CONCLUDING STATEMENT

Czech Republic: Staff Concluding Statement of the 2023 Article IV Mission

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The Czech Republic's economic growth slowed considerably following Russia's war in Ukraine, reflecting disruptions in global value chains, significant increases in energy and other commodity prices, an erosion in real wages, and a necessary tightening in monetary policy. Growth is expected to pick up in 2024—led by consumption and fixed investment, as inflation fades and real income starts rising again, supported by net exports. Nevertheless, GDP is unlikely to reach the levels that would have been given by its pre-pandemic trend by 2028. Inflation, having peaked in 2022, is projected to meet its target by early 2025. Risks are tilted to the downside for activity and to the upside for inflation.

Key Policy Recommendations

- ***Monetary policy.*** Staff recommends keeping the policy stance tight for some time to ensure inflation returns to target in a timely manner and to reduce the risk of an upward shift in inflation expectations. High uncertainty calls for a flexible approach to policy setting.

- ***Fiscal policy.*** The approved consolidation for 2024 will help the disinflation effort. Given the uncertain outlook, automatic stabilizers should function fully. Despite a low debt-to-GDP ratio, preserving and enhancing policy space will be vital to address future shocks, support economic transformation, and help ensure long-term debt sustainability.

- ***Macrofinancial policies.*** Current levels of the countercyclical capital buffer, loan-to-value and debt-to-income ratios seem appropriate given that the risk of the real estate exposures substantially diminished. Reactivating the debt-service-to-income ratio would be advisable to help manage potential systemic risks. Closely monitoring the risks of an increasing share of euro-denominated bank loans is warranted.

- ***Structural policies.*** With the economy being impacted by structural changes, including population aging and a global shift away from fossil-fuel based power, aiding labor and capital reallocation, boosting digitalization and productivity, and accelerating the green transformation are key goals.

Outlook and Risks

Economic activity slowed down notably in 2023 but a rebound is expected in 2024, driven by a recovery in domestic demand. In 2023 real GDP growth is estimated to have declined to -0.4 percent, mainly reflecting a decline in household consumption amidst a significant fall in real wages, deteriorating consumer sentiment, and heightened uncertainty. Growth is projected to increase to about 1.2 percent in 2024, mainly driven by a recovery of consumption and fixed investment, as inflation declines, and real wages recover. Aggregate investment will be dampened by subdued public investment, mainly due to a gradual phase in of the new cycle of the EU investment and structural funds (2021-2027). Growth in net exports will continue to positively contribute to overall growth, with elevated unfulfilled orders continuing to be completed as supply disruptions ease. The labor market is projected to marginally tighten in 2024, as economic activity improves, with the unemployment rate decreasing modestly to about 2.6 percent. Wage growth is projected to decline gradually as real wages catch up towards labor productivity and purchasing power is restored. However, staff projects the recovery in real wages and real unit labor costs to be matched by a compression in profit shares back to their pre-energy-shock levels, given recovering but still subdued demand levels, allowing the disinflation process to continue.

Inflation is projected to meet the CNB's target by early 2025. The ongoing disinflation reflects the diminishing impact of price shocks from commodity prices and a substantial decrease in domestic demand pressures. This is apparent in falling core inflation, which primarily reflects the dampening effect of the tight monetary policy stance. Continued drops in commodity prices (food and fuel) are expected to support a fall in administered price inflation. As anticipated, the downward trend in headline inflation paused in 2023Q4 due to a statistical base effect—reflecting last year's drop in electricity prices caused by the government's energy savings tariff. Once this base effect subsides, the decline in inflation is projected to resume.

Risks to the growth outlook are tilted to the downside. Spillovers from a weaker global outlook remain a downside risk. Economic activity and inflation could negatively be affected by a possible renewed surge in global energy prices, new supply chain disruptions, or an increase in geopolitical tensions, and potential broader geo-economic fragmentation. Heightened global financial volatility due to stress in global financial markets could negatively impact pricing and availability of financing. While a low probability event, a disorderly house price correction could impair banks' and households' balance sheets—markedly tightening financial conditions—and adversely impacting aggregate demand. While vulnerabilities in the financial sector exist, financial stability risks appear contained given the strong buffers and profitability of the banking system.

Risks to inflation are tilted to the upside. These relate to inflation expectations becoming untethered—against the backdrop of high inflation, a tight labor market and the currently elevated but declining household saving rate. Inflation expectations have been decreasing but remain above the inflation target. Moreover, inflation pressures could also arise from strong wage growth and a failure of profit margins to compress rapidly in an environment of rebounding growth, resulting in stronger repricing of goods and services. Also, inflation expectations could rise if new global energy or commodity price shocks arise or if the expected increase in administered prices reverses the downward inflation momentum. Additionally, an abrupt return of the household saving rate to near long-term average levels could boost household consumption and heighten demand driven inflationary pressures. A falling differential in policy interest rates vis-a-vis major central banks or geopolitical shifts in regional sentiment could exert depreciation pressure on the koruna and add to inflationary pressures. On the other hand, a slower recovery than expected in the baseline or an unexpected significant fall in global demand could accelerate the convergence of inflation to the target.

Monetary Policy

Given high uncertainty on the persistence of inflation, staff recommends maintaining a tight monetary policy stance until there is firm evidence that inflation is on course to converge to target. Although the policy rate has remained unchanged since June 2022, recent decreases in inflation and its expectations have raised the ex-ante real policy interest rate and tightened the monetary policy stance. Given heightened profit shares the ongoing recovery in real wages can be absorbed by firms without adding significant upward pressure on prices, allowing the disinflation to continue. This will require, however, aggregate demand to remain contained. In the absence of sharp downside surprises in inflation, staff advises to maintain a tight monetary policy stance—by keeping the nominal policy rate broadly unchanged through early 2024—to consolidate the disinflation process and provide insurance against a costly de-anchoring of inflation expectations. Thereafter, the nominal policy interest rate could be lowered cautiously and gradually, consistent with the decline in inflation, with a pace that could be accelerated if inflation expectations align faster to the target than envisaged. Given high uncertainty around the path of commodity prices, wages, profits, and inflation, a data-driven, meeting-by-meeting approach to determine the interest rate path remains essential.

Fiscal Policy

Fiscal plans for 2024 appropriately emphasize consolidation, but fiscal policy should remain flexible given the uncertain outlook. In cyclically adjusted terms, staff projects the fiscal deficit to contract by 1.3 percent of potential GDP. The contractionary stance is appropriate to support disinflation efforts, with the output gap set to nearly close in 2024. However, given uncertainty on the growth outlook, it is prudent to allow automatic stabilizers to operate.

Over the medium-term, fiscal policy is guided by Czechia's fiscal responsibility act (FRA), which sets a minimum fiscal consolidation path that delivers a sustainable debt-to-GDP ratio and a low prudent fiscal balance. During the pandemic, fiscal balances were allowed to deviate from the medium-term objective (MTO) in the FRA, with a clear fiscal consolidation path back to target. In line with this, staff's baseline envisages a debt-to-GDP ratio of 42.5 percent and a structural balance of -0.8 percent of potential GDP by 2028, which is consistent with the MTO—a structural balance of -0.75 percent of GDP. Czechia is at a low overall risk of sovereign stress; hence, reaching the MTO by 2028 will contribute to keeping debt sustainable over the medium term. The November 2023 fiscal outlook identifies measures through 2025 but reaching the MTO would require identifying additional measures.

In the medium and long term, spending pressures will increase to facilitate economic transformation toward a green digital economy and address the impact of population aging. The economic challenges of global technological shifts and population aging calls for structural reforms, investments, and efforts to ease the reallocation of labor and capital. The structural transformation may entail a heavy burden on some segments of the population, requiring social safety net support. Public sector infrastructure will need to be adapted to accommodate clean energy initiatives and digitization. To ensure a skilled workforce aligned with emerging activities, active labor market policies (ALMP) and ongoing education system reforms will be imperative. The aging population will give rise to a pension funding gap in the long-term. For intergenerational fairness and to avoid disruptive fiscal adjustments, the actuarial deficit of the pension system would call for higher general government structural balances than the currently targeted MTO. Also, an additional buffer is warranted to protect against future shocks and fiscal risks.

Although EU funds will cover part of the forthcoming spending pressures, additional fiscal measures will be required. These should include growth-friendly tax measures, reprioritization of spending and improved spending efficiency. Staff recommends the following measures:

- **As the recovery takes hold, ensure that the Personal Income Tax (PIT) and real estate related taxes deliver pre-pandemic tax revenue as a percentage of GDP.** This would yield above 1.5 percent of GDP. It is crucial to note that the reduction of the PIT was originally presented as a temporary measure.
- **Further advance pension reform.** Staff welcomes recent regulatory reforms to the pension system. These initial steps need to be complemented with additional reforms to improve the long-term sustainability of the pension system, including the linking of retirement age to life expectancy.

Macroprudential and Financial Sector Policies

The macroprudential policy setting is broadly adequate but the deactivation of the debt-service-to-income ratio should be reconsidered. Estimates of the financial cycle suggest the partial release of the Countercyclical Capital Buffer (CCyB) was justified. Staff also supports maintaining the Loan-to-Value (LTV) and Debt-to-Income (DTI) ratios at current levels, as the implementation of borrower-based measures has contributed to responsible lending practices and lowered the systemic risk in the banking sector. Although the increase in policy rates and its transmission toward lending rates made the Debt-Service-to-Income (DSTI) levels more binding, deactivating the DSTI allows banks to provide potentially riskier loans from a DSTI perspective. Staff therefore recommends reinstating this instrument, and going forward, recalibrating and improving its design, including by legislative changes, rather than its deactivation and reactivation.

Staff assesses that the banking sector is broadly resilient. Financial sector indicators point to a well-capitalized, liquid, and profitable banking system compared to its European peers. Staff welcomes the improvements in supervisory risk measurement for sectoral/ individual exposures and reiterates the importance of further progress in this area. However, pockets of vulnerability remain and require close monitoring.

- **The risks associated to the increase in the euroization of corporate loans need to be carefully scrutinized.** Staff welcomes the incorporation of these risks into the CNB's financial stability analysis, and the capital requirements on risks associated to banks' FX positions. Although stress test results suggest that these risks are not systemically important, close monitoring of the credit, exchange rate, and counterparty risks, including in derivative transactions, are warranted.
- **Since the pandemic, the banking sector's direct risk exposure to the Treasury increased but remains contained.** While sovereign risk is low and not expected to change, exposures need to be monitored.
- **Although risks from real estate exposures have diminished substantially, they require continued monitoring.** The evolution of loan quality over the cycle, and possible nonperforming loans down the line, should continue to be managed.

Structural Policies

Policies should support the envisaged structural transformation of industries, including towards a greener economy, by facilitating the reallocation of capital and labor, and advancing technological innovation.

To support the green transformation of the economy, the government has set out a decarbonization strategy. The goals are to achieve a greener energy mix—by phasing out coal by 2033, while increasing the shares of renewables and nuclear energy—and bolstering energy efficiency. Reaching these goals is expected to help Czechia meet European climate and energy targets by 2030. The strategy is to split the cost of the needed investment for decarbonization between the public and private sectors. Investment needs by 2050 are estimated at about CZK 3.5 trillion of which about CZK 1-1.2 trillion are identified from public support including EU funds. To encourage private investment, carbon prices under EU's ETS1 and ETS2 (starting in 2027), which together will cover most sources of emissions, will tilt relative prices toward bolstering greener energy sources, while encouraging efficiency. Private investment in green sources will also be encouraged by regulatory guidance, including banning the registration of new fossil-fuel vehicles within the next decade and setting building requirements for energy efficiency, among others. Additional incentives, recommended by staff, may include the use of feebates in the agriculture sector (and other sectors not covered under the European Trading Systems), targeted subsidies for R&D investment and faster rates of depreciation of machinery and equipment that use fossil fuels if they are replaced by those that use clean fuels.

Structural reforms can help facilitate the reallocation of capital. Streamlining regulations related to business establishment and insolvency is essential for promoting corporate restructuring and improving capital reallocation. Streamlining Czechia's business regulatory framework, including by simplifying the construction permitting process, should enhance the ease of doing business. Sustained private investment relies on improved SMEs' access to alternative funding sources, in particular venture capital and equity financing.

To facilitate labor reallocation, active labor market policies could play a useful role. Training and lifelong learning are crucial to aid in workers' transition to growing sectors of the economy. Policymakers should proactively facilitate engagement, effective job matching, and the cross-sectional reallocation of workers through increased investments in ALMPs, which encompass reskilling and vocational training initiatives. Staff welcomes the government's Labor Market Prediction Project (KOMPAS) designed to identify mismatches between labor demand and supply and provide job search assistance. Modernized vocational education can develop specific skills and raise the economy's adaptability to structural change. The government's Database of Retraining and Further Education Courses is important to support the upskilling and reskilling. Sustaining key education and curricula reforms requires adequate resources.

To improve labor force participation and alleviate labor shortages, staff recommends the following:

- **Stepping up policies to enhance employment prospects for disadvantaged groups.** Staff welcomes the Job Integration Program (effective 2024). Improving vocational training and education in technical and digital skills remains essential. Continued efforts to integrate women with young children should build on recent improvements in childcare provision and early childhood education, and target more flexible use of parental allowances and enhanced opportunities for job searching. A greater use of flexible and part-time work arrangements would also help enhance participation.
- **Continuing efforts to effectively integrate refugees and facilitate the inflow of migrants.** The provision of language training, childcare, and job search support should continue to support refugees. The recently developed "pathways to work" program to support provision of skills to high-school immigrant children is welcome. Efforts to develop an immigration point-based system should continue.

Structural reforms should also support technological innovation. Incentives for R&D could boost productivity and create high value-added sectors. Providing targeted support to emerging and innovative firms encourages technological advancement and innovation. Implementation of the Innovation Strategy and National Development Plan is important to foster the technical and digital competencies essential for high productivity sectors, particularly in Knowledge Intensive Sectors. Planned reforms under the Recovery and Resilience Facility to provide digital equipment to schools, revise the IT curriculum, expand life-long learning in digital technologies, and implement the new digital governance structure should be accelerated.

The IMF team thanks the Czech authorities and other counterparts for their warm hospitality, flexibility, and high-quality discussions.