Czech Republic
Rating Report

STABLE OUTLOOK

AA-

Credit strengths

- Good record of fiscal consolidation and favourable debt profile
- Competitive industrial sector

Credit challenges

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

Rating rationale:

Risks to sustained economic growth due to the energy crisis: The energy crisis has had a severe impact on the Czech economy due to the country's significant dependence on energy imports from Russia. As a result, inflationary pressures have significantly weakened medium-term growth. This situation has further exacerbated existing structural challenges, including labour market tightness, an energy-intensive economic structure and reliance on external demand.

Robust fiscal policy framework and favourable debt profile: The Czech Republic's credit ratings are supported by the country's solid track record of fiscal consolidation, prudent fiscal policies, and a favourable debt profile. Additionally, the country benefits from liquidity buffers, further enhancing its financial stability.

Rating challenges include: i) an economic structure reliant on external demand and Russian oil, which makes the country vulnerable to external shocks; and ii) adverse demographic trends, such as an ageing population and labour shortages that constrain potential growth and create medium-term pressures on public finances.

Czech Republic's sovereign rating drivers

Risk pillars		Quantitative		Reserve currency	Qualitative*	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	a-	CZK [+0]	0	AA-
Public Finance Risk		20%	aa		+2/3	
External Economic Risk		10%	a		+1/3	
Financial Stability Risk		10%	aaa		+1/3	
ESG Risk	Environmental Factors	5%	a-		0	
	Social Factors	7.5%	bb+		0	
	Governance Factors	12.5%	aa-		0	
Indicative outcome			**a+**		**+1**	
Additional considerations					**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 Stable Outlook reflects Scope's view that risks to the ratings are balanced over the next 12-18 months.

Positive rating-change drivers

- Fiscal performance improves materially, resulting in significant decline in the public debt ratio
- The country's resilience to external shocks is strengthened notably, supporting macroeconomic sustainability

Negative rating-change drivers

- Ongoing fiscal deficits and a continuous rise in the public debt-to-GDP ratio
- Persistently high inflation levels exceeding expectations continue to hinder medium-term growth

Ratings and Outlook

Foreign currency

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

Local currency

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

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Bloomberg: RESP SCOP

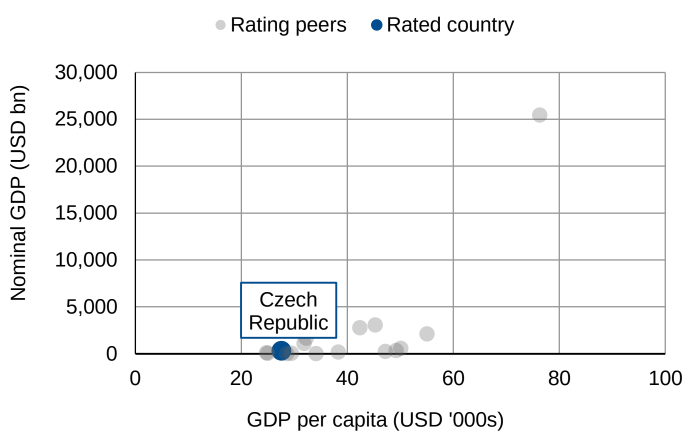
Domestic Economic Risks

- **Growth outlook:** In 2022, the Czech Republic's economic output expanded by 2.5%, which was a slowdown compared to the previous year's growth of 3.5%. This growth was primarily driven by fixed capital investment and inventory accumulation. However, inflationary pressures and tighter monetary policy hindered household consumption, resulting in a year-on-year GDP growth of -0.2% in Q1 2023. We anticipate subdued growth of 0.2% for the current year due to lower inventory levels, weak external demand, and households facing limited real disposable income due to ongoing inflationary pressures. As inflation eases gradually and export conditions improve with a more stable supply chain, along with increased capital investments, we anticipate a growth recovery to reach 3% in 2024. Beyond that, growth is projected to stabilise around the medium-term potential of 2.5% in the following years, although it will still be below pre-crisis levels.
- **Inflation and monetary policy:** In 2022, Harmonised Index of Consumer Prices (HICP) inflation in the Czech Republic averaged at 14.8%. It reached a peak of 19.1% in January 2023, primarily driven by increases in energy and food prices. As global inflationary pressures subsided due to subdued external demand and declining energy costs, inflation decelerated to 14.3% year-on-year in April. However, it remains elevated due to the impact of other goods and services, along with robust wage growth. The recent appreciation of the Koruna and the tight monetary policy should contribute to a gradual easing of inflation levels over the next two years.
- **Labour markets: T**he Czech labour market maintains the lowest unemployment rate in the EU, standing at 2.5% as of March 2023 and demonstrates a high employment rate of 75.6% in Q1 2023, despite the sluggish growth momentum. However, labour market imbalances persist across most economic sectors, primarily due to labour shortages, which pose a constraint on long-term output growth. The ongoing tightness in the labour market continues to drive wage growth, averaging 7.9% in Q4 2022 across the whole economy, presenting long-term competitiveness challenges. The substantial influx of Ukrainian refugees has provided some relief by alleviating labour market mismatches and the associated wage pressures.

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

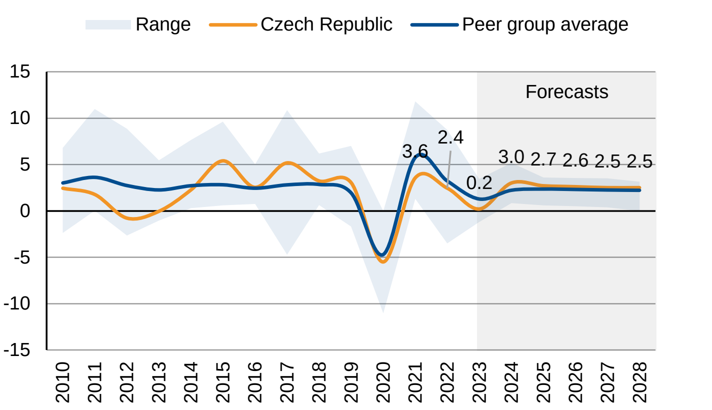
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Growth potential of the economy	Neutral	0	Robust economic performance, although growth potential constrained by slow labour productivity growth, labour shortages and weakening demographics
	Monetary policy framework	Neutral	0	Credible central bank; small local currency bond market limits effectiveness of monetary policy
	Macro-economic stability and sustainability	Neutral	0	Moderate diversification; reliance on external markets; persistent labour shortages

Nominal GDP and GDP per capita, USD



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

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

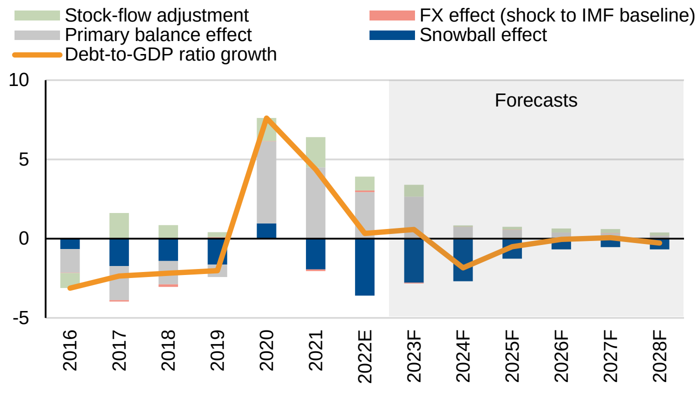
Public Finance Risks

- **Fiscal outlook:** The headline budget deficit improved to 3.6% of GDP in 2022, from 5.1% of GDP in 2021. This progress was driven by the phased withdrawal of Covid-19-related programs, robust tax revenue, and increased social security contributions. However, it was partially offset by substantial government support provided to households and businesses in response to high energy costs and humanitarian aid for Ukrainian refugees. For 2023, we anticipate the fiscal deficit to remain at 3.6% of GDP. This projection considers continued support to households and companies through energy price caps. Pressures arise from high interest rates, growing pension obligations and healthcare spending. The government's agreement on a reform package represents a crucial step towards fiscal consolidation and addressing long-term sustainability issues in social spending. The gradual phasing out of energy support measures and reduced pension indexation should alleviate short-term spending pressures. We expect the general government deficit to start narrowing in 2024, reaching around 1.8% of GDP.
- **Debt trajectory:** After a period of fiscal consolidation, the growth rate of the debt-to-GDP ratio has accelerated above the EU average following the Covid-19 crisis. Despite starting from moderate levels, the ratio increased from 30% in 2019 to 44.1% in 2022. Going forward, with rising interest expenditures and persistent albeit declining fiscal deficits, the debt-to-GDP ratio is expected to hover around 40% of GDP in the long-term.
- **Debt profile and market access:** The Czech government benefits from strong market access, supported by a favourable debt profile and significant deposits, amounting to approximately 18% of GDP at the end of 2022. In terms of public debt composition, 75% is held domestically, while 89% is denominated in the local currency. The average maturity of Czech public debt remains adequate, standing at 6.2 years in 2022, an improvement compared to 5.0 years in 2017. Similarly to its peers, borrowing costs have increased over the past year.

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

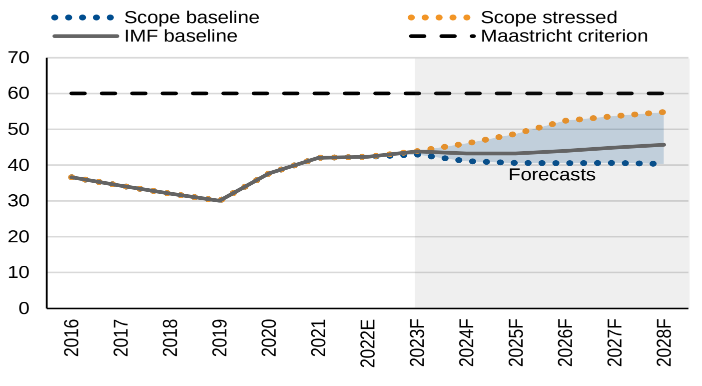
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Fiscal policy framework	Strong	+1/3	Credible fiscal policy framework; affordable fiscal space for a sizeable fiscal stimulus
	Debt sustainability	Strong	+1/3	Moderate debt burden and manageable financing needs also under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

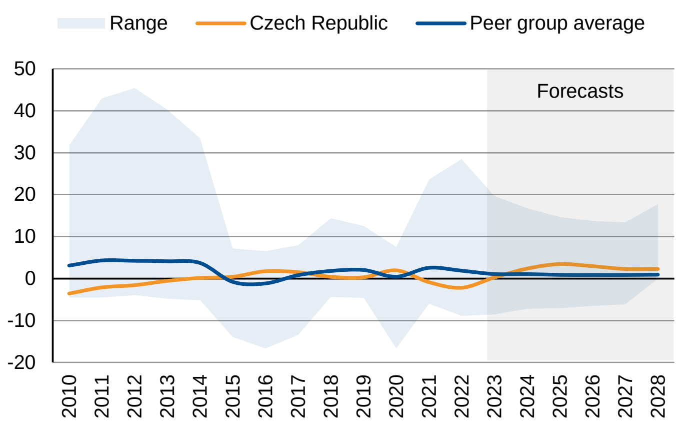
External Economic Risks

- **Current account:** After having generated steady surpluses averaging 1.0% of GDP during the period of 2014-2020, the Czech Republic's current account balance shifted to a deficit of 2.8% of GDP in 2021. This deficit further widened to 6.1% of GDP in 2022, primarily due to a deterioration in the balance of goods and services. Factors such as higher commodity prices and transportation costs weakened export performance. Additionally, the expansion of the primary income deficit, attributed to the dividend distribution of foreign-controlled companies worsened the current account. We anticipate a gradual improvement in the current account balance over the next two years, despite remaining below pre-pandemic levels. This will be favoured by an ease of price pressures in the industry and energy sector, improving supply chain stability and economic recovery in the major trading partners.
- **External position:** The Czech Republic has improved its net international investment position in recent years. It has reduced it by more than half, decreasing from a peak of -45% of GDP in 2012 to approximately -20% of GDP as of Q4 2022. The composition of this position is favourable, with more than half of external liabilities attributed to foreign direct investments. The country's gross external debt has declined consistently, falling from 82% of GDP in 2018 to 66% of GDP as of Q4 2022. However, the short-term share of the debt is approximately 60%.
- **Resilience to shocks:** The Czech economy is deeply intertwined with global trade, making it susceptible to economic downturns in its key trading partners, with Germany accounting for over 30% of exports. Foreign currency borrowing is limited. The stock of foreign currency reserves has declined to USD 132bn in October 2022, but has since improved, coupled with the recent appreciation of the koruna. As a result, the need for the Czech National Bank (CNB) to intervene in foreign exchange markets has diminished. Reserve coverage of short-term debt remains at comfortable levels, standing at 116% as of December 2022. However, this coverage decreased in the second half of last year due to the rise in short-term foreign debt.

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

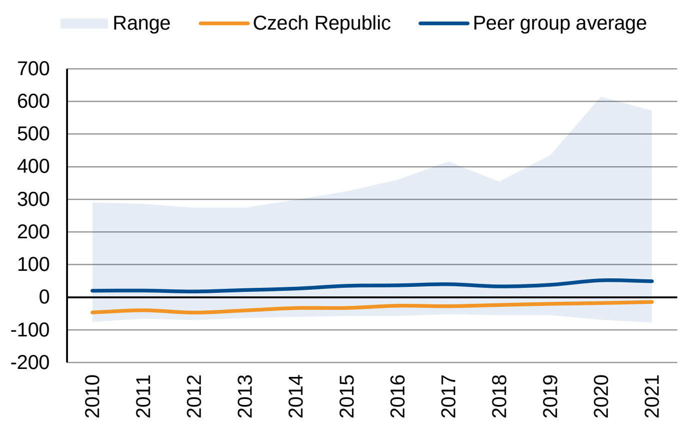
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a	Current account resilience	Neutral	0	Free floating currency and competitive industrial base support medium-term current account balance
	External debt structure	Strong	+1/3	External liabilities mostly consist in direct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

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

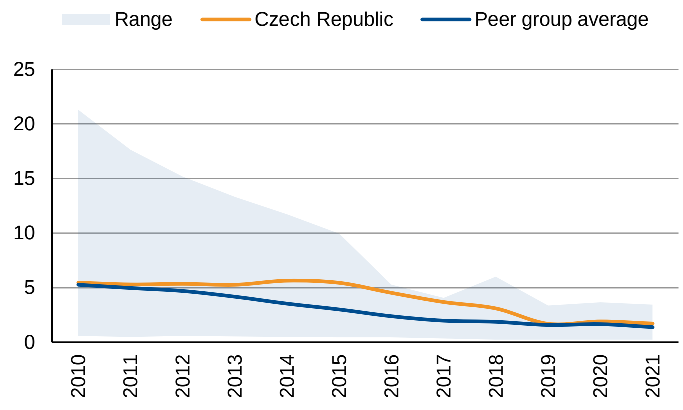
Financial Stability Risks

- **Banking sector:** The capitalisation of the predominantly foreign-owned Czech banking sector remains robust, with the sector further strengthening its capital adequacy in the past year. As of Q4 2022, it maintained a Tier 1 capital ratio of 19.4%. However, this ratio has declined compared to its peak of 23.8% in Q2 2021, primarily due to dividend distribution following the end of profit distribution restrictions. The banking sector experienced a significant increase in profit, rising from around CZK 33bn to CZK 75bn in 2021. This growth was primarily driven by higher interest rate profits, fuelled by strong credit growth and low impairment losses. Nevertheless, the banking sector faces uncertainty regarding future profits due to the impact of the war in Ukraine on the economy. Additionally, there are potential risks for banks arising from rapid credit expansion.
- **Private debt:** The private sector debt in the Czech Republic remains at a moderate and stable level, standing at 86% of GDP as of Q3 2022. While credit to households had been increasing since the onset of the Covid-19 crisis, it has recently slowed down, primarily due to a cooling mortgage market. As of Q3 2022, household credit accounted for 33.2% of GDP. The ratio of non-performing loans to total loans continued to decline in 2022, but the coverage of loans by provisions decreased and government loan guarantee schemes and banks' relief policies for borrowers at risk had a favourable impact on the overall situation.
- **Financial imbalances:** Housing prices have continued to surge, reaching 20.7% YoY growth on average during the first three quarters of 2022, according to Eurostat data. In response, the Czech National Bank (CNB) has adopted a cautious approach by maintaining tight credit standards. The countercyclical capital buffer has been held at 2.5%, effective from April 2023. There are signs that the pace of house price growth has started to moderate in Q4 2022, coinciding with the rise in interest rates. The combination of high energy and living costs creates additional pressure on the sustainability of households' debt service.

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

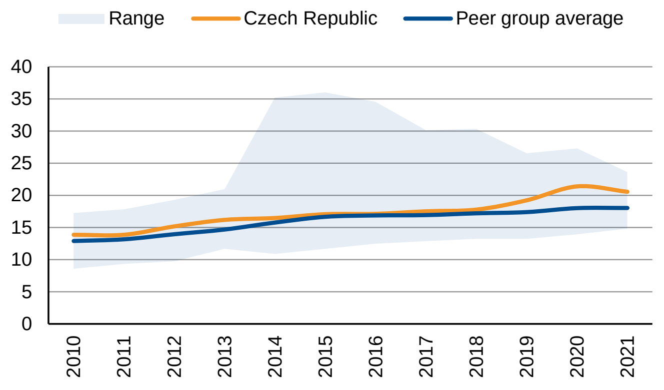
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Strong	+1/3	High capitalisation levels; robust funding profile
	Banking sector oversight	Neutral	0	Effective supervisory control; timely and comprehensively regulatory measures
	Financial imbalances	Neutral	0	Moderate household and private sector indebtedness; low savings

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

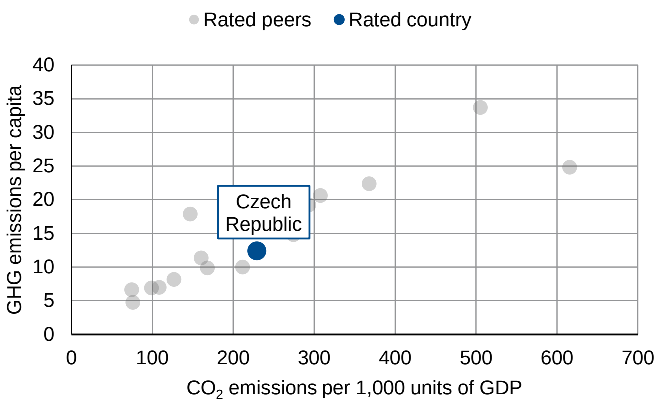
ESG Risks

- **Environment:** Given its role as a transit country with a significant proportion of economic output derived from manufacturing, the Czech Republic's economy stands out as one of the most carbon-intensive among EU member states. The country also exhibits higher-than-average levels of municipal waste per capita and a low recycling rate. To address these environmental challenges, the Czech Republic's national recovery plan emphasizes climate objectives by allocating 42% of its total funds to related measures. The recovery and resilience plan will be funded with grants totalling EUR 7bn. The government has set ambitious targets, aiming to reduce greenhouse gas (GHG) emissions by 26% by 2030. The Czech Republic plans to phase out coal from its energy mix by 2033. These initiatives demonstrate the country's commitment to transition towards a more sustainable and environmentally-friendly economy.
- **Social:** The country demonstrates strength in certain social-related credit factors, such as high employment rates and relatively moderate levels of income inequality. Challenges include deficiencies in health infrastructure and significant regional disparities compared to peer countries. The aging population leads to a gradual rise in the old-age dependency ratio, posing long-term implications for economic growth and the sustainability of public finances. According to the European Commission, the projected cost of population aging, encompassing increased expenses in pensions, healthcare, long-term care and education, amounts to 6.1% of GDP over the period of 2019-2070 (EU average of 1.9%).
- **Governance:** In May 2023 the government presented a comprehensive fiscal consolidation program, demonstrating commitment to address the country's fiscal challenges. Under Prime Minister Fiala's leadership efforts have been made to strengthen the Czech Republic's relationship with the European Union (EU). The previous strain experienced during the Babiš premiership has been replaced by a more pro-European stance, with the appointment of Petr Pavel as president in March 2023.

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

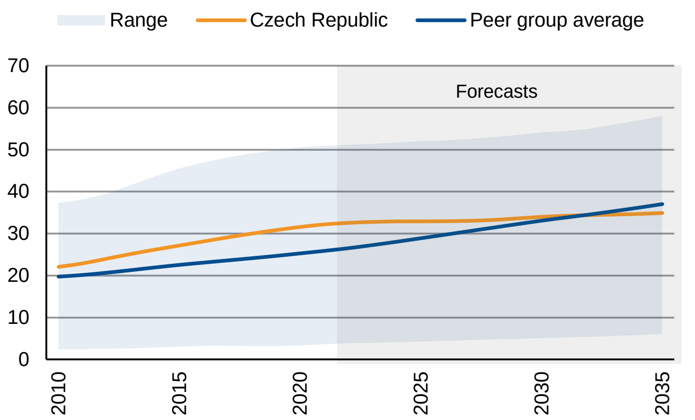
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a	Environmental factors	Weak	-1/3	Meaningful transition risks; carbon-intensive economy as a transit country with a high share of manufacturing
	Social factors	Neutral	0	Adverse demographics resulting in declining working-age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

Emissions per GDP and per capita, $mtCO_2e$



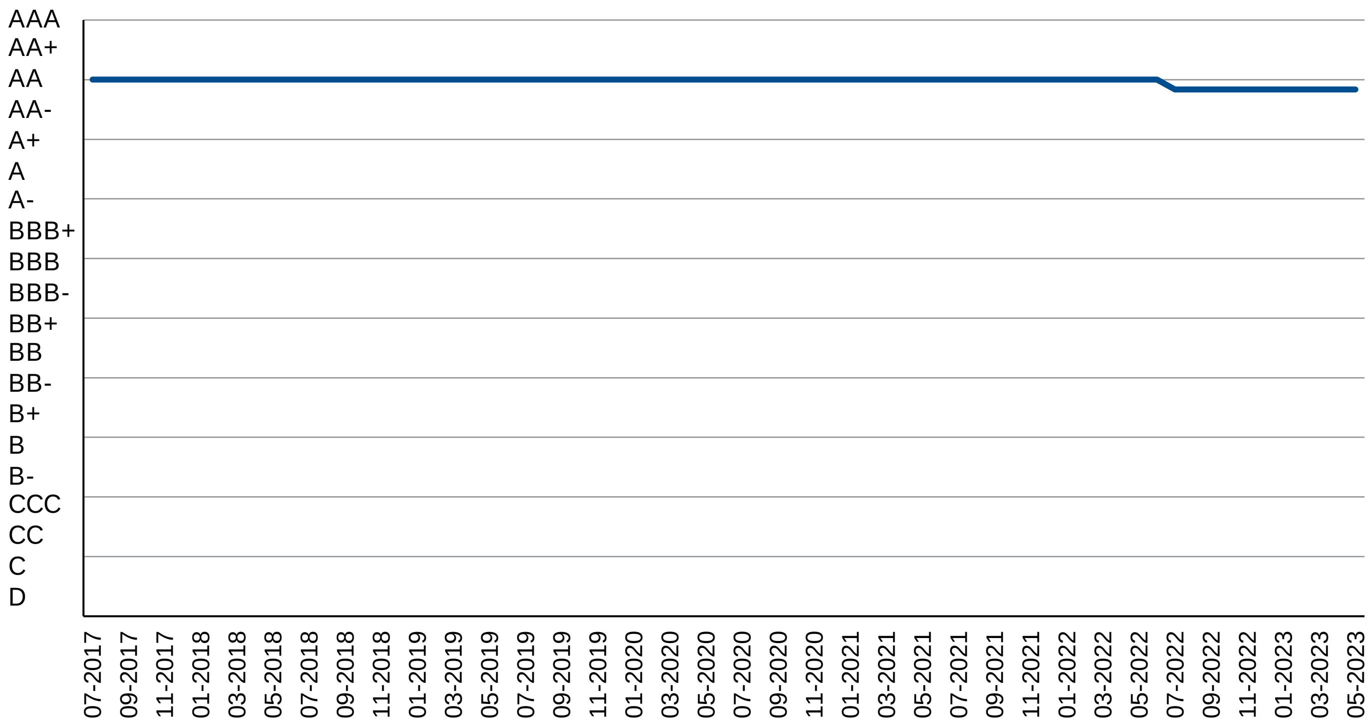
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history (foreign-currency long-term debt)



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, including a methodological reserve-currency adjustment.

Peer group*
Belgium
Estonia
France
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 30 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

Pillar	Core variable	Source	2018	2019	2020	2021	2022	2023
Domestic Economic	GDP per capita, USD '000s	IMF	23.5	23.7	23.0	26.3	27.6	31.4
	Nominal GDP, USD bn	IMF	249.0	252.5	246.0	281.8	290.4	330.5
	Real growth, %	IMF	3.2	3.0	-5.5	3.6	2.4	-0.5
	CPI inflation, %	IMF	2.1	2.8	3.2	3.8	15.1	11.8
	Unemployment rate, %	WB	2.2	2.0	2.6	2.8	-	-
Public Finance	Public debt, % of GDP	IMF	32.1	30.0	37.7	42.0	42.3	43.8
	Interest payment, % of revenue	IMF	1.4	1.2	1.4	1.5	1.6	2.2
	Primary balance, % of GDP	IMF	1.5	0.8	-5.2	-4.5	-2.9	-3.3
External Economic	Current account balance, % of GDP	IMF	0.4	0.3	2.0	-0.8	-2.2	0.3
	Total reserves, months of imports	IMF	8.5	9.1	11.3	9.6	-	-
	NIIP, % of GDP	IMF	-23.6	-20.1	-17.7	-14.3	-20.4	-
Financial Stability	NPL ratio, % of total loans	IMF	3.1	1.7	1.9	1.7	-	-
	Tier 1 ratio, % of risk-weighted assets	IMF	17.2	17.9	19.2	21.3	19.6	-
	Credit to private sector, % of GDP	WB	51.3	50.3	53.1	-	-	-
ESG	CO_2 per EUR 1,000 of GDP, $mtCO_2e$	EC	252.5	233.7	224.2	229.5	-	-
	Income share of bottom 50%, %	WID	25.4	25.5	25.5	25.5	-	-
	Labour-force participation rate, %	WB	76.8	76.9	-	-	-	-
	Old-age dependency ratio, %	UN	30.0	30.8	31.6	32.2	32.6	32.8
	Composite governance indicators*	WB	0.9	0.9	1.0	1.0	-	-

* Average of the six World Bank Worldwide Governance Indicators.

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of May 26	42.24

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