ACRA AFFIRMS LT AA TO THE CZECH REPUBLIC, OUTLOOK STABLE

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The following ratings have been affirmed 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 outlooks on the long-term foreign currency credit rating and the local currency credit rating are Stable. The Stable outlook assumes that the rating will highly likely stay unchanged within the 12 to 18-month horizon.

Positive rating assessment factors

- Relatively high level of welfare.
- Moderate level of public debt with a relatively deep domestic market.
- Prudent monetary policy.
- Strong external position.

Negative rating assessment factors

- Small size and high openness of the economy.
- Low diversification of the industrial sector.
- High dependence on the key trade partner.
- High energy dependence.

CREDIT RATING RATIONALE

In 2021, the Czech Republic's economy expanded by 3.5%, which is slightly more than ACRA's estimate of 3.3%. The growth was driven by strong consumption of households, recovery of investments, and robust dynamic of inventories. On the other hand, weak exports and solid imports limited the growth. Compared to other EU countries, the Czech Republic's recovery was rather weak, due to prolonged lockdowns and supply shortages of semiconductors, which negatively affected the automobile sector. In 2021, GDP increased by 5.3% in Euro area. Recent data (industrial production and retail sales, for example) signal the weak economy performance. Thus, ACRA estimates that this year's GDP growth will slow down to 1.2% and will be around 3% in the next two years.

The economy of the Czech Republic depends heavily on energy imports. According to the U.S. Energy Information Administration (EIA), the country's energy import is around 67% of energy produced internally. Russia is the main energy supplier. The Czech economy imports from Russia

100% of its total gas imports and 50% of oil imports. Due to this reason and because the country in landlocked, the Czech Republic, along with Hungary and Slovakia, was excluded from the EU ban on Russian oil imports that will become effective in December 2022. Increased energy prices will negatively influence various indicators, including inflation, current account, and budget balance.

The Czech Republic will continue to benefit from EU funds in the coming years. The total amount of available financing is around EUR 30 bln. The two main instruments are the regular seven-year (2021–2027) EU budget and the “Next Generation European Union” instrument. In 2013–2020, the country received more than EUR 25 bln of EU Funds. According to estimates made by officials, the cumulative impact of EU funds, since the accession to the EU in 2004 to 2024, is estimated at 45% of real GDP in 2020.

In the long term, the country’s GDP growth is constrained primarily by the high concentration on the automotive industry, which accounts for 10% of output and 23.3% of total exports. It exposes the country to industry-specific risks and risks associated with global trade tensions and environmental policies. Moreover, carmakers may be susceptible to major changes in the industry with a larger focus on electric vehicles, self-driving cars, and car sharing. Relatively high R&D expenditures (around 2.0% of GDP in 2020) and a high share of investments (26% of GDP) in 2021 could mitigate these risks.

The Czech Republic, along with other countries worldwide, is suffering from rising inflation. In June 2022, inflation reached 17.2% y-o-y, which is significantly above the upper tolerance band of the target (3.0%). The main driver is the energy prices that boost prices of housing, food and transportation. Currency appreciation, the unique factor for the Czech Republic among the CEE peers, will help partially mitigate the negative impact of energy prices on inflation. This year, koruna has become stronger against euro by 24% on average compared to the 2021 average.

In response to rising inflation pressure, the Czech National Bank (CNB) has hiked the key rate to 7.0%, 675 b.p. up cumulatively compared to the lowest value in the middle of 2021. An important feature of this inflation cycle is that inflation expectations are also increasing. In June 2022, analysts’ expectations of one-year inflation increased to 6.0%. In this environment, heightened inflation is likely to remain for a certain period. At the same time, it is reasonable to assume that the CNB will be more aggressive in its monetary policy. ACRA expects the average inflation rate above 13.0% (closer to 15%) this year before it slows to 3.0% in 2024.

In 2021, the general government deficit totaled 5.9% of GDP, comparable to that a year before (5.8% of GDP) and wider than ACRA’s forecast (4.0% of GDP). The main driver was poor revenue performance (4.7% growth) caused by personal tax cut decisions of the previous government and one-off anti-crisis measures to support the economy. Inflation will increase budget revenues this year, but due to surging energy prices and support to Ukraine, expenditures will increase as well. Recently, the Government approved the updated budget for this year, improving deficit to CZK 330 bln, compared to initially planned CZK 380 bln. According to ACRA's estimates, this year's deficit could be around 4.5% of GDP.

The general government debt is expected at 42.9% of GDP at the end of 2022, compared to 30% of GDP in 2019, before the crisis. ACRA believes that the government will comfortably cover its financing needs with borrowings. Thanks to a developed and relatively deep domestic market, the budget deficits in the previous two years were successfully financed mostly by fixed-rate, local currency-denominated notes and bonds. Unlike other central banks in the CEE region, the CNB did not buy government bonds in the secondary market. Because of higher yields on the local market, government may take advantage of borrowing in euro. Taking into account the fact that the last Eurobond issuance was in 2012, demand for a potential new issuance will be strong. Moreover, recent ECB decisions to accept member state's debt will help the country place Eurobonds. According to officials, a specific feature of the potential euro-denominated bonds could be the local governing law.

Debt affordability remains high with the ratio of interest payment to revenues low at 1.8% in 2021. ACRA expects this ratio to remain around 2.0% in 2022.

A long-term challenge for the country is the increasing cost of its aging population in terms of pensions, healthcare costs, long-term care, and education. According to the EU 2021 Aging Report, these costs will increase by 6.1 p.p. and reach 24.7% of GDP in 2070 vs. 18.6% of GDP currently. This increase of costs is the third largest among peers, after Slovakia and Slovenia.

The banking sector weathered the crisis well. The ratio of NPLs to gross loans totaled 2.9% in Q1 2022, close to the lowest level (2.37%) recorded in October 2020. By the end of Q1 2022, residential property prices had risen by 24.7% y-o-y — the highest rate in the EU. Prices are driven by strong demand and supply shortages of housing stock. On the other hand, recent interest hikes cooled down the prices. In November 2021, the CNB responded by reintroducing several macroprudential measures, which were lifted during the crisis, and raising the countercyclical buffer to 2%. Banks are well positioned to face this environment. Capitalization remains strong (the regulatory capital to RWA ratio was 19.6% in Q1 2022). The banking sector's profitability has recovered. In ACRA's opinion, there will be no need for the government to support the banking sector.

In the first six months of 2022, exports of goods and services measured in USD rose by 3.9% (by 13.9% measured in EUR) compared to the same period in 2021, while imports increased by 13.1% (24.1%). Energy prices were the main driver behind import dynamics. Despite this and thanks to lower outflows from primary account, current account balance in Q1 2022 was significantly better that in the last two quarters of 2021, when it was in deficit of USD 0.4 bln, compared to USD 3.9 bln and USD 2.4 bln in Q3 and Q4 2021. At the same time, there were speculative flows into financial account, which could cause appreciation of the koruna, but they were absorbed by Central Bank's reserves. ACRA expects a 2.5% current account deficit this year mainly due to higher energy prices.

The Czech Republic's ability to withstand external shocks is backed by a high level of reserves — USD 157.4 bln (EUR 150.6 bln) in June 2022. In Q1 2022, the country's foreign currency reserves covered 81.9% of total external debt, short-term (due in one year) external debt is covered by 10.9x (in 2021).

The country's institutional framework is robust and the strongest among CEE peers. Almost all of the Czech Republic's governance indicators have been historically strong, with some having slightly improved in recent years. In October 2021, the ruling party (ANO) lost a parliamentary election to the SPOLU coalition. It is reasonable to assume the continuity of economic policies under the new government. The first positive step was fiscal consolidation in 2022.

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:

- Monetary policy efficiency;
- Fiscal policy and fiscal flexibility.

In view of the abovementioned modifiers, the Czech Republic's Indicative credit rating has been raised. A Final credit rating of AA has been assigned. There are no analytical adjustments and limitations that could result in an adjustment of the Final rating. In connection with this, the long-term foreign currency credit rating remains at AA.

POTENTIAL OUTLOOK OR RATING CHANGE FACTORS

A positive rating action may be prompted by:

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

A negative rating action may be prompted by:

- Worsening of the fiscal position;
- Prolonged negative impact of high energy prices;
- Lower than expected growth.

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 credit ratings of the Czech Republic were revised and disclosed prior to the dates specified in the Calendar of sovereign credit rating revisions and publications due to prompt performance of revision procedures. Planned revision date: August 10, 2022, new revision date: August 5, 2022. Planned publication date: August 15, 2022, new publication date: August 10, 2022.The sovereign credit ratings and their outlooks are expected to be revised within 182 days following the publication date of this press release as per the Calendar of sovereign credit rating revisions and publications.

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

In assigning the credit ratings, ACRA used only information, the quality and reliability of which was, in ACRA's opinion, appropriate and sufficient to apply the methodologies.

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.

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.

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