CONCLUDING STATEMENT

Czech Republic: Staff Concluding Statement of the 2021 Article IV Mission

FOR IMMEDIATE RELEASE

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The Czech Republic entered the pandemic on a strong economic footing and utilized its ample policy space built over time to successfully address the crisis. Swift utilization of an extensive set of fiscal, monetary, and macroprudential policies cushioned the impact of the shock and helped protect people, jobs and businesses. The labor market withstood the impact of the pandemic relatively well, but long-term pressures continue. Inflation remained marginally above the tolerance band in 2020 but increased substantially in late 2021. Macrofinancial vulnerabilities persist as house price growth has reached record highs amid significant risk-taking by households. Given the ongoing resurgence of COVID-19 cases in Europe, the recovery could be impeded by further waves of infections. Hence, commensurate with the recovery, policy support should be cautiously reduced, while ensuring policy coordination to avoid cliff effects. Support should be pivoted to rein in increasing inflation, rebuild policy space, address macrofinancial imbalances, and build forward better.

Key Policy Recommendations:

- ***Monetary policy.*** *Amid high inflation and increasing domestic price pressures, staff supports the monetary policy stance. Going forward, in light of the current significant uncertainty, policy action should carefully weigh risks from raising rates too quickly, possibly jeopardizing the economic recovery versus those from hiking too slowly and risking inflation expectations becoming untethered.*
- ***Fiscal policy.*** *Carefully scaling back fiscal support measures in the short term is appropriate, but fiscal policy should remain flexible given the uncertain outlook, while facilitating reallocation and providing a bridge to the economy of the future.*

- ***Macrofinancial.*** *Tightening macroprudential tools in coordination with balancing tax incentives and improving housing supply are warranted to address increasing household risk-taking and restrain fast-rising property prices.*
- ***Green transformation.*** *A strategy based on enhanced carbon pricing, reinforced by broader incentives across sectors is recommended. The Recovery and Resilience Facility provides an opportunity to finance mitigation and productivity-enhancing investments to accelerate the transformation.*

Outlook and Risks

Growth in the near term is projected to rebound amid elevated inflation. The baseline outlook projects output growth to rebound to 2.6 and 3.5 percent in 2021 and 2022 respectively. Pent-up demand is expected to continue to boost private consumption, while public consumption tapers off as support measures are withdrawn. Unemployment is expected to remain low and wage growth to return to pre-pandemic rates. Supported by strong foreign demand, net exports are expected to recover as supply chain issues resolve by mid-2022. Inflation is projected to remain elevated into 2022 driven by domestic pressures—heating labor and housing markets—and foreign drivers—supply chain disruptions and high energy prices. Inflation is forecasted to converge to the policy target by early 2023 amid the rise in policy rates and ebbing of current inflation pressures.

Risks remain tilted to the downside. Amid the ongoing resurgence of COVID-19 cases, the recovery could be impeded by further waves of infections. Further tightening in the labor market could deter a swift economic rebound. Longer-than-expected surges in energy prices or prolonged disruptions to global supply chains could continue hindering the recovery and further increasing inflationary pressures, imperiling inflation expectations from becoming de-anchored. A housing price correction could ignite adverse feedback loops and weigh on banks' balance sheets.

Monetary Policy

Staff supports the monetary policy stance. Persistent labor and housing market pressures are significantly contributing to high and rising inflation. The CNB's stance of raising the policy rate is appropriate to counteract inflation pressures and prevent inflation expectations from becoming untethered. Going forward, policy action should carefully consider risks from raising rates too quickly. Downside risks to the outlook due to possible resurgent pandemic waves, longer-than-expected rises in energy prices or prolonged disruptions to global supply chains may be exacerbated by a premature tightening of policy. Unexpected rate hikes may also destabilize asset prices and financial markets. On the other hand, delayed policy action, amid strong labor and housing market pressures, risks inflation expectations becoming untethered, wage-price spirals developing, and second-round inflation pressures spreading.

Fiscal Policy

Carefully scaling back fiscal support measures in the short term is appropriate, but fiscal policy should remain flexible given the uncertain outlook. The Czech Republic entered the pandemic with substantial fiscal space, which allowed for the much-needed deployment of sizeable fiscal policy measures. Despite the resulting increase in public debt, its level as a share of GDP is still among the lowest in the EU. Nevertheless, fiscal consolidation should proceed in a state-contingent and well-communicated manner as the recovery is entrenched to ensure that fiscal space remains available.

Barring any setbacks in the recovery, remaining broad-based and non-targeted support measures should be reversed in the 2022 budget to arrest growing debt and replenish fiscal buffers. The 2022 budget envisages a deficit reduction as pandemic-related measures are set to expire. Unless other—possibly more growth-friendly—revenue-side measures can be implemented, the reversal of the relaxation of the personal income tax regime and the reintroduction of the real estate transfer tax should proceed. Revenue side measures could be accompanied by consolidation on the expenditure side. This would facilitate the reduction of public debt much earlier than under the currently-implied trajectory.

Addressing public debt sustainability pressures in the long term will be paramount. The sustainability of the pension system in the long run is challenged by demographic pressures, which will start to become increasingly binding at the turn of the decade. Re-linking the retirement age to adjust automatically to life expectancy and generating more revenue from less-distortionary taxes, such as consumption and real estate taxes would help. The latter would also contribute to reduce pressures in the housing market.

Macroprudential and Financial Sector Policies

Increasing risk-taking by lenders amid high and rapidly-rising property prices warrant tightening macroprudential tools and deploying housing supply and tax policies. Tightening DTI, DSTI and LTV limits to pre-pandemic levels is appropriate as a start but close monitoring of market developments is necessary to determine if subsequent action is needed. Clear communication of macroprudential policy actions and continuing adequate coordination of the overall policy mix are key to ensure a smooth stabilization. Proper calibration of macroprudential tools for lower risk groups, such as first-time home buyers, is warranted to safeguard adequate access to financing. Supply constraints should be relaxed by ensuring the proper implementation and further simplification of the construction permitting process. Increasing property taxation, including through valuation consistent with market prices and further reducing mortgage interest deductibility would help curve demand.

Although the banking sector remains well capitalized, profitable, and liquid, vulnerabilities remain. In 2020, capitalization and liquidity in the banking sector reached historical highs. Profitability, while remaining positive, dropped by nearly half. At the same time, the banking system has continued to become more concentrated in residential mortgages amid declining risk weights for mortgage lending. A sudden correction of housing prices or a shock to household incomes risking their ability to repay could have a system-wide impact jeopardizing financial stability. Impairment charges, albeit remaining low are likely to increase further as support policies are fully unwound. Moreover, the current outlook with rapid and significant increases in asset prices and prospects for a rapid recovery provides ground for risk build up. The high degree of foreign ownership in the Czech banking sector warrants close monitoring of developments in home countries of parent institutions.

Prudential tools should be further improved and deployed to maintain financial stability. Leveraging on information contained in the mortgage database and the credit registry, a fully risk-based prudential framework should be enhanced to ensure at all times that adequate provisioning and capital buffers remain consistent with higher risks in overheating-prone sectors and risk measurement is adequately forward looking. Close monitoring of non-performing loans and cross-border linkages should continue as policy support is reduced. Guidance on dividend payouts should remain in place as needed to protect capital buffers. Improvements to the AML/CFT framework and efforts to monitor foreign financial flows, in line with staff's previous recommendations, were made and the relevant authorities should continue their efforts in this respect.

Labor Market Policies

Commensurate with the recovery, policies should continue shifting to targeted support and facilitating reallocation. The crisis "Antivirus" package successfully contained the rise in unemployment. Going forward, continuing job-retention schemes should increase financial contributions from employers to improve incentives for self-selection of participating companies. Active Labor Market Policies should be stepped up to better support the unemployed with job matching, while enhancing training and reskilling programs, including for the employed. Efforts to have vocational and educational programs guided by information on current and future labor market demand are welcome and should continue.

Enhancing employment prospects for disadvantaged groups and increasing labor supply will support growth. As a high proportion of low-skilled jobs will be exposed to automation, lifelong learning schemes are welcome to enhance workers' technical and digital skills. To support employment of mothers with young children, the expansion of childcare services should continue, combined with flexibility on the use of parental allowances and enhanced opportunities for job sharing. Policies to attract foreign workers and streamline the administrative process to obtain employment and residency permits—including through a multicriteria points-based system—can reduce labor market tightness. A mechanism linking the retirement age to life expectancy should be reinstated.

Investment and Productivity

The recovery offers an opportunity to build forward better by increasing productivity growth and investment. Building on the Innovation Strategy and the

National Investment Plan, policies should focus on ensuring that workers are equipped with technical and digital skills, encouraging broad-based innovation. To capitalize on SMEs' potential, well-targeted R&D grants, tax incentives and better access to equity finance are critical. Staff recommends developing standards for information disclosure, reviewing regulation for pension funds and providing incentives for institutional investors to ensure that adequate resources are available for investment vehicles targeting SMEs. Improving the implementation of insolvency procedures can minimize barriers to corporate restructuring, spur capital reallocation and improve recovery rates in the wake of the crisis.

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