Czech Republic—2014 Article IV Consultation
Concluding Statement of the IMF Mission
Prague, June 30, 2014

The economy is steadily strengthening on the back of strong exports and a pickup in domestic demand. The central bank's foreign exchange intervention policy has helped stem deflationary pressures, but inflation remains very low. Sharp fiscal adjustment over the last few years enabled an exit from the Excessive Deficit Procedure. Going forward, the challenge for the authorities is to ensure a sustainable recovery and macroeconomic stability, while comprehensively addressing obstacles to higher potential growth. To this end, the mission recommends: (i) adopting a clear growth-friendly medium-term fiscal strategy in line with the medium-term objective; (ii) maintaining supportive monetary conditions until inflation expectations become well anchored around the central bank's inflation target; and (iii) advancing structural reforms aimed at increasing labor force participation, enhancing investment in human and physical capital, and improving the business environment.

Economic outlook and risks

1. **The economy exited the recession in 2013 and signs of a strong growth momentum are building up.** The recovery was triggered by exports, but has been increasingly supported by domestic demand. Unemployment entered a gradually falling path in 2013, but slack in the labor market still exists. Although inflation has declined, it has remained in positive territory aided by the weaker exchange rate. The mission projects a pickup of output growth to 2½ percent this year with balanced contributions from external and domestic demand—the latter is to turn positive for the first time since 2010. The effects of the depreciated exchange rate and recovering demand conditions are expected to push inflation gradually toward the 2 percent target starting from late 2014. Over the medium term, output growth is set to stabilize at around 2 percent.

2. **Risks to the outlook are balanced.** The ongoing recovery in Czech Republic's trade partners, domestic slack, supportive macroeconomic policies, and the improving automotive cycle point to upside risks to growth. On the downside, if the euro area recovery falters, the Czech economy will be negatively affected through the trade channel. The impact would be larger if low growth turns self-reinforcing through low investment. Moreover, escalation of geopolitical tensions in the region could affect exports and also create uncertainty regarding energy security.

Fiscal policy

3. **Sharp fiscal adjustment over the last few years enabled an exit from the Excessive Deficit Procedure and kept debt levels contained, at the expense of exacerbating the recession.** The structural balance improved by 1.3 percentage points of GDP in 2013 to -0.6 percent of GDP, about the same pace of consolidation as the average of

the last three years. Capital spending was compressed, partly due to implementation bottlenecks, while an increase in VAT rates helped boost revenues. As a result, the general government deficit narrowed to 1.5 percent of GDP in 2013 from 4.2 percent in 2012, which was also due to one-off factors, including 1.5 percent of GDP of financial compensations to churches.

4. **Pending adoption of a medium-term fiscal framework, fiscal targets should remain consistent with the medium-term objective of 1 percent of GDP structural deficit.** Increasing structural deficits rapidly now to deviate from 1 percent of GDP would not be an appropriate policy stance, and could necessitate another round of, possibly pro-cyclical, consolidation in the future. The mission's baseline scenario implies that, if the expenditure ceilings in the latest Convergence Program are respected, the structural fiscal deficit would hover at around 1-1¼ percent of GDP over 2014-16. Cognizant of the need to sustain the nascent recovery, the mission supports the slight relaxation of the fiscal stance implied by this path in the near term, underpinned by a recovery in capital spending. In this respect, it would be essential to not ratchet up re-current expenditure, if revenues surprise on the upside.

5. **A clear medium-term fiscal framework, enshrined in legislation, is important for anchoring fiscal policy and avoiding pro-cyclicality.** The Ministry of Finance has prepared an updated proposal of the Fiscal Framework Reform, which includes expenditure ceilings derived from the medium-term objective of 1 percent of GDP structural deficit, a debt brake rule starting at 55 percent of GDP (net of financing reserve), and a Fiscal Council. In the mission's view, adoption of this proposal would help eliminate the pro-cyclical bias of fiscal policy, which exacerbated the economic cycle in recent years. The proposed structural deficit target strikes the right balance between reducing debt and creating long-term fiscal space on the one hand, and allowing adequate space for current fiscal policy priorities on the other. Moreover, this rule would be consistent with EU fiscal framework requirements.

6. **Within this envelope, there is room to increase capital expenditure.** The mission recommends boosting capital spending to address the country's infrastructure needs thus reversing the recent decline in public investment. Higher utilization of EU funds should be the first step. Eliminating obstacles in planning and implementation of public projects without compromising governance would help in this respect. Within the envelope of a 1 percent of GDP structural deficit, increases in capital spending can also be financed through rationalizing re-current spending and stepped-up efforts to improve tax administration. In this connection, the mission considers the introduction of a lower VAT rate for pharmaceuticals, books, and infant food an untargeted way to address a social priority as well as an additional complication for tax administration.

Monetary policy

7. **Inflation will gradually rise towards the target, supported by the ongoing recovery and the Czech National Bank's (CNB) foreign exchange intervention policy.** With policy interest rates near zero, market interest rates at historical lows, and liquidity in the banking system high, in November 2013, the CNB started using the exchange rate as a new tool to avoid a persistent and large undershooting of its inflation target. Since then, low-inflation pressures in the euro area, and food and energy price trends continue to keep headline inflation very low. Nevertheless, inflation is expected to start moving gradually towards the target after several months, helped by the pass-through to tradables prices and the ongoing recovery. In any case, the tail risk of a self-fulfilling deflationary spiral seems to have been averted, as suggested by rising wage growth and positive consumption trends.

8. **Supportive monetary conditions will be necessary until inflation expectations are entrenched around the inflation target.** There are still risks to the nascent recovery, mainly from the external side. Given the sizable output gap and the persistence of very low inflation, it would be appropriate to still keep in place the current foreign exchange intervention policy. However, the mission recommends a return to the floating exchange rate regime in conjunction with inflation targeting, which has served the country well, once deflation risks recede, and the inflation forecast and inflation expectations become entrenched around the inflation target. The pre-existence of a consistent monetary policy framework, and a credible and transparent central bank would make the exit easier. CNB's communications have appropriately emphasized the priority of the inflation objective and the role of the exchange rate policy as an instrument to achieve it, and this remains an essential distinction.

Financial sector policies

9. **The financial system is sound and resilient**. Czech banks, mostly owned by euro area banking groups, are self-financed with a low average loan-to-deposit ratio and strong capital and liquidity buffers. Profits moderated somewhat, but still helped further strengthen banks' capitalization ratio to above 16 percent. Credit growth remains low but, with healthy balance sheets in the financial and non-financial sectors, the mission assesses this mostly to be driven by weak demand for credit.

10. **Work is ongoing to improve financial regulation and the supervision framework**. Supervisory resources have been increased for on-site inspections; the implementing law of the Capital Requirements Regulation IV has been approved by the Parliament, allowing for the introduction of systemic bank buffers; and work on the EU-wide initiative for unified resolution schemes is continuing. A draft law on credit unions—a small but problematic sector of credit providers—would help reduce reputation risks to the financial system.

Boosting potential growth

11. **This is an opportune time to undertake structural reforms that would put the Czech Republic on a higher growth trajectory.** Medium-term growth is estimated at 2 percent, constrained by slow productivity growth, an aging population, and structural obstacles in the labor market, thus impeding a speedy convergence of Czech per capita income to the level of other advanced European economies. Although important steps have been taken to reduce labor market rigidities, labor participation in some segments remains low, thus calling for targeted policies. Consideration should be given to upgrading skills and addressing skill shortages in the technical fields, by education and training of less-advantaged populations (e.g., through apprenticeship programs), vocational training in close cooperation with businesses, and improved incentives of the education system to better match workforce needs. Moreover, reducing uncertainty regarding tax policies and simplifying compliance with taxation requirements should help enhance the business environment. Finally, strengthening research and development, improving infrastructure, and facilitating SMEs' expansion and better integration into the international value chain would support a faster convergence.

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