April 1, 2021

Lead analysts:

Mikhail Nikolaev, Associate Director
+7 (495) 139-0302 ext. 179
mikhail.nikolaev@acra-ratings.ru

Zhannur Ashigali, Associate Director
+7 (495) 139-0302
zhannur.ashigali@acra-ratings.ru

ACRA affirms LT **AA** to the **Czech Republic,** outlook **Stable**

ACRA has affirmed the following ratings to the Government of the Czech Republic (hereinafter, the Czech Republic, or the country) under the international scale:

- **Long-term** foreign currency credit rating at **AA** and local currency credit rating at **AA**;
- **Short-term** foreign currency credit rating at **S1+** and local currency credit rating at **S1+**.

The outlook on the long-term foreign currency credit rating is **Stable** and local currency credit rating is **Stable**. This reflects the resilience of the country's macroeconomic and external positions to the COVID-19 shock and moderately weakening public finance position, which however has not driven the country's credit rating down. The **Stable outlook** assumes that the rating will most likely stay unchanged within the 12 to 18-month horizon.

Credit rating rationale

The Czech Republic's AA sovereign credit rating is supported by a wealthy economy, strong, though moderately weakening, fiscal position, efficient monetary policy, and a solid external position. The rating is constrained by the country's small and open economy that is highly concentrated on a particular industry and a narrow range of trade partners, which made it vulnerable to the negative consequences of the COVID-19 pandemic. Among the long-term challenges is the high cost of an aging population.

In 2020, the Czech Republic experienced the second deepest GDP fall in the CEE region after Croatia. Its economy contracted by 5.6%, though less than 6.5-10% expected by ACRA earlier. Certain recovery of external demand by the end of 2020, anti-crisis fiscal package, and a lower share of the services sector in comparison with the core Europe and its CEE peers allowed the country to avoid deeper contraction. ACRA expects that the country's EUR 214 bln economy will recover more slowly compared to its peers and the GDP growth in 2021 and 2022 is estimated at 3.0% and 4.5%, respectively.

The key factors that will affect the country's GDP in 2021 include the COVID-19 resurgence and effectiveness of the vaccination campaign. The Czech Republic has suffered from the third wave of COVID-19 occurred at the beginning of 2021, which was comparable with the preceding two. As for the speed of vaccination, it has been below the EU average so far, with 4.5 persons out of 100 fully vaccinated compared to 4.8 in the EU. The supporting factor for the GDP growth will be impact of EU funds, which amount disbursed to the Czech Republic will be higher than initially planned.

The Czech National Bank (CNB) swiftly responded to the crisis caused by the pandemic using conventional instruments. In 2020, it slashed the key rate twice by the total of 200 bp and set the policy rate at 0.25%. It also released additional liquidity for banks by lowering the countercyclical capital buffer by 125 bp to 0.5% (thus maintaining the levels of systemic risk buffer and capital conservation risk buffer), loosened conditions on mortgages and signaled its readiness to provide support with foreign currency liquidity and conduct quantitative easing operations. ACRA believes that the CNB's actions helped to contain the negative impacts of the crisis on the economy. Historically, the CNB has shown that it is able to achieve its goals and act efficiently. The case in point is the seamless abandonment of the currency floor in 2017, which did not cause any spikes in local currency and therefore inflation volatility. Prior the crisis, the CNB stopped the rate hiking cycle, which it launched in 2017 with the aim to keep inflation at the target of 2% (tolerance band is +/-1 p.p.). Elevated policy rate gave room for monetary easing at the onset of the COVID-19 crisis.

The country's fiscal position has weakened against the pre-crisis strong levels. In 2020, general government deficit reached 6.2% of GDP, which was better than the official autumn expectation (6.4%) and ACRA's estimate at 6.5%. Better than expected outcome was driven by higher than planned revenues, thanks to the GDP fall not so deep than expected and underutilization of the stimuli package.

The announced package was the biggest in the CEE region – around 20% of GDP, but it was primarily made up of guarantees, which were used only partially. Going forward, deficits will persist in the coming years. The latest official estimate for the 2021 budget deficit is 8.5% of GDP. ACRA expects the deficit to be at 8.0% and 6.0% of GDP in 2021 and 2022. Unlike 2020, when the fiscal gap was driven by one-off measures to support economy during the pandemic, in the coming years the one-off measures are supposed to gradually vanish and the recurrent ones to take the lead. Such measures include personal tax cuts (the contribution to deficit is around CZK 90 bln), increase in social benefits (CZK 28 bln), and higher salary and social transfers. The fiscal easing could be partially explained by the 2021 parliamentary elections.

EU funding inflows will support investments, which are expected by officials to increase by 12.3% this year. Last year, EU member states agreed on the new funding framework for the next budget period of 2021–2027. Apart from the regular Multiannual Financial Framework (MFF), this framework will include additional instruments designed to combat COVID-19 – Next Generation EU and SURE. The total amount of funding that will be available in next seven years is about EUR 2 trln, which is almost two times higher than the planned before COVID-19. Thus, the Czech Republic will benefit from this source and the total inflows in the next seven years are expected at around 20% of GDP.

ACRA believes that the government will comfortably cover its increased financing needs with borrowings. The government relies primarily on bonds denominated in local currency and it is ready to issue foreign currency denominated bonds both domestically and abroad. In case the government decides to issue Eurobonds, ACRA expects that the demand will be strong, taking into account that the last Eurobond issuance was as far back as 2012 (EUR 2.75 bln); in 2019 and 2020, the Ministry of Finance switched to domestic market to borrow in foreign currency and raised EUR 1.3 bln in total. The main instrument was fixed-rate bonds in the local currency; issuance of floating rate bonds and bills was limited. Banks were the main investors in government bonds in 2020. Even though non-residents increased their holdings by 0.8% last year, their share in the local currency government bonds had fallen by around 10 pp to 31% by the end of 2020.

Yields on CZK denominated government bonds have almost doubled in 2020, but this is not going to affect the country's ability to service its debt. The yield on ten-year bonds reached 2.0% by the end of March 2021. ACRA expects that debt level will reach 43.9% of GDP by the end of 2021, compared to 30.2% in 2019. Despite the increase, the Czech Republic spent mere 1.3% of its revenues to service the debt in 2020, which is lower than its CEE peers (around 3.1% on average). In case the yield continues to increase, CNB has an instrument to support the market. Moreover, cash accumulated by the government in 2020 amounted to around 16% of GDP.

The banking sector seems to have weathered the crisis well. The fundamentals of the country's banking industry looked solid prior to the crisis: banks were well-capitalized (21.4% of regulated capital to RWA), had a low share of non-performing loans (4.1% of gross loans), and met liquidity requirements. The macroprudential rules are strong. In particular, the CNB was one of the first regulators in Europe to introduce countercyclical measures, thus strengthening the banking regulatory framework.

As for the asset quality, the impact of the last year's crisis is yet to be seen. The forbearance measures like six-month holidays for social payments and a moratorium on the repayment of loans and mortgages were lifted at the end of last year. The fiscal package was large enough to support creditworthiness of economic agents and provide liquidity to employers, households, and banks. Going ahead, the ability to service debts will be driven by the speed of economic recovery.

Moreover, the rate of credit expansion among residents was moderate in 2020. It grew by 3.6% y-o-y (as of January 1, 2021), including loans granted to households (6.4%) and non-financial sector (-0.2%). The Q3 2020 data showed that the banking sector's profitability fell substantially: compared to 2019, ROE fell from 18.2% to 8.7% and ROA fell from 1.2% to 0.6%. Lower profitability in 2020 is likely associated with higher provisions, which will allow weathering potential risks with asset quality.

Other contingencies, although on a longer-term horizon, are the country’s aging population, which poses a challenge to its public finances. Due to a poor demographic situation, the Czech Republic's expenditures in support of elderly people are the highest among the CEE peers.

The Czech Republic’s ability to withstand external shocks is high. At the end of 2020, the country’s foreign currency reserves covered 82.6% of total external debt, whereas short-term external and FX debt were 14.0x and 188.0% covered, respectively. In 2020, the country’s net international investment position (NIIP) reached -12.6% of GDP, which was one of the strongest among its CEE peers. The local currency’s depreciation last year was only 3.0% vs EUR, and international reserves have increased. At the same time, improvement in the current account, which achieved 3.6% of GDP, is likely to be temporary. Exports were supported by the recovery in Germany, whereas imports contracted significantly. With the recovery of external demand, ACRA expects the current account surplus to diminish.

The country’s institutional framework is robust and the strongest among the CEE peers. Almost all of the Czech Republic’s governance indicators have been historically strong, with some having slightly improved in recent years. During 2020, the popularity of the leading party (ANO) decreased, which may lead to formation of a new coalition following the parliamentary elections in October 2021. However, ACRA expects the continuity in the strong economic policies.

Sovereign model application results

The Czech Republic has been assigned an AA Indicative credit rating in accordance with the core part of ACRA’s sovereign model.

A number of modifiers in the modifiers part of the model allow the Indicative credit rating to be increased. These include the following, which are determined by the Methodology for Credit Rating Assignment to Sovereign Entities under the International Scale:

- Efficacy of structural, economic and monetary policies;
- Fiscal policy framework and fiscal flexibility;
- Debt sustainability.

A negative modifier is the following:

- Sustainability of economic growth.

In view of the abovementioned modifiers, the Czech Republic’s credit rating has not been changed. Therefore, a Final credit rating of AA has been assigned. There are no extraordinary factors that could adjust the Final rating. In connection with this, the Assigned credit rating remains at AA.

Potential rating downgrade factors

- Slowdown in the recovery due to the COVID-19 resurgence;
- Further worsening of the fiscal position.

Potential rating upgrade factors

- Stronger than expected growth;
- Improvement in the budget position in the coming years;
- Alleviating the aging costs and economic competitiveness issues.

Issue ratings

No outstanding issues have been rated.

Regulatory disclosure

The sovereign credit ratings have been assigned to the Czech Republic under the international scale based on the Methodology for Credit Rating Assignment to Sovereign Entities under the International Scale and the Key Concepts Used by the Analytical Credit Rating Agency Within the Scope of Its Rating Activities.

The sovereign credit ratings of the Czech Republic were published by ACRA for the first time on October 29, 2019. The sovereign credit ratings and their outlook are expected to be revised within 182 days following the publication date of this press release as per the Calendar of planned sovereign credit rating revisions and publications.

The sovereign credit ratings are based on information from publicly available sources, as well as ACRA's own databases. The sovereign credit ratings are unsolicited. The Government of the Czech Republic did not participate in the credit rating assignment.

ACRA provided no additional services to the Government of the Czech Republic. No conflicts of interest were discovered in the course of the sovereign credit rating assignment.

Analytical Credit Rating Agency (Joint-Stock Company), ACRA (JSC)
75, Sadovnicheskaya embankment, Moscow, Russia
www.acra-ratings.com

The Analytical Credit Rating Agency (ACRA) was founded in 2015, with its 27 shareholders representing major Russian corporate and financial institutions and its authorized capital exceeding RUB 3 bln. ACRA's main objective is to provide the Russian financial market with high-quality rating products. Methodologies and internal documents of ACRA are developed in compliance with Russian legislation and with regard to global rating industry best practices.

The provided information, including, without limitation, credit and non-credit ratings, rating assessment factors, detailed credit analysis results, methodologies, models, forecasts, analytical reviews and materials, as well as other information placed on the ACRA website (further referred to as Information), coupled with the ACRA website software and other applications, are intended for information purposes only. Information must not be modified, reproduced or distributed by any means, in any way or form, either in whole, or in part, in marketing materials, as part of public relations events, in news bulletins, in commercial materials or reports without prior written consent from, and reference to, ACRA. Any use of Information in violation of these requirements or the law is prohibited.

ACRA credit ratings reflect ACRA's opinion about the ability of a rated entity to meet its financial obligations or about the credit risk of individual financial obligations and instruments of a rated entity at the time of publication of the relevant Information.

Non-credit ratings reflect ACRA's opinion about certain non-credit risks assumed by interested parties interacting with a rated entity.

The assigned credit and non-credit ratings reflect all material information pertaining to a rated entity and known by ACRA (including the information received from third parties), the quality and reliability of which ACRA considers appropriate. ACRA shall not be responsible for the accuracy of information provided by clients or relevant third parties. ACRA does not audit or otherwise verify the provided data and shall not be held responsible for their accuracy and completeness. ACRA conducts rating analysis of information provided by customers using its own methodologies, with the texts thereof available on ACRA's website – www.acra-ratings.com/criteria.

The only source that reflects the latest Information, including the one about credit and non-credit ratings assigned by ACRA, is ACRA's official website – www.acra-ratings.com. Information is provided on an "as is" basis.

Information shall be considered by users exclusively as ACRA's statement of opinion and must not be regarded as advice, recommendation or suggestion to buy, hold or sell securities or other financial instruments of any kind, nor shall it be viewed as an offer or advertisement.

Neither ACRA, nor its employees and persons affiliated with ACRA (further referred to as the ACRA Parties) provide any direct or implied guarantee expressed in any form or by any means regarding the accuracy, timeliness, completeness or applicability of Information for making investment and other decisions. ACRA does not act as a fiduciary, auditor, investment or financial advisor. Information must be regarded solely as one of the factors affecting an investment decision or any other business decision made by any person who uses ACRA's information. It is essential that each of such persons conduct their own research and evaluation of a financial market participant, as well as an issuer and its debt obligations that may be regarded as an object of purchase, sale or possession. Users of Information shall make decisions on their own, involving their own independent advisors, if they deem it necessary.

ACRA Parties shall not be responsible for any action taken by users based on Information provided by ACRA. ACRA Parties shall under no circumstances be responsible for any direct, indirect or consequential damages or losses resulting from interpretations, conclusions, recommendations and other actions taken by third parties and directly or indirectly connected with such information.

Information provided by ACRA is valid only as of the date of preparation and publication of materials and may be amended by ACRA in the future. ACRA shall not be obliged to update, modify or supplement Information or inform anyone about such actions, unless the latter was recorded separately in a written agreement or is required by legislation of the Russian Federation.

ACRA does not provide advisory services. ACRA may provide additional services, if this does not create a conflict of interest with rating activities.

ACRA and its employees take all reasonable measures to protect all confidential and/or material non-public information in their possession from fraud, theft, unlawful use or inadvertent disclosure. ACRA provides protection of confidential information obtained in the course of its business activities as required by legislation of the Russian Federation.