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CZECH REPUBLIC

2013 ARTICLE IV CONSULTATION

August 2013

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 2013 Article IV consultation with the Czech Republic, the following documents have been released and are included in this package:

- **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 20, 2013, 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 9, 2013. 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.
- **Informational Annex** prepared by the IMF.
- **Press Release** (PR) summarizing the views of the Executive Board.

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

Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

CZECH REPUBLIC

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

July 9, 2013

KEY ISSUES

Context: The export-led recovery in 2010–11 subsided as euro area import demand slowed. Combined with weak domestic demand, growth has noticeably underperformed trade partners and peers since the middle of 2011. Economic activity is expected to be weak in 2013 and recover gradually thereafter. Risks are to the downside due to the prolonged euro area recession.

Policies: Short-term macroeconomic policies should avoid creating additional drag with a neutral fiscal stance and monetary policy addressing deflationary pressures at the zero lower bound. In the medium- to long-term, it is important to strengthen competitiveness, in particular, by enhancing investment both in physical and human capital.

- Further pro-cyclical fiscal policy should be avoided and a neutral stance would be appropriate until the economic recovery gains strength. In a severe adverse scenario, fiscal policy should play an active role through temporary and targeted measures. A simple and easy-to-monitor structural fiscal balance rule should be adopted in order to provide a medium term fiscal anchor.

- The accommodative monetary stance should be maintained for an extended period of time. If a persistent and large undershooting of the inflation target is in prospect, with monetary policy constrained by the zero lower bound and fiscal policy playing an active role, foreign exchange interventions could be employed to help guide inflation expectations toward the target.

- The financial system is strong and the main risk is a protracted or deeper recession that would harm asset quality. Proactive bank supervision should be employed to ensure continued adequate capital and liquidity buffers to preserve financial stability.

- Investment in both physical and human capital is critical to enhance future growth potential, and the business environment should be improved to attract private investment. Higher labor participation, labor market flexibility, and active labor policies are important to increase potential growth and avoid long-term negative impact of unemployment.

Approved By
Ajai Chopra and Vivek Arora

Staff team: Mr. Yoshida (head), Messrs. Dalgıç, Ebrahimy, Gracia (all EUR); Mr. Kollár (Alternate Executive Director) joined most discussions; Mr. Chopra (EUR) attended the final policy meetings.
Mission dates: May 9–20, 2013.

CONTENTS

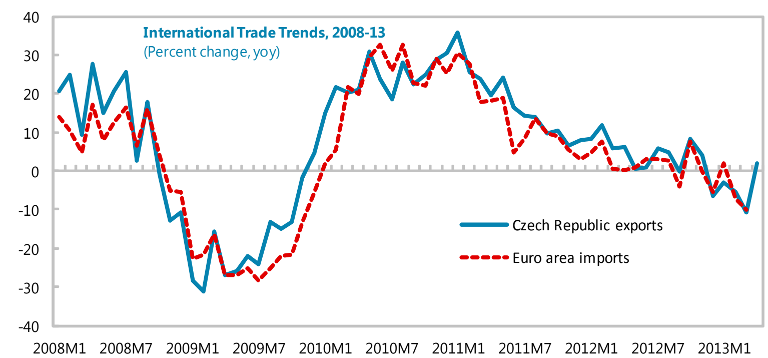
ANNEXES

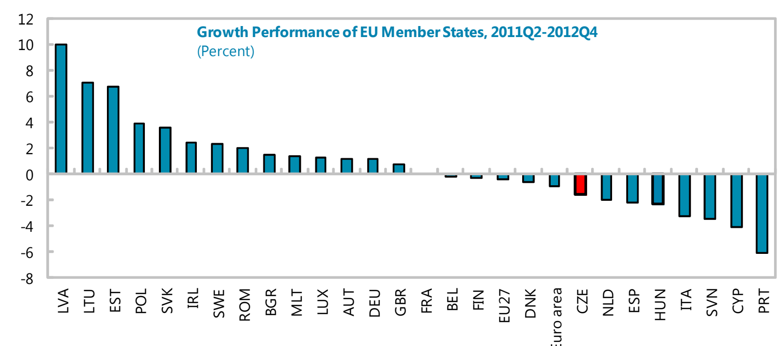
CONTEXT

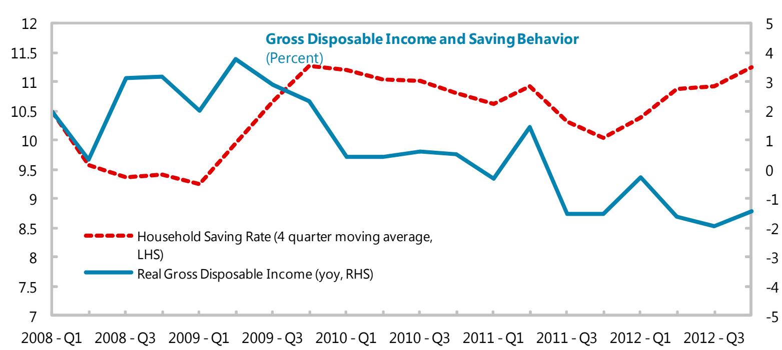
A. Recent Developments

1. **The Czech economy has avoided financial volatility but remains in recession.** The economy has avoided serious imbalances in the recent volatile economic environment, benefitting from strong policy frameworks and sound fundamentals. However the export-led recovery observed in 2010–11 subsided as euro area import demand slowed, and growth has noticeably underperformed trade partners and peers since the middle of 2011 mainly because of weaker domestic consumption and investment. Real GDP contracted for four quarters in a row in 2012 and recorded a 1.2 percent decline for the year with only net exports contributing positively to growth.

2. **Weak private consumption is particularly prominent and only partially explained by the labor market performance.** Private consumption declined by 2.7 percent in 2012. Employment growth was moderately positive reaching 0.4 percent for the year, but unemployment increased from 6.5 percent to 7.2 percent between 2011Q4 and 2012Q4 as the participation rate increased. Real wages declined by an average of 1 percent in the first three quarters with only a one-off rise in the last quarter and real gross disposable income declined by 1.3 percent in 2012. Consumers then responded by increasing their savings rate, which went up to 11.2 in 2012 from 10.0 percent in the previous year. Given healthy household balance sheets, this cautious consumer behavior is mostly attributable to increases in the VAT rates and cuts in social spending at a time when labor market has been weakening, and to prolonged uncertainty in euro area economies that are closely linked to the Czech economy.







3. Headline inflation was pushed above the two percent target by the effects of indirect taxes and food and energy prices in 2012. Inflation averaged 3.3 percent in 2012 mainly due to increases in the VAT rates and positive contributions from foods and fuel. Both of these effects subsided and inflation fell below the target in January 2013 and averaged 1.8 percent in the first quarter of this year. Demand side inflationary pressures have been largely absent and inflation expectations have been well-anchored. The Koruna has depreciated by about 3 percent since September 2012 and is likely to become a key inflationary factor.

4. Weak domestic demand has also narrowed the current account deficit despite slowing export demand. The external current account deficit declined to 2.4 percent of GDP in 2012 from 2.8 percent, mainly on account of an improvement of the trade balance. Income deficit, in contrast, widened due to higher accrued profits of foreign-owned firms. Non-FDI capital flows turned into a moderate outflow in 2012 after strong inflows in 2009-11. The financial account surplus in 2012 was driven by a net inflow of direct investment owing to reinvested earnings as well as a surplus on portfolio investment. These net inflows were largely offset by a net outflow of other investment, primarily due to a rise in short-term assets of monetary financial institutions abroad.

5. Pro-cyclical fiscal consolidation continued in 2012 resulting in a stronger structural fiscal position than before the crisis. The overall deficit without one-offs in 2012 was 2.5 percent of GDP, down from 3.2 percent of GDP in 2011. The structural balance improved by 1.5 percent of GDP on account of a combination of revenue measures, in particular an increase of the reduced VAT rate by 4 percentage points, and expenditure measures. Fiscal over-performance relative to the budget was largely due to under-execution of capital spending, down by 0.6 percent of GDP compared to 2011, to 3.1 percent of GDP. This fiscal consolidation, however, became a drag on economic activity at a time when the output gap widened by about 2 percentage points.

6. The central bank's policy rate has been reduced to almost zero, but credit growth remains subdued. The Czech National Bank (CNB) continued to take a lead role in countering economic weaknesses and cut the policy rate by 70 basis points in three steps in June, October and November to 0.05 percent, and committed itself to continued low rates. Long-term money market rates also moved lower in the face of weak growth and inflation expectations. This, together with declining risk premium, made government bond yields decline to record lows. The yield on the 10-year bond stabilized around 2 percent before a moderate rise in June this year, significantly less than peers. The falling rates, however, did not translate into faster credit growth. Credit to the corporate sector and households grew only by 2.6 percent at end-2012 compared to 6.3 percent of the previous year. Increased cautiousness about economic prospects played a role in limiting both credit demand and, to a lesser extent, supply.

B. Outlook and Risks

7. **Economic activity is expected to be weak in 2013 and recover gradually thereafter.** This pattern is similar to that projected for euro area trade partners, on whom the outlook of the Czech economy is heavily dependent. An improvement in the euro area economy will encourage Czech exports, but only starting in late 2013, and gradually improving confidence is expected to foster moderate domestic demand recovery thereafter. Prospects are for a prolonged period of modest growth with the output gap closing only gradually. Inflation is forecast to hover below the 2 percent target in 2013 and risks are to the downside. The current account deficit will remain smaller than the historical average.

8. **Risks are mainly to the downside and the main risk is further deterioration of euro area growth.** If growth prospects for the euro area worsen, it would discourage sentiment and delay the recovery of the already policy-constrained Czech economy (See Annex I, Risk Assessment Matrix). Lower export demand from the euro area, the market for two-thirds of Czech exports, would have a significant impact on the growth prospects. The recent disappointing export performance indicates that the economy is at the risk of being dragged deeper into recession, and the current poor growth performance, if protracted, runs the risk of translating itself into a long-term decline in potential growth due to lower investment.

9. **The Czech financial system appears well positioned to withstand spillover risks.** A reemergence of financial stress in the euro area, possibly due to stalled or incomplete delivery of euro area policy commitments as discussed in the Risk Assessment Matrix (Annex I), entails a risk of deleveraging by European parent banks, which would adversely affect Czech domestic credit conditions through parent-subsidiary relationship. However, the effect of such deleveraging would be limited since Czech banks are self-reliant in their funding. This soundness of the financial sector as well as good standing of balance sheets of households and the corporate sector limits the vulnerability to the euro area financial spillovers. If risks to European financial stability were to increase to extreme levels, spillovers could also take the form of confidence loss and become damaging to Czech financial stability.

POLICY DISCUSSIONS

Against the background of the ongoing prolonged recession due to the euro area slump and weak domestic demand, discussions focused on appropriate policy measures to support the economy in the short term and enhance growth potential in the medium- to long-term while mitigating long term negative impacts of the recession. Short-term macroeconomic policies, therefore, should avoid creating additional drag with a neutral fiscal stance and monetary policy addressing deflationary pressures at the zero lower bound. If deflationary pressures intensify due to global or domestic risks, fiscal policy should play an active role. In the medium- to long-term, it is important to be vigilant against risks to potential growth and strengthen competitiveness, in particular, by enhancing investment both in physical and human capital.

Box 1. The Authorities' Policies and Past IMF Policy Recommendations

The policies implemented in 2012 were broadly consistent with previous IMF advice with fiscal stance being a notable exception.

Key recommendations	Implementation
In the short-run, let automatic stabilizers work to avoid an overly contractionary fiscal stance	Additional pro-cyclical fiscal measures were introduced in response to a weaker growth outlook in early 2012
Introduce a fiscal rule; preferably targeting structural balance, covering all levels of government, and incorporating a debt brake and an independent fiscal council	The latest proposal incorporates a structural balance rule with debt brake and a fiscal council.
Adopt an easing bias in monetary policy	The CNB cut its policy rate by 70 bps in three moves.
Start considering policy options for the zero bound for interest rates. FX intervention is a good candidate.	The CNB analyzed potential unconventional policy tools, and announced FX interventions as the next step.
Strengthen the financial sector framework along the lines of FSAP recommendations	The authorities took action in many of the areas highlighted by the FSAP. See Annex 2.

A. Fiscal Policy

10. With a budget deficit projected below 3 percent of GDP in 2013, the Czech Republic should be able to exit the Excessive Deficit Procedure and complete the consolidation effort started in 2010. The total structural fiscal consolidation since 2010 has amounted to about 4.2 percent of GDP resulting in a structural deficit of 1.7 percent of GDP in 2013 (from 6 percent of GDP in 2009). Fiscal performance this year is, so far, consistent with the budget even under a moderately weaker macroeconomic environment than expected.

Czech Republic: Fiscal Stance 2009-2016
(in percent of GDP)

	2009	2010	2011	2012		2013		2014		2015		2016	
				IMF	Auth	IMF	Auth	IMF	Auth	IMF	Auth	IMF	Auth
Total revenue	38.9	39.1	40.0	40.3	40.1	40.4	40.4	40.3	40.2	40.2	39.5	40.1	38.9
Total expenditure	44.7	43.8	43.2	44.6	44.5	43.3	43.3	43.2	43.0	42.8	42.3	42.6	41.7
Net lending	-5.8	-4.8	-3.3	-4.4	-4.4	-2.9	-2.8	-2.9	-2.9	-2.6	-2.8	-2.4	-2.8
excluding all one-offs	*-6.1*	*-4.8*	*-3.2*	*-2.5*	*-2.3*	*-2.9*	*-2.8*	*-2.9*	*-2.9*	*-2.6*	*-2.8*	*-2.4*	*-2.8*
Structural balance	-6.0	-4.9	-3.3	-1.8	-1.7	-1.7	-1.8	-1.8	-1.8	-1.8	-2.1	-1.9	-2.4
Public Debt	*34.2*	*37.9*	*41.0*	*45.9*	*45.8*	*47.8*	*48.5*	*49.2*	*50.3*	*49.8*	*51.2*	*50.2*	*51.9*
Nominal GDP	3,759	3,791	3,823	3,830	3,843	3,892	3,858	4,006	3,939	4,157	4,079	4,319	4,228

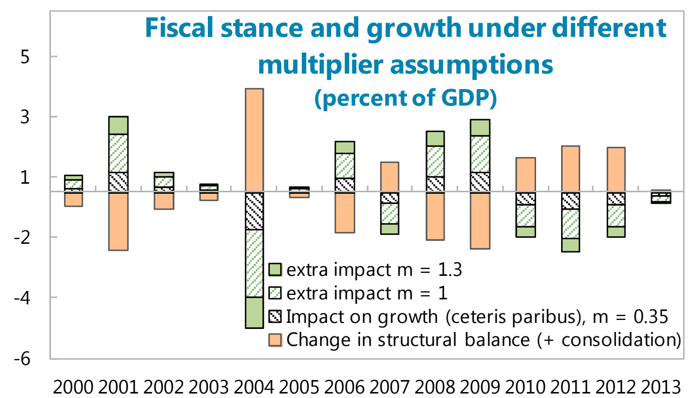
Source: IMF calculations and Fiscal Outlook of the Czech Republic, May 2012, Ministry of Finance.

11. The new medium-term fiscal framework modifies previous consolidation plans and projects a relaxation in the outer years. The authorities plan to take a supportive neutral stance in 2014 and anticipate a moderately positive fiscal stance in 2015–16 in order to support growth.

This medium-term stance, based mainly on revenue measures and with expenditures largely consistent with the previous plans, will be anchored in a fiscal deficit around 3 percent of GDP and will result in a structural relaxation of around 0.7 percent of GDP by 2016.

12. A structural fiscal rule has been proposed by the Ministry of Finance (MOF) to complement the Constitutional Law on Fiscal Responsibility. It consists of a structural balance rule with a balanced target to be achieved by 2021. This target is tighter than the medium-term objective agreed with the European Commission (-1 percent of GDP) and would imply a structural primary surplus of around 1.5 percent of GDP. The new framework, if approved by Parliament, will introduce, among other things, a medium-term structural anchor, a debt brake, and a fiscal council (Box 2). Given that current debt levels are close to the initial thresholds under the debt brake, transitional arrangements will have to ensure that the debt brake does not become the de facto binding fiscal rule with a pro-cyclical nature.

13. Staff considered that a neutral fiscal stance over the next few years until the economic recovery would gain strength was appropriate. This neutral stance would require avoiding future fiscal over-performance and could be followed by a moderate and gradual consolidation after 2015 with the aim of achieving a structural balance by 2021. In a severe adverse scenario, staff argued that fiscal policy should play an active role through temporary and targeted measures. In such an environment and with monetary policy constrained at the zero lower bound, fiscal policy would be more effective than under normal circumstances.[1] Going forward, recent reductions in capital spending should also be reversed including by increasing the absorption capacity of EU funds.



14. The authorities agreed that a neutral fiscal stance in 2014 was appropriate but saw scope to use fiscal policy to support growth over the medium term. The authorities' latest update of the Convergence Program targets a headline deficit of just below 3 percent of GDP for 2014–16, which given the cycle provides fiscal space to implement discretionary measures in support of the economy. They argued that the budget was relatively robust to external shocks that

[1] The characteristics of the Czech Republic, a small open economy with a flexible exchange rate, suggest that fiscal multipliers are relatively small. This has been confirmed by empirical estimates that, for the output elasticity of the budget balance, range from 0.3 to 0.5. However, the effects of fiscal policy shocks on economic activity are likely nonlinear, and multipliers are larger in downturns than in expansions. The relationship between fiscal stance and growth using different multipliers is depicted in the text chart. See Selected Issues Paper, *Fiscal Strength of the Czech Republic*.

would, therefore, be manageable. They also thought that the risk of a severe adverse scenario had decreased.

15. The further fiscal reforms in progress to increase the efficiency of the public sector are welcome. These include an introduction of the single collection point in 2014–15 consolidating different revenue collection agencies (including revenue, customs and social security agencies), and harmonizing the revenue bases used for the personal income tax and social security contributions. At the same time, a new treasury system, introduced in 2013 in order to increase the coverage of the treasury single account, would result in more comprehensive and timely expenditure reporting.

Box 2. New Fiscal Framework

The current framework, introduced in 2004, has weaknesses that lead to a pro-cyclical bias. It consists of a three-year rolling budgetary framework that converts general government balance targets into expenditure ceilings, the only binding numerical fiscal constraint for the state budget and six state funds. Weaknesses include:

- Lack of a clear medium-term anchor and a long-term sustainability objective
- Limited coverage to less than 60 percent of general government spending
- Lack of proper enforcement mechanism or corrective actions

The proposed new framework addresses most of these. The framework consists of a structural balance rule with a balanced target and a debt brake supplemented with a borrowing constraint on local governments and a deficit constraint on social security funds. The rule derives general government expenditure by adjusting revenues for cyclical factors, revenue and expenditure one-offs, and a three-year correction factor. The debt brake starts to apply when public debt, adjusted for MOF's liquid reserves, exceeds 45 percent of GDP and has increasingly demanding requirements if it exceeds 50, 55, and 58 percent of GDP, with a ceiling at 60 percent of GDP. Both the debt brake and the fiscal rule incorporate some escape clauses.

The new framework consists of a Constitutional Law and an Act on Rules of Fiscal Responsibility. The former incorporates the debt brake, Fiscal Council, and local governments' debt rule and requires a super majority in both chambers of Parliament to be modified. The latter specifies the practical implementation of the Constitutional Law including the structural balance rule and requires a simple majority in both chambers of Parliament to be modified.

Transparency and accountability would be enhanced with the introduction of an independent Fiscal Council and a Committee for Budgetary Forecasts. The Committee would assess government forecasts requiring its reformulation if deemed optimistic. At the same time, more demanding and regular reporting criteria would be introduced as well as the requirement to prepare annual reports including on tax expenditures and contingent liabilities.

B. Monetary Policy

16. Inflation risks are to the downside while the policy rate is technically at the zero lower bound. The CNB's aggressive rate cuts in 2012 brought the policy rate to the zero lower bound and it was announced that this accommodative stance would be kept for an extended period. Inflation declined below the 2 percent target level starting from January 2013. Inflation is projected to remain at around 1¾ percent through 2014 as the large output gap continue to suppress demand-side inflation and the inflationary impact of VAT increases and energy prices moderate. Risks to inflation forecasts are to the downside in line with the risks to the external demand and commodity prices.

17. The CNB has identified FX interventions as the next step for monetary easing. While details of such operations have not been specified, this is a welcome step clarifying that the CNB has access to effective tools at the zero lower bound and helping keep control of inflation expectations. While CNB Board members so far see the appropriate trigger for interventions slightly differently because of different views as to the downside risks and the entry and exit costs of the operations, there is a consensus that FX interventions would be an integral part of the inflation targeting regime.

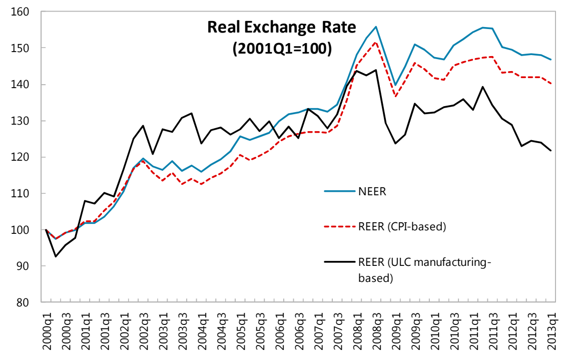
18. Staff agreed that, if a persistent and large undershooting of the inflation target is in prospect, FX interventions should be employed. As the Czech Republic is a small open economy and pass through is relatively high, FX interventions is expected to quickly help guide inflation expectations toward the target. In contrast, purely quantitative easing through purchases of domestic financial assets is less promising given the systemic liquidity surplus in the banking system, scarcity of private financial assets to purchase, and the very low long-term interest rates for the government bonds.

19. The operational aspects of possible interventions should pay due regard to transparency. For example, the use of pre-announced interventions of fixed sizes per period would be a good candidate in terms of market communication and ease of exit, while allowing sufficient flexibility to adjust as needed. The authorities agreed with the considerations of transparency and ease of exit and reiterated the commitment to the inflation targeting regime, while they remained noncommittal on any modality stressing the importance and advantages of flexibility.

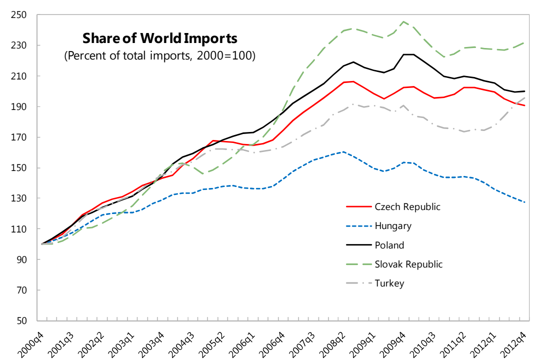
20. Importantly, FX interventions should potentially be used solely as a tool of inflation targeting, not aiming at a certain exchange rate level. Staff and the authorities agreed that the exchange rate is broadly in line with fundamentals. The Fund's new EBA methodology supports this assessment when using the current account based indicators, but diverges when using a real exchange rate based model (Box 3). Staff's assessment is based on the observations that the real exchange rate derived from manufacturing ULC is below the 10-year average; Czech exports have largely maintained their world market share despite the weakness in the core markets; the trade balance has been positive and improving; and the country's relative price level is consistent with its income level.

Box 3. External Sector Assessment

- **The koruna's long-term appreciation trend appears to have moderated.** The Czech economy has gone through substantial structural change in the '00s integrating itself into German supply chain and benefitting from rapid productivity growth. These gains were the main drivers of real exchange rate appreciation without losing competitiveness. More recently, favorable wage productivity dynamics in the manufacturing sector have continued, while both nominal and real appreciation has slowed.

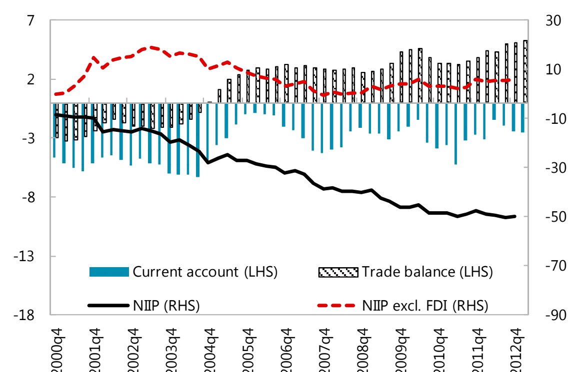


- **Export market share has been stable in the post-crisis period.** Following earlier robust gains, the market share of Czech exports has broadly stabilized in the last five years.



- **Current account deficit is stable at levels consistent with fundamentals.** The Czech Republic has run current account deficits averaging -2.8 percent of GDP between 2008 and 2012. These deficits are mainly due to large foreign earnings associated with the stock of inward direct investment that more than outweighs the trade surplus.

- **Current account deficits have been largely financed by FDI inflows.** While, portfolio and other investment inflows have increased in the 2009-2011 period with signs of reversal in 2012, the traditional source of funding the current account deficit has been net FDI inflows, which covered an average of 80 percent of the current account deficit in the last five years. The FDI flows are underpinned by foreign earnings reinvested in the country, thus providing a steady source of financing. The accumulated external deficits over the years have led to a moderate negative net international investment position (NIIP) of about 50 percent of GDP, but reflecting the prevalence of FDI financing, NIIP excluding the FDI position is positive. Reserve coverage is comfortably above standard benchmarks, and reaches 147 percent of short-term debt at end-2012.



- **The new EBA methodology confirms that the external balance is overall sound, but finds some overvaluation of the koruna.** The panel-based current account regression has a fitted value of 1.1 percent deficit, which is moderately narrower than the 2012 cyclically-adjusted deficit of 1.9 percent. Benchmarked against the current account deficit level that would stabilize the net foreign asset position of the country, 2.2 percent, the 2012 outturn of 2.4 percent and the 2.1 percent projection by staff in 2013 suggests that there are no major imbalances. Based on a multilateral real exchange rate model, the EBA exercise shows an overvaluation of 20 percent of the koruna but this estimate needs to be treated with caution as it may not capture factors such as initial undervaluation and rapid quality and productivity improvements.

C. Financial Sector

21. Imminent risks to financial stability appear to be contained. Czech banks, largely owned by euro area banking groups, are highly profitable and self-financed with a low system-wide loan to deposit ratio and strong capital and liquidity buffers. The banking system had a year of record profits in 2012, helping further strengthen the capitalization. However demand for credit remains weak and there are signs of increasing competition for market share especially in well-performing segments such as mortgages and large corporations. Therefore, profitability is likely to moderate as volume growth slows and margins become compressed.

22. The Czech financial system has proved resilient to the effects of the global crisis and weak domestic economy. The most recent stress test indicated that the capitalization of the sector as a whole would remain around 11 percent, significantly better than the regulatory minimum of 8 percent, even in a severe stress scenario with a large drop in GDP and protracted stagnation—a cumulative contraction of about 7 percentage points over a three-year horizon—and with partial impairment of the sector's exposure to European countries whose government debt exceeds 60 percent of GDP. Given the strong capital and funding positions, the banks would comfortably abide by the upcoming Basel III and CRD IV standards.

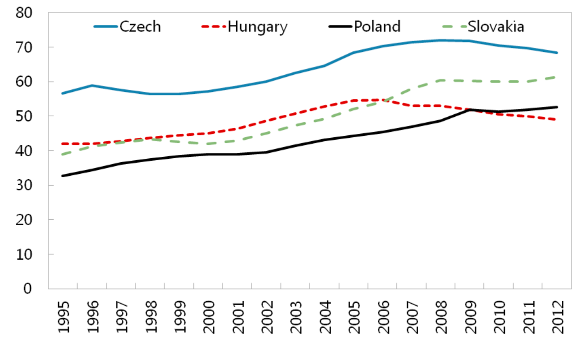
23. The main risk for the Czech banking system is a protracted or deeper recession that would harm asset quality. Although existing capital and liquidity buffers are expected to keep the system resilient, supervisory activities should proactively ensure that provisions are adequate and buffers remain strong in the face of potential further economic weakening. Another property price decline due to a protracted or deeper recession would pose a risk to the financial system that has relatively high exposure to the real estate market (see Annex I, Risk Assessment Matrix). This, however, should be tempered by the limited run-up in prices in the boom period and prudent loan to value ratios. The authorities agreed with these risk assessments, but noted that the risks are two-sided for the real estate market given the historically low interest rates. Staff and the authorities agreed that the credit union sector comprise a non-systemic risk that nonetheless needs to be addressed. To this end, the CNB has prepared a proposal, which incorporates FSAP advice and introduces a size limit for credit unions.

24. Improvements of the financial stability framework would help safeguard the Czech financial system against a wider range of risks. The authorities have made welcome efforts to implement the recommendations made by the Fund's FSAP Update in December 2011, including lowering regulatory limits on exposures to parent banks, strengthening cooperation between the Ministry of Finance and the CNB, and raising the role and profile of the CNB's macroprudential policies. It is important to adopt the draft proposal on the regulation of credit unions, which is a small segment in the financial system but with higher-than-average risks. Other FSAP suggestions for improvement were in the areas of bank resolution and deposit insurance, where recent European-wide initiatives to harmonize tools and policies have taken precedence and would need to be implemented once finalized as EU Directives. In this regard, the authorities recognize the importance of the Single Supervisory Mechanism, but do not opt to enter at this stage. Staff noted it would still be important to strengthen the cooperation with home supervisors, which would become the ECB in most cases, and make preparations for a more integrated European financial policy framework.

D. Structural Issues

25. Moving up the value added chain is important for the Czech economy to stay competitive. Convergence of Czech per capita output to other advanced European economies has stalled in recent years. At the same time, the increasing degree of openness to trade in tandem with evolving regional trade supply chains has played an important role for the growth of the Czech economy. As the study on "the German-Central European Supply Chain" suggests, the future prospect of the economy, therefore, hinges on how the export sector maintains and strengthens its competitiveness and broadens domestic value added. A key factor is to raise the share of knowledge intensive industries in exports by shifting to more technologically sophisticated products. In this regard, policies that enhance investment in research and development are important.

Income Convergence
(GDP per capita relative to Germany, in percent)



Sources: OECD

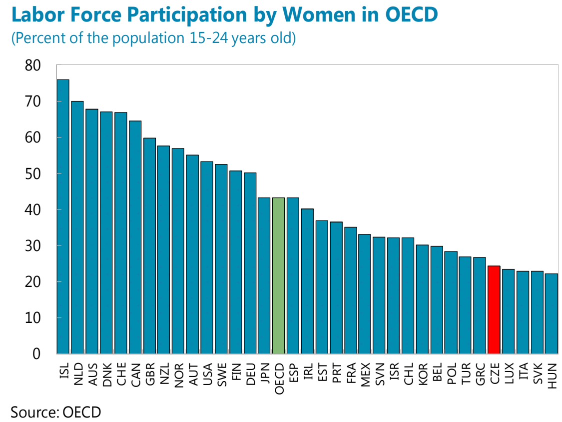
26. Investment in both physical and human capital is critical to enhance future growth potential. Enhancing private investment especially FDI is critical for future growth. In this regard, reducing uncertainty by improving the legal framework for formation, restructuring and liquidation of firms and minimizing administrative costs could significantly contribute to a better business environment. At the same time, developing and maintaining a highly capable and skilled workforce is essential for attracting more knowledge intensive industries as well as increasing labor productivity. Improving education especially at the tertiary level and vocational training has vital importance.

27. Higher labor participation, labor market flexibility, and active labor policies are important to increase potential growth and avoid long-term negative impact of unemployment. While employment is expected to be stable, with a declining share of productive age population, the economy requires wider sources of labor supply. Policies to enable labor market flexibility such as definite-term employment have been implemented. For some segments of the workforce where labor market participation is low such as woman with young children, targeted policies such as public support for childcare could be effective. In order to avoid long-term negative impact of unemployment, active labor market policies providing information, counseling and retraining are important.

Box 4. Women's Labor Force Participation

Women's labor force participation is significantly below the OECD average and the underperformance is more pronounced for women in the 15-24 age group, where those with young children represent a large share.

The government places great importance on the work-life balance especially of women with young children, and is taking such initiatives as to give tax incentives for employers who provide childcare for their employees as well as to give tax discounts for childcare expenses to parents. The government also intends to expand the availability of childcare to children as early as at the age of 6 month to provide greater opportunities for women to participate in the labor force.



STAFF APPRAISAL

28. **The Czech economy, despite its strong fundamentals, is in the midst of a prolonged recession because of the euro area slump and weak domestic demand.** A further slowdown in the euro area would exacerbate the situation, creating the risk of lower growth in the long run. Short-term macroeconomic policies should therefore be geared toward supporting the economy and not creating additional drag. Boosting potential growth in the medium- to long-term will require implementation of additional structural reforms.

29. **Given the large fiscal consolidation achieved so far, further consolidation efforts should be avoided until the economic recovery gains strength.** Thus, fiscal over-performance, particularly at the expense of capital spending, should be avoided as well as further pro-cyclical fiscal tightening in the event of weaker than expected economy activity. A neutral fiscal stance would be appropriate over the next few years until the economic recovery gains strength.

30. **The structural balance rule and debt brake being considered for the new fiscal framework would enhance the transparency and predictability of fiscal policy and reduce pro-cyclicality.** The framework's effectiveness and credibility would be enhanced by its design and adoption being rooted in broad consensus and incorporating an independent fiscal council. The structural target adopted should strike the right balance between short- and medium-term demand stabilization concerns with the long-term sustainability considerations, including the need to stabilize debt in the near future.

31. **If a persistent and large undershooting of the inflation target is in prospect, additional tools should be employed.** FX interventions would be an effective and appropriate tool to address

deflationary risks in the context of inflation targeting framework. This is expected to quickly increase the price level and help increase inflation expectations toward the target. The operational aspects of possible FX interventions should pay due regard to transparency. This would allow the market to form expectations in accordance with the CNB's inflation target.

32. Banking supervision should proactively ensure that provisions are adequate and buffers remain strong. The main risk is a protracted or deeper recession that would harm asset quality of the Czech banking sector. While existing capital and liquidity buffers are expected to keep the system resilient, proactive supervision would add to the strength in the face of potential further economic weakening.

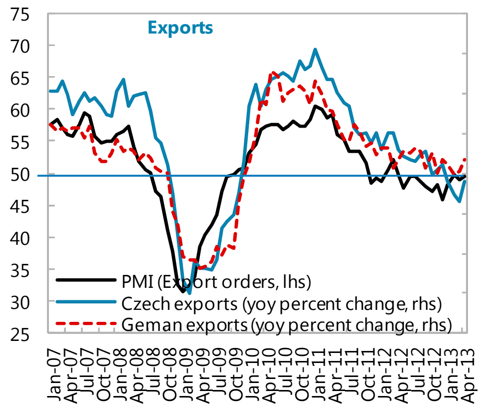
33. Improvements of the financial stability framework would help safeguard the Czech financial system against a wide range of risks. The authorities' efforts to implement the recommendations by the Fund's FSAP Update in December 2011 are welcome. It is important to adopt the draft proposal on the regulation of credit unions. Improvements in the areas of bank resolution and deposit insurance need to be implemented. It would be important to strengthen the cooperation between home and host supervisors and make preparations for a more integrated European financial policy framework.

34. Enhancing investment in both physical and human capital especially FDI is critical for future growth and moving up the value added chain. Reducing uncertainty by improving the legal framework and minimizing administrative costs for formation, restructuring, and liquidation of firms could significantly contribute to a better business environment. A highly capable and skilled workforce is essential to attract more knowledge intensive industries placed higher in the value added chain. Higher labor participation would enhance potential growth while active labor market policies providing information, counseling, and retraining would help avoid long-term negative impact of unemployment. For some segments of the workforce such as women with young children where labor market participation is low, targeted policies such as public support for childcare could be effective.

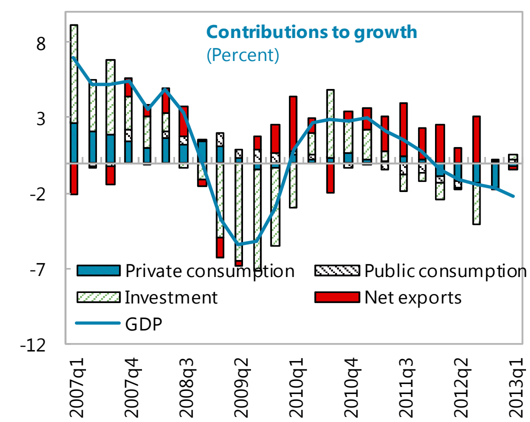
35. It is recommended that the next Article IV consultation with the Czech Republic be held on the usual 12-month cycle. The Czech Republic is an Article VIII country, and its data provision is adequate for surveillance (Information Annex).

Figure 1. Czech Republic: Macroeconomic Developments, 2007–13

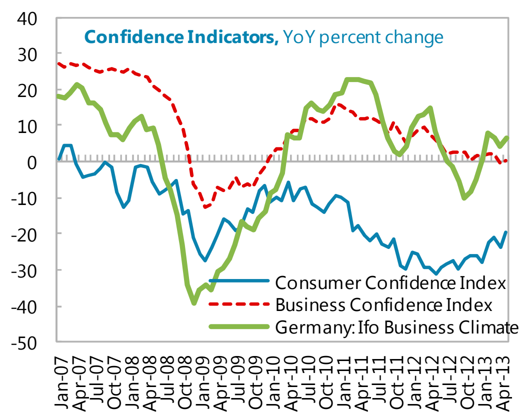
Export slowdown has triggered the Czech recession...



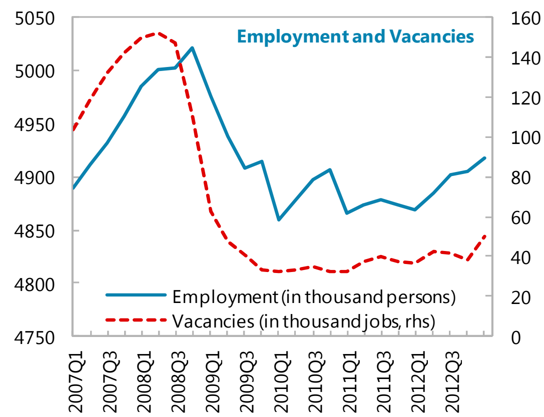
...but domestic factors, especially fiscal drag has led to a disproportionate decline in domestic demand.



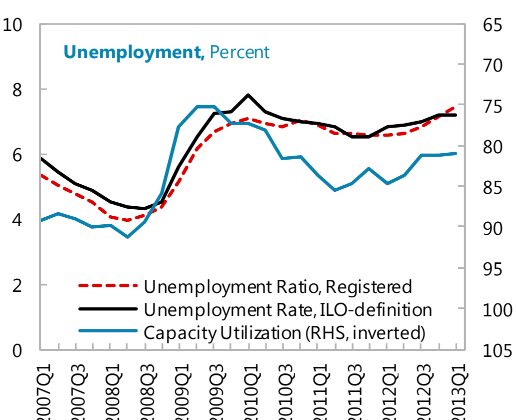
Potential recovery is conditional on euro area recovery, and survey data has some early positive signals.



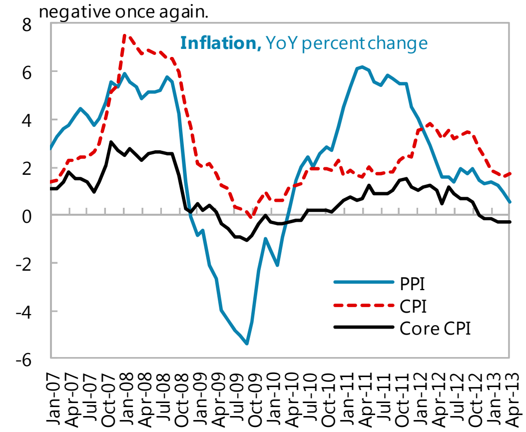
Employment has been broadly stagnant in the post crisis period...



...and unemployment, while relatively low, has been persistent.

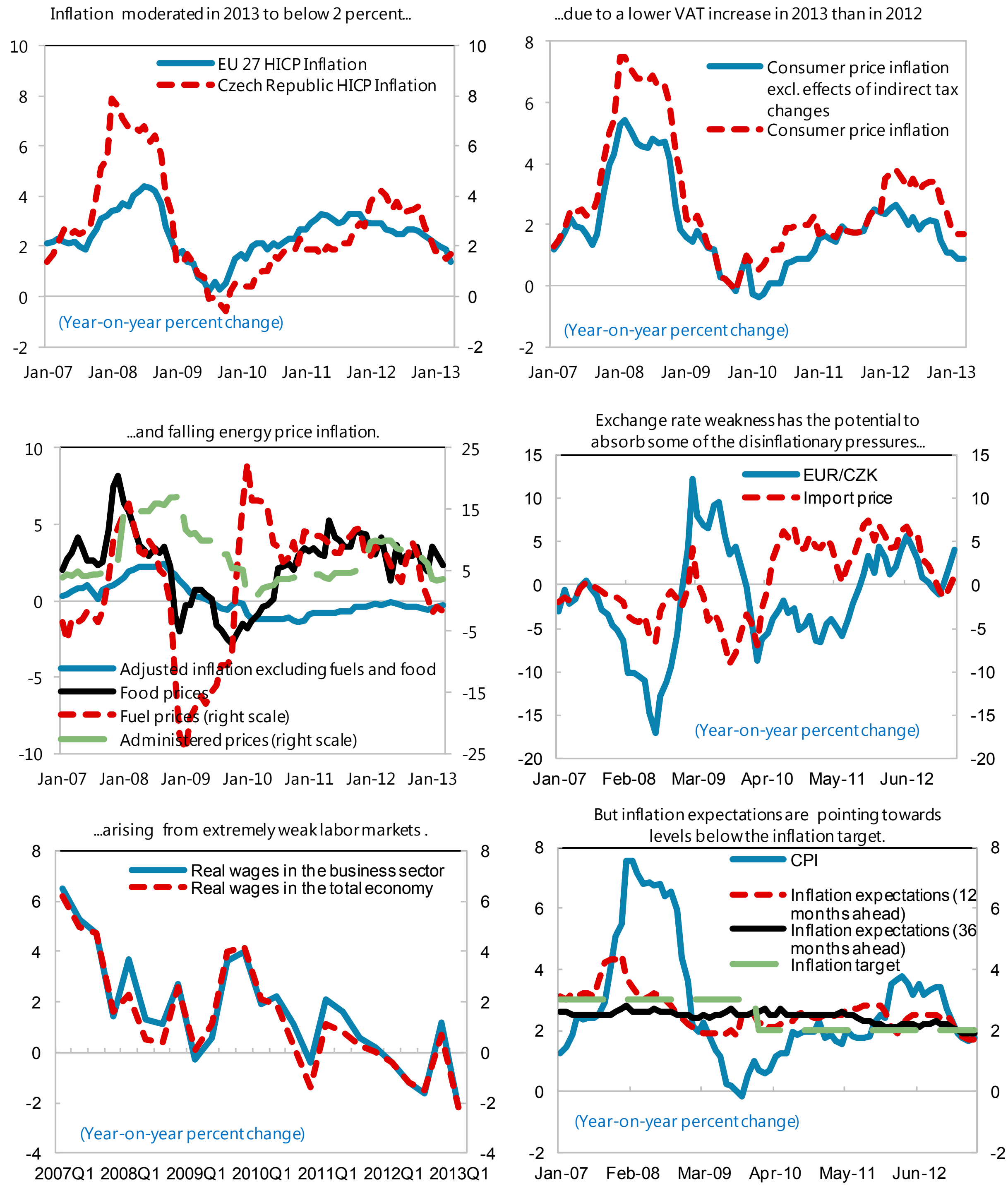


CPI inflation fell below 2 percent in 2013 as the effects of 2012 VAT increase subsided, and core inflation turned negative once again.



Source: Haver; Eurostat; EMED; and IMF staff calculations.

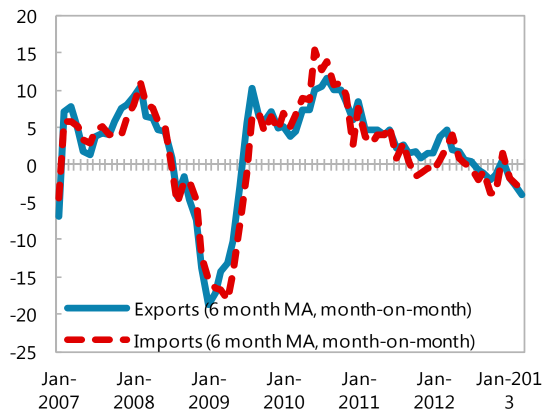
Figure 2. Czech Republic: Inflation Developments, 2007–13



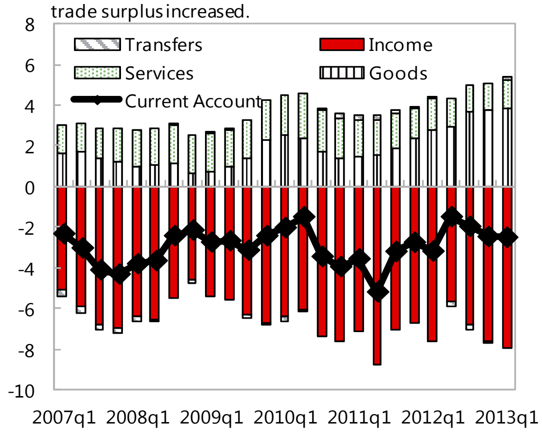
Source: Czech Statistical Office, Czech National Bank, Haver.

Figure 3. Czech Republic: External Sector Developments, 2007–13

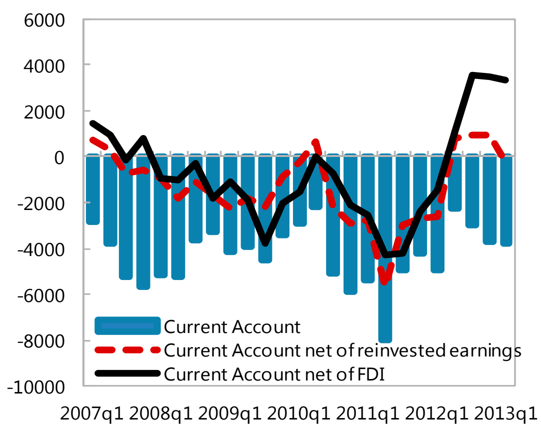
Export momentum continued to slow in 2012 and 2013...



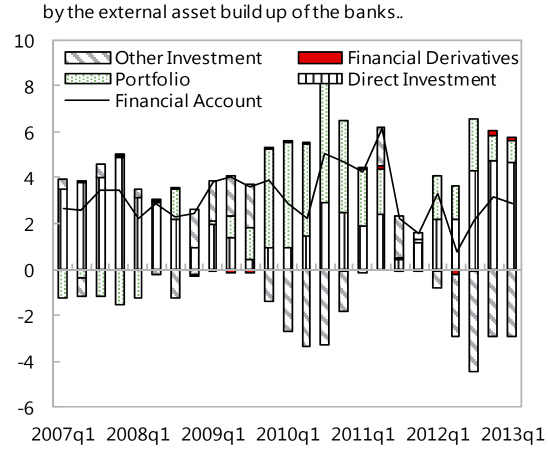
...but, with imports restrained by domestic demand, the trade surplus increased.



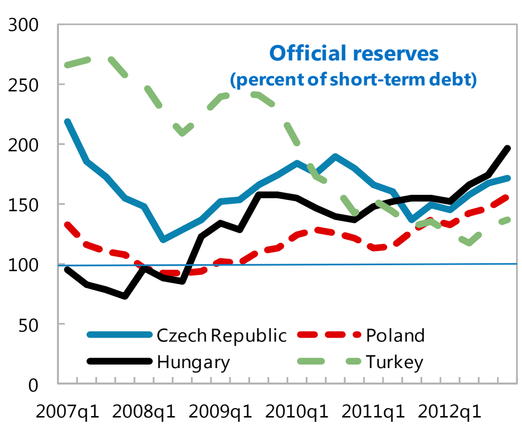
Income deficit has a significant counterpart in retained earnings, providing steady financing for the external deficit.



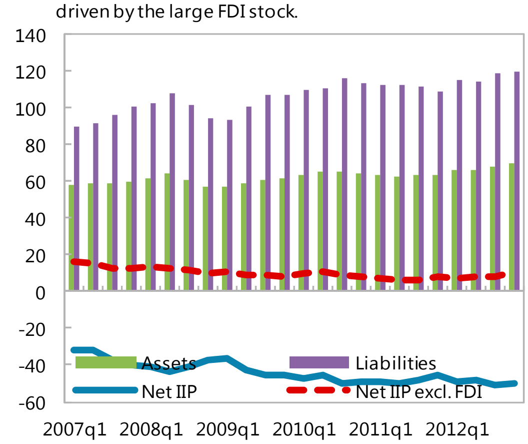
Other investment outflows were driven by various factors led by the external asset build up of the banks..



Stock vulnerabilities are limited, with adequate reserve coverage...



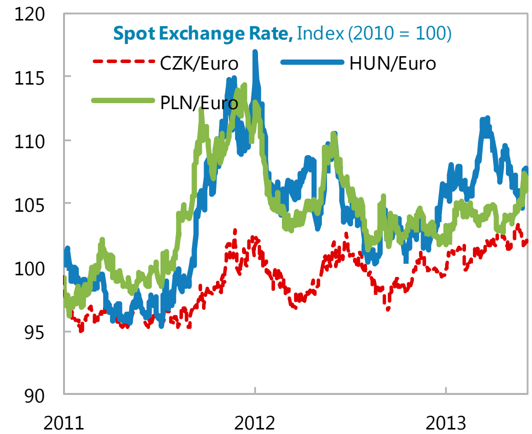
...and a net international investment deficit that is mainly driven by the large FDI stock.



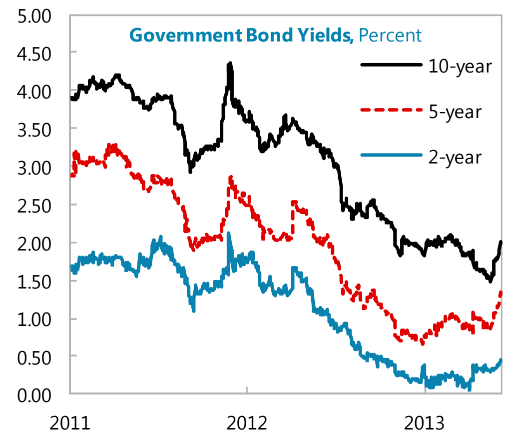
Sources: Czech Statisical Office, Czech National Bank, and IMF staff estimates.

Figure 4. Czech Republic: Financial Markets

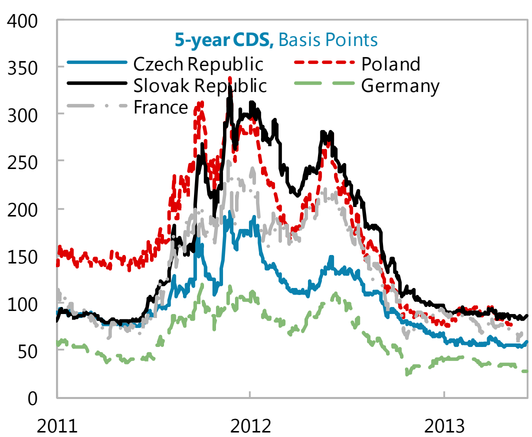
The koruna has overperformed regional currencies,with less volatility.



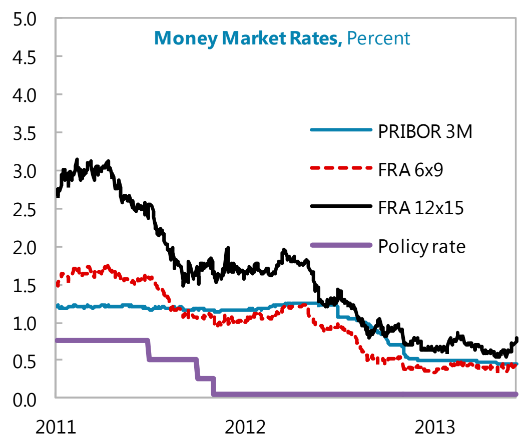
Bond yields are at record lows...



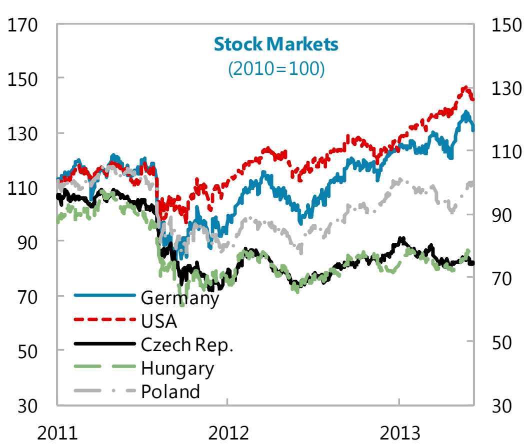
...thanks to lower credit risk...



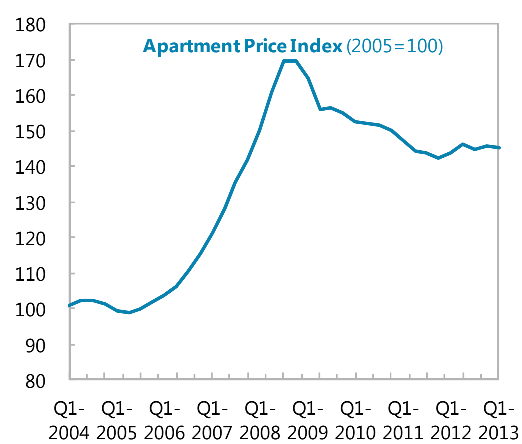
...and expectations of continued easy monetary policy.



Equities have underperformed regional and global markets...

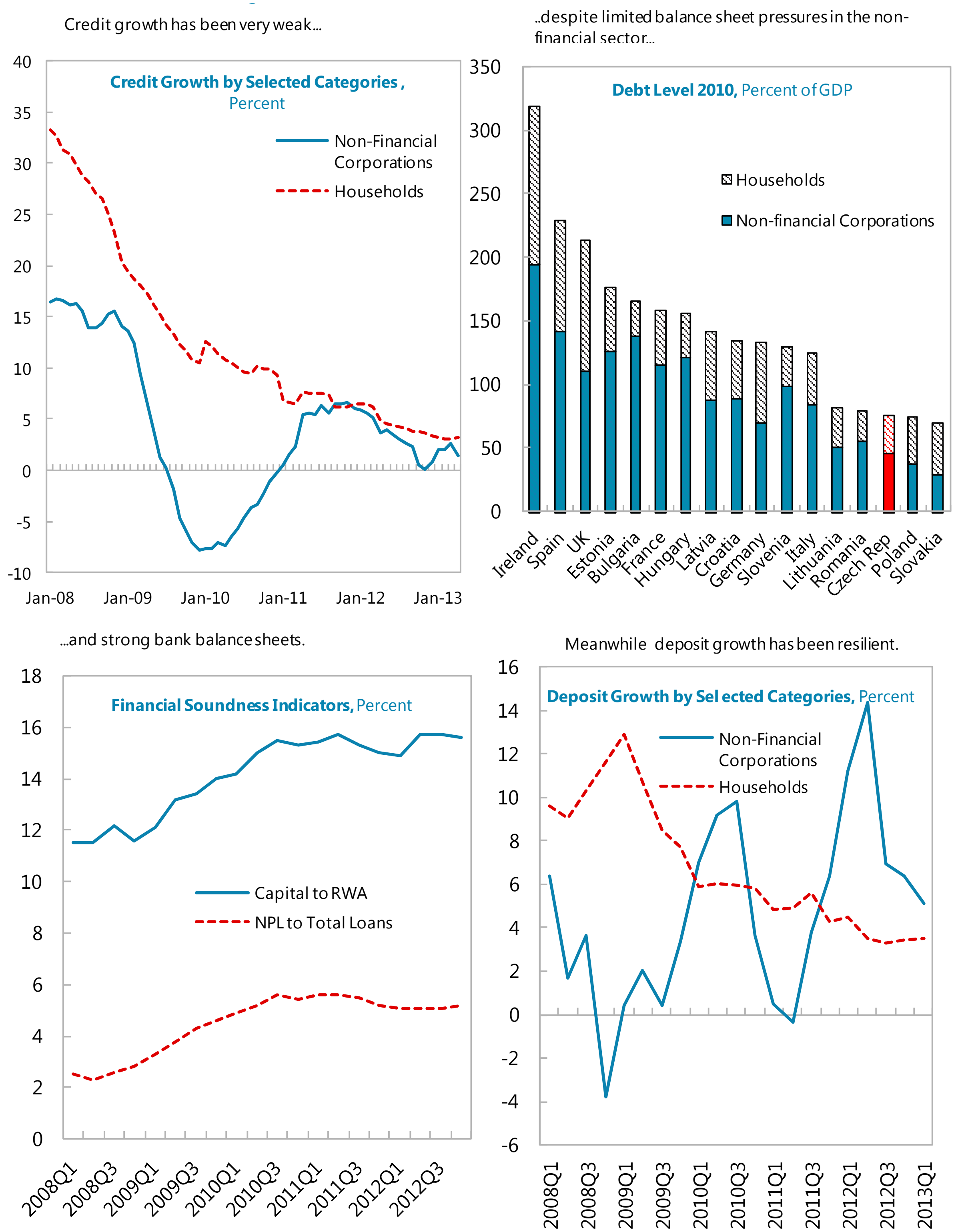


...while real estate prices held stable.



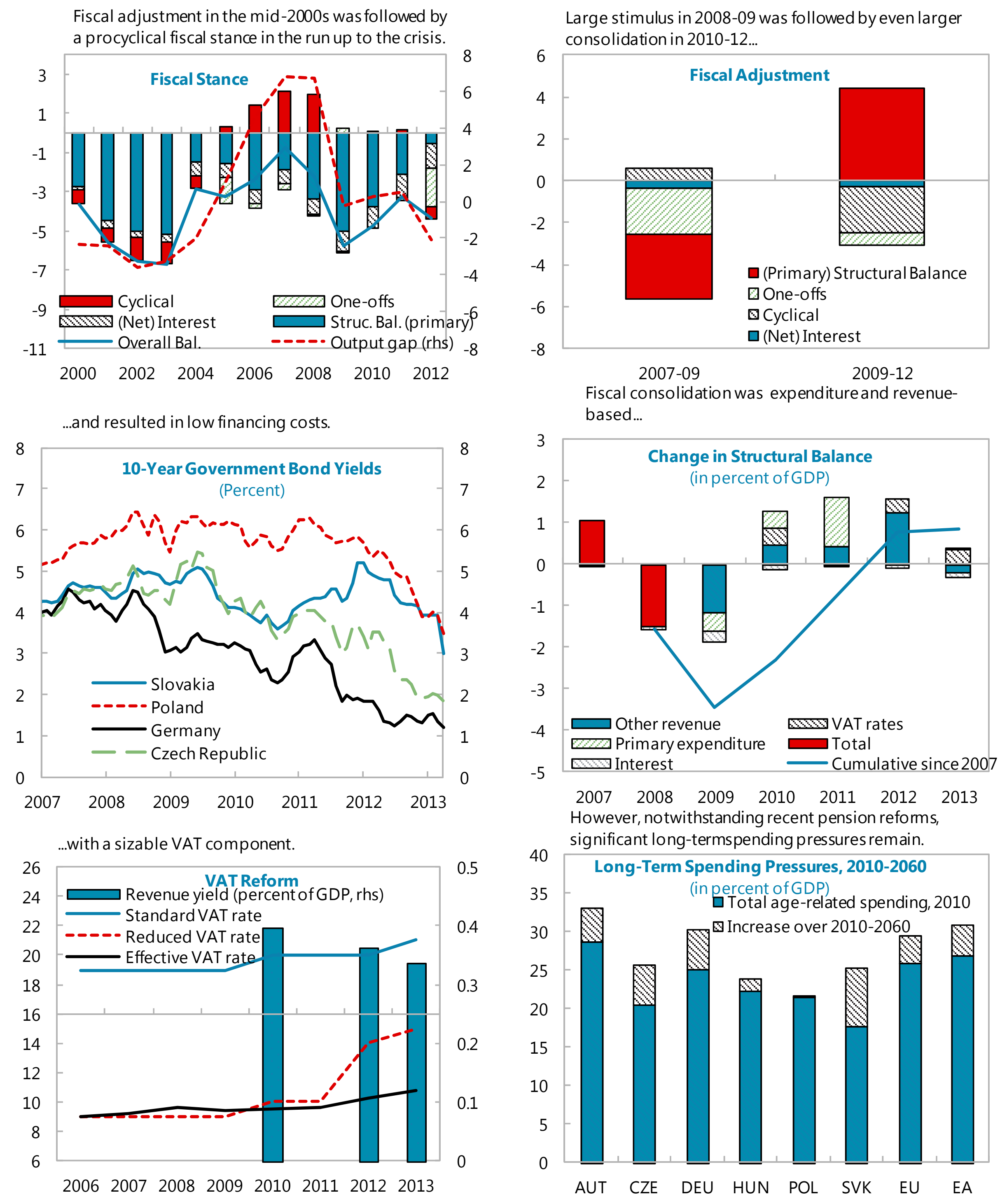
Sources: Bloomberg; Dealogic; Haver; BIS; and Global Insight.

Figure 5. Czech Republic: Evolution of Bank Credit



Sources: Haver; CNB; and IMF staff calculations.

Figure 6. Czech Republic: Fiscal Developments and Prospects



Sources: Haver; National Authorities; and IMF staff calculations.

Table 1. Czech Republic: Selected Economic Indicators, 2008–15

	2008	2009	2010	2011	2012	2013	2014	2015
						Staff Proj.		
Nominal GDP (USD billions)	225.4	197.2	198.5	216.1	195.7	201.3	203.8	208.4
Population (millions)	10.4	10.5	10.5	10.5	10.5	10.5	10.5	10.6
GDP per capita (USD thousands)	21,715	18,838	18,892	20,603	18,624	19,125	19,327	19,732
Real economy (change in percent, unless stated otherwise)								
Real GDP	3.1	-4.5	2.5	1.8	-1.2	-0.4	1.5	2.1
Domestic demand	2.2	-5.4	2.0	-0.1	-2.7	-0.1	1.0	1.9
Private consumption	2.8	0.2	0.9	0.5	-2.7	1.1	1.0	2.0
Investment	1.9	-20.2	5.4	0.8	-4.1	-2.9	1.6	2.0
Exports	4.0	-10.9	15.4	9.5	4.0	2.1	5.7	5.0
Imports	2.7	-12.1	15.4	7.0	2.3	2.0	5.8	5.2
Ouput gap (percent of potential output)	6.7	-0.3	0.3	0.5	-2.1	-3.6	-3.3	-2.5
CPI (average)	6.3	1.0	1.5	1.9	3.3	1.8	1.8	2.0
PPI (average)	4.5	-3.1	1.3	5.5	2.1	...	...	...
Unemployment rate (in percent)	4.4	6.7	7.3	6.7	7.0	7.4	7.5	7.3
Gross national savings (percent of GDP)	26.8	21.4	21.0	21.7	21.2	20.6	20.7	20.6
Gross domestic investments (percent of GDP)	4.6	5.1	4.3	3.7	3.1	3.0	3.1	3.2
Public finance (percent of GDP) 1/								
General government revenue	38.9	38.9	39.1	40.0	40.3	40.4	40.3	40.2
General government expenditure	41.1	44.7	43.8	43.2	44.6	43.3	43.2	42.8
Net lending / Overall balance	-2.2	-5.8	-4.8	-3.3	-4.4	-2.9	-2.9	-2.6
Primary balance	-1.2	-4.5	-3.4	-1.9	-2.9	-1.4	-1.3	-1.0
Structural balance (in percent of potential GDP)	-4.5	-5.7	-4.9	-3.4	-3.6	-1.7	-1.7	-1.7
General government debt	28.7	34.2	37.9	41.0	45.9	47.8	49.2	49.8
Money and credit (end of year, percent change)								
Broad money (M3)	13.6	0.2	1.9	2.8	4.8	1.6	2.9	3.8
Private sector credit	16.1	0.8	3.0	5.5	2.6	...	...	...
Interest rates (in percent, year average)								
Three-month interbank rate	4.0	2.2	1.3	1.2	1.0	...	...	...
Ten-year government bond	4.6	4.7	3.7	3.5	2.3	...	...	...
Balance of payments (percent of GDP)								
Trade balance (goods and services)	2.7	4.3	3.4	3.9	5.1	5.5	5.7	5.7
Current account balance	-2.1	-2.5	-3.8	-2.8	-2.4	-2.1	-1.9	-1.9
Gross international reserves (US$ billion)	37.0	41.6	42.5	40.3	44.9	48.3	49.9	51.5
(in months of imports of goods and services)	3.2	4.5	4.0	3.2	3.7	3.8	3.7	3.6

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

1/ Assumes unchanged policies

Table 2. Czech Republic: Balance of Payments, 2008–15

	2008	2009	2010	2011	2012	2013	2014	2015
						Staff proj.		
				(Billions of US$)				
Current account balance	-4.8	-4.8	-7.6	-6.1	-4.7	-4.3	-3.9	-3.9
Trade Balance	248.5	193.7	225.2	267.5	255.9	267.3	283.6	299.6
Exports	125.1	99.1	114.0	136.3	131.7	137.8	146.1	154.2
Imports	-123.4	-94.6	-111.2	-131.2	-124.2	-129.5	-137.5	-145.3
Nonfactor Services	39.4	35.0	37.9	43.0	41.6	43.4	46.1	48.7
Receipts	21.9	19.4	20.9	23.2	22.1	23.1	24.5	25.8
Payments	-17.5	-15.5	-17.0	-19.8	-19.5	-20.3	-21.6	-22.8
Factor Income (net)	-10.6	-13.2	-14.8	-14.7	-14.7	-15.2	-15.4	-15.7
Transfers	-0.3	-0.2	0.5	0.2	0.0	-0.1	-0.1	-0.1
Capital account	1.6	2.7	1.7	0.8	2.7	1.8	1.8	1.8
Financial account	5.4	7.8	9.1	3.6	6.2	6.8	6.3	6.3
Direct investment, net	6.6	2.9	6.1	2.2	10.6	10.3	8.9	8.2
Portfolio investment, net	0.0	8.6	7.7	0.4	2.2	2.3	2.2	2.2
Other Investment and Financial derivatives, net	3.2	-2.7	-3.4	0.7	-5.6	-4.4	-3.4	-2.7
Errors and omissions	0.2	-2.6	-1.1	0.8	0.0	0.0	0.0	0.0
Change in reserves 1/	-2.4	-3.1	-2.1	1.0	-4.2	-4.3	-4.2	-4.2
Memorandum items:								
Current account, percent of GDP	-2.1	-2.5	-3.8	-2.8	-2.4	-2.1	-1.9	-1.9
Trade balance, percent of GDP	2.7	4.3	3.4	3.9	5.1	5.5	5.7	5.7
Foreign direct investment, net, percent of GDP	1.0	1.0	2.5	1.2	4.7	4.4	3.7	3.3
Terms of trade (% change)	-1.4	2.0	-1.9	-1.6	-0.5	0.3	0.0	0.0
Gross official reserves	37.0	41.6	42.5	40.3	44.9	49.9	53.7	57.6
in months of the current year's imports	3.2	4.5	4.0	3.2	3.7	4.0	4.1	4.1
as a ratio to the short-term debt 2/	100.1	131.6	137.2	123.4	146.8	163.6	177.2	189.5
as percent of GDP	16.4	21.1	21.4	18.6	22.9	24.8	26.4	27.6
External debt, percent of GDP	37.4	45.3	47.5	43.6	52.1	50.5	49.5	48.5

Sources: Czech Statistical Office; Czech National Bank; and IMF staff estimates and projections.
1/ Changes in reserves reflect off-market conversion of large privatization receipts, EU transfers, eurobond issuance, and sales of accumulated interest.
2/ Remaining maturity basis.

Table 3. Czech Republic: The Statement of Operations of General Government, 2008–15 1/

(In billions of Koruny)

	2008	2009	2010	2011	2012	2013	2014	2015
							Proj.	
Revenue	**1,498.6**	**1,462.1**	**1,481.1**	**1,528.4**	**1,541.8**	**1,572.5**	**1,613.9**	**1,671.3**
Taxes	714.4	686.7	685.2	719.8	736.7	760.7	782.1	810.0
Personal income tax	142.4	136.0	131.7	142.8	144.3	148.2	152.8	157.6
Corporate Income tax	161.9	132.3	127.4	129.0	128.5	131.7	135.1	139.0
VAT	254.8	254.0	258.8	265.2	272.9	287.0	294.8	307.4
Excise	126.1	137.3	138.4	149.8	151.7	154.2	158.7	163.7
Other taxes	29.1	27.1	28.8	33.0	39.3	39.7	40.8	42.4
Social contributions	599.2	559.7	577.8	592.3	600.2	605.3	623.5	648.1
Grants	48.8	77.5	85.7	82.9	71.9	73.0	73.9	75.4
Other revenue	136.2	138.3	132.4	133.4	133.0	133.5	134.4	137.7
Property income	30.3	31.3	30.6	28.1	28.9	26.4	25.7	26.1
Sales of goods and services	102.9	104.1	98.7	102.4	102.7	105.7	107.2	110.0
Other revenue	2.9	2.9	3.0	2.8	1.4	1.4	1.5	1.5
Expenditure	**1,583.5**	**1,679.6**	**1,661.8**	**1,653.0**	**1,709.8**	**1,686.1**	**1,729.9**	**1,780.4**
Expense	**1,407.4**	**1,487.8**	**1,497.7**	**1,512.9**	**1,591.0**	**1,571.1**	**1,606.9**	**1,649.4**
Compensation of employees	279.6	292.9	285.6	279.7	281.5	284.0	290.8	300.4
Use of goods and services	227.9	238.3	234.8	223.8	219.8	220.4	226.8	232.3
Interest	39.4	47.4	51.1	52.5	56.0	60.4	64.2	69.4
Subsidies	62.3	74.7	71.3	79.8	77.4	76.6	76.8	77.7
Grants	36.2	34.1	32.9	36.8	34.8	0.0	0.0	0.0
Social benefits	675.4	728.3	740.2	754.6	766.9	789.8	808.9	835.4
Other expenses	86.6	72.1	81.8	85.7	154.6	139.9	139.4	134.1
Net acquisition of nonfinancial assets	**176.1**	**191.8**	**164.0**	**140.0**	**118.8**	**115.0**	**123.0**	**131.0**
Gross Operating Balance	**91.2**	**-25.6**	**-16.7**	**15.5**	**-49.2**	**1.5**	**7.0**	**21.9**
Net lending/borrowing (overall balance)	**-85.0**	**-217.4**	**-180.7**	**-124.6**	**-167.9**	**-113.5**	**-116.0**	**-109.1**
Net financial transactions	**-85.0**	**-217.4**	**-180.7**	**-124.6**	**-172.8**	**…**	**…**	**…**
Net acquisition of financial assets	**41.8**	**0.1**	**-22.6**	**18.2**	**-34.6**	**…**	**…**	**…**
Currency and deposits	75.3	-57.8	-12.9	0.0	0.0	…	…	…
Debt securities	1.9	3.8	-4.2	0.0	0.0	…	…	…
Loans	-3.0	0.1	2.1	0.0	0.0	…	…	…
Equity and investment fund shares	-23.2	-8.8	0.7	0.0	0.0	…	…	…
Other financial assets	-9.1	62.8	-8.4	18.2	-34.6	…	…	…
Net incurrence of liabilities	**126.8**	**217.5**	**158.1**	**137.0**	**133.6**	…	…	…
Currency and deposits	0.0	0.0	0.0	0.0	0.0	…	…	…
Debt securities	78.5	165.1	163.1	137.0	133.6	…	…	…
Loans	0.0	21.9	5.8	0.0	0.0	…	…	…
Other liabilities	48.3	30.6	-10.9	0.0	0.0	…	…	…
Adjustment and statistical discrepancies 2/	*0.0*	*0.0*	*0.0*	*-5.7*	*-4.7*	*…*	*…*	*…*
Memorandum item:								
General government debt	1,104.3	1,285.6	1,437.0	1,569.0	1,758.9	1,860.7	1,968.8	2,069.6
Primary balance	-45.5	-170.0	-129.6	-72.0	-111.9	-53.1	-51.9	-39.7
Structural balance 3/	-169.3	-224.9	-184.7	-127.1	-67.5	-64.8	-69.4	-72.3
Structural primary balance 3/	-138.9	-186.6	-141.2	-80.7	-19.9	-12.9	-13.9	-11.0
Output gap 3/	259.0	-10.4	11.2	18.4	-79.6	-138.2	-132.4	-105.6

Sources: Ministry of Finance and IMF staff estimates and projections.

1/ Assumes unchanged policies.

2/ Adjustments for cash-accrual differences, valuation changes and other discrepancies.

3/ Structural balances are as percent of potential GDP. Staff estimates of output gap.

Table 4. Czech Republic: The Statement of Operations of General Government, 2008–15 1/

(In percentage of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015
							Proj.	
Revenue	**38.9**	**38.9**	**39.1**	**40.0**	**40.3**	**40.4**	**40.3**	**40.2**
Taxes	18.6	18.3	18.1	18.8	19.2	19.5	19.5	19.5
Personal income tax	3.7	3.6	3.5	3.7	3.8	3.8	3.8	3.8
Corporate Income tax	4.2	3.5	3.4	3.4	3.4	3.4	3.4	3.3
VAT	6.6	6.8	6.8	6.9	7.1	7.4	7.4	7.4
Excise	3.3	3.7	3.7	3.9	4.0	4.0	4.0	3.9
Other taxes	0.8	0.7	0.8	0.9	1.0	1.0	1.0	1.0
Social contributions	15.6	14.9	15.2	15.5	15.7	15.6	15.6	15.6
Grants	1.3	2.1	2.3	2.2	1.9	1.9	1.8	1.8
Other revenue	3.5	3.7	3.5	3.5	3.5	3.4	3.4	3.3
Property income	0.8	0.8	0.8	0.7	0.8	0.7	0.6	0.6
Sales of goods and services	2.7	2.8	2.6	2.7	2.7	2.7	2.7	2.6
Other revenue	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Expenditure	**41.1**	**44.7**	**43.8**	**43.2**	**44.6**	**43.3**	**43.2**	**42.8**
Expense	**36.6**	**39.6**	**39.5**	**39.6**	**41.5**	**40.4**	**40.1**	**39.7**
Compensation of employees	7.3	7.8	7.5	7.3	7.3	7.3	7.3	7.2
Use of goods and services	5.9	6.3	6.2	5.9	5.7	5.7	5.7	5.6
Interest	1.0	1.3	1.3	1.4	1.5	1.6	1.6	1.7
Subsidies	1.6	2.0	1.9	2.1	2.0	2.0	1.9	1.9
Grants	0.9	0.9	0.9	1.0	0.9	0.0	0.0	0.0
Social benefits	17.5	19.4	19.5	19.7	20.0	20.3	20.2	20.1
Other expenses	2.3	1.9	2.2	2.2	4.0	3.6	3.5	3.2
Net acquisition of nonfinancial assets	**4.6**	**5.1**	**4.3**	**3.7**	**3.1**	**3.0**	**3.1**	**3.2**
Gross Operating Balance	**2.4**	**-0.7**	**-0.4**	**0.4**	**-1.3**	**0.0**	**0.2**	**0.5**
Net lending/borrowing (overall balance)	**-2.2**	**-5.8**	**-4.8**	**-3.3**	**-4.4**	**-2.9**	**-2.9**	**-2.6**
Net financial transactions	**-2.2**	**-5.8**	**-4.8**	**-3.3**	**-4.5**	**...**	**...**	**...**
Net acquisition of financial assets	**1.1**	**0.0**	**-0.6**	**0.5**	**-0.9**	**...**	**...**	**...**
Currency and deposits	2.0	-1.5	-0.3	0.0	0.0	....	....	....
Debt securities	0.0	0.1	-0.1	0.0	0.0	....	....	....
Loans	-0.1	0.0	0.1	0.0	0.0	....	....	....
Equity and investment fund shares	-0.6	-0.2	0.0	0.0	0.0	....	....	....
Other financial assets	-0.2	1.7	-0.2	0.5	-0.9	....	....	....
Net incurrence of liabilities	**3.3**	**5.8**	**4.2**	**3.6**	**3.5**	**...**	**...**	**...**
Currency and deposits	0.0	0.0	0.0	0.0	0.0	....	....	....
Debt securities	2.0	4.4	4.3	3.6	3.5	....	....	....
Loans	0.0	0.6	0.2	0.0	0.0	....	....	....
Other liabilities	1.3	0.8	-0.3	0.0	0.0	....	....	....
Adjustment and statistical discrepancies 2/	*0.0*	*0.0*	*0.0*	*-0.2*	*-0.1*	...	...	...
Memorandum item:								
General government debt	28.7	34.2	37.9	41.0	45.9	47.8	49.2	49.8
Primary balance	-1.2	-4.5	-3.4	-1.9	-2.9	-1.4	-1.3	-1.0
Structural balance 3/	-4.4	-6.0	-4.9	-3.3	-1.8	-1.7	-1.7	-1.7
Structural primary balance 3/	-3.6	-5.0	-3.7	-2.1	-0.5	-0.3	-0.3	-0.3
Output gap 3/	6.7	-0.3	0.3	0.5	-2.1	-3.6	-3.3	-2.5
GDP at current market prices (billions of Koruny)	3,848.4	3,759.0	3,790.9	3,823.4	3,830.5	3,891.8	4,005.5	4,156.7

Sources: Ministry of Finance and IMF staff estimates and projections.

1/ Assumes unchanged policies.

2/ Adjustments for cash-accrual differences, valuation changes and other discrepancies.

3/ Structural balances are as percent of potential GDP. Staff estimates of output gap.

Table 5. Czech Republic: General Government Financial Balance Sheet, 2008–12

(In billions of Koruny)

	2008			2009			2010			2011			2012		
	Trans-actions	OEF	Closing Opening balance	Trans-actions	OEF	Closing Opening balance	Trans-actions	OEF	Closing Opening balance	Trans-actions	OEF	Closing Opening balance	Trans-actions	OEF	Closing Opening balance
Net worth and its changes	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**
Nonfinancial assets	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**	**....**
Net Financial Worth:	**-85.0**	**-222.6**	**259.1**	**-217.4**	**60.0**	**101.7**	**-180.7**	**-113.0**	**-192.1**	**-124.6**	**95.6**	**-221.1**	**-163.3**	**-65.9**	**-450.2**
Financial Assets	**41.8**	**-161.4**	**1,582.5**	**0.1**	**54.9**	**1,637.5**	**-22.6**	**-93.8**	**1,521.1**	**2.9**	**96.5**	**1,620.5**	**135.6**	**-64.1**	**1,691.9**
Currency and deposits	75.3	2.6	473.3	-57.8	0.4	415.9	-12.9	-75.4	327.6	-33.3	83.8	378.1	119.7	-0.7	497.1
Debt securities	1.9	-0.9	20.8	3.8	-0.2	24.4	-4.2	-12.2	8.0	0.5	0.0	8.5	-0.2	0.2	8.4
Loans	-3.0	-8.7	39.9	0.1	-0.9	39.0	2.1	-1.0	40.1	0.6	0.8	41.4	-1.0	-0.2	40.2
Equity and inv. fund shares	-23.2	-162.1	806.4	-8.8	59.6	857.1	0.7	2.7	860.6	0.2	13.6	874.3	1.7	-62.6	813.5
Other financial assets	-9.1	7.7	242.2	62.8	-3.9	301.1	-8.4	-7.9	284.8	34.9	-1.7	318.1	15.4	-0.8	332.7
Liabilities	**126.8**	**61.2**	**1,323.4**	**217.5**	**-5.1**	**1,535.9**	**158.1**	**19.2**	**1,713.2**	**127.4**	**0.9**	**1,841.5**	**298.9**	**1.8**	**2,142.1**
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt securities	78.5	2.2	955.5	165.1	-4.1	1,116.5	163.1	17.7	1,297.2	130.2	4.0	1,431.4	202.4	4.4	1,638.2
Loans	0.0	0.6	153.2	21.9	-0.3	174.8	5.8	-3.7	176.9	2.8	1.3	180.9	2.9	-0.3	183.5
Other liabilities	48.3	58.3	214.7	30.6	-0.6	244.6	-10.9	5.3	239.0	-5.5	-4.4	229.1	93.5	-2.3	320.4
Memorandum items:															
Net financial worth (in % of GDP)			6.7			2.7			-5.1			-5.8			-11.8
Financial assets (in % of GDP)			41.1			43.6			40.1			42.4			44.2
Liabilities (in % of GDP)			34.4			40.9			45.2			48.2			55.9
o/w foreign liabilities (%)			29.4%			30.3%			33.8%			33.8%			33.8%
GDP nominal prices			3,848.4			3,759.0			3,790.9			3,823.4			3,830.5

Source: Ministry of Finance

Table 6. Czech Republic: Medium-Term Macroeconomic Scenario, 2008–18

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Real sector	(change, percent, unless stated otherwise)										
Real GDP	3.1	-4.5	2.5	1.8	-1.2	-0.4	1.5	2.1	2.2	2.4	2.4
Private Consumption	2.8	0.2	0.9	0.5	-2.7	1.1	1.0	2.0	2.0	2.0	2.0
Public Consumption	1.2	4.0	0.2	-2.7	-1.2	0.3	0.3	1.5	1.5	2.0	2.0
Investment	1.9	-20.2	5.4	0.8	-4.1	-2.9	1.6	2.0	2.5	3.0	3.0
Exports, goods and services	4.0	-10.9	15.4	9.5	4.0	2.1	5.7	5.0	5.0	5.0	5.0
Imports, goods and services	2.7	-12.1	15.4	7.0	2.3	2.0	5.8	5.2	5.2	5.2	5.2
contribution of net exports (percent)	1.0	0.3	0.8	2.4	1.6	0.2	0.5	0.4	0.4	0.4	0.4
CPI inflation	6.3	1.0	1.5	1.9	3.3	1.8	1.8	2.0	2.0	2.0	2.0
Unemployment (percent of labor force)	4.4	6.7	7.3	6.7	7.0	7.4	7.5	7.3	7.0	6.7	6.4
Output gap 1/	6.7	-0.3	0.3	0.5	-2.1	-3.6	-3.3	-2.5	-1.8	-0.9	0.0
Gross domestic savings (in percent of GDP)	26.8	21.4	21.0	21.7	21.2	20.6	20.7	20.6	20.6	20.7	20.8
Public	13.1	9.9	10.5	11.6	12.2	12.8	13.1	13.2	13.4	13.5	13.8
Private	13.7	11.5	10.5	10.1	8.9	7.8	7.6	7.4	7.2	7.2	7.0
Gross capital formation	4.6	5.1	4.3	3.7	3.1	3.0	3.1	3.2	3.2	3.2	3.2
Public finances 2/	(in percent of GDP)										
Revenues	38.9	38.9	39.1	40.0	40.3	40.4	40.3	40.2	40.1	40.0	40.0
Expenditures	41.1	44.7	43.8	43.2	44.6	43.3	43.2	42.8	42.6	42.4	42.4
Net lending	-2.2	-5.8	-4.8	-3.3	-4.4	-2.9	-2.9	-2.6	-2.4	-2.4	-2.4
General government debt	28.7	34.2	37.9	41.0	45.9	47.8	49.2	49.8	50.2	50.4	50.7
Balance of payments	(in percent of GDP)										
Current account balance	-2.1	-2.5	-3.8	-2.8	-2.4	-2.1	-1.9	-1.9	-1.9	-1.8	-1.8
Trade balance	0.8	2.3	1.4	2.4	3.8	4.1	4.2	4.2	4.2	4.2	4.2
Services balance	1.9	2.0	2.0	1.5	1.3	1.4	1.4	1.4	1.5	1.5	1.5
Net factor income	-4.7	-6.7	-7.5	-6.8	-7.5	-7.5	-7.5	-7.5	-7.5	-7.5	-7.5
Current transfers	-0.1	-0.1	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capital account balance	0.7	1.4	0.8	0.4	1.4	0.9	0.9	0.9	0.9	0.9	0.9
Financial account balance	3.1	5.4	5.4	2.0	4.5	4.2	4.0	3.9	3.8	3.7	3.7
Direct investment, net	1.0	1.0	2.5	1.2	4.7	4.4	3.7	3.3	3.2	3.1	3.0
Portfolio investment, net	0.0	4.4	3.9	0.2	1.1	1.1	1.1	1.1	1.0	1.0	1.0
Other investment & derivatives, net	1.4	-1.4	-1.7	0.3	-2.9	-2.2	-1.7	-1.3	-1.3	-1.2	-1.2
Errors and omissions, net	0.1	-1.3	-0.5	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.6
Change in reserves (- increase) 3/	-1.1	-1.6	-1.0	0.5	-2.1	-2.1	-2.1	-2.0	-2.0	-1.9	-1.9

Sources: Czech Statistical Office, Czech National Bank, Ministry of Finance, and IMF staff estimates and projections.
1/ In percent of potential GDP.
2/ Assumes unchanged policies. On ESA-95 basis.
3/ Changes in reserves reflect off-market conversion of large privatization receipts, EU transfers, Eurobond sales and sales of accumulated interest.

Annex I. Risk Assessment Matrix

	Source of Risks	Relative Likelihood	Impact if Realized
Global	*Stalled or incomplete delivery of euro area policy commitments*	**Medium** Financial stress re-emerges and bank-sovereign links re-intensify.	**Low** The main effect will be through trade channel. Negative financial spillovers through the banking system and the corporate sector are also possible, but less important. Pro-cyclical fiscal tightening in pursuit of nominal targets can exacerbate the cycle.
	Protracted period of slower European growth	**Medium** Larger than expected deleveraging or negative surprise on potential growth.	**High** Lower export demand from the euro area, the market for two thirds of all exports, will negatively affect growth in the Czech Republic. Direct effects of deleveraging will be limited as Czech banks are largely self-reliant in their funding.
	Deeper than expected slowdown in EMs	**Medium** Synchronized growth shock triggered by financial sector stresses or setbacks in fiscal and structural reforms.	**Medium** Lower exports and capital inflows, especially FDI, will hamper growth. Pro-cyclical fiscal tightening in pursuit of nominal targets can exacerbate the cycle.
Domestic	*Sharp falls in property prices*	**Low** Price declines subsided for the most part, but a renewed decline is still possible, though not very likely. Unsold inventory continues to pressure prices, but mortgages are performing well thanks to prudent LTV ratios and low interest rates.	**Medium** The financial system has high exposure to the real estate market through mortgages as well as credit to developers. Widespread losses on these portfolios could lead to financial instability.
	Hysteresis and lower potential growth	**Medium** Czech economy is heavily exposed to slowly growing and volatile markets (mainly euro area) and industries (e.g. automotive).	**Medium** Unemployment is moderate relative to EU average, but rising. Fixed investment is stagnant, and industrial structure is unchanged in the value chain. Potential growth may remain low for extended periods, and may even lead to long-term output losses.

The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline. The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with authorities.

Annex II. FSAP Recommendations and Implementation

Recommendations	Status
Macroprudential Framework	
Elevate financial stability to a policy objective in the CNB law	Legal amendment is planned.
Improve the decision-making mechanisms within the CNB to take timely action to address systemic risk	Regular meetings on financial stability is instituted.
Upgrade the stress testing framework for banks, focusing on group-wide risk monitoring	Implemented.
Regulation and Supervision	
Increase the number of supervisory staff to strengthen the intrusiveness of supervision	Not implemented, CNB deemed resources adequate.
Introduce a "prompt corrective action" framework	Supervisory manuals are being updated. EU directives on CRD4 and bank resolution will also bring about improvements.
Set large exposure limits in line with the globally agreed levels	Limits on exposures to foreign parent institutions have been tightened.
Continue closely monitoring significant transactions between subsidiaries and their parents, and take action, if necessary	Monitoring is continued.
Strengthen the framework for supervising financial conglomerate	Legislative amendment is in Parliament, and amendments in regulations are adopted.
Strengthen the CU sector by restructuring the existing institutions	Legislation drafted, but not submitted to Parliament.
Crisis Management and Resolution Frameworks	
Operationalize the framework for providing public support to banks; Adjust the treshhold for imposing conservatorship	Work on operationalizing is ongoing. Major legislation changes are pending the EU directive in this area.
Enhance governance of the Deposit Insurance Fund (DIF), increase its target size and strengthen the provisions for budgetary financing of possible shortfalls, clarify the trigger for payout of insured deposits, and allow the DIF to fund the transfer of deposits via purchase & assumption agreements	Improvements that do not require legal changes have been carried out. Change in legislation is pending the drafting of the EU directive in this area.

Annex III. Debt Sustainability Analysis

1. **The Czech Republic's fiscal position is strong and is expected to remain so under the baseline scenario.** Under this scenario, long-term debt dynamics are sustainable but with increasing debt over the medium term that reaches 51 percent of GDP in 2018 (see table 1a). The baseline assumes relatively stable revenues in percent of GDP (which, given the closing output gap, is consistent with some moderate structural reduction of the tax burden) as well as declining expenditures reflecting both efficiency gains on the expenditure side as well as cyclical improvement that puts less pressure on spending. In any case, expenditures in 2018 are projected to be similar to pre-crisis levels.

2. **Under standard alternative scenarios public debt trajectory worsens and reaches 53-67 percent of GDP by 2018** (see figure 1a). These include a permanent ½ standard-deviation shock to growth, interest rate and primary balance independently and a ¼ standard-deviation shock to the three combined, a one-time 30 percent depreciation of the REER, and a one-time 10 percent of GDP shock to contingent liabilities. Under most alternative scenarios, debt trajectory ceases to be declining and increases moderately except for the growth shock where the upwards trend is substantial. On the other hand, under interest rate and depreciation shocks debt stabilizes at a somewhat higher level compared to the baseline scenario.

3. **Other factors that may potentially affect the strength of fiscal policy and long-term sustainability appear to be moderate.** The financial system in the Czech Republic is relatively small (assets, credit and deposits at 130, 60, and 90 percent of GDP respectively) and has a conservative balance sheet structure with a high share of loans denominated in local currency, high capital and large liquidity. As a consequence, fiscal risks associated with the financial system appear manageable. Similarly, the absence of significant (external or internal) imbalances, manifested in moderate external and public financing requirements, and small current account deficit also point to low risk of a fiscal crisis or long-term sustainability concerns.

4. **However, ageing dynamics create large medium- and long-term fiscal challenges for the Czech Republic that, if unchecked, will require significant fiscal consolidation over the medium-term.** The European Commission estimates in its latest report on fiscal sustainability that age-related public spending in the Czech Republic will increase by 5.2 percentage points of GDP over the next 50 years versus the European average of 3.6 percentage points. This is distributed in pension related spending, 2.7 percentage points of GDP increase against the EU average of 1.4 percent of GDP, and health related spending, 1.7 percentage points of GDP against the EU average of 1.1 percent of GDP.

Table 1a. Czech Republic: Debt Sustainability Framework, 2008–18

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	28.7	34.2	37.9	41.0	45.9	**47.8**	**49.2**	**49.8**	**50.2**	**50.4**	**50.7**	**0.0**
o/w foreign-currency denominated	4.0	5.6	6.8	6.7	8.5	8.9	9.1	9.3	9.3	9.4	9.4	
Change in public sector debt	0.8	5.5	3.7	3.1	4.9	1.9	1.3	0.6	0.4	0.2	0.3	
Identified debt-creating flows (4+7+12)	0.9	5.3	4.7	3.4	3.2	1.9	1.3	0.6	0.4	0.2	0.3	
Primary deficit	1.2	4.5	3.4	1.9	2.9	1.4	1.3	1.0	0.7	0.5	0.5	
Revenue and grants	38.9	38.9	39.1	40.0	40.3	40.4	40.3	40.2	40.1	40.0	40.0	
Primary (noninterest) expenditure	40.1	43.4	42.5	41.9	43.2	41.8	41.6	41.2	40.8	40.5	40.5	
Automatic debt dynamics 2/	-0.1	1.6	1.4	1.2	1.3	0.8	0.2	-0.1	-0.1	-0.1	-0.2	
Contribution from interest rate/growth differential 3/	-0.3	1.9	1.1	1.1	1.4	0.8	0.2	-0.1	-0.1	-0.1	-0.2	
Of which contribution from real interest rate	0.5	0.6	1.9	1.7	0.9	0.7	0.9	0.9	0.9	1.0	0.9	
Of which contribution from real GDP growth	-0.8	1.3	-0.8	-0.7	0.5	0.2	-0.7	-1.0	-1.1	-1.2	-1.2	
Contribution from exchange rate depreciation 4/	0.2	-0.4	0.4	0.1	0.0	...	...	...	...	...	...	
Other identified debt-creating flows	-0.2	-0.8	-0.2	0.3	-1.0	-0.3	-0.2	-0.2	-0.2	-0.2	0.0	
Privatization receipts (negative)	-0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.4	-0.8	-0.2	0.3	-1.0	-0.3	-0.2	-0.2	-0.2	-0.2	0.0	
Residual, including asset changes (2-3) 5/	-0.1	0.2	-0.9	-0.3	1.6	0.0	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	73.7	87.9	97.0	102.7	114.1	118.3	122.0	123.8	125.0	125.9	126.7	
Gross financing need 6/	5.8	9.9	9.7	8.3	11.0	11.2	11.1	11.5	11.5	11.3	11.2	
in billions of U.S. dollars	13.1	19.5	19.3	18.0	21.6	22.6	22.6	23.9	24.5	24.6	24.7	
Scenario with key variables at their historical averages 7/						**47.8**	**50.0**	**52.1**	**54.3**	**56.5**	**58.8**	**0.2**
Scenario with no policy change (constant primary balance) in 2013-2018						**47.8**	**49.0**	**50.1**	**51.0**	**52.0**	**53.2**	**0.0**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	3.1	-4.5	2.5	1.8	-1.2	-0.4	1.5	2.1	2.2	2.4	2.4	
Average nominal interest rate on public debt (in percent) 8/	3.9	4.3	4.0	3.7	3.6	3.4	3.4	3.5	3.6	3.9	3.9	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.9	2.0	5.6	4.6	2.1	1.5	2.0	1.9	2.0	2.2	2.0	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-7.4	9.2	-6.2	-1.7	0.7	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	1.9	2.3	-1.6	-0.9	1.4	2.0	1.4	1.6	1.7	1.7	1.9	
Growth of real primary spending (deflated by GDP deflator, in percent)	3.5	3.3	0.3	0.3	1.9	-3.6	1.0	1.1	1.4	1.7	2.3	
Primary deficit	1.2	4.5	3.4	1.9	2.9	1.4	1.3	1.0	0.7	0.5	0.5	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

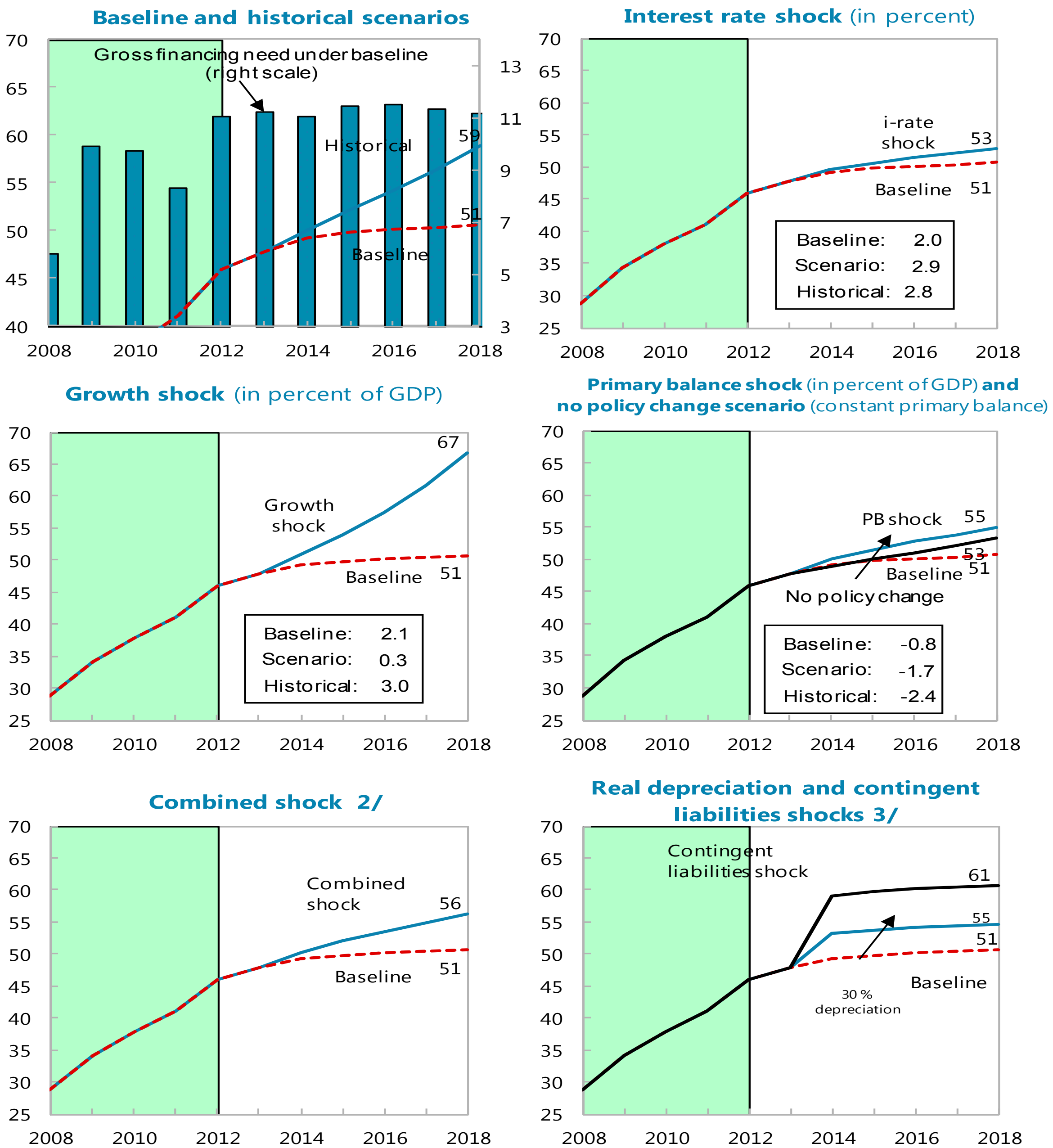
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 1a. Czech Republic: Public Debt Sustainability: Bound Tests 1/

(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

CZECH REPUBLIC

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 9, 2013

Prepared By European Department

CONTENTS

FUND RELATIONS

(As of May 31, 2013; unless specified otherwise)

Membership Status: Joined 1/01/1993; Article VIII

General Resources Account

	SDR Million	Percent of Quota
Quota	1,002.20	100.0
Fund Holdings of Currency	665.15	66.37
Reserve position in Fund	337.05	33.63
Lending to the Fund		
Borrowing Agreement	128.90	

SDR Department:

	SDR Million	Percent Allocation
Net Cumulative Allocation	780.20	100.0
Holdings	751.01	96.26

Outstanding Purchases and Loans: None

Financial Arrangements:

Type	Amount Approval Date	Amount Expiration Date	Approved (SDR Million)	Drawn (SDR Million)
Stand-by	3/17/1993	3/16/1994	177.00	70.00

Projected Payments to Fund:
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2013	2014	2015	2016	2017
Principal					
Charges/Interest	0.01	0.02	0.02	0.02	0.02
Total	0.01	0.02	0.02	0.02	0.02

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 ±0.5 percent to ±7.5 percent around the central rate. On May 27, 1997, managed floating was introduced. In the Annual Report on Exchange Arrangements and Exchange Restrictions, the de facto exchange rate regime of the Czech Republic is classified as a free float. Since 2002, the CNB has not engaged in direct interventions in the foreign exchange market. International reserves have been affected by the off-market purchases of large privatization receipts and EU transfers and the sales of the accumulated interest. On May 31 2013, the exchange rate of the Czech koruna stood at CZK 18.769 per U.S. dollar.

The Czech Republic has accepted the obligations of Article VIII and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. The Czech Republic maintains exchange restrictions for security reasons, based on UN Security Council Resolutions and Council of the European Union Regulations that have been notified to the Fund for approval under the procedures set forth in Executive Board Decision No. 144-(52/51).

Last Article IV Consultation:

The last Article IV consultation with the Czech Republic was concluded on May 4, 2012. The staff report and PIN were published on May 18, 2012.

FSAP Participation and ROSCs:

An FSAP was carried out in late 2000/ early 2001. The Financial System Stability Assessment was considered by the Executive Board on July 16, 2001, concurrently with the staff report for the 2001 Article IV Consultation. An FSAP update was carried out in 2011. ROSCs on: banking supervision; data dissemination; fiscal transparency; securities market; and transparency of monetary and financial policies were published on the Fund’s external website on July 1, 2000.

Technical Assistance: See attached table.

Implementation of HIPC Initiative: Not Applicable

Implementation of Multilateral Debt Relief Initiative (MDRI): Not Applicable

Implementation of Post-Catastrophic Debt Relief (PCDR): Not Applicable

Safeguards Assessments: Not Applicable

Czech Republic: Technical Assistance, 1991–2013		
Department	**Timing**	**Purpose**
FAD	December 1991– September 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
	May 1995	Follow-up visit on public financial management
	June 1995	Follow-up visit by FAD consultant on VAT administration
	June–July 1999	Medium-term fiscal framework
MCM	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	Bond issuance and monetary management
	February 1993	Follow-up visit on bond issuance and monetary
	November 1993	management and management of cash balances
		Data management and monetary research
	April 1994	Foreign exchange laws (jointly with LEG) and external
	January 1995	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 MFD)
	June–August 2000	Inflation targeting (financed by MFD)
	February–March 2005	Inflation targeting (financed by MFD)
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
	February 2003	Implementing GFSM 2001
	November 2006	GFSM 2001 Pilot Project
		GFSM 2001 implementation

STATISTICAL ISSUES

1. **Data provision is adequate for surveillance.** The Czech Republic subscribed to the Special Data Dissemination Standard in April 1998, and metadata and annual observance reports for 2006–09 are posted on the Fund's Dissemination Standards Bulletin Board.

2. **Data on core surveillance variables are available 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 reported monthly with a lag of between one and 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 to three months. Since 2003, the main components of the balance of payments are also available monthly. 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 state budget accounts and are available with a two- to three-month lag.

3. **While data quality is generally high, some deficiencies remain in certain areas**, and the authorities are taking measures to improve data accuracy.

- National accounts data are subject to certain weaknesses. Value added in the small scale private sector is likely to be underestimated, as the mechanisms for data collection on this sector are not yet fully developed and a significant proportion 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 by respondents. Large swings in individual components of spending and the overall GDP from quarter to quarter bring into question the reliability of the quarterly data and hamper business cycle analysis.

- Recently, revisions 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 fixed base price indices for exports and imports; these indices are currently presented on the basis of the same month of the previous year.

- Monetary survey data provided to the European 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. In 2002, to meet EU statistical conventions, the CNB implemented the European Central Bank's (ECB) framework for collecting, compiling, and reporting monetary data. The data published in IFS are based on monetary accounts derived from the ECB's framework. The same set of accounts also forms the basis for monetary statistics published in the CNB's bulletins and on the website, which are thereby effectively harmonized with the monetary statistics published in IFS, although the presentation in IFS differs somewhat from the CNB's.

- Annual and quarterly fiscal data are compiled on ESA-95 basis by the Czech Statistical Office, including non-financial accounts, financial accounts, and financial balance sheets. The Ministry of Finance uses the ESA-95 methodology for the Convergence Program targets. Some adjustments are to be done when converting data from the national (fiscal targeting) methodology to the ESA-95 based fiscal accounts. The differences relate mainly to the coverage of the institutions classified in the general government sector (for example, the Czech Consolidation Agency is included in the central government under ESA definition), exclusion of financial transactions, different classification of some specific government transactions (for example, called guarantees) and the time of recording of government transactions (ESA-95 records transactions on accrual basis).

Czech Republic: Table of Common Indicators Required for Surveillance

(As of June 28, 2013)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	current	current	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	May 2013	Jun. 2013	D	M	M
Reserve/Base Money	May 2013	Jun. 2013	M	M	M
Broad Money	May 2013	Jun. 2013	M	M	M
Central Bank Balance Sheet	Jun. 2013	Jun. 2013	M	M	M
Consolidated Balance Sheet of the Banking System	May 2013	Jun. 2013	M	M	M
Interest Rates[2]	current	current	D	D	D
Consumer Price Index	May 2013	Jun. 2013	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2012	May 2013	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	May 2013	Jun. 2013	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2013 Q1	Jun. 2013	Q	Q	Q
External Current Account Balance	Mar. 2013	Jun. 2013	M	M	M
Exports and Imports of Goods and Services	Mar. 2013	Jun. 2013	M	M	M
GDP/GNP	2013 Q1	Jun. 2013	Q	Q	Q
Gross External Debt	2013 Q1	Jun. 2013	Q	Q	Q
International Investment Position[6]	2013 Q1	Jun. 2013	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments. Data for the state budget are available with monthly frequency and timeliness, while data on extra budgetary funds are available only on an annual basis.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).

Press Release No. 13/288
FOR IMMEDIATE RELEASE
August 2, 2013

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2013 Article IV Consultation with the Czech Republic

On July 24, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Czech Republic[1] and considered and endorsed the staff appraisal without a meeting on a lapse-of-time basis.[2]

The economy has avoided serious imbalances in the recent volatile economic environment, benefitting from strong policy frameworks and sound fundamentals. However the export-led recovery observed in 2010–11 subsided as euro area import demand slowed. Growth has noticeably underperformed trade partners and peers since the middle of 2011 mainly because of weaker domestic consumption and investment. Real GDP contracted for four quarters in a row in 2012 and recorded a 1.2 percent decline for the year with only net exports contributing positively to growth. Private consumption declined by 2.7 percent in 2012. Weak demand conditions helped suppress inflation and the external current account deficit. Inflation averaged 3.3 percent in 2012 mainly due to increases in the VAT rates and positive contributions from foods and fuel. Both of these effects subsided and inflation fell below the target in January 2013 and averaged 1.8 percent in the first quarter of this year. The current account deficit declined to 2.4 percent of GDP in 2012 from 2.8 percent, mainly due to an improvement of the trade balance.

Pro-cyclical fiscal consolidation continued in 2012 resulting in a stronger structural fiscal position than before the crisis. The overall deficit without one-offs in 2012 was 2.5 percent of GDP, down from 3.2 percent of GDP in 2011. The structural balance improved by 1.5 percent of GDP on account of a combination of revenue measures, in particular an increase of the reduced VAT rate by 4 percentage points, and expenditure measures. Fiscal over-performance relative to

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

the budget was largely due to under-execution of capital spending, down by 0.6 percent of GDP compared to 2011, to 3.1 percent of GDP.

The Czech National Bank (CNB) continued to take a leading role in countering economic weaknesses. It cut the policy rate by 70 basis points in three steps in June, October and November to 0.05 percent, and committed itself to continued low rates. Long-term money market rates also moved lower in the face of weak growth and inflation expectations. The falling rates, however, did not translate into faster credit growth. Credit to the corporate sector and households grew only by 2.6 percent at end-2012 compared to 6.3 percent of the previous year. Increased cautiousness about economic prospects played a role in limiting both credit demand and, to a lesser extent, supply.

Executive Board Assessment

In concluding the 2013 Article IV consultations with the Czech Republic, Executive Directors endorsed staff's appraisal, as follows:

The Czech economy, despite its strong fundamentals, is in the midst of a prolonged recession because of the euro area slump and weak domestic demand. A further slowdown in the euro area would exacerbate the situation, creating the risk of lower growth in the long run. Short-term macroeconomic policies should therefore be geared toward supporting the economy and not creating additional drag. Boosting potential growth in the medium- to long-term will require implementation of additional structural reforms.

Given the large fiscal consolidation achieved so far, further consolidation efforts should be avoided until the economic recovery gains strength. Thus, fiscal over-performance, particularly at the expense of capital spending, should be avoided as well as further pro-cyclical fiscal tightening in the event of weaker than expected economy activity. A neutral fiscal stance would be appropriate over the next few years until the economic recovery gains strength.

The structural balance rule and debt brake being considered for the new fiscal framework would enhance the transparency and predictability of fiscal policy and reduce pro-cyclicality. The framework's effectiveness and credibility would be enhanced by its design and adoption being rooted in broad consensus and incorporating an independent fiscal council. The structural target adopted should strike the right balance between short- and medium-term demand stabilization concerns with the long-term sustainability considerations, including the need to stabilize debt in the near future.

If a persistent and large undershooting of the inflation target is in prospect, additional tools should be employed. Foreign exchange (FX) interventions would be an effective and appropriate tool to address deflationary risks in the context of inflation targeting framework. This is expected to quickly increase the price level and help increase inflation expectations toward the target. The operational aspects of possible FX interventions should pay due regard to transparency. This would allow the market to form expectations in accordance with the CNB's inflation target.

Banking supervision should proactively ensure that provisions are adequate and buffers remain strong. The main risk is a protracted or deeper recession that would harm asset quality of the Czech banking sector. While existing capital and liquidity buffers are expected to keep the system resilient, proactive supervision would add to the strength in the face of potential further economic weakening.

Improvements of the financial stability framework would help safeguard the Czech financial system against a wide range of risks. The authorities' efforts to implement the recommendations by the Fund's FSAP Update in December 2011 are welcome. It is important to adopt the draft proposal on the regulation of credit unions. Improvements in the areas of bank resolution and deposit insurance need to be implemented. It would be important to strengthen the cooperation between home and host supervisors and make preparations for a more integrated European financial policy framework.

Enhancing investment in both physical and human capital especially FDI is critical for future growth and moving up the value added chain. Reducing uncertainty by improving the legal framework and minimizing administrative costs for formation, restructuring, and liquidation of firms could significantly contribute to a better business environment. A highly capable and skilled workforce is essential to attract more knowledge intensive industries placed higher in the value added chain. Higher labor participation would enhance potential growth while active labor market policies providing information, counseling, and retraining would help avoid long-term negative impact of unemployment. For some segments of the workforce such as women with young children where labor market participation is low, targeted policies such as public support for childcare could be effective.

Czech Republic: Selected Economic Indicators, 2008-14

	2008	2009	2010	2011	2012	2013	2014
						Proj.	
Nominal GDP (USD billions)	225.4	197.2	198.5	216.1	195.7	201.3	203.8
Population (millions)	10.4	10.5	10.5	10.5	10.5	10.5	10.5
GDP per capita (USD thousands)	21,715	18,838	18,892	20,603	18,624	19,125	19,327
Real economy (change in percent, unless stated otherwise)							
Real GDP	3.1	-4.5	2.5	1.8	-1.2	-0.4	1.5
Domestic demand	2.2	-5.4	2.0	-0.1	-2.7	-0.1	1.0
Private consumption	2.8	0.2	0.9	0.5	-2.7	1.1	1.0
Investment	1.9	-20.2	5.4	0.8	-4.1	-2.9	1.6
Exports	4.0	-10.9	15.4	9.5	4.0	2.1	5.7
Imports	2.7	-12.1	15.4	7.0	2.3	2.0	5.8
Ouput gap (percent of potential output)	6.7	-0.3	0.3	0.5	-2.1	-3.6	-3.3
CPI (average)	6.3	1.0	1.5	1.9	3.3	1.8	1.8
PPI (average)	4.5	-3.1	1.3	5.5	2.1	…	…
Unemployment rate (in percent)	4.4	6.7	7.3	6.7	7.0	7.4	7.5
Gross national savings (percent of GDP)	26.8	21.4	21.0	21.7	21.2	20.6	20.7
Gross domestic investments (percent of GDP)	4.6	5.1	4.3	3.7	3.1	3.0	3.1
Public finance (percent of GDP) 1/							
General government revenue	38.9	38.9	39.1	40.0	40.3	40.4	40.3
General government expenditure	41.1	44.7	43.8	43.2	44.6	43.3	43.2
Net lending / Overall balance	-2.2	-5.8	-4.8	-3.3	-4.4	-2.9	-2.9
Primary balance	-1.2	-4.5	-3.4	-1.9	-2.9	-1.4	-1.3
Structural balance (in percent of potential GDP)	-4.5	-5.7	-4.9	-3.4	-3.6	-1.7	-1.7
General government debt	28.7	34.2	37.9	41.0	45.9	47.8	49.2
Money and credit (end of year, percent change)							
Broad money (M3)	13.6	0.2	1.9	2.8	4.8	1.6	2.9
Private sector credit	16.1	0.8	3.0	5.5	2.6	…	…
Interest rates (in percent, year average)							
Three-month interbank rate	4.0	2.2	1.3	1.2	1.0	…	…
Ten-year government bond	4.6	4.7	3.7	3.5	2.3	…	…
Balance of payments (percent of GDP)							
Trade balance (goods and services)	2.7	4.3	3.4	3.9	5.1	5.5	5.7
Current account balance	-2.1	-2.5	-3.8	-2.8	-2.4	-2.1	-1.9
Gross international reserves (US$ billion)	37.0	41.6	42.5	40.3	44.9	48.3	49.9
(in months of imports of goods and services)	3.2	4.5	4.0	3.2	3.7	3.8	3.7

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

1/ Assumes unchanged policies