Capital Market Dynamics

Foreign Exchange ► Following a sharp depreciation at the start of 2013 (about 2% versus the euro), the Czech koruna (CZK) remained weak through early February, tested by speculation of unconventional monetary policy easing and domestic political strife. Over a longer horizon, the currency is positioned for gradual appreciation, given the economy’s favourable recovery prospects, contained inflation profile, developed local capital markets and net external creditor position. We expect the CZK to close the year around 24.8 per euro, strengthening to 24.2 by end-2014.

Sovereign Debt & Credit Ratings ► The sovereign creditworthiness of the Czech Republic is solid, warranted by a stable monetary and fiscal policy framework, relatively low public and private sector debt and lack of significant external or banking sector vulnerabilities. Each of Standard & Poor’s, Moody’s and Fitch categorizes the nation’s long-term foreign-currency credit rating as investment grade (roughly on par with China, Japan and Chile), with a “stable” outlook. According to the assessment of S&P, the large proportion of domestic-currency debt affords the country a higher tolerance for leverage. Investor confidence is reflected in very low funding costs; the yield on the government’s 10-year benchmark bond, at 2.0%, currently trades around an all-time low, and is only 33 basis points higher than the yield on equivalent German bunds. This is the lowest spread within the Central and Eastern European peer group.

Economic Outlook

Growth ► Following a weak performance in 2013, the Czech economy should return to a stable growth trajectory by next year. We expect a negligible real GDP contraction this year of approximately ¼% to be followed by a +1¼% rebound in 2014. The current recession began in the first quarter of 2012 on account of the euro crisis and its adverse effects on domestic confidence, in tandem with ongoing, pronounced fiscal consolidation. A 0.2% q/q decline in output in the fourth quarter brought the total loss to 1.1% for the year overall. The unemployment rate reached 7.5% in December (up from 6.7% a year prior), though it remains below the European Union (EU) average of 10.7%. The Czech National Bank (CNB) foresees external demand as the sole driver of economic activity in 2013. By 2014, however, household and investment spending should start to pick up in the context of an accommodative monetary environment, a relaxed fiscal campaign, accelerating global growth and continued domestic banking sector stability. EU leaders recently approved the 2014-20 programming budget, which allocates €20.5 billion in investment funds to the Czech Republic, lower than the €26.7 billion received during the last budgetary period (2007-13), but still a noteworthy boost to Czech economic prospects over the medium term.

Inflation & Monetary Context ► The headline inflation rate spent most of 2012 above the central bank’s 1-3% tolerance range due to imported food prices and tax changes, including a value-added tax (VAT) increase. At 1.9% y/y in January, the rate is expected to stay slightly above the 2% target this year on the back of a second VAT hike, and to fall below in 2014. With the benchmark interest rate already at technical zero (0.05%), there has been some discussion of using unconventional policy measures, namely currency market interventions, to spur growth. After the last CNB meeting, however, this option seems a more remote possibility in light of recent currency weakness.

Fiscal & Current Account Balance ► The Czech Republic maintains a sturdy fiscal profile. Notwithstanding a spike in the fiscal deficit to 5% of GDP in 2012—due to one off factors, including a church restitution settlement and the temporary suspension of a portion of EU funding—the shortfall is set to narrow to below 3% by 2014. Normal EU funding should resume this year, though European Commission officials remain cautious of the government’s management of these distributions. The gross government debt is relatively low, though rising; it will likely peak at around 48% of GDP in 2014 (compared to 28% prior to the global recession). The nation’s robust trade surplus is more than offset by a substantial income account deficit resulting from profit repatriation of foreign-owned companies, leaving the current account in a deficit equivalent to 2½% of GDP in 2012. This should narrow modestly over the forecast horizon.

Institutional Framework & Political Environment

Governance ► The Czech political environment is fragile. The centre-right coalition government lacks a firm majority in either house of parliament, and must therefore rely on opposition support for policy/reform implementation, which has been slow. It has also been burdened by coalition infighting (most recently over the EU fiscal compact) and a series of corruption scandals, facing five votes of no confidence since coming to power in 2010. The next parliamentary election is scheduled for 2014, though a call for an early vote is highly possible. The World Bank ranks the Czech Republic 65th of 185 countries surveyed in its 2013 Ease of Doing Business report (29th of 31 OECD countries, above Greece and Italy), and notes a considerable improvement in business regulation since 2005.

Financial Sector ► The banking sector is profitable and well-positioned to withstand external financial volatility, given the high proportion of local-currency denominated loans and the fact that domestic subsidiary banks are net lenders to foreign parent banks. A Tier 1 ratio of 15.2% in the third quarter of 2012 suggests sufficient capital adequacy, while the non-performing loans ratio has remained relatively contained in recent years (5.1% as of the third quarter). The IMF notes that liquidity buffers are ample, but that supervision of the financial sector should be further improved.

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