

Czech Republic – Central Bank's Role In Building the Banking System

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CZECH **CNB** NATIONAL BANK

Arrangement of Presentation

- Starting conditions in 1990
- Final outcome of the banking sector transformation
- Interaction between monetary policy and banking sector regulation
- Role of fiscal policy

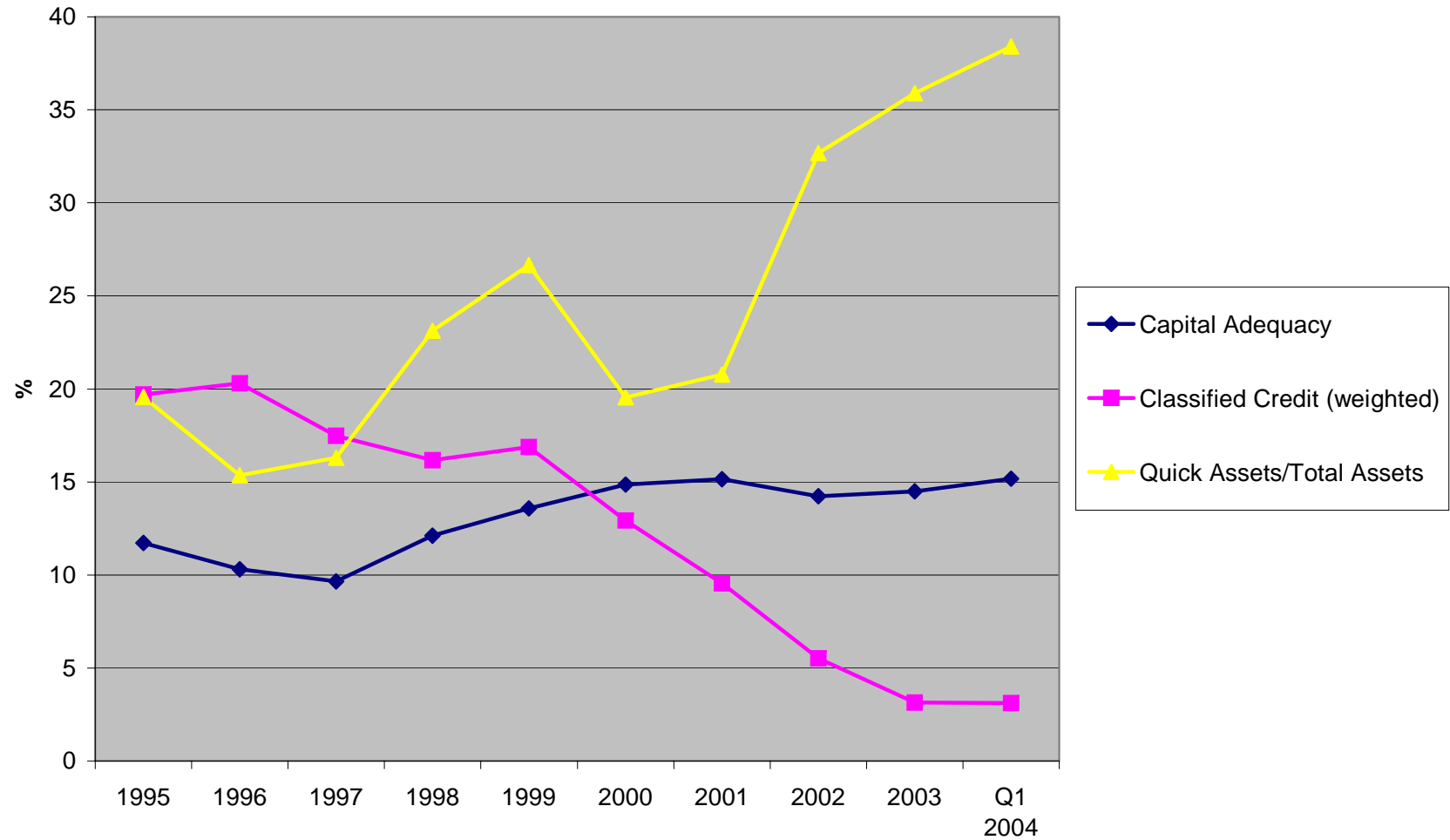
Starting Conditions

- Banking system dominated by state monobank (SBCS)
- SBCS functions subordinated to central planning - fiscal policy
- Monopoly structure of BS (4 banks), low capitalization
- Missing systems of external and internal controls
- Low share of private sector on GDP, no track record, missing informal rules of business activities
- Absence of reforms prior 1989 \Rightarrow high saving rate - but inability to reallocate the savings efficiently

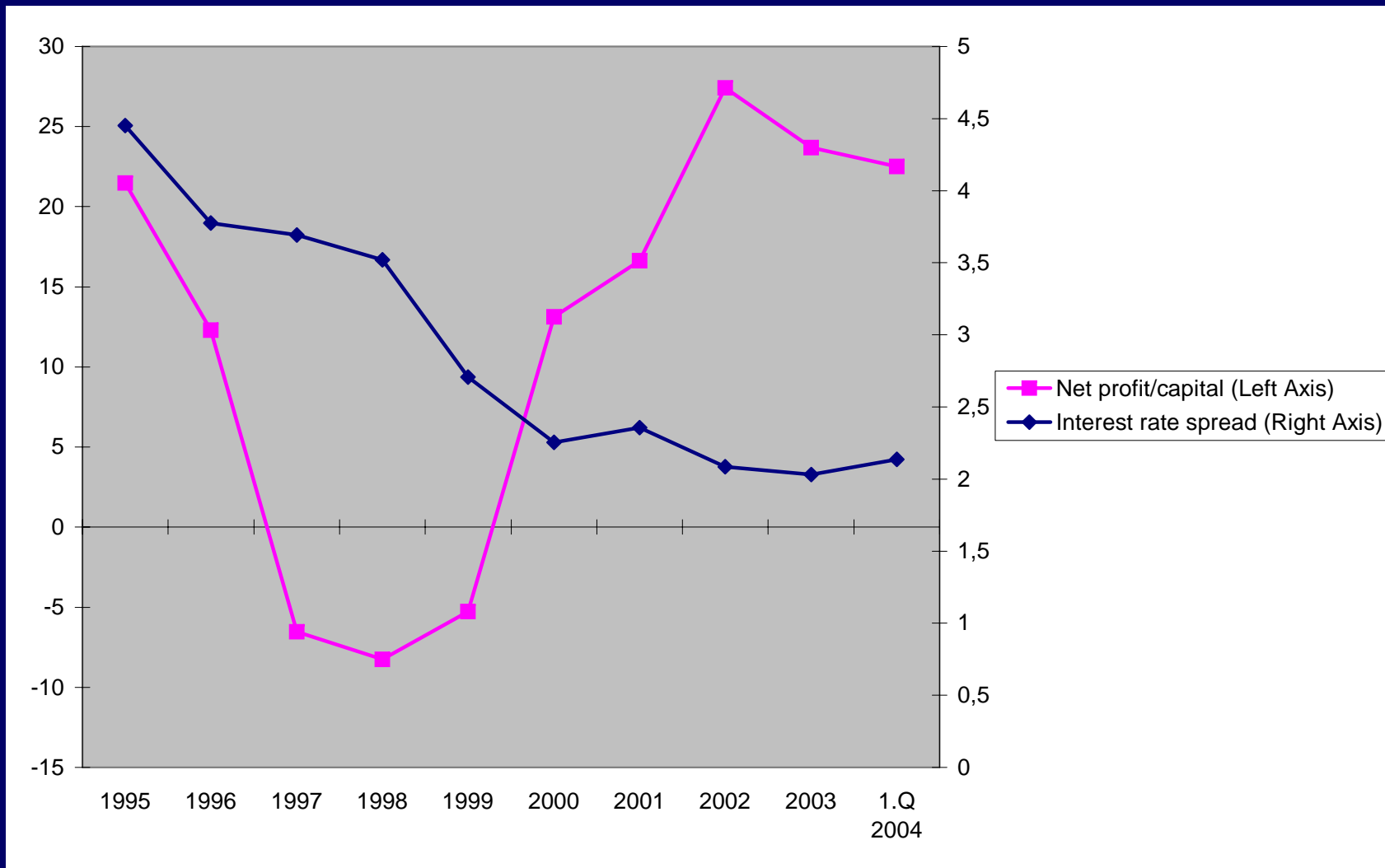
Current Situation

- Banking sector sound and stable
- Improving indicators of financial soundness
- Financial depth relatively high to other new EU member states
- BS controlled by foreign owners (as in other NMS)
- Increasing effectiveness of the banking sector
- Increasing competition- new products, cross-selling
- Banking regulation and supervision harmonized with EU standards

Banking Sector Soundness Indicators



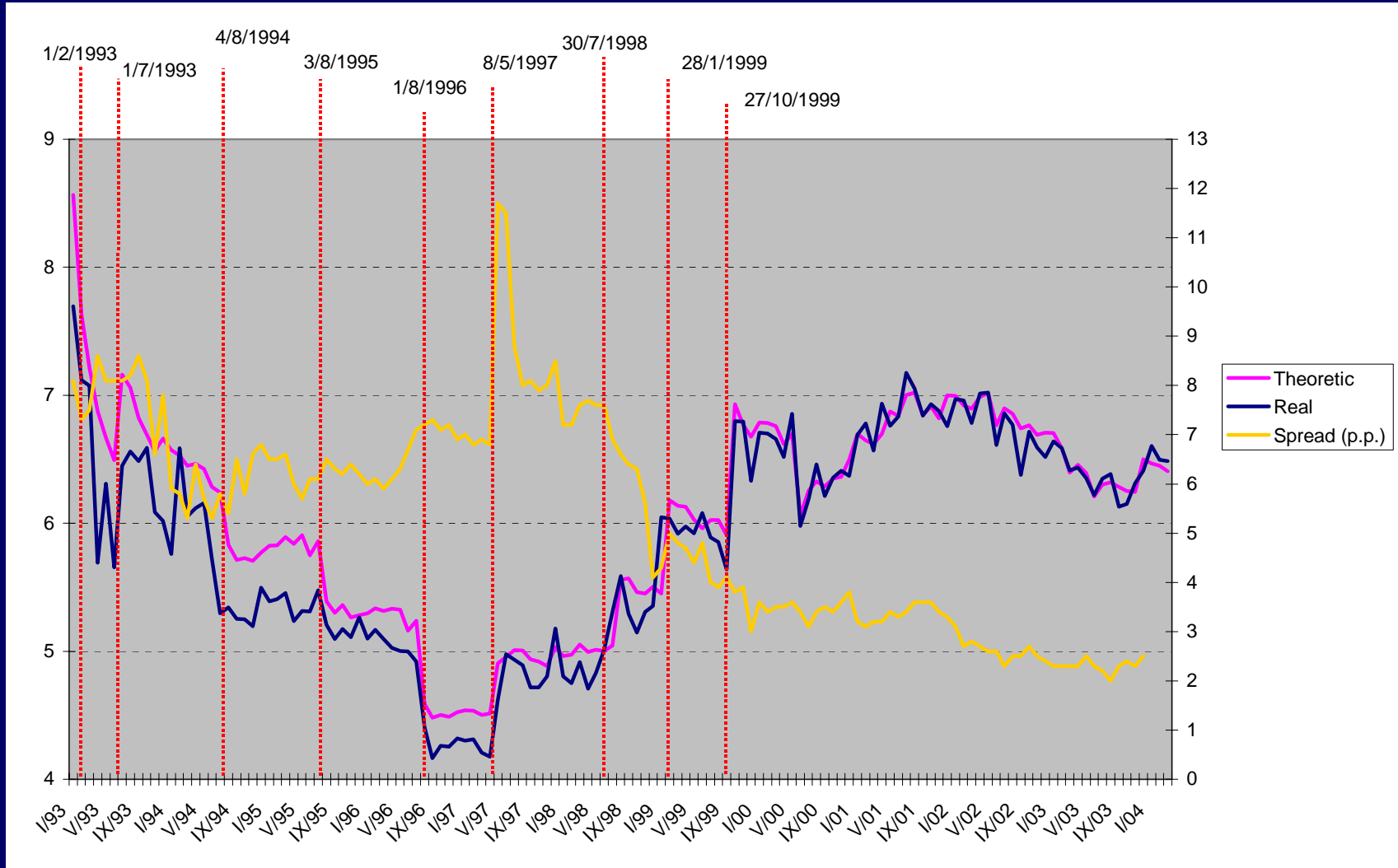
Profitability of the Czech Banking Sector



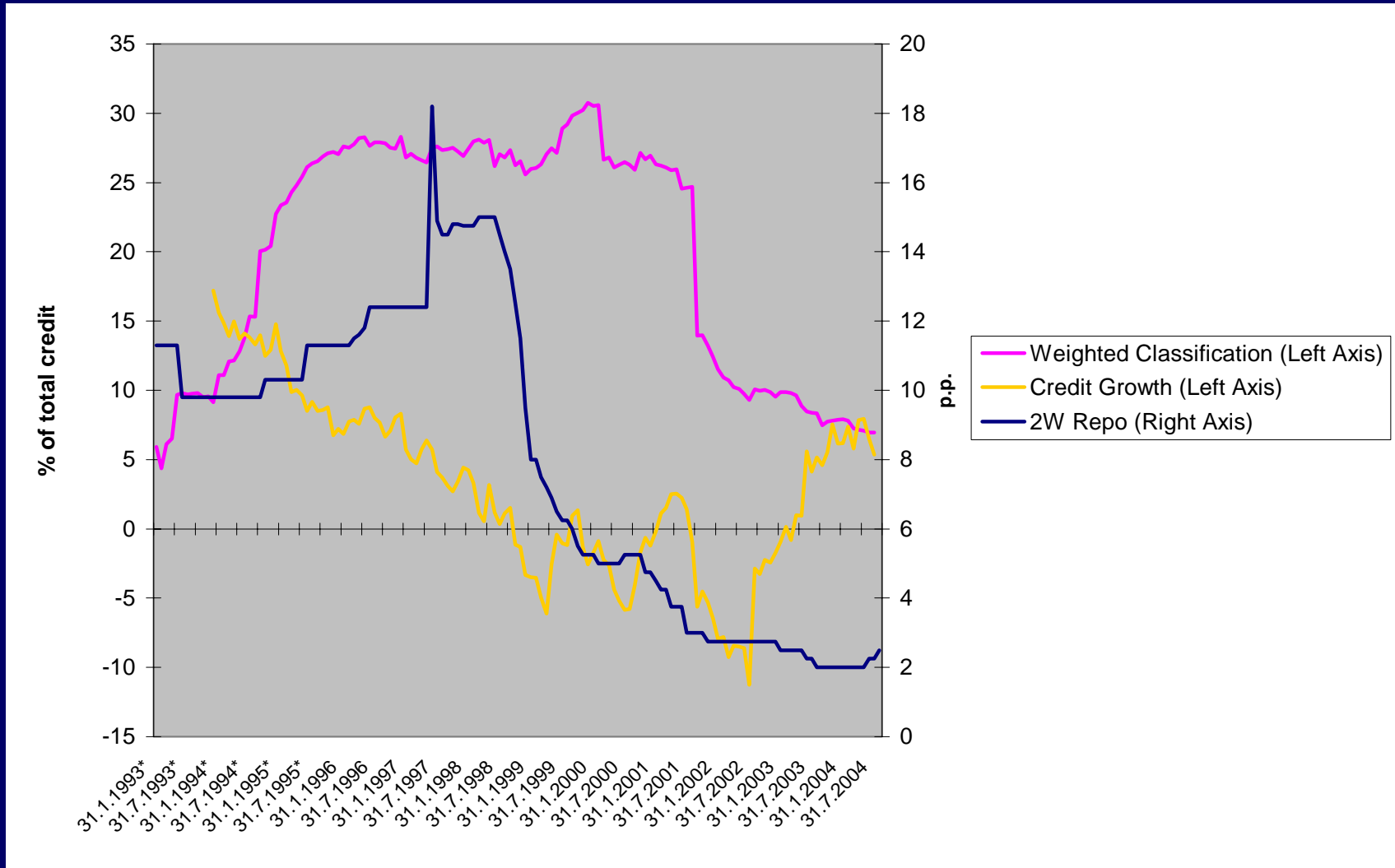
Monetary Policy Effects on BS

- Instruments of monetary policy built up in parallel with the establishment of banking supervision \Rightarrow attempt to address both MP and BS problems
- Possible reaction of MP instruments to financial instability?
Lender of the last resort function
- Impact of capital inflows - financial crisis in 1997 resulting in change in MP - inflation targeting
- Reaction of the supervision to financial instability- ceteris paribus tightening to MP, possible error to macro models

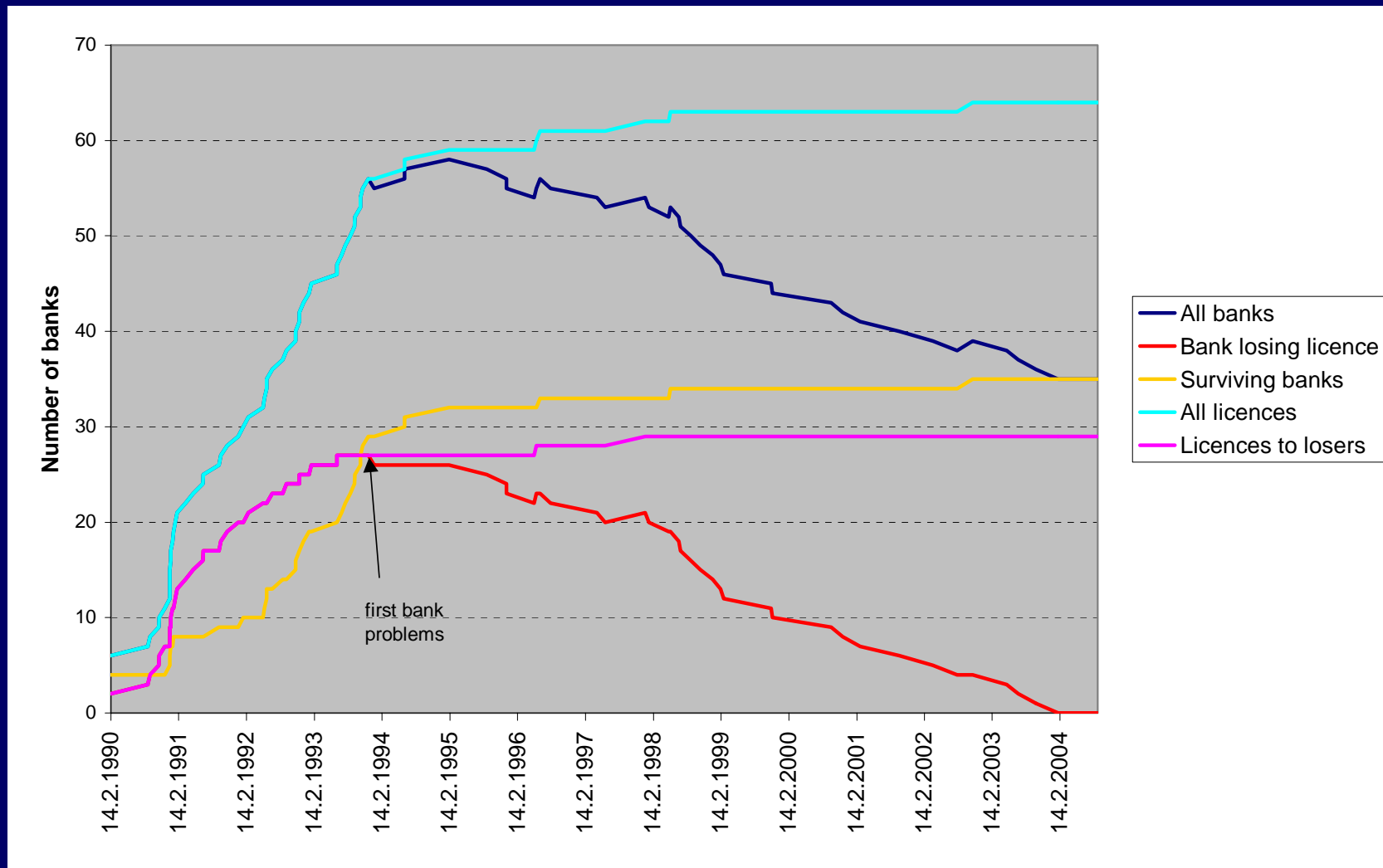
Changes to the Money Multiplier



MP Instruments in Reaction to Bad Loans



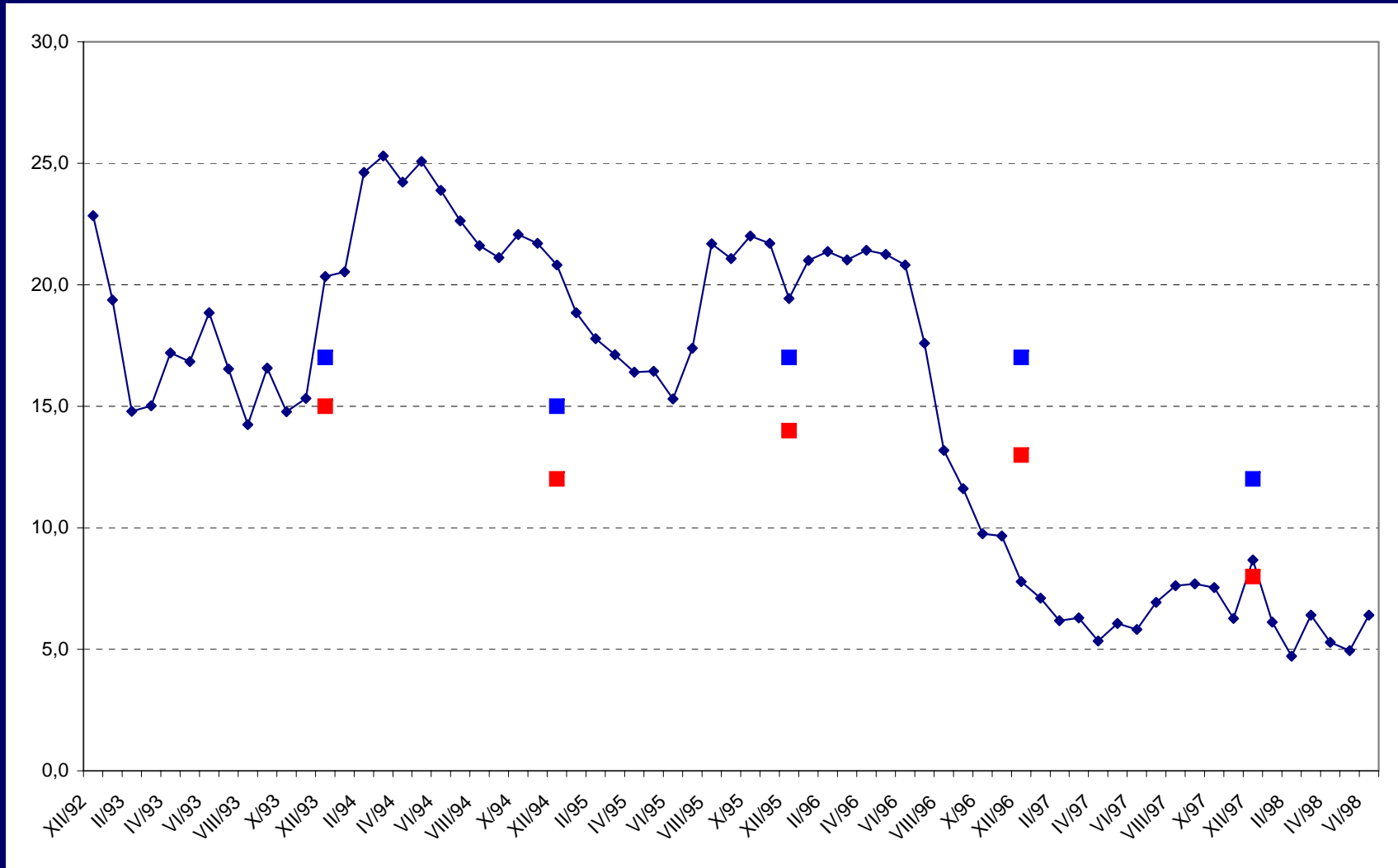
Ex Post Success of the Licensing Policy



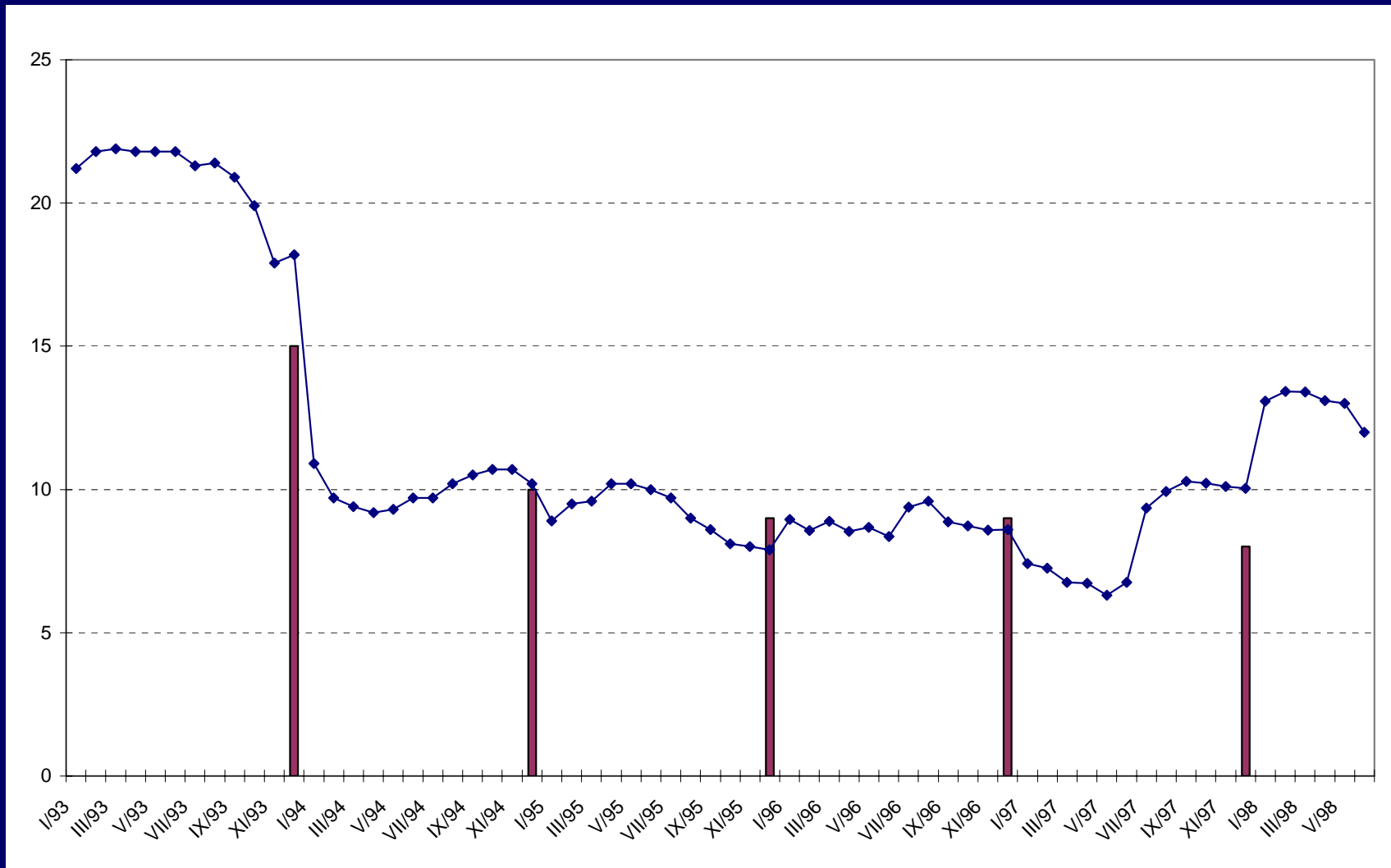
Role of Banking Sector in Capital Inflows

- Capital account liberalization \Rightarrow massive capital inflows (about 15% of GDP), in combination with fixed ER \Rightarrow loss of MP autonomy
- Inflows mainly through portfolio investments, distributed via banks - in combination with bad corporate governance of banks resulted in deterioration of asset portfolio
- The bad loans problem further worsened the MP autonomy problem
- Bad loans postponed bank privatization
- May 1997 crisis- shift to inflation targeting at the end of 1997

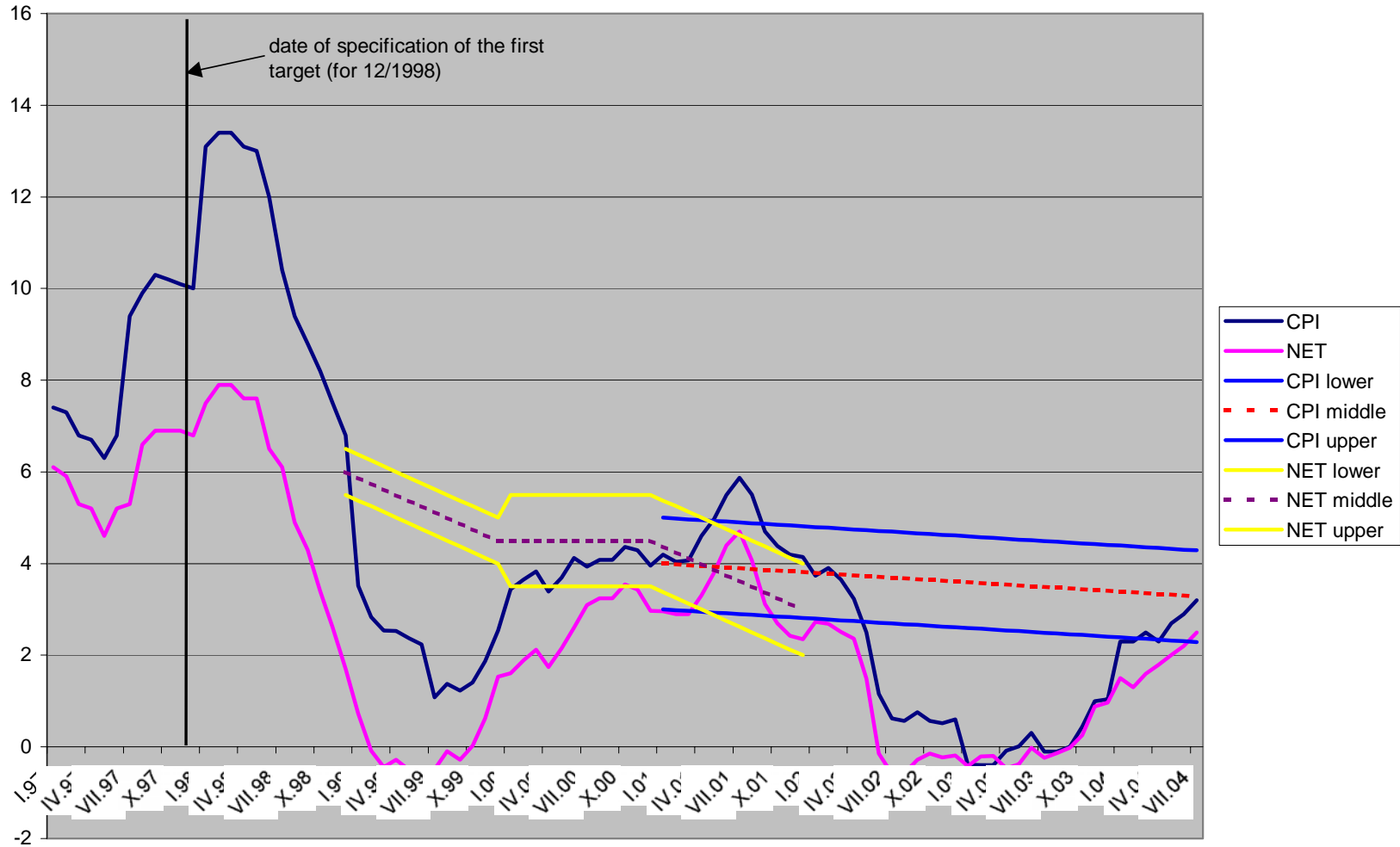
Overshooting Money Targets



Inflation Forecasts Prior Inflation Targeting



Actual Inflation versus Target



Ex Post Evaluation of Inflation Targeting

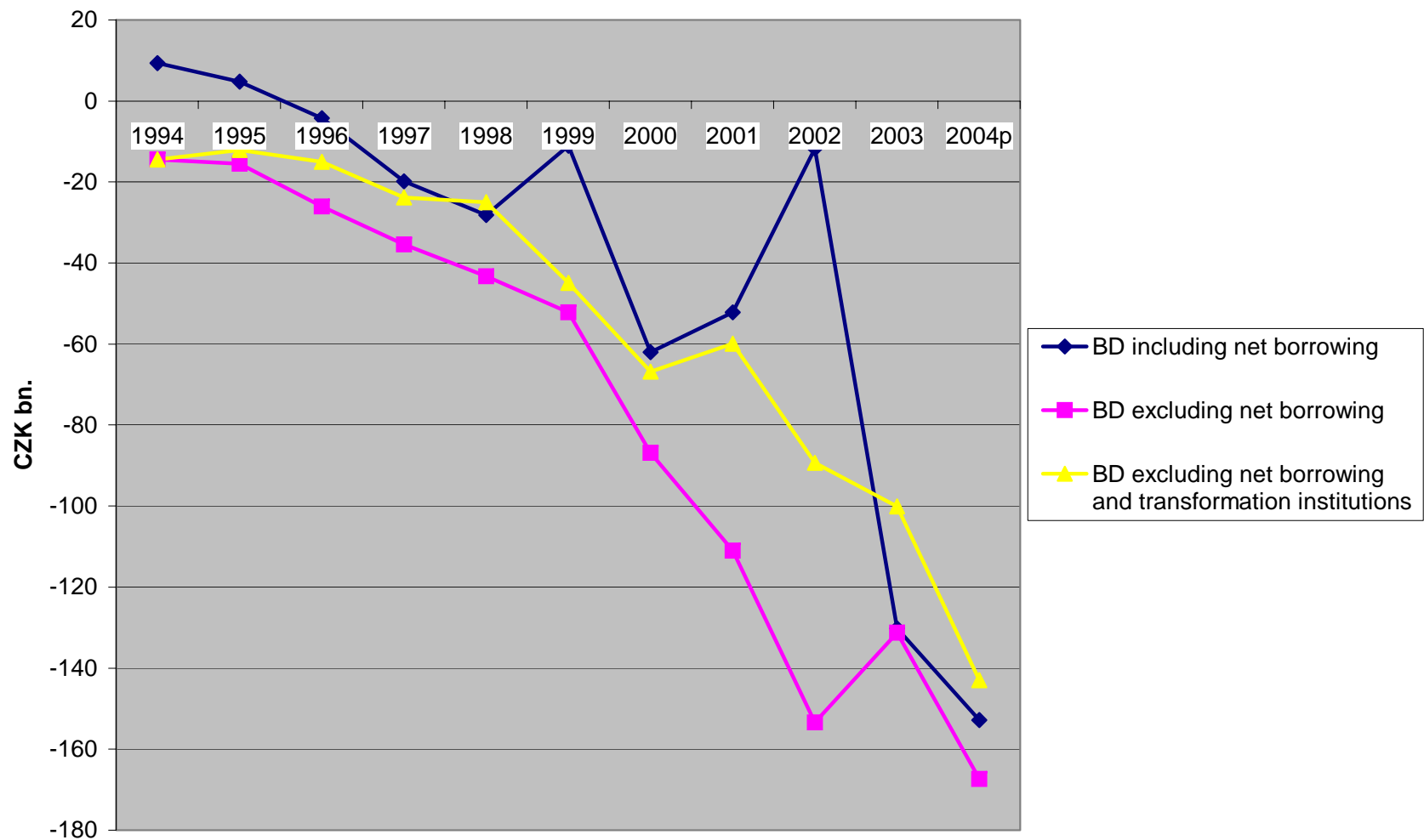
- Systematic undershooting the target
- Possible result of change in economic environment due to changes in regulation, influencing stability of coefficients in econometric models
- But also many other reasons- one time shock to VAT in 1997, lower pace in deregulation than originally expected, excessive appreciation in 2002...
- The main reason for instability comes from earlier deficiency of internal control, explosion of low quality loans, ...

	Stay	Number of Months	Percentage of cases
Target: net inflation	above target	1.0	2.8%
	below target	26.0	72.2%
	on target	9.0	25.0%
Target: total CPI	above target	4.0	11.1%
	below target	20.0	55.6%
	on target	12.0	33.3%
Targets: total	above target	5.0	6.9%
	below target	46.0	63.9%
	on target	21.0	29.2%

Role of Government in Developing BS

- Relatively strong role
- Semi-fiscal expenditures in 1st half 1990s - through BS,
- Postponed fiscal expenses due to clearing the commercial banks balance sheets later
- Shift of some costs to transformation-specific institutions (National Property Fund, Czech Consolidation Bank/Agency)
- Failure of state (as an owner) in corporate governance of banks (implicit contracts between govt. and bank management)
- Postponing of privatization- final privatization was forced by circumstances

Budget Deficits



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