

Selected parts of the document approved by the Government at its session on 16 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”**

**PART I**

**Draft  
RESOLUTION**

The Government

*approves* the method proposed for dealing with the exchange rate effects of privatisation and other foreign exchange revenues of the State in Part III of this Document. Specifically:

1. In 2002 the Ministry of Finance (MoF) will not issue bonds denominated in foreign currencies.
2. In 2002 the ministries and selected state-owned institutions will, in co-operation with the MoF and the CNB, meet their foreign exchange commitments out of the proceeds from privatisation.
3. The National Property Fund's proceeds from the sale of Komerční banka set aside for settling the costs and losses of the Czech Consolidation Agency (ČKA) by Government Resolution No. 661/2001 will not be converted on the foreign exchange market. The ČKA will obtain a partial koruna equivalent through a transaction with ČMZRB according to the mechanism described in item 3 of Part III of this Document. The remainder will, where required, be converted directly by the CNB according to the mechanism described in item 3 of Part III of this Document.
4. Priority in dealing with other ČMZRB, or MUFIS, foreign exchange commitments will be given to converting koruna into euro with the ČKA.
5. ČEB will ensure its prospective needs for financing foreign currency assets through a transaction with the State according to the method specified in Part III.
6. The MoF will keep the funds acquired from the de-blocking of Russian debt on the CNB's foreign exchange account until at least 31 May 2002. The conversion of these funds into koruna will be dealt with in accordance with item 3 of Part III of this Document.
7. With respect to the State's commitments towards the CNB connected with banking sector consolidation and the division of the Federation, an amount with a koruna equivalent of CZK 25 billion will be deposited on a foreign exchange account at the CNB. The terms and conditions of maintenance of this account will correspond to the mechanism proposed in Option 3 in Part III of this Document...
8. The remaining foreign exchange resources of the State (both the existing resources and those acquired in the future) which will need to be converted to koruna will be purchased directly from the State into the CNB's foreign exchange reserves. To offset partially the future losses of the CNB arising from the sterilisation of these additional foreign exchange reserves, the CNB will charge the State a fee for direct conversions of foreign exchange revenues in accordance with Option 3a in Part III of this Document.

## PART III

### **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**

#### Description of the problem

The nominal foreign exchange rate of the koruna appreciated throughout 2001 against the euro and against the weighted basket of currencies of the Czech Republic's trading partners (known as the nominal effective exchange rate). This trend accelerated strongly in the last months of the year. The current exchange rate represents a year-on-year appreciation of the koruna against the euro of almost 10% (despite reflecting a certain correction recently following the announcement of an agreement between the Government and the CNB addressing the exchange rate effects of privatisation revenues).

In conditions of a substantially narrower inflation differential than in the past, a certain nominal appreciation of the exchange rate can be regarded as a balanced phenomenon reflecting the improving competitiveness of the Czech economy on international markets. However, the present pace of this appreciation is not due solely to improving competitiveness. Underlying it are market expectations that, in line with the Government's pronouncements, the year 2002 will see a multiple increase in privatisation proceeds in the Czech Republic and that sooner or later these revenues will – to a comparatively large extent – have to be converted on the foreign exchange market. (Other foreign exchange revenues of the State which need to be converted into koruna are having the same effect. This Document therefore assumes that these cases will be treated in the same way as the privatisation revenues.) It is also evident that privatisation itself – chiefly concerning the services and power-generation industries – has no direct impact on the growth potential of the economy and its export capacities. So, it can be concluded that the exchange rate is at present being determined primarily by the Government's measures, with no direct relationship to the balanced development of macroeconomic fundamentals. The balance of payments data show that no inflow of short-term debt capital is being registered. This means that the strong exchange rate is not due to speculation on the interest differential. For this reason, interest rate policy has little chance of helping to curb the pressure on the exchange rate.

The risk is moreover increased by the fact that the appreciation of the koruna comes at an inconvenient period, as it is combined with the effects of a downturn in economic growth around the world, and particularly in the EU, which is the Czech Republic's main trading partner (accounting for around 70% of Czech exports). This unfavourable combination could, if protracted, harm the competitiveness of Czech exports, significantly decrease economic growth in the Czech Republic and cause GDP to depart from its balanced level again. The present combination of factors also presents a risk for the current account, i.e. for the external balance of the Czech economy. Sooner or later the exchange rate would have to weaken back to its fundamentally justified value, but the aforementioned exchange rate fluctuations would have negative consequences for the economy.

In such a situation it is necessary to point out the joint responsibility of the Government and the central bank for exchange rate developments, which both sides accepted in 2000 in a document *Monetary Policy Strategy in a Period of Foreign Capital Inflow*. The mechanisms defined in this document have not always been entirely fulfilled, but in some phases they have

nevertheless helped to diminish the appreciation pressures on the exchange rate. Now, though, when privatisation proceeds many times exceeding any previous transactions are expected, these mechanisms are proving insufficient. This is the result, inter alia, of the public budget deficits, which require the use of privatisation proceeds to partially cover public spending.

Consequently, the CNB and the MoF have agreed that the existing co-operation mechanisms for dealing with the inflow of privatisation revenues need to be improved and expanded. The aim is to send the market a clear and indisputable signal that privatisation proceeds will not be allowed on the foreign exchange market in the period ahead.

The proposed strategy is based primarily on the assumption that the best solution is to keep the privatisation revenues (and other foreign exchange revenues of the Government, e.g. from the de-blocking of its foreign receivables) to the maximum possible extent on a foreign exchange account at the CNB or to use them without the need for conversion into koruna. To this end, an inventory has been drawn up of the existing and potential foreign exchange commitments of the State in its broad sense (i.e. including entities repaying their foreign currency credits out of state subsidies, entities which are linked to the State's finances through government guarantees etc.). The State's foreign exchange revenues from privatisation will be used to the maximum possible extent for future payments arising from these commitments.

One of the elements of this mechanism, however, must be direct conversion of the State's foreign exchange revenues into CNB foreign exchange reserves. This is the only way to ensure that the State's foreign exchange revenues will be available to cover its current koruna needs without entering the foreign exchange market. However, one should be aware that this type of transaction transfers certain costs which are fiscal in nature to the central bank. These costs ensue from the fact that the costs of sterilising foreign exchange reserves in the form of the two-week repo rate exceed in the longer term the sum of the CNB's interest rate and exchange rate income from its foreign exchange reserves. The CNB considers an average annual level of 2% of the additionally purchased foreign exchange reserves up until the Czech Republic's EMU entry to be a realistic estimate of this quasi-fiscal cost (this expected to be higher during the initial phase and to fall gradually with continuing convergence towards the eurozone). Based on the assumption of EMU entry in 6 to 7 years, the net present value of the CNB's cumulated loss from this transaction would amount to 11%–13% of the original amount (i.e. in the order of tens of billions of koruna). Given the past losses from banking sector stabilisation and from exchange rate changes, the CNB is unable to bear an additional loss of this magnitude, since it could undermine confidence in its financial stability.

This Document therefore proposes a method for involving the State in covering the sterilisation losses. This involvement reflects the fact that the loss is directly associated with the privatisation process and that it is therefore correct to "debit" it from the privatisation revenues. It also reflects the fact that if the privatisation proceeds were to be sold on the market, a substantial one-off appreciation of the exchange rate would occur which would decrease the koruna value of the State's foreign exchange revenues. The fee can thus be regarded by the State as a kind of "investment" aimed at eliminating this exchange rate effect. In other words, the State will receive a similar amount in koruna after paying the fee as it could realistically expect from selling its foreign exchange revenues on the market. In addition, compared with the latter option the economy will save considerable costs linked with unbalanced appreciation of the exchange rate and a subsequent, no-less-costly, correction.

To address this situation, the following set of measures has been proposed.

### Proposed solutions

1. The specific steps – based on the inventory of existing and potential foreign exchange commitments – will be as follows:
  - In 2002, the MoF will not issue bonds denominated in foreign currencies.
  - The MoF will, without delay, require the ministries and selected state-owned institutions to enumerate their necessary foreign exchange expenditure in 2002 and make payments from funds provided from the State's privatisation revenues.<sup>1</sup>
  - The NPF's funds on the euro account with the ČKA (hereinafter referred to as "KOMB") set aside from the sale of Komerční banka for covering the ČKA's costs and losses by Government Resolution No. 661/2001 will not be converted on the foreign exchange market. The ČKA will receive a partial koruna equivalent through the conversion of approximately EUR 314 million in a transaction with ČMZRB. ČMZRB will use these euros in accordance with the "Agreement on the Provision of Financial Manager Activities Linked with the Credits Accepted from EIB, Reg. No 2001/9003" for the transformation of the receivables arising from this Agreement. This specific conversion will be effected by 28 February 2002 according to a schedule agreed between the NPF, the ČKA and ČMZRB and, given its nature, will not affect the market (ČMZRB will use the euros to repay the EIB credit in 2007–2012). Furthermore, MUFIS, or ČMZRB, will later repay USD 52 million and ČMZRB has offered to cover this need by exchanging koruna for euro with the ČKA.
  - ČEB will cover its potential needs for financing foreign currency assets through a transaction with the State using privatisation proceeds.<sup>2</sup>
  - The MoF will, without delay, look into the current status and prospective addressing of the MoF guarantee for České dráhy (Czech Railways) in respect of the EIB and propose that this guarantee be covered using the State's foreign exchange revenues.
  - The MoF will keep the funds acquired from the de-blocking of the Russian debt on the foreign exchange "CNB account" at least until 31 May 2002. Any conversion of these funds into koruna will be addressed subsequently in accordance with item 3 of Part III of this Document.
2. The preparations of future privatisation transactions will include negotiations with a privatisation consultant and with investors on payment of part of the privatisation price in koruna, financed by the investor by means of a koruna credit.
3. The remainder of the privatisation (and other foreign exchange) revenues which the State is unable to keep on its foreign exchange account with the central bank and for which it proves impossible to agree with the investor on payment in koruna will be purchased directly by the CNB into its foreign exchange reserves. (If conversion is necessary, the same mechanism will be applied to the State's other foreign exchange revenues or to the remainder of the NPF's foreign exchange deposit with the ČKA arising from the addressing of the exchange rate effects of KOMB's privatisation pursuant to Government Resolution No. 661/2001.) To eliminate or mitigate the CNB's losses from sterilising these direct conversions (and to partially address the as yet unsettled past relations between the Government and the CNB – e.g. the losses from the consolidation of the

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<sup>1</sup> Using the CNB's banking statistics, it has been determined that the amount of foreign currency needed to cover the commitments of ministries and other state institutions is about EUR 12 million per month on average.

<sup>2</sup> ČEB prospectively requires foreign currency amounting to USD 350 million and EUR 50 million for financing its planned foreign currency assets.

banking sector covered by state guarantee and the resolution of the CNB's receivable from the NBS), the following procedure will be applied:

Option 3a:

- An amount from the State's foreign exchange revenues with a koruna equivalent of CZK 25 billion will be deposited on a non-interest-bearing foreign exchange account at the CNB (derived from the current level of the State's commitments to the CNB: a CZK 22.5 billion state guarantee associated with banking sector consolidation plus CZK 2.4 billion as the unresolved part of the CNB's receivable from the NBS; this amount thus does not take into account the IPB case, which is covered by an MoF counterguarantee to the CNB). The target amount will be achieved in the course of 2002 (and maybe later) by the depositing of at least 20% of each privatisation revenue on the account up to the agreed amount. The money will be deposited on the aforementioned account up until 2007, when the State's commitments to the CNB associated with banking sector consolidation fall due. If the CNB's receivable from the State continues, this money can subsequently be used only to cover the State's commitments to the CNB.
- In 2002 the CNB will charge the State a fee for the direct conversion of privatisation revenues at a rate of 3% for the first CZK 50 billion, 6% for the part of the conversions between CZK 50 billion and CZK 100 billion, and 9% for the part of conversions above CZK 100 billion. If the limits of CZK 50 billion for conversion with the 3% fee or of CZK 100 billion with the 6% fee are not exhausted in 2002, these limits will remain in effect until they are exhausted in the subsequent period. Conversely, if the direct conversions exceed CZK 100 billion in 2002, in each of the following years the conversion will only be effected at the highest rate. At the same time, however, this highest rate will decrease by 2 percentage points a year, i.e. to 7% in 2003, 5% in 2004 and so on down to 0% in 2007.

Option 3b:

- An amount from the State's foreign exchange revenues with a koruna equivalent of CZK 25 billion will be deposited on a non-interest-bearing foreign exchange account at the CNB (derived as in Option 3a). The target amount will be achieved in the course of 2002 by the depositing of at least 20% of each privatisation revenue on the account up to the agreed amount. The account will be remunerated at the LIBOR rate minus 3/8 of a percentage point. The original amount plus interest will be deposited on the aforementioned account up until 2007, when the State's commitments to the CNB associated with banking sector consolidation fall due. If the CNB's receivable from the State continues, this money can subsequently be used only to cover the State's commitments to the CNB.
- In 2002, the CNB will charge the State a fee for the conversion of privatisation revenues. The fee will be at the lower boundary of the estimate of the ensuing costs, i.e. 10% of the converted sum. In subsequent years the fee will decrease by 2 percentage points a year, i.e. to 8% in 2003, 6% in 2004 and so on down to 0% in 2007.

This mechanism will be implemented via two agreements made between the NPF and the CNB, namely an agreement on a non-interest-bearing foreign exchange deposit of the NPF with the CNB amounting to CZK 25 billion, and an agreement on the maintenance of an NPF

account with the CNB for the purposes of converting the State's foreign exchange revenues into koruna.

Every six months after this mechanism is introduced, the CNB and MoF will jointly evaluate the medium-term trends in the economy and financial markets. If they conclude that there has occurred a substantive change compared with the scenario described in this Document (particularly with regard to the calculation of sterilisation losses), the two parties will in good faith negotiate a change to the mechanism so that the State's fee to the CNB does not exceed the economically justified level.

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The Government adopted Option 3a.