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MISSION CONCLUDING STATEMENT

Czech Republic: Staff Concluding Statement of the 2022 Article IV Mission

November 22, 2022

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under [Article IV \(/external/pubs/ft/aa/aa04.htm\)](/external/pubs/ft/aa/aa04.htm) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

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

Prague, The Czech Republic:

The Czech Republic's nascent recovery from the pandemic has been stifled by Russia's war in Ukraine. Inflation, which is well above target, and the rise in the cost of living are causing significant social pressure. The labor market remains tight and vulnerabilities from a heated property market persist. Uncertainty is high due to the war with risks to economic activity tilted to the downside and risks to inflation tilted to the upside.

Key Policy Recommendations:

- **Monetary policy.** *While a careful tread between high inflation and weakening economic activity is needed, priority should be given to decisively quelling inflation. Staff recommends further hikes to the policy rate in the short term, to bring down high inflation and to ensure fulfillment of the inflation target over the medium term, while reducing the risk of inflation expectations becoming untethered.*

- **Fiscal policy.** Targeted and temporary support to alleviate the cost-of-living crisis should remain a priority while limiting the impact on aggregate demand so as not to add to inflationary pressures. Unwinding previously-adopted untargeted support measures can enhance policy space to support the vulnerable in the short term, while also helping to address long term debt sustainability pressures.
- **Macrofinancial.** The recent retightening of borrower-based tools is welcome, as these have helped tame risk taking by banks and households. These tools should be supported by improved property taxation and measures to bolster housing supply. Conditional on market developments, further calibration of macroprudential tools may be needed.
- **Structural policies** should continue strengthening the integration of women, migrants and refugees into the labor market, while facilitating the green and digital transitions. The indexation of the retirement age to life expectancy would improve pension sustainability and increase the labor supply. Policies to foster the green transformation can bolster energy security by enhancing energy efficiency and increasing the supply of renewables.

Outlook and Risks

Growth is projected to remain subdued and inflation high in the near term, as Russia's war in Ukraine weighs on the recovery. A rebound is expected from 2024. Growth is projected to slow to 2.3 percent in 2022 and turn negative to around -0.5 percent in 2023 as households' purchasing power weakens, and firms rein in investment amidst higher uncertainty and falling consumer sentiment. Labor market tightness is expected to ease as the economy cools and Ukrainian refugees integrate into the labor force. Growth is projected to significantly rebound by end 2024 mainly driven by consumption and exports. In the near term, inflationary pressures are expected to be driven by external and domestic factors. Barring additional shocks—and if commodity and food prices soften as currently predicted by futures markets, inflation expectations remain tethered, and remaining GVC bottlenecks ease—headline inflation is projected to achieve the policy target during 2024, as the contractionary monetary policy actions taken by the CNB take effect.

Risks to the outlook are tilted to the downside and risks to inflation to the upside. While the Czech Republic sourced virtually all of its gas from Russia, physical gas disruptions are unlikely this winter, even under the baseline scenario of a complete shut-off, as gas storage levels are at capacity and some re-sourcing took place. Nevertheless, the economy remains vulnerable to the availability of and further increases in energy and commodity prices, which could further impact consumption, fixed investment and exports. This could also deepen the recession, which could further moderate underlying inflationary pressures. In the unlikely event of a disorderly house price correction, financial disruptions could impair banks' and households' balance sheets, potentially suppressing aggregate demand. The risk of inflation expectations becoming untethered or wage-price spirals forming—against the backdrop of already high inflation and an easing but still tight labor market—are high. Inflation expectations appear to remain broadly anchored but are above the inflation target and nominal wage growth, though below inflation, has continued increasing. Depreciation pressures on the koruna could arise if the interest rate differential versus major central banks narrows as they tighten their monetary policies. On the other hand, an unexpected significant fall in global demand could cause a fall in external inflationary pressures.

Monetary Policy

Staff recommends further monetary policy tightening in the short term to ensure fulfillment of the inflation target over the medium term, while reducing the risk of inflation expectations becoming untethered. Staff recommends that the CNB should place greater weight on the minimization of this risk. While a careful tread between high inflation and weakening economic activity needs to be taken, priority should be given to decisively quelling inflation. Keeping expectations tethered is of key importance, as higher inflation expectations would eventually require a significantly stronger tightening to restore price stability and thus entail more costly economic adjustments. By increasing the rate above its current level, the CNB could bring down currently elevated inflation and expectations and reinforce its strong commitment to the price stability objective. Consistent with the CNB baseline scenario, staff analysis shows that further interest rate tightening would steer inflation to the target sooner thus allowing an earlier reduction of the policy rate.

Fiscal Policy

The current fiscal stance is appropriately contractionary, but fiscal policy should remain flexible given the

uncertain outlook. The headline deficit is projected to decrease by about $\frac{3}{4}$ percentage points to $4\frac{1}{4}$ percent of GDP in 2022 and the then to remain at the same level in 2023. In cyclically adjusted terms, the fiscal stance is mildly contractionary in both years—in 2022 due to expiring pandemic-related measures, and in 2023 as the output gap turns negative. The contractionary stance is called for by above-target inflation and a tight labor market. It will avoid compounding inflationary pressures by adding to aggregate demand. The pace of consolidation could be reassessed in the event of severe shocks.

Support for households and firms amidst the cost-of living crisis is justified but measures that are targeted, temporary, and preserve price signals to incentivize energy savings are preferable. The energy price shock is imposing hardship on vulnerable households and weakening output. That said, relief should be limited in size, temporary, and interfere minimally with price signals which are necessary to encourage energy savings. The one-off lump-sum allowance applied to households' energy bills, and the allowance for families with children subject to income caps, preserve price signals and incentives to conserve energy, and are therefore welcome. Energy savings have already been achieved by allowing energy prices to pass through to end consumers. However, the waivers of the renewable energy surcharge and excise and road taxes, and the energy price caps for households and SMEs are not targeted, and they blunt the incentives for further energy savings. While containing a sizeable degree of price pass-through, the energy subsidies for large firms that incur large energy bills could be designed better, for instance by linking relief to past energy usage, or offering lump-sum support, to avoid lowering the effective price of current consumption. Alternatively, energy consumption below a minimum necessary level could be subsidized at a guaranteed price, while consumption above that level would be based on market prices.

Unwinding previously-adopted untargeted support measures can enhance policy space to extend further support to the vulnerable, while also helping to address long-term debt sustainability. The personal income tax (PIT) regime as well as the property transfer tax should be reinstated to pre-pandemic levels as soon as conditions allow, as untargeted policy support is unwarranted in an environment of high inflation and low unemployment. Such measures could lift the primary balance above its debt-stabilizing level as early as 2024. If increasing taxes in the current environment is not feasible, once the acute cost of living crisis wanes, the reintroduction could be undertaken in phases, while increasing the progressivity of the PIT and stepping up transfers for the vulnerable. Any remaining savings would serve to replenish fiscal buffers, improving policy space to address future shocks and stabilizing debt. Moreover, the unwinding of untargeted measures would further support the policy mix in its fight against inflation.

The windfall tax can help offset the cost-of-energy relief measures but is second best to a permanent excess profit tax that avoids disincentivizing investment. Given the current circumstances, staff assesses the tax to be an acceptable way to generate revenue, as it is strictly temporary and imposed only on excess profits, allowing producers to recover their operating costs and keep a portion of the excess profits. Nevertheless, by undermining tax certainty, a windfall tax may weaken the investment climate and discourage future investment due to its ad-hoc nature and is second-best to a permanent fiscal regime that determines clear rules under which excess profits can be taxed.

Macprudential and Financial Sector Policies

The retightening of borrower-based measures is welcome, as these appear to be taming risk taking, but debt servicing capacity should be monitored. While retightened borrower-based measures are increasingly binding for a growing number of borrowers, close monitoring of debt servicing is warranted, especially if additional increases in interest rates materialize or continued increases in the cost of living further limit the ability to service debt. Further loosening or tightening of macroprudential measures may be needed conditional on market developments and risk-taking behavior. Property taxes should be based on market valuations and mortgage interest deductibility should be eliminated to disincentivize larger housing purchases and higher indebtedness.

Improvements in risk measurement across the cycle and for individual exposures should be considered. Loss absorbing buffers, liquidity and profitability in the banking sector are robust. Staff assesses the system to be broadly resilient. However, vulnerabilities mainly due to high concentration of banks in the real estate sector, combined with the projected economic downturn require close monitoring of risk exposures. The CNB retightened the countercyclical capital buffer rate as the impact of the pandemic waned. Staff welcomes the development of models to assess sectoral risk weights. However, leveraging information for corporates, staff recommends to further enhance models to improve the measurement of risk at the individual exposure level. Moreover, staff recommends combining the proposed modeling

framework with macroprudential stress tests to quantify potential losses due to contagion across Czech and foreign financial entities. Such a framework would also be of great use to improve calibration of macroprudential tools.

Labor Market Policies

Policies to enhance inclusion should be stepped up to address labor shortages and skill mismatches. Active Labor Market Policies (ALMPs) should focus on sectors with still high labor shortages, and target training and upskilling measures to the lower-skilled and employees at risk of losing their jobs. Participation in the labor market would also benefit from better linking of the retirement age to life expectancy and increasing the participation of vulnerable groups. Continued efforts to integrate women with young children should build on recent improvements in childcare provision, while further improving parental leave policies to maximize labor market participation.

Facilitating the inflow of migrants and effectively integrating Ukrainian refugees would help alleviate labor shortages. The recent upgrades to the government immigration programs, which have helped attract a higher number of skilled foreign workers should be sustained in line with the Innovation Strategy. In parallel, the effective integration of Ukrainian refugees would help ease labor market tightness. Going forward, policies should prioritize the adequate provision of language training, childcare, job search support, and ease of qualification recognition, which should accelerate integration, reduce skill downgrading, and boost productivity gains.

Structural policies should support technological innovation and the redeployment of workers. Although technological change, automation, and the transition to electric vehicles would help boost productivity, they could adversely affect employment. Similarly, the lack of skilled labor in the green and digital sectors could delay the diffusion of innovation and the digital-green transition. Policies should therefore facilitate the cross-sectoral reallocation of workers through enhanced ALMPs, including reskilling and vocational training.

Productivity and the Green and Digital Transition

Limited progress in enhancing productivity underscores the need for further scaling up investment. A timely implementation of the Innovation Strategy and the key reforms and investments of the Resilience and Recovery Plan (RRP) would help build the technical and digital skills needed in high productivity sectors. Meanwhile, to improve the business environment, improved incentives, support for business R&D, and venture capital and equity financing for SMEs are needed. In parallel, further streamlining the Czech Republic's business regulatory framework, including simplifying the construction permitting process, should strengthen the ease of doing business.

Policies to foster the green transformation can bolster energy security by enhancing energy efficiency and increasing the supply of renewables. Given the current energy security concerns, delaying the phase out of coal facilities is an option that could secure supplies in the short term. However, amid continuing efforts to diversify to alternative energy supply sources, priority should be given to policies that encourage greater investment in renewables and enhance energy efficiency in line with the Fit for 55 package and REPowerEU plan. Significant green investments via the RRP are key to supporting the green transition.

Long-term Sustainability of the Pension System

Ensuring sustainability of the pension system would require a multi-pronged reform. Strengthening sustainability would require linking the retirement age to adjust automatically to life expectancy complemented by net increases in revenue through growth-friendly improvements to the tax system including by raising environmental and property taxes and enhancing compliance.

The IMF team thanks the Czech authorities and other counterparts for their accommodative flexibility, warm hospitality and high-quality discussions.

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