Czech Republic: Staff Concluding Statement of the 2024 Article IV Mission

November 26, 2024

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Prague, Czech Republic – November 26, 2024. *The Czech economy is slowly regaining ground after an unprecedented combination of shocks. These developments unfold as the country transitions from heavily manufacturing-based, export-oriented growth to a more mature and diversified economy. A prudent policy mix has underpinned a return to price stability while preserving fiscal and financial buffers. The monetary policy rate could be further reduced towards a neutral level by mid-2025 along with a broadly neutral fiscal and macroprudential stance. Structural policies could better support the ongoing transformation by reducing administrative burdens and red tape, facilitating the allocation of labor and capital towards higher value-added sectors and firms, and promoting a more ambitious green transition.*

Context

The Czech economy is slowly recovering. After a period of stagnation, growth has picked up over the past three quarters, but has been slow and uneven. Consumer spending has strengthened, fueled by a rebound in real wages and early signs of a decline in the household saving rate. In contrast, investment remains weak, hampered by uncertainty about global trade, the effects of tight policies, and a slow absorption of EU funds.

Inflation has moderated. Led by lower commodity prices, restrictive monetary policy, and economic slack, headline inflation has reached the Czech National Bank's (CNB) 2 percent target and remained close to it over the summer. It has drifted higher in recent months, mainly reflecting volatile food prices. Core inflation remains above 2 percent on sticky services price growth and recovery in real wages.

Outlook and Risks

The recovery is poised to extend into next year. As the policy mix becomes more supportive of economic activity and external demand gradually strengthens, growth should gain further momentum. Earlier wage moderation also supports competitiveness of Czech manufacturers in export markets. As a result, growth is expected to accelerate to 2.4 percent in 2025 from a projected 1 percent this year. Despite the cyclical upswing, however, weak productivity growth and structural labor shortages are set to weigh down on medium-term potential growth, which is now estimated at around 2 percent.

Inflation is expected to converge back to target again. After a further increase above 3 percent in the near term on food price base effects, inflation is projected to converge back towards 2 percent by mid-2025, aided by the lagged effect of tight monetary policy and macroeconomic slack.

Risks to growth are on the downside while risks to inflation appear balanced. Further geoeconomic fragmentation, a weaker than anticipated recovery among key European trading partners, especially Germany, and stronger than expected effects of past monetary policy tightening point to downside growth risks. These factors would also weigh inflation down. On the other hand, stronger wage growth and stickier services inflation than expected, along with protracted increases in commodity prices, could exert upward pressure on inflation.

Monetary policy—Managing Inflation Risks as Restrictive Stance Is Gradually Removed

Staff sees ground for continuing to lower the policy rate. Monetary policy has been appropriately eased. However, with inflation expectations broadly anchored and output below potential, the current stance remains tight. This leaves room for additional rate cuts to achieve a neutral policy rate by mid-2025, which IMF staff estimates at around 3 percent, albeit subject to large uncertainty. Further easing should be pursued in a gradual, data-dependent manner, carefully weighing risks of core inflation remaining elevated due to second-round effects against the possibility of inflation undershooting the 2 percent target. Sustained wage growth above productivity growth or protracted commodity price increases would call for a more gradual decline in the policy rate, whereas signs that inflation might undershoot the target would call for the policy rate to be lowered to a neutral level before mid-2025.

The current risk management approach could give way to a gradual return to forecast-based inflation targeting. In a high-uncertainty environment, a data-dependent approach makes greater use of recent inflation developments, but it may also result in larger market volatility. Once uncertainty recedes and inflation stabilizes more closely to target, the CNB could consider putting more weight on forecast-based inflation targeting, weighing costs and benefits relative to a data-dependent, meeting-by-meeting approach. Throughout this transition, clear and transparent communication, including a strong commitment to bringing inflation back to target, will remain critical to keep expectations firmly anchored.

Consideration should be given to reducing the size of the central bank balance sheet over time. The CNB carries foreign currency reserve assets of more than 40 percent of GDP and well above reserve adequacy metrics, a legacy of the FX floor in place during 2013-17. In 2023, the central bank improved profitability considerably through various ad hoc cost rationalization measures and diversification towards higher yielding assets, including gold and equities. Recently, the rate of minimum reserve requirement was also raised by 2 percentage points to 4 percent. Aiming to gradually reduce the size of the balance sheet would help limit risks to the CNB’s financial position. After due consideration, this could be done through a transparent and predictable mechanism of small, regular FX sales above and beyond the existing program so as to minimize any impact on the exchange rate.

Fiscal policy—Preserving Buffers while Supporting Transformation

Staff supports the commitment to a broadly neutral fiscal policy, but the 2025 state budget is subject to some risks. Fiscal consolidation efforts have been commendable. The budget deficit is projected to stay below 3 percent of GDP this year, despite the slow economic recovery and the additional spending to deal with the recent floods. A broadly neutral fiscal stance in 2025 is appropriate, considering the narrowing (but still negative) output gap and the tight monetary stance. However, under staff's baseline, possible cost overruns and revenue shortfalls are estimated to leave the deficit around ¼ percentage points above the authorities' projection of 2.3 percent of GDP.

Additional measures will be required over the medium term to keep the deficit at prudent levels. Preserving fiscal policy space would help absorb future spending pressures, including for aging- and security-related spending. Accordingly, staff's recommended path, broadly aligned with the national fiscal rule, entails a further adjustment of about ½ percentage points of GDP a year over 2027–28 to reach a structural deficit of less than 1 percent of GDP by 2028. Productivity-enhancing spending should be safeguarded, and automatic stabilizers should operate freely. However, absent a severe downside shock, discretionary stimulus should be avoided, as it could ignite price and wage pressures, given the tight labor market, and hurt competitiveness.

Policy action should be considered on both the revenue and the spending side. Against the backdrop of a restrained fiscal environment, it is vital for taxation and spending to be aligned with the strategic objective of delivering inclusive and sustainable growth. Social security contributions currently account for nearly half of the revenue collected, while revenue from property, environmental, and consumption taxes is well below the EU average. Staff encourages the authorities to revisit over time the composition of tax revenue. Following the large changes enacted in 2021, the structure of the personal income tax should also be reassessed against the intended revenue collection and degree of progressivity. Ongoing efforts to modernize the tax administration are set to strengthen revenue resilience. On the spending side, the actions taken to improve the sustainability of the Czech pension system are welcome, but limiting the annual increase in the retirement age to one month reduces the intended effects of the reform and may require further adjustments in the future. To limit costs and mitigate economy-wide labor shortages, the sustained expansion of the public sector workforce should be contained going forward, including in fragmented local administrations and locally provided services. Spending on social benefits could be better targeted. Efficient and better targeted absorption of EU Cohesion funds along with faster progress towards unlocking Recovery and Resilience Facility (RRF) funds could support productivity-enhancing capital spending.

Financial policies—Calibrating Frameworks with Evolving Risks

Financial stability risks remain contained but warrant continuous vigilance. Residential property prices have staged a moderate rebound in recent months, adding to long-standing affordability concerns, especially for the Prague metropolitan area. Recent initiatives to offer affordable rental housing may provide some relief. Real estate funds are not systemic institutions, but their role in the domestic commercial real estate market has grown significantly. Close monitoring of risks stemming from loans secured by commercial property collateral should further be pursued. Supervisors should continue to review bank exposures and ensure that credit risks are accurately reflected in banks' risk weights. Additionally, given banks' high exposure to Czech sovereign debt and to euro loans to non-financial corporations, the authorities should continue to regularly evaluate the effect of mark-to-market losses on securities portfolios and the impact of exchange rate fluctuations on corporate exposure.

The current macroprudential stance is broadly appropriate. While the Czech Republic is the only EU country to have lowered the countercyclical capital buffer (CCyB) rate since 2020, the rate had been tightened comparatively more (up to 2.5 percent) during the upward phase of the financial cycle. Staff assesses the current 1.25 percent CCyB rate as appropriate and urges the authorities to exert caution in considering additional easing. A further release of the CCyB would be advisable only in response to clear materialization of financial risks. The introduction of a general systemic risk buffer is welcome given the structural headwinds facing the economy. Mortgage activity should be monitored closely to identify potential early triggers for the reactivation of Debt-Service-to-Income and Debt-to-Income limits.

Structural policies—Accelerating Sustainable and Inclusive Growth

Decisive action is needed to support economic transformation. Non-auto manufacturing, energy, and construction, once important Czech engines of growth, have run out of steam, hampered by decelerating productivity growth, higher energy costs, and sluggish demand. The auto industry has shown resilience so far, but, absent adequate supporting infrastructure, the required transition to electric vehicles and exposure to foreign competition are set to exert significant pressures in the coming years. Higher value-added sectors, including ICT services, are constrained by lack of skilled labor and limited access to capital, undermining their ability to compete on global markets. Significant integration in global value chains, concentration in terms of trading partners, products, and suppliers, and high energy intensity make the Czech economy vulnerable to geoeconomic fragmentation and much needed decarbonization efforts and prone to shocks. The newly adopted Economic Strategy usefully identifies key focus areas to achieve long-term, sustainable growth. Building on this diagnosis, the authorities are urged to undertake concrete policy actions:

- **More targeted active labor market policies would facilitate labor reallocation and enhance participation.** Despite the recent decline in vacancies, the Czech labor market suffers from structural job shortages, particularly among skilled workers. The proposed amendments to the Labor Code promote greater flexibility in the labor market and should be adopted swiftly. Use of existing data on job mismatches could inform modernized vocational training and targeted upskilling and reskilling measures, facilitating labor reallocation. Aligning education programs with labor market needs could further address skill shortages. Recent migration flows have been successfully absorbed by the Czech labor market. Policies should continue to focus on integrating migrants in the most productivity-enhancing way possible. Addressing the gender pay gap and increasing the availability of affordable, high-quality childcare and eldercare facilities could encourage more women to enter the workforce and boost labor participation.

- **Efforts to ease restrictions, reduce administrative burdens and accelerate digitalization would attract capital and support growth prospects.** Deepening the EU single market would allow the Czech Republic, like other EU members, to better leverage economies of scale, foster competition, lower costs, and enhance resilience. Domestic structural policies should accompany this progress, supporting business climate and making the Czech Republic a more attractive destination for foreign capital. Priority should be given to reducing administrative burdens and red tape, especially among local municipalities, expediting spatial planning and construction permit processes, and enhancing adoption of digital technologies. Harmonizing IT systems in the public administration, upgrading online government services to businesses, and expanding digital infrastructures, including broadband, would also be critical. Encouraging use of existing tax credits for research and development would support innovation. Expanding availability of venture capital and equity financing would boost opportunities for startups and allow young firms to scale up.

- **The commitment to climate neutrality should be met by more ambitious steps.** The authorities are planning to expand nuclear power capacity, building on Czech established know-how in this area, to reduce emissions and achieve greater energy security in the long run. However, the Czech energy mix currently remains dominated by fossil fuels, which still represented two thirds of gross available energy in 2023. The authorities have committed to phasing out dependence on coal by 2033 and have aligned with the EU's goal of achieving net-zero greenhouse gas emissions by 2050. At current policies, however, the latter target is likely out of reach. Investment in renewables remains low by international standards and could be scaled up, including through recently identified acceleration zones, while boosting energy efficiency.

The mission would like to thank the Czech authorities for their warm hospitality, open collaboration, and fruitful discussions.