INTERNATIONAL MONETARY FUND

Czech Republic—Article IV Consultation Discussions

Preliminary Conclusions of the Mission—May 7, 2002

1. Since the mission last visited the Czech Republic in October 2001, the Czech economy has been buffeted by a number of macroeconomic shocks. The global economy slowed down further, adversely affecting the growth of Czech exports, while simultaneously the Czech koruna appreciated sharply. In spite of this, however, the Czech economy has remained remarkably resilient, showing only modest signs of deceleration so far. This testifies to the improving supply side of the economy, brought about by buoyant foreign direct investment (FDI) and progress in structural reforms in recent years. The mission welcomes this very positive development.

2. This said, there remain challenges that need to be overcome to maintain the positive momentum. In the short term, the economy is likely to remain weak until the euro zone returns to stronger growth later this year. Meanwhile, the economy still has to cope with the koruna's recent appreciation, the effects of which may yet be largely in the pipeline. Interest rate cuts by the Czech National Bank (CNB) over the past months will be helpful in this respect. Medium-term fiscal sustainability continues to be a major concern. Addressing this problem is an important task of the government and the parliament that will emerge from the upcoming elections, and priority should be given to reform of the pension and social benefit systems. While banking sector restructuring has largely been completed, other areas of structural reform—including corporate sector restructuring and reform of the legal and regulatory environment—need to be accelerated. Progress in these areas will greatly facilitate the Czech Republic's catch-up with its European Union (EU) partners through an improved investment environment, and will lay the ground for a smooth accession to the EU and eventual participation in the euro zone.

Macroeconomic conditions

3. Against the background of the slowdown of trading partner demand, the economy decelerated toward the end of 2001, but robust investment and exports mitigated the impact. Weak foreign demand will continue to constrain growth in the first half of 2002. In addition, the rapid appreciation of the koruna over the past few months will weaken the Czech Republic's external competitiveness. However, provided that the exchange rate stabilizes, the expected recovery of the EU economies later this year, together with the recent interest rate cut by the CNB, will likely lead to a pickup of growth in the second half of this year. The mission expects GDP growth to be 3-3.25 percent in 2002, and to accelerate next year.

4. Inflation has continued to fall since mid-2001, and is expected to stay on its decelerating path, before turning upward in late-2002. Inflation is expected to fall below the CNB's target range temporarily from mid-2002 to early-2003, but from mid-2003 onward, it

will likely return to the range, reflecting the recovery of domestic and external demand. The unemployment rate remains high, but an increasing part of this is attributable to skill and regional mismatches, resulting from the difficulty in reallocating labor away from the sectors under restructuring to the sectors with buoyant growth, as well as from the low mobility of workers. Although still limited, shortages of certain types of skilled workers are also reported. These mismatches have contributed to the high level of long-term unemployment, which indicates that slack in the economy may be smaller than it appears, and the room for growth without inflation may be less than what the headline unemployment figure suggests. The current account deficit in 2002 will likely remain broadly unchanged from last year at some 5 percent of GDP. The FDI inflows in the pipeline—both greenfield investment and privatization—will amply finance this deficit.

Fiscal policy

5. The absence of decisive fiscal consolidation to date remains disappointing. The better-than-expected fiscal outturn at the general government level in 2001, while welcome, was the result of cyclical and special factors, rather than of deliberate efforts to contain the deficit. These factors include better-than-anticipated revenue collection and some spending restraint, the latter partly reflecting delays in spending by the new extrabudgetary funds for transport and housing.

6. The 2002 budget does not aim to correct the fiscal imbalances and, on the face of it, would appear very expansionary. The general government deficit—excluding privatization receipts, proceeds from the sale of Russian debt, and transfers to transformation institutions—is projected to increase by 2.4 percentage points of GDP over the estimated 2001 outturn. The widening deficit comes largely from higher spending, partly as a result of the more ambitious spending plans of the extrabudgetary funds for transport and housing. Also, the transfer of spending responsibilities from the state budget to local governments and the extrabudgetary funds does not appear to have been accompanied by a commensurate reduction in the size of the state budget. As last year's one-off factors are not expected to be repeated, lower revenues (as a share of GDP) also contribute to the fiscal slippage. But a detailed analysis of likely fiscal developments in 2002 is hampered by the increasing complexity of the fiscal accounts, resulting from the existence of a larger number of extrabudgetary funds as well as from an additional layer of local government. This tends to reduce the ability of the Ministry of Finance to monitor and control overall fiscal spending.

7. Irrespective of its sources, however, the envisaged expansion is cyclically unwarranted and runs counter to the objective of medium-term fiscal consolidation. The mission advocates that the expenditure ratio be restrained to its 2001 level. This would imply a reduction—relative to the budget—in general government expenditures (excluding transfers to transformation institutions) of CZK 35 billion, or 1.5 percent of GDP. The mission recommends that cuts target expenditures that least affect future economic growth, including subsidies to public enterprises and construction savings accounts.

8. Much-needed reforms to address fiscal sustainability over the medium term and beyond can no longer be put off. Over the next few years, the realization of contingent liabilities from bank restructuring, costs related to EU accession, the drying up of privatization proceeds, the growing future imbalances in the public pension system, and the mounting needs for spending on infrastructure make it imperative to address the sustainability of public finances by cutting expenditures in non-priority areas and introducing fundamental reforms to reduce mandatory spending. Ambitious fiscal reforms will become all the more pressing if the Czech Republic chooses to aim at early adoption of the euro. Regrettably, very little progress has been made over the last couple of years, and important fiscal measures have been left for the period after the election. The parliament that emerges from the upcoming elections will be faced with the difficult task of dealing promptly and decisively with the fiscal reform agenda, especially with the reform of the social benefit and pension systems. Social benefits are contributing to fiscal pressures, and there is room to contain costs while improving incentives to work (see paragraph 18 below). Pension reform is a second important area, and the Czech Republic faces the same demographic challenges as its future EU partners. Several alternative reform proposals have been developed, including those presented in the World Bank's recent study, and the mission urges that political parties come to a broad consensus on how to implement lasting reform measures.

Monetary and exchange rate policy

9. In 2001, the CNB successfully achieved its end-year target for net inflation under conditions of dynamic growth in the domestic economy, aided by lower world commodity prices toward the end of the year. Looking forward, headline inflation is expected to fall below the continuous target band for a sustained period from mid-2002, owing to the still remaining output gap as well as the lagged effect of the recent rapid appreciation of the koruna on traded goods prices.

10. The koruna's appreciation has complicated the conduct of monetary policy in recent months. The reasons for the appreciation have been much discussed by market analysts, and include: the concern in late 2001 that privatization receipts would be converted in the market; forthcoming large greenfield FDI; gains in productivity and efficiency; and expectations of EU accession and eventual adoption of the euro. Speculative excesses and Czech exporters' hedging operations have also been cited. Against this background, the CNB has maintained its focus on achieving its inflation target, and the mission believes the recent 50 basis point cut in the repo rate to be consistent with this objective. The rapid rise in the koruna, together with the reduction in inflation, led to a tightening of monetary conditions in recent months that—in the absence of the interest rate cut—would have caused an undershooting of the inflation target over the targeting horizon (12-18 months ahead). Lower interest rates may also take some upward pressure off the exchange rate.

11. This assessment notwithstanding, the mission believes that the balance of risks to inflation still lies on the downside. Based on past experience, the size of the exchange rate pass-through to inflation seems to be limited. However, competition in retailing has increased

sharply, suggesting that lower costs for imported goods would now be more likely to be passed on to consumers. If the reduced profitability of export and import-competing industries results in a temporary cutback in investment and employment, downward pressure on inflation may further increase in the coming year. For these reasons, vigilance is needed to ascertain the overall effect of the koruna's appreciation.

12. Within the context of the inflation targeting framework, the authorities have at their disposal additional tools to prevent exchange rate instability. Key among these is the agreement between the government and the CNB to withhold all government foreign currency receipts from the market. This agreement has the potential to reduce uncertainty in the foreign exchange market, and the mission urges the authorities to make use of its full potential, including in the context of the proceeds from Transgas. An alternative to this, namely, the conversion by the government of foreign exchange inflows on the market, would drive up the exchange rate, and would be more costly for the economy, and most likely for the government as well. The mission also commends the government's intention to pay foreign suppliers and creditors directly from its foreign exchange proceeds. Since more inflows from large-scale privatization are expected to come in the future, the mission encourages the government that emerges from the elections to continue with the current agreement.

13. EU accession includes taking on the obligations of the Maastricht Treaty, implying eventual adoption of the euro when all criteria are met. In the mission's view, the medium-term benefits for the Czech Republic of joining the euro zone are clear, owing to the close integration of goods and capital markets with those in the EU. Foreign investors will likely pay increasing attention to the stability provided by eurozone membership as it expands to include some of the new EU members. In light of these considerations, the new government should promptly formulate its views on a desirable timetable and concrete steps toward the adoption of the euro, and disclose them as appropriate, in order to reduce uncertainty and possible currency speculation stemming from it. In addition, the period until EMU should be used to actively prepare and implement needed fiscal consolidation, and to increase the flexibility of labor markets. The annual medium-term pre-accession economic programs (PEPs) required by the EU can provide a means to frame policies to ensure that macroeconomic and structural objectives are met by the target EMU entry date.

Structural Reforms

14. The mission welcomes the renewed interest in accelerating the disposal of bad assets. Bad assets do not get better over time; they deteriorate further. With the pending transfer of further assets from CSOB stemming from the old IPB, total non-performing assets on the books of the Czech Consolidation Agency (CKA) could reach some CZK 300 billion. In a few select cases, corporate restructuring under the lead of the public sector may be possible. But in the vast majority of cases, the private sector is more efficient at doing so, and the best method for this is likely to be direct sales of packages of assets to private institutions willing to take on the work-out of these assets. In preparing for such sales, the CKA should aim to ensure maximum competition and the highest possible yield. For this purpose, the packages

should be large enough to attract first-tier bidders. A transparent and well-structured sales process will also be key. Providing bidders sufficient time to evaluate the quality of the loan packages will reduce uncertainty and discounts associated with it. Clear rules for the tender, applied equally to all bidders, will provide confidence that the process is fair. Finally, the next package sale should be seen as a part of a process: the first step in a predictable sequence of sales to dispose of all non-performing assets of CKA suitable for disposal through this method.

15. The increasing share of spending outside the State Budget poses a challenge for fiscal transparency. The Czech Republic meets many of the objectives set out in the *Code of Good Practices on Fiscal Transparency*, and the introduction of new budgetary rules in 2001 has contributed to an improvement in the accountability of public finances. Through its regular publications, the Ministry of Finance has maintained a high standard of public availability of information on government finances. However, the creation of extrabudgetary funds responsible for a significant share of public spending poses a challenge for the efficiency and overall control of public spending as well as for its transparency. Moreover, fiscal reporting does not reflect fully the potential for future fiscal risks stemming, for example, from past guarantees, tax concessions, or current commitments to cover future liabilities. The mission welcomes the disclosure of contingent liabilities, as reflected for example in the Czech Republic's last PEP. A further step toward making the role of government more transparent, as well as disclosing key areas of fiscal risk, would be to consider preparing and publishing an annual statement on contingent liabilities, tax expenditures, quasi fiscal activities, and current commitments entailing significant future obligations.

16. Financial sector stability has increased as a result of the completion of bank privatization. With the sale of Komercni banka, the bulk of the banking sector is now in private hands, most of it held by strategic investors. While the newly-privatized banks are likely to remain cautious lenders at first as internal reorganization proceeds, over the medium term the Czech economy should benefit from a more efficient banking system. The recently-approved amendment to the Banking Act contains a number of significant steps forward in providing an appropriate legal and regulatory framework for the financial sector, consistent with the EU *acquis communautaire.* A key feature of the new law is the extension of consolidated supervision to cover both credit risk and market risk. The mission also welcomes the strengthening of anti-money laundering provisions. Looking ahead, it will be important to ensure efficient cooperation between the agencies responsible for supervision of the different parts of the financial sector, as well as with foreign supervisors.

17. The legal and regulatory framework has improved, but problems remain. Two key areas are the reform of the bankruptcy process and of the commercial registers. The current bankruptcy process is still too slow and favors liquidation rather than restructuring. Proposals for a new bankruptcy law, which would address these shortcomings and strengthen creditor rights, are still at the drafting stage, and the mission encourages the rapid adoption of a new legislative framework after full consultation with the legal and business community. Even more important is the strengthening of the judiciary. Ongoing initiatives to encourage specialization of judges and the promotion of education and training are very important for

legal certainty and predictability. In the area of commercial registers, the amendment of the legal framework requiring a more rapid treatment of requests for entry or changes by the courts has not borne the expected fruits, and complaints of long delays remain widespread. Here, the solution would not appear to lie in further changing the law, but in ensuring its full application. Alternatively, commercial registers could be operated outside of the court system, as is the case in many advanced economies. In sum, there is still significant scope for improving the legal and regulatory environment to provide a better investment climate, for domestic and foreign investors alike.

18. Another key to sustainable medium-term growth is to increase labor market flexibility, so that more of the Czech population can enjoy the benefits of the catch-up process through higher employment and reduced unemployment. Ensuring an adequate supply of labor to match further incoming foreign capital will also help maintain a favorable environment for FDI. In this regard, the skill and regional mismatches, and the growing share of the long-term unemployed, are worrisome. One remedy for these problems is to attract FDI firms to regions associated with high unemployment, and the mission welcomes CzechInvest's efforts in this respect. The government's policy of gradually relaxing rent control will also facilitate labor mobility. The social benefit system provides an important safety net for the disadvantaged, but its undifferentiated application and too-high benefit levels relative to wage income the benefit recipients could earn if employed reduce incentives to work. A graduated decline in some benefits over time, stricter application of means testing, and adjusting the level of the Minimum Living Standard (the scale used to determine benefit levels and eligibility) to better reflect true minimum living costs, are likely to assist in avoiding the poverty trap, whereby some families would be worse off working than relying on benefits. Some workers in industries under restructuring receive occupation-specific severance benefits, but are not required to spend the benefits on activities targeted at obtaining new jobs. Part of these benefits should be linked to the workers' efforts to find new jobs.

19. Building upon the gains brought about by structural reforms and the emergence of a vibrant export-oriented sector, the Czech Republic has the potential for sustained rapid growth. Much has been achieved in the last few years. But to place the Czech Republic securely and irreversibly on a path of rapid convergence with its future EU partners, structural reforms must be accelerated. The mission urges the next government and parliament to move courageously to complete this agenda, realizing that it may imply some short-term costs. The challenge ahead will be to persevere, and to build a broad-based consensus in the process. We wish the Czech Republic success in its endeavors.