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COMMISSION STAFF WORKING DOCUMENT

In-depth review for Czechia

Accompanying the document

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European Commission

Czechia

In-Depth Review 2023

On the basis of this in-depth review for Czechia undertaken under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances, the Commission has considered in its Communication "European Semester – 2023 Spring Package" (COM(2023) 600 final) that:

Czechia is not found to experience imbalances. Vulnerabilities relate to price competitiveness and house prices, but seem limited going forward as household debt is contained and inflation is expected to decelerate significantly faster than the EU average. The economy was strongly affected by the energy price shock with inflation rising fast. A loose fiscal stance since the pandemic has also contributed to the acceleration of inflation. While overall price pressures remain elevated, cost competitiveness is projected to partially recover going forward amid falling energy prices, without there being any immediate external sustainability challenges. Inflation is expected to decelerate significantly faster than the EU average. However, if inflation persist, that could pose some risks for Czechia's competitiveness. The recent deterioration of the current account warrants close monitoring going forward. In recent years, demand for housing increased strongly, spurred by low interest rates, high income growth and loosened macroprudential measures, and supply of housing did not keep up. House prices grew more strongly during the pandemic but started to moderate in mid-2022 amid higher interest rates and stricter lending conditions. However, risks of a significant house price correction appear to be low, household debt is contained, and the banking sector is sound; a continued limited supply response over the medium-term would nonetheless continue to drive prices up. Continued efforts are needed to rein in inflation. Bringing inflation down quickly requires a strong deceleration in demand growth, which in turn can be achieved by sufficiently tight monetary and fiscal policy.

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1. INTRODUCTION

In 2022, over the previous annual cycle of surveillance under the Macroeconomic Imbalance Procedure (MIP), Czechia was not subject to an in-depth review to assess its vulnerabilities. ([1]) The 2023 Alert Mechanism Report published in November 2022 concluded that an in-depth review (IDR) should be undertaken for Czechia this year, with a view to examine newly emerging vulnerabilities and their implications. The AMR concluded that in Czechia, concerns related to cost competitiveness and house price developments, which existed already before the COVID-19 pandemic, persist. Nominal unit labour costs are set to grow further, with an appreciation of the real effective exchange rate being underway and core inflation being very high compared to Czechia's euro area peers. Nominal house price growth has been amongst the highest in the EU, while house prices are estimated as being overvalued.

Czechia's post-pandemic recovery was impeded by surging inflation in 2022 and is expected to remain weak in 2023. ([2]) In 2022, the Czech economy grew by 2.5%, dampened by a worsening financial situation of households, slowing external demand and receding problems in global value chains. Economic activity is forecast to increase only moderately (0.2%) in 2023 driven by exports but being held back by low consumption on the back of a decline in real disposable income, a tight financial situation of households, and rather low consumer sentiment. GDP growth is forecast to increase by 2.6% in 2024 supported by recovering domestic demand and an improving economic situation in Czechia's main trade partners. Consumer price inflation (HICP) increased to 14.8% in 2022 and peaked at 19.1% in January 2023, driven by fast-growing prices for commodities and production inputs. Cost pressures are set to ease during 2023 on the back of a decline in real income and tight monetary policy, bringing inflation down to 11.9% in 2023 and 3.4% in 2024. More expansionary fiscal policy presents an upside risk to both the growth and the inflation forecast. If inflation expectations become unanchored and contribute to wage increases, inflation could exceed expectations. At the same time, downside risks could stem from a stronger-than-forecasted downturn in domestic consumer and investment demand.

This in-depth review presents the main findings of the assessment of macroeconomic vulnerabilities for Czechia. Vulnerabilities related to housing and competitiveness in Czechia are also discussed in horizontal thematic notes that were recently published. ([3])The MIP assessment matrix is published in the 2023 Country Report for Czechia. ([4])

([1]) European Commission (2022), European Semester Spring Package 2022, COM(2022) 600 final.

([2]) European Commission (2023), European Economic Forecast: Spring 2023, Institutional Paper 200.

([3]) European Commission (2023), Housing Market Developments: Thematic Note to Support In-Depth Reviews, European Economy: Institutional Papers, 197. European Commission (2023), Inflation Differentials in Europe and Implications for Competitiveness: Thematic Note to Support In-Depth Reviews, European Economy: Institutional Papers, 198.

([4]) European Commission (2023), Country Report Czechia 2023, SWD(2023) 603 final.

2. ASSESSMENT OF MACROECONOMIC VULNERABILITIES

Gravity, evolution and prospects

Czechia has been facing several vulnerabilities that need to be monitored. The Czech economy enjoyed a robust expansion before the COVID-19 pandemic, with GDP growth averaging 3.6% per year between 2014-2019. While inflation stood at 3.3% in 2020 and 2021, the Czech economy was negatively impacted by very high inflation in 2022 and 2023-Q1, related to the rapid increase in energy prices that accompanied the Russian invasion of Ukraine. Currently, while slowing down, inflation in Czechia, including core inflation, is substantially higher than the euro area average. If the high rate of inflation turns out to be persistent, it could negatively affect Czechia's competitiveness. Amid supply-side frictions and a strong increase in energy prices, external balances deteriorated in 2022, but concerns are limited by the strong stock position of the net international investment position. In parallel, the Czech economy has experienced very rapid house price growth since the pandemic. This IDR examines the possible implications of these developments to assess the extent of vulnerabilities facing the Czech economy and whether they are a cause for concern for the near future.

Housing Market

On 5 April 2023, the Commission presented a horizontal thematic note on housing, which also covers Czechia. It showed that house prices more than doubled over the last decade in Czechia. Since 2010 house prices have grown by over 120% in nominal terms, compared to a 42.5% of consumer price increase. Lower interest rates have played a significant role in increasing demand for housing (graph 2.1 e). Nevertheless, since 2020 house prices have increased well beyond what would seem to be explained by low interest rates and rising household incomes. In addition, relative to rents, house prices have appreciated more significantly over recent years. Overall, house prices appear overvalued by around 30% (Q3 2022).

Multiple factors drove house price growth in last decade and its recent acceleration. A low interest rate environment, solid growth in disposable income, rather loose credit standards and optimistic expectations about future price growth were the key drivers of house price increases in last decade. This was coupled with a very weak response in housing supply, to which also contributed deficiencies in the existing legislation like the Building Act ([5]) and capacity constraints of local public administrations. An insufficiently developed rental market also played a role. After the outbreak of the pandemic, property prices accelerated even more due to a further easing of monetary policy but also temporary macroprudential easing. This was accompanied by the spreading of remote working and supportive government measures, which protected the purchasing power of households and

(5) Building Act (No. 183/2006 Coll.) that sets out the conditions for granting building permits, procedures for construction but also deals with urban and territorial planning.

further boosted the demand for housing. On the supply side, construction output declined notably in 2020 by 4.8%, with only a mild recovery in 2021 of 2.5%. During the first half of 2022, large household savings, accumulated during the pandemic, as well as frontloading effects related to the announced tightening of macroprudential policy measures and expected increase in mortgage interest rates contributed to a further increase in the price dynamics. Furthermore, high inflation and increasing labour costs in the construction sector have been driving up prices of new buildings in the recent years.

Housing affordability in Czechia is among the lowest in the EU. The ratio of house prices to income is now over 50% higher than a decade ago and over a third higher than their peak level at the start of the global financial crisis. Czechia now emerges as one of the least affordable countries in the EU. For example, according to Deloitte ([6]) the purchase of owner-occupied housing in Czechia (70 m2) required more annual gross salaries (13.3) than in any other EU country and the average transaction price of a new dwelling attained 3342 EUR/m2 in 2021 (compared to 2014 EUR/m2 in Hungary or 1729 EUR/m2 in Poland). According to Deloitte Real Index Q4 2022, the average price per m2 in Prague (slightly below 5000 EUR per m2) is now well above house prices in other capital cities of the regional peers.

Housing supply in Czechia has been rather weak and lagged behind the strong demand. There are long-term supply bottlenecks due to rigid urban planning and a long approval process for new developments. The average growth in the number of constructed dwellings was 8.8% over the 5 years before the pandemic. The number of newly constructed dwellings decreased by 5.4% in 2020 and stagnated in 2021, as a result of the slowdown in construction activity during the pandemic. The supply of housing increased again in 2022, with the number of constructed dwellings growing by almost 14%. The number of building permits for new buildings in Czechia has been decreasing each year since 2018. In 2020, it took an average of 250 days to obtain a building permit in Czechia, compared to around 150 days for the OECD average. Relevant constraints are largely of an administrative nature (such as inefficient construction law, strict zoning rules,). In this respect, the regulatory framework has represented the main obstacle to higher rates of new housing construction. This applies, in particular, to lengthy and administratively demanding processes in construction and spatial planning procedures. Beyond administrative bottlenecks, the strong demand for city living is putting upward pressure on house prices in Prague and Brno and reinforcing regional differences in house prices.

The rental market in Czechia presents a relatively limited alternative to purchasing a property, and the stock of social housing is insufficient. Despite the price-to-rent ratio increasing strongly over the last decade, which should make the renting more attractive, only around 20% of the Czech households live in rental housing (compared to the EU average of 30%, 2021 figure). The limited offer in the rental market further boosts the demand for acquiring properties. Since the pandemic, rental prices have increased above their long-term growth rates, but still lagged behind the sharp increase in house prices. Notable acceleration of rental prices has been recorded in the last year amid significant increase of mortgage rates constraining households' ability to purchase a property. In Czechia, there is also a comparatively low supply of social housing. The proportion of social housing out of the total stock of rental dwellings is 0.4%, well below the EU average. It is limited, in particular for low-income and vulnerable groups, due to the absence of a legal framework providing systemic support for social housing. The municipal rental stock is very small and there are no incentives to offer rental or cooperative housing, which would increase the supply of affordable housing. Constrained access to housing and underused housing allowances induce substantial economic costs and efficiency losses by limiting labour mobility. The integration of people fleeing Ukraine and staying in Czechia further increases the demand for

([6]) Deloitte (2022): Property Index – Overview of European residential Markets, 11th edition, August 2022.

affordable housing. In recent years, investment in new social housing units has relied mostly on EU funding. Czechia's Recovery and Resilience Plan includes some investments aimed at increasing the provision of affordable housing.

The housing market appears to be cooling off since summer 2022. Monetary policy tightening that started in the second half of 2021 gradually translated into a considerable rise in mortgage interest rates by some 3-4 percentage points over the last year. This led to a decline in annual provision of new mortgage credit by 60% in 2022, concentrated particularly in the second half of 2022. In reaction to the slump in debt-financed demand for housing, house price dynamics began to slow down in Q2 2022. Quarter-on-quarter growth of house prices in Q4 2022 declined by 2.2%, down from 1.3% increase in Q3 and 3.9% increase Q2. Annual house price growth stood at 17% in 2022 (and 7% in Q4 2022), down from 20% in 2021 (and 25% in Q4 2021). The listing of properties on the market has increased substantially since the second quarter of 2022, signalling increasing supply of housing. This increase has however been mainly driven by an increased number of second-hand properties offered for sale amid a significant tightening of financing conditions for home purchase. The number of listings has roughly doubled in the second half of 2022, and it seems to have stabilised at the beginning of 2023. Higher frequency data of private providers suggest a significant regional differentiation with some regional capitals such as Ústí na Labem or České Budějovice showing a double-digit decline of house prices (in annual terms) in early 2023.

Increases in mortgage rates do not seem to pose risks to the banking sector. Historically, the most common mortgage rate fix in Czechia is around five years. Many households took advantage in 2021 and early 2022 to refix the mortgage interest rate in anticipation of monetary tightening. Consequently, there will not be an immediate increase in mortgage payments for most current mortgage holders, but rather a gradual increase as fixed periods end. Overall, mortgage interest payments do not make out a substantial share of GDP. Thus, the increases in interest payments should not have a substantial effect on the banking sector. The Czech banking sector is well capitalised, and the ESRB assessment from February 2022 was that the macroprudential policy mix appears to be both appropriate and sufficient. While recent years were marked by strong credit flows, which peaked in early 2022 and represented a sharp increase in nominal debt levels, over the last decade household debt has edged up only gradually and represents some 34% of GDP. This is well below prudential and fundamental benchmarks. While not being substantial in size, household debt is concentrated among a small share of the population with mortgages. Czechia introduced a new law on personal insolvency in 2017, which has made it easier for individuals to apply for debt relief and avoid bankruptcy and may have contributed to the overall decrease in personal insolvencies in the country. ([7])

Going forward, a number of factors support expectations of only moderate house price dynamics going forward, while housing affordability remains a challenge in Czechia. Demand for housing is set to be constrained by lower disposable income of households amid expected negative real wage growth in 2023. The increase in interest rates in the past two years and the tightening of macroprudential measures since mid-2022 was also reflected in tighter credit standards in the banking sector. The more difficult access to credit alongside the current economic slowdown, the reduction in household purchasing power and increased economic uncertainty weight on housing demand. On the supply side, envisaged policy measures, such as the shortening of the time to obtain a building permit or the support of government affordable housing, should stimulate housing supply in medium

([7]) According to the data from the Czech Credit Bureau, the number of personal bankruptcies in has been decreasing steadily over the past few years. In 2019, there were around 8,660 personal insolvencies, which was a decrease of 11.8% compared to the previous year. The trend of decreasing personal insolvencies continued in 2020 despite the pandemic, with a total of 6,721 cases reported, which was a decrease of 22% compared to the previous year.

term. Taking these demand and supply factors together, the growth of property prices is expected to be moderated in the coming years. Moreover, it is expected that there will be stronger regional differences in local housing supply. While in real terms, the house price dynamics are expected to remain relatively muted, the price-to-income ratios may take some years to return to pre-pandemic levels, making housing affordability a persistent challenge, especially in some urban areas.

Competitiveness

On 5 April 2023, the Commission published a horizontal thematic note on competitiveness, which also covers Czechia. It showed that the domestic part of inflation (i.e. domestic wage, markup and taxation dynamics) played a particularly strong role in the recent surge in inflation in Czechia – more so than in other countries in the region. Nevertheless, export prices are strongly driven by import price developments, rather than by domestic factors. At the same time, domestic demand and observed price pressures could still lead to external sustainability concerns via import developments going forward, warranting close monitoring. Expected wage increases are likely to lead to an appreciation of the ULC-based real exchange rate in 2023.

Inflation in Czechia grew rapidly in 2022 and the first quarter of 2023. Headline inflation in Czechia usually outpaces average inflation in the EU somewhat, but since 2022 inflation rates have strongly diverged (graph 2.1 a). From an average HICP inflation rate of around 3% over 2019-21, which already presented an acceleration vis-à-vis the previous decade, inflation jumped to 14.8% in 2022. Inflation peaked at 19.1% in January 2023 and started declining afterwards. The rise in consumer prices was broad-based. Fast-growing prices for food and energy played an important role. At the same time, the impact of energy inflation on households and businesses was cushioned by various support measures taken by the government. Price increases of services and non-energy industrial goods were more pronounced than in other countries in the region, suggesting important contributions of supply-side bottlenecks, the material shortages, and transportation cost. As a result, core inflation jumped to 12.4% in 2022; considerably above the rates observed for the EU (9.2%) and the EA (8.4%).

An expansionary fiscal stance in 2020-2021 is also likely to have contributed to the acceleration of inflation. As a response to the COVID-19 crisis, the government introduced a series of measures to support the economic recovery. Several measures were initially presented as temporary but have eventually been made permanent. Although the support provided during the pandemic and during the energy crisis was warranted, the permanent measures could have contributed to further fuelling the inflation during 2022. The phasing out of energy measures and the limited growth of other government expenditures is expected to lift some of the pressures on inflation this year and next.

Core and HICP-based REERs have been appreciating in Czechia since 2016, both vis-à-vis the euro area and its 42 main trade partners. Since 2018, the core REER appreciated by more than 15 %, out of which 10 pps occurred over 2022, pointing at a marked acceleration (graph 2.1 b). Czechia's HICP and ULC-based REER appreciation in 2022 outpaced those observed in other countries in the region. Both nominal unit labour cost growth and exchange rate dynamics contributed to the ULC-based REER developments. The koruna appreciated, driven by interest rate differential and better market sentiment related to the CNB's declaration that it was ready to prevent excessive fluctuations of the koruna, using foreign exchange reserves to support the domestic currency in a few instances.

Unit labour costs grew faster than in the EU over the last decade and growth accelerated in recent years. The annual average growth of nominal unit labour costs (ULC) in Czechia was 3% over the years 2012-2022, compared to an EU average of 1.7% (graph 2.1 c). The longer-term growth trend stems from persistently higher inflation, but also reflects that real wage growth persistently outperformed productivity growth since 2016. A sustained process of catching-up towards EU averages contributes to strong wage developments. In addition, the tight labour market adds further pressure. The Czech unemployment rate was very low at 2.2% in 2022, and the employment rate very high (81.3% vs EU27: 74.7%). In 2022, nominal ULC growth in Czechia accelerated further to an annual rate of 4.8% versus 2.7% in the EU. While nominal wages grew relatively fast (by 6.8% in 2022), real wages declined due to the high inflation (by 1.8% when using the GDP deflator and 9.2% when using the private consumption deflator in 2022).

Government policy has a limited direct influence on wage developments, with the only tool being the minimum wage. The government influences wage developments in the private sector only indirectly by setting minimum wages and minimum guaranteed wage levels for specific job groups according to the complexity, responsibility and difficulty of the work performed. The minimum wage in Czechia remained at 40% of the average nominal wage for more than 5 years, as minimum wage increases were largely aligned with the overall wage dynamics. Unlike in previous years, the latest increase in the minimum wage was not accompanied by a corresponding rise in the minimum levels of guaranteed wages.

The persistence of inflation differentials represents a risk to competitiveness going forward. Inflation is expected to ease to 11.9% in 2023 and to fall to 3.4% in 2024. Should inflation rates remain above those in major trade partners for longer, Czechia's cost competitiveness could deteriorate further if not counteracted by productivity growth. Higher inflation rates could spill into wage negotiations, especially after the decline in real wages in 2022. Nominal ULC growth is expected to remain high but should remain in check as there is little concern for a possible price-wage spiral. Still, recorded inflation differentials pose a challenge to the cost competitiveness of the Czech economy going forward.

The external balance of Czechia has deteriorated in recent years. Over the period 2014-19, Czechia continued to record small current account surpluses. In 2020, Czechia's current account balance first picked up to 2% of GDP and moved subsequently into a deficit of 2.8% of GDP in 2021. The deficit further widened to 6.1% of GDP in 2022. The evolution of the current account was mainly shaped by the developments in the balance of trade in goods, which moved from a surplus of 4.9% of GDP in 2020, down to 1.1% in 2021 and to -1.5% of GDP in 2022. Over the same period, the balance of trade in services, as well as the primary income account also declined, albeit mildly, while the secondary income account remained stable.

In 2021, the trade balance deteriorated mainly on account of deteriorating non-energy trade volumes, whereas in 2022 the energy price increase dwarfed other dynamics. The balance of trade volumes in goods and services excluding energy has deteriorated over 2020-22 and is expected to further deteriorate and turn into a deficit over the forecast horizon. The terms of trade of non-energy exports had a moderating impact; but the energy price effect had a particularly strong negative impact on the trade balance in 2022. Its impact is expected to dissipate in 2023 and 2024 – but non-energy terms of trade effects are likely to start dragging the trade balance downwards over the forecast horizon (graph 2.1 d).

Czechia's net international investment position (NIIP) was negative and amounted to -19.7% of GDP in 2022, down from -14.5% of GDP at the end of 2021. The decline was mainly driven by net transaction effect on top of the deficit on the investment income balance. The negative investment position continues to reflect the extensive ownership interests of foreign investors in the Czech economy, which are regarded as materially less risky from the macroeconomic vulnerability viewpoint than indebtedness related to debt instruments. Thus, the NIIP excluding non-defaultable instruments (NENDI), is much more favourable for Czechia and amounts to 28.3% of GDP end of 2022. Overall, given Czechia's sound stock position, Czechia's NIIP currently does not present a particular reason for concern even if the negative current account developments warrant close monitoring going forward.

Assessment of MIP relevant policies

Housing market developments have been affected by monetary and macroprudential tightening in recent years. Faced with rising prices and a risk of de-anchored inflation expectations, the Czech National Bank (CNB) has started early to tighten monetary policy. Between June 2021 and June 2022, it raised the policy interest rate from 0.25% to 7%. The monetary tightening and the increase in mortgage interest rates contributed to a sizeable drop in the provision of new mortgage credit in second half of 2022, which was accompanied a decline in house prices in the recent months. The CNB has also implemented several macroprudential measures over the past years. Loan-to-value (LTV), debt service-to-income (DSTI), and debt-to-income (DTI) ratios were introduced in 2017 to limit the amount of risky mortgages being issued by banks. The CNB also imposed on banks requirements for a counter-cyclical capital buffer (CCyB) in 2019. In response to the COVID-19 pandemic, the CNB eased the macroprudential measures in 2020, such as temporarily lifting the limit on the LTV ratio for borrowers who had lost their jobs or had a significant decline in income, and the abolition of DSTI and DTI limits. The easing of the macroprudential stance, combined with low interest rate supported the mortgage borrowing between 2020 and early 2022. The macroprudential measures were tightened again as of April 2022.

The efficiency of the housing market could be improved by facilitating housing supply, and some measures have been adopted. While demand for housing has been cooling off recently in response to tighter monetary conditions and strict macroprudential policies, supply of housing has been facing several constraints which have contributed to the long-standing increases in property prices. In 2017 Czechia started working on the recodification of the public construction law, which formed a basis for the new Building Act. The new Building Act is designed to bring significant acceleration of the process of granting construction permits for all types of constructions. Key elements comprise a significant reduction of the number of approval processes for a single construction permit, with strictly set time limits, as well as the digitalization of zoning and building management. Some additional measures that the Czech government has taken to support the supply of housing include: (i) increased funding for the State Housing Development Fund, which provides loans and grants to developers and municipalities for affordable housing projects; (ii) reduced VAT rates for constructions related to social housing; ([8]) (iii) introduction of a programme to encourage renovation of existing buildings for affordable housing, with financial incentives for property owners; (iv) expansion of public-private partnerships to increase the supply of affordable rental housing; (v) launch of a programme to promote energy-efficient construction and renovation, which aims to reduce energy consumption in buildings and lower energy costs for residents.

Some systemic support for affordable housing is being put in place. While several measures target low-income groups and young families (e.g. through subsidised rents, guaranteed rents, interest-free loans or subsidies to cover the rental deposit), the supply of affordable and social housing is insufficient, as recognised also by Czechia's country specific recommendations and Recovery and Resilience plan. In 2022, the Czech government implemented the sub-program "Supported housing" to expand the offer of subsidised

([8]) According to articles 48 and 49 of VAT Act (No. 235/2004 Coll.)

apartments (i.e. rental apartments intended for social housing). Two additional support programs are being prepared for construction and renovation, to be announced in April 2023. In addition, a draft law on housing support is planned to be proposed still this year, coming into effect in 2025. The aim of this law is to create a legal framework for municipalities to ensure support for households threatened by housing shortage or already in housing shortage, and to increase the availability of rental housing.

Recurrent property taxation is low and does not have an impact on property prices, and transaction taxes were permanently removed during the pandemic. Over the years, the tax system has continued to favour homeownership through low recurrent property taxation and promoted debt-financed housing acquisition. In advance of an anticipated negative impact of the COVID-19 crisis on house prices, the government has permanently eliminated at the end of 2020 the 4% transaction tax that was applied on all property transactions. This is likely to have further contributed to the increase in property prices during the past 3 years. In addition, the remaining recurrent property taxation is very low at 0.2% of GDP compared to 1.1% EU average. The tax is based on the size of property and its level has not been adjusted since 2009. Recent discussions point to a potential increase in the taxation levels but the increase is not likely to have a significant impact on property prices, remaining overall still low. Instead, a more meaningful change in the design of the tax, for example based on updated property values in order to allow a targeted impact on the property prices, does not seem to be on the political agenda for the moment.

Inflationary pressures were affected by monetary policy adjustments. The CNB has proactively raised the policy rate in response to rising inflation already in the second half of 2021 and policy rates were increased at a relatively fast pace to attain 7% in June 2022. However, since then the policy rates remained unchanged despite continuing inflation pressures. The CNB intervened several times in the exchange rate market in 2022 (selling reserves of around 700 bn. CZK) to prevent depreciation pressures of the koruna. In 2023, the koruna appreciated which has significantly limited the imported inflation related to the increase of energy prices. While inflation seems to be on a declining path after the high levels in the past year, a tight monetary policy stance is needed to keep inflation expectations anchored and avoid a negative impact also on the competitiveness of the country. ([9])

Government support measures helped households and businesses cope with the energy crisis and contain inflation and thus lowered pressures on price competitiveness. With the unfolding of the energy crisis in 2022, the Czech government took several measures that contributed to lowering inflation with positive impact on the competitiveness of Czech businesses. During 2022, several energy support measures ([10]) reduced household's and companies' energy bills, thus having a direct impact on inflation for the last quarter of 2022 but also lowering secondary round inflationary effects by containing producers' prices increases. Additionally, caps on electricity and gas prices have been legislated for 2023. ([11]) The caps should contribute to lower inflation expectations in the

(9) IMF (2023): 2022 Article IV Consultation – Press Release, and Staff Report, January 2023 concluded about 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."

(10) The measures included a lump sum contribution to the energy bills of households ("savings tariff") in the last quarter of 2022, lowering the end-users contribution to the renewables support scheme, lowering excises for fuel or support for operating losses of industry affected by high energy prices.

(11) The Czech government approved price caps at EUR 200 per MWh excluding VAT for electricity and EUR 100 per MWh excluding VAT for gas for small consumers and further extended the scheme to industrial companies starting January 2023, with the difference between market prices and cap levels to be compensated from the state budget.

economy for 2023 and indirectly help to reduce growth pressures on salaries and nominal ULC growth. While the caps are mostly untargeted, the relatively high price level at which they are set also helps preserve end users' incentives to save energy. The caps are also financed by levies on revenues above a certain level and surplus profits of energy producers, thus reducing the negative impact on the government budget. While the energy prices are on a downward path, maintaining the framework for further support in place for targeted interventions is essential in assuring that energy inflation does not again spike out of control.

An alignment of the fiscal policy with the monetary policy is needed in order to contain inflationary pressure. A loose fiscal policy over the past 3 years was partly justified by the need to react to the COVID and the energy crisis and led to the budget deficit reaching a high 5.8% of GDP in 2020 before starting to decline to 3.6% in 2022. The pace of public debt increase has also been high, with public debt-to-GDP reaching 44.1% in 2022 compared to 30.0% in 2019. A gradual return to a sustainable fiscal path is necessary to ensure debt sustainability, but also to prevent fiscal policy to again fuel inflation growth inducing further loss of price competitiveness. According to the Commission Spring 2023 forecast, the overall fiscal stance is likely to turn contractionary already in 2023 and 2024, as the government took measures to limit the growth of public expenditures (e.g. social spending on pensions, salaries of public employees) below nominal GDP growth and the energy support measures begin to be phased-out. Still risks remain to potential further growth in expenditures. The government has announced its intention to propose a fiscal consolidation plan of at least 1pp of GDP for 2024 but the details have not yet been established. To prevent further upwards pressure on inflation, the fiscal policy should be aligned with the monetary policy in reducing the overall demand impulse while only providing targeted support if required by the energy situation.

Policy needs to address the structural tightness of the labour market to stem excessive wage growth. Labour supply has been structurally insufficient, which applies to broad range of occupations, and adds upward pressure on wage growth. The Czech government has recently taken steps to facilitate labour migration from non-EU countries (such as Armenia, Georgia and North Macedonia) to address some of the labour and skills shortages. Still, further efforts are needed including measures to raise the labour market participation of women (in particular those with small children), disadvantaged groups such as persons with disabilities, low-skilled, older workers, and long-term unemployed persons and strengthening the upskilling and reskilling of working age population.

Improving non-price competitiveness and promoting productivity growth can help countering the losses in cost competitiveness. There is room to further step up performance in terms of research, development and innovation, including by strengthening education and training systems. This could help Czechia to fulfil its ambition to shift to higher value-added positions in the supply chain, as described in several strategic documents related to education, research, development and innovation. Czechia's strong industrial sector has the potential to develop innovative green technology solutions. This could lead to the creation of new industries, products, and services strengthening the country's competitiveness. However, the impact of the green transition on the Czech competitiveness will depend on several factors, including the country's ability to innovate and adapt to new technologies and more effective energy sources.

There is scope to reduce the administrative burden on start-ups and to lower the cost of resolving insolvencies. A business-friendly climate that eases the entry and exit of low- and high emission firms can aid in the diffusion of new green technologies. Effective insolvency procedures are crucial to minimise barriers to corporate restructuring and spur productivity-enhancing capital reallocation. Still, the cost of resolving insolvencies is too high in Czechia and need to be lowered to allow for creative destruction, boost green investment and allow new innovative firms to bring low-carbon technologies to the market while inefficient high-carbon firms exit. Higher carbon prices increase the costs for domestic firms, raising concerns about international competitiveness. Czech firms and households seem highly concerned about external competitiveness in relation to climate policies.

Conclusions

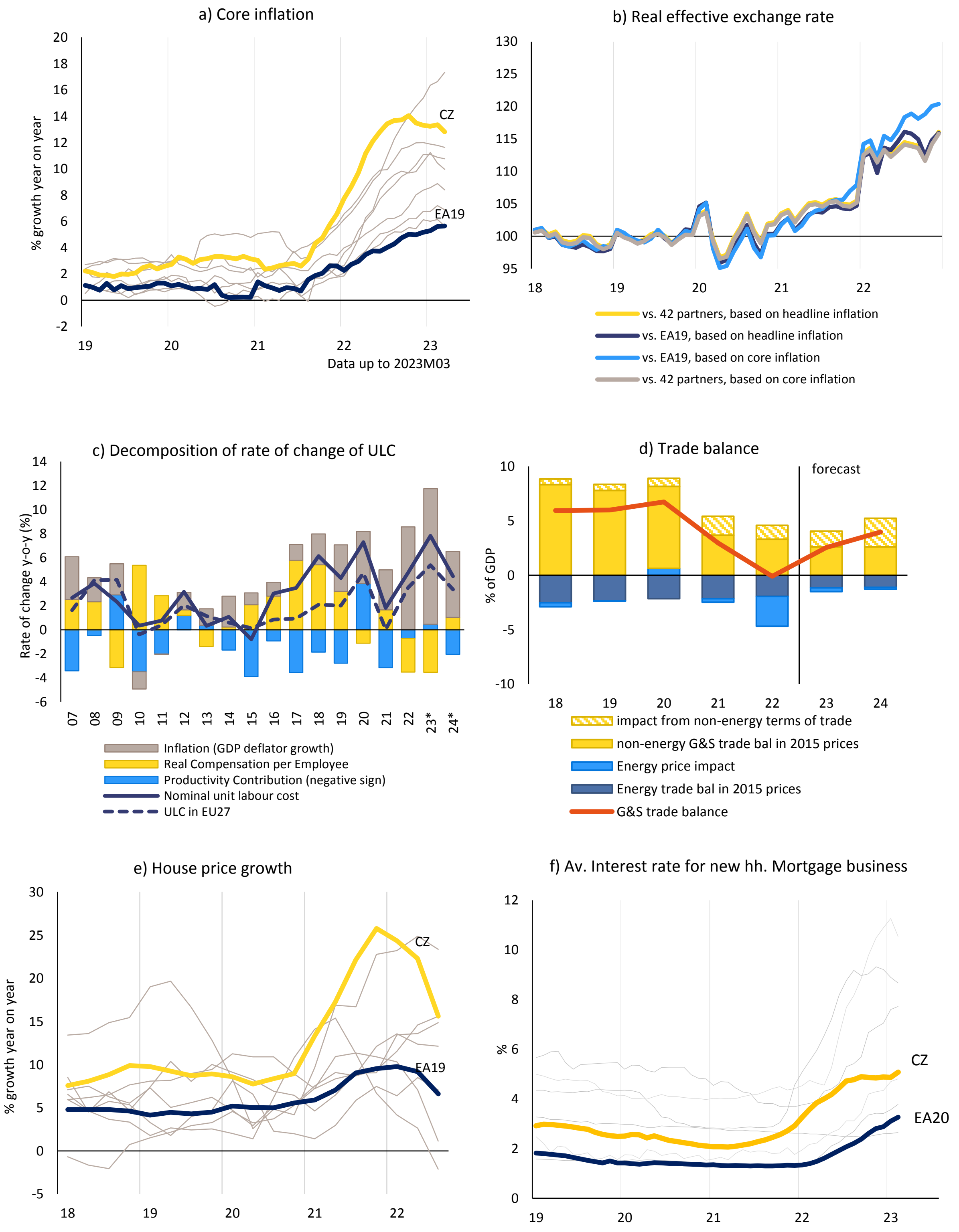
In Czechia, vulnerabilities relating to competitiveness and house price developments have been increasing. The Czech economy was strongly hit by the energy price shock. While still facing elevated price pressures and related secondary effects, Czechia's price competitiveness is projected to partially recover going forward amid decreasing energy prices, without immediate external sustainability challenges. Nevertheless, the recent deterioration of the trade and the current account balance warrant close monitoring going forward. While demand for housing increased strongly in the past amid low interest rates, high disposable income and insufficient macroprudential measures, the supply of housing did not match this increase. House prices started to increased strongly during the pandemic times but in the second half of 2022 they went into a period of moderation, given higher interest rates and stricter lending conditions. As yet, risks of a significant house price corrections are considered to be very low, and household debt is also low and the banking sector is sound. A remaining concern related to competitiveness is whether inflation will revert swiftly to historical averages or rather prove sticky for an extended period of time which could carry risks for Czechia's cost competitiveness going forward.

Continued efforts are needed to provide a policy environment conducive to reining in price growth. Bringing consumer, output and asset inflation rates down to the EU average quickly requires a strong deceleration in demand growth, which in turn can be achieved by sufficiently tight monetary and fiscal policy. While the fiscal stance is already expected to turn contractionary in 2023 and 2024, amid a gradual phase-out of energy support measures, risks remain of further slippages due to inflationary pressures on the budget expenditures. Further fiscal consolidation efforts are needed to ensure a permanent reduction in the structural deficit (by containing expenditures growth or broadening the taxation base including property taxation) and to ensure that the fiscal policy is not further fuelling inflation and a loss of price competitiveness. Improving non-price competitiveness and promoting productivity growth can help countering the losses in cost competitiveness. There is scope to reduce the administrative burden on start-ups and to lower the cost of resolving insolvencies.

Based on the findings in this in-depth review, the Communication "European Semester – 2023 Spring Package" sets out the Commission's assessment as to the existence of imbalances or excessive imbalances in Czechia, in line with Regulation 1176/2011. ([12])

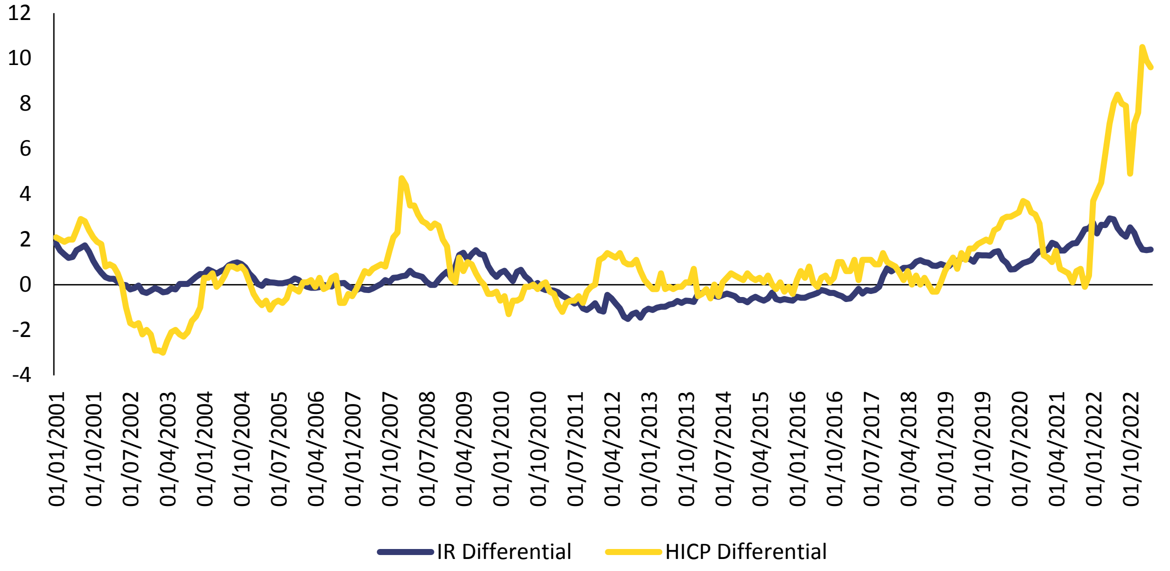
([12]) European Commission (2023), European Semester Spring Package 2023, COM(2023) 600 final.

Graph 2.1: **Selected graphs, Czechia**



Source: Eurostat, ECB, Comext and European Commission services

Graph 2.2: **HICP differentials**



Source: European Commission services

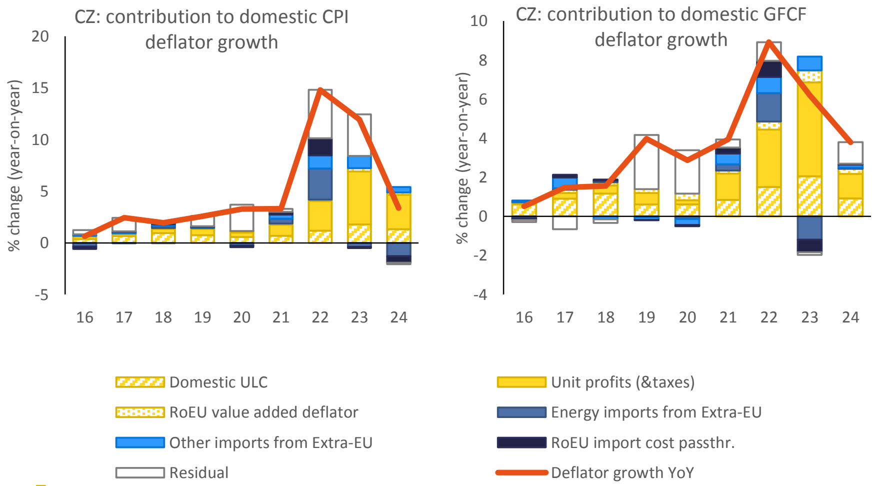
Box 1: Inflation exposures and cross-border pass-through

This box sheds light on the sources of inflation in Czechia and its spill-overs with EU partners. The period since 2021 has been characterized by pandemic aftershocks and global supply chain disruptions compounding global inflationary pressures and a surge in commodity prices triggered by Russia's war of aggression against Ukraine. As a result, inflation in Czechia surged to unprecedented levels. In response, wages and profits also picked up across the EU, which further added to price pressures in Czechia. With input-output data, domestic inflation can be decomposed into the contributions from key cost factors. Taking into account some data limitations, the framework can be used to attribute consumer and investment price changes to i) extra-EU import price changes, which include both directly imported inflation and inflation passed through from EU partners import costs ii) domestic unit labour cost changes iii) domestic unit profit changes, including indirect taxation changes and iv) rest-of-EU value added price changes. ([13])

Data suggests that inflation in Czechia was sustained by both domestic and external drivers in 2022, whereas the importance of domestic drivers is expected to increase in 2023. In 2022, as shown in Graph 2.3, energy prices contributed markedly to consumer and investment inflation. Spill-overs, particularly in the form of import cost pass-through, from other EU countries contributed mildly. Domestic value added inflation contributed substantially. Consumer and investment inflation is expected to subside somewhat this year amid decline of imported inflation component. Energy inflation is set to lower inflation. By contrast, domestic value added inflation, particularly unit profits, is expected to keep inflation elevated. In 2024, consumer and investment inflation is projected to fall further, still sustained by domestic wages and profits.

([13]) The graphs below are based on national accounts data and the Commission's Spring 2023 forecast, which are combined through a 'Ghosh' matrix based on Eurostat's Figaro input-output available for 2015-2020. HICP is taken as the measure of the price of private consumption, including non-residents. Energy import prices from extra-EU reflect realised median prices until 2022, and energy price assumptions underlying the Spring forecast thereafter. Other goods prices reflect median Eureopan prices per industry until 2022, and forecast non-energy goods and service trade prices for 2023-2024. Value added deflators are assumed to affect all industries within a country to the same degree. Changes in import prices and value added deflators are assumed to affect demand prices with a delay of 5 months for consumption inflation and no delay for investment inflation. For a similar analysis using an input-output-based methodology, see "Inflation Differentials in Europe and Implications for Competitiveness: Thematic Note to Support In-Depth Reviews" European Commission 2023, Institutional paper 198.

Graph 2.3: **Components of gross fixed capital formation deflator growth and consumer price inflation**



Source: European Commission services

Table 2.1: **Selected economic and financial indicators (Part 1), Czechia**

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-18	2019	2020	2021	2022	forecast 2023	forecast 2024
Real GDP	5.5	0.2	3.1	3.0	-5.5	3.6	2.5	0.2	2.6
Potential growth (1)	4.2	1.7	2.4	2.6	1.4	0.5	2.1	1.5	1.6
Contribution to GDP growth:									
Domestic demand	4.0	-0.3	2.8	3.3	-4.2	2.4	1.3	0.1	2.5
Inventories	0.4	-0.4	0.2	-0.3	-0.9	4.8	1.0	-0.3	-0.2
Net exports	1.1	1.0	0.1	0.0	-0.4	-3.6	0.2	0.4	0.2
Contribution to potential GDP growth (1):									
Total Labour (hours)	0.3	-0.1	0.6	0.3	-0.2	-0.7	1.0	0.5	0.4
Capital accumulation	1.0	0.8	0.6	0.9	0.6	0.6	0.7	0.7	0.7
Total factor productivity	2.9	1.0	1.2	1.4	1.0	0.6	0.4	0.3	0.4
Output gap (2)	2.8	-0.1	-0.2	2.7	-4.3	-1.4	-1.1	-2.3	-1.3
Unemployment rate	7.3	6.4	4.6	2.0	2.6	2.8	2.2	2.8	2.6
Harmonised index of consumer prices (HICP)	1.8	2.7	1.2	2.6	3.3	3.3	14.8	11.9	3.4
GDP deflator	1.9	0.9	2.1	3.9	4.3	3.3	8.6	11.3	5.5
External position									
Current account balance (% of GDP), balance of payments	-3.7	-2.3	0.6	0.3	2.0	-2.8	-6.1	-3.2	-1.3
Trade balance (% of GDP), balance of payments	1.0	3.5	6.5	6.0	6.7	2.8	-0.1	.	.
Primary income balance (% of GDP)	-4.5	-5.3	-5.4	-5.0	-4.2	-5.1	-5.5	.	.
Secondary income balance (% of GDP)	-0.2	-0.4	-0.4	-0.6	-0.5	-0.5	-0.5	.	.
Current account explained by fundamentals (CA norm, % of GDP) (3)	-0.4	0.1	0.4	0.7	0.8	0.7	0.9	1.0	1.1
Required current account to stabilise NIIP above -35% of GDP over 20Y (% of GDP) (4)	-1.2	-2.3	-3.0	-2.4	-2.3	-2.1	-2.2	-2.1	-1.9
Capital account balance (% of GDP)	0.2	0.9	1.2	0.4	1.2	1.7	0.1	.	.
Net international investment position (% of GDP)	-25.9	-43.5	-31.1	-19.8	-16.3	-14.5	-19.7	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (5)	17.8	8.6	22.7	30.2	37.3	36.9	28.3	.	.
Net FDI flows (% of GDP)	-4.2	-1.7	-1.1	-2.4	-2.6	-0.5	-2.5	.	.
Competitiveness									
Unit labour costs (ULC, whole economy)	1.7	2.1	2.8	4.3	7.3	1.8	4.8	7.8	4.4
Nominal compensation per employee	6.3	2.5	4.1	7.2	3.1	5.0	5.5	7.3	6.6
Labour productivity (real, hours worked)	5.0	0.3	1.8	2.7	2.4	0.4	-1.1	-1.3	1.1
Real effective exchange rate (ULC)	2.6	2.0	-0.4	1.7	-0.1	4.8	5.5	6.0	0.9
Real effective exchange rate (HICP)	2.2	2.4	-0.5	0.6	0.3	3.8	9.7	.	.
Export performance vs. advanced countries (% change over 5 years)	66.4	29.7	2.2	3.1	8.7	3.8	.	.	.
Private sector debt									
Private sector debt, consolidated (% of GDP)	55.3	77.5	81.6	78.6	81.7	78.8	75.1	.	.
Household debt, consolidated (% of GDP)	16.8	28.6	31.0	31.5	33.9	34.4	32.5	.	.
Household debt, fundamental benchmark (% of GDP) (6)	26.6	37.6	43.2	42.8	46.4	46.3	46.0	.	.
Household debt, prudential threshold (% of GDP) (6)	75.1	87.1	59.4	57.9	56.1	55.0	52.9	.	.
Non-financial corporate debt, consolidated (% of GDP)	38.6	48.9	50.6	47.1	47.7	44.4	42.5	.	.
Corporate debt, fundamental benchmark (% of GDP) (6)	53.1	58.5	63.7	60.4	64.2	63.1	61.6	.	.
Corporate debt, prudential threshold (% of GDP) (6)	88.4	103.7	73.3	71.5	74.0	75.6	73.4	.	.
Private credit flow, consolidated (% of GDP)	5.8	4.3	4.2	1.4	0.6	2.9	4.9e	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-2.1	-0.9	-1.1	-2.8	1.4	-2.0	-5.1	-1.0	1.1
Households, net lending (+) or net borrowing (-) (% of GDP)	1.1	1.9	1.9	2.1	6.2	6.2	4.7	3.2	2.3
Net savings rate of households (% of net disposable income)	7.0	7.4	6.9	8.5	14.7	14.8	.	.	.

(e) estimate based on ECB quarterly data
(1) Potential output is the highest level of production that an economy can reach without generating inflationary pressures. The methodology to compute the potential output is based on K. Havik, K. Mc Morrow, F. Orlandi, C. Planas, R. Raciborski, W. Roeger, A. Rossi, A. Thum-Thysen, V. Vandermeulen, The Production Function Methodology for Calculating Potential Growth Rates & Output Gaps, COM, European Economy, Economic Papers 535, November 2014.
(2) Deviation of actual output from potential output as % of potential GDP.
(3) Current accounts in line with fundamentals ("current account norms") are derived from reduced-form regressions capturing the main determinants of the saving-investment balance, including fundamental determinants, policy factors and global financial conditions. See L. Coutinho et al. (2018), "Methodologies for the assessment of current account benchmarks", European Economy, Discussion Paper 86/2018, for details.
(4) This benchmark is defined as the average current account required to halve the gap between the NIIP and the indicative MIP benchmark of -35% of GDP over the next ten years, or to stabilise the NIIP at the current level if it is already above the indicative MIP benchmark. Calculations make use of Commission’s T+10 projections.
(5) NENDI is a subset of the NIIP that abstracts from its pure equity-related components, i.e. foreign direct investment (FDI) equity and equity shares, and from intracompany cross-border FDI debt, and represents the NIIP excluding instruments that cannot be subject to default.
(6) Fundamentals-based benchmarks are derived from regressions capturing the main determinants of credit growth and taking into account a given initial stock of debt. Prudential thresholds represent the debt threshold beyond which the probability of a banking crisis is relatively high, minimising the probability of missed crisis and that of false alerts. Methodology to compute the fundamentals-based and the prudential benchmarks based on Bricongne, J. C., Coutinho, L., Turrini, A., Zeugner, S. (2019), “Is Private Debt Excessive?”, Open Economies Review, 1- 42.
Source: Eurostat and ECB as of 2023-04-28, where available; European Commission for forecast figures (Spring forecast 2023)

Table 2.2: **Selected economic and financial indicators, Czechia**

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-18	2019	2020	2021	2022	forecast 2023	forecast 2024
Housing market									
House price index, nominal	7.6	1.0	5.6	9.2	8.5	19.7	16.9	.	.
House price index, deflated	5.6	-0.9	4.4	6.2	5.4	16.4	0.8	.	.
Overvaluation gap (%) (7)	-2.0	-0.2	-6.6	5.0	8.9	22.9	35.0	.	.
Price-to-income overvaluation gap (%) (8)	-6.3	-0.1	-2.0	7.6	14.1	27.3	34.2	.	.
Residential investment (% of GDP)	4.4	4.4	4.0	4.4	4.6	4.7	4.8	.	.
Government debt									
General government balance (% of GDP)	-3.0	-3.6	-0.1	0.3	-5.8	-5.1	-3.6	-3.6	-3.0
General government gross debt (% of GDP)	27.8	36.5	38.1	30.0	37.7	42.0	44.1	42.9	43.1
Banking sector									
Return on equity (%)	14.6	11.7	8.4	12.5	8.0	12.1	.	.	.
Common Equity Tier 1 ratio	22.1	17.4	16.5	20.6	22.8	18.8	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (9)	.	.	2.6	1.5	1.6	1.4	.	.	.
Gross non-performing loans (% of gross loans) (9)	.	.	3.0	1.7	1.9	1.7	1.4	.	.
Cost of borrowing for corporations (%)	.	.	3.3	3.6	1.9	4.5	.	.	.
Cost of borrowing for households for house purchase (%)	.	.	2.7	2.5	2.1	2.9	4.9	.	.

(1) (7) Unweighted average of price-to-income, price-to-rent and model valuation gaps. The model valuation gap is estimated in a cointegration framework using a system of five fundamental variables; total population, real housing stock, real disposable income per capita, real long-term interest rate and price deflator of final consumption expenditure, based on Philiponnet, N., Turrini, A. (2017), "Assessing House Price Developments in the EU," European Economy - Discussion Papers 2015 - 048, Directorate General Economic and Financial Affairs (DG ECFIN), European Commission. Price-to-income and price-to-rent gaps are measured as the deviation to the long term average (from 1995 to the latest available year).
(8) Price-to-income overvaluation gap measured as the deviation to the long term average (from 1995 to the latest available year).
(9) Domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.
Source: Eurostat and ECB as of 2023-04-28, where available; European Commission for forecast figures (Spring forecast 2023)