INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 09/46
FOR IMMEDIATE RELEASE
April 14, 2009

International Monetary Fund
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Washington, D. C. 20431 USA

IMF Executive Board Concludes 2008 Article IV Consultation with the Czech Republic

On February 6, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation with the Czech Republic.[1]

Background

Generally strong fundamentals helped the Czech economy weather the global financial crisis until late 2008. Robust productivity growth, improved fiscal performance, and a comfortable external position, supported by inflows of foreign direct investment, placed the economy in a relatively favorable position. Reflecting these strengths, the adverse effects on activity and risks in the banking system remained contained, as compared with the regional peers. Inflation started to recede rapidly, after having risen sharply in the first half of 2008. As the ripple effects of the global financial crisis began to impact the economy, the Czech National Bank acted aggressively, cutting the policy rate by a total of 200 basis points.

Growth is projected to slow sharply in 2009 amid a gathering recession abroad and tightening credit at home. The shrinking demand from the euro area, and especially Germany, will curtail exports and direct investment inflows. Tightening credit conditions at home and shrinking profit margins will weigh on capital spending. Household consumption is expected to grow only modestly as plummeting confidence and rising unemployment overshadow the favorable impact of declining inflation on disposable income. Risks to this growth outlook are clearly tilted to the downside. The downward phase of the cycle has

[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.

coincided with a deeper-than-projected recession in the euro area, and tighter credit conditions at home.

The financial sector came under increasing pressure in the latter part of 2008. Liquidity tightened considerably in interbank markets, and trading activity in the government bond market froze temporarily in October. Meanwhile, credit risk, especially in the corporate sector, rose amid the worsening outlook for economic activity.

Competitiveness was adequate but under incipient pressure. Export volumes enjoyed double-digit growth for the greater part of the year, with market shares continuing to expand. The koruna was broadly in line with fundamentals despite some recent erosion of competitiveness due to the lagged effects of the earlier appreciation and rising unit labor costs.

In the face of stronger-than-expected fiscal outturns in recent years of rapid growth, the authorities have sought to lower deficit targets while adhering to the nominal expenditure ceilings, thereby affirming their commitment to the medium-term objective of a deficit of 1 percent of GDP by 2012. Streamlining of social spending under the 2007 fiscal reform package and buoyancy of corporate tax revenues resulted in a fiscal outturn in 2008 of less than half that initially budgeted. With the rapid worsening of the near-term growth outlook, the fiscal deficit in 2009 is likely to be higher than the budgeted 1½ percent of GDP.

Executive Board Assessment

Executive Directors praised the generally strong fundamentals that have helped the Czech economy weather the initial spillover effects of the global financial crisis relatively well. Directors noted, however, that the Czech economy, highly open to trade and investment flows, has begun to be adversely affected by the global crisis. Given the prospect of a sharp economic downturn in 2009, it will be important to preserve financial stability and mitigate the impact of the downturn, using the flexibility gained from past sound policies. At the same time, the authorities should remain mindful of their medium-term fiscal and inflation objectives.

While welcoming the resilience of the Czech banking sector, Directors noted that financial system risks have increased. They supported the authorities' measures to maintain confidence and ensure financial stability, and encouraged further steps to support the smooth functioning of markets and to promote greater transparency in the government bond market. Financial supervisors need to remain vigilant and ensure that their toolkit is sufficient to address any emerging weakness. Directors also called for the strengthening of financial safety nets. Although it is reassuring that the lending by the subsidiaries of foreign banks is predominantly in local currency and is largely financed by local deposits, Directors considered that, in view of the dominant presence of these foreign banks, proactive collaboration with their financial authorities in home countries is warranted.

Directors supported the Czech National Bank's recent decisions to cut the policy interest rate. With inflation projected to fall below the target of 3 percent and a sharp slowdown in prospect, there is scope for further prudent easing depending on movements in the koruna and the extent of weakness in demand. Directors considered that the central bank's communication strategy should ensure that expectations are well anchored to the revised inflation target of 2 percent, effective January 2010.

Directors viewed competitiveness to be adequate and the external position to remain strong. They noted the staff's assessment that the koruna exchange rate is broadly in line with fundamentals. Concerns about the excessively strong koruna in the first half of 2008 have been eased by the recent significant reversal of the appreciation.

Directors welcomed the authorities' intention of supporting economic activity in the face of a sharper than expected downturn. They also agreed that fiscal policy needs to give due weight to financing constraints and to preserving the hard-won gains in fiscal consolidation. The recent strengthening of the fiscal position and the authorities' commitment to the nominal expenditure ceilings have created room for countercyclical policy, including the full operation of automatic stabilizers. Directors welcomed the revised budget for 2009, which implies a slightly expansionary stance. Should the downturn prove deeper than expected, they saw room for some further discretionary stimulus, given the relatively low government debt and limited macroeconomic imbalances. Any such stimulus measures, however, should be temporary and well targeted.

Directors commended the authorities' commitment to press ahead with essential structural reforms over the longer term. They welcomed the ongoing reforms in pensions and health care, which should help ensure fiscal sustainability. Looking ahead, creating fiscal space to cope with the demographic transition through greater efficiency in public spending will be important. Directors also reiterated the scope for reforms in the tax-benefits system and labor markets to enhance incentives to work, generate fiscal savings, and raise potential growth.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2008 Article IV Consultation with the Czech Republic is also available.

Czech Republic: Selected Economic Indicators, 2003-10

	2003	2004	2005	2006	2007	2008	2009	2010
						Staff Est.	Staff Proj.	
Real economy (change in percent)								
Real GDP	3.6	4.5	6.3	6.8	6.0	4.0	-1.3	1.4
Domestic demand	4.1	3.2	1.3	5.4	5.1	2.5	-0.1	1.3
CPI (year average)	0.1	2.8	1.8	2.5	2.8	6.3	2.1	2.0
PPI (year average)	-0.3	5.7	3.0	1.6	4.0	4.4	n.a.	n.a.
Unemployment rate (in percent)								
Survey-based 1/	7.8	8.3	7.9	7.1	5.3	4.0	5.3	5.6
Registered 1/	9.9	9.8	8.9	8.1	6.6	5.3	6.5	6.9
Gross national savings (percent of GDP)	21.1	22.4	24.3	23.9	24.8	22.9	22.4	22.6
Gross domestic investments (percent of GDP)	27.4	27.6	25.7	26.5	26.5	25.1	25.5	25.9
Public finance (percent of GDP) 2/								
General government revenue	40.7	42.2	41.3	41.1	41.6	41.2	41.1	41.1
General government expenditure	47.3	45.1	44.8	43.8	42.6	42.5	44.4	44.5
Net lending	-6.6	-2.9	-3.6	-2.7	-1.0	-1.2	-3.3	-3.4
General government debt	30.1	30.4	29.7	29.6	28.9	29.2	31.4	33.1
Money and credit (end of year, percent change)								
Broad money 3/	6.9	4.4	8.0	9.9	13.2	7.9	n.a.	n.a.
Private sector credit (percent change, eop)	11.8	15.3	20.8	21.6	27.3	16.0	n.a.	n.a.
Interest rates (in percent, year average)								
Three-month interbank rate	2.1	2.6	2.2	2.6	4.1	3.6	n.a.	n.a.
Ten-year government bond	4.8	4.0	3.6	3.7	4.7	4.1	n.a.	n.a.
Balance of payments (percent of GDP)								
Trade balance	-2.7	-0.5	2.0	2.0	3.4	2.6	1.0	0.5
Current account	-6.2	-5.2	-1.3	-2.6	-1.8	-2.2	-3.1	-3.3
Gross international reserves (US$ billion)	27.0	28.4	29.6	31.5	34.9	38.3	44.4	47.2
Reserve cover (in months of imports of goods and services)	5.5	4.5	4.1	3.6	3.2	2.7	3.0	3.0
Exchange rate								
Nominal effective exchange rate, pa (2000=100)	116.8	118.0	125.3	131.7	135.6	140.6	n.a.	n.a.
Real effective exchange rate, pa (CPI-based; 2000=100)	116.8	118.3	125.3	132.3	136.8	148.5	n.a.	n.a.

Sources: Czech Statistical Office; Czech National Bank; Ministry of Finance; and IMF staff estimates and projections.
1/ In percent of total labor force.
2/ On ESA-95 basis.
3/ For 2008, data refer to November.