COMMISSION OF THE EUROPEAN COMMUNITIES

SEC(90) 2590 final

Brussels, 24 January 1991

Proposal for a

COUNCIL DECISION

providing medium-term financial assistance
for the Czech and Slovak Federal Republic

(presented by the Commission)

EXPLANATORY MEMORANDUM

The request for financial support

In a letter addressed to Vice-President Christophersen on October 18 the Minister of Finance of Czechoslovakia Mr. V. Klaus formulated a request for financial assistance from the G-24 and the Community to support the reform programme the government will implement starting January 1, 1991.

In response to this letter the Commission has convened several meetings to discuss the Czechoslovak request. Both the Group of 24 industrial countries, whose assistance is coordinated by the Commission, and the Council of Ministers of the European Community have endorsed the principle of providing assistance to the country in view of the difficult external situation it will be facing next year. There has also been a general recognition of the urgency of responding to the Czechoslovak request both in view of allowing the IMF to finalize its discussions with the authorities on a stand-by arrangement and in view of providing a strong signal to the Czechoslovak population in connection with the comprehensive wide-ranging reform effort.

The request as formulated in the letter of Finance Minister Klaus to Vice President Christophersen was for financial assistance to be used both for strengthening the reserve position in view of the move towards convertibility and for balance of payments support. Following consultations with the IMF, estimates of the financing gap -- including the need for reserve support -- to be covered by the G-24 and the Community now seem to converge around US $ 1 billion for 1991.

At the meeting of the European Council in Rome on December 15-16, the Heads of State and Government have agreed in principle on a Community initiative to meet the financing requirements for Central and Eastern European countries that are not covered by public or private contributions. As a first case of this initiative, the European Council has confirmed that, in the context of the G-24, the Community would support the programme undertaken by Czechoslovakia to stabilise its economy and to make its currency convertible. The Council of Ministers of Economic and Financial Affairs of December 17 has instructed the Commission to continue its negotiations with G-24 and other third countries on the basis of a mandate allowing the Community to provide up to 375 mecu of a 750 mecu financial assistance package to Czechoslovakia.

Some non-EEC G-24 members have already made firm pledges for substantial amounts; most others, while having revealed a positive attitude towards active participation in the support scheme, were not yet in a position to commit themselves, but will clarify their position within the weeks to come.

The Czechoslovak reform process

The basic principles in the Government's reform programme were endorsed by Parliament at the end of September. The main reforms include price liberalisation, liberalisation of foreign trade, internal convertibility of the Koruna, transformation of large state enterprises into joint stock companies and their subsequent privatisation, establishment of financial markets and tax reforms. Parliament has already approved a Restitution Act which allows small shops and production units to be given back to their original owners. An initial law on privatisation has been passed at the end of October, enabling some 70,000 former state-owned small businesses to be sold off by auction. Most other reform laws, including large-scale privatisation under the Transformation Law are expected to be enacted before the end of the month.

In principle, the price reform which is expected to take effect on January 1, will entail a complete liberalisation. During a transition period, however, the Government intends to regulate some key prices in view of "delaying" major price increases. Wage policies will be very restrictive by only allowing a partial adjustment of nominal wages to price rises. In addition, a tight stance of financial policies is planned to dampen inflationary pressures. In 1990, monetary policy was already non-accommodating and it is the intention in 1991 to accommodate only a small proportion of the overall price impact from price reform, the oil price increase and the devaluation. Fiscal policy is expected to be tightened substantially to produce a budget surplus in 1991 of about 1 percent of GDP, partly by a strong reduction in subsidies and military expenditure.

Special measures are also being considered to help contain the negative short-run impact on the balance of payments that may result from trade liberalisation and convertibility. The authorities have consulted GATT on the possibility of introducing an import surcharge for finished products of 10-20 percent for a pre-determined period. In addition, a system of import licences for consumer products may be maintained during a transition period.

<u>The need for additional financial support</u>

Czechoslovakia's external situation is expected to deteriorate substantially in 1991. In addition to the import needs associated with the process of structural adjustment, Czechoslovakia will be faced with the need to adjust to the collapse of the Comecon system and the shift to hard currency pricing and settlements. The decline will be reinforced by the general rise in world energy prices and by the additional costs associated with the shortfall in oil deliveries by the USSR. Nevertheless, Czechoslovakia anticipates that it will be able through a comprehensive set of domestic measures to contain the current account deficit to some 2.5 billion US $ in 1991. On the assumption that non-debt creating flows (mainly direct investment) will remain rather modest in the short run, and that 800 million $ of outstanding claims on the Soviet Union could be used as payment for oil and raw material imports, the overall balance to be financed will amount to US $ 1.7 billion. To this should be added a minimum build-up of foreign exchange reserves of US $ 1.6 billion which would raise the total amount of free currencies to an equivalent of somewhat less than 2 months of imports. This should be considered to be a minimum level in view of the envisaged move to convertibility of the Koruna, which will be introduced in an environment characterized by major uncertainties.

In order to support the reform process at this critical stage, the Czechoslovak authorities have requested financial assistance from the IMF, G-24 and the European Community. The country is finalizing its discussions with the Fund, which has indicated that a total amount of US $ 1.4 billion could be made available through access to Fund facilities.

This includes access to the oil element in the compensatory and contingency financing facility to the amount of some 80% plus access to a stand-by credit for 90% of Czechoslovakia's quota in the Fund. It is the understanding that most of the oil element would be disbursed up front whereas the stand-by would be provided in tranches, the first one early 1991 and a second later on during the year.

Under the assumption that the country can raise bank credits for an amount of some 600 million $, and that the World Bank would provide a Structural Adjustment Loan of 300 million US $, the remaining financing gap to be covered by G-24 sources would amount to some 1 billion US $.

The IMF has made clear that it would have to renegotiate the arrangements it is about to conclude with the Czechoslovakian authorities in case the G-24 does not provide the required financing. The Fund has also indicated that the additional degree of import compression that would be required to close the financing gap in the absence of such support could seriously jeopardize the achievement of the policy objectives underlying the government's reform effort.

Main features of the loan

Given the positive orientation by the European Council, the Commission is proposing that the Community would participate up to 375 mecu in a medium-term financial support programme package from the G-24 -- and possibly third countries -- to Czechoslovakia, the total amount of which would be ecu 750 million (approximately 1 billion US dollars).

The loan the Commission is envisaging will be closely linked to the IMF stand-by agreement and would be disbursed in two tranches, the first tranche being subject to approval of the stand-by agreement, the second one -- which is to be disbursed in the third or fourth quarter of the year -- subject to compliance with a number of performance criteria which are to be discussed with the Czechoslovak government and in close cooperation with the IMF. The loan would be reimbursed, as requested by the Czechoslovak government, during a four year period, starting in 1994.

The Community would provide the money through a market borrowing and lending programme on behalf of Czechoslovakia with a guarantee by the Community budget. The borrowing and lending operations will be matched.

Proposal for a
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providing medium-term financial assistance for the Czech and Slovak Federal Republic

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community, and in particular Article 235 thereof,

Having regard to the proposal from the Commission[1] submitted following consultations with the Monetary Committee,

Having regard to the opinion of the European Parliament[2],

Whereas the people of Czechoslovakia have close historic relationships with the people of the Community; whereas that country is undertaking fundamental political and economic reforms and has decided to adopt a market economy model;

Whereas the said reforms will strengthen mutual confidence and bring Czechoslovakia closer to the Community;

Whereas Czechoslovakia and the Community have entered into negotiations for the conclusion of Europe-Agreements establishing a relationship of association;

Whereas the European Council of 14 and 15 December 1990 confirmed that in the context of the Group of 24 industrial countries (G-24) the Community would support the programme undertaken by Czechoslovakia to stabilise and modernise its economy and to make its currency convertible;

Whereas this programme is expected to be implemented in a difficult external environment;

Whereas the Czechoslovak authorities have requested financial assistance from the International Monetary Fund (IMF), the G-24 and the European Community; whereas, over and above the estimated financing which could be provided by the IMF, the World Bank and official bilateral creditors, a financial gap of some 750 million ecu remains to be covered in order to prevent a further erosion of Czechoslovakia's reserve position and avoid an additional degree of import compression which could seriously jeopardise the achievement of the policy objectives underlying the government's reform effort;

Whereas the Commission as coordinator of assistance from the Group of 24 industrial countries has invited them and other third countries to provide medium-term financial assistance to Czechoslovakia;

1)
2)

Whereas the grant by the Community of a medium-term loan to Czechoslovakia is an appropriate measure to support the balance of payments of Czechoslovakia, to strengthen the country's reserve position and facilitate currency convertibility;

Whereas the Community loan should be managed by the Commission;

Whereas the Treaty does not provide, for the adoption of this Decision, powers other than those of Article 235,

HAS DECIDED AS FOLLOWS :

Article 1

1. The Community shall grant to Czechoslovakia a medium-term loan facility of a maximum amount of ecu 375 million in principal, with a maximum duration of seven years, with a view to ensuring a sustainable balance-of-payments situation, strengthening the reserve position and facilitating the introduction of currency convertibility.

2. To this end the Commission is empowered to borrow, on behalf of the Community, the necessary resources that will be placed at the disposal of Czechoslovakia in the form of a loan.

3. This loan will be managed by the Commission in full consultation with the Monetary Committee and in a manner consistent with any agreement reached between the IMF and Czechoslovakia.

Article 2

1. The Commission is empowered to negotiate with the Czechoslovak authorities, after consultation with the Monetary Committee, the terms and conditions of the loan. These terms and conditions shall be consistent with the agreement referred to in the third paragraph of Article 1 and with arrangements made by the G-24.

2. The Commission shall verify at regular intervals, in collaboration with the Monetary Committee and in close coordination with G-24 and the IMF, that the economic policy in Czechoslovakia is in accordance with the objectives of this loan and that its conditions are being fulfilled.

Article 3

1. The loan shall be made available to Czechoslovakia in two equal instalments. The first instalment shall be released as soon as a "stand-by arrangement" has been concluded between Czechoslovakia and the IMF and the second instalment after a period of at least two quarters.

2. The funds shall be paid to the National Bank of Czechoslovakia.

Article 4

1. The borrowing and lending operations referred to in Article 1 shall be carried out using the same value date and must not involve the Community in the transformation of maturities, in any exchange or interest-rate risk, or in any other commercial risk.

2. The Commission shall take the necessary steps, if Czechoslovakia so decides, to include in the loan conditions, and also to exercise, an early repayment clause.

3. At the request of Czechoslovakia, and where circumstances permit an improvement in the interest rate on the loans, the Commission may refinance all or part of its initial borrowings or restructure the corresponding financial conditions. Refinancing or restructuring operations shall be carried out in accordance with the conditions set out in paragraph 1 and shall not have the effect of extending the average duration of the borrowing concerned or increasing the amount, expressed at the current exchange rate, of capital outstanding at the date of the refinancing or restructuring.

4. All related costs incurred by the Community in concluding and carrying out the operation under this Decision shall be borne by Czechoslovakia.

5. The Monetary Committee shall be kept informed of developments in the operations referred to in paragraphs 2 and 3 at least once a year.

Article 5

The Commission shall address to the European Parliament and to the Council a report, which will include an evaluation, on the implementation of this Decision.

Done at Brussels,

For the Council
The President

FINANCIAL RECORD

1. Budget line concerned

Article (B0-213) loan guarantee for aid to Czechoslovakia (to be created through an amending and/or supplementary Budget).

2. References (legal base)

Article 235 of the Treaty

3. Classification of the Expenditure

Obligatory

4. Description and Justification for the action

a) Description of the action

Provision of a guarantee from the Community for a loan to Czechoslovakia in view of ensuring a sustainable balance-of-payments position and helping to introduce currency convertibility.

b) Justification for the action

- The G24 and the Council of the EEC have endorsed the principle of providing assistance in response to a request from Czechoslovakia.

- The budget entry is intended to provide a budgetary support for guarantee offered by the European Community to cover a loan extended to Czechoslovakia.

5. Nature of the expenditure and method of calculation

a) Nature of the expenditure

A guarantee to a loan to Czechoslovakia.

b) Method of calculation

A token entry is proposed given that the amount and timing of any call on this budget line cannot be calculated in advance and because it is expected that this budget guarantee will not be called.

6. Effect of the action on intervention credits

Only in the case of an effective call on the guarantee.