CHAPTER 13

Subnational Finance Today and Tomorrow in the Czech Republic: Impacts of the Financial Crisis and Global Recession

Introduction

The Czech Republic had not participated in the global market for mortgage-backed assets. When the crisis struck Europe, the country had been doing well economically, although it had experienced economic challenges, as discussed in earlier chapters of this book, associated with its transition to market democracy. It had undertaken extensive reforms in its effort to qualify for membership in the EU, and in 2004 it did accede to membership. At the onset of the financial crisis, it was still engaged in the effort to qualify to adopt the euro and was pursuing rather conservative economic and financial policies to advance that effort. Among its most significant economic challenges was the attempt to deliver modern European entitlements in the form of pensions and health care to its citizenry. Having overextended in these areas, the Czech Republic was busy applying the needed discipline to public budgets.

Initially, the Czechs were not overly concerned about the global financial crisis and anticipated that its impact on their economy would not be extreme. They viewed the global crisis not only from a Czech but also from a European perspective, since the Czech government was about to assume the EU’s rotating presidency. That was to be the first time a newly admitted member of the EU and former bloc country from the central planning economies would hold the temporary EU presidency.
This chapter will begin with a review of the economic situation in the Czech Republic both before and after the onset of the financial crisis. The fiscal impacts of the crisis, including those associated with the decline of export markets, resulted in reduced output and employment, as well as declining tax revenues. Both domestic economic policies and the policies that the Czechs advocated for the EU (in its presidency role) will be addressed. We will also consider budget management efforts designed to permit the Czech Republic to qualify for adoption of the euro, as well as the attempt to rein in current and prospective pension and health spending.

The Czech Economic Situation and the Crisis

Through 2008 and into 2009, strong fundamentals helped the Czech economy respond resiliently to the global financial crisis (IMF, 2008). Through that period, productivity growth continued, fiscal performance improved gradually, and the republic’s participation in external trade was robust. Economic development was also supported by inflows of foreign direct investment. Although prices from the global economy for food, fuel, and utilities were not favorable, the Czech koruna helped contain inflation within the country.

In the months following the onset of the financial crisis in the summer of 2007, the financial turmoil increased. The extent of the contagion and the speed of its spread, together with the depth of the downturn in the advanced economies, soon convinced the Czechs that they would be unable to sit tight and ride the recession through relatively unscathed. They hoped that speedy policy responses would help stabilize the financial situation and reduce the risk of a hard landing.

After three years of exceptional growth performance, the economy was expected in 2009 to slow sharply with tightening credit at home and the deepening recession in Europe (ibid.). In 2008, growth slowed to about 4 percent, reflecting a slowdown in domestic demand, and the IMF projected a more severe GDP slowdown in 2009 to approximately 1.5 percent. The reduction in demand across the euro area for Czech goods, and particularly in Germany, was expected to curtail export growth and produce a strong diminution of direct investment inflows from European partner economies. The tightening credit conditions in the Czech Republic were projected as a further drag on capital spending, offsetting the stimulus provided by the new Hyundai automobile plant opened in November 2008 and by the increasing inflows of EU funds.