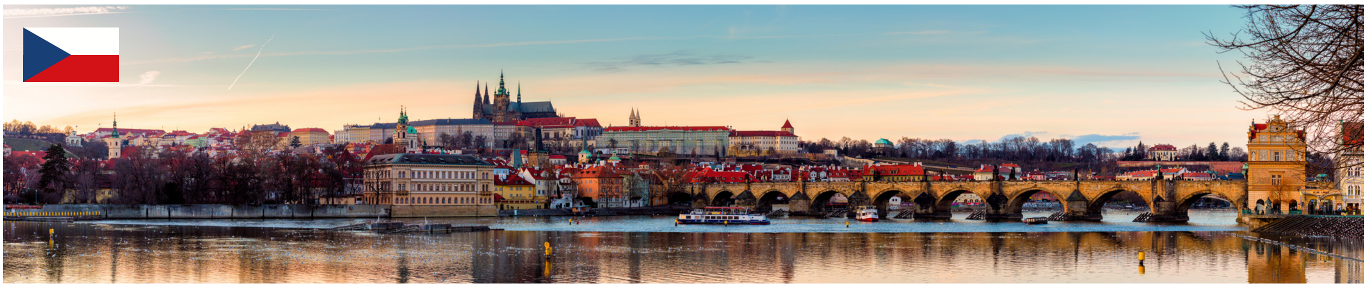

Czechia

Highlights

- **A modest economic recovery is under way.** Real gross domestic product (GDP) growth was just 0.4 per cent year on year in the first half of 2024, with ongoing normalisation of the inventory cycle, weak fixed capital investments and a decline in value added in the manufacturing sector holding back the economy.
- **Major floods brought significant damage and fiscal costs.** Czechia was one of the European countries most affected by heavy rainfall in September 2024. That forced the authorities to revise upwards the deficit target by around 0.4 per cent of GDP in the 2024 budget, while the European Union (EU) offered emergency grants.
- **Pension reform is advancing.** Following a politically intensive process and negotiations, a new pension reform plan advanced in August 2024, adopting a more moderate approach to raising the retirement age. This is expected to result in savings of about 0.4 per cent of GDP, lower than initially projected.

Key priorities for 2025

- **Efforts to reduce energy intensity need to accelerate.** The country needs to make full use of EU-funded and private investment to prepare its industry for the long-term challenges associated with the green transition.
- **Unlocking the permit system is important to boost construction.** Given the issues related to the new permit system, a swift update is needed to ease the strain on the housing market and enable planned investment projects.
- **Future-proofing the manufacturing sector is important for long-term competitiveness.** Amid the potential structural changes in the EU economy, Czech industry needs to accelerate innovation in decarbonisation, automation and digitalisation to ensure global competitiveness as well as diversify export markets.

Main macroeconomic indicators (per cent)

	2020	2021	2022	2023	2024 proj.
GDP growth	-5.3	4.0	2.8	-0.1	1.1
Inflation (average)	3.3	3.3	14.8	12.0	2.5
Government balance/GDP	-5.8	-5.1	-3.2	-3.7	-2.4
Current account balance/GDP	1.8	-2.1	-4.7	0.3	1.9
Net FDI/GDP [neg. sign = inflows]	-2.5	-0.5	-1.2	-0.2	0.2
External debt/GDP	74.7	75.1	67.4	59.9	na
Gross reserves/GDP	61.0	60.4	44.9	43.6	na
Credit to private sector/GDP	51.9	53.1	49.0	46.0	na

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Macroeconomic developments and policy response

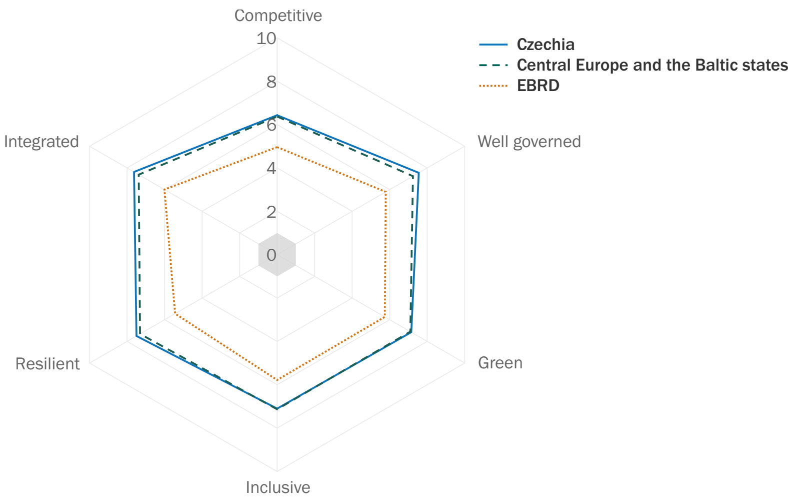
The economy is undergoing a modest recovery. In the first half of 2024, real GDP grew by 0.4 per cent year on year on the back of slowly recovering private consumption. In terms of sectors, growth was supported mainly by trade and financial services, but held back by manufacturing, construction and professional services. Weak foreign demand led to annual declines in industrial output in all months except one by July 2024. Still, in a sign of resilience, passenger car production reached a record level in the first half of 2024, largely on the back of strong growth by the third-largest manufacturer. On the expenditure side, protracted destocking held back GDP growth, and investment declined in the first half of the year in annual terms, as the construction sector has contracted annually since late 2022.

Households remain cautious despite rapid wage growth, ongoing disinflation and a tight labour market. Wages have recovered strongly in 2024, growing by 5.0 per cent in the first quarter and 3.9 per cent in the second quarter, year on year, albeit lower than in most regional peers and almost 10 per cent below the 2021 peak. In addition, the unemployment rate remains very low at 2.6 per cent. Inflation was just 2.2 per cent as of August 2024 and has been within the central bank's target range since the beginning of 2024. Consequently, the gross household saving rate has remained relatively high at around 19 per cent since mid-2022 (versus 11 per cent on average pre-Covid), although decreasing slightly in early 2024. The central bank's policy rate was cut to 4.25 per cent in 2024, but the resulting positive real interest rate gives a further incentive for households to save rather than spend.

Conservative fiscal policy is helping to lower the deficit in 2024. After recording a fiscal deficit of 3.8 per cent of GDP in 2023, the authorities have committed to a consolidation plan in 2024 and 2025, targeting a deficit of 2.5 per cent of GDP this year. This plan includes, on the expenditure side, a reduction in subsidies and savings on public administration. Revenues will grow through a rise in the corporate and personal income tax rates from 2025, an increase in levies for the self-employed, changes in the taxation of value-added tax, a re-introduction of sickness insurance for employees and a hike in property taxes. As a result, by August 2024 the budget deficit was 10 per cent lower than in 2023 in nominal terms. However, the floods in September 2024 forced the authorities to increase the target deficit to 2.8 per cent of GDP in 2024 and 2.3 per cent in 2025, up by 0.2 per cent of GDP. Still, EU grants will likely cover most of the estimated damages.

Growth prospects remain relatively weak. Considering the growth drivers at play in 2024 and the potential changes in 2025, there is limited space to benefit from stronger growth sources for the economy, especially for the rest of 2024. As a result, we forecast real GDP growth of 1.1 per cent in 2024, in line with the government's expectations. The main growth enabler, assuming persistent low inflation, would be further easing of monetary conditions, which could spur investment and household consumption in 2025. The latter should also eventually benefit from more robust real wage growth. There is uncertainty regarding export growth, as it is unclear whether the German economy, a key export destination for Czech companies, will rebound. We thus expect a domestically driven real GDP growth rate of 2.4 per cent in 2025.

Assessment of transition qualities (1-10)



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Structural reform developments

The production of energy from photovoltaic plants has increased. Czechia's solar power generation has continued to grow in 2024, albeit more slowly than the best-performing countries in the region. Solar sources accounted for more than 10 per cent of total electricity production in June 2024, compared with a share of around 5 per cent two years ago, representing a 69 per cent increase in absolute generated power over this period. This follows legislative changes introduced in 2023 that simplified the granting of permits for small-scale installations and accelerated permitting procedures for projects with more than 1 MW of capacity. In addition, energy communities were introduced in July 2024, allowing electricity sharing across the grid.

Energy security remains a priority, with a nuclear expansion project moving ahead. On top of the need to replace Russian gas, Czechia faces the even more daunting task of replacing its significant coal-based capacity. Coal-based power generation still accounted for 40 per cent of total production in 2023. While gas supplies were replaced with liquefied natural gas supplied from the Netherlands and Germany, the authorities remain committed to expanding the Dukovany nuclear power plant with two more units. In July 2024, the government selected South Korea's KHNP to carry out this project, which should start in 2029 and lead to commercial operation in 2038. Two companies, however – Westinghouse of the United States of America and EDF of France – have appealed the result of the tender. The estimated costs of the project range between 5.5 and 9.0 per cent of 2023 GDP.

Pension reform has advanced, but at a slower pace than originally planned. Pension reform, proposed by the government in April 2024, has been a key, politically important reform throughout the past year. It would bring estimated annual savings of 2.2 per cent of GDP. Negotiations were still ongoing as of August 2024, with a major change compared with the April proposal being a more gradual increase in the retirement age – from up to two months a year to just one month. Together with a slower indexation formula, the updated reform would still save about 1.7 per cent of GDP. The bill passed the second reading in parliament but it needs another two readings before being passed into law.

A new digitalised building permit system has been introduced but it has encountered problems. Efforts to digitalise the building permit system are part of the government's Recovery and Resilience Plan, to be financed from the EU's Recovery and Resilience Facility (RRF). The process, however, has proved to be more difficult than expected. Following the new system's introduction in July 2024, both private companies and public officials raised concerns about its functionality. In August 2024, the regional development ministry announced a new tender for the system, which could delay both private and EU-funded projects while the current system is still in use.

The authorities have progressed with expanding affordable housing. Given that Czechia has one of the least affordable housing markets in the EU, public authorities have prioritised the expansion of support schemes to develop more affordable housing for rentals, targeting those on lower incomes, public servants and young citizens. The government has identified more than 200 plots owned by the state which will be used for new buildings, in cooperation with municipalities and the private sector. After receiving a state aid notification in April 2024, the State Investment Support Fund and the National Development Bank will use RRF funding of around €380 million to channel preferential loans.

Efforts are under way to improve childcare. Women in Czechia are less active in the labour market than key regional peers, partly due to child-rearing responsibilities. In an effort to expand childcare options, the government has decided that in municipalities where children cannot find a place in kindergarten, the authorities will have to place them in a so-called children's group, which is a non-profit facility that operates based on education and care plans but is less demanding to establish than a kindergarten. If this is not possible, municipalities will have to compensate families with an amount equivalent to the maximum childcare benefit. The change will enter into force from 2026 for children above three years old.