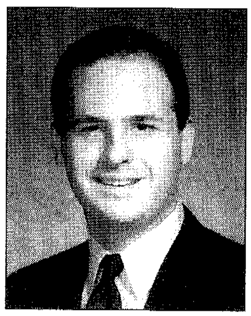
CZECHOSLOVAK BANKING: A FRESH START

Eric Wolfe



Introduction

There were no financial instruments in Czechoslovakia prior to 1989: no bonds, no stocks, no commercial paper. Holding cash or placing money in a savings account at the State Bank, the only financial intermediary, were the only two liquid alternatives for citizens. The simplicity of the financial system was astounding. During the communist period, the Statni Banka (State Bank) of Czechoslovakia performed all commercial and central banking functions for the country. The State Bank's sole purpose was to aid in financing the central government's production plan; it had very little power or autonomy. After the communist reign ended in 1989, Czechoslovakia was in dire need of a new, strong financial system that would help foster reforms in all areas of the emerging market economy.

The Pre-reform Monobank

During the communist era from 1948 to 1989, the State Bank of Czechoslovakia was a central bank as well as the only commercial bank in Czechoslovakia. The State Bank, having no independence because of its control by the government, served all state-owned enterprises. It also exercised complete control over credit and regulated four other specialty banks, one of which handled currency exchanges and foreign trade. Two savings banks, one in the Czech region and one in Slovakia, also existed, handling deposits for individuals. The smallest of the specialty banks handled accounts for private clients, but did not provide credit. (Tesar)

The money supply was of little importance in pre-reform Czechoslovakia and other centrally-planned economies. The major purpose of the monetary system was to finance the production plan. This production plan dictated the financial plan, which consisted of a budget, a credit, and a cash plan. (Sundararajan, p. 3) The level of output was set by a central planning agency and was not, therefore, sensitive to changes in the money supply, interest rates, or exchange rates. Interest rates charged on loans were fixed at a low level and did not vary with the payment risks involved; because loans were made to state enterprises, the banks never assessed the risks involved in making loans.

Personal loans were not granted by banks. The exchange rate was fixed at a low rate and was only used for accounting purposes. The State Bank, therefore, did not affect the economy through monetary policies, since the only role of the monetary system was to finance the production plan and to ensure that state enterprises had the necessary funds for planned transactions.

Reforms in Banking

Financial system reforms began on January 1, 1990, when a two-tiered banking structure, modeled after the Belgian system, was introduced into Czechoslovakia. The State Bank transferred its commercial banking functions to three state-owned financial institutions, while it operated as a central bank. The newly-created commercial banks are Komercni Banka Praha, Vseobecna Uverona Banka Bratislava and the already existing Investicni Banka Praha. Czechoslovakia currently permits the establishment of private banks, although under strict regulation. The regulatory process is now being redefined, with new laws being passed to facilitate the establishment of a sound, Western-style banking system. Three distinct types of foreign banks are permitted: representative offices, joint ventures, and independent subsidiaries of foreign banks. Banks are now given the freedom to perform all banking activities associated with Western banks. This initiates competition in the banking industry for loans, deposits, and other financial services.

The State Bank, operating solely as a central bank, has been granted more independence, given the new tools of monetary policy at its disposal. Monetary policy consists primarily of controlling interest rates on deposits and loans, credit ceilings, exchange rates, and the regulation of the commercial banks. These policy measures are carried out solely by the State Bank of Czechoslovakia. The main purpose of the State Bank is to create a sound banking industry, keep the country's currency stable, control inflation, and encourage economic growth. The success of the banking industry lies in the hands of the State Bank since it has increased power in this newly-formed system.

The Central Bank

Structure

The State Bank was given complete power over monetary policy and the regulation of banks. As stated in the Act Concerning Banks of 1991, one of the main functions of the State Bank is to safeguard the stability of the Czechoslovak currency. (Act Concerning Banks, p. 1) To accomplish this, the State Bank may decide upon and implement monetary policy. It is also responsible for the circulation of currency, the smooth functioning of the system of payments and clearing, and the development and supervision of the banking system in Czechoslovakia.

The State Bank of Czechoslovakia is now independent of the government and has the freedom to exercise its duties and powers. It must inform the Federal Assembly of the Czech and Slovak Federal Republics semiannually of the monetary condition of the country. The State Bank must also report any major monetary policy decisions to the public. It has the exclusive right to issue banknotes, currency, and commemorative coins. The unit of currency in Czechoslovakia is the koruna (crown), which is further divided into one-hundred hellers. The printing of banknotes and the minting of coins is supervised and safeguarded by the State Bank, which will exchange damaged or worn out banknotes for undamaged banknotes.

The State Bank of Czechoslovakia is structured much like the United States Federal Reserve; it has two regional offices rather than twelve and a federal headquarters. The governing body is the Bank Board, which is responsible for determining all aspects of monetary policy, including methods of implementation. The seven-person Board is led by the Governor, who is appointed by the President of Czechoslovakia on the recommendation of the government. Other members include the two Vice-Governors of the State Bank, the Vice-Governor entrusted with the management of the headquarters of the State Bank for the Czech Republic, his deputy, the Vice-Governor entrusted with the management of the headquarters of the State Bank for the Slovak Republic, and his deputy. The terms of appointment are six years, and re-appointment is allowed with no restriction on the number of re-appointments.

By law the Bank Board must abide by several regulations. It is required to meet not fewer than ten times a year. There must be a simple majority of members present in order for the Bank Board to adopt a decision. All operations of the State Bank, including the state of its accounts, are kept secret; all employees of the Bank, including the Bank Board, are duty-bound to maintain professional secrecy on official matters.

The federal headquarters of the State Bank is in charge of implementing all decisions made by the Bank Board. It conducts transactions with the state, administers monetary reserves in gold and foreign exchange, issues securities, conducts open market operations, and supervises banks within the scope set by the Bank Board.

The headquarters of the State Bank of Czechoslovakia for the Czech Republic and the headquarters of the State Bank of Czechoslovakia for the Slovak Republic implement those Bank Board decisions which pertain to their respective republics. The two headquarters control all branch offices of the State Bank, supervise and regulate banks, and control government transactions in their respective republics.

Monetary Policy

The State Bank has many tools available for implementing monetary policy. It is able to regulate interest rates paid on deposits and the amount of interest charged on all loans. It exercises the power to limit the amount of loans that a bank or individual can issue, and can regulate the level of reserves required to be held by banks in an account at the State Bank. The mandatory minimum reserve may not exceed thirty percent of the total liabilities of the bank. If a reserve requirement of greater than thirty percent is required to control inflation, the State Bank must pay interest, equivalent to the discount rate, on the additional reserves required. Banks which fail to meet their reserve requirements will be assessed a fine on the deficient amount, at an interest rate of up to triple the discount rate.

The State Bank, behaving much like the Federal Reserve Banks in the United States, is a bank for Czechoslovak commercial banks. It will hold deposits for the banks, make discount transactions, and buy and sell government bonds and other government securities. Other accounts held at the State Bank are the federal budget, the Republics' budgets, state funds, and state assets and liabilities. The Czechoslovak government has not yet decided whether the State Bank will be permitted to grant overdrafts or credits on any of these state accounts. The Czechoslovak government and the governments of both republics are allowed to issue bonds through the State Bank, which is also permitted to buy and sell these bonds in order to regulate the money supply. The State Bank, in association with the governments, is responsible for deciding and implementing the foreign exchange component of monetary policy. Since the koruna is not internationally traded, the State Bank sets the rate of exchange of the koruna with respect to foreign currencies, regulates the price of gold in banking operations, and holds foreign exchange and gold to implement balance of payments policies.

In 1991 the State Bank's monetary policy was focused on the stabilization of the economy. The State Bank hoped to achieve a reduction in the growth of aggregate demand, a stable currency, an acceptable rate of inflation, a reasonably low interest rate on deposits, a sound financial system, and equilibrium in the balance of payments account. The Board of the State Bank believes that "until greater effectiveness of the use of indirect monetary tools is achieved, credit limits set for each bank will be the tool of monetary policy." (*Czechoslovak Banking*, p. 10) In order to attract deposits, the State Bank set relatively high interest rates, to induce debtors to reduce debt and also to attract deposits. The exchange rate was set at a level that ensured a balance of payments equilibrium.

Bank Regulation

The final responsibility of the State Bank is the supervision of banks in order to ensure a sound banking system. This supervision includes granting licenses to carry out banking operations, regulating the banks, and sanctioning banks that fail to meet required regulations. The banks are required to immediately submit all necessary documents to the State Bank when it is performing an investigation. The latter also has the authority to issue a warning and order a correction of the problem, levy a fine, or repeal a bank's license in part or in full.

First attempts at conducting and enforcing monetary policy were difficult during 1990 for the State Bank. Initially, monetary policy was exercised through strict credit ceilings imposed on individual banks. A very restrictive monetary policy, which included a ceiling on the interest rate paid on deposits, was implemented in order to reduce the rate of inflation. The maximum interest rate on new bank credits from January to March 1991 was twenty-four percent, and by August it was lowered to nineteen and one half percent. These rates represent, for the most part, negative real interest rates since the Czechoslovak inflation rate was almost seven percent per month for the first half of 1991. (Sujan)

Commercial Banks

Industrial Structure

Six commercial banks dominate the Czechoslovakian market for loans. The three largest were formed from the old State Bank and have granted sixty-six percent of outstanding loans. (Tesar) In order to enter the industry, it is necessary for a new bank to obtain the appropriate licenses. In fact, as the President of the State Bank has said:

> Foreign bank entry is very open....Foreign banks can come as a joint venture, but a joint venture can be 100% owned, so that means in effect that we can have bank subsidiaries here, but it is not possible to open a branch. We could not afford to do that....It would mean endangering our own emerging banking industry - it would mean killing the baby. (Ash, p. 20)

Since a large demand for banking licenses exists, many new banks are opening offices in Czechoslovakia. The Czechoslovak government defines a bank as a commercial company, cooperative, or state banking institution which accepts deposits and provides credit on its own account. (Act Concerning Banks, p. 1) Under this definition, there exist three types of banks in Czechoslovakia. The first type includes Czechoslovak owned and operated banks. The second category of banks includes subsidiaries of foreign banks. The third type is comprised of joint ventures in which foreign banks and Czechoslovak banks merge to form new banks that will perform banking functions only in Czechoslovakia. A representative office is not considered a bank; therefore it is easier to secure a license with the State Bank. This type of office does not perform banking functions, but rather sends business to a main office abroad. At the beginning of 1991, there were thirty-one representative offices, five joint venture banks and three foreign subsidiaries in Czechoslovakia. (*Czechoslovak Banking*, p. 6) This rapid growth seems very promising, but in fact there are only 26,000 Czechoslovaks working in the banking industry, which is a very low number for a Western nation of the same size. Given where banking stood in this country just a few years ago, there probably is an acute shortage of skills from the highest level at the State Bank to the loan officers at local commercial banks.

Banking Licenses

All types of banks are required to file an application with the State Bank of Czechoslovakia for a license to operate. This application is then reviewed by the State Bank of Czechoslovakia, the Federal Ministry of Finance, and the Ministry of Finance of the Republic where the bank is to operate. The application must also be accompanied by the organizational rules of the proposed bank, a three-year business plan, and the availability of the minimum basic capital. The State Bank will take three to six months to review the application and render a decision. The term of the license is indefinite and may not be transferred to a third party.

The decision to grant a banking license is made only after careful consideration of the factors that make for successful banks. First and most importantly, the State Bank reviews the origin and adequacy of the basic capital and additional financial resources of the applicant. Basic capital must be at least ten million United States dollars or its equivalent. The second factor under consideration is the professional capacity of the proposed management of the bank. The State Bank wants to ensure that management has the necessary skills to successfully run the bank. Finally, the future profitability and liquidity projections of the bank are also considered. The State Bank wants to be assured that each bank will be financially stable in the future.

Capital Standards

The State Bank imposes different capital standards for different types of banks in Czechoslovakia. Banks that were established before January 1, 1990, are currently required to keep an average capitalization of 1.5 percent of total assets, which will increase to 2.0 percent by the end of 1991. The state savings banks are only required to keep a minimum capitalization of 1.0 percent. All banks created after January 1, 1990, are required to keep a reserve of 8.0 percent of total assets, which is in accordance with the capital standards of the international Basle Accord. This regulation gives state banks and older banks an advantage, thereby creating a barrier to entry in the banking sector and hindering competition. However, the state enterprises, which started out seriously under-capitalized, are forced to keep large low-interest loans with a small chance of repayment on their balance sheets. In addition to the capital standards, banks must keep the amount of medium- and long-term loans below 125 percent of short- and long-term assets. Total credit exposure of any one client cannot exceed 50 percent of the capitalization of the bank. These parameters for granting credit can be altered at the discretion of the State Bank of Czechoslovakia.

The operations allowed under the banking license include most functions that Western banks perform, such as payment and clearing operations, trading in foreign exchange, payments with firms abroad, deposit services, and the granting of credit. In addition, banks are permitted to provide services involving the sale, purchase, or safekeeping of stocks and bonds. Banks are only allowed to perform those banking functions stated in their individual licenses; however the State Bank will grant many different operations to a single bank.

Foreign Exchange Institutions

The State Bank of Czechoslovakia heavily regulates the financial institutions that are licensed to trade in foreign exchange. These institutions must disclose their daily position and all sales and purchases of foreign exchange. They must maintain a ratio of total foreign exchange assets to liabilities within the range of 0.85 to 1.05. If the institution's foreign exchange ratio falls outside this range, it is obligated to sell or buy currency from the State Bank. Heavy fines will be levied on the institution if it does not comply with this regulation.

All foreign exchange rates are set daily by the State Bank of Czechoslovakia. Institutions are allowed to charge their clients a margin of plus or minus one percent of these set rates. The State Bank also requires foreign exchange financial institutions to disclose records of all clients that trade heavily in the foreign exchange market. These regulatory measures must be taken because the currency in Czechoslovakia is not completely convertible. Citizens are allowed to purchase only a small amount of convertible currency, although businesses are allowed to exchange money freely for current account transactions. For example, if an automobile producer needed to buy steel from a German company, the producer could freely convert korunas into marks at the official exchange rate. However, an individual could convert only a small amount of korunas into marks for travel to Germany. Neither an individual nor a company could convert korunas into marks for investment in Germany. These limitations help to strengthen the koruna against other world currencies. If no limitations were placed on conversion, many people would choose to hold foreign currencies with lower inflation rates.

On June 5, 1991, the State Bank of Czechoslovakia introduced forward contracts as an important means for managing exchange rate risks. Banks are now permitted to perform forward market transactions. The forward rates will be determined solely according to interest rate differentials between the koruna and the convertible currency. Since this is a new regulation, the State Bank requires that the commercial banks submit all information about forward transactions in order to evaluate the functioning of this market.

The privatization of the commercial banks is a slow and difficult process. Regulation is intended to produce a sound banking industry. The industry is currently dominated by the five state banking institutions, and credit is granted almost exclusively by those institutions. The low capital requirements give the state-owned banks and older institutions an advantage over the newly-formed banks. These regulatory measures, coupled with the massive network of branches that the state-owned commercial banks possess, cause the smaller banks to be at a disadvantage. Unfortunately, there is currently little venture capital available for entrepreneurs in Czechoslovakia. The bankers believe that there is no way to adequately compensate the bank for the substantial risks involved in making most loans. Therefore, it is very difficult for individuals to borrow money for investment purposes.

Conclusion

Several laws have been passed during 1991 to promote a sound and competitive banking industry in Czechoslovakia. These reforms are necessary to not only foster a sound financial system, but also to promote structural reforms of the non-financial sector and to obtain macroeconomic stabilization. (Sundararajan, p. 1) The State Bank has been given complete independence from the government in all areas except foreign exchange, and can set monetary policy in the way it sees fit without the approval of the government.

Many firms entered the banking industry in Czechoslovakia during 1991. Consequently, in the past two years the banking sector has gone from a monopolistic structure to one which is somewhat competitive. However, there are still many regulatory factors that are preventing the banking industry from becoming completely competitive. For example, the reserve requirements differ among the banks, depending on the formation date of the bank, and credit ceilings are set by the State Bank on a bank-by-bank basis. Also, the state-owned commercial banks have a near monopoly on credit.

In order for the transition to a free market economy to be successful in Czechoslovakia, the government must create a sound financial system. Despite some difficulties, Czechoslovakia seems on its way to achieving such a system. It is following the Western example, which has proven to be successful. The State Bank remains inexperienced at deciding and implementing monetary policy, but thus far inflation has been kept to reasonable levels for a transition to a free market economy. From the pre-reform monobank to Czechoslovakia's two-tiered banking structure, the reforms have allowed monetary policy to be effective through the newly-formed central bank and the emergence of a competitive commercial banking industry.

REFERENCES

The Act Concerning Banks. The Federal Assembly of the Czech and Slovak Federal Republic, pp. 1-18.

Ash, Nigel. "Starting From Scratch." *Euromoney*, June 1991, pp. S19-S21.

Czechoslovak Banking. The State Bank of Czechoslovakia, 1991, pp. 1-10.

Mejstrik, Michal. Center for Economic Research and Graduate Education, Prague, Czechoslovakia, interview, August 5, 1991.

The Rules For Granting Credits to Banks and Minimum Reserve Requirement Build-Up. The State Bank of Czechoslovakia, February 25, 1991, pp. 1-3.

Rules of Interbanking Foreign Exchange Market. The State Bank of Czechoslovakia, June 5, 1991, pp. 1-5.

Rules of Liquidity and Capital Adequacy of the State Bank of Czechoslovakia for the Management of Banks and Savings Banks. The State Bank of Czechoslovakia, April 17, 1991, pp. 1-2.

Smith, Alan. *The Planned Economies of Eastern Europe*. New York, Holmes & Meier Publishers, Inc., 1983, pp. 83-98.

Sujan, Ivan. President, The Federal Statistics Office, Prague, Czechoslovakia, interview, August 6, 1991.

Sundararajan, V. "Financial Sector Reform and Central Banking in Centrally Planned Economies." IMF Working Paper, December 1990, pp. 1-21.

Tesar, Vlastimil. Director of Banking Supervision, The State Bank of Czechoslovakia, Prague, Czechoslovakia, interview, August 8, 1991.