

RESEARCH

Research Update:

Czech Republic FC 'A-/A-2', 'LC A/A-1' Ratings Affirmed; Outlook Positive

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Rationale

On Nov. 20, 2006, Standard & Poor's Ratings Services affirmed its 'A-/A-2' foreign currency and 'A/A-1' local currency sovereign credit ratings on Czech Republic. The outlook is positive.

The ratings on the Czech Republic are supported by good prospects for economic growth, a well-diversified economy, and an above-par external position. The challenge of implementing fiscal and social security system reforms, along with the need to improve labor market flexibility and the business environment, are the main constraining factors on the ratings.

The Czech Republic has a GDP per capita estimated at \$13,000 in 2006, which is high when compared with other 'A'-rated sovereigns. Its small and increasingly open economy is fully integrated with the EU-25 countries, which are the destination of about 85% of Czech exports. Medium-term economic prospects remain good, with GDP growth projected at above 4% in 2007 and 2008, after reaching about 6% in 2005 and 2006. Significant foreign direct investment (FDI) has supported the development of a strong services sector and a well-diversified manufacturing and export base. Exports are expected to continue their robust expansion and to remain the principal contributor to economic growth.

The general government deficit is expected to reach 3.8% of GDP in 2006, despite economic growth being higher than the government anticipated. The 2007 budget, drafted and passed during a period of political deadlock, is again expansionary. The general government deficit is expected to be nearly 4% of GDP, but gradually decline thereafter to about 3% in 2009, although costs related to expected pension and health care reform, may temporarily further increase the deficits in the short term. General government debt is forecast to rise from 32% of GDP in 2006 to more than 35% of GDP by 2009. The slower fiscal consolidation also means that the Republic would not be in a position to join ERM-II in 2007, thereby delaying the prospect of EMU membership originally planned for 2009-2010. Taking into account both the slowing progress with fiscal consolidation and the domestic political situation, Standard & Poor's expects the Czech Republic to join EMU no earlier than 2012.

The current account deficit is projected to remain at 3.0%-3.5% of GDP in the forecast period, given the strong export growth and rebounding domestic demand. FDI inflows, underpinned by reinvested profits and brighter EU-25 economic prospects, should continue to provide full coverage of the external gap. The Czech Republic is expected to remain in a net external creditor position in the foreseeable future.

Outlook

The positive outlook on the Czech Republic reflects the expectation that economic reform and fiscal consolidation will gain pace as a stable coalition government settles into power. In addition, good economic prospects and low external risks will preserve the economy's solid external position. If the government progresses with economic and fiscal reforms, for example in the areas of pensions and health care, its creditworthiness would improve. Conversely, if no substantial reforms, particularly in the social security system, are enacted in 2007, the outlook would revert to stable.

Ratings List

Foreign currency sovereign credit ratings
A-/Positive/A-2
Local currency sovereign credit ratings
A/Positive/A-1
Foreign currency senior unsecured debt
A-
Local currency senior unsecured debt
A
Local currency CP
A-1

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