Deloitte.

Outlook for the Czech economy in 2024

Recovery from high inflation

Economics & Statistics
January 2024

A few words of introduction

A look back at last year reveals the problems of an economy that has undergone a series of unusually strong shocks in recent years. From the pandemic to the energy crisis. Unfortunately, the Czech Republic is the only EU country that has still not been able to cope with the negative effects of these shocks and where the performance of the economy has still not reached the level of the end of 2019.

However, last year can also be seen as a turning point. The government was able to push through a consolidation package that should bring public finances significantly closer to a sustainable long-term position. In other words, the growth rate of government debt as a share of GDP should slow down significantly in the coming years.

Gradual changes in the pension system are an essential contribution to long-term sustainability. The change in the indexation formula and the linking of the retirement pension age to increasing life expectancy should reduce the expected deficits in the pay-as-you-go first pillar of the pension system very significantly over the next decades.

Finally, the digitization of public administration has moved forward in a more fundamental way. Pensions and social benefits can be processed online. We will soon have ID cards on our mobile phones. There is still hope that we will also see fully digitized building procedures in the near future. The Czech Republic is woefully behind in this area and is in an unenviable position in international comparisons. However, things are starting to move.

Similarly, the situation is turning for the better in the construction of transport infrastructure. The preparation of the construction of new sections of the motorway network has noticeably accelerated and the hope that the Czech Republic will stop being the butt of jokes about impassability and unflattering comparisons with Poland has increased. Here too, there is much work to be done. The state will need around CZK 5 trillion to invest in transport infrastructure development, repair, and maintenance between 2024 and 2050.

The energy sector has shown that it is a very important part of the economy. The transformation ahead will be challenging. It will not be easy to meet all the targets expected of it. From an economic point of view, it will be essential to ensure a stable supply of all types of energy at prices that will keep the Czech economy competitive. Already this year we are facing two crucial moments. The first is the update of the State Energy Concept. The second is the selection of suppliers for the new unit for the Dukovany nuclear power plant. In the energy sector, the necessary costs over the next 30 years are estimated at CZK 3 to 4 trillion.

Efficient spending on better education, science and research is an investment in the future. Last year's PISA test results give hope that, with more and better targeted investment in our children, the Czech Republic can have enough talented young people in the future to continue its journey to the top of the global economy. If this is complemented by research and development focused on practical applications leading to higher added value in production through closer cooperation between universities and companies, the shift will be more visible.

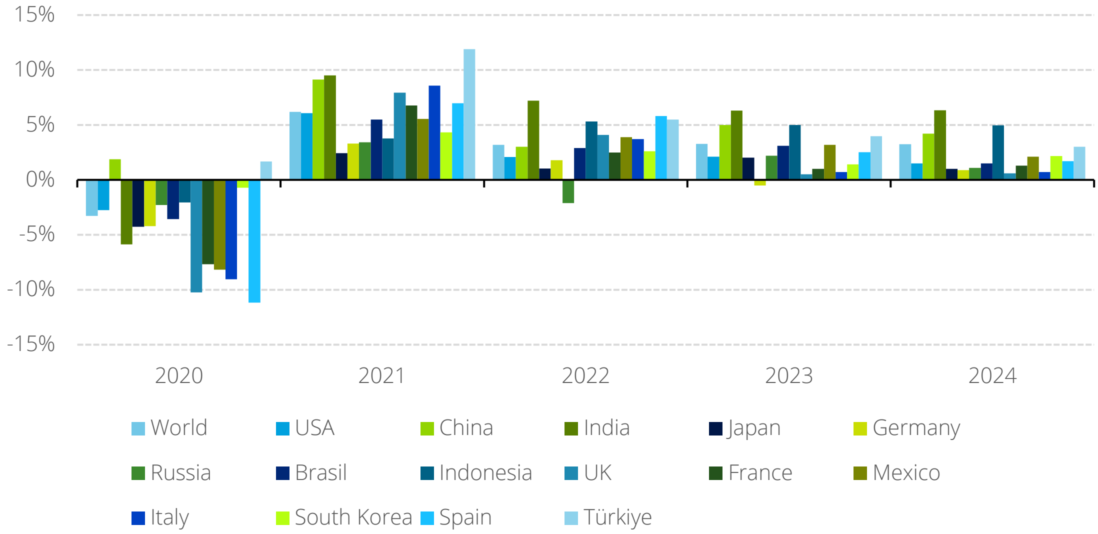
After several difficult years, 2024 gives the Czech economy hope to breathe and return to growth. Conditions remain difficult in a number of areas. In particular, the geopolitical situation is still a source of instability. However, the main challenges the Czech Republic faced, including high inflation, have subsided or are fading. It is time to move forward again.

Global economy

In 2022, the main topics were the war between Russia and Ukraine and the energy crisis. Unfortunately, both the war and the energy crisis are continuing, although energy markets have calmed down considerably this year and the worst-case scenarios have not materialized. Even in this heating season, there is plenty of natural gas. At the same time, this heating season is likely to be the last one in which there could still be some problems with natural gas shortages. Europe has thus survived the energy war initiated by Russia. Russia has lost a very creditworthy customer and does not have an adequate replacement for the shortfall in supply to Europe. China does take some Russian natural gas, but this cannot compensate for the drop in supplies to Europe.

On the other hand, Europe is currently dependent on the LNG spot market and has to overpay mainly Asian customers to get LNG supplies. Although the price of gas and electricity is much lower than a year ago, short-term price fluctuations cannot be ruled out. However, there should no longer be a physical shortage of gas. The situation should then improve in 2026, when the first natural gas should arrive in Europe from the long-term contracts that European countries have signed this year with Qatar and the US in particular. This will reduce dependence on the spot market.

Chart 1: GDP growth: selected countries (%)



Source: IMF

The calming of the situation on the energy markets was also associated with a reduction in inflation. In the US, inflation peaked in June 2022 at 9.1% and has been falling since then, with minor exceptions. At the beginning of 2023, inflation was 6.5%. By the end of 2023, it had fallen to 3%. Inflation in the euro area peaked in October 2022 at 10.6%. It slowed to 5.5% in January 2023 and gradually fell to below 3% by the end of 2023.

The central bank's fight against high inflation continued in 2023. The Fed raised the key interest rate from a range of 4.25% to 4.50% to a range of 5.25% to 5.50%. It will not raise interest rates further but will leave them at this level for a longer period of time, as inflation is still not at the Fed's target and is showing inertia. The ECB raised its main interest rate from 2.50% to 4.50%. Cautious monetary easing can be expected in 2024. According to the Fed, the key rate should be 4.6% at the end of this year, so we should expect roughly three 25 basis point interest rate cuts. The ECB is expected to start cutting interest rates gradually in the second half of 2024.

Even in 2023, financial markets were unsettled. In 2022 they took aim at the UK, last year they took a much bigger bite - the US. In April, yields on long-dated US Treasury bonds began to rise. In May, this rise caused the collapse of several medium-sized US banks (such as Silicon Valley Bank). Credit Suisse of Switzerland, which was taken over by UBS, also collapsed. This minor banking crisis has been resolved. However, US government bond yields continued to rise until the end of October. What are the reasons for this rise? Firstly, the Fed's tight monetary policy and secondly, the unwillingness of the Republicans and Democrats to cooperate on fiscal matters. In June, the Republicans threatened technical bankruptcy (not raising the debt ceiling) if spending cuts were not made. A compromise was found at the last minute. In response, Fitch downgraded the US credit rating to AA+. Now, only Moody's rates the US's liabilities at the highest level, but it too is considering a downgrade.

The global economy grew by 3.0% in 2023, according to the IMF's estimate, slowing from 3.5% in 2022. In 2024, global GDP growth is expected to reach 2.9%. The main drag on growth will be the lagged effect of central banks' restrictive monetary policies. Of the major economies, India is expected to grow fastest (6.3%), followed by China (4.2%). The US economy is also expected to grow (1.5%). Some European economies are currently in recession but should emerge from it during the year. For example, the German economy should grow by 0.9% in 2024 after a 0.5% contraction in 2023.

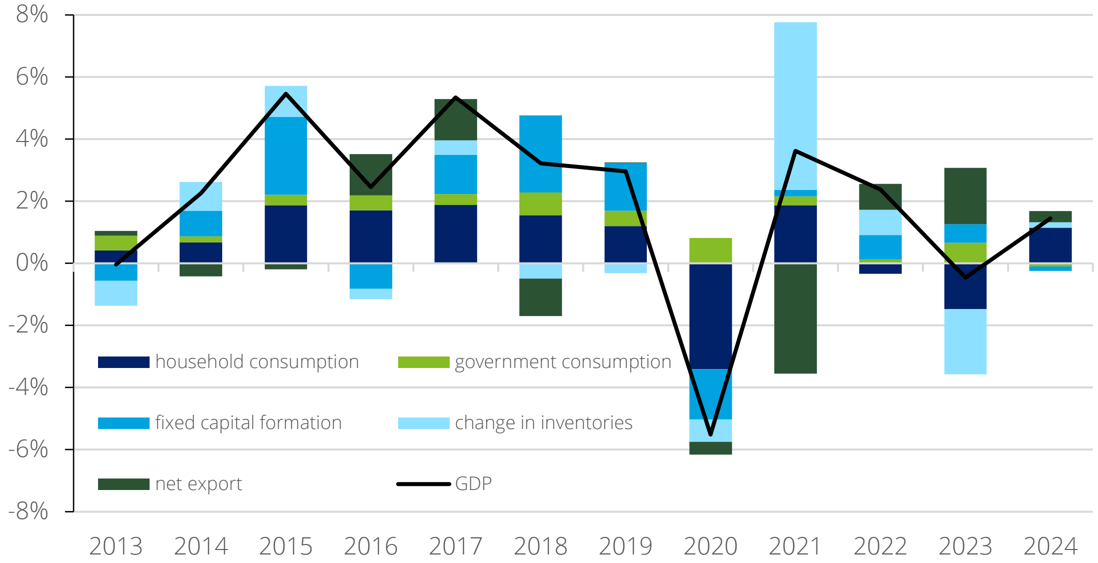
Czechia

GDP

In 2022, an energy crisis took place across Europe, the consequences of which the Czech economy faced throughout 2023. Inflation was very high in the country, and although it started to decline in 2023, it still had a very negative impact on the economy. This can be illustrated by the example of the Czech gross domestic product, which is the only one in the EU that has not yet reached the pre-pandemic level of Q4 2019. While other economies were growing, the Czech economy stagnated and in H2 2023 it will probably show a decline in GDP for two quarters in a row, putting it into recession. The economy is hampered by high inflation reducing real household incomes, the effectiveness of high interest rates slowing down investment activity of companies and weak demand from abroad. Of particular note is the weak performance of the German economy, which is closely linked to the Czech economy.

In Q1 2023, GDP grew by 0.1% quarter-on-quarter and fell by 0.4% year-on-year. On a quarter-on-quarter basis, there was a very significant fall of 1.3% in household consumption and 0.4% in gross fixed capital formation. In contrast, government consumption rose by 0.5% and foreign trade also made a positive contribution, as exports stagnated, and imports fell by 1.4%. The situation was almost identical in Q2, with GDP rising by 0.1% quarter-on-quarter and falling by 0.4% year-on-year. This time, household consumption grew by 0.6% and government consumption by 0.7%, while gross capital formation, including inventories, fell by 1%. Exports and imports were flat quarter-on-quarter and therefore foreign trade was neutral in relation to GDP. In Q3, GDP had already fallen by 0.5% quarter-on-quarter and by 0.7% year-on-year. Household consumption fell again by 0.3% and gross fixed capital formation by 0.3%. Exports also started to fall, by 1.2%, and as they fell more than imports (-1.1%), the contribution of foreign trade was negative. We do not expect an improvement in Q4, instead we expect a quarter-on-quarter decline of 0.4% (annualized 0.7%). The decline will be mainly due to the continued decline in gross fixed capital formation. Overall, we expect GDP to fall by 0.6% year-on-year in 2023, with the economy reaching its pre-pandemic level in 2024 at the earliest.

Chart 2: GDP growth and contributions of individual components



Source: CZSO, Deloitte

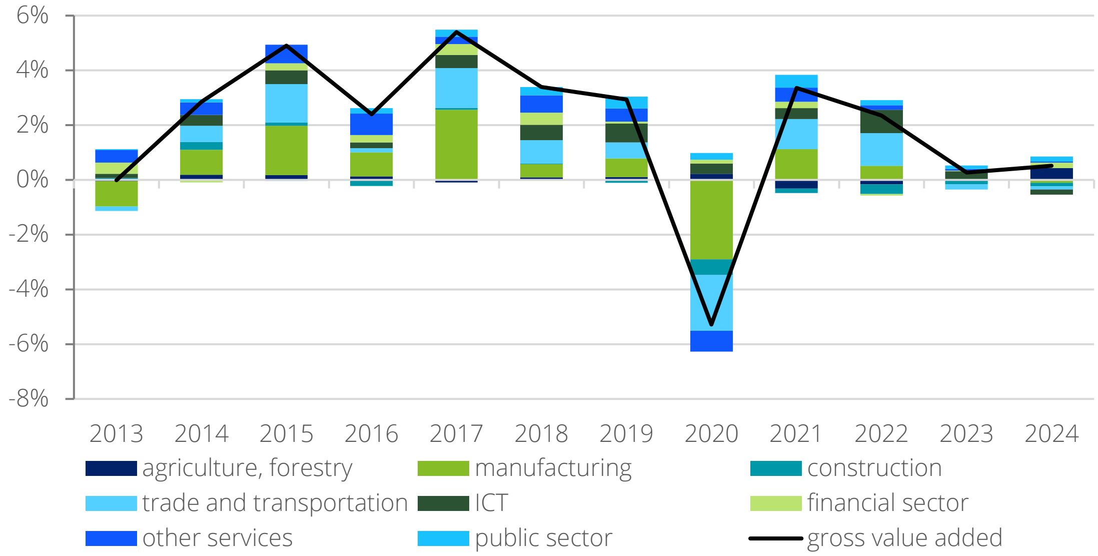
In terms of contributions to overall GDP growth, we expect the largest contributions to 2023 to come from the external trade balance (1.8 percentage points), thanks to export growth, government consumption (0.7 percentage points) and gross fixed capital formation (0.6 percentage points).

Household consumption expenditure is forecast to contribute negatively by 1.5 percentage points and inventory formation negatively by 2.1 percentage points.

In terms of GDP formation, information, and communication activities (0.3 percentage point) and manufacturing (0.2 percentage point) will be the largest contributors to GVA in 2023. Industrial production grew mainly in the automotive sector due to a large number of orders from previous years, when automakers could not produce at full capacity due to disrupted supply chains. These orders were mainly met in the first half of the year, but in the second half the number of new orders started to decline significantly due to low demand at home and abroad. Other industries with positive contributions include professional, scientific, technical, and administrative activities (0.1 percentage point) and public administration and defense, education, human health, and social work activities (0.1 percentage point). Most other industries, on the other hand, showed a decline in production throughout the year, with significant declines in the production of basic metals, chemicals, and plastics, for example. Other industries with negative contributions to GVA include trade, transport, accommodation, and food services (-0.2 percentage point), construction (-0.1 percentage point) and real estate activities (-0.1 percentage point).

Our forecast assumes GDP growth of 1.1% in 2024. The main driver of growth will be a recovery in household consumption (+2.6%), mainly due to falling inflation boosting real household incomes. By contrast, gross fixed capital formation is expected to fall by 0.5%. Firms are having to reduce investment due to rising costs and declining profitability and are postponing projects in progress. Government consumption is expected to fall by 0.5%, under pressure from the start of the fiscal consolidation announced by the government in 2023. Foreign trade is expected to show a positive contribution, especially due to the gradual recovery of external demand. However, there is considerable uncertainty about the future economic development of neighboring Germany in particular as a major export partner.

Chart 3: Gross value-added growth and sectoral contributions



Source: CZSO, Deloitte

At the end of 2023, the Czech economy was below its potential with an output gap of 4.5% (according to the production function), which means that capacity utilization is lower than usual. With GDP growth next year, the output gap should gradually decrease. The economy should not reach the above potential until 2026 at the earliest.

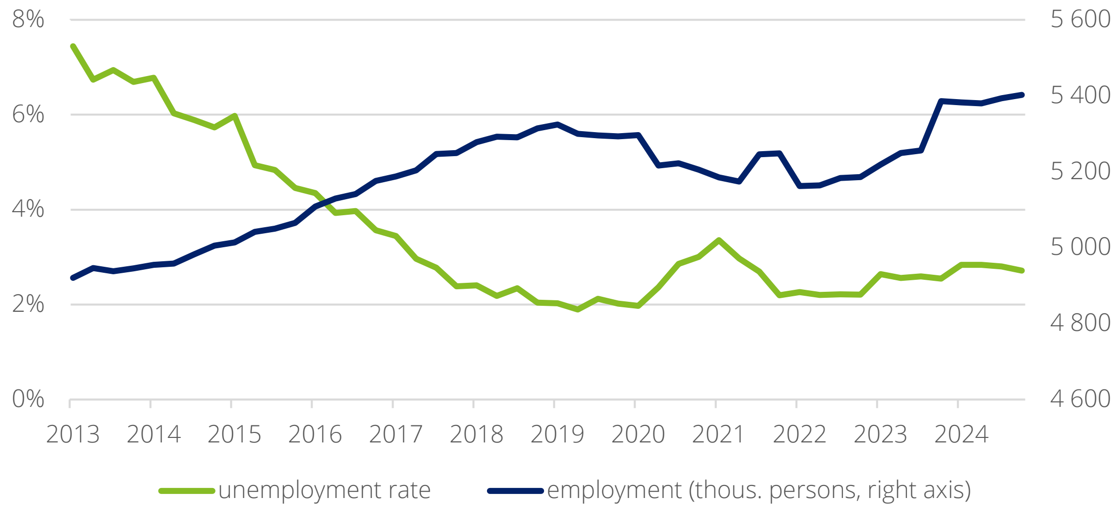
The Czech economy has slightly underperformed in real economic convergence to more advanced countries. In 2023, GDP per capita in PPP terms has fallen from 91% to 90% of the EU average, but this is still higher than, for example, Spain (86%). Unless there is a gradual transition to a higher value-added economy and an acceleration of GDP growth in the coming years, the divergence from the EU average may continue in the following years.

Labour market

The trend over the past decade has been steadily increasing employment and a falling unemployment rate, which stood at 2% in 2019. This level could be described as too low as the labour market began to overheat. Labour shortages were causing nominal wage growth to significantly outpace labour productivity. The impact of the pandemic and the energy crisis on the labour market was expected to be significant, but in retrospect this cannot be confirmed. The unemployment rate was 2.6% in 2020, 2.9% in 2021 and 2.4% in 2022. These were still the lowest figures in the EU. The rise in unemployment would probably have been higher if it had not been for the government's program of subsidies to maintain jobs.

In 2023, the downward trend in the unemployment rate stopped and a slight increase began to occur. The latest measured value, from October, is 3.0%. For the full year 2023, we expect an unemployment rate of 2.7%. It is evident that the labour market has returned to almost pre-pandemic levels. The number of job vacancies registered at the labour offices has fallen by around 10 000 to 280 000 over the past year. On the other hand, the number of registered jobseekers increased by around 10 000 year-on-year to 260 000. If this trend continues, the labour market could gradually move from a surplus of jobs to a shortage, which would also imply a rise in unemployment. Now, however, there is still a surplus of vacancies on the labour market (more demand than supply) - this is a structural phenomenon, i.e. it is not a temporary phenomenon. According to regional statistics, in Q2 2023, the unemployment rate was lowest in Vysočina Region (1.3%), Central Bohemia (1.5%) and Pilsen Region (1.5%), while the Moravian-Silesian Region (4.0%) and Karlovy Vary Region (3.5%) were the worst performers.

Chart 4: Employment and unemployment rate



Source: CZSO, Deloitte

Long-term labour shortages are contributing to upward pressure on wages. Average wages in nominal terms are expected to rise by around 7.5% this year, but even this growth will not compensate for high inflation. This is why real wages will fall for the second year in a row, by 8.5% in 2022 and by a further 3% in 2023, the biggest fall in living standards since the economic transition in the early 1990s. Average wages increased most significantly in the production and distribution of electricity, gas and heat due to high energy prices (16.9%), in real estate (+10.5%) and in accommodation, catering and hospitality (9.7%), while the least was added in education (+4.1%). From a regional perspective, wages grew fastest in the Ústí nad Labem region (8.0%), but least in Prague (5.9%).

For the first time since 2020, wage growth started to outpace labour productivity growth. Unit labour costs (including wage growth, employment, and productivity) rose by 0.4% in 2023.

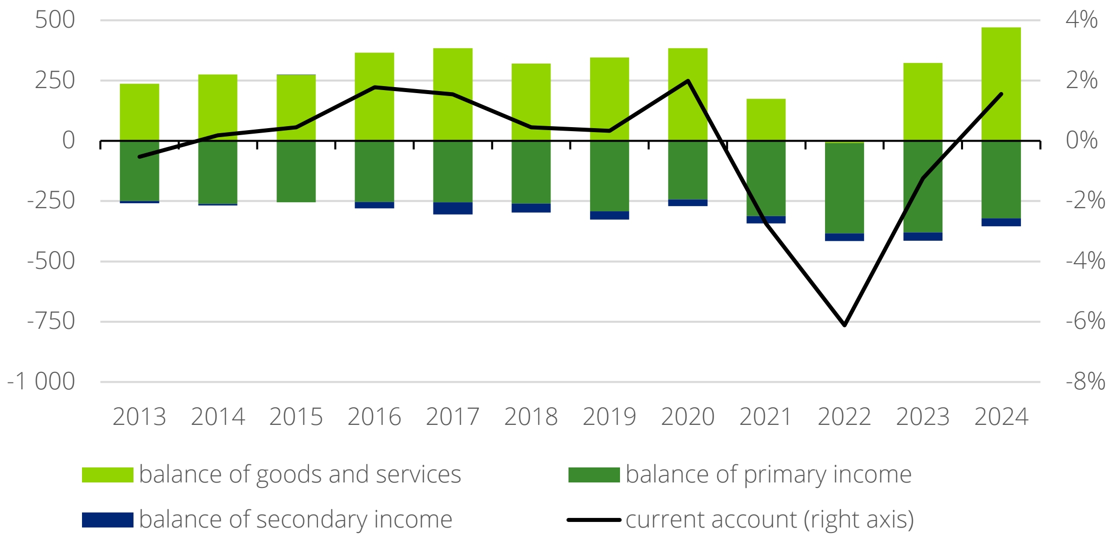
For 2024, our forecast assumes continued moderate growth in unemployment, i.e. the unemployment rate should oscillate around 2.8%, with employment falling slightly. The development of firms in the context of high energy prices remains a significant risk. If more firms start to close, unemployment could rise at a faster pace. Conversely, in the longer term, strong graduates will retire from the labour market and the new workforce is unlikely to be able to replace them. Thus, we can expect more and more companies to rely on robotics and automation. For 2024, we expect average wages to grow by 5.5%, and, thanks to a steady decline in inflation close to the inflation target, real wages should rise again by 1.9% after two years.

External relations

In 2020, the current account of the balance of payments reached its highest surplus in history (2.0% of GDP), mainly due to a significant reduction in dividend outflows combined with a reduction in GDP as a reference base. In 2021, the opposite situation occurred. Dividend outflows resumed, pushing the balance of primary income (wages, profits, dividends, and interest) into a higher deficit, while the surplus on trade in goods and services started to decline. In 2022, the small open economy experienced an unprecedented situation, namely a deficit in the balance of goods and services of CZK 9.4 billion, which was the last deficit the Czech economy experienced before joining the EU in 2003. This was due to the high prices of energy and other commodities that the Czech Republic must absorb from the global market, which significantly increase import prices and thus the value of imports of goods and services in absolute units. Overall, the current account deficit amounted to CZK 415 billion (6.1% of GDP), which last occurred in 1996.

As this was largely a short-term phenomenon, we expect the current account deficit to narrow significantly to CZK 93 billion (1.3% of GDP) in 2023. The balance of goods and services will return to a surplus of around CZK 323 billion, thanks to the reduction in import prices and the increase in exports. The primary income balance will reach a record deficit of CZK 380 billion, mainly due to dividend payments abroad. The balance of secondary income (taxes, social benefits, inter-household transfers) will reach a deficit of around CZK 34 billion, which is not significantly different from previous years.

Chart 5: Current account of the balance of payments (% of GDP) and its components (CZK billion)



Source: CZSO, CNB, Deloitte

The Czech Republic's external debt fell by 3.8 percentage points year-on-year to 62.9% of GDP in Q3 2023. When analyzing the debt structure in more detail, the reduction was mainly in short-term debt. Government debt increased by around CZK 75 billion due to an increase in the volume of bonds held by non-residents and the banking sector (including CNB liabilities). The external indebtedness of the central bank fell significantly by CZK 175 billion. For commercial banks, long-term foreign indebtedness increased due to an increase in the volume of debt securities held by foreign entities. A continued downward trajectory of external debt is expected in the coming years.

The net investment position of the Czech Republic, which compares the stock of assets held by Czech entities abroad with the stock of assets held by foreign entities in the Czech Republic, showed a declining deficit from 2010 to 2021, from 50% of GDP to 17% of GDP. In 2022, the investment position deficit worsened (24% of GDP) due to an increase in foreign direct investment and a significant appreciation of the Czech koruna, resulting in a revaluation of foreign assets and liabilities; in addition, the CNB sold off its foreign exchange reserves. In Q3 2023, the country's investment position improved as the deficit decreased by CZK 250 billion to CZK 1.1 trillion due to a reduction in the volume of foreign entities' funds in domestic banks. CZK (19% of GDP).

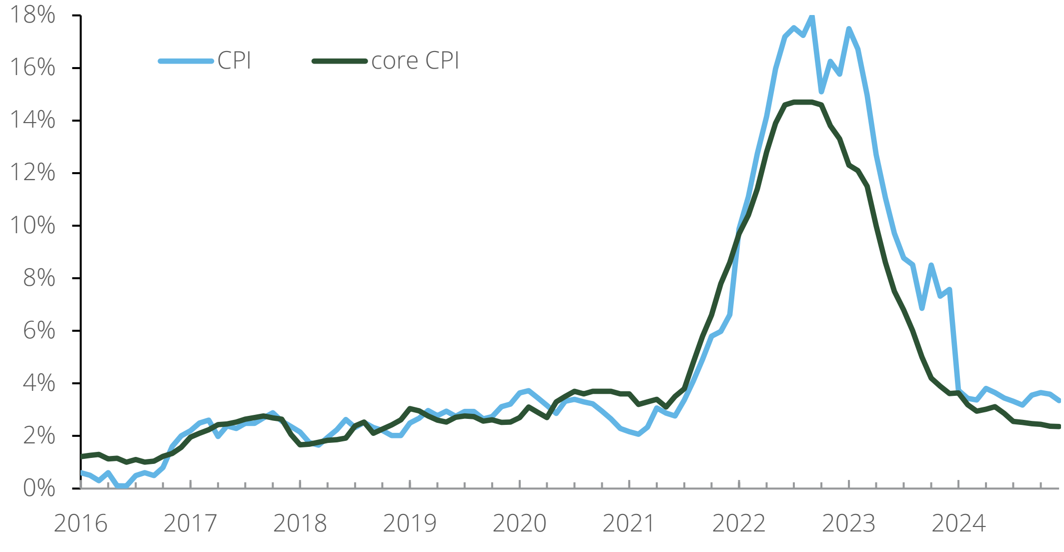
In 2024, the Czech Republic's external economic relations will be determined by energy price developments and continued growth in exports of goods and services thanks to slowly rising foreign demand. In our model, we expect a surplus of CZK 470 billion in the balance of goods and services, while the balance of primary income will be in significant deficit - as in previous years (CZK 340 billion). Overall, the current account would return to a surplus of CZK 103 billion (1.4% of GDP).

Inflation

When prices in the economy started to rise in 2021, no one expected the heights to which inflation would rise. The combination of strong post-pandemic demand disrupted supply chains, an overheated labour market and an energy crisis has created a price shock unprecedented since the 1990s. Inflation has begun to rise sharply, and in September 2022 inflation reached its peak, with the Consumer Price Index rising by 18% year-on-year. Had it not been for the government's introduction of a savings tariff in the form of a state subsidy as well as the waiver of the RES levy, inflation would have surpassed the 20% mark in October. For the whole of 2022, average inflation was 15.1%, the highest since 1993.

The year 2023 was marked by a gradual decline in inflation, but it was well above the 2% inflation target throughout the year. Higher interest rates from the CNB helped to reduce inflation, which reduced the volume of mortgage and consumer loans to a minimum. Households began to save and firms to postpone their investments. The situation was greatly helped by the calming of world stock markets, which brought down energy and gas prices. For example, the price of the natural gas contract for the next quarter in the TTF virtual hub in 2022 even surpassed the level of EUR 300/MWh, and at the end of 2023 the price was around EUR 35/MWh. This has gradually slowed down price increases in housing, water, energy, and fuels, but also food and transport due to the fall in oil prices.

Chart 6: Inflation



Source: CZSO, CNB, Deloitte

Unlike in many other countries, demand pressures from an overheated labour market are feeding through into Czech inflation. It was already tight before the pandemic and labour shortages are adding upward pressure on wages. Employees want to keep nominal wage growth in line with inflation, which raises costs for firms. Firms are trying to translate the cost into the end prices of their products and services. This process can trigger a wage-inflation spiral that ends in inflation of tens of percent. This is why it is important that inflation is brought down to sustainable levels as soon as possible and that firms' and households' inflation expectations are anchored at a low and stable level.

The consumer price index rose by 17.5% year-on-year in January 2023. Inflation slowed to 7.3% in the latest data from November. However, this includes the effect of the low base of comparison last year due to the austerity tariff described above. Without this change, inflation would have slowed further to below 5%. For the full year 2023, we expect average inflation of 10.8%.

Other price indices have seen similar unprecedented growth in 2022. The industrial producer price index rose by an average of 24.3%, and the agricultural producer price index by 31.8%. World food prices rose by the most since 2008. The war in Ukraine plays an important role, as Ukraine is a key exporter of food commodities to the world. Inflation in construction prices accelerated by 12.4% and market services prices by 5.8%. Price indices have fallen significantly this year, according to the latest data from November, industrial producer prices are up 0.8% year-on-year, agricultural producer prices are in significant deflation, specifically down 16.2%, construction work prices are up 3.3% and only market services prices are slowing down very slightly, rising 5% this month. Prices of new and old homes are down 3% year-on-year in mid-2023. The last time home prices fell was in 2012 as the financial crisis receded. It is evident that despite the lack of new housing construction, demand is being significantly hampered by high interest rates limiting households' access to mortgage credit.

For 2024, inflation is expected to continue to fall towards the inflation target. Based on the seasonally adjusted month-on-month change, a significant decline in inflationary pressures can be observed in recent months, but the traditional January revaluation will be crucial to show what the real inflation expectations in the economy are. Moreover, a question mark hangs over the development of energy prices. Although the unregulated market price of electricity and gas is falling on the exchanges, the Energy Regulatory Authority has announced a significant increase in the regulated component of energy prices of around 20-30%, which may ultimately nullify the effect of the fall in prices on the exchanges. Food prices may be another problematic item. Although the government has reduced the VAT rate on food from 15% to 12%, supermarkets have already announced that they will be forced to increase prices from the new year onwards due to rising energy prices. In our model, we expect average inflation of 2.7% for 2024. The evolution of the war in Ukraine and "unanchored" inflation expectations remain a risk to the forecast.

Monetary policy

After 2022, which was a very turbulent year for Czech monetary policy, monetary policy stabilized last year. For most of 2023, the central bank kept rates unchanged and only at the very end of the year did we see one 25 basis point cut. The main two-week repo rate is thus currently 6.75%. In particular, the effect of the high 2022 benchmark base and the calming of the situation on the energy markets worked in the CNB's favor. The fact that there is low demand in the economy due to wage growth lagging behind inflation also helped. The CNB should thus achieve its inflation target at the end of 2024 or early 2025 (see the inflation chapter).

Although the CNB has started a rate-cutting cycle, it is cautious about easing monetary policy. The CNB's forecast already recommends cutting interest rates for a longer period. Central bankers are probably worried about a large repricing in January and are waiting for the release of January inflation in February before cutting interest rates sharply. Unfortunately, the economy fell back into recession in the second half of the year. The monetary policy horizon is a year to a year and a half. At this horizon, inflation will probably already be close to the inflation target. It therefore made sense to start the interest rate cut cycle at the end of 2023, when it became clear that the economy had fallen back into recession.

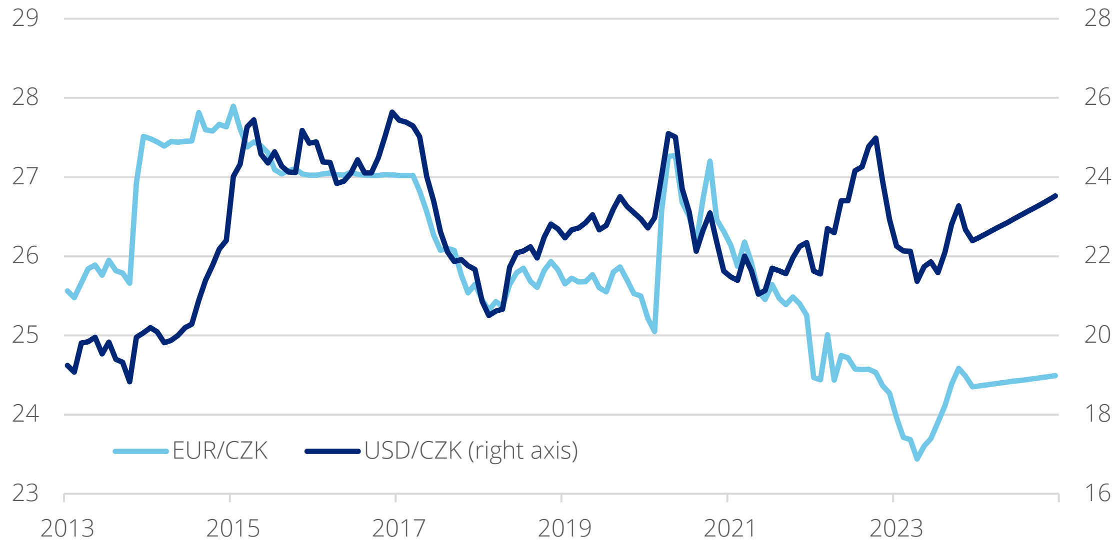
Given that the CNB had postponed the start of the interest rate cut cycle by about one quarter, the pace of cuts could be relatively brisk. According to our estimated reaction function, the key interest rate should be 3.50% at the end of this year. Interest rates could be cut by 325 basis points cumulatively, equivalent to 13 cuts of 25 basis points. The current Board has been relatively cautious in both raising and lowering interest rates. It is therefore possible that it will not be as aggressive as our model, estimated on the basis of the behavior of previous Boards, suggests.

The koruna started 2023 below 24 EUR/CZK. It held below this level until July. In July, the CNB formally ended the FX interventions it had introduced in 2022 following the appointment of a new governor. Although the CNB did not actively intervene last year, the threat of intervention was enough to keep the koruna at relatively strong levels. After the formal end of interventions, the koruna weakened above 24 EUR/CZK.

Further weakening of the koruna was helped by rising expectations of monetary easing by the CNB, while the ECB raised interest rates back in September and the interest rate differential between koruna and euro rates was narrowing. However, the CNB's postponement of the start of interest rate cuts prevented even more depreciation. For example, in October the koruna traded above 24.60 EUR/CZK. After the CNB left interest rates unchanged in October, the koruna strengthened to 24.15 EUR/CZK. The koruna subsequently ended the year slightly below 24.60 EUR/CZK in response to the December rate cut.

Next year, the koruna is likely to come under pressure again. The CNB will ease monetary policy, but the ECB will have to be cautious with easing. Nevertheless, the koruna should end the year close to 24.50 EUR/CZK.

Chart 7: Exchange rates



Source: CNB, Deloitte

Fiscal policy

The energy crisis delayed the consolidation of public finances by one year. In 2023, the government had one last chance to enforce austerity measures. In 2024, the Czech Republic will face two elections, for the European Parliament and regional councils, and the campaign for the 2025 parliamentary elections will get underway. This is what has happened, with the government pushing through an austerity package that will reduce budget deficits by a total of CZK 150 billion over the next two years.

The main pillar of this package is a reduction in non-investment subsidies. However, this is also a problematic item, because the subsidies for supporting renewable energy sources will be reduced and, as a result, the regulated part of the electricity price will rise. In total, non-investment subsidies are being reduced by CZK 84 billion. In addition, public wages and salaries are being reduced, operating expenditure is being cut, support for building savings is being reduced and other austerity measures are being introduced. The government has also adjusted the parameters of the pension system to limit its deficits.

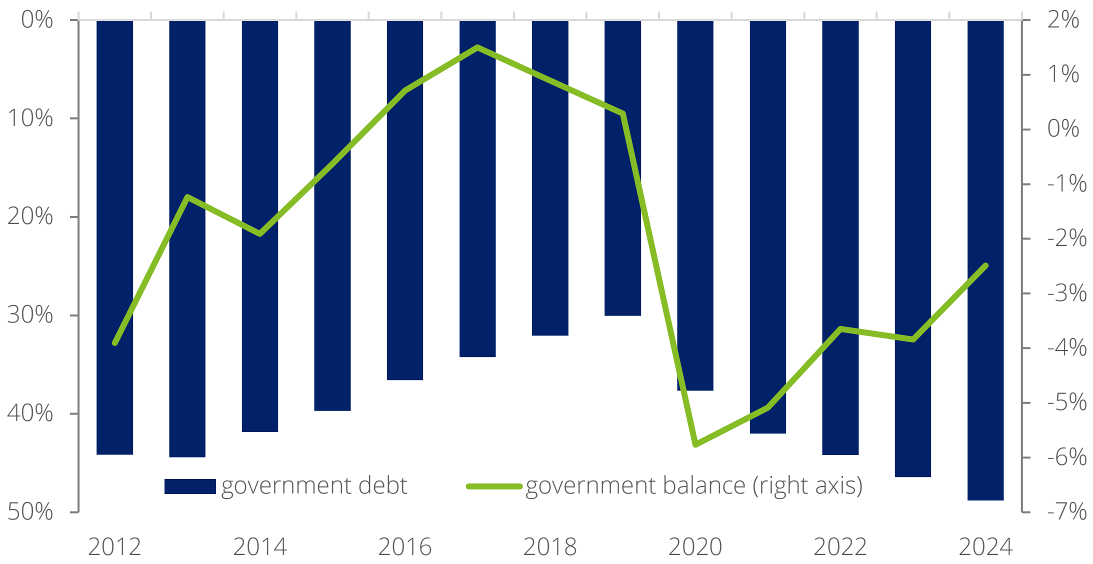
However, taxes are also being increased. A key measure is a 2-percentage point increase in the corporate tax rate to 21%. Taxes on individuals are also being increased. Although the tax rate is not being increased, some tax credits and exemptions are being abolished. Employees' sickness insurance is reintroduced at a reduced rate of 0.6%, which until 2008 was at a rate of 1.1%. In addition, property taxation is increased. On the other hand, VAT is slightly reduced. Until 2023, there were two reduced rates: 10% and 15%. However, this will mean a shortfall of around CZK 10 billion.

Overall, the government's efforts to stabilize public finances, which are currently on an unsustainable trajectory, can be viewed positively. On the other hand, the government is complicating fiscal consolidation with unnecessary mistakes, such as the already discussed VAT reduction or the abolition of the EET. The construction of new nuclear reactors will be very fiscally costly, although the costs will be spread over a very long period of time. As a result, the government has not yet put public finances back on a sustainable trajectory but has only slowed down the increase in the debt-to-GDP ratio in the future. Further austerity measures will therefore have to come, but they are likely to emerge after the 2025 elections to the Chamber of Deputies.

In 2023, the government kept the state budget deficit below the planned CZK 295 billion, when the deficit reached CZK 288.5 billion. But without above expectations of good EU revenues and above expectations of good corporate tax collections, the planned budget deficit could not have been maintained. The government also helped itself by taking the budget of the State Transport Infrastructure Fund out of the state budget. The budget for 2024 is approved with a deficit of CZK 252 billion.

In 2023, the public finances as a whole show a deficit of 3.6% of GDP, according to our estimate. However, this should be the last year in which the deficit is above 3% of GDP. The public deficit should be around 2% of GDP in 2024. The debt-to-GDP ratio increases by 3 percentage points to 47% of GDP in 2023, according to our estimate. From 2024 onwards, it will grow much more slowly, but should continue to rise. If there is no further consolidation of public finances, it could reach 50% of GDP by the end of the decade.

Chart 8: General government balance and debt (% of GDP)



Source: CZSO, Deloitte

The tax burden stagnated in 2023. The composite tax quota stagnated at 34.8% of GDP in mid-2023. Tax rates remained stable in 2023. In 2024, we estimate that the tax quota will rise to 35.3% due to the tax package.

The Czech Republic's credit rating remained unchanged last year and remains in good territory. Standard & Poor's maintains the Czech Republic's credit rating (long-term foreign currency rating) at AA- with a stable outlook. Moody's upgraded the rating outlook to stable from negative. The decision to return the rating outlook to stable is mainly due to a significant reduction in risks related to Russian gas supplies, which was the main reason for the downgrade to negative in August 2022. Fitch rates the Czech Republic's liabilities at AA-. The outlook remains negative.

Summary

In 2022, the global economy was affected by the war between Russia and Ukraine and the energy crisis. The easing of tensions in energy markets led to a fall in inflation in 2023. Central banks, especially the Fed and the ECB, continued to fight inflation by raising interest rates. In financial markets, 2023 was a turbulent year, with rising US Treasury yields and the collapse of several banks. According to the International Monetary Fund, the global economy grew by 3.0% in 2023 and is expected to grow by 2.9% in 2024, with India and China as the leading growth economies.

The Czech economy experienced negative impacts from the energy crisis and high inflation in 2023, leading to stagnation and a decline in GDP. This trend was mainly driven by a decline in gross fixed capital formation and low demand from abroad. In particular, the problems in the German economy, which is closely linked to the Czech economy, had a negative impact. GDP is expected to decline by 0.6% in 2023, with growth expected to resume in 2024.

In 2024, we expect GDP growth of 1.1%. Foreign trade is expected to make a key contribution. The reduction in inflation should support a recovery in household consumption growth. However, gross fixed capital formation and government consumption are expected to decline. Real economic convergence towards more advanced countries has stalled and its resumption requires a return to faster GDP growth in the coming years.

The downward trend in the unemployment rate has been halted, although the labour market remains structurally oversupplied with jobs. Long-term labour shortages are supporting wage growth, but despite an expected wage increase of 7.5% in 2023, real wages will fall for the second year in a row. The forecast for 2024 assumes a moderate rise in unemployment and further wage growth of 5.5%, with real wages expected to rise again by 1.9%.

The strong demand that came after the end of the pandemic, problems in supply chains, an overheated labor market, and the energy crisis brought an inflationary shock in 2022. In September 2022, inflation peaked at 18%. In 2023, inflation gradually declined, but the annual average is still expected to reach 10.8%. For 2024, inflation is expected to continue to fall towards the inflation target. Risks lie mainly in geopolitical developments in Ukraine and the Middle East. Among domestic factors, the evolution of inflation expectations or inflation inertia will be crucial. We expect average consumer price inflation to be 2.7% in 2024.

For most of 2023, the central bank kept rates unchanged and only at the very end of the year did we see one 25 basis point cut. Given that the CNB has delayed the start of the interest rate cut cycle by roughly one quarter, the pace of cuts could be quite brisk. The key interest rate could be 3.50% at the end of 2024.

The government has pushed through an austerity package that will reduce budget deficits by a total of CZK 150 billion over the next two years. With this package, the government has not yet put the public finances back on a sustainable trajectory but has only slowed down the increase in the debt-to-GDP ratio in the future. Further austerity measures will thus have to come, but they are likely to appear after the 2025 parliamentary elections. For 2024, a draft state budget with a deficit of CZK 252 billion has been adopted.

Basic data and forecasts

	2019	2020	2021	2022	2023	2024
GDP, CZK bn, current prices	5 791	5 709	6 109	6 786	7 358	7 475
GDP, EUR bn, current prices	225,6	215,8	238,2	276,3	306,7	306,0
GDP, growth rate	3,0 %	-5,5 %	3,5 %	2,4 %	-0,6 %	1,1 %
Industrial production growth rate	-0,1 %	-6,9 %	8,3 %	2,6 %	-0,2 %	-0,3 %
Construction output, growth rate	2,9 %	-5,1 %	1,8 %	3,5 %	-1,8 %	-2,3 %
Retail sales, growth rate	4,8 %	-0,9 %	4,2 %	-3,0 %	-3,8 %	4,2 %
Unemployment, % of labour force, average	2,0 %	2,4 %	2,8 %	2,2 %	2,6 %	2,8 %
Consumer prices, average	2,8 %	3,2 %	3,8 %	15,1 %	10,8 %	2,7 %
Consumer prices, eop	3,2 %	2,3 %	6,6 %	15,8 %	7,2 %	2,9 %
Industrial producer prices, average	2,6 %	0,1 %	7,1 %	24,3 %	5,2 %	-7,4 %
Industrial producer prices, eop	2,1 %	0,0 %	13,2 %	20,1 %	0,6 %	-3,9 %
Average national wage, growth rate	7,9 %	1,8 %	5,8 %	5,3 %	7,5 %	5,5 %
Trade balance, CZK bn	145,7	179,9	-9,2	-204,8	113,8	274,8
Current account, CZK bn	19,2	113,7	-168,0	-381,2	-126,5	108,4
in % of GDP	0,3 %	2,0 %	-2,8 %	-6,1 %	-1,3 %	1,4 %
Financial account, CZK bn	8,4	163,3	-40,0	-341,0	-58,0	180,9
in % of GDP	0,1 %	2,9 %	-0,7 %	-6,1 %	0,2 %	2,4 %
Foreign direct investment inflow, CZK bn	109,0	44,2	251,5	67,4	48,7	160,7
in % of GDP	1,9 %	0,8 %	4,1 %	1,1 %	0,6 %	2,1 %
Gross external debt, CZK bn	189,8	193,2	237,2	218,5	234,9	207,9
in % of exports of goods and services	102,5 %	108,2 %	118,4 %	100,8 %	101,0 %	85,3 %
in % of GDP	75,7 %	75,7 %	86,1 %	77,1 %	77,6 %	71,8 %
FX reserves, USD bn	149,9	166,1	173,6	140,0	142,2	146,4
in months of imports of goods and services	10,3	11,8	10,7	7,4	9,2	7,6
General government budget, CZK bn	16,7	-329,2	-310,6	-247,5	-260,4	-142,3
in % of GDP	0,3 %	-5,8 %	-5,1 %	-3,6 %	-3,6 %	-1,9 %
General government debt, CZK bn	1 740	2 150	2 567	2 998	3 473	3 624
in % of GDP	30,0 %	37,7 %	42,0 %	44,2 %	47,2 %	48,4 %
Broad money (M3), growth rate, eop	6,4 %	10,0 %	6,8 %	6,1 %	9,3 %	0,9 %
2-week repo rate, eop	2,00 %	0,25 %	3,75 %	7,00 %	6,75 %	3,50 %
3M PRIBOR, average	2,12 %	0,86 %	1,13 %	6,28 %	7,13 %	4,54 %
3M PRIBOR, eop	2,18 %	0,35 %	3,50 %	7,26 %	7,06 %	3,56 %
CZK/EUR, average	25,67	26,45	25,65	24,56	23,99	24,43
CZK/EUR, eop	25,50	26,31	25,26	24,27	24,35	24,49
CZK/USD, average	22,93	23,21	21,68	23,36	22,19	22,99
CZK/USD, eop	22,94	21,63	22,35	22,92	22,39	23,52

Source: CZSO, CNB, Ministry of Finance. Forecasts: Deloitte

Authors of the analysis

David Marek
dmarek@deloittece.com
+420 606 656 599

Václav Franče
vfrance@deloittece.com
+420 608 233 624

Filip Pastucha
fpastucha@deloittece.com
+420 732 492 557