

Czech Republic



Targeting deficit reduction, privatisation, healthcare and tax reforms were at the top of the Czech Republic's governmental economic agenda in 2008. The strong economic growth of previous years presented an ideal opportunity for reducing the deficit and introducing structural reforms. The agenda started to change significantly in the third quarter of the year however when clear signs of financial and economic crisis spread across Europe.

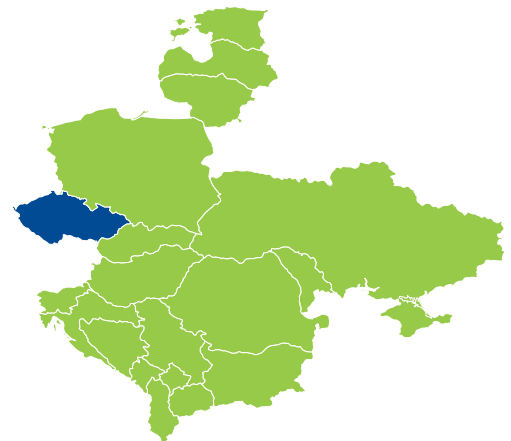
On the international stage, the Czech Republic assumed the EU Presidency during the first half of 2009, a particular challenge for a relatively small country. Its actual performance in this task was significantly affected when in March 2009 the ruling coalition was subject to a vote of no confidence in the Czech parliament. An interim government was appointed and parliamentary elections were brought forward to October 2009.

Discussions on adopting the Euro came to halt in 2009 following this vote of no confidence, and will in all probability only begin again following October 2009 parliamentary elections and the return of some stability to the turbulent economic climate. Further increases in the budget deficit, which is likely to exceed 4% in 2009 and 2010, could further delay the Czech Republic's introduction of the Euro.

Unemployment among the Czech Republic's 10.2 million population stood at 6% of the workforce, while the average gross monthly wage was EUR 915 – an increase of over 7% during the year, which together

with a weakening of domestic currency has upheld CPI inflation at 3.6% in 2008, still much higher than in 2005-2007.

Like all economies in Europe, the Czech Republic has been seriously affected by the rippling effects of the global recession. Strong growth from 2005 to 2007, when the country's GDP grew at annual rate of over 6%, was followed by a subsequent sharp economic decline in 2008 where the growth decreased to 3% while the fourth quarter in 2008 already showed decline. Current predictions estimate that GDP will decline by some 4% in 2009, reaching its low in the second and third quarter. This sudden shift from strong growth to economic decline presented a clear challenge both for the country's policy makers and its economy as a whole.



That said, the Czech economy is one of the most robust in the Central European region. Low levels of public debt (which should not exceed 40% of GDP in the foreseeable future, even after increases associated with the current crisis), favourable external debt, a high proportion of FDI in the net external position, and a trade balance surplus are all reducing the risk of economic destabilisation.



In 2008, the country's exports reached over EUR 107 billion, which even after the rapid decline towards the end of the year represents annual growth of 6.5% and an exceptionally high proportion of its EUR 138 billion GDP (77%). The value of the Czech Republic's exports significantly outweighed those of its imports, which rose by 4.6% in 2008 to almost EUR 100 billion.

However, as an open economy that is highly dependent on exports, the Czech Republic has seen demand plunge due to dramatically worsening economic conditions in Western Europe. The depreciation of the Czech Crown (after rapid appreciation peaking in mid-2008) has eased export pains for some companies, but this alone cannot compensate for the falling demand affecting many industries, such as car-manufacturing. A reliance on an export-oriented economy based in particular on manufacturing, the automotive and consumer electronics sectors, has delivered a serious blow to Czech growth

and employment prospects. There have been boosts for some sectors of the economy, such as the car scrapping bonus introduced by Germany and other European economies, which positively affected international sales of cars and car components manufactured in the Czech Republic, but such stimulus packages are temporary and the potential for market decline following their withdrawal presents a concern.

The Czech Republic has been proven in recent months to possess one of the CE region's strongest financial sectors. Generally favourable economic conditions and a primary focus by the banks on servicing the domestic economy (with a growing emphasis on retail lending products) reduce the costs of writing off toxic assets in the Czech banking sector due to their low exposure to such markets. This approach has also created a high deposit-to-loan ratio, which combined with the good liquidity of the Czech banks enabled them to weather the storm, at least in the short term.

Nevertheless, a majority of the banking institutions have tightened their credit terms to reduce their exposure within an economy that is facing unprecedented uncertainty. The key question facing the banks and their regulator is how large the losses arising from the declining quality of their loan portfolios could prove to be. While the Czech National Bank is suggesting that the banking sector can sustain substantial further economic decline, it is still not clear how much the Czech banks could be affected by the country's short-term economic development. So far, first quarter data for 2009 suggest that the banks continue to post strong profits even within a recession.

The commercial real estate and construction sectors are also affected by a decline in demand and the expectation of falling prices following the recent period of strong growth. As a consequence, the development of new office space came to a complete halt during the first half of 2009. In contrast, the demand for residential property is riding the recession better. The ability and willingness of the banks to continue providing mortgages (albeit under tighter lending criteria) also has the potential to help the market, which is still waiting for a pick up in activity as the majority of would-be buyers are waiting for the price reductions which are now to some extent underway.

Czech Republic	2005/2007 Average Values	2007-2008	2008
	Change (%)	Change (%)	
Population (mil.)	-0.1	-0.1	10.2
Average monthly gross wage (EUR)	11.3	7.1	915.2
EUR Exchange rate vis-à-vis	-4.4	1.0	26.8
USD Exchange rate vis-à-vis	-6.1	5.2	19.1
	Real change (%)	Real change (%)	EUR mil.
GDP	6.4	3.0	138,164
Private consumption	4.1	2.7	67,249
Public consumption	1.6	1.7	28,072
Gross fixed capital investments	6.2	-0.1	33,281
Exports (goods and services)	14.2	6.5	106,587
Imports (goods and services)	11.2	4.6	99,753
	Nominal change (EUR mil.)	Nominal change (EUR mil.)	EUR mil.
Trade balance	1,397	-796	2,522
Current account balance	209	-586	-4,611
General government balance	453	-738	-2,072
General government gross debt	4,705	3,694	37,372
External debt	7,698	9,520	47,965
Foreign currency reserves	23,871	2,251	25,692
	Percentage point change	Percentage point change	%
Economic activity rate	-0.1	-0.3	58.5
Unemployment rate	-1.2	0.0	6.0
CPI rate (previous year = 100%)	0.9	-1.8	3.6
Central bank interest rate	0.3	-1.3	2.3
Interbank PRIBOR 12M	0.5	-0.3	3.9
10-year yield on Treasury Bond	0.2	-0.4	4.3

Sources used: Reuters EcoWin Pro

Contacts

Czech Republic

Office Managing Partner

Michal Petrman
+420 246 042 520
mpetrman@deloittece.com

Function Leaders

Michal Brandejs
Audit
+421 2 582 49 210
mbrandejs@deloittece.com

Tomas Seidl
Tax
+420 246 042 655
tseidl@deloittece.com

Petr Kymlicka
Consulting
+420 246 042 480
pkymlicka@deloittece.com

Josef Kotrba
Financial Advisory
+420 246 042 366
jkotrba@deloittece.com

Vladimir Vanek
Enterprise Risk Services
+420 246 042 361
vvanek@deloittece.com

Industry Leaders

Mike Jennings
Financial Services
+420 246 042 576
mijennings@deloittece.com

Vladimir Vanek
Energy & Resources
+420 246 042 361
vvanek@deloittece.com

Dariusz Nachyla
Technology, Media & Telecommunications
+48 22 511 0631
dnachyla@deloittece.com

Diana Rogerova
Real Estate
+420 246 042 572
drogerova@deloittece.com

Martin Buransky
Public Sector
+420 246 042 351
mburansky@deloittece.com

Country Review Analysts

Tomasz Ochrymowicz
+48 22 511 0456
tochrymowicz@deloittece.com

Rafal Antczak
+48 22 511 0043
rantczak@deloittece.com

Clients & Markets

Matthew Howell
+420 234 078 558
mathowell@deloittece.com

Eva Usai Blumental
+420 246 042 751
eblumental@deloittece.com

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