Executive Summary

The economic outlook has deteriorated

Russia's war of aggression against Ukraine has derailed the Czech Republic's post-pandemic recovery and further disrupted the impressive catch-up with OECD average incomes seen in the previous two decades. Steep rises in energy and commodity prices and disruptions in gas and oil imports from Russia triggered a cost-of-living crisis with a risk of broader energy shortages. Lower global growth, constraints in global supply chains and higher uncertainty have dampened activity.

Inflation has risen to high levels and become entrenched. Core inflation was persistently among the highest in the European Union throughout 2022. Inflation expectations have increased markedly, with corporates expecting around 7% inflation at a three-year horizon. The authorities had reacted swiftly and decisively to support the economy during the COVID-19 crisis. However, in hindsight, loose overall macroeconomic policy in 2020-21 contributed to high inflation by boosting demand over supply capacity.

The unemployment rate remains very low but rising prices have eroded domestic demand. High uncertainty and the looming energy crisis have resulted in large falls in consumer and business sentiment, lowering private consumption and investment. Real wages have fallen steeply.

Economic growth will be subdued in 2023 and pick up in 2024 amid reduced supply disruptions and resuming expansion in trading partners. High energy prices, tightened financing conditions and low sentiment will hold back private investment in 2023. Private consumption will be constrained by rising prices. Inflation will start falling from the currently very high levels but will only approach the 2% target towards the end of 2024.

Risks around the projections are considerable. Renewed rises in commodity and energy prices, a strong depreciation of the koruna and de-anchored inflation expectations could further feed inflation pressures and trigger a destabilising wage-price spiral. On the other hand, a deeper recession and lower confidence would lower inflation more quickly.

Table 1. Growth is slowing

	2022	2023	2024
Real GDP growth, %	2.4	0.1	2.4
Unemployment rate, %	2.3	2.6	2.8
Consumer price index, % change	15.1	13.0	4.1
Fiscal balance (% of GDP)	-3.8	-4.3	-3.7

Source: Calculations based on OECD Economic Outlook 112 database.

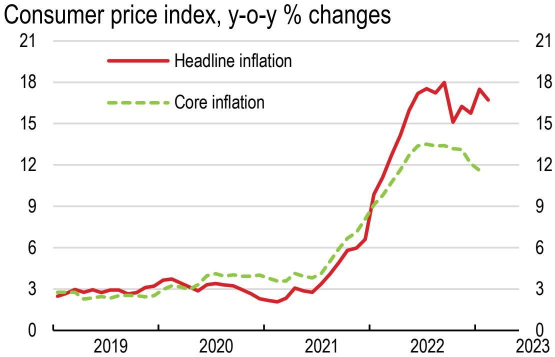
A tight macroeconomic policy stance is needed to fight inflation

Monetary policy has rightly been tightened to counter rising prices and manage inflation expectations. Fiscal policy should avoid boosting aggregate demand, while providing support to cushion living standards.

The Czech National Bank (CNB) raised the policy interest rate from 0.25% to 7% between June 2021 and June 2022, after which it paused. The CNB has also intervened on the exchange rate market to prevent excessive fluctuation and stem depreciation pressures on the koruna.

Figure 1. Inflation has risen sharply

Consumer price index, y-o-y % changes



Source: Czech Statistical Office.

StatLink https://stat.link/uazbd2

Public spending pressures have intensified. The Czech Republic has welcomed the highest number of Ukrainian refugees per capita among European countries, providing basic services and income support. Countering the adverse impact of the energy crisis and rising prices of essential goods on the vulnerable has necessitated further public spending. Moreover, the need for defence spending has risen. Support measures provided to households and firms should be temporary and targeted at the most vulnerable to avoid fuelling inflation and designed to preserve incentives for energy savings.

Safeguarding long-term fiscal sustainability

The Czech Republic faces high fiscal pressures in the medium to long term that threaten fiscal sustainability. Action on both the expenditure and revenue sides should be considered to close expected future gaps in public budgets.

Recent expansionary fiscal policy helped preserve jobs and incomes, but it has led to a high deficit and increased public debt. Untargeted cash transfers and a permanent cut in tax revenues from late 2020, whereby fiscal revenues fell by roughly 2 percentage points of GDP in structural terms, aggravate the fiscal challenge. Fiscal rules have been loosened and there is no clear path towards fiscal consolidation. Looking ahead, population ageing will result in future steep rises in public spending on pensions, health, and long-term care, significantly pushing up the debt-to-GDP ratio. Without reform, a substantial increase in fiscal revenues would be required to counter the rise in expenditures. Raising the effectiveness in the public sector and continuing to fight corruption would also help curb increases in public spending.

There is scope to revise the tax system to better align economic, environmental and societal objectives. The tax burden on labour is high due to significant social security contributions. Personal income taxes remain low and are only weakly progressive. There is strong reliance on reduced VAT rates that have been shown to be poorly targeted to fight poverty. On the other hand, environmental and real estate taxes, which are less distortive to growth, are low.

Pensions are set to exert pressures on public spending. Pension spending is estimated to rise by 3.5 percentage points of GDP by 2060. Yet, Czech workers retire much earlier than in most OECD peers. The employment rate - while high overall - falls sharply after the age of 60. The current system of regularly reviewing the statutory retirement age relies too much on recurring government initiatives, raising the risk that the retirement age might not be increased in a timely and sufficient manner to curtail spending pressures. Moreover, under current provisions, early retirement age is set to remain at 60.

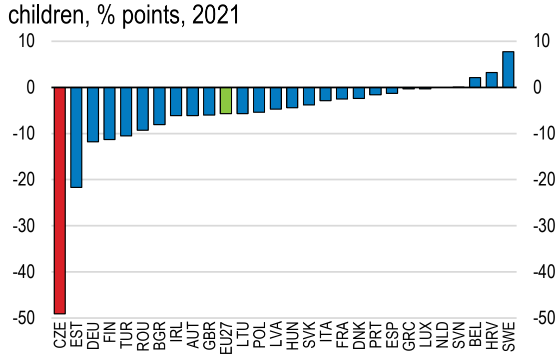
Tackling recurring labour and skills shortages

The Czech labour market is strong: the unemployment rate is very low, and the employment rate and job security are high. However, chronic labour shortages are a major obstacle to growth.

Mothers could be better integrated into the labour market. Female employment falls significantly and for a prolonged period after childbirth, adversely impacting women's subsequent careers. The gender wage gap is sizeable. Very long parental leave and generous family cash benefits discourage mothers from returning to work. The lack of childcare capacity is another constraint and enrolment of children under three in early childhood education and care is among the lowest in the OECD.

Figure 2. Female employment falls significantly after childbirth

Employment gap between mothers[1] and women without children, % points, 2021



1. With one child under 6 years old. Source: Eurostat database.

StatLink https://stat.link/qtv17c

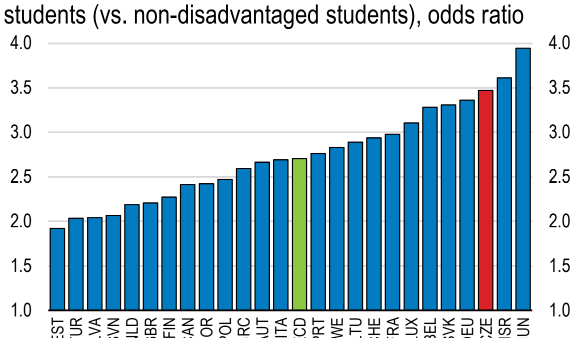
Labour migration policy is not geared to attract skilled foreign workers. Labour shortages have prompted Czech employers to look for workers from abroad. Immigration has been rising steadily. Despite rising skills needs, close to 90% of foreign workers from non-EU countries work in low- to medium-skilled jobs. Conditions in terms of permit duration, family reunification and labour market mobility in the Czech Republic for highly skilled workers are less favourable than in peer countries.

The education sector could contribute more effectively to building skills in demand. Many jobs in the future will require high education and skills, and demand is growing for core and technical competences. Yet, tertiary educational attainment, despite progress in recent years, lags significantly behind OECD peers and skills shortages in growing sectors remain large. Despite workers' good basic digital skills, the economy lacks specialists in information and communication technology. Modernised vocational education and training, better adapted to adult learning, can effectively build skills in demand and raise the economy's adaptability to structural change.

Inequalities in education persist. Parents' socio-economic status has a strong impact on performance in school. Drop-out rates vary widely across regions, and teacher quality in disadvantaged schools is low. Abolishing early tracking, reducing differences in school quality - including by closing small local schools - and attracting better teachers to disadvantaged schools would help raise equality of opportunity. Explicitly targeting disadvantage in school funding could help in this regard.

Figure 3. Parents' socio-economic status strongly affects school performance

Likelihood of low performance among disadvantaged students (vs. non-disadvantaged students), odds ratio



Note: A socio-economically disadvantaged student is from the bottom quarter of the PISA index of economic, social and cultural status. Source: OECD (2019), PISA 2018 Results (Volume II).

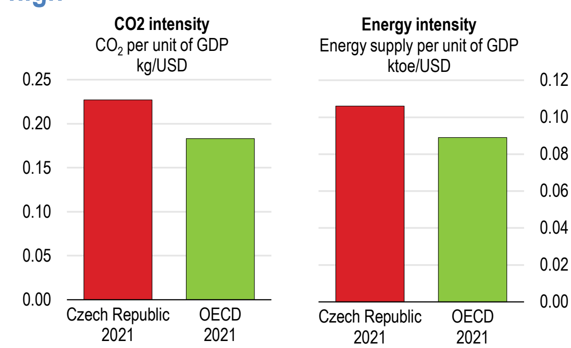
StatLink https://stat.link/isxftm

Pursuing the climate agenda

The Czech Republic has made significant headways in reducing greenhouse gas (GHG) emissions over the past three decades. Still, GHG-intensity remains high, largely driven by the extensive use of coal for electricity production and heat generation. Reliance on heavy industry coupled with older and poorly insulated dwellings make the Czech economy highly energy intensive. Major investments are needed to alter the energy mix and improve energy efficiency.

Current environmental policies are not stringent enough to effectively curb emissions. Effective carbon tax rates are among the lowest in the OECD. The Czech Republic does not have an explicit carbon price. Furthermore, tax exemptions are applied on various fuels, which decreases end-use prices and limits incentives to save energy or to switch to cleaner fuels.

Figure 4. Emissions and energy intensity are high



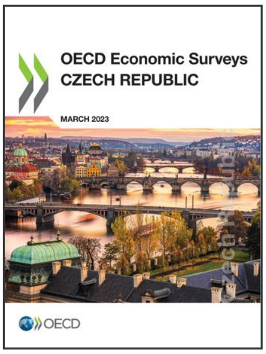
Source: OECD Green Growth Indicators; IEA World Energy Statistics and Balances.

StatLink https://stat.link/6i5kwx

Low energy efficiency in buildings and use of coal in heating inhibit the green transition. Czech buildings have among the highest energy consumption per square meter in the EU and a large number of households still rely on coal for residential heating. Existing regulation and subsidies do not provide sufficient incentives to raise investment for boosting energy-efficiency. Permitting processes are complex, impeding spending on green technologies and infrastructure.

Inclusive labour policies can ease the green transition. On the path towards net zero the Czech economy will have to restructure. Relative prices will shift, jobs will be shed while others will be created. Some sectors and some groups of workers are more at risk and policy should ensure a fair green transition. Retraining and other active labour market policies can help displaced workers find jobs more quickly and effectively match jobseekers with emerging opportunities.

MAIN FINDINGS	KEY RECOMMENDATIONS
Weathering the economic slowdown without aggravating macroeconomic imbalances	
Inflation and inflation expectations have risen steeply. Inflation has become entrenched at high levels and is broad-based.	Maintain a tight monetary policy stance until inflation is firmly on the path towards the 2% target.
Fiscal policy has been expansionary and macroeconomic policies are not sufficiently coordinated.	Start fiscal consolidation while providing targeted support to households and firms if needed.
Ensuring long-term fiscal sustainability	
High fiscal pressures in the medium to long term (including those related to population ageing) threaten sustainability. Without reform, the debt-to-GDP ratio is set to rise dramatically.	Prepare a more ambitious and credible medium-term fiscal consolidation plan, including the path for improvements in the structural balance.
The 2020 tax package - changes to the personal income tax and abolished real estate stamp duty - permanently reduced tax revenues. Personal income taxes are low and only weakly progressive.	Strengthen tax revenues, including through more progressive personal income taxation.
Revenues rely heavily on social security contributions and result in a high tax wedge. Lower reliance on direct taxation of labour and higher revenues from property and indirect taxes, including environmental taxes, could boost growth sustainably.	Shift towards real estate, consumption and environmental taxes, and reduce social security contributions.
The population is ageing rapidly and age-related spending will rise steeply over the coming decades. Almost one-third of people retire before the statutory retirement age. Even when the statutory age rises to 65, under current provisions the early retirement age will remain at 60.	Continue to raise the statutory and minimum early retirement ages and link them to life expectancy.
Indicators of control and perceived corruption in the public sector suggest that the Czech Republic underperforms compared to OECD peers. Czech citizens tend to think that corruption is widespread. The 2021 Rule of Law Report of the European Commission noted a lack of progress.	Continue efforts to fight corruption.
Tackling recurrent labour and skills shortages	
Childbirth has a large impact on labour market activity of mothers. The gender wage gap is sizable. Family cash benefits and tax breaks are generous while public childcare support is low, particularly for children under the age of three.	Keep expanding the supply of affordable and high-quality childcare facilities. Lower untargeted family cash benefits and gradually reduce the maximum duration of parental leave.
Current permit conditions are restrictive and not geared towards attracting and retaining high-skilled foreign workers. Conditions in terms of permit duration and associated family reunification and labour market mobility for highly skilled workers are less favourable than in many OECD peers.	Increase the duration of initial work permits to five years for highly skilled migrants and offer immediate temporary residence and work rights for accompanying family members.
Socio-economic factors have a large impact on student performance and attainment. Much of the inequality stems from variation between schools. Many schools are too small to provide education effectively.	Introduce explicit and objective criteria (based on school, student or local area characteristics) in the funding formula for schools to further address inequalities and disadvantage.
Disadvantaged schools are more likely to have staff shortages and they employ the least experienced teachers.	Offer better career paths to teachers and increase incentives for high-quality teachers to work in remote areas.
Skills shortages in many technical fields remain large with a particular lack of ICT specialists. Besides higher and more specialised skills, strong core skills can ensure that workers are resilient to change. Education should provide workers with the right skill sets and easy access to learning, including for adults.	Modernise VET education, as planned in the 2030+ education strategy, by modernising curricula, strengthening core skills, involving employers more closely and better adapting it to adult learning.
Pursuing the climate agenda	
The Czech Republic remains highly reliant on fossil fuels for electricity production and heat generation. Greater reliance on renewable sources of energy will require grid investments. Moreover, increases in energy efficiency are urgently needed to move towards medium to long term climate targets.	Upgrade the grid and provide adequate incentives for scaling up renewable and low-emission energy capacity and boosting energy efficiency.
Coal remains one of the main fuels for electricity generation and residential heating and accounts for close to a third of the primary energy supply.	Keep commitments to phase out coal from the energy mix by 2033.
Effective carbon rates are among the lowest in the OECD. Current policies result in too low a price on carbon and do not provide a consistent price signal across fuels and energy uses. Carbon price trajectories can enable planning and facilitate long-term investment in low-carbon technologies.	Once energy prices subside from their current high levels, introduce an explicit carbon price (with a pre-announced price trajectory) to cover all emissions for sectors outside the EU ETS.
Low energy efficiency in buildings and use of coal in heating inhibit the green transition. Czech buildings have among the highest energy consumption per square meter in the European Union and approximately 300 000 households still use inefficient individual coal boilers to heat their homes.	Strengthen incentives for installing efficient green heating technologies in residential buildings. Scale up investments into energy efficiency retrofits of buildings.
Cumbersome regulations and lengthy construction processes, restrictive spatial planning and complex process for obtaining electricity production licenses are severe barriers to green investment.	Streamline permitting processes for renewable investments and simplify regulations and processes in construction and spatial planning.
Some groups of workers could be more adversely affected by the green transition. Low-skilled workers rarely take part in adult education programmes. Spending on training for the unemployed could be boosted.	Expand active labour market policies - including targeted training and reskilling programmes - to help displaced workers find jobs more quickly and to effectively match jobseekers with emerging opportunities.



From:

OECD Economic Surveys: Czech Republic 2023

Access the complete publication at:
https://doi.org/10.1787/e392e937-en

Please cite this chapter as:

OECD (2023), “Executive Summary”, in *OECD Economic Surveys: Czech Republic 2023*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/8d64dcd7-en