

# Scientific Life

## LOOKING BACK TO REFORMS, LOOKING BACK TO THE CONFERENCE "TWENTY YEARS OF FINANCIAL AND BANK REFORMS IN THE CZECH REPUBLIC"

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In November 2009, under the auspices of Václav Klaus, President of the Czech Republic, the Faculty of Finance and Accounting at the University of Economics in Prague and the Czech National Bank organized the conference "*Twenty Years of Financial and Bank Reforms in the Czech Republic*". In three consecutive blocks, the conference was aimed at the fundamental economic and financial reforms, central and commercial banking system and development of capital market in this country.

In his speech President Václav Klaus described the main contours of the transformation process. He accentuated that the transformation steps had not been taken in a vacuum: there existed internal political pressures, later foreign economic actors and lobbyists exerted their influence. Mr. Klaus emphasized that unlike the other transforming countries the rehabilitation of the banking sector in Czechoslovakia was not done through inflationary depreciation of credits and deposits. In fact, the preparation of a crucial reform of the banking system started before November 1989 because the splitting of a monobank into commercial banks, which really occurred in 1990, had already been prepared.

The banking sector rehabilitation could not be considered as an outright priority because the banks had to "*breathe*" with economy. a decisive way of ensuring competition among banks was to allow the entry of the new economic actors into an emerging sector of real commercial banking. The German model of universal banks was preferred to the U.S. model. What was retrospectively underestimated was the aggressive development and influence of financial intermediation in the form of funds or foreign investment banks. From the aspect of monetary policy the monetarist doctrine was preferred while according to Mr. Klaus the policy was to be strict in the initial phase (and it really was) with a gradual relief in the second phase. However, Mr. Klaus is convinced that the actual monetary policy in this country was too strict in the years 1996-2002 and the jump tightening of bank regulation in 1997 and 1998 was a big

mistake. The increase in the volume of bad credits in that period was a consequence of recession, not its cause.

The determination of the moment of the fixed exchange rate abandonment was an important uncertainty in monetary policy. Similarly, it was difficult to determine the moment of flow liberalization on the capital (today the so called financial) account of balance of payments. The capital account liberalization was forced by our effort to join the OECD and Mr. Klaus is not sure if it was not done very soon. The exchange rate liberalization was forced by the currency crisis in 1997 while the government previously urged the CNB to make liberalization sooner.

In the beginnings of transformation the most violent disputes were about the rate of the Czechoslovak koruna devaluation. Whereas the International Monetary Fund enforced higher devaluation, domestic critics wanted much lower devaluation. Until now Mr. Klaus has considered the rate of devaluation adopted at the end of 1990 as one of the most difficult political decisions that has ever been made. Finally, the exchange rate outlasted more than six years, which was a record result among the transforming countries!

Another dispute was about the character of our banking system in the nineties and is connected with the term “*bank socialism*”. According to Mr. Klaus it is only a political label and not the analysis of the actual situation because nobody has ever dictated any credits to anybody. Mr. Klaus believes that bad credits were partly a legacy of the past and partly an inevitable product of transformation. Banks surely made great mistakes, but in Klaus’s opinion they were not greater than the mistakes made by U.S. banks in recent years. According to Mr. Klaus the cheap sale of banks after recession in 1997 and 1998 to foreign investors was a fantastic success of foreign lobbyists and advisors.

Mr. Klaus is convinced that the currency separation in 1993, which was performed shortly after the Czechoslovak federation was split, was successful. The separation is, however, instructive from the aspect that the existence of common currency is not only the question of intention or political will but it is mainly the question of economic parameters. And it also furnishes an instructive lesson for our heading to another monetary union, *i.e.* to the euro area.

In conclusion president Václav Klaus stated that although the Czech economy was experiencing deep recession, the banking and financial systems were built on good foundations. And it is not so little at all.

Klaus’s contribution was followed by Panel I „Twenty Years of Financial and Monetary Reforms in the Czech Republic“, chaired by Vladimír Tomšík. The first panellist was Pavel Kysilka, who was one of the actors of the currency separation. The monetary union between the Czech Republic and the Slovak Republic was very delicate from the very beginning. Mr. Kysilka recalled the statement of Jan Stráský, the last federal prime minister, who said that the monetary union would not last longer than by the “*plum-picking time*”. But this forecast turned out to be too optimistic because the monetary union did not survive its first phase, the phase of elementary trust. Main arguments against the monetary union of the newly emerged independent states were the expectations that the Slovak party would lose the pace of reform and would slacken the fiscal policy. Economic agents did not believe in the vitality of the monetary union, and as a depreciation of the future Slovak currency was expected, liquidity was transferred from Slovakia to the Czech Republic. Without elementary

trust it was not possible to maintain the monetary union. Moreover, during negotiations about the currency separation the Slovak party appeared not only to prefer their own currency but also to show better preparedness in the area of its real introduction.

According to Mr. Kysilka, the Czech koruna itself has attained a good position during its 17-year existence. In 1997 it underwent only a temporary 10% weakening, but in the long run it is an extraordinarily successful currency. After a decrease in inflation and nominal interest rates it became a financing tool for foreign investors. Consequently, the success of the Czech currency evokes a relatively low appetite of the population for the adoption of the single European currency.

Martin Mandel discussed some general problems from the aspect of monetary macroeconomics. Having shortly recalled the latest monetary development he focused on selected current problems of monetary policy. Taking into account the present regime of monetary policy (inflation targeting) the credibility of the central bank is a crucial issue. Mr. Mandel tested the credibility of CNB through inflationary expectations of the financial market. If these expectations were not influenced by the targets and prognoses of CNB, but by the past actual inflation, it would imply that the central bank is not credible. An empirical analysis showed that inflationary expectations are explained by the current prognosis and inflation target for the most part while the past inflation (its influence indicates the presence of adaptive expectations) influences the expectations surprisingly weakly.

Another frequently discussed problem of the present monetary policy is the real independence of interest rate policy on interest rate decisions of the ECB. Obviously, the coefficient of correlation between Czech and European monetary-policy rates gradually increased. It is possible to refuse by the Granger causality test that ECB would not influence Czech interest rates.

Finally, the last discussed problem was a question whether the real effective exchange rate of the koruna is a stabilization rather than destabilization element in our convergence process. Based on VAR model and cointegration analysis Mr. Mandel drew a conclusion that the effective exchange rate was a stabilization element. There is a dispute about the fact whether this positive role of exchange rate development is not overshadowed by its excessive medium-term volatility due to “*destabilization*” speculation.

Vladimír Dlouhý chose the adoption of the euro in the Czech Republic from an economist’s point of view as the subject of his contribution (on the contrary, Miroslav Kalousek, who presented the subsequent contribution, discussed the same theme from a politician’s point of view). Based on statistical data, Vladimír Dlouhý described the hitherto economic development in the Eurozone. During the ten years of the Eurozone existence there was an explicit convergence of inflation rates in the member countries, and naturally interest rates also converged to each other. The results from the aspect of real economy are not so unambiguous; similarly, according to Vladimír Dlouhý, neither is the expected influence on the deepening of international trade within the euro area quite significant. It is to note that the present deep crisis is a real test of EMU. It showed that the fiscal coordination was negligible and that the EMU would necessarily face divergent tendencies of economic development in the particular countries.

As concerns the potential joining of the Czech Republic the euro area, Mr. Dlouhý sees its main positive aspects in impacts on economic growth while risks and costs are

seen in the influence of asymmetric external shocks. As for the timing of joining the euro area Mr. Dlouhý considers the year 2014 as an opportune date of the adoption of single currency if the accession criteria are not changed. It should afford sufficient freedom to Czech economic policy in the years to come when short-term shocks cannot be fully excluded.

Miroslav Kalousek dealt with the same theme as Vladimír Dlouhý, but he spoke as a politician. He did not answer the question whether to adopt the euro or not, but when it should be adopted. Mr. Kalousek is convinced that it cannot be otherwise if we want to respect the agreements. According to Mr. Kalousek, the euro area has proved its vitality in the course of the current crisis. Unlike the past episodes, the domestic market did not undergo any disruptive exchange rate crises that brought shocks into mutual trade. Mr. Kalousek does not consider a possibility of weakening the national currency during crisis as a fair instrument of economic policy. In his opinion, the intentionally weakened exchange rate is hardly different in its consequences from general export subsidy and general import charge, which are the instruments the EU member country should not use against its business partners that were also hit by the crisis. Mr. Kalousek also strongly opposes to any softening of accession criteria. He recognizes that their present form is outdated and does not have a substantial economic support, but the opening of a new debate about them does not guarantee that new criteria would be better. Mr. Kalousek believes that at the present time the effort aimed at the adoption of the euro is identical to the effort aimed at the credible consolidation of public finance. In his opinion, other fears from the adoption of the euro are secondary.

In a subsequent block – Panel II “Twenty Years of Banking System in the Czech Republic”, chaired by Petr Dvořák – the speakers devoted their contributions to development of the commercial Jiří Kunert summarized the short, but very rich in events, history of commercial banking since the beginning of reforms. His view on bank development was sharply different in many aspects from Václav Klaus’s view. The role of bank credits was absolutely crucial due to the chronic undercapitalization of former state enterprises and because new firms were practically beginning from zero. Unlike the advanced economies, according to Mr. Kunert the low capital resources of firms caused that credits assumed the character of risky capital invested in business. The severance of commercial banks from the former Czechoslovak State Bank was the first step to establish a banking sector. However, newly emerged large banks had certain monopoly advantages that enabled their transformation to ordinary banks and favoured them in comparison with new small banks. New Czech banks were established with borrowed money, they did not have either good facilities or top management. According to Mr. Kunert, being corrupted by high salaries and luxurious cars managers in small banks countenanced how shareholders used the bank resources for their own needs. Mr. Kunert is convinced that the partial privatization of banks by the voucher method with the holding of the government’s controlling stake was a mistake. In Mr. Kunert’s opinion, Czech banks were to be sold to foreign investors as quickly as possible because then there would be a greater pressure on the appropriate allocation of credits.

As for bank supervision, Mr. Kunert said that it only rather caught up with banks due to the very dynamic development of bank services. However, the supervision is currently functional, independent and professional. At present, better supervision is required

especially in other countries. Mr. Kunert is convinced that the regulation is sufficient. The problem was that this regulation was not performed duly. The future development of the banking system will bring about a return to the previous state, its deglobalization and reregulation. Banking business will be governed by the client's centrality.

Miroslav Singer spoke in detail about the connection between bank supervision and macroeconomic development. After a brief survey of economic development in the mid-nineties he analyzed in greater detail the double crisis in 1997 and 1998 – banking sector crisis and currency crisis and related economic recession. As for the bank crisis, Mr. Singer considers the postponement of privatization of large banks beyond the period 1994–1995 as a mistake. According to his estimation, this postponement cost the economy about 15% of the then annual GDP. Moreover, jump depreciation of the exchange rate and dramatic increase in interest rates caused a shock the size of which is not usually simulated in stress tests of banks. Currency crisis and real economy crisis were caused by the underestimation of risks ensuing from economy overheating and by a failure to manage the exit strategy from the fixed exchange rate.

Within ten years since the crisis there has been a radical improvement both in the domestic banking sector and in the macroeconomic framework. The banking sector in Czech economy is not a source of shocks; on the contrary, it is buffering them. Mr. Singer is convinced that the transfer of supervision to the pan-European level without being accompanied by the respective fiscal or tax responsibility may be a risk for financial stability.

Michal Mejstřík dealt with the position of Czech banks in the framework of regional consolidators. He recalled that Czech banks were fully integrated into the groups of large foreign banking houses – 97% of the balance sheet total of the Czech banking sector was controlled by foreign banks in 2008. The extent of bank intermediation has been increasing in the Czech Republic but it is still far from being at the usual level of the countries of West Europe. It means that the banks in this country (similarly like in the other countries of Central and Eastern Europe) have a great growth potential. The present crisis and related changes in the banking system in other countries will substantially influence the banking sector in this country because of the interconnection of Czech banks with West European financial groups. During the crisis the large banks appeared not to be willing to take the downside risk. According to Mr. Mejstřík, one of the methods of preventing the doctrine “*too-big-to-fail*” is to segment the big actors so that it will be possible to divide them quickly in the case of fall.

Kamil Janáček illustrated development of the Czech banking system on an example of Komerční banka. This commercial bank started its activity with ten personal computers and mainly with the portfolio of loans, 85% of which would be classified as doubtful or loss according to the present criteria. However, the dynamic growth of demand for bank services and favourable interest spreads enabled the bank to create sufficient rectifying items and reserves and to show a profit by the year 1997. It was also typical of the other large Czech banks. Similarly like in the other banks there was a rapid increase in unpaid loans in 1997 and Komerční banka was heavily afflicted by the jump measure of the CNB taken in 1998, which required 100% loan loss reserves that were secured by immovables. This measure was introduced at the least opportune moment and Mr. Janáček is convinced that it contributed to the credit crunch of Czech economy. When finally a decision on privatization was made in 1999, it was more

and more obvious that the bank would be unsalable without the rehabilitation of its portfolio. According to Mr. Janáček, in spite of considerable recovery costs the net yield from the ownership and sale of Komerční banka was positive for the government. Contrary to Mr. Kunert, Mr. Janáček believes that from the very beginning it was not possible to privatize 100% of banks by foreign capital. This capital always aimed at precisely selected companies while large banks were not within its focus by the end of the nineties.

Mr. Janáček said that besides undisputable benefits the transformation had its costs and it was logical that a part of them was imposed in the banking sector. Compared to the other post-communist countries these costs were among the lowest.

The last block of the conference – Panel III “Twenty Years of Capital Market in the Czech Republic”, chaired by Petr Musílek – was devoted to the development of the capital market in the Czech Republic. Taking into account its specific features the speakers dealt with legal regulations of its functioning and historical development of legislation in this area in this country. Jan Dědič was the first speaker who recalled the old Roman-law principle: the more corrupt the state, the more laws it needs. Another Roman-law principle is that laws should be simple so that even inexperienced people could remember them. However, today’s tendency towards more detailed regulation is in contradiction with this principle. The original regulation of capital market by the Securities Act having about forty paragraphs was enlarged to more than 200 paragraphs in the current Act on Capital Market Activities. The rules are often changed, and they are very detailed. It holds good that the more detailed the rules, the easier their circumvention. Mr. Dědič is convinced that the Czech Republic would currently need stabilization and transparency of law in the area of capital market.

In Mr. Dědič’s opinion the legal regulation of capital market should be based on fundamental principles to a larger extent. It does not make any sense to define duties that cannot be supervised by the state. The basic assumption of the actual functioning of regulation is that the regulated actors will identify themselves with a regulatory provision and will understand its purpose. An emphasis on the detailed and minute regulation of capital market is typical of continental Europe and logically influences the Czech law. However, we should think over such development and judge whether a further regulation of the rights and duties of actors in capital market does not restrain them to such an extent that could consequently eliminate any capital market completely in the Czech Republic.

A contribution presented by Tomáš Ježek, who mainly spoke about the situation in capital market before the Securities Commission was founded, was very critical. In the beginning, the legislation was indifferent towards the regulation of secondary market, insider trading, self-trading, *etc.* a large number of companies privatized by the voucher method were accepted *ex offio* to the secondary market that had very low liquidity and the quotations of which were easy to manipulate. In addition, the companies did not perform their information duties. In 1997 a delisting of 1,400 companies was done, many of them changed their shares to a physical form, which resulted in non-transparent ownership. Mr. Ježek considers the then Act on Investment Funds from 1992 as heavily defective because it elevated the manager of the fund to the position of its owner. Due to a negligent approach of the Ministry of Finance of the Czech Republic (the then regulator) there emerged up to 500 traders in securities. The stock exchange executive



officers saw that the capital market did not have a future without tough and respected supervision and so the stock exchange itself would not have a chance to exist any longer. The stock exchange executive officers set a paradoxical task – they were interested in the origination of an authority they would themselves be subjected to. But the Ministry of Finance originally opposed the foundation of the Securities Commission, according to Mr. Ježek its top representatives pushed through a false and dangerous theory that the capital market should be left without supervision and regulation at least until the capital concentration was accomplished. Mr. Ježek is convinced that this theory was a result of the so called false liberalism when the government erroneously considered the resultant capital concentration as a higher value than the voluntariness of property transfer is. After the Securities Commission started to work, relicensing of traders in securities was gradually performed, information duty was done better and share funds were opened.

In conclusion, Tomáš Ježek stated that the use of capital market on a large scale could not be a result of nothing smaller than profound and gradual changes in the nation's financial culture.

The tone of Petr Koblic's contribution was also critical as he considered the absence of domestic investors as a crucial problem of the Czech stock exchange. It culminated at the turn of 2000 and 2001 and according to Mr. Koblic it resulted from the absolute disillusion of domestic investors from developments in the second half of the nineties. Out of the initial almost 6 million potential investors – “*voucher shareholders*” – by 2001 there remained hardly two thousand small investors who regularly traded. The share of domestic institutional investors also developed in a nonstandard way – their share is currently only about 5%, which is unfortunately a very low percentage in regional comparison.

At the present time, small domestic investors return to the market and account for up to 20% of the volume of dealings. Mr. Koblic ascribes this new trend to statutory compulsory repurchase, relicensing of funds and traders in securities, improved supervision, *etc.* According to stock exchange estimations the number of small investors has increased 30 times in the last eight years but it is still incomparably smaller than in Austria and economies of comparable size.

Mr. Koblic stated that he did not fear about the capital market development in the Czech Republic very much but there are many areas where improvements could be made. *E.g.* the fact that all issues of IPO are organized by the artificially founded mother in the Netherlands or Luxembourg proves that all issuers want to avoid Czech justice, administrative bodies, Czech law, which is not surely a satisfactory situation.

The last speaker in this block and at the conference was Dušan Tříška, whose speech largely opposed especially Tomáš Ježek's opinions. Mr. Tříška considers the Securities Commission as a principal enemy and today's legislation in the area of capital market as so to say worse than in the beginnings of transformation. Mr. Tříška is an advocate of voucher privatization, not only of its beginnings but also of all subsequent action. In his contribution he dealt in greater detail with the problem of investment privatization funds. He recalled the absolutely fascinating rate (from the current aspect) of adopted changes: *e.g.* only 107 days elapsed between the publication of the “Procedure for the Foundation of Investment Privatization Funds” and the deadline of the acceptance of applications for the foundation of investment privatization funds. However, Mr. Tříška's

attitude to the institute of investment privatization funds was critical, besides other things, because there does not exist a way of guaranteeing the credibility of investment privatization funds. According to Mr. Tríska, the concentration of property rights should not have been realized *a priori* within the investment privatization funds but *ex post*, i.e. in the secondary share market. But it was clear already in autumn 1990 that for political reasons some intermediaries had to be included in the voucher privatization scheme. The role of investment privatization funds was further complicated by the fact that the EU experts showed the inability to distinguish the standard institutions of collective investment from privatization funds that were intended to have quite a different function (corporate governance in a privatized company). The result was quite an erroneous restriction of the percentage share the privatization funds could hold in one privatized company. The economic community's opinions could however be heard only when they did not collide with the political agreement. According to Mr. Tríska it could happen that some rational opinions had to be sacrificed in favour of progress. Mr. Tríska also recalled that thanks to voucher privatization it was possible to explain the most important institutions of market economy to the population at large.

In general, the conference showed that the short history of economic reforms, reforms of the banking system and financial markets in the Czech Republic was very rich in events the interpretation of which has become the object of many debates and disputes until now. These debates, different opinions or even disputes are very interesting not only from historical aspects but also from the aspect of future development. Nowadays it is not clear in what direction the capital market regulation will or should proceed nor is the method and mode of bank regulation evident. Finally, apparently historical considerations about the opportune timing of abandonment of the fixed exchange rate or about the short existence of the Czech-Slovak monetary union are very instructive for current practical economic policy and for the future of Czech economy as a whole.