International Monetary Fund

Czech Republic—2006 Article IV Consultation

Concluding Statement

November 21, 2006

1. **The sharp acceleration in economic growth in 2005–06 with continued low inflation has placed the economy on a firmer footing**. The momentum of recent growth has been sustained by strong productivity gains and rapid expansion of exports, underpinned by the emergence of the Czech Republic as a regional hub for automotive manufacturing. The external current account deficit has narrowed and the koruna has strengthened. This impressive performance reflects past policy reforms and growing integration with the European Union. However, sustaining this success calls for continued political commitment to fiscal consolidation and structural reforms in labor and product markets.

2. **The uncertainty created by the prolonged political stalemate should not be allowed to deflect policymaking from the pursuit of necessary reforms**. Financial markets have taken the political uncertainty in stride, assured by the economy's recent strong performance, the generally sound fundamentals, and a record of responsible governance. However, the experience of emerging markets suggests that policy drift, if allowed to persist, can be costly over the medium term. It is thus important to guard against complacency and competitive populism.

3. **Economic growth is expected to remain robust in 2007, albeit slowing from its current rapid pace**. Real GDP is projected to rise by just under 5 percent, with domestic demand becoming the primary driver of growth. Private consumption will strengthen,

supported by gains in disposable incomes and low interest rates. Business investment will remain strong as integration of global supply chains continues. With the projected recovery in the euro area and a favorable competitive position, exports should remain buoyant, although, with rising imports, their net contribution to growth will decline. The current account deficit will continue to be comfortably financed, largely by foreign direct investment flows. Headline inflation is expected to rise, but remain around the target of 3 percent. The risks to the outlook for growth are tilted to the downside. A downturn in major markets or a sharp rise in global interest rates will have an adverse impact on growth. Moreover, the economy may not remain entirely immune to a sharp reversal in investor sentiment towards the region. At home, a worsening fiscal outlook under uncertain political prospects could well begin to take its toll on investor confidence.

4. **A large pre-election fiscal relaxation has reversed the recent favorable trend in public finances in 2006**. The general government cash deficit (excluding privatization receipts and transfers to transformation institutions) is estimated to widen to about 3¾ percent of GDP, reflecting higher social transfers for pensions and health care and tax cuts for low-income households. Fiscal policy is thus adding a strong procyclical impulse of about 2½ percent of GDP to an already booming economy. Higher revenues have been used for raising mandatory social spending and tax cuts. Together with the large social spending in the pipeline, this trend points to a weakening political commitment to fiscal prudence and a missed opportunity to advance fiscal consolidation in good times.

5. **Rationalizing relatively inefficient spending can help contain the fiscal deficit in 2007 while maintaining the quality of public services**. The draft budget implies a further increase in the structural deficit. With growth projected to remain above potential, a counter-

cyclical fiscal stance would be desirable. At this stage of the budget process, at least a neutral policy stance is warranted, which would require additional measures amounting to ½ percent of GDP. The focus should be on cuts in relatively inefficient spending rather than discretionary areas, such as capital spending. For instance, better targeting of the recently approved social transfers could provide room to trim spending.

6. **Looking ahead, major spending pressures loom on the horizon**. The phasing-in of the social benefits package will add to fiscal deficits in 2008–09 and limit the fiscal room for maneuver due to higher mandatory entitlements. Moreover, claims on the budget for co-financing of EU-funded projects are expected to rise as the pace of project implementation picks up from its current low level. Although public debt is low at present and the outlook over the next few years is broadly favorable, debt dynamics could be adversely affected by risky guarantees for infrastructure projects, bank restructuring, and environmental cleanup, especially as financing from privatization proceeds shrink. Further risks arise from ongoing arbitration cases involving compensation to foreign entities. Above all, the impending aging-related pressures on public spending—projected to be among the highest in the EU over the coming decades—suggest that the window of opportunity to fund pension reserves is limited.

7. **A renewed political commitment to expenditure-based fiscal consolidation is necessary to address these pressures**. We welcome the authorities' proposal for an annual reduction in the structural deficit by ½ percent of GDP in the forthcoming Convergence Program. In addition, we also recommend aiming for a structural fiscal balance or a small surplus by early in the next decade. The recent rapid economic growth suggests that more ambitious fiscal targets over the medium term are desirable to widen the room for countercyclical policy in a downturn. With a relatively high tax wedge and corporate income

tax rate, fiscal consolidation will need to rely primarily on spending restraint. In this regard, any new tax proposals would need to ensure budget neutrality. Expenditure restructuring should be guided by the relative efficiency of spending and the need to enhance its flexibility. This will be especially crucial as the Czech Republic prepares to enter the monetary union. In this context, the following spending areas are key priorities for reform:

- **Social transfers**: The efficiency of social benefits can be improved by better targeting transfers to low-income households. For instance, the share of the Czech population receiving social welfare assistance exceeds that in most other new EU member states. Moreover, the state budget covers the health insurance premia of over half the population, regardless of income. Consequently, there is scope for reducing social transfers without adversely affecting low-income beneficiaries by increasing the role of means testing.

- **Health care**: The public healthcare system has been under growing financial strain in recent years, which will intensify with population aging. As the private share of total healthcare spending is among the lowest in the EU, introducing co-payments on a means-tested basis would help contain demand pressures. Structural reforms are also needed to address rising healthcare costs. Key steps in this direction include (i) providing a greater role for private sector provision and insurance to reduce pressure stemming from broad public healthcare coverage; (ii) rationalizing excess healthcare facilities; (iii) reducing the high share of drug costs in healthcare spending; and (iv) reforming the inefficient hospital financing mechanism.

- **Pensions:** Spending on pensions is set to rise gradually to 14 percent of GDP by 2050 from about 8 percent in 2005. To address these spending pressures, the mission recommends an early phase-in of a higher retirement age and additional parametric reforms 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 pension model adopted, as they will help facilitate the transition to the new system, while lowering fiscal and intergenerational welfare costs of aging.

8. **Institutional measures are needed to enhance public financial management and support fiscal reforms**. Specifically:

- The recent upward revision of the medium-term expenditure ceilings, despite stronger-than-expected growth, suggests the need for renewed political commitment to comply with spending ceilings and the rule requiring any windfall gains to be saved.

- While recent measures to limit the carryover of unspent allocations of individual ministries is a step in the right direction, further limits on the drawdown of these reserves are necessary to prevent a loss of budgetary control.

- Budget management can be improved through expenditure reviews and increased reliance on performance budgeting.

- The introduction of a unified treasury system would also help to strengthen expenditure management.

- Fiscal transparency can be enhanced by integrating extrabudgetary funds in budget preparation, reporting and implementation. In this context, the mission welcomes the authorities' efforts to introduce *GFSM 2001*-based fiscal accounts as an initial step towards reconciling the large differences in the cash and accrual-based fiscal data.
- Finally, emerging public-private partnerships in infrastructure projects should be underpinned by an appropriate regulatory framework to ensure that they deliver value for money while controlling contingent liabilities.

9. **With inflation close to the target and expectations well anchored, the Czech National Bank has pursued a measured pace of monetary tightening**. Upside risks to inflation have stemmed from capacity constraints, the fiscal loosening, and potential second-round effects of energy price increases. However, the CNB has been mindful of the offsetting impact of a strong koruna and continued wage moderation, assisted by the lingering labor market slack and inflows of foreign labor. The CNB has also considered structural influences, such as robust productivity growth and shrinking margins reflecting growing global competition and the role of international retail chains.

10. **Looking ahead, a continued cautious pace of monetary tightening would be appropriate**. Headline inflation is expected to rise gradually over the monetary policy horizon, driven partly by increases in excise taxes for tobacco, rents, and other regulated prices. Underlying inflation is also set to creep up as domestic demand strengthens against the backdrop of negative real interest rates and an expansionary fiscal policy. The CNB will be assessing incoming data in the context of the uncertainties in estimating the output gap. The pace of global monetary tightening and the course of the koruna will be important. The

CNB will also need to give due weight to the evolving stance of fiscal policy and the prospects for continued wage moderation.

11. **Plans to clarify the strategy for entry into the European Monetary Union are welcome**. Euro adoption remains an important opportunity for reaping the gains from enhanced trade and investment. A delayed timetable for euro adoption was widely anticipated and by itself should not constitute a significant setback. However, the delay underscores anew the critical role of adhering to the path of strong fiscal consolidation, strengthening the institutional fiscal framework, and enhancing the flexibility of labor and product markets. Policy credibility on these fronts will be all the more crucial not only during the transition to the euro but in order to maximize the eventual gains from adopting it.

12. **The banking sector appears to be in good health, but faces challenges**. Lending to households—mortgages, and more recently consumer loans—has expanded at rapid rates in recent years, raising household debt and credit risks. Although remaining above the minimum levels, banks’ capital cushions have declined as balance sheets expanded and are expected to decline further when the new capital accord is introduced. The financial sector supervisory framework is undergoing significant changes following the recent integration of banking, insurance, and securities supervision under the CNB. Against this backdrop, ensuring that supervision remains proactive, risk-based, and forward-looking becomes increasingly important. Supervision of rapidly growing institutions and cooperation with foreign supervisors need to be strengthened. Consideration could be given to refining prudential regulations further, for example, by differentiating provisioning or capital requirements across banks by the degree of risk they face, and encouraging best practices in stress testing by banks.

13. **A more flexible labor market is needed to enhance growth potential and the economy's resilience to shocks**. A high tax wedge and disincentives to work embedded in generous welfare and early retirement programs weaken incentives to work, reducing participation rates for younger and older workers in the face of population aging. The recent decision to phase out rent controls should help reduce geographical mismatches between labor demand and supply, but the new labor code has missed the opportunity for substantive progress in improving labor market flexibility, particularly in the area of employment protection.

14. **Further steps to improve the business climate would help preserve the attractiveness of the Czech Republic to investors**. Recent legislative initiatives in this area are encouraging. A new law is expected to speed up the bankruptcy resolution process, which is among the lengthiest and costliest in the world. The next task is effective implementation of the new law. Introduction of e-government and "one-stop shop" for company registration and licensing would also be important in reducing the cost of doing business. Continued efforts towards divestment of state holdings and limiting state support of strategic companies would help promote greater efficiency.