INTERNATIONAL GROUP OF RATING AGENCIES

Moscow - Ekaterinburg - Almaty - Minsk - Frankfurt - Hong-Kong

Research Report on Czech Republic

30th of January, 2015

Author:

Hector Alvarez
Expert of Rating-Agentur Expert RA GmbH

For further information contact:

Rating-Agentur Expert RA GmbH
Office 601a, Mainzer Landstrasse 49,
60329 Frankfurt am Main, Germany
+49 (69) 3085-54-85
E-mail: info@raexpert.eu
www.raexpert.eu

Main Economic Indicators of Czech Republic

Macro indicators	2011	2012	2013
Gross pub. debt, bill CZK	1583	1775	1788
Nominal GDP, bill CZK	3823	3846	3884
Real GDP growth, %	2,0	-0,8	-0,7
Gross gov. debt/GDP,%	41,4	46,2	46,0
Deficit (surplus)/GDP,%	-3,3	-4,2	-1,5
Inflation rate,%	2,4	2,4	1,4
Curr. Account balance/GDP,%	-2,9	-1,3	-1,4

Development indicators	2013
Inequality adj. HDI	0,81
GDP per capita (Thou. of USD)	27,3

Sources: RAEX (Europe) calculations based on data from World Bank, IMF, Bloomberg

Introduction

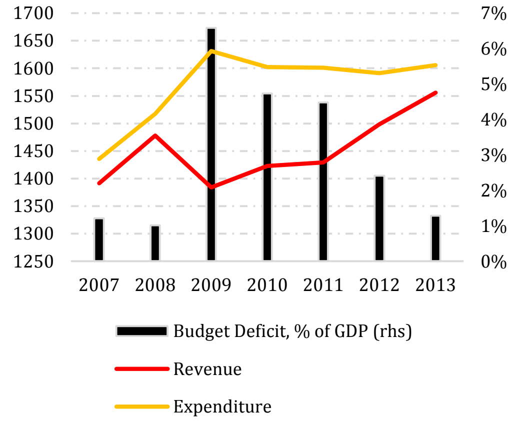
Czech Republic is characterized by stable levels of short- and long-term debt, narrow fiscal deficit, low unemployment, sufficient amount of external reserves and a strong financial sector. Supported by these fundamentals, the country is on the verge of achieving a sustained economic recovery after experiencing a steady decline of GDP since 2012. This recovery has been supported by an increase in exports, domestic demand and, in a lesser extent, household consumption. However, current economic conditions in the European Union (EU) may have an adverse effect on the recovery. Regarding monetary policy, unconventional tools (e.g. FX market intervention) have worked as expected by raising inflation expectations; though, levels of sterilization should be closely monitored as a prolonged intervention in the FX market could carry adverse consequences for the economy.

Reasonable levels of short- and long-term debt. The level of gross government debt in Czech Republic was 46,4% of GDP in 2013. Although this number has been steadily increasing, it is still at an acceptable degree and is expected to decrease in future years. In addition, yields on the 10Y government bonds remain at historically low levels (0,23%). Furthermore, short-term debt, is well covered by the current amount of foreign exchange reserves (more than 500% of short-term debt).

Narrow deficit and conservative fiscal policy pave the way to reignite a rebounding economy. After achieving important fiscal consolidation, bringing down the deficit to 1,5% in 2013 from 5,8% in 2009 through an increase in revenues and controlled spending (see graph 1), it was determined that the country was able to exit the EU Excessive Deficit Procedure. This means that the government now has fiscal space to support domestic demand in the short-term and in case external imbalances may arise, e.g. slowdown in exports. Furthermore, in the long-term the government plans to implement a program which includes supporting industry modernization, education, optimization of the state administration and a sustainable pension scheme. At the same time, the new fiscal plan takes into account the mid-term convergence to a 1%

deficit along with an introduction of fiscal rules, a debt break and a fiscal council.

Graph 1: Fiscal Budget Dynamics (Mill. of CZK)



Source: RAEX (Europe) calculations based on data from the Ministry of Finance of the Czech Republic

Strong and liquid banking sector, but private credit remains slightly weak and credit unions[1] have significant risks. The banking sector in Czech Republic is mainly foreign-owned; despite this, these banks finance themselves with domestic deposits. Moreover, the banking system has shown satisfactory levels of capital adequacy (above 8%) and profitability (ROA of 1,3% for 2013). Non-performing loans (NPLs) have been gradually declining as a percentage of total loans and leverage ratios are above 3%. Despite these positive factors, there has been low demand for credit from corporates and households due to tight rules of loan approval. Besides slow credit growth, one of the main concerns of the Czech financial system is credit unions, a branch of the financial sector which is highly risky. As can be observed in table 1, NPLs rose by 8,7 p.p. to 22,7% of total loans, an amount which is not covered by the level of provisions (16,6%). At the same time, the profitability of this segment went from positive to neutral in this one year span. Even though the share of clients in the credit union segment is merely 1% of the total client base of the financial sector, bad performance of credit unions reduces general confidence in the overall financial system carrying reputational risks. Thus, further regulatory measures within this sector are now being designed.

Table 1: Credit Unions indicators

Indicators	2012	2013
Interest rate spread	5,1%	4,8%
Client NPL ratio	14,0%	22,7%
Coverage of NPLs by provisions	16,2%	16,6%
ROA	0,5%	0,0%
Share of sector in client loans	0,8%	1,0%

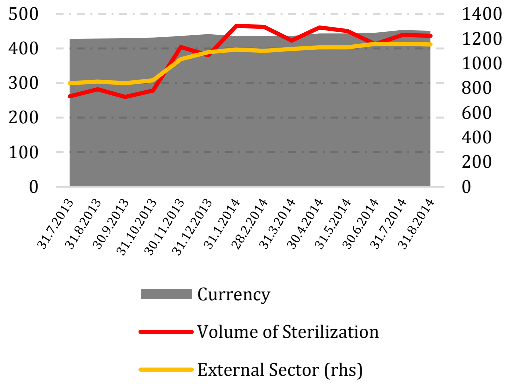
Source: RAEX (Europe) calculations based on data from the CNB

The economy is highly dependent on external demand from the EU, especially on Germany. The economy of Czech Republic is mainly dependent on exports and thus, to the economic health of its main trading partners: the EU and Germany in particular (31,8% of total exports). Under the current economic conditions, this represents a risk for the country. The EU is on the brink of deflation and may have adverse repercussion on the recovery of the Czech economy. In fact, the Current Account deficit widened in 2014, showing the impact of the EU slowdown. As domestic demand has picked up lately, it slightly reduces the pressure of exports on GDP.

Exchange rate intervention has worked as an additional tool of monetary policy, nonetheless, sterilization levels must not be overlooked. Many factors, such as weakened external demand, strong exchange rate, decline in wages and tight fiscal policy, contributed to ignite the risk of a deflationary spiral in the country in 2013. After the Czech National Bank (CNB) exhausted all conventional tools of monetary

[1] A credit union is a financial cooperative which is controlled by its members (owners).

Graph 2: Monetary Base Dynamics (Mill. of CZK)



Source: RAEX (Europe) calculations based on data from the CNB

policy[2], the CNB decided to intervene the exchange rate market in order to prevent the appreciation of the CZK and, thus, drive inflation towards the 2% target. The consequences of this intervention have been positive so far: higher import prices, which increase consumer prices, higher exports which contribute to additional output, and higher inflation expectations which translate into a potential increment in consumption. Although this intervention and the guaranteed floor on the EUR/CZK (27 CZK per EUR) by the CNB have had positive effects on inflation expectations, the level of sterilization in the economy should not be overlooked. By the time the CNB intervened, in order to maintain a constant level of currency, sterilization levels increased (see graph 2). One of the risks of intervening the FX market is that if inflows of foreign capital continue, high sterilization costs may be incurred. Due to the recent quantitative easing measures from de European Central Bank (ECB), the aforementioned risks are likely to materialize bringing capital inflows to the country and, thus, exerting pressure on the CNB to maintain the exchange rate and elevating the sterilization costs.

Conclusion

The main threat to the economic recovery of Czech Republic is the economic environment surrounding the EU. As mentioned in the report, the country is highly dependent on exports and its main trading partners are members of the EU. Despite this, Czech Republic has strong fundamentals that will support the mitigation of external imbalances, namely, low amount of debt and narrow fiscal deficit. These factors are important to drive economic growth in the short-term. Adding to this, current monetary policy (FX market intervention) is in line with the objective of the CNB and has functioned correctly bringing inflation expectations close to the targeted value. However, if this measure is not only a temporary tool, then risks of incurring in high sterilization costs may arise. The banking sector is solid and liquid and does not represent a burden to the economy. Nevertheless, non-fulfillment of the planned policies designed to regulate and exercise further control over credit unions, may weaken the whole financial system.

[2] The Czech National Bank (CNB) realized that reducing the policy rates to almost zero in order to lift inflation above the lower band of the inflation target (2% ±1%) was not enough.