Euler Hermes Economic Research

Country Report

Czech Republic

Emerged from recession

General Information

GDP	USD195.7 billion (World ranking 51, World Bank 2012)
Population	10.5 million (World ranking 81, World Bank 2012)
Form of state	Parliamentary Democracy
Head of government	Bohuslav SOBOTKA
Next elections	October 2014, legislative (Senate)

Strengths

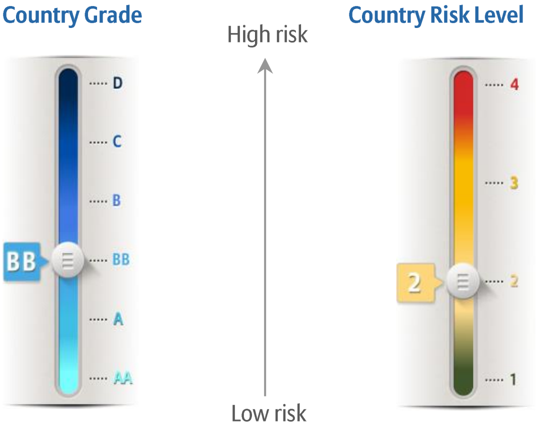
- EU membership and good international relations
- High income economy with fairly strong underlying macro-economic fundamentals
- Solid monetary policy
- Continued large inflows of foreign direct investment
- Manageable external debt burden
- Sound banking sector that has proven resilient to adverse shocks
- Favourable business environment

Weaknesses

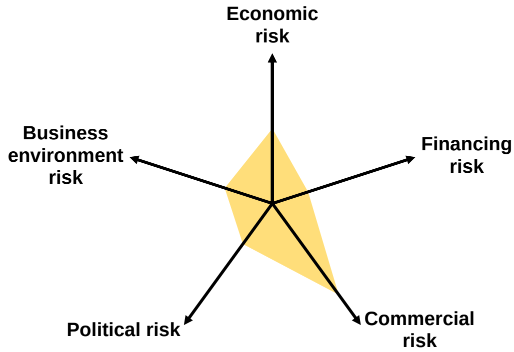
- History of fragile coalition governments, resulting in often ineffective policymaking and slow reform progress
- Rapid increase in the number of insolvencies since 2008
- High export dependence and unfavourable export structure

Country Rating

BB2

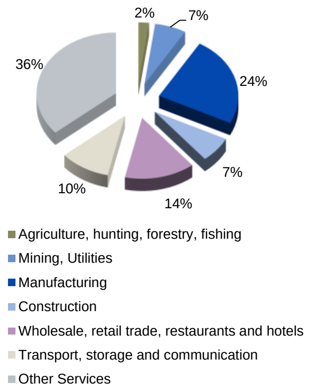


Risk Dimensions



Economic Structure

GDP breakdown (% of total, 2011)



Sources: UnctadStat, Euler Hermes

Trade structure (% of total, 2011)

By destination/origin

Exports		Rank		Imports
Germany	32%	1	30%	Germany
Slovakia	8%	2	8%	Poland
Poland	6%	3	8%	Slovakia
France	6%	4	7%	Netherlands
Austria	5%	5	5%	China

By product

Exports		Rank		Imports
Road vehicles	18%	1	10%	Electrical machinery, apparatus and appliances
Electrical machinery, apparatus and appliances	10%	2	8%	Road vehicles
Office machines and automatic data processing machines	8%	3	7%	Office machines and automatic data processing machines
Other industrial machinery and parts	7%	4	5%	Iron and steel
Telecommunication and sound recording apparatus	5%	5	5%	Petroleum, petroleum products and related materials

Economic Forecast

	2010	2011	2012	2013	2014f	2015f
GDP growth (% change)	2.5	1.8	-1.0	-0.9	2.0	1.5
Inflation (%, end-year)	2.3	2.4	2.4	1.4	1.2	2.0
Fiscal balance (% of GDP)	-4.8	-3.3	-4.4	-1.5	-2.0	-2.5
Public debt (% of GDP)	37.9	41.0	45.7	46.0	45.0	46.0
Current account (% of GDP)	-3.9	-2.7	-1.3	-1.4	-0.5	-1.0
External debt (% of GDP)	47.5	43.6	51.8	50.7	52.0	51.0

Sources: IHS Global Insight, national sources, Euler Hermes

Economic Growth

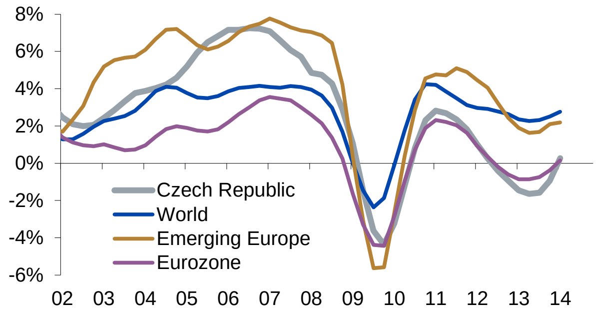
Solid economic recovery in 2014

The economy had been in a protracted recession until mid-2013, and full-year real GDP contracted by -0.9% in 2013, after -1% in 2012. A gradual but broad-based recovery began in H2 2013 and gathered momentum in Q1 2014 as domestic demand improved and external trade activity picked up. Real GDP growth accelerated to +2.5% y/y and posted 0.4% in q/q seasonally-adjusted terms in Q1 2014. Private and public consumption rose at the same rate (+1.4% y/y) while fixed investment increased by +5% y/y. Growth of exports and imports picked up to +9.7% and 10.6% y/y, respectively, so that net exports made a small positive contribution to Q1 GDP growth since the level of exports is higher than imports. EH expects the recovery to stabilise, resulting in full year growth of about +2% in 2014 (thanks to a high carryover effect). In 2015, growth is forecast to slow to +1.5%.

Insolvencies will continue to rise

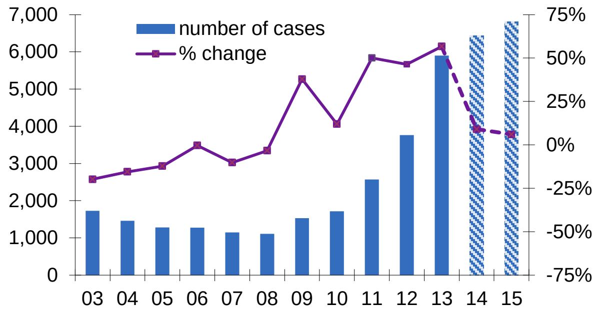
The sharp increase in the number of insolvencies since 2008 continued in 2013 (5,897 cases, up +57% y/y and +431% from 2008). EH expects further increases of +9% to around 6,430 cases in 2014 and +6% to 6,800 cases in 2015.

GDP growth (% y/y, 4 qtrs cumulated)



Sources: IHS Global Insight, national sources, Euler Hermes

Insolvencies



Sources: ISIR, Central Statistical Office, Euler Hermes

Monetary policy aimed at countering deflation pressures

The monetary policy framework is based on inflation targeting. Since the beginning of 2010, the Czech National Bank (CNB; the central bank) has pursued a continuous inflation target of 2%±1pp. Monetary policy has been generally prudent in recent years, ensuring relative price and exchange rate stability. In fact, the CNB has recently been more concerned about potential deflation and a too strong koruna (CZK).

Average inflation fell from 3.3% in 2012 to 1.4% in 2013. The CNB lowered its key policy interest rate to 0.05% in November 2012, initially aimed at supporting economic activity (which eventually seems to pay off). In September 2013, the central bank announced to retain the policy rate at this historic low over a longer horizon until inflation pressures increase markedly. Moreover, in November 2013 the CNB decided to launch interventions against the CZK, setting the target exchange rate at CZK27:EUR1, aimed at bringing inflation back within the CNB's target band and boosting exports. The CZK fell one-off by 6.5% against the EUR and has since been relatively stable at around CZK27.5:EUR1, but inflation – after a temporary spike of 1.4% y/y in December 2013 – has fallen even further to an average 0.2% in the first four months of 2014 (0.1% y/y in April). The interventions against the CZK are likely to continue until inflation starts to accelerate. EH expects this to begin in H2 2014, with inflation reaching about 1.2% at the end of the year.

Exchange rate risk is limited

Analysis of the real effective exchange rate indicates that the CZK has moved from an overvaluation of about 11% at end-2009 and 7% in mid-2011 to a moderate undervaluation since 2013. Moreover, the US quantitative easing tapering talks in 2013 and its eventual implementation in 2014 have had no significant impact on the CZK – in contrast to a number of other emerging market currencies which have fallen substantially over the past 12 months.

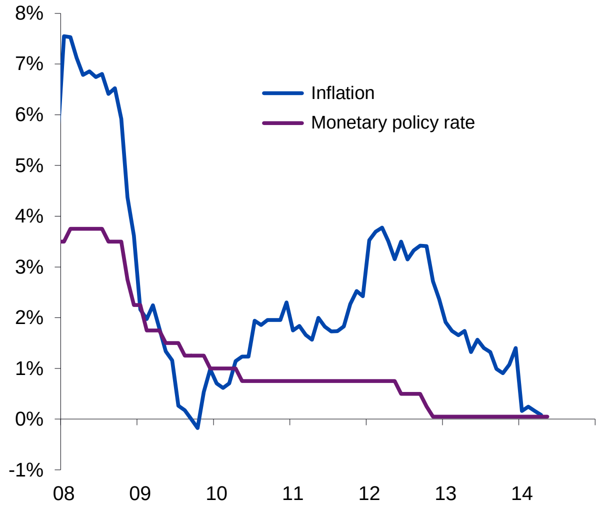
Banking sector is resilient

According to the IMF, the banking sector has proven resilient to the effects of the great global financial crisis, the Eurozone debt crisis and the weak domestic economy and is in a healthy state overall. Despite the sharp rise in the number of insolvencies over the past few years, the share of non-performing loans in total loans has remained almost unchanged at just over 5% since 2010. Private sector credit growth has moderated to a modest 2.5% y/y in March 2014.

Fiscal deficit likely to widen moderately after sharp decline in 2013

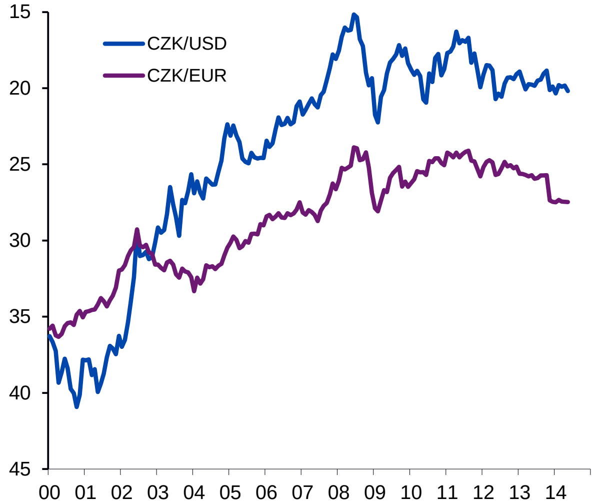
The budget deficit (ESA-95 basis) decreased from 4.4% of GDP in 2012 to just 1.5% in 2013 but is forecast to rise again as the new government has announced an end to fiscal austerity. Nonetheless, the annual deficit should still meet the Maastricht criterion of less than 3% of GDP in 2014-2015. Total public debt has risen from 29% of GDP in 2008 to 46% in 2013. While this is still a relatively favourable ratio by current EU standards, the sharp uptrend requires close monitoring.

Inflation rate (12-month moving average, %) and policy interest rate (%)



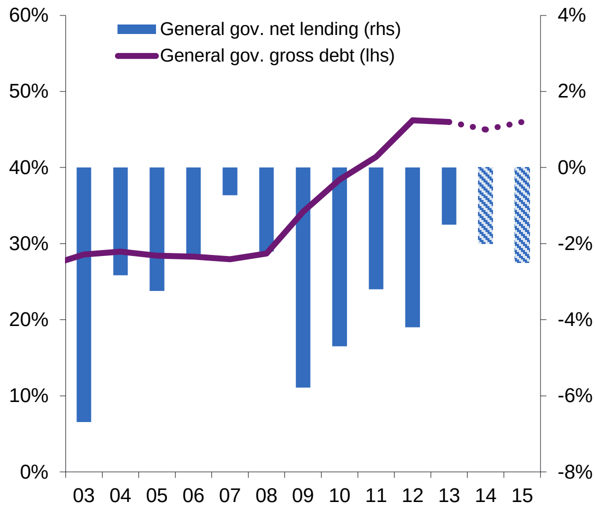
Sources: IHS Global Insight, national sources, Euler Hermes

Exchange rate of the CZK



Sources: Czech National Bank, IHS Global Insight, Euler Hermes

Fiscal balance and public debt (% of GDP)



Sources: IMF, Euler Hermes

External Sector

Current account close to balance

The annual current account deficit has been relatively moderate since 2005 and amounted to 1.4% of GDP (EUR2.15bn) in 2013. Moreover, the cumulative net foreign direct investment (FDI) inflows have more than covered the cumulative current account deficits in the period 2005-2013. The current account posted a surplus of around EUR2.6bn in Q1 2014 – up from a surplus of EUR0.4bn in Q1 2013 as exports grew faster than imports – and EH expects it to be near-balanced in the year as a whole. In 2015 a small current account deficit of 1% of GDP or so is forecast.

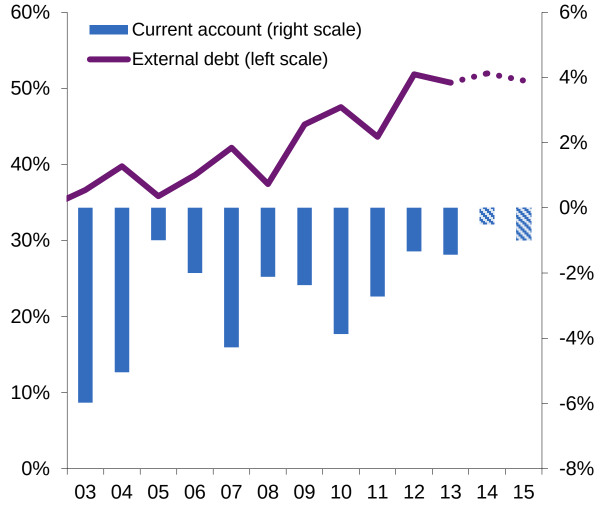
External debt is manageable

Gross external debt is elevated in relation to GDP (about 52%) but moderate in relation to export earnings (62%). The debt-service ratio is forecast at 19% in 2014. Overall, the external debt burden should be manageable in the near future.

Foreign exchange reserves are adequate

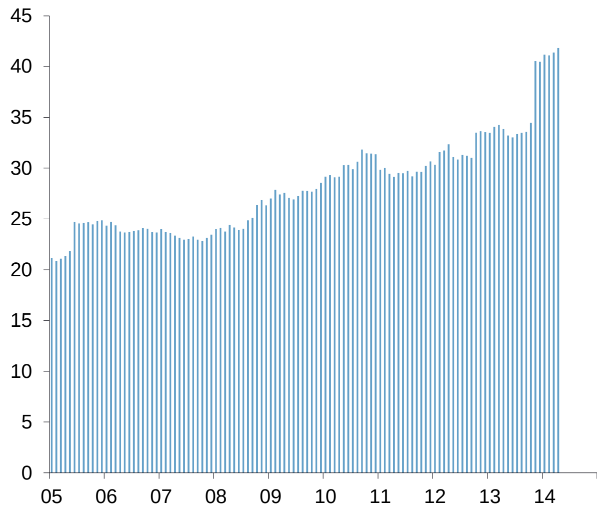
Foreign exchange reserves got a boost in November 2013, when the CNB decided to launch interventions against the CZK, growing by about EUR6bn in one month. Reserves expanded further to EUR42bn in April 2014 which is sufficient to cover 4.6 months of imports or, in other terms, all external debt payments falling due in 2014.

Current account and external debt (% of GDP)



Sources: IHS Global Insight, national sources, Euler Hermes

Foreign exchange reserves (EUR billion)



Sources: Czech National Bank, Euler Hermes

Last review: 2014-06-05
Country Risk Analyst:
Manfred Stamer
manfred.stamer@eulerhermes.com