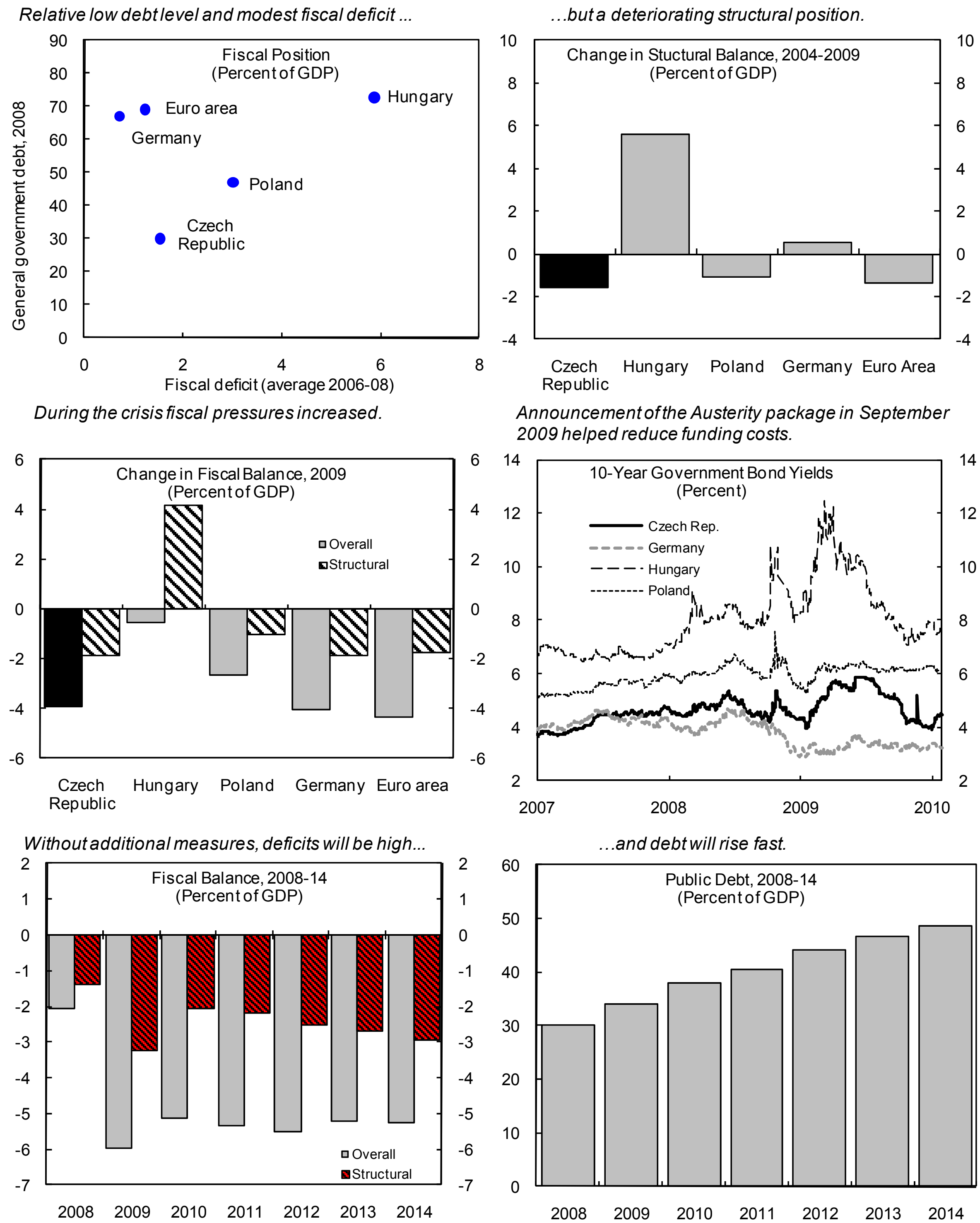
	2008	2009	2010	2011	2012	2013	2014	2015
Revenues	40.9	38.8	40.7	40.8	41.5	41.6	41.6	41.5
Expenditures	42.9	44.8	45.8	46.1	47.0	46.8	46.8	46.8
o/w Interest Expenditures	1.1	1.2	1.7	2.1	2.1	2.1	2.1	2.1
Overall Balance	-2.0	-6.0	-5.1	-5.3	-5.5	-5.2	-5.3	-5.3
Structural Balance 1/	-1.4	-3.3	-2.0	-2.2	-2.5	-2.7	-2.9	-3.2
Primary Budget Balance	-1.0	-4.8	-3.4	-3.3	-3.5	-3.2	-3.2	-3.2

Source: Ministry of Finance and staff estimates.
1/ Cyclically-Adjusted Primary Balance in percent of potential GDP

[5] See Selected Issues Paper on Structural Reform Agenda to Ensure Fiscal Sustainability and Promote Growth.

[6] Measured as the cyclically-adjusted primary deficit.

Figure 4. Czech Republic: Fiscal Situation, 2004-10



Sources: Haver; EMED; Eurostat; Reuters; Bloomberg, and IMF staff calculations.

2010 Austerity Measures (Fiscal impact in 2010, compared to unchanged 2009 policies, percent of GDP)	
Total	**2.1**
(+) Revenue Increases	**1.8**
An increase in VAT by 1 pp in both rates	0.5
An increase in excise taxes	0.3
An increase in the real estate tax	0.1
Income tax and Social security contributions	0.9
(+) Expenditure Cuts	**0.3**
Social security contributions	-0.1
Lower sick leave and maternity-leave benefits	0.1
Wage bill savings	0.1
A pension freeze in 2010	0.2
Source: Ministry of Finance and IMF staff calculations.	

13. **The crisis has highlighted the urgency of fiscal adjustment.** The 2010 budget aims to reverse the deteriorating fiscal position, as unchanged policies would lead to further widening of the budget deficit to over 7 percent of GDP. As the interim government lacks the mandate to address longer-term structural issues, the budget relies on permanent tax increases and temporary expenditure cuts which partly undo earlier expansion. Staff projects that these measures will lead to a structural improvement of 1.2 percent of GDP.

14. **The 2010 budget appropriately balances the objectives of preserving fiscal sustainability and supporting economic recovery.** With the economic cycles historically closely linked to those of the trading partners, in particular Germany, and the projected recovery in those countries, the growth of the Czech economy is expected to pick up in 2010. Given very low fiscal multipliers in the highly open Czech economy,[7] additional fiscal stimulus would have limited effect. In this regard, poorly-targeted spending initiatives (such as the 13th month pension) in the pre-election period should be resisted, as they are likely to result in higher imports and not stimulate the domestic economy. Furthermore, monetary policy is likely to continue to be supportive. At the same time, starting fiscal consolidation would help lower borrowing costs and likely aid economic recovery by crowding in private investment.[8]

15. **Beyond 2010, further consolidation will be needed**. The government that will be formed after the May general elections will need to propose a credible and durable plan for fiscal consolidation for 2011–13. Mustering broad support among the social and political

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[7] According to 2009 OECD Economic Outlook Interim Report, "Government spending multipliers are negatively correlated with openness, and the OECD estimate of the multiplier for Poland is indeed about 2.5 times that for the Czech Republic."

[8] The announcement of the Austerity package in September of 2009 helped reduce the spreads on long-term government bonds, which nevertheless remain above the pre-crisis levels. More broadly, staff's calculations suggest that a worsening of the fiscal position could lead to a large increase in the cost of borrowing both via higher debt levels and higher interest rates on account of large fiscal expansion (an increase of 20 basis points for a worsening of 1 percent of GDP in the primary fiscal balance) and fast population aging (additional 10 basis points). See "The State of Public Finances Cross-Country Fiscal Monitor: November 2009" http://www.imf.org/external/pubs/ft/spn/2009/spn0925.pdf

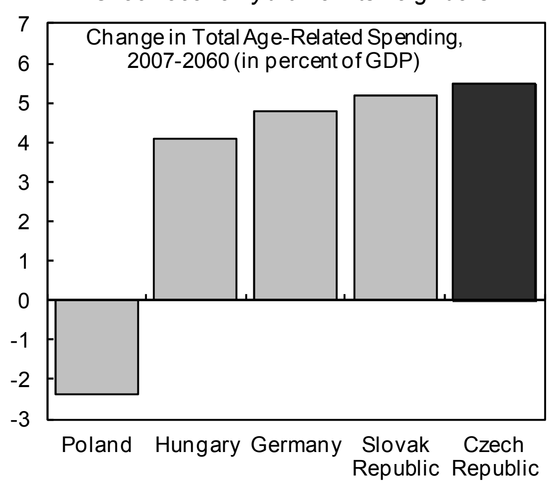
partners, who represent a wide range of views on the appropriate strategy, will be crucial for its successful design and implementation. International experience suggests that expenditure based consolidations tend to be more durable. In the Czech Republic, medium-term adjustment should cover expenditures measures, and particularly reduce the high mandatory spending (about 70 percent of total). At the same time, there is scope to raise revenues and improve efficiency of the tax system. Since direct taxation tends to restrain growth to a larger degree, the emphasis should be put on indirect taxes. The following measures were proposed by staff:

- *Expenditure measures.* Rationalizing mandatory expenditures and the generous welfare system is unavoidable. Re-organizing public institutions and positions would help reduce the overall wage bill without reducing wage levels. Introducing means testing would improve targeting of social benefits, yield savings, and enhance work incentives. There is scope for improving efficiency of public services delivery and public procurement.

- *Revenue measures*. The tax base needs to be expanded by eliminating exemptions and loopholes. VAT rates should be unified at the higher rate in order to eliminate the across-the-board subsidization of certain goods (that could instead be replaced with direct means-tested cash subsidies). Taxation of real estate property, currently generating about one fifth of the OECD average, should be based on market values. The combination of social security and personal income taxation results in low work incentives for those with low and middle incomes and thus could be revisited. While the scope for raising additional revenues from direct taxation is likely to be limited during the nascent recovery, the current corporate income tax rate could be reconsidered as it is below the OECD average. Improving tax administration could improve efficiency of revenue collection.

16. **Moreover, long-term age-related spending pressures underscore the need for fundamental pension and health care reforms**.[9] The Czech population is projected to age at one of the fastest rates among OECD countries, with the old-age dependency ratio set to triple to 61 percent over the next 50 years, and the elderly accounting for one third of the population in 2060 compared with

Aging will have a bigger fiscal impact on the Czech economy than on its neighbors.



Source: EC Aging Report 2009, Table 1.

[9] See Selected Issues Paper on Structural Reform Agenda to Ensure Fiscal Sustainability and Promote Growth.

14 percent in 2007. Meanwhile, the pension and health care systems remain largely unreformed, with only limited private participation. As a result, total age-related public spending is projected to increase by close to 6 percentage points of GDP over the next 50 years based on current policies, reaching 23½ percent of GDP by 2060.

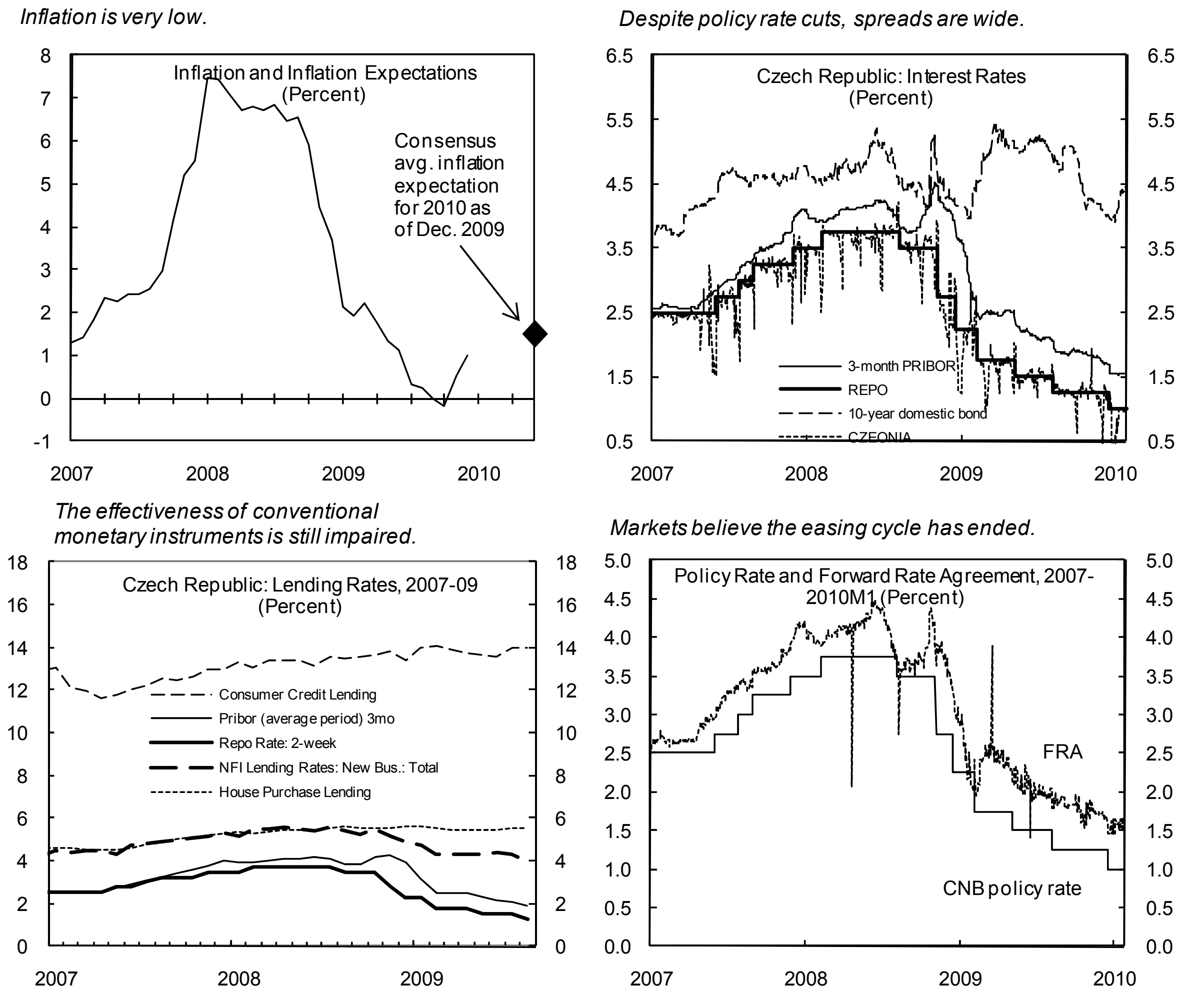
17. **Pension reforms will need to focus both on further changes to the PAYG system in the near future and systemic changes over the medium term.** Effective January 2010, a number of parametric changes were introduced to the current first-pillar pension system (PAYG) aimed at increasing the effective retirement age, including: a gradual increase in the retirement age to 65 by 2030; a gradual lengthening of the required insurance period from 25 to 35 years of work; a further reduction in old-age pensions when retiring early; and a tightening of the criteria for disability pensions. Meanwhile, the gradual extension of the period for early retirement from 3 to 5 years will have a negative impact on the effective retirement age. Looking ahead, there will be a need for further parametric changes to the PAYG system to boost its sustainability, such as better linking contributions to benefits, moving forward the introduction of the increase in the retirement age to 65 to year 2020, and reducing the period for early retirement back to 3 years. Over the medium term, the authorities will need to consider moving to a fully funded second-pillar private pension scheme, as well as additional prefunding of reserves to finance future deficits of the PAYG pension scheme (or transition deficits if moving toward private sector funds) through upfront fiscal consolidation measures, or any forthcoming privatization revenues.

18. **Comprehensive health care reform will also be essential for fiscal sustainability over the medium term**. The introduction of the user fees in 2008 was a first step in the right direction; looking ahead, such fees could usefully be made means tested. Over the medium term, there is a need for both institutional and financing reforms, to enhance the efficiency of the system and ensure its long-term sustainability. Such reforms could build on the 2006–08 government health care proposal and focus on: reducing the current broad coverage of publicly provided and insured services and allowing greater scope for private sector provision of health services, in turn introducing more competition among insurers and providers; and introducing voluntary insurance, personal health accounts, and choices in health benefits plans. Given the sheer complexity of health care reforms, a working group with broad representation should be established to lead the reform effort.

Monetary Policy Should Shift To Tightening Once the Economy Recovers Steadily

19. **The supportive monetary policy stance remains appropriate for now, but should shift to tightening as the recovery gathers momentum.** Staff's baseline forecast implies that the inflation environment will remain benign in the near future. The recently-approved VAT and excise hikes are expected to push average headline inflation to over 1½ percent in 2010, still below the new inflation target of 2 percent that came into effect in January 2010 (Box 3). Moreover, the fiscal package will somewhat contain domestic demand and suppress monetary-relevant inflation, and second-round effects of indirect tax increases will be

negligible in a context of surplus capacity. Still, the easing cycle of monetary policy seems to have come to an end and monetary policy should switch to tightening as the recovery starts gaining momentum.

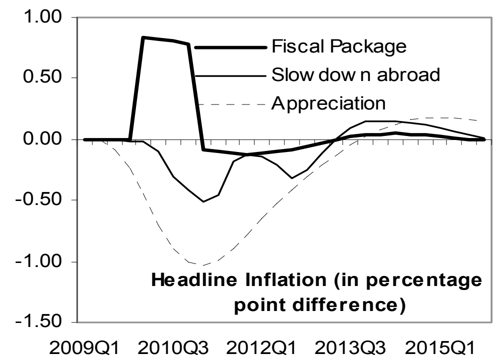


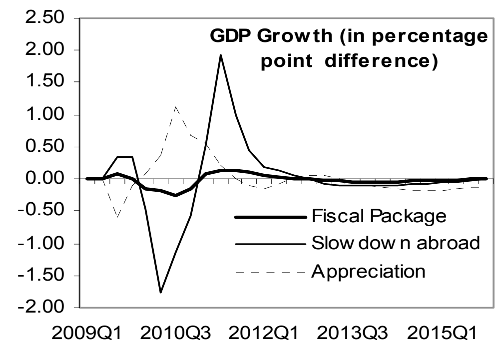
Sources: Bloomberg; EMED; Haver; and Czech National Bank.
1/ The forward rate agreement (FRA) are over the counter interest rate agreements for the 3 month interest rate, 2 months in the future. FRA's are used as a leading indicator of future monetary policy decisions.

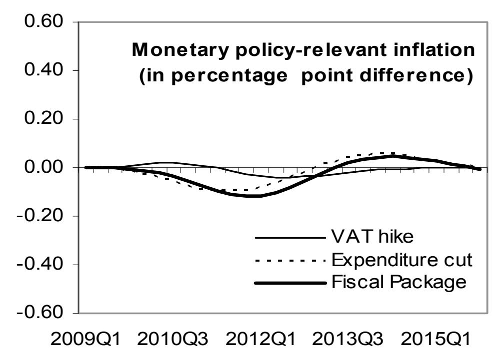
20. **No target date has been set for euro adoption.** An announcement of the euro adoption date was scheduled for November 1, 2009, but was postponed until after the elections in the spring of 2010 since the interim government does not have the mandate to determine the date. Poll results among domestic analysts show that the majority believe 2015 is the earliest realistic target date for euro adoption.

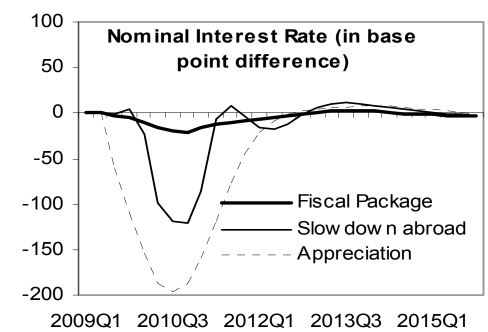
Box 3. Challenges Facing Monetary Policy in the Aftermath of the Crisis

Simulations using the IMF's Global Integrated Monetary and Fiscal model[1/] suggest the need for further monetary policy easing if various exogenous shocks were to occur. These simulations indicate how the formulation of monetary policy would need to take into account the impact of shocks, abstracting from the projected gradual economic pickup in staff's baseline projections. The shocks considered include: fiscal tightening, lengthening of the global slowdown, and a further appreciation of the exchange rate.









The fiscal package will slightly dampen inflationary pressures as well as output growth. The tax increase (mostly VAT)[2/] is set to push inflation up, but not influence the monetary–policy relevant inflation (inflation adjusted for first-round effects of changes to indirect taxes). The reaction of monetary policy to the tax hike would be muted because the monetary authorities would not react to the increase in indirect taxes, with the reaction to cuts in expenditures ranging from 20 to 25 basis points. The ensuing slowdown in consumption due to the VAT hike would be temporarily compounded by the decrease in social expenditures, pushing down GDP growth by ¼ percentage point. Second-round effects of indirect tax increases will be negligible in a context of weak demand.

In the event of a prolonged collapse in foreign demand, additional cut in the policy rate would be needed. Weaker-than-projected export markets causing a double dip fall in growth of 1–2 percentage points in the first half of 2010 could result in rapid disinflation.

A koruna appreciation of 2 percentage points would generate more than ¾ percentage point additional disinflation, as imports would become cheaper. Although the koruna slowed its appreciation trend at end-2009, unexpected strengthening in 2010 could warrant additional interest rate decreases as well.

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

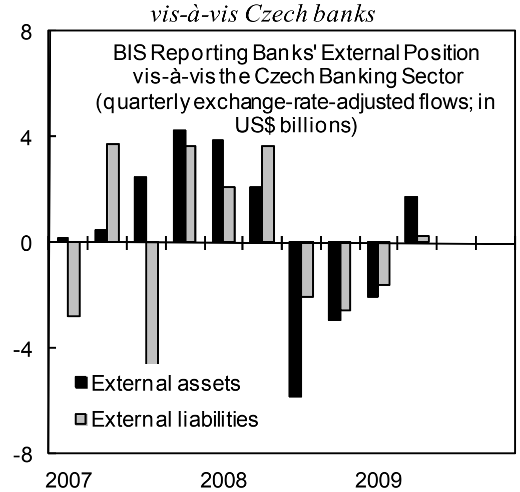
2/ The fiscal package also include increases in excises and changes in the social security contribution rate that are not considered in this analysis.

Maintaining Financial Stability

21. **The Czech banking sector has so far weathered the global financial turmoil relatively well owing to healthy capital and liquidity buffers, strong retail funding, and limited exposure to foreign currency risk (Figure 5).** Czech banks, which are mainly foreign owned, follow a traditional retail-oriented business model and hence have virtually no exposure to opaque structured products. Their solvency and leverage ratio have been broadly in line with that of their peers. However, contrary to other banking sectors in the region, Czech banks fund their activities mainly through domestic retail deposits and display good liquidity with a loan-to-deposit ratio well below 100 percent. Moreover, the share of lending in foreign exchange, and hence the implicit vulnerability stemming from currency mismatch, is minimal.[10] As a result of all these factors, Czech banks have been less vulnerable to the upheavals in their foreign parents' financial conditions and to the vagaries of global financial markets. Similarly, risks of contagion from any potential financial shocks in the region looking ahead appear, at this stage, limited.

22. **As a result, the Czech Republic has been one of the few advanced countries where the authorities were not forced to implement bank recapitalization or other exceptional measures to shore up financial sector stability.** Measures to support financial sector confidence were fairly limited. In line with the commitments taken at the EU level, the deposit insurance limit was raised to €50,000. The CNB widened the range of liquidity-providing operations and strengthened the monitoring of banks' liquidity positions.[11] During the crisis, foreign banks reduced their exposure towards Czech banks, which was partially matched by a decline in their liabilities (asset position of the Czech banking sector vis-à-vis foreign banks). This trend has reverted in the second quarter of 2009. As a result, there has been no material shift in foreign banks' net external position vis-à-vis Czech banks.

Limited change in foreign banks' net position vis-à-vis Czech banks



Source: BIS.

23. **However, local bond markets are not functioning in an efficient way and capital markets remain underdeveloped.** Despite steps taken by the CNB to improve the liquidity

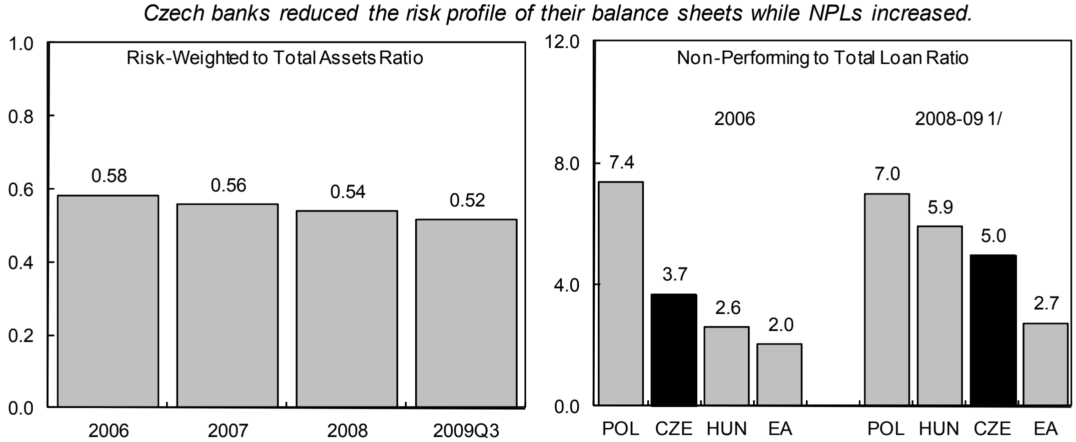
[10] As of end-2008, the share of foreign currency loans was virtually zero for bank lending to households and stood at around 18 percent for nonfinancial corporations.

[11] As of end-September 2009, the ratio of quick assets to total assets was 26.5 percent; it was 23 percent at the end of 2008.

of the local currency government bond market, trading remains thin due to the opaqueness of public debt management. Capital market development is hampered by poorly-targeted subsidies and tax exemptions on certain savings products and old regulations regarding private pension funds. Further measures should be taken to support the smooth functioning of these markets: (i) enhance the transparency of the government bond market by, for example, adhering to the announced size of bond issuances, to enable accurate pricing by dealers; (ii) rationalize subsidies and tax exemptions for deposits in building societies and contributions in voluntary third-pillar pension funds; (iii) improve the regulation regarding the third-pillar pension funds.

24. **Although the Czech banking sector continued to post good profits in 2009, the economic downturn has started to take its toll.** The economic contraction and the consequent increase in unemployment have fostered a relatively rapid deterioration in the quality of banks' loan portfolio, particularly in the corporate segment. During the first part of 2009, the sharp drop in trade flows together with the weakening of the exchange rate affected the financial conditions of export-oriented firms, some of which turned out to be over-hedged due to the uncertainty regarding foreign exchange earnings. Banks have reacted by tightening lending standards, to some extent reflecting parent banks' policies, restructuring the hedging operations of over-hedged firms, and more generally reducing the risk profile of their assets. As of end-September 2009, still positive growth of banks' net operating income has been partially offset by increasing provisioning on nonperforming loans (NPLs), which have reached almost 5 percent of total loans. The coverage provided by loan loss provisions has, however, declined to about 60 percent from 70 percent at end–2007, mainly due to composition factors. The return on equities has declined by less than 2 percent.

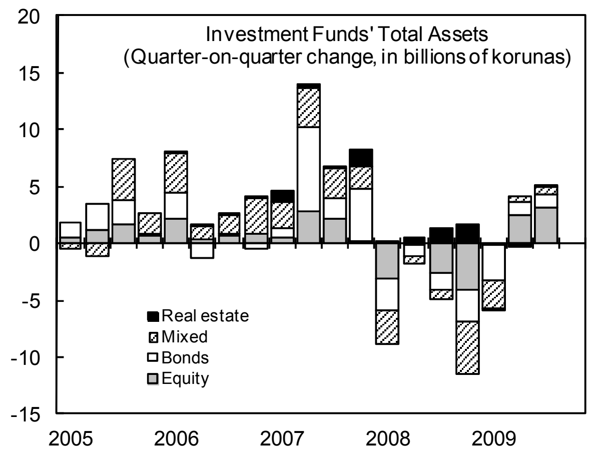
Czech banks reduced the risk profile of their balance sheets while NPLs increased.



Source:s Czech National Bank; country authorities; and IMF staff calculations.
1/ CZE, HUN = June 2009; POL = April 2009; EA = end-2008.

25. **In 2008, owing to adverse developments in bond and equity markets, Czech nonbank financial institutions suffered significant losses, which were partially recuperated during 2009.** During the crisis the profit and capital buffers of insurance companies and pension funds were dented by portfolio investment losses and withdrawal of funds, which have reflected households' increased liquidity preference and low returns.

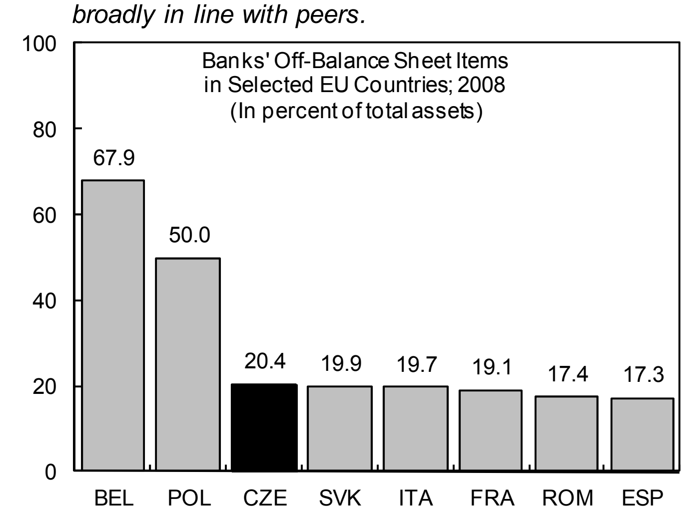
Pension funds were recapitalized by their shareholders. Given the impact of financial market developments, in 2009 accounting rules for pension funds and insurance companies were amended to allow them to value as hold-to-maturity, rather than marked-to-market, their government-bond holdings up to 30 percent of their portfolios. Regulation on pension fund capital was tightened. In 2008 and early 2009, mutual funds experienced sizeable net redemptions, which represented a major turnaround compared to 2007. The recent rebound of equity and bond markets has helped non-bank financial institutions to partly recover.



Sources: BIS; CNB; ECB; and OECD

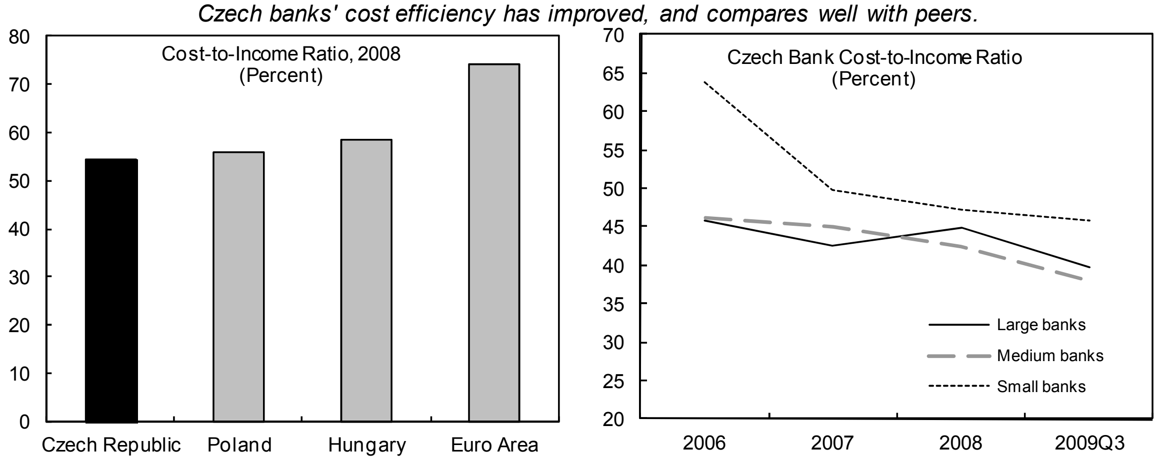
26. **Going forward, credit quality will remain the key challenge putting banks' profitability under pressure**. Reflecting the weak economic outlook, bank lending to the corporate sector is expected to remain depressed while retail credit growth is likely to slow owing to raising unemployment. Banks' NPLs are bound to increase, though the private sector's contained debt levels and low interest rates may be mitigating factors. Lower revenues, mainly reflecting lower lending activity, growing loan loss provisioning and reduced risk tolerance would put pressure on banks' profitability. Despite the costs associated with exchange rate volatility in the first half of 2009, risks associated with off-balance sheet operations remain limited since derivative instruments are mainly used for hedging exchange and interest rate risk rather than for speculative purposes. Further improvements in cost efficiency, which already compares well with peer banking sectors, will become key for the Czech banks. Against this background, the CNB needs to (i) continue monitoring high single-borrower concentration in the corporate sector and commercial real estate exposure and, more generally, developments in banks' profitability so as to preserve adequate capital buffers, as well as banks' liquidity positions; (ii) further improve macro-prudential analysis

The size of Czech banks' off-balance sheets are broadly in line with peers.



Source: ECB, EU Banking Sector Stability Report, August 2009 by taking into account the interaction among liquidity, market, and credit risk; and (iii) enhance the integration between macro-prudential analysis and supervisory activity.

Czech banks' cost efficiency has improved, and compares well with peers.



Sources: BIS; CNB; ECB; and OECD

27. **Although the weak operating environment may constrain banks' willingness to lend, some factors bode well for banks' ability to resume lending once the economic outlook improves.** Czech banks display healthy capital buffer, which, on average, the CNB estimates to be sufficient to withstand stress scenarios.[12] Parent banks have shown strong commitment to the market, which should mitigate the risks stemming from global de-leveraging; albeit slowly, they are working out their problems: some have raised fresh capital from either private or public sources, while others are in the process of disengaging from public support. The low loan-to-deposit ratio leaves room for new lending, the growth of which will remain tied to deposit generating capacity.

28. **The Czech Republic has a sound financial supervisory and prudential framework, which has been further strengthened by enriching the array of remedial measures to deal with weak credit institutions and systemic risk.** A recent study conducted at the request of the EU Commission concluded that the Czech Republic has fully implemented the Capital Requirement Directive, which translates Basel II into a European regulatory framework.[13] A recent amendment to the Act on Banks, effective September 2009, allows the creation of a bridge bank (which can be fully owned by the state) in order to take over ailing credit institutions; entrusts the special administrator of a bank in conservatorship with the powers to carry out purchase-and-assumption (P&A) transactions; and streamlines the procedures for increasing a bank's capital. The amendment also strengthens the CNB's oversight powers on banks' liquidity and it enables the CNB to temporarily prohibit or

[12] http://www.cnb.cz/m2export/sites/www.cnb.cz/en/financial_stability/fs_reports/fsr_2008-2009/index.html

[13] http://ec.europa.eu/internal_market/bank/studies/index_en.htm,

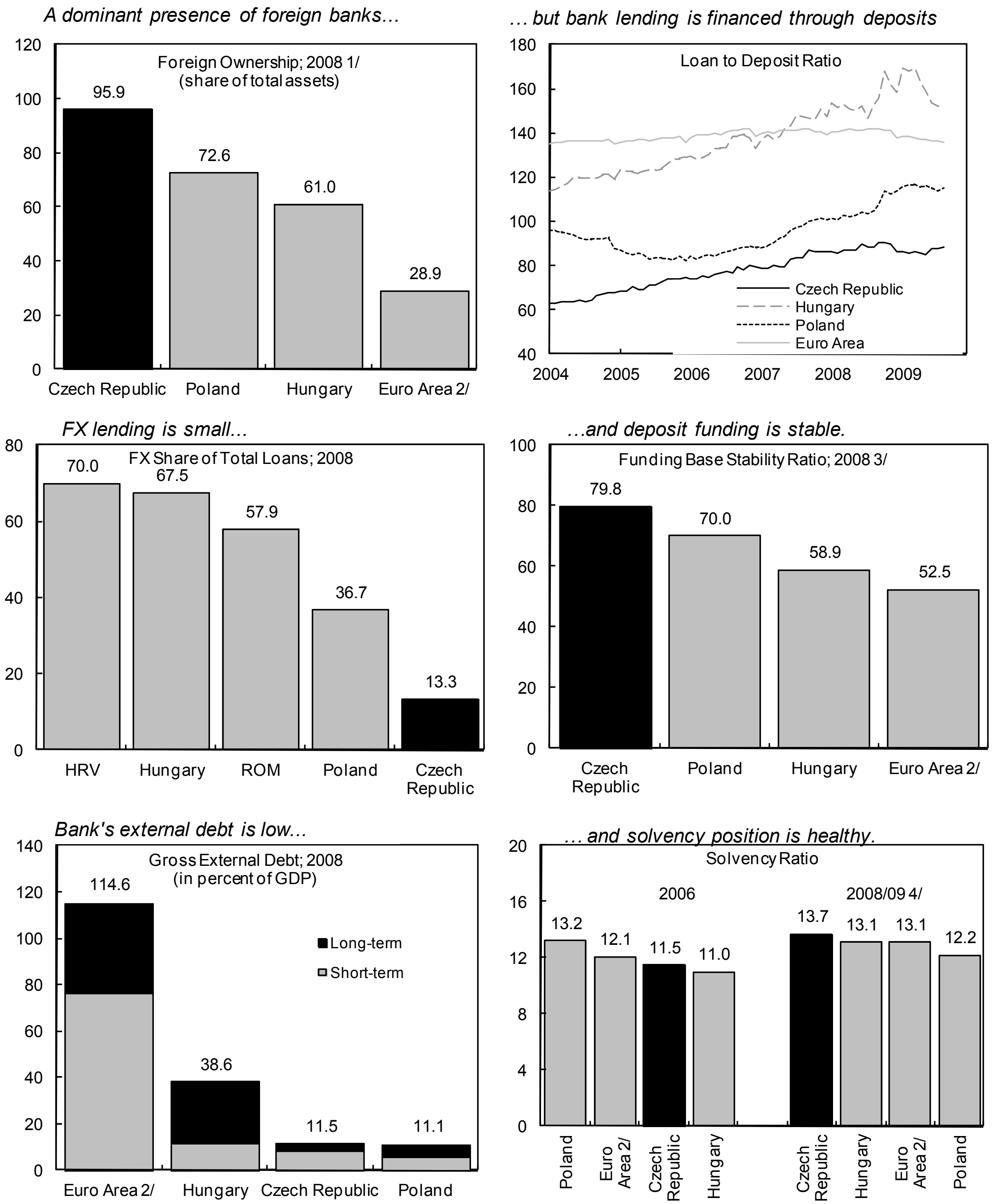
restrict some banking activities across-the-board, including branches of foreign banks, in case the stability of the banking and financial system as a whole is in jeopardy.

29. **However, further improvements in the deposit insurance and bank resolution techniques can be considered.** The section of the Act on Banks regarding the resources of the Deposit Insurance Fund (DIF), which in the Czech Republic acts as a mere paybox, is currently under review. The main amendments concern the shortening of the depositors' pay-out period, the establishment of a target for the DIF's resources, the temporary increase in credit institutions' contributions and the potential recourse to financial assistance from the state budget in case the DIF were unable to borrow from the market. A financially sound DIF would shore up depositors' confidence. However, there is also the need to ensure the DIF's access to timely and accurate information on insured deposits in order to meet its obligations to depositors promptly.[14] To this end, the information sharing process between the CNB and the DIF needs to be reviewed. While preserving the role of the CNB as unified supervisor, consideration could be given to further strengthen the bank resolution framework by envisaging the potential use of the DIF resources in carrying out "assisted" P&A transactions (provided that the "least-cost-solution" principle is satisfied).

30. **Since the Czech banking sector is virtually foreign-owned, intensive supervisory coordination with cross-border authorities is crucial**. In this context, the ongoing revision of the EU financial sector supervisory framework should be viewed by the Czech authorities as an opportunity to strengthen the liaison with home-country supervisors and contribute to the development of a strong cross-border resolution framework.

[14] Pursuant to the revision of the EU Directive, the payout delay is going to be reduced to twenty working days; this period can be extended by additional ten days only under exceptional circumstances.

Figure 5. Czech Republic: Banking Sector, 2008-09



Sources: BIS; CNB; ECB; GFSR; IFS; and OECD.

1/ Foreign-controlled subsidiaries and branches.

2/ EA = Euro area excluding Cyprus, Malta, Slovakia, and Slovenia.

3/ Defined as the ratio of total deposits (other than from credit institutions) to the sum of total deposits and debt certificates.

4/ CZE=June 2009; HUN=June 2009; POL=April 2009; EA=end-2008.

INTERNATIONAL MONETARY FUND

CZECH REPUBLIC

Staff Report for the 2010 Article IV Consultation—Informational Annex

Prepared by the European Department

February 5, 2010

Contents Page

Appendixes

Appendix I. Czech Republic: Fund Relations

(As of December 31, 2009; unless specified otherwise)

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

II. **General Resources Account**

	SDR Million	% Quota
Quota	819.30	100.0
Fund holdings of currency	665.33	81.21
Reserve position in Fund	153.98	18.79

III. **SDR Department**:

	SDR Million	% Allocation
Net cumulative allocation	780.20	100.00
Holdings	794.44	101.83

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

V. **Financial Arrangements**:

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

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

VII. **Exchange Rate Arrangement**:

The currency of the Czech Republic is the Czech koruna, created on February 8, 1993 upon the dissolution of the currency union with the Slovak Republic, which had used the Czechoslovak koruna as its currency. From May 3, 1993, to May 27, 1997, the exchange rate was pegged to a basket of two currencies: the deutsche mark (65 percent) and the U.S. dollar (35 percent). On February 28, 1996, the Czech National Bank widened the exchange rate band from ±0.5 percent to ±7.5 percent around the central rate. On May 27, 1997, managed floating was introduced. In the *Annual Report on Exchange Arrangements and Exchange Restrictions,* the de facto exchange rate regime of the Czech Republic is classified as 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 December 31, 2009, the exchange rate of the Czech koruna stood at CZK 18.368 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 2008 Article IV consultation with the Czech Republic was concluded on February 6, 2009. The staff report and PIN were published on April 14, 2009.

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. 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. **Safeguards Assessments:** Not Applicable

Czech Republic: Technical Assistance, 1991–2005

Department	Timing	Purpose
FAD	Dec. 1991–Sept. 1993	Regular visits by FAD consultant on VAT
	March 1993	administration
	September 1993	Public financial management
	November 1993	Follow-up visit on public financial management
	January 1994	Follow-up visit on public financial management
	July 1994	Follow-up visit on public financial management
	May 1995	Follow-up visit by FAD consultant on VAT
	June 1995	administration
	June–July 1999	Follow-up visit on public financial management
		Follow-up visit by FAD consultant on VAT
		administration
		Medium-term fiscal framework
	February 2008	Evaluation of merger of Tax and Customs

		Administrations (with the WB)
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)
	February 2000	Inflation targeting
	January 2002	Inflation targeting
	November 2002	Inflation targeting
	May–June 2003	AML/CFT Assessment
RES	September 1999	Inflation targeting (financed by MFD)
	June–August 2000	Inflation targeting (financed by MFD)
	March 2001	Inflation targeting (financed by MFD)
	June—July 2002	Inflation targeting (financed by MFD)Inflation
	February–March 2005	targeting (financed by MFD)
	April 2005	Inflation targeting (financed by MFD)
STA	May 1993	Money and banking statistics
	February 1994	Balance of payments
	April 1994	Government finance
	November 1994	Money and banking statistics
	January–February 1999	Money and banking statistics
	May 2002	Monetary and financial statistics
	February 2003	Implementing GFSM 2001
	November 2006	GFSM 2001 Pilot Project

APPENDIX II: STATISTICAL ISSUES

Data provision is adequate for surveillance. The Czech Republic subscribed to the Special Data Dissemination Standard in April 1998, and metadata and annual observance reports for 2006–2008 are posted on the Fund's Dissemination Standards Bulletin Board (http://dsbb.imf.org).

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; trade balance data are available monthly, with a two–month lag. Annual data published in the *Government Finance Statistics Yearbook* cover all operations of the general government, including the extrabudgetary funds excluded from the monthly data. These annual data are available on a timely basis. Monthly fiscal data published in *International Financial Statistics (IFS)* cover state budget accounts and are available with a two- to three-month lag.

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

- National accounts data are subject to certain weaknesses. Value added in the small-scale private sector is likely to be underestimated, as the mechanisms for data collection on this sector are not yet fully developed and a significant proportion of unrecorded activity stems from tax evasion. However, quarterly estimates for small enterprises (less than 20 employees) have been improved recently using administrative data on social insurance. Discrepancies between GDP estimates based on the production method and the expenditure method are large and are subsumed under change in stocks. There are swings from quarter to quarter in some seasonally adjusted series that need to be corrected by smoother trend-cycle data.

- Recently, revisions to procedures for processing export data have brought external trade statistics close to the practice in the EU.

- 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 January 26, 2010

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	1/26/10	1/26/10	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Dec. 2009	1/08/10	D	M	M
Reserve/Base Money	12/31/09	1/14/10	10 days	10 days	10 days
Broad Money	Nov. 2009	12/31/09	M	M	M
Central Bank Balance Sheet	1/20/10	1/25/10	10 days	10 days	10 days
Consolidated Balance Sheet of the Banking System	Nov. 2009	12/31/09	M	M	M
Interest Rates[2]	1/26/10	1/26/10	D	D	D
Consumer Price Index	Dec. 2009	1/11/10	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Dec. 2008	Jan. 2009	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Nov. 2009	1/8/10	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2009 Q3	Dec. 2009	Q	Q	Q
External Current Account Balance	2009 Q3	Dec. 2009	Q	Q	Q
Exports and Imports of Goods and Services	Nov. 2009	Jan. 2010	M	M	M
GDP/GNP	2009 Q3	Dec. 2009	Q	Q	Q
Gross External Debt	2009 Q3	Dec. 2009	Q	Q	Q
International Investment Position[6]	2009 Q3	Dec 2009	Q	Q	Q

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments. Data for the state budget are available with monthly frequency and timeliness, while data on extra budgetary funds are available only on an annual basis.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).

Statement by the Staff Representative on the Czech Republic
February 22, 2010

This statement provides information on economic developments since the staff report was issued (SM/10/30). The new information does not alter the thrust of the staff appraisal.

1. **The recently released data are in line with staff expectations.** According to flash estimates, the Czech economy contracted by 4.3 percent in 2009. Unemployment continued to increase, reaching 9.8 percent in January, up from 9.2 percent a month earlier. Inflation remains benign, with the year-on-year CPI increase at 0.7 percent in January, compared to 1 percent in December.

2. **As expected, the central bank kept its key policy rate unchanged at 1 percent in its February 4 meeting.** According to the latest Inflation Report, the CNB expects inflation to remain subdued in the first half of the year and to reach the 2 percent target in the first half of 2011.

3. **On February 8, the government approved the new Convergence Program.** The program aims to reduce the budget deficit to 4.2 percent of GDP in 2012. This would require an additional adjustment of 1.2 percent of GDP in 2013 to meet the target mandated by ECOFIN. The program acknowledges the need for significant reductions in current (and particularly mandatory) expenditures, with the new government having to identify specific measures. To a lesser extent the program emphasizes revenue increases and proposes one new measure (introduction of a second PIT rate of 31 percent for incomes exceeding the social security ceiling).

4. **Rising concerns about debt sustainability in the euro zone have led to some increase in interest rates on government debt.** The authorities have not encountered any problems attracting financing, but the average yield at the latest bond auction on February 10 was some 40 basis points higher than at the previous auction in December 2009. Although overall demand was twice the amount offered, the authorities decided to sell only about 60 percent of the offered bonds.

5. The general elections have been scheduled for May 28–29, 2010.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 10/36
FOR IMMEDIATE RELEASE
March 2, 2010

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

IMF Executive Board Concludes 2010 Article IV Consultation with Czech Republic

On February 22, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Czech Republic.[1]

Background

The Czech economy's fundamentals were strong prior to the global economic and financial crisis. Nevertheless, due to its highly open nature, the economy was hit by spillover effects. A downturn in the euro area depressed exports, while investment declined due to a drop in FDI and the tightening of banks' lending standards. Monetary and fiscal easing provided helpful stimulus, thereby cushioning the economic downturn. Between August 2008 and December 2009 the Czech National Bank cut the policy rate by 275 basis points, while automatic stabilizers and fiscal measures widened the budget deficit by 4 percent of GDP in 2009. The real output decline is estimated to be 4⅓ percent in 2009.

The recovery of the Czech economy is expected to be gradual. GDP is projected to grow by 1½ percent in 2010, supported by exports and a buildup of inventories, while fixed capital formation will remain depressed and consumer spending is expected to decline reflecting still-rising unemployment, a slowdown in wage growth, and the unwinding of fiscal stimulus. Furthermore, the adverse effects of the crisis are likely to be long lasting. A collapse in

[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.

investment and slowdown in total factor productivity growth reduced dramatically the output growth rate in 2009–10, and over the medium-term growth is not expected to reach pre-crisis levels. Risks to the short-term outlook seem balanced.

The tax hikes approved as part of the 2010 budget are expected to push average headline inflation to over 1½ percent in 2010, but still below the target of 2 percent. The external position remains solid, as the drop in exports has been accompanied by an even larger fall in imports, thus improving the trade balance despite the real appreciation.

Credit to the economy has decelerated dramatically reflecting both unfavorable investment sentiment and tighter credit conditions. Household credit, however, continued its double-digit growth and mortgage lending has performed relatively well. Overall, the banking sector weathered the turmoil relatively well, owing to healthy capital and liquidity buffers, strong retail funding, and limited exposure to foreign currency risk. This helped avoid the need to implement bank recapitalization from public funds or use other exceptional measures to shore up financial sector stability.

Executive Board Assessment

The Executive Directors noted that the Czech Republic entered the crisis from a strong macroeconomic position, bolstered by integration with the EU and sound policies. However, spillover effects have taken their toll on the highly open Czech economy.

Directors viewed the authorities' policy response to the crisis—monetary and fiscal easing—as appropriate. The external position remains robust and the real exchange rate is in line with fundamentals. The banking sector has weathered the global financial turmoil relatively well without the need for the authorities to undertake bank recapitalization or other exceptional measures to shore up financial sector stability.

Directors expected that the revival of the Czech economy would be gradual and dependent on the global recovery, supported by exports and a buildup of inventories. They considered that the supportive monetary policy stance remains appropriate for now, but should shift to tightening as the recovery gathers momentum.

Directors agreed that the main challenge for the authorities will be to reverse the recent widening of budget deficits in a sustainable manner. They viewed the 2010 budget as appropriately balancing the objectives of attaining fiscal sustainability and supporting economic recovery, and cautioned against any additional spending prior to the May general elections. The new government will need to propose a credible and durable plan for medium-term fiscal consolidation in order to achieve debt sustainability, including in light of spending pressures from population aging. The new plan should draw and expand on the recently approved Convergence Program. A number of Directors called for greater focus on expenditure reductions than in the past, including measures to improve the efficiency of public services. Directors supported the need to cut expenditures, in particular mandatory spending, as well as to expand the tax base, unify VAT rates, and improve tax administration. While Directors viewed reconsidering the Corporate Income Tax (CIT) rate as a possibility, a number of Directors did not favor raising it. It will also be crucial to tackle the longer-term fiscal challenges of pension and health care reforms, which will need a broad political consensus. Improved monitoring of budget execution will be important.

Directors considered that the adverse effects of the crisis are likely to be long lasting, and that growth is not expected to reach pre-crisis levels owing to the abating convergence process and worsening demographic trends. They called for swift implementation of growth-enhancing structural reforms to increase productivity and labor participation, and to improve the business climate.

Directors noted that capital markets development has been hampered by poorly-targeted subsidies, tax exemptions on certain savings products, and old regulations regarding private pension funds, and suggested that further measures be taken to support the smooth functioning of these markets.

Directors considered that further improvements in cost efficiency would become key for Czech banks as the economic downturn affects banking sector profitability, and encouraged the authorities to closely monitor developments. Still, Directors thought that banks' soundness, low loan-to-deposit ratio, and parent banks' commitment to the market bode well for banks’ ability to resume lending as the economic outlook improves.

Directors welcomed the strengthening of the financial supervisory and prudential framework through an array of remedial measures, and expressed support for the Czech National Bank’s continued efforts to improve and enhance the integration of macro-prudential analysis and supervision activity. Given the virtually complete foreign ownership of banks, intensive cross-border supervisory coordination remains crucial.

Czech Republic: Selected Economic Indicators, 2005–11

	2005	2006	2007	2008	2009	2010	2011
					Est.	Staff Proj.	
Real economy (change in percent)							
Real GDP	6.3	6.8	6.1	2.5	-4.3	1.7	2.6
Domestic demand	1.3	5.5	5.2	1.1	-5.3	0.6	2.1
CPI (year average)	1.8	2.5	2.9	6.3	1.0	1.6	2.0
PPI (year average)	3.1	1.5	4.1	4.5	-3.1	n.a.	n.a.
Unemployment rate (in percent)							
Survey-based 1/	7.9	7.1	5.3	4.4	7.2	8.8	8.5
Registered 1/	8.9	8.1	6.6	5.4	8.2	9.9	9.6
Gross national savings (percent of GDP)	24.3	24.2	23.9	22.2	20.9	21.0	20.3
Gross domestic investments (percent of GDP)	25.7	26.8	27.0	25.3	23.0	22.7	22.7
Public finance (percent of GDP) 2/							
General government revenue	41.4	41.1	41.9	40.9	38.8	40.7	40.8
General government expenditure	45.0	43.7	42.5	42.9	44.8	45.8	46.1
Net lending / Overall balance	-3.6	-2.6	-0.7	-2.0	-6.0	-5.1	-5.3
General government debt	29.7	29.6	29.0	30.0	34.2	37.9	40.5
Money and credit (end of year, percent change)							
Broad money 3/	8.0	9.9	13.2	6.6	4.3	4.0	n.a.
Private sector credit (percent change, eop) 3/	20.8	21.6	27.3	16.0	2.8	1.5	n.a.
Interest rates (in percent, year average)							
Three-month interbank rate	2.2	2.6	4.1	3.6	1.5	n.a.	n.a.
Ten-year government bond	3.6	3.7	4.7	4.1	3.7	n.a.	n.a.
Balance of payments (percent of GDP)							
Trade balance	2.0	2.0	3.4	2.8	2.9	2.9	3.3
Current account	-1.3	-2.6	-3.1	-3.1	-2.1	-1.7	-2.4
Gross international reserves (US$ billion)	29.6	31.5	34.9	41.5	42.7	45.9	47.5
Reserve cover (in months of imports of goods and services)	4.1	3.6	3.2	3.2	4.3	4.3	4.1
Exchange rate							
Nominal effective exchange rate, pa (2000=100) 3/	125.3	131.7	135.4	142.5	149.5	n.a.	n.a.
Real effective exchange rate, pa (CPI-based; 2000=100) 3/	125.5	132.6	136.8	148.8	155.1	n.a.	n.a.

Sources: Czech Statistical Office; Czech National Bank; Ministry of Finance; and IMF staff estimates and projections.
1/ In percent of total labor force.
2/ On ESA-95 basis.
3/ For 2009, data refer to November.

Statement by Mr. Willy Kiekens, Executive Director for the Czech Republic and Mr. Miroslav Kollar, Advisor to the Executive Director
February 22, 2010

We thank staff for their papers and constructive approach during the mission. The Czech authorities broadly agree with the staff's appraisal, especially with respect to the need for fiscal consolidation. The authorities welcome staff's call for reforms in the pension and health care system. They observe that a fundamental reform in these areas requires wide political consensus.

Political background

The current caretaker government, which was set up in early 2009 after the collapse of the previous coalition government, has a limited political mandate and is therefore constrained with respect to fundamental fiscal or other reforms. The next general elections will be held in May 2010. The two major political parties have somewhat different approaches for fiscal consolidation. While the social democrats of the CSSD generally prefer tax increases, the civic democrats of the ODS favor cuts in mandatory expenditures, especially the benefits system, and increase in effectiveness of the tax system and tax collections. With respect to pension and health care system reforms, neither of the major political parties has made any strong commitment yet.

Economic background

The Czech economy has been severely hit by the global economic and financial crisis. According to preliminary data released by the Czech Statistical Office on February 12, 2010, real GDP fell by 4.3 percent y-o-y in 2009, driven mainly by a decline in external demand and investments. GDP contracted by 4.2 percent in 4Q 2009. Industrial production declined by 13.4 percent y-o-y in 2009.

The unemployment rate reached 6.8 percent in 2009. The Czech National Bank (CNB) estimates that unemployment may reach a peak of 8.9 percent in 2010/2011.

The extent of the Czech economy's decline was similar to other Western European economies but was less severe than in some of the Eastern European economies. The Czech economy's decline reflects its strong trade linkages to Western Europe, especially Germany.

The future course of economic growth in the Czech Republic largely depends on the growth dynamics in Western Europe. The Czech authorities expect some improvement in economic activity in 2010, with a more sustained economic rebound expected in 2011. The end of the cash-for-clunkers program in Germany and the weaker than expected economic growth in Western Europe in 4Q 2009, which suggests only a gradual and uneven recovery of foreign demand, are the main external risks to economic growth in the Czech Republic. The CNB expects GDP to grow by 1.4 percent in 2010 and by 2.1 percent in 2011. The Czech Ministry of Finance (MoF) is somewhat more optimistic as it expects GDP growth of 2.6 percent in 2011. The main drivers of GDP growth in 2010 will be net exports while household consumption will be quite week this year.

With a deficit of 6.6 percent of GDP in 2009, the fiscal position worsened significantly but remains comparable to a number of Western European countries and more favorable than in some other Eastern European countries as well as in some euro area countries.

Monetary policy and the banking sector

CPI inflation bottomed in 2009, reaching 0.2 percent in 3Q 2009. The CNB started to decrease its policy interest rates already in August 2008, from 3.75 percent to 1 percent currently. The February 2010 forecast of the CNB sees inflation returning to its new 2 percent target in the first half of 2011, suggesting that the cycle of interest rates easing may have probably ended. The main drivers of inflation in 2010 will be tax changes, a rise in regulated rents, growing gasoline prices and a modest recovery in food price growth. There are no apparent fundamental inflationary pressures in the economy at the moment, even though there is uncertainty associated with the nominal wage growth. The transmission mechanism of the monetary policy is improving and remained operational even during the crisis. The CNB did not have to rely on any truly non-conventional monetary policy measures. The measures introduced during the crisis (i.e. liquidity-providing repo operations with fixed rate, full allotment and collateralized by Czech government bonds), were used by the banks only to a very small extent. Monetary policy performed well during the crisis and retained its credibility. Inflation expectations remain anchored. The CNB regards the current level of the CZK/EUR exchange rate as broadly in line with fundamentals and believes that the trend of equilibrium real appreciation will resume in the medium to longer term. Foreign investors perceive the Czech economy as stable with a relatively low public debt level.

With respect to enhancing the integration between macro-prudential analysis and supervision analysis, the CNB established a macro-financial panel taking place before each monetary-policy meeting of the Central Bank Board. This panel gathers representatives from both the monetary policy department and the supervision and financial stability departments to discuss e.g. current macro-prudential issues and results the banking sector stress-tests.

The Czech banking sector proved largely resilient to the crisis. Czech banks operate in a conservative business model and have relatively healthy balance sheets. As staff pointed out, the share of foreign exchange loans is very low, banks are well capitalized and funded domestically mainly from deposits. The economic downturn is causing an increase in non-performing loans and default rates, especially loans to corporations. Nevertheless, even the most pessimistic scenarios of the CNB's stress-tests show that the banking sector is able to withstand even a significant increase in default rates without any intervention from the government or central bank. The future course of the banks' lending will be conditioned on the economic growth prospects both at home and in Western Europe.

With respect to the staff appraisal of the Deposit Insurance Fund (DIF), the authorities believe that the role of the DIF should be limited to a pay-box.

Fiscal policy

Fiscal policy is the main challenge for the next Czech government. During the current economic crisis, the fiscal position significantly worsened. According to the January 2010 numbers from the MoF, the overall budget deficit in 2009 reached 6.6 percent of GDP and is projected to reach 5.3 percent of GDP in 2010. Public debt increased from 30 percent of GDP in 2008 to approximately 35.2 percent of GDP in 2009. With more than 70 percent of government expenditures being mandatory and quasi-mandatory, the structural problems of public finances are obvious and existed already before the crisis. The overall budget deficit worsened during the crisis because of both automatic stabilizers and anti-crisis measures. The austerity package approved by the current government attempts to bring the deficit down in 2010. Even though the current government has a limited mandate and tenure, it tries to act responsibly and prepare the ground for the next government with respect to fiscal consolidation. The Czech Republic has been one of the first European countries to start fiscal consolidation. There was a shift from direct to indirect taxation in 2010, which is in accordance with staff's proposal. The MoF's long-term goal is to unify the VAT tax rate. In the medium term, it plans to move more goods from the lower tax rate to the higher tax rate. The MoF is currently working on reviewing the tax base and minimizing the occurrence of exemptions by 2011. The MoF agrees with staff that social benefits system is too generous and should be better targeted. In cooperation with the World Bank, the MoF plans to establish one collecting agency for all taxes (except of tariffs) by 2013. The MoF is also aware of the fact that more efforts should be made in improving the entrepreneurial environment and the competitiveness of the Czech economy.

The authorities believe that the government bond market is slowly recovering from the crisis. On the primary market, investors' demand for government bonds is still strong. The MoF regards its debt management to be transparent, rooted in its publicly available debt management strategy and sees no troubles for refinancing in 2010.

On February 8, 2010, the government approved the Convergence Program – a medium-term budget plan that should lead to compliance with the fiscal Maastricht convergence criterion by 2013. The budget deficit should be reduced to 3 percent of GDP by 2013. All political parties respect this commitment and agree that without necessary fiscal consolidation measures, this goal cannot be achieved. The Convergence Program sets out the goal and sketches possible solutions to reduce the budget deficit to 3 percent by 2013. The concrete measures will need to be approved and taken by the new government. An appropriate legislative framework needs to be prepared in advance for the 2011 budget measures. The Convergence Program was sent to the European Commission.

On February 8, 2010, the government also approved its exit strategy. The consolidation of public finances and the fight against corruption are at its forefront, with a proposal to harmonize the tax base for the calculation of personal income tax and social and health insurance, to reduce wages in the public sector, confirmed doubling of the real estate tax, and other temporary changes or increases in indirect taxes and personal income tax. Additional proposed measures include improving the business environment, reducing administrative burden on companies and a wide array of concrete steps in the energy industry, housing policy, tourism, EU funds administration, transport policy, export policy, social policy, employment policy, agriculture, and environmental policy. These government proposals received mixed feedback from the political parties but could serve as a guideline for the future government.

Structural issues

The current government welcomed the reform call by staff in the pension and health care systems, though admitted that these two areas are the most sensitive issues in the Czech Republic. Their reform will require a broad political consensus. Both of these areas are largely affected by the rapidly ageing Czech population. For the pension system, a number of smaller changes have been already approved both to the pay-as-you-go system and the voluntary pension pillar. Last January, the Minister of Finance together with Minister of Labor and Social Affairs re-established the so-called Bezdek Committee for the pension reform. This advisory body should evaluate its findings from 2004-2005, based on the current economic environment and recommend the most suitable scenario and future reform steps.

With respect to the health care reform, there is no platform set up to discuss possible reform proposals yet, but all political parties envision a need for a deeper structural reform of the health care system.