INTERNATIONAL MONETARY FUND

IMF Country Report No. 15/198

CZECH REPUBLIC

2015 ARTICLE IV CONSULTATION—PRESS RELEASE; AND STAFF REPORT

July, 2015

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2015 Article IV consultation with the Czech Republic, the following documents have been released and are included in this package:

- A **Press Release**
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse of time basis, following discussions that ended on May 19, 2015, 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 June 29, 2015.
- An **Informational Annex** prepared by the IMF staff.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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July 23, 2015

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IMF Executive Board Concludes 2015 Article IV Consultation with Czech Republic

On July 15, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Czech Republic and considered and endorsed the staff appraisal without a meeting.[2]

The Czech economy is growing strongly on account of improving domestic demand and robust exports. Growth accelerated in the first quarter of this year and high frequency indicators, including retail sales, production and consumer confidence suggest that the growth momentum has continued in recent months. The labor market also has been recovering fast and the unemployment rate declined to the lowest level since 2009. Led by an improving trade balance due to positive terms-of-trade developments, the current account turned to a surplus. In the face of a drop in energy and food prices, headline inflation decelerated sharply in 2014 and is hovering just above zero, while core inflation remains stable.

Following substantial pro-cyclical fiscal tightening in 2011–13, fiscal policy has been supportive of the economic recovery. Specifically, the general government deficit increased from 1.2 percent of GDP in 2013 to 2.0 percent in 2014, implying about a 1 percentage point easing in the fiscal stance. The relaxation was mainly due to a negative surprise in excise collections, and an increase in capital spending.

Monetary policy has remained accommodative. In November 2013, constrained by the zero lower bound and facing deflationary pressures, the Czech National Bank decided to use the exchange rate as an additional instrument for inflation targeting and announced its commitment "to prevent excessive appreciation of the koruna below CZK27 per € by intervening in the

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

foreign exchange market”. The exchange rate has been hovering above that level without any official intervention in the foreign exchange market since November 2013.

The banking sector is stable and credit growth shows signs of a recovery**.** Czech banks are self-financed with a low system-wide loan-to-deposit ratio and strong capital and liquidity buffers. Despite a slight increase in the non-performing loan ratio to 5.6 percent last year, the ratio remains low. Credit growth is slowly recovering driven by demand from the corporate sector and recent lending surveys point to easing lending standards and gradually rising demand for credit. Funding costs have declined further.

The outlook is for strong growth and low inflation. Growth is projected to accelerate to 3 percent in 2015, mainly on account of higher investment and improving household consumption. Inflation is likely to remain very low in 2015, before rising gradually toward the cenral bank’s target in 2016, as base effects from the oil price shock fade and declining economic slack starts to pull inflation up. Over the medium term, output growth is set to stabilize at around 2¼ percent, but a period of faster growth is possible, driven by the strong pipeline of FDI coming into effect.

Executive Board Assessment

In concluding the 2015 Article IV consultation with the Czech Republic, Executive Directors endorsed staff’s appraisal, as follows:

The Czech economy is growing strongly but challenges remain. The economic upturn is driven by robust exports and improving domestic demand being helped by accommodative macroeconomic policies. The labor market has been recovering fast with strong employment gains and real wage growth picking up gradually. But while disinflationary pressures seem to have abated, inflation is still below the central bank’s target. In addition, potential growth is well below the level necessary to facilitate fast convergence toward the income levels of other advanced European countries. Thus, the challenge for the authorities is to create the conditions for sustainable growth while safeguarding macroeconomic stability.

Fiscal policy and the medium-term fiscal objective need to be anchored in fiscal framework legislation, and the composition of the budget should be improved. The remaining output gap, low inflation, and the fact that monetary policy is at the zero lower bound warrant maintaining a slightly accommodative fiscal stance this year, as planned by the authorities. At the same time, though, modest and very gradual fiscal consolidation will be necessary beginning next year, in line with the authorities’ commitment to a medium-term objective of a 1 percent of GDP structural deficit. Moreover, this objective should be cast in fiscal framework legislation that would include expenditure ceilings, a debt brake rule, and a fiscal council—thus helping anchor fiscal policy and guard against pro-cyclical tendencies. Finally, there is scope to improve budget composition, with increased capital spending to address infrastructure needs offset by efficiency gains in current spending and improved revenue administration.

The central bank should continue to focus on inflation targeting. The exchange rate floor has proven effective in fending off deflationary pressures, and in combination with recovering demand conditions, inflation is expected to rise toward the central bank's target in the second half of 2016, thus facilitating an exit from the exchange rate floor. The central bank should thus maintain its focus on inflation targeting in its policymaking and communication, while continuing to evaluate the conditions that would trigger a normalization of monetary policy and the mechanics of its implementation. However, given the only gradual closing of the output gap and asymmetric risks at the zero lower bound, monetary policy will likely need to remain supportive for some time even after abolishment of the exchange rate floor and return to a floating exchange rate.

Continued vigilance will be needed to sustain the stability of the financial system. The banking sector is self-financed with low system-wide loan-to-deposit ratio and strong capital and liquidity buffers, which make it resilient to shocks. Moreover, bank supervision has been strengthened by increasing supervisory resources, approving a new law on credit unions, and starting utilizing the macroprudential toolkit of the Capital Requirements Regulation IV. Nevertheless, proactive supervision remains necessary along with further gradual improvements in the supervisory architecture, including the transposition of the Bank Recovery and Resolution Directive into domestic law.

An ambitious structural reform agenda is key to lifting Czech Republic's potential growth. Sustained progress on wide-ranging reforms to increase labor market participation, enhance investment in human and physical capital, and improve the business climate is essential for higher investment and growth. Reforms of the labor market should aim at increasing labor participation among women with children and low-skilled workers, while greater emphasis should be placed on mitigating skills mismatches. Priority should also be given to promoting research and innovation, enhancing apprenticeship programs, simplifying tax compliance and other administrative procedures, and improving infrastructure.

Czech Republic: Selected Economic Indicators, 2010–20

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Staff Proj.					
Nominal GDP (USD billions)	207.0	227.3	206.8	208.8	205.6	181.1	188.9	195.7	200.4	202.9	206.2
Population (millions)	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.6	10.6	10.6	10.6
GDP per capita (USD)	19,787	21,676	19,680	19,855	19,562	17,205	17,917	18,545	18,966	19,193	19,496
Real economy (change in percent, unless stated otherwise)											
Real GDP	2.3	2.0	-0.8	-0.7	2.0	3.0	2.8	2.6	2.2	2.2	2.2
Real GDP per capita	1.9	1.7	-1.0	-0.8	2.0	2.8	2.6	2.5	2.1	2.1	2.1
Domestic demand	1.8	0.0	-2.2	-0.8	2.2	3.8	3.3	2.9	2.6	2.6	2.6
Private consumption	1.0	0.2	-1.8	0.4	1.7	3.0	2.8	2.4	2.3	2.3	2.3
Investment	4.4	1.9	-3.7	-5.1	3.1	6.5	5.0	4.5	3.7	3.7	3.7
Exports	14.8	9.3	4.1	0.3	8.8	7.2	6.2	5.0	4.0	4.0	4.0
Imports	14.9	6.7	2.4	0.3	9.5	8.5	7.0	5.5	4.6	4.6	4.6
Ouput gap (percent of potential output)	-0.2	0.2	-1.9	-3.6	-2.8	-1.2	0.0	0.5	0.4	0.2	0.0
CPI (average)	1.5	1.9	3.3	1.4	0.4	0.2	1.3	2.0	2.0	2.0	2.0
Unemployment rate (in percent)	7.3	6.7	7.0	7.0	6.1	5.4	5.0	4.7	4.8	5.0	5.0
Gross national savings (percent of GDP)	23.5	24.9	24.8	24.5	25.7	27.4	27.2	27.1	27.1	27.1	27.2
Gross domestic investments (percent of GDP)	27.2	27.0	26.3	25.0	25.1	25.9	26.2	26.5	26.8	27.2	27.5
Public finance (percent of GDP)											
General government revenue	38.6	39.7	39.9	40.8	40.1	40.2	39.2	39.4	39.6	39.6	39.7
General government expenditure	43.0	42.4	43.8	41.9	42.0	42.3	40.5	40.5	40.5	40.5	40.6
Net lending / Overall balance	-4.4	-2.7	-3.9	-1.2	-2.0	-2.0	-1.3	-1.0	-0.9	-0.9	-1.0
Structural balance (percent of potential GDP)	-4.3	-2.7	-1.4	0.1	-0.9	-1.5	-1.4	-1.3	-1.1	-1.0	-1.0
General government debt	38.2	39.9	44.6	45.0	42.6	41.0	40.5	39.9	39.3	38.9	38.5
Money and credit (end of year, percent change)											
Broad money (M3)	1.9	2.8	4.8	5.8	4.4	...	...	...	...	...	...
Private sector credit	3.0	5.5	2.6	3.7	3.1	...	...	...	...	...	...
Interest rates (in percent, year average)											
Three-month interbank rate	1.3	1.2	1.0	0.5	0.4	...	...	...	...	...	...
Ten-year government bond	3.9	3.7	2.8	2.1	1.6	...	...	...	...	...	...
Balance of payments (percent of GDP)											
Trade balance (goods and services)	3.0	3.9	5.0	5.8	6.9	7.9	7.5	6.9	6.6	6.3	6.0
Current account balance	-3.7	-2.1	-1.6	-0.5	0.6	1.5	1.0	0.5	0.2	-0.1	-0.4
Gross international reserves (US$ billion)	42.5	40.3	44.9	56.2	54.5	51.7	53.7	56.6	59.6	62.5	65.9
(in months of imports of goods and services)	3.9	3.2	3.6	4.6	4.1	4.3	4.1	4.0	4.1	4.1	4.2
Exchange rate											
Nominal effective exchange rate (index, 2005=100)	119.2	123.2	118.4	116.9	111.7	...	...	...	...	...	...
Real effective exchange rate (index, CPI-based; 2005=100)	120.1	122.3	118.2	116.2	110.0	...	...	...	...	...	...

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

INTERNATIONAL MONETARY FUND

CZECH REPUBLIC

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

June 26, 2015

KEY ISSUES

Context. The economy is growing strongly on account of improving domestic demand and robust exports. Fiscal policy has been supportive of the recovery and the authorities' medium-term fiscal objective is appropriate, but fiscal framework legislation that would anchor policy is yet to be approved. The central bank's use of an exchange rate floor as an additional instrument to achieve its inflation objective, in the context of the inflation-targeting framework, has helped stem deflationary pressures, but inflation is still well below target. The financial system is sound and resilient to shocks. The challenge for the authorities is to safeguard macroeconomic stability and create conditions for strong and sustainable growth.

Policy recommendations.

- **Fiscal policy.** Maintain a supportive fiscal stance this year, but embark on a modest and very gradual fiscal consolidation thereafter, consistent with the medium-term deficit objective. Embed this objective in a comprehensive framework to enhance its effectiveness in anchoring fiscal policy. Improve budget composition, with higher capital spending to address infrastructure needs offset by efficiency gains in current expenditure and improved revenue administration.

- **Monetary policy.** Continue to focus on inflation targeting in policymaking and communication, and maintain supportive monetary conditions until deflation risks recede and inflation expectations become entrenched around the inflation target. Consider carefully the timing and mechanics of the eventual normalization of monetary policy.

- **Financial sector.** Remain vigilant and be ready to address possible risks to financial stability**.**

- **Structural reforms.** Remove impediments to higher potential growth, including through policies to increase labor market participation of certain segments of the population, enhance investment in human and physical capital, and improve the business climate.

Approved by
Philip Gerson and Bob Traa

Discussions took place in Prague during May 11–20, 2015. The staff team comprised Messrs. Christou (Head), Dalgıç and Thegeya, and Ms. Shabunina (all EUR). Mr. Kollár (OED) attended some meetings. Mr. Iossifov (EUR) contributed from headquarters and Mmes. Chen and Moraes Rego (both EUR) assisted in the preparation of the staff report. The staff team met with Czech National Bank Governor Singer, Minister of Finance Babis, other senior officials, and representatives from the private sector and trade unions. Czech Republic is an Article VIII country (Informational Annex: Fund Relations). Data provision is adequate for surveillance (Informational Annex: Statistical Issues).

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CONTEXT

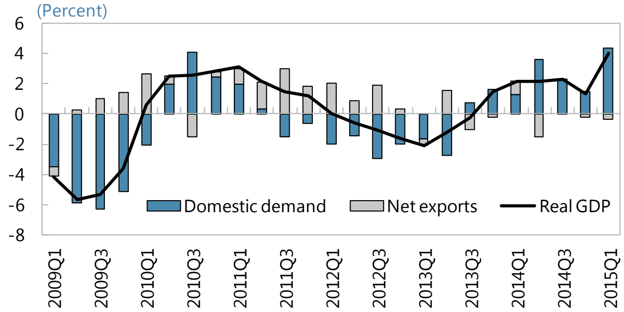
1. **The Czech economy is growing at a strong pace but challenges remain.** With the support of accommodative macroeconomic policies, output growth rebounded in 2014. A further acceleration is in train, with both exports and domestic demand performing well. The central bank's use of an exchange rate floor as an additional instrument to achieve its inflation objective has helped stem deflationary pressures, but inflation remains well below target. At the same time, fiscal framework legislation that would anchor policy is yet to be approved. The challenge for the authorities is to create conditions for sustainable growth while maintaining macroeconomic stability.

2. **The strong growth performance has helped keep the coalition stable.** The government—a coalition of the Social Democrats, a new center right party (ANO), and the Christian Democrats—took office in January 2014, roughly simultaneous with the upturn in the business cycle, following the previous fiscally-conservative and euro-skeptic coalition. Although the new government is friendlier to the EU policy agenda, it is ideologically diverse. On one hand, its overall orientation is toward more activist social welfare-enhancing policies, while on the other hand, ANO has pledged not to increase taxes and to put strong emphasis on improving tax administration.

BACKGROUND AND RECENT DEVELOPMENTS

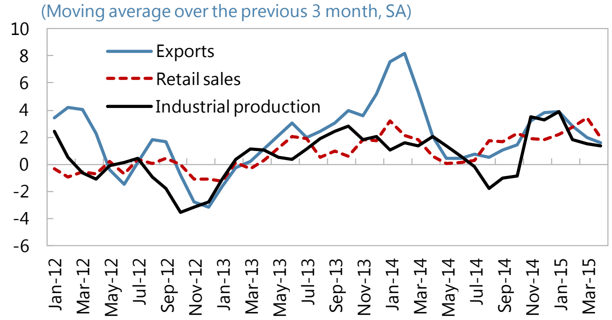
3. **The Czech economy is growing strongly.** Real GDP expanded by 2 percent in 2014, with both exports and domestic demand, particularly investment, performing well. Investment benefitted from public resources, with local government activity and EU-funded projects being carried out at a higher-than-expected pace. Consumption growth was supported by robust labor income gains and reached the pre-crisis growth rate in 2014:Q4. The growth momentum continued this year, with output growth accelerating markedly to 4.2 percent y-o-y in 2015:Q1. While this performance was probably influenced by tobacco excise legislation that increased cigarette re-stocking early in the year, growth was broad-based and driven by domestic demand. Moreover, high frequency indicators provide further evidence of economic growth gaining a strong footing, with Purchasing Managers' Indexes showing continued improvements in output, new orders, and employment.

Contributions to Growth
(Percent)



Source: Czech Statistical Office.

Momentum Indicators
(Moving average over the previous 3 month, SA)

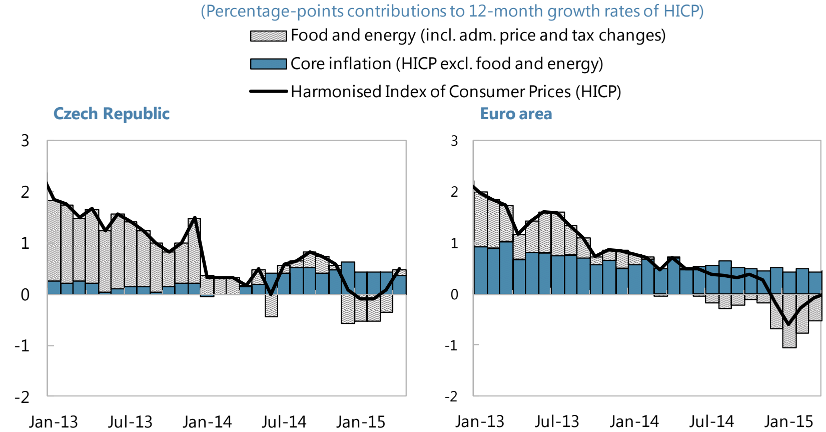


Source: Haver Analytics.

4. **The labor market has been recovering fast.** Employment growth gathered speed in the second half of 2014 and reached 1.3 percent y-o-y in 2015:Q1, while the unemployment rate has declined to 5.7 percent, the lowest level since 2009:Q1. Real wage growth also turned positive in 2014 (2.1 percent), boosted by the improving labor market as well as a 2 percent public wage adjustment in 2014 and a 6.3 percent increase in the minimum wage effective August 2013. The minimum wage was further increased by 8.2 percent in 2015.

5. **Inflation has been hovering just above zero.** In the face of a drop in energy and food prices, headline inflation decelerated sharply to an average of 0.4 percent in 2014, and declined further to 0.1 percent in 2015:Q1, before picking up slightly to 0.7 percent y-o-y in May. Meanwhile, inflation adjusted for food, fuel, indirect taxes, and administered prices (core inflation) has remained stable at around 1 percent since mid-2014. One-year ahead inflation expectations, which had been boosted by the introduction of the exchange rate floor, declined in early 2015, while 3-year ahead expectations remain stable at around the 2 percent inflation target, reflecting the credibility of the central bank (CNB).

Contributions to Headline Inflation, 2012-15
(Percentage-points contributions to 12-month growth rates of HICP)



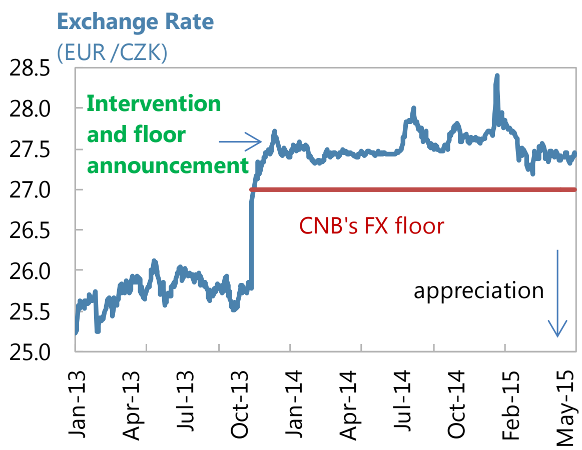
Sources: Eurostat and Fund staff estimates.

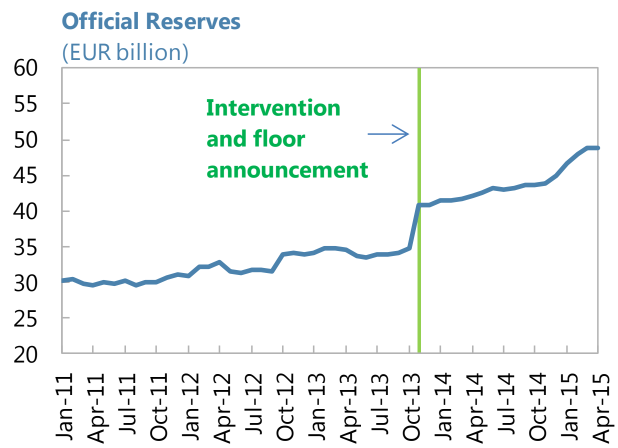
6. **Fiscal policy has been supportive of the recovery.** Following substantial pro-cyclical fiscal tightening in 2011–13, the general government deficit increased from 1.2 percent of GDP in 2013 to 2.0 percent in 2014, implying about a 1 percentage point deterioration in the cyclically-adjusted fiscal balance. The relaxation was mainly due to an increase in capital spending and a negative surprise in excise collections[1]. The headline deficit widened further as a result of statistical changes to comply with ESA2010 methodology, which entailed, among other issues, the inclusion of the Deposit Insurance Agency that had a one-off payout in 2014 in the general government.

7. **Monetary conditions remain accomodative.** In November 2013, constrained by the zero lower bound and facing deflationary pressures, the CNB decided to use the exchange rate as an additional instrument for inflation targeting and announced its commitment "to prevent excessive appreciation of the koruna below CZK27 per € by intervening in the foreign exchange market." The exchange rate floor was considered preferable over purely quantitative easing through purchases of domestic financial assets given the ample excess liquidity in the banking system, scarcity of private

[1] Cigarette excises were increased in January 2014, leading to pre-stocking by retailers and lower-than-forecast sales under the new excises throughout 2014.

sector assets to purchase, and shallowness of secondary government bond markets. The exchange rate has been hovering above the floor without any further intervention in the FX market since the CNB purchases of euro in November 2013[2] with some limited volatility around the time of oil price declines (markets braced for the deflationary impact and possibly a weaker koruna) and ECB's quantitative easing.[3]





Source: Haver Analytics.

8. The banking sector is stable, and credit growth shows some signs of a recovery. Czech banks are self-financed with a low system-wide loan-to-deposit ratio and strong capital and liquidity buffers. Despite a slight increase in the non-performing loan (NPL) ratio to 5.6 percent last year, due to an increase in NPLs of the government-owned Export bank, the ratio remains low. Credit growth accelerated to 3½ percent y-o-y in April, on account of a pickup in corporate-sector demand, while household credit growth remains robust.

9. Funding costs remain low. Bond yields have declined to historical lows on expectations of prolonged monetary policy accomodation earlier in 2015 before starting to rise in line with euro area trends: the 10-year bond yield recently reached almost 1.2 percent compared with lows of 0.4 percent in April. Czech Republic is rated investment grade with a stable outlook, and five-year credit default swap rates have been steady at around 50 basis points.

10. The current account turned to a surplus. Led by an improving trade balance, the current account registered a 0.6 percent of GDP surplus in 2014 compared with a 0.5 percent deficit in 2013. The trade balance improvement was driven by favorable terms-of-trade developments, notwithstanding strong import volume growth that outpaced that of exports. Meanwhile, the income deficit remained stable at around 6 percent of GDP.

[2] The gradual reserve accumulation during 2014–15 is due to EU funds and other fiscal inflows.

[3] The de facto exchange rate arrangement was retroactively reclassified from *other managed* to *stabilized* effective November 19, 2013.

11. Staff's assessment is that the real exchange rate is broadly in line with fundamentals. The EBA methodology yields mixed results for the Czech Republic, with current account balance-based approaches pointing to marginal undervaluation and the multilateral REER approach showing an overvaluation (Box 2). Other considerations also point to the absence of evident imbalances in the external position, or of significant shortcomings in non-price competitiveness indicators (Figure 6). Overall, staff assesses the exchange rate to be in broad equilibrium.

OUTLOOK AND RISKS

12. Staff expects growth to accelerate to 3 percent in 2015. Investment, supported by growing business confidence, higher capacity utilization and greater take-up of EU funds, is expected to be the main driver of growth. At the same time, the strength of the labor market and improved consumer confidence would provide a boost to private consumption. On the other hand, while export growth remains robust, the net export contribution is projected to turn negative, as strong domestic demand would boost imports. Inflation is likely to remain very low in 2015, before rising toward the target in 2016, as base effects from the oil price shock fade and declining economic slack starts to pull inflation up. (These projections assume the exchange rate floor remains in place through mid-2016, as the authorities have announced.) Over the medium term, output growth is set to stabilize at around 2¼ percent. Finally, the current account is projected to remain in surplus, thanks to a lower oil import bill, before moving toward a small deficit on account of improving investment and in line with fundamentals.

Czech Republic: Key macroeconomic indicators, 2013-20
(in percent of GDP, unless otherwise indicated)

	2013	2014	2015	2016	2017	2018	2019	2020
					Projections			
Real GDP growth (percent)	-0.7	2.0	3.0	2.8	2.6	2.2	2.2	2.2
Inflation (period average, percent)	1.4	0.4	0.2	1.3	2.0	2.0	2.0	2.0
General government overall balance	-1.2	-2.0	-2.0	-1.3	-1.0	-0.9	-0.9	-1.0
General government gross debt	45.0	42.6	41.0	40.5	39.9	39.3	38.9	38.5
Current account	-0.5	0.6	1.5	1.0	0.5	0.2	-0.1	-0.4
Reserves (in billions of euros)	41.0	44.2	46.3	47.6	49.6	51.6	53.5	55.5
Reserves (in billions of dollars)	56.2	54.5	51.7	53.7	56.6	59.6	62.5	65.9
Gross external debt	63.4	66.6	63.4	61.3	60.7	60.5	60.5	60.3

Sources: Czech authorities, and IMF staff projections

13. Risks to the outlook—highlighted in the Risk Assessment Matrix—are broadly balanced. On the upside, the positive effects from lower oil prices, supportive macroeconomic policies, the ongoing recovery in Czech Republic's trade partners, and ECB's quantitative easing could turn out to be larger than currently forecast. On the downside, if the euro area recovery were to falter, the Czech economy would be negatively affected through the trade channel. The impact would be larger still if low growth turned self-reinforcing through low investment. Moreover, escalation of geopolitical tensions in the region or reemergence of sovereign stress in Europe could affect exports and also create negative confidence effects. To this end, financial market turbulance could generate safe-haven inflows that would contribute to appreciation pressures in the absence of the floor.

Authorities' views

14. The authorities broadly agreed on the near-term outlook, medium-term prospects, and the balance of risks. Among positive factors affecting the outlook, they emphasized their stepped-up efforts to boost infrastructure spending, in particular associated with EU-financed programs. They also saw an upside to medium-term growth on account of a strong pipeline of FDI, both due to the global investment cycle and gains in Czech Republic's relative cost position. Downside risks were, in their view, mostly external, related to the possible intensification of geopolitical tensions and its negative impact on market sentiment in the region. Finally, they were somewhat concerned about renewed financial stesss in the euro area, possibly related to developments in Greece. However, they emphasized that direct spillovers from a prolonged period of financial market turbulence were quite small, given the very limited exposure of the banking system to Greece.

POLICY DISCUSSIONS

Discussions focused on the need for a growth-friendly medium-term fiscal strategy, enshrined in legislation; structural reforms to encourage investment and enhance productivity; and continued efforts to achieve the central bank's inflation target and preserve financial stability.

A. Anchoring Fiscal Policy

15. The 2015 fiscal stance is supportive of the recovery. The authorities plan to keep the 2015 fiscal deficit just below 2 percent of GDP, which appears feasible and would imply a fiscal impulse of 0.6 percentage points. Key expenditure measures include increases in investment financed by national sources, in addition to EU funds; salaries; and health care and mandatory social spending. The introduction of a second reduced VAT rate on pharmaceuticals, books and child nutrition, and tax credits for families with children will weigh on revenues. Although the projected fiscal stance is somewhat expansionary, given the remaining output gap, low inflation, and the fact that monetary policy is at the zero lower bound, staff did not advocate a tightening this year, but instead encouraged the authorities to allow automatic stabilizers to operate in both directions.

16. The government's medium-term fiscal objective is appropriate. The Convergence Program envisages gradual fiscal consolidation over 2016–18 aimed at reaching the medium-term objective (MTO) of a 1 percent of GDP structural deficit (from the projected 1.5 percent level in 2015). This adjustment relies to a large extent on gains from improvements in revenue administration, but also includes some savings from rationalization of spending owing to the introduction of a central purchasing system. Staff welcomed the authorities' commitment to the MTO, which will put the debt ratio on a downward path while allowing adequate space for current fiscal policy priorities. Reaching this objective would require only modest and very gradual fiscal consolidation beginning next year, which accounts for the relative absence of major deficit-reduction initiatives.

17. Staff emphasized that embedding the medium-term objective in a comprehensive framework would enhance its effectiveness in anchoring fiscal policy. The updated government proposal of the fiscal framework reform—which includes expenditure ceilings to guide spending, a debt brake rule starting at 55 percent of GDP to gradually correct deficit overruns, and a fiscal council to promote transparency—is under consideration by Parliament. Timely adoption of this proposal would help anchor fiscal policy and guard against pro-cyclical tendencies in policymaking.

18. Although the overall fiscal position is relatively strong, the budget composition could be improved, with higher capital spending to address infrastructure needs offset by efficiency gains in current expenditure and improved revenue administration. Total government spending is somewhat below the advanced economy average, but spending on social benefits is relatively high and has been rising (Box 3). Staff thus argued that expansion of means testing and adherence to the indexation rules for the adjustment of social benefits would help contain spending pressures. Moreover, health spending is high relative to outcomes, suggesting room for efficiency gains. To this end, staff welcomed the authorities' envisaged measures to enhance the transparency of health insurance companies' finances, the launching of newly-created standardized diagnostic and therapeutic algorithms, and improvements in data management and sharing. Conversely, sizeable infrastructure gaps push transportation costs above the OECD average, pointing to spending needs. On the revenue side, staff welcomed the authorities' efforts to strengthen tax administration through the introduction of electronic VAT reporting and electronic cash registers. However, budgeted revenue gains should be conservative to avoid putting pressure on deficit outturns.

Authorities' views

19. The authorities re-affirmed their commitment to gradual fiscal consolidation over the medium term and to the fiscal framework legislation. They considered the expansionary fiscal stance this year necessary to support the economic recovery and to lean against downside macro risks, especially given the moderate level of public debt. Nevertheless, they were determined to proceed with fiscal consolidation starting next year, in line with their medium-term fiscal objective. In this regard, their priority would be to increase the effectiveness of tax collections, and they were optimistic that their efforts—also benefitting from experiences of other countries—would bear fruit. Finally, they were hopeful that the approval of fiscal framework legislation by Parliament would take place expeditiously.

B. Achieving the Inflation Target

20. Extreme deflationary risks have declined, and staff projects inflation to gradually rise toward the central bank's target in 2016. Although the positive impulse from the exchange rate floor was counteracted by the slump in energy and other commodity prices, as well as by low core inflation throughout Europe, Czech core inflation remains stable at around 1 percent. At the same time, positive dynamics in the real economy and labor markets suggest that a scenario that involves damaging second-round effects of low inflation—such as liquidity hoarding and wage depression—has become less likely. In fact, retail sales are growing at a healthy pace, and in the key automotive industry wage agreements have centered on 3–3½ percent wage increases, considerably higher than last year. Finally, empirical evidence suggests that inflation has been driven by external factors (accompanying cross-country Selected Issues Paper), while second-round effects have not contributed measurably to the post-2012 disinflation (Appendix I). Against this backrdrop and based on current policies remaining in place through 2016:H1 (including the exchange rate floor), inflation is projected to start rising gradually towards the target in 2016.

21. Staff encouraged the CNB to maintain its focus on inflation targeting in its policy making and communication, and to consider carefully the timing and mechanics of the eventual normalization of monetary policy. The policy rate has been at the zero lower bound since November 2012, and the authorities have committed to maintain the exchange rate floor through 2016:H1, thus avoiding an open-ended arrangement. The floor has proven effective in supporting a return to the inflation target, as inflation expectations on current policies are consistent with achieving the target. With the current level of the exchange rate assessed to be broadly in line with fundamentals, and no interventions having taken place since the initial few days of the introduction of the floor, there is little economic reason to expect large moves in the exchange rate after the exit. Instead, the floor seems to be playing a supportive role both as a clear and credible signal of the CNB's commitment to the inflation target and as a type of insurance policy against the risk of sustained safe-haven inflows in the event of an external shock that would undermine achievement of the target. The pre-existence of a consistent monetary policy framework and CNB's continued transparent communication strategy—appropriately emphasizing the priority of the inflation objective and the temporary role of the exchange rate floor as an instrument to achieve it—should facilitate a smooth exit once justified by fundamentals like higher inflation outturns.

22. Monetary policy would likely need to remain supportive. In staff's view, given the only gradual closing of the output gap and asymmetric risks at the zero lower bound, monetary policy would likely need to remain supportive for some time even after abolishment of the exchange rate floor. Moreover, the CNB has sufficient tools to counter any unintended tightening of monetary conditions after the exit, including through discretionary interventions. To this end, modestly negative policy interest rates could be considered, but mainly to discourage capital inflows (amidst negative interest rates in other currencies). However, too deeply negative policy interest rates could risk cash hoarding and in turn reduce financial intermediation and weaken monetary transmission, especially if they were viewed as likely to persist for some time. At the same time, potential transmission from negative interest rates to activity is likely to be very weak. As for purchases of domestic assets, the scope for such purchases is very limited, given ample liquidity, already very low levels of domestic yields, and limited availability of domestic assets.[4]

[4] The local bond market monthly turnover averages about CZK 8–12 billion, or 0.2-0.3 percent of GDP.

Authorities' views

23. The authorities broadly agreed with staff's inflation outlook, while noting that monetary policy decisions are becoming more data-dependent. They noted that the real economy has turned the corner, with domestic demand taking over as the engine of growth and core inflation trending upwards. Accommodative policies, including the exchange rate floor, have played a useful role in this regard. However, they noted that wages were growing more moderately than hoped, perhaps due to: second-round effects from low inflation expectations; greater-than-believed slack in the job market; and compositional effects that suppress average wage growth. Coupled with statistical noise from tax-related effects, it was difficult to settle the matter decisively. The authorities, therefore, leaned towards a wait-and-see attitude and careful observation of incoming data. They also repeated their commitment to inflation targeting and the floating exchange rate regime as soon as conditions allow normalization of monetary policy. They saw the koruna as fairly valued, and together with projected positive inflation differentials with the euro area, foresaw a smooth exit. The authorities were cautious regarding other unconventional monetary policies, such as negative policy rates and domestic asset purchases, as they assessed these to be relatively ineffective and prone to be misinterpreted as negative signals about the economy's health. They did not see much scope for euro adoption to be advanced in this government's term, amidst domestic unpopularity and ongoing changes in euro area policy frameworks[5]

C. Safeguarding Financial Stability

24. The financial system is stable and resilient to shocks. Recent stress tests conducted by the CNB incorporated a scenario of Europe-wide debt deflation coupled with sharp declines in both domestic and external demand and a rise in long-term yields. These were found to be manageable with estimated system-wide capital shortfalls of just 0.4 percent of GDP. The relatively low potential capital need is mainly due to the high initial capitalization, which averages 18 percent across the system. Moreover, profitability remains strong by advanced country standards, notwithstanding the low interest rate environment. Among external risk factors, direct exposures to Russia are limited, and the recent losses of Export bank appear to be linked to problems with risk management and due diligence rather than economic developments.[6]

25. Although credit growth remains low, it is expected to be boosted by the strong recovery underway. Corporate credit demand is reportedly limited due to still-low investment levels, but also because of corporates' tendency to utilize internal resources for investment and, to a lesser extent, other financing sources such as corporate bonds, rather than because of problems with access to bank credit. Household credit growth has been stable at a slightly higher level, mainly driven by continued demand for mortgages. At the same time, recent lending surveys point to easing lending standards and gradually rising demand for credit, which along with the healthy

[5] Country Report No. 15/98 discusses pros and cons of euro adoption and pre-requisites for a successful transition.

[6] The authorities have already taken measures to change management and strengthen controls.

balance sheets in the financial and non-financial sectors and signs of a strong recovery suggest that credit growth will likely rise going forward—a view shared by the banks.

26. The regulatory and supervisory framework is being improved in the context of local and global initiatives. The authorities continued to make progress toward implementing the recommendations of the 2012 FSAP. In addition to the increase in supervisory resources for on-site inspections, a new law on credit unions brought limits to their size, deposit-interest ratio, borrower eligibility, and increased contributions to resolution and insurance funds among other provisions aimed at reducing risks from this small part of the sector. Moreover, the CNB has started implementing the macroprudential toolkit of the Capital Requirements Regulation IV by requiring across-the-board "conservation buffers", supplemented by a "systemic buffer" targeted at the largest banks. The Bank Recovery and Resolution Directive and Deposit Guarantee Schemes Directive are expected to be soon transposed into local law and would help introduce new tools and harmonize resolution frameworks within the EU. The working group on Banking Union opted for staying out of the Banking Union for now, but decided to re-visit the issue on an annual basis[7].

Authorities' views

27. The authorities broadly shared staff's assessment. They saw financial sector risks as mainly relating to domestic economic conditions, which have taken a turn for better in the last year, and reduced risks of a debt deflation. They noted a nascent recovery in lending activity, amidst higher demand, positive asset quality trends, tightening interest rate margins, and lower provisioning. The authorities saw the possibility of countercyclical macroprudential measures, if credit growth turned out to be much faster than foreseen now. As for external risks, they saw a euro area wide debt deflation as the main worry, but emphasized that direct linkages between the Czech financial sector and developments in Greece and Russia were limited.

D. Boosting Potential Growth

28. Raising Czech Republic's growth prospects remains a key challenge. After averaging 4.5 percent during 2000–07, economic growth fell to 0.9 percent during 2010–14. While this was mainly due to a slowdown in the euro area, growth performance is unlikely to return to pre-crisis levels. Potential growth is estimated at 1.4 percent for this year, and, as investment increases, is projected to increase to 2.2 percent over the medium term—a level insufficient to facilitate fast convergence towards the income levels of other advanced European economies. This reflects a number of challenges facing the supply side of the economy. Demographic headwinds are already evident with the working age population having declined 4.2 percent in the last five years. Moreover, although important steps have been taken to reduce labor market rigidities, including more flexible employment arrangements, strengthened public employment services, and affordable high-quality childcare facilities, labor participation in some segments of the population—women with young

[7] Country Report No. 15/98 discusses the potential benefits from joining the Banking Union before euro area membership.

children and low-skilled workers—remains low (Box 4). Finally, skills mismatches and low investment in research and development (R&D) present headwinds to moving up the value-added chain.

29. Staff thus called for an ambitious reform agenda to remove impediments to faster potential growth. Addressing low labor participation—and helping achieve the authorities' goal of raising overall participation from 70 percent to 75 percent by 2020—calls for targeted policies, including further progress in providing affordable childcare, and raising the effectiveness and scope of job search assistance and training services. Emphasis should also be given on upgrading skills and addressing skill shortages in high technology sectors, including through education and training for less-advantaged groups, such as improvement of apprenticeship programs and avoiding selectivity of the education system—these steps should help human capital accumulation and reduce structural unemployment. Moreover, the business environment could be further enhanced by simplifying tax compliance and other administrative procedures, and by implementing priorities identified in the anti-corruption action plan on financial control, management of state-owned companies, and access to information. Finally, improving transport infrastructure, and strengthening R&D, would also support faster growth.

Authorities' views

30. The authorities agreed that further progress with structural reforms is needed to lift Czech Republic's potential growth. They broadly shared the mission's assessment regarding impediments to stronger growth and pointed to a number of actions envisaged in their National Reform Program. They were confident that recent measures aimed at raising female labor participation—namely, extension of the availability of childcare facilities for longer time, tax relief for private childcare expenditures, and establishment of a government fund to support new public kindergartens—would bear fruit. They emphasized that improving transport infrastructure was indeed a key priority and referred to stepped up efforts to increase the utilization of EU funds, and medium-term plans detailed in their Transport Policy. Additionally, a number of programs are being implemented to strengthen cooperation between business and research organizations, and support the development of start-ups. Finally, the authorities pointed to progress in reducing the administrative burden and reiterated their commitment to push forward with a number of targeted anti-corruption measures included in the government legislative agenda for 2015.

STAFF APPRAISAL

31. The Czech economy is growing strongly but challenges remain. The economic upturn is driven by robust exports and improving domestic demand being helped by accommodative macroeconomic policies. The labor market has been recovering fast with strong employment gains and real wage growth picking up gradually. But while disinflationary pressures seem to have abated, inflation is still below the central bank's target. In addition, potential growth is well below the level necessary to facilitate fast convergence toward the income levels of other advanced European countries. Thus, the challenge for the authorities is to create the conditions for sustainable growth while safeguarding macroeconomic stability.

32. Fiscal policy and the medium-term fiscal objective need to be anchored in fiscal framework legislation, and the composition of the budget should be improved. The remaining output gap, low inflation, and the fact that monetary policy is at the zero lower bound warrant maintaining a slightly accommodative fiscal stance this year, as planned by the authorities. At the same time, though, modest and very gradual fiscal consolidation will be necessary beginning next year, in line with the authorities' commitment to a medium-term objective of a 1 percent of GDP structural deficit. Moreover, this objective should be cast in fiscal framework legislation that would include expenditure ceilings, a debt brake rule, and a fiscal council—thus helping anchor fiscal policy and guard against pro-cyclical tendencies. Finally, there is scope to improve budget composition, with increased capital spending to address infrastructure needs offset by efficiency gains in current spending and improved revenue administration.

33. The central bank should continue to focus on inflation targeting. The exchange rate floor has proven effective in fending off deflationary pressures, and in combination with recovering demand conditions, inflation is expected to rise toward the central bank's target in the second half of 2016, thus facilitating an exit from the exchange rate floor. The central bank should thus maintain its focus on inflation targeting in its policymaking and communication, while continuing to evaluate the conditions that would trigger a normalization of monetary policy and the mechanics of its implementation. However, given the only gradual closing of the output gap and asymmetric risks at the zero lower bound, monetary policy will likely need to remain supportive for some time even after abolishment of the exchange rate floor and return to a floating exchange rate.

34. Continued vigilance will be needed to sustain the stability of the financial system. The banking sector is self-financed with low system-wide loan-to-deposit ratio and strong capital and liquidity buffers, which make it resilient to shocks. Moreover, bank supervision has been strengthened by increasing supervisory resources, approving a new law on credit unions, and starting utilizing the macroprudential toolkit of the Capital Requirements Regulation IV. Nevertheless, proactive supervision remains necessary along with further gradual improvements in the supervisory architecture, including the transposition of the Bank Recovery and Resolution Directive into domestic law.

35. An ambitious structural reform agenda is key to lifting Czech Republic's potential growth. Sustained progress on wide-ranging reforms to increase labor market participation, enhance investment in human and physical capital, and improve the business climate is essential for higher investment and growth. Reforms of the labor market should aim at increasing labor participation among women with children and low-skilled workers, while greater emphasis should be placed on mitigating skills mismatches. Priority should also be given to promoting research and innovation, enhancing apprenticeship programs, simplifying tax compliance and other administrative procedures, and improving infrastructure.

36. It is recommended that the next Article IV consultation with the Czech Republic be held on the standard 12-month cycle.

Czech Republic—Risk Assessment Matrix[1/]

	Source of Risks	Relative Likelihood	Impact if Realized	Policy Response
Global	*Protracted period of slower growth in advanced and emerging economies*	**High/Medium** In the euro area, weak demand and persistently low inflation from a failure to fully address crisis legacies and appropriately calibrate macro policies leads to "new mediocre" rate of growth. In emerging markets, maturing of the cycle, misallocation of investment, and incomplete structural reforms leading to prolonged slower growth	**Medium** Coupled with a fragile recovery in domestic demand, weaker export growth would delay the recovery from the crisis.	Policies supporting domestic demand, as well as diversifying trade partners and specialization could help cushion the impact on the economy.
	Political fragmentation erodes the globalization process and fosters inefficiency: Russia/Ukraine	**Medium** The mounting conflict depresses business confidence and heightens risk aversion, amid disturbances in global financial, trade and commodity markets	**Medium** Disruption of gas supply and increase in gas prices would adversely affect production. Russia and Ukraine are not main markets for Czech exports, but supply chain effects can trigger a slowdown.	An easing bias would be appropriate provided supply constraints do not become binding.
	Surges in global financial market volatility	**High** Investors reassess underlying risk and move to safe-haven assets given slow and uneven growth as well as asymmetric monetary exit, with poor market liquidity amplifying the impact on volatility	**Low** Czech sovereign and banks are not reliant on external borrowing to any significant extent.	Maintaining accommodative monetary conditions, while loosening the fiscal stance would allow to absorb the shocks through the trade channel.
	Bond market stress from reassessment in sovereign risk in euro area	**Medium** Euro area sovereign stress re-emerges due to policy uncertainty, faltering reforms, and political and social upheaval, particularly in Greece.	**High** Through strong trade and financial ties with Europe, could lead to a significant economic slowdown. Banks, while sound, may turn conservative and limit credit provision. Households and firms can postpone spending as experienced in 2011–12.	Maintaining accommodative monetary conditions, while loosening the fiscal stance would allow shock absorption through the trade channel. Closer monitoring of Czech subsidiaries of euro area parent banks would be necessary to avoid financial spillovers, such as excessive transfer of liquidity and capital out of the country.
Domestic	*Permanently lower potential growth*	**Medium** If the recovery falters, hysteresis effects could reduce potential growth, structural reforms needed to boost potential growth could be delayed due to lack of political appetite.	**Medium** Potential growth may remain low for extended periods, and may even lead to long-term output losses	Advancing structural reforms and safeguarding public investment would help mitigate risks of further reductions in potential growth.

[1/] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks at the time of discussions with the authorities.

Box 1. Response to Past Fund Policy Advice

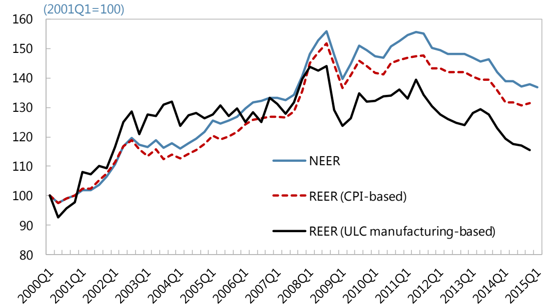
Policy implementation has been broadly consistent with IMF advice.

Key recommendations	**Implemented policies**
Adopt a growth-friendly fiscal strategy entailing a slight relaxation of the fiscal stance in the near term to support the economic recovery and a commitment to a medium-term objective of a 1 percent of GDP structural deficit.	Implemented. The fiscal stance eased in 2014 and is projected to easy slightly further in 2015, especially on account of higher capital spending. The medium-term structural deficit objective of 1 percent of GDP is included in the Convergence Program but has not yet been enshrined in legislation.
Adopt a fiscal rule which has wide coverage, is easy to monitor, incorporates a debt brake, and is monitored by an independent Fiscal Council.	Not yet implemented. A new proposal by the government, broadly in line with these recommendations, is under discussion in parliament.
Continue to focus on inflation targeting and keep the exchange rate floor in place until deflation risks recede and inflation expectations become entrenched around the inflation target.	Implemented. The Czech National Bank has committed to maintaining the exchange rate floor through 2016:H1, while emphasizing in its communication the temporary nature of the floor and the exit horizon.
Continue to strengthen the financial sector framework along the lines of FSAP recommendations.	Implemented. The authorities have elevated financial stability to a policy objective in the CNB law, increased the number of supervisory staff, improved decision-making mechanisms within the CNB to address systemic risk, and implemented a new law on credit unions among other measures.

Box 2. Competitiveness Assessment

The koruna depreciated moderately in recent years, but remains stronger than historical averages. Following a long appreciation trend, the post-2011 depreciation was mainly driven by nominal exchange rates, as markets re-evaluated Czech growth prospects in the context of the euro area turmoil. Since the FX interventions, the currency has been stable, while in both real and nominal terms it remains above historical averages. However, the historical sample is dominated by a period of rapid convergence and equilibrium appreciation driven by productivity gains. ULC-based measures suggest that the underlying competitive position has been more stable and is currently broadly in line with historical norms.

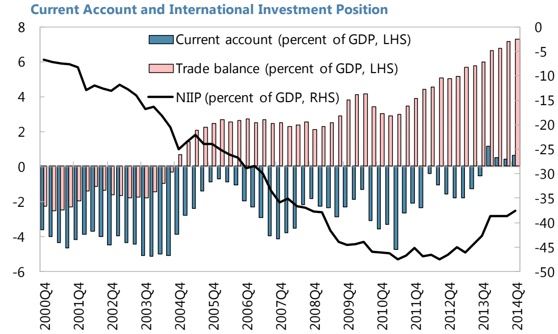
Real Exchange Rate
(2001Q1=100)



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

Current account and international investment positions reveal no major competitiveness issues. Reflecting the high FDI stock, Czech Republic traditionally had a large income deficit that outweighs the trade surplus. The trade balance has trended higher since 2012, as domestic demand trailed external demand, and it is likely to stabilize in the near-term excluding terms-of-trade effects. The accumulated deficits had led to a moderate negative NIIP of about 36 percent of GDP. Excluding the net FDI stock of 58 percent at end-2014, the NIIP is comfortably positive. Market share has also been relatively stable.

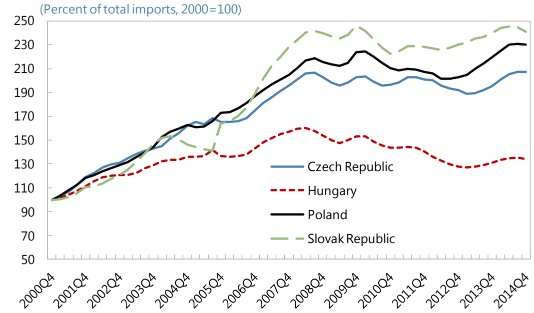
Current Account and International Investment Position



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

The EBA assessment yields mixed results. Specifically, the Current Account Balance approach suggests that the current account balance is stronger than the norm of 1 percent of GDP deficit, indicating a marginal undervaluation of 3 percent in 2014. Benchmarked against the 1.9 percent deficit that would stabilize the net foreign asset position, the 2014 outturn suggests an undervaluation of 5.4 percent. In contrast, the multilateral REER approach finds a 10.4 percent overvaluation, as the real exchange rate remains above what would be predicted on the basis of selected fundamental determinants. Using latest REER data and the projected 2015 current account balance does not change the results.

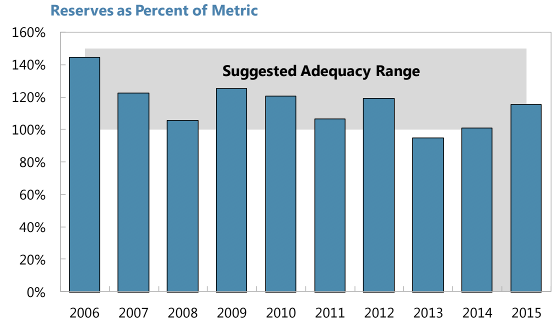
Share of World Imports
(Percent of total imports, 2000=100)



Source: Direction of Trade Statistics.

Reserves remain at a comfortable level. While there have been no further interventions, CNB continues to accumulate reserves due to EU funds and other fiscal inflows. Capital flows have been on the whole subdued with evidence of some external build-up of assets by households and corporates in the last few quarters. Reactions to events such as the Swiss peg exit and the ECB QE announcement, both in January 2015, have been limited to the exchange rate and the financial account.

Reserves as Percent of Metric

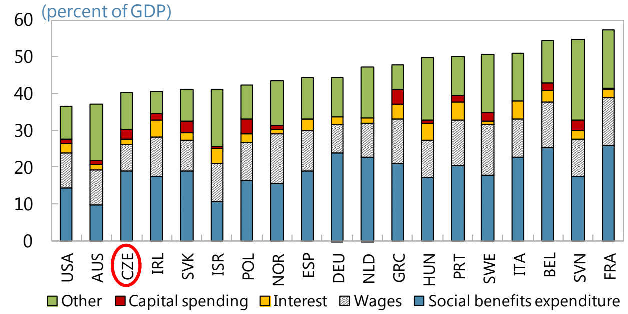


Sources: Czech Statistical Office; Czech National Bank; and IMF staff estimates.

Box 3. Efficiency of Public Spending

Total government spending in the Czech Republic is not high in comparison with other advanced economies; however, there is scope for improving its composition. Government spending at 42 percent of GDP is still lower than the advanced economy average of 45 percent. Interest spending is particularly low due to low debt and interest rate levels; while the public wage bill is also lower than in most advanced economies. Capital spending is somewhat high compared to advanced economies but lower than in Poland and the Slovak Republic. On the other hand, spending on social benefits, equivalent to 20 percent of GDP, exceeds the advanced economies' average by 2½ percentage points.

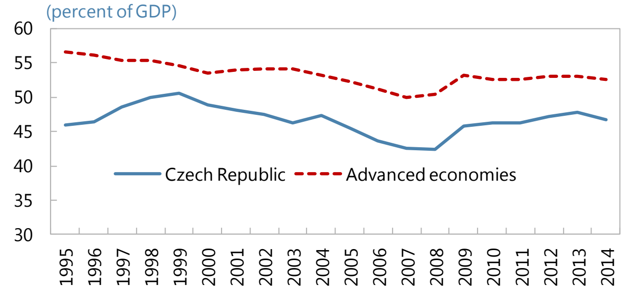
Composition of Government Spending, 2013
(percent of GDP)



Source: WEO.

Compressed capital spending in recent years has resulted in stagnant public capital stock. Although the capital stock in advanced economies has been declining for many years, yet the current gap with the Czech Republic is even larger than it was in 2000. Within the medium-term envelope of a 1 percent of GDP structural deficit, improvements in efficiency of social spending can help create space for higher capital spending.

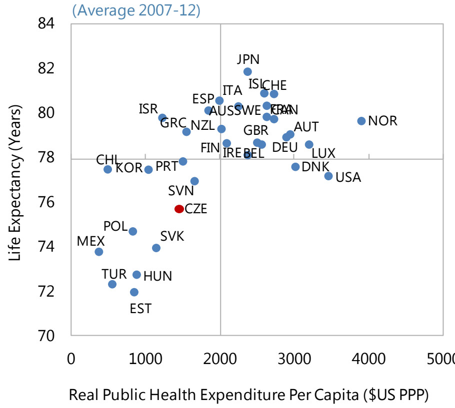
Public Capital Stock
(percent of GDP)



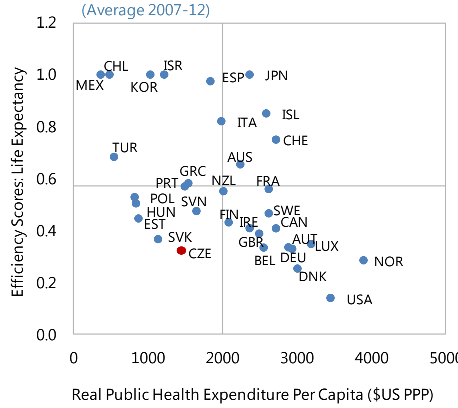
Sources: Center for International Comparisons (2013); Organisation for Economic Co-operation and Development; and IMF staff estimates.

Health outcomes (measured by life expectancy) are below those of countries with similar level of public health spending. Efficiency frontier analysis for public health spending indicates a potential for savings in the range of 2-4 percent of GDP. Input efficiency score based on life expectancy as an output indicator and real public health spending as input is estimated at 0.32, which is significantly lower than a score of 1 for an "efficient/frontier" country and suggests that 68 percent of public resources could be saved to achieve the same outcome. If infant mortality is used as an output indicator, the efficiency score measure is higher, at 0.7, suggesting savings of 30 percent. Several factors might have contributed to the relatively low health sector efficiency. Those include a high number of doctor consultations and hospital discharges, a high share of pharmaceutical expenditure in total spending, and a relatively low share of general physicians.

Public Expenditure on Health and Life Expectancy
(Average 2007-12)



Efficiency of Public Expenditure on Health
(Average 2007-12)



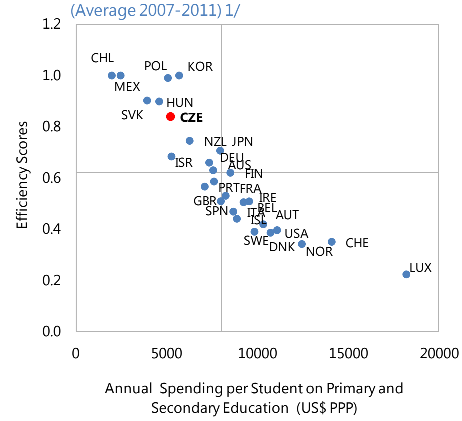
Sources: OECD and IMF staff calculations.

Box 3. Efficiency of Public Spending (continued)

Increasing health spending efficiency would entail policies aimed at containing both cost pressures and excess demand for health services. Specifically, there could be room to trim excess bed capacity, reduce pharmaceutical costs, and introduce means-tested co-payments to contain growing pressure on the public healthcare system. Introducing soft-gate keeping (e.g., requirement of referral from the general physician) would help manage demand. Moreover, substantial scope exists in providers' network streamlining, and increased transparency of service delivery contracts.

The education system appears to be efficient in delivering strong average scores on international standardized tests. However, there could be medium-term challenges in supplying appropriately skilled workers for the shifting labor market. Reforms should thus aim at seeking greater cost recovery in areas where public spending provides significant private benefits. For example, there could be room to increase out-of-pocket tuition fees. Additionally, it is important to ensure that the supply of secondary education in some regions meets the growing demand for pre-university educational streams, to avoid a mismatch in the supply and demand for skilled labor.

Efficiency of Public Expenditure on Education
(Average 2007-2011) 1/

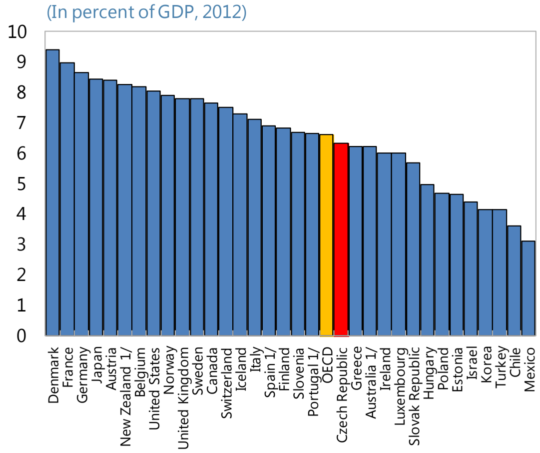


Sources: OECD Education Database and Author's calculations.
1/ Spending data is up to 2011, while the PISA scores refer to 2012.

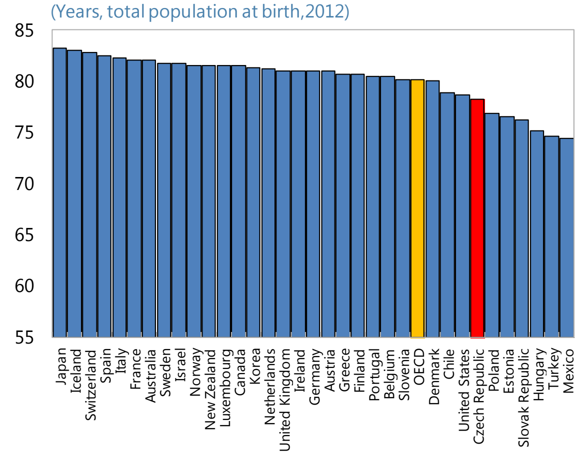
Box 3. Efficiency of Public Spending (continued)

Czech Republic and OECD Countries: Health Care Spending and Outcomes

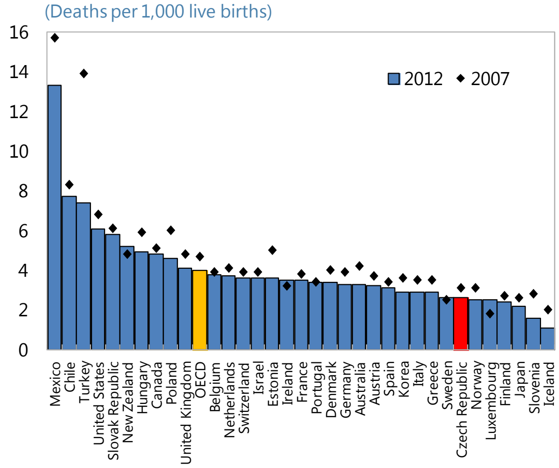
Public Expenditure on Health
(In percent of GDP, 2012)



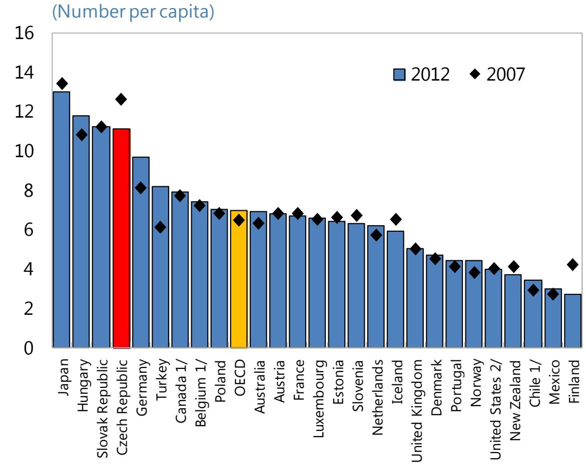
Life Expectancy
(Years, total population at birth,2012)



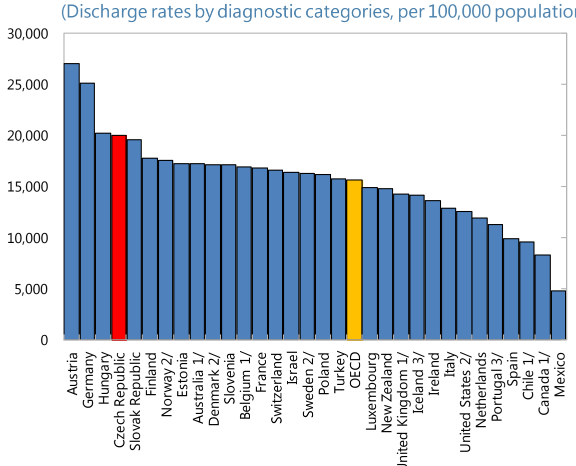
Infant Mortality Rate
(Deaths per 1,000 live births)



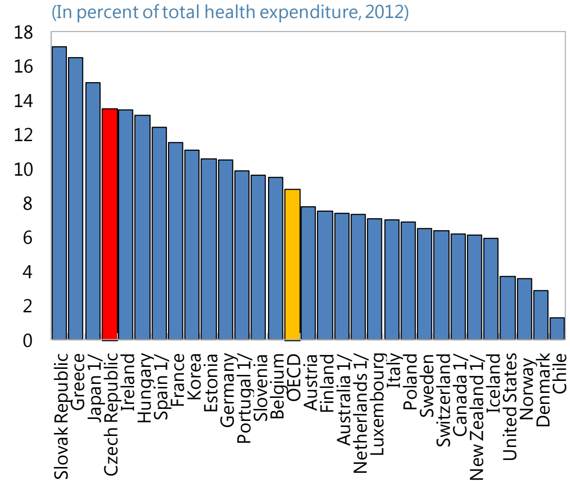
Doctor Consultation
(Number per capita)



Hospital Discharges, 2012
(Discharge rates by diagnostic categories, per 100,000 population)



Pharmaceutical Spending
(In percent of total health expenditure, 2012)

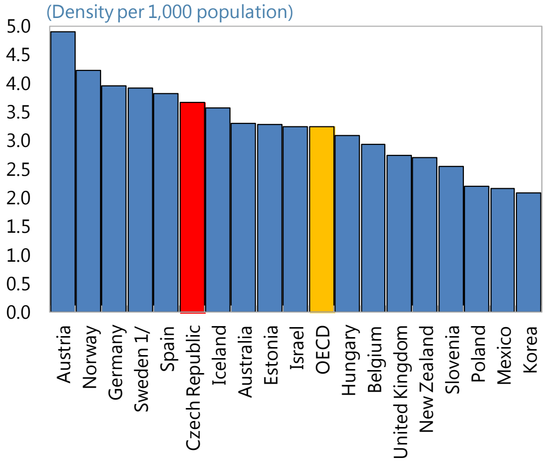


Source: OECD Health Statistics Database and OECD National Accounts Database.
1/ Use 2011 value instead.
2/ Use 2010 value instead.
3/ Use 2009 value instead.

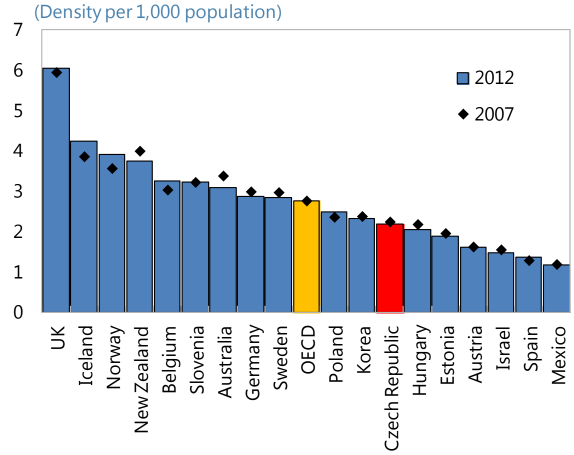
Box 3. Efficiency of Public Spending (concluded)

Czech Republic and OECD Countries: Health Care Spending and Outcomes

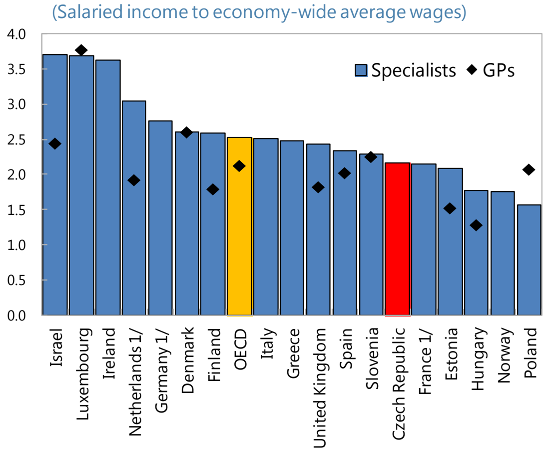
Practicing Physicians, 2012
(Density per 1,000 population)



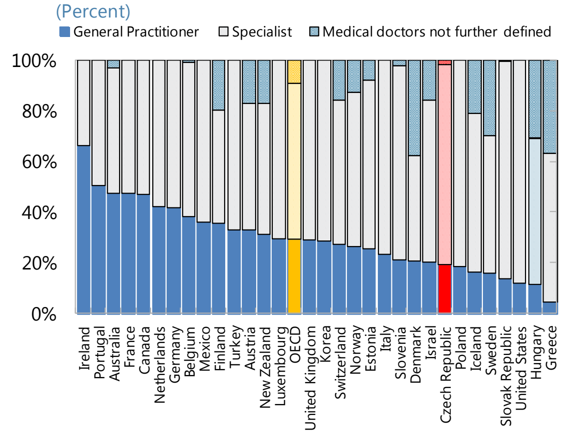
Practicing Nurses to Practicing Physicians Ratio
(Density per 1,000 population)



Remuneration of Doctors, 2012
(Salaried income to economy-wide average wages)



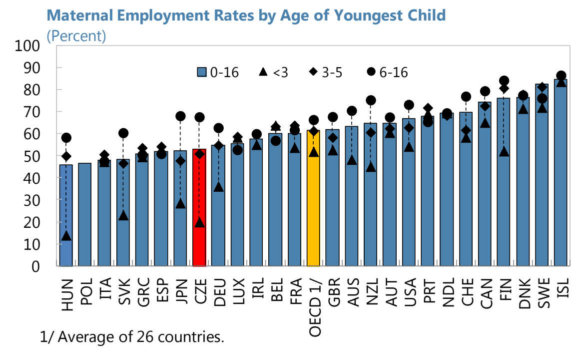
Generalist and Specialist as a Share of all Doctors, 2011
(Percent)



Source: OECD Health Statistics Database and OECD National Accounts Database.
1/ Use 2011 value instead.

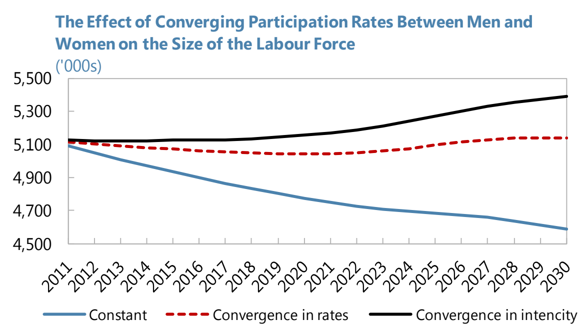
Box 4. Gender Gaps in the Labor Market

Female labor market participation (FLMP) in the Czech Republic is low. It is below the OECD average, and also lags rates in peer countries in the region. In particular, employment of mothers with children under 3 (at about 20 percent in 2008) is the second lowest in the OECD.



1/ Average of 26 countries.
Source: OECD.

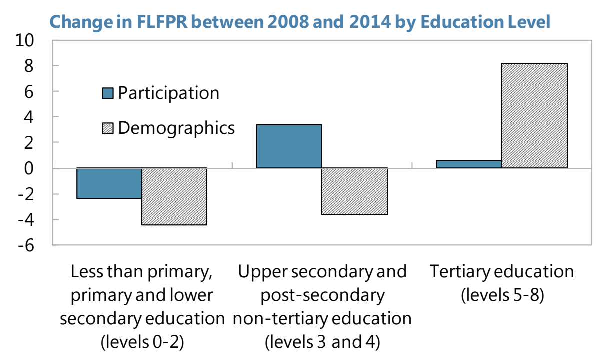
Increasing FLMP could help shore up long-term growth. Like many other advanced economies, population ageing and low fertility rates are compressing Czech Republic's active labor force. On current trends, the labor force will shrink by around 10 percent by 2030. Increasing low FLMP could help offset these adverse trends and boost long-term growth. The OECD estimates that full convergence in participation rates by 2030 can increase Czech annual per capita growth rates by 0.8 percent, on average.



Source: OECD.

A number of factors affect FLMP. The lack of flexible work options and shortage of affordable child care are the key factors limiting the labor participation of women with children (see: Female Labor Force Participation, European Commission, 2014); the latter is most acute for children under three and Czech Republic has the lowest share of formal childcare for children of that age group.

There seems to be scope for policies to increase female labor participation, especially for lower education groups. The overall female labor force participation rate (FLFPR) increased by 4.6 percentage points during 2008–14, to 65.6 percent in 2014. This was largely driven by the increase in the participation rates of women with secondary education, as well as the decline in the share of women with primary education only, which have the lowest participation ratio of 27 percent. Moreover, a much larger share of working-age women now hold tertiary degrees (20 percent vs. 12 percent in 2008), and are exhibiting an already high level of 78 percent participation. At the same time, participation rates of women with primary education have declined even further. These trends suggest that policies—such as the provision of affordable childcare—aimed at lower education groups could be effective in raising overall female labor participation. The authorities have taken a number of measures to increase availability of childcare, including tax relief for private child care expenditures by companies and individuals and an establishment of a government fund to support new public kindergartens.

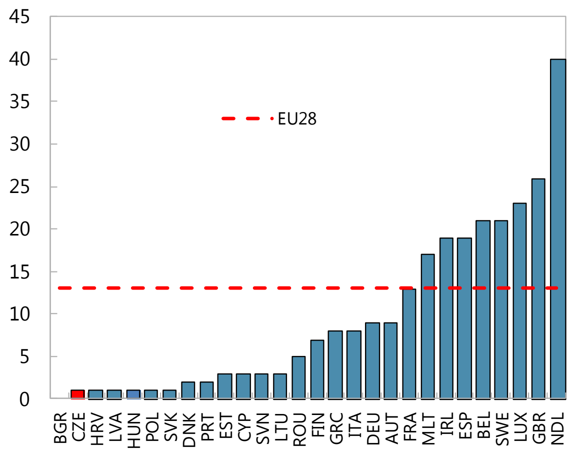


Sources: Eurostat and IMF staff calculations.

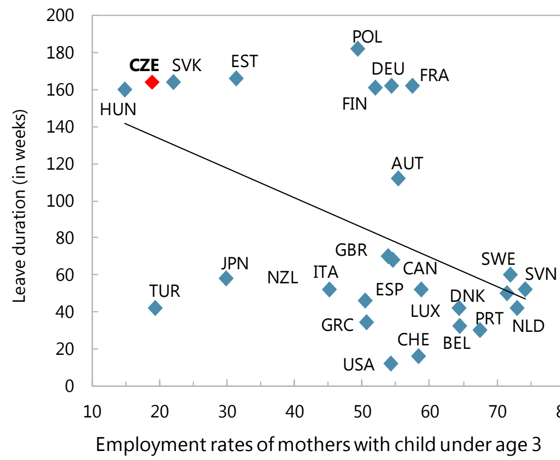
Box 4. Gender Gaps in the Labor Market (continued)

Czech Republic: Selected Indicators Affecting Female Labor Force Participation

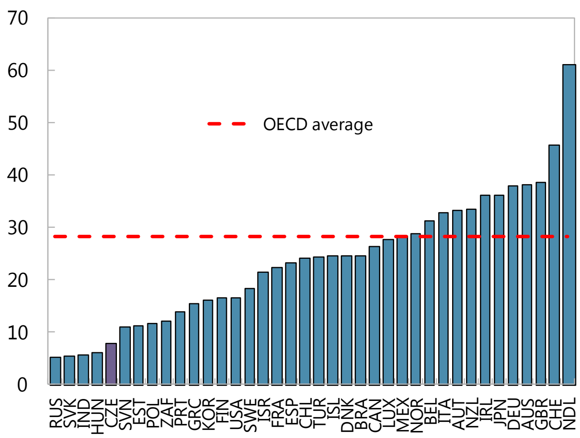
Formal Childcare under the Age of 3, 2013 1/
(Percent over population)



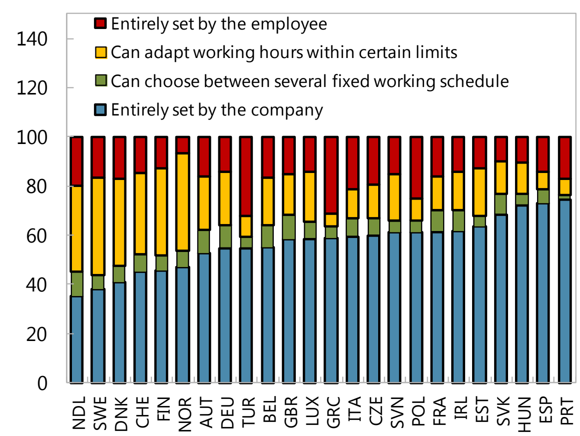
Employment Rates for Mothers with Children below Age 3 and Leave Duration



Share of Women in Part-Time Employment, 2013 2/
(Percent)



Proportion of Employees Having Working Time Set, 2009
(Percent)

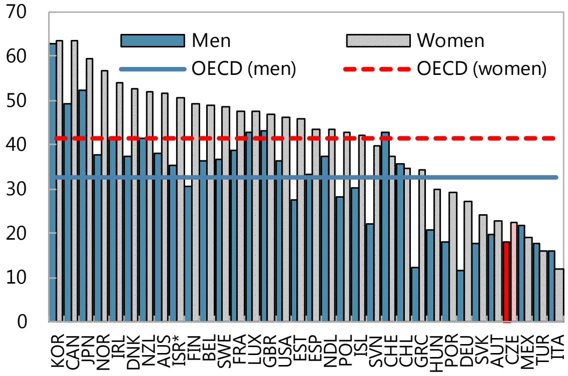


Sources: Eurostat SILC 2013, and OECD.
1/ 2012 data for Lithuania
2/ Brazil, India, Russia and South Africa are not OECD members. 2012 data for Russia.

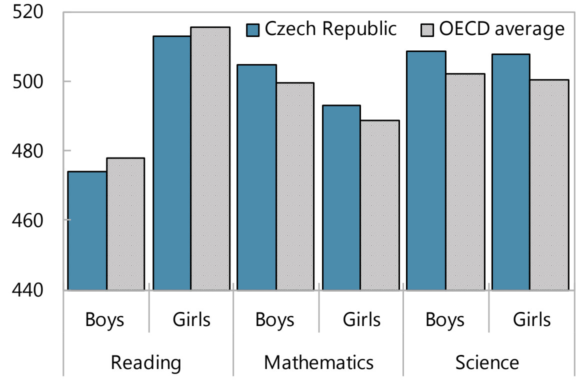
Box 4. Gender Gaps in the Labor Market (concluded)

Czech Republic: Gender Gaps

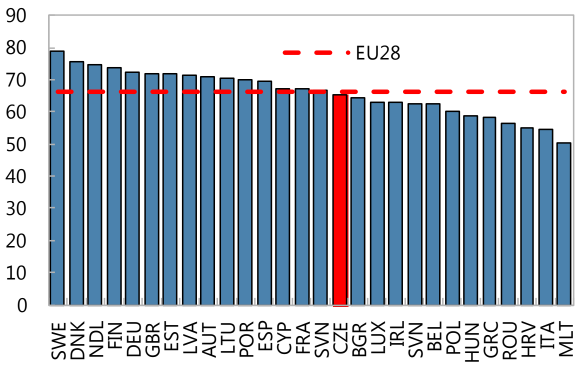
Proportion of the Population with Tertiary Education, 2009
(24-35 years old)



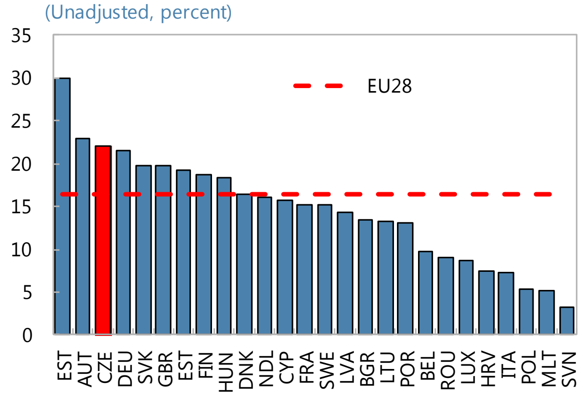
Student Performance by Gender, 2012
(Mean score PISA)



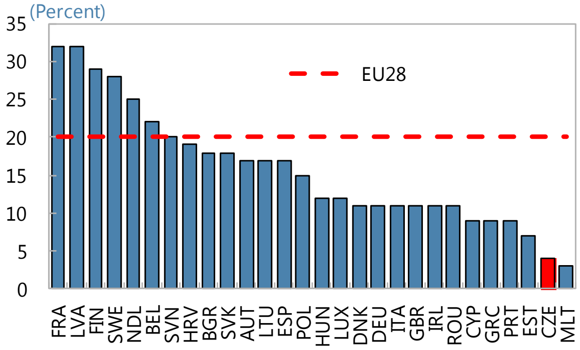
Female Labour Force Participation Rate, 2013
(Percent)



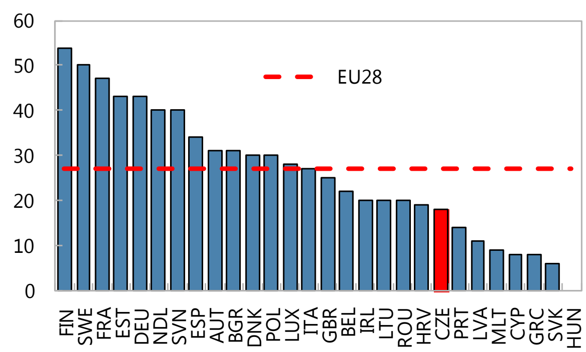
Gender Pay Gap
(Unadjusted, percent)



Proportion of Women in Political and Economic Decision-Making: Board Members of Largest Publicly Listed Companies, 2013
(Percent)

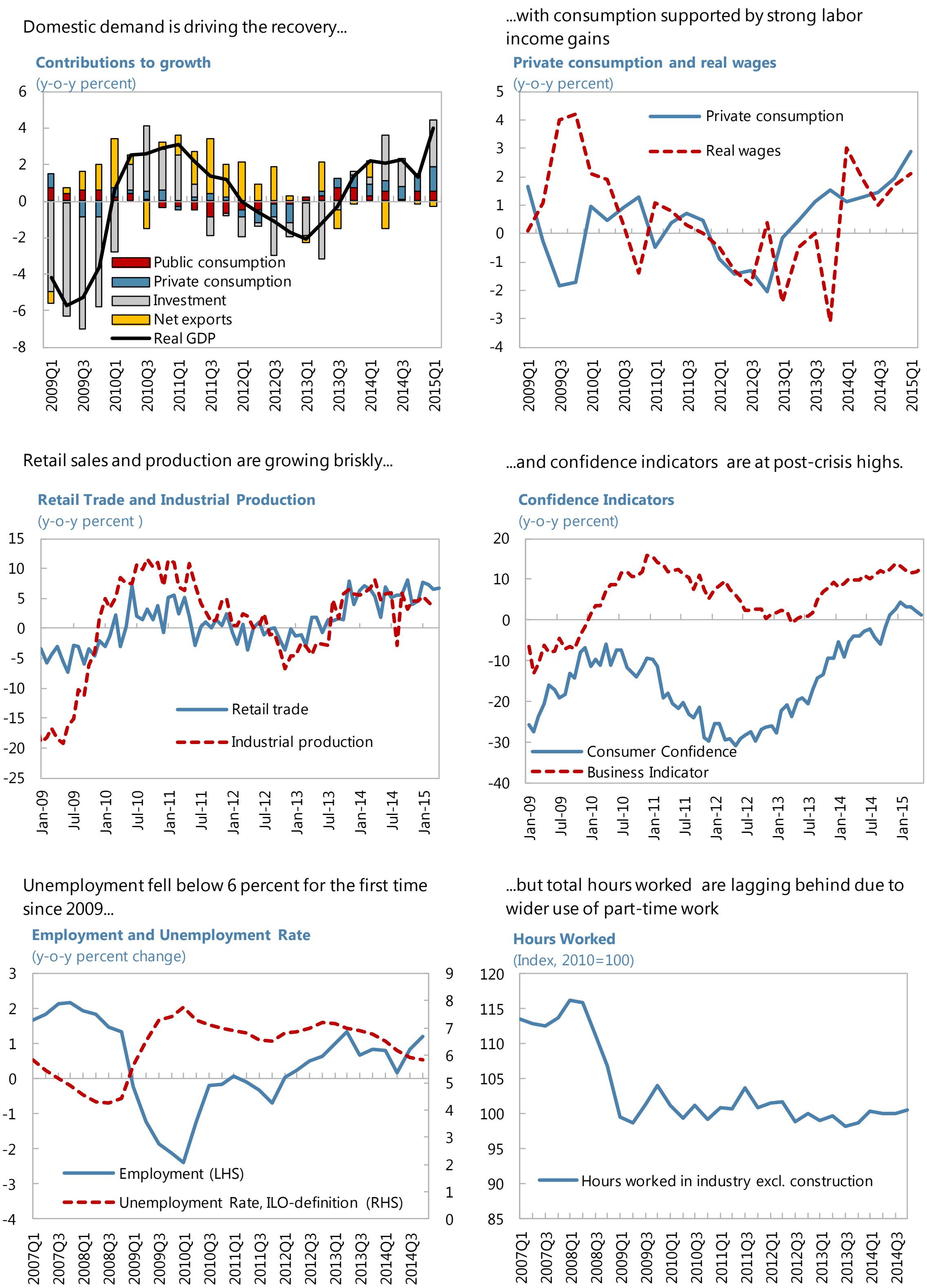


Proportion of Women in Political and Economic Decision-Making: Cabinet, 2013
(Percent)



Sources: European Comission, Eurostat, and OECD.

Figure 1. Czech Republic: Macroeconomic Developments

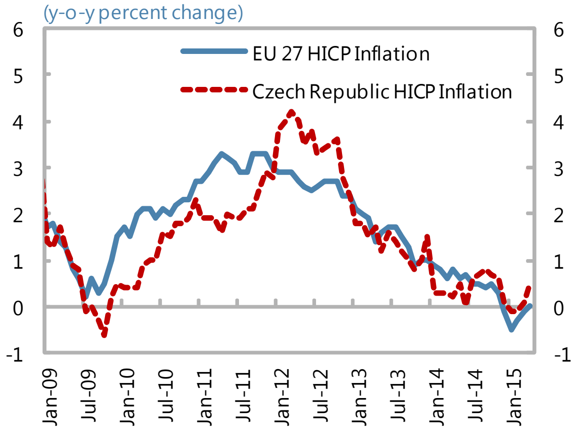


Sources: Haver; Eurostat; EMED; and IMF staff calculations.

Figure 2. Czech Republic: Inflation

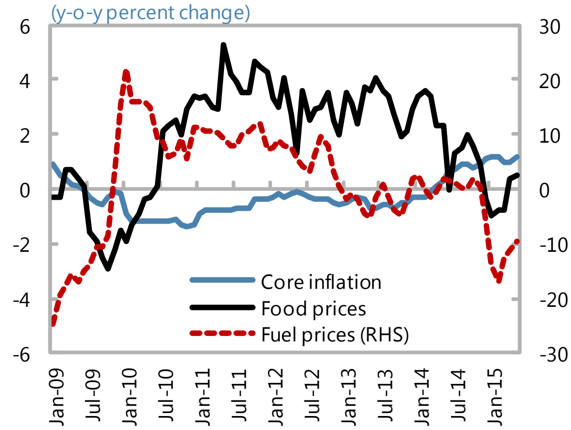
Inflation has continued to track Europe-wide inflation trends...

HICP Inflation
(y-o-y percent change)



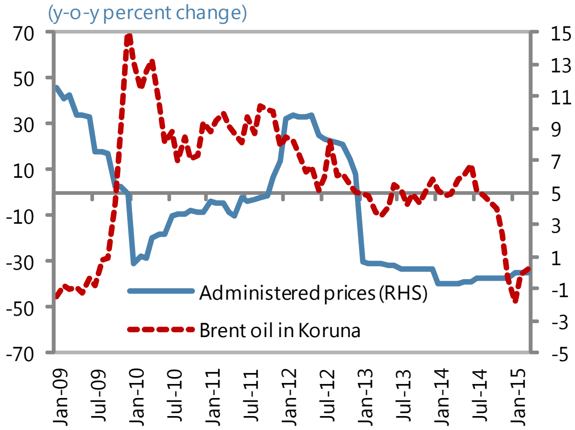
...driven by cost factors primarily from energy and, to a lesser extent, food prices

Prices
(y-o-y percent change)



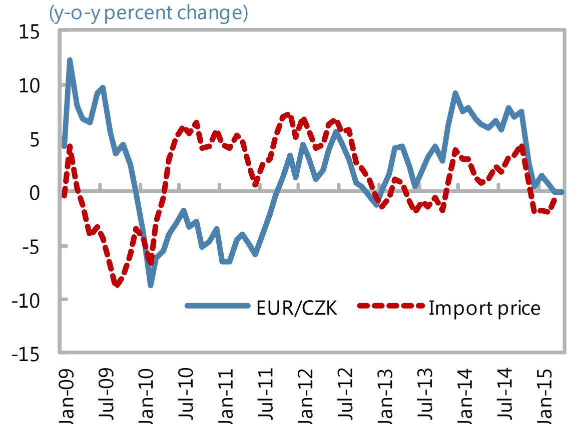
The oil price shock has also delayed effects through administered energy prices.

Prices
(y-o-y percent change)



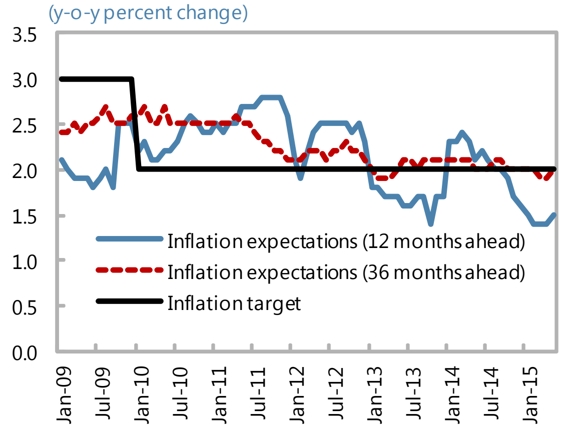
The boost from the exchange rate floor faded away against this background.

Import price and exchange rate
(y-o-y percent change)



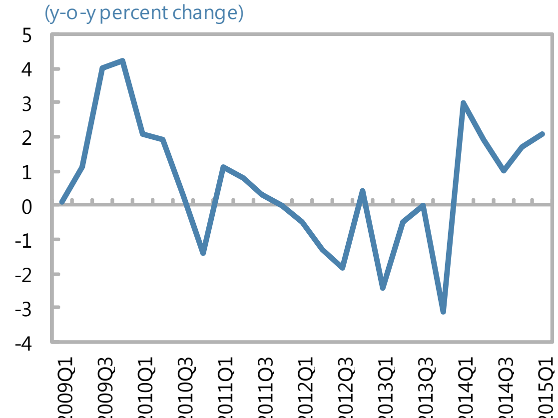
Short-term inflation expectations dipped again-but not medium-term expectations.

Inflation expectations
(y-o-y percent change)



Nominal wage growth is picking up.

Nominal wages
(y-o-y percent change)

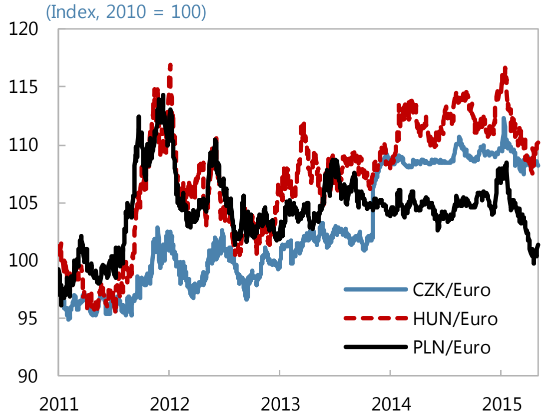


Sources: Czech Statistical Office, Czech National Bank, and Haver Analytics.

Figure 3. Czech Republic: Financial Markets

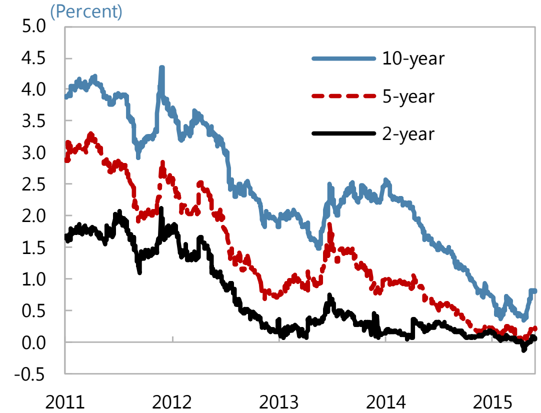
The koruna has followed regional trends but in a much tighter range.

Spot Exchange Rate
(Index, 2010 = 100)



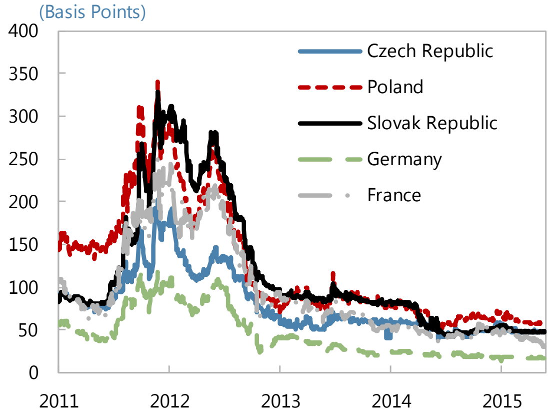
Longer bond yields have reached new lows, as the yield curve flattened.

Government Bond Yields
(Percent)



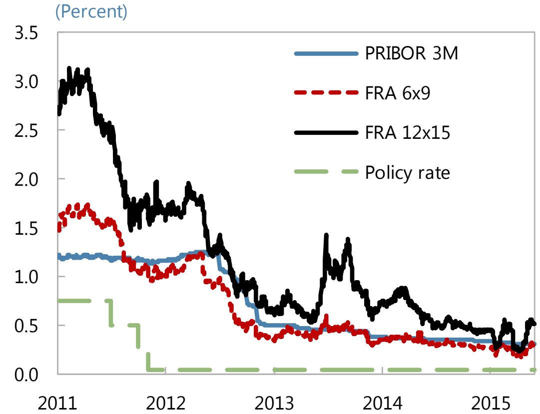
Markets deem Czech Republic a good credit...

5-year CDS
(Basis Points)



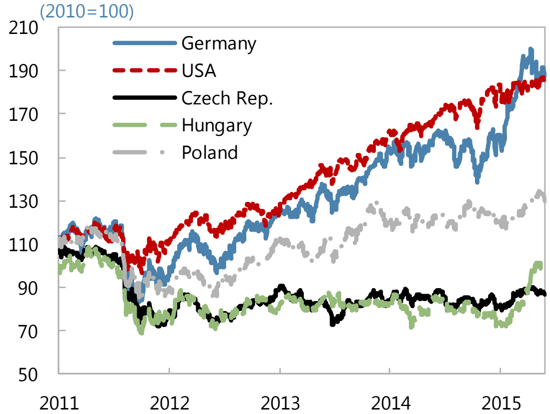
...while expecting low policy rates to be sustained.

Money Market Rates
(Percent)



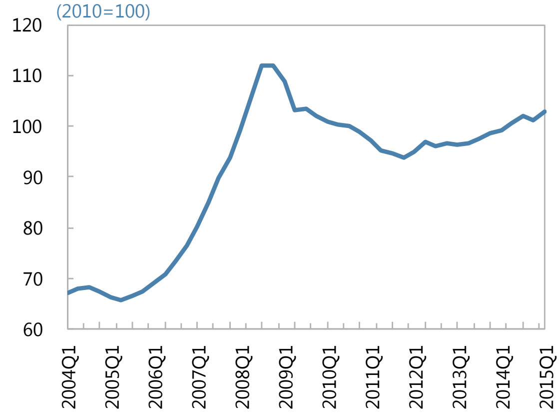
Equities have underperformed most regional and global markets...

Stock Markets
(2010=100)



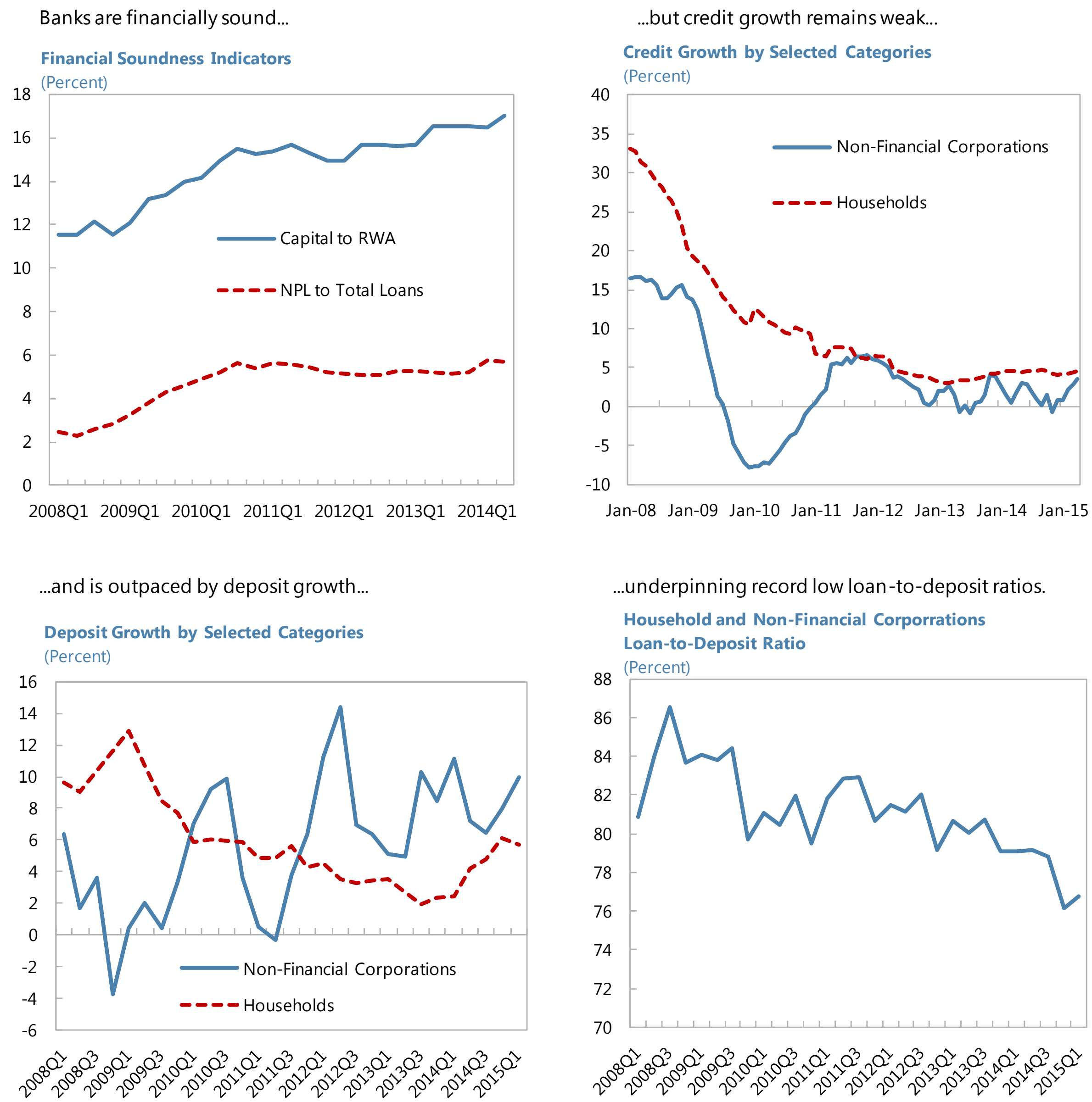
...while real estate prices continue their mild recovery.

Apartment Price Index
(2010=100)



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

Figure 4. Czech Republic: Bank Lending

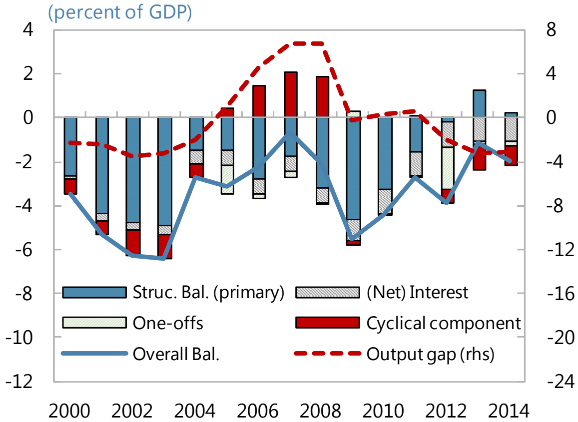


Sources: Haver; CNB; and IMF staff calculations.

Figure 5. Czech Republic: Fiscal Developments and Prospects

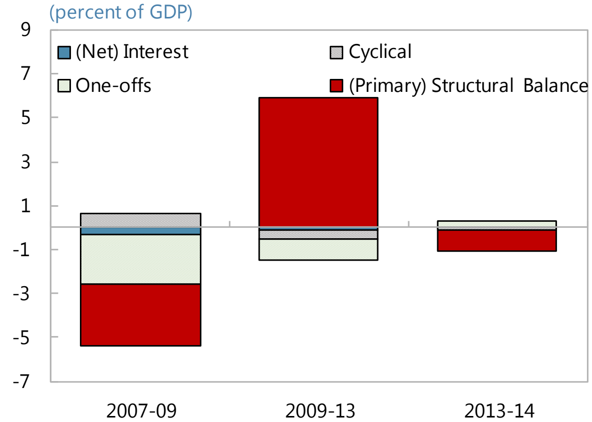
Fiscal stimulus in post-crisis years was followed by consolidation beginning in 2010.

Fiscal Stance
(percent of GDP)



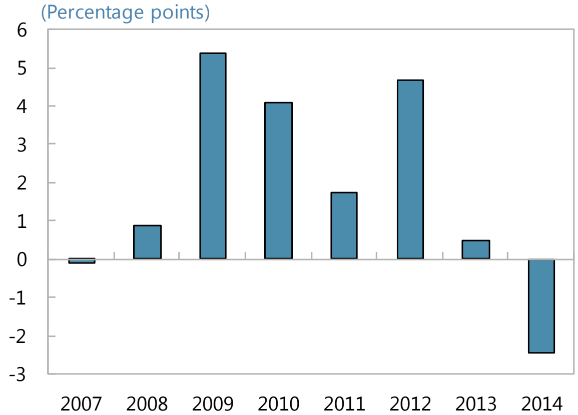
Recently, authorities supported a fiscal relaxation to support economic recovery.

Fiscal Adjustment
(percent of GDP)



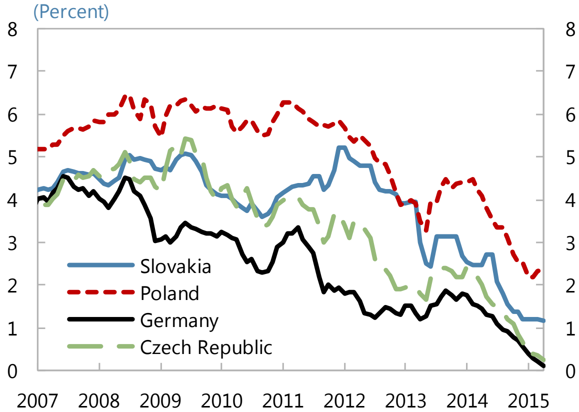
However, debt levels decreased due to use of state cash buffers...

Change in general government debt
(Percentage points)



...and declining financing costs.

10-Year Government Bond Yields
(Percent)



Sources: Bloomberg, and IMF staff calculations.

Figure 6. Czech Republic: Competitiveness Indicators

Sources: Czech Republic authorities; Haver; OECD; World Bank, *Doing Business Indicators*; IMF, *IFS; DxTime*; IMF, *World Economic Outlook*; and IMF staff estimates and calculations.

1/ Covers the period June, 2014. Rank out of 189 countries.

2/ Rank for 2014–15. Ranking out of 144 countries.

Table 1. Czech Republic: Selected Economic Indicators, 2010–20

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Staff Proj.					
Nominal GDP (USD billions)	207.0	227.3	206.8	208.8	205.6	181.1	188.9	195.7	200.4	202.9	206.2
Population (millions)	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.6	10.6	10.6	10.6
GDP per capita (USD)	19,787	21,676	19,680	19,855	19,562	17,205	17,917	18,545	18,966	19,193	19,496
Real economy (change in percent, unless stated otherwise)											
Real GDP	2.3	2.0	-0.8	-0.7	2.0	3.0	2.8	2.6	2.2	2.2	2.2
Real GDP per capita	1.9	1.7	-1.0	-0.8	2.0	2.8	2.6	2.5	2.1	2.1	2.1
Domestic demand	1.8	0.0	-2.2	-0.8	2.2	3.8	3.3	2.9	2.6	2.6	2.6
Private consumption	1.0	0.2	-1.8	0.4	1.7	3.0	2.8	2.4	2.3	2.3	2.3
Investment	4.4	1.9	-3.7	-5.1	3.1	6.5	5.0	4.5	3.7	3.7	3.7
Exports	14.8	9.3	4.1	0.3	8.8	7.2	6.2	5.0	4.0	4.0	4.0
Imports	14.9	6.7	2.4	0.3	9.5	8.5	7.0	5.5	4.6	4.6	4.6
Ouput gap (percent of potential output)	-0.2	0.2	-1.9	-3.6	-2.8	-1.2	0.0	0.5	0.4	0.2	0.0
CPI (average)	1.5	1.9	3.3	1.4	0.4	0.2	1.3	2.0	2.0	2.0	2.0
Unemployment rate (in percent)	7.3	6.7	7.0	7.0	6.1	5.4	5.0	4.7	4.8	5.0	5.0
Gross national savings (percent of GDP)	23.5	24.9	24.8	24.5	25.7	27.4	27.2	27.1	27.1	27.1	27.2
Gross domestic investments (percent of GDP)	27.2	27.0	26.3	25.0	25.1	25.9	26.2	26.5	26.8	27.2	27.5
Public finance (percent of GDP)											
General government revenue	38.6	39.7	39.9	40.8	40.1	40.2	39.2	39.4	39.6	39.6	39.7
General government expenditure	43.0	42.4	43.8	41.9	42.0	42.3	40.5	40.5	40.5	40.5	40.6
Net lending / Overall balance	-4.4	-2.7	-3.9	-1.2	-2.0	-2.0	-1.3	-1.0	-0.9	-0.9	-1.0
Structural balance (percent of potential GDP)	-4.3	-2.7	-1.4	0.1	-0.9	-1.5	-1.4	-1.3	-1.1	-1.0	-1.0
General government debt	38.2	39.9	44.6	45.0	42.6	41.0	40.5	39.9	39.3	38.9	38.5
Money and credit (end of year, percent change)											
Broad money (M3)	1.9	2.8	4.8	5.8	4.4	...	...	...	...	...	...
Private sector credit	3.0	5.5	2.6	3.7	3.1	...	...	...	...	...	...
Interest rates (in percent, year average)											
Three-month interbank rate	1.3	1.2	1.0	0.5	0.4	...	...	...	...	...	...
Ten-year government bond	3.9	3.7	2.8	2.1	1.6	...	...	...	...	...	...
Balance of payments (percent of GDP)											
Trade balance (goods and services)	3.0	3.9	5.0	5.8	6.9	7.9	7.5	6.9	6.6	6.3	6.0
Current account balance	-3.7	-2.1	-1.6	-0.5	0.6	1.5	1.0	0.5	0.2	-0.1	-0.4
Gross international reserves (US$ billion)	42.5	40.3	44.9	56.2	54.5	51.7	53.7	56.6	59.6	62.5	65.9
(in months of imports of goods and services)	3.9	3.2	3.6	4.6	4.1	4.3	4.1	4.0	4.1	4.1	4.2
Exchange rate											
Nominal effective exchange rate (index, 2005=100)	119.2	123.2	118.4	116.9	111.7	...	...	...	...	...	...
Real effective exchange rate (index, CPI-based; 2005=100)	120.1	122.3	118.2	116.2	110.0	...	...	...	...	...	...

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

Table 2. Czech Republic: Balance of Payments, 2010–20

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Staff Projections					
					(percent of GDP)						
Current account balance	-3.7	-2.1	-1.6	-0.5	0.6	1.5	1.0	0.5	0.2	-0.1	-0.4
Trade balance	1.0	1.9	3.1	4.1	5.6	6.5	6.1	5.6	5.3	5.0	4.7
Exports	55.8	60.0	65.0	65.1	71.4	74.7	78.0	80.0	81.4	82.9	84.4
Imports	54.8	58.2	62.0	61.0	65.8	68.2	71.9	74.4	76.2	77.9	79.6
Nonfactor services	2.0	2.0	1.9	1.7	1.3	1.4	1.4	1.4	1.3	1.3	1.3
Receipts	10.7	10.9	11.8	11.4	12.3	12.5	12.7	12.9	13.1	13.3	13.6
Payments	8.7	8.8	9.8	9.7	10.9	11.1	11.3	11.5	11.8	12.0	12.3
Factor income (net)	-6.4	-5.5	-5.9	-6.0	-6.1	-6.2	-6.2	-6.2	-6.1	-6.1	-6.1
Transfers	-0.3	-0.4	-0.7	-0.3	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.3
Capital account	1.0	0.3	1.3	2.0	0.8	0.7	0.7	0.7	0.8	0.8	0.8
Financial account	-3.2	-1.9	0.3	1.7	1.1	2.2	1.8	1.2	1.0	0.7	0.4
Direct investment, net	-2.4	-1.1	-3.0	0.2	-3.1	-1.1	-1.1	-1.1	-1.2	-1.3	-1.4
Portfolio investment, net	-3.8	-0.1	-1.4	-2.2	2.1	1.7	1.6	1.5	1.1	0.5	0.3
Other investment and financial derivatives, net	1.9	-0.2	2.9	-0.5	0.6	0.7	0.4	-0.3	0.0	0.3	0.3
Errors and omissions	-0.5	-0.1	0.6	0.2	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves	1.1	-0.4	2.0	4.4	1.7	0.9	0.9	1.2	1.1	1.1	1.1
Memorandum items:											
Gross official reserves (US$ billions)	42.5	40.3	44.9	56.2	54.5	51.7	53.7	56.6	59.6	62.5	65.9
in months of the current year's imports	3.9	3.2	3.6	4.6	4.1	4.3	4.1	4.0	4.1	4.1	4.2
as a ratio to the short-term debt	91.0	76.7	94.4	103.2	92.4	99.3	102.2	105.1	108.6	112.8	117.3
External debt, percent of GDP	55.4	54.9	60.2	63.4	66.6	63.4	61.3	60.7	60.5	60.5	60.3

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

Table 3. Czech Republic: The Statement of Operations of General Government, 2010–20 [1/]
(in billions of koruny)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
								Staff Projections			
Revenue	**1,524.3**	**1,598.1**	**1,613.9**	**1,665.7**	**1,709.3**	**1,795.9**	**1,829.3**	**1,924.8**	**2,013.9**	**2,100.7**	**2,191.7**
Taxes	702.8	755.5	776.3	812.3	823.8	859.0	906.6	949.2	992.3	1,030.7	1,071.1
Personal income tax	131.3	142.7	144.1	150.6	156.7	158.4	164.4	172.0	179.2	186.8	194.7
Corporate Income tax	127.4	129.0	127.5	132.6	147.1	153.9	163.0	170.4	177.5	185.0	192.9
VAT	263.5	276.5	286.1	303.8	319.5	325.5	343.8	359.9	376.9	393.1	410.1
Excise	148.0	170.7	175.7	183.1	158.2	173.2	181.5	186.9	192.5	196.8	201.4
Other taxes	32.7	36.5	42.9	42.2	42.3	48.0	53.8	60.0	66.2	69.0	71.9
Social contributions	577.8	592.3	600.0	606.4	628.3	653.5	684.3	721.5	751.8	783.6	816.9
Grants	85.7	84.3	71.6	76.8	89.2	113.0	68.6	76.7	85.0	93.6	102.5
Other revenue	158.0	166.0	166.0	170.2	168.1	170.3	169.8	177.3	184.9	192.8	201.1
Property income	36.9	34.7	35.0	37.5	36.5	43.3	37.5	39.1	40.7	42.4	44.2
Sales of goods and services	116.9	127.2	126.6	127.7	129.0	124.4	129.6	135.3	141.1	147.2	153.6
Other revenue	4.3	4.1	4.3	5.0	2.5	2.7	2.8	2.9	3.0	3.2	3.3
Expenditure	**1,698.7**	**1,707.2**	**1,771.8**	**1,712.9**	**1,793.6**	**1,886.8**	**1,890.0**	**1,974.8**	**2,057.7**	**2,149.4**	**2,245.3**
Expense	**1,511.5**	**1,540.6**	**1,615.5**	**1,571.9**	**1,628.0**	**1,671.0**	**1,722.4**	**1,794.0**	**1,863.4**	**1,940.8**	**2,021.8**
Compensation of employees	285.8	280.2	286.7	294.0	304.2	316.7	327.7	340.9	354.5	368.7	383.4
Use of goods and services	226.7	218.9	197.8	207.2	210.7	214.9	218.1	223.6	229.1	234.9	240.7
Interest	52.6	53.0	57.8	55.0	56.3	51.9	52.7	54.3	56.9	58.3	60.0
Subsidies	79.0	99.3	99.7	109.4	116.3	113.7	118.9	124.3	129.5	135.0	140.8
Grants	32.9	36.8	34.8	22.4	19.3	20.2	21.1	22.1	23.0	24.0	25.0
Social benefits	739.8	754.5	766.2	778.8	804.5	839.0	863.9	903.4	939.6	983.6	1,029.8
Other expenses	94.7	97.9	172.5	105.0	116.7	114.7	120.0	125.5	130.7	136.3	142.1
Net acquisition of nonfinancial assets	**187.2**	**166.6**	**156.2**	**141.0**	**165.6**	**215.7**	**167.6**	**180.8**	**194.4**	**208.6**	**223.5**
Gross Operating Balance	**12.8**	**57.5**	**-1.7**	**93.8**	**81.3**	**124.9**	**106.9**	**130.8**	**150.6**	**159.9**	**169.8**
Net lending/borrowing (overall balance)	**-174.4**	**-109.1**	**-157.9**	**-47.2**	**-84.3**	**-90.9**	**-60.7**	**-50.0**	**-43.8**	**-48.7**	**-53.6**
Net financial transactions	**-180.7**	**-108.9**	**-157.9**	**-47.2**	**-84.6**	**-90.9**	**-60.7**	**-50.0**	**-43.8**	**-48.7**	**-53.6**
Net acquisition of financial assets	**-22.6**	**24.2**	**65.5**	**-20.7**	**-104.2**	**-77.3**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net incurrence of liabilities	**158.1**	**128.7**	**223.3**	**21.4**	**-21.8**	**13.6**	**60.7**	**50.0**	**43.8**	**48.7**	**53.6**
Adjustment and statistical discrepancies 1/	*0.0*	*-4.4*	*-0.1*	*-5.2*	*-2.2*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Memorandum item:											
General government debt	1,508.5	1,604.0	1,803.6	1,839.7	1,816.1	1,828.9	1,891.6	1,947.5	1,999.5	2,059.9	2,125.7
Primary balance	-121.8	-56.1	-100.1	7.8	-27.9	-39.0	-8.0	4.2	13.0	9.6	6.4
Structural balance 2/	-172.0	-107.0	-56.1	5.3	-37.7	-66.7	-64.3	-61.1	-53.3	-51.9	-54.3
Cyclically adjusted primary balance	-129.8	-67.9	-86.3	46.2	1.0	-31.2	-17.8	-13.6	-3.6	-4.9	-6.0
Change in cyclically adjusted primary balance	40.1	61.9	-18.4	132.6	-45.2	-32.2	13.3	4.3	10.0	-1.3	-1.1

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

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

2/ In percent of potential GDP.

Table 4. Czech Republic: The Statement of Operations of General Government, 2010–20 1/

(in percent of GDP)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Staff Projections					
Revenue	**38.6**	**39.7**	**39.9**	**40.8**	**40.1**	**40.2**	**39.2**	**39.4**	**39.6**	**39.6**	**39.7**
Taxes	17.8	18.8	19.2	19.9	19.3	19.3	19.4	19.4	19.5	19.4	19.4
Personal income tax	3.3	3.5	3.6	3.7	3.7	3.5	3.5	3.5	3.5	3.5	3.5
Corporate Income tax	3.2	3.2	3.1	3.2	3.4	3.4	3.5	3.5	3.5	3.5	3.5
VAT	6.7	6.9	7.1	7.4	7.5	7.3	7.4	7.4	7.4	7.4	7.4
Excise	3.7	4.2	4.3	4.5	3.7	3.9	3.9	3.8	3.8	3.7	3.6
Other taxes	0.8	0.9	1.1	1.0	1.0	1.1	1.2	1.2	1.3	1.3	1.3
Social contributions	14.6	14.7	14.8	14.8	14.7	14.6	14.7	14.8	14.8	14.8	14.8
Grants	2.2	2.1	1.8	1.9	2.1	2.5	1.5	1.6	1.7	1.8	1.9
Other revenue	4.0	4.1	4.1	4.2	3.9	3.8	3.6	3.6	3.6	3.6	3.6
Property income	0.9	0.9	0.9	0.9	0.9	1.0	0.8	0.8	0.8	0.8	0.8
Sales of goods and services	3.0	3.2	3.1	3.1	3.0	2.8	2.8	2.8	2.8	2.8	2.8
Other revenue	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Expenditure	**43.0**	**42.4**	**43.8**	**41.9**	**42.0**	**42.3**	**40.5**	**40.5**	**40.5**	**40.5**	**40.6**
Expense	**38.2**	**38.3**	**39.9**	**38.5**	**38.2**	**37.4**	**36.9**	**36.8**	**36.6**	**36.6**	**36.6**
Compensation of employees	7.2	7.0	7.1	7.2	7.1	7.1	7.0	7.0	7.0	7.0	6.9
Use of goods and services	5.7	5.4	4.9	5.1	4.9	4.8	4.7	4.6	4.5	4.4	4.4
Interest	1.3	1.3	1.4	1.3	1.3	1.2	1.1	1.1	1.1	1.1	1.1
Subsidies	2.0	2.5	2.5	2.7	2.7	2.5	2.5	2.5	2.5	2.5	2.5
Grants	0.8	0.9	0.9	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Social benefits	18.7	18.8	18.9	19.1	18.9	18.8	18.5	18.5	18.5	18.6	18.6
Other expenses	2.4	2.4	4.3	2.6	2.7	2.6	2.6	2.6	2.6	2.6	2.6
Net acquisition of nonfinancial assets	**4.7**	**4.1**	**3.9**	**3.5**	**3.9**	**4.8**	**3.6**	**3.7**	**3.8**	**3.9**	**4.0**
Gross Operating Balance	**0.3**	**1.4**	**0.0**	**2.3**	**1.9**	**2.8**	**2.3**	**2.7**	**3.0**	**3.0**	**3.1**
Net lending/borrowing (overall balance)	**-4.4**	**-2.7**	**-3.9**	**-1.2**	**-2.0**	**-2.0**	**-1.3**	**-1.0**	**-0.9**	**-0.9**	**-1.0**
Net financial transactions	**-4.6**	**-2.7**	**-3.9**	**-1.2**	**-2.0**	**-2.0**	**-1.3**	**-1.0**	**-0.9**	**-0.9**	**-1.0**
Net acquisition of financial assets	**-0.6**	**0.6**	**1.6**	**-0.5**	**-2.4**	**-1.7**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net incurrence of liabilities	**4.0**	**3.2**	**5.5**	**0.5**	**-0.5**	**0.3**	**1.3**	**1.0**	**0.9**	**0.9**	**1.0**
Adjustment and statistical discrepancies 1/	*0.0*	*-0.1*	*0.0*	*-0.1*	*-0.1*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Memorandum item:											
General government debt	38.2	39.9	44.6	45.0	42.6	41.0	40.5	39.9	39.3	38.9	38.5
Primary balance	-3.1	-1.4	-2.5	0.2	-0.7	-0.9	-0.2	0.1	0.3	0.2	0.1
Structural balance 2/	-4.3	-2.7	-1.4	0.1	-0.9	-1.5	-1.4	-1.3	-1.1	-1.0	-1.0
Cyclically adjusted primary balance	-3.3	-1.7	-2.1	1.1	0.0	-0.7	-0.4	-0.3	-0.1	-0.1	-0.1
Change in cyclically adjusted primary balance	1.0	1.6	-0.4	3.3	-1.1	-0.7	0.3	0.1	0.2	0.0	0.0
Output gap	-0.2	0.2	-1.9	-3.6	-2.8	-1.2	0.0	0.5	0.4	0.2	0.0
Nominal GDP (billions of Koruny)	3,954	4,022	4,048	4,086	4,266	4,463	4,667	4,881	5,086	5,301	5,527

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

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

2/ In percent of potential GDP.

Table 5. Czech Republic: Medium-Term Macroeconomic Scenario, 2010–20

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Staff projections					
Real sector	(percent change, unless stated otherwise)										
Real GDP	2.3	2.0	-0.8	-0.7	2.0	3.0	2.8	2.6	2.2	2.2	2.2
Private consumption	1.0	0.2	-1.8	0.4	1.7	3.0	2.8	2.4	2.3	2.3	2.3
Public consumption	0.4	-2.9	-1.0	2.3	2.3	2.0	2.0	1.9	1.9	1.9	1.9
Investment	4.4	1.9	-3.7	-5.1	3.1	6.5	5.0	4.5	3.7	3.7	3.7
Fixed investment	1.3	1.1	-2.9	-4.4	4.5	6.5	5.0	4.5	3.7	3.7	3.7
Exports, goods and services	14.8	9.3	4.1	0.3	8.8	7.2	6.2	5.0	4.0	4.0	4.0
Imports, goods and services	14.9	6.7	2.4	0.3	9.5	8.5	7.0	5.5	4.6	4.6	4.6
contribution of net exports (percent)	0.4	1.9	1.3	0.0	0.0	-0.5	-0.3	-0.2	-0.3	-0.3	-0.4
Inflation (CPI, percent)	1.5	1.9	3.3	1.4	0.4	0.2	1.3	2.0	2.0	2.0	2.0
Unemployment (percent of labor force)	7.3	6.7	7.0	7.0	6.1	5.4	5.0	4.7	4.8	5.0	5.0
Output gap 1/	-0.2	0.2	-1.9	-3.6	-2.8	-1.2	0.0	0.5	0.4	0.2	0.0
Gross domestic savings (in percent of GDP)	23.5	24.9	24.8	24.5	25.7	27.4	27.2	27.1	27.1	27.1	27.2
Public	10.3	11.7	12.5	13.0	12.4	13.0	13.2	13.5	13.6	13.6	13.7
Private	13.2	13.2	12.3	11.5	13.4	14.5	14.0	13.6	13.5	13.5	13.5
Gross capital formation (in percent of GDP)	27.2	27.0	26.3	25.0	25.1	25.9	26.2	26.6	26.9	27.2	27.5
Public finances	(in percent of GDP)										
Revenues	38.6	39.7	39.9	40.8	40.1	40.2	39.2	39.4	39.6	39.6	39.7
Expenditures	43.0	42.4	43.8	41.9	42.0	42.3	40.5	40.5	40.5	40.6	40.6
Net lending	-4.4	-2.7	-3.9	-1.2	-2.0	-2.0	-1.3	-1.0	-0.9	-0.9	-1.0
Structural balance 1/	-4.3	-2.7	-1.4	0.1	-0.9	-1.5	-1.4	-1.3	-1.1	-1.0	-1.0
General government debt	38.2	39.9	44.6	45.0	42.6	41.0	40.5	39.9	39.3	38.9	38.5
Balance of payments	(in percent of GDP)										
Current account balance	-3.7	-2.1	-1.6	-0.5	0.6	1.5	1.0	0.5	0.2	-0.1	-0.4
Trade balance	1.0	1.9	3.1	4.1	5.6	6.5	6.1	5.6	5.3	5.0	4.7
Services balance	2.0	2.0	1.9	1.7	1.3	1.4	1.4	1.4	1.3	1.3	1.3
Net factor income	-6.4	-5.5	-5.9	-6.0	-6.1	-6.2	-6.2	-6.2	-6.1	-6.1	-6.1
Current transfers	-0.3	-0.4	-0.7	-0.3	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.3
Capital account balance	1.0	0.3	1.3	2.0	0.8	0.7	0.7	0.7	0.8	0.8	0.8
Financial account balance	-2.2	-1.6	1.6	3.7	1.9	3.0	2.5	2.0	1.7	1.5	1.2
Direct investment, net	-2.4	-1.1	-3.0	0.2	-3.1	-1.1	-1.1	-1.1	-1.2	-1.3	-1.4
Portfolio investment, net	-3.8	-0.1	-1.4	-2.2	2.1	1.7	1.6	1.5	1.1	0.5	0.3
Other investment & derivatives, net	1.9	-0.2	2.9	-0.5	0.6	0.7	0.4	-0.3	0.0	0.3	0.3
Errors and omissions, net	-0.5	-0.1	0.6	0.2	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves (- increase)	1.1	-0.4	2.0	4.4	1.7	0.9	0.9	1.2	1.1	1.1	1.1

Sources: Czech Statistical Office, Czech National Bank, Ministry of Finance, and IMF staff estimates and projections.
1/ In percent of potential GDP.

Table 6. Czech Republic: Financial Soundness Indicators

(in percent unless indicated otherwise)

	2009	2010	2011	2012	2013	2014
Capital						
Regulatory capital to risk-weighted assets	14.0	15.3	15.0	15.6	16.5	17.0
Regulatory Tier 1 capital to risk-weighted assets	12.6	13.9	13.9	15.2	16.2	16.5
Capital to assets	6.1	6.5	6.5	6.9	7.2	7.3
Profitability						
Return on assets	1.4	1.3	1.2	1.4	1.2	1.2
Return on equity	26.4	19.7	18.3	20.4	16.2	16.5
Interest margin to gross income	55.8	63.1	64.5	60.7	59.9	61.8
Noninterest expenses to gross income	42.0	46.8	47.2	46.9	46.8	47.2
Trading income to total income	9.5	4.6	4.1	8.9	8.7	6.3
Personnel expenses to noninterest expenses	40.5	39.7	41.0	41.2	41.4	40.1
Liquidity						
Liquid assets to total assets	27.1	29.4	29.9	32.6	33.8	30.5
Liquid assets to short-term liabilities	70.0	71.1	72.2	71.4	67.4	64.9
Customer deposits to total (noninterbank) loans	128.2	129.6	126.0	133.1	128.3	123.2
Foreign-currency-denominated loans to total loans 1/	21.2	21.6	22.2	20.9	29.1	28.9
Foreign-currency-denominated liabilities to total liabilities 1/	14.2	14.3	15.0	14.1	21.5	23.3
Sensitivity to market risk						
Net open position in foreign exchange to capital	0.5	0.4	-3.2	5.1	1.2	1.2
Gross asset position in financial derivatives to capital	54.0	43.2	57.5	46.5	29.5	37.5
Gross liability position in financial derivatives to capital	50.9	41.2	53.5	40.5	29.7	34.3
Net open position in equities to capital 1/	8.3	8.1	9.3	7.8	6.2	6.6
Memo item						
Nonperforming loans to total gross loans	4.6	5.4	5.2	5.2	5.2	5.6

Source: Czech National Bank

1/ 2014Q2 value is used instead.

Table 7. Czech Republic: Monetary Indicators, 2007–14
(billions of koruny)

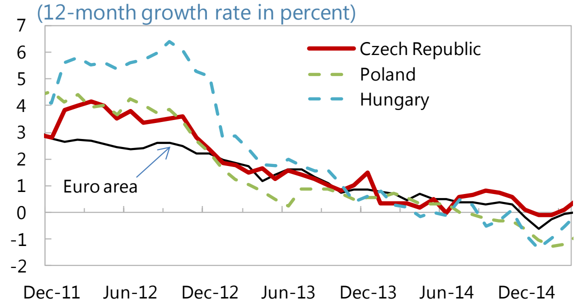
	2007	2008	2009	2010	2011	2012	2013	2014
Monetary Aggregates								
M2	2478	2641	2753	2845	2994	3129	3279	3430
M1	1439	1545	1662	1911	2042	2213	2380	2654
Quasi Money	1040	1096	1091	934	953	917	898	776
Net Domestic Assets	1508	1666	1750	1830	2001	1982	1964	2111
Net Domestic Credit to the Government Sector	72	23	166	225	335	316	319	469
Domestic Credits to the Rest of the Economy	1628	1890	1905	1962	2070	2124	2202	2282
Net Foreign Assets	970	975	1003	1015	993	1148	1315	1319
Central Bank Accounts								
Currency in Circulation	324	366	354	358	378	389	405	432
Net Foreign Assets	633	720	770	799	805	860	1121	1198
Credit								
Private Sector	1451	1700	1723	1809	1923	1968	2048	2103
Corporations	743	848	782	780	828	835	867	875
Households	708	851	940	1028	1095	1132	1181	1228
Foreign Currency	128	157	147	146	160	152	194	202
Corporations	127	156	146	144	159	151	193	200
Households	1	1	1	1	2	2	2	2
Deposits								
Private Sector	1904	2031	2162	2274	2384	2486	2589	2762
Corporations	614	591	611	633	673	716	777	838
Households	1290	1440	1551	1642	1711	1770	1812	1923
Foreign Currency	187	191	185	183	188	205	221	266
Corporations	128	125	118	121	128	145	160	192
Households	58	66	67	62	60	60	62	75
Interest Rates (percent)								
Discount Rate	2.5	1.3	0.3	0.3	0.3	0.1	0.1	0.1
Lombard Rate	4.5	3.3	2.0	1.8	1.8	0.3	0.3	0.3
Repo Rate - 2 Weeks	3.5	2.3	1.0	0.8	0.8	0.1	0.1	0.1
PRIBOR - 1 Week	3.6	2.8	1.3	0.8	0.8	0.3	0.2	0.2

Source: Czech National Bank.

Appendix I. Background Note on Drivers of Disinflation Trends

Inflation has declined sharply across Europe starting in 2012. At end-April 2015, the 12-month inflation is either zero or negative for the euro area (EA) and across all Central and Eastern European (CEE) countries outside the euro zone, except Romania (Figure1). In the Czech Republic, inflation has been close to zero since December 2014.

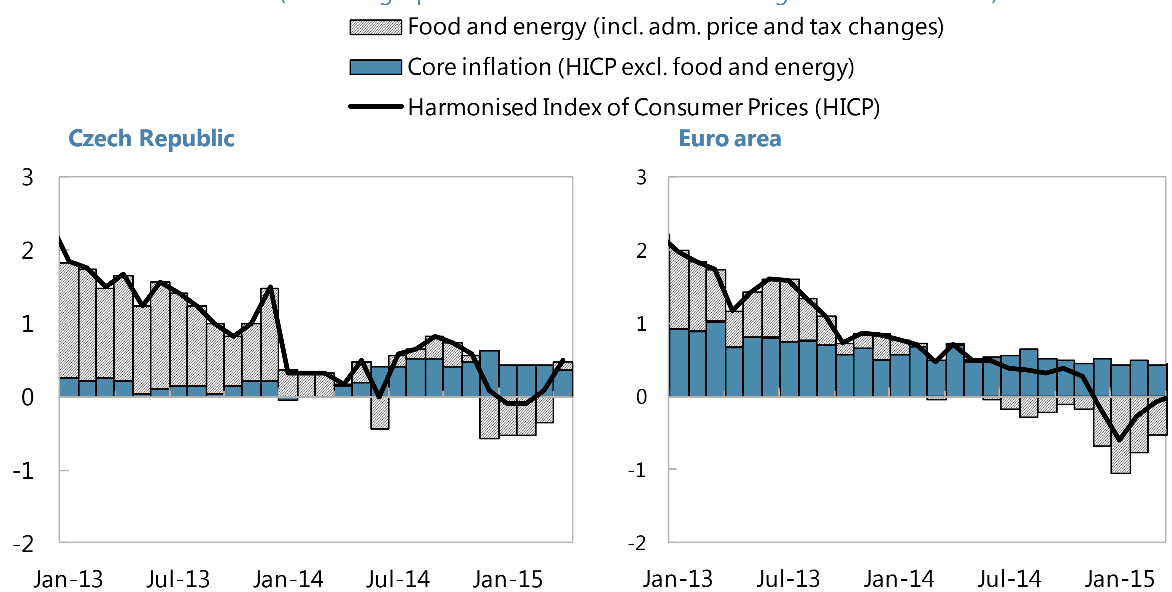
Headline inflation
(12-month growth rate in percent)



Source: Eurostat Harmonized Consumer Price Indices.

The synchronized disinflation across the continent points to common external causes, such as developments in shared trade partners or international commodity prices (Figure 2). The pass-through of external shocks to the overall price level can be broken down into first- and second-round effects. *First-round effects* capture: (1) changes in energy and unprocessed food prices and prices of other imported goods in consumer baskets; and (2) the impact on other prices via the cost of inputs. *Second-round effects* reflect the impact (if any) channeled through inflation expectations via: (1) softening of contemporaneous demand, as economic agents attempt to take advantage of expected future price cuts; and (2) wage and price-setting behavior, which can embed the expectation of disinflation in the evolution of future wages and prices. In extreme cases, the latter channel can trigger a deflationary spiral—a self-feeding, vicious feedback loop between inflation expectations and prices.

Contributions to Headline Inflation, 2012-15
(Percentage-points contributions to 12-month growth rates of HICP)



Sources: Eurostat and Fund staff estimates.

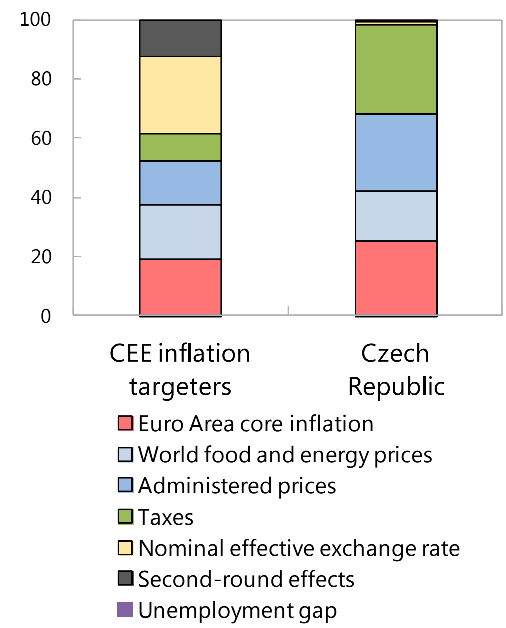
We analyze the main drivers of disinflation in the Czech Republic in two steps:

- We first apply the panel coefficients from an updated version of the open-economy, New Keynesian, Phillips curve for the CEE region in Iossifov and Podpiera (2014) to Czech data. We re-estimate the regression with quarterly data for ten CEE countries over 2004–14, and consider separately the effect of forward-looking expectations and the autonomous dynamics of inflation. This allows a breakdown of the impact of external shocks into first- and second-round effects.
- We then estimate regression models of households' and firms' inflation expectations in CEE, using data until the onset of disinflation in 2012. Analysis of the out-of-sample forecasting performance of the model helps identify the normal (i.e., fitted) reaction of inflation expectations to oil prices and other external shocks and any overshooting (i.e., abnormally large negative residuals) that can signal unanchoring of inflation expectations.

Decomposition of inflation variance into contributions by the explanatory variables in the regression model shows that (Figure 3):

- First-round effects of lower commodity prices, as captured by the combined impact of world food and energy prices and administered prices[1], account for the largest share of the inflation decline both in the Czech Republic and across other CEE inflation targeters;
- Disinflation spillovers from the euro area have been an important factor in the Czech Republic and other CEE inflation targeters, in light of their close trade links with the euro area and the high import-content in domestic demand;
- Nominal effective exchange rates have played an important role in other CEE inflation targeters, but not in the Czech Republic if we consider the entire 2012–14 period. However, they have contributed positively since the introduction of the FX-floor instrument by the Czech National Bank in November 2013;

Sources of Disinflation 2012-14
(Contributions to inflation variance, percent)



Source: IMF staff calculations.

- Changes in indirect taxes have contributed sizably to the easing of domestic price pressures in the Czech Republic and to a lesser extent in other CEE inflation targeters. This reflects base

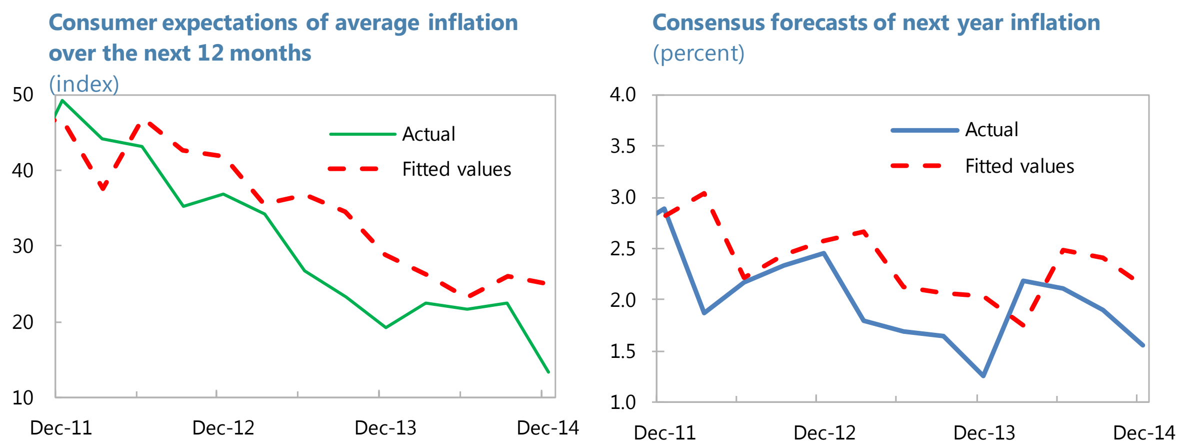
[1] Administered prices are mostly of energy products (electricity, gas, and heating) consumed by households, but also include healthcare. The inflation target is a medium-term one, and as such short-run deviations from the target are tolerated particularly when caused by first-round effects of exogenous supply shocks, such as administered price changes. Monetary policy is, however, concerned about second-round effects of supply shocks.

effects from the significant fiscal consolidation efforts across the region in 2011/12, aimed at exiting the EU's Excessive Deficit Procedure.

- The domestic economic cycle— measured by the unemployment gap—has had no measurable impact in the recent disinflationary episode.
- Second-round effects, as measured by the contribution of forward-looking inflation expectations, have not contributed to the post-2012 disinflation in the Czech Republic and can account for 12 percent of the observed inflation variance across all CEE inflation targeters over the period.

Analysis of the out-of-sample forecasting performance of CEE-wide regressions of households' and firms' inflation expectations suggests that these models cannot fully explain the fall in inflation expectations of both professional forecasters and the general public in the Czech Republic in 2012–14 (Figure 4). Until mid-2014, the forecasts have eventually reverted back to the actual realizations. It remains to be seen whether the same will occur in 2015. But, as seen above, this has not had discernible impact on inflation so far.

Czech Republic: Gap Between Actual and Fitted Inflation Expectations, 2012-15



Sources: European Commission, Consensus Economics Forecasts, and Fund staff estimates.
Note: Fitted values from a fixed-effects regression over the period prior to the latest episode of falling world oil prices (2004-2011) of the two proxies of inflation expectations on their first-lags (interacted by a dummy variable for exchange rate regime) and the log of the world price of oil in USD, multiplied by the fraction of consumer basket spent on energy. Consensus forecasts are for the average inflation in the years shown on the horizontal axes, made 12 months prior to the month, for which actual inflation is shown. Consumer inflationary expectations index reflect survey responses to the question on price trends over next 12 months. It is calculated as +1* ("Pecentage thinking it will rise a lot")+ 1/2 * ("Pecentage thinking it will rise moderately"- 1/2 * ("Pecentage thinking it will stay about the same") - 1 * ("Pecentage thinking it will fall").

Looking forward, consumer inflation expectations—which have historically been a good predictor of inflation developments—show tentative signs of bottoming out. It remains to be seen whether this will turn into a sustained trend in the remainder of 2015. However, both measures of inflation expectations have a long way to go to return to where they were prior to the onset of disinflation. Furthermore, it should be kept in mind that survey-based indicators can be wrong. For example, Moghadam, Teja, and Berkmen (2014) point out that long-term inflation expectations had also been positive on the eve of the three deflationary episodes in Japan.

Appendix II. Debt Sustainability Analysis

Public debt declined to 43 percent of GDP in 2014 despite the fiscal relaxation, due to the favorable cyclical developments and as the authorities used available treasury liquidity. Provided the fiscal targets specified in the government's convergence program are met, public debt is projected to stay on a downward path, reaching 39 percent of GDP over the medium-term on the back of the economic recovery and strong revenue collection. Public debt and gross financing needs are relatively immune to a variety of isolated shocks, including a shock to real GDP growth.

Baseline and Realism of Projections

The baseline scenario assumes a structural relaxation from a deficit of 0.9 percent of GDP in 2014 to 1.5 percent in 2015 with the structural deficit gradually declining to 1 percent of GDP by 2020. This year's structural relaxation is mostly due to an increase in capital expenditure, and higher health and pension spending. Projections assume a recovery of growth underpinned by strong domestic demand, with real GDP increasing by 3.0 percent in 2015 and 2.8 percent in 2016, and medium-term growth converging at 2.2 percent. The inflation rate is projected to gradually move toward the 2 percent target in 2016.

The outlook for the fiscal path is benign under the baseline. Staff projects that the debt-to-GDP ratio will decline steadily from 43 percent in 2014 to 39 percent in 2020. The ratio would also decline in 2015 despite the expansionary fiscal stance as the authorities plan to continue relying on available treasury liquidity. Gross financing needs are projected to stay below 8 percent of GDP throughout the projection period.

Shock and Stress Tests

A shock to real GDP growth is the main risk over the short term. Assuming that a shock to real GDP growth occurs with a consequent impact on the primary balance, inflation, and the real interest rate, public debt would rise to 51 percent of GDP and gross financing needs would increase to 12 percent of GDP by 2017. Thereafter, debt would decline to 50 percent of GDP and gross financing needs would drop to 9 percent of GDP by 2020.

Czech Republic Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

(in percent of GDP unless otherwise indicated)

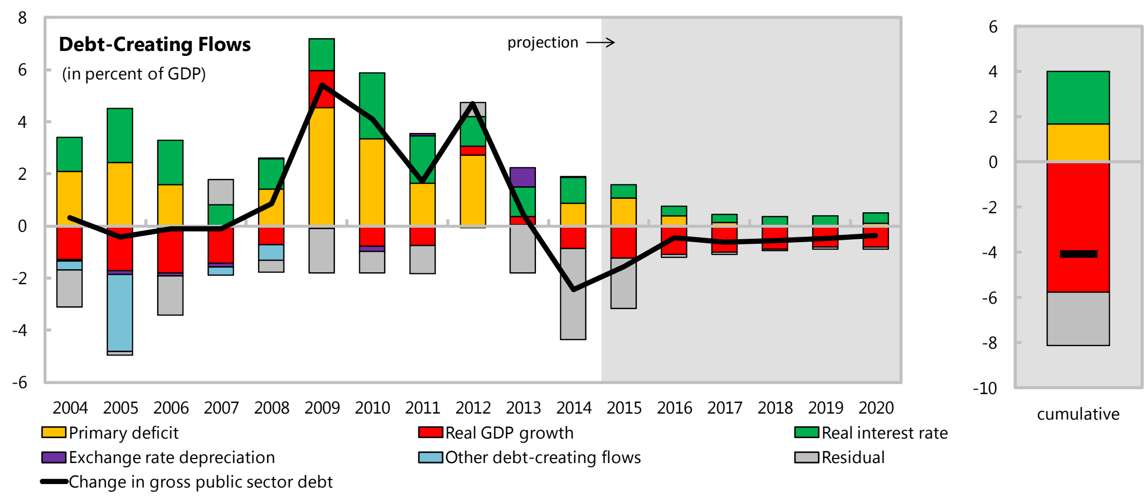
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2004-2012 [2]	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	33.1	45.0	42.6	41.0	40.6	39.9	39.3	38.9	38.5
Public gross financing needs	3.0	1.2	2.0	7.5	7.8	6.8	7.1	7.3	7.1
Real GDP growth (in percent)	2.8	-0.7	2.0	3.0	2.8	2.6	2.2	2.2	2.2
Inflation (GDP deflator, in percent)	1.4	1.7	2.4	1.6	1.8	1.9	2.0	2.0	2.0
Nominal GDP growth (in percent)	4.3	1.0	4.4	4.6	4.6	4.6	4.2	4.2	4.3
Effective interest rate (in percent) [4]	3.9	3.0	3.1	2.9	2.7	2.8	3.0	3.0	3.2

As of June 18, 2015		
Sovereign Spreads		
EMBIG (bp) 3/		38
5Y CDS (bp)		50
Ratings	Foreign	Local
Moody's	A1	A1
S&Ps	AA-	AA
Fitch	A+	AA-

Contribution to Changes in Public Debt

	Actual			Projections							
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	1.8	0.5	-2.5	-1.6	-0.5	-0.6	-0.6	-0.5	-0.4	-4.1	
Identified debt-creating flows	2.4	2.2	1.0	0.4	-0.3	-0.5	-0.5	-0.4	-0.3	-1.7	
Primary deficit	2.2	0.1	0.9	1.1	0.4	0.1	0.0	0.0	0.1	1.7	-0.4
Primary (noninterest) revenue and grant	38.6	40.5	39.9	40.0	39.0	39.2	39.4	39.4	39.4	236.5	
Primary (noninterest) expenditure	40.8	40.6	40.7	41.1	39.4	39.3	39.3	39.4	39.5	238.2	
Automatic debt dynamics [5]	0.7	2.2	0.2	-0.7	-0.7	-0.7	-0.5	-0.4	-0.4	-3.4	
Interest rate/growth differential [6]	0.8	1.4	0.1	-0.7	-0.7	-0.7	-0.5	-0.4	-0.4	-3.4	
Of which: real interest rate	1.5	1.1	1.0	0.5	0.4	0.3	0.4	0.4	0.4	2.3	
Of which: real GDP growth	-0.7	0.3	-0.9	-1.2	-1.1	-1.0	-0.8	-0.8	-0.8	-5.8	
Exchange rate depreciation [7]	-0.1	0.7	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
General government net privatization p	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroar	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8]	-0.6	-1.8	-3.5	-1.9	-0.1	-0.1	-0.1	-0.1	-0.1	-2.3	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

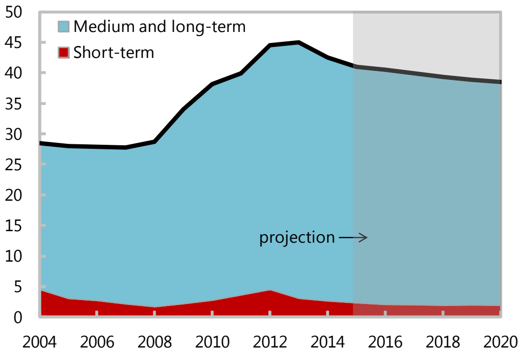
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Czech Republic Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

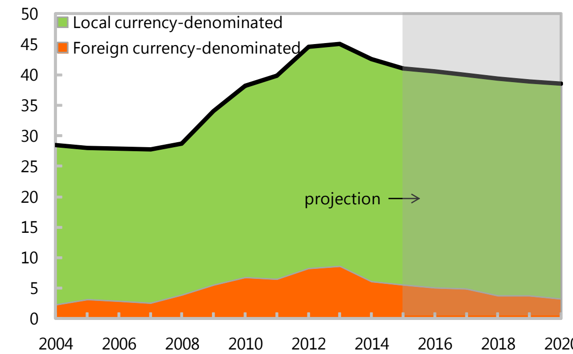
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

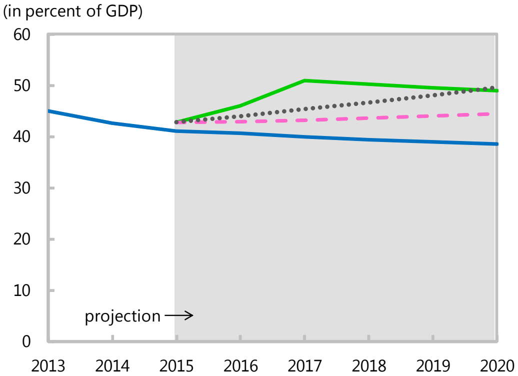


Alternative Scenarios

Baseline
Historical
Real GDP growth
Constant Primary Balance

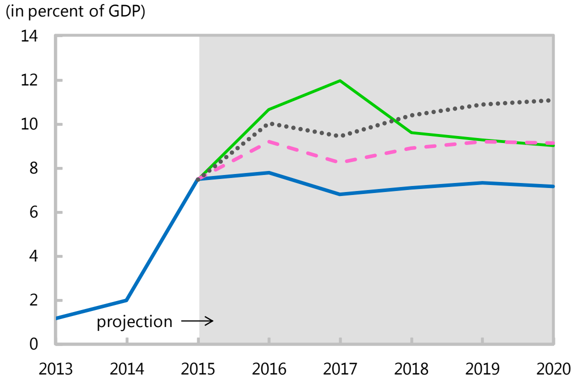
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	3.0	2.8	2.6	2.2	2.2	2.2
Inflation	1.6	1.8	1.9	2.0	2.0	2.0
Primary Balance	-1.1	-0.4	-0.1	0.0	0.0	-0.1
Effective interest rate	2.9	2.7	2.8	3.0	3.0	3.2
Constant Primary Balance Scenario						
Real GDP growth	3.0	2.8	2.6	2.2	2.2	2.2
Inflation	1.6	1.8	1.9	2.0	2.0	2.0
Primary Balance	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
Effective interest rate	2.9	2.6	2.7	2.8	2.8	2.9
Real GDP growth						
Real GDP growth	3.0	-0.9	-1.0	2.2	2.2	2.2
Inflation	1.6	0.9	1.0	2.0	2.0	2.0
Primary Balance	-1.1	-2.2	-3.8	0.0	0.0	-0.1
Effective interest rate	2.9	2.6	2.8	2.9	2.9	3.0

Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	3.0	2.1	2.1	2.1	2.1	2.1
Inflation	1.6	1.8	1.9	2.0	2.0	2.0
Primary Balance	-1.1	-1.9	-1.9	-1.9	-1.9	-1.9
Effective interest rate	2.9	2.6	3.0	3.2	3.4	3.6

Source: IMF staff.

INTERNATIONAL MONETARY FUND

CZECH REPUBLIC

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 26, 2015

Prepared By | European Department

CONTENTS

FUND RELATIONS

(As of June 10, 2015; unless specified otherwise)

Membership Status: Joined 01/01/1993; Article VIII

General Resources Account

	SDR Million	Percent of Quota
Quota	1,002.20	100.0
Fund Holdings of Currency	651.85	65.04
Reserve position in Fund	350.35	34.96
Lending to the Fund		
Borrowing Agreement	27.70	

SDR Department:

	SDR Million	Percent Allocation
Net Cumulative Allocation	780.20	100.0
Holdings	751.61	96.34

Outstanding Purchases and Loans: None

Financial Arrangements:

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

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

	Forthcoming				
	2015	2016	2017	2018	2019
Principal					
Charges/Interest	0.01	0.03	0.03	0.03	0.03
Total	0.01	0.03	0.03	0.03	0.03

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 (CNB) 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. Between 2002 and 2013, the CNB had not engaged in direct interventions in the foreign exchange market, and the de facto exchange rate regime was classified as a free float. In November 2013, facing the zero lower bound for policy rates and a persistent and large undershooting of its inflation target, the CNB intervened in the market to weaken the currency, and announced its commitment to resist any appreciation beyond CZK 27 per euro. Since then, the koruna traded between CZK 27.0 and CZK 28.33 per euro. The de facto exchange rate arrangement was retroactively reclassified from other managed to a stabilized arrangement, effective November 19, 2013. The de jure exchange rate arrangement remains floating. On June 10, 2015, the exchange rate stood at CZK 27.27 per euro and CZK 24.10 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).

Last Article IV Consultation:

The last Article IV consultation with the Czech Republic was concluded on August 27, 2014. The staff report and the press release were published on September 2, 2014.

FSAP Participation and ROSCs:

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

Technical Assistance: See attached table.

Implementation of HIPC Initiative: Not Applicable.

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

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

Safeguards Assessments: Not Applicable.

Czech Republic: Technical Assistance, 1991–2015

Department	Timing	Purpose
FAD	December 1991–September 1993	Regular visits by FAD consultant on VAT administration
	March 1993	Public financial management
	September 1993	Follow-up visit on public financial management
	November 1993	Follow-up visit on public financial management
	January 1994	Follow-up visit on public financial management
	July 1994	Follow-up visit by FAD consultant on VAT administration
	May 1995	Follow-up visit on public financial management
	June 1995	Follow-up visit by FAD consultant on VAT administration
	June–July 1999	Medium-term fiscal framework
MCM	February 1992	Monetary management and research, foreign exchange operations, and banking supervision
	June 1992	Monetary research
	July 1992	Long-term resident expert assignment in the area of banking supervision (financed by EC-PHARE; supervised by the Fund)
	December 1992 and	Bond issuance and monetary management
	February 1993	Follow-up visit on bond issuance and monetary
	November 1993	management and management of cash balances
		Data management and monetary research
	April 1994	Foreign exchange laws (jointly with LEG) and external
	January 1995	liberalization
	May 1995	Monetary operations
	May 1995	Banking system reform
	May 1996	Economic research
	April 1997	Banking legislation
	February–June 1999	Monetary research—inflation targeting
	June 1999	Integrated financial sector supervision (with WB)
RES	September 1999	Inflation targeting (financed by MFD)
	June–August 2000	Inflation targeting (financed by MFD)
	February–March 2005	Inflation targeting (financed by MFD)
STA	May 1993	Money and banking statistics
	February 1994	Balance of payments
	April 1994	Government finance
	November 1994	Money and banking statistics
	January–February 1999	Money and banking statistics
	May 2002	Monetary and financial statistics
	February 2003	Implementing GFSM 2001
	November 2006	GFSM 2001 Pilot Project
		GFSM 2001 implementation

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance

General:

- Data provision is adequate for surveillance.

National Accounts:

- National accounts data are subject to certain weaknesses. Value added in the small scale private sector is likely to be underestimated, as the mechanisms for data collection on this sector are not yet fully developed and a significant proportion of unrecorded activity stems from tax evasion. Discrepancies between GDP estimates based on the production method and the expenditure method are large and are subsumed under change in stocks. Quarterly estimates of national accounts are derived from quarterly reports of enterprises and surveys. The estimates are subject to bias because of nonresponse (while annual reporting of bookkeeping accounts is mandatory for enterprises, quarterly reporting is not) and lumping of several expenditure categories in particular quarters by respondents. The Czech Republic adopted the *European System of Accounts 2010 (ESA 2010)* in September 2014. The transition from the *ESA 1995 (ESA95)* required the revision of national accounts data.

Price Statistics:

- The Czech Statistical Office (CSO) compiles and disseminates a monthly consumer price index (CPI) using a weighting structure based on expenditure data collected during 2012. Weights are updated biannually. A monthly Harmonized Index of Consumer Prices (HICP) is disseminated according to European regulations. The producer price index is released monthly with coverage including manufacturing, construction, agriculture, and select business services (business to business only). The CSO also compiles and releases monthly import and export price indexes based on data collected directly from establishments engaged in export and/or import activities.

Government Finance Statistics:

- Annual and quarterly fiscal data are compiled on *ESA2010* basis by the Czech Statistical Office, including non-financial accounts, financial accounts, and financial balance sheets. The Ministry of Finance uses the ESA methodology for the Convergence Program targets. The *ESA 2010* methodology includes a wider coverage of the general government sector, different classification of some government transactions, and impacts the calculation of GDP. Government transactions are recorded on an accrual basis.

Monetary and Financial Statistics: • 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 data published in the *International Financial Statistics* (*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.
Financial sector surveillance: • CNB is reporting Financial Soundness Indicators for Deposit Takers on a quarterly basis.
External sector statistics: • Starting in 2014, external sector statistics are compiled according to the *Balance of Payments and International Investment Position Manual, sixth edition (BPM6)* and in accordance with legal requirements of the ECB and Eurostat. Balance of payments financial account transactions are generally derived from changes in stock data adjusted by exchange rate, price, and other changes; they are not directly based on the value of current transactions. Quarterly external debt statistics are reported to the Quarterly External Debt Statistics (QEDS) database.

II. Data Standards and Quality

Subscriber to the Fund's Special Data Dissemination Standard since April 1998.	Data ROSC was published on July 1, 2000.

Table of Common Indicators Required for Surveillance

(As of June 10, 2015)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	current	current	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	May 2015	Jun. 2015	D	M	M
Reserve/Base Money	Apr. 2015	May 2015	M	M	M
Broad Money	Apr. 2015	May 2015	M	M	M
Central Bank Balance Sheet	Apr. 2015	May 2015	M	M	M
Consolidated Balance Sheet of the Banking System	Apr. 2015	May 2015	M	M	M
Interest Rates[2]	current	current	D	D	D
Consumer Price Index	May 2015	Jun. 2015	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2014 Q4	Jun. 2015	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	May 2015	Jun. 2015	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2014 Q4	May 2015	Q	Q	Q
External Current Account Balance	Mar. 2015	May 2015	M	M	M
Exports and Imports of Goods and Services	Mar. 2015	May 2015	M	M	M
GDP/GNP	2015 Q1	May 2015	Q	Q	Q
Gross External Debt	2014 Q4	Mar. 2015	Q	Q	Q
International Investment Position[6]	2014 Q4	Mar. 2015	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).