CZECH REPUBLIC

Highlights

- **The economy has bounced back strongly after a significant decline in 2020.** Export-oriented industries and a rise in demand contributed to a robust recovery in the first half of 2021, while employment has remained stable.
- **The European Union (EU)'s Recovery and Resilience Facility (RRF) plan includes major infrastructure projects but also emphasises the need for reform.** Under the national plan, 42 per cent of the €7 billion plan will be invested into green transition and 22 per cent into digital transformation.
- **Progressive income taxation was reintroduced.** The government abandoned the concept of "super-gross salary" and a flat tax rate. It has shifted to a more employee-friendly system of taxing gross income with two tax rates of 15 and 23 per cent, while the annual personal tax deduction was increased.

Key priorities for 2022

- **The green transition requires concrete steps in the direction of renewable energy.** Reducing the share of the coal industry presents a challenge for certain industrialised regions. Concrete actions are needed to further increase energy use from renewable sources, especially solar, by using Modernisation and Just Transition Funds.
- **Productivity and innovation capacities of the small and medium-sized enterprise (SME) sector should be addressed.** The government's post-crisis response should further focus on supporting productivity in the SME sector through upskilling and promoting digitalisation. A focus should be put on higher value-added research and development investment, which can broaden innovation capacities.
- **The government should emphasise investments in infrastructure and connectivity.** The Czech Republic, which will hold the EU presidency in the second half of 2022, should leverage the country's export-oriented industry, with an emphasis on promoting interconnection, modernising infrastructure and developing trans-European transport networks.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	5.2	3.2	3.0	-5.8	3.4
Inflation (average)	2.5	2.1	2.8	3.3	2.7
Government balance/GDP	1.5	0.9	0.3	-5.6	-8.0
Current account balance/GDP	1.5	0.4	0.3	3.6	1.6
Net FDI/GDP [neg. sign = inflows]	-0.9	-0.9	-2.4	-1.3	-1.2
External debt/GDP	88.0	81.3	76.5	76.1	n.a.
Gross reserves/GDP	63.4	59.0	59.1	62.9	n.a.
Credit to private sector/GDP	51.8	50.7	50.3	53.1	n.a.

CONTINUES

Covid-19: macroeconomic implications

Export-oriented industries have triggered a swift recovery of gross domestic product (GDP) growth in 2021. Despite a stable and competitive economy, the Covid-19 pandemic had a strong negative impact on GDP, which fell 5.8 per cent in 2020, representing the largest economic downturn in the country's history. Export-oriented industries, however, started driving growth in the third quarter of 2020, and GDP in the first half of 2021 increased by 3 per cent year-on-year. Prolonged containment measures at the beginning of 2021 slowed the improvement of household consumption, but investment growth has contributed significantly to the recovery. By the middle of 2021, industrial production had reached its pre-crisis level, although the automotive sector currently faces global shortages of parts and materials, which affect the continuation of production. The tourism sector has experienced a slow recovery, as expressed by the volume of tourist visits in the first half of 2021, which reached only a third of the level of the same period in 2019.

The employment rate remained stable throughout the crisis, while wages are set to grow. The unemployment rate reached 2.6 per cent in 2020 and increased to 3.2 per cent in the second quarter of 2021, due in part to intensified anti-pandemic measures. This remains one of the lowest unemployment rates in the EU. Nominal wage growth was 3.2 per cent year-on-year in the first quarter of 2021 and is set to grow further. In part, this can be attributed to a deficit in skilled workers. Among other factors, higher energy prices, wage pressures and pent-up demand influenced the rise in inflation, which exceeded 4 per cent year-on-year in September 2021. The Czech National Bank increased the main interest rate to 1.5 per cent in October 2021 in the biggest rate hike since 1997.

Fiscal expenditures continue to grow. To overcome the impact of the recession, the general government deficit in 2020 reached 5.6 per cent of GDP, staying slightly below the EU average. Public debt increased to 37.7 per cent of GDP, below most neighbouring peers. The fiscal deficit is likely to remain elevated in the short term. Public finances will be under additional pressure from the unreformed "pay-as-you-go" pension system.

GDP is expected to continue to grow in the short term. Assuming a further improvement in the pandemic situation, the economy should continue to recover. The main driver of growth will be increased consumer demand and higher investment, especially in the automotive sector, as well as the effective use of EU funds in the short and medium term. Consequently, the European Bank for Reconstruction and Development (EBRD) projects GDP growth of 3.4 per cent in 2021 and 4.6 per cent in 2022. The impact of global supply chain disruptions, the possibly incomplete implementation of the RRF and uncertainty surrounding potential new Covid-19-related measures constitute the main downside risks to the otherwise favourable outlook.

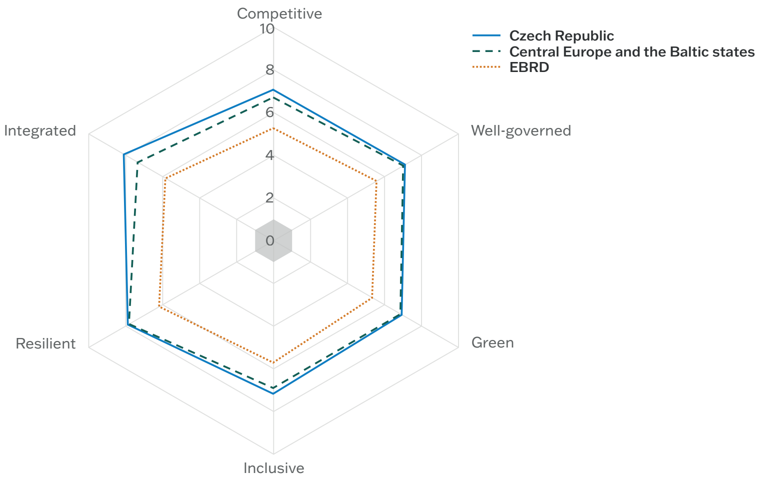
Policy response to Covid-19

The policy response in 2020 successfully supported employment retention. The government's Covid-19 response in 2020 provided around 5.4 per cent of GDP to support employment, the self-employed and specific sectors through compensation, bonuses and financial support. The total amount of guarantees and loans reached approximately 15 per cent of GDP. A total of 1.2 per cent of GDP was spent on support to the health sector.

The 2021 budget envisages an increased fiscal gap. The budget continues to support sectors affected by the pandemic through wage compensation. Along with decreasing personal income tax rates and other tax changes (see below), the government wants to boost economic activity. The period for submitting tax refund applications has been extended and the employment support fund has been increased by more than 60 per cent. In addition to the budget measures in February 2021, bonuses were added for health and social care employees, and entrepreneurs were offered two additional support programmes. The impact of these measures could result in a fiscal gap in 2021 of 8.5 per cent of GDP, according to the Finance Ministry. In August 2021 the Czech National Bank increased the policy rate by 25 basis points to 0.75 per cent.

CONTINUES

Assessment of transition qualities (1-10)



Structural reform developments

The government's RRF plan of €7 billion in grants involves a commitment to strengthen reform capacity. The national plan is based on six pillars, with a focus on green transition and digitalisation. Investments in physical railway infrastructure, building renovation and a transition towards clean energy are followed by the digital transition, which envisages the development of a high-speed internet network and an increase in the public administration's digital capacity. Significant reforms will be dedicated to anti-corruption legislation, support of public investment and creating new financial opportunities for entrepreneurs through the national development bank. More efficient government services will be crucial to the timely selection and implementation of projects that are eligible for financing.

"Kurzarbeit" was introduced to further support employment. This short-time work scheme, introduced in July 2021 as an amendment to the Employment Act, provides state support for reduced-scale employment caused by unexpected events. Employers will be able to use the measure for a maximum of 12 months and 80 per cent of the employee's salary will be compensated.

The government has reintroduced progressive income taxation. According to the new income tax rules, from the beginning of 2021, two tax rates apply on all income types – 15 per cent on income up to CZK 1.7 million (€67,000) annually and 23 per cent for income above this amount. In addition, the basic annual personal tax deduction has been increased to the average wage for the prior calendar year and the real estate acquisition tax has been eliminated.

An amendment to the Act on the Czech National Bank (CNB) increased the scope of its monetary policy. With the accepted amendment from March 2021, the Senate allowed the CNB to temporarily execute open market operations with all participants in the financial market. With a wider range of financial instruments at the CNB's disposal, also with maturities of more than one year, these measures are likely to strengthen the country's financial markets.

CONTINUES

Foreign direct investment (FDI) is subject to stronger supervision. According to the newly introduced FDI control regime, from May 2021, potential risk capital flows will be monitored. More specifically, any foreign investor wanting to acquire at least a 10 per cent share in a company in the Czech Republic will be subject to further supervision by national regulators. Depending on the type of investment, supervision will be exercised by different national regulators.

A new strategy for supporting SMEs has been approved. The strategy, adopted in March 2021, aims to improve the business environment for SMEs for the period 2021-27. Along with facilitating access to finance and the market, aligning market needs with the education system and a broad digitalisation effort, the strategy includes 107 measures that will promote the efficient development of SMEs.

A new reserve fund will be used to cover unforeseen costs in the South Moravian Region, which was affected by a tornado in June 2021. With an amount of approximately €0.8 million, the government supported the initial costs associated with the natural disaster. The compensation for entrepreneurs includes an interest-free loan of up to approximately €1.7 million, as well as subsidies of up to approximately €40,000 for the reconstruction of fixed assets destroyed in the tornado. Subsidies for rebuilding homes amount to approximately €79,000 per household and loans with low interest rates are also planned.