

Credit Opinion: Liberec, Region of

Liberec, Region of

Czech Republic

Ratings

Category	Moody's Rating
Outlook	Stable
NSR Issuer Rating -Dom Curr	Aa1.cz

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Key Indicators

Liberec, Region of

	2002	2003	2004	2005	[1]2006
Net Direct and Guaranteed Debt/Operating Revenue (%)	0.00	0.00	3.58	5.87	6.74
Debt Service/Total Revenue (%)	0.00	0.00	0.00	0.02	0.13
Gross Operating Balance/Operating Revenue (%)	6.14	3.76	4.57	9.81	10.05
Cash Financing Surplus (Requirement)/Total Revenue (%)	2.68	1.16	2.88	-0.64	-3.52
Intergovernmental Transfers/Operating Revenue (%) [2]	99.34	99.02	97.22	97.38	97.85
Self-Financing Ratio	1.00	1.00	1.00	0.95	0.75
Capital Spending/Total Expenditure (%)	10.18	6.73	7.10	11.61	13.58

[1] Adjusted budget as of April [2] Intergovernmental transfers = current transfers + shared taxes

Opinion

Credit Strengths

Credit strengths for the Liberec Region include:

Greater spending autonomy following recent changes to revenue structure

Good operating performance

Supportive cash position

Manageable debt service obligations

Credit Challenges

Credit challenges for the Liberec Region include:

Limited revenue flexibility and capacity to generate independent sources of revenue

Rigidity in operating expenses

Limited capacity to take on debt to fund infrastructure needs

Rating Rationale

Moody's assigns a national scale issuer rating of Aa1.cz to the Liberec Region. The rating, as affirmed with the application of Moody's Joint Default Analysis rating methodology for regional and local governments (RLGs), reflects the following inputs: a) Baseline Credit Assessment (BCA) of 7 (on a scale of 1 to 21, where 1 represents the lowest credit risk); b) the A1 local currency rating of the Czech Republic Government; c) 90% default dependence (degree to which the region's and the Czech Republic's default risks are correlated); and d) 35% likelihood that the central government would act to prevent a default by the region.

Liberec Region's BCA of 7 reflects the following factors:

The operating environment for Czech RLGs reflects that of OECD emerging market economies, with a relatively high GDP per capita within the emerging markets universe, modest GDP volatility and a relatively high ranking on the World Bank's Government Effectiveness Index. The combination of these characteristics suggests a moderate level of systemic risk, as reflected in the A1 rating assigned to debt issued by the national government.

The BCA also reflects the current institutional framework for Czech RLGs, the main features of which include limited spending flexibility and heavy reliance on earmarked central government transfers, with no leeway for regions to generate additional own-source revenue. As it is still evolving, the framework may also contain some elements of unpredictability. This combination of factors limits the ability of Czech regions to plan and constrains debt servicing capacity.

Despite a rigid and still evolving fiscal framework, the Liberec Region has been generating positive operating results and, so far, has borrowed little to fund investment. In 2005, the region posted a modest financing deficit due to a sharp increase in capital expenditure. In 2006 it borrowed to cover part of the cost of road reconstruction, pushing its debt ratios slightly above the peer group average. Nevertheless, debt obligations remain easily manageable, well within the region's repayment capacity under current operating performance and repayment schedules. However, significant additional long-term borrowing under the current financial framework, with revenue heavily dependent on central government allocations and national economic growth, would likely put pressure on the region's financial profile.

Default dependence of 90% reflects heavy reliance on central government resources either in the form of shared taxes, which are determined and collected nationally and redistributed on a per capita basis, or transfers from the state budget.

A 35% likelihood of extraordinary support reflects Moody's assessment of the central government's promotion of greater accountability for Czech regions. The limited oversight exercised by the central government also suggests a policy favouring non-intervention. Finally, reputation risk issues for the central government would appear modest given the region's low indebtedness, which primarily takes the form of bank loans.

Rating Outlook

The stable rating outlook is based on the expectation that, under the current institutional framework, the region will not add significantly to its debt and will maintain positive financial performance.

What Could Change the Rating - Up

Changes in the financial and institutional framework that significantly improve the region's self-funding and debt-repayment capacity, notably in the form of changes in the law or additional sources of revenue and greater spending autonomy

What Could Change the Rating - Down

A sharp deterioration in operating performance or, under the current financial framework, a significant increase in the amount of long-term debt would have a negative impact on the rating

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