The Financial Crisis:
Impacts on the Czech Economy and Lessons for Supervisors

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Overview

- Simplified anatomy of the crisis
- The crisis and the Czech economy
- Lessons for supervisors

Simplified anatomy of the crisis

Government and CB measures to support **financial sector** (September/October 2008)

Govt and CB measures to support **domestic demand** (November 2008 onwards)

2007

Mortgage crisis

Summer 2008

Banking crisis

Autumn 2008

Real economy crisis

Second-round impacts on banking sector from real economy

Further waves of measures to support financial sector due to unfavourable developments in real economy (December 2008 onwards)

Negative feedback from the real economy will be critical!

The crisis and the Czech economy

Specific features of the Czech financial system

- System based on excess liquidity (CNB withdraws liquidity from the market)
- Favourable profit and growth opportunities in traditional banking
- Support for competition in banking, but avoidance of excessive regulation of revenue streams among other things
- Long-run appreciation of currency + low nominal interest rates + currency risk ⇨ very low foreign borrowing by government and households (+ less attractive investment in foreign assets)
- Fiscal prudence

Specific features of the Czech financial system – cont.

- Rapid and balanced real convergence
- Since 1993 independent central bank (defined by Constitution); independence tested by Constitutional Court
- Conservative monetary policy (inflation targeting framework) ⇨ low inflation over long run
- Integration of supervision in 2005 and functional re-organisation (consolidated supervision of all segments of financial system since 2006)

Czech situation is rather different from that in developed markets

Implications

- Balanced financial system financed by deposits rather than by foreign funds
- Sound non-financial sector and households (in total, financial assets and liabilities, indebtedness, etc.)
- Highly profitable banking
- Negligible share of toxic assets in domestic financial system (less than 1% of total assets)
- High ability for rapid supervisory action (tested in practice and by Société Générale hiccup)

Financial system in Czech Republic is less vulnerable than its counterparts abroad

Propagation of the crisis

- Different channels related to financial system:
  - Stock market (limited importance)
  - Money market (with a delay)
  - Money market and government bonds illiquid (CNB measures → bond market gradually starting to work again)
  - Other sectors dependent on government bonds (pension funds, money and bond funds, insurance companies) under pressure from bond portfolios (solvable partly by HTM)
  - CNB does not accept collateral other than government bonds and T-bills (but is ready to help on individual basis in case of need) ⇨ still some manoeuvring space

Overall direct contagion within financial system has been rather limited

Propagation of the crisis – cont.

- Through real economy
  - Exports (very high export intensity of GDP)
  - Automotive industry (share of automotive and electronics and optical production in manufacturing is almost 40%)
  - Increased saving (quite conservative habits)
  - Helpful: drop in food, fuel and commodity prices
- February 2009 CNB forecast:
  - GDP: -0.3% in 2009; 0.9% in 2010
  - Headline inflation: 0.9% in 2009Q4, 2.1% in 2010Q2

Still waiting for full propagation – risks are clearly on downside!

Lessons for supervisors

Roles of main institutions

	Ministry of Finance (taxpayer)	Supervision
Prevention	small (mainly legislation)	yes
Identification of problems/institutions	no	yes
Solving of crisis situation	yes (sizeable costs)	yes (small costs)
Drawing conclusions	yes	yes

Resolving crises similar in size to current one requires cooperation between finance ministers, i.e. representatives of treasuries/taxpayers, rather than supervisors!

Difference between financial supervision and control room of nuclear power plant

- No screens or ability to stop transactions with push of red button!
- No possibility of watching transactions in real time
- Information has been available for analysis (often even from public sources; CDOs)

Unfortunately, the perception of the public and even some major decision-makers suffers from confusion between control room and financial sector supervision

What would deeper international integration of supervisory information have achieved?

- CDOs – nothing; US issue, but at least one big national regulator in EU prevented (Spain)
- Northern Rock – nothing (British domestic case)
- Denmark – nothing (again, domestic case, real sector bubble)
- Iceland – could have prevented excessive expansion of banking sector
- Société Générale – nothing (rogue trader)
- US investment banks (domestic issue of overleveraging)
- AIG (domestic issue – several supervisors for one industry!)
- Hungary, Baltic countries, foreign currency borrowing in Eastern Europe – sooner risk recognition by **home** supervisors would have helped

Coordinated failure was "achieved" not by supervisors, but by major monetary authorities allowing too lax conditions for several years

What can an integrated supervisor do in one day? Measures adopted in the Czech Republic

- Collection of information daily (implemented one day after decision)
    - Cash requirements (1 and 2 days ahead)
    - Money market and government bond market (real time)
    - Financial institutions (banks and other important players) in addition (one day delay): next slide

What can an integrated supervisor do in one day? Measures adopted in the Czech Republic – *cont.*

  - Liquidity
  - Exposure within group
  - Deposits
  - Limits
  - Withdrawals from money market funds
  - Credit provided by 6 major banks (from December)
- Ad hoc info on toxic exposures (after CDOs, Iceland, Lehman, etc.) collected from all parts of financial groups (e.g. banks, insurance companies, investment funds, pension funds) at same time on same day
- Talks between Governor and Vice-Governor and banking association

What can an integrated supervisor do in one day? Measures adopted in the Czech Republic – cont.

- In fact, CNB supervision may currently rather resemble control room of nuclear power plant (but still no screens or red buttons)
- Financial groups very much appreciate having just one partner during crisis

Consolidation enables fast action and comprehensive information gathering and evaluation, and engenders higher respect for supervisor in financial community

Our lessons

- Efficiency of consolidated supervision at country level
  - Ideally within strong independent central bank (information on cash and money market + integrity)
  - Before any concentration of supervision on European level, consolidation and integration of supervisory bodies in individual countries must occur (otherwise European supervisor will coordinate different numbers of institutions in different countries)

Ability to finance damage due to regulatory failure must be driving principle of allocation of responsibilities. Imagine Iceland as home supervisor with higher powers!

Our lessons – cont.

- Consolidation of supervision on national level: 3–5 years of (hard) work
- Consolidation on international level should give scope for diversity of regulatory opinions within same set of principles even on significant issues (i.e. CDO permission)

Balance between competencies, rights, responsibilities and ability to pay in case of failure matters!

Our lessons – *cont.*

- Transfer of competence would not have solved majority of cases; would even have worsened situation in Spanish banking (and in Czech Republic, among others)
- Independence of subsidiaries saved their value in the event of problems in financial groups (Komerční banka – SG; AIG CR)
- Existence of own currency complicates withdrawal of money from subsidiaries to parents

What we do recommend – Step up work, or start now!

- Progress in lightening the load on industry
  - Elimination of national discretion
  - Reporting
  - Ratings, incentives – more detailed consideration needed (bank employees are better paid than people in rating agencies – the former should be more aware of what they do)
- Consolidation of supervision on national level

We should focus on practical, clearly helpful and achievable goals

There might be different opinions on:

- International financial architecture
- Right of international financial group (industry) to shape debate on regulatory and supervision institutions after crisis
- Proper regulatory burden
- Home/host issues
- etc.

But, integration on national level would:

- enhance information to be integrated internationally
- relax the regulatory burden on the industry (in Europe at least halving the number of supervisors to deal with)
- be a necessary step for efficient integration of supervision
- enhance the status of supervisors

Thank you

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