

**Czech Republic: 2002 Article IV Consultation—Staff Report; Staff Supplement; 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 2002 Article IV consultation with the Czech Republic, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 7, 2002**, 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 July 11, 2002.** 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 staff supplement of **July 23, 2002** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its July 26, 2002 discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for the Czech Republic.

The document(s) listed below have been or will be separately released.

Report on the Observance of Standards and Codes—Fiscal Transparency;  
Banking Supervision, Insurance Regulation, Securities Regulation, Payment  
Systems, and Monetary and Financial Policy Transparency—Updates ;  
Selected Issues and Statistical Appendix

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 2002 Article IV Consultation**

Prepared by the Staff Representatives for the  
2002 Consultation with the Czech Republic

Approved by Alessandro Leipold and Leslie Lipschitz

July 11, 2002

The 2002 Article IV consultation discussions were held in Prague during April 24–May 7, 2002. The mission met with: Governor Tuma of the Czech National Bank (CNB); First Deputy Finance Minister Janota; senior officials in the CNB and government ministries and agencies; the Parliamentary Budget Committee; trade unions; academics; and representatives of financial institutions and foreign investor groups.

The team was headed by Mr. Takeda, and included Messrs. Takizawa, Tzanninis, and Ms. van Elkan (all EU1), and Mr. Nord, the Regional Resident Representative in Central Europe. Mr. Jonas (Advisor to the Executive Director) attended several of the meetings.

The Czech Republic has accepted the obligations under Article VIII, Sections 2(a), 3, and 4 as of October 1, 1995, and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. The authorities have expressed their intention to publish this staff report.

The mission conducted updates of the Report on Standards and Codes (ROSC) modules on the financial and fiscal sectors. The Czech Republic meets the Special Data Dissemination Standard (SDDS) specifications.

In concluding the last Article IV consultation on July 16, 2001, Directors called for policies to maintain economic recovery while restoring the long-term sustainability of public finances. They considered the monetary stance as appropriately accommodative, but saw a need for tighter fiscal policy in order to prevent an undue widening of the current account deficit in the context of weaker external demand. Directors urged further progress in reforming the pension system and the legal and regulatory environments, and in corporate restructuring. They also supported more rapid disposal of bad assets acquired through bank restructuring.

Parliamentary elections were held on June 14–15, 2002 and the Social Democrats (CSSD), which had been in power during the past four years, won the plurality, defeating the conservative Civil Democrats. The CSSD leader, Mr. Spidla, formed a government with the center-right Coalition; together, they command 101 seats in the 200-seat lower house.

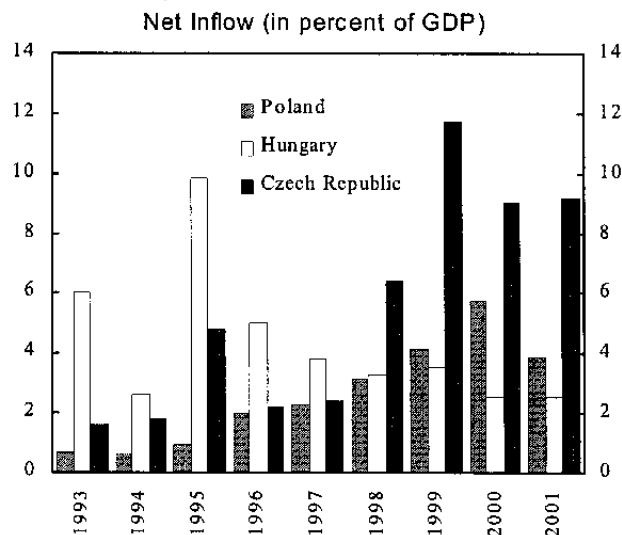
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## I. BACKGROUND

1. **The Czech Republic has made significant strides over the last couple of years, though important challenges remain.** Following a period of inaction on the structural front and a protracted recession, growth has resumed since 2000 without impairing the hard-won disinflation gains achieved in the late 1990s. Underlying this performance has been supporting macroeconomic policies, large foreign direct investment (FDI) inflows, and steady progress with structural reforms. However, these achievements were not without costs. Enterprise restructuring has contributed to rising structural unemployment, while the concentration of FDI in certain areas—together with limited labor mobility—resulted in large regional disparities in unemployment. Moreover, sizable losses were accumulated by banks, which had to be transferred to the government to allow the banks to be sold to strategic investors, adding to medium-term fiscal pressures. Importantly, the fiscal reform agenda required for medium-term sustainability of the public finances remains to be tackled.

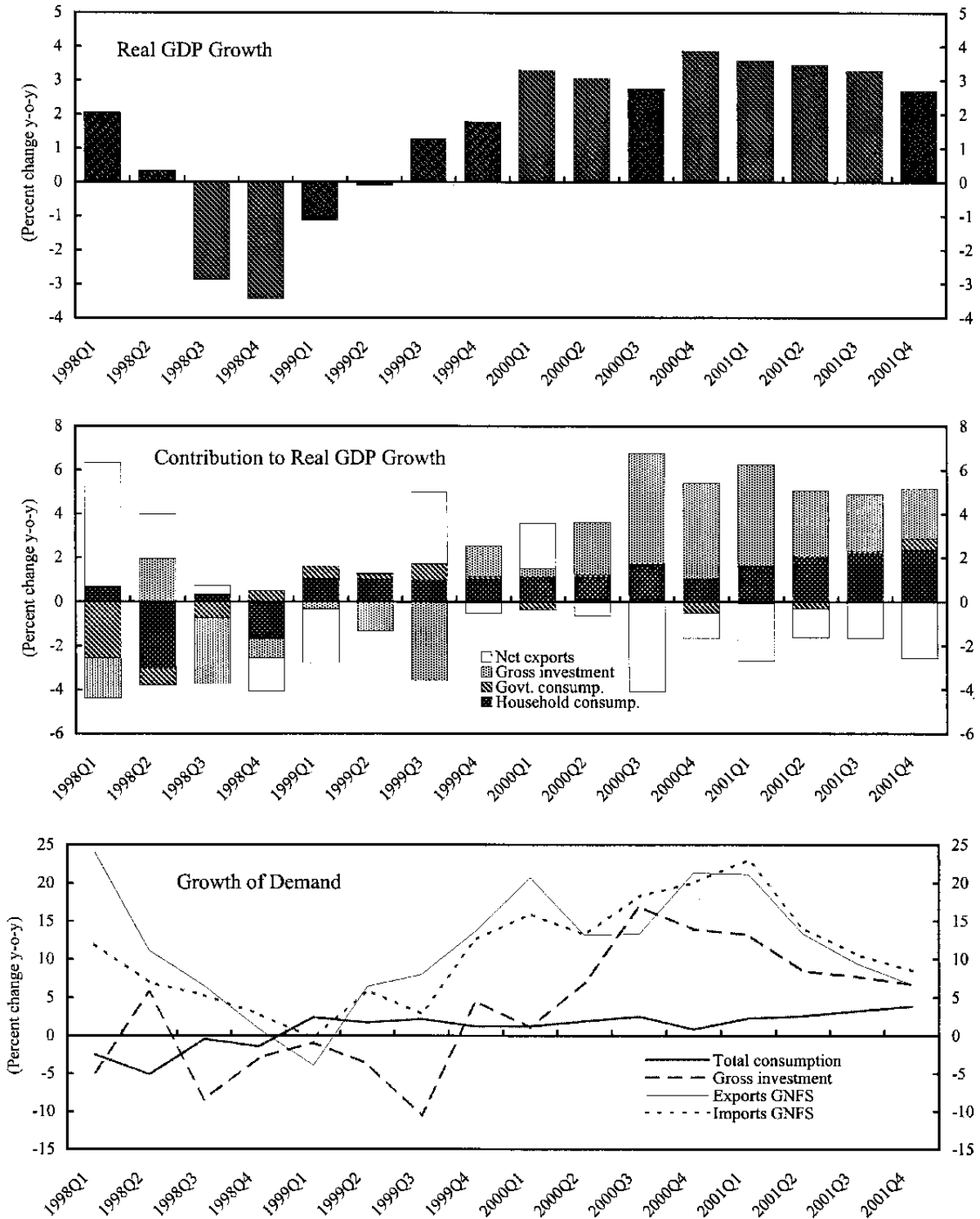
2. **Despite the large trade and investment links with the European Union (EU), the Czech economy weathered the recent global slowdown remarkably well.** Growth of real GDP stayed constant at 3.3 percent from 2000 to 2001, notwithstanding a modest deceleration in the second half of the year as the slowdown of the EU economies depressed export growth (Table 1 and Figure 1). Strong fixed investment and buoyant household consumption—underpinned by robust wage growth and small gains in employment—helped sustain the pace of domestic demand at 4.9 percent. Moreover, the external current account deficit narrowed in 2001 as growth of imports moderated more than exports, reflecting the large import content of exports and lower oil prices (Table 2 and Figure 2).

3. **An important contributing factor to the recent strength of the Czech economy has been significant inflows of FDI.** Gross FDI inflows reached US\$ 4.9 billion in 2001 (8.7 percent of GDP), the highest in the region, bringing the stock to over \$20 billion, some 40 percent of GDP. Low wages, a well-educated and disciplined work force, favorable geographic location, political and economic stability, and the prospect of EU accession have made the Czech Republic an attractive destination for greenfield FDI. The privatization program has also attracted considerable foreign investment. As a result, the economy has benefited from, among other things, a gradual increase in the access to its major export markets that has cushioned the impact of the slowdown in external demand (Figure 3). At the same time, FDI has



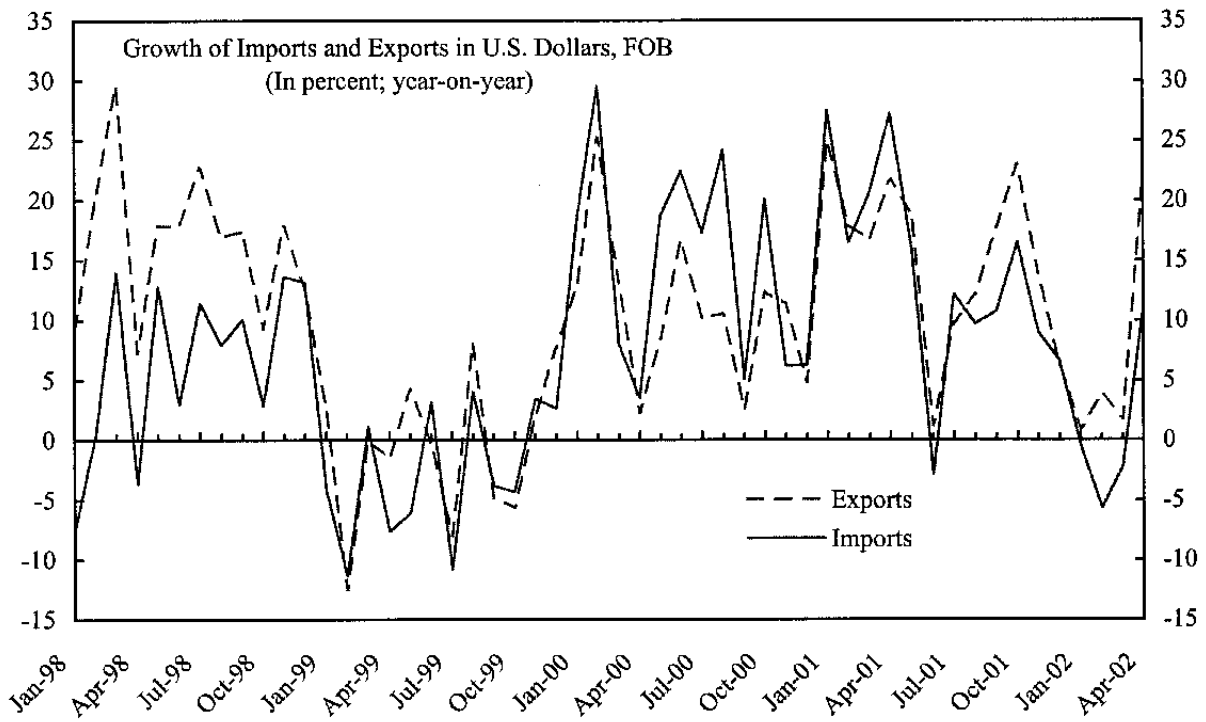
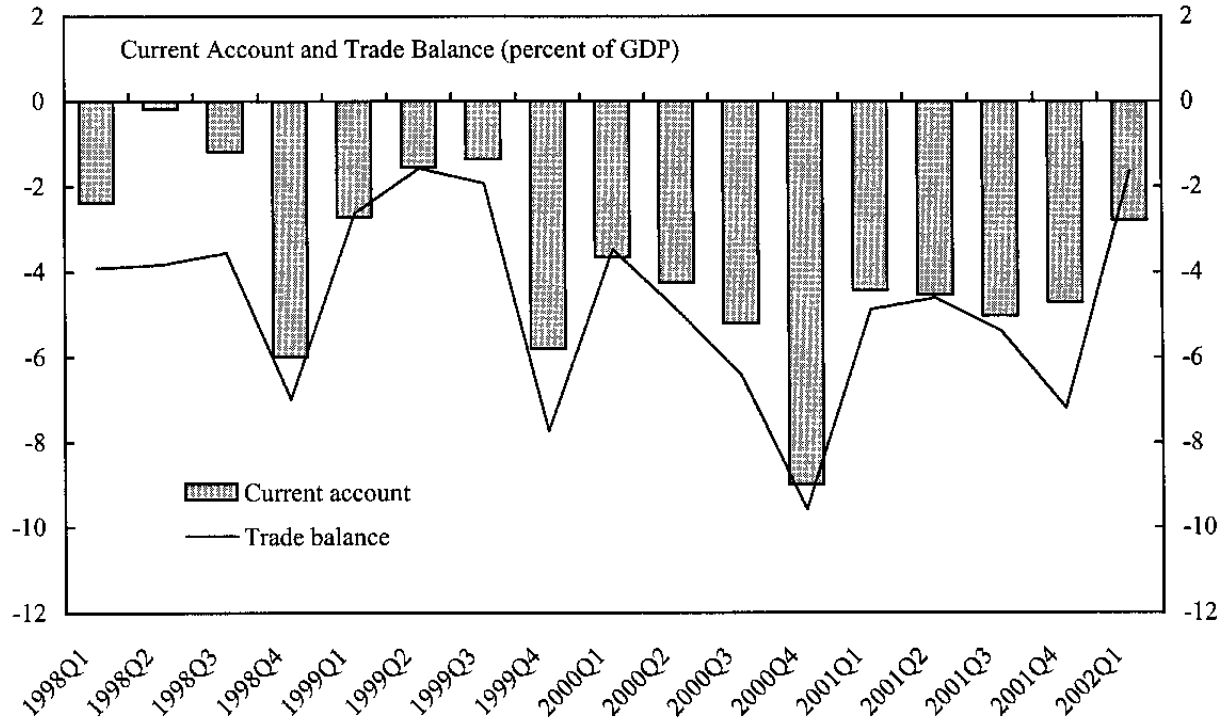
Source: EBRD Transition Report, 1998 and 2001.

Figure 1. Czech Republic: Developments in GDP, 1998-2001



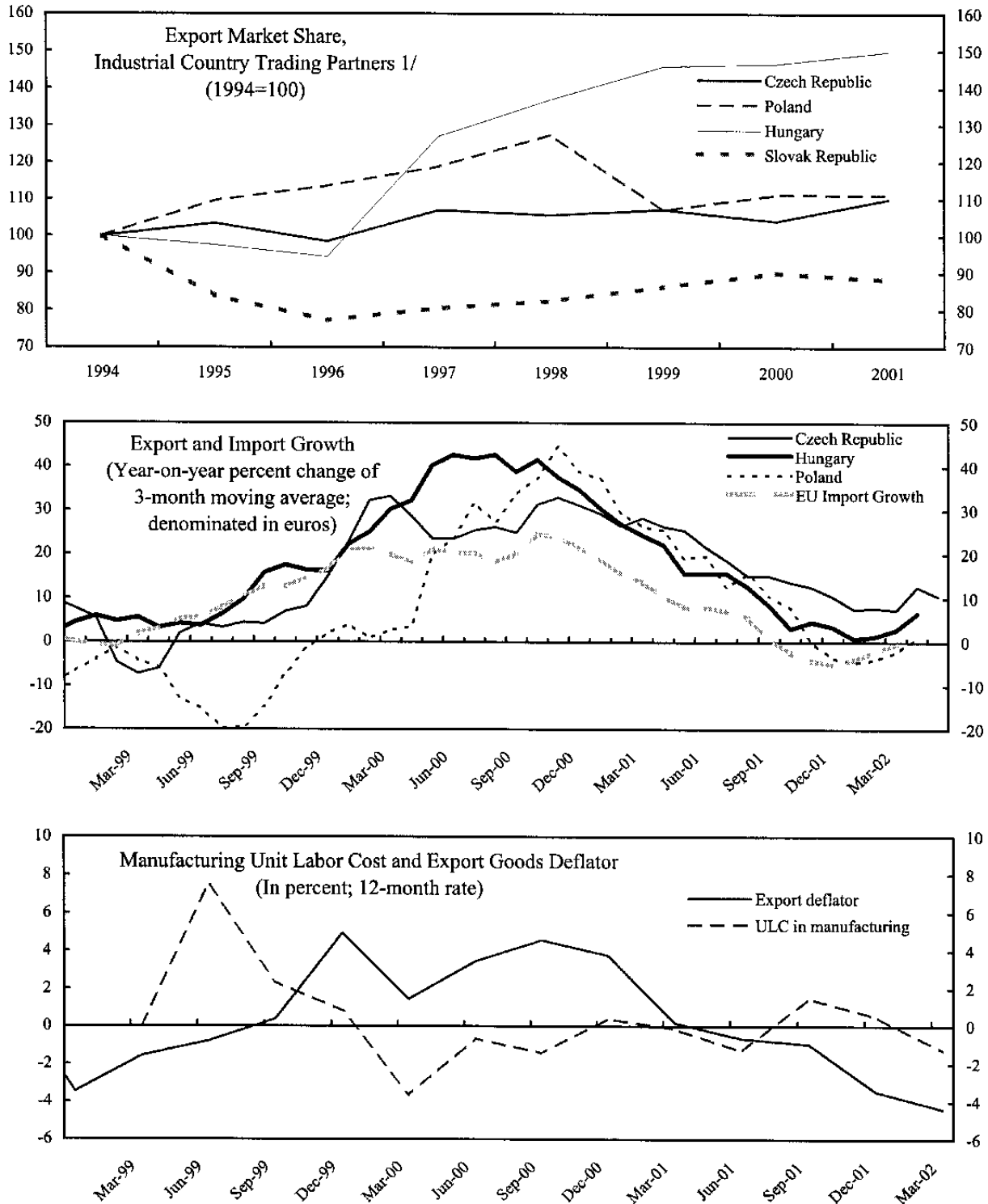
Sources: Czech Statistical Office; and Fund staff calculations.

Figure 2. Czech Republic: External Current Account and Trade Developments, 1998-2002



Sources: Czech National Bank; Czech Statistical Office; and Fund staff calculations.

Figure 3. Czech Republic: Competitiveness, 1994-2002



Sources: Direction of Trade Statistics; the OECD; and Fund staff estimates.

1/ Includes Austria, Belgium, France, Germany, Italy, Netherlands, the United Kingdom, and the United States, which account for approximately 75 percent of total Czech exports.

been the main driving force behind domestic investment and employment creation, and has contributed to a broader base of growth as the foreign-owned firms increasingly rely on an expanding domestic supply network.

4. **The large FDI inflows and anticipation of future inflows have contributed to a sharp appreciation of the koruna.** The koruna appreciated by 5–6 percent vis-à-vis the euro in the fourth quarter of 2001 amid speculation that large privatization receipts would be converted on the market (Figure 4). In response, the government and the Czech National Bank (CNB) agreed in early 2002 on a strategy to insulate the foreign exchange market by converting the bulk of the government's foreign currency privatization receipts at the CNB.<sup>1</sup> This, however, did not halt the rise of the koruna, and a further 6 percent appreciation occurred through mid-April, prompting a series of strong policy responses by the CNB (see below). After a short period of stability, the koruna appreciated again in late June, and was up by 13 percent (year-on-year) vis-à-vis the euro in early July (text chart).



1/ Upward movement denotes appreciation.

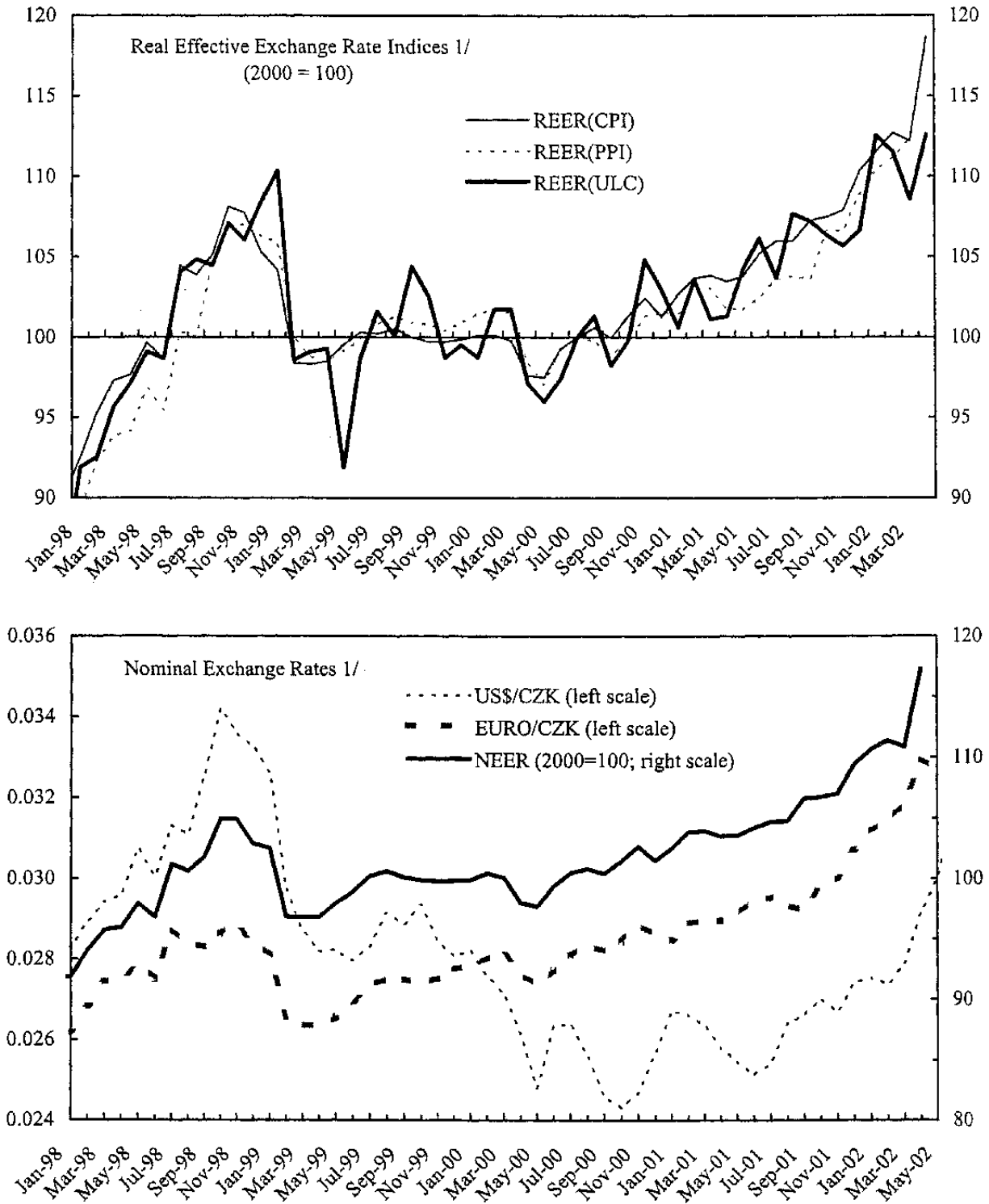
5. **Inflation pressures have dissipated considerably in recent months.** After peaking at 5.9 percent in July 2001, inflation embarked on a downward trajectory, benefiting from falling food and international commodity prices, weakening demand, and the stronger koruna (Figure 5). Net inflation—CPI inflation net of the impact of administered price and indirect tax changes, which the CNB had targeted till end-2001 before switching to headline inflation—fell to 2.4 percent at end-December, near the bottom of the target range of 2-4 percent. Headline inflation was 2.5 percent in May, below the target band.<sup>2</sup> Industrial producer prices have been falling (year-on-year) in recent months.

<sup>1</sup> According to their agreement, the government pays a fee that increases with the cumulative amount converted, in order to compensate the CNB for possible valuation losses on its increased foreign reserves. The fee starts at 3 percent of the amount to be converted, and rises to 9 percent. The funds thus converted and then spent by the government are sterilized by the CNB through its repo operations.

<sup>2</sup> The target range for headline inflation linearly declines from 3–5 percent at the beginning of 2002 to 2–4 percent at end-2005.

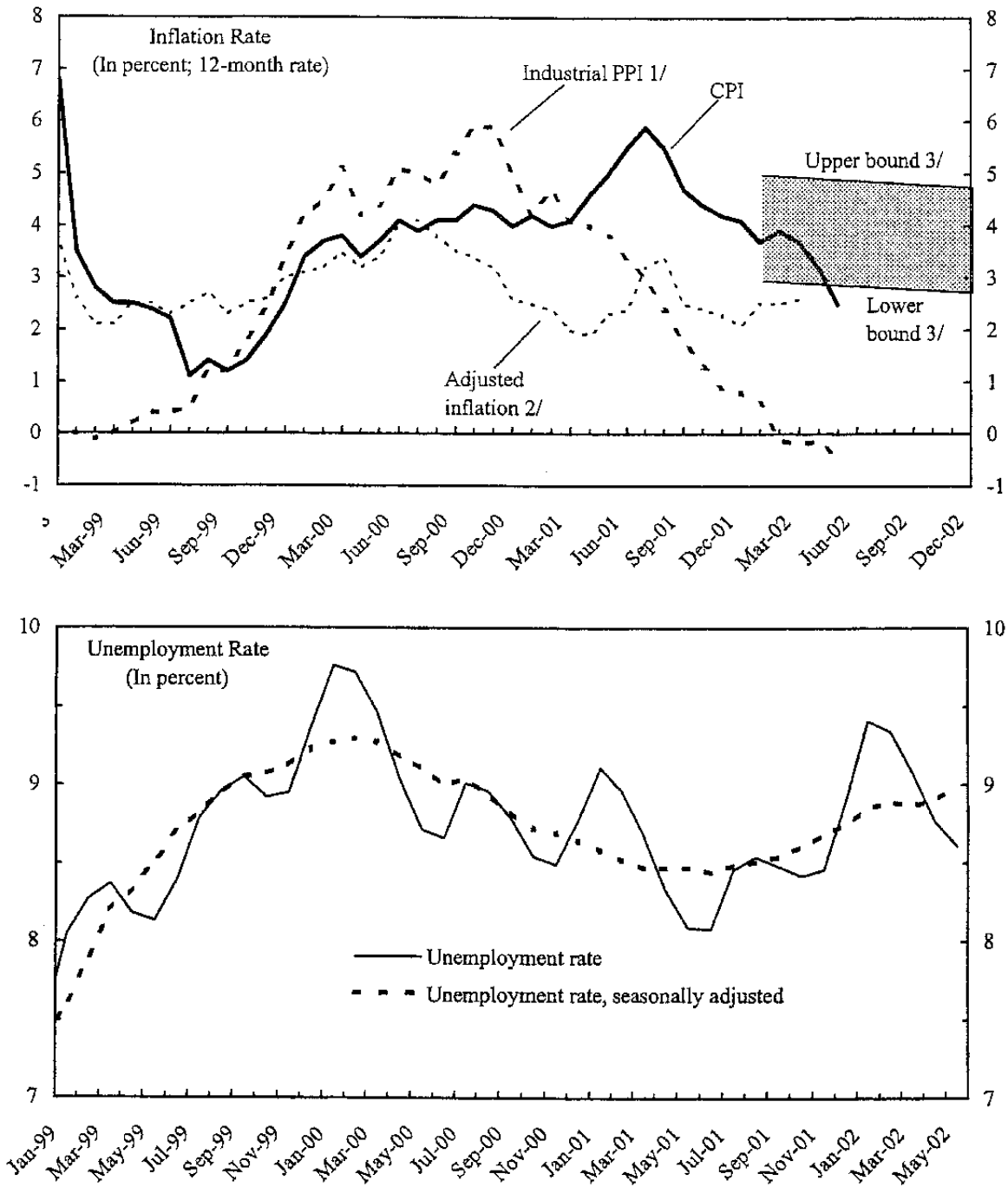


Figure 4. Czech Republic: Exchange Rate Indicators, 1998-2002



Sources: Czech National Bank; and Fund staff estimates.  
1/ Upward movement denotes an appreciation.

Figure 5. Czech Republic: Price and Unemployment Developments, 1999-2002



Sources: Czech National Bank; Czech Statistical Office; and Fund staff calculations.

1/ Producer price index in mining, manufacturing, and energy.

2/ Adjusted inflation is CPI inflation excluding administered prices and the effects of changes in indirect taxes and food prices.

3/ The Czech National Bank's target band for headline CPI inflation.

6. **The CNB cut interest rates, and intervened in the foreign exchange market, amid growing concerns that the koruna's momentum could undermine external competitiveness and stunt growth.** The rapid appreciation of the koruna, a more benign inflation outlook, and concerns about economic prospects in the aftermath of September 11, prompted the CNB to cut interest rates by a cumulative 100 basis points in late 2001 and early 2002, and by an additional 50 basis points in late April. The rate cuts helped offset some of the tightening of monetary conditions imparted by the stronger koruna, and reduced the interest rate differential with the euro area (Figures 6 and 7). Moreover, the CNB intervened in the foreign exchange market on several occasions to stem the rapid rise of the koruna and help secure the inflation objective.

7. **The real economy has yet to show any effects of the stronger koruna.** Industrial production and sales have decelerated from spring last year, but their growth has picked up in recent months (Figure 8). The latest trade figures do not provide any evidence of a sharply worsening trade balance, though some of the effects of the appreciation of the koruna may yet be in the pipeline.

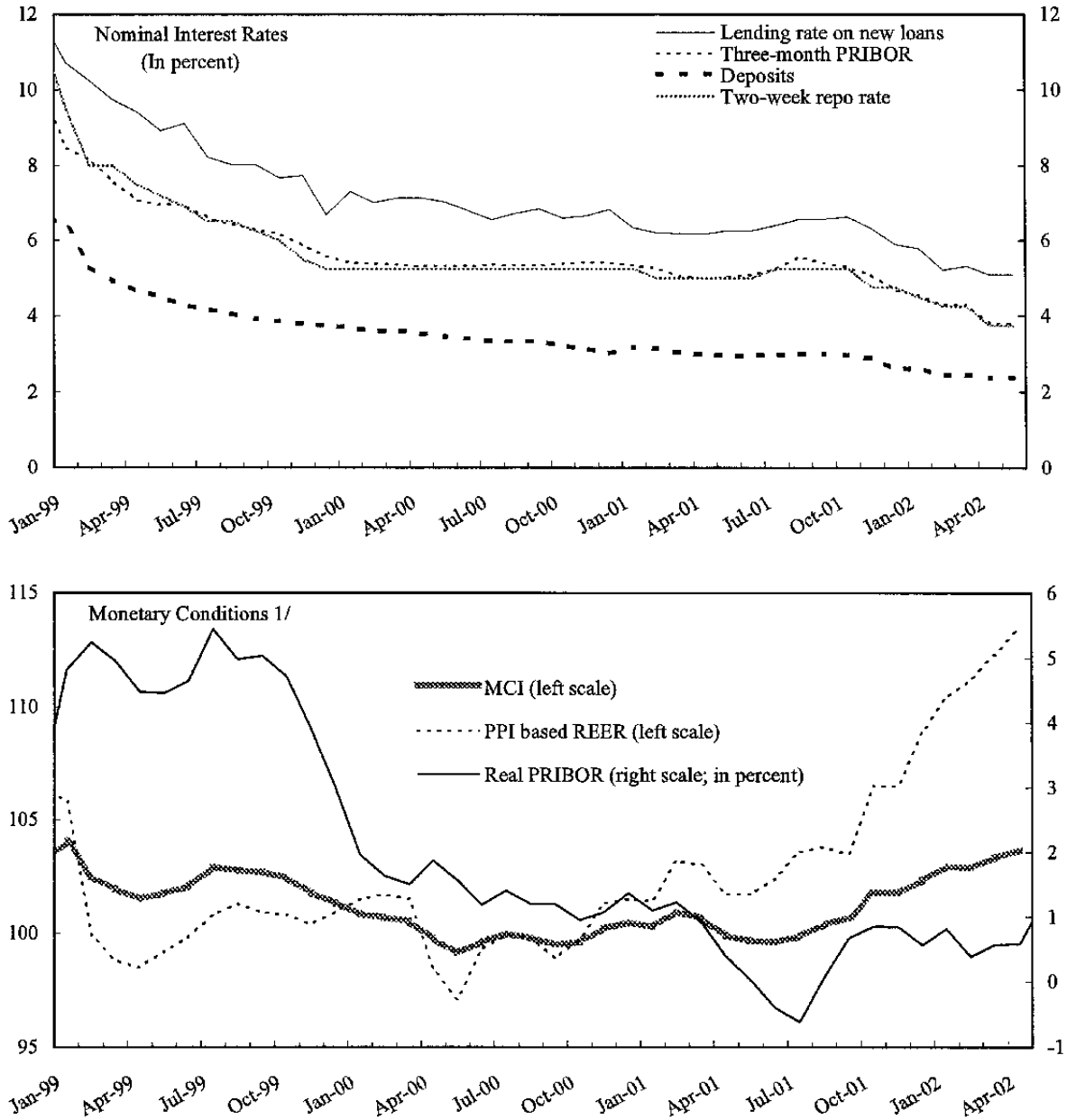
8. **Despite plans for a considerable expansion, the fiscal deficit contracted in 2001.** The adjusted general government deficit is estimated to have been 2.9 percent of GDP in 2001, 2.1 percentage points of GDP below the budget target and 0.6 percentage points of GDP lower than the 2000 outturn (Table 3 and Figure 9).<sup>3</sup> Cyclical as well as special factors contributed to this outcome. Revenue collections exceeded budget targets by 1.3 percent of GDP, buoyed by the stronger-than-expected economy in the first half of 2001. Some savings on capital expenditure and net lending (0.6 percent of GDP) were achieved reflecting, in part, slow spending by the new Transportation and Housing Funds rather than deliberate efforts to contain spending.

9. **Budget plans for 2002 envisage a substantial widening of the general government deficit, and contain no measures geared toward fiscal consolidation.** The 2002 budget implies an adjusted general government deficit of 5.0 percent of GDP, a large increase from the estimated 2001 outturn of 2.9 percent of GDP. Over half the envisaged widening derives from higher spending, owing to more ambitious spending plans of the two new extrabudgetary funds and the temporary duplication of spending responsibilities from the

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<sup>3</sup> The adjusted deficit excludes: privatization receipts, proceeds from the sale of UMTS licenses (for wireless telephony), and the repayment of Russian debt from the revenue side; and grants to transformation institutions (to cover costs related to the management of bad assets) from the expenditure side. These adjustments are made to capture the direct impact of fiscal policy on aggregate demand.

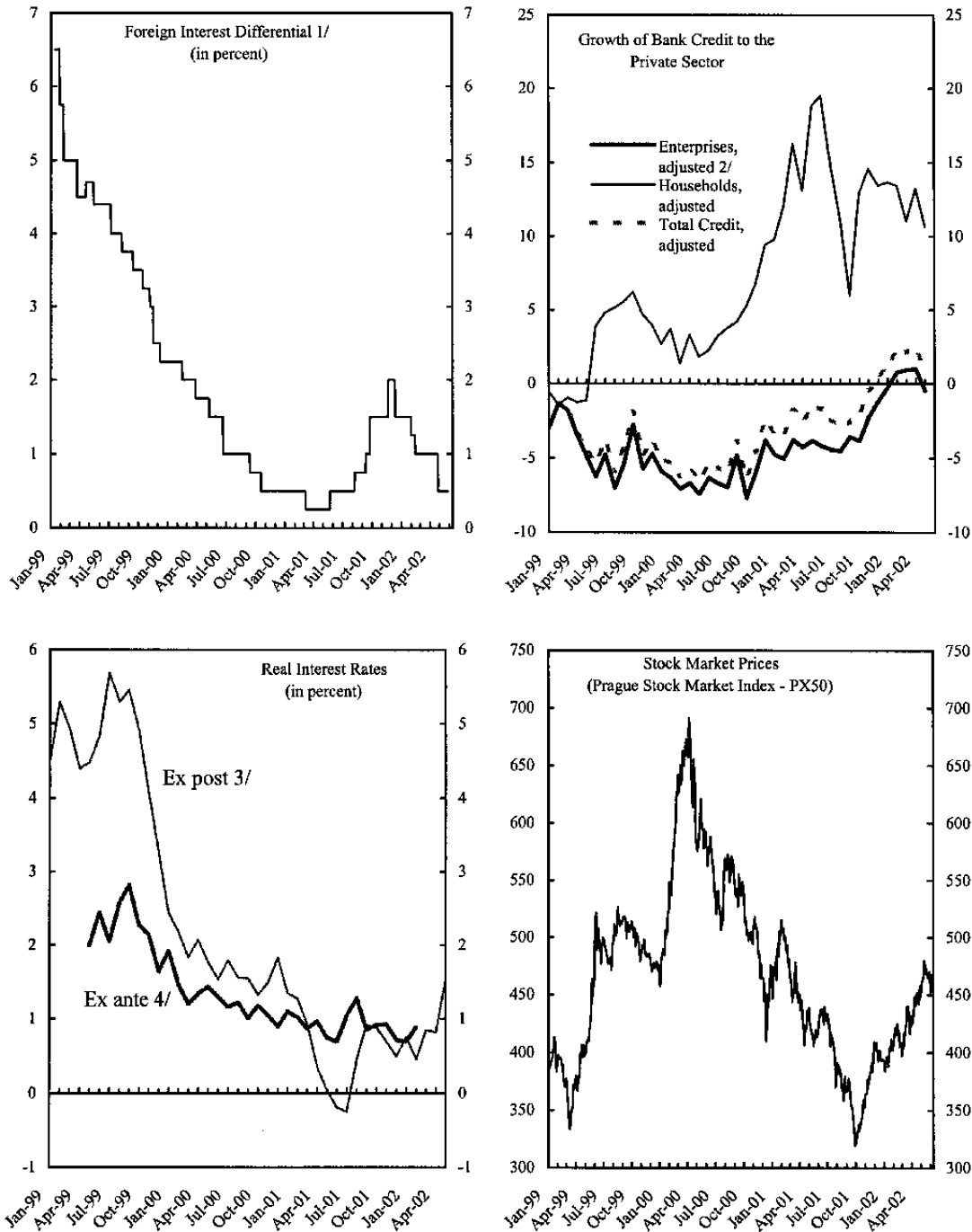
Figure 6. Czech Republic: Interest Rates and Monetary Conditions, 1999-2002



Sources: Czech National Bank; and Fund staff estimates.

1/ Real interest rate used is three-month PRIBOR deflated by contemporaneous CPI inflation. REER used is PPI based (2000=100). The change in the Monetary Condition Index (MCI) is defined as two-thirds of the change in the real interest rate (in percentage point terms), and one-third of the change in the PPI-based REER (in percent).

Figure 7. Czech Republic: Selected Financial Market Indicators, 1999-2002



Sources: Bloomberg; Czech National Bank; and Fund staff calculations.

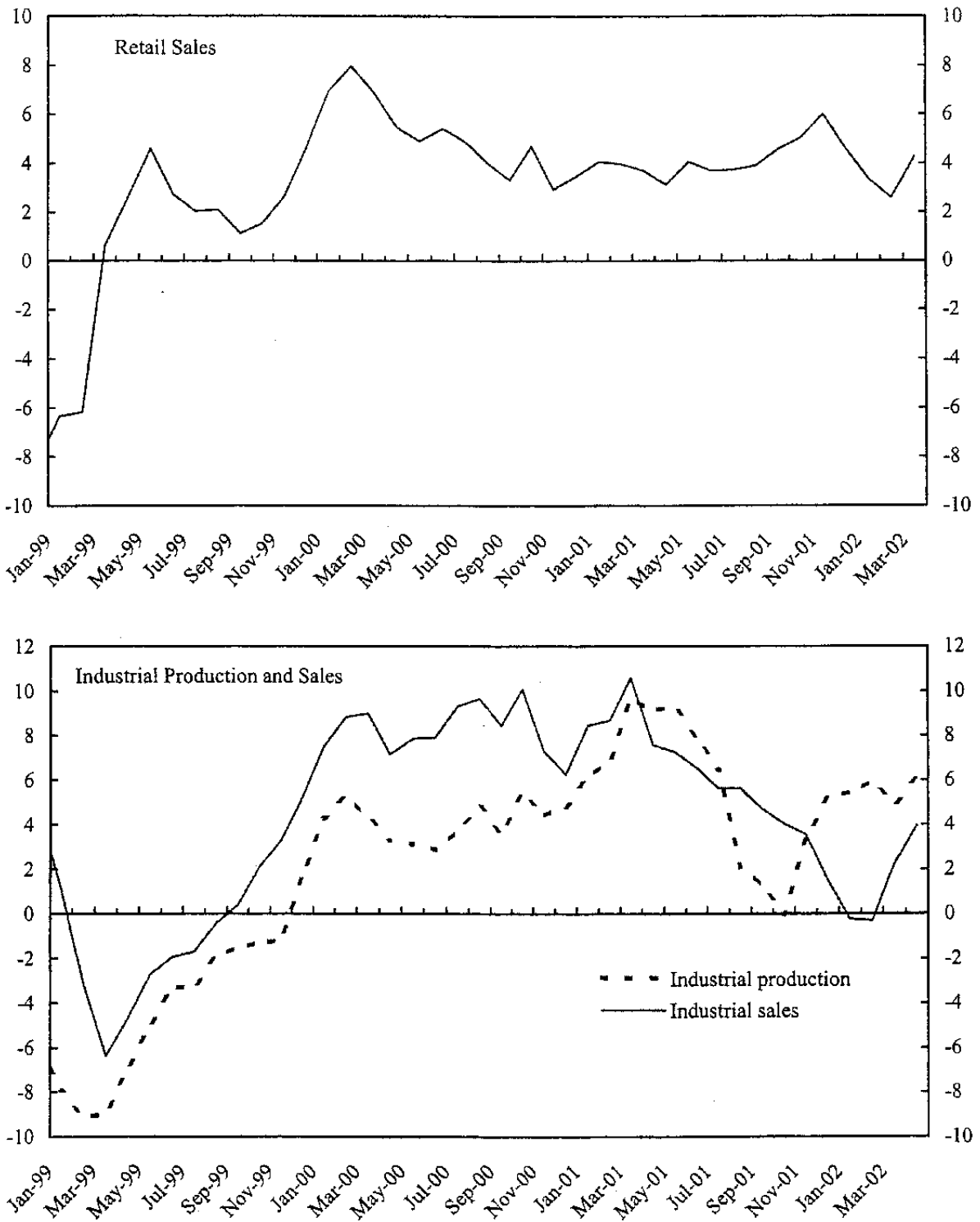
1/ CNB two-week repo rate less ECB minimum main refinancing operations rate.

2/ Adjusted to account for removal of KoB's status as a banking institution in September 2001, exchange rate effects on foreign-currency-denominated loans, loan write-offs, and transfer of IPB loans to CKA.

3/ One-year PRIBOR less ex post CPI.

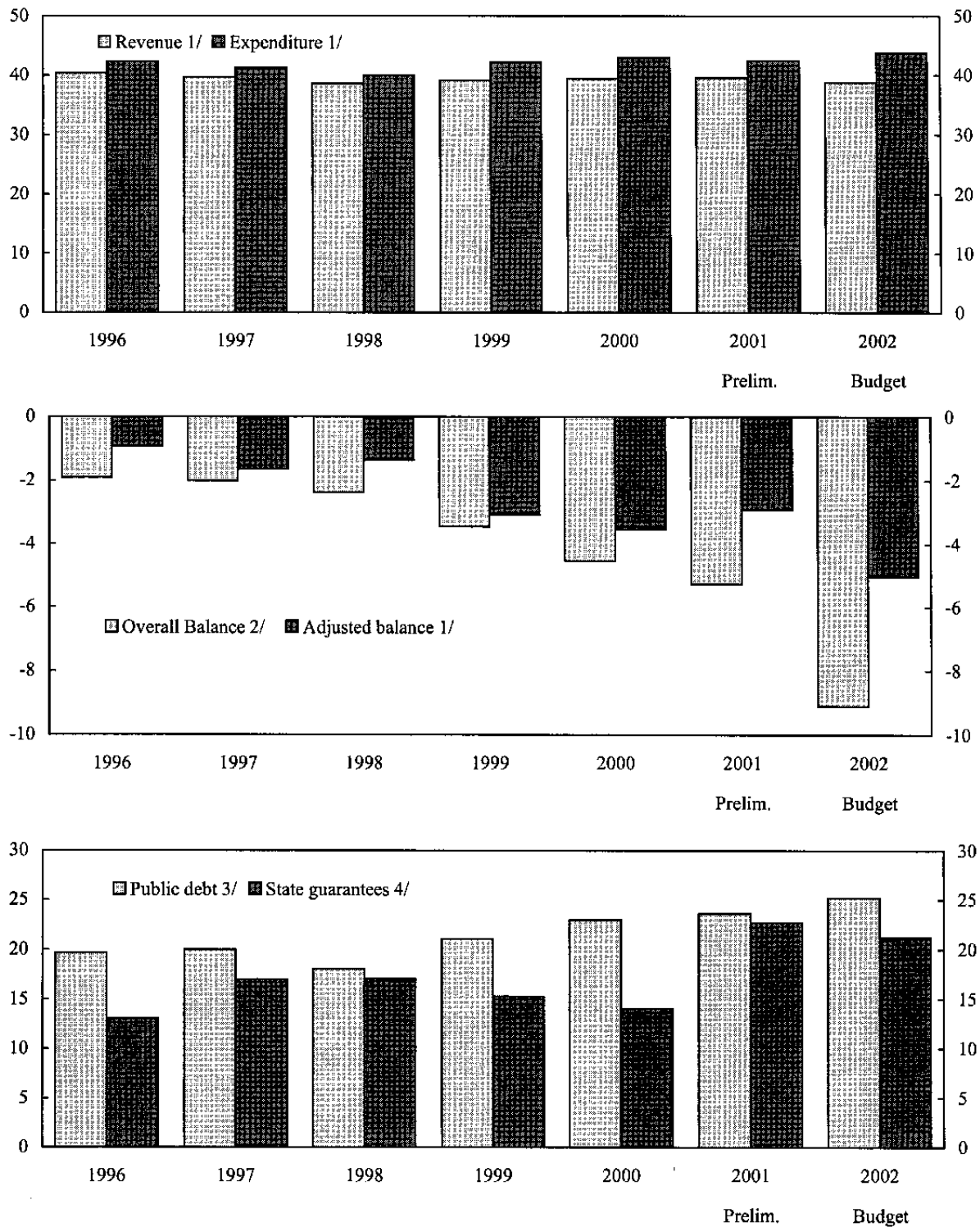
4/ One-year PRIBOR deflated by inflation expected by selected economic sectors according to the CNB Statistical Survey.

Figure 8. Czech Republic: Retail Sales, Industrial Production and Sales, 1999-2002  
(Three-month moving average; year-on-year percent change)



Sources: Czech Statistical Office; and Fund staff calculations.

Figure 9. Fiscal Operations of the General Government, 1996-2002  
(In percent of GDP)



Sources: Czech Ministry of Finance; and Fund staff estimates.

1/ Figures exclude: privatization receipts, proceeds from the sale of UMTS licenses, and the repayment of Russian debt from the revenue side; and grants to transformation institutions from the expenditure side.

2/ Authorities' presentation.

3/ Debt of general government and liabilities of transformation institutions.

4/ Figures include a CZK 33 billion guarantee maturing in 2004 not included in official reported statistics; they exclude guarantees of the NPF. For 2001, they include CZK 155.7 billion of guarantees to the CKA. For 2002, guarantees are assumed unchanged from 2001.

introduction of a new layer of regional governments.<sup>4</sup> The front-loading of expenditures in the run-up to the elections has contributed to a larger-than-usual state budget deficit for the first five months. Planned privatization revenue in 2002 amounts to 9.8 percent of GDP, of which 5.3 percentage points are accounted for by the completed sale of the monopoly gas distributor. The prospects for another major sale (Cesky Telecom), expected to yield up to 3.5 percent of GDP, are uncertain, left to the next government to handle.

10. **Structural problems in the labor market seem to be gradually deepening.** Behind cyclical fluctuations in unemployment (see Figure 5) lies a disparity across sectors, with workers of some regions, age groups, and educational levels experiencing disproportionately higher unemployment rates. Adding to these mismatches, a rising share—now more than half—of the unemployed is long-term unemployed, partly reflecting work disincentives arising from the social benefit system. Although not yet an immediate threat, this adverse tendency could limit the scope for FDI and sustainable growth over the medium term.<sup>5</sup>

## II. REPORT ON THE DISCUSSIONS

11. The Czech economy has, for the most part, left behind the baggage of transition, and the pace of convergence with the EU is accelerating; the challenge now, and in the coming years, is to continue this process smoothly. Catching up to the income levels of its EU neighbors will likely entail a combination of strong economic growth and real exchange rate appreciation. However, too much of the latter could impede the former. Indeed, a fundamental question the authorities are facing is how to cope with large capital inflows; absorbing them through intervention would entail large sterilization costs, while allowing them to push up the value of the koruna sharply could lead to significant macroeconomic imbalances. Given the limited flexibility of fiscal policy to moderate the real appreciation, the monetary authorities have to find the right balance between monetary easing and acceptance of a certain degree of appreciation (together with its nominal and real consequences). This was one of the main topics of the discussions. The mission also discussed strategies to promote sustained economic growth and convergence to EU income levels, forward planning for the transition to ERM2 and the euro, and the creation of an environment conducive to the

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<sup>4</sup> Fourteen administrative regions were established in late 2000 to facilitate coordination with the European Commission (EC) (including for receipt of structural aid) and Eurostat.

<sup>5</sup> A detailed analysis of rising structural unemployment is contained in the Selected Issues paper accompanying this report.



efficient allocation of factors of production, including through substantive reform of the corporate sector, the business legal environment, and labor markets.<sup>6</sup>

12. **At the time of the mission, the impending elections had created somewhat of a vacuum on future macroeconomic policies and structural reforms, but the staff used the opportunity to convey its views to a broad range of politicians and policy makers.** While the authorities acknowledged the policy adjustments needed for the Czech Republic to achieve sustainable growth and secure full-fledged EU membership (including the eventual adoption of the euro), important decisions regarding the future policy agenda were deferred until after the elections.<sup>7</sup> The mission emphasized that further delays in decision making could preclude early achievement of key macroeconomic objectives, and complicate eventual adoption of the euro.

#### A. Economic Outlook

13. **Private analysts and some government officials had a sanguine view about growth prospects this year, despite the strengthening of the koruna.** They thought that the effects of the stronger currency on economic growth would be limited as the share in GDP of labor-intensive industries—which would be most affected by the koruna’s appreciation—was already quite low. They were reassured by the apparent resilience of economic activity and the strong trade performance so far this year. They also noted that the coming on-stream of new export capacity would cushion the negative effects from the stronger koruna and support growth once EU demand accelerated later in the year. However, the CNB cautioned, and the mission concurred, that much of the effect of the stronger currency on trade could still be in the pipeline. In addition, appreciation-induced substitution toward imported goods could hurt the import-competing sector and dampen growth.<sup>8</sup> As a result, the staff expects GDP growth this year to stay broadly constant and the current account

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<sup>6</sup> The Czech Republic has provisionally closed 25 of the 31 chapters of the *acquis communautaire* in its negotiations toward accession to the EU, and appears set to join the EU as part of the first wave of enlargement, possibly as early as January 2004.

<sup>7</sup> A supplement to this report will be issued prior to the Board discussion, which will cover recent developments and the new government’s policy stance to the extent that it has been defined.

<sup>8</sup> High frequency data on corporate profitability, which would shed light on the impact of the appreciation on competitiveness, are not available. However, as shown in the bottom panel of Figure 3, the growth of manufacturing unit labor costs has exceeded that of export prices since the second quarter of 2001, suggesting that profits are likely being squeezed. Also, there have been some signs in recent months that manufacturing employment is weakening.

deficit not to improve as a share of GDP (4.6 percent), in spite of the expected EU recovery (Table 5).<sup>9</sup>

14. **The authorities were optimistic about medium-term growth prospects as cost competitiveness, though weakened, still remained strong.** In their view, the foreign-dominated export sector would continue to underpin GDP growth. According to government officials in charge of FDI promotion, foreign investors were expecting the koruna to appreciate over the life of their investments as a result of real convergence, and hence did not seem to be deterred by the recent strength of the currency. Moreover, while increasing labor costs have begun to push labor-intensive industries further east to lower labor-cost countries, the authorities considered that productivity-adjusted labor costs still remained low in comparison to the EU, and saw a promising potential for sustained export growth from foreign firms relocating their production bases to the Czech Republic.

#### **B. Monetary and Exchange Rate Policy**

15. **The CNB attributed the koruna's rapid appreciation over the past three quarters to several factors, but thought that speculative forces had been the main factor in recent months.** Changes in fundamentals, including gains in productivity and efficiency and the Balassa-Samuelson effect, were seen to be consistent with an annual increase in the real exchange rate of about 4–5 percent, which explained only a fraction of the recent appreciation. Expectations that privatization receipts would be converted in the market and hedging by exporters were also cited. However, the CNB pointed out that, so long as the privatization receipts were kept from the market according to the agreement between the CNB and the government, the rest of the balance of payments this year was expected to be broadly in balance, which, in their view, implied that upward pressure on the koruna, if any, should be minimal. From these, they concluded that there was an appreciable “bubble” element in the koruna's recent ascent.

16. **The staff was cautious about the authorities' “bubble” interpretation, but shared the CNB's concern about the potential deflationary threat of the koruna's appreciation.** The staff noted that it was difficult to determine the “fundamental” value of the exchange rate—and hence the presence or absence of a bubble—because of the forward-looking nature of exchange rate determination. In particular, the ongoing process of real convergence might lead market participants to believe that the koruna's eventual conversion rate to the euro would be substantially higher than the current exchange rate, which in turn

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<sup>9</sup> While acknowledging the difficulty of arriving at reliable estimates of the output gap in an economy undergoing rapid transformation, staff estimates suggest that the small negative output gap that existed in mid-2001 widened slightly in the second half of the year and will remain broadly constant in 2002. The CNB and the ministry of finance (MoF) also estimate the gap in 2001 to be negative but small ( $\frac{1}{4}$ –1 percent of GDP).

might induce them to bid up the koruna today. However, if such an early “convergence play” went too far, it would undermine short-term macroeconomic stability, and could even disrupt the real convergence process over the medium term. The authorities attributed the halt in the koruna’s rise since late April to perceptions of this risk.

17. **All agreed that the recent rapid appreciation had contributed to a low inflation outlook.** Inflation was expected to remain below the target band through early 2003, reflecting the lagged effect of the earlier rapid appreciation.<sup>10</sup> Absent any further policy measures, inflation 12–18 months ahead (the period targeted by the CNB) would likely be near the lower boundary of the target band (about 2½–4½ percent). The staff saw downside risks to this inflation forecast, reflecting the potential for greater pass-through to prices of the exchange rate than occurred in the past due to stronger competition in retailing. In addition, reduced profitability of export and import-competing industries could lead to temporary cutbacks in investment and employment, placing further downward pressure on inflation in the coming year.

18. **In view of the low inflation outlook, the CNB cut interest rates by a further 50 basis points in late April in order to ease monetary conditions and keep inflation within the target band 12–18 months down the road.** The staff supported the rate cut, which it saw as evidence of the CNB’s clear focus on inflation targeting. The CNB officials noted that although exchange market intervention continued to be an option, their recent interventions had not yielded the hoped-for reversal of the previous appreciation. The staff argued that although the use of intervention was consistent with the authorities’ view that the exchange rate had a “bubble” element, it should be used only sparingly.

19. **The authorities expressed their continued support for the agreement on the treatment of privatization receipts, which would help reduce uncertainty in the foreign exchange market.** The CNB and the MoF viewed the agreement not to convert any government foreign currency receipts on the market—and for the government to refrain from issuing foreign currency debt—as crucial for lowering the risk of exchange rate speculation, and both parties were committed to its implementation. The staff welcomed this assurance. Moreover, since several large-scale privatizations would take place only after the elections, the staff stressed the need for the next government to adhere to the agreement.

20. **The staff urged the authorities to plan ahead for the adoption of the euro, even though the event was still some years away.** In order to reduce uncertainty and associated exchange rate instability, the staff urged the authorities to develop, and announce as appropriate, a timetable with concrete steps for adopting the euro. The authorities noted that once the date of EU accession was set, the next government, in consultation with the CNB,

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<sup>10</sup> Slower growth of regulated prices than assumed when the target band was set in April 2001 will also tend to depress inflation relative to target.

would formulate the plan for adopting the euro. The CNB confirmed its intention to continue with inflation targeting until the adoption of the euro. Owing to the potential conflict between inflation targeting and an exchange rate band, the CNB was opposed to establishing an ERM2-type band any earlier than required, and once formally in the ERM2, they would seek to remain within the mechanism for the minimum-allowable amount of time. As to the likely timing of adoption of the euro, some CNB officials felt that alignment with the EU was already well advanced in many respects, but pointed out that the need to lower the fiscal deficit to the Maastricht ceiling and downward inflexibility of real wages were main obstacles. The staff agreed, and argued that, whatever the decision on timing, the authorities should use the period until then to actively prepare and implement needed fiscal consolidation, and to enhance the flexibility of labor markets.

### C. Fiscal Policy

21. **The staff expressed concern about the substantial widening of the general government deficit—2.1 percent of GDP on an adjusted deficit basis—foreseen in the 2002 budget.** In this regard, the staff questioned whether a smaller deficit could not be achieved given the significantly better-than-expected outturn in the previous year. The authorities explained that the expected decline in the revenue ratio (0.7 percent of GDP below the estimated 2001 outturn; see Table 3), which initially reflected their practice of conservative revenue estimates, was now deemed more realistic given the downward revision of the economic outlook since the budget was framed and the revenue loss from the appreciation of the koruna. As regards possible expenditure savings, they thought that the State Housing Fund might underspend its budget, but only by some ¼ percent of GDP. They also noted that shortfalls in privatization revenue would not, as in the past, lead to spending cuts by the extrabudgetary funds, which could fill the gap by exercising their ability to issue debt. The conclusion, therefore, was that the deficit this year would be in line with the budget.<sup>11</sup>

22. **The staff urged expenditure cuts, but the authorities saw limited scope for such action.** The staff considered the envisaged deficit expansion to be cyclically unwarranted, and counter to the objective of medium-term fiscal consolidation. The staff thus advocated cutting expenditure by 1.5 percent of GDP to bring the expenditure ratio somewhat below its 2001 level, targeting unproductive expenditures such as subsidies to public enterprises and construction savings accounts. The authorities thought it would be difficult to achieve such a reduction in the remainder of the year without touching the wage bill and capital

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<sup>11</sup> In response to staff's concern that front-loading expenditures (see ¶ 9) might relax budget discipline for the year as a whole, the authorities noted that annual expenditures would be constrained by budgetary rules introduced in January 2001 that limited the permissible deviation of actual spending from approved levels. This should preclude an overshooting of the deficit from the spending side.

expenditures. Expenditures of extrabudgetary funds were deemed particularly difficult to curtail given the Funds' financial autonomy and the need for parliamentary approval for any changes in spending plans.

23. **The analysis of fiscal developments and prospects was hindered by the increasing complexity of the fiscal accounts, resulting from the growing number of extrabudgetary funds as well as an additional layer of local government.** In staff's view, the increasing complexity of intergovernmental financial relations and associated reclassification of expenditures had reduced the ability of the MoF to monitor and control overall fiscal spending. The authorities agreed that these changes had temporarily complicated budget planning and monitoring, but hoped that the situation would improve once the transition was completed. Moreover, they recognized that the transfer of spending responsibilities from the state budget to local governments and the extrabudgetary funds was not accompanied by a commensurate reduction in the size of the state budget.<sup>12</sup>

24. **The authorities concurred that reforms directed at ensuring fiscal sustainability over the medium term will need to be among the top priorities of the next government.**<sup>13</sup> Given an already high tax burden, they thought that revenue increases should not be the primary source for deficit reduction, as was the case in their previous Pre-accession Economic Program (PEP) submission;<sup>14</sup> rather, the key to successful consolidation would be a reform of mandatory expenditures, particularly entitlements. The MoF was working on a tentative proposal to cut the fiscal deficit over the medium term, first stabilizing it in 2003 and reducing it by 0.5 percentage points of GDP in subsequent years. They pointed out, however, that it would be up to the next government to decide on both the pace and the modalities of fiscal consolidation. They also noted that, for the same reason, this year's PEP (to be submitted to the EC in August) would be unlikely to contain specific new deficit-cutting measures.

25. **The staff argued that the new government's consolidation plan would have to be ambitious, if the authorities wished to keep the option of being among the first group of countries to adopt the euro.** The staff recalled that last year's PEP indicated that the Czech fiscal deficit was substantially worse than that of Hungary and Poland (text chart). The authorities' calculation of the deficit on an ESA95 basis—the relevant deficit concept under

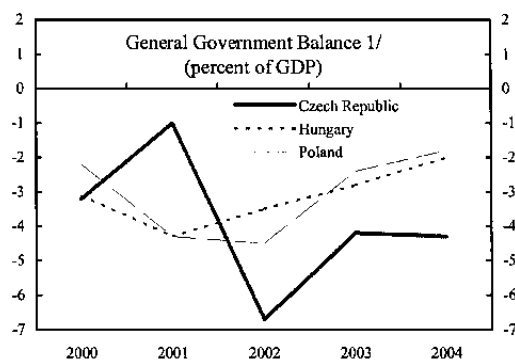
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<sup>12</sup> The transfer of spending responsibilities from the state budget to local governments is funded by a tax-sharing arrangement. As a result, an approximately equal amount of revenue and expenditure carved out from the state budget has been shifted to local government budgets.

<sup>13</sup> Fiscal sustainability issues are discussed in detail in Appendix I.

<sup>14</sup> For a detailed discussion of the PEP see SM/01/195 (6/28/01).

the Maastricht Treaty—was expected to be well above 6 percent of GDP in 2002, which implied that a fairly rapid pace of deficit reduction would be required to reach the 3 percent of GDP ceiling by 2006–07, when some among the first group of accession countries might adopt the euro. The staff discussed a range of possible measures that would achieve this goal.<sup>15</sup> The authorities saw merit to the staff’s arguments, but reiterated that political decisions would have to be made by the new government, including on the timing of the adoption of the euro.



1/ Projections for 2002 are based on the authorities medium-term plans.

26. **Over the longer term, the Czech Republic is destined to face the same demographic challenges as its future EU partners.** The deficit of the pension system, currently around 1 percent of GDP, is expected to rise steadily to a staggering 8 percent by 2050, and the staff argued that it was absolutely essential to introduce far-reaching reforms.<sup>16</sup> The authorities pointed to changes in early retirement provisions made in 2001 as evidence of their commitment to pension reform. However, this, by itself, was far from sufficient to reduce the pension deficit in the future to a manageable level.

#### D. Financial Sector Stability

27. **Financial sector soundness has improved.**<sup>17</sup> The FSAP conducted in 2001 concluded that the resilience of the Czech financial system to macroeconomic shocks and structural weaknesses has strengthened considerably. It also noted, however, that while progress had been made in improving the legislative and regulatory framework of the financial system, critical challenges remained, notably better enforcement through a strengthening of supervisory capacity and improvements in the court system.<sup>18</sup> Since then,

<sup>15</sup> These measures—based on World Bank recommendations in its 2001 Public Expenditure Review of the Czech Republic (World Bank, *Czech Republic: Enhancing the Prospects for Growth with Fiscal Sustainability*, March 2001)—included, among others: (i) expanding user co-payments for health services; (ii) scaling back subsidies related to construction savings accounts; (iii) increasing transport user fees; and (iv) terminating the preferential VAT treatment of residential construction.

<sup>16</sup> See World Bank, March 2002, *Czech Pension System: Challenges and Reform Options*.

<sup>17</sup> For a full discussion, see the updated ROSCs that accompany this report.

<sup>18</sup> See *Czech Republic—Financial System Stability Assessment* (SM/01/189, 6/27/01).

banking system soundness has been further consolidated. Komerční banka, the last remaining state-owned commercial bank, has been privatized. Capital adequacy remains strong; classified and nonperforming loan ratios have declined (in part due to government cleanup of banks); and bank profitability relative to assets and capital has risen sharply—despite weak growth of credit to the private sector—owing to a decline in the creation of provisions and some savings from layoffs (see text table). The Czech authorities were confident that the amendment of the Act on Banks, which came into effect on May 1, 2002, would strengthen the CNB’s ability to conduct consolidated supervision over financial groups. Financial sector supervision remains spread across three institutions (the CNB, the Securities Commission, and the MOF), and the authorities agreed that this would require close cooperation in an environment where institutional divisions in the financial sector were becoming increasingly blurred.

Banking Sector Soundness and Profitability

	1999	2000	2001	2002 March
Capital adequacy ratio (in percent)	13.6	14.9	15.4	14.9
Classified credits (as percent of total credits)	32.2	29.8	21.5	19.6
Nonperforming credits (as percent of total credits) 1/	22.0	19.9	13.7	11.8
Profit from banking activities (as percent of average bank assets) 2/	4.2	4.0	3.8	3.7
Net-of-tax profit (as percent of average bank assets)	-0.3	0.7	0.7	1.5
Net-of-tax profit (as percent of Tier 1 capital)	-4.3	12.0	12.9	26.7
Number of banking sector employees	48,924	44,932	40,871	40,720

Source: Czech National Bank.

1/ Includes substandard, doubtful, and loss credits.

2/ Gross operating profit excluding administrative expenses, net creation of reserves and provisions, and other operating expenses.

28. **The mission met the Financial Intelligence Unit of the MoF to discuss anti-money laundering and combating terrorist financing.**<sup>19</sup> The authorities explained that the amendment to the Act on Banks improved the anti-money laundering framework by prohibiting the opening of new anonymous savings passbooks and setting a fixed timetable

<sup>19</sup> A questionnaire produced by MAE and LEG was sent to the Unit. The discussion was based on the authorities’ response to the questionnaire.

for eliminating existing ones. Moreover, the amendment to the Criminal Code would come into effect as from July 2002, expanding the scope of prosecuting money laundering. These amendments addressed the weaknesses of the Czech system identified by the staff.

### **E. Structural Reforms and Other Issues**

#### **Corporate restructuring and the legal framework**

29. **The authorities planned to resume bulk sales of bad assets transferred from banks to the Czech Consolidation Agency (CKA).** The decision reflected in part the large increase in sellable assets (about CZK100 billion, or 5 percent of GDP) that will be acquired by CKA in mid-2002 from IPB, a major commercial bank that failed in 2000. The planned series of four package sales would exhaust the CZK 180 billion in CKA's assets sellable through this channel. The staff welcomed the decision as the private sector would be best placed to determine how to dispose of bad assets, and cautioned that the number of public sector-led corporate restructurings should be strictly limited.

30. **Efforts were underway to correct inadequacies in the corporate legal environment that added to the cost of doing business in the Czech Republic.** The ministry of justice had begun preparing a new Bankruptcy Act with the objective of introducing a number of improvements, such as greater rights and protections for creditors and increasing opportunities for enterprise restructuring instead of liquidation. The staff supported this initiative, and hoped that the next government would accelerate work in this area, after consultation with the legal and business communities, and submit a new draft law to parliament at the earliest opportunity. In addition, extensive reform of the judiciary was underway that would raise the required qualifications for judges and prosecutors, and promote specialization of judges into defined fields of law. In the area of commercial registers, the staff suggested that privatizing the registers, as in many advanced economies, could reduce inefficiencies and delays, a frequent source of complaints from foreign investors. However, ministry of justice officials downplayed the extent of delays, and reiterated their view that courts should continue to be responsible for commercial registers.

#### **Labor markets**

31. **The authorities were not convinced of the effectiveness of measures to enhance labor mobility, and not all interlocutors agreed on the severity of work disincentive problems.** While staff argued that encouraging workers' geographical mobility by removing disincentives—for example, rent control—would facilitate the relocation of labor and help raise employment levels, the authorities were skeptical about the effectiveness of such measures. There was agreement, however, that continuing to guide FDI to areas with disproportionately high unemployment rates through infrastructure development and maintaining the existing investment incentives would help reduce persistent disparities in unemployment. Restraining minimum wage growth and reducing excessive employment protection imposed by regulation would increase labor market flexibility and facilitate real



wage adjustments to macroeconomic shocks.<sup>20</sup> The staff cautioned that future FDI and economic growth could be limited by labor shortages, and that these could be exacerbated by work disincentives coming from undifferentiated social assistance benefits and benefit levels that exceeded the wage income that the recipients could earn if employed. The authorities acknowledged this, but cited political difficulties in lowering the generosity of benefits. However, trade unions argued instead for raising wages. The authorities and the staff agreed that reducing long-term unemployment would require enhancing active labor market policies, including linking existing severance benefits in industries under restructuring to participation in programs targeted at obtaining new jobs.

### **Transparency and international standards**

32. **The increasing share of spending outside the state budget poses a challenge for fiscal transparency.**<sup>21</sup> The Czech Republic meets many of the standards set out in the *Code of Good Practices on Fiscal Transparency*, and the authorities noted that the introduction of new budgetary rules in 2001 had contributed to an improvement in the accountability of public finances, inter alia, by ensuring the disclosure of contingent liabilities and requiring the government to seek parliamentary approval for all state guarantees. Through its regular publications, the MoF has maintained a high standard of public availability of information on government finances. However, staff noted that extrabudgetary funds and local governments, including the newly established regions, are responsible for a rising share of public spending (40 percent in 2001, projected to increase to 44 percent in 2002). This raises the question of how to ensure overall control and transparency of public spending, especially given the need to monitor and control the general government deficit as defined for the Maastricht criteria.

### **III. STAFF APPRAISAL**

33. **Over the past year, the Czech economy has weathered a number of macroeconomic shocks remarkably well, but challenges remain to realizing the country's potential for sustained rapid growth.** The economy's resilience so far testifies to the improving supply side, brought about by buoyant FDI and progress in structural reforms in recent years. The challenge now is to maintain this positive momentum. In the short term,

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<sup>20</sup> The Czech Republic's employment protection ranks fourth among OECD countries with respect to dismissals of individuals under regular employment, and second with respect to collective dismissals such as layoffs (*OECD Employment Outlook*, 1999). In particular, long mandatory notice periods and generous compulsory severance terms tend to raise employers' costs of labor adjustment.

<sup>21</sup> For a full discussion see *Czech Republic—Fiscal Transparency: An Update* (SM/02/217, 7/12/02).

the economy has to cope with the koruna's recent appreciation, the effects of which may yet be in the pipeline. In the medium term, fiscal sustainability continues to be a major concern. While banking sector restructuring has largely been completed, other areas of structural reform—including corporate sector restructuring and reform of the legal and regulatory environment—need to be accelerated. Progress in these areas will greatly facilitate the Czech Republic's catch-up with its EU partners through an improved investment environment, and will lay the ground for a smooth accession to the EU and eventual participation in the euro zone.

34. **Monetary policy has played, and will need to continue to play, a key role to counteract the deflationary effects of the koruna's appreciation.** Decisive policy actions were necessary to stem the currency's upward movement, especially in light of the unfavorable global economic conditions. The CNB's interest rate cuts, sizable interventions, and repeated public warnings about the economic consequences of exchange rate developments stabilized the koruna for a while since April, but upward pressure resurfaced in late June. Although recent economic indicators do not show any major adverse impact on the economy of the past appreciation, considerable effects may still be in the pipeline, given the sheer size and speed of appreciation. The CNB should stand ready to loosen further if signs of strain appear in coming months, either in the real economy or in the foreign exchange market that might risk depressing inflation below the target band 12–18 months ahead. Looking further ahead, risks to inflation will be more balanced as the global economy recovers, thereby strengthening the Czech Republic's external demand.

35. **The exchange rate developments highlight the importance of clarifying the Czech Republic's intended path toward the ERM2 and the eventual adoption of the euro.** Although difficult to quantify, there is a clear link between the exchange rate today and the process by which the koruna will join ERM2 and eventually be converted to the euro. Uncertainty and speculation about the latter therefore tend to generate instability of the former. In order to stabilize market expectations, the new government and the CNB should formulate their strategy toward the adoption of the euro, and disclose it as appropriate. Any such strategy should be credible, especially with respect to the government's plan for fiscal deficit reduction, and consistent with other policy objectives, including that of maintaining low and stable inflation.

36. **The government and the parliament that have emerged from the recent elections need to undertake a fundamental reformulation of fiscal policy geared toward putting the fiscal deficit on a decisively downward path.** The 2002 budget is unnecessarily expansionary, and its spending plan should be revised down, targeting expenditure items that contribute least to medium-term growth. The fiscal reform agenda should be addressed promptly and decisively, especially the reform of the social benefit and pension systems. Over the next few years, the realization of contingent liabilities from bank restructuring, costs related to EU accession, the drying up of privatization proceeds, and the mounting needs for spending on infrastructure make it imperative to address the sustainability of public finances by cutting expenditures in nonpriority areas and introducing fundamental reforms to rein in

mandatory spending. In particular, there is room to reform the social benefit system so as to contain fiscal costs as well as to improve incentives to work, while preserving the existing social safety net. Pension reform is the other important area, where several alternative reform proposals have already been developed and their payoffs over time carefully analyzed. What is now needed is to move from these proposals to the adoption and implementation of concrete reforms.

37. **On the structural front, the new parliament and government should accelerate reform efforts initiated by their predecessors.** Completing privatization of remaining major state-owned companies will contribute to a more efficient functioning of the economy. The disposal of bad assets taken over by the government through bulk sales will greatly facilitate corporate restructuring. The legal and regulatory framework remains in need of further improvement, including the reform of the bankruptcy process and of the commercial registers. These reforms will improve the attractiveness of the Czech Republic for investors, and thereby strengthen the foundation of sustained growth.

38. **The improving condition of the financial sector will enable it to better fulfill its intermediation role and contribute to the growth of the economy.** As a result of the entry of new strategic investors, many banks are undergoing major internal reorganizations leading to improved risk management procedures, the introduction of new products, and the enhancement of cost-cutting measures. These efforts should continue to augment banking sector profitability and stability. However, the growing complexity of the structure of financial groups will pose an added supervisory challenge. The increased powers of the CNB to conduct consolidated supervision over certain types of financial groups is welcome, but with supervision of the entire sector spread across three institutions, it will be necessary to develop a flexible framework for effective cooperation between these institutions at all levels.

39. **The authorities should continue their efforts to improve the quality of economic statistics, increase transparency, and comply with international standards.** Statistical indicators are generally adequate for surveillance purposes, and the ongoing harmonization of statistical methodology with international best practices is welcome. The authorities' strong commitment to transparency and international standards is evidenced by their contribution to updating the ROSC modules and in the legal corrections taken to remedy weaknesses in the anti-money laundering framework. In the area of fiscal transparency, however, the increasing reliance on extrabudgetary funds is a setback which will hinder the government's ability to monitor and control spending. In order to improve the efficiency of spending decisions and expand the scope for deficit-cutting expenditure retrenchment, the new housing and transport funds should be eliminated and their responsibilities incorporated into the state budget.

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

Table 1. Czech Republic: Selected Economic and Financial Indicators, 1997–2002

	1997	1998	1999	2000	2001	2002 Proj. 1/
<b>Real sector</b>						
			(Percent change)			
Real GDP	-0.8	-1.0	0.5	3.3	3.3	3.2
CPI inflation						
Period average	8.5	10.7	2.1	3.9	4.7	3.0
12-month change	10.0	6.8	2.5	4.0	4.1	2.7
Net inflation, 12-month change 2/	6.8	1.7	1.5	3.0	2.4	...
Real wages (industry), period average	3.2	-0.2	4.6	1.0	2.0	4.0
Registered unemployed, per. average (percent of labor force)	4.3	6.1	8.6	9.0	8.5	8.8
			(In percent of GDP)			
<b>Fiscal sector 3/</b>						
Revenues	39.6	38.6	39.1	39.3	39.5	38.7
Expenditures and net lending	41.6	40.9	42.6	43.9	44.8	47.8
Overall balance	-2.0	-2.4	-3.5	-4.5	-5.3	-9.1
Adjusted to exclude grants to transformation institutions to cover costs related to management of bad assets	-1.6	-1.4	-3.1	-3.5	-2.9	-5.0
Gross debt	12.9	13.0	14.5	16.7	18.7	19.5
Loan guarantees outstanding 4/	17.0	17.0	15.3	14.0	22.7	...
			(12-month change in percent)			
<b>Money and credit (end-of-period)</b>						
Broad money	4.7	5.4	7.7	5.6	13.0	...
Credit to enterprises and households 5/	9.4	0.7	-4.7	-2.5	0.5	...
Net foreign assets	26.7	25.6	34.1	18.0	18.9	...
Velocity (percentage change, end-of-period)	0.7	0.3	-1.0	0.2	-0.9	...
<b>Interest rates</b>						
Average lending rate on new loans	16.5	11.9	6.7	6.8	5.9	...
Average deposit rate	8.0	6.7	3.7	3.0	2.6	...
			(In billions of U.S. dollars)			
<b>Balance of payments</b>						
Merchandise exports	22.4	25.9	26.3	29.1	33.4	35.2
Merchandise imports	27.3	28.5	28.2	32.2	36.5	38.6
Trade balance	-4.9	-2.6	-1.9	-3.1	-3.1	-3.4
Current account	-3.6	-1.4	-1.5	-2.7	-2.6	-3.0
(Percent of GDP)	-6.7	-2.2	-2.7	-5.3	-4.6	-4.6
Nondebt capital inflows (percent of GDP) 6/	3.3	7.6	11.7	10.9	9.7	12.0
			(In billions of U.S. dollars)			
<b>Reserves and external debt</b>						
Gross official reserves (end-of-period)	9.8	12.6	12.8	13.1	14.5	20.9
(In months of imports of goods and services)	3.6	4.4	4.5	4.2	4.1	5.6
Total external debt (end-of-period)	21.6	24.3	22.8	21.6	21.8	22.8
(Percent of GDP)	44.6	39.5	43.2	41.2	38.5	35.2
Short-term debt (convertible currencies, end-of-period)	7.1	9.1	8.5	9.1	9.2	9.1
External debt service ratio in convertible currencies						
(Percent of exports of goods and nonfactor services)	15.9	15.4	12.7	12.3	8.6	9.6
			(Percent change)			
<b>Exchange rate (period average)</b>						
Nominal effective 7/	-3.5	0.7	0.1	1.1	4.8	6.6
Real effective (ULC-based) 8/	-2.4	8.5	3.4	-0.8	3.9	11.2
<b>Memorandum item:</b>						
GDP in nominal terms						
(In US\$ billions)	53.0	57.0	54.7	51.4	56.7	64.7
(In CZK billions)	1,680	1,839	1,902	1,985	2,158	2,325

Sources: Czech authorities; and Fund staff estimates and projections.

1/ Staff projections.

2/ Net inflation excludes administered prices and the effects of changes in indirect taxes.

3/ General government operations and debt; central government guarantees. Revenues and expenditures exclude privatization receipts.

4/ Includes a CZK 33 billion government guarantee not included in official reported statistics. For 2001, includes CZK 155.7 billion government guarantees to the CKA.

5/ Adjusted to account for removal of KoB's banking license in September 2001, exchange rate effects on foreign-currency-denominated loans, loan write-offs, and transfer of IPB loans to CKA.

6/ Inflows for direct investment and equity securities. Includes privatization-related FDI.

7/ For 2002, figure is 12-month growth rate for March.

8/ For 2002, figure is 12-month growth rate for April.

Table 2. Czech Republic: Balance of Payments, 1997-2003  
(In millions of U.S. dollars)

	1997	1998	1999	2000	2001	Proj.	
						2002	2003
<b>Current account balance</b>	<b>-3,564</b>	<b>-1,255</b>	<b>-1,462</b>	<b>-2,718</b>	<b>-2,638</b>	<b>-2,985</b>	<b>-3,011</b>
Trade balance 1/	-4,893	-2,603	-1,903	-3,131	-3,081	-3,381	-3,349
Exports	22,359	25,853	26,265	29,052	33,381	35,233	39,136
Imports	27,252	28,456	28,167	32,183	36,462	38,614	42,485
Nonfactor services	1,763	1,919	1,200	1,414	1,524	1,685	1,673
Receipts	7,162	7,646	7,048	6,862	7,090	7,663	8,320
Payments	5,399	5,726	5,848	5,448	5,566	5,979	6,648
Factor income (net)	-791	-1,087	-1,349	-1,373	-1,549	-1,774	-1,839
Current transfers	357	516	590	372	467	486	505
<b>Financial account balance</b>	<b>1,082</b>	<b>2,923</b>	<b>3,080</b>	<b>3,836</b>	<b>4,031</b>	<b>9,389</b>	<b>9,563</b>
Direct investment, net 2/	1,275	3,591	6,234	4,943	4,820	7,366	8,647
Portfolio investment, net	1,086	1,069	-1,395	-1,767	916	1,159	322
Financial derivatives, net	...	...	...	-36	-85	-2	0
Other investment, net	-1,279	-1,737	-1,759	696	-1,621	866	594
<b>Errors and omissions, net</b>	<b>705</b>	<b>270</b>	<b>36</b>	<b>-295</b>	<b>381</b>	<b>-412</b>	<b>0</b>
<b>Change in reserves</b> (- increase)	<b>1,767</b>	<b>-1,941</b>	<b>-1,651</b>	<b>-819</b>	<b>-1,765</b>	<b>-6,404</b>	<b>-6,552</b>
<b>Memorandum items:</b>							
Current account (in percent of GDP)	-6.7	-2.2	-2.7	-5.3	-4.6	-4.6	-4.3
Trade balance (in percent of GDP)	-9.2	-4.6	-3.5	-6.1	-5.4	-5.2	-4.7
Net foreign direct investment (in percent of GDP)	2.4	6.3	11.3	9.6	8.5	11.4	12.3
Gross official reserves (in months of imports of goods and services)	3.6	4.4	4.5	4.2	4.1	5.6	6.7
Total external debt (in percent of GDP)	44.6	39.5	43.2	41.2	38.2	35.2	33.3

Sources: Czech National Bank; and Fund staff projections.

1/ Beginning in 1999, trade data are compiled on a net basis.

2/ Includes privatization-related FDI.

Table 3. Czech Republic: Consolidated General Government Budget, 2000-02 1/

	2000	2001		2002	2000	2001		2002
	Actual	Budget 2/	Prelim.	Budget 2/	Actual	Budget 2/	Prelim.	Budget 2/
	(In billions of koruny)				(In percent of GDP)			
<b>Total revenue and grants</b>	781.0	821.4	852.9	895.5	39.3	38.1	39.5	38.7
<b>Total revenue</b>	779.8	821.4	850.1	895.5	39.3	38.1	39.4	38.7
<i>Current revenue</i>	770.3	809.0	840.4	880.1	38.8	37.5	38.9	38.1
Tax revenue	720.8	762.3	782.0	822.2	36.3	35.3	36.2	35.6
Nontax revenue	49.5	46.7	58.4	57.9	2.5	2.2	2.7	2.5
<i>Capital revenue (excluding privatization)</i>	9.5	12.4	9.7	15.4	0.5	0.6	0.4	0.7
<b>Grants</b>	1.2	0.0	2.8	0.0	0.1	0.0	0.1	0.0
<b>Total expenditure and net lending</b>	871.0	1,035.6	966.4	1,105.9	43.9	48.0	44.8	47.8
<b>(excluding grants to transformation institutions)</b>	851.2	930.3	915.8	1,011.7	42.9	43.1	42.4	43.8
<b>Total expenditure</b>	867.9	1,027.1	963.9	1,102.7	43.7	47.6	44.7	47.7
<i>Current expenditure</i>	751.7	899.5	843.1	971.4	37.9	41.7	39.1	42.0
<i>(excluding grants to transformation institutions)</i>	732.0	794.2	792.5	877.2	36.9	36.8	36.7	37.9
Goods and services	171.0	190.1	175.0	206.7	8.6	8.8	8.1	8.9
Interest payments	21.2	24.8	21.8	25.1	1.1	1.1	1.0	1.1
Subsidies and other current transfers	559.5	684.6	646.3	739.6	28.2	31.7	29.9	32.0
<i>Capital expenditure</i>	116.2	127.7	120.8	131.3	5.9	5.9	5.6	5.7
<b>Net lending (excluding privatization)</b>	3.1	8.4	2.6	3.2	0.2	0.4	0.1	0.1
<b>Overall Balance</b>	-90.0	-214.2	-113.6	-210.4	-4.5	-9.9	-5.3	-9.1
Adjusted to exclude grants to transformation institutions								
to cover costs related to management of bad assets	-70.2	-108.9	-63.0	-116.2	-3.5	-5.0	-2.9	-5.0
<b>Financing</b>	90.0	214.2	113.6	210.4	4.5	9.9	5.3	9.1
Privatization receipts	28.0	161.6	63.2	226.1	1.4	7.5	2.9	9.8
<i>Of which: proceeds from sale of mobile phone licenses</i>	0.0	20.0	1.8	0.0	0.0	0.9	0.1	0.0
Proceeds from sale of Russian debt	0.0	1.2	0.0	20.4	0.0	0.1	0.0	0.9
Net increase in financial liabilities	62.0	51.4	50.4	-36.1	3.1	2.4	2.3	-1.6
<b>Memorandum items:</b>								
Primary balance 3/	-49.0	-84.1	-41.1	-91.1	-2.5	-3.9	-1.9	-3.9
Grants to transformation institutions (KoB/CKA, CI, CF)								
to cover costs related to management of bad assets	19.7	105.2	50.6	94.2	1.0	4.9	2.3	4.1
General government debt 4/	332.4	413.5	404.5	451.4	16.7	19.2	18.7	19.5

Sources: Ministry of Finance; and Fund staff estimates.

1/ Includes the state budget, State Financial Assets, National Property Fund, Czech Land Fund, extrabudgetary funds, social funds, and local governments.

2/ Ministry of Finance estimates for general government, consistent with the state budget proposal.

3/ Overall balance (excluding grants to transformation institutions) plus interest payments.

4/ Includes liabilities of the state budget, National Property Fund, Health Insurance Fund, and local governments.

Table 4. Czech Republic: Vulnerability Indicators, 1997-2002  
(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	Latest Data		Date
					2001	2002	
<b>Financial indicators</b>							
Public sector debt 1/	20.0	18.0	21.0	23.0	23.6	...	December-01
State government guarantees 2/	17.0	17.0	15.3	14.0	22.7	22.6	March-02
Broad money (percent change, 12-month basis)	4.7	5.4	7.7	5.6	13.0	9.8	April-02
Private sector credit (percent change, 12-month basis) 3/	9.4	7.0	-4.7	-2.5	0.5	0.9	May-02
Domestic credit	66.7	58.7	55.6	53.8	46.9	43.0	April-02
One-year PRIBOR (end of period, in percent)	17.0	8.9	5.8	5.9	4.5	4.1	May-02
One-year PRIBOR, real (in percent) 4/	7.0	2.1	3.3	1.9	0.4	1.6	May-02
Classified credits (percent of total credits)	27.0	26.5	32.2	29.8	21.5	19.6	March-02
Of which: loss credits	...	13.4	13.4	10.4	7.4	6.0	March-02
<b>External indicators</b>							
Exports G&NFS (percent change, 12-month basis in US\$)	-1.2	13.0	-0.1	7.8	12.7	2.8	March-02
Imports G&NFS (percent change, 12-month basis in US\$)	-3.5	4.6	-0.4	10.6	11.7	-1.5	March-02
Terms of trade (percent change, 12-month basis)	1.2	5.0	-0.7	-2.6	2.1	4.4	March-02
Current account balance	-6.7	-2.2	-2.7	-5.3	-4.6	-2.7	March-02
Capital and financial account balance	2.0	5.1	5.6	7.5	7.1	7.7	March-02
Of which: Inward portfolio investment (debt securities etc.)	1.6	0.0	0.7	-0.3	0.3	0.0	March-02
Other investment, net (loans, trade credits etc.)	-2.4	-2.8	-3.2	1.4	-2.9	2.5	March-02
Inward foreign direct investment	2.5	5.9	11.5	9.7	8.7	3.9	March-02
Net Foreign Assets (NFA) of commercial banks (in US\$ billions)	2.6	4.2	6.3	8.3	10.9	9.2	April-02
Gross official reserves (in US\$ billions)	9.8	12.6	12.8	13.1	14.5	20.4	May-02
Net International Reserves (NIR) (in US\$ billions)	9.8	12.6	12.8	13.1	13.9	16.4	May-02
Central bank short-term foreign liabilities (in US\$ billions)	0.0	0.0	0.0	0.1	0.6	4.0	May-02
Central bank foreign currency exposure (in US\$ billions)	9.7	12.6	12.8	13.1	13.9	16.4	May-02
Short-term foreign assets of commercial banks (in US\$ billions)	7.2	9.1	9.3	8.3	9.9	8.2	March-02
Short-term foreign liabilities of commercial banks (in US\$ billions)	4.9	6.5	6.4	6.0	5.3	6.7	March-02
Foreign currency exposure of commercial banks (in US\$ billions)	4.4	6.6	7.6	8.3	10.9	9.2	April-02
Official reserves in months of imports G&NFS	3.6	4.4	4.5	4.2	4.1	5.9	May-02
Reserve money to (gross official) reserves (percentage)	67.2	61.5	45.8	44.6	45.0	33.1	May-02
Broad money to (gross official) reserves (percentage)	347.9	329.5	289.9	284.3	304.3	240.4	May-02
Total short-term external debt to gross official reserves (percentage) 5/	111.5	104.5	91.4	96.4	80.0	...	December-01
Total external debt	44.6	39.5	43.2	41.2	36.5	31.8	March-02
Of which: Public sector debt 6/	3.7	2.4	2.4	1.6	1.5	1.7	March-02
Total external debt to exports G&NFS (in percent)	73.2	73.0	68.6	60.2	53.6	52.9	March-02
Total external debt service payments to exports G&NFS	15.9	15.4	12.7	12.3	8.6	...	December-01
External interest payments to exports G&NFS	3.0	3.1	3.1	2.4	2.2	...	December-01
External amortization payments to exports G&NFS	13.0	12.3	9.6	9.9	6.4	...	December-01
Exchange rate (per US\$, period average)	31.71	32.27	34.60	38.59	38.04	31.73	June-02
REER depreciation (-) (end of period; 12-month basis; CPI-based)	-6.3	16.9	-5.2	1.4	8.9	14.7	April-02
<b>Financial market indicators (end of period)</b>							
Stock market index	488	386	490	479	332	423	July-02
Foreign currency debt rating (Moody's)	...	...	...	Baa1	Baa1	Baa1	July-02
Spread of benchmark bonds (basis points) 7/	...	...	98	102	134	117	July-02

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

1/ Debt of general government and liabilities of transformation institutions.

2/ Beginning in 2001, includes CZK 155.7 billion (7.2 percent of 2001 GDP) of guarantees to the Czech Consolidation Agency.

3/ Adjusted to account for removal of KoB's banking license in September 2001, exchange rate effects on foreign-currency-denominated loans, loan write-offs, and transfer of IPB loans to CKA.

4/ Deflated by CPI inflation.

5/ Includes amortization of medium- and long-term (M&LT) debt on a remaining maturity basis. Based on M&LT debt outstanding at the end of the preceding year.

6/ General government and the central bank.

7/ Yield spread on a five-year, deutschmark-denominated bond issued by the Cesky Telekom.

Table 5. Czech Republic: Macroeconomic Framework, 1999-2007 1/

	1999	2000	2001	Proj.					
				2002	2003	2004	2005	2006	2007
(In percent of GDP)									
Foreign saving 2/	2.7	5.3	4.6	4.6	4.3	4.1	4.0	3.9	3.8
Gross national saving 3/	25.4	24.4	25.3	25.4	26.1	26.8	27.4	28.0	28.7
Gross domestic saving 4/	28.1	29.7	30.0	30.0	30.4	30.9	31.4	31.9	32.5
Gross domestic investment	28.1	29.7	30.0	30.0	30.4	30.9	31.4	31.9	32.5
(Percentage change in real terms)									
GDP	0.5	3.3	3.3	3.2	3.7	3.9	4.1	4.2	4.3
Domestic demand	0.3	4.0	4.9	3.3	3.6	3.5	3.4	3.4	3.3
Final consumption	1.9	1.6	3.0	3.2	3.0	2.9	2.8	2.8	2.7
Gross capital formation	-2.9	9.4	8.9	3.6	4.7	4.5	4.4	4.5	4.4
Exports of goods and nonfactor services	6.1	17.0	12.3	6.7	8.0	7.3	7.6	6.5	6.9
Imports of goods and nonfactor services	5.4	17.0	13.6	6.5	7.5	6.6	6.6	5.6	5.8
(Contribution to growth, in percent)									
GDP	0.5	3.3	3.3	3.2	3.7	3.9	4.1	4.2	4.3
Domestic demand	0.4	4.3	5.3	3.6	3.9	3.8	3.7	3.6	3.5
Final consumption	1.3	1.2	2.2	2.3	2.2	2.1	2.0	1.9	1.9
Gross capital formation	-1.0	3.1	3.1	1.3	1.7	1.7	1.7	1.7	1.7
Net exports	0.1	-1.0	-2.0	-0.4	-0.2	0.1	0.4	0.6	0.8
Exports of goods and nonfactor services	4.2	12.3	10.0	5.9	7.3	7.0	7.5	6.7	7.2
Imports of goods and nonfactor services	-4.0	-13.3	-12.1	-6.3	-7.5	-6.9	-7.1	-6.1	-6.4

Sources: Data provided by the Czech Statistical Office and Czech National Bank; Fund staff projections.

1/ The projections are based on the gradual fiscal adjustment scenario, described in Appendix 1.

2/ External current account deficit.

3/ Gross domestic investment less foreign saving.

4/ Gross national saving less net factor income from abroad and foreign transfers.



## Sustainability of the Czech Public Finances

### Fiscal-sustainability issues

For any given primary deficit-to-GDP ratio, the path of the debt-to-GDP ratio converges to a finite value if the nominal GDP growth rate exceeds nominal interest rates. In the Czech Republic, long-term nominal interest rates are just above 5 percent at present, slightly above euro-area levels. Assuming that future inflation rates will be 3 percent on average (the mid point of the CNB's target range at end-2005), and that the potential growth rate will be around 4 percent over the medium term, the nominal GDP growth rate will be about 7 percent, exceeding nominal interest rates. Hence, under these assumptions, the Czech debt-to-GDP ratio will eventually converge, but this does not mean that public debt is sustainable. If the current primary deficit-to-GDP ratio of about 4 percent continues in the future, it can be shown that the debt-to-GDP ratio will keep rising until it stabilizes at 200 percent. Such a path of the debt-to-GDP ratio would be associated with mounting interest payments (and mounting overall deficits), as well as likely higher nominal interest rates through the resultant rise in risk premia. For the debt-to-GDP ratio to converge to a level below the Maastricht ceiling of 60 percent, the primary deficit-to-GDP ratio should be contained within 1.2 percent.

### Fiscal adjustment scenarios

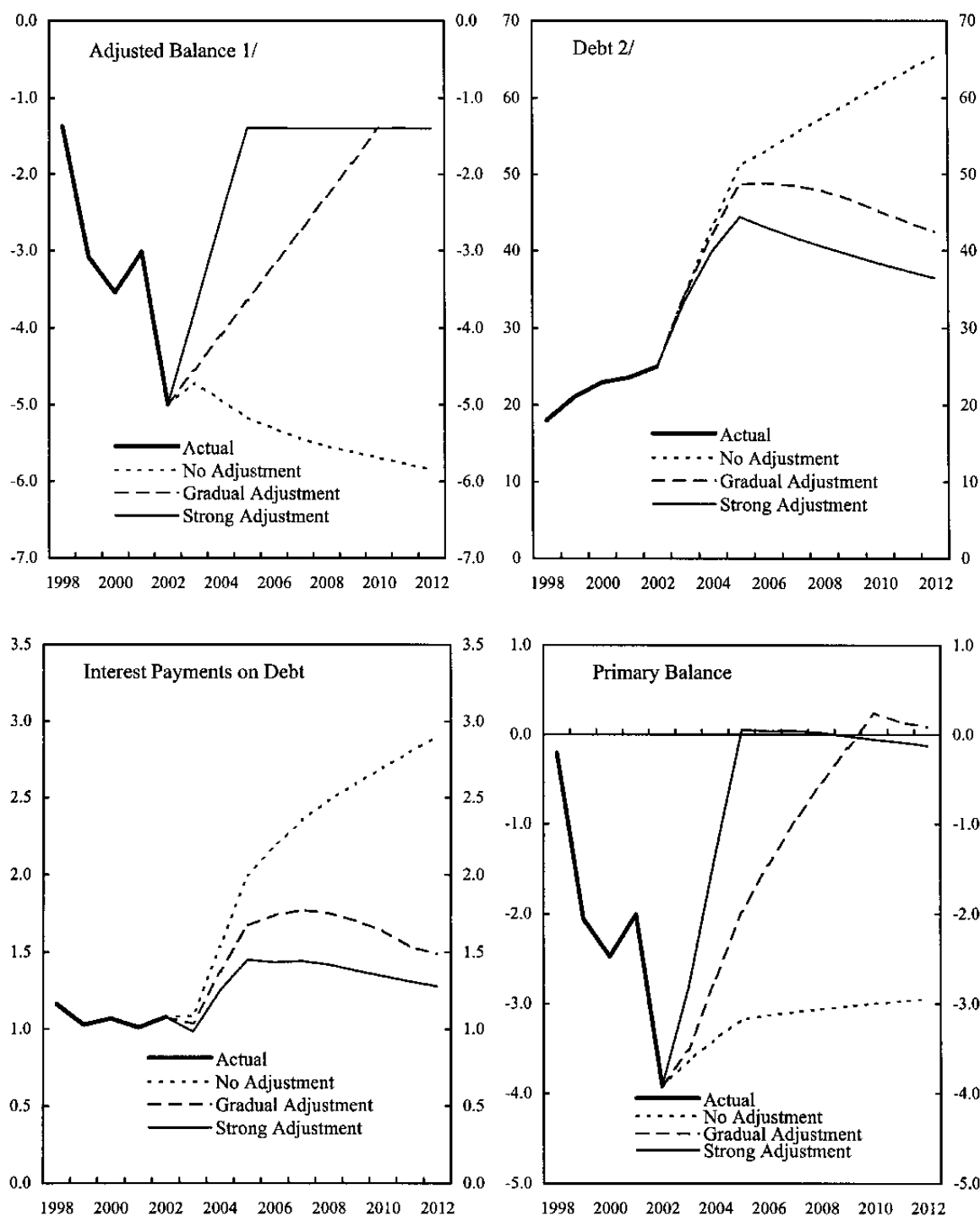
The staff has used three alternative fiscal adjustment paths for medium-term scenario analysis (see figures on the next page). The current debt-to-GDP ratio—about 25 percent—is very low among transition economies, but there is a substantial stock of state guarantees (some 23 percent of GDP at end-2001). It is assumed in this analysis that these guarantees will be exercised during 2003–05, which explains the initial rise in the debt stock under all three scenarios.

- **The no adjustment path** assumes that the primary balance remains constant (in koruna terms) during 2003–05, and begins to rise slowly in 2006, reflecting the gradual deterioration in pension system finances. This path—which would imply only a modest reduction in the primary deficit relative to GDP from its peak of 3.9 percent in 2002 to about 3 percent in 2012—would result in a steady increase in the debt-to-GDP ratio, exceeding 60 percent by 2009. In addition, it would accompany a pronounced rise in the interest-payments-to-GDP ratio from 1.1 percent in 2002 to 2.9 percent of GDP in 2012.
- **The gradual adjustment path** envisages lowering the adjusted general government deficit to 1.4 percent of GDP (broadly equivalent to 3 percent of GDP on ESA95 basis, the relevant Maastricht criterion) by 2010. For the reduced level of deficits to be sustainable after 2010, a fundamental reform of the pension system would be necessary (otherwise, the deficit would again widen sharply toward 2050). This adjustment path—which would require reaching a slight primary surplus by the target date—would reverse the upward trend in the debt-to-GDP ratio and keep it well

below the Maastricht ceiling. However, this path does not allow the Czech Republic to be among the first group of countries to adopt the euro due to the slower pace of fiscal deficit reduction.

- In the **strong adjustment scenario**, the target of lowering the adjusted general government deficit to 1.4 percent of GDP is reached by end-2005. As in the previous scenario, a fundamental pension reform is necessary for the deficit reduction to be sustainable, in addition to other expenditure restraint measures. This scenario would place the Czech Republic in a position to join the euro zone at the earliest possible date (i.e., two years after EU accession, assuming the Czech Republic's immediate participation in ERM2 after accession). Such an adjustment path naturally yields an even better public debt profile than the gradual adjustment policy, but would require implementing very strong measures.

Czech Republic: Operations of the General Government, 1998-2012  
(In percent of GDP)



Sources: Czech Ministry of Finance; and Fund staff calculations.

1/ Excludes: privatization receipts, proceeds from the sale of UMTS licenses, and the repayment of Russian debt from the revenue side; and grants to transformation institutions from the expenditure side.

2/ Assumes the realization of state guarantees during 2003-05, amounting to 22.7 percent of GDP at end-2001.

**Czech Republic: Fund Relations**  
(As of May 31, 2002)

I. **Membership Status:** Joined 1/01/1993; Article VIII

II.	<b>General Resources Account</b>	<u>SDR Million</u>	<u>% Quota</u>
	Quota	819.30	100.0
	Fund holdings of currency	698.86	85.30
	Reserve position in Fund	120.45	14.70
	Financial Transaction Plan transfers (net)	24.00	

III.	<b>SDR Department:</b>	<u>SDR Million</u>	<u>% Allocation</u>
	Holdings	1.52	N/A

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:**

<u>Type</u>	<u>Approval Date</u>	<u>Expira- tion Date</u>	<u>Amount Approved (SDR Million)</u>	<u>Amount Drawn (SDR Million)</u>
Stand-by	3/17/1993	3/16/1994	177.00	70.00

VI. **Projected Obligations to Fund:** None

VII. **Exchange Rate Arrangement:**

The currency of the Czech Republic is the Czech koruna, created on February 8, 1993 upon the dissolution of the currency union with the Slovak Republic, which had used the Czechoslovak koruna as its currency. From May 3, 1993 to May 27, 1997, the exchange rate was pegged to a basket of two currencies: the deutsche mark (65 percent) and the U.S. dollar (35 percent). On February 28, 1996, the Czech National Bank widened the exchange rate band from  $\pm 0.5$  percent to  $\pm 7.5$  percent around the central rate. On May 27, 1997, managed floating was introduced. On July 10, 2002, the exchange rate of the Czech koruna stood at CZK 29.29 per U.S. dollar.

VIII. **Last Article IV Consultation:**

The last Article IV consultation with the Czech Republic was concluded on July 16, 2001. The staff report and PIN were published on July 25, 2001.

IX. **Technical Assistance:** See attached table.

- X. **Resident Representative Post:** The post in Prague was closed in December 1995. A regional office covering the Czech Republic and Hungary was opened in January 1999 when Mr. Nord assumed the post, based in Budapest. The regional office will close at end-July 2002.
- XI. **Implementation of HIPC Initiative:** Not Applicable
- XII. **Safeguards Assessments:** Not Applicable

## Czech Republic: Technical Assistance, 1991–2002

Department	Timing	Purpose
FAD	Dec. 1991–Sept. 1993	Regular visits by FAD consultant on VAT administration
	March 1993	Public financial management
	September 1993	Follow-up visit on public financial management
	November 1993	Follow-up visit on public financial management
	January 1994	Follow-up visit on public financial management
	July 1994	Follow-up visit by FAD consultant on VAT administration
		Follow-up visit on public financial management
	May 1995	Follow-up visit by FAD consultant on VAT administration
	June 1995	Medium-term fiscal framework
	June–July 1999	
MAE	February 1992	Monetary management and research, foreign exchange operations, and banking supervision
	June 1992	Monetary research
	July 1992	Long-term resident expert assignment in the area of banking supervision (financed by EC-PHARE; supervised by the Fund)
	December 1992 and February 1993	Bond issuance and monetary management
	November 1993	Follow-up visit on bond issuance and monetary management and management of cash balances
	April 1994	Data management and monetary research
	January 1995	Foreign exchange laws (jointly with LEG) and external liberalization
	May 1995	Monetary operations
	May 1995	Banking system reform
	May 1996	Economic research
	April 1997	Banking legislation
	February–June 1999	Monetary research—inflation targeting
	June 1999	Integrated financial sector supervision (with WB)
RES	September 1999	Inflation targeting (financed by MAE)
	June–August 2000	Inflation targeting (financed by MAE)
STA	May 1993	Money and banking statistics
	February 1994	Balance of payments
	April 1994	Government finance
	November 1994	Money and banking statistics
	January–February 1999	Money and banking statistics
	May 2002	Monetary and financial statistics

### Czech Republic: Statistical Issues

1. Data on core surveillance variables are provided to the Fund regularly and with minimal lags (reporting to STA is less current, especially for foreign trade and the national accounts). Exchange rates and interest rates set by the Czech National Bank (CNB) are reported daily with no lag. Gross and net international reserves are reported on a monthly basis with a one-week lag, as well as on a 10-day basis (with the CNB's balance sheet) with a one-week lag. Consumer prices, reserve money, broad money, borrowing and lending interest rates, central government fiscal accounts, and foreign trade are provided monthly with a lag of one–four weeks. Final monetary survey data are available with a lag of about one month. GDP and balance of payments data are made available on a quarterly basis with a lag of two–three months. Annual data published in the *Government Finance Statistics Yearbook* cover all operations of the general government, including the extrabudgetary funds excluded from the monthly data. These annual data are available on a timely basis. Monthly fiscal data published in *International Financial Statistics (IFS)* cover central and local budget accounts and are available with a two–three month lag.

2. While data quality is generally adequate, there remain deficiencies in some areas, and the authorities have—or are—taking measures to improve data accuracy.

- National accounts data suffer from a number of weaknesses. The value added in the small-scale private sector is likely to be underestimated, as the mechanisms for collection of data on this sector are not yet fully developed. It is also believed that a large volume of unrecorded activity stems from tax evasion. Discrepancies between GDP estimates based on the production method and the expenditure method are large, and are subsumed under change in stocks. Quarterly estimates of national accounts are derived from quarterly reports of enterprises and surveys. The estimates are subject to bias because of nonresponse (while annual reporting of bookkeeping accounts is mandatory for enterprises, quarterly reporting is not) and lumping of several expenditure categories in particular quarters. Large swings in individual components of spending and the overall GDP from quarter to quarter also raise serious questions on reliability of the data.
- Revisions in recent years to procedures for processing export data have brought external trade statistics close to the practice in the EU. However, a continued weakness of foreign trade statistics is the unavailability of price indices for exports and imports with a fixed base; these indices are currently presented on the basis of the same month of the previous year.
- Although there are some differences with the *IFS* presentation, monetary survey data provided to the European I Department are generally adequate for policy purposes. However, large variations in the interbank clearing account float, especially at the end of the year, require caution in interpreting monetary developments. The CNB has made a major effort to identify the causes of these variations and adjust the data. A STA mission (January–February 1999) provided recommendations regarding

valuation, accrued accounting, and treatment of financial derivatives in monetary statistics. The mission also reviewed and updated the system of reporting data for *IFS*, which has resulted in improvement in the published monetary statistics. A number of further enhancements in data reporting were recommended by the follow-up mission in May 2002. The mission was informed that the CNB is well advanced in implementing the European Central Bank's (ECB) framework for monetary data, and in the near term will initiate reporting of a harmonized set of monetary data that meet the *IFS* and the ECB requirements, and which will also be the basis for the internal compilation of official monetary statistics.

3. The Czech Republic is in observance of the Special Data Dissemination Standard (SDDS), meets the SDDS specifications, and its metadata are posted on the Fund's Dissemination Standards Bulletin Board on the internet.



Czech Republic: Core Statistical Indicators  
(As of June 14, 2002)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	External Debt/ Debt Service	Central Government Balance	GDP
Date of latest observation	6/14/02	5/31/02	5/31/02	5/31/02	4/02	6/14/02	5/02	4/02	Q1 2002	Q4 2001	5/02	Q4 2001
Date received	6/14/02	6/7/02	6/14/02	6/14/02	5/31/02	6/14/02	6/10/02	5/24/02	6/5/02	4/10/02	6/3/02	3/19/02
Frequency of data	Daily	Daily	10 days	10 days	Monthly	Daily	Monthly	Monthly	Quarterly	Quarterly	Monthly	Quarterly
Frequency of reporting	Daily	Monthly	10 days	10 days	Monthly	Daily	Monthly	Monthly	Quarterly	Quarterly	Monthly	Quarterly
Source of update	Reuters	CNB 1/	CNB	CNB	CNB	CNB	CSO 2/	CSO	CNB	CNB	MoF 3/	CSO
Mode of reporting	Electronic	Electronic	Mail/ Electronic	Mail/ Electronic	Mail/ Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Mail/ Electronic	Electronic
Confidentiality	No	No	No	No	No	No	No	No	No	No	No	No
Frequency of publication	Daily	Monthly	10 days	10 days	Monthly	Daily	Monthly	Monthly	Quarterly	Quarterly	Monthly	Quarterly

1/ CNB = Czech National Bank.

2/ CSO = Czech Statistical Office.

3/ MoF = Ministry of Finance.

INTERNATIONAL MONETARY FUND

CZECH REPUBLIC

Staff Report for the 2002 Article IV Consultation  
Supplementary Information

Prepared by the European I Department

Approved by Susan Schadler

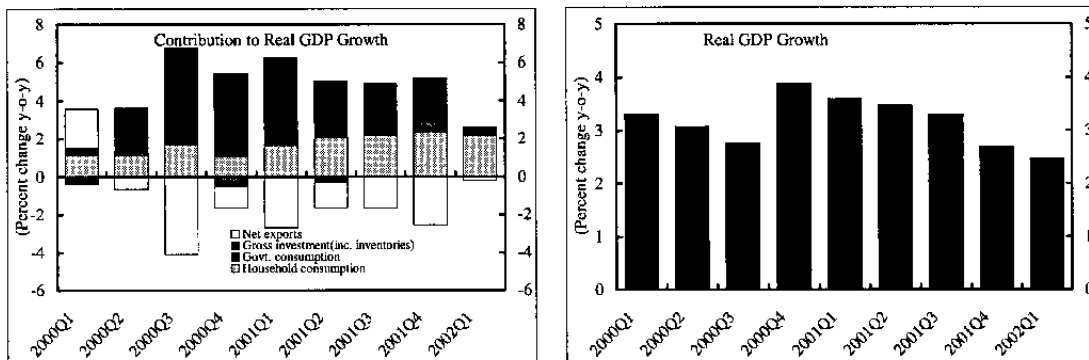
July 23, 2002

1. This supplement contains information on recent economic and policy developments in the Czech Republic that became available since the circulation of the staff report for the Article IV consultation (SM/02/215). This information does not alter the general thrust of the staff appraisal.

I. MACROECONOMIC DEVELOPMENTS

2. **Economic growth continued in the first quarter of 2002, though at a slightly slower pace.** GDP expanded by 2.5 percent (year-on-year) in the first quarter, down marginally from 2.7 percent in the fourth quarter of 2001 (see text chart). Fixed investment and household consumption continued to grow strongly (by 8.1 percent and 3.3 percent, respectively). However, weak demand in trading partners contributed to a further slowdown in Czech exports (to 3.1 percent, down sharply from a 2001 average of 12.3 percent), but import growth also softened (to 3.1 percent), helping to cushion the effect on GDP growth.

Figure 1. Czech Republic: Developments in GDP, 2000-02

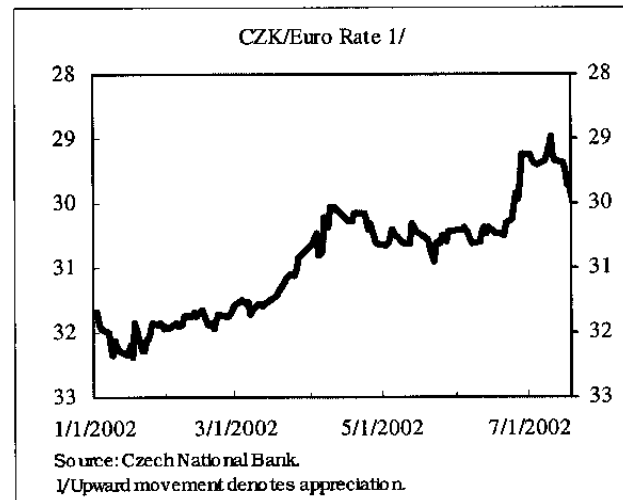


Sources: Czech Statistical Office; and Fund staff calculations.

3. **Higher-frequency indicators reveal a somewhat mixed picture of economic activity during the second quarter.** Industrial production expanded by 5.1 percent in the 12 months to May, implying only a marginal slowdown from earlier in the year, while the unemployment rate remained about stable in June at 8.7 percent. On the other hand, the trade deficit widened sharply in May, despite favorable terms of trade movements. Export growth (measured in euro terms) was significantly weaker (3.8 percent, year-on-year) compared with almost 10 percent for the first five months of the year, while import growth declined only slightly. Imports of cars were particularly strong in May, consistent with an increase in demand caused by an exchange-rate-induced drop in domestic prices.

4. **Reflecting the stronger koruna-euro exchange rate and the weakening U.S. dollar, inflation continued on its downward path in June.** Consumer prices increased by 1.2 percent in the year to June, down sharply from 2.5 percent in the previous month and approaching the historical low set in September 1999. The strengthening koruna helped push down prices of foreign goods and services, including fuels, vacations abroad, and some food items. Deflation at the level of producer prices intensified in June, with prices dropping at the faster pace of 0.8 percent (year-on-year).

5. **The koruna strengthened further in early July, hitting new highs against the euro, and then retreated some** (see text chart). Market reports suggest that developments in Poland and Hungary, which led to temporary weakening of the zloty and forint, respectively, may have played a role in fueling additional inflows into koruna assets. Strong warnings by the Czech National Bank (CNB) about the strength of the currency and an announcement that the CNB is “ready to employ its monetary policy instruments” are thought to have contributed to the retreat. However, even after the retreat, the exchange rate is still considerably higher than its level a month ago.



6. **In view of the further strengthening of the koruna, the staff has updated its macroeconomic forecast for 2002, as shown in the revised PIN table (attached).<sup>1</sup>** Conditioned on no further movement of the exchange rate, GDP growth is now expected to

<sup>1</sup> In addition to recent movements in the koruna-euro exchange rate, the updated projections take into account first quarter GDP and current account data, as well as revised assumptions about the global economic environment, which imply weaker import demand by Czech trading partners and a more depreciated U.S. dollar relative to the euro.

reach only 2.9 percent this year, compared with the earlier projection of 3.2 percent, reflecting a smaller growth contribution from the external sector. In addition, the external current account deficit is projected to widen some for the year as a whole, notwithstanding the better-than-expected first quarter outcome. The stronger koruna is also expected to push inflation further below the CNB's target band over the next 12–18 months.

## II. POLICY DEVELOPMENTS

7. **The new coalition government formed by the CSSD and the two-party Coalition agreed on a broad policy agenda for their term in office.** They agreed that accession to the EU at the earliest possible date (if endorsed by a successful referendum of the Czech people) is among the priorities of the new government. They also affirmed their intention to: further develop the welfare state; fight corruption and economic crime; make changes to the pension system (without, however, specifying any measures that would significantly improve future balances); devolve more spending powers to regions and municipalities; and consolidate public finances at a gradual pace (see below).

8. **The agreement sets the start of fiscal consolidation in 2005,** with a goal to bringing down the general government deficit to not more than 4.9–5.4 percent of GDP on an ESA95 basis by 2006, above the 3 percent criterion needed to join the euro. This might imply a further widening of the deficit in the next two years, from an anticipated 6.6 percent of GDP on an ESA95 basis in 2002. Underpinning the deficit reduction would be revenue and expenditure measures to be spelled out in a four-year fiscal plan to be formulated and approved by end-2002, though the agreement has set some general principles, such as keeping the tax-to-GDP ratio at around its 2000 level. The new Finance Minister Sobotka has reportedly said that the Czech Republic should not rush to meet the Maastricht deficit criterion to avoid causing social instability, and could join the euro sometime before 2010.

**Czech Republic: Selected Economic and Financial Indicators, 1997–2002**

	1997	1998	1999	2000	2001	2002 Proj. 1/
	(Percent Change)					
Real sector						
Real GDP	-0.8	-1.0	0.5	3.3	3.3	2.9
CPI inflation						
Period average	8.5	10.7	2.1	3.9	4.7	2.7
12-month change	10.0	6.8	2.5	4.0	4.1	2.2
Registered unemployed, per. average (percent of labor force)	4.3	6.1	8.6	9.0	8.5	8.9
	(In percent of GDP)					
Fiscal sector 2/						
Revenues	39.6	38.6	39.1	39.3	39.5	38.7
Expenditures and net lending (incl. bank restructuring costs)	41.6	40.9	42.6	43.9	44.8	47.8
Balance	-2.0	-2.4	-3.5	-4.5	-5.3	-9.1
Excluding grants to cover costs related to management of bad assets	-1.6	-1.4	-3.1	-3.5	-2.9	-5.0
Gross debt	12.9	13.0	14.5	16.7	18.7	19.5
Loan guarantees outstanding 3/	17.0	17.0	15.3	14.0	22.7	...
	(12-month change in percent)					
Money and credit (end-of-period)						
Broad money	8.7	5.2	8.1	5.6	13.0	...
Credit to enterprises and households 4/	9.4	-3.5	-3.9	-2.5	0.5	...
Net foreign assets	20.1	25.6	33.2	18.0	18.9	...
Interest rates						
Average lending rate on new loans	16.5	11.9	6.7	6.8	5.9	...
Average deposit rate	8.0	6.7	3.7	3.0	2.6	...
	(In billions of U.S. dollars)					
Balance of payments						
Merchandise exports	22.4	25.9	26.3	29.1	33.4	35.7
Merchandise imports	27.3	28.5	28.2	32.2	36.5	39.4
Trade balance	-4.9	-2.6	-1.9	-3.1	-3.1	-3.8
Current account	-3.6	-1.4	-1.5	-2.7	-2.6	-3.4
(Percent of GDP)	-6.7	-2.2	-2.7	-5.3	-4.6	-4.7
Nondebt capital inflows (percent of GDP) 5/	3.3	7.6	11.7	10.9	9.7	11.6
	(In billions of U.S. dollars)					
Reserves and external debt						
Gross official reserves (end-of-period)	9.8	12.6	12.8	13.1	14.5	21.7
(In months of imports of goods and services)	3.6	4.4	4.5	4.2	4.1	5.8
Total external debt (end-of-period)	21.6	24.3	22.8	21.6	21.8	23.4
(Percent of GDP)	44.6	39.5	43.2	41.2	38.5	33.0
Short-term debt (convertible currencies, end-of-period)	7.1	9.1	8.5	9.1	9.2	9.4
External debt service ratio in convertible currencies						
(Percent of exports of goods and nonfactor services)	15.9	15.4	12.7	12.3	8.6	9.6
	(Percent change)					
Exchange rate (period average)						
Nominal effective	-3.5	0.7	0.1	1.1	4.8	...
Real effective (ULC-based)	-2.4	8.5	3.4	-0.8	3.9	...

Sources: Czech authorities; and Fund staff estimates and projections.

1/ Staff projections.

2/ General government operations and debt; central government guarantees. Revenues and expenditures exclude privatization receipts. For 2002, budget numbers.

3/ Includes a CZK 33 billion government guarantee not included in official reported statistics. From 2001, includes CZK 155.7 billion of government guarantees to CKA.

4/ Adjusted to account for removal of KoB's banking license in September 2001, exchange rate effects on foreign-currency-denominated loans, loan write-offs, and transfer of IPB loans to CKA.

5/ Inflows for direct investment (equity capital and reinvested earnings) and equity securities. Includes privatization-related FDI.



INTERNATIONAL MONETARY FUND

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International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

## **IMF Concludes 2002 Article IV Consultation with the Czech Republic**

On July 26, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Czech Republic.<sup>1</sup>

### **Background**

The Czech economy has made significant strides in recent years, though important challenges remain. Following a period of inaction on the structural front and a protracted recession, growth has picked up and inflation remains subdued. Underlying this performance have been supportive macroeconomic policies, large foreign direct investment (FDI), and steady progress with structural reform. However, enterprise restructuring has led to rising structural unemployment and large regional disparities in unemployment rates. Sizable losses were accumulated by banks, which had to be transferred to the government to allow the banks to be sold to strategic investors, adding to medium-term fiscal pressures. Importantly, the fiscal reform agenda required for sustainability of public finances remains to be tackled.

Despite large trade and investment links with the European Union (EU), the Czech economy weathered the recent global slowdown remarkably well. Real GDP growth remained at 3.3 percent in 2001, notwithstanding slower EU export demand in the second half of the year.

Strong fixed investment and buoyant household consumption—underpinned by robust wage growth and modest gains in employment—helped sustain domestic demand. Moreover, the external current account deficit narrowed in 2001 as the growth of imports moderated more than exports, reflecting the large import content of exports and lower oil prices.

Sizable inflows of FDI (reaching cumulatively some 40 percent of GDP, the highest in the region) were the main driving force behind domestic investment and employment creation, and

<sup>1</sup> 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.

generated positive spillovers to domestic suppliers. FDI has also brought about increased access to major export markets, helping to cushion the impact on the Czech economy of the slowdown in external demand.

Large FDI inflows and anticipation of future inflows led to a rapid appreciation of the koruna over the last three quarters. Concerned about the effects on external competitiveness and growth, the Czech National Bank (CNB) cut interest rates by a cumulative 2.25 percentage points since late-2001 (the most recent was a 75 basis point cut in late July) and intervened in the foreign exchange market on several occasions to stem the currency's rapid rise and secure the inflation objective. In addition, the government and the CNB agreed in early 2002 not to convert foreign currency privatization receipts on the market.

Inflation declined sharply over the past 12 months, due to falling food and international commodity prices, weakening demand, and the stronger currency. Headline inflation—the measure targeted by the CNB since the beginning of 2002—fell to 2.5 percent in May from 5.9 percent in July 2001, dropping below the target band, while industrial producer prices have declined in recent months.

The real economy has yet to show any effects of the stronger koruna. Industrial production and sales have accelerated in recent months, while the trade balance has improved. However, given the speed and size of the appreciation, it is reasonable to expect that some of its effects may still be in the pipeline.

Despite plans to the contrary, the fiscal deficit contracted in 2001. At 2.9 percent of GDP, the adjusted general government deficit (which excludes privatization receipts, proceeds from the sale of mobile phone licenses and Russian debt from revenue, and grants to transformation institutions to cover costs of bad asset management from expenditure) came in about 2 percentage points below the budget target and 0.6 percentage points below the 2000 outturn. Cyclical and one-off factors contributed to this outcome.

Budget plans for 2002 envisage a substantial widening of the adjusted general government deficit, and contain no measures geared to fiscal consolidation. The 2002 budget implies an adjusted general government deficit of 5 percent of GDP. Over half the planned widening comes from higher spending by the two new extrabudgetary funds and the temporary duplication of spending responsibilities from the introduction of a new layer of regional governments.

Structural problems in the labor market seem to be gradually deepening. Large disparities in unemployment rates exist across different regions, age groups, and levels of educational attainment. Moreover, more than half of the unemployed are now long-term unemployed, partly reflecting work disincentives created by the social benefit system. Although not yet an immediate threat, this adverse tendency could limit the economy's ability to attract future FDI and reduce the scope for sustainable growth over the medium term.

### **Executive Board Assessment**

Executive Directors were encouraged by the way the economy has coped with the slowdown in foreign demand and appreciation of the koruna. This resilience is evidence of an improving supply side, brought about by buoyant FDI flows and structural reforms. Nevertheless, further

progress is needed in tackling the looming fiscal imbalance and maintaining the reform momentum in key structural areas. Moving forward resolutely on these issues would accelerate the Czech Republic's convergence with its EU partners, and lay the groundwork to benefit from membership of the EU and, in due course, the euro area.

Directors welcomed the Czech Republic's good economic performance over the past year, with moderate growth, achievement of the inflation target, and a manageable—though sizeable—current account deficit, which was more than fully financed by capital inflows. The country's low external debt and high reserves have helped limit its external vulnerability.

Directors welcomed the key role that monetary policy has played in offsetting the tightening effects of the koruna's appreciation. In this regard, they saw the magnitude and speed of the recent appreciation as potentially posing a continuing challenge—since its effects on inflation and growth could still be in the pipeline. They therefore commended the recent decision to cut interest rates by a further 75 basis points, thus countering the undue tightening of monetary conditions, and reducing the risks of inflation undershooting its target band in the period ahead.

Directors commended the progress the Czech Republic has made in preparing for EU accession. EU membership would further integrate the economy into global markets, and improve its medium-term growth prospects. Directors welcomed the authorities' intention to develop a medium-term fiscal framework—complementing the medium-term monetary framework already in place. Together, these frameworks should be conceived in the context of the commitment to move to ERM2, and the ultimate goal of adopting the euro. This strategy would need to be underpinned by credible plans to reduce the fiscal deficit, which would also improve the short-term policy mix. Greater transparency in these issues would provide to exchange market participants a clearer frame of reference for basing expectations—which can only be helpful in avoiding market excesses.

Several Directors noted that ERM2 provides a potentially flexible framework within which to develop policy, while some cautioned that the multilateral decision regarding adoption of the euro must prudently take into account the progress made by the Czech Republic in achieving structural and fiscal readiness for euro area membership. They urged, at the same time, that the pace of such reforms should be rapid.

Directors expressed concern about the fiscal outlook, and stressed the need for decisive steps to achieve fiscal consolidation. They pointed out that the fiscal deficit, already large, would continue to expand in the absence of adjustment measures. Along with the realization of contingent liabilities and a decline in privatization receipts, this would push the government debt-to-GDP ratio above the Maastricht ceiling within a decade. This calls for decisive action to reduce the deficit, and in the view of most Directors, such action should be implemented urgently.

With regard to priorities in the public finances, Directors urged the authorities to press forward in tackling structural problems at all levels of government. Restraining expenditures in nonpriority areas, and introducing fundamental reforms in mandatory spending to rein in costs, would be crucial. In particular, the pension and social benefits systems needed to be revamped—while preserving their essential social safety net aspects—and the authorities were encouraged to implement the pension reform measures that had been identified. Directors also stressed that the increasing reliance on extrabudgetary funds is a setback to fiscal transparency. These funds



should be integrated into the state budget, thus providing an accurate picture of the public finances that would facilitate greater efficiency and a broader reach as expenditure cuts are implemented.

Directors encouraged the new government to accelerate structural reforms, more broadly, to enhance the efficiency of the economy and improve the investment climate. They welcomed the privatization of a number of major state-owned companies over the past year, and urged completing the remaining privatization projects. The package sale of impaired assets acquired by the government from failed banks is needed to facilitate the restructuring of the corporate sector. Directors advocated further improving the legal and regulatory framework, including reform of the bankruptcy process and of the commercial registers. To help secure medium-term growth prospects, Directors urged the authorities to take measures to enhance the structure and efficiency of the labor market—striking a better balance between social and efficiency considerations, with a view to encouraging wider participation.

Directors welcomed the improvements in internal banking procedures brought about by privatization of the sector, which should enhance its long-term profitability and stability, and allow it to better fulfill its intermediation role. At the same time, the increasingly complex structure of financial groups complicates supervision of the financial sector. Directors therefore endorsed the expansion of the Czech National Bank's authority to conduct consolidated supervision over certain types of financial groups, while highlighting the need for effective cooperation between the three institutions charged with financial sector supervision.

Directors welcomed the authorities' efforts to improve the quality of economic statistics and comply with international standards. They commended the ongoing harmonization of statistical methodology with international best practice, and the contribution to updating the Report on Standards and Codes modules. Directors also commended the legal amendments that would remedy weaknesses in the anti-money laundering framework.

**Public Information Notices (PINs)** are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2002 Article IV Consultation with the Czech Republic is also available.

**Czech Republic: Selected Economic and Financial Indicators, 1997–2002**

	1997	1998	1999	2000	2001	2002 Proj. 1/
	(Percent Change)					
Real sector						
Real GDP	-0.8	-1.0	0.5	3.3	3.3	2.9
CPI inflation						
Period average	8.5	10.7	2.1	3.9	4.7	2.7
12-month change	10.0	6.8	2.5	4.0	4.1	2.2
Registered unemployed, per. average (percent of labor force)	4.3	6.1	8.6	9.0	8.5	8.9
	(In percent of GDP)					
Fiscal sector 2/						
Revenues	39.6	38.6	39.1	39.3	39.5	38.7
Expenditures and net lending (incl. bank restructuring costs)	41.6	40.9	42.6	43.9	44.8	47.8
Balance	-2.0	-2.4	-3.5	-4.5	-5.3	-9.1
Excluding grants to cover costs related to management of bad assets	-1.6	-1.4	-3.1	-3.5	-2.9	-5.0
Gross debt	12.9	13.0	14.5	16.7	18.7	19.5
Loan guarantees outstanding 3/	17.0	17.0	15.3	14.0	22.7	...
	(12-month change in percent)					
Money and credit (end-of-period)						
Broad money	8.7	5.2	8.1	5.6	13.0	...
Credit to enterprises and households 4/	9.4	-3.5	-3.9	-2.5	0.5	...
Net foreign assets	20.1	25.6	33.2	18.0	18.9	...
Interest rates						
Average lending rate on new loans	16.5	11.9	6.7	6.8	5.9	...
Average deposit rate	8.0	6.7	3.7	3.0	2.6	...
	(In billions of U.S. dollars)					
Balance of payments						
Merchandise exports	22.4	25.9	26.3	29.1	33.4	35.7
Merchandise imports	27.3	28.5	28.2	32.2	36.5	39.4
Trade balance	-4.9	-2.6	-1.9	-3.1	-3.1	-3.8
Current account	-3.6	-1.4	-1.5	-2.7	-2.6	-3.4
(Percent of GDP)	-6.7	-2.2	-2.7	-5.3	-4.6	-4.7
Nondebt capital inflows (percent of GDP) 5/	3.3	7.6	11.7	10.9	9.7	11.6
	(In billions of U.S. dollars)					
Reserves and external debt						
Gross official reserves (end-of-period)	9.8	12.6	12.8	13.1	14.5	21.7
(In months of imports of goods and services)	3.6	4.4	4.5	4.2	4.1	5.8
Total external debt (end-of-period)	21.6	24.3	22.8	21.6	21.8	23.4
(Percent of GDP)	44.6	39.5	43.2	41.2	38.5	33.0
Short-term debt (convertible currencies, end-of-period)	7.1	9.1	8.5	9.1	9.2	9.4
External debt service ratio in convertible currencies						
(Percent of exports of goods and nonfactor services)	15.9	15.4	12.7	12.3	8.6	9.6
	(Percent change)					
Exchange rate (period average)						
Nominal effective	-3.5	0.7	0.1	1.1	4.8	...
Real effective (ULC-based)	-2.4	8.5	3.4	-0.8	3.9	...

Sources: Czech authorities; and IMF staff estimates and projections.

1/ Staff projections.

2/ General government operations and debt; central government guarantees. Revenues and expenditures exclude privatization receipts. For 2002, budget numbers.

3/ Includes a CZK 33 billion government guarantee not included in official reported statistics. From 2001, includes CZK 155.7 billion of government guarantees to CKA.

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5/ Inflows for direct investment (equity capital and reinvested earnings) and equity securities. Includes privatization-related FDI.

**Statement by Willy Kiekens, Executive Director and Jiri Jonas, Advisor to the  
Executive Director for the Czech Republic  
July 26, 2002**

**Introduction**

Despite its very high degree of openness, the Czech economy has so far been relatively unscathed by recent adverse external developments. Czech growth in 2001 was relatively robust, and remains so in 2002 as well. Nevertheless the slower than expected EU recovery and the koruna appreciation should somewhat slow the growth of GDP. The staff has lowered its projection of GDP growth in 2002 from 3.2 to 2.9 percent, while the Ministry of Finance's last quarterly projection lowers it from 3.4 to 3 percent.

Given its limited dependence on external borrowing, the Czech Republic was largely unaffected by investors' recent disenchantment with emerging market countries. Sustained large inflows of foreign direct investment have been more than sufficient to finance the current account deficit while simultaneously supporting strongly growing investment demand and helping to offset the effect of negative net exports on output growth. Companies under foreign control represent the most dynamic segment of the Czech economy. In May, overall industrial sales in real terms increased by 2.6 percent year on year, while industrial sales of companies under foreign control grew by almost 10 percent.

The past year was also a period of rapid structural changes within the Czech economy, connected with extensive privatizations, improvements of corporate governance, and more careful bank lending policies. Unfortunately the unsupportive external environment did not cushion the temporary but unavoidable costs of this rapid restructuring, the worst of which was the increase in worker layoffs. And rapid appreciation of the koruna put additional pressure on the corporate sector. These factors helped prolong the period of high unemployment, but also led a rapid reduction of inflation, which fell to 1.2 percent in June, its lowest level since September 1999.

**Exchange Rate Developments and Monetary Policy**

According to the Global Market Monitor for July 1, the second quarter of this year saw the koruna appreciate by 20 percent against the dollar, a stronger appreciation than any other emerging market currency. From the staff report one might draw the impression that some Czech officials and private analysts were not much concerned about the effect of the stronger currency. But the koruna's further strengthening since the time of the discussion with the staff has increased these concerns.

The managers of several companies have called on the government and the Czech National Bank (CNB) to find a way of arresting the currency appreciation, and there is some anecdotal evidence that some Czech companies have already been priced out of the market by the strong koruna, and that several large companies are turning to foreign suppliers.

The question to be answered is to what extent the currency appreciation represents an equilibrium phenomenon reflecting the productivity enhancing effects of FDI, and to what extent it is simply an exchange rate misalignment. The large FDI inflows of recent years

should certainly contribute to an appreciation of the real equilibrium exchange rate. But the speed and size of the actual appreciation raises the question whether the FDI inflows are the only force or the principal force driving the currency movements.

First, as shown by Table 31 in the Statistical Appendix, a large part (about half) of FDI inflows went to non-manufacturing industries, whose potential for increasing competitiveness and strengthening exports is limited. And second, even in the manufacturing sector, not all firms can benefit from productivity-enhancing FDI flows: many find it difficult to cope with a rapid large currency appreciation that gives them little time to cut costs, start new investments, reorganize production, or otherwise adjust to the new environment. Some can do it, others cannot.

The authorities tried hard to limit the currency appreciation. The staff explains how the government and the CNB agreed to exclude privatization-related inflows of foreign currency from the foreign exchange market. The CNB has several times reduced interest rates, most recently yesterday, when it cut short-term interest rates by 75 points to 3 percent; and has also intervened in the foreign exchange market. The CNB has also warned publicly against the possible emergence of an exchange rate bubble. The staff is more cautious about the "bubble" interpretation, arguing that it is hard to know the equilibrium level of the exchange rate. But the CNB has in mind a somewhat different kind of bubble: it was referring to the speed of the appreciation rather than the level of the exchange rate. The CNB spoke out about the possibility of an exchange rate bubble specifically to warn against the risks of a currency appreciation followed by a sudden reversal.

The new Prime Minister has said that dealing with the effects of the strong koruna will be a major priority for his government. In August, he is to meet and discuss this issue with the central bank governor and the finance minister, on the basis of a report prepared by the working group of specialists presently being convened from the CNB and the Ministry of Finance.

In addition to its effects competitiveness, the koruna appreciation also strongly affects inflation, because in the very open Czech economy, imports exceed 50 percent of GDP. The large appreciation of the koruna has contributed to this year's rapid decline in inflation, which has brought it below the CNB's target band. Under the inflation targeting framework's escape clauses, deviations from the target are allowed if they result from unexpected changes in the exchange rate or world commodity prices. But the currency appreciation also affects other variables that influence the CNB's monetary policy decisions, and large exchange rate swings complicate the conduct of monetary policy.

## **Fiscal Policy**

During last year's Board discussion on the Czech Republic, many Directors called for a fiscal policy tightening to restore the long-term sustainability of the public finances and prevent the current account deficit from widening. In the end, both the adjusted general government deficit and the current account deficit decreased somewhat during 2001. But the decrease was more the result of temporary factors than of real progress in solving the structural problems of the Czech Republic's public finances. Now the data for the first half of 2002 show that state budget deficit only reached CZK 0.9 billion. This result, too, mostly reflects one-time receipts

from privatization and partial repayment of the Russian debt. By the end of this year it is projected that both the state budget deficit and the general government deficit will widen significantly.

This widening is unlikely to complicate macroeconomic management very much in the short run, for several reasons. First, the public debt remains low, liquidity in the economy is ample, and there will be no problem in issuing new debt to finance the part of the deficit that will not be covered by privatization revenues. Second, with inflation near its historical low and demand pressures absent, budgetary developments are unlikely to create inflationary pressures. And third, despite the stronger koruna it is not projected that a widening of the budget deficit will push the current account deficit above last year's level in 2002.

Nonetheless it is easy to understand the staff's concern about the implications of fiscal developments. There is a large outstanding stock of government guarantees that may need to be recognized at some point, and these, combined with continuing and even growing large fiscal deficits and the eventual exhaustion of privatization revenues, will eventually add up to a sizable increase in the stock of public debt and debt service costs. This could complicate the fiscal deficit reduction required by the Maastricht criteria, and delay the Czech Republic's entry into the European Monetary Union.

CSSD, which has a majority in the new coalition government, attaches high importance to the maintenance of a generous social security system. Without serious reforms of social spending, future budget deficits are likely to increase significantly. The smaller center right party in the coalition government would prefer a larger reduction in government deficits, but the coalition agreement between the two parties assumes a very gradual reduction of the general government deficit to 4.9--5.6 percent of GDP in 2006. However, the new Government's official economic policy program has yet to be finalized, and the new finance minister does not consider the deficit figures in the coalition agreement as targets, but as maximum permissible ceilings. It is his ambition to bring these deficits well below those levels.

The Ministry of Finance is preparing to make an important change in the fiscal policy framework. For the first time there will be a medium-term fiscal framework covering the whole period of the present government, till 2006. Since a similar medium-term framework for monetary policy is already in place, combining this new fiscal policy framework with the strategy for achieving EMU accession (see below) should produce a new integrated framework for economic policy, define the strategy for EMU accession, and anchor market expectations.

### **EU/EMU Accession**

The new Government has declared that early accession to the EU is its first priority, and it intends to complete the negotiations quickly and close the remaining chapters by the end of 2002. But the strategy for adopting the euro and joining the monetary union has not yet been formulated. Discussion is lively concerning the merits of fast versus slow adoption of the euro. Some discussants stress the need to make more progress with fiscal consolidation and increase labor market flexibility before adopting the euro; others emphasize the risks of volatile capital flows and financial instability to which a small, open economy with a fully liberalized capital account is exposed, and argue in favor of quick EMU accession.

The CNB is presently working on an analytical study of these issues, which will be discussed with the Government later this year. This discussion should lead to the formulation of a strategy for the EMU accession, as recommended by the staff.

### **Other Issues**

The new Government maintains the commitment to complete the privatization. It also recognizes the benefit of FDI for the Czech economy, and attaches great importance to maintaining an attractive investment climate for foreign companies and using market incentives to direct foreign investment to areas with high unemployment.

The new Government recognizes the problem of high unemployment highlighted in the staff paper, and particularly the increase in long-term unemployment. Measures aimed at dealing with these problems will be the core of the new Government's employment policy.

Finally, the authorities understand the urgency of a rapid disposal of assets taken over from banks by the Czech Consolidation Agency (CKA). The longer these assets are held by the CKA, the more their market value will diminish. On July 10, the CKA launched a tender for the first package of assets with a nominal value of CZK 37.8 billion, which is expected to be completed by the end of September.