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IMF Executive Board Concludes 2006 Article IV Consultation with the Czech Republic

On February 21, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Czech Republic.[1]

Background

Economic performance strengthened during 2005–06, supported by the expanding capacity of the export-oriented automotive sector and a cyclical recovery in the European Union. The momentum of growth has been underpinned by strong productivity gains, leading to a surge in exports and further investment in the tradable goods sector. The koruna strengthened, helping keep inflation down, while competitiveness and the external position have remained favorable. Earlier policy reforms and growing integration with the EU have helped build a solid foundation for income convergence in the Czech Republic.

Growth is projected to remain robust in 2007–08, although its momentum will slow as the effects of the recent export capacity expansion unwind. Investment, especially in machinery and transport equipment, is expected to remain buoyant, supported by strong corporate profitability. Private consumption will also continue to grow strongly on the back of rising employment and an expansionary fiscal policy stance. Risks to growth are broadly balanced, with the upside risks stemming from external factors (lower oil prices and stronger recovery in the eurozone)

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

offsetting the downside risks to confidence, in view of the uncertain political prospects in the aftermath of a close outcome of the June 2006 national elections.

Increases in regulated prices have pushed headline inflation closer to the 3 percent target in 2006, but the underlying inflationary pressures have remained subdued. Lingering slack in the labor market and inflows of migrant workers kept wage inflation moderate, which, coupled with strong productivity gains, helped contain labor costs. There are no apparent signs of the second-round effects from increases in energy and other regulated prices, which, together with well anchored expectations, underscores the strong credibility of the Czech National Bank (CNB).

Although the koruna has continued to strengthen, both in nominal and real effective terms, this has not hindered the gradual rise in export market shares. The trade account has turned into a surplus during 2005–06. Profit repatriation has kept the current account in deficit, but at a moderate level. This external position is expected to continue to be strong over the medium term.

Monetary policy has been tightened gradually, as the CNB has attempted to strike a balance between the risk of rising resource pressures, continuing productivity gains, and the strengthening koruna. The policy rate was raised in steps from a historic low of 1¾ percent in the summer of 2005 to 2½ percent in January 2007. Inflation is expected to rise over the policy horizon, in part owing to projected increases in regulated prices and indirect taxes, but is projected to remain around the target. Credit to the private sector, especially to households, continues to grow strongly.

Fiscal gains achieved in 2005 were relinquished in 2006. Fiscal policy turned expansionary, and the general government deficit is estimated to have risen to 3¾ percent of GDP, reflecting pre-election tax cuts and increases in social transfers for pensions and health care. A large social spending package in the budget for 2007 is expected to raise mandatory spending in the coming years.

Executive Board Assessment

Executive Directors commended the Czech authorities for the recent strong economic performance. They noted that buoyant growth, sustained by rapid productivity gains, was in line with the recent regional dynamism, and had been accompanied by low inflation and a comfortable competitive position. Against the background of recent fiscal deterioration, Directors underscored the importance for the new government of establishing clear policy signals, and emphasized the need to resume progress on the agenda of fiscal and structural reforms.

Directors noted that a large pre-election fiscal relaxation had led to a reversal of the recent favorable trend in public finances in 2006. The procyclical fiscal stimulus, with the economy set to register another year of robust growth, was untimely. In particular, Directors considered that the decision to increase mandatory social spending in the 2007 budget had worsened the fiscal position, representing a missed opportunity to consolidate fiscal gains in good times.

Directors welcomed the authorities' intention to achieve an annual reduction in the structural deficit by ½ percent of GDP in their forthcoming Convergence Program. They encouraged the government to identify expeditiously concrete expenditure measures to achieve such reductions. Directors emphasized the importance of focusing expenditure reforms on improving efficiency and budgetary flexibility. In the absence of early and comprehensive pension and healthcare reforms, Directors judged that a structural balance or a small surplus would be needed by early in the next decade to prepare for the fiscal costs of aging.

Directors stressed the vital role of institutional reforms to improve public financial management and transparency. In this context, they welcomed the authorities' plans to bring fiscal accounts in line with international best practices. Directors encouraged the authorities to adhere to the spending ceilings under the medium-term fiscal framework when formulating annual budgets, and to integrate extrabudgetary funds into the budget.

With inflation expected to rise against a backdrop of stronger demand but remain close to the target of 3 percent, Directors considered that the cautious pace of monetary tightening pursued by the Czech National Bank was appropriate. They noted that monetary policy would need to strike a careful balance in the period ahead between the rising pressures on resources on the one hand, and favorable influences on inflation such as the strength of the koruna and the supply-driven nature of recent growth, on the other.

Directors welcomed the authorities' plans to clarify their strategy for euro adoption. The economy is already enjoying the gains of nominal convergence and the competitive position is comfortable. Directors underlined, nevertheless, that euro adoption remains an important opportunity for enhanced trade, investment and growth. Policy credibility on fiscal consolidation and structural reforms is crucial not only during the transition to the euro but to maximize the gains from adopting it.

Directors observed that the financial system is generally sound, but faces challenges. They called for strengthening bank supervision to ensure that it remains proactive and forward-looking, especially in view of the recent rapid credit expansion. They welcomed the integration of supervisory functions for banking, insurance and securities under the Czech National Bank, which should bring efficiency gains. The high foreign ownership of banks suggests that closer cooperation with foreign supervisory authorities would be desirable.

Directors welcomed the recent legislative measures to speed up the bankruptcy resolution process. The decision to phase out rent controls should help facilitate labor mobility. Directors welcomed the greater scope for contractual employment afforded by the new labor code, but noted the need for further reforms in the area of employment protection, with the objective of increasing labor market flexibility.

Czech Republic: Selected Economic Indicators, 2002-07

	2002	2003	2004	2005	2006 Est.	2007 Proj.
Real economy (change in percent)						
Real GDP	1.9	3.6	4.2	6.1	6.0	4.8
Domestic demand	4.0	4.1	2.9	1.8	4.9	4.8
CPI (year average)	1.8	0.1	2.8	1.8	2.6	3.2
PPI (year average)	-0.5	-0.3	5.7	3.0	1.6	n.a.
Unemployment rate (in percent)						
Survey based 1/	7.3	7.8	8.3	7.9	7.1	6.9
Registered 1/	9.2	9.9	9.2	8.9	8.1	7.9
Gross national savings (percent of GDP)	23.2	21.1	21.6	24.4	23.5	23.8
Gross domestic investment (percent of GDP)	28.7	27.4	27.6	26.5	27.8	28.1
Public finance (percent of GDP) 2/						
General government revenue	36.8	38.2	38.0	39.0	38.8	38.9
General government expenditure 3/	43.2	44.2	42.0	42.6	43.7	43.5
General government balance 3/	-6.5	-6.0	-4.0	-3.6	-4.8	-4.7
Adjusted to exclude grants to transformation institutions to cover costs related to management of bad assets.	-3.9	-4.8	-3.3	-1.9	-3.7	-4.4
Targeted: adjusted balance excluding net lending 4/	-3.6	-3.9	-2.7	-1.6	-3.6	-4.2
General government debt	18.0	21.5	23.7	25.6	27.6	29.4
Including debt of the Czech Consolidation Agency	24.9	27.4	27.4	27.0	28.3	29.8
Money and credit (end of year, percent change)						
Broad money 5/	3.5	6.9	4.4	8.0	9.0	n.a.
Private sector credit (percent change. eop) 5/	-6.7	10.4	15.8	22.3	23.3	n.a.
Interest rates (in percent, year average)						
Three-month interbank rate	3.6	2.3	2.4	2.0	2.3	n.a.
Ten-year government bond 5/	4.9	4.1	4.8	3.5	3.8	n.a.
Balance of payments (percent of GDP)						
Trade balance	-2.9	-2.7	-1.0	1.4	1.4	1.3
Current account	-5.5	-6.2	-6.0	-2.1	-4.3	-4.2
Gross international reserves (US$ billion)	23.7	27.0	28.4	29.6	31.8	33.8
Reserve cover (in months of imports of goods and services)	6.1	5.5	4.4	4.1	3.6	3.2
Exchange rate						
Nominal effective exchange rate (2000=100) 5/	116.5	116.0	116.4	123.5	129.3	n.a.
Real effective exchange rate (CPI-based; 2000=100)	116.7	112.9	113.0	118.9	124.3	n.a.

Sources: Czech Statistical Office; Czech National Bank; Ministry of Finance; and Fund staff projections.

1/ In percent of total labor force.
2/ Staff estimates for 2006 and 2007.
3/ Excluding privatization revenues of the National Property Fund and the Czech Land Fund, the sale of shares and voting rights.
4/ General government deficit excluding transfer to transformation institutions and net lending.
5/ For 2006, data refer to November.