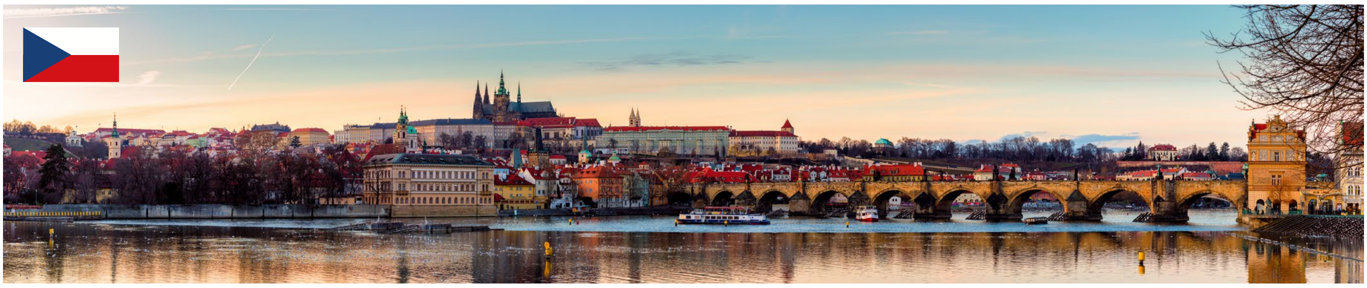


Czech Republic

Highlights

- **The economy was slow to recover to pre-pandemic levels.** After 3.5 per cent growth in 2021, gross domestic product (GDP) expanded 4.2 per cent year on year in the first half of 2022, but the short-term outlook is gloomy in light of global developments.
- **The government has introduced energy price caps to the end of 2023.** The authorities announced at the end of September 2022 their decision to cap energy prices for households and small businesses, to be offset by windfall taxes and dividends.
- **A series of green investments have started as part of the country's Recovery and Resilience Plan (RRP).** The strong green focus of the RRP has led to a series of tenders to finance private-sector energy and resource efficiency, as well as renewable energy production.

Key priorities for 2023

- **Energy security risks need to be mitigated, in particular, by accelerating efforts towards a green transition.** The Czech Republic is one of the countries in the region most dependent on Russian energy imports, and a shutdown of supply would inflict significant damage. While the country has ensured one-third of annual gas consumption through liquefied natural gas (LNG) deliveries, a structural shift towards renewables and energy efficiency needs to be accelerated.
- **Solutions to protect the most vulnerable are needed in light of a significant deterioration in real incomes.** The Czech Republic is projected to see one of the deepest real wage declines in 2022, which will affect real GDP growth and household wealth in 2023. The government needs to ensure that the most vulnerable segments are protected through targeted measures.
- **Support for Ukrainian refugees should continue and shift towards long-term integration.** As of the middle of September 2022, more than 430,000 refugees from Ukraine had entered the Czech Republic, one of the highest numbers in the region. The authorities need to step up solutions to ensure labour and social integration, including addressing skills mismatches and offering access to social services.

TABLE Main macroeconomic indicators %

	2018	2019	2020	2021	2022 proj.
GDP growth	3.2	3.0	-5.5	3.5	2.5
Inflation (average)	2.0	2.6	3.3	3.3	16.3
Government balance/GDP	0.9	0.3	-5.8	-5.1	-4.0
Current account balance/GDP	0.5	0.3	2.0	-1.8	-4.3
Net FDI/GDP [neg. sign = inflows]	-0.9	-2.4	-2.6	-0.2	-1.0
External debt/GDP	81.6	75.7	75.7	73.2	n.a.
Gross reserves/GDP	59.2	58.5	62.2	62.4	n.a.
Credit to private sector/GDP	20.3	19.6	19.9	19.6	n.a.

CONTINUES

Macroeconomic developments and policy response

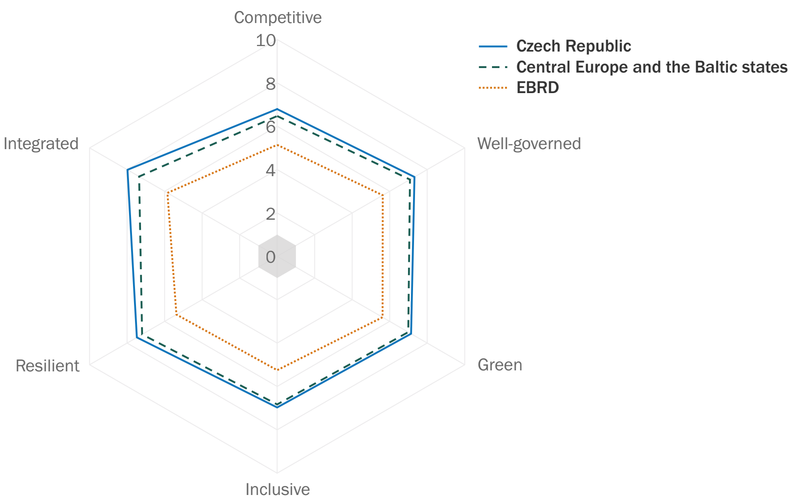
GDP growth showed signs of weakness in the first half of 2022, despite robust growth. In the first quarter of 2022, GDP expanded 4.9 per cent year on year (0.6 per cent quarter on quarter), supported by a rebound in investment and foreign trade. However, in quarterly terms, final consumption declined for the second quarter in a row, reflecting the negative effects of rising inflation. Net exports' negative contribution to growth in the second half of 2021 was partly reversed in the first quarter of 2022, as exports performed well. In the second quarter of 2022, GDP expanded 3.6 per cent year on year (0.5 per cent quarter on quarter), as the economy proved more resilient than expected, although retail turnover and industrial output declined on a yearly basis, heralding weaknesses ahead. This is confirmed by the preliminary 0.4 per cent quarter-on-quarter GDP decline.

Inflation remains broad based. In September 2022, inflation accelerated to 18.0 per cent, with core inflation at 14.7 per cent – among the highest in the European Union (EU) – implying strong broad-based inflationary pressures. The Czech National Bank has hiked the policy rate by a cumulative 200 basis points so far this year, to 7.0 per cent as of September 2022. The energy price cap will alleviate some of the inflationary pressures that were expected through further tariff adjustments. Real wages are likely to fall by about 6-7 per cent this year, moderating fears of a wage-price spiral, despite a very tight labour market.

Inflation-boosted budget revenues will only partly offset announced government support. Fiscal policy was expansionary in 2021 and, according to the government's October 2022 forecast, the fiscal deficit will reach 4.4 per cent of GDP in 2022. Measures to address the effects of high inflation and the energy crisis include additional pension indexation in July and October 2022, a one-off CZK 5,000 (about €200) transfer to low-income households and an array of energy subsidies. On top of this, the government has capped electricity and gas prices for households and small firms from October 2022 to December 2023, at an estimated cost of CZK 130 billion (€5.27 billion). This will be offset by a windfall tax on energy, banks and fuel producers, which will neutralise the fiscal impact of the support measures, according to the government. State expenditure on refugees was CZK 13.9 billion (€570 million) as of the end of September 2022.

Strong headwinds and downside risks complicate the growth outlook. We forecast economic growth of 2.5 per cent in 2022 and 0.5 per cent in 2023, with the risk of a recession in the second half of 2022 driven by negative real wage growth, weak business confidence and high-interest rates. Moreover, the external demand outlook remains uncertain. Weak momentum going into 2023 and the high risk of energy supply disruptions significantly affect next year's outlook, but funding under the EU's Recovery and Resilience Facility may provide an upside.

CHART Assessment of transition qualities (1-10)



CONTINUES

Structural reform developments

The Czech RRP has been approved and implementation has commenced. The European Commission approved the Czech RRP in July 2021, disbursed the pre-financing tranche of €915 million in September 2021, and signed the operational agreements that detail all the targets and reform milestones in July 2022. In addition to meeting the EU's policy goals of green transition, digital transformation and enhancing economic and social resilience, the €7 billion plan includes provisions to ensure effective implementation and monitoring. The first request for disbursement is scheduled for September 2022, but delays are possible, as two targets, one on flood protection and another on RRP implementation control, have been delayed.

The government has issued a number of public calls for private investment in green projects. As part of the RRP, the government has launched several programmes to support private entities in the green transition. These include reducing the energy intensity of apartment buildings, photovoltaic panel installation, investments in the circular economy, subsidies for electric vehicles and water-saving investments. The private sector showed high interest in the photovoltaic scheme, as the total estimated investment for submitted projects was more than €600 million as of the end of August 2022, resulting in a subsidy of about €225 million (above the €203 million budget). On top of this, in December 2021 the government adopted the Circular Czechia Strategy 2040, covering waste management, water reuse and recycling, product design, bio economy and the prevention of food waste.

Investment in the railway network is being frontloaded. In the first quarter of 2022 the government launched a public call for the electrification of, safety improvements in and digitalisation of the country's railway system. The plan also includes the construction of seven tunnels and bridges for railway use and the modernisation of 35 railway stations and about 120 km of track, the latter to be completed by the end of 2022. The allocation to the sustainable transport component of the RRP amounts to CZK 24 billion (€970 million).

The Czech-Moravian Guarantee and Development Bank (ČMZRB) has been reorganised into the National Development Bank and will channel RRP funds. The ČMZRB has acted as the country's main promotional bank, offering largely preferential loans and guarantees. As of September 2021 the institution became a national development bank and its goals have been expanded in line with the "do no significant harm" principle of the EU. The institution will also now manage two new funds: the National Development Fund, channelling private funds into public infrastructure, and the National Development Investments, a vehicle for quasi-equity investments, as part of the RRP.

Judicial reform has advanced with a new Courts and Judges Act. The RRP includes anti-corruption reforms, including strengthening the legislative framework of the judiciary. As a reform milestone, the government adopted the Courts and Judges Act at the end of 2021, which changed procedures for the selection of judges and court officials, introduced mandatory training for candidates, limited the role of the Ministry of Justice in selecting judges and limited court chair mandates. It also requires the judgements of the lower courts to be published on an electronic platform. The act was based on the recommendations of the Group of States against Corruption (GRECO).

Digital transformation is a priority in the RRP, and initiatives cover both the public and private sectors. The RRP includes multiple measures to enhance digitalisation. Among the milestones already implemented are the creation of a platform for the digitalisation of the economy, gathering relevant stakeholders to promote relevant reforms, and a public tender for support for the digital transformation of small and medium-sized enterprises worth €85 million started in June 2022. Cybersecurity is a recurring topic in the RRP. Notably, related to digitalisation, in 2021 there was a change in notary regulation to allow the online creation of companies.

There is strong state buy-in to enhance skills and digitalise the educational system. In the first quarter of 2022 the government established the Reskilling and Upskilling Committee to upgrade qualifications. The Ministry for Education has initiated changes in university programmes to increase the focus on digital skills and careers and to create new study programmes, including cybersecurity, artificial intelligence and e-governance. In schools, information technology-related teaching hours will be increased alongside courses in data modelling and programming, among other things. Moreover, the ministry will provide schools with funds to digitalise study materials and purchase new digital devices. The government is also expected to launch regional training centres to promote Industry 4.0 standards.