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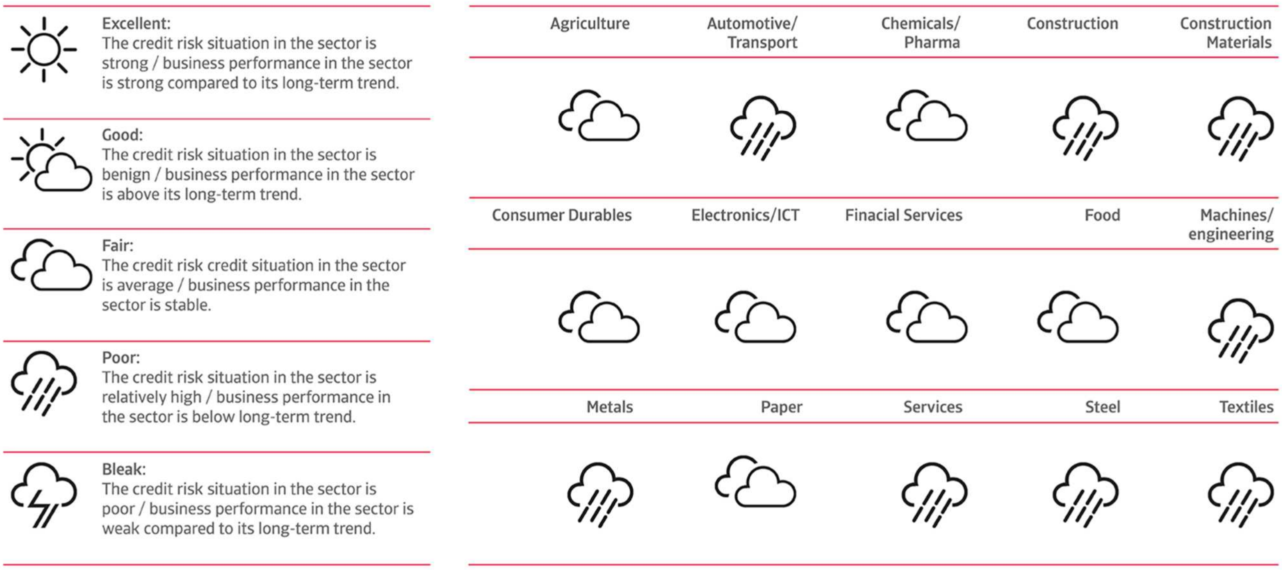
Czech Republic Country Report

October 2020

An economy highly vulnerable to foreign trade losses

Czech Republic industries performance forecast

October 2020



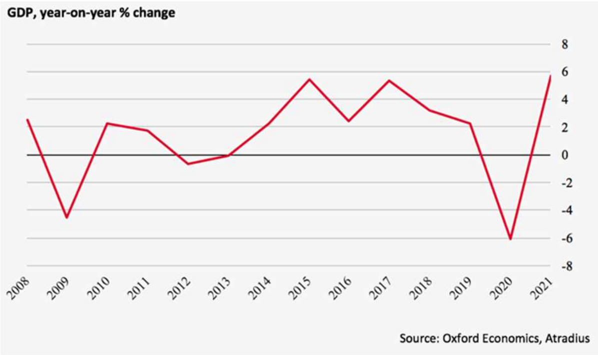
Political Situation

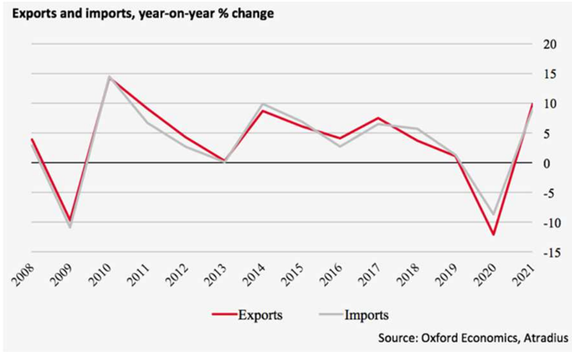
Minority government expected to remain in place until October 2021

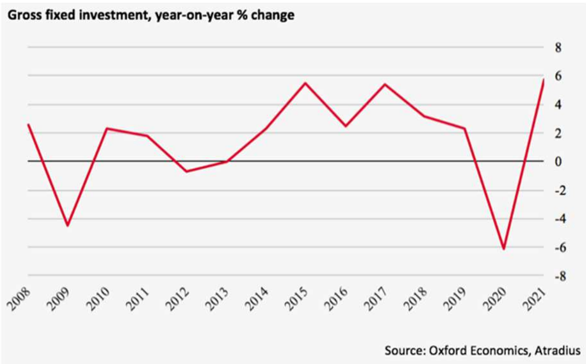
The current coalition government between the populist party “ANO 2011” (“Yes 2011”) and the leftist Czech Social Democratic Party (CSSD) is still lacking a majority, with only 93 seats in the 200 member parliament. However, due to an informal tolerance agreement, the government has the principal backing of the pro-Russian Czech Communist Party. At the same time, Prime Minister Andrej Babis from the ANO 2011 has also been able to secure majorities with the support of other parties.

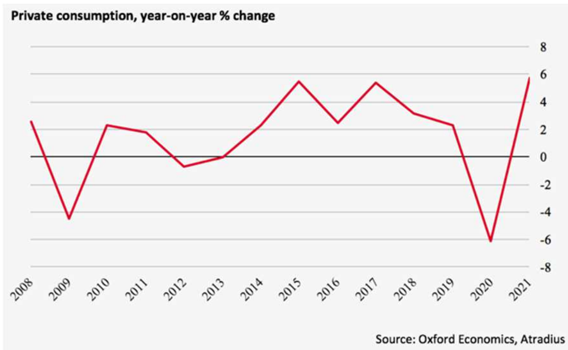
There has been some public pressure on Prime Minister Andrej Babis to resign, due to repeated allegations of abusing political power in both business deals and judicial matters. However, he and his ANO party still enjoy wide popular support, which has been mirrored by the outcome of the regional elections in early October 2020. It is expected that the current coalition government will remain in place until the next parliamentary election in October 2021.

Economic Situation









The economic downturn has hit mainly manufacturing and exports

Due to economic repercussions caused by the coronavirus pandemic, GDP contracted by 2% year-on-year in Q1 of 2020 and even by 11% in Q2. In April 2020 alone, manufacturing output and export of goods decreased by about 30%. While many restrictions on travel, economic activities and social meetings were abolished in May, the sharp increase in coronavirus cases since September is a downside risk for an economic rebound. In early October, the Czech government has again declared a state of emergency, accompanied by additionally tightening measures.

In 2020 the economy is expected to contract by about 6%, with industrial production and exports recording double-digit contraction rates (10.6% and 12% respectively). The Czech economy is highly integrated into international value chains, and at almost 70%, the export-to-GDP ratio is one of the highest in the EU, making the economy highly vulnerable to major foreign trade losses. Rising unemployment and adverse consumer sentiment are affecting private consumption, which is forecast to contract 4% in 2020. Inflation remains close to 3% in 2020, driven by the introduction of new indirect taxes, increases in food prices and a depreciation of the currency.

Comprehensive fiscal and monetary measures have been taken to counter the recession. In order to support the business cycle, the Central Bank reduced its key policy rate by 200 basis points between February and May 2020, to 0.25%. Additionally, it raised the number of repurchase auctions to raise liquidity levels in the banking sector. At the same time, the government announced a fiscal package of EUR 8.8 billion (4.3% of GDP), including wage subsidies for employers, a lowering of the VAT rate, tax waivers and tax deferrals, and loan guarantees.

Despite a major increase in 2020, public debt remains sustainable

Due to pandemic related additional spending and lower tax revenues, the fiscal deficit is expected to increase to more than 8% of GDP in 2020. This, together with a lower nominal GDP, will increase public debt to more than 44% of GDP in 2020, up from 28.5% in 2019. However, this is still relatively low compared to other EU countries. Public debt also remains manageable in terms of government revenues. Non-residents hold almost 50% of public debt, while less than 10% is denominated in foreign currency. Public debt is expected to remain rather resilient against interest rate and exchange rate shocks.

Banking sector remains robust

Recent stress tests by the Central Bank concluded that the Czech banking sector is well prepared for negative shocks during the pandemic. The capital adequacy ratio was higher than 18% by the end of 2019, while the non-performing loans (NPL) ratio was rather low at 2.5%. Another risk mitigating factor is that banks are not dependent on foreign capital. However, the ongoing recession reduces the profitability of banks and increases the NPL ratio. Real private sector credit growth is expected to slow down to 1.3% in 2020, in line with the economic downturn.

Ongoing woes in some major industries

The global and domestic economic downturn has mainly affected major sectors like automotive, construction, machines, metals and steel, and services.

Automotive is a key industry in the Czech Republic, with a high share of exports, mainly to Germany. Producers and suppliers have suffered from globally deteriorating sales for passenger cars and commercial vehicles, which has led to severe liquidity strains and cash shortfalls. Czech automotive value added is expected to contract by more than 22% in 2020.

At the same time, the construction industry has been severely affected by the recession, with postponements of projects and reduced order volumes. Operating margins are very tight in this industry, with increased credit risk mainly for smaller players.

Deteriorated demand from automotive and construction as key buyer sectors has had a negative impact on machinery and steel, as well as on metals producers and wholesalers. Those industries already recorded lower margins in 2019 due to increased labour and energy costs.

In the service sector, many segments have heavily suffered from the lockdown measures between March and May 2020, especially hotels and catering, restaurants, bars, entertainment and cultural events, travel agencies and tour operators. Due to the recent rise in infections, a rebound is unlikely in the coming months. Hotels and catering value added is expected to shrink 11% in 2020.

Rising insolvencies expected in the coming months

In order to support businesses, the government enacted various supportive instruments enabling companies to overcome cash constraints in the short-term. Additionally, a temporary special protection of debtors against insolvency petitions filed by their creditors was implemented (an amendment to the insolvency law as a response to the coronavirus related repercussions). While some support schemes like tax reliefs and short-time work have been extended, the amendment to the insolvency law has meanwhile expired. Therefore, it is expected that payment delays and business insolvencies will increase towards the end of 2020 and in early 2021, mainly in the industries mentioned above.

A strong rebound in 2021 expected if the pandemic is contained

Assuming the pandemic comes to a gradual end, a robust recovery of investments, exports and industrial output should lead to an economic growth rate of more than 5% in 2021. Inflation is expected to decrease below 2.5% as the pressure from food prices wanes and the koruna strengthens. The public deficit will decrease to about 3% of GDP.

However, this recovery outlook remains susceptible to downside risks. The recent rise of infections in several European countries, including the Czech Republic, casts a doubt over the strength of the recovery after the initial strong bounce. Ongoing subdued demand from the Eurozone and the UK would hurt a rebound of Czech exports. In the mid-term, the Czech export performance remains vulnerable to the structural challenges in the automotive sector (decreasing sales and profits, shift to more e-mobility away from combustion engines and potential US tariffs on car and car part imports from the EU).