Press Release No. 16/320
FOR IMMEDIATE RELEASE
June 7, 2016

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2016 Article IV Consultation with the Czech Republic

On June, 24, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Czech Republic.

The Czech Republic has been growing fast on account of a favorable external environment, high EU funds utilization, and accommodative macroeconomic policies. Strong efforts to absorb EU funds supported a sharp pickup in investment, while higher employment and wages, and improving consumer sentiment benefitted private consumption. Unemployment has fallen significantly to the lowest level in the EU. The current account surplus widened in 2015, on account of an improvement in the income account mainly due to stronger EU transfers. Headline inflation remained subdued in 2015, as positive domestic developments were offset by external disinflationary factors.

Fiscal performance was better than expected in 2015, on account of robust tax revenues and spending discipline. But, the main driver was a significant shift in the structure of funding of public investment during the transition between EU fund cycles. To maximize EU fund absorption, government units shifted its focus to EU-funded investments, postponing domestically-financed investments.

Monetary policy has remained accommodative. In November 2013, constrained by the zero lower bound, the Czech National Bank decided to use the exchange rate as an additional inflation targeting instrument to fight deflationary pressures. Appreciation pressures started building up in mid-2015 prompting the CNB to intervene and defend the floor. In February 2016, the CNB Board extended its commitment to the floor until end-2016.

The banking sector is stable and credit growth remains robust. Czech banks have high capital buffers and profitability, strong asset quality, and low non-performing loans. Credit growth has been driven by corporate sector demand for long-term investment loans and household

[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.

demand for mortgages and consumer credit. Low mortgage rates have boosted lending, putting upward pressure on prices. Moreover, some deterioration in the affordability-of-housing indicators has taken place recently.

Economic activity is expected to decelerate in 2016. Higher disposable income and employment will boost private consumption, but growth will be affected by the slow start of investment projects financed by EU funds. As base effects from the oil price shock fade and domestic demand pressures build-up, inflation is expected to reach the 2-percent target in mid-2017. Over the medium-term, output growth is set to stabilize at around slightly above 2 percent in line with economy's potential.

Executive Board Assessment[2]

Executive Directors commended the Czech Republic's favorable economic performance—including strong economic growth and a steady decline in unemployment—which has been underpinned by its solid fundamentals, a favorable external environment, positive growth impact from high EU fund utilization, and supportive macroeconomic policies. At the same time, Directors noted that potential growth is insufficient to achieve fast convergence toward the income levels of other advanced European countries. Accordingly, they encouraged the authorities to maintain their prudent macroeconomic management, while implementing structural reforms to boost potential growth.

Directors welcomed the authorities' continued fiscal discipline, and deemed their medium-term fiscal deficit objective appropriate. They noted that, with the structural deficit already below this objective, there is space for increasing public spending on much-needed infrastructure to support higher medium-term potential growth. Directors urged the authorities to resist pressures to reduce taxes and increase current spending in the run up to next year's elections, and to avoid changes in the pension system that could jeopardize its long-term sustainability. They emphasized that a speedy adoption of fiscal framework legislation would help anchor fiscal policy, guard against pro-cyclicality, and enhance predictability.

Directors concurred that the balance of risks to inflation is tilted to the downside and, thus, saw merit in maintaining the currently accommodative monetary policy stance until the inflation forecast and inflation expectations become entrenched around the inflation target. They called on the central bank to continue to focus on inflation targeting and to prepare the modalities for an eventual exit from the exchange rate floor to a floating exchange rate once conditions allow. Directors agreed that, if downside risks to inflation were to materialize, the central bank could employ other tools to counter an undesirable tightening of monetary

[2] 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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

conditions. These could include using negative interest rates to help mitigate speculative capital inflows as well as discretionary interventions in case market conditions became disorderly. Nevertheless, a number of Directors called on the authorities to exercise caution in using negative interest rates, noting that they could have negative implications for bank profitability and financial stability.

Directors welcomed the progress in strengthening the financial supervisory and regulatory frameworks. They concurred that the financial system is sound and resilient to shocks, with a low, system-wide loan-to-deposit ratio as well as strong capital and liquidity buffers. Noting that a strong housing market could become a potential source of risk, Directors welcomed the steps already taken to tighten mortgage lending standards, and encouraged the authorities to remain vigilant to prevent a buildup of vulnerabilities and to further tighten the macroprudential stance if current trends continue. In this regard, they recommended giving the central bank the authority to issue binding macroprudential regulations.

Directors welcomed the recently adopted 2016 National Reform Program, and stressed the importance of its steadfast implementation to raise potential growth, noting that priority should be given to enhancing investment in physical and human capital and to promoting innovation. Directors also called for efforts to boost the effectiveness and efficiency of infrastructure spending; reform the education system to prevent skill shortages from becoming binding in the future and, thus, help attract more knowledge-intensive industries; and improve the coordination and prioritization of spending on research and development. Directors underscored the need for more predictable policy and regulation and for a reduction in the administrative burden, which will help boost the business environment, competiveness, and investment.

Czech Republic: Selected Economic Indicators, 2011–21

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Nominal GDP (USD billions)	227.3	206.4	208.3	205.3	181.8	183.9	189.6	192.5	194.1	195.7	194.4
Population (millions)	10.5	10.5	10.5	10.5	10.5	10.6	10.6	10.6	10.6	10.6	10.7
GDP per capita (USD)	21,676	19,651	19,810	19,526	17,252	17,412	17,911	18,156	18,264	18,384	18,221
Real economy (growth rate in percent, unless stated otherwise)											
Real GDP	2.0	-0.9	-0.5	2.0	4.2	2.2	2.7	2.4	2.2	2.2	2.2
Real GDP per capita	1.7	-1.1	-0.6	2.0	3.9	1.9	2.4	2.2	2.0	2.0	2.0
Domestic demand	0.0	-2.3	-0.6	2.3	4.7	1.6	3.1	2.8	2.7	2.7	2.7
Private consumption	0.3	-1.5	0.7	1.5	2.8	3.2	2.9	2.5	2.3	2.3	2.3
Investment	1.8	-4.1	-5.0	4.4	9.9	-2.0	3.5	4.0	4.0	4.0	4.0
Exports	9.3	4.3	0.0	8.9	7.0	6.4	6.1	5.0	4.0	4.0	4.0
Imports	6.7	2.7	0.1	9.8	7.9	6.0	6.9	5.7	4.7	4.7	4.7
Output gap (percent of potential output)	0.6	-2.1	-4.2	-2.7	0.2	0.2	0.2	0.2	0.2	0.1	0.0
CPI (average)	1.9	3.3	1.4	0.4	0.3	0.6	1.9	2.0	2.0	2.0	2.0
Unemployment rate (in percent)	6.7	7.0	7.0	6.1	5.0	4.3	4.3	4.3	4.3	4.3	4.4
Gross national savings (percent of GDP)	24.9	24.7	24.2	25.4	27.6	26.8	26.5	26.4	26.4	26.4	26.4
Gross domestic investments (percent of GDP)	27.0	26.3	24.8	25.3	26.7	25.4	25.5	25.9	26.3	26.8	27.2
Public finance (percent of GDP)											
General government revenue	40.4	40.7	41.6	40.8	42.2	40.7	40.7	40.8	40.7	40.7	40.6
General government expenditure	43.2	44.7	42.7	42.8	42.6	41.3	41.3	41.3	41.2	41.1	41.1
Net lending / Overall balance	-2.7	-3.9	-1.3	-1.9	-0.4	-0.6	-0.6	-0.5	-0.5	-0.5	-0.5
Structural balance (percent of potential GDP)	-2.8	-1.5	0.1	-0.8	-0.3	-0.6	-0.8	-0.6	-0.5	-0.5	-0.5
General government debt	39.9	44.7	45.1	42.7	41.1	40.8	39.8	38.9	37.9	37.1	36.2
Money and credit (end of year, percent change)											
Broad money (M3)	2.8	4.8	5.8	5.9	8.0	...	...	...	...	...	...
Private sector credit	5.5	2.6	3.7	3.6	6.5	...	...	...	...	...	...
Interest rates (in percent, year average)											
Three-month interbank rate	1.2	1.0	0.5	0.4	0.3	...	...	...	...	...	...
Ten-year government bond	3.7	2.8	2.1	1.6	0.6	...	...	...	...	...	...
Balance of payments (percent of GDP)											
Trade balance (goods and services)	3.9	5.0	5.8	6.5	6.4	6.9	6.5	6.1	5.6	5.1	4.7
Current account balance	-2.1	-1.6	-0.5	0.2	0.9	1.4	1.0	0.6	0.1	-0.4	-0.8
Gross international reserves (billions of euros)	30.6	34.2	41.0	44.2	60.4	67.0	74.9	80.5	83.5	85.7	86.1
(in months of imports of goods and services)	3.1	3.6	4.5	4.1	5.5	6.1	6.4	6.7	6.8	6.7	6.5
Exchange rate											
Nominal effective exchange rate (index, 2005=100)	123.2	118.4	116.9	111.6	110.3	...	...	...	...	...	...
Real effective exchange rate (index, CPI-based; 2005=100)	122.3	118.2	116.1	109.9	108.0	...	...	...	...	...	...

Sources: Czech National Bank; Czech Statistical Office; Ministry of Finance; Haver Analytics, and IMF staff estimates and projections.