INTERNATIONAL MONETARY FUND

Czech Republic—2004 Article IV Consultation Mission

Preliminary Conclusions, May 25, 2004

1. **Accession to the European Union marks the completion of transition for the Czech Republic, but also reminds of economic challenges ahead**. Furthering catch-up to EU income levels and adopting the euro should now become the focus of policies. A skilled work force and an open regime for trade and capital flows have encouraged development of a large and vibrant manufacturing and service base that has led economic growth in recent years. But with the most readily-tapped business opportunities already exploited, sustaining and even accelerating income convergence in the future will place a higher premium on fiscal and monetary policies to promote macroeconomic stability, measures to contain and offset fiscal risks and enhance financial sector supervision, an efficient business-legal system, and flexible product and labor markets.

2. **Although economic fundamentals generally remain strong, inaction in some key policy areas is eroding this favorable position**. Public debt has reached moderate levels and, without fundamental pension and health care reforms, it will continue to grow rapidly, risking a ratcheting-up of Czech interest rates. The business-legal environment discourages investment by engendering uncertainty and costly delays, and through inadequate protection of creditor rights. Segments of the labor market are increasingly constrained by shortages of skilled labor, obstacles to inter-regional mobility, and disincentives for job search. These impediments to future growth have previously been identified by the IMF, other international institutions, and by the Czech authorities themselves, and we welcome initial steps taken in some areas. But in the crucial areas of pension and health care reform, progress is slow or has stalled. The authorities' intention to adopt the euro around 2009-10 provides an added beacon for confronting these challenges and implementing policies that lay the foundation for a successful experience in the eurozone. Concerted progress on these fronts will benefit Czech citizens.

Economic Outlook

3. **Strong consumer demand and public investment underpinned solid growth in 2003**. Fast real wage gains brought by unexpectedly low inflation, rapid consumer borrowing, and a surge in public investment contributed to growth of 2.9 percent. But the export sector also performed relatively well despite subdued external demand, supported by improving competitiveness from a weaker koruna and falling unit labor costs in manufacturing, and expanding export capacity due to earlier investment. As a result, the trade deficit relative to GDP narrowed slightly. However, the current account deficit, which includes significant outflows of income from foreign direct investment in the Czech Republic, widened to 6½ percent of GDP largely reflecting one-off factors. Moreover, the financing of the external deficit shifted to non-FDI sources as privatization activity slowed and the ownership structure of two large foreign-owned firms changed.

4. **With EU demand set to pick up gradually in 2004, Czech growth should firm to about 3¼ percent**. But the composition of growth is likely to shift toward net exports and export-related fixed investment as foreign demand recovers and new export capacity continues to come on-stream, while slower growth in real wages would dampen household consumption. Public infrastructure spending is also expected to contribute to growth. The trade deficit is projected to narrow further, bringing the current account deficit to under 5½ percent of GDP. Downside risks to this forecast dominate. Relative to baseline, a more restrained recovery in the EU, sustained high world oil prices, and faster appreciation of the koruna would dampen growth through their effect on exports and related investment.

5. **Medium-term growth prospects should strengthen conditional on success in restoring fiscal viability, improving the business environment, and increasing labor market flexibility**. Over the next few years, we expect demand to increase broadly in line with a gradual rise in potential output growth to 3¾ percent. Underpinning the stronger growth potential would be further capital deepening and gains in factor productivity brought by domestic and foreign investment. Fiscal adjustment is needed over the medium term to allow the current account deficit—and hence the use of external saving—to decline and make room for higher private investment.

Monetary and Exchange Rate Policy

6. **Easing monetary conditions over the past year were supportive of growth, but with inflation now on the rise, policies should gradually tighten in the period ahead**. In late 2003 inflation began to recover from negative levels as the effects of rising food prices (due to a poor harvest), koruna depreciation, and wage growth in excess of productivity in the non-traded sector began to feed through. Pass-through of these factors will continue to contribute to inflation this year, but the main drivers will be adjustments to indirect taxes and regulated prices, and EU-related changes in the trade regime. The exact contribution of taxes and other administrative measures to inflation is uncertain because cyclical conditions and inflationary expectations also play a role. However, we expect the combined direct impact of all administrative measures to be around 1½ percentage points. The slack in the economy and strong competition in the retail market will limit the pass-through to prices of higher VAT rates on certain goods and services. These conditions are also likely to restrict retailers' ability to increase margins on goods and services with declining VAT rates. Year-on-year headline inflation is expected to peak at around 4 percent at end 2004, and then to decrease as the direct VAT effect dissipates and earlier price pressures unwind. Second-round effects on future inflation are not expected to be significant owing to the anchor role for expectations of the inflation target and weak labor market conditions that should contain demands for real wage catch-up. Although inflation will fall in the first half of 2005, the diminishing slack in the economy suggests that monetary policy should soon enter a tightening cycle to keep inflation close to the middle of the CNB's target band. The precise timing and size of future interest rate increases should take into account the robustness of economic growth and the effects of exchange rate developments on monetary conditions.

7. **The CNB's new inflation targeting (IT) framework ensures continuity and a sound anchor for monetary policy during the pre-euro period**. Setting the target at 3 percent with a tolerance margin of ±1 percent avoids an easing or tightening of monetary policy on account of moving to the new framework in 2006. Moreover, the level of the target permits a policy stance similar to that in the euro area while allowing room for structural sources of inflation differentials. Given the investment in establishing its IT credentials, the CNB intends to continue with this framework during the pre-euro period of ERM2, when inflation and nominal exchange rate variability must be simultaneously contained. However, responsibility for meeting these goals lies not just with the CNB; credibility of the strategy for meeting the Maastricht fiscal criteria and sustained efforts to boost the resilience of the economy to shocks will also be critical. With the euro changeover projected for 2009-10, the authorities should start now to prepare. Placing the fiscal deficit on a firm downward path and bolstering the flexibility of the labor market are particular priorities.

Fiscal Policy

8. **The Czech Republic's fiscal health continued to deteriorate in recent years**. *First*, the general government deficit (excluding privatization receipts and transfers to transformation institutions) widened to above 5 percent of GDP in 2003, primarily reflecting upward drift in fiscal flows to households and enterprises. Identifying the individual categories of spending is complicated by fiscal devolution. However, some channels are evident, and include social transfers, subsidies, and capital injections to state enterprises in the form of lending. Also, the increase in subsidies to semi-budgetary organizations does not appear to have been matched by reductions in other categories as would be expected from the reclassification of expenditures. *Second*, public debt continued to climb and on some measures, the Czech Republic has "graduated" to a moderate debt level. Even with large privatization receipts, debt will be pushed higher by the cost of called guarantees, residual obligations from bank and enterprise restructuring, and continuing deficit trends. *Third*, little progress with entitlement reforms—such as pensions and health care—leaves public finances ill-prepared for coping with spending pressures from population aging.

9. **We support the government's plan to reverse these trends and contain the fiscal deficit within a multiyear framework**. There are several positive elements in this plan. As a first step in the necessary adjustment, the general government deficit would gradually return during 2004-06 to its 2002 level relative to GDP, even while making room for the costs of EU accession and gradually reducing corporate income taxes. The plan is formulated in an explicit medium-term framework with a rolling 3-year horizon, and with the added discipline of expenditure ceilings. Moreover, annual state budgets and policies with multiyear implications must conform to this medium-term framework, giving a high degree of predictability to fiscal policy.

10. **Nonetheless, experience during 2004, the first year of the medium-term plan and a "test year" for its implementation, so far has been mixed**. That the 2004 budget observes the state budget expenditure ceiling is an encouraging sign of the political will to implement the medium-term plan. Notwithstanding, the general government deficit

(excluding privatization receipts and transfers to transformation institutions) is projected to widen by over 1 percentage point to 6.4 percent of GDP. The main reasons for the increase are larger subsidies, higher capital spending, and a decline in nontax revenue. Loopholes in the coverage of the expenditure ceiling contribute to the problem. For example, capital injections in the form of lending and subsidies provided to non-financial enterprises through the National Property Fund are not covered, and some extrabudgetary funds can exceed their ceilings by shifting spending from one year to the next. In addition, recent post-budget measures to compensate families and pensioners for indirect tax hikes have not been accompanied by offsetting expenditure cuts in other areas. Partly as a result of extra spending outside the ceiling, current projections indicate that the plan's original general government deficit target for 2004 is likely to be missed by a wide margin.

11. **The credibility of the plan would be restored by bringing the general government deficit for 2004 close to its original target and by strengthening the fiscal framework for future years**. To this end, we recommend that the government take the following steps:

- Find savings of ¼-½ percent of GDP in 2004.

- Broaden the coverage of the expenditure ceilings to the widest possible range of spending items and general government units. In addition, closer coordination between the central, regional, and municipal governments is needed to ensure that all levels contribute to the adjustment effort.

- Adhere to the expenditure targets, and avoid post-budget spending measures. Expenditure ceilings should be respected even when higher revenues would finance an increase in spending without endangering the deficit target.

- Enhance the clarity of communications with the press and the public. The proliferation of deficit measures has created some suspicion that the government is exploiting differences in fiscal concepts to its advantage. This would be avoided by using a consistent set of fiscal indicators (preferably those in the medium-term framework), and explaining fiscal projections and evaluating performance both at the level of the general government and the state budget compared with the targets.

12. **Implementing plans for 2005-06 will present additional challenges.** The medium-term plan targets an evenly-phased deficit reduction for 2005-06. Given the timing of the realization of revenues from the tax measures already in place, changes on the revenue side will modestly contribute to the adjustment in 2005. However, in 2006, delayed effects from reductions in the tax burden on corporate and personal income will lead to a fall in revenues. Delivering the 2006 deficit target with the fall in revenues will require implementing substantial spending cuts—a difficult task in an election year. Pressures for permanent expenditure increases are mounting for 2005 in the areas of pensions and public sector wages. These should be resisted to deliver the 2005 expenditure target and avoid raising even further the required expenditure adjustment in 2006. Increasing the credibility of the fiscal

plan indeed requires bringing forward to 2005 significant permanent savings. This would lead to a smaller-than-planned deficit next year. Such a strategy presupposes that the necessary deficit reduction measures in the total amount of 1¾ percent of GDP can be identified and implemented soon. Reducing operating expenditures, while necessary, will not suffice; an early restructuring of entitlements is needed.

13. **We welcome the government's intention to continue deficit reduction beyond 2006 and to prepare pension and health care reforms.** We recommend reducing the deficit below 2 percent of GDP by 2008-09 to strengthen the fiscal position and help keep public debt at a moderate level. However, these results would eventually become undone without prompt reforms to slow the growth of pension and health care spending. On the pension front, long lags from the reforms to their impact on public spending warrant early action, and we urge the government to speed up the formulation of its proposals. As significant changes to pension system parameters are likely to be needed, forging social consensus on the necessity and nature of the reforms is also required. On health care, measures will likely have to include steps to shift a larger share of the financial burden to final users.

Financial Sector Issues

14. **The benefits of a restructured banking sector are apparent, but potential risks should be closely monitored**. Bank profitability is strong, nonperforming loans are declining, and bank lending—led by credit to households—is rebounding. But this new dynamism of banks and the change in their loan structure exposes the financial sector and the economy more broadly to systemic risks that may not be detected with individual bank-based or backward-looking financial indicators. The CNB has taken steps to adapt to this new setting by publishing its first banking sector stability report which aims to assess risks arising from macroeconomic and financial linkages, relying in part on a stress-testing framework. We see the need for further enhancement of supervisory capacity. Stress testing should include credit-risk scenarios where the quality of household loans degrades in response to adverse macroeconomic shocks differently from historical patterns for corporate loans. To assess the effects of such risks, comprehensive data is needed on household indebtedness, including debt concentrations and the volume of nonbank debt, and indicators of debt servicing capacity, such as disposable income of indebted households. The growing volume of mortgage lending suggests that the housing market is a related risk, and a database of residential real estate transactions should be established to monitor developments in prices and turnover. In the years ahead, merging the financial supervisors should bring synergies, but the process should not be allowed to distract from effective oversight of the sector.

Structural Issues

15. **Continued reduction of direct state involvement in the enterprise sector will improve resource allocation efficiency**. Growth during the period of economic transition was dragged down by the initial misallocation of capital into nonviable sectors and the reinforcement of this pattern by bank lending decisions through the mid 1990s. Cleaning up and privatizing banks, and restructuring and privatizing some large state companies has

helped ensure that investment decisions are made on a market basis. However, privatization has recently slowed, and we urge that it continue expeditiously. We welcome the government's decision to accelerate the disposal of assets held by the Czech Consolidation Agency (CKA), but recommend to strictly limit the number of sensitive companies excluded from this process. All state support to sensitive companies—preferably within the context of restructuring plans—should be transparently recorded in the general government's accounts. This covers support for financial, investment, operating, and wage expenses, and the provision of guarantees. Furthermore, no additional bad assets should be transferred to the CKA prior to its closing in 2007. The Czech railway system continues to drain public resources, even following its financial restructuring at end 2002. Devising a transparent restructuring plan aimed at creating a more efficient railway sector would improve the government's budget position over the medium term.

16. **To increase the economy's future growth potential and accelerate income catch up, the Czech Republic will need to improve its attractiveness to new investment**. Competition for new investment is strong and decisions are influenced by many factors. Corporate income taxation (CIT) has a direct bearing. The government plans to gradually reduce the statutory tax rate to 24 percent by 2006 while also shortening depreciation periods. But the latter measure makes comparing effective tax rates across countries more difficult. In our view, reducing tax deductions and allowances with offsetting declines in the statutory CIT rate would be preferable. Other less-readily quantifiable factors also affect investment decisions. An efficient and predictable business-legal environment is needed to attract small- and medium-sized enterprises—which are expected to bring the next wave of investment. We therefore welcome the government's progress in drafting comprehensive new laws on bankruptcy and commercial registries. These aim to improve creditors' rights, reduce discretion of bankruptcy judges, and standardize and streamline applications for entries into the commercial registers. However, the proposed timetable envisages a long lag before enactment. To bridge this interval, amendments to the existing laws should be legislated without delay. A good basis for these amendments is the recent proposals put forward by a broad cross-section of parliament with the backing of the business and banking community.

17. **Continued structural shifts in labor demand, an aging workforce, and a larger role for labor markets in cushioning economic shocks after euro adoption will increase the premium on labor market flexibility**. While the Czech labor market exhibited considerable flexibility during the past decade, recent trends raise concerns that this flexibility is slowly eroding. Despite solid growth, unemployment—particularly long-term unemployment—has risen, and regional differences appear to have ossified. The authorities recognize these problems and have begun to address the lack of motivation for job search, in particular by school leavers. But the source of some youth unemployment may also lie with the education system, parts of which produce graduates with insufficient or outdated skills. More generally, avoiding persistent skill-mismatch is key, and life-long upgrading of skills is fast becoming necessary to enable the Czech economy to gradually move up the technology ladder. For the long-term unemployed, compulsory activation through training or work should be considered. Reducing impediments to labor mobility, including through easing rent

control, is another priority. On the labor demand side, continuing to upgrade transport infrastructure, reducing non-wage labor costs, and keeping labor market regulations sufficiently flexible would increase the likelihood of job-rich growth. While some of these steps involve fiscal costs—and their implementation would require a restructuring of public spending—their benefits would be reflected in a labor market more responsive to the changing needs of the global economy.

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