



Summary

The Czech Republic entered its second recession in three years. After the global financial crisis caused the economy to contract by 4.7% in 2009, it has failed to make a full recovery. Especially consumption remains subdued, as austerity measures and increased unemployment continue to depress domestic demand. As a result, slow growth in 2010 and the first half of 2011 was largely driven by the export sector. Unfortunately, the recession in the eurozone is reducing demand for Czech exports. Consequently, the first quarter of 2012 saw the economy contract by 1% q-o-q, constituting the third consecutive quarter in which GDP contracted. For 2012 as whole, we expect GDP to remain stable (i.e. we expect a 0% growth rate).

Still, large downside risks remain, including a eurozone break-up and excessive deleveraging by eurozone banks. On a more positive note, if the government fails to implement all the scheduled austerity measures, GDP growth may surprise on the upside.

Things to watch:

- Eurozone debt crisis and impact on Czech Republic (exports and FDI)
- Deleveraging by eurozone banks and impact credit availability in the Czech Republic.
- An ageing population and an expensive pension scheme

Author:

Anouk Ruhaak
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details:

P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-64860
A.N.Ruhaak@rn.rabobank.nl

Czech Republic						
National facts		Social and governance indicators		rank / total		
Type of government	Parliamentary democracy	Human Development Index (rank)	27 / 187			
Capital	Prague	Ease of doing business (rank)	64 / 183			
Surface area (thousand sq km)	79	Economic freedom index (rank)	30 / 179			
Population (millions)	10.5	Corruption perceptions index (rank)	57 / 183			
Main languages	Czech (95%) Slovak (2%)	Press freedom index (rank)	14 / 178			
Main religions	Roman Catholic (27%) Protestant (2%)	Gini index (income distribution)	25.82			
Head of State (president)	Vaclav Klaus	Population below \$1.25 a day (PPP)	0			
Head of Government (prime-minister)	Petr Necas	Foreign trade 2011				
Monetary unit	Czech koruna (CZK)	<i>Main export partners (%)</i> <i>Main import partners (%)</i>				
Economy 2011		Germany	32	Germany	30	
<i>Economic size</i> <i>bn USD</i> <i>% world total</i>		Slovakia	9	China	7	
Nominal GDP	215	0.31	Poland	6	Poland	7
Nominal GDP at PPP	273	0.34	France	5	Slovakia	6
Export value of goods and services	162	0.74	<i>Main export products (%)</i>			
IMF quatum (in mln SDR)	1002	0.46	Machinery and transport equipment	54		
<i>Economic structure</i> 2011 5-year av.		Intermediate manufactured	17			
Real GDP growth	1.7	2.8	Raw Materials and fuels	7		
Agriculture (% of GDP)	2	2	Chemicals	6		
Industry (% of GDP)	38	37	<i>Main import products (%)</i>			
Services (% of GDP)	60	61	Machinery and transport equipment	43		
<i>Standards of living</i> <i>USD</i> <i>% world av.</i>		Intermediate manufactured	18			
Nominal GDP per head	20423	190	Raw Materials and fuels	12		
Nominal GDP per head at PPP	25892	209	Chemicals	11		
Real GDP per head	14326	177	<i>Openness of the economy</i>			
		Export value of G&S (% of GDP)	75			
		Import value of G&S (% of GDP)	71			
		Inward FDI (% of GDP)	2.5			

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

Introduction and update

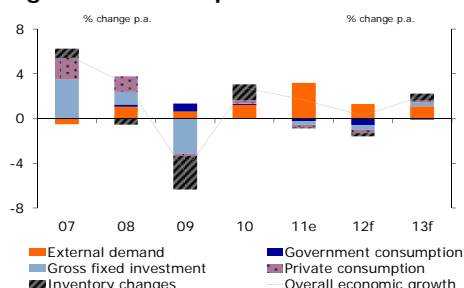
The Czech Republic was hit hard by the global financial crisis, which caused GDP to contract by 4.7% in 2009. A slow recovery in 2010 and the first half of 2011, is now being followed by a new recession. In the first quarter of 2012, the economy contracted by 1% q-o-q, constituting the third consecutive quarter in which GDP contracted. For 2012 as a whole, we expect production to remain the same as in 2011 (i.e. 0% growth). The lack of growth is caused by sluggish domestic demand and reduced demand in the eurozone, the main destination of Czech exports. Especially the latter is felt, since, in the absence of domestic demand, exports have been driving growth. Slowing exports are also expected to push up the current account deficit to 3% of GDP, from 2.1% of GDP in 2011, which is still below the pre-crisis deficit.

Despite the recession, we expect inflation to overshoot the 3% upper- limit set by the central bank, as increased taxes will push up prices. Still, in general, slow domestic demand and further austerity measures are expected to dampen inflation in the coming years.

On top of this already pessimistic outlook, the downside risks remain substantial. The first is the risk of a credit crunch, as a result of reduced lending by foreign banks, which are strapped for cash. On the upside, Czech banks, including the subsidiaries of eurozone banks, are well capitalized and most foreign lending is denominated in local currency (i.e. the Czech Republic's koruna). The possibility of a eurozone break-up presents another risk, with a potentially severe impact. This is not merely because of the importance of the eurozone, and specifically Germany, as the main destination for Czech exports, but also because of the importance of the region as the main source of foreign direct investments into the Czech Republic and, as discussed above, the overwhelming

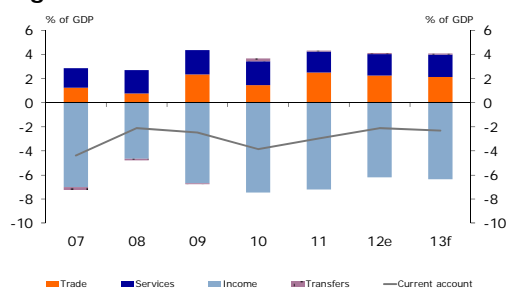
presence of eurozone banks in the country. All in all, these uncertain times provide little reason for optimism. On top of this uncertainty, the unstable coalition seems struggling to spur the necessary reforms and austerity measures needed to halt the increase in public debt (see below).

Figure 1: Growth performance



Source: EIU

Figure 2: Current account balance

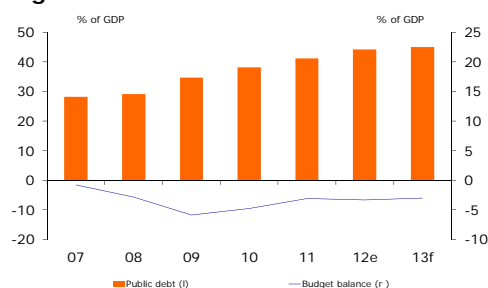


Source: EIU

An unstable coalition...

Last April, we witnessed the break-up of the Czech republic's coalition, previously made up of the public affairs party (VV), T09 and the Civic Democratic Party (ODS). The break-up was largely caused by a corruption scandal surrounding VV, which eventually caused it to leave the coalition. In addition, disagreement on the speed and nature of the many proposed austerity measures formed another point of friction. However, in light of the coalition's low popularity, the remaining coalition parties feared that they would not survive early elections. Indeed, the crisis and the austerity measures implemented over the last year have been fuelling public discontent. The fear of early elections proved sufficient motivation to find consensus and build a coalition, which now consists of ODS, T09 and a new fraction comprising former VV members. Still, the fact that the new coalition holds only a small majority makes it fragile. It thus appears unlikely that this coalition will survive until the parliamentary election in 2014.

Figure 3: Fiscal indicators



Source: EIU

... that is still set on reducing the fiscal deficit

The crisis in 2009, combined with the subsequent stimulus measures and continued slow growth caused the public debt to expand from 28% of GDP in 2007, to roughly 44% of GDP in 2012. Although the debt level itself is not an immediate cause for concern, also because it is largely financed domestically, the rapid increase is worrisome. In an attempt to control the public debt level, the government already implemented a series of austerity measures, including a reduction in social expenditure and public wages, as well as an increase in taxes. Together these and other measures helped bring down the budget deficit from 4.5% of GDP in 2010, to 3.1% of GDP in 2011.

Nonetheless, more is needed. In order to further reduce the budget deficit, the government proposed additional tax increases and recently approved a much-needed pension reform. Whether these proposals will also be adopted, however, is by no means certain. In light of the high level of public discontent, and given that the coalition only holds a small majority, the proposed tax increases may not pass parliament.

In an attempt to force the issue, prime-minister Petr Necas announced it will dismantle the government if the austerity measures are not accepted. On the one hand, this more than suggests that the government is taking its finances seriously. On the other hand, tying its fate to that of the austerity measures may prove a strategic blunder, which could create a far bigger mess than the one it hopes to solve. We therefore deem it unlikely that the government will be able to reduce the budget deficit to below 3% of GDP. Instead, we expect a budget deficit of roughly 3.5% of GDP, with large downside risks.

Czech Republic							
Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
<i>Key country risk indicators</i>							
GDP (% real change pa)	5.7	3.1	-4.7	2.7	1.7	0.3	2.0
Consumer prices (average % change pa)	2.9	6.3	1.0	1.5	1.9	3.3	2.1
Current account balance (% of GDP)	-4.4	-2.1	-2.5	-3.8	-2.9	-2.1	-2.3
Total foreign exchange reserves (mln USD)	34550	36655	41157	41909	39670	39810	42070
<i>Economic growth</i>							
GDP (% real change pa)	5.7	3.1	-4.7	2.7	1.7	0.3	2.0
Gross fixed investment (real % change pa)	13.2	4.1	-11.5	0.1	-1.2	-1.8	1.2
Private consumption (real % change pa)	4.1	3.0	-0.4	0.6	-0.5	-0.7	0.5
Government consumption (real % change pa)	0.4	1.2	3.8	0.6	-1.4	-3.0	-0.6
Exports of G&S (real % change pa)	11.2	4.0	-10.0	16.4	11.0	5.2	6.2
Imports of G&S (real % change pa)	12.8	2.7	-11.6	16.0	7.5	4.1	5.8
<i>Economic policy</i>							
Budget balance (% of GDP)	-0.8	-2.8	-5.9	-4.8	-3.1	-3.3	-3.0
Public debt (% of GDP)	28	29	35	38	41	44	45
Czech Republic, Money market interest rate (%)	3.1	4.0	2.2	1.3	1.2	1.3	1.2
M2 growth (% change pa)	16	14	1	2	4	1	5
Consumer prices (average % change pa)	2.9	6.3	1.0	1.5	1.9	3.3	2.1
Exchange rate LCU to USD (average)	20.3	17.1	19.1	19.1	17.7	18.7	18.8
Recorded unemployment (%)	6.6	5.4	8.1	9.0	8.5	8.6	8.7
<i>Balance of payments (mln USD)</i>							
Current account balance	-7931	-4782	-4849	-7602	-6348	-4340	-4940
Trade balance	2237	1704	4578	2802	5313	4580	4440
Export value of goods	106521	125112	99131	114026	138534	145610	161460
Import value of goods	104284	123407	94553	111223	133221	141030	157010
Services balance	2919	4371	3910	3927	3779	3670	3980
Income balance	-12684	-10550	-13184	-14803	-15601	-12750	-13520
Transfer balance	-403	-307	-152	472	161	150	160
Net direct investment flows	8963	2257	1953	4961	4149	1800	3500
Net portfolio investment flows	-3159	1808	7014	4771	12104	3340	1970
Net debt flows	14457	2331	3914	5701	7266	1800	3090
Other capital flows (negative is flight)	-8879	493	-3434	-6950	-19373	-3060	-1360
Change in international reserves	3451	2108	4598	882	-2202	-460	2260
<i>External position (mln USD)</i>							
Total foreign debt	74937	79568	81733	85626	95034	93750	96210
Short-term debt	22964	23105	22349	21732	23695	22250	21800
Total debt service due, incl. short-term debt	33216	40949	41058	38375	40204	42850	41320
Total foreign exchange reserves	34550	36655	41157	41909	39670	39810	42070
International investment position	-78433	-79863	-95292	-98817	-96237	n.a.	n.a.
Total assets	117195	122751	126225	129218	128652	n.a.	n.a.
Total liabilities	195628	202614	221517	228035	224889	n.a.	n.a.
<i>Key ratios for balance of payments, external solvency and external liquidity</i>							
Trade balance (% of GDP)	1.2	0.8	2.3	1.4	2.5	2.2	2.1
Current account balance (% of GDP)	-4.4	-2.1	-2.5	-3.8	-2.9	-2.1	-2.3
Inward FDI (% of GDP)	5.9	2.9	1.5	3.4	2.5	1.9	2.4
Foreign debt (% of GDP)	42	35	42	43	44	46	46
Foreign debt (% of XGSIT)	56	49	64	59	55	53	49
International investment position (% of GDP)	-43.5	-35.4	-48.6	-50.0	-44.7	n.a.	n.a.
Debt service ratio (% of XGSIT)	25	25	32	27	23	24	21
Interest service ratio incl. arrears (% of XGSIT)	3	3	3	2	2	1	1
FX-reserves import cover (months)	3.5	3.1	4.5	3.9	3.1	3.0	2.8
FX-reserves debt service cover (%)	104	90	100	109	99	93	102
Liquidity ratio	121	115	118	117	112	111	111

Source: EIU

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