Czech National Bank

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FOREWORD

The Czech Republic and its institutions, including the Czech National Bank, are celebrating their tenth anniversary in 2003. Ten years have also passed since the Czech currency was introduced. This provides us with a good opportunity to take stock of what has happened in this time and of where we are now. This publication is aimed at anyone who is interested in banking and the currency and is intended to provide an overall picture of the central bank's own short history.

WHAT CAME BEFORE...

The November 1989 revolution and the social changes that followed brought about a search for parallels with the ideas and practical systems applied in the former democratic Czechoslovakia. As far as the economy was concerned, however, it was clear that the manner and objective of the transformation had been preordained by the almost 50-year period of totalitarian rule and the situation in the more advanced neighbouring world, rather than by the legacy of a bygone era when Czechoslovakia had been a democratic legal state with a market economy.

This is not to underestimate the eminent economists of the inter-war **First Republic**, who made the Czechoslovak koruna one of the strongest currencies in the world. Thanks in particular to the foresight of the first Minister of Finance, Alois Rašín and the successful reforms he engineered, Czechoslovakia successfully avoided the wave of hyperinflation that struck Germany, Austria, Hungary and other countries after the First World War. Monetary policy had other leading lights – for instance the governors of the National Bank of Czechoslovakia Vilém Pospíšil and Karel Engliš. And it is the legacy of these figures, that is, the legacy of non-inflationary and prudent policy, that inspires the CNB to this day.

Sadly, these traditions were not resumed after the Second World War. After 1948, the banking sector – just like the entire system of economic management – was subordinate to central planning and command management by the political centre. 1950 saw the establishment of the State Bank of Czechoslovakia (SBCS), which was given a monopoly on central and commercial banking. The public's savings deposits were administered by Česká spořitelna and Slovenská spořitelna (the state-owned Czech and Slovak savings banks).

*This bringing together of commercial banking activities and the central bank's monopoly under one roof, i.e. in the State Bank of Czechoslovakia, came under criticism in the dying days of Communism, when an economic reform programme was prepared and slowly implemented. This period saw the drafting of the State Bank of Czechoslovakia Act and Banking Act, both of which took effect on **1 January 1990**. These constituted a key step in splitting the functions of central and commercial banking; otherwise, though, they were very much a product of their time, reflecting the endeavour to reform a communist economy. The task of approving the* *principles of banking and monetary policy fell to the government. Typical of the time was a provision that banks were obliged to issue a loan provided that it arose out of "the binding outputs of the state plan". In 1990, the commercial activities of the former "monobank" were transferred to the newly established Komerční banka (on Czech territory) and Všeobecná úvěrová banka (in Slovakia). The law permitted new banks to be founded without providing for adequate conditions governing their establishment and subsequent activities. State supervision of banks was made the responsibility of the Czech and Slovak ministries of finance.*

The central monetary institution set up in the Czech Republic in 1993 was not an entirely new phenomenon. Indeed, its legal status, primary tasks, modus operandi and organisational structure were all based on those of the State Bank of Czechoslovakia in the former federation. And the SBCS in turn had been strongly shaped by the main changes ongoing in society, the economy and, within it, banking in the preceding three years since the "Velvet Revolution" in late 1989.

The three-year existence of the **Czech and Slovak Federal Republic (CSFR)** was, in the economic area, marked by two key factors:

a) the beginnings of the implementation of **structural changes** in the economy, changes necessitated by the profound change in its engagement with the international environment. In just a short space of time, its geographical orientation swung drastically away from the states of the former COMECON, which had accounted for three-quarters of Czechoslovak foreign trade, and towards the advanced Western nations. This caused problems for many companies and led to an economic downturn: gross domestic product was around 13% lower in 1992 than it had been in 1989;
b) the implementation of **economic reforms**, involving rapid liberalisation of prices and foreign trade, extensive privatisation, and stringent policies to ensure macroeconomic stabilisation while maintaining an essential social safety net.

Of huge importance to future monetary policy, and economic policy as a whole, was the setting of the **exchange rate regime** and initial exchange rate of the Czech koruna. The system of many different rates for the former Czechoslovak koruna was incompatible with the needs of the economic transformation. It would be impossible to liberalise foreign trade or prices without abandoning this administratively and subjectively created system.

The monetary authorities of the states tackling the issue of transition to a market economy were faced with two problems: 1) choosing between a fixed exchange rate and a floating exchange rate, and 2) if they chose a fixed exchange rate, deciding on the initial rate. The CSFR opted for a fixed rate within a horizontal band, whereas in their transformation processes Hungary and Poland for the most part applied a "crawling peg", where the exchange rate of the domestic currency was periodically depreciated at a predetermined rate. The main arguments for choosing a fixed rate were as follows:

- *a fixed rate functions as a nominal anchor for internal macroeconomic variables such as prices, wages and budgets;*
- *a fixed rate imports price stability from abroad;*

- *a fixed rate stabilises inflation expectations and makes economic calculations easier to perform.*

After three devaluations in 1990, the exchange rate was fixed at 28 korunas to the dollar. This level allowed the initial nominal exchange rate to be maintained for several years with no major problems. It also bolstered the competitiveness of the Czechoslovak economy (in 1992 alone, for example, exports to the countries of the European Community rose by 36% on the previous year) and provided domestic companies with temporary protection for implementing structural changes (this protection was reinforced at the start of the reform with an import surcharge).

These factors had a strong bearing on economic performance and, within that, on banking and the currency:

- the sudden liberalisation of prices led to high annual consumer price inflation in 1991 (of 57%). The speed and comprehensiveness of the reforms, however, subsequently stabilised inflation at a much lower level;
- relative to other European transforming economies, the Czech Republic was in better macroeconomic shape;

Results of several economies (for 1992)

	Annual GDP change	Inflation rate	Unemployment rate
Czech Republic	- 0.5	11.1	2.6
Slovakia	- 6.5	10.0	4.8
Hungary	- 3.1	23.0	12.3
Poland	+ 2.6	43.0	13.6
Slovenia	- 5.5	207.3	11.5

- with its stabilisation policy (caps on lending, a relatively high discount rate and a high required reserves ratio) the SBCS prevented the onset of an inflationary spiral;
- the liberalisation of foreign trade also necessitated some liberalisation measures in the forex area. “Internal convertibility” of the koruna was introduced, giving businesses virtually free access to foreign exchange for current account payments;
- the rapid and extensive privatisation programme spawned dozens of new businesses and related demand for banking services. At the start of 1990 there had been six banks operating in the CSFR, whereas by the end of the following year there were 38. The capital market was virtually non-existent, so bank loans were the sole way of financing the transformation and privatisation of the economy. However, banks lacked the necessary information and experience when it came to assessing the soundness of new businesses;
- the banking sector assumed many doubtful claims on domestic and foreign entities. For this reason **Consolidation Programme 1** was launched in 1992 in order to clear such debts from the portfolios of the existing banks and move

them into the public-sector Konsolidační banka ("Consolidation Bank", a vehicle founded originally to assume and deal with the debts inherited from the communist era). The losses – i.e. the net costs of this programme – totalled some CZK 100 billion.

An important moment was the renewal of **Czechoslovakia's membership** of both the **International Monetary Fund** and the **World Bank**. Following the signing of the relevant treaties in September 1990, discussions were opened on a programme of financial aid. The negotiations proceeded quickly and the subsequent loans enabled the economic reforms to proceed more smoothly. The terms under which the aid was granted bolstered the CSFR's credibility and in turn generated better access to the financial markets. The IMF played a major role in providing technical assistance to the SBCS and, later on, the CNB by helping to train staff and draft new laws and other regulations.

Hand in hand with the implementation of the economic reform scenario, new banking legislation was prepared in 1990 and 1991. Two **new laws** – the SBCS Act (No. 22/1992 Coll.) and the Act on Banks (No. 21/1992 Coll.) – took effect on **1 February 1992**. Experts from the IMF and other financial institutions and central banks assisted in drafting these laws. This meant the creation of modern legislation whose principles could be assumed without problem by the CSFR's successor states.

The start of the economic transformation necessitated the retaining of several regulatory powers at that time which would later be gradually phased out. These provided an insurance policy against possible unforeseen monetary excesses. For instance, the SBCS had the right to impose caps on lending by banks and to stipulate minimum interest rates on deposits and maximum rates on loans. Under a special law (No. 528/1990 Coll.), forex operations with natural persons and capital (financial) account operations remained strictly regulated. This protection of the balance of payments was bolstered by the introduction of a temporary import surcharge, which, however, had inflationary effects.

Thus far we have been discussing the ***breakneck development of the banking sector at the start of the transformation process****. As mentioned earlier, a large number of new banks were established under legislation drafted in the period of "perestroika". The 1992 Act on Banks may have provided for the principles of operation of commercial banks (including requirements for capital, liquidity, loan diversification and suchlike), but what was needed now was an authority to ensure that the banks were abiding by these principles. A banking supervision department was set up at the SBCS on 1 July 1991, at a time when 25 new banking licences had already been issued. Banking licences were issued subject to the agreement (later on the opinion) of the Ministry of Finance.*

The pressure to issue licences was justified by a need to provide competition to the large banks majority-owned by the state. It should also be borne in mind that the shift away from central planning was accompanied by considerable social and political aversion to any kind of regulatory measures placing excessive restrictions on private market enterprise. The largest commercial banks continued to provide inadequately secured loans to the enterprise sector, and this in a situation where many companies were already suffering the consequences of the collapse of traditional Eastern markets. As is well known, widely promoted privatisation loans also fostered growth in bad debts and contributed to the subsequent problems of the banking sector.

The purpose of this introductory section has been to show that while the CNB and the banking sector as a whole were able to build on the positive results achieved at the start of the economic reform process, they also took on a considerable burden of open and hidden debts whose seriousness only came to light later on in the transformation process. In several cases the banks took on costs which by nature belonged in the public sector – for example support for continued production and employment in inefficient businesses.

1993: THE ESTABLISHMENT OF THE CZECH REPUBLIC, THE CZECH NATIONAL BANK AND THE NEW CURRENCY

Constitutional Act No. 542/1992 Coll., on the Dissolution of the Czech and Slovak Federal Republic, defined 1 January 1993 as the date of dissolution of the Federation and all its institutions. Accordingly, on this date the State Bank of Czechoslovakia ceased to exist and the Czech National Bank (CNB) became the central bank of the Czech Republic.

The constitution of the new state, the Czech Republic, passed on 16 December 1992 with effect from 1 January of the following year, emphasised the special status of the central bank by devoting a separate section to it – Title 6. This stated:

(1) The Czech National Bank shall be the central bank of the state. Its primary objective shall be to maintain currency stability; interventions into its activities may only be made pursuant to the law.
(2) Its status, powers and other details shall be provided for in law.

The **Act on the Czech National Bank** (No. 6/1993 Coll.) was passed by the Czech National Council one day later. As mentioned earlier, the Act was based on the previous Act on the State Bank of Czechoslovakia, as well as on similar legislation in other countries. On 1 January 1993, the CNB assumed the relevant rights and duties of the former SBCS. Owing to the dissolution of the Federation, the bank's organisational structure was rationalised, with the Principal Offices for the Czech Republic and the Slovak Republic being closed down and their powers abolished. The former President of the SBCS, Josef Tošovský, was appointed Governor.

In accordance with the Constitution, the Act restated that the CNB's primary objective was to maintain the **stability of the Czech currency**. To this end the CNB was tasked with:

- setting monetary policy;
- issuing banknotes and coins;
- managing the circulation of currency, administering payments and clearing between banks, and promoting smooth and efficient operation thereof;
- supervising banking activities and seeing to the sound operation and purposeful development of the banking system in the Czech Republic;
- carrying on other activities pursuant to this Act and pursuant to special legislative acts (namely, the Act on Banks and the Foreign Exchange Act).

Article 9 of the Act stated that when pursuing its primary objective the CNB should be independent of any instruction given by the Government.

The aforementioned principles and wording of the Act remained almost unchanged for several years thereafter, in contrast to the often hasty revisions made to laws governing other areas of the economy. A minor change was made in 2001–2002 in connection with work to finalise the harmonisation of Czech law with European legislation.

Early 1993 was a transitory episode in the development of banking. On 1 January, a ***Treaty on the Monetary Arrangement between the Czech Republic and Slovakia*** *entered into force. This was based on the existence of a common currency (the Czechoslovak koruna). To manage this currency, a "Monetary Committee" was set up, on which the two successor central banks were represented with an equal number of members. This body in fact assumed the primary functions of the central banks, since it made decisions on the money supply, on the volume of trading executed by the national central banks, on the liquidity and capital rules for banks, on fundamental issues of money circulation and payments and on foreign exchange reserves management, and declared the exchange rate of the koruna. The motive for establishing this arrangement was to avoid complicating the already difficult process of splitting the Federation with monetary issues.*

The chief problem with the Monetary Committee was that it had a mechanism that prevented the majority view from being adopted. This paralysed the Committee's decision-making whenever the members had differences of opinion. To those in the know it was plain that this state of affairs was untenable, so as early as the end of 1992 preparatory work started on separating the currency. The new Act on Banks indeed counted on the existence of a separate currency.

On 2 February, thanks to rapid preparatory work, the Czech National Bank was able to pass a **Currency Separation Act** with effect from 8 February 1993. The preparations at the same time undermined the confidence of foreign investors, who withdrew their investments from the successor states, and led to an alarming fall in foreign exchange reserves to just a few hundred million dollars. This brought the Czech Republic and Slovakia to the verge of a payment crisis, but thankfully the public remained unaware of this fact.

Some parameters of the currency separation

Cash changeover period	4 days
No. of federal banknotes withdrawn (incl. stamped notes)	495 million
No. of coins withdrawn (out of the total of 3.2 billion)	761 million
No. of imported stamps	160 million
Limit on cash exchanged per person	CZK 4,000

The currency separation involved stamping higher-denomination (100 koruna and above) federal banknotes, leaving smaller notes and coins unchanged in circulation, recording currency exchange transactions on identity cards, and issuing stamped notes only to legal entities. The success of the changeover was due not only to good organisation, but also to the disciplined approach of the public, who deposited their excess cash temporarily at banks. People could exchange cash at branches of Česká spořitelna and Česká pošta (the Czech Post Office). Notes were stamped by the staff of Komerční banka and companies were then served at branches of Komerční banka and the CNB.

The introduction of the new Czech currency went surprisingly well. According to a later poll, 86% of those surveyed were impressed by the success of the separation. The lower house of the Czech Parliament went so far as to praise to the CNB for the “impeccable course” of the operation. The Czech currency-separation scenario became part of a set of IMF recommendations. Significantly for the CNB as a new institution, the project won it considerable **credibility in the eyes of the public**. The only serious unresolved monetary issue was a CNB receivable of CZK 26 billion against the National Bank of Slovakia arising from the division of the former SBCS’s balance sheet and the splitting of federal cash. As a partial guarantee against this debt (which had been recognised by the auditors), an amount of Slovak monetary gold was held temporarily in the Czech Republic. Following the signing of an intergovernmental treaty, the receivable was transferred to the Government for the symbolic sum of 1 koruna and 4.1 tonnes of gold were transferred to Slovakia. In this way the CNB – with no regard for its own considerable loss – contributed to the political consolidation of relations between the two successor states of the former federation.

In many areas, efforts were made to nurture a **special relationship** between the Czech Republic and Slovakia, a relationship respecting the traditionally close ties between their two economies. This included maintaining the customs union between the two countries. A special clearing system was set up to settle mutual payments. This enabled such payments to be settled in domestic currencies, i.e. without the need to use foreign exchange reserves. The conversion rates between the Czech and Slovak currencies were derived from their exchange rates against convertible currencies. Limits were placed on excesses of imports over exports, with amounts over the limit having to be settled in foreign exchange. The clearing system became a key means of promoting Czech-Slovak trade in the initial years following the partitioning of the Federation.

The economic situation in the Czech Republic in 1993 was affected by numerous factors. Gross domestic product stayed virtually flat at the previous year's level, so there was no repeat of the earlier sharp decline. This decline had been the fate of all the transforming economies as the price of their previous isolation from the advanced world and a lack of funds to implement structural reforms.

The GDP decline in transforming economies

	per cent of GDP 1993/1989
Czech Republic	87.0
Slovakia	74.9
Hungary	73.3
Poland	87.5
Romania	76.1
Slovenia	84.3

Following the rapid and extensive liberalisation of prices (1991), the Czech economy underwent one more major inflationary impulse in 1993. This was linked with the introduction of a VAT system in which the basic rate (23%) was set quite high above the norm in the EU at that time. Without this extraordinary effect, inflation would have been roughly half the level actually recorded.

The CNB's monetary policy strategy rested on two pillars. The first was a fixed **exchange rate of the koruna** against a basket of major currencies; between 1991 and the spring of 1996, the rate moved within a narrow band of ± 0.5%. The original currency basket (consisting of five currencies) was later reduced to the German mark and the US dollar, with the mark having the larger share. This adequately reflected the structure of Czech foreign economic relations. To begin with, there were no problems with maintaining the fixed exchange rate, thanks to the fact that international capital movements – which exploit interest rate differentials – had not been liberalised. Another reason was that the devaluation undertaken at the start of the economic reform had created a sufficiently soft environment for Czech companies to adjust and be competitive. The exchange rate was able to fulfil the role of a nominal transformation anchor, and the CNB was thus easily able to meet its commitments arising out of the fixed nature of the rate. In the early transformation years there were no appreciation or depreciation pressures. The balance of payments was balanced, and monetary policy could be oriented towards the money supply.

The second pillar of monetary policy strategy was indeed the targeting of an appropriate **money supply**. This strategy was based on the practice in the German Bundesbank, then undoubtedly the most highly respected central monetary institution. The strategy assumed that the stock of money in the economy is a reliable inflation signal which the central bank can respond to in advance with policy measures. The monetary aggregate M2 – comprising currency in circulation, sight deposits, time deposits and foreign currency deposits – was chosen as the criterion. The appropriateness of the M2 trend was assessed using predictions for inflation, GDP and the velocity of money. The monetary policy targets themselves were still restrictive in 1993, in line with the nation's macroeconomic situation and the economic reform scenarios adopted. The implicit incompatibility of the mixed monetary policy scheme – simultaneous targeting of a fixed nominal exchange rate and the money supply – had yet to make itself felt.

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Since its establishment, the CNB's **basic organisational structure** has comprised a head office in Prague and seven branches (in Prague, České Budějovice, Plzeň, Ústí nad Labem, Hradec Králové, Brno and Ostrava). The risks arising from the unsatisfactory condition of the CNB's premises to the running of the central bank and the nation's banking and economic system as a whole were evaluated as far greater than the costs of comprehensive renovation. As a result, all the CNB's premises underwent complete restoration in the years that followed. With the establishment of many new commercial banks, the interbank koruna payment system had to be reorganised and a new Clearing Centre was set up. Technical and material provision was also made for the operation of the customs union, linked with the special clearing system between the two successor states of the Federation.

In 1993 the CNB had a workforce of around 1,550. This figure rose over the subsequent 2–3 years as the banking supervisory system was established and the number of banking transactions and security criteria rose. Since 1998, as a result of a reorganisation and ongoing rationalisation, the number of staff has fallen below the 1993 level (and currently stands at around 1,480). Right from the outset, the CNB has strongly promoted language tuition (on average 500 members of staff take language lessons each year) and personal contacts with experts from foreign banks. The CNB made a major contribution to maintaining and developing economic research work in the Czech Republic by founding an Economics Institute as a special organisational unit of the central bank.

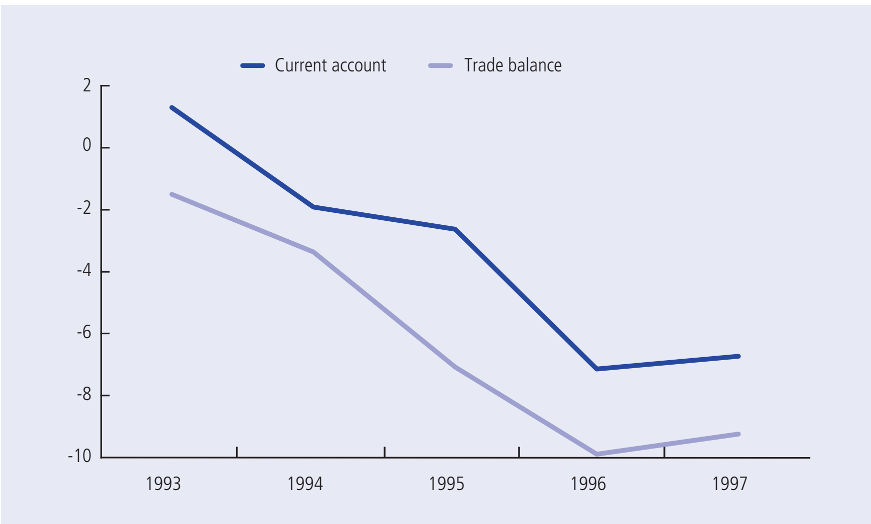
1994–1996: GROWING MACROECONOMIC IMBALANCES, SERIOUS PROBLEMS IN THE BANKING SECTOR, FOREIGN EXCHANGE LIBERALISATION, MONETARY POLICY TIGHTENING

The years 1994 and 1995 saw dynamic economic growth, although this was accompanied by increasingly imbalanced tendencies. On the one hand there were **unquestionably positive features**: GDP rose by up to 5% a year amid a very modest unemployment rate of around 3%. Inflation gradually fell below 10% and the public budgets were broadly balanced. The Czech Republic was lauded as a textbook example of successful economic transformation, and its external ratings rose. One of the consequences was a large inflow of foreign capital. The Czech Republic was the first transforming economy to gain membership of the

OECD, and this too was generally viewed as confirmation of the success of the path taken. The koruna became a widely convertible currency and attracted much interest on foreign money markets.

A more detailed look, however, reveals the **weaknesses of this situation**: high wage growth not covered by productivity gains; much faster domestic demand growth than GDP growth; a switch from surplus to deficit in the state's international investment position; and excessive inflows of external, chiefly short-term financial assets. All these are the hallmarks of an overheating economy. A very clear and alarming trend was the sharp deterioration of the trade balance and current account deficit, which according to internationally recognised criteria reached critical figures in 1996.

Current account and balance of trade as a percentage of GDP



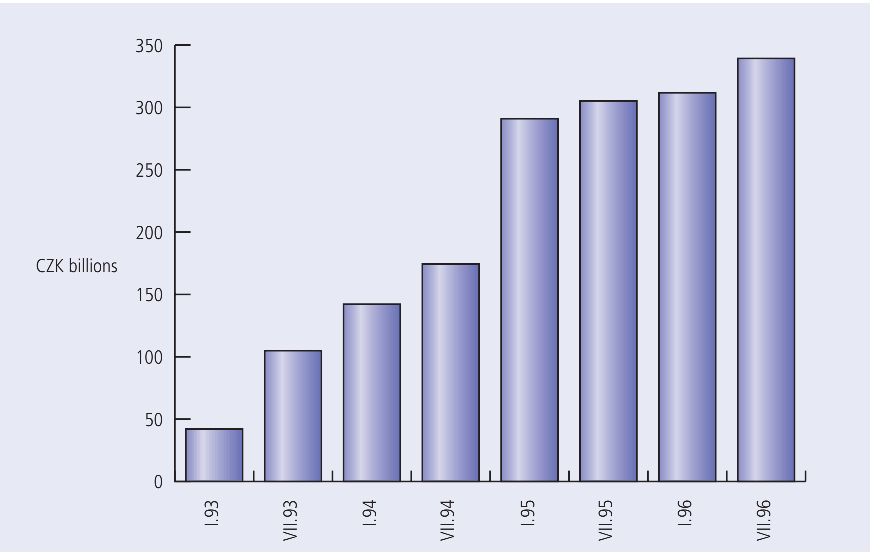
The country's gradually increasing internal and external debt was also reflected in **developments in the banking sector**. New problems piled up on top of those inherited from the past. The large commercial banks remained largely in state ownership and continued issuing loans to prop up the nation's key businesses. The situation at the time was assessed with the benefit of hindsight by the former CEO of Komerční banka Richard Salzmann, who characterised the "baggage of the past" as follows:

"[Prior to the transformation] credit had been the absolutely overriding, vitally important, legal and planned source of funding for state enterprises and co-operatives. For this reason it was also not secured in any way – along with its loans the bank [i.e. Komerční banka] received not a koruna in collateral, pledges and suchlike ... Was there any real possibility of demanding immediate repayment in a situation where loans were not secured in any way, businesses had no money, and bankruptcy law was virtually non-functional? Doing so would have meant the

instant and irreversible loss of all loans. The bank therefore preferred to rely on the expectation that the economic transformation, including privatisation, would create better chances of renewed prosperity. That is why it renewed corporate loans ... It was the entirely natural instinct of self-preservation: the hope of getting at least something back was better than the certainty of instantly receiving nothing."

Added to this were problems associated with the hasty founding of new small banks. Besides the understandable reasons for their failure – inexperience and microeconomic instability – it became increasingly clear that many new banks were being established and operated for the purpose of getting hold of savers' money and then lending that money on to companies belonging to the bank's shareholders (owners) or related parties. All this led to sharp growth in bad debts – in particular loans that were not repaid properly and on time.

Classified loans 1993–1996



Note: The low figures recorded up until 1994 were also probably due to a lack of reporting discipline; the first regulation on mandatory classification was issued in 1994.

In the mid-1990s, the Czech banking sector got into a very bad situation – as regards unrepaid loans – among the transforming economies, and hence into a situation which in the future would precipitate extremely large – and still hotly debated – losses. Let us recap the main reasons:

- ongoing lending to companies unable to cope with the new environment;
- difficulties getting to grips with projects in new, quickly founded companies;
- inexperience among the staff of domestic banks;
- intentional "tunnelling" (the Czech term for misappropriation of assets).

It is not easy to separate out the weights of the individual causes of the banks' subsequent problems and failures. However, the oversimplified idea that they were all caused by the banks themselves through their own incompetence or the criminal actions of managers and shareholders, does not hold water. Quite the reverse, the bulk of the difficulties were linked with the legacy of Communism, as it was the banks that had to bear the brunt of the costs that inevitably accompanied the transformation of the economy.

The CNB responded to the small banks' problems by announcing **Consolidation Programme II**. The following measures were applied in banks whose capital ratio fell below the threshold of 8%:

- equity capital reduction and imposition of conservatorship;
- cessation of business;
- sale of bank with a view to future merger;
- equity capital increase by existing shareholders or a new investor.

Out of the total of 18 small banks, 15 entered the Programme. The overall gross cost of around CZK 33 billion placed a serious financial burden on the central bank. The upward trend in the number of banks being founded was reversed in this period to a natural decline

The Czech banking sector

	Licences issued	Conservatorship imposed	Licence revoked because of:		Active banks and branches of foreign banks
			financial situation	some other reason	
1993	10	1	0	0	52
1994	4	1	1	1	55
1995	1	0	3	0	55
1996	2	6	2	0	53
1997	0	0	4	0	50
1998	1	0	4	3	45
1999	0	0	3	0	42
2000	0	1	1	1	40
2001	0	0	0	2	38
2002	1	0	0	2	37

The developments in the small-banks sector were accompanied by a fall in public confidence and by the risk of a massive outflow of deposits from this segment of the economy. For this reason, a **Stabilisation Programme** was drawn up. A new institution, Česká finanční, was established as a vehicle to buy up bad debts under predefined conditions and on the basis that they would be returned at a later date. The main aim of the Stabilisation Programme, which six banks entered, was to help such institutions to overcome a difficult period and lay the groundwork for the entry of a strategic investor capable of strengthening the bank's capital or merging it with a better capitalised bank. The economic slump in 1998 and 1999, however, worsened the situation further and practically all the banks in the Stabilisation Programme were gradually wound up (through licence revocations or takeovers).

Following the bad experience with the large number of small banks, **the powers of the supervisory authority were strengthened** in a 1994 amendment to the Act on Banks. The amendment introduced the possibility of reducing a bank's equity capital and defined in more detail the principle of conservatorship. It also legislated for a deposit insurance scheme for natural persons (initially applying only to non-anonymous koruna deposits of up to CZK 100,000). Another amendment – in 1996 – laid down banks' obligations relating to banking secrecy and introduced an anti-money laundering reporting duty. It also tightened up the licensing conditions, restricted banks' links with the corporate sector and introduced tougher measures against shareholders who demonstrably act to the financial detriment of a bank. These measures were difficult to enforce, as there was still a general conviction that excessive regulation of entrepreneurial activity was unnecessary.

An omen for the problems that were to hit the large banks was the case of ***Agrobanka Praha*** *(AGB). In 1993 AGB had admitted to financial problems, and up to the end of 1995 it had been pursuing a programme to improve its financial situation. Things took a turn for the worse when a group around Motoinvest took control of AGB. The bank ceased to fulfil its recovery programme, undertook high-risk securities trades and allowed its credit portfolio to deteriorate. Moreover, it failed to comply with the remedial measures imposed upon it and, following a run on deposits, got itself into an untenable liquidity situation that culminated in the imposition of conservatorship on 17 September 1996. AGB was the fifth largest commercial bank in the Czech Republic and its failure threatened to undermine the consolidation measures applied in the small-banks subsector and to impact on the banking sector as a whole. To safeguard the stability of the sector, a decision was made to keep the bank open for business as normal during the period of conservatorship and to boost client confidence by issuing a CNB guarantee for its deposits. Once conservatorship had been imposed, the external auditors confirmed that the bank's losses exceeded its capital. The situation was eventually resolved by selling part of AGB's business to a strategic investor founded by GE Capital Bank. The risks attaching to this sale were covered by the CNB. The total loss ran to some CZK 35 billion. AGB subsequently had its licence revoked and the company went into liquidation.*

The CNB was at that time confronted with problems stemming from **inflow of foreign capital**. This inflow was truly vast: in 1995 the capital account surplus ran to CZK 223 billion, or around 18% of GDP. It was linked with the funding of the mounting current account deficits and with borrowing from abroad, and for the most part it was channelled into banks that had few opportunities (projects) to invest it effectively. Although the inflow allowed certain foreign loans to be repaid ahead of schedule, there was an ever-present risk of its being used to fund consumption, which in turn would have greatly increased the inflationary pressures. Given that the state had a low level of debt and hence an insufficient volume of government securities (bonds) was available, the CNB resorted to sterilising the excessive inflows using its own specific instruments: central bank bills. Banks gradually deposited CZK 200 billion at the CNB. This sum also derived partly from the clean-up of the banking sector, which had been financed by the central bank.

Turning to the central bank's monetary policy, some **difficulties also began to emerge with using the money supply as an intermediate target** of policy. This was partially related to that fact that in the unstable Czech economy there was not a strong enough linkage between the targeted monetary aggregate and inflation. Besides this, financial innovations and the gradual liberalisation of capital flows also fostered instability.

However, the main source of the difficulties was the fact that the **policy was aimed simultaneously at two targets**: a fixed exchange rate and appropriate money supply growth. In a situation where wage growth was significantly outpacing productivity growth and where vast investment projects were being implemented in the state sector, this demand impulse was bolstered by the excessive inflow of foreign capital. It was also fostered by the gradual liberalisation of financial (at that time capital) market transactions, a positive yield differential (i.e. higher interest rates in the Czech Republic) and by foreign investors' positive take on the transformation of the Czech economy. Foreign investors were providing primarily short-term funds to Czech entities. The inflexible domestic demand side was unable to absorb all the additional funds.

The Czech Republic's entry into the OECD was tied to a requirement to introduce full ***external convertibility of the koruna*** *for current account transactions and to liberalise its conditions for financial account transactions, for example by abolishing the forex surrender duty and by allowing loans to be accepted from non-residents. These revisions were contained in the Foreign Exchange Act (No. 219/1995 Coll.), which took effect on 1 October 1995. Another major change as compared to the previous legislation was that the Act only mentioned those financial account transactions which were subject to regulation – all others were liberalised so there was no need to refer to them in the Act (the "what isn't banned is allowed" principle).*

One measure intended to strengthen the economy's defences against the inflow of speculative capital was the **widening of the koruna's fluctuation band** to ± 7.5%. The step was aimed at increasing the exchange rate risk undertaken by foreign investors and thus eliminating at least part of their profits from the high interest rate differential. The relaxing of the exchange rate provided room for a more autonomous monetary policy allowing more effective interventions in domestic money creation. The rate of capital inflow really did subsequently decrease and money supply growth returned to the target band. However, monetary policy was still confronted with demand pressures and lacked adequate support from other macroeconomic policies. A monetary policy tightening became necessary in order to compensate for the easier fiscal and wage policy.

These negative traits in the economy led the CNB in 1996 to **tighten monetary policy**. This move is still the subject of a debate that will probably never be definitively resolved. The main reason for the debate is that a sharp slowdown in economic growth followed in 1997. The causes of this, however, are interpreted differently: either as a consequence of the “drastic” tightening of monetary policy, or as an inevitable response to the previous unbalanced and therefore unsustainable trend, generated in turn by a build-up of various factors.

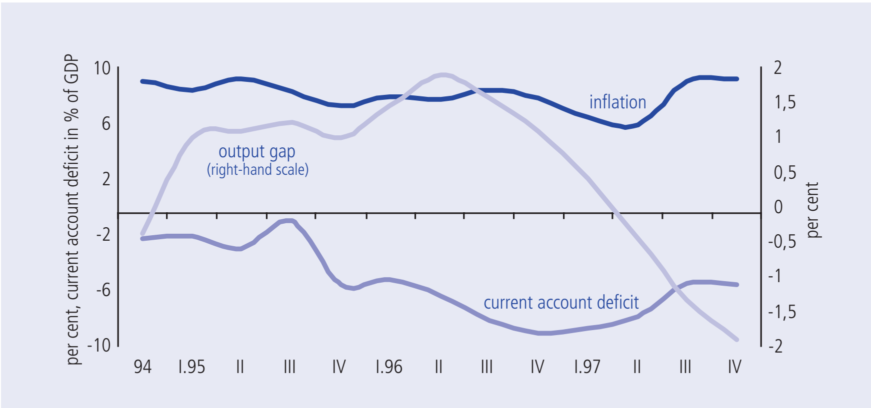
The tightening of monetary policy involved the central bank raising its key interest rates (the discount rate from 9.5% to 10.5%) and its required reserves ratio (from 8.5% to 11.5%). In relation to the inflation rate at that time, the increase in the discount rate and the subsequent rise in the market repo rate were very slight. Just to illustrate: the increase was equivalent to a rise of 0.2 percentage points at an inflation rate of 2%. Even the seemingly drastic increase in the required reserves ratio was no reason for the banks to curb their lending activity, as they already had excessive liquidity sterilised at the central bank. Nor was the impact of the central bank’s measures assessed as significant subsequently. This is evidenced, for example, by the forecast for rapid GDP growth contained in the draft state budget issued by the Government three months later.

The **monetary policy instruments** used to steer the money supply were gradually enhanced. To begin with, regulation of the money stock had been based on the use of the direct instruments referred to in the previous section. A more sophisticated approach was adopted based on targeting of the monetary base (currency in circulation + reserves). This makes use of the empirically derived relationship between the monetary base and the money supply. Monetary base management involves the use of open market operations, refinance loans, rediscount bills and Lombard loans. Just as with the relationship between the money supply and inflation, here too difficulties soon emerged. These arose from instabilities in the multipliers characterising the relationship between the monetary base and the money supply.

In 1996, **repurchase agreements** (repos) became the main instrument of monetary policy. In repos, the central bank accepts excess liquidity from banks in exchange for eligible securities and undertakes to return the borrowed principal plus an agreed-upon amount of interest at a later date. The basic repo term was set at 14 days. Against a background of a fixed exchange rate, liberalised capital flows and relatively easy fiscal and income policy, this monetary policy – based on market instruments – fell ever deeper into the “sterilisation trap”. The foreign exchange interventions needed to maintain the fixed rate led to sharp growth in the money supply. To mitigate the inflationary consequences of this, it was necessary to absorb (sterilise) the surplus money from the market, which stimulated growth in interest rates. The higher interest rates led in turn to growth in the interest rate differential and hence to further inflow of capital.

In conditions of persisting rigidity of domestic supply, the excess aggregate demand manifested itself primarily in a widening current account deficit. The impact on inflation was not significant, as the fixed exchange rate prevented any faster rise in prices.

Macroeconomic developments 1994–1997



Note: The "output gap" (right-hand scale) describes the difference between potential output and actual output. A situation where actual output is higher than potential (= values above zero) is usually a sign of an overheating economy, future inflation pressures and/or a widening current account deficit, and hence can be regarded as a cue for tighter monetary policy.

1997–1998: CURRENCY TURMOIL, CORRECTIVE MEASURES, ECONOMIC RECESSION, INFLATION TARGETING

The Czech koruna enjoyed a unique status among the currencies of the reforming European states. According to estimates, in April 1997, for example, the total daily turnover in these currencies was USD 8.1 billion, with the Czech koruna accounting for 70% of the total. Minimal restrictions engendered rapid mass movements of short-term foreign capital in response to economic developments. The adjustments to monetary policy adopted at the start of 1997, necessitated by the critical state of the external imbalance, were viewed by the markets as too little, too late. The extreme appreciation caused by the exceptionally strong inflow of speculative capital was therefore logically replaced by a rapid turnabout.

The unhealthy situation is very clear when we look at the **balance of payments**. The inflow of external funds peaked in 1995, when the proportion of short-term funds was particularly high. In 1997, the inflow was substantially lower and for the first (and last) time was insufficient to cover the current account deficit (see the balance of payments chart in Annex 1) and the foreign exchange reserves recorded a decrease. By way of comparison: a similarly huge capital inflow was seen again in 2002; however, the table below, containing selected data for the financial account (formerly the capital account), shows that this is incomparably sounder in structure and therefore that there is no danger of a repeat of the 1997 financial crisis.

Balance of payments (in CZK billions)

	1995	1997	2002
Financial account surplus	218.3	34.3	340.3
FDI in Czech Republic	68.0	40.6	276.1
Portfolio investment in Czech Rep.	44.7	40.4	28.9
Other investment in Czech Rep.	181.2	102.2	- 11.1
of which: short-term loans	93.2	78.1	- 10.2

An **attack on the koruna** (i.e. mass selling of koruna assets and purchasing of foreign currencies) erupted in May 1997, causing the nominal exchange rate to fall by more than 10% against its central parity and by more than 15% relative to the pre-crisis level. Czechs still have vivid memories of the days and weeks when exchange rates shot upwards and exchange offices ran out of foreign currencies, while out on the streets illegal moneychangers made an unwelcome return. But the impacts on the economy were even worse: more expensive inputs, payment problems, and an outflow of foreign exchange. The direct trigger mechanisms of the currency crisis were as follows:

- very negative first-quarter reports on the economy: a sharp slowdown in growth (from around 5% to negative figures), a further deterioration of the balance of trade, and a high state budget deficit;
- tension on the internal political scene;
- a withdrawal by investors from many emerging economies with similarly unbalanced external relations, followed by currency crises in those economies (Thailand, Philippines and Malaysia) – the “contagion” problem.

In an effort to prevent an excessive devaluation of the koruna, the Czech National Bank intervened promptly in the foreign exchange market and made it as difficult as possible to gain access to loans that might have been used to further weaken the currency (i.e. to purchase foreign currency). The CNB temporarily increased its interest rates – the Lombard rate to as high as 50% – and implemented a number of administrative measures restricting access to the market. By agreement with the commercial banks it restricted residents’ access to koruna funds and prevented access to refinance loans for banks. On 26 May, the Governor of the CNB and the Prime Minister announced that the fixed exchange rate had been abandoned in favour of a managed float.

On 28 May 1997, the governing coalition approved a **stabilisation and recovery programme**. In an accompanying statement, the leaders of the ruling parties stated among other things that the retreat from the overvalued exchange rate, which had been out of line with the performance of the economy, was the price paid for a series of economic policy mistakes. The grave economic situation was labelled as a consequence of long-running tendencies such as poor efficiency of the banking system (exacerbated by state bail-outs), the propping up of inefficient activities from budgetary funds, and poor enforceability of the law.

The programme contained the following measures:

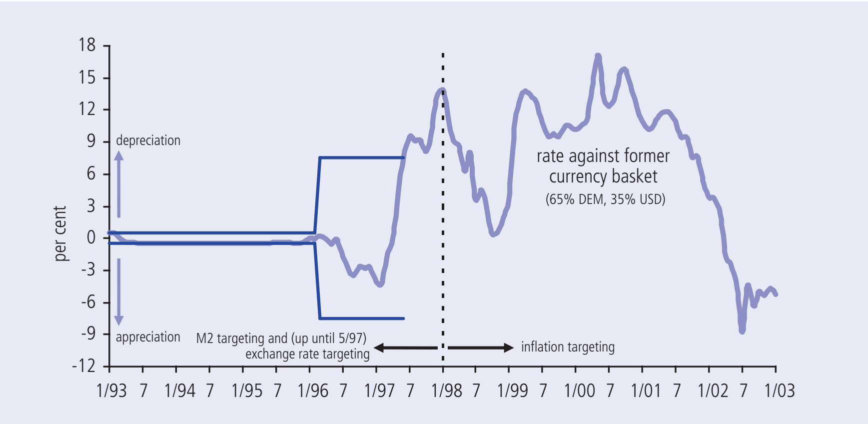
- further cuts in budgetary expenditures (state administration, investments, social transfers);
- support for consistently restrictive CNB policy in an effort to minimise the rise in inflation and reduce the current account deficit;
- suitable CNB measures to bolster the stability of the currency;
- radical restrictions on imports financed from public budgets;
- measures to encourage wage restraint and to freeze wages in the budgetary sector.

Despite the fact that the economic **consequences of the currency shock** became blurred with the aftermath of another serious event (catastrophic flooding) in the months that followed, making it hard to separate one from the other, it can generally be said that ultimately **they were not dramatic**. The exchange rate flattened out at around 10% below the former central parity, meaning that the koruna depreciated by far less than the currencies of other states that had suffered similar shocks. In Thailand, for instance, the exchange rate weakened by 35% in just a few days, while Indonesia and South Korea saw falls of 28% and 30% respectively. In the Czech Republic the impact of the weaker exchange rate on inflation was less than two percentage points, which, given the highly open Czech economy, testifies to the effectiveness of the efforts to curb domestic demand. The first signs of an improvement in the current account balance appeared. And there were no appreciable downward revisions of the Czech Republic's ratings.

The approach of the CNB and other bodies during the currency crisis was later the subject of much thought and debate, often leading to contradictory conclusions. Worthy of note is a statement made in May 1999 by Michael Deppler, the IMF's Director for Western and Central Europe. Mr Deppler said that the Czech Republic had been a model for how to proceed in the event of a monetary crisis and had shown that if the central bank acted sufficiently decisively, even a country which otherwise had serious economic weaknesses could handle such a crisis. If the CNB had not done so, the Czech Republic could have met with the same fate as the Asian countries plunged into a debt crisis by sharp devaluations.

The result of overcoming the crisis was an economic recession. Domestic demand fell, the construction industry, among others, was hit hard, and the devalued exchange rate started to affect inflation and consequently real wages. A major consequence of the crisis was **the loss of the nominal anchor of the transformation process –** the fixed exchange rate of the Czech koruna.

The exchange rate under the fixed regime and after the introduction of the floating rate and inflation targeting



Re-introducing the former dual-target regime (money supply management and a fixed exchange rate) seemed impossible not only theoretically, but also for practical reasons. The instability in the wake of the currency shock also ruled out any responsible consideration of tying the Czech currency to the mark or the future European currency (in the form of a currency board). The following options therefore presented themselves:

a) targeting an intermediate target – the money stock – in conditions of a floating exchange rate;
b) maintaining the exchange rate within a set band against an anchor currency;
c) inflation targeting.

True, there were also suggestions for multi-criteria monetary management until some degree of macroeconomic stability was restored. But it was impossible to believe that a monetary policy lacking a declared, transparent target could foster the desired stability. After holding talks with a wide range of experts, the CNB Bank Board approved the introduction of an inflation targeting scheme at the end of 1997.

The new monetary policy framework was intended to:

- provide the economy with a new nominal anchor, in the form of a clearly defined and publicly disclosed target for inflation, or, more specifically, for the pace of the disinflationary process,
- provide an internally consistent scheme to enhance the transparency of central bank policy,
- reduce the problem of the hard-to-quantify relationship between monetary aggregates and inflation (as the criterion for setting monetary policy was now the inflation forecast directly),
- introduce an element of certainty into the economy and shape inflation expectations, thereby favourably affecting prices and wages.

The principle of monetary policy under the inflation targeting scheme consists in adopting and disclosing an inflation target and in implementing the necessary monetary policy measures based on **inflation forecasts**. It reflects the observation that monetary policy measures – i.e. primarily interest rate reductions or increases – have a lagged effect on inflation. In the Czech Republic, the horizon of most effective transmission is reckoned to be 4–6 quarters. For the inflation forecasts to reliably fulfil the function of this fundamental criterion, they needed to be much improved.

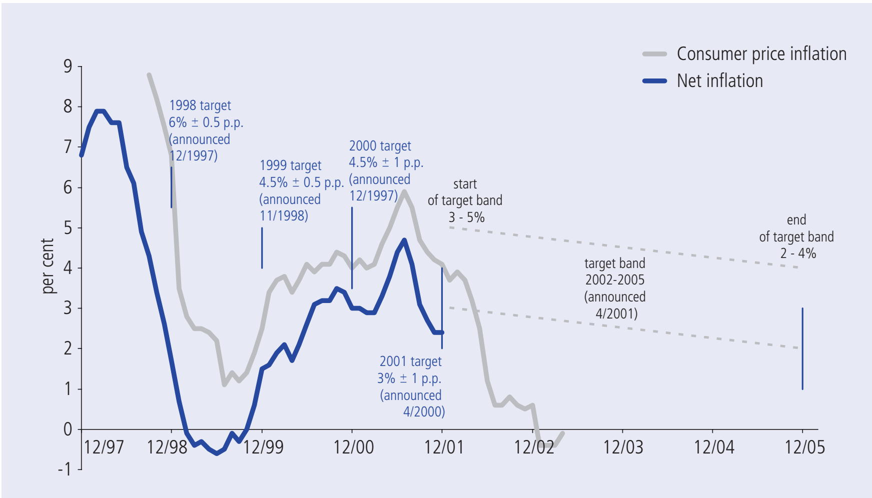
At first, "conditional" inflation forecasts were used. These modelled future inflation under current (constant) interest rate conditions. Improvements to the forecasting system and the introduction of an aggregate model of the economy enabled the CNB to switch to "unconditional" inflation forecasts containing the central bank's model reaction to macroeconomic developments.

The inflation target was formulated in December 1997 in terms of annual **"net inflation"** of 4.5% ± 1 percentage point for 2002, in other words as a medium-run target. In order to alter inflation expectations more quickly, an interim target was set for 1998 (annual net inflation of 6% ± 0.5 percentage points, i.e. moderate disinflation). Although the inflation target path can be characterised as a project of moderate disinflation, the targets were initially criticised as over-ambitious, unrealistic and anti-growth. This perception of the new monetary strategy was exacerbated by the fact that it had been adopted without consultation with the Government, although this was linked with the political situation at the time (a change of administration).

Net inflation was defined as consumer price inflation net of changes to regulated prices and indirect taxes. It thus described inflation in 82% of the consumer basket. This reduction was introduced mainly because of considerable uncertainties at the time regarding the intentions of the next government (in the run-up to elections in June 1998) in the area of price regulation.

In the shifting external environment, prices were volatile in the period following the introduction of inflation targeting; at the same time, though, there was clear evidence of the emergence and existence of a low-inflation environment in the economy. The success of inflation targeting was due in part to the rising **transparency** of the CNB's monetary-policy decision-making. The bank's commitment to steer prices within the set band was announced sufficiently in advance for households, firms and public budgets to be able to incorporate it into their plans. The decisions on interest rates, and the reasons for those decisions, started to be disclosed regularly in publicly available minutes of the CNB Bank Board's meetings and communicated to the media at news conferences held straight after the Board's meetings. The CNB's quarterly Inflation Reports are debated by the parliamentary Budget Committee and later also in a plenary session of the Chamber of Deputies (the lower house of the Czech Parliament) and distributed to a wide range of interested parties.

Consumer price inflation in the inflation targeting period

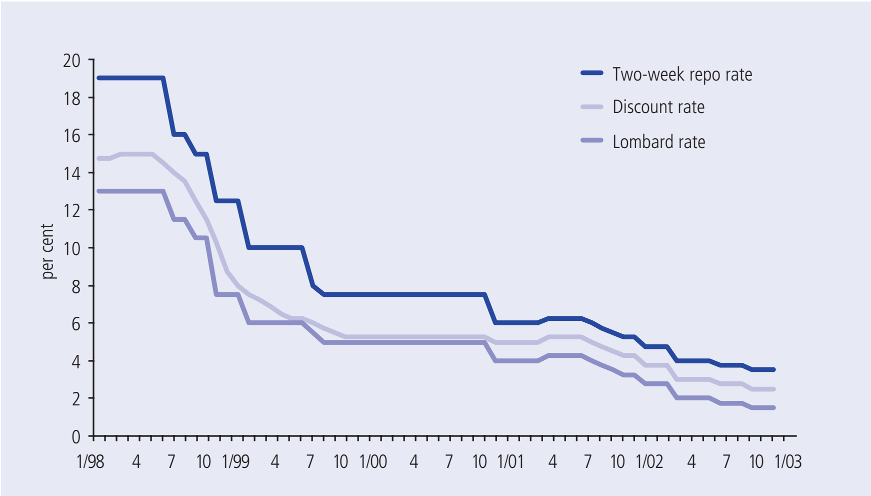


1999–2001: GRADUAL ECONOMIC RECOVERY, DISINFLATION, COMPLETION OF BANK PRIVATISATIONS, DISPUTES OVER THE CNB'S INDEPENDENCE, THE IPB CASE

In 1999 the economy was still stagnating. In the years that followed, though, it grew at an **annual rate of around 3%**. The highest growth rate was recorded for fixed capital formation (investment), thanks to the inflow of foreign funds. By contrast, the growth rate of GDP was constantly slowed by imports outpacing exports. Household expenditure growth steadily picked up to 3–4%.

The period from mid-1998 to mid-1999 was characterised by **rapid disinflation**. This can be attributed primarily to a combination of anti-inflationary external and internal factors lying either entirely or largely beyond the purview of the CNB. The external environment was marked by an extreme decline in world prices of food and raw materials. These factors accounted for around 3 percentage points of the undershooting of the inflation targets. The internal factors – in particular a sizeable fall in economic performance and the competitive policies adopted by retail chains on the domestic market – worked in parallel. The easing of inflation pressures allowed the central bank to reduce its interest rates radically.

Central bank interest rates



Conversely, in 2000 and throughout most of 2001 there was a gradual **pick-up in inflation** towards the CNB's inflation targets. Initially, inflation was affected primarily by rising import prices, most notably oil prices, and by a depreciation of the koruna's exchange rate against the dollar. In mid-2000, rising prices of food on the domestic market became the dominant factor. However, subdued demand growth and fierce competition on the retail market prevented any escalation of the demand-inflation impulses.

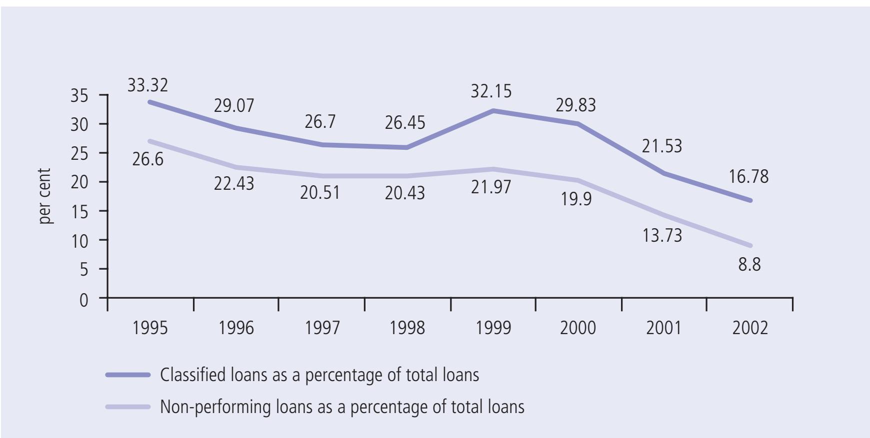
When making its monetary policy decisions, the CNB weighed up the risks of an inflation pick-up due to the growing expansiveness of the macroeconomic environment (i.e. accelerating economic growth, rising public budget deficits and so on) and its negative impact on inflation expectations. It also considered the risks associated with the intensity and duration of the external cost shock and its secondary impacts in conditions of economic recovery. The analyses suggested, however, that even taking these risks into account, inflation at the time of most effective transmission (i.e. 4–6 quarters after a monetary policy decision) would be consistent with the inflation targets. Accordingly, the CNB left its interest rates unchanged for 15 months.

A further disinflationary wave, again caused mainly by external factors (falling world prices and appreciation of the koruna), allowed the CNB to lower its rates further. This reduction provided a strong stimulus for household borrowing, thereby eliminating the negative effect of the still subdued level of external demand. Analyses meanwhile suggested that there was no threat of a re-emergence of inflationary pressures in the near future.

The adoption of the **CNB Monetary Strategy** document signified a major adjustment of monetary policy to the new conditions. The strategy was based on the need to set the long-term inflation target in a way that would make it consistent with the strategy for the Czech Republic's integration into European structures. More room was devoted to the problem of the difference in price levels between the Czech Republic and the EU. The document stated that these differences were concentrated in nontradable commodities (most notably services), where the equalising of price levels is a very long process that is moreover conditional on faster productivity growth in the Czech Republic than in other countries. In the strategy, the long-term inflation target was formulated in terms of annual net inflation of 2% ± 1 percentage point for 2005. When presenting this target, the CNB Bank Board emphasised that the credibility of the target, and hence its effectiveness, would be greatly enhanced by a commitment from the Government to help meet it.

In the banking sector, the main events of 1999–2001 were **the privatisation of three large Czech banks and the imposition of conservatorship on IPB**. Before the privatisations could take place, the three banks' capital had to be increased and their portfolios cleared of bad debts by transfer to Konsolidační banka (today the Czech Consolidation Agency). The state sold its stake in Československá obchodní banka to KBC Bank of Belgium in 1999, its holding in Česká spořitelna to Erste Bank of Austria the following year, and its stake in Komerční banka to France's Société Générale in 2001. The aggregate net costs of cleaning up these banks prior to their privatisation ran to some CZK 85 billion. On the other hand, it should be borne in mind that if their portfolios had not been cleaned up, the income from the sales would have been considerably lower.

Credit portfolio quality



*An important step on the path towards banking sector stability was the averting of a system-wide crisis from **the failure of Investiční a poštovní banka (IPB)**. The management and shareholders of IPB allowed the bank to fall into a hopeless condition in just a short space of time. Deposits totalling CZK 300 billion had been jeopardised by bad loans and loss-making transactions. Hundreds of thousands of accounts belonging to companies and private* *individuals were in danger of being frozen and a large section of the economy was thus threatened with paralysis. The immediate cause of the crisis was a run on the bank. As the bank's managers and shareholder had failed to take the steps needed to address the liquidity problems or to eliminate their underlying causes, conservatorship was imposed on the bank. On the same day the CNB issued a guarantee for IPB's creditors in order to quell the fears of the public and the bank's customers and help the bank overcome its liquidity problems. Once conservatorship had been imposed, the external auditors confirmed that the bank's losses exceeded its capital, so the CNB opened proceedings to have its banking licence revoked. The bank's critical situation was resolved through the sale of its business to a strategic investor – Československá obchodní banka (ČSOB). Under the contract of sale, IPB's assets and liabilities were transferred to ČSOB. To limit the risks attaching to the takeover of IPB's business, the Ministry of Finance and the CNB issued guarantees to the investor.*

The financial sector, and indirectly the banking sector as well, was adversely affected by **the collapse of the credit unions**. Although they were not banks but rather co-operative societies owned by their depositors, who were meant to be jointly responsible for managing them, the public ignored this importance difference. The collapse, which affected as much as 90% of the deposits in this sector, was due to the public's naive trust in much-hyped promises of high interest rates on deposits. The managers of the credit unions then often misappropriated depositors' funds to finance their own companies or to line their own pockets. The state supervisory authority was unable to detect such practices in time, never mind prevent them. However, the depositors' outrage assumed such proportions that they were eventually compensated at taxpayers' expense.

The year 2000 saw frequent debate over the **independence** of the central bank. The efforts to curb this independence were in several respects at odds with European institutions' requirements that Czech law be harmonised with European legislation within the framework of the accession negotiations. This manifested itself in the legislative process when the CNB Act was going through Parliament.

The CNB Act was amended in 2000 to bring a number of provisions into line with EU law (the "harmonisation amendment"): the primary objective of the CNB, previously formulated as monetary stability, was changed to price stability; a provision was added stating that the CNB must support the economic policies of the Government (without prejudice to the central bank's primary objective); the possibility of the CNB providing short-term credit to the state was repealed; and the CNB's powers to impose credit ceilings and interest-rate limits on banks were abolished. However, the amendment also contained a number of controversial changes: approval of the CNB's operating budget by Parliament, setting of the inflation target by agreement with the Government, a conflict with the Constitution regarding the appointment of members of the Bank Board, and so on. In June 2001 the Constitutional Court overruled all the controversial provisions on the grounds that they contravened the constitutional independence of the CNB. The Court also confirmed the appointment of Zdeněk Tůma as the new CNB Governor.

The build-up of new demands on the CNB, the endeavour to streamline its operations, and the prospect of closer integration into European structures led the CNB Bank Board to effect a **reorganisation of the CNB** in 2001. The new Organisational Statute specified the collective decision-making powers of the Bank Board in more detail, increased the responsibilities of the CNB's basic management units (departments), reduced the number of organisational units and managers, and put greater emphasis on research work. The posts of executive directors of all departments were filled on the basis of a competitive recruitment procedure.

In this period the CNB's **research activities** were stepped up considerably. The core research work was decentralised to specific departments, while the task of co-ordinating the work was given to a new department overseen by the Governor. The research is currently project-based and focuses on the following topics: convergence of the Czech economy into European structures, monetary and fiscal policy, macroeconomic modelling, the financial sector and the real economy. The research priorities are formulated after discussion in the Research Advisory Committee (whose members include foreign experts) and following consultations with the Bank Board. The economic research work also involves evaluating important documents discussed by the Bank Board, helping to organise international conferences and visits by foreign experts, and collaborating with researchers at other central banks.

2002: THE RESULTS ACHIEVED OPEN UP THE PATH TO THE EUROPEAN MONETARY UNION

The world economy went through a phase of very **slow economic growth** in 2002, the only exceptions being some of the Asian nations, most notably China. The expected recovery failed to materialise and the forecasts all indicated that it would be slow in coming. This situation had especially unpleasant consequences for the Czech Republic, as its most important trading partner – Germany – was particularly hard hit by the economic stagnation. On the other hand, the disappointing economic growth, and hence subdued demand, had a strongly depressing effect on inflation.

Results for 2002 (in per cent)

2002/2001	GDP growth	Average inflation rate
USA	2.5	1.6
European Union	1.0	2.1
Germany	0.2	1.4
Slovakia	4.4	3.1
Poland	1.3	1.9
Hungary	3.3	5.3
Czech Republic	2.0	1.8

Note: The data are taken from the OECD database as at April 2003 and may be subject to change.

As a result of a deferment of the regular annual increases in administered prices and changes to indirect taxes (stipulated, among other things, as a condition for the Czech Republic's accession to the EU), consumer prices even recorded a brief year-on-year fall in early 2003.

In 2002 a number of further **changes were made to the inflation targeting system**. Up until that time, the inflation targets had been declared in terms of annual net inflation for the end of the relevant year – for example, a target range of 2%–4% had been set for December 2001 in the April of the previous year. In the interests of enhancing the transparency of its inflation targets and thus improving its communications with the public, the CNB Bank Board decided to switch to targeting **headline inflation** (measured by the annual consumer price index) in the form of a linearly descending band.

Target band for headline inflation

Start	January 2002	3%–5%
Finish	December 2005	2%–4%

It is clear from the level of the target band that the CNB in its considerations respects the need for a gradual equalising of prices levels with neighbouring EU member states, as the band is positioned above the target of the European Central Bank, which wants to keep inflation in the euro area below 2%.

The CNB also updated its "**escape clauses**", i.e. factors which are completely or largely outside the purview of monetary policy and which the central bank does not respond to directly with monetary policy action even though they can cause inflation to deviate considerably from the targets. The factors are:

- major changes in world prices of raw materials, energy-producing materials and other commodities;
- major changes in the koruna's exchange rate which are not connected with domestic economic fundamentals and domestic monetary policy;

- major changes in the conditions for agricultural production which have an impact on prices;
- changes in regulated prices whose effects on inflation would exceed 1–1.5 percentage points;
- step changes in indirect taxes.

The fact is that since the introduction of inflation targeting in 1998, the inflation outturns have often been lower than the inflation targets (see also the chart at the end of Section 4). Sometimes this is passed off as bad policy or even as a mistake in the choice of ***an inflation targeting scheme****. That the cases of undershooting of the targets have been caused mainly by external factors beyond the CNB's control has already been mentioned. But it should also be emphasised that assessments of the success of the inflation targeting scheme cannot be narrowed down to a mechanical, "economic planner's" comparison of target versus outturn. The point of targeting inflation and declaring inflation targets is to create a climate of foreseeable and credible central bank policy which (abstracting from extraordinary situations) tries to steer inflation towards targets that are disclosed in advance.*

A serious monetary and macroeconomic problem in 2002 was the **appreciation of the koruna's exchange rate**. During the course of the year, the koruna appreciated in nominal terms by as much as 15% year-on-year against the euro and the dollar. Although this trend might seem objective, its intensity in 2002 became a highly unpleasant factor which affected the competitiveness of the Czech economy and prevented the originally forecast improvement on the balance of trade and current account from being achieved. The koruna's appreciation was caused by foreign-investor demand associated with the completion of the privatisation process and the implementation of several major investment projects. The inflow of foreign direct investment reached a record level of around USD 10 billion for the year.

Only at the end of the year did the exchange rate return to a tenable level. This was chiefly due to an agreement struck between the CNB and the Government on a procedure for depositing foreign-exchange privatisation revenues and converting them into foreign exchange reserves. Another factor underlying the necessary weakening of the koruna was the low interest rates, which among other things enhanced the effectiveness of the central bank's interventions in the foreign exchange market.

The increased frequency of the CNB's ***foreign exchange interventions*** *(sales/purchases of foreign exchange in the market) was sometimes accompanied by highly simplistic comments on the alleged associated losses. Two important facts should be borne in mind. First: when the central bank intervenes in the market, in exchange for its korunas it receives the equivalent in foreign currency (or vice versa). At the moment of the intervention, no one knows whether the price of this equivalent will go up or go down, so it is pointless to write about profits or losses at that moment. For instance, in 2002 the CNB made two large intervention purchases (in April and in September), each amounting to around EUR 1 billion, at exchange rates of 30.62 and 29.25 korunas to the euro respectively. Given the exchange rate at the end of the year (which is what counts as regards quantifying the profit/loss), these two interventions had a positive effect of more than CZK 3 billion on the profit for 2002. This is because in the* *meantime the koruna depreciated, hence the koruna value of the foreign exchange assets in the CNB's balance sheet increased. Second – and even more important – the impact on the central bank's bottom line is not of primary significance. The CNB intervenes chiefly in order to help reverse movements in the exchange rate which might threaten the stability of the economy. Any losses associated with such interventions must be compared with those which might be caused to the whole economy by a sharp, unidirectional deviation of the exchange rate. Such a situation was ultimately prevented in 2002.*

Of major importance to the banking sector in 2002 was **a further amendment to the Act on Banks**. As with the amendment to the CNB Act, the primary aim was to complete the harmonisation of Czech law with the European legislation. The amendment introduced the principle of supervision on a consolidated basis (i.e. supervision of entire groups, for example financial groups containing a bank) and the principle of the single banking licence (i.e. the automatic right for a bank to carry on business in the Czech Republic if it already has a licence issued by an EU member state, and vice versa), and set forth rules for co-operation between regulators at international level. The measure that attracted most public attention was a ban on opening anonymous deposit-book accounts and a procedure for dealing with the more than six million such accounts then held with savings bank Česká spořitelna. This measure, too, was part of the harmonisation process and was intended to exert more effective pressure against money laundering.

The banking sector was stable in 2002. The sale of the large banks to foreign corporations paved the way for faster penetration of modern know-how into Czech banking practice and helped to improve management standards, capitalisation and efficiency in the sector. While the number, range and scope of banking services increased, the number of workers in the sector fell by almost a third. In the years immediately following the establishment of the Czech Republic the capital ratio of the sector had been only just above the required threshold of 8%, whereas by 2002 it had reached 14.4%. The further improvement in credit portfolio quality is depicted in the chart in the previous section. Despite these positive results, it became clear at the start of 2003 that some institutions, chiefly the smaller ones, are potentially susceptible to liquidity crises if they overstep the bearable level of risk and if they do not enjoy the protection of a sound, well capitalised partner.

Banking supervisory regulations and practices are now largely in line with international standards. In this area, closer ties have been forged with foreign regulators, approaches to the problem of money laundering are being enhanced, and other measures are being implemented that set requirements for the treatment of various banking risks. CNB Banking Supervision underwent a comprehensive and generally positive assessment in 2001 by a mission organised by the IMF and World Bank under the Financial Sector Assessment Program (FSAP).

*Throughout the past decade, however, the CNB has been unable to overcome the oversimplified notions in some quarters regarding **the possibilities of banking supervision**. Blame for bank failures has very often been laid automatically on unsatisfactory supervisory work. The simple fact that the blame for such collapses lies first and foremost with the owners (shareholders), managers and supervisory board members who, inadvertently or even intentionally, allowed the bank to enter into loss-making transactions, is meanwhile ignored. Also poorly understood is the fact that the central bank has to abide strictly by the statutory procedures when dealing with problems uncovered by its supervisors and cannot do anything that might threaten the freedom of private enterprise. For instance, no member of the CNB's staff is allowed to make premature mention of the problems of a particular bank: that would be a sure-fire way of rapidly destroying the bank, not to mention the member of staff himself (through criminal prosecution).*

In all areas of activity, the CNB's tenth anniversary was marked by increasingly intensive preparations for **the Czech Republic's accession to the EU and later adoption of the single European currency**. In this connection the CNB issued several conceptual documents:

- "Challenges for the Czech National Bank in the Years Ahead" – a concise statement on what the central bank of a state wishing to join the EU and adopt the euro should look like and how it should operate;
- "Medium-term Plan for 2002–2004" – conceptual plans and a schedule of specific tasks for each individual area of activity of the central bank;
- "The Czech Republic and the Euro – Draft Accession Strategy" – a summary of the starting points for progressing towards the single currency and an overview of the related risks and potential benefits.

A publication such as this, which is a review of past events, cannot go into sufficient detail about the content of these conceptual documents and others like them that are in the pipeline (such as the document on the price impacts of our future membership of the EU and the euro area). Nor can it describe the latest and most difficult issues associated, for instance, with future monetary policy strategy in ERM II. Those interested in obtaining more detailed information should therefore consult the relevant parts of CNB's website or refer to the special publications listed in the annex.

***

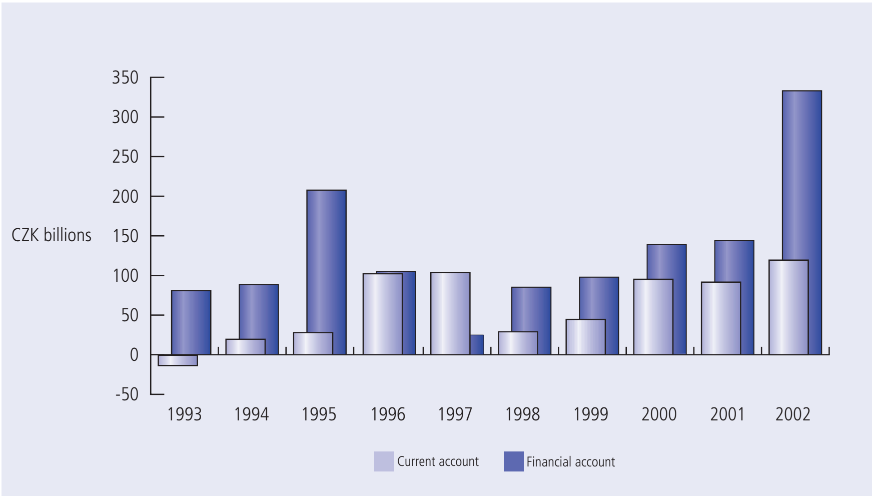
Given the importance of the central bank to the economy and to society as a whole, it is only natural that **discussions about the work and specific actions of the central bank** have gone on, and continue to go on, in the media and in the public domain. The CNB is probably second only to the Government in terms of its influence on the economy, and given its targets and priorities it is only logical that its work is occasionally misunderstood by the general public, the media and by figures in political life. Sometimes the view of the CNB is distorted by a single, and perhaps extreme, event. But the key factor in any overall assessment must be how the central bank has fulfilled its primary constitutional and statutory tasks over the past decade.

To conclude this look at the CNB's ten-year history, it is therefore vital to emphasise above all else that developments in the Czech Republic have led to a level of price stability that is fully comparable with the situation in the most advanced countries. Low inflation has allowed interest rates to be reduced in a flexible manner, and this in turn has fostered sustained economic growth despite the adverse global environment in recent years. The external stability of the Czech currency is evidenced by the fact that the koruna's exchange rates against the euro (and formerly the German mark) and against the dollar are virtually the same as they were at the start of the reform process. This is a rare phenomenon in the transforming economies. Payments proceed smoothly, quickly and securely. The banks' losses have for the most part been the price paid objectively for the vital and costly transformation of the economy. After ten years, the banking sector has attained a far higher level of stability and efficiency, thanks mainly to the successful privatisation of the large banks, and the methods used to regulate it are comparable with those applied in the advanced world.

In the Czech Republic's referendum on accession to the EU, the majority of those who turned out to vote were in favour of joining. The status of the CNB, and its operation and results hitherto, are a guarantee that central banking in the Czech Republic will in no event prevent or hinder the nation's further integration into European structures and ultimate adoption of the single European currency.

ANNEX 1

BALANCE OF PAYMENTS OF THE CZECH REPUBLIC 1993–2002
(current account balance with opposite sign)



ANNEX 2

FINANCIAL INFORMATION ON THE CNB

The CNB Act states that the CNB shall independently and with due diligence manage the assets entrusted to it by the state. However, the internal operating expenses that the bank can influence directly and independently represent less than 5% of total expenses. A major component affecting the CNB's bottom line are costs associated with its primary objective, i.e. with operations executed with a view to maintaining price (currency) stability. It is impossible to set a verifiable income accounting entry against such expenses; all one can do is assess whether the CNB succeeded in fulfilling its objective, and that is what this entire publication has set out to do.

The CNB's bottom line was very volatile in 1993–2002:

CNB Finances (balance of expenses and income in CZK billions)	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
1 Monetary policy implementation	-1.31	-6.55	-6.30	-11.50	-11.97	-20.34	-14.37	-13.99	-15.82	-15.91
2 Foreign exchange transactions	1.69	2.51	13.60	13.60	12.76	13.95	14.79	21.87	28.52	27.29
3 Valuation changes	-1.86	1.54	1.00	-8.34	44.65	-35.61	31.52	-3.52	-40.12	-26.15
4 Transactions with Czech Republic	2.48	0.51	-2.60	-4.30	-3.93	-2.87	-1.35	-1.00	-0.43	-0.81
5 Other financial transactions	4.88	10.59	3.00	7.87	10.07	8.84	-2.53	3.78	0.77	7.94
6 Operations and currency circulation	-1.63	-1.65	-1.50	-1.90	-2.51	-2.46	-2.74	-3.04	-2.60	-2.40
	4.25	6.95	7.20	-4.57	49.07	-38.49	25.32	4.10	-29.68	-10.04
7 Receivable from NBS	-2.47	-2.63	-2.60	-2.63	-2.63	-2.63	-9.44	0.00	0.00	0.00
8 Banking sector consolidation *	0.00	-2.88	-3.60	-1.45	-35.69	-26.10	1.69	-1.58	1.05	0.57
9 Other non-recurring income	0.00	0.00	0.00	0.00	0.00	16.48	14.81	0.00	0.00	0.00
Profit/loss	**1.78**	**1.44**	**1.00**	**-8.65**	**10.75**	**-50.74**	**32.38**	**2.52**	**-28.63**	**-9.47**

** Creation of reserves and provisions, loss from sale of receivables to Česká finanční, and sale of Česká finanční*

Notes:

- The item "Monetary policy implementation" consists chiefly of losses connected with transactions with banks (repos), in which the CNB pays banks interest on short-term deposits. The bulk of these resulted from the sterilisation of the foreign capital inflows in 1994–1995.
- Foreign exchange transactions constitute the relatively stable income on the CNB's foreign exchange reserves deposited at foreign banks. The growth in the income stems from the rising volume of these reserves.
- The losses/income from changes in the koruna value of foreign exchange reserves as of the end of the calendar (accounting) year are very volatile. If the exchange rate of the koruna appreciates (as was the case in the past two years), the result of the koruna valuation is a loss; in the opposite case a profit results. If the exchange rate is fixed, then logically the ensuing profits and losses here are minimal.
- The costs associated with the consolidation of the banking sector were

considerable, cumulatively representing a loss of CZK 68 billion for the CNB over the ten years. Another above-average item was the loss from writing off the receivable from the National Bank of Slovakia dating from the splitting of the federal currency: CZK 26 billion. These two items can be given as the main reasons for the CNB's accumulated loss of CZK 52 billion at the end of 2002.
- The non-recurring income in 1998 was caused by the sale of gold for around five times its book value; in 1999 it was due to the sale of the stake in ČSOB.

Management of foreign exchange reserves

An important part of the CNB's financial operations is the management of foreign exchange reserves, i.e. making decisions on their size, structure and investment location and in particular on the execution of foreign exchange transactions. When managing its reserves, the CNB aims to achieve maximum and stable returns subject to limits on market and credit risks. In the mid-1990s the reserves fluctuated just below USD 10 billion, but by the start of 2003 they had reached around USD 24 billion. The rapid rise over the past two years is due to the koruna's appreciation, which has necessitated interventions and an agreement with the Government on the conversion of privatisation revenues. Unlike in the early years, only two reserves currencies are now used in the management of the reserves – the dollar and the euro, in a ratio of approximately 3:7.

Material provision for the CNB's activities

From 1993 onwards the six branches of the central bank were either built or underwent major renovation work. In 1997 the reconstruction of the CNB's headquarters was commenced. This investment project was launched because the risks from the condition of the buildings to the central bank's operations and to the entire banking and economic system were untenable and far higher than the projected costs of comprehensive reconstruction

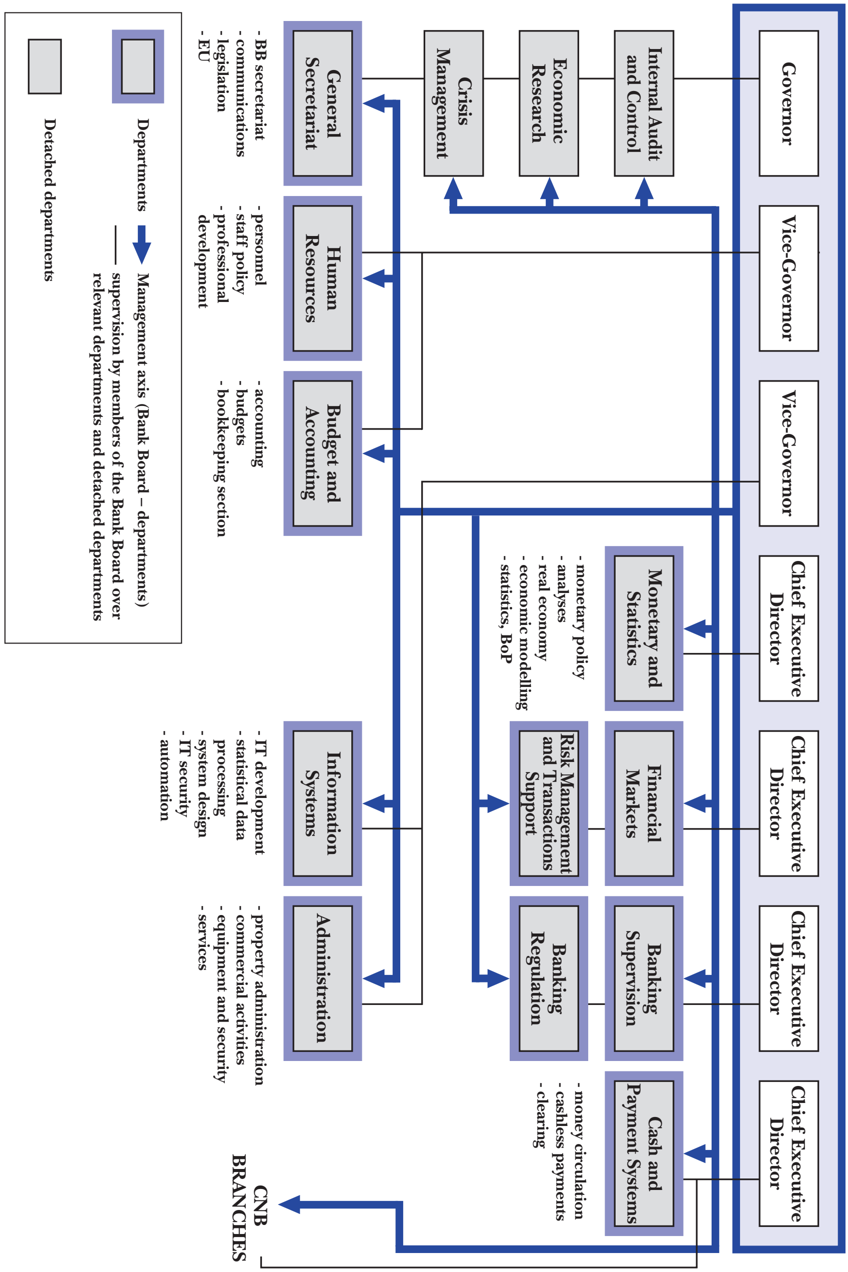
Just a few figures suffice to give an idea of the scale of ***the reconstruction of the Prague headquarters****: a floor area of 9,600 m^2, one-third of which specially equipped for particular banking activities (clearing, dealing, cash operations, computer centre) and an enclosed space of 316,000 m^3. The former Živnobanka banka building had been in operation for 60 years without any repairs or maintenance work, while the highly dilapidated Commodity Exchange building had been in service for 100 years. The costs of the reconstruction ran to CZK 5.1 billion. Besides the premises given over exclusively to meeting the central bank's main tasks the reconstruction project also involved building a Congress Centre, significantly extending the CNB's Special Library for the public, and building a money exhibition.*

Fundamental changes were made to the system environment by implementing state-of-the-art communications, database systems and Internet technology. The CNB's computer network was turned into a sophisticated and highly integrated system of technologies and applications. Emphasis was placed on standardisation in order to reduce the acquisition, maintenance and development costs. These IS/IT changes had also been necessitated by sharp growth in the quantity of data for processing. For example, in 1992 the then Czechoslovak interbank system had processed less than 60 million transactions, worth around CZK 7 trillion. Last year, it was almost 300 million transactions totalling CZK 110 trillion. The Short-term Bond System has shown similarly large increases. Considerable financial resources also had to be channelled into cash operations, for instance to purchase sorting machines capable of processing up to 60,000 banknotes an hour.

The cost-effectiveness of the construction investment, information technology and other equipment purchased is shown indirectly by the fact that the cash and non-cash circulation of money is proceeding smoothly, securely and quickly and there has never been a breakdown or system failure. Moreover, the CNB's approach to protecting the currency from alteration and counterfeiting is much valued by experts and the general public. The efficiency of the central bank's work is also confirmed by the fact that it has reduced its workforce by some 300 people since 1995.

ANNEX 3

ORGANISATIONAL CHART



ANNEX 4

WHERE CAN I FIND OUT MORE...?

The Czech National Bank provides financial professionals and the public with relevant information through a range of regular and occasional publications and in particular via its website http://www.cnb.cz. The website offers a full range of up-to-date information not given in this brief overview (such as information and documents issued by particular specialised departments of the CNB, press releases, and articles and speeches by Bank Board members). Enquiries and requests should be sent to the following address: info@cnb.cz

Regular publications:

- ***Inflation Reports*** (published quarterly in Czech and English in printed form, on CD-ROM and on the CNB website)
- ***Financial Reports*** (submitted to the Chamber of Deputies of the Czech Parliament in accordance with the CNB Act; published in Czech and English on the CNB website and on CD-ROM with the CNB Annual Report)
- ***Annual Reports*** (published once a year in Czech and English in printed form, on CD-ROM and on the CNB website)
- ***Banking Supervision*** (published once a year in Czech and English in printed form, on CD-ROM and on the CNB website)
- ***Balance of Payments*** (published once a year in printed form and on CD-ROM in Czech only and on the CNB website in Czech and English)
- ***Statistical publications*** (balance of payments statistics, current account of the Czech Republic – geographical breakdown, indicators of monetary and economic development, banking statistics – Monthly Bulletin, monetary instruments and prudential rules for banks, foreign direct investment, balance of payments reports. Published on an ongoing basis in Czech and English in printed form and on the CNB website)
- ***Working Paper Series*** (research papers published on an ongoing basis in printed form and on the CNB website in English only)
- ***CNB Internal Research and Policy Notes*** (published on an ongoing basis on the CNB website in English only)
- ***Minutes of the CNB Bank Board meetings*** (published in Czech and English on the CNB website and subsequently in the CNB's Inflation Reports)

Occasional publications:

- ***The Czech National Bank's Forecasting and Policy Analysis System*** (March 2003; in English only)
- ***Inflation Targeting in Transition Economies: The Case of the Czech Republic*** (A collection of papers issued on the occasion of the IMF/WBG Meetings in Prague in September 2000 – in English only)
- ***Workshop on Inflation Targeting*** (April 1999, in English only)

- ***A collection of lectures from the conference in honour of the 70th anniversary of central banking in the Czech Republic*** (April 1996; in Czech and English)
- ***Měnová politika v české historii (Monetary Policy in Czech History)*** (F. Vencovský, June 2001; in Czech only)

(Note: Except for "Monetary Policy in Czech History", all the occasional publications listed above can also be found on the CNB website)

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