INTERNATIONAL MONETARY FUND

Czech Republic—October 2001 Staff Visit

Concluding Statement (Preliminary)—October 30, 2001

1. Following the recession of 1997–99, the Czech Republic has witnessed an acceleration of growth and transformation of its economy, facilitated by growing foreign direct investment (FDI). This has boosted employment and has enhanced the competitiveness of Czech enterprises through the introduction of new technologies and effective management. Supportive macroeconomic policies have helped the economic recovery, and progress with structural reform—particularly in the banking sector—has laid the foundation for sustained long-term growth. The challenge over the medium term is to further enhance the momentum of growth and reduce the income gap with the European Union (EU), while preserving hard-won disinflation gains and protecting the external balance. In the near term, economic management is complicated by uncertainty regarding the depth of the global slowdown following the events of September 11 and their aftermath on the one hand, and the prospects of large inflows of foreign capital on the other.

Current Macroeconomic Conditions and Prospects

2. Economic growth accelerated in the first half of 2001,supported by strong investment demand and a rebound in household consumption. Construction remained particularly strong, benefiting from FDI in greenfield projects. However, several indicators suggest a moderation of this pace, primarily reflecting the weakening of external demand and decelerating investment. Despite stronger-than-expected growth in the first half of 2001, we therefore maintain our GDP growth forecast of around 3.3 percent in 2001, which is based on a slowdown in the second half of the year. The outlook for 2002 is clouded by considerable uncertainty, but if the EU economies begin to recover in the second half of 2002, then the Czech Republic could realize a modest increase in its growth rate to around 3.5 percent.

3. Consistent with this outlook, we expect headline inflation to decline to around 4 percent by the end of 2002, comfortably within the Czech National Bank's (CNB) target range. While household consumption is expected to remain buoyant, demand-induced price pressures are likely to continue to be subdued due to strong competition in the retail sector. Sharp increases in food prices—the main factor driving up inflation from May through July—were attributable to temporary effects, and their unwinding is already taking place. Reflecting the openness of the Czech economy, weak external demand, particularly in Germany, will moderate domestic inflation by slowing the increase in traded goods prices, and by restraining growth in labor demand and thus easing wage pressures. The prospect of large FDI will continue to put upward pressures on the koruna, directly lowering the prices of tradable goods. Imported oil prices will also tend to suppress inflation in the future.

4. Pressures on the external current account deficit are expected to increase in response to the slowdown of demand in the Czech Republic's major trading partners. Although imports are also decelerating—reflecting some moderation of investment activity and the large import content of exports—the current account deficit is expected to widen to more than 5 percent of GDP in 2001, and could reach a similar order of magnitude in 2002 as well. Sizeable FDI inflows, including those related to privatization, will likely provide ample financing for the deficit, but their impact on the koruna is posing a major policy challenge (see below).

Macroeconomic Policies

5. Over the past couple of years, following the emergence of the Czech economy from recession, we have advocated a less stimulative policy stance by pursuing a more prudent fiscal policy and maintaining an accommodative monetary policy. In view of the deterioration in the external environment since our visit last Spring, we have slightly modified our policy recommendation. While we continue to emphasize the need for a more prudent fiscal policy, we call for a more accommodative monetary policy, making the overall macroeconomic policy stance broadly neutral. In addition to contributing toward medium-term fiscal consolidation, a more prudent fiscal stance at this juncture would help keep the external current account deficit in check at a time when external demand is weakening. A more accommodative monetary policy, within the constraint of inflation targeting, would help the domestic economy weather the global downturn, and would also tend to attenuate the koruna's appreciation.

6. When assessed against this policy mix prescription, fiscal policy continues to be a disappointment. The general government deficit, as defined for the purpose of measuring its aggregate demand impact, is projected to increase by about 1 percent of GDP in 2001, and slightly less than 1 percent of GDP in 2002 according to the government's budget proposal.[1] This implies that fiscal policy this year and next is quite expansionary.

7. More importantly, the 2002 budget contains no significant fiscal reform measures that are needed to improve sustainability of public finances over the medium term. As clearly stated in the 2002 state budget document as well as in the Czech Republic's Pre-Accession Economic Program submitted to the EU, the government considers large fiscal deficits to be the principal risk for the economy over the medium term. The budget document also characterizes the Czech demographics as a time bomb requiring a pension system reform that goes beyond the one implemented recently. It is therefore rather puzzling why the government, in full understanding of the situation, does not attempt to introduce fundamental fiscal reforms, in cooperation with other political parties that support fiscal responsibility.

[1] Privatization receipts, proceeds from the sale of UMTS licenses, and the expected repayment of Russian debt are excluded from the revenue side because, unlike taxes, they do not result in a decline in the domestic private sector's disposable income. Similarly, grants to transformation institutions to cover bank restructuring costs are excluded from the expenditure side, since they neither generate government demand for goods or services nor influence private sector income.

However, the question in this important area seems to have shifted by and large to what the next government can or will do.

8. Monetary policy was slightly tightened in July, when the CNB raised its key policy rate. Behind this action were the uncertainty connected with how quickly cost pressures would spill over to demand pressures and inflation expectations, a closing output gap, and an expansionary fiscal stance. Although these factors still remain, the balance of risks has shifted. In particular, the concern about the spillover has since subsided considerably, reducing the likelihood that the inflation target toward the end of 2002 and beyond will be overshot. In the meantime, the continuing appreciation of the koruna is effectively tightening monetary conditions. Therefore, in our view, there would be a strong case for the CNB to return to a more acommodative policy stance, but the room for easing is constrained by an expansionary fiscal policy next year, which prevents the policy mix we propose from being realized.

9. One major factor complicating the conduct of macroeconomic policies is the koruna's appreciation and its relationship with privatization inflows. We have argued over the past year or so that the koruna's appreciation was broadly consistent with fundamentals and that Czech firms' competitiveness was not being undermined. Although we have not fundamentally changed this evaluation, the continuing appreciation of the koruna, which led to the CNB's intervention last Thursday for the first time since March 2000, is a cause for concern. Many market commentators have attributed the appreciation to large FDI inflows, especially those associated with completed and expected privatization deals. The question is whether this appreciation will continue as other (and much larger) privatization deals are completed, and if so, how the authorities should respond to it.

10. In answering this question, it should be noted, first of all, that although the pending privatization deals will hopefully contribute to increased efficiency of the firms to be privatized, these are mostly domestic utility companies whose positive impact on external competitiveness is rather small. If the market correctly sees this, capital inflows resulting from the deals should not lead to a large and lasting appreciation of the koruna, even if the proceeds were fully converted in the market. This gives a certain rationale for the CNB's intervention when an appreciation is deemed to be a reaction to privatization, namely, a failure on the part of the market to correctly assess the impact of privatization inflows on the equilibrium exchange rate. Second, however, given the size of the Czech foreign exchange market, any major conversion of foreign exchange can have a disruptive short-term effect. This argues for a policy of sealing off a large part, if not all, of these privatization-related inflows from the market. Under this policy, the proceeds would be held by the government without conversion and/or would be converted to koruna funds through bilateral transactions with the CNB. We advocate this policy as a precautionary measure, particularly in light of weakening external demand that makes the Czech economy vulnerable to unwarranted exchange rate appreciation. Should part of the privatization proceeds need to be channeled through the market, this should be done gradually over time. Third, if the extent to which, and how, the proceeds are kept from the market is not firmly determined and a case-by-case decision is made for individual privatization deals, it will introduce uncertainty among

market participants about the possible (short-term) impact of the deals on the exchange rate, and become a potential source of speculation. A clear joint statement by the government and the CNB, specifying the rules according to which privatization proceeds will be dealt with, would be useful in dispelling this uncertainty.

Structural Policy Issues

11. The completion of the banking sector privatization with the sale of Komercni banka has created the foundation for the development of an efficient and competitive banking system. Provided that it is accompanied by a further strengthening of the legal and regulatory framework, including in the area of bankruptcy, the banks should be able to resume lending to the private sector, thus fostering sustainable economic growth over the medium term. At the same time, the clean-up of the banks' balance sheets has saddled the Czech Consolidation Agency (CKA) with a large volume of non-performing assets, which is set to grow further with the transfer of the bad assets of the old IPB. Bad assets do not get better over time, and disposing rapidly and efficiently of these assets should be the main objective of the CKA. The pool sale in early 2001, despite its low yield, was a success because it combined speed and transparency with a clear arms-length transaction. Future sales, in whatever form, should ensure that these same criteria are met. In particular, the CKA should strictly limit its involvement in enterprise restructuring, which is best left to the private sector.

12. As mentioned above, the Government is moving rapidly on its ambitious privatization program. While we support the objective of transferring assets to the private sector if their use would be demonstrably more efficient in private hands, both the process and the end result need to be well-guided by the public sector. The regulatory framework for the post-privatization period needs to be clear. And the privatization process needs to be marked by transparency and clarity.