Czech Republic – 2013 IMF Article IV Consultation Concluding Statement
May 20, 2013

The Czech Republic's economic fundamentals are strong. But the economy is in the midst of a prolonged recession because of the euro area slump and weak domestic demand. A further slowdown in the euro area would exacerbate the situation, creating the risk of lower growth in the long run. Short-term macroeconomic policies should therefore be geared toward supporting the economy and not creating additional drag. Boosting potential growth in the medium term will require implementation of additional structural reforms. Against this backdrop, the mission's key recommendations are:

- *Keep fiscal policy neutral until the economic recovery gains strength. Adopt a simple and easy-to-monitor structural fiscal balance rule to provide a medium-term fiscal anchor.*
- *Maintain the accommodative monetary stance for an extended period.*
- *In a severe adverse scenario where deflationary pressures mount, use fiscal policy to support the economy and deploy unconventional monetary policy tools, notably foreign exchange intervention.*
- *Use proactive bank supervision to ensure continued adequate capital and liquidity buffers to preserve financial stability.*
- *Strengthen policies to enhance investment in both physical and human capital, improve the business environment, and increase labor participation in order to boost potential growth.*

Macroeconomic Outlook and Risks

1. The Czech economy remains in recession. The economy has shown remarkable stability in the recent volatile economic environment, benefitting from strong policy frameworks and sound fundamentals. However, the export-led recovery observed in 2010-11 subsided as euro area import demand slowed, and growth has noticeably underperformed trade partners and peers since the middle of 2011 mainly because of weaker domestic consumption and investment. Weak private consumption was particularly prominent, driven initially by lower real disposable income, and subsequently also by an increased tendency towards precautionary savings.

2. **Economic activity is expected to be weak in 2013 and recover gradually thereafter.** This pattern is similar to that projected for euro area trade partners, on whom the outlook of the Czech economy is heavily dependent. In addition, pro-cyclical fiscal consolidation set to meet the EDP target this year has induced cautious consumer and business behavior, while room for further cutting policy interest rates is exhausted by reaching the zero lower bound. Unemployment is lower than the EU average but is on the rise, and domestic demand is not expected to rebound to any significant extent this year. Prospects are for a prolonged period of modest growth with the output gap closing only gradually.

3. **Risks are mainly to the downside and include further deterioration of euro area growth and permanent scars to potential growth.** If growth prospects for the euro area worsen, it would discourage sentiment even more and delay the recovery of the already policy-constrained Czech economy. With recent disappointing export performance, the economy is at the risk of being dragged deeper into recession. Also, the current poor growth performance, if protracted, runs the risk of translating itself into a long-term decline in potential growth due to lower investment.

Public Finances

4. **With a budget deficit projected at 2.8 percent of GDP in 2013, the Czech Republic should be able to exit the Excessive Deficit Procedure.** The structural consolidation of around 4.5 percent of GDP over 2010-2013 has resulted in a stronger fiscal position than before the crisis. Thus, fiscal over-performance this year, particularly at the expense of lower capital spending, should be avoided. In addition, further pro-cyclical fiscal tightening in the event of weaker than expected economic activity should also be avoided by allowing automatic stabilizers to fully operate. Over the next few years, until the economic recovery gains strength, a neutral fiscal stance would be appropriate. This neutral stance could be followed by a moderate, gradual consolidation after 2015 with the aim of achieving the structural balance target incorporated in the new fiscal framework. In a severe adverse scenario, fiscal policy should play an active role through temporary and targeted measures. In such an environment and with monetary policy interest rates already at the zero lower bound, fiscal policy would be more effective than under normal circumstances in providing needed support to domestic demand.

5. **The structural balance rule and debt brake being considered for the new fiscal framework would enhance the transparency and predictability of fiscal policy and reduce pro-cyclicality.** The framework's effectiveness and credibility would be enhanced if its design and adoption is rooted in broad consensus. The final version of the framework would benefit from ensuring independence of the fiscal council and adopting a structural target that strikes the right balance between long-term sustainability considerations and short- and medium-term demand concerns.

Monetary Policy

6. **The policy interest rate has reached the zero bound, but risks to inflation are to the downside.** The Czech National Bank (CNB) was swift to cut its policy rate by 70 basis points to 0.05 percent between June and November 2012. Inflation declined below the 2 percent target level starting from January 2013, as the effects of 2012 VAT hike subsided and contributions from food and fuel fell. Inflation is projected to remain at around 1¾ percent through 2014, but risks are to the downside in line with the risks to the growth outlook.

7. **If a persistent and large undershooting of the inflation target is in prospect, the CNB should employ additional tools.** The CNB's statement that additional monetary easing within the context of inflation targeting framework would come from foreign exchange (FX) interventions is welcome and has been clearly communicated. The mission agrees that FX interventions would be an effective and appropriate tool to address deflationary risks. As the Czech Republic is a small open economy and pass through is relatively high, FX interventions would quickly increase the price level and help increase inflation expectations toward the target. The operational aspects of possible interventions should pay due regard to transparency, which would allow the market to form expectations in accordance with the CNB's inflation target, thus adding to the effectiveness of interventions and making an exit from the policy easier. The mission assesses the exchange rate to be in line with the fundamentals, and the focus of FX interventions should not be to target a certain exchange rate level.

Financial Stability

8. **The Czech financial system has proved resilient to the effects of the global crisis and a weak domestic economy.** Czech banks, largely owned by euro area banking groups, are highly profitable and self-financed with a low system-wide loan to deposit ratio. Profitability is likely to moderate somewhat from the record level achieved in 2012, as margins come under pressure from competition and impairments that would moderately increase due to weak economic activity. The main risk for the Czech banking system is a protracted or deeper recession that would harm asset quality. Although existing capital and liquidity buffers are expected to continue to keep the system resilient, as indicated by the CNB's regular stress tests, supervision should proactively ensure that provisions are adequate and buffers remain strong in the face of potential further economic weakening.

9. **Improvements of the financial stability framework would help safeguard the Czech financial system against a wide range of risks.** The authorities have made welcome efforts to adopt the recommendations made by the Fund's FSAP Update in December 2011, including lowering regulatory limits on exposures to parent banks, strengthening cooperation between the Ministry of Finance and the CNB, and increasing the role and profile of the CNB's macroprudential policies. It is important to adopt the draft proposal on the regulation of credit unions, which is a small segment in the financial system but with higher-than-

average risks. Other FSAP suggestions for improvement were in the areas of bank resolution and deposit insurance, where recent European wide initiatives have taken precedence and would need to be implemented in due course. If the authorities do not opt to enter the Single Supervisory Mechanism at this stage, it would still be important to strengthen the cooperation between home and host supervisors and make preparations for a more integrated European financial policy framework.

Structural Reforms

10. Enhancing private investment and especially FDI is critical for future growth and moving up the value chain. In this connection, reducing uncertainty by improving the legal framework and minimizing administrative costs for formation, restructuring and liquidation of firms can significantly contribute to a better business environment. A highly capable and skilled workforce is also essential to attract more knowledge intensive industries placed higher in the value added chain. Education reforms would work to this effect. In addition, higher labor participation would enhance potential growth while active labor market policies providing information, counseling and retraining help avoid the permanent negative impact of higher long term unemployment. Although overall labor participation is above the OECD average, participation is low for some segments of the workforce such as women with young children, and experience elsewhere suggests that targeted policies such as public support for childcare can be effective to address the problem.

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