Czech Republic --- 2012 Article IV Consultation Concluding Statement
February 27, 2012

Macroeconomic Outlook and Challenges

1. **The post-crisis recovery stalled in 2011 mainly because of deteriorating external conditions.** The economy lost momentum from the second quarter, when exports—the main growth driver in the last two years—moderated in line with trends in global trade. Moreover, final domestic demand, which had been weak throughout the recovery, slowed further partly due to fiscal consolidation. All these factors limited GDP growth to about 1¾ percent in 2011. Despite the recent global turmoil, domestic financial conditions have remained calm.

2. **Going forward, the Czech economy faces substantial headwinds from the euro area recession.** Activity is expected to remain flat in 2012 and grow around 2 percent next year, as global conditions improve. In the short run, exports will continue to be affected by the euro area weakness. Domestic demand will likely remain anemic, as suggested by confidence indicators and slow employment creation. Unemployment is expected to increase marginally, while the output gap widens somewhat during this year. Inflation is forecast to average slightly above 3 percent in 2012. However, it is expected to be at target from 2013 onwards as one-off effects (mainly from this year's VAT adjustments) dissipate and disinflationary effects of the economic slack play out. The current account deficit will remain well-contained.

3. **Risks to this scenario are tilted to the downside.** A potential intensification of the sovereign debt crisis in Europe would negatively affect the economy through the trade channel. In addition, the close financial integration with the euro area entails a clear spillover risk via banking and financial markets channels. However, strong fundamentals in the Czech Republic, including a manageable level of public debt, a comfortable external position and a resilient financial system, limit the vulnerability against these risks.

4. **Against this background, policies should aim at maintaining macroeconomic and financial stability, safeguarding fiscal sustainability, and enhancing the growth potential.** The mission's key recommendations are the following:

- Upgrade the fiscal framework by adopting a rule that ensures debt sustainability while avoiding procyclical fiscal policy;

- Continue focusing on the gradual structural fiscal consolidation. Given the mission's assessment of Czech fiscal space, and to the extent market conditions allow, let automatic stabilizers work. If the outlook deteriorates significantly, consider repacing the current fiscal consolidation plan;

- Consider adopting an easing bias as inflation is likely to move towards the target and downside risks cloud the outlook;

- Closely monitor the relations between foreign parent banks and the Czech subsidiaries, and stand ready to take action should spillovers become imminent;

- Continue efforts to strengthen the financial stability policy framework in line with the recent FSAP mission recommendations;

- Persevere with the structural reform agenda to boost potential growth.

Public Finances

5. **Since the last Article IV consultation, significant progress has been made in tackling medium-term fiscal challenges, but further efforts are warranted.** The mission welcomes authorities' resolute implementation of the pension reform, including the retirement age increase and other parametric changes to the pay-as-you-go system that reduced its projected long-term deficits from about 4 to 2 percent of GDP. This was accompanied by raising the preferred VAT rate from 10 to 14 percent from 2012—as an intermediate step towards the unification of the two rates next year. In the area of health care reform, various measures were implemented to curtail the costs and increase private participation. Continuation of the pension, health, and tax reforms is important for securing long-term sustainability of the public sector. In this context, additional parametric changes in the pay-as-you-go pension system may be needed. To harness the rising costs of the health care, additional measures to streamline expenditures and to increase private co-payments could be considered.

6. **The mission welcomes the government's plan to introduce a fiscal rule.** Given the current manageable level of public debt and sound institutional capacity in the Czech Republic, consideration could be given to a structural fiscal balance rule for the general government, augmented with a debt brake. Such a rule would ensure fiscal sustainability while avoiding unwarranted procyclicality, and would be consistent with the new EU fiscal framework. Other types of rules currently under consideration may achieve the same broad objectives. However, it is essential for any rule to have an appropriately wide coverage, provide clear guidance to the annual budgeting process, and be consistent with supranational rules. An independent fiscal council would foster an effective implementation of the fiscal rule.

7. **Fiscal policy needs to strike a balance between consolidation and avoiding an overly contractionary stance; the mission believes that the 2012 budget achieves this.** Given the mission's assessment of Czech fiscal space, and to the extent market conditions

allow, it recommends (and would have preferred) letting automatic stabilizers operate, that is, accommodating cyclically driven revenue shortfalls. If the outlook worsens significantly, the planned fiscal consolidation could be repaced, particularly in 2013. Any change will need to be clearly communicated to the public and carefully fitted into the context of the European Union (EU) commitments. If the defined contribution component of the pension system (the second pillar) is introduced as planned in 2013 with associated revenue shortfalls for the budget, the unchanged nominal targets as defined by the Excessive Deficit Procedure could imply an overly tight fiscal stance.

Monetary Policy

8. **The monetary policy rate is appropriate, although an easing bias could be considered.** Consistent implementation of the inflation targeting framework continues to serve the economy well, and inflation expectations remain well-anchored. The policy rate at 0.75 percent for almost two years coupled with market expectations for a continuation of the low rates have provided needed support to the economy without evidence of excessive risk taking in any particular financial market segment. There are no signs of demand side inflation pressures, and wage growth is subdued. Despite some upside risks arising from commodity prices and currency movements, in view of the likely disinflationary effects of downside scenarios and the constraints faced by fiscal policy, there is a case for an easing bias.

9. **The free floating exchange rate regime continues to work favorably for the Czech Republic.** The exchange rate has functioned as the main absorber of external shocks, and together with the limited foreign exchange mismatches, it has facilitated the pursuit of an independent and effective monetary policy. The mission assesses that the koruna is broadly in line with its fundamental determinants.

10. **With the policy rate at 0.75 percent, it is important to have strategies for coping with the zero-bound constraint.** Given the limited room for conventional monetary policy, the use of unconventional tools may need to be contemplated for scenarios of a significant undershoot of the inflation target. Key criteria in deciding among the potential actions should include effectiveness against disinflationary pressures as well as the ease of reversing them. Foreign exchange interventions may be considered in this regard, if the exchange rate fails to fully respond to negative shocks.

Financial Policy

11. **The Czech financial system has proved resilient to the effects of the global crisis, but spillover risks remain elevated**. Despite slow GDP growth at home and financial strains abroad, the performance of banks is very good, with strong capitalization, solid profits, and ample liquidity. This resilience, which has been confirmed by the FSAP stress tests, reflects to a large extent a relatively conservative structure of bank balance sheets (particularly low loan-to-deposit ratios) and relatively low indebtedness of the corporate and household sectors.

Nevertheless, the financial system is facing a number of risks, particularly related to the macroeconomic and financial developments in the euro area, where the parents of the major Czech banks are based. Importantly, the situation of Czech banks is different from those in most other European host countries as the Czech subsidiaries are typically net creditors vis-a-vis their parents.

12. **The mission is encouraged by the authorities' efforts to strengthen the financial stability policy framework**. In particular, the mission welcomes Czech National Bank's (CNB) efforts to improve bank reporting requirements and to intensify monitoring of transactions between parents and subsidiaries. Actions to implement many of the recommendations of the recent FSAP mission are already underway. The limit on banks' exposures to parent groups is planned to be reduced from 100 percent to 50 percent of bank capital. Legal amendments aimed at broadening the mandate of the CNB and regulating the activities of credit unions are under preparation. Work is also ongoing to strengthen the macroprudential policy framework and stress testing. It would be important to implement other FSAP recommendations, particularly in the areas of bank supervision and crisis management.

Structural Reforms

13. **Steady implementation of the structural reforms is critical to boost potential growth and diversify the growth sources.** The mission welcomes the government's comprehensive reform strategy, which sets an ambitious goal of making the Czech economy one of the 20 most competitive economies in the world by 2020. This strategy outlines concrete plans for developing infrastructure, strengthening institutions and governance, reforming the education sector, further increasing labor market flexibility, and improving the business climate. Development of the export promotion strategy to support diversification of exports to new products and markets is another important step in the right direction. However, implementation of these plans requires sustained efforts, and the benefits will accrue over the long run. In particular, enhancing cooperation among the ministries would be pivotal in ensuring the success of these initiatives.

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