Office Memorandum

To: Members of the Executive Board August 26, 2014

From: The Secretary

Subject: **Czech Republic—Statement by the European Central Bank Representative**

Attached for the **information** of Executive Directors is a statement by the European Central Bank representative for the Executive Board discussion on the Czech Republic, to be held on Wednesday, August 27, 2014.

Att: (1)

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Statement by the ECB Representative on the Czech Republic
(Preliminary)
Executive Board Meeting
August 27, 2014

We thank staff for the comprehensive report and Messrs. Prader and Kollar for their informative Buff statement. We associate ourselves with the views expressed by Mr. Snel in his gray and would like to make a few additional points.

We broadly share staff's view on the **macro economic outlook** for the Czech Republic. The recovery has now been under way since 2013 Q2, and expansion in 2013 Q4 and 2014 Q 1 has been particularly vigorous, underlining the renewed growth momentum. The progressive shift of growth drivers from external to domestic demand components, together with improving labour market conditions, point to a more lasting recovery going forward. We fully agree with staff that raising the growth potential constitutes a challenge for the Czech Republic, notably in the light of an aging population. As pointed out by staff, the Czech industry is strongly characterised by cross-border production sharing. While this creates the potential for technology spillovers which, under certain conditions, could lead to higher growth, it also bears the risk of being locked into low value-added activities.

With regard to **monetary policy and inflation**, ECB concurs with staff that the use of the exchange rate instrument may have contributed to slowing the decline in inflation, thereby preventing a spell of negative inflation. That being said, this strategy appears to have been less effective than initially suggested by the Czech National Bank (CNB). This is also reflected in the recent prolongation of the use of the exchange rate instrument until at least 2016. Moreover, in the current context, subdued inflation is a development that is not specific to the Czech Republic, but affects neighbouring countries and the euro area, which may suffer from adverse spillovers from foreign exchange intervention conducted by the Czech Republic.

Within the CNB inflation targeting framework, foreign exchange intervention is intended to prevent the appreciation of the koruna beyond a given level against the euro. From a Eurosystem perspective, however, this can be seen as unilateral, non-coordinated FX intervention to weaken the Czech koruna against the euro, in a context where the ECB shares the same concern as the CNB - namely the risk of undershooting its inflation objective. We concur with staff that stronger growth and rising wages should contribute to inflation returning towards the CNB's target in the medium-term, while the impact of foreign exchange intervention would progressively fade out.

Concerning the Czech Republic's **fiscal position**, ECB agrees with staff's assessment that the Czech Republic has reached a sound position thanks to considerable efforts over the 2009-13 period. However, we would caution against the staff recommendation to switch to an expansionary fiscal stance in the near term. It would seem appropriate for the Czech authorities not to increase the structural deficit above the country's medium-term objective (MTO), while reprioritising government spending in a growth-friendly way and creating more room for growth-enhancing capital spending.

ECB broadly agrees with staff's overall assessment that the Czech **financial system** is relatively sound and resilient to shocks. The capital position of the sector is strong and improving, the liquidity situation is good with a sufficiently low loan-to-deposit ratio, profitability remains positive, and the asset quality is adequate. Notwithstanding these strengths, risks to the Czech financial stability may stem from several sources such as a somewhat deteriorating liquidity situation of the banking sector, and signs of increasing foreign currency exposure. Thus, ECB concurs with staff's recommendation for vigilance concerning financial sector’s future developments.