International Monetary Fund

Czech Republic—2008 Article IV Consultation

Concluding Statement

November 24, 2008

1. **Strong fundamentals have helped the Czech economy weather the global financial crisis over the past year.** Robust productivity growth, improved fiscal performance, and a comfortable external position supported by inflows of foreign direct investment placed the economy in a relatively favorable position. The strong koruna helped contain inflation, despite a sharp rise in the prices of food, fuel and utilities, and sustained demand pressures. However, in recent months, clear signs of spillover from the global crisis have begun to appear. The speed and enormity of the spreading financial turmoil and the depth of the downturn in advanced economies suggest that the authorities need to be ready with speedy policy responses to preserve financial stability and mitigate the risk of a hard landing.

2. **Following three years of exceptionally rapid expansion, the economy is set to slow sharply next year amid a gathering recession abroad and tightening credit at home.** With economic growth already moderating to about 4 percent in 2008, reflecting a slowdown in domestic demand, we project a sharp slowdown in 2009 to around 1½ percent. The shrinking demand from the euro area, and Germany in particular, will sharply curtail export growth and direct investment inflows. Meanwhile, tightening credit conditions at home will weigh on capital spending, offsetting the stimulus from the new automobile plant and the rising inflows of EU funds. Household consumption is expected to grow only modestly as plummeting confidence and rising unemployment overshadow the favorable impact of declining inflation

on real disposable incomes. Risks to this scenario are clearly tilted to the downside, stemming primarily from a possible credit crunch that could hold back spending by corporations and households, and a deeper-than-projected recession in the eurozone.

3. **A strong koruna helped keep inflation pressures in check, creating room for monetary easing as demand pressures abated.** The policy stance shifted in mid-year in view of the changing balance of risks between inflation and growth, amid a sharply rising koruna. Indeed, the Czech National Bank (CNB) was the first central bank in Europe to reverse the tightening policy cycle in August 2008. As the ripple effects of the global slowdown and the financial crisis began to impact the economy, the CNB acted aggressively in early November to cut the policy rate by 75 basis points, exceeding market expectations.

4. **With inflation likely to fall below the CNB's target of 3 percent amid a sharp slowdown, scope exists for further easing.** Even if the recent reversal of the koruna appreciation were to continue for some time, falling commodity prices and weakening demand are projected to reduce both core and headline inflation, with the latter expected to decline to 2½ percent in 2009. Under the shadow of ongoing turmoil in financial markets and uncertainty about the effectiveness of the traditional channels of monetary policy transmission, the CNB will need to continue acting with vigilance and agility. It will be important that the CNB communication strategy ensures that expectations are well anchored to the new target of 2 percent from January 2010.

5. **Despite the sharp real appreciation of the koruna, the external position has remained strong.** The trade balance is in surplus and the modest current account deficit is expected to be comfortably financed by direct investment inflows. The effective exchange rate

of the koruna, adjusted for either relative consumer prices or unit labor costs, appreciated significantly in the first half of 2008, but has weakened recently. Export competitiveness is adequate, especially as the recent koruna depreciation is beginning to offset the adverse impact from the earlier appreciation on profit margins. Model-based approaches to assessing the equilibrium exchange rate support the view that the koruna is broadly in line with fundamentals and consistent with external stability.

6. **The global financial turmoil has affected the Czech Republic, and domestic financial markets and institutions have come under increasing pressure.** Despite a healthy external position, this spillover is not surprising, given the growing integration of the Czech financial sector with the rest of Europe and the very high level of foreign ownership of the banking sector. Exposure to sub-prime securities by Czech banks appears to be low as is their involvement in structured financial products; however, off-balance sheet amounts are high relative to on-balance sheet totals and need to be monitored closely. Spreads facing parent banks of major Czech subsidiaries have widened as market concerns over the health of these banks and their exposures to emerging Europe have risen. As is the trend in other countries, the proportion of short-term loans from parent banks may be rising.

7. **The authorities have been called upon to take the measures necessary to maintain confidence in the financial system and to ensure its stability.** Steps taken by the CNB to ease the tightness in money and bond markets include the introduction of repurchase facilities to improve the distribution of liquidity. Further steps could be taken to support the smooth functioning of these markets:

- **In the interbank market,** the range of instruments acceptable as collateral could be widened. At present, only government bonds are accepted for the CNB's new repurchase facilities for liquidity provision. If this proves insufficient, steps to mitigate perceptions of rising counterparty risks may be necessary.

- **In the bond market,** the government could ensure greater transparency by, for example, adhering to the announced size of bond issuances, to enable accurate pricing by dealers. Issuances should also take into account the need for developing the local market.

8. **Financial supervisors need to be vigilant and ensure that their toolkit is sufficient to address weaknesses as they arise:**

- The supervisory authorities will soon be putting in place a framework for systemic assessment to help review the potential effects of a crisis. Since any decision to intervene would likely be discretionary, a consistent approach needs to be established among the relevant authorities from the outset.

- The Czech Republic has adopted the Basel II framework. In this context, the supervisory authority should put in place the modalities for the application of Pillar II as soon as possible, to ensure that banks remain well-capitalized.

9. **In the current uncertain environment, strengthening financial safety nets and crisis preparedness measures is crucial:**

- The CNB has supervisory tools in place to preserve the continuity of access to key banking functions in systemically important banks. These measures should be continually enhanced, and where discretion is required, supervisory response should be prompt.

- The features of the Deposit Insurance Fund could be calibrated to ensure transparency and credibility. The level of deposit insurance has been increased to cover 100 percent of deposits up to €50,000 in line with the EU agreement. In the context of the pending revision of the relevant legislation, clarifying the capacity and features of the scheme would help maintain confidence.

- Domestic crisis management arrangements between the CNB and the Ministry of Finance have been established and tested. More formal arrangements between the authorities and the private sector should be considered.

- Cross-border bank linkages are very important for the Czech Republic, a major host country to subsidiaries of Western European banks. In this regard, proactive collaboration with financial authorities and governments in home countries is essential.

10. **Recent fiscal gains should serve the Czech Republic well in the turbulent times ahead**. The structural fiscal balance improved significantly in 2007. The authorities' commitment to the deficit objective of 1 percent of GDP (on ESA-95 basis) by 2012 through saving these up-front fiscal gains and adhering to the nominal expenditure ceilings is welcome. As the growth outlook worsens more significantly than assumed in the medium-term plan, these early savings have helped create a cushion for a cyclical margin to stay within the Stability and Growth Pact threshold deficit of 3 percent of GDP. The savings have also helped support the government's liquidity position, relieving financing pressures in a tight financial market.

11. **With the outlook for growth worse than assumed in the budget, the fiscal deficit in 2009 is likely to be higher than planned**. Although revenue growth will likely decline rapidly, the streamlining of social spending under the 2007 fiscal reform package and the still buoyant corporate tax revenues should keep the general government deficit close to 1½ percent of GDP in 2008, resulting in a small stimulus. For 2009, the government plans a budget deficit of 1.6 percent of GDP, with cuts in corporate income tax and social security

contribution rates largely offset by the tightening of the wage bill and social transfers. Reflecting mainly revenue shortfalls from slower growth, staff project a deficit of around of 2½ percent of GDP, which would imply a neutral fiscal stance.

12. **Fiscal policy should aim at supporting growth, but be mindful of potential financing constraints and medium term fiscal goals**. Automatic stabilizers should be allowed to operate fully. With low government debt and limited domestic and external imbalances, scope for discretionary fiscal stimulus may exist if the outlook for growth were to worsen even further. Nonetheless, the recent freezing of the government bond market that led to the cancellation of a bond issue underscores risks despite relatively strong economic fundamentals. Any discretionary measure needs to be temporary and well targeted to vulnerable social groups. Faster implementation of EU-funded projects and bringing forward planned infrastructure spending could help boost demand while safeguarding the longer-run fiscal position.

13. **Over the medium term, the momentum of reforms will need to be restored to address long-term challenges and ensure high growth**. Fiscal space will need to be created to cope with the demographic transition through greater efficiency in public spending. In this regard, the introduction of user fees in the health sector and plans to modernize the tax administration are welcome. The forthcoming regulatory reforms should encourage private pension savings and pave the way for the development of a funded system. Recent parametric pension reforms should help reduce fiscal pressures and increase labor force participation. Considerable scope exists for improving incentives to work through reforms of the labor market and the tax-benefit system. The beneficial effects of such structural reforms would reinforce each other, promoting economic stability and sustained growth.