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Research Report on Czech Republic

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Introduction

The economy of the Czech Republic had a favorable year in 2014 as shown by its main macroeconomic and private sector indicators. The real GDP recovery, driven by private consumption, investment and exports, as well as a reduction in the fiscal deficit and unemployment, exports growth and a current account surplus, are some of the indicators which changed positively compared to 2013. In addition, unpredictable conditions in some EU countries have not shown a negative impact in the Czech economy so far, however, the delicate exposure of Czech Republic to the EU and Germany will be on watch by the Agency. Sound monetary and fiscal policies along with a resilient and well capitalized financial system round up the healthy state of the Czech economy.

Main Economic Indicators of Czech Republic

Macro indicators	2012	2013	2014
Gross pub. debt, bill CZK	1775	1788	1775
Nominal GDP, bill CZK	4048	4086	4266
Real GDP growth, %	-0,8	-0,7	2,0
Gross gov. debt/GDP, %	43,9	43,8	41,6
Deficit (surplus)/GDP, %	-4,0	-1,4	-1,0
Inflation rate, %	2,4	1,4	0,1
Curr. Account balance/GDP, %	-1,6	-0,5	0,6

Development indicators	2014
Inequality adj. HDI	0,81
GDP per capita (Thou. of USD)	29,9

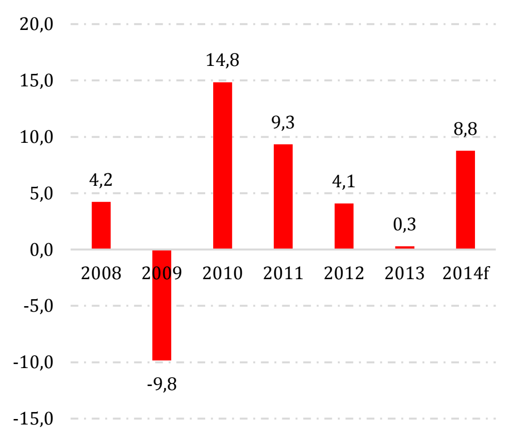
Default indicator	24.07.2015
5-Year CDS spread (Bp)	47
10Y Gov Bond Yield, %	0,86

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

Steady and bearable short- and long-term general government debt alongside low yield on long-term government bonds. Gross government debt in the Czech Republic remained stable posting a figure of 41,6% of GDP at the end of 2014, almost 2 p.p. lower than in 2013. The decline was mainly pushed by the government's use of old financial reserves. Furthermore, the very acceptable levels of short-term debt still prevail; at the end of 2014 it stood at 193 billion CZK and it represented only 4,5% of GDP and 11,6% of budget revenues. The debt yield for the 10Y government bond remains at satisfactory levels (0,89%). Such a low yield means that the financing cost for the Czech government is remarkably low and investors' perceptions of long-term risk is negligible.

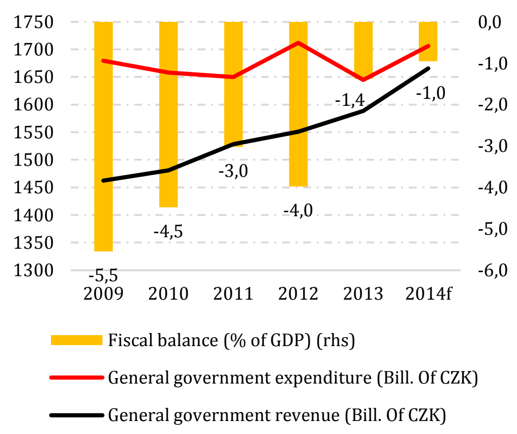
Improved macroeconomic indicators showed a strengthened economy. Real GDP in Czech Republic grew for the first time since 2012 at a rate of 2% in 2014 driven, mainly, by private consumption, investments and solid exports, which increased by more than 8% from 2013 to 2014 (see graph 1). With respect to GDP per capita at PPP, it has been steadily increasing having reached a level of 29 925 USD by the end of 2014. In addition, the unemployment rate is at its lowest level since the 2008 global financial crisis and it has remained fairly stable for the past six years. Inflation, albeit low, has started to pick-up at the beginning of 2015 as it is moving towards the CNB (Czech National Bank) 2% target.

Graph 1: Volume of exports (% change)



Source: RAEX (Europe) calculations based on data from IMF

Graph 2: Fiscal balance



Source: RAEX (Europe) calculations based on data from IMF

This recent increase in inflation is a positive sign for an economy threatened by deflationary pressures in recent years.

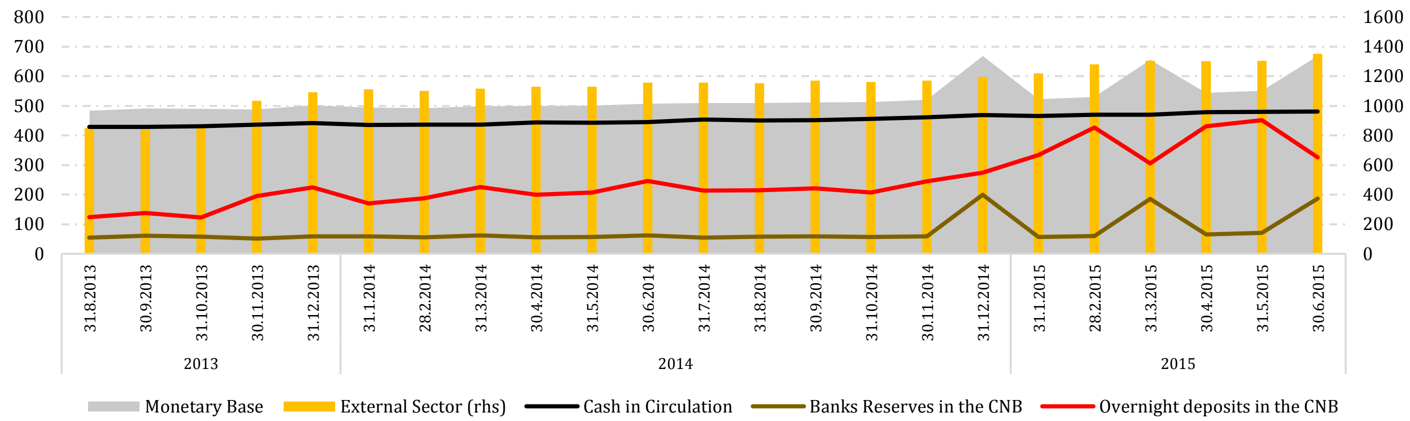
Fiscal policy remains flexible and fiscal deficit continues to narrow. The government continues to narrow its budget deficit (see graph 2) providing even more fiscal space (deficit was 1% of GDP in 2014). The reduced deficit provides the government with the opportunity to be flexible and accommodative in its fiscal stance. In fact, the authorities have planned further spending for 2015 in order to, alongside an already expansionary monetary policy, propel consumption and spur inflation towards the CNB target. Besides the spending strategy, the government's fiscal policy is also focused on increasing the effectiveness of tax collection. Additionally, mid-term objectives regarding fiscal balance (steady 1% deficit by 2020) and investment programs[1] appear to be in the right direction. In April 2015, the government approved the update of the "Convergence Programme of the Czech Republic" where the authorities reiterate their commitment of maintaining a fiscal balance above -3% and the effective use of the treasury's available liquidity.

Well-positioned and resilient financial system with steady private credit levels, however, these levels have not picked-up as expected. The banking sector remains solid with strong fundamentals. In 2014 the average ROA was 1,2%, NPLs increased slightly though they are still at acceptable levels (5,6%) and the loan-to-deposit ratio was 76,1% in the first quarter of 2015. Additionally, the latest stress tests performed by the CNB showed that the banking sector is robust even with scenarios portraying depressed economic growth and deflation. This is mainly due to the fact that banks are well capitalized and liquid, thus, they would be able to absorb unexpected shocks and still have a decent capital adequacy. Comparably, the insurance sector also appears to be healthy and resilient. Even when the financial system resembles strength, private credit remains low and has not hiked. By analyzing the monetary statistics of the country, it can be observed that even though the CNB has issued money already twice in order to control the EUR/CZK exchange rate, this money is deposited in the Central Bank as excess reserves or overnight deposits instead of remaining in circulation. Even when the monetary base is growing, the currency in circulation has stayed practically flat (see graph 3). Moreover, as mentioned in the previous research report for Czech Republic, despite overall structural risks having declined, credit unions remain a cause of concern for the financial system stability. The bad performance of these institutions was more pronounced in 2014 when the

[1] Refer to previous research report to see these programs: Research Report on Czech Republic from 30th of January 2015 (http://raexpert.eu/reports/Research_report_Czech_Republic_30.01.2015.pdf)

NPL ratio rose up to 30% of total loans and their assets decreased for the second year in a row by 0,9% mainly due to one credit union's license being revoked. In an attempt to reduce this risk, the authorities introduced new legislation whose progress will be monitored by the Agency.

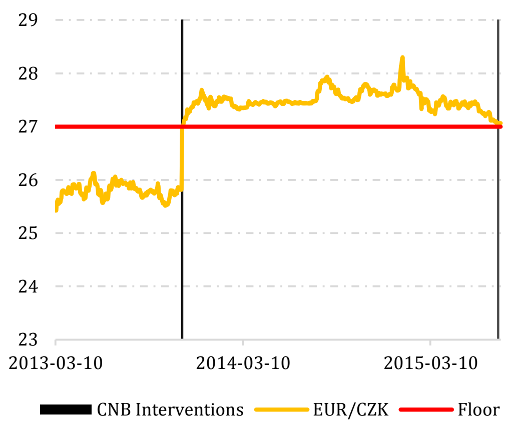
Graph 3: Monetary Base Dynamics (Bill. Of CZK)



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

Monetary policy continues to include potential exchange rate interventions as a tool, however, inflation was still away from the CNB target in 2014. The monetary policy from the CNB continues to be on the same trend as reported on our previous research report, an inflation targeted policy with EUR/CZN exchange rate interventions. The floor introduced on the EUR/CZN exchange rate has aided to increase inflation expectations (matching inflation forecasts). At the beginning of 2015, the Central Bank confirmed it will continue to maintain the exchange rate floor until the end of 2016. However, the CNB has not had the need to intervene the market to stop an appreciating CZK since the program started in 2013, until recently, when the CZK was slowly appreciating (see graph 4). Once there are no more deflation risks, the floor on the exchange rate will be lifted. In addition to this, the Central Bank has maintained the two-week repo rate at 0,05%.

Graph 4: EUR/CZK Exchange rate



Source: RAEX (Europe) calculations based on data from BNP Paribas

External exposure to Germany and the EU still remains as a latent risk. This exposure and dependence on the EU, especially on Germany, continues to be a potential risk for the Czech economy. Even though the EU economies are starting to recover, the situation in the European block remains unstable and unpredictable. Despite these circumstances, the current account showed a positive balance in 2014 (0,6% of GDP). Still, this exposure and its effect will be closely monitored by the Agency.

Conclusion

The general assessment of the Czech Republic can be summarized as a stable well-positioned economy with some external risk exposure. The macroeconomic indicators from 2014 show an important improvement in almost every part of the economy. This positive outcome is the result of successful policies from the government (monetary and fiscal mainly) which propelled an increase in exports and domestic consumption. In addition, the banking system stands strong and resilient to any potential external shocks, however, private credit has yet to pick up. As mentioned in the previous research report, the economy appears to be solid and in the correct path for further growth and consolidation. Nonetheless, being an export driven country and a key player in the global supply chain, the main hazard is still the external exposure to the EU, especially to Germany.