



INSTITUTO DE ESTUDOS ESTRATÉGICOS E INTERNACIONAIS

XVII INTERNATIONAL LISBON CONFERENCE

PORTUGUESE PRESIDENCY

INSTITUTIONAL REFORM AND EXTERNAL ACTION OF THE EUROPEAN UNION

Lisbon, 11 - 12 November 1999

**THE EURO INFLUENCE ON FINANCIAL CONSOLIDATION AND REGULATION IN
THE PREPARATION FOR THE ACCESSION TO EU**

(The Case of the Czech Republic)

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Preparation for accession to EU (and to Economic and Monetary Union) is a key challenge facing the economic and financial system in the Czech Republic.

To become a member of the EU the Czech Republic has to meet **two major criteria**

- to create a fully functioning market economy
- and to be able to cope with both the competitive pressures and market forces that exist within the Union.

At first sight, the Czech Republic has already progressed a long way to meeting these criteria: private enterprise is the dominant form of ownership; direct fiscal intervention is not excessive; price stability had been maintained and a high degree of trade integration with the EU has been established.

The Czech Republic has indicated that it accepts and will comply fully with the EMU acquis as defined by title VII of the EC Treaty and the other relevant texts. It has also stated that the administrative structures to implement and enforce the acquis will be in place.

But according to Regular Report 1999 (/2/, p. 37), **the Czech Republic has made little additional progress in its preparation for participation in Economic and Monetary union**. As regards the acquis that has to be implemented before accession, the legislation on privileged access of public authorities to financial institutions is in conformity with the acquis, as is that on the independence of the Czech National Bank. However, the legislation on the central bank still provides for the possibility to provide short-term credits to the government by purchasing State treasury bills within three months of their purchase.

Compliance with the EMU acquis is conditional on completion of the process of liberalisation of capital movements.

According to assessment in terms of **the Copenhagen criteria** (/2/):

The Czech Republic can be considered to be a functioning market economy.

However, there are still some structural problems, related to remaining shortcomings in the legal framework and problems of enforcement. Priorities for reform should include

- * the completion of the bank privatisation process;
- * a cleaning up of banks' portfolios;
- * further measures to improve corporate governance.

There should be increased transparency in the public accounts to prevent a further accumulation of liabilities by public institutions. It is also important that the authorities adopt policies to restore economic growth and ensure sustainability of the external accounts over the medium-term.

The Czech Republic should be able to cope with competitive pressures and market forces within the Union in the medium term, provided that it implements the remaining necessary structural reforms swiftly. The authorities need to concentrate on developing an environment supportive of business activity, and thus conducive to economic growth. In this respect, the improvement of the legal framework, the strengthening of corporate governance, the acceleration of enterprise restructuring, and the continued reform of the financial markets, are essential. This will result in more efficient enterprise and banking sectors and lead to sustained increases in productivity and competitiveness.

Two important documents with great consolidation and regulation capacity for financial sector and total economy (and for preparation the accession to EU) have been adapted:

- **Czech National Bank Monetary Strategy** (approved by the Board of the Czech National Bank on 8 April 1999)
- **Joint Assessment of the Economic Policy Priorities of the Czech Republic** has been agreed with the European Commission (on the basis of the adapted "Economic Strategy of the Accession to the European Union" by the Czech government in May 1999).

The CNB Monetary Strategy is a basis for **monetary policy co-ordination with the economic policy** of the government and the Joint Assessment of economic policy priorities includes **both macroeconomic and structural policy measures**.

1. Basic Features of the Monetary Policy

The Czech Republic accession to EU in itself is not tied to any quantitatively specified criteria for price and monetary stability. Nevertheless, **as early as in this phase it is desirable to create conditions for keeping inflation and the interest rate differential as low as possible**. This already ensues from the necessity of creating preconditions for closer links of Czech currency with the euro, regardless of whether the rules for the current exchange rate system (ERM II) will apply to new EU member states, and thus to EMU candidates, or whether the scheme will be adjusted. It is also

possible **that there will not be a significant gap between the Czech Republic's entry into the EU and into EMU.**

Accession to the eurozone is tied to the fulfillment of a set of macroeconomic criteria, including price and monetary ones. The current member states qualified for membership by meeting the Maastricht convergence criteria¹.

The substantial gap in price levels will be the principal problem of the Czech Republic's accession. This view has been fostered by the fact that, at present, the **price level in the CR is only 43% of the EU average** and international comparisons (eg with Poland and Hungary) indicate that the difference is bigger than would correspond to our economic level. From this it is concluded that if the gap is maintained, or even if it is narrowed somewhat, it will be a destabilising factor in our accession to the EU, or may even prevent it altogether. Under this line of reasoning, attempts to stabilise at low inflation are in fact undesirable or even counterproductive.

The **convergence processes in the price area** will necessarily continue also after the Czech Republic's accession to the EU. These are long-term processes, with inertia and many barriers. After all, this is exactly what the experience of the EU countries documents. Even after decades of a single market and integration processes, the price levels of the member states continue to differ by up to $\pm 30\%$ from the EU average.

To achieve a balance between economic growth and price and monetary stability, it is desirable that the main parameters of the long-term inflation target be the result of a joint assessment and consensus between the government and the central bank (CNB).

The CNB proposes that **the long-term inflation target** for year-on-year net inflation be specified in the form: $2\% \pm 1$ percentage point; this target should be achieved in 2005.

This proposal is based on the assumption that **the Czech Republic's accession to the EU can be expected sometime between 2003 and 2005.**

¹ In the price area, the criteria require that inflation measured by the year-on-year consumer price index (CPI) not exceed the average of the three countries with the lowest inflation by more than 1.5 percentage points. At the same time, nominal long-term interest rates in candidate countries must not exceed the average value of the three countries with the lowest inflation by more than 2 percentage points. In addition, it is required that the exchange rate be included in the ERM exchange rate systems for at least two years prior to EMU entry and fulfil its stability criteria.

Given the ongoing adjustment of relative prices and the certain distortion in expressing changes in the quality of goods and services, as well as in technological progress, the European Central Bank has defined price stability as inflation of less than 2%.

The proposed mid-value for the long-term inflation target, and consequently the definition of the price stability category for the Czech economy, is slightly higher than the target declared for eurozone countries by the European Central Bank. This primarily reflects the fact that the probable extent of the distortion of price indices due to changes in the quality and range of goods and services, as well as to the more intense adjustment of relative prices in the still transforming Czech economy, will continue to be larger than in eurozone countries.

A comparison of the proposed long-term target for 2005 ($2\% \pm 1$ percentage point) and the current medium-term target for the year 2000 ($4.5\% \pm 1$ percentage point) shows that the long-term target establishes only a very slow trajectory toward price and monetary stability. A linear trajectory (from which the reality will deviate to a greater or lesser extent in individual phases) would mean net inflation falling by about 0.5 percentage points a year. In essence, this involves creating the prerequisites for stabilising the disinflation that has already been achieved and for completing the shift to a low-inflation economy.

In locating the realistic alternatives for the Czech Republic's accession to the EU in the period between 2003 and 2005, **the CNB regards it as justified to consider the 2005 horizon as the period for attaining price and monetary stability.** A comparison of the potential costs and effects for the possible alternatives, ie for 2003 in particular, confirms the legitimacy of this choice.

In forthcoming years, the CNB will announce its **inflation targets** based on an assessment of new information and forecasts to ensure that the long-term inflation target is met within the projected horizon and at minimal cost. When setting the upper and lower limits of the corridor for its targets, the CNB will be guided by the principle that the setting and implementing of these targets must not:

- generate an acceleration in inflation (allowing for exogenous and temporary influences),
- be directed below the price stability level, defined as $\% \pm 1$ percentage point.

Achieving and **maintaining price and monetary stability is one of the preconditions for long-term development for the small and very open Czech economy.** It is also an inevitable prerequisite for future integration into the EU and EMU. It is in the common interest of the government, central bank and all other entities, including trade unions, to achieve this goal at minimal cost.

Analyses clearly show that **with a co-operative approach and credible inflation targets shared by economic entities, it is possible to achieve the objective of**

price and monetary stability within the proposed horizon of 2005. Moreover, the positive development of inflationary expectations, reduction of transaction costs and better flexibility and adaptability of the economy can **minimise the costs accompanying the above process.** In contrast, with non-cooperative decision-making and behaviour it is necessary to rely more on restrictive economic policies. Under such conditions, the costs, in the form of negative effects on aggregate economic output and employment, could be much higher, or the time horizon for meeting the long-term target might have to be prolonged.

The economic policy of the government, especially in the fiscal and wage-income areas, and **the monetary policy** of the central bank **are communicating vessels and create the overall macroeconomic environment in the economy.** Even though specific conditions change over time and in individual phases, as does the appropriateness of the settings of the above policies, the general trend should not be one of a tight monetary policy subsequently off setting or counterbalancing excessively relaxed wage-income or fiscal dimensions. On the contrary, the conditions of the still transforming and, at the same time, very open Czech economy should normally require a prudent wage-income policy combined, as far as possible, with a more relaxed monetary policy.

In the present environment of **increasing globalisation of capital flows**, the vulnerability of small, open economies (which are not sufficiently shielded by co-operation with the dominant institutions and monetary authorities in their regions) is increasing. **The Czech economy has a substantial degree of openness, and its economic and price development is sensitive to trends and changes in its external environment.** It is therefore desirable to **co-operate with international institutions**, reduce in-built uncertainties and eliminate the unfavourable consequences of any deviations and the possibility of these being reflected in the decisions of foreign investors and domestic market participants.

2. Macroeconomic Scenarios

The Joint Assessment has been based primarily on the government's "Economic Strategy of EU accession – Competitiveness, Growth, Employment, Solidarity" of May 1999. This document includes a wide range of policies. In particular, the long-term monetary strategy of the central bank (CNB), and medium-term fiscal projections produced by the government, have been important contributing documents to this Joint Assessment.

The main objective of the economic policy of the Czech government is to

- meet the Copenhagen criteria,
- and to close the gap in GDP per capita between the Czech Republic and the European Union. To this end, the medium-term target for economic growth has been set at 2 to 3 percentage points above GDP growth in the EU. In a break with the past, economic policy is to be pursued with greater attention to sustained increases in the competitiveness of the Czech economy, rather than focussing too much on macroeconomic policy.

The Joint Assessment outlines **two quantitative macroeconomic scenarios**. The scenarios extend to the year 2005 and serve as an illustration of the likely macroeconomic outlook under different policy choices.

The more optimistic main scenario, the "pro-growth" scenario, assumes that the government adopts proactive macro and micro economic policies designed to eliminate the remaining structural weaknesses in the economy and promote competitiveness. This pro-growth **scenario projects**

- low but positive **annual GDP growth** of an average 2.1 % between 2000 and 2002, accompanied by a rise in unemployment due to accelerated economic restructuring. This would be followed by much higher growth of 5 % per year from 2003 onwards,
- **consumer price inflation** edges up in the first three years, partly as a result of the final steps of price deregulation, which will be completed by 2002. Nevertheless, the underlying trend in net inflation is downwards, and the scenario is fully compatible with the Czech National Bank's proposed long-term target of 2 % (± 1 %) for the end of 2005,
- **the general government deficit** is reduced from over 3% of GDP in 2000, or more than 5 % before net lending, to sustainable levels after the year 2002,
- **the current account of the balance of payments** is projected to return close to balance by 2002.

The aim of the Joint Assessment is to help in the prioritisation of policies and in their sequencing. Economic priorities and the timetable for the completion of social and structural reform have to be set realistically and carefully. If the government tries to do too much over too short a period, it will quickly run into significant budgetary constraints. The accumulation of high general government deficits will prove unsustainable in the long run and make it difficult for the monetary authorities to be more accommodating. On the other hand, if the government fails to tackle the high

levels of mandatory expenditures on the public budgets, and fails to make the public finances more transparent, it is likely to encounter the same problem even without having set the necessary reforms in motion.

The only way out of this dilemma is the route chosen by the current government, which is the same as that followed by EU governments in the run up to EMU:

- public finances need to be made completely transparent and hidden debts must be revealed,
- the remaining administered prices should be liberalised in accordance with a clear timetable.

This will allow monetary policy to be based on the convergence at a reasonable pace of inflation rates to euro-zone levels, and will help to build a lasting social consensus behind the need to keep real wage increases below the trend of labour productivity improvements. For this, it is essential that wage bargaining is based on forward-looking inflationary expectations and that the monetary authorities provide an explanation to the public when they are not able to keep inflation within the specified target range. In turn, the need to maintain a sufficient degree of exchange rate stability will act as an indispensable disciplinary force on the fiscal authorities.

Co-ordination and consensus are key words in the formulation and implementation of economic policy in the Czech Republic. An important prerequisite for an appropriate mix of economic policies is a regular exchange of views between the government, social partners, and the Czech National Bank (CNB), notwithstanding its independence.

The central bank (CNB) has a statutory responsibility to ensure the stability of the currency. Monetary policy aims to achieve currency stability by maintaining price stability at minimal cost and without excessive fluctuations in economic output and employment. Although in transition economies some overall inflation can be helpful in accommodating relative price adjustments, **the Czech monetary authorities consider high inflation to be very unstable and volatile, and certainly inappropriate for a small open economy.** Therefore, the CNB is trying to consolidate on the progress made so far in reducing inflation, and to converge gradually to the low inflation rates prevailing in the EU.

The main instrument of monetary policy is **interest rates**. The delays with which interest rate changes are transmitted, and their eventual impact on inflation and the volume of credits are, however, difficult to estimate. In addition, the indirect effects of

changes in these rates on exchange rate stability in an environment of liberalised capital movements cannot be ignored. Moreover, these effects are, more uncertain for rapidly developing economies than for more mature economies. Monetary policy in catching-up economies is successful when it combines the containment of nominal exchange rate fluctuations with real exchange rate appreciation reflecting the prospect and realisation of productivity growth and quality improvements. Exchange rate stability achieved within a regime of managed floating and liberalised capital movements is a strong indication of sound economic policies and political stability.

In principle, **the Czech Republic can join the EU with any exchange rate regime between the current managed float and a full peg to the euro.** Although it is premature to consider the change of the present regime to a more fixed exchange rate arrangement, the CNB and the government recognise that current policy must position the economy for ultimate adoption of the euro as currency. The appropriate timing for adoption of the single currency will require a high degree of fundamental convergence with the EU. **A key consideration for the decision on full membership of the euro-zone will be the long-term sustainability of public finances – it is also one of the main challenges facing the Czech government at present.**

The general **government budget** of the Czech Republic moved from moderate surpluses to small deficits up until 1998, to an estimated deficit for 1999 of 3.3 % of GDP. The expected deficit figures include the use of resources to cover state guarantees and indirect liabilities. Overall, **the gross "hidden" debt** (including risk-adjusted estimates for possible liabilities from state guarantees) amounted to approximately 13% of GDP at the end of 1998, which is about the same as the level of recorded government debt.

3. Financial Consolidation and Regulation

A key **weakness of the Czech economy remains the financial sector.** The banking sector continues to be seriously over-burdened by bad loans, with some banks more badly affected than others (classified credits form around one third of the loan portfolio). The build up of a large number of classified loans in the past was partly due to the passive attitude that state-owned banks adopted towards bad debtors. However, **this situation has improved over the past year with stricter bank supervision and the cleaning up of the most affected banks in the run-up to their privatisation.** But, classified credits continue to be accumulated due to the poor health of the economy. The privatisation of the remaining state-controlled banks, improvements in bankruptcy legislation, and increased separation between the commercial and

investment arms of banks should improve the situation further, whilst also improving the framework for corporate governance.

In the past the insufficient regulatory framework and the wide variety of trading channels and practices led to frequent non-transparent deals and price manipulation in the Czech capital market. **The regulatory framework has been strengthened through the establishment of a Securities Commission.** However, the capital market is still largely illiquid, does not encourage strong corporate governance, and is a negligible source of finance for commercial and industrial enterprises. The continued presence of divergent prices for the same stock due to the fragmented organisation of the securities market remains an important problem.

EMU presents the financial system with important challenges. In a highly competitive environment expected to arise from EMU pressure on financial stability. In that regard, a more structural co-ordination between the financial sector supervisory authorities would be appropriate.

Building a sound market-oriented financial system is fundamental to the transition for the accession to EU and EMU. The development of sound and stable financial sector in the Czech Republic needs

- the development of regulatory and supervisory arrangements that support the operation of market discipline
- the creation of an institutional setting and financial infrastructure necessary for sound finance
- the promotion of market discipline and corporate governance over financial institutions.

The legal and institutional infrastructure of prudential supervision and regulation of financial institutions and transparency and fairness of security market in the Czech Republic is based on international experiences and agreements.

In **the Czech banking sector** the medium-term "Conception for the further development of banking supervision" (approved by the Czech National Bank [CNB] Bank Board in January 1998) is based on the "Core Principles for Effective Banking Supervision and Regulation" of the Basle Committee on Banking Supervision and Regulation (which were announced at the International Conference of Banking Supervisors held in Sydney in 1989: the Czech Republic was one of the countries that participated in the drafting of these principles).

State supervision and regulation of **the Czech capital market** is based on the application of the "Objectives and Principles of Security Regulation" by the International Organisation of Security Commissions (IOSCO).

Responsible institution for the state supervision and regulation of **the Czech insurance market** is the Ministry of finance.

The EBRD's Office of the General Counsel conducted a **survey ranking the Central European Candidate Countries (CECC) for accession to EU according to extend and effectiveness, of financial laws and regulations**. The survey questions were based in large part on core principles developed by the Basle Committee and IOSCO. The survey attempted to measure how the financial laws and regulations in the region approximate core international principles.

Countries that have received a 3 rating have reasonably comprehensive financial laws and regulations in the banking sector.

Most transition economies have received a 3 rating for the functioning securities market.

According to used classification system **the extensiveness** of legal rules on banking and securities activities, **the legislation for banking and securities activities in the Czech Republic is reasonably comprehensive** but would benefit from further refinement in some areas. Banking regulations generally conform to the Basle Committee's Core Principles. For achieving conformity with minimum international standards (IOSCO) further refinement to regulation of securities intermediaries and/or investment funds and creation of shareholders depositories and registers is needed.

The **effectiveness** of legal rules on banking and securities activities in the Czech Republic is influenced by the inconsistentness which creates a certain degree of uncertainty.

Sources:

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