Czech Republic
Rating Report

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, weighing on growth potential and public finances

Rating rationale:

Downside risks due to the energy crisis: Material weakening of the country's medium term growth prospects and intensified inflationary pressure are slowing fiscal consolidation. The energy crisis remains the key downside risk given the country's significant energy dependence on Russia, amplified by an economic structure dominated by energy-intensive businesses coupled with weaker external demand from key export markets

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

Rating challenges include: i) an economic structure reliant on external demand and Russian energy, which exposes the country to external shocks; 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		Reserve currency	Qualitative*	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	a	CZK [+0]	+1/3	AA
Public Finance Risk		20%	aa-		+2/3	
External Economic Risk		10%	bbb		+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+**			**+2**	
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 Negative Outlook reflects 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 significant decline in the public debt ratio
- Notably strengthened resilience to supply chain shocks and/or energy supply disruptions, supporting macroeconomic sustainability

Negative rating-change drivers

- Growth prospects worsen more than expected, due to for example energy supply disruptions, weighing on the country's macroeconomic stability
- Materially higher debt ratios than projected

Ratings and Outlook

Foreign currency

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

Local currency

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

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Bloomberg: RESP SCOP

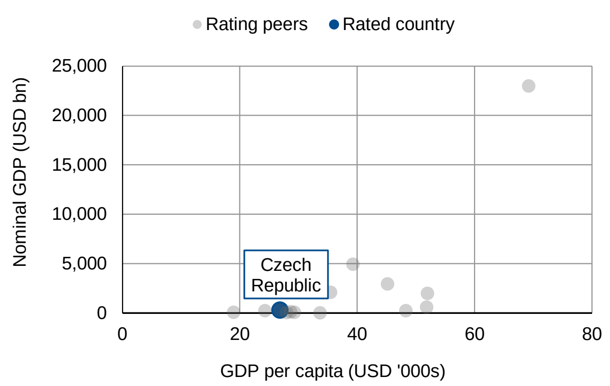
Domestic Economic Risks

- **Growth outlook:** According to preliminary estimates of the Czech Statistical Office, real GDP fell by 0.4% QoQ in Q3 2022 and was 1.6% higher YoY. The negative impact on consumption and business investment caused by inflationary pressures and tighter monetary policy should be partially mitigated by the government's support measures and by the disbursement of EU funds allocated under the Recovery and Resilience Facility (amounting to EUR 7bn, 3.1% of GDP). We expect GDP growth at 2.5% this year, before falling to 0.2% in 2023, with persistently subdued domestic demand due to high inflation and deteriorating households' and businesses' financial conditions. Economic growth should then trend back towards the medium-term potential in subsequent years, which we estimate at 2.5% annually.
- **Inflation and monetary policy:** Inflation accelerated rapidly in recent months, raising from an annual average of 3.3% in 2021 to 15.5% YoY in October 2022. Annual inflation is expected to fall significantly in Q4 thanks to the energy saving package. The Czech National Bank (CNB) has tightened monetary policy markedly, hiking its key two-week repo rate by a cumulated 675bps since June 2021, to 7% in June 2022 and left unchanged at this level since then.
- **Labour markets:** The Czech labour market has one of the lowest unemployment rates in the EU (2.2% as of September 2022) and a high employment rate, at 75.9% in Q3 2022. Skilled labour shortages are affecting most economic sectors and represent a constraint on long-term output growth. Persistent labour market tightness has fuelled rapid wage growth in recent years – expected to be around 6.7% in 2022 – posing long-term competitiveness challenges. The arrival of Ukrainian refugees had added almost 90,000 workers to the Czech labour force as of September 2022, participating in alleviating these pressures somewhat.

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

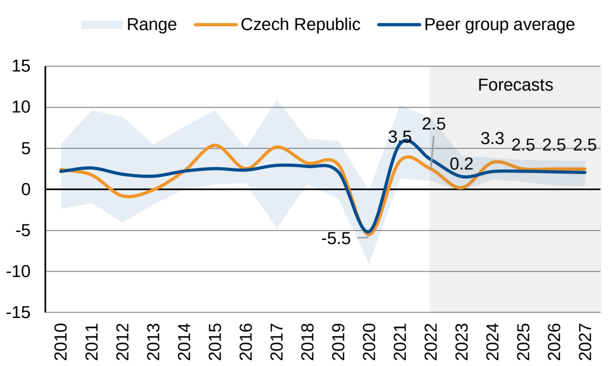
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a	Growth potential of the economy	Strong	+1/3	Robust economic performance and stronger growth potential compared to peers; slow labor productivity growth
	Monetary policy framework	Neutral	0	Credible central bank; small local currency bond market limits effectiveness of monetary policy
	Macro-economic stability and sustainability	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

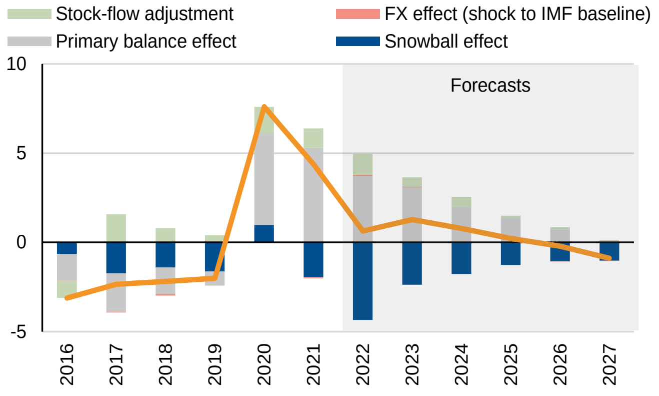
Public Finance Risks

- **Fiscal outlook:** Following a high deficit of 5.1% of GDP in 2021, the gradual phase-out of Covid measures was offset by fiscal support to households and firms for high inflation (amounting to almost 2% of GDP), as well as humanitarian and financial assistance to Ukrainian refugees. Although government revenues will benefit from tax income, particularly from the taxation of energy corporates' windfall profits, energy and humanitarian support measures, as well as the government commitment of raising the level of military expenditure to 2% of GDP by 2024 (up from 1.4% currently) will keep expenditure high also in 2023. The Government plans to present a comprehensive pension reform in 2023, which could represent a key step of fiscal consolidation and address long-term sustainability issues in social spending. We expect the general government deficit to remain elevated in 2022 and 2023, at 4.6% and 4.3% of GDP, respectively.
- **Debt trajectory:** Following a period of material fiscal consolidation, the Covid-19 crisis has put public debt on an upward trajectory. The debt-to-GDP ratio increased to 42.0% at end 2021, up 12pps from its pre-crisis level. We expect it to rise further in coming years and to peak at around 47% of GDP in 2025.
- **Debt profile and market access:** The Czech government benefits from strong market access, a supportive debt profile and significant deposits (expected to be at around 18% of GDP at year-end 2022). In 2021, 72% of public debt was held domestically and 92% 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 5.52% in October 2022, up from 2.34% in the same month the year before.

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

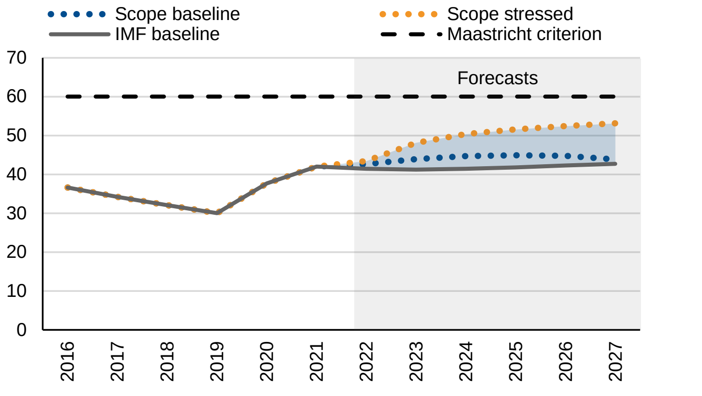
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa-	Fiscal policy framework	Strong	+1/3	Credible fiscal policy framework; affordable fiscal space for a sizeable policy stimulus
	Debt sustainability	Strong	+1/3	Moderate debt burden and manageable financing needs also under 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

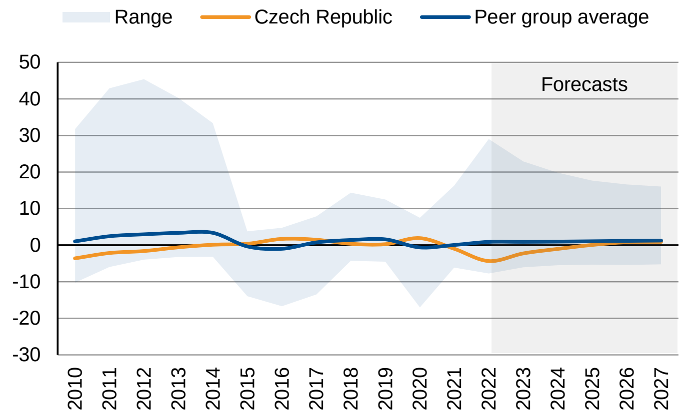
External Economic Risks

- **Current account:** After having generated steady surpluses averaged 1.2% of GDP over 2014-20, the Czech Republic's current account 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. The current account deficit continued to decline over 2022, reaching 3.5% of GDP in Q2 2022. We expect the balance of goods to remain significantly subdued relative to its pre-pandemic levels, due to high energy prices and the economic slow-down in key European trading partners.
- **External position:** The Czech Republic's net international investment position has improved significantly in recent years, having more than halved from a high of -45% of GDP in 2012 to about -18% of GDP as of Q2 2022. Its composition is favourable, with around half of external liabilities corresponding to foreign direct investments. Similarly, the gross external debt has declined steadily, from 82% of GDP in 2018 to 71% of GDP in Q2 2022, although the short-term share is around 63%.
- **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 150bn as of June 2022, covering comfortably about 123% of short-term external debt.

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

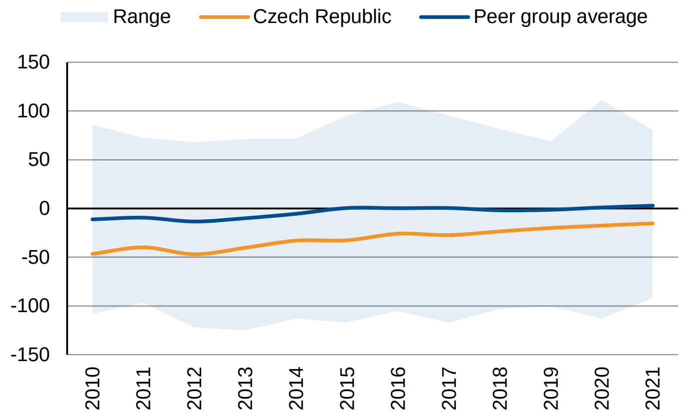
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Current account resilience	Neutral	0	Freely floating currency and competitive industrial base support medium-term current account balance
	External debt structure	Strong	+1/3	External liabilities mostly consist of direct investment and equity rather than debt-creating flows
	Resilience to short-term 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

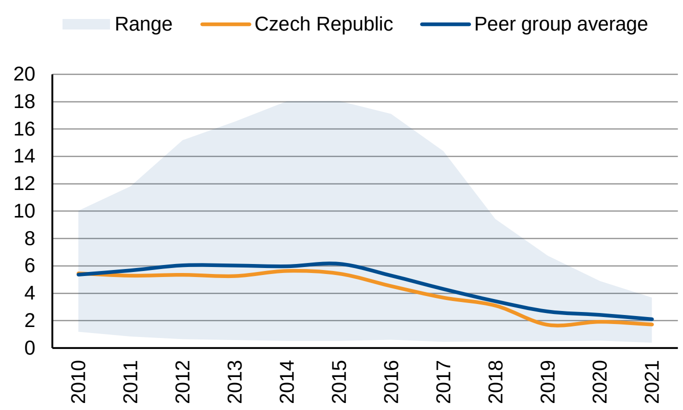
Financial Stability Risks

- **Banking sector:** The capitalisation of the mostly foreign-owned Czech banking sector remains robust, with the sector strengthening its capital adequacy further last year, with a Tier 1 capital ratio of 22.3% as of end-2021. The substantial increase in the banking sector's profit of around CZK 23bn to CZK 70bn in 2021 reflects the relatively low, pandemic-induced base of 2020 and a significant decrease in impairment losses. The war in Ukraine and associated disruptions in global supply chains have increased the potential credit risks, as reflected in banks' expectations of higher credit losses from the second half of 2022 onwards.
- **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. The ratio of non-performing loans to total loans went down in 2021, and coverage of loans by provisions decreased because of the release of provisions. Government loan guarantee schemes and banks' relief policies for at-risk borrowers continued to have a favourable effect.
- **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 gradually increased the countercyclical capital buffer rate to 2.5%, effective from April 2023.

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

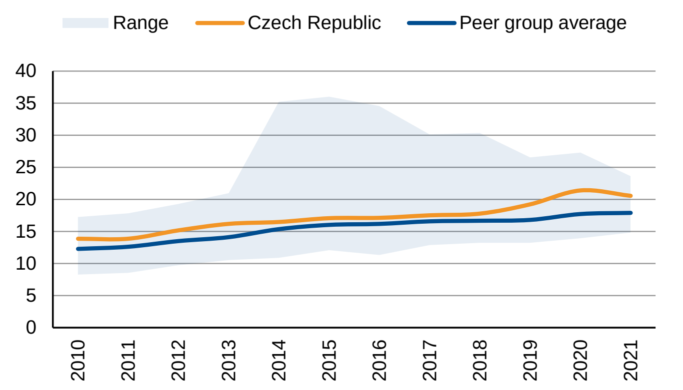
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Strong	+1/3	High and strengthened capitalisation levels; robust funding profile
	Banking sector oversight	Neutral	0	Effective supervisory control; timely and comprehensively regulatory measures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

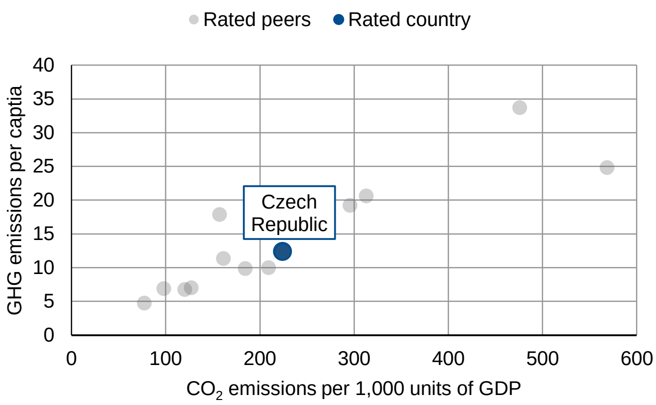
ESG Risks

- **Environment:** 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, as well as above-average amount of municipal waste per capita and a low recycling rate. The Czech Republic's national recovery plan devotes 42% of its total allocation to measures that support climate objectives, including investments in renewable energy, the replacement of coal-fired boilers and improvements in the energy efficiency of residential and public buildings. Overall, the Czech Republic's recovery and resilience plan will be financed by EUR 7bn in grants. In January, the government said it wanted coal to be phased out of the energy mix by 2033, five years sooner than the 2038 target originally recommended by the government's Coal Commission.
- **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*

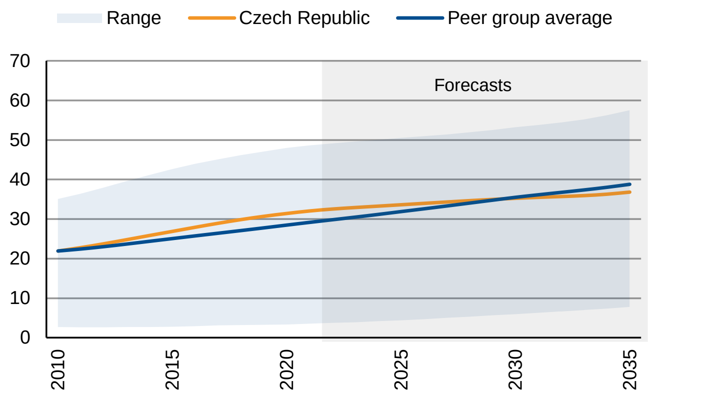
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Environmental factors	Neutral	0	Meaningful transition risks; carbon-intensive economy as a transit country with a high share of manufacturing
	Social factors	Neutral	0	Adverse demographics resulting in declining working-age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

Emissions per GDP and per capita, $mtCO_2e$



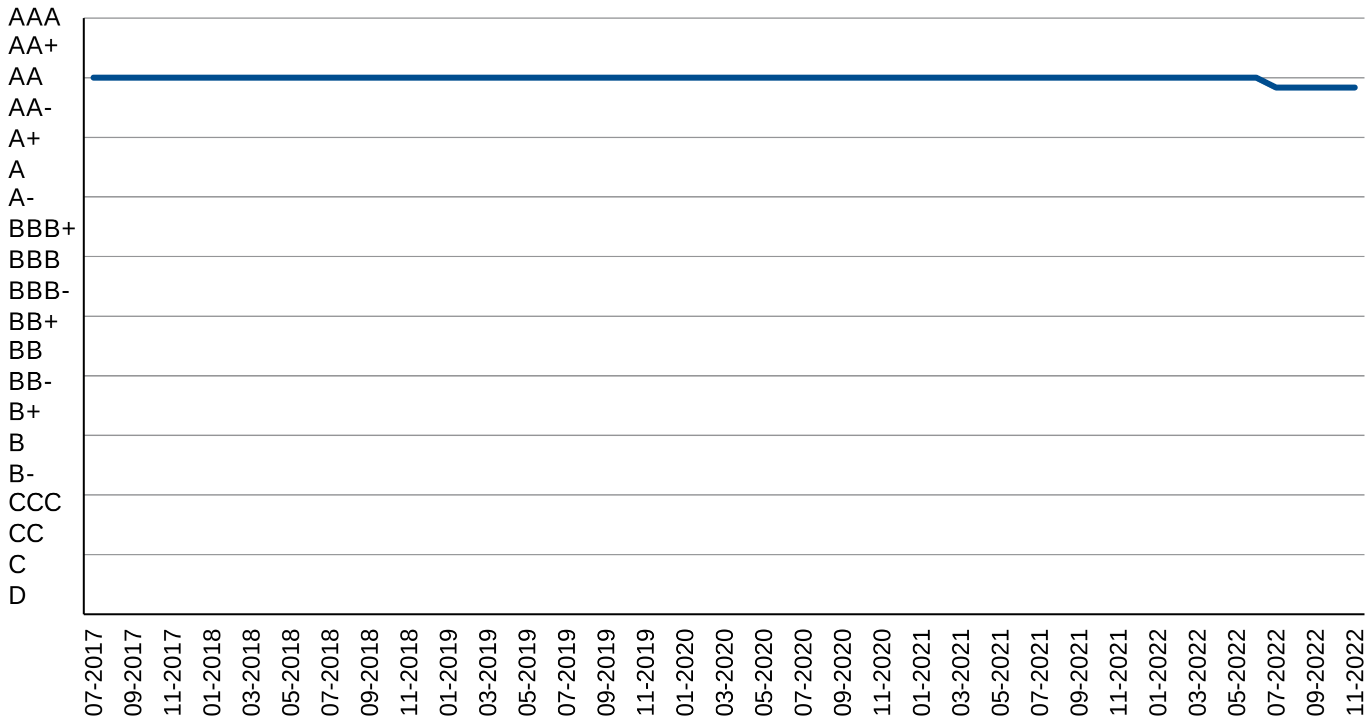
Source: European Commission, Scope Ratings

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
Czech Republic
Estonia
France
Italy
Japan
Malta
Portugal
Slovenia
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	2017	2018	2019	2020	2021
Domestic Economic	GDP per capita, USD '000s	IMF	20,667	23,468	23,714	23,001	26,849
	Nominal GDP, USD bn	IMF	218.6	249.0	252.5	246.0	281.8
	Real growth, %	IMF	5.2	3.2	3.0	-5.5	3.5
	CPI inflation, %	IMF	2.5	2.1	2.8	3.2	3.8
	Unemployment rate, %	WB	2.9	2.2	2.0	2.6	2.8
Public Finance	Public debt, % of GDP	IMF	34.2	32.1	30.0	37.7	42.0
	Interest payment, % of revenue	IMF	1.6	1.4	1.2	1.4	1.4
	Primary balance, % of GDP	IMF	2.1	1.5	0.8	-5.2	-5.3
External Economic	Current account balance, % of GDP	IMF	1.5	0.4	0.3	2.0	-0.8
	Total reserves, months of imports	IMF	9.9	8.5	9.1	11.3	9.6
	NIIP, % of GDP	IMF	-27.4	-23.6	-20.1	-17.7	-15.4
Financial Stability	NPL ratio, % of total loans	IMF	3.7	3.1	1.7	1.9	1.7
	Tier 1 ratio, % of risk-weighted assets	IMF	16.9	17.2	17.9	19.2	21.3
	Credit to private sector, % of GDP	WB	50.9	51.3	50.3	53.2	-
ESG	CO_2 per EUR 1,000 of GDP, $mtCO_2e$	EC	263.6	252.5	233.7	224.2	229.5
	Income share of bottom 50%, %	WID	25.2	25.4	25.5	25.5	25.5
	Labour-force participation rate, %	WB	76.1	76.8	76.9	-	-
	Old-age dependency ratio, %	UN	29.0	29.9	30.7	31.4	32.1
	Composite governance indicators*	WB	1.0	1.0	0.9	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 30 November 2022	54

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