May 19, 2009
Approval: 5/27/09

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 09/12-4

4:30 p.m., February 6, 2009

4. Czech Republic—2008 Article IV Consultation

Documents: BUFF/09/22; SM/09/8 and Correction 1, and Correction 2, and Supplement 1; SUR/09/18

Staff: Thakur, EUR; Gerson, SPR

Length: 1 hour, 6 minutes

Executive Board Attendance

T. Kato, Acting Chair

Executive Directors	**Alternate Executive Directors**
	I. Mwanawina (AE), Temporary
	D. Sembene (AF), Temporary
	D. Vogel (AG)
	C. Legg (AU)
W. Kiekens (BE)	
	A. Joseph (BR), Temporary
	H. Li (CC), Temporary
	E. Valle (CE), Temporary
	P. St-Amant (CO), Temporary
A. Fayolle (FF)	
	S. von Stenglin (GR)
	N. Choudhary (IN), Temporary
	J. Cardoso (IT), Temporary
	K. Harada (JA), Temporary
	A. Jbili (MD), Temporary
	M. Choueiri (MI), Temporary
	T. Galac (NE), Temporary
	J. Bergo (NO)
	A. Lushin (RU)
	A. Al Nassar (SA)
	N. Raman (ST), Temporary
	P. Gasiorowski (SZ), Temporary
	P. Wood (UA), Temporary
	R. Hills (UK), Temporary

L. Hubloue, Acting Secretary
S. Zucchini, Assistant

Also Present
IBRD: P. Williams. ECB: G. Pineau, F. Ramon-Ballester. European Department: S. Munoz, S. Thakur. Fiscal Affairs Department: J. Jonas, A. Tuladhar. Monetary and Capital Markets: L. Ong. Office of the Managing Director: C. McDonald. Research Department: R. Bems. Secretary's Department: P. Cirillo, M. Yslas. Strategy, Policy, and Review Department: P. Gerson. Senior Advisors to Executive Directors: C.Dahlhaus (GR), B. Lischinsky (AG), S. Polak (BE), J.Poulain (FF), N. Riad (Mi). Advisors to Executive Directors: M. Leemets (NO), S. Na (AU), A. Shabunina (RU), F. Waqabaca (ST).

4. CZECH REPUBLIC—2008 ARTICLE IV CONSULTATION

The staff representative from the European Department (Mr. Thakur) submitted the following statement:

> This statement provides information on economic developments since the staff report was issued (SM/09/8). The new information does not alter the thrust of the staff appraisal.
>
> The downturn in demand and activity accelerated sharply and inflation slowed further. Industrial production fell by 17 percent in the year to November 2008, led by a sharp decline in the automobile sector, and retail sales dropped by over 6 percent over the same period. Exports fell by almost 18 percent, led by vehicles and machinery, while imports declined by 13 percent. Indicators of consumer and business confidence fell further in January 2009. Consumer price inflation declined to 3.6 percent in the year to December 2008, a 15-month low, driven by prices of food and fuel.
>
> Staff has lowered its projection for growth in 2009 to -1¼ percent from 1½ percent. The sharp downward revision reflects the deepening recession in the Euro area, especially Germany, as well as deteriorating prospects for domestic demand. While investment is set to slow down markedly, especially in the key automobile sector, private consumption is projected to weaken further, reflecting dimmer prospects for employment and lower household confidence.
>
> The authorities have lowered their projection for growth as well. The Ministry of Finance now forecasts growth of 1.4 percent in 2009, down from 3.7 percent. The sharp downward revision is driven by exports of goods and services, which are expected to fall by close to 1 percent. The Czech National Bank (CNB) is due to publish its latest assessment of economic prospects on February 5. Based on public statements of CNB officials, market participants expect a sharp downward revision in the forecast for growth and a further cut in the policy interest rate.
>
> In light of the worsened outlook for growth, the authorities revised the budget for 2009 in late January. The Ministry of Finance raised its projection for the fiscal deficit to 3 percent of GDP from 1.6 percent of GDP (on ESA-95 basis). The higher deficit reflects primarily lower revenues, and is to be partially financed through a

drawdown of reserves. With the deficit outturn for 2008 better than expected at around 1¼ percent of GDP due to lower capital spending, the revised budget implies a slightly expansionary fiscal stance for 2009.

The koruna continued to depreciate, in line with the trend in the regional currencies. Against the euro, the koruna fell by 4.1 per cent during January, following a decline of 6 percent in December 2008.

Table 1. 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) 3/	11.8	15.3	20.8	21.6	27.3	19.0	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 Fund staff estimates and projections.

1/ In percent of total labor force.
2/ On ESA-95 basis.
3/ For 2008, data refer to November.

Mr. Kiekens and Mr. Polak submitted the following statement:

The Czech authorities thank the staff for the useful discussions in preparation of the 2008 Article IV consultation report.

Macroeconomic Outlook

After an average growth of 6.4 percent during the period 2005—2007, growth in 2008 is estimated to have declined to around 4 percent. In 2009, the highly open Czech economy is set to slow down further due to the deteriorating outlook in its main trading partners.

In its January outlook update, the Czech Ministry of Finance revised the October forecast for output growth in 2009 from 3.7 percent to 1.4 percent. This is in line with the January 2009 Interim Forecast of the European Commission which anticipates growth of 1.7 percent. However, both outlooks point to downside risks.

Macroeconomic forecasts and their risk assessments are currently fraught with unprecedented uncertainty. Continuous revisions to the global and Euro zone economic outlook make it difficult to assess the impact of exogenous variables on the Czech economy. Weakening external demand will weigh on export and investment activities despite the current depreciation of the Czech koruna. Weaker business activity will slow down employment growth, which in turn will moderate domestic demand. The consensus forecast for 2009 has dropped from 4.4 percent in August 2008 to 0.3 percent in the January 2009 survey.

Policy Challenges

The Czech Republic has entered the current global crisis without significant macroeconomic imbalances and with a sound financial system. Nevertheless, macroeconomic management is facing significant challenges because of uncertainty about the economic contraction in main trading partners. The authorities are aware that the Czech economy is heavily dependent on exports, concentrated in a few sectors and towards a few countries. Therefore, in the short term, domestic demand should be boosted with fiscal stimulus measures, while in the medium to long term, structural reforms to improve the competitiveness and flexibility of the economy will make the economy more resilient to adverse external shocks. National policy choices of a small open economy have a limited impact on the current global conditions. In a small open economy, demand-stimulating measures, significantly leak to external economies. Therefore, the Czech

authorities support a coordinated international approach in reversing the current global slowdown.

On December 2, 2008, the Czech Government announced its "Strategy of Preparedness and Growth Acceleration" to mitigate risks related to the global financial crisis. Early this year, the National Economic Council was established to identify measures to minimize the impact of the unfavorable external cyclical conditions, while preserving long-term objectives. A comprehensive set of structural reforms is well-identified to improve the economy and will be implemented when a broader political consensus across ruling and opposition political parties can be reached on the detailed nature and sequence of particular reforms.

Public Finances and Fiscal Stimulus

The general government deficit has been reduced from 2.7 percent of GDP in 2006 to 1 percent in 2007. For 2008, this deficit was broadly stable at 1.2 percent, despite less favorable economic growth, thanks to the beneficial effects of the January 2008 fiscal measures.

The 2009 budget, adopted last October, targeted a deficit of 1.6 percent of GDP. However, as automatic stabilizers will be allowed full play, and because of the fiscal stimulus plan, the deficit is now expected to be at 3 percent of GDP. Assuming adherence to the spending ceilings outlined in the medium-term budget, the deficit should be 2.9 percent of GDP in 2010 and 2.5 percent in 2011.

As part of the European Economic Recovery Plan, the Czech government announced the following stimulus measures, equivalent to about 1 percent of GDP:

- Cuts in employees' social security contributions with a net budget cost of CZK 18.4 billion;

- CZK 14.4 billion contribution to construction and modernization of infrastructure within the State Fund of Transport and Infrastructure;

- Increase of salaries in the government sector by CZK 2.7 billion following a decrease in public sector salaries in real terms in 2008;

- Increase of capital of the Czech Export Bank (CEB) and other export promoting institutions by some CZK 2 billion;
- Increase in the capital of Supporting Guarantee Agricultural and Forestry Fund by CZK 0.3 billion;
- CZK 0.6 billion investment incentives for technology centre projects;
- CZK 0.5 billion for environment related projects, which are co-financed by EU Funds.

The government is determined to cut, in 2009, expenses for CZK 15 billion, or 0.4 percent of GDP. If approved by the parliament, these cuts will create budget room to absorb the cost of additional structural measures to boost the domestic economy.

Resources from EU funds are expected to have an expansionary effect, without affecting the general government balance.

Financial Sector Resilience

It is important to assess each country on its own merits and to avoid associating a country with the problems in the region when this is not justified. The Czech Republic has managed to avoid contagion from the financial turmoil. The main financial institutions remain sound, well-capitalized and profitable. A comfortable level of local currency deposits shields these institutions from liquidity strains and provides them with stable financing at reasonable costs compared to other volatile external sources.

Although the Czech financial sector is not immune to the global financial crisis, its healthy conditions have helped avoid financial distress. The Czech financial system was comprehensively restructured and consolidated during the last decade. An independent central bank conducted successfully monetary policy aimed toward maintaining price stability. Financial regulation and supervision, covering the entire financial sector, was the responsibility of the central bank which encouraged sound financial practices. This setting has enabled domestic interest rates to be lower than in the Eurozone, making foreign currency loans not attractive for households and corporate borrowers.

The strengths of the Czech financial system, which is mainly foreign owned, are: (i) growth opportunities in traditional banking and their reasonable profitability, (ii) negligible share of structured credits, not exceeding 1 percent of total assets, and (iii) stable funding by local deposits rather than by foreign funds. In the Czech Republic, the deposit to loan ratio is double the average ratio in the original members of the European Union.

The Staff Report concludes that "concerns about the health of the banking sector have intensified. Temporary withdrawals by depositors, contributing to a further tightening in liquidity conditions…". This was most likely a temporary episode stemming from neighboring countries announcing more generous deposit insurance schemes. After the alignment of the deposits guarantee scheme with the EU agreement in mid-October 2008, covering 100 percent of deposits up to euro 50,000, withdrawal of deposits stopped. The staff has also expressed concern about the high off-balance sheet liabilities. The Czech authorities remain vigilant and monitor these developments. They would appreciate it if the staff could provide a more detailed analysis and comparison with similar economies.

The staff caution against the quick and significant reduction of exposures of foreign banks in the region. We would like to draw attention to the difference between a parent bank withdrawing existing funds and not extending new financing. Subsidiaries of foreign banks, with funding from local sources, as is mainly the case in the Czech Republic, are in a more stable condition than subsidiaries and branches that rely on foreign currency funding from the parent bank. In addition, the allocation of liquidity by a subsidiary to its foreign parent bank is constrained by the prudential regulation limiting risk concentration on counterpart to 20 percent of own capital. Nonetheless, the CNB monitors the situation of the main financial institutions daily in order to react without delay if appropriate. The banking law might be amended to strengthen the supervisory system as needed.

Euro Adoption Prospects

The Czech authorities annually assess the extent to which economic conditions, in particular, nominal and real convergence, are sufficiently aligned with the euro area. The Czech Republic has been

improving its sustainable macroeconomic convergence with the euro area in all traditional indicators. Also, the government's financial position is no longer a barrier to fulfilling the Maastricht criteria, now that the excessive deficit procedure has been terminated. Since the one-off inflationary effect that caused a temporary hike in inflation in 2008 has subsided, inflation in 2009 is expected to allow fulfillment of the price stability criterion. The criterion on long-term interest rates has been and will continue to be fulfilled.

The Czech Republic does not participate in ERM II and, thus, does not fulfill the exchange rate criterion. In addition, the present global financial crisis has increased the volatility of the exchange rate, so fulfillment of the exchange rate criterion within ERM II could be difficult and costly. Given the current assessment and the uncertain near-term outlook, the Ministry of Finance and the CNB have recommended that the government should not set a target date for adopting the Euro.

Mr. Vogel and Mr. Lischinsky submitted the following statement:

Background

In recent years, the Czech Republic has exhibited a robust GDP growth, which, unlike other countries, has not been accompanied with significant imbalances. On the contrary, fundamentals in the Czech Republic seem to be strong, thus we tend to believe that the country could be in a relatively good position to face the potential spillovers from the crisis. However, as noted Mr. Kiekens and Mr. Polak in their candid and helpful buff statement "macroeconomic forecast and their assessments are currently fraught with unprecedented uncertainty". Some episodes observed in the financial system, for instance a temporary withdrawal by depositors, may have reflected certain concerns associated with regional developments (we tend to agree that, at an early stage, more generous deposit insurance schemes in other countries in the region could have been an important explanation of the above-referred episode) and the situation of some Western European parent banks.

Policies and Questions

Sound policies over the past years give the country some room to implement counter cyclical fiscal policies and ease monetary

conditions. At the same time, considering that investor confidence is a critical factor at this stage, we fully agree with the authorities on the importance of taking into account possible financing constraints and medium-term fiscal goals.

It is not easy to determine when a fiscal stimulus package will be triggered without the risk that it could come too late. In this regard, we welcome the revised budget for 2009, which, as underlined by the Staff Representative, implies a slightly expansionary fiscal stance. We also note the authorities' decision to implement structural reforms to ensure fiscal sustainability over the medium term. How could the political situation (e.g., a lack of consensus in the ruling coalition) affect the authorities' possibilities to design and implement these measures? Of course, we welcome these critical steps, but we wonder whether it would not be better to focus on the more urgent measures over the short term in order to avoid adding more pressures on the political arena. Furthermore, while we welcome the creation of the National Economic Council, we wonder whether this system could deliver results in a timely manner.

FDI is a central element in the balance of payments equilibrium and, in this regard, the staff projected a figure of 4.2 percent of GDP for 2009, which is almost the same figure observed last year, as well as the average in the period 2003-2008. Meanwhile, Table 5 shows that privatization revenues would reach an amount equivalent to 2 percent of GDP, while the average was 0.7 percent in the above-referred period. We would appreciate a more comprehensive explanation from the staff on these projected figures, which, a priori, seem to be too optimistic.

Private sector credit growth rates seem to be an important explanation of the Czech Republic's economic growth, having almost doubled from about 11.8 percent to 22.7 percent in 2008. Since the staff report does not have projections for this variable, we would like the staff to elaborate on the perspectives of this important factor for 2009, which, as noted, is key to understanding the growth forecast provided.

In general, and beyond this case, we fully share Mr. Kiekens and Mr. Polak's comments on the importance of making efforts "to assess each country on its own merits and to avoid associating a country with the problems in the region when this is not justified".

Conclusions

As underlined, robust growth and taking care not to generate important imbalances, as shown by the Czech Republic, has not been the rule in this country's region in past years. Although the recent satisfactory performance is not a safe-conduct and the regional developments are substantially affecting the Czech economy, we believe that it may have more room for maneuver than other countries to mitigate the negative effects of the crisis. At the same time, we note that the outlook for growth is deteriorating at a fast pace. The authorities will also have to deal with key factors, such as those related to investor confidence, and potential uncertainty that may arise from the political situation.

With these remarks, we wish the authorities every success in their future endeavors.

Mr. Daïri and Mr. Jbili submitted the following statement:

Several years of strong growth underpinned by sound macroeconomic policies and reforms have helped the Czech economy weather the initial spillover effects of the global crisis. Going forward, the economy faces much stronger headwinds in connection with the worsening global conditions and declining domestic demand. GDP is projected to contract by 1 ¼ in 2009, pressures on the financial sector are intensifying, and the current account position is expected to deteriorate, albeit moderately. Nonetheless, relatively low public debt, declining inflation, and adequate competitiveness provide room for countercyclical policies without jeopardizing the authorities' medium-term fiscal and inflation objectives. We are in broad agreement with the staff appraisal.

We commend the authorities for moving promptly to ease liquidity conditions, in the face of deteriorating growth prospects and decelerating inflation. We also welcome the steps taken to address the concerns about the health of the financial system, by raising the deposit guarantee and introducing repo facilities to address the tight liquidity conditions in the bond market. Nonetheless, credit risk related to the corporate sector is rising, and there seems to be a great deal of uncertainty about foreign banks maintaining their lending to the economy. We concur with staff recommendations to strengthen

financial safety nets, and welcome the establishment of crisis management arrangements between the CNB and the Ministry of Finance. We note the reference in footnote 1 to the large off-balance sheet liabilities consisting of derivative transactions, which are equivalent to 3 times the on-balance sheet assets. We would appreciate staff comments on the potential risks related to these off-balance sheet items and whether they predate the current financial crisis.

Fiscal policy in 2009 faces the challenge of supporting growth in an environment of lower fiscal revenue and potential financing constraints. We agree with the need to allow automatic stabilizers to play and see merit in a discretionary fiscal stimulus package to soften the impact of the exogenous shock on domestic demand. The authorities have raised their projection for the fiscal deficit in 2009 to 3 percent of GDP, in line with their lower growth projection. While staff statement indicates that the higher deficit reflects primarily lower revenue, Mr. Kiekens and Mr. Polak indicate that it includes the fiscal stimulus plan and the fact that automatic stabilizers will be allowed full play. Could staff clarify if they agree with the authorities' projection, taking into account all relevant factors, including staff projection of a GDP contraction in 2009? Also, we would appreciate indications on the order of magnitude of the EU-funded projects and their impact on growth.

With these comments, we wish the authorities full success in their endeavors.

Mr. El-Khouri and Ms. Choueiri submitted the following statement:

Solid fundamentals, reflected in healthy productivity growth, an improved fiscal performance, and a comfortable external position, have helped the Czech economy weather the global financial crisis until late 2008. However, strong spillover effects from the intensification of the global downturn, notably a deeper than expected recession in the euro area, are sharply slowing down the growth momentum, while exerting increasing pressure on the financial sector. Against this background, the well-written staff report rightly focuses on how policies could be calibrated to ensure financial stability and facilitate a smooth landing. We thank Messrs. Kiekens and Polak for an informative buff statement which clearly articulates the views of the authorities on these issues.

While there is general agreement between the authorities and staff that economic activity will slow down in 2009, in the midst of a gathering recession abroad and tightening credit at home, views about the magnitude of such downturn diverge considerably. The Ministry of Finance has recently lowered its growth projection for 2009 to 1.4 percent of GDP. Staff has also revised its forecast downward to -1.25 percent of GDP. We would be grateful for staff's clarification on the main reasons for the large disparity in these projections.

The Czech National Bank appropriately shifted its stance toward monetary easing in mid-2008 in view of the changing balance of risks between inflation and growth. With inflation expected to decline below the target of 3 percent in 2009 as a result of falling commodity prices, the lagged impact of the currency appreciation, and weakening demand, there is clearly some scope for further monetary easing. However, we agree with staff that the magnitude and pace of such easing would need to be considered against movements in the koruna and the extent of weakness in demand, and would have to take into account the fact that the effectiveness of the traditional channels of monetary policy has become more uncertain.

The improved fiscal position over the past years, as well as the authorities' adherence to the nominal expenditure ceilings, and thus their commitment to the medium-term objective of a deficit of 1 percent of GDP by 2012, leave room for automatic stabilizers to operate in 2009. The Ministry of Finance has now revised its projection for the fiscal deficit for 2009 to 3 percent of GDP, as compared to a deficit of about 1 percent of GDP in 2008, implying a slightly expansionary fiscal stance for 2009. In view of the revised growth projections, does staff consider the present fiscal stimulus to be adequate?

The Czech banking system has been profitable and liquid, although financial system risks have increased significantly in the latter part of 2008, reflecting the effects of the global crisis and the anticipation of a sharp economic slowdown. Liquidity has tightened considerably in interbank markets. At the same time, the country's high dependence on foreign banks with significant exposure to emerging Europe has given rise to questions about their continued ability and willingness to maintain lending to the economy, as noted by staff. Meanwhile, credit risk, especially in the corporate sector, has risen significantly as growth prospects worsened. Accordingly, the

authorities' early moves to maintain confidence and ensure financial stability, including by improving liquidity, are welcome. Additional measures suggested by staff, aimed at easing the tightness in money and bond markets, while enhancing financial supervision and strengthening financial safety nets and crisis preparedness, merit serious consideration.

With these remarks, we wish the authorities success in their stabilization efforts.

Mr. Ge and Ms. Li submitted the following statement:

We thank staff for the well-written and concise report and Mr. Kiekens and Mr. Polak for their helpful buff statement.

We are pleased the Czech economy maintained solid growth during the past several years, and its strong fundamentals have helped weather the global financial crisis until recently.

Yet given that the global market situation has further deteriorated, and the demand from the euro area has continuously declined, the Czech economy is inevitably affected by the recent global spillover effects. Its financial sector has come under increasing pressure, while fortuitously; its fiscal position and low government debt provide some room for a discretionary fiscal stimulus package. Looking forward, we agree that the near-term risk for the Czech Republic is still on the downside, and in the long run, the authorities may face challenges arising from fiscal sustainability and an aging population.

While we broadly agree with the thrust of the report, we wish to highlight a few points.

Financial Sector Stability

We note risks in the Czech financial system have increased in recent months, although its banks enjoyed strong profits and comfortable liquidity during the past several years, and the predominance of foreign controlled banks is a source of concern. In this regard, Mr. Kiekens and Mr. Polak's further explanation on Czech foreign subsidiaries' funding resources helps us better understand the situation, although we still encourage the authorities' ongoing

coordination with foreign supervisors as a precautionary measure. We observe bank loans to households for home purchases and to non-financial corporations account for around

The staff and 85 percent of total loans correctly indicate the potential credit risks if the property market may reverse in the future. In this regard, we welcome its banking supervisors' close monitoring of property market development, and appreciate staff's updated information on said development, since the property price data on page 15 is just up to 2007.

Monetary Policy Sector

We commend CNB on its timely monetary policy reaction amidst the quickly changing environment, and agree there is more room for policy easing if needed, given that inflation gradually fell below the CNB's target of 3 percent.

Fiscal Sustainability

The Czech fiscal position experienced a small deficit in recent years, while its government debt remains low. We are encouraged by the authorities' readiness to shift to a more expansionary fiscal stance as needed, and it should be based on measures that are well-targeted and easily reserved when conditions normalize. Under the current situation, a modest increase in the fiscal deficit than previous years is appropriate. Meanwhile, as staff indicated, over the medium term, it is a challenge for the authorities to adopt more efficiency-enhancing measures in the fiscal sector, in order to offset the increasing fiscal costs emerging from population aging and ensure fiscal sustainability. In this context, the measures being planned, as mentioned in paragraph 32 are welcome, and we hope to see their early implementation when the environment recovers.

We wish the authorities every success in their future reform endeavors.

Mr. Legg and Mr. Na submitted the following statement:

We thank staff for a well-focused and concise report, and Mr. Kiekens and Mr. Polak for their helpful buff statement.

We are pleased to note that the Czech economy has achieved exceptionally rapid expansion in recent years not only as a competitive exporter in the region but also as the most important host country for the major international banks in emerging Europe. As the global financial crisis worsens, the authorities are not free from the adverse spill-over effects. Considering the downside risks, including the subsequent liquidity and credit risks in the financial sector and the negative impact on exports caused by a deeper recession in the region, we concur with staff that the authorities' policy priorities should focus on ensuring financial stability and maintaining market confidence. We urge the authorities to focus on making full use of, and further strengthening, their advantages - stable inflation, healthy export competitiveness and broadly strong fundamentals.

On the fiscal front, given the low government debt and strong fiscal outturn in recent years, we are encouraged by the scope for discretionary fiscal stimulus aimed at supporting growth and facilitating an increase in domestic demand. On the other hand, we support the authorities' commitment to the medium-term fiscal deficit objectives, and further urge the authorities to strike a measured balance between achieving short-term goals and establishing medium-term fiscal sustainability.

It is clear that the financial market is under pressure, requiring careful attention. We have no doubt that, at this turbulent period, the authorities are warranted in taking preemptive and decisive measures, supported by vigilant monitoring and a sophisticated communication strategy. We note with concern that the banks have considerable off-balance sheet liabilities, which could provoke unexpected financial instability and loss of confidence. In this regard, we would appreciate staff's elaboration on the expected magnitude of such losses and the authorities' policy measures in addressing risks relating to off-balance sheet liabilities. We further encourage the authorities to take concerted efforts in strengthening financial safety nets and establishing crisis preparedness measures in collaboration with relevant external agencies. In terms of the cross-border financial linkages and the exogenous nature of the current crisis, proactive collaboration and information sharing with governments in the region needs to be pursued in a timely manner.

With regard to credit risks for the corporate sector, it is noted that such risks for small and medium enterprises (SMEs) have

increased significantly, relative to those facing large companies. Given that loans to non-financial corporations account for more than 50 percent of total loans, we would like to know what portion of such loans has gone into SMEs in 2008 as well as the contribution SMEs make in terms of employment in the economy.

The charts on page 6 well illustrate the Czech Republic's macroeconomic development. According to the first chart, the impressive contribution of net exports during 2008 Q3 and Q4 presents a striking contrast to that of investment, which contributed negatively to GDP growth over the same period. We would appreciate the latest data for both factors in 2008 Q4 as well as the staff projection for future trends.

With these remarks, we wish the authorities all the success in their future endeavors.

Mr. Assimaidou submitted the following statement:

We thank Mr. Kiekens and Mr. Polak for their helpful buff statement and staff for a comprehensive report.

Until recently, the Czech economy has continued to display strong fundamentals which were expected to facilitate the authorities' efforts to weather the damaging effects of the global slowdown and financial turmoil. Fiscal performance has improved and the external position is still strong. External debt as a fraction of GDP remains relatively low. After reaching a level twice as high as the central bank's target of 3 percent, inflation is decreasing, and is forecast to be below this target in 2009. At the same time, large productivity gains have been made and the unemployment rate has followed a steadily decreasing path although it is now projected to increase going forward.

Against this background, the Czech economy has recently begun to grow at a lower pace. We note with concern from staff's latest update that the downturn in demand and economic activity has further deepened since the issuance of the staff report, justifying significantly lower growth projections by both staff and the authorities. That said we call on staff to elaborate further on the significant divergence between the authorities' and staff's growth projections for 2009.

We note that the authorities have underscored their commitment to a medium-term fiscal objective of a deficit of 1 percent of GDP by 2012. However, in the face of the worsening in the growth outlook, there appears to be significant scope for fiscal policy to play a key role in supporting growth in the short run, especially since the fiscal position has strengthened significantly until recently, partly on account of fiscal discipline. While noting from staff that the higher fiscal deficit for 2009 reflects primarily lower revenues, we wonder whether the adoption of a more expansionary fiscal stance for 2009 would not be appropriate in view of the further deterioration in the growth outlook and the low level of public debt. We would welcome from staff further comments on what it considers as an appropriate fiscal stimulus package under current circumstances.

It is reassuring to note from Messrs. Kiekens and Polak's statement that the main financial institutions remain sound. We encourage the authorities to pursue their efforts aimed at addressing the significant vulnerabilities in the financial sector. The further tightening of liquidity conditions does not bode well for the soundness of the smaller Czech banks which are currently coping with increasing liquidity risks. The reported increase in credit risks is another concern which deserves to be promptly addressed as well. In order to help banks address these risks, the authorities are well advised to promptly take necessary actions aimed notably at reinvigorating the interbank market and at preventing erosion of confidence in financial markets. In this connection, we concur with staff's suggestion that diversifying the range of instruments acceptable as collateral in the interbank market may prove useful.

That nearly all banking assets (about 97 percent) are foreign-owned makes the financial system highly vulnerable to potential reversal of capital flows. We note that a withdrawal of short-term funding by foreign banks could provoke a 2.6 percentage point decline in the rate of GDP growth according to staff's estimates. This could be a key cause for concern at a time when market concerns over the soundness of Western European parents of Czech subsidiaries have heightened. Nevertheless, it is reassuring that subsidiaries of foreign banks in the Czech Republic draw their funding from domestic sources, as reminded by Mr. Kiekens and Mr. Polak. Still, continued vigilance remains critical and the authorities should stand ready to take any steps that may be necessary to strengthen the regulatory and

supervisory framework with a view to preserving the soundness of the financial sector.

With these remarks, we wish the authorities every success in implementing their policy and reform agenda.

Mr. Yamaoka and Mr. Harada submitted the following statement:

We thank the staff for their informative paper and Mr. Kiekens and Mr. Polak for their insightful statement.

The Worsening of the Economic Situation

The deterioration of the economic activities in the fourth quarter of 2008, after the Lehman Brothers shock, was substantial, not only in the Czech Republic, but also in many other countries. Since there was a significant economic slowdown in the final quarter of 2008, it will inevitably reduce the 2009 growth rate by a "negative carry-over." In this regard, we appreciate the statement by the Staff Representative of the Czech Republic as it provides a useful update of relevant information. Since the deterioration in output is usually followed by a decline in nominal income and employment, as well as an increase in non-performing loans with a time-lag, we would like to encourage the authorities to be vigilant against various downward pressures on the economy.

Financial Stability

At the current juncture, it is especially important that the Czech economy maintain the stability of the financial system. If non-performing loans were to increase, the authorities will be required to take necessary actions to resolve these at the earliest opportunity. We must bear in mind that most resolution measures, such as public capital injections, the public purchase of bad assets and the strengthening of deposit insurance, increase fiscal expenditures. (In addition, the economic slowdown per se will also require an increase in fiscal expenditures to stimulate the economy and to expand social safety nets.) In this regard, the recently-observed high sovereign spread may increase the government's difficulties with fundraising activities. In view of the current bond market environment, it might be useful to discuss how the Fund provides necessary financing resources to resolve bank problems potentially experienced by countries with a high sovereign spread. The Fund's financial support would contribute

to avoiding the "vicious cycle" of government funding problems and banking sector resolution delays.

Monetary Policy

The Czech Republic's monetary policy will face a new challenge posed by deflationary impact. Given that (i) the Czech National Bank (CNB) has maintained negative real interest rates over the past year, (ii) the actual inflation has far exceeded its target, and (iii) the country's long-term interest rates are high, the CNB is likely to remain in a difficult situation with respect to its policy conduct. Moreover, under the deflationary pressures expected to emerge in upcoming quarters, the CNB will be severely questioned as to whether its available policy tools and its published interest rate path are consistent with its inflation target. We would like to encourage the CNB to overcome these problems through good communication policies.

The Adoption of the Euro

We agree with the recommendation that the government should not set a target date for adopting the euro, as indicated in Mr. Kiekens and Mr. Polak's statement. Indeed, given the current global financial crisis, any changes in exchange rate frameworks may be risky.

With these remarks, we wish the authorities every success in their policy making.

Mr. Stein and Mr. von Stenglin submitted the following statement:

We thank staff for a concise and well-focused report and Mr. Kiekens and Mr. Polak for their informative statement. Following its accession to the EU, the Czech Republic enjoyed substantial growth and has further advanced convergence to EU income levels. Over the course of 2008, however, the cyclical upswing receded, coinciding with a sharp deterioration in the external and financial environment. However, the Czech Republic is in a relatively strong position to weather the adverse macroeconomic development, contrary to many other countries in the region. The rapid economic expansion seen in recent years has been broad-based with a large investment component, a neutral impact exerted by fiscal policy, and a positive contribution from the external sector. The country's external position is relatively strong and considerably more balanced than in many comparable

countries, with buoyant foreign direct investment inflows covering a moderate current account deficit. Through 2008, gross international reserves have increased in absolute terms despite the presence of substantial capital outflows. The updated baseline projection may still be subject to downside risks such as ongoing and deepening turmoil in financial markets, further worsening financing conditions, and weakness in external demand.

Fiscal Policy

Owing to prudent policies under the 2007 fiscal reform package, the Czech Republic's fiscal position has strengthened significantly. Budget deficits and structural deficits in 2007 and 2008 turned out substantially lower than previously anticipated, signaling a welcome progress toward fiscal consolidation and fulfillment of EMU convergence criteria.

Going forward, we agree with staff and the authorities that fiscal policy must strike a balance between appropriate countercyclical impulses on the one hand, and medium-term fiscal objectives on the other hand, with due regard paid to constrained financing conditions. The recent consolidation has afforded room for the full operation of automatic stabilizers. We encourage the authorities not to forfeit recent fiscal gains. Maintaining a certain fiscal space for a possible further functioning of automatic stabilizers and/ or fiscal stimulus could be wise.

Additional discretionary impulses should come into consideration only if downside risks were to materialize under a more adverse macroeconomic development. In this case, we welcome the authorities' intention to be mindful of potential financing constraints and medium-term fiscal goals, given that fiscal sustainability in the Czech Republic is considered to be subject to significant risks. Measures under a fiscal stimulus package should be temporary and targeted, while duly taking into account the government's limited ability to contract new debt. Accelerated implementation of EU-funded projects appears an appropriate way to stimulate domestic demand, but care must be taken to safeguard efficiency and accountability in the allocation of funds. The Ministry of Finance should consider gaining a higher control over the state budget outcome and implement more effective tools to limit possible expansions of public debt at municipal level.

While management of the present turbulence has moved to the forefront of the current political agenda, further structural reforms over the long term remain equally important. In this respect, we encourage the authorities to continue pressing ahead with reforms in health care and the pension system in order to improve budgetary positions in view of future demographic developments. Also, further action in the labor market is warranted, in particular in view of the impact of existing employment protection legislation.

Monetary Policy

In line with staff, we see scope for further monetary easing, provided that inflation continues to converge to the CNB's target rate. Furthermore, we concur with the authorities that the risk of deflation is small and see no cause for concern under present and expected conditions. However, with a new, lower target set for Jan. 2010, the authorities should adopt a cautious approach when easing policy, ensuring that inflation expectations remain well-anchored.

Financial Sector

The Czech financial sector is being buffeted by spillovers resulting from the turbulence in the international financial environment. While external debt is low in comparison to the country's regional peers, vulnerabilities have arisen from the significant share of short-term liabilities and uncertainties regarding the risks affecting foreign parent banks. The upswing in property prices observed in 2007 adds to concerns about credit quality of banks' lending portfolios, although the development, again, seems considerably less excessive than in some other economies. Although banks' exposure to sub-prime securities and to toxic assets do not seem to play a significant role, off-balance sheet liabilities appear to be high relative to on-balance sheet assets, which contributes to concerns about the stability of the Czech financial sector in the future. We are nevertheless heartened by the fact that lending has taken place predominantly in local currency and has been backed to a large extent by local deposits.

We support the measures recommended by the staff to buttress stability and confidence in the financial system. In particular, this relates to the full implementation of Basel II as well as the

recommendation to pursue a consistent approach on government intervention and recapitalization in the banking sector. Moreover, the Deposit Insurance Fund can be further buttressed and transparency enhanced.

Mr. Bakker and Mr. Galac submitted the following statement:

We subscribe to the views expressed by Mr. Stein and Mr. von Stenglin in their gray, and would like to add the following comments and questions for discussion.

The downside risks to growth in 2009 are primarily related to a potential sharp downturn in the demand for Czech exports. If combined with worsening domestic financing conditions, this could disproportionately affect the automobile producers which have already begun cutting their capacity for 2009. Another sector where risks may yet materialize is real estate, which has also been an important driver of corporate credit demand recently. In this regard, the authorities may wish to consider whether a better diversified export sector would leave the country less exposed to asymmetrical shocks in the external demand. Staff could provide more detail on the recent developments in the automobile and real estate sectors.

Falling commodity prices, weakening export demand, and rising unemployment will help bring inflation towards the central bank target. The question is, at the same time, how effective further rate cuts will be, given the dislocations in the money markets. In any case, we agree with staff that it will be important that the CNB communication strategy ensures that expectations are well anchored to the new inflation target of 2 percent from January 2010. In addition, we would like to stress the importance of carefully communicating the central bank's actions should the exchange rate movements prevent the central bank from adjusting the policy rate along the anticipated path, a possibility indicated in Box 3 of the staff report. We also note the importance of clearing out the recent ambiguity about the target date for the Euro adoption which now appears to have been postponed until an undetermined date.

We agree with staff that high dependence on foreign banks, and a rather large share of off-balance sheet liabilities of Czech banks may represent significant risks going forward. To better understand the extent of these risks, we invite staff to provide more detail on the

composition of these liabilities and the associated risks. The authorities have moved to maintain depositors' and investors' confidence and ensure financial stability. While we support the additional staff recommendations to further strengthen the crisis preparedness, more information on the recommendation to put in place modalities for the application of the second pillar of Basel II would be appreciated.

Mr. Bergo and Ms. Leemets submitted the following statement:

After three years of rapid expansion, the growth outlook does not look bright due to rapidly decreasing external demand. We welcome the opportunity to discuss policy challenges in the Czech Republic, and would like to associate us with the views presented by Messrs. Stein and von Stenglin, particularly on the fiscal and structural agenda. We also thank Messrs. Kiekens and Polak for their well-balanced buff and would limit ourselves to some comments on monetary and financial sector issues.

Regarding the CNB's decision to lower the inflation target to 2 percent from 2010, we note that although it may be more easily attainable in a projected deflationary environment, would it still be a necessary step? As we learn from the buff, the authorities have no deadline for the Euro adoption; therefore having no actual political pressure to lower the inflation target further. In addition, would this step be premature given the potential future inflationary pressures from unavoidable structural changes and ongoing price convergence towards the EU levels?

On financial sector, we were quite concerned to see staff noting that the increased pressures to the Czech financial sector from the global crisis are there "given its rapid integration with the rest of Europe and very high level of foreign ownership". While we agree that a retrenchment of parent banks from the country (or the region more broadly) would imply a significant impact on the real economy, we cannot agree to the notion that the financial integration or foreign ownership per se is a major risk. For example, the bank group's business model, which determines the level and dependency on market-based (wholesale) financing of parent banks, and the banks' internal liquidity management practice would be more relevant indicators in the current situation. Different business models capture different levels of risks. Thus, we would appreciate a more nuanced approach in staff's assessment of the banking sectors in CEE countries

and their actual challenges. Therefore, we can agree with Messrs. Kiekens and Polak that "it is important to assess each country on its own merits", but would also stress the potential role of regional financial surveillance in such a highly integrated region as the CEE. In the Czech case, we take comfort of the business models of banks as they have concentrated on deposits and loans, and largely avoided risky investments. Furthermore, the loan-deposit ratio has been around a very prudent 100 percent level.

Nevertheless, off-balance sheet liabilities appear to be high relative to on-balance sheet assets, and we would appreciate staff's comments on the actual nature of these assets. Although Czech banks' exposure to sub-prime securities and to toxic assets do not seem to play a significant role, there are reports that especially smaller banks have not followed the best practices in prudently evaluating credit risks. These concerns bring us to regret that the FSAP has not been updated since the first assessment in 2001. Meanwhile, we trust the authorities in taking the necessary measures to maintain confidence in the financial system and to guarantee its stability, including close cooperation with home country supervisors.

Mr. Sadun and Mr. Cardoso submitted the following statement:

We thank staff for their well-written report. We broadly concur with the thrust of the staff's appraisal. We also thank Mr. Kiekens and Mr. Polak for their helpful and insightful buff statement. As we fully share the views expressed by Mr. Stein and Mr. von Stenglin, we will limit our remarks to just three points.

Despite the relatively strong fundamentals of the Czech Republic and the good economic performance of recent years, the deepening of the global crisis is striking hard and tilting risks to the downside. We agree that the recent sharp downturn in economic activity and deterioration of macroeconomic indicators is mainly driven by the weakening external environment.

Regarding inflation, we are pleased with the staff's correction to ¶11 of the report, but we would appreciate it if staff could explain some apparent contradictions between the movements in inflation in the Czech Republic and the evolution in oil and food prices. For example, inflation started to accelerate in late 2007 well before the oil and food price hikes; conversely, inflation started to decline

beginning in early 2008, during the period of the sharpest oil and food price increases. Staff comments are welcome.

Yet on inflation, staff suggests that there is scope for further easing as inflation is expected to fall below the CNB's target of 3 percent in 2009. We would advise greater prudence in view of the experience on the evolution in prices in late 2007 and the fact that developments in real wages and disposable income may hinder the decline in inflation. Additionally, the authorities are committed to reducing the inflation target to 2 percent from 2010, which will align it with the ECB's inflation target. Therefore, well anchored expectations will be essential to maintain inflation within the new target and avoid possible new slippages.

For 2009, the challenge will be to strike the right balance between, on one side, sustaining economic growth and employment through adequate countercyclical impulses based on the Czech stimulus package and, on the other side, preserving macroeconomic stability. A careful monitoring on the economic evolution will be necessary, and we agree that additional discretionary impulses should come into consideration if downside risks were to materialize under more adverse economic developments.

However, we note that although the measures under the current stimulus package appear to be well targeted, not all of them have a temporary nature. The reduction in social security contributions paid by employees which reduces tax revenue by approximately 0.5 percent of GDP has a permanent nature. This measure would not be easily reversed.

Furthermore, this measure is not consistent with last year's staff recommendation. In last year's selected issues paper on "Tax and Pension Reform in the Czech Republic—Implications for Growth and Debt Sustainability", staff mentioned that (¶107) "in the absence of pension reforms, social security contributions would need to <u>rise</u> to offset the age-related spending pressures and maintain debt within the Maastricht limits until 2050". We also note in last year's report that (¶18) "Staff stressed that the Czech Republic remains one of the few countries that has yet to start reforming its pension system despite having one of the largest fiscal gaps that need to be filled".

Therefore, given the above, and taking into consideration that since last year's consultation there were no major advances in structural reforms in this area, if a more prolonged slowdown materializes under the current trend of population ageing, this measure may need to be counterbalanced by future tax increases.

To conclude, in recent years Czech Republic has benefited well from EU accession. We commend the Czech authorities for reaping the benefits of its integration and for the good macroeconomic performance of recent years, which have allowed solid strides toward convergence with the euro area. Those achievements have placed the Czech Republic in a much favorable position, when compared with its regional peers, to cope with the current global financial crisis.

Ms. Agudelo and Mrs. Joseph submitted the following statement:

We thank staff for the informative report and Mr. Kiekens and Mr. Polak for their helpful statement.

Years of robust growth with comfortable fiscal and external positions underpinned the Czech economy for most of 2008, in light of a deteriorating global environment. However, as international conditions worsened, the economy slowed, reflecting mainly falling domestic demand and declining export growth. Despite the latter, financing of the external current account remained relatively strong, as direct investment inflows continued to enter into the country comfortably. The economy's intention to join the Eurozone has led to a significant strengthening of the fiscal position and the containment of the deficit below 3 percent of GDP.

The outlook for 2009 has worsened, as indicated in the most recent statement from staff, with risks mainly on the downside. A deeper-than-expected recession in the Eurozone would slow exports and direct investment inflows further, and domestic demand is estimated to contract this year. On the positive side, both core and headline inflation should slow, while the downturn in the economy is expected to ease conditions in the tight labor market. The policy challenges facing the authorities are to design measures to engineer a soft landing for the economy and to maintain financial stability. In this regard, we welcome the information provided by Mr. Kiekens and Mr. Polak that the government has established a National Economic

Council to deal with these issues as well as to identify structural reforms to enhance economic development.

As pointed out by staff, the authorities must bolster economic growth without derailing medium-term fiscal sustainability. Staff's suggestions with respect to a modest fiscal stimulus (including more rapid implementation of EU-funded projects) have merit, as they should be in line with medium-term fiscal goals and at the same time, not strain the government's access to financing. This should be added to the possibility of having automatic stabilizers operate fully.

The dampening impact of the fall in commodity prices and the slowing economy on inflation should allow for an easing of monetary policy to support growth. We note that the authorities will monitor developments including the pace of the slowdown and the evolution of the koruna and will adjust monetary policy accordingly.

Staff indicated that the global financial turmoil has heightened concerns about the financial system in the Czech Republic partly because the system is dominated by subsidiaries of foreign banks with a large exposure to other emerging European economies. Liquidity has tightened, manifested by conditions in the interbank market and the government bond market. However, Mr. Kiekens and Mr. Polak stated that this was a temporary situation, which has since eased. We welcome their assertion that the concern of staff about the large exposure of foreign-owned banks is covered by prudential limits with respect to risk concentration. In addition, regulatory oversight has also been strengthened, including improved monitoring of banks' liquidity positions. Crisis management measures have been put in place by the authorities who have endorsed the importance of proactive collaboration with financial regulators in the host countries of the parents of foreign-owned subsidiaries.

With these remarks, we wish the authorities success in the future.

Mr. Guzmán and Ms. Valle submitted the following statement:

We thank staff for a concise document and Mr. Kiekens and Polak for an informative buff statement.

The Czech economy has sound fundamentals and policy management has been adequate so far. These elements have helped the country weather the global turmoil better than other regional peers. However, as the crisis deepens, especially in the country's European partners, challenges are increasing, as spill-over effects materialize. The main sources of risk are the external sector (through the export channel) and the financial sector. Therefore, the authorities' policies should focus on these two elements and, thus, be aimed at maintaining (investors) confidence, strong fundamentals and export competitiveness.

We associate ourselves with the comments made by Mr. Stein and Mr. Von Stenglin in their gray statement and thus, we will only make the following three comments:

On the outlook, we note that staff, in the statement issued by the staff representative on February 3, have markedly revised growth projections down, especially for 2009. We share the view that economic activity deteriorated significantly in the fourth quarter of 2008 and that this necessarily has an impact on growth rates in 2009. However, the note that new numbers differ substantially from the EC and the authorities' projections and, although to a lesser extent, also from the Central Bank's recently revised scenario. We note that for Germany (the country whose recession is singled out by staff in their explanation for the revision) the EC's and staff's growth projections for 2009 are broadly in line. The explanation could be in the domestic demand side, but we fail to see why it has changed so suddenly to explain the downward correction. Thus, could staff elaborate on the source of this discrepancy and be more explicit on the reasons for the revised projections? What is the risk balance to this new growth outlook? We are mindful that macroeconomic forecasts and risk assessments are, under the current circumstances, subject to unprecedented uncertainty.

In the report, staff mention that a neutral stance strikes an appropriate balance between the goal of supporting growth and the pressures of financing risks (#30) but also welcome the authorities' readiness to shift to a more expansionary fiscal stance, as needed. However, in BUFF/09/22, in light of the worsened outlook, staff assesses now the fiscal stance as slightly expansionary. Under the new projections, what are staff's fiscal policy recommendations? Would a

more expansionary fiscal stance still be appropriate? If, so what would be the implications for fiscal sustainability?

Undoubtedly, and despite proving resilient so far and in better shape than in other countries in the region, the financial sector has come under increasing pressure. We agree with staff that the main concerns come from the existence of short-term liabilities and uncertainties regarding the risks affecting foreign parent banks. Liquidity has tightened considerably, bond markets and credit risk is rising, amid the worsening outlook of economic activity. We welcome measures already adopted by the authorities in order to maintain confidence and ensure financial stability.

Mr. Lushin and Ms. Shabunina submitted the following statement:

Prudent economic policies placed the Czech economy among the least vulnerable in the region. Yet the nature of the current crisis is such that even sound domestic policies are not able to shield the economy from its propagating adverse impact. Strong economic fundamentals should lessen the transmission of negative shocks. Nevertheless, gathering recession in the Euro area and large dependence on the auto industry are tilting the GDP growth towards the negative range. While we share the thrust of staff's appraisal, we would welcome additional discussion of the two following issues: the structure of the fiscal stimulus and its financing, and the risks stemming from foreign banks' financing.

Fiscal Stimulus

We note the fact that both staff and the authorities see the discretionary fiscal stimulus in 2009 as appropriate. While we share this conviction, we believe that two important questions deserve additional attention: 1) is the fiscal stimulus designed in the most effective way for achieving its goal of boosting economic growth? 2) what are the financing sources available and the consequences of drawing on them? The risk of a higher than projected deficit due to the fall in revenues (January data and the worsened outlook for growth point in this direction) should be met with the appropriate contingency plan.

Listed measures from the fiscal package include reduction in the social payroll tax, contributions to the infrastructure investment

fund and salary increase for the government employees. While the first two measures are among the group of the most effective fiscal instruments, we wonder if this is true for the public salary increase, especially if it goes beyond preserving the level of real wages.

The staff's buff statement informs us that the higher deficit is "to be partially financed through a drawdown of reserves". In this respect we have two questions: 1) what is the staff estimate of this "partial" financing? 2) why the updated projections for reserves levels in 2009 are higher than in the initial report? Governments of the EMEs find it increasingly difficult to get financing. Given that the supply of sovereign debt from advanced economies is going to increase, borrowing conditions for the EMEs are likely to tighten even further. If a substantial part of the deficit is to be financed from the reserves it is unclear to us how their level can exceed the previously projected one for 2009.

Banking System

The risks to the stability of the Czech banking system are contained and vulnerability indicators are reassuring: both the dependency on the external funding sources and the share of loans denominated in foreign currency are low. However, liquidity tightening by the parent banks is adding to the downside risks. We also join staff in their call for increased vigilance over the large off-balance sheet accounts of the banks.

The report informs us that liquidity limits set by the foreign parent banks for their foreign operations result in the rising liquidity risk for their local subsidiaries (p.14). Looking ahead, we see similar risk coming from the domestic bias in the support packages provided by the governments of the parent banks. We understand from Mr. Kiekens' and Mr. Polak's buff that these risks may not be especially pronounced in the Czech Republic. However, a high share of short term loans in foreign funding and the risks associated with its withdrawal as presented in Box 2 are disquieting. We, therefore, would welcome more staff comments on the risks in this area.

The CNB should be commended for the high level of transparency: publishing the information on the off-balance sheet liabilities should diminish the potential dangers caused by uncertainty. At the same time, the large size of the off-balance sheet liabilities

requires close monitoring by the regulator and perhaps the related stress tests of the system vulnerability indicators.

Mr. Chua and Mr. Waqabaca submitted the following statement:

Czech Republic

We thank staff for the concise and well-focused report and Mr. Kiekens and Mr. Polak for their helpful statement.

We commend the authorities for fostering strong economic fundamentals that have supported high growth in recent years. Undoubtedly, spillover effects from the crisis will put the recent impressive performance under pressure and we agree that the economy is likely to slow significantly in 2009. Further, risks are tilted firmly to the downside as the Czech Republic faces a number of coincident risks, not the least of which are trade shocks arising from the weak Eurozone performance, and a tightening of financial conditions that will affect domestic demand.

Having said that, we take note that the staff's growth projections seem to be far weaker than either the official expectations or forecasts by other institutions. Even as the authorities revised their forecasts down, we note that the staff has downgraded their projections by 2¾ percentage points. We would appreciate some idea of why staff's views are relatively pessimistic. We would also like to understand why the current account deficit is now expected to rise from 2.2 percent of GDP in 2008 to 3.1 percent in 2009 and 3.3 percent in 2010. This is in stark contrast to the old projections, which saw a roughly stable deficit. Staff's elaboration would be welcome. However, we agree that the gains from past reforms should now help the Czech Republic weather the difficult global environment.

The focus of this year's report is appropriately on the financial sector. The large foreign ownership of bank assets, coupled with exposure to the rest of Europe and an impending economic slowdown has intensified risks to the financial sector. As such, cracks have surfaced in what is otherwise a strong banking system. The critical first step is to ensure that the credit system continues to function. The CNB's prompt actions in providing liquidity and preserving confidence are appropriate and well-crafted. While liquidity has declined in some segments of the market, the Czech financial system

has not seen wholesale credit retrenchment. Further, the provision of liquidity by major central banks should, hopefully, reduce the risk of hoarding.

The key risk now comes from the retrenchment in demand and the impact on asset values. What measures do the authorities envisage to address credit risks that will arise especially if economic growth falls below 1 percent? The Czech system also faces another source of vulnerability, given its deep links with its neighbors. Are there any signs of retrenchment of funds by foreign owned banks since the staff report was drafted? Finally, we took note that Czech banks have large off-balance sheet exposures, mostly derivatives (footnote 1). What is the nature of these exposures, and how were they funded? How would different shocks—liquidity, credit and valuation—affect bank capital? In view of this, we are encouraged that the authorities have taken steps in improving the supervisory capacity and crisis resolution preparedness.

We note the strong agreement between staff and the authorities on macroeconomic policy. Where the last Article IV discussions were focused on inflation as the key macro risk, staff has appropriately placed emphasis on growth this year. We commend the CNB for acting swiftly in easing interest rates when it was clear inflation was no longer the key concern. In this context, we appreciated the analysis in Box 3. We agree that demand retrenchment is likely to overwhelm any effect coming from monetary loosening or exchange rate depreciation, and disinflation is the most likely outcome. We were also intrigued to note that the bulk of the increase in the CPI in 2008 was due to one-off adjustments and the spike in food and fuel prices. By our back-of-the-envelope calculations, the demand-driven price increase would have breached the Czech National Bank (CNB)'s inflation target, but only by about 1-1.5 percentage points. On the other hand, last year's staff report advocated staying on a "sustained tightening path" on the basis that the primary cause was excess demand. It might have been useful then to clearly assess how the CNB could deal with a price increase that was largely outside the scope of monetary policy to affect. We hope that future staff reports will look more critically at the underlying factors driving prices before coming to policy recommendations.

We were intrigued to note that the CNB has decided to publish forecasts of the exchange-rate path beginning in 2009. We would

appreciate additional information on this step including what measures will be published, what the communications strategy is and whether the forecasts will take into account structural and fundamental factors or also transient and cyclical ones. On one hand, we can see some value in this step as it helps alert the public as to the authorities' views on what the fundamental path of the exchange rate is. Communicated properly, such a step could also reduce risks of an exchange rate overshooting. Having said that, we see two risks associated with this move. First, as noted by staff, it could lead to some confusion regarding the objectives and focus of monetary policy. More importantly, if the forecasts involve exchange rate evaluations, the CNB may run into the inherent difficulties associated with such evaluations. We look forward to understanding how these will be resolved.

We welcome the assessment that, as a result of past prudent fiscal policy, the Czech authorities have the fiscal space to provide some support in the difficult months ahead. While a small deficit is projected for 2009, the slowdown in the economy may necessitate an economic stimulus to support growth, address tight liquidity conditions, and revive consumer confidence that has been hampered by rising unemployment. We certainly agree that automatic stabilizers should be given full play. Is the level of support provided by automatic stabilizers in the Czech Republic comparable to that elsewhere in the region and in Europe generally? In this respect, we welcome the authorities' readiness to shift to a more expansionary fiscal stance, if needed. What is the scope for discretionary stimulus? We recall that in last year's Article IV report, staff had some concerns about medium-term fiscal sustainability. We do not advocate any fiscal tightening at this time but we trust that staff will keep this issue in mind in future consultations. In this context, the on-going work on formulating effective exit strategies once the crisis is over could prove valuable in future discussions.

With these remarks, we wish the authorities success in their policy endeavors.

Mr. Fayolle submitted the following statement:

We thank staff for a concise report as well as Messrs. Kiekens and Polàk for their informative buff statement. We broadly share the

views put forward by Messrs. Stein and von Stenglin and we would like to highlight the following.

The solid fundamentals of the Czech economy have supported a solid growth over the last years and have helped the country weather rather well the first wave of the financial crisis that started in august 2007. However, since last September the outlook sharply deteriorated for key trade partners' economies. More broadly, the current crisis points out the risks of an export-driven growth model, based on the specialisation in one specific sector—the car-making industry—among the hardest hit globally.

Considerable progress has been made in fiscal consolidation over the least years, which helped the country enter the crisis with a relatively low public debt and a strong fiscal position. This allows for a full operation of the automatic stabilizers as well as for a discretionary measures to help smoothen the downturn. We would like to emphasize that in order to be effective, a fiscal stimulus would have to be well targeted towards increasing private consumption in a timely and bold manner. This could contribute to rebalancing growth from external to domestic sources, helping not only to avoid a deep recession in the short-term but also making the Czech growth path less dependant on external factors in the longer-run. This said, the authorities will have to keep in mind the longer-term goals of public finances in relation to demographic challenges. In this regard, further reforms of the health care and pensions systems will be needed in the medium run.

We agree with staff that the rapidly falling inflation allows for further monetary policy loosening. Indeed, inflation is expected to decrease below the 3 percent-target of the Central Bank. We strongly encourage such a loosening that could contribute to sustain domestic demand, increase the liquidity of the financial sector, and maintain a low value of the currency for the export oriented sector while the low share of foreign currency loans to the private sector limits the emergence of negative balance sheet effects.

The external position of the country appears relatively more solid than that of most countries in the region: the trade balance is in surplus and the low current deficit mainly stems from repatriation of profits by foreign companies. In addition, the foreign exchange reserves represent 150 percent of the short term external debt. This

said, vulnerabilities have arisen in the banking sector due to tightening conditions and a large share of short-term liabilities. In addition, the relative share of off-balance sheet items is quite high. We fully share staff's recommendations on how to support the financial sector, in particular regarding the modalities of government intervention and recapitalization in the banking sector. Nevertheless, we note that unlike many countries in the region, the share of foreign currency loans is relatively small (less than 10 percent of total credits). This limits, for the private sector, the negative balance sheet effects that could stem from a further depreciation of the currency, thus safeguarding against negative feedback on the credit quality of the banks.

Mr. Talbot and Mr. Hills submitted the following statement:

We thank staff for a useful report, and Mr. Kiekens and Mr. Polak for their helpful buff statement. We broadly agree with staff's assessment that the Czech Republic is one of the economies better-placed to ride out the current global financial situation, given its relatively low external imbalances and public sector debt. Nevertheless, there are some worrying signs in recent macroeconomic data. While we broadly associate ourselves with the points made by Mr. Stein and Mr. von Stenglin, we take a slightly different view on the role of fiscal and monetary policy.

Macroeconomic Projections

In Tuesday's update, staff materially lowered its projection for GDP growth in 2009 from 1.5 percent to -1.3 percent. We would be interested to find out more about what components of GDP account for this revision. Could staff also please clarify what conditioning assumption has been used for the exchange rate projection?

Could staff also please comment on how sensitive these projections would be to a sharper downturn in demand in the Czech Republic's major trading partners?

The Domestic Policy Response

On fiscal policy, the sharp downward revision to the macroeconomic outlook would, to us, suggest a larger discretionary fiscal impulse at this juncture, particularly in light of the prudent fiscal

policies pursued hitherto by the Czech Republic. In paragraph 31, staff "welcomed the authorities' readiness to shift to a more expansionary fiscal stance if needed". Could staff confirm whether they would now advocate a further discretionary stimulus?

On monetary policy, we would tend to agree with the conclusions of Box 3 in the staff report, which, given the sharp slowdown in activity (which is even sharper in the new staff projections), suggests that a further easing of monetary policy may soon be warranted. We agree with staff that it would be very wise for the CNB to have a clear communication strategy given the upcoming reduction in the inflation target. But in our view it is likely that the bleak outlook for growth will be more than sufficient to ensure that inflation expectations remain anchored to their new, lower, target in the near future.

Financial and External Sectors

The staff report notes that the Czech Republic has a high dependence on foreign banks with significant exposure to emerging Europe. Fortunately, most of the lending has been in local currency lending and has been funded by domestic deposits. Nevertheless, could staff please comment on whether there has been any more recent evidence of repatriation of funds to foreign parents, perhaps due to deleveraging related to the parent bank's operations in other emerging European countries?

Could staff please comment on the prospects for FDI inflows to the Czech Republic over the next couple of years, in view of the global credit problems, declining export demand and increasing capacity in existing facilities?

Structural Reforms

We note the importance of the government's commitment to medium-term structural reforms, notably in the field of healthcare (which could help the longer-term fiscal position), and energy efficiency (which could reduce the economy's reliance on oil and gas imports).

Mr. O'Sullivan and Mr. St-Amant submitted the following statement:

We thank the staff for its informative and well-focused documents. We also thank Mr. Kiekens and Mr. Polak for a statement that provides useful additional information and interpretation.

We congratulate the authorities for the strong policies pursued in recent years. We are particularly impressed by the progress made on improving the fiscal situation. The deficit has been reduced and the debt to GDP ratio is relatively low. This gives some room for the authorities to provide discretionary fiscal stimulus in response to the strong negative external shock that is affecting the Czech economy.

We also note that the inflation target and the flexible exchange rate appear to have served the Czech Republic well in absorbing external shocks, including the fluctuations in commodity prices and now the global crisis. Given the huge size of the ongoing external demand shock, the inflation risks appear minimal at this point. On the other hand, as is made clear in the report, there may be a risk of undershooting the inflation target or even of entering into deflation. This calls for an aggressive easing of monetary policy. We thus see the recent policy interest rate cuts as appropriate. We believe that the monetary policy easing, the inflation target (to the extent it is effective in anchoring inflation expectations), and a temporary increase in the fiscal deficit should help protect against persistent deflation. However, we encourage the authorities to stand ready to use non conventional monetary policy instruments (quantitative and/or qualitative easing) in case their monetary policy becomes constrained by the zero-lower-bound to short-term interest rates.

The staff's reports mention various risks to financial stability in the Czech Republic. We find the quick run up in the household debt service burden in 2006 and 2007 (shown in paragraph 20 of the main paper) particularly worrying, especially given that this came in the context of large increases in property prices and of strong credit growth. Could the staff please provide comments on the risk that financial stability and domestic consumption might be negatively affected by a further deterioration in households' financial situation? We would also appreciate that the staff provide more details about the nature and implications of the banks' large off-balance-sheet exposures.

On this, we wish the authorities success in addressing the present challenges.

Mr. Heath and Mr. Wood submitted the following statement:

The outlook for Czech economic growth has worsened sharply in recent months, as exports and industrial production have contracted and confidence has deteriorated. However, prudent fiscal policies, past structural reforms, and a relatively balanced external position have put the Czech Republic in a better position than its regional peers to withstand the current global crisis. The authorities now have some flexibility to cushion the impact of the slowdown while maintaining their commitment to medium-term goals of inflation reduction and fiscal consolidation.

We broadly agree with the staff's assessment of the outlook. Recent data in the staff statement suggest that risks to economic growth are on the downside. In particular, the auto sector, which is a large part of the overall economy, has seen its prospects weaken significantly with the global downturn. We agree with the staff that past fiscal reforms have created room for the full operation of automatic stabilizers this year and that the authorities could consider further fiscal stimulus if downside risks are realized. It is important, however, that measures be well-targeted and temporary. In addition, we agree with Messrs. Stein and von Stenglin that the authorities should be mindful of potential financing constraints, especially given the drying up of liquidity in the government bond market.

We note that the staff analysis suggests the koruna is broadly in line with fundamentals. Significant real appreciation through the first half of 2008 had raised concerns about competitiveness, but the subsequent depreciation has reduced such concerns.

Messrs. Kiekens and Polak indicate that the authorities have recommended that the government not set a target date for euro adoption, given the uncertain near-term outlook. We would appreciate staff comment on the pluses and minuses of setting a target date at this point, given that the Czech Republic is likely to fulfil soon most of the Maastricht criteria except that for the exchange rate.

Inflationary pressures have eased significantly, as commodity prices have declined and domestic demand has slackened. In that

context, the CNB's policy easing since mid-year has been appropriate. We agree with the staff that there remains room for further monetary easing if economic growth prospects continue to deteriorate and inflation continues to fall. As it responds to changes in the outlook, the CNB should use its communications to anchor expectations around its new target of 2 percent inflation starting in January 2010.

The Czech banking system appears to have had relatively little exposure to toxic assets, and it has avoided the excessive reliance on foreign-currency lending that has occurred elsewhere in the region. Nonetheless, the staff report notes that liquidity risk is rising and that credit risk has increased significantly. We support the staff's suggestion that further measures could be taken to maintain confidence in the financial system and ease the tightness in money and bond markets. In particular, it would be reasonable to widen the range of instruments acceptable as collateral in the interbank market.

Mr. Moser and Mr. Gasiorowski submitted the following statement:

Despite generally solid fundamentals, the Czech Republic is facing a slowdown, resulting in a significant part from the recession in the advanced economies. The grim prospects for the European Union and Germany especially—the Czech Republic's largest trading partner—are weighing on the exports and FDI outlook. This comes on top of slowing private consumption and investment activities. In addition, the banking sector, which is dominated by foreign banks, has recently come under pressure.

We understand that the update provided by staff reflects recent revisions of the global economic outlook. However, the size of the 2009 growth revision is very large even for turbulent times. We also note that that such a revision appears only after less than a month since the issuance of the original staff report, and that it stands at odds with the EC interim forecasts and the revised projections of the Czech National Bank. We wonder where the differences are between the authorities' and staff's projections. Staffs' comments would be welcomed.

We welcome the authorities' commitment to long-term fiscal sustainability aimed at timely euro adoption and necessary fulfillment of the Maastricht criteria. Given the increasing cost of access to the international bond markets, we consider the stimulus package to be

well targeted on structural reforms with a focus on improving competitiveness and maximum and prompt use of EU funds. As EU-funded projects require co-financing from public sources, we consider it appropriate to create room to absorb additional expenditures. At the same time, we welcome that the authorities are planning further structural reforms to tackle the challenges of rising pension and health costs, although they remain politically difficult.

The central bank (CNB) has rightly cut policy rates aggressively, as inflation pressures have receded. Regarding the future interest rate path, the extent of the slowdown as well as the development of the koruna will be key for the inflation outlook, and will thus determine the scope of further easing. Given the recent numbers on industrial production and industrial prices, the 50 bp easing announced on February 5 seems to be within the appropriate scope .

We consider the new inflation target of 2 percent, applicable from January 2010, to be a helpful element in the Czech Republic's strategy to meet the Maastricht criteria on a sustainable basis.

We note that the CNB intends to publish a fan chart of the koruna-euro nominal exchange rate. However, we agree with staff that publishing such forecasts may be perceived as a regime change. Therefore, in order to underline the fact that the inflation rate remains the key target, the CNB may consider postponing such a publication until the unrest on exchange rate markets eases.

We welcome the measures taken by the authorities to deal with liquidity problems in the banking sector, including daily monitoring of the liquidity positions of banks. We note that staff suggests further steps to mitigate perceptions of rising counterparty risk in case that the widening of the range of collateral in the interbank market is not sufficient. Could the staff elaborate on the particular measures they have in mind? We would also like staff to elaborate on whether the weaknesses noted in the 2001 FSAP still remain?

The staff sees a risk resulting from the shrinking of the foreign owned banks' balance sheets. In this regard, we share Mr. Kiekens and Mr. Polak's opinion on the difference between withdrawal of existing funds from the banking sector and curtailing of new financing. If the risk of withdrawal is indeed significant and the measures taken by the

authorities insufficient, could the staff elaborate on the mechanisms allowing for the repatriation of funds? Could the staff also tell us if the effects of parent banks' central management of liquidity and risk are visible in the Czech interbank trading?

Supervisors will have to be vigilant about the strength of individual banks. The strong profits in 2008, rising capital adequacy ratios, low loan-to-deposit ratios and dominant local currency lending should act as important buffers to an unavoidable increase in credit risk and nonperforming loans resulting from the economic slowdown. However, the staff also mentions that off-balance sheet liabilities appear to be high. Could the staff give additional information on the nature, size and economic implications of these liabilities?

Finally, on the format of the staff report: as on previous occasions, we would like to stress that we prefer the staff appraisal and the executive summary to be presented separately, given that they serve different functions.

Mr. Gasiorowski agreed with Mr. Bergo and Ms. Leemets with regard to the foreign ownership of Czech banks. It was not just foreign ownership that created a risk, but a business model of the subsidiary of the parent banks and the parent banks themselves that might expose a certain bank to risks. The more nuanced approach Mr. Bergo and Ms. Leemets had called for would be welcome more generally in the assessment of the banking sectors in the Central and Eastern European countries. In this regard, the comment made by Mr. Lushin and Ms. Shabunina about the domestic bias in the support packages provided by the governments of the parent banks was very accurate.

As for the measures to support lending, the staff had proposed the extension of the range of collateral for the central bank, Mr. Gasiorowski continued. It could be observed that in some countries, even the extension of the range of collateral was not necessarily increasing the amount of lending, because the money was invested in Treasury bonds thus not flowing to the private sector.

In line with Mr. Talbot's and Mr. Hills's request, more information on the prospects of FDI inflows would be welcome, Mr. Gasiorowski said.

The representative from the European Central Bank (Mr. Pineau) made the following statement:

> The Czech Republic experienced strong growth in the last three years and now is faced with a slowdown affecting the euro area and Europe at large. Given a strong policy framework and initial conditions, the economy should be in a rather good position to withstand the negative spillovers. It is also interesting—and there is a reference to that in the buff statement by Mr. Kiekens—to see some signs of a partial decoupling from other countries in the region. I will come back to this later on.
>
> I share most of the points made in the gray by Mr. Stein and Mr. von Stenglin, and I will focus on the outlook, fiscal policy, monetary policy, and shortly on the financial sector. The outlook looks very uncertain, perhaps even more uncertain than for other economies in the region. If you look at the growth rate estimates, the range of estimates is wide if you compare the Fund's estimates with the European Commission's. The authorities tend to take a middle ground, at least on the basis of the latest estimates of the central bank.
>
> One point in this respect is that the slowdown in the Czech Republic will certainly be linked or related mainly to external factors because, as far as domestic consumption is concerned, a feature in the Czech Republic is that the household sector is less exposed to lending in foreign currencies, thus implying that volatility in the exchange rate should be less of a problem than in other countries.
>
> Turning to fiscal policy, the authorities have made progress in recent years in creating fiscal space. They have been using part of it in a rather prudent manner by introducing discretionary measures. According to the latest estimates, the overall fiscal impulse should be on the order of 1 percentage point of GDP, which is lower than the EU average. We would tend to consider that this is a cautious approach, again because of the uncertainties with respect to the outlook for this year and next. If, for example, Fund staff turned out to be right in projecting a rather significant contraction for this year, then there might be a need to do more at a later stage in the downswing. Another consideration for prudence is more of a medium-term nature. The fact that sustainability is not ensured in the Czech Republic, in particular because, in contrast to other authorities in the region, the country has

not yet initiated significant reforms as far as pension entitlements are concerned.

On monetary policy, uncertainties relating to growth might play a role when it comes to inflation developments. Given that the authorities have set a new objective for next year at 2 percent in line with the ECB's definition of price stability, we would consider that they should adjust policy rates looking closely at developments in inflation expectations. As it could be expected, recently such expectations have developed positively, but there is a need to condition further easing on positive developments with respect to expectations.

Turning quickly to the exchange rate, we understand that projecting an exchange rate development path is considered best practice in the context of an inflation-targeting framework. At the same time, it is not clear, at a technical level, that this would be as easy to do in the case of the Czech Republic as in a country like Norway, for example. Specifically we are aware that the Czech koruna and developments in the exchange rate are still affected by common regional factors.

Lastly, on the financial sector, like in other countries in the region, foreign-controlled banks play an important role. However, cross-border funding or financial flows between parent banks and their subsidiaries in the Czech Republic are much smaller than in other countries. This factor is probably favorable in terms of financial vulnerability, and might explain, in part, the partial decoupling I referred to at the beginning.

The staff representative from the European Department (Mr. Thakur), in response to questions and comments from Executive Directors, made the following statement:

I will start by talking about the differences in the forecasts for growth for 2009, which the ECB representative just noted, among the authorities and the European Commission, and staff's latest forecast, which is now for a fall in GDP.

I would say that the main difference boils down to the assessment of the prospects for private consumption. If you look at the ministry of finance's forecasts and the staff's, that is where the

differences lie. There is also some difference in the negative contribution of net exports to growth, on which the staff is more pessimistic than the Commission and the authorities. That is essentially related to our WEO forecasts for Germany, which is a large trading partner and export market for the Czech Republic.

On private consumption, we consider that the positive effects that would derive from lower inflation on households' real incomes will be outweighed by slower nominal wage growth, higher unemployment, which has already started to pick up rapidly, and a more general deterioration in household confidence. The January numbers are quite sobering in terms of the fall in both business and consumer confidence. So, while staff hope to turn out to be wrong on this issue, that is where the differences in the grow forecast lie. I would note that credit growth in the Czech Republic has been slowing—although consumer credit is not as large a factor as in some industrial countries governing private consumption—and we give a lot of weight to this factor. I would also note that, in this current uncertain situation, various projections for growth are like a moving target. In mid-November, during the mission to Prague, we were in fact at the lower end of the range of forecasts. Unfortunately, our judgment at that time that the risks were tilted to the downside, turned out to be correct.

I would also note that this morning The Minister of Finance , Mr. Kalousek, gave an interview in Prague in which he referred to the CNB's forecast just issued yesterday—which at minus 0.3 percent—and said that he hopes that growth will be closer to zero rather than negative. So, even the Minister is taking into account the rapid deterioration in the external situation and the domestic indicators. Mr. Kalousek reportedly went on to say, that he could not exclude a significantly worse outcome for growth this year. A number of private forecasters, including major banks in the Czech Republic, are also forecasting a fall in GDP. So, my point is simply that the staff's forecast, once the developments on the external and domestic front are considered, is not too far out of line.

The sensitivity of the forecast to the external prospects for growth is a question that has been raised by a couple of Directors. The Czech Republic is a very open economy. Seventy percent of GDP consists of exports, half of which go to Germany. As you know, there has also been a sharp downward assessment of the prospects for

growth in Germany. There was a question also about the exchange rate assumption underlying the forecasts. This is a standard assumption that the World Economic Outlook makes, which is an unchanged real exchange rate, and that is what we have used for our estimates.

Turning to fiscal policy, I will first talk about the prospects for the fiscal outturn. There has been a lot of change since the budget was issued at the end of October. The authorities are currently projecting an increase of the deficit in 2009 from 1.2 of GDP to 3 percent. The 3 percent of GDP projection is only one of the three scenarios that the ministry of finance has considered. The minister, in his interview this morning, also referred to a considerably worse scenario characterized by a fall in GDP. If that occurs, the deficit number will likely be higher than expected and breach the Maastricht's 3 percent deficit-to-GDP ceiling. Staff's forecast, given our lower growth number, is of a deficit of 3½ percent of GDP. That is broadly consistent with the estimate of the elasticity of the budget deficit to GDP at 0.39, as calculated by the OECD.

I would say that, looking back probably a year from now, we might find that the budget outturn might turn out not to be less pessimistic. Recent experience in the Czech Republic has shown that budget estimates, in particular revenue estimates were fairly conservative; the outturn has tended to be better than projected. This has been true for recent years. The initial estimate of capital spending also has tended to be high. This was particularly true in the last two years. It is not simply because of the cycle; but because of the fairly good record of spending discipline, particularly in 2008. So, the actual outturn might in fact be significantly better than the current forecast suggests.

On the policy front, several Directors have asked whether a discretionary stimulus is warranted now that the staff is forecasting a recession in the Czech Republic. We generally are supportive of the authorities' position that automatic stabilizers should be first allowed to work; that is our first-base scenario. They have indicated in their recent budget statement as well as in the minister of finance's interview this morning that they are ready to consider discretionary measures, if the outlook worsens. We welcome this position. The newly-created National Economic Council, which is a non-partisan expert body, is charged with the task of identifying specific measures, . This has involved political negotiations, particularly considering that a

fragile coalition government is ruling in Prague. So, we may need to wait for awhile and see what discretionary measures would be acceptable to the government, which could then be passed through parliament. Some of these measures are in line with what we have suggested.

Before adopting discretionary measures, however, I should underline that, as we state in the staff report, the pipeline of EU-funded projects that exist in the Czech Republic give the authorities some flexibility to implement a more expansionary fiscal policy without jeopardizing their underlying fiscal position.

There are financing constraints, which the minister of finance has repeatedly underlined. The situation in the bond market last October, when there was a temporary freeze, suggests that we cannot ignore these financing constraints. There is also the issue of fiscal sustainability, which the authorities have repeatedly stressed and on which we agree as well. In recent years—this is my third mission to Prague—we have repeatedly brought to the attention of the authorities and discussed at the Board the problem of increasing demographic pressures threatening the country's medium-term sustainability. The Czech Republic is, in fact, one of the faster-aging countries in the European Union As was just pointed out by the ECB representative, the record on pension and healthcare reforms is not as good as one would want it to be. So, there are sustainability concerns that also are weighing on the authorities' mind. On balance, they are prepared to take discretionary steps and will monitor the evolving situation carefully. Our recommendation is in tune with their position on this.

On the characteristics of the fiscal package, its composition, and how effective it will be, I acknowledge that several of the suggestions of the National Economic Council—spending on infrastructure, education, and health, in particular targeting spending toward vulnerable groups that have a higher propensity to spend—are measures that we have also discussed and recommended to the authorities. So we can support them.

The reduction in the Social Security contributions is somewhat fortuitous. This was not part of the stimulus package, rather it was part of the reform of the benefits system that was put in place in 2007 and implemented last year. It just so happened that such reforms came on stream when the economy is turning sharply down. In that context, we

tend to agree with the remark by Mr. Sadun and Mr. Cardoso that the reduction in the Social Security contributions is a permanent measure. While it would be beneficial in the short term, it may not be such a wise step in the longer term, because this will be difficult to reverse.

Be that as it may, the question of the political feasibility of some of these discretionary measures was raised by Directors in their grays. In a coalition government, which has exactly half of the seats in parliament, passing these measures is not going to be easy. The National Economic Council, which is an independent expert body, may help to generate the consensus on what measures would be acceptable to both parties.

On the fiscal front, there was a question about the exact size of the EU funds. They are quite sizable; for 2009 they are about € 3.4 billion—roughly equivalent to 2¼ percent of GDP. The issue mainly is how fast the government can use these funds. The absorption capacity of the Czech economy has not been very high historically. This is the result of a number of administrative issues, particularly the slow start-up of the use of these funds. While this is an area where things can be improved, one should not be excessively ambitious about how much these funds can help deliver in terms of fiscal stimulus. Therefore, some of the other discretionary measures that are being considered at present may well become necessary, if the downturn is as sharp as we are predicting it to be.

On the financing of the deficit, there is some scope from the drawdown of reserve funds that have been accumulated in recent years because of underspending by line ministries. That gives some room of maneuver for the authorities.

On the size of the automatic stabilizers, they have been relatively low, hovering at around 0.39, compared to the advanced and the OECD countries, where the average is 0.45. Automatic stabilizers in the Czech Republic are on the lower side because the share of unemployment benefits and other income-related transfers is relatively low. The introduction of the flat tax, although that is a recent event, would also affect the size of the automatic stabilizers.

On the questions of monetary policy and inflation, as we indicated in yesterday's staff statement, the CNB cut policy rates by 50 basis points. We are back to where interest rates were three years

ago. There is still room to cut if the situation so warrants , but in the last four months we have been witnessing a fairly rapid easing of monetary policy, which is indeed warranted.

On the question concerning food and fuel prices and the inflation path, it boils down to the step of increasing the VAT rate, which also took place in January 2008, and complicated the dynamics of the inflation path. That resolves the apparent contradiction that some of you noted in the inflation path and the timing of the food and fuel price increases.

On the question related to the CNB's innovation of including an exchange rate forecast in their inflation forecast, this is something that has been done by a couple of other countries that follow an inflation-targeting regime. This forecast is presented as a fan chart; and it was published yesterday for the first time. It is going to be published as a trajectory, conditional on assumptions of the forecast and information available at the time it is prepared. It is good in terms of the technology of inflation targeting, and I think we are generally sympathetic to it. I believe the Czech Republic is viewed by many students of inflation targeting as a country that has a central bank that is at the forefront in doing things in line with best practice. However, I do agree that communication implications have to be managed. Markets need to be very clear that there is no dual-policy objective being pursued by the CNB. We believe this is clear to the market participants, but it is something that will need to be monitored.

Mr. Bergo raised some questions about the wisdom of reducing the inflation target from 3 percent to 2 percent from January 2010. This decision was taken sometime ago. It can be debated it, but it is driven by the desire to align the target with the ECB target. It should be noted that the Czech Republic has consistently undershot its current 3 percent inflation target for 2—3 years now. The authorities have a credible inflation-targeting framework. So, on balance, the decision to reduce the inflation target to 2 percent should not create problems. Furthermore, given the slowdown that is in prospect, there should be no issues in meeting this target.

There were several questions on the financial sector. Let me start with the issue of the off-balance-sheet liabilities and what the implications of their large size are. First, let me start by saying that we want to commend the Czech authorities for their transparency on

publishing the off-balance-sheet items on the CNB's website. Off-balance sheet items have been a key focus of the financial stability discussions in international forums, such as the FSF, and, given their role in the recent financial crisis, they remain an important item. It should be noted that the Czech Republic is one of a few countries in the world where off-balance-sheet data is published. So, this is something that needs to be commended before we discuss the implications of this data. So, this transparency is all to the good.

The problem with this practice being so uncommon is that, ironically, it makes it very difficult to make international comparisons. So, there is a basic problem in comparing this off-balance sheet data with other countries' data, as the Czech authorities suggest that we do. I want to point out that we are in continuing dialogue with the Czech authorities on these off-balance-sheet liabilities, their composition, and what needs to be looked into. On the cross-country comparison, it is not so much the comparison across countries or even institutions that matters, but it is the capacity of individual banks to absorb the off-balance-sheet liabilities, if they materialize. That is the key in assessing vulnerability. Given that perspective, that is the spirit in which we have pursued these discussions with the Czech National Bank. It is not our intention to allude to any problems that we see and that the Czech authorities have not seen. That is not the spirit in which we have referred to these numbers in the staff report. It is merely the intention to suggest that vigilance is called for because in many other countries these items have created vulnerabilities.

I would not go into the composition of these items. We have mentioned some in the staff report. Eighty percent of them are derivative transactions; they could be futures, forwards, and options. They are not typically considered toxic or subprime assets. But I would not want to be too definitive on these, because we do not fully understand the details of some of these transactions and items. I would say that there is a counterparty risk in the event any pledge or guarantee cannot be met.

The net contingent liabilities are about CZK 85 billion . Here, we made a simple stress test of what would happen if all of these were realized. Our calculations suggest that that would reduce total liquidity of the banking system by around 30 percent. So, this is potentially something to be watched and monitored carefully.

There were several questions on funding and liquidity risk versus credit risk. There were also questions on the risk of retrenchment of funds by parents of foreign banks. There were also questions about the mechanisms that might be used for retrenching funds from the Czech Republic. We have discussed some of these issues in Box 2 in the staff report. The main point is that the major foreign banks' subsidiaries are largely financed by local deposits, and that means that the funding risk would typically be lower than if they were to rely on wholesale or capital markets. However, it is also true that, whatever the source of funding , banks are not obliged to roll over maturing loans or make new loans. That is where the source of the concern lies. As experienced elsewhere, in an environment of sharply-rising credit risks, banks can hoard liquidity rather than lend , and that can lead to a credit crunch. These are the concerns that we have alluded to in our discussion with the authorities. Recent BIS data for the third quarter of 2008 seems to support the assertion that there may be a risk of retrenchment of funds from the Czech Republic.

There was a question about whether the weaknesses identified by the 2001 FSAP remain. There are some issues concerning the explicitness of the guarantee of the Deposit Insurance Agency. The authorities are aware of the issues and are looking into them.

As for the remaining questions that I have not yet addressed, I intend to respond bilaterally, particularly with regard to the automobile sector, the construction sector, and foreign direct investment. I would say that there is likely to be a downward revision of the forecast for FDI , particularly since privatization plans might have to be postponed given the uncertain financial market situation.

Mr. Raman wondered, given that the Czech koruna was classified as an independent float according to the current staff's classification, what the meaning of exchange rate forecasting was. It was a fairly technical question, which could be answered by the staff bilaterally.

Turning to fiscal policy, on the one hand, there seemed to be a sense of optimism about the potential fiscal outturn, which might not be as constrained as the initial numbers suggested, Mr. Raman continued. However, such optimism seemed to be based on the idea that expenditure had been, and would continue to be, very tightly controlled. Was that because cost controls had been strong and implementation had been on schedule, or had implementation bottlenecks prevented the authorities from spending the available money? Such an issue was very much linked to the issue of

EU funds. Was absorptive capacity lacking or rather was implementation capacity holding back spending?

Mr. Lushin noted that the fiscal deficit was now estimated to be around 3 percent of GDP. The staff mentioned in its statement that it would be partially financed through a drawdown of reserves. It was not clear what kind of reserves these were and whether they were international reserves. It was in fact puzzling that that in the updated staff statement the amount of reserves was higher than in the initial staff report. The staff's explanation would be welcome.

On the risks associated with foreign bank lending, Box 2 in the staff report stated that claims by foreign banks on the non-bank private sector amounted to about 56 percent of Czech GDP at the end of 2007, of which one third was attributable to more volatile short-term claims, Mr. Lushin continued. It would be interesting, as it made a substantial difference, to understand if these were loans from foreign banks or from foreign subsidiaries within the Czech economy. If those were subsidiaries that were largely financed through local deposits, there was not so much risk as it could be thought at a first glance. Differently, if those loans were financed through outside-the-country financing, the risks were substantial. Box 2 in the staff report was therefore confusing, and the assurance in Mr. Kiekens's buff statement that that was not actually an issue was welcome.

Mr. St-Amant noted that a chart in the staff paper showed a very sharp increase in the debt-service ratio for households. He would be interested in the staff's comments on the possible risks that such a factor may pose for future consumption, and on a risk of a sharp increase in households' defaults on debts.

The staff representative from the European Department (Mr. Thakur), in response to additional questions and comments from Executive Directors, made the following further statement:

> I will get back to Mr. Raman on the technical issue of exchange rate forecasting.
>
> On the public expenditure implementation, it is indeed an issue of implementation capacity and administrative hurdles. The full use of EU funds has been a problematic issue for some time, as there are various judicial and administrative obstacles that prevent identification and implementation of proper projects.
>
> On the question of budgetary reserves, the reference in the staff report is to unspent local currency reserves; it is not foreign exchange

reserves. These have been built up to a level of around CZK 32 billion, about 0.85 percent of GDP.

On the question about the claims by foreign banks on the non-bank private sector amounting to about 56 percent of Czech GDP at the end of 2007, this represents funding from all sources. This is cross-border as well as subsidiaries. Box 2 in the staff report refers to a rough estimate of the impact on GDP of a sudden retrenchment by foreign parent banks, based on a simulation exercise. .

On the household-debt ratios, they have indeed risen sharply. The main point is that there could be an impact on consumption, although there is no evidence of a lot of withdrawal of equity from households, as is happening in some advanced economies. The consumer credit culture is not as widespread in the Czech Republic as in advanced countries. This is a mitigating factor that suggests that there will not be a drastic effect on consumption, but increased household-debt ratios are still likely to have a significant effect.

Mr. Kiekens made the following concluding statement:

After such a heavy week for Board meetings, I am extremely grateful for the sharpness by which my colleagues were contributing to this debate. To name one, I was extremely intrigued by Mr. Lushin's sharp question on what kind of reserves is available to finance the government's fiscal deficit.

In addition, we all know that listening to eminent central bankers requires full attention in order not to be misguided, and that applies also to what the representative from the ECB had to say. He started to say that the level of uncertainty in the Czech Republic is probably even higher than in the other countries in the region. That gives the impression that the Czech Republic is in a worse situation than other countries, which—I suppose—is exactly the opposite of what he meant to say. The growth levels that are currently projected are better than in many other countries in the region. The degree of uncertainty, according to the representative from the ECB, stems from the wide divergence of forecasts. However, it suffices to listen carefully to what the staff said to understand that these divergences are less large than what the representative from the ECB at first glance considered them to be. The minister of finance, who had the most optimistic forecasts, said—according to staff—in today's press

conference, that he would be happy to see the Czech Republic's growth to be close to zero rather than negative. If you take that into consideration, that lowers considerably the level of uncertainty about the forecasts.

More importantly, I believe that the representative from the ECB considered that the 1 percent fiscal stimulus was probably on the low side, which implies that there is room for more fiscal stimulus in the Czech Republic. This points to a relatively strong fiscal position. The staff explained well to us the dilemma, or at least the constraints, that the Czech authorities may face if the growth performance showed further below what is now predicted. I believe that we all in Europe, and more at the global level, need to achieve fair burden sharing in fiscal efforts and that every country should do its fair share. However, for countries that have fiscal or financing constraints because markets are more reluctant to finance their deficits, one should accept that the burden sharing needs to be judged according also to market access. The staff was quite clear on that.

The Deputy Prime Minister today announced that the Czech Republic will postpone a public debt issue, because the spreads were considered at least today as too high, showing or pointing to some limitations. However, let me clarify to Mr. Lushin, who had a most pertinent question, that the reserves that the authorities may use to finance the deficit this year are those resulting from applying a mechanism or carry-forward of unspent budget appropriations of the previous year.

Let me comment on a few more specific issues. I believe that the impression that one can have from reading the staff report with regard to the problems that may stem from the foreign banks in the Czech Republic is wrong. There is no country in the region where foreign banks collect locally more liquidity than they self-employ. It is sufficient to look at the graph on page 13 of the staff report where the four major foreign banks, except Raiffeisen, have collected significantly more local deposits than they use in their lending. They indeed use only 64, 67, and 71 percent of what they have collected locally. Credit is therefore not dependent on foreign funding as there is indeed more funding in the Czech Republic than lending. There is only one exception among the major banks—Raiffeissen—which indeed needs some funding elsewhere. These four banks probably represent 90 percent of the credit portfolio.

If there is a concern, it is just the opposite, namely that Czech liquidity would be drained toward foreign countries rather than that foreign liquidity would not flow into the Czech Republic. In this respect, I can assure you that the Czech authorities are vigilant and will enforce normal prudential rules so that subsidiaries that are legally independent from their mother banks can only have credit exposure to the mother banks within a limit of 20 percent of their own capital. This is a basic rule of prudential regulation. I think these are very important clarifications.

Turning to the issue of the central bank publishing its off-balance-sheet items, the staff explained how the Czech Republic is among a very few countries in the world to do so. Nonetheless, the team could make an assessment of the relative size of these items in comparison with those other countries. For the time being, let me confirm that the Czech authorities are looking carefully into potential risks that could stem from these off-balance-sheet items, as any other prudential supervisor is doing.

I should not tell you much more except then addressing another sharp remark, made by Mr. St-Amant from the Canadian Executive Director Office, on the graph on page 15 of the staff paper, which shows a sharp increase in the households' debt-service burden. Looking more carefully at that graph, it shows that the debt-service burden in terms of disposable income increased from 2005 to 2007 from 1.1 percent to 2 percent of households' disposable income. I believe that, in other countries, households' debt-service burdens are much higher than in the Czech Republic.

In closing, only one other important task remains for me. This is an emotional moment for me, but particularly for the mission chief, Mr. Thakur, since this is his last Article IV consultation. After a long and successful career in the Fund, I would like to salute Mr. Thakur for his service to the Czech Republic and to all other countries he worked on in his 35 year long career. He served with expertise and professionalism, giving wisdom and employing diplomatic skills, as you all have observed today.

There is something that is encouraging. In the Article IV consultations with the Czech Republic he was accompanied and supported by a young team of apt, competent, and devoted

professionals. Mr. Lushin will have observed, when he asked his pointed question on reserves to finance the fiscal deficit, that immediately two of his younger colleagues were giving him a small piece of paper. I am sure they wrote the correct answer on that piece of paper, which Mr. Thakur did not need, because he certainly knew the answer equally well. That professional young team bodes well for the Fund.

Let me conclude by expressing, on behalf of my authorities, gratitude for a constructive consultation.

The Acting Chair (Mr. Kato) made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They 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.

It is expected that the next Article IV consultation with the Czech Republic will be held on the standard 12-month cycle.

APPROVAL: May 27, 2009

SHAILENDRA J. ANJARIA
Secretary