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SM/02/215
Correction 1

CONTAINS CONFIDENTIAL INFORMATION

August 1, 2002

To: Members of the Executive Board

From: The Secretary

Subject: **Czech Republic—Staff Report for the 2002 Article IV Consultation**

The attached corrections to SM/02/215 (7/12/02) have been provided by the staff:

Page 2, Contents, under Figures, item 1: for "1998–2002" read "1998–2001"
under Tables, item 3: for "2002–02" read "2000–02"

Page 4, Figure 1: revised

Page 23, para 29, line 4: for "2001" read "2000"

Page 27, Table 1: revised due to revisions of historical monetary survey data.
column 1, line 13: for "8.7" read "4.7"
line 15: for "20.1" read "26.7"
line 16: for "-2.3" read "0.7"
column 2, line 13: for "5.2" read "5.4"
line 14: for "-3.5" read "0.7"
line 16: for "2.4" read "0.3"
column 3, line 13: for "8.1" read "7.7"
line 14: for "-3.9" read "-4.7"
line 15: for "33.2" read "34.1"
line 16: for "-5.7" read "-1.0"
column 4, line 16: for "4.8" read "0.2"
column 5, line 16: for "-3.1" read "-0.9"

Page 30, Table 4: revised due to revisions of historical monetary survey data.
column 1, line 3: for "8.7" read "4.7"
line 5: for "67.7" read "66.7"
column 2, line 3: for "5.2" read "5.4"
line 4: for "-3.5" read "7.0"
line 5: for "60.4" read "58.7"

Page 30, Table 4: revised due to revisions of historical monetary survey data.
column 3, line 3: for "8.1" read "7.7"
line 4: for " -3.9" read "-4.7"
column 4, line 3: for "6.5" read "5.6"
column 5, line 3: for "11.1" read 13.0"
line 5: for "48.0" read "46.9"

Page 42, third para., line 3: for "1.5 percentage" to "2.25 percentage"
line 4: "(the most recent was a 75 basis point cut in late July)" added

Page 44, column 3, line 1: for "-0.5" read '0.5"

Questions may be referred to Mr. Takeda (ext. 37158) and Ms. van Elkan (ext. 34763) in EU1.

Att: (7)

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CONTAINS CONFIDENTIAL INFORMATION

INTERNATIONAL MONETARY FUND

CZECH REPUBLIC

Staff Report for the 2002 Article IV Consultation

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

Approved by Alessandro Leipold and Leslie Lipschitz

July 11, 2002

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

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

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

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

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

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

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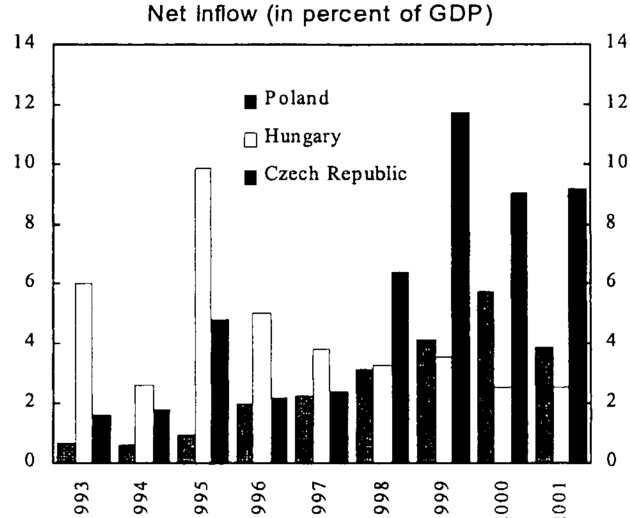
I. Background

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

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

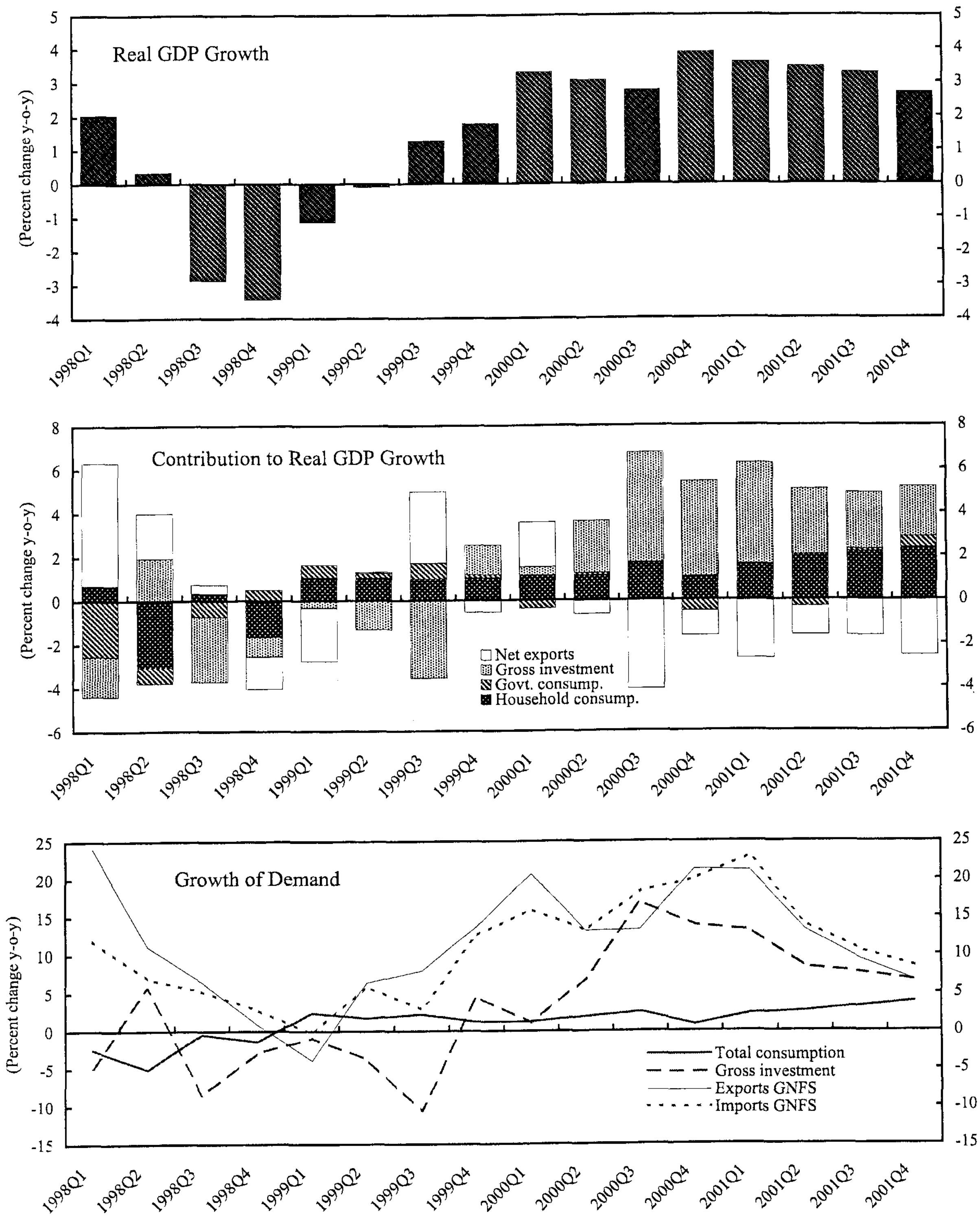
3. **An important contributing factor to the recent strength of the Czech economy has been significant inflows of FDI.** Gross FDI inflows reached US$ 4.9 billion in 2001 (8.7 percent of GDP), the highest in the region, bringing the stock to over $20 billion, some 40 percent of GDP. Low wages, a well-educated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

Net Inflow (in percent of GDP)



Source: EBRD Transition Report, 1998 and 2001.

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



Sources: Czech Statistical Office; and Fund staff calculations.

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

E. Structural Reforms and Other Issues

Corporate restructuring and the legal framework

29. **The authorities planned to resume bulk sales of bad assets transferred from banks to the Czech Consolidation Agency (CKA).** The decision reflected in part the large increase in sellable assets (about CZK100 billion, or 5 percent of GDP) that will be acquired by CKA in mid-2002 from IPB, a major commercial bank that failed in 2000~~1~~. The planned series of four package sales would exhaust the CZK 180 billion in CKA's assets sellable through this channel. The staff welcomed the decision as the private sector would be best placed to determine how to dispose of bad assets, and cautioned that the number of public sector-led corporate restructurings should be strictly limited.

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

Labor markets

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

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

Transparency and international standards

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

III. Staff Appraisal

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

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

[21] For a full discussion see *Czech Republic–Fiscal Transparency: An Update* (SM/02/217, 7/12/02).

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

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

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

1/ Staff projections.
2/ Net inflation excludes administered prices and the effects of changes in indirect taxes.
3/ General government operations and debt; central government guarantees. Revenues and expenditures exclude privatization receipts.
4/ Includes a CZK 33 billion government guarantee not included in official reported statistics. For 2001, includes CZK 155.7 billion government guarantees to the CKA.
5/ Adjusted to account for removal of KoB's banking license in September 2001, exchange rate effects on foreign-currency-denominated loans, loan write-offs, and transfer of IPB loans to CKA.
6/ Inflows for direct investment and equity securities. Includes privatization-related FDI.
7/ For 2002, figure is 12-month growth rate for March.
8/ For 2002, figure is 12-month growth rate for April.

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

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

Sources: Czech National Bank; and Fund staff projections.

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

2/ Includes privatization-related FDI.

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

	2000 Actual	2001 Budget 2/	2001 Prelim.	2002 Budget 2/	2000 Actual	2001 Budget 2/	2001 Prelim.	2002 Budget 2/
	(In billions of koruny)				(In percent of GDP)			
Total revenue and grants	781.0	821.4	852.9	895.5	39.3	38.1	39.5	38.7
Total revenue	779.8	821.4	850.1	895.5	39.3	38.1	39.4	38.7
Current revenue	770.3	809.0	840.4	880.1	38.8	37.5	38.9	38.1
Tax revenue	720.8	762.3	782.0	822.2	36.3	35.3	36.2	35.6
Nontax revenue	49.5	46.7	58.4	57.9	2.5	2.2	2.7	2.5
Capital revenue (excluding privatization)	9.5	12.4	9.7	15.4	0.5	0.6	0.4	0.7
Grants	1.2	0.0	2.8	0.0	0.1	0.0	0.1	0.0
Total expenditure and net lending	871.0	1,035.6	966.4	1,105.9	43.9	48.0	44.8	47.8
(excluding grants to transformation institutions)	851.3	930.4	915.8	1,011.7	42.9	43.1	42.4	43.8
Total expenditure	867.9	1,027.1	963.9	1,102.7	43.7	47.6	44.7	47.7
Current expenditure	751.7	899.5	843.1	971.4	37.9	41.7	39.1	42.0
(excluding grants to transformation institutions)	732.0	794.2	792.5	877.2	36.9	36.8	36.7	37.9
Goods and services	171.0	190.1	175.0	206.7	8.6	8.8	8.1	8.9
Interest payments	21.2	24.8	21.8	25.1	1.1	1.1	1.0	1.1
Subsidies and other current transfers	559.5	684.6	646.3	739.6	28.2	31.7	29.9	32.0
Capital expenditure	116.2	127.7	120.8	131.3	5.9	5.9	5.6	5.7
Net lending (excluding privatization)	3.1	8.4	2.6	3.2	0.2	0.4	0.1	0.1
Overall Balance	-90.0	-214.2	-113.6	-210.4	-4.5	-9.9	-5.3	-9.1
Adjusted to exclude grants to transformation institutions to cover costs related to management of bad assets	-70.3	-109.0	-63.0	-116.2	-3.5	-5.0	-2.9	-5.0
Financing	90.0	214.2	113.6	210.4	4.5	9.9	5.3	9.1
Privatization receipts	28.0	161.6	63.2	226.1	1.4	7.5	2.9	9.8
Of which: proceeds from sale of mobile phone licenses	0.0	20.0	1.8	0.0	0.0	0.9	0.1	0.0
Proceeds from sale of Russian debt	0.0	1.2	0.0	20.4	0.0	0.1	0.0	0.9
Net increase in financial liabilities	62.0	51.4	50.4	-36.1	3.1	2.4	2.3	-1.6
Memorandum items:								
Primary balance 3/	-49.1	-84.2	-41.1	-91.1	-2.5	-3.9	-1.9	-3.9
Grants to transformation institutions (KoB/CKA, CI, CF) to cover costs related to management of bad assets	19.7	105.2	50.6	94.2	1.0	4.9	2.3	4.1
General government debt 4/	332.4	413.5	404.5	451.4	16.7	19.2	18.7	19.5

Sources: Ministry of Finance; and Fund staff estimates.

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

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

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

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

Corrected: 8/1/02

Table 4. Czech Republic: Vulnerability Indicators, 1997-2002

(In percent of GDP, unless otherwise indicated)

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

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

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

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

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

4/ Deflated by CPI inflation.

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

6/ General government and the central bank.

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

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FOR IMMEDIATE RELEASE

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

IMF Concludes 2002 Article IV Consultation with the Czech Republic

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

Background

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

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

[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. This PIN summarizes the views of the Executive Board as expressed during the July 26, 2002 Executive Board discussion based on the staff report.

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

Sizable inflows of FDI (reaching cumulatively some 40 percent of GDP, the highest in the region) were the main driving force behind domestic investment and employment creation, and generated positive spillovers to domestic suppliers. FDI has also brought about increased access to major export markets, helping to cushion the impact on the Czech economy of the slowdown in external demand.

Large FDI inflows and anticipation of future inflows led to a rapid appreciation of the koruna over the last three quarters. Concerned about the effects on external competitiveness and growth, the Czech National Bank (CNB) cut interest rates by a cumulative ~~1.5~~ 2.25 percentage points since late-2001 (the most recent was a 75 basis point cut in late July) and intervened in the foreign exchange market on several occasions to stem the currency's rapid rise and secure the inflation objective. In addition, the government and the CNB agreed in early 2002 not to convert foreign currency privatization receipts on the market.

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

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

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

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

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

Executive Board Assessment

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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, 1997–2002

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

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

1/ Staff projections.

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

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

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

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