

# *Avoiding the Eye of the Storm: The Experience of the Czech Republic*

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## *Global causes of crisis*

- Credit was provided on basis of resale (after repackaging) rather than on ability to repay
- Massive scale of “bad loans” was enabled by excess cheap liquidity due to major monetary policy mistakes
- Major developed countries’ supervisors and regulators failed to respond

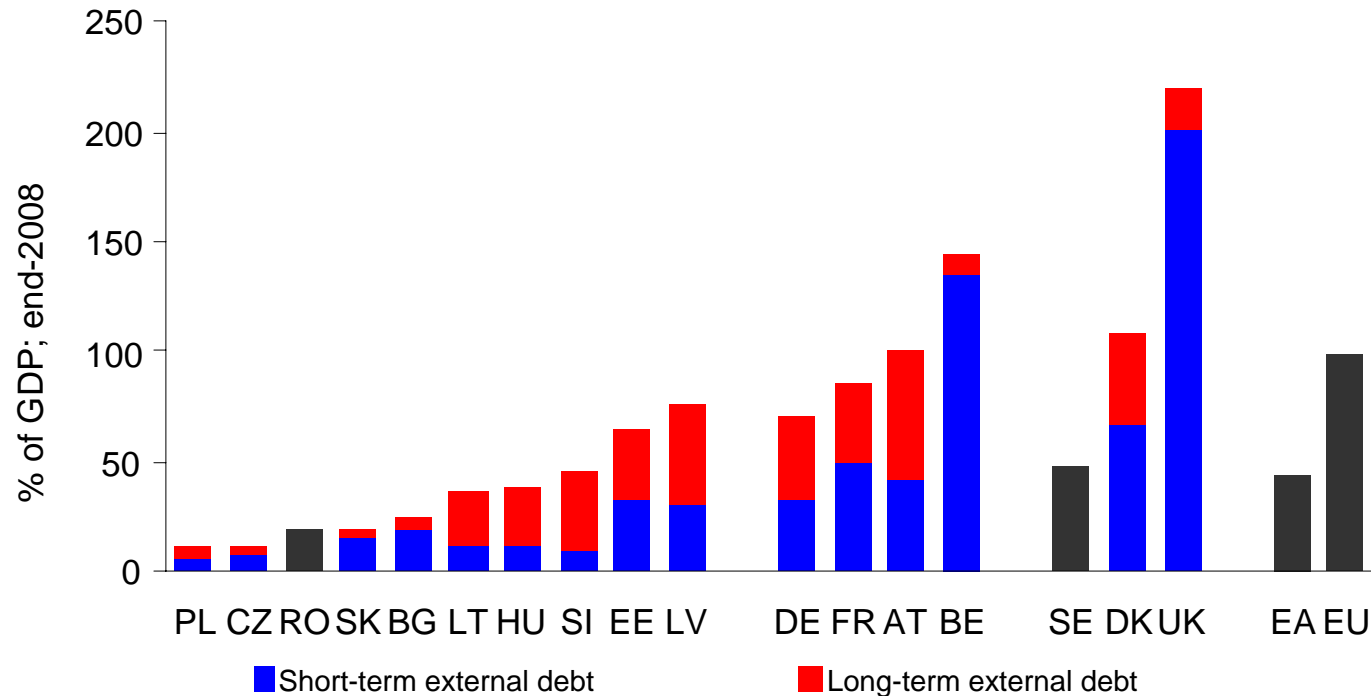
The financial crisis was caused to an overwhelming extent by policy failures in developed countries.

## *Causes of crises in Europe*

- Except for forex lending in some CEECs, home-host issues played no role in crisis in European financial institutions.
- In the case of forex lending problems, host supervisors were limited by lack of power w.r.t. branches.
- During crisis no problem was caused by ring-fencing (no trapped liquidity etc.); some subsidiaries were not harmed thanks to being perceived as independent.
- Pro-cyclical elements of regulatory framework might have contributed to crisis. The changes resulted - among other factors - from success of financial industry lobbies in European regulation nexuses (Brussels and Basel) during upward phase of cycle.

Failure of some European supervisors to act was due to mix of fragmentation of institutions in national context, lack of independence, and capture by national financial groups .

# Despite all recent headlines, CEE banking sectors had no excessive foreign debt

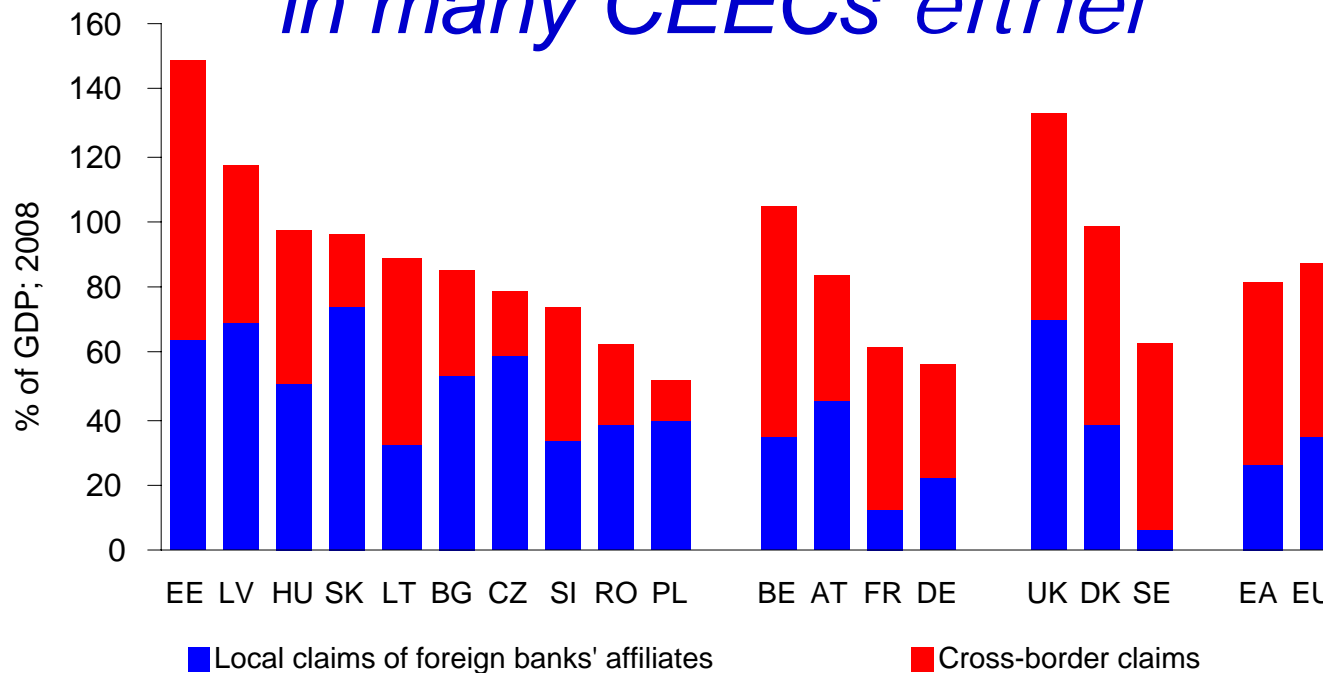


Source: BIS, IMF

Note: Maturity distributions were not available for some EU countries; EU is the weighted average for the EU countries, with shares in GDP used as the weights.

Even “worst” CEE banking sectors had relatively low foreign debts.

## *External liabilities are not that high in many CEECs either*

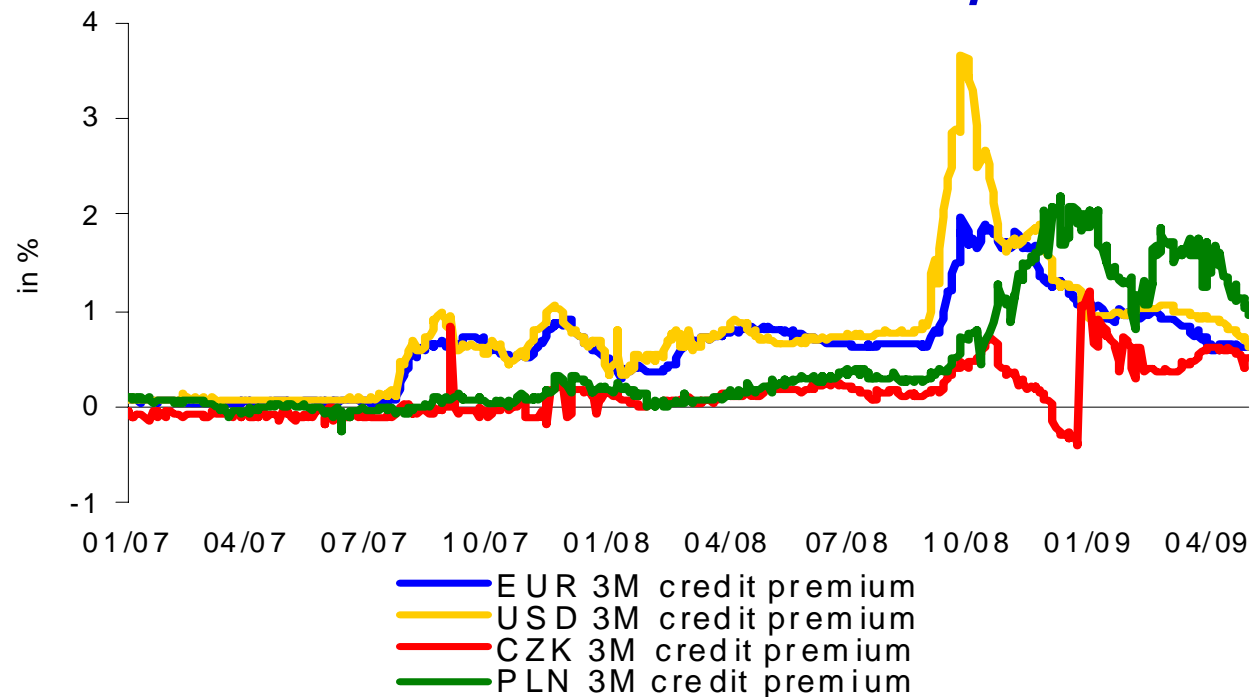


Source: BIS, IMF, Eurostat, CNB calculation

Note: Calculation based on BIS data using both available methods. The data for the EU and euro area (EA) are not consolidated.

Mistreatment and misinterpretation of statistical data by financial institutions as well as IMF contributed to sense of urgency (and cost us some money on debt financing).

*Still, in many respects some CEECs suffered less than developed markets*



Source: Bloomberg, Reuters, CNB calculation

Note: The credit premium is calculated as the difference between the 3M interbank rate and the 3M OIS of the relevant currency.

Polish credit premium hovered around that of EU and US, while Czech one was similar or lower.

## *Czech financial (banking) sector*

- Has excess liquidity (CNB withdraws money), deposits represent over 120% of loans
- “Self-contained” (provides loans from primary deposits)
- Has traditional conservative model (sufficient growth opportunities)
- Has low NPL ratio
- No household and only 1/5 of total corporate loans are forex loans
- Negligible ratio of “toxic” assets (< 1% of assets)
- Well capitalized and remains profitable
- W.r.t. external position, Czech financial (banking) system is net creditor.

**Czech financial system has been less vulnerable than elsewhere from beginning of crisis**

## *Czech financial system - Effects of crisis*

- Rate of credit growth declined from well over 20% to 5-10% p.a. and significantly tightened non-interest conditions in some segments of credit market (notably development projects). Demand for loans also declined.
- Loan interest rates are mostly flat or modestly decreasing – CNB's rate cuts have been offset by growing bank risk margins.
- Stock market, pension and investment funds suffered most, but correspondingly less than in many developed countries.
- Gradual rise in default rate on bank loans and other debt can be expected due to dramatic fall in external demand. Still, stress tests suggest that financial sector should remain stable (recapitalization needs up to 1% of GDP) even in most dramatic scenarios.

**Czech financial system remains stable and public confidence in banking institutions persists**

## *Policy responses – monetary and measures to support liquidity*

- Key monetary policy rate cut several times: by 0.75 p.p. on Nov. 7, 2008; by 0.50 p.p. on Dec. 18, 2008; by 0.50 p.p. on Feb. 6, 2009; and by 0.25 p.p. on May 11, 2009, to current level of 1.50%.
- Introduction of liquidity-providing facility (banks can obtain liquidity from CNB for 2 weeks or 3 months)
- Option of using government bonds as collateral in such operations in order to increase liquidity
- Introduction of HTM for insurers and pension funds

All these measures have helped improve functioning of markets and boost market confidence. Still, new facilities have been mostly unused in recent months. Only Czech state debt is being accepted as collateral.

## *Policy responses in supervision and regulation*

- Daily or weekly info (introduced 1 day after decision): cash requirements (1 and 2 days ahead), money market and govt bond market (in real time), from financial institutions (banks and other key players) with 1-day lag: 1) liquidity, 2) intra-group exposures, 3) deposits, 4) limits, 5) withdrawals from money market funds.
- Ad hoc gathering of information on toxic asset holdings (after CDOs, Iceland, Lehman Brothers collapse, etc.); information from all parts of financial groups (i.e. banks, insurers, investment funds, pension funds) at same time.
- Consultations between Governor and Vice-Governor and Banking Association (weekly or fortnightly) at beginning.
- Increased deposit insurance but no universal guarantees or assurances provided.

## *Lessons – 5 principles*

1. Before crisis, regulation (allowing for profitability of traditional banking) and macro policies matter more than supervision.
2. World and financial sector are fundamentally uncertain. Supervisors will not always be right. Diversification of national policies (keeping common principles) and preservation of some barriers to prevent direct spread of losses (i.e. via domicile) must not be precluded.
3. Right to supervise and regulate must be complemented with resources to cover damage caused by failures.
4. Industry is not best taxpayer advisor and its cost saving motivation for consolidated supervision need not be highest priority for policymakers.
5. Crisis wasn't caused by failure of rules. Also, one shouldn't design new fire station when fire is still raging.

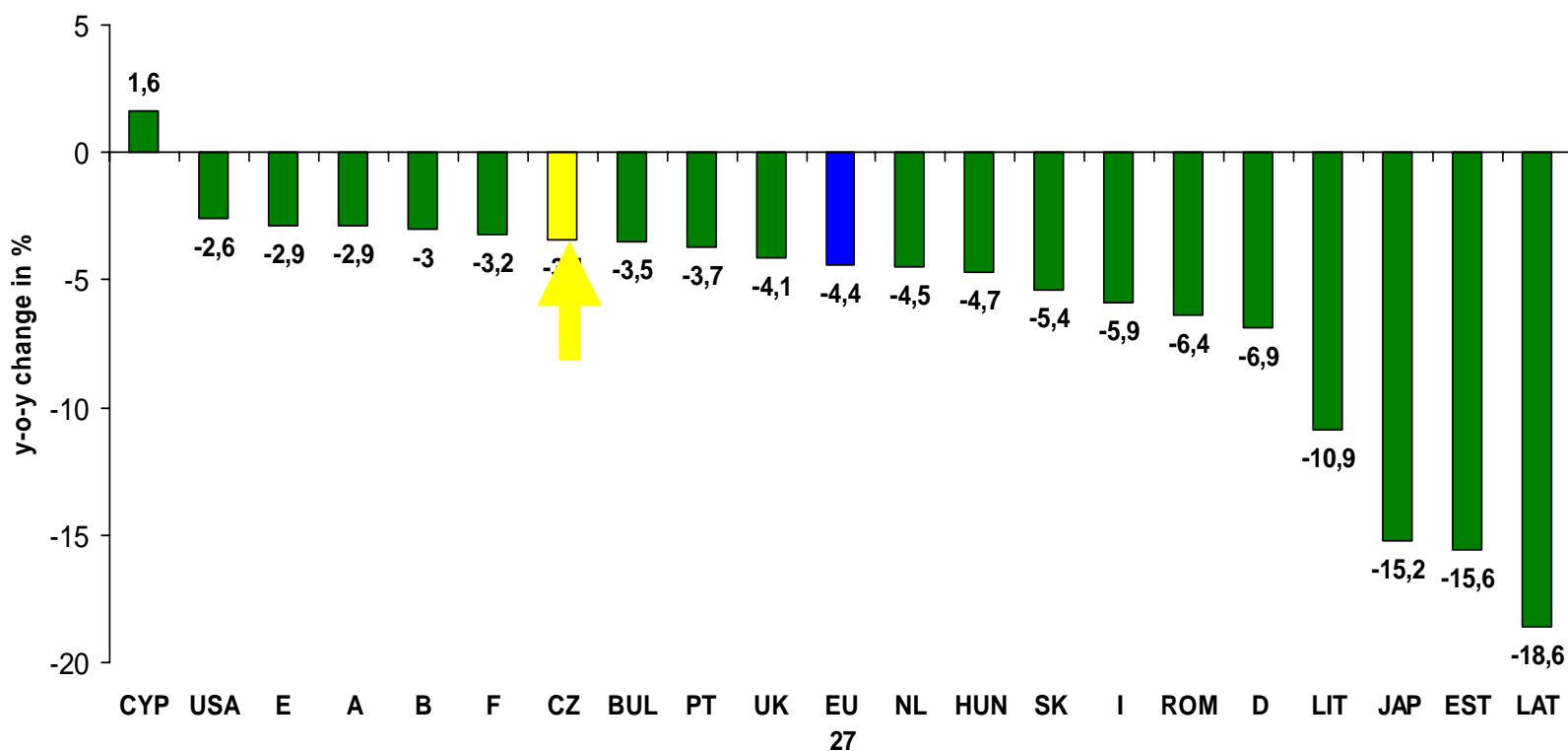
Our experience suggests that supervision integrated within central bank works quite well.

## *Lessons – European situation*

- Many countries have been pre-occupied by their current problems, preventing them from paying closer attention to proposed reshaping of framework.
- Changes (under notion of de Larosière report) pushed ahead at breathtaking pace. Current implementation paper proposed by EC would mean shift of rights to home policy institution despite explicitly opposite conclusion of report.
- Industry lobby still powerful enough.
- Move of powers at EC level to new institution(s) with culture inherited from ones that have failed in recent past is threat.
- No integration at national level considered by European institutions (almost 80 supervising in EU institutions are to stay).

Motivation to act fast no matter what the result is, and also attempts to use the crisis to promote further centralization at agencies with no financial resources (budgets) to cover losses caused by their possible failures, are clearly not helping.

*Still, we are doing relatively well as signaled by below-average drop in 1Q09 GDP...*



**...and happy ending is never bad thing!**

*Thank you*



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