Czech Republic
Rating Report

SCOPE AA NEGATIVE OUTLOOK

Credit strengths

- Good record of fiscal consolidation, moderate levels of public debt
- Competitive, export-oriented industrial sector

Credit challenges

- Reliance on global supply chains and external demand
- Adverse demographic trends weigh on growth potential and public finances

Rating rationale:

Sound public finances and robust fiscal framework: The Czech Republic's ratings are underpinned by the country's robust public finances with a good track record of fiscal consolidation, sound fiscal policies, moderate debt levels and substantial liquidity buffers

Reduced growth prospects following the outbreak of the Ukraine conflict: Material weakening of the country's medium term growth prospects which will add pressure on budgetary revenues. The Czech Republic counts among the most exposed countries to the fallout from the Ukraine conflict, in view of its reliance on Russian energy coupled with an economic structure dominated by energy intensive manufacturing with complex value chains such as the automotive industry.

Rating challenges include: i) an economic structure reliant on external demand and Russian energy, which exposes the country to external shocks and weighs on macroeconomic sustainability; and ii) adverse demographic trends related to an ageing population, and labour shortages that limit potential growth and increase medium-term pressures on public finances.

Czech Republic's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	aa+	Reserve currency adjustment (notches)	-1/3	AA
Public Finance Risk		25%	aa+		+1/3	
External Economic Risk		10%	a+		0	
Financial Stability Risk		10%	aaa		0	
ESG Risk	Environmental Risk	5%	aa		-1/3	
	Social Risk	5%	a-		0	
	Governance Risk	10%	a+		0	
Overall outcome		**aa**		**0**	**0**	

Note: The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings.

Outlook and rating triggers

The Negative Outlook represents Scope's view that risks to the ratings over the next 12 to 18 months are tilted to the downside.

Positive rating-change drivers

- Improved fiscal performance, resulting in a significant decline in the public debt ratio
- Structural reforms that reduce reliance on external demand and strengthen macroeconomic sustainability

Negative rating-change drivers

- Growth prospects notably worsen, due to energy supply disruptions, weighing on the country's macroeconomic sustainability and/or fiscal metrics
- Debt sustainability weakens materially as a result of a protracted period of loosened fiscal stance

Ratings and Outlook

Foreign currency

Long-term issuer rating	AA/Negative
Senior unsecured debt	AA/Negative
Short-term issuer rating	S-1+/Stable

Local currency

Long-term issuer rating	AA/Negative
Senior unsecured debt	AA/Negative
Short-term issuer rating	S-1+/Stable

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Bloomberg: RESP SCOP

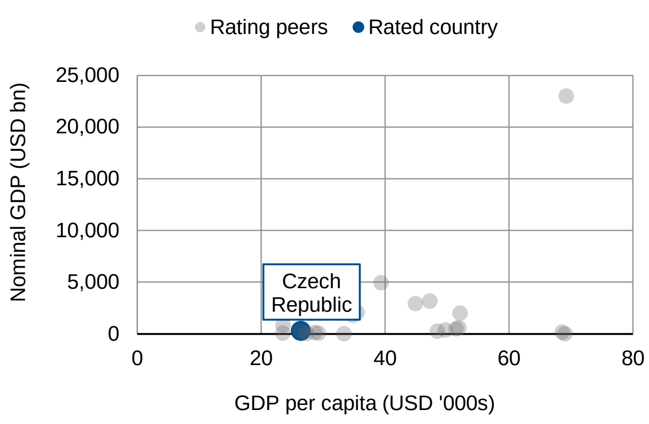
Domestic Economic Risks

- **Growth outlook:** After experiencing a significant drop in output in 2020 with a 5.8% decline in real GDP, the Czech economy experienced a muted recovery in 2021 (+3.3%), reflecting a negative contribution of foreign trade and modest investment growth which partially offset the rebound in household consumption. Growth picked up pace in 2022 Q1 (+4.8% YoY) thanks to buoyant private demand but is expected to decelerate significantly for the rest of the year. The impact of the war in Ukraine on global value chains will weigh on exports and manufacturing, especially on the automotive industry (about 9% of GDP). Accelerating inflation, tightening monetary policy will negatively impact consumption and business investment, though this should be partially mitigated by the government's support measures as well as by the disbursement of EU funds allocated under the Recovery and Resilience Facility (amounting to EUR 7bn, 3.1% of GDP). We thus expect growth to slow down to 1.6% in 2022, before recovering to 2.7% in 2023 and trending back towards the medium-term potential in subsequent years, which we estimate at 2.5% annually.
- **Inflation and monetary policy:** Similarly, to peers, inflation accelerated significantly in the recent period, averaging a 3.8% in 2021 and rising to 16% YoY in May. External factors, including surging energy and commodity prices, have been the main drivers of this acceleration, though domestic price dynamics have picked up as well, in a context of very tight labour markets, with core inflation rising to 13.9% YoY in May. The Czech National Bank (CNB) has tightened policy markedly in reaction, hiking its policy rate by a cumulated 675bps since June 2021, up to 7% last month.
- **Labour markets:** The Czech labour market is strong, with one of the lowest unemployment rates in the EU (2.4% as of March 2022) and a very elevated employment rate, at 75.3% at end-2021. Skilled labour shortages are affecting large segments of the economy and represent a significant constraint on long-term growth. The tightness in the labour market has fuelled rapid wage growth in recent years (+6.6% in 2021), posing long term competitiveness challenges. The arrival of Ukrainian refugees had added an estimated 50,000 workers to the Czech labour force as of May 2022, participating in alleviating these pressures somewhat.

Overview of Scope's qualitative assessments for Czech Republic's *Domestic Economic Risks*

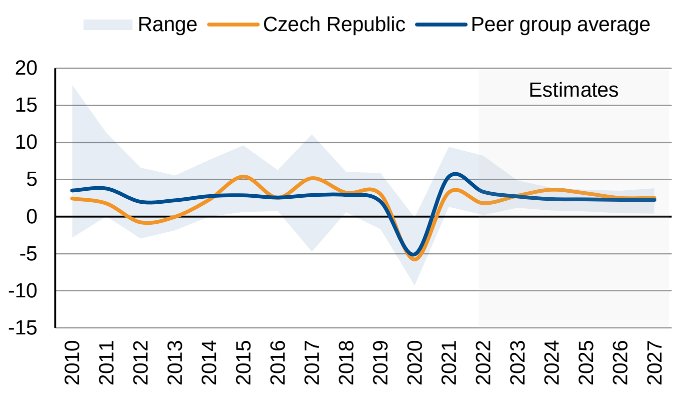
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Growth potential of the economy	Neutral	0	Robust economic performance; slow labor productivity growth
	Monetary policy framework	Neutral	0	Credible central bank; small local currency bond market limits effectiveness of monetary policy
	Macro-economic stability and sustainability	Weak	-1/3	Moderate diversification; reliance on external markets; persistent labor shortages

Nominal GDP and GDP per capita, USD '000s



Source: IMF World Economic Outlook (WEO), Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

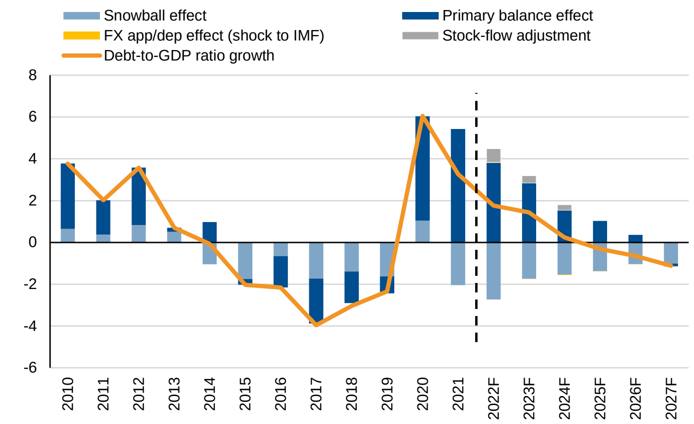
Public Finance Risks

- **Fiscal outlook:** Despite the strong economic rebound, the general government deficit increased slightly from the previous year in 2021, to 5.9% of GDP (+0.1pp), largely owing to the continuation of Covid-19 support measures as well as to the cuts included in the 2021 tax package, which became effective in January 2021. Moving forward, we expect the fiscal consolidation process to be only gradual, due to the permanent effect of tax cuts on revenue as well as to the weaker economic outlook. Additional spending pressures relate to measures included in the "Umbrella against inflation", estimated at nearly CZK 100bn (EUR 4bn, 1.6% of GDP), to expenditures aimed at supporting the integration of Ukrainian refugees, as well as to the recently stated government commitment of raising the level of military expenditure to 2% of GDP by 2024 (up from 1% currently). We thus expect the general government deficit to remain elevated, above the Maastricht criterion threshold, in 2022 and 2023, at 4.8% and 3.8% of GDP, respectively.
- **Debt trajectory:** Following a period of material fiscal consolidation, the Covid-19 crisis has put public debt on a slow, upward trajectory. The debt-to-GDP ratio increased to 41.9% at end 2021, up nearly 12pps from its pre-crisis level. We expect it to rise further in coming years and to peak at around 45% of GDP in 2025.
- **Debt profile and market access:** The Czech government benefits from strong market access, a supportive debt profile and significant liquid public sector deposits (13.7% of GDP as of 2021 Q3). In 2021, 68% of central government debt was held domestically and 93% was locally denominated. The average maturity of Czech public debt is adequate, having increased to 6.4 years in 2021 from 5.0 years in 2017. Similarly to peers, borrowing costs have increased since the beginning of the year, with 10-year yields averaging at 4.7% in May 2022, up from 1.8% the year before.

Overview of Scope's qualitative assessments for Czech Republic's *Public Finance Risks*

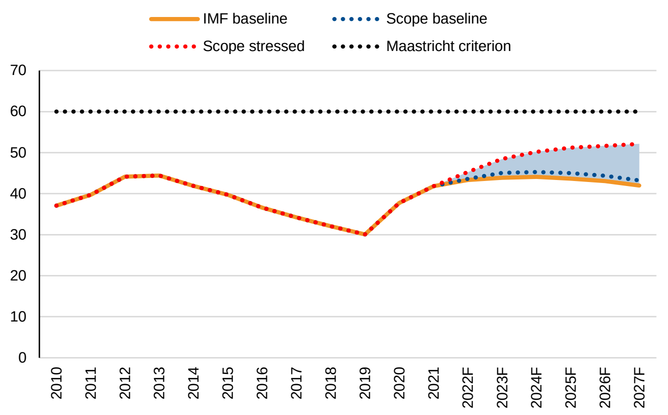
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Fiscal policy framework	Strong	+1/3	Credible fiscal policy framework; affordable fiscal space for a sizeable policy stimulus
	Debt sustainability	Neutral	0	Moderate debt burden and manageable financing needs also under adverse scenarios
	Debt profile and market access	Neutral	0	Substantial liquid assets in form of public sector deposits

Contributions to changes in debt levels, pps of GDP



Source: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

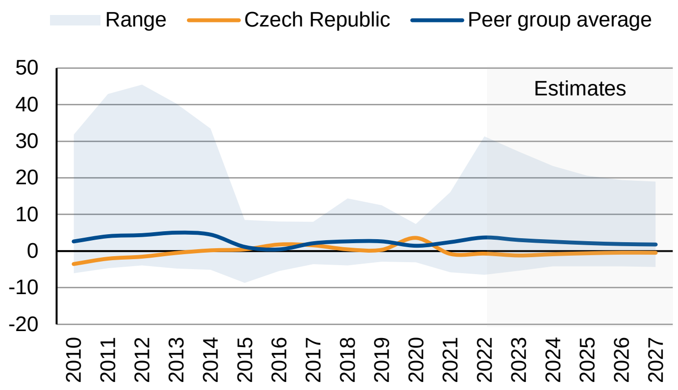
External Economic Risks

- **Current account:** The Czech Republic had generated steady current account surpluses in the leading up to the crisis, averaging at 1.2% of GDP over 2014-20. The balance swung to a deficit of 0.8% of GDP in 2021 following a significant weakening of the export performance, caused by material production constraints in some key export industries. We expect the balance of goods surplus to remain subdued relative to its pre-pandemic levels, due to the additional supply chain disruptions caused by the Ukraine war, to the economic slow-down in key European trading partners, as well as to the expected halt in trade with Russia, with exports to the country weighing about 1.7% of GDP.
- **External position:** The Czech Republic's net international investment position has improved significantly in recent years, having more than halved from a high of -44% in 2012 to about 15% at end-2021. Its composition is favourable, with around half of external liabilities corresponding to foreign direct investments. Similarly, the gross external debt has declined steadily, from 81% in 2018 to 69% in 2021.
- **Resilience to shocks:** The Czech economy is highly integrated in global trade, making the country vulnerable to economic downturns in its main trading partners, first among them Germany (more than 30% of exports). Offsetting factors include limited foreign currency borrowing from both the public and private sector. The stock of foreign currency reserves has declined somewhat since the beginning of the year, in part due to FX market intervention from the CNB to support the koruna in the wake of Russia's invasion of Ukraine, albeit remaining elevated, at USD 162bn, covering about 131% of short-term external debt.

Overview of Scope's qualitative assessments for Czech Republic's *External Economic Risks*

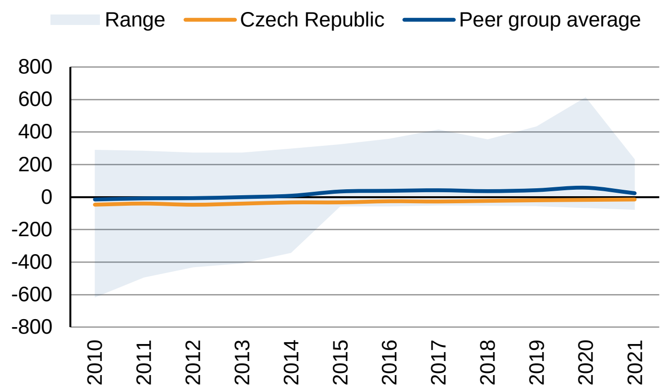
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Current account resilience	Neutral	0	Freely floating currency and competitive industrial base support medium-term current account balance
	External debt structure	Strong	+1/3	External liabilities mostly consist of direct investment and equity rather than debt-creating flows
	Resilience to short-term shocks	Weak	-1/3	Small, open economy; reliance on external demand and foreign direct investment

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings GmbH

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings GmbH

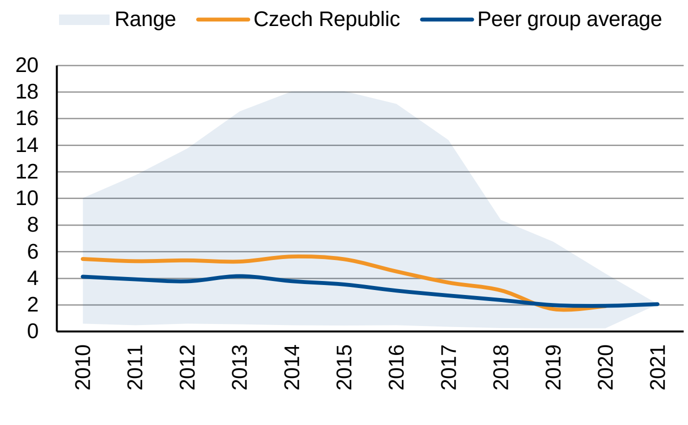
Financial Stability Risks

- **Banking sector:** The mostly foreign-owned Czech banking sector is well capitalised, with a Tier 1 capital ratio of 22.3% as of end-2021. The NPL ratio is low, at 1.4% of total, having decreased after a moderate uptick during the pandemic. Profitability is strong relative to European peers, with an aggregate RoE of 11.7% as of 2021 Q4, though it remains subdued compared to its pre-crisis levels (15.5% on average over 2017-19).
- **Private debt:** Private sector debt is moderate, stable, at about 86% of GDP as of end-2021. Credit to households had picked up since the beginning of the Covid-19 crisis, albeit remaining low relative to peer countries, at 34.6% of GDP. It has slowed down significantly in recent months, as reflected in the 40% fall in new mortgage loans in April 2022, following a rapid increase in interest rates.
- **Financial imbalances:** Strong mortgage lending activity has fuelled elevated housing prices growth in recent years, causing some financial stability concerns. In February 2022, the European Systemic Risk Board estimated that house price overvaluation in the Czech Republic was among the highest in the EU. Accordingly, the CNB announced stricter limits to credit ratios from April 2022. It also enacted a 2% (+150bps) increase to the countercyclical capital buffer rate, effective January 2023.

Overview of Scope's qualitative assessments for Czech Republic's *Financial Stability Risks*

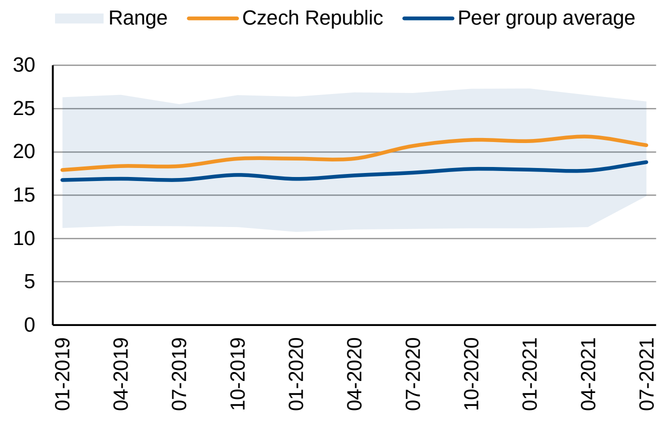
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	High capitalisation levels; declining profitability from a worsening operating environment
	Banking sector oversight	Neutral	0	Effective supervisory control; timely and comprehensive regulatory measures
	Financial imbalances	Neutral	0	Moderate household and private sector indebtedness; low savings

Non-performing loans (NPLs), % of total loans



Source: World Bank, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

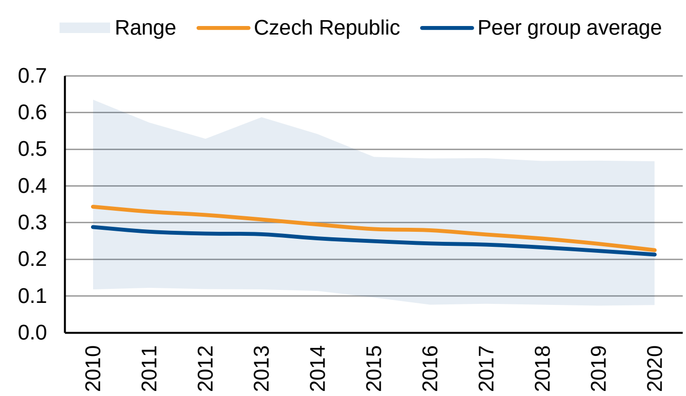
ESG Risks

- **Environment:** The Czech economy is one of the most carbon-intensive in the EU, reflecting its status as a transit country with a high share of GDP from manufacturing. It is heavily reliant on fossil fuels, especially coal (one third of total energy supply) and has been slow to transition to renewable sources (15% of its energy mix, with a 2030 target of 22%). Reliance on Russian energy imports is significant, with an estimated 70% of hard coal imports, 49% of crude oil imports and 100% of natural gas imports. The new government has announced plans to phase out coal from its energy production by 2033, partly through an increase in nuclear energy capacity.
- **Social:** The country performs well on some key social-related credit factors, including elevated employment rates and moderate levels of income inequality. Challenges include weak health infrastructure and high regional disparities relative to peers. Population ageing is causing a steady increase in the old-age dependency ratio, weighing on long-term growth prospects and the sustainability of public finances. The European Commission estimates the additional cost of ageing, through increases in pension, healthcare, and long-term care expenditures, at 6.1% of GDP over 2019-70, well above the EU average (1.9%).
- **Governance:** The October 2021 parliamentary elections resulted in a new government led by centre-right Prime Minister Petr Fiala. He has affirmed his commitment to fiscal discipline, enacting a CZK 100bn (1.6% of GDP) cut to the government deficit in early 2022, and has worked towards improving ties with the EU, which had come under strain under the Babiš premiership. Despite its diverse nature, the governing coalition has proven broadly stable since its inception.

Overview of Scope's qualitative assessments for Czech Republic's *ESG Risks*

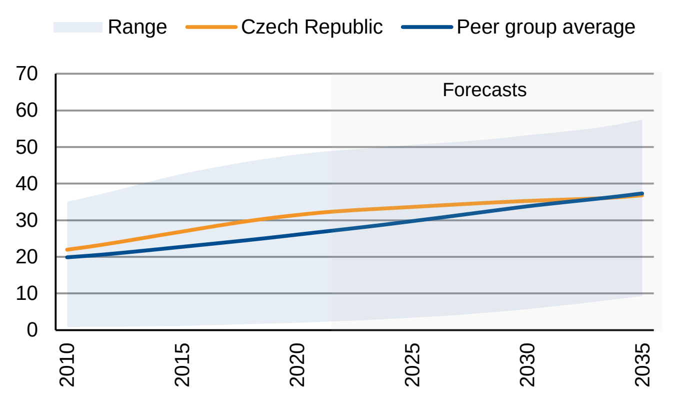
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Environmental risks	Weak	-1/3	Meaningful transition risks; carbon-intensive economy as a transit country with a high share of manufacturing
	Social risks	Neutral	0	Adverse demographics resulting in declining working-age population; high employment rates
	Institutional and political risks	Neutral	0	Robust institutions; moderate reform momentum

CO_2 emissions per GDP, $mtCO_2e$



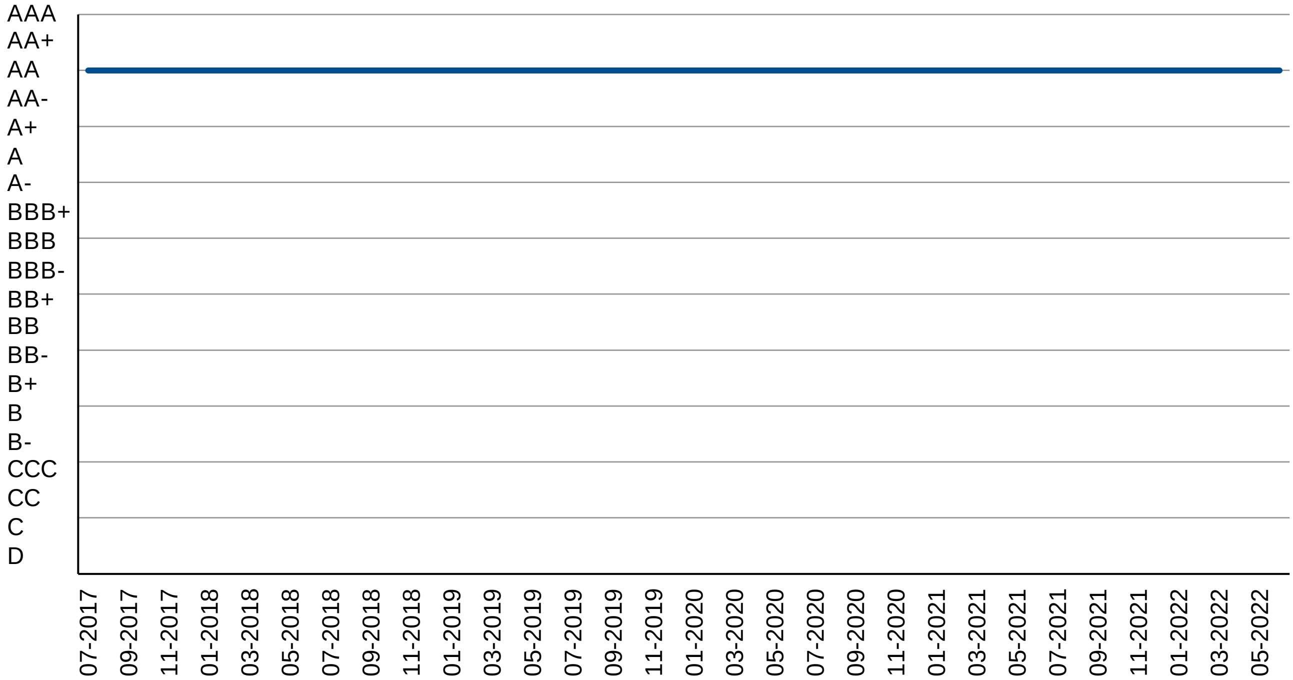
Source: European Commission, Scope Ratings GmbH

Old age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

Appendix I. Rating history



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard embedding a methodological reserve-currency adjustment.

Peer group*
Belgium
Estonia
France
Italy
Japan
Lithuania
Malta
Slovenia
United Kingdom
United States

Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 29 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021E	2022F	2023F
Domestic Economic Risk								
GDP per capita, USD '000s	18.6	20.7	23.5	23.7	22.9	26.4	27.6	29.7
Nominal GDP, USD bn	196.3	218.6	249.0	252.5	245.3	282.6	296.2	318.9
Real growth, %[1]	2.5	5.2	3.2	3.0	-5.8	3.3	1.6	2.7
CPI inflation, %	0.7	2.5	2.1	2.8	3.2	3.8	9.0	6.0
Unemployment rate, %[1]	4.0	2.9	2.2	2.0	2.6	2.8	2.5	2.5
Public Finance Risk								
Public debt, % of GDP[1]	36.6	34.2	32.1	30.1	37.7	41.9	43.6	45.1
Interest payment, % of government revenue	2.3	1.8	1.8	1.7	1.8	1.7	2.4	2.3
Primary balance, % of GDP[1]	1.6	2.2	1.6	1.0	-5.0	-5.1	-3.8	-2.8
External Economic Risk								
Current account balance, % of GDP	1.8	1.5	0.4	0.3	3.6	-0.8	-0.7	-1.2
Total reserves, months of imports	6.5	9.9	8.5	9.1	11.2	-	-	-
NIIP, % of GDP	-25.9	-27.4	-23.6	-20.1	-17.7	-15.4	-	-
Financial Stability Risk								
NPL ratio, % of total loans	4.5	3.7	3.1	1.7	1.9	-	-	-
Tier 1 ratio, % of risk-weighted assets	17.1	17.5	17.8	19.2	21.4	20.8	-	-
Credit to private sector, % of GDP	51.1	50.9	51.3	50.3	53.2	-	-	-
ESG Risk								
CO_2 per EUR 1,000 of GDP, $mtCO_2e$	279.1	267.5	256.4	242.0	224.6	-	-	-
Income quintile share ratio (S80/S20), x	3.6	3.5	3.5	3.5	-	-	-	-
Labour-force participation rate, %	75.2	76.1	76.8	76.9	-	-	-	-
Old-age dependency ratio, %	27.9	29.0	29.9	30.7	31.4	32.1	32.5	32.9
Composite governance indicator[2]	0.9	1.0	1.0	0.9	1.0	-	-	-

[1] Forecasted values are produced by Scope
[2] Average of the six World Bank Worldwide Governance Indicators
Source: European Commission, IMF WEO, World Bank, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification — Advanced economy

5y USD CDS spread (bps) as of 30/06/2022 — 40

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