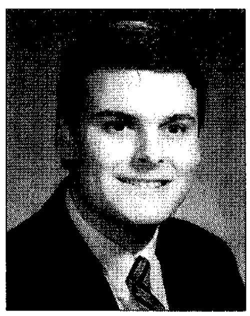
1-1-1992

An Economy in Transition: Creation of Financial Market Institutions and Infrastructure in Czechoslovakia

Christopher Croteau
Lehigh University

AN ECONOMY IN TRANSITION: CREATION OF FINANCIAL MARKET INSTITUTIONS AND INFRASTRUCTURE IN CZECHOSLOVAKIA

Christopher Croteau



Introduction

Until two years ago, Czechoslovakia was the paradigm of a centrally planned economy: no private sector, no legal basis for private ownership, artificially controlled prices, allocation of capital by government fiat, and a tightly managed program of international trade largely restricted to the communist bloc. Beginning in 1990, Czechoslovakia (officially, the Czech and Slovak Federal Republic or CSFR) undertook the arduous and ambitious task of converting the fundamental structure of its economy to one driven by free market forces.

Expectedly, this transition has resulted in some painful short-term economic dislocations in the form of unemployment, inflation and a general reduction in the standard of living. These hardships resulted from exposing the heretofore sheltered Czechoslovak economy to free market forces—thereby inflicting the true costs of the historical misallocation of resources—and from the disruption in trade caused by the deepening crisis in the Soviet Union. (Marer, p. 5)

Czechoslovak economic reform is progressing on three fronts: the privatization of its industrial sector, its integration into the world economy, and the creation of financial markets. (Koromzay, 1992) This paper will focus exclusively on the third prong of Czechoslovak economic reform: the development of financial market institutions and infrastructure. In other words, it will treat the development of financial institutions such as brokerage firms and institutional investors, and financial infrastructure such as efficient transference of information via computers needed for modern financial transactions. Nonetheless, it is important to recognize the interdependence of the various elements of the overall reform movement. The development of financial markets cannot be viewed in isolation from the concurrent development and implementation of entrepreneurship, basic market mechanisms, and democratic institutions. An example is useful to illustrate both the magnitude of the problems faced in economic reform and the interdependence of the reform tasks. Privatization—the cornerstone of reform—will entail shifting the ownership of some 120,000 small and medium size enterprises and more than 4,000 large enterprises to the private sector. (Koromzay, p. 36) During the first half of 1991, this privatization effort resulted in the number of individuals engaged in private sector jobs increasing from 156,000 to 580,000. (Sujan, p. 5) Clearly, the development of efficient financial markets is essential to the further success of Czechoslovakia's privatization plan. Later stages of the privatization plan will involve the distribution of vouchers to Czechoslovak citizens for a nominal price. The vouchers can be used later for the purchase of stock in privatized Czechoslovak companies. For example, the Czechoslovak government predicts that 2,285 companies with an approximate book value of seven billion crowns will have been privatized by the end of the summer of 1992. (Koromzay p. 36) Without functioning secondary financial markets to provide necessary liquidity and market pricing for the vouchers, there will be a great deal of market uncertainty.

The development of financial markets is hindered by the legacy of the nation's past communist rule. For example, the current legal framework is completely unprepared to deal with commercial issues, especially those related to financial instruments. Furthermore, there is a general lack of both the financial knowledge and the technology needed to promote modern efficient financial markets. Under the past system, there was no need for Western style markets because capital was allocated according to the wishes of the government. Additionally, many financial instruments were unnecessary because there was only one form of ownership — that of the state. Therefore, it is necessary for Czechoslovakia to transform its markets from instruments of state patronage to tools for the efficient allocation of capital.

In its plan to promote the development of financial markets, the State Bank of Czechoslovakia has cited seven necessary preconditions for the development of efficient financial markets: 1) the development of a commercial legal framework, 2) creation of a stock exchange authority, 3) the development of financial instruments, 4) the development of financial intermediaries, 5) participation by institutional investors, 6) the development of a viable secondary market, and 7) the computerization of the stock exchange. (Kucera, 1991)

The Legal Framework

The first precondition for the development of efficient financial markets is the creation of a legal framework which will provide for clearly defined and enforceable property rights and contracts. The cornerstone of legal reform was the legalization of private enterprise in 1990. The current Czechoslovak legal framework for financial markets is composed of three laws. The Bond Act is the source of rules for the issuance of bonds by the state or by other legal persons. The Competition and Liquidation Act deals with the treatment of bankruptcy proceedings. Finally, the Bills of Exchange and Cheque Act governs the creation of notes and similar instruments. However, there is still much important legislation to be enacted. Five of the most important are: a Securities Act, a Stock Exchange Act, a Banking Code, a Tax Code, and an Investment Companies Act.

Securities Act

A Securities Act has been proposed which, if it is implemented by mid-1992 as hoped, will provide a broad legal framework for financial markets. This law will cover the following fundamental issues: the definition of individual securities, financial intermediary licensing, certification procedures for financial markets personnel, financial reporting requirements, security transfer regulations, insider trading, and the development of an independent authoritative body similar to the Securities and Exchange Commission to oversee the financial markets.

It is clear that such general purpose legislation as the Securities Act is needed to form a basic foundation for the securities market. Czechoslovakia's acceptance of a market economy has placed it in the position of catching up on forty years of Western commercial legislation in a short period of time.

Stock Exchange Act

A preliminary Stock Exchange Act is currently under discussion by the Czechoslovak government. This legislation describes the elements necessary for the creation of stock exchanges and analyzes the features of a proposed regulatory authority for the exchanges. The proposed Stock Exchange Act calls for authority over the exchanges to be divided among the Federation (CSFR), the two republics, and the stock exchange authority. The supervision of the operation of each stock exchange will lie with the Federation.

Two stock exchanges are planned: one in Prague and one in Bratislava. The licensing of each exchange will be performed by the respective republic. In addition, the stock exchange authority acting as a self-regulating body will provide rules for participation in the stock exchanges, trading, and security acceptance. Finally, this Act will provide for the organizational structure and legal system (stock exchange courts) of the new exchanges.

Banking Code

A two-tier banking system for Czechoslovakia was instituted on January 1, 1990, which separates central banking and commercial banking functions. (Koromzay, p. 36) Currently, Czechoslovak commercial banks are performing both commercial and investment banking functions. The Czechoslovak government must now decide on whether to adopt a Glass-Steagall type separation of these functions or to allow banks to continue to encompass both investment and commercial banking functions. Banks in Czechoslovakia today are to a large extent performing these two functions through independent divisions. This should allow for a relatively easy adjustment to a system similar to that of the United States. It is evident that due to the large role currently played by banks in the Czechoslovak economy—they are the only financial intermediaries and are the main source of commercial credit—a separation of these two functions would enhance investor confidence. The enhancement of investor confidence would be the result of the more effective supervision of investment banking practices. Hence, there would not be a strong link between banking risk and market risk.

Tax Code

Czechoslovakia is currently revising its tax code, but the Ministry of Finance estimates that the revised code will not be finished until 1993. This task is especially difficult because a large portion of the tax burden is now borne by companies. This allocation of the tax burden greatly reduces the amount of earnings available to companies to reinvest. Ideally, the new system will switch a greater portion of the tax burden onto individual citizens, thereby freeing funds for reinvestment.

A second problem facing the authors of the new tax code is that the current code does not cover many transactions involving financial instruments (e.g. capital gains on stock). As a result uncertainty surrounding the tax structure until 1993 will clearly hinder the development of a financial market in Czechoslovakia. Preliminary tax regulations are needed before 1993 to allay investor uncertainty. Such tax policies as the preferential treatment of capital gains are needed before 1993 to promote involvement in the newly evolving financial markets. In addition, taxation of joint ventures and foreign investment should be structured to promote the inflow of capital.

Investment Companies Act

There are plans to enact legislation during 1992 which will govern the establishment and regulation of investment companies. Investment companies have been created for the sole purpose of facilitating the voucher privatization scheme. New legislation is needed to induce institutional investors to enter the market.

These large investors will create needed liquidity in developing financial markets. It is estimated that one half of the two to four million citizens participating in the voucher system will use investment companies. (Koromzay, p. 36) An important result of this consolidation of ownership is that the investment companies will be able to exert more ownership control than if ownership were dispersed among millions of individual Czechoslovak citizens.

Stock Exchange Authority

In order to create a fair and efficient capital market, it is necessary that a self-regulating authoritative body be initiated to create and enforce the regulations of the capital market. Currently, a large portion of this role is performed by a temporary securities commission, which is composed of representatives of the State Bank of Czechoslovakia and commercial banks. This commission was created to manage the secondary capital market until the Securities Act is approved and permanent stock exchanges are formed. The main responsibilities of the commission are to create and enforce regulations and to make decisions on the admission of securities based on prospectuses. It is also the task of the commission to ensure proper disclosure and adherence to financial standards. To this point, only banks have been given licenses to act as intermediaries, but in the future this role will be given to others (e.g. brokers) as well.

According to government plans, an independent Commission for Securities and Stock Exchanges will eventually serve as the permanent regulatory body. It is hoped that this commission will be formed as quickly as possible so that the basic groundwork may be created before large volume capital market operations begin. This independent commission will also enhance investor confidence in the stock exchanges. Ultimately, the State Bank will relinquish its licensing role to the commission. Moreover, the commission will be given the responsibility for the creation of rules for equitable trading, the determination of equity requirements for intermediaries, the implementation of testing for market professionals, and the acceptance of new securities. It is imperative that this commission create standards equivalent to current international financial standards in order, once again, to gain investor confidence.

In the money market, the State Bank of Czechoslovakia has taken on the role of supervisor. This bank controls the money market through the implementation of monetary instruments, loan refinancing, and minimum reserve requirements. (Kucera p. 8) In order to provide necessary investor confidence it is essential that the central bank be given complete freedom to set standards free from government influence. The central bank must help to promote efficient bank clearings and timely disclosure of market information for participants. Furthermore, it must promote the creation of more money market instruments. The development of modern efficient money and capital markets depends greatly on the development of adequate financial instruments.

Financial Instruments

In the current money market, interest rates are determined by the competitive bidding among banks for refinancing loans. Commercial notes are only in their infancy and are used in very few financial transactions. The central bank is currently promoting the use of these notes by extending favorable discounting terms. It is felt to be essential that these instruments be utilized to allow for greater commercial credit, especially as a form of payment during privatization.

Short-term government credit instruments such as U.S. Treasury bills are nonexistent in the current Czechoslovak money market. However, a weak interbank deposit market of short-term certificates has developed in which dominant regional commercial banks intermediate for smaller savings banks. (Koromzay, p. 36) Unfortunately, the lack of volume in this market has prevented interest rates from playing an equilibrating role as of yet. Treasury bills and certificates of deposit are needed to provide for short term credit with high liquidity. The issuance of Czechoslovak "Treasury bills" is expected in 1992 after necessary Parliamentary action.

Issues in the Czechoslovak bond market have been largely unsuccessful. As of August, 1991, there were only ten bond issues by commercial banks and companies on the market. The failure of these issues is due to several factors. High inflation caused by the reduction of price controls has had an extremely adverse effect on initial issues. Also, investor uncertainty about future financial prospects of the issuing firms has caused many investors to be wary, especially since many investors are waiting for issues by larger more stable firms.

The Czechoslovak government has not as yet issued any general purpose bonds. Government bonds are an essential part of a developing bond market, because they have a guaranteed return and they allow the central bank to create sufficient liquidity. Government bonds can also be used as a tool of monetary policy.

The development of a relatively stable and liquid bond market prior to large scale privatization is necessary because it is anticipated that the stock market will be highly volatile, due to investor uncertainty and to large scale speculation. In fact it may be some time before the highly speculative nature of initial share offerings is reduced. Therefore, new firms without substantial financial backing will be forced to turn to the bond market in search of capital.

Financial Intermediaries

As of January 1992, thirty-four banks were in operation in Czechoslovakia. Most of these banks are licensed to perform both investment banking and commercial banking functions. Eleven of the thirty four are currently involved in the secondary market for securities. (Kucera, p. 14) These banks deal primarily in interbank loans. The Czechoslovak banking system is highly regionalized and financial power is highly centralized. Therefore, the Czechoslovakian government must make provisions for growth in the number of intermediaries, especially small brokerage firms. Brokerage firms are not susceptible to the risks inherent in the banking system and will help to insulate the markets from banking financial risks. Furthermore, a relatively large number of intermediaries will lead to greater competition and to a lower cost of capital for firms. Finally, an efficient intermediary network will help to increase the speed of the privatization effort.

Institutional Investors

It is clear that the level of savings accumulated by Czechoslovak citizens under the old system will not be sufficient to bring about large scale privatization. Therefore, large institutional investors are necessary for providing capital and liquidity to Czechoslovakia's financial markets. According to the World Bank, there are four factors which will play a major role in determining the amount of capital investment by large institutional investors in developing stock markets: 1) the supply of new issues in the market, 2) expected rate of return and diversification available, 3) the regulatory and tax environment, and 4) the disclosure of market information. (Dailami and Atkin, p. 34) In the case of Czechoslovakia much of this new stock will occur through the privatization of industries. Unfortunately, this source of new stock carries with it substantial difficulties which will delay its acceptance by international investors.

First, there is a general dearth of financial information both about general economic indicators and accounting data. The Federal Statistical Office is not currently producing data consistent with Western standards on the performance of the Czechoslovak economy. This lack of information is due to the auditing role the statistical office played under the command economy. (Blades, p. 13) Previously, the office was in charge of ensuring that production quotas were being met. The past propaganda role played by the statistics office has also led to a loss of independence. As a remedy Blades suggests the appointment of internationally known experts, who would lend greater legitimacy to the financial data and markets as a whole. In addition, the statistical office has in the past concentrated on production statistics and has to a large extent ignored the service economy. The statistics office needs to produce timely and accurate data on gross domestic product, employment, and prices.

The second major factor determining foreign investment in Czechoslovakia's capital markets is the expected rate of return and the level of additional diversification available. Investors will base their decision to invest to a large degree on the performance of the Czechoslovak economy and the correlation of these returns with the returns available in home markets. Clearly, the Czechoslovak economy is in a period of great uncertainty, and it will be very difficult for an investor to make predictions about possible rates of return and diversification without a reliable financial history as a guide.

The World Bank points to the regulatory and tax environment as a third key determinant of foreign institutional investment. (Dailami and Atkin, p. 34) A foreign institutional investor wants to be sure that there is a legal system in place, which will provide for adjudication if contracts are violated. Moreover, the investor wants to be assured that stock trading is fair and is supervised effectively. An authoritative body similar to the U.S. Securities and Exchange Commission (SEC) is needed to ensure the investor that his financial interests are protected from wrongdoing. Finally, the country's tax code will have a large impact on the attractiveness of the Czechoslovak market. It is clear from the previous discussion that the tax code will most likely not be in place in time for a large part of the privatization effort.

The fourth key factor determining the amount of capital investment by large institutional investors is the timely and accurate disclosure of market information. Institutional investors will demand immediate disclosure of financial information which meets international standards of accuracy. This makes it necessary for the Czechoslovak stock exchange to implement international standards of accounting and financial disclosure. Such disclosure is especially important in the case of the Czechoslovak economy because it will be experiencing rapid change.

Based on the four factors described above, it appears to this author that the Czechoslovak stock market will not be able to initially depend on foreign institutional investment to provide the necessary capital for the early years of the transition to a market economy. High levels of foreign institutional investment will not occur until the development of a stable and efficient secondary market for shares of stock.

Secondary Market

The need for a stable and efficient secondary market is particularly acute for the successful implementation of privatization through the voucher system. A secondary market is needed to create liquidity and to enable the determination of market prices for the vouchers.

A temporary secondary market for capital stock was created in April, 1991, by an arrangement between the State Bank of Czechoslovakia and eight commercial banks. (Kucera p. 18) The resulting "Agreement on Cooperation to Secure a Temporary Secondary Market" created a three tier structure consisting of a Participants Assembly, a Market Commission, and a work group. (Kucera, p. 18)

The Participants Assembly is a grouping of the security market's members which serves as a forum where market members may air suggestions on how to improve the trading system. The Market Commission is the regulatory authority in charge of monitoring the trading in the interim stock exchange. Its specific duties include making decisions on acceptance of new securities, setting brokerage fees, and implementing and interpreting market rules. The Market Commission is composed of five members elected from the Participants Assembly, a representative of the Federal Ministry of Finance, and a representative of the State Bank of Czechoslovakia. The last tier in the Agreement, the work group, is composed of staff of the State Bank of Czechoslovakia. The work group is responsible for the technical matching of supply and demand of securities, the registration of trades, and the distribution of information on trades.

Trading in the temporary secondary market first took place in July 24, 1991. As of this writing, trading occurs once every two weeks. The temporary stock market is of great importance as a testing facility for the development of a permanent exchange. Through this temporary market many technical activities such as the accounting and clearing system and dematerialization of securities may be tested. Dematerialization refers to the elimination of the need for paper stock certificates for proof of ownership. Instead, computerized data bases are used to keep track of stock ownership.

In order to prepare for the creation of a permanent stock exchange, a temporary independent committee not associated with the temporary secondary market has been formed. This "Preparatory Committee for the Establishment of a Stock Exchange" has taken on the immense task of preparing Czechoslovakia for a stock exchange. The committee is composed of the State Bank of Czechoslovakia and the commercial and savings banks of Czechoslovakia. Currently, the committee is funding research on a clearing account system and quick and efficient dissemination of market information. The committee is also funding efforts for the training of future exchange participants and operators. (Kucera, p. 20) The efforts currently being conducted by the committee are essential for the development of an effective modern exchange in Czechoslovakia.

Computerization

In order to create an efficient modern stock exchange, the implementation of computer technology is essential. The Czechoslovak government is well aware of this fact and has brought in foreign experts to aid in the development of a computerized and dematerialized stock market. In fact, it is hoped that a Center for Securities may be formed for the recording of privatization data and stock exchange data into a centralized data bank. The centralized data bank would enhance accuracy for both privatization coupons and stock exchange transactions. Clearly, the steps towards this centralized data base are in their infancy stage and must be implemented gradually. The utilization of centralized date bases would enable much-needed coordination between the privatization effort and the stock market. It cannot be expected that the initial computerization efforts will initially meet international standards, but a concentrated effort by the Czechoslovaks should result in a workable solution in the future.

International Cooperation and Support

For obvious humanitarian and political reasons, Western governments and international economic organizations can play an important role in promoting the economic revolution underway in Eastern Europe by providing temporary technical and financial assistance.

Two such efforts which are currently underway illustrate the possibilities. In late 1990, the Securities and Exchange Commission formed an Emerging Markets Advisory Committee (EMAC) to provide training and other technical assistance to foreign government officials charged with developing financial instruments and markets. (Mann, p. 113) Similarly, as a result of the Conference on the Transition to a Market Economy in Eastern Europe held in 1990 and organized by the World Bank and Organization for Economic Cooperation and Development (OECD), a "Partners in Transition" program has been developed. This program is designed to assist countries which are well on the way to a market economy (such as Czechoslovakia) to adopt successful economic institutional arrangements and policies. One of the first results of this program was to arrange for regular country-by-country economic surveys patterned after those made in the OECD member countries. (Marer, p. 7)

Conclusion

Although much remains to be done, great strides have been made to transfer ownership of Czechoslovak enterprises from the government to private hands and to establish modern financial markets. Major structural and policy reforms currently underway include the legalization of private enterprise, tax and banking law reform, and the wholesale privatization of the industrial base. While the further development of the financial market institutions and infrastructure necessary to support a free market economy must proceed at a pace sufficient to avoid political unrest, speed is not the only concern. A thoughtful, well-publicized schedule for implementing reforms will provide the predictability necessary to instill confidence in Czechoslovak citizens and the international business community.

The responsibility for political and economic reform in Eastern Europe of course ultimately resides with the involved countries themselves. However, Western governments and bilateral institutions can and should continue to support the forces of change in those countries. Among other things, this international cooperation and support should take the form of continuing technical assistance and training in the development of capital markets.

REFERENCES

Blades, Derek. "The Statistical Revolution in Central and Eastern Europe," *OECD Observer*, Vol. 170, June/July 1991, pp. 13-16.

U.S. Department of Commerce. "Czechoslovakia Privatization Information," August, 1991.

U.S. Department of Commerce. "Foreign Economic Trends and Their Implications for the United States," International Trade Administration Publication 91-43, July, 1991.

Dailami, Mansoor and Michael Atkin. *Stock Markets in Developing Countries*, World Bank Publication WPS 515, October, 1990.

Institute for East-West Security Studies. *Money, Banking and Credit in Eastern Europe and the Soviet Union*, May, 1991.

Karomzay, Val. "Spotlight on the Czechoslovak and Slovak Federal Republic," *OECD Observer*, Vol. 174, February/March 1992, pp. 35-37.

Kucera, Miroslav. Lecture: "Development of Financial Market in Czechoslovak Economy," August, 1991.

Marer, Paul. "The Transition to a Market Economy in Central and Eastern Europe," *OECD Observer*, Vol. 169, April/May 1991, pp. 5-10.

Mann, Michael and Joseph Mari. "Developments in International Securities Law and Regulation," Securities Regulation Seminar. Los Angeles, October 1990.

Owens, James. "Options for Tax Reform," *OECD Observer*, Vol. 170, June/July 1991, pp. 17-19.

State Bank of Czechoslovakia. "Rules of Interim Secondary Securities Market," n.d.

Sujan, Ivan. "A Short Analysis of the Czechoslovakian Economy in the First Half of 1991," CSFR Federal Statistical Office, 1991.

United Nations University. "Foreign Portfolio Investment in Emerging Equity Markets," World Institute for Development Economics Research, March 1990.