



CZECH REPUBLIC

January 2024

2023 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; STAFF STATEMENT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR CZECH REPUBLIC

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2023 Article IV consultation with Czech Republic, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its January 22, 2024, consideration of the staff report that concluded the Article IV consultation with Czech Republic.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on January 22, 2024, following discussions that ended on November 21, 2023, with the officials of Czech Republic on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 15, 2023.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for Czech Republic.

The documents listed below will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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International Monetary Fund
Washington, D.C.



IMF Executive Board Concludes 2023 Article IV Consultation with Czech Republic

FOR IMMEDIATE RELEASE

Washington, DC – January 30, 2024: On January 22, the Executive Board of the International Monetary Fund (IMF) concluded the 2023 Article IV consultation¹ with Czech Republic.

Economic activity slowed down notably in 2023 but a rebound is expected in 2024, driven by a recovery in domestic demand. In 2023 real GDP growth is estimated to have declined to -0.4 percent, mainly reflecting a decline in household consumption amidst a significant fall in real wages, deteriorating consumer sentiment, and heightened uncertainty. Growth is projected to increase to about 1.2 percent in 2024, mainly driven by consumption and fixed investment, as inflation declines, and real wages recover. Inflation is projected to meet the Czech National Bank's target by early 2025. The ongoing disinflation reflects the diminishing impact of price shocks from commodity prices and a substantial decrease in domestic demand pressures. This is apparent in falling core inflation, which primarily reflects the dampening effect of the tight monetary policy stance. Continued drops in commodity prices (food and fuel) are expected to support a fall in administered price inflation.

Risks to the growth outlook are tilted to the downside and risks to inflation are tilted to the upside. Spillovers from a weaker global outlook remain a downside risk. Economic activity and inflation could negatively be affected by a possible renewed surge in global energy prices, new supply chain disruptions or an increase in geopolitical tensions, and potential broader geo-economic fragmentation. Heightened global financial volatility due to stress in global financial markets could negatively impact pricing and availability of financing. Risks to inflation relate to inflation expectations becoming untethered—against the backdrop of high inflation, a tight labor market and the currently elevated but declining saving rate. Moreover, inflation pressures could also arise from strong wage growth and a failure of profit margins to compress rapidly in an environment of recovering growth, resulting in stronger repricing of goods and services. Also, inflation expectations could rise if new global energy or commodity price shocks arise or if the expected increase in administered prices reverses the downward inflation momentum. Additionally, an abrupt return of the household saving rate to near long-term average levels could boost household consumption and heighten demand driven inflationary pressures. A falling differential in policy rates vis-a-vis major

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

central banks or geopolitical shifts in regional sentiment could exert depreciation pressure on the koruna and add to inflationary pressures.

Executive Board Assessment²

Executive Directors commended the authorities for maintaining macroeconomic and financial stability amidst challenging conditions and welcomed the expected economic recovery in 2024. Noting the elevated downside risks to the outlook, Directors encouraged the authorities to maintain their prudent macroeconomic policy mix to ensure price stability and continue to implement necessary structural reforms to facilitate the green and digital transformation of the economy.

Directors agreed that maintaining a tight monetary policy stance remains appropriate to ensure inflation returns to target in a timely manner. Noting the recent policy actions, Directors concurred that the central bank should adopt a cautious, data-driven approach to potential further rate cuts.

Directors welcomed the authorities' commitment to fiscal prudence and emphasized the need to remain flexible given the uncertain outlook. If current conditions persist, Directors broadly concurred that further fiscal consolidation is needed to support the disinflation efforts and reach the medium-term objective in the Fiscal Responsibility Act by 2028. Such efforts could also help build fiscal buffers in the face of aging pressures and can support economic transformation. Directors also emphasized the importance to protect the most vulnerable and welcomed the authorities' commitment to pension system reforms.

Directors welcomed the resilience of the financial sector, noting that banks are well-capitalized, liquid, and profitable while asset quality remains strong. They concurred that macroprudential policy settings are broadly adequate but called for vigilance as pockets of vulnerabilities warrant close monitoring, including in the housing market, foreign currency corporate loans, and cyber security. A number of Directors found no immediate need to reactivate debt- and debt-service to income ratios, at this stage. Directors welcomed improvements in risk-based supervision and encouraged further progress in this area. They concurred that efforts to strengthen the safeguards against AML/CFT risks should be continued.

Directors agreed that addressing structural challenges arising from the country's demographic dynamics and the global energy transition will be critical to maintain sustainable growth. They highlighted that structural reform policies should facilitate the reallocation of labor and capital and advance technological innovation to support economic transformation, including towards a greener and more digitalized economy. They welcomed the authorities' decarbonization strategy and noted the need for continued efforts to meet the country's climate targets.

² At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

Czech Republic: Selected Economic Indicators, 2020–28									
	2020	2021	2022	2023	2024	2025	2026	2027	2028
	Staff projections								
NATIONAL ACCOUNTS									
Real GDP (expenditure)	-5.5	3.5	2.4	-0.4	1.2	2.5	2.7	2.6	2.5
Domestic demand	-5.6	8.2	2.6	-3.7	0.6	2.3	2.6	2.6	2.7
Consumption	-4.1	3.3	-0.3	-1.5	2.2	2.4	2.7	2.6	2.5
Public	4.2	1.4	0.6	2.5	1.1	1.1	1.2	1.4	1.4
Private	-7.2	4.1	-0.8	-3.2	2.6	3.0	3.3	3.2	3.0
Investment	-9.3	20.4	8.8	-8.2	-2.7	2.1	2.5	2.7	3.0
Exports	-8.0	6.8	7.2	2.7	2.5	5.0	5.1	5.2	5.4
Imports	-8.2	13.2	6.3	-0.3	1.9	4.9	5.1	5.3	5.3
Contribution to GDP									
Domestic demand	-5.1	7.8	1.5	-3.0	0.6	2.2	2.5	2.5	2.5
Net exports	-0.4	-4.3	0.9	2.6	0.6	0.4	0.2	0.1	0.0
Investment (percent of GDP)	26.5	26.0	26.8	25.9	26.2	25.6	25.5	25.6	25.7
Gross domestic investments (percent of GDP)	26.2	30.2	32.2	28.9	27.2	26.7	26.5	26.5	26.6
Gross national savings (percent of GDP)	28.1	27.5	26.0	28.1	27.0	27.0	27.4	28.0	28.6
Output gap (percent of potential output)	-0.6	0.8	0.4	-0.5	-0.3	0.0	0.5	0.1	0.0
Potential growth	-2.2	2.1	2.8	0.5	1.0	2.2	2.2	2.9	2.6
LABOR MARKET									
Employment	-1.4	0.3	-1.6	-0.1	0.9	-0.6	-0.4	-0.1	0.3
Total labor compensation	1.5	6.1	7.9	6.8	4.9	3.9	4.3	4.4	4.8
Unemployment rate (average, in percent)	2.4	2.7	2.1	2.7	2.6	2.5	2.4	2.4	2.4
PRICES									
Consumer prices (average)	3.2	3.8	15.1	10.6	2.8	2.0	2.0	2.0	2.0
Consumer prices (end-of-period)	2.3	6.6	15.8	7.4	2.9	2.0	2.0	2.0	2.0
Producer price index (average)	0.1	7.1	...	...	...	...	...	...	...
GDP deflator (average)	4.3	3.3	8.6	9.0	3.7	2.2	1.6	1.7	2.0
MACRO-FINANCIAL									
Money and credit (end of year, percent change)									
Broad money (M3)	10.0	6.8	6.1	8.5	4.9	4.8	4.3	4.3	4.6
Private sector credit	3.6	8.9	5.0	4.5	4.0	3.5	3.5	3.5	3.5
Interest rates (in percent, year average)									
Three-month interbank rate	0.9	1.1	...	...	...	...	...	...	...
Ten-year government bond	1.1	1.9	4.2	1.2	1.7	1.7	1.7	1.7	1.7
Exchange rate									
Nominal effective exchange rate (index, 2005=100)	99.7	103.6	...	...	...	...	...	...	...
Real effective exchange rate (index, CPI-based; 2005=100)	100.0	104.6	...	...	...	...	...	...	...
PUBLIC FINANCE (percent of GDP)									
General government revenue	41.5	41.4	41.4	42.6	41.9	41.6	41.5	41.5	41.4
General government expenditure	47.2	46.5	44.6	46.2	44.1	43.3	43.0	42.6	42.2
Net lending / Overall balance	-5.8	-5.1	-3.2	-3.6	-2.2	-1.7	-1.5	-1.2	-0.8
Primary balance	-5.2	-4.5	-2.7	-2.8	-1.2	-0.7	-0.5	-0.2	0.2
Structural balance (percent of potential GDP)	-5.5	-5.4	-3.4	-3.4	-2.1	-1.8	-1.8	-1.3	-0.8
General government debt	37.7	42.0	44.2	44.2	44.3	44.2	44.0	43.6	42.5
BALANCE OF PAYMENTS (percent of GDP)									
Trade balance (goods and services)	6.7	2.8	-0.1	3.5	3.9	4.9	5.0	5.0	5.0
Current account balance	2.0	-2.8	-6.1	-0.9	-0.2	0.3	1.0	1.5	2.0
Gross international reserves (billions of euros)	135.4	153.3	131.3	140.3	149.3	158.3	166.3	172.3	176.9
(in months of imports of goods and services)	11.9	11.0	7.6	8.4	8.8	8.9	8.8	8.5	8.2
(in percent of short term debt, remaining maturity)	142.8	136.7	116.2	117.5	119.3	122.4	126.5	131.2	137.0
MEMORANDUM ITEMS									
Nominal GDP (USD billions)	246.0	281.8	290.5	335.5	350.4	368.4	385.1	400.1	416.8
Population (millions)	10.7	10.5	10.8	11.0	11.1	11.1	11.0	11.0	11.0
Real GDP per capita	-5.6	5.4	-0.6	-2.0	0.4	2.8	3.0	2.9	2.8
GDP per capita (USD thousands)	22.98	26.79	26.83	30.50	31.61	33.33	34.94	36.42	38.06

Sources: Czech National Bank; Czech Statistical Office; Ministry of Finance; Haver Analytics, and IMF staff estimates and projections.

Structural balances are net of temporary fluctuations in some revenues and one-offs. COVID and energy price-related one-offs are however included.



CZECH REPUBLIC

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION

December 15, 2023

KEY ISSUES

Context: Growth slowed considerably following Russia's invasion of Ukraine, reflecting disruptions in global value chains, significant increases in energy and commodity prices, an erosion in real wages, and a necessary tightening in monetary policy. Growth is expected to pick up in 2024, led by consumption and fixed investment—as inflation fades and real income recovers—supported by net exports. Nevertheless, over the medium term, GDP is not expected to reach the levels consistent with its pre-pandemic trend. Inflation peaked in 2022 and is projected to meet its target by early 2025. Risks are tilted to the downside for activity and to the upside for inflation.

Policy Recommendations: The priorities are reducing inflation to target, restoring fiscal space, and maintaining macro-financial stability, while remaining nimble in the face of high uncertainty. Boosting potential growth is essential as structural shifts weigh on the medium-term outlook.

- **Monetary Policy.** Staff recommends keeping the policy stance sufficiently tight for some time to ensure inflation returns to target in a timely manner and to reduce the risk of an upward shift in inflation expectations. High uncertainty calls for a flexible approach to policy setting.
- **Fiscal Policy.** The approved consolidation for 2024 will help the disinflation effort. Given the uncertain outlook, automatic stabilizers should function fully. Despite a low debt to GDP ratio, preserving and enhancing policy space will be vital to address future shocks, support economic transformation and help ensure long-term debt sustainability.
- **Macrofinancial Policies.** Current levels of the countercyclical capital buffer and loan-to-value ratios seem appropriate given that risks associated to real estate exposures have diminished. Reactivating the limits on the debt-to-income and debt-service-to-income ratios would be advisable to help manage potential systemic risks. Closely monitoring the risks of an increasing share of euro-denominated bank loans is warranted.
- **Structural Policies.** With the economy being impacted by structural changes, including population aging and a global shift away from fossil-fuel based power, aiding labor and capital reallocation, boosting digitalization and productivity, and accelerating the green transformation are key goals.

Approved By
Oya Celasun (EUR)
and Fabian Valencia
(SPR)

Discussions took place in Prague during November 7–21, 2023. The staff team comprised Messrs. Segoviano (head), El Said, Canales-Kriljenko and Mmes. Fan, Primus (all EUR). Mr. Marek (OED) attended some meetings. Mr. Alasal and Mmes. Kumar, Zdanovich (all EUR) assisted in the preparation of the staff report. The staff team met with CNB Deputy Governors Eva Zamrazilova and Jan Frait, CNB Board Members Karina Kubelkova, Jan Kubicek, and Tomas Holub, CNB Executive Directors Libor Holub, Radek Urban, Petr Kral and Jan Schmidt, Deputy Minister of Finance Marek Mora, Director of Economic Strategies and Policies David Prušvic, Fiscal Council Member Petr Musil, other senior officials, and representatives from the private sector.

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BACKGROUND

1. The Czech Republic had a strong pre-pandemic economy marked by robust growth and substantial buffers.

Decisive policy action mitigated the pandemic’s economic fallout in 2020. However, Russia’s war in Ukraine had a significant impact on the country’s budding recovery, as the economy was impacted by disruptions to global value chains, significant increases in energy and commodity prices, and high inflation, with a necessary tightening in monetary policy. Although economic growth is anticipated to pick up starting in 2024, Czechia’s unemployment rate is at historically low levels but unlike most countries in Europe, GDP has not yet recovered to its 2019 level.

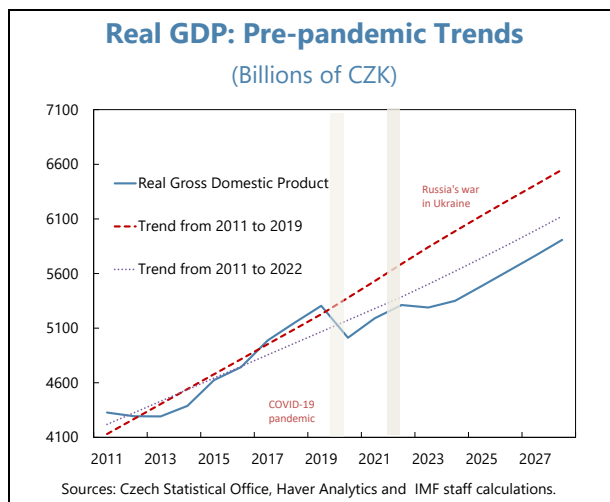
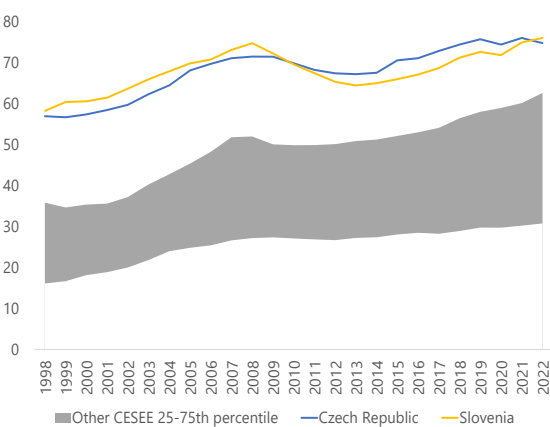


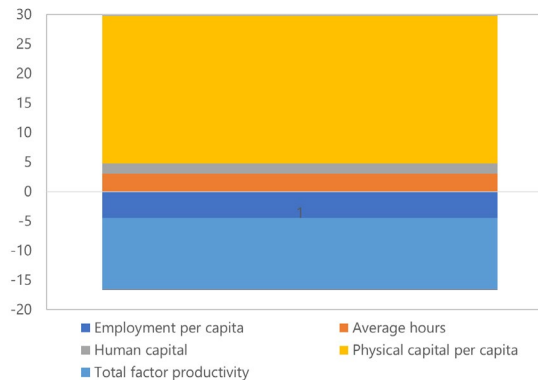
Figure 1. Czech Republic: GDP Per Capita Convergence

GDP Per Capita PPP
(Percent of Germany's)



Source: IMF World Economic Outlook Database.

Contributions to GDP Per Capita Convergence with Germany^{1/}
(Change in predicted value, panel regression contributions)



Source: IMF staff estimates. Penn World Table version 10.10.

^{1/} The chart shows the factors explaining the difference in predicted values of the ratio of GDP per capita in Czechia with Germany between 1994 and 2019 from a production-function-type panel regression with time and country fixed effects using data from the Penn World Tables, version 10.01 for 41 countries, including most in the CESEE area, the largest advanced economies in Europe, and the US. All panel variables scaled to corresponding levels in Germany.

2. Improvements in Czech living standards have stalled and might be hampered by global structural changes.

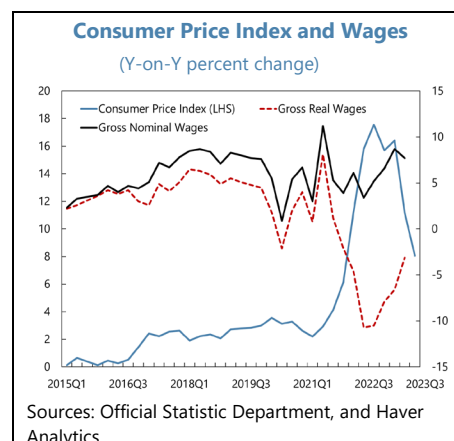
Since the fall of the Berlin wall, significant physical capital investment, improvements in human capital, and relatively higher working hours per person has been partly offset by lower total factor productivity and employment per capita relative to Germany (Figure 1). Improvement in living standards might be further hampered as the Czech economy is being affected by global structural shifts.

3. Policy action is needed to secure a successful transformation of the economy amidst structural shifts. The Czech economy faces challenges, probably more acutely than other developed economies, as long-standing issues are intertwining with global structural shifts. These include the need to address climate transition and mitigation challenges, as well as an aging population. A broad trend of decarbonization, including the shift towards carbon pricing and electric vehicles and the phasing out of fossil fuel-based power within the EU require major capital and labor reallocation, and significant investments. With an aging population, weighing on labor supply and fiscal balances, urgent structural reforms are essential to direct resources towards higher value-added sectors to maintain living standards, and support the digital and green transformation of the economy.

RECENT DEVELOPMENTS

4. Economic activity has slowed down notably in 2023. In 2023 real GDP growth is estimated to have declined to -0.4 percent, mainly reflecting a decline in household consumption amidst a significant fall in real wages, deteriorating consumer sentiment, and heightened uncertainty.¹ Following its fall during late 2022 and early 2023, due to high interest rates, fixed investment is projected to remain weak in 2023. Meanwhile, the buildup in inventories experienced in 2022 is being reversed as supply disruptions fade. These also come with strong export growth, while import growth has remained subdued due to the downturn in domestic demand. Hence, strong net exports have helped contain the slowdown in economic activity.

5. Tightness in the labor market has eased modestly as the economy slowed. Amid falling vacancy rates, the unemployment rate picked up slightly to 2.8 percent in 2023: Q3 but remains low by historical standards and is among the lowest in Europe (Figure 2).^{2, 3} Nominal wages increased broadly across all sectors but lagged behind inflation, resulting in a sharp fall in real wages. As nominal wages continued to grow and inflation started to rapidly decline, real wages started to recover in the second half of 2023.⁴



¹ Household consumption fell by 0.8 percent of GDP in 2022 and is projected to fall by around 3.2 percent of GDP in 2023.

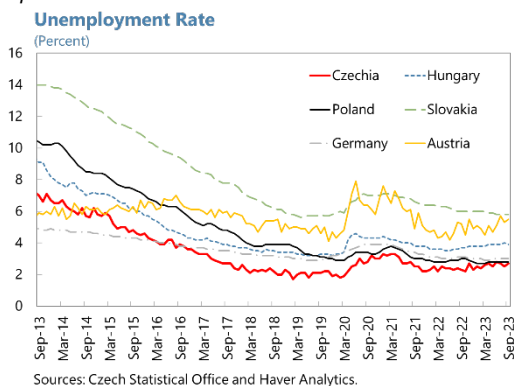
² The NAIRU is estimated to have been about 3.9 percent in 2022.

³ It is estimated that about 100,000 Ukrainian workers were absorbed in Czechia's labor market (around 2 percent of the labor force).

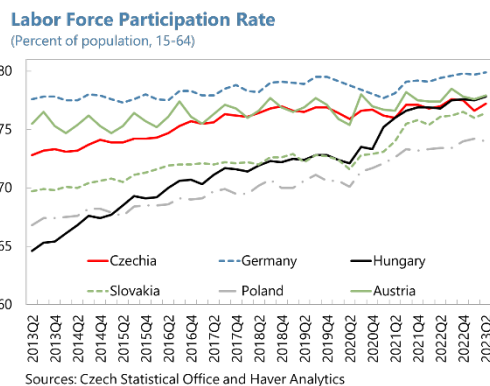
⁴ Real wages fell by about 10.7 percent from end 2019 to 2022: Q2. Despite a recent recovery, real wages in 2023: Q1 remained about 3 percent below their level relative to end 2019.

Figure 2. Czech Republic: Labor Market Developments

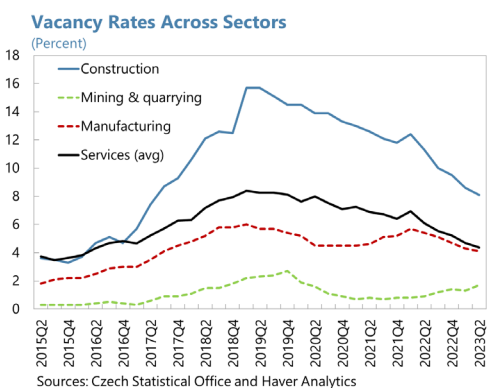
The unemployment rate modestly increased as the economy decelerated but remains among the lowest in Europe ...



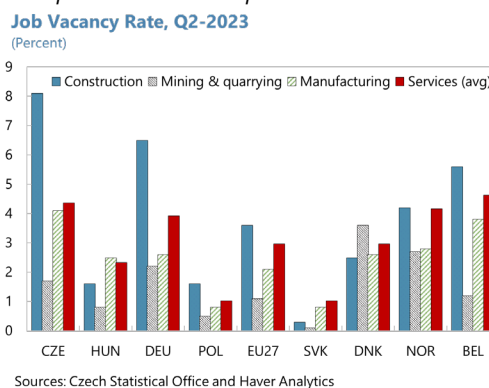
...while labor force participation has also increased slightly over time and remained stable since the pandemic.



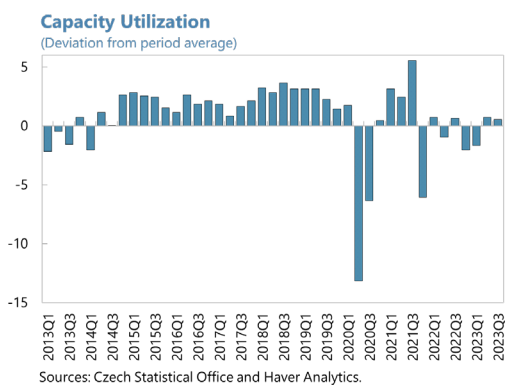
Vacancy rates have declined gradually since 2019...



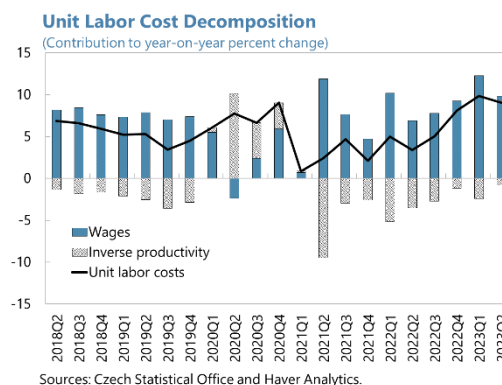
...although vacancies in some sectors remain relatively high compared to other European countries.



While fluctuating, capacity utilization is converging to the average ...

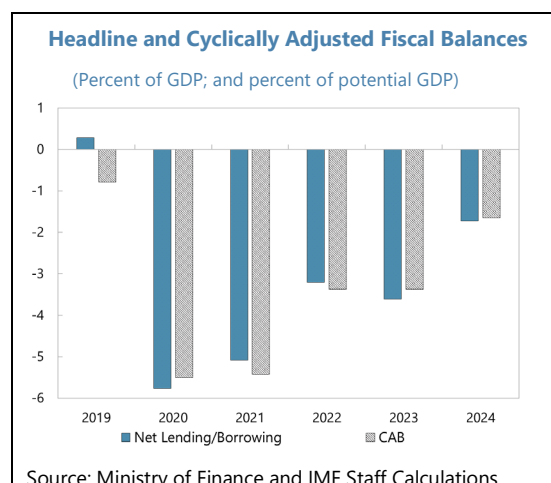


...and the growth of unit labor costs is below pre-pandemic trends.



6. The CNB has maintained the policy rate at 7 percent since June 2022. Though inflation is falling, it remains elevated. Twelve-month headline and core inflation decreased from peaks of 18.0 percent and 14.7 percent in September 2022 and October 2022 respectively, to 8.5 percent and 4.2 percent in October 2023 (Figure 3).⁵ A negative output gap, reflecting in part the tight stance of monetary policy, as well as the rapid unwinding of growth in foreign prices—until recently a major factor in domestic cost growth—are driving down inflation and inflation expectations. The fall in core inflation has been mainly driven by cooling demand-pull inflation pressures—amid falling consumption and investment—with the imputed rent component registering a significant decline—due to a fall in construction prices and deceleration of new property prices. As a result, underlying inflation momentum is also declining, with the October reading at 2.4 percent.⁶ While indicators of inflation expectations remain above the target rate—at around 2.8 percent for 12 months ahead for financial markets in October 2023, and 6.6 percent for nonfinancial firms in Q3 2023, respectively—these have receded from their peaks. The inverted yield curve on government bonds suggests that financial markets expect further disinflation.⁷

7. The fiscal stance was contractionary in 2022. The general government fiscal deficit ended up at 3.2 percent of GDP in 2022, lower than the 2021 deficit of 5.1 percent, on account of higher revenue—from social contributions and taxes on production and imports—outweighing the increase in expenditures (Figure 4). The latter included support for Ukrainian refugees, pension hikes and transfers to mitigate elevated energy prices. The fiscal impulse in 2022 was -2.0 percent of potential GDP as the cyclically adjusted balance was reduced from -5.4 to -3.4 against the backdrop of a decrease of the output gap of about 0.4 percent of potential output. Debt at end-2022 was 44.2 percent of GDP—14.1 percentage points higher than in 2019.



8. While the general government (GG) deficit is expected to increase in 2023, the fiscal stance is expected to remain broadly neutral relative to 2022. The GG budgeted deficit of 3.6 percent of GDP is likely to be met.⁸ The overall fiscal stance will likely remain broadly neutral, as

⁵ The headline inflation rate reached its lowest point since 2022 at 6.5 percent in September 2023. However, this is due to the statistical base effect—reflecting last year’s drop in electricity prices caused by the government’s energy saving tariffs implemented in 2022: Q4.

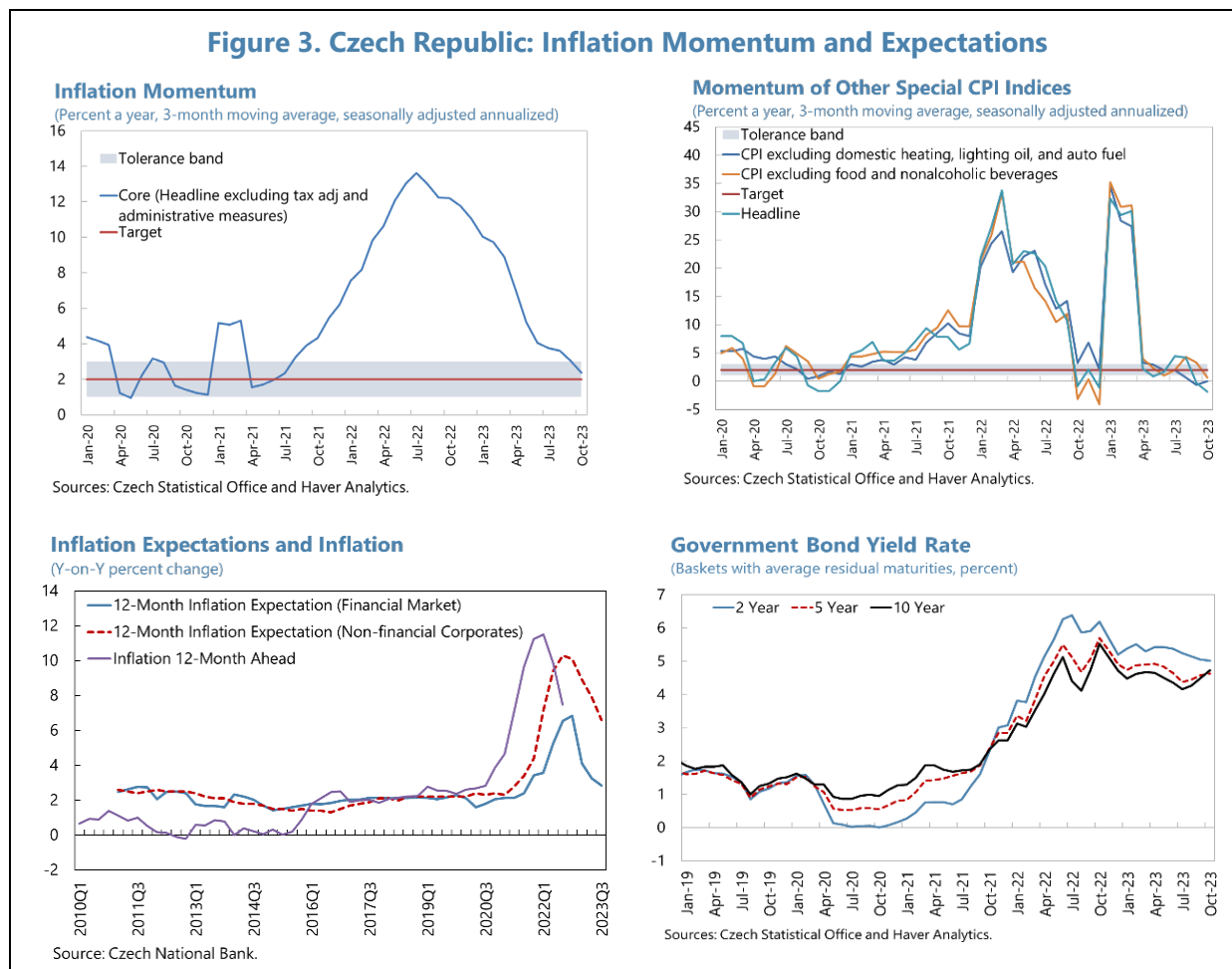
⁶ The momentum was measured as the 3-month seasonally adjusted annualized inflation rate excluding administrative prices. The momentum excluding food and nonalcoholic beverage prices is also about 0.65 percent. When excluding domestic heating, auto fuels, and lighting oil, the momentum is 0.0 percent in October 2023. The headline three-month-over-three-month inflation rate was 4.6 percent.

⁷ [Survey of financial market inflation expectations, September 2023](#), CNB.

⁸ The GG balance is the sum of the central government, local governments, and social security balances. The state budget is key to the central government balance as local government balances are usually in surplus and the social

(continued)

the cyclically adjusted balance is projected to remain unchanged in 2023 at around -3.4 percent of potential output, 2.6 percentage points weaker than its pre-pandemic level. Debt over GDP at end 2023 is projected to remain around 44.2 percent.



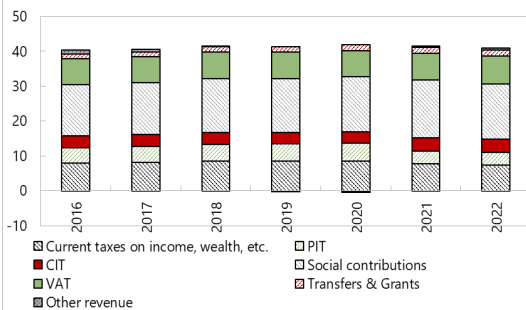
security funds typically breakeven. For the state budget, the January-October outturn ended up at 2.9 percent of GDP deficit, lower than budgeted for the same period by 0.4 percent of GDP. The better-than-budgeted performance of the state budget contributed to meet the budgeted GG balance and was on account of higher corporate and personal income taxes as well as higher dividends from the utility company (CEZ). The utility company (CEZ) dividend payout reached a record CZK 54bn (0.7 percent of GDP).

Figure 4. Czech Republic: Fiscal Sector

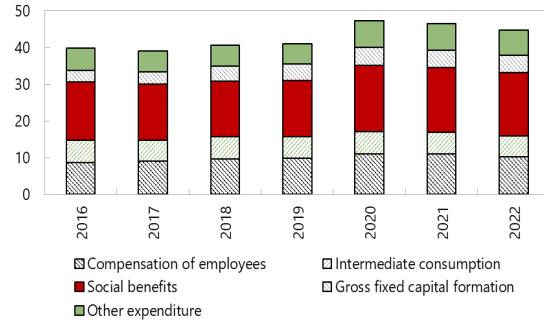
Revenue declined because of the change in the PIT regime, ...

...while spending increased strongly, reflecting the policy measures in response to COVID-19...

General Government Revenue
(Percent of GDP)



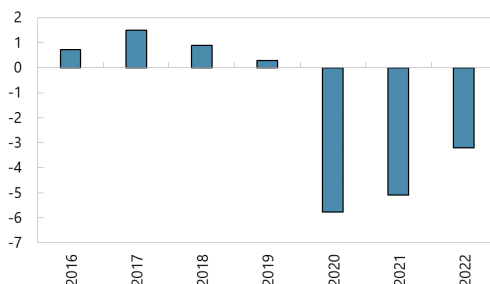
General Government Expenditure
(Percent of GDP)



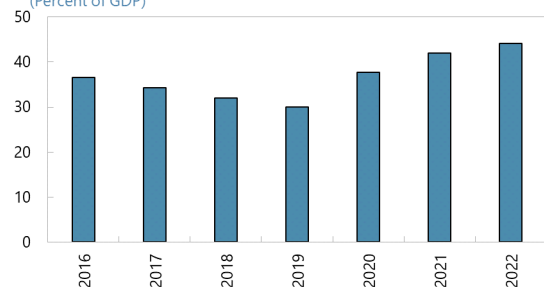
...turning the fiscal surplus into a sizeable deficit...

...and significantly increasing public debt.

General Government Balance
(Percent of GDP)



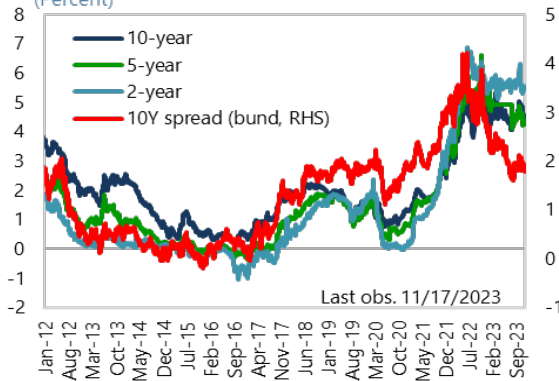
Public Debt
(Percent of GDP)



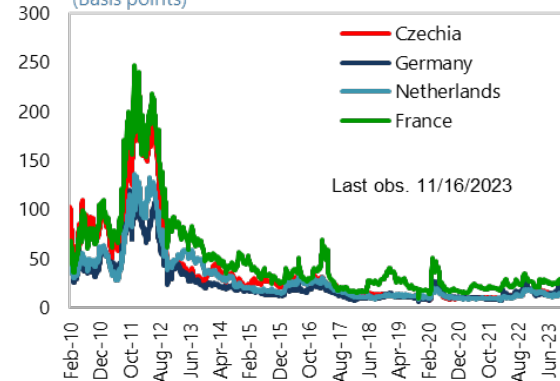
Bond yields and spreads increased as the CNB started tightening monetary policy, ...

...while CDS spreads continue to be low.

Sovereign Bond Yields
(Percent)

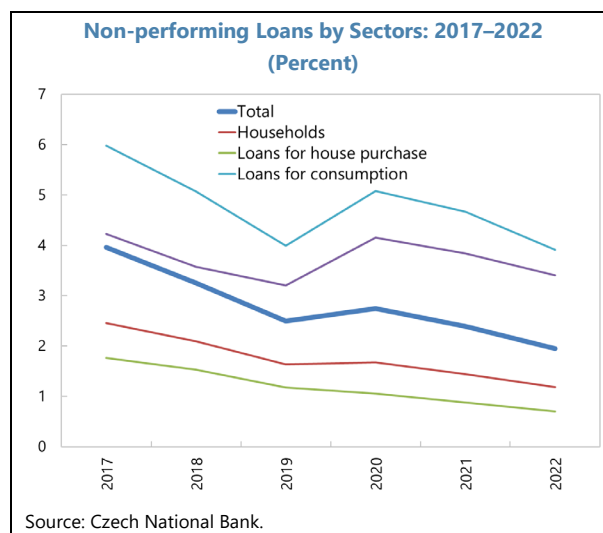


Sovereign 5-year EUR CDS Spreads
(Basis points)



Sources: Czech Republic Ministry of Finance; Bloomberg; and IMF staff calculations.

9. Risks from the housing market have declined. The nominal growth rate in housing prices has turned mildly negative and indicators of overvaluation have declined. The real value of apartment prices in Prague is four percent below pre-pandemic levels although prices remain above pre-2020 levels outside of the capital. Moreover, in real terms new mortgages and other loans for household purchase is 39 percent below the pandemic level but have started to recover this year. The ratio of household debt to disposable income had returned to pre-pandemic levels during 2022. Despite the acute increase in interest rates, households' overall interest rate expenses declined relative to disposable income, partly because inflation eroded the value of the existing mortgage debt given the prevalence of fixed nominal interest rate mortgages (Figure 5).⁹ Nonperforming loans for households have continued to decline throughout the period and have been significantly lower than for nonfinancial corporations. The euroization of corporate loans has increased raising credit risks, although stress tests conducted by the CNB suggest the unhedged portion does not raise systemic stability concerns.



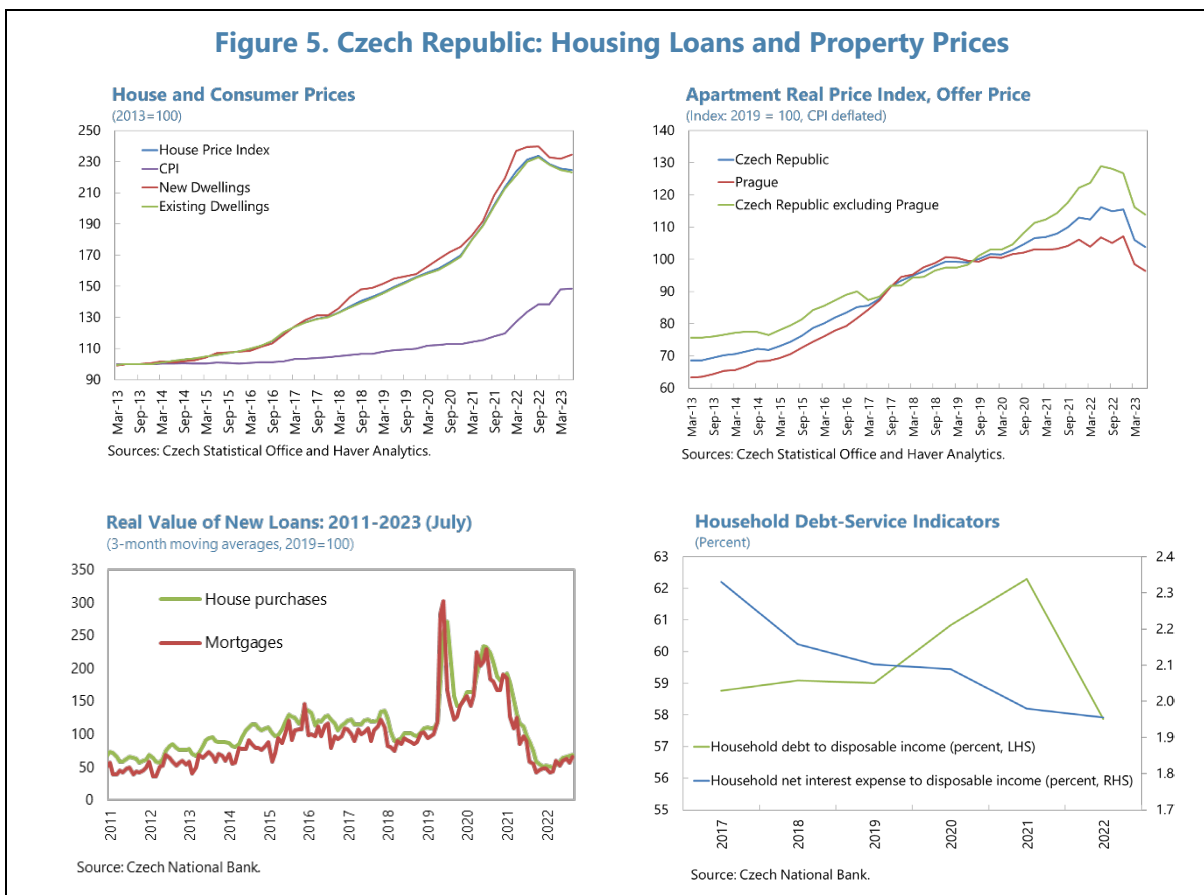
10. The financial system remains well capitalized, liquid, and profitable and fares well compared to its peers (Figure 6). The capital ratio in the banking sector is well above the regulatory requirement, and its Tier 1 ratio is relatively high by European standards. Liquidity has remained strong, as measured by the share of liquid assets in the balance sheet and a liquidity coverage ratio comfortably above the 100 percent minimum requirement. The strong reliance on domestic deposits for funding is reflected on a solid net stable funding ratio. Bank profitability has recovered and the return on equity of Czech banks fares well relative to its peers.

11. Systemic risk emanating from the corporate sector appears contained. While corporate leverage and the interest burden has tended to increase, profitability has improved on average for a large sample of firms, and corporate defaults remained subdued. The monetary policy tightening cycle has resulted in higher interest payments, especially since 2022 (Figure 14). Correspondingly, the interest coverage ratio has declined, but remains at a comfortable level.¹⁰ The return on equity varies sharply across firms, with the median and mean firm traded on the stock exchange showing a trend reduction, while the weighted average firm (by capitalization) has stabilized at a comfortable level and the one computed by the CNB from a broader sample has increased substantially. While the probability of default has increased, corporate loan defaults have remained contained, and the number of registered joint-stock firms has increased.

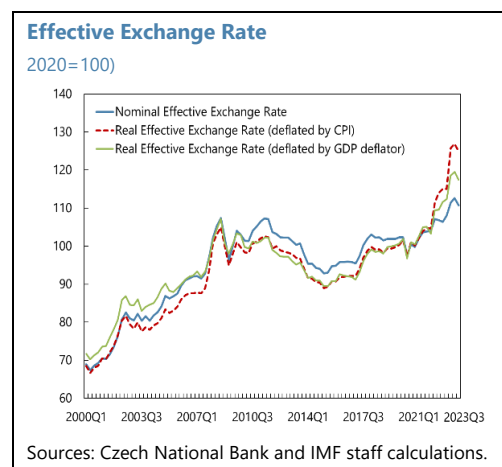
⁹ About 80 percent of the existing mortgages are above one-year maturities.

¹⁰ Defined as the ability to service interest payments out of current operations.

Figure 5. Czech Republic: Housing Loans and Property Prices



12. Staff assesses the external position in 2023 to be broadly in line with fundamentals and desirable policy settings. Amid the increase in export growth—as supply chain issues are being resolved—and subdued consumption and import growth associated with the decline in real incomes, the CA deficit continued to narrow to 3.9 percent of GDP at end-July 2023 (Figure 7).¹¹ The CA deficit is projected to continue narrowing, reaching a deficit of 0.9 percent of GDP by end-2023. Goods’ trade surplus has been the primary contributor in the CA balance improvement as inventories, transitorily built up when supply chains got disrupted, are being lowered and finished products are being exported. Staff assesses the external position in 2023 to be broadly in line with fundamentals and desirable policy settings, after including an adjustment for temporary supply chain disruptions (Annex I). The external debt is moderate and assessed to be sustainable (Annex IV).



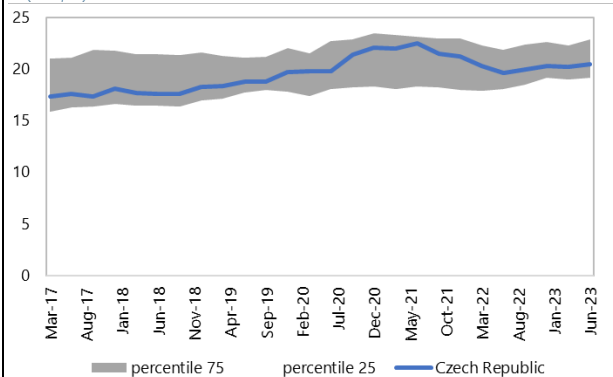
¹¹ Measured in 12-month rolling basis.

Figure 6. Czech Republic: Financial Sector Indicators Relative to European Peers¹

Capital adequacy ratios are solid...

Regulatory Capital to Risk-weighted Assets

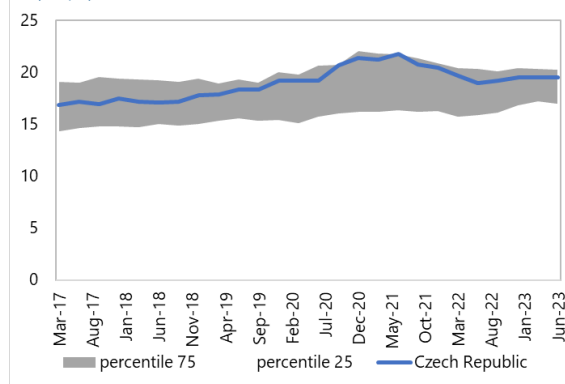
(EOP, %)



...especially with respect to Tier 1 capital.

Tier 1 Capital to Risk-weighted Assets

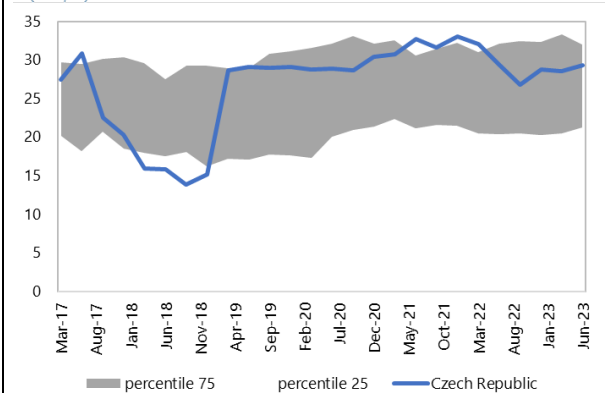
(EOP, %)



Liquidity is strong....

Liquid Assets to Total Assets

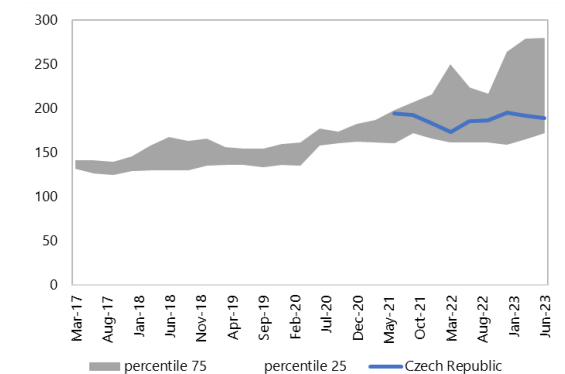
(EOP, %)



...with a relatively high liquid coverage ratio.

Liquidity Coverage Ratio

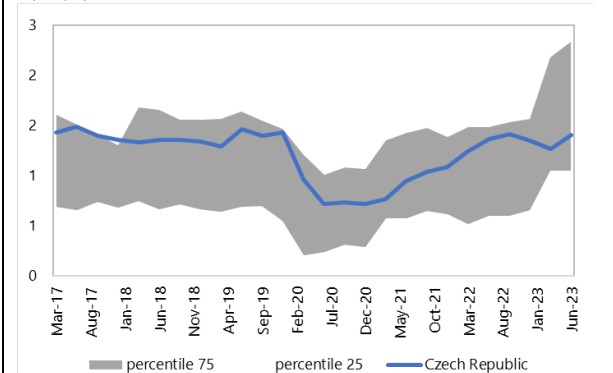
(EOP, %)



The system is profitable,

Return on Assets

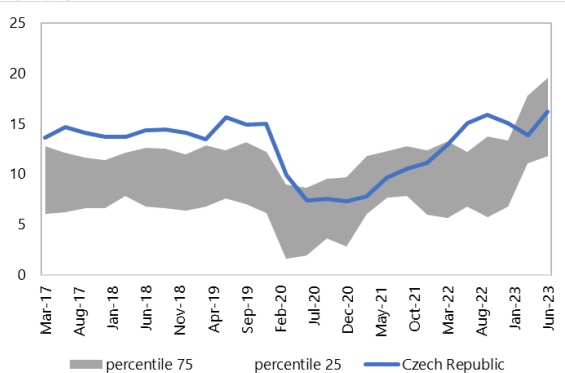
(EOP, %)



with relatively large return on equity.

Return on Equity

(EOP, %)

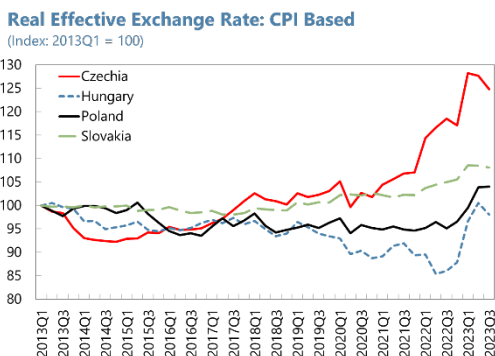


Sources: IMF, Haver Analytics and IMF staff calculations.

1/ The shaded areas correspond to the two center quartiles of the distribution of the corresponding indicators across countries in Europe for which the data is available for each observation.

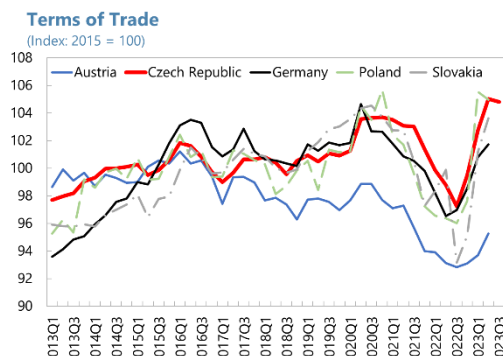
Figure 7. Czech Republic: External Position and Competitiveness

The REER appreciation slowed down relative to competitors...



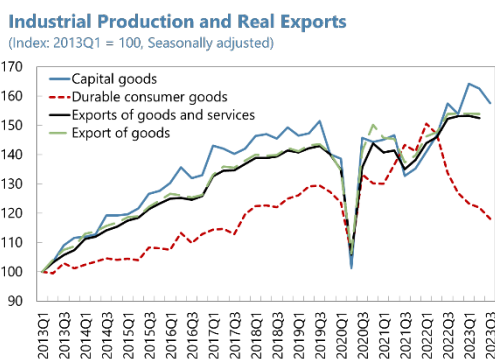
Sources: Czech Statistical Office, Haver Analytics and IMF staff calculations.

...as the terms of trade is back to pre-pandemic levels.



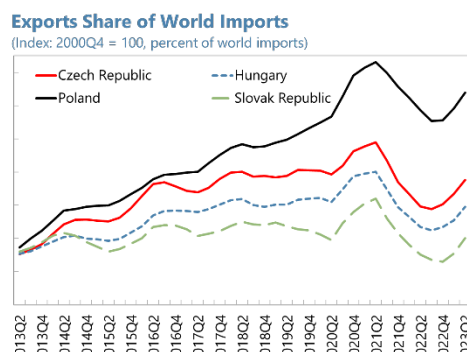
Sources: Czech Statistical Office and Haver Analytics.

Exports continue to recover after a sharp drop at the onset of the pandemic, ...



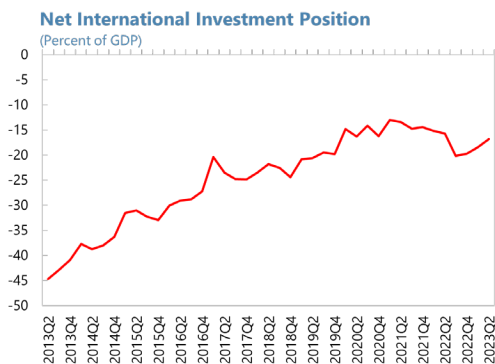
Sources: Czech Statistical Office and Haver Analytics.

...as Czechia exports share of world imports is slowly recovering relative to pre-pandemic levels and in line with peers.



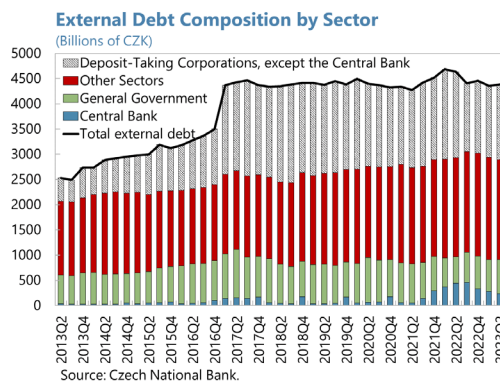
Source: Direction of Trade Statistics.

The NIIP remains at a comfortable level...



Sources: Czech Statistical Office and Haver Analytics.

...and external debt remained stable nominally.



Source: Czech National Bank.

OUTLOOK AND RISKS

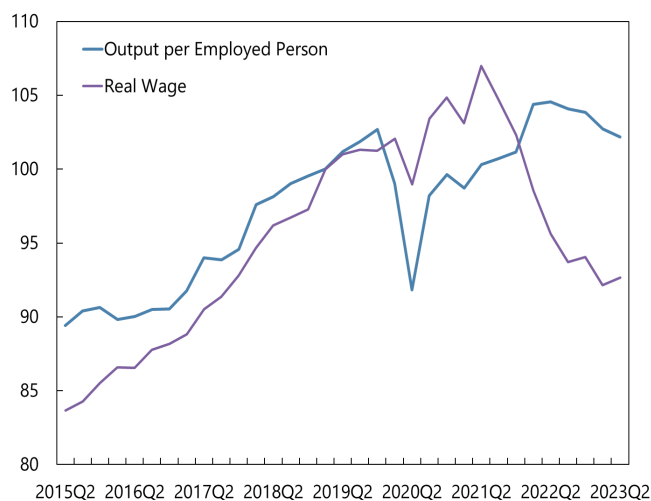
13. Growth is projected to pick up in 2024 driven by a recovery in domestic demand.

Growth is projected to increase to about 1.2 percent in 2024, mainly driven by a recovery of consumption and fixed investment, as inflation declines, and real wages recover (Figure 8).¹² Private investment is also expected to pick up speed as external demand recovers. Overall aggregate investment will be dampened by subdued public investment, mainly due to a gradual phase in of the new cycle of the EU investment and structural funds (2021-2027). Growth in net exports will continue to positively contribute to overall growth, with elevated unfulfilled orders continuing to be completed as supply disruptions ease.

The labor market is projected to marginally tighten in 2024, as economic activity improves, with the unemployment rate marginally decreasing to about 2.6 percent. Wage growth is projected to decline gradually as real wages catch up towards labor productivity and purchasing power is restored. However, staff projects the recovery in real wages and real unit labor costs to be matched by a compression in profit shares back to their pre-energy-shock levels, given recovering but still subdued demand levels, allowing the disinflation process to continue.¹³

Productivity and Wages

(Index, 20=100)



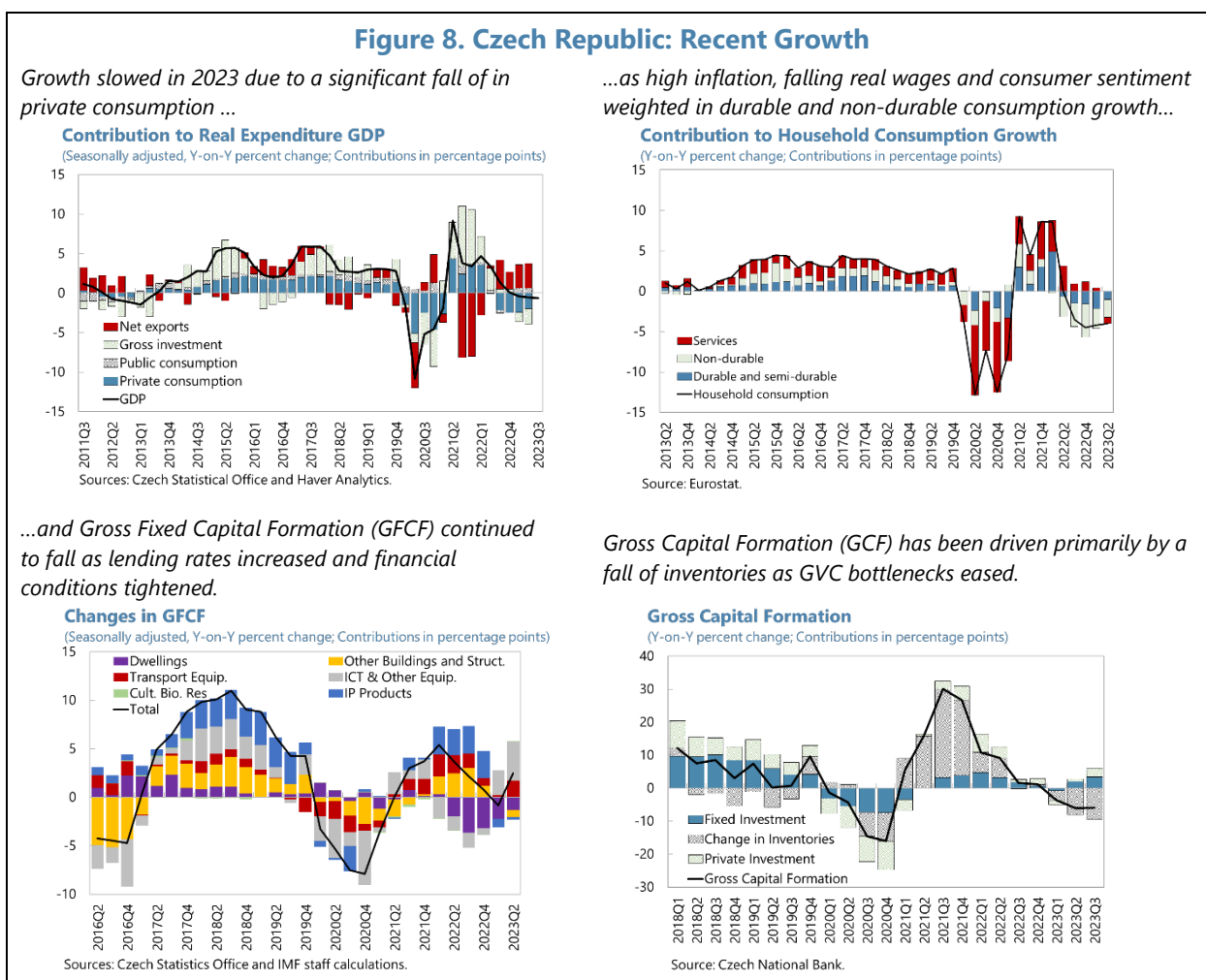
Sources: Czech National Bank and IMF staff calculations.

14. Inflation is projected to meet the CNB's target by early-2025. The ongoing disinflation reflects the diminishing impact of price shocks from commodity prices and a substantial decrease in domestic demand pressures. This is apparent in falling core inflation, which primarily reflects the dampening effect of the tight monetary policy stance. Continued drops in commodity prices (food

¹² Real wages have declined sharply relative to productivity since 2022.

¹³ The sharp increase in inflation last year eroded real wages well below productivity (as measured by output per worker), increasing profit margins. The increase in real wages envisaged for 2024, and the corresponding normalization in profit margins, would allow real domestic demand to recover and need not be inflationary because workers would be recovering some of their lost purchasing power, backed by output productivity. Despite the decline in profit margins, profitability would remain solid. Similar patterns are found in a paper using euro area data: [Euro Area Inflation after the Pandemic and Energy Shock: Import Prices, Profits and Wages \(imf.org\)](#).

and fuel) are expected to support a fall in administered price inflation (Figure 9).^{14, 15} As anticipated, the downward trend in headline inflation paused in 2023: Q4 due to a statistical base effect—reflecting last year’s drop in electricity prices caused by the government’s energy savings tariff. Once this base effect subsides, the decline in inflation is projected to resume. These projections, which consider information up to October 2023, are contingent upon inflation expectations remaining anchored.¹⁶ Uncertainty about this baseline is high.



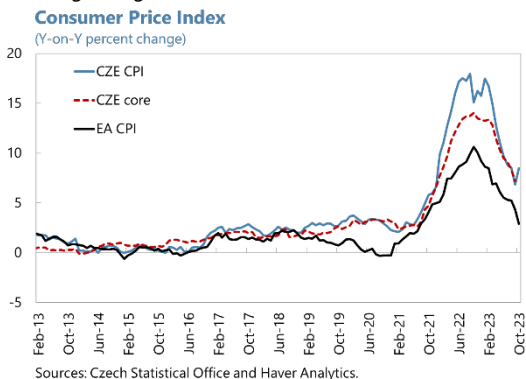
¹⁴ Continued drops in food and fuel prices are expected, based on agricultural commodity and energy prices on exchanges ([WEO October 2023](#)). The latter also supporting an anticipated fall in gas and electricity prices, which will reduce administered price inflation. The fall in administered prices is expected even after accounting for planned price increases due to the reintroduction of the fee for renewable energy, increase in energy distribution fees and increases in the VAT rate on selected goods and services. An annual increase of about 6 percent in administered prices is expected in January 2024, mainly due to the re-introduction of fees for transmission and renewable energy defined in the fiscal consolidation package.

¹⁵ Imputed rent index is calculated as index of costs on acquisition, increasing and maintenance of housing stock for owner occupied housing, including related services and taxes, paid by household. For more details, please check [Methodological note to consumer price index - imputed rentals - since November 2021, CZSO](#).

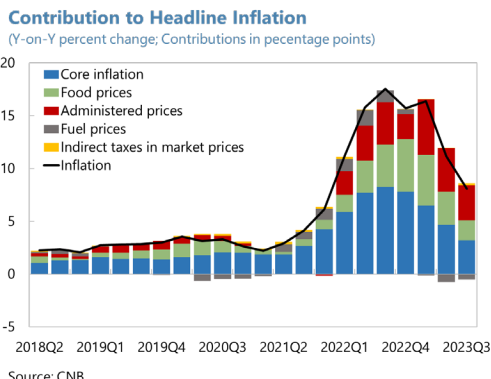
¹⁶ IMF staff estimates are based on a reduced-form model that features adaptive learning instead of rational expectations, as featured in Annex 2.7 of the October 2022 World Economic Outlook (WEO) based on Alvarez and Dizioli, 2023.

Figure 9. Czech Republic: Inflation

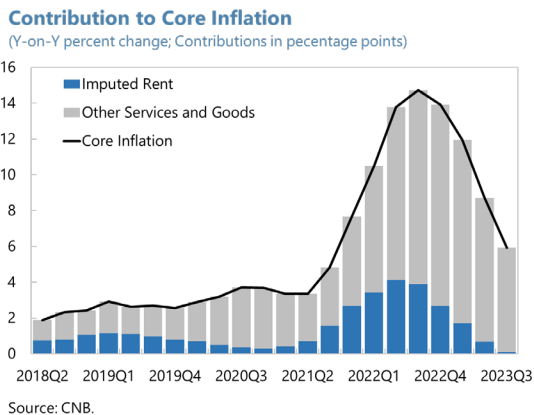
Inflation has peaked in July 2022, and started to decline rapidly since the beginning of 2023...



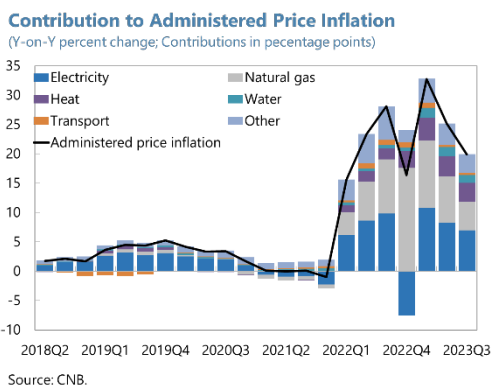
...core inflation, food prices and fuel prices are the main drivers of the disinflation.



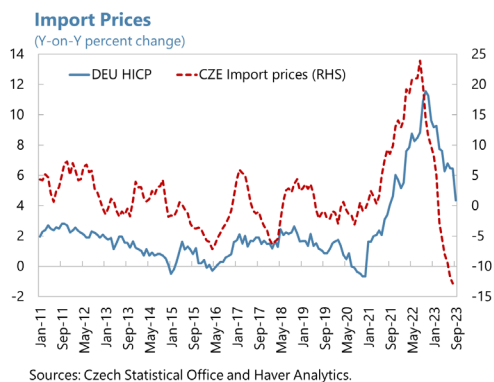
The decrease in core inflation has been driven by both imputed rents and other goods and services although inflation for the latter remain high, ...



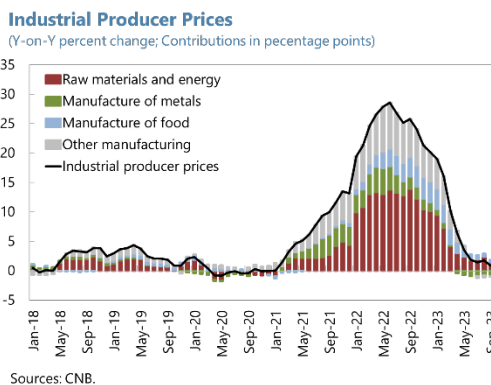
...while the decrease in administered prices has been driven by housing-related gas and electricity costs.



Import prices have been decreasing rapidly since the beginning of the year ...



...while producer price disinflation is broad-based.



15. Risks to the growth outlook are tilted to the downside. Spillovers from a weaker global outlook remain a downside risk. Economic activity and inflation could negatively be affected by a possible renewed surge in global energy prices, new supply chain disruptions or an increase in geopolitical tensions, and potential broader geo-economic fragmentation. Heightened global financial volatility due to stress in global financial markets could negatively impact pricing and availability of financing. While a low probability event, a disorderly house price correction could impair banks' and households' balance sheets—markedly tightening financial conditions—and adversely impacting aggregate demand (Annex II GRAM). While vulnerabilities in the financial sector exist (Section D), financial stability risks appear contained amid strong buffers and profitability of the banking sector.

16. Risks to inflation are tilted to the upside. These relate to inflation expectations becoming untethered—against the backdrop of high inflation, a tight labor market and the currently elevated but declining saving rate. Inflation expectations have been decreasing but remain above the inflation target. Moreover, inflation pressures could also arise from strong wage growth and a failure of profit margins to compress rapidly in an environment of recovering growth, resulting in stronger repricing of goods and services. Also, inflation expectations could rise if new global energy or commodity price shocks arise or if the expected increase in administered prices reverses the downward inflation momentum.¹⁷ Additionally, an abrupt return of the household saving rate to near long-term average levels could boost household consumption and heighten demand driven inflationary pressures. A falling differential in policy rates vis-a-vis major central banks or geopolitical shifts in regional sentiment could exert depreciation pressure on the koruna and add to inflationary pressures. On the other hand, a slower recovery than expected in the baseline or an unexpected significant fall in global demand could accelerate the convergence of inflation to the target. An alternative downside scenario based on these risks illustrates likely policy responses (Annex VII).

Authorities' Views

17. The authorities broadly agreed with staff's assessment of the outlook and risks. They envisage the economy contracting in 2023 and growth gradually strengthening in 2024 to about 2.5–3 percent in 2025, while headline inflation is expected to fall substantially in early 2024. They agree that a weaker global outlook, a renewed surge in global energy prices, and an increase in geopolitical tensions are key risks to the outlook, which are tilted to the downside for growth and to the upside for inflation.

¹⁷ As part of the fiscal consolidation package (Section B), the government will withdraw its subsidies towards renewables and electricity transmission at the start of 2024. The resulting higher corporate energy costs could be reflected in higher repricing in January.

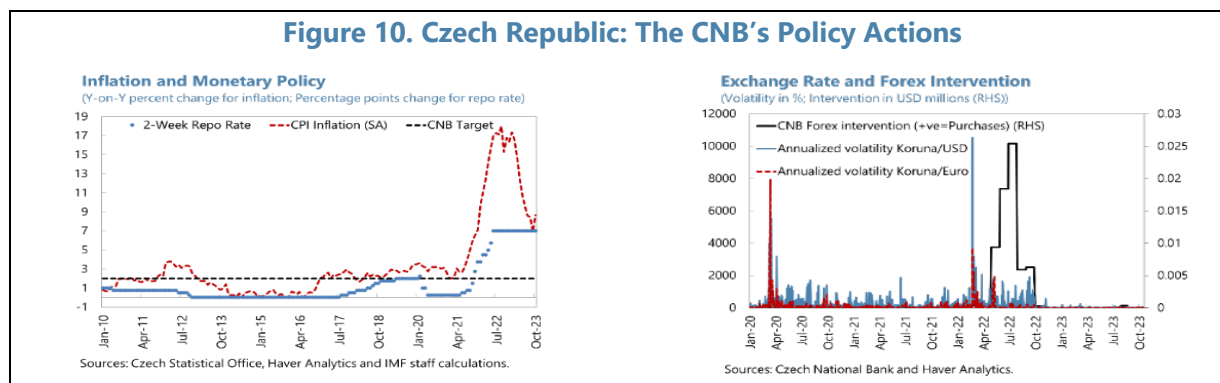
POLICY DISCUSSIONS

Policies must focus on bringing inflation to target, replenishing fiscal space, and maintaining macro-financial stability, all the while keeping flexibility in the face of high uncertainty. Efforts to enhance productivity is paramount in the face of population aging and structural shifts.

18. The overall macroeconomic policy mix is broadly adequate. A sufficiently tight monetary policy stance needs to be maintained for some time to ensure a timely return to price stability. The planned fiscal consolidation in 2024 will aid the disinflation process while helping to rebuild fiscal space. Macroprudential policies overall seem broadly adequate. However, the debt-service-to-income and debt to income limits should be reactivated to ensure responsible practices in mortgage lending.¹⁸

A. Monetary Policy

19. Amid falling inflation but with risks tilted to the upside, the CNB has kept the policy rate at 7 percent (Figure 10).¹⁹ The CNB regarded the current settings of the monetary conditions as appropriate for inflation to return to the inflation target by early-2025. Given upside risks to inflation assessed by the CNB—which are broadly consistent with risks assessed by staff—staff agrees with the CNB’s call for caution with regard to easing monetary policy and their support for keeping rates at the current level for longer than implied by the baseline scenario of the CNB’s current forecast.^{20, 21} Recently the koruna weakened against the Euro, but as of October 2023 remained 1.2 percent above its level one year ago.



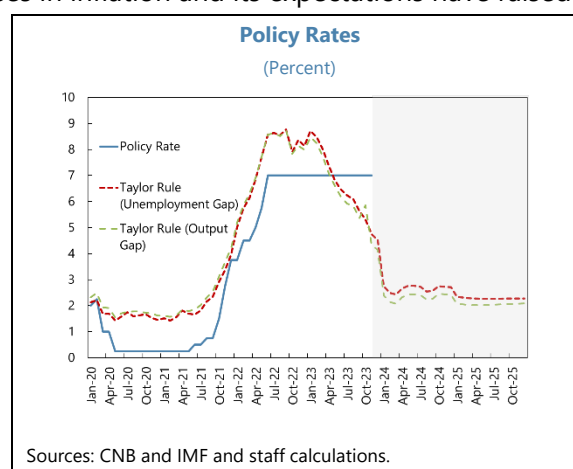
¹⁸ A summary of the authorities’ response to past IMF recommendations is included in Annex V.

¹⁹ The CNB began increasing its policy rates in June 2021, starting at 0.25 percent, and reaching 7 percent by June 2022.

²⁰ In addition to the baseline scenario which implies a gradual decrease in interest rates since 2023: Q4 onwards, the CNB also presents a risk scenario. It assumes a stronger increase in the inflation momentum following the adjustment of administered prices in January (expected to amount to 10 percent in the month) with an impact of 1 percentage point on annual inflation rate. The inflation dynamics change because of the stronger increase in the momentum. Under this risk scenario, the policy rate should be kept at the current level for longer until the end of 2024: Q1, to ensure the inflation rate close to target within the policy horizon of 12-18 months.

²¹ The CNB also communicated that forthcoming monetary policy decisions will be based on their forecasts and assessments of newly available data, including evaluations of the persistence of the disinflationary trend, analyses of labor market pressures, and the evolution of domestic and external demand. In previous months, with positive interest rate differentials, especially with the ECB, the koruna strengthened.

20. Given high uncertainty on the persistence of inflation, staff recommends maintaining a tight monetary policy stance until there is firm evidence that inflation is on course to converge to target. At this stage, overestimating the persistence of inflation and erring on the side of overtightening policy would be less costly than underestimating the degree of persistence and delivering too little tightening, as the latter could lead to an upward drift in inflation expectations and require a sharp further tightening in monetary policy later. Although the policy rate has remained unchanged since June 2022, recent decreases in inflation and its expectations have raised the ex-ante real policy interest rate and tightened the monetary policy stance.²² Given heightened profit shares, the ongoing recovery in real wages can be absorbed by firms without adding significant upward pressure on prices, allowing the disinflation to continue. This will require, however, aggregate demand to remain contained. In the absence of sharp downside surprises in inflation, staff advises to maintain a tight monetary policy stance²³—by keeping the nominal policy rate broadly unchanged through early 2024—to consolidate the disinflation process and provide insurance against a costly de-anchoring of inflation expectations.²⁴ Thereafter, the nominal policy interest rate could be lowered cautiously and gradually, consistent with the expected decline in inflation, with a pace that could be accelerated if inflation expectations align faster to the target than envisaged. Given high uncertainty around the path of commodity prices, wages, profits, and inflation, a data-driven, meeting-by-meeting approach to determine the interest rate path remains essential.



21. Staff highlight risks of raising the unremunerated minimum reserve requirement (MRR) from the current level under present circumstances. Partly given concern about the increase in central bank losses related to monetary policy tightening, the CNB decided to stop remunerating the mandatory minimum reserve requirements (2 percent of the deposit reserve base) effective October 2023.²⁵ Unremunerated minimum reserves requirements may impede banks' capital accumulation, restrict their credit provision, weigh on macro-financial stability, and reduce the predictability of monetary policy transmission. They also may signal that the CNB's balance sheet policies are set with a view to its own finances rather than its core mandate.

²² Staff estimates the monetary policy stance—calculated as the nominal interest rate discounted by 1-year-ahead inflation expectations minus the real neutral rate in the steady state—at about 2.6 in October 2023. Staff estimates the real neutral rate at 1.5 percent. These estimates are surrounded by much uncertainty but are in line with market expectations, survey of analysts, and ECB staff estimates.

²³ For example, relative to the stance implied by a simple Taylor Rule.

²⁴ The interest rate path suggested by Taylor Rule estimations imply rates lower than 7 percent since May 2023 with rates increasing steadily to about 2 percent by end 2024. The estimation for October 2023 is around 6.4 percent.

²⁵ See, press release: [CNB ends remuneration of minimum reserves](#). In September 2023, in addition to the mandatory reserve requirements, banks voluntarily held on average about 44 percent of the deposit reserve base at the central bank, primarily in the form of sterilization deposits, remunerated as a function of the policy rate.

22. The flexible exchange rate arrangement has served Czechia well. It has played the role of shock absorber, helped stabilize the economy, and contributed to the transmission of monetary policy. The central bank has not conducted foreign exchange market operations to affect the exchange rate since October 2022, but resumed its program of sales of part of the income on international reserves in August 2023, with the explicit mandate to execute transactions with minimal impact on the exchange rate.²⁶ Although the CPI-based real exchange rate has appreciated by about 25 percent since 2019, other real exchange rate indicators computed from unit labor costs, producer price indices, and deflators deliver a smaller appreciation. In staff's external sector assessment, the current-account-based real exchange rate gap is assessed to be broadly in line with fundamentals and desirable policy settings (Annex I).²⁷ Staff supports that the central bank has limited its presence in the foreign exchange market this year.

Authorities' Views

23. The CNB noted that under the current tight monetary policy stance, inflation rates exhibited a rapid decline in 2023. However, the Bank Board assessed the risks of the forecast as being significant and tilted to the upside. Still elevated inflation expectations, which could manifest themselves in stronger repricing of goods and services at the start of next year and in wage bargaining pressures not absorbed by declining profit margins are the main risks. The Bank Board indicated it would take a cautious, gradual, and data-driven approach to start reducing interest rates.

B. Fiscal Policy

24. The draft 2024 budget aims at consolidation. The budget targets an overall general government fiscal deficit of 2.2 percent of GDP in 2024, a considerable reduction from the 2023 budget target of 3.6 percent.²⁸ The consolidation is based on the streamlining of government operations, cuts to the public sector wage bill, as well as measures previously recommended by staff (Table 1). These comprise among others the removal of subsidies for business entities and increases of taxes, including the corporate income tax rate, excise taxes on alcohol, tobacco, and gambling. Another key aspect of the package is the streamlining of the value-added tax (VAT) structure and the re-introduction of the contribution of employee sickness insurance at the rate of 0.6 percent.²⁹

²⁶ See press releases: [CNB keeps interest rates unchanged](#), and [CNB resumes sales of part of income on international reserves](#).

²⁷ The Czech Republic has a relatively deep foreign exchange market and fairly well-established inflation targeting framework that helps anchor inflation expectations around the inflation target over the monetary policy horizon. The IMF's integrated policy framework (IPF) outlines country characteristics, including financial frictions and vulnerabilities, and the nature of shocks that could warrant the use of foreign exchange intervention ([IMF 2020a](#), [2020b](#)).

²⁸ This deficit also embeds a reduction of the state budget deficit, which in 2024 targets CZK 252bn (3.3 percent of GDP) compared to a deficit target of CZK 295bn in the 2023 budget (4.0 percent of GDP).

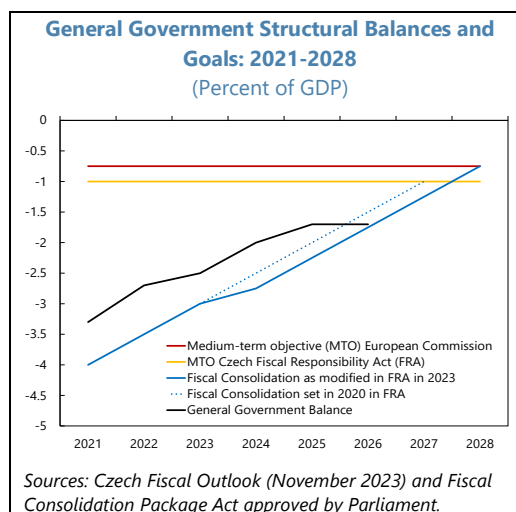
²⁹ From 2024, there should be two rates, the current 2.1 percent paid by the employer and a new 0.6 percent paid by the employee. The motivation for this measure is to eliminate the imbalance in the health insurance system, which

(continued)

25. Fiscal plans for 2024 appropriately emphasize consolidation, but fiscal policy should remain flexible given the uncertain outlook. In cyclically adjusted terms, staff projects the fiscal deficit to contract by 1.3 percent of potential GDP. The contractionary stance is appropriate to support disinflation efforts, with the output gap set to nearly close in 2024. However, given uncertainty on the growth outlook, it is prudent to allow automatic stabilizers to operate. Staff assesses there is substantial fiscal space.

26. Over the medium-term, fiscal policy is guided by Czechia’s fiscal responsibility act (FRA), which sets a minimum fiscal consolidation path that delivers a sustainable debt-to-GDP ratio and a low prudent fiscal balance. During the pandemic, fiscal balances were allowed to deviate from the medium-term objective (MTO) in the FRA, with a clear fiscal consolidation path back to target. In line with this, staff’s baseline envisages a debt-to-GDP ratio of 42.5 percent and a structural balance of -0.8 percent of potential GDP by 2028, which is consistent with the MTO—a structural balance of -0.75 percent of GDP.

Czechia is at a low overall risk of sovereign stress; hence, reaching the MTO by 2028 will contribute to keeping debt sustainable over the medium term (Annex III). The November 2023 fiscal outlook identifies measures through 2025, but reaching the -0.75 percent of GDP MTO—as envisaged in the fiscal consolidation path in the FRA—would require identifying additional consolidation measures to reduce the structural deficit by ½ a percentage point of GDP in 2027–28.



has been affected by the rate cuts in 2009 and 2019, and by the additional costs of benefits such as paternity or care leave. In 2009, the employee contribution was unsystematically abolished. In 2019 the rate paid by employers as compensation for the cancellation of the waiting period was reduced. Since then, the health insurance account has shown a negative balance.

Table 1. Czech Republic: Fiscal Consolidation Measures, 2024–25

Measure	Expected gain (loss)				Explanation
	2024		2025		
	CZK bn	Percent of GDP	CZK bn	Percent of GDP	
Revenue	65.0	0.8	8.0	0.1	
Value added tax	-2.7	0.0	0.7	0.0	Higher VAT on products with higher excise taxes. Consolidation of reduced VAT rates-10 percent and 15 percent rates-into a single 12 percent rate.
Excise tax	5.7	0.1	3.2	0.0	Higher rates on fuels, tobacco, alcohol
Gambling tax	1.1	0.0	0.0	0.0	Rate increase from 23% to 30%
Real estate tax	10.0	0.1	0.6	0.0	Increase in the real estate tax to approximately 1.8 times, with a variable coefficient ranging from 0.5-1.5 depending on the type and usage of land.
Corporate income tax	21.9	0.3	0.0	0.0	Increase the corporate income tax rate by 2 pp to 21 percent
Personal income tax	8.2	0.1	0.3	0.0	Reduce the threshold to 36 times the average wage from 48. The income tax rate currently stands at 15 percent, with the marginal tax rate of 23 percent applied for annual incomes above 48 times the average wage. Thus implying a wider range of wealthier households would pay the higher personal income tax.
Social security contributions	21.5	0.3	3.0	0.0	Increase of employee-paid sickness insurance by 0.6 pps
Other ^{1/}	-0.7	0.0	0.1	0.0	
Expenditure	49.0	0.6	16.0	0.2	
Public sector wages	12.0	0.2	-0.1	0.0	Fiscal consolidation measures
Savings in interest costs due to a lower deficit	0.0	0.0	4.5	0.1	Fiscal consolidation measures
Reduction of national subsidies	31.6	0.4	8.7	0.1	Removal of subsidies not linked to their original objective of reducing social, regional, health and many other inequalities.
Other ^{2/}	4.9	0.1	2.6	0.0	
Total	114.0	1.5	24.0	0.3	

Source: Ministry of Finance.

1/ Includes Increase in the fee for the extraction of minerals (with an increase for black coal); Increase in the price of the motorway vignette and its valorization; other items especially Others (esp. the impact of the reduction in the volume of salaries on revenues)

2/ Includes Change in the terms of payment of unemployment benefits; Reduction of building savings support for existing contracts by 50 percent; and Intermediate consumption (state operation and termination of customs offices)

27. In the medium and long term, spending pressures will increase to facilitate economic transformation toward a green digital economy and address the impact of population aging.

The economic challenges of global technological shifts and population aging calls for structural reforms, investments, and efforts to ease the reallocation of labor and capital (Section E). The structural transformation may entail a heavy burden on some segments of the population, requiring social safety net support. Public sector infrastructure will need to be adapted to accommodate clean energy initiatives and digitization. To ensure a skilled workforce aligned with emerging activities, active labor market policies (ALMP) and ongoing education system reforms will be imperative. The aging population will give rise to a pension funding gap in the long-term. For intergenerational fairness and to avoid disruptive fiscal adjustments, the actuarial deficit of the pension system would call for higher general government structural balances than the currently targeted MTO. Also, an additional buffer is warranted to protect against future shocks and fiscal risks.

28. Although EU funds will cover part of the forthcoming spending pressures, additional fiscal measures will be required. These should include growth-friendly tax measures, reprioritization of spending and improved spending efficiency. Staff recommends the following measures:

- **As the recovery takes hold, ensure that the PIT and real estate related taxes deliver pre-pandemic tax revenue as a percentage of GDP.** This would yield above 1.5 percent of GDP.³⁰ It is crucial to note that the reduction of the PIT was originally presented as a temporary measure.
- **Further advance pension reform.** Staff welcomes recent regulatory reforms to the pension system. These initial steps need to be complemented with additional reforms to improve the long-term sustainability of the pension system, including the linking of retirement age to life expectancy.

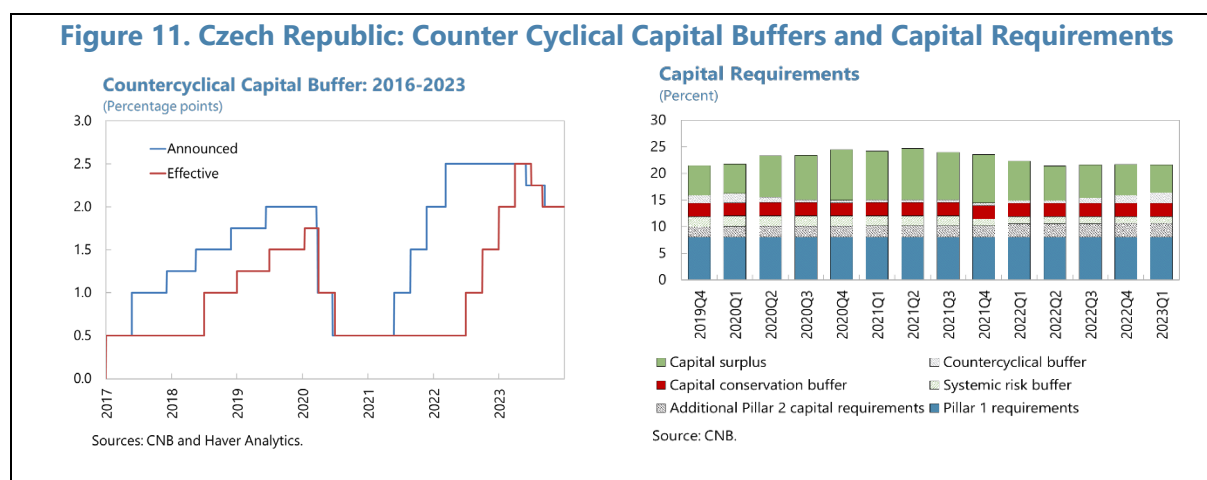
Authorities' Views

29. The authorities concurred with the need for further fiscal consolidation over the medium-term. They noted that the fiscal effort is frontloaded in 2024–25 and that additional measures will be needed to reach the MTO by 2028. They agreed that long-term pressures from aging-related spending require further reforms to the pension system and acknowledged the need for additional public spending to facilitate the transformation toward a green digital economy. They argued that making changes to the PIT regime to recover pre-pandemic tax revenues would be politically challenging.

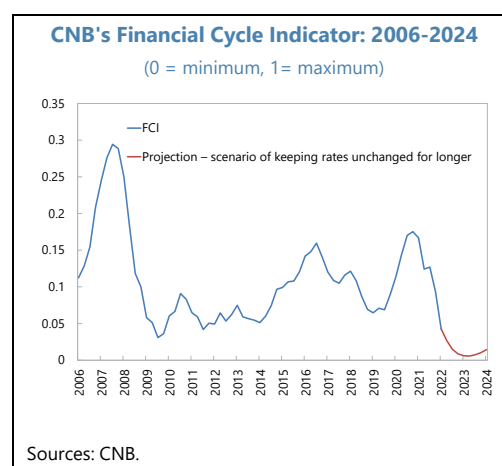
³⁰ See 2022 IMF Article IV Consultation [Country Report No. 2023/031](#).

C. Macroprudential Policy

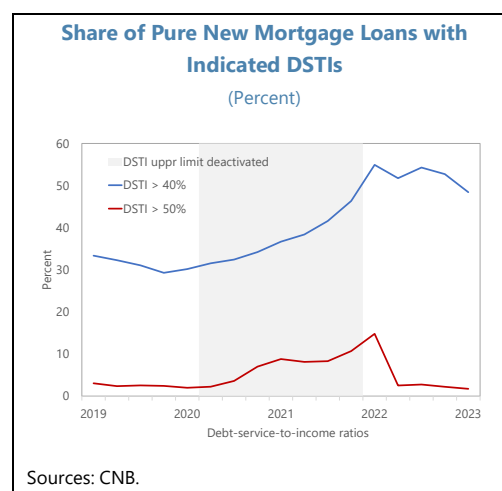
30. Macroprudential policy has been recalibrated. Between June 2022 and April 2023, the CNB raised the Countercyclical Capital Buffer (CCyB) by 200 basis points—to a maximum level of 250 basis points, as had previously been announced (Figure 11). However, between July and September 2023, the CNB released the CCyB by 50 basis points in two steps, partly because the financial conditions were tighter than envisaged when the increases were announced. The net increase in the CCyB did not lead to higher capital levels, which were comfortable, but reduced the surplus over regulatory requirements (Figure 11, right panel). In addition, while keeping the upper limits of Loan-to-Value (LTV) unchanged, the CNB removed the Debt-Service-to-Income (DSTI) and the Debt-to-Income (DTI) limits in June and November 2023, respectively, based on concerns that the rising interest rates made them binding for a larger share of possible borrowers. The deactivation of the DTI limits will be effective in early 2024.



31. Staff assessed the current level of the CCyB as appropriate and cautioned against further reductions. The monetary policy tightening, together with the deployment of macroprudential instruments, helped arrest and later reverse the expansionary phase of the cycle. CNB's estimates, confirmed by the recent evolution of new real mortgage loans, suggest that the cycle would be well below historical average levels. Staff's analysis of the financial conditions (FCs), which have become tight, is consistent with these views. The reduction in risks arising from the real estate market also suggest that capital requirements need not be as high as had been envisaged a year ago. Moreover, even with the recent relaxation, at 200 basis points, the CCyB requirements in the Czech Republic are among the three highest in Europe. The remaining uncertainty in the outlook suggest caution, however, in further reductions in the CCyB.



32. The loan-to-value limits remain appropriate, but the debt-to-income and debt-service-to-income limits should be reactivated. The implementation of borrower-based measures has contributed to responsible lending practices and lowered the systemic risk in the banking sector (Figure 12). With the reintroduction of the borrower-based measures, which were deactivated between July 2020 and November 2021, the distribution of mortgage borrowers in banks' balance sheets moved toward lower levels of risk. Although the increase in policy rates and its transmission toward lending rates made the debt-service to income level requirements more binding, deactivating the upper limit allows banks to provide potentially riskier loans from a DSTI perspective. Deactivating the DTI add another dimension to the level of borrower risk. Staff therefore recommends reinstating these instruments, and going forward, recalibrating and improving its design, including by legislative changes, rather than its deactivation and reactivation.



Authorities' Views

33. The authorities highlighted that risks to financial sector stability have declined. With the financial cycle well below its median level and subdued new credit activity, the macroprudential policy stance could be prudently relaxed. They noted that although the CCyB has been relaxed from its peaks, it remained among the highest in Europe. They argued that the temporary deactivation of the DSTI and DTI would not lead to any substantial systemic risk given the low levels of new credit activity, the backstop of the remaining LTV, and prudent credit allocation by banks supported by risk-based capital requirements.

D. Financial Sector Policies

34. Staff assesses that the banking sector is broadly resilient. Financial sector indicators point to a well-capitalized, liquid, and profitable banking system compared to its European peers. Asset quality remains strong, as measured by the declining trend in nonperforming loans, although the evolution of loans in stage II needs to be closely monitored. Staff welcomes the improvements in supervisory risk measurement for sectoral/individual exposures and reiterates the importance of further progress in this area.

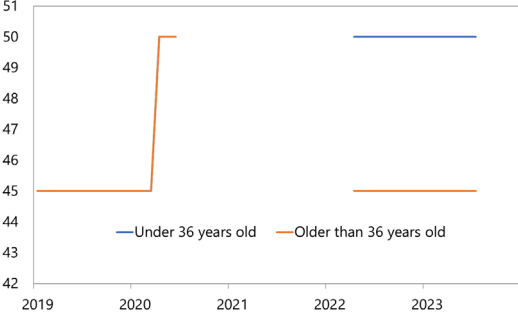
35. Nevertheless, pockets of vulnerability remain and require close monitoring.

- The risks associated to the increase in the euroization of corporate loans needs to be carefully scrutinized. The share of the stock of foreign currency loans to corporations has increased to about 50 percent of the total corporate loan portfolio despite real exchange appreciation. Although this has been followed by an increase in banks derivative asset and liability positions, foreign currency exposures in percent of capital remain contained (Figure 13).

Figure 12. Czech Republic: Borrower-Based Macprudential Measures

The debt service to income ratio was deactivated again in July 2023.

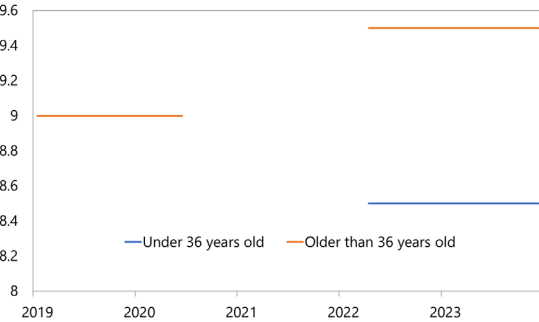
Debt-Service-to-Income Ratio Upper Limit
(Percent of net monthly income on debt service)



Source: CNB.

The debt-to-income ratio has remained in place, unchanged since its reinstatement in 2022.

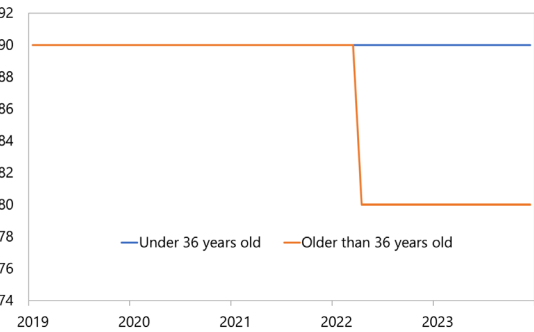
Debt-to-Income Ratio Upper Limit
(Multiple of net annual income)



Source: CNB.

The LTV ratio has remained in place, unchanged for borrowers under 36 years old since before the pandemic

Loan-to-Value Ratio Limit
(Percent size of the loan relative to the value of the pledged property)

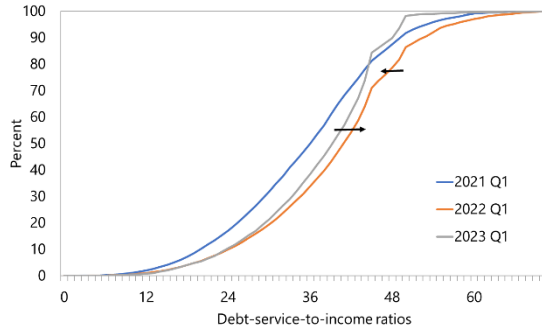


Source: CNB.

Sources: Czech National Bank and IMF staff calculations.

It had been effective in reducing the share of borrowers under higher risk.

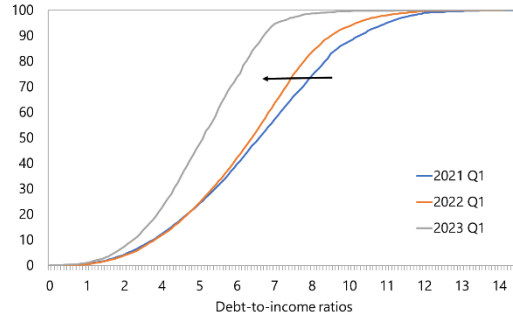
DSTI Cumulative Distribution of Mortgage Loans
(Percent)



Source: CNB.

... helping shift the distribution of borrowers towards those with greater repayment capacity.

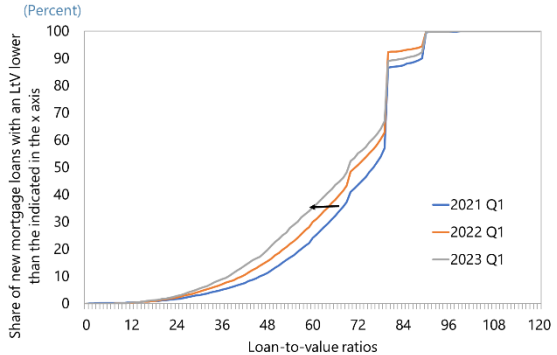
DTI Cumulative Distribution of Mortgage Loans
(Percent)



Source: CNB.

... also leading to a safer distribution of borrowers.

Cumulative LTV Distribution
(Percent)



Source: CNB.

The ability of corporate borrowers to repay in the context of an exchange rate realignment, and the ability of counterparties to derivative transactions to honor their obligations, need to be periodically assessed in determining the riskiness of these exposures. Staff welcomes the incorporation of these risks into the CNB's financial stability analysis, and the assessment of these exposures in banks risk positions subject to capital requirements. Although stress tests suggest that these risks are not systemically important, close monitoring of the related credit, exchange rate, and counterparty risks, including in derivative transactions, are warranted.

- Since the pandemic, the banking sector direct risk exposure to the treasury increased but remains contained. However, indirect exposure also increased through households and corporates. Over this period, the financial net worth of households and firms improved significantly, which partly explains at times their ability to consume above their income by reducing their stock of savings during the pandemic. The counterpart to this risk, however, is the deterioration in the net worth of the general government and the central bank. Maintaining the strength of household and corporate balances sheets, and the financial sector, ultimately depends on the ability of the treasury to honor its obligations and maintain the country's low sovereign risk. While sovereign risk is low at present, exposures need to be monitored.
- Although risks from real estate exposures have diminished, they require continued monitoring. The evolution of loan quality over the cycle, and possible nonperforming loans down the line, need to be managed.
- As in all countries, the preparation for contingent cyberattacks to the financial sector is warranted given the exposure to this risk.
- Stress tests conducted by the CNB indicate that vulnerabilities in the non-bank financial sector (NBF), commercial and residential real estate sectors are contained and do not give raise to financial stability risks. Moreover, the NBF remains relatively small, accounting for about 20 percent of the financial sector.

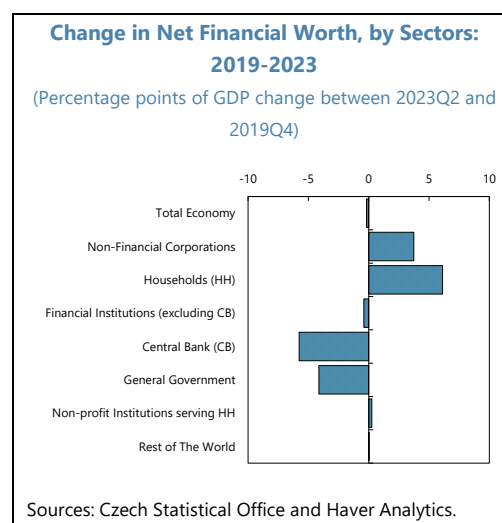
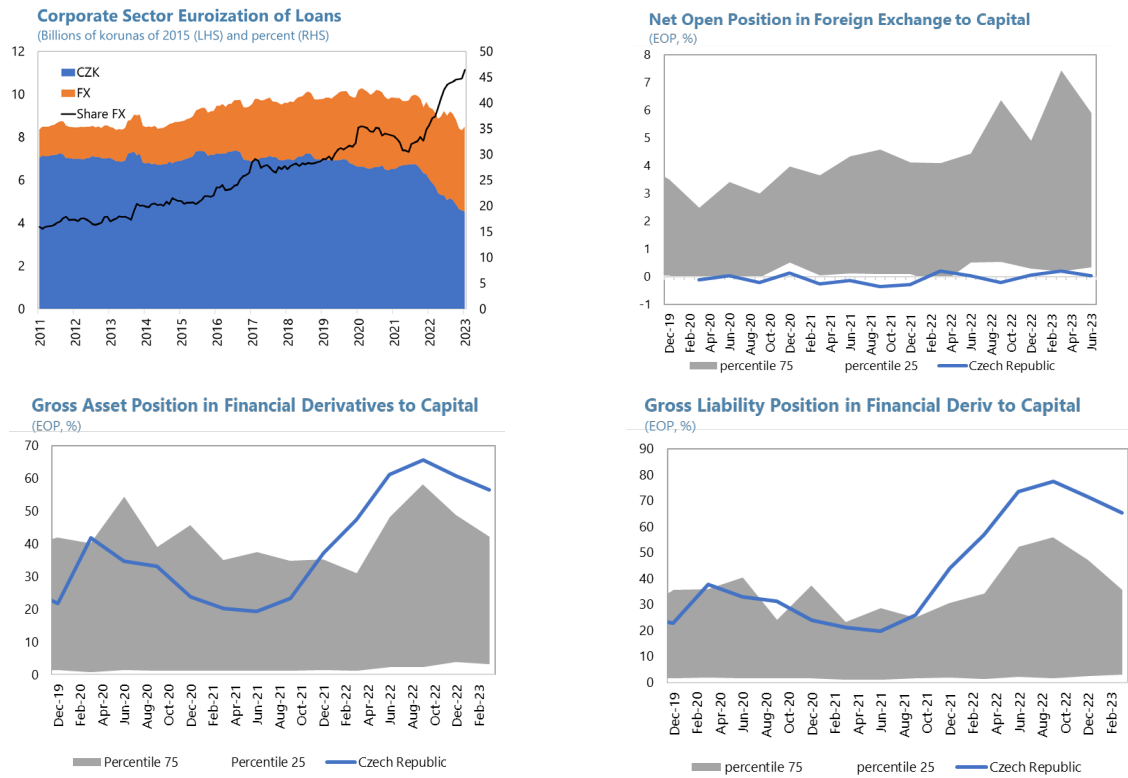


Figure 13. Czech Republic: Managing Risks in the Euroization of Corporate Loans



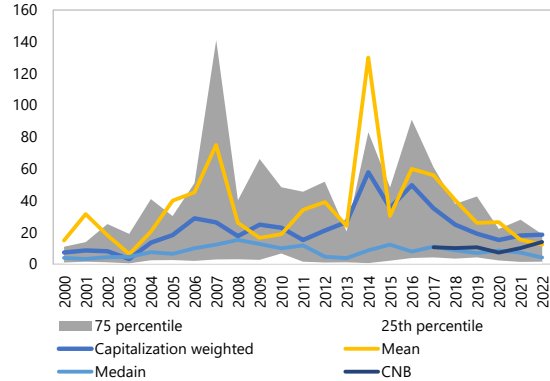
Sources: CNB, IMF's Financial Soundness Indicators Database, and Haver Analytics. For Czech net open foreign exchange positions, data provided by CNB on bank US dollar and euro exposures.

Figure 14. Czech Republic: Corporate Sector Indicators

The (size-adjusted) profitability of tradable firms has improved but remains subdued in the median firm.

Return on Equity

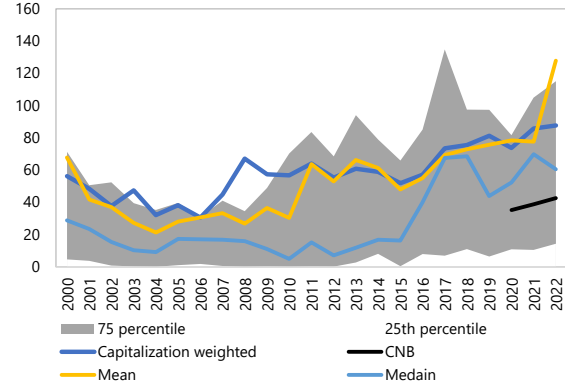
(Percent)



Leverage has tended to increase over time as measured by the debt-to-equity ratio.

Debt-to-Equity Ratio

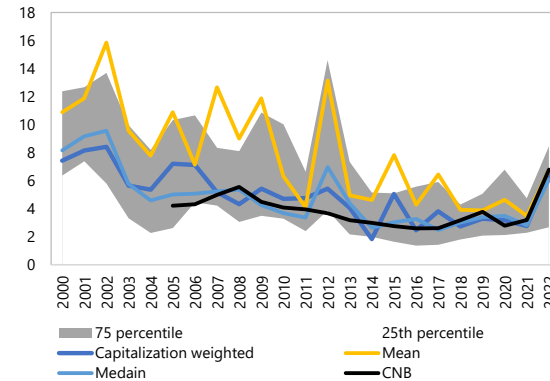
(Percent)



The increase in average interest rate paid by firms has tended to increase recently with monetary tightening...

Estimated Average Interest Rate

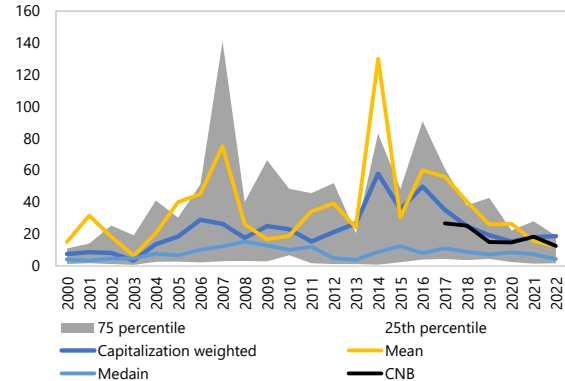
(Percent a year)



... and tended to reduce the comfortable interest coverage ratio.

Interest Coverage Ratio

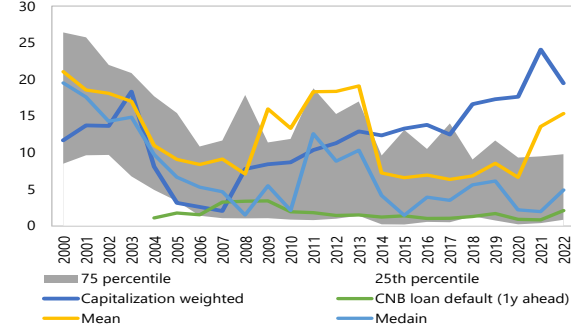
(Percent)



The probability of default as derived from Altman Z-scores has tended to increase in the size-weighted firm.

Probability of Default

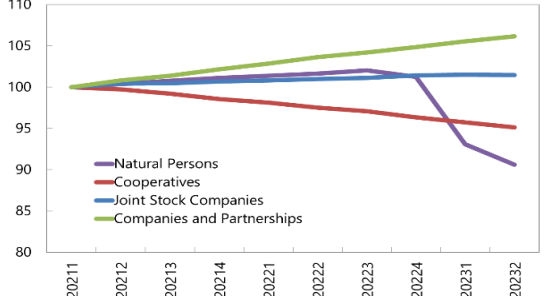
(Percent, from Cumulative Logistic Distribution of Altman Z-score)



While the number of registered companies and partnerships has continued to grow, there has been a decline in natural-persons firms and cooperatives.

Registered Firms

(2021Q1 = 100)



Sources: IMF's Corporate Vulnerability Indicators, CNB, and Haver Analytics.

The IMF's Corporate Vulnerability Indicators database covers firms traded in the stock exchange. The CNB indicators are averages from a sample of 1700 nonfinancial firms. CNB loan default rates are actual through 2002Q3 and forecasts thereafter.

36. Continued efforts are needed to safeguard the financial and real-estate sectors from money laundering risks and cross-border illicit financial flows. The authorities are encouraged to use the analysis of financial flows data to enhance the understanding of cross-border risks. Obtaining information on beneficial ownership of Czech real-estate, addressing regulatory gaps related to financial intermediaries, and increasing STR reporting by real-estate intermediaries is important. Efforts to reduce the transnational aspects of corruption need to continue (Box 1).

Authorities' Views

37. The authorities noted that the financial system remains sound. They stressed that capital and liquidity buffers are at comfortable levels to withstand adverse shocks and that banks have remained profitable and nonperforming loans contained. They noted that risks in housing markets have declined, and that households' gross disposable incomes had recovered relative to housing prices and should be able to absorb repricing of fixed interest-rate mortgages in the coming years. On AML/CFT issues, the authorities indicated they obtain transactional data from banks for understanding cross-border risks.

Box 1. Transnational Aspects of Corruption¹

Although foreign bribery risks are relatively contained, further efforts are needed. None of the 500 largest multinational enterprises (MNEs) is headquartered in Czech Republic and the scale of foreign direct investment is relatively not significant.² Czech Republic has taken efforts to enhance detection of foreign bribery and published guidance on corporate liability. In addition, the authorities reported that the Whistleblower Protection Act came into force in August 2023. A bill was also introduced in June 2023 to amend the law on the Public Prosecution Service. However, the authorities are advised to adopt further measures to promote effective investigation, prosecution, and sanctions of foreign bribery offences, including adopting legislation to ensure the protection of prosecutorial independence from improper political influence.

While the level of exposure to the laundering of foreign proceeds of corruption is relatively limited, existing safeguards and enforcement need further enhancement. Risks are particularly acute in the real estate sector. Efforts to ensure transparency of non-resident beneficial ownership in the sector and to ensure that intermediaries implement relevant preventive measures should be strengthened. Specific statistics in relation to suspicious transactions reports involving foreign politically exposed persons and in relation to convictions for the laundering of foreign proceeds of corruption should be maintained, to ascertain the effectiveness of the AML/CFT system on these aspects.

¹ Czech Republic volunteered to have its legal and institutional frameworks assessed in the context of bilateral surveillance for purposes of determining whether it: (a) criminalizes and prosecutes the bribery of foreign public officials; and (b) has an effective AML/CFT system that is designed to prevent foreign officials from concealing the proceeds of corruption.

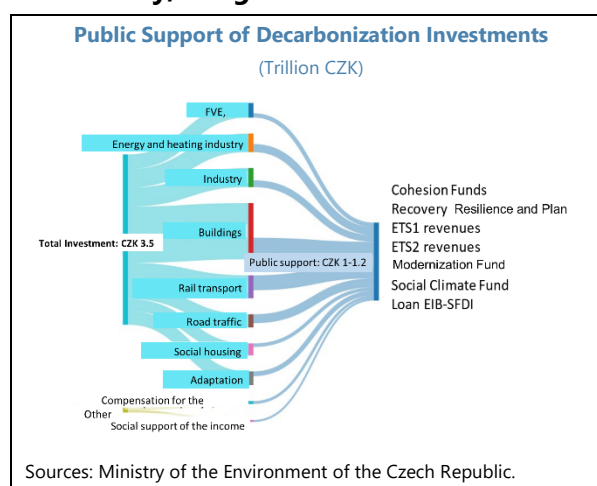
² See [OECD- UNSD Multinational Enterprise Information Platform](#), and International Financial Statistics International Investment Position, Assets, Direct investment.

E. Structural Policies

38. Czechia confronts challenges arising from global structural shifts and an aging population. Czechia has a highly energy-intensive economy with a coal-intensive energy mix, which results in substantial decarbonization and industrial transformation challenges (Figure 15).³¹ This includes the transition from the production of internal combustion engine to that of electric vehicles and the global trends toward automation. Simultaneously, the aging of the population is envisaged to reduce the labor supply—in an economy already suffering significant shortages in qualified personnel—and to increase pension deficits in the long-term putting pressure on fiscal balances. Policies should support the envisaged structural transformation of industries, including towards a greener economy, by facilitating the reallocation of capital and labor, and advancing technological innovation.

39. To support the green transformation of the economy, the government has set out a decarbonization strategy. The goals are to

achieve a greener energy mix—by phasing out coal by 2033, while increasing the shares of renewables and nuclear energy—and bolstering energy efficiency.³² Reaching these goals is expected to help Czechia meet European climate and energy targets by 2030.³³ In the medium to long run, a shift to renewables would make Czechia less dependent on fossil fuel imports and would thereby improve Czechia’s medium to long term energy security. The strategy is to split the cost of the needed investment for decarbonization between the public and private sectors. Investment needs by 2050 are estimated at about CZK 3.5 trillion of which about CZK 1–1.2 trillion are identified from public support including EU funds.^{34,35} To encourage private investment, carbon prices under EU’s Emissions Trading System (ETS)1 and ETS2 (starting in 2027), which



³¹ Czechia currently has one of the highest CO2 intensity in Europe. See [OECD Economic Surveys 2023: Czech Republic](#).

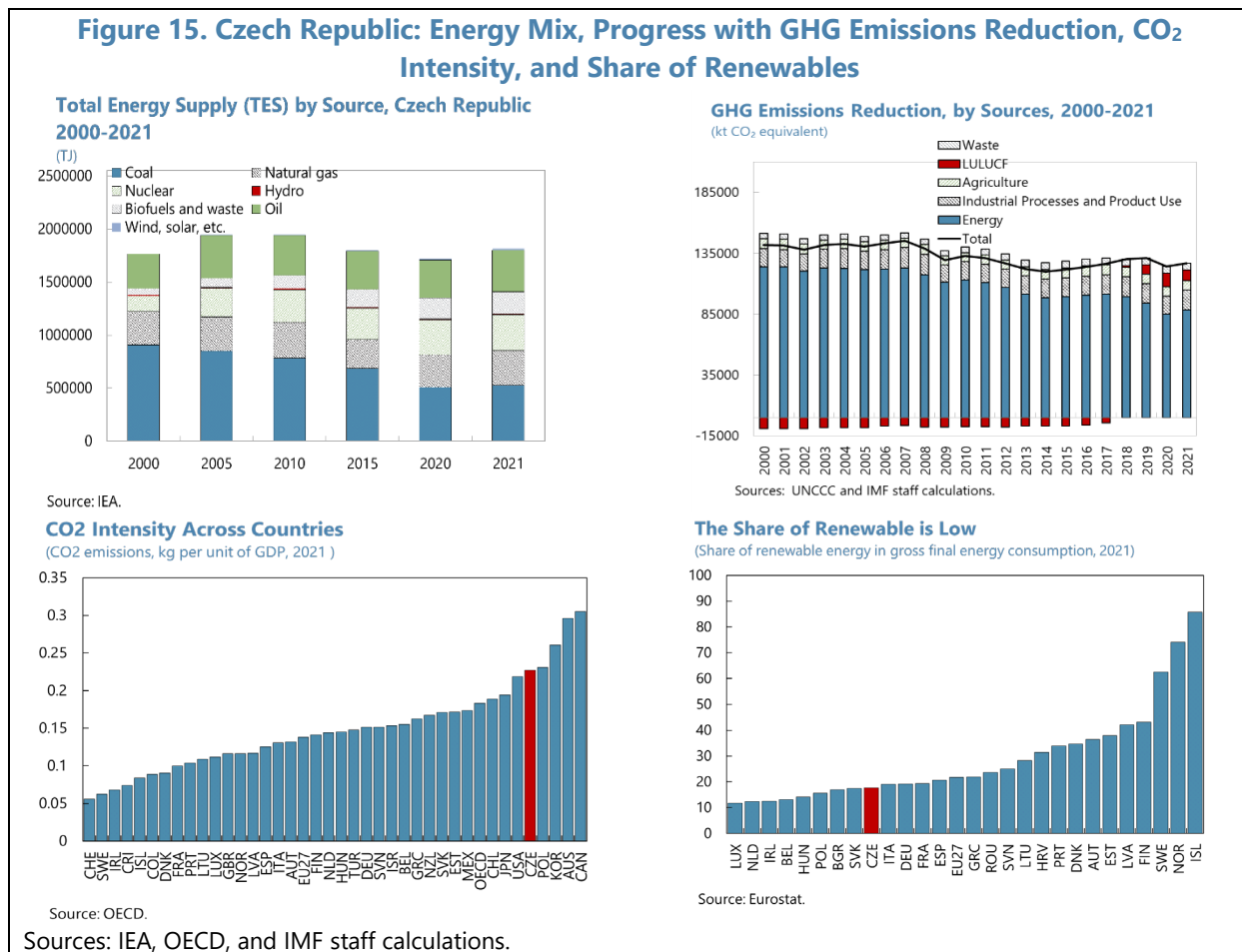
³² This strategy includes raising the share of renewable energy (mainly photovoltaics and wind energy, with the contribution of biofuels and biomass) to 30 percent by 2030 (up from close to 18 percent in 2021) and increasing nuclear power to 33 percent by 2040 (up from 15 percent in 2016). See the ["Update of the Czech National Plan of the Republics in the field of energy and climate"](#), October 2023.

³³ The Czech Republic is committed to achieve greenhouse gas emission reductions in line with the commitments under the 2030 Fit for 55 package. The authorities’ modelled scenario shows that in the sectors covered by EU ETS, Czechia is expected to reduce emissions by 63 percent in 2030 compared to the 1990 level—supporting the EU-wide target of at least 55 percent reduction in emissions by 2030. In the non-ETS sectors (under the Effort Sharing Regulation), Czechia is expected to reduce emissions by 32 percent in 2030, compared to its target of 26 percent.

³⁴ Public support includes funding from: Cohesion Funds, Recovery and Resilience Plan (Annex VI), ETS1 and ETS2 revenues, Modernization Fund, Social Climate Fund, and Loan from EIB-SFDI.

³⁵ See the ["Update of the Czech National Plan of the Republics in the field of energy and climate"](#), October 2023.

together will cover most sources of emissions, will tilt relative prices toward bolstering greener energy sources, while encouraging efficiency. Private investment in green sources will also be encouraged by regulatory guidance, including banning the registration of fossil-fuel vehicles within the next decade and setting building requirements for energy efficiency, among others.³⁶ Additional incentives, recommended by staff, may include the use of feebates in the agriculture sector (and other sectors not covered under the European Trading Systems), targeted subsidies for R&D investment and faster rates of depreciation of machinery and equipment that use fossil fuels if they are replaced by those that use clean fuels.



40. Structural reforms can help facilitate the reallocation of capital. Streamlining regulations related to business establishment and insolvency is essential for promoting corporate restructuring and improving capital reallocation.³⁷ Streamlining Czechia’s business regulatory framework,

³⁶ To incentivize the private sector, the Investment Incentive Act (amended by Act No. 89/2023 Coll.) offers: (i) Corporate income tax relief for a period of 10 years, (ii) Cash grant in the amount of CZK 200,000 for each newly created job, (iii) Cash grant for training employees in the amount of 50 percent to 70 percent of training costs, and (iv) Cash grant on capital investment in the amount of up to 20 percent of eligible costs (max. CZK 0.5 billion). The government should assess the effectiveness and flexibility of these programs to support private investment. See: [Are you interested in investment incentives in the Czech Republic? - CzechInvest](#)

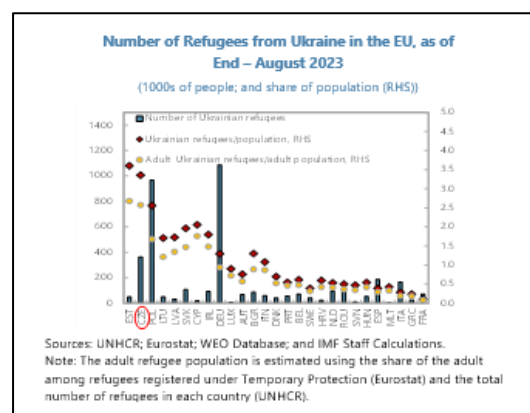
³⁷ OECD, Economic Surveys 2020: Czech Republic. See [OECD, Economic Surveys 2020: Czech Republic](#).

including by simplifying the construction permits should enhance the ease of doing business.³⁸ Sustained private investment relies on improved SME's access to alternative funding sources, in particular venture capital and equity financing.

41. To facilitate the labor reallocation, active labor market policies (ALMPs) could play a useful role. Training and lifelong learning are crucial as they aid in workers' transition to growing sectors of the economy.³⁹ Policymakers should proactively facilitate engagement, effective job matching, and the cross-sectional reallocation of workers through increased investments in ALMPs, which encompass reskilling and vocational training initiatives. Staff welcomes the government's [Labor Market Prediction Project](#) (KOMPAS) designed to identify mismatches between labor demand and supply and provide job search assistance. Modernized vocational education can develop specific skills and raise the economy's adaptability to structural change.⁴⁰ Other ALMPs like job search assistance could help match jobseekers with opportunities. In this regard, the government's Database of Retraining and Further Education Courses is important to support the upskilling and reskilling.⁴¹ Sustaining key education and curricula reforms requires adequate resources.

42. To improve labor force participation and alleviate labor shortages, staff recommends the following:

- **Stepping up policies to enhance employment prospects for disadvantaged groups.** Employment gaps persists for low-skilled, foreign, and young workers, and mothers with young children (Figure 16). Staff welcomes the Job Integration Program (effective 2024). Improving vocational training and education in technical and digital skills remains essential. Continued efforts to integrate women with young children should build on recent improvements in childcare provision and early childhood education, and target more flexible use of parental allowances and enhanced opportunities for job searching.⁴² A greater use of flexible and part-time work arrangements would also help to enhance participation.



³⁸ The Czech business environment performs below the EU average, mainly due to administrative and regulatory burdens. Setting up a company could take up to 25 days, one of the longest times in the EU. See [EC, 2023 Country report – Czechia](#).

³⁹ Celasun, Oya, Galen Sher, Petia Topalova and Jing Zhou, 2023. "Cars and the Green Transition: Challenges and Opportunities for European Workers" IMF Working Paper, International Monetary Fund, Washington, DC.

⁴⁰ See [OECD Economic Surveys 2023: Czech Republic](#).

⁴¹ See: [Nabídka rekvalifikací a vzdělávacích kurzů \(uradprace.cz\)](#) and [Databáze rekvalifikace \(mpsv.cz\)](#).

⁴² The Early Childhood Education and Care Services, which is funded by UNICEF, is targeted to improve access to early learning opportunities for children up to age six.

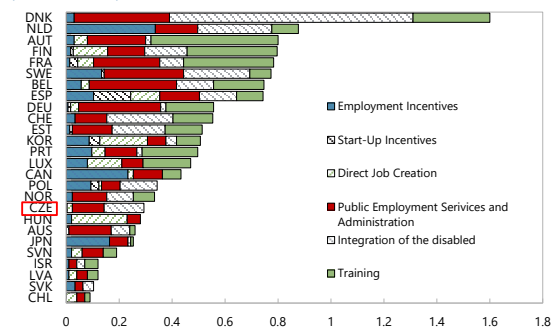
Figure 16. Czech Republic: Spending on ALMP and Employment Gaps for Disadvantaged Groups

ALMP spending has been comparatively low, despite still high employment gaps in many population segments.

Generous parental leave and child cash benefits combined with relatively limited but improving supply of childcare...

Public Spending on Active Labor Market Policies, 2021

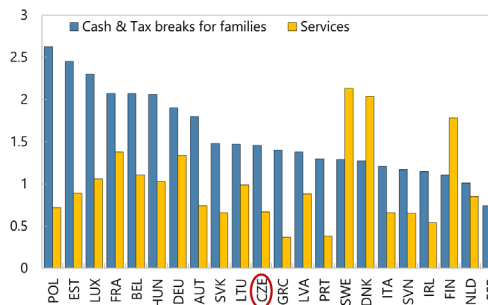
(Percent of GDP)



Sources: OECD; and IMF staff calculations.

Public Spending on Family Benefits by Type of Expenditure

(Percent of GDP, 2019 and latest available)



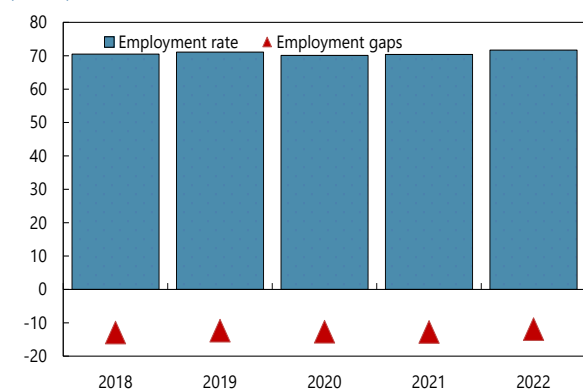
Source: OECD Social Expenditure Database.

The employment gap for mothers with young children remain relatively unchanged.

The employment gap remains high among the youth.

Employment Gaps for Women with Children wrt Prime-Age

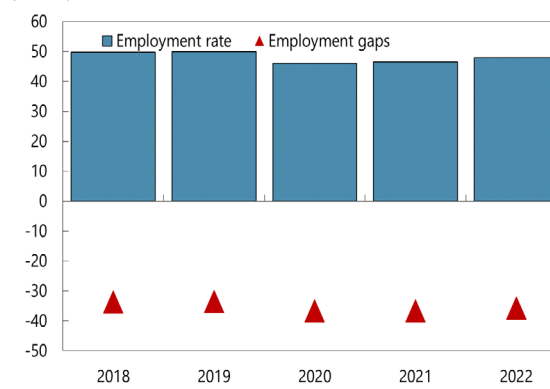
(Percent)



Source: OECD.

Employment Gaps for Youth (20-24) wrt Prime-Age Men

(Percent)



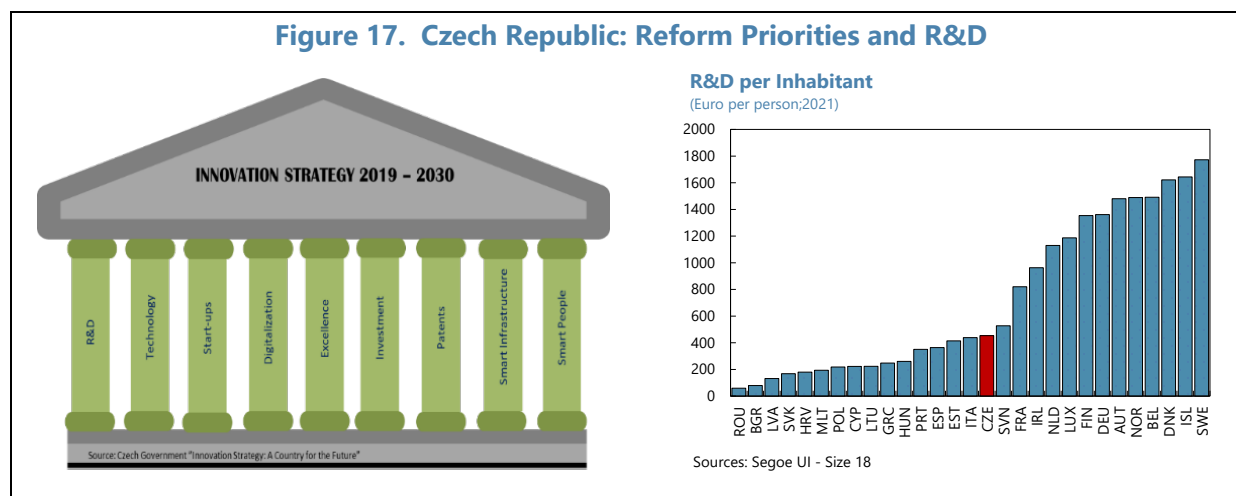
Source: OECD.

- Continuing efforts to effectively integrate refugees and facilitate the inflow of migrants.** The provision of language training, childcare, and job search support should continue to support refugees. The recently developed “pathways to work” program to support provision of skills to high-school immigrant children is welcome. Extending initial work permits to five years and granting immediate temporary residence and work rights to accompanying family members are recommended. The “Key and Research Staff” and “Highly Qualified Employee” programs have successfully attracted qualified employees. Efforts to develop an immigration point-based system should continue.

43. Structural reforms should also support technological innovation. Incentives for R&D could boost productivity and create high value-added sectors (Figure 17). Providing targeted support to emerging and innovative firms encourages technological advancement and innovation.⁴³

⁴³ R&D Tax Incentives: Czech Republic (OECD, 2021).

Implementation of the [Innovation Strategy](#) and [National Development Plan](#) is important to foster the technical and digital competencies essential for high productivity sectors, particularly in Knowledge Intensive Sectors. Planned reforms under the Recovery and Resilience Facility to provide digital equipment to schools, revise the IT curriculum, expand life-long learning in digital technologies, and implement the new digital governance structure should be accelerated.



Authorities' Views

44. The authorities recognized that Czechia is going through significant structural changes that call for support in the reallocation of capital and labor, and advancing technological innovation. They reiterated their commitment to phasing out coal by 2033 and scaling up investment into renewable and low emissions energy sources. They noted that incentives through the EU funds and cash grants are expected to encourage the private sector to step up green investment. The authorities highlighted ongoing structural reforms, with a focus on training and reskilling, to increase labor force participation and reduce labor shortages.

STAFF APPRAISAL

45. Czechia's economy is estimated to have contracted in 2023 but a gradual recovery is expected in 2024. Household demand declined with real wages falling more than productivity and consumer sentiment deteriorating amidst increased uncertainty. While fixed capital formation started to recover, the drawdown of inventories turned overall investment growth negative. External demand decelerated, but the current account deficit narrowed with lower domestic demand. Staff assesses the external position in 2023 to be broadly in line with fundamentals and desirable policy settings. In 2024, growth is projected to pick up, mainly driven by a recovery of consumption and fixed investment, as inflation continues to decline and real wages recover. Uncertainty around the outlook is high with risks to economic activity tilted to the downside and those for inflation to the upside.

46. Tight monetary policy has helped sharply reduce the inflation momentum, but additional effort is needed to consolidate the disinflation process. Staff recommends keeping the policy stance tight for some time to ensure inflation returns to target in a timely manner and to reduce the risk of an upward shift in inflation expectations. High uncertainty calls for a flexible approach to policy setting. Consolidating the disinflation process will allow for an orderly recovery in real wages and domestic demand.

47. The approved fiscal consolidation for 2024 will aid disinflation efforts. The consolidation package is an important step consistent with the path envisaged in the FRA to reach the MTO of a -0.75 percent of GDP structural balance by 2028. Reaching the MTO would entail identifying additional consolidation measures to reduce the structural deficit by ½ a percentage point (as stipulated in the FRA) in 2027–28. Staff assesses there is substantial fiscal space. Despite a low debt-to-GDP ratio, further consolidation will be crucial to build buffers to address future shocks, support economic transformation, and help ensure long-term debt sustainability in the face of impending spending pressures, including deterioration in pension gap in the long-term. In the event of the realization of adverse risks, it would be advisable to let automatic stabilizers operate freely. In case of a major shock, targeted fiscal support might be needed.

48. Staff assesses the banking sector to be broadly resilient and macroprudential policy settings broadly adequate. Financial indicators point to a well-capitalized, liquid, and profitable banking system. However, pockets of vulnerability remain that require close monitoring. Staff welcomes improvements in risk-based supervision and encourages further progress in this area. At 2 percent, the CCyB setting is adequate. Borrower-based measures (LTV, DTI, and DSTI) have contributed to responsible lending practices and manage systemic risk. Staff recommends reinstating DTI and DSTI, and going forward, recalibrating and improving their design, including by legislative changes, rather than their deactivation and reactivation.

49. Policies should support the reallocation of labor and capital to support the economic transformation, including towards a greener economy. As an economy with high energy-intensive sectors and a coal-intensive energy mix, Czechia must grapple with the process of decarbonization and the structural transformation of industries, particularly the transition from the production of internal combustion engine to that of electric vehicles and the global trends toward automation. Simultaneously, the aging of the population is envisaged to reduce the labor supply and to increase pension deficits in the long-term putting pressure on fiscal balances. Policies should support the envisaged structural transformation of industries, including towards a greener economy, by facilitating the reallocation of capital and labor, and advancing technological innovation.

50. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Table 2. Czech Republic: Selected Economic Indicators, 2020–28
(Annual percent change, unless otherwise indicated)

	2020	2021	2022	2023	2024	2025	2026	2027	2028
	Staff projections								
NATIONAL ACCOUNTS									
Real GDP (expenditure)	-5.5	3.5	2.4	-0.4	1.2	2.5	2.7	2.6	2.5
Domestic demand	-5.6	8.2	2.6	-3.7	0.6	2.3	2.6	2.6	2.7
Consumption	-4.1	3.3	-0.3	-1.5	2.2	2.4	2.7	2.6	2.5
Public	4.2	1.4	0.6	2.5	1.1	1.1	1.2	1.4	1.4
Private	-7.2	4.1	-0.8	-3.2	2.6	3.0	3.3	3.2	3.0
Investment	-9.3	20.4	8.8	-8.2	-2.7	2.1	2.5	2.7	3.0
Exports	-8.0	6.8	7.2	2.7	2.5	5.0	5.1	5.2	5.4
Imports	-8.2	13.2	6.3	-0.3	1.9	4.9	5.1	5.3	5.3
Contribution to GDP									
Domestic demand	-5.1	7.8	1.5	-3.0	0.6	2.2	2.5	2.5	2.5
Net exports	-0.4	-4.3	0.9	2.6	0.6	0.4	0.2	0.1	0.0
Investment (percent of GDP)	26.5	26.0	26.8	25.9	26.2	25.6	25.5	25.6	25.7
Gross domestic investments (percent of GDP)	26.2	30.2	32.2	28.9	27.2	26.7	26.5	26.5	26.6
Gross national savings (percent of GDP)	28.1	27.5	26.0	28.1	27.0	27.0	27.4	28.0	28.6
Output gap (percent of potential output)	-0.6	0.8	0.4	-0.5	-0.3	0.0	0.5	0.1	0.0
Potential growth	-2.2	2.1	2.8	0.5	1.0	2.2	2.2	2.9	2.6
LABOR MARKET									
Employment	-1.4	0.3	-1.6	-0.1	0.9	-0.6	-0.4	-0.1	0.3
Total labor compensation	1.5	6.1	7.9	6.8	4.9	3.9	4.3	4.4	4.8
Unemployment rate (average, in percent)	2.4	2.7	2.1	2.7	2.6	2.5	2.4	2.4	2.4
PRICES									
Consumer prices (average)	3.2	3.8	15.1	10.6	2.8	2.0	2.0	2.0	2.0
Consumer prices (end-of-period)	2.3	6.6	15.8	7.4	2.9	2.0	2.0	2.0	2.0
Producer price index (average)	0.1	7.1	...	...	...	...	...	...	...
GDP deflator (average)	4.3	3.3	8.6	9.0	3.7	2.2	1.6	1.7	2.0
MACRO-FINANCIAL									
Money and credit (end of year, percent change)									
Broad money (M3)	10.0	6.8	6.1	8.5	4.9	4.8	4.3	4.3	4.6
Private sector credit	3.6	8.9	5.0	4.5	4.0	3.5	3.5	3.5	3.5
Interest rates (in percent, year average)									
Three-month interbank rate	0.9	1.1	...	...	...	...	...	...	...
Ten-year government bond	1.1	1.9	4.2	1.2	1.7	1.7	1.7	1.7	1.7
Exchange rate									
Nominal effective exchange rate (index, 2005=100)	99.7	103.6	...	...	...	...	...	...	...
Real effective exchange rate (index, CPI-based; 2005=100)	100.0	104.6	...	...	...	...	...	...	...
PUBLIC FINANCE (percent of GDP)									
General government revenue	41.5	41.4	41.4	42.6	41.9	41.6	41.5	41.5	41.4
General government expenditure	47.2	46.5	44.6	46.2	44.1	43.3	43.0	42.6	42.2
Net lending / Overall balance	-5.8	-5.1	-3.2	-3.6	-2.2	-1.7	-1.5	-1.2	-0.8
Primary balance	-5.2	-4.5	-2.7	-2.8	-1.2	-0.7	-0.5	-0.2	0.2
Structural balance (percent of potential GDP)	-5.5	-5.4	-3.4	-3.4	-2.1	-1.8	-1.8	-1.3	-0.8
General government debt	37.7	42.0	44.2	44.2	44.3	44.2	44.0	43.6	42.5
BALANCE OF PAYMENTS (percent of GDP)									
Trade balance (goods and services)	6.7	2.8	-0.1	3.5	3.9	4.9	5.0	5.0	5.0
Current account balance	2.0	-2.8	-6.1	-0.9	-0.2	0.3	1.0	1.5	2.0
Gross international reserves (billions of euros)	135.4	153.3	131.3	140.3	149.3	158.3	166.3	172.3	176.9
(in months of imports of goods and services)	11.9	11.0	7.6	8.4	8.8	8.9	8.8	8.5	8.2
(in percent of short term debt, remaining maturity)	142.8	136.7	116.2	117.5	119.3	122.4	126.5	131.2	137.0
MEMORANDUM ITEMS									
Nominal GDP (USD billions)	246.0	281.8	290.5	335.5	350.4	368.4	385.1	400.1	416.8
Population (millions)	10.7	10.5	10.8	11.0	11.1	11.1	11.0	11.0	11.0
Real GDP per capita	-5.6	5.4	-0.6	-2.0	0.4	2.8	3.0	2.9	2.8
GDP per capita (USD thousands)	22.98	26.79	26.83	30.50	31.61	33.33	34.94	36.42	38.06

Sources: Czech National Bank; Czech Statistical Office; Ministry of Finance; Haver Analytics, and IMF staff estimates and projections. Structural balances are net of temporary fluctuations in some revenues and one-offs. COVID-related one-offs are however included.

Table 3. Czech Republic: Balance of Payments, 2020–28
(Percent of GDP)

	2020	2021	2022	2023	2024	2025	2026	2027	2028
	Staff Projections								
Current account balance	2.0	-2.8	-6.1	-0.9	-0.2	0.3	1.0	1.5	2.0
Trade balance	4.9	1.1	-1.5	2.7	2.6	3.4	3.3	3.2	3.0
Exports	59.4	62.4	63.3	57.5	56.4	57.2	57.8	59.0	60.1
Imports	54.4	61.2	64.8	54.8	53.8	53.8	54.5	55.8	57.1
Nonfactor services	1.8	1.7	1.3	0.8	1.3	1.5	1.7	1.8	1.9
Receipts	10.6	10.6	11.6	11.1	11.3	11.6	11.9	12.3	12.7
Payments	8.8	8.9	10.3	10.3	10.0	10.1	10.2	10.5	10.7
Factor income (net)	-4.2	-5.1	-5.5	-3.9	-4.1	-4.5	-4.1	-3.5	-3.0
Transfers	-0.5	-0.5	-0.5	-0.5	-0.1	-0.1	0.1	0.1	0.1
Capital account	1.2	1.7	0.1	1.3	1.2	1.4	1.5	1.5	1.5
Errors and omissions	-0.3	0.9	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Financial account (change in stocks, + = increase)	2.9	-0.1	-5.5	0.4	1.0	1.7	2.4	3.0	3.5
Direct investment, net	-2.6	-0.5	-2.5	-1.4	-1.2	-1.2	-1.3	-1.2	-1.1
Portfolio investment, net	-2.4	1.2	4.9	-0.1	0.4	0.4	0.7	1.0	0.9
Other investment and derivatives, net	6.8	-5.3	-3.4	-1.0	-1.0	-0.1	0.8	1.6	2.4
Reserve assets	0.8	4.8	-4.5	2.9	2.8	2.7	2.3	1.6	1.2
<i>Memorandum items</i>									
Gross official reserves (billions of euros)	135.4	153.3	131.3	140.3	149.3	158.3	166.3	172.3	176.9
in months of the current year's imports	11.9	11.0	7.6	8.4	8.8	8.9	8.8	8.5	8.2
as a ratio to the short-term debt	142.8	136.7	116.2	117.5	119.3	122.4	126.5	131.2	137.0
External debt, percent of GDP	76.4	76.3	67.0	63.5	64.1	63.4	61.7	59.1	55.5

Sources: Czech National Bank; Czech Statistical Office; and IMF staff estimates and projections.

Table 4. Czech Republic: General Government Operations, 2020–28
(Percent of GDP)

	2020	2021	2022	2023	2024	2025	2026	2027	2028
				Staff Projections					
Revenue	41.5	41.4	41.4	42.6	41.9	41.6	41.5	41.5	41.4
Taxes	19.9	19.2	19.2	19.4	19.6	19.7	19.6	19.5	19.3
Personal income tax	5.2	3.7	3.6	3.7	3.8	3.8	3.8	3.8	3.8
Corporate income tax	3.1	3.8	4.2	4.6	4.3	4.2	4.1	4.0	3.9
VAT	7.4	7.6	7.9	7.7	7.8	7.9	8.0	8.0	8.0
Excise	3.1	3.0	2.5	2.2	2.2	2.2	2.1	2.1	2.1
Other taxes	1.1	1.1	1.0	1.1	1.4	1.6	1.6	1.6	1.6
Social contributions	15.9	16.6	16.0	16.0	16.5	16.4	16.4	16.6	16.6
Capital and other current transfers and subsidies	1.8	1.8	1.9	2.5	1.9	1.8	1.7	1.6	1.6
Other revenue	3.8	3.8	4.3	4.7	3.9	3.8	3.7	3.8	3.9
Property income	0.6	0.6	1.1	1.5	0.7	0.5	0.5	0.6	0.7
Sales of goods and services	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2
Other revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure	47.2	46.5	44.6	46.2	44.1	43.3	43.0	42.6	42.2
Expense	42.4	41.8	39.9	41.2	39.3	38.5	38.3	37.9	37.4
Compensation of employees	11.1	11.1	10.2	10.2	10.0	10.0	9.9	9.9	9.8
Use of goods and services	6.1	5.8	5.8	6.0	6.0	5.9	6.0	5.9	5.9
Interest	0.8	0.8	1.1	1.4	1.6	1.6	1.6	1.6	1.6
Subsidies	3.0	3.3	2.2	2.9	1.6	1.6	1.6	1.6	1.6
Grants	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Social benefits	18.0	17.7	17.1	17.6	17.5	17.3	17.1	16.8	16.6
Other expenses	3.1	2.9	3.1	2.7	2.1	1.8	1.8	1.7	1.6
Net acquisition of nonfinancial assets	4.8	4.7	4.7	5.0	4.8	4.8	4.7	4.8	4.9
Gross Operating Balance	-0.9	-0.4	1.4	1.4	2.7	3.1	3.1	3.6	4.1
Net lending/borrowing (overall balance)	-5.8	-5.1	-3.2	-3.6	-2.2	-1.7	-1.5	-1.2	-0.8
Net financial transactions	-5.8	-5.1	-3.2	-3.6	-2.2	-1.7	-1.5	-1.2	-0.8
Net acquisition of financial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	5.8	5.1	3.2	3.6	2.2	1.7	1.5	1.2	0.8
<i>Adjustment and statistical discrepancies 1/</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>
Memorandum item:									
General government debt	37.7	42.0	44.2	44.2	44.3	44.2	44.0	43.6	42.5
Primary balance	-5.2	-4.5	-2.7	-2.8	-1.2	-0.7	-0.5	-0.2	0.2
Structural balance 2/ 3/	-5.5	-5.4	-3.4	-3.4	-2.1	-1.8	-1.8	-1.3	-0.8
Cyclically adjusted primary balance	-4.9	-4.8	-2.8	-2.6	-1.1	-0.8	-0.7	-0.2	0.2
Change in cyclically adjusted primary balance	-4.7	0.2	2.0	0.2	1.5	0.3	0.0	0.5	0.5
Output gap	-0.6	0.8	0.4	-0.5	-0.3	0.0	0.5	0.1	0.0
Nominal GDP (billions of Koruny)	5,709	6,109	6,786	7,363	7,726	8,096	8,448	8,810	9,215

Sources: Ministry of Finance and IMF staff estimates and projections.
1/ Adjustments for cash-accrual differences, valuation changes and other discrepancies.
2/ In percent of potential GDP.
3/ Structural balances are net of temporary fluctuations in some revenues and one-offs. COVID-related one-offs are however included.

Table 5. Czech Republic: Macroeconomic Framework, 2020–28
(Annual percent change, unless otherwise indicated)

	2020	2021	2022	2023	2024	2025	2026	2027	2028
	Staff Projections								
Real sector									
Real GDP	-5.5	3.5	2.4	-0.4	1.2	2.5	2.7	2.6	2.5
Private consumption	-7.2	4.1	-0.8	-3.2	2.6	3.0	3.3	3.2	3.0
Public consumption	4.2	1.4	0.6	2.5	1.1	1.1	1.2	1.4	1.4
Investment	-9.3	20.4	8.8	-8.2	-2.7	2.1	2.5	2.7	3.0
Fixed investment	-6.0	0.7	3.0	2.9	4.5	2.1	2.5	2.8	2.9
Exports, goods and services	-8.0	6.8	7.2	2.7	2.5	5.0	5.1	5.2	5.4
Imports, goods and services	-8.2	13.2	6.3	-0.3	1.9	4.9	5.1	5.3	5.3
contribution of net exports (percent)	-0.4	-4.3	0.9	2.6	0.6	0.4	0.2	0.1	0.0
Inflation (CPI, percent)	3.2	3.8	15.1	10.6	2.8	2.0	2.0	2.0	2.0
Unemployment (percent of labor force)	2.4	2.7	2.1	2.7	2.6	2.5	2.4	2.4	2.4
Output gap 1/	-0.6	0.8	0.4	-0.5	-0.3	0.0	0.5	0.1	0.0
Gross domestic savings (in percent of GDP)	28.1	27.5	26.0	28.2	27.0	27.0	27.4	28.0	28.6
Public	11.8	11.9	13.0	12.4	14.0	13.9	13.9	13.9	13.9
Private	16.4	15.6	13.0	15.7	13.0	13.0	13.5	14.1	14.7
Gross capital formation (in percent of GDP)	26.2	30.2	32.2	28.9	27.2	26.7	26.5	26.5	26.6
Balance of payments									
Current account balance	2.0	-2.8	-6.1	-0.8	-0.2	0.3	0.9	1.5	2.0
Trade balance	4.9	1.1	-1.5	2.7	2.6	3.4	3.3	3.2	3.0
Services balance	1.8	1.7	1.3	0.8	1.3	1.5	1.7	1.8	1.9
Net factor income	-4.2	-5.1	-5.5	-3.9	-4.1	-4.5	-4.1	-3.5	-3.0
Current transfers	-0.5	-0.5	-0.5	-0.4	-0.1	-0.1	0.0	0.0	0.0
Capital account balance	1.2	1.7	0.1	1.3	1.2	1.4	1.5	1.5	1.5
Errors and omissions, net	-0.3	0.9	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Financial account balance (change in stocks, + = increase)	2.9	-0.1	-5.5	0.5	1.0	1.7	2.4	3.0	3.5
Direct investment, net	-2.6	-0.5	-2.5	-1.4	-1.2	-1.2	-1.3	-1.2	-1.1
Portfolio investment, net	-2.4	1.2	4.9	-0.1	0.4	0.4	0.7	1.0	0.9
Other investment and derivatives, net	6.8	-5.3	-3.4	-0.9	-1.0	-0.2	0.7	1.5	2.4
Reserve assets	0.8	4.8	-4.5	2.9	2.8	2.7	2.3	1.6	1.2
Sources: Czech National Bank, Czech Statistical Office, Ministry of Finance, and IMF staff estimates and projections.									
1/ In percent of potential GDP.									

Table 6. Czech Republic: Monetary Accounts, 2016–23M8
(Millions of Koruna)

	2016M12	2017M12	2018M12	2019M12	2020M12	2021M12	2022M8	2022M12	2023M8
	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual
CENTRAL BANK									
Net foreign assets	2106412	2985280	3030033	3216469	3345952	3485093	2928294	2801545	2860313
Net domestic assets	-259148	-97266	-109531	-165172	-351083	-429971	293552	-18964	571305
Net domestic claims	-180100	-267401	-280731	-290096	-421127	-538485	-7009	-508071	1921
Claims on Central government (net)	-182582	-269895	-282275	-291684	-422749	-540217	-8776	-509855	123
Claims on State and Local Government	0	0	0	0	0	0	0	0	0
Claims on Public Nonfinancial Corporations	0	0	0	0	0	0	0	0	0
Claims on Private Sector	139	151	186	230	264	392	427	444	458
Claims on Other Depository Corporations	0	0	0	0	0	0	0	0	0
Claims on Other Financial Corporations	2343	2343	1358	1358	1358	1340	1340	1340	1340
Other items net	-79048	170135	171200	124924	70044	108514	300561	489107	569384
Monetary base	1847182	2887928	2920502	3051296	2994868	3055121	3221848	2782583	3431615
OTHER DEPOSITORY CORPORATIONS									
Net foreign assets	-298352	-1017200	-1006766	-965321	-840991	-939718	-640217	-599145	-529864
Net domestic assets	4122714	5193732	5450210	5690202	5968037	6583890	7378744	6835938	7762109
Net domestic claims	4731355	5781781	6037834	6304012	6636735	7264404	8018350	7505014	8441262
Claims on Central government (net)	563765	456146	503536	504681	798498	994129	1191903	1158046	1330624
Claims on State and Local Government	45986	43560	46724	49552	54328	57673	57052	60769	63892
Claims on Public Nonfinancial Corporations	0	0	0	0	0	0	0	0	0
Claims on Private Sector	2449087	2601560	2777045	2911233	3029470	3281919	3454769	3428245	3592746
<i>of which: Private Sector Credit</i>	<i>2441067</i>	<i>2594590</i>	<i>2769157</i>	<i>2905749</i>	<i>3021778</i>	<i>3272754</i>	<i>3445487</i>	<i>3418012</i>	<i>3581151</i>
Claims on Central Bank	1326752	2341778	2349795	2449977	2330575	2370123	2551533	2092082	2768901
Claims on Other Financial Corporations	345765	338737	360734	388569	423864	560560	763093	765872	685099
Other items net	-608641	-588049	-587624	-613810	-668698	-680514	-639606	-669076	-679153
Liabilities to the Central Bank	0	0	0	0	0	0	0	0	0
Liquid Liabilities	3314704	3677099	3920592	4178404	4584638	4917612	5308050	5254665	5884145
Transferable deposits	2907734	3224133	3385558	3529186	4127130	4363733	4227299	4100131	4293038
Other deposits	405260	453044	529659	648189	456530	554963	1081331	1153808	1586748
Securities other than shares	1710	-78	5375	1029	978	-1084	-580	726	4359
Non-liquid liabilities	470968	459209	463285	483998	478983	656965	839233	870045	790672
DEPOSITORY CORPORATIONS									
Net foreign assets	1,808,060	1,968,080	2,023,267	2,251,148	2,504,961	2,545,375	2,288,077	2,202,400	2,330,449
Net domestic assets	2,060,907	2,299,122	2,529,967	2,590,725	2,813,708	3,135,213	4,292,910	3,863,272	4,778,307
Net domestic claims	3,224,503	3,172,602	3,407,308	3,563,939	3,885,033	4,355,796	5,459,808	4,904,861	5,674,282
Claims on Central government (net)	381,183	186,251	221,261	212,997	375,749	453,912	1,183,127	648,191	1,330,747
Claims on State and Local Government	45,986	43,560	46,724	49,552	54,328	57,673	57,052	60,769	63,892
Claims on Public Nonfinancial Corporations	0	0	0	0	0	0	0	0	0
Claims on Private Sector	2,449,226	2,601,711	2,777,231	2,911,463	3,029,734	3,282,311	3,455,196	3,428,689	3,593,204
<i>of which: Private Sector Credit</i>	<i>2,441,206</i>	<i>2,594,741</i>	<i>2,769,343</i>	<i>2,905,979</i>	<i>3,022,042</i>	<i>3,273,146</i>	<i>3,445,914</i>	<i>3,418,456</i>	<i>3,581,609</i>
Claims on Other Financial Corporations	348,108	341,080	362,092	389,927	425,222	561,900	764,433	767,212	686,439
Other items net	-1,163,596	-873,480	-877,341	-973,214	-1,071,325	-1,220,583	-1,166,898	-1,041,589	-895,975
Broad money	3,830,195	4,226,892	4,493,667	4,779,393	5,255,243	5,610,992	5,989,745	5,953,591	6,551,325
<i>Memorandum items:</i>									
Year-on-year growth (percent)									
Monetary base	32.7	56.3	1.1	4.5	(1.8)	2.0	(10.2)	(8.9)	6.5
Broad money	6.5	10.4	6.3	6.4	10.0	6.8	5.5	6.1	9.4
Claims on private sector									
Depository Corporations, Claims on Private Sector	6.9	6.2	6.7	4.8	4.1	8.3	8.6	4.5	4.0
Depository Corporations, Credit to Private Sector	6.9	6.3	6.7	4.9	4.0	8.3	8.6	4.4	3.9
Financial Corporations, Credit to Private Sector									
Broad money multiplier (ratio)	2.07	1.46	1.54	1.57	1.75	1.84	1.86	2.14	1.91

Sources: Czech National Bank; Czech Statistical Office; Ministry of Finance; Haver Analytics, and IMF staff estimates and projections.

Structural balances are net of temporary fluctuations in some revenues and one-offs. COVID-related one-offs are however included.

Table 7. Czech Republic: Financial Soundness Indicators, 2016–23Q2
(In percent, unless otherwise indicated)

	2016	2017	2018	2019	2020	2021	2022	2023Q2
Core FSIs								
Regulatory capital to risk-weighted assets	17.7	18.1	18.3	19.7	22.1	21.2	20.3	20.5
Tier 1 capital to risk-weighted assets	17.1	17.5	17.8	19.2	21.4	20.5	19.5	19.5
Nonperforming loans net of provisions to capital	18.2	14.8	12.0	9.4	10.2	9.1	7.8	7.6
Capital to assets (leverage ratio)	7.2	6.5	6.5	6.8	7.3	6.9	6.7	5.8
Nonperforming loans to total gross loans	4.5	3.7	3.1	1.7	1.9	1.7	1.5	1.2
Provisions to nonperforming loans	49.1	49.2	51.8	55.4	50.4	52.2	53.4	51.6
Return on assets	1.5	1.4	1.3	1.4	0.7	1.1	1.3	1.4
Return on equity	12.6	13.7	14.2	15.0	7.3	11.1	15.1	16.3
Interest margin to gross income	59.0	59.2	64.8	69.0	66.7	64.9	70.0	66.3
Noninterest expenses to gross income	46.9	47.1	47.1	51.1	55.8	55.9	48.0	51.6
Liquid assets to total assets	29.0	20.3	15.1	29.1	30.4	33.0	28.7	29.3
Liquid assets to short-term liabilities	53.8	39.8	30.0	38.7	40.9	45.1	40.3	38.5
Additional FSIs								
Large exposures to capital						56.1	57.2	
Gross asset position in financial derivatives to capital	24.6	18.8	19.1	21.8	23.8	37.3	60.7	47.1
Gross liability position in financial derivatives to capital	21.9	19.0	18.6	22.9	24.0	44.0	71.6	54.7
Trading income to total income	11.3	12.7	6.8	3.5	5.1	5.1	3.3	5.9
Personnel expenses to noninterest expenses	42.5	43.4	44.5	41.3	40.5	40.7	40.0	39.9
Customer deposits to total (noninterbank) loans	121.9	128.3	128.2	72.8	82.3	78.6	81.5	75.8

Sources: IMF Financial Soundness Indicators.

Annex I. External Sector Assessment

Overall Assessment: The forecasted external position for 2023 is broadly in line with fundamentals and desirable policy settings. The assessment attempts to account for certain transitory factors owing to disruptions to global value chains (GVCs) and deteriorating terms of trade resulting from the war in Ukraine. The estimated CA gap is -0.8 percent of GDP, with a range of 1 to -1 percent of GDP, reflecting uncertainty around any point estimate. The REER gap is estimated to be 1 percent (± 1.8) percent implying that the exchange rate was broadly in line with fundamentals and desirable policy settings. For the first half of 2023, the 4-quarter average of the current account balance to GDP ratio strengthened.

Potential Policy Responses: The external position forecasted for 2023 is broadly in line with fundamentals and desirable policy settings. The external sector assessment finds no contribution from policies to the gap. If the CA gap widens in the future in a way that indicates an imbalance, then the authorities could consider implementing structural policies to reduce it.

Foreign Assets and Liabilities: Position and Trajectory

Background. The net international investment position (NIIP) deteriorated to about -20 percent of GDP in 2022 from about -14 percent in 2021. Gross assets and liabilities fell to 122 and 141 percent of GDP, respectively. Gross external debt (67 percent of GDP in 2022) remains relatively modest and is expected to continue falling over the medium-term. Through mid-2023, the NIIP has improved to -17 percent of GDP and external debt fallen to about 62 percent of annual GDP (over the last 4 quarters). The NIIP is expected to improve in the medium term together with the financial account.

Assessment. The current NIIP and its projected path do not imply risks to external sustainability.

	NIIP:	Gross Assets:	Res.Assets:	Gross Liab.:	Debt Liab.:
2023 (est) (% GDP)	-21	108	42	129	64

Current Account

Background. The 4-quarter current account to GDP ratio (CA) registered small surpluses through mid-2021, with trade surpluses offsetting large primary income deficits. In the second half of 2021, however, the current account balance turned negative reflecting a sharply lower trade surplus, driven by supply-side disruptions and surging energy prices. These disruptions worsened in 2022 with the war in Ukraine but have started to improve through mid-2023 and the CA is expected to end 2023 in a small surplus. In the medium term, the CA is expected to remain in surplus as lagging supply chain issues are fully resolved.

Assessment. For 2023, given staff's forecast, the current account is assessed to be broadly in line with fundamentals. The EBA CA model estimates a norm of -0.8 percent of GDP against a cyclically adjusted CA deficit of 0.8 percent of GDP. The resulting EBA gap amounted to 0.0 percent of GDP. No policy gap was identified. In view of shocks related to the war in Ukraine, which are judged to be transitory, staff suggests the following additional adjustments. First, an adjustment of -0.6 percent of GDP is made to the cyclically adjusted CA balance to account for half of the change in the primary income balance to -3.9 percent of GDP, compared to a 5-year pre-pandemic average of -5.1 percent of GDP. Second, an adjustment of 1.6 percent of GDP is made to reflect half of the decline in the trade balance to 3.5 percent of GDP vs. a pre-pandemic 5-year average of 6.6 percent of GDP. Half of the gap is used in the case of the primary income and trade balances because of uncertainty around projections and the persistence of GVC impediments.

2023	Proj. CA:	Cycl. Adj.	EBA CA	EBA CA	Prim. inc.	Trade bal.	Staff CA
(% GDP)		CA:	Norm:	Gap:	Adj.:	Adj.:	Gap:
	-0.9	-0.8	-0.8	0.0	-0.6	1.6	0.9

Real Exchange Rate
<p>Background. The CPI-based real effective exchange rate (REER) has appreciated by about 25 percent since the authorities exited the koruna floor in April 2017 notwithstanding transitory periods of depreciation following the onset of the pandemic and of the war in Ukraine. Other real appreciation measures, however, indicate a lower degree of appreciation, including those computed through unit labor costs, production price indices, or GDP deflators.</p> <p>Assessment. Under the CA gap model, staff assesses the REER gap to be 1.6 percent, broadly in line with fundamentals and desirable policy settings, as it is within the tolerance range of -5 to 5 percent. External balance assessment (EBA) models that look directly at the real exchange rate suggest currency appreciation: the index REER gap was estimated at 43 percent, while the REER level model suggests a 17 percent gap relative to fundamentals. Nevertheless, the gap estimated from these models is mostly in the residuals, suggesting that these identified gaps reflect factors outside these REER models.</p>
Capital and Financial Accounts: Flows and Policy Measures
<p>Background. The financial account (measuring the change in net assets abroad) declined to -5.5 percent of GDP in 2022 from -0.1 percent of GDP in 2021, with falls in net FDI, other investment and reserve assets offsetting an increase in net portfolio assets abroad (associated, in turn, to large nonresident portfolio outflows). In 2023, the financial account is expected to be roughly in balance and projected to turn positive over the medium-term.</p> <p>Assessment. Risks related to capital flows are assessed to be relatively small.</p>
FX Intervention and Reserves Level
<p>Background. Gross international reserves fell by EUR22 billion to EUR131 billion (47 percent of GDP) in 2022, reflecting about EUR26 billion in foreign exchange intervention sales by the Czech National Bank (registered as a 4.5 percent of GDP decline in reserve assets in the balance of payments). The CNB did not intervene in the foreign exchange market to affect the exchange rate between October 2022 and November 2023. Nevertheless, in August 2023, it resumed its program of sales of part of its income on international reserves with the explicit mandate to execute transactions with minimal impact on the exchange rate.</p> <p>Assessment. Reserves were equivalent to approximately 8 months of imported goods and services in 2022 and are expected to increase slightly in 2023. They are assessed to be sufficient to insulate against external shocks and disorderly market conditions. Although reserves declined in 2022 and the ratio to GDP declined further so far in 2023, reserves remain between 3 and 4 times above the IMF's reserve adequacy metric.</p>

Annex II. Risk Assessment Matrix

Conjunctural Risks ¹			
Risks	Likelihood	Impact on Czechia	Recommended Policy Response
Intensification of regional conflict(s). Escalation of Russia's war in Ukraine or other regional conflicts and resulting economic sanctions disrupt trade (e.g., energy, food, tourism, and/or critical supply chain components), remittances, FDI and financial flows, and payment systems, and lead to refugee flows.	High	High The war in Ukraine or other regional conflicts increase likelihood of trade and supply chain disruptions, higher inflation, and confidence shocks	Diversify trade, particularly imports of energy. Develop contingency plans. Accelerate investments in energy efficient and renewable sources of energy, and in critical energy infrastructure such as the as the Poland – Czechia gas pipeline being revamped.
Commodity price volatility. A succession of supply disruptions (e.g., due to conflicts, uncertainty, and export restrictions) and demand fluctuations causes recurrent commodity price volatility, external and fiscal pressures in EMDEs, contagion effects, and social and economic instability	High	High Supply disruption will cause high and volatile food and energy prices in the region.	Keep participating in European policy responses. Diversify energy and food supply. Incentivize domestic production of food and renewable energy.
<p>Abrupt global slowdown or recession. Global and idiosyncratic risk factors combine to cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and market fragmentation causing sudden stops in EMDEs.</p> <ul style="list-style-type: none"> U.S: Amid tight labor markets and/or commodity price shocks, inflation remains elevated, prompting the Fed to keep rates higher for longer and resulting in more abrupt financial, housing and commercial real estate market correction, and "hard landing". Europe: Intensifying fallout from the war in Ukraine, recurrent energy crisis and supply disruptions, and monetary tightening exacerbate economic downturns, and housing and commercial real estate market corrections. <p>China: Sharper-than-expected slowdown in the property sector, unexpected fiscal tightening due to local government financing stress and decline in investment, and/or rising geopolitical tensions disrupt economic activity.</p>	<p>Medium</p> <p>Medium</p> <p>Medium</p> <p>Medium</p>	<p>Medium</p> <p>Given its integration in GVCs, Czechia's inflation and economic activities would be significantly affected by recession in Europe and recurrent energy crises and supply disruptions.</p>	<p>Keep participating in European policy responses. Monetary policy stance should be forward-looking, and data driven. Diversify energy and food supply. Incentivize domestic production of food and renewable energy.</p>
Monetary policy miscalibration. Amid high economic uncertainty and financial sector fragility, major central banks pause monetary policy tightening or pivot to loosen policy stance prematurely, de-anchoring inflation expectations, triggering a wage-price spiral and spillovers to financial markets.	Medium	Medium Czechia faces the same monetary policy miscalibration risks. Combatting inflation and maintaining inflation expectation anchored are still policy priorities.	Keep monetary policy sufficiently tight until there are clear signs of inflation rates and expectations stabilizing around target rates.
<p>¹ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path. The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. The conjunctural shocks and scenarios highlight risks that may materialize over a shorter horizon (between 12 to 18 months) given the current baseline. Structural risks are those that are likely to remain salient over a longer horizon.</p>			

Risks	Likelihood	Impact on Czechia	Recommended Policy Response
Systemic financial instability. Sharp swings in real interest rates and risk premia, and asset repricing amid economic slowdowns and policy shifts trigger insolvencies in countries with weak banks or non-bank financial institutions, causing market dislocations and adverse cross-border spillovers.	Medium	Medium Czechia would be relatively insulated given the high reliance on domestic financing in both public and private sectors.	Closely monitor and manage financial sector risks. Enhance the resilience of household and financial sectors by fine-tuning the macroprudential toolkit as needed.
Sovereign debt distress. Domino effects of higher global interest rates, a growth slowdown in AEs, and/or disorderly debt events in some EMDEs spillover to other highly indebted countries, resulting in capital outflows, an increase in risk premia, and loss of market access.	Medium	Medium Czechia would be less exposed to these shocks because of its high dependence on domestic financing in both public and private sectors, along with its relatively low debt level.	Vigilantly monitor and manage financial sector risks. Strengthen the resilience of household and financial sectors by adjusting the macroprudential toolkit as required.
Social discontent. High inflation, real income loss, and spillovers from crises in other countries (including migration) worsen inequality, trigger social unrest, and give rise to financing pressures and detrimental populist policies. This exacerbates imbalances, slows growth, and triggers market repricing.	Medium	Medium High and volatile food and energy prices, and lower real income in the region could increase the risks of social unrest.	Continue to engage in European policy responses, diversify energy and food sources, encourage domestic production of food and renewable energy, and direct support measures towards vulnerable populations.
Structural Risks			
Source of Risks, Likelihood, and Time Horizon		Impact on Czechia	Recommended Policy Response
Deepening geoeconomic fragmentation. Broader and deeper conflict(s) and weakened international cooperation result in a more rapid reconfiguration of trade and FDI, supply disruptions, protectionism, technological and payments systems fragmentation, rising input costs, financial instability, a fracturing of international monetary and financial systems, and lower potential growth.	High	High Geopolitical tensions between Europe and Russia have escalated due to support for Ukraine and could potentially intensify further if the war in worsens, leading to broader regional consequences.	Allocate further targeted fiscal assistance with focus on critical security-related sector. And continue to enforce AML/CFT frameworks to protect the financial sector.
Cyberthreats. Cyberattacks on physical or digital infrastructure (including digital currency and crypto assets ecosystems) or misuse of AI technologies trigger financial and economic instability.	Medium	High Given the ongoing geopolitical tensions with Russia and recent cyber-attacks, there are risks of additional cyber threats.	Enhance preparedness for cyberattacks through extensive risk monitoring in cooperation with private and public sector stakeholders.
Extreme climate events. Extreme climate events driven by rising temperatures cause loss of human lives, severe damage to infrastructure, supply disruptions, lower growth, and financial instability.	Medium	Medium Czechia's strategy on climate adaptation to Change identifies industry and energy as the main sectors subject to climate change risks and emphasis on connectivity across sectors.	Accelerate the implementation the National Action Plan on Adaptation which established a robust scheme to build and enhance the energy sector's climate resilience.
Disorderly energy transition. Disorderly shift to net-zero emissions (e.g., owing to shortages in critical metals) and climate policy uncertainty cause supply disruptions, stranded assets, market volatility, and subdued investment and growth.	Medium	Medium Industry and energy are the main sectors identified as the main sectors subject to climate change risks, especially given the connectivity across sectors.	Continue implementing the National Action Plan on Adaptation to build and enhance the energy sector's climate resilience.

Annex III. Sovereign Risk and Debt Sustainability Framework

Figure 1. Czech Republic: Risk of Sovereign Stress

Horizon	Mechanical signal	Final assessment	Comments
Overall	...	Low	The overall risk of sovereign stress is low, reflecting a relatively low level of vulnerability in the near-term and medium term horizons.
Near term 1/			
Medium term	Low	Low	Medium-term risks are assessed as low against a mechanical low signal.
Fanchart	Low	...	
GFN	Low	...	
Stress test		...	
Long term	...	Moderate	Long-term risks are assessed as moderate. The large amortization module shows gradual declines in GFN and debt relative to GDP both under the baseline and customized scenarios (with t+5). GFN and debt relative to GDP are expected to increase with climate change adaptation and mitigation.
Sustainability assessment 2/	...	...	Not required for surveillance-only countries.
Debt stabilization in the baseline			Yes
DSA Summary Assessment			
<p>Commentary: The risk of Czech Republic experiencing sovereign stress is low overall. Czechia borrows from the market and there are no significant near term borrowing risks. The public debt ratio is projected to decline in the medium term, driven by the primary balance. Most indicators have started to normalize as the recovery from the COVID-19 shock has proceeded well and support measures to the cost-of-living crisis (has been) phased out. Over the long term, the long-term analysis highlights that risks are assessed as moderate. The large amortization module shows gradual declines in GFN and debt relative to GDP. GFN and debt relative to GDP are expected to increase with climate change adaptation and mitigation.</p>			

Source: Fund staff.

Note: The risk of sovereign stress is a broader concept than debt sustainability. Unsustainable debt can only be resolved through exceptional measures (such as debt restructuring). In contrast, a sovereign can face stress without its debt necessarily being unsustainable, and there can be various measures—that do not involve a debt restructuring—to remedy such a situation, such as fiscal adjustment and new financing.

1/ The near-term assessment is not applicable in cases where there is a disbursing IMF arrangement. In surveillance-only cases or in cases with precautionary IMF arrangements, the near-term assessment is performed but not published.

2/ A debt sustainability assessment is optional for surveillance-only cases and mandatory in cases where there is a Fund arrangement. The mechanical signal of the debt sustainability assessment is deleted before publication. In surveillance-only cases or cases with IMF arrangements with normal access, the qualifier indicating probability of sustainable debt ("with high probability" or "but not with high probability") is deleted before publication.

Figure 2. Czech Republic: Debt Coverage and Disclosures

1. Debt coverage in the DSA: 1/					CG	GG	NFPS	CPS	Other	Comments
1a. If central government, are non-central government entities insignificant?					n.a.					
2. Subsectors included in the chosen coverage in (1) above:										
Subsectors captured in the baseline					Inclusion					
CPS	NFPs	GG: expected	CG	1	Budgetary central government	Yes				
				2	Extra budgetary funds (EBFs)	Yes				
				3	Social security funds (SSFs)	Yes				
				4	State governments	Yes				
				5	Local governments	Yes				
				6	Public nonfinancial corporations	No				
				7	Central bank	No				
				8	Other public financial corporations	No				
3. Instrument coverage:					Currency & deposits	Loans	Debt securities	Oth. acct. payable 2/	IPSGs 3/	
4. Accounting principles:					Basis of recording		Valuation of debt stock			
					Non-cash basis 4/	Cash basis	Nominal value 5/	Face value 6/	Market value 7/	
5. Debt consolidation across sectors:					Consolidated		Non-consolidated			

Color code: chosen coverage Missing from recommended coverage Not applicable

Reporting on Intra-Government Debt Holdings

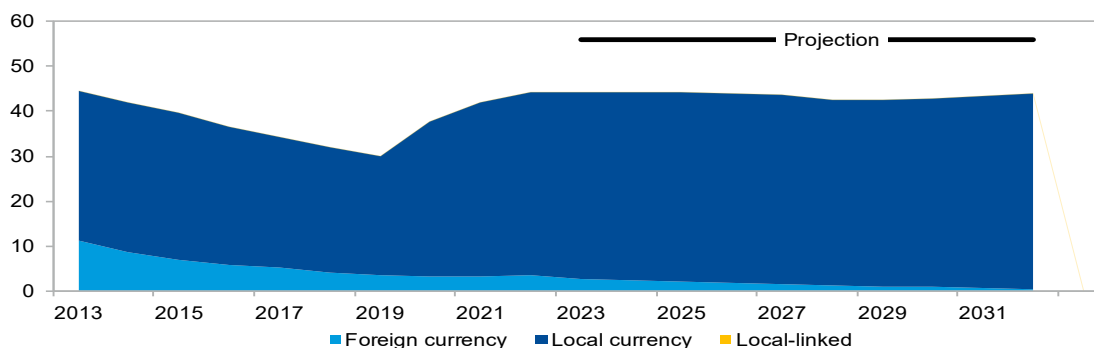
Issuer	Holder	Budget. central govt	Extra-budget. funds (EBFs)	Social security funds (SSFs)	State govt.	Local govt.	Nonfin. pub. corp.	Central bank	Oth. pub. fin corp	Total
		1	Budget. central govt							
2	Extra-budget. funds									0
3	Social security funds									0
4	State govt.									0
5	Local govt.									0
6	Nonfin pub. corp.									0
7	Central bank									0
8	Oth. pub. fin. corp									0
Total		0	0	0	0	0	0	0	0	0

1/ CG=Central government; GG=General government; NFPS=Nonfinancial public sector; PS=Public sector.
 2/ Stock of arrears could be used as a proxy in the absence of accrual data on other accounts payable.
 3/ Insurance, Pension, and Standardized Guarantee Schemes, typically including government employee pension liabilities.
 4/ Includes accrual recording, commitment basis, due for payment, etc.
 5/ Nominal value at any moment in time is the amount the debtor owes to the creditor. It reflects the value of the instrument at creation and subsequent economic flows (such as transactions, exchange rate, and other valuation changes other than market price changes, and other volume changes).
 6/ The face value of a debt instrument is the undiscounted amount of principal to be paid at (or before) maturity.
 7/ Market value of debt instruments is the value as if they were acquired in market transactions on the balance sheet reporting date (reference date). Only traded debt securities have observed market values.

Commentary: The coverage in this SRDSA is for the general government. The DSA is prepared on a cash basis so there is no significant other accounts payable.

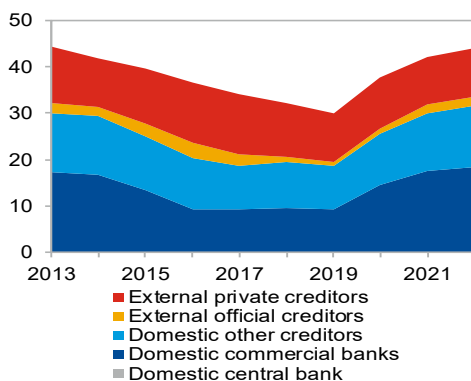
Figure 3. Czech Republic: Public Debt Structure Indicators

Debt by Currency (percent of GDP)



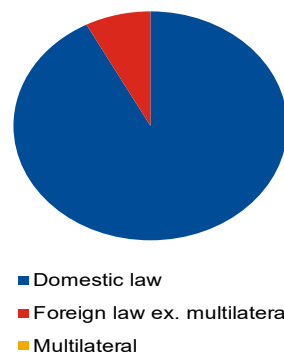
Note: The perimeter shown is general government.

Public Debt by Holder (percent of GDP)



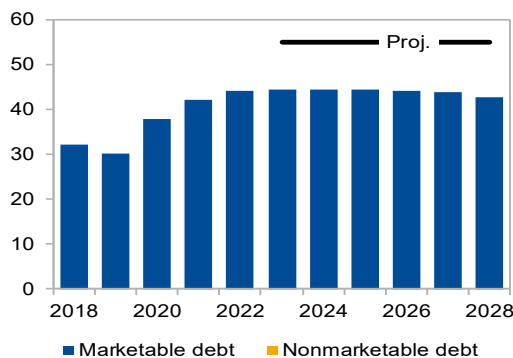
Note: The perimeter shown is general government.

Public Debt by Governing Law, 2022 (percent)



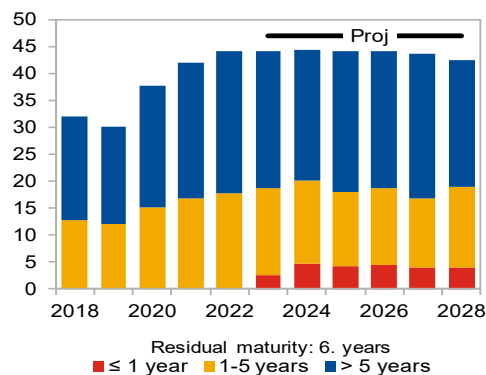
Note: The perimeter shown is general government.

Debt by Instruments (percent of GDP)



Note: The perimeter shown is general government.

Public Debt by Maturity (percent of GDP)



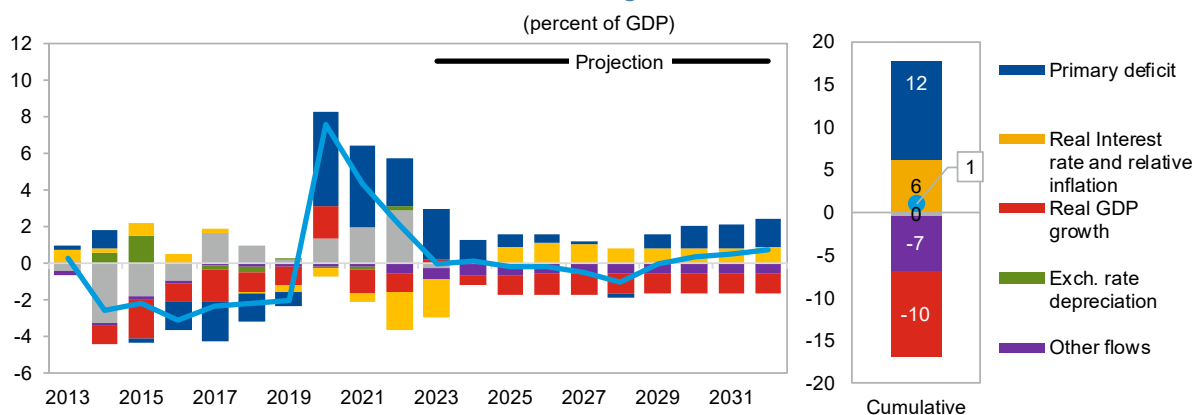
Note: The perimeter shown is general government.

Commentary: In Czech Republic, most debt is denominated in local currency, with moderate non-resident holdings. Currency risks are also minimal for Czechia. In the medium term, more than half of the instruments will be matured after 5 years and public debt will be mainly in domestic currency. The authorities indicated that their debt issuance strategy focuses on issuing local currency debt with an average maturity ranging between 5-7 years.

Figure 4. Czech Republic: Baseline Scenario
(Percent of GDP unless indicated otherwise)

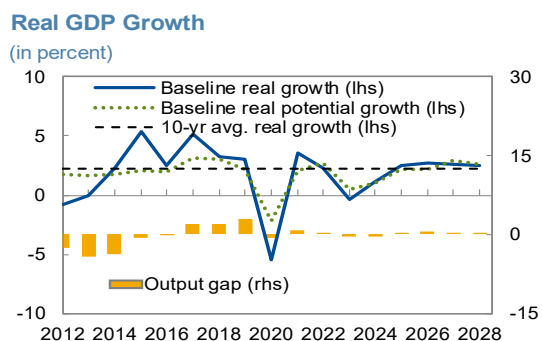
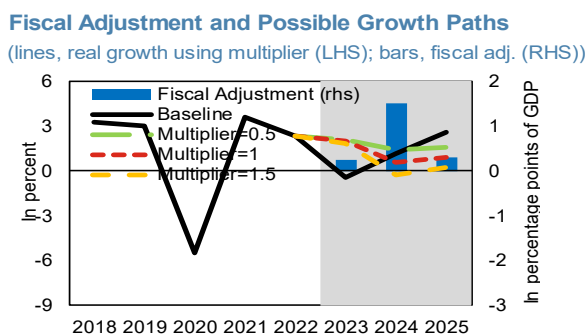
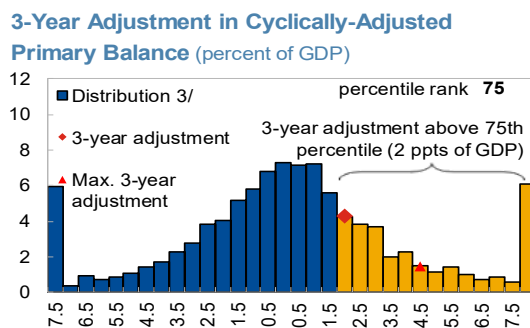
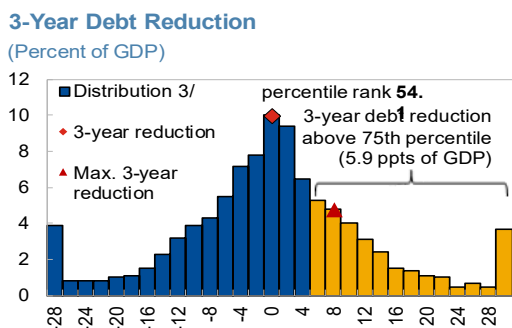
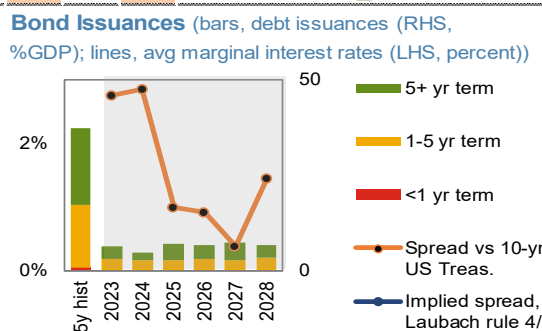
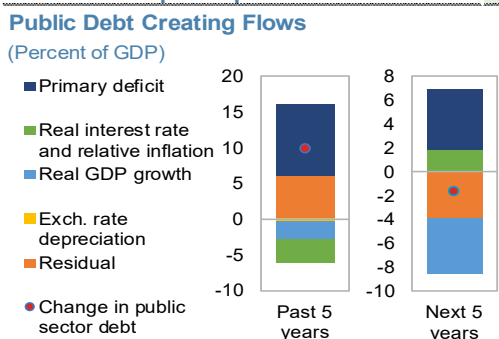
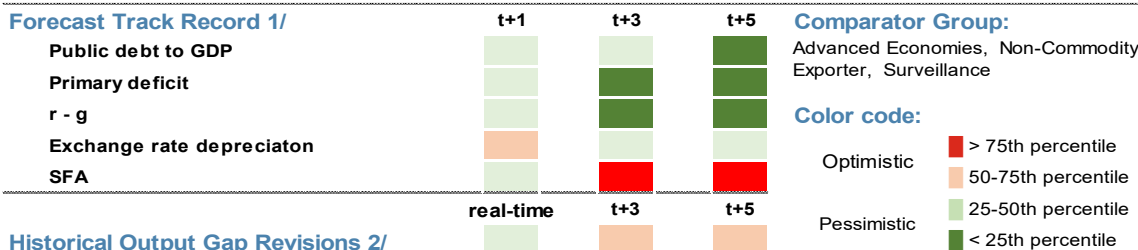
	Actual	Medium-term projection						Extended projection			
	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Public debt	44.2	44.2	44.3	44.2	44.0	43.6	42.5	42.5	42.8	43.3	44.1
Change in public debt	2.2	0.0	0.1	-0.1	-0.2	-0.5	-1.0	0.0	0.4	0.5	0.7
Contribution of identified flows	-0.8	0.3	0.2	-0.1	-0.2	-0.5	-1.0	0.0	0.4	0.5	0.7
Primary deficit	2.7	2.8	1.2	0.7	0.5	0.2	-0.2	0.8	1.2	1.3	1.5
Noninterest revenues	40.8	42.0	41.4	41.0	40.9	40.9	40.8	40.9	41.3	41.7	42.1
Noninterest expenditures	43.4	44.7	42.5	41.7	41.3	41.0	40.6	41.7	42.5	43.0	43.6
Automatic debt dynamics	-2.8	-1.9	-0.4	-0.2	-0.1	0.0	-0.2	-0.2	-0.2	-0.2	-0.2
Real interest rate and relative inflation	-2.0	-2.1	0.1	0.9	1.1	1.1	0.8	0.8	0.8	0.8	0.9
Real interest rate	-2.1	-2.2	0.1	0.9	1.1	1.1	0.8	0.8	0.8	0.8	0.9
Relative inflation	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real growth rate	-1.0	0.2	-0.5	-1.1	-1.1	-1.1	-1.1	-1.0	-1.0	-1.0	-1.1
Real exchange rate	0.2	...	...	...	...	...	...	...	...	...	...
Other identified flows	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(minus) Interest Revenues	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Other transactions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Contribution of residual	2.9	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross financing needs	7.3	6.4	4.6	7.1	6.8	7.3	6.7	8.2	8.5	9.5	8.8
of which: debt service	5.2	4.3	4.0	6.9	6.9	7.8	7.6	8.1	7.9	8.8	7.9
Local currency	4.8	3.9	3.7	6.6	6.6	7.5	7.3	7.8	7.7	8.6	7.8
Foreign currency	0.4	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.1
Memo:											
Real GDP growth (percent)	2.3	-0.4	1.2	2.5	2.7	2.6	2.5	2.5	2.5	2.5	2.5
Inflation (GDP deflator; percent)	8.6	9.0	3.7	2.2	1.6	1.7	2.0	2.0	2.1	2.1	2.1
Nominal GDP growth (percent)	11.1	8.5	4.9	4.8	4.3	4.3	4.6	4.6	4.6	4.6	4.6
Effective interest rate (percent)	3.0	3.5	3.9	4.2	4.2	4.2	4.1	4.1	4.1	4.1	4.2

Contribution to Change in Public Debt



Staff commentary: Public debt will rise marginally in 2023 but then decline in the medium term, driven by growth and the improvement in the primary balance. From 2030, public debt is projected to increase, driven by additional ageing pressures and higher pension spending.

Figure 5. Czech Republic: Realism of Baseline Assumptions



Commentary: The 3-year adjustment in the cyclically-adjusted primary balance is within the highest 75-percentile. The unwinding of COVID-19 related spending and energy support measures led to a decline in the cyclically adjusted primary balance. Following a sharp decline in 2023, staff is projecting a recovery in private consumption in 2024-25, despite the contractionary fiscal stance in 2024. Therefore, the growth projection is higher than the levels implied by the fiscal multipliers in 2024-25.

Source : IMF Staff.

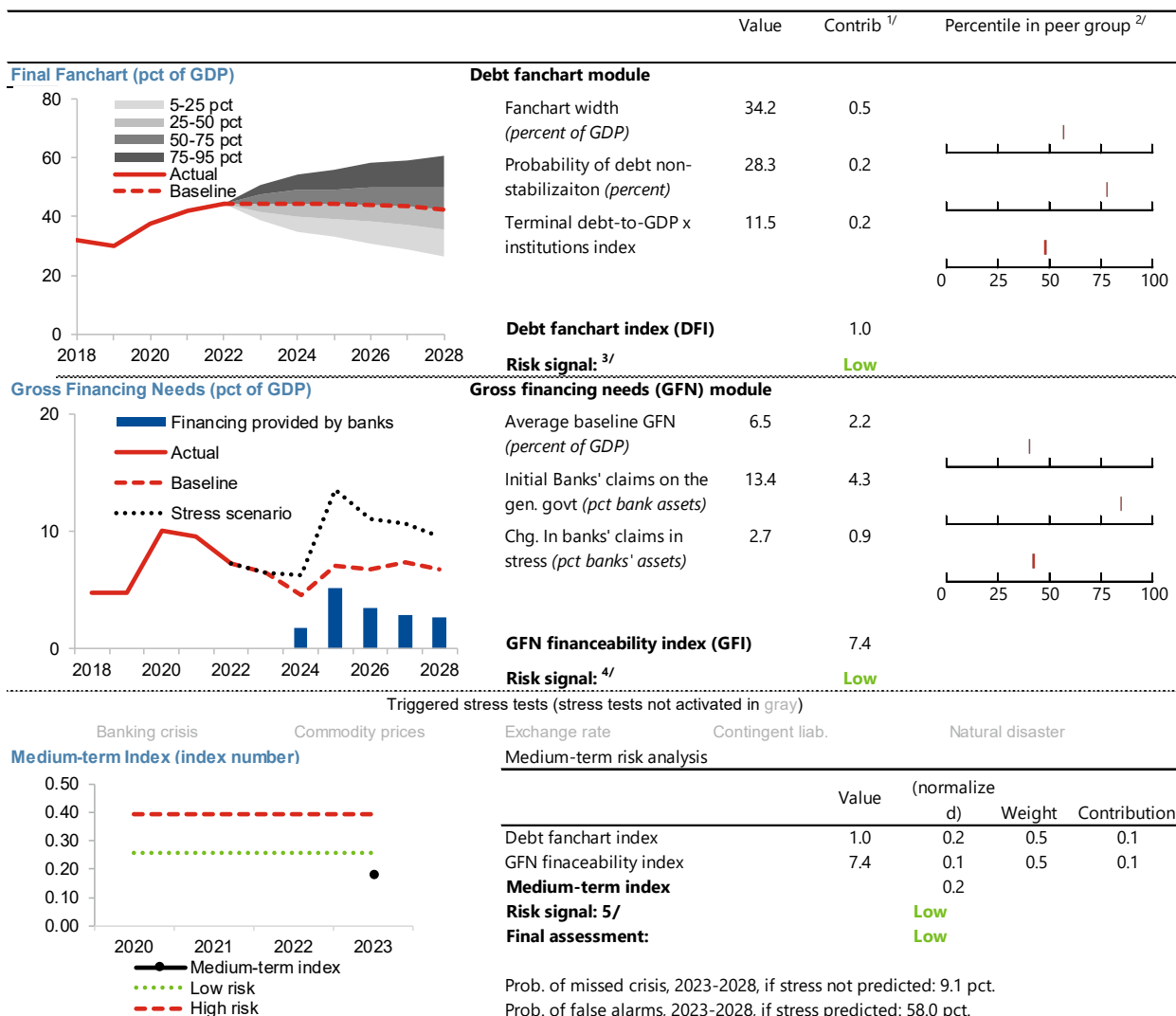
1/ Projections made in the October and April WEO vintage.

2/ Calculated as the percentile rank of the country's output gap revisions (defined as the difference between real time/period ahead estimates)

3/ Data cover annual observations from 1990 to 2019 for MAC advanced and emerging economies. Percent of sample on vertical axis.

4/ The Laubach (2009) rule is a linear rule assuming bond spreads increase by about 4 bps in response to a 1 ppt increase in the projected debt-to-GDP ratio.

Figure 6. Czech Republic: Medium-Term Risk Assessment



Commentary: The fanchart risk score is low, given the relatively wide fanchart and probability of debt not stabilizing. Gross financing needs are manageable and staff assesses that the banking sector is broadly resilient, well capitalized, liquid, and profitable. It is expected that the banking sector will have ample borrowing space with vulnerabilities easing as the monetary stance is relaxed. The risk signal of the GFN module is low.

Source: IMF staff estimates and projections.

1/ See Annex IV of IMF, 2022, Staff Guidance Note on the Sovereign Risk and Debt Sustainability Framework for details on index calculation.

2/ The comparison group is advanced economies, non-commodity exporter, surveillance.

3/ The signal is low risk if the DFI is below 1.13; high risk if the DFI is above 2.08; and otherwise, it is moderate risk.

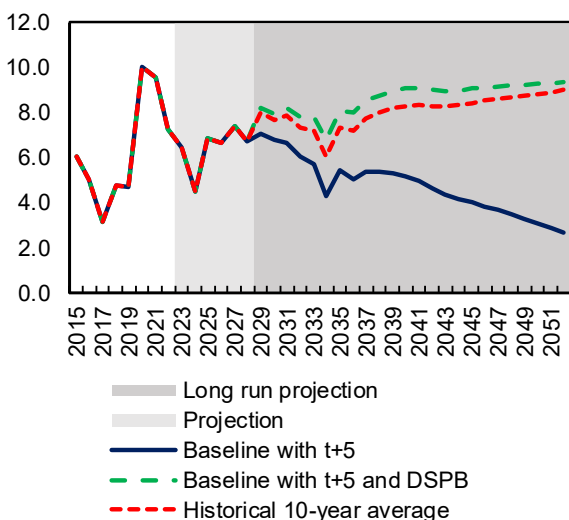
4/ The signal is low risk if the GFI is below 7.6; high risk if the DFI is above 17.9; and otherwise, it is moderate risk.

5/ The signal is low risk if the GFI is below 0.26; high risk if the DFI is above 0.40; and otherwise, it is moderate risk.

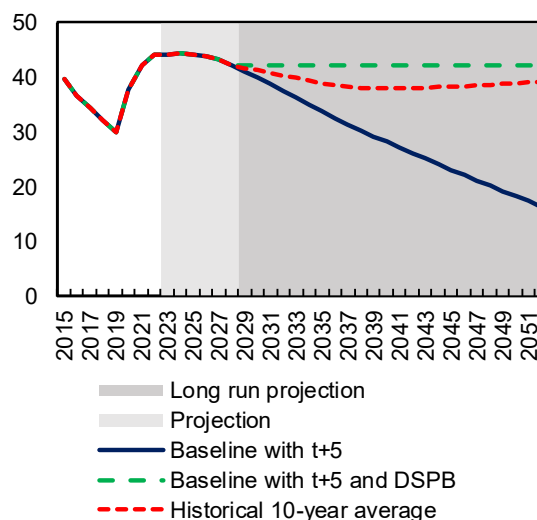
Figure 7. Czech Republic: Long-term Risk Assessment: Large Amortization

Projection	Variable	Risk Indication
Medium-term extrapolation	GFN-to-GDP ratio	Green
	Amortization-to-GDP ratio	Green
	Amortization	Red
Medium-term extrapolation with debt stabilizing primary balance	GFN-to-GDP ratio	Red
	Amortization-to-GDP ratio	Red
	Amortization	Red
Historical average assumptions	GFN-to-GDP ratio	Green
	Amortization-to-GDP ratio	Red
	Amortization	Red
Overall Risk Indication		Red

GFN-to-GDP Ratio



Total Public Debt-to-GDP rRtio



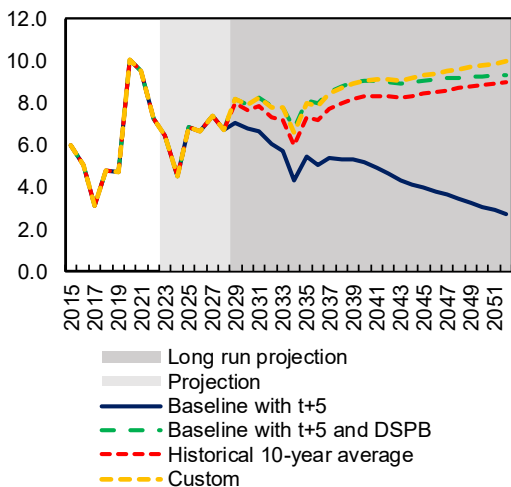
Commentary: Staff's baseline scenario, Baseline with t+5, shows both GFN- and public debt-to-GDP ratios declining over the long-term as Czechia converges to steady-state growth. While the Baseline with t+5 and DSPB scenario shows stabilization of the long-term GFN and public debt ratios at higher levels than staff's baseline.

Figure 8. Czech Republic: Long-term Risk Assessment: Large Amortization Including a Customized Scenario

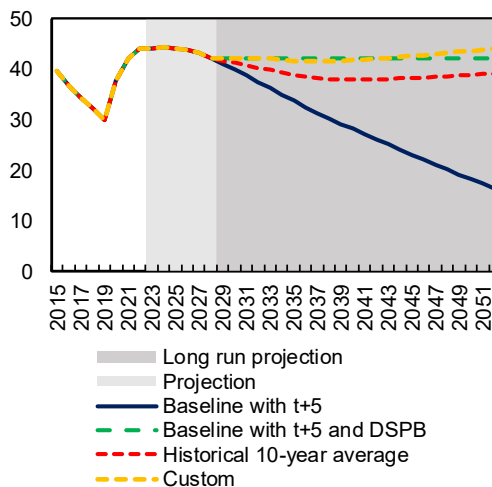
Projection	Variable	Risk Indication
Medium-term extrapolation	GFN-to-GDP ratio	
	Amortization-to-GDP ratio	
	Amortization	
Medium-term extrapolation with debt stabilizing primary balance	GFN-to-GDP ratio	
	Amortization-to-GDP ratio	
	Amortization	
Historical average assumptions	GFN-to-GDP ratio	
	Amortization-to-GDP ratio	
	Amortization	
Overall Risk Indication		

Variable	2028	2032 to 2036 average	Custom Scenario
Real GDP growth	2.5%	2.5%	2.5%
Primary Balance-to-GDP ratio	0.2%	-1.3%	-0.9%
Real depreciation	-1.6%	-2.0%	-1.9%
Inflation (GDP deflator)	2.0%	2.1%	2.1%

GFN-to-GDP Ratio



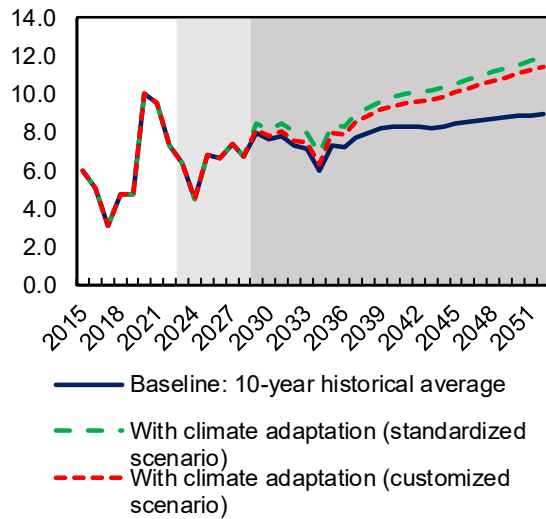
Total Public Debt-to-GDP Ratio



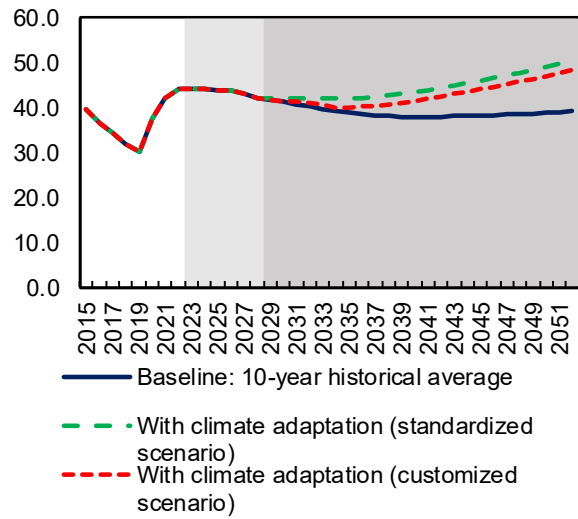
Commentary: Staff's baseline scenario, Baseline with t+5, shows both GFN- and public debt-to-GDP ratios declining over the long-term as Czechia converges to steady-state growth. While the Custom scenario shows an increase in the long-term GFN and public debt ratios at higher levels than staff's baseline, this is due to the fact that a smaller primary surplus is required to stabilize debt than is consistent with the projected steady-state.

Figure 9. Czech Republic: Climate Change Adaptation

GFN-to-GDP Ratio



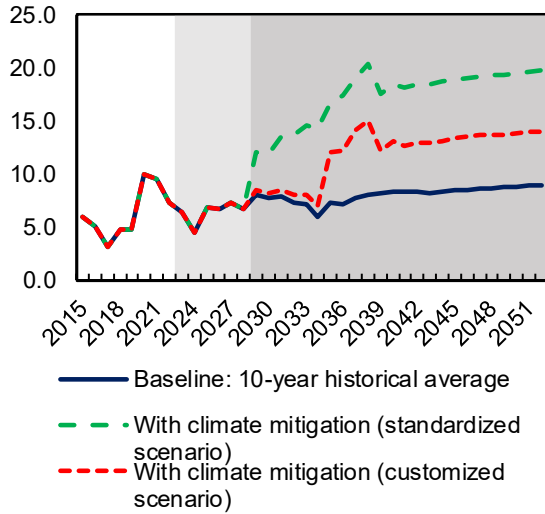
Total Public Debt-to-GDP Ratio



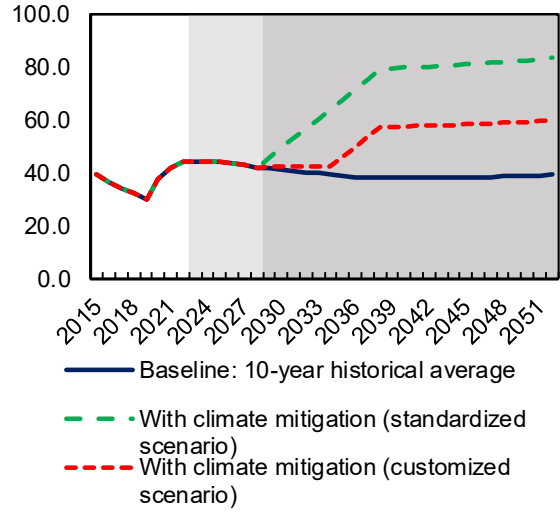
Commentary: Both the gross financing ratio to GDP and the public debt ratio to GDP increase higher than the baseline when climate adaptation is incorporated. Under the stress scenarios, the GFN-to-GDP ratio will increase above 10 percent in the long-term and public debt-to-GDP will increase above 45 percent.

Figure 10. Czech Republic: Climate Change Mitigation

GFN-to-GDP Ratio



Total Public Debt-to-GDP Ratio



Commentary: Both the gross financing ratio to GDP and the public debt ratio to GDP increase higher than the baseline when climate mitigation is incorporated. Under the stress scenarios, the GFN-to-GDP ratio will increase above 10 percent in the long-term and public debt-to-GDP will increase above 55 percent.

Table 1. Czech Republic: External Debt Sustainability Analysis
(Percent of GDP, unless otherwise indicated)

	Actual				Projections								Debt-stabilizing non-interest current account 6/ -3.4
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029		
Baseline: External debt	76.5	76.4	76.3	67.0	63.5	64.1	63.4	61.7	59.1	55.5	52.9		
Change in external debt	-4.9	-0.1	-0.1	-9.3	-3.5	0.6	-0.8	-1.6	-2.6	-3.6	-2.6		
Identified external debt-creating flows (4+8+9)	-3.8	-2.6	-7.4	-5.8	-0.2	-1.7	-3.1	-3.8	-4.2	-4.5	-4.5		
Current account deficit, excluding interest payments	-0.3	-2.0	2.8	6.1	0.9	0.2	-0.3	-1.0	-1.5	-2.0	-2.0		
Deficit in balance of goods and services	-6.0	-6.7	-2.8	0.1	-3.5	-3.9	-4.9	-5.0	-5.0	-5.0	-5.0		
Exports	73.9	69.9	73.0	74.9	68.6	67.8	68.8	69.8	71.2	72.8	74.5		
Imports	67.9	63.2	70.1	75.1	65.1	63.8	63.9	64.7	66.3	67.9	69.5		
Net non-debt creating capital inflows (negative)	-2.3	-2.7	-0.4	-2.5	-1.3	-1.2	-1.2	-1.2	-1.1	-1.0	-1.1		
Automatic debt dynamics 1/	-1.1	2.0	-9.7	-9.4	0.2	-0.7	-1.6	-1.6	-1.5	-1.4	-1.3		
Contribution from nominal interest rate	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Contribution from real GDP growth	-2.4	4.3	-2.4	-1.6	0.2	-0.7	-1.6	-1.6	-1.5	-1.4	-1.3		
Contribution from price and exchange rate changes 2/	1.3	-2.3	-7.3	-7.9	...	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 3/	-1.1	2.5	7.3	-3.6	-3.3	2.3	2.3	2.2	1.6	0.9	1.9		
External debt-to-exports ratio (in percent)	103.6	109.2	104.6	89.4	92.6	94.6	92.1	88.5	83.0	76.3	71.1		
Gross external financing need (in billions of US dollars) 4/	118.8	106.1	111.9	121.9	117.9	126.6	131.6	134.2	134.4	131.2	127.9		
in percent of GDP	47.0	43.1	39.7	42.0	37.4	38.3	38.0	37.1	35.6	33.3	31.0		
Scenario with key variables at their historical averages 5/					63.8	64.6	64.9	64.6	63.1	61.2	60.5	-4.3	
Key Macroeconomic Assumptions Underlying Baseline					Historical Average	Standard Deviation							
Real GDP growth (in percent)	3.0	-5.5	3.6	2.3	2.2	3.1	-0.4	1.2	2.5	2.7	2.5	2.5	
GDP deflator in US dollars (change in percent)	-1.6	3.1	10.6	11.5	2.5	8.0	9.0	3.7	2.2	1.6	2.0	2.0	
Nominal external interest rate (in percent)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Growth of exports (US dollar terms, in percent)	-2.6	-7.8	19.5	5.9	3.6	9.4	5.7	3.2	6.7	6.0	6.1	6.5	
Growth of imports (US dollar terms, in percent)	-3.0	-9.3	27.1	10.4	4.5	11.6	0.2	2.4	5.2	5.9	6.4	6.7	
Current account balance, excluding interest payments	0.3	2.0	-2.8	-6.1	-0.3	2.5	-0.9	-0.2	0.3	1.0	1.5	2.0	
Net non-debt creating capital inflows	2.3	2.7	0.4	2.5	1.5	1.5	1.3	1.2	1.2	1.1	1.0	1.1	

1/ Derived as $[r - g - r(1+g) + ea(1+r)] / (1+g+rr+gr)$ times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-r(1+g) + ea(1+r)] / (1+g+rr+gr)$ times previous period debt stock. r increases with an appreciating domestic currency ($e > 0$) and rising inflation (based on GDP deflator).

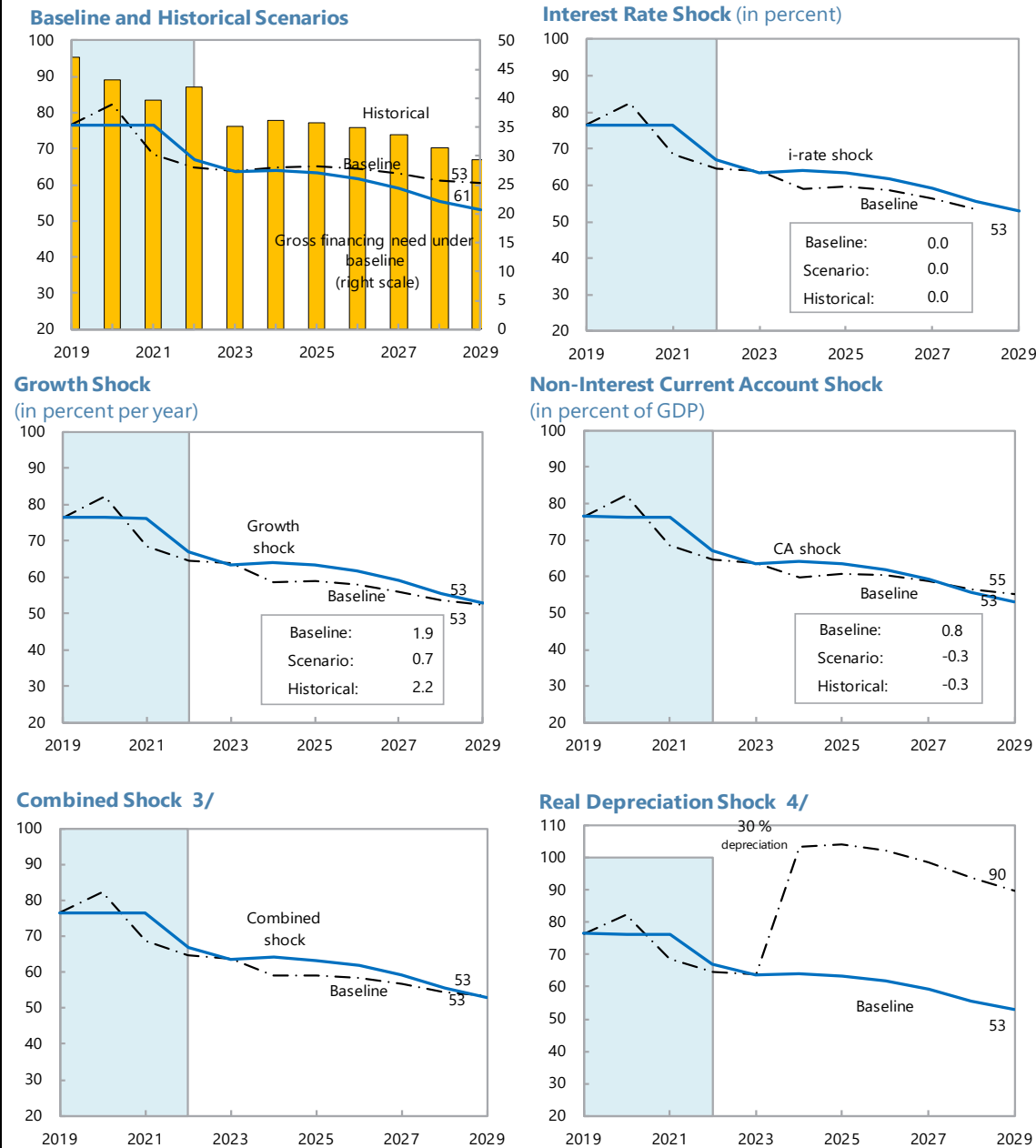
3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 1. Czech Republic: External Debt Sustainability: Bound Tests 1/ 2/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
 1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
 2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
 3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
 4/ One-time real depreciation of 30 percent occurs in 2021.

Annex V. Authorities' Response to Past IMF Policy Recommendations

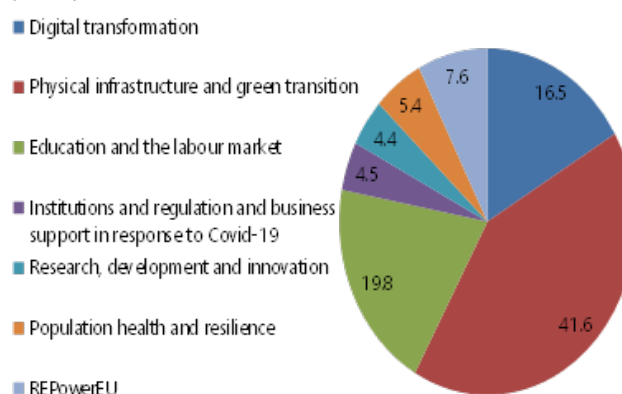
	Key Recommendations	Actions
Monetary	Staff recommended further hikes to the policy rate in the short term to bring down high inflation while reducing the risk of inflation expectations becoming untethered.	Policy rate was left unchanged, although decline in inflation and inflation expectations implied a tightening of the policy stance.
Macprudential and Financial	The retightening of borrower-based tools was welcomed, although staff suggested further calibration of macroprudential tools may be needed. Improved property taxation and measures to bolster housing supply was recommended. Staff recommended authorities to consider improvements in risk measurement across the cycle and for individual exposures.	The LTV was left unchanged, but the DTI and DSTI were deactivated. Some improvements in property taxation were adopted. Total building permits granted declined in 2023, although nonresidential building permits increased. Notable progress was made in measuring risk for individual exposures and across the cycle.
Fiscal	Staff advised that targeted and temporary support to alleviate the cost-of-living crisis should remain a priority, while unwinding previously adopted untargeted support.	Support to households and firms was provided to alleviate the cost-of-living crisis. Some new measures were appropriately targeted and most one-off untargeted measures were removed from the 2024 budget. Some of the previous untargeted measures remained.
Structural	Staff recommended to improve the integration of women, migrants, and refugees into the labor market, and to facilitate the green and digital economic transformation. Staff also recommended the indexation of the retirement age to life expectancy to improve pension sustainability and increase labor supply.	Some progress was made on the structural front, but significant challenges ahead remain. Some progress was done in advancing the reform of the pension system, but retirement age was not linked to life expectancy.

Annex VI. Resilience and Recovery Plan¹

The Resilience and Recovery Plan (RRP) contains reforms aiming to address bottlenecks to lasting and sustainable growth, and investments targeted to accelerate the transition towards low-carbon and climate-resilient economy, while maximizing the benefits of the digital transformation, and improving the quality of public administration. The RRP also aims at fostering social cohesion and resilience by increasing the availability and quality of healthcare, addressing long-standing challenges of inequalities in education, and investing in pre-school facilities.

1. The implementation of the Resilience and Recovery Plan (about €9.2 billion of grants and loans or 3 percent of GDP over 2021–2026) has commenced. The Recovery and Resilience Plan (RRP) was kick-started in September 2021 with the disbursement of the pre-financing payment (€915 million, 13 percent of the Recovery and Resilience Facility (RRF) allocation) for the implementation of crucial investment and reform measures outlined in Czechia's RRP. In March 2023, Czechia received the first disbursement (€928 million), after the satisfactory fulfilment of all 37 milestones and targets (EC, 2023a). The related 37 milestones and targets cover reforms of school curricula to promote digital literacy and digital skills, eHealth, the country's audit and control system, the law on the registration of beneficial owners, as well as investments for the reconstruction of three railway bridges, 45 safer railway level crossings and digital tools for education (EC, 2023b). The implementation of the RRF is expected to boost Czechia's green and digital transition, as well as social resilience. The macroeconomic impact of the RRF is estimated at about 1.2 percent increase in GDP by 2026 (EC, 2022).

Share of the NRP Budget Contributing to Each Pillar (Percent)



Sources: Czechia authorities IMF staff calculations.

2. The RRF will support the green transition by increasing the share of renewable energies in the energy mix and improving energy efficiency. Key measures for the green transition are: (i) energy efficiency (€1.6 billion) for the financing of large-scale renovation programs to increase the energy efficiency of residential and public buildings (ii) investments in renewable energy sources for businesses and households (€907 million); (iii) financing the modernization and digitalization of electricity distribution grids strengthening the integration of renewable energy (€316 million); (iv) investments in sustainable mobility (€1.2 billion), notably in low-emission vehicles for the business sector, improving railway infrastructure, and promoting electric charging stations and cycling pathways; (v) investment in the circular economy (€121 million), including recycling

¹ [Czechia's recovery and resilience plan](#), European Commission. Czechia's RRP was updated October 2023 to introduce a REPowerEU chapter.

infrastructure and support for circular economy solutions and water savings in businesses; and (vi) investment in forestry management aims at increasing sustainability of Czech forests (€335 million).

3. In line with the REPowerEU Plan's objectives, the RRF also includes reforms and investments to reduce reliance on fossil fuels. The REPowerEU measures include 15 reforms and 9 investments, which will be supported by a grant of €681 million.² Key reforms are to: (i) facilitate the Renovation Wave by supporting and advising households, businesses and public sector entities in the renovation of their buildings; (ii) streamline and accelerate permitting for renewables; (iii) simplify the linking of renewables to the grids; and (iv) provide support to energy communities. The investments will facilitate the modernization and digitalization of the electricity grid, develop new photovoltaic energy sources, electrify railways, support the purchase of electric or hydrogen vehicles and cargo e-bikes by private companies, and promote green skills and sustainability in universities.

4. The RRF will help facilitate the digital transformation by improving digital infrastructure and connectivity, e-government services, the digital transformation of businesses, and digital skills. The RRF will support the ongoing education reform by revamping the digital curricula in education, providing digital equipment and training to schools, incorporating new university programs in fast-growing digital fields, and upskilling and reskilling courses for citizens (€585 million). Furthermore, the plan will invest in the areas of (i) digital transformation and cyber-security of public administration, the justice system and health care (€790 million); (ii) the digital transformation of businesses, digital innovation hubs, high-capacity networks, and 5G networks (€662 million); and the construction of university infrastructure (€368 million).

5. Economic and social resilience is also expected to be boosted by RRF measures. In order to reinforce economic and social resilience, the plan envisages to improve the business environment (€222 million), particularly access to finance for companies, construction licensing procedures, anti-corruption measures, and cooperation between public and private research. The RRF's reforms and investments also aim to ensure equal access to education (€451 million), notably through increasing access to affordable pre-school care, reinforced support for disadvantaged children, and additional tutoring for children at risk of failure. Czechia will also invest in the resilience of healthcare services (€823 million), including by building new hospitals and long-term care facilities, acquiring new medical equipment, strengthening cancer screening programs and the rolling out e-Health. Investments will be dedicated to support new construction of affordable housing (€358 million).

² Czechia's Brexit Adjustment Reserve of €55 million is expected to be added to the grant of €681 million to finance the REPowerEU measures. See [Czechia's recovery and resilience plan](#).

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Annex VII. Downside Scenario and Contingent Policy

1. **In the adverse scenario, Czechia experiences a contraction of economic activity and pressure on inflation.** The scenario assumptions encompass several key risk factors, including the intensification of Russia’s war in Ukraine and other regional conflicts, the possibility of a sudden global economic slowdown or recession, fluctuations in commodity prices, misalignment in monetary policies, systemic financial instability, including sharp shifts in real interest rates, risk premiums, and asset repricing in some countries.
2. **Shocks are assumed to impact the economy at different magnitudes and sequences through four main channels.** The commodities channel entails rising energy prices increasing input costs for businesses and, in conjunction with higher food and energy prices for households, elevating consumer price inflation and reducing real incomes, consequently weighing on private consumption and investment. The trade channel suggests a decrease in external demand from major trading partners, which would lead to a reduction in Czechia’s exports. The labor mismatch channel involves tight labor markets and reduced efficiency in matching workers to suitable job opportunities. Finally, the financial conditions channel entails a tightening of global financial conditions potentially affecting domestic financial markets, resulting in stock market losses and the potential for an impact on economic activity.
3. **Careful calibration of economic policies would be needed.** The policy mix would depend on the nature and composition of the shocks.¹
 - Fiscal policy can play a counter-cyclical role. If adverse shocks were to put the economy in deep recession, such as during the pandemic—the consolidation path could be slowed down—with clear communication of the reasons, and a plan to return to the medium-term-objective (MTO) target and to ensure medium-to-long-term debt sustainability. It is essential to devise targeted aid without stoking inflation.
 - The monetary policy action would need to be data driven. CNB should stand ready to further tighten monetary policy if the inflationary effect of the shock (exchange rate) can be expected to dominate potential disinflationary effects (output, financial stability), impeding efforts to move inflation towards target. If growth decelerates substantially or inflationary pressures subside faster in a sustained manner, monetary policy can respond with a more accommodative stance.
 - Financial sector policies must ensure adequate incentives for appropriate risk-taking while maintaining the banking system’s ability to finance viable debtors and keep adequate buffers. Calibration of prudential policies should account for sector specific developments. Close monitoring of financial sector risks and debt-servicing would be warranted, especially if further increases in interest rates materialized or increases in prices further limited the ability to service debt.

¹ The IMF’s integrated policy framework agenda includes the development of models that allow the study of the interaction between monetary, fiscal, macroprudential, and foreign exchange policies. Although this work is still in progress, preliminary insights suggest that the appropriate policy mix and deployment of policy tools will depend on the nature of the shocks.



CZECH REPUBLIC

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

December 15, 2023

Prepared By

European Department
(In consultation with other departments)

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FUND RELATIONS

(As of October 31, 2023)

Membership Status

Joined 01/01/1993; Article VIII.

General Resources Account

	<u>SDR Million</u>	<u>Percent Quota</u>
Quota	2,180.20	100.00
Fund Holdings of Currency	1,590.00	72.93
Reserve Position	590.20	27.07

SDR Department

	<u>SDR Million</u>	<u>Percent Allocation</u>
Net cumulative allocation	2,869.82	100.00
Holdings	2,554.23	89.00

Outstanding Purchases and Loans

None.

Latest Financial Arrangements

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	March 17, 1993	March 16, 1994	177.00	70.00

Projected Payments to the Fund

	Forthcoming (SDR Million)				
	<u>2023</u>	<u>2024</u>	<u>2025</u>	<u>2026</u>	<u>2027</u>
<u>Principal</u>					
<u>Charges/Interest</u>	<u>3.26</u>	<u>13.29</u>	<u>13.28</u>	<u>13.29</u>	<u>13.29</u>
<u>Total</u>	<u>3.26</u>	<u>13.29</u>	<u>13.28</u>	<u>13.29</u>	<u>13.29</u>

Implementation of HIPC Initiative

Not applicable.

Implementation of Multilateral Debt Relief Initiative (MDRI)

Not applicable.

Implementation of Post-Catastrophic Debt Relief (PCDR)

Not applicable.

Safeguards Assessment

Not applicable.

Exchange Rate Arrangement

The currency of the Czech Republic is the Czech koruna, created on February 8, 1993, upon the dissolution of the currency union with the Slovak Republic, which had used the Czechoslovak koruna as its currency. The de jure exchange rate arrangement is free floating and the de facto exchange rate arrangement is floating. The external value of the koruna is solely determined by supply and demand in the interbank foreign exchange market, in which the Czech National Bank (CNB) might participate.

The Czech Republic has accepted the obligations of Article VIII, Section 2(a), 3, and 4 of the IMF's Articles of Agreement, and maintains an exchange system that is free of multiple currency practices and restrictions on the making of payments and transfers for current

international transactions. The Czech Republic maintains exchange restrictions for security reasons, based on UN Security Council Resolutions and Council of the European Union Regulations that have been notified to the Fund for approval under the procedures set forth in Executive Board Decision No. 144–(52/51).

Last Article IV Consultation

Concluded on January 20, 2023 (IMF Country Report No. 23/31).

FSAP Participation

An FSAP was carried out in late 2000/ early 2001. The Financial System Stability Assessment was considered by the Executive Board on July 16, 2001, concurrently with the staff report for the 2001 Article IV Consultation. An FSAP update was carried out in 2011. ROSCs on: banking supervision; data dissemination; fiscal transparency; securities market; and transparency of monetary and financial policies were published on the Fund’s external website on July 1, 2000.

Technical Assistance (last mission)

Department	Timing	Purpose
FAD	June/July 1999	Medium-term fiscal framework
MCM	February/June 1999	Integrated financial sector supervision (with WB)
RES	June/August 2000	Inflation targeting (financed by MFD)
STA	November 2006	GFSM 2001 implementation

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance

General

Data provision is adequate for surveillance.

National Accounts

The Czech Statistical Office (CSO) compiles and disseminates annual and quarterly national accounts on ESA2010 basis. The CSO compiles annual Supply-Use Tables (SUT) by 88 types of economic activities and 88 products, but there is room for improvements. For example, discrepancies between GDP estimates based on the production method and the expenditure method are subsumed under changes in inventories, which sometimes significantly changes the first estimates of inventories obtained directly from the surveys.

Price Statistics

The CSO compiles and disseminates a monthly consumer price index (CPI) using a weighting structure based on average expenditure data from 2019–2022. A monthly Harmonized Index of Consumer Prices (HICP) is disseminated according to European regulations. The producer price index is released monthly with coverage including industrial activities, construction, agriculture, and select business services. The CSO also compiles and releases monthly import and export price indexes based on data collected directly from establishments engaged in export and/or import activities. A quarterly residential property price index is also compiled.

External Sector Statistics

The CNB compiles and disseminates balance of payments and international investment position statistics in line with the sixth edition of the Balance of Payments and International Investment Position Manual (BPM6) and in accordance with legal requirements of the ECB and Eurostat. CNB generally derives balance of payments financial account transactions from changes in position data adjusted by exchange rate, price, and other changes. The CNB monthly disseminates the data template on International Reserves and Foreign Currency Liquidity. Czech Republic also participates in the Coordinated Direct Investment Survey (CDIS) and the Coordinated Portfolio Investment Survey (CPIS) and reports quarterly external debt statistics to the World Bank's Quarterly External Debt Statistics (QEDS) database.

Government Finance Statistics

Fiscal data in the GFSM 2014 framework is reported through the Eurostat convergence project with the IMF. Annual and quarterly fiscal data are compiled on ESA2010 basis by the Czech Statistical Office, including non-financial accounts, financial accounts, and financial balance sheets. The Ministry of Finance uses the ESA methodology for the Convergence Program targets. The ESA 2010 methodology includes a wider coverage of the general government sector, different classification of some government transactions, and impacts the calculation of GDP. Government transactions are recorded on an accrual basis.

Monetary and Financial Statistics

Monthly MFS data is sent to STA by ECB and is based on standardized report forms (SRFs). Monetary survey data is also provided to the European Department for policy purposes. MFS data covers the central bank (CNB) and the other depository corporations which comprises other monetary financial institutions which are defined under the European Union law to include deposit-taking corporations, electronic money institutions and other issuers of deposits and close substitutes of deposits. Data from the other financial corporations are currently not compiled. The Czech Republic reports 39 data series of the Financial Access Survey (FAS), including mobile and internet banking, gender-disaggregated data, and the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10.1 of the Sustainable Development Goals (SDGs).

II. Data Standards and Quality

The Czech Republic has adhered to the SDDS Plus since April 2016. The Czech Republic publishes data on its [National Summary Data Page \(NSDP\)](#). Metadata are posted on the [Dissemination Standards Bulletin Board](#). A [data ROSC](#) was published on July 1, 2000.

Czech Republic: Table of Common Indicators Required for Surveillance
(As of December 6, 2023)

	Date of latest observation	Date received	Frequency of data ⁷	Frequency of reporting ⁷	Frequency of publication ⁷
Exchange rates	Current	Current	D	D	D
International reserve assets and reserve liabilities of the monetary authorities ¹	November 2023	December 2023	M	M	M
Reserve/base money	November 2023	December 2023	M	M	M
Broad money	November 2023	December 2023	M	M	M
Central bank balance sheet	November 2023	December 2023	M	M	M
Consolidated balance sheet of the banking system	November 2023	December 2023	M	M	M
Interest rates ²	November 2023	November 2023	D	D	D
Consumer price index	October 2023	November 2023	M	M	M
Revenue, expenditure, balance, and composition of financing ³ – general government ⁴	June 2023	October 2023	Q	Q	Q
Revenue, expenditure, balance, and composition of financing – central government	October 2023	November 2023	M	M	M
Stocks of central government and central government-guaranteed debt ⁵	September 2023	October 2023	Q	Q	Q
External current account balance	September 2023	November 2023	M	M	M
Exports and imports of goods and services	September 2023	November 2023	M	M	M
GDP/GNP	September 2023	December 2023	Q	Q	Q
Gross external debt	June 2023	October 2023	Q	Q	Q
International investment position ⁶	June 2023	October 2023	Q	Q	Q

¹ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

² Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

³ Foreign, domestic bank, and domestic non-bank financing

⁴ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments. Data for the state budget are available with monthly frequency and timeliness, while data on extra budgetary funds are available only on an annual basis.

⁵ Including currency and maturity composition.

⁶ Includes external gross financial asset and liability positions vis-à-vis nonresidents.

⁷ Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Semi-annually (SA), Annually (A), Irregular (I), or Not Available (NA).

**Statement by the Staff Representative on Czech Republic
January 22, 2024**

1. Recent developments and data releases are in line with staff expectations regarding the outlook and balance of risks. GDP growth for Q3 was slightly revised downward to -0.6 percent from -0.5 percent (y/y). The state budget fiscal deficit, a key driver of the general government deficit, ended up at CZK 288.5bn (about 3.9 percent of GDP), lower than the 2023 annual budget deficit target of CZK 295bn (about 4.0 percent of GDP). In December, twelve-month headline and core inflation decreased to 6.9 and 3.6 percent, respectively, from 7.3 and 3.9 percent in November, respectively. The one-year-ahead financial markets inflation expectations increased marginally to 2.9 percent.

2. In its December meeting, the CNB Board lowered the policy rate by 25 basis points to 6.75 percent. This decision kept a contractionary monetary policy stance, as advised in the staff report. The CNB board stated that future decisions will rely on the most recent forecasts and assessment based on the most updated data. In light of the significant uncertainty surrounding commodity prices, wages, profits and inflation, staff supports the data-driven, meeting-by-meeting approach to determine the interest rate path.

**Statement by Mr. Daniel Palotai, Executive Director for Czech Republic and
Ms. Hana Hejlova, Senior Advisor to Executive Director
January 22, 2024**

On behalf of the Czech authorities, we would like to thank the mission team led by Miguel Segoviano for the very constructive policy dialog during the staff visit and Article IV mission, as well as for the insightful staff report and the very useful Selected Issues Paper. The Czech authorities broadly share staff's assessment of the current economic challenges and note the policy recommendations, which are mostly in line with the authorities' policy agenda. The authorities' specific comments on the key policy areas are presented below.

Recent developments and outlook

The Czech economy was in a downturn in 2023 amid persisting, although decreasing, inflationary pressures. The economy was still impacted by the receding inflationary pressures from the external environment and demand pressures from the domestic economy. GDP declined by 0.4 percent in 2023 according to the estimates, with inflation at 10.7 percent for the year as a whole. Economic activity was held back by lower household consumption, which was dampened by the tight monetary policy, deteriorated real purchasing power and an increased savings rate mainly due to weaker economic sentiment. Economic growth was also subdued due to decreasing additions to inventories, which were returning to normal after the supply chain disruptions had subsided. The Czech authorities estimate that the economy is currently below its potential, but the labor market still remains somewhat tight.

The economy is projected to return to positive growth in 2024 (at 1.2 percent), and inflation is expected to decline from 2.6 percent in 2024 to the central bank's 2 percent target in early 2025. Economic growth is expected to be driven by a recovery in household consumption on the back of a persistently strong labor market, restored real purchasing power, and a gradual return of the savings rate to normal. The effect of increasing household consumption on inflation is expected to be offset by the decreasing profit margins of the producers. The recently adopted fiscal consolidation package will complement the still tight monetary policy and reduce inflationary pressures with a slightly dampening effect on economic activity. Downside risks to economic growth include uncertainty about the domestic wage growth and the development of external demand. Upside risks to inflation include inflation expectations, which may become unanchored and the impact of changes in indirect taxes.

Monetary policy

In the last two years, the Czech National Bank (CNB) responded timely and vigorously to the increasing inflation. In the first half of 2020, the CNB reduced the key monetary policy rate three times to 0.25 percent in response to the pandemic-induced shock. As inflation had started picking up, the CNB increased interest rates nine times between June 2021 and June 2022, bringing the key monetary policy rate to 7 percent. Inflation peaked at 18.0 percent in September 2022, before falling to 6.9 percent in December 2023 (actually to 4.2 percent if adjusted by a statistical base effect stemming from an administratively driven temporary drop in electricity prices in the last three months of 2022). The last rate is broadly in line with expectations.

The CNB has recently started to lower key policy rates, but later and to a smaller extent than what would be consistent with the baseline scenario of its Autumn 2023 forecast. As inflation is expected to fall significantly in 2024, keeping the monetary policy stance unchanged could become excessively tight. That said, projections consistent with the CNB's Autumn 2023 forecast imply a decline in interest rates by approximately 0.5 pp from the fourth quarter of 2023 onwards. Given the risk of still elevated inflation expectations which could manifest in stronger repricing of goods and services and wage bargaining at the beginning of 2024, the Bank Board decided to keep interest rates unchanged in November 2023. In December 2023 (after the cut-off date of the staff report), the Bank Board decided to lower the monetary policy rates by 0.25 percent, i.e., less than implied by the baseline scenario.

Going forward, the CNB stands ready to adjust the pace of the interest rate reduction process as deemed necessary to safeguard price stability. In line with the IMF staff's view, the Bank Board still sees inflationary risks and considers it necessary to persist with a tight monetary policy stance and approach potential further rate cuts with caution. Therefore, the Bank Board expects the interest rate path in the coming quarters to be higher than in the baseline scenario of the last forecast. At the same time, they state that the interest rate reduction process can be paused or terminated at any time at levels that are still restrictive if inflation does not decrease in line with the forecast.

Fiscal policy

Before deteriorating in recent years, the Czech Republic had one of the lowest public debt-to-GDP ratios in the EU and public budget surpluses. Since 2020, the general government has been running deficits exceeding the EU Stability and Growth Pact benchmark of 3 percent of GDP. This is the result of measures taken on both the revenue and expenditure side during the pandemic, followed by policies in response to the war in Ukraine (primarily related to energy availability and affordability). In 2020 and 2021, the general government deficit thus exceeded 5 percent of GDP, before falling to 3.2 percent of GDP in 2022. In 2023, the government ran a deficit of CZK 288.5 billion, which was CZK 71.9 billion lower than in 2022 and more favorable than the approved plan. While the Czech Republic continues to meet the EU Maastricht criterion of 60 percent of GDP for the level of general government debt as well as the national debt rule, the fiscal policy space is shrinking significantly, considering the additional demands stemming from the challenges of energy self-sufficiency, population ageing and the transition to a low-carbon economy.

The government committed to significant steps to improve fiscal sustainability in both the medium and long term, making it one of its highest priorities, and successfully pushed through an extensive legislative package of consolidation measures. As of the start of 2024, a number of one-off measures, primarily related to mitigating the effects of high energy prices, came to an end. At the same time, an extensive consolidation package will enter into force, which was legislated by Parliament in December 2023. Besides concrete measures, the consolidation package includes an amendment to the national balance rule, which implies a return to the medium-term budgetary objective at least three years faster than previously anticipated. In 2023, the government also put forward several changes to the pension system that make up the first part of the reform. At the same time, the government does not intend, by any

means, to ensure fiscal sustainability by reducing public investment. Overall, the forecast of the Fiscal Outlook of the Czech Republic envisages a gradual reduction of the general government deficit to 1.5 percent of GDP in 2026. Furthermore, the fiscal balance should fall below the Maastricht criterion and the Stability and Growth Pact reference value for excessive deficits already in 2024.

The consolidation package is consistent with previous recommendations by international institutions. A key element on the expenditure side is the revision and suspension of subsidies which turned out to be costly but untargeted. The payment of unemployment benefits will be tightened, and the central government will reduce operational expenditures and public salary costs. One of the most significant changes on the revenue side is the increase in the corporate income tax by 2 pp to 21 percent, which will bring it closer to the EU and OECD average. Other important changes will be the reintroduction of the sickness insurance rate for employees and an increase in the real estate tax to approximately 180 percent. The package also includes an increase in taxation of “vices” (alcohol and tobacco products, gambling), and a modest increase in the personal income tax for high-income households. Finally, the package simplifies the value added tax system, consolidating the two reduced rates into one at 12 percent. The timing of the package in a period of renewed economic recovery should support the implementation of the consolidation measures.

Financial policies

Counter cyclical buffer (CCyB)

During the last economic and financial expansion, the CNB reacted to the fast build-up of cyclical risks by increasing the CCyB rate to the maximum. In response to the pandemic-induced shock, the CNB decided to lower the CCyB rate three times from 2 percent to 0.5 percent in the first half of 2020. Following a rapid change in the financial cycle, the CNB swiftly increased the CCyB rate three times up to 2 percent over the course of 2021. In March 2022, the CNB increased the CCyB for the last time, bringing it to the maximum rate of 2.5 percent.

As cyclical risks recede, the CNB approached a partial release of the CCyB in 2023. In line with weak economic activity and a tight monetary policy, the financial cycle was in a downturn in 2023. This was according to all components of the financial cycle indicator used by the CNB, including the slowdown in growth in new loans to households, the slowdown in property price growth and the decline in the debt of households and corporations. Moreover, the previous strong profitability of non-financial corporations, low unemployment rate and the application of borrower-based measures for mortgage loans during the previous expansion fostered diminishing of risks in banks’ balance sheets. In view of these developments, the Bank Board decided to lower the CCyB rate from 2.5 percent to 2.25 percent in June and to 2 percent in September 2023. According to the CNB’s estimates, this rate is sufficient to cover the additional capital needed to cover unexpected cyclical credit losses and the growth in risk weights as a result of adverse developments. Going forward, projections consistent with the CNB’s Autumn 2023 forecast suggest only a gradual rebound of the financial cycle.

The asynchronous developments in the CCyB policy compared to other EU countries are well justified. The divergence in the policy decisions can be explained by the different monetary policy time profiles (the CNB had to tighten earlier and more significantly), previous exuberant developments of cyclical risks, and the consequent increase in the CCyB to the maximum rate (in line with quantification of cyclical risks accumulated in banks' balance sheets).

Borrower-based measures (BBMs)

The CNB was mitigating risks related to residential real estate loans from the beginning of the last expansion. The CNB had already issued recommendations to limit the LTV (loan-to-value), DTI (debt-to-income) and DSTI (debt service-to-income) ratios back in 2015 and 2016. During 2020, the CNB eased the LTV limits, and lifted the DTI and DSTI limits in response to the pandemic-induced shock. As the housing and mortgage markets continued overheating, the CNB tightened or reintroduced the LTV, DTI and DSTI limits in November 2021. To this end, the CNB used its new legally binding powers, which had become available in the meantime.

In response to the slowdown in cyclical risks, and consistent with the statutory powers, the CNB discontinued some of the BBMs in 2023. Mortgage lending to households remained subdued in 2023, while house prices declined for the first time in years. As the contribution to systemic risks – a condition for the legally binding measures – was declining in the new production of loans, the Bank Board decided to deactivate the DSTI limits in June 2023. The main role of DSTI limits, as complements to DTI limits, is to mitigate risks related to an increase in interest rates. As the interest rates peaked in 2023, the DSTI limits were no longer fulfilling their key role. At the same time, the high interest rates were naturally constraining borrowers from taking up large loans. An ex-post assessment showed that there was indeed no major increase in the demand for new mortgage loans with high LTV or DTI values after the DSTI limits had been lifted. Simulations also indicated that the difference between the default rates and credit losses would be small if the other BBMs were also deactivated. The Bank Board therefore decided to further discontinue the DTI limits in November 2023, while the LTV limits were kept in place. In line with the development of the financial cycle, projections forecast only a gradual recovery of the mortgage market going forward without the potential for a systemic risk build-up.

Regarding the use of BBMs, the Czech authorities believe that as far as the provision of new mortgage loans does not contribute to a build-up of systemic risks, the difference between the structural and cyclical approach can be considered insignificant. Conditions for the use of BBMs, which are related to the identification of systemic risks and which de facto imply the cyclical use of BBMs, also exist in the legal frameworks of some other EU countries. Unlike staff, the Czech authorities therefore do not consider such a condition to be a sufficient reason for revising the law.

Policy related to corporate foreign currency loans

The importance of foreign currency funding of domestic non-financial corporations has been increasing for long, reflecting the openness of the Czech economy. The share of euro loans in the total outstanding amount of domestic banks' loans to non-financial corporations was

close to 50 percent in the third quarter of 2023. The figure for total loans to domestic corporations, i.e., counting in loans from foreign banks and intercompany loans, was even higher.

The CNB has strengthened the supervision of foreign currency corporate loans. The risk related to these loans can be hedged through derivative transactions, or naturally by foreign currency revenues of the firms. Still, the vulnerability of the corporations may be exacerbated under certain conditions, e.g., in the event of a drop in foreign currency income or a downturn in external demand. An analysis of the CNB showed that the additional burden on corporations would not be systemically important per se, but it could exacerbate other adverse conditions. If needed for strengthening the resilience of the domestic banking sector, the CNB stands ready to set a general or sectoral systemic risk buffer to address these risks.

Structural reform agenda

The authorities put a premium in their reform agenda on addressing carbon dependence and population ageing as they constitute risks to the long-term prosperity. The Czech industry is strongly energy-intensive and the use of fossil fuels in the energy sector is above the EU average. This may induce higher costs for firms to transition to a climate-neutral economy in the future. Another challenge, as in other European peers, is the ageing population, putting a strain on sustainability of the pension and health care systems. Despite the positive balance of foreign migration and the increasing statutory retirement age, labor shortages persist. In 2023, the unemployment rate in the Czech Republic remained the lowest in the EU in spite of subdued economic activity.

The government makes significant progress in implementing the policy reforms, with a number of them still in the pipeline. The annual National Development Plan for 2023 summarizes the main actions taken, including the support of the green transition (incentives for private investment, support to small and medium-sized enterprises), reducing the mismatches between labor supply and demand, increasing the participation in the labor force (job integration program for disadvantaged persons and support to families with children), and digital transformation of the economy. Meanwhile, the implementation of the Innovation Strategy should foster the change towards higher value-added, and therefore less labor-intensive businesses without harming businesses' economic competitiveness. The second part of the pension system revision is currently in preparation.