

Can the Czech Economy Grow Out of Debt?¹

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Summary

In connection with the growing budget deficits of several EU countries, discussions – including in the Czech Republic – have introduced the idea that a state could “grow out of debt”. This notion is based on the premise that the ability to repay debt depends not so much on the absolute amount of debt, but rather on the **debt-to-GDP ratio**, which relates the size of the debt to the size of the economy (GDP). This ratio can be reduced not only by cutting the debt itself, but also through stronger economic growth. Stronger growth allows for greater budget deficits and further borrowing. A key condition is that the rate of economic growth must consistently exceed the interest rate at which the state can borrow. In this regard, arguments based on the idea of “growing out of debt” currently have very weak support in the Czech economic context, and this support is likely to weaken further in the foreseeable future.

Growing out of debt

For the stability and sustainability of government finances, the actual **amount of a government debt**², is not as important as **the level of indebtedness (debt ratio)** – that is, the ratio of government debt to the size of the economy, measured by gross domestic product (GDP). The process of the economy growing out of government debt can be simplified as follows:

- At the beginning of the 1st year, the state borrows one billion Czech crowns for one year.
- During the 1st year, the economy grows, and interest is added to the one-billion debt.
- If the economy grows faster than the debt increases (due to interest), then by the end of the 1st year, the debt (one billion + interest) in relation to the size of the economy will be smaller. **Thanks to strong GDP growth during the year, the debt ratio will therefore decrease.**
- At the beginning of the 2nd year, the state borrows again to repay the debt (the one billion borrowed previously plus interest). From the state's perspective, neither the principal (one billion) nor the interest accrued during the 1st year is actually repaid.
- At the end of the 2nd year, if the GDP growth rate exceeds the interest rate on the debt, **the debt ratio will decrease further**, despite the increase in debt due to additional interest.
- This process is repeated in the following years. Despite the growing amount of borrowed money (the original one billion + annually accruing interest) and without any ongoing repayments, the debt ratio gradually decreases. **The economy thus gradually grows out of the one-billion debt borrowed at the beginning.**

1 This study represents the author's own views and not the official position of the Economics Institute of the Czech Academy of Sciences nor of the Charles University Center for Economic Research and Graduate Education (CERGE). The author thanks Jaroslav Borovička, Tomáš Holub, Daniel Münich, and Petr Viliš for valuable comments and advice. Any inaccuracies and errors are the responsibility of the author. Michal Franta works at the IDEA think tank at CERGE-EI.

2 This text focuses on the debt of the Czech state (government debt), not on the debt of Czech public budgets (public debt), which also include the budgets of regions, municipalities, health insurance companies, and others. This is in order to relate the considerations in the text directly to the revenues and expenditures of the state budget, as discussions about growing out of debt are often held specifically in the context of government debt. Nevertheless, from a purely economic perspective, it would likely be more appropriate to work with the finances of the entire government sector. For example, fiscal rules are formulated as targets for the public budget balance in relation to GDP.

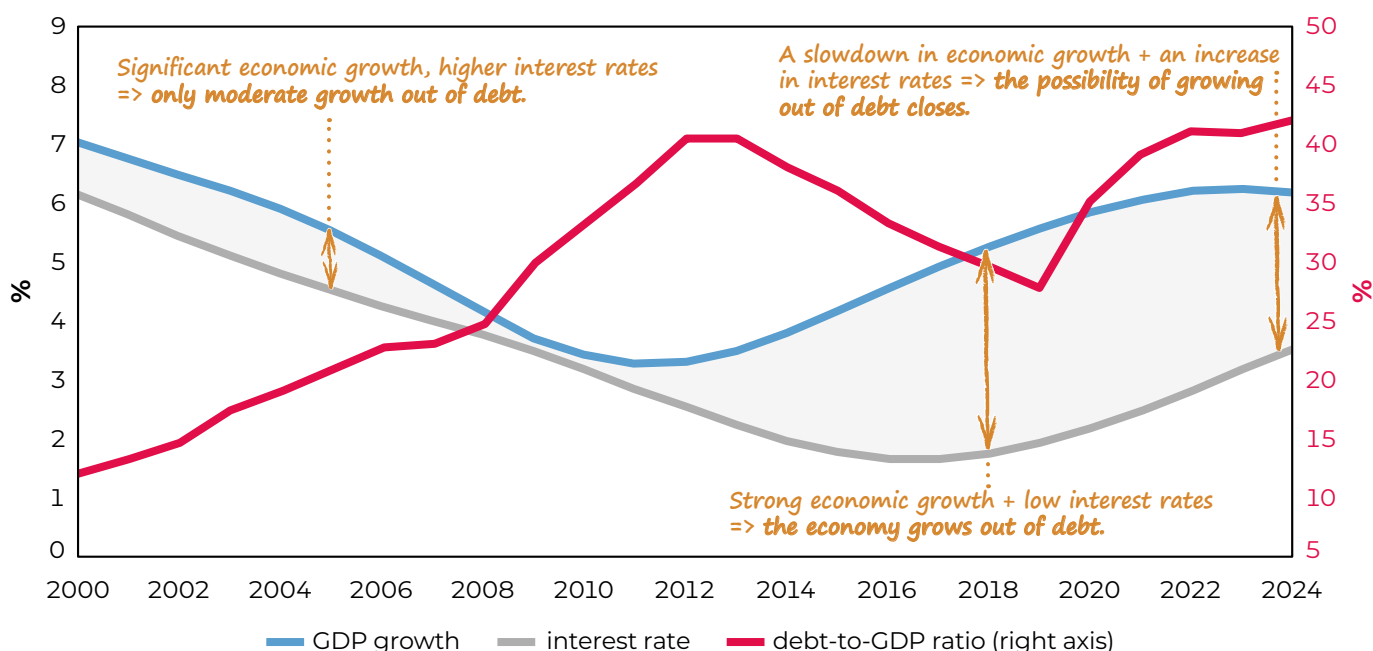
The one billion originally borrowed can already be spent by the state in the 1st year, and there is no need to increase tax rates or reduce budget expenditures in the future to repay it. The state does not need to generate any **primary surplus** in the future to repay the borrowed billion – that is, a budget surplus before accounting for interest payments (debt service). In other words, the borrowed billion does not need to be repaid, and the country's debt ratio will still decline. All that is required is for the economy to consistently grow at a rate higher than the interest rate paid on government debt. It is no coincidence that discussions about growing out of debt tend to appear more frequently during periods of low interest rates.³

It is possible to grow out of debt if the rate of economic growth consistently exceeds the interest rate paid on government debt.

More sophisticated versions of the argument about growing out of debt presume an active government role. Specifically, they involve the idea that the government can use the borrowed billion to enhance the country's long-term economic growth potential. A wide range of options is available – from increasing investments in education, science, and healthcare, to investing in energy, transportation, and other public infrastructure. Higher long-term economic growth would eventually lead to a lower debt ratio. The government could therefore actively support the process of growing out of debt through a larger budget deficit, without the need to raise tax rates or cut expenditures in the future.⁴

Graph 1: Growing out of debt is possible with high economic growth and low interest rates

(growth of nominal GDP, government debt interest rate and government debt-to-GDP ratio (right axis))⁵



³ One of the most recent major discussions of this kind was sparked by a lecture by Olivier Blanchard, which was also published as "Public Debt and Low Interest Rates" in the *American Economic Review*, 2019, 109(4). For domestic discussions, see, for example [\[link\]](#)

⁴ In this version of the argument about growing out of debt, it is not necessary for the rate of economic growth to exceed the interest rate paid on government debt.

⁵ GDP growth and the government debt interest rate are smoothed to make their comparison clearer. The variables are smoothed using an HP filter with a smoothing parameter of 100, in which the endpoint bias of the smoothed series is addressed by incorporating GDP and interest rate forecasts for 2025 and 2026, available here [\[link\]](#)

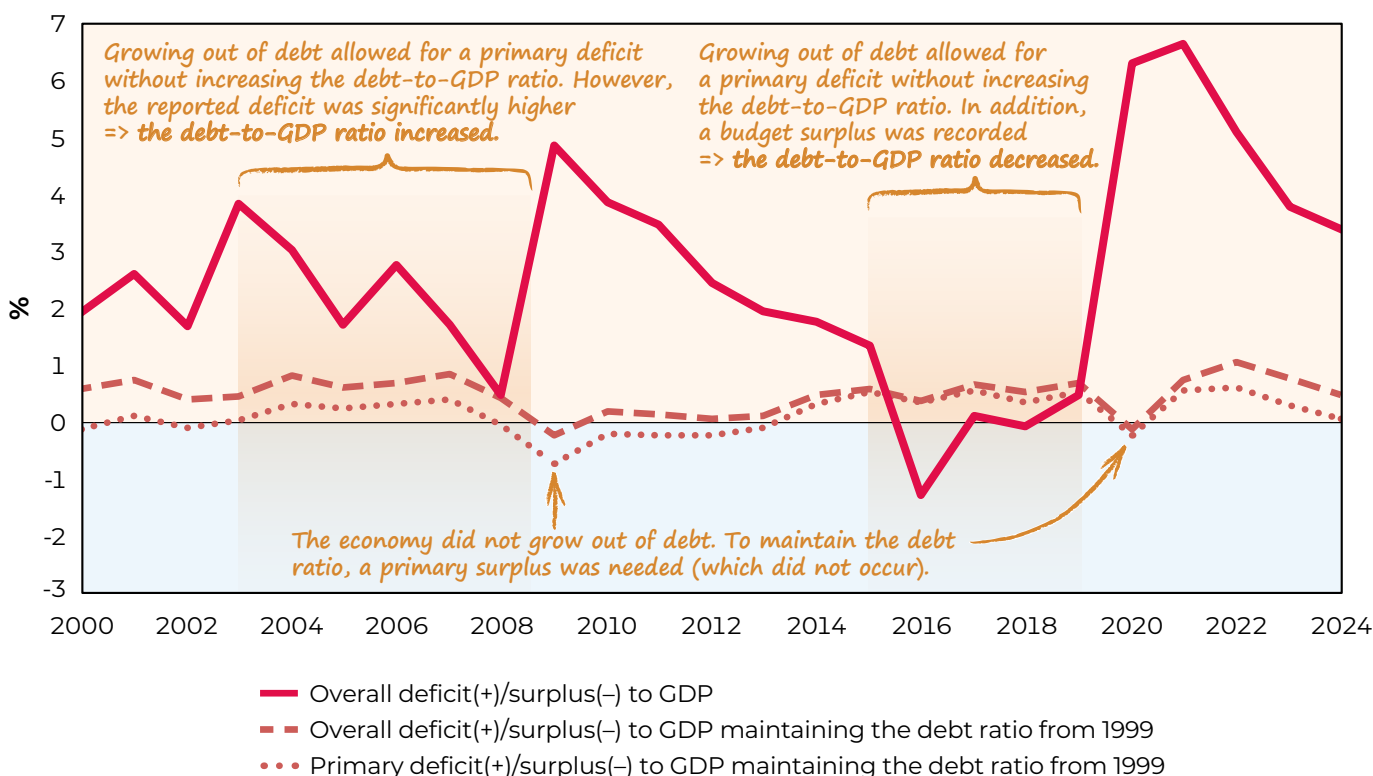
Historical experience

Faster growth rates of the Czech economy (GDP) compared to the interest rate on government debt has indeed enabled the country to grow out of debt over the past quarter-century (**Graph 1**). If governments had not increased the debt during this period and had only borrowed to pay interest on the existing debt⁶, the Czech Republic's debt ratio would have declined – just like in the introductory example. Conversely, if Czech governments had been satisfied with merely **maintaining the initial debt-to-GDP ratio**, they could have continued borrowing over time – the total debt could have grown even beyond what was needed to service the existing debt.

The possibility of further borrowing enabled by the Czech economy growing out of government debt has been the subject of public debate, and therefore we examine it in more detail in the following simulations. We show how large budget deficits could have been possible since the year 2000 thanks to the Czech economy's growing out of debt. We show the **size of the deficits governments could have run without causing increases in the debt-to-GDP ratio**.

As noted above, growing out of debt was possible after 2000 because the GDP growth rate exceeded the interest rate at which the state borrowed on the financial market. The difference between the nominal GDP growth rate and the interest rate⁷ averaged 1.90 percentage points between 2000 and 2024.

Graph 2: The Czech economy's growth out of debt after 2000 may have allowed only moderate additional borrowing
(simulation of total and primary budget deficits as a share of GDP that would maintain the debt ratio at its 1999 level)



6 This means that the state budgets would not show primary deficits.

7 We consider the interest rate to be represented by the yield on ten-year government bonds. At the end of 2024, the average maturity of government debt was 6.3 years – see [1](#). For the purposes of the analysis presented in this text, we regard the approximation of the interest rate paid on government debt by the yield on ten-year government bonds as sufficient.

Our simulationsⁱ show that such debt reduction through growth allowed for an average annual budget deficit of roughly **half a percent of GDP (Graph 2)**. Without accounting for expenditures on servicing government debt (i.e., interest payments), this allowed for an average (primary) budget deficit of **0.16% of GDP**. Such a deficit would not have increased the **debt ratio**, which would have remained at the 1999 level – i.e., 10% of GDP. In other words, if state budgets had reported deficits no larger than this, it would not have been necessary to reduce spending or raise taxes in order to repay them, either immediately or in the future. The debt resulting from such deficits would not have needed to be repaid, as the Czech economy would have gradually grown out of it. On the other hand, higher reported budget deficits led to an increase in the debt ratio.ⁱⁱ

The effect of growing out of debt after 2000 allowed for annual budget deficits averaging roughly half a percent of GDP.

However, following the year 2000, the state budget deficit reached substantially higher levels, averaging 2.6% of GDP. This significantly exceeded the deficit level that could have been sustained through the growth out of debt effect – the 0.5% of GDP noted above.⁸ Actual budget deficits significantly exceeded levels that would have maintained a stable debt ratio. As a result, between 2000 and 2024, the government debt-to-GDP ratio rose markedly – from a low of 10% to 42% of GDP.

The pace of debt accumulation after 2000 significantly exceeded any realistically conceivable capacity for growing out of debt.

In other words, during the period 2000–2024, it was not appropriate to justify increasing budget deficits by claiming that the Czech economy would eventually grow out of the higher debt. The pace of debt accumulation during that time significantly exceeded any realistically conceivable capacity for growing out of debt.

Can the Czech economy grow out of debt?

We now move from reflections based on known past developments to considerations of an uncertain future.ⁱⁱⁱ Compared to the past quarter-century, the long-term outlook suggests that the growth rate of the Czech economy will be lower, while interest rates on government debt will be higher. Such a combination will significantly constrain the Czech economy's ability to grow out of its debt. Furthermore, without substantial changes in fiscal policy, no meaningful support for long-term economic growth can be expected from the governments. The outlook for the individual factors that jointly determine the Czech economy's potential to grow out of debt warrants a more detailed discussion:

1) Czech economic growth rate and interest rates

From the perspective of government debt and economic growth, the past 25 years in the Czech Republic have been unique for several reasons. We witnessed a global financial crisis followed by a decade of exceptionally low interest rates.⁹ A number of additional factors contributed to a trend of persistently low interest rates: population ageing in advanced economies and market globalization, which suppressed price growth.¹⁰ In addition, the growth rate of the Czech economy was supported by technological advancement and, more broadly, by economic convergence towards more developed economies.

⁸ The logic behind this reasoning is drawn from the paper by Cochrane (2021), available here [8](#)

⁹ Unconventional monetary policies implemented by central banks lowered interest rates on longer-term debt instruments, including government debt.

¹⁰ Link [10](#)

The continuation of conditions favorable to growing out of debt is unlikely in the future. The gap between the Czech economy's growth rate and the interest rate on government debt is expected to narrow further – due both to a decline in the average economic growth rate and to persistently higher interest rates. The fading effects of the financial crisis, combined with deglobalization, will contribute to higher interest rates. Moreover, the Czech economy's growth potential stemming from its convergence towards more advanced economies has been largely exhausted.

The decline in the gap between the economic growth rate and government debt interest rates may reach a level where interest rates remain higher than GDP growth over the long term.¹¹ In such a situation, growing out of debt becomes impossible.

2) Fiscal policy

Future Czech governments can contribute to growing the economy out of debt through appropriate fiscal policy. This primarily involves reforms that increase the pace of long-term economic growth. On the other hand, it can be expected that interest rates on debt will likely rise in the future due to fiscal policy. We once again examine both possibilities in more detail:

Future Czech governments can help the Czech economy grow out of debt through reforms that increase the pace of long-term economic growth.

a) Interest rates on government debt

The fiscal policy of future Czech governments is likely to contribute to higher interest rates associated with government debt.¹² There are two main reasons:^{iv}

- Increases in both domestic and global public debt¹³ will lead to a rise in the supply of government bonds, which will result in a decline in their prices and, consequently, an increase in their yields.
- As the volume of a country's debt increases, so does the likelihood of default. This probability of default is reflected in the rise of the so-called risk premium, which is the portion of interest payments that represent the cost of the risk of sovereign default. An increase in the risk premium leads to a rise in the interest rate the country pays on its debt.¹⁴

Future increases in the interest rate on government debt due to rising debt levels will mean less room for the economy to grow out of debt.

b) Modernization reforms

A common argument in the context of the impact of fiscal policy on the chances of growing out of debt is based on budget deficits used to finance structural reforms. Through improved infrastructure, better and higher-quality education, or research and innovation, these reforms can increase the productive potential of the economy and thus its growth.¹⁵ According to the basic logic of growing out of debt, this leads to a decrease or slowdown in the growth of the debt-to-GDP ratio.¹⁶

11 A situation in which the interest rate on government debt is consistently higher than GDP growth rate is not historically unusual — see, for example, the 1980s and 1990s in the United States.

12 Estimates of the relationship between fiscal variables and long-term interest rates for the U.S. can be found here [🔗](#).

13 [Link 🔗](#)

14 This channel through which the size of public debt affects interest rates also includes scenarios of an explosive rise in interest rates. Expectations of difficulties repaying public debt lead to increases in the risk premium, which makes the debt more expensive. This, in turn, leads to further debt growth due to rising interest payments. At the same time, rising interest reinforces expectations of repayment problems, and so on. Such a scenario was observed during the Greek debt crisis between 2010 and 2015.

15 The potential of an economy reflects the amount of goods and services it can produce when operating at full capacity (factories, human capital, etc.).

16 Growing out of debt is also supported by short-term stimulation of the real economy, which leads to increased tax revenues, as illustrated in the theoretical model by Angeletos, G. M., Lian, C., and C. K. Wolf (2024): "Can deficits finance themselves?", *Econometrica*, 92(5), 1351–1390. However, such stimulation also leads to rise in inflation.

On a practical level, however, a major question is the extent to which governments can genuinely support long-term economic growth through investments and reforms. Although the empirical evidence from around the world is relatively weak, it does suggest that this possibility exists.¹⁷ The proposed reforms are typically structural in nature, meaning that they are demanding in terms of implementation and time, and tend to be unpopular and politically difficult to pass. In addition, we observe a trend in the Czech Republic of declining intensity of real investments within total government expenditures.¹⁷ The effects considered in theoretical models and identified in empirical literature can only be assumed for the Czech situation and outlook with great caution.¹⁸

The outlook for the long-term growth rate of the Czech economy and interest rates on government debt, even considering the expected effects of fiscal policy, is not very optimistic regarding the possibility of growing out of debt – rather the opposite.

The outlook for the growth rate of the Czech economy and interest rates is not optimistic regarding the possibility of growing out of debt.

Other options for reducing the level of government debt

A higher economic growth rate compared to the interest rate paid on government debt represents only one possible way to reduce the level of government indebtedness. Historical episodes of more significant debt reduction, as described in the **Textbox**, typically combine multiple approaches. Some of these are briefly mentioned here:

Higher revenues and lower expenditures

The debt ratio can, of course, be reduced by cutting expenditures or increasing state budget revenues, for example by raising taxes. This option is not directly dependent on the relationship between the pace of economic growth and interest rates on debt – fiscal consolidation is entirely under the government's control. However, economic growth itself significantly influences this method of reducing the debt ratio. In a rapidly growing economy, it is politically more feasible to increase certain expenditures more slowly than to cut spending in a stagnating economy. On the other hand, many expenditures are directly or indirectly linked to economic growth. When such expenditures are financed through debt, economic growth does not necessarily translate into a lower debt ratio. For example, if defense spending commitments are formulated relative to GDP, then higher GDP growth automatically implies an obligation to plan for higher defense expenditures.

Unexpected inflation

The debt ratio is also reduced by unexpected inflation. An unexpected increase in inflation, similar to what occurred in 2021–2023, does not change the current size of government debt or the agreed interest rates the state pays on that debt.¹⁹ However, an increase in inflation raises the nominal size of the economy (nominal GDP). This leads to a decrease in the government debt ratio. But if the rise in inflation is anticipated, the debt ratio does not decline, because in that case the expected inflation increase is reflected in higher interest rates and thus in interest payments.²⁰

17 The share of total capital expenditures by government institutions in overall expenditures (i.e., capital and current) has been trending downward, from around 20% at the turn of the millennium to currently slightly above 10%. Source of data: [8](#), section Government finance statistics, Revenues and expenditures of government institutions.

18 Investments related to decarbonization or defense spending represent potential routes through which the government can influence the potential of the domestic economy, provided that these investments are directed toward research and development.

19 For most government bonds, the interest paid is not linked to inflation. An exception was, for example, the “Dluhopisy Republiky” (Republic Bonds).

20 The rise in rates due to higher expected inflation reflects both an increase in short-term interest rates, driven by tighter monetary policy responding to higher inflation, and an increase in long-term interest rates as a result of rising inflation expectations.

In the text above, we assume that inflation and inflation expectations in the Czech Republic will remain close to the CNB's inflation target, i.e., that price growth will be stable and more or less predictable. Therefore, we do not consider a decline in the debt ratio due to an unexpected surge in inflation. However, this is by no means historically unusual. We have seen it, for example, in the recent past during the period 2021–2024 in the Czech Republic and, further back in history, in the US after World War II (see [Textbox](#)).

Financial repression

The debt ratio can also be influenced by direct government intervention, such as setting a maximum interest rate (see the case of the US after World War II in the [Textbox](#)), restricting cross-border capital flows, or regulating the banking sector to encourage banks to purchase government bonds (see the case of the United Kingdom after World War II in the [Textbox](#)).

Selected foreign episodes of “growing out of debt”

We describe several successful and unsuccessful historical episodes in which countries did (or did not) grow out of debt:

- **The US and the United Kingdom after World War II**

After World War II, the U.S. federal debt reached an unprecedented 119% of GDP. By the second half of the 1960s, the debt ratio had fallen below 40% of GDP.²¹ The two main reasons were strong economic growth and low interest rates.²² The U.S. economy thus grew out of debt in the way discussed in this text. Unexpected inflation in 1946–1947 also contributed to debt consolidation. In addition, the U.S. government and the Federal Reserve (Fed) jointly set long-term interest rates until 1951, directly influencing the interest paid on government debt (financial repression).

The story was similar for the United Kingdom after World War II. In its case, financial repression also took the form of bank regulation, in which the state required banks to hold a certain share of their assets in government bonds.

- **Japan since the “Lost Decade” (from the 1990s) and Italy at the turn of the millennium**

Over the past three decades, Japan has recorded the most significant increase in the debt ratio among developed economies, currently exceeding 200% of GDP. A characteristic feature of the Japanese economy is its long-term stagnation. Zero GDP growth means that interest rates, which cannot fall significantly below zero, cannot be low enough for the economy to grow out of debt.²³ Since the mid-1990s, both inflation and inflation expectations in Japan have hovered around zero, so unexpected inflation could not contribute to reducing the debt ratio.

Italy faced a similar problem at the turn of the millennium. Within Europe, Italy had one of the highest debt ratios, exceeding 100% of GDP. The Italian economy grew very slowly, and after joining the euro area, it could no longer be stimulated by currency depreciation. This significantly limited the scope for growing out of debt. Moreover, low inflation in the euro area did not lead to inflation surprises that could have helped reduce Italy's debt ratio.

21 [Link](#)

22 See, for example, the study by Meisenbacher, B., and D. J. Wilson (2024): “The Long-Run Fiscal Outlook in the United States”, Federal Reserve Bank of San Francisco Economic Letter, 2024-04.

23 The existence of a lower bound for interest rates is due to the fact that, beyond a certain level, the lender would effectively be paying interest to the borrower.

Technical Notes

i Calculations are based on the following equation for the evolution of the debt ratio over time:

$$\frac{Debt_t}{GDP_t} = \left(\frac{1 + r_t}{1 + g_t} \right) \frac{Debt_{t-1}}{GDP_{t-1}} - \frac{PS_t}{GDP_t},$$

where $Debt_t$ represents government debt at the end of year t , GDP_t is the gross domestic product for year t , r_t is the interest rate on government debt paid in year t , g_t is the nominal GDP growth rate in year t and PS_t is the primary surplus of the government budget for year t , defined as the difference between government revenues and expenditures, excluding interest payments on government debt ($r_t Debt_{t-1}$).

To express the evolution of the debt ratio using the overall government budget balance, which includes interest payments on government debt, the equation can be modified as follows:

$$\left(\frac{1 + r_t}{1 + g_t} \right) \frac{Debt_{t-1}}{GDP_{t-1}} - \frac{PS_t}{GDP_t} = \frac{Debt_{t-1} - (PS_t - r_t Debt_{t-1})}{(1 + g_t) GDP_{t-1}} = \frac{Debt_{t-1}}{(1 + g_t) GDP_{t-1}} - \frac{Balance_t}{GDP_t},$$

where $Balance_t$ is the government budget balance for year t . A negative balance indicates a budget deficit and increases the debt ratio.

A simulation of the size of the balance (as a share of GDP) that would keep the debt ratio unchanged can then be calculated from the above equation, assuming a constant debt ratio equal to the level observed at the end of 1999, as follows:

$$\frac{Balance_t}{GDP_t} = - \frac{g_t}{1 + g_t} \frac{Debt_{1999}}{GDP_{1999}}.$$

ii The decomposition of the change in the debt ratio between two consecutive years into the effect of “growing out of debt” and the effect of budget deficits can be carried out based on the following equation for the change in the debt ratio:

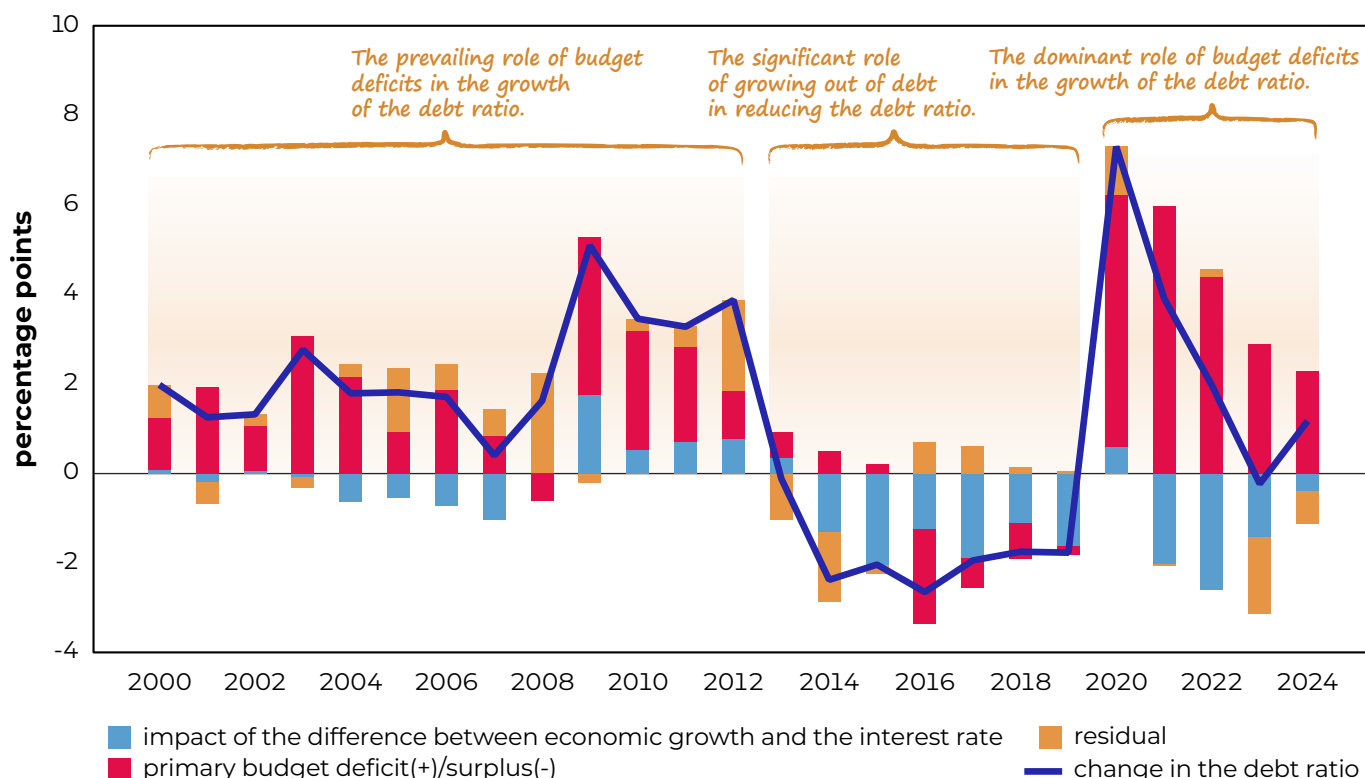
$$\Delta \frac{Debt_t}{GDP_t} = \left(\frac{r_t - g_t}{1 + g_t} \right) \frac{Debt_{t-1}}{GDP_{t-1}} - \frac{PS_t}{GDP_t}.$$

The first term represents the effect of the difference between the interest rate and GDP growth (a higher interest rate increases the debt ratio), and the second term captures the impact of primary deficits (as a share of GDP). The resulting decomposition for the Czech Republic in the period 2000–2024 is shown in **Graph 3**.

Graph 3 shows that budget deficits (red bars) had a dominant impact on debt developments. The effect of growing out of debt (blue bars) is less pronounced and is often outweighed by the impact of primary deficits (for example, during the COVID-19 pandemic in 2020 and 2021).

iii If the average growth rate of nominal GDP ($g = 5.24\%$) and the interest rates paid on government debt ($r = 3.34\%$) observed over the past quarter century were to remain the same in the next quarter century, it would be possible, with a constant debt ratio equal to that observed in 2024 (42% of GDP), to finance an annual balance of $\frac{Balance_t}{GDP_t} = - \frac{g}{1 + g} \frac{Debt_{2024}}{GDP_{2024}} = -2.1\%$ GDP. If we subtract interest payments on government debt from this figure, we arrive at a primary balance as a share of GDP of $\frac{PS_t}{GDP_t} = \frac{r - g}{1 + g} \frac{Debt_{2024}}{GDP_{2024}} = -0.76\%$ GDP.

Graph 3: The debt ratio of the Czech Republic was primarily driven by budget deficits
(the decomposition of changes in the debt ratio into the contributions of primary deficits and the difference between GDP growth and the interest rate on government debt)



Note: The residual contains the part of the change in the debt ratio that is not explained by the two main components. It therefore includes, for example, changes in the debt ratio due to a different average interest rate on debt than the rate of the ten-year government bond, discrepancies arising from aggregating data to annual frequency, etc.

Such deficits would not lead to an increase in the domestic economy's debt ratio. From the perspective of state finances, these are rather interesting figures. A deficit of 2.1% of GDP is close to the estimates of the structural deficit for 2025 from the Ministry of Finance's Macroeconomic Forecast of April 2025 [\[1\]](#). However, in the main text we argue that assuming the same pace of economic growth and the same interest rates on government debt for the next 25 years as in the past 25 years is unrealistic.

A similar conclusion is reached in the alternative scenario from this year's Report on the Long-Term Sustainability of Public Finances [\[2\]](#). The assumption of labor productivity being higher by 1 percentage point each year compared to the baseline scenario does not lead to a qualitative change in the outlook for public sector debt. Higher productivity implies higher long-term growth, while long-term interest rates remain unchanged. Even such an increased difference between the long-term growth rate and the interest rates on government debt does not result in growing the economy out of debt (a decline in the debt ratio).

^{iv} The relationship between the size of government debt and interest rates is much more complex. In addition to the two dominant channels mentioned in the main text, there are other channels at play. Government debt, for example, crowds out private capital because most savings flow into government bonds. Capital depreciates and the marginal product of capital rises, which again corresponds to an increase in interest rates in the economy. More marginally, it may also happen that a larger amount of risk-free government debt can be used as collateral for obtaining loans, which leads to an increase in investment, GDP, and consequently interest rates due to tighter monetary policy.

^v Empirical literature usually examines the short-term effects of government spending on economic growth, the so-called fiscal multipliers, over a horizon of one or two years. The concept of growing out of debt, however, involves much longer horizons. Unfortunately, there is little empirical evidence for these.

Empirical evidence on long-term economic growth is described in the article “The Long-Run Effects of Government Spending”, which will soon be published in the *American Economic Review*. The article shows how a shift in government spending toward research and development within the category of defense expenditures has affected long-term productivity and GDP in the United States. However, this does not involve deficit financing, i.e., debt creation from which the economy subsequently grows out of thanks to stronger economic growth. Similarly indirect evidence is provided by Cloyne et al. (2022), “Short-term Tax Cuts, Long-Term Stimulus”, NBER WP 30246. This article documents the existence of a long-term impact of temporary corporate tax cuts on the rate of innovation and productivity in the U.S. economy during the years 1950–2019. Thus, this is not a measure related to government spending, but to revenues.

Estimates of the impact of structural reforms on economic growth are provided in Budina et al. (2025), “Europe’s National-Level Structural Reform Priorities”, IMF WP/25/14. The authors estimate that structural reforms (labor market, business regulation, fiscal policy, etc.) could lead to a potential medium-term GDP increase of 7% for Central and Eastern European countries. However, these estimates are associated with considerable uncertainty. For example, a 7% GDP increase over a five-year horizon corresponds to an annual GDP growth of 1.7%.

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