Euler Hermes Economic Research

Country Report

Czech Republic

On track for continued recovery

General Information

GDP	USD208.80 bn (World ranking 50, World Bank 2013)
Population	11 mn (World ranking 81, World Bank 2013)
Form of state	Parliamentary Democracy
Head of government	Bohuslav SOBOTKA
Next elections	2017, legislative (Chamber of Deputies)

Strengths

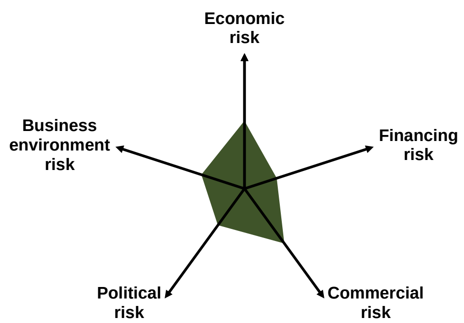
- EU membership and good international relations
- High income economy with fairly strong underlying macro-economic fundamentals
- Solid monetary policy
- Continued large inflows of foreign direct investment
- Manageable external debt burden
- Sound banking sector that has proven resilient to adverse 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 from 2008 to 2014
- High export dependence and unfavourable export structure

Country Rating

BB1



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
Germany	28%	1	26%	Germany
Slovakia	10%	2	10%	China
Poland	7%	3	8%	Slovakia
Netherlands	5%	4	8%	Poland
France	5%	5	5%	Russia

By product (% of total)

Exports		Rank		Imports
Cars And Cycles	10%	1	9%	Computer Equipment
Computer Equipment	7%	2	6%	Electrical Apparatus
Electrical Apparatus	7%	3	5%	Vehicles Components
Vehicles Components	7%	4	5%	Miscellaneous Hardware
Engines	6%	5	4%	Plastic Articles

Source: Chelem (2013)

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Recovery gathers momentum

In 2014 the economy recovered from two years of recession, with real GDP expanding by +2%. Domestic demand was the key growth driver, especially fixed investment which rebounded to +4.5% growth after declining in the previous two years. External trade activity regained momentum in 2014, proving resilient towards any potential adverse effect from the Russia crisis. Exports increased by +8.8% and imports by +9.5% so that net exports had a small negative impact on 2014 growth. This growth pattern broadly continued in Q1 2015. Real GDP growth actually picked up to +4.2% y/y from +1.2% in Q4 2014, however, the strong acceleration was largely due to a one-off effect from inventories, which drove up gross capital formation by +11.4% y/y, despite more moderate growth of +3% y/y in fixed investment. Inventories were pushed upward mainly by restocking of tobacco products after a sizeable drop in late 2014, in connection with an excise tax adjustment. Household and government consumption increased by +3% and +1.4% y/y, respectively. Exports expanded by +7.8% y/y and imports by +9% y/y so that net exports again made had a small negative contribution to Q1 growth. Even though the Q1 surge in inventories will not continue in the coming quarters, the economic recovery is expected to retain momentum in 2015. Euler Hermes forecasts full-year growth of +3% in 2015 and +2.7% in 2016.

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).

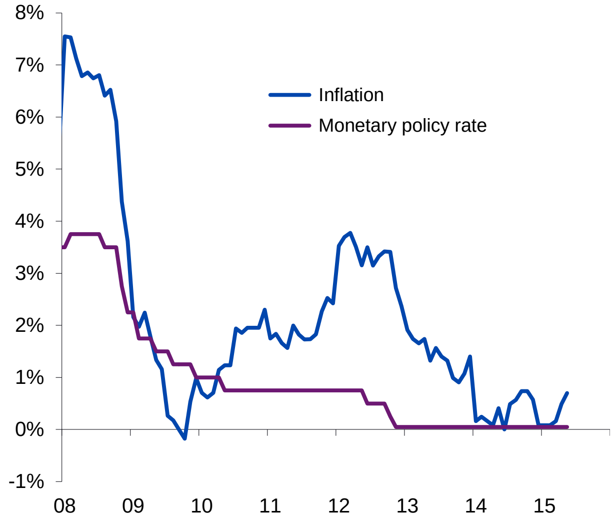
Average inflation fell from 3.3% in 2012 to 1.4% in 2013 and just 0.4% in 2014. The CNB lowered its key policy interest rate to 0.05% in November 2012, initially aimed at supporting economic activity (which eventually has paid off). In September 2013, the central bank announced to retain the policy rate 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. However, inflation has remained very low and below the CNB's target band since the start of 2014 – it stood at 0.7% y/y in May 2015. Euler Hermes expects inflation to gradually pick up in H2 2015, reaching about 1% at the end of the year. Hence the interventions against the CZK are expected to continue until early 2016, at least.

Key economic forecasts

	2013	2014	2015f	2016f
GDP growth (% change)	-0.7	2.0	3.0	2.7
Inflation (%, end-year)	1.4	0.1	1.0	1.8
Fiscal balance (% of GDP)	-1.2	-2.0	-1.9	-2.0
Public debt (% of GDP)	45.0	42.6	42.3	42.0
Current account (% of GDP)	-0.5	0.6	0.2	0.1
External debt (% of GDP)	66.9	67.0	67.5	68.0

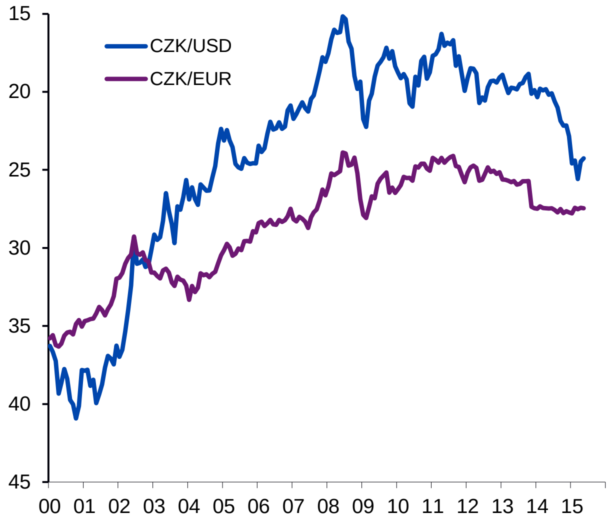
Sources: National sources, IHS, Euler Hermes

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



Sources: National sources, IHS, Euler Hermes

Exchange rate of the CZK

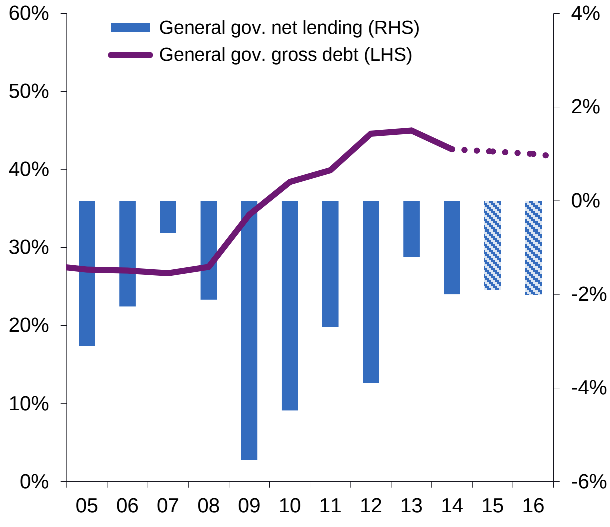


Sources: Czech National Bank, IHS, Euler Hermes

Public finances are favourable

The budget deficit (ESA-2010 basis) increased from -1.2% of GDP in 2013 to -2% in 2014 as the new government has relaxed fiscal austerity. Euler Hermes expects that the annual deficit will continue to meet the Maastricht criterion of less than -3% of GDP in 2015-2016. Total public debt rose from 28.7% of GDP in 2008 to 45% in 2013 but improved to 42.6% in 2014 thanks to the economic recovery. This is a very favourable ratio by current EU and developed market standards.

Public finances (% of GDP)



Sources: Eurostat, IHS, Euler Hermes

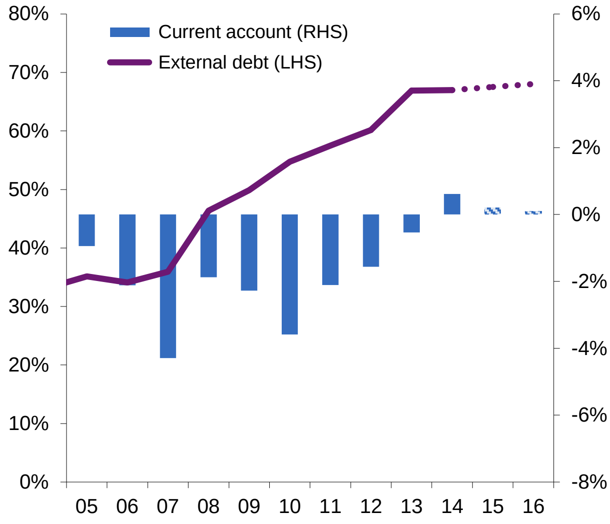
Current account in surplus since 2014

After relatively moderate deficits from 2008 to 2013, the annual current account balance shifted to a small surplus of +0.6% of GDP in 2014. In Q1 2015, the current account posted a surplus of around EUR3.4 bn, slightly up from EUR3 bn in Q1 2014. Euler Hermes forecasts small external surpluses for 2015 and 2016 as a whole. Moreover, net foreign direct investment inflows have continued to be strong, accounting for +3.1% of GDP in 2014.

External debt is manageable

Gross external debt is elevated in relation to GDP (about 67%) but moderate in relation to export earnings (80%). The debt-service ratio is forecast at 17% in 2015. Overall, the external debt burden should be manageable in the near future.

Current account and external debt (% of GDP)



Sources: National sources, Euler Hermes

Foreign exchange reserves are adequate

Foreign exchange reserves have grown steadily from EUR40.5 bn at end-2013 to EUR44.5 bn at end-2014 and EUR49.3 in May 2015. The current level of reserves is sufficient to cover around five months of imports or, in other terms, all external debt payments falling due in 2015.

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Country Risk Analyst:
Manfred Stamer
manfred.stamer@eulerhermes.com