August 1999

IMF Staff Country Report No. 99/90

Czech Republic: Selected Issues

This Selected Issues report on Czech Republic was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with this member country. As such, the views expressed in this document are those of the staff team and do not necessarily reflect the views of the Government of Czech Republic or the Executive Board of the IMF.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431

Telephone: (202) 623-7430 • Telefax: (202) 623-7201
Telex (RCA): 248331 IMF UR
E-mail: publications@imf.org
Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

CZECH REPUBLIC

Selected Issues

Prepared by a staff team consisting of J. Artus, R. Nord, T. Laursen,
and V. Haksar (all EU1), S. Symansky (FAD),
and A. Ariyoshi and A. Gulde (both MAE).

Approved by the European I Department

July 6, 1999

Contents Page

I. Overview 3

II. The Enterprise Sector and Corporate Governance in the Czech Republic 5

III. Issues in Financial Sector Performance and Restructuring 19

IV. Medium-Term Fiscal Policy Projections and Analysis 39

Tables

II-1. Financial Performance of the Enterprise Sector 1997–97 18
III-1. Structure of the Banking System 35
III-2. Assets and Liabilities by Types of Banks 35
III-3. Aggregate Indicators of Banking Structure and Performance 36
III-4. Assets and Liabilities of the Banking Sector 37
III-5. Recent Loan Portfolio Shifts 38
IV-1. Central Government (State) Budget, 1993-99 55
IV-2. General Government Budget, 1993-99 56
IV-3. Macroeconomic Assumptions for Passive Baseline 57
IV-4. Medium-Term Forecast–General Government Revenues 58
IV-5. Medium-Term Forecast–General Government Expenditures 59
IV-6. Passive Medium-Term Forecast–General Government 60
IV-7. Passive Medium-Term Forecast by Ministry of Finance–General Government 61
IV-8. Increased Spending Scenario–General Government 62
IV-9. Reform Scenario–General Government 63
IV-10. Low Growth Scenario–General Government 64
IV-11. Fiscal Risk Scenario–General Government 65

IV-12. EU Accession Scenario–General Government 66

Figures

III-1. Credit Growth, 1995-99 (y-o-y) 25
IV-1. State and General Government Deficit and Debt 40
IV-2. Medium-Term Fiscal Scenarios–Deficit to GDP 47
IV-3. Alternative Medium-Term Fiscal Scenarios 50

Boxes

1. The Voucher Privatization Scheme 6
2. The Bankruptcy Framework in the Czech Republic 9
3. The OECD Principles of Corporate Governance 11

Appendix

Supervisory Regulations in the Czech Republic 67

I. Overview

1. In the context of the 1999 Article IV consultation discussions, the mission explored in some depth issues relating to the enterprise sector and corporate governance, financial sector performance and restructuring, and medium-term fiscal prospects in the Czech Republic. These issues all play a prominent role at the current conjuncture of the Czech transition process, and the Fund staff's analysis and assessment was summarized in the staff report. The background work is presented in greater detail in this paper—admittedly, it remains rather tentative given the complexity of the issues, and further analysis is required in all areas.

2. Chapter II discusses issues relating to the enterprise sector and corporate governance. This includes an overview and assessment of enterprise performance along with a discussion of the concept of corporate governance and its application in the Czech Republic, including how corporate governance practices compare in an international context. The chapter finds that the enterprise sector has performed relatively poorly in recent years compared to that of other advanced transition economies, and it attributes this in large part to weak corporate governance. In particular, the weak corporate governance has been the result of the ownership structure arising from the voucher privatization program, with strategic investors established in only about one-third of the enterprises, incentive problems surrounding the investment privatization funds, and the ownership of these funds by the major commercial banks. Further, these problems have been exacerbated by an inadequate bankruptcy process preventing the required exit of unviable enterprises. While the regulatory framework has been strengthened considerably over the last couple of years, there remains an urgent need to strengthen enforcement of existing laws and regulations, including not least the regulatory and judicial process starting with the bankruptcy framework.

3. Chapter III discusses issues related to financial sector performance and restructuring. The chapter takes stock of banking sector developments and performance and reviews financial policy and supervisory challenges, including the definition of policies for bank privatization and the appropriate prudential framework. The study finds that there are notable weaknesses in the areas of capital, asset quality, and profitability in the major banks. These problems can be traced to the structures established during the pre-transition period and early transition phase with inadequate or poor privatization of the large banks and many enterprises. The recent weak financial performance of the state-controlled banks reflects the need to provision for or write-off the large stock of non-performing loans, but also a high cost structure and increasing competition from more efficient banks for prime customers. Also, the external environment has deteriorated with the ongoing recession. The structural weaknesses in the bank and enterprise sectors have contributed importantly to the recent dramatic slow down in credit growth and have dampened the effectiveness of the credit channel of monetary policy transmission. Significant progress has been made over the last year in bank privatization with the sale of two of the state-controlled banks, but privatization of the remaining two—which are the largest of the banks—is complicated by their very poor loan portfolio. The optimal strategy needs to consider not only the fiscal cost, but also the cost of time and need to avoid a further deterioration of the banks and the financial

intermediation process. Also, the regulatory and supervisory framework for banks has been strengthened markedly over the last year, but further changes are needed to fully comply with EU directives and to strengthen some aspects of banking supervision, notably relating to market risk and consolidated supervision. Further, accounting standards should be enhanced and capital market oversight improved.

4. Chapter IV provides medium-term fiscal projections and discusses their policy implications. The fiscal situation has been deteriorating in recent years, and while part of this is due to the downturn in the economy such that automatic fiscal stabilizers should be allowed to operate, the structural problems in the budget and new spending pressures raise concern about the medium-term outlook for the public finances. Even under possibly optimistic macroeconomic assumptions, projections based on current programs and policies suggest that the fiscal position would develop in a manner inconsistent with maintaining macroeconomic stability and EU accession requirements. Also, there are numerous additional fiscal challenges arising over the medium term, including EU accession related spending on the environment, infrastructure, etc., realization of the large stock of contingent liabilities, potential bank and enterprise restructuring costs, and further down the road the social security system as the population ages. Further, there are risks related not only to the macroeconomic environment, but also potential difficulties in containing discretionary expenditure programs. These additional pressures and risks could render fiscal developments unsustainable. While EU accession would also be associated with fiscal benefits in the form of transfers from the union—and hardly on its own undermine the fiscal situation—fiscal adjustment will inevitably be required, and a medium-term program to consolidate the public finances should be developed as soon as possible. The chapter presents a fiscal reform scenario consistent with the staff's medium-term, structural reform based macroeconomic framework, based on both revenue and expenditure measures and reform. The suggested measures include increasing indirect taxes consistent with EU harmonization and curtailing enterprise subsidies as well as social transfers through reform of mandatory programs.

II. The Enterprise Sector and Corporate Governance in the Czech Republic[1]

A. Introduction

5. At the beginning of the transition process, the Czech Republic (then Czech and Slovak Federation) had one the largest state sectors of all central and eastern European countries, accounting for more than 95 percent of GDP (including the cooperative sector). Privatization was pursued in a variety of ways: restitution to previous owners; free transfer of property to municipalities; direct sale; and privatization by voucher. By the end of 1997, following rapid privatization of medium and large enterprise assets (of which about half through voucher privatization), roughly 78 percent of GDP was being produced in the private sector[2]

6. The speed of privatization, and the diversity of the methods used, attracted attention to the privatization process in the Czech Republic. Especially the mass privatization by voucher was the subject of intense debate and much early admiration (Box 1). At the same time, increasing criticism was voiced both within and outside the Czech Republic that the loose regulation in the aftermath of the privatization process provided an inadequate framework for development of the corporate sector. In particular, shortcomings in corporate governance practices became increasingly evident in the 1990s, leading the Czech authorities to introduce several rounds of regulatory reform in recent years. This paper is structured as follows. Section B provides a brief overview of the enterprise sector in the Czech Republic, including the voucher privatization process and the state of the sector by the end of 1998; Section C introduces the topic of corporate governance and its relevance in the case of the Czech Republic; Section D provides an assessment of corporate governance practices in the Czech Republic in an international context; and Section E concludes.

B. Performance of the Enterprise Sector in the Czech Republic

7. Before transition, the enterprise sector in the Czech Republic was characterized by some large, internationally active corporations (often diversified industrial conglomerates) and a large number of small and medium-sized enterprises. Similar to other transition economies, the transformation into a market economy forced restructuring on many enterprises. Initially, enterprise performance (judged by various profitability measures, admittedly not always strictly comparable) would appear to have been above average in the Czech Republic, compared for example to Poland and Hungary, and unemployment remained far lower than in the other transition economies.

---

[1] Prepared by Roger Nord, Regional Resident Representative.

[2] Czech Statistical Office–Statistical Yearbook 1998.

Box 1. The Voucher Privatization Scheme[1]

There have been two waves of mass privatization in the Czech Republic: 1991-93 and 1994. In preparation, the book value of equity was determined and the number of shares for sale in each individual enterprise was set such that (at least on paper) all shares were of equal value. It was also decided what equity share would remain with the National Property Fund either temporarily or permanently, and 3 percent of the shares were set aside to guard against future restitution claims. If a direct investor had been identified (domestic or foreign), then those shares would also not be offered for sale. Very little restructuring took place before privatization.

Under the voucher scheme, all citizens 18 years or older could buy, for a nominal fee, a package of vouchers worth 1000 points. With these points, they could bid for shares on offer or, before bidding started, they could sell their points to investment funds, which could use them to bid. In five sequential rounds of bidding, prices were adjusted until the market cleared. The shares thus obtained then became tradable on the stock exchange.[2]

Many individuals offered the bulk of their points to investment funds, which ended up with 72 percent of the shares in the first wave and 64 percent in the second wave. Although there were a very large number of funds, a single sponsor could own several funds: after the first wave, the ten largest founders accounted for roughly two thirds of shares allocated.[3] The investment funds were dominated by banks: bank-sponsored funds accounted for about 67 percent of all points acquired by funds. At the same time, there were restrictions on the ownership of individual enterprises: investment funds could not invest more than 10 percent of their assets in a single company and could not hold more than 20 percent of the equity of a company.

All funds created in the first wave were established as joint-stock companies and were closed-end funds, so that investors wanting to exit had to sell their shares in the secondary market. In the second wave, there were also some open-end funds (i.e., with an obligation on the part of the investment fund to redeem shares at net asset value).

---

[1]For a detailed exposition, see Shafik (1995); a useful summary description (on which this box draws heavily) is included in Claessens (1997).

[2]This resulted in an extremely large number of publicly traded companies, many more than typically found in market economies.

[3]See Kotrba, Kocenda, and Hanousek (1998).

8. However, in 1996–97, as restructuring progressed further in neighboring countries, Czech enterprises began to compare unfavorably as profits weakened and losses mounted.[3] One of the key reasons would appear to have been the survival of many large industrial enterprises—nominally in private hands after the rapid privatization of the early 1990s, but de facto still under state tutelage—whose competitive position weakened sharply as a result of excessive wage increases and a real appreciation of the exchange rate.[4]

9. There appeared to be some improvement in 1998, with profits in the overall enterprise sector (large enterprises with more than 100 employees) increasing substantially both on an operational basis and before taxes and the return on equity reaching 5 percent (Table II-1). The performance in industry was, however, not as favorable, with profits broadly unchanged in real terms but the return on equity still appearing rather high. Further, while the number of loss-making firms declined, total losses increased. Also, about 60 percent of industrial enterprises generated a return which was smaller than the risk-free rate of interest.

10. Although information on debt is not available from enterprise sector data, banking sector data shows that enterprises' net indebtedness increased markedly, mainly as a result of deposit withdrawals, while there has been little change in the level of credit.[5] The amount of overdue loans stabilized at about 8 percent of GDP consistent with enterprise sector data on gross arrears.

11. For some of the large enterprises, the situation appears to have deteriorated further. Data obtained from a privately-maintained database on those enterprises that would qualify for "revitalization" under the recently approved Industrial Revitalization Program[6] indicates that their financial leverage has been rising—mainly in the form of increasing long-term bank debt—while profits have stagnated in nominal terms, and equity and balance sheets have contracted. In addition, it is likely that many of these enterprises have not been servicing their debts to the banks, and their financial statements may not adequately reflect accrued losses. Consistent with this, their liquidity situation has been gradually deteriorating, evidenced by declining liquidity ratios and the continued run-down of bank deposits.

---

[3] The World Bank (1999a) study also finds that the performance of the enterprise sector in the Czech Republic, while superior in the early phases of transition, compares unfavorably with other countries in the region, especially Hungary, since 1996.

[4]State involvement was either through indirect ownership (state-owned banks owned investment funds which in turn owned enterprises) or through lending via state-owned banks.

[5]Somewhat contrary to expectations, there would appear to have been some shift in the maturity structure of credits from short- and medium-term to long-term.

[6]For a full description of the revitalization program, see Box 3 of the staff report.

12. A serious barrier to more rapid restructuring, in addition to the lack of incentives stemming from continued indirect state ownership and/or control, has been the inadequate legal and regulatory framework for bankruptcy (Box 2). Laws strongly protective of the debtor's position, and weak and inconsistent enforcement of even those laws that do exist, have resulted in a very unsatisfactory framework for restructuring through bankruptcy, which had proved successful elsewhere in Central Europe.[7] This has led to a lack of exit from the market, that is, inertia in the normal ongoing process of corporate renewal. These problems of "external" governance resulting from the lack of an efficient legal and regulatory framework are likely to be as important as issues of "internal" corporate governance discussed in the following sections.

C. Corporate Governance and Practices in the Czech Republic

The Concept of Corporate Governance

13. Corporate governance is concerned with the framework for monitoring and accountability of public corporations. In privately-held firms, ownership and control are in the same hands. In public corporations, however, shareholders, when parting with their funds, cede control to the management of the firm. The separation of ownership and control has been a cornerstone of capitalism. But it does bring with it a host of problems on how best to structure incentives such that managers maximize the value of the firm, that is, of shareholders, rather than their own.

14. The dominant academic view regards corporate governance as an agency problem.[8] The entrepreneur raises finance from investors. The investors need the entrepreneur or manager for his specific human capital skills to generate a return on their investment, while the entrepreneur needs the financial capital. The contractual view of the firm sees the relationship between the two parties as a contract that specifies their mutual obligations, balancing the managerial discretion necessary for the efficient operation of the firm and the control rights resting with investors.

---

[7]For example in Hungary (Bonin and Schaffer 1994).

[8]The contractual view of the firm dates back at least to Coase (1937) and has seen many extensions, including prominently Fama and Jensen (1983). For a useful overview of the literature on corporate governance, see Shleifer and Vishny (1996).

Box 2. The Bankruptcy Framework in the Czech Republic

The Czech Bankruptcy Act was initially enacted in 1992 and amended ten times since then. Since 1992, there has been a steady increase in the number of filings, reaching over 4000 in 1998. However, bankruptcy procedures are very slow and more than half of the cases are still pending. As a result, many view bankruptcy as a last resort aimed at liquidation rather than as a process of financial and corporate restructuring. There have been few if any bankruptcies against large enterprises.

The bankruptcy process is initiated by the filing of a petition with the court. However, the court has substantial discretion in issuing a bankruptcy order and it is not unusual for there to be a delay of up to one year before the court accepts the petition. In principle, the petition can be for liquidation or settlement (called "composition"). However, mainly because of the long delays involved (and the difficulty in obtaining injunctions or restraining orders that would ensure that there would be some remaining assets) there have in fact been no cases of court-supervised settlement since 1992. In addition, while in the absence of any cases this has not been tested, some observors point to potential weaknesses in the law governing composition, such as the requirement that the debtor satisfy the court that a minimum proportion of liabilities will be able to be repaid.[1]

By all accounts, the most important bottleneck has been the weakness of the Czech court system. An emphasis on form over substance often compounds the already long delays and the absence of case law makes the outcome of any court procedure extremely uncertain. Moreover, there is a wide-spread lack of expertise in financial matters that has stymied a rapid and efficient bankruptcy process. In particular, the court-appointed administrators—while not civil servants, but typically private sector lawyers—often lack both experience and, more importantly, the incentive to ensure an efficient bankruptcy process as their remuneration is determined principally by the duration of their involvement rather than the size of the recovery. Unlike in some other countries, the creditors have no say in the appointment of the administrator.

Ideally, the bankruptcy framework would encourage a substantial number of out-of-court settlements *in the shadow of bankruptcy*, quite common in some countries. This option exists and has been used in the Czech Republic—on a purely contractual basis. To encourage more recourse to out-of-court settlements, two factors are of critical importance. First, there should be no legal or tax barriers to seeking an out-of-court work-out. Current Czech tax law, for example, treats a debt write-down as a taxable receipt by the debtor. Second, most importantly, the threat of bankruptcy as an alternative should be credible and enforceable. This will require a strengthening of the legal framework for bankruptcy and steps to improve the functioning of the court system. Following examples in other countries, the creation of specialist bankruptcy courts may be an attractive option.

[1] *Czech Republic—Capital Markets Review*, A World Bank Country Study, May 1999.

15. Corporate governance systems vary greatly across countries, reflecting the historical evolution of the corporate and financial sectors.[9] Successful corporate governance typically rests, to varying degrees, on two pillars: legal protection of investors (dominant in the United States and the United Kingdom), and/or reliance on large investors, especially banks (for example, Germany and Japan). But while investor protection laws might be weaker in countries where corporate ownership is dominated by powerful large shareholders, there is still a need for a well-functioning legal system to enforce basic rights, such as voting rights and the power to pull collateral, to exercise their power over the management.[10] Reflecting the growing perception that efficient corporate governance mechanisms are important for sound investment decisions, there have been various national and international efforts to draw up codes of conduct in the area of corporate governance (Box 3).[11]

Corporate Governance in the Czech Republic

The impact of voucher privatization

16. The two waves of voucher privatization resulted in the creation of some 1700 joint stock companies with tradable securities. There were concerns about the widely dispersed ownership, although the sale of citizens' points to the investment funds and subsequent secondary trading led to some concentration of ownership. By 1997 it had reached levels that were roughly comparable to those prevailing in Western Europe and higher than those prevailing in the U.K. and the U.S.[12] However, strategic investors were the largest owner in only just over one third of a representative sample of enterprises reviewed by the World Bank.

---

[9]The nexus of legal systems and economic development is a growth area (see, for example, La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998), which relates ownership concentration to the protection of investors' rights). But while the development of debt and equity markets does depend on a supportive legal framework, including the protection of investors' rights, evidence that such markets are required for successful economic growth, while mounting, remains tentative.

[10]A recent contribution to corporate governance literature argues that in transition economies, in particular, external governance through the consistent enforcement of the legal and regulatory environment is crucial (Berglöf and Von Thadden 1999).

[11]At the national level, a well-known early example is the Cadbury Report (1992) in the United Kingdom; a recent example of establishing international standards is the OECD *Principles of Corporate Governance* (1999). These and other such guidelines are available on the web page of the European Corporate Governance Network http://www.ecgn.ulb.ac.be).

[12]World Bank (1999a), Chapter IV.

Box 3. The OECD Principles of Corporate Governance[1]

In May 1999, the OECD completed its work to develop—in conjunction with national governments relevant international organizations (including the Fund and the World Bank), and the private sector—a set of corporate governance standards and guidelines. In doing so, it recognized that one element in improving economic efficiency is corporate governance, which involves a set of relationships between a company's management, its board, its shareholders, and other stakeholders. The OECD stressed that it would not be useful to seek to establish a single global standard of corporate governance. Rather, the Principles embody common elements of good practice, are non-binding, and aim to serve as a reference point for policy makers and market participants alike.

The principles cover five areas:

The protection of shareholders rights: This includes the right to secure methods of ownership registration and transfer; the right to obtain information on corporate developments and major decisions; the right to participate and vote in general shareholder meetings, including in absentia; the right to elect members of the board; the right to a share in the residual profits; and the right to a transparent framework of corporate financial control that clearly articulates investors' rights and recourse.

The equitable treatment of shareholders: All shareholders, including minority and foreign shareholders, should receive equitable treatment and have the opportunity to obtain effective redress for violation of their rights. Self-dealing and insider trading should be prohibited, and officers of the corporation should be required to disclose their material interests in transactions or matters affecting the corporation.

The role of stakeholders: The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

Disclosure and transparency: The corporate governance framework should ensure that timely and accurate information is disclosed on all material matters regarding the financial situation, performance, ownership, and governance of the company. Information should be prepared, audited and disclosed in accordance with high-quality standards of disclosure and audit, and an annual independent external audit should be required.

The role of the board: The corporate governance framework should ensure strategic guidance and effective monitoring of the company by the board, and the board's accountability to the company and the shareholders.

[1]For the full text, including annotations, see http://www.oecd.org/daf/governance/principles.htm.

Investment funds (bank-sponsored and nonbank funds together) were the largest owner in over half of the sampled cases.

17. There were several reasons why ownership structure resulting from voucher privatization led to severe governance problems. First, the incentive for active control by investment funds was at least muted by their limitation to holding a maximum of 20 percent of the equity in a company. Second, more importantly, the closed-end nature of the funds discouraged responsive behavior by fund managers who did not need to fear a deterioration in the net asset value of the fund since they had no obligation to redeem shares.[13] Moreover, the structure of the remuneration of investment fund managers did not promote active asset management, as it was typically only loosely related to performance. Finally, the important role of commercial banks, which owned many large investment funds, was problematic: state-owned banks remained both major shareholders and principal creditors in nominally privatized enterprises.

18. In sum, the legal and regulatory framework for monitoring and oversight over corporations was weak (and enforcement even weaker), resulting in wide-spread abuses by unconstrained management. This included infamous "tunneling" operations, in which managers engaged in asset stripping by milking cash out of the enterprise by engaging in fictitious or overpriced contracts with suppliers, often companies owned by the managers themselves. These practices were certainly unethical and in some cases also illegal. In this light, it is not surprising that recent comparative analyses have come to the conclusion that there is marked relationship between ownership structure and enterprise performance in the Czech Republic: firms with concentrated ownership *and* in which ownership is concentrated outside the investment funds seem to perform better than firms with either diffuse ownership or firms in which the owners are investment funds.[14]

The strengthening of the regulatory framework in 1996-98

19. The first steps were taken in 1996 to improve corporate governance. An amendment of the Commercial Code improved minority shareholders' rights by: (i) mandating a large shareholder to offer to buy out minority shareholders every time its holdings exceed 50, 66, and 75 percent of the equity; (ii) introducing a number of rules governing general shareholder meetings, including requiring a 75 percent majority for key decisions; and (iii) requiring the disclosure of purchases of shares (by a single investor or by investors acting in concert) exceeding 10 percent of the enterprise's equity. This was accompanied by an amendment of the Investment Fund Act that, *inter alia*, improved disclosure rules.

---

[13]In open-ended funds, investors have the right to sell back their shares at any time at the prevailing net asset value, while in closed-end funds, such sales can only take place if mutually agreed.

[14]Weiss and Nikitin (1997).

20. Capital market regulation was further strengthened in 1998 with the amendment of the Banking Act, which aims at reducing conflicts of interest by curtailing banks' ability to take control and play an active role in non-financial enterprises. In 1998, the supervision of capital markets was vested in a newly-created Securities Commission (SC). While lacking the ability to issue decrees itself (it must do so through the Ministry of Finance), the SC was given substantive enforcement powers. Moreover, further amendments to the Investment Fund Act included the mandatory opening of closed-end funds and a reduction (from 20 to 11 percent) in the maximum holding limit, with the objective of inducing funds to sell and create more consolidated corporate ownership.

21. In a recent review of the Czech capital market, the World Bank found much progress since 1996, but still room for further improvement. The next section will review the current regulatory framework for corporate governance against the background of the recently-adopted OECD *Principles*.

D. An Assessment of Corporate Governance Practices in the Czech Republic Today

Overview

22. The framework for corporate governance in the Czech Republic has undoubtedly been strengthened in recent years. Especially the framework for internal governance, including rules for corporate disclosure and the protection of minority shareholders has improved. This is in line with the OECD's *Principles*, as documented in the self-assessment by the SEC below.

23. However, as noted in the World Bank's *Capital Markets Review*, there remains a need to urgent need to strengthen the enforcement of existing laws and regulations. Without an improvement in the judicial and regulatory process, that is, in external governance, further refinement in the laws and regulations themselves are likely to be of little avail.

Self-assessment[15]

24. In order to assess the Czech Republic's framework for corporate governance, the Securities Commission conducted a self-assessment of Czech practices against the background of the OECD's *Principles* under the five headings of the OECD: shareholder protection; the equitable treatment of shareholders; the role of stakeholders; disclosure and transparency; and the role of the board.

---

[15]This section is based on a self-assessment provided by the Czech Securities and Exchange Commission.

Shareholder protection

25. **Shareholder protection is embodied in the provisions of the Commercial Code (1996).** However, enforcement of the existing laws has been weak; in particular, delays in judicial proceedings are long. The creation of the Czech Securities Commission (SC) in 1998 has helped, as it was empowered to enforce existing regulations and draft new regulations in the areas of: calculation of voting rights shares, rules governing acting in concert, rules governing mandatory public offerings; rules governing minimum price calculations; and rules governing disclosure.

26. Shareholders participate in decisions concerning fundamental corporate changes, which are taken by General Shareholder meetings. Shareholders can place items for discussion on the agenda. However, the amount of information provided to shareholders ahead of the meetings varies between companies and shareholders can only vote in person, not by proxy.

The equitable treatment of shareholders

27. **Within any class, all shareholders have the same voting rights.** Holdings of 10 percent or above of publicly tradable shares are regularly disclosed by the Securities Center and changes in voting rights are subject to shareholder vote. Self-dealing and insider trading is prohibited (although difficult to detect). Members of the Board and managers are not required to disclose their material interests in transactions or matters affecting the corporation.

The role of stakeholders

28. The rights of stakeholders are ensured on a contractual basis.

Disclosure and transparency

29. **All issuers of publicly tradable securities are obliged to disclose:** (i) an audited annual report; (ii) a semi-annual financial report; and (iii) all material changes continuously. However, compliance with these obligations is weak, especially among small companies.

30. Disclosure requirements include the financial and operating results of the company; company objectives; major share ownership and voting rights (above 10 percent); membership of the board and key executives, and their remuneration; and material foreseeable risk factors that could have an impact on the share price. Material issues regarding employees and other stakeholders, as well as governance structures and policies, do not necessarily need to be disclosed.

31. **Accounting standards** for the preparation of company accounts are determined by the Czech Accounting Act (1991, amended 1994 and 1997). There are currently some differences between Czech accounting standards and International Accounting Standards

(IAS). A further amendment currently underway would address most of the differences, so that in substance the Czech standards would be well within the EU margin of difference from the IAS.[16] The Ministry of Finance is responsible for the enforcement of accounting standards and can impose penalties for noncompliance. For the registration of securities, full IAS compliant accounts are required by the SC.

32. **Auditing standards** are set by the Czech Chamber of Auditors, in accordance with the applicable law. The Chamber's policy is to follow IAPC rules as closely as possible; the Big 5 accounting firms are very active in the Czech Republic. The system is essentially self-regulatory.

The role of the Board

33. The role of the Board is governed by the relevant provisions of the Commercial Code, which include a general requirement to act with due diligence and care.

E. Conclusions

34. The Czech Republic started with a larger state sector than other central European transition economies and the voucher privatization scheme was successful in rapidly privatizing a broad section of the corporate sector. However, in stark contrast with other countries in the region, it was less successful in bringing about a fundamental restructuring of the corporate sector, and enterprise performance and profitability in recent years suffered correspondingly.

35. There are several reasons for this poor performance, including an inadequate legal and regulatory framework to ensure efficient exit through a functioning bankruptcy process. Moreover, weak enforcement, that is, failures in the judicial and regulatory process, has also hampered the development of a more efficient corporate sector.

36. However, an important factor has also been the absence of a proper incentive structure for sound corporate decision making. The separation of ownership and control as a result of voucher privatization should in itself not have been an impediment, judging by the experience of other countries. But the owners of the newly-privatized enterprises, often investment funds (and hence, indirectly, state-owned banks) did not exercise proper monitoring and control over the management of the enterprises, which in many cases remained unchanged. Rules governing the treatment of minority shareholders and the framework for corporate disclosure and transparency were woefully inadequate and allowed for inappropriate, in some cases illegal, activities by corporate management. Moreover, the

---

[16]It was recognized that some IAS "soft" rules, such as *substance over form*, did not mesh well with the Czech tradition of legal positivism—which itself was, however, undergoing long-overdue change.

absence of an efficient bankruptcy framework, characterized by rules tending to favor the debtor and a weak judicial process, weakened the scope for exercising discipline by creditors dramatically.

37. In recent years, the Czech authorities have taken several important steps to improve the regulatory framework. The revisions of the Commercial Code in 1996 and 1998 have introduced many of the rules common in other market economies. The creation of an independent Securities Commission in 1998 was a positive step. A comparison of the Czech Republic's corporate governance practices with the recently-approved OECD *Principles* confirms that in most areas Czech rules and regulations are now in line with international practice, albeit with some deviations regarding minority shareholder protection. However, a recent World Bank Report points to remaining shortcomings, particularly in enforcing compliance with existing rules.

38. Comprehensive further amendments of the Commercial Code and Securities Act are under preparation, with the aim of becoming effective on January 1, 2000. They draw heavily on both the World Bank report and the OECD *Principles*, and the objective is to bring the Czech legal and regulatory framework fully in line with best international practice, including the introduction of proxy voting and more comprehensive disclosure requirements.

39. There remains a need to strengthen the judicial and regulatory process, starting with the bankruptcy framework. A critical factor is improving the speed and reliability of the judiciary. This is a medium-term task, involving not only changes in the law but attracting and training high-quality judges (and, for example, bankruptcy administrators). But it is likely to be critical in restoring the Czech Republic to a path of high and sustainable economic growth.

Bibliography

Berglöf, Erik and Ernst-Ludwig von Thadden (1999), The Changing Corporate Governance Paradigm—Implications for Transition and Developing Countries, paper prepared for the *Annual World Bank Conference on Development Economics*, April 28-30, 1999.

Bonin, John P. and Mark E. Schiffer (1994), Banks, Firms, Bad Debts and Bankruptcy in Hungary 1991-94, paper prepared for the *Workshop on Enterprise Adjustment in Eastern Europe* hosted by the World Bank, September 22-23, 1994.

Cadbury Commission, *Report of the Committee on the Financial Aspects of Corporate Governance*, (December 1992).

Claessens, Stijn (1997), Corporate Governance and Equity Prices: Evidence from the Czech and Slovak Republics, *Journal of Finance*, 52(4), 1641-58.

Coase, Ronald (1937), The Nature of the Firm, *Economica*, 4, 386-405.

Czech Statistical Office, *Statistical Yearbook* 1998.

Fama, Eugene and Michael Jensen (1983), Separation of Ownership and Control, *Journal of Law and Economics*, 26, 301-25.

Kotrba, Jan, Evzen Kocenda, and Jan Hanousek (1998), Corporate Governance of Privatization Funds in Czech Republic, in: *Governance of Privatization Funds -- Experiences of Czech Republic, Poland, and Slovenia*, unpublished manuscript, Central & Eastern European Privatization Network (C.E.E.P.N.), Ljubljana, Slovenia.

La Porta, Rafael, Florencio Lopes-de-Silanes, Andrew Shleifer, and Robert W. Vishny (1998), Law and Finance, *Journal of Political Economy*, 106, 1113-1155.

Shafik, Nemat (1995), Making a Market: Mass Privatization in the Czech and Slovak Republics, *World Development 23*

Shleifer, Andrei and Robert W. Vishny (1996), A Survey of Corporate Governance, *NBER Working Paper* No. 5554.

Weiss, Andrew and Georgyi Nikitin (1997), Performance of Czech Companies by Ownership Structure, unpublished manuscript, Department of Economics, Boston University, Boston, MA.

World Bank (1999a), Czech Republic: Capital Markets Review, *World Bank Country Study,* The World Bank, Washington, D.C.

World Bank (1999b), "Enterprise Sector Report," Chapter VII in Czech Republic—*Towards EU Accession*.

Table II-1. Czech Republic: Financial Performance of the Enterprise Sector 1997-98

(In millions of korunas)

	Enterprise Sector 1/		Change	Industry 1/		Change	Financially distressed enterprises 2/		Change
	1997	1998	in percent	1997	1998	in percent	1997	1998	in percent
Net operational surplus (EBIT)	128,753	153,995	1.20	102,010	109,657	1.07	1,005	973	0.97
Profit before tax	55,974	73,249	1.31	42,754	47,724	1.12	218	708	3.25
Profit after tax	...	...	...	...	...	...	314	485	1.54
Return on equity (percent)	3.84	5.03	1.19	5.14	5.75	0.61	5.71	8.54	2.83
Number of profit making enterprises	...	...	...	1,501	1,594	1.06	...	...	...
Profits	...	...	...	74,115	82,694	1.12	...	...	...
Number of loss making enterprises	...	...	...	901	813	0.90	...	...	...
Losses	...	...	...	-31,907	-34,461	1.08	...	...	...
Gross arrears	140,365	141,403	1.01	85,956	84,242	0.98	...	...	...
Net arrears	46,929	49,161	1.05	29,356	29,771	1.01	...	...	...
Net arrears as a share of equity (percent)	3.22	3.38	0.16	3.53	3.59	0.06	...	...	...
Long-term liabilities	...	...	...	...	...	...	716	721	1.01
Short-term liabilities	...	...	...	...	...	...	1,847	1,540	0.83
Long-term bank loans	...	...	...	...	...	...	1,049	1,958	1.87
Short-term bank loans	...	...	...	...	...	...	843	848	1.01

Sources: Czech Statistical Office; Ministry of Industry and Trade; and Aspekt commercial database.

1/ Large enterprises (>100 employees).

2/ Enterprises eligible for Revitalization Program (Average).

III. Issues in Financial Sector Performance and Restructuring[16]

A. Overall Financial Sector Structure

Background

40. Many of the current financial sector problems in the Czech Republic can be traced to structures established during the pre-transition period and early in the transition phase. Most important, voucher privatization of banks did not lead to an effective end to state control in key institutions. Hence, until mid-1998, the four dominant Czech banks remained to a large extent state-owned and were effectively state-controlled. Their business activities continued to be geared towards large industrial loans, with credit allocation, at least in part, dictated by industrial needs. The two largest banks remain burdened with a large share of non-performing loans, relatively weak management and control systems, and a product mix that does not fully cater to the needs of the private sector. Meanwhile, the newly established private banks were initially too small to compete and soon, following an early period of lax supervision, experienced widespread financial difficulties. Foreign banks that opened branches and subsidiaries mainly catered to foreign and exporting customers. New types of financial institutions that were introduced—for example mutual funds, leasing companies, and housing banks—did expand the scope of financial sector participants, but remained small in comparison. The stock market, which has been in existence only since the early 1990's, was for some time under-regulated and mainly a market for secondary trading of shares. Thus, it could not fulfill a significant financing function.

41. Fundamental changes in the financial sector appear imminent as efforts are now under way to complete structural changes neglected during the early transition. In this venture, bank privatization takes center stage but other issues, such as revisions to the supervisory framework, are equally important. The present chapter will take stock of banking sector developments and performance and review financial policy and supervisory challenges, including the definition of policies for bank privatization and the appropriate prudential framework.

Structure of the banking sector

42. After a period of early expansion, the Czech banking sector began consolidating in the mid-1990s (Table III-1). The overall change in the number of banks conceals opposing trends. First, there has been a marked rise and subsequent decline in the number of small domestic institutions. This development paralleled those in other transition economies, initially spurred by relatively lax rules on bank licensing during early transition, followed by a significant tightening of the supervisory framework. In the Czech context, some of the banks not meeting the tighter criteria were closed by the central bank; others merged, or

[16] Prepared by Akira Ariyoshi and Anne-Marie Gulde.

exited in an orderly liquidation process. At the same time, the number of foreign banks and foreign bank branches has continued to steadily increase.

43. In terms of economic importance—measured by shares of total assets, or in terms of their role in credit and deposit markets—the banking industry continues to be dominated by the large state-controlled banks (Table III-2). Nevertheless, concentration has been declining and especially foreign banks have developed into a significant pillar of the system (Table III-3). By now, foreign banks and foreign bank branches account for about a quarter of total assets of the banking system. While growing somewhat slower, their share in deposits is also significant, attesting to their desire to increasingly become active in the retail market.

Economic importance and performance

44. The banking sector has increased its already significant size over the past years. Total assets of the sector in 1998 amounted to almost 200 percent of GDP, similar to the figures for Germany (176 percent), Hungary (175 percent), Spain (185 percent), and France (179 percent). In contrast, the banking sectors of other transition economies are considerably smaller—for example, Slovenia (76 percent) or Poland (49 percent). For the Czech Republic this difference is due to a high level of financial intermediation at the outset of the transition process, relative monetary stability since then, and the absence of significant alternative financial institutions.

45. Notwithstanding balance-sheet growth and the key role of the banks in the financial sector, there are notable weaknesses in the Czech banking sector in the areas of capitalization, asset quality, and profitability (Table III-3).

46. According to the regulations currently in place, the banking system is adequately capitalized with *capital ratios* exceeding the required 8 percent. Aggregate capitalization increased from 9½ percent in 1997 to nearly 12 percent in 1998. These levels should, however, be interpreted cautiously. While above prudential limits, it is generally argued that capital ratios in emerging markets—due to higher risks and less liquid markets—should exceed the 8 percent level established by the Basle standards. Against this background, and given that the capitalization in neighboring Poland (15.5 percent in 1998) and Hungary (18.3 percent in 1997) is higher, capital levels in the Czech Republic should not be regarded as comfortable. Also, the recent increase in capitalization was mainly in Tier 2 capital, with core capital remaining broadly constant. Further, banks have currently set aside provisions for only about 50 percent of loans classified substandard and below, which could turn out to be insufficient if many of the weak borrowers go into liquidation or require substantial reduction of debt in the course of restructuring. In addition, there are concerns that the deductibility of collateral from provisions and the lack of provisioning requirements for market risk mean that current reported capital levels are overstated. The recent revision of the provisioning regulations, which will be phased in over a three-year period, will require a significant buildup of new provisions or a write-down of assets, which would impact the capital base.

47. Regarding asset quality, classified credits has remained high in the Czech Republic over the past years. By end-1998, about one-third of all loans were classified as watch, substandard, doubtful, or loss. Even adjusting for the watch category—which includes credits that are expected to be serviced in full but have higher risks—and excluding Konsolidacni Banka, the level of problem loans is high, at about 18 percent, and indicative of a significant burden on the banking system. Whether the continued high level of problem loans point to a fundamental problem in the banks is harder to assess: the largest share among nonperforming loans fall in the loss category—representing often old, policy based loans—which in the absence of well-defined workout procedures continue to be carried on the balance sheets. To the extent that these loans are fully provisioned, they "inflate" a bank's balance sheet and can complicate the analysis of underlying movements in bad loans, but are not indicative of significant economic risks. Two caveats to this argument apply in the case of the Czech Republic. First, at present, provisions for these loans are "net of collateral". As a result of the Czech National Bank's (CNB) new provisioning rules, additional provisions for these loans will have to be formed over the next three years. Further, while these loans have declined significantly from 1995 to 1997, the levels have stabilized since then, despite substantial write-offs. This is indicative of a new group of loans having moved into the substandard category.

48. Looking ahead, developments in asset quality, in addition to macroeconomic factors, will depend to a large extent on the structures that will result from the ongoing privatization process. On the assumption that privatization (see also Section C for details) will bring strategic investors into all of the remaining state-controlled banks, business practices should improve, which together with tightened prudential rules should, at a minimum, lead to stable asset qualities. The speed at which the "overhang" of impaired assets can be reduced will, *inter alia*, depend on cyclical factors, which ultimately will decide banks' earnings and their capability to close the remaining provisioning shortfalls.

49. In light of the portfolio problems and the associated need for provisioning, profitability of the banking sector has been weak for a number of years. In 1998, the banking sector recorded losses of CZK 5.6 billion (0.3 percent of GDP)—more than double the losses in 1997. In both years, losses reflected the need for creating provisions, reserves, and write-offs. Given the very limited tax deductibility of provisions, after-tax losses were even higher, amounting to CZK 3.5 billion (0.2 percent of GDP) in 1997 and CZK 8.5 billion (0.5 percent of GDP) in 1998. Profitability also suffered from relatively high labor costs—costs per employee have increased by about 40 percent from 1995 to 1998—and the still limited fee generating services.

50. As suggested by the data on banking sector structure, aggregate data on bank performance is dominated by the outcomes for the four large banks. The weak performance of these institutions—with all four recording losses in 1997 and three of these recording losses in 1998 as well—is attributable to a number of factors, predominantly the need to provision or write off bad loans, but also the high cost structure, and increasing competition

from more efficient banks for prime customers.[17] Bank performance also suffered from the recession in 1997–98. Finally, in 1998 at least one of the large banks recorded significant losses in connection with unhedged exposure to the Russian government securities market.

51. Driven by weak performance and the uncertain outlook for privatization, the index of Czech bank stocks fell sharply from 804 points in 1996 to 505 points in 1997 and to 345 points by end-1998—a 57 percent decline over the two-year period. The fall in stock prices, which left a number of banks' shares at below nominal issue values, was significantly steeper than the fall in the overall stock price index which declined by 27 percent during 1996 to 1998.

Other financial institutions and capital markets

52. Other financial institutions in the Czech Republic include credit unions, pension funds, insurance companies, and investment funds, but all are dwarfed by the size and importance of the banking system.[18] Credit unions hold assets of CZK 5 billion (0.3 percent of GDP).[19] Private pension funds and life insurance companies in the Czech Republic play a somewhat larger role than in other transition economies, but their importance still lags way behind that of such institutions in Western Europe. To date, they both collect relatively small contributions and premiums (each around 3 percent of the average wage), which shows their limited role in the collection of long-term savings. Finally, investment funds, which were originally introduced as part of the voucher privatization, did not take the pivotal role in the financial and capital markets that had initially been hoped for. From 1994 to March 1998 the

---

[17]Net creation of provisions in 1997 amounted to CZK 30 billion and to CZK 12 billion in 1998, while write-offs amounted to CZK 11 billion in 1997 and CZK 30 billion in 1998. There seems to be little progress in streamlining the financial sector. Employment in the banking sector stayed virtually unchanged during the period 1995 to 1998 at about 53,000 employees. At the same time, operating costs per employee increased by about 30 percent in real terms.

[18] The banking system includes specialized banks, most importantly the housing banks, but excludes credit unions.

[19] Before World War II, the Czech Republic had a long tradition of credit unions but these institutions were closed in the 1950s. All of the 76 currently operating unions were founded after a new law on credit unions was passed in 1995. Currently, credit unions are only lightly supervised and some are in financial difficulties. A major revision of the credit union act, including provisions to strengthen supervision and make it compatible with minimum capital requirements under EU regulations, is expected to be presented to Parliament in the near future.

number of investment funds declined from 617 to 336, while total assets declined from about 12 percent of GDP to less than 8 percent of GDP.[20]

53. Concerning financing facilities for the commercial and industrial sector, it is again banks that are the dominant players. While a stock market exists, its size measured by capitalization at end-1998 amounted to only CZK 394 billion (22 percent of GDP), of which nearly half was accounted for by government-owned stocks. New issues of stock, which in 1996 and 1997 amounted to about 2 percent of GDP, were only in a few cases actually undertaken to raise fresh capital. The majority of such issues reflected adjustments in stock structure or new introductions to the market that did not yield additional financing for the enterprises concerned.

B. Macroeconomic Linkages with Financial Sector Issues

54. Financial sector weakness has potential repercussions for macroeconomic policy making. This section discusses two pertinent effects: the implications of banking sector uncertainties on credit availability, and possible constraints on monetary policy transmission.

The "credit crunch"

55. In connection with the deepening recession, it has been argued that the Czech economy suffers from a "credit crunch." Overall, bank lending behavior is said to be influenced both by internal efforts to reduce exposure but also by recent changes in the prudential framework, most notably the regulation that eliminates the possibility to deduct collateral from provisioning requirements (see Section D on changes in provisioning requirements).

56. Analyzing bank assets shows that in fact significant shifts in bank investments have taken place that are consistent with a "credit crunch" explanation (Table III-4). Most important, credit to the economy as a share of bank assets has declined from about 45 percent of assets in 1996 to less than 40 percent at the end of 1998. As an alternative to granting credits, banks have increasingly turned to inter-bank time deposits and investments in CNB bills. Between 1996 and 1998, inter-bank time deposits have grown from 15 percent of banking sector assets to nearly 17 percent of assets while in the same period bank holdings of CNB bills have increased from 3 percent of banking sector assets to 7 percent of assets. In addition, banks show an increasing liquidity preference with free reserves with the CNB now

---

[20] Assets of investment funds are based on a sample constructed by the Securities Commission, for which end-1998 figures are not available. Amendments to the Investment Fund Act approved in July 1998 require opening of all existing closed end funds by end-2002 and a reduction in the maximum holding of shares in one company from 20 to 11 percent, essentially requiring a wider portfolio distribution.

amounting to almost 8 percent of banks' assets.[21] The shifts to such assets, which have a lower or zero risk weight, explain to a large extent the increase in bank risk-weighted capital adequacy ratios.

57. Based on asset shifts alone, it is difficult to distinguish conclusively between the effects of tight monetary policy and a genuine "credit crunch," defined as a reluctance of banks to lend "at any interest rate." It is likely that the tight monetary policy stance in the first half of 1998 and the attendant high interest rates for CNB bills contributed to the decline in lending. Nevertheless, circumstantial evidence on a credit crunch, especially for those firms not able to enter into business relations with foreign banks, is confirmed by an analysis of recent portfolio shifts in banks (Table III-5). This shows that while loans to the private sector contracted somewhat, loans to small businesses declined sharply in 1998.

58. Even assuming that the observed decline in lending reflects more than cyclical factors, there is some ambiguity regarding to what extent the recent change in provisioning requirements has influenced or solely caused the change in lending behavior. On the one hand, credit to the economy started contracting already from mid-1997 (Figure III-1) while the change in provisioning requirements was announced only in July 1998 and will be implemented only gradually. Yet, the new regulation was publicly debated beforehand and it might well be that, at the margin, some of the banks' behavioral changes were a reflection of the announcement effect. Higher provisioning will, whether it be through voluntary recognition of asset impairment or tighter regulation, cut into the capital base and thereby put pressure on banks to reduce the volume of risk assets.

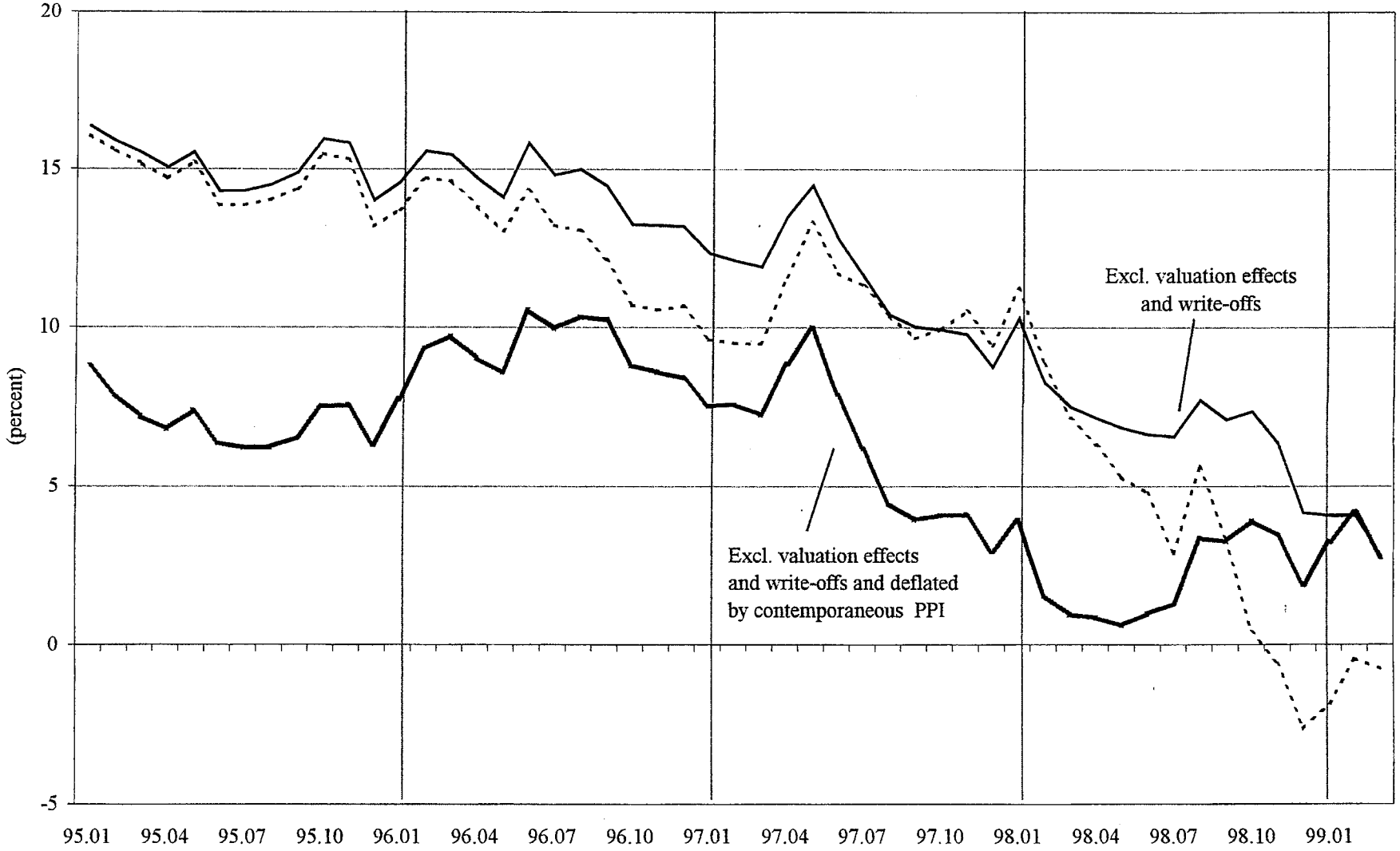
59. Banks themselves confirmed the shift in business behavior implied in the data. While some new credits are being given, they are mainly concentrated in the extremely competitive market for prime customers, where lending rates on new loans and interest rate spreads have been declining. For all other businesses, the need to lower banks' risk profile in the run-up to privatization has reduced credit availability. In addition to the alternative investments for banks mentioned above, banks are also increasingly offering loans to households, which have a low observed default risk.

Monetary policy implications

60. Banking sector problems and the associated imminent structural changes—especially privatization and adaptation to a stricter regulatory environment—appear to have dampened the effectiveness of the credit transmission channel of monetary policy. In particular, the CNB's recent round of interest rate cuts—the CNB's two-week repo rate has been lowered in increments from 15 percent in mid-1998 to below 7 percent in May 1999—has not translated into a revival of growth in credit to the economy. The need to strengthen banks' balance sheets and the poor economic outlook for the enterprise sector continues to depress lending

[21] Free reserves are remunerated.

Figure III-1. Czech Republic: Credit Growth, 1995-99 (y-o-y)



Sources: CNB; and staff estimates.

and investment. With the intermediary role of banks impaired, the potency of monetary policy has been reduced mainly to "second order" effects working through a weaker exchange rate and lower debt servicing costs on the high share of variable interest credit. At the same time, however, the risks of easing monetary policy have been reduced as banks are less likely to lend to poorly governed enterprises which in the past have used credit to finance large wage increases.

C. Bank Privatization

Progress in bank privatization

61. The state sold significant stakes in the four major banks in the mass (coupon) privatization process in the early 1990s but chose to not relinquish effective control over them in the initial stages of transition. The first major shift in this policy was initiated with respect to Investicni a Postovni Banka (IPB), with the government announcing in the summer of 1996 its intention to sell the state's 36 percent stake in the bank in 1997.[22] An agreement was eventually reached in March 1998 with Nomura, a Japanese investment bank, in which Nomura committed itself to subscribe to a capital increase in addition to the purchase of the state's shares, in order to recapitalize IPB and take a controlling stake in the bank.[23]

62. As the negotiation for the sale of IPB was proceeding, the government in August 1997 announced a policy to sell the state's stake in the remaining three large banks to strategic investors. The decision reflected a recognition that the lending and other activities of state-controlled banks lacked full accountability and were not conducive to promoting industrial restructuring and improving economic efficiency. Privatization advisors were appointed for each of the banks in February 1998. Holdings in Ceskoslovensko Obchodni Banka (CSOB) were the first to be put out for tender—a short-list of four European banks was prepared in January 1999, and binding bids were submitted by three banks in April, with the KBC group (Kredietbank) of Belgium being chosen in May as the winner of the bidding. In March 1999, the government adopted a timetable for the privatization of the other two banks with completion targeted for end-1999. Following this schedule, an advertisement for the sale of Ceska Sporitelna (CS) was published in April. Action on Komercni Banka (KB) is expected to follow in the near future.

---

[22] Apart from the ordinary shares, the state held "golden shares" that allowed it to call a general shareholders meeting and also to block certain changes to the bank's statute.

[23] Subsequently, the IPB general shareholders' meeting in June 1998 voted on another capital increase in which Nomura chose not to participate. In addition to its share being diluted by this capital increase, Nomura also sold a portion of its shares to other shareholders to bring its share of ownership to below 50 percent.

Issues in bank privatization

63. The sales of banks are not simple exercises in any situation, but the difficulties have been compounded in the case of the Czech Republic due to the poor quality of the banks' loan books. An extensive, and possibly very difficult, workout will be required to recover value from the non-performing loans, and the amounts that can be ultimately recovered, net of costs, are highly uncertain. The second issue is that the banks have large exposures to firms that are weak and highly indebted, so that even though the firm may be current in its debt service obligations, there is a risk that the firm may default on the loans in the near future. This risk has increased with the economic recession.

64. The weaknesses in bank balance sheets could likely depress their sale price, and may require cleaning up of the balance sheets to make the banks attractive enough to strategic investors. The authorities have approached the issue in a number of ways, with varying consequences for the character of the transaction and the fiscal costs involved.

65. A first case, though not a privatization but a resolution of a failed bank, was that of Agrobanka. The bank was put under forced administration by the central bank, and a buyer was sought for its assets. Eventually, the assets and matching liabilities were sold to a foreign financial institution (GE Capital), but the new bank took over only the performing loans, which were bought at a discount to reflect the perceived credit risk. The state (in this case the CNB) therefore had to accept the non-performing loans as well as a loss on the performing loans.

66. The sale of IPB was the opposite extreme, with the bank essentially sold "as-is." This case is, however, thought to be somewhat unique, since the acquirer was not considered to be a strategic investor in the narrow sense of the word. The new owner is believed to have bought the bank not to acquire a foothold in the Czech banking market, but rather to gain return on investment from the restructuring and eventual sale of the bank, either in its entirety or of constituent parts, including the bank's securities investment portfolio. In an "as-is" sale, the risks in the portfolio are transferred to the new owner. The government incurs no direct costs, but must accept a lower price on the shares to reflect the risk of potential losses in the bank's balance sheet. Any upside potential from a successful asset recovery will accrue to the new owners.

67. In the case of CSOB, the largest obstacle to the sale was the exposure that it had inherited from the pre-1990 period. In particular, exposure originally guaranteed by the Slovak government and amounting to about two-thirds of CSOB's Tier 1 capital is not being serviced, creating a very large uncertainty concerning the ultimate value and viability of the bank. While the issue is being pursued in the International Center for Settlement of Investment Disputes, the Czech state has agreed to guarantee this exposure in order to eliminate the credit risk involved and to make the sale of their share of the bank possible. The remaining non-performing and classified credits of CSOB were considered to be limited in size and scope and no major obstacle to sale. Indeed, the winning bid by the KBC valued

CSOB at 2.3 times the book value, reflecting the purchaser's confidence in the strength of the balance sheet and potential earnings power.

68. The cases of CS and KB are more complex, as both banks carry a large and diverse portfolio of low-quality assets, and because the desire to sell the banks to strategic investors with a long-term commitment to banking operations would mean that an "as-is" sale would be more difficult, as well as costly, since such an investor would likely heavily discount the value of impaired assets. For CS, the government has already taken off loans with a book value of CZK 10 billion and has tacitly approved a recapitalization of around CZK 6 billion, with KB also receiving a capital injection of CZK 9.5 billion from the government. In both cases, the amount of recapitalization is close to one-half of shareholder equity at the end of 1998.

69. Take-out of loans and recapitalization in particular can be fairly simple and straightforward, and may be done quickly. However, it may not necessarily be favorable in terms of the cost to the government. A take-out of the loans, unless it is done at prices that are low enough to reflect the true value of the loans taken out, implies a subsidy to the bank. For example, in the CS case last year, the government effectively assumed a loss of some CZK 4 billion in a transaction valued at CZK 10 billion by purchasing the loans at above their expected recovery value. Moreover, management of assets requires expertise that the acquiring government agency may not have, and often results in high costs or low recovery. On the other hand, to the extent that the buyer may demand a large discount on the impaired assets, the government may gain by taking out the impaired assets simply because it will retain the upside potential from any subsequent recovery on the assets. Recapitalization through government subscription to new shares could also result in a transfer of wealth to non-state shareholders if the shares are bought at prices that are higher than the value of the bank, and if the other shareholders do not participate in the recapitalization.[24] However, recapitalization by the government would increase its control over the bank which may facilitate sale.

70. Other methods are more complex but may be constructed to minimize the cost to the government while making the bank attractive to prospective buyers. The Information Memorandum for the CS sale proposes a "ring-fencing" of problems loans so that the acquiring bank would not be required to carry the credit risk but would be given the

---

[24]A difficulty in avoiding such a transfer is that the Czech commercial code does not allow issue of new shares at below face value. Therefore, if the per share *value* of a bank is below the face value, subscription to new shares by the state at face value will result in some gain to the non-state shareholders who do not participate in the capital increase. Ideally, there should be a reduction in the number of shares to bring the value of shares in line with the face value prior to recapitalization, but it may be difficult to enlist enough support to carry such a motion in the shareholders meeting, particularly as the state is seen to have had a controlling interest in the bank.

opportunity to work out the loans under an incentive structure. If the scope of the ring-fencing and structure of the incentives are appropriate, such a scheme could prove useful.

71. Uncertainties regarding the outlook for KB and CS, combined with the unavailability of sufficiently detailed information, make it difficult to explore numerical estimates of the potential fiscal cost arising from any necessary restructuring measures in connection with the privatization of these banks. First, given the uncertainty about the quality of these banks' loan portfolios—which in turn reflects questions concerning the viability of enterprises and the economic outlook—private sector analysts present widely varying estimates of the recapitalization needs, ranging from 0 to 10 percent of GDP. Second, a strategy for addressing these problems has yet to be decided on by the government—an important step since it will at least have an impact on the timing at which any fiscal costs arise. In addition, the strategy itself is likely to affect the outlook for these banks, and therefore may have an influence on their franchise value at the time of privatization, thus determining the share of costs that can be recovered in the sale.[25] Finally, the value of the banks and therefore the cost of bank restructuring also depends on a range of external factors—including expected regional growth rates, market saturation, and so forth—that determine their business outlook, but remain to be analyzed, presumably in the context of specific privatization proposals.

72. However, in considering the various options, one further element that needs to be taken into account is the implicit cost of time. If a bank is allowed to drift without clear managerial direction in anticipation of privatization, the bank's franchise value may be eroded and asset quality could deteriorate further. From a macroeconomic perspective, the "credit crunch" caused in part by the conservative behavior of banks prior to privatization imposes a cost on the economy. Therefore, in addition to the direct fiscal costs of any operation, the authorities need to weigh them against the opportunity cost of time. There is no single "best method," and the authorities will need to make a case-by-case, informed judgment on what decision would yield the best results in terms of speed and cost, while preserving the integrity of the banking system.

D. Regulation and Supervision of the Financial Sector

Banking supervision

73. The *Act on the Czech National Bank* assigns bank supervision responsibilities to the CNB. The law that sets forth bank regulation is the *Act on Banks*, which defines the basic requirements and parameters for licensing, regulation and supervision, as well as establishing a deposit insurance scheme and special procedures for bank liquidation and imposition of conservatorship. The banking act provides the CNB with the authority to write supervisory

---

[25] For example, some countries that have used "purchase and assumption" strategies or selective sales of parts of the banks' business have been able to achieve higher returns than would have resulted from outright sales.

regulations, and the CNB has published a number of provisions that establish detailed requirements on various aspects of bank supervision including disclosure, capital adequacy, and provisioning for loan losses. The CNB's supervisory arm consists of a staff of 83 persons, who conduct both on-site and off-site examinations.

74. The regulatory framework for bank supervision has been improved considerably, with two revisions to the *Act on Banks* introduced during 1998. The first revision, a relatively minor one, was implemented in February, and a second, major revision became effective from September 1998. The first revision related to the creation of a "Chinese wall," preventing the use of insider information between commercial and investment banking activities and segregating banking and commercial activities, while the second revision corrected many of the shortcomings in the law relating to bank licensing and supervision that had been identified in the course of a series of failures of small banks during the mid-1990s. The authorities recognize that some further changes are needed to comply with EU directives and to further strengthen some aspects of bank supervision, but the framework appears sufficiently comprehensive for the authorities to be able to adequately supervise banks.[26]

75. Effective banking supervision not only requires that the regulatory framework is appropriate, but that it is implemented vigorously. Shortcomings in the regulatory framework and lax supervision no doubt contributed to the failure of many small banks from 1994–96, but the CNB showed a willingness to force exit of non-viable institutions during that period and has also been making efforts to strengthen supervision. In 1998, in addition to the legislative changes noted above, supervisory regulations concerning disclosure and reporting, Y2K preparedness, and provisioning for loan losses were established or strengthened. The new "bank performance report," now mandatory each year, requires an audited statement of the risk management system in each bank. The supervisors are operating an early warning system where significant and sudden changes in financial indicators are flagged and analyzed for potential problems. The CNB has also recently added a third team of on-site examiners to strengthen regular on-site examinations.

76. A significant regulatory change that affected the banking sector in 1998 was the decision announced in July to strengthen provisioning requirement for loan losses. The banks had been allowed to provision for loan losses after netting out the value of the associated collateral from their claims. However, the weaknesses of creditor rights in the legal framework, as well as the limited judicial capacity to handle cases have meant that it is very difficult to foreclose a property, and the bankruptcy process is typically very slow. As a result, loss-grade loans that have been non-performing for a number of years remain on the books, for which banks incur carrying costs. Moreover, the recent recession resulted in a large downward revision in the value of collateral. Therefore, the CNB decided to disallow

---

[26] In April 1997, MAE provided technical assistance concerning the revision of the banking act. The subsequent amendments to the act cover most of the points identified by the MAE mission.

the netting out of the value of real estate collateral in calculating the loan loss provisions for those loans that were overdue by more than 360 days. This measure will be phased in over three years, beginning end-1998. Banks will be required to increase provisioning faster for those loans that have been non-performing over a longer period of time, but in any case all loans overdue for more than 360 days must be fully provisioned by end-2000. The aggregate impact of this measure is expected to be about CZK 50 billion, or roughly one-half of Tier 1 capital and slightly larger than the annual operating profits before provisioning and write-off of the banking system in recent years. A brief description of the main regulatory and supervisory rules is provided in the Appendix.

Assessment of the bank supervisory system and areas for further reform

77. The CNB has conducted a self-assessment of its compliance with the Basle Committee's *Core Principles for Effective Banking Supervision.*[27] The CNB feels that it has not implemented five of the 25 principles, while the remainder are considered to be either partially or fully implemented. The five that have not been implemented relate to market risk, country risk, and certain aspects of consolidated supervision. The CNB prudently believes that the principles have only been partially met in areas such as risk management where the quality of implementation, rather than the existence of rules, is the key constraining element. Most other formal criteria are considered to be fully realized.

78. The CNB continues to address the major shortcomings in prevailing supervisory arrangements. A new rule requiring banks to set aside capital for market risk was approved in June 1999 and will become effective early next year. The supervision of market risk is becoming increasingly important as banks have increased their off-balance sheet derivatives transactions. One bank incurred large losses in 1998 as a result of derivatives-related exposure to the market risk of Russian government securities that was not adequately recognized by the management. The CNB estimates that the size of off-balance sheet transactions in domestic banks is now about 60 percent of the total balance sheet.[28]

79. In consolidated supervision, the CNB sees a major gap in the supervision of bank holding companies. While the current rules allow supervisor's access to information on a

---

[27] The Core Principles, and whether they are adhered to, can be interpreted in widely diverging ways, and the Basle Committee is currently working on a detailed methodology that will allow a more consistent assessment. The CNB is a member of the contact group that is developing the new methodology, but this methodology was not available at the time of CNB's self-assessment. As such, the assessment described here is necessarily subjective in nature.

[28] This figure is in terms of notional principal on a gross basis, and it is small by comparison with internationally active banks. Most of the activity could be attributed to foreign exchange and interest rate forwards and swaps.

bank's subsidiaries, they do not allow the CNB to access the banks' parent or sister companies: that is, they do not allow the CNB to supervise banks on a group-wide basis if the bank is a subsidiary in a group of firms.[29] The CNB hopes to have the banking act revised within the next couple of years to address this issue. Also, the CNB in June 1999 approved tightened accounting rules requiring banks to fully disclose their holdings in group companies and any connected subsidiaries.

80. In addition to this, there is room for a further improvement in consolidated supervision within the current framework. Supervisory regulations, including capital adequacy and large exposure limits, are not administered on a fully consolidated basis. The current Czech capital adequacy rules do attempt to offset this shortcoming by requiring the banks to deduct from capital the equity holdings in a subsidiary for capital adequacy calculations, and supervisors can obtain the information relating to a subsidiary through the parent bank. However, the rules would not be able to fully capture on a timely basis the risk that arises from, say, a bank's lending to a subsidiary, which then on-lends to risky customers. Current large exposure rules may also be circumvented in this manner. Furthermore, the banking act does not allow the supervisor to review the establishments of individual subsidiaries or significant investments, which weakens the supervisor's ability to oversee a bank's operation on a fully consolidated basis.

81. The strengthening of consolidated supervision and introduction of market risk regulations can and should be enhanced by a revision of accounting standards. Current Czech accounting standards tend to stress form over economic substance. For example, accounts are unconsolidated; there is very little recognition of valuation changes, so that unrealized foreign exchanges gains and losses are not recognized until income is realized; and interest on loans is recognized in accordance with the credit contract even when loans are overdue. Such accounting practices not only provide a wrong picture to the management and supervisor, but could also encourage misleading disclosure and reporting and provide distorted incentives. The misdirected incentives could be further aggravated by the fact that corporate income taxes are levied upon profits calculated according to the Czech accounting standards. While the CNB may be able to issue regulations to offset the weaknesses in accounting practices, as it has done in the case of requiring provisioning for depreciation of the market value of securities holdings, an effective and efficient bank supervision function needs to be based on a good set of accounting standards.

Deposit insurance and the safety net

82. The Czech Deposit Insurance Fund (DIF) was set up in 1994. In the event of bank failure, the principal method of resolution available is liquidation of the bank, administered by a liquidator appointed by the CNB subject to court approval. In liquidation, small

---

[29] The CNB can exercise some influence through its ability to screen the transfer of major stakes of shares in banks and to regulate transactions with related parties.

depositors are protected through an up-front payoff from the DIF. The CNB may, if it judges the situation in a bank endangers the stability of the banking system, impose a conservatorship on a bank. The CNB appoints the conservator, who has broad powers over the bank. After the most recent revision, the DIF covers 90 percent of a single depositor's deposits (both household and corporate) up to CZK 400,000.[30] The amount is roughly equivalent to three years' worth of average wages. The DIF is financed by annual premiums from banks equal to 0.5 percent of insured deposits. At the moment, the DIF is allowed only a straight payoff to individual depositors as a means of insurance payout.

83. Liquidation of a bank and payoff of insured deposits is not necessarily cost effective even in the case of resolution of small institutions, since the liquidation value of an institution is usually considerably smaller than the going-concern value, so that the DIF may end up incurring a large loss when it winds down banks that seem to be only marginally insolvent . For larger institutions, liquidation cum payoff will certainly be regarded as extremely disruptive, so that the CNB may invariably have to resort to the imposition of conservatorship. This may also prove costly since the CNB will likely have to provide unlimited liquidity support during conservatorship. The ultimate cost of bank resolution could be reduced if the DIF could be used to facilitate the sales of failed banks or a part of a failed bank's businesses on a going-concern basis. This could be done by providing cash support to the acquiring bank in a "purchase and assumption" operation of a failed bank, or by providing matching assets in a deposit transfer; options that are not available under the current legislation. There are also economic benefits in that the dislocation of the intermediation function and disruptions in the provision of banking services could be kept to a minimum through such arrangements.

Capital market regulations and accounting standards[31]

84. While substantial improvements have been made in the area of banking supervision, significant tasks lie ahead in the regulation and supervision of other financial markets. The most pressing is the need to improve the regulatory oversight of the capital market. The poor performance of investment funds and the alleged asset-stripping by fund managers and corporate managers have seriously affected the credibility and impaired the role of the capital

---

[30] Originally, the deposit insurance was limited to households only and covered 80 percent of deposits up to CZK 100,000. However, in the wave of failures of small banks in the mid-1990s, the CNB temporarily provided an additional guarantee covering the full amount of deposit to a limit of CZK 4 million for all depositors, in order to prevent panic. The extended guarantee effectively covered the full amount of deposits of 99 percent of the depositors, although in terms of the value of the deposits, the coverage was about two-thirds. The revised law's limit of CZK 400,000 is now applicable.

[31] These issues are also discussed from a corporate governance perspective in Chapter I of this Issues Paper.

market as an alternative source of financing for Czech corporations. Steps have been taken to improve the situation by requiring all investment funds to convert to open-ended funds within a period of three years, and by creating a Securities Commission (SC).[32] Whether the capital market can gain credibility and expand its role will depend very much on the extent to which the SC can exercise its powers effectively. In particular, the SC will need to address the problem of shares being traded off-market at divergent prices, as this puts the integrity of the price mechanism in serious doubt. Without sufficient confidence in the price of traded shares, the market can never perform a proper function in allocating investment. The SC's effectiveness could be enhanced further if it were given the powers to establish regulations on its own, rather than being simply an enforcer of regulations established by the government. The role of self-regulatory organizations such as the stock exchange could also be considered within this framework.

85. A crucial element in capital market oversight is the enforcement of disclosure by publicly traded companies. The Prague Stock Exchange has moved to de-list companies that do not provide disclosure material within the prescribed time limit, and there are also plans to introduce an electronic disclosure system similar to the U.S. EDGAR system. Accurate and timely disclosure of financial information is essential for establishing a fair and efficient market. In this context, it should also be emphasized that disclosure is meaningless unless the information provided gives the investors an accurate and comparable picture of corporate finances. A major upgrading of accounting standards to internationally recognized levels is therefore of priority (proper accounting standards and disclosure may well have deterred some of the deterioration in corporate balance sheets and other problems that the Czech economy is now facing).

[32] The creation of Chinese walls and other revisions to the banking act in early 1998 cited earlier were a part of the overall reform relating to the capital market.

Table III-1. Czech Republic: Structure of the Banking System

(End-year)

	1.1.1990	1990	1991	1992	1993	1994	1995	1996	1997	1998
Total banks	5	9	24	37	52	55	55	53	50	45
Of which:										
Large banks	5	5	6	6	6	6	6	5	5	5
Small banks	--	4	14	19	22	21	18	12	9	8
Foreign banks	--	--	4	8	11	12	12	13	14	13
Foreign bank Branches	--	--	--	3	7	8	10	9	9	10
Specialized Banks	--	--	--	1	5	7	9	9	9	9
Banks under Conservatorship	--	--	--	--	1	1	0	5	4	0

Source: The CNB.

Table III-2. Czech Republic: Assets and Liabilities by Types of Banks

(In percent, end-1998)

	Total	of which			
		Big	Small	Foreign 1/	Specialized
Total assets	100	66.06	3.54	24.94	5.47
Of which:					
Liquid assets	100	74.85	4.99	18.08	2.08
Deposits in other banks	100	43.94	2.14	41.46	12.45
Credits (gross)	100	74.06	2.80	20.45	2.70
Securities in and investment portfolio (gross)	100	74.41	4.35	10.39	10.86
Total liabilities	100	66.06	3.54	24.94	5.47
Of which:					
Clients deposits	100	73.01	4.14	15.71	7.14
Banks' deposits	100	44.47	0.4	53.37	1.77
Central bank loans	100	99.46	0	0.54	0
Equity	100	54.03	14.79	22.05	9.13
Reserves, reserve and capital funds	100	73.11	1.87	21.61	3.41

Source: The CNB.

1/ Includes foreign branches.

Table III-3. Czech Republic: Aggregate Indicators of Banking Structure and Performance

	1995	1996	1997	1998
Concentration				
Number of banks	55	53	50	45
Number of banks accounting for				
25 percent of assets	2	2	2	2
75 percent of assets	5	6	8	9
Size of the banking sector				
Total assets of banks (percent of GDP)	155.4	160.0	182.2	195.4
Total loans of banks (percent of GDP)	68.1	74.8	85.7	91.0
Foreign currency denominated assets (percent of total assets)	14.7	16.3	22.3	19.9
Foreign currency denominated liabilities (percent of total Liabilities)	15.8	17.1	21.3	18.2
Central bank credit (percent of GDP)	5.8	5.3	5.8	4.2
Central bank credit (percent of liabilities)	4.1	3.5	3.3	2.2
Standing, Profitability and performance				
Reserve and provision creation (net)	14,282	3,167	30,028	11,945
Pretax return, CZK millions	11,373	10,537	-2,485	-5,643
Net profit after taxes	9,697	10,092	-3,567	-8,490
Average pretax return on total assets 1/	0.66	0.55	-0.11	-0.23
Substandard loans (as percent of total loans) 1/ 2/ 3/	23.55	20.01	18.51	18.54
Surplus(+) or shortage (-) of provisions (CZK millions) 4/	-68,426	-74,689	-67,919	-58,064
Average interest rate spread (lending - deposit rate)	5.85	5.75	5.5	4.77
Capital/risk weighted assets (in percent)	10.21	9.81	9.51	11.96
Core capital/riskweighted assets (in percent)	9.31	9.09	8.61	9.44
Liquid assets (as percent of total assets)	26.51	22.88	20.42	25.21

Sources: The CNB; and staff estimate

1/ Excluding Konsolidacni Banka.
2/ Classified as substandard or lower.
3/ Loans to the Slovak collection unit are deducted.
4/ Excluding collateral.

Table III-4. Czech Republic: Assets and Liabilities of the Banking Sector

				1998			
	1995	1996	1997	Q1	Q2	Q3	Q4
Total assets (CZK millions)	1,587,812	1,790,886	2,107,275	2,053,109	2,224,924	2,273,263	2,282,596
Of which (in percent of total assets)							
Cash	1.32	1.4	1.29	1.21	1.25	1.11	1.19
Deposits with the CNB	9.26	7.5	9.02	10.49	10.84	12.51	11.72
Minimum reserves	4.32	5.97	4.15	4.64	4.35	3.94	3.82
Free reserves	4.94	1.53	4.87	5.85	6.49	8.57	7.9
Deposits and credits with banks	18.76	21.08	22.84	19.49	22.08	20.04	21.31
Current accounts	0.71	1.09	0.9	0.6	1.1	0.8	0.79
Time deposits	9.99	14.99	18.49	15.36	17.74	16.23	16.87
Interbank credits	8.06	5.00	3.45	3.53	3.24	3.01	3.65
Treasury-bill holdings	2.08	2.72	1.82	1.67	1.77	1.31	2.22
CNB bill holdings	7.38	3.4	4.3	4.84	5.02	7.12	7.01
Credits	44.04	45.20	43.7	44.38	42.03	40.96	40.37
To state and local government	0.27	0.18	0.37	0.53	0.6	0.54	0.55
to the economy	43.77	45.02	43.33	43.85	41.43	40.42	39.82
Tradable securities	7.82	8.3	4.66	4.98	4.55	4.21	4.28
Bonds	6.43	6.33	4.02	4.38	4.13	3.71	3.83
Shares	1.39	1.97	0.64	0.6	0.42	0.5	0.45
Investment securities	0.65	0.53	3.11	3.41	3.23	3.37	3.01
Other assets	8.67	9.86	9.25	9.53	9.23	9.37	8.9
Total assets	100	100	100	100	100	100	100
Total liabilities (in CZK million)	1,587,812	1,790,886	2,107,275	2,053,109	2,224,924	2,273,263	2,282,596
of which: (in percent of total assets)							
Loans from CNB	2.02	1.72	1.42	1.53	1.57	0.67	0.89
Interbank deposits and credits	21.19	23.68	22.77	20.64	21.57	19.63	19.64
Current accounts	0.93	0.94	0.93	0.79	0.97	0.78	0.52
Time deposits	13.86	17.32	16.84	14.93	16.24	14.32	14.6
Interbank loans	6.4	5.42	5	4.92	4.36	4.53	4.52
Deposits	53.04	53.01	52.36	52.14	51.13	50.79	52.64
Client deposits	49.78	51.17	50.88	50.49	49.44	49.1	51.07
State and municipalities	2.11	1.59	1.41	1.59	1.59	1.64	1.47
Certificates of deposits	1.15	0.25	0.07	0.06	0.1	0.05	0.1
Bonds issued	3.08	3.4	3.97	4.01	3.81	3.49	3.44
Other liabilities	12.12	9.9	11.51	13.39	14.02	16.67	14.78
Capital and reserves	8.56	8.29	7.98	8.28	7.9	8.75	8.6
Total liabilities	100	100	100	100	100	100	100

Source: The CNB.

Table III-5. Czech Republic: Recent Loan Portfolio Shifts

(CZK millions)

	June 1997	Dec. 1997	June 1998	Dec. 1998	Jan. 1999
Total loans	1,111,287	1,141,500	1,172,998	1,160,339	1,178,196
percent change		2.7	2.8	-1.1	1.5
Loans to public sector	171,023	173,506	153,065	150,571	154,193
percent change		1.5	-11.8	-1.6	2.4
Loans to private sector	770,751	778,360	791,449	759,950	768,194
percent change		1.0	1.7	-4.0	1.1
Loans to government	13,221	16,258	23,556	28,309	30,559
percent change		23.0	44.9	20.2	7.9
Loans to small business	60,432	60,654	52,542	44,126	43,844
percent change		0.4	-13.4	-16.0	-0.6
Loans to households	43,814	49,832	54,453	63,119	64,751
percent change		13.7	9.3	15.9	2.6
Other loans	52,046	62,892	97,933	114,265	116,655
Percent change		20.8	55.7	16.7	2.1

Source: The CNB.

IV. Medium-Term Fiscal Policy Projections and Analysis[32]

A. Introduction

86. At the beginning of transition, the fiscal position of the Czech Republic appeared quite enviable, at least according to the reported data. Its debt stock was very low—less than 20 percent of GDP—and through 1995, both the central and general government balances were in surplus. Official statements by the government indicated that fiscal policy was, and would continue to be, formulated with a goal of budget balance. However, since 1995 there has been a noticeable deterioration in the fiscal position (Tables IV-1 and IV-2; Figure IV-1). In 1999, the authorities and Fund staff anticipate a general government deficit of around 4 percent of GDP. Although part of this is likely to be cyclical and the underlying or structural deficit smaller, there is a concern that the apparent trend deterioration in the balance will continue. Furthermore, there are numerous looming medium-term challenges facing the Czech government, many of which will be associated with substantial fiscal costs. Some of these include: investment spending related to EU accession (to meet EU directives related to the development of regional governments, the legal system, environmental standards, and the transportation network); bank and enterprise restructuring; and the realization of contingent liabilities (the "hidden" debt). Of course there are also potential benefits associated with these initiatives, including likely transfers from the EU, but also the higher growth that should accompany the whole accession and reform process. Lastly, although the country is not facing an immediate demographic problem, over the longer term, the pension system as currently designed along with related health care expenditures, will introduce a significant drain on the budget.

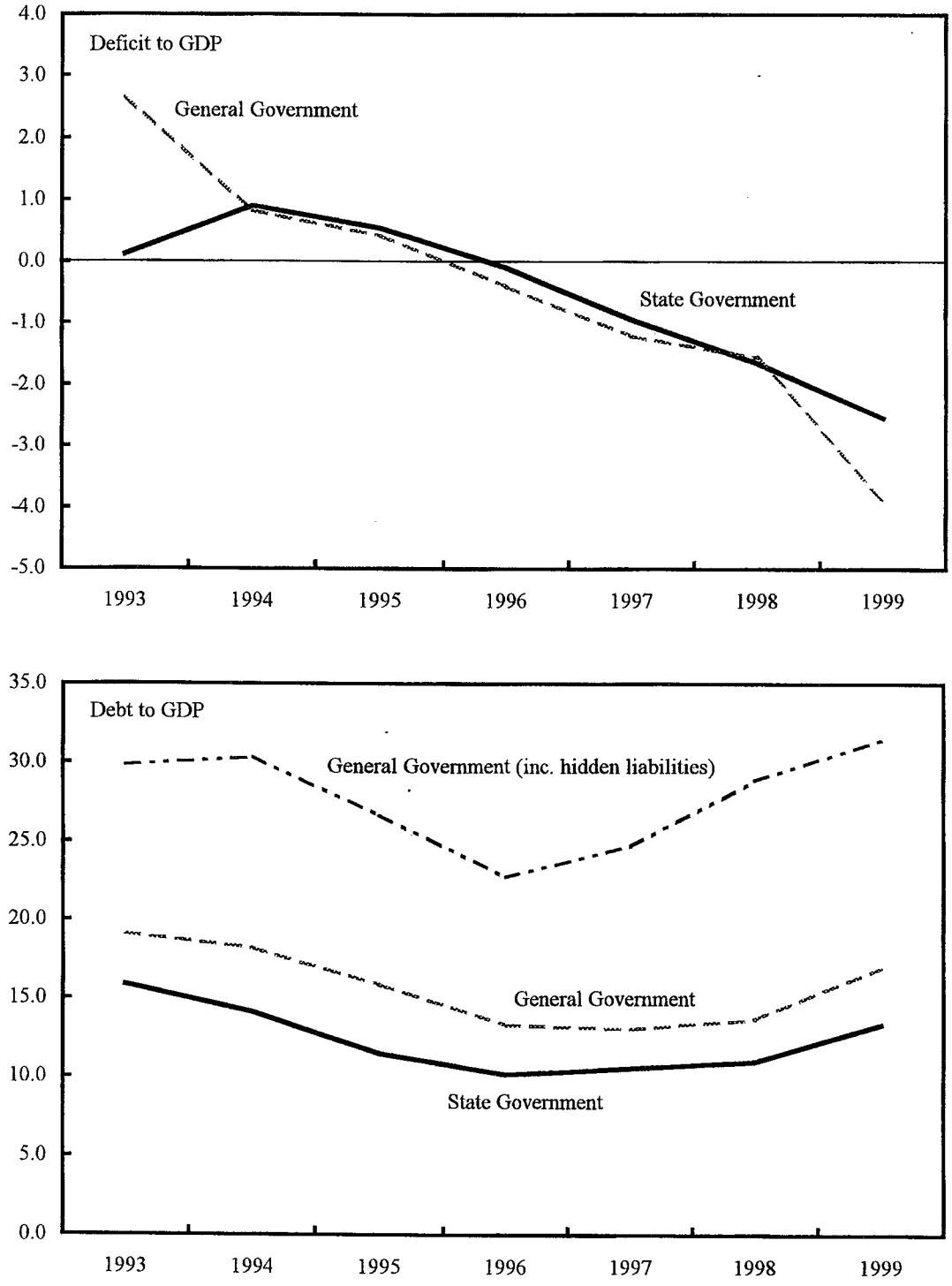
87. The government has argued that fiscal control is necessary to provide the room for investment spending and enable the country to achieve its potential growth. Furthermore, although there are no specific rules dictating fiscal policy for EU accession, candidates are expected to demonstrate that they operate within, or at least close to, the Maastricht fiscal ceiling. These are among the issues that shape fiscal policy over the medium term, and which this paper explores. Section B develops a medium-term baseline fiscal projection assuming unchanged policies and discusses a possible reform scenario. Section C provides several alternative fiscal projections derived from a variety of assumptions about growth, EU accession, and policy alternatives. Section D discusses the implications of these projections and provides some views on policy issues, as well as the potential steps in this analysis.

88. The projections presented in this chapter show that even under somewhat optimistic assumptions, but absent a change in policies, the likely fiscal situation is inconsistent with the stated goal of balance, and the deficit above the indicative Maastricht ceiling of 3 percent of GDP at the time that the country would hope to accede to the EU. Furthermore, in the absence of industrial reform and the accompanying supply-side led growth, or if the

---

[32] Prepared by Steven Symansky.

Figure IV-1. Czech Republic: State and General Government Deficit and Debt



Source: Staff estimates.

government fails to control several expenditure items, the fiscal situation could become unsustainable. Also, in the absence of policy measures, the projections are inconsistent with the underlying macroeconomic framework.

89. At the outset it should be recognized that this chapter represents a first attempt at providing a quantitative medium-term fiscal outlook for the Czech government and should be viewed as work in progress. It represents a collaborative effort by the Fund staff and the Czech authorities.[33] The quantitative as well as the qualitative analysis contained in this chapter represents an important step forward in the area of medium-term fiscal analysis, and the authorities have already begun to refine and improve upon this work as part of their ongoing efforts in this direction.

90. At this time, the chapter is focussed mainly on discussing the methodology and the medium-term projections while only tentatively discussing the structural problems in the budget and the desirable medium-term fiscal strategy, including policy measures to redress the problems and tensions in the fiscal outlook. Furthermore, the analysis is not integrated into a well-articulated medium-term framework as all of the projections assume a given macroeconomic outlook. Since only one fiscal projection is likely to be consistent with a given macroeconomic outlook, at this point the results point to potential inconsistencies and tensions between macroeconomic projections, based on a view of the country implementing significant reform—including control over public finances—and fiscal projections that indicate that the deficit and debt are not well contained. At this stage, until the government engages in a detailed and in-depth examination of expenditure and revenue, much of the analysis will remain very general.

B. A Medium-Term Fiscal Projection

91. The Ministry of Finance (MOF) of the Czech Republic regularly produces a document containing a macroeconomic forecast that includes fiscal data.[34] However, the macroeconomic forecast is generally limited to two years ahead and there are no detailed fiscal projections. At best there is a forecast of the current year's fiscal outturn, but even this is only available at a very aggregate level. Until this year, even within the MOF, a consistent set of fiscal projections beyond the current budget year—whether for the central government or the general government—have not been compiled (fiscal projections are not required in budget documents). However, as part of the EU accession process, the government must

---

[33]Soon after preliminary projections were presented and discussed with the authorities, they were translated into Czech, and a version was presented to the Cabinet and subsequently made public.

[34] "Czech Republic: Macroeconomic Forecast," Ministry of Finance of the Czech Republic. It is produced quarterly, and in addition to the paper version of the document, is available on the MOF external web site, www.mfcr.cz/scripts/hpe/default.asp?MakroPre.

provide a medium-term economic forecast, including of the government sector. In addition, during last year's discussion in the Parliament, the MOF agreed to present a medium-term forecast as part of its annual budget submission.[35]

Macroeconomic Assumptions

92. Not surprisingly, the macroeconomic assumptions are a critical factor in the forecast and the choice here is much more controversial. If a government is trying to provide a rosy fiscal outlook or to create room for additional fiscal expenditures, there is a strong incentive for overly-optimistic assumptions. For an industrial country, there are usually a large number of macroeconomic forecasts that can be used as a foil to scrutinize the official forecast.[36] However, in the Czech Republic, the number of alternative forecasts are more limited, although there are some from the private sector. The macroeconomic forecast used in the fiscal projections is the one contained in the 1999 Czech Republic Article IV Staff Report, and is essentially consistent with a reform view of the Czech economy. As this is not the only realistic set of assumptions, one of the fiscal scenarios presented in Section C illustrates how the outturn can be affected by a less optimistic macroeconomic outlook. In fact, the assumptions used in the staff's forecast are more optimistic than those used by the authorities.

93. In particular, the growth rate of real potential output is assumed to gradually increase to 4 percent and, after several years of disappointing growth, the output gap (estimated at about 6 percent in 1999) is assumed to be gradually eliminated by 2003. Consistent with the return to potential output, actual growth is assumed to pick up to 5 percent in 2002–03 before declining to 4 percent thereafter. Inflation is assumed to decline to less than 4 percent over the medium term consistent with the Czech National Bank's (CNB's) monetary strategy. Interest rates are assumed to decline with inflation, with long-term rates falling to below 8 percent. An important, but often overlooked variable in the fiscal forecast, is the wage assumption. Changes in real wages can have important effects on the revenue projections since wages affect disposable income and thus consumption and indirect taxes, as well as personal income tax revenue. The projections assume that the wage bill will grow slower

---

[35] The benefits of a multi-year budget forecast are well-known and included as part of the Code of Good Practices on Fiscal Transparency. In particular, article 2.1.2 of the Code states that *Information comparable to that in the annual budget should be provided for the outturns of the two preceding fiscal years, together with forecasts of key budget aggregates for the two years following the budget.* Hungary is an example of a transition country that provides a medium-term budget outlook.

[36] In Canada, in order to provide conservative fiscal forecasts, the Canadian Department of Finance uses the consensus GDP forecast, and then subtracts 1 percent, while 50 basis points are added to the consensus interest rate.

than nominal GDP over the medium term so as to allow for the assumed switch from consumption to investment that underpins the resumption of growth.[37]

Passive Baseline

94. There are various strategies that one can pursue in creating the projection. The most standard approach, and the one used in this paper, is to assume the current set of tax regulations and expenditures programs.[38] This is often referred to as the "current services" or passive baseline. It does not necessarily reflect the "best" forecast of the budgetary outcome since such a forecast may violate the stated goals of the government and be inconsistent with the underlying macroeconomic framework; rather it reflects the likely outturn if new policy actions are not taken.

95. In designing the projections, decisions have to be made about the degree of disaggregation. This includes the extent to which projections are made of the various levels of government as well as the degree of detail in the revenue and expenditure projections. Although information from the state (central) and general government budgets were provided to the staff at a fairly disaggregated level, and reasonable forecasting methods could be applied to individual items, less information was available for the other levels of government.[39] In particular detailed information on inter-governmental transfers, that is essential when aggregating up to the general government level, was not readily available.[40] Although separate forecasts for each level of government might have been the preferred approach, based on data availability the projections were made only for the general government. As far as the level of disaggregation of revenues and expenditures is concerned, the forecast includes nearly 20 different categories. A thorough description of the

---

[37] The wage rate is assumed to grow at 9 percent in 1999 and 7 percent thereafter. The growth rate of 6.6. percent in the wage bill in 1999 reflects the increase in unemployment in that year.

[38] For an overview of the tax system in the Czech Republic see "Taxation in Eastern Europe," Deloitte, Touche, and Tohmatsu International, 1997, pp.17-28.

[39] The general government budget is comprised of: the State (Central) Government, the Local Government, State Financial Assets, the National Property Fund, State Funds (including the Czech Land Fund), and Health Funds.

[40] At the time the forecast was first assembled, the authorities were able to provide detailed information for the state and general government budgets, and aggregate data on inter-governmental transfers through 1999. However, detailed data were unavailable for other levels of government or on inter-governmental transfers that affect individual revenue and expenditure items.

assumptions underlying the fiscal forecast were included in a version of this paper presented to the authorities and summarized below.

96. The medium-term revenue projections (through 2003) were largely based on input from the tax forecasting experts in the MOF who used micro-simulation models to produce their own forecasts. In particular, this information was used in the forecasts for the direct, indirect, and social security taxes. Unless otherwise noted, the revenue items are assumed to grow at the rate of the scale variable which implicitly assumes an elasticity of one (Table IV-4). However, there are several important revenue categories such as indirect and direct taxes, and non-tax revenue which are assumed to grow faster or slower than their scale variable. Several assumptions may appear arbitrary, but they are based on historical patterns, as well as information about consumption patterns, tax administration, and tax elasticities. Over time, these projections should be increasingly refined as the ex-post data become available, are compared to the forecast, and the differences evaluated.

97. Personal income taxes are expected to grow more slowly than wages in 1999 reflecting some continued increase in unemployment, and the indexation of income tax brackets approved in December 1998.[41] Thereafter, these taxes are forecasted to grow slightly faster than wages on the assumption that neither exemptions nor tax brackets are indexed. Enterprise taxes would grow only modestly despite the increasing profit share implicit in the macroeconomic assumptions owing in part to the 7 year loss-carryover rules (which effectively results in income averaging). Indirect taxes would initially grow slower than nominal GNP reflecting in part an assumed change in the consumption pattern toward lower VAT rated goods during a period of low growth, but this should be reversed as growth picks up.[42] However, as long as there are specific excise taxes, the growth in these taxes will be somewhat restricted. Also, VAT revenues as a percent of GDP, will decline over the medium term as wages (which affect disposable income) are expected to grow slower than GDP, and custom duty rates are assumed to decline in accordance with agreements with the WTO. This is consistent with the underlying view in our reform scenario that there will be a significantly greater increase in investment and exports, than in consumption. Social security contributions grow directly with wages and would thus decline modestly as a share of GDP over the medium term. The projections for the final three revenue items (other taxes, non-tax current revenue, and capital revenue), which comprise less than 10 percent of total general government revenue, all used the same projection methodology.[43] These projections are

---

[41] Although inflation indexation of tax brackets and deductions is not built into the tax code, the Parliament has regularly adjusted these in order to offset the inflation bias in the system.

[42] During a period of uncertainty and/or slow growth, individuals tend to purchase relatively fewer luxury goods which are taxed at the high VAT rate.

[43] Historically, these revenue categories tend to exhibit significant fluctuation and do not depend on stable bases. They are assumed to grow at 96 percent of the growth rate of nominal GDP which implies that they will only increase modestly over the medium term.

consistent with both the assumptions that there will be less government ownership in enterprises and that fixed fee revenues will not be systematically indexed to inflation. Also, VAT revenues, as a percent of GDP, will decline over the medium-term as wages (which affect disposable income) are expected to grow slower than GDP, and custom duty rates are assumed to decline in accordance with agreements with the WTO.

98. Taken together, these assumptions imply that the significant decline in revenue (as a share of GDP) that has been occurring since the early 1990s (from 45 percent in 1993 to 40 percent in 1998) is broadly arrested. While a revenue ratio of close to 40 percent is not high by European standards, the split between social security contributions and income related taxes on the one hand, and indirect taxes on the other, is a source of concern as it creates a significant labor tax wedge.

99. The expenditure forecast is based on informed, but crude assumptions about real or nominal spending derived from discussions with the authorities and assumed macroeconomic developments (Table IV-5). While it would have been preferable to divide the spending items into their mandatory and non-mandatory components, or work from a "bottom-up" approach based on specific information about individual programs, those details were not available. The expenditure forecasts could be refined over time by building on detailed information provided by the line ministries. The projections generally reflect containment of several items that could easily increase substantially if the government is not resolute in holding the line. For example, there could be significant costs related to the restructuring of banks and enterprises, investment and other spending needs related to the EU accession process, realization of the contingent liabilities beyond what is already included in the projections, and a private sector demand for social and transfer programs equal to those of Western European countries.[44] The potential fiscal costs related to several of these risks are not included in the baseline projection but are explored further below.

100. After increasing in 1999 as a result of the large wage increase agreed in December 1998 to compensate for the freeze in government wages in 1997–1998, the wage bill should decline slowly as a share of GDP reflecting the authorities intentions to reduce the size of the civil service and restrict the rate of increase in real wages. Similarly, the government believes that spending on other goods and service can be held constant in real terms. Transfers are largely dictated by mandatory programs such as social security, but are also subject to considerable political pressure for increased funding. Consistent with demographics and current programs, real spending on health and pensions is projected to grow by 4 percent a

[44] Some of what have been characterized as the "hidden deficits" that arise from government guarantees and restructuring costs are explicitly included in the government 's projections and thus do not necessarily represent additional budgetary expenditures. See "Dealing with Contingent Liabilities" by Hana Polackova in Czech Republic: Toward EU Accession, Vol. II, pg. 35-48, World Bank, 1999, for an in-depth assessment of this issue.

year.[45] The pension system is not facing an immediate problem, but unless changes are made, pension expenditures will begin to rise at a very fast rate sometime after 2010. Other transfers, which include unemployment and disability payments, are assumed to grow at a fairly fast rate in the next couple of years owing to continued high unemployment. To the extent that the government undertakes additional labor market programs or adds to the social safety net, this spending category may face significant pressure over the medium term. Subsidies to enterprises include direct and indirect support for various financial and non-financial enterprises and should decline over the medium term as the restructuring process is advanced. Interest payments are calculated based on the debt dynamics and excludes any interest imputed on contingent liabilities. Capital expenditures will likely rise over the medium term, primarily because of the need to meet several of the EU directives associated with the accession process: real fixed investment spending is assumed to grow at a modest rate of 2 percent. Other investment and net lending are assumed to be unchanged in nominal terms.

101. On this basis, total expenditures as a share of GDP will grow over the medium term, before declining gradually toward the current ratio by around 2005. The overall fiscal deficit rises and remains in the range of 5 percent of GDP over the medium term, before declining gradually to below 3 percent of GDP by 2008 (Table IV-6; Figure IV-2). The debt ratio (excluding hidden liabilities) increases from 14 percent of GDP in 1998 to nearly 35 percent of GDP by 2008. If the hidden liabilities are added as a debt item, and assuming no increase in these liabilities, the debt ratio reaches 40 percent by 2003. These fiscal prospects are quite worrisome, not least because the projections are based on relatively optimistic assumptions.[46]

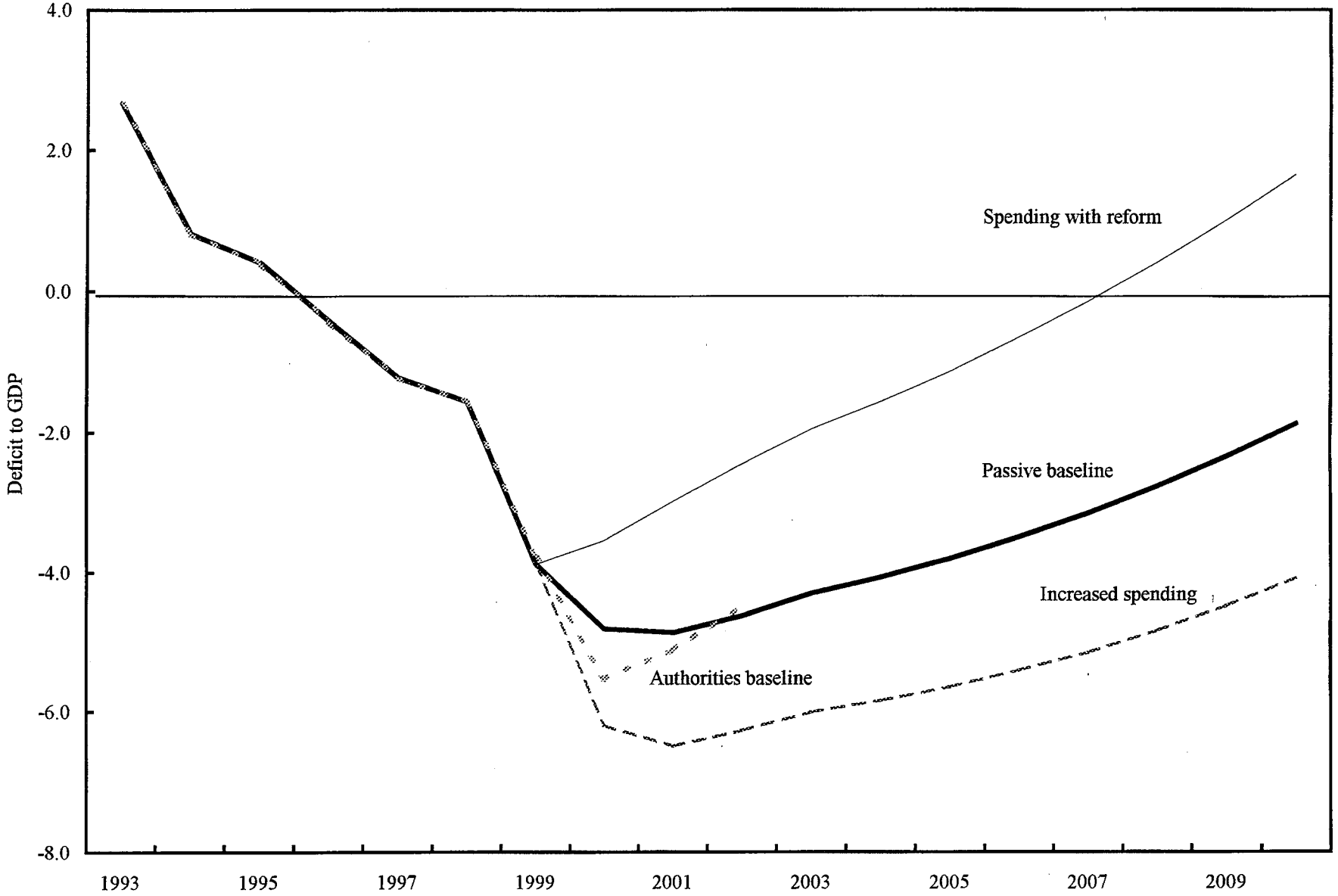
102. Although the medium-term fiscal problem is apparent from these projections, it is less clear whether the underlying reasons for the deterioration are to be found on the revenue or expenditure side. The trend decline in the revenue ratio suggests a lack of buoyancy in the tax system, whether due to inelastic taxes, a relative decline in tax bases, or even weakening tax administration, as there has been little change in the relatively high tax rates (especially on personal income and wages, including social security contributions). Revenue reforms should thus focus on shifting the burden from direct to indirect taxes and increasing the buoyancy of revenues—especially those that are relatively unresponsive to nominal income

---

[45] The government believes that it can limit the growth in health care spending as it is not paid directly by the government but is a negotiated payment with insurance providers, and the Czech Republic already has spent considerable sums investing in health care facilities.

[46] The authorities' passive baseline scenario, which is based on detailed projections from spending ministries and separate forecasts by several of the extra-budgetary funds, shows roughly similar results although the projections here rely on more aggregate information (Table IV-7).

Figure IV-2. Czech Republic: Medium-Term Fiscal Scenarios - Deficit to GDP



growth. On the expenditure side, several categories have already been severely compressed, including capital expenditures, and it will be necessary to consider reforms to mandatory programs (that make up the bulk of expenditures) as well as containing certain expenditure items that have been allowed to grow very rapidly in recent years (notably subsidies to financial and non-financial enterprises).

The Augmented Expenditure Scenario

103. There are two obvious sources of added strains on government finances. First, there are likely to be additional costs related to the EU accession process. Although the costs associated with this process could be very large if the government were to meet all the legal, environmental, infrastructure, and other requirements of accession, for the sake of realism it is assumed that the government will increase investment spending, relative to the passive baseline, by 1 percent of GDP a year, phased in gradually starting in 2000.[47] Second, there will be significant costs associated with the hidden liabilities, which the government is committed to explicitly acknowledging.[48] This expenditure has been incorporated into the projection by capitalizing 50 percent of the estimated value of these liabilities.[49] In this scenario, the deficit rises to over 6 percent of GDP in 2000 and remains at this level over the medium term, while the debt ratio (including the hidden liabilities) rises to 45 percent of GDP by 2003 (Table IV-8).

The Reform Scenario

104. In order to address the fiscal deterioration and concerns about the structure of revenues and expenditures, as well as to be consistent with the economic reform scenario discussed in the staff report, several policy initiatives are required. In particular, the fiscal deficit would need to be reduced to about 2 percent of GDP over the medium term to ensure that the macroeconomic adjustment is sustained and that sufficient room is made available for private investment, as well as avoiding potential problems with EU accession in this area. An illustrative fiscal reform scenario in line with the authorities professed objectives could include: (i) tax reform, consistent with the recent restructuring of revenues signed into law in June 1999, includes a decline in direct taxes, an increase and regular indexation of excise taxes consistent with EU directives and greater harmonization of indirect taxes at the higher VAT rate. However, the tax reform in this scenario goes further than the new law as it results

---

[47] Larger increases in investment spending, which are more consistent with meeting the EU directives, are included in the next section.

[48] See for example the statement by the government on the hidden liabilities in its 1998 budget, as well as the discussion of fiscal policy in the published forecast of the MOF.

[49] Although the choice of 50 percent capitalization is arbitrary, it reflects the fact that some of these expenditures are already imbedded in the passive expenditure projection.

in an increase in revenue of about 2 percent of GDP; (ii) a reduction in subsidies to financial and non-financial enterprises amounting to about 1 percent of GDP; and (iii) reform of the pension system and some other transfer payments amounting to about 1 percent of GDP. Under these assumptions, the fiscal deficit declines gradually to 2 percent of GDP by 2003 and government debt (including hidden liabilities) is contained to just over 30 percent of GDP and on a declining trend, well within the indicative Maastricht ceilings (Table IV-9). As important, this scenario also represents important changes in the structure of expenditures and revenues compared to the passive scenario. Although the implementation of these measures will take strong political will, and the precise measures that can achieve these targets would need to be spelled out, this scenario would nevertheless seem plausible. This scenario is the one used in the staff report.

C. Risk Scenarios

105. The development of a fiscal outlook should attempt to define some of the risks inherent in the projections. Some of these risks have already been discussed and in this section these are quantified by examining several alternative projections: (i) lower growth; (ii) reduced fiscal control; and (iii) a more complete EU accession initiative. While none of these are necessarily more likely than either the reform or passive scenarios, they are indicative of some alternative, and plausible fiscal outturns. However, the list is far from exhaustive (e.g., they exclude any bank/enterprise restructuring costs or increase in contingent liabilities), but the scenarios are only meant to be suggestive.

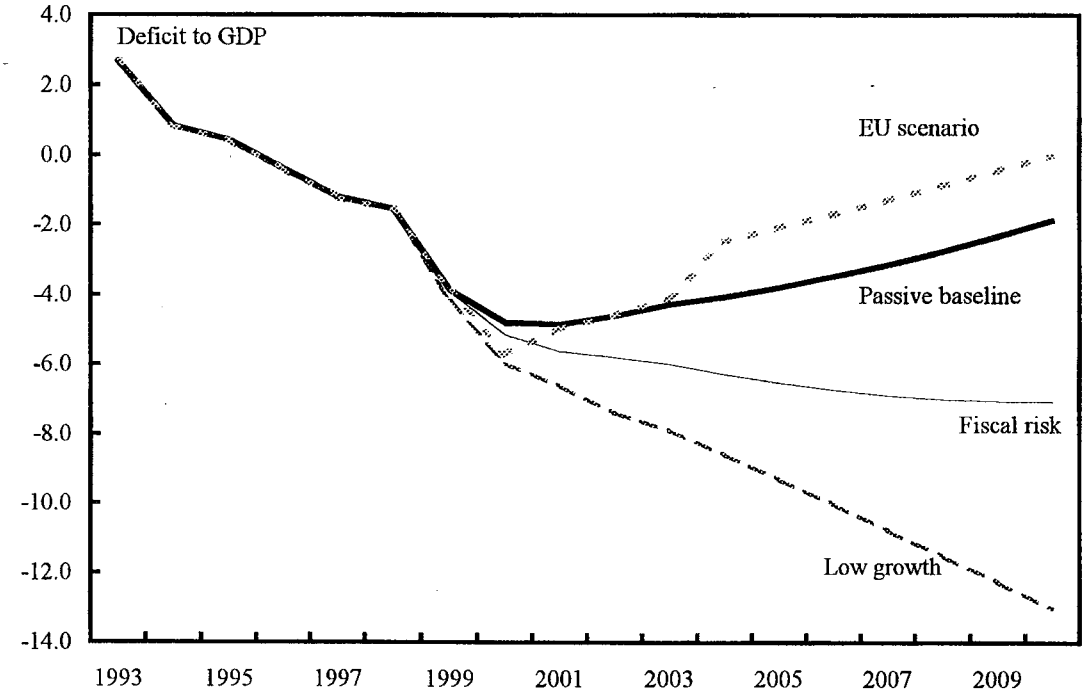
Lower Growth

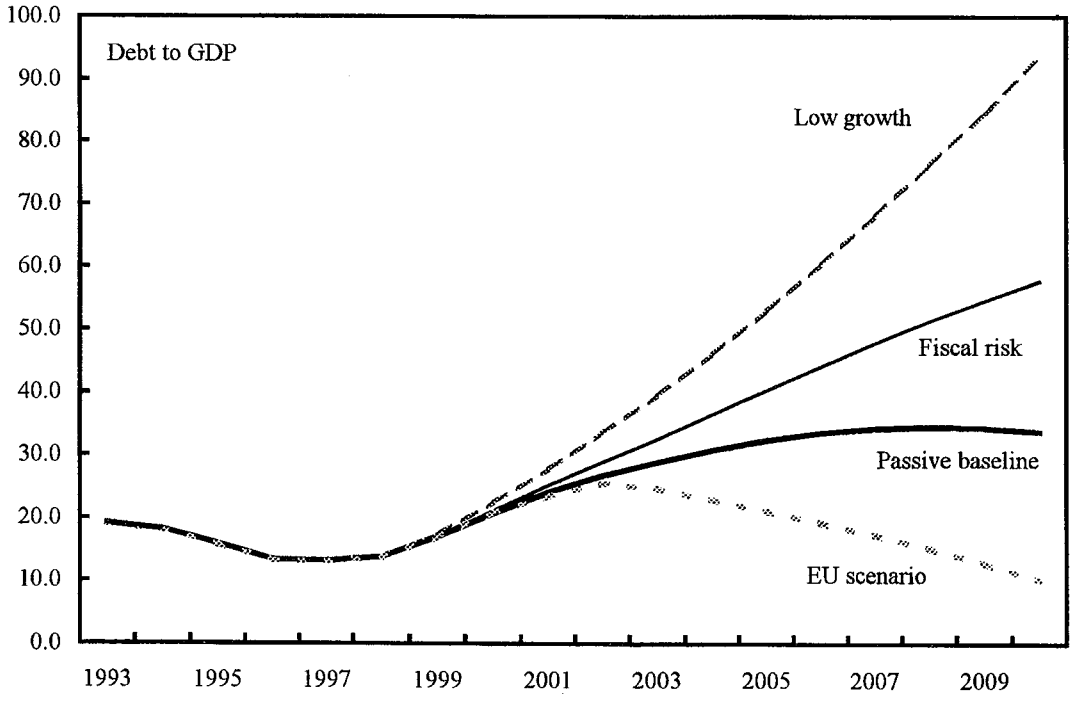
106. The medium-term growth assumptions included in the economic reform scenario and fiscal scenarios above may be viewed as optimistic, especially if the structural reform process is not accelerated as envisaged. In this scenario, the real GDP growth rate is assumed to be 1.5 percent less, settling at 2.5 percent over the medium term, while the inflation rate and the growth in other price variables are assumed to be 1 percent lower.[50] The net result of these changes in the macroeconomic assumptions is that the fiscal position becomes unsustainable, with the deficit rising to over 8 percent of GDP by 2003 and 13 percent by 2010 and debt increasing to nearly 40 percent of GDP by 2003 (or 51 percent including hidden liabilities) and about 100 percent of GDP by 2010 (Table IV-10; Figure IV-3). The revenue ratio remains largely unchanged, but expenditures, which are generally assumed to be unaffected by changes in nominal income, rise significantly as a share of GDP. While this is hardly a realistic scenario since the government would need to make adjustments, it illustrates the deterioration that could occur if relatively high rates of growth are not achieved.

---

[50] The effect on inflation of lower growth depends upon the source of the output decline: to the extent that it is a supply-side shock, inflation would tend to increase, but it would tend to decline if the output gap increases.

Figure IV-3. Czech Republic: Alternative Medium-Term Fiscal Scenarios





Source: Staff estimates.

Fiscal risk

107. Fiscal risk refers to a wide range of issues, but in this scenario it is assumed that tax administration deteriorates and that discretionary spending is not kept in check. Although the size of the change in taxes and spending is rather arbitrary, it is an attempt to quantify the possible slippage in the fiscal balance. This analysis should be increasingly refined over time, especially as the expenditure projections become more detailed and the nature of the risks become clearer. In this scenario, it is assumed that the growth rate of tax revenue is somewhat below the passive baseline projections, but the larger deterioration is on the expenditure side.[51] The government accepts an increase in almost every spending category except for capital expenditures. They fail to reduce the size of the civil service, spending on other goods in services is not held constant in real terms, and almost every transfer payment rises. The net result is a deficit of over 6 percent of GDP by 2003 which stabilizes at that higher level, with the debt stock rising to over 60 percent of GDP by 2010 (Table IV-11). If such an outcome were to occur, it would probably adversely affect growth through crowding out, and in all likelihood, the more realistic scenario would be a combination of this projection and the previous low growth scenario resulting in a clearly unsustainable evolution of public finances.

EU Accession

108. The final scenario is referred to as EU accession. There are a number of hard to answer questions on financial, legal, administrative, and political issues that complicate a straightforward examination of the fiscal costs of joining the EU. These include: (i) will EU structural funds be used to finance additional investment expenditures associated with EU accession or will it be possible to use these funds to finance current investment spending plans? (ii) to what extent will the Czech Republic be required to meet EU directives in areas such as the environment? (iii) is it likely that the Czech Republic will accede in 2003 as envisaged? (iv) although none of the new entrants into the EU are formally required to meet the Maastricht fiscal criteria, what will be the implications of not meeting these criteria? (v) how much in the way of transfers will the Czech Republic likely receive before and after accession? The answers to these questions will critically affect any estimate of the fiscal costs and benefits of accession, and thus there is significant uncertainty surrounding this projection. The analysis here assumes the following:

- The cost of additional infrastructure investments will be about 3 percent of GDP per year through 2003, declining to 1¾ percent of GDP thereafter. While this may well be an underestimate of the required costs of building a transportation network, developing a

[51] The Cabinet has recently compiled a list of new programs for the 2000 budget in several expenditure areas such as agriculture. If all these programs were implemented they would add additional expenditures of around 2 percent of GDP.

regional government, and meeting the environmental directives, it is hardly realistic to expect that a country could or would be able to increase spending much more than this.[52]

- According to EU estimates, the Czech Republic could hope to receive additional transfers of about 0.7 percent of GDP in the period leading up to accession and up to 3 percent of GDP thereafter. Although these numbers are speculative, they are similar to estimates used in studies for Poland, Hungary, and other countries hoping to be in the first group of acceding countries. These funds are to be used for infrastructure and other investment projects, as well as agricultural support.[53]

- The Czech Republic must make a contribution to the EU based on a formula related to GDP, VAT, and custom receipts, which would be approximately 1¼ percent of GDP. These payments would commence after accession, but based on the experience of other lower income countries, it is expected that they would be phased in gradually over a 5 year period.

- The Czech Republic will be reforming its system of indirect taxes. This is done partly to meet EU conditions but also for its own sake. It must raise the tax rate on certain items such as petroleum products and cigarettes. It is estimated (based on information provided by the authorities) that the dual effect of raising the excise rate on several goods to EU standards and raising many goods from the lower 5 percent VAT rate to the higher 20 percent rate, would increase tax revenue by about 1.6 percent of GDP per year. It is assumed that these changes would be phased in gradually over 2 years beginning in 2000.

109. The most speculative aspect of this projection is related to the additional investment spending. To some extent this spending is directly related to EU transfer payments; without this spending the transfers from the EU will not be forthcoming. But, the government may simply be able to reclassify several current investment projects as *new* in order to receive the EU transfers. Probably, there is even more uncertainty about the degree to which the EU will require the Czech Republic to meet certain standards. On the one hand, it is fairly clear that most of the items covered in the Acquis Communautaire related to the legal system will be required, but these will only need legislative action and are not associated with any significant fiscal costs. It will also be important for the government to demonstrate that the

---

[52] The World Bank has estimated that the environmental costs alone would be over 3 percent of GDP per year (see "Czech Republic: Complying with the European Union Environmental Directives," World Bank, March 1999). The EU estimates of the environmental costs for the Czech Republic are even greater.

[53] Our current understanding is that this transfer is not be treated as revenue when defining the deficit, but rather as a financing item.

restructuring of the economy is near complete, but again, this may, or may not, result in additional expenditures. However, the standards that are estimated to have the greatest cost, such as those related to the environment, are also those that are least likely to be enforced. Thus the estimate of new investment of up to 3 percent of GDP may be viewed either as a gross overestimate, or equally, an underestimate depending upon how one views the enforcement of EU standards.

110. Relative to the passive scenario, the EU accession projection indicates that there would be an increase in the measured deficit over the medium term as the additional investment spending is greater than the increase in VAT revenues (Table IV-12). However, the degree of debt accumulation would be more limited as the deficit would be partly financed by EU transfers. Although the measured deficit would exceed the indicative 3 percent of GDP Maastricht target, it would be declining at a reasonable rate and the debt stock would remain low by EU standards and on a declining trend.

D. Policy Implications and Concluding Observations

111. First, even under optimistic assumptions, unless the government implements several policy measures, fiscal deficits will be large and there will likely be a significant buildup of debt over the medium and long term. Second, the fiscal situation would deteriorate further under a variety of plausible assumptions related to growth prospects and fiscal control. Third, while EU accession will likely entail net costs over the medium term, it would not by itself jeopardize the fiscal outlook and could indeed have a net positive fiscal impact subsequent to accession.

112. In order to achieve the objective of fiscal control there are certain initiatives that the government would need to pursue:

- It would be necessary to hold the line on new expenditure demands, including guarantees, off-budget expenditures, and subsidies to the enterprise sector.

- It would be necessary to consider a variety of alternative policy measures that could address the potential fiscal deterioration, including their short- and medium-term implications. Such measures should be aimed at both a stabilization of the trend decline in the revenue ratio and a reduction in the level of expenditures. Tax reform should focus on a restructuring of revenues toward greater reliance on indirect taxes rather than direct taxes, consistent with EU harmonization. Expenditure reforms would likely include reform of mandatory expenditure programs, including social transfers, and reducing the share of subsidies in expenditures.

- As part of the MOF's efforts to increase fiscal transparency, the ministry should regularly include statements and quantify "fiscal risks" by providing a baseline and alternative projections in its regular official forecasts. As part of this initiative, there should be a regular ex-post evaluation of the fiscal outturn, including decomposition of deviations from the original budget into the impact of policy measures and cyclical

developments. This would improve future projections by providing an indication of the reasons for differences between the forecast and the outturn.

- The fiscal projections should be refined further in a number of areas. First, they should be integrated into a consistent medium-term macroeconomic framework, that ideally would reveal the macroeconomic implications of alternative fiscal strategies. Except in an extreme Ricardian-type model, a change in public savings will affect most macroeconomic variables, including interest rates, external savings, investment, and output. At a minimum, the authorities should provide a well-articulated fiscal forecast that is consistent with their underlying macroeconomic projections. Second, the authorities should continue refining the very aggregate approach employed in this exercise by coordinating individual projections from the various level of governments and building up the general government forecast from these projections. The EU's fiscal criteria are at the general government level and therefore it is critical for the central government to have an informed view on expected developments in the finances of other levels of government. Third, every attempt should be made to relate the various expenditure items to individual programs. This would facilitate the analysis of the impact of policy measures, as well as changes in the macroeconomic environment.

Table IV-1. Czech Republic: Central Government (State) Budget, 1993-99

	1993	1994	1995	1996	1997	1998	1999
Revenue	**349.0**	**381.1**	**433.7**	**476.4**	**499.6**	**530.0**	**546.5**
Total Current Revenue	**345.4**	**377.6**	**429.3**	**472.9**	**496.4**	**527.0**	**546.5**
Tax Revenue	**336.5**	**366.6**	**409.7**	**457.4**	**478.4**	**509.6**	**530.6**
Indirect Taxes	136.6	153.7	172.7	194.5	201.2	205.2	212.1
Direct Taxes	72.4	70.2	72.7	78.3	74.8	87.4	84.0
Personal Income Tax	1.5	5.8	8.5	29.7	33.2	36.3	37.4
Enterprise Tax	70.9	64.4	64.2	48.6	41.6	51.1	46.6
Social Security Contributions	109.8	132.7	154.3	174.3	191.0	203.9	220.9
Other Taxes	17.7	10.0	10.0	10.3	11.4	13.2	13.6
Non-Tax current Revenue	8.9	11.0	19.6	15.5	17.9	17.4	16.0
Non-tax capital revenue	3.6	3.5	4.4	3.5	3.2	3.0	0.0
Expenditure incl. L-R	**347.9**	**370.7**	**426.5**	**478.0**	**515.2**	**559.4**	**593.8**
Expenditure excl. L_R	351.9	372.9	425.2	480.4	515.9	557.6	592.1
Current expenditures	**319.6**	**333.8**	**369.6**	**423.4**	**466.2**	**507.5**	**534.4**
Goods and services	97.4	106.9	95.7	103.6	96.2	101.4	110.1
Wages and salaries	30.0	40.8	40.4	45.5	47.8	47.4	53.0
Other goods and services	67.4	66.1	55.3	58.1	48.4	54.0	57.1
Transfers to Households	118.0	137.0	155.6	180.7	211.0	228.7	244.0
Health Insurance	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Pensions	102.6	123.8	147.2	150.7	151.1	166.1	172.9
Other transfers	15.4	13.2	8.4	30.0	59.9	62.6	71.2
Subsidies to Enterprises	89.9	89.9	115.7	125.0	141.1	157.7	160.6
Interest payments	14.3	0.0	2.6	14.0	17.9	19.8	19.6
Capital Expenditures	**32.3**	**39.1**	**55.6**	**57.0**	**49.7**	**50.1**	**57.8**
Fixed investment	13.1	19.7	21.5	25.8	16.3	16.5	20.2
Other investment	19.2	19.4	34.1	31.2	33.4	33.6	37.5
Lending minus repayments	-4.0	-2.2	1.3	-2.4	-0.7	1.8	1.7
General Gvt Deficit	**1.0**	**10.4**	**7.2**	**-1.6**	**-15.6**	**-29.3**	**-47.3**
General Gvt Deficit (exc. Net lending)	-3.0	8.2	8.5	-4.0	-16.3	-27.6	-45.6
Current Deficit	25.7	43.8	59.7	49.5	30.1	19.5	12.2
Primary Deficit	11.4	8.2	11.1	10.0	1.6	-7.8	-26.0
Debt	**158.8**	**161.7**	**154.4**	**155.2**	**173.1**	**194.7**	**247.8**
Debt valuation		-5.3	-15.8	4.8	0.0	0.0	0.0
				(in percent of GDP)			
Revenue	**34.8**	**33.2**	**32.2**	**31.1**	**30.3**	**29.8**	**29.4**
Total Current Revenue	**34.4**	**32.9**	**31.8**	**30.9**	**30.1**	**29.7**	**29.4**
Tax Revenue	**33.5**	**31.9**	**30.4**	**29.8**	**29.0**	**28.7**	**28.5**
Indirect Taxes	13.6	13.4	12.8	12.7	12.2	11.5	11.4
Direct Taxes	7.2	6.1	5.4	5.1	4.5	4.9	4.5
Personal Income Tax	0.1	0.5	0.6	1.9	2.0	2.0	2.0
Enterprise Tax	7.1	5.6	4.8	3.2	2.5	2.9	2.5
Social Security Contributions	10.9	11.6	11.4	11.4	11.6	11.5	11.9
Other Taxes	1.8	0.9	0.7	0.7	0.7	0.7	0.7
Non-tax Current Revenue	0.9	1.0	1.5	1.0	1.1	1.0	0.9
Non-tax Capital revenue	0.4	0.3	0.3	0.2	0.2	0.2	0.0
Expenditure incl. L-R	**34.6**	**32.3**	**31.6**	**31.2**	**31.2**	**31.5**	**31.9**
Expenditure excl. L-R	35.0	32.5	31.5	31.3	31.3	31.4	31.8
Current Expenditure	**31.8**	**29.1**	**27.4**	**27.6**	**28.3**	**28.6**	**28.7**
Goods and Services	9.7	9.3	7.1	6.8	5.8	5.7	5.9
Wages and Salaries	3.0	3.6	3.0	3.0	2.9	2.7	2.8
Other Goods and Services	6.7	5.8	4.1	3.8	2.9	3.0	3.1
Transfers to Households	11.8	11.9	11.5	11.8	12.8	12.9	13.1
Health Insurance	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Pensions	10.2	10.8	10.9	9.8	9.2	9.3	9.3
Other Transfers	1.5	1.1	0.6	2.0	3.6	3.5	3.8
Subsidies to Enterprises	9.0	7.8	8.6	8.2	8.6	8.9	8.6
Interest Payments	1.4	0.0	0.2	0.9	1.1	1.1	1.1
Capital Expenditure	**3.2**	**3.4**	**4.1**	**3.7**	**3.0**	**2.8**	**3.1**
Fixed Investment	1.3	1.7	1.6	1.7	1.0	0.9	1.1
Other Investment	1.9	1.7	2.5	2.0	2.0	1.9	2.0
Lending minus Repayments	-0.4	-0.2	0.1	-0.2	0.0	0.1	0.1
General Government Deficit	**0.1**	**0.9**	**0.5**	**-0.1**	**-0.9**	**-1.7**	**-2.5**
General Government Deficit (exc. net lending	-0.3	0.7	0.6	-0.3	-1.0	-1.6	-2.4
Current Deficit	2.6	3.8	4.4	3.2	1.8	1.1	0.7
Primary Deficit	1.1	0.7	0.8	0.7	0.1	-0.4	-1.4
Debt	**15.8**	**14.1**	**11.4**	**10.1**	**10.5**	**11.0**	**13.3**
GDP	1004.1	1148.6	1348.7	1532.6	1649.5	1776.7	1861.6

Source: Czech authorities.

Table IV-2. Czech Republic: General Government Budget, 1993-99

	1993	1994	1995	1996	1997	1998	1999
Revenue	**446.7**	**504.3**	**578.4**	**634.2**	**662.3**	**707.5**	**746.3**
Total Current Revenue	**438.7**	**498.0**	**571.9**	**626.0**	**653.3**	**696.6**	**737.3**
Tax Revenue	**393.0**	**446.0**	**511.3**	**576.2**	**608.7**	**651.6**	**683.1**
Indirect Taxes	137.8	154.9	173.6	195.3	210.6	214.6	226.7
Direct Taxes	100.6	118.3	135.1	142.4	143.4	162.5	164.9
Personal Income Tax	29.7	54.5	68.6	80.5	87.9	94.9	100.9
Enterprise Tax	70.9	63.8	66.5	61.8	55.6	67.6	64.0
Social Security Contributions	132.1	162.3	192.6	222.0	245.5	264.0	280.3
Other Taxes	22.5	10.5	10.0	16.6	9.2	10.5	11.2
Non-Tax current Revenue	45.7	52.0	60.6	49.7	44.6	45.0	54.2
Non-tax capital revenue	8.0	6.3	6.5	8.2	9.0	10.9	9.0
Expenditure incl. L-R	**420.0**	**494.9**	**572.8**	**640.4**	**682.2**	**735.1**	**818.6**
Expenditure excl. L_R	442.7	518.7	593.1	662.2	697.8	751.0	825.8
Current expenditures	**379.6**	**435.3**	**495.1**	**561.6**	**605.2**	**656.9**	**727.6**
Goods and services	126.9	130.4	122.6	139.3	136.6	148.5	160.2
Wages and salaries	37.1	48.6	50.2	57.4	62.3	62.7	67.9
Other goods and services	89.8	81.8	72.4	81.9	74.3	85.8	92.3
Transfers to Households	169.6	205.6	241.3	278.0	310.1	338.3	377.6
Health Insurance	46.2	63.2	74.1	86.1	93.0	101.9	117.0
Pensions	76.6	88.2	109.8	127.6	151.1	166.2	182.9
Other transfers	46.8	54.2	57.4	64.3	66.0	70.2	77.7
Subsidies to Enterprises	65.5	83.9	114.6	126.1	137.7	148.9	165.2
Interest payments	17.7	15.4	16.6	18.2	20.7	21.2	24.5
Capital Expenditures	**63.1**	**83.4**	**98.0**	**100.6**	**92.6**	**94.1**	**98.2**
Fixed investment	39.6	54.3	63.5	69.2	60.9	59.3	63.4
Other investment	23.5	29.1	34.5	31.4	31.7	34.8	34.8
Lending minus repayments	-22.7	-23.8	-20.3	-21.8	-15.6	-15.9	-7.2
Lending minus repayments (exc. pvt)	-0.6	-0.8	13.2	4.3	-4.1	-1.8	-3.6
General Gvt Deficit	**1.0**	**10.4**	**7.2**	**-1.6**	**-15.6**	**-29.3**	**-47.3**
General Gvt Deficit (exc. Net lending)	-3.0	8.2	8.5	-4.0	-16.3	-27.6	-45.6
Current Deficit	25.7	43.8	59.7	49.5	30.1	19.5	12.2
Primary Deficit	11.4	8.2	11.1	10.0	1.6	-7.8	-26.0
Debt	**158.8**	**161.7**	**154.4**	**155.2**	**173.1**	**194.7**	**247.8**
Debt valuation		-5.3	-15.8	4.8	0.0	0.0	0.0
				(in percent of GDP)			
Revenue	**44.5**	**43.9**	**42.9**	**41.4**	**40.2**	**39.8**	**40.1**
Total Current Revenue	**43.7**	**43.4**	**42.4**	**40.8**	**39.6**	**39.2**	**39.6**
Tax Revenue	**39.1**	**38.8**	**37.9**	**37.6**	**36.9**	**36.7**	**36.7**
Indirect Taxes	13.7	13.5	12.9	12.7	12.8	12.1	12.2
Direct Taxes	10.0	10.3	10.0	9.3	8.7	9.1	8.9
Personal Income Tax	3.0	4.7	5.1	5.3	5.3	5.3	5.4
Enterprise Tax	7.1	5.6	4.9	4.0	3.4	3.8	3.4
Social Security Contributions	13.2	14.1	14.3	14.5	14.9	14.9	15.1
Other Taxes	2.2	0.9	0.7	1.1	0.6	0.6	0.6
Non-tax Current Revenue	4.5	4.5	4.5	3.2	2.7	2.5	2.9
Non-tax Capital revenue	0.8	0.5	0.5	0.5	0.5	0.6	0.5
Expenditure incl. L-R	**41.8**	**43.1**	**42.5**	**41.8**	**41.4**	**41.4**	**44.0**
Expenditure excl. L-R	44.1	45.2	44.0	43.2	42.3	42.3	44.4
Current Expenditure	**37.8**	**37.9**	**36.7**	**36.6**	**36.7**	**37.0**	**39.1**
Goods and Services	12.6	11.4	9.1	9.1	8.3	8.4	8.6
Wages and Salaries	3.7	4.2	3.7	3.7	3.8	3.5	3.6
Other Goods and Services	8.9	7.1	5.4	5.3	4.5	4.8	5.0
Transfers to Households	16.9	17.9	17.9	18.1	18.8	19.0	20.3
Health Insurance	4.6	5.5	5.5	5.6	5.6	5.7	6.3
Pensions	7.6	7.7	8.1	8.3	9.2	9.4	9.8
Other Transfers	4.7	4.7	4.3	4.2	4.0	4.0	4.2
Subsidies to Enterprises	6.5	7.3	8.5	8.2	8.3	8.4	8.9
Interest Payments	1.8	1.3	1.2	1.2	1.3	1.2	1.3
Capital Expenditure	**6.3**	**7.3**	**7.3**	**6.6**	**5.6**	**5.3**	**5.3**
Fixed Investment	3.9	4.7	4.7	4.5	3.7	3.3	3.4
Other Investment	2.3	2.5	2.6	2.0	1.9	2.0	1.9
Lending minus Repayments	-2.3	-2.1	-1.5	-1.4	-0.9	-0.9	-0.4
Lending minus repayments (exc. pvt)	-0.1	-0.1	1.0	0.3	-0.2	-0.1	-0.2
General Gvt Deficit	**2.7**	**0.8**	**0.4**	**-0.4**	**-1.2**	**-1.6**	**-3.9**
General Gvt Deficit (exc. Net lending)	0.5	-1.2	-2.1	-2.1	-1.9	-2.3	-4.1
Current Deficit	0.4	-1.3	-1.1	-1.8	-2.2	-2.4	-4.3
Primary Deficit	5.9	5.5	5.7	4.2	2.9	2.2	0.5
	2.2	0.1	0.1	-0.6	-0.9	-1.3	-3.0
Debt	**19.1**	**18.1**	**15.8**	**13.3**	**13.0**	**13.7**	**16.9**
Debt (inc. hidden debt)	**29.8**	**30.3**	**26.6**	**22.7**	**24.7**	**28.9**	**31.4**
GDP	1004.1	1148.6	1348.7	1532.6	1649.5	1776.7	1861.6

Source: Czech authorities.

Table IV-3. Czech Republic: Macroeconomic Assumptions for Passive Baseline

	1993	1995	1997	1998	1999	2000	2001	2002	2003	2005	2010
Nominal GDP	1,004	1,349	1,650	1,777	1,862	1,981	2,145	2,337	2,544	2,960	4,320
growth rate		17.4	7.6	7.7	4.8	6.4	8.3	8.9	8.9	7.9	7.9
Real GDP	1,118	1,222	1,282	1,248	1,248	1,266	1,304	1,370	1,438	1,555	1,892
growth rate		6.4	1.0	-2.7	0.0	1.5	3.0	5.0	5.0	4.0	4.0
GDP Deflator	90	110	129	142	149	156	164	171	177	190	228
growth rate		10.4	6.6	10.7	4.8	4.8	5.1	3.7	3.7	3.7	3.7
CPI	91	109	129	143	148	156	164	173	179	193	231
growth rate		9.1	8.5	10.7	3.6	5.3	5.7	5.0	3.7	3.7	3.7
Wages and Salaries	356	495	620	650	693	740	795	853	914	1,050	1,487
growth rate		18.2	7.1	4.9	6.6	6.8	7.5	7.2	7.2	7.2	7.2
Long-Term Interest Rate		9.3	10.5	12.1	8.3	8.2	8.1	7.7	7.7	7.7	7.7

Source: Staff projections.

Table IV-4. Czech Republic: Medium-Term Forecast - General Government Revenues

	1993	1995	1997	1998	1999	2000	2001	2002	2003	2004	2005	2010
General government revenue	446.7	578.4	662.3	707.5	746.3	792.9	845.2	904.4	970.0	1040.7	1117.3	1610.8
% of GDP	44.5	42.9	40.2	39.8	40.1	40.0	39.4	38.7	38.1	37.9	37.7	37.3
Total Revenue	438.7	571.9	653.3	696.6	737.3	783.8	835.7	894.4	959.6	1029.9	1106.1	1597.5
% of GDP	43.7	42.4	39.6	39.2	39.6	39.6	39.0	38.3	37.7	37.5	37.4	37.0
Tax Revenue	393.0	511.3	608.7	651.6	683.1	728.4	778.1	834.2	896.6	964.7	1038.7	1517.2
% of GDP	39.1	37.9	36.9	36.6	36.7	36.8	36.3	35.7	35.2	35.2	35.1	35.1
Indirect Taxes	137.8	173.6	210.6	214.6	226.7	239.9	252.0	267.5	284.4	303.1	323.6	462.7
tax growth		112.1	107.8	101.9	105.6	105.8	105.0	106.1	106.3	106.6	106.8	107.8
wage growth		118.2	107.1	105.2	106.6	106.8	107.5	107.2	107.2	107.2	107.2	107.2
Scale					0.991	0.991	0.977	0.990	0.992	0.994	0.996	1.006
% of GDP	13.7	12.9	12.8	12.1	12.2	12.1	11.7	11.4	11.2	11.0	10.9	10.7
Direct Taxes	100.6	135.1	143.4	162.5	164.9	177.6	192.4	209.3	229.4	251.7	276.2	436.2
% of GDP	10.0	10.0	8.7	9.1	8.9	9.0	9.0	9.0	9.0	9.2	9.3	10.1
Personal Income Tax	29.7	68.6	87.9	94.9	100.9	110.4	121.7	134.3	148.3	163.8	180.8	296.8
tax growth		125.8	109.1	108.0	106.3	109.5	110.2	110.4	110.4	110.4	110.4	110.4
wage growth		118.2	107.1	105.2	106.6	106.8	107.5	107.2	107.2	107.2	107.2	107.2
scale factor					0.997	1.025	1.025	1.030	1.030	1.030	1.030	1.030
% of GDP	3.0	5.1	5.3	5.3	5.4	5.6	5.7	5.7	5.8	6.0	6.1	6.9
Enterprise Tax	70.9	66.5	55.6	67.6	64.0	67.2	70.7	75.0	81.1	87.9	95.3	139.5
tax growth		104.3	89.9	121.7	94.7	105.0	105.2	106.0	108.1	108.5	108.4	107.9
lagged GDP growth			1.13	1.12	1.08	1.07	1.07	1.07	1.08	1.08	1.08	1.08
Scale factor					0.873	0.985	0.985	0.990	1.000	1.000	1.000	1.000
% of GDP	7.1	4.9	3.4	3.8	3.4	3.4	3.3	3.2	3.2	3.2	3.2	3.2
Social Security Contributions	132.1	192.6	245.5	264.0	280.3	299.4	321.8	345.0	369.8	396.5	425.0	601.7
tax growth		118.7	110.6	107.5	106.2	106.8	107.5	107.2	107.2	107.2	107.2	107.2
wage growth		118.2	107.1	104.9	106.6	106.8	107.5	107.2	107.2	107.2	107.2	107.2
% of GDP	13.2	14.3	14.9	14.8	15.1	15.1	15.0	14.8	14.5	14.4	14.4	13.9
Other Taxes	22.5	10.0	9.2	10.5	11.2	11.4	11.9	12.4	13.0	13.5	13.9	16.6
tax growth		95.2	55.4	114.1	106.7	102.2	104.0	104.6	104.5	103.5	103.5	103.5
GDP growth		117.4	107.6	107.9	104.8	106.4	108.3	108.9	108.9	107.9	107.9	107.9
Scale factor						0.960	0.960	0.960	0.960	0.960	0.960	0.960
% of GDP	2.2	0.7	0.6	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.4
Non-tax Revenue - current	45.7	60.6	44.6	45.0	54.2	55.4	57.6	60.2	62.9	65.1	67.5	80.3
tax growth		116.5	89.6	101.0	120.4	102.2	104.0	104.6	104.5	103.5	103.5	103.5
GDP growth		117.4	107.6	107.9	104.8	106.4	108.3	108.9	108.9	107.9	107.9	107.9
Scale factor						0.960	0.960	0.960	0.960	0.960	0.960	0.960
% of GDP	4.5	4.5	2.7	2.5	2.9	2.8	2.7	2.6	2.5	2.4	2.3	1.9
Capital Revenue	8.0	6.5	9.0	10.9	9.0	9.2	9.6	10.0	10.4	10.8	11.2	13.3
tax growth		102.7	109.8	120.7	82.6	102.2	104.0	104.6	104.5	103.5	103.5	103.5
GDP growth		117.4	107.6	107.9	104.8	106.4	108.3	108.9	108.9	107.9	107.9	107.9
Scale factor						0.960	0.960	0.960	0.960	0.960	0.960	0.960
% of GDP	0.8	0.5	0.5	0.6	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.3

Source: Czech authorities and staff estimates.

Table IV-5. Czech Republic: Medium-Term Forecast - General Government Expenditures

	1993	1995	1997	1998	1999	2000	2001	2002	2003	2004	2005	2010
Expenditure incl. L-R	420.0	572.8	682.2	735.1	818.6	888.4	949.7	1012.5	1079.4	1152.3	1229.8	1691.9
% of GDP	41.8	42.5	41.4	41.3	44.0	44.8	44.3	43.3	42.4	42.0	41.5	39.2
Expenditure excl. L_R	442.7	593.1	697.8	751.0	825.8	895.6	956.9	1019.7	1086.6	1159.5	1237.0	1699.1
% of GDP	44.1	44.0	42.3	42.2	44.4	45.2	44.6	43.6	42.7	42.3	41.8	39.3
Current exp.	379.6	495.1	605.2	656.9	727.6	793.0	849.4	908.0	970.4	1038.7	1111.2	1543.7
% of GDP	37.8	36.7	36.7	36.9	39.1	40.0	39.6	38.9	38.1	37.8	37.5	35.7
Goods and Services	126.9	122.6	136.6	148.5	160.2	169.4	179.8	189.6	197.5	205.7	214.3	262.8
% of GDP	12.6	9.1	8.3	8.3	8.6	8.6	8.4	8.1	7.8	7.5	7.2	6.1
Wages and Salaries	37.1	50.2	62.3	62.7	67.9	72.3	77.1	81.8	85.7	89.8	94.0	118.5
real wage bill index		94.8	100.2	90.9	104.6	101	101	101	101	101	101	101
% of GDP	3.7	3.7	3.8	3.5	3.6	3.6	3.6	3.5	3.4	3.3	3.2	2.7
Other Goods and Services	89.8	72.4	74.3	85.8	92.3	97.2	102.7	107.8	111.8	116.0	120.3	144.3
Real spending index		81.1	83.7	104.2	103.8	100	100	100	100	100	100	100
% of GDP	8.9	5.4	4.5	4.8	5.0	4.9	4.8	4.6	4.4	4.2	4.1	3.3
Transfers to Households	169.6	241.3	310.1	338.3	377.6	417.9	450.6	486.0	523.1	563.0	606.1	876.0
% of GDP	16.9	17.9	18.8	19.0	20.3	21.1	21.0	20.8	20.6	20.5	20.5	20.3
Health Insurance	46.2	74.1	93.0	101.9	117.0	127.6	139.5	150.5	162.3	175.1	188.8	275.6
Real spending index		106.2	101.3	98.9	109.6	104	104	104	104	104	104	104
% of GDP	4.6	5.5	5.6	5.7	6.3	6.4	6.5	6.4	6.4	6.4	6.4	6.4
Pensions	76.6	109.8	151.1	166.2	182.9	200.3	215.9	233.5	251.9	271.6	293.0	427.6
Real spending index		114.1	109.2	99.4	106.2	104	102	103	104	104	104	104
% of GDP	7.6	8.1	9.2	9.3	9.8	10.1	10.1	10.0	9.9	9.9	9.9	9.9
Other Transfers	46.8	57.4	66.0	70.2	77.7	90.1	95.2	101.9	108.9	116.3	124.2	172.8
Real spending index		97.1	94.7	96.0	106.9	110	100	102	103	103	103	103
% of GDP	4.7	4.3	4.0	3.9	4.2	4.5	4.4	4.4	4.3	4.2	4.2	4.0
Subsidies to Enterprises	65.5	114.6	137.7	148.9	165.2	176.7	185.7	192.7	201.8	213.5	225.9	299.1
Real spending index		123.7	102.5	97.6	105.9	102	100	100	101	102	102	102
% of GDP	6.5	8.5	8.3	8.4	8.9	8.9	8.7	8.2	7.9	7.8	7.6	6.9
Interest Payments	17.7	16.6	20.7	21.2	24.5	29.0	33.3	39.7	48.0	56.4	65.0	105.8
adj interest rate		8.0	10.2	9.9	10.1	9.2	8.1	7.7	7.7	7.7	7.7	7.7
interest rate		9.3	10.5	12.1	8.3	8.2	8.1	7.7	7.7	7.7	7.7	7.7
adj factor					1.8	1	0	0	0	0	0	0
% of GDP	1.8	1.2	1.3	1.2	1.3	1.5	1.6	1.7	1.9	2.1	2.2	2.4
Capital Expenditure	63.1	98.0	92.6	94.1	98.2	102.6	107.5	111.7	116.1	120.9	125.8	155.4
% of GDP	6.3	7.3	5.6	5.3	5.3	5.2	5.0	4.8	4.6	4.4	4.3	3.6
Fixed Investment	39.6	63.5	60.9	59.3	63.4	67.8	72.7	76.9	81.3	86.1	91.0	120.6
Real spending index		106.1	82.6	87.9	102.0	102	102	102	102	102	102	102
% of GDP	3.9	4.7	3.7	3.3	3.4	3.4	3.4	3.3	3.2	3.1	3.1	2.8
Other Investment	23.5	34.5	31.7	34.8	34.8	34.8	34.8	34.8	34.8	34.8	34.8	34.8
Nominal index		118.3	101.0	109.8	100	100	100	100	100	100	100	100
% of GDP	2.3	2.6	1.9	2.0	1.9	1.8	1.6	1.5	1.4	1.3	1.2	0.8
Lending minus Repayments	-22.7	-20.3	-15.6	-15.9	-7.2	-7.2	-7.2	-7.2	-7.2	-7.2	-7.2	-7.2
Nominal index		85.3	71.6	101.9	100	100	100	100	100	100	100	100
% of GDP	-2.3	-1.5	-0.9	-0.9	-0.4	-0.4	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2
Lending minus Repayments(exc privat)	-22.7	13.2	-4.1	-1.8	-3.6	-7.2	-7.2	-7.2	-7.2	-7.2	-7.2	-7.2
General Gvt Deficit Nominal value	-26.7	-5.6	19.9	27.6	72.3	95.4	104.5	108.1	109.4	111.6	112.5	81.1
% of GDP	-2.7	-0.4	1.2	1.6	3.9	4.8	4.9	4.6	4.3	4.1	3.8	1.9
General Gvt Debt Nominal value	191.6	213.3	215.2	242.8	315.1	410.5	515.0	623.1	732.5	844.1	956.6	1455.3
% of GDP	19.1	15.8	13.0	13.6	16.9	20.7	24.0	26.7	28.8	30.8	32.3	33.7

Source: Czech authorities and staff estimates.

Table IV-6. Czech Republic: Passive Medium-Term Forecast - General Government

	1993	1995	1997	1998	1999	2000	2001	2002	2003	2004	2005	2010
						(in percent of GDP)						
Revenue	**44.5**	**42.9**	**40.2**	**39.8**	**40.1**	**40.0**	**39.4**	**38.7**	**38.1**	**37.9**	**37.7**	**37.3**
Total Current Revenue	43.7	42.4	39.6	39.2	39.6	39.6	39.0	38.3	37.7	37.5	37.4	37.0
Tax Revenue	39.1	37.9	36.9	36.7	36.7	36.8	36.3	35.7	35.2	35.2	35.1	35.1
Indirect Taxes	13.7	12.9	12.8	12.1	12.2	12.1	11.7	11.4	11.2	11.0	10.9	10.7
Direct Taxes	10.0	10.0	8.7	9.1	8.9	9.0	9.0	9.0	9.0	9.2	9.3	10.1
Personal Income Tax	3.0	5.1	5.3	5.3	5.4	5.6	5.7	5.7	5.8	6.0	6.1	6.9
Enterprise Tax	7.1	4.9	3.4	3.8	3.4	3.4	3.3	3.2	3.2	3.2	3.2	3.2
Social Security Contributions	13.2	14.3	14.9	14.9	15.1	15.1	15.0	14.8	14.5	14.4	14.4	13.9
Other Taxes	2.2	0.7	0.6	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.4
Non -tax Current Revenue	4.5	4.5	2.7	2.5	2.9	2.8	2.7	2.6	2.5	2.4	2.3	1.9
Non-tax Capital Revenue	0.8	0.5	0.5	0.6	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.3
Expenditure incl. L-R	**41.8**	**42.5**	**41.4**	**41.4**	**44.0**	**44.8**	**44.3**	**43.3**	**42.4**	**42.0**	**41.5**	**39.2**
Expenditure excl. L_R	44.1	44.0	42.3	42.3	44.4	45.2	44.6	43.6	42.7	42.3	41.8	39.3
Current Expenditure	37.8	36.7	36,7	37.0	39.1	40.0	39.6	38.9	38.1	37.8	37.5	35.7
Goods and Services	12.6	9.1	8.3	8.4	8.6	8.6	8.4	8.1	7.8	7.5	7.2	6.1
Wages and Salaries	3.7	3.7	3.8	3.5	3.6	3.6	3.6	3.5	3.4	3.3	3.2	2.7
Other Goods and Services	8.9	5.4	4.5	4.8	5.0	4.9	4.8	4.6	4.4	4.2	4.1	3.3
Transfers to Households	16.9	17.9	18.8	19.0	20.3	21.1	21.0	20.8	20.6	20.5	20.5	20.3
Health Insurance	4.6	5.5	5.6	5.7	6.3	6.4	6.5	6.4	6.4	6.4	6.4	6.4
Pensions	7.6	8.1	9.2	9.4	9.8	10.1	10.1	10.0	9.9	9.9	9.9	9.9
Other Transfers	4.7	4.3	4.0	4.0	4.2	4.5	4.4	4.4	4.3	4.2	4.2	4.0
Subsidies to Enterprises	6.5	8.5	8.3	8.4	8.9	8.9	8.7	8.2	7.9	7.8	7.6	6.9
Interest payments	1.8	1.2	1.3	1.2	1.3	1.5	1.6	1.7	1.9	2.1	2.2	2.4
Capital Expenditure	6.3	7.3	5.6	5.3	5.3	5.2	5.0	4.8	4.6	4.4	4.3	3.6
Fixed investment	3.9	4.7	3.7	3.3	3.4	3.4	3.4	3.3	3.2	3.1	3.1	2.8
Other investment	2.3	2.6	1.9	2.0	1.9	1.8	1.6	1.5	1.4	1.3	1.2	0.8
Lending minus repayments	-2.3	-1.5	-0.9	-0.9	-0.4	-0.4	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2
Lending minus repayments(exc priv)	-0.1	1.0	-0.2	-0.1	-0.2	-0.4	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2
General Gvt Deficit (inc. Net lending)	**2.7**	**0.4**	**-1.2**	**-1.6**	**-3.9**	**-4.8**	**-4.9**	**-4.6**	**-4.3**	**-4.1**	**-3.8**	**-1.9**
General Gvt Deficit (exc pvt)	**0.5**	**-2.1**	**-1.9**	**-2.3**	**-4.1**	**-4.8**	**-4.9**	**-4.6**	**-4.3**	**-4.1**	**-3.8**	**-1.9**
Current Deficit	5.9	5.7	2.9	2.2	0.5	-0.5	-0.6	-0.6	-0.4	-0.3	-0.2	1.2
Primary Deficit	2.2	0.1	-0.9	-1.3	-3.0	-3.7	-3.7	-3.2	-2.7	-2.3	-1.8	0.4
Debt	**19.1**	**15.8**	**13.0**	**13.7**	**16.9**	**20.7**	**24.0**	**26.7**	**28.8**	**30.8**	**32.3**	**33.7**
Debt (inc hidden liabilities)	**29.8**	**26.6**	**24.7**	**28.9**	**31.4**	**34.4**	**36.6**	**38.2**	**39.4**	**40.6**	**41.4**	**39.9**

Source: Czech authorities and staff estimates.

Table IV-7. Czech Republic: Passive Medium-Term Forecast by Ministry of Finance - General Government

	1993	1995	1997	1998	1999	2000	2001	2002
	(in percent of GDP)							
Revenue	**44.5**	**42.9**	**40.2**	**39.8**	**40.3**	**38.4**	**37.3**	**36.6**
Total Current Revenue	43.7	42.4	39.6	39.2	38.9	37.7	36.9	36.4
Tax Revenue	39.1	37.9	36.9	36.7	36.5	35.6	34.9	34.6
Indirect Taxes	13.7	12.9	12.8	12.1	12.5	12.2	11.7	11.3
Direct Taxes	10.0	10.0	8.7	9.1	8.4	8.2	8.1	8.3
Personal Income Tax	3.0	5.1	5.3	5.3	5.2	5.3	5.4	5.5
Enterprise Tax	7.1	4.9	3.4	3.8	3.2	2.9	2.7	2.8
Social Security Contributions	13.2	14.3	14.9	14.9	14.9	14.7	14.5	14.5
Other Taxes	2.2	0.7	0.6	0.6	0.6	0.6	0.6	0.5
Non -tax Current Revenue	4.5	4.5	2.7	2.5	2.4	2.1	2.0	1.8
Non-tax Capital Revenue	0.8	0.5	0.5	0.6	1.3	0.7	0.4	0.2
Expenditure incl. L-R	**41.8**	**42.5**	**41.4**	**41.4**	**44.0**	**44.0**	**42.4**	**41.1**
Expenditure excl. L_R	44.1	44.0	42.3	42.3	43.6	43.9	42.3	41.0
Current Expenditure	37.8	36.7	36.7	37.0	38.3	38.8	37.8	37.0
Goods and Services	12.6	9.1	8.3	8.4	9.2	9.5	9.4	9.2
Wages and Salaries	3.7	3.7	3.8	3.5	3.5	3.7	3.6	3.5
Other Goods and Services	8.9	5.4	4.5	4.8	5.7	5.8	5.8	5.7
Transfers to Households	16.9	17.9	18.8	19.0	19.9	20.0	19.6	19.3
Subsidies to Enterprises	6.5	8.5	8.3	8.4	8.0	8.0	7.4	7.1
Interest payments	1.8	1.2	1.3	1.2	1.2	1.3	1.4	1.4
Capital Expenditure	6.3	7.3	5.6	5.3	5.4	5.0	4.6	4.0
Fixed investment	3.9	4.7	3.7	3.3	2.8	2.8	2.7	2.5
Other investment	2.3	2.6	1.9	2.0	2.6	2.2	1.8	1.5
Lending minus repayments	-2.3	-1.5	-0.9	-0.9	0.4	0.1	0.1	0.1
General Gvt Deficit (inc. Net lending)	**2.7**	**0.4**	**-1.2**	**-1.6**	**-3.8**	**-5.5**	**-5.1**	**-4.5**
General Gvt Deficit	0.4	-1.1	-2.2	-2.4	-3.4	-5.5	-5.0	-4.4
Current Deficit	5.9	5.7	2.9	2.2	0.6	-1.1	-0.9	-0.6
Primary Deficit	2.2	0.1	-0.9	-1.3	-2.6	-4.2	-3.7	-3.1
Debt	**19.1**	**15.8**	**13.0**	**13.7**	**16.8**	**21.1**	**24.4**	**26.9**

Source: Czech authorities and staff estimates.

Table IV-8. Czech Republic: Increased Spending Scenario - General Government

	1993	1995	1997	1998	1999	2000	2001	2002	2003	2004	2005	2010
						(in percent of GDP)						
Revenue	**44.5**	**42.9**	**40.2**	**39.8**	**40.1**	**40.0**	**39.4**	**38.7**	**38.1**	**37.9**	**37.7**	**37.3**
Total Current Revenue	43.7	42.4	39.6	39.2	39.6	39.6	39.0	38.3	37.7	37.5	37.4	37.0
Tax Revenue	39.1	37.9	36.9	36.7	36.7	36.8	36.3	35.7	35.2	35.2	35.1	35.1
Indirect Taxes	13.7	12.9	12.8	12.1	12.2	12.1	11.7	11.4	11.2	11.0	10.9	10.7
Direct Taxes	10.0	10.0	8.7	9.1	8.9	9.0	9.0	9.0	9.0	9.2	9.3	10.1
Personal Income Tax	3.0	5.1	5.3	5.3	5.4	5.6	5.7	5.7	5.8	6.0	6.1	6.9
Enterprise Tax	7.1	4.9	3.4	3.8	3.4	3.4	3.3	3.2	3.2	3.2	3.2	3.2
Social Security Contributions	13.2	14.3	14.9	14.9	15.1	15.1	15.0	14.8	14.5	14.4	14.4	13.9
Other Taxes	2.2	0.7	0.6	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.4
Non -tax Current Revenue	4.5	4.5	2.7	2.5	2.9	2.8	2.7	2.6	2.5	2.4	2.3	1.9
Non-tax Capital Revenue	0.8	0.5	0.5	0.6	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.3
Expenditure incl. L-R	**41.8**	**42.5**	**41.4**	**41.4**	**44.0**	**46.2**	**45.9**	**45.0**	**44.1**	**43.8**	**43.4**	**41.4**
Expenditure excl. L_R	44.1	44.0	42.3	42.3	44.4	46.6	46.2	45.3	44.4	44.0	43.6	41.5
Current Expenditure	37.8	36.7	36.7	37.0	39.1	40.7	40.2	39.5	38.9	38.6	38.4	36.9
Goods and Services	12.6	9.1	8.3	8.4	8.6	8.6	8.4	8.1	7.8	7.5	7.2	6.1
Wages and Salaries	3.7	3.7	3.8	3.5	3.6	3.6	3.6	3.5	3.4	3.3	3.2	2.7
Other Goods and Services	8.9	5.4	4.5	4.8	5.0	4.9	4.8	4.6	4.4	4.2	4.1	3.3
Transfers to Households	16.9	17.9	18.8	19.0	20.3	21.1	21.0	20.8	20.6	20.5	20.5	20.3
Health Insurance	4.6	5.5	5.6	5.7	6.3	6.4	6.5	6.4	6.4	6.4	6.4	6.4
Pensions	7.6	8.1	9.2	9.4	9.8	10.1	10.1	10.0	9.9	9.9	9.9	9.9
Other Transfers	4.7	4.3	4.0	4.0	4.2	4.5	4.4	4.4	4.3	4.2	4.2	4.0
Subsidies to Enterprises	6.5	8.5	8.3	8.4	8.9	8.9	8.7	8.2	7.9	7.8	7.6	6.9
Interest payments	1.8	1.2	1.3	1.2	1.3	2.1	2.2	2.3	2.6	2.8	3.0	3.7
Capital Expenditure	6.3	7.3	5.6	5.3	5.3	5.9	6.0	5.8	5.6	5.4	5.3	4.6
Fixed investment	3.9	4.7	3.7	3.3	3.4	4.2	4.4	4.3	4.2	4.1	4.1	3.8
Other investment	2.3	2.6	1.9	2.0	1.9	1.8	1.6	1.5	1.4	1.3	1.2	0.8
Lending minus repayments	-2.3	-1.5	-0.9	-0.9	-0.4	-0.4	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2
Lending minus repayments(exc priv)	-0.1	1.0	-0.2	-0.1	-0.2	-0.4	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2
General Gvt Deficit (inc. Net lending)	**2.7**	**0.4**	**-1.2**	**-1.6**	**-3.9**	**-6.2**	**-6.5**	**-6.3**	**-6.0**	**-5.9**	**-5.7**	**-4.1**
General Gvt Deficit (exc pvt)	**0.5**	**-2.1**	**-1.9**	**-2.3**	**-4.1**	**-6.2**	**-6.5**	**-6.3**	**-6.0**	**-5.9**	**-5.7**	**-4.1**
General Gvt Deficit	0.4	-1.1	-2.2	-2.4	-4.3	-6.6	-6.8	-6.6	-6.3	-6.1	-5.9	-4.2
Current Deficit	5.9	5.7	2.9	2.2	0.5	-1.1	-1.3	-1.2	-1.1	-1.1	-1.0	0.0
Primary Deficit	2.2	0.1	-0.9	-1.3	-3.0	-4.5	-4.7	-4.2	-3.7	-3.3	-2.8	-0.6
Debt	**19.1**	**15.8**	**13.0**	**13.7**	**16.9**	**22.1**	**26.9**	**31.0**	**34.4**	**37.8**	**40.7**	**48.4**
Debt (inc hidden liabilities)	**29.8**	**26.6**	**24.7**	**28.9**	**31.4**	**35.7**	**39.5**	**42.5**	**45.1**	**47.6**	**49.8**	**54.6**

Source: Czech authorities and staff estimates.

Table IV- 9. Czech Republic: Reform Scenario - General Government

	1993	1995	1997	1998	1999	2000	2001	2002	2003	2004	2005	2010
						(in percent of GDP)						
Revenue	**44.5**	**42.9**	**40.2**	**39.8**	**40.1**	**40.8**	**41.0**	**40.3**	**39.7**	**39.5**	**39.3**	**38.9**
Total Current Revenue	43.7	42.4	39.6	39.2	39.6	40.4	40.6	39.9	39.3	39.1	39.0	38.6
Tax Revenue	39.1	37.9	36.9	36.7	36.7	37.6	37.9	37.3	36.8	36.8	36.7	36.7
Indirect Taxes	13.7	12.9	12.8	12.1	12.2	13.1	13.7	13.4	13.2	13.0	12.9	12.7
Direct Taxes	10.0	10.0	8.7	9.1	8.9	8.8	8.6	8.6	8.6	8.8	8.9	9.7
Personal Income Tax	3.0	5.1	5.3	5.3	5.4	5.5	5.4	5.5	5.6	5.7	5.9	6.6
Enterprise Tax	7.1	4.9	3.4	3.8	3.4	3.3	3.1	3.1	3.0	3.1	3.1	3.1
Social Security Contributions	13.2	14.3	14.9	14.9	15.1	15.1	15.0	14.8	14.5	14.4	14.4	13.9
Other Taxes	2.2	0.7	0.6	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.4
Non -tax Current Revenue	4.5	4.5	2.7	2.5	2.9	2.8	2.7	2.6	2.5	2.4	2.3	1.9
Non-tax Capital Revenue	0.8	0.5	0.5	0.6	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.3
Expenditure incl. L-R	**41.8**	**42.5**	**41.4**	**41.4**	**44.0**	**44.4**	**44.0**	**42.8**	**41.7**	**41.1**	**40.5**	**37.2**
Expenditure excl. L_R	44.1	44.0	42.3	42.3	44.4	44.7	44.3	43.1	42.0	41.3	40.7	37.4
Current Expenditure	37.8	36.7	36.7	37.0	39.1	38.8	38.3	37.3	36.4	35.9	35.5	32.8
Goods and Services	12.6	9.1	8.3	8.4	8.6	8.6	8.4	8.1	7.8	7.5	7.2	6.1
Wages and Salaries	3.7	3.7	3.8	3.5	3.6	3.6	3.6	3.5	3.4	3.3	3.2	2.7
Other Goods and Services	8.9	5.4	4.5	4.8	5.0	4.9	4.8	4.6	4.4	4.2	4.1	3.3
Transfers to Households	16.9	17.9	18.8	19.0	20.3	20.2	20.2	19.9	19.7	19.6	19.6	19.4
Health Insurance	4.6	5.5	5.6	5.7	6.3	6.4	6.5	6.4	6.4	6.4	6.4	6.4
Pensions	7.6	8.1	9.2	9.4	9.8	9.9	9.8	9.6	9.5	9.5	9.5	9.5
Other Transfers	4.7	4.3	4.0	4.0	4.2	3.9	3.9	3.9	3.8	3.7	3.7	3.5
Subsidies to Enterprises	6.5	8.5	8.3	8.4	8.9	7.9	7.8	7.3	7.0	6.9	6.7	6.0
Interest payments	1.8	1.2	1.3	1.2	1.3	2.1	2.0	1.9	1.9	1.9	1.9	1.3
Capital Expenditure	6.3	7.3	5.6	5.3	5.3	5.9	6.0	5.8	5.6	5.4	5.3	4.6
Fixed investment	3.9	4.7	3.7	3.3	3.4	4.2	4.4	4.3	4.2	4.1	4.1	3.8
Other investment	2.3	2.6	1.9	2.0	1.9	1.8	1.6	1.5	1.4	1.3	1.2	0.8
Lending minus repayments	-2.3	-1.5	-0.9	-0.9	-0.4	-0.4	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2
Lending minus repayments (exc priv)	-0.1	1.0	-0.2	-0.1	-0.2	-0.4	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2
General Gvt Deficit	**2.7**	**0.4**	**-1.2**	**-1.6**	**-3.9**	**-3.5**	**-3.0**	**-2.5**	**-2.0**	**-1.6**	**-1.1**	**1.7**
General Gvt Deficit (exc pvt)	**0.5**	**-2.1**	**-1.9**	**-2.3**	**-4.1**	**-3.5**	**-3.0**	**-2.5**	**-2.0**	**-1.6**	**-1.1**	**1.7**
General Gvt Deficit	0.4	-1.1	-2.2	-2.4	-4.3	-3.9	-3.3	-2.8	-2.2	-1.8	-1.4	1.5
Current Deficit	5.9	5.7	2.9	2.2	0.5	1.6	2.2	2.6	2.9	3.2	3.5	5.8
Primary Deficit	2.2	0.1	-0.9	-1.3	-3.0	-1.8	-1.4	-0.8	-0.3	0.1	0.6	2.8
Debt	**19.1**	**15.8**	**13.0**	**13.7**	**16.9**	**19.5**	**20.9**	**21.7**	**21.9**	**21.8**	**21.4**	**12.2**
Debt (inc hidden liabilities)	**29.8**	**26.6**	**24.7**	**28.9**	**31.4**	**33.1**	**33.5**	**33.2**	**32.5**	**31.7**	**30.5**	**18.5**

Source: Czech authorities and staff estimates.

Table IV-10. Czech Republic: Low Growth Scenario - General Government

	1993	1995	1997	1998	1999	2000	2001	2002	2003	2004	2005	2010
						(in percent of GDP)						
Revenue	**44.5**	**42.9**	**40.2**	**39.8**	**40.0**	**40.2**	**39.9**	**39.3**	**38.7**	**38.6**	**38.4**	**38.1**
Total Current Revenue	43.7	42.4	39.6	39.2	39.6	39.7	39.5	38.8	38.3	38.2	38.0	37.8
Tax Revenue	39.1	37.9	36.9	36.7	36.8	37.1	37.0	36.4	36.0	36.0	35.9	36.1
Indirect Taxes	13.7	12.9	12.8	12.1	12.3	12.3	12.0	11.7	11.5	11.3	11.2	11.1
Direct Taxes	10.0	10.0	8.7	9.1	8.9	9.1	9.2	9.2	9.2	9.4	9.6	10.4
Personal Income Tax	3.0	5.1	5.3	5.3	5.4	5.6	5.8	5.9	5.9	6.1	6.2	7.0
Enterprise Tax	7.1	4.9	3.4	3.8	3.5	3.5	3.4	3.3	3.3	3.3	3.4	3.4
Social Security Contributions	13.2	14.3	14.9	14.9	15.1	15.2	15.2	15.0	14.8	14.7	14.6	14.2
Other Taxes	2.2	0.7	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.4
Non-Tax current Revenue	4.5	4.5	2.7	2.5	2.7	2.6	2.5	2.4	2.3	2.2	2.1	1.7
Non-tax capital revenue	0.8	0.5	0.5	0.6	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.3
Expenditure incl. L-R	**41.8**	**42.5**	**41.4**	**41.4**	**44.3**	**46.2**	**46.5**	**46.7**	**46.6**	**47.2**	**47.7**	**51.2**
Expenditure excl. L_R	44.1	44.0	42.3	42.3	45.1	47.0	47.3	47.4	47.3	47.8	48.3	51.6
Current exp.	37.8	36.7	36.7	37.0	39.8	41.7	42.1	42.3	42.4	43.0	43.6	47.3
Goods and services	12.6	9.1	8.3	8.4	8.8	9.0	9.0	8.9	8.7	8.5	8.3	7.5
Wages and salaries	3.7	3.7	3.8	3.5	3.7	3.8	3.8	3.8	3.7	3.7	3.6	3.4
Other goods and services	8.9	5.4	4.5	4.8	5.1	5.2	5.2	5.1	4.9	4.8	4.7	4.2
Transfers to Households	16.9	17.9	18.8	19.0	20.5	21.9	22.2	22.5	22.5	22.8	23.1	24.6
Health Insurance	4.6	5.5	5.6	5.7	6.4	6.6	6.7	6.8	6.8	6.9	7.0	7.5
Pensions	7.6	8.1	9.2	9.4	9.9	10.5	10.7	10.9	11.0	11.1	11.3	12.1
Other transfers	4.7	4.3	4.0	4.0	4.2	4.7	4.7	4.8	4.7	4.8	4.8	4.9
Subsidies to Enterprises	6.5	8.5	8.3	8.4	9.0	9.2	9.0	8.7	8.5	8.4	8.4	8.2
Interest payments	1.8	1.2	1.3	1.2	1.4	1.6	1.9	2.3	2.7	3.3	3.8	7.0
Capital Expenditures	6.3	7.3	5.6	5.3	5.4	5.3	5.2	5.1	4.9	4.8	4.7	4.3
Fixed investment	3.9	4.7	3.7	3.3	3.5	3.5	3.5	3.5	3.4	3.4	3.4	3.3
Other investment	2.3	2.6	1.9	2.0	1.9	1.8	1.7	1.6	1.5	1.4	1.4	1.0
Lending minus repayments	-2.3	-1.5	-0.9	-0.9	-0.9	-0.8	-0.8	-0.7	-0.7	-0.7	-0.6	-0.5
Lending minus repayments(exc. priv)	-0.1	1.0	-0.2	-0.1	-0.2	-0.4	-0.4	-0.3	-0.3	-0.3	-0.3	-0.2
General Gvt Deficit	**2.7**	**0.4**	**-1.2**	**-1.6**	**-4.2**	**-6.0**	**-6.6**	**-7.4**	**-7.9**	**-8.6**	**-9.3**	**-13.0**
General Gvt Deficit (exc. pvt)	**0.5**	**-2.1**	**-1.9**	**-2.3**	**-4.9**	**-6.4**	**-7.0**	**-7.8**	**-8.3**	**-8.9**	**-9.6**	**-13.3**
Current Deficit	5.9	5.7	2.9	2.2	-0.2	-2.0	-2.6	-3.5	-4.1	-4.8	-5.6	-9.5
Primary Deficit	2.2	0.1	-0.9	-1.3	-3.7	-5.1	-5.5	-5.8	-5.8	-6.0	-6.1	-6.5
Debt	**19.1**	**15.8**	**13.0**	**13.7**	**17.4**	**22.5**	**27.8**	**33.6**	**39.5**	**46.1**	**53.1**	**93.5**
Debt (inc. hidden liabilities)	**29.8**	**26.6**	**24.7**	**28.9**	**32.0**	**36.5**	**41.0**	**45.9**	**51.1**	**57.1**	**63.6**	**101.6**

Source: Czech authorities and staff estimates.

Table IV-11. Czech Republic: Fiscal Risk Scenario - General Government

	1993	1995	1997	1998	1999	2000	2001	2002	2003	2004	2005	2010
						(in percent of GDP)						
Revenue	**44.5**	**42.9**	**40.2**	**39.8**	**39.9**	**39.7**	**39.0**	**38.2**	**37.6**	**37.3**	**37.0**	**36.1**
Total Current Revenue	43.7	42.4	39.6	39.2	39.4	39.2	38.6	37.8	37.2	36.9	36.6	35.8
Tax Revenue	39.1	37.9	36.9	36.7	36.7	36.7	36.1	35.4	34.9	34.7	34.5	34.1
Indirect Taxes	13.7	12.9	12.8	12.1	12.2	12.1	11.7	11.4	11.2	11.0	10.9	10.7
Direct Taxes	10.0	10.0	8.7	9.1	8.9	8.9	8.8	8.7	8.7	8.7	8.8	9.1
Personal Income Tax	3.0	5.1	5.3	5.3	5.4	5.5	5.6	5.6	5.6	5.7	5.8	6.2
Enterprise Tax	7.1	4.9	3.4	3.8	3.4	3.4	3.2	3.1	3.1	3.0	3.0	2.9
Social Security Contributions	13.2	14.3	14.9	14.9	15.1	15.1	15.0	14.8	14.5	14.4	14.4	13.9
Other Taxes	2.2	0.7	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.4
Non-Tax current Revenue	4.5	4.5	2.7	2.5	2.7	2.6	2.5	2.4	2.3	2.2	2.1	1.7
Non-tax capital revenue	0.8	0.5	0.5	0.6	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.3
Expenditure incl. L-R	**41.8**	**42.5**	**41.4**	**41.4**	**43.8**	**44.9**	**44.6**	**44.0**	**43.6**	**43.6**	**43.6**	**43.2**
Expenditure excl. L_R	44.1	44.0	42.3	42.3	44.6	45.7	45.4	44.7	44.2	44.1	44.1	43.5
Current exp.	37.8	36.7	36.7	37.0	39.3	40.5	40.3	39.9	39.6	39.7	39.8	39.9
Goods and services	12.6	9.1	8.3	8.4	8.7	8.8	8.8	8.7	8.5	8.3	8.2	7.6
Wages and salaries	3.7	3.7	3.8	3.5	3.6	3.7	3.7	3.7	3.6	3.6	3.6	3.4
Other goods and services	8.9	5.4	4.5	4.8	5.0	5.1	5.1	5.0	4.8	4.7	4.6	4.2
Transfers to Households	16.9	17.9	18.8	19.0	20.3	21.2	21.2	21.0	21.0	21.2	21.3	22.2
Health Insurance	4.6	5.5	5.6	5.7	6.3	6.6	6.7	6.7	6.7	6.7	6.8	7.1
Pensions	7.6	8.1	9.2	9.4	9.8	10.1	10.1	10.0	10.0	10.1	10.2	10.7
Other transfers	4.7	4.3	4.0	4.0	4.2	4.5	4.4	4.4	4.3	4.3	4.3	4.3
Subsidies to Enterprises	6.5	8.5	8.3	8.4	9.0	9.0	8.8	8.5	8.2	8.2	8.1	7.7
Interest payments	1.8	1.2	1.3	1.2	1.3	1.5	1.6	1.7	1.9	2.1	2.2	2.4
Capital Expenditures	6.3	7.3	5.6	5.3	5.3	5.2	5.0	4.8	4.6	4.4	4.3	3.6
Fixed investment	3.9	4.7	3.7	3.3	3.4	3.5	3.4	3.3	3.2	3.2	3.1	2.8
Other investment	2.3	2.6	1.9	2.0	1.9	1.8	1.6	1.5	1.4	1.3	1.2	0.8
Lending minus repayments	-2.3	-1.5	-0.9	-0.9	-0.9	-0.8	-0.7	-0.7	-0.6	-0.6	-0.5	-0.4
Lending minus repayments(exc priv)	-0.1	1.0	-0.2	-0.1	-0.2	-0.4	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2
General Gvt Deficit	**2.7**	**0.4**	**-1.2**	**-1.6**	**-3.9**	**-5.2**	**-5.6**	**-5.8**	**-6.0**	**-6.3**	**-6.5**	**-7.1**
General Gvt Deficit (exc pvt)	**0.5**	**-2.1**	**-1.9**	**-2.3**	**-4.6**	**-5.6**	**-6.0**	**-6.2**	**-6.3**	**-6.6**	**-6.8**	**-7.3**
Current Deficit	5.9	5.7	2.9	2.2	0.1	-1.2	-1.8	-2.1	-2.4	-2.8	-3.2	-4.1
Primary Deficit	2.2	0.1	-0.9	-1.3	-3.4	-4.5	-4.8	-4.8	-4.7	-4.8	-4.9	-5.0
Debt	**19.1**	**15.8**	**13.0**	**13.7**	**16.9**	**21.1**	**25.1**	**28.8**	**32.5**	**36.4**	**40.3**	**57.7**
Debt (inc hidden liabilities)	**29.8**	**26.6**	**24.7**	**28.9**	**31.5**	**34.7**	**37.7**	**40.4**	**43.1**	**46.2**	**49.4**	**63.9**

Source: Czech authorities and staff estimates.

Table IV-12. Czech Republic: EU Accession Scenario - General Government

	1993	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2010
						(in percent of GDP)							
Revenue	**44.5**	**42.9**	**41.4**	**40.2**	**39.8**	**40.1**	**40.8**	**41.0**	**40.3**	**39.7**	**39.5**	**39.3**	**38.9**
Total Current Revenue	43.7	42.4	40.8	39.6	39.2	39.6	40.4	40.6	39.9	39.3	39.1	39.0	38.6
Tax Revenue	39.1	37.9	37.6	36.9	36.7	36.7	37.6	37.9	37.3	36.8	36.8	36.7	36.7
Indirect Taxes	13.7	12.9	12.7	12.8	12.1	12.2	12.9	13.3	13.0	12.8	12.6	12.5	12.3
Direct Taxes	10.0	10.0	9.3	8.7	9.1	8.9	9.0	9.0	9.0	9.0	9.2	9.3	10.1
Personal Income Tax	3.0	5.1	5.3	5.3	5.3	5.4	5.6	5.7	5.7	5.8	6.0	6.1	6.9
Enterprise Tax	7.1	4.9	4.0	3.4	3.8	3.4	3.4	3.3	3.2	3.2	3.2	3.2	3.2
Social Security Contributions	13.2	14.3	14.5	14.9	14.9	15.1	15.1	15.0	14.8	14.5	14.4	14.4	13.9
Other Taxes	2.2	0.7	1.1	0.6	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.4
Non-Tax current Revenue	4.5	4.5	3.2	2.7	2.5	2.9	2.8	2.7	2.6	2.5	2.4	2.3	1.9
Non-tax capital revenue	0.8	0.5	0.5	0.5	0.6	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.3
Expenditure incl. L-R	**41.8**	**42.5**	**41.8**	**41.4**	**41.4**	**44.0**	**46.5**	**46.0**	**44.9**	**43.8**	**42.0**	**41.4**	**38.9**
Expenditure excl. L_R	44.1	44.0	43.2	42.3	42.3	44.4	46.9	46.3	45.2	44.1	42.3	41.7	39.1
Current exp.	37.8	36.7	36.6	36.7	37.0	39.1	38.6	38.2	37.3	36.4	36.0	35.6	33.6
Goods and services	12.6	9.1	9.1	8.3	8.4	8.6	8.6	8.4	8.1	7.8	7.5	7.2	6.1
Wages and salaries	3.7	3.7	3.7	3.8	3.5	3.6	3.6	3.6	3.5	3.4	3.3	3.2	2.7
Other goods and services	8.9	5.4	5.3	4.5	4.8	5.0	4.9	4.8	4.6	4.4	4.2	4.1	3.3
Transfers to Households	16.9	17.9	18.1	18.8	19.0	20.3	21.1	21.0	20.8	20.6	20.5	20.5	20.3
Health Insurance	4.6	5.5	5.6	5.6	5.7	6.3	6.4	6.5	6.4	6.4	6.4	6.4	6.4
Pensions	7.6	8.1	8.3	9.2	9.4	9.8	10.1	10.1	10.0	9.9	9.9	9.9	9.9
Other transfers	4.7	4.3	4.2	4.0	4.0	4.2	4.5	4.4	4.4	4.3	4.2	4.2	4.0
Subsidies to Enterprises	6.5	8.5	8.2	8.3	8.4	8.9	8.9	8.7	8.2	7.9	7.8	7.6	6.9
Interest payments	1.8	1.2	1.2	1.3	1.2	1.3	0.0	0.1	0.2	0.2	0.2	0.2	0.3
Capital Expenditures	6.3	7.3	6.6	5.6	5.3	5.3	8.3	8.1	7.9	7.7	6.3	6.1	5.4
Fixed investment	3.9	4.7	4.5	3.7	3.3	3.4	6.5	6.5	6.4	6.3	5.0	4.9	4.6
Other investment	2.3	2.6	2.0	1.9	2.0	1.9	1.8	1.6	1.5	1.4	1.3	1.2	0.8
Lending minus repayments	-2.3	-1.5	-1.4	-0.9	-0.9	-0.4	-0.4	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2
Lending minus repayments(exc priv)	-0.1	1.0	0.3	-0.2	-0.1	-0.2	-0.4	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2
General Gvt Deficit	**2.7**	**0.4**	**-0.4**	**-1.2**	**-1.6**	**-3.9**	**-5.7**	**-5.0**	**-4.6**	**-4.1**	**-2.5**	**-2.1**	**0.0**
General Gvt Deficit (exc pvt)	**0.5**	**-2.1**	**-2.1**	**-1.9**	**-2.3**	**-4.1**	**-5.7**	**-5.0**	**-4.6**	**-4.1**	**-2.5**	**-2.1**	**0.0**
Current Deficit	5.9	5.7	4.2	2.9	2.2	0.5	1.8	2.4	2.5	2.9	3.1	3.4	5.0
Primary Deficit	2.2	0.1	-0.6	-0.9	-1.3	-3.0	-6.0	-5.2	-4.7	-4.2	-2.5	-2.1	0.2
Debt	**19.1**	**15.8**	**13.3**	**13.0**	**13.7**	**16.9**	**20.9**	**23.6**	**25.5**	**24.8**	**22.9**	**21.1**	**10.1**
Debt (inc hidden liabilities)	**29.8**	**26.6**	**22.7**	**24.7**	**24.5**	**31.4**	**34.5**	**36.1**	**37.1**	**35.4**	**32.8**	**30.2**	**16.4**

Source: Czech authorities and staff estimates.

Supervisory Regulations in the Czech Republic

Licensing

113. A license from the CNB is required to conduct banking, which is defined in law as accepting deposits from the general public and providing credits. The CNB has the sole power to grant and withdraw licenses. Prior to the revision in September 1998, the Ministry of Finance's agreement was required, but the CNB now has only to ask for the Ministry's "standpoint," which is understood to be non-binding, prior to making a decision. The law provides for a "fit and proper" test in licensing, and also allows the CNB to screen and reject transfer of ownership or a significant block of shares. The CNB has published detailed requirements for license applications which are available on the CNB's web-site, including a minimum capital of CZK 500 million for domestic incorporation.

Capital adequacy and prompt corrective action

114. The CNB has adopted the standard risk asset-based framework for capital adequacy, although it has not yet incorporated market risk into the capital requirement. The minimum requirement is an 8 percent capital asset ratio. In addition to any discretionary action that it may take in the event of non-compliance with these rules, the CNB is mandated to impose prompt corrective action in the event of a decline in the capital ratio to below two-thirds of the stipulated minimum, and to withdraw the license when the ratio falls below one-third of the minimum capital requirement.

Large exposure and connected lending

115. The credit exposure of a bank toward a borrower or a group of interrelated borrowers must not exceed 25 percent of capital, except in the case of a domestic bank or a bank incorporated in an OECD country for which the limit is 125 percent of capital. For a borrower with a special relationship with the bank (such as those corporations in which the bank holds 10 percent or more of the shares but excluding the above banks), the exposure limit is 20 percent of capital, and the terms of the loans must, by law, be at arms-length. In addition, the total amount of exposure toward the 10 largest debtors or groups must not exceed 230 percent of capital.

Provisioning for credit risk

116. The CNB requires banks to classify their assets into five categories: standard, watch, substandard, doubtful, and loss. Classification must be reviewed at least every quarter. For watch claims and below, the CNB requires provisioning of 5, 20, 50 and 100 percent respectively of the outstanding claims net of the value of collateral attached to the claim. A new regulation introduced in July 1998 does not allow netting of the value of real estate

collateral for loss grade claims. This regulation will be phased in over a three-year period, and reflects the difficulty in exercising creditor rights for real estate collateral.

117. The rules require that any loan whose interest or principal is overdue for 31–90 days, 91–180 days, 181–360 days and 361 days and over are classified as watch, substandard, doubtful and loss, respectively. The criteria for classification also stresses qualitative judgement, and furthermore, all the claims to a single entity are classified at the worst credit classification irrespective of the actual repayment status of each loan. The CNB also requires any foreign loans that are not naturally hedged by foreign currency income of the borrower to be classified as "watch." Bank supervisors can also adjust the classification done by banks as a result of their on-site inspection. The amount of classified credit is thus substantially larger that the amount of non-performing loans, as demonstrated below.

Czech Republic: Amount of Claims by Classification or by the Number of Overdue Days
(All banks excluding Konsolidacni Banka, end-1998)

(In million of crowns)

	Watch/ 31–90 days	Substandard/ 91–180 days	Doubtful/ 181–360 days	Loss/ 361+ days
By classification	59,492	33,560	38,902	138,004
By number of days overdue	9,586	8,325	25,472	105,824

Source: The CNB.

Foreign Exchange Risk

118. For domestically incorporated banks, foreign exchange exposure is regulated through limits, observable on a daily basis, on open positions for foreign currencies and Czech crowns, covering both on- and off-balance sheet exposure. The limits are:

- 20 percent of capital on the overall foreign exchange position for all currencies (defined as the sum of short and long positions in individual foreign currencies);
- 15 percent of capital on the open crown position.

with sub-limits of:

- 15 percent of capital for the open position in any currency for which the CNB publishes rates (convertible currencies);
- 4 percent of capital for the open position of other foreign currencies as a group and 2 percent individually.

Liquidity risk

119. The CNB does not impose common balance-sheet ratios with respect to liquidity. The CNB provision on the Liquidity Rules of Banks, issued in December 1996, requires banks to set up an information system that will allow an adequate management of liquidity, and to report to the CNB on a monthly basis. The CNB reserves the right to impose specific ratios on a bank in the event that it judges the liquidity management of a bank to be inadequate. Currently, the CNB monitors data on overall liquidity and does not differentiate domestic and foreign currency liquidity.

Market risk

120. As noted above, the CNB has not yet implemented the regulation on market risk. Nor does it require mark-to-market accounting for banks' trading activities. The CNB does, however, require provisioning for on-balance sheet securities held by banks, which has the effect of writing down their value to the lower of book or market. The regulation requires that for the trading account, banks must recalculate to market and provision on a daily basis the sum of the unrealized losses on each security (no account is taken of unrealized gains). For securities held in the investment account, banks must provision against the net loss, if any, between the market and the book value for the entire investment portfolio (i.e., after netting out gains and losses on each security).

Other regulations

121. The CNB does not have specific regulatory requirements concerning other types of risk including interest rate risk and country risk. However, it has established a regulation requiring the banks to submit an audited annual report describing the banks risk management practices, management system, internal audit system, and credit and collateral monitoring system. The CNB has also published a directive requiring banks to formulate a strategy to cope with the Y2K problem, including the preparation of a contingency plan.

122. Banks are prohibited from owning or having a controlling interest in a non-financial entity. Furthermore, if the bank has a qualifying holding in an entity (i.e., directly or indirectly holds more than 10 percent of a company's shares or exercises a significant role in the management and/or control of an entity), then the qualifying holdings in a single entity cannot exceed 15 percent of the bank's capital, and qualifying holdings taken together must not exceed 60 percent of the bank's capital.

123. An anti-money laundering law passed in 1996 requires banks and other financial institutions to report to the Ministry of Finance's Financial Analytical Unit unusual transactions (that depart from the normal scope or character of a specific type or specific customer), and also mandates customer identification for transactions in excess of CZK 500,000 and maintenance of that data for ten years. The banking act separately requires customer identification of transactions in excess of CZK 100,000.