International Monetary Fund

Czech Republic—2010 Article IV Consultation

Concluding Statement

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The macroeconomic position was strong before the global financial and economic crisis

1. Prior to the crisis, the Czech Republic benefited from integration with the EU, supported by strong macroeconomic policies. Large foreign direct investment inflows (FDI) fostered trade integration, underpinning an export-led expansion. Higher initial standard of living contained consumption convergence pressures. An improved fiscal performance contributed to the comfortable external position. This, combined with credible inflation targeting, resulted in generally low inflation and interest rates. A liquid and conservative banking sector limited the build-up of balance sheet vulnerabilities.

But spillover effects have taken their toll

2. The highly open Czech economy has been significantly affected by the global crisis. A downturn in the euro area—especially in Germany, the main trading partner—depressed exports and output fell by 4¼ percent in 2009. A drop in FDI, and the tightening of domestic banks' lending standards hit the corporate sector, leading to a decline in investment. Private consumption held up in spite of rising unemployment, reflecting a supportive fiscal policy.

3. The external position remained robust despite a sharp decline in capital inflows. The drop in exports was offset by a larger fall in imports, improving the trade balance. FDI more than halved and no longer fully finances the current account deficit, but rising inflows of EU funds filled the gap. The initial depreciation of the Czech koruna was subsequently reversed, and the real exchange rate remains in line with fundamentals. Overall, market sentiment vis-à-vis the Czech Republic remains relatively favorable, reflecting limited vulnerabilities.

4. The Czech banking sector has weathered the global financial turmoil relatively well. Healthy capital and liquidity buffers, strong retail funding, and limited exposure to foreign currency risk eliminated the need for the authorities to undertake bank recapitalization or other exceptional measures to shore up financial sector stability. However, liquidity in the interbank market and trading activity in the domestic bond market remain below pre-crisis levels.

The policy response was adequate

5. Monetary and fiscal easing provided a sizeable stimulus. The Czech National Bank (CNB)—the first central bank in Europe to start easing monetary policy in August 2008—cut the policy rate by a total of 275 basis points through December 2009. Although the effectiveness of the traditional monetary transmission mechanism has weakened, such easing—combined with well-timed verbal interventions—kept inflation largely in positive territory, though well below the target. Automatic stabilizers and fiscal measures helped cushion the decline in growth, increasing the overall fiscal deficit by some 4 percentage points of GDP.

The short-term recovery will depend on external demand

6. The revival of the Czech economy is expected to be gradual and dependent on the global recovery. GDP is projected to grow by 1½ percent in 2010, supported by exports and a buildup of inventories, while fixed capital formation will likely remain depressed. Consumer spending is expected to decline reflecting still-rising unemployment, a slowdown in wage growth and the unwinding of fiscal stimulus. Risks to the short-term outlook seem balanced.

Cautious monetary policy will be appropriate while inflation expectations are subdued

7. The inflation environment will remain benign in the near future. The recently-approved VAT and excise hikes are expected to push average headline inflation to over 1½ percent in 2010, still below the new inflation target of 2 percent that came into effect in January 2010. The easing cycle of monetary policy seems to have come to an end and, looking ahead, the policy stance should shift to tightening once the economy recovers steadily and inflation expectations rise.

The crisis has highlighted the urgency of fiscal adjustment

8. The crisis took a major toll on the fiscal position. During the years of rapid economic growth the opportunity for more fundamental fiscal consolidation was missed. The crisis led to a sharp widening of the overall deficit in 2009, a rapid accumulation of debt, and an increase in interest rate spreads. In the absence of additional adjustment measures, the budget deficit is projected to remain above 5 percent of GDP over the medium term, with the level of public debt doubling to 60 percent of GDP in less than a decade. We estimate that a structural adjustment of at least 0.7 percent per year will be required to achieve a deficit of below 3 percent of GDP in 2013 mandated by ECOFIN. This, however, will not be sufficient to achieve debt sustainability over the long term, in particular given spending pressures of population aging.

9. The 2010 fiscal budget balances the objectives of fiscal sustainability and supporting economic recovery. The budget—a first step to reverse the deteriorating fiscal position—mostly relies on permanent indirect tax increases and, to a lesser degree, on temporary expenditure cuts that will expire in 2011. In this regard, pressures to approve increases in spending in the pre-election period should be resisted.

10. The government that will be formed after the May general elections will need to propose a credible and durable plan for fiscal consolidation. Broad support among the social and political partners will be crucial for its successful implementation. Without such a plan, market sentiment could deteriorate and the cost of public sector borrowing increase, thus crowding out the private sector and undermining the economic recovery.

11. Fiscal consolidation during 2011-13 should focus on both expenditure and revenue measures. International experience suggests that expenditure-based fiscal consolidations tend to be more durable.

- *Expenditures.* Rationalizing mandatory expenditures and the generous welfare system is unavoidable. Re-organizing public institutions and positions would help reduce the overall wage bill without reducing wage levels. Introducing means-testing would improve targeting of social benefits, yield savings, and enhance work incentives. There is scope for improving efficiency of public services delivery and public procurement.

- *Revenues*. The tax base needs to be expanded by eliminating exemptions and loopholes. VAT rates should be unified at the higher rate and taxation of real estate property be based on market value. While the scope for raising additional revenues from direct taxation is likely to be limited during the nascent recovery, the current corporate income tax rate could be reconsidered as it is below the OECD average. Improving tax administration could improve efficiency of revenue collection.

Demographic trends heighten the need for sustainable pension and health care reforms

12. A longer-term fiscal challenge arises from the projected rapid aging of the Czech population and the related increase in social spending. While the pension and health care systems remain largely unreformed, with limited private participation, the associated spending is expected to increase by 6 percentage points of GDP over the next 50 years, bringing total age-related spending to about one quarter of GDP.

13. Pension reforms should make the public pension scheme sustainable over the long term and promote the development of a complementary sound private pension system. While the significant parametric changes to the current PAYG system effective January 2010 are mostly welcomed, there will be a need for further changes. Additional changes should be aimed at better linking contributions to benefits and further increasing the effective retirement age (for example by moving forward to 2020 the increase in the statutory retirement age to 65 and reducing the period for early retirement back to 3 years). Over the medium term, consideration should be given to moving to a fully funded second-pillar private pension scheme, and to prefunding additional reserves to finance future deficits of the PAYG scheme (or transition deficits if moving toward private pension funds) through upfront fiscal consolidation measures or any privatization revenues.

14. Fundamental health care reforms are equally important. The user fees, introduced in 2008, were a first step in the right direction and could usefully be made means tested. Given the sheer complexity of health care reform, there is a need to establish a working group with broad representation to lead the reform efforts on:

- *Institutional reform*—reduce the broad coverage of publicly provided and insured services and allow greater scope for private sector provision of health services, in turn introducing more competition among insurers and providers.

- *Financing reform*—introduce voluntary insurance, personal health accounts, and choices in health benefits plans to ensure long-term financial sustainability of the health care system.

Structural reforms are needed to support long-term growth in the post-crisis environment

15. The adverse effects of the crisis are likely to be long lasting. A collapse in investment and slowdown in total factor productivity growth reduced dramatically the growth rate in 2009-10. Looking ahead, growth is not expected to reach pre-crisis levels due to abating convergence process, worsening demographic trends, and uncertainties regarding global long-term growth as a result of the crisis.

16. Against this background, the swift implementation of growth-enhancing structural reforms becomes critical. The focus should be on increasing productivity and labor participation, and improving the quality of the labor force and the business climate to attract foreign direct investment. The array of measures includes further promoting work incentives through changes to the tax-benefit system, improving labor market flexibility and the quality of education, and further reducing barriers to business entry and exit**.**

Domestic capital markets should be developed further

17. Local bond markets are not functioning in an efficient way and capital markets remain underdeveloped. Despite steps taken by the CNB to improve the liquidity of the local currency government bond market, trading remains thin due to the opaqueness of public debt management. Capital market development is hampered by poorly-targeted subsidies and tax exemptions on certain savings products and old regulations regarding private pension funds. Further measures should be taken to support the smooth functioning of these markets:

- Enhance the transparency of the government bond market by, for example, adhering to the announced size of bond issuances, to enable accurate pricing by dealers.

- Rationalize subsidies and tax exemptions for deposits in building societies and contributions in voluntary third-pillar pension funds.

- Improve the regulation regarding the third-pillar pension funds.

Credit quality is a challenge, but banks' financial health bodes well for credit recovery

18. The economic downturn has started to take its toll on the banking sector. The share of banks' nonperforming loans is expected to rise, thus exercising pressure on banks' profitability, though the private sector's moderate debt levels and low interest rates may be mitigating factors. High single-borrower concentration in the corporate sector and commercial real estate exposure require high vigilance. Against this background, further improvements in cost efficiency will become key for the Czech banks. The CNB should continue closely monitoring developments in banks' profitability, so as to preserve adequate capital buffers and liquidity positions. Banks' soundness, low loan-to-deposit ratio, and parent banks' commitment to the market bode well for banks' ability to resume lending as the economic outlook improves.

19. The Czech Republic has a sound financial supervisory and prudential framework. The framework was further strengthened by the recent widening of the array of remedial measures to deal with weak credit institutions and systemic risk. Important reforms of the deposit insurance framework, in line with EU agreements, are pending in parliament. Given the shortening of the pay-off period of insured depositors, the timeliness and periodicity of basic information sharing between the CNB and the Deposit Insurance Fund need to be reviewed. The CNB should continue its efforts in: (i) improving macro-prudential analysis by taking into account the interaction among liquidity, market, and credit risks; and (ii) enhancing the integration between macro-prudential analysis and supervision activity.

20. Given the virtually complete foreign ownership of banks, intensive supervisory coordination with cross-border authorities remains crucial.

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In closing we wish to thank our hosts for their cooperation and hospitality.