

COUNTRY REVIEW

Czech Republic



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EULER HERMES COUNTRY RISK GRADE: BB

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- EU membership and good international relations
- High income economy with mostly strong underlying macro-economic fundamentals
- Prudent monetary policy
- Relatively low levels of public debt and external debt
- Continued large inflows of foreign direct investment
- Sound, stable, and efficient banking sector that is resilient to adverse shocks

Weaknesses

- History of fragile coalition governments, resulting in often ineffective policymaking and slow reform progress
- High export dependency and unfavourable export structure
- Seemingly overvalued real effective exchange rate and currency vulnerability to external shocks

Country Risk Assessment

Ratings	Czech Republic		Median Grade BB	Poland	Peers Brazil	Taiwan
	Latest	Previous				
Systemic Political Risk:	P2+	P2+	P2-	P2+	P2+	P2+
Systemic Economic Risk:	E3	E3	E3	E3	E3	E2
ME rating:	ME3	ME3	ME3	ME3	ME3	ME2
<i>Structure</i>	1.6	1.6	4.0	1.6	1.6	3.3
<i>Policy</i>	4.3	4.3	4.2	3.6	4.0	1.7
<i>Solvency</i>	1.3	1.3	1.7	2.8	3.3	1.3
<i>External Liquidity</i>	3.2	5.2	2.8	4.2	2.8	1.3
SBE rating:	SBE2	SBE2	SBE2	SBE2	SBE3	SBE2
COUNTRY GRADE:	BB	BB		BB	BB	A

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Economic Studies

ECONOMIC STRUCTURE

Country Profile

Capital city:	Praque
Population:	10.425 mn (2009)
GDP:	USD 190350 mn (2009)
Currency:	Czech Koruna (CZK)
Form of state:	Parliamentary democracy
Head of government:	Prime minister Petr NECAS (since June 2010)
Next elections:	President: February 2013 / Chamber of Deputies: June 2014

Major Industries (% of GDP at market prices, 2009)		Global Assumptions		2010	2011
Services	60.0%	Real GDP grth (% yr/yr)		3.3	2.9
Industry	37.5%	Inflation (% av) *		1.2	1.4
Agriculture	2.5%	Dated Brent (USD/b)		75	70
* Major economies					

Main Exports (% of total, 2009)		Main Imports (% of total, 2009)	
Machinery & transport equipment	53.0%	Machinery & transport equipment	33.5%
Intermediate manufactured goods	18.0%	Intermediate manufactured goods	14.5%
Raw materials & fuels	6.5%	Raw materials & fuels	9.5%
Chemicals	6.5%	Chemicals	9.0%
Lead Export Markets (% of total exports, 2009)		Lead Import Markets (% of total imports, 2009)	
EU27	86.0%	EU27	67.5%
Germany	32.5%	Germany	30.5%
Slovak Republic	9.0%	Poland	7.0%
Poland	6.0%	Slovak Republic	6.5%
France	5.5%	China	5.5%

Basic indicators

Selected economic indicators	2007	2008	2009	2010f	2011f
Nominal GDP (USD mn)	174,246	216,110	190,350	197,040	203,376
Population (mn)	10.32	10.42	10.43	10.43	10.43
GDP per capita (USD)	16,883	20,736	18,259	18,895	19,497
Real GDP growth (% yr/yr)	6.1	2.5	-4.1	2.0	2.0
Inflation (% eop)	5.5	3.6	1.0	2.0	2.0
Fiscal balance (% of GDP, ESA-95 Basis)	-0.7	-2.7	-5.9	-5.2	-4.5
Current account balance (% of GDP)	-3.3	-0.6	-1.1	-2.1	-2.5
External debt/GDP (%)	43.6	38.4	45.5	40.8	41.5
External debt/Exports of goods & services (%)	54.4	49.5	65.1	57.1	55.8
Debt-service ratio (%)	5.2	5.6	7.6	6.7	7.6
Foreign exchange reserves (USD mn)	34,445	36,472	39,670	37,000	40,000
Import cover (months)	3.1	2.8	3.9	3.4	3.4
Exchange rate assumption, CZK:USD (av)	20.3	17.1	19.1	19.0	19.2
Exchange rate assumption, CZK:EUR (av)	27.8	24.9	26.4	25.2	24.0
f: CRU central forecast					

Sources: National figures, IMF, ECB, World Bank, Euler Hermes Economic Studies

Political Stability

Overall systemic political risk is relatively low. The Czech Republic is a well-established democracy and has good international relations, reflected in memberships of NATO, OECD and the EU. However, fragile coalition governments have resulted in ineffective policymaking and slow reform progress for several years. In March 2009, the collapse of the then ruling centre-right minority government caused government instability at a quite inappropriate time as effective policies to tackle the economic crisis then underway were needed. In the meantime, a more stable looking centre-right coalition government—comprising the Civic Democratic Party (ODS) and two new parties, TOP 09 and Public Affairs (VV)—has taken office under Prime Minister Petr Necas of the ODS after winning a comfortable parliamentary majority in the general election in May 2010. The three coalition members share a commitment to fiscal consolidation and to the reform of public services. However, this commitment may be tested soon. Voters have already punished the fiscal austerity programme in municipal and Senate (upper house) elections in October 2010, where all three governing parties performed relatively poor which means that they now face incentives to soften radical reforms. Moreover, the opposition Czech Social Democratic Party (CSSD) has won a narrow majority in the Senate (41 out of 81 seats), giving it the possibility to slow or undermine radical reform plans.

Economic Stability

The Czech Republic is classified as an advanced, high-income economy with estimated GDP per capita of about USD18000 in 2009. Services account for around 60% of GDP, industry 37.5% and agriculture 2.5%. The economy is export-intensive, with an export-to-GDP ratio of about 70%. Hence, strong trade links with the EU make the economy vulnerable to the EU business cycle—fellow EU members account for around 86% of Czech merchandise exports and 68% of imports. Moreover, machinery & transport equipment, a sector particularly susceptible to global slowdowns, accounts for 53% (including 17% for motor vehicles) of merchandise exports. Consequently, the global economic crisis had a significant impact on the economy, mainly via the external trade route, as demand for the country's exports suffered. But the economy had not overheated prior to the global crisis—in contrast to the Baltic and most Balkan economies—and is now on track of a solid recovery as macro-economic fundamentals have remained robust overall.

Real GDP contracted by 4.1% in 2009 after annual average growth of 5.4% in 2005-2008 to -4.1%, as the impact of the global recession weakened exports, business investment and eventually also private consumption as unemployment rose. Growth recovered to about 2.2% yr/yr in the first three quarters of 2010. A breakdown of the GDP components for Q3 2010 has yet to be released, but data for H1 indicate that the recovery was led by a rebound in external demand and inventory restocking. Domestic demand remained relatively weak—private consumption grew by 0.6% yr/yr in H1, government spending growth decelerated to 1.8% and fixed investment contracted by 5.4%. Early data for Q3 suggest that both industrial production and exports have expanded at a slower pace than in Q2. We expect full-year growth of about 2% in 2010 and in 2011.

Monetary policy has been generally prudent in recent years, ensuring relative price and exchange rate stability. Annual inflation has gradually picked up from 1% at end-2009 to 2% in October 2010 and we expect it to remain around this level—which is also the central bank's new inflation target—until end-2011. In the wake of the global financial crisis, the freely floating koruna showed bouts of weakness and volatility, reflecting increased global risk aversion to emerging markets (particularly to Emerging Europe) but the currency has now regained most of its losses against the euro between mid-2008 and February 2009. Currently the real effective exchange rate appears overvalued by about 10%. The koruna will remain vulnerable to external shocks and market sentiment, but solid economic fundamentals and relatively prudent policies should protect it from a very sharp decline.

Public finances are not a major cause of concern yet but require monitoring. The economic downturn in 2008-2009 along with substantial expansionary fiscal policy measures to tackle it pushed the fiscal deficit (ESA-95 basis) up from just 0.7% of GDP in 2007 to 2.7% in 2008 and 5.9% in 2009. We expect a gradual narrowing to about 5.2% in 2010 and 4.5% in 2011. Thanks to a still comparatively low level of public debt of some 40% of GDP, the government currently does not have any financing problems. Recently it successfully issued a 10-year EUR2bn Eurobond on favourable terms.

The annual current account deficit has been relatively moderate since 2005 and amounted to just 1.1% of GDP in 2009. Moreover, net foreign direct investment (FDI) inflows more than covered the current account deficit in 2005-2008 as well as in Q1-Q3 2010. In 2009 the coverage was still good at 64%. Official FX reserves show some monthly volatility but overall have been increasing gradually and stood at USD41.8bn in October 2010. This is sufficient to cover more than three months of imports or,

in other terms, all short-term debt and principal repayments due in 2011. Overall, external liquidity risk and transfer and convertibility risk have decreased to moderate levels.

The external debt burden is manageable. Gross external debt stood at 45.5% of GDP and 65% of export earnings at end-2009. These ratios are expected to improve in 2010-2011. Thanks to a favourable maturity structure, the debt-service ratio will be a manageable 7-8% in 2011.

Structural Business Environment

The Structural Business Environment is fairly strong. The Czech Republic is placed in the second highest category and ranked 56th out of 212 countries in our assessment overall. The World Bank's *2011 Doing Business* survey ranks the Czech Republic 63rd out of 183 countries, showing particular strengths regarding trading across borders, registering property, availability of credit information and closing businesses. The latter marks a significant improvement as it was still flagged as a weakness in the *2010* survey. The *2011* survey continues to highlight weaknesses with regard to paying taxes and starting businesses. Another broad measure of the pro-business environment, the Heritage Foundation's *2010 Index of Economic Freedom* assigns the Czech Republic rank 34 out of 179 countries, which is roughly unchanged from previous years. Transparency International's *Corruption Perception Index 2010* ranks the country 53rd out of 178 countries, down from rank 45 in 2008 and 41 in 2007.

The financial system has shown strength. The banking sector—which is very open, completely restructured and privatised and mostly foreign-controlled—has so far been resilient to the impact of the global financial crisis. The supervisory framework is well-established. Risks in the banking system were contained thanks to a conservative retail-oriented business model, a low loan-to-deposit ratio, healthy liquidity buffers and limited exposure to FX risk. Nonetheless, the global crisis and the domestic economic downturn have had some modest implications for the banking sector. Private sector credit growth—which was not excessive in recent years—has virtually come to a standstill in H1 2010 and the share of nonperforming loans in total loans increased from 2.8% in 2007 to a still manageable 5% in late 2009. But overall the banking sector has remained well-capitalised and profitable. Consequently, the Czech Republic did not need to implement bank recapitalisation or other exceptional measures in order to shore up financial system stability.

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Charts

