

# CZECH REPUBLIC

Rating Analysis - 7/29/20

\*EJR Sen Rating(Curr/Prj) AA/ AA

\*EJR CP Rating: A1+

EJR's 3 yr. Default Probability: 1.0%

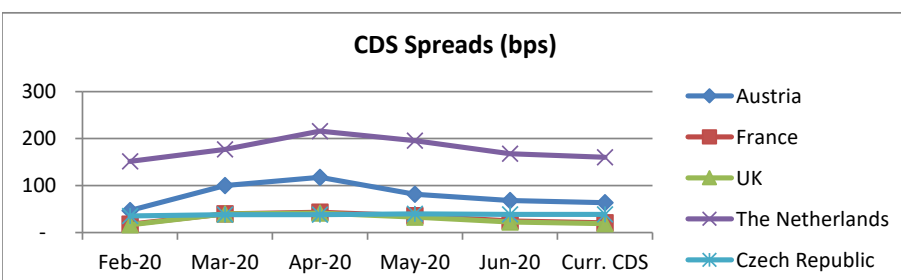
The spread of the pandemic has been contained, but despite this, the loss of production and disrupted supply chains have had a deep adverse economic impact. OECD expects the GDP to decrease by 13.2% in 2020 and expects the economy to recover only partially by end-2021. Bold policy support will help the economy recover from the crisis, but unemployment is likely to rise significantly from low levels.

Although consumer confidence has been firming from April's over seven plus year low, it remains well below its long-term average. Meanwhile, the industrial sectors are showing signs of respite with a climbing manufacturing PMI through Q2. That said, operating conditions for the sector remain weak due to depressed demand. The country has lifted most COVID19-related restrictions but a recent spike in new cases poses a sizable risk to the full resumption of activity. The GDP is seen shrinking 7.0% in 2020, before rebounding by 5.1% in 2021. On the more positive side, the business confidence index bounced back in June to 93.3 (May: 91.9) after declining for five consecutive months. We are affirming.

CREDIT POSITION	Annual Ratios (source for past results: IMF)					
	2017	2018	2019	P2020	P2021	P2022
Debt/ GDP (%)	35.9	32.5	31.1	30.6	30.5	30.7
Govt. Sur/Def to GDP (%)	0.8	1.1	0.7	0.5	0.3	-0.2
Adjusted Debt/GDP (%)	35.9	32.5	31.1	30.7	30.5	30.8
Interest Expense/ Taxes (%)	3.6	3.6	3.5	3.3	3.2	3.1
GDP Growth (%)	5.8	5.7	6.0	2.3	2.3	2.5
Foreign Reserves/Debt (%)	1.8	1.7	1.9	1.8	1.9	1.8
Implied Sen. Rating	AA+	AA+	AA+	AA	AA	AA

INDICATIVE CREDIT RATIOS	AA	A	BBB	BB	B	CCC
Debt/ GDP (%)	100.0	115.0	130.0	145.0	170.0	200.0
Govt. Sur/Def to GDP (%)	2.5	0.5	-2.0	-5.0	-8.0	-10.0
Adjusted Debt/GDP (%)	95.0	110.0	125.0	140.0	160.0	190.0
Interest Expense/ Taxes (%)	9.0	12.0	15.0	22.0	26.0	35.0
GDP Growth (%)	3.5	3.0	2.0	1.0	-1.0	-5.0
Foreign Reserves/Debt (%)	3.0	2.5	2.0	1.5	1.0	0.5

PEER RATIOS	Other NRSRO Sen.	Debt as a % GDP	Govt. Surp. Def to GDP (%)	Adjusted Debt/ GDP	Interest Expense/ Taxes %	GDP Growth (%)	Ratio- Implied Rating*
Federal Republic Of Germany	AAA	59.8	1.6	59.8	3.3	2.5	AA+
Kingdom Of The Netherlands	AA+	48.7	1.8	48.7	3.0	4.5	AAA
Republic Of Austria	AA+	70.3	1.2	70.3	5.2	3.1	AA+
French Republic	AA	98.1	-2.5	98.1	4.7	2.9	AA-
United Kingdom	AA	88.1	-1.2	88.1	8.0	4.3	AA+

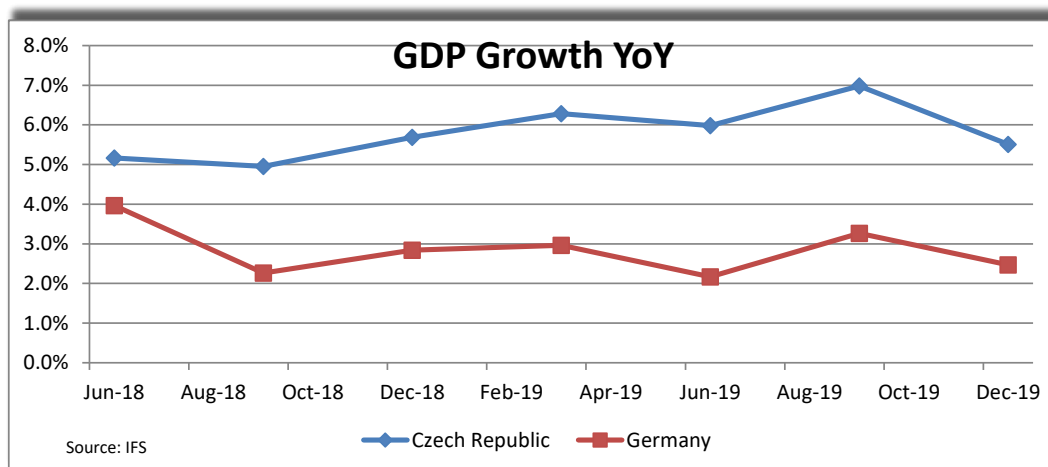


Country	EJR Rtg.	CDS
Austria	A+	63
France	A+	21
UK	A+	19
The Netherlands	AA-	160
Czech Republic	AA	38

**Economic Growth**

While retail sales data showed relatively mild contraction in April, after a positively revised March result, the industrial production data showed a larger fall associated with a negative revision to the March data. April industrial production dropped by 23% MoM in constant prices, following the slightly negative revised -11% reading in March (nominal exports fell by 19% MoM and imports by 12.6%). The car industry showed 72% MoM contraction and the non-car manufacturing -15% MoM, while the energy sector declined 12%. As a result, the IP fell by 34% YoY. The car industry fell by 80% YoY. New orders dropped by 42% YoY.

Weaker than expected industrial data reflects efforts by the Central Bank to keep its currency weak, given its expectation of a 34% YoY contraction in real total exports in Q2 2020. A weaker koruna, resilient producer prices and stronger policy action that in relative terms, underpin demand and reduce uncertainty are key factors to watch for.



**Fiscal Policy**

The recently announced fiscal support at almost 21% of GDP amid the steps already taken so far, have aided the Czech economy by 1.6% of GDP during April and May. The newly envisaged state budget deficit at CZK500bn also represents a positive risk, given the unallocated budgetary reserve at 1.8% of GDP which could mitigate the impact from additional shocks. The large fiscal transfers to the regional and municipal governments comes ahead of the regional elections in October 2020 and the not too distant general election in October 2021.

	Surplus-to-GDP (%)	Debt-to-GDP (%)	5 Yr. CDS Spreads
Czech Republ	0.73	31.08	38.49
Germany	1.58	59.76	14.33
The Netherla	1.84	48.70	20.78
Austria	1.17	70.34	18.94
France	-2.53	98.12	160.23
UK	-1.24	88.12	63.27

Sources: Thomson Reuters and IFS

**Unemployment**

The unemployment rate in the Czech Republic increased to 3.7 percent in May 2020 from 3.6 percent in the previous month and in line with market expectations. It was the highest jobless rate since February of 2018. The number of unemployed increased by 3.5 thousand from a month earlier to 269 thousand. A year ago, the jobless rate was lower at 2.6 percent. The economy is expected to contract sharply this year as Covid-19 and related containment measures shutters demand.

	Unemployment (%)	
	2018	2019
Czech Reput	2.27	2.04
Germany	3.40	3.20
The Netherla	3.84	3.76
Austria	4.86	4.53
France	9.11	8.43
UK	4.09	3.80

Source: Intl. Finance Statistics

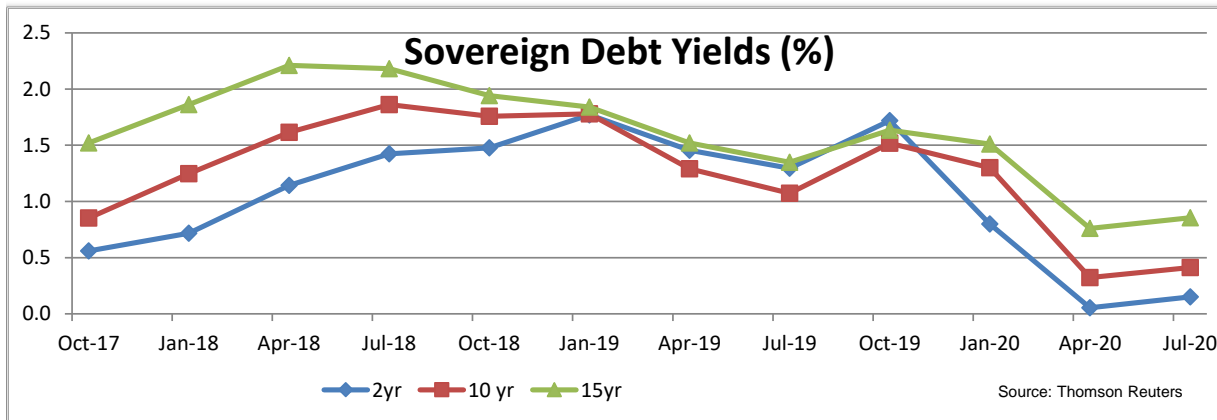
**Banking Sector**

The total assets of the Czech banking sector stood at CZK 8,719 billion at the end of May 2020. Loans to residents are the predominant asset item. Their volume reached CZK 6,186 billion. Deposits of residents, which are the most important item among banking sector liabilities, totalled CZK 5,469 billion. In the long-term, the Czech Republic Private Debt to GDP is projected to trend around 132.36 percent in 2021 and 130.92 percent in 2022.

Bank Assets (billions of local currency)		
	Assets	Mkt Cap/ Assets %
Komerčni Banka	1,059.9	14.1
<hr/>		
Total	1,059.9	
EJR's est. of cap shortfall at 10% of assets less market cap		-43.4
Czech Republic's GDP		5,652.4

**Funding Costs**

Czech Republic has lowered its interest rates by 0.75 percentage points, from 1% to an annual rate of 0.25%. This change is the first to have taken place since on March 27, 2020, when the Central Bank lowered interest rates by 0.75 percentage points to 1%. The Lombard rate and the discount rate were also kept at 1 percent and 0.05 percent, respectively. In the long-term, the Czech Republic Interest Rate is projected to trend around 1.00 percent in 2021 and 1.75 percent in 2022. Interest Rate in Czech Republic averaged 4.70 percent from 1995 until 2020, reaching an all-time high of 39 percent in June of 1997 and a record low of 0.05 percent in November of 2012.



**Ease of Doing Business**

Major factors for growing the economy are the ease of doing business and the economic freedom; although not the sole factor for determining economic growth, a country which makes it easy for businesses to operate and provides a reasonably free environment to conduct business has a good chance for growth. The chart on the right indicates that with an overall rank of 41 (1 is best, 189 worst) is above average.

The World Bank's Doing Business Survey*			
	2019	2018	Change in
	Rank	Rank	Rank
<b>Overall Country Rank:</b>	<b>41</b>	<b>30</b>	<b>-11</b>
<b>Scores:</b>			
Starting a Business	134	81	-53
Construction Permits	157	127	-30
Getting Electricity	11	15	4
Registering Property	32	32	0
Getting Credit	48	42	-6
Protecting Investors	61	62	1
Paying Taxes	53	53	0
Trading Across Borders	1	1	0
Enforcing Contracts	103	91	-12
Resolving Insolvency	16	25	9

\* Based on a scale of 1 to 189 with 1 being the highest ranking.

**Economic Freedom**

As can be seen below, Czech Republic is above average in its overall rank of 74.8 for Economic Freedom with 100 being best.

<b>Heritage Foundation 2020 Index of Economic Freedom</b>				
<b>World Rank 74.8*</b>				
	<b>2020 Rank**</b>	<b>2019 Rank</b>	<b>Change in Rank</b>	<b>World Avg.</b>
<b>Property Rights</b>	76.8	74.8	2.0	56.6
<b>Government Integrity</b>	64.2	47.6	16.6	43.8
<b>Judicial Effectiveness</b>	49.9	52.1	-2.2	45.1
<b>Tax Burden</b>	82.0	82.6	-0.6	77.3
<b>Gov't Spending</b>	52.7	52.1	0.6	66.0
<b>Fiscal Health</b>	97.8	97.6	0.2	69.1
<b>Business Freedom</b>	69.7	72.4	-2.7	63.3
<b>Labor Freedom</b>	77.6	78.1	-0.5	59.4
<b>Monetary Freedom</b>	80.8	81.5	-0.7	74.6
<b>Trade Freedom</b>	86.4	86.0	0.4	73.8

\*Based on a scale of 1-100 with 100 being the highest ranking.  
 \*\*The ten economic freedoms are based on a scale of 0 (least free) to 100 (most free).  
 Source: The Heritage Foundation

**Credit Quality Driver: Taxes Growth:**

Czech Republic has grown its taxes of 6.0% per annum in the last fiscal year which is more than the average for its peers. We expect tax revenues will grow approximately 6.0% per annum over the next couple of years and 5.4% per annum for the next couple of years thereafter.

**Credit Quality Driver: Total Revenue Growth:**

CZECH REPUBLIC's total revenue growth has been more than its peers and we assumed a 7.0% growth in total revenue over the next two years.

Income Statement	Peer Median	Issuer Avg.	Assumptions	
			Yr 1&2	Yr 3,4,5
Taxes Growth%	3.7	6.0	<b>6.0</b>	<b>5.4</b>
Social Contributions Growth %	4.1	7.3	<b>7.0</b>	<b>7.0</b>
Grant Revenue Growth %	0.0	NMF		
Other Revenue Growth %	0.0	NMF		
Other Operating Income Growth%	0.0	2.9	<b>2.9</b>	<b>2.9</b>
Total Revenue Growth%	3.6	6.1	<b>7.0</b>	<b>6.3</b>
Compensation of Employees Growth%	4.4	10.3	<b>10.3</b>	<b>10.3</b>
Use of Goods & Services Growth%	3.3	3.9	<b>3.9</b>	<b>3.9</b>
Social Benefits Growth%	3.3	8.0	<b>8.0</b>	<b>8.0</b>
Subsidies Growth%	7.3	8.6		
Other Expenses Growth%	0.0			
Interest Expense	1.8	2.3	<b>2.3</b>	<b>2.3</b>
Currency and Deposits (asset) Growth%	3.9	0.0		
Securities other than Shares LT (asset) Growth%	0.0	0.0		
Loans (asset) Growth%	0.8	(10.5)	<b>(10.5)</b>	<b>(10.5)</b>
Shares and Other Equity (asset) Growth%	7.9	1.2	<b>1.2</b>	<b>1.2</b>
Insurance Technical Reserves (asset) Growth%	1.8	0.0		
Financial Derivatives (asset) Growth%	7.6	(49.5)	<b>(10.0)</b>	<b>(10.0)</b>
Other Accounts Receivable LT Growth%	0.3	2.6	<b>2.6</b>	<b>2.6</b>
Monetary Gold and SDR's Growth %	0.0	0.0	<b>5.0</b>	<b>5.0</b>
Other Assets Growth%	0.0	0.0		
Other Accounts Payable Growth%	(0.7)	2.0	<b>3.0</b>	<b>3.0</b>
Currency & Deposits (liability) Growth%	5.1	(40.9)	<b>0.5</b>	<b>0.5</b>
Securities Other than Shares (liability) Growth%	2.7	3.4	<b>2.4</b>	<b>2.4</b>
Loans (liability) Growth%	(2.2)	(20.0)	<b>0.5</b>	<b>0.5</b>
Insurance Technical Reserves (liability) Growth%	0.0	(19.2)	<b>3.0</b>	<b>3.0</b>
Financial Derivatives (liability) Growth%	0.0	(29.0)	<b>(10.0)</b>	<b>(10.0)</b>
Additional ST debt (1st year)(billions CZK)	0.0	0.0		

**ANNUAL OPERATING STATEMENTS**

Below are Czech Republic's annual income statements with the projected years based on the assumptions listed on page 5.

	ANNUAL REVENUE AND EXPENSE STATEMENT					
	(BILLIONS CZK)					
	2016	2017	2018	2019	P2020	P2021
Taxes	972	1,043	1,106	1,172	1,242	1,317
Social Contributions	703	760	834	895	958	1,025
Grant Revenue						
Other Revenue						
Other Operating Income	<u>266</u>	<u>267</u>	<u>305</u>	<u>314</u>	<u>314</u>	<u>314</u>
Total Revenue	1,941	2,069	2,245	2,381	2,514	2,656
Compensation of Employees	419	462	521	574	633	698
Use of Goods & Services	291	296	326	338	352	366
Social Benefits	753	776	818	883	954	1,031
Subsidies	108	110	119	130	130	130
Other Expenses				144	144	144
Grant Expense						
Depreciation	209	212	220	230	230	230
Total Expenses excluding interest	<u>1,917</u>	<u>1,991</u>	<u>2,148</u>	<u>2,299</u>	<u>2,443</u>	<u>2,598</u>
Operating Surplus/Shortfall	24	78	97	82	72	57
Interest Expense	<u>44</u>	<u>38</u>	<u>40</u>	<u>41</u>	<u>42</u>	<u>42</u>
Net Operating Balance	-20	40	57	41	30	15

**ANNUAL BALANCE SHEETS**

Below are Czech Republic's balance sheets with the projected years based on the assumptions listed on page 5.

Base Case	ANNUAL BALANCE SHEETS (BILLIONS CZK)					
	2016	2017	2018	2019	P2020	P2021
<b>ASSETS</b>						
Currency and Deposits (asset)	433	549	577	601	673	676
Securities other than Shares LT (asset)	14	14	14	13	13	13
Loans (asset)	110	90	83	74	66	59
Shares and Other Equity (asset)	563	546	576	583	590	597
Insurance Technical Reserves (asset)	3	3	4	4	4	4
Financial Derivatives (asset)	2	1	1	0	0	0
Other Accounts Receivable LT	321	340	347	356	365	375
Monetary Gold and SDR's						
Other Assets					0	0
Additional Assets		<u>0</u>	<u>0</u>	<u>0</u>		
<b>Total Financial Assets</b>	<b>1,446</b>	<b>1,544</b>	<b>1,601</b>	<b>1,631</b>	<b>1,711</b>	<b>1,723</b>
<b>LIABILITIES</b>						
Other Accounts Payable	304	338	337	344	354	365
Currency & Deposits (liability)	8	6	9	5	5	5
Securities Other than Shares (liability)	1,802	1,724	1,629	1,685	1,726	1,767
Loans (liability)	154	141	172	137	107	93
Insurance Technical Reserves (liability)	8	7	5	4	4	4
Financial Derivatives (liability)	1	0	0	0	0	0
Other Liabilities						
<b>Liabilities</b>	<b>2,278</b>	<b>2,217</b>	<b>2,152</b>	<b>2,176</b>	<b>2,227</b>	<b>2,224</b>
<b>Net Financial Worth</b>	<b><u>-833</u></b>	<b><u>-673</u></b>	<b><u>-552</u></b>	<b><u>-545</u></b>	<b><u>-515</u></b>	<b><u>-500</u></b>
<b>Total Liabilities &amp; Equity</b>	<b>1,446</b>	<b>1,544</b>	<b>1,601</b>	<b>1,631</b>	<b>1,711</b>	<b>1,723</b>

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**Comments on the Difference between the Model and Assigned Rating**

In this case, there has been little change in the recent results and therefore we have used our best judgement in making adjustments which are reflected in the results for the projected ratings. We have assigned a rating of "AA" whereas the ratio-implied rating for the most recent period is "AA+"; we expect results to decline slightly.

**Changes in Indicative Ratios**

We have not made any adjustment in the indicative ratios at this time.



**SEC Rule 17g-7(a) Disclosure (Non-NRSRO)**

Below are the disclosures as required by Paragraph (a) of Rule 17g-7.

**1. The symbol in the rating scale used to denote the credit rating categories and notches within categories and the identity of the obligor, security, or money market instrument as required by Paragraph (a)(1)(ii)(A) of Rule 17g-7:**

For the issuer CZECH REPUBLIC with the ticker of 1040Z CP we have assigned the senior unsecured rating of AA. There are three notches in our rating categories (e.g., A- A, and A+) except for AAA and those deep into speculative grade, i.e., CC, C, and D do not have notches.

**2. The version of the procedure or methodology used to determine the credit rating as required by Paragraph (a)(1)(ii)(B) of Rule 17g-7:**

We are using the Methodologies for Determining Credit Ratings (Main Methodology) version #15 available via [egan-jones.com](http://egan-jones.com) under the tab at the bottom of the page "Methodologies".

**3. The main assumptions and principles used in constructing the procedures and methodologies used to determine the credit rating as required by Paragraph (a)(1)(ii)(C) of Rule 17g-7:**

The credit rating assigned reflects our judgement regarding the future credit quality of the issuer. Regarding the specific assumptions used, please refer to projections on pages 1, 6, and 7 of this Rating Analysis Report.

**4. The potential limitations of the credit rating as required by Paragraph (a)(1)(ii)(D) of Rule 17g-7:**

Our rating pertains solely to our view of current and prospective credit quality. Our rating does not address pricing, liquidity, or other risks associated with holding investments in the issuer.

**5. Information on the uncertainty of the credit rating as required by Paragraph (a)(1)(ii)(E) of Rule 17g-7:**

Our rating is dependent on numerous factors including the reliability, accuracy, and quality of the data relied upon in determining the credit rating. The data is sourced from publicly available information from the IMF and other similar sources. In some cases, the information is limited because of issues such as the lack of reported data, a delay in reporting data, restatements, inaccurate accounting and other issues. Such issues are not always readily apparent. EJR aims to identify such shortcomings and make adjustments using its best judgement.

**6. Whether and to what extent third-party due diligence services have been used in taking the rating action as required by Paragraph (a)(1)(ii)(F) of Rule 17g-7:**

EJR does not utilize third-party due diligence services.

**7. How servicer or remittance reports were used, and with what frequency, to conduct surveillance of the credit rating as required by Paragraph (a)(1)(ii)(G) of Rule 17g-7:**

Servicer or remittance reports normally pertain to structured finance issuers; this report does not pertain to a structured finance issuer (EJR is not an NRSRO for structured finance or sovereigns/ municipal issuers). Regarding surveillance, the minimum time period for corporation issuers is normally one year.

**8. A description of the data that were relied upon for the purpose of determining the credit rating as required by Paragraph (a)(1)(ii)(H) of Rule 17g-7:**

EJR uses publicly available information from the IMF, governmental filings and other similar sources for ratings on sovereign issuers.

**9. A statement containing an overall assessment of the quality of information available and considered in the credit rating as required by Paragraph (a)(1)(ii)(I) of Rule 17g-7:**

*The information is generally adequate and acceptable.*

**10. Information relating to conflicts of interest as required by Paragraph (a)(1)(ii)(J) of Rule 17g-7:**

This rating is unsolicited.

**11. An explanation or measure of the potential volatility of the credit rating as required by Paragraph (a)(1)(ii)(K) of Rule 17g-7:**

Our rating aims to assess the probability of the payment of obligations in full and on-time. Factors which affect such probability, and in turn our rating, include changes in the operating performance of the issuer, changes in capital structure, and merger and acquisition events.

**12. Information on the content of the credit rating as required by Paragraph (a)(1)(ii)(L) of Rule 17g-7:**

Regarding the historical performance of the credit rating, our rating transition matrix is available in our Form NRSRO, exhibit 1. The expected probability of default and the expected loss in the event of default is listed on the first page of this report.

**13. Information on the sensitivity of the credit rating to assumptions as required by Paragraph (a)(1)(ii)(M) of Rule 17g-7:**

Below is a summary of the impact of the 5 assumptions which independently would have the greatest impact on our "ratio-implied rating":

	Assumptions			Resulting Ratio-Implied Rating		
	Base	Optimistic	Pessimistic	Base	Optimistic	Pessimistic
Taxes Growth%	6.0	10.0	2.0	A1+	A1+	A1+
Social Contributions Growth %	7.0	10.0	4.0	A1+	A1+	A1+
Other Revenue Growth %		3.0	(3.0)	A1+	A1+	A1+
Total Revenue Growth%	7.0	9.0	5.0	A1+	A1+	A1+
Monetary Gold and SDR's Growth %	5.0	7.0	3.0	A1+	A1+	A1+

**14. If the credit rating is assigned to an asset-backed security, a description of: (i) the representations, warranties, and enforcement mechanisms available to investors; and (ii) how they differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities, as required by Paragraph (a)(1)(ii)(N) of Rule 17g-7:** This credit rating is not assigned to an asset-backed security.

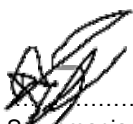
**ATTESTATION FORM**

In compliance with the US Securities and Exchange Commission (SEC) Rule 17g-7(a), the Egan-Jones analyst who published the report is responsible for the rating action and to the best knowledge of the person:

- 1) No part of the credit rating was influenced by any other business activities,
- 2) The credit rating was based solely upon the merits of the obligor, security, or money market instrument being rated, and
- 3) The credit rating was an independent evaluation of the credit risk of the obligor, security, or money market instrument.

**Analyst Signature:**

**Today's Date**

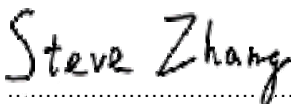


July 29, 2020

.....  
Sun Amanuel NG  
Senior Rating Analyst

**Reviewer Signature:**

**Today's Date**



July 29, 2020

.....  
Steve Zhang  
Senior Rating Analyst

**(Note, see our senior report for additional disclosures.)**

## Sovereign Rating Methodology (Non-NRSRO)

**Scope and Limitations: Sovereign Issuer Credit Quality Ratings (CQR) are a forward-looking assessment of a sovereign's capacity and willingness to honor its existing and future obligations in full and on time. Sovereigns are assigned two CQRs: a Local-Currency CQR, which reflects the likelihood of default on debt issued and payable in the currency of the sovereign, and a Foreign-Currency CQR, which is an assessment of the credit risk associated with debt issued and payable in foreign currencies.**

**Key Rating Drivers: EJR's approach to sovereign risk analysis is a synthesis of quantitative and qualitative judgments. The quantitative factors EJR uses are:**

- Debt in relation to GDP.
- Surplus or deficit in relation to GDP.
- Debt plus potential under-funding of major banks in relation to GDP.
- Interest expense in relation to taxes.
- GDP growth.
- Foreign reserves in relation to debt.

Debt levels for many sovereign issuers have increased at an accelerating rate over the past decade, affecting implied ratings. EJR also considers unemployment levels and funding costs. EJR recognizes that no model can fully capture all the relevant influences on sovereign creditworthiness, meaning that the its sovereign ratings can and do differ from those implied by the rating model. Some of the qualitative factors that impact its ultimate assessment of credit quality include the flexibility, stability and overall strength of the economy, efficiency of tax collection, acceptance of contract law, ease of doing business, trade balances, prospects for future growth and health and monetary policy, and economic freedom. These subjective and dynamic qualitative issues are not captured by the model but affect sovereign ratings.

*For additional information, please see Exhibit 2: Methodologies in EJR's Form NRSRO.*