

**Evaluation of the Partnership  
between the Czech Republic  
and the World Bank  
1998-2005**



## Acronyms and Abbreviations

A&A	Accounting and Auditing
AAA	Analytical and Advisory Activities
CAS	Country Assistance Strategy
CEM	Country Economic Memorandum
CNB	Czech National Bank
EC	European Commission
ECA	Europe and Central Asia
ECB	European Central Bank
ERM	Exchange Rate Mechanism
FATF	Financial Action Task Force for Money Laundering
FAU	Financial Analysis Unit
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Program
FSF	Financial Stability Forum
FSSA	Financial System Stability Assessment
GEF	Global Environment Facility
IAS	International Accounting Standards
IDF	Institutional Development Fund
IFA	International Financial Architecture
IMF	International Monetary Fund
KE	Knowledge Economy
MIC	Middle and Upper Income Country
MOE	Ministry of Environment
MOF	Ministry of Finance
MOH	Ministry of Health
MOJ	Ministry of Justice
MOLSA	Ministry of Labor and Social Affairs
NEES	National Energy Efficiency Study
OECD	Organization for Economic Cooperation and Development
OED	Operations Evaluation Department
PER	Public-Private Partnership
QAG	Quality Assurance Group
ROSC	Reports on the Observance of Standards and Codes
SAL	Structural Adjustment Loan
VZP	General Health Insurance Agency

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## FOREWORD

The achievements of the Czech Republic since the Velvet Revolution in 1989 and especially over the past few years have been impressive. Earlier successes in economic and social transformation have been consolidated and institutions have been strengthened. Human development indicators, already at a high level, have further improved. Accession to the European Union in 2004 was a clear confirmation of progress across a broad front.

The graduation of the Czech Republic from World Bank borrower status in 2005 was the result of these successes and marks another important transformation: from recipient of development assistance to full development partner, contributing with its experience and resources to the development of other countries.

This book has been prepared to help mark the Czech Republic's graduation from World Bank borrower status. It is a review of the partnership between the Czech Republic and the World Bank from 1998 and the role that the assistance provided by the World Bank played in this transition. It is based on interviews with key policy makers during this time and with technicians who played important roles, as well as with a number of World Bank Staff. The World Bank would like to express its appreciation to all those who contributed to this study and to those who assisted in its publication.

The main finding of this review is that a partnership based on knowledge sharing can have significant impact even when not accompanied by lending. This result depended strongly on the commitment of both the Government and the World Bank to establish clear priorities and work closely together; on staff continuity on both parts to ensure that knowledge and trust built-up in the partnership could be more easily maintained; and on the deliberate focus on generating experience and insights that could benefit other countries in addition to the Czech Republic. The latter aspect of the partnership, most evident in the collaborative work on financial architecture, has been key to our commitment to being an effective Knowledge Bank.

**Shigeo Katsu**  
*Vice President*  
Europe and Central Asia Region  
The World Bank  
*February 2006*



## **PREFACE AND ACKNOWLEDGEMENTS**

The Czech Republic has made remarkable progress in transforming its economy. This book looks at one aspect of that progress, the role played by World Bank assistance from 1998 to 2005. This program first focused on improving management of the liabilities of the Czech Republic in the private and public sectors as the economy was emerging from a financial crisis. Success in this area permitted the program to move to a second, more forward looking theme of accelerating accession to the European Union, with a special focus on improving expenditure programs. As the economy further progressed, a new theme emerged based on developing the tools of the International Financial Architecture. Work on this third cluster was strongly collaborative in two senses. First, key institutions on the Czech side contributed considerable resources and expertise to complement World Bank assistance. Second, this work benefited not only participating Czech institutions but also benefited the World Bank as new tools of the International Financial Architecture were tested and improved, enabling, their application in turn to other less advanced countries.

This book is the result of a collective effort on the part of a number of people. World Bank staff who worked on the Czech Republic and counterpart Czech officials who played key roles in formulation and implementation of the program were all generous in discussing the program and its components. Special mention must be made of Deputy Finance Minister Tomas Prouza for his role as the main counterpart for a mission to Prague in May, 2005, which was an important basis for this book. Jana Matesova from the Executive Director's office in the World Bank played a special role in developing and implementing the entire partnership program from 1998, and gave unstintingly of her time in discussing the program from her unique vantage point.

Shigeo Katsu, Vice President of the Europe and Central Asia region of the World Bank, Roger Grawe, past Country Director for Central Europe and the Baltics, and Daniela Gressani, the current Country Director for Central Europe and the Baltics all played key roles in developing the partnership with the Czech Republic, and their genuine interest in the Czech Republic has made preparation and publication of this book possible. Suman Mehra from the Central Europe and Baltics Country Unit helped enormously, and special thanks go to Ruta Ziogeliene for superb assistance in the preparing and organizing the report.

**Michael Lav**  
*February 2006*

## EXECUTIVE SUMMARY

The Czech Republic's progress in economic and social development since 1990 now place it in the top rank of middle income countries. That progress is anchored not only in a broad domestic consensus in support of reforms achieved to date but also in the country's accession to the European Union. It is, therefore, entirely appropriate that the Czech Republic graduated from World Bank borrower status in 2005.

The relationship between the Czech Republic and the World Bank during 1998-2005 was at first tailored to the country's emerging needs as it recovered from currency turbulences and as it sought to complete the transformation to a more advanced market economy. More recently, the relationship has moved to another dimension, namely, collaborative work with the World Bank in developing more advanced tools of International Financial Architecture to be used not only to benefit the Czech Republic but also to assist other countries.

The relationship between the Czech Republic and the World Bank was somewhat unusual, consisting solely of knowledge sharing since the Czech Republic did not borrow from the World Bank during this time. While the program was robust in terms of output, the budget costs for the World Bank were modest, relative to the norms used by the World Bank. An important reason for this was cost-sharing, which was especially significant considering the public goods component of the work program noted above.

In the absence of the normal World Bank program management vehicles such as a Country Assistance Strategy (CAS) (which was not called for in the absence of a lending program), other mechanisms were established to guide the program. Annual exchanges of letters codified the proposed work program for each year, ensuring that the priorities of the Czech authorities were clearly and formally communicated and confirming the commitment by the World Bank to support the program.

The Ministry of Finance (MOF) was an effective counterpart, which made this level of control and coordination possible. Almost universally,

effective champions on the Czech side played important roles in task formulation and implementation. Beyond this, the effectiveness of the program was greatly enhanced by the willingness of Czech counterparts to allocate substantial amounts of quality staff time, and a willingness to bear the implicit costs of such collaboration in addition to the agreed explicit cost sharing. For its part, the World Bank was, in general, able to respond to requests in a timely fashion and with effective staff resources. Priority was also placed on continuity, so that World Bank staff involved in such work could transmit their findings to their colleagues. Finally, especially in the absence of a World Bank country office, coordination was greatly enhanced by effective use of the office of the Czech Government's representative to the World Bank Board of Directors.

This document presents the rationale for the program, describes its components, and assesses the effectiveness and, where possible, the impact of the program. In providing this material, the intention is to make the Czech/World Bank experience more widely available with the hope that lessons learned may be useful for other countries. At the same time, and on the occasion of the Czech Republic's graduation from World Bank borrower status, it reflects the World Bank's appreciation of the broad-ranging progress achieved by the Czech Republic and the productive collaboration which formed the basis of the partnership model that evolved.

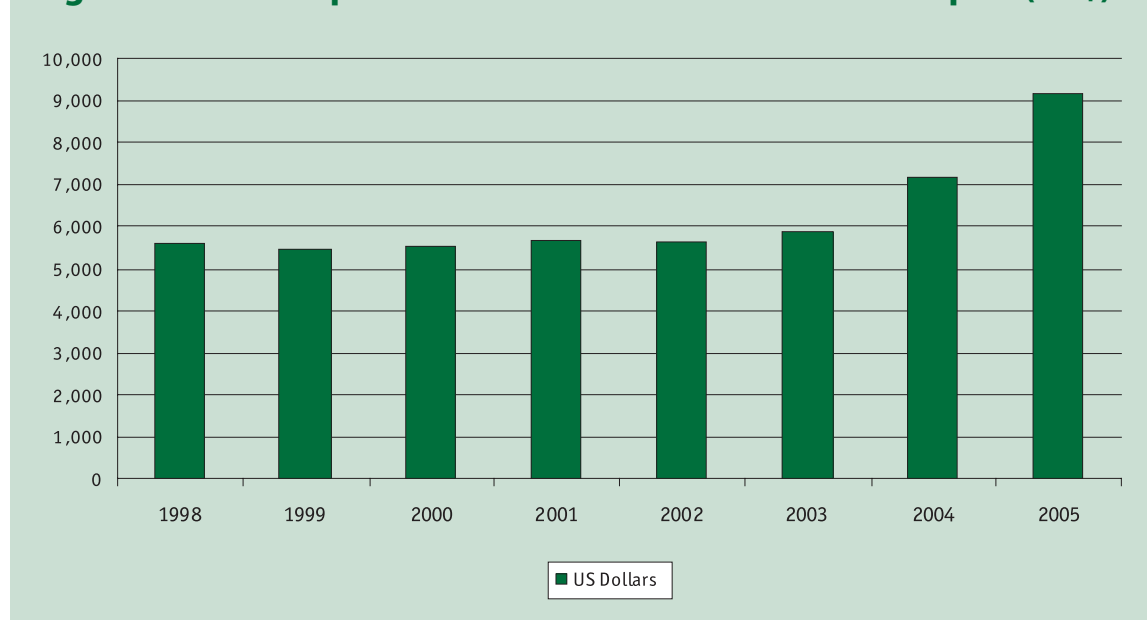
The paper finds that the relationship between the Czech Republic and the World Bank during 1998-2005 moved gradually beyond assistance to mutually advantageous cooperation. Not only did the Czech authorities share the costs of the World Bank program; most important, the relationship focused increasingly on piloting innovative work in the Czech Republic to learn lessons and develop analytical instruments that can be used to the benefit of other countries. While this appears an appropriate and in fact desirable evolution of the partnership between the World Bank and a country at the level of economic and institutional development of the Czech Republic, it is in no way the definite answer to the complex question of the World Bank's engagement in middle income countries.

## I. INTRODUCTION

The Czech Republic announced its intention to graduate from World Bank borrower status on April 4, 2005. Czech Finance Minister Bohuslav Sobotka noted that "After 15 years of economic, social, and political transition, the Czech Republic is an advanced and growing economy, a member of the European Union, striving to reestablish its position among the world's most developed economies."

Progress in human development has been equally impressive. Life expectancy has increased from 71.4 years in 1990 to 75.2 years in 2003, and during that time infant mortality decreased from 10.9 to 3.9 per 1,000 live births, while the incidence of tuberculosis declined from 36.6 per to 11.6 per 100,000 people during the same time. The ratio of girls to boys in primary and secondary education exceeds 100 percent, and the expected years of schooling reached 15 in 2003.

**Figure 1 Czech Republic: Gross National Income Per Capita (US\$)**



Source: World Bank Atlas.

The Czech Republic's achievements have indeed been substantial. Accession to the European Union, noted above, has been a key achievement underpinning, and, in turn, promoting, substantial progress in a number of areas. GNI per capita has been increasing rapidly, from US\$5,690 in 2000 to US\$9,150<sup>1</sup> in 2004, and GDP growth rates have been sustained at about 4 percent per year during that time. The value of exports increased from US\$15.9 billion in 1994 to US\$67.1 billion in 2004, and the value of trade now exceeds 125 percent of GDP. Total debt service in 2003 was only 9 percent of the value of exports of goods and services, compared to about 20 percent in the mid-1990s. Net foreign direct investment has ranged from 5 percent to 15 percent of GDP during the last five years, compared to 2 percent to 6 percent of GDP from 1994-1998.

The road to the Czech Republic's enviable position has not been direct. From the Velvet Revolution in 1989 through 1996, Czechoslovakia and the Czech Republic, which emerged at the end of 1992, were perceived as the most successful transition economy in Central and Eastern Europe. GDP growth was adequate (and in sharp contrast to the steep prolonged declines experienced by other transition economies), unemployment was low, and inflation and the current account balance were held well within prudent limits.<sup>2</sup>

Two sets of events altered that perception. First, macroeconomic performance started to lag in 1996 when the current account deficit of the balance of payments reached 6.7 percent of GDP due to a sharp drop in export growth based in

<sup>1</sup> World Bank Atlas Methodology. The Ministry of Finance estimates that GNI increased from US\$5,800 in 1998 to US\$11,300 in 2005.

<sup>2</sup> See *Czech Republic: Toward EU Accession*, September 1999, World Bank, for further details.

## Box 1: World Bank Assistance Pre-1998

World Bank support began in the broadly typical World Bank approach to the unique situation of transition economies of Eastern Europe during the years 1991 through 1994. Technical assistance addressed a number of key issues, especially macro issues, energy, environment, and the legal framework for private sector activities. Financial assistance began with the Structural Adjustment Loan (SAL) to Czechoslovakia in FY91 to support the transformation program; this loan was later divided into Czech and Slovak components when the two countries emerged from the Czechoslovak federation. A Power and Environmental Improvement Project for the Czech Power Company for US\$260 million was implemented, followed by a Telecommunications Project in 1994 for US\$80 million. In addition, GEF has extended three loans to the Czech Republic and financed a strategy document. The outcome of each project was rated Satisfactory by Operations Evaluation Department (OED), but in very different circumstances. The SAL could only support the initial phases of the transformation process, leaving virtually untouched important work in private sector and financial sector development, as well as in pensions, health care reform, and other topics. In telecommunications, reform outpaced the World Bank's project when the company was privatized and thereafter pursued a rapid reform program, leading to the early closing and repayment of the World Bank loan. The World Bank's support of the Czech Power Company had a clearer impact, leading to improved efficiency and substantial reduction of air pollution in northern Bohemia, and facilitating the interconnection of the Czech and German power grids.

Following these three projects, the Czech Republic has not borrowed from the World Bank. The World Bank for its part proposed discussions about possible adjustment lending. In fact, the Czech Republic did not borrow from any other multilateral source after the initial stabilization of the economy had been achieved in the early 1990's. This stance consistently reflected the priorities of fiscal policy at that time. While the Czech Government used the World Bank's advice and funds sparingly, it actively pursued its candidacy to host the IMF-World Bank Annual Meetings at the same time, reflecting good-if unusual-relations with the Bretton Woods institutions. From 1994 through 1997 there were only a few requests for Analytical and Advisory Activities (AAA), as the Czech Republic pursued its own course of development based on the perception that Czech expertise was adequate to develop and implement the transformation, and that external financial and advisory assistance was not needed. The only exceptions were a request for a Capital Markets Study in the Fall of 1996, and a small but effective environment program supported by the Global Environment Facility (GEF).

part on the erosion of competitiveness caused in turn by a number of factors including the management of the koruna within an exchange rate band. Fiscal balances deteriorated in the second half of the 1990s. The koruna was subjected to speculative attacks in May 1997, based largely on evaluations of domestic conditions, but also related to the currency crises occurring in East Asian and other countries through this time period. The banking sector, largely state-owned but with numerous small weak private banks, was subject to severe stresses. In response, a managed float for the koruna was introduced in May 1997, allowing for devaluation, and the Government headed by Mr. Vaclav Klaus implemented austerity measures in the second half of the 1997. This could not prevent a full-blown recession in 1998 with GDP

contracting by more than 1 percent per year in 1997 and 1998 accompanied by a rapid rise in unemployment. A continuing loss of confidence by consumers and investors, combined with the impact of heavy summer flooding in 1997, and domestic governance issues and political pressures led to the resignation of the Government in November 1997 to be replaced by a largely technocratic cabinet headed by Mr. Josef Tosovsky, Governor of the Czech National Bank (CNB).

A second but related set of events concerned the core of the transition process. The privatization program based on vouchers had been widely hailed (including by many in the World Bank) as the standard against which other privatization programs should be evaluated, but which in the

event combined with inadequate governance of the banking sector and the corporate sector did not bring expected results. According to the World Bank study, *Czech Republic: Completing the Transformation of Banks and Enterprises*, the stock of non-performing loans in the balance sheet of commercial bank and specialized transformation institutions reached the equivalent of 26 percent of GDP at the end of 1999.

In 1997 and early 1998, the full extent of these losses was not known with certainty, but the technocratic government which came to office realized the need for new policies and sought external technical assistance to buttress its own analysis of the situation. After a four year hiatus in dialogue, the World Bank was invited to pursue diagnostic studies to explore the causes of problems and propose programs to contain losses, reverse declines, and help set the country on a path of sustainable development. Even at that time, however, the government did not borrow from the World Bank. The decision was motivated by an adequate level of foreign reserves, good access to international markets (due to a satisfactory credit rating) and high inflows of foreign direct investment.

The initial request for advice led to the first cluster of technical assistance comprising work on capital market development and other reforms needed to complete the transformation, and to address key fiscal issues including the government's contingent liabilities.

In addition, the new Government sought to re-assure existing foreign direct investment and keep it from fleeing the country, and to attract new foreign direct investment to spur economic growth. It therefore sought to implement programs which were not only sound but also were seen to be sound by the foreign business community. More broadly, the government also wished to accelerate the Czech Republic's then lagging European Union accession process. When the Tosovsky government was succeeded by an elected socialist Government in June 1998, the new government continued to engage the World Bank in pursuing these objectives. This led to a second cluster of World Bank assistance, beginning in 1999 with the broad-based Country Economic Memorandum (CEM), and followed by a Public Expenditure

Review (PER) and a number of other tasks. Broadly characterized the first cluster focused on loss containment while the second cluster moved on to improving public sector expenditure management and accession to the EU.

As progress in attaining these objectives was achieved, Czech/World Bank relations moved on to a third cluster, based largely on the Czech authorities' desire to be in the forefront of financial sector reforms and to support and assist the World Bank's development of innovative work on the International Financial Architecture (IFA) based on the Financial Sector Assessment Program (FSAP) and Reports on the Observance of Standards and Codes (ROSC) programs of the World Bank and the International Monetary Fund (IMF).

In addition to IFA work, World Bank staff also continued to work on broad reforms that had been identified in the second cluster of cooperation, those needed for fiscal sustainability. Such work included engagement in social sectors and the framework for public-private partnerships (PPPs) as a means of financing public goods in infrastructure and elsewhere. These areas of collaboration have had less impact to date.

During this time, from 1998 to 2005, the working relationship between the World Bank and the Czech Republic has been structured through informal rather than formal mechanisms. In the absence of a lending program there was no natural decision point which would normally have motivated preparation by the World Bank of a formal CAS. Rather, the work program was structured on the basis of an annual exchange of letters between the Government and the World Bank, supplemented as needed by exchanges when it was felt desirable to modify existing agreements.

In view of the Czech Republic's graduation from borrower status and the absence of a formal evaluation, this report seeks to document the program, the extent to which the program achieved its objectives, and the program's benefits to the Czech Republic and the World Bank, and to identify remaining issues to be addressed in the two or three years subsequent to graduation when the World Bank would still plan to make available some resources for technical assistance.

## Box 2: Perspectives on the Relationship between the World Bank and the Czech Republic: 1998-2005

The partnership which developed between the World Bank and the Czech Republic during these years was unusual. The Czech Republic was one of a small group of high performing non-borrowing, higher income countries which continued to seek limited engagement with the World Bank. Other countries in this group included Estonia, Hungary, and Malaysia, which, like the Czech Republic, are classified by the World Bank, as upper middle income countries, and Slovenia and Korea, classified as high income countries. These are investment grade middle income countries with strong, stable capital market access which face low spreads in international financial markets. World Bank support for AAA work on the Czech Republic was greater than average for other countries in this group. This work also benefited from support from the Czech Republic including substantial cost-sharing. This led to a work program that stands out both for its intensity and for its emphasis on partnership between the Czech Republic and the World Bank in developing new tools for use in other countries.

The review also evaluates the model of cooperation which was used, and offers some suggestions for possible modifications of that model, in the interests of sharing knowledge with other countries and World Bank country programs for which it may be relevant. This model differs in several important ways from the standard one followed by the World Bank, which is designed to guide lending as well as knowledge sharing. Given the World Bank's increasing focus on institutional development and knowledge sharing, the kind of model that has governed relations between the Czech Republic and the World Bank should be looked at carefully for its relevance for other situations. This review thus seeks to derive lessons for the World Bank as it formulates partnerships with other countries approaching the Czech Republic's level of development.

In the continuing spirit of collaboration which has marked the relationship between the Czech Republic and the World Bank, this review has been pursued, and, as indeed, could only have been done, with the active involvement of a number of officials of the Czech Republic.

*"On behalf of the Czech Government, let me express our hopes that the partnership between the Czech Republic and the World Bank after graduation will be as productive and satisfactory as it has been in the past several years."*

**Bohuslav Sobotka**  
Minister of Finance, April 2005

## II. DESIGNING THE ASSISTANCE PROGRAM: GUIDING PRINCIPLES

The resumption of assistance in 1998 was agreed between the Government and the World Bank based on an informal shared assessment of the country's needs. Subsequently, a more organized but still informal and flexible arrangement evolved. This was based on an annual exchange of letters between the Government under the auspices of the MOF, which has been responsible for relations with the World Bank, and the Vice President for ECA.

These arrangements and the work program which evolved from them were based on a set of principles. During the first stages of collaboration, the Czech Republic sought to benefit from knowledge sharing and from the World Bank's considerable convening power which would be useful to develop and promote domestic reforms. The Government and the Czech National Bank would also benefit from the informal learning aspects of participating with the World Bank staff in these endeavors. For its part, The World Bank sought to provide independent and unbiased perspectives on key issues.

As the program moved to developing various aspects of the Czech financial infrastructure, sharing of costs and benefits emerged as a key aspect of what has become a cooperative partnership rather than more traditional forms of assistance. The Czech Republic sought to benefit from participating in the development

of tools and diagnostics with the World Bank in order to be at the forefront of the IFA development program. For its part, the World Bank sought not only to assist development in the Czech Republic but also to improve the analytical basis of its IFA tools. The high quality of the relevant institutions and associated staff in the Czech Republic led to a productive interaction with the World Bank, so that World Bank staff could work efficiently in expanding their own knowledge base that could, in turn, be shared with other countries. Thus, there were clear advantages to both parties in pursuing this collaboration.



It was agreed that costs of the program would be shared. In general, the World Bank would provide staff and associated costs, the Czech Republic would provide translations of documents (and more sophisticated processing as in pensions, see below) and disseminate products. Beyond this, on occasion, the Czech Republic would also pay for staff travel and subsistence. Further, the Czech Republic has also shared costs of international conferences and, in the case of the PPP conference of 2004, that share was about two-third of the total costs.

It was understood that the World Bank would rely primarily on its own staff rather than consultants to ensure that lessons and knowledge were internalized and the potential for sharing knowledge with other countries was maximized. An additional benefit of relying on staff was that the start-up costs for each task would be minimized for both parties. However, it was recognized that consultants would occasionally need to be used when specialized expertise not readily available in the World Bank was required.

### III. THE ASSISTANCE PROGRAM

The work program as it evolved had three clusters. The first cluster comprised liability management in the sense of improving the transparency of contingent liabilities, mapping them and limiting Government obligations generated by the aftermath of the controversial voucher privatization program, a weak financial sector, and other problems. This was motivated by an urgent need for damage control and for establishing a framework for responsible fiscal management. The second cluster was more forward looking and focused on improving expenditure (“asset”) management. The third cluster has focused on reforms in the Czech Republic’s financial architecture.

#### A. THE FIRST WORK PROGRAM CLUSTER: LIABILITY MANAGEMENT

Initial discussions between the Czech government and the World Bank at the end of 1997 focused on the Government’s very large contingent liabilities. Doubts also arose about the validity of estimates of the fiscal deficit. In traditional analysis reflected in IMF Article IV Consultations, the fiscal balance looked good. But, in addition to the contingent liabilities of the public sector banks, the Government was financing a number of off-budget programs, including through guarantees, which were not adequately accounted for, much less controlled.

The technocratic Government sought the outside analysis which could be provided by the World Bank to firm up estimates of the damage and enable a credible presentation to the public as a call to reform. The elections in the late Spring of 1998 led to a new Socialist

Government which confirmed its interest in pursuing this work program with the World Bank. The new Government also made clear that the program would comprise only technical assistance, with no borrowing.

## CAPITAL MARKETS REVIEW

The financial sector problems facing the country quickly focused discussions of World Bank assistance on capital market reforms. A first mission occurred in April 1998 and, in early October 1998, the newly elected Government specifically confirmed continuing interest in this work. The counterpart of the World Bank mission played a very effective role as champion in terms of setting up the task and ensuring constructive collaboration. The Government confirmed that it would implement comprehensive capital market reforms and requested the World Bank to evaluate the program and suggest any needed modifications or extensions. In addition, the Government also requested that the World Bank take into consideration the need to harmonize institutions and policies with those of the European Commission (EC) to strengthen relations with the EC. The EC, for its part, agreed to support this work.

The report entitled *Capital Market Review* found that the major reforms of the 1990s, including trade and price liberalization, tax system overhaul, and sharp reductions in subsidies had been insufficient to induce an effective transformation and sustainable growth. As stated in page viii of the report, *“The internal mechanisms of corporate governance were not sufficiently strengthened, opening room for abuse by large shareholders and managers. The external mechanisms of corporate governance were also visibly weak - the major commercial banks remained under State ownership and subject to political pressures, and the bankruptcy framework remained dysfunctional and ineffective.”*

The Review noted the loss of confidence induced by the voucher privatization program which had been subverted for private gains, and estimated that the stock of bad loans in the portfolios of banks had reached the equivalent of 20 percent of GDP in 1997. It also noted that the Czech Securities and Exchange Commission (SEC)

was established only in 1998, after the voucher market had been extensively tunneled. In other words, the assets had been surreptitiously sold or removed from privatized enterprises and the gains transferred to other owners (usually through insider transactions on terms advantageous to insiders and not generally disclosed to the public).

The Review noted the ongoing reform efforts by the Government and the CNB, including the privatization of quasi-private banks under state control.<sup>3</sup> The Review also identified gaps and made detailed policy recommendations for reform of the securities market, investment funds, corporate governance, pension funds, and insurance companies. It was widely disseminated and discussed in draft starting at the end of 1998, and published in May 1999. Many of its recommendations were implemented and were the basis for numerous changes in the Commercial Code and other laws and practices governing capital markets. The Review was also a foundation for later work including that pursued under the FSAP and ROSCs (see below). It set a high standard for the level of cooperation between the World Bank and the Czech Republic (and was cited by the Quality Assurance Group (QAG) as a best practice study), one in which high quality work improved standards within the World Bank and contributed substantially to the development of the client country.

The Review benefited from technical inputs and comments from a number of Czech officials and academics, including senior MOF officials and participants from the SEC, Charles University and the Center for Economic Research and Graduate Education of Charles University (CERGE-Prague), thereby setting a precedent for active participation by counterparts that would be maintained through the following tasks.

There is an interesting financing aspect to this study. The ECA Region's budget for privatization/capital markets studies had been allocated to other work which, *inter alia* and based on partial data, seemed to imply that the Czech privatization program was working.<sup>4</sup> In the middle of the World Bank's fiscal year, there was little flexibility in the relevant unit's budget, so funding for the *Capital Market Review* came

<sup>3</sup> The share of private ownership of these banks was large but diffuse, thereby allowing the State to wield effective control, hence the term “quasi-private.”

<sup>4</sup> *Privatization and Restructuring in Central Europe*, World Bank Technical Paper No. 368, August 1997.

primarily from the research and institution building groups in the World Bank. The interest of these groups in the study reflected the view that the World Bank faced reputational risks by its endorsement of the voucher scheme which, due to insufficient rules and enforcement, was by then becoming widely discredited in the Czech Republic (although still often lauded externally). The EC also provided a small contribution to funding the work; its welcome participation was motivated by a desire to support the Czech Republic's transformation and to assist their country in formulating its accession strategy.

There are five main operational aspects of the *Capital Markets Review* relevant for the tasks which followed. First, the Czech Government requested it in response to a serious problem, and supported the study with a high level of cooperation from well-qualified counterparts. Second, it was tailored to the specifics of the Czech economy and its particular transformation issues. Third, it was widely recognized to be of high quality in both the Czech Republic and the World Bank, both for its relevant and specific recommendations as well as for its rigorous analytic standards. The World Bank's QAG rated it as "highly satisfactory," "a well-focused report" which "clearly specifies issues" and which "is likely to have a significant impact." Fourth, despite covering a wide range of technically challenging issues, the report was completed in a timely fashion. Fifth, Czech counterparts skillfully managed its wide and effective dissemination in the Czech Republic.

An advance draft of the *Capital Markets Review* was shared with Czech professionals through a public consultation event that took place in November 1998. This event firmly established a tradition of public discussions of all World Bank non-confidential AAA work that had been requested by the Czech Government. The Czech authorities also requested the World Bank to provide copyrights for the Czech version, outsourced the translation of the *Capital Markets Review* final version to Czech, published, and disseminated it within the country, all fully funded by the Czech Government. This set a precedent for dissemination of all formal AAA tasks, which included a major public discussion of the final

output or public consultations on an advance draft in a seminar or forum (typically attended by 80-200 participants), a publication for public distribution in English, and publication in Czech with expenses covered by the Czech authorities, typically in one of the major Czech economic weeklies.

In addition, the Review played an important educational role for World Bank work on other countries (Bosnia, etc.) which had pursued a voucher privatization scheme similar to that used in the Czech Republic and for which the *Capital Markets Review* analysis was useful in devising corrective policies. This set a standard which became more explicit in later work, namely, the World Bank and the Czech Republic agreeing to a work program which would have externalities and generate results that would be useful for other countries. Because of its quality and its early role in the AAA program, the *Capital Markets Review* brought a great deal of credibility to the World Bank.

## CONTINGENT LIABILITIES

Fiscal management was another important issue. The new government was concerned that the budget was not capturing comprehensively all obligations. Contingent liabilities were known to exist but were not systematically accounted for either by the authorities in the Czech Republic, or, indeed, by other international financial institutions at the time. Government officials became interested in the topic during a multi-country seminar organized by the World Bank, and requested work on this by World Bank staff. The World Bank's analytical and advisory program benefited from the presence of a Czech national staff, who was familiar with budget issues and was able to improve the methodology for accounting for contingent liabilities in the national budget, motivate the implementation of the improved methodology effectively in the Czech Republic, and help disseminate the methodology more broadly, including work through the present with the European Union (EU). This work, in material reproduced in the CEM but also in other fora<sup>5</sup>, identified a "hidden" fiscal deficit equivalent to 4.1 percent of GDP in 1997 and 3.5 percent of GDP in 1998 resulting from

<sup>5</sup> Including *Dealing with Contingent Liabilities* in the report *Czech Republic: Crisis, Adjustment and EU Accession* published by the World Bank 1999, and *Government at Risk: Contingent Liabilities and Fiscal Risk* co-published by the World Bank and Oxford University Press, Washington, D.C. 2002.

*"In the late 1990s, our aim to enhance the transparency of our fiscal system and processes brought us together with the World Bank in the area of developing a methodology of evaluation of, and provisioning for, contingent fiscal liabilities. The system developed by the World Bank within the framework of this collaboration, raised awareness about the necessity to properly manage fiscal contingencies, and helped us to improve the budgetary process, as well as to better manage fiscal risks..."*

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off-budget activities of four agencies and a number of separately issued state guarantees.

The methodology initially used for this analysis has been refined over time, although the initial estimates have been confirmed as reasonably accurate<sup>6</sup> and is now widely used in World Bank country analyses. For example, the ROSC Fiscal Transparency module makes use of this kind of analysis. The World Bank has been active in advising the EU on utilizing the methodology, and the IMF and other agencies have also incorporated the analysis in their evaluations.

This work had a substantial impact. Strict new rules were introduced to limit contingent liabilities. Guarantees are now considered under a new set of procedures with strict limitations on generating new obligations. The widely recognized quality of this work brought the World Bank a great deal of credibility in the Czech Republic and elsewhere in Central Europe where the problem was widely encountered.

### COMPLETING THE TRANSFORMATION OF BANKS AND ENTERPRISES

The Czech authorities requested additional work on transformation issues in the Spring of 1999, and this work resulted in a World Bank mission in October 1999 and publication of their final report in October 2000.

*Completing the Transformation* was a broader look at the Czech economy, which noted its problematic microeconomic underpinnings which led to weak macro performance. It

highlighted the lingering problems in the major banks and in large segments of the corporate sector, resulting in a stock of non-performing loans in the banks and transformation institutions. An updated and more precise estimate of this loss was produced which amounted to one third of all bank loans, the equivalent of 26 percent of GDP at the end of 1999. The Report (page vii) also revisited with more detail and insight the *"weak internal and external mechanisms of corporate governance"* that had *"allowed controlling insiders to tunnel or strip the assets of many enterprises to their own benefit, to the detriment of minority shareholders (the population at large) and the other stakeholders."*

*Completing the Transformation* went on to note the accelerating reform efforts, including bank privatization, the proposed merger of two important transformation institutions (the Konsolidacni Banka and the Ceska Financni), and the efforts to improve creditor rights (which are still ongoing). The report identified remaining challenges, including a workout of the large stock of bad assets, an improved legal framework for restructuring enterprises, and many improvements in the Bankruptcy Law. It recommended a diversified multi-track approach for debt workouts (with a centralized component limited to a few of the largest and most complex cases, and several decentralized components to deal with the some 12,000 medium and small-scale enterprises holding bad debts). It also recommended reforms to remove legal obstacles to restructuring viable enterprises and to implementing rapid liquidation of non-viable enterprises, and other improvements in the bankruptcy framework. A number of these and other recommendations have been implemented, including transfer of work-out processes from a Government-owned bank to a Government agency with a sunset provision, and steps towards a multi-level resolution process. The World Bank's QAG rated this as a Best Practice report.

### PUBLIC PRIVATE PARTNERSHIPS (PPP)

Work on PPP was initiated in 2003 and continues intermittently to the present. PPP projects with significant fiscal consequences generated well-founded concern about proceeding with other

<sup>6</sup> See for example *The Effect of Off-Budget Transactions on Czech Fiscal Policy* by Vladimir Bezdek of the CNB and Ales Krejdl of the MOF. The improved methodology confirms the original findings.

PPP projects in the absence of a much-improved framework for considering the fiscal implications of PPPs.

PPPs can be useful in some cases to improve the quality and effectiveness of public investment programs. A major impact of PPP projects can be quality enhancement, since in some circumstances private firms may be able to implement projects more effectively than public sector agents. Yet, they have had an uneven history in many countries. A popular, and politically convenient, view of PPPs is that they enable a government to implement off-balance sheet projects structured in such a way that the public authority and/or users pay only for services rendered satisfactorily and not for assets, which are inputs to service provision. The urgency of properly integrating the PPPs and the risks they entailed into the fiscal accounts reflects, on the one hand, the pressure to increase investment in order to accelerate the convergence process and, on the other hand, the pressure stemming from troublesome fiscal deficits. The temptation to shift risks off-budget through the use of improperly accounted for PPPs has become a very real one.

The early experiment with the D47 Highway Project highlighted the dangers of pursuing PPPs in the absence of an adequate fiscal and policy framework. This motivated the Government to develop a strategy and oversight mechanisms for a PPP program, and it was in this context that the Government sought World Bank assistance. Discussions began in 2003, and World Bank assistance has been utilized subsequently in developing the Government's strategy for PPP, which was approved by the Cabinet in January 2005.<sup>7</sup> A Regulatory and Monitoring Unit in the MOF is now working to develop budget rules to account for PPP projects with transparency, even if they do not formally constitute debt, and ensure that Eurostat accounting regulations are followed. A first set of pilot projects has been approved by the Czech Government and these are being pursued to test modalities.

The World Bank has also assisted in developing "PPP Centrum" (a joint stock company, fully state-owned), which is a small-scale resource center for technical assistance for ministries, regional governments, and municipalities de-

signed to be a focal point for procuring additional technical resources for these agencies when needed for particular projects. The Ministry of Regional Development is also an active player in developing the PPP framework, since many pos-

*"Our collaboration with the World Bank on principles of good governance of public-private partnerships was an extension of the above aim to properly manage fiscal contingencies and risks. The regional forum on good governance of public-private partnerships initiated by the Czech Republic and organized jointly by the World Bank and the Czech Republic for the benefit of countries of central and south-eastern Europe proved to be another successful innovative project...."*

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sible PPP projects could fall within its purview.

To facilitate sharing of knowledge, the World Bank and the Czech Government sponsored the *Regional Forum on Governance for Public Private Partnerships* in Prague in February 2004, which enabled a number of central and southeastern European countries to tap global, not just regional experience, draw on expert advice, and, in turn, allow World Bank PPP experts to draw out regional lessons of experience. The conference was supplemented by the very useful seminar *"Central Europe and the Baltics – Current Issues in Fiscal Reform"* organized jointly by the World Bank and the Czech Government in November 2005, which dealt with, among others, the issue of managing fiscal risks in PPPs. Participants, who included Ministers of Finance and other senior officials, concluded that follow-up events may have an important future role after more experience with a few successful PPP projects.

The conference resulted in setting up an informal network<sup>8</sup> of interested parties to facilitate further networking and capacity building among PPP experts and stakeholders in Central and South Eastern Europe.

Finally, the conference was an interesting example of cost sharing. The Czech Republic contributed about two-thirds of the cost of the conference, and the World Bank, the remainder. Given

<sup>7</sup> Partnership UK is also reported to have been a very useful resource in this endeavor.

<sup>8</sup> This network is known as the Prague Public Private Partnership Platform, or "Five Ps".

the substantial costs involved and the regional nature of the conference, the Czech willingness to provide funding was concrete evidence of the important role that the Czech Republic is playing in its new partnership with the World Bank.

### **OUTCOME OF THE FIRST WORK PROGRAM CLUSTER**

The first cluster of the work program comprised a series of high quality ESW tasks which had an important impact on economic management, including *Capital Market Review*, *Completing the Transformation*, and *Contingent Liabilities*. The work on PPPs appears to have been a valuable adjunct to this work, particularly in raising regional awareness through the Prague conference. Overall, this first cluster of work has been highly satisfactory in terms of its quality and impact.

### **B. THE SECOND WORK PROGRAM CLUSTER: EXPENDITURE PROGRAMS AND EU ACCESSION**

As the work on liability management proceeded and the problems generated in the mid-1990s began to be addressed, a second overlapping cluster of assistance was initiated. The country began to look more towards the future, and it was time to identify policies and programs to sustain economic development in general and, in particular, to speed accession to the EU.

#### **MACROECONOMIC WORK**

##### *Czech Republic: Towards EU Accession (Country Economic Memorandum)*

Although EU accession had been a stated government priority for several years, faster progress on the accession agenda was clearly needed. In the second half of 1998, after work was completed on the *Capital Markets Review* but before work on *Completing the Transformation* was initiated, the World Bank launched work on a Country Economic Memorandum (CEM). This was largely at the initiative of the World Bank but with the concurrence of the Government. It was facilitated by new thinking in the World Bank's ECA Region which saw a well-

cused coherent program of AAA as useful even in the absence of a lending program. This CEM was one in the series of CEMs for EU candidate countries which focused on accession issues. In spite of its more "generic" World Bank origins and the lack of a direct Czech "champion" for this work, the CEM came to be seen as useful by the Czech authorities in assisting to orient policies and programs to support EU accession.<sup>9</sup>

The CEM was a comprehensive compendium of economic knowledge and analysis which makes detailed recommendations that provided a road map for implementing reforms needed for accession in such areas as the energy and water sectors and their impact on the environment, as well as in transportation and other sectors, and provided macro analysis and recommendations.

The CEM also firmly established the World Bank's country economic team as a resource for the Czech Republic. The knowledge and access gained by the Bank team in the course of the CEM enabled them to be more accessible to MOF and other staff, and to learn of needs for informal technical assistance. Czech officials cited several instances in which the World Bank team responded very quickly to informal requests for expertise and provided key inputs which had a significant impact on reforms.

The dissemination of the CEM was a major event. Over 200 people attended the main presentation, and there were supplementary seminars with the Government, press, academics, and others. The CEM was translated into Czech and circulated widely. This cemented and mainstreamed the dissemination process, established earlier in connection with the *Capital Markets Review*, which was to be followed for all tasks in the future.

The CEM followed the same pattern as the *Capital Markets Review* in its close collaboration with the EC, firmly establishing close working arrangements with the EC as the norm for World Bank work with the Czech Republic and indeed for other countries such as Slovakia, Slovenia and Hungary. Working relations were not particularly close, however, between the World Bank and the IMF during this time. For example, there were no joint missions. Nor did the formal

<sup>9</sup> A noted expatriate Czech economist, who also served as Director of CERGE in Prague (Mr. Jan Svejnar), played an important role as a peer reviewer and interpreter of local events. His important role in promoting CERGE also had spin-off effects for work on a wide range of issues.

publications of the IMF including Article IV Consultations deal extensively with many of these issues including contingent liabilities and public expenditure composition and efficiency. The World Bank collaborated closely with a wide range of Government counterparts, as well as a number of institutions outside Government, of which particular mention must be made of the CNB.

### *Enhancing the Prospects for Growth with Fiscal Stability (Public Expenditure Review)*

The Public Expenditure Review (PER) was motivated by the large deficits revealed by the analysis in the CEM in the context of large anticipated EU accession costs for environment, also discussed in the CEM. At the same time, the EC encouraged the World Bank and the Czech Republic to pursue a PER, in view of its concerns about managing the fiscal deficit in the context of accession. Consequently World Bank/EC coordination was very close. The EC actively supported this process and was kept fully informed. The PER was based on a series of missions which visited the Czech Republic during 2000.

The PER helped to establish an appropriate framework and methodology for economic analysis which became the basis for later work and public debate. It also showed the wide-ranging implications of fiscal policy, as in, for example, its analysis of the role of fiscal disincentives in the labor market. Although the CEM had involved other Ministries, it was perceived as a primarily analytic exercise while the PER engaged relevant ministries directly in relation to their resource base. The PER provided a number of well thought out proposals to further improve the legal and institutional framework for managing public finance. This improved fiscal framework was also important for discussions concerning accession to the EU and for membership in the EU. Finally, the MOF also encouraged a public presentation of the PER's advance draft in Prague in March 2001.

The PER presentation was accompanied by a series of media events and followed by broad public dissemination of the full text in Czech. The level of public discourse was improved as

journalists gained an economic perspective on the budget that broadened earlier perceptions and resulted in better coverage of economic policy issues.

Many of the specific recommendations suggested by the PER were implemented, however, some with appropriate refinements. As a result of the PER and other recommendations, fiscal management is now much more transparent. Unfortunately, systemic reforms were not implemented in key areas such as health and pensions. By the time the final PER was available in September 2001, the Government was nearing the end of its mandate and was unable to seriously consider introducing systemic reforms. However, this work was not wasted as the PER put pensions and health care systems reforms on the table for discussion which is helping to define current reform proposals.

World Bank staff working on the PER were complemented by a number of consultants. While consultants can frequently play a useful role, there can be drawbacks especially in terms of continuity. When the same consultant could not be engaged for subsequent work, there was time lost and an extra cost imposed on counterparts who had to repeat briefings for the new team. This consideration became important and has resulted in a much greater emphasis on using World Bank staff rather than consultants for work on the Czech Republic. We shall return to the issue of consultants later in the discussion of the work program (see section VII).

### *Fiscal Reforms: IDF Grant-financed work*

As part of the work on contingent liabilities and budget management, an IDF grant was provided to finance work on four topics.

*"Strategies for Implementing Medium-Term and Performance-Oriented Budgeting in the Czech Republic"* was a very useful exercise which was translated into Czech. A number of seminars at the political and technical level were held to introduce its concepts more broadly among the range of agencies which were affected by the recommendations. Almost of all the recommendations from this study were implemented. A new law on budgeting rules was based on this

paper, and many new practical rules for budgeting were introduced as a direct result of this work.

*“State Debt and Contingent Liability Management: Strategies for the Czech Republic”* was a very useful guide to appropriately manage debt in the MOF including specific suggestions for constituting a team to do this work. At the time, the MOF had a team of only four individuals to do this work, with little guidance. The study made a number of practical suggestions for market familiarization and benchmarks and a large number of other very useful suggestions. The Swedish team financed by the IDF also provided excellent assistance on the legal framework for such work, based on the Swedish model. In implementing the work, the team also fostered a stronger working relationship between CNB and MOF on these issues.

The remaining component of the IDF grant *“Developing and Strengthening of Treasury Functions”* was much less useful. Both of the supporting expert studies, *“Advisory Services on the Preconditions for Building a Treasury Function in the Czech Republic”* and the subsequent *“Strategic Direction of the State Treasury Function in the Czech Republic”* turned out to be more pro forma studies with little practical value, too general and not very useful.

Much more work will be needed if the Czech Republic is to introduce a treasury system. The current system is still based on that of the past regime and uses the inherited system in the CNB as a basis. This involves a budget system decentralized to the line ministries in the 1990’s which gave line ministers more control, with a large measure of daily management residing with the CNB.

At the same time, there was a very well received grant for capacity building workshops. About 200 local experts and analysts attended the workshops on budget planning and analysis prepared by Dutch experts.

#### *Intergovernmental Fiscal Relations in the Transition*

This work began as part of the PER but was organized into a separate task in order to better high-

light its contribution to the policy reform discussion and in view of its high quality. It identified a number of problems in municipal and regional finance and offered concrete suggestions to deal with issues such as debt management, expenditure control, reducing fiscal fragmentation and rationalizing expenditure among municipalities, and other management reforms.

While the Government did adopt a reform program for Regional Development, a number of the recommendations in this report have yet to be implemented. In addition, problems seem to be growing in this area. There is an increasing need to encourage cooperation among communities in order to pool resources. While municipal debt only totals 4 percent of GDP, it needs to be carefully monitored given the implications of municipal fiscal positions for the overall fiscal situation and management of public finances generally. Finally, there is an opportunity for reforms to enable the Czech Republic to interact to a greater extent with the EC at the sub-national level.

#### **AAA WHICH ADDRESSED SPECIFIC EXPENDITURE PROGRAMS**

Sector work was pursued concerning those key expenditure programs where outstanding issues were evident from work on the CEM and PER, and where there was a consensus that further World Bank assistance would be useful.

#### *Pension Reform*

Pension reforms had been discussed as early as 1993 and several scenarios were constructed, but the Government decided not to engage the World Bank at that time. The reason for this was that the World Bank itself had been debating pension policy in the mid-1990s and recommendations had been changing. At the same time, the Czech Republic looked with some concern at reforms in neighboring countries such as Hungary and Poland. The World Bank offered assistance in pension reform in 1997/98 as part of the work program for capital market reforms but the Czech authorities declined referring to the mixed experience with World Bank policy recommendations in neighboring countries and the wealth of their own domestic policy work in the social security area. By 1999, the Ministry

of Labor and Social Affairs (MOLSA) had constructed several models with its own expertise, and work in this area continued to be explicitly excluded from Czech Republic requests for assistance from the World Bank, although periodic dialogue continued.

However, the PER helped clarify to a broad audience the need for pension reforms and established a natural basis for cooperation in this area. With that explicit understanding, an assistance program was agreed. Collaboration centered on work with the Social Insurance Department of MOLSA.

A first piece of work, *“Czech Pension System: Challenges and Reform Options”* built on the more general work in the PER and set out in more detail the issues in this sector. The more in-depth *“Interactive Model of Czech Pension System”* which was very well documented and transparent and which became an extremely useful basis for cooperation followed this work. The model was developed specifically for use in the Czech Republic because the World Bank’s widely distributed product in this area known as PROST (Pension Reform Simulation Toolkit) was seen to be a black box and, therefore, not adequate for modeling the impact of the full range of parametric and systemic variations that the Czech technical team wished to consider. MOLSA staff contributed to building the model and devised a training kit incorporating the model on a CD ROM which was widely used in seminars and discussions which involved a large number of officials and stakeholders.

The model was a useful addition to the already existing wealth of technical products which enabled clearer definitions of costs, benefits, and trade-offs in various options. It helped Czech policy makers to better understand the relationships between demographic and socio-economic factors and the regulatory system on the one hand and the outcomes of pension reform (in terms of socio-economic indicators) on the other.<sup>10</sup> However, the political consensus needed to concretely design a pension reform was still missing. Therefore, in 2004, Prime Minister Spidla (who had been Minister of Labor and Social Welfare at the time of the PER) decided to bring technocrats back to the discussions,

to review pension reform proposals by various political parties in an effort to depoliticize the pension debate and propose reforms. The Executive Team, consisting of five economists from the CNB, MOF and MOLSA and one external advisor, started working in October 2004. A parallel political body- the Pension Reform Committee- was also created. Each of the five political parties had two representatives on this committee. Apart from that, the Prime Minister, MOF and MOLSA also had their own representatives attending the Committee’s meetings. The Executive Team developed its own models to explore a number of reform options. The older models, some of which were developed thanks to the World Bank’s activities, helped in this respect. The work of the Executive Team and the Commission has been fully transparent. All of the data and the structure of the models and other assumptions have been published on a website which is user friendly. There has been a great deal of feedback which in turn has been processed by the Executive Team. The modeling exercises were finished in June 2005 and the decision rests with the political leadership as to whether to propose a reform before the elections to be held next spring.

The World Bank has also provided other assistance for pension reform. *The Evaluation of Notional Defined Contribution Option for the Reform of the Pension System* explores the implications of such a system for the Czech Republic and is intended as a general discussion piece. It has been left in draft pending demand for further work. Another piece of work, *Strengthening of the Private Voluntary Pension Scheme in the Czech Republic* is regarded as a very clear and useful paper which is of substantial interest to the pension fund industry but which is not yet viewed by the Government as a basis for reform. The pension industry believes that at some point, reforms will be needed since voluntary pension products are not of great interest to participants or the industry and the large pension funds are in the market only because they want to offer a full range of financial instruments to their clients.

Further work on aspects of pension funds has been pursued under the *Pilot Assessment of Governance of the Insurance Sector* discussed below.

<sup>10</sup> Reference provided by the Chairman of the Pension Reform Committee (described below).

The World Bank's work on pension reforms has spanned many subjects, with sectoral overlap. The Social Sector Team, with MOLSA as its counterpart, has handled much of the broad work on pension reform. At the same time, Financial Sector staff was working with its counterpart, the MOF, on pension fund industry issues, key for reforms involving the third pillar. Some differences of emphasis and perspective emerged for a time. This would have been minimized had an overall lead for all World Bank work on pensions been designated with clearly defined terms of reference.

### *Health Care*

While the Czech Republic has been spared the concerns about the poor and deteriorating overall quality of health care which have characterized several other central European countries, there are serious questions about excess capacity, inefficient use of resources, and financial sustainability. Early in the transition, the Government attempted to introduce a major health care reform which met widespread opposition and was interrupted. However, both the CEM and, more importantly, the PER identified a number of issues in the health sector including the fact that health sector expenditures now comprise about 7 percent of GDP and are likely to increase under the current system due to the rapid aging of the Czech population. This reinforced concerns in the MOF about the fiscal sustainability of health care expenditures, and the MOF sought to find a basis for drawing on the World Bank's expertise to provide recommendations for maintaining quality while containing costs.

Besides the overall level of expenditures, there are a number of systemic issues. Examples include excess capacity of acute care hospital beds which results in high fixed costs. In case of a lack of agreement between the providers and health insurers, the Ministry of Health (MOH) intervenes and sets the terms of the contract, often to the benefit of providers at the expense of the financial stability of insurers. There is a lack of management autonomy in the hospital sector and the financial discipline in the public sector hospitals and the largest public insurer, the General Health Insurance Agency (VZP), has been weakened through a series of bailouts.

There is no Freedom of Information Act for hospitals, which might be useful in allowing the public to learn about differences in health care quality among hospitals. Social programs (such as long-term assisted living) are expensive and cannot continue to be funded from the health insurance premiums without limitations if sustainability is to be achieved. VZP has a worrisome deficit (about 7.5 percent of revenues as of early 2005), while the remaining eight employer-based health insurers run a financial surplus of similar magnitude which, however, is gradually eroding. Health insurers act primarily as collection agencies, with limited controls over services purchased or payments for services. At the same time, the private health care system is reported to be growing very rapidly.

As part of its general monitoring brief in the transition economies, the ECA region's health team had maintained general contact with members of the health establishment in the Czech Republic through attendance at conferences and occasional visits to Prague; but there was no formal work program or even consultation on health policy. Cooperation restarted at the request of the MOF in 2004 with the initiation of a working group comprising all major stakeholders. The working group identified core areas for a World Bank expert team which visited the Czech Republic in May 2004. An Aide-Memoire written by end-June was translated and used by the MOH as a basis for an important statement of issues. The Aide-Memoire proposed several options for reducing the financial burden of the social health insurance system, suggested ways to optimize the provision of health services, explored patient co-payments, and pharmaceutical policies. After several changes in the position of MOH and in the midst of intensified political debates about the future course of health care policy, the formal dialogue between the Czech authorities and the World Bank in this sector was put on hold.

### *Environment*

#### **a) The National Energy Efficiency Study (NEES)**

The NEES, the first comprehensive study for energy efficiency carried out after 1989, was co-financed by the Government of the Netherlands

and the Czech Republic and managed by the World Bank, with the Czech Ministry of Environment (MOE) and the Czech Ministry of Industry and Trade as counterparts. The NEES, published in 1999, comprised two parts: (1) Rational Use of Energy and (2) Renewable Energy Sources. Each part contained a detailed policy analysis and policy recommendations, and a brief Action Plan for implementation. The Minister of Environment presented the final document to the Czech Government. It was endorsed as a useful basis for reform efforts and as such it served as a key background document for: (1) Energy Policy of the Czech Republic (2000); (2) Environment Policy of the Czech Republic (2001); (3) Energy Management Act 406/2000, and (4) the National Programme for Energy Efficiency and the Utilization of Renewable and Secondary sources of Energy (2001).

#### **b) The Water Management Study**

This study was funded by a technical assistance grant from the Government of Denmark, managed by the World Bank during 1998. The grant funded ten experts to work in the MOE for up to one year, and thereby enabled the Czech Republic to become more familiar with thinking in the EU about environment and water management. The work resulted in a compendium of water projects which has been a useful investment guide for the Czech Republic, and has been key to generating several GEF projects which have been successful. Most important, a component of the work, "Pre-Accession Planning to Meet the Requirements of EU Legislation in the Water Sector in the Czech Republic" was found to be particularly useful in helping the Czech Republic to meet the *Acquis Communautaire*. While an important guide to specific investments, the exercise did not fully meet World Bank expectations of developing improved decision-making tools for the Czech Government to evaluate the costs and benefits of investment in this area. In addition, in terms of economic costs and benefits, there may have been some overinvestment in improving environment. However, since an improved environment was a key EU Accession requirement, this was an important and useful activity regardless of the shortcomings.

#### **c) Global Environment Fund (GEF)**

GEF and environment work held a special role

which was welcomed from the earliest phase of the relationship. A number of factors strengthened this relationship over time. The World Bank made a loan to the Czech power industry to help clean up Northern Bohemia and had good contacts with the Ministries of Energy and Environment. The World Bank was able to give the Czech Republic a good assessment of the environmental costs of meeting *Acquis Communautaire*.

One important GEF project was the Kyjov Waste Heat Utilization Project. This project went well in the beginning, but ran into financial difficulties as Czech markets were opened to imports and nuclear energy supplies came on track, all leading to a surplus of electricity. However, demand has picked up and electricity prices have come back on track, so the project is again financially feasible.

Another initiative is the Prototype Carbon Fund, work on which was initiated with a workshop in 2001 with a large Czech delegation leading to work on sub-projects as a legal framework was developed with contributions from the MOF, Ministry of Justice (MOJ), MOE, and others. There are now about 20 operations underway, including about 15 small hydro projects. A list of GEF projects is given in Annex A.

### **REGIONAL INITIATIVES**

Czech participation in ECA regional initiatives has been valuable. Participation in the Government/World Bank/ OSI Budapest Conference, *Roma in an Expanding Europe*, in 2003 and follow-up with the International Steering Committee for the Decade of Roma Inclusion, 2005-2015 has been valuable in highlighting the challenges faced in the Czech Republic to include the Roma minority in the gains of growth and development that have characterized the Czech transition. The Czech Republic is a potential recipient of grants from the Roma Education Fund (along with the Roma Decade, an outcome of the Budapest conference) to promote better education outcomes for Czech Roma. Concerning the development of a knowledge economy, the Czech Republic, under the purview of the Ministry of Technology, has participated actively in four regional Knowledge Economy (KE) conferences

from 2002 to 2005. The Czech participants organized their own national KE Forum in 2004 for which the World Bank provided expert speakers.

## OTHER WORK

### *Computer Systems*

The World Bank gave a grant of US\$75,000 to the Czech Republic to debug computer systems and ensure a smooth transition to the year 2000. There were no problems with the transition. However, it is difficult to document or evaluate the exact contribution of this grant.

### *Liability Management*

In May 2005, the Czech Republic renewed its collaboration with the World Bank in the area of building capacity for liability management through a Needs Assessment of the MOF's liability management function conducted by the World Bank's Treasury Department.

## OUTCOME OF THE SECOND WORK PROGRAM CLUSTER

The second cluster of the work program covered a wide range of topics. Both the CEM and the PER were rated as best practice by the QAG unit of the World Bank and were clearly of high quality. While both the CEM and the PER played an important role in moving along the EU accession agenda and providing specific recommendations for reforms, the PER would have been even more valuable had it been delivered earlier at a time when the Government would have been able to utilize recommendations more effectively for systemic reforms. The work on pension reforms was of high quality, well appreciated by the authorities and a good basis for the work carried on by Czech organizations. While the lack of a political consensus for implementing reforms has limited the impact of this work, it has certainly been useful. This output could have been rated even more highly had there been better coordination of the inputs for pension reform, already alluded to above. The work on fiscal aspects of health care reforms has been important and very useful in focusing the debate on key issues. It thus had a high payoff despite its short duration and the



fact that an Aide-Memoire was the only output. The NEES was of good quality with substantial impact. The water sector work provided a useful menu of projects to the authorities but does not appear to have had the desired systemic impact on water management. Finally, the IDF grant contributed to budget reforms but fell short of its objective of supporting introduction of a treasury system.

## C. THE THIRD WORK PROGRAM CLUSTER: INTERNATIONAL FINANCIAL ARCHITECTURE (IFA)

As work progressed through the first two clusters of the assistance program outlined above, the Czech Republic and the World Bank sought to identify a focus for further mutually beneficial collaboration. Looking beyond the traditional role of the World Bank as a provider of assistance to developing countries, the Czech Republic and the World Bank sought a collaborative framework in which advanced development of technically challenging material would yield useful results for both parties. A natural candidate for this type of collaboration was the unfold-

ing work on IFA which was being pursued by the World Bank and the IMF in the wake of the financial crisis of 1997/1998, and in the context of the Financial Stability Forum (FSF) which was convened in April 1999.

At the outset, this work comprised the FSAP which is a broad review/diagnostic of the sector.<sup>11</sup> The FSF established 12 key standards for sound financial conditions, each covered by a Code or a Standard. Three of these are in macroeconomic policy and data transparency (monetary and financial policy transparency, fiscal policy transparency, and data dissemination), six in institutional and market infrastructure (insolvency, corporate governance, accounting, auditing, payment and settlement, and market integrity which includes recommendations of the Financial Action Task Force and Recommendations against Terrorist Financing), and three concerning financial regulation and supervision (banking supervision, securities supervision, and insurance supervision). Beyond this, a number of other tools are being or have been developed

*“Over the most recent years, our initial client-provider relationship evolved into a true collaborative partnership that has been truly gratifying. A major part of our collaboration focused on piloting of innovative approaches for use in a broader range of countries and in the World Bank’s regional and global programs. Most prominent among them was a system for diagnosing financial sector vulnerability, known as the International Financial Architecture, or IFA, which has been developed by the World Bank and International Monetary Fund. A significant part of the system, which is being used by many countries, as well as its extensions like the Global Bank Insolvency Initiative and a series of financial sector corporate assessments, were piloted in the Czech Republic, often for the first time worldwide. Our experts have learnt a great deal from this collaboration, our regulation and supervision over the financial markets have become more efficient and their capacity has been enhanced...”*

**Bohuslav Sobotka**

Minister of Finance, April 2005

related to corporate governance for particular sectors, including investment fund supervision, pension fund governance assessments, and banking governance.

<sup>11</sup> While work on the FSAP overlapped with and contributed to work on the PER and *Completing the Transformation*, it was actually a precursor for a substantial body of work on ROSCs and Assessments, and so for purposes of this analysis is treated as part of the Third Phase of Bank assistance.

The IMF and the World Bank are jointly responsible for this work. In general, the IMF is primarily responsible for ROSCs concerning policy transparency (data, fiscal, and monetary and fiscal policy), while the IMF and the World Bank share work on financial sector regulation and supervision (payments systems, securities, banking supervision, securities, insurance and anti-money-laundering) and the World Bank assesses market integrity (corporate governance, accounting, auditing, and insolvency and creditor rights). In the Czech case, the IMF was primarily responsible for work on policy transparency while the World Bank was primarily responsible for work on financial sector regulation and supervision and market integrity.

This is indeed a broad agenda, yet one for which each component has a strong rationale. Work could only proceed on a collaborative basis, and the Czech Republic did indeed participate on a very reciprocal basis in pursuing each of the above topics. The material below first discusses the FSAP and then selected ROSCs and Assessments of particular interest for this Review.

## FINANCIAL SECTOR ASSESSMENT PROGRAM (FSAP)

### Background

The Czech Republic’s participation in the FSAP program originated in a proposal made in 1999 by the IMF and the World Bank. An FSAP Confidentiality Protocol was developed which addressed the confidentiality issue of concern to MOF, and the MOF has strongly supported FSAP ever since.

The CNB felt that this was a high priority in that it would complement the kind of review of the financial sector that the CNB had thought necessary in any event. Working with the World Bank/IMF was seen as useful for addressing various aspects of financial sector reforms and for building political support to implement necessary reforms as and when identified by the collaborative work. While this has turned out to be demanding in terms of staff resources at the CNB, MOF, and other institutions, the process was seen as useful. Based on a proposal by the Czech authorities, the results of the FSAP/FSSA were used by the EC one year after completion for a complex assessment

(PEER review) of the stability and strength of the Czech financial sector, which was related to the process of the preparation of the Czech Republic for entry into the EU.

The Czech Republic has been an active participant in the program. It was the first country to do an FSAP update and has participated in the preparation of all of the ROSCs Pilot Assessments. It has also participated in Pilot Assessments of all instruments to assess the best practice in the financial sector<sup>12</sup>, including some that have not yet been mainstreamed and six of them as the first-ever country.

While the Ministry of Finance is formally responsible for financial sector policy, the main counterpart for much of this work was the CNB, with the MOF as the key counterpart for work on insurance, anti-money-laundering, and corporate governance. The MOJ has played a role in work on insolvency. Later segments addressed insolvency and creditor rights protection follow-up for which the MOJ was a key counterpart along with the MOF. Support and interest of the MOJ has been highly variable during this period, especially concerning the work on insolvency and creditor rights.

### *FSAP Studies*

The FSAP was prepared in missions in November–December 2000 and in February 2001, and published in July 2001.<sup>13</sup> The mission was led by the IMF with the Deputy Chief from the World Bank, and included key staff on capital markets which contributed substantially to the value of the FSAP. This was not the first FSAP mission (Hungary preceded) but it was a very early one and parts of the Czech FSAP work were pioneering efforts (e.g. the work on bankruptcy and corporate governance). While the full study is confidential, consistent with the general IMF/World Bank rules for the FSAPs, the Financial System Stability Assessment (FSSA) is available to the public and captures many of the key points of the FSAP. It noted that there was a strong incentive on the part of the authorities, especially the CNB, to host the FSAP work in view of the very large banking sector losses noted above. The Government and especially the MOF also had a motivation since it provided cash injec-

tions to the banks, prior to privatization, or in some cases, re-privatization, and wanted a new framework for strategic partners.

The CNB found that this first FSAP mission was large but useful as the CNB was pursuing an overhaul of legislation to harmonize with EU, so that the time was ripe for suggestions for reform. The FSAP helped define a work program in a number of sectors including banking, the corporate sector, insurance sector, pension funds, and credit unions and leasing companies.

Among the key conclusions of the FSSA were:

- Reform efforts have substantially strengthened the financial system and when the last state bank would be privatized, 90 percent of the banking system would be owned by reputable foreign banks.
- While the first large State bank privatization (Investicni a Postovna Banka, IPB) had been a failure, subsequent privatizations were highly successful. The clean-up of the banks' balance sheet (then estimated at 21 percent of GDP when fully budgeted) added to fiscal pressures, but the FSSA noted that Foreign Direct Investment (FDI) and other inflows have reduced inflationary pressures.
- The non-bank sector, except insurance, was also undergoing consolidation and did not pose any immediate stability related concern.
- The legal and regulatory framework had been improved, but enforcement needed to be strengthened and was still unsatisfactory. Improved enforcement would require a build up of supervisory capacity, a more proactive approach by self-regulatory organizations, and improvements in the court system.
- Adoption of the mutual fund model for pension funds would improve transparency and the FSSA recommended that it be implemented as soon as possible.

<sup>12</sup> The Global Bank Insolvency Initiative, the Banking Sector Governance Assessment, the Insurance Sector Governance Assessment, the Assessment of Governance in the Collective Investment Fund Sector, the Pension Fund Sector Assessment.

<sup>13</sup> In addition, work on a pilot FSAP was undertaken in 1999.

## REPORTS ON THE OBSERVANCE OF STANDARDS AND CODES (ROSCS) AND RELATED WORK

### *Background*

Along with the FSSA were included ROSCs on Data Dissemination (1998 and updates), Fiscal Transparency (1999 and updates), Transparency of Monetary and Financial Policy (1999), Fiscal Policy (1999 and updates), Banking Supervision (1999 and updates), Securities Market (1999 and updates), and Payment Systems, with subsequent work on Transparency of Monetary and Financial Policy, Banking Supervision, Insurance Regulation, Securities Regulation, Corporate Governance, and Payment Systems. The information on FSAP and particular ROSCs has been updated frequently as work has proceeded.<sup>14</sup> The last FSAP Update was in 2004, for which the IMF was the lead agency with the World Bank being consulted for specific inputs.

The Assessments of Corporate Governance in Banking, Insurance, Mutual Funds, and Pension Funds were all new products generally pursued subsequent to the first tranche of ROSCs and were developed by ECA staff in collaboration with financial sector specialists, although the ROSC for Corporate Governance of Pension Funds was pioneered by ECA staff for use in Slovakia. The ROSCs for Insolvency and Creditor Rights, Anti-Money Laundering, Bank Insolvency, and Accounting and Auditing were also implemented by World Bank Staff or with substantial inputs by World Bank Staff.

### *Corporate Governance Assessments*

The first World Bank analysis of corporate governance in the Czech Republic was part of the Capital Markets Review (1999).

In 2000, the Czech authorities opted for the Corporate Governance ROSC to be conducted as part of the FSAP (2001). At that time, the methodology of the Corporate Governance Country Assessment based on Organization for Economic Cooperation and Development (OECD) Principles (Report on Observance of Standards and Codes in Corporate Governance) was a work-in-progress. Its implementation in the Czech Republic

was the first ever worldwide and it significantly contributed to the development of this ROSC. The ROSC was part of the FSAP output and it was also published together with the FSSA (2001).

In the following months, as experience with assessing the OECD Principles of Corporate Governance across countries mounted, the methodology of the Corporate Governance ROSC evolved significantly so that the results of the initial Czech Assessment in this area are no longer comparable with those of other countries. The World Bank and the Czech authorities agreed on a re-assessment based on the new methodology. The reassessment was conducted in March-May 2002, released in July 2002, presented at a public seminar in Prague in November 2002 and published in Czech immediately thereafter.

A number of reforms were recommended. Concerning company insiders (i.e. related parties) the governing legislation should be broadened to treat loans and leases, as well as to improve creditor rights. Stricter rules should be implemented governing cases in which companies can withhold damaging information. Better enforcement of shareholder rights, including fully accessible shareholder meetings, should be effected. Auditor independence should be further strengthened. In the Czech Republic, management is often in charge of hiring and firing auditors, which can interfere with their independence. Requiring shareholders and the Supervisory Board to approve at an annual meeting an auditor's dismissal would be a step in the right direction. Institutional investors such as pension plans and investment funds do not tend to vote at shareholder meetings because they do not believe it is worth the cost to them, and thus, do not uphold the interests of the many smaller shareholders they represent. When they do vote, they usually simply agree with management. Requiring such institutions to reveal how and if they vote would strengthen transparency and improve the likelihood of responsible voting. The ROSC also noted that both the Czech Securities Commission and the Chamber of Auditors would be in a better position to uncover and enforce violations if they had more staff.

Given the small number of listed companies, this work has not yet had a major impact, although

<sup>14</sup> The Completed ROSC reports can be obtained from [http://www.worldbank.org/ifa/rosc\\_cg.html](http://www.worldbank.org/ifa/rosc_cg.html).

its purview also extends to those companies which are publicly traded even if they are not listed.

A large part of the Czech financial sector remained outside the purview of this assessment. The pilot Corporate Governance Assessment thus underscored an important lesson. In countries with small capital markets, few listed companies and closely held financial institutions, an assessment of OECD Principles of Corporate Governance for listed companies cannot fully capture the governance factor as an important institutional underpinning for sound finance. This finding accelerated preparations for assessments of financial sector governance.

### *Financial Sector Governance Assessments*

#### **a) Pilot Assessment of Governance of the Banking Sector**

The assessment of governance in the banking sector in the Czech Republic took place in 2004 and early 2005, the first time this assessment had been used anywhere in the world. The area of banking governance is increasingly viewed as quite crucial for financial sector stability in countries with banking-dominated financial sectors and it has been subject to intensive work by several international bodies. However, international consensus on best practice in this area has yet to emerge. Thus, the recommendations of the Pilot Assessment need to be taken as an exploratory effort appropriate for a Pilot Assessment, with particulars to be worked out in the course of future reforms. It is in this context and the spirit of searching for improvements without mandating absolute standards that this work was initiated. While in banking dominated financial sectors, such as in the Czech Republic, the Assessment of the banking sector governance would typically be the most urgent among financial sector governance assessments, the Czech authorities chose to proceed with work on the insurance sector first, due to policy priorities. When work on the insurance sector governance hit the barrier of vested interests and had to be interrupted, Czech authorities chose to launch the Collective Investment Fund Governance Assessment as a role model for other sectors. Scheduling of the Banking Sector Governance Assessments respected the time flow of the banking supervi-

sion experts most needed for this assessment.

The Pilot Assessment noted the substantial changes in the banking sector since the late 1990s, and confirms that highly respected foreign banks own 90 percent of banking assets. In this context the Assessment finds that the quality of management, the transparency of ownership and control and standards of financial reporting by Czech banks have improved significantly during the last several years and met relatively high standards. Building on these strengths, the Pilot Assessment also went on to suggest a number of reforms to further improve the quality of governance, including strengthening CNB supervisory authority, improving disclosure, enhancing the quality, independence and public oversight of audits, and re-assessing the regulatory framework for the bank sector by standards of competition and market contestability.

In addition to these recommendations, the Assessment made a number of recommendations regarding the roles and functions of bank management and/or supervisory boards. These dealt with issues of accountability to shareholders, formal responsibility to set strategic direction, external performance review of board members, and strengthening risk management, including transactions with related parties, through an internal audit mechanism or other structure. While the Czech law requires a two-tier board structure, recommendations were provided in the context of separate management and supervisory boards. However, the authors of the Pilot Assessment believe that the issues apply to all banks and can be dealt with in any governance structure.

As no internationally accepted set of principles and guidelines of best practice in governance of banking had existed before, the work in the Czech banking sector also involved testing of such principles of best practice. Public dissemination of the Assessment took place in Prague in January 2005. The Assessment elicited constructive responses. However, some serious objections were raised against some of the World Bank's recommendations which seemed not to correspond to the Czech environment and EU legislation. This refers, for example, to

the requirement for banks of all sizes to establish an Audit Committee (viewed as excessive due to the existing requirement in the CNB Provisions issued for banks that, in case of the nonexistence of an audit committee its duties have to be covered by the Supervisory Board of the bank), scope of information disclosure, etc. A number of recommendations were directed to institutions responsible for general arrangements for corporate rules other than the CNB. Based on the view that a number of final recommendations and assessments were not relevant in the Czech context and due to the fact that some of the proposed measures had already been launched or implemented prior to the assessment under review, the CNB ultimately did not approve its publication.

#### ***b) Pilot Assessment of Governance of the Insurance Sector***

Insurance has been a difficult area to pursue, not just in the Czech Republic but generally. There is no clear best-practice model for insurance supervision, and the insurance sector presents special problems in analysis because liabilities are generally opaque to outside observers, while, at the same time, very large cash flows are generated by some classes of insurance products, for example, compulsory auto insurance. These two factors allow a great deal of financial flexibility to managers in the insurance industry, which, without proper regulation/supervision, can lead to problems.

In the Czech context, work began on the insurance sector in *Capital Market Review*. However, detailed work at that time had not been possible, and some aspects of the sector had been difficult to penetrate. Subsequently, the insurance sector was then to have been covered at the same time as the FSAP, but adequate information could not be accessed from Czech counterparts and market participants. It should be noted that the Insurance Sector Supervisory Agent was initially somewhat reluctant to work with the World Bank, but with continued dialogue and an increasing awareness of the rationale for the work program came to support the further work. An OECD review suggested that improvements in governance of the insurance sector were important. A template was developed from the banking supervision template, but this needed substantial modification.

Work on the Pilot Assessment of Governance in the Insurance Sector began in 2003 but because of these difficulties could not be pursued expeditiously. Cooperation improved over time so that work on the Assessment was restarted in earnest in 2004/2005, and the pilot Assessment was published in draft in October 2005. It sought to develop a trial set of benchmarks for assessing the governance of insurance sectors, and to conduct a trial assessment of the Czech insurance governance framework against these benchmarks. The report noted three main issues: (a) the potential for related party transactions to exceed prudent levels combined with the incomplete implementation of EU Directives relating to conglomerates; (b) the vastly inadequate functions of Supervisory Boards in the governance of major insurance companies, and (c) the non-separation of life and non-life insurance businesses combined with the bankruptcy system which has in the past lent itself to misallocation of earmarked assets. The pilot assessment explores each of these issues in some depth.<sup>15</sup>

In October 2005, the Pilot Assessment of Governance in the Insurance Sector was publicly discussed in a seminar in Prague.

There are already plans to strengthen the insurance supervision system. Extensive personnel changes took place in early 2005. In April 2006, insurance supervision will move, together with the supervision of pension funds and collective investment funds, to the CNB. Supervision over all financial sector segments will be integrated.

This is a clear example of work on ROSCs and similar assessments which was of benefit to the World Bank. A new template had to be developed for this pilot assessment and worked through in some detail with counterparts in the Czech Republic. The resulting template is much improved and will be useful in pursuing work, and perhaps further modifications, in other countries.

#### ***c) Pilot Assessment of Governance of the Collective Investment Fund Sector***

There has been substantial progress in reforming mutual funds. However, a key issue remains in that further reforms are needed to separate the assets of the managers from the assets of beneficiaries.

<sup>15</sup> See comments on insurance in Accounting and Auditing ROSC.

The assessment of governance of the collective investment fund sector in the Czech Republic was the first use of this instrument in any country. As no internationally accepted principles of best practice for governance in the collective investment fund sector had existed before, the pilot work also included a development of such a set of draft principles and guidelines.

The assessment outcomes were discussed and disseminated in the form of a public seminar in Prague in November 2004 and was published as a volume of the red-cover series of ESW on the Czech Republic.

The pilot assessment pointed to six problem areas which needed to be addressed in this sector:

- 1) There are potential conflicts of interest between fund managers, depositors and shareholders of investment funds, particularly if the depository and the fund management company are components of the same financial group.
- 2) The quality of oversight over fund managers by Supervisory Boards needs to be strengthened.
- 3) State-of-the-art comprehensive risk management systems and internal controls need to be introduced.
- 4) Stronger regulation and sanctions in the case of abuse are needed to protect the legitimate interests of owners of shares and holders of units in unit funds.
- 5) The mandate of the SEC needs to be extended to include consumer protection against abusive practices in marketing and selling collective investment products.
- 6) There is a need to prepare adequate laws and other aspects of the regulatory framework for Special Funds not treated by the existing capital market acts and secondary regulation before such funds begin operating in the Czech Republic.

**d) Pilot Assessment of Governance of the Pension Fund Sector, forthcoming**

Huge liabilities are being created as the deficit of the private pension funds is growing. The need for change is widely acknowledged (see material on pension reform above). Substantive work on this task began in October 2005 and results will be reported when available.

Work in this area raised an issue of coordination among World Bank staff between financial sector and social protection specialists. It is clear that there needs to be an overall task manager who coordinates inputs from both sets of specialists, and that the MOF needs to be kept fully informed of all initiatives, including those involving the MOLSA. See also comments under pension reform section above.

*Accounting and Auditing Report on the Observance of Standards and Codes*

The Czech Republic has made considerable progress in accounting and auditing (A&A), and all the requirements set out in the *Acquis Communautaire* were achieved. But A&A is a moving target, and, at the same time, the methodology is less clear than in some other sectors. The MOF has been motivated to improve A&A and there was a clear and committed counterpart. However, progress has been slowed by lack of staff, and there are difficulties in working with some of the commercial banks which may not see the benefits of proposed changes.

Following presentation of the ROSC, the Government adopted an action plan based on the ROSC recommendations, with a very reasonable set of priorities. However, implementation of the action plan depends on preparation of issues papers, which is where the lack of qualified staff has had an impact. Also, in this area, wording must be exact so the translation process takes a long time.

Despite these issues, the Czech Republic has benefited from World Bank assistance as the World Bank has been a good sounding board for improved A&A. Informal advice has been sought from the World Bank, on an ad hoc basis, and solutions are sought which do not involve drawn-out formal proceedings which might occur if the Czech Republic asked such questions of the EC. Of course, the EC has the final say on acceptability, but this informal advice by the World Bank enables reforms to move more quickly in meeting EU standards with obvious benefits to all Czech enterprises in addition to the accounting profession itself.

Being at the right (highly) technical level, the A&A ROSC was very useful in serving as the

motivation for many reforms. MOF prepared and coordinated activities and was an effective and efficient counterpart. The ROSC also promoted the implementation of EU Directives. Financial statements and annual reports are now much more accessible, and the MOF makes them available electronically.

The World Bank has benefited from its work on A&A in the Czech Republic in terms of methodology and practice in the EU context. Such work has been useful in laying the groundwork for A&A reforms in Southeast Europe and for the Global Development Learning Network.

There are, however, several outstanding issues. For example, the International Accounting Standards (IAS) on insurance was only issued a year ago, and international standards are not yet an adequate benchmark in insurance. There is also low demand by banks for enterprise financial statements because, despite recent improvements such as a required annex on tax and social contribution arrears, the perceived quality is low. An EU Directive to create a public body to supervise the auditing industry remains to be implemented. There is a need for a better definition of a public interest entity and duties of these entities. Finally, information about IAS needs to be more widely dispersed. By default, this now resides in MOF but the function could reside in a professional association or institution of higher learning.

*Insolvency and Creditor Rights Systems (Report on the Observance of Standards and Codes) and Insolvency and Creditor Rights Policy Note*

The need for reform in this area has been evident for some time. For example, 25 amendments to the Bankruptcy Code were introduced from 1991-2005; but these were not very satisfactory. While the Resolution Corporation handled a few of the largest exposures, the judicial mechanisms which were used to deal with smaller cases were not effective. *Completing the Transformation of Banks and Enterprises* had offered a number of suggestions; but few of its recommendations on insolvency were implemented. Rather, the Government had spent large sums of money recapitalizing enterprises/banks before privatization, which ran directly against

the World Bank's recommendations. In the wake of the Czech Republic's 1998 financial sector crisis, the Government continued to pursue recapitalization often through non transparent work-outs.

In early 2000, the World Bank and IMF discussed with the Czech authorities the content of their forthcoming FSAP and ROSC pilot exercise. By then, the World Bank's work on developing global, internationally accepted principles and guidelines of best practice in insolvency and creditor rights protection and on methodology of the corresponding ROSC, was close to the piloting stage and Czech authorities opted for testing the Insolvency and Creditor Rights ROSC as part of the FSAP. It was the very first application of this tool worldwide and much effort, during the Czech pilot, went into developing it.

As work proceeded on *Completing the Transition* and the FSAP/ROSC reports, the intention was for insolvency reform to move ahead at the same pace as the banking sector reforms. The World Bank offered suggestions of modifications to the Bankruptcy Act which were not accepted (such as a 30 percent carve-out). Other issues needed to be addressed. Tax obligations could be onerous with bankruptcy, with the requirement to pay taxes on the write-off. The Court system for bankruptcy proceedings was (and is) normally very slow (although it can move quickly on occasion). Major creditors nominate trustees, who can arrange for sale of assets to another insider.

EC guidance on bankruptcy for within country cases is not strong. There are no EC directives concerning corporate insolvency (and only a few for insurance). However, there are regulations on cross-border insolvencies for a company with assets in two or more countries, and the Czech Republic will need to adopt laws to become consistent with these.

In this context, there has been wide support for the World Bank's work, with the exception of some judges and those profiting from the inside deals that the current system protects. Because of the influence of these forces, cooperation has been intermittent on the Czech side. In the Fall of 2001, a Task Force started to produce a reform

program. The World Bank formally reviewed principles of the reform and found them broadly consistent with the internationally accepted principles and guidelines of insolvency and creditor rights protection. The formal Work Program between Czech authorities and the World Bank assumed that the World Bank would also review the draft law but the authorities never forwarded anything for the World Bank to review, and did not inform the relevant World Bank staff of Task Force meetings. At one point the EBRD was asked to advise, presumably under pressure to seek outside input; however this was not an area in which EBRD had the requisite expertise. This was also a constraint on the World Bank side as the World Bank's leading expert was continually in demand for other tasks, so that the policy note which the World Bank had promised in 2002 was only delivered in 2004.

This note was intended to assist the authorities in their efforts to develop a new insolvency law. The note gives a description of the legal framework for insolvency, and notes that some of the 17 amendments to the Bankruptcy Law have been helpful but many others have not. It goes on to note that the Czech Insolvency Law is not too dissimilar from such laws in other EU8, but that all of these fall short of Insolvency Law in the EU15 and the United States. A weak institutional framework for insolvency results in excessive administrative costs and other inefficiencies. Other requisites for improvement are capacity building in the courts, a regulatory system to monitor the actions of administrators, and an expedited system of reaching out of court settlements.

Despite this checkered history, the motivation for further reforms remains strong. The Czech Republic has not scored particularly well in the global "Doing Business" survey with creditor rights as one of the lagging areas. While the earlier World Bank work, up to the FSAP/ICR ROSC, led to major changes in the regulation for listed companies, these comprise only six major enterprises, while business practices have not really changed for the vast number of unlisted companies. Consequently, the Government (under the leadership of Deputy Prime Minister Martin Jahn) completed work on a new draft law in August 2005. The main features of the draft

Czech law is a significant reduction of the scope for the abuse of power by courts and court-appointed bankruptcy trustees, strengthening of creditor rights, streamlining the process of bankruptcy and enhancing the potential of preserving a company as a going concern. The draft law would also introduce the institution of personal bankruptcy; thus, the draft law which would constitute a major step forward. The Government essentially reached an agreement to merge the two Insolvency Law drafts and the merged draft has been successfully shepherded through the first reading in the Czech Parliament.

### *Assessment of the Framework for Resolution of Insolvency of Banks*

This work was pursued as part of the Pilot Project on Global Bank Insolvency Initiative. The World Bank was invited to work on this subject although similar expertise could have been obtained from the EU. However, the informal, collaborative exchanges possible with the World Bank made it easier to get a neutral evaluation of problems and correct them, rather than pursue the more formal procedure with the EU.

On the occasion of preparation of the transposition of the EC Directive on Supplementary Supervision over Financial Conglomerates, which came into effect in September 2005, the CNB initiated several important changes in the Bankruptcy Act and the Banking Act. The main aim of these changes was to unify the Czech legal framework for resolving problem banks with the EU legal framework. For example, under the pre-existing legal framework, general bankruptcy laws applied to banks. In contrast, the new provisions establish the right of the CNB to submit a proposal for a bank's bankruptcy and specify that withdrawal of a bank's license by CNB is the key for any bankruptcy proceedings for banks.

The World Bank has effectively assisted the Czech Republic in preparing to meet EU standards in this field. The next step will be for supervisors from the CNB to work with EU supervisors in the future to ensure appropriate levels of expertise. The World Bank's work is now almost finished, and has led to a good model for other countries to follow.

### *Pilot Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) ROSC*

While not formally part of the IFA, the AML/CFT ROSC is related to the IFA diagnostics and provides a deeper insight into several issues treated in the FSAP and previous ROSCs. The Czech authorities volunteered for a pilot assessment which was conducted in parallel and closely coordinated with the ROSC on Accounting and Auditing as well as with the first stage of the Pilot Assessment of Insurance. The work of all three teams was closely coordinated, which allowed the teams to use synergies, exchange information, and, in areas of perceived vulnerabilities, go more in depth than would have otherwise been possible.

This ROSC notes that much of the Czech program is well run with high standards<sup>16</sup> with the notable exception of the insurance sector which could allow for considerable leakage. The Financial Analysis Unit (FAU) of the MOF welcomes outside evaluations as a basis for improvement, and FAU is eager to collaborate with external agencies. In addition to the ROSC, the Czech Republic and the FAU had been evaluated two years ago by Moneyval, the Financial Action Task Force (FATF)-Style Regional Body established by the Council of Europe. However, the IMF/World Bank evaluation was the basis for FAU's recent evaluation and proved extremely valuable in creating a common perspective among local and external partners. IMF/World Bank assistance came at the right time, while FAU was drafting its amendments for reform, and, more than just harmonizing with the second EU Directive, it enabled the Czech Republic to move ahead of the second Directive and to partly harmonize known elements of the forthcoming third EU Directive.

Although FAU is the centerpiece of the Czech effort, it is just one part of the whole system which the IMF/World Bank ROSC covered. Against this generally well-run program, the IMF/World Bank assessment noted that the FAU needed improved staffing to fully carry out its functions. In response, the FAU sought increases in staffing but these were limited by budget constraints. As an alternative, the FAU in its legislative amendment passed on to regulating

agencies supervision authority in their fields (for example, the CNB in its regulatory role in banking, SEC in its then-regulatory role for securities, etc.) FAU then receives reports from these agencies and exercises quality control in reviewing this reporting. This enables a 100 percent exchange of information between FAU and CNB and other supervisory agencies, based on signed agreements, rather than the partial exchanges of the prior system. Full information is also exchanged when preparing for an audit, and FAU retains the right to audit particular cases if it feels the need. Activities in the following sectors are not governed by a regulator, so audits are done by FAU: real estate, legal professions, auditors, accountants, business consultants, currency exchange vendors and some other non-regulated activities. Note that the insurance sector is covered by the insurance supervisor which currently resides in the MOF but which will become a part of an integrated regulator in 2006.

The pilot ROSC also recommended more training for staff of other agencies working with the FAU, but FAU has only limited staff and can not allocate them to more external training. As an alternative, FAU disperses information to regulating agencies through websites and written material (two books have been published with such information). Collaborating agencies have also moved in this direction, and the CNB has drafted and published a full set of measures, while the SEC has also published a comprehensive set of guidelines.

Despite these staff shortages, the Czech Republic's FAU could help out on an exceptional basis with training FAU units in countries to the East which speak Russian. This would assist the work of FAU for the Czech Republic since upgrades in such countries would aid work in the Czech Republic through harmonization of systems.

Finally, the Sanctions Bill has been reformed in line with the ROSC's recommendations. There used to be government to government exchanges on sanctions, but as a result of the reforms, FAU now corresponds directly with FAUs in other countries, which speeds up and enhances exchanges.

<sup>16</sup> The Director of FAU is on the World Bank/IMF roster for AML/CFT work.

## CONSUMER PROTECTION AND OTHER FINANCIAL SECTOR WORK

The World Bank has begun working on “*How to Strengthen Consumer Protection in Financial Services*” with a first mission in the Spring of 2005, a second one in October 2005. The study was requested by the Czech MOF which has been proactive in the area of financial services regulation, including consumer protection, with a separate department established in the Ministry for this purpose. While improved institutional arrangements have been introduced concerning credit card fraud in line with EU accession requirements, other areas such as bank fees and disclosure of information to retail clients were not regulated. Further, an assessment was deemed desirable for areas such as the wholesale and retail sale of financial instruments of insurance and pension funds, and a range of other subjects. The work is expected to be completed in early Spring 2006 and disseminated in the Czech Republic, under the aegis of the MOF, in April 2006. Finally, more work is also needed in the area of bankruptcy of financial institutions.

## ASSESSMENT AND OUTCOME OF THE THIRD WORK PROGRAM CLUSTER

The Czech FSAP, ROSCs, and ROSC-style-assessments-in-progress have been the first and so far the only complete set of IFA diagnostics. While it was extremely capacity intensive for the Czech authorities, the pilot allowed for checking of consistencies, synergies, complementarities, and redundancies across the components of the IFA diagnostics. It also provided insights and inspiration in terms of sequencing of the segments, mutual linkages and procedural issues. A separate World Bank assessment of the effects of this important undertaking is currently underway and should be available shortly.

The FSAP and ROSC program have been completely demand driven, in terms of the Czech participation, the timing, the scope, the sequencing, and the utilization of results. The World Bank has made every effort to accommodate requests, given the high priority the Czech authorities gave to this work and the knowledge that well-qualified Czech counterpart staff would be available to work with World Bank

experts. Dissemination has been excellent, with translations into Czech, public seminars, press conferences, and good media coverage. The CNB and MOF have made good use of the results of the program. A number of laws and CNB/MOF practices have been reformed and improved. As with any such broad and diverse program, implementation could be strengthened in some areas, as discussed below.

The top management of the CNB has confirmed that the FSAP/ROSC process has been satisfactory. The payoff for the Czech Republic has been a significant amount of staff skills upgrading with increased competency in key areas of the IFA. The CNB also views that the program has strengthened the mutual interests and relationships between the CNB and World Bank. The World Bank was viewed as an independent outside standard of evaluation and source of recommendations, which helped formulate and move reforms.

Having benefited from this close relationship in recent years, CNB management now feels that there is a need to be more selective so that the major impetus for reforms is well grounded in the national capacity that has been built up during the FSAP/ROSC program. The reforms associated with the program have also increased the work load of key CNB and MOF staff resulting in higher opportunity costs to interacting with visiting financial sector teams. (It goes without saying that such teams should be very well managed to minimize the drain on CNB staff capacity.) Finally, CNB is moving towards even closer relations with the EU and European Central Bank (ECB).

## SUMMARY

In sum, from the World Bank perspective, the Czech Republic was an ideal country for early work on the FSAP and the ROSCs because of the substantial professional capacity in the CNB and MOF. Thus, as World Bank/Fund staff developed templates, new approaches, and technologies, they could be field-tested and collaboratively evaluated with knowledgeable counterparts in the Czech Republic. Given the strongly collaborative nature of this effort, there has been a valuable payoff from this work for the World Bank.

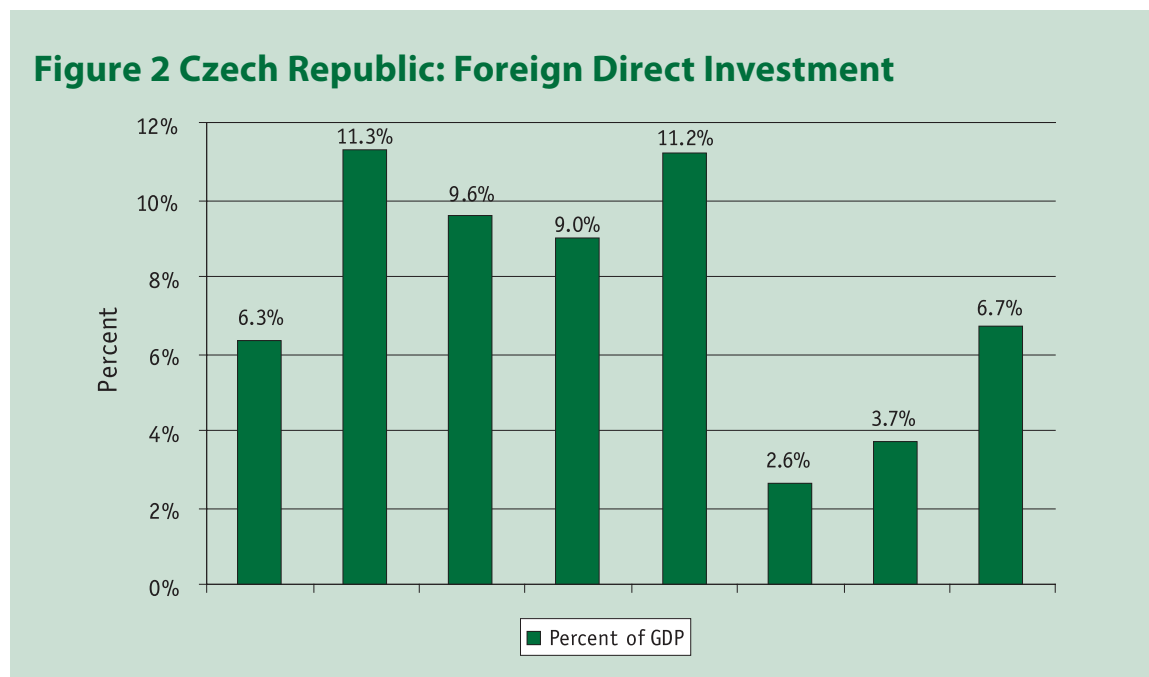
The Czech Republic is regarded as (close to) best practice in the implementation of ROSCs, and it has been a real benefit to have an EU member state in this position to guide other countries both in ECA and globally. The knowledge gained through the ROSC program has become an important component in the overall Middle Income Country agenda.

#### IV. PERSPECTIVES ON DEVELOPMENT RESULTS OF THE WORK PROGRAM

This section gives a brief overview of some of the important achievements of the Czech Republic during the last seven years. It notes the parts of the work program discussed above which addressed issues relevant to such achievements. However, it is not possible to draw direct inferences or identify strong linkages between the implementation of the work program and such progress. Many other factors intervened. For example, the Czech Republic achieved major gains through the EU accession process and subsequent membership in the EU, and parts of the World Bank program facilitated these, but it is not possible to separate out the impact of the World Bank program from

these other factors, nor would it be especially useful to try to do so. Rather, this section is intended to show the extent to which the World Bank program was on target in addressing key issues and the extent to which reasonable suggestions were made.

As implied above, the World Bank is only one partner in this process in which the Czech Republic itself plays the central and major role. The World Bank contributed selectively. The first cluster of the World Bank's analytical and advisory program improved the clarity of the issues facing the Czech Republic, including the faulty privatization program, the large fiscal deficits, and began to outline key structural issues. The main components of this work program, including the *Capital Markets Review* and *Completing the Transformation* outlined costs and suggested measures for correcting past mistakes and moving the economy back to a growth path. The second cluster began looking ahead and suggested structural and fiscal reforms needed to sustain a solid growth path, including reforms needed for EU Accession and to attract FDI. The third cluster identified particular topics associated with the IFA which need to be pursued in order to ensure financial sector resilience of the highly open Czech economy.



Source: IMF

Note: The Czech MOF estimates that FDI reached 7.5 percent of GDP in 2005.

**Table 1 Banking Sector Basic Financial Soundness Indicators, 2001-2004**

	2001	2002	2003	2004
Regulatory capital to risk-weighted assets (in percent)	15.4	14.3	14.5	12.6
Classified credits (in percent of total credits)	20.8	15.8	11.2	10.8
Nonperforming loans (in percent of total loans)	13.4	8.1	4.9	4.1
Liquid assets (in percent of total assets)	20.8	32.5	35.9	32.8
After-tax return on average assets (in percent)	0.7	1.2	1.2	1.3

Source: IMF Article IV 2005 Consultation – Staff Report.

### RECENT ECONOMIC PERFORMANCE<sup>17</sup>

GDP growth has been strengthening from about 1 percent in 2002, to 3.2 percent in 2004, 4.7 percent in 2004, and almost 5 percent in 2005. During that time, investment has been increasing and industrial production has been strong. Consumer confidence has been improving, especially in 2005. The unemployment rate is in the 7-8 percent range, lower than most European comparators.

The balance of payments position has recently strengthened. The current account deficit decreased from 6.3 percent of GDP in 2003 to 5.2 percent of GDP in 2004. Exports of good and services grew in nominal terms by an astonishing 24 percent in 2004, and 8 percent in 2005 compared to a 7 percent increase in 2003, based on large increases in machinery and transport equipment exports, largely to the EU15 countries. Gross FDI increased from 2.3 percent of GDP to 4.1 percent of GDP from 2003 to 2004, and net FDI increased from 2.1 percent to 3.6 percent of GDP in those years. Net FDI as a percentage of GDP is higher than any country in EU8 except for Latvia and Estonia. The fiscal deficit declined to almost 3 percent of GDP in 2004 and 2005, and public debt has been stabilized at around 37 percent of GDP.<sup>18</sup>

Following the most recent IMF Article IV consultations, the IMF noted that the past two years have seen an acceleration of GDP growth with low inflation. Investment surged last year,

with strong corporate profitability. A record-breaking expansion of exports substantially narrowed the trade deficit, and the fiscal picture improved.

### STRUCTURAL POLICIES

Yet, to sustain this economic performance, the Czech authorities and observers agree that structural reforms are needed, especially in public sector management. Many of these come with large built-in transitional costs. Among these, the pension system and health care will require additional reform. Improved budgeting and expenditure management through implementation of a treasury system could lead to significant savings. A consistent set of deficit definitions is needed to avoid confusing the public.

In the financial sector, banks are becoming stronger as a result of reforms, restructuring and the salutary role of foreign partners. The share of nonperforming loans continued to decline in 2004 while capital ratios remained adequate and profitability increased. In general, the basic financial soundness indicators have improved, in some cases dramatically.

Concerning private sector development, the Czech Republic is about average for the EU8 in terms of the indicators used by the World Bank's *Doing Business* survey. It lags seriously only in the area of closing a business, for which it takes an average of 9.2 years, compared to the EU8 average of 3.3 years, and the EU14 average of

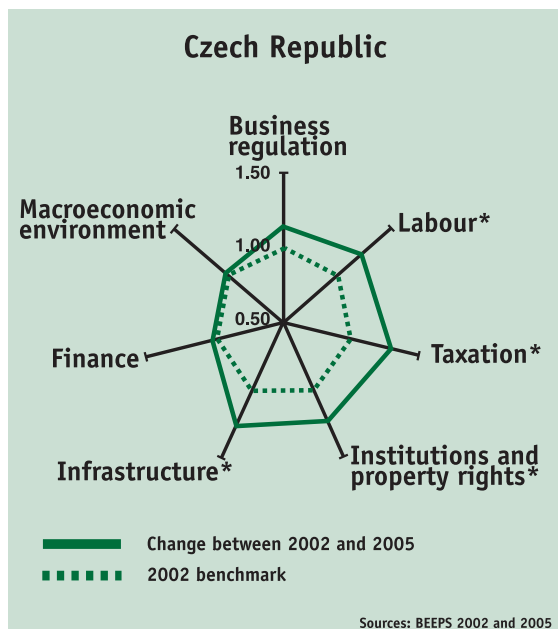
<sup>17</sup> The EU8 Quarterly Economic Reports are a useful source of current information on the EU8 countries including the Czech Republic. See <http://Inweb18.worldbank.org/ECA/eca.nsf/0/02502ABF40FC4CBA85256E7D0054A94A?OpenDocument>

<sup>18</sup> Czech MOF data, in ESA methodology

1.5 years. This may well be related to the less effective framework for bankruptcy in the Czech Republic and to delays in bankruptcy reform noted earlier.<sup>19</sup>

Concerning corporate governance, the EBRD Transition Indicator Scores for 2005 give the Czech Republic a rating of 3+, marginally below the highest rated countries of Estonia, Hungary, Poland, and the Slovak Republic, but higher than Lithuania, Latvia, and Slovenia, among other countries. The rating of 3+ for the Czech Republic in 2005 also compares favorably with a rating of 2 for the Czech Republic in 1996, and a rating for 3 for 1997-1999. However, the rating of 3+ was already achieved in 2000. This indicates the need for a stronger focus on implementation to gain the benefits of the cooperative analytical work which has been done as discussed above.

**Figure 3 Changes in the business enrolment, 2002-2005**



Source: EBRD Transition Report 2005, p. 20.

Concerning labor, it is clear that additional reforms would be beneficial to increase labor mobility, without which the country's ability to adjust to external shocks and changes in relative prices will remain unduly constrained with larger than desirable losses in output as and when such shocks occur.

<sup>19</sup> See World Bank: *Doing Business 2006* and as reported in the World Bank's EU8 Quarterly Economic Report, October 2005. *Doing Business* refers to the EU14 rather than the EU15 since data for Luxembourg is not available.

The economic overview presented above confirms that the Czech Republic has taken adequate steps to enjoy a much more robust GDP growth scenario with healthy domestic and foreign business investment, improving employment, reasonably strong balance of payments, and a fiscal stance which positions the country to meet its convergence targets.

At the same time, it is also clear that more needs to be done in key areas such as pensions and health sector reforms to more solidly lock in these gains.

## V. OVERALL QUALITY OF THE WORLD BANK'S ASSISTANCE PROGRAM

This section is a brief assessment of the quality of the Assistance program using the same methodology as used by the World Bank's QAG.

### SCOPE AND STRATEGIC RELEVANCE

While the overall objectives of the assistance program have not been set out in formal documentation which would allow for an assessment of the clarity of its objectives, it is apparent from the above the scope of assistance has been fully appropriate with high relevance to country circumstances. It is now increasingly recognized that the assistance program (and particularly the AAA program) for Middle and Upper Income Countries (MICs) needs to be responsive to country demands and circumstances and is not necessarily amenable to multi-year programming in the CAS mold. The relevance and success of the Czech program has been influential in this regard. In this context it is important that there has been a well-defined audience for each part of the assistance program.

### INTERNAL QUALITY

The components of the assistance program had well-defined issues, sound analysis, appropriate use of empirical evidence, logical progression from analysis to conclusions and recommendations. A number of the components received QAG ratings of "best practice" and "highly satisfactory."

## DIALOGUE AND DISSEMINATION

Communication and participation and the tasks' contribution to the policy dialogue, has been very high. Client participation has been extensive. Dissemination has been extensive with publication of most of the key reports in the Czech language and in the media. Workshops and seminars at formative and final stages of major outputs have figured prominently in the program. A major focus of the FSAP and ROSC program has been on building capacity. Finally, one should note that the Czech authorities have assumed the major responsibility for this aspect of the program in line with the partnership approach.

## COHERENCE AND INTEGRATION

Each of the three clusters of the assistance program has had a strong coherence and the components have been part of an integrated work program.

## WORLD BANK INPUTS AND PROCESSES

**Adequacy of AAA funding and efficiency of resource use.** The Czech program benefited from the willingness of World Bank management to support a non-lending program at relatively high resource levels at least in the initial years.<sup>20</sup> This was linked in part to the interest of the World Bank in ensuring that it played a constructive and active role in a successful accession to the EU and that it demonstrated the success of the transition process with which the World Bank had been so closely associated.

**Skills mix of task teams and effectiveness of the country team in design and implementation of the analytical and advisory program.** The first cluster of the program benefited from the proximity of both country and sector staff familiar with issues affecting the financial sector in transition economies since this staff was located in the World Bank office in Budapest. This facilitated assembling a strong team for the initial work on capital markets. This set the standard for the subsequent work program and created strong interest in the program among World Bank staff which has been sustained throughout. The strong interest and involvement from the Czech representative to the World Bank

Board of Directors also contributed to attracting high quality staff especially from outside the Region.

**Managerial attention to the quality of the program both at entry and during implementation.** The decentralization of the Country Director to Budapest in late 1997 certainly facilitated the ability of the World Bank to respond quickly and appropriately when opportunities arose, beginning with the change in government in late 1997. Regional management grew to see the Czech Republic as a test case for demonstrating the World Bank's relevance to an upper MIC in a non-lending context. Although the initial arrangements between the World Bank and Government were more opportunistic than planned, the eventual pattern of an annual exchange of letters confirming the program and more or less continuous monitoring of the program shared by both the Government and the World Bank's country unit proved a robust and dependable arrangement.

As the program evolved toward a partnership especially with the FSAP/ROSC cluster, the traditional ratings of the World Bank Quality Assurance Group seem inadequate to capture the capacity building nature of the ROSC/Assessment work program for World Bank staff and Czech counterparts alike. An assessment of benefits to the World Bank should be an additional component of such ratings for this kind of program.

## VI. REMAINING CHALLENGES

The above discussion covered a number of areas in which further work might be desirable. In addition, there may be value in pursuing work on topics not yet addressed. While the observations here are based on an assessment of the results achieved thus far, it is clear that future work will be increasingly limited given the graduation of the Czech Republic and that whatever work is undertaken will be done at the request of the Czech authorities. Therefore, as would be expected for a country in the position of the Czech Republic, this list is primarily a suggested agenda for the authorities of the Czech Republic in the first instance.

<sup>20</sup> For FY00-04, actual Bank Budget expenditures on the work program for the Czech Republic were larger than for a number of other non-borrowing upper middle income countries, and, on a per capita basis, twice the expenditure level for Korea.

## A. FISCAL ISSUES

### *Pension Reform and Health Care Reform*

While the fiscal targets of the convergence program can be met with discretionary expenditure cuts, after the Czech Republic joins ERM II, pension and health care costs will continue to rise and threaten fiscal stability, providing a rationale for continued activity in these areas as part of the World Bank's limited post-graduation program. Work on health care reform has started but much more could be done in terms of working out a program with the Czech Republic. In contrast, a great deal of work has been done on pension reform, and the key steps are now to be taken at the political level in the Czech Republic. However, at some point, it might be useful to draw on the "convening power" of the World Bank to crystallize action on pension reform. An important additional area for further work could be assistance to implement the reforms in pension fund management, the need for which was analyzed under the ROSC program.

### *PPPs*

Further work on PPPs might indeed be useful as the Czech Republic obtains some implementation experience from its ongoing pilot program.

### *Asset/Liability Management*

A needs assessment is in progress looking at debt management, the management of contingent liabilities, and in general a broad approach to debt management including domestic market development. Should a separate Debt Management Unit be set up, or should it be kept in the MOF? Should diversification efforts be maintained or changed? Derivatives such as swaps are used, are they appropriately managed? Should the debt recording system be strengthened?

### *A Treasury System*

There is as yet no Treasury system despite the IDF grant (see discussion above). Since a Treasury system is seen as increasing the power of the MOF and reducing the power of the line ministries, there is substantial opposition to the introduction of a treasury system.

### *Regional Development*

Recommendations from *Intergovernmental Fiscal Relations in the Transition* remain to be implemented.

## B. INTERNATIONAL FINANCIAL ARCHITECTURE ISSUES

### *Insolvency*

As noted above, in the Summer of 2005, the Government approved a new draft bill on insolvency for firms. If this is not approved by the Parliament in the coming months, the Government might wish the World Bank to do more work in this area as a catalyst for re-engaging relevant stakeholders.

### *Integrated supervision*

Supervision issues have been addressed in a number of ROSCs and Assessments. An integrated supervision program could yield many benefits of improved efficiency and effectiveness. The Czech Republic decided to merge all parts of financial sector supervision as of April 1, 2006 (the respective legislative act was approved by the Chamber of Deputies and is to be discussed in the Senate). Experience from other countries indicates that such integration is demanding, and that it can take approximately three years to build institutions and capacity to meet the challenges of effective implementation of such a system. There may well be value in exploring whether World Bank assistance would be useful in this area.

### *Accounting and Auditing*

Implementation of the recommendations (see ROSC on accounting and auditing) needs further work and is, in fact, an ongoing program. However, in addition to the ongoing program and as work proceeds in implementing these recommendations, assistance on the impact of such reforms on the tax base on corporate revenues and the consequences of using IAS in accounting for the impact on the tax base should be explored and may require additional work.

### *Consumer Protection in the Financial Market*

As noted under “Other Financial Sector Work” in Chapter III, work on consumer protection began in 2005. This work should be completed since an improved framework for consumer protection would be an important aspect of a stronger market economy.

## **VII. OBSERVATIONS AND LESSONS**

### **EVOLVING PARTNERSHIP MODEL**

The relationship between the World Bank and the Czech Republic has clearly moved beyond assistance and has, in fact, been based on mutually advantageous cooperation, as would seem appropriate for a relationship with a country at the level of development of the Czech Republic. The World Bank should focus its work in the Czech Republic on technically challenging areas where both partners stand to gain in terms of developing new tools, diagnostics, and approaches, and where lessons learned can be useful to other countries. The World Bank should maximize the transmission of knowledge from its work on the Czech Republic, and should, to the extent practical, use staff rather than consultants who may not be readily available for follow-on work or work in similar countries.

There is a public goods component in this kind of partnership model, which has been brought out most clearly in the work on ROSCs and related assessments. There is a substantial burden in terms of staff time imposed on the Czech Republic in piloting assessments and other new tools which can only be developed and refined through intensive participation of highly qualified staff on the Czech side. Once these tools are developed, they are available to use on other countries which do not have to make the intensive investment in staff time already made by the Czech Republic. For example, in the area of financial sector governance, the work with the Czech Republic involved the development of a set of detailed criteria for evaluating the quality of governance in banking, insurance and collective investment funds. The approach used for the bank governance report in the Czech

Republic was further refined and used for other countries such as the Slovak Republic and FYR Macedonia. Similar assessments are now underway in Jordan and Indonesia. This aspect of the work has been recognized by the World Bank which has included IFA among its global public goods priorities; but, as applied to an individual country program, it needs to be made explicit at an early stage given the implications for funding when public goods are involved. And of course program evaluation needs to proceed from this perspective as well.

An important management aspect of the program has been the role played by the Czech representative to the World Bank Board of Directors during this period. While this relationship has always played an important role, World Bank staff had much more direct and frequent contact with Czech authorities during the initial stages of the work program, when work was ongoing for *Completing the Transition*, the CEM and PER. As the focus of the program became more narrowly concentrated in a few topics in which a small number of key staff largely in Washington were involved, the direct link to the Ministry of Finance provided by the Czech representative played an increasingly critical role in articulating client needs and feedback. It should be noted that the contribution of the Czech representative to the success of the partnership model depended also on the continuity provided during this period. In addition, such engagement with the country program and members of the country team goes beyond the terms of reference for staff of the Board of Directors.

As a result of the above, the program with the Czech Republic, certainly in the most recent phase and for the foreseeable future, is demand driven, albeit, cognizant of and responsive to the World Bank’s global priorities and institutional strengths, as it should be. Requests for work have been thought through and fully vetted with the responsible offices and agencies in order to align with Government priorities and absorptive capacity. Thus, the central role of the Czech MOF is key to the success of this partnership model.

There have been clear benefits to the World Bank in pursuing such a program even in the

absence of lending. This is strong reason to use budget resources to offset at least in part the cost of such operations. However, cost-sharing by the Czech Government has also been an important aspect. The willingness of the Czech authorities to bear a substantial portion of costs is confirmation of their interest in the program and at least a partial guarantee of relevance and follow-through.

## MODALITIES

The modalities now governing the program evolved from the high level discussions which occurred between the World Bank and the MOF semi-annually at the Spring and Annual Meetings. The Spring Meetings coincided with the World Bank's work programming cycle so that the discussions naturally focused on activities for the coming fiscal year. It was a logical step to follow up such discussions with a more formal exchange of letters which then became the basis for the program. Given the special nature of the program, flexibility has its advantages, so that letters rather than formal documents are a plus, as they can be, and were, modified during the course of the year in response to special situations.

## COMPARATORS

Work with the World Bank will only be regarded as useful as long as it is and is seen to be based on independent views which facilitate access to best practice. Whether this implies regional or global comparators depends on the kind of constraints seen to be important in the Czech Republic. As a first cut, it would appear useful to make available the best thinking on a subject, and then, if necessary, modify best thinking to a regional perspective if some regional linkages impose a binding constraint. Even where this occurs, it is probably always useful to have access to the first best solution and be aware of the constraints and costs associated with limiting comparators to only a regional basis. There will be cases, perhaps most cases, where regional alternatives make the most sense; but this is a decision which is best made with a full awareness of whether these are first best solutions or not. Furthermore, in many areas of interest to the Czech Republic, best practice on both a world

and regional basis is often a moving target, and the decision as to how best to orient reforms should take this into account. In this context it is important that World Bank staff engage in a full dialogue with Czech counterparts including explanations for not modifying recommendations based on Czech comments as applicable. This is of course a fundamental rule of any partnership-based relationship or capacity building exercise.

## FEATURES OF SUCCESSFUL COOPERATION

There are two factors which were present in each of the successful tasks outlined above. The first was the presence of a champion on the client side, a determined, knowledgeable agent of change who feels a commitment to reform and is able to exercise either formal or informal authority to pursue change. The second is the role of communication between the champion and the task manager embodying mutual respect.

## EVALUATIONS

Programs with the Czech Republic and similar countries will always have an experimental component. As such, it would make sense to evaluate them and to ensure that such evaluations are available to World Bank staff and client countries.

## ANNEX A

GEF (US\$)	Co-financing (US\$)	Total Project Cost (US\$)	Project	Achievement of Objectives
2.00	0.75	2.75	<p><b>Biodiversity Protection</b></p> <p>The key objective of this GEF pilot project is to seek innovative and replicable solutions to global environmental challenges. The project is to protect ecosystem biodiversity in three representative ecosystems (zones containing alpine meadows, lowland forests and wetlands), and to support the activity of three transnational biodiversity protection networks. It also introduces user fees and related charges for visitors and concessions in order to manage the areas in a financially sustainable manner and within their carrying capacity.</p>	Review not available
0.10	0	0.1	<p><b>Biodiversity Strategy, Action Plan, National Report to the Conference of the Parties</b></p> <p>Formulate strategies and actions necessary for the protection and sustainable use of the Czech Republic's biodiversity, as well as prepare a plan for their implementation. The primary product will be a BSAP. In addition, the Czech Republic's first national report will be prepared.</p>	Review not available.
2.3	1.85	4.15	<p><b>Phaseout of Ozone Depleting Substances</b></p> <p>The principal objective were to assist Czech Republic in phaseout of Ozone Depleting Substances (ODS) production and consumption in a cost-effective manner by 1996, as mandated by MP, and to: (a) initiate phase out of production of chlorofluorocarbons (CFCs); (b) phase in the operation of a national network for refrigerant recovery/reclamation/ recycling; and (c) support applied engineering efforts to use ODS substitutes in manufactured goods, thereby reducing immediate and future needs for regulated subjects.</p>	The objectives of the project were fully achieved. All ODS production and use of new CFCs was phase out through implementation of sub-projects and enactment of relevant legislation. On 1/1/96, a ban on ODS production and import was imposed in accordance with MP commitments. When project closed early 1998, <b>it was rated one of the first successfully completed ODS phaseout projects in the world.</b>
5.8	19.1	24.9	<p><b>Kyjev Waste Heat Utilization</b></p> <p>The project objective were to (a) demonstrate a gas-fired, combined-cycle cogeneration system in Czech Republic where this technology has not been widely used; (b) stimulate technological and institutional changes to promote energy efficiency through developing combined-cycle heat and power (CHP) systems for joint industrial and municipal purposes; (c) achieve local environmental benefits by reducing share of coal and lignite in fuel-mix for heat and power generation; and (d) demonstrate the possibility of cooperative efforts between the MoE and private sector in enhancing environmental benefits.</p>	The objective of the project, mainly to reduce GHG, was achieved. All project components were successfully erected and completed on time, and commissioned. Ratings for achievement: Institutional Dev. (H); Environmental (H); Physical (SU); Financial (M); Social - Private sector dev. (H); Public sector mgmt. (SU)

## ANNEX B

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