Directorate A - Economic and Scientific Policy
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Czech Republic

Economic Policy Brief

Briefing Note

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Czech Republic

Economic Policy Brief

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Table 1: Main features of European Commission's autumn forecast

Main features of country forecast - THE CZECH REPUBLIC

		2007			Annual percentage change					
bn CZK		Curr. prices	% GDP	92-04	2005	2006	2007	2008	2009	2010
GDP at constant prices		3530.2	100.0	2.1	6.3	6.8	6.0	4.4	3.6	3.9
Private consumption		1697.6	48.1	3.8	2.5	5.4	5.3	3.2	4.1	4.2
Public consumption		718.5	20.4	0.8	2.9	-0.7	0.4	1.1	0.7	0.6
Gross fixed capital formation		857.7	24.3	4.9	1.8	6.5	6.7	4.5	4.4	5.0
of which : equipment		354.7	10.0	9.0	1.2	8.1	5.2	4.0	3.5	3.8
Exports (goods and services)		2830.3	80.2	9.9	11.6	15.8	14.9	11.1	6.8	8.5
Imports (goods and services)		2652.7	75.1	13.7	5.0	14.2	14.2	9.9	7.0	8.4
GNI at previous year prices (GDP deflator)		3316.9	94.0	-	7.4	5.8	5.2	3.8	3.5	4.9
Contribution to GDP growth :	Domestic demand			3.4	2.4	4.1	4.3	2.8	3.2	3.4
	Stockbuilding			0.3	-0.7	1.1	0.6	0.1	0.2	0.0
	Foreign balance			-1.6	4.6	1.6	1.0	1.5	0.2	0.5
Employment				-	1.1	1.7	2.7	1.1	0.6	0.3
Unemployment rate (a)				-	7.9	7.2	5.3	5.0	5.0	5.2
Compensation of employees/head				-	4.7	6.3	6.4	7.6	8.1	8.0
Unit labour costs whole economy				-	-0.4	1.3	3.1	4.2	4.9	4.3
Real unit labour costs				-	-0.1	0.4	-0.5	0.9	2.5	2.2
Savings rate of households (b)				-	-	9.1	8.8	8.6	9.4	10.6
GDP deflator				7.9	-0.3	0.9	3.6	3.2	2.3	2.0
Harmonised index of consumer prices				-	1.6	2.1	3.0	6.6	3.1	2.7
Terms of trade of goods				-	-1.7	-1.7	1.3	-0.9	-0.2	-0.3
Trade balance (c)				-4.5	2.0	2.0	3.4	3.4	3.2	3.1
Current account balance (c)				-3.8	-1.7	-2.2	-1.5	-1.9	-2.2	-1.2
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-4.0	-2.3	-1.8	-0.8	-1.7	-1.9	-0.9
General government balance (c)				-	-3.6	-2.7	-1.0	-1.2	-1.3	-1.4
Cyclically-adjusted budget balance (c)				-	-3.4	-3.3	-2.0	-2.0	-1.7	-1.5
Structural budget balance (c)				-	-2.2	-3.1	-1.8	-2.0	-1.7	-1.5
General government gross debt (c)				-	29.8	29.6	28.9	26.6	26.4	26.3

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.

Source: European Commission Autumn 2008 Economic Forecast

1. Executive Summary

The current report aims to provide a brief overview of current developments in the Czech economy, covering the macroeconomic issues facing the Czech economy as well as a general overview on financial services.

Political Brief[1]

The current Czech government under Prime Minister Mirek Topolánek is a coalition of the conservative Civic Democratic Party *(Občanská demokratická strana – ODS)*, the Christian Democratic Union – Czechoslovak People's Party *(Křesťanká a demokratická unie – Československá strana lidová)* and the Green Party *(Strana zelených – SZ)*. Together, the coalition parties only control 100 of the 200 seats in the lower chamber of Parliament and rely on the support of renegade deputies of opposition parties.

Policy differences among the main parties are stark. The ODS emerged as the largest party in parliament following the June 2006 general elections, with their best result since 1992. However, with the background of a hung parliament, disputes within the government coalition made it difficult for Prime Minister Mirek Topolánek's government to push through the parliament some of its key legislative proposals on healthcare, pensions and Church restitution.

Severe political infighting between Mirek Topolánek and the opposition Social Democratic Party *(Česká strana sociálně demokratická – ČSSD)* continues, threatening to weaken the effectiveness of the Czech European Union presidency. In the past, the ČSSD initiated several no-confidence votes against the government and is likely to continue its aggressive campaign if it does not obtain political concessions. Among other issues, these conditions pertain to the priorities of the Czech EU presidency, Czech participation in the US defence shield project, and the introduction of a law that would prevent the state from privatising national healthcare facilities. Given the fragility of the governing coalition, it can be expected that it will be forced to make certain political compromises.

Trust in the government is low and the results of the mid-term elections to a part of the Senate seats and regional governments have further weakened the position of Mirek Topolánek: the ODS lost power in all 13 regions as well as 6 seats in the Senate. However, the government is likely to hold on to power as it is in few people's interest to bring down the government ahead of the EU presidency.

Economic Synopsis

- The economic performance started to deteriorate in the first half of 2008 if compared to the developments of the past few years. While the annual real GDP growth rate was still at an impressive 6% in 2007, it is now estimated to drop by 260 basis points to 4.4% in 2008, a figure that, if put into the context of a euro zone recession and the strong trading links of the Czech Republic with the euro zone, still holds up well.
- Recent years have brought about fundamental reforms in Czech public finances. Consequently, estimates for government balances have been subject to high uncertainty and the general government deficit of -1% of GDP for 2007 was significantly lower than anticipated. The reform adopted in August 2007, and mostly coming into effect in 2008, is a comprehensive overhaul of the welfare and tax systems, and fully in line with contemporary international best practices.

[1] Largely taken from Global Insight Report: Czech Republic (Country Intelligence), November 2008, and Economist Intelligence Unit, Country Report Czech Republic, November 2008.

- Inflation has been high since the end of 2007 and surged further in the first half of 2008 reaching a nine-year high of 7.9% in January 2008 before declining to 5.7% by October 2008 (Eurostat HICP monthly data, annual rate of change). The hike was fuelled by a range of administrative measures, the introduction of environmental taxes, a rise in excise duty and hikes in regulated prices. The surge in commodity prices had boosted inflation additionally, while the appreciation of the currency has partly helped curbing imported inflation.
- The Czech currency, the koruna, is managed as a free-floating currency. Following an appreciation trend that began in 2004, the koruna surged during the first seven months of 2008 reaching a record level of 23.013/euro in July, up nearly 17% year-on-year, before subsequently falling back slightly. Czech authorities have been under pressure from exporters to halt the koruna's strengthening.
- Czech monetary policy has been based on an inflation-targeting regime since 1998. However, monetary policy decisions suggest that the exchange rate also acts as a crucial variable in the decisions of the Czech National Bank *(Česká národní banka – ČNB)*. In March 2004, the ČNB put its inflation target at 3.0% for the period beyond January 2006. In March 2007 a new target of 2.0% was introduced as of 2010.
- The financial sector is highly concentrated with foreign capital controlling 97% of the total assets of the banking sector and 75% of the total assets of the insurance sector. This may create issues on cross border supervision and systemic risk, which is something the Czech authorities are very aware of.

2. General Economic Situation[2]

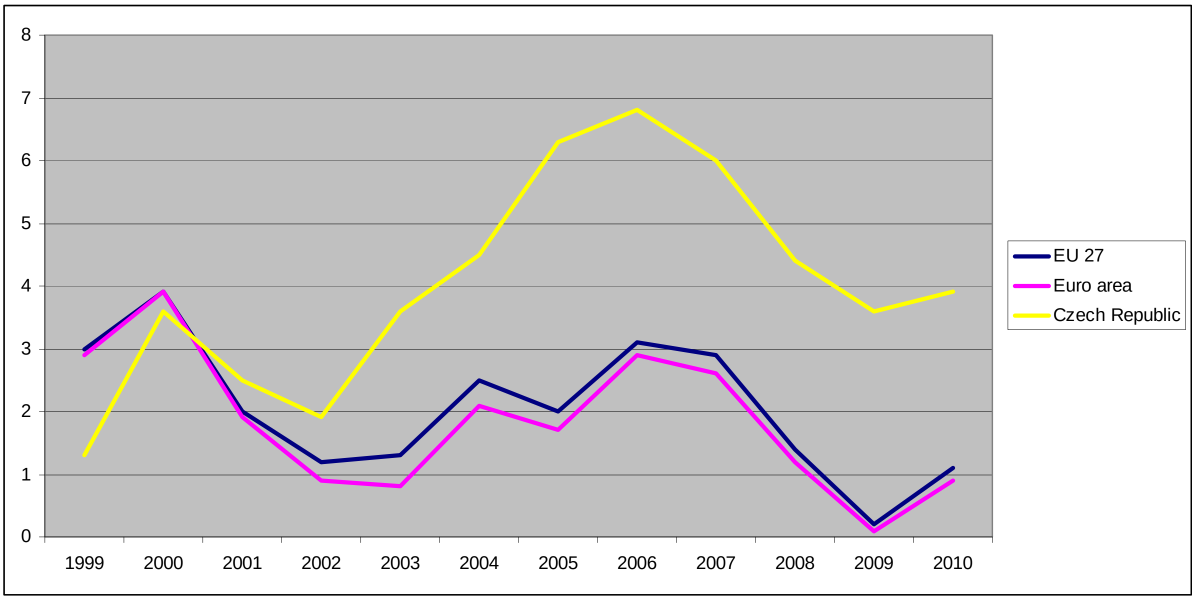
GDP growth has been strong but will be affected by global recession

The economic performance started to deteriorate in the first half of 2008 if compared to the developments of the past few years. While the annual real GDP growth rate was still at an impressive 6% in 2007, it is now estimated to drop by 260 basis points to 4.4% in 2008, a figure that, if put into the context of a euro zone recession, still holds up well. Net exports are the main contributor to growth.

Within the manufacturing sector, Czech GDP has been closely tied to the automotive industry in recent years. Domestic demand, the main driver of growth in the last two years, slowed considerably due to in particular the negative impact of the fiscal reform package, the so-called Stabilisation Package, mainly the increase in the lower band of VAT dampening private consumption. A surge in inflation eroded disposable income growth.

Despite slowing external demand and the appreciation of the Czech koruna, export was still robust in the first half of 2008 while import growth decelerated, affected by the relatively weaker domestic demand. The current account deficit has been modest so far.

Figure 1: Annual real GDP growth rates 1999-2010 in comparison, percentages



Source: Eurostat, 2008-10 data are forecasts.

Czech per-capita GDP remains moderately below the EU-27 average. Eurostat data published in June 2008 indicated that Czech per-capita GDP reached 82% of the European Union average in 2007 by purchasing-power standards. This fares well in comparison with the nine other new Member States that joined the EU in 2004 (ranking behind Cyprus and Slovenia), and also surpasses Portugal.

The cooling global economy as well as the expected weakening in domestic demand is likely to dampen future performance of the economy. The close links of the Czech economy with its trading partners in the EU, and in particular Germany, will in all likelihood see to a pass-through of the rapid deterioration of the economic environment in these trading partners to the Czech economy.

[2] This section largely draws on the Economist Intelligence Unit, Country Report Czech Republic November 2008; European Commission Autumn Economic Forecast, November 2008; Global Insight Report: Czech Republic (Country Intelligence), November 2008.

Various signals from the corporate sector indicate the deteriorating situation, which stems from a combination of the looming global recession, a still-strong koruna and rising labour costs in the Czech Republic. For example, Crystalex, the largest traditional glassworks company, filed for bankruptcy in September, after banks refused loans and revelations of mismanagement. Škoda Auto, the largest Czech manufacturer, has halted production for five days in late October, owing to weaker external demand. Various automotive subcomponent manufacturers face cutbacks. By contrast, Foxconn (Taiwan), an electronics manufacturer, wants to expand capacity in the Czech Republic shifting existing jobs from Hungary, in a move that it has described as regional boost rather than a scale-back. Hyundai is about to open its newly built factory in the north-east of the Czech Republic.

Looking at the autumn forecast of the European Commission, expecting economic growth to slow down to about 4.4% for 2008, a further decline to 3.6% is forecasted for 2009 before growth is expected to edge up again to 3.9% in 2010. Domestic demand is set to recover in 2009, while the contribution from net export is likely to drop on account of a weak external environment and in particular the outlook for Germany. Consumer spending is expected to accelerate in 2009, based on slowing inflation and the negative impact of the Stabilisation Package fading away.

Regional differences in economic development are stark in the Czech Republic. Rapid growth in trade and services has kept unemployment in the cities low, particularly in and around Prague. Rural areas have benefited from jobs in both services and manufacturing, particularly in areas close to the German and Austrian borders. The main losers have been northern Bohemia and northern Moravia, which are dominated by the coal and steel industries. Already suffering from severe environmental damage, these regions have the highest unemployment rates and the lowest standards of living in the country, even if recent strong growth pushed down the unemployment rate to 15% in the worst performing areas. Nevertheless, the regional differences in standards of living remain significant: Prague is the 12th wealthiest region in the whole EU27 according to Eurostat, reaching 157% of EU27 GDP average, compared with just 60% in the poorest region of Central Moravia.

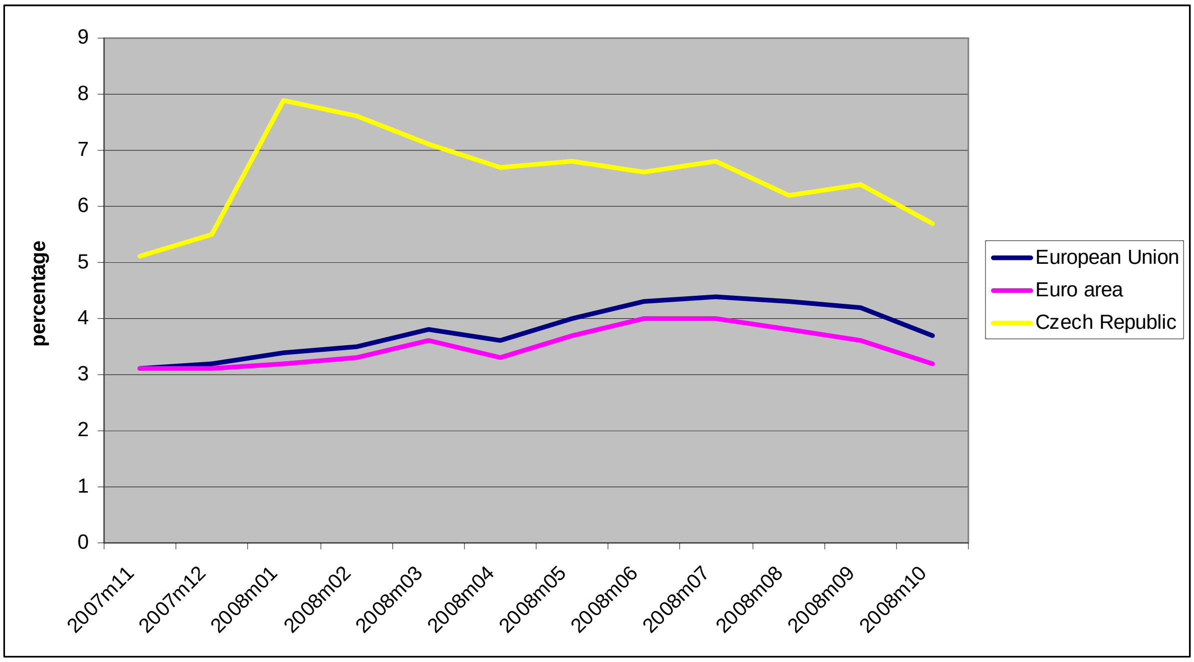
Inflationary pressures easing

Inflation has been high since the end of 2007 and surged further in the first half of 2008 reaching a nine-year high of 7.9% in January 2008 before declining to 5.7% in October 2008 (Eurostat HICP monthly data, annual rate of change). The hike was fuelled by a range of administrative measures, including the increase in the lower VAT rate from 5% to 9%, the introduction of environmental taxes with effect from January 2008, a further rise in excise duty and hikes in regulated prices. The surge in commodity prices had boosted inflation additionally, while the appreciation of the currency has partly helped curbing imported inflation.

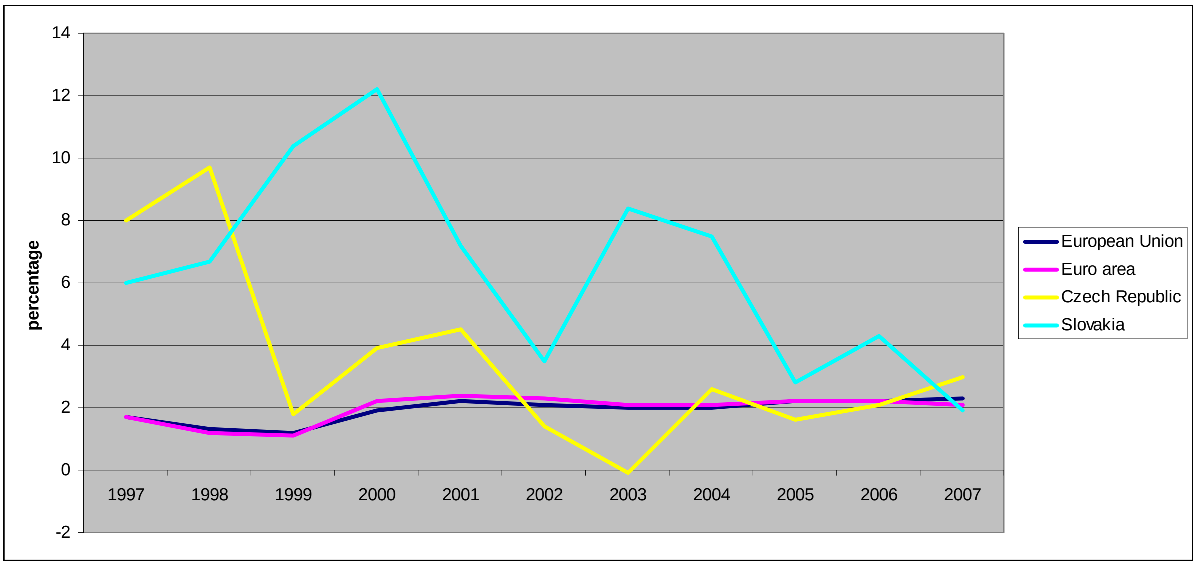
Inflation is expected to fall in 2009 as the indirect tax measures drop out of the calculation and global commodity prices fall sharply. The appreciation of the koruna should help to dampen imported price pressures. The gradual decline in inflation should also be supported by moderate domestic demand while high nominal wage growth could lead to second round effects.

Figure 2: Inflation performance in comparison

HICP - Monthly data, annual rate of change, November 2007 - October 2008



HICP - Annual average rate of change, 1997-2007



Source: Eurostat.

Exchange Rates

The Czech currency, the koruna, is managed as a free-floating currency. It is not inside the Exchange Rate Mechanism.

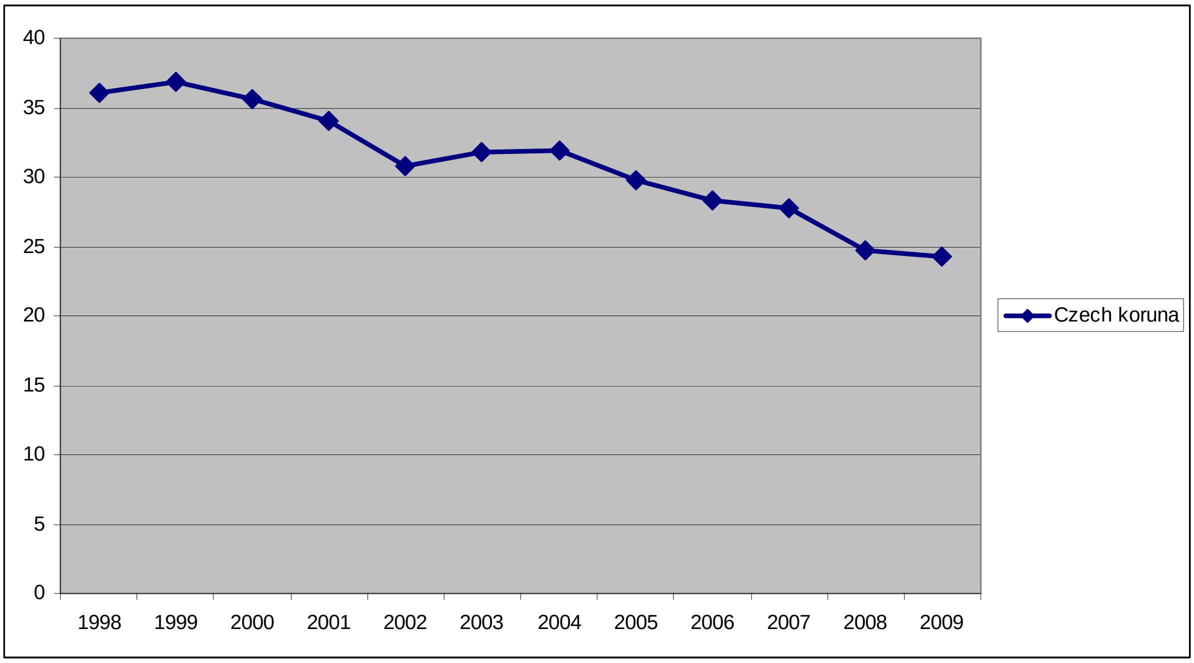
Following an appreciation trend that began in 2004, the koruna surged during the first seven months of 2008. By July 2008, it reached a record level of 23.013/euro, up nearly 17% year-on-year. Although the currency fell back to 25.395/euro by 17 November 2008, it was still up considerably year on year.

The recent appreciation trend has been driven by robust GDP growth, a foreign trade surplus, continued inflows of foreign direct investment and strong regional sentiment.

Czech authorities have been under pressure from exporters to halt the koruna's strengthening. Claiming that a rising koruna translates into corporate losses, the Czech Exporters' Association set up a crisis committee in February 2006 trying to coordinate efforts to weaken the koruna and improve conditions for exporters.

Since reaching the unprecedented high of 23.013/euro in July, the currency has given up some of the gains that it made in the first half of 2008 against the euro. The recent depreciation reflects weaknesses in emerging-market currencies globally, as well as a cut in interest rates by the ČNB in August. Nevertheless, economic performance will continue to support the koruna, and as a result the currency is expected to strengthen against the euro by just under 10% in nominal terms on average in 2008. The pace of appreciation will slow in 2009, as foreign currency inflows will not be as substantial as in recent years, before accelerating in 2010 as the economy strengthens and as export performance receives a boost from a recovery in the euro zone.

Figure 3: Exchange Rate development CZK-EUR, annual average exchange rate, 1998-2009



Source: Eurostat, 2008 and 2009 values are forecasts.

Monetary Policy

Since 1998, when the Czech National Bank established a pre-announced inflation-targeting regime and enhanced the transparency of the policy-making process, Czech monetary policy has been based on this regime. However, monetary policy decisions since 1998 suggest that the exchange rate also acts as a crucial variable in the ČNB's decisions.

The framework for monetary policy remains largely unchanged since 1998. To increase transparency further, the ČNB shifted in April 2001 to targeting the consumer price index (CPI) rather than net inflation. In March 2004, the ČNB put its inflation target at 3.0% (within a fluctuation band of ±1 percentage point), marginally above the price stability level for the euro area, for the period beyond January 2006. That move was followed in March 2007 by a shift to a new target of 2.0% as of 2010.

The planned downward shift in the inflation target to 2 percent from 2010 further underlines the importance of preserving credibility and enhancing transparency of policy communication.

The decision to lower the target is based on the assessment that low inflation has firmly taken roots in the economy and that any real appreciation in the remaining process of convergence toward euro zone membership would continue to manifest itself through currency appreciation rather than higher inflation.

With the onset of a spike in headline inflation in 2007 shaping expectations was critical in achieving the target with minimal output losses. In this context, the decision to publish a forecast-consistent interest-rate path and make public the voting records of the Executive Board meetings, beginning in 2008, should enhance transparency and policy credibility and smooth the transition to a lower inflation target.

The ČNB does not set koruna exchange-rate targets, but prefers to make periodical market interventions to smooth nominal currency fluctuations and control liquidity. Thus, the exchange rate operates under a free float, although the bank is known to make occasional shifts in interest rates and interventions on foreign currency markets, with the aim of stabilising the koruna’s value vis-à-vis the euro.

The ČNB abandoned its monetary tightening stance in August 2008. The August move on interest rates was influenced partly by the surge in the koruna vis-à-vis the euro, a development is seen to have damaged the competitiveness of Czech exports, particularly given the economic slowdown in the euro zone. The benchmark two-week repo rate currently stands at 2.75% even though inflation remains stubbornly high at 5.7% in the monthly Eurostat data. The ČNB views high inflation as a one-off effect of recent tax hikes, and thinks that inflation will fall rapidly as the economy cools.

The ČNB’s main critic in recent years has been Václav Klaus, President of the Czech Republic and, important in this context, professor of economics. He is said to attribute the economic slowdown in early 1997 and the subsequent recession entirely to excessively restrictive monetary policy in late 1996. As president of the Czech Republic, Klaus appoints the members of the Bank's Executive Board. Members of the ČNB’s Board that he has appointed since 2005 tend to be allied with Klaus' party, the ODS, unlike Zdeněk Tůma, the ČNB's governor, the only member of the board not appointed by him.

The prospects for euro adoption

As an EU Member State, the Czech Republic has pledged to adopt the euro as its currency at the earliest opportunity. This will necessarily involve meeting the Maastricht criteria. However, after taking office in January 2007, the current government cancelled its predecessor's euro adoption target (2010) and has yet to put forward an alternative date.

The main obstacle to the fulfilment of the Maastricht criteria continues to be the medium-term prospects for public finances in the context of looming long-term spending pressures from population aging while delays in achieving substantial fiscal consolidation could also pose a threat to the fulfilment of the price stability criterion.

Nevertheless, euro adoption has recently emerged as a key topic in economic policy debates in the Czech Republic, partly owing to the strengthening of the koruna, which led to calls from export-oriented industrial groups for rapid euro entry. However, both the government and the ČNB insist that the country cannot join the euro zone unless further structural reforms are implemented.

In November the government announced that the previously suggested 2012 target date was not feasible. The authorities have stated that they intend to carry out further fiscal reforms. Prime Minister Mirek Topolánek has declared that simply fulfilling the Maastricht criterion of a budget deficit is insufficient, and that reform of the pensions and healthcare systems are essential before euro adoption can occur. Although the authorities are proposing further reforms in these areas in 2009 and 2010, the deadlocked parliament could be a major obstacle to reform progress and, therefore, euro zone membership.

2. Fiscal Policy and Taxation

Recent years have brought about fundamental reforms in Czech public finances. Consequently, estimates for government balances have been subject to high uncertainty and the general government deficit of -1% of GDP for 2007 was significantly lower than anticipated. Various organizations (EC, OECD) had been anticipating a deficit around the order of magnitude of 3%. The smaller deficit was mainly due to strong growth, and falling unemployment in 2007.

General structure of taxes

With a tax/GDP ratio of about 36,6% in 2007, the Czech tax burden is slightly lower than the EU-15 average but slightly higher than those of e.g. Poland (34,8) or Slovakia (29,6%).[3] The Czech tax structure stands out internationally by its reliance on the social security contributions and corporate income taxes, at the expense of personal income and consumption taxation. The most recent reforms have addressed these sectors, but its impacts are still to show.

A number of tax and welfare measures had been implemented in recent years, most of which tad tended to raise the fiscal deficit such as the 2006 tax cuts and the 2006/07 benefit increases. However, the most impact has come, and is still expected, from the most recent reforms, introduced in the following. It is too early to assess the budgetary impact of these reforms reliably at this stage

Reform package 2007-08 – tax shift from income to consumption

The reform adopted in August 2007, and mostly coming into effect in 2008, is a comprehensive overhaul of the welfare and tax systems, and fully in line with contemporary international best practices. The reform implies an overall shift of the tax burden from income to consumption, thus aiming at spurring savings and investment, while also reducing pollution and carbon dioxide emissions through new excises on energy consumption. It also intends to strengthen work incentives, partly by compressing real replacement rates, partly by cutting personal income taxes, in particular at the lower and higher end of the earnings scale. A reduction of the corporate income tax rate should strengthen the competitiveness of the Czech Republic in terms of attracting investment, and several measures are applied in the health and social area in an attempt to contain spending increases.

Personal income tax: The centrepiece of the tax reform is a 15 percent flat tax on personal income in 2008, and 12,5% in 2009. Since the tax will be levied on gross earnings plus the employer's social security contributions, the effective flat rate is 23 percent. Like the recent wave of flat tax reforms in Central- and Eastern Europe, this is not a classical flat expenditure tax with one marginal rate, but a one-rate tax on personal income. In practice, however, there will still be multiple marginal effective tax rates due to the tax credits, the social security contributions and the means-tested social benefits.

Social security contributions: There will be a cap on social security contributions for wage earners, kicking in at 4 times the average wage (about CZK 1,000,0000 annually).

The corporate income tax will be lowered gradually from 24 percent to 19 percent in 2010. There will be some modest expansion of the tax base.

[3] Data from Public Finances in EMU 2008, European Commission.

The lower VAT rate, currently at 5 percent, will be raised to 9 percent. The standard 19 percent rate will be maintained. This measure should raise revenue from indirect taxation significantly as the lower band applies mostly to essential goods.

Expenditure side

The new reform reduced social and welfare benefits to some extent. Health charges on consultations, hospitalisations and medicines are expected to contribute to a budgetary saving around the order of magnitude of a 1/4 % of GDP.

Fiscal outlook

The outturn for the first half of 2008 has been in accordance with the governments budgetary planning. The Commission predicts that the 2008 deficit will be -1.2% of GDP, given that the budgetary planning stays on its current track. The structural deficit should slightly improve to -1,5% by 2010. The Czech public debt stock has been relatively constant in recent years at moderate levels of 28,9% of GDP for 2007 (European Commission), set to slowly decrease to 26% in 2010 (see Table 1).

The wide range of tax reforms implemented in 2008 (see above), continuing through 2009 and 2010 are set to leave a considerable degree of uncertainty over tax revenues in the coming years.

Rapid ageing is a big challenge in the Czech Republic. The additional budgetary impact of ageing is expected to be around 7% of GDP by 2050, a figure higher than in other comparable economies.[4] Indeed, further reforms of the pension and healthcare systems at the face of this ageing pressure present the largest budgetary challenges to the government at present.

Table 2 below shows the budgetary estimates of the European Commission for the Czech Republic.[5] In the lower part, the data are taken from the last Convergence programme for the Czech Republic (November 2007). The upwards correction (i.e. improvement) of most figures in the upper part exemplifies the Commission's revision with the higher-than-anticipated growth in the summer of 2008. This positive assessment was even improved in the most recent Commission assessment (autumn 2008, see Table 1) for the year 2008, however for 2009 the estimate is slightly worse in Table 1 above (-1,3%) than in Table X (-1,1) below. The uncertainty over the budgetary impact of the financial crisis as well as the reforms may yet change the below figures in the coming months.

Table 2: Budgetary estimates in 2007 and 2008, European Commission 2008

	2006	2007	2008	2009
Commission Spring Forecast 2008				
General government balance	-2,7	-1,6	-1,4	-1,1
Structural balance	-2,9	-2,3	-1,9	-1,5
Government gross debt	29,4	28,7	28,1	27,2
CZ Convergence Programme Nov 2007				
General government balance	-2,9	-3,4	-2,9	-2,6
Structural balance	-3,1	-4,1	-3,4	-2,8
Government gross debt	30,1	30,4	30,3	30,2

[4] OECD Economic Surveys: Czech Republic, p. 25, OECD April 2008.
[5] European Commission, 2008 Report on Public Finances in EMU.

4. Competition policy[6]

Evolution and enforcement

Competition policy and law in the Czech Republic have successfully and largely converged on European practices. The Competition Act, after some revisions in recent years, now closely follows the substantive terms and enforcement methods of the EC. The competition agency, ÚOHS (*Úřad pro ochranu hospodářské soutěže or Office for the protection of competition*), has evolved in this process through a shift in its enforcement approach.

For a long time, enforcement against hard-core price fixing had been limited, but it has stepped up recently. The Switchgear case in 2007 was an important opportunity to show how clandestine international cartels operate and how leniency can be used to uncover them.[7] Correcting and eliminating resale price agreements is a high priority now. In a recent review, the OECD recommends that enforcement could be strengthened further by providing for stronger sanctions against individuals who are involved in cartel behaviour and associations that are the vehicle for reaching prohibited agreements.[8]

Sectoral analysis: concentration on networks and services

In terms of sectors, competition policy attention has concentrated on problems in network and service sectors. Results have been mixed. ÚOHS has moved vigorously against abuses in telecoms. In electric power and natural gas, decisions about privatisation led to re-creation of integrated national-scale firms. Problems about access to storage are slowing the development of competition in the natural gas sector.

In the *gas sector*, provider choice was opened up to domestic users in January 2007, six months ahead of the EU-Directive deadline. While this is welcome, the incumbent, RWE, still has considerable influence throughout the supply chain. In the *electricity sector*, supplier choice for households was also implemented in January 2007. The grid has been separated from the incumbent, and is run as a state-run company. Nevertheless, ČEZ remains influential. The price of *telecommunications* remains high compared with other OECD countries, and is contributing to a low take up of broadband Internet. However, the consensus view is that legislation and oversight of the sector is sound and that competition is intensifying. There has been some fine-tuning of regulation. In particular, special rules that clouded the powers of the ÚOHS in telecommunications markets were removed in 2007. Oversight of the sector needs to remain strong, with recent cases brought by the competition authority exemplifying active efforts by the dominant provider to limit competition.

In other sectors, the ÚOHS is putting a greater emphasis on public relations, transparency and advocacy (*i.e.* direct discussions with parties without the use of formal legal proceedings). There is an ongoing campaign to remove non-essential regulations in the liberal professions. Furthermore, the Office has provided welcome resistance to inappropriate proposals to protect suppliers to retail chains. Finally, additional tools for tackling cartels are being developed.

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[6] This section has been largely taken from the OECD Competition Law and Policy Review in the Czech Republic, No 88943, OECD 2008 as well as the OECD Economic Surveys: Czech Republic, April 2008, p.29-30.

[7] Commission DG COMP, IP/07/80

[8] See OECD Competition Law and Policy Review in the Czech Republic, No 88943, OECD 2008.

5. Financial Services the Czech Republic

The financial sector is highly concentrated with foreign capital controlling 97% of the total assets of the banking sector and 75% of the total assets of the insurance sector. This may create issues on cross border supervision and systemic risk, which is something the Czech authorities are very aware of.

Historic

Following transition into democracy, commercial lending in the Czech Republic in the 90's was slowly transferred to commercial banks. However, the transfer revealed many non-performing loans, which in the clean-up of the financial markets were transferred to a government owned bank. Full privatisation took longer than in Hungary and Poland and soft lending practices continued leading to a stronger recession than in neighbouring countries in 1997/1998. The subsequent shake out of the sector encouraged more transparency and competition but also led to a high degree of foreign ownership.[9] Despite this, the Czech Republic has one of the highest financial sectors in the Visegrad group of countries (Hungary, Poland, Slovakia, Czech Republic). Total capitalisation as a sum of the financial system stands at 140% of GDP compared to 90% of GDP in Slovakia and Poland in 2006.[10]

Institutions

In 2006, the Czech National Bank integrated all supervisory activities for all financial market sectors. The new structure is organised into the Financial Market Regulation and Analyses, a licensing and enforcement department and a supervision department. Therefore, all segments of the financial services sectors are supervised by a single supervisory concept as the ČNB esteems the risk adherent to the different sectors are the same.

Regarding consolidated cross border groups operating in the Czech Republic, the ČNB as host supervisor expects much closer contact with home supervisors under bilateral memorandums of understanding, especially in the run up to applying Basel II and CRD in the Czech Republic (the incorporation of CRD into national law was in July 2007)

Banking Sector

Banks represent 73.3% of the Czech financial markets[11]. As of 31 December 2007, there were 37 banks and foreign branches. The group of the 4 largest banks represents 61% of this figure[12]. Consolidation affects the Czech banking market, too. A further impact on the market is also the large number of EU banks (198) which is offering their services in the Czech Republic without having a branch established. At the end of 2007, 97.6% of the sector's total assets were in foreign hands with the EU share in this at 90%. The big four banks come from EU countries.

In 2007 the sector's profits from activities grew by 15% with the biggest profits coming from small banks. Most of the growth came from interest income, with profit from financial operations dropping by 30% due to market conditions and revaluation at fair value in the books.

Lending activities have grown and now compose 51% of the banking assets. The loan portfolio is still in majority to households (81%).With mortgages taking up 41.4% of that figure[13].Default is standing at 7% for consumer credit and at 1.54% for mortgages.

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[9] EBRD 2006 and World Bank report 2006.
[10] World Bank 2007.
[11] ČNB
[12] ČNB
[13] Percentages are taken from the ČNB 2007.

Regarding credit risk, since 2004 the volume of bad loans has been decreasing and also the loans to government institutions, something which had been changing since the reform of the system in the 1990's.

In 2007 further development of the off-balance sheet portfolio of banks continued, mostly interest rate swaps and forward exchange currency swaps.

Lastly, the capital ratio of banks in 2007 stood at 11.5%, mainly due to the increase in regulatory capital due to the application of Basel II.

Securities

In 2007 Mifid was applied in the Czech Republic, taking effect on November 1, 2007. The 3 largest investment firms have 63.2% of the market, this figure increases to 75.6% for mutual funds. Most of the trades carried out were in the money markets for about 69%, 16% in equities and 14.5% in bonds, which is a conservative investment profile.

In the pension fund sector the market is concentrated in 10 active pension fund providers; again the market here is concentrated in the hands of the 3 largest pension funds, which have 56% of the total. Contributions have been rising by 14% year-on-year. However the ratio of pension fund insurance to GDP is low in the Czech Republic standing at 4.7% in 2007. Under Czech law investments of pension funds should be in "relatively safe assets"[14]. This according to the report is for 85% in bonds and money markets.

There are two stock exchanges, the PSE and the RM-S (which only accounts for 0.5% of the total regulated business both majority focussed on equities trading, with bond trading decreasing yearly since 2002. Derivatives trading represent only a small percentage.

Regarding new issuance of securities, the ČNB has been very much focussed on the information contained in annual reports especially regarding remuneration of senior management and conflict of interest reporting.

Insurance

In 2007, there were 34 domestic insurance companies and 17 branches of EU groups. Insurance groups represent 7.7% of the financial market assets in the Czech Republic. The growth as in the banking sector of EU and EEA groups providing services in the Czech Republic under the freedom to provide services without setting up an undertaking in the country is on the rise and now stands at 478 undertakings, mostly in non-life insurance with more than 100 notified from the UK and Ireland.

The share of foreign ownership is rising to 71% in 2007, with Czech ownership mostly in the small to medium sized groups.

[14] Citation from ČNB annual report, 2007.