AIDE MEMOIRE

IMF STAFF VISIT TO THE CZECH REPUBLIC, FEBRUARY 4–6, 2004

I. SHORT-TERM MONETARY POLICY CONSIDERATIONS

1. Economic growth is rebounding and prospects remain positive. Strong household consumption—underpinned by sharp real wage increases due to unexpectedly low inflation, and brisk consumer lending by banks—helped support!a solid pace of economic growth in 2003. For 2004, consumption growth is expected to moderate as real wage increases slow significantly. At prevailing exchange rates, competitiveness is sound. Recovering EU domestic demand and strong public sector investment are expected to support!growth of about 3.0 percent in 2004.

2. Notwithstanding the weakening of the koruna relative to the euro over the past year, underlying inflation through December remained subdued. Looking ahead, one-off indirect tax measures will temporarily raise measured inflation, but we expect underlying inflation to rise only gradually, and to exceed the bottom of the target band some 15–18 months from now. Risks to this inflation outlook appear balanced. Recovery in Europe is not yet in hand and a sustained increase or further rise in the value of the euro against the U.S. dollar could delay its appearance. But the pass-through to inflation of the cumulative koruna depreciation against the euro—especially in light of strong consumer demand—cannot be ruled out. In addition, the newly agreed increases in indirect taxes, which could add an additional 1 percentage point to headline inflation, may increase second-round inflation effects by triggering demands for real wage catch-up. We therefore consider the current stance of monetary policy to be appropriate and recommend that interest rate changes be kept on hold for now. Looking ahead, the Czech National Bank (CNB) will need to closely monitor these risks and continue to act preemptively.

II. FISCAL POLICY

3. The authorities have recognized the need for fiscal adjustment and have agreed on a path for lowering the deficit to 4 percent of GDP in 2006. We strongly support!these plans including pre-set expenditure ceilings. However, we believe that there is both the need and the scope to be more ambitious. Several arguments suggest that an appropriate target may be a deficit of 1½–2 percent of GDP—a deficit of this size would stabilize public debt at a low level, provide a sufficient cyclical safety margin to meet the Maastricht criterion, and strengthen the fiscal position ahead of intensifying budget pressures from population aging.

4. In light of the substantially better-than-expected outturn in the cash-based general government deficit for 2003, the deficit target for 2006 appears unambitious. However, since the overperformance in 2003 was due mostly to several one-off revenue and expenditure items, including the temporary postponement of investment spending, we agree that it does not warrant a change in the original 2006 deficit target. Nonetheless, we are concerned that

markets may interpret the small decrease in the deficit during 2003-06 as a lack of commitment to fiscal reform, which could undermine the credibility of fiscal plans. We therefore urge the authorities to better communicate to the public the reasons for the overperformance in 2003.

5. The government's recent tax package proposal does, however, provide an opportunity for more adjustment in the deficit in 2004 and 2005. The package—a reduction in the standard VAT rate, shifts of several items from the preferential to the standard rate, and changes to income taxes—is intended to be revenue neutral when fully phased in. But in 2004 and 2005, the tax changes will yield net revenue gains that may be a temptation for additional spending that risks becoming permanent. If this were to occur, reaching the 4 percent of GDP deficit target in 2006, an election year, would require measures to meet the planned reduction in the deficit in that year, plus additional measures to undo the expenditure counterpart to the higher temporary revenue gains of the preceding years. Spending the temporary tax windfall would also weaken the disciplining effect of the plan's pre-set expenditure ceilings. To avoid these problems, we strongly advise to use any temporary revenue gains for deficit and debt reduction. Moreover, any watering-down of the proposals to shift items to the standard rate will jeopardize the long-run revenue neutrality of the package.

6. Fiscal control and transparency could be greatly increased by broadening the targeted measure of the fiscal deficit to include gross lending. Until recently, this item was relatively small, but it more than doubled in 2003 to 1 percent of GDP and is expected to be 0.8 percent of GDP in 2004. While some of this may reflect transactions of a truly financial nature, there is the risk that lending with a significant subsidy element is also included in this category. Moreover, spending by the National Property Fund should be integrated into the pre-set expenditure ceilings as this would provide a broader basis for framing the needed expenditure reduction measures.

7. The fiscal policy horizon should extend beyond the current three years. To provide sufficient underpinnings for a euro adoption strategy, fiscal plans should be specified until at least 2009–10. The prospect of population aging also calls for lengthening the planning horizon. In light of its impact on fiscal sustainability, long-term pension projections—including the fiscal effects of possible reform measures—should be prepared and made public. This would highlight the long-term demands on the public budget and help generate broad-based consensus for the necessary reforms.

III. Euro Adoption Strategy

8. The government and the CNB have announced their intention to adopt the euro around 2009–10. This target date seems prudent as it allows time to assess and further the structural readiness of the real economy. We are encouraged that the Ministry of Finance and the CNB will jointly review on an annual basis progress toward this goal. The intervening period needs to be used productively for fiscal consolidation and to increase the flexibility of the real economy, including the labor market. We would however advise against announcing

a more explicit euro timetable that includes, for example, clarification of the entry date and milestones along the way until significantly more progress has been achieved with fiscal adjustment. Such an approach would avoid providing financial markets justification for reassessing the feasibility of euro adoption plans.

9. The monetary policy framework from 2006 until euro adoption will be an important component in the strategy for a successful entry into the EMU. The decision to continue with inflation targeting is sensible as it would help preserve past disinflation gains by keeping inflation expectations low and avoid a potentially disruptive monetary policy regime change. Moreover, by providing a consistent framework for monetary policy actions and combined with strong progress on the fiscal side, inflation targeting can help discourage excessive exchange rate volatility and increase the likelihood that the koruna enters ERM2 at an appropriate and sustainable parity.

10. Introducing a successor inflation targeting framework provides the opportunity to set targets in line with medium-term goals and to assess whether changes relative to the current framework are warranted. In our opinion, the target should shift from a band to a point with a tolerance margin as this would enhance transparency of the target and better focus expectations. Now that low inflation has been achieved, the target should be horizontal and open ended (even though it will obviously be set aside at the time of euro adoption), and continue to be based on headline inflation. We recommend setting the target point at 3 percent, which would allow a monetary policy stance similar to that in the euro area while accommodating structural sources of inflation differentials. Moreover, this target would avoid relaxing or tightening monetary policy when transitioning to the new framework. A tolerance margin of ±1 percent would signal commitment to the target, yet allow for forecast and implementation risk, as well as ensure a smooth transition to the new target. As the framework will be in effect several years before euro adoption, the choice of the target need not be exactly equivalent to the expected Maastricht criterion on inflation; doing otherwise could sacrifice real income growth in the intervening years.

11. The CNB has established regular and open communications with financial markets and the public. This communication includes statements regarding under what conditions monetary policy would not react to forecasted inflation moving outside the target band and reasons for missed targets. These clear communications are generally preferred to escape clauses—which can serve to undermine the transparency of the target. Moreover, while escape clauses may have provided a crutch in the early years of inflation targeting in the Czech Republic, effective communications make them largely redundant. Reducing the number and specificity of escape clauses would also move the Czech framework closer to other well-established inflation targeting frameworks.