

Czech Economy: Spring 2001

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In 2000, the revival of economic growth, observable since the second half of 1999, accelerated. GDP grew by 3.1 % which was much better result against original expectations from the beginning of 2000. While in 1999, the upturn of Czech economy was driven mainly by exports, in 2000 the gross capital formation and private consumption have taken over the role of main pro-growth factors. Fast growth in the European Union first helped to revive demand for Czech industrial goods; the resulting growth of Czech industry, with some delay, boosted domestic investment demand.

Table 1: Main Macroeconomic Indicators

		1995	1996	1997	1998	1999	2000	2001f
GDP growth	%, real	5.9	4.8	-1.0	-2.2	-0.8	3.1	3.5
Industrial sales	%, real	9.2	6.8	6.1	0.6	-0.5	7.7	7.0
Industrial production	%, real	n.a.	2.0	4.5	1.6	-3.1	5.1	5.0
Construction output	%, real	8.5	4.8	-3.9	-7.0	-6.5	5.3	7.0
Retail sales	%, real	4.8	11.4	1.9	-7.2	2.1	4.6	4.5
Inflation	%, average	9.1	8.8	8.5	10.7	2.1	3.9	4.3
Inflation	%, e.o.p.	7.9	8.6	10.0	6.8	2.5	4.0	4.0
Net inflation*	%, e.o.p.	7.3	6.6	6.8	1.7	1.5	3.0	3.0
Industrial producer prices	%, e.o.p.	7.2	4.4	5.7	2.2	3.4	5.0	4.5
Nominal wages	%, average	18.5	18.4	10.5	9.3	8.2	6.6	8.0
Unemployment rate	%, e.o.p.	2.9	3.5	5.2	7.5	9.4	8.8	7.5
Exports	%, nom.	23.5	6.6	20.0	17.7	9.2	23.3	17.0
Imports	%, nom.	33.7	13.0	15.3	7.5	7.5	28.2	16.5
Trade balance	CZK bill.	-105.9	-155.8	-151.2	-76.3	-69.9	-126.8	-120.0
Current account	USD bill.	-1.4	-4.3	-3.2	-1.0	-1.1	-2.4	-2.4
Current account	% of GDP	-2.6	-7.4	-6.1	-1.9	-2.0	-4.8	-4.4
Financial account	USD bill.	8.2	4.3	1.1	2.6	2.5	3.4	4.0
Financial account	% of GDP	16.5	7.4	2.1	4.8	4.7	6.8	5.5
State budget	% of GDP	0.5	-0.1	-1.0	-1.6	-1.6	-2.4	-2.2
Gross foreign debt	USD bill.	17.2	21.2	21.6	24.3	22.9	21.5	21.0
Official FOREX reserves	USD bill.	14.0	12.4	9.8	12.6	12.9	13.1	14.0
M2 growth	%, e.o.p.	19.8	9.2	10.1	5.2	8.1	6.5	8.0
PRIBOR 3M	%, average	10.95	12.02	16.00	14.33	6.85	5.36	5.5
CZK/EUR**	average	36.22	35.32	35.75	35.85	36.88	35.6	35.0
CZK/USD	average	26.55	27.14	31.71	32.27	34.60	38.6	37.2

Source: Czech National Bank, Czech Statistical Office, forecasts by Komerční banka (bold figures)

Note: *) target indicator of the CNB; consumer price inflation net of administered prices; **) until 1998 the CZK/DEM exchange rate converted by 1 EUR = 1.95583 DEM; n.a. = not available

*) till 1996 production of goods, since 1997 industrial sales

***) till 1994 according to the old methodology

Restored growth of fixed capital investment (growth of 5.2 %) was predominantly oriented on investment in machinery and technological equipment which accelerated Czech industrial output to a notable extent (5.1 %). Growth in industry and also in other sectors was accompanied by ongoing restructuring showing that the overall economic growth was based on solid macroeconomic and microeconomic background.

Since the third quarter of 2000 on, building investments have recovered as well, construction output growing rapidly in the second half of 2000 (full-year growth rate was 5.3 %). Recovery in construction lagged behind that in industry due to the fact that primary impetus for economic growth came from the part of foreign demand and foreign investments. Growth in construction was however pulled predominantly by large commercial construction, residential construction still waiting for recovery.

Czech business sector witnessed great progress in 2000. Continuing restructuring led to a significant productivity increase outpacing the growth of real wages almost four times in industry and construction. This explains why Czech exporters succeed to compete on demanding foreign markets even under strong exchange rate of CZK; moreover, this factor prevented Czech economy from cost-inflationary pressures.

In the first months of 2001, the relatively strong domestic demand growth continued. It could be proved by the data in industry and construction. Both the industrial and construction output reached high double-digit growth rates. In January –February 2001 industrial output grew by 10 % and construction output by 14.4 %, year-on-year. While mining and quarrying stagnated, the rapid growth in industry was concentrated in manufacturing industries. Growth in construction continued to be driven mostly by large commercial construction, housing construction still waiting for recovery. Unlike in industry, where small and medium sized enterprises profited from

overall conjuncture, recovery in construction has been concentrated in biggest companies. Recession in small construction has been preserving, leaving small and medium sized construction companies in difficult situation.

In the beginning of 2001, external conditions offer better prospects than in 2000. Import prices have been declining since December 2000 in the first place due to decrease of world oil price. As a consequence, in February 2001 terms of trade reached 100.6 and for the first time from March 1999, their value exceeded 100. Although the trade deficit reached CZK 17.1 bill., January – February 2001, the above mentioned factors are promising for the rest of the year.

Similar factors provoking slowdown of import prices have been hampering both consumer and producer prices. Some fluctuation of consumer price index which was observed in the first quarter of 2001 was due to volatile world oil prices, nevertheless their level is generally lower than in 2000 and we do not expect oil prices to cause significant inflationary pressures in the rest of 2001. At the same time the developments of producer and consumer prices have been converging: at the end of March 2001 the growth of CPI was 4.1, which was exactly the same as PPI.

The development of unemployment in the first quarter of 2001 corresponded both to medium term trend and seasonal developments. After a small increase in January 2001, the unemployment rate fell under the year-end level of 2000, reaching 8.7 in March 2001. The unemployment in the Czech republic is more and more the structural one. As a consequence, the share of long-term unemployed is continuously increasing, reaching ...% in the end of March 2001.

Outlook

The developments of the economy at the beginning of 2001 correspond to our earlier expectations; for these reason we do not change our 2001 forecasts – with the only exception of foreign trade deficit. We cut our forecast from CZK 140 bill. to CZK 120 bill. due to favourable developments of import prices and Terms of Trade.

We expect GDP growth in 2001 to reach roughly 3.5 %. Industrial output will increase by 5 % in 2001 and we forecast a construction output growth of 7 %. We expect the same growth rate of inflation in 2001 as in 2000 (headline inflation 4,0 %, net inflation 3 %). Accelerating economic growth will affect the labour market favourably as well: unemployment rate will continue to decline under the eight percent level, reaching 7,5 % at the end of 2001.

Privatisation in the Czech Republic : Results, Problems and Open Issues

Kamil Janáček

1. The Extent of the Problem

In none of the other smaller European communist countries was the elimination of private property as complete as in the former Czechoslovakia. Poland had private farming; in Hungary there was always some private sector, and its role increased in the Eighties. Even East Germany retained some forms of private business. This was not the case in Czechoslovakia.

Here, though only the largest companies and banks were nationalized in October 1945, all the remaining industrial firms were seized by the new communist regime after 1948 and turned into state-owned enterprises. In the Fifties, 99 % of private farms were massed together into co-operatives in which

private property rights were disregarded; the same happened to small businesses in retail trade and services. Since then, for 30 years, no private enterprise practically existed in Czechoslovakia.

Elimination of private entrepreneurial activity was one of the reasons why the country was lagging more and more behind in its economic performance. Complete „socialist“ ownership formed a firm base for a full-fledged command economy, with highly monopolized production structures. The absence of private activities enabled complete central price fixing, with the result that prices, in the end, lost any role for efficient allocation of resources.

In state-owned enterprises or formal cooperatives, individual initiative and responsibility was largely lost, as was entrepreneurial know-how. Collective irresponsibility arose. In the social sphere, people became accustomed to relying on a paternalistic state in every respect.

Centralization of enterprise profits in the state budget led to huge redistributions - profits were taken away from efficient producers, and used to subsidize loss-making ones.

Productivity growth within the economy had been slowing down since the Sixties, and by the end of the Eighties, productivity actually began to fall. Czechoslovakia was lagging behind in the technical level and quality of its products, losing ground in international competition, and becoming more and more dependent on the „soft“ Soviet and other COMECON markets.

In 1989 in the Czech Republic, 98.5 % of GDP was produced in the state-owned sector, private sector having only a tiny 1.5 % share. For comparison, the share of private sector on GDP in the former East Germany was 8.5 %, it was 14 % in Hungary, and 26 % in Poland. This shows the huge extent of the privatization task in the Czech economy at the start of transition, even compared to the above mentioned neighbour countries.

2. The Strife for Fast Privatisation

Rapid privatization of state-owned enterprises was seen as one of the main pillars of transformation. Other pillars were the freeing of prices after 40 years of central price control, and the opening of the economy - i.e. freeing of exports and imports, and introducing convertibility of the currency for external trade. All the transformation steps however were preceded by a year of preparation and macroeconomic stabilization in 1990 - so that the transformation program really started as of January 1991.

The privatization program went along three, or better to say four, lines: restitution, small-scale, and large-scale privatization of existing enterprises (compare the Annex for statistical data) - and the emergence of new private businesses as soon as private business activities were legalized.

- Restitution, to natural persons, of property nationalized after February 1948 started in 1991 and concerned mainly real estate and retail businesses. It was the first step to create a new basis for small private enterprise, and till 1995, roughly a hundred thousand persons got their former property back. Restitution to natural persons was accompanied by partial restitution of church property - mainly to the Catholic Church - while another part of church property restitution remains unresolved owing to lack of political consensus up to now.
- Small-scale (or „small“) privatization concerned small state-owned businesses, mainly in retail trade and services, which were sold by auction. Small privatization started in 1991 and was completed in 1993. More than 22 thousand of small businesses were auctioned, in a total book value of about CZK 30 billion.
- Large-scale („large“) privatization was the key, and most difficult, part of the privatization program. It involved almost all large industrial enterprises that were in state hands - with the exception of some public

utilities.

The combined book value of enterprises going into the program of large privatization greatly exceeded the financial possibilities of the Czechoslovak citizens; consequently, public tender or direct sale to domestic and foreign buyers were combined with a give-away transfer of part of the property to Czech and Slovak citizens - the so-called voucher privatization.

Privatization projects were prepared by the management, while any natural or legal person could submit a competing privatization project: on the average, four competing projects were submitted for each enterprise (including projects submitted by potential foreign buyers). The winning project was chosen by the respective (Czech or Slovak) Ministry for Privatization. This means that the ministry (or, in conflicting cases, the Government) decided on the actual breakdown of the different privatization methods to be used.

The process actually began in 1991 with the direct sale of some large enterprises to foreign investors, the liquidation of some non-viable units and by turning state-owned enterprises into the legal form of joint-stock companies. But mass-scale large privatization started with the first round of voucher privatization opened in May 1992. As of January 1993 however, Czechoslovakia was divided into two states - the Czech Republic and the Slovak Republic - and this paper, from here on, will follow the progress and results of privatization in the Czech Republic only. The Czech government introduced a second round of voucher privatization in 1993.

In big strategic enterprises (and banks), the most usual privatization procedure was to transform the state-owned enterprise into a joint-stock company, and to offer its stock partly for sale, partly for distribution through vouchers - a small part remaining aside for restitution (in a Restitution

Investment Fund, RIF), and another part being retained in the hands of the state represented by the Fund of National Property.

3. The Pros and Cons of Fast Privatisation

From the very start of the transformation program, it was seen as vital not only to privatize, but to privatize quickly. The motto was to „privatize as much as possible, as fast as possible“.

Ministerial officials were unable to play the role of effective owners for thousands of enterprises. After the collapse of central planning, they also had very few effective instruments to control the behaviour of firms. The economy could no more subsidize the increasing numbers of state-owned enterprises that actually were value subtractors - the value of their output was lower than the cost of the inputs which they absorbed. So-called „production for production“ was increasing, with little effect for the final consumer. External conditions also changed for the small and highly open Czechoslovak economy as the traditional „soft“ markets were breaking down and trade had to be re-oriented.

Former Czechoslovakia had ample experience with reform attempts that failed to increase the efficiency of the economy based fully on state ownership. Fast privatization was seen as the only viable solution - but it faced a fundamental problem: there was no domestic capital capable to buy such a vast volume of property.

Selling it all to foreign investors was politically unfeasible. It was also practically impossible, as it would have required to attract, within two to three years, USD 40 bill. of foreign investment. Moreover, foreign capital would not have been interested in the whole range of privatized firms. If confronted with actual figures on the cumulative foreign direct investment inflow during the

whole 1990s (approximately USD 16 bill.), the idea of mass privatization by foreign capital is clearly unrealistic.

The political feasibility was no less important at the time when decisions on the form and speed of privatization were taken. In the years 1991 to 1993, the entrepreneurs' interest groups, the trade unions, and most of the general public supported the slogan „Czech firms into Czech hands“. Even some very liberal economists backed the idea that the so-called family silver must remain in the hands of Czech capital. In this prevailing social climate, it was a success that the government pushed through the principle of equal access for everybody - that is, no discrimination of, but no big advantages for, foreign capital.

Only practical experience gained during privatization could change this prevailing attitude. Several years later, with the visible economic success of most foreign-owned firms, it became clear that foreign owners bring not only capital but know-how, managerial experience, access to markets, and employment opportunities. Yet, in spite of that, it would be a heroic and naive abstraction to think that the bulk of privatization could have been based on foreign capital.

The solution that was found, as shown above, was a combination of voucher privatization of almost half of the property, direct sale (financed predominantly by privatization credits granted by Czech banks) for another part, and with a third part being privatized by foreign investors. This solution had the benefit of being fast. It prevented huge potential losses of trying to run a state-owned economy for another decade, or, rather, decades.

Of course, there are seldom benefits without some costs. The main problems are presently seen, first, in the lack of effective corporate governance, and second, in the two-sided position of banks as creditors and owners. Let us discuss both problems briefly.

Corporate Governance

Voucher privatization was not best suited to bring effective owners immediately into the privatized firms. It formed only a basis on which effective corporate governance could evolve gradually. A major role in voucher privatization was played by the so-called investment privatization funds (IPFs). The IPFs were originally proposed by the government with the idea of assisting voucher holders, and limiting the dispersion of ownership. Actually, the funds succeeded in concentrating in their hands the bulk of the property privatized by vouchers, and became very important owners. That opened the way for a large role of investment funds in the ownership structure.

Nevertheless, the concept of IPFs had some serious weaknesses from the very origin. Legally, they were inspired by European Union and U.S. legislation, suitable for funds as a tool of collective investment. For this reason, the IPFs' maximum stake in one company was limited by law to 20 % of the shares, and simultaneously, the fund was not allowed to invest more than 10 % of its assets in the equity of one issuer. After the IPFs became the main owners emerging from large privatization (according to some estimates, in 1996 they owned more than two-thirds of assets privatized by vouchers), economists realized that there is no one but the IPFs who could act as agent of corporate governance. In fact however, only the largest IPFs formed by banks were capable of playing this role, as the banks delegated experts to the supervisory boards of companies in which their IPFs had large stakes. But due to legally limited stakes, their influence was undercut, leaving the real control in the hands of managers.

The still underdeveloped capital markets with low liquidity, on the one hand, and the ambiguous position of investment funds toward playing the role of effective owners on the other, opened the problem of effective corporate governance in the Czech economy. The country thus was positioned

somewhere between the American model of corporate governance, and the German, or European, model.

The usefulness of the 20 % ownership limit was widely discussed, with OECD even proposing to decrease the limit. But for effective corporate governance, IPFs needed larger stakes. A radical solution found at the start of 1996 was the transformation of IPFs into joint stock companies, in the form of holdings, to which no ownership restrictions are applied. Thus, the holdings escaped the change in law which came into effect in 1998, when, following the recommendation of the OECD, the limit for IPFs was decreased to 11 %. A concentration of ownership followed the transformation into holdings, and opened the potential for a better corporate governance. Subsequently, it could be observed that the restructuring of companies, especially the large „mastodons“ inherited from the past, speeded up substantially.

On the other hand, the transformation of IPFs into holdings opened another serious problem - that of inadequate legal protection of minority shareholders, whose interests the holdings often neglected. This problem was alleviated only in 1999 by the amendment of law, forcing the majority shareholders (with more than 50 % on equity) to buy out the shares of minority shareholders, at a price representing a six-month average of the Prague Stock Exchange price.

Double role of banks

Some of the largest investment privatization funds (now called investment funds) are owned by big Czech banks which, in turn, were till the end of the 1990s partly state-owned. That opened the way for criticism that privatization was only formal. In fact however, the state had little possibility to control businesses via the banks directly. More important was the line of control of companies by bank credits, where the state had only limited possibilities of

involvement. Nevertheless, both public opinion and the government often indirectly pushed banks to continue the financing of ailing companies, to avoid mass unemployment and social unrest. This pressure however proved short-sighted and counter-productive, enhancing the bad loan problem in the portfolios of banks, which the government is presently forced to resolve. That is why the government is now pushing for finalizing the privatization of the state stakes in the banking sector.

Banks that indirectly, via the investment funds, own large amounts of industrial property are in a double position as owners and creditors. In the last two years, additional legal measures to strengthen the „Chinese wall“ between banks and their investment funds were taken, to alleviate possible problems of conflict of interest and to bring the respective Czech law fully in accordance with European Union legislation.

The present position of the Czech banking sector is still largely defined by the role which the banks played during privatization, as creditors. The part of small and large privatization that went by sale into domestic hands was almost fully financed by credits by Czech banks. In addition, Czech banks also financed the newly emerged private firms that mushroomed in the first years of transformation: between 1990 and 1993, the total number of firms in the Czech Republic increased 50 times (from 18 800 to 1 119 000). The result was an enormous increase of demand for bank credit, and bank services generally. Credit activities in this period, of course, involved an unusually high degree of risk. By taking the burden of this risk, the Czech banking system made privatization and economic transformation possible.

The privatized firms also carried a high burden - that of large past debts from the communist era, debts which reflected the decreasing efficiency of the „command economy“. Enterprise debts in the Czech Republic were not written off by the government, so that the firms were privatized with all their liabilities.

Unlike in Poland in Hungary where double- or triple-digit inflation effectively wrote-off the old debts of companies, in the Czech Republic inflation was successfully kept at low levels. That was a remarkable success on the one hand. It preserved, for households, most of the purchasing power of their savings. But, on the other hand, it meant that Czech firms entered the phase of microeconomic restructuring with a substantial burden of past debts. Via the ownership relations, as well as via bad loans (due to enterprise insolvency), this burden has to a large part been transferred to Czech banks. This is a problem with which the Czech economy is struggling till today, and it will preoccupy us for several years to come.

The Government and the Czech National Bank later helped to relieve part of this burden by programs of recapitalization and consolidation of small banks. Despite all the efforts, 15 small banks collapsed and were either closed down or taken over by large banks, in 1995-2000. As to large banks, the government has in 1999 and 2000 transferred a part of their bad loans to a special institution, the Konsolidační banka (basically, a bad-asset management agency). The aim is that with cleaned portfolios, the large banks can function normally, and be privatized in a standard way by strategic foreign partners.

4. Was Privatisation Too Hasty?

Both among Czech economists and in international circles, a dispute exists on privatization. Privatization was one of the main pillars of transformation. Was it correct to privatize fast, and to start privatization before a standard institutional framework of the market economy was established? Lately, it was Joseph Stiglitz, Chief Economist of the World Bank, who cast doubt on one of the pillars of the so-called Washington Consensus (the basic IMF and World Bank recommendations to the post-communist transition economies, stating that transition toward a market economy must include macroeconomic stabilization, liberalization of prices, trade, and capital

movements, as well as mass privatization). The critics - with the benefit of hindsight - now argue that the transforming economies should have concentrated their effort, first, on building and strengthening the basic institutions of the market economy and the legal system. Only afterwards, mass (and fast) privatization was to be started. The slogan is „Regulation and institutions prior to privatization“.

Let us leave aside the problem whether it is at all possible (except in the virtual reality of a theoretical concept) to start building a market economy without its main constituting element, i.e. private property, or privately-owned firms. In the light of this problem, the only realistic view is to discuss the adequate speed of privatization in the transition from a centrally-planned system toward a market economy.

However, even here, the critics of the adopted way of privatization can find no strong evidence. Two recently published studies¹ have come to two fundamental conclusions:

- in spite of all problems, privatization in transition economies can be seen as a success. Countries that did a fast and massive privatization (e.g. Poland, Hungary, Czech Republic, Slovenia, Estonia) have substantially better macroeconomic figures than those who hesitate to privatize, hoping that the state-owned firms can survive (e.g. Ukraine, Belarus, Russia).
- any privatization is better than none, because in general, private firms are much more efficient, more profitable, they export more, and restructure faster.

¹ Nellis, John: Time to Rethink Privatization in Transition Economies? IFC Discussion Paper No. 38, 1999.
Hawrylyshyn, Oleg - McGettigan, Donal: Privatization in Transition Countries: A Sampling of the Literature. IMF Working Paper WP/99/6.

It is of course true that there has been a weak point - the problem of efficient management, and effective corporate governance in general. Discussing the Czech way of fast privatization, the voucher method which helped to solve the problem of lack of capital at the start of privatization (and helped to gain support of most citizens for radical economic transformation), suffers from this weak point. Insufficient or wrong enforcement of ownership rights then can, in some cases, lead to inefficient functioning of firms, and to non-ethical or illegal behaviour of the owners. However, the social and economic costs of waiting for a well-established institutional market framework would have been much higher than the costs of fast privatization - as experience of some other countries in the last decade shows.

5. Privatisation and Economic Efficiency

Opinions on the effect of privatization on efficiency of the Czech economy differ significantly among Czech economists. One stream argues that at least one part - the voucher privatization - led to substantial loss of efficiency. In their view, only in companies privatized by standard methods, and mainly by foreign capital, can one observe productivity growth and visible gains in efficiency.

This view however is not substantiated by facts, as both Czech and foreign analyses show (see, i.a., Pohl at al., 1997). Empirical evidence, rather, indicates that companies which had sound management, good prospects on domestic and foreign markets, and started early with restructuring, show significant increases of productivity and profitability, without respect to their ownership structure. Of course, there is a high share of foreign-owned companies among them, as these had easier access to foreign financing, know-how, and could restructure earlier and faster.

Indirectly, one can prove that the micro-efficiency has improved during the last decade, by some macro-data. At the end of the Eighties, the (then) Czechoslovak foreign trade was primarily oriented on soft Comecon markets, their share reaching 70 %. Within the last ten years, we succeeded not only to shift trade to advanced, mainly European Union markets (EU now represents 71 % of Czech exports), but also to increase the share of higher-value-added goods in exports. In 1993, the share of SITC groups 7 and 8 (machinery, technological equipment and industrial consumer goods) represented 38 % of Czech exports. The respective figure for September 2000 is 64 %. This inevitably reflects a substantial increase of efficiency, not only in a few large companies. Almost 50 % of exports in these commodity groups are exports by small and medium-sized companies, largely owned by Czech capital. The importance of these figures is underlined by the high degree of openness of the Czech economy (combined share of exports and imports on GDP exceeding 135 %) which means that exporting companies form the bulk of the economy and their results are thus highly representative.

6. What to Do Next?

Evaluating ten years of economic transformation in the Czech Republic, we can conclude that the privatization program has created a private corporate structure, separating the state from most of the property which was formerly state-owned. It has also been an important step toward a functioning capital market. At the same time, some weaknesses, as analyzed above, still prevail. The weaknesses are mainly rooted in the institutional and legal framework.

Creating and improving the institutional framework of market economy is a permanent, unending task. Implementing the laws takes time and requires numbers of competent experts. This process can be speeded up in some aspects,

but it cannot be „solved“ in a short horizon (and once for ever). Yet it has to be said that in this sphere, more could have been done to the benefit of private enterprise - by making the activities of some government institutions more efficient and transparent, and providing more support to small and medium-sized firms. I do not mean financial support - which exists since several years - but consultancy on legal procedures, on accounting, on preparing entrepreneurial projects, etc. In this respect, experience from some EU countries remained untapped. In general, convergence to the European Union and the necessity to adopt the „acquis communautaire“ is a factor speeding up the process of institutional change toward a full-fledged market economy in the Czech Republic.

The main problem of effective corporate governance lies in the former IPFs, which, as holdings, often still have a fuzzy and non-transparent, or weakly defined incentive structure. As a result, they lack a strong long-term strategy and a strife for long-lasting success. More important than sanctions for improper behaviour, in the longer perspective, is a pressure for acquiring the standards of proper corporate governance, good corporate citizenship, vision, awareness of the need to live in a globalized economy. Here, education and exchange of experience with the help of entrepreneurs' organizations (chambers of commerce and other interest groups as the Business Leaders Forum in the case of the Czech Republic) is as important as the improvement of the legal framework.

Annex

1) RESTITUTIONS

Legal Framework:

- Law No. 403/1990 (On Relieving the Consequences of Some Property Injustice), October 1990
- Law No. 87/1991 (On Extra-court Rehabilitations), March 1991

Property Concerned:

- only property nationalized after February 25, 1948
- originally only Czech citizens eligible (later changed by the Constitutional Court)
- concerned mostly real estate and retail businesses
- until 1995 over 100,000 cases; the majority was real estate
- retail: 17,000 - 20,000 cases

Restitution of Church Property:

- first round based on the Law No. 298/1990 (On Regulation of Property Relations of Religious Orders and Congregations and the Olomouc Archdiocese; amended by Law No. 338/1991)
- around 250 properties returned to the Catholic Church (out of 800; the remaining roughly 550 properties were not demanded by the Church)
- restitution of the remaining property (land, forests etc.) is still unresolved and currently represents a major political problem

2) SMALL PRIVATIZATION

Legal Framework:

- Law No. 427/1990 (On the Transfer of State Ownership of Certain Properties to Other Legal or Physical Bodies), October 1990
- no preferences to employees

Property Concerned:

- The small privatization went on between January 1991 and December 1993; the number and value of items sold was the following:

Table 1: Small Privatization in the Czech Republic

	Number of Units Sold	Value (in CZK bil.)
1991	15,291	18.3
1992	6,411	11.1
1993	640	0.8
Total	22,342	30.2

Source: Fund of National Property

- The sectoral composition of privatized property was as follows (the group "others" refers to cars, trucks, garages, warehouses, production plants, factories, houses, offices and cultural centers):

Table 2: Sectoral Structure of Units in Small Privatization

	Number of Units	Average Final Price
Shops	13,042	1,194,000
Restaurants	1,861	1,790,000
Services	4,007	1,491,000
Others	3,435	2,185,000
Total	22,345	1,665,000

Source: Fund of National Property

3) LARGE PRIVATIZATION

Legal Framework:

- Law No. 92/1991 ("The Transition Law"), February 1991 (+ several amendments, the most important one is Law No. 222/1993, July 1993)

Privatization Process:

- there were competing privatization projects (the basic project was prepared by the management of companies); the winning project was selected by the government
- the privatization projects have been implemented by the Fund of National Property (FNP)
- 3 % of each company went into the Restitution Investment Fund (RIF)

Time Schedule:

- 2 privatization waves (1st wave: 1991 - mid 1993, 2nd wave: mid 1993 - 1994)
- since 1995 privatization has taken standard forms (sales on secondary market, direct sales etc.)

Table 3: Time Schedule of Large Privatization

	Projects submitted to the FNP	Property (in CZK bil.)	Completed projects	Property (in CZK bil.)
1991-94	4227	869.2	2329	840.1
1995	1050	23.5	1212	20.3

1996	714	11.7	1211	21.9
Total*	5991	904.4	4752	882.3

*) as of December 31, 1996

Source: Fund of National Property

Privatization Methods

- a variety of privatization methods was used in the Czech large privatization. The property of former state companies was either sold directly, or a joint-stock company was formed and its shares were then privatized.

Table 4: Completed Property Sales and Restitutions (as of July 31, 1997)

	Projects submitted	Property (in CZK bil.)
Public auction	1016	7.6
Public tender	1077	28.6
Direct sale	5686	61.7
Free transfer, restitution etc.	4600	48.5
Total	12379	146.3

Source: Fund of National Property

- voucher privatization was the main, but not the only, method of joint-stock company privatization (see Table 5)

Table 5: Joint-Stock Companies Privatization (as of December 31, 1996)

	Property (in CZK bil.)	In % of the Total
Public offer	12.6	1.8 %
Direct sale	35.3	5.0 %
Employee shares	2.2	0.3 %
Public tenders	17.8	2.5 %
Voucher method	341.4	48.0 %
Free transfers	52.3	7.3 %

Restitution or shares for RIF	21.4	3.0 %
RIF shares	6.1	0.9 %
Others	13.0	1.8 %
Strategic holdings by the FNP	170.1	23.9 %
Other holdings by the FNP	38.8	5.5 %
Total	711.7	100.0 %

Source: Fund of National Property

Voucher Privatization:

- all shares had the nominal value of CZK 1000 and were dematerialized
- every Czech citizen over 18 living in the Czech Republic was eligible to buy a "voucher book" for CZK 1000 in each wave
- the shares were allocated for vouchers in several rounds of auctions

Table 6: Voucher Privatization - Basic Facts

	1st Wave	2nd Wave	Total
Number of companies	988	861	1664
Number of shares offered (mil.)	212.5	155.0	359.5
Number of shares sold (mil.)	198.0	149.3	347.3
Eligible citizens (mil.)	7.2	7.2	-
Number of participants (mil.)	5.95	6.16	-
Number of shares per one participant	35.1	25.2	60.3
Number of IPFs	265	194	326
% of vouchers invested by individuals	73.3	63.5	-
% of vouchers invested through IPFs	26.7	36.5	-

Source: Fund of National Property

Table 7: Inflow of Foreign Direct Investment , 1991 - 30.06.2000

Country of origin	mill. USD	% of total
Germany	4253,2	24,3
Netherlands	2958,0	16,9
Belgium	2528,1	14,4
U.S.A.	1924,8	11,0
Austria	1562,2	8,9
Switzerland	1359,5	7,8
France	877,1	5,0
Others	2062,3	11,7

Total	17525,0	100,0
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Source: Czech National Bank

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Balance of Payments

Eva Zamrazilová

External imbalance gained on importance in the second half of 2000, again. Final figures for GDP and balance of payments showed that the current account deficit amounted to 4.8 % of GDP. Balance of payments 2000 ended in the black, inflow of capital exceeding the current account deficit; this however did not apply for the third quarter of 2000.

Table 1: Balance of Payments (CZK bill.)

	H1 1999	Q1-3 1999	Q1-4 1999	H1 2000	Q1-3 2000	Q1-4 2000f
<i>CURRENT ACCOUNT</i>	-11.6	-12.2	-54.2	-27.2	-47.0	-91.4
o.w. Foreign trade	-19.9	-29.0	-65.8	-43.4	-76.8	-126.8
Balance of services	12.4	26.3	38.1	19.5	32.5	53.9
Balance of incomes	-13.6	-23.4	-44.2	-9.9	-12.6	-30.0
Transfers	9.4	13.7	17.7	6.6	9.8	11.0
<i>CAPITAL ACCOUNT</i>	-0.1	-0.1	-0.1	-0.1	-0.1	0.0
FINANCIAL ACCOUNT	14.6	32.2	106.6	51.6	59.4	129.6
o.w. Direct investments	46.6	118.2	215.7	74.9	108.5	172.8
Portfolio investments	8.5	9.1	-48.3	-24.4	-44.2	-68.2
Long-term capital	4.8	4.8	-11.0	33.0	22.6	-4.9
Short-term capital	-45.2	-100.0	-24.8	-29.5	-26.7	31.7

Source: Czech National Bank

External imbalance has been concentrated to foreign trade.

1. Goods and Invisibles

Trade with Goods

Czech foreign trade has been affected by two main factors: world prices of raw materials and demand on markets of main trading partners. The demand for Czech exports has been strong since 1999, while prices of raw materials have been fluctuating.

The exports grew quickly in 2000, due to strong foreign demand. Last quarter registered a small acceleration against second and third quarter, exports growing by 23.3 % in 2000. The exports grew fast in spite of the developments of exchange rate against EUR, appreciating from 36 CZK /EUR in January 2000 to 34.8 CZK/EUR in December 2000. Exports were supported by competitive gains as restructuring boosted labour productivity and helped to keep wage growth moderate. Notable part of these achievements was enabled by new foreign owners.

At the same time, favourable development of exports caused an increase of domestic investment demand. Part of this demand could not be met by domestic supply, especially new technologies, software and know-how. Czech industry is heavily dependent on raw material imports. Imports of consumption goods grew modestly, whereas imports of raw materials, intermediate goods and investment goods increased sharply. Strong dependence of export-oriented production on imported goods combined with stronger domestic demand and oil price hike resulted in rapid growth of imports. The imports grew more rapidly than exports in 2000, the growth rate of imports reaching 28.2 %. Trade deficit thus reached CZK 126.8 bill.

However, volume figures look quite different. Volume of imports increased by 19.7 %, only negligibly higher than volume of exports (18.5 %), in 2000. The difference between development of growth rates in current prices and constant prices is illustrated in Figure 1.

If the 1999 terms of trade had been preserved, the trade deficit would have reached only CZK 88 bill., which would have been very close to prior expectations from the beginning of the year 2000. 70 % of the year-on-year increase in the trade deficit was caused by world raw materials price-hike, while the rest was due to the increase in domestic demand. In the course of 2000, the impact of growing domestic demand has been gradually more and more significant.

Trade with Services

Trade with services has been usually reaching a surplus of about CZK 50 bill, which was able to compensate significant part of trade deficit only up to the levels of CZK 100 bill. In 2000, surplus in services compensated for about 40 % of trade deficit.

The surplus of services amounted to CZK 54 bill., which is a very favourable full-year figure. Tourism was performing well: while incomes increased, expenditures declined. Receipts from other services (advertising, legal services, insurance, financial services etc.) registered a jump in the last quarter mostly as a consequence of one-off payments. Long-term tendency of growing payments for other services has been continuing in 2000, being one of adverse effects of strong inflow of foreign direct investments. Foreign investors coming into the Czech Republic often prefer to buy some of the above mentioned services in domestic country. One of the reasons may be low quality of these services offered in the Czech Republic – this is one of the bottlenecks on the supply side of the economy.

Foreign Trade and GDP

Total impact of external sector on the growth of gross domestic product was negative: trade with goods and services caused decline in GDP amounting to CZK 18 bill. (constant 1995 prices). As outlined above, the impact of trade

with goods was a negative one, while the impact of services was positive. Trade with goods caused decline in GDP reaching CZK 30 bill., trade with services was able to compensate for part of this negative impact causing growth in GDP amounting CZK 12 bill. in 2000.

Table 2: External Sector and GDP

	Growth of GDP	Absolute increase/ decline	Growth of exports	Growth of imports	GDP increase/ decline due to net exports	Growth of exports	Growth of imports	GDP increase/ decline due to net exports
			Trade with goods			Trade with services		
1995	5,9	77.5	17,0	27,0	-60.4	15,8	0,1	25.2
1996	4,8	66.6	6,2	12,5	-48.2	18,2	22,7	1.1
1997	-1,0	-14.9	13,7	10,7	1.1	-6,8	-7.6	-1.4
1998	-2,2	-31.5	13,7	8,0	25.7	1,1	7.6	-10.2
1999	-0,8	-10.7	6,4	3,4	18.7	-1,2	7.3	-15.4
2000	3,1	43.2	20,0	20,8	-30.2	14,0	8.4	13.0

Source: Czech Statistical Office

Balance of Incomes

Improving prospects offers balance of incomes, an upturn starting in the second quarter of 2000. While in the first quarter of 2000 the deficit increased by 22 % year – on- year, it declined by 27 % in the first half of 2000, by 46 %, January to September 2000 and by 33 % in the whole 2000. This item represents a sort of connection between current and financial account. While it had been quickly deteriorating during the period of massive inflow of debt capital to Czech Republic, it has been slowly recovering since 1998.

Main part of this current account item (both on revenue and expenditure side) are interests from debt capital. Interests paid to Czech investors from

abroad have been growing due to strengthening activity of Czech subjects abroad. On the other hand, the interests paid by Czech subjects declined due to lower inflow of debt capital into the Czech economy. As a consequence revenue on incomes balance increased by CZK 14 bill., while expenditures stagnated in 2000. Nevertheless, growing importance of dividends payments, repatriations of profits is neodvratný. Regarding these factors, it is most probable that balance of incomes is very likely to deteriorate in the future.

2. Inflow of Investments

Financial account of the balance of payments registered an inflow of CZK 129.6 bill, predominantly due to continuing massive inflow of foreign direct investments (CZK 172.8 bill.).

Direct Investments

In the last quarter of 2000, the inflow was highest again, as a consequence of seasonal factors: the inflow amounted to CZK 37.6 bill in Q1, CZK 37.3 bill. in Q2, CZK 33.6 bill. in Q3 and 64.3 in Q4. According to methodical changes made by the Czech National Bank, loans provided by investors mother company to invested one are included into direct investments as well, instead of being part of other investments as before the change. Full-year figure for 1999 thus increased from CZK 173 bill. to CZK 213 bill. as a consequence of this methodical change.

Foreign direct investments have been playing important role in recovery of the Czech economy. In the Czech economy, transmission channel reallocating money from banking sector to business one, does not still work properly. This is the reason why foreign investments are so important in investment activities. This is a great difference against 1994 – 1996: foreign capital was also very important for posttransformation recovery, however the

main part of capital inflow were borrowing capital (especially long-term loans for Czech companies) in those years. On the contrary, main part of nowadays capital inflow has been represented by direct investments. Moreover, foreign owners have been speeding up restructuring of Czech companies, so that present economic growth has been based on more solid macroeconomic fundamentals in contrast with posttransformation recovery in the mid-Nineties.

Portfolio Investments

Less favourable picture offers another item of financial account, i.e. portfolio investments. Balance of portfolio investments deteriorated by another CZK 24 bill. in the last quarter of 2000 (in first half deficit of CZK 24.4 bill., in first three quarters deficit of 44.2 bill.), so that full-year net outflow amounted to CZK 68.2 bill. In the second half of 2000, foreign investors were not very keen to buy Czech securities. On the other hand, Czech residents sought to diversify their portfolio and tried to avoid low returns on domestic market. In 2000, purchases of foreign securities made by Czech subjects amounted to CZK 86 bill.

It is worth mentioning that, for the first time in the history of the Czech Republic, net investment position in portfolio investments turned to the red during the last quarter of 2000: while total portfolio investment abroad amounted to USD 4.7 bill., the inflow of these investments amounted to USD 4.4 bill. at the end of 2000.

Debt Capital

Net outflow of long-term capital totalled CZK 4.9 bill. in 2000. Last quarter saw an outflow of CZK 27.5 bill. Long-term assets stagnated, the withdrawal of Czech banking assets from abroad has stopped as of the third

quarter of 2000. Long-term loans of Czech companies declined as well as other parts of long-term capital.

The developments in the area of hot money were different, showing again volatility of this item. In 2000, the net inflow of short-term capital amounted to CZK 31.7 bill., the inflow in the last quarter reaching CZK 58.5 bill. Czech banks as well as other subjects withdraw their assets from abroad, behaviour of foreign subjects being quite similar.

3. Risks of Future Developments

Tendencies on Financial Account

Problem of deepening current account deficit has been often understated due to permanently high inflow of direct investments. Regarding recent tendencies on financial account, at least two less favourable issues must be mentioned. Structure of financial account deteriorated in the course of 2000, predominantly as a consequence of rapidly growing purchases of foreign securities by Czech subjects. Final net outflow of portfolio investments amounted to almost 40 % of net inflow of direct investments. Foreign investors are not very interested in Czech securities, while the Czech demand for foreign securities has been permanently increasing. Even though one reason for growing demand of Czech investors were domestic and foreign interest rates developments, the tendency of increasing demand for foreign stocks and bonds seems to be a permanent one: Czech investors are seeking to diversify their portfolios. Regarding that one cannot expect a change in these tendencies in the near future, which does not seem to be very favourable for Czech balance of payments prospects.

After finishing Czech privatisation, the foreign direct investments inflow will somewhat diminish, not probably reaching levels of 1999 or 2000. If the

tendencies in portfolio investments did not change, both structure and total result of financial account would deteriorate.

Twin deficit

Widening of the current account deficit went alongside with widening of the fiscal deficit: Czech economy seems to have fallen into the twin deficit trap.

Stability of public finance has been representing one of the main economic bottlenecks since 1997.

Public deficiency had several breakpoints:

1996 – for the first time since 1993 state budget revenue was lower against the original assumptions,

1997 – state budget finished with a notable deficit of CZK 15.7 bill.,

1998 – state budget outlays were higher against the plan,

1999 - state budget was set-up as a deficit one,

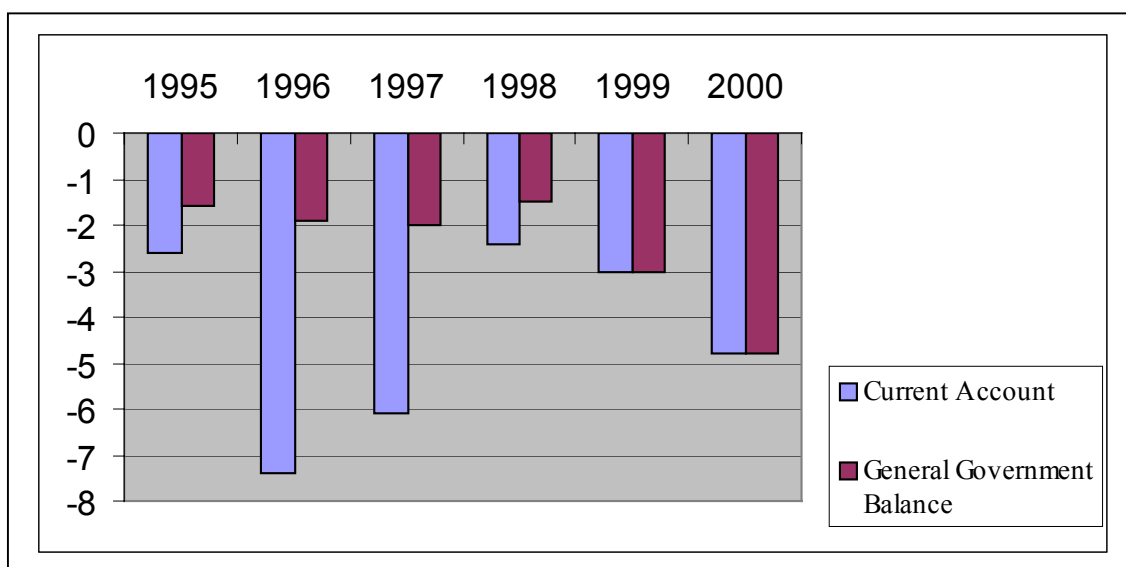
2000 - social insurance revenue corresponded to plan, anyway social expenditures exceeded social revenues by CZK 34.2 bill.

The deficiency in public finance was firstly not perceived as a structural problem, since the fiscal tension in 1996 – 1998 was caused by deficits on the revenue side due to economic recession. While the economy was in a recession, the widening of state budget deficit could be looked at as a normal operation of automatic stabilizers. A breakthrough into this idea happened in 2000: though the economic growth accelerated, state budget and public finance experienced deepening deficit, showing that the main reason of deficiency has been in structural part of the deficit. Therefore it is evident that the problems of state budget will not be solved automatically with stronger economic growth.

Half of the deficit connected with social insurance belongs to pensionary system, the deficit on pensionary account amounting to CZK 17 bill. Pension expenditures as currently designed would continue to grow faster than contributions and will continue to put strong pressures on spending which would not be sustainable. At the same time, the interest payments amounted to CZK 20 bill. in 2000, showing clearly that the price for growing indebtedness of state is even higher than the price for improperly set-up pensionary system. Level of public expenditure increased between 1998 and 2000 from 41.6 % of GDP to 46 %.

While the state budget deficit amounted to 2.4 % of GDP, the general government balance including local budgets, public health insurance funds and extra-budgetary funds was twice as high reaching 4.8 %. Both current account and public finance deficit have thus come close to generally acceptable limits see Figure 1.

Figure 1: Current Account and General Government Balance (in % of GDP)



Source: Czech National Bank, the World Bank

Even though macroeconomic framework of the economy offers much better picture than before, the lesson from May 1997 should not be forgotten. Exceeding of generally acknowledged criteria, it is not only a question of threatening instability of the exchange rate which would bias expectations of economic subjects, but this is predominantly a question of confidence. Confidence may be lost easily but difficult to be acquired again. International financial markets (and foreign investors) do not tolerate the criteria indicating for macroeconomic stability exceeding generally acceptable limits. Growing cautiousness of investors as well as changes in rating might hamper the inflow of foreign direct investments which will be necessary to compensate current account deficits. And once the external deficits may be provoked by

unfavourable external conditions as weak demand or high raw material prices, consolidating of public finance is almost fully in hands of domestic agents.

2001 Prospects

In the beginning of 2001, the area of foreign trade offers better prospects than in 2000. While in the course of 2000 the growth of import prices was double-digit (average growth in 2000 amounting to 12 % y/y), a significant slowdown has been observable as a consequence of world raw material prices developments since December 2000. In December 2000, the import prices grew by 6.8 %, in January 2001 by 5.6 % and in February 2001 by 3.6 % only. Slowdown in import prices has been improving terms of trade, which reached 100.6 % in February 2001, reaching a positive value for the first time since March 1999.

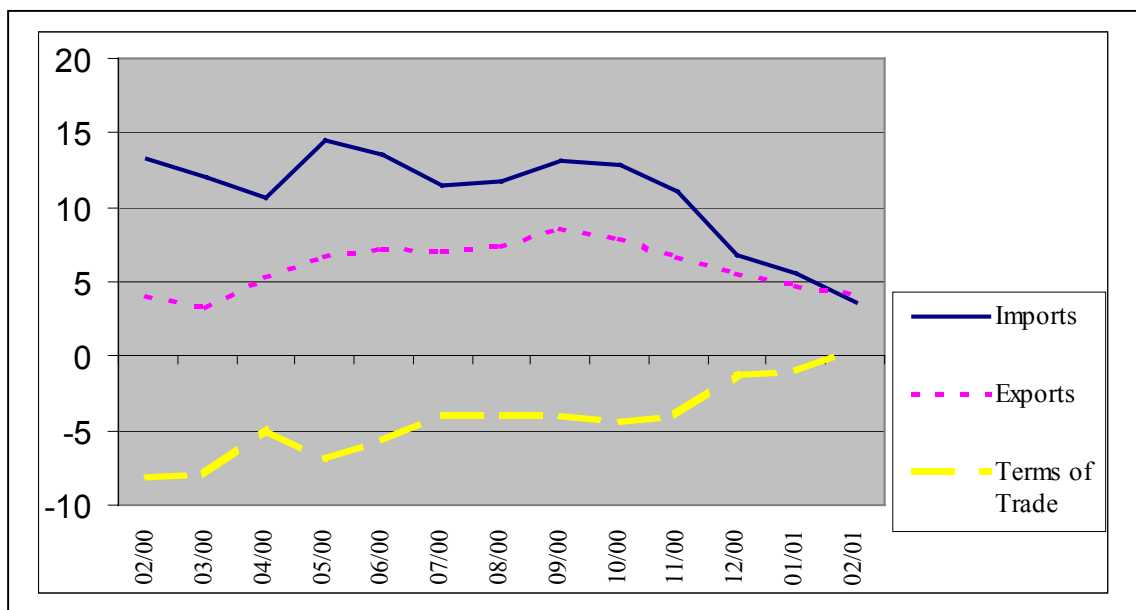
Moreover, the growth of exports remained high, in February 2001 the growth of exports even outpaced the growth of imports. Massive inflow of long term investments seems to have a strong pro-growth effect which has started to be visible recently. Although the trade deficit reached CZK 17.1 bill., January – February 2001, the above mentioned factors are promising for the rest of the year.

The external environment developments have not been unfavourable so far and will be most probably friendly even in the rest of the year. In spite of some slowdown in the EU countries, the West European conjuncture will be strong enough to support Czech exports. The price of oil will be most probably stabilised around the level of USD 26 per barrel which will keep growth of import prices rather low. Under these conditions, the trade deficit would

slightly decline in 2001, keeping the ratio of current account deficit to GDP in acceptable limits.

Nevertheless, in mid-term horizon, the threat of external imbalance seems to be imminent. Given the recent developments on financial account and long-term stable trend in trade with invisibles, long-term sustainable limit for trade deficit can be estimated. Trade deficit up to CZK 100 bill. seems to be a level above which macroeconomic stability could be threatened; this applies even more regarding chronic deficiency of public finance.

Figure 2: Export and Import Prices, Terms of Trade



Source: Czech Statistical Office

Banking and Capital Markets in Central Europe

Kamil Janáček

The aim of this article is to analyze the developments in the financial sectors of three Central-European countries: Czech Republic, Hungary, and Poland. These countries have some essential common features. They are in the final stage of transition toward full-fledged market economies; they all are strongly and increasingly dependent on the developments in the euro-zone; and all three countries are in the first wave of candidates for European Union accession.

First, we shall discuss monetary policy, then recent trends in the banking sectors, and, finally, the situation on the financial markets. Beside the common features also some important differences in situation and policies will be illuminated.

1. Monetary Policy

Czech Republic

In all three countries, exchange rate policy has been an important part of monetary policy during the last decade. Czech Republic was using a fixed exchange rate as an anchor between 1991 and May 1997. Afterwards, it was the first of the three to go over to a floating regime, in which the exchange rate is managed but without any officially declared fluctuation band. While in the first period the exchange rate target was combined with money supply targeting,

form January 1998 the Czech Republic combines floating with direct inflation targeting.

Keeping inflation under strict control was one of the primary tasks during the whole Czech economic transformation. Between 1992 and 1998, yearly inflation was around 10 %, lowest among the Central European economies. In 1999, inflation was suppressed to 2.5 % annually, and in 2000, it amounted to 4 %. Thanks to this, we are in the last two years experiencing a very low interest rate differential toward the euro (presently the official repo rate is only 25 basic points above the euro-zone rate). As will be shown below, this has a strong influence on the yields of bonds and equities, as well as on situation in the banking sector.

It has to be said that the relatively low inflation, paradoxically, had also some negative consequences for both the enterprise and banking sectors: Unlike in Poland or Hungary, in Czech Republic the bad debts from the communist era and from the start of transition were not wiped off by inflation and have remained a burden which the economy has been fighting up to the present time.

For the next future, Czech monetary policy will further use the framework of direct inflation targeting, in spite of repeated undershooting of the targets in the last three years. The main aim of the Czech National Bank remains a fast convergence toward inflation levels of the euro-zone. Within the country, this strict disinflation policy has been lately criticized due to the GDP decline which it helped to produce, and from which the economy is only very slowly recovering.

Hungary

The exchange rate regime in Hungary has been that of a crawling peg, with pre-announced depreciation (presently, 0.3 % per month since April 2000). Monetary policy has been strongly determined by the endeavour to keep the exchange rate within the pre-announced depreciation bands. In principal, it amounted to an exchange rate targeting monetary policy regime. The intention is to keep the crawling peg until inflation falls to 5 %.

In the endeavour to keep the currency from appreciating beyond the band, the National Bank has, during the last five years, been easing its monetary policy, repeatedly cutting interest rates. The problem of convergence of inflation levels toward EU standards so far remains open (with inflation presently at the level of 10.5 % annually). Experts expect that, under the new National Bank governor, tightening will not come soon - but that it may have to be more dramatic later. Given slower progress in reducing inflation, and a likely acceleration in domestic spending in 2001 (election year), the problem of accommodative monetary policy may become very pressing in the near future in Hungary.

Poland

Among the three countries, Poland had a biggest inflation problem during the first transition years, experiencing even a short spell of hyperinflation. Monetary policy was based on a crawling peg, similarly to Hungary. The monetary policy stance was tightened almost continuously from 1994 to 1998, with a positive result of bringing inflation to one-digit levels. In 1998, direct inflation targeting was introduced in Poland, and in April 2000, Poland went over to a free float.

The adverse side of disinflation has been the high level of both nominal and real interest rates that were necessary to achieve this goal. The Polish National Bank was under a growing critique of businessmen and politicians in

2000. Under the new governor, the bank board started to decrease the official rates toward a more accommodative monetary policy.

In spite of lack of success with keeping the direct inflation targets (contrary to the Czech experience, here it was on the side of overshooting), this policy framework will be used in the further medium-term strategy, with the aim to bring inflation down to 4 % till the end of 2003.

2. Banking Sector

A widespread opinion is that in the three countries under scrutiny, the weights of foreign capital in banking differ significantly. However, this is hardly true nowadays: at the end of 2000, foreign capital owned between 65 and 75 % of the banking sectors in each of these countries (measured by assets). This is a classical example of present opinions being misled by past facts.

Czech Republic

In the year 2000, the government took steps to allow privatization of the large banks to be finished by the end of 2001. Česká spořitelna, the country's second largest bank, was privatized in February 2000, by Austrian Erste Bank. IPB, the third largest bank, had been since two years private in the hands of Nomura Securities, when, after getting into serious trouble, it had to be sold, in June 2000, to the Czech fourth largest bank, ČSOB. (ČSOB is fully owned by Belgian KBC.) In this deal, the government and the Czech National Bank gave to ČSOB a guarantee to cover all losses (before the deal, the Nomura-owned IPB was for a short time put under forced administration following a deposit run which cost an outflow of deposits equal to about 10 % of assets, or 2 % of GDP). Disputes continue about a put option on IPB shares. Nomura is

demanding damage compensation in the amount of USD 750 mil., from the Czech Finance Ministry.

Komerční banka, the largest Czech bank until the IPB-ČSOB merge, is awaiting privatization during 2001. The 60 % of shares now in state hands will be on sale. From a list of roughly 30 interested banks, the government has put the Hypovereinsbank, the Unicredito, the Societe Generale, and Credit Agricole on a short list of would-be buyers. After completing the due diligence process within Komerční banka, these four bidders will be asked to present their final bids till mid April of this year. The official time-table presumes to sign the final contract in June 2001.

The above-mentioned four largest banks have a 70 % share in total assets of the Czech banking sector. Smaller banks underwent consolidation and a wave of mergers in the last years and are now predominantly owned by foreign capital.

The fact that privatization of Czech banking is approaching its final stage is a result of a longer process of consolidation and cleaning of bank portfolios, to facilitate the entry of foreign strategic owners. The burden of bad debts so far has been only partly cleared. The largest part of bad debts was shifted to a special government-formed institution (a „bad bank“), the Konsolidační banka. The workout of bad loans will be a lengthy and difficult process, but a comprehensive strategy has been outlined. Konsolidační banka will be transformed into a non-bank consolidation agency, giving it a larger scope for workout activities. As in Hungary and Poland, a mixed private sector-government strategy for workout will be applied, based on sales of assets to third parties, and on outsourcing of asset management to the private sector. (The first auction of bad loans took place in February, and Goldman Sachs bought CZK 8.9 bill. of bad loans for 7 % of face value).

Thanks to privatization, bank bail-outs, and reduced needs for provisioning, major banks have posted better results in 2000 than in the years before. The same applies for the sector of small banks. This is a good news for the Czech business sector, as after two years of net decline of credit, Czech banks can now be expected to enhance their lending activities, especially in relation to SMEs and in consumer credit. Better bank management (thanks inter alia to foreign strategic partners) should ensure that the problem of bad loans will not be reproduced. Deposit inflows to domestic banks are likely to leave them with enough liquidity to fund stepped-up domestic lending, without substantial borrowing abroad.

Hungary

Among the three analyzed countries, Hungary was the first one to start with the privatization of banks by foreign capital. The banks were first cleared of bad debts, the estimated costs of this operation being evaluated at USD 5 to 7 billion. Subsequently, they were offered to foreign bidders. Hungarian strategy of privatization was one strategic partner - a foreign bank - for each domestic bank. This distinguishes Hungary from Poland where not only banks but other financial institutions, mainly insurance companies, were encouraged to participate in privatization of domestic banks. Moreover, preferred were solutions where several foreign institutions participated in the purchase of an individual domestic bank.

In 2000, consolidation of the banking sector was accelerated with the merger between K&H Bank, owned by Belgium's KBC, and ABN-AMRO's Hungarian subsidiary. Moreover, Citibank bought from ING its retail operations in the country. The authorities intend to privatize the last large bank, Postabank, in 2001. The government selected CFFB as privatization advisor. (Postabank was taken over by the government in 1998 after a USD 0.8 bill.

capital injection to cover losses resulting from loans to borrowers connected to the bank former management. The total costs of the bail-out will be even higher, by 100 to 200 million dollars, because of low recoveries on loans transferred in 1998 from Postabank to a special bank consolidation company.)

Increased lending to non-government borrowers combined with stronger fees from banking services resulted in an increase of the banking sector profits by almost 25 %. Average return on equity strengthened to 17 % from 14 % in 1999, but variation among the individual banks increased significantly. Despite the sharp pick-up in economic activity and in demand for banking services in 2000, the growth in bank profitability was limited by intensified competition among banks lending to the corporate sector, lower interest rate spreads, and increased rivalry with non-bank financial institutions in attracting household deposits. Loan quality has improved despite the acceleration of lending, with the share of nonperforming loans falling to 3.2 % (from 3.6 % at the end of 1999).

Poland

In Poland, too, the foreign capital owns a majority share in the banking sector (see also above). The Polish government so far does not plan to privatize fully the two remaining large banks and one small state bank. The authorities intend to retain majority ownership in one of the large banks, PKO-BP (the savings bank), while selling only a minority stake through flotation on the stock exchange. The government is now searching for a privatization advisor and has yet to formulate a concrete plan.

In the other large bank, BGZ (the agricultural bank), the government intends to sell its 66 % stake to the cash-strapped regional cooperative banks which now own the remaining 34 %. The sale will be in the nominal amount. At the same time, the government intends to issue additional shares and

convertible bonds to increase BGZ capital as needed to meet requirements by the banking supervisory agency. Moves to privatize the remaining government stake in PZU to a consortium of European insurance companies Eureko were stopped by the Treasury Ministry. Under a new Treasury Minister, the negotiations re-started at the end of February 2001.

Despite all the hesitation about the form of privatization of the remaining state banks, consolidation in the banking sector continued, raising the share of foreign capital to almost 70 %. Citigroup acquired a nearly 90 % stake in Bank Handlowy, the second largest bank. Powszechny Bank Kredytowy and BPH, the fifth and sixth largest bank, merged effectively and are now owned by Hypovereinsbank and Bank Austria-Creditanstalt. Mid-sized WBK and Bank Zachodni were also merged by the majority owner, Allied Irish Bank. Consolidation combined with increasing interest rates led to moderately wider interest margins and better position of banks.

3. Financial Markets

In all three countries analyzed, the convergence toward European Union and the endeavour for a fast EU accession has a strong impact on the development on financial markets. First, the most liquid equities are traded abroad, either in London or in Frankfurt or Paris. Increase of electronic trading will further strengthen this trend. As a result, the role of local stock exchanges will be limited. Attempts to create a special trading place for stocks of these three countries, outside of the large financial centres, have a low probability of success - as the fate of NEVEX, special exchange created by the Vienna Stock Exchange, shows.

Second, the increasing ties with the European Union and the prospect of accession seems to protect financial markets in Czech Republic, Hungary and

Poland, to some extent, from contagion effects of financial crises in other emerging markets - as the recent crisis in Turkey has shown. Other factors that helped keep their markets stable during the Turkish crisis were continued economic growth, strong inflow of FDI, and the lack of direct trade with Turkey.

Czech Republic

In the first quarter of 2000, the Czech stock prices were increasing. At the end of March, when the growing trend of American technological stocks Nasdaq stopped, Czech stocks also ceased to grow. From April to November 2000, a gradually declining tendency of stock prices prevailed. A new period of growth, enabled by a favourable sentiment on foreign stock markets, and by the figures about positive GDP growth in the third quarter of 2000, begun in December 2000. For the whole year 2000, the stock index of Prague Stock Exchange PX-50 declined (in year-on-year comparison) by 5.6 %. This result still looks relatively well compared to the development of stock indices abroad: American Nasdaq fell by 35.7 % y/y, British Financial Times Stock Exchange FTSE 100 declined by 12.8 % y/y and German DAX Xetra weakened by 7.5 % y/y (for more details see Table 1).

This relatively favourable development of Czech stock prices cannot be overrated because the volumes of almost all stock deals are very low. Moreover, the Czech stock market suffers from low liquidity. Only the stocks of banks and telecommunication companies were favourably influenced in 2000 by government steps towards privatisation of these companies, associated in the case of large banks also with state financial aid.

The Czech stock market was also affected by a lack of foreign investors' interest in portfolio investment in Czech stocks. The financial account of the

balance of payments showed in the first three quarters of 2000 an outflow of portfolio investment reaching CZK 44 bill.

In 2001, the ongoing privatisation process, as well as the low stock and asset prices, will create favourable conditions for a concentration of larger equity stakes, which could help to set in a bull trend in the Czech stock market. An acceleration of economic growth should also support the growing trend of stock prices. Contrary to this, the possibility of a rise of domestic interest rates in the second half of 2001 will tend to bring the stock prices down. However, the possible rise in interest rates will probably be modest and should thus not change the overall growing trend of stock prices.

Due to stable official interest rates, interbank interest rates and Treasury bill yields changed little (being at 5.3-5.4 percent) during 2000, after substantial declines in 1999. Average interest rates on bank deposits fell to 3.3 % at the end of the year.

Hungary

In 2000, capital outflows and an increased volatility in equity markets abroad contributed to a decline in share prices. In dollar terms, stock prices fell by 24.5 % over the year. Equity market capitalisation declined to UDS 13 bill. at the end of August 2000 from USD 16.3 bill. at the end of 1999. At the same time, average daily turnover fell to USD 80 mil. from USD 270 mil. in 1999. Only at the end of the year, the Budapest Stock Exchange experienced a recovery and increase in daily trading volumes.

Rising inflation and an increase of official interest rates caused yields on three-month Treasury bills to increase to 11.8 % in the fourth quarter of 2000. The increase in yields partly reverses sharp declines at the end of 1999. Yields on longer-term government securities increased more than on Treasury bills because of the pickup of inflation.

Poland

Interest of foreign investors in Polish equities was the main reason why the fall of stock prices in Poland was, in 2000, the lowest among the three countries (2.5 % in dollar terms). The Warsaw Stock Exchange introduced a new trading system in late November extending continuous trading of the exchange's most liquid stocks and reducing the number of shares covered by single price fixing. The new system significantly expands the exchange's trading capacity, bringing it into line with the standards of Europe's major exchanges. The channelling of substantial savings into the market through pension funds should also help to increase the liquidity of the market in the future. At the end of 2000, pension funds invested USD 0.8 bill. in the equity market (this amounted to one-third of their total assets and accounted for about 3 % of market capitalization).

Government securities yields rose sharply in February 2000 and again in August 2000, in line with increases in official interest rates, but fell in the fourth quarter of 2000 in anticipation of a monetary easing at the start of 2001. The yield curve remained relatively flat up to maturities of two years, but inverted at longer maturities in line with expectation that inflation will fall and interest rates converge toward lower European Union levels over the longer term.

Table 1: Development of Stock Indexes in 2000

Index	Level (December 29, 2000)	Change in 2000 (in %)		Yearly Minimum	Yearly Maximum
		in local currency	in USD		
PX-50 (Prague)	478.5	-5.6	-11.0	409.9	691.1
BUX (Budapest)	7 849.75	-14.9	-24.5	6 684.74	10 471.90
WIG (Warsaw)	17 847.50	-3.2	-2.5	14 873.40	22 868.40
SAX (Bratislava)	92.65	22.7	11.3	70.19	98.74
Dow Jones IA	10 786.90	N/A	-4.8	9 796.03	11 723.00
Nasdaq Composite	2 470.52	N/A	-35.7	2 291.86	5 048.62
S&P 500	1 320.28	N/A	-8.3	1 264.74	1 527.46
FTSE 100	6 222.50	N/A	-12.8	5 994.60	6 798.10
DAX Xetra	6 433.61	N/A	-7.5	6 200.71	8 064.97
CAC 40	5 926.42	N/A	-4.6	5 450.11	6 922.33

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