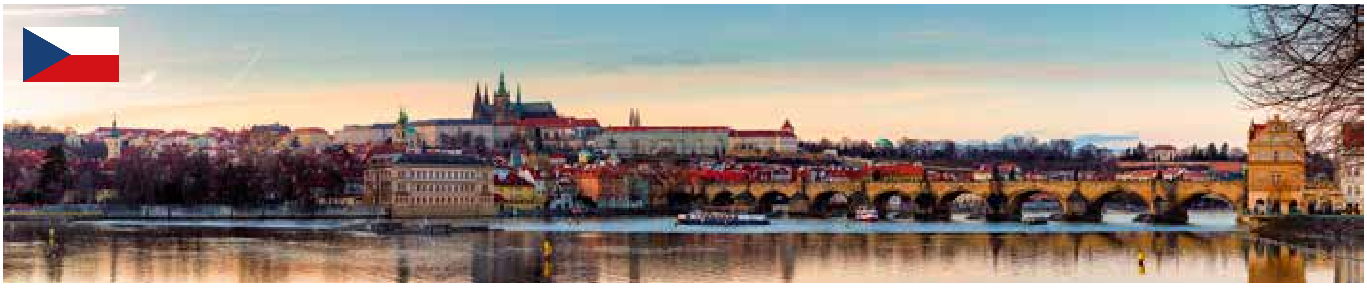


Czech Republic

Highlights

- **The economy remains in stagnation.** Gross domestic product (GDP) growth declined 0.6 per cent annually in the first half of 2023 but the first signs of improvement have started to appear, pointing to marginally positive growth for the entire year.
- **A new law will allow for easier corporate restructuring.** Under the new law approved by parliament, the majority threshold needed to approve a restructuring has been lowered from 90 per cent to 75 per cent. The new law could effectively enable the government to increase its control of the CEZ energy group.
- **The use of European Union (EU) funds has stepped up.** The country had used 87.1 per cent of its 2014-20 EU Multiannual Financial Framework funds by August 2023, alleviating concerns that major funds would be lost due to insufficient absorption.

Key priorities for 2024

- **The authorities should discontinue energy compensation measures.** While these measures helped to support vulnerable groups through the energy crisis, stopping them now would aid fiscal tightening and allow price incentives to encourage energy savings.
- **Progress on implementing the Recovery and Resilience Plan (RRP) should be stepped up.** The authorities should focus on green transition, including large programmes to improve energy efficiency and heating systems.
- **Pension reform should be completed.** Outstanding steps include introducing a retirement age linked to life expectancy.

Main macroeconomic indicators (per cent)

	2019	2020	2021	2022	2023 proj.
GDP growth	3.0	-5.5	3.6	2.4	0.1
Inflation (average)	2.6	3.3	3.3	14.8	10.9
Government balance/GDP	0.3	-5.8	-5.1	-3.2	-4.1
Current account balance/GDP	0.3	2.0	-2.8	-6.1	0.5
Net FDI/GDP [neg. sign = inflows]	-2.4	-2.6	-0.5	-2.5	n.a.
External debt/GDP	75.7	75.7	74.0	65.6	n.a.
Gross reserves/GDP	58.5	62.2	62.4	46.7	n.a.
Credit to private sector/GDP	50.3	53.0	54.8	50.9	n.a.

Macroeconomic developments and policy response

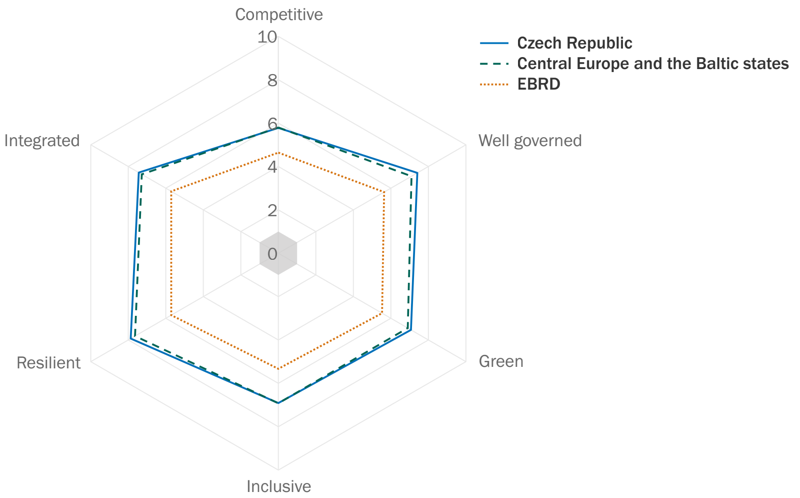
Economic growth has remained close to zero since the middle of 2022. The economy has been slow to recover from a collapse in consumption in the second half of 2022, resulting from a sharp drop in purchasing power. In addition, inventory adjustment is still taking its toll on the headline GDP numbers. On a positive note, consumption has started to show signs of improvement in 2023, as the structurally tight labour market prompts hoarding and wage growth. Amid rapidly declining inflation, sentiment and higher spending power have improved. The normalisation of energy prices has also provided a significant boost to Czech terms of trade, despite the uncertainty of the external demand outlook.

Inflation is moderating from a relatively high peak. The rate of consumer price growth reached 18 per cent in September 2022 but had returned to single digits by the summer of 2023, helped by a moderation in food and energy prices. Further declines are likely, as the strong base effects are still ahead. The Czech National Bank's (CNB) target inflation rate of 2 per cent could be achieved in early 2024.

Fiscal policy in early 2023 was accommodative, but tightening is on the horizon. In the first part of 2023, the authorities provided some counter-cyclical smoothing of demand, leading to a deficit of 6.1 per cent of GDP in the first quarter. In the second quarter, public finances improved and a fiscal surplus of 1.5 per cent of GDP was recorded. The government has committed to an austerity package, targeting a deficit of 2.1 per cent of GDP in 2024. The package includes eliminating tax exemptions, rebalancing local and central revenues, and increasing excise taxes on tobacco and alcohol.

Sticky inflation and weak foreign demand are the main drivers of downside growth. Considering how the economy performed in the first half of 2023, the remainder of the year should not bring major changes, putting GDP growth at around 0.1 per cent for the year as a whole. This will be driven by weaker consumption and exports, offset by a possible upturn in investor confidence arising from declining imports, rebounding investments, and enhanced political stability amid the formation of a new government. The economy should rebound by 2.5 per cent in 2024, supported by moderating inflation, accelerated absorption of EU funds, and revived foreign demand, although fiscal consolidation will damp growth in the short term. Another energy price shock and the protracted weakness of key trading partners are the main downside risks.

Assessment of transition qualities (1-10)



Structural reform developments

Financing conditions are easing. In June 2023 the CNB eased mortgage-lending limits and reduced the counter-cyclical capital buffer from 2.5 per cent to 2 per cent. This was in response to a major decline in loan volumes following an earlier tightening of monetary policy. In addition, from January 2024, businesses will be able to keep accounts in a foreign currency (euros, dollars or pounds) if they use that currency frequently.

Corporate restructuring is being made easier. In August 2023 parliament approved a law lowering the majority threshold needed for a decision to be made from 90 per cent to 75 per cent. The new bill, once signed into law, has potential consequences for the CEZ energy group, of which the state owns 70 per cent. Increased control over energy generation could allow the state to influence the energy market more directly, subject to EU notification procedures. Meanwhile, CEZ announced a potential bid for three small modular reactors, which could generate one gigawatt of power by 2040. The first reactor is planned to be completed in 2032 at the Temelín nuclear power station; the other two will eventually replace part of the capacity at the Dětmarovice and Tušimice coal-fired power plants. Contracting is still in the early phase, particularly for the latter two reactors.

Pension reform is advancing. Reforms in this area have been somewhat piecemeal, and some have faced significant opposition. The cabinet has announced reforms to the retirement age, but not yet signed them into law. So far, the legal changes to the system include smaller but more accurate indexation, conditions that limit early retirement through indexation cuts and adjustments to benefits for the self-employed.

Energy compensation measures are likely to be discontinued in 2024. This move would be in line with the European Commission's recommendations and falling energy prices. Current energy price ceilings apply to households and to small and large businesses, with additional limits and rules around profitability eligibility for the latter. They are theoretically financed by windfall taxes on the banking, energy and petrochemical sectors, which the government forecasts to reach CZK 46 billion (€1.9 billion) in 2023. Although the windfall taxes are due to be removed in 2025, the Ministry of Finance is considering removing them (and the energy price cap) sooner.

The use of EU funds has stepped up. The authorities had used 87.1 per cent of the country's 2014-20 EU Multiannual Financial Framework funds by August 2023, alleviating concerns that major funds would be lost due to insufficient absorption. Separately, the Czech Republic requested only CZK 19.4 billion (€800 million) in loans from the Recovery and Resilience Facility, effectively cancelling some planned investments as part of a fiscal tightening drive.

The economy is absorbing increasing numbers of Ukrainian refugees. As of the middle of 2023, 46 per cent of the approximately 220,000 Ukrainian refugees of working age in the Czech Republic were employed. According to rules announced in June 2023, the state will support refugee housing for five months, but will stop providing indefinite support to private families housing refugees.