Aide Memoire
IMF Staff Visit to the Czech Republic, November 9-11, 2005

A Fund mission conducted discussions with the Czech authorities during November 9-11, focused on the analysis of recent macroeconomic developments, policy implications of strong credit growth to households, and pension reform measures aimed at dealing with the consequences of a rapidly-aging population. This note summarizes the mission's views on policy issues and lays out recommendations.

Economic developments and prospects

1. **Economic growth remains strong based on robust net exports**. Although domestic demand softened in the first half of 2005—as investment growth slowed from last year's exceptional rates and consumption remained subdued—it was more than compensated by the increase in net exports. Growth is expected to reach close to 5 percent for the year as a whole, as growing cross-border integration of production continues to support net export growth. Domestic demand is expected to pick up somewhat in 2006, reflecting private and infrastructure investment, and a renewed cycle of inventory accumulation. Nevertheless, despite low real interest rates, the domestic demand recovery will remain fragile, partly reflecting the adverse effect of cost increases on disposable incomes and corporate profitability. The medium-term outlook is favorable, assuming progress in reforms to improve labor market flexibility and continued gains in export market shares.

2. **Underlying inflation is in check**. While increases in fuel and regulated prices pushed year-on-year headline inflation to 2.6 percent at end-October, net inflation (excluding effects of taxes and regulated prices) and core inflation (excluding fuel prices and unprocessed food) remain at around 1 percent. Slack in the labor market has helped keep wage pressures under control and strong competition has limited the pass-through of cost increases to prices. Cost increases from rising fuel and electricity prices are being partially offset by koruna appreciation. Long-term inflation expectations of financial markets remain well anchored below the 3 percent inflation target, largely reflecting central bank (CNB) credibility.

Monetary Policy

3. **In this environment, the CNB can take time assessing conditions before further policy rate increases**. Looking ahead, there are neither visible demand-side pressures nor evidence to suggest that fuel and regulated price increases would lead to significant second-round effects. First-round effects of these increases are projected to take inflation above 3 percent in early-2006, but they should fade quickly after that. The preemptive increase of the main policy rate by 25 basis points on October 27—which signaled the CNB's determination to maintain price stability—brought to an end the easing cycle initiated by the CNB a year ago and eliminated the negative interest rate differential against the main ECB rate. Although a tightening cycle in the quarters ahead appears reasonable given above-trend growth, in the mission's view, it might be appropriate to wait for evidence of underlying inflationary pressure before the next move on rates. In the meantime, CNB communications

can continue to convey readiness to act swiftly if such evidence becomes available, and aim at moderation in wage settlements.

Fiscal Policy

4. **2005 budget execution is overperforming**. The general government deficit target of 5 percent of GDP in 2005 is likely to be significantly undershot, owing mainly to robust tax performance and a slowdown in goods and services spending in the state budget. Staff projects the general government deficit on an adjusted cash basis (excluding privatization financed net lending and grants to transformation institutions) to reach 2.8 percent of GDP, which implies a slight decline in the structural deficit compared to 2004. This budget execution is commendable for it has contributed to the positive macroeconomic performance, where above-trend growth has coexisted with low inflation and interest rates, and a narrowing external current account deficit. But these developments do not provide comfort for the coming years.

5. **The 2006 budget proposal could reverse these gains**. Fiscal performance in 2005 masks underlying risks, because budgetary underspending of over 1 percent of GDP will be transferred into reserves for the coming year. Full implementation of the 2006 draft budget—with a deficit of 4 percent of GDP—and the spending authorizations from reserves would imply an increase in the structural deficit of around 2½ percent of GDP. There is a danger that a reversal of fiscal policy of this magnitude could fuel inflationary pressures, and an expansionary stance in 2006 would entail a more sizable monetary tightening, given the significant supply shocks already faced by the economy. The mission thus recommends maintaining a broadly neutral fiscal policy stance for the coming year.

6. **The 2006-08 budget represents a missed opportunity to advance consolidation and raises implementation risks for the medium-term fiscal plans**. The upward revision of medium-term revenue forecasts may be too sanguine—it assumes that most of the overperformance of revenues is structural, when indeed part of it reflects cyclical factors. And this revision has unfortunately allowed an increase in planned expenditures, as spending measures identified in last year's Convergence Program were rejected. The resulting breach in spending ceilings and implied increase in the structural deficits calls into question the credibility of the medium-term fiscal framework. Furthermore, the less conservative revenue assumptions and backloading of consolidation makes the fiscal position more vulnerable in the run-up to euro adoption. The expenditure drift also reduces the scope for any sustainable future tax reform aimed at reducing the tax burden. This is regrettable, given looming challenges for debt sustainability from the drying up privatization revenues, large risky outstanding guarantees, and rising population aging pressures. Dealing with these challenges requires a renewed commitment to fiscal consolidation aimed at achieving fiscal balance by early next decade.

7. **The revision of the expenditure ceilings and the significant carryover of reserves underscore weaknesses in the fiscal framework and risks for fiscal policy control**. Part of the reason for the overperformance in recent years is related to systematic overbudgeting of

expenditures, which, combined with the provision for carryover of unspent allocations can lead to a loss of budgetary control in the future. The present system *de facto* delegates partial control over fiscal policy to individual ministries, as they face increasingly loose constraints on their spending decisions. While this approach to fiscal affairs is risky and nontransparent, it has provided the right incentives to save, and led to good fiscal outcomes so far. But the period ahead—with elections scheduled in June 2006—may test the resilience of fiscal discipline under the present fiscal management system. Moreover, the lack of a single treasury system complicates expenditure management and results in higher fiscal costs, as it requires a larger cushion of cash to protect against the uncertainty of volatile fiscal flows.

8. **In this context, the mission recommends that substantial institutional measures be undertaken to prevent further erosion of fiscal policy control by the Ministry of Finance**. Specifically, budgeting procedures and management need to be improved including through expenditure audits and program budgeting. The fiscal framework needs to be strengthened through a stronger legal standing and effective enforcement mechanisms. The government should adhere to original spending limits. Fiscal policy also needs to be more transparent through improvements in fiscal accounting and publication of budget execution data, to ensure accountability and allow proper coordination of macroeconomic policies. Taken together, these measures will help restore the effectiveness and credibility of the fiscal framework and provide the basis for a more predictable fiscal policy.

Public Pension Reform

9. **The Czech Republic is projected to age at one of the fastest rates in Europe over the next few decades**. By 2050, the elderly will account for 53 percent of the population, and the working-age population will shrink by 22 percent compared with 2005. Long-term debt sustainability and fiscal scenario analysis projects budgetary spending on pensions and health care to rise to 21 percent of GDP by 2050 from about 14 percent in 2005 and debt to reach 100 percent of GDP by 2025.

10. **To address fiscal sustainability concerns arising from this demographic shift, political parties have prepared reform plans**. These proposals vary significantly in terms of the overall paradigm for old-age income support and the parametric changes required to restore viability of public pensions. While some envisage a sole objective of poverty relief for public pensions, others foresee broader goals of safety net provision and old-age income insurance. Yet, other proposals plan a more limited role for public pensions and rely more on private sources for income replacement.

11. **Consensus on the new pension model has not been achieved so far, and in the meantime discussions have focused on measures that can be implemented relatively easily**. Specifically, these are: an extension of retirement age to age 65; prefunding of projected pension debt using privatization revenues and pension surpluses; and fiscal incentives for voluntary savings. Discussions are also on-going on the issue of increasing labor force participation in the context of welfare reforms.

12. **Staff analysis suggests that these near-term measures will not be sufficient in restoring pension system viability**. More far-reaching reforms in the public pension system are needed. Even if the new pension model envisages a shift to private funded pensions, existing retirement incentives need to be reviewed, as there are indications that the existing pension system provisions can discourage continuing labor market participation. The weak link between contributions and benefits also increases the risk that, given a choice, a significant number of contributors could switch out of the system. In addition, pension benefit reform and fiscal consolidation will be needed to create reserves for pre-financing pension system deficits or transition deficits. Early implementation of these reforms will help reduce welfare costs over the long run and lower the burden on the young. The mission thus recommends:

- Increasing statutory retirement age with accompanying measures to ensure that the effective retirement age also rises;

- Prefunding reserves for pension deficits through fiscal consolidation measures, in addition to the foreseeable pension surpluses and privatization revenues, while ensuring good governance for fund management;

- Postponing further retirement saving incentives until a cost-benefit analysis of the existing incentives is undertaken; and

- Implementing a parametric reform that will reduce the implicit pension debt and increase the rate of return of the pension system by strengthening the link between contributions and benefits.

These measures need to be implemented irrespective of the choice of the new model adopted, as they will help facilitate the transition to the new system, while lowering fiscal and welfare costs of aging.

Household credit growth and financial stability

13. **Household sector credit has expanded at a fast clip in the Czech Republic in recent years**. This credit growth largely reflects the process of financial deepening, which has been facilitated by the privatization of banks and the reorientation of their activities toward household lending. Cyclical factors (such as strong GDP growth or low interest rates) appear to have played a secondary role in stimulating credit growth, and there is no evidence so far of overheating or an asset price boom. Although rising, aggregate household indebtedness remains moderate by international standards.

14. **The financial system is sound and resilient to adverse shocks**. Banks, most of which are foreign-owned, are highly profitable and well capitalized. Moreover, efforts are on-going to strengthen financial sector surveillance and continue to preserve financial stability, including through the introduction of Basel II regulations.

15. **At the same time, household credit growth may entail prudential risks**. Risks appear to have been limited so far, although a broader loss in confidence or interbank contagion under a severe adverse shock cannot be ruled out. The build-up of financial risks has been associated largely with rapid growth in housing credit, partly fueled by certain features of the regulatory framework for construction saving, as well as a recent acceleration of consumer credit growth. This dynamic lending environment—although positive for consumers—puts a premium on individual bank risk management practices.

16. **In this light, staff recommends focusing policy responses on supervisory and prudential measures to prevent an excessive build-up of financial risks**:

- Ensuring good risk management at the bank level through supervision is a priority. Particular attention needs to be given to the practices of rapidly-expanding and vulnerable institutions;

- Strengthening the prudential framework through risk-based, forward-looking measures implemented in a way that ensures a level-playing field and limits costs for banks;

- Continued improvements in data collection, analysis and exchange at the CNB to help make supervision more proactive.

In addition, the mission recommends an independent review of the housing credit market to assess implications of the current regulatory framework for financial soundness and development.

****

We thank the authorities for stimulating and open discussions, and for their cooperation and hospitality.