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Investment
Essentials

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AXA Investment Managers - Research & Investment Strategy **WEEKLY COMMENT**

Czech Republic: the bright spot in Central Europe

Key points

- Czech Republic is a small, open economy particularly exposed to swings in external demand from Germany.
- Being exposed to Germany is actually an advantage for CZ: based on our estimates, the Czech GDP could increase by 2% this year, even discounting a slowdown in Germany.
- The Czech banking sector is well capitalized, with low ratios of non-performing loans relative to total loans and manageable liquidity needs, as domestic credit growth is primarily financed by domestic deposits.
- The probability of a crisis in the balance of payments is low, with the current account deficit stable at 2% of GDP and half of it financed by foreign direct investment.
- The Czech koruna is aligned with its fundamentals and supported by sound fiscal finances.

by
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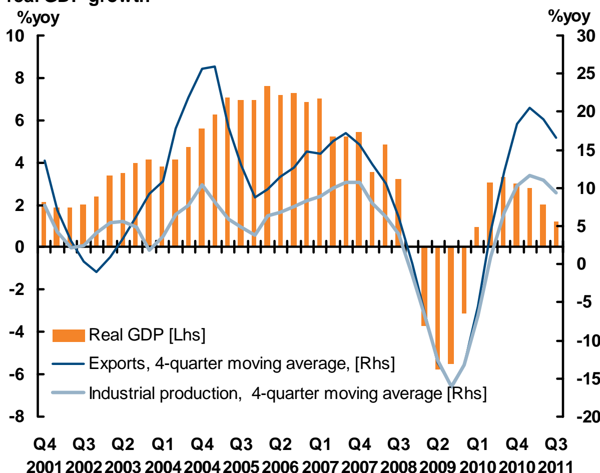
Exhibit 1

Weaker external demand signals that an economic slowdown is imminent



Source: Datastream, AXA IM Research

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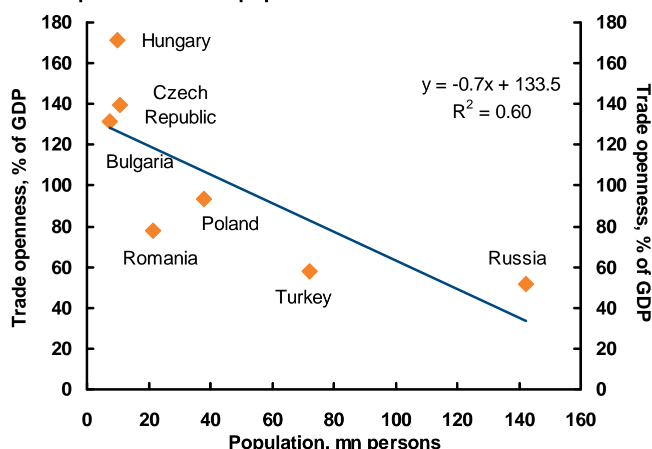
Economic activity is primarily dependent on external demand

The Czech Republic (CZ) is a small, open economy exposed to swings in external demand, as its high degree of openness demonstrates. Indeed, trade openness, defined as the sum of imports and exports as a percentage of GDP, is the second highest in the Central Eastern Europe (CEE), just behind Hungary (*Exhibit 2*). In particular, it is higher than that of a commodity dependent economy like Russia's. As the chart shows, there is a statistically significant inverse relationship between trade openness and population size in the CEE, signalling that domestic demand may not be enough to sustain economic activity in the countries most exposed to international trade should external demand subside considerably. CZ exports are comprised primarily of machinery and transport equipment (55% of total), manufactured goods (17%), and chemicals and related products (6%).

Exhibit 2

An inverse relationship exists between trade openness in CEE and population



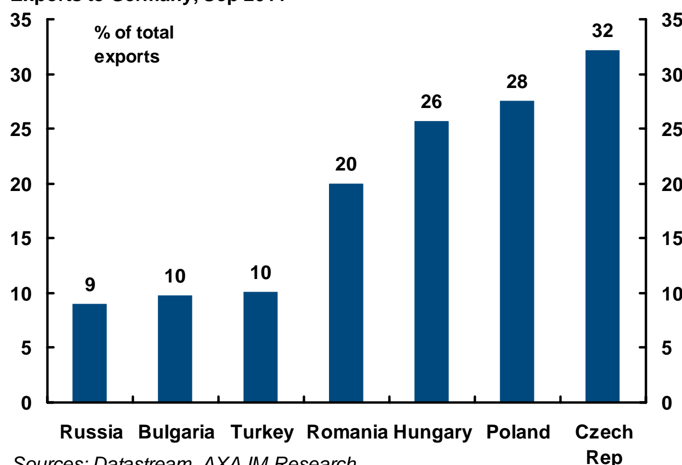
Source: Datastream, IMF World Economic Outlook Sept 2011, AXA IM Research

Being exposed to Germany is advantageous

The euro area sovereign debt crisis has proved to be versatile and long-lasting, testing the patience of international investors. In this tumultuous setting, investors avoid fiscally weak countries in the euro area and invest in countries with sound fiscal finances and strong macro fundamentals. Consequently, countries exposed through trade to these safe-haven economies can benefit from the more resilient prospects of their trading partner. Germany is an example of just such a safe-haven economy, to which CZ is particularly exposed through trade. *Exhibit 3* shows that the share of total exports shipped to Germany is the highest for CZ within CEE countries, making Germany not only the single most important trading partner of CZ but also a significant source of positive and negative economic shocks.

Exhibit 3

The share of total exports shipped to Germany is the highest for CZ



Sources: Datastream, AXA IM Research

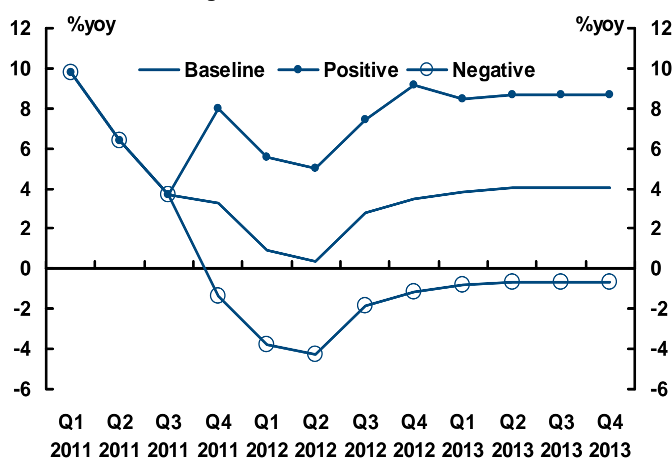
When the euro area and Germany plunged into recession in 2008, external demand for Czech exports tumbled, resulting in double-digit drops in industrial production and exports. Eventually, real GDP declined by 4.1%yoy in 2009. The large share of exports to Germany in total CZ exports is attributable to the outsourcing of German production and German foreign direct investment (FDI) to CZ. In fact, 13% of total inward FDI to CZ originate in Germany. The auto industry is still the largest single industry, accounting for about 20% of CZ manufacturing. More than 1mn cars were produced in 2010, and 80% of them were exported.

CZ exports and industrial production move in tandem with real GDP growth (*Exhibit 1*), implying that as the outlook for the German economy becomes more favourable, CZ exports and real GDP growth will improve as

well. More importantly, German domestic demand is likely to accelerate, thus underpinning CZ exports. The reason for this is that the German labour market is very tight, with unemployment down to 5.5% in December (EU harmonized data). Consequently, wage negotiations between employers and employees in Germany should imply a rise in real wages, of around 2%, in the medium term, offering a strong boost to the purchasing power of German consumers, which will benefit countries that ship a large portion of their exports to Germany.

Exhibit 4

Real GDP growth in CZ will remain positive in 2012-13 under our baseline scenario



Source: Datastream, AXA IM Research

Modelling the German-Czech link in the next part of the analysis, we delve into the exposure of the economic activity of CZ to the German economy through international trade. Specifically, we estimate a small structural econometric model, where CZ real GDP growth depends on CZ real credit growth and exports, while the latter depend on the German real GDP growth. After estimating, we simulate the path of real GDP growth in CZ under three different scenarios for real GDP growth in Germany. Under the baseline scenario, real GDP growth in Germany will average 0.9% in 2012 and 1.5% the following year, while real credit growth will match the 2010-2011 average. In *Exhibit 4,* we see that real GDP growth in CZ will be positive in 2012-2013 under the baseline scenario and will improve substantially once real GDP growth in Germany moves higher relative to that in the baseline scenario by one standard deviation (positive scenario). But it will decline considerably under the negative scenario, where real GDP growth in Germany is lower by one standard deviation. Hence, we anticipate that economic activity in CZ in 2012 will benefit from the decoupling of the German economy from its peers in the euro area, as higher real wages boost domestic demand and diversify the drivers of economic growth in Germany.

The banking sector is sound

CZ's banking sector is well capitalized, with low ratios of non-performing loans relative to total loans and manageable liquidity needs, as domestic credit growth is primarily financed by domestic deposits. Specifically, the core Tier I capital adequacy ratio stood at 14% in the 2nd quarter of 2011, well above the 9% threshold applied in the last round of stress tests run by the European Banking Authority. Moreover, non-performing loans are 6% of total loans, half the rate seen in Hungary, for instance. Credit expansion in CZ is primarily financed by domestic deposits, as credit is about 75% of deposits and compares favourably to the Baltic economies, where it is cruising above 150%. In fact, CZ has the lowest credit to deposit ratio in the CEE, signalling that reliance on foreign financing for the domestic credit expansion is low. The foreign exchange risk embedded in bank assets is limited as well. Loans in foreign currency stand at 20% of total loans, well below the 65% seen in Hungary and Romania, for example.

The probability of a balance of payment crisis is low

Furthermore, the risk of a balance of payment crisis is limited, since the current account deficit (2% of GDP) is limited and almost half of it is financed by net FDIs. The current account deficit is mostly attributable to a deficit of 7% of GDP in the income balance, with the balance of trade and current transfers posting a surplus of 5% and 0.3% of GDP, respectively. Furthermore, the income deficit consists primarily of a net deficit in dividends and reinvested earnings (90% of total income balance), rather than a deficit in interest debt

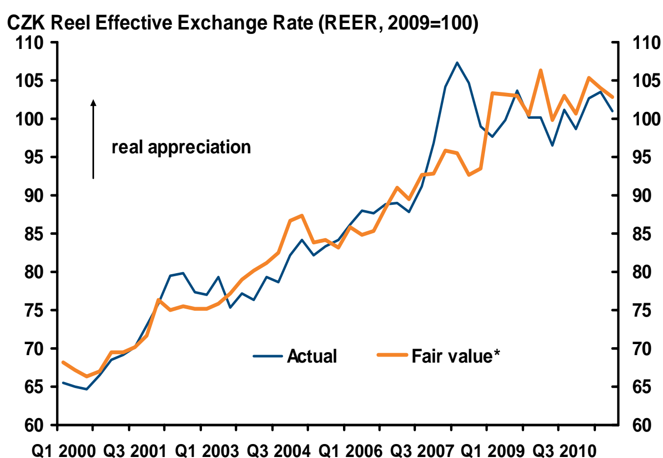
payments paid abroad. This feature implies that an economic slowdown will not only lower the import bill but will also automatically trim the income deficit, as foreign-owned companies will have fewer profits available for possible repatriation in a downswing. Eventually, the current account balance will improve considerably.

Sound fiscal fundamentals support the currency

The koruna depreciated considerably against other currencies in 2011, amidst uncertainty regarding the end result of the euro area sovereign debt crisis. However, the CZK is not mispriced in trade-weighted terms. According to our econometric model, the CZK is aligned to its macroeconomic fundamentals, i.e., net foreign assets and terms of trade (*Exhibit 5*). We anticipate that the koruna will depreciate further in the first half of 2012, before recovering subsequently given the country's sound fiscal fundamentals.

Exhibit 5

CZK is in line with its fundamentals



* REER implied by a regression on net foreign assets as a % of GDP and the terms of trade

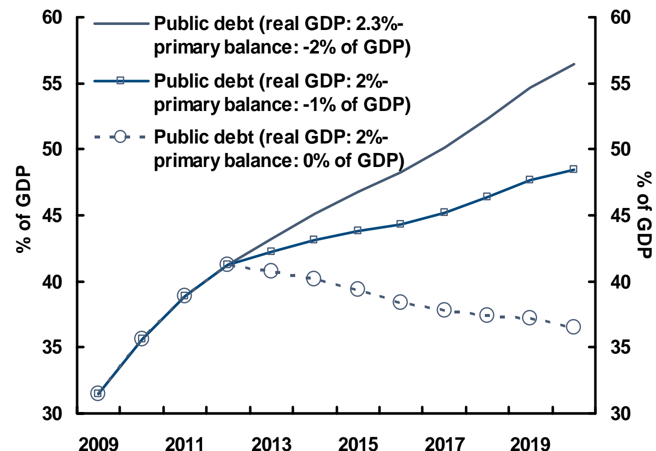
Source: Datastream, National Central Bank, AXA IM Research

Indeed, the fiscal deficit narrowed to 3.8% of GDP in 2011, from 4.1% in the previous year, and undershot the annual target of 4.6% for 2011. The 2012 budget pencils in a fiscal deficit of 3.2% of GDP, which at first glance appears attainable considering the government's successful track record. However, we should not expect the government to undershoot its target for the fiscal deficit again, since the ruling coalition is fairly fragmented and the likelihood of fiscal slippages has resurfaced. Specifically, a three-party, centre-right coalition government controls 115 of the 200 seats in the lower House of Parliament following elections in May 2010. But a series of corruption scandals and political obstruction to government reforms tested the stability of the coalition, as the second no confidence vote submitted in August 2011 by the junior partner in the coalition government showed. Moreover, the likelihood of fiscal slippages is further exacerbated by the government's recent refusal to join the "fiscal compact", which forges fiscal discipline in the euro area, citing the need to secure ratification at home first.

Government debt: progress needed

Exhibit 6

Sovereign debt dynamics considerably improve under a balanced primary budget



Source: Ministry of Finance, European Commission, AXA IM Research

The public debt of CZ is the seventh lowest in the EU, (40% of GDP as of 2011 Q3). Yet the sustainability of public debt is undermined by a persistent primary deficit. Indeed, the primary balance has posted a surplus only once (2004: 0.4% of GDP) since CZ joined the EU in 2004, and has been -2.5% of GDP on average. We see in *Exhibit 6* that, assuming a primary deficit of 2% on average and an annual growth rate of real GDP equal to potential (2.3%), the public debt would rise to 64% of GDP by end-2024. However, it is still below the

maximum sustainable level (i.e., the level beyond which a debt distress event is likely or inevitable) of 35% to 77% of GDP suggested for an emerging market by the IMF. We note in *Exhibit 6* that CZ sovereign debt dynamics would impressively improve should the primary budget be balanced, suggesting that it will not take much in terms of fiscal adjustment to bring debt dynamics towards the lower end of the IMF's proposed band of sustainability. Also, the sovereign debt is fairly insulated from foreign exchange risk, as only 17% of total debt is issued in hard currency, as opposed to Hungary, where almost half of the public debt is in foreign currency. Last but not least, the public debt is not prone to a high rollover risk as its average maturity is around 6 years, compared to the euro area average of around 7 years.

In conclusion, the Czech Republic is a small, open economy exposed to swings in international trade, but it can benefit once the economic prospects of its trading partners improve. Germany, CZ's closest trading partner, is currently decoupling from its euro area peers as domestic demand is expected to strengthen substantially in the years ahead on the back of real wage increases. The favourable outlook for the CZ economy is further enhanced by an extremely sound banking sector with low foreign exchange risk, manageable liquidity needs, and a high quality portfolio of loans. Finally, its sovereign debt is manageable as the fiscal effort needed to improve debt dynamics is within the government's reach, while the budgetary execution has been prudent thus far.

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