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FOR AGENDA

SM/00/158

July 12, 2000

To: Members of the Executive Board

From: The Secretary

Subject: **Czech Republic—Report on the Observance of Standards and Codes**

The attached report on the observance of standards and codes (ROSC) for the Czech Republic has been prepared in the context of the 2000 Article IV consultation discussions with the Czech Republic, which is tentatively scheduled for discussion on Wednesday, July 26, 2000.

The ROSC for the Czech Republic includes a revised version of EBS/99/158, Supplement 5, (9/1/99), which was considered by the Executive Board on September 8, 1999, and draws together various modules covering descriptions and assessments of the Czech Republic's observance of a range of international standards. It also includes a short factual update of developments since the issuance of EBS/99/158, Supplement 5. All other revisions are minor and editorial and the thrust of the staff assessment remains unchanged. It is expected that, following the Board discussion, this version will replace the version already published on the Fund's external website.

Mr. Takeda (ext. 37158), Mr. Tzanninis (ext. 34114), and Ms. van Elkan (ext. 34763) are available to answer technical or factual questions relating to this paper prior to the Board discussion. Mr. Di Calogero (ext. 38011), Mr. Cangiano (ext. 37330), and Mr. Ariyoshi (ext. 39414) are available to answer technical or factual questions specifically relating to the data, fiscal, and financial sector modules prior to the Board discussion.

Att: (1)

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Department Heads

CZECH REPUBLIC

Report on the Observance of Standards and Codes (ROSC)

Prepared by:

Staff of the International Monetary Fund

ABBREVIATIONS AND ACRONYMS

CAS	Czech Accounting Standards
CNB	Czech National Bank
CSO	Czech Statistical Office
DSBB	Dissemination Standards Bulletin Board
ESA	European System of Accounts
EU	European Union
GFS	Government Finance Statistics
IAS	International Accounting Standards
IOSCO	International Organization of Securities Commissions
IT	Inflation Targeting
MLSA	Ministry of Labor and Social Affairs
MOF	Ministry of Finance
NPF	National Property Fund
NSDP	National Summary Data Page
OECD	Organization for Economic Cooperation and Development
PSE	Prague Stock Exchange
RISC	Report on Implementation of Standards and Codes
RM	Czech acronym for one of the two organized equity markets
SAO	Supreme Audit Office
SC	Securities Commission
SDDS	Special Data Dissemination Standard
SPAD	Czech acronym for System Supporting the Market for Shares and Bonds
QFA	Quasi Fiscal Activity

Update

Czech Republic

Prepared by staff from the
International Monetary Fund on the basis of
information provided by the Czech authorities

International Monetary Fund

Prepared in June 2000

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REPORT ON THE OBSERVANCE OF STANDARDS AND CODES CZECH REPUBLIC—AN UPDATE[1] JUNE 2000

This note provides a factual report on developments since the September 1999 "Experimental Report on the Observance of Standards and Codes—Czech Republic." For a full description of institutions and practices, it should be read in conjunction with the original report.[2]

A. Data Dissemination

The Czech Republic is a subscriber and meets the specifications of the Special Data Dissemination Standard (SDDS) for the coverage, periodicity, and timeliness of data, as well as for advance release calendars. Since the September 1999 ROSC, it has put in place a National Summary Data page, which is linked to the IMF's Dissemination Standards Bulletin Board and provides actual economic data corresponding to the SDDS requirements in a common format. Since April 2000, the Czech Republic has been releasing detailed information on international reserves and foreign currency liquidity that conforms with the required data template.

B. Fiscal Transparency

Substantial progress has been made to address the issues identified in the September 1999 fiscal ROSC module. A new *Law on Budgetary Rules* has been approved by Parliament, which addresses many of the previous shortcomings (see below). In addition, the new *Public Administration Reform Act* and amendment of the *Law on Municipalities* aim at clarifying the roles and responsibilities of different levels of government.

The new budgetary rules comprise five main changes:

- **Expost changes in the State Budget will be strictly limited.**[3] Unanticipated revenue can no longer be spent without Parliamentary assent and the approved expenditure thus

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[1] Prepared by Mr. Nord (European I Department), in consultation with the Czech authorities.

[2] The report was issued to the Executive Board as EBS/99/158, Supplement 5 (9/1/99) and is available on the IMF website as http://www.imf.org/external/np/rosc/cze/index.htm.

[3] The new *Law on Budgetary Rules* covers only the operations of the State Budget. However, together with the new *State Property Law*, it stipulates that any extrabudgetary funds must be created by separate laws, which themselves must be in conformity with the new *Law on Budgetary Rules*.

represents an overall cap.[4] Within a budgetary chapter, increases in individual spending lines (votes) may not exceed 10 percent, even if the overall chapter ceiling is observed. Across budgetary chapters, the government's discretion is limited to 5 percent additional spending, but only if equivalent savings are realized elsewhere.

- **Rules on government guarantees are tightened substantially.** Each individual guarantee must now be approved in a separate law, either at the time of the budget submission or separately.

- **All spending must be executed by institutions approved by law**. Past practice of establishing spending institutions by ministerial decree will be discontinued.

- **Budgetary presentation and monitoring will be made more transparent and accountable**. The presentation of the state budget must include a medium-term outlook covering two years beyond the budget under consideration.[5] Moreover, the quarterly reports to Parliament will become more timely and user-friendly, with a semiannual focus on budget deviations and proposed remedies. These reports must also cover the operations of the extrabudgetary funds.

- **The government can no longer operate on the basis of an unapproved budget.** Under current rules, the budget provisorium is the proposed budget, even if it has been rejected by Parliament. Under the new rules, the Czech practice will be brought in line with that in many other countries: the government will need to limit total monthly expenditure to 1/12 of the previous year's spending until the new budget is approved.

C. Transparency of Monetary and Financial Policies

In early 2000, there was a wave of bankruptcies in the credit union (kampelicka) sector, and a large number of credit unions were placed under forced administration. The guarantee fund maintained by the credit unions does not suffice to cover all insured deposits and the government has proposed to step in to indemnify all depositors 80 percent of their deposits, up to a maximum of CZK 100,000. The credit union sector is regulated by a separate

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[4] There are a few small, and well-defined exceptions. For example, if certain mandatory expenditures are running above expected levels (for example, unemployment benefits because of a higher-than-anticipated number of unemployed) then the government is not obliged to call for a halt in payments. Also, if expenditures are linked to precise additional financing such as EU funds, then they do not fall under the ceiling.

[5] However, the medium-term framework required by law can remain quite general; it does not require, for example, medium-term projections of individual spending items or even budgetary chapters, but only broad revenue and expenditure magnitudes.

legislative act, which assigns the responsibility of supervising to the *Office for Credit Union Supervision.*

D. Compliance with Basel Core Principles for Effective Banking Supervision

A new regulation was issued in July 1999 regarding **consolidated supervision**, stipulating that from April 2000 the capital adequacy ratio (CAR) on credit risk and large exposure limits should be calculated both on a solo and a consolidated basis (only once a year on a consolidated basis). However, this covers only financial subsidiaries of a bank—it does not cover nonfinancial subsidiaries, nor cases where the bank is a subsidiary of a nonbank holding company, for example.[6] This would require an amendment of the *Act on Banks*, which is under consideration.

The CNB has introduced a requirement for a capital charge for **market risk**, designed to contribute to the effective supervision of off-balance-sheet transactions. This is assessed on a solo basis, however. The CNB is considering extending it to a consolidated basis by 2002/03. The CNB has also introduced a market value accounting standard for the derivative transactions of banks starting in January 2000 in accordance with the international accounting standards. Starting January 1, 2001, market value accounting will also be introduced for the securities portfolios held by banks.

E. Transparency and the Securities Market

Since the August 1999 report, a number of changes are now being made to the regulatory framework governing the securities market, with the overall objective of bringing Czech legal and regulatory practice closer to international standards and harmonizing Czech law with EU law.[7] All amendments listed below are due to enter into force on January 1, 2001.

The *Commercial Code* is being amended. Key elements of the amendment are: (i) a strengthening of minority shareholders' rights, including the disclosure requirements of large shareholdings and mandatory buy-outs in case of take-overs;[8] (ii) a clarification of other

[6] Under the Agreement on Cooperation with the Ministry of Finance and the Securities Commission, the CNB has the possibility of acquiring information from other domestic financial market regulators and, under certain circumstances, the possibility of requiring on-site examinations; however, the Czech legal system hampers a full exchange of information.

[7] Draft laws have been submitted to Parliament and, in some cases, approved. Before entering into force, they must also be approved by the Senate and signed by the President.

[8] A buyer is required to make an offer to minority shareholders if its purchase results in a shareholding exceeding 40 percent of outstanding equity. This compares with levels of 25-30 percent in many other market economies.

take-over rules and providing the Czech Securities Commission with regulatory powers in this area; and (iii) a clarification of the responsibilities of boards of directors. Overall, the amendment is intended to accord with the OECD's Principles of Corporate Governance.

The *Securities Act* is being amended. A key feature of the amendment concerns tightening disclosure requirements to be listed as a publicly tradable company and standardizing the requirements in all public exchanges. With few exceptions, the amendment aims to incorporate all relevant EU directives.

The *Accounting Act* is being amended. It is intended to align Czech accounting standards with international standards. It allows corporations to choose to publish accounts on either Czech standards or IAS. It also gives the stock exchange the power to require either Czech standards or IAS.

The *Bonds Act* is being amended. The amendment provides for enhanced disclosure requirements, streamlines the approval process for issuing bonds, and provides for the formation of creditors' committees aimed at strengthening the position of creditors.

Finally, the *Stock Exchange Act* is being amended, aimed at strengthening the supervisory powers of the Securities Commission and introducing several technical changes to ensure more transparency in trading.

Later this year, the preparation of an amendment of *Securities Commission Act* will begin, with the objective of improving the ability of the Securities Commission to regulate capital markets and enforce existing regulations. This amendment would likely enter into force in December 2001.

Meanwhile, the Securities Commission has recently submitted for public discussion a draft of principles of best practice in securities markets. The goal is to establish general rules of behavior for market participants and their basic responsibilities. The principles are grounded in the Commission's authority to demand compliance with best practice in the Czech capital market, and to set market standards that would meet EU standards. The Commission intends to publish this proposal in the form of a recommendation whose principles should be obeyed by all market participants. The proposal is based on the Best Practice Principles published by the International Organization of Securities Commissions (IOSCO). Its aims are to increase trust in the Czech capital market, educate the investing public, protect investors, and fight against financial crime.

Overview

Czech Republic

Prepared by a staff team from the International Monetary Fund on the basis of information provided by the Czech authorities

International Monetary Fund

Prepared in August 1999 and reissued in July 2000

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Overview

1. The policy making process in the Czech Republic has undergone significant changes in recent years, which have improved both the transparency of various economic and financial policies and the quality of the economic policy framework. Following the abandonment of the exchange rate peg in May 1997 and a period with no clear nominal anchor for monetary policy, an inflation targeting framework was introduced from 1998. The legal and regulatory framework for banks has been strengthened; so has bank supervision, which is now to a large extent in compliance with Basle Core Principles in most areas. Measures have also been taken to address the problems of weak securities market regulation and oversight, including through the establishment of a Securities Commission. In the fiscal area, important steps have been taken to identify contingent liabilities and so-called hidden debt, and work has begun to place the budget more solidly in a medium-term fiscal and overall macroeconomic framework. Further, the authorities have subscribed to the Fund's Special Data Dissemination Standard (SDDS).

2. Transparency is by nature a general and somewhat diffuse concept, which in many areas is difficult to distinguish clearly from the broader questions of the quality of economic information and data, or even of the underlying policy framework or the policies themselves. Internationally accepted standards of good practices have been or are being developed in a number of economic and financial policy areas that not only focus on narrow disclosure practices, but also on other elements of the policy framework such as how clearly areas of responsibility are defined and the extent to which an effective basis for the conduct of policy is provided. It is mainly against these standards that this experimental report considers transparency and its underpinnings in the Czech Republic.

3. The report covers transparency practices in the core areas of Fund surveillance: data dissemination (considered against the *Special Data Dissemination Standard*); fiscal policy (considered against the *Code of Good Practices on Fiscal Transparency*); monetary and financial policies (considered against the *Code of Good Practices on Transparency of Monetary and Financial Policies)*; and banking supervision (considered against the Basel Committee's *Core Principles of Effective Banking Supervision*). In addition, the report also assesses practices in the securities market, where transparency has been an important concern in the Czech Republic throughout the transition process.

4. The chapters on fiscal transparency, the transparency of monetary and financial policies, and banking supervision have been prepared on the basis of self-assessments undertaken by the authorities of their practices compared with the different codes and principles, while the chapter on data dissemination has been prepared by Fund staff on the basis of discussions with the authorities. The securities market chapter is also based on discussions with the authorities and was prepared in collaboration with the World Bank, drawing heavily on the Bank's recent study of the Czech capital market.

5. In the staff's view, the Czech Republic has made considerable progress in recent years in enhancing transparency practices in several key areas related to economic policy,

and the level of transparency achieved is in many respects quite impressive for a transition economy. All transition plans related to the SDDS have been completed. The Czech National Bank (CNB) has made a commendable effort to improve various aspects of its monetary policy framework, bring banking supervision and regulation closer to international best practices, and provide information on a broad range of its operations in a timely and comprehensive fashion. The establishment of a Securities Commission (SC) is already yielding tangible results in terms of increasing the integrity of securities transactions, including by relicensing investment firms and strengthening disclosure requirements in the capital market. Finally, the Ministry of Finance (MOF) has devoted significant resources to improving the transparency of fiscal operations and the framework for fiscal policy.

6. Important areas nevertheless remain where further progress in improving transparency and compliance with international standards could be made. Notably:

- In the area of data dissemination, while the Czech Republic complies fully with the SDDS, some weaknesses remain, for example in the quality of the national accounts and external sector data.

- In the area of fiscal transparency, it would be desirable to reduce the government's room for maneuver in changing expenditures from the appropriated level and to strengthen control over local government budgets, incorporate all guarantees and other contingent liabilities as well as quasi-fiscal operations in the budgetary process, and strengthen the medium-term and risk assessment of fiscal policy.

- In the area of monetary and financial policies, the CNB should continue its efforts to clarify the operating procedures for monetary policy, and further steps should be taken to clarify the responsibilities of the different financial policy regulators and strengthen reporting in certain areas, while involving the public more actively in changes under way.

- In the area of bank supervision, the regulatory framework needs to be strengthened in regard to consolidated supervision and market risk, and there remains scope to improve the implementation of bank supervision.

- *In the area of the securities market, further reforms are needed with respect to both* regulation and enforcement to address continued fragmentation and further improve the integrity and transparency of the market.

Fund staff welcomes the several initiatives that are currently under way to support improvements in these areas.

7. Finally, IMF staff would like to thank the authorities for their willingness to participate in this experimental transparency report and for devoting a significant amount of scarce resources to comprehensive and frank self-assessments and discussions with staff in the various aspects of transparency considered in this report. IMF staff recognizes that the authorities efforts were all the more impressive in light of the tight deadlines they faced.

Data Dissemination

Czech Republic

Prepared by a staff team from the International Monetary Fund on the basis of information provided by the Czech authorities

International Monetary Fund

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DATA DISSEMINATION[1]

1. The Czech Republic subscribes to the Fund's Special Data Dissemination Standard (see Box 1). Different agencies are responsible for compiling and disseminating the various sectoral data that are available on the macroeconomy. These responsibilities, along with the relevant legislation that governs the data-related work, are summarized in Appendix I.

A. Description of Practice

2. Since its subscription to the SDDS was acknowledged in May 1998, the Czech Republic has moved decisively to improve data dissemination. The authorities have announced a total of 12 transition plans outlining the steps to be taken to come into observance of the SDDS for five data categories (general government operations, central government operations, central government debt, the analytical accounts of the banking sector, and the analytical accounts of the central bank). In addition, there have been 15 transition plans for the dissemination of advance release calendars that meet the SDDS requirements. All of the Czech Republic's transition plans were completed by the end of May 1999. The Czech Republic is not taking any permanent flexibility options or "as relevant" options for the periodicity and timeliness of the data, or any calendar flexibilities for the dissemination of advance release calendars (Appendix II describes the flexibility options under the SDDS).

3. Although the Czech Republic has not yet established a National Summary Data Page (NSDP), intensive preparatory work has been done with the aim of completing the NSDP in the fourth quarter of 1999 and meeting the end-1999 deadline. This page would present all the actual data described on the Dissemination Standards Bulletin Board (DSBB) in one Internet website and could be hyperlinked to the DSBB.[2]

B. IMF Staff Commentary

- **Coverage, Frequency, and Timeliness.** On the basis of the information provided by the authorities and reviewed by the staff, the Czech Republic meets the specifications of the SDDS for the coverage, periodicity, and timeliness of data, and for advance release calendars (Appendix III contains copies of the Summary of Observance and Advance Release Calendar pages). The Czech Republic is the third subscriber so far to reach this stage. Once the NSDP is set up, observance of the SDDS can be monitored continuously. On the basis of the data published as press releases and/or on the relevant websites of the Czech Statistical Office (CSO), the Ministry of Labor and Social Affairs (MLSA), the MOF, and the CNB, it appears

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[1] Prepared by Mr. Di Calogero and Ms. Montanjees (both Statistics Department), in consultation with the Czech authorities and the European I Department.

[2] The website for the DSBB is http://dsbb.imf.org.

Box 1. The Special Data Dissemination Standard

The SDDS was established in April 1996 to guide Fund members that have, or that might seek, access to international capital markets in the provision of their economic and financial data to the public. The objectives of the SDDS are to enhance the availability of timely and comprehensive statistics and, therefore, contribute to the pursuit of sound macroeconomic policies and improved functioning of financial markets.

The SDDS is a "best practice" standard against which a country's dissemination practices can be measured. It covers four sectors of the economy (real, fiscal, financial, and external), as well as population, and has four dimensions: the data dimension (the coverage, periodicity, and timeliness of the data); access by the public to those data; the integrity of the data; and the quality of the data.

Countries that subscribe to the SDDS are required to provide descriptions of their data dissemination practices (metadata) for posting on the IMF's Dissemination Standards Bulletin Board (DSBB). Subscribers are also required to maintain an Internet website, referred to as a national summary data page (NSDP), which contains the actual data, and to which the DSBB is electronically linked. A NSDP is to be in place for each subscriber by the end of 1999.

The DSBB metadata also provides information on subscribers' practices for the following aspects of transparency: simultaneous release of the data; laws governing the compilation and release of the data; access to the data by other government officials prior to release; ministerial commentary accompanying the release of the data; revision policy; and advance notice of major changes in methodology.

Countries that subscribe to the SDDS undertake to be in full observance of the Standard by the implementation deadlines which come into effect during 1999 and early 2000 (see the DSBB for a schedule of implementation deadlines). For practical purposes, continuous staff monitoring of observance of the SDDS is limited to the coverage, periodicity and timeliness of the data and to the dissemination of advance release calendars.

The SDDS was designed to assist users in making their own assessment of data quality by *providing information on the DSBB on the dissemination of documentation of methodology* and the publication of more detailed data which provide an assurance of the reasonableness of the data. In addition, Summary Methodologies designed to shed light on data quality, and using a standard format for all countries for each data category, are expected to be disseminated on the DSBB by the end of 1999.

that data that are consistent with the DSBB metadata are being disseminated for the prescribed SDDS data categories.[3] Data are released on a timely basis. Discussions with users of Czech economic statistics, including news services, confirm that the advance release calendars are strictly adhered to.

- **Access by the Public**. The advance release calendars ensure proper access to the data by the public by allowing for simultaneous release to all parties. Generally, this is done through faxed press releases to the major news agencies under 15–30 minute embargo. News agencies report that this is working well.

- **Integrity**. Currently, neither the data compiled by the CSO, the CNB, the MOF, nor the MLSA are provided to government officials before their public release. Some data releases (by the CSO and the MLSA) are accompanied by commentary; the monetary data released by the CNB are issued without commentary. Commentary could usefully be provided to explain special factors: there have been instances where this has not been the case, leading to some confusion among users.

- **Quality**.[4] The availability of summary methodology statements on the DSBB is designed to facilitate users' ability to assess the quality of data disseminated by the Czech Republic. To date, summary methodology statements have been provided to the Fund for all data categories. After review by Fund staff and related follow-up with the authorities, statements for the production index, and the consumer and producer price indices, as well as for merchandise trade data have been posted on the DSBB. The remaining statements will be posted in due course.

- Reflecting the views of data users, there would appear to be room for improvement in the quality of the data that is being disseminated for selected data categories. For example, with respect to the **national accounts**,[5] quarterly estimates are derived from the quarterly reports of enterprises and from various surveys. The estimates are subject to bias because of accounting rules (annual reporting of bookkeeping accounts is mandatory for enterprises, but quarterly reporting is not) and the lumping of several expenditure categories in particular

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[3] The website for the CSO is http://www.czso.cz; http://www.mpsv.cz for the MLSA; http://www.mfcr.cz for the MOF; and http://www.cnb.cz for the CNB.

[4] The SDDS states that: "A set of standards that deals with the coverage, periodicity, and timeliness of the data must also address the quality of statistics. Although quality is difficult to judge, monitorable proxies, designed to focus on information the user needs to judge quality, can be useful." The SDDS, therefore, does not attempt to measure or assess data quality, but tries to ensure that data users are provided with sufficient information to form their own assessments, including by providing summary methodology statements.

[5] In addition to information provided to Fund staff, the comments on the national accounts draw on "National Accounts of Central and Eastern Europe," OECD, 1997.

quarters when spending may have occurred during other time periods. It is, however, noteworthy that the CSO published in June 1999 revised national accounts covering the period 1994–98 and including GDP by sector of origin rebased to 1995 prices. Data for the period 1990–93 should be made available in the near future. The authorities are in the process of implementing the European System of Accounts (ESA) 95. On **external trade and the current account**, revisions in recent years to procedures for processing export data have brought external trade statistics close to the practice of the EU. However, there continue to be some discrepancies in the current account data published by the central bank and the statistical office. Progress has been made towards implementing the methodology in the Fund's *Balance of Payment Manual,* 5th Edition.

THE INSTITUTIONAL FRAMEWORK FOR DATA COMPILATION IN THE CZECH REPUBLIC

1. The CSO is the Czech Republic's official statistical agency, and is responsible for compiling and disseminating all the data on the real sector data, employment, population, and merchandise trade, but not unemployment.

2. The CSO operates under the terms of the *State Statistical Service Act* No. 89/1995, which defines the independence of the CSO and its rights and duties towards the reporting units, including the confidentiality of individual data. The Act also specifies the method of imposing reporting duty on businesses and rules out the imposition of reporting duty on the members of the population. Under the terms of the Act, surveys involving the population may only be performed voluntarily unless the reporting duty is laid down in a special law, such as for the population census due to be conducted in 2001.

3. Contributing to the independence of the CSO is the fact that the CSO President is appointed by the President of the Czech Republic (on the basis of a proposal made by the Prime Minister) and that its budget is approved by the Parliament of the Czech Republic. Although not a member of Cabinet, the CSO President may attend Cabinet meetings.

4. There is no legal requirement for the CSO to publish its data, and the agency does so as a service to the public, on the basis of an internal directive of the CSO President.

5. The MLSA is the agency responsible for compiling and disseminating the data on registered unemployment. In compiling the data, the MLSA is governed by the terms of *Act No. 1/1991*, and the *Employment Act No. 9/1991*. These acts specify the definition of a registered unemployed person and the categories of citizens considered to be jeopardized ("at risk") in the labor market. Dissemination of the data is governed by the terms of *State Statistical Service Act* (referenced above).

6. There is no legal requirement for the MLSA to publish the unemployment data, which is done as a service to the public.

7. The MOF is the agency responsible for compiling and disseminating the data for the fiscal sector. The compilation of the data is governed by a variety of acts.

(a) The data concerning the central government are compiled according to the *State Budget Act (576/1990)* and approved every year by the Czech Parliament. *Act 576/1990* defines the obligation of the Czech Parliament to receive the State budget data on a quarterly basis, but there is no act requiring the MOF to compile and publish central government budgetary data; the data are published by the MOF as a service to the public.

(b) The data on the extrabudgetary funds of the central government are governed by the following laws: *Acts 239/1992, 241/1992, 388/1991, 77/1969*, and the *State Budget Act*, in the case of the State Funds; by *Act 171/1991*, in the case of the National Property Fund; and by Act 569/1991 in the case of the Czech Land Fund.

(c) The data on the health insurance organizations are governed by *Acts 48/1997, 592/1992, 280/1992, and 551/1991*, and subsequent regulations and supplementary declarations.

(d) The data on local governments are governed by both the *State Budget Act* and the *Law on Municipalities (Act 367/1990)*.

8. There is no law concerning the compilation and dissemination of data on central government debt. These data are disseminated by the MOF as a service to the public.

9. The CNB is responsible for compiling and publishing the data on the financial sector and the external sector, with the exception of merchandise trade. The compilation of the data are governed by the terms of the *Act on the Czech National Bank (Act 6/1993)*, which specifies that commercial banks are obliged to provide information to the CNB and that the CNB is obliged to publish aggregate information on monetary developments for the general public, as well as data on international reserves and exchange rates. The CNB is also governed by the terms of the *Law on Protection of Personal Data in Information Technology Systems (Act 256/1992)*, which provides for the protection of the confidentiality of individual data.

10. With the exception of the data on monetary aggregates, international reserves, and exchange rates, there is no law requiring the publication of the financial and external sector data; these data are published by the CNB as a service to the public.

11. Copies of the Acts governing the CSO, MLSA, MOF, and CNB are published in Czech in the *Collection of Laws of the Czech Republic* which is available in public libraries and, under the terms of the *Act on the Collection of Laws*, at the offices of all local authorities. The *Act on the Czech National Bank* is also published in the General Information section of the CNB Internet website in both Czech and English.

FLEXIBILITY AND "AS RELEVANT" OPTIONS UNDER THE DSBB

1. A "flexibility option" allows a subscriber to disseminate data with a lower frequency (the periodicity element) or with a greater lag (the timeliness element), or both, than prescribed for the data category under the SDDS. The SDDS allows all subscribers two flexibility options on an ongoing basis. Also, the Executive Board of the IMF has agreed to provide subscribers with an additional temporary flexibility option to smooth the transition to observance of the SDDS. This temporary option expires at the end of 1999. There are some restrictions on the use of flexibility options. No flexibility is available with respect to international reserves. In addition, flexibility may only be taken with respect to the timeliness, but not the periodicity, of data on the national accounts and the balance of payments, and only if the other data categories under the SDDS that are indicated as tracking *developments in these areas are disseminated with the prescribed periodicity and timeliness.* For national accounts, the tracking category is the production index, and the tracking categories for the balance of payments are merchandise trade and international reserves.

2. "Calendar flexibilities," which can be taken for a maximum of two data categories, exempt the subscriber from having to publish the precise release date for those data categories. Nevertheless, the one quarter-ahead approximate release dates must still be disseminated.

3. Finally, "as relevant" options are available for certain data categories because of structural or institutional factors; these options reflect that certain data categories may not be relevant to the economy of a given country, or it may not be possible to disseminate data with the prescribed periodicity and/or timeliness.

DISSEMINATION STANDARDS BULLETIN BOARD

AS PROVIDED BY CZECH REPUBLIC AS A SUBSCRIBER TO THE SDDS

Last update: 04/13/1999

Czech Republic
Summary Page on Observance and Transition Plan

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Check marks (x) indicate that the specifications of the SDDS for data coverage, periodicity, and timeliness are met. Where Czech Republic has made use of the SDDS's flexibility on these elements or presented plans to meet the specifications during the transition period, the table shows Czech Republic's present practice and a footnote that indicates the use of the flexibility or the transition plan.

Category (and, if different, national descriptor)	Coverage	Periodicity	Timeliness
Real sector			
National accounts	x	x	X
Production index	x	x	X
Labor market: Employment	x	x	X
Labor market: Unemployment	x	x	X
Labor market: Wages/Earnings	x	x	X
Price indices: Consumer prices	x	x	X
Price indices: Producer prices	x	x	X
Fiscal sector			
General government or public sector operations	x	x	X
Central government operations	x	x	X
Central government debt	x	x	X
Financial sector			
Analytical accounts of the banking sector	x	x	X
Analytical accounts of the central bank	x	x	X
Interest rates	x	x	...
Stock market: Share price index	x	x	...
External sector			
Balance of payments	x	x	X
International reserves	x	x	X
Merchandise trade	x	x	X
International investment position	x	x	X
Exchange rates	x	x	...
Population	x	x	...

AS PROVIDED BY CZECH REPUBLIC AS A SUBSCRIBER TO THE SDDS

Last update: 08/01/1999

Czech Republic Advance Release Calendar

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Data Category (and, if different, *national descriptor)*	Date of last calendar *release* (mm/dd/yy)	Calendar flexi-*bility*	Notes	Release*			
				Aug.	Sep.	Oct.	Nov.
Real sector							
National accounts	01/01/99				14 (Q2 99)		
Production index	01/01/99			9 (06 99)	8 (07 99)	11 (08 99)	9 (09 99)
Labor market: Employment	01/01/99		1/	9, 30 (06 99), (Q2 99)	8 (07 99)	11 (08 99)	9, 29 (09 99), (Q3 99)
Labor market: Unemployment	01/01/99			9 (07 99)	8 (08 99)	8 (09 99)	8 (10 99)
Labor market: Wages/Earnings	01/01/99		2/	9, 30 (06 99, Q2 99)	8 (07 99)	11 (08 99)	9, 29 (09 99, Q3 99)
Price indices: Consumer prices	10/01/98			9 (07 99)	8 (08 99)	8 (09 99)	8 (10 99)
Price indices: Producer prices	10/01/98			12 (07 99)	13 (08 99)	13 (09 99)	11 (10 99)
Fiscal sector							
General government or public sector operations	10/15/98						
Central government operations	10/15/98			27 (07 99)	28 (08 99)	27 (09 99)	26 (10 99)

Central government debt	10/13/98				17 (Q2 99)		
Financial sector							
Analytical accounts of the banking sector	01/01/99			31 (07 99)	30 (08 99)	30 (09 99)	30 (10 99)
Analytical accounts of the central bank				16 (07 99)	15 (08 99)	15 (09 99)	15 (10 99)
Interest rates			3/				
Stock market: Share price index			3/				
External sector							
Balance of payments	01/01/99				3 (Q2 99)		
International reserves	01/01/99			9 (07 99)	7 (08 99)	7 (09 99)	8 (10 99)
Merchandise trade	01/01/99			20 (07 99)	21 (08 99)	21 (09 99)	19 (10 99)
International investment position					28 (Q2 99)		
Exchange rates	10/01/98		3/				
Population	01/01/99				1 (Q2 99)		

*Release dates can be specified as a specific date, a range of dates, or a no-later-than (NLT) date. The period (or date) to which data to be released relate is shown in parentheses.
1/ Quarterly release dates refer to the Labor Market: Employment data. Monthly release dates refer to the Labor Market: Employment in Industry data.
2/ Quarterly release dates refer to the Labor Market: Wages/Earnings data. Monthly release dates refer to the Labor Market: Average Monthly Earnings in Industry data.
3/ Not applicable. Daily data are disseminated daily.

All dates are expected dates of release and are subject to change.

Fiscal Transparency

Czech Republic

Prepared by a staff team from the International Monetary Fund on the basis of information provided by the Czech authorities

International Monetary Fund

Prepared in August 1999 and reissued in July 2000

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FISCAL TRANSPARENCY[1]

1. This chapter provides an assessment of fiscal management practices in the Czech Republic against the requirements of the IMF *Code of Good Practices on Fiscal Transparency—Declaration on Principles*. Box 1 highlights key aspects of this code.[2]

A. Description of Practice

Clarity of Roles and Responsibilities

2. The roles and responsibilities of the government sector are defined and distinguished from the private sector in the *Constitution* and in several laws. The general government includes the central government (including state financial assets and extrabudgetary funds) and the local and municipal governments, and general government data are prepared and reported according to the ESA, as well as the IMF's *Government Financial Statistics* (GFS).

3. The fiscal operations of the central government are governed by the *Law on. Budgetary Rules* and some secondary legislation. In addition, there are specific laws governing individual extrabudgetary funds.

4. The *Constitution* and the *Law on Municipalities* give spending autonomy to local governments. While local governments have the right to borrow and issue guarantees, they are heavily dependent on revenue from the central government in the form of direct transfers and revenue sharing. Both the taxes subject to sharing and the sharing formula are specified in the *Law on Budgetary Rules*. The distribution of responsibilities between the individual levels of government will be redefined in several public sector reform acts currently under consideration by the government, including the *Public Administration Reform Act*, which is expected to be passed into law in late 1999. One of the purposes of this act is to create a regional level of government as defined in the *Constitution*, primarily since transfers from the EU are effected at the regional level.

5. The legal framework for Czech budgetary operations tends to rely more on *principles* of handling public funds—combined with detailed instructions and regulations rather than on high-level *codified procedures and strong administrative control*. The Parliament approves state budget revenues and expenditures (including grants for local governments) and the budgets of the

[1] Prepared by Mr. Symansky (Fiscal Affairs Department), in consultation with the Czech authorities and the European I Department.

[2] The IMF's *Code of Good Practices on Fiscal Transparency—Declaration on Principles*, the manual explaining the code, a blank questionnaire, and a blank self-evaluation report are all available on the IMF external web site (www.imf.org/fiscal).

Box 1. Code of Good Practices on Fiscal Transparency—Declaration on Principles [1]

Fiscal transparency makes a major contribution to the cause of good governance. It leads to better-informed public debate about the design and results of fiscal policy, makes governments more accountable for the implementation of fiscal policy, and thereby strengthens credibility and public understanding of macroeconomic policies and choices. In a globalized environment, fiscal transparency is of considerable importance to achieving macroeconomic stability and high-quality growth.

The IMF's *Code* of *Good Practices on Fiscal Transparency* is based on the following **key objectives**: (i) The government sector should be clearly distinguished from the rest of the economy, and policy and management roles within government should be well defined. There also should be a clear legal and administrative framework for fiscal management; (ii) The public should be provided with full information on the past, current, and projected fiscal activity of government with a public commitment to the timely publication of fiscal information; (iii) Budget preparation, execution, and reporting should be undertaken in an open manner. Budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks. Budget data should be classified and presented in a way that facilitates policy analysis and promotes accountability. Procedures for the execution and monitoring of approved expenditures should be clearly specified. Fiscal reporting should be timely, comprehensive, and reliable, and should identify deviations from the budget; and (iv) There should be independent assurances of integrity by subjecting fiscal information to public and independent scrutiny.

The Code sets out what governments should do to meet these objectives in terms of principles and practices. Guidelines to the implementation of the Code are provided in a supporting *manual*. The Code acknowledges diversity across countries in fiscal management systems and in cultural, constitutional, and legal environments, as well as differences across countries in the technical and administrative capacity to improve transparency. While there is scope in all countries for improvement with respect to some aspects of fiscal transparency covered in the Code, diversity and differences across countries inevitably imply that many countries may not be able to move quickly to implement the Code.

[1] *This is largely taken from the IMF's Fiscal Transparency website* www.imf.org/external/np/fad/trans/index.htm.

extrabudgetary funds,[3] but there is no statute that prohibits the government from changing the appropriated budget after it is approved by Parliament (see section on budget execution). However, a new *Law on Budgetary Rules*, which is expected to be passed by end-1999, will provide a more comprehensive fiscal framework emphasizing greater transparency and accountability. The new law contains provisions: (i) requiring a medium-term fiscal framework and medium-term budget forecasts; (ii) limiting the power of government to change the budget after parliamentary approval; (iii) improving monitoring and reporting, including of information on guarantees, tax arrears, equity holdings, and the use of appropriate methods of asset valuation; and (iv) limiting spending from unanticipated revenue.

6. The general procedures relating to taxes (and fees), including appeals, are determined by the *Act on Administration and Collection of Taxes and Fees.* Rules governing specific issues relating to each tax are covered in individual tax laws. There is no separate statute or code of conduct, but the behavior governing tax officials is covered in the various tax statutes. Tax administration is supported by a tax information system which records taxpayers on the basis of taxpayer identification numbers (TIN) linked together for all taxes. Information is kept in a central database, and the statutes dictate that information from tax procedures, including the returns, are confidential.

7. While the distinction between fiscal and private sector activity is generally clear, there are several areas where the distinction is blurred, which is not surprising for a country in transition. There are several institutions that were established under the *Commercial Code* which are not a part of the government sector, but neither respond completely to private market incentives. The obligations of these institutions are either explicitly or implicitly guaranteed by the government, but their operations, which are of a fiscal nature, are not completely captured in the fiscal accounts. Important examples include:

- *Konsolidacni Banka*—a state-owned workout and development bank that provides loans to enterprises and financial institutions and also holds equity positions in several companies—has its obligations guaranteed by the state. *Konsolidacni* receives a transfer from the state to cover losses (which is in the budget), but otherwise its operations do not show up in the government accounts. In addition to *Konsolidacni*, there are a few other institutions (e.g., the Czech Export Bank) that essentially are engaged in fiscal activity.[4] These institutions, especially *Konsolidacni,* are believed to account for the major source of quasi-fiscal activity (QFA) in the Czech Republic.

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[3] The budget of the health funds is an exception. Although the health funds are extrabudgetary, their budget is not included with those of the central government or the other extrabudgetary funds.

[4] The following internet sites provide further information on these institutions: www.kobp.cz - Konsolidacni Banka Praha; www.ceb.cz - Czech Export Bank.

- The *Agricultural Guarantee Support Fund (PGRLF)* is controlled by the Ministry of Agriculture, and thus its obligations receive an implicit government guarantee. However, while the activities of this and similar funds are essentially fiscal and are reported to the relevant ministry, they are excluded from the fiscal accounts. The government is considering fully including the activity of such funds in the government accounts.

8. Another area where the distinction between the government and private sector activity is blurred relates to the government holdings of equity. The government, through the *National Property Fund (NPF)*—an extrabudgetary fund, has equity in various enterprises which the government argues is primarily for the purpose of preparing them for privatization.[5] The activities of these enterprises are reported to the NPF. There are also a limited number of government commercial entities, such as the *Czech Railway* and *Transgas*, which are explicitly classified as public sector entities, but the *Commercial Code* is applied to their activities. It is estimated that the activity of all enterprises with full or partial government ownership accounts for over 20 percent of total economic activity in the Czech Republic. However, there is no consolidated report of the government's equity holdings. The new *Law on Budgetary Rules* would require that all government equity holdings be recorded. In addition to the equity interest in the non-financial enterprises, the government holds equity in two commercial banks which are being prepared for privatization (*Komerčni Banka* and *Česka Sporitelna*). These banks now account for about 35 percent of the total amount of outstanding loans in the economy. They comply with the banking sector regulations and the government does not use them for fiscal purposes, although they are not profitable.[6]

9. The CNB is independent in setting monetary policy and does not appear to have used monetary policy tools for fiscal purposes (e.g., inflationary finance). However, there is evidence of non-transparent QFAs, notably, the provision of financial support to banks by the CNB. However, the CNB has recently taken steps to be transparent about its non-standard operations by isolating in *Česka Finančni* (a subsidiary of the CNB) all of the assets of the troubled small- and medium-sized banks acquired by the CNB in connection with the recent bank stabilization program.[7] While the CNB does not receive funds from the central government, it does not transfer profits to the budget.

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[5] See www.fnm.cz for more information on the NPF.

[6] See www.csas.cz and www.kb.cz for more information on the two banks that will be privatized.

[7] The CNB website is at www.cnb.cz and the act establishing the CNB can be found at www.cnb.cz/en/zakony/cnb/index.htm. The website of *Česka Finančni* is www.czfinanc.cz

Public Availability of Information

10. The MOF releases a substantial amount of fiscal information on its website in a timely manner that goes beyond the requirements of the SDDS.[8] The coverage of the state budget is extensive and available by economic, functional, and *vote* (i.e., administrative) classification. The state budget is publicly available, and includes a policy statement and the underlying macroeconomic and fiscal assumptions.[9] In addition to standard budgetary data for the central government for the current and past two fiscal years, there is detailed information on intergovernmental grants, revenues and expenditures of extrabudgetary funds, and transfers to local governments. In 1998, the government began publishing information in the budget on the outstanding value of state guarantees granted by the MOF and other agencies. Although the reporting of guarantees is not required by law, a statement on guarantees will be required in the state budget document under the new *Law on Budgetary Rules*.

11. The state budget document is comprehensive. Line ministries prepare detailed budgets covering activities within their areas of responsibility. These budgets, which are included in the budget document, are further broken down by individual agencies within each ministry. All entities fully financed from the central budget are required to produce both individual budgets and information about their activities. Contributory organizations—which finance part of their activities from fees and charges—are shown in budget documents on a net basis. While their budgets are reported to an individual spending ministry, they are not required to publish their accounts. The transfers they receive from the government account for about 12½ percent of total state expenditures. Since these organizations are in the areas of health, education, and road maintenance, among others, they are engaging in fiscal activities, and by including only their net transfer, the fiscal accounts underestimate the importance of these activities.

12. The state budget document includes a projection for the local government sector, which allows the fiscal position of the general government to be evaluated, although this projection tends to be inaccurate because of poor information. In the tax area, all tax laws and their amendments are officially published in the *Collection of Laws* and ample assistance is available to assist taxpayers in filling out their returns.[10] Tax expenditures are not reported, although the EU will require that tax incentives to industry be monitored and reported. There is little or no information reported on QFAs.

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[8] Fiscal data on the budget and actual out-turn can be viewed at www.mfcr.cz/scripts/hpe/default.asp?VlfinSta

[9] Many of the documents of the State Buget are available at www.mfcr.cz/scripts/HP/default.asp?Rozpocet and an example of the local government budget can be seen at www.prague-city.cz/rozpocet/index.html

[10] Tax instructions can be viewed at http://www.mfcr.cz/scripts/hp/default.asp?FinZprav

Open Budget Preparation, Execution, and Reporting

13. Although not required by law, the official budget document contains a fairly precise policy statement including a projection of economic fundamentals and the main fiscal priorities.[11] The macroeconomic forecasts prepared by the MOF used in assessing the fiscal outturn are updated on a quarterly basis and are publicly available. The budget distinguishes between existing and new policies by *vote*, although this information is not aggregated or comprehensive. While the government provides data on what it refers to as *hidden debt*, this is not a statutory requirement (see Box 2).

14. The Czech Republic is increasingly placing budgetary decisions in a medium-term framework. Although currently there is no legal requirement to do so, the new *Law on Budgetary Rules* proposes that medium-term forecasts of the main revenue and expenditure categories should be included in the annual budget. A medium-term forecast is also needed in preparation for EU accession, and the MOF has recently released some "unofficial" fiscal forecasts; the government has indicated that the 2000 budget document will include a medium-term forecast. Together with the IMF, the MOF has begun developing medium-term and 10-year fiscal forecasts.[12] In addition, long-term strategic studies have been undertaken in specific areas (e.g., social security) on an ad hoc basis. The MOF also very recently began calculating structural and cyclical balances and measures of fiscal sustainability.

15. There is not a formal statement of fiscal risk, nor is fiscal risk quantified.[13] The recently produced medium-term fiscal forecasts give some indication of risk related to output variability, possible slippages in spending, and the possible investment costs associated with EU accession.

16. There are two problems in budget execution. First, and most critically, the government can alter spending from the amounts that are appropriated in the budget by Parliament. The new *Law on Budgetary Rules* will limit this flexibility to 5 percent of expenditures, by ministry and in aggregate, depending upon revenue performance (i.e., increased expenditures will be allowed if revenue is higher than budgeted). As regards control over budget execution, financial control, and internal and external audit control have

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[11] The key macroeconomic assumptions can be viewed at www.mfcr.cz/scripts/hpe/default.asp?MakroPre

[12] See *Medium-Term Fiscal Policy Projections and Analysis* in *Czech Republic: Selected Issues*, Chapter IV, July 7, 1999.

[13] There is a section of the budget entitled "fiscal risk" but it relates exclusively to *hidden debt*.

Box 2. Hidden Liabilities in the Czech Republic

In Resolution 104, February 9 1998, the MOF was charged with identifying poor quality claims resulting from the economic transformation, hidden debt funding, and state guarantees. These hidden debts capture fiscal activity that is not already included in the fiscal accounts of the government. This initiative was the outcome of joint work of the MOF and the World Bank, including a well publicized seminar.[1] As a result, the government included an inventory of hidden forms of debt in its draft of the 1999 state budget. The authorities recognized that this was necessary to enhance the transparency of the budgetary system and identify an important component of fiscal risk. Hidden financing has several serious shortcomings because decisions are made outside the regular budgetary process: (i) priorities are not based on an accurate assessment of cost; (ii) interest payments can be higher than warranted since guaranteed debt may carry a premium over central government debt; and (iii) by not conforming to market pressures, the behavior of these institutions can be irresponsible and increase the likelihood of government bailouts. The government has publicly reconfirmed its desire to take over all hidden liabilities which are on the books of public institutions used to finance the costs of transition (Konsolidacni Banka, Česka Inkašni, Česka Financni, and the NPF).

In 1998, the hidden liabilities were estimated to be around 13 percent of GDP, and the World Bank and the government estimate that they are expected to grow at a very fast rate. There are two types of hidden liabilities. First there are state guarantees that emerged from government support of development projects. At the end of 1998, these guarantees amounted to 6 percent of GDP after accounting for the risk associated with each guarantee (16 percent of GDP unadjusted for risk). The annual subsidy component of these guarantees is estimated at about 1.5 percent of GDP. Second, there are bad assets in the public sector institutions resulting from directed credits and purchases of low quality assets from banks in the process of transition. After accounting for reserve provisioning, it is estimated that the outstanding stock of unfunded liabilities is about 7 percent of GDP.

The government has taken steps to be transparent about the size of the problem by providing an inventory of its hidden debt, but it has not yet developed a clear policy initiative to deal with the problem. Even in the proposed new *Law on Budgetary Rules*, control of guarantees is rather limited. The solution must include the creation of a legal and institutional framework that forces proper accounting of the true cost to the government within the budget process.

[1] See "Dealing with Contingent Liabilities" by Hana Polackova in *Czech Republic: Crisis, Adjustment, and EU Accession, Vol. II*, pg. 35-48, World Bank, 1999.

been strong, but there has been some difficulty controlling off-budget activities of ministries and there has been little in the way of performance accountability. Second, monitoring and control over general government finances are complicated by the relative high degree of autonomy and flexibility granted to local governments. Therefore, actual local government finances can vary substantially from what was assumed when the state budget was approved. Furthermore, there is often a long lag between the outturn in local government finances and when they are reported to the central government. Weak control over local governments, and thus general government deficits, may become problematic as the Czech Republic prepares to enter the EU.

17. The budget and accounting system of the Czech Republic is modern and effective, and uses a modified cash accounting basis (i.e., allows for some accrual accounting). As indicated earlier, fiscal data comply with ESA and GFS standards. Budget execution is monitored and controlled internally at various stages, and detailed and timely reports from the treasury account can be produced by *vote* and in aggregate. The final accounts of the central government reflect high standards of coverage and reliability, and include a reconciliation with bank accounts. Indeed, the MOF reconciles spending on a daily basis using reports from the banking system. The various outturns using treasury accounts are compared to budget appropriations as well as revised spending authorization. The Supreme Audit Office (SAO) audits the government accounts on an ad hoc basis and provides a report to the Parliament and the Cabinet.

18. The procurement law that governs purchases by the government complies with EU standards. It is strictly adhered to, and subject to internal and external audit. All private sector labor laws are binding for the government and the rules governing pay, hiring, and firing practices are well understood.

Independent Assurances of Integrity

19. The SAO performs high quality auditing.[14] The responsibilities of the SAO are mandated in the *Constitution* and its head is appointed by the President and approved by Parliament. It audits and assesses management of revenues and expenditures, state property and funds, as well as the performance of various programs within the state budget. It audits the accounts of the ministries and government agencies, guarantees by the state, state securities, including their amortization, and the awarding of state contracts. On an ad hoc basis, it offers opinions on government reports dealing with budget performance, drafts of new legal regulations, various government programs, and the performance of ministries and agencies. The SAO exercises only ex-post audit control. There is no formal mechanism to follow up its recommendations. The SAO produces a quarterly report of its findings that is available to the public. Twice a year and before the budget forecasts are released, a panel of experts, including individuals from the private sector, scrutinize the macroeconomic assumptions.

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[14] Information on the SAO can be viewed at www.nku.cz

B. IMF Staff Commentary

- Fiscal management in the Czech Republic has become increasingly transparent. The public has access to a significant amount of data to assess fiscal policy, both in paper and electronic form. It is also noteworthy that the provision of fiscal data tends to exceed the standards of the SDDS. It is commendable that the authorities include extrabudgetary funds in their fiscal accounts and provide detailed information on guarantees. In addition, taxpayers' rights and appeals procedures are well defined and appear to be observed in practice. The budgetary process is open, and the audit system appears to function well. Fiscal monitoring and reconciliation is quite advanced.

- While fiscal management practices meet many of the requirements of the Code, there remain a number of important areas where improvement is needed.

  - While the authorities provide a significant amount of information, even in some areas that many countries ignore such as guarantees, the government has yet to adequately address the "culture of guarantees." This does not point just to a transparency issue, but rather to one of fiscal risk. In this area the Czech Republic falls short of good practice. The budget process should ensure that the expected fiscal cost and risk of guarantees are brought to bear in decisions over their use.

  - In general, all significant QFAs of public enterprises and public financial institutions should be reported and quantified where possible. More information on all of these activities would reduce an important source of fiscal risk—namely, potential requirements for future support from the central government budget. In particular, it is important to avoid the accumulation of hidden liabilities as they may surface as an unexpected and very large fiscal shock. New extrabudgetary funds or activities should be avoided or clearly included in the budgetary process in order to maximize transparency.

  - Consolidating and disseminating information on all financial and non-financial public enterprises in a comprehensive enterprise report would be a useful step forward.

  - Reporting of tax expenditures should be developed.

  - The contributory enterprises should make their reports publicly available since they can be an important source of fiscal activity. Currently they are only captured in the government accounts through the transfers they receive from the state budget.

  - The flexibility granted to the central government to ignore the budget appropriated by Parliament should be re-examined since it undermines the whole budgetary process.

- While the requirement for a medium- and a long-term fiscal forecast is not formalized, recent efforts indicate that they are already addressing this shortcoming. Utilizing sensitivity and scenario analysis as part of a thorough fiscal risk statement could help develop a greater appreciation of the fiscal situation.

- If the new *Law on Budgetary Rules* is enacted it will go a long way towards overcoming many of the shortcomings in the current set of budgetary procedures. The new law would address several fiscal management problems by limiting the amount of guarantees that are granted and restricting the flexibility granted to the government to make changes in budgeted expenditures.

Transparency of Monetary and Financial Policies

Czech Republic

Prepared by a staff team from the International Monetary Fund on the basis of information provided by the Czech authorities

International Monetary Fund

Prepared in August 1999 and reissued in July 2000

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Transparency of Monetary and Financial Policies[1]

1. This chapter describes and assesses the transparency practices of the Czech Republic based on a self-assessment prepared by the authorities of the existence of good practices as outlined in the *Code of Good Practices on Transparency in Monetary and Financial Policies*. Box 1 highlights key aspects of this code.

A. Description of Practice

Clarity of Roles, Responsibilities and Objectives

2. ***Monetary Policy***. The central bank of the Czech Republic is the Czech National Bank (CNB). The CNB is responsible for the formulation and conduct of monetary policy. It was established in the *Constitution* (adopted on December 16, 1992) as the central bank and its specific functions are defined in the *Act on the Czech National Bank* of December 17, 1992 (No. 6/1993), henceforth referred to as the CNB Act.[2] The *CNB Act* defines the operational structure of the central bank and the range of its activities. The CNB is directed by a Governor, two Vice Governors, and a board consisting of four other members. Monetary policy decisions are taken by majority vote by the CNB board. The Governor, Vice Governors and the members of the CNB board are appointed by the President of the Republic for renewable terms of six years.

3. The *Constitution* defines the CNB's primary objective as that of safeguarding the stability of the Czech currency, and it is widely understood that achieving broad price stability is the ultimate goal of monetary policy (the next subsection provides more detail). The *CNB Act* provides specifically for the independence of monetary policy by stating that: "In providing for its primary objective, the CNB is independent of any instruction given by the Government." The act prohibits overdrafts on government accounts maintained at the CNB and sets a limit on the possibility to grant short-term credit to the government through the purchase of treasury bills. The *Constitution* provides for the central bank's operational independence by requiring that any additional functions beyond those in the *CNB Act* imposed on the central bank be set out in specific laws. Thus, the CNB's involvement in

[1] Prepared by staff from the Monetary and Exchange Affairs Department (led by Mr. Ariyoshi) and the European I Department (led by Mr. Feldman), in consultation with the Czech authorities.

[2] The CNB is the successor institution to the State Bank of Czechoslovakia, which was dissolved in October 1992 when the Czechoslovak Federation split into two independent entities.

Box 1. Code of Good Practices on Transparency in Monetary and Financial Policies

The Fund, working together with the Bank for International Settlements, and in consultation with other institutions, has prepared a code of transparency practices for monetary and financial policies.[1] The code identifies desirable transparency practices for central banks in their conduct of monetary policy, and for central banks and other financial agencies in their conduct of financial policies.

The design of good transparency practices in the draft code is based on two main principles.

- Better public information will promote the efficiency of markets and thereby improve the effectiveness of monetary and financial policies. The beneficial effects of transparency work principally through improving the policy transmission mechanisms. In the case of monetary policy, this is achieved through fostering the public's understanding of the goals of monetary policy and through the monetary authorities demonstrating credible steps towards achieving these goals. For financial policies, the clarification of policy objectives reduces uncertainty, enabling market participants to take proper account of the policy framework when making economic decisions.

- Good governance calls for central banks and financial agencies to be accountable, particularly when monetary and financial authorities are given a high degree of autonomy. In cases where conflicts could arise because different tasks are being undertaken within one agency, or because similar tasks are being shared by different agencies, transparency regarding the mandates of individual agencies can enhance their effectiveness, strengthen governance, and facilitate policy consistency. So can clear rules and procedures regarding the operations of these agencies.

The code acknowledges that in certain circumstances there could be *bona fide* reasons for limiting transparency, for example in the areas of foreign exchange operations or when considerations of financial market stability play an overriding role. **In focusing on transparency, the code is not designed to offer judgment on the appropriateness or desirability of specific monetary or financial policies.**

[1] *Code of Good Practices on Transparency in Monetary and Financial Policies,* which is available on http://www.imf.org/external/np/mae/mft/index.htm.

fiscal operations and agency roles performed on behalf of the government are defined by law. Moreover, details of the specific arrangements in this regard are publicly available.[3]

4. ***Financial Policies.*** Financial policies encompass measures related to the regulation, supervision, and oversight of the financial and payment systems with the aim of promoting financial stability, market efficiency, and consumer protection. In the Czech Republic, financial institutions include universal and specialized banks, credit unions, insurance companies, investment and pension funds, and securities firms.

5. Supervision and regulation are undertaken by different entities, depending on the particular financial activity.[4] Supervision of and regulations for the activities of universal and specialized banks are the responsibility of the CNB. In the case of securities firms and investment funds, the MOF issues regulations, and the SC is responsible for enforcement and preparation of drafts of government decrees. For pension funds, supervision is undertaken by the state supervisor of pension funds (which is within the MOF) in cooperation with the SC and the depositories of the individual pension funds. The MOF is responsible for supervising and regulating insurance companies. Credit unions and savings cooperatives are supervised and regulated by a separate institution under the general purview of the MOF.[5] The payment system is owned and operated by the CNB and not subject to supervision by another agency. The rules for stock market clearing and settlement are defined in the *Stock Exchange Act* and the *Stock Exchange Rules*. Finally, accounting rules for all financial institutions are set by the MOF.[6]

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[3] For example, the specific rules and procedures that determine the CNB's relationship with the fiscal authorities are in the *CNB Act*, *Act No. 530/1990 on Bonds*, and the *Act on Budgetary Rules*.

[4] The supervisory and regulatory authority of the respective entities are defined in the *CNB Act* (as concerns banking supervision), *Act No. 87/95* (credit unions), *Act No. 185/1991*, as amended by *Act No's. 320/1995* and *149/1995* (insurance), *Act No 42/94* (pension funds) and in the *Act on the Securities Commission* (No. 15, January 13, 1998) (investment funds and securities firms).

[5] While the office of Supervision over Savings Cooperatives is formally an independent institution, the MOF appoints its director, determines its statutes and rules governing its performance, and approves an annual report on its performance and its budget.

[6] Compliance with accounting rules is monitored by the relevant supervisory authority during on-site visits and off-site assessments.

Open Process for Formulating and Reporting Monetary and Financial Policies

6. *Monetary Policy.* The CNB has wide discretion, within the bounds of operational powers granted to it by the *CNB Act* and other laws, to implement monetary policy in order to meet the basic objective set out in the *Constitution*. The *CNB Act* requires the CNB to provide an annual report to Parliament and a quarterly report to the general public. These requirements are fulfilled through publication of an annual *Report on Economic and Monetary Developments* and a quarterly *Inflation Report*. The CNB also publishes a monthly bulletin including statistical data and commentary on recent developments, as well as summary minutes of its board meetings (with a delay of two weeks or less). In addition, all board decisions are published as a press release, with press conferences being conducted for key decisions.

7. *The CNB has adopted an inflation targeting framework (see Box 2) and reports on its* operations in the *Inflation Report*. While the CNB does not conduct formal consultations with the public prior to revising monetary regulations, important changes are announced through press releases that are also placed on the CNB website.

8. *Financial Policies*: Regulations are established on the basis of relevant laws, and implementing ordinances and provisions. Laws are debated and adopted in Parliament, while the relevant supervisory agencies—the CNB for banking and the MOF for all other areas—have the authority to issue regulations related to these laws. The relevant documents are all publicly available, with those related to the CNB and the SC also placed on the web pages of the respective institutions.[7] The SC's consultations with the MOF on its proposals for new regulations are open to the public.

9. The relationship between the financial supervisors (i.e., the CNB, MOF, and SC) is set out in the constituting laws of the respective bodies, and is supported by a trilateral agreement among the institutions concerned. The contents of the trilateral agreement and the extent of consultation among supervisors are focused on three basic areas: (i) exchange of information; (ii) cooperation in supervision; and (iii) common consultations and license information transfer.[8] There is some overlap in that the same institution may be subject to supervision by different agencies concerned with separate aspects of its activities, and the mandates and powers of the different supervisors and how they coordinate their activities is not always clear.

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[7] The SC web page is located at http://www.sec.cz

[8] Coordination between supervisors is limited by the obligations of confidentiality. The trilateral agreement defines when and how much information can be exchanged between supervisors, which information is exchanged automatically and which must be specifically requested, and provides a framework for regular meetings and consultations.

Box 2. Transparency of the Inflation Targeting Framework

Inflation targeting (IT) is a monetary policy framework that sets quantitative targets for some future rate of inflation, the attainment of which is understood to be the overriding objective of monetary policy. Additionally, IT regimes require a methodology for producing inflation forecasts as well as a forward-looking operating procedure whereby policy instruments are adjusted based on deviations of the inflation forecast from the inflation target. In the Czech Republic, following the exchange rate crisis in May 1997 and subsequent abandonment of the peg, the CNB began to lay the groundwork for adopting an IT framework.

Transparency of the Czech IT regime. A *Report on the Monetary Program and Monetary Policy of the CNB in 1998 and in the Medium Term* was released to the public at end-1997, immediately following the CNB board decision to pursue inflation targeting. The report (i) discussed the rationale behind targeting inflation; (ii) defined clearly that the CNB would target CPI inflation excluding the effects of indirect tax and administered price changes (including a detailed description of how this *net* inflation target would be calculated); and (iii) announced an indicative target for end-1998 along with a medium-term target for net inflation at end-2000. The report also provided a short explanation of how the level of the inflation target had been chosen, how the conditional inflation forecast would be developed, and how deviations from the target would trigger corresponding adjustments in short-term interest rates, the CNB's main operating instrument. The goals and functioning of the IT regime are communicated by the CNB to the public through publication of a quarterly *Inflation Report*, regular release of CNB board minutes, as well as issuance of press statements. The *Inflation Report* (released one month after the end of the quarter) summarizes economic and policy developments as background for the inflation outlook and is the main written vehicle for sharing views with the public. Short minutes of the monthly monetary policy discussion meetings of the CNB board are released with a two- week lag, and are also published separately in the *Inflation Report*. In addition, the CNB released a *Monetary Strategy Document* this year, to initiate discussions with the government on the medium–term inflation objective in the context of EU accession. All these reports, minutes, and press releases are placed on the CNB's web-site at the time that they are released to the public. In practice, CNB board members and other senior officials also meet with the press to discuss the monetary policy outlook, particularly when decisions are made with respect to changes in interest rates.

International Comparisons. All inflation targeting central banks explain and motivate their policies in regular inflation reports or monetary policy statements. The depth and detail of the analysis in these reports varies, as does the style of presentation of information. While best practices with regards to the transparency of IT regimes are still evolving, international comparisons can provide some perspective. At least three central banks—the Reserve Bank of New Zealand (RBNZ), Bank of England (BOE), and Sveriges Riksbank (SR)—publish the time path of their inflation forecasts over the course of the next 2–3 years, including confidence intervals for the forecast. BOE and SR forecasts are explicitly conditional on unchanged interest rates while the RBNZ presents an interest rate trajectory required to achieve the inflation target. The RBNZ also presents three-year paths for inflation, the output gap, a three-month interest rate and the exchange rate; the BOE has also started presenting an output forecast. The RBNZ issues a short explanatory press statement instead of minutes of its six–weekly monetary policy committee meetings. The BOE releases comprehensive minutes of monthly monetary policy meetings, along with details of the data prepared by BOE staff for the committee's consideration in deciding on interest rate policy. BOE minutes publish the voting record of individual committee member's regarding interest rate policy. The CNB has tended to present a numerical range for its inflation forecast for specific points in time but does not always make it clear whether a change in interest rates will be needed to meet the inflation target. Further, the published minutes of the CNB board meetings are typically concise summary minutes.

Public Availability of Information

10. The presentation and release of the CNB's monetary data follow the Fund's SDDS requirements. The CNB maintains a publication program in which these data are made available, and much of the information is also posted on the CNB's website. In addition to the aggregate balance sheet of the banking sector, which is published as part of the CNB's monetary data, the central bank also disseminates financial data on the banking sector. These are published quarterly on an aggregate basis by the CNB in the form of a press release and also included in the CNB's Annual Report.

11. The CNB issues an annual Banking Supervision Report, discussing regulatory issues and some selected indicators of the banking system. The SC publishes a monthly report of its own activities, as well as quarterly budget and activities reports, while its first annual report is about to be published. The supervisor for pensions issues quarterly reports on the drawing of contributions from the state budget, but no other information is disclosed. The new *Act on Insurance*, which is expected to become effective in early 2000, will oblige the MOF to issue an annual report on its supervisory activities. Aggregated data on the activities of non-bank financial institutions are currently not published by the MOF, although industry associations, for example of insurance companies and pension funds, do publish aggregate information on its membership.

Accountability and Assurance of Integrity by the Central Bank and Financial Supervisory Agencies

12. As required by the *CNB Act* and mentioned above, the central bank submits an annual *Report on Economic and Monetary Developments* to Parliament and a quarterly *Inflation Report* to the public. Financial statements of the CNB are audited by an external auditor and are included in the CNB's *Annual Report*. The main avenue for accountability of the CNB remains the publication of the various reports and statements it issues regarding its activities and their subsequent scrutiny and discussion in the Parliament and by the general public. The SC provides budget reports to Parliament but, as an enforcement agency, the SC is ultimately held accountable through scrutiny of its enforcement actions during the judicial process (including appeals).

13. Pension funds and insurance companies are regulated by the MOF, which is held accountable in the same way as any government ministry, through the Minister and the Parliament. In the case of non-compliance, the insurance or pension funds supervisory authority initiates an administrative process that can lead to the imposition of regulatory provisions, including penalties, suspension of new business (for insurance companies), or the nomination of a property administrator (for pension funds). The scope of penalties is determined by the relevant laws and hence known to insurance companies and pension funds. Except in the case of revoking a license, the results of an administrative process are not made public.

B. IMF Staff Commentary

- The CNB has a large degree of independence and autonomy in monetary policy formulation and implementation. The primary vehicle for ensuring transparency and accountability is through the publication of quarterly *Inflation Reports* and other reports, release of summary minutes from meetings of the policy making board, public commentaries by high level CNB officials, and data dissemination through different channels. In these areas, the CNB has made commendable efforts to provide information on a broad range of aspects of its operation in a timely and comprehensive fashion.

- The operation of the inflation targeting (IT) regime has increased transparency. The independence of the central bank, and the fact that it is not required to, nor does it, explicitly target other variables, supports its IT framework. The presentation and disclosure of information underlying the inflation outlook and related monetary policy decisions is close to the standards of industrial countries. While the discussion of the inflation forecast in the *Inflation Report* is less detailed than in some industrial countries, this is understandable in light of the comparative difficulty and large uncertainty associated with forecasting inflation in the Czech Republic at the current juncture. Nevertheless, the focus in many official commentaries on a short-term "indicative" inflation target, combined with limited discussion of the medium-term inflation forecast, tends to obscure the CNB's operating procedures.

- Further progress could be made to improve the transparency of financial policies. While relevant public reports are issued by several regulators, it would be helpful if this were a more uniform practice. In addition, further efforts could be made to define more clearly the mandates and powers of the various regulatory agencies, and how cooperation is to be implemented when supervision and regulation is shared by different agencies. The public could also be involved more consistently in the process of changing financial policies through more widespread use of open consultation.

Banking Supervision

Czech Republic

Prepared by a staff team from the International Monetary Fund on the basis of information provided by the Czech authorities

International Monetary Fund

Prepared in August 1999 and reissued in July 2000

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COMPLIANCE WITH BASEL CORE PRINCIPLES FOR BANKING SUPERVISION[1]

A. Description of Practice

1. The Czech National Bank (CNB) is responsible for banking supervision in the Czech Republic. The *Act on the Czech National Bank* assigns the responsibility of banking supervision to the CNB, while the *Act on Banks*, supplemented by provisions issued by the CNB, provides the regulatory framework. The CNB has been improving its regulatory and supervisory framework to conform to international best practices, and to bring it in line with EU norms in preparation for EU accession. Texts of the above-mentioned laws, supervisory regulations, as well as an annual report on the state of the banking sector, are accessible on the CNB's website.

2. The CNB provided a self-assessment of compliance with the *Basle Core Principles for Effective Banking Supervision* (see Appendix I, which also lists the core principles for reference). This exercise was undertaken to help assess the transparency of banking supervision and its underlying foundations. It is based on the draft assessment methodology published by the Basel Committee in May 1999. The CNB was a member of the contact group that developed this methodology. The self-assessment results show that the Czech Republic is compliant or largely compliant in 11 principles, partly compliant in 8, and largely non-compliant or non-compliant in 6.[2,3] The following provides an overview of the current supervisory environment, based on the self-assessment and on information gathered by IMF staff on earlier occasions.

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[1] Prepared by a team from the Monetary and Exchange Affairs Department (led by Mr. Ariyoshi), in consultation with the Czech authorities.

[2] The six categories used by the CNB in their self-assessment (fulfilled, fulfilled to a large extent, fulfilled partially, not fulfilled to a large extent, not fulfilled, and not applicable) are somewhat different from the five categories in the draft Core Principles Methodology Handbook published by the Basel Committee (compliant, largely compliant, materially non-compliant, non-compliant, and not applicable). As a result, the concordance between the CNB categories and those in the Handbook is not always straightforward. For example, the category "fulfilled partially" could, if the Handbook methodology were followed strictly, be classified as either largely compliant or materially non-compliant. Which category the "partially fulfilled" items would fall into would depend on the assessment of the quality of on-site examination and other supervisory practices.

[3] In this classification, Principle 1 is counted as being largely fulfilled/fulfilled, although one of the sub-items is assessed to be partially fulfilled.

Legal Framework

3. The CNB sees the existing *Act on Banks* as being largely adequate as a basis for complying with EU norms and Basle Core Principles, although it considers that some revisions are necessary to bring the system into full compliance with both. Required revisions include the deletion of the clause requiring the CNB to support the Deposit Insurance Fund, and a strengthening of the law to permit consolidated supervision of financial and mixed conglomerates. The current law confers broad supervisory powers to the CNB, including those in licensing and delicensing, establishing supervisory regulation, reporting and disclosure, and enforcement actions, as well as powers to impose conservatorship and propose liquidation. Detailed requirements for licensing, including application forms are published. Regulatory rules established by the CNB pursuant to legislation include those on capital adequacy, large exposure, foreign currency exposure, provisioning for loan losses and securities valuation losses, and separation of investment and commercial banking activity. These regulations, with some exceptions such as the capital charge for market risk which is planned to be introduced shortly, cover most of the areas stipulated in the Basle Core Principles.

Implementation

4. Supervisory capacity, while rapidly improving, is still seen as being in the development stage. Major revisions to the *Act on Banks* and many detailed regulations have been introduced over the last two years so that there is not as yet a very long track record of implementation. The CNB's self-assessment reflects this: while the CNB deems itself to be largely compliant when the principles call for the existence of a legal framework, the self-assessment falls into the partially-fulfilled category when the principles call for ensuring effective oversight of bank activities.

Transparency (Accounting and Disclosure) Aspects

5. Banks are required to maintain accounts in accordance with the *Accounting Act*, and disclose an audited annual report including financial performance based on these accounts. Bank supervisors have the power to reject auditors selected by the bank that is being audited, and the auditor is required to inform the bank supervisor of any material fact that became known to the auditor having a potentially adverse impact on the bank's performance. Banks are also required to disclose information on shareholders and summary financial information at the end of each quarter, not later than six weeks after the end of each quarter.

6. The Czech Accounting Standards (CAS), which are established by the *Accounting Act* and implementing ordinances, are applied on an unconsolidated basis and deviate in some significant respects from international accounting standards (IAS), including in the treatment of foreign exchange gains/losses and the recognition of overdue interest. Major banks, however, publish consolidated IAS statements along with unconsolidated CAS data. The CNB and the MOF have also introduced regulations to compensate for some of the shortcomings of CAS: for example, regarding the lack of consolidation, the *Act on Banks* requires disclosure of data on banks' subsidiaries and related companies, and banks are

required to deduct from their capital their holdings in subsidiaries for the purpose of calculating capital adequacy ratios. In addition, a MOF decree requires banks and other financial institutions to compile consolidated annual accounts for disclosure to shareholders, though not to supervisors.

Other Related Issues

7. Bankruptcy legislation generally favors debtors and the enforcement of loan contracts tends to be troublesome and time consuming. Moreover, loan valuation can be problematic because of the difficulties in enforcing creditor rights. It is also not uncommon for non-performing loans secured by real estate collateral to remain on the books of banks for several years, because of difficulties in foreclosure and in generally obtaining prompt decisions from the courts. Legislative initiatives have been taken and are being considered in order to improve creditors' rights and facilitate banks' ability to recover their loans in a timely fashion.

B. IMF Staff Commentary

- The authorities are to be commended for their efforts to improve the supervisory regime to bring it into compliance with international best practices and to therefore implement banking supervision in a transparent way. As noted by the authorities, most of the legal and institutional framework is in place, although the staff sees some gaps in the accounting framework. Consolidated supervision and supervision of market risk are also areas where the existing regulatory framework needs to be strengthened, and the staff welcomes the authorities' intentions to do so in the near future, including by introducing capital requirements for market risk as recently approved by the CNB.

- For many areas of the Core Principles, the extent to which the principles are fulfilled depends on whether supervision is implemented appropriately, rather than on the existence of rules, regulations, or examinations. The staff has not conducted a full and independent assessment that would allow it to judge the degree to which supervision is implemented in compliance with the Core Principles. However, it expects that, given the limited institutional experience of CNB in bank supervision, there is scope for improving the quality of implementation in all aspects of supervision. As in most countries, staff development will be a key issue.

- Existing supervisory practices are formally consistent with the disclosure aspect of the Core Principles, but shortcomings in accounting practices mean that disclosure practices fall short of best standards of transparency. While many banks produce IAS based accounts on their own initiative, effective and consistent application of disclosure and supervision will require improvements in the CAS. For example: accounts are currently unconsolidated; there is very little recognition of valuation changes; and interest on loans is recognized in accordance with the credit contract even when overdue. Such accounting practices provide a distorted picture to bank management and bank supervisors. Recognizing these shortcomings, the authorities are preparing a new *Act on Accounting*, which is expected to come into force in 2001 and is designed to ensure full compliance with IAS.

Czech Republic: Self-Assessment on Compliance with Basel Core Principles for Effective Banking Supervision

Principle	Not fulfilled/ largely not fulfilled	Partially fulfilled	Fulfilled/ largely fulfilled	Overall assessment comment.
1 (1). Clear responsibilities and objectives for each supervisory agency.			X	Fulfilled to a large extent. Laws could benefit from further clarity in some areas.
1 (2). Operational independence and adequate resources.			X	Fulfilled to a large extent. There still exists a lack of sufficiently qualified people for the area of general policy and the regulatory framework for banking supervision, as well as for on-site inspections.
1(3). A suitable legal framework for authorization and ongoing supervision.			X	Fulfilled.
1(4). A suitable legal framework to address compliance with laws as well as safety and soundness concerns.			X	Largely fulfilled. It would be appropriate to consider whether the obligation to supply information and documents also in the periods between onsite examinations should not be set forth explicitly in the *Act on Banks*.
1(5). Legal protection for supervisors.		X		Limited protection of banking supervisors in the performance of banking supervision does exist. The protection of banking supervisors in other countries will be studied as a model for a possible amendment to the *Act on Banks*.
1(6). Arrangement for sharing of information between supervisors and protection of confidentiality of shared information.		X		Partially fulfilled. For cooperation with domestic supervisors, legal obstacles to information sharing, particularly affecting the MOF, will need to be removed. Restrictions for foreign supervisors or external auditors to perform supervision within the country also still need to be removed.

2. Clearly defined permissible activities for banks and control of the use of the word 'bank.'			X	Largely fulfilled. While the use of the name "bank" is controlled, further measures are needed to strengthen the enforceability of the *Act on Banks* in the area of collection of deposits by unlicensed entities.
3. Criteria for structure, directors, operating plan, controls, financial condition, and capital base.			X	Fulfilled.
4. Authority to review and reject transfer of ownership.			X	Fulfilled.
5. Authority to review major acquisitions and investments.		X		Partially fulfilled. The banking supervisory agency individually approves any acquisition or investment undertaken in the form of a purchase or sale of the whole or a part of a business, as well as amalgamations and mergers. However, other forms of investment do not need CNB approval.
6. Minimum capital adequacy requirements (meet Basle Capital Accord for internationally active banks).			X	Largely fulfilled.
7. Independent evaluation of loan and investment policies.			X	Largely fulfilled.
8. Policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves.			X	Largely Fulfilled. Evaluation of collateral (particularly real estate) is problematic. However, legislation in that area does not fall within the powers of the CNB.
9. Prudential limits and management information system on concentration of exposure.		X		Partially fulfilled, with the exception of consolidated supervision and sectoral and geographical exposures.

10. Arm's length rule and monitoring for connected lending.		X		Partially fulfilled. There may be a need to amend the *Act on Banks* to include the right for supervisors to make judgements on whether certain parties should be considered "related;" the definition of related parties needs to be broadened.
11. Policies and procedures for country risk and transfer risk.	X			Largely not fulfilled. In connection with the preparation of the provision on capital adequacy, such provisions are only now being introduced in the Czech Republic.
12. Measuring and monitoring market risk. Limit and/or specific capital charge on market risk exposure.		X		Only partially fulfilled as there is need for further training of supervisory staff to deal with market activities of banks, including evaluation of internal models. Greater attention needs to be paid to understanding all elements of market risks and the banks' (including senior managements') handling of such risks.
13. Comprehensive risk management process.		X		Partially fulfilled. More emphasis needs to be placed on stress testing and contingency planning. Decision needs to be taken on adequate capital requirement for risks other than market and credit risks.
14. Adequate internal controls.			X	Fulfilled.
15. Strict "know-your-customer" rules and high ethical and professional standards.		X		Partially fulfilled. Certain criteria that have to be met in practice should be introduced into the laws or regulations. The supervisory agency is not empowered to regulate anti-money-laundering measures, but in the course of supervision checks compliance with laws related to money laundering.

16. Effective supervisory system consisting of on-site and off-site supervision.		X		Partially fulfilled. The supervisory agency does not evaluate its own effectiveness. Methodology for both off-site surveillance and on-site examination exists and is systematically updated to ensure the interconnection of both instruments and a comprehensive approach to individual banks.
17. Regular contact with bank management and understanding of bank's operations.			X	Largely fulfilled. However, no explicit requirement for reporting adverse developments or breaches of laws and regulation.
18. Analytical reports and statistical returns on solo and consolidated basis.	X			The Principle has been fulfilled with regard to obtaining information from banks on a solo basis and has not yet been fulfilled with respect to obtaining information on a consolidated basis.
19. Independent validation of supervisory information through on-site examination or external auditors.			X	Largely fulfilled. It is necessary to further standardize the procedures for on-site examinations in the form of written documents (manuals).
20. Ability to supervise on a consolidated basis.	X			Consolidated supervision has not yet been introduced. The CNB has issued a provision on consolidated supervision which covers groups headed by banks. However, its enforceability is a moot point as the effective performance of supervision on a consolidated basis will be governed by an amendment to the *Act on Banks*. The first consolidated returns for supervisory purposes will be submitted by banks for 1999 and subsequently once each year. From 2003, it is expected that returns will be submitted on a semi-annual or quarterly basis.
21. Adequate records and consistent accounting policies and practices; regular financial statements that fairly reflect the bank's condition.		X		To fulfil this principle, the CAS will need to be adjusted to bring them into line with international best practices.

22. Adequate supervisory measures to ensure timely corrective action.			X	Largely fulfilled. Consideration should be given to amending the *Act on Banks* to allow stricter individual sanctions.
23. Exercise global consolidated supervision.	X			Largely unfulfilled. It will be regulated by the forthcoming provision on supervision on a consolidated basis and in particular by the amendment to the *Act on Banks.*
24. International exchange of information with other supervisors.	X			Not fulfilled. Fulfillment will be secured primarily in the form of cooperation agreements with foreign supervisory authorities. Some agreements are already under preparation, and in other cases negotiations on co-operation have been started.
25. Supervision of local operation of foreign banks and information sharing with home country supervisors.	X			Largely unfulfilled to date. Will be addressed in the form of cooperation agreements with foreign supervisors.

Securities Market

Czech Republic

Prepared by a staff team from the International Monetary Fund on the basis of information provided by the Czech authorities

International Monetary Fund

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TRANSPARENCY AND THE SECURITIES MARKET[1]

1. This chapter discusses the institutional framework and practices in the Czech securities market, focussing on the equity market and the investment funds.

2. The origins of the Czech securities market are closely linked to the mass voucher privatization scheme, which formed the center piece of the government's economic reform program in the early and mid–1990s.[2,3] The voucher privatization led rapidly to a very large number of publicly tradable companies and the capital market was lightly regulated in order to encourage secondary trading and ownership transfer. In 1997, the Czech Republic had over 2,100 listed joint stock companies, with a market capitalization of around 30 percent of GDP, suggesting a capital market much larger than in other transition economies and of comparable size to some well-established Western European markets.

3. However, these figures are somewhat misleading. First, the bulk of the listed companies are in fact not traded. Second, government holdings of enterprise shares through the NPF (which are not traded) account for about 40 percent of market capitalization. Adjusting for double counting resulting from the role of investment funds as major shareholders in some large enterprises,[4] the World Bank estimated that in 1997 the "true" size of the Czech capital market was around 14 percent of GDP—much closer to that of other transition economies and countries with the same level of per capita income.

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[1] Prepared by Mr. Nord (European I Department) and Mr. Rocha (World Bank), in consultation with the Czech authorities.

[2] The development of the capital market is discussed at length in, for example, the World Bank's recent report: *Czech Republic –Capital Markets Review*, A World Bank Country Study, May 1999.

[3] For a summary of the voucher privatization scheme, see, for example, *The Enterprise Sector and Corporate Governance in the Czech Republic–An Assessment*, in *Czech Republic–Selected Issues*, IMF 1999 (SM/99/157, Sup. 1, 7/7/99).

[4] The double counting results from the role of investment funds as intermediaries: total market capitalization includes both the value of these intermediaries' shares as well as that of the securities in which they invest.

A. Description of Practice[5]

Regulatory Framework

4. The Czech securities market is regulated by a number of laws and decrees introduced gradually since 1991, and amended on several occasions since then, including: *the Bonds Act (1990); the Commercial Code (1991); the Securities Act (1992); the Stock Exchange Act (1992); the Investment Fund Code (1992); and the Securities Commission Act (1998).*

5. Primary supervision over the securities market was exercised by the MOF until 1998 when an independent SC was established. The SC has enforcement powers in specific areas related to securities issuance and trading, although the enforcement of provisions contained in the *Commercial Code* (e.g., those governing buy-outs and the obligations of publicly-traded companies) *remains with the commercial courts.*

6. The SC is guided in its work by the Czech Republic's objective to join the European Union (EU). Hence EU standards and regulations, rather than IOSCO principles, have constituted the SC's primary frame of reference in its first year of operation.[6] The SC also actively participates in international fora addressing financial crime. The SC does not have the authority to issue new regulations, which must be adopted as government decrees and remains within the purview of the MOF. However, it has the responsibility to initiate regulations by preparing drafts of government decrees for the MOF in its areas of competence.

7. The regulatory powers of the SC as well the penalties for non-compliance are publicly known. The appeals process against decisions of the SC comprises, in the first instance, an appeal to the SC Board, which has established independent appeals committees to handle such cases. Further appeals then go to regional courts and, in the final instance, to the Constitutional Court.

8. The regulatory framework and the practices of the SC, including its objectives, role and responsibilities, modalities of accountability, and internal rules and regulations are posted on its public web site. The SC issues monthly reports on its activities and decisions, as well as quarterly budget and activities reports, which are also available on its web site. Before finalizing any proposal for new market regulations, the SC solicits input from a variety of affected groups through widespread public consultation, and its recommendations and drafts of new regulations are also posted on its web site.

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[5] This is a summary prepared by the IMF and the World Bank staff. It was reviewed by the authorities and based on information provided by them.

[6] It appears that the Czech securities regulations comply with the majority of IOSCO principles, the main exception being the role of self-regulatory organizations, which are currently not covered by the Czech regulatory system.

Functioning of the Czech Securities Market

9. The Czech **equity market** is characterized by a multiplicity of dealing channels. An investor has three options: (i) go through a broker to the Prague Stock Exchange (PSE); (ii) deal directly on the "RM" system (one of the two organized equity markets, the other being the PSE); or (iii) deal privately off-market with another investor. A broker, in turn, can either operate as a member of the PSE, deal on the RM system, or deal bilaterally with another member of the PSE off-market.

10. As noted in the World Bank report, this structure of the equities market has contributed to fragmentation and price distortion.[7] In 1998, the PSE introduced a market maker-based trading system (SPAD–The Czech acronym for System Supporting the Market for Shares and Bonds), which increased sharply the proportion of trading on the PSE taking *place at market-determined prices. However, the RM-System (which in 1998 accounted for* about 16 percent of trading) continues to be dominated by direct trades. Trading completely outside the two organized markets accounted for a further 20 percent of the trading volume in 1998.

11. At least since the 1996 amendments of the *Commercial Code* and the *Securities Act*, joint stock companies have been subject to extensive disclosure requirements.[8] Initial compliance was patchy, however, and in February 1999 the SC issued fines to over 800 publicly-traded companies for failure to comply with disclosure requirements. Since then, compliance has improved dramatically.

12. **Investment funds** were introduced in 1992, during the first wave of the voucher privatization program. They were expected to play a number of important roles, including collecting vouchers from individuals, bidding for shares in primary auctions, conducting secondary trading, and exercising active corporate governance. However, liberal licensing criteria, lax supervision, limited disclosure rules, and weak performance incentives contributed to poor performance of these funds, and the perception that several investment funds were vehicles for fraudulent transactions. In addition, the closed-end structure of the funds, which exempted them from the obligation to redeem shares at their net asset value on demand, acted as a disincentive for fund managers to maximize the value of their portfolio.

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[7] The World Bank (1999) estimated, based on an analysis of data on stock price behavior between January 1996 and March 1998, that formal market mechanisms handled only 5 percent of trading volume, with most transactions negotiated off-market at prices that differed significantly from those determined in the formal market. It was not uncommon to observe significantly different prices for the same security in the various markets.

[8] Companies are required to prepare annual audited balance sheets and income statements, an extensive and detailed annual report, and six-monthly financial statements, unaudited but following a standard format. Companies listed on the PSE must submit quarterly financial statements as well.

13. Beginning in 1998, the government started to reform the regulatory framework of the securities market, including the investment funds. The 1998 amendment to the *Investment Fund Act* mandated the gradual conversion of closed-end to open-end funds, and the SC was established in that year. The conversion of closed-end funds is proceeding well, with half of the funds having already opened voluntarily and ahead of schedule. The SC's first task, the relicensing of all securities brokers, investment companies, and public market organizers, is almost completed and is likely to lead to a sharp reduction in the number of licenses.

B. IMF Staff Commentary

- The segmentation and (initial) loose regulation of the securities market contributed to a lack of transparency in pricing of securities, evidenced by the frequent multiple prices for the same security. Technical factors, such as the absence of a harmonized dealing and settlement system, have partly accounted for the price divergence. Another reason would appear to be the willingness of large investors to pay a premium for corporate control. However, there has also been evidence of fraudulent transactions, including the use of shell companies for asset stripping, which may help explain the significant price differences between markets.

- This has been compounded by weak corporate governance on the part of many of the investment funds. At the level of individual enterprises, insufficient corporate disclosure, largely because of the lack of enforcement of existing requirements rather than inadequate requirements *per se*, also weakened outside monitoring and control. Recent improvements in compliance with disclosure requirements are a welcome sign of increased transparency, but the lack of enforcement responsibility of the SC in some critical areas such as the regulations governing shareholders' rights has continued to cast a pall over the Czech capital markets and prevented the confidence of investors from being fully restored. In addition, the lack of direct regulatory powers remains an impediment for the effective functioning of the Commission.

- While the establishment of the SC was an important step forward and the Commission is characterized by far-reaching transparency in its structure and operation, issues need to be addressed, despite the 1998, reforms in both the areas of regulation and enforcement, as well as market fragmentation, if capital markets are to be strengthened on a durable basis. The focus of further reform—currently under consideration—should be two-fold:

- **First, further strengthen the regulatory framework.** A comprehensive package of legislation (amendment of the *Commercial Code*, the *Accounting Act*, the *Securities Act*, the *Securities Commission Act*, and *the Bonds Act*) is being prepared with the aim to introduce it on January 1, 2000. This package should, *inter alia*, strengthen minority shareholders' rights, clarify the responsibilities of boards of directors, improve disclosure, and facilitate takeovers of inefficient companies by strategic investors. The package should also strengthen the enforcement powers of the Commission, enabling the agency to enforce key regulations of the *Commercial Code* (e.g., minority shareholder rights). The authorities expect that several companies will be unable to comply with these stricter rules, resulting in a reduction in the number of publicly tradable companies to those that really fit the profile. Such a package would greatly improve transparency in securities market activities and strengthen corporate governance. In this regard, it would also be desirable to invest the SC with direct regulatory powers and reduce its dependence on the MOF.

- **Second, address the continued fragmentation of the securities market.** The authorities are also making efforts in this direction, by strengthening the role of SPAD (the dealer system introduced in early 1998) and introducing an order routing system, ensuring the execution of best orders. Enhancing the transparency of off-market trading by imposing stringent disclosure requirements equivalent to those prevailing in the formal markets would also contribute to reducing price divergence.

- It will be important that efforts on both fronts are carried to fruition if much-needed transparency and confidence in the Czech capital market are to be restored.