DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

EBS/92/162

CONFIDENTIAL

October 14, 1992

To: Members of the Executive Board

From: The Secretary

Subject: Czech and Slovak Federal Republic - Review Under the Stand-By Arrangement

Attached for consideration by the Executive Directors is a paper on the review under the stand-by arrangement for the Czech and Slovak Federal Republic, which is tentatively scheduled for discussion on Monday, November 16, 1992. A draft decision appears on page 9.

Mr. Lipschitz (ext. 38866), Mr. Weerasinghe (ext. 38873), or Ms. van der Willigen (ext. 38861) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

CZECH AND SLOVAK FEDERAL REPUBLIC

Staff Report for Review Under Stand-By Arrangement

Prepared by the European I and
Policy Development and Review Departments

(In consultation with other departments)

Approved by Massimo Russo and Joaquin Ferrán

October 14, 1992

I. Introduction

On April 3, 1992, the Executive Board approved a one-year stand-by arrangement for the Czech and Slovak Federal Republic in the amount of SDR 236 million (40 percent of quota). Czechoslovakia has so far made the first two purchases under this arrangement, totalling SDR 36 million, and Fund holdings of Czechoslovak koruny now stand at 290 percent of quota (Table 1 and Appendix I). Completion of the present review is a condition for the third and fourth purchases, as is observance of the performance criteria for the third and fourth quarters of 1992 respectively. All performance criteria were met for the second quarter (Table 2), and those for the third quarter are thought to have been met also; final data for end-September will become available in early November. Discussions for the present review were held in Prague and Bratislava during September 9-18, with the Federal First Deputy Prime Minister, Mr. Filkus; the Czech and Slovak Prime Ministers, Messrs. Klaus and Mečiar; the Federal, Czech, and Slovak Ministers of Finance, Messrs. Klak, Kočárník, and Tóth; other Ministers of the Czech and Slovak governments with economic portfolios; the Governor of the State Bank of Czechoslovakia, Mr. Tošovský; and other senior officials. 1/

The discussions covered both developments and prospects for 1992, and, to the extent permitted by the substantial uncertainty about the institutional framework, the outlook for 1993. Barring unexpected political developments, the Czech and Slovak Federal Republic is likely to be dissolved on January 1, 1993, with independent Czech and Slovak states emerging in its stead.

1/ The staff team consisted of Mr. Lipschitz, Mr. Weerasinghe, Ms. Mrakovcic, Ms. van der Willigen, Mr. Doyle (all EU1), Mr. van der Mensbrugghe (PDR), and Ms. Kamaldinni (PDR). The team was assisted by Mr. Carter, Resident Representative in Czechoslovakia.

Discussions on the relations between these two states were at an early stage at the time of the mission's visit, precluding a thorough analysis of prospects beyond the end of this year.

In the attached letter, the Federal Minister of Finance and the Governor of the State Bank of Czechoslovakia describe recent developments as they see them and the outlook for the remainder of the year. In light of the strength of reserves, they indicate that they do not intend to make the remaining purchases under the stand-by; nevertheless, they wish to continue the arrangement as a set of guidelines for economic policy and a framework for monitoring performance.

II. Recent Developments

Financial policies have been broadly on track so far (Table 3), but the split of nominal income growth between real output and prices has been better than expected. Although the trough in GDP was deeper than originally thought, the pick-up appears to have come sooner. Inflation has been below program projections, with consumer prices rising by only 4 1/2 percent in the first eight months of 1992.

Data on economic activity remain incomplete. Provisional figures for the first half, however, point to a slight increase in industrial production by large state enterprises, and much stronger growth in both construction and the small-scale private sector. Moreover, final demand is growing faster than total demand, the wedge reflecting an enormous, and overdue, rundown of inventories. Some revival in fixed investment is already evident, even ahead of the completion of the "first wave" of large-scale privatization (see pages 5-6). Consumption too appears to have been picking up since March, reflecting a rise in employment, but perhaps also a rundown of household stocks and a recovery of consumer confidence; real wages have remained at about their end-1991 level.

Registered unemployment has fallen, from a peak of 7.1 percent in January to 5.3 percent in August, only partly in response to a tightening of eligibility criteria for unemployment compensation. Large state enterprises appear to be maintaining employment, perhaps postponing the shake-out until after the completion of the "first wave". But more new jobs are also being created, and the number of vacancies has doubled since the beginning of the year. Regional differences in the labor market remain pronounced: in August, the unemployment rate in the Czech lands was 3 percent while that in Slovakia was 11 percent, and almost 90 percent of all vacancies were in the Czech lands.

The balance of payments has remained very strong. Net international reserves at mid-year exceeded program projections by more than US$1 billion, and the current account registered a surplus of US$0.7 billion in the first half, compared with a projected deficit of US$0.2 billion. Exports to the West have been growing strongly, registering a year-on-year increase in volume of some 10 percent in the first half; but this has been more than offset by a further large fall in exports to the former CMEA. At the same time imports have been far below projected levels, as the pick-up in final demand has been associated with a running down of stocks and increased output in the services sector and small-scale private enterprises, rather than--as anticipated in the program--with an import-intensive restructuring of large state firms. The competitive exchange rate, strengthened by low inflation, may also have played a part in the low import-intensity of demand.

III. Policy Issues

On present policies, the objectives of the program with respect to output and inflation appear likely to be more than met. Real GDP, which was projected to be flat through the year (i.e. fourth quarter to fourth quarter), now seems set to increase; 1/ the deeper-than-initially-estimated trough at the end of 1991 will, however, leave the year-on-year change close to the fall of 5 percent projected in the program. The rise in the consumer price index should remain in single digits, compared with the program projection of 12 percent.

1. Financial policies

The overall objectives of fiscal policy were achieved in the first half of the year, with the budget close to balance; but signs of strain were already evident (Table 4). Despite unexpectedly high one-off inflows from the settlement of accounts for 1991, central government revenues fell short of program projections. This was attributable in part to low inflation, but turnover tax and payroll tax, in particular, were also affected by the rapid changes in the structure of production (with a shift of resources into private activity and services) and an increase in tax avoidance, evasion, and arrears. There was, in addition, a shortfall in capital revenues, which were to provide funding for the completion of a housing program begun under the previous regime: sales of newly completed apartment buildings could not proceed as the relevant bill failed to win parliamentary approval. These various revenue shortfalls were offset by expenditure reductions of similar magnitude.

In the third quarter, despite some strengthening of revenues, the overall fiscal balance began to deteriorate as previously-postponed expenditures were undertaken. In the staff's view, with no action, the deficit for the year (excluding privatization proceeds) might have reached almost double the programmed 3 percent of GDP. Revenues would have fallen short by one percent of GDP, and expenditures increased to include four large items totalling some 1 1/2 percent of GDP: additional subsidies to the railway; the above-budget costs of a pension increase in June; increased social assistance claims in the

1/ Staff projections now see real GDP growth of 3-4 percent through the year. Projections are, however, rendered extremely hazardous by the very high inventory/output ratio. It is conceivable that, even with rapid growth of final domestic demand, GDP will drop as a result of a perfectly appropriate running down of inventories.

wake of the curtailment of unemployment benefits; and the costs of the ongoing construction of Gabčíkovo dam, which had not been included in the budget. 1/

Despite the complicated politics of the impending dissolution of the federation, the Government has taken commendable action to contain the deficit. In September, it raised consumer taxes on alcoholic beverages, cigarettes, and petroleum products (for an annual yield of 3/4 percent of GDP). Moreover, budget allocations, mainly for consumption expenditure and subsidies, have been cut by about one percent of GDP. To avoid a repetition of the expenditure surge that occurred at the end of 1991, control systems have been strengthened (with technical assistance from the Fund). Releases of funds, which used to be essentially at the discretion of spending ministries, will now be subject to approval by the Ministry of Finance, and will be made monthly in the fourth quarter; and clear agreements have been reached with the State Bank that ministries may not overdraw their releases. Moreover, the likely need for savings relative to budget allocations has been under discussion since early in the year, and expenditure regulation throughout the year has been geared to this end. With these measures, the Government intends to keep the deficit to 4 percent of GDP. Staff projections are slightly less sanguine, particularly as regards the room for savings in expenditure, but do not envisage the deficit exceeding 4 1/2 percent of GDP.

The conduct of monetary policy has been complicated by the substantial injection of liquidity through the balance of payments (Table 5), and by the market-segmentation effects of impending dissolution of the federation. Credit to the nongovernment sector--and especially to the emerging private sector, which now accounts for a fifth of the stock outstanding--has grown more rapidly than programmed, but this has been offset by the contractionary effect of higher-than-expected privatization receipts. 2/ Broad money is nonetheless growing faster than programmed; notably, much of this growth is taking place in quasi-money, suggesting that, in the absence of alternative financial assets, portfolio considerations continue to play a major part in money holdings. 3/ At the same time, demand for refinance has not slackened. While some Czech banks, which have imposed limits on their exposure to Slovakia, hold sizable excess reserves with the State Bank, the principal Slovak bank has continued to look to the State Bank for liquidity.

1/ The latter three items are suggestive of an early breakdown of fiscal policy coordination between the federal and republican governments: there was some evident underbudgeting of spending that could not be avoided, allowing, implicitly, for larger-than-agreed-upon deficits.

2/ The growth of credit has also been associated with a waning of disintermediation, as interenterprise arrears fell--albeit by a small amount--during the first half of the year.

3/ The increasing trend in foreign currency deposits (which now account for about 9 percent of broad money) has continued, probably reflecting increased transactions demand for foreign currency by the small-scale private sector.

The State Bank, while remaining mindful of the risk of stifling an incipient revival of output through overly tight credit policy, has leaned against pressures for a more expansionary stance. In September, it curtailed refinance sharply, raised the rates charged at the daily refinance window and on "last-resort" money, and increased reserve requirements by a percentage point; this stance has been reflected in rising interest rates in the interbank market and in refinance auctions. With the tightening of reserve money management, the State Bank eliminated formal bank-specific credit ceilings for the large banks in October; the ceilings on the small banks had already been removed in April.

The authorities have set their target for the net domestic assets of the banking system somewhat below the ceiling set as a performance criterion, and consider the program limit on net bank credit to Government to be the maximum sustainable without inflationary financing. In this light, no changes in the performance criteria on credit are proposed and any additional financing required by the Government will have to come from nonbank sources at market-determined rates of interest. Notably, insurance companies and other nonbank participants have recently been allowed access to the primary market for government debt.

Even without the planned division of the country, macroeconomic policies would face major challenges in 1993. The introduction of VAT will cause prices to jump, and the likely ending of tax-based incomes policies (at least for privatized firms) will place the burden of containing inflation squarely on monetary and fiscal policies. The difficulties will be exacerbated by the budgetary imbalances that have begun to emerge, and by the risks of revenue losses associated with tax reform. With dissolution of the Federation, it will be essential to establish a framework for monetary, trade, and payments arrangements between the Czech and Slovak states that does not disrupt macroeconomic stability. In some areas, notably that of exchange arrangements, this will require an enormous and careful effort at institution building. Both governments are alert to the challenges and risks in this situation.

2. Structural reform

Following the "big bang" of 1991, there have been some further adjustments in prices and the payments system. Rents, water prices, and public transport tariffs have been raised, and the prices of metallurgical products completely deregulated; and coverage of current account convertibility has been broadened to include unincorporated private businesses. The import surcharge remains at 10 percent.

Considerable progress has been made on privatization. Some 2,500 enterprises are included in the "first wave" of large-scale privatization. Of these, 1,500 firms--with a book value equivalent to 50 percent of GDP--are being put into private hands wholly or partly through the voucher scheme. 1/ Three rounds of bidding have been completed to date, and two thirds of all

1/ See SM/92/65, Chapter VIII, for a detailed description.

shares on offer (including the full allotment of shares for 173 enterprises) have been allocated to new owners. Despite the potential for financial irregularities in the operations of the (so far little regulated) Investment Privatization Funds (IPFs), the process appears to have been relatively untainted thus far. The first wave of voucher privatization will continue as planned despite the political complications, and is expected to be completed by year-end, probably with two more rounds of bidding. Conventional privatization (of both large-scale and unincorporated businesses) continues apace, with auctions, private sales, joint ventures, and other arrangements being announced frequently.

Progress is being made, belatedly, on the institutional and regulatory framework that will surround transactions in shares once these have been distributed. A securities law is to be presented to Parliament in November. Regulation of IPFs has been strengthened somewhat through the adoption of a basic law, and regulatory offices are to be set up quickly in the Ministries of Finance. Finally, preparations are being made to set up stock exchanges in Prague and Bratislava, and to use the infrastructure developed for voucher privatization to create an extensive over-the-counter market in shares.

The problem of nonviable enterprises, however, persists. The authorities view this as largely outside the domain of Government; privatization of most remaining state enterprises--through vouchers or conventional sales--is envisaged, and the liability of the Government is seen as limited. So far there have been no major bankruptcies, although the bankruptcy law adopted last year allows for them in cases where firms are insolvent. A clause due to come into effect in October 1992 would also have permitted bankruptcies of firms that were merely illiquid, without allowing them any period of protection from creditors for reorganization. Mindful of the chain of interenterprise arrears --and not least arrears from the former U.S.S.R. to Czechoslovak enterprises-- the authorities have decided to postpone by six months the entry into force of this clause; during this time the law will be amended to provide for "Chapter 11"-type proceedings. In the meantime, they will encourage the banks to initiate bankruptcy proceedings against insolvent enterprises.

Besides provisioning by the banks themselves against bad loans, bonds issued by the National Property Funds (the recipients of the proceeds from privatization), with a value equivalent to almost 5 percent of GDP, have been used to write down bad debts and to recapitalize the banks. Although these actions may not be sufficient to deal with the problem of inherited bad debt, the major banks' capital-asset ratios have increased markedly and are now in the neighborhood of 6 percent. To prevent compounding the stock bad-debt problem with low-quality new lending, banking supervision has been strengthened, and regulations on capital adequacy, liquidity, and large exposures have been adopted.

Finally, both republics still intend to implement the major tax reform planned for January 1993--all the more so in light of the increasing difficulty of collecting taxes under the old laws. Most of the required legislation has been put in place, with the notable exception of the laws on the social security funds, which are expected to go to Parliament by November.

Administrative preparations are proceeding, albeit with a significant delay relative to the original timetable: the staffing of tax offices has been strengthened, training and systems design are underway, and taxpayer education and registration have begun.

3. The balance of payments

The overall balance of payments is now expected to record a surplus of US$2.2 billion in 1992, compared with the program projection of US$0.8 billion (Table 6). This improvement mirrors a similar strengthening of the current account and the trade balance. Exports will be somewhat lower than expected, with higher exports to the West and lower exports to the former CMEA. Rapid growth of exports to the European Community prompted the European Commission, upon request from France, Germany, and Italy, to impose quantitative restrictions on the import of certain steel products from Czechoslovakia into these countries; this is not expected to have a major impact in 1992, but will depress export growth significantly in 1993 if the limits are renewed. At the same time, as discussed in section II, imports are now likely to be very much lower than programmed. On capital account, there will be further administrative delays in disbursements of official loans and, in light of the strength of reserves, the State Bank will not now engage in market borrowing. There is no evidence thus far that the impending dissolution of the federation has given rise to capital outflows on any significant scale, although it may be dampening the--initially very strong--inflows of foreign direct investment.

The unexpected strength of the balance of payments in 1992 would augur well for the external situation of a hypothetical Czechoslovakia in 1993 and beyond. However, it is as yet impossible to project the external balances of independent Czech and Slovak republics, as both the framework for commerce between them and the details of their policies remain to be worked out. The confidence of both residents and nonresidents in the two emerging states will have to be maintained, and trade, monetary and exchange arrangements will have to be structured in such a way as to minimize economic disruptions.

IV. Staff Appraisal

Despite the upheavals associated with the coming dissolution of the federation, performance under the program so far has exceeded expectations: real growth, employment, inflation, and the balance of payments are all doing better than expected.

The fiscal balance, nevertheless, has come under pressure from an erosion of tax revenues and from some underbudgeting for commitments already made. The authorities--showing considerable political resolve in difficult circumstances --have adopted corrective fiscal measures. As long as strict control over expenditures is maintained throughout the remainder of the year, the resulting deficit, although still larger than programmed (at 4-4 1/2 percent of GDP), should not unduly threaten macroeconomic stability. Moreover, to the extent that the deficit exceeds the initial program projection, it will be financed outside the banking system.

Monetary conditions have been influenced by a substantial injection of liquidity through the balance of payments. In response, the authorities have reduced their targets for the net domestic assets of the banking system, and they are resisting pressures to ease refinance policy emanating from regional cash shortages and money market segmentation. As a result, interbank rates have risen. It will be important to allow further increases in interest rates if these are needed to elicit nonbank financing of the Government and to reconcile competing claims on financial savings.

The authorities have not allowed the impending division of the country to stall systemic reform. The progress of the voucher privatization scheme is especially impressive: the bulk of the shares involved has already found new owners. However, further restructuring of the enterprise sector will require an appropriate framework for financial intermediation--that is, an orderly secondary market for equities, careful regulation of both investment funds and banks, and a further strengthening of bank balance sheets through adequate provisioning. Nor can the issue of terminally unprofitable enterprises be avoided. While it is appropriate to shield firms from unnecessary bankruptcy on grounds of illiquidity alone, provisions to allow such protection should be inserted into the bankruptcy law as soon as possible, so that the law may then take full effect. In the meantime, bankruptcy proceedings should begin for insolvent enterprises.

Despite all the progress this year, it must be recognized that it is not possible to project developments beyond the planned division of the country on January 1, 1993. Macroeconomic management will face a number of challenges, made all the more important by the need to maintain confidence during the transition period. In the fiscal area, the authorities of the two new countries will inherit the strains that have appeared this year. The planned tax reform will be important in this regard, and administrative preparations for it need to be accelerated if substantial revenue losses are to be avoided; but, even so, determined action will be needed to rein in imbalances. Monetary policy too will require a deft hand, so as to contain price pressures arising from the introduction of VAT and perhaps from wage demands in some areas. Finally, the institutional framework for monetary, trade, and exchange arrangements is of paramount importance. Monetary and exchange arrangements will need to be structured in such a way as to minimize disruptive speculative flows, and, given the interdependence of the Czech and Slovak economies, trade will need to be maintained and an adequate mechanism for settlements established.

In light of the strength of the balance of payments, the authorities have decided not to make the remaining purchases under the stand-by arrangement. They wish, however, to continue the stand-by, as they value the careful monitoring and close dialogue with the Fund under the arrangement. On the strength of the good performance on almost all aspects of the program, and the action taken to bring the fiscal imbalance back to manageable proportions, the staff recommends completion of the review.

V. Proposed Decision

Accordingly, the following decision is proposed for adoption by the Executive Board:

1. The Czech and Slovak Federal Republic has consulted with the Fund in accordance with paragraph 4(c) of the stand-by arrangement approved on April 3, 1992 (EBS/92/42, Supp. 1, 4/16/92) and paragraph 23 of the letter of the Minister of Finance and the Governor of the State Bank dated March 2, 1992.

2. The letter of the Minister of Finance and the Governor of the State Bank dated October 12, 1992 shall be attached to the stand-by arrangement, and their letter dated March 2, 1992 shall be read as supplemented by the letter of October 12, 1992.

3. The review contemplated in paragraph 4(c) of the stand-by arrangement is completed.

Table 1. Czechoslovakia: Projected Payments to the Fund

As at September 30, 1992

(In millions of SDRs)

	1992	1993	1994	1995	1996	1997	1998	1999	Remaining Period	Total
Obligations from outstanding use of Fund resources										
1. Principal repurchases	--	--	203.6	435.2	281.6	117.2	75.6	8.3	--	1,121.5
2. Charges and interest 1/	13.8	76.6	73.1	52.6	24.8	11.5	4.9	0.5	--	257.9
Total	13.8	76.6	276.7	487.8	306.4	128.7	80.5	8.8	--	1,379.4
(Percentage of quota)	2.3	12.9	46.9	82.6	51.9	21.8	13.6	1.4	--	233.7
Obligations from prospective use of Fund resources										
1. Principal repurchases	--	--	--	--	--	--	--	--	--	--
2. Charges and interest 1/	--	--	--	--	--	--	--	--	--	--
Total	--	--	--	--	--	--	--	--	--	--
(Percentage of quota)	--	--	--	--	--	--	--	--	--	--
Cumulative (outstanding and prospective)										
1. Principal repurchases	--	--	203.6	435.2	281.6	117.2	75.6	8.3	--	1,121.5
2. Charges and interest 1/	13.8	76.6	73.1	52.6	24.8	11.5	4.9	0.5	--	257.9
Total	13.8	76.6	276.7	487.8	306.4	128.7	80.5	8.8	--	1,379.4
(Percentage of quota)	2.3	12.9	46.9	82.6	51.9	21.8	13.6	1.4	--	233.7

Source: Fund staff estimates.

1/ Projections are based on current rates of charge, including burden-sharing adjustments where applicable.

Table 2. Czechoslovakia: Performance Criteria, 1992

	Dec. 31, 1991	April 1-June 30 1992		July 1- Sept. 30, 1992	Oct. 1- Dec. 31, 1992
	Actual	Program	Actual	Program	Program
		(In billions of koruny)			
Net credit from the banking system to the Government	52	64	48.9	70	82
Net domestic assets of the banking system	690	732	704.8	754	781
		(In millions of U.S. dollars)			
Change in net international reserves in convertible currencies 1/	1,139 2/	--	1,510	150	300
Net disbursements of external debt in convertible currencies 1/					
1-12 year maturity	...	800	308	1,000	1,200
1-5 year maturity	...	300	258	500	600

Source: EBS/92/42; and data provided by the Czechoslovak authorities.
1/ Cumulative from December 31, 1991.
2/ Stock at December 31, 1991.

Table 3. Czechoslovakia: Selected Economic and Financial Indicators

	1988	1989	1990	1991	1992 Program	1992 First Half Est.	1992 Rev. Proj
Real sector (change in percent)							
Real gross domestic product	...	...	-0.4	-15.9	-5.0	-13.0 1/	-5.0
Consumer prices:							
Period average	0.2	1.4	10.8	58.7	13.1	12.0 1/	10.2
End period	0.6	1.5	18.4	53.6	12.0	3.1	9.1
Industrial wholesale prices:							
Period average	--	-0.7	4.4	66.8	8.2	9.2 1/	8.9
End period	...	-0.7	16.6	54.8	9.0	5.3	8.7
Real wage (period average)	2.1	0.9	-5.7	-26.6	-- 2/	7.0	...
Unemployment, end-period (percent of labor force)	--	--	1.0	6.6	9.5	5.5	5.3
Savings and investment (percent of GDP)							
Total savings	...	27.6	30.7	26.7	27.1	...	21.3
Domestic	...	29.4	28.3	31.0	26.0	...	24.8
Foreign	...	-1.8	2.4	-4.3	1.1	...	-3.5
Gross investment	...	27.7	30.7	26.7	27.7	...	21.3
Fixed investment	...	...	...	21.7	25.7	...	25.8
Stockbuilding	...	...	...	5.0	1.4	...	-4.5
Fiscal operations (percent of GDP)							
Total							
Revenue	58.0	62.1	60.2	50.8	51.0	...	49.8
Expenditure 3/	59.5	64.5	60.1	52.8	53.9	...	54.2
Balance 3/	-1.5	-2.4	0.1	-2.0	-2.9	...	-4.4
Money and credit (end period, percent change)							
Net domestic assets	10.5	1.1	4.7	24.3	13.1	2.2	11.3
Credit to enterprises and households	3.1	-2.7	1.4	20.3 4/	13.4	7.6	16.5
Broad money	11.5	3.5	0.5	26.9	12.0	6.9	17.5
Interest rates (percent)							
Credit to enterprises/private sector 5/	5.1	5.7	6.5	17.2	17.0	15.5	...
Household savings deposits	4.0	4.0	4.3	12.6	...	11.6	...
Balance of payments (US$ billions) 6/							
Merchandise exports	15.0	14.2	11.7	10.6	10.7	5.1	10.2
CMEA	8.8	7.8	5.5	3.5	3.0	...	2.1
Other	6.2	6.4	6.3	7.1	7.7	...	8.0
Merchandise imports	14.6	14.1	13.2	10.7	12.2	5.0	10.5
Trade balance	0.4	0.1	-1.5	-0.1	-1.5	--	-0.3
Current account	1.1	0.9	-1.3	0.9	-0.6	0.7	0.7
(in percent of GDP)	2.1	1.9	-2.9	2.9	-1.7	1.8	2.0
Official reserves (end-period) (in months of following year's imports) 7/	2.5	2.0	0.6	1.3	2.2	2.1	2.8
External debt 7/	7.3	7.9	8.2	9.6	10.6	9.8	9.9
Debt service (in percent of exports of goods and nonfactor services) 7/	24.8	24.4	19.5	15.2	12.4	11.2	13.4

Sources: Data provided by the Czechoslovak authorities; Fund staff estimates and program projections.

1/ Changes over same period last year.
2/ End-1992 over end-1991.
3/ Excluding stock adjustments (Mainly takeover of export credits, and transfers to the banks and foreign trade organizations on account of devaluation profits and losses).
4/ Includes the recent debt write-down operation. Abstracting from this, credit to enterprises and households increased by 25 percent.
5/ From 1992, for the private sector.
6/ Transactions with CMEA members in transferable rubles in the years prior to 1991 converted at cross-rates.
7/ Convertible currencies only.

Table 4. Czechoslovakia: Fiscal Operations 1/

	1989	1990	1991	1992 Program 2/	1992 First Half	1992 Projected
	(In billions of koruny)					
Revenue	472.1	492.8	496.8	513.6	245.2	506.1
Individual income taxes	52.5	54.7	60.0	65.4	37.4	74.9
Profit taxes	83.2	100.3	134.3	122.5	61.2	123.7
Turnover tax	134.6	147.8	123.4	135.3	56.9	125.0
Payroll tax	95.4	98.4	107.4	121.5	54.1	111.8
Taxes on international trade	13.9	25.8	11.5	14.6	6.7	14.0
Other taxes 3/	23.4	22.5	2.4	2.3	0.6	2.3
Nontax current revenue 4/	69.0	43.1	57.8	47.0	28.3	54.6
Capital revenue	0.1	0.2	--	5.0	--	--
Expenditure	490.1	492.1	516.0	543.0	247.3	550.6
Current expenditure	436.9	435.8	450.0	476.6	218.3	481.4
Consumption expenditure 5/	176.2	186.3	196.6	192.8	83.8	189.8
Interest	0.2	1.7	4.6	8.2	4.0	11.0
Transfers to enterprises	150.7	128.9	69.5	56.1	25.5	59.4
Transfers to households	104.0	112.3	157.7	168.2	79.5	169.9
Transfers to subsidized organizations 6/	5.8	6.6	21.6	51.3	25.5	51.3
Capital expenditure and transfers	47.8	55.6	59.9	67.6	27.0	68.6
Capital expenditure	12.5	16.9	41.1	49.0	15.9	51.0
Capital transfers	35.3	38.7	18.8	18.7	11.1	17.6
Net lending	5.4	0.7	6.2	-1.1	1.9	0.7
Stock adjustments 7/	-8.0	-54.4	21.5	--	--	--
Balance	-26.1	-53.7	2.3	-29.4	-2.1	-44.5
Excluding stock adjustments	-18.1	0.7	-19.2	-29.4	-2.1	-44.5
Financing (domestic) 8/	26.1	53.7	-2.3	29.4	2.1	44.5
Bank	26.5	52.8	-2.3	29.4	-2.9	30.0
Other	-0.5	0.9	--	--	5.0	14.5
	(In percent of GDP)					
Memorandum items:						
Excluding stock adjustments:						
Revenue	62.1	60.2	50.8	51.0	...	49.8
Expenditure	64.5	60.1	52.8	53.9	...	54.2
Balance	-2.4	0.1	-2.0	-2.9	...	-4.4

Sources: Data provided by the Czechoslovak authorities; Fund staff estimates; and program projections.

1/ Including federation and republics (both budgetary and off-budget operations), local authorities, and extrabudgetary funds; excluding National Property Funds, subsidized organizations, and funds of the ministries.

2/ Original program adjusted for extrabudgetary activities of local authorities and for transfer of many activities in the health sector to subsidized organizations.

3/ Includes some payroll tax in 1989-90.

4/ Includes timing adjustment.

5/ Includes transfers abroad and timing adjustment.

6/ Subsidized organizations perform functions similar to those of budgetary organizations, but keep their own revenues rather than remitting them to the budget.

7/ Transfers to cover devaluation losses of banks and foreign trade organizations (1990-91), and takeover of export credits from foreign trade banks (1989-91).

8/ Loans to Government for balance of payments support are treated as if channeled directly to the banking system.

Table 5. Czechoslovakia: Monetary Survey

	1989	1990	1991	1992 (Program) June	1992 (Program) Dec.	1992 Prel. June	1992 Rev.Proj. Dec.
	(In billions of koruny)						
Net international reserves 1/	17.8	-4.3	8.9	1.5	1.7	41.9	53.0
Foreign assets 2/	37.8	27.7	92.1	102.5	116.3	139.2	159.3
Foreign liabilities	20.0	32.0	83.2	101.1	114.6	97.3	106.3
Net domestic assets	530.0	555.0	689.6	731.1	780.2	704.8	767.8
Domestic credit	583.6	640.2	770.7	818.4	863.7	806.7	867.9
Net credit to Government	5.9	54.2	51.8	63.0	81.0	48.9	82.0
Net credit to Property Funds	0.0	0.0	13.7	10.4	-16.0	-0.8	-36.0
Credit to ent. and household	577.7	586.0	705.2	745.0	798.7	758.6	821.9
Credit to enterprises	530.8	536.0	649.8 3/	688.6	740.9	702.7	764.9
Credit to households	46.9	50.0	55.4	56.4	57.8	55.9	57.0
Broad money	547.8	550.7	698.5	732.6	781.9	746.7	820.8
Money	311.1	291.2	371.9	389.1	415.0	378.2	415.7
Currency outside banks	68.0	73.7	68.4	...	...	95.0	...
Demand deposits	243.1	217.5	283.5	...	...	283.2	...
Households	107.5	103.3	94.2	...	...	96.6	...
Enterprises 4/	135.6	114.2	189.3	...	...	186.6	...
Quasi money	236.7	259.5	326.6	343.5	366.8	368.5	405.1
Time and savings deposits	232.5	231.7	279.9	...	...	302.4	...
Households	170.2	167.4	210.8	...	...	222.7	...
Enterprises 4/	62.3	64.3	69.1	...	...	79.7	...
Foreign currency deposits 1/	4.2	27.8	46.7	...	...	66.1	...
Households	1.7	9.8	26.8	...	...	40.0	...
Enterprises	2.5	18.0	19.9	...	...	26.1	...
Other items, net 5/	53.6	85.2	81.1	87.3	83.5	101.9	100.1
	(Change in percent of broad money at beginning of year)						
Memorandum items:							
Broad money	3.5	0.5	26.9	4.9	12.0	6.9	17.5
Money	0.3	-3.6	14.6	2.5	6.2	0.9	6.3
Quasi money	3.2	4.2	12.2	2.4	5.8	6.0	11.2
Net international reserves	2.6	-4.0	2.4	-1.1	-1.0	4.7	6.3
Net domestic assets	0.9	4.6	24.5	5.9	13.0	2.2	11.2
Domestic credit	2.9	10.3	22.7	6.8	13.3	5.2	13.9
Other items, net	-2.0	-5.8	1.8	-0.9	-0.3	-3.0	-2.7

Source: Data provided by the State Bank of Czechoslovakia and program projections.

1/ End of period. At current exchange rates through 1990, and at end-December program rates for subsequent periods.

2/ From 1990 is strictly comparable with international reserves at end-period exchange rate. Earlier data use State Bank valuation of monetary gold.

3/ Includes the recent debt write-down operation through the bond issue from the National Property Funds. Abstracting from this, credit to enterprises was Kcs 29 billion higher.

4/ Including insurance companies.

5/ Including net nonconvertible assets and long-term assets of Obchodni Bank. Includes certain foreign assets that have been reclassified as government assets in the fiscal accounts.

Table 6. Czechoslovakia: Balance of Payments

(In billions of U.S. dollars) 1/ 2/

	1990 Revised	1991 Actual Converti-ble curr.	1991 Actual Clearing	1991 Actual Total	1992 First Half	1992 Prog.	1992 Proj.
Current account	-1.3	0.4	0.6	0.9	0.7	-0.6	0.7
Trade balance	-1.5	-0.4	0.4	-0.1	--	-1.5	-0.3
Exports, f.o.b.	11.7	8.3	2.3	10.6	5.1	10.7	10.2
Imports, f.o.b.	-13.2	-8.8	-1.9	10.7	-5.0	-12.2	-10.5
Of which: oil & gas	(-1.5)	(-2.6)	(-0.4)	(-3.0	(-1.3)	(-2.4)	(-2.7
Services balance	0.2	0.8	0.1	0.9	0.4	1.2	1.0
Receipts	2.7	2.6	0.3	2.9	1.3	3.2	2.8
Payments	-2.5	-1.8	-0.2	-2.0	-0.9	-2.0	-1.8
Income balance	-0.3	-0.1	0.1	--	0.1	-0.5	-0.1
Receipts	0.5	0.5	0.1	0.7	0.3	0.5	0.6
Payments	-0.8	-0.6	--	-0.6	-0.2	-1.0	-0.7
Transfers (net)	0.2	--	--	--	0.1	0.2	0.2
Capital account	0.7	0.3	-0.6	-0.3	0.7	1.4	1.0
Net direct investment	0.2	0.6	--	0.6	0.4	0.7	0.7
Official project loans	--	--	--	--	--	0.2	--
Official program loans	--	0.5		0.5	0.4	0.9	0.7
(of which: EC	--	0.2		0.2	0.2	0.3	0.2
G24	--	0.1		0.1	--	0.2	--
WB/Japan)	--	0.2		0.2	0.2	0.4	0.4
Trade credits	--	-1.2	-0.6	-1.7	-0.1	-0.2	-0.2
Net MT/LT Financial credit	0.6	0.3		0.3	-0.1	-0.1	-0.3
SBCS market borrowing	--	0.3		0.3	--	0.2	--
Commercial bank borrowing	0.6	--		--	-0.1	-0.3	-0.3
Val. adj., errors & omissions	-0.3	0.5	--	0.5	0.2	--	0.5
Overall balance	-0.9	1.2	--	1.2	1.5	0.8	2.2
Financing	0.9	-1.2		-1.2	-1.5	-0.8	-2.2
Use of gross reserves	1.1	-2.1		-2.1	-1.6	-1.0	-2.3
Use of Fund credit (net)	--	1.3		1.3	0.3	0.4	0.3
Short-term bank liabilities	-0.2	-0.4		-0.4	-0.2	-0.2	-0.2
Memorandum items:							
Current account to GDP (%)	-2.9	1.1		2.9	1.8	-1.7	2.0
Gross reserves (end period)	1.2	3.3		3.3	4.9	4.3	5.6
Official reserves	0.5	1.4		1.4	2.2	2.4	2.9
(In months of following year's imports)	0.6	1.3		1.3	2.1	2.2	2.8
NIR (end period)	--	1.1		1.1	2.7	2.0	3.4
Trade volumes (percent changes):							
CMEA exports	-18			-69		-15	-41
Non-CMEA exports	13			12		6	10
Imports	10			-52		13	-3
Terms of trade (percent changes)							
CMEA	5			-7		20	8
Non-CMEA	-5			--		-1	--

Sources: *Data provided by the authorities; EBS/92/42 and staff estimates.*

1/ Due to rounding, totals may not add.
2/ Transactions in transferable rubles were converted into U.S. dollars at cross rates.

Czechoslovakia: Fund Relations
(As of September 30, 1992)

I. Membership Status: Joined 9/20/90; Article XIV

		SDR Million	% Quota
II.	General Resources Account:		
	Quota	590.00	100.0
	Fund holdings of currency	1,711.50	290.1

		SDR Million	% Allocation
III.	SDR Department:		
	Holdings	44.44	0.0

		SDR Million	% Quota
IV.	Outstanding Purchases and Loans:		
	Stand-by arrangements	655.50	111.1
	CCFF	466.00	79.0

V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	4/03/92	4/02/93	236.00	36.00
Stand-by	1/07/91	4/03/92	619.50	619.50

VI. Projected Obligations to Fund (SDR Million; Based on Existing Use of Resources Only):

	Overdue	Forthcoming				
	8/31/92	1992	1993	1994	1995	1996
Principal	--	--	--	203.6	435.2	281.6
Charges/interest	--	13.8	76.6	73.1	52.6	24.8
Total		13.8	76.6	276.7	487.8	306.4

VII. Exchange Rate Arrangement:

The currency of Czechoslovakia is the koruna, pegged to a basket of five currencies. On September 28, 1992, the exchange rate stood at Kcs 27.47 per U.S. dollar. Special exchange arrangements apply to settlements with some socialist countries outside the former Council for Mutual Economic Assistance.

VIII. Article IV Consultation:

The last Article IV consultation was concluded at EBM/92/44 on April 3, 1992 (EBS/92/42, March 9, 1992, and SM/92/65, March 23, 1992). Czechoslovakia is on a 12-month consultation cycle.

IX. Technical Assistance: See the attached Table 7.

X. Resident Representative: Mr. J. Carter, since May 1991.

Table 7. Czechoslovakia: Technical Assistance, 1991-92

Department	Timing	Purpose
FAD	February and July 1991	Advice on the design of new corporate and personal income taxes
	May and September 1991	Advice on policy and administrative aspects of the introduction of VAT
	Since December 1991 1/	Regular visits by FAD consultant on VAT administration
	March 1992	Advice on tax administration (particularly VAT)
	April 1992	Examination of budgeting and expenditure control
	Late 1992 2/	Advice on tax policy and administration in Slovakia
	Late 1992 2/	Assistance with establishment of a Treasury in Slovakia
LEG	March 1991	Assistance with the drafting of income tax and tax administration laws
	July 1991	Assistance with the drafting of income tax law
	October 1991	Assistance with the drafting of income tax, VAT, and tax administration laws
	January 1992	Assistance with the drafting of income tax law
	February 1992	Follow-up visits by consultants focusing on the income tax and tax administration laws
MAE	April 1991 Sept./Oct. 1991 Feb./March 1992	Full-scale missions; design of monetary policy instruments and operating procedures; development of foreign exchange operations and the legal framework for central and commercial banking and the reorganization of the State Bank 3/
	Through September 1991	Regular visits by experienced central banker
	May 1991	Design of monetary instruments
	Since July 1992 1/	Long-term resident expert assignment in the area of banking supervision
	Late 1992 2/	Full-scale assessment mission to Slovakia
STA	June 1991	Government finance statistics
	September 1991	Balance of payments statistics

1/ Continuing.
2/ Planned.
3/ Visits by experts from cooperating central banks took place in between full-scale missions to follow up on specific topics.

CONFIDENTIAL

Prague, Czechoslovakia

October 12, 1992

Dear Mr. Camdessus,

1. The elections of June 1992 have changed the political landscape of the Czech and Slovak Federal Republic, and preparations are underway for the dissolution of the federation in early 1993. The economic policies of the Federal Government and the Governments of both republics remain committed, however, to consolidating the gains made since the overthrow of the Communist regime, safeguarding financial stability, and building an institutional framework conducive to private initiative and economic growth. The preparations for dissolution will aim at avoiding any disruptions to interrepublican commerce, and this objective will also be preeminent in the structuring of post-dissolution economic reforms in the two republics.

2. The performance of the Czech and Slovak Federal Republic under the current stand-by arrangement has exceeded expectations. During the eight months through August, consumer prices have risen by only 4 1/2 percent with stronger-than-expected real economic activity (especially in the burgeoning private sector), and reserves have increased by over US$2 billion with the current account registering a surplus of about US$1 billion. For the year as a whole, it is now almost certain that the economy will do better than the projections in the financial program agreed at the beginning of the

year: real growth will be positive through the year and the unemployment level far below projections, inflation may well be in single digits, the current account will see a substantial surplus against a projected deficit of US$600 million, and reserves will exceed the projected level by perhaps US$1 1/2 billion. Despite the better-than-expected split of nominal income between prices and output and the stronger external position, the Government and the monetary authorities are of the view that the performance criteria specified in the stand-by arrangement continue to provide a useful framework for economic policy.

3. All performance criteria under the stand-by arrangement were met in June and are thought to have been met again in September. However, the underlying fiscal position has weakened considerably and the margin with respect to net bank credit to the Government is shrinking. Lower-than-projected consumption expenditure and changes in the structure of employment have reduced critical components of the tax base. Also, tax avoidance and evasion have increased in the context of tax laws that are now seriously out of date. On the expenditure side, failure to budget properly for commitments that had already been made added to the problem. Without new measures these developments would have widened the deficit by 2 1/2 percentage points of GDP on the program definition. The Government has taken all possible measures to forestall this eventuality, raising consumer taxes on alcoholic beverages, cigarettes, and gasoline, and cutting allocations for subsidies and other current spending. Also, the systems of expenditure control have been reinforced in order to avoid a repetition of

the overspending that took place at the end of 1991. These measures should reduce the deficit by some 1 1/2 percentage points of GDP. The aggregate financing need of all levels of government--excluding the proceeds from privatization--should, therefore, not exceed 4 percent of GDP.

4. Within the original monetary and credit projections, the contractionary impact of conventional privatizations has created room for more financing of the nongovernmental sector. Credit to the emerging private sector has expanded especially rapidly: this sector now accounts for about a fifth of total enterprise credit. But inflows through the balance of payments have raised money growth above the projected level. Monetary policy has had to balance the risk of reigniting inflation, by allowing this additional liquidity to remain in the system, against that of stifling an incipient resurgence of output. The monetary authorities have taken the middle ground: refinance has been made more restrictive and the target for net domestic assets has been set somewhat below the program ceiling; nevertheless, money growth will be allowed to be higher than initially envisaged. The authorities would be loath to see any amendment to the original program ceilings. In particular, it is considered appropriate that the performance criterion on net bank credit to Government remain unchanged and that any additional budget financing be sought outside the banking system.

5. Systemic reform continues apace. Most importantly, the massive program of voucher privatization of large-scale enterprises--involving, in the first

"wave," enterprises with an aggregate book value equivalent to some 50 percent of GDP--is going well. This process is expected to be completed by the end of the year, and 56 percent of the shares to be disposed of through vouchers have already been allocated. Conventional sales continue in parallel with the voucher program, as do auctions of small enterprises; the entire small-scale sector should be in private hands by the end of the year.

6. In addition, the federal authorities and those in both republics are continuing to develop the legal and institutional framework to support private economic activity. Stock exchanges will open in Bratislava and Prague in early 1993, and the infrastructure developed for voucher privatization will provide the basis for an extensive over-the-counter market. Prudential banking regulations have already been adopted in the areas of capital adequacy, liquidity rules and large exposures. Both republics intend to implement the major tax reform planned for January 1993; most of the necessary laws have been put in place, and programs to strengthen tax administration are underway. Clearly a significant part of administrative capacity will be devoted to ensuring a smooth dissolution of the Federation and this might well slow down institutional reform in some areas; but governments at all levels are bent upon maintaining the momentum of reform while avoiding economic disruptions from dissolution.

7. Given the strength of the balance of payments, the authorities see no need to make the remaining purchases under the current arrangement with the

Fund. The stand-by arrangement, however, provides an appropriate framework for monitoring economic developments and continuing the dialogue on policies.

Yours sincerely,

Jan Klak
Federal Minister of Finance

Josef Tošovský
Governor
State Bank of Czechoslovakia

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.c. 20431
U.S.A.