Updated Strategy for Dealing with the Exchange Rate Effects of Foreign Exchange Revenues of the State

1. Introduction

The January 2002 *Strategy for Dealing with the Exchange Rate Effects of Capital Inflows from Privatisation of State Property and from Other Foreign Exchange Revenues of the State* (hereinafter the "Strategy") has proved to be an effective tool enabling the Government of the Czech Republic and the Czech National Bank to contribute to stabilising the exchange rate and thus also the overall macroeconomic environment of the Czech Republic. Following a sharp appreciation in 2001–2002, the exchange rate underwent a correction and was subsequently relatively smooth, even though major privatisations were carried out in that period. The privatisation revenues of the state were converted into CNB international reserves and thus did not affect the foreign exchange market. The Government covered part of the CNB's losses arising from the increase in reserves and associated with the gradual appreciation of the koruna against the major reserve currencies.

After a period free of any major privatisations, some major strategic businesses can be expected to be privatised in the coming years. The conversion of these revenues on the foreign exchange market could have significant undesirable effects. The sharp appreciation of the koruna in late 2007/early 2008 makes it all the more important to prevent such effects. If this appreciation were to persist, it could adversely affect the Czech economy. The Czech Government and the central bank therefore need to clearly reaffirm their joint responsibility for the exchange rate and to build on the tried and tested mechanisms of the 2002 Strategy. This time, however, it is also necessary to take into account the changing nature of the challenges for public budgets and the postponement of the expected euro adoption date beyond the originally envisaged horizon.

Another new phenomenon that has emerged since the Czech Republic joined the EU in 2004 is the flows of funds between the Czech Republic and the EU budget. These flows have so far been realised for the most part via accounts at the CNB, which has conducted currency conversions to the debit of its international reserves without any impact on the koruna's exchange rate. However, considerations regarding the "hedging" of EU fund inflows against exchange rate appreciation, which have been in the public eye recently, may cause the exchange rate to appreciate. It is therefore necessary to clarify and communicate to the public the mechanism for converting flows of funds between the Czech Republic and the EU in order to avoid such undesirable effects on the foreign exchange market. At the same time, there is room for discussion of the specific conditions of the services provided by the Czech National Bank to its government sector clients in connection with the inflow of EU funds so that such conditions meet the needs and interests of both parties.

Since the inflow of EU funds is currently a more topical issue than future privatisations, it is addressed first in this document. Privatisation revenues and other related issues are dealt with subsequently.

2. Financial flows between the Czech Republic and the EU – description of the issue

On joining the EU in 2004, the Czech Republic became both a contributor to the joint EU budget and a recipient of funds under specific EU policies. About 98% of the funds between the Czech Republic and the EU have so far flowed through the CNB, where the European Communities (hereinafter the "EC") have two accounts (a foreign currency account and a

koruna account). Only a small part of the funds for Community programmes is paid directly from Brussels. These cover smaller-scale projects, for example in education or culture.

The CNB also maintains:

- the Ministry of Finance's accounts from which own resources are transferred to EC accounts (and budgetary compensation is received to prevent the Czech Republic's position vis-à-vis the EU from deteriorating);
- the two main accounts of the National Fund of the Ministry of Finance for receiving funds for structural operations from the EC account;
- payment unit accounts, from which funds are distributed to individual projects;
- the Ministry of Agriculture's account for receiving Common Agricultural Policy funds;
- pre-accession aid and transition facility accounts (currently being wound up).

The EC accounts and the counterparty accounts on the Czech side are maintained in CZK or EUR. Movements on and between the accounts and conversions of funds from CZK into EUR and vice versa are conducted on the basis of client orders, for conversions at the CNB's purchase/sale exchange rate to the debit/credit of the central bank's international reserves. This means that the vast majority of currency conversions of financial flows between the Czech Republic and the EU are conducted on accounts with the CNB, i.e. off the foreign exchange market, and thus do not directly affect the exchange rate.

Own resource payments and, where appropriate, funds from Brussels go onto the EC accounts with the CNB. These payments are made in CZK in monthly cycles based on the Council Decision on the system of the ECs' own resources. Funds transferred by the Czech Ministry of Finance to the EC budget are the primary source for drawing on funds by the Czech side. The EC subsidises the account from Brussels where necessary, i.e. in the event of a significant net inflow of funds into the Czech Republic.

EC funds are received partly through the account of the Czech Ministry of Agriculture (Common Agricultural Policy payments) and partly through the Czech Ministry of Finance's National Fund, which handles payments related to structural operations. Revenues from the structural funds are realised in accordance with the National Development Plan for 2004–2006 or, where applicable, the Operational Programmes for 2007–2013. The funds are paid to final recipients in advance (pre-financed) from the state budget in CZK after specified conditions have been met. The projects are co-financed by Czech entities from public budgets or from private sources.

Final recipients apply for funds for projects co-financed from the EU with managing authorities (applications for the 2007–2013 programming period are in CZK).[1] The managing authorities release funds for national co-financing and pre-financing of EU funds from the state budget (in CZK). Subsequently, the managing authorities apply to the National Fund, which administers EU funds (in EUR), for a refund of money paid from the state budget (in CZK). As soon as the National Fund receives the application from the managing authority, it releases the required sum in CZK into the budget chapter from the EU funds on its accounts[2].

[1] For programmes for the 2004–2006 programming period, payments are made to final recipients in either Czech koruna or euro, with the currency of the payment depending on the currency of the agreement between the final recipient and the supplier. For the 2007–2013 programming period, payments are made to final recipients in koruna only, with the exception of payments to recipients under the Operational Programme Cross-Border Cooperation Czech Republic – Polish Republic, which are made in euro.

[2] The National Fund is a recipient of advance payments, set as a specified percentage of the programme's total allocation with the structural funds and cohesion fund for each year.

At the same time, at the request of the managing authority, it draws up an application for further EU funds (ongoing payments), converting the application from CZK to EUR at the ECB's exchange rate (set on the last business day of the previous month). Since the National Fund pays funds in CZK converted from EUR at the CNB's current exchange rate, but applies for EU funds based on koruna applications converted into EUR at the ECB's exchange rate set at a different point in time, an exchange rate difference arises, which is paid from the state budget. An appreciating exchange rate generates an exchange rate loss, while a depreciating exchange rate generates an exchange rate profit.

Since the total programme allocation – approved in a European Commission decision – is specified in EUR, an appreciation of the koruna also has an impact in the form of reducing the koruna equivalent of this allocation. The koruna value of the allocations to individual managing authorities thus declines. This has recently given rise to extensive media coverage of the issue and to considerations of possibly "hedging" the future inflow of EU funds against exchange rate risk. Such considerations are having negative consequences, because:

- Any such "hedging" transactions would mean that the commercial financial institutions acting as counterparties in such transactions would in all probability hedge their exchange rate risk by means of spot transactions on the foreign exchange market, thus exerting upward pressure on the exchange rate of the koruna.
- Mere speculation on such transactions may have a psychological impact on foreign exchange market participants and trigger an appreciation. Given the expected strong inflow of EU funds into the Czech Republic, this impact may be significant.
- Any significant appreciation of the exchange rate would have negative impacts on the Czech economy. An undesirable situation might thus arise where, by contrast, funds from EU programmes and projects intended to speed up the real convergence of the Czech economy would slow down such convergence. At the same time, the appreciation of the exchange rate would reduce the koruna equivalent of the future inflow of EU funds into the Czech Republic and thus exacerbate the problem.
- Hedging against exchange rate movements off the foreign exchange market by means of (spot or future) purchases of EUR into the CNB's international reserves would only mean further transmission of the risk of potential losses to the central bank. This is not justified given the fiscal nature of the inflow of EU funds.
- Payments to final recipients of funds under EU programmes and projects in the 2007–2013 programming period are made in CZK.[3] These entities are therefore not exposed to any direct exchange rate risk against which they might hedge.[4] So, for these entities, any "hedging" transactions would be purely speculative, involving the opening of short foreign exchange positions in EUR. This would entail accepting exchange rate risk, which is undesirable in terms of the prudential management of public institutions.
- The managing authorities should concentrate on high-quality logistical preparation for drawing on EU funds, in order to make maximum use of the allocation of funds to the Czech Republic. In a situation where not all funds have been fully drawn on, the declining koruna equivalent of the euro allocation is, to some extent, a virtual problem.

[3] Except payments to recipients under the Operational Programme Cross-Border Cooperation Czech Republic – Polish Republic, which are made in euro.

[4] One possible exception applies to applicants who cover part of their project implementation costs in euro, but receive funds in koruna. In such cases, hedging against depreciation of the koruna, and not the – recently discussed – hedging against appreciation, would come into consideration. However, it is difficult to estimate the extent of such cases, as the necessary data do not exist.

Efforts to resolve it might distract attention from the primary issue of preparing and implementing high-quality projects.

The solution to the problem described above is contained in points (1) to (6) of the draft agreement between the Czech Government and the CNB.

3. Future privatisation revenues – description of the issue

There are few strategically important corporations left to be privatised. In some cases, however, the potential revenues amount to billions of EUR. It is therefore necessary to know how these large sums will be dealt with in terms of currency conversions and to inform the market of the chosen solution well in advance.

The 2002 Strategy was based on the assumption that the best solution is to hold privatisation revenues (and other government foreign exchange revenues) as far as possible on a foreign exchange account with the CNB and to use them as and when necessary to repay the state's foreign exchange liabilities without having to convert them into koruna. However, previous privatisations have seen large conversions of funds into koruna to the debit of the CNB's international reserves. The situation now is very different. At the current stage of development of the Czech economy, there are no longer any large transformation costs needing to be paid by the Government, and the need to finance the state's current deficits is decreasing thanks to the gradual consolidation of public finances. By contrast, tackling the sustainability of public finances, including the implementation of the pension reform, is gaining prominence. There is thus an opportunity to set up a fund to finance the costs of this reform from the proceeds of privatisation. This fund could hold foreign exchange assets.[5] The option of holding most of the privatisation revenues without converting them into koruna thus seems significantly more realistic than in the past and should be used as much as possible.

If it still proves necessary to convert part of the privatisation revenues into koruna, these conversions should be performed in such a way as not to affect the exchange rate. As in the past, however, any conversions of privatisation revenues into koruna to the debit of the CNB's international reserves may be associated with expected losses for the central bank, stemming mainly from appreciation of the koruna.[6] Given the current large volume of international reserves and the related high accumulated loss in the CNB's balance sheet stemming from the appreciation of the koruna's nominal exchange rate, and also given the future additional load on the CNB resulting from the accumulation of international reserves through the purchase of the net flow of funds between the Czech Republic and the EU authorities, the CNB has minimal scope for accepting further losses. As in the 2002 Strategy, it is therefore necessary to find a mechanism that will largely offset the CNB's expected future losses or leave them entirely on the shoulders of the Czech Government.

The 2002 Strategy used the mechanism of a conversion fee substantially in excess of the usual market fee to compensate the CNB for its expected future losses associated with the increase in the international reserves. The fee was set in such a way as to encourage the latest possible conversion of privatisation revenues into koruna, as it declined gradually from 9% in 2002 to 0% in 2007 (in the expectation that euro adoption would be imminent by that time). With the benefit of hindsight, however, this mechanism seems suboptimal. Its main drawback is the

[5] Like the funds set up in some countries to collect significant foreign exchange revenues from exports of energy-producing commodities.

[6] Or, more generally, stemming from the fact that the costs of sterilising international reserves in the form of the two-week repo rate exceed the CNB's koruna income on international reserves in the long term. However, the loss is essentially reduced to valuation changes if domestic and foreign interest rates are similar.

need to negotiate a fee acceptable to both parties in advance. A fee that might on the one hand seem too high to the Czech Government may on the other hand later prove to be insufficient to compensate the CNB (to which the entire risk is transferred) for its loss. Such is the experience with the 2002 Strategy. Looking back, it is clear that the fee set under the 2002 Strategy only partially compensated the CNB for its future losses, as the appreciation of the koruna systematically exceeded the original assumptions (and euro adoption was postponed beyond the originally envisaged horizon).

It is therefore proposed that the new mechanism to be used in the future should be based on a foreign exchange swap. This financial derivative is advantageous to the Czech Government, since it enables it to avoid currency conversion *de facto* and to leave the funds in foreign currency while using the koruna converted at the current exchange rate on the swap trading date. Strictly speaking, therefore, this solution is not a conversion, as it is equivalent to leaving the privatisation revenues in euro. It is a mechanism for using these funds, as and when necessary, to cover the short-term koruna liquidity needs of the Czech Government. The Czech Ministry of Finance envisages conducting such foreign exchange transactions, where necessary, under market conditions with financial market counterparties with which it has concluded ISDA documentation. However, it is also possible that the central bank will be the Government's counterparty, as the foreign exchange swap is exchange rate neutral to the CNB and no exchange rate risk would be transferred to it. The only risk associated with the swap is the risk of a change in the EUR-CZK interest rate differential, which, however, is symmetrical for both counterparties. The use of the swap would thus not systematically deteriorate the outlook for the CNB's finances and would not need to be accompanied by any compensation mechanism, the amount of which would have to be agreed in advance with the Czech Government. The foreign exchange swap may be extended (rolled) for any period of time, ideally until the adoption of the euro in the Czech Republic.

The proposed measures for dealing with the Czech Government's future privatisation revenues are summarised in points (7) to (9) of the draft agreement between the Czech Government and the CNB.

4. Other related issues

In the 2002 Strategy, the Government pledged that the Ministry of Finance would not issue in foreign currency that year. This helped to calm the foreign exchange market. Although several foreign currency bonds were issued in the years that followed, most of them were hedged against exchange rate risk so as not to significantly affect the exchange rate.[7] This practice should be continued. No matter how appropriate it is in terms of efficient state debt management to leave open the option of issuing bonds on foreign markets, issues with exchange rate effects would ultimately be disadvantageous to the Czech Government and the CNB because of their macroeconomic implications and adverse impacts on the koruna value of EU programme allocations and the CNB's international reserves. That is why the measures under point (10) are set out in the draft agreement between the Government and the CNB.

[7] The exception being an issue of yen-denominated bonds in January 2006.