

Czech Republic: 2003 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Czech Republic

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with the Czech Republic, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 27, 2003, 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 August 8, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff supplement of **August 20, 2003** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its August 22, 2003 discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for the Czech Republic.

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

Selected Issues and Statistical Appendix Paper
Report on the Observance of Standards and Codes—Fiscal Transparency
Module—Update
Report on the Observance of Standards and Codes—Banking Supervision—
Update

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

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INTERNATIONAL MONETARY FUND

CZECH REPUBLIC

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the
2003 Consultation with the Czech Republic

Approved by Michael Deppler and G. Russell Kincaid

August 8, 2003

The 2003 Article IV consultation discussions were held in Prague during May 14–27, 2003. The team, headed by Ms. Schadler, included Mmes. Bal Gündüz, Krajnyák, van Elkan (all EU1) and Mitchell Casselle (MFD). Mr. Kiekens (Executive Director) and Mr. Jonas (Advisor to the Executive Director) attended several meetings. The mission met with: Governor Tuma of the Czech National Bank (CNB); Minister of Finance Sobotka; officials in the CNB and government ministries and agencies; the Parliamentary Budget Committee; trade unions; academics; and representatives of financial institutions and foreign investor groups.

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

The coalition government that emerged after the June 2002 elections lost its single-seat majority in parliament in July 2003.

In concluding the last Article IV consultation on July 26, 2002, Directors commended the economy's good performance, but urged the authorities to address looming fiscal problems and maintain the momentum for structural reforms. The authorities have taken or recently initiated action in these areas. Directors welcomed the role of monetary policy in containing the koruna's appreciation.

The mission conducted updates of the Report on Standards and Codes (ROSC) modules on the banking and fiscal sectors. The Czech Republic meets the Special Data Dissemination Standard (SDDS) specifications. Data in this report reflect information received by July 30, 2003. More recent data can be obtained from:

Czech Statistical Office.....<http://www.czso.cz/eng/angl.htm>
Czech National Bank <http://www.cnb.cz/en/index.php>
Ministry of Finance.....http://www.mfcr.cz/index_en.php
Information and documentation on economic
statistics can also be found at the Special Data
Dissemination Standard website of the IMF SDDS..... <http://dsbb.imf.org/country.htm>

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Executive Summary

Background. Growth slowed to 2 percent in 2002 with falling inflation. The koruna appreciated steeply against the euro until mid-year, when cuts in policy interest rates to euro-area levels and intervention led to a partial reversal. Although the trade balance improved, the current account deficit widened to 6½ percent of GDP due to a large increase in reinvested earnings and transferred dividends. The fiscal position continued to deteriorate and the general government deficit is projected to widen to about 7¼ percent of GDP in 2003.

Outlook. Growth is projected to remain moderate, at 1¾ percent in 2003, strengthening in 2004 to about 2½ percent. A pickup in external demand and solid private consumption growth should drive the recovery. Headline inflation should increase as the effect of falling food prices wanes but remain contained, at slightly above 2 percent at end-2003. Indirect tax changes will imply a temporary increase in inflation in 2004. The current account deficit should narrow to 5–6 percent of GDP.

Policy issues and discussions

Guarding against downside risks. With risks to the outlook on the downside and fiscal policy constrained by the need for adjustment, staff and the authorities agreed that any policy response to weaker-than-expected growth in 2003 should come from interest rate policy. Subdued inflation prospects have since induced the CNB to ease. The CNB intends not to react to an expected tax-induced increase in inflation in 2004, while countering possible second-round effects—a position that staff supported.

Ensuring fiscal adjustment. The sharp deterioration in the fiscal accounts and severely adverse demographics have brought home the need for fiscal adjustment. The government has put forward proposals for a reduction in the general government deficit relative to GDP by about 2¼ percentage points over 2004–06. Staff commends the proposal, which relies on expenditure cuts and indirect tax increases consistent with EU harmonization. But further efforts will be needed, both to replace those expenditure measures that are likely to be temporary and to restore full fiscal sustainability and make progress toward the Maastricht deficit criterion. Formulating fiscal policy plans within a medium-term framework would, in addition, bring a welcome lengthening in the policy horizon.

Defining a monetary policy framework. The current inflation targeting framework expires in 2005, and the new framework should provide a smooth transition to ERM2. The authorities are holding off their euro adoption plans until sustainable fiscal adjustment is underway and euro adoption requirements become clearer. Staff recommends making progress toward the Maastricht criteria irrespective of the precise timing of euro adoption, and endorses the CNB's intention to continue inflation targeting at least until ERM2 entry. On the future inflation target, staff calculations suggest that targeting a point in the 2½–3 percent range with a symmetric ±1 percent band would accommodate structural sources of inflation and meeting the Maastricht criteria. Direct foreign exchange intervention should continue to be limited to instances when clearly temporary influences are at work.

Responding proactively to potential financial sector risks. While banking sector soundness does not appear at risk, the recent acceleration of credit growth to households could become a source of vulnerability and warrants a proactive supervisory response. Addressing weaknesses in supervisory capabilities is also an ongoing task. Bank lending to enterprises remains slack, but current strong indicators of banking sector soundness should position banks well to respond to legal and institutional changes that will enhance the attractiveness of such lending.

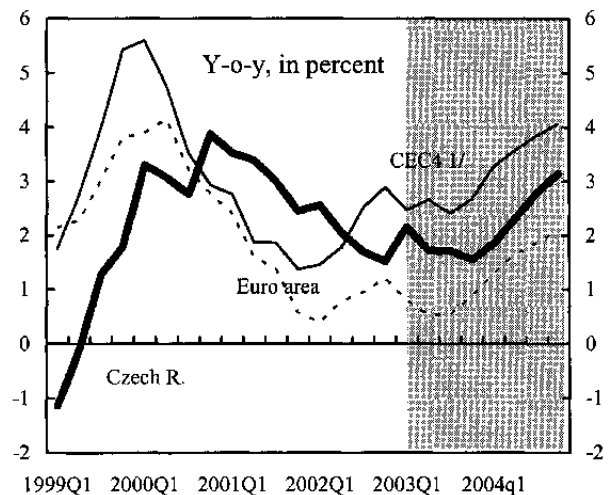
I. BACKGROUND

1. **The Czech Republic will complete the transition from central planning to EU membership in little more than a decade.** Initial conditions were good—the fiscal position was healthy and external and public debt low—and stabilization occurred rapidly. But restructuring proceeded slowly and only speeded up after the 1997 currency crisis. The new momentum for structural reforms, including privatization, increased the country’s attractiveness for foreign investors and helped modernize the economy. Although it raised unemployment, it set the stage for renewed growth by the late 1990s (Figure 1).

2. **Recently, the economy has shown considerable resilience in the face of the global slowdown** (Table 1). GDP growth slowed, but still posted a rate of 2 percent in 2002 despite serious floods. At 2.2 percent, it remained solid in the first quarter of 2003. Growth was underpinned by strong private consumption (reflecting rapid growth of wages and lending to households), rising goods exports, and a sizable fiscal stimulus. On the negative side, investment, which is geared toward prospects for final demand in Europe, slowed. Restructuring and weakening growth contributed to the upward drift of the registered unemployment rate (Figure 2).

3. **The export sector held up well despite a stronger koruna.** Like other Central European countries (CECs), the Czech Republic has a strong record in penetrating the EU market. Geographical advantage, reinforced by growing cross-border integration of production processes, has outweighed any direct cost-competitiveness disadvantage vis-à-vis competitors from other regions. Thus, the EU’s share in exports is about 70 percent (over 80 percent including the CECs). Much of these exports is generated by foreign direct investment (FDI), which the Czech Republic has been remarkably successful in attracting. As a result, the temporary rise of the koruna against the euro from late 2001 until mid-2002 and sluggish demand in Europe slowed but did not halt export growth. Reflecting this, the trade balance

GDP Growth, 1999-2004



Sources: Czech Statistical Office; World Economic Outlook; Eurostat; and IMF staff estimates.
1/ PPP-GDP weighted growth of Hungary, Poland, Slovak Republic, and Slovenia.

FDI Inflows, 1994-2002
(Average in percent of GDP)

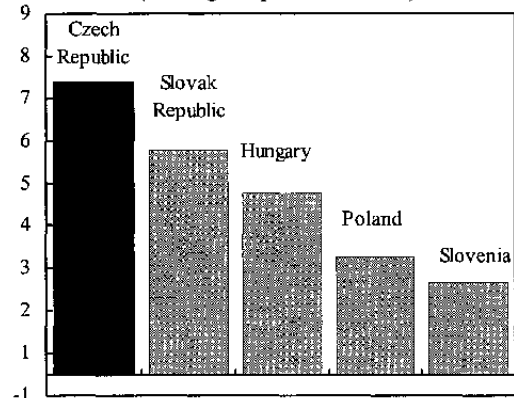
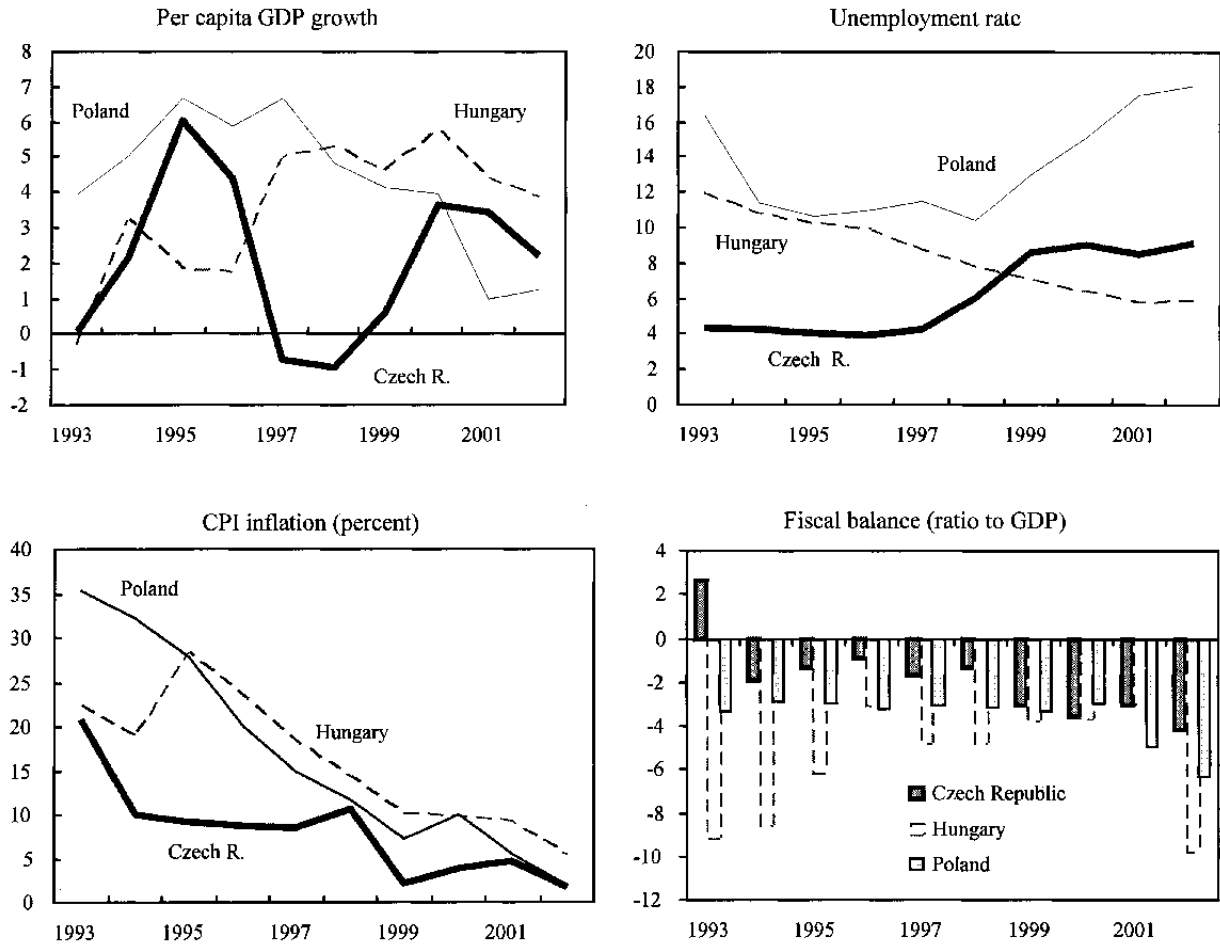
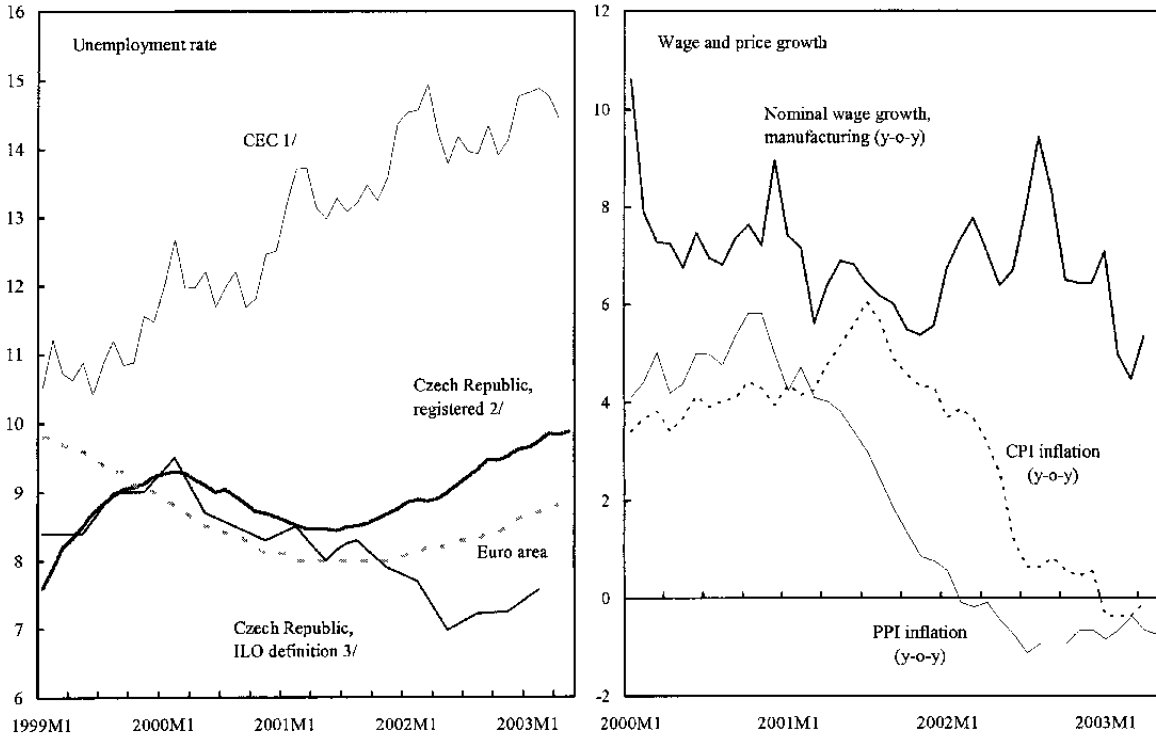


Figure 1. Czech Republic: Macroeconomic Indicators, 1993-2002
(In percent)



Source: IMF World Economic Outlook.

Figure 2. Czech Republic: Labor Market Conditions, 1999-2003

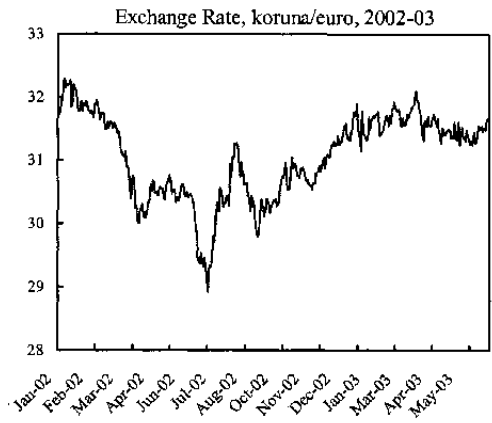


Sources: Czech Statistical Office; World Economic Outlook; Eurostat; and IMF staff calculations.
1/ PPP-GDP weighted average of four Central European countries (Hungary, Poland, Slovak Republic, Slovenia).
2/ Seasonally adjusted.
3/ Based on quarterly labor force survey data.

improved. However, the current account deficit widened to 6½ percent of GDP on account of a large increase in reinvested earnings and transferred dividends by FDI firms (Table 2).

4. With a surge in FDI and other investments, the koruna came under strong upward

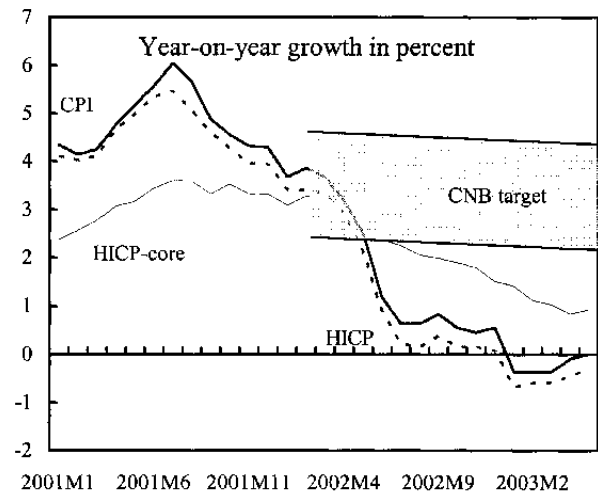
pressure beginning in late 2001. FDI accelerated sharply owing to the privatization of the gas utility. Expectations of an appreciation precipitated other inflows as commercial banks in particular attempted to reap gains on koruna holdings by repatriating their foreign deposits and borrowing from abroad. These pressures and their likely inflation effects prompted the CNB to cut interest rates sharply and undertake some \$6½ billion of sterilized intervention and off-market purchase of privatization receipts. Late in the year, after the koruna had stabilized, banks partially reversed their inflows by buying foreign debt instruments. The CNB's sterilization operations resulted in an increase in central bank instruments on the balance sheet of banks, bringing banks' holdings of government and CNB paper to about one-third of total assets.



Source: Czech National Bank.

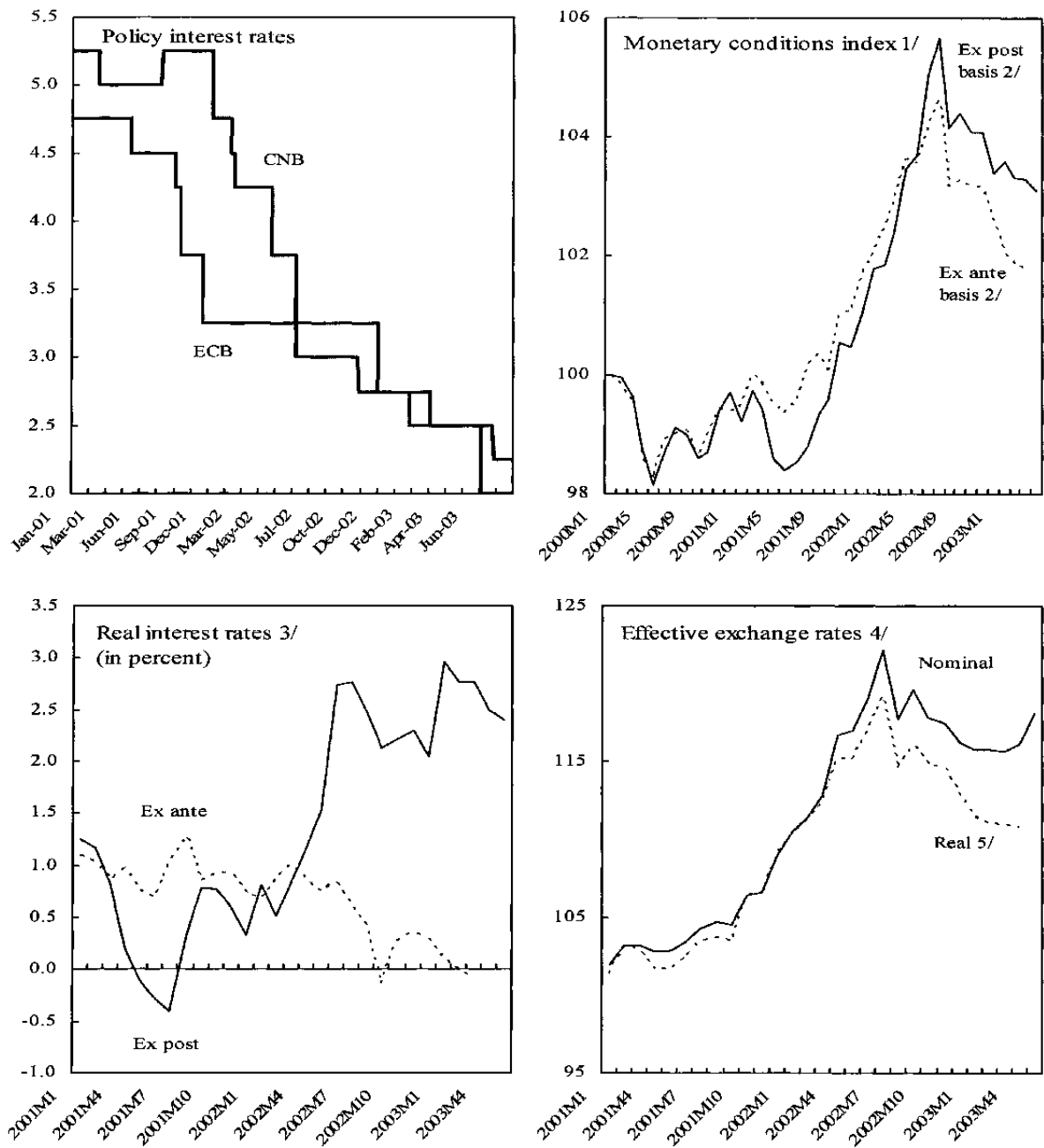
5. Faced with low expected inflation, koruna appreciation and slowing growth, the CNB eased policy rates throughout 2002 and early 2003 (Figure 3). The timing and size of the cuts were heavily influenced by the pressure on the koruna. But the moves were consistent with the inflation targeting framework, as the forecast of inflation fell well below the gradually declining target band. Behind the sharp drop in inflation were falling food prices and the pass-through of the koruna's appreciation. Real wage growth in manufacturing is estimated to be in line with productivity growth. However, wage increases have also been strong in less productive sectors—reflecting the Balassa-Samuelson effect—keeping core inflation at about 1 percent. The interest rate cuts left the spread between the two-week repo rate and the ECB policy rate nil or negative most of the past year. The negative spread eased pressures on the currency and lowered the monetary conditions index. Although the index remains some 3–4 percent above its 2000 average, owing largely to the

Inflation Developments



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

Figure 3. Czech Republic: Monetary Policy Indicators, 2001-03



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).

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

3/ 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.

4/ Czech National Bank. Weights based on foreign trade turnover.

5/ PPI-based.

cumulative 10 percent real appreciation of the koruna relative to 2000, part of this increase reflects the equilibrium real appreciation.¹

6. The 2003 budget foresees continued lax fiscal policy. The adjusted general government deficit (excluding transfers to the Czech Consolidation Agency (CKA) to finance costs of managing bad assets) widened by about 1¼ percentage points of GDP in 2002 and is expected to rise by a further 3 percentage points this year to a record 7¼ percent of GDP (Table 3).

Recent Fiscal Developments, 2001-03 1/

	2001	2002	2003 2/	Change, 2001-03
Revenues	39.1	39.9	40.1	1.0
Expenditures, total 3/	44.3	46.9	48.7	4.3
Adjusted expenditures 4/	42.0	44.1	47.4	5.4
Goods and services	8.4	9.2	9.5	1.1
Interest	0.9	0.7	1.0	0.1
Subsidies 4/	7.3	7.7	8.7	1.4
Transfers 5/	20.1	20.5	21.2	1.1
Capital expenditure	5.2	5.6	6.6	1.5
Net lending	0.1	0.3	0.4	0.3
Adjusted deficit 4/	-2.9	-4.2	-7.3	-4.4
<i>Memorandum item</i>				
Transfers to transformation institutions	2.3	2.8	1.3	

1/ In percent of GDP.

2/ MoF estimates based on the 2003 budget.

3/ Excluding proceeds from privatization and the sale of Russian debt.

4/ Adjusted for transfers to transformation institutions to cover the costs of managing bad assets.

5/ In 2003, includes one-off transfers of 0.5 percent of GDP.

and the rest on goods and services (mainly to establish a new layer of regional government), transfers, and investment. One-off events in 2003 also play a part.² Thanks to sizable privatization receipts in 2002, general government debt increased only moderately over the two years.

II. REPORT ON THE DISCUSSIONS

7. The discussions covered demands on policies in the face of weak activity in Europe, a growing fiscal problem, and the challenges of enhancing integration with Western Europe. In this context, the key issues were fiscal adjustment, keeping monetary policy on an even keel as prospects for inflation and euro adoption evolve, ensuring banking system soundness and efficient financial intermediation, and continuing institutional and structural reforms.

8. The authorities expected a gradual strengthening in activity during 2003 to provide an opportunity to initiate fiscal adjustment and press ahead with structural reforms. Output growth was expected to pick up as prospects for a recovery in the EU firmed. Although Czech inflation was likely to return to rates above those in the euro area, underlying inflationary

¹ The monetary conditions index is a weighted average of the short-term real interest rate and the real effective exchange rate, with weights of two-thirds and one-third, respectively.

² Restitution payments to a foreign investor related to a lost arbitration and flood-related spending add about ½ and ¼ percentage points to the deficit, respectively.

pressures were expected to remain subdued. Against the background of a severe deterioration of the fiscal accounts, starting a multi-year fiscal adjustment in 2004 was recognized to be a priority. Should downside risks to growth and inflation materialize, the appropriate response would be monetary easing, while the proposed fiscal adjustment would not be altered. On the structural side, continued privatization and institutional reform were seen to be required to strengthen growth prospects. While noting the sluggishness of bank lending to enterprises in recent years, the authorities felt that the conclusion of bank privatization, which had put virtually all bank assets in the hands of foreign-owned banks while transferring bad assets to the CKA, positioned banks to increase lending activity. Planned legal and institutional reforms were expected to strengthen the attractiveness of bank lending to enterprises. Looking further ahead, plans for adopting the euro would be formulated taking into account how quickly fiscal adjustment was accomplished and the readiness of the economy for monetary union.

A. Economic Outlook

9. **The short-term outlook appears reasonably positive.** The authorities and staff expected recovery to begin during 2003 and to strengthen in 2004. Modest differences in the expected pace of the recovery were due to different assumptions about the external environment. Although the first quarter did bear out the perceived resiliency, a gloomier outlook for Europe has prompted staff to revise down its growth projections since the discussions—by about ¼ percentage point to 1¾ percent in 2003 and by over ½ percentage point to about 2½ percent in 2004. Nevertheless, the basic picture remains one of solid private consumption growth and strengthening exports as demand in Europe recovers. Unemployment is projected to increase only slightly. The current account deficit, mostly financed by FDI, should narrow to 5–6 percent of GDP (Table 4). Inflation should remain contained owing to a negative output gap and continuing effects from last year’s appreciation of the koruna, but should pick up during 2003 (to slightly above 2 percent by end-2003 on staff’s projections) as the effects of falling food prices wane. In 2004, indirect tax changes are expected to temporarily increase inflation

10. **The balance of risks is on the downside.** The possibility of prolonged weakness in Europe represents a direct risk for exports, investment, and employment. Indeed, the increasing synchronization of developments in the Czech economy with cyclical conditions in Europe raises the possibility of confidence spillovers to consumption. Should these downside risks to growth materialize, inflation would likely turn out to be lower than under the baseline projection.

11. **Medium-term prospects are favorable, provided that fiscal problems are tackled, institutional reforms continue, and external competitiveness is maintained.** The authorities and staff agreed that, under these conditions, medium-term potential growth could rise to 3½–4 percent, despite small negative effects from a shrinking labor force. Direct and indirect effects of

	Decomposition of Growth 1/	
	Actual 1995-2002	Potential 2003-08
GDP growth	2.1	3.1
Labor	-0.4	-0.1
Capital	1.5	1.4
TFP	0.9	1.9

Source: IMF staff calculations.

1/ Capital stock data are not available.

The 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 5.5 percent.

foreign investment (its stock was over 40 percent of GDP in 2001), cumulated benefits of structural reforms, and a flexible labor market should raise total factor productivity growth. In this scenario, external current account deficits should be about 5 percent of GDP.

B. Monetary and Exchange Rate Policy

12. **The 18-month outlook for inflation, which conditions monetary policy under the inflation targeting framework, was softening.** The CNB's central forecast, published in April, saw inflation rising to about 3 percent by late 2003, owing to a rebound in food prices and dissipating effects of the koruna's appreciation. In addition, indirect tax changes before EU accession were expected to add 2–2.5 percentage points to headline inflation in 2004 and temporarily push it above the target range. While this one-off effect was not a concern to policy makers, a possible wage response was. At the time of the mission, however, sentiment in the CNB was shifting toward the view that tax effects might be smaller than originally estimated. Also, with increasing risks of a slower-than-expected recovery in the euro area, the output gap could close more slowly than previously envisaged, muting the projected price pick-up and the risks of a wage response to the tax changes. In July, the CNB lowered its estimates of the inflation impact of indirect tax changes to 1.5 percentage points and its projection for inflation in 2003–04.³

13. **The CNB, who at the time of the discussions was awaiting clearer indications for inflation prospects before deciding the direction of the next interest rate change, has since moved to easing policy.** While agreeing with the CNB's approach of delaying policy moves until potential inflationary pressures were more convincingly ruled out, staff urged the authorities to move quickly to reduce rates once they were. Staff pointed to the negative output gap and risks of a weak external environment as limiting prospective inflationary pressures. Since the discussions, continued low inflation, soft first quarter growth in the EU, and a reduction in the ECB's policy interest rates prompted the CNB to cut its policy rate by 25 basis points on June 26. Looking forward, the CNB did not intend to respond to the impact of the tax changes on inflation, but would react preemptively to any second-round wage effects—a position supported by staff.

14. **The authorities and staff agreed that foreign exchange market intervention should be exceptional.** The CNB explained that the sterilized intervention on several occasions during 2002 was a departure from the record of the past few years. It was, however, a response to their perception that the appreciation of the koruna since October 2001 was an overshoot. They felt that the intervention, including the off-market conversion of privatization inflows into koruna, had played a role in halting the appreciation. Staff questioned whether the simultaneous, aggressive cuts in interest rates had not in fact been the decisive factor. In this light, had the effects of sterilized intervention on the exchange rate been large or clear enough to warrant the potential costs—in terms of both possible losses for the CNB and clear communications with

³ The revision, reflected in the CNB's July forecast, resulted from revised assumptions about coverage of the planned indirect tax changes, the recognition that competition in the retail sector may prevent full transmission of the tax increases, and a weaker growth outlook.

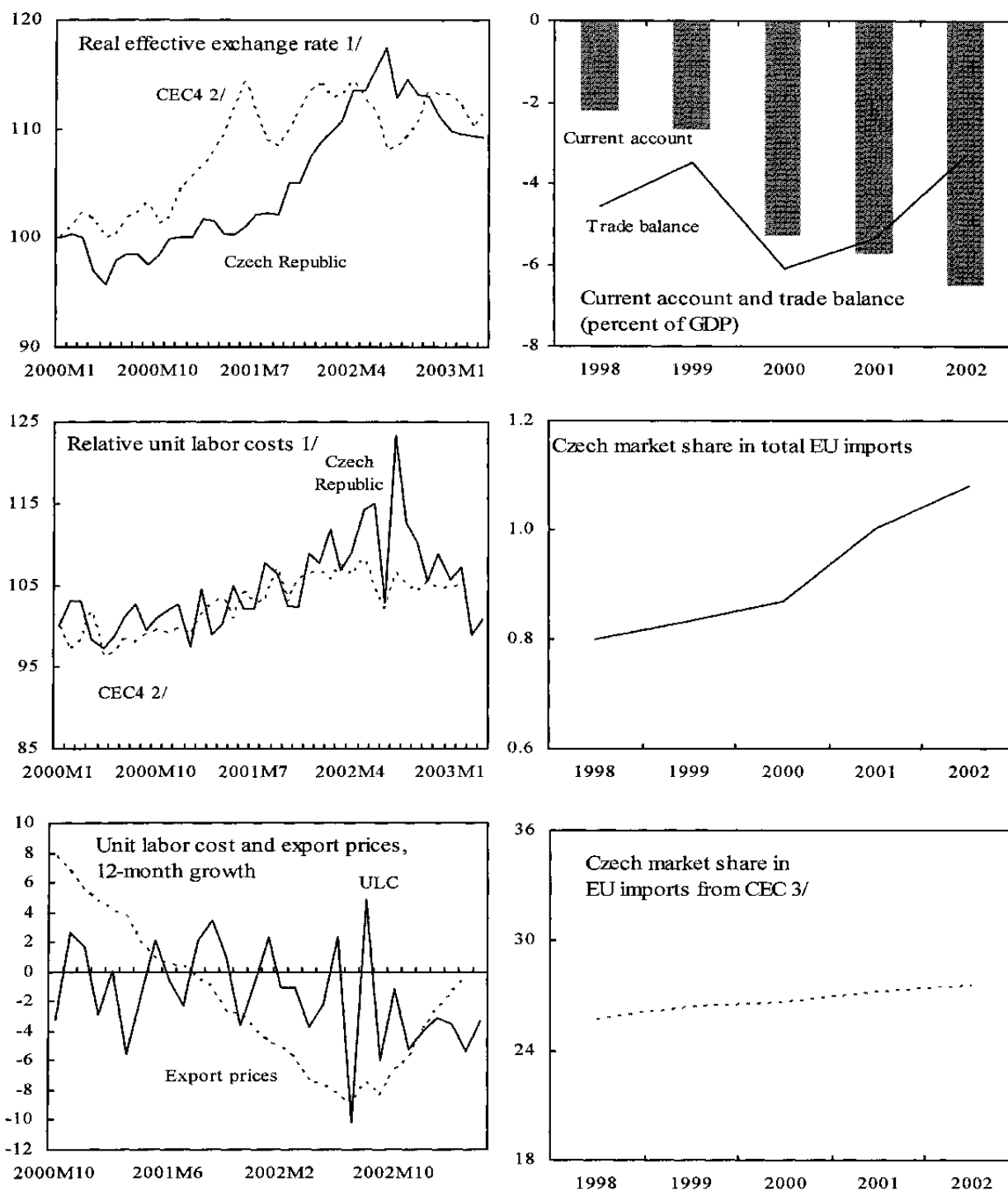
markets? Although the jury was still out on the relative importance of interest rate cuts and intervention in halting the appreciation, the authorities acknowledged that intervention could entail some costs: losses would accrue if short-term koruna interest rates rose above euro interest rates or the koruna appreciated. They were also concerned that the large volume of liquid CNB instruments on banks' balance sheets could reduce their ability to control credit growth without large interest rates changes. Finally, as regards the clarity of communications with the market, while the interventions might have created room for speculation about policy in the future, most officials felt that the market understood the exceptional nature of the interventions. Indeed, the authorities intended to intervene only in exceptional circumstances, an approach that staff supported.

15. **There was agreement that the current level of the exchange rate, judged against a broad set of indicators, was in the manageable range.** The authorities felt that firms had weathered the strong koruna in 2002 with little adverse effect. Nevertheless, they welcomed the depreciation of the koruna against the euro by about 10 percent since its peak in mid-2002. As a result, cost-competitiveness indicators were back in line with those of other CECs, profits of the export sector were rising, and exports were resilient (Figure 4). Sizable greenfield foreign investment and high (and increasing) reinvested earnings reinforced the view that the Czech Republic remained competitive as an investment location. Staff concurred with these points, but noted that the 10 percent real effective appreciation since 2000 had probably exceeded that justified by estimated Balassa-Samuelson effects. Also, while cost competitiveness had come back in line with that of other CECs, it needed to be judged also against that of rising exporting countries in the rest of the world. While data comparability problems hinder direct, up-to-date comparisons with non-European emerging markets, informal indicators suggest some weakening of competitiveness against these countries. At present, however, any weakening appeared unlikely to offset the considerable geographic advantage vis-à-vis the European market.

16. **The timetable for euro adoption would be based on progress in formulating a convincing medium-term fiscal adjustment program and more general indications of readiness for monetary union.** The CNB believed that the risks of a soft-peg exchange rate regime counseled minimizing time spent in ERM2. They therefore intended to enter ERM2 only when fiscal policy was clearly on a sustainable adjustment track. The timing decision would be influenced not only by prospects for satisfying the Maastricht tests, but also by their judgment on the economy's readiness to participate in the union. On the latter, staff noted that measures of business cycle synchronization and integration with the euro area were not as strong as in other CECs but were strengthening.

17. **The authorities were hoping for greater clarity on the requirements for euro adoption before decisions on a new monetary policy framework were made.** The current policy framework is based on an inflation target that expires in 2005, so decisions on a new target or framework will be needed in early 2004. Ideally these would be based on a clear view of

Figure 4. Czech Republic: Indicators of External Competitiveness, 1998-2002



Sources: Czech Statistical Office; Czech National Bank; International Financial Statistics Direction of Trade Statistics; and IMF staff calculations.

1/ Relative to industrial country partners, January 2000=100.

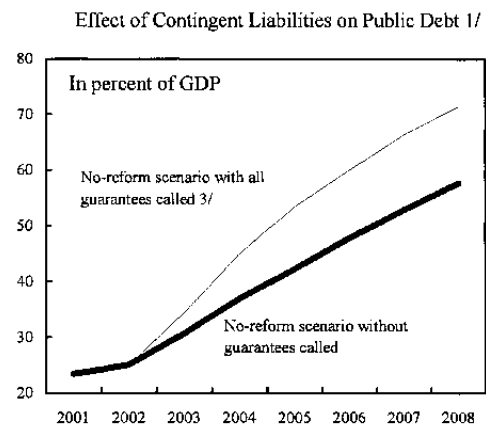
2/ Trade-weighted average of four Central European countries (Hungary, Poland, Slovak Republic, Slovenia).

3/ Czech Republic, Hungary, Poland, Slovak Republic, and Slovenia.

the path and requirements of ERM2 and euro adoption. The CNB's accumulated experience with inflation targeting and the risks to credibility in shifting to a new framework argued for continuing inflation targeting until euro adoption. The authorities and staff agreed that—as inflation would be affected by real convergence and administrated prices and tax changes for some time—the future inflation target should be calibrated to accommodate structural sources of inflation.⁴ Staff's calculations indicate that targeting a point in the 2½–3 percent range with a symmetric ± 1 percent band would do so and satisfy the Maastricht inflation criterion. The authorities viewed inflation targeting as feasible even during ERM2 if the Maastricht exchange rate stability criterion were assessed relative to a fairly wide exchange rate band. Were the exchange rate stability criterion interpreted more narrowly, the CNB indicated that it might gear monetary policy to targeting the nominal exchange rate.

C. Fiscal Policy

18. **The discussions indicated a strengthened political will to address the risks to fiscal sustainability.** The widening deficit, high tax burden, and mandatory and quasi-mandatory nature of 80 percent of total expenditures had established the need for adjustment. Population aging would further stress fiscal accounts beginning in 2006.⁵ While public debt is low (27 percent of GDP), high deficits and a drop in privatization revenues will contribute to a steep increase in coming years. Moreover, government guarantees, provided for exports, infrastructure projects, the debts of the Czech railways, and in connection with the failure of the IPB bank, amount to about 20 percent of GDP⁶ and are not accounted for in the debt. The medium-term goal of meeting the Maastricht deficit limit also argued for a decisive change in policy. The alternative to adjustment was grim: public debt would rise rapidly to over 50 percent of GDP under



Sources: Ministry of Finance; and IMF staff calculations.

1/ Including CKA's debt. Assumes a deficit path consistent with the authorities' no-reform scenario.

2/ Assumes all guarantees are called in 10 years, one-third of which in 2003–05.

⁴ The CNB estimates ongoing productivity-based equilibrium real appreciation (the Balassa-Samuelson effect) at about 1½ percent per annum, in line with estimates in other CECs. Administered price adjustment and aligning indirect taxes with the EU will also contribute to inflation in the next few years.

⁵ Demographics in the Czech Republic are among the most adverse in Europe: the old-age dependency ratio will reach about 57 percent by 2050, and age-related public spending is projected to increase by about 9 percentage points of GDP over the next 50 years.

⁶ Total nominal amount of guarantees. On a risk-adjusted basis, the authorities' 2003 Pre-accession Economic Programme estimates that a cumulative 5 percent of GDP could be called in 2003–08.

the authorities' no-reform scenario (Appendix I), and lapses in progress toward meeting the Maastricht criteria could negatively affect investor confidence, exchange markets and interest rates.

19. A government proposal for fiscal adjustment in 2004–06, with the weight of the measures on the expenditure side, is now before parliament. At the time of the discussions, the Ministry of Finance (MoF) had prepared a proposal to reduce the deficit from a projected 6¼ percent of GDP (without one-off spending) in 2003 to 4 percent of GDP by 2006.⁷ The 2004 budget would incorporate the first stage of the adjustment effort and reduce the deficit relative to GDP by about ¾ percentage point.⁸ Beyond narrowing the deficit, the proposal makes room for higher EU-related spending (Table 5) and gradual cuts in the corporate income tax rate from 31 percent to 24 percent (Box 1). About one-quarter of the adjustment is envisaged

Fiscal Adjustment Proposal, 2003-06
(In percent of GDP)

	2003	2004	2005	2006
Deficit (authorities' no-reform scenario) 1/, 2/	-6.2	-8.1	-8.3	-7.7
Adjustment relative to no-reform scenario				
Revenue adjustment	0.0	0.9	1.1	0.9
Expenditure adjustment	0.0	-1.8	-2.4	-2.8
<i>Of which: limited civil service reform 3/</i>		-0.6	-0.9	-1.0
Targeted deficit	-6.2	-5.5	-4.8	-4.0
Cumulative change from 2003		-0.7	-1.4	-2.2

Sources: Ministry of Finance; and IMF staff estimates.

1/ Excludes privatization revenues, transfers to CKA, and net lending. Based on MoF estimates of revenues and expenditures and IMF staff GDP projections.

In 2003, excludes one-off spending of about 0.7 percent of GDP.

2/ The steep increase in the deficit in 2004 is mostly due to EU-related revenue losses and spending increases, and the full implementation of the civil service reform that would introduce a new system of remuneration.

3/ Budgetary impact of the new system of remuneration limited to 5 billion koruny;

2 percent per annum decline in employees of budgetary and semi-budgetary organizations

Box 1. Corporate Income Tax Rates in Selected Accession Countries

The corporate income tax (CIT) rate in the Czech Republic is high compared with other CECs. Moreover, across the region, countries with higher CIT rates are planning substantial cuts that by 2004 will put CIT rates in the 15–19 percent range. Caution is needed in interpreting the effects of these changes on countries' competitiveness—which depends on features of the tax system other than tax rates, as well as a variety of nontax factors. Nevertheless, these developments illustrate regional pressures on tax policy.

Corporate Income Tax Rates in Selected Accession Countries

	Current Rate	Future Rate	By:
Czech Republic	31	24	2006
Hungary	18	18	n.a.
Latvia	19	15	2004
Lithuania	15	15	n.a.
Poland	27	19	2004
Slovak Republic	25	19	2004

Source: IMF country desk data.

⁷ These figures are on the authorities' definition of spending, which, in contrast to staff's, excludes net lending (about 0.4 percent of GDP in 2003). Net lending captures the net acquisition of financial assets for policy purposes. These transactions often involve a subsidy element.

⁸ The disappearance of one-off 2003 spending items would contribute another ¾ percentage point.

to come from revenue measures—mainly by shifting certain goods and services from the preferential to the regular VAT category and increasing excises. The bulk of the adjustment is thus on the expenditure side and, with the exception of savings from limiting the budgetary impact of civil service reform, distributed across many small measures. Implementation of measures requiring legislation—mainly changes to social benefits—is planned for 2004 and 2005. Since the discussions, government backing for the deficit targets and the main institutional changes has been secured, but some measures underpinning the adjustment have yet to be agreed. Parliament started discussions on the proposal on July 22.

20. Staff welcomed the proposals, especially those to rein in public spending.

As the recent widening of the general government deficit was due to increasing expenditures—a trend that the authorities' no-reform scenario saw continuing—placing most of the burden of adjustment on public spending was clearly appropriate. Permanent savings would result from many of the measures, notably cutting public employment to limit the wage bill and trimming social spending (mainly by lowering benefit levels, slowing indexation, and reducing abuse). The proposed changes to the pension system—such as increasing the retirement age to 63 years and shifting to a notionally defined contribution system—and measures to reduce the level and incidence of sickness benefits were also likely to bear significant long-term savings.

21. Spending restraint would need to be taken further to stabilize debt and meet the Maastricht 3 percent of GDP deficit limit.

Some aspects of the proposed expenditure measures raised staff concerns. First, compressing operating expenditure and delaying the full implementation of civil service reform would only temporarily restrain spending. Second, questions remained as to whether the measures targeted the areas that had produced the bulk of the recent increase in expenditures. Specifically, on a GFS basis, increases in subsidies and

Effects of the Proposed Adjustment Measures, 2004-06 1/

	2004	2005	2006
	(In billions of koruny)		
Revenues	21.8	29.4	22.9
Indirect taxes	27.5	38.8	43.1
Corporate income tax	-5.7	-12.1	-21.9
Other	0.0	2.7	1.7
Expenditures	45.4	65.4	78.1
Wages	16.2	25.7	31.2
<i>Of which: civil service reform 2/</i>	14.2	23.2	28.5
Transfers	8.9	13.0	11.7
Subsidies 3/	-1.5	0.3	2.4
Other 4/	21.8	26.4	32.8

Source: Ministry of Finance.

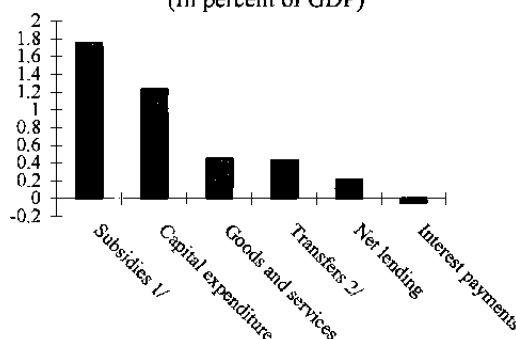
1/ Compared to the authorities' no-reform scenario.

2/ Includes limiting the budgetary effect of a new system of remuneration to 5 billion koruny, and reducing the number of employees in budgetary and semi-budgetary organizations by 2 percent per annum.

3/ Changes to construction savings subsidies.

4/ Includes lower military spending, savings on operating expenditure, lower subsidies to businesses, and lower debt service cost.

Increase in Expenditure Categories, 2000-03
(In percent of GDP)



Sources: Ministry of Finance; and IMF staff estimates.

1/ Without transfers to CKA.

2/ Excludes one-off transfers of 0.5 percent of GDP in 2003.

transfers to nonfinancial enterprises had accounted for much of the widening in the deficit since 2000; it was not clear how far the proposed measures would go in reversing rises in this category. Third, further pension reform will be necessary to ease future population aging stresses. This could build on the proposed measures, including (i) allowing average benefits to fall below 40 percent of the average wage, (ii) increasing further the statutory retirement age, (iii) extending the minimum contributory period, and (iv) tightening eligibility for noncontributory periods. The authorities acknowledged these concerns. On the second point, they explained that classification problems, partly related to ongoing fiscal devolution to regions, complicated the analysis of past expenditure trends. Moreover, much of this spending appeared to occur on semibudgetary organizations such as schools and hospitals.⁹

22. Implementation of the program would be helped by strengthened budgetary procedures. The MoF was pressing to (i) introduce a medium-term fiscal framework with binding expenditure targets; (ii) incorporate spending by extrabudgetary funds in the responsible ministries' expenditure ceilings and the budget procedure; and (iii) limit the issuance of new public guarantees and account for them explicitly in the budget.¹⁰ Staff supported these disciplining changes, currently under discussion in the parliament: they would help focus on the longer-term consequences of policy choices and contribute to a coherent strategy for meeting the Maastricht fiscal criteria. Also, acting on the recommendations of the fiscal ROSC update would enhance transparency and complement the reform proposal.

23. Public support for the reforms was a major question. The authorities were determined to take every opportunity to explain the need for reform and to press ahead even with unpopular aspects of it. Although the public showed signs of accepting the necessity of fiscal adjustment (labor union representatives voiced their understanding to the mission), broad support for the specific proposals was not assured. Staff pointed to the danger to credibility should the proposal be watered down during the political process or implementation slip.

D. Financial Sector Issues

24. While some aftereffects of the cleanup and privatization of the banking sector persist, financial indicators had strengthened impressively. Following the large-scale transfer of non-performing loans to the CKA and the completion of bank privatization, profitability and capital adequacy ratios were strong, and the stock of nonperforming loans, adjusted for write-offs

⁹ Semibudgetary organizations operate through separate budgets, maintain their own bank accounts, and retain revenue generated by their activities. They are related to the state budget or local governments only through grants received from, or surpluses paid into, the budgetary accounts. Major groups include healthcare providers and institutions providing educational, cultural, and other services.

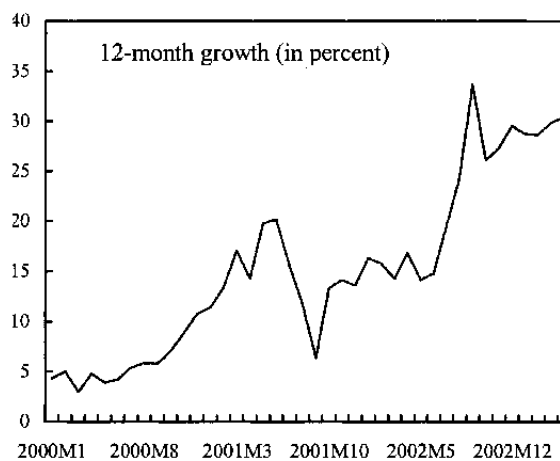
¹⁰ However, contrary to the effort to make the fiscal implications of guarantees more transparent, the general guarantee issued to the Railway Transport Infrastructure Administration (a central government entity) in 2003 would not be covered by this provision and would be exempt from the requirement for parliamentary approval of new guarantees on an individual basis.

transferred to the CKA, was declining (Table 6).¹¹ The past year and a half had seen the continuation of trends since the banking sector cleanup in the composition of banks' balance sheets. Bank holdings of liquid government and CNB paper had continued to rise to over a third of total assets, reflecting banks' caution in taking on risks and the 2002 sizable sterilized foreign exchange intervention. Lending to enterprises had fallen, albeit more slowly than in previous years, but lending to households had accelerated sharply.

25. **The continuing drop in bank lending to nonfinancial enterprises was viewed as part of the lingering effects of previous banking sector difficulties.** Banks, recovering from large loan losses and adapting to risk management systems introduced by new foreign owners, remained highly cautious about lending to enterprises—a development typical of other post-crisis countries. In particular, the reluctance to lend to small and medium-sized enterprises reflected the perceived riskiness of these clients, heightened by inadequate protection of creditors' rights under the existing bankruptcy law. A large part of banking system-wide assets, therefore, was held in government and central bank instruments. The authorities, while hoping to see a revival in bank lending to enterprises, emphasized that risk assessment practices were improving and the reluctance to lend to enterprises was a reflection of genuine risks. Nevertheless, they believed that the state needed to play a supportive role by changing the legal infrastructure to increase protection to creditors. Amendments to the Bankruptcy and Settlement Act to address the most obvious shortcomings and loopholes were under preparation.

26. **In contrast, lending to households had accelerated sharply and discussions focused on the challenges this presented to supervisors.** Banks and the authorities confirmed that the rapid increase in lending to households reflected two factors: First, a perception of acceptable risk—supported by the still-low share of household credit (21 percent of total credit in May 2003) and anecdotal evidence on so-far negligible default ratios on mortgages; and, second, households' strong credit demand in the face of prospects for rapidly rising incomes and historically low interest rates. The authorities thought the low stock of credit to households—about 8 percent of GDP in 2002—moderated the need for

Credit Growth to Households, 2000-03



Source: Czech National Bank.

¹¹ The European Union has requested a government assessment by April 2004 of whether selected cases of aid to banks comply with EU guidelines on state aid. On a cumulative basis, funds provided by the government to the CKA and its predecessors to cover losses on bad assets amounted to about 10 percent of GDP during 1997–2003. Should aid not be found compliant, at least part of it would need to be returned to the state, and bank soundness could be impacted significantly.

prudential concerns. They considered banks' internal risk management practices adequate to impose appropriate limits on exposure to loans secured by real estate. Staff argued that despite the low current exposure to households, the rapid change called for close monitoring of key indicators, including household indebtedness and delinquencies, housing and property prices, and banks' aggregate and individual exposure to households, for early signs of vulnerabilities. Establishing prudential norms, such as loan-to-value rules for mortgage loans, in line with international best practices, would also help contain vulnerabilities.

27. **Progress in strengthening the supervisory and regulatory framework is continuing.** The authorities' efforts were directed toward implementing prudential norms and supervisory practices on risk, improving banks' risk management and facilitating consolidated supervision—steps identified as priorities in the 2001 FSSA (Box 2). Staff applauded these initiatives and pointed to other areas where improved supervisory capacity and measures to address institutional shortcomings were needed to safeguard banking soundness and ensure efficient financial intermediation. Recent developments in the banking sector made clear to the CNB that specific provisions should be included in the amendments to the bankruptcy law to deal with liquidation of insolvent banks. Staff also called for further improvements in the CNB's practices for managing licensing and change of ownership processes, in enforcement powers, and in prompt corrective action practices.

E. Structural and Other Issues

28. **Strengthening the institutional and legal framework remains critical for maintaining a strong record on FDI.** The authorities and representatives of the private sector saw shortcomings in these areas to be the weakest link in an otherwise attractive environment for foreign and domestic investors. Shortcomings in the existing bankruptcy law (particularly regarding creditors' rights), an overburdened judiciary, slow and nontransparent legal procedures, and inefficiencies in the operation of the Commercial Registries were considered to be important hindrances. The authorities were preparing amendments to the bankruptcy law to, inter alia, strengthen creditors' rights, increase the capacity of administrators for bankrupt firms, and address bank liquidation issues. Banks and government officials also emphasized the importance, particularly for small-to-medium size firms, of improving transparency and timeliness of financial data, managerial flexibility, and technical capacity. Private sector initiatives, primarily focused on training and financial disclosure, were under way to improve the situation.

**Box 2. BCP Readiness—Second Factual Update of Compliance with Basel Core Principles (BCPs)
Covering July 2002–May 2003**

The factual update of compliance with the BCPs found progress in several areas, consistent with recommendations of the 2001 FSAP/FSSA report.¹

Framework for risk management

- The CNB has issued new rules for managing credit and market risks. Banks are also required to adopt procedures for monitoring and controlling country and transfer risks.
- The CNB has issued new rules on banks' credit risk management, asset classification, and loan loss provisioning. Compliance is inspected through on-site examinations.
- Banks are required to establish internal audit departments, adopt policies on market risk management, and test internal management and control systems.
- The CNB plans to base its assessment of banks' performance on their individual risk profiles. The assessment would feed into the customization of future supervisory activities.

Consolidated supervision

- The CNB now monitors credit risk and market risk at a consolidated level, and amendments to the Act on Banks require banks to provide to the CNB information on all members of a consolidated financial group.
- A memorandum of understanding (MOU) was signed among the domestic supervisory agencies, allowing consolidated supervision of banking, insurance, pension funds, and the capital market.²
- MOUs have been signed with several supervisory agencies abroad.

Other areas

- Efforts are underway to comply with international standards on AML/CFT.³
- The CNB is developing a framework for macroprudential analysis and stress testing capacity (with technical assistance from the IMF's Monetary and Financial Systems Department).

Nevertheless, some shortcomings remain.

Regarding preconditions for a well-functioning financial system:

- Weaknesses in creditors' rights and procedural issues may discourage lending, prompt over-collateralization and affect enforcement of financial contracts.
- The Bankruptcy Law does not treat explicitly the special requirements of liquidation of financial institutions.
- Bankruptcy proceedings and other judicial procedures are slow and judiciary capacity for handling financial matters is insufficient.

Regarding supervisory practices, deficiencies exist in some areas of change of control practices. Further amendments to the Act on Banks are needed for enforcement powers, operational risks, and connected or related parties transactions.

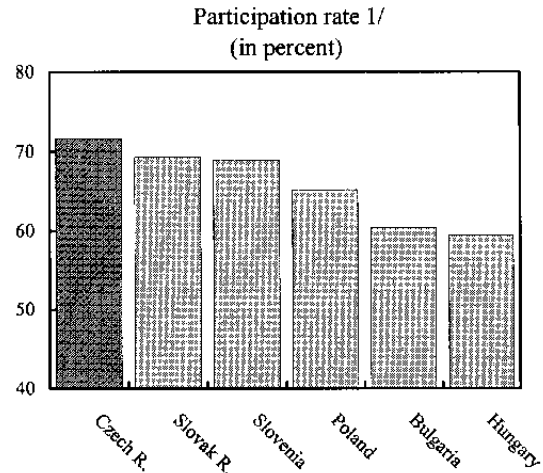
¹ "Czech Republic: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency; Banking Supervision; Insurance Regulation; Securities Regulation; Corporate Governance; and Payment Systems" (IMF Country Report No. 01/113, 07/01).

² After the mission, in June 2003, the MoF issued a draft proposal calling for consolidation of supervision for financial institutions/markets into one agency.

³ An AML ROSC was recently undertaken. A report will be submitted to the Board (date to be decided).

29. **With much of the state's holdings of enterprises, banks, and other assets now divested, the authorities are aiming to complete remaining privatizations and asset sales and close the associated institutions.** The authorities expected the privatization of several strategic companies (including Czech Telecom and the petrochemical company Unipetrol) to be concluded in 2004–05 and indicated that the privatization of other remaining state assets might be accelerated. After the mission, the MoF proposed to partially divest state holdings in the vertically-integrated electricity company CEZ. The sale of assets taken over by the Czech Consolidation Agency in the cleanup of the banking sector was proceeding apace, with the sale of a third bundle of assets (concluded on July 7) and a further bundle to be offered for sale later this year. The authorities were searching for strategic buyers for the viable companies in which the state had acquired majority ownership. Owing to EU limits on state aid and the inability of CKA to grant loans, the authorities did not foresee CKA taking on more bad assets.

30. **The recent increase in unemployment was a concern, but the authorities did not see it as an indication of significant labor market rigidities.** Over the last decade, the Czech labor market had accommodated massive structural change while unemployment was moderate and participation rates were the highest among the CECs. The authorities considered the labor market flexible and attributed the recent upward creep of the registered unemployment rate mostly to temporary effects from restructuring. This was consistent with the widening gap between the registered and the survey-based unemployment rate: some of the unemployed—possibly those with outdated skills—were likely withdrawing from the labor market. The authorities thought that the regional concentration of unemployment reflected skill mismatches, low mobility, and weak labor demand in depressed regions. Staff emphasized that to prevent the emergence of a long-term problem, motivating job search, providing retraining opportunities, reducing impediments to labor mobility, and lowering nonwage labor costs should be considered even if—as in the case of easing rent controls or reducing nonwage labor costs—they involved some fiscal costs.



Source: Eurostat.

1/ Ratio of labor market participants to the 15-64 cohort.

31. The Czech Republic has completed the alignment of its customs legislation with the *acquis communautaire*. Efforts are underway to align policies with the *acquis* on common commercial policy and to coordinate positions in the World Trade Organization with the EU.

32. Work on implementing the OECD's Anti-Bribery Convention continues. A new criminal code is under preparation and would introduce the criminal responsibility of legal persons.

III. STAFF APPRAISAL

33. **The Czech economy has turned in a solid performance over the past few years, and medium-term prospects are good.** Healthy growth, low inflation, moderate (albeit growing) unemployment, a successful restructuring of the economy and impending EU membership attest to the achievements. One feature marring this picture is the recent deterioration of the public finances. But a responsible monetary policy, continuing institutional reforms and the emergence of political will to tackle the fiscal problem make for a strong medium-term outlook. And while the authorities have not articulated a strategy for euro adoption, adhering to these policy intentions will be crucial for meeting the Maastricht criteria and keeping options on the timing of euro adoption open.

34. **The short-term outlook is positive, although downside risks are significant.** Growth is expected to remain resilient and gradually strengthen with the European recovery. Inflation and the current account deficit should remain subdued. However, given the Czech economy's openness, much depends on the strength and timing of the pickup in the EU.

35. **The outlook for low underlying inflation leaves scope for monetary policy to continue to support growth.** This leeway is welcome in view of the plans to start a much-needed fiscal adjustment in 2004. Near-term monetary policy decisions will need to balance the immediate downside risks to growth and inflation against the likely increase in inflation as food prices recover and indirect tax adjustments are made. The experience in halting the strong appreciation of the koruna in 2002 speaks to the importance of interest rate policy in avoiding undue exchange rate pressures. While the subsequent depreciation has returned the koruna to a manageable level, the authorities should use all the scope provided by low inflation to limit further appreciation. Taking these considerations together, the decision, after the mission, to lower the policy rate was an appropriate response to weakening prospects for European recovery and softening inflation expectations.

36. **Past success with inflation targeting recommends renewing the commitment to it when decisions on the post-2005 framework are made early next year.** Ideally these decisions will be made against the background of greater clarity on prospects and requirements for euro adoption. Yet, even if uncertainties remain, the authorities should continue inflation targeting at least until entering ERM2. As regards the inflation target itself, a point in the range of 2½–3 percent, with a symmetric ± 1 percent band, would provide room for stability of both inflation and the nominal exchange rate as the effects of real convergence on relative prices take place. In this framework, the role for foreign exchange market intervention should be exceptional. While the intervention in 2002 may have played a role in halting the koruna's appreciation, interest rate adjustments were probably more important and sent clearer signals to markets consistent with the fundamentals of inflation targeting.

37. **The government's new resolve to address the three-year-long deterioration in the fiscal accounts is welcome.** The intention to reduce the general government deficit to 4 percent of GDP by 2006, while cutting corporate tax rates and reprioritizing spending to accommodate EU-related demands, represents the first step in restoring public finances to good health. Given the root of the current fiscal problem—expenditure increases—and the Czech Republic's high

tax burden, the emphasis on expenditure restraint is well-placed. Many of the proposed expenditure measures, such as reforms of pensions or sickness benefits, would yield permanent savings and make the adjustment sustainable. Formulating fiscal policy plans and annual budgets within a medium-term framework would bring a welcome lengthening in the policy horizon, help build public support for key objectives, and bolster implementation of the adjustment measures. Other proposed institutional reforms—such as incorporating spending by extrabudgetary funds in the responsible ministries' expenditure ceilings and internalizing the budgetary impact of new public guarantees and limiting their issuance—would help reduce policy implementation risk. Acting on the recommendations of the fiscal ROSC update could complement these changes.

38. **The challenge now is to implement the proposals and prepare for more over the medium term.** Diluting the proposals—always a risk during discussions on detailed proposals—would only push the burden of adjustment to later years. Over the medium term, additional scope for permanent savings, particularly on mandatory and quasi-mandatory spending, will need to be found, both to replace temporary measures and to prepare for population aging and move toward the Maastricht deficit limit.

39. **A sound banking system requires that supervisors respond proactively to new potential risks.** While broad indicators of banking system soundness are reassuring, rapidly increasing exposures to households could become a source of vulnerability. To evaluate the prudential implications of this trend, supervisors should give priority to collecting information on household indebtedness, housing and property prices, and banks' aggregate and individual exposure to households. They should also monitor closely banks' ability to assess the risk of this new and dynamic class of credit and adopt appropriate prudential norms for loan-to-value ratios for real estate lending. In other areas of financial supervision, progress continues, but addressing weaknesses in supervisory capabilities is an ongoing task. The CNB should work to increase the efficacy of prompt corrective action, bank licensing and change of control practices, and bolster supervisory capacity with respect to operational risks and connected or related party lending.

40. **Redressing shortcomings of the judicial and legal systems is the top priority for structural reform.** The forthcoming amendments to the bankruptcy law represent an opportunity to strengthen creditors' rights, but more transparent legal procedures, more timely court decisions, and better-functioning Commercial Registries are also necessary to improve the business environment. Proceeding with privatization will also be critical, and restructuring efforts should start targeting pockets of the economy (for example, Czech Railways) where the process is at an early stage. Steps to preserve and improve labor market flexibility remain crucial for maintaining external competitiveness and adapting to shocks to the economy.

41. It is recommended that the **Article IV consultation** remain on the standard 12-month cycle.

Table 1. Czech Republic: Selected Economic and Financial Indicators, 2000-04

	2000	2001	2002	2003 1/	2004 1/
Real economy (change in percent)					
Real GDP	3.3	3.1	2.0	1.7	2.6
Domestic demand	4.0	5.1	3.4	1.9	2.6
CPI (year average)	3.9	4.7	1.8	1.1	3.9
PPI, industry (year average)	4.9	2.9	-0.5
Unemployment rate, year average (in percent)					
Registered 2/	8.8	8.9	9.2	9.4	9.2
Labor force survey-based 2/	8.8	8.1	7.3	7.5	7.3
Gross national savings (percent of GDP)	24.4	23.8	21.7	21.0	20.3
Gross domestic investments (percent of GDP)	29.7	29.6	28.2	26.6	25.4
Public finance (percent of GDP)					
General government revenue	39.3	39.1	39.9	40.1	40.5
General government expenditure 7/	43.9	44.3	46.9	48.7	47.2
General government balance 7/	-4.5	-5.3	-7.1	-8.6	-6.7
Adjusted to exclude grants to transformation institutions to cover costs related to management of bad assets	-3.5	-2.9	-4.2	-7.3	-6.0
Targeted deficit concept 3/	-3.4	-2.8	-3.9	-7.0	-5.5
General government debt	16.7	18.6	19.5	26.7	31.4
Including debt of the Czech Consolidation Agency	23.0	24.4	27.0	33.1	36.0
Money and credit (end of year, percent change)					
Broad money	5.6	13.0	3.2
Domestic credit to nonbanks (percent change, end of period) 4/	-4.2	2.0	4.3	3.7	...
Interest rates (in percent)					
3-month interbank rate (end of period) 5/	5.4	4.7	2.6	2.3	...
10-year government bond 5/	6.7	4.6	2.7	3.8	...
Balance of payments (percent of GDP)					
Trade balance	-6.1	-5.4	-3.3	-2.0	-1.4
Current account	-5.3	-5.7	-6.5	-5.6	-5.1
Gross international reserves (US\$ billion)	13.1	14.5	23.7	28.0	29.2
Reserve cover (in months of imports of goods and services)	4.2	4.1	6.1	5.8	5.5
Fund position (as of April 30, 2003)					
Holdings of currency (percent of quota)				75.7	
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 (July 30, 2003)				CZK 28.00 =US\$1	
Nominal effective exchange rate (2000=100) 6/	100.0	104.4	116.4	116.1	...
Real effective exchange rate (CPI-based; 2000=100) 6/	100.0	105.5	116.5	112.7	...

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

1/ Staff estimates and projections.

2/ In percent of total labor force.

3/ General government deficit excluding transfer to transformation institutions and net lending.

4/ For 2003, data refer to growth rate from March 2002 to March 2003.

5/ For 2003, data refer to June 1.

6/ For 2003, data refer to April.

7/ 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.

Table 2. Czech Republic: Balance of Payments, 2000-04
(In millions of U.S. dollars)

	2000	2001	2002	2003 1/	2004 1/
Current account balance	-2,718	-3,273	-4,523	-4,796	-4,753
Trade balance	-3,131	-3,068	-2,286	-1,713	-1,311
Exports	29,052	33,378	38,198	48,943	53,225
Imports	32,183	36,446	40,484	50,656	54,537
Nonfactor services	1,414	1,524	668	502	421
Receipts	6,862	7,090	7,061	8,178	9,277
Payments	5,448	5,566	6,393	7,676	8,856
Factor income (net)	-1,373	-2,197	-3,781	-4,814	-5,197
Capital account	-5	-9	-4	-4	-4
Financial account balance	3,836	4,544	11,198	5,851	5,683
Direct investment, net	4,943	5,476	9,029	4,717	4,596
Portfolio investment, net	-1,767	916	-1,428	381	381
Financial derivatives, net	-36	-85	-131	0	0
Other investment, net	696	-1,764	3,728	753	706
Errors and omissions, net	-295	502	-44	0	0
Change in reserves	-819	-1,765	-6,627	-1,051	-926
Memorandum items:					
Current account (in percent of GDP)	-5.3	-5.7	-6.5	-5.6	-5.1
Trade balance (in percent of GDP)	-6.1	-5.4	-3.3	-2.0	-1.4
Net foreign direct investment (in percent of GDP)	9.6	9.6	13.0	5.5	4.9
Gross official reserves (in months of imports of goods and services)	4.2	4.1	6.1	5.8	5.5

Sources: Czech National Bank; and IMF staff projections.
1/ IMF staff projections.

Table 3. Czech Republic: Consolidated General Government Budget, 2000-03 1/

	2000	2001	2002	2003	2000	2001	2002	2003 2/
	(In billions of koruny)				(In percent of GDP)			
Total revenue and grants 3/	781	849	907	953	39.3	39.1	39.9	40.1
Total revenue	780	847	904	942	39.3	38.9	39.7	39.6
Current revenue	770	837	893	932	38.8	38.5	39.3	39.2
Tax revenue	721	782	833	882	36.3	36.0	36.6	37.1
Nontax revenue	49	55	60	50	2.5	2.5	2.6	2.1
Capital revenue	9	10	11	10	0.5	0.4	0.5	0.4
Grants, incl. EU compensation	1	3	2	11	0.1	0.1	0.1	0.5
Total expenditure and net lending 6/ excluding grants to transformation institutions	871	965	1,068	1,158	43.9	44.3	46.9	48.7
Total expenditure	868	962	1,060	1,149	43.7	44.2	46.6	48.3
Current expenditure	760	850	932	991	38.3	39.1	40.9	41.7
Goods and services	180	184	209	226	9.1	8.4	9.2	9.5
Interest payments	21	20	16	24	1.1	0.9	0.7	1.0
Transfers to households and nonfinancial enterprises	399	434	465	490	20.1	19.9	20.4	20.6
Transfers abroad, incl. EU	3	3	3	14	0.1	0.1	0.1	0.6
Subsidies	158	209	240	237	7.9	9.6	10.5	10.0
excluding grants to transformation institutions	138	158	176	207	6.9	7.3	7.7	8.7
Capital expenditure	108	112	128	158	5.4	5.2	5.6	6.7
Net lending (excluding privatization and the sale of Russian debt)	3	3	7	9	0.2	0.1	0.3	0.4
Overall balance 6/ Adjusted to exclude grants to transformation institutions to cover costs related to management of bad assets	-90	-115	-161	-205	-4.5	-5.3	-7.1	-8.6
to cover costs related to management of bad assets	-70	-64	-97	-174	-3.5	-2.9	-4.2	-7.3
Financing 7/								
Privatization receipts 4/	28	61	129	15	1.4	2.8	5.6	0.6
Proceeds from the sale of UMTS licenses	0	2	0	0	0.0	0.1	0.0	0.0
Proceeds from the sale of Russian debt	0	0	20	0	0.0	0.0	0.9	0.0
Net increase in financial liabilities 7/	62	52	12	190	3.1	2.4	0.5	8.0
Memorandum items:								
Grants to transformation institutions to cover costs related to management of bad assets	20	51	64	31	1.0	2.3	2.8	1.3
General government debt 5/ Including debt of the Czech Consolidation Agency	332	405	444	635	16.7	18.6	19.5	26.7
Including debt of the Czech Consolidation Agency	456	531	615	788	23.0	24.4	27.0	33.1

Sources: Ministry of Finance; and IMF staff estimates.

1/ Includes the state budget, Czech Consolidation Agency, State Financial Assets, extrabudgetary funds, social security funds, and local governments.

2/ The total amounts of revenue and expenditure differ on the GFS and the national classification due to the different treatment of issued state bond premiums.

3/ Excluding revenues from UMTS licence sales

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

5/ Includes liabilities of the state budget, extrabudgetary funds, social security funds, and local governments. Staff estimates for 2003.

6/ Excluding privatization revenues of the NFP and the CLF, the sale of shares and voting rights by local governments, and the sale of Russian debt.

7/ IMF staff estimates.

Table 4. Czech Republic: Medium-term Macroeconomic Scenario, 2000-08

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Real sector	(Percent growth)								
Real GDP	3.3	3.1	2.0	1.7	2.6	3.7	4.0	4.1	4.1
Consumption	1.6	4.1	4.4	3.6	3.4	3.2	3.3	3.4	3.4
Investment	9.4	7.2	1.3	-1.5	0.9	3.2	4.7	5.2	4.9
<i>Of which: fixed investment</i>	5.3	5.5	0.6	-1.8	1.5	3.4	4.5	5.2	5.2
Exports, goods and services	17.0	11.9	2.8	5.1	5.4	7.5	7.1	7.0	7.1
Imports, goods and services	17.0	13.6	4.3	5.0	5.2	6.6	6.5	6.6	6.6
CPI inflation	3.9	4.7	1.8	1.1	3.9	3.2	2.9	2.8	2.8
GDP deflator	1.1	6.3	2.6	2.7	3.9	2.8	2.6	2.5	2.6
Gross domestic savings 1/	24.4	23.8	21.7	21.0	20.3	20.1	20.2	20.1	20.2
Public	1.6	0.6	-0.4	-1.0	-2.8	-1.1	-0.5	0.3	1.5
Private	22.8	23.2	22.1	22.0	23.1	21.3	20.7	19.9	18.7
Public finances 2/	(In percent of GDP)								
Revenues	39.3	39.1	39.9	40.1	40.5	41.1	41.0	41.0	40.9
Expenditures 5/	43.9	44.3	46.9	48.7	47.2	47.0	46.1	44.7	43.9
Overall balance 5/	-4.5	-5.3	-7.1	-8.6	-6.7	-5.9	-5.1	-3.7	-3.0
Adjusted balance 3/	-3.5	-2.9	-4.2	-7.3	-6.0	-5.2	-4.4	-3.7	-3.0
Cyclically adjusted	-3.0	-2.7	-3.8	-6.4	-5.0	-4.4	-4.0	-3.5	-3.0
Targeted balance 4/				-7.0	-5.5	-4.8	-4.0	-3.3	-2.6
General government debt	16.7	18.6	19.5	26.7	31.4	34.3	37.2	38.6	39.1
Including debt of the Czech Consolidation Agency	23.0	24.4	27.0	33.1	36.0	37.5	39.1	40.4	40.8
Balance of payments									
Current account balance	-5.3	-5.7	-6.5	-5.6	-5.1	-4.9	-4.9	-5.0	-5.0
Trade balance	-6.1	-5.4	-3.3	-2.0	-1.4	-1.6	-1.5	-1.6	-1.7
Services balance	2.7	2.7	1.0	0.6	0.4	0.9	0.9	1.2	1.5
Net factor income	-2.7	-3.8	-5.4	-5.6	-5.5	-5.5	-5.7	-6.0	-6.3
Current transfers	0.7	0.8	1.3	1.4	1.4	1.4	1.5	1.5	1.5
Financial account balance	7.5	7.9	16.1	6.8	6.1	6.9	5.9	6.1	6.2
Direct investment, net	9.6	9.6	13.0	5.5	4.9	5.5	4.4	4.3	4.5
<i>Of which: privatization revenue</i>	1.3	2.8	5.6	0.6	0.3	1.1	0.0	0.0	0.0
Portfolio investment, net	-3.4	1.6	-2.1	0.4	0.4	0.4	0.4	0.3	0.3
Financial derivatives, net	-0.1	-0.1	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Other investment, net	1.4	-3.1	5.4	0.9	0.8	1.0	1.1	1.4	1.4
Errors and omissions, net	-0.6	0.9	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves (- increase)	-1.6	-3.1	-9.5	-1.2	-1.0	-2.0	-1.0	-1.1	-1.2

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

1/ In percent of GDP.

2/ Projections for 2003 are based on the budget. Projections for 2004-06 are based on the MoF adjustment proposal. For 2007-08, the reduction in the general government deficit is assumed to continue at a similar pace, with the adjustment coming from the expenditure side.

3/ Excluding transfers to transformation institutions.

4/ Excluding net lending and transfers to transformation institutions.

5/ Excluding privatization revenues of the NPF and CLF, the sale of shares and voting rights by the local governments, and the sale of Russian debt..

Table 5. Czech Republic: EU-related Fiscal Flows, 2004-06 1/
(In billions of koruny)

	EU payment appropriations			Public expenditure from EU payments 2/			Public copayments			Net effect on budget 3/		
	2004	2005	2006	2004	2005	2006	2004	2005	2006	2004	2005	2006
Pre-accession payments 4/	6	5	3	6	5	3	2	2	1	-2	-2	-1
Total inflow	21	39	43	11	29	36	10	13	15	0	-4	-8
<i>Agriculture</i>	<i>3</i>	<i>14</i>	<i>17</i>	<i>3</i>	<i>14</i>	<i>17</i>	<i>8</i>	<i>8</i>	<i>9</i>	<i>-8</i>	<i>-8</i>	<i>-9</i>
CAP	2	10	11	2	10	11	7	6	6	-7	-6	-6
Market measures	2	4	4	2	4	4	0	0	0	0	0	0
Direct payments 5/	0	6	7	0	6	7	7	6	6	-7	-6	-6
Rural development 6/	2	4	6	2	4	6	1	2	3	-1	-2	-3
Structural actions	6	12	15	6	12	15	3	5	6	-3	-5	-6
Structural Fund 6/	6	10	11	6	10	11	3	5	5	-3	-5	-5
Cohesion Fund 6/	0	2	4	0	2	4	0	0	1	0	0	-1
Internal policies	2	3	4	2	3	4	0	0	0	0	0	0
Existing policies	2	3	4	2	3	4	0	0	0	0	0	0
Nuclear safety	0	0	0	0	0	0	0	0	0	0	0	0
Institution building	0	0	0	0	0	0	0	0	0	0	0	0
Schengen	0	0	0	0	0	0	0	0	0	0	0	0
Special cash-flow facility	6	3	3	0	0	0	0	0	0	6	3	3
Compensations	4	6	3	0	0	0	0	0	0	4	6	3
Total own resources	-19	-30	-31							-19	-30	-31
Traditional own resources	-2	-3	-3							-2	-3	-3
VAT resource	-2	-4	-4							-2	-4	-4
GNP resource	-13	-20	-21							-13	-20	-21
U.K. rebate	-2	-3	-3							-2	-3	-3
Net revenue losses							-8	-30	-35	8	30	35
Loss of customs duties							5	8	7.9	-5	-8	-8
Net gain on VAT							0	-22	-24	0	22	24
Excises							-13	-16	-19	13	16	19
Total effect										-14	-5	-6
In percent of GDP										-0.5	-0.2	-0.2

Sources: Ministry of Finance; and IMF staff estimates.

1/ Based on the Copenhagen agreement. The Ministry of Finance's baseline is based on more conservative assumptions regarding inflows from the Structural and Cohesion Funds.

2/ From the perspective of the budget, EU payment appropriations are treated on a gross basis.

3/ Assuming that copayments do not substitute for previously existing expenditure.

4/ Assuming a 30 percent copayment ratio.

5/ Assuming maximal top-off to farmers.

6/ Assumptions on copayments are based on National Development Plan estimates.

Table 6. Czech Republic: Financial Soundness Indicators, Credit and Depository Institutions, 1998-2003
(In percent, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003 Q1
Regulatory capital to risk-weighted assets	12.1	13.6	14.9	15.5	14.2	14.1
Nonperforming loans to total gross loans	20.4	21.9	19.1	13.4	8.1	7.6
Nonperforming loans less provisions to capital	72.5	71.0	70.5	39.0	13.2	10.6
Loan-loss provisions to nonperforming loans	54.1	52.3	46.8	60.3	77.5	80.2
After-tax return on average assets	-0.4	-0.3	0.7	0.7	1.1	1.1
After-tax return on average equity	-5.7	-4.3	13.0	16.5	25.3	24.6
Liquid assets to total assets	17.2	19.5	19.5	20.8	32.7	36.1
Net open position in foreign exchange to capital	40.3	19.1	25.5	13.1	-50.4 1/	-26.5 /1

Source: Czech National Bank. 2/

1/ Worst case scenario results based on CNB information, including all balance sheet items, spot operations, options, letters of credit, promissory notes and the full value of guarantees. The results are largely due to guarantees in foreign exchange issued by banks. Insufficient information was available during the mission to assess the probability of the guarantees being called, although the authorities believe it to be very low. The CNB is developing a framework for macroprudential analysis and stress testing capacity (with technical assistance from the IMF's Monetary and Financial Systems Department). In this context of the stress testing exercise, the prudential analysis of banks' open FX exposures and appropriate supervisory responses will be further examined.

2/ Adjusted by the CNB to deduct Union Banka from the data series.

Table 7. Czech Republic: Vulnerability Indicators, 1997-2003
(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001	Latest Data		Date
						2002	2003	
Financial indicators								
Public sector debt 1/	20.0	18.0	21.0	23.0	24.4	27.0	...	January-03
State government guarantees 2/	17.0	17.0	15.3	14.0	15.7	22.9	...	December-02
Broad money (percent change, 12-month basis)	10.8	5.4	7.7	5.6	13.0	3.2	2.1	May-03
Private sector credit (percent change, 12-month basis) 3/	9.4	0.7	-4.7	-4.2	1.8	4.3	5.6	May-03
Domestic credit	66.7	58.7	55.6	53.8	46.5	40.0	42.0	May-03
One-year PRIBOR (end of period, in percent)	17.0	8.9	5.8	5.9	4.5	2.6	2.3	July-03
One-year PRIBOR, real (in percent) 4/	7.0	2.1	3.3	1.9	0.4	2.0	2.0	July-03
Classified credits (percent of total credits)	26.4	26.0	31.9	28.9	20.8	15.8	15.0	March-03
Of which: loss credits	15.0	13.4	13.3	9.6	7.0	3.9	3.4	March-03
External indicators								
Exports G&NFS (percent change, 12-month basis in US\$)	-1.2	13.5	-0.6	7.8	12.7	11.8	25.0	March-03
Imports G&NFS (percent change, 12-month basis in US\$)	-3.5	4.7	-0.5	10.6	11.6	11.6	26.3	March-03
Terms of trade (percent change, 12-month basis)	1.2	5.0	-0.7	-2.6	2.5	2.8	1.4	April-03
Current account balance	-6.7	-2.2	-2.7	-5.3	-5.7	-6.5	-2.7	March-03
Capital and financial account balance	2.0	5.1	5.6	7.5	7.9	16.1	5.9	March-03
Of which: inward portfolio investment (debt securities etc.)	2.4	1.9	0.9	0.9	1.4	1.3	1.2	March-03
other investment, net (loans, trade credits etc.)	-2.4	-3.0	-3.2	1.4	-3.1	5.4	6.1	March-03
inward foreign direct investment	2.5	6.5	11.5	9.7	9.9	13.4	5.6	March-03
Net Foreign Assets (NFA) of commercial banks (in US\$ billions)	2.6	4.2	6.3	8.3	10.9	10.3	10.0	May-03
Gross official reserves (in US\$ billions)	9.8	12.6	12.8	13.1	14.5	23.7	25.6	June-03
Net International Reserves (NIR) (in US\$ billions)	9.8	12.6	12.8	13.1	13.9	23.3	25.0	May-03
Central bank short-term foreign liabilities (in US\$ billions)	0.0	0.0	0.0	0.1	0.6	0.4	0.6	May-03
Central bank foreign currency exposure (in US\$ billions)	9.7	12.6	12.8	13.1	13.9	23.3	25.0	May-03
Short-term foreign assets of commercial banks (in US\$ billions)	7.2	9.1	9.3	8.3	9.9	7.1	5.9	March-03
Short-term foreign liabilities of commercial banks (in US\$ billions)	4.9	6.5	6.4	6.0	5.3	5.8	5.5	March-03
Foreign currency exposure of commercial banks (in US\$ billions)	2.6	4.2	6.3	8.3	10.9	10.3	10.0	May-03
Official reserves in months of imports G&NFS	3.6	4.4	4.5	4.2	4.1	6.1	5.9	June-03
Reserve money to (gross official) reserves (percentage)	67.2	61.5	45.8	44.6	45.0	35.5	38.2	May-03
Broad money to (gross official) reserves (percentage)	347.9	329.4	290.0	284.2	304.3	231.1	243.0	May-03
Total short-term external debt to gross official reserves (percentage) 5/	111.4	104.4	93.4	96.4	80.0	58.1	49.8	March-03
Total external debt	44.6	39.5	43.2	41.2	36.2	34.8	33.3	March-03
Of which: public sector debt 6/	4.3	2.9	2.8	2.1	1.4	2.1	2.3	March-03
Of which: public and publicly guaranteed debt 6/	13.8	13.1	13.4	12.4	9.3	9.1	8.8	March-03
Total external debt to exports G&NFS (in percent)	73.2	72.7	68.6	60.2	53.6	58.2	52.5	March-03
Total external debt service payments to exports G&NFS	15.9	15.3	12.7	12.3	8.6	9.1	7.0	April-03
External interest payments to exports G&NFS	3.0	3.1	3.1	2.4	2.2	2.2	1.2	April-03
External amortization payments to exports G&NFS	13.0	12.2	9.6	9.9	6.4	6.9	5.8	April-03
Exchange rate (per US\$, period average)	31.71	32.27	34.60	38.59	38.04	32.74	26.93	June-03
REER appreciation (+) (period average; CPI-based)	-0.4	9.5	-0.2	1.2	5.3	10.1	0.3	June-03
REER appreciation (+) (12-month change; CPI-based)	-6.5	20.7	-4.8	2.0	6.9	4.6	0.3	June-03
Financial market indicators (end of period)								
Stock market index (PX-50)	495	394	490	479	395	461	535	June-03
Foreign currency debt rating (Moody's)	Baa1	Baa1	Baa1	Baa1	Baa1	A1	A1	June-03
Domestic currency debt rating (Standard & Poor's)	AA	AA-	AA-	AA-	AA-	A+	A+	June-03

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

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

2/ Includes guarantees provided to CSOB on IPB balance sheet.

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

4/ Deflated by CPI inflation.

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

6/ General government and the central bank.

Czech Republic: External and Fiscal Sustainability

Table A1 shows the results of the external debt sustainability framework for the Czech Republic. Under the baseline scenario, the Czech Republic's external debt stock (private and public) is projected to decline relative to GDP from 38 percent in 2002 to 31 percent in 2008. This reflects continuing inflows of FDI, positive automatic contributions due to GDP growth and—particularly in 2003—appreciation of the koruna relative to the U.S. dollar, together with moderating external current account deficits. Continued rapid growth in exports will induce a decline in the ratio of external debt to exports. While the annual gross external financing need (defined as the sum of the current account deficit, amortization on medium- and long-term external debt, and the outstanding stock of short-term debt) is expected to increase modestly in U.S. dollar terms; relative to GDP, this ratio is expected to decline due to favorable growth and exchange rate developments.

To assess the robustness of these conclusions, staff conducted several stress tests, based on various adverse scenarios, including negative shocks to the current account, GDP growth, external interest rates, and a large depreciation of the koruna vis-à-vis the U.S. dollar. The results indicate that the Czech Republic's debt dynamics remain manageable with, in all but one instance, the external debt-to-GDP ratio remaining below 50 percent in 2008.

Turning to fiscal sustainability (Table A2), under the reform scenario—which assumes that the general government deficit is reduced in line with the current adjustment proposal's targets until 2006, deficit reduction continues at a similar pace in 2007–08, and that about 80 percent of CKA's debt is fully assumed—the stock of government debt is projected to increase to about 39 percent of GDP. Under the standard adverse shock scenarios, public debt should be sustainable in the medium term, remaining below the Maastricht ceiling of 60 percent of GDP. However, under the authorities' no-reform scenario, the stock of public debt is projected to increase to well above 50 percent of GDP and could exceed the Maastricht limit in the case of adverse shocks.

Table A2. Czech Republic: Public Sector Debt Sustainability Framework, 1997-2008
(In percent of GDP, unless otherwise indicated)

	Actual						Projections						
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	
I. Medium-Term Projections, Reform Scenario													
1 Public sector debt 1,2/	12.9	13.0	14.5	16.7	18.6	19.5	26.7	31.4	34.3	37.2	38.6	39.1	
Of which: foreign-currency denominated	3.6	3.0	2.0	1.7	1.7	1.5	1.6	1.9	2.1	2.2	2.3	2.3	
2 Change in public sector debt	-0.2	0.1	1.4	2.3	1.8	0.9	7.1	4.7	2.9	2.9	1.3	0.5	
3 Identified debt-creating flows (4+7+12)	1.3	0.0	0.9	2.6	0.9	0.2	7.1	4.7	2.9	2.9	1.3	0.5	
4 Primary deficit 3/	0.8	1.2	2.8	3.5	4.4	6.2	7.6	5.6	4.2	3.2	1.7	0.8	
5 Revenue and grants	39.6	38.6	38.7	39.3	39.1	39.9	40.1	40.5	41.1	41.0	41.0	40.9	
6 Primary (noninterest) expenditure 3/	40.4	39.8	41.5	42.8	43.4	46.1	47.7	46.0	45.3	44.2	42.7	41.7	
7 Automatic debt dynamics 4/	1.4	-0.4	1.0	0.5	-0.6	-0.4	0.1	-0.5	-0.3	-0.3	-0.4	-0.3	
8 Contribution from interest rate/growth differential 5/	0.3	0.0	0.6	0.4	-0.5	-0.1	0.2	-0.5	-0.3	-0.3	-0.4	-0.3	
Of which: contribution from real interest rate	0.3	-0.1	0.7	0.9	-0.1	0.2	0.5	0.2	0.8	1.0	1.1	1.2	
Of which: contribution from real GDP growth	0.1	0.1	-0.1	-0.5	-0.5	-0.3	-0.3	-0.7	-1.1	-1.3	-1.4	-1.5	
11 Contribution from exchange rate depreciation 6/	1.0	-0.4	0.4	0.1	-0.1	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	
12 Other identified debt-creating flows	-0.8	-0.8	-2.9	-1.4	-2.8	-5.6	-0.6	-0.3	-1.1	0.0	0.0	0.0	
13 Privatization receipts (negative)	-0.8	-0.8	-2.9	-1.4	-2.8	-5.6	-0.6	-0.3	-1.1	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 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	0.0	0.0	
16 Residual, including asset changes (2-3)	-1.5	0.1	0.5	-0.3	0.9	0.7	0.0	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	32.7	33.8	37.3	42.6	47.6	49.0	66.6	77.6	83.4	90.8	94.1	95.6	
Gross financing need 7/	5.9	6.1	7.8	8.9	18.7	13.1	15.3	14.6	15.2	15.2	14.6	14.3	
In billions of U.S. dollars	3.1	3.5	4.3	4.6	10.7	9.1	13.2	13.7	15.2	16.1	16.6	17.3	
Key Macroeconomic and Fiscal Assumptions													
Real GDP growth (in percent)	-0.8	-1.0	0.5	3.3	3.1	2.0	1.7	2.6	3.7	4.0	4.1	4.1	
Average nominal interest rate on public debt (in percent) 8/	10.0	9.8	8.1	7.6	6.0	3.9	5.4	4.6	5.7	5.7	5.7	6.1	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.0	-0.8	5.2	6.5	-0.3	1.3	2.6	0.7	3.0	3.1	3.2	3.5	
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-21.1	16.0	-17.0	-4.9	4.3	20.3	3.3	0.7	1.0	1.0	0.9	0.9	
Inflation rate (GDP deflator, in percent)	8.0	10.6	3.0	1.1	6.3	2.6	2.7	3.9	2.8	2.6	2.5	2.6	
Growth of real primary spending (deflated by GDP deflator, in percent)	3.4	-2.5	4.9	6.5	4.6	8.1	5.3	-1.0	2.1	1.5	0.4	1.7	
II. Stress Tests for Public Debt Ratio													
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-07							20.2	21.1	21.1	22.4	23.6	24.8	
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004							27.7	34.3	37.2	40.1	41.4	41.9	
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004							27.9	34.6	37.7	40.9	42.4	43.0	
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004							26.4	32.9	35.8	38.7	40.0	40.5	
5. Combination of 2-4 using one standard deviation shocks							24.2	29.3	30.1	31.0	30.4	28.9	
6. One time 30 percent real depreciation in 2003 9/							27.3	32.0	34.9	37.8	39.2	39.7	
7. 10 percent of GDP increase in other debt-creating flows in 2003							36.7	41.2	44.0	46.9	48.1	48.6	
Historical statistics for key variables (past 10 years)							Historical Average		Standard Deviation		Average 2003-08		
Primary deficit			1.5			2.9					3.9		
Real GDP growth (in percent)			1.9			2.3					3.4		
Nominal interest rate (in percent) 8/			7.7			1.9					5.5		
Real interest rate (in percent)			0.5			3.7					2.7		
Inflation rate (GDP deflator, in percent)			9.2			5.9					2.9		
Revenue to GDP ratio			39.8			1.5					40.8		
Memorandum items							26.7	34.0	40.2	46.4	51.6	56.5	
Public sector debt based on the authorities' no-reform scenario													

1/ General government gross debt without the debt of the Czech Consolidation Agency.

2/ Assumes that about 80 percent of the debt of the Czech Consolidation Agency (about 5.5 percent of GDP in 2002) is taken over by 2008 but no guarantees are called.

3/ Including transfers to the Czech Consolidation Agency and its subsidiaries.

4/ Derived as $[(1 - \pi(1+g) - g + \alpha\varepsilon(1+r)) / (1+g+\pi+g\pi)]$ 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).

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

6/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

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

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

9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table A1. Czech Republic: External Debt Sustainability Framework, 1997-2008
(In percent of GDP, unless otherwise indicated)

	Actual						Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
I. Baseline Medium-Term Projections												
1 External debt	40.8	42.7	41.6	42.0	39.1	37.8	32.3	31.0	31.1	31.0	31.0	30.8
2 Change in external debt	4.1	1.9	-1.2	0.5	-2.9	-1.3	-5.5	-1.3	0.0	-0.1	0.1	-0.2
3 Identified external debt-creating flows (4+8+11)	6.8	-9.1	-4.8	-0.4	-9.6	-12.7	-7.1	-2.5	-2.4	-1.4	-1.2	-1.3
4 Current account deficit, excluding interest payments	5.1	0.4	0.8	3.6	4.2	5.1	4.7	4.3	4.3	4.3	4.4	4.5
5 Deficit in balance of goods and services	-5.9	-1.2	-1.3	-3.3	-2.7	-2.3	-1.4	-0.9	-0.8	-0.6	-0.4	-0.2
6 Exports	55.7	58.8	60.5	69.8	70.8	65.1	66.5	66.6	68.1	69.2	70.4	71.6
7 Imports	-61.7	-60.0	-61.8	-73.2	-73.5	-67.4	-67.9	-67.5	-68.9	-69.8	-70.8	-71.8
8 Net nondebt creating capital inflows (negative)	-3.2	-8.4	-9.0	-8.6	-11.1	-12.3	-5.4	-4.8	-5.4	-4.4	-4.3	-4.4
9 Net foreign direct investment, equity	2.4	6.3	11.3	9.6	9.6	13.0	5.5	4.9	5.5	4.4	4.3	4.5
10 Net portfolio investment, equity	0.8	2.1	-2.3	-1.0	1.5	-0.7	-0.1	-0.1	-0.1	0.0	0.0	0.0
11 Automatic debt dynamics 1/	5.0	-1.1	3.4	4.6	-2.7	-5.5	-6.4	-2.0	-1.2	-1.3	-1.3	-1.4
12 Contribution from nominal interest rate	1.7	1.8	1.9	1.7	1.5	1.4	0.8	0.8	0.7	0.6	0.6	0.5
13 Contribution from real GDP growth	0.3	0.4	-0.2	-1.4	-1.2	-0.6	-0.5	-0.8	-1.1	-1.2	-1.2	-1.2
14 Contribution from price and exchange rate changes 2/	3.0	-3.3	1.7	4.4	-3.1	-6.3	-6.7	-2.0	-0.8	-0.7	-0.7	-0.7
14 Residual, including change in gross foreign assets (2-3)	-2.7	11.0	3.7	0.8	6.7	11.4	1.6	1.3	2.4	1.3	1.2	1.1
External debt-to-exports ratio (in percent)	73.2	72.7	68.7	60.2	55.3	58.1	48.6	46.6	45.6	44.7	44.1	43.0
Gross external financing need (in billions of U.S. dollars) 3/ in percent of GDP	13.4 25.3	12.4 21.8	13.8 25.0	15.1 29.3	15.0 26.2	17.2 24.7	19.4 22.6	19.5 20.8	20.5 20.5	21.2 19.9	22.4 19.7	23.9 19.9
Key macroeconomic and external assumptions												
Real GDP growth (in percent)	-0.8	-1.0	0.5	3.3	3.1	2.0	1.7	2.6	3.7	4.0	4.1	4.1
Exchange rate appreciation (U.S. dollar value of local currency, change in percent)	-14.4	-1.7	-6.6	-10.4	1.5	16.2	18.3	2.5	-0.2	-0.1	-0.3	-0.3
GDP deflator in U.S. dollars (change in percent)	-7.6	8.7	-3.9	-9.5	7.9	19.2	21.6	6.5	2.6	2.4	2.3	2.3
Nominal external interest rate (in percent)	4.2	4.8	4.3	3.8	4.1	4.5	2.7	2.6	2.3	2.0	1.9	1.8
Growth of exports (U.S. dollar terms, in percent)	-2.0	13.5	-0.6	7.8	12.7	11.8	26.2	9.4	8.8	8.3	8.2	8.3
Growth of imports (U.S. dollar terms, in percent)	-3.7	4.7	-0.5	10.6	11.6	11.6	24.4	8.7	8.5	8.0	7.9	7.9
II. Stress Tests for External Debt Ratio												
1. Real GDP growth, nominal interest rate, dollar deflator, noninterest current account, and nondebt inflows are at historical average in 2003-07							34.0	29.9	27.1	23.3	19.5	15.6
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004							33.3	33.0	32.9	32.7	32.7	32.4
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004							33.7	34.0	33.9	33.7	33.6	33.3
4. Change in U.S. dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004							47.1	57.7	56.7	55.5	54.5	53.3
5. Noninterest current account is at historical average minus two standard deviations in 2003 and 2004							35.2	37.1	36.9	36.6	36.4	35.9
6. Combination of 2-5 using one standard deviation shocks							44.2	51.7	50.9	50.0	49.2	48.2
7. One time 30 percent nominal depreciation in 2003							54.0	51.4	50.6	49.7	49.0	48.0
Historical statistics for key variables (past 10 years)												
				Historical Average						Average 2003-08		
Current account deficit, excluding interest payments				3.5						4.4		
Net nondebt creating capital inflows				8.0		2.1				4.8		
Nominal external interest rate (in percent)				4.5		...				2.2		
Real GDP growth (in percent)				1.9		2.3				3.4		
GDP deflator in U.S. dollars (change in percent)				5.1		11.2				6.3		

1/ Derived as $[r - g - \rho(1+g) + e\alpha(1+r)] / (1+g+\rho+gp)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + e\alpha(1+r)] / (1+g+\rho+gp)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($e > 0$) and rising inflation (based on GDP deflator).

3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

Czech Republic: Fund Relations
(As of April 30, 2003)

- I. **Membership Status:** Joined 1/01/1993; Article VIII
- II. **General Resources Account**
- | | <u>SDR Million</u> | <u>% Quota</u> |
|--|--------------------|----------------|
| Quota | 819.30 | 100.0 |
| Fund holdings of currency | 619.94 | 75.67 |
| Reserve position in Fund | 199.36 | 24.33 |
| Financial Transaction Plan transfers (net) | 28.00 | |
- III. **SDR Department:**
- | | <u>SDR Million</u> | <u>% Allocation</u> |
|----------|--------------------|---------------------|
| Holdings | 4.03 | N/A |
- IV. **Outstanding Purchases and Loans:** None
- V. **Financial Arrangements:**
- | | <u>Approval</u> | <u>Expira-
tion</u> | <u>Amount</u> | <u>Amount</u> |
|-------------|-----------------|-------------------------|----------------------|----------------------|
| <u>Type</u> | <u>Date</u> | <u>Date</u> | <u>Approved</u> | <u>Drawn</u> |
| | | | <u>(SDR Million)</u> | <u>(SDR Million)</u> |
| Stand-by | 3/17/1993 | 3/16/1994 | 177.00 | 70.00 |
- VI. **Projected Obligations to Fund:** None
- VII. **Exchange Rate Arrangement:**
 The currency of the Czech Republic is the Czech koruna, created on February 8, 1993 upon the dissolution of the currency union with the Slovak Republic, which had used the Czechoslovak koruna as its currency. From May 3, 1993 to May 27, 1997, the exchange rate was pegged to a basket of two currencies: the deutsche mark (65 percent) and the U.S. dollar (35 percent). On February 28, 1996, the Czech National Bank widened the exchange rate band from ± 0.5 percent to ± 7.5 percent around the central rate. On May 27, 1997, managed floating was introduced. In the 2002 edition of the *Annual Report on Exchange Arrangements and Exchange Restrictions*, the exchange rate regime of the Czech Republic was classified as independently floating. On July 30, 2003, the exchange rate of the Czech koruna stood at CZK 28.00 per U.S. dollar.
- VIII. **Last Article IV Consultation:**
 The last Article IV consultation with the Czech Republic was concluded on July 26, 2002. The staff report and PIN were published on August 7, 2002.
- IX. **Technical Assistance:** See attached table.
- X. **Implementation of HIPC Initiative:** Not Applicable
- XI. **Safeguards Assessments:** Not Applicable

Czech Republic: Technical Assistance, 1991–2002

Department	Timing	Purpose
FAD	Dec. 1991–Sept. 1993	Regular visits by FAD consultant on VAT administration
	March 1993	Public financial management
	September 1993	Follow-up visit on public financial management
	November 1993	Follow-up visit on public financial management
	January 1994	Follow-up visit on public financial management
	July 1994	Follow-up visit by FAD consultant on VAT administration
	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
MAE	February 1992	Monetary management and research, foreign exchange operations, and banking supervision
	June 1992	Monetary research
	July 1992	Long-term resident expert assignment in the area of banking supervision (financed by EC-PHARE; supervised by the Fund)
	December 1992 and February 1993	Bond issuance and monetary management
	November 1993	Follow-up visit on bond issuance and monetary management and management of cash balances
	April 1994	Data management and monetary research
	January 1995	Foreign exchange laws (jointly with LEG) and external liberalization
	May 1995	Monetary operations
	May 1995	Banking system reform
	May 1996	Economic research
	April 1997	Banking legislation
	February–June 1999	Monetary research—inflation targeting
	June 1999	Integrated financial sector supervision (with WB)
RES	September 1999	Inflation targeting (financed by MAE)
	June–August 2000	Inflation targeting (financed by MAE)
STA	May 1993	Money and banking statistics
	February 1994	Balance of payments
	April 1994	Government finance
	November 1994	Money and banking statistics
	January–February 1999	Money and banking statistics
	May 2002	Monetary and financial statistics
	February 2003	Implementing GFSM 2001

Czech Republic: Statistical Issues

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

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

- National accounts data suffer from a number of weaknesses. The value added in the small-scale private sector is likely to be underestimated, as the mechanisms for collection of data on this sector are not yet fully developed. It is also believed that a large volume of unrecorded activity stems from tax evasion. Discrepancies between GDP estimates based on the production method and the expenditure method are large, and are subsumed under change in stocks. Quarterly estimates of national accounts are derived from quarterly reports of enterprises and surveys. The estimates are subject to bias because of nonresponse (while annual reporting of bookkeeping accounts is mandatory for enterprises, quarterly reporting is not) and lumping of several expenditure categories in particular quarters. Large swings in individual components of spending and the overall GDP from quarter to quarter also raise serious questions on reliability of the data.
- Revisions in recent years to procedures for processing export data have brought external trade statistics close to the practice in the EU. However, a continued weakness of foreign trade statistics is the unavailability of price indices for exports and imports with a fixed base; these indices are currently presented on the basis of the same month of the previous year.
- Although there are some differences with the *IFS* presentation, monetary survey data provided to the European I Department are generally adequate for policy purposes. However, large variations in the interbank clearing account float, especially at the end of the year, require caution in interpreting monetary developments. The CNB has made a major effort to identify the causes of these variations and adjust the data. In 2002, the CNB implemented the European Central Bank (ECB) framework for

monetary data. It also initiated reporting of monetary accounts that meet the *IFS* as well as the ECB requirements. The same set of accounts also forms the basis of monetary statistics published in the CNB's bulletins and on the website, which are thereby effectively harmonized with the monetary statistics published in *IFS*.

3. 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 on the internet.

Czech Republic: Core Statistical Indicators
(As of July 30, 2003)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	External Debt/ Debt Service	Central Government Balance	GDP
Date of latest observation	7/30/03	6/30/03	7/10/03	7/10/03	5/31/03	7/30/03	6/03	6/03	Q1 2003	Q1 2003	5/03	Q1 2003
Date received	7/30/03	7/7/02	7/21/03	7/21/03	6/30/03	7/30/03	7/8/03	7/22/03	6/30/02	6/30/03	6/30/03	6/16/03
Frequency of data	Daily	Daily	10 days	10 days	Monthly	Daily	Monthly	Monthly	Quarterly	Quarterly	Monthly	Quarterly
Frequency of reporting	Daily	Monthly	10 days	10 days	Monthly	Daily	Monthly	Monthly	Quarterly	Quarterly	Monthly	Quarterly
Source of update	CNB 1/	CNB	CNB	CNB	CNB	CNB	CSO 2/	CSO	CNB	CNB	MoF 3/	CSO
Mode of reporting	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet
Confidentiality	No	No	No	No	No	No	No	No	No	No	No	No
Frequency of publication	Daily	Monthly	10 days	10 days	Monthly	Daily	Monthly	Monthly	Quarterly	Quarterly	Monthly	Quarterly

1/ CNB = Czech National Bank.
2/ CSO = Czech Statistical Office.
3/ MoF = Ministry of Finance.

INTERNATIONAL MONETARY FUND

CZECH REPUBLIC

Staff Report for the 2003 Article IV Consultation
Supplementary Information

Prepared by the European I Department

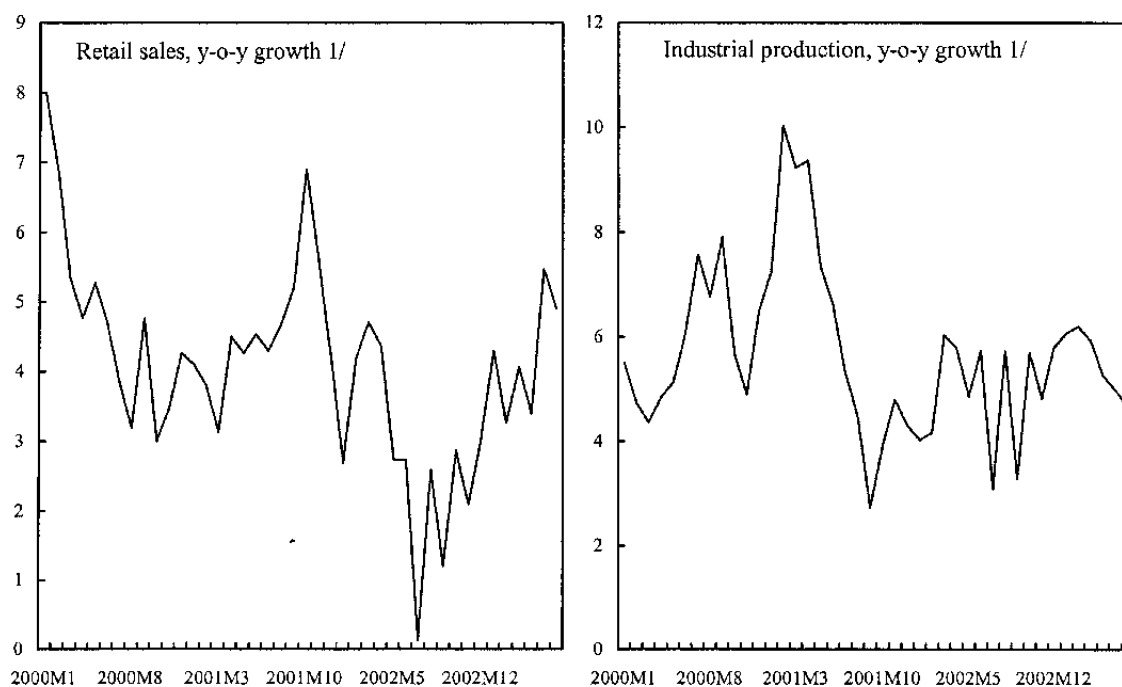
Approved by Michael Deppler and G. Russell Kincaid

August 20, 2003

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

I. MACROECONOMIC DEVELOPMENTS

2. **High-frequency indicators point to weaker but still reasonably resilient activity.** Industrial production expanded by 5 percent in the second quarter (year-on-year), marginally down from 6.2 percent in the first quarter. Exports (measured in euro terms) grew by

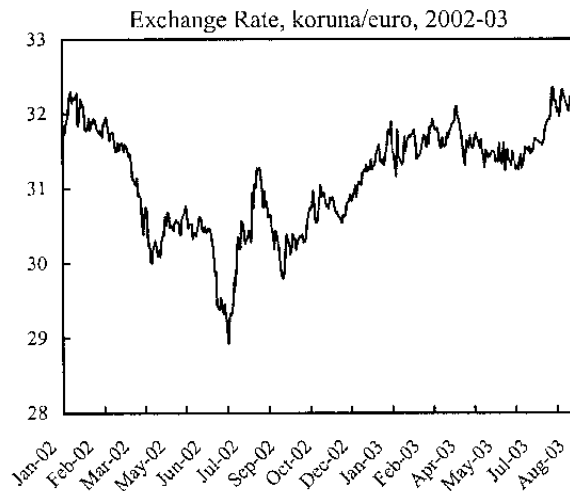


Source: Czech Statistical Office.
1/ Three-month moving average.

3.7 percent (year-on-year) in the second quarter, lower than the 6.8 percent in the first quarter. Import growth also slowed (to 3.5 percent from 5.7 percent in the first quarter). Meanwhile, retail sales remained strong, growing by 7.5 percent in the year to June.

3. **After weakening somewhat in July, the koruna held steady against the euro in early August.** Since reaching its high in mid-2002, the koruna depreciated against the euro to about the same level as in early 2002.

4. **Headline inflation dipped back into negative territory in July.** After increasing by 0.3 percent in the year to June, consumer prices declined by 0.1 percent in July. Falling prices for food products and traded goods, including clothing and consumer durables, more than offset an increase in services prices. Producer price deflation continued as prices declined by 0.6 percent (year-on-year) in July.



Source: Czech National Bank.

II. POLICY DEVELOPMENTS

5. **Downward revision to its inflation projections and softer 2003 growth prospects prompted the Czech National Bank (CNB) to cut its policy interest rate by 25 basis points to 2 percent on July 31—the second 25 basis point cut since the mission.** In its July Inflation Report, the CNB significantly revised downwards its inflation projections for 2003–04, to 0.7–1.4 percent—below the target band—by end-2003 and to 2.5–3.9 percent—in the lower half of the target band—by end-2004. The CNB continues to expect inflation to increase as the effect of exogenous factors shifts from disinflationary to neutral, growth recovers, and indirect taxes are raised. However, the pickup is now expected to be more subdued than envisaged in the CNB’s April forecast. Underlying the revision is a reassessment of the direct and indirect effects of indirect tax increases in 2003–04. As the CNB no longer expects the indirect tax increases to apply to restaurant and hotel services, it has revised the direct effect of the tax changes on inflation to 1 percentage point from its previous estimate of 2–2.5 percentage points. In addition, a weaker growth outlook (the CNB now expects a slower pickup in growth in 2003 and revised its projections for GDP growth from 2.3–2.9 percent to 2.1–2.9 percent) and strong competition in the retail sector make strong indirect effects unlikely. In view of these developments, staff has also updated its inflation forecast for 2003–04, revising it down by about ½ percentage points. Staff now projects inflation to pick up to just over 1.5 percent by end-2003 and further to about

4 percent by end-2004 (or to 0.6 and 3.5 percent, respectively, on an annual average basis (Table 1)).¹ As staff projections for GDP growth had already been predicated on a pickup slower than previously envisaged by the authorities, they have not been revised. In light of subdued prospects for inflation throughout the forecast period, staff supports the CNB's decision to cut its policy interest rate, lowering it to the level of the ECB's policy rate.

6. **Parliament passed to the second reading the bills that form the basis for the government's fiscal reform proposal.** While detailed discussions and resolutions on the bills are only expected in late September, the parliamentary action allows the government to incorporate the effects of the proposed changes in its draft 2004 budget. However, some proposed measures, particularly on the expenditure side, may yet prove contentious: unions have threatened protests and strikes in September over measures to contain wage increases in the public sector, the Minister of Labor and Social Affairs has suggested higher-than-proposed increases in pensions, and line ministries are seeking to spend about 30 billion koruny (about 1¼ percent of GDP) more in 2004 than the proposal's expenditure ceiling allows.

¹ The updated projections also take into account revised assumptions about the global economic environment, including oil prices and exchange rates, which led to small revisions on projections for trade flows and the balance of payments.

Table 1. Czech Republic: Selected Economic and Financial Indicators, 2000-04

	2000	2001	2002	2003 1/	2004 1/
Real economy (change in percent)					
Real GDP	3.3	3.1	2.0	1.7	2.6
Domestic demand	4.0	5.1	3.4	1.9	2.6
CPI (year average)	3.9	4.7	1.8	0.6	3.5
PPI, industry (year average)	4.9	2.9	-0.5
Unemployment rate, year average (in percent)					
Registered 2/	8.8	8.9	9.2	9.4	9.2
Labor force survey-based 2/	8.8	8.1	7.3	7.5	7.3
Gross national savings (percent of GDP)	24.4	23.8	21.7	21.0	20.4
Gross domestic investments (percent of GDP)	29.7	29.6	28.2	26.7	25.5
Public finance (percent of GDP)					
General government revenue	39.3	39.1	39.9	40.2	40.6
General government expenditure 7/	43.9	44.3	46.9	48.8	47.3
General government balance 7/	-4.5	-5.3	-7.1	-8.6	-6.7
Adjusted to exclude grants to transformation institutions to cover costs related to management of bad assets	-3.5	-2.9	-4.2	-7.3	-6.0
Targeted deficit concept 3/	-3.4	-2.8	-3.9	-7.0	-5.5
General government debt	16.7	18.6	19.5	26.8	31.5
Including debt of the Czech Consolidation Agency	23.0	24.4	27.0	33.1	36.1
Money and credit (end of year, percent change)					
Broad money	5.6	13.0	3.2
Domestic credit to nonbanks (percent change, end of period) 4/	-4.2	2.0	4.3	3.7	...
Interest rates (in percent)					
3-month interbank rate (end of period) 5/	5.4	4.7	2.6	2.4	...
10-year government bond 5/	6.7	4.8	3.2	3.8	...
Balance of payments (percent of GDP)					
Trade balance	-6.1	-5.4	-3.3	-2.1	-1.4
Current account	-5.3	-5.7	-6.5	-5.7	-5.1
Gross international reserves (US\$ billion)	13.1	14.5	23.7	27.7	28.6
Reserve cover (in months of imports of goods and services)	4.2	4.1	6.1	5.8	5.6
Fund position (as of April 30, 2003)					
Holdings of currency (percent of quota)				75.7	
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 (July 30, 2003)				CZK 28.00 =US\$1	
Nominal effective exchange rate (2000=100) 6/	100.0	104.4	116.4	116.1	...
Real effective exchange rate (CPI-based; 2000=100) 6/	100.0	105.5	116.5	112.7	...

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

1/ Staff estimates and projections.

2/ In percent of total labor force.

3/ General government deficit excluding transfer to transformation institutions and net lending.

4/ For 2003, data refer to growth rate from March 2002 to March 2003.

5/ For 2003, data refer to June 1.

6/ For 2003, data refer to April.

7/ 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.



INTERNATIONAL MONETARY FUND

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September 5, 2003

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

IMF Concludes 2003 Article IV Consultation with the Czech Republic

On August 22, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Czech Republic.¹

Background

The Czech Republic will have completed the transition from central planning to European Union (EU) membership in little more than a decade. Initial conditions were good—the fiscal position was healthy and external and public debt low—and stabilization occurred rapidly. But restructuring proceeded slowly and only speeded up after the 1997 currency crisis. Structural reforms, including privatization, got new momentum afterwards and increased the country's attractiveness for foreign investors, helped modernize the economy, and set the stage for renewed growth by the late 1990s.

Recently, the economy has shown considerable resilience in the face of the global slowdown. GDP growth slowed, but still posted a rate of 2 percent in 2002 despite serious floods. At 2.2 percent, it remained solid in the first quarter of 2003. Growth was underpinned by strong private consumption (reflecting rapid growth of wages and lending to households), rising goods exports, and a sizable fiscal stimulus. On the negative side, investment, which is geared toward prospects for final demand in Europe, slowed. Restructuring and weakening growth contributed to the upward drift of the registered unemployment rate.

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.

The export sector held up well despite a stronger koruna. Like other Central European countries, the Czech Republic has a strong record in penetrating the EU market. Geographical advantage, reinforced by growing cross-border integration of production processes, has outweighed any direct cost-competitiveness disadvantage vis-à-vis competitors from other regions. As a result, the temporary rise of the koruna against the euro from late 2001 until mid-2002 and sluggish demand in Europe slowed but did not halt export growth. Reflecting this, the trade balance improved. However, the current account deficit widened to 6½ percent of GDP on account of a large increase in reinvested earnings and transferred dividends by foreign direct investors.

With a surge in FDI and other investments, the koruna came under strong upward pressure beginning in late 2001. FDI accelerated sharply owing to the privatization of the gas utility. Expectations of this appreciation precipitated other inflows as commercial banks in particular attempted to reap gains on koruna holdings by repatriating their foreign deposits and borrowing from abroad. These pressures and their likely inflation effects prompted the Czech National Bank (CNB) to cut interest rates sharply and undertake some \$6½ billion of sterilized intervention and off-market purchase of privatization receipts. Late in the year, after the koruna had stabilized, banks partially reversed their inflows by buying foreign debt instruments. The CNB's sterilization operations resulted in an increase in central bank instruments on the balance sheets of banks, bringing banks' holdings of government and CNB paper to about one-third of their total assets.

Faced with low expected inflation, koruna appreciation and slowing growth, the CNB eased policy rates throughout 2002 and early 2003. The timing and size of the cuts were heavily influenced by the upward pressure on the koruna. But the moves were consistent with the inflation targeting framework, as the forecasts of inflation fell well below the gradually declining target band. Behind the sharp drop in inflation were falling food prices and the pass-through of the koruna's appreciation. Real wage growth in manufacturing is estimated to be in line with productivity growth. However, wage increases have also been strong in less productive sectors, keeping core inflation at about 1 percent. The interest rate cuts had left the spread between the two-week repo rate and the European Central Bank policy rate nil or negative over most of the past year. The negative spread eased pressures on the currency and lowered the monetary conditions index.

The 2003 budget foresees continued lax fiscal policy. The adjusted general government deficit (excluding transfers to the Czech Consolidation Agency to finance costs of managing bad assets) widened by about 1¼ percentage points of GDP in 2002 and is expected to rise by a further 3 percentage points this year to a record 7¼ percent of GDP. The rise reflects mainly expenditure increases, but one-off events in 2003 also play a part. Thanks to sizable privatization receipts in 2002, general government debt increased only moderately over the two years.

Executive Board Assessment

Executive Directors commended the authorities for the Czech economy's solid performance, attested to by healthy growth, low inflation, moderate (albeit growing) unemployment, successful economic restructuring, and approaching EU membership. They welcomed the recent referendum results in favor of EU accession. Directors regretted the deterioration of the public finances in the past few years, but welcomed plans to correct it. They emphasized that, in addition to responsible monetary policy and continuing institutional reforms, tackling the fiscal deficit is a precondition for a strong medium-term outlook, meeting the Maastricht criteria, and keeping options on the timing of euro adoption open.

Directors noted that the prospects for a strong recovery of the Czech economy were linked to those for Europe as a whole. The current account deficit was substantial, but needed to be seen against the backdrop of sizable reinvested profits from foreign direct investment. In light of the sizable output gap and the lagged effects of the koruna appreciation on prices, Directors expected inflation to remain low.

In these circumstances, Directors supported the decision to lower the policy interest rate in response to expectations of slower growth in Europe and softening inflation expectations at home. More generally, they commended the authorities on their proactive interest rate cuts since early 2002, which had contributed appropriately to halting and then reversing the appreciation of the koruna.

Directors recommended continuing the successful policy of inflation targeting when decisions on the post-2005 framework are made early next year. They recommended that the target be chosen with a view to providing room for low inflation and a broadly stable nominal exchange rate as the effects of real convergence on relative prices take place. Directors supported the authorities' intention to intervene in the foreign exchange market only in exceptional circumstances.

Directors welcomed the government's commitment to address the deterioration in the fiscal accounts by reducing the general government deficit to 4 percent of GDP by 2006, while cutting corporate income tax rates and reprioritizing spending to accommodate EU-related demands. Directors supported the emphasis on expenditure restraint, particularly on measures that yield permanent savings, as well as the intention to formulate fiscal policy plans and annual budgets within a forward-looking medium-term framework. Directors considered that other proposed institutional reforms—such as incorporating spending by extrabudgetary funds in the ministries' expenditure ceilings, and internalizing the budgetary impact of new public guarantees—would help reduce policy implementation risk. They urged the authorities to act on the recommendations of the fiscal Report on the Observance of Standards and Codes (ROSC) to complement these changes.

Directors emphasized that the challenge now will be to implement the fiscal adjustment proposals and to strengthen consolidation efforts. In this context, additional scope for

permanent savings, particularly on mandatory and quasi-mandatory spending, will need to be identified to replace temporary measures, prepare for population aging, and move toward the Maastricht deficit limit.

While the broad indicators of banking system soundness are reassuring, Directors encouraged bank supervisors to respond proactively to new potential risks so as to maintain that soundness. Rapidly increasing exposures to households could become a source of vulnerability. To evaluate the prudential implications of this trend, bank supervisors should give priority to collecting information on household indebtedness, housing and property prices, and banks' aggregate and individual exposure to households. They should also monitor banks' ability to assess the risks of this dynamic class of credit and adopt appropriate prudential norms for loan-to-value ratios for real estate lending. Directors welcomed efforts to continue to strengthen supervisory policies and practices. Directors also urged the authorities to press ahead with institutional and legal changes, especially with respect to creditor rights. This should help stimulate bank lending to enterprises, which remains sluggish.

Directors emphasized that continued progress with structural reforms remains essential for strong medium-term prospects; and redressing shortcomings in the judicial and legal system should be given top priority. Legal procedures should be more transparent and decisions more timely, and the functioning of the Commercial Registries needs to be improved. Directors urged the authorities to renew their commitment to measures that would promote mobility and flexibility in the labor market, which would complement their intention to press ahead with privatization and restructuring. They noted that a strong regulatory structure could help ensure that public monopolies would not be replaced in the privatization process by de facto private monopolies.

Directors commended the authorities' efforts to comply with international standards on AML/CFT and looked forward to the issuance of the ROSC AML module.

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

Czech Republic: Selected Economic and Financial Indicators, 2000-02

	2000	2001	2002
Real economy (change in percent)			
Real GDP	3.3	3.1	2.0
Domestic demand	4.0	5.1	3.4
CPI (year average)	3.9	4.7	1.8
PPI, industry (year average)	4.9	2.9	-0.5
Unemployment rate, year average (in percent)			
Registered 1/	8.8	8.9	9.2
LFS-based 1/	8.8	8.1	7.3
Gross national savings (percent of GDP)	24.4	23.8	21.7
Gross domestic investments (percent of GDP)	29.7	29.6	28.2
Public finance (percent of GDP)			
General government revenue	39.3	39.1	39.9
General government expenditure 2/	43.9	44.3	46.9
General government balance 2/	-4.5	-5.3	-7.1
Adjusted to exclude grants to transformation institutions to cover costs related to management of bad assets	-3.5	-2.9	-4.2
General government debt	16.7	18.6	19.5
Including debt of the Czech Consolidation Agency	23.0	23.4	25.1
Money and credit (end of year, percent change)			
Broad money	5.6	13.0	3.2
Domestic credit to nonbanks (percent change, end of period)	-4.2	2.0	4.3
Interest rates (in percent)			
3-month interbank rate (end period)	5.4	4.7	2.6
10-year government bond	6.7	4.6	2.7
Balance of payments (percent of GDP)			
Trade balance	-6.1	-5.4	-3.3
Current account	-5.3	-5.7	-6.5
Gross international reserves (US\$ billion)	13.1	14.5	23.7
Reserve cover (in months of imports of goods and services)	4.2	4.1	6.1
Fund position (as of April 30, 2003)			
Holdings of currency (percent of quota)		75.7	
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 (July 30, 2003)		CZK 28.00=US\$1	
Nominal effective exchange rate (2000=100)	100.0	104.4	116.4
Real effective exchange rate (CPI-based; 2000=100)	100.0	105.5	116.5

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

1/ In percent of total labor force.

2/ 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.

**Statement by Willy Kiekens, Executive Director for the Czech Republic
and Jiri Jonas, Senior Advisor to Executive Director
August 22, 2003**

With its transition from central planning to market economy largely completed, the Czech Republic now faces another milestone: entry in the European Union and eventual adoption of the euro. This prospect has now become the major force steering macroeconomic policies and driving structural and institutional reforms. The disciplining effects of EU/EMU membership are already visible in financial market indicators, and are contributing to the Czech economy's increased resilience to external shocks. But these benefits do not come automatically: significant policy efforts are still required to enable the Czech Republic to fully capture the benefits of economic and financial integration with Western Europe.

Recent Developments

Despite the weak external environment and the further slowing of growth in Western Europe, growth in the Czech economy accelerated somewhat during the first quarter of 2003, mostly due to household consumption. In addition, exports to Western Europe continued to grow rapidly, supported by the koruna's slight weakening against the euro. But fixed capital investment remained weak due to weak external demand and uncertainty about the timing and strength of eventual recovery.

But despite its first quarter rally, growth did not gain sufficient strength to head off a further year-on-year decline in employment and rise in unemployment. New graduates entering the labor market in June pushed the unemployment rate up to 9.9 percent. But productivity is rising briskly, and together with progress in structural reforms is creating favorable conditions for faster growth later on.

After dipping below zero in early 2003, consumer price inflation began to increase gradually, only to fall again in July to -0.1 percent year-on-year. Producer prices also continued to fall, reaching -0.6 percent year-on-year in July. The reason for such low inflation was a decline in foodstuff prices and an appreciation of the koruna against the dollar that lowered the koruna prices of imported energy.

Despite the weakness of Western demand, the Czech trade deficit is still declining. During the first half of 2003, it fell to CZK 18.1 billion, compared to CZK 22.4 billion in the first half of 2002. There are three reasons for this decline. First, both the volumes and prices of imported oil have fallen. Second, the relative weakness of investments has reduced the importation of investment goods. And third, despite weak demand in Western Europe Czech exports remain robust, particularly those of foreign controlled companies. The negative factor income balance resulting from the repatriation of the profits of foreign investors pushed the current account deficit to CZK 60.6 billion in the first half of 2003, slightly higher than CZK 59 billion of last year. This deficit is still fully covered by net foreign direct

investment, which--though much less than the record CZK 207 billion in the first half of 2002--reached CZK 64.5 billion in the first half of 2003.

Based on the latest data, the near term outlook has economic activity remaining relatively robust, driven mostly by consumer demand. In June, retail sales increased by a strong 7.5 percent, supported by strongly growing real disposable incomes. June industrial production rose 6.2 percent year-on-year, and industry sales rose even higher, by 7.5 percent. Despite weakening external demand, the latest Inflation Report of the Czech National Bank (CNB) left projected GDP growth in 2003 unchanged at 2.1 - 2.9 percent. It expects a further acceleration to 2.1 - 3.8 percent in 2004, with stronger investment demand and a slowing of consumer demand.

Monetary and Exchange Rate Policy

The CNB has responded quickly to continuing weak inflation and moderate economic growth by cutting interest rates. At the end of June, it cut the repo rate by 25 points, to 2.25 percent, and again at the end of July to 2 percent. This later rate cut was a response to the postponement of EU-related tax adjustments to 2004 and the reassessment of their primary and secondary effects on inflation. It is now expected that these effects will be milder than formerly thought. Given the expected persistence of the negative output gap, the CNB does not expect a significant acceleration of inflation anytime soon. In 2004, inflation is projected to reach only the lower part of the target band.

The CNB is presently conducting its monetary policy in a framework of inflation targeting with a managed exchange rate. The CNB does not target any particular level of exchange rate, but has sometimes intervened in the forex market to correct a perceived overshooting of the koruna. It is hard to say with certainty whether the interest rate cuts or the forex interventions were the more effective tool for arresting and partly reversing the koruna appreciation. What is important is that the CNB used both instruments and succeeded in reaching its objective.

In preparation for next year's EU entry and the eventual adoption of the euro, the CNB has begun working on its monetary policy strategy for the period between 2005 (the last year for which an inflation target has already been set) and the adoption of the euro. Inflation targeting framework has worked well in the Czech Republic, and the CNB continues to improve its functioning. This being true, there are good reasons for maintaining this framework right up until euro adoption. The CNB would consider pursuing inflation targeting even within the ERM-2 mechanism, as long as the fluctuation band used to assess the criterion of exchange rate stability is sufficiently wide. Of course, the CNB is fully aware that the existence of two nominal targets, the exchange rate and the inflation rate, could affect the clarity and credibility of monetary policy. Therefore, it does not intend to remain in the ERM-2 mechanism any longer than necessary.

At the end of 2002, the CNB has submitted to the Government a document entitled "The Czech Republic and the Euro--a Proposed Strategy for Euro Adoption," intended to become the basic document of the euro adoption strategy. Thereafter the Government asked

the Ministry of Finance and the Ministry of Industry to collaborate with the CNB to finalize this strategy by September 30, 2003. The new document should define the strategies for participating in ERM-2 and for meeting the Maastricht exchange rate criterion. After consultations with representatives of the European Union Commission and the European Central Bank, the CNB is recommending the following:

- It is not desirable to stay in the ERM-2 for more than two years. Therefore, the Czech Republic should not join ERM-2 unless there are sufficient assurances that two years later it will be able to adopt the euro.
- It is not desirable to join the ERM-2 immediately after EU entry. Doing so would lead to the assessment of the exchange rate convergence criterion in mid 2006, but it is projected that the fiscal deficit for 2006 will still be above 3 percent (see below). This makes progress with fiscal consolidation a crucial factor for setting the time of the euro adoption. The CNB recommends continuing to pursue fiscal consolidation and structural reforms, so as to strengthen the competitiveness and efficiency of the Czech economy.
- The strategy for euro adoption to be submitted by September 30, 2003, should contain mechanisms for regularly assessing Czech compliance with the Maastricht criteria and the degree of convergence of the Czech economy with the euro zone.

Fiscal Policy

The general government deficit continued to rise in 2002 and a further significant increase to 8.6 percent of GDP (without adjusting for the cost of transfers to transformation institutions) is projected for 2003. Until now, privatization revenues and ample liquidity have kept the financing of the growing deficits from becoming a problem. Low inflation and low nominal interest rates on government borrowing have limited interest payments to about 1 percent of GDP. The relatively weak growth and the negative output gap mean that fiscal expansion does not threaten CNB's inflation target. But the current fiscal trends are clearly unsustainable in medium and longer terms. Fund missions have repeatedly warned the authorities of the eventual risks created by the absence of fiscal consolidation; and more recently, the approach of EU entry and eventual euro adoption have become prominent topics in the public discussion about the need for fiscal reforms.

The authorities have now taken the crucial step from recognizing the problem to addressing it. In June 2003, the Government approved a public sector reform strategy which has now been submitted to Parliament. Its main objectives are (1) to reduce the general government deficit to 4 percent by 2006 (the year of the next parliamentary election); (2) to improve the efficiency of government spending and strengthen longer term budgetary discipline by introducing medium term expenditure ceilings; (3) to reduce corporate taxes and implement reforms harmonizing the Czech taxation system with the EU requirements; and (4) to increase the transparency of the public finances (see measures described in paragraph 22 of the staff report.).

One advantage of this somewhat delayed beginning of fiscal reform is that the extensive discussions of recent years, and the unmistakable deterioration of the public finances, both now ensure strong public and political support for it. The most important political question is no longer whether to undertake fiscal consolidation, but how fast it should proceed and how it can best be accomplished. Given the rapidly growing contribution of mandatory spending to the widening deficits, and given the already relatively heavy burden of taxation in the Czech Republic, the government is relying mainly on spending constraints. Naturally, such a policy is never politically easy to implement. But the government is explaining to the public that further delays of fiscal reforms will not make them go away but will make them still more painful later on.

Structural Issues

Following the completion of privatization, and the removal of most bad assets from banks' balance sheets, the situation in the banking sector is significantly better. At the same time, the banks have become more careful about lending to companies, particularly small and medium sized enterprises, and prefer to invest in government and CNB securities instead. And most recently they have begun a rapid expansion of their lending to households. The authorities are well aware that even though household bank debt is relatively low now, its rapid growth must be monitored carefully. It is expected that the consolidation of banks' balance sheets and the improved protection of creditors' legal rights will lead to a revival of banks' lending to enterprises.

Now that the privatization of banks has been completed, the authorities are focusing on completing the sale of the state's stakes in several nonfinancial strategic companies, including Czech Telecom and Unipetrol. As the privatization process nears its end, the authorities are thinking of terminating the National Property Fund by the end of 2005, and the Czech Consolidation Agency by the end of 2007.

The authorities are closely monitoring developments in the labor market, and remain concerned about the growth of unemployment. The Czech Republic's participation rate remains high, which suggests that there are no significant labor market rigidities. Growing unemployment can also be seen as reflecting the continuation of structural reforms under relatively weak growth conditions. But there are serious and persistent problems in the Czech labor market, including regional pockets of high unemployment; skill mismatches caused by shifts in the structure of demand for different skills; and the low regional mobility of labor due partly to rent controls. These problems have yet to be effectively addressed.