

Czech Republic—2011 Article IV Consultation Concluding Statement
February 21, 2011

1. **The Czech economy has rebounded from the downturn owing to its strong fundamentals and the global recovery.** Low public debt, comfortable external position, and a stable financial sector contained the decline in output, while deep economic integration with the euro area allowed the Czech economy to benefit from the recovery of trading partners, particularly Germany. Spillovers from the debt crisis in the euro area periphery into the Czech Republic have been minor due to limited real and direct financial linkages, as well as high capital and liquidity buffers of Czech banks.

2. **However, policy challenges are mounting.** With large structural deficits and population aging fiscal pressures will be rising and, in the absence of additional consolidation beyond 2011, public debt would continue growing. Monetary policy is complicated by the contrasting influences on inflation of the climbing world commodity prices and the still nascent recovery. Sustaining robust productivity and GDP growth in the long run also requires significant policy efforts.

3. **What should be done?** Ensuring debt sustainability and promoting durable long-term growth requires:

- *Defining additional fiscal consolidation measures* beyond 2011, including through pension, health care, and social benefits reforms, to support the government's medium-term fiscal targets and preserve market credibility;
- *Maintaining accommodative monetary policy* until the negative output gap narrows considerably, unless a spike in inflation expectations, substantial widening of the interest rate differential against other advanced countries, or rapid tightening of labor market slack necessitate earlier action;
- *Pursuing productivity-enhancing structural reforms* to buttress potential growth in the medium term;
- *Continuing to monitor main risks for the banking sector* that may arise from further deterioration of credit portfolios and from foreign parent banks.

4. **Broad-based support across the political and social spectrum** will be necessary for successful implementation and durability of the reforms.

Growth Outlook

5. **The recovery is expected to slow down in the near term given fiscal consolidation at home and abroad.** The IMF mission projects growth of 1¾ percent in 2011. Net exports and fixed investment are expected to drive economic activity, while private consumption growth will likely be modest. Unemployment is forecast to decline slowly and the output gap to narrow only marginally in 2011. Downside risks arise from the possibility of tensions in

the euro area periphery spreading to the core of Europe, thereby reducing growth in the euro area and the Czech Republic.

6. **Growth-enhancing structural reforms should be pursued.** In the long run, growth is likely to slow down as demographic trends constrain productive capacity. In the medium term, however, there is still a significant scope for convergence to productivity and income levels in the EU-15 countries. But this will require growth-promoting structural reforms focused on increasing labor participation and labor market flexibility; enhancing the efficiency of higher education, R&D, and the public sector; and further improving the business climate to attract foreign direct investment.

Public Finances

7. **The 2011 budget is a significant step towards achieving fiscal sustainability.** The fiscal consolidation this year appropriately focuses on expenditure cuts, although some of the across-the-board measures do not necessarily reflect the relative values of different government activities. The adjustment measures adopted by the authorities should reduce the general government deficit to around 4 percent of GDP in 2011. The negative impact on growth is expected to be relatively limited due to the high degree of openness of the Czech economy.

8. **A credible package of additional consolidation measures is needed from 2012 onwards to put public finances on a sustainable path.** The government's medium-term deficit targets—aiming to balance the general government budget by 2016—are appropriate as they reverse public debt dynamics. Specifying early on a comprehensive consolidation strategy would increase the credibility of fiscal adjustment and lower the output costs of fiscal tightening. Expenditure-based consolidations tend to be more durable, and hence more credible. Thus rationalizing mandatory spending and the generous welfare state is unavoidable and re-organizing public institutions and positions would help further. In addition, there is also some scope to raise revenues, for example from real estate taxes.

9. **Long-term fiscal sustainability cannot be achieved without addressing pension and health-care spending pressures arising from population aging.** An extension of the retirement age currently under discussion is appropriate, but by itself not sufficient to achieve the sustainability of the pay-as-you-go (PAYG) pillar. Thus additional parametric changes, such as modification of the pension-indexation formula, will be needed. An introduction of a second, fully-funded defined-contribution pillar would help diversify sources of retirement income, but its voluntary nature as currently discussed would likely limit its size. Moreover, likely self-selection by high-wage earners in opting out of the redistributive first pillar may exacerbate the pressures on PAYG finances in the long term. The planned reduction in social security contributions and their partial diversion to the second pension pillar (though limited in the voluntary system) would reduce budgetary revenues and widen the overall fiscal deficit. The proposal to raise revenues instead through a unification of the VAT at the higher

of the two rates would be appropriate on efficiency grounds, but in the absence of additional measures would be insufficient to balance the budget by 2016. Furthermore, support for the vulnerable segments of the population would need to be ensured. There is also room to improve the functioning of the third pension pillar by revising the regulatory framework to facilitate a more diversified asset allocation. Comprehensive institutional and financing reforms of the health care system will also be critical to maintain the soundness of public finances.

10. **Improving fiscal institutions can help buttress the market confidence in the durability of fiscal adjustment.** In particular, strengthening of the budgetary rules and introduction of an act on budget discipline and responsibility could be useful to ring-fence fiscal consolidation gains in the medium term. Creation of an autonomous National Budget Council that provides an independent evaluation of fiscal policies could help prevent fiscal deficits from escalating with election cycles.

Monetary Policy

11. **The policy of low interest rates remains appropriate in the environment of a sizeable negative output gap and ongoing fiscal consolidation.** The fiscal adjustment in 2011 will curb domestic demand and together with the recent appreciation of the koruna will dampen inflationary pressures. Inflation is expected to remain close to the 2 percent target this year, but would significantly, although temporarily, increase once the VAT rates are unified. A gradual increase in policy rates should be initiated once the output gap starts to close at a significant pace, although a faster reduction of domestic labor market slack or a rise in inflation expectations would be a signal for the tightening cycle to begin earlier.

12. **The timing of the tightening cycle will also need to take into account external conditions.** Changing the interest rate differential vis-à-vis other advanced economies could lead to large capital flows, with implications for the exchange rate and inflation. Should significant capital inflows occur, with the real exchange rate broadly in equilibrium, an adequate level of foreign exchange reserves, and a sizeable output gap, the appropriate policy response would be to allow the currency to appreciate within the current framework of the freely floating exchange rate, and—if needed— lower the policy interest rates.

Financial Sector

13. **The banking sector has been stable and is well prepared to support the recovery, but downside risks remain.** The deterioration of credit quality observed in the last two years is expected to moderate. Banks appear to be well positioned to support economic activity, but credit growth in the near term is likely to remain below its pre-crisis pace. Downside risks are associated with an adverse scenario of a sharp slowdown in Europe, including in the Czech Republic, which could translate into further deterioration of credit quality. Particularly banks more heavily exposed to corporates operating in highly cyclical sectors could be affected under distressed macroeconomic conditions. Also, possible risks stemming from

reputational and financial contagion from foreign parent banks, while receding, cannot be entirely ruled out.

14. **The recent reduction of government subsidies to the depositors of building societies is a step in the right direction towards reforming the sector.** Existing regulations limit the scope of operation and products offered by building societies, and as a result some institutions have significant maturity mismatches in their balance sheets. Regulatory changes establishing a more level playing field among building societies and commercial banks would allow the removal of these distortions over time, increasing efficiency in the provision of financial services, and releasing scarce public resources that are needed elsewhere.

15. **Maintaining sound financial supervision and a strong governance framework for domestic banks remains critical.** Protecting the financial soundness of the banking sector will require continued vigilance and cross-border cooperation, given the prevalent foreign ownership and the still vulnerable financial situation of some parent banking groups abroad. In this vein, it is important to maintain adequate capital buffers of domestic banks and to ensure that the management of liquidity and the allocation of capital across-borders do not impair financial soundness. The authorities are encouraged to maintain the strong governance framework and financial transparency for their supervised entities, and to deepen their ongoing work with peer supervisors.

The mission is grateful to the authorities and all our interlocutors for their excellent cooperation, open discussions, and warm hospitality.