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# Transformation process

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# Transformation process - generally

- Transformation vs. reform
  - A transformation
    - Changes of the economic system as a whole
      - In the Czech republic – changes from the central planned economy to the market oriented economy
  - A reform
    - A partial changes inside the existing system
      - Reform of taxation system
      - Reform in pension system, etc.
  - The main question
    - What was the aim of Czech (Czechoslovak) transformation?
      - Does not exist of exact answer.
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# Transformation process - generally

- One of the aim: get near to developed market oriented countries.
  - Several types of market oriented economies
  - Depending on
    - government interventions in the economy
    - The level of social system and policy
- Problem of setting future economy as a whole:
  - Free market economy - liberal approach
  - Market oriented economy with social attributes
  - A compromise between free market and central planned economy

| Public Opinion in 1991 | Economic system before 1989 | Free market | Market with social attributes |
|------------------------|-----------------------------|-------------|-------------------------------|
| Popularity in %        | 5                           | 48          | 47                            |

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# Possible forms of economy system

- Free market
    - Representatives: Klaus, Dyba, Dlouhy
    - A limited role of government, limited interventions in the economy
    - Priority: the low rate of inflation
  - Market economy with social attributes
    - Representatives: Zeman, Komarek
    - Base on Keynes's ideas
    - The policy bases on interventions, strong role of government
    - Priority: low level of unemployment
  - Compromise
    - Increase the role of market in central planed economy
    - Establishing of competition between companies
    - Limitation of state aids to ineffective companies
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# Main changes of system from central planned to market oriented economy

- Prompt reform steps
    - Price liberalization
    - Liberalization of foreign trade
    - Free establish of business
    - Elimination of state aids for companies
    - Set of capital and financial market
    - Liberalization of proprietorship
  - Long-term tasks
    - Legal framework
    - Changes in justice
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# Approach in transformation process

## ■ The gradualism

- Slow pace of reforms
- All negative factors could be limited by the slow pace of reforms
  - Optimism about situation in business companies
  - Afraid of social pressures

## ■ The shock theory

- Quick pace of reform
- Basic reforms in short time horizon
- Accompanied by stabilization policy and withdrawal of government interventions
- The main ideas based on expectation that in society there will be a will for victims
  - The will to reforms will be declining to reforms

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# Political development

- Political development was initial for the whole process of transformation.
  - After the communism coup in 1948 in Czechoslovakia was communism government till 1989.
  - After mass demonstration in Nov 1989 led demission of government and set cabinet of National Unity that governed till first free election.
  - At the same time at the end of 1989 was elected Vaclav Havel as the first president of Czechoslovakia.
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# Political development

- First free election was in 1990
    - Referendum about the previous political regime
  - The winner of the election were representatives of reforms ideas
    - In Czech Republic won Obcanske forum (The Civil Forum) – organized group of reformers
    - In Slovakia won Verejnost proti nasili (The Public against violence)
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# Political development

- Government coalition split in 1991 when Civil Forum was left by future members of *Obcanska demokraticka strana* (ODS).
  - First two years of transformation was characteristic by disputes between representatives of Czech and Slovak Republic
    - Dispute about a “dash”
      - Czech and Slovak Federative republic or
      - Czech-Slovak Federative Republic
    - Slovakia representatives rejected V. Havel as a president
    - Disputes about competences
      - Which competence will be at the hands of federal government and which at the hands of national governments.
  - In 1990 was decided about next election in 1992.
    - The winning coalition got public permission for quick continuation of economic reforms
    - This coalition gained 150 chairs from 200 in House of Parliament.
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# Political development

- The winning was a success of reformers because in a lot of former communist countries in 1992-1993 won political parties that rejected or slowed down next reforms.
  - In Slovakia was situation different because there won left oriented party.
  - It means that representatives of particular republics had different opinions about future transformation and reforms.
  - There were divergence tendencies in both countries.
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# The important political-economical topic

- Army industry
  - Army industry was concentrated in more in Slovakia (60 %)
  - Weapons was produced in more than 100 companies and there was employed about 70 000 employees.
  - The boom of Czechoslovak army production was in 1987 it is volume was 29 billion of CSK.
  - Army production represented 3 % of the total production and 10-11 % of the total industry production.
  - In the 1980's 70% of production was exported
    - 60 % in communism countries in Europe
    - The rest in the countries of the Third World (bad debts)
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# Army industry

- In the 1980's Czechoslovakia 7<sup>th</sup> largest exporter of weapons.
  - Federal government in 1991 decided about cutting of army production about 85-89 %.
  - Cutting of army production in Slovakia about 90 % was negatively perceived.
  - Slovakia regarded with cutting of army as a unreasonably direction from Prague with all negatives that impacted in Slovakia.
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# The important political-economical topic

- Other problem was a position of Slovakia in the federal republic.
  - There were different opinions about the role of federal government and national governments.
  - Slovakia pressed for the higher level of independency.
  - Negatively relation between both countries affected the transformation process
  - Negative impacts of transformation were more significant in the Slovak Republic
    - 1991 unemployment in Czech republic 4,1 % in Slovakia 12 %.
    - In Slovakia increased voices that wanted slowed down reforms.
      - Differences
        - Czech Republic aim: to finish reform process
        - Slovakia aim: to resolve all social impact of reforms
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# The important political-economical topic

- Slovakia representatives wanted
  - Slower pace of privatization process
  - Less restrictive economy policy
  - Abandon of voucher privatization
- Slovakia was supported by financial transfers from the Czech Republic
  - To limited social differences

|                       | <b>Slovakia</b> | <b>Czech Republic</b> |
|-----------------------|-----------------|-----------------------|
| Satisfied with reform | 57 %            | 77 %                  |
| Gradualist reforms    | 64 %            | 36 %                  |
| Radical reforms       | 48 %            | 52 %                  |

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# Political development

- After election in 1992 in both countries were set strong national governments and the role of federal government was limited.
  - The situation led to splitting of countries that was executed on 1<sup>st</sup> January 1993.
    - But in 1991 only 9 % of Czech and 15 % of Slovak citizens wanted splitting of Czechoslovakia.
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# Economic context of Czechoslovakia splitting

- In the process of country splitting was also necessary splitting of the federal property.
  - There were two criterias
    - Territorial – primary criteria
    - Number of inhabitants – if primary criteria could not be used
  - The most of the property was split in rate 2:1 (primary criteria)
    - From army technologies to federal debts
  - Assets and liabilities of bank were divided according to the bank seat.
  - Problems were related with
    - Airways
    - Some public buildings in Prague or
    - 7,5 tones of Slovak gold from Slovakia Republic during WWII
  - Main problem
    - Property of State Bank of Czechoslovakia
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# Economic context of Czechoslovakia splitting

- After the splitting of the balance sheet of the State Bank of Czechoslovakia and the splitting of federal money in circulation
    - arose debt of National Bank of Slovakia in volume 26 billion CSK in the face of the Czech Republic.
  - As a guarantee for settlement the Czech Republic froze Slovakia gold.
  - The debt was doubted by Slovakia for several times although international auditors confirmed it.
  - The dispute was solved in 1999. There was signed record about transfer and receiving of Slovakia gold.
  - Slovakia debt against Czech Republic
    - that has never not been admitted by Slovakia
    - was paid off by symbolic 1 CZK.
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# Political development

- The role of Czech government was strong till the end of 1996.
  - Opposition was weak
    - first labour unions protests against government was not till 1994.
  - In next elections in 1996 was elected right oriented coalitions but new government was weak
    - Only 99 chairs from 200.
  - This government was not able to continue in reforms.
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# Political development

- There was a lot of disputes inside coalition and disputes pointed after monetary tremor in 1997.
  - Government was modified by several times and a lot of pro-reforms ministers left.
  - Weak government ruled till autumn 1997 in that time had been very significant economic recession.
  - After government failure there was “care government“ till early election in 1998.
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# Sum up of political progress

- The whole time period can be divided in two parts.
  - Till 1997 general support of transformation process.
    - But the enthusiasm was declining gradually and government established in 1996 was weaker than previous governments.
  - There is a question if this political development and long term of government was to the benefit for the transformation process as a whole.
    - Long term government led to quick privatization but did not prevent corruption and setting of some political problems.
    - On the basis of Poland experience alternating of governments during the transformation process can speed up this process as a whole.
  - In the second period governed left oriented government of Milos Zeman that continued in some right oriented reforms
    - The privatization of banking sector
    - The sale of state companies
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# First years of transformation of financial system in the Czech Republic

- First step – establishing of new banking system
  - Prior the 1990's – so called mono-structure banking system
  - Although there was several banks with different function the major role was played by the central bank called the State Bank of Czechoslovakia (SBCS)
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# First years of transformation of financial system in the Czech Republic

- Except for standard central bank functions like:
    - Monetary policy
    - Managing circulation of money
    - Tax collections
  - The SBCS was also responsible for:
    - Granting of financial and state organizations
    - Maintaining of their accounts
    - other roles as a commercial bank
  - All decisions on granting credits were the subject of the state plan.
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# Transformation into a two-tier system and liberal regulation

- In 1989 first step were taken to abandon the mono-bank system.
  - As a reason on 1<sup>st</sup> January 1990 Komerčni banka (in the Czech Republic) and Všeobecná uverová banka (in Slovakia) were established.
  - These banks together with Investiční banka and Investiční a rozvojová banka taking over all commercial activities of SBCS.
  - These bank were established as a state financial companies.
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# Transformation into a two-tier system and liberal regulation

- Rules for establishing new banks were liberal and the law lacked basic elements of prudential banking.
- The minimum basic capital required for establishing new bank was originally only 50 mil CSK.
- Banks could be (and were) established from
  - a loan granted by a single company and
  - could grant a higher loan (then shareholder's capital) to the same company (exposure limits were missing at that time).
- The law allowed banks to exit in the form of
  - State financial institutions
  - Joint-stock companies
  - Co-operatives
  - Joint venture

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# Transformation into a two-tier system and liberal regulation

- Basic conditions for establishing a banks with foreign capital were similar to the conditions of domestic banks.
  - A subsidiary of foreign banks had to be established in the form of joint stock company and had to follow the same rules as Czech banks.
  - Foreign banks were usually very cautious in this new and non-standard environment and focused mainly on solvent or foreign clients.
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# Transformation into a two-tier system and liberal regulation

- Originally the role of commercial banks had been only the collection and redistribution of available financial resources.
  - The transformed commercial banks lacked well-trained staff of loan officers, risk assessment system, etc.
  - Liberal framework provided strong growth of opportunities:
    - Rapid development of private sector through small- and large privatization -> strong demand for bank products, esp. credits
    - Massive growth in number of opened accounts and
    - Increase in payment and clearing
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# Transformation into a two-tier system and liberal regulation

- The expansion of existing bank's business networks and products
  - A range of new small banks with Czech capital entered the market because state banks were not able to satisfy rising demand
  - The entrance of these small banks was originally welcomed as a effort to establish a competitive environment in financial services.
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# The economic environment

- Characteristics of environment at the early the 1990's
    - Improper legal framework
    - Ineffective law enforcement
    - Missing market institutions – stock exchange, security exchange commission or registry
  - As a reason of non-existence of a security market the demand for financial services was mostly based on loan finance.
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# Problems with loan

- Assessing of financial health of loan applicants was seriously hampered by:
    - Non-existence of past company data
      - Establishment of new companies
      - Changing business of original companies
    - Vague auditing and reporting standard
    - Uncertainty about business activities in new environment
    - Needs of new business relations
    - Together with massive development of banks and their services negative phenomena appeared on the market. Including financial crime
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# The new role of central bank

- The main goal of the central bank – monetary stability – was incorporated into new Constitution in 1990 (1993 after split-off CR and SR again in 1993)
  - In addition new central bank took the leading role in
    - Bank licensing
    - Partly in supervision
    - Provide of activities beneficial to the entire banking system
      - Development of clearing and settlement mechanism
      - Capital market – particularly stock exchange
      - Bank training and education
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# Split of Czechoslovakia

- After the split of Czechoslovakia in 1993 State Bank of Czechoslovakia was transformed into
    - Czech National Bank
    - Slovak National Bank
  - The transformation was no problem-free
    - The allocation of former federal assets and liabilities could not be fully equitable
    - Leaving some assets and liabilities as unresolved
      - (transferred into KB and CSOB)
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# First steps of central bank

- Establishment of standard monetary tools (deposit, lombard and repo rates, open market operations, obligatory minimum reserve)
  - Establishment of an interbank payment system
  - Establishment market with short-term debt instrument
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# Other financial market institutions

- Market for Short-term debt instruments
    - The short term instruments market started its operation in 1992.
    - The system has been used for:
      - Registration of debt instruments issued in book-entry form with maturities up to one year
      - Settlement of trades with securities
    - Securities trading on the market have a form of
      - Short term instruments issued by Ministry of Finance (T-Bills)
      - And by CNB (CNB - bills)
      - Short terms instruments of banks and non-banks approved by Security Commission.
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# Other financial market institutions

- The short term instruments market system was created as a segment of the financial market both for
    - Needs of Ministry of Finance – T-bills to adjust short term imbalances between state budget revenues and expenditures
    - Needs of CNB, which has used bill operations as a monetary policy instrument (for withdrawing and supplying liquidity via repo operations)
    - Needs of the interbank financial market – used for trading between market participants and with their clients.
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# Other financial market institutions

- The short term instruments market system has never been public market
  - Participants
    - All domestic banks
    - All domestic investment companies
    - All domestic pension funds
    - And corporate sector or natural persons.
    - From foreign participants there are foreign banks or investment companies
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# Public capital market

- The new environment required new market institutions, such
    - Prague Stock Exchange, Center for Securities, Commercial Registry, clearing centers, etc.
  - These institutions helped to revival capital market in the Czech Republic.
  - The Czech Stock Exchange has roots in the 19<sup>th</sup> century its tradition was interrupted by
    - WWII
    - Communist regime
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# Public capital market

- Modern history of PSE started in the early 90's when the Preparatory Committee for the Foundation of the Prague Stock Exchange was set up.
  - On 24<sup>th</sup> August 1993 a new company composed of eight banking houses, was transformed into an association.
  - Upon adoption of the Stock Exchange Act, the association was later converted into the Prague Stock Exchange.
  - The Stock Exchange started to work fully on 6<sup>th</sup> April when first trading session took place on its trading floor.
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# Non-bank financial institutions

- At the beginning of the transformation the number of non-bank financial institutions was limited.
  - Life and asset insurance businesses were concentrated in the monopolistic Ceska statni pojistovna.
  - Their premium revenues that can invest transferred mostly to the treasury and they were not acting as a institutional investors.
  - In case of social and health insurance the payments flowed directly into the government treasury and these flows were included directly into budget revenues and expenditures.
  - The rapid development of non-bank financial institutions was influenced by factors outside the financial sector.
    - Privatization
    - Sale of state enterprises
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Thank you for attention

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