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# The Czech Republic

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# TRANSFORMATION OF THE FINANCIAL SYSTEM

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# The Transformation of the Financial System

- Final exam test:
  - 20 questions
    - 19 -20: A
    - 17 – 18: B
    - 15 – 16: C
    - 13 – 14: D
    - 12: E
    - 11 – 0: F
- Form: multiple choice: 4 possible answers only 1 is correct
- Time 15 minutes
- Date: on 26th May 2009 at 12.50, class P6
- Alternative exam terms: will be set in IS

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# Essay

- Extent: 500 words
- Topic: an optional topic related with the Czech Republic, transformation process etc.
- Deadline: on 26<sup>th</sup> May 2010.
- Upload via Information System
- It is necessary condition for the successful finishing of this course.

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## BPF\_TFSC, Transformation of the Financial system, jaro 2010

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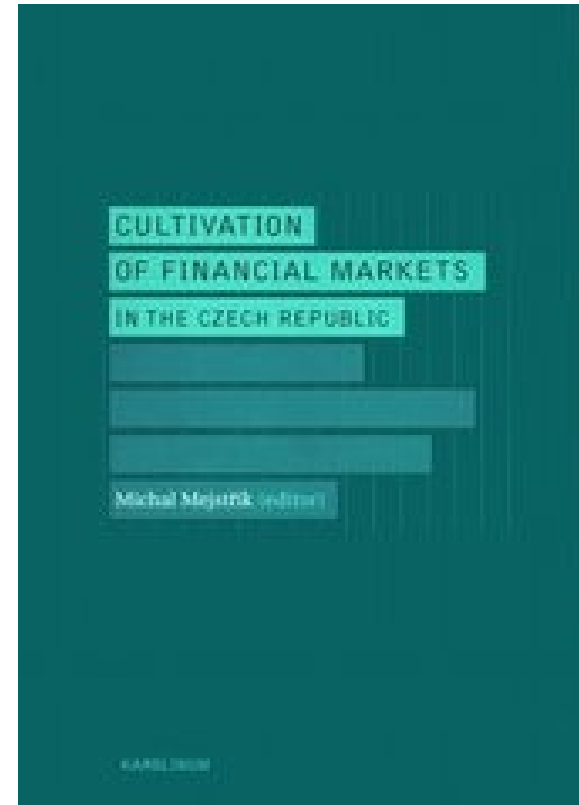
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# Literature

- Lecture notes – *The Transformation of the Financial system in the Czech Republic* by Martin Svoboda et al.
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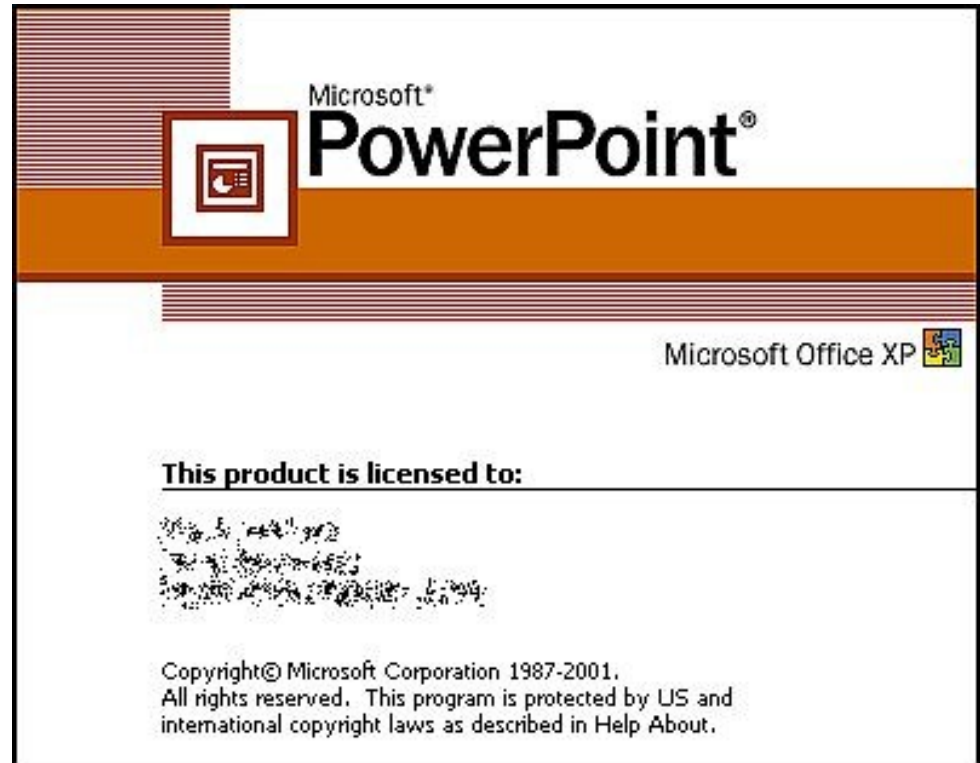
# Literature

- *Cultivation of Financial Markets in the Czech Republic* by Michal Mejstrik et al.



# Literature

- Power Point presentations from lectures





# Economic situation in the Czech Republic

- The Czech Republic:
  - Developed
  - High – income economy
  - GDP per capita 82% of the EU average
- One of the most stable and prosperous of the post-communist country
  - Economic growth of over 6% annually in the last three years
    - Led by
      - exports in the European Union especially Germany
      - foreign investment

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# Economic situation in the Czech Republic

- The rate of corruption is one of the highest among the other developed OECD countries
  - Public budget debt remains in deficit despite of strong growth of economy in several last years
    - in 2007 1,58 % GDP
    - In 2008 1,2 % GDP
      - According to EU accounting rules
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# International ranking

- Human development index: Ranks 23rd out of 178 countries
  - Index of economic freedom: Ranks 31st out of 157 countries
  - Reporters without Borders – worldwide press freedom index: Ranks 14th out of 169 countries
  - Global Competitiveness Report: Ranks 29th out of 125 countries
  - Democracy index: Ranks 18th out of 167 countries
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# Rating of the Czech Republic according to rating agencies

- The Czech Republic
  - Rating of the Czech Republic credit risk
    - The trustworthiness of the Czech Republic as the borrower
    - Since 2008
      - A1, A, A+
-

## Developments of the rating of the CR

(Foreign Currency Long-Term Sovereign Debt Ratings)

	Moody's	Standard and Poor's	Fitch
1992	Ba1	—	—
1993	Baa3	BBB	—
1994	Baa2	BBB+	—
1995	Baa1	A	A-
1996	Baa1	A	A-
1997	Baa1	A	BBB+
1998	Baa1	A-	BBB+
1999	Baa1	A-	BBB+
2000	Baa1	A-	BBB+
2001	Baa1	A-	BBB+
2002	A1	A-	BBB+
2003	A1	A-	A-
2004	A1	A-	A-
2005	A1	A-	A
2006	A1	A-	A
2007	A1	A	A
2008	A1	A	A+

Last update: 25 June 2009

MOODY'S		STANDARD & POOR'S		Fitch
<b>Investment grades</b>				
Aaa	France, Germany, Netherlands, Austria, USA, Switzerland, Finland, Norway, Denmark, Ireland, United Kingdom, Sweden, Spain, New Zealand, Canada, Singapore, Australia, Luxembourg	AAA	France, Germany, Netherlands, Norway, Austria, Switzerland, USA, United Kingdom, Singapore, Denmark, Finland, Canada, Australia, Sweden, Luxembourg	Austria, Finland, France, Germany, Netherlands, Norway, USA, Switzerland, United Kingdom, Ireland, Singapore, Denmark, Spain, Sweden, Canada, Luxembourg
Aa1	Belgium,	AA+	Belgium, New Zealand, Spain, Hong Kong,	Australia, New Zealand, Belgium
Aa2	Portugal, Italy, Slovenia, Hong Kong, Japan, Kuwait	AA	Slovenia, Ireland, Japan	Portugal, Japan, Slovenia, Hong Kong, Kuwait,
Aa3	Taiwan, Cyprus	AA-	Taiwan, Kuwait, S. Arabia	Italy, Cyprus
A1	<b>CZECH REPUBLIC</b> , Estonia, Greece, Chile, Slovakia, S.Arabia, China, Malta, Israel,	A+	Italy, Chile, Cyprus, Portugal, Slovakia, China,	Taiwan, Korea, S.Arabia, Malta, China, <b>CZECH REPUBLIC</b> , Slovakia,
A2	Poland, Korea	A	<b>CZECH REPUBLIC</b> , Malta, Estonia, Korea, Israel,	Chile, Greece, Israel
A3	Malaysia, Lithuania,	A-	Malaysia, Greece, Poland	Malaysia, Poland
Baa1	Mexico, S. Africa, Hungary, Russia, Iceland,	BBB+	Mexico, S.Africa	S.Africa, Mexico, Estonia
Baa2	Kazakhstan	BBB	Croatia, Bulgaria, Lithuania, Russia	Hungary, Russia, Lithuania
Baa3	Croatia, India, Latvia, Bulgaria, Romania	BBB-	Kazakhstan, India, Iceland, Hungary, Brazil,	Croatia, India, Brazil, Iceland, Bulgaria, Kazakhstan,
<b>Non-investment grades</b>				
Ba1	Egypt, Brazil	BB+	Montenegro, Latvia, Romania, Egypt,	Macedonia, Romania, Egypt, Latvia
Ba2		BB	Vietnam, Macedonia	Indonesia
Ba3	Vietnam, Turkey, Indonesia	BB-	Turkey, Serbia, Indonesia, Mongolia	Vietnam, Serbia, Turkey,
B1	Mongolia,	B+	Belarus	
B2	Turkmenistan, Bosnia, Ukraine,	B		Mongolia, Ukraine
B3	Argentina, Pakistan	B-	Argentina,	Moldova
Caa1	Cuba, Moldova	CCC+	Pakistan, Ukraine	
Caa2		CCC		
Caa3		CCC-		
Ca		SD		

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# Czechoslovakia at the end of the 1980's

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# Introduction

- Further analysis of the transformation process has to go from initial economic conditions.
  - Although the most of central planned economic aspects were negative there will be also mentioned positive ones.
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# Positives of Czechoslovakia situation

- Positive characteristics were related with
    - Geographical position of the Czech Republic (Czechoslovakia)
    - Level of human capital
    - Situation in society and economy
  - The most important characteristic was macroeconomic stability
  - Location of Czechoslovakia in the central Europe and having common border with Germany and Austria.
    - It was important for future development of foreign trade and establishing of economic contacts with western Europe countries.
    - These contacts helped to integrate Czechoslovakia in world economy in next years.
  - Czechoslovakia had a relative advantage to compare with more eastern situated former communism countries.
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# Positives of Czechoslovakia situation

- Education
  - Education was supported area, especially technical fields (engineering, metallurgy).
- Czechoslovak economy was suffered with several structural imbalances,
  - economic growth was weak, but level of economic development compared with other countries in the east block was relative high.
- Czechoslovakia was together with East Germany the most developed country of the eastern block.
- Development of Czechoslovakia was only relative
  - It mean that Czechoslovakia was compared only with countries of soviet block.
  - Economic level (GDP) in Czechoslovakia at the beginning of the 1950's was comparison with economic level of Austria.
  - In the 1980's GDP of Austria was 5 time higher than Czechoslovakia GDP (CSSR: 3.450\$, Austria: 17.300\$)
  - BUT: Till the end of the 1980's Czechoslovakia was considered to be medium developed country.
    - According to UNO statistic (GDP per capita) CSSR was in 43th place in the world.

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# Positives of Czechoslovakia situation

- Czechoslovakia was stable in macroeconomic level.
  - In the country was low inflation
    - Official as well as
    - Hidden inflation
    - Level of living costs rose about 26 % (1970 - 1989),
      - in Poland where in autumn 1989 inflation rose about 640%.
  - An imbalance between demand and supply
    - Surplus of money and lack of goods
    - Was not so significant as in other soviet block countries.
  - Public finance was balanced, the level of public debt was low (17 % of GDP) and foreign debt was low as well.
  - One of the communism aim was full employment.
    - In a lot of economy sectors was “over employment”
      - about 15 % in whole economy.
    - Very high was a participation level – share of employees in whole population.
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# Positives of Czechoslovakia situation

- Economic policy of communism regime in Czechoslovakia was long-term restrictive and it limited imbalances in the economy as a whole.
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# Problems of Czechoslovakia situation

- A lot of deformations
    - From economic system as a whole
    - to closeness of economy
    - and orientation to RVHP markets.
  - These deformations led to
    - ineffectiveness,
    - wasting with resources
    - limitation of the economic growth pace
    - and lag behind developed countries.
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# Direction of the economy

- Economy was central
    - Directed and
    - Planned.
  - Planning was limited only on following of economic plan.
  - In economy there was no competition and there was no will to improve quality of products.
    - In addition there was an effort to eliminate competition.
  - Level of government control was huge
    - second largest after Soviet Union.
  - Different situation was e.g. in Poland or Hungary were was preserve high level of autonomy.
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# Chronological list of reforms

Reforms	Hungary	Poland	Czechoslovakia
Cancellation of binding plans	1968	1982	1990
Cancellation of central allocations of resources	1968	1991	1990
First steps of price liberalization	1968	1957, 1975	1991
Entrance in IMF and the WB	1982	1986	1990
Freedom of trade	1982	No limitation	1991
Bankruptcy law	1986	1983	1991, 1992
Two-tier banking system	1987	1988	1990
New system of income taxation	1988	1992	1993

# Direction of the economy

- Central system was accompanied by monopolization of economy.
- Socialistic government created monopoly structure in all economic sectors.

Concentration of production in Czechoslovakia		
	100 largest companies	200 largest companies
Total number of employees In thousand	878.503	1.250.941
% of working power	26	38
Total value of assets	753	942
% of total value of assets	51	63



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# Direction of the economy

- One of the directed economy problem was that the economic centre was not able to recognize and estimate demand of particular goods.
  - In the market oriented economy the information about demand is reflected by price changes but in socialistic countries prices were fixed.
  - The result of this was that
    - on the one hand there was surplus of goods that customers do not demand and
    - on the other hand there was a lack of other goods, black market and corruption.
  - Lack of supply was deeper because of companies limited outputs.
  - Companies also were not able to export and thus got foreign currency to buy new technologies.
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# Central planning

- Communism governments considered central plan as more effective then chaotic market oriented system.
  - In Czechoslovakia central plan controlled economy as a whole.
  - This was related with a lot of disadvantages
    - Subjects was not ready for changing their production and they had no will for changes.
    - A lot of problems were related with the creation of plans
      - The plan was theoretically created for 5 years but in practice the plan was created only for one year.
      - When economic situation was getting worse the plan was set more easier and the level of claims was decreasing.
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# Common property

- In the Czechoslovakia there were 4 kinds of companies
  - State companies
  - Co-operations
  - Companies of foreign trade
  - Municipality companies
- In 1948 almost all private property was nationalized and private sector did not exist.
- The main reason of nationalization of ideological
  - but important was also the fact that a state company was more suitable for state control and central direction.
- In 1980's 87% of national income was produced in state companies, 10% in co-operations and only 2 % in private sector.
- In 1989 in private sectors worked only 1.2 % of working power.
  - Private agriculturists: 1949: 2 million, at the end of 1980's 10.000.

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# The role of market subjects – lack of initiative

- The serious problem in economy was the lack of initiative from particular market subjects.
    - State property
    - Limited possibility how to influence decision process
    - No competition
  - It led to no interest of market subjects to fulfill consumer needs.
  - Companies work with “soft” budget limitation it meant that companies did not care about financial resources and they got them in the form of
    - State aids
    - Bank loans
  - There were also some indirect state aids like
    - Free or very cheap land for companies
    - Cheap energy and building material, etc.
-

# The role of market subjects – lack of initiative

- The value of state aids were significant.
- In this situation company solvency was not important because there was no possibility of failure or bankruptcy.

<b>State aids and transfer payments to companies in % of GDP</b>			
Year	Bulgaria	Czechosl lovakia	Hungry
Total value of current costs			
1985	48	51	53
1989	52	55	57

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# Weak level of technologies, infrastructure and knowledge

- Companies and management were not motivated to improve quality of their products.
  - One of the reason was that almost all were sold.
  - Companies were not under competition pressure and economic environment did not lead to improvements.
  - Lack of investment led to using of old technologies and equipments.
    - In 1989 average age of machines were 11 years and depreciation over 57 %.
  - The reason was lagging behind developed countries in almost all sectors.
    - 1966: 12 % of Czechoslovakia products achieved of world level
    - In 1979: only 2 %.
  - Communism government tried to solved these problems but there was also western European country embargo imposed on export technologies in socialistic countries (Coordinating Committee on Export Control). Primary was limitation of technologies exports that could be used in army.
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# Pricing system

- Prices were fixed and central directed.
  - Prices were not fixed permanently
  - In the time of imbalances there were price correction that often led to change of price.
    - Electrical energy was changed in 1979 and its price rose about 50%.
    - Companies used some way indirect pricing changes
      - They “introduced” innovations when the same product was selling in new package and at the higher price or
      - At the same price customer got less of product.
  - Prices were nor delivered information about demand or supply and whole system was bended by taxes that were almost individual.
    - Different taxes for different companies
    - In this system existed more than 1500 various taxes.
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**Sales taxes in CSSR in %**

Sector	The lowest rate	The highest rate
Agriculture	-240	66
Fuel, coal, oil	-189	76
Electric energy	-181	0
Metal, steel	-33	25
Metals	-27	33
Chemical industry	-216	71
Engineering	-291	83
Building material	-171	20
Wooden products	-75	46
Paper	-80	52
Glass	-69	69
Textile	-137	70
Clothes	-44	79
Leather	-222	52
Printing	-111	76
Foods	-224	88
Others industries	-100	62
Constructions	0	0
total	-291	88



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# Pricing system

- Prices of e.g. foods or consumer's goods were supported by negative sales tax
  - The total volume of price aids were significant
    - In 1990; 3 % of GDP
  - State-aided were at most prices of
    - Foods, energy and consumer's commodities
    - The prices of durables were high but prices of non-durable low
-

# Pricing system

- The most important aspect of fixed prices was confusion of market subjects.
  - Producers did not know which goods were demanded
  - Consumers did not realize rarity of commodities
    - State-aided prices of energy or water led to wasting with them
- On the other hand if produced knew which goods were demanded they did not change their behavior because of other above mentioned aspects
- The reason of this situation was existing of scarce commodities and black market.
- One of the most important price in economy is
  - Exchange rate.
- In central planned economies this exchange rate was composited from two components.
  - Official exchange rate + coefficient
  - Particular exporting products had also own additional fees or encounter fees (support or restrict exports)
  - And there was also other fees for exchange of foreign currencies
    - different for domestic people and
    - different for foreigners.
  - It mean that there was system of several exchange rates

# Foreign trade and openness of the economy

- Czechoslovak economy was closed to external influences.
- Ration of openness: GDP to export
  - Export to GDP in 1987 only 19,4 % (2008; 80 %)
- Limited influence of foreign economy to Czechoslovak economy.
- Foreign trade was oriented in eastern markets ( 70 % exports led to eastern communism countries)
- The Czech Republic was member of RVHP
  - Organization of mutual exchanges of goods between socialistic countries
  - All exchanges were based on government bilateral agreements.
  - In the 1980's main reason low quality of Czech goods

# Foreign trade and openness of the economy

Geographical orientation of Czechoslovak foreign trade	Imports		Exports	
	1928	1989	1928	1989
<b>Country</b>				
<b>EC</b>	<b>54,79</b>	15,37	<b>43,92</b>	16,46
<b>USA</b>	5,94	0,32	5,56	0,56
<b>Japan</b>	0,07	0,33	0,19	0,76
<b>Eastern Europe</b>	16,67	16,66	20,55	16,45
<b>Soviet union</b>	1,04	<b>45,58</b>	1,32	<b>43,14</b>
<b>other</b>	21,49	21,74	28,46	22,64

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# Foreign trade and openness of the economy

- Eastern orientation of Czechoslovak trade was related with a lot of negatives
    - Limited competition in eastern markets
    - A lot of exports were state-aided
    - Liabilities in this countries were irredeemable
    - Lack of western goods in domestic market that could rise competition and quality of production
    - Exports were mediated by the **Companies of Foreign Trade** that had monopoly for trading with foreign counties
      - In 1990: 52 companies trading with foreign countries
      - Producers did not have an contact to their consumers
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# Foreign trade and openness of the economy

- Foreign investment in Czechoslovakia were limited as well.
    - 50 companies with foreign participation
      - In Hungary d Poland approximately 500
    - Limited were fluctuation of Czechoslovak employees
      - In Soviet union and other socialistic countries
    - In Czechoslovakia worked employees from Vietnam and Cuba this countries settled their liabilities to Czechoslovakia by this form.
-

# Structure of Economy

- Economic structure was bended.
- Communism economy was focused on
  - development in industry and
  - neglect of services
- Industry was focused on heavy industry
  - But without suitable raw material background and thus
  - this produces were energetic-intensive

<b>Energetic- and materials-intention for 1000\$ GDP</b>		
<b>Consumption of -</b>	<b>CSSR</b>	<b>Developed country</b>
energy	20	13,3
steel	77,1	27,0

# Characteristic of economic growth

- The pace of economic growth was decreasing.
- In the 1950's economic growth was specific
  - Added of new resources in production
  - Was not base on effectiveness of growth or productivity
- Economic system did not tend to changes and growth of effectiveness
  - Attempted to maximization of imputes and limitation of outputs
  - In Czechoslovakia three time higher consumption of energy than was average of OECD countries.

<b>Basic macroeconomic data: annual changes</b>	<b>1970-1980</b>	<b>1980-1990</b>
<b>GDP</b>	4,77	1,5
<b>National income</b>	4,66	1,31
<b>Personal consumption</b>	3,22	1,69
<b>Growth fixed investments</b>	5,77	0,89
<b>Real wage</b>	1,99	-0,09



# Political system

- There was no competition between political parties
- In the Constitution there was determined the leading role of communism party.
- Formally, there existed other political parties but their influence was insignificant.
- All parties were concentrated in National front, that presented political monopoly.
- Attendance in vote was obligatory and enforced by government.
- In economical field policy influenced choosing of managers instituted to state companies that had to be members of Communist party.

Election	1954	1960	1964	1971	1976
National front	97,89 %	99,86 %	99,9 %	99,96 %	99,39 %

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# Sum up

- At the beginning of transformation process Czechoslovakia had several advantages compared with other transformation countries.
  - Economy was not so disrupted with several imbalances as e.g. Poland.
  - Positive was
    - nearness of western markets and
    - inherited specialized working power.
  - Problems was related with
    - Central planned economy
    - Subjects were not motivated to effectiveness and innovations because
      - Proprietorship were state
      - Information were bended by fixed prices
    - Foreign trade was focused on eastern markets
    - Structure of economy was bended with emphasis on industry.
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Thank you for you attention

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