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January 2008
IMF Country Report No. 08/39

Czech Republic: 2007 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Czech Republic

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the Article IV consultation with the Czech Republic, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 20, 2007, with the officials of the Czech Republic on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 7, 2008. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its January 23, 2008 discussion of the staff report that concluded the Article IV consultation.

- Statement by the Executive Director for the Czech Republic.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

CZECH REPUBLIC

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation with the Czech Republic

Approved by Alessandro Leipold and G. Russell Kincaid

January 7, 2008

Executive Summary

- **The Czech economy continues to perform well and external vulnerabilities are limited**. The growth momentum has been sustained and the economy has so far weathered the recent market turmoil well. External debt is low and the modest current account deficit is comfortably financed by direct investment flows. While the koruna has appreciated sharply in recent months, it is estimated to be broadly in line with fundamentals.

- **Growth, while still robust, is likely to slow in 2008 and inflation expected to rise sharply**. Downside risks to growth stem primarily from external sources. Headline inflation is set to double due to a series of shocks arising from indirect taxes as well as food and energy price increases. Strong demand on resources is also increasing underlying inflation.

- **Monetary policy needs to be on a sustained tightening path**. The appropriate pace of tightening will depend on the degree of koruna appreciation and second-round effects of indirect tax and energy price increases. The Czech National Bank's high credibility, and recent steps to enhance transparency of policy communication, should serve to anchor inflation expectations. This would also facilitate the transition to the lower inflation target of 2 percent from 2010.

- **The main medium-term policy challenge centers on achieving sustainable fiscal consolidation**. The authorities plan to lower the deficit below the Maastricht threshold limit from 2008 onwards. Building on the considerably better-than-budgeted outcome in 2007, the authorities should maintain the originally targeted adjustment for 2008. Beyond that, there was broad consensus that the recently approved tax and welfare reform package, while introducing some welcome changes in the tax structure, does not sufficiently advance fiscal consolidation. Comprehensive pension and health care reforms, implemented early, will be essential for sustainable public finances. Absent such reforms, tax cuts can be ill afforded. Labor market reforms could also help alleviate fiscal adjustment.

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I. INTRODUCTION[1]

1. **Reaping the benefits of EU integration and prudent macroeconomic policies, the Czech Republic has made solid strides toward convergence with the EU-15**. Over the past few years, growing trade linkages fostered by strong direct investment inflows, coupled with a regional cyclical upswing, have underpinned an export-led boom, accompanied by low inflation and an improving external balance. Reassured by these strong fundamentals, market sentiment has remained benign, allowing the economy to tide over an extended political gridlock[2] and global market turmoil with fairly low financial market and exchange rate volatility.

2. **Sustaining this growth momentum with external stability will require addressing the key challenge of fiscal consolidation**. This is also a prerequisite to ensuring smooth euro entry. With one of the highest primary fiscal deficits in the region and large demographic shifts underway, structural fiscal and pension reform remains a key priority to restore longer run debt sustainability and improve incentives to work. Labor market reforms to reduce structural unemployment, and increase flexibility and participation could make a substantial contribution to reducing the fiscal gap and enhancing income convergence. Given the importance of building a social consensus on durable fiscal consolidation measures, staff organized, jointly with the authorities, a conference on the fiscal reform agenda with participation by representatives from the public and private sectors and the academic community.

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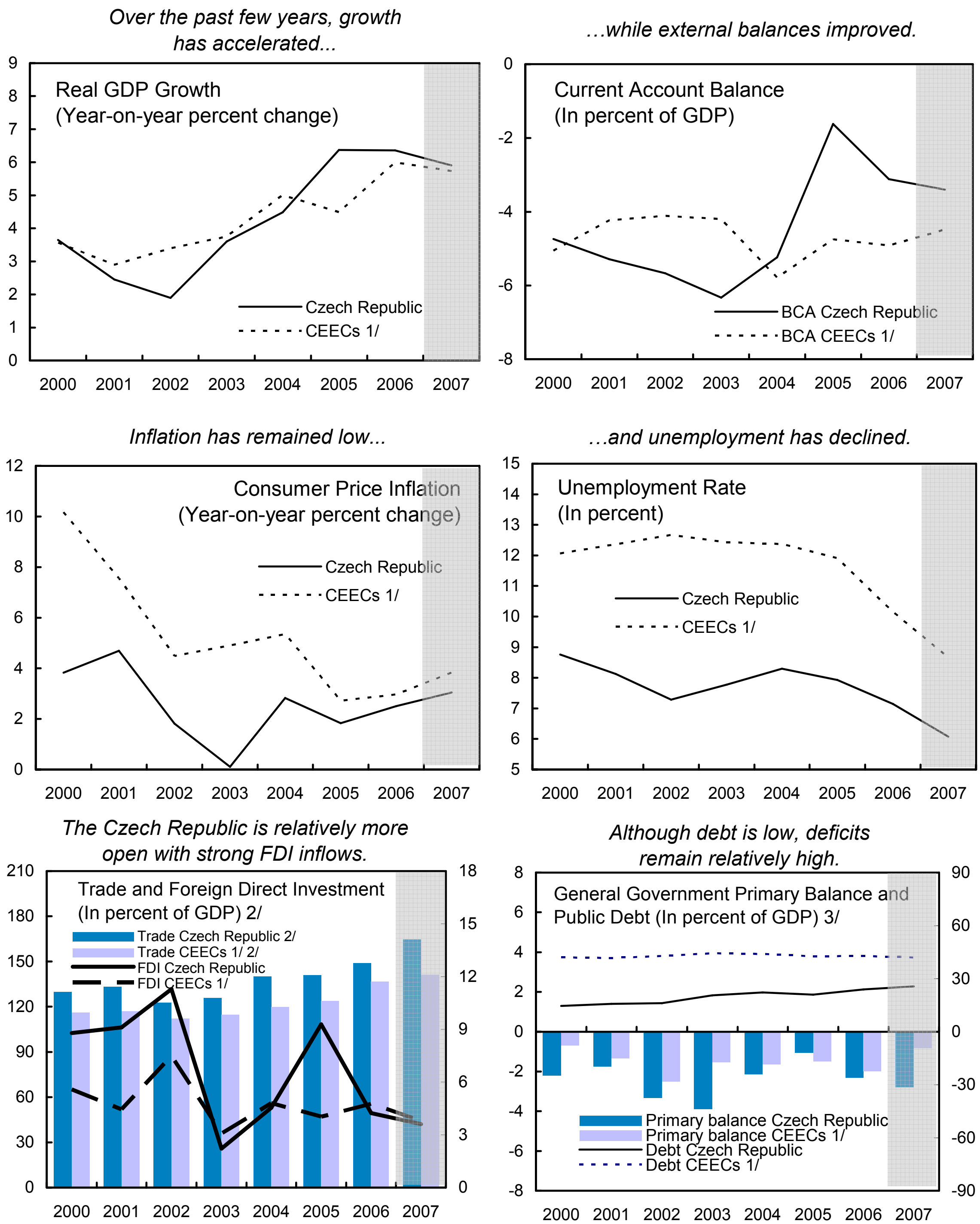
[1] A staff team comprising Mr. Thakur (head), Mr. Dalsgaard, Ms. Muñoz, and Ms. Tuladhar (all EUR) held discussions in Prague during November 8–20. Mr. Polak (Senior Advisor to the Executive Director) joined the discussions. Messrs. Rosenberg and Tirpak from the Regional Representative's office also participated. The Czech Republic has accepted the obligations of Article VIII of the Articles of Agreement and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions and subscribes to the SDDS.

[2] Following an indecisive election outcome in June 2006, a center-right coalition took office in January 2007 with the support of two opposition members.

Czech Republic and CEECs: Comparative Macroeconomic Developments, 2000-07



Sources: WEO; Eurostat; and IMF staff estimates.

1/ Average for Hungary, Poland, the Slovak Republic, and Slovenia.

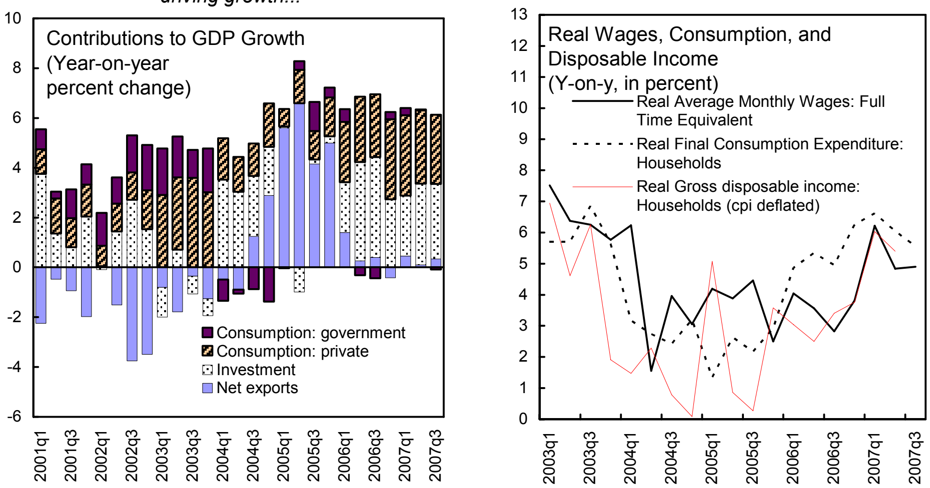
2/ Trade is defined as exports plus imports of goods and services and is measured on the left scale. Net foreign direct investment is measured on the right scale.

3/ Primary balance is measured on the left scale and public debt on the right scale.

II. Background

3. **A strong cyclical upswing continued apace in 2007**. GDP growth is likely to be sustained at close to 6 percent for the third year in a row, driven by domestic demand (Figure 1 and Table 1). While export growth has remained robust, led by the automobile sector, strong corporate profitability has fuelled fixed investment. Consumption has remained strong, reflecting rising disposable earnings from strong wage gains, higher social transfers and rapid credit expansion.

Domestic demand is increasingly driving growth... *...boosted by private consumption.*

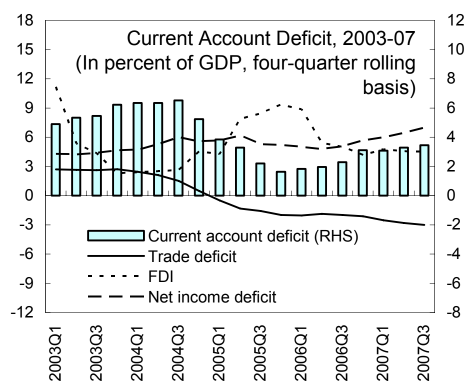


Source: Czech Statistical Office; and IMF staff calculations.

4. **Rapid growth has begun to stretch capacity limits (Figure 2)**. The unemployment rate has declined to the lowest level this decade, marked by a decline in both short and long term unemployment. With labor shortages emerging despite a steady rise in immigration, wage gains are rapidly catching up with strong productivity growth, squeezing profitability margins. Capacity utilization rates in industry also stand at record high levels. Estimates of output gap measures also point to a positive gap in 2007.

5. **The current account deficit has widened, but remains largely financed by inflows of direct investment (Figure 3)**. Although the saving rate remains relatively high, the pickup in investment led to a rise in the current account deficit to around 3½ percent of GDP in 2007 from about 3 percent in 2006 (Table 2). Trade and services balance surpluses continued to improve on account of strong exports of the automobile and electronic sectors. However, with record profits, these were offset by a sharp rise in repatriation of dividends by foreign investors.

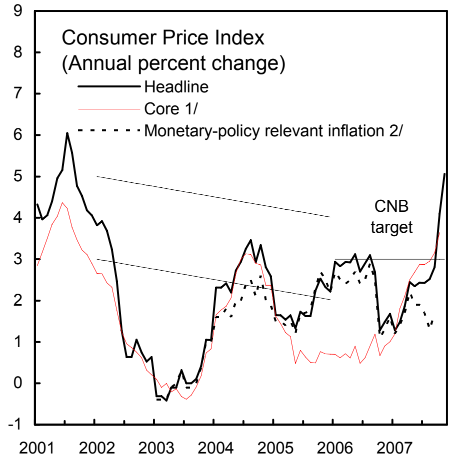
The current account deficit has widened in 2006-07 as profit repatriations rose but has been adequately financed by FDI flows.



Source: Czech Statistical Office; and Czech National Bank.

6. **Underlying inflation has picked up from the low levels of recent years**. Core inflation, which had remained subdued at around 1 percent, has risen steadily since late 2006, fuelled by higher domestic demand amid tightening labor markets, strong credit expansion, and rising food and regulated prices. The depreciation of the koruna during the first half of 2007, precipitated by the negative carry trade vis-à-vis the euro area also added to inflation. Although the liquidation of these carry trades amid the global financial turmoil in August contributed to reversing the depreciation, strong consumption demand and rising food and oil prices pushed headline inflation to 5 percent in the year to November 2007, well above the upper margin of the Czech National Bank's (CNB) tolerance band of 1 percent around the target of 3 percent.

Strong domestic demand has fuelled a rise in core inflation.



Sources: Czech Statistical Office; Eurostat; and IMF staff estimates.
1/ Harmonized CPI excluding energy and seasonal food.
2/ Adjusted for first-round impact of changes to indirect taxes.

7. **Consistent with the inflation targeting framework, monetary policy was tightened in recent months to counter rising inflation pressures (Figure 4)**. Monetary conditions eased in early 2007 as the policy rate was kept unchanged, rising inflation lowered real interest rates, and the koruna depreciated. Against a backdrop of strong domestic demand and a widening of the interest rate differential vis-à-vis the euro area—already at 125 basis points in May 2007—the CNB raised its policy rate in steps from 2 ½ percent to 3 percent in early summer. Despite tightening credit conditions in European financial markets, the CNB raised the rate further to 3 ¼ percent in August and to 3 ½ percent in November 2007. Although real rates have turned negative, the rapid appreciation of the koruna in recent months—about 5 percent since October—has contributed to tightening monetary conditions. The Czech policy rate remains among the lowest in the EU.

8. **Fiscal policy in 2007 is expansionary even though strong growth has resulted in a considerably more favorable outturn than budgeted**. Spurred by the strength in household incomes, consumption and corporate profits, buoyant tax revenues are likely to keep the general government deficit (on ESA-95 basis) below 3 percent of GDP, fortuitously offsetting the large increase in social benefits stemming from pre-election commitments (Table 3). With a widening positive output gap, the fiscal stance for 2007 is nevertheless estimated to be expansionary, albeit modestly.

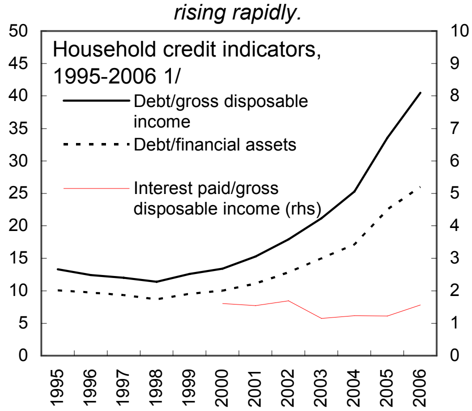
Fiscal Stance, ESA-95, 2005-07 (In percent of GDP)

	2005	2006	2007	
	Actual	Actual	Auth Proj.	Staff Proj.
Revenue	41.3	40.7	39.8	40.4
Expenditure	44.9	43.6	43.3	43.2
General Government Deficit	-3.5	-2.9	-3.4	-2.8
Cyclically Adjusted Deficit 1/	-2.8	-2.9	-3.7	-3.4
Cyclically Adjusted Primary Deficit	-1.6	-1.8	-2.6	-2.2
Change (Fiscal Impulse)	1.4	0.2	0.8	0.4
Memo:				
Nominal GDP growth	6.3	7.5	9.6	10.2
General Government Debt	30.2	30.1	30.4	29.5

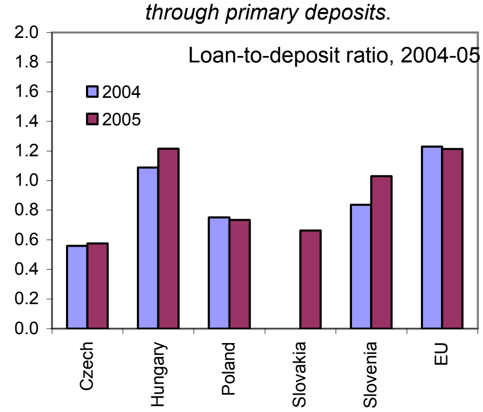
Source: Ministry of Finance and staff estimates.
1/ Assumes staff estimates of output gap.

9. **Near-term vulnerabilities are limited**. Public debt remains relatively low at around 30 percent of GDP, with limited exposure to foreign currency debt. While external debt has risen to around 41 percent of GDP at end-2006, gross international reserves continued to rise

Household debt ratios are rising rapidly.



Bank lending is financed predominantly through primary deposits.

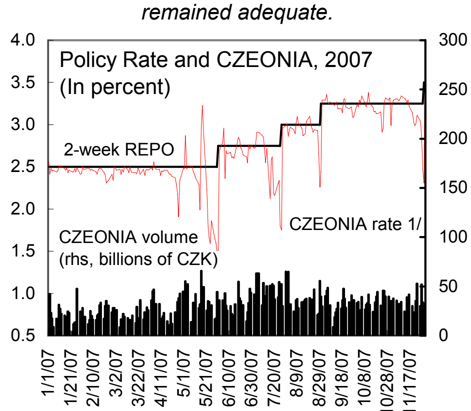


Source: Financial Stability Report, 2006; Czech National Bank.
1/ Data for 2005 and 2006 are only estimates.

as well, reaching above US$ 31 billion by end-October, covering over 3 months of imports and 1.2 times short-term maturing debt (Table 4). While household debt—primarily mortgages—has risen rapidly, credit risks are limited by the low level of foreign currency borrowing, with bank lending financed primarily through domestic deposits.

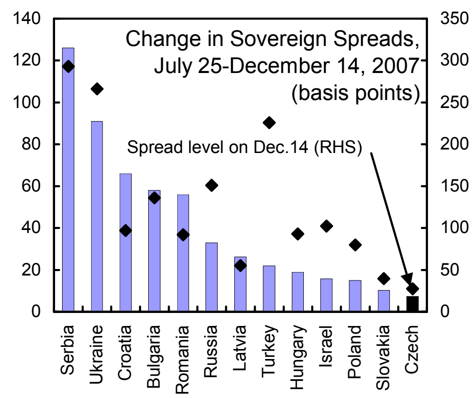
10. **Investor sentiment remains positive, with almost no spillover from the global market turbulence**. Liquidity conditions in the money markets have remained benign with

Financial market liquidity has remained adequate.



Source: Bloomberg.
1/ Czech Overnight Index Average.

Sovereign spreads, already low, have changed little.



Source: Bloomberg; and IMF staff calculations.

overnight rates moving in line with the policy rate. Sovereign spreads, already low, rose little during August-December 2007, reflecting limited reliance on cross-border bank loans and sound financial position of borrowers (Figures 5 and 6). Yields remain the lowest in Central Europe.

III. ECONOMIC OUTLOOK

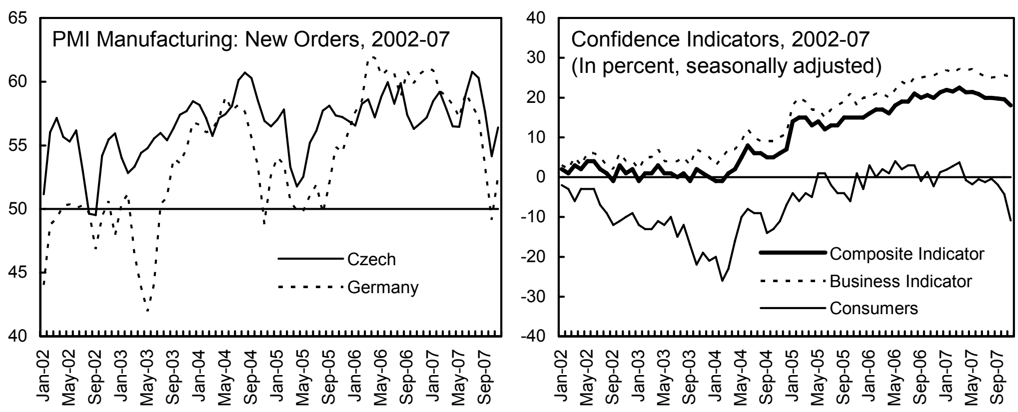
11. **Economic growth is expected to slow in 2008 but should remain solid on the back of continued strong domestic demand**. Staff projects growth to decline to about 4½ percent, in line with the consensus, as recent fiscal measures to raise VAT and reduce social benefits weigh on private consumption and growth in the euro area weakens. The planned tightening of the fiscal stance will also contribute to a dampening of domestic demand. On the other hand, fixed investment is projected to rise supported by strong corporate profits, tax cuts and the need for capacity expansion. Over the medium term, output is expected to be boosted by the coming on stream of a large export-oriented project in the automobile sector,[3] boosting integration with domestic supplier chains (Table 5). Output is thus likely to remain above its potential level and unemployment low.

Comparative Growth and Inflation Forecasts, 2007-09
(In percent)

	2007	2008	2009
Growth			
IMF (November)	5.9	4.6	5.2
Consensus (November)	5.8	4.8	4.8
MOF (October)	5.9	5.0	5.1
CNB (October)	6.2	5.0	5.6
Inflation (annual average)			
IMF	3.0	5.4	3.5
Consensus	2.7	4.5	3.1
MOF	2.3	3.8	2.2
CNB	2.4	4.9	3.5

Sources: Consensus Forecasts, Czech authorities, and IMF staff estimates.

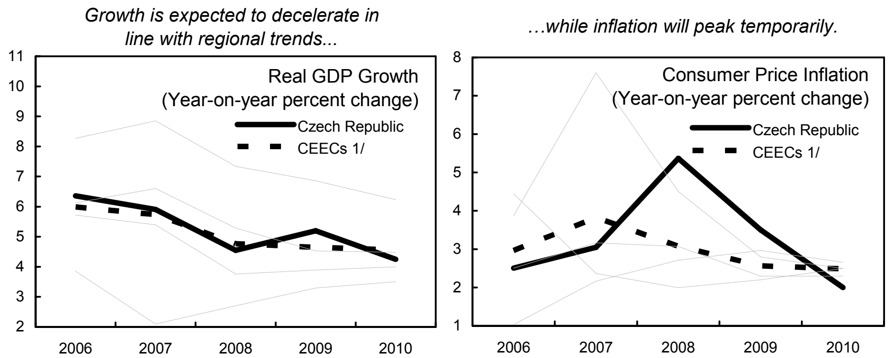
Forward looking indicators suggest a slowdown but still robust growth.



Source: Haver.

[3] Hyundai is expected to start a major new automobile plant in late 2008, which could contribute nearly a percentage point to GDP growth.

Czech Republic: Macroeconomic Developments, 2006-10



Sources: WEO; and IMF staff estimates.
1/ Average for Hungary, Poland, the Slovak Republic, and Slovenia.

12. **The risks to this forecast are on the downside, stemming primarily from fragility of growth in major export markets**.[4] There is so far no discernible spillover through credit channels from the ongoing financial market turbulence abroad. However, if the turmoil were to persist leading to a more pronounced slowdown in the euro area and the United States, it could adversely affect Czech exports. Continued high oil prices could also place a further drag on growth. Labor supply constraints at home add to these risks. Despite these risks, stress tests suggest that external debt will remain stable over the medium term (Figure 7 and Table 6).

13. **Inflation is set to rise sharply against a backdrop of demand and wage pressures as well as rising food and energy prices and increases in indirect taxes**. Headline inflation is forecast to rise above 5 percent in 2008, well above the upper margin of the Czech National Bank's tolerance band around the target of 3 percent, mainly on account of the first round effects of increases in VAT and excises. Core inflation is also expected to rise in the face of a positive output gap and a tight labor market. Following a lengthy period of low inflation, there is a risk of such a rapid doubling of headline inflation feeding into inflation expectations with knock-on effects on wage and price setting. A slower pace of koruna appreciation could also remove a recent significant anti-inflationary influence, placing a greater burden on monetary policy.

14. **Medium-term growth prospects hinge on deeper structural reforms**. Aging will increase pressures on the public finances and the labor market. The tax-benefit system has created low-wage and unemployment traps. Labor supply constraints despite high long term unemployment, skill mismatches and sizable regional disparities point to low labor market flexibility, exacerbated by strict employment protection regulations (Figure 8). Rankings of business competitiveness have slipped, reflecting concerns regarding growing scarcity of skilled labor, slow judicial processes, and corruption. Rising wage pressures could erode

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[4] The staff forecasts are being reassessed in the context of the ongoing World Economic Outlook round.

competitiveness. Failure to address these structural weaknesses could adversely affect labor utilization and investment, reducing growth prospects in the face of intensifying regional competition. Against this background, staff projects potential growth to slow to around 4½ percent.

EU8: Business Competitiveness Rankings, 2007 (Change from last year)

Heritage Foundation Economic Freedom		IMD World Competitiveness Scoreboard		WEF Global Competitiveness Index		World Bank Doing Business Index	
Estonia	12 (-5)	Estonia	22 (-3)	Estonia	25 (1)	Lithuania	16 (-1)
Lithuania	22 (1)	Lithuania	31	**Czech Republic**	29 (0)	Estonia	17 (0)
Czech Republic	**31 (-10)**	**Czech Republic**	**32 (-4)**	Slovenia	33 (-3)	Latvia	24 (7)
Slovakia	40 (-5)	Slovakia	34 (-1)	Latvia	36 (3)	Slovakia	36 (-2)
Latvia	41(-2)	Hungary	35 (0)	Slovakia	37 (-1)	**Czech Republic**	52 (-2)
Hungary	44 (-4)	Slovenia	40 (-1)	Lithuania	40 (-6)	Slovenia	61 (-5)
Slovenia	58 (-20)	Poland	52 (-2)	Hungary	41 (-6)	Hungary	66 (-6)
Poland	87 (-26)	Latvia	n.a.	Poland	48 (-5)	Poland	75 (-1)

Sources: Heritage Foundation, IMD, World Economic Forum, World Bank.

IV. POLICY DISCUSSIONS

15. **The central theme of the discussions was the imperative of strong fiscal consolidation as a prerequisite to ensuring smooth euro entry and sustained long-term growth with external stability**. Although the longer-term structural challenges formed the backdrop for the fiscal reform strategy, the consultation centered on three key topics seen as pivotal to sustained and balanced growth:

- the need for a restrictive policy stance in 2008, in view of a still positive output gap and rising inflation pressures, with an appropriate mix between fiscal and monetary policy;
- implications of the recently adopted fiscal package, and the importance of setting clear priorities between competing objectives of fiscal consolidation and tax relief;
- the need for vigilance over the financial sector in the current uncertain market environment.

A. Ensuring Sustainable Public Finances

16. **Durable fiscal reform remains the primary policy challenge**. Seeking to reverse the trend toward fiscal relaxation afforded by the gains from the economic upswing, the authorities recently unveiled a tax and welfare reform package (Box 1). It aims to reduce excessive deficits[5] and stabilize the medium-term budget while lowering the tax burden. The authorities plan to reduce the deficit from the officially projected 3.4 percent of GDP in 2007 to 2.9 percent in 2008. They plan to further lower the deficit to 2.3 percent of GDP by 2010, entailing a cumulative fiscal effort of about 1½ percent of GDP over the next three years. However, they acknowledge that underlying expenditure measures to achieve these goals are

[5] The Czech Republic has remained under the Excessive Deficit Procedure of the EU since 2004.

yet to be fully spelled out and pressure from the coalition partners for further tax cuts remain. Although public debt remains low and stable (Figure 9 and Table 7) owing to the favorable growth and financing from privatization revenues, the authorities recognize the crucial role of expenditure consolidation to address challenges created by a rapidly aging population.

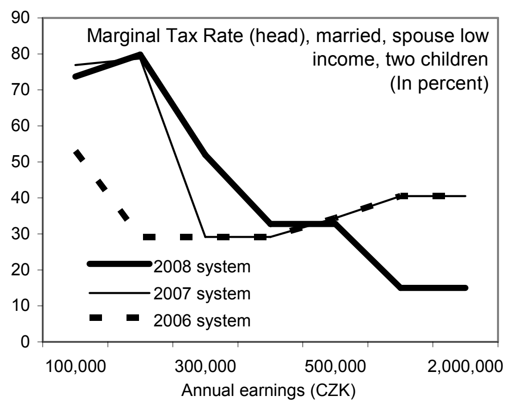
Box 1. The Tax and Welfare Reform Package: Key Measures

The recently adopted tax and welfare reform package seeks to strengthen government finances, lower the tax burden while also promoting growth and employment. Key measures include:

	Impact on Fiscal Balance (In percent of GDP)		
	2008	2009	2010
Introduction of a flat rate of personal income tax at 15 percent (while broadening the tax base to include social security contributions and increasing tax credits)	-0.6	-0.7	-0.8
Phased reduction of corporate income tax from the current 24 percent to 19 percent by 2010	-0.2	-0.6	-0.8
Increase in the lower VAT rate from 5 percent to 9 percent and introduction of environmental taxes	1.0	1.0	0.9
Introduction of a ceiling on social security contributions	-0.2	-0.2	-0.2
Reduction and streamlining of social benefits, and health care reform 1/	0.5	0.7	0.6
Total	0.6	0.2	-0.2

Source: Czech Ministry of Finance.
1/ Adjusted to exclude measures not yet approved (health care in 2010) and savings due to postponement of measures (casualty and sickness insurance).

An analysis of the fiscal reform package suggests some desirable features.[1] The Czech tax system currently relies heavily on social security contributions and corporate income taxes. A shift in the tax structure away from direct towards indirect taxes will likely contribute to enhanced savings and investment.



However, the package does not fully deliver on its objectives in an efficient and cost-effective way. The personal income tax cuts are largely unnecessary and not well-targeted. The substantial disincentives to work at low wages – as shown by the marginal tax rates caused by the combined effects of income tax, social security contributions and withdrawal of benefits–have not been effectively addressed (text chart). The cap on social security contributions would also reduce revenue efficiency.

Furthermore, the package does not address the critical task of fiscal consolidation in the medium- to long-term since the permanent tax cuts are offset by spending measures which are of a temporary nature or yet to be defined.

[1] For further details, see accompanying background paper on Tax and Welfare Reform in the Czech Republic—Structural Implications and Challenges.

17. **Against this backdrop, staff argued for saving any cyclical gains for the 2008 budget**. The authorities agreed that the 2007 outturn was likely to be better than the projected 3.4 percent of GDP, absent one-off or large end-of-year spending—by over ½ percent of GDP in staff's estimates. Based on a more favorable 2007 deficit estimate, staff argued that the fiscal effort envisaged in the already approved budget, would imply a commensurately lower deficit target, of around 2¼ percent of GDP, in 2008. Attaining this target would require that additional discretionary spending—from accumulated reserves of prior years—does not offset this adjustment; automatic stabilizers should however be allowed to play around this path. This adjustment was deemed appropriate given the still positive output gap and risks to achieving the planned consolidation in 2009–10.

Fiscal Outlook, ESA-95, 2006-10 (In percent of GDP)

	2006	2007	2008	2009	2010
	Actual	Staff Projections			
General Government Deficit	-2.9	-2.8	-2.2	-2.1	-2.5
Cyclically Adjusted Deficit	-2.9	-3.4	-2.9	-3.0	-3.3
Cyclically Adjusted Primary Deficit	-1.8	-2.2	-1.6	-1.8	-2.1
Change (Fiscal Impulse)	0.2	0.4	-0.6	0.2	0.3
Memo:					
General Government Debt	30.1	29.5	28.9	28.4	28.5

Source: Ministry of Finance and staff estimates.

18. **The authorities concur that fiscal consolidation, centered on pension and health care reforms, needs to be sustained beyond 2008, although political constraints could limit its scope**. The authorities' Convergence Program plans an annual consolidation of around ½ percent of GDP in structural terms and a medium term deficit objective of 1 percent of GDP by 2012 to meet the SGP requirements and accommodate age-related spending pressures. Staff stressed that the Czech Republic remains one of the few countries that has yet to start reforming its pension system despite having one of the largest fiscal gaps that need to be filled. In the absence of comprehensive pensions and health care reforms, the medium-term objective would not ensure sustainable public finances.[6] Officials noted that despite recent progress, political constraints remained.

Sustainability Gap Indicators (percent of GDP) 1/

	Change in Age-related Expenditures, 2005-50	S1	S2 2/
Czech Republic	**7.7**	**2.5**	**5.5**
Hungary	7.1	7.9	9.8
Slovenia	9.9	3.9	7.3
Poland	-3.2	-0.4	-0.2
Slovakia	3.7	1.3	3.0
EU25	4.1	2.1	3.4

Source: Long Term Sustainability of Public Finances in the EU, 2006.
1/ S1 measures the change in primary balance needed to keep debt below 60 percent in 2050.
2/ S2 measures the change in primary balance needed to meet the intertemporal budget constraint.

19. **The authorities stressed that the fiscal package represented a delicate compromise within the governing coalition**. The tax reform proposals, although revenue neutral in 2008, will lead to a loss of revenues in 2009 and beyond. Officials also acknowledged that the expenditure measures only slow down rather than arrest the current rapid pace of growth in mandatory spending. Significant risk remains that measures such as compression of public sector wages and the freezing of social benefits will not be

[6] See accompanying background paper on Tax and Pension Reform—Implications for Growth and Debt Sustainability

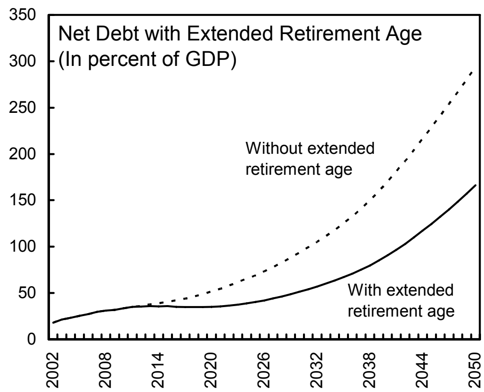
sustainable. In their view, the package contained positive features such as greater discretionary scope in the budget through deindexation of social benefits and improved targeting of some parental and child benefits. Staff noted that these measures nevertheless did not fully claw back the large social spending approved ahead of the 2006 elections.

20. **Looking ahead, the fiscal strategy needs to (i) strike a balance between spending and revenue measures; (ii) achieve systemic reforms in pensions and healthcare; and (iii) promote complementary reforms in the labor market**.

- The authorities agreed that spending measures are a priority not only to achieve the needed consolidation but also to enhance efficiency and budgetary flexibility. Staff cautioned that without durable offsetting expenditure measures, the Czech Republic cannot afford the planned tax cuts and may even have to consider tax increases.

- On pension reform, political consensus has been reached on raising the retirement age to 65 years, but since it is unlikely to restore pension system viability, creation of pension reserves to ensure greater intergenerational equity is being planned. Increased reliance on private pension savings, including through a partial voluntary opt-out is also being considered. In health care, the introduction of co-payments has marked an important step towards containing excess demand pressures. Further efforts to contain costs and reduce distortions in the system are being debated by the political parties.

Extending the statutory retirement age would help alleviate fiscal pressures but would not ensure pension system viability.



Source: IMF staff calculations.

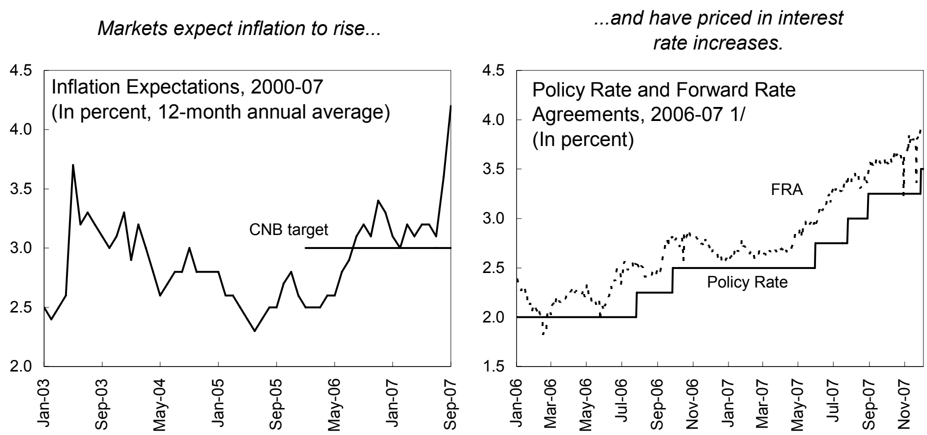
- The officials were receptive to the staff's view that labor market reform to lower structural unemployment and tax-benefit reform to reduce disincentives to work can ease fiscal adjustment. However, they were not optimistic on the near-term prospects of changes to the employment protection regulations, following closely on the heels of the new labor code passed in 2006.

B. Monetary Policy Conduct and Communication

21. **With inflation projected to be above target, monetary policy would need to remain on a sustained path of tightening**. CNB officials noted that in deciding the precise pace of tightening in the face of the projected sharp rise in inflation, they will need to weigh factors such as the developments in the koruna, recent evidence of weaker European growth and the stance of fiscal policy.[7] While recent wage negotiations suggest continued wage

[7] See accompanying background paper on Challenges to Monetary Policy.

moderation, the behavior of the exchange rate, driven in recent months largely by movements in the U.S. dollar, could complicate monetary management (Box 2). Inflation expectations pose another significant source of uncertainty. They further noted that in the recent period of low inflation since 2004, the inflation process had exhibited considerable persistence, easing the task of monetary policy. With a series of upward shocks to inflation in the period ahead, against a backdrop of tightening labor market conditions, staff and CNB officials agreed that it was important to ensure that expectations remained well anchored to the inflation target through timely policy tightening.

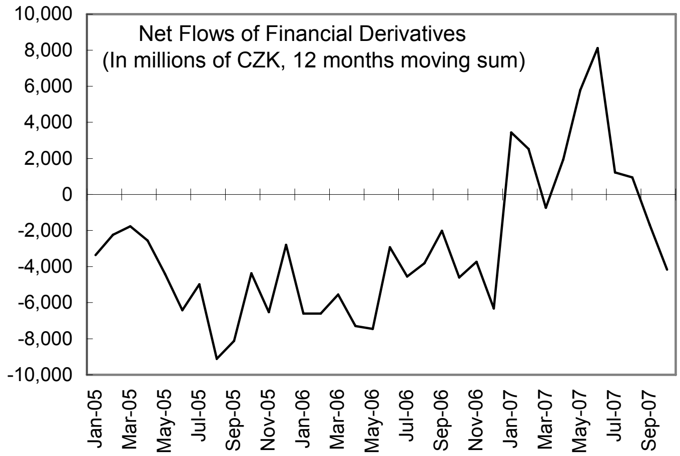


Source: Bloomberg; and Czech National Bank.
1/ The forward rate agreement (FRA) are over the counter interest rate agreements for the 3 month interest rate, 2 months in the future. FRA's are used as a leading indicator of future monetary policy decisions.

22. **The planned downward shift in the inflation target to 2 percent from 2010 further underscores the importance of preserving credibility and enhancing transparency of policy communication**. The decision to lower the target is based on the assessment that low inflation has taken firm roots in the Czech economy and that any real appreciation in the remaining process of convergence would continue to manifest itself through koruna appreciation rather than higher inflation. With the onset of a spike in headline inflation reflecting a number of one-off shocks, shaping expectations was critical in achieving the target with minimal output losses. In this context, officials felt that the recent decision to publish a forecast-consistent interest-rate path and make public the voting records of the Executive Board meetings, beginning in 2008, should enhance transparency and policy credibility and smooth the transition to a lower inflation target.

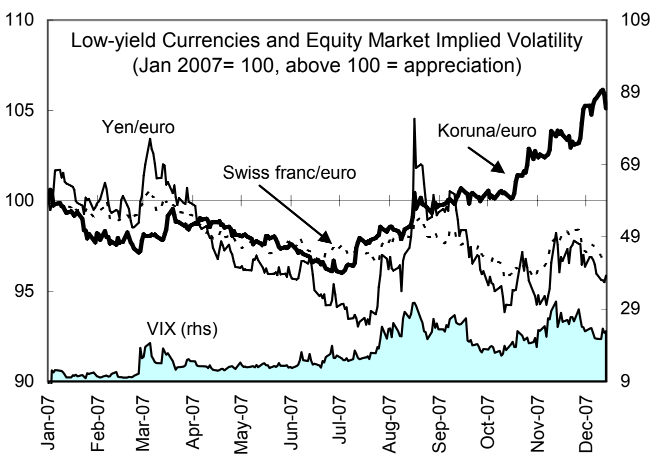
Box 2. Is the Czech Koruna Funding Carry Trades?

The use of the Czech koruna as a funding currency for carry trades has been an important driver of the exchange rate movements in 2007. Low interest rates and exchange rate volatility, and increasing liquidity in local foreign exchange markets made the koruna an attractive currency for carry trades leading to a depreciation by more than 4 percent during the first half of 2007. The main instruments for these transactions comprised of financial derivatives—primarily outright forwards and currency swaps—which showed two spikes in January and June 2007 preceding the net outflows from July 2007 (text chart). Hedge funds based in London and New York were the main participants reportedly trading the koruna for Turkish lira, Hungarian forint, and Polish zloty.



Source: Czech National Bank.

The appetite for carry trade using koruna as a funding currency has since disappeared. The subsequent monetary tightening initiated the first round of carry-trade unwinding, while the risk re-assessment following the global financial market turmoil further accelerated the liquidation of carry-trade positions. The Czech koruna has visibly decoupled from other low-yield currencies and is again moving with CEE-4 currencies (text chart). The recent appreciation could also be driven by the weakening of the US dollar which seems to have led to a withdrawal of funds from U.S. assets to be invested in economies that are closely integrated with the euro area—yielding extra profits on the appreciation of these currencies against the euro.

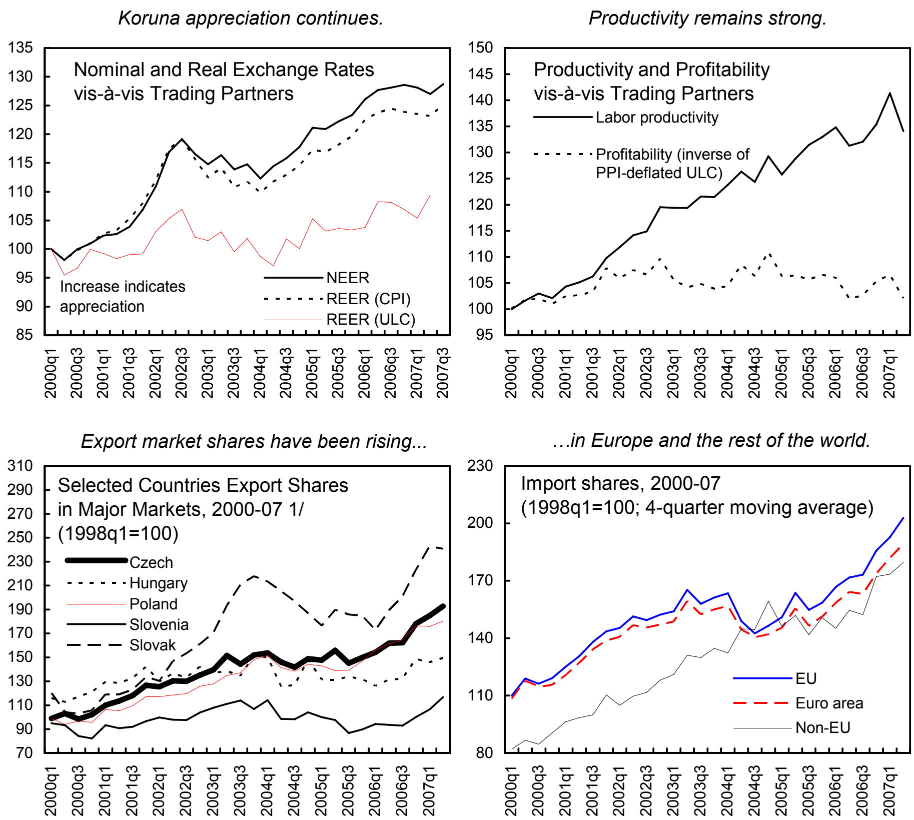


Source: Bloomberg L.P.; and IMF staff estimates.

C. Competitiveness and External Stability

23. **The staff and the authorities agreed that the koruna had remained broadly in line with fundamentals, with limited risks to external stability**. The real effective exchange rate, measured by consumer prices as well as by unit labor costs, has been broadly stable over the past year (Figures 10 and 11). Staff estimates the underlying current account deficit (excluding temporary factors such as cyclical fluctuations, one-off shocks, and adjustment lags) in 2007 at around 3 percent of GDP, slightly below the expected deficit and

in line with its estimated equilibrium level. These estimates imply that the koruna has been close to its equilibrium level.[8] Since the consultation discussions, the koruna has appreciated by about 5 percent against the euro by mid-December. Trade performance has remained robust, with double-digit growth in exports volume, rising export market shares in both the EU and world markets, and strong profitability of large exporters. Net foreign liabilities, mostly FDI, account for 30 percent of GDP and are projected to remain broadly stable. Since 2003, intervention has been limited to conversion of a large one-off privatization receipt in 2005, portfolio gains, and proceeds of EU transfers. CNB officials stressed that the koruna is floating independently since intervention was not intended to influence the exchange rate. In view of the large, albeit off-market, transactions, the exchange system is classified by the staff as a managed float with no predetermined path (see informational annex).



1/ Major Czech trading partners include Austria, Belgium, France, Germany, Hungary, Italy, the Netherlands, Poland, Russia, the Slovak Republic, UK, and USA. Data for Belgium starts in 1997.
Source: IMF DOT and IMF staff calculations.

24. **The authorities have not announced a specific target date for euro adoption, pending more progress on fiscal consolidation and economic alignment with the euro area.** They continue to strive to meet the Maastricht criteria for euro entry in a sustainable

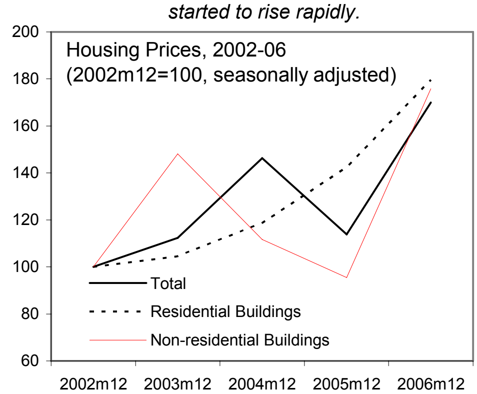
[8] Staff estimates of the equilibrium current account deficit are around 2½ percent of GDP. Mid-December 2007 CGER estimates suggest that the real effective exchange rate, while on the strong side, is not appreciably out of line with underlying fundamentals. For an illustration of these concepts, see IMF Occasional Paper No. 167.

manner. The CNB's decision to reduce the inflation target to 2 percent from 2010 will align it with the ECB's inflation target. Staff reiterated that euro adoption remains an important opportunity for reaping further gains from enhanced trade and investment opportunities and would serve as an important anchor for policy credibility, especially under more adverse economic conditions.

D. Maintaining Financial Stability

25. **Credit growth has continued at a brisk pace, led by credit to households**. Credit to the private sector increased by 25 percent in the year to September 2007, in line with regional trends. High demand for mortgage loans, supported by the low interest environment, a VAT hike in the construction sector in 2008 and increasing household repayment capacity contributed significantly to sustained household credit growth of around 30 percent. Enterprise credit has also accelerated with rising demand to finance expansion, including by property developers. Despite the rapid growth of house prices and rising interest rates, credit risk related to the household sector is currently low, given that most of the loans are denominated in domestic currency and on fixed interest rates terms. Moreover, the credit-to-GDP ratio remains relatively low by regional standards.

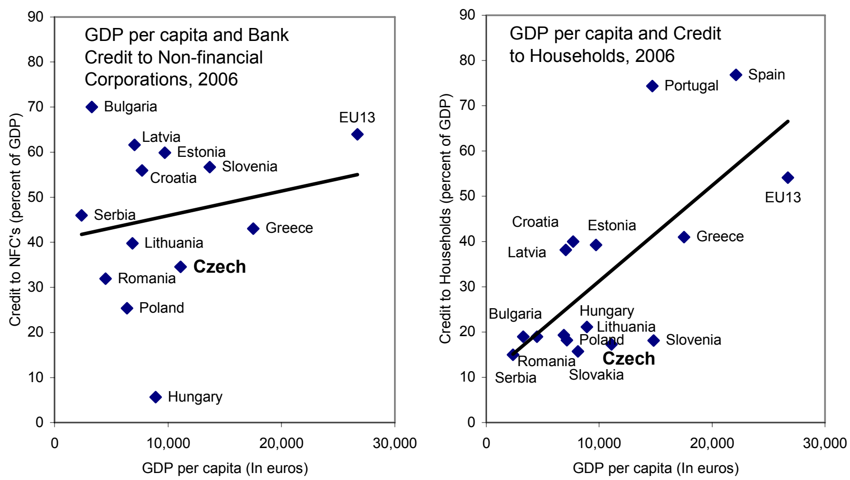
Recently, housing prices have started to rise rapidly.



Source: Haver.

Bank Credit to Households and Non-financial Corporations in European Emerging Markets, 2006

Bank credit to corporations and to households remains low by EMU standards.



Source: Eurostat; ECB; Country Authorities; and IMF staff calculations.

26. **Financial stability indicators suggest that risks are contained**. The Czech markets have remained largely unscathed by the recent turmoil, reflecting limited reliance on cross-border bank borrowing and virtual absence of securitization. Capital adequacy ratios have remained comfortably above the minimum regulatory thresholds despite a slight decline in 2005-06 reflecting rapid asset growth and record-high dividends. Bank profitability also remains healthy. Non-performing loan ratios, although lagging indicators, have been broadly stable and loan-to-value ratios indicate that banks are well collateralized. Sensitivity and stress test results, albeit limited to only the first-round impact of shocks, indicate that banks would be able to withstand the risk of sizeable defaults without jeopardizing capital positions.

Financial Sector Indicators, 2003-07

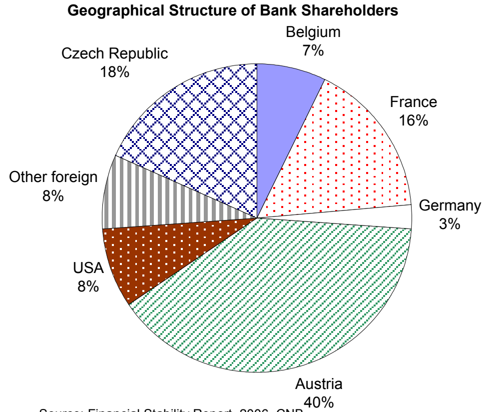
	2003	2004	2005	2006	2007q3
Number of banks	35	35	36	37	38
Of which: foreign-controlled	26	26	27	28	30
Regulatory capital to risk-weighted assets (in percent)	14.5	12.6	11.9	11.4	11.9
Nonperforming loans (in percent of total loans)	4.9	4.1	4.3	3.6	3.0
Liquid assets (in percent of total assets)	36.4	33.6	32.8	30.4	28.6
After-tax return on average assets (in percent)	1.2	1.3	1.4	1.2	1.3

Sources: CNB; and IMF staff calculations.

27. **The authorities plan to further integrate supervisory functions to strengthen efficiency**. With the introduction of unified supervision in 2006, the CNB took an important step to guard against contagion risk within pension and insurance markets. From 2008, the CNB will enhance integration by changing its supervisory organization from a sectoral model (banking, insurance, and securities) to a functional model (supervision, licensing and sanctions, regulation and analysis). Continued coordination of supervisory responsibilities with foreign (home country) supervisors will be important given the predominant foreign control of banks[9] and the expected implementation of Basel II and the Markets in Financial Instruments Directive in 2008.

Foreign ownership of banks is relatively high in the Czech Republic.

Geographical Structure of Bank Shareholders



Source: Financial Stability Report, 2006, CNB.

[9] Foreign bank branches, all operating under the single European license, accounted for 9.3 percent of total bank assets at end-2006.

V. Staff Appraisal

28. **Over the past year, the Czech economy has maintained the momentum of rapid growth and made further strides toward convergence with the EU-15**. However, sustaining this success through a less benign global environment and tighter supply constraints at home calls for a tight policy stance. Over the medium term, ensuring sustainable public finances would call for a higher political priority for pensions, healthcare and labor market reforms.

29. **The economy is currently at a fairly advanced stage of a strong cyclical upswing and a slowdown in growth is likely in 2008**. Growth is nevertheless expected to remain solid on the back of continued strong domestic demand and unemployment low. The risk to this central forecast is mainly on the downside, stemming primarily from a possibly weaker external environment.

30. **With inflation set to rise sharply well above the target of 3 percent, monetary policy would need to be on a sustained tightening path**. The projected increase in inflation to 5 percent in 2008 is driven by demand and wage pressures as well as rising food and energy prices and increases in indirect taxes. Following a lengthy period of low inflation, the risk that a rapid rise in inflation gets embedded into expectations will require further timely increases in the policy rate. The planned downward shift in the inflation target to 2 percent from 2010 onwards also underlines the importance of preserving the CNB's high policy credibility, inter alia, by enhancing the clarity of policy communication. In this context, recent steps to improve transparency are welcome.

31. **The external competitive position remains comfortable and vulnerabilities limited**. The favorable indicators include a stable real effective exchange rate over the past year, robust export performance with rising export market shares and a moderate current account deficit, financed by direct investment inflows. These indicators suggest that the koruna has been broadly in line with fundamentals and consistent with external stability, although the recent sharp appreciation, if continued, would weigh on competitiveness.

32. **Financial stability indicators suggest that risks are contained**. Limited exposure to foreign markets and strong fundamentals have helped insulate the financial sector from the recent turmoil. Nevertheless, in an environment of rising interest rates and house prices, supervisory vigilance is needed to ensure that household credit risks do not build up, particularly for low-income borrowers.

33. **The tax and welfare reform recently passed by Parliament promotes a number of desirable modifications to the structure of the tax regime**. These include the shift from taxation of income to that of consumption, the introduction of excises on energy consumption and the planned cut in the corporate income tax rate which will help maintain the attractiveness of Czech Republic as an investment location. However, given the advanced

cyclical position of the economy and the need to strengthen public finances, the tax cut could have been phased in more gradually.

34. **The fiscal reform package is, however, insufficient to advance the critical task of fiscal consolidation in the medium term**. Indeed, the package is likely to add to long-term fiscal pressures since the proposed tax cuts are permanent and well-defined, while some of the offsetting spending measures are of a temporary character and as yet undefined.

35. **Against the backdrop of the recent procyclical fiscal stance, cyclical gains for the 2008 budget should be saved and the planned fiscal adjustment implemented in full**. A more ambitious deficit target than that implied by the budget should be feasible in view of the favorable outcome in 2007. Such prudence in 2008 is all the more advisable in view of the absence of specific expenditure measures underlying the planned fiscal adjustment in 2009-10. With a tightening monetary policy cycle underway and the need to anchor inflation expectations, a tight fiscal stance is also essential to ensuring a balanced policy mix.

36. **Fiscal consolidation needs to be sustained beyond 2008 to meet the challenges posed by the aging population and to ensure smooth euro entry**. An annual structural consolidation of at least ½ percent of GDP would help stabilize debt over the medium term and provide a safety margin in respecting the Stability and Growth Pact limit of 3 percent of GDP under more adverse cyclical conditions, and create fiscal space for accommodating age-related spending. Recent changes in budgetary rules limiting rollover of unspent allocations should alleviate risks in attaining these budget targets.

37. **Durable fiscal consolidation calls for a strategy that sets clear fiscal priorities with adequate balance between spending and revenue measures**. Precedence should be given to expenditure rationalization. Absent expenditure restraint, tax cuts can be ill afforded and even tax increases may have to countenanced as part of a more sharply defined strategy to set fiscal priorities. Possible options include raising the low VAT rate further, reducing corporate loopholes, pruning personal tax credits, and increasing environmental taxes.

38. **Pension and healthcare reforms should clearly be key pillars of the medium-term fiscal strategy**. They should be implemented sooner rather than later, given the long lags with which especially pension reforms have their impact. Along with the welcome increase in the retirement age to 65 years, complementary reforms to raise the effective retirement age and reliance on private pensions will also be needed. In health care, the introduction of co-payments should help contain excess demand pressures and enhance efficiency of health care spending. Early consensus on more comprehensive reforms would be vital.

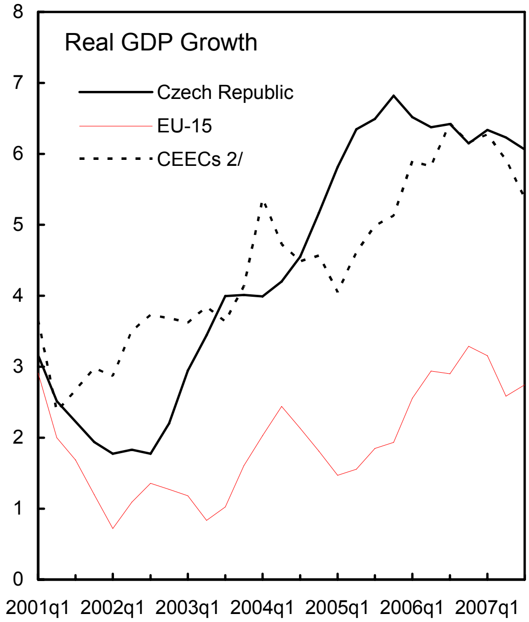
39. **Labor market reform can help alleviate fiscal adjustment**. The recent fiscal package fails to fully offset the adverse impact of the pre-election increase in social benefits on incentives to work. The substantially enhanced tax credits are not targeted and their effects on labor supply uncertain. Higher labor market participation and lower structural

unemployment could be achieved through better targeted active labor market policies, less rigid regulations regarding hiring and dismissals, and an improved design of the tax-benefit system. More flexible labor markets would also help position the Czech economy for a smoother path to euro adoption.

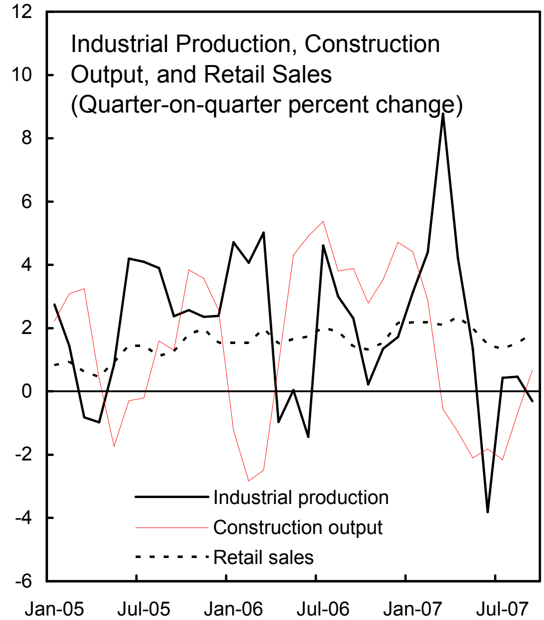
40. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Figure 1. Czech Republic: Growth Developments, 2001-07 1/
(Annual percent change, unless indicated otherwise)

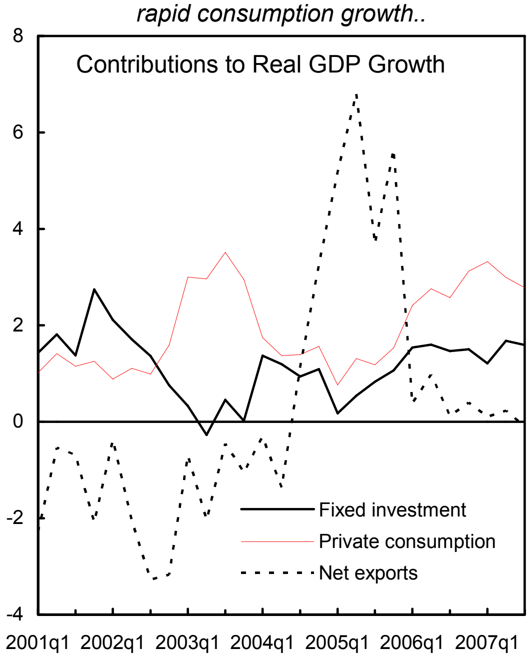
Economic growth has continued at a rapid pace...



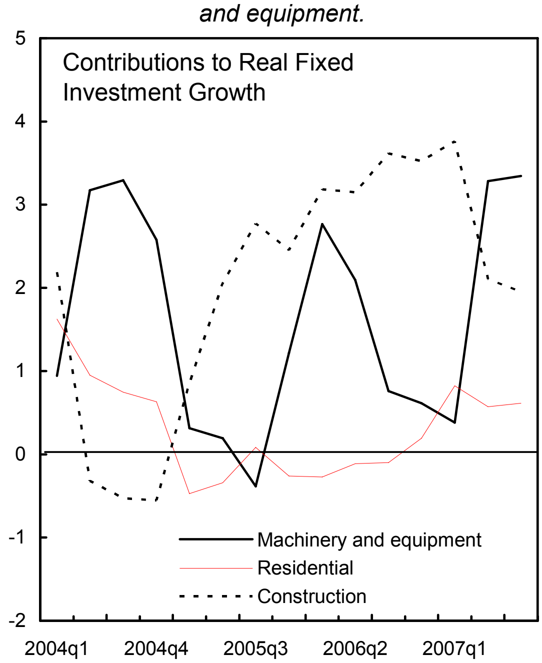
...but is expected to slow down.



Strong domestic demand is driven by rapid consumption growth..

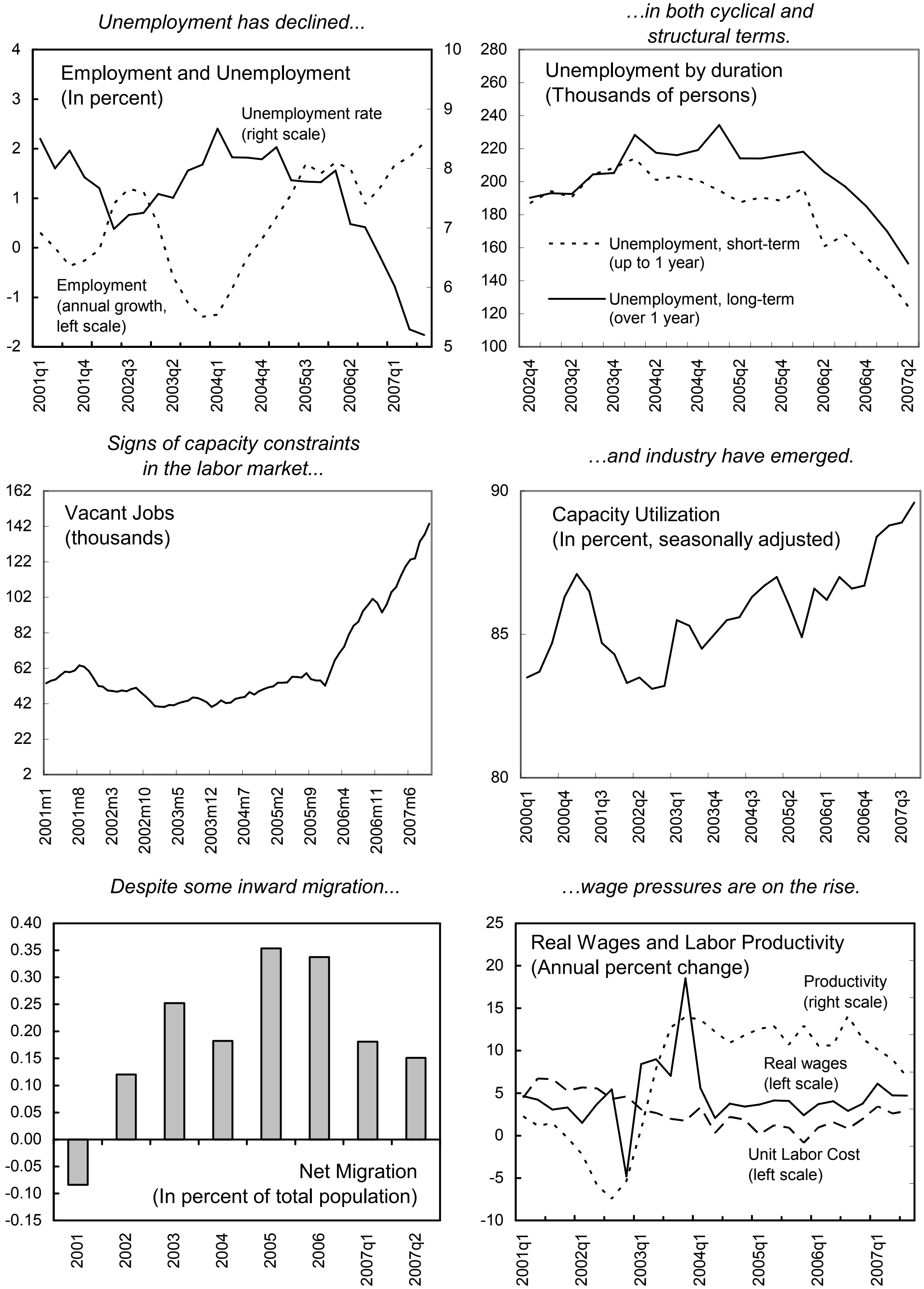


...and buoyant investment in machinery and equipment.



Sources: Czech Statistical Office; Eurostat; and IMF staff estimates.
1/ All series are seasonally adjusted.
2/ Average for Hungary, Poland, the Slovak Republic, and Slovenia. Excludes Slovenia in 2007q3.

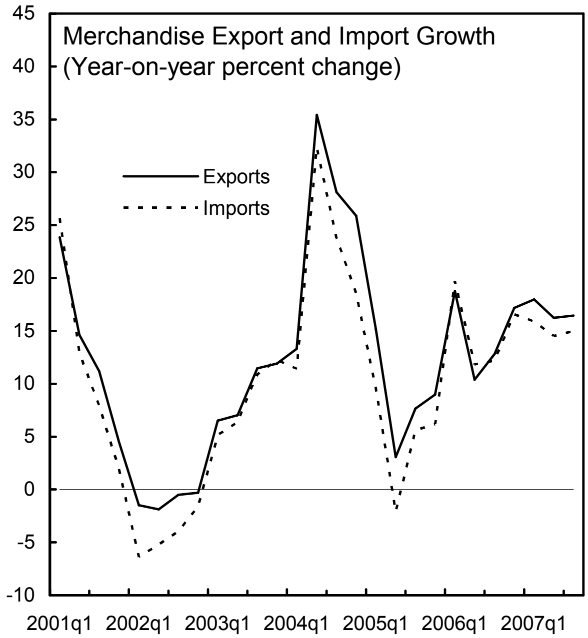
Figure 2. Czech Republic: Labor Market Indicators, 2000-07



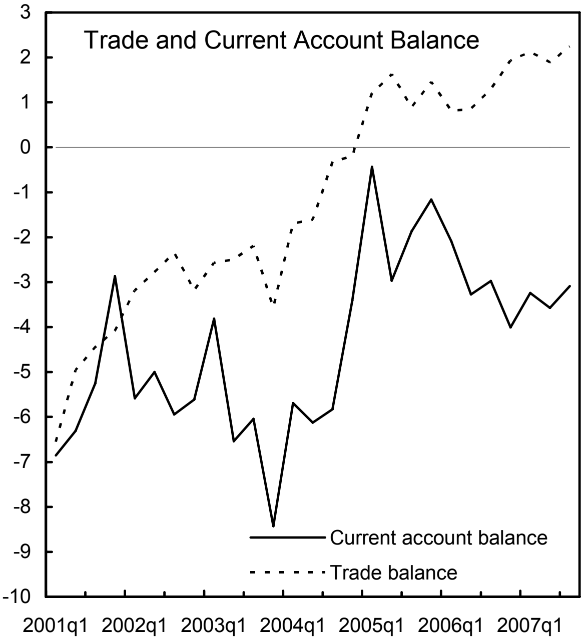
Source: Czech Statistical Office; European Commission; Eurostat; and IMF staff calculations.

Figure 3. Czech Republic: External Sector Developments, 2001-07
(In percent of GDP, unless otherwise indicated)

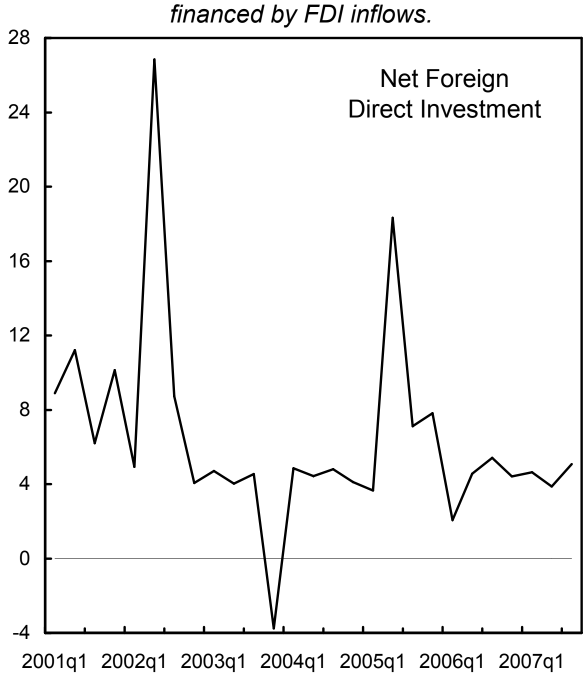
Export growth remained strong leading to an increasing trade surplus.



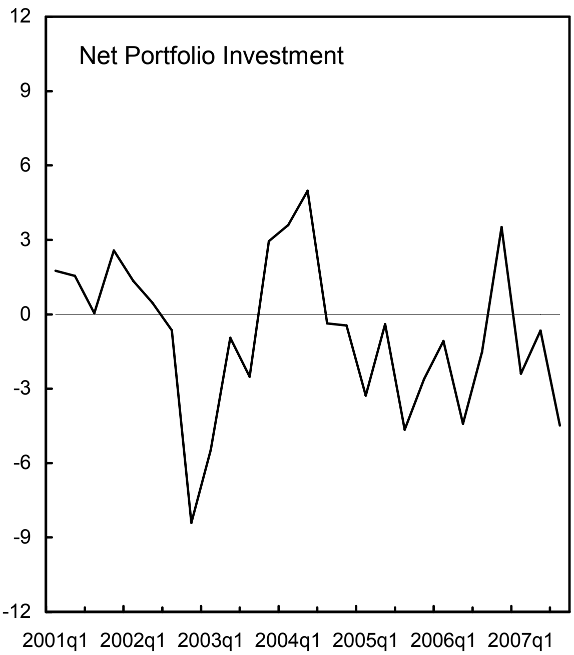
Nevertheless, the current account deficit has widened owing to profit repratiations...



...but it continues to be comfortably financed by FDI inflows.

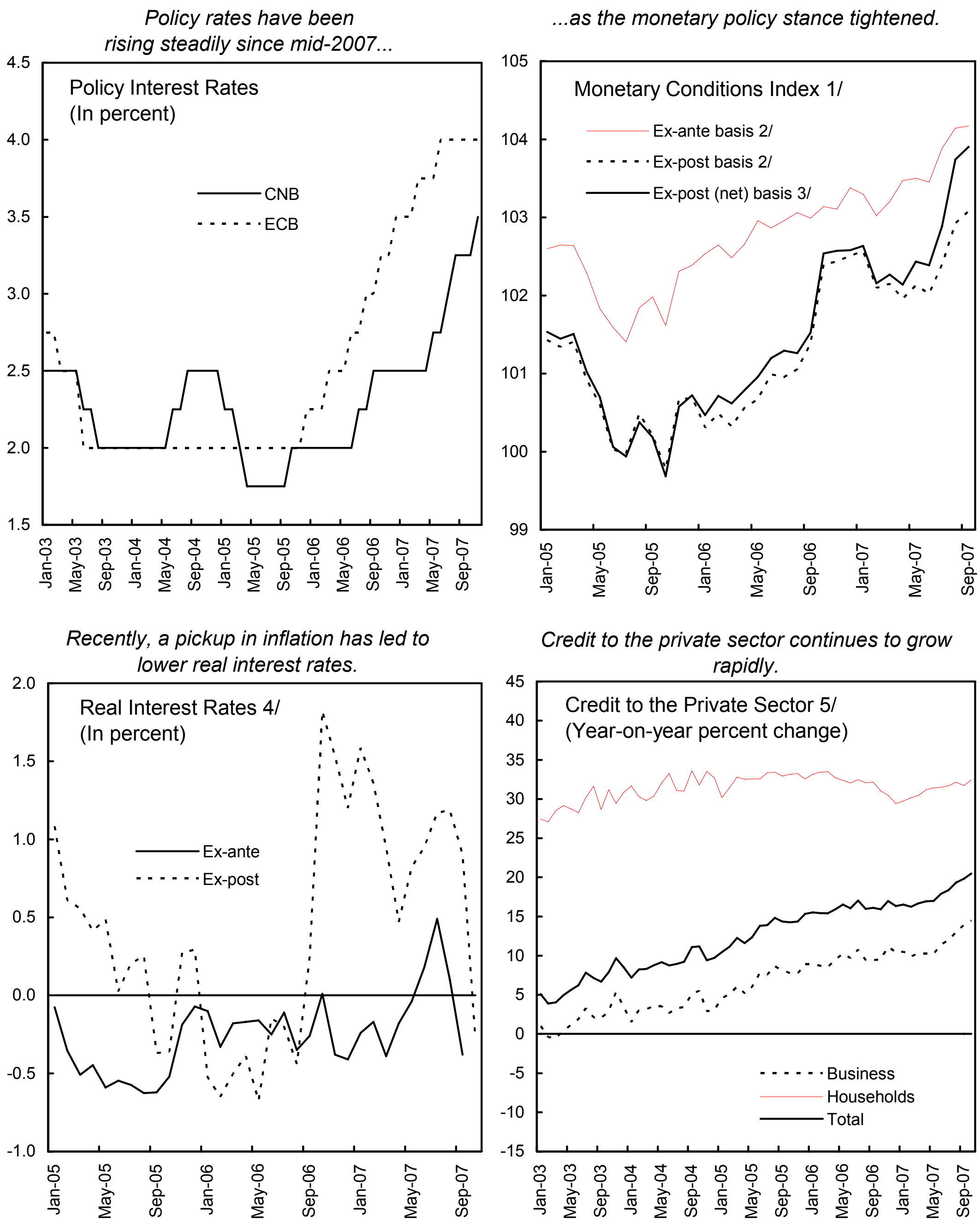


Portfolio outflows have been volatile.



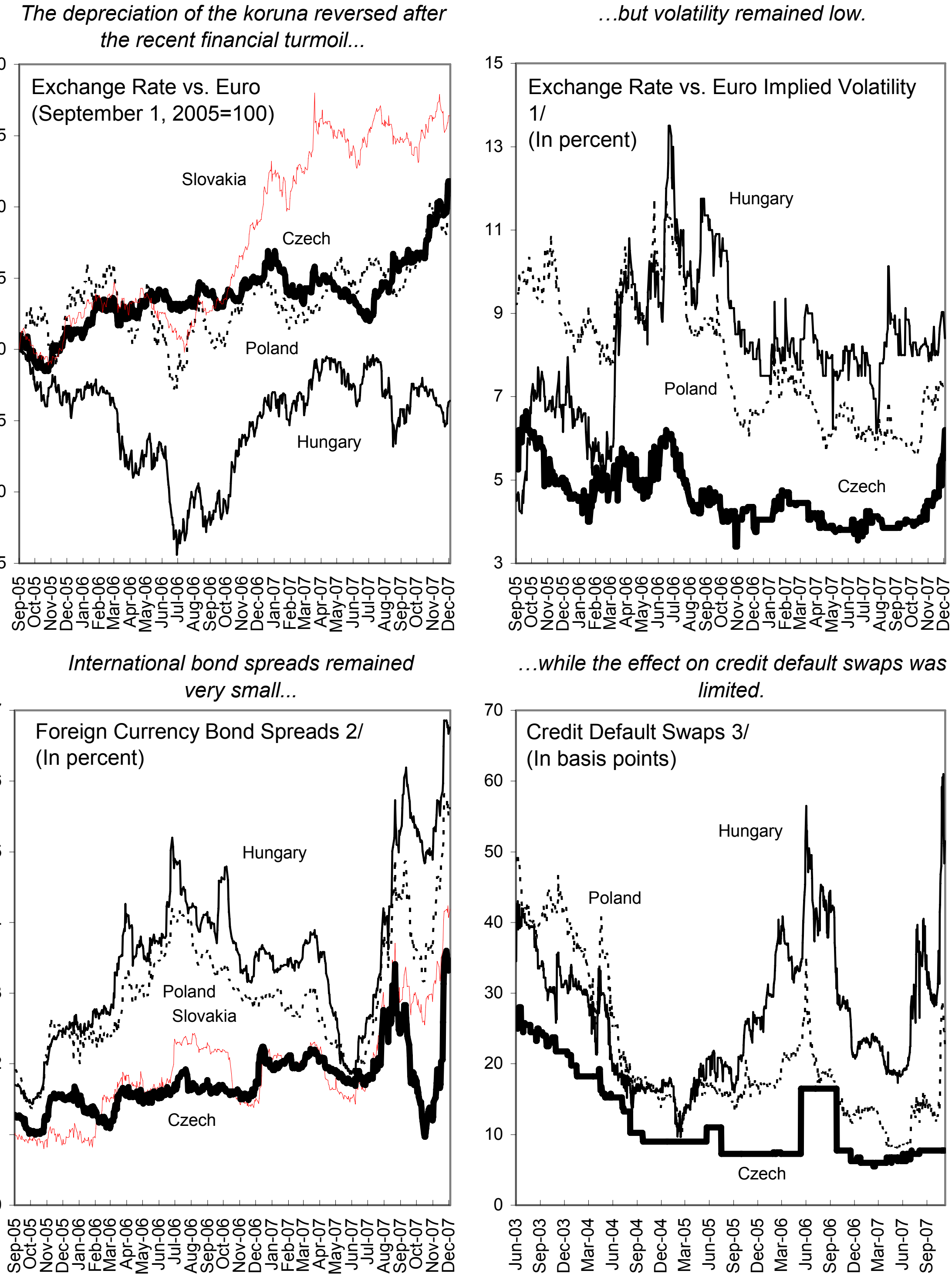
Sources: Czech National Bank; Czech Statistical Office; and IMF staff estimates.

Figure 4. Czech Republic: Monetary Policy Indicators, 2003-07



Sources: Czech National Bank; European Central Bank; and IMF staff estimates.
1/ Weighted average of real short-term interest rate and real effective exchange rate (weights: 2/3 and 1/3, respectively). January 2003=100.
2/ Based on 1-year PRIBOR deflated by 12-month backward and forward-looking CPI inflation, respectively.
3/ Based on interest rate deflated by 12-month backward-looking inflation excluding first-round impacts of changes to indirect taxes.
4/ Ex post real interest rates are 1-year PRIBOR, deflated by 12-month CPI inflation; ex ante real interest rates are deflated by 12-month inflation expected in a survey conducted by the Czech National Bank Statistical Survey.
5/ Business and total adjusted for loan write-offs and changes in classification of financial institutions.

Figure 5. Czech Republic: Financial Indicators, 2003-07



Source: Bloomberg.

1/ The volatility implied by the market price of a 1-month option contract based on a theoretical pricing model. Implied volatility includes future expectations of price movement, which are not reflected in historical volatility.

2/ Spread of 5-year euro denominated international government bond versus 5-year Bund.

3/ Five-year credit default swap spreads on sovereign debt.