

# Country report

## CZECH REPUBLIC

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### Summary

Despite strong economic growth in the Czech Republic's main trading partner Germany, the country's economic recovery remains sluggish amidst ongoing budgetary consolidation and relatively tempered export growth. With domestic demand being dampened by ongoing austerity measures, the country's economic growth will be highly exposed to economic developments in the euro zone. Even though the current account deficit widened to about 3% of GDP on the back of a declining trade and services surplus, continuous inflows of FDI and portfolio investments should guarantee that the deficit will be completely financed. Though hopes were high that the newly elected centre-right government would bring some stability into Czech politics, continuous tensions among the coalition partners have cast doubts on the government's ability to embark on their ambitious reform package and stay their fiscal consolidation course. Yet, owing to a general consensus on the need for structural reforms and austerity among most of the Czech political parties, the problems of the current government will at most delay the reform progress.

### Things to watch:

- Government stability and progress in budgetary consolidation
- Structural reforms in the fields of pensions and healthcare
- Economic recovery in the euro zone

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Czech Republic			
<b>National facts</b>		<b>Social and governance indicators</b> rank / total	
Type of government	Parliamentary democracy	Human Development Index (rank)	28 / 169
Capital	Prague	Ease of doing business (rank)	63 / 183
Surface area (thousand sq km)	79	Economic freedom index (rank)	28 / 179
Population (millions)	10.5	Corruption perceptions index (rank)	45 / 180
Main languages	Czech (95%) Slovak (2%)	Press freedom index (rank)	23 / 178
Main religions	Roman Catholic (27%) Protestant (2.1%)	Gini index (income distribution)	25.8
		Population below \$1 per day (PPP)	n.a.
Head of State (president)	Václav Klaus	<b>Foreign trade</b> 2009	
Head of Government (prime-minister)	Petr Nečas	<i>Main export partners (%)</i> <i>Main import partners (%)</i>	
Monetary unit	Czech koruna (CZK)	Germany	32
		Slovakia	9
		Poland	6
		France	6
		Germany	31
		Slovakia	7
		Poland	7
		France	6
<b>Economy</b> 2010		<i>Main export products (%)</i>	
<i>Economic size</i> <i>bn USD</i> <i>% world total</i>		<i>Main import products (%)</i>	
Nominal GDP	192	0.31	Machinery & transport equipment
Nominal GDP at PPP	262	0.35	Intermediate manufactured goods
Export value of goods and services	148	0.80	Chemicals
IMF quatum (in mln SDR)	819	0.38	Raw materials & fuels
<i>Economic structure</i> 2010      5-year av.		<i>Main import products (%)</i>	
Real GDP growth	2.3	3.5	Machinery & transport equipment
Agriculture (% of GDP)	2	3	Intermediate manufactured goods
Industry (% of GDP)	37	38	Raw materials & fuels
Services (% of GDP)	60	59	Chemicals
<i>Standards of living</i> <i>USD</i> <i>% world av.</i>		<i>Openness of the economy</i>	
Nominal GDP per head	18248	185	Export value of G&S (% of GDP)
Nominal GDP per head at PPP	24905	212	Import value of G&S (% of GDP)
Real GDP per head	13476	168	Inward FDI (% of GDP)
			77
			74
			3.5

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

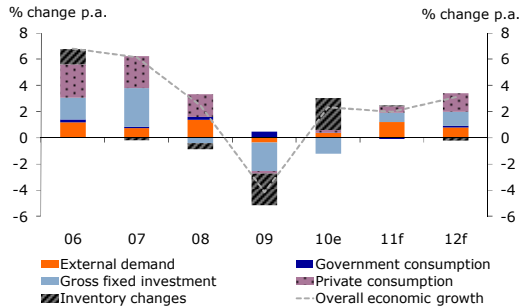
### Economic structure and growth

The economy of the Czech Republic is highly open and closely linked to neighbouring Germany. With a nominal GDP of USD 192bn in 2010, it is one of the smaller EU economies. In terms of nominal GDP per capita in PPP terms, the Czech Republic belongs to the most wealthy Central and Eastern European economies, second only to euro zone member Slovenia. Nominal GDP per capita in PPP terms is still about 30% lower than in Germany. The Czech economy is strongly industrialized, even compared to its Western neighbour, with manufacturing generating 37% of GDP in 2010. The country's manufacturing industry is dominated by the auto sector, which is closely integrated into German supply chains with Skoda, the Czech Republic's main car brand, being part of the Volkswagen group. Engineering outside of the automobile sector, another major source of national income, is increasingly shifting to high-tech production. With its various spas and the historic centre of its capital, Prague, the country's tourism sector attracts about 6.5mln foreign tourists each year. Owing to the integration of the respective manufacturing sectors and the dominance of intra-industry trade, exports to and imports from Germany account for about one-third of all Czech trade, respectively.

The Czech Republic's largely foreign-owned banking sector weathered the global financial crisis well. None of the country's institutions needed support from the government and the withdrawal of funds by foreign parent banks did not pose a problem as ample liquidity was provided by the European Central Bank and certain parent banks received capital support from their respective governments. The banking sector is well-capitalized with regulatory capital to risk-weighted assets standing at 15.6% in September 2010. Non-performing loans accounted for about 6.5% of all

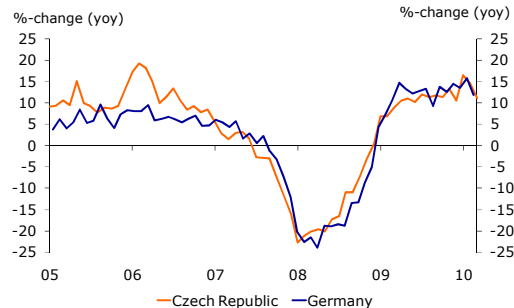
loans. Foreign currency risk is low, since about 93% of credit is denominated in Czech korunas. Despite foreign ownership, bank funding is predominantly done locally and domestic-currency deposits exceed loans. Owing to the banks' strong domestic retail focus, direct exposure to structured financial products, as well as euro zone government debt is quite limited. However, due to foreign ownership, Czech banks are indirectly exposed to these risks via their respective foreign parent banks, whose solvency, in some cases, has not yet been restored. Consequently, deteriorating asset quality at parent banks might lead to increased profit repatriations.

**Chart 1: Growth performance**



Source: EIU

**Chart 2: Industrial production**



Source: Eurostat

Even though the depth of the 2009 recession in the Czech Republic and Germany was comparable, with GDP growth at -4.1% and -4.7%, respectively, the Czech Republic's economic recovery remained relatively tempered. GDP in 2010 expanded by 2.3%, while Germany posted a record economic growth of 3.5% on the back of strong exports and rising investments. The Czech Republic's economic growth was mainly driven by inventory changes and, to a small extent, a rise in external demand. Exports likely suffered from declining sales of new cars in Europe, which is the Czech Republic's main export market. Sluggish private demand amidst budgetary consolidation also tempered economic growth, while investments were still on a downward trend last year. We expect that investments will pick up in line with improving exports, leading to 2% economic growth in 2011. Still, fixed investment growth will be limited by the end of the inventory restocking and declining investments in solar power. Growth in 2012 will likely increase to 3.1%, as private demand gains strength on the back of declining unemployment levels and government consumption growth turns positive amidst the phasing out of budgetary consolidation. Key risks to the Czech Republic's economic outlook stem from the ongoing European debt crisis, which could negatively affect the Czech Republic's banks through increased profit repatriation in order to support their foreign parent banks, hurting Czech credit provision. An escalation of the European debt crisis would also hurt external demand and likely lead to less investments into the Czech Republic's export industries.

**Political and social situation**

The current Czech government, consisting of Prime-Minister Petr Nečas's Civic Platform (ODS), the Tradition Responsibility Prosperity 09 (TOP09) party and the Public Affairs (VV) party, took office in June 2010. While only coming in second in the May 2010 parliamentary elections, the ODS managed to form a government as the Czech Social Democratic Party (ČSSD) failed in gaining support for a minority government from the far-left Communist party (KSČM) and the centre-right parties were not interested in a possible coalition with the ČSSD. Given that all parties forming the current Czech administration belong to the centre-right of the political spectrum, ideological differences within the coalition are quite limited. The main goals of the incumbent government are

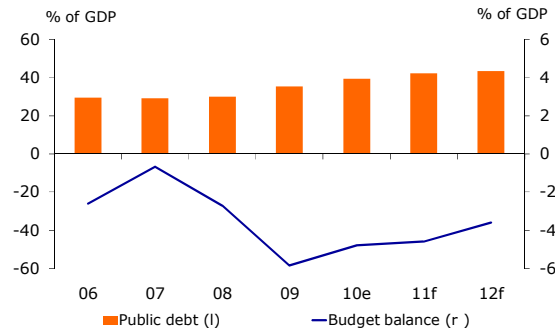
budgetary consolidation, labour and pension reform, as well as fighting corruption. The coalition enjoys a comfortable majority of 118 out of 200 seats in parliament, but owing to the ČSSD's success at the October 2010 senate elections, it does not have a majority in both chambers of parliament. Since the Senate can only block legislation in the fields of constitutional changes and foreign policy, the absence of a majority in the upper chamber will at most lead to delay in the passing of new laws. The Senate's recent rejection of the Czech Republic's national reforms plan, which is linked to the EU2020-strategy, illustrates that the government will likely face stiff opposition within the Senate as far as its plans for fiscal consolidation and structural reforms are concerned.

Even though hopes were running high last year that the newly elected government would bring some stability into Czech politics, allegations of corruption concerning several key politicians have seriously undermined the coherence of Prime-Minister Petr Nečas's three-party centre-right coalition. Despite a recent considerable cabinet reshuffle, tensions re-erupted when deputy Prime-Minister Radek John, leader of the Public Affairs party and in charge of fighting corruption, handed in his resignation claiming lacking support from the cabinet. His party threatened to leave the coalition unless new anti-corruption legislation was considered and the cabinet was reshuffled once more. While President Vaclav Klaus expressed his concern about the stability of the government, the cabinet survived a vote of no-confidence amidst the most recent crisis. While it remains to be seen whether the Public Affairs party will indeed leave the government amid low party approval ratings, the continuous tensions do not bode well for the realization of the administration's reform targets, even if the government were to remain in office for the entire legislative term. Still, we do not expect that the budgetary consolidation process should be seriously affected by the political tensions. In 2010, the previous government pushed through austerity measures despite upcoming elections, bearing witness to the preference for fiscal prudence among the Czech political elite. The Czech Republic's stance towards EU policies will likely remain pragmatic in the years to come as the ongoing European debt crisis strengthened euro-sceptic sentiment among Czech politicians. Relations with the United States will likely remain cordial.

### **Economic policy**

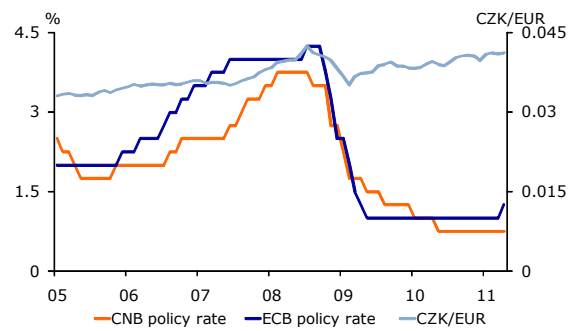
The Czech Republic currently faces various economic and fiscal policy challenges. In the short-term, the government needs to rein in the country's substantial budget deficit. Additionally, labour-market and pension reforms need to address ageing-related problems that will become an issue in the medium-term. The budget deficit had worsened considerably in 2009, increasing from 2.7% of GDP in the previous year to 5.8% of GDP, as tax revenues tumbled in line with falling output and fiscal stimulus measures equivalent to 2.2% of GDP were implemented. The previous government managed to push through budget deficit-narrowing measures equivalent to 2% of GDP ahead of the May 2010 parliamentary elections. The current government has made the further structural reduction of the deficit her top policy priority. Preferring expenditure cuts over tax increases, the incumbent government aims to reduce the budget deficit to 4.6% and 4.2% of GDP in 2011 and 2012, respectively. The government intends to meet the Stability and Growth Pact budget deficit criterion of 3% of GDP in 2013. Since most of the expenditure cuts are related to public wages and social security payments, substantial opposition from the country's trade unions can be expected, which will likely put the current instable government to the test. Delays to budgetary consolidation can thus not be excluded. As a consequence of the strong decline in output in 2009 and the implementation of stimulus measures, the Czech public debt ratio increased from its pre-crisis level of about 30% of GDP to 39% of GDP in 2010. Depending on the successful implementation of austerity measures, public debt growth in this and the next year will slow and public debt will likely amount to 42% of GDP in 2011 and 43% of GDP in 2012.

Chart 3: Public finances



Source: EIU

Chart 4: Policy rate and exchange rate



Source: CNB/ECB

In order to reduce fiscal risks in the medium- and long-term, the government has announced plans to reform the country's pension system. With the Czech Republic belonging to the fastest ageing European countries, the government intends to broaden the current pay-as-you-go pension system by introducing a privately managed mandatory second pillar. Despite cross-party consensus as to the need for such a reform, disagreement about the actual implementation had hindered progress in the past, limiting pension reforms to a rise in the retirement age and tightened eligibility standards for early retirement.

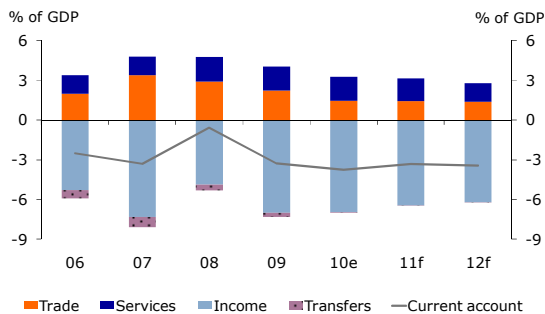
Czech monetary policy is expected to remain loose during most of 2011 as inflation pressures are limited by sluggish domestic demand and continuous appreciation of the Czech koruna, despite a negative interest rate differential with respect to the euro zone. The Czech central bank (CNB) had gradually cut its main policy rate from 3.75% in November 2008 to 0.75% in May 2010, undercutting the ECB rate by 25bp. While the ECB raised its main policy rate on April 13<sup>th</sup>, 2011, to 1.25%, CNB held its main policy rate steady as the ongoing European debt crisis could boost the Czech koruna, which should have an anti-inflationary effect. With inflation at 1.7% in March, below the 2% CNB target since December 2010, a very tempered economic recovery, and continuous appreciation of the local currency, CNB's decision to postpone its interest rate hike seems sensible. Since the turmoil of the European debt crisis has increased euro-scepticism among Czech policy-makers, we do not expect that the Czech Republic will join the euro zone soon. So far, the incumbent government has not set a target date for euro introduction and it will likely refrain from doing so in the remainder of its term. Referring to the need to meet certain fiscal criteria in order to be allowed to introduce the euro, prime minister Nečas recently stressed that the Czech Republic has a 'de-facto opt-out' clause, since it cannot be forced to meet these criteria.

### Balance of Payments

In line with several other emerging Central and Eastern European economies, the Czech Republic has been posting moderate current account deficits of about 4% of GDP in recent years, which were largely reflecting the economy's catching up process. Since 2005, the Czech current account deficit improved markedly as the country began generating trade surpluses in the range of 2%-3% of GDP. However, since the onset of the economic crisis in 2007, these trade surpluses are on a downward trend, as export growth has recently been outpaced by growing imports. Still, we expect that the Czech trade surplus will stabilize at about 1.4% of GDP in both 2011 and 2012. The development of the surplus on the services balance reflects these developments, with the services surplus likely amounting to 1.8% and 1.7% of GDP in 2011 and 2012, respectively. Partly owing to the relatively weak performance of the Czech Republic's goods and services exports, profit

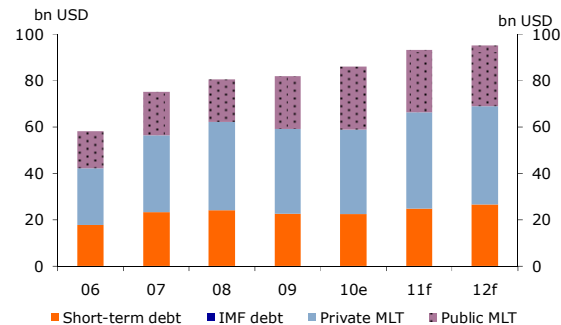
repatriations by foreign owners of Czech companies are expected to gradually decline in 2011 and 2012. This will lead to an improvement of the income account deficit from 6.9% of GDP in 2010 to 6.2% of GDP in 2012. Overall, these developments should lead to a stabilization of the current account deficit at about 3.3% of GDP in these years.

**Chart 5: Current account**



Source: EIU

**Chart 6: External debt**



Source: EIU

Even though net foreign direct investments declined strongly during the economic crisis, they will not bounce back in the coming years as demand for the Czech Republic's main exports remains tempered amidst a shaky recovery of the European economy. We therefore expect that net FDI will cover about 50% of the Czech current account deficit in both 2011 and 2012, while net portfolio investment flows will finance about 70% of the current account deficit in 2011 before declining to 50% in 2012. While the Czech Republic's dependence on portfolio investment and debt inflows is considerable, its good reputation on international capital markets should ensure the financing of the current account deficit in the years to come.

**External position**

The Czech Republic's external position is acceptable. Its total external debt stock is expected to remain at a constant 46% of GDP in the coming years, with medium- and long-term debt accounting for 2/3 of all debt. About 44% of all external debt is denominated in Czech koruna. In contrast to its Central and Eastern European peers, the Czech Republic is a net external creditor, which over the years enabled the private sector to build up an external asset stock that can be drawn down if the need were to arise. Owing to the country's tempered growth prospects, ongoing budgetary consolidation, as well as the likely development of a privately funded second pillar for the country's pension system, the Czech Republic will likely remain a net external creditor in the years to come.

With a liquidity ratio of 116% in 2011 and 114% in 2012, as well as foreign exchange reserves only covering 3.5 and 3.3 months in these years, the liquidity position is relatively weak. Foreign exchange reserves stood at 49% of total external debt in 2010 and are expected to increase to 52% and 55% in 2011 and 2012, respectively. Yet, we do not think that the relatively low level of foreign exchange reserves poses a problem for the Czech Republic as the floating exchange rate regime reduces the need to hold substantial reserves and the country's good reputation on international capital markets should ensure the availability of external financing.

Czech Republic							
Selection of economic indicators	2006	2007	2008	2009	2010e	2011f	2012f
<i>Key country risk indicators</i>							
GDP (% real change pa)	6.8	6.1	2.5	-4.1	2.3	2.0	3.1
Consumer prices (average % change pa)	2.5	2.9	6.3	1.0	1.5	2.2	2.2
Current account balance (% of GDP)	-2.5	-3.3	-0.6	-3.3	-3.7	-3.3	-3.4
Total foreign exchange reserves (mln USD)	31182	34550	36655	41157	42156	48810	52030
<i>Economic growth</i>							
GDP (% real change pa)	6.8	6.1	2.5	-4.1	2.3	2.0	3.1
Gross fixed investment (% real change pa)	6.0	10.8	-1.5	-7.9	-4.6	3.0	4.5
Private consumption (real % change pa)	5.0	4.9	3.6	-0.3	0.4	0.9	2.7
Government consumption (% real change pa)	1.2	0.5	1.1	2.6	0.3	-0.5	0.5
Exports of G&S (% real change pa)	15.8	15.0	6.0	-10.8	18.0	9.9	8.0
Imports of G&S (% real change pa)	14.3	14.3	4.7	-10.6	18.0	9.1	7.6
<i>Economic policy</i>							
Budget balance (% of GDP)	-2.6	-0.7	-2.7	-5.8	-4.8	-4.6	-3.6
Public debt (% of GDP)	29	29	30	35	39	42	43
Money market interest rate (%)	2.3	3.1	4.0	2.2	1.3	1.4	2.2
M2 growth (% change pa)	14	16	14	1	2	7	10
Consumer prices (average % change pa)	2.5	2.9	6.3	1.0	1.5	2.2	2.2
Exchange rate LCU to USD (average)	22.6	20.3	17.1	19.1	19.1	18.6	19.1
Recorded unemployment (%)	8.1	6.6	5.4	8.1	9.0	9.0	8.3
<i>Balance of payments (mln USD)</i>							
Current account balance	-3558	-5747	-1255	-6201	-7188	-6700	-7030
Trade balance	2843	5909	6333	4232	2813	2860	2890
Export value of goods	95147	122697	146232	107536	126354	150160	167830
Import value of goods	92304	116788	139900	103304	123541	147300	164950
Services balance	2000	2439	3913	3448	3443	3470	2840
Income balance	-7486	-12735	-10516	-13297	-13353	-12940	-12680
Transfer balance	-915	-1360	-985	-584	-90	-80	-90
Net direct investment flows	4043	8963	2257	1382	4964	3500	3700
Net portfolio investment flows	-3411	-3160	1805	4456	4772	4650	3570
Net debt flows	11771	14824	3060	3126	6077	7790	3900
Other capital flows (negative is flight)	-6989	-11506	-3766	1741	-7627	-2600	-920
Change in international reserves	1857	3374	2101	4504	998	6640	3220
<i>External position (mln USD)</i>							
Total foreign debt	58368	75332	80734	82114	86337	93580	95400
Short-term debt	17941	23399	24258	22718	22480	24870	26630
Total debt service due, incl. short-term debt	26365	33299	41411	42281	38792	41390	44160
Total foreign exchange reserves	31182	34550	36655	41157	42156	48810	52030
International investment position	-51781	-78283	-78719	-88822	n.a.	n.a.	n.a.
Total assets	90451	117195	122751	128298	n.a.	n.a.	n.a.
Total liabilities	142232	195478	201470	217120	n.a.	n.a.	n.a.
<i>Key ratios for balance of payments, external solvency and external liquidity</i>							
Trade balance (% of GDP)	2.0	3.4	2.9	2.2	1.5	1.4	1.4
Current account balance (% of GDP)	-2.5	-3.3	-0.6	-3.3	-3.7	-3.3	-3.4
Inward FDI (% of GDP)	3.9	6.1	3.0	1.4	3.5	2.7	3.0
Foreign debt (% of GDP)	41	43	37	43	45	46	47
Foreign debt (% of XGSIT)	50	50	44	60	55	51	47
International investment position (% of GDP)	-36.3	-44.9	-36.4	-46.7	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	23	22	23	31	25	23	22
Interest service ratio incl. arrears (% of XGSIT)	2	2	2	3	2	1	1
FX-reserves import cover (months)	3.6	3.2	2.8	4.1	3.6	3.5	3.3
FX-reserves debt service cover (%)	118	104	89	97	109	118	118
Liquidity ratio	122	120	115	116	116	116	114

Source: EIU

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