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Statement by Mr. Kiekens on The Czech Republic—2002 Article IV Consultation Executive Board Meeting 02/80 July 26, 2002

Introduction

Despite its very high degree of openness, the Czech economy has so far been relatively unscathed by recent adverse external developments. Czech growth in 2001 was relatively robust, and remains so in 2002 as well. Nevertheless the slower than expected EU recovery and the koruna appreciation should somewhat slow the growth of GDP. The staff has lowered its projection of GDP growth in 2002 from 3.2 to 2.9 percent, while the Ministry of Finance's last quarterly projection lowers it from 3.4 to 3 percent.

Given its limited dependence on external borrowing, the Czech Republic was largely unaffected by investors' recent disenchantment with emerging market countries. Sustained large inflows of foreign direct investment have been more than sufficient to finance the current account deficit while simultaneously supporting strongly growing investment demand and helping to offset the effect of negative net exports on output growth. Companies under foreign control represent the most dynamic segment of the Czech economy. In May, overall industrial sales in real terms increased by 2.6 percent year on year, while industrial sales of companies under foreign control grew by almost 10 percent.

The past year was also a period of rapid structural changes within the Czech economy, connected with extensive privatizations, improvements of corporate governance, and more careful bank lending policies. Unfortunately the unsupportive external environment did not cushion the temporary but unavoidable costs of this rapid restructuring, the worst of which was the increase in worker layoffs. And rapid appreciation of the koruna put additional pressure on the corporate sector. These factors helped prolong the period of high unemployment, but also led a rapid reduction of inflation, which fell to 1.2 percent in June, its lowest level since September 1999.

Exchange Rate Developments and Monetary Policy

According to the Global Market Monitor for July 1, the second quarter of this year saw the koruna appreciate by 20 percent against the dollar, a stronger appreciation than any other emerging market currency. From the staff report one might draw the impression that some Czech officials and private analysts were not much concerned about the effect of the stronger currency. But the koruna's further strengthening since the time of the discussion with the staff has increased these concerns.

The managers of several companies have called on the government and the Czech National Bank (CNB) to find a way of arresting the currency appreciation, and there is some anecdotal evidence that some Czech companies have already been priced out of the market by the strong koruna, and that several large companies are turning to foreign suppliers.

The question to be answered is to what extent the currency appreciation represents an equilibrium phenomenon reflecting the productivity enhancing effects of FDI, and to what extent it is simply an exchange rate misalignment. The large FDI inflows of recent years
should certainly contribute to an appreciation of the real equilibrium exchange rate. But the speed and size of the actual appreciation raises the question whether the FDI inflows are the only force or the principal force driving the currency movements.

First, as shown by Table 31 in the Statistical Appendix, a large part (about half) of FDI inflows went to non-manufacturing industries, whose potential for increasing competitiveness and strengthening exports is limited. And second, even in the manufacturing sector, not all firms can benefit from productivity-enhancing FDI flows: many find it difficult to cope with a rapid large currency appreciation that gives them little time to cut costs, start new investments, reorganize production, or otherwise adjust to the new environment. Some can do it, others cannot.

The authorities tried hard to limit the currency appreciation. The staff explains how the government and the CNB agreed to exclude privatization-related inflows of foreign currency from the foreign exchange market. The CNB has several times reduced interest rates, most recently yesterday, when it cut short-term interest rates by 75 points to 3 percent; and has also intervened in the foreign exchange market. The CNB has also warned publicly against the possible emergence of an exchange rate bubble. The staff is more cautious about the "bubble" interpretation, arguing that it is hard to know the equilibrium level of the exchange rate. But the CNB has in mind a somewhat different kind of bubble: it was referring to the speed of the appreciation rather than the level of the exchange rate. The CNB spoke out about the possibility of an exchange rate bubble specifically to warn against the risks of a currency appreciation followed by a sudden reversal.

The new Prime Minister has said that dealing with the effects of the strong koruna will be a major priority for his government. In August, he is to meet and discuss this issue with the central bank governor and the finance minister, on the basis of a report prepared by the working group of specialists presently being convened from the CNB and the Ministry of Finance.

In addition to its effects competitiveness, the koruna appreciation also strongly affects inflation, because in the very open Czech economy, imports exceed 50 percent of GDP. The large appreciation of the koruna has contributed to this year's rapid decline in inflation, which has brought it below the CNB's target band. Under the inflation targeting framework's escape clauses, deviations from the target are allowed if they result from unexpected changes in the exchange rate or world commodity prices. But the currency appreciation also affects other variables that influence the CNB's monetary policy decisions, and large exchange rate swings complicate the conduct of monetary policy.

Fiscal Policy

During last year's Board discussion on the Czech Republic, many Directors called for a fiscal policy tightening to restore the long-term sustainability of the public finances and prevent the current account deficit from widening. In the end, both the adjusted general government deficit and the current account deficit decreased somewhat during 2001. But the decrease was more the result of temporary factors than of real progress in solving the structural problems of the Czech Republic's public finances. Now the data for the first half of 2002 show that state budget deficit only reached CZK 0.9 billion. This result, too, mostly reflects one-time receipts from privatization and partial repayment of the Russian debt. By the end of this year it is projected that both the state budget deficit and the general government deficit will widen significantly.

This widening is unlikely to complicate macroeconomic management very much in the short run, for several reasons. First, the public debt remains low, liquidity in the economy is ample, and there will be no problem in issuing new debt to finance the part of the deficit that will not be covered by privatization revenues. Second, with inflation near its historical low and demand pressures absent, budgetary developments are unlikely to create inflationary pressures. And third, despite the stronger koruna it is not projected that a widening of the budget deficit will push the current account deficit above last year's level in 2002.

Nonetheless it is easy to understand the staff's concern about the implications of fiscal developments. There is a large outstanding stock of government guarantees that may need to be recognized at some point, and these, combined with continuing and even growing large fiscal deficits and the eventual

exhaustion of privatization revenues, will eventually add up to a sizable increase in the stock of public debt and debt service costs. This could complicate the fiscal deficit reduction required by the Maastricht criteria, and delay the Czech Republic's entry into the European Monetary Union.

CSSD, which has a majority in the new coalition government, attaches high important to the maintenance of a generous social security system. Without serious reforms of social spending, future budget deficits are likely to increase significantly. The smaller center right party in the coalition government would prefer a larger reduction in government deficits, but the coalition agreement between the two parties assumes a very gradual reduction of the general government deficit to 4.9--5.6 percent of GDP in 2006. However, the new Government's official economic policy program has yet to be finalized, and the new finance minister does not consider the deficit figures in the coalition agreement as targets, but as maximum permissible ceilings. It is his ambition to bring these deficits well below those levels.

The Ministry of Finance is preparing to make an important change in the fiscal policy framework. For the first time there will be a medium-term fiscal framework covering the whole period of the present government, till 2006. Since a similar medium-term framework for monetary policy is already in place, combining this new fiscal policy framework with the strategy for achieving EMU accession (see below) should produce a new integrated framework for economic policy, define the strategy for EMU accession, and anchor market expectations.

EU/EMU Accession

The new Government has declared that early accession to the EU is its first priority, and it intends to complete the negotiations quickly and close the remaining chapters by the end of 2002. But the strategy for adopting the euro and joining the monetary union has not yet been formulated. Discussion is lively concerning the merits of fast versus slow adoption of the euro. Some discussants stress the need to make more progress with fiscal consolidation and increase labor market flexibility before adopting the euro; others emphasize the risks of volatile capital flows and financial instability to which a small, open economy with a fully liberalized capital account is exposed, and argue in favor of quick EMU accession.

The CNB is presently working on an analytical study of these issues, which will be discussed with the Government later this year. This discussion should lead to the formulation of a strategy for the EMU accession, as recommended by the staff.

Other Issues

The new Government maintains the commitment to complete the privatization. It also recognizes the benefit of FDI for the Czech economy, and attaches great importance to maintaining an attractive investment climate for foreign companies and using market incentives to direct foreign investment to areas with high unemployment.

The new Government recognizes the problem of high unemployment highlighted in the staff paper, and particularly the increase in long-term unemployment. Measures aimed at dealing with these problems will be the core of the new Government's employment policy.

Finally, the authorities understand the urgency of a rapid disposal of assets taken over from banks by the Czech Consolidation Agency (CKA). The longer these assets are held by the CKA, the more their market value will diminish. On July 10, the CKA launched a tender for the first package of assets with a nominal value of CZK 37.8 billion, which is expected to be completed by the end of September.

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Concluding Remarks by Mr. Jonas on
The Czech Republic
Executive Board Meeting 02/80
July 26, 2002

Mr. Chairman

I wish to thank Directors for their thoughtful comments and advice. I cannot promise that the Czech authorities will follow all of it, but I will certainly convey the Board's views to my authorities.

It is not surprising that Directors directed most of their remarks to the fiscal and exchange rate issues and the EMU accession.

Many Directors were concerned about fiscal developments and my authorities' medium-term fiscal strategy. I think it is useful when discussing discuss fiscal policy to distinguish between the short- and long-term perspectives. For the short-term, there is less cause for serious concern about fiscal policy. The public debt remains low, the fiscal deficit can be easily financed, inflation is low, and fiscal policy is not giving rise to excessive demand pressures. Given the braking of growth by global weakness and the appreciation of the koruna, we may even wonder if a sharp fiscal consolidation might be appropriate from cyclical standpoint.

But for several reasons, fiscal developments may have more serious implications for the long term. First is the financing aspect. At some future time privatization revenues will dry up and the authorities will have to issue more debt to finance the fiscal deficits. This would result in a more rapid increase of debt and debt service costs, especially if interest rates should also go up. Second, continued and even wider fiscal deficits could damage growth. Mr. Chatah mentioned that while the investment/GDP ratio in the Czech Republic is very high, we have yet to see the full benefits of this investment boom in terms of higher growth. Large fiscal deficits financed by borrowing would crowd out private investment and reduce future growth. And finally, the speed of the fiscal consolidation will affect the timing of the Czech Republic's EMU accession.

Concerning the EMU accession, there are two possibilities. First, the moment of EMU entry might be deliberately postponed after examining the costs and benefits of an early versus a somewhat delayed entry. The market would probably not react adversely to a deliberate postponement of EMU membership. In the second scenario EMU entry would be delayed by the authorities inability or unwillingness to reduce fiscal deficits to the necessary minimum level. In such a case the market reaction might be much less benign, particularly if other countries like Hungary and Poland were able to join EMU at an earlier stage.

For these reasons, I agree with Directors that there is a strong case for acting forcefully and soon to bring the fiscal situation under control. Most Directors also felt that the relatively high level of government spending makes it preferable to pursue fiscal deficit reduction by cutting expenditures. Mr. Varela took a somewhat different view. He noted that compared with the EU average, the Czech Republic's public spending-to-GDP ratio is relatively low, making room for government revenues to increase further. Some increase in government
revenues is likely to result from the EU tax policy harmonization, but I think that an immediate convergence of government revenues to the EU level would slow growth and delay real convergence with the EU.

Several Directors mentioned reports in the press that the Czech authorities are planning to raise the minimum wage from 40 percent to 60 percent of the average wage, and that the public deficit will be

reduced to only some 5 percent of GDP by 2006. Let me point out that now, so soon after the election and before the government has finalized its program, the noise-to-signal ratio is very high and press reports should be seasoned with several grains of salt. In few weeks, once the government has finalized its program, we will have more authoritative information about its policy intentions.

Overall there is good reason to hope that this government will begin gradually addressing the fiscal problems. This is a very young government: the minister of finance is only 30 years old, and he and his colleagues will have to live for a long time with the consequences of their policy decisions, including the reformation of the pension and social systems.

I will comment only briefly on monetary and exchange rate policies. Several Directors have suggested that the present monetary policy framework could be changed by introducing a ERM2-type band for exchange rate fluctuations. And Mr. Kranen has suggested replacing the inflation targeting band with an inflation ceiling like that of the European Central Bank. The Czech National Bank (CNB) has invested a lot of effort in creating a well-functioning inflation targeting framework, and I think they have done a pretty good job. At this stage, there is little reason to second-guess that framework in this way.

Many Directors mentioned the Czech Republic's EMU accession, and they agreed with the staff about the desirability of spelling out the strategy for EMU accession so as to provide an anchor for market expectations. Our buff statement explained that the CNB is currently working on a paper about the options for the EMU accession. These will soon be discussed with the government. By the time of the staff's November visit, the strategy will already be formulated and the staff can have an interesting discussion about it.

In ending, Mr. Chairman, permit me one comment on the effectiveness of Fund surveillance. This issue was raised two days ago during our discussion of Japan's Article IV report, and several Directors raised it again today, in connection with my authorities' apparent disregard of staff's and Directors' concerns about fiscal developments. I would like to encourage the staff not to feel frustrated. Even though its advice is not always followed promptly and fully, the staff's views are listened to in the Czech Republic, and they carry weight during policy deliberations. The staff should continue its candid policy dialog with my authorities. I think that in the medium-term there will be a convergence between the staff's policy recommendations and the policies implemented by my authorities.

Thank you, Mr. Chairman.