August 2005
IMF Country Report No. 05/276

Czech Republic: 2005 Article IV Consultation—Staff Report and Public Information Notice on the Executive Board Discussion

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 2005 Article IV consultation with the Czech Republic, the following documents have been released and are included in this package:

- the staff report for the Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 24, 2005, 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 20, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its August 1, 2005 discussion of the staff report that concluded the Article IV consultation.

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.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

CZECH REPUBLIC

Staff Report for the 2005 Article IV Consultation

Prepared by Staff Representatives for the
2005 Consultation with the Czech Republic

Approved by Susan Schadler and G. Russell Kincaid

July 20, 2005

Article IV consultation discussions were held in Prague during May 11–24. The staff team, headed by Mr. Fernández-Ansola, included Mmes. Tamirisa and Tuladhar, and Mr. Ganelli (all EUR). The mission met with Governor Tůma of the Czech National Bank (CNB), Minister of Finance Sobotka, other senior officials, parliamentarians, and representatives of opposition parties, trade unions, financial institutions, foreign investors, and think tanks. Mr. Kiekens (Executive Director), Mr. Polak (Advisor to the Executive Director), and Mr. Rosenberg (Regional Resident Representative) attended some of the meetings. Mr. Fernández-Ansola participated in a press conference after the concluding meeting.

The previous consultation was concluded on August 6, 2004. The conclusion of the Executive Board's discussion and country documents are available at www.imf.org.

The Czech Republic subscribes to the Fund's Special Data Dissemination Standard, and its data provision to the Fund is adequate for surveillance. The country has accepted the Article VIII obligations and maintains an exchange rate system free of restrictions. In accordance with UN Security Council resolutions, the Czech Republic maintains restrictions on, and imposes sanctions against, individuals, groups, and organizations associated with terrorism.

Contents Page

Tables

Appendices

EXECUTIVE SUMMARY

Background and Outlook. Growth picked up significantly in 2004 driven by an investment and export surge related to EU entry, but inflation remained low, owing to continued slack in the economy. Supported by cross-border integration of production, strong export growth improved the external accounts. The fiscal deficit narrowed—reversing a widening trend—but largely because of one-off factors. Staff and the authorities shared the view that, under the baseline, growth will remain healthy in 2005–06, led by domestic demand and supported by net exports. Risks around this baseline appear evenly balanced. Headline inflation is expected to remain low in 2005–06 as continued economic slack and moderate wage growth are likely to contain second-round effects of oil price increases. All agreed that the Czech Republic's main problem is that growth might not be sustained if problems stemming from continued rigidities in the labor market and business-legal environment, and challenges from an aging population are not addressed. The authorities judged that consensus on their reform strategy might be elusive prior to June 2006 elections.

Policy Discussions:

Monetary policy: Current market and official expectations suggest that inflation is likely to remain below the 3 percent target through the end of 2006. However, uncertainties call for a cautious approach to future interest rate changes.

Fiscal policy: While a withdrawal of fiscal stimulus in 2004 was appropriate, staff is concerned that fiscal consolidation is set to be reversed in 2005. With growth remaining strong, staff emphasize the desirability of accelerating and deepening fiscal consolidation, particularly in light of the backloading of expenditure adjustment under the authorities' fiscal plans. Adjustment should come from expenditure reforms, and centered on entitlement reform and expenditure rationalization in all budget chapters. Sustained fiscal consolidation through the medium–term—focusing on pensions, healthcare, and benefits reform—is needed to prepare for aging.

Structural policy: All sides agreed that the pace of structural reform should be accelerated to sustain strong growth. Progress in improving the business-legal environment has been made, but more is required, and implementation of labor market reforms has been piecemeal. A virtually flat employment trend despite solid GDP growth in recent years suggests that the flexibility of the labor market may be eroding. Staff argue for a comprehensive agenda, combining labor market and entitlement reforms.

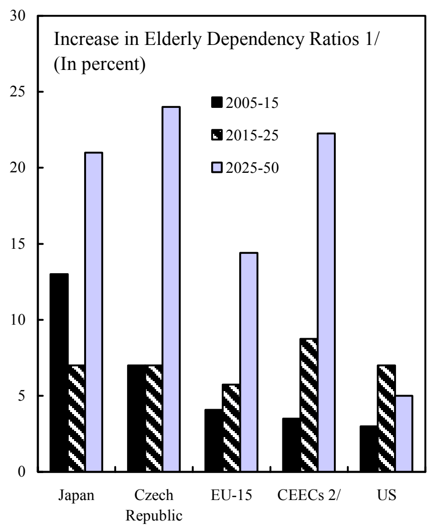
Financial sector: The financial system is sound, and well-positioned to withstand moderate macroeconomic shocks. Staff welcome progress made in strengthening the financial system, but recommend closer integration of stress-testing with bank supervision, and further improvements in data collection.

I. Introduction

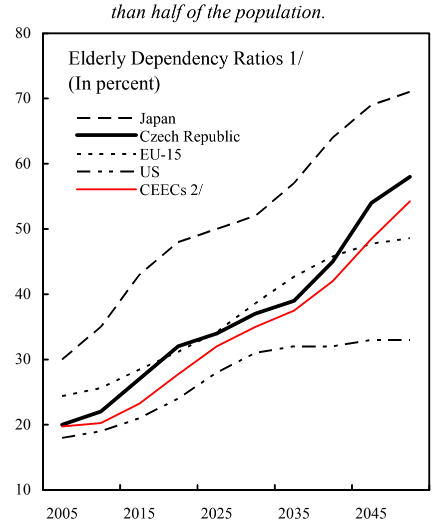
1. **Following a decade of moderate growth, the Czech Republic enjoyed a strong recovery last year, as it entered the European Union**. Investment surged, as external demand recovered and firms adapted to the EU environment. A record-breaking export performance narrowed the trade deficit, and growth rose. Fiscal developments were also positive, while inflation and real interest rates remained low, and the koruna appreciated. These accomplishments confirm the Czech Republic's strengths as one of the most open and advanced new EU members (Figure 1 and Table 1).

2. **However, raising or even sustaining growth in the future will require addressing key policy challenges**. Despite the recent spurt, growth has conformed to the modest trend of surrounding Central European Countries (CEECs) (Figure 1). Aging pressures—more pronounced than in most other OECD countries and CEECs—compounded by work disincentives for the young and a tendency of older workers to exit the labor market early, are set to harm growth and fiscal sustainability (text figure). Although public sector indebtedness is moderate at present, primary fiscal deficits are large (Figure 1). Obstacles to geographical mobility and skills mismatches between jobseekers and vacancies have perpetuated structural unemployment, and foreign investors consider that weaknesses in the business-legal environment could discourage future investment.

The Czech population is aging...

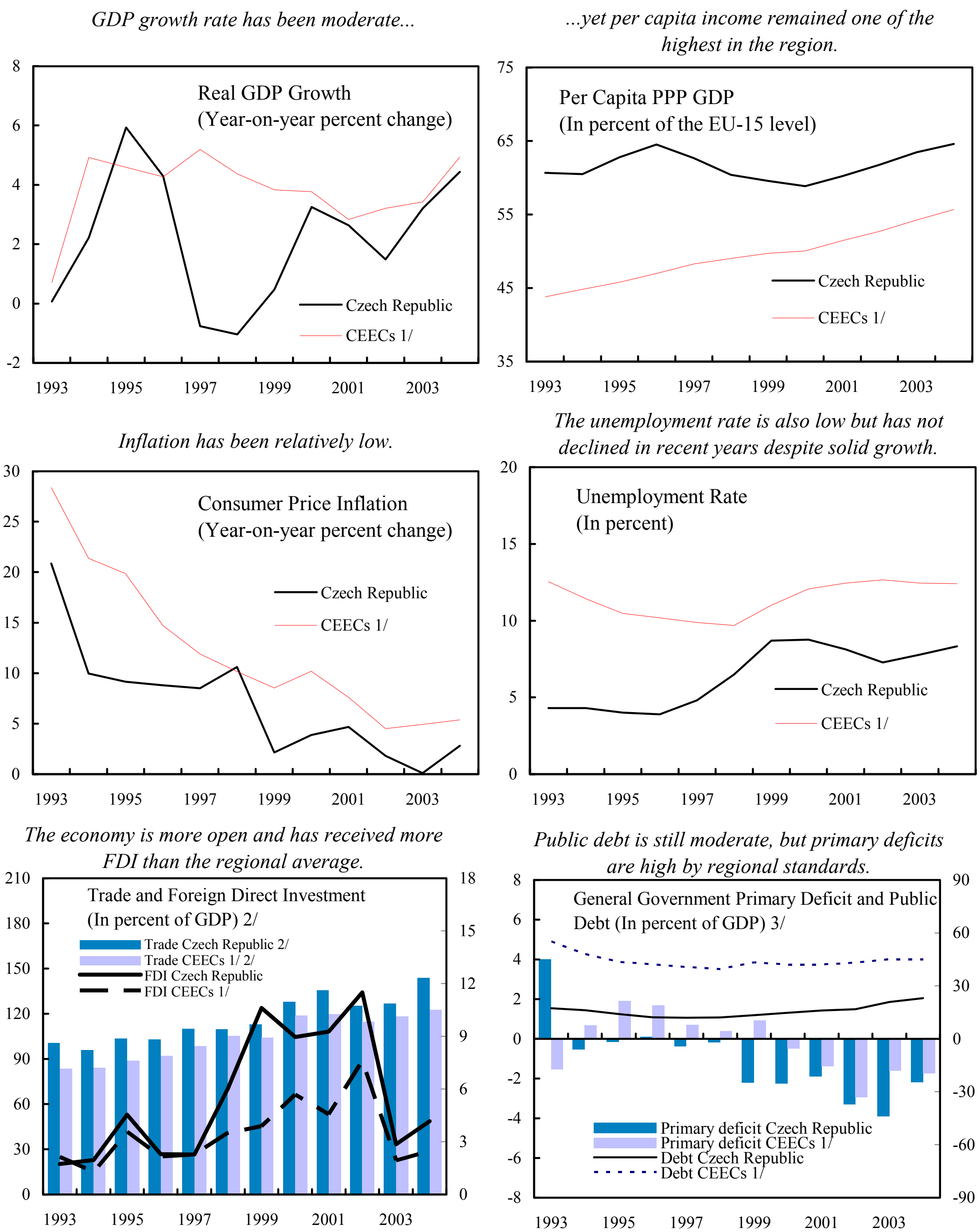


...and by 2050, the elderly will account for more than half of the population.



Source: United Nations.
1/ The ratio of the population aged 65 and above to the population aged 15-64.
2/ Average for Hungary, Poland, Slovakia, and Slovenia.

Figure 1. Czech Republic: A Decade of Reform, 1993-2004



Sources: WEO; Eurostat; and IMF staff estimates.

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

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

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

3. **Despite initial steps and the development of a medium-term strategy, overall progress in structural and fiscal reforms has been slow** (Box 1). The medium-term strategy aims to reach the EU average GDP per capita by 2013.[1] But consensus on key aspects of this strategy has been elusive among the governing coalition, which has a slim parliamentary majority. Pension, healthcare, and entitlements reforms are unlikely before the June 2006 parliamentary elections.

Box 1. Past Fund Policy Recommendations and Implementation

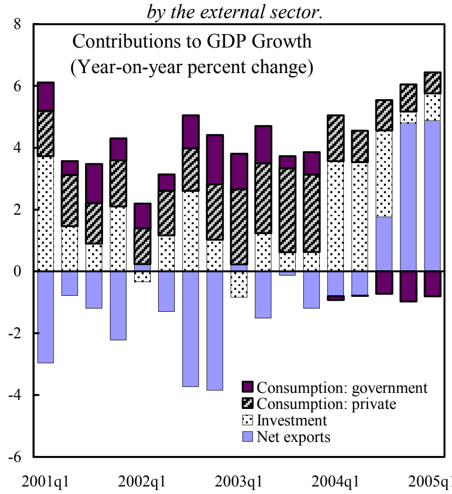
The pace of policy implementation has largely reflected difficulties in building domestic political consensus. Despite agreement on the need for fiscal consolidation, progress in expenditure reform so far has been slow. Although the authorities have made progress on privatization, key reforms to improve labor market flexibility and strengthen creditor rights, long supported by staff, are also lagging.

On monetary policy, the Fund has consistently supported the authorities' operation of the inflation-targeting regime, apart from some nuances on the timing of monetary policy responses to changing macroeconomic conditions. All agree on the need to continue to strengthen monitoring of systemic sources of risks, and for the authorities to develop stress testing as a way to supervise more proactively the financial sector.

II. Background

4. **Buoyant exports and investment supported brisk economic activity in 2004**. Annual growth reached almost 4½ percent. The contribution of the external sector turned positive, and export-related investment rose in response to the growing cross-border integration of production (text figure and Figure 2). Foreign-owned firms now account for most industrial exports. Household consumption grew only modestly, as lagging employment weighed on disposable incomes, and government consumption declined. In the second half of 2004, in line with regional developments, growth started to lose steam, as domestic demand weakened. However, it remained firmer than in other CEECs, sustained by healthy export growth and a rising external sector contribution. Quarter-on-quarter export and import

Growth is increasingly driven by the external sector.

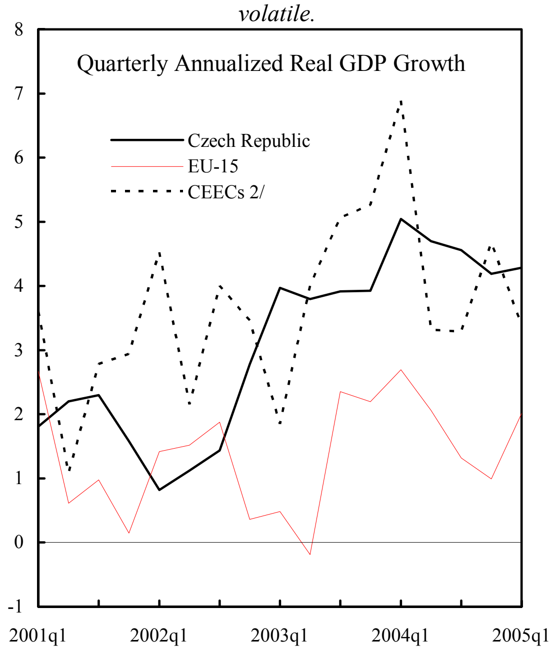


Source: Czech Statistical Office.

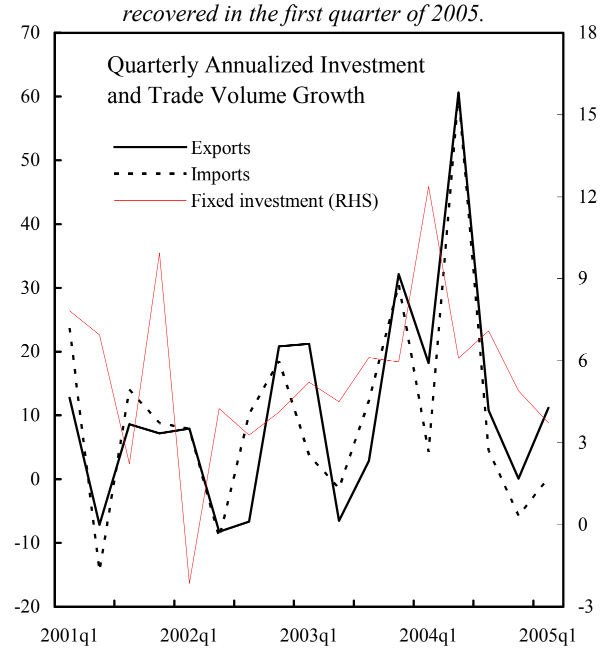
[1] *Economic Strategy for the Czech Republic* prepared by the Prime Minister's Office, Prague, Czech Republic, June 2005.

Figure 2. Czech Republic: Growth Developments, 2001-05 1/
(In percent)

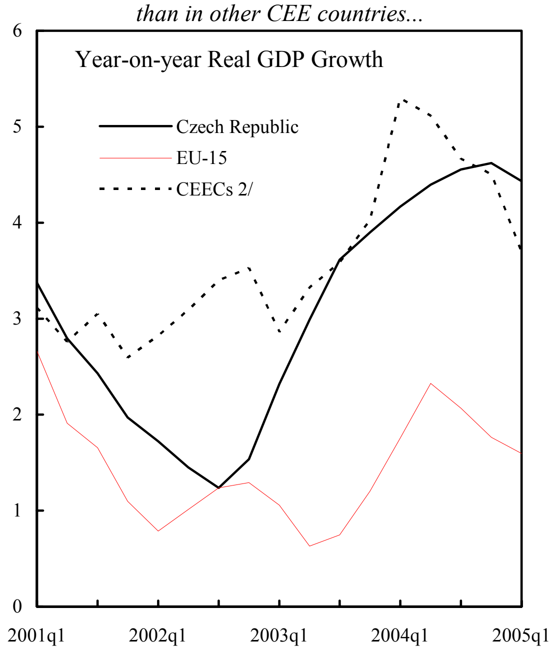
Growth followed regional patterns, but has been less volatile.



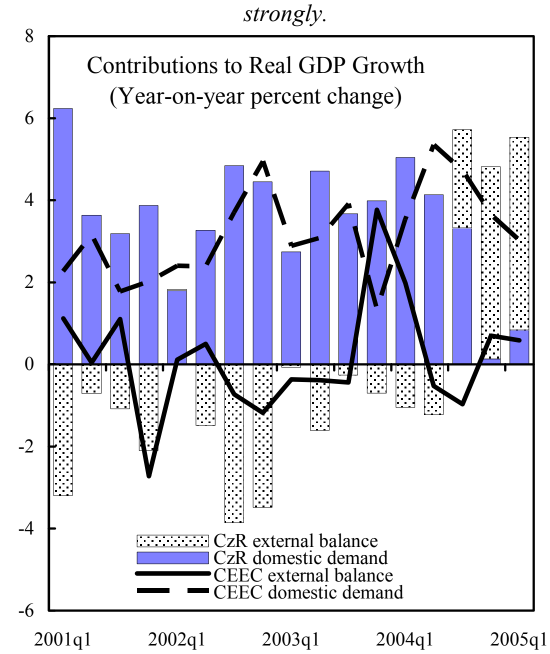
Following a slowdown in late 2004, exports and imports recovered in the first quarter of 2005.



Year-on-year GDP growth has slowed, but less so than in other CEE countries...



...as the external sector contribution increased more strongly.

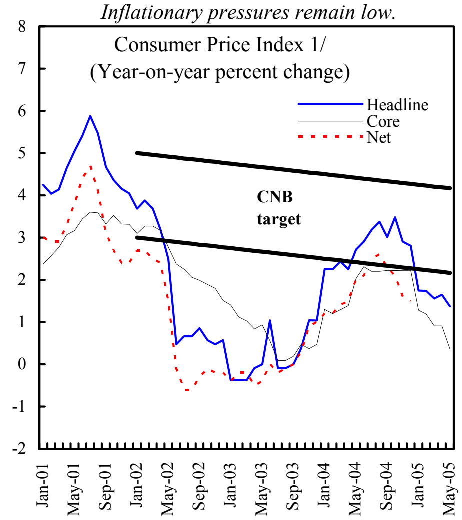


Sources: Czech Statistical Office; Eurostat; and IMF staff estimates.
1/ All series are seasonally adjusted.
2/ Average for Hungary, Poland, the Slovak Republic, and Slovenia.

growth increased in the first quarter of 2005, and investment growth was positive. Given the strong correlation of Czech exports and industrial production with German leading indicators, the near-term outlook for exports and investment remains favorable (Figure 3).

5. **Despite the economic recovery, employment rose only modestly in 2004 due to ongoing restructuring** (Figure 4). Foreign direct investment and continued restructuring led to a significant pickup in labor productivity, but structural unemployment persisted, owing to skills and regional mismatches and policy-induced disincentives to work. Restrained by cyclical unemployment, wages grew moderately, which, combined with productivity increases, resulted in a modest increase in unit labor costs.

Inflationary pressures remain low.



Sources: Czech National Bank; Czech Statistical Office; and Eurostat.

1/ Net CPI excludes the contribution of changes in indirect taxes and regulated prices.

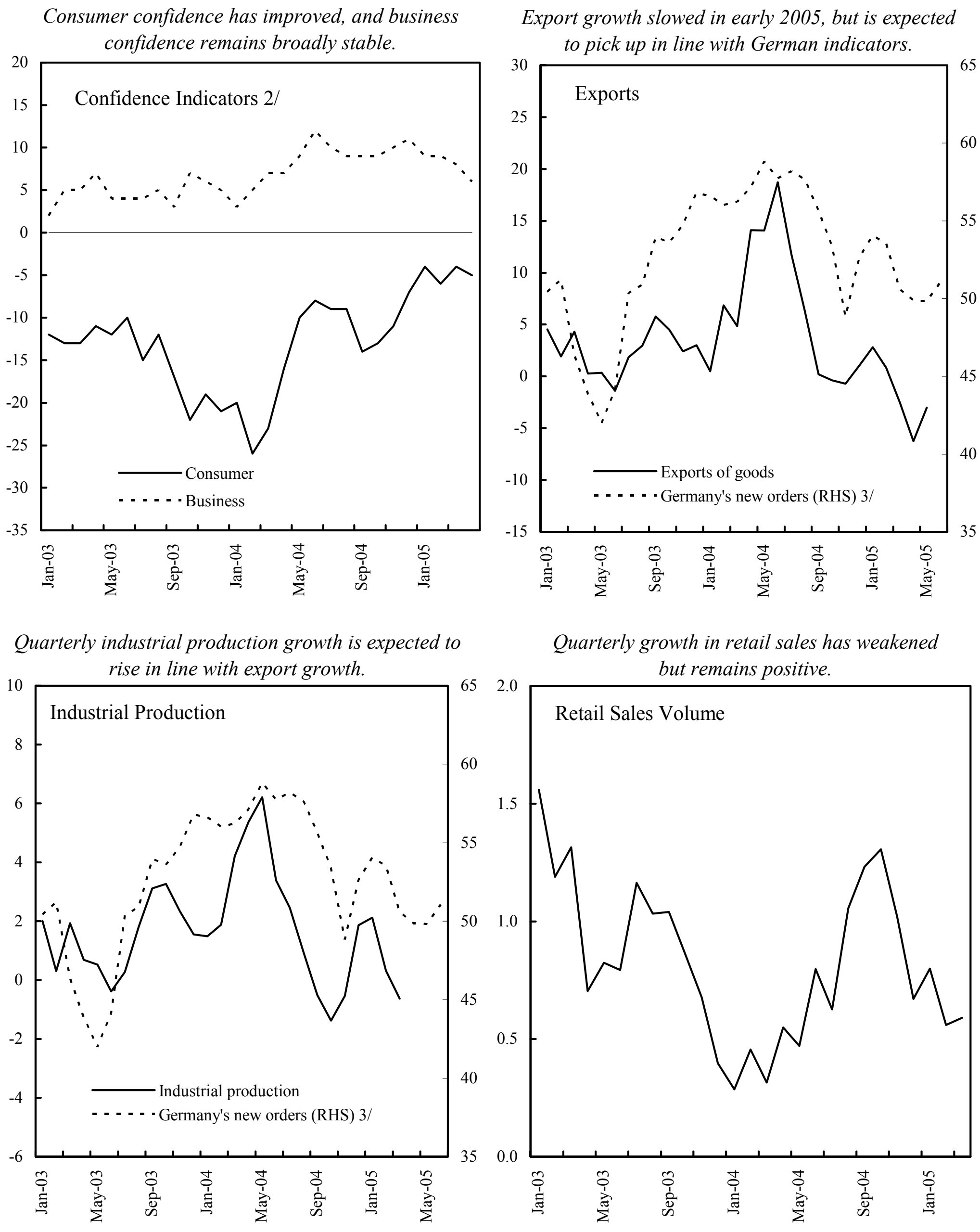
6. **Thus far, output growth has not had discernible effects on inflation or the current account**. With new additions to productive capacity and strong productivity growth, there seems to be more slack in the economy than previously anticipated, and the authorities and staff have revised potential output series, implying a negative but small output gap in 2004–05 using staff GDP projections. Together with low inflation expectations, this has helped contain wage increases and inflation. A fortuitous combination of koruna appreciation, good harvest, and strong retail competition also kept core inflation low in 2004 (text figure and Figure 5). With exports outpacing imports and the terms of trade improving, trade was nearly balanced in 2004, and the current account deficit narrowed substantially. The latter was largely financed by FDI (Table 2 and Figure 6).

7. **New budgetary rules and strong growth helped narrow the general government deficit in 2004**. The adjusted general government deficit declined from above 4¾ percent in 2003 to 3¼ percent in 2004 (6 percent had been expected in the budget) (Table 3).[2] Almost 1 percentage point of the decline in the deficit reflected changes in the budgetary rules that

---

[2] The adjusted deficit is a cash-based definition consistent with GFS 86, which excludes privatization receipts and transfers to the Czech Consolidation Agency (CKA) but includes nonprivatization net lending. The authorities use an alternate cash-based deficit definition for their targets, which excludes privatization receipts, net lending, and transfers to transformation institutions. An accrual-based ESA 95 deficit measure is used for the Convergence Program targets. Fiscal analysis in this report is based on the adjusted deficit definition, since detailed fiscal tables are available only on this basis. Differences between the adjusted deficit and ESA 95 methodology are explained in Appendix II.

Figure 3. Czech Republic: Leading Indicators, 2003-05 1/
(Quarter-on-quarter percent change, unless otherwise indicated)



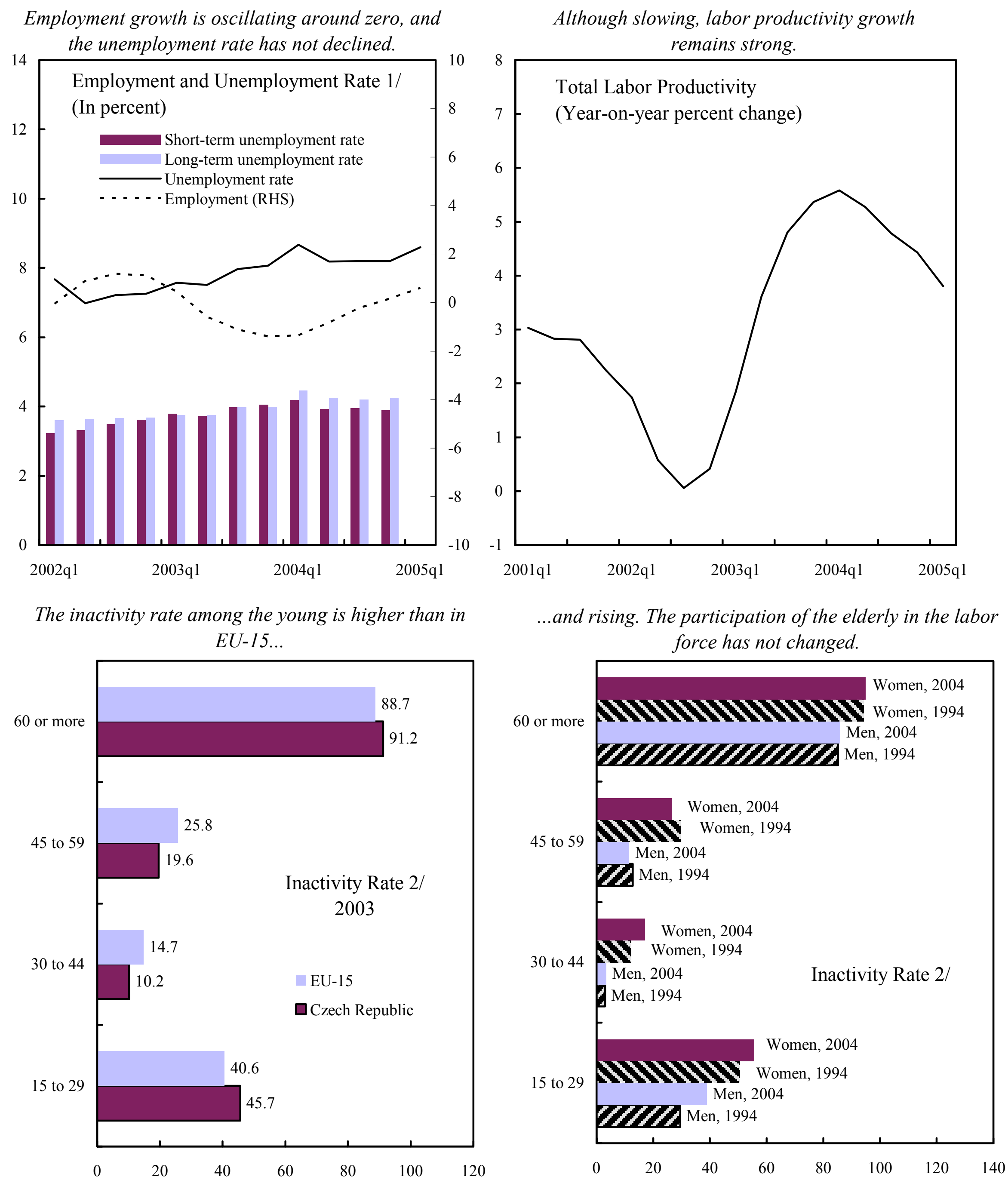
Sources: Eurostat; Reuters; Czech Statistical Office; and IMF staff estimates.

1/ All series are seasonally adjusted.

2/ Indices are survey-based, weighted average of seasonally adjusted confidence indicators, 1995=100. Consumer confidence indicator is composed of expected financial situation of consumers, expected total economic situation, expected total unemployment, and expected savings in the next 12 months. Business indicator covers industry, construction, and trade.

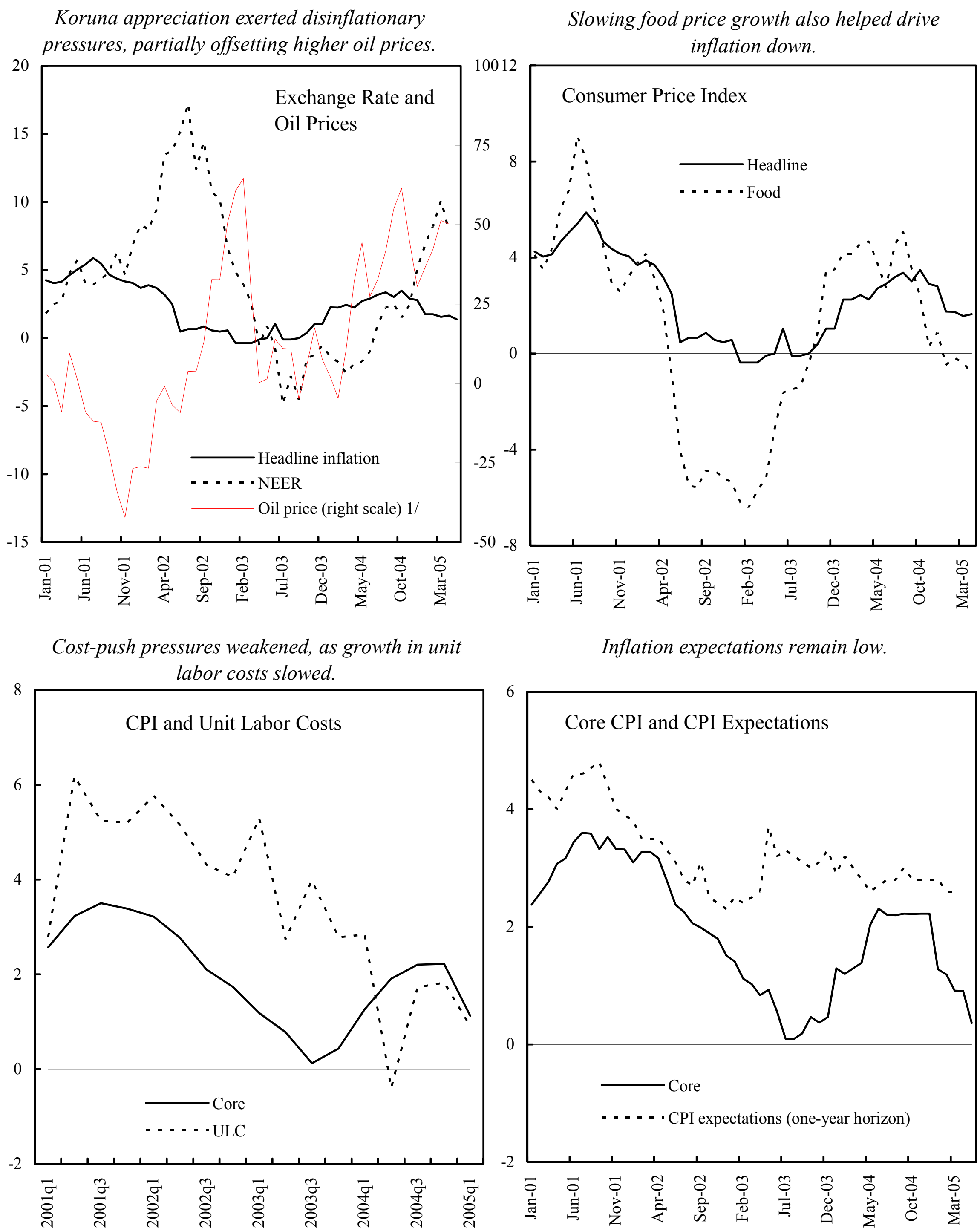
3/ Purchasing managers' index in manufacturing, new orders (the right scale). This survey-based index measures the prevailing direction of change in business conditions at individual company level. An index reading above 50.0 indicates an overall increase in new orders, below 50.0 an overall decrease. The greater the divergence from 50.0, the greater the rate of change signalled.

Figure 4. Czech Republic: Labor Market Indicators, 1994-2005



Sources: Czech National Bank; Eurostat; Czech Statistical Office; and IMF staff estimates.
1/ Unemployment rates are in percent of total labor force. Employment is measured in thousands, as a year-on-year percent change.
2/ In percent of population for the respective cohort.

Figure 5. Czech Republic: Inflation Developments, 2001-05
(Year-on-year percent change, unless otherwise indicated)



Sources: Czech National Bank; Czech Statistical Office; Eurostat; and IMF staff estimates.
1/ In dollars per barrel.

allowed line ministries to carry over unspent allocations to future years.[3] It also reflected some reduction in sickness benefits and public employment. At the same time, tax revenues, adjusted for collection delays relating to EU accession, remained strong, given a pickup in growth and the harmonization of indirect taxes with the EU.

8. **In line with regional trends, market sentiment on the Czech Republic remains positive**. Supported by a rebalancing of investors' portfolios following accession of CEECs into the EU, portfolio outflows reversed in 2004 (Figure 6). Ample global liquidity and the favorable performance of the Czech economy helped lower spreads. Long-term interest rates and sovereign bond spreads are similar or narrower than those for other CEECs (Figure 7). Following depreciation in 2003, the koruna strengthened in 2004–early 2005, in line with regional trends, although interest rate increases in the summer of 2004 might have also contributed. Appreciation has slowed recently, possibly reflecting a smaller risk appetite by investors and greater uncertainty following rejection of the EU constitution by some countries, as well as the April cut in policy rates.

III. Report on the Discussions

9. **Discussions covered demands on policies in the face of weakening activity in Europe, difficult fiscal problems, and an aging population**. The key issues were the sustainability and credibility of fiscal policy, structural reforms to support the medium-term growth objectives, and the maintenance of a monetary policy attuned to an evolving macroeconomic situation. The authorities saw maintaining fiscal policy within the Convergence Program parameters as the immediate priority. They were also trying to lay the groundwork for reforms that could be implemented following the 2006 elections. While recognizing the uncertainty surrounding long-term simulations, all agreed that population aging, a focus of this year's consultation, would have tangible effects on growth and the fiscal balance (Box 2). Dealing with these effects requires an integrated policy response comprising fiscal reforms, efforts to promote labor force participation and labor market flexibility, and measures to improve the business-legal environment.[4] The authorities acknowledged that these policies were also essential to support investment, which was key to realizing the favorable growth scenario they envisaged.

10. **Recognizing that euro adoption goals provide direction to policies, the authorities noted that the exact timing for adoption would be revisited after the elections**. The goal is to adopt the euro around 2009–10, and the authorities' euro area accession strategy emphasizes the importance of appropriate preconditions for joining. The

---

[3] Unused allocations for cofinancing of EU transfers accounted for about 20 percent of the total carryover amount, while about 60 percent represented current spending.

[4] *Selected Issues* papers.

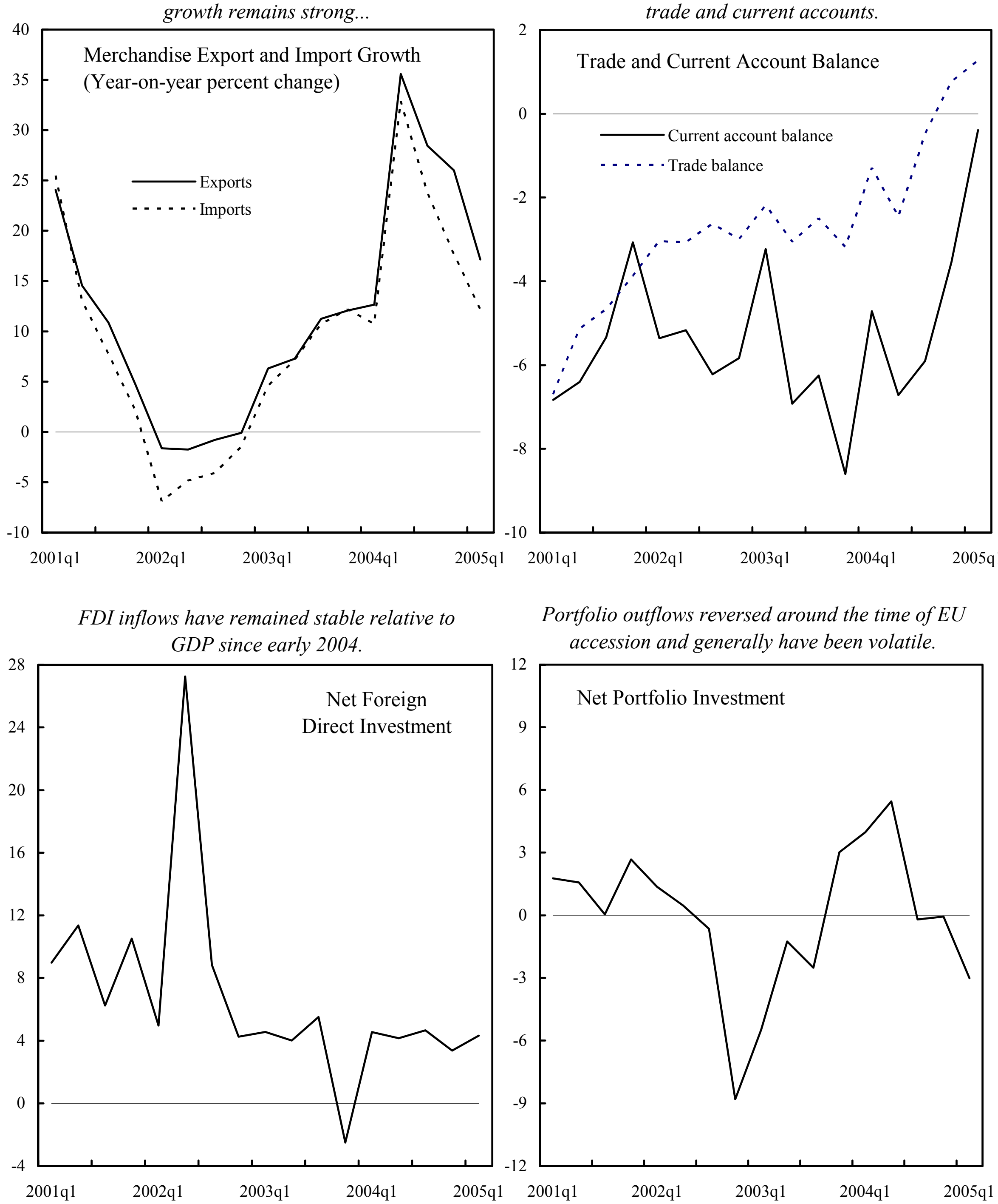
Figure 6. Czech Republic: External Sector Developments, 2001-05
(In percent of GDP, unless otherwise indicated)

Although slowing from exceptional rates, export growth remains strong...

...and has led to a significant narrowing of the trade and current accounts.

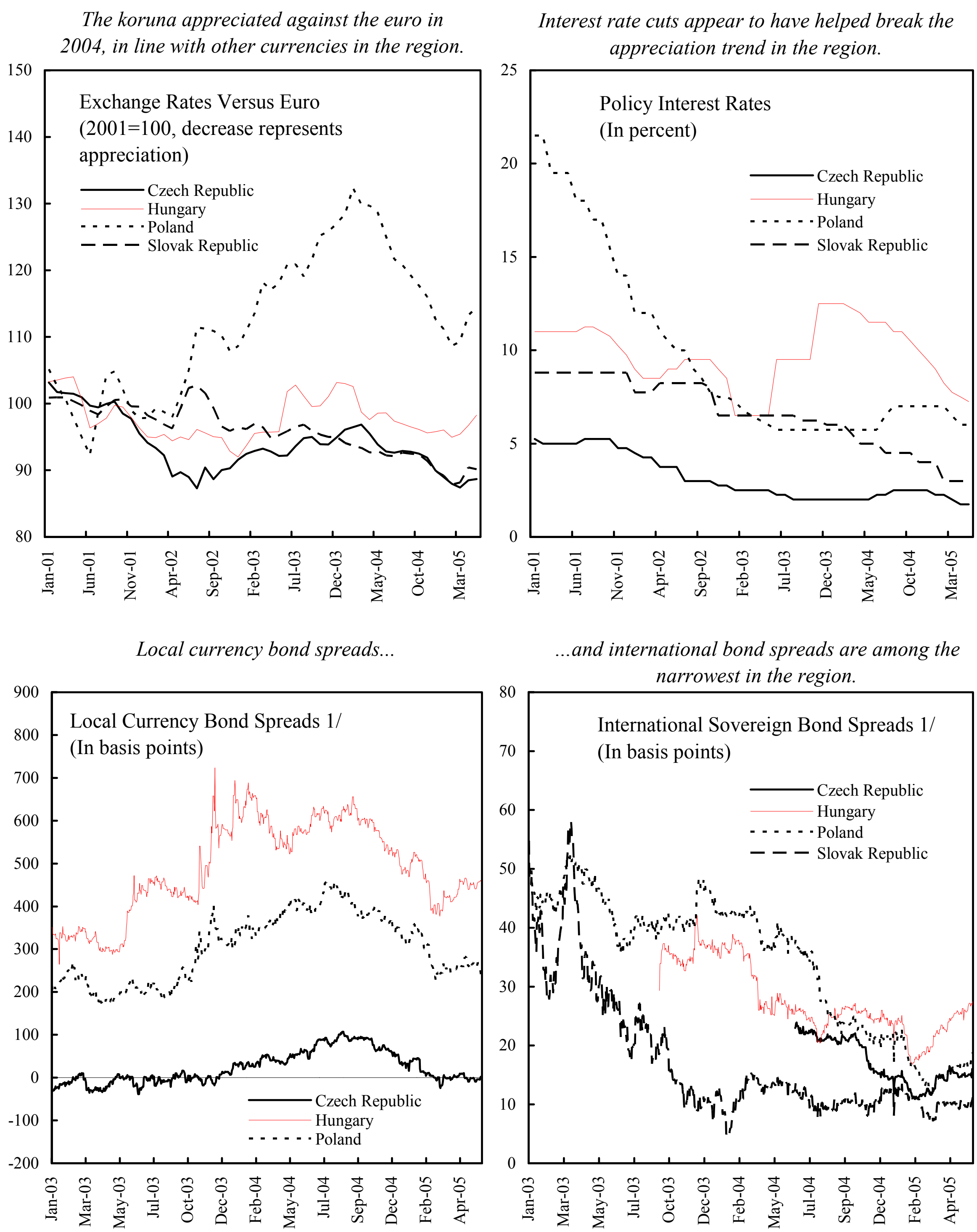
FDI inflows have remained stable relative to GDP since early 2004.

Portfolio outflows reversed around the time of EU accession and generally have been volatile.



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

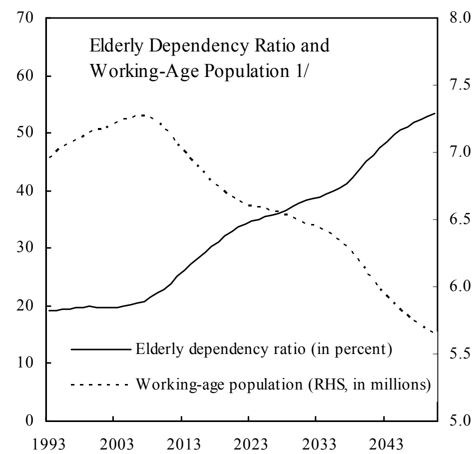
Figure 7. Czech Republic: Financial Indicators, 2001-05



Sources: Bloomberg; Czech National Bank; and IMF staff estimates.
1/ Relative to Germany.

Box 2. How Will Population Aging Affect the Czech Economy?[1/]

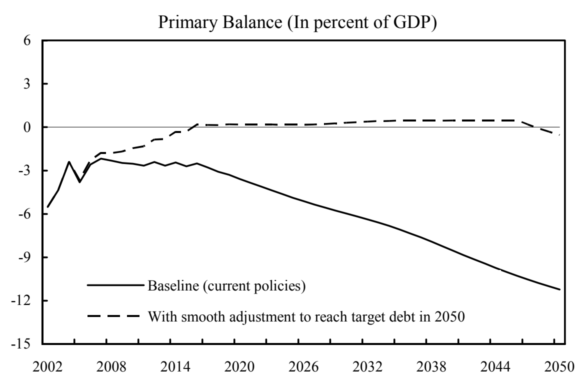
The Czech Republic faces a severe **demographic shock** in the coming decades. With rising longevity and the second-lowest fertility rate in the world, the Czech population is aging and projected to get smaller. By 2050, the elderly will account for 53 percent of the population, and the working-age population will shrink by 22 percent compared with 2005.



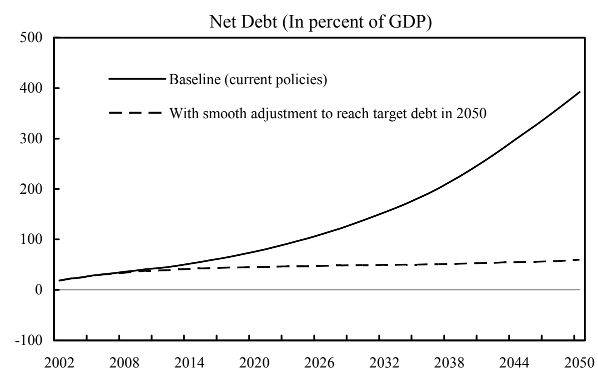
Source: Czech authorities.
1/ The ratio of the population aged 65 and above to the population aged 15-64.

Staff simulations show that the **macroeconomic implications** of population aging are likely to be significant. As the active labor force shrinks, employment, consumption, investment, and total and per capita real GDP will decline.

Under prevailing policies, staff project budgetary spending on pensions and health care to rise to 22 percent of GDP by 2050 from about 14 percent in 2005. Using a long-term debt sustainability and fiscal scenario analysis based on the generational accounting framework, staff projects an **unsustainable fiscal position,** with debt reaching 100 percent of GDP by 2025. The intertemporal fiscal gap—the adjustment in the primary deficit needed to meet the intertemporal budget constraint—is estimated at over 10 percent of GDP in net present value terms. Every two-year delay will raise the needed adjustment by ⅓ percent of GDP. To maintain net debt at 60 percent of GDP by 2050, a smooth adjustment targeting a primary balance or a small surplus beginning early in the next decade would be needed.



Source: IMF staff estimates.



Private saving remains inadequate in the face of population aging. Staff estimates that household financial assets—currently around 140 percent of disposable income—need to rise to be consistent with the structural determinants observed in more advanced countries and to prepare for aging. Households also need to redistribute their assets from nonfinancial assets, currently accounting for 60 percent of their total assets, and low-return financial assets into more strategic forms of long-term investment.

[1/] For more details, see *Selected Issues* papers.

authorities agreed that euro adoption could bring gains for trade and growth, provided supporting policies were strong, and recognized that reducing the fiscal deficit in a sustainable manner was the main challenge. They were also concerned that adopting the euro without addressing the fiscal and structural rigidities could lead to a prolonged period of slow growth. Staff agreed that fiscal and structural reforms were essential to avoid a slow-growth equilibrium in the euro area.

A. Economic Outlook

11. **There was a broad agreement about the outlook for 2005–06, with all predicting rising consumption and a deceleration of investment and exports from exceptional rates in 2004** (Table 4). While investment will slow, reflecting the disappearance of one-off factors in 2004 and recent appreciation, high profitability and continued FDI and infrastructure investment should prevent more than a moderate deceleration. Softer external demand and koruna appreciation are also expected to lower year-on-year export growth. Private consumption is likely to strengthen, benefiting from higher employment and wage growth, and anticipation of income tax cuts. The government is expected to provide a positive stimulus in 2005. Staff, thus, projects growth of 4 percent in 2005–06, with the trade account posting a surplus and the current account deficit narrowing to just over 3 percent of GDP. Leading indicators and first quarter results for 2005 are broadly consistent with the baseline forecast (Figure 3), and risks around it appear evenly balanced. On the one hand, a slowdown in the EU, higher oil prices, and weaker employment would dampen growth. On the other, a pickup in EU growth compared to baseline, a larger-than-expected fiscal impulse or faster wage growth would stimulate growth in the short run.

12. **Over the medium term, strong prospects for growth and sustainable macroeconomic balances will require fiscal adjustment**. In line with the authorities' view, staff estimates potential growth at less than 4 percent, although all acknowledge that estimates of potential output are not precise. Assuming labor market reforms proceed at the historically gradual pace, the projected increase in labor force participation is unlikely to offset the decline in the working-age population due to aging (Box 2). This would lead to a decline in the labor factor (text table). Total factor productivity is assumed to grow in line with recent history and at rates similar to those observed in the EU-15 catching-up countries (Greece,

Decomposition of Growth, 1995-2010 1/
(In percent)

	Actual		Potential	
	1995-99	2000-04	2005-06	2007-10
GDP Growth	1.9	3.1	3.6	3.6
Labor	-0.5	-0.1	-0.1	-0.1
Capital 2/	1.8	1.4	1.9	2.0
TFP	0.5	1.8	1.8	1.7

1/ Based on two alternative models of a transition economy: a one-sector model with a constant depreciation rate and a two-sector model with an "old technology" sector characterized by an initially higher, declining depreciation rate and a "new technology" sector with a lower, constant depreciation rate.
2/ Capital stock data are not available. Calculations assume a capital-output ratio of 4 and a 35 percent depreciation in 1994. In the following years, the rate of depreciation is assumed to remain constant at 5½ percent in the one-sector model and converge to 5½ percent in the two-sector model.

Ireland, Portugal, and Spain), based on continued FDI inflows, especially in skill-intensive activities. Access to EU funds should also help upgrade infrastructure. A sizable fiscal consolidation over the medium term would be needed to accommodate strong fixed investment, while keeping the current account deficit below 3 percent of GDP and debt ratios on a sustainable path.

B. Fiscal Policy

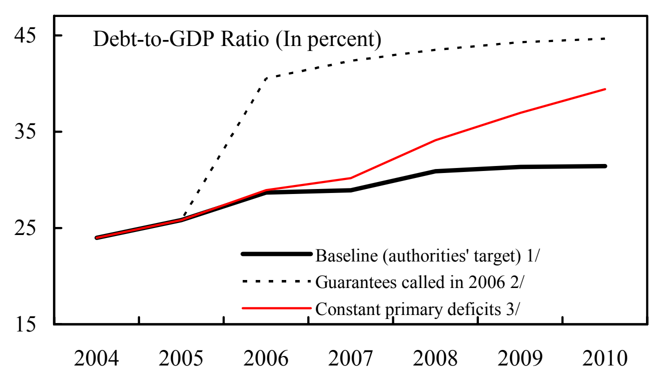
13. **The authorities have outlined a fiscal adjustment plan that seeks to reverse the general trend over the past six years toward larger primary deficits and meet the Maastricht deficit criterion by 2008** (text table). The plan—broadly consistent with the Czech Republic's Convergence Programme—is underpinned by annual expenditure ceilings and a rolling three-year fiscal framework. With primary deficits among the highest in the EU and rising, the fiscal plan seeks to avoid a rapid build-up of debt (Figure 8). In response to regional tax competition and to increase supply-side incentives, the authorities have started to phase in reductions in corporate income taxes, cumulatively amounting to about ¾ percent of GDP over 2004–06. In addition, they are planning to introduce permanent personal income tax cuts for low- and middle-income taxpayers of about ⅓ percent of GDP in 2006. Thus, further adjustment needs to rely on expenditure reductions. The authorities have broadly identified spending reform measures in the areas of social benefit reform, public employment and wages, and discretionary cuts in all budgetary chapters, but these have yet to be approved.

Medium-Term Deficit Targets 1/

	2004 2/	2005	2006	2007
ESA-95	3.0	5.0	3.8	3.3
Authorities targeted definition 3/	2.8	4.4	3.4	3.3
Adjusted deficit 4/	3.3	4.9	3.9	3.8

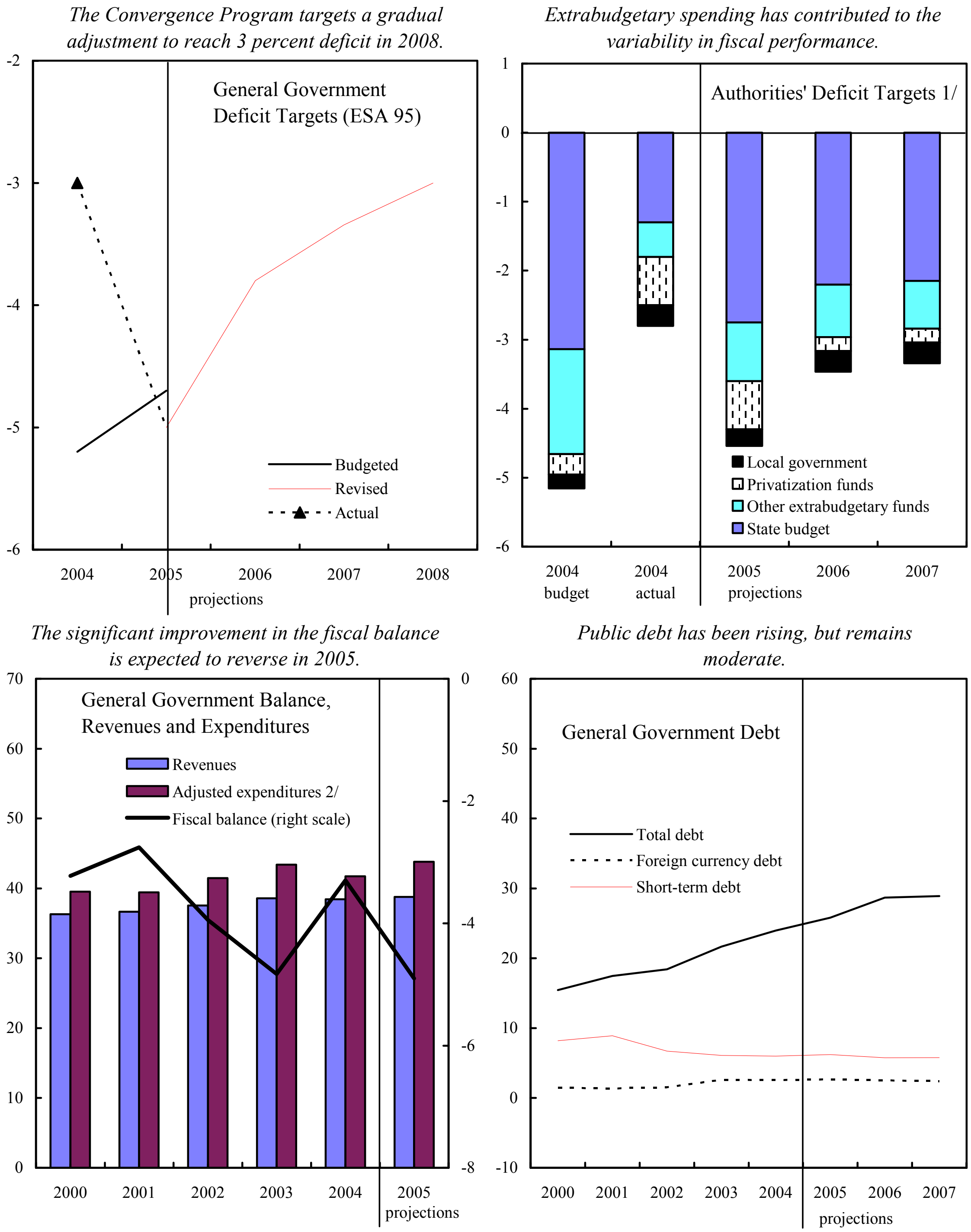
1/ In percent of GDP.
2/ 2004 data is actual.
3/ Excluding privatization revenues, net lending and transfers to transformation institutions; including approved spending from reserves in 2005.
4/ Corresponds to the authorities' targeted definition and non-privatization net lending of 0.5 percent, as budgeted in 2005; includes approved spending from reserves in 2005.

14. **Staff viewed these targets as adequate given debt sustainability considerations, but expressed concerns about risks to the fiscal plan**. Under the staff's baseline scenario, assuming the authorities adhere to their 2005–07 plan and continue consolidation to bring the deficit to around 2½ percent of GDP by 2010, public debt is projected to reach around 30 percent of GDP by 2010 (text figure and Table 6). Adhering to this smooth adjustment path up to 2010 and thereafter achieving structural balance by 2015 is needed to maintain



Sources: Country authorities; and IMF staff estimates.
1/ Assuming GDP growth rate of 3.7 percent, real interest rate of 1.7 percent and deficit path approaching about 2.5 percent in 2010.
2/ Assuming high-risk guarantees and 60 percent of other guarantees (excluding ecological ones) are called in 2006.
3/ Assuming a constant primary deficit of 3.2 percent, corresponding to the 2002-04 average.

Figure 8. Czech Republic: Fiscal Policy Indicators
(In percent of GDP)



Sources: Ministry of Finance; and IMF staff estimates and projections.
1/ Excluding privatization revenues, net lending and transfers to transformation institutions; including approved spending from reserves in 2005.
2/ Excluding privatization net lending and transformation institution grants.

a sustaninable debt ratio in the face of aging pressures (Box 2). Staff noted, however, that even in this relatively favorable scenario, there would be risks. A large share of outstanding guarantees is considered to be high risk and could be called.[5] If commitment to reform were to wane and primary deficits remained at the average level of 2002–04, debt could climb to 40 percent of GDP by 2010. In this scenario, the easy financing conditions the government has enjoyed so far may not last, and debt servicing costs would rise. An immediate challenge to the credibility of the authorities' fiscal plan is that adjustment is back-loaded to 2006–07, while significant permanent measures needed to achieve this adjustment have not yet been approved.

15. **Staff argued for bolstering the plan's credibility by shifting forward to 2005 part of the adjustment and adopting permanent measures to meet the medium-term plans**. Current budgetary plans for 2005 imply a significant expansionary stance relative to GDP—a 1½ percentage point increase in the adjusted deficit, including approved spending from last year's reserves of ½ percent of GDP—which would neither be apt with growth running at close to potential nor consistent with the strategy of gradual consolidation (text table).

Staff's Fiscal Recommendations, 2004-07

		2004	2005	2006	2007
		Actual	Projections		
	(In percent of GDP)				
(1)	Adjusted deficit 1/	-3.3	-4.9	-3.9	-3.8
(2)	Recommended adjustments 2/	...	1.0	...	...
(1)-(2)	Recommended deficit	-3.3	-3.9	-3.9	-3.8
	Change	...	-0.6	0.0	0.1
	of which:				
	Tax measures 3/	...	...	-0.4	-0.2
	One-offs 4/	...	...	...	-0.6
	Required additional adjustment 5/	...	...	0.4	0.9
	Memo: Cyclically adjusted recommended deficit	-3.0	-3.8	-3.7	-3.1

1/ Corresponds to the authorities' target (excluding net lending, transfers to transformation institutions and privatization receipts) plus non-privatization net lending of 0.5 percent. The 2005 deficit includes approved spending from reserves of 0.5 percent.
2/ Lower-than-budgeted goods and services spending (0.9 percent of GDP) and privatization-financed extrabudgetary fund spending (0.1 percent of GDP) in line with the 2004 outcome.
3/ Based on the 2004 tax measures identified and estimated in the Convergence Program, adjusted for collection delays, R&D allowance, tobacco excise tax hikes, higher expense deductions for self-employed, and reduced income tax rates for low wage earners.
4/ A CNB guarantee called in 2004, payment planned in 2007.
5/ The authorities have proposed expenditure measures relating to sickness benefits, public employment and wages, social support benefits, and discretionary cuts in 2006 and 2007. It also plans lower privatization fund spending in 2006.

Staff observed that lowering the deficit by 1 percent of GDP relative to the authorities' 2005 target would ensure the credibility of the consolidation plan and contain growth in public

[5] Guarantees total the equivalent of 16 percent of GDP, excluding ecological guarantees that are not quantified.

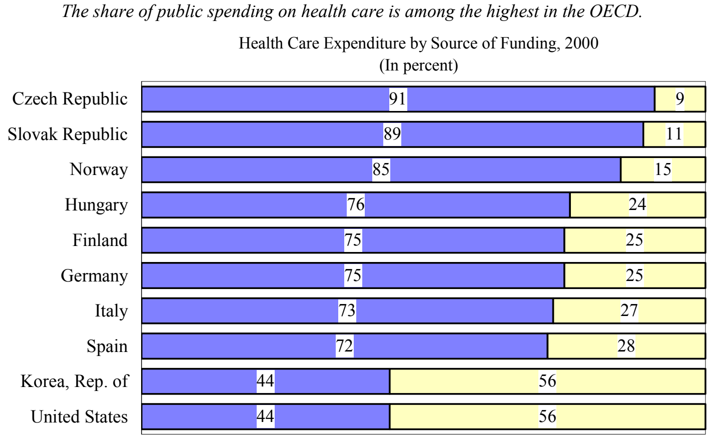
debt in the face of significant long-term debt sustainability pressures. In addition, front-loading of adjustment to 2005 would limit a procyclical fiscal stimulus in 2005 and minimize inefficient spending implied by the significant carryover from the 2004 allocation apart from cofinancing for EU transfers. This could be achieved by maintaining the growth of discretionary spending on goods and services at historical rates, and containing extrabudgetary fund spending financed out of privatization revenues at the 2004 levels. Even if the authorities were to implement staff's recommendations for 2005, reducing the deficit in 2006–07 would still require expenditure measures amounting to a cumulative 1⅓ percent of GDP. The mission urged the authorities to specify their plans for permanent savings in 2006–07 soon.

16. **Although the authorities agreed that front-loading consolidation is desirable, they thought that the scope for savings in 2005 was smaller than suggested by staff**. They noted that work on systemic expenditure reform was not sufficiently advanced to allow implementing measures in 2005. Moreover, they viewed the 2004 overperformance as one-off, related to EU-entry and changed budgetary rules allowing the carryover of unspent allocations, and noted election-year spending pressures, increasing demand for cofinancing of EU transfers, and downward risks in VAT collections. In this context, staff expressed concerns that the recently-proposed measures to lower personal income taxes could undermine fiscal targets, and cautioned that any further tax cuts need to be offset through expenditure cuts or base-broadening measures.

17. **The authorities shared staff concerns about longer-term budgetary pressures from population aging**. The rapid rise in elderly dependency ratio and the high public burden of age-related spending (text figure) calls for decisive reform in pensions, healthcare and social benefits (Box 2).

- On **pensions**, despite the recent increase in the statutory retirement age and elimination of an overly generous early retirement scheme, the system remains unsustainable. An expert committee has completed technical work on reform options. As there is little scope to increase payroll taxation, most proposals focus on changes in system parameters while some also consider introducing a voluntary second-pillar private pension system or a notionally defined contribution system. Staff agreed on the need to increase the retirement age from its still-low level by international standards, but further reforms might be needed given the large size of the expected fiscal gap. In the

The share of public spending on health care is among the highest in the OECD.

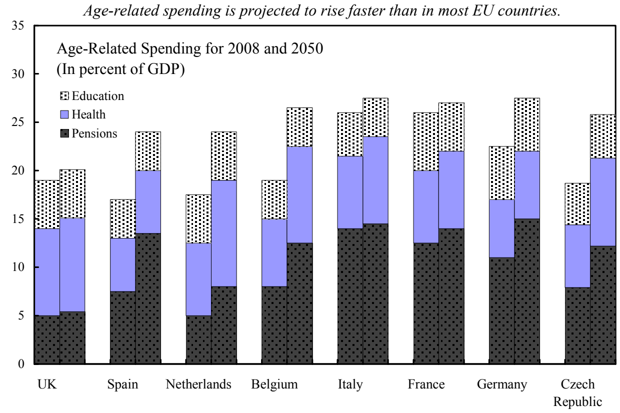


Source: OECD (2005)

meantime, staff suggested keeping pension indexation to the legal minimum.

- On **healthcare**, the authorities recognized that the system was unsustainable because of poor incentives for cost control by providers and virtually free services for users. Insurance companies do not have actuarial and control roles, but mainly channel funds from taxpayers to service providers. As a result, sizable arrears have built up, and yet another bailout of health insurers is under discussion. Staff emphasized that instead of stopgap measures, systemic reforms focusing on both the demand and supply of health services were needed to limit moral hazard and prepare for the demands of elderly care.

Age-related spending is projected to rise faster than in most EU countries.



Sources: HM Treasury (2004); European Commission's Assessment of Member States' Stability and Convergence Programmes (2004); and IMF staff estimates.

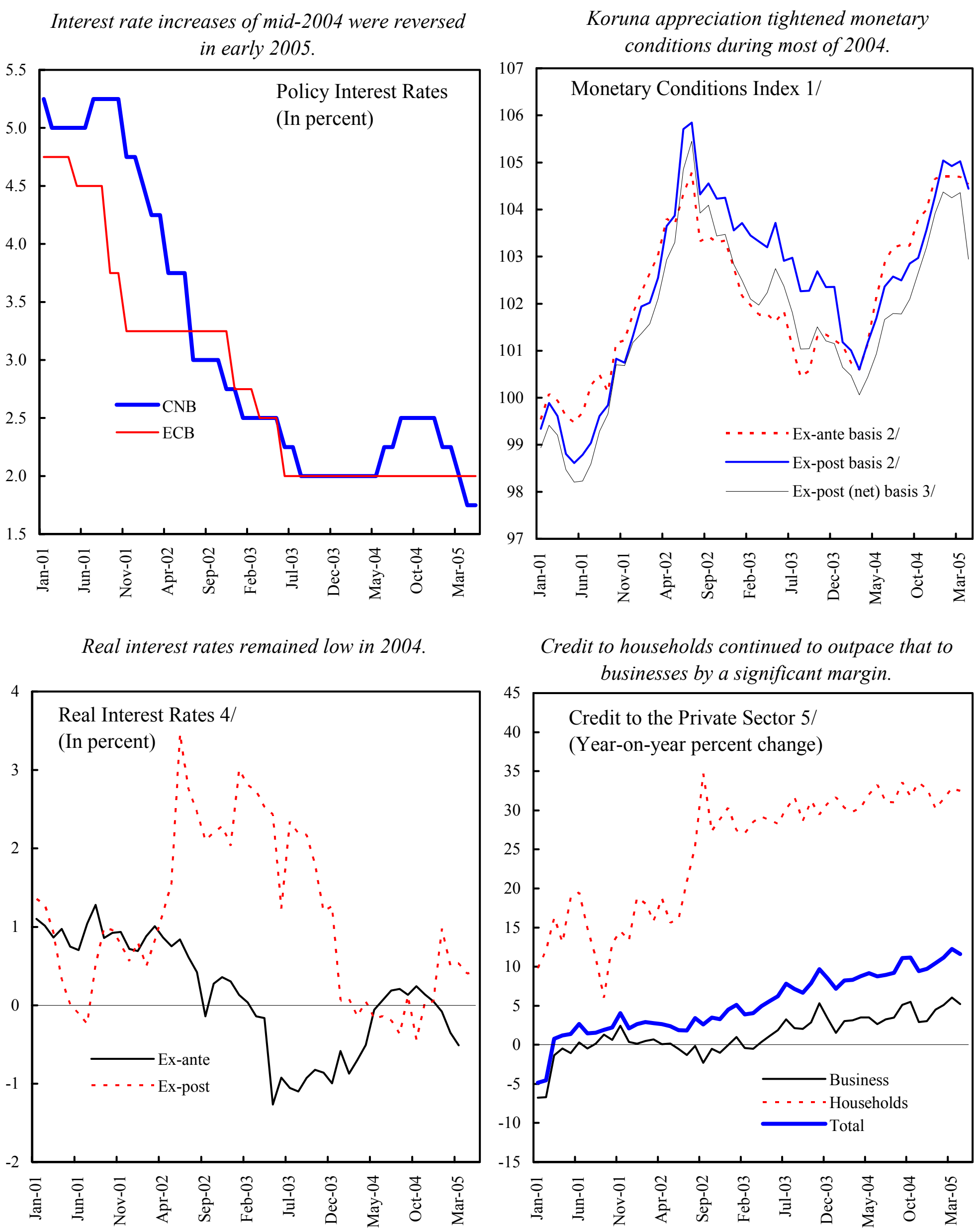
18. **A stronger fiscal framework would help reinforce discipline at a time of increasing risk of fiscal drift**. The authorities acknowledged that budgetary shortcomings, as reflected in persistent underspending of budgets in the past, combined with carryover provisions, posed significant risks for fiscal policy implementation. Staff noted that expenditure ceilings had been weakened by carryover rules allowing spending from reserves outside the ceilings, and that transparency was hindered by off-budget spending and delays in fiscal reporting on extrabudgetary funds.[6] The finance minister intends to explore ways to strengthen budgetary rules on carryover spending to enhance the discipline of the fiscal framework. Given concerns about debt sustainability, staff recommended introducing a fiscal rule that targeted a structural balance or a small surplus over the medium term. This indicative fiscal stance is based on staff's debt sustainability analysis incorporating demographic projections (Box 2). While the authorities did not discard the idea of new, stronger fiscal rules, for now they were concentrating on meeting targets under their fiscal framework.

C. Monetary Policy

19. **A reassessment of the inflation outlook in early 2005 led the CNB to reduce policy rates** (Figure 9). The CNB considered that the cumulative rate cut of 75 basis points in January–April had been needed because two factors had led to a downward revision of

[6] The National Property Fund (NPF) is expected to close at end-2005, and the accounts will be transferred to the Ministry of Finance. But spending from the NPF account will remain outside the expenditure ceilings and the budget. Transfers to the CKA financed through bonds are also treated as outside the budget.

Figure 9. Czech Republic: Monetary Policy Indicators, 2001-05



Sources: Czech National Bank; European Central Bank; and IMF staff estimates.

1/ Weighted average of real short-term interest rate and real effective exchange rate (weights: 2/3 and 1/3, respectively). January 2000=100.

2/ Based on 1-year PRIBOR deflated by 12-month backward and forward-looking CPI inflation, respectively.

3/ Based on interest rate deflated by 12-month backward-looking inflation excluding effects of indirect tax and administered price changes.

4/ Ex post real interest rates are 1-year PRIBOR, deflated by 12-month CPI inflation; ex ante real interest rates are deflated by 12-month inflation expected in a survey conducted by the Czech National Bank Statistical Survey.

5/ Business and total adjusted for loan write-offs and changes in classification of financial institutions. Adjustments from May 2004 and beyond are staff estimates.

inflation projections: substantial additions to productive capacity had delayed the closing of the output gap and the stronger-than-expected koruna appreciation had led to lower import prices. Staff agreed with this assessment, noting that retail competition and productivity growth, which appeared to be stronger in the Czech Republic than in other CEECs, also helped delay the onset of inflationary pressures (text table). The limited second-round effects of indirect tax and regulated price increases also suggest low inflationary expectations, pointing to the increased credibility of monetary policy. Headline inflation is now about 1½ percent, below the CNB target band, and the CNB's main policy rate stands at 1¾ percent, 25 basis points below the ECB rate.

Supermarkets in CEECs, 2002
(In percent, unless indicated otherwise)

	Czech Republic	Hungary	Poland	Slovak Republic
Market share of super- and hypermarkets and discount stores	55	48	44	49
Share of income spent in foreign food retailers	14	10	7	8
Foreign food retail sales per urban resident (in U.S. dollars)	808	503	302	377

Source: Shopping Monitor CEE (INCOMA Research) as reported by L. Dries, T. Reardon, and J. Swinnen,"The Rise of Supermarkets in Central and Eastern Europe: Implications for the Agrifood Sector and Rural Development," *Development Policy Review*, Vol. 22 No. 5, 2004, pp. 525-56.

20. **The CNB thought that the outlook for inflation remained benign and did not envisage a need for further interest rate changes in the near future**. Like staff, they have a baseline projection with average CPI inflation staying below 2 percent in 2005 and rising to 2¼ percent by end-2006—below the 3 percent point target but within the lower half of the tolerance band. The CNB considered that the structure of growth (driven by investment and exports) and other noncyclical factors were the main reasons for the low demand-pull price pressures, and was concerned that an activist approach aimed at bringing inflation to the point target might generate unnecessary interest rate volatility. Therefore, the CNB preferred to await the effect of recent interest rate cuts before making further moves. While some members of the CNB Board expressed doubts about the sustainability of a negative interest differential with euro area rates, particularly given the more advanced stage of the cycle in the Czech Republic, the prevailing view was that domestic rates were at the right level given projected inflation. Staff agreed, and saw no need to link tightly CNB actions to ECB rates. Over a longer horizon, the authorities envisaged an increase of real interest rates above the current levels to maintain inflation on target.

21. **Monetary policy is complicated by uncertainties about fiscal policy**. Some members of the CNB Board emphasized the difficulty of deciding on the appropriate course of action given doubts about the fiscal outturn in 2005. Nonetheless, they expected a smaller-than-budgeted expansion in 2005, which would maintain the policy mix consistent with a benign inflation outlook and a narrowing external current account. The outlook after the 2006

elections was more uncertain. Further monetary policy moves would thus depend on evidence of continued commitment to sustain fiscal consolidation.

22. **Noting the strength of exports and moderate growth in unit labor costs, the CNB viewed competitiveness as adequate**. Staff agreed that, despite the recent reversal of the real depreciation of 2003, productivity and profitability growth outpaced that in partner countries, and earlier gains in world market shares had been sustained (Figure 10).[7] Because Czech wages were higher than in the second-wave accession countries, staff flagged the risk of wage growth exceeding significantly productivity growth (largely attributed to FDI inflows until now). The authorities noted that some slowdown in FDI was to be anticipated, even with strong competitiveness, owing to the low capital intensity of high-tech products and strategic services that were expected to comprise the next wave of FDI.[8]

23. **The inflation-targeting framework has gained well-deserved credibility and is expected to continue to anchor inflationary expectations**. The post-2005 inflation targeting framework (a 3 percent point target with a tolerance band of ±1 percent) announced last year provides the necessary continuity with the existing end-2005 target (2–4 percent) and should help anchor monetary policy in the run-up to euro adoption. The authorities confirmed that, in this framework, the role of foreign exchange market intervention will continue to be exceptional. Staff noted that it would be desirable for the Inflation Report to clarify whether the forecast, which includes a path for interest rates, reflected the Board's or the staff's views. The authorities acknowledged that there had been some ambiguity on that score. They agreed to consider the staff's suggestion, but noted that they thought they had addressed the problem by shortening the publication lag of Board minutes and by holding periodic meetings of both CNB Board members and staff with analysts.

D. Financial Sector Issues and Resilience to Shocks

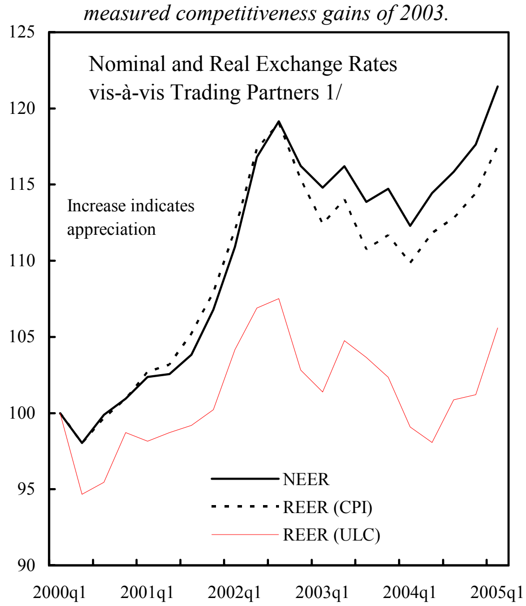
24. **The authorities consider the banking sector sound and well-positioned to withstand moderate macroeconomic shocks**. Past restructuring and improved risk management have strengthened banks. The capital-adequacy ratio, although declining in line

[7] Empirical assessments of equilibrium exchange rates present a mixed picture. Cointegration models suggest the koruna is close to equilibrium; however, these models have mean-reverting properties. More forward-looking panel models indicate that over the longer term the koruna might need to depreciate to service large foreign liabilities in a sustainable manner.

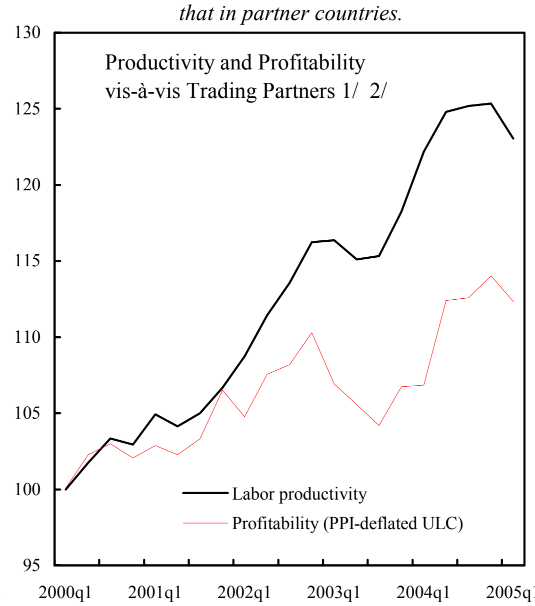
[8] The changing nature of capital flows, with an increasing importance of portfolio and other investment flows, may lead to more macroeconomic volatility in the future, and monetary policy may need to be more responsive in these circumstances (*Selected Issues* paper).

Figure 10. Czech Republic: Competitiveness Indicators, 2000-05
(2000q1=100, unless otherwise indicated)

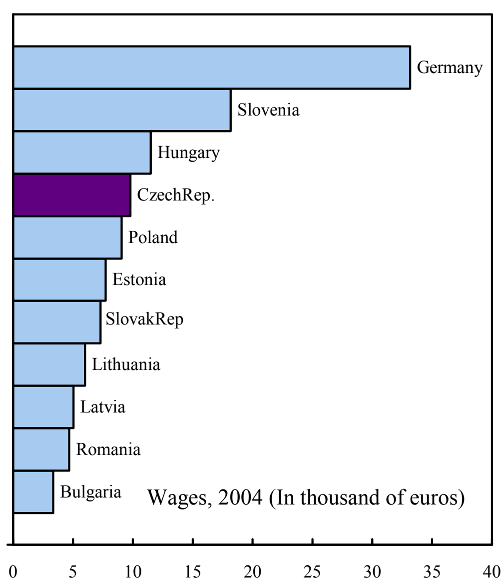
Nominal appreciation in 2004 reversed the REER-measured competitiveness gains of 2003.



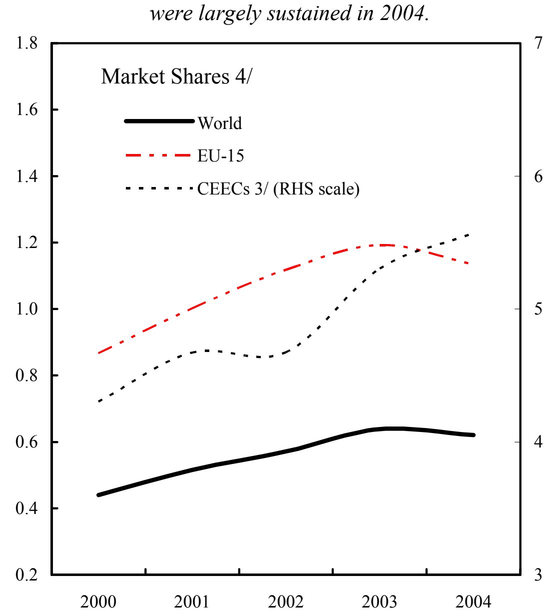
Productivity and profitability growth exceeded that in partner countries.



Wages are still below those in Germany, but toward the top of the CEE range.



Gains in market shares achieved since 2000 were largely sustained in 2004.



Sources: Eurostat; IMF, Direction of Trade Statistics; Statistical Offices of each country; and IMF staff estimates.

1/ Trade weights based on 2000-03 data for exports and imports of goods. Partner countries comprise Austria, Belgium, France, Germany, Hungary, Italy, Netherlands, Poland, Russia, the Slovak Republic, United Kingdom, and United States.

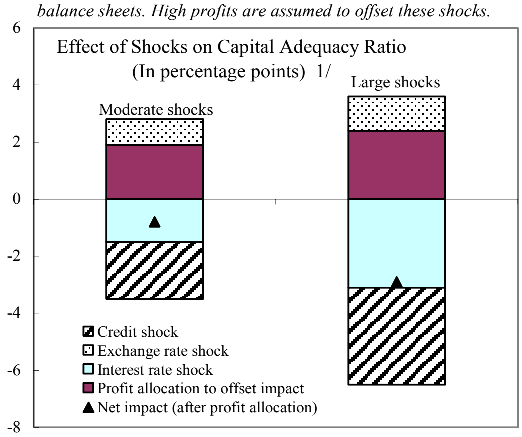
2/ In manufacturing. Czech data divided by data for partner countries.

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

4/ Partner countries' imports from Czech Republic with respect to imports from world, in percent.

with a pickup in lending, was 4 percentage points above the required 8 percent minimum in early 2005 (text table). Nonperforming loans remain low, and profitability has been rising. Stress testing by the authorities in consultation with MFD staff suggests that the banking system would remain well-capitalized under moderate shocks (text figure). Shocks broadly comparable to the 1997 crisis would leave about 7 percent of banks with a negative capital, with recapitalization costs amounting to about ½ percent of GDP.

Credit and interest rate shocks present the greatest risk for bank balance sheets. High profits are assumed to offset these shocks.



Sources: Czech National Bank.
1/ Moderate (large) shocks assume 1 percentage point (2 p.p.) increase in interest rates, 15 percent (20 percent) effective depreciation, and 30 percent (3 p.p.) rise in the NPL ratio.

Financial Soundness Indicators, 2001-05

	2001	2002	2003	2004	2005 Q1
Structure of the banking system					
Number of banks	38	37	35	35	35
Of which: foreign-controlled	26	26	26	26	26
Banking sector assets (in percent of GDP)	106.9	102.8	99.8	95.8	92.5
Bank credit outstanding (in percent of GDP)	40.3	40.4	41.5	42.2	39.7
Basic financial soundness indicators					
Regulatory capital to risk-weighted assets (in percent)	15.4	14.3	14.5	12.6	12.7
Classified credits (in percent of total credits)	20.8	15.8	11.2	10.8	12.7
Nonperforming loans (in percent of total loans)	13.4	8.1	4.9	4.1	4.8
Liquid assets (in percent of total assets)	20.8	32.5	35.9	32.8	36.7
After-tax return on average assets (in percent)	0.7	1.2	1.2	1.3	1.8
Financial soundness indicators focusing on the household sector					
Bank credit to households (in percent of total bank assets)	5.6	7.2	9.3	11.8	11.7
Bank credit to households (year-on-year growth rate)	13.6	28.3	31.9	32.4	...
Household bank debt (in percent of disposable income)	11.6	14.1	17.7	21.6	...
Households financial liabilities (in percent of disposable income)	45.6	46.4	...	...	...
Households financial liabilites (in percent of financial assets)	31.3	32.1	...	...	...
Housing prices (year-on-year growth rate)	...	21.5	16.6	10.6	5.8

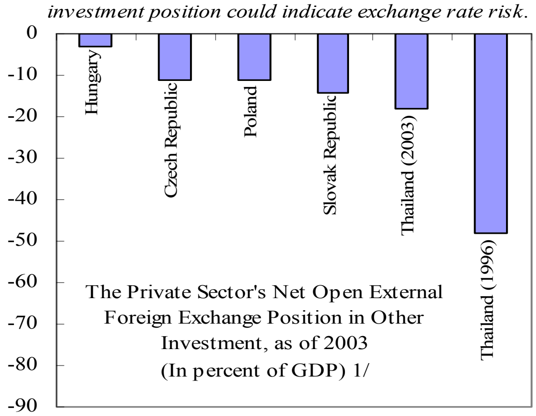
Sources: CNB; and IMF staff calculations.

25. **The shared view was that rapid growth of credit to households could pose financial stability risks in the future**. Bank consumer and mortgage lending expanded, albeit from a low base, at an annual rate of more than 30 percent in recent years (text table above). The authorities considered vulnerabilities from lending to households to be contained at present, given banks' fairly low exposure to households (about 12 percent of assets) and the small share of classified loans (3⅓ percent of mortgage loans and 11 percent of consumer loans). Staff agreed, noting that further increases in household liabilities would be justified

by the standards of more developed countries.[9] However, if financial assets do not keep pace, households' liquidity and solvency could be at risk under adverse macroeconomic shocks. In particular, a return of real interest rates to levels significantly above zero could be disruptive in case of substantial household indebtedness and high asset prices. Staff thus recommended that supervisors consider taking a more proactive approach by integrating stress testing of household loan quality more closely into their work. To this end, staff suggested collecting data on household loan portfolio structure and prices of housing transactions, and encouraged bank supervision to stay vigilant to any signs of banks easing credit standards. Looking forward, population aging points to the need to encourage long-term savings programs (Box 2). Accordingly, staff noted that pension fund regulations and savings subsidies may need to be reviewed, as they appear to encourage medium-term savings at the expense of long-term savings.

26. **Most vulnerability indicators are at comfortable levels, but risks remain for the government sector**. A strong reserve position—official reserves cover about 1½ times the economy's short-term debt at remaining maturity—provides a cushion against any reasonable temporary financing shortfall, while a floating exchange rate should enable smooth adjustment to most shocks (Table 5). The moderate external and public debt ratios (below 40 percent of GDP) have been broadly stable in recent years, and could absorb the impact of plausible adverse shocks, including to GDP growth, FDI and interest rates (Tables 6–7). However, delays in fiscal reforms, the drying up of privatization revenues, and large contingent liabilities also present risks for public debt sustainability and deficit financing. Staff noted that further analysis of currency mismatches in private sector balance sheets suggested by the international investment position would help identify the extent of unhedged exchange rate risk (text figure).

Currency mismatches in private sector international investment position could indicate exchange rate risk.



Sources: IMF, *IFS;* and *WEO* .
1/ International assets minus liabilities.

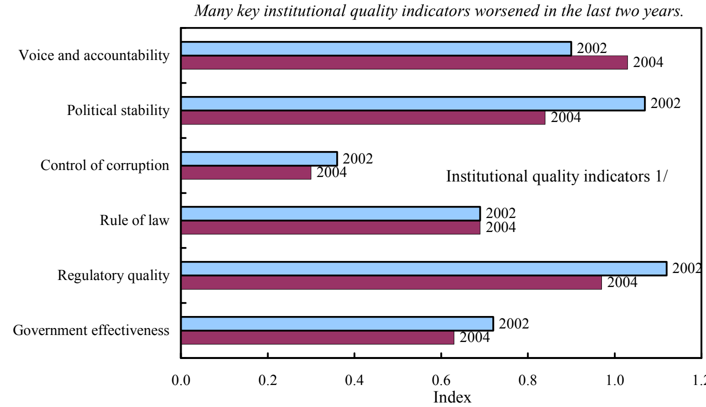
E. Long-Term Growth and Structural Policy

27. **Weaknesses in the business-legal environment risk discouraging future investment and holding back growth**. The Czech Republic's proximity to Western Europe, highly skilled labor force, low wages compared with EU-15 countries, and free access to the rest of the EU market make the Czech Republic an attractive destination for foreign investment. But representatives of the investor community still find the business-legal environment wanting compared to the standards already adopted by some other countries in

[9] *Selected Issues* paper.

the region and expected from EU members. Quantitative measures of institutional quality confirm this assessment (Figure 11 and text figure). Investors flagged weak creditor rights, excessive discretion of bankruptcy judges, and cumbersome and lengthy legal procedures as key problems. The authorities noted the recent creation of the Business Environment Development Council, a business-government consultative body that focuses on improving the business-legal system, and the streamlining of company registration through the introduction of single standardized forms and an automatic five-day deadline. Staff welcomed these initiatives—crucial for lowering the cost of doing business, especially for small and medium-sized firms—but noted other areas where progress was lagging. Continued delays in adopting bankruptcy legislation are holding up the closure of insolvent firms and provide scope for asset stripping, and one-stop-shop services allowing combined application for commercial registry and trade licenses remain limited.

Many key institutional quality indicators worsened in the last two years.

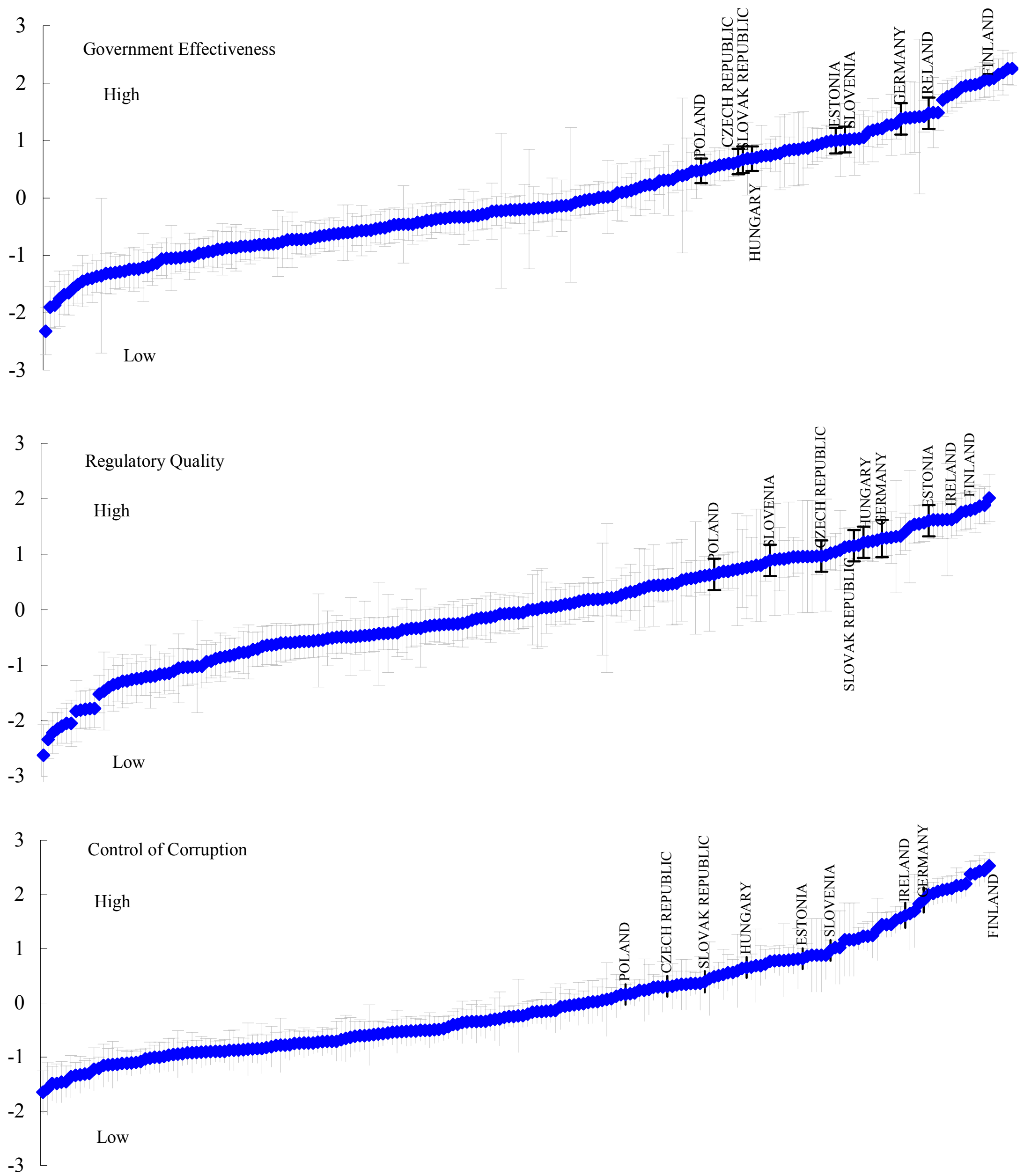


Source: World Bank.
1/ Survey-based indicators. For details, see Kaufmann and others (2005).

28. **The authorities are planning reforms in the labor market to increase flexibility and prepare for an aging workforce.** A virtually flat employment trend despite solid GDP growth in recent years suggests that the flexibility of the labor market may be eroding. The authorities attributed this trend to disincentives generated by the benefit system, skills mismatches, and high nonwage costs. They have prepared legislation to tighten benefit entitlements, encourage retraining, and increase geographical mobility. Staff welcomed the legislation but noted delays in its adoption. It also considered that the intended effect on labor participation of the planned reduction in income taxes is likely to be limited unless accompanied by a reform of the benefits system. Disincentives to work are particularly strong for younger workers with large families, among whom the unemployment rate is 5 percentage points higher than in families with no children. Social benefits could be reformed to lower the implicit tax on employment and, in certain cases, introduce in-work benefits. Attractive early retirement schemes and scope for abuse of disability benefits are reducing the labor force participation of older workers. The authorities noted the recent elimination of a generous early retirement pension scheme and ongoing discussions to better control sickness benefits which act as a pathway for disability benefits. The authorities have also proposed measures to encourage performance-based financing of schools and universities, and improve R&D cooperation with industry. Staff agreed that this would help preserve the Czech Republic's attractiveness for FDI, and noted that other measures—reducing impediments to labor mobility, including through easing rent control—would also limit persistent skills mismatches.

Figure 11. Czech Republic: Institutional Quality Indicators, 2004 1/
(Normalized indices)

The quality of institutions in the Czech Republic is broadly in line with that in other CEECs, but below par compared with more developed EU economies and other transition economies, like the Baltics.



Source: World Bank.

1/ The black line represents estimates of survey-based governance indicators for more than 200 industrial and developing countries, and the thin vertical lines are standard errors around these estimates. For more details, see D. Kaufmann, A. Kraay, and M. Mastruzzi, 2005, "Governance Matters IV: Governance Indicators for 1996-2004."

29. **Continued reduction in direct state involvement in the enterprise sector should help improve allocative efficiency and supply-side responsiveness**. The authorities reported the privatization of Český Telecom and progress in the preparation for sale of the electricity company (CEZ). The authorities also confirmed plans to divest most assets from the CKA and to terminate its activities by end-2007. Meanwhile, they are not planning to transfer new bad assets to CKA, and any such transfer will require parliamentary approval. Staff welcomed this approach, underscoring that CKA bailouts of health insurance companies under discussion should be resisted. In order to limit future drains on the budget, staff reiterated that state support to strategic companies needs to take place only in the context of viable restructuring plans and be transparently recorded in government accounts.

IV. Staff Appraisal

30. **The Czech Republic's recent strong economic performance augurs well for its near-term outlook**. Substantial foreign direct investment and growing cross-border integration of production processes have helped raise GDP growth and improve the external balance. Inflation has stabilized at a low level, and the sovereign risk premium has fallen. Corporate and banking profitability is strong, and banks remain well-capitalized to take advantage of lending opportunities in a growing economy. A skilled workforce and an open regime for trade and capital flows supports a large manufacturing and service base. After a year in the EU, the Czech economy has shown dynamism, which provides comfort about the economic outlook.

31. **But continued inaction in key areas could prevent the economy from realizing its full potential over the medium term**. The Czech Republic's attractiveness to foreign and domestic investors could be slowly undermined by continued rigidities in the labor market and the business-legal environment, and an uncertain policy setting that shortens the horizon for decision making. Without an early and comprehensive response, population aging is set to slow growth and undermine the sustainability of the fiscal position. Implementing policies to address these problems has become imperative to sustain economic performance and keep pace with other new EU member states.

32. **An immediate priority is to accelerate fiscal consolidation**. Robust growth offers the opportunity to eliminate the back-loading of adjustment in the authorities' fiscal plan and strengthen its credibility in the face of significant long-term debt sustainability concerns. Part of the adjustment can be shifted forward to 2005 by maintaining expenditure savings achieved in 2004 and using revenues from stronger-than-expected growth to build in a cyclical margin. Nonetheless, cumulative savings needed for 2006–07 are substantial, and the authorities should take decisive steps to adopt the corresponding measures. With elections scheduled in 2006, there is considerable merit to taking early action to secure the recommended adjustment.

33. **Continued consolidation beyond 2007 is needed to ensure fiscal sustainability in the face of population aging pressures**. Structural balance or a small surplus will be needed over the long term to shore up the fiscal position ahead of intensifying budget pressures from

population aging. This requires structural reforms in key spending areas. On pensions, the considerable progress made towards evaluating reform options is welcome, and an early political consensus on reform is the next priority. Options under consideration imply significant transitional deficits and it would be prudent to set aside a substantial share of privatization revenues to finance these deficits. On healthcare, the arrears buildup is symptomatic of deep-rooted problems and underscores the urgency of reform. Measures need to include a rationalization of the supply of health services, incentives for providers to contain costs, greater sharing of the financial burden with final users, and transformation of health insurance companies from payment agencies into true insurers. On social benefits, as part of labor market reform, a restructuring of entitlements is needed to reduce welfare traps, improve incentives to work, and save budget resources.

34. **The complexity of tasks and the institutional weaknesses require a strengthening of the fiscal framework**. Recently introduced budgetary rules on the carryover of spending by line ministries encouraged more rational spending by ministries but unveiled weaknesses in budgeting. In addition, these rules weakened the fiscal framework, as carryover spending is outside the expenditure ceilings. Teeth need to be restored to the fiscal framework for policy sustainability and credibility. Budgetary control also needs to be improved by integrating the budget approval process for extrabudgetary funds with the state budget and extending expenditure ceilings to cover carryover spending and extrabudgetary funds. Also, the transparency of fiscal policy needs to be enhanced by timely reporting of spending by extrabudgetary funds, and by consistently using as the targeted fiscal concept the broadest possible and most commonly used measure of the deficit. The delayed shift to GFSM 2001, which is close to standardized European fiscal indicators, should be expedited. Strengthening the fiscal framework along these lines would provide policy credibility and maximize benefits from improved confidence.

35. **Together with fiscal reform, structural reforms aimed at bolstering the role of the private sector should raise growth potential**. Recent privatizations underscore the authorities' intention to reduce the role of the state in the economy, which should be confirmed by completing the pending privatization in the electricity sector. Avoiding further transfers of bad assets to the CKA is essential to signal that there will be no new bailouts and to wind down CKA with a minimum cost to taxpayers. Progress in improving the business-legal environment has been slow, and the simplification of company registration should be seen as a first step toward creating a one-stop shop for investors combining company registration and licensing. The creation of modern bankruptcy procedures—another task that has been pending for several years—is crucial to enable effective restructuring of poorly performing companies. The authorities should pursue early approval of an amendment on bankruptcy procedures for financial institutions, still under consideration in parliament.

36. **With the outlook for inflation low, monetary policy can remain accommodative**. Reducing interest rates in the second half of 2004 and April 2005 was appropriate given the benign inflation outlook. The trends that gave rise to these decisions are expected to prevail in the period ahead, and current market and official expectations suggest that inflation is likely to remain below the 3 percent target through the end of 2006. However, uncertainties

call for a cautious approach to future interest rate changes. Measured in terms of unit labor costs, competitiveness against trading partners has eroded over the past year, reversing gains made in 2003. Other factors—including labor quality—appear to have compensated as demonstrated by the dynamism of exports and growth, but continued growth of unit labor costs relative to trading partners would be a cause for concern.

37. **The low inflation is a testament to a credible monetary policy**. The inflation targeting framework—by relying primarily on the interest rate instrument rather than foreign exchange intervention—has provided a transparent and credible foundation for monetary policy. The CNB has taken welcome steps to improve public communications and thus clarify its policy intentions and decisions. It would also be helpful to clarify in the Inflation Report the respective roles of the CNB Board and staff in the elaboration of the forecast.

38. **Rapid growth in lending to households calls for a further strengthening of financial sector surveillance**. The CNB has made significant progress in the analysis of financial risks. But rapid credit growth exposes households to liquidity and solvency risks under adverse macroeconomic shocks, and requires closer supervision in an environment of easy financial conditions. In the event of higher interest rates, banks would be exposed to dual risks of rising loan defaults and declining collateral prices. Vigilance in this area will thus require close integration of stress testing with bank supervision, and collecting data on household's overall financial position and prices of housing transactions.

39. **Euro adoption can bring considerable economic gains provided the right policies are in place**. Credibly reducing the fiscal deficit below the Maastricht limit and improving labor market flexibility are key in this regard, with the latter playing a substantial role in cushioning economic shocks after euro adoption and maintaining competitiveness. Adhering to the current timetable for euro adoption will require securing an early agreement on the required policies.

40. The next Article IV consultation with the Czech Republic is expected to be conducted under the standard 12-month cycle.

Table 1. Czech Republic: Selected Economic Indicators, 2001-05

	2001	2002	2003	2004	2005 1/
Real economy (change in percent)					
Real GDP	2.6	1.5	3.2	4.4	4.1
Domestic demand	4.1	2.7	3.4	2.9	3.1
CPI (year average)	4.7	1.8	0.1	2.8	1.6
PPI (year average) 2/	2.9	-0.5	-0.3	5.7	3.9
Unemployment rate (in percent)					
Survey-based 3/	8.1	7.3	7.8	8.3	7.9
Registered 3/	8.6	9.2	9.9	9.2	8.8
Gross national savings (percent of GDP)	23.5	22.3	21.0	22.4	24.8
Gross domestic investments (percent of GDP)	28.9	27.9	27.1	27.6	28.1
Public finance (percent of GDP)					
General government revenue	36.7	37.5	38.6	38.4	38.8
General government expenditure 4/	41.6	44.1	44.6	42.5	45.1
General government balance 4/	-5.0	-6.6	-6.0	-4.0	-6.3
Adjusted to exclude grants to transformation institutions to cover costs related to management of bad assets	-2.8	-3.9	-4.8	-3.3	-4.9
Targeted: adjusted balance excluding net lending 5/	-2.6	-3.7	-3.9	-2.8	-4.4
General government debt	17.5	18.4	21.7	24.0	25.8
Including debt of the Czech Consolidation Agency	22.9	25.5	27.7	27.8	28.4
Money and credit (end of year, percent change)					
Broad money 6/	13.0	3.5	6.9	4.4	4.7
Private sector credit (percent change, eop)	2.1	4.5	8.5	8.4	11.6
Interest rates (in percent)					
Three-month interbank rate 6/	4.7	3.5	2.3	2.4	2.1
Ten-year government bond 7/	5.0	4.6	4.0	4.3	2.7
Balance of payments (percent of GDP)					
Trade balance	-5.0	-3.0	-2.7	-0.8	0.3
Current account	-5.4	-5.6	-6.2	-5.2	-3.3
Gross international reserves (US$ billion)	14.5	23.7	27.0	28.4	33.3
Reserve cover (in months of imports of goods and services)	4.1	6.1	5.5	4.4	4.4
Exchange rate					
Nominal effective exchange rate (2000=100) 7/	104.7	115.8	117.0	119.4	127.9
Real effective exchange rate (CPI-based; 2000=100) 7/	105.7	116.6	114.2	115.8	123.6

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

1/ Staff estimates and projections.
2/ For 2005, data refer to May.
3/ In percent of total labor force.
4/ Excluding privatization revenues of the National Property Fund and the Czech Land Fund, the sale of shares and voting rights by local governments, and the sale of Russian debt.
5/ General government deficit excluding transfer to transformation institutions and net lending.
6/ For 2005, data refer to April.
7/ For 2005, data refer to March.

Table 2. Czech Republic: Balance of Payments, 2001-05
(In millions of U.S. dollars)

	2001	2002	2003	2004	2005 1/
Current account balance	**-3,273**	**-4,166**	**-5,570**	**-5,574**	**-4,049**
Trade balance	-3,068	-2,179	-2,458	-869	414
Exports	33,378	38,319	48,599	66,678	80,856
Imports	36,446	40,497	51,058	67,547	80,442
Nonfactor services	1,524	668	469	485	867
Receipts	7,090	7,061	7,764	9,666	11,671
Payments	5,566	6,393	7,295	9,181	10,804
Factor income (net)	-2,197	-3,532	-4,132	-5,429	-6,169
Transfers	467	877	552	239	839
Capital account	**-9**	**-4**	**-3**	**-545**	**294**
Financial account balance	4,544	10,625	5,805	7,040	8,076
Direct investment, net	5,476	8,276	2,351	3,917	8,285
Portfolio investment, net	916	-1,428	-1,336	2,421	-504
Financial derivatives, net	-85	-131	137	-60	0
Other investment, net	-1,764	3,908	4,654	762	295
Errors and omissions, net	**502**	**172**	**225**	**-656**	**0**
Change in reserves	**-1,765**	**-6,627**	**-457**	**-264**	**-4,321**
Memorandum items:					
Current account (in percent of GDP)	-5.4	-5.6	-6.1	-5.2	-3.3
Trade balance (in percent of GDP)	-5.0	-3.0	-2.7	-0.8	0.3
Net foreign direct investment (in percent of GDP)	9.0	11.2	2.6	3.7	6.7
Gross official reserves					
(in months of imports of goods and services)	4.3	5.7	4.6	4.0	4.0
(as a ratio to the short-term debt by remaining maturity)	1.2	1.7	1.5	1.4	1.4
Terms of trade (percentage change) 2/	2.0	2.0	1.1	2.1	-0.2

Sources: Czech National Bank; and IMF staff projections.

1/ IMF staff projections.
2/ Goods.

Table 3. Czech Republic: Consolidated General Government Budget, 2001-05 1/

	2001	2002	2003	2004	2005 2/
	(In percent of GDP)				
Total revenue and grants 3/	36.7	37.5	38.6	38.4	38.8
Total revenue	36.6	37.4	38.1	37.5	37.1
Current revenue	36.1	37.0	37.6	37.1	36.6
Tax revenue	33.8	34.5	35.0	35.0	34.9
Nontax revenue	2.4	2.5	2.6	2.1	1.7
Capital revenue	0.4	0.5	0.4	0.4	0.4
Grants, incl. EU compensation	0.1	0.1	0.5	0.9	1.8
Total expenditure and net lending 4/	41.6	44.1	44.6	42.5	45.1
excl. grants to transformation institutions	39.4	41.5	43.4	41.7	43.8
Total expenditure	41.6	43.9	43.7	42.1	44.6
Current expenditure	36.7	38.6	38.2	36.5	38.4
Goods and services	7.9	8.6	8.0	7.4	9.2
Interest payments	0.9	0.7	0.8	1.1	1.2
Transfers to households and nonfinancial enterprises	18.7	19.2	19.2	18.6	18.1
Transfers abroad, incl. EU	0.1	0.1	0.5	0.7	1.1
Subsidies	9.0	9.9	9.6	8.7	8.8
excluding grants to transformation institutions 5/	6.8	7.3	8.4	8.0	7.4
excluding semibudgetary organizations	2.3	2.4	2.6	2.4	3.1
Capital expenditure	4.8	5.3	5.5	5.6	6.2
Net lending (excl. privatization and the sale of Russian debt)	0.1	0.2	0.9	0.3	0.5
Overall balance 4/	-5.0	-6.6	-6.0	-4.0	-6.3
Adjusted to exclude grants to transformation institutions					
to cover costs related to management of bad assets	-2.8	-3.9	-4.8	-3.3	-4.9
Cyclically adjusted balance	-2.9	-3.4	-4.3	-3.0	-4.8
Targeted: adjusted balance excluding net lending	-2.6	-3.7	-3.9	-2.8	-4.4
Financing 5/					
Privatization receipts 6/	2.6	5.2	1.0	0.5	3.5
Proceeds from the sale of UMTS licences	0.1	0.0	0.0	0.2	0.0
Proceeds from the sale of Russian debt	0.0	0.8	0.0	0.0	0.0
Net increase in financial liabilities	2.2	0.5	5.1	3.3	2.8
Memorandum items					
Grants to transformation institutions to cover					
costs related to management of bad assets	2.2	2.7	1.2	0.7	1.4
General government debt 7/	17.5	18.4	21.7	24.0	25.8
Including debt of the Czech Consolidation Agency	22.9	25.5	27.7	27.8	28.4
General government balance, ESA95-based	-5.9	-6.9	-11.7	-3.0	-5.0

Sources: Ministry of Finance and IMF staff estimates.

1/ Includes the state budget, State Financial Assets, National Property Fund, extra-budgetary funds social security funds, and local governments.

2/ Staff estimates consistent with the 2005 state budget. Estimates are based on staff's GDP projections. Includes approved spending from reserves of 0.5 percent.

3/ Excluding revenues from UMTS licence sales

4/ Excluding privatization revenues of the National Property Fund, the Czech Land Fund, and the sale of shares and voting rights by the local governments.

5/ IMF staff estimates.

6/ Includes privatization receipts of the National Property Fund, the Czech Land Fund, and the sale of shares and voting rights by local governments.

7/ Includes liabilities of the state budget, extrabudgetary funds, social security funds, and local governments. Staff estimates for 2004.

Table 4. Czech Republic: Medium-term Macroeconomic Scenario, 2001-10

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Real sector					(Percent growth)					
Real GDP	2.6	1.5	3.2	4.4	4.1	3.9	3.7	3.5	3.5	3.5
Consumption	3.0	3.3	4.4	0.9	2.0	2.2	2.9	3.0	3.0	3.0
Investment	6.3	3.5	1.3	7.8	5.4	6.4	6.4	5.5	5.1	4.1
o/w fixed investment	5.4	3.4	4.7	7.6	4.7	5.3	5.4	5.5	5.5	5.5
Exports, goods and services	11.8	2.7	8.1	22.3	10.4	8.3	7.3	7.7	7.6	7.3
Imports, goods and services	12.9	4.9	7.8	18.4	8.2	7.7	7.4	7.7	7.5	7.0
CPI inflation	4.7	1.8	0.1	2.8	1.6	2.0	2.5	3.0	3.0	3.0
GDP deflator	4.9	2.8	2.6	3.0	2.7	1.7	2.9	3.3	3.2	3.3
Gross domestic savings 1/	23.5	22.3	21.0	22.4	24.8	25.5	26.0	26.2	26.7	26.9
Public	0.3	-0.5	-1.4	-0.9	1.1	-0.7	0.8	0.4	2.1	2.3
Private	23.2	22.8	22.4	23.3	23.7	26.1	25.2	25.9	24.6	24.6
Public finances					(In percent of GDP)					
Revenues	36.8	37.6	38.6	38.6	38.8	37.6	37.4	37.3	37.3	37.2
Expenditures	41.6	44.1	44.6	42.5	45.1	41.9	42.0	40.2	39.8	39.4
Overall balance	-5.0	-6.6	-6.0	-4.0	-6.3	-4.2	-4.7	-2.8	-2.5	-2.2
Adjusted balance	-2.8	-3.9	-4.8	-3.3	-4.9	-3.9	-3.8	-2.8	-2.5	-2.2
Cyclically adjusted	-2.9	-3.4	-4.3	-3.0	-4.8	-3.9	-3.3	-1.8	-1.1	-0.3
Targeted balance (adjusted balance excl net lending)	...	...	-3.9	-2.8	-4.4	-3.4	-3.3	-3.0	-2.7	-2.4
General government debt	17.5	18.4	21.7	24.0	25.8	28.7	28.9	30.9	31.3	31.4
Including debt of the Czech Consolidation Agency	22.9	25.5	27.7	27.8	28.4	30.8	30.1	30.9	31.3	31.4
Balance of payments					(In percent of GDP)					
Current account balance	-5.4	-5.6	-6.2	-5.2	-3.3	-3.1	-2.7	-2.6	-2.2	-2.2
Trade balance	-5.0	-3.0	-2.7	-0.8	0.3	0.5	0.6	0.6	0.5	0.5
Services balance	2.5	0.9	0.5	0.5	0.7	0.9	1.2	1.4	1.7	2.0
Net factor income	-3.6	-4.8	-4.6	-5.1	-5.0	-5.1	-5.1	-5.3	-5.1	-5.3
Current transfers	0.8	1.2	0.6	0.2	0.7	0.7	0.7	0.6	0.7	0.6
Financial account balance	7.5	14.4	6.4	6.6	6.5	2.8	5.0	2.4	2.1	2.0
Direct investment, net	9.0	11.2	2.6	3.7	6.7	3.2	5.8	3.2	3.3	3.3
o/w privatization revenue	2.7	5.3	0.9	0.5	3.5	0.0	2.6	0.0	0.0	0.0
Portfolio investment, net	1.5	-1.9	-1.5	2.3	-0.4	-0.4	0.0	0.0	0.0	0.0
Financial derivatives, net	-0.1	-0.2	0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Other investment, net	-2.9	5.3	5.1	0.7	0.2	0.0	-0.8	-0.8	-1.2	-1.2
Errors and omissions, net	0.8	0.2	0.2	-0.6	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves (- increase)	-2.9	-9.0	-0.5	-0.2	-3.5	0.0	-2.6	0.0	0.0	0.0

Sources: Czech Statistical Office, Czech National Bank, Ministry of Finance, and IMF staff estimates.
1/ In percent of GDP.

Table 5. Czech Republic: Selected Vulnerability Indicators, 2001-05

	2001	**2002**	**2003**	**2004** 1/	**2005** 1/	**Latest observation**
Key Economic and Market Indicators						
Real GDP growth (in percent)	2.6	1.5	3.2	4.4	4.1	Proj
CPI inflation (period average, in percent)	4.7	1.8	0.1	2.8	1.6	Proj
Short-term (ST) interest rate (in percent) 2/	4.5	2.8	2.0	2.5	2.3	Feb-05
International sovereign bond spread (bps, end of period) 3/	...	...	...	14.0	13.0	Feb-05
Exchange rate of the koruna to the dollar (end of period)	36.3	30.1	25.7	22.4	24.1	Apr-05
External Sector						
Exchange rate regime			Managed floating			
Current account balance (percent of GDP)	-5.4	-5.6	-6.1	-5.2	-3.3	Proj
Net FDI inflows (percent of GDP)	9.0	11.2	2.6	3.7	6.7	Proj
Exports (percentage change of US$ value, GNFS)	12.7	12.1	24.2	35.5	25.4	Proj
Real effective exchange rate (2000 = 100)	105.7	116.6	114.2	115.8	112.6	Jan-05
Gross international reserves (GIR) in US$ billion	14.5	23.7	27.0	28.4	33.3	Proj
GIR in percent of ST debt at remaining maturity (RM)	119.3	175.0	154.7	159.3	163.3	Proj
GIR in percent of ST debt at RM and foreign currency deposits	82.2	120.1	111.7	109.6	116.6	Proj
Net international reserves (NIR) in US$ billion	14.5	23.7	27.0	28.4	32.5	Proj
Total gross external debt (ED) in percent of GDP	36.8	36.6	38.5	42.3	37.5	Proj
o/w ST external debt (original maturity, in percent of total E	42.6	38.7	39.8	36.0	36.0	Proj
Total gross external debt in percent of exports of GNFS	55.3	59.5	61.9	59.3	49.8	Proj
Gross external financing requirement (in US$ billion) 4/	15.0	16.8	19.6	23.4	27.1	Proj
Public Sector (PS) 5/						
Overall balance (percent of GDP)	-5.0	-6.6	-6.0	-4.0	-6.3	Proj
Primary balance (percent of GDP)	-4.1	-5.9	-5.3	-3.0	-5.1	Proj
Debt-stabilizing primary balance (percent of GDP) 6/	...	...	...	...	-0.4	Proj
Gross PS financing requirement (in percent of GDP) 7/	18.4	13.1	12.2	10.4	11.3	Proj
Public sector gross debt (PSGD, in percent of GDP)	17.5	18.4	21.7	24.0	25.8	Proj.
Public sector net debt (in percent of GDP)	16.1	16.7	21.0	23.0	24.3	Dec-04
Financial Sector (FS) 8/						
Capital adequacy ratio (in percent)	15.4	14.3	14.5	12.6	12.7	Mar-05
NPLs in percent of total loans	13.4	8.1	4.9	4.1	4.8	Mar-05
Provisions in percent of NPLs	60.3	77.5	76.7	69.4	61.0	Mar-05
Return on average assets (in percent) 9/	0.7	1.2	1.2	1.3	1.8	Mar-05
Return on equity (in percent) 10/	16.6	27.4	23.8	23.4	32.1	Mar-05
Foreign currency deposits (in percent of total deposits)	13.8	11.3	10.3	10.2	11.4	Apr-05
Domestic loans in foreign currency (in percent of total loans)	15.6	12.3	11.0	10.6	10.2	Apr-05
Net open forex position (in percent of capital) 11/	0.1	-0.5	-0.1	-0.1	0.3	Apr-05
Credit to private sector (percent change)	-19.6	-6.6	9.3	12.4	15.5	Apr-05
Memo item:						
Nominal GDP in billions of U.S. dollars	55.7	60.9	73.8	90.4	107.0	Proj

1/ Staff estimates, projections, or latest available observations as indicated in the last column.
2/ One-month interbank offer rate (PRIBOR), eop.
3/ The Czech Republic is not included in the EMBI index.
4/ Current account deficit plus short-term debt by remaining maturity.
5/ Public sector covers: general government. The deficit measure excludes privatization revenues but includes transfers to CKA. The debt measure excludes CKA debt.
6/ Based on averages for the last five years for the relevant variables (i.e., growth, interest rates).
7/ Overall balance plus debt amortization.
8/ Financial sector includes: commercial banks.
9/ A ratio of net profit to average assets.
10/ A ratio of net profit to average capital.
11/ Sum of on- and off-balance sheet exposure.

Table 6. Czech Republic: Public Sector Debt Sustainability Framework, 2001-10
(In percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004			Projections 2005	2006	2007	2008	2009	2010	
							I. Baseline Projections						**Debt-stabilizing primary balance 10/**
Public sector debt 1/	17.5	18.4	21.7	24.0			**25.8**	**28.7**	**28.9**	**30.9**	**31.3**	**31.4**	**-0.4**
o/w foreign-currency denominated	1.4	1.5	2.6	2.6			2.7	2.5	2.4	2.2	2.1	1.9	
Change in public sector debt	2.0	0.9	3.3	2.3			1.8	2.9	0.2	2.0	0.5	0.1	
Identified debt-creating flows (4+7+12)	-1.0	-2.3	2.7	0.9			-0.2	2.5	-0.6	0.9	0.5	0.1	
Primary deficit	1.9	3.3	4.1	2.2			3.7	2.7	2.1	1.3	0.7	0.5	
Revenue and grants	36.7	37.5	38.6	38.4			38.8	37.6	36.8	36.3	35.8	35.2	
Primary (noninterest) expenditure	38.6	40.8	42.6	40.6			42.5	40.3	38.9	37.6	36.6	35.7	
Automatic debt dynamics 2/	-0.3	-0.3	-0.5	-0.8			-0.3	-0.1	-0.1	-0.4	-0.3	-0.4	
Contribution from interest rate/growth differential 3/	-0.2	-0.1	-0.2	-0.4			-0.3	-0.1	-0.1	-0.4	-0.3	-0.4	
Of which contribution from real interest rate	0.1	0.2	0.3	0.5			0.6	0.8	0.9	0.6	0.7	0.6	
Of which contribution from real GDP growth	-0.4	-0.2	-0.6	-0.9			-0.9	-1.0	-1.0	-0.9	-1.0	-1.0	
Contribution from exchange rate depreciation 4/	-0.1	-0.2	-0.2	-0.3			...	...	...	...	...	...	
Other identified debt-creating flows	-2.6	-5.3	-0.9	-0.5			-3.5	0.0	-2.6	0.0	0.0	0.0	
Privatization receipts (negative)	-2.6	-5.3	-0.9	-0.5			-3.5	0.0	-2.6	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	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes	3.0	3.3	0.6	1.4			2.0	0.3	0.8	1.1	0.0	0.0	
Public sector debt-to-revenue ratio 1/	47.6	49.0	56.2	62.4			66.5	76.2	78.5	85.1	87.5	89.2	
Gross financing need 5/	18.4	13.1	12.2	10.4			11.3	11.6	10.4	9.3	9.4	8.5	
in billions of U.S. dollars	11.2	9.7	11.1	11.1			14.4	15.8	15.2	14.5	15.7	15.3	
Key Macroeconomic and Fiscal Assumptions					10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	2.6	1.5	3.2	4.4	2.1	2.1	4.1	3.9	3.7	3.5	3.5	3.5	3.7
Average nominal interest rate on public debt (in percent) 6/	6.0	3.9	4.5	5.5	7.0	2.2	5.6	5.2	6.2	5.5	5.9	5.5	5.7
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.1	1.1	1.9	2.5	2.0	2.5	2.9	3.5	3.3	2.2	2.7	2.2	2.8
Nominal appreciation (increase in US dollar value of local currency, in percent)	4.3	20.3	17.5	14.7	3.0	15.4	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	4.9	2.8	2.6	3.0	5.1	3.5	2.7	1.7	2.9	3.3	3.2	3.3	2.9
Growth of real primary spending (deflated by GDP deflator, in percent)	5.9	8.2	4.0	-1.5	3.2	3.7	10.5	-3.9	1.6	-2.2	0.7	1.2	1.3
Primary deficit	1.9	3.3	4.1	2.2	1.8	1.5	3.7	2.7	2.1	1.3	0.7	0.5	1.8
A. Alternative Scenarios							**II. Stress Tests for Public Debt Ratio**						**Debt-stabilizing primary balance 11/**
A1. Key variables are at their historical averages in 2005-09 8/							**25.8**	**27.9**	**27.8**	**30.6**	**32.4**	**34.1**	**-0.1**
A2. No policy change (constant primary balance) in 2005-09							**25.8**	**28.9**	**30.2**	**34.1**	**36.9**	**39.4**	**-0.7**
A3. Country-specific shock in 2006, with reduction in GDP growth (relative to baseline) of one standard deviation 9/							**25.8**	**40.5**	**42.4**	**43.5**	**44.3**	**44.7**	**-0.2**
B. Bound Tests													
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006							**25.8**	**29.5**	**30.8**	**32.7**	**33.2**	**33.2**	**-0.4**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006							**25.8**	**32.7**	**39.3**	**45.9**	**50.7**	**54.8**	**-0.7**
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006							**25.8**	**30.7**	**33.5**	**35.5**	**35.9**	**35.9**	**-0.5**
B4. Combination of B1-B3 using one standard deviation shocks							**25.8**	**30.5**	**33.2**	**35.2**	**35.6**	**35.6**	**-0.5**
B5. One time 30 percent real depreciation in 2005 10/							**25.8**	**29.9**	**30.2**	**32.1**	**32.6**	**32.6**	**-0.4**
B6. 10 percent of GDP increase in other debt-creating flows in 2005							**25.8**	**38.7**	**38.9**	**40.7**	**41.1**	**41.0**	**-0.5**

1/ General government gross debt (excluding CKA debt).
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = 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 $r - \pi (1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ The 2008 jump in government debt is associated with closing of CKA and taking over its remaining obligations. For projections, this line includes exchange rate changes.
6/ Defined as general government deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ Derived as nominal interest expenditure divided by previous period debt stock.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ Assumes that 90 percent of guarantees are called in 2006 and GDP growth stabilizes at 2.5 percent.
10/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
11/ 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.

Table 7. Czech Republic: External Debt Sustainability Framework, 2000-10
(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004			Projections 2005	2006	2007	2008	2009	2010	
								I. Baseline Projections						**Debt-stabilizing non-interest current account 7/**
External debt	38.8	36.8	36.6	38.5	42.3			**37.5**	**35.6**	**33.4**	**31.3**	**29.3**	**27.5**	**-3.6**
Change in external debt	0.4	-2.0	-0.2	1.9	3.9			-4.8	-1.9	-2.2	-2.1	-2.0	-1.8	
Identified external debt-creating flows (4+8+9)	1.2	-6.4	-11.6	-3.3	-3.2			-4.0	-1.0	-3.9	-1.2	-1.5	-1.5	
Current account deficit, excluding interest payments	3.1	3.7	4.3	5.0	4.0			1.9	1.7	1.4	1.4	1.2	1.2	
Deficit in balance of goods and services	3.1	2.5	2.0	2.2	0.4			-1.0	-1.4	-1.8	-2.1	-2.2	-2.5	
Exports	64.5	66.5	61.5	62.2	71.3			75.3	78.6	80.9	83.0	85.2	87.3	
Imports	67.6	69.0	63.6	64.4	71.7			74.3	77.2	79.1	81.0	82.9	84.9	
Net non-debt creating capital inflows (negative)	-5.9	-8.4	-10.9	-2.8	-2.3			-5.7	-2.7	-5.3	-2.7	-2.8	-2.8	
Automatic debt dynamics 1/	4.1	-1.6	-5.1	-5.5	-4.9			-0.1	-0.1	0.0	0.1	0.1	0.1	
Contribution from nominal interest rate	1.8	1.7	1.4	1.1	1.2			1.4	1.3	1.3	1.2	1.1	1.0	
Contribution from real GDP growth	-1.6	-0.9	-0.5	-1.0	-1.4			-1.5	-1.4	-1.2	-1.1	-1.0	-1.0	
Contribution from price and exchange rate changes 2/	3.9	-2.4	-6.0	-5.6	-4.7			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-0.8	4.3	11.5	5.2	7.1			-0.9	-0.9	1.7	-0.9	-0.5	-0.3	
External debt-to-exports ratio (in percent)	60.2	55.3	59.5	61.9	59.3			49.8	45.3	41.3	37.7	34.4	31.5	
Gross external financing need (in billions of US dollars) 4/	15.1	15.0	16.8	19.6	23.4			27.1	27.2	26.8	26.9	26.7	26.9	
in percent of GDP	27.0	24.6	22.8	21.6	21.8			22.1	21.2	19.6	18.5	17.1	16.2	
Key Macroeconomic Assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	3.9	2.6	1.5	3.2	4.4	2.5	2.3	4.1	3.9	3.7	3.5	3.5	3.5	3.7
Exchange rate appreciation (US dollar value of local currency, change in percent)	-10.4	1.5	16.2	16.1	9.8	1.6	10.7	7.8	-1.2	0.3	0.3	0.3	0.3	1.3
GDP deflator (change in domestic currency)	1.4	4.9	2.8	1.9	3.7	6.3	5.0	2.3	1.7	2.4	3.0	2.9	2.8	2.5
GDP deflator in US dollars (change in percent)	-9.2	6.5	19.4	18.2	13.8	8.0	12.1	10.3	0.5	2.7	3.3	3.2	3.1	3.8
Nominal external interest rate (in percent)	4.4	4.7	4.5	3.7	3.6	4.5	0.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Growth of exports (US dollar terms, in percent)	7.8	12.7	12.1	24.2	35.5	14.4	13.0	21.2	9.0	9.6	9.7	9.6	9.4	11.4
Growth of imports (US dollar terms, in percent)	10.6	11.6	11.6	24.4	31.5	14.0	13.2	18.9	8.6	9.0	9.4	9.4	9.1	10.8
Current account balance, excluding interest payments	-3.1	-3.7	-4.3	-5.0	-4.0	-3.2	1.8	-1.9	-1.7	-1.4	-1.4	-1.2	-1.2	-1.5
Net non-debt creating capital inflows	5.9	8.4	10.9	2.8	2.3	5.5	2.8	5.7	2.7	5.3	2.7	2.8	2.8	3.7
								II. Stress Tests for External Debt Ratio						**Debt-stabilizing non-interest current account 7/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2006-10 5/								**37.5**	**32.4**	**30.7**	**26.9**	**23.5**	**20.4**	**-6.7**
A2. Country-specific shock in 2006, with reduction in GDP growth and FDI (relative to baseline) 6/								**37.6**	**35.9**	**33.9**	**32.0**	**30.2**	**28.5**	**-2.9**
B. Bound Tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006								**37.5**	**36.3**	**34.9**	**32.7**	**30.7**	**28.8**	**-3.6**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**37.5**	**37.7**	**37.3**	**34.7**	**32.3**	**30.2**	**-4.0**
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006								**37.5**	**42.3**	**48.0**	**44.2**	**40.8**	**37.6**	**-5.2**
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006								**37.5**	**40.7**	**43.7**	**41.3**	**39.0**	**36.9**	**-3.8**
B5. Combination of B1-B4 using one standard deviation shocks								**37.5**	**42.4**	**48.1**	**45.3**	**42.7**	**40.3**	**-4.5**
B6. One time 30 percent nominal depreciation in 2005								**37.5**	**49.6**	**45.9**	**42.4**	**39.1**	**36.1**	**-5.0**

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate,
ε = νομιναλ αππρεχιατιον (ινχρεασε ιν δολλαρ ϖαλυε οφ δομεστιχ χυρρενχψ), ανδ α = σηαρε οφ δομεστιχ–χυρρενχψ δενομινατεδ δεβτ ιν τοταλ εξτερναλ δεβτ.
2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ GDP growth stabilizes to 2.5 percent and FDI is lower by $1 bill compared to baseline.
7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Czech Republic: Fund Relations
(As of May 31, 2005)

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

II. **General Resources Account**

	SDR Million	% Quota
Quota	819.30	100.0
Fund holdings of currency	582.73	67.78
Reserve position in Fund	236.57	28.87

III. **SDR Department**:

	SDR Million	% Allocation
Holdings	5.90	N/A

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

V. **Financial Arrangements**:

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

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

VII. **Exchange Rate Arrangement**:
The currency of the Czech Republic is the Czech koruna, created on February 8, 1993 upon the dissolution of the currency union with the Slovak Republic, which had used the Czechoslovak koruna as its currency. From May 3, 1993 to May 27, 1997, the exchange rate was pegged to a basket of two currencies: the deutsche mark (65 percent) and the U.S. dollar (35 percent). On February 28, 1996, the Czech National Bank widened the exchange rate band from ±0.5 percent to ±7.5 percent around the central rate. On May 27, 1997, managed floating was introduced. In the 2004 edition of the *Annual Report on Exchange Arrangements and Exchange Restrictions,* the de facto exchange rate regime of the Czech Republic was classified as managed floating with no pre-announced path for the exchange rate. On June 30, 2005, the exchange rate of the Czech koruna stood at CZK 24.18 per U.S. dollar.

VIII. **Last Article IV Consultation**:
The last Article IV consultation with the Czech Republic was concluded on August 6, 2004. The staff report and PIN were published on August 6, 2004.

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

X. **Implementation of HIPC Initiative**: Not Applicable

XI. **Safeguards Assessments:** Not Applicable

Czech Republic: Technical Assistance, 1991–2005

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

Czech Republic: Statistical Issues

41. 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 central and local budget accounts and are available with a two- to three-month lag.

42. While data quality is generally adequate, some deficiencies remain in certain areas; 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 also bring into question the reliability of the quarterly data.

- 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* is 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 fiscal data on ESA-95 basis has been prepared by the Czech Statistical Office. Quarterly data for non-financial accounts have also been compiled and quarterly financial accounts will be prepared by 2006. The Ministry of Finance uses the ESA-95 methodology for the Convergence Program targets. The ESA-95 methodology differs from the national (fiscal targeting methodology) in terms of the coverage of the institutions (for example, the CKA is included in the central government under ESA definition) and inclusion of financial transactions and other accrual items (for example, called guarantees).

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

CZECH REPUBLIC: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

AS OF JUNE 22, 2005

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]
Exchange Rates	6/19/05	6/19/05	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	5/31/05	6/07/05	D	M	M
Reserve/Base Money	5/01/05	5/11/05	10 days	10 days	10 days
Broad Money	4/28/05	5/10/05	M	M	M
Central Bank Balance Sheet	5/01/05	5/11/05	10 days	10 days	10 days
Consolidated Balance Sheet of the Banking System	Apr 2005	5/24/05	M	M	M
Interest Rates[2]	6/19/09	6/19/05	D	D	D
Consumer Price Index	May 2005	6/08/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Dec 2004	Jan 2005	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Dec 2004	Jan 2005	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Dec 2004	Jan 2005	A	A	A
External Current Account Balance	2005 Q1	June 2005	Q	Q	Q
Exports and Imports of Goods and Services	Apr 2005	5/24/05	M	M	M
GDP/GNP	2005 Q1	June 2005	Q	Q	Q
Gross External Debt	2005 Q1	June 2005	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.
[5] Including currency and maturity composition.
[6] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 05/108
FOR IMMEDIATE RELEASE
August 9, 2005

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2005 Article IV Consultation with the Czech Republic

On August 1, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Czech Republic.[1]

Background

Recent accession to the EU and gains in growth performance reinforced the Czech Republic's position as one of the most open and developed economies among the new member states. Thanks to substantial foreign direct investment, its manufacturing sector is closely integrated into cross-border production networks, and foreign-owned firms now account for most of industrial exports.

Notwithstanding a recent spurt, growth potential remains constrained by impediments to the geographical mobility of workers, skills mismatches, and weaknesses in the business-legal environment. Adverse demographic trends presage unsustainable pressures on the budget and weakening economic prospects. Despite initial steps in some areas and the development of a medium-term strategy, overall progress in alleviating structural impediments to growth has been slow. Implementing the requisite policies has become all the more imperative for the Czech Republic to maintain its relatively favorable position among new member states and keep pace with quickly catching up peers.

Accession to the EU combined with a cyclical recovery accelerated growth last year. GDP expanded by 4.4 percent in 2004, with net exports gradually replacing investment as the main

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

source of growth. Household consumption grew only modestly, as lagging employment weighed on disposable incomes. Unemployment—of which more than half is long-term—remained at about 8 percent. With favorable terms of trade, an export boom narrowed the trade deficit. Although appreciation and rising unit labor costs unwound competitiveness gains achieved in 2003, market shares remained broadly stable.

Despite a pickup in growth, inflation stayed low, as a soft labor market, expanding productive capacity, and strong productivity growth kept core inflation down. Excluding the effects of administrative price changes related to EU accession, underlying inflation has risen only modestly, remaining on average below 2 percent. Headline inflation is about 1½ percent, below the Czech National Bank (CNB) target band.

The trade deficit narrowed to less than 1 percent of GDP in 2004, turning into a surplus in the first quarter of 2005. The current account deficit declined to 5¼ percent of GDP, in 2004, with rising profit and dividend repatriations offsetting the narrower trade deficit. The current account deficit was largely financed by greenfield and brownfield FDI, which rebounded to 3⅔ of GDP, despite the lack of major privatizations.

Monetary conditions tightened during 2004, owing to a cumulative 50 basis point increase in policy interest rates in the summer of 2004 and a 6 percent nominal appreciation of the koruna against the euro during the year. A strengthening of the koruna led the inflation-targeting CNB to reassess the inflation outlook and reduce the main policy rate by cumulative 75 basis points to 1¾ percent by April 2005.

The fiscal deficit declined in 2004. The general government deficit—excluding privatization receipts and transfers to the Czech Consolidation Agency (CKA) to cover the costs of managing bad assets—narrowed relative to GDP by about 1¾ percentage point to near 3¼ percent of GDP in 2004. The decline mainly reflected changes in the budgetary rules that allowed line ministries to carry over unspent allocations to future years, as well as a reduction in sickness benefits and public employment. Tax revenues remained strong, given a pickup in growth and harmonization of indirect taxes with the EU. Public debt is still a moderate 24 percent of GDP and can be financed with ease, as the success of the recent Eurobond issues illustrates.

Banking sector indicators are positive, and bank lending—led by credit to households—continues to rebound. Past restructuring and improved risk management have strengthened banks, and the authorities' stress testing suggests that the banking system is resilient to moderate macroeconomic shocks. As banks introduced new mortgage and consumer loan facilities into a largely untapped retail market, bank lending to households has risen at an annual rate of 20–30 percent for about three years, outpacing lending to corporates by a wide margin.

Executive Board Assessment

Executive Directors commended the authorities for the Czech Republic's strong economic performance in the first year of EU membership. Moreover, the near-term outlook has brightened, in part because significant foreign investments have expanded capacity, lowered inflationary pressures, and contributed to a robust export performance.

At the same time, Directors noted that the Czech Republic's continuing attractiveness to foreign and domestic investors may be affected by rigidities in the labor market and weaknesses in the business-legal environment. In addition, primary fiscal deficits are large, and population aging could slow growth and undermine fiscal sustainability. Directors emphasized that sustaining the good economic performance will require an integrated policy response to these challenges.

Directors considered that robust economic growth offers the authorities the opportunity to advance the pace of deficit reduction and implement in full the reforms under the medium-term fiscal adjustment plan. Substantial budgetary savings will be needed to achieve the medium-term fiscal targets. Directors therefore encouraged the authorities to sustain the consolidation gains made in 2004 and to approve quickly the expenditure-reducing measures identified for 2006 and beyond, which would also bolster the credibility of the medium-term plan.

Directors called for a further strengthening of the fiscal framework to address existing institutional weaknesses and contain the risk of fiscal drift. The budget approval process for extrabudgetary activities should be integrated with that for the state budget, and expenditure ceilings should be extended to cover carryover spending and extrabudgetary activities. Enhancing fiscal policy transparency will require the timely reporting of spending from extrabudgetary funds and a shift to a comprehensive fiscal definition—preferably the standardized European Union definition.

Directors stressed that, to deflect the adverse effect that population aging is expected to have on the public finances, ambitious expenditure reforms will be needed to ensure a sound long-term fiscal position. They welcomed the progress made in evaluating pension reform proposals, and noted the need to build a political consensus for such a reform. They cautioned that delays in health care reform and repeated bailouts of health insurance companies increase moral hazard and raise contingent liabilities for the budget. They saw an urgent need to create incentives for containing costs and allowing greater burden-sharing of costs with final users.

Directors commended the authorities for having achieved low inflation. The inflation-targeting framework has gained well-deserved credibility and is a sound anchor for inflationary expectations. Given the benign inflation outlook, Directors supported the recent interest rate cuts. Looking ahead, the absence of demand pressures justifies an accommodative monetary policy stance. However, uncertainties about fiscal policy, in particular, call for a cautious approach to future interest rate cuts. Directors underscored that, while the Czech Republic's near-term competitiveness is not in question, a continued rise in unit labor costs relative to trading partners would be a cause for concern. Directors welcomed the authorities' continued policy of non-intervention in the foreign exchange market and their commitment to use the interest rate instrument to achieve price stability. They also welcomed recent efforts by the Czech National Bank to improve public communication of its monetary policy decisions, and encouraged it to seek further refinements.

Directors welcomed the indications of strong banking system soundness and the ongoing improvements in banking supervision. At the same time, given the rapid increase in credit to households, continued supervisory vigilance is needed in this sector, including through improved collection of data on household loan portfolios and better evaluation of household loan quality. Directors also noted the need to promote policies that encourage long-term savings, to prepare for the demands of an aging population and the expected transfer of financial risks from the public sector to households.

Directors observed that a more flexible labor market will be needed to deal with the implications of the decline in the number of active labor market participants as the population ages. Greater flexibility will also be important given that the labor market will have to play a larger role in cushioning economic shocks after the euro is adopted. Directors called on the authorities to speed up the adoption of legislation to tighten benefit entitlements, encourage retraining, and increase geographical mobility. They particularly encouraged the authorities to focus on reforming the social benefit system to reduce disincentives to work and increase labor force participation. Efforts to improve the quality of education, as well as research and development activities, will also be important.

Directors considered that bolstering the role of the private sector would be key for raising productivity in the economy and long-term growth. They welcomed the resumption of privatization, but noted that slow reforms of bankruptcy procedures hinder the restructuring of poorly performing enterprises. They urged swift approval of new bankruptcy legislation.

Directors felt that euro adoption can bring considerable economic gains provided that the appropriate flexibility of the economy is achieved and the right policies are in place. They stressed that adhering to the current timetable for euro adoption will require securing an early agreement on, and building public support for, sustainable fiscal consolidation and structural reforms.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Czech Republic: Selected Economic and Financial Indicators, 2002-04

	2002	2003	2004
Real economy (change in percent)			
Real GDP	1.5	3.2	4.4
Domestic demand	2.7	3.4	2.9
CPI (year average)	1.8	0.1	2.8
PPI (year average)	-0.5	-0.3	5.7
Unemployment rate (in percent) 1/			
Survey-based	7.3	7.8	8.3
Registered **2/**	9.2	9.9	9.2
Gross national savings (percent of GDP)	22.3	21.0	22.4
Gross domestic investments (percent of GDP)	27.9	27.1	27.6
Public finance (percent of GDP)			
General government revenue	37.5	38.6	38.4
General government expenditure **3/**	44.1	44.6	42.5
General government balance **3/**	-6.6	-6.0	-4.0
Adjusted to exclude grants to transformation institutions to cover costs related to management of bad assets	-3.9	-4.8	-3.3
Targeted: adjusted balance excluding net lending **4/**	-3.7	-3.9	-2.8
General government debt	18.4	21.7	24.0
Including debt of the Czech Consolidation Agency	25.5	27.7	27.8
Money and credit (end of year, percent change)			
Broad money	3.5	6.9	4.4
Private sector credit (percent change, eop)	4.5	8.5	8.4
Interest rates (in percent)			
Three-month interbank rate	3.5	2.3	2.4
Ten-year government bond	4.6	4.0	4.3
Balance of payments (percent of GDP)			
Trade balance	-3.0	-2.7	-0.8
Current account	-5.6	-6.2	-5.2
Gross international reserves (US$ billion)	23.7	27.0	28.4
Reserve cover (in months of imports of goods and services)	6.1	5.5	4.4
Fund position (as of May 31, 2005)			
Holdings of currency (percent of quota)			71.13
Holdings of SDRs (percent of allocation)			n.a.
Quota (millions of SDRs)			819.3
Exchange rate			
Exchange rate regime			Managed float
Koruna per U.S. dollar (June 28, 2005)			CZK 24.83=US$1
Nominal effective exchange rate (2000=100)	115.8	117.0	119.4
Real effective exchange rate (CPI-based; 2000=100)	116.6	114.2	115.8

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

1/ In percent of total labor force.
2/ The methodology for calculatig the registered unemployment rate changed in 2004. Under the old methodology, the registered unemployment rate in 2004 is estimated at 10.2 percent.
3/ Excluding privatization revenues of the National Property Fund and the Czech Land Fund, the sale of shares and voting rights by local governments, and the sale of Russian debt.
4/ General government deficit excluding transfer to transformation institutions and net lending. Concept targeted by the authorities.