Czech Republic
Rating Report

AA STABLE OUTLOOK

Credit strengths

- Track record of fiscal consolidation, moderate levels of public debt
- Solid economic growth prospects
- 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

The Czech Republic's AA- rating is underpinned by: i) robust public finances with a good record of fiscal consolidation, sound fiscal policies, a moderate level of debt and a substantial liquidity buffer; and ii) a strong record of steady economic performance with a competitive, export-oriented industrial sector and solid economic growth prospects.

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

The 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		-1/3	AA
Public finances risk		25%	a+		+1/3	
External economic risk		10%	aa		0	
Financial stability risk		10%	aaa		0	
ESG Risk	Environmental risk	5%	aa		0	
	Social risk	5%	a-		0	
	Governance risk	10%	a+		0	
Overall outcome		**aa**		**0**	**0**	

Note: The sum of the qualitative adjustments, capped at 1 notch per rating pillar, is weighted equally and 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 Stable Outlook reflects Scope's view that risks to the ratings are balanced over the next 12 to 18 months.

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

- A structural decline in foreign demand or prolonged disruptions to supply chains, weakening growth potential
- Materially higher debt ratios than projected because of fading fiscal discipline, for example

Ratings and Outlook

Foreign currency

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

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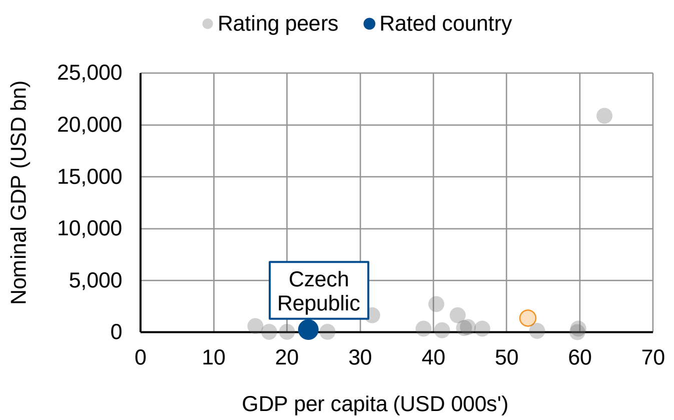
Domestic economic risks

- **Growth outlook:** The Czech Republic's small, open, supply-chain dependent economy was hit hard by the pandemic, with a 5.8% drop in output in 2020 compared to negative 4.4% for Slovakia and negative 2.5% for Poland. We estimate economic growth to have reached 3% in 2021, supported by a rebound in household and public consumption and investment. GDP is expected to stand about 3% below its pre-crisis level at the end of 2021 as global supply chain distortions weigh on external trade. We expect growth to accelerate to 4.7% in 2022. The improving economic outlook is supported by pent-up demand boosting private consumption, recovering net exports, low unemployment and increased EU funds.
- **Inflation and monetary policy:** Supply-side constraints, notably related to a tight labour market, fragile global supply chains and strong demand, are pushing inflation well above the Czech National Bank (CNB)'s 2% target. Year-on-year inflation reached 6.6% in December, leading the CNB to hike its benchmark rate to 3.75% in December, 350 bps above the January 2021 level. Inflation averaged at 3.8% in 2021 and should further accelerate to around 6% in 2022.
- **Labour market:** The Czech Republic benefits from a strong labour market, with unemployment declining to 2.3% in November 2021, the lowest level in the EU, despite the end of the government's labour market support measures. We expect unemployment to decline further and return to pre-pandemic levels. Labour shortages are impacting sectors such as construction, manufacturing and IT.

Overview of our qualitative assessments of the Czech Republic's domestic economic risk

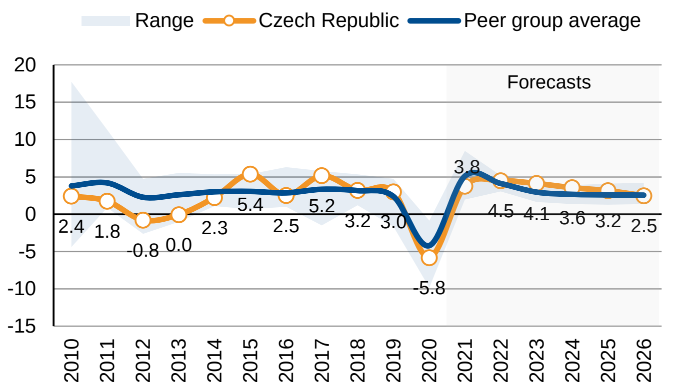
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Growth potential of the economy	Neutral	0	Robust economic performance; slow labour productivity growth
	Monetary policy framework	Neutral	0	Credible central bank; small local currency bond market limits effectiveness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

Nominal GDP and GDP per capita, USD '000s



Source: IMF, Scope Ratings

Real GDP growth, %



Source: IMF, Scope Ratings

Public finance risks

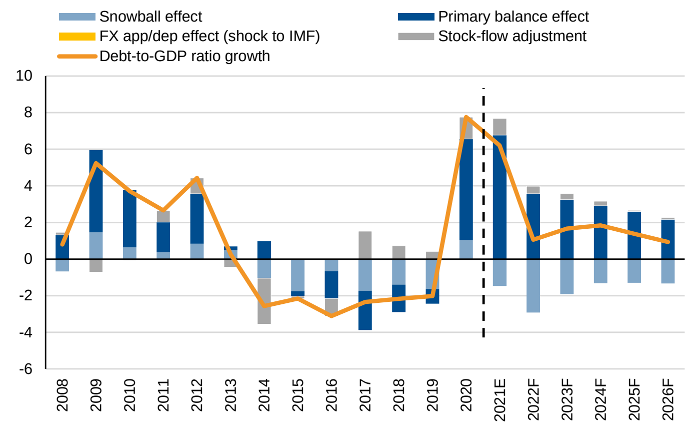
- **Fiscal outlook:** We expect the general government deficit to decline to 4.3% in 2022 from 7.5% in 2021. The newly elected government has already approved a year-long freeze on increases in public wages and expressed its intention to revise the 2022 budget and reduce the deficit. The deficit should gradually narrow to around 4% in 2023. Although most of the government's exceptional support measures are expected to be phased out early in 2022, the consolidation is being slowed down by the decrease in revenue caused by the 2021 tax package, which brought about a permanent decrease in the personal income tax. Higher inflation is to push up several expenditure items, including pensions..

- **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 reached around 42% in 2021, and we expect it to climb to around 45% in 2023. This is still well below the Stability and Growth Pact's 60% limit.
- **Market access:** The country's public finances outlook benefits from strong market access, a supportive debt profile and significant liquid public sector deposits (13.7% of GDP as of 2021 Q3). In November 2021, 68 % of public debt was held domestically and 96.1% 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.

Overview of Scope's qualitative assessments of the Czech Republic's public finances risk

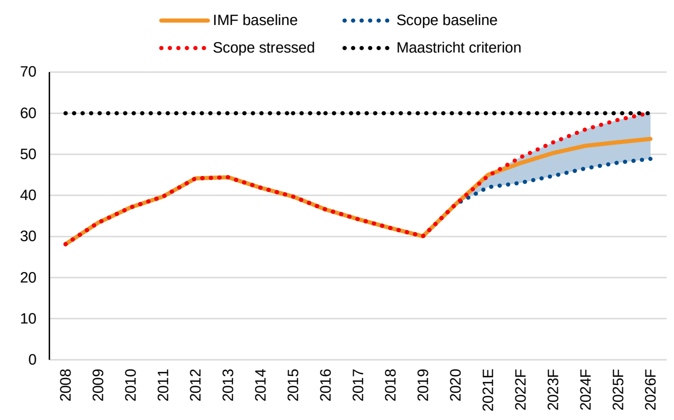
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Fiscal policy framework	Strong	+1/3	Credible fiscal policy framework; adequate fiscal space for sizeable policy stimulus
	Debt sustainability	Neutral	0	Moderate debt burden and manageable financing needs even under adverse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

Contributions to changes in debt levels, pps of GDP



Source: Scope Ratings

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings

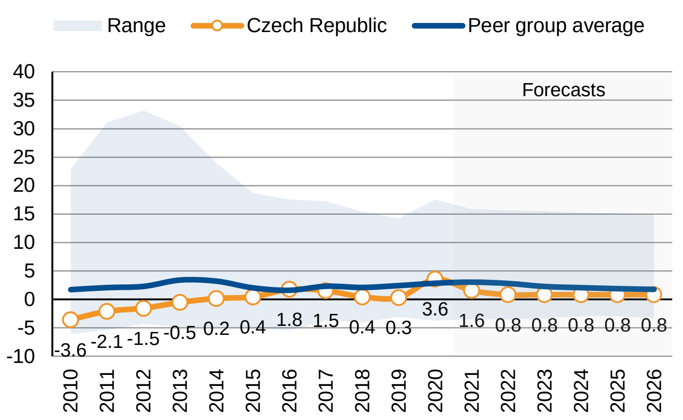
External economic risks

- **Current account:** The Czech Republic has generated robust current account surpluses in the past seven years owing to its deep integration in global value chains. The automotive sector, which represents around a quarter of exports, was very negatively impacted by the Covid-19 crisis due to a fall in demand and global supply chain disruptions. This includes the shortage of semiconductors, which led to production shutdowns in the automotive industry (24% of exports in 2020).
- **External position:** The Czech Republic's net international investment position has improved steadily in recent years to negative 11.7% of GDP in 2020 from negative 26.1% of GDP in 2016. Foreign direct investment represented 51.3% of external liabilities as of Q3 2021, making the country more resilient to sudden changes in investor sentiment.
- **Resilience to shocks:** The Czech economy is small and highly integrated in global trade, with exports of goods and services representing almost 74% of GDP in 2019. This makes 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.

Overview of Scope's qualitative assessments of the Czech Republic's external economic risk

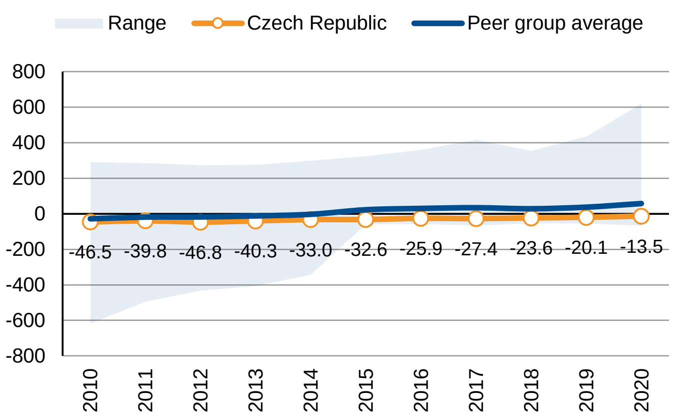
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Current account resilience	Neutral	0	Freely floating currency and competitive industrial base support medium-term current account balance
	External debt structure	Strong	+1/3	External liabilities mostly consist of direct 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, Scope Ratings

NIIP, % of GDP



Source: IMF, Scope Ratings

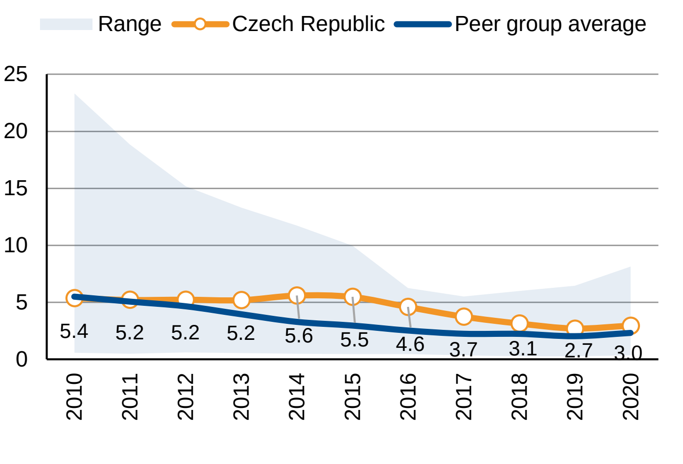
Financial stability risks

- **Banking sector:** The mostly foreign-owned Czech banking sector is well capitalised, with an overall capital ratio of 24.4% and a Tier 1 capital ratio of 23.8% as of H1 2021. The aggregate liquidity coverage ratio stood at 228% as of H1 2021 (up 39 pp YoY), reflecting increasing resilience to short-term shocks. The NPL ratio was a healthy 2.9% as of June 2021 following a small uptick during the pandemic. Banking sector profitability, which dipped in 2020, has since been gradually recovering and should be supported in the medium term by the CNB's rate hikes.
- **Private debt:** Despite record-high volumes of new loans in the first three quarters of 2021, Czech households remain moderately indebted compared to peers, with a debt-to-GDP ratio below 60% as of H1 2021.
- **Financial imbalances:** The mortgage lending market has been very active throughout the crisis, driving a rapid increase in residential real estate prices. This has been supported by high fundamental demand and a temporary easing of credit standards, as seen in a rising share of loans with high loan-to-value and debt-to-income ratios. The CNB has announced stricter limits to credit ratios from April 2022. On the macroprudential side, it has also announced it would raise the countercyclical capital buffer rate to 2%, an increase of 150 bps effective January 2023.

Overview of Scope's qualitative assessments of the Czech Republic's financial stability risk

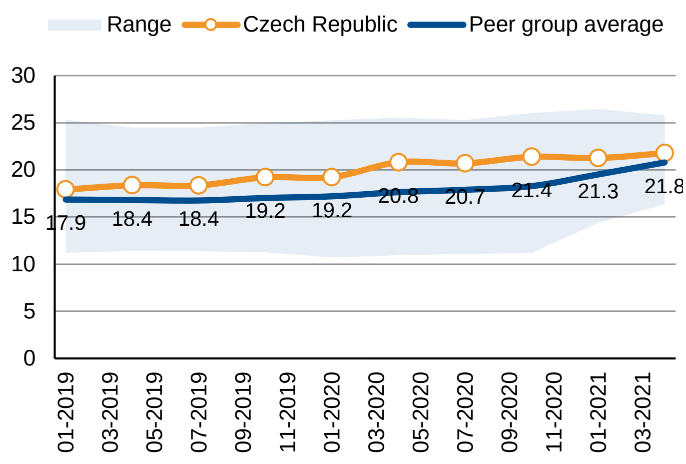
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	High capitalisation levels; declining profitability from a worsening operating environment
	Banking sector oversight	Neutral	0	Effective supervisory control; timely and comprehensive regulatory measures
	Financial imbalances	Neutral	0	Moderate household and private sector indebtedness relative to peers; rising upward price pressures in the housing market

NPLs, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

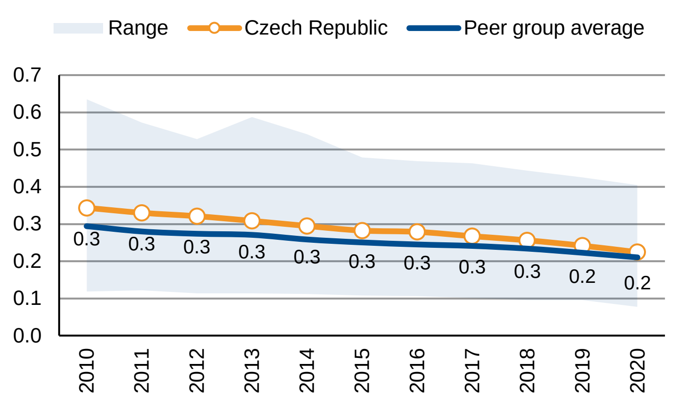
ESG risks

- **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. The country's greenhouse gas emissions are elevated at 9.6 metric tonnes per capital versus the EU average of 6.4. 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%). 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:** Following a period of uncertainty, the October 2021 parliamentary elections resulted in a new government led by centre-right Prime Minister Petr Fiala. He has signaled his intention to improve ties with the EU and adopt a fiscally conservative, pro-business stance while revising the former government's 2022 budget downwards. The new government has a comfortable majority (108 MPs out of 200). Instability could stem from ideological disagreements among the five parties that make up the coalition.

Overview of Scope's qualitative assessments of the Czech Republic's ESG risk

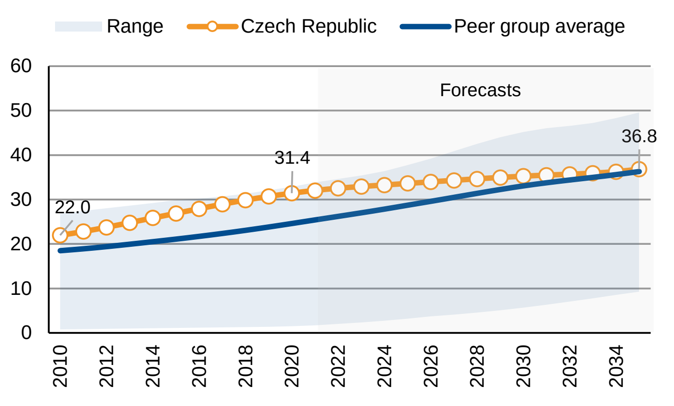
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Environmental risks	Weak	-1/3	Meaningful transition risks; carbon-intensive economy as a transit country with a high share of manufacturing
	Social risks	Neutral	0	Adverse demographics resulting in declining working-age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

CO2 emissions per unit of GDP, mtCO2e



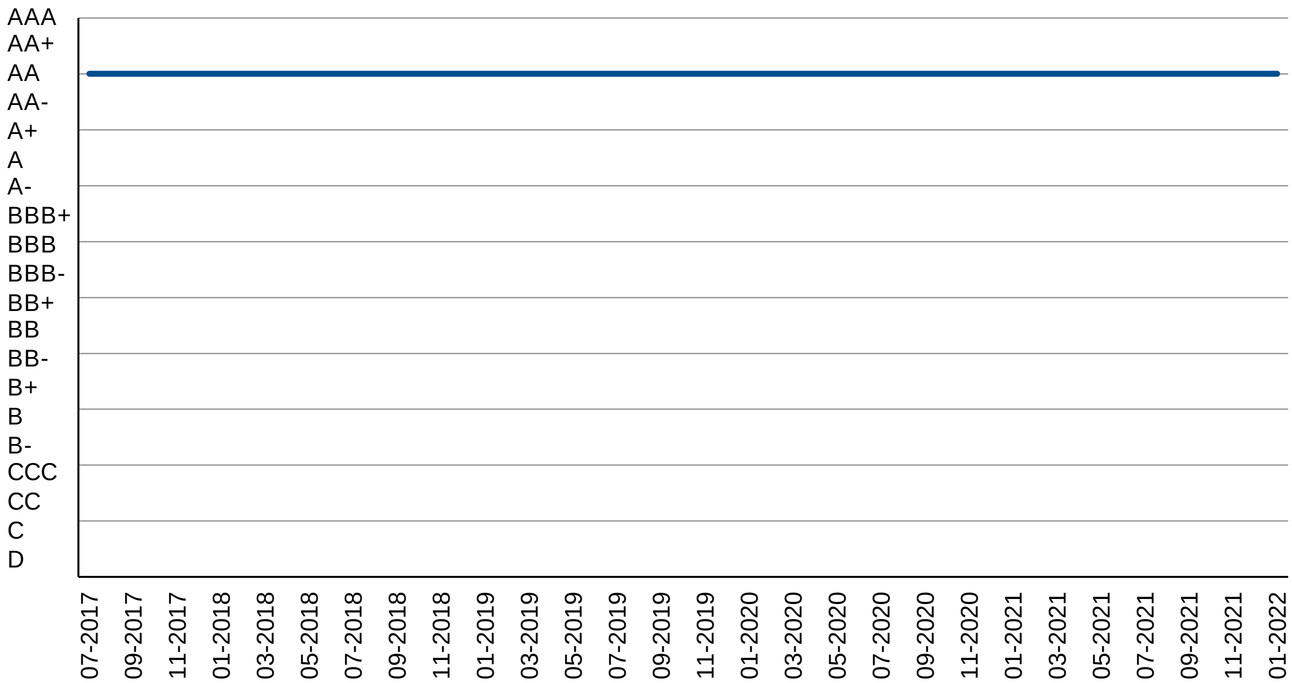
Source: European Commission, Scope Ratings

Old-age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history



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.

Peer group
Belgium
United States
Estonia
Latvia
Lithuania
Poland
Slovenia

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) used in Scope's quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021E	2022F
Domestic economic risk							
GDP per capita, USD 000s'	18.6	20.7	23.5	23.7	22.9	25.8	28.1
Nominal GDP, USD bn	196.3	218.6	249.0	252.5	245.3	276.9	302.1
Real growth, %[1]	2.5	5.2	3.2	3.0	-5.8	3.0	4.7
CPI inflation, %	0.7	2.5	2.1	2.8	3.2	3.8	4.1
Unemployment rate, %[1]	3.9	2.9	2.2	2.0	2.5	2.7	2.6
Public finance risk							
Public debt, % of GDP[1]	36.6	34.2	32.1	30.0	37.7	42.0	43.1
Interest payment, % of government revenue	2.3	1.8	1.8	1.7	1.8	1.9	2.0
Primary balance, % of GDP[1]	1.6	2.2	1.7	1.0	-4.8	-6.8	-3.9
External economic risk							
Current account balance, % of GDP	1.8	1.5	0.4	0.3	3.6	1.6	0.8
Total reserves, months of imports	6.5	9.9	8.5	9.1	11.3	-	-
NIIP, % of GDP	-25.9	-27.4	-23.6	-20.1	-13.5	-	-
Financial stability risk							
NPL ratio, % of total loans	4.6	3.7	3.1	2.7	3.0	-	-
Tier 1 ratio, % of risk weighted assets	17.1	17.5	17.8	19.2	21.4	21.8	-
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, mtCO2e	279.1	267.5	256.4	242.0	224.6	-	-
Income quintile share ratio (S80/S20), x	3.6	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
Composite governance indicator[2]	0.9	1.0	1.0	0.9	1.1	-	-

[1] Forecasted values are produced by Scope and may differ from those presented in the charts of the previous sections.
[2] Average of the six World Bank Governance Indicators
Source: European Commission, IMF, World Bank, Scope Ratings

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 14 January 2022	35

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