DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR THE

CZECH REPUBLIC

As approved by the Board of Directors on 30 September 2003

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EXECUTIVE SUMMARY

The Czech Republic continues to meet the conditions specified in Article 1 of the Agreement Establishing the Bank. The Czech Republic has made considerable progress in transition with 80% of economic activity in private hands, a large degree of price liberalisation, an open foreign trade regime and no major constraints to foreign investment.
The macroeconomic environment remains overall favourable. GDP growth is good despite the weak economic performance of the major export markets in the EU. Interest rates are below the EU level, boosting consumption and investment and reducing cost of funding the fiscal deficit. In 2002, FDI of US$ 9 billion was the highest of all countries in Central and Eastern Europe. On the negative side, the general government deficit has increased in recent years and is forecast to remain above 5% of GDP in the medium term. The unemployment rate is around 10% and is expected to remain a long-term problem.

The Czech authorities are conscious that a number of reforms are needed to further enhance the competitiveness of the country and to manage and control the increasing budget deficit. Looking forward, a number of key challenges should be addressed:

- Improvement of the business climate (increase of effectiveness of judicial enforcement; granting of licences and permits; granting of residence permits for foreigners, improvement of the bankruptcy code; improvement of the laws on taking security).

- Increased transparency in awarding public contracts, including at municipal level, and in the privatisation process to create an environment in which corruption is fought effectively.

- Fiscal reform in order to maintain fiscal stability in the long term and ensure efficient provision of public services. The government needs to focus on shortcomings of the pension system and inefficiencies in the health care and the social safety net.

- Privatisation of the remaining state-owned companies such as Czech Telecom, Unipetrol and CEZ.

- The government, as well as regional and municipal bodies, will need to consider multiple ways to prepare projects and mobilise co-financing in order to make an efficient use of the EU Cohesion and Structural Funds.

- Local SMEs should get more attention in terms of financial instruments available to them and improvement of the environment they operate in.

As of 30 June 2003 the Bank had committed EUR 873 million in 42 direct and 32 regional projects which helped to attract additional EUR 3 billion from sponsors and co-financiers. The Bank can continue to play an important role over the strategy period by focusing selectively on areas where it is additional.

In order to help ensure that the Czech Republic remains at the cutting edge of the transition process and in recognition of the key challenges outlined above, the Bank's activities will be based on the following operational objectives:

- **Financial Sector**
  The Bank will work closely with local banks and various sponsors to develop the range of financial products which are not currently well supplied to the economy such as equity, mezzanine funding and a broader range of SME finance. The Bank will also support further the development of non-banking financial institutions such as leasing companies, pension funds and asset management companies. In particular, it will support a second generation of equity funds (small equity) as well as turnaround funds, the presence of which is particularly needed.

- **Enterprise Sector**
  The Bank will support the privatisation of the last few remaining state assets, such as Czech Telecom. The Bank will actively support the restructuring, consolidation, and possibly, regional expansion of the local private sector through the direct or indirect provision of equity and quasi equity in order to increase the capital base of the Czech economy. The Bank will support foreign direct investment, focusing on (a) green-field and brown-field projects in the regions of higher unemployment; (b) smaller foreign investors who may have limited experience in the country; and (c) complex projects that require substantial structuring experience.

- **Infrastructure and Environment**
  The Bank will promote the introduction of schemes that do not rely on a sovereign guarantee in order to help alleviate budgetary pressures. The Bank will seek to be involved with the national and local authorities to prepare, co-finance and implement projects and programmes intended to maximise the use of EU Cohesion and Structural Funds. In putting together funding structures, it will work closely with the national authorities as well as the EIB and local banks in order to avoid overlap and exploit synergies. The Bank will support railways restructuring and modernisation and explore the scope for financing projects through public-private partnerships, mainly for municipalities and to some extent in the road sector. The Bank will also seek to channel finance to smaller municipalities with the support of the EU, and will pay particular attention to projects which can promote the development of less advanced regions of the country.

The Bank will continue to ensure that all EBRD operations in the Czech Republic are subject to the Bank's Environmental Procedures and incorporate, where appropriate, Environmental Action Plans.

1. THE BANK'S PORTFOLIO

1.1 Overview of activities to date

The Bank has been an active participant in the Czech transition to a market economy financing mainly private sector projects across a broad spectrum of sectors. At the end of June 2003, the Bank's cumulative commitments in the Czech Republic (including regional projects) had reached EUR 873 million representing 4.1% of the Bank's net cumulative commitment volume. The Bank helped to mobilise a further EUR 3 billion of co-investment, representing a multiplier of 3.35.

The table below gives an overview of the Bank's current portfolio in the Czech Republic by sector as of end of June 2003. Totalling EUR 530.4 million, it represented 3.8 per cent of the overall portfolio. Both, the private/state ratio and the non-sovereign/sovereign ratio stood at 98:2, being among the highest in the Bank's countries of operation.

Table 1: Current Portfolio by Industry (including regional projects)
(as of 31 June 2003)

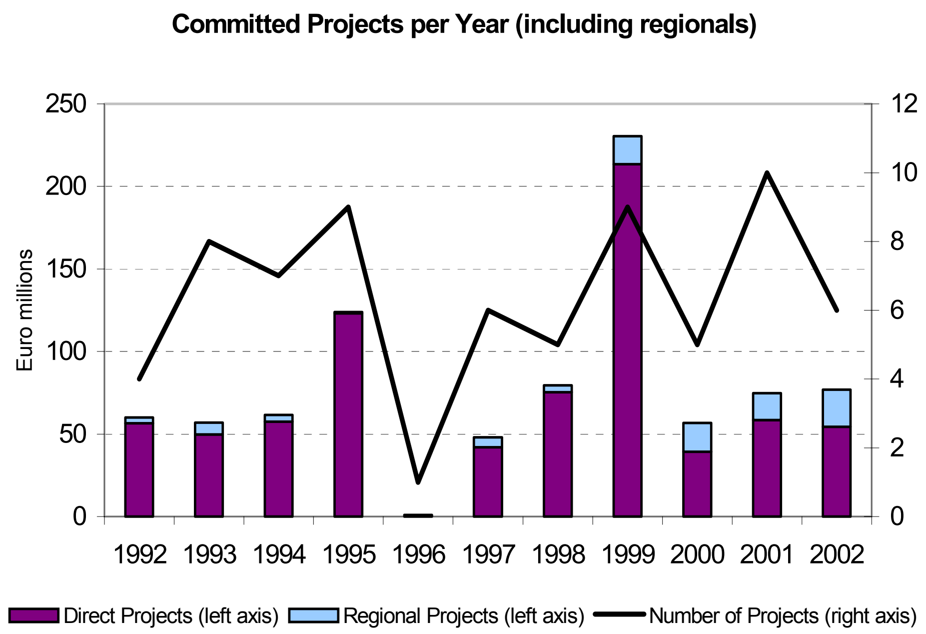
Sector	No of Projects	EBRD finance (EUR million)	Portfolio share (%)
General Industry	**2**	**42.6**	**8%**
Industry and Commerce	**13**	**122.7**	**22%**
Agribusiness	4	26.2	
Property Tourism and Shipping	5	53.5	
Telecom Informatics & Media	4	43.0	
Financial Institutions	**34**	**288.8**	**56%**
Bank Equity	1	125.0	
Bank Lending	5	38.0	
Non Banking Financial Institutions	8	48.6	
Equity Funds	20	77.2	
Infrastructure	**7**	**76.3**	**14%**
Transport	1	12.4	
Municipal & Environment Infrastructure	2	28.6	
Energy Efficiency	3	34.0	
Power & Energy	1	1.3	
TOTAL	**56**	**530.4**	**100%**
of which debt	17	284.1	56%
of which equity	39	238.3	43%
of which guarantee	1	8.0	1%
of which private	55	517.9	98%
of which state	1	12.4	2%
of which direct	28	433.9	83%
of which regional	29	96.5	17%
of which non-sovereign	56	517.9	98%
of which sovereign	1	12.4	2%

A major portion of the current portfolio (56%) relates to Financial Institutions, a reflection of the EBRD's significant role in the privatisation of the Czech banking sector, its support of SMEs through credit lines and the support of non-banking financial institutions and venture funds. Projects in Industry and Commerce sub-sectors represent 22% of the portfolio, General Industry accounts for 8%. The exposure to the infrastructure sector represents 14% of the portfolio reflecting the fact that the high needs in this sector are served mainly by the EIB and commercial banks, often using sovereign guarantees.

In 2002, the EBRD signed new projects in an amount of EUR 70 million (including regional allocations). The new projects, though smaller in size, represent a good mixture of products serving the competitive Czech market (equity, mezzanine financing, acquisition finance, and SME lines).

Chart 1 illustrates the history of the Bank's activities in the Czech Republic in terms of number of projects signed and amounts financed by the Bank in each year (no project was signed in 1991). In the early years the amounts were above the EUR 50 million level per year with substantial growth in 1995 to EUR 124 million. During years 1996-97 problems in the local industry have become obvious and there were no on-going privatisations, which resulted in a lack of financially sound business opportunities for the Bank. From 1998 the situation has changed, banks started to be privatised and investment incentives have been introduced motivating foreign investors to pursue opportunities in the country. The Bank's projects of recent years are usually of smaller size in different sectors of the economy demonstrating the Bank's flexibility in offering new products addressing the changing needs of the economy (for project-related details see Annex 9).

Chart 1:



1.2 Implementation of previous strategy

The 2001 country strategy outlined the following strategic priorities for the Bank in the Czech Republic:

- The promotion of privatisation, restructuring and consolidation of the local private sector mainly through provision of equity;
- The development of SMEs directly and via local banks;
- The support of infrastructure investments through financing structures without sovereign guarantees.

Since 2001, the Bank signed 20 projects (including relevant regional projects), representing total commitments of approximately EUR 176 million. The Bank's contribution was most significant with respect to the provision of equity and equity-type funds to local companies including SMEs. In addition, the Bank managed to support SMEs by providing credit lines to banks and leasing companies. Further credit lines are expected to be signed in the course of 2003. With respect to the restructuring of the private local sector, the Bank was able to get involved in the restructuring of two companies in co-operation with strategic investors. In infrastructure, the Bank has not been able to make a contribution because the country did not make sufficient progress with respect to transparent rules for PPPs for motorways and because large municipalities received loans from the EIB and local commercial banks. However, the Bank is currently working on innovative facilities for smaller municipalities.

1.3 Transition Impact of the Bank's Portfolio and Lessons Learnt

1.3.1 The Financial Sector

The Bank has helped address the major banking sector challenges through its instrumental role in the privatisation of two large banks (Ceska Sporitelna and CSOB). Policy dialogue between the Bank and foreign investors and the authorities has supported financial restructuring of the sector with bad debts being consolidated in the state owned Consolidation Bank, now Consolidation Agency.

In the case of Ceska Sporitelna (CS), one of the largest banks in the country, the Bank took a pre-privatisation equity stake with a view to strengthen its balance sheet. The Bank also took a board seat and contributed to the enhancement of corporate governance. CS has since been successfully privatised to Erste Bank and the Bank exited the investment in 2002. In the case of CSOB, the Bank facilitated completion of the privatisation by purchasing a stake held by the Slovak Government. Shortly after the completion of privatisation, in June 2000, CSOB entered into agreement with the government and took over the IPB, one of the largest Czech banks, which was at the edge of bankruptcy. The Ministry of Finance and Czech National Bank granted CSOB state financial assistance in relation to this rescue acquisition. The merger resulted in CSOB being the largest universal bank in the Czech Republic. The continuing participation and support of the Bank during the difficult merger process is highly appreciated by the sponsor and the management.

The Bank's involvement with the non-banking financial institutions started relatively early. Through the Winterthur multi-project facility, the Bank set up a new insurance company focusing on the development of the life insurance market. The follow up investment in 2002 supported the acquisition of a voluntary pension fund helping to consolidate the fragmented market. This acquisition made the company a market leader in this growing industry. The Bank has also invested in an insurance company with an Austrian investor, with the aim to further diversify products available to the market and increase competition in the sector.

The Bank was involved in the development of a mutual fund industry. The Bank's participation in one mutual fund was key to the fund acquiring a sub-registrar license from the Ministry of Finance. The demonstration effect of this is manifest in a number of license applications that have since been made.

Accessibility of financing to the SME sector has been improved through two EU EBRD SME credit lines to banks and one to a leasing company. The Bank played an important role in setting up the venture capital industry and is a significant investor in the Czech private equity sector via several Czech-focused as well as regional private equity funds. The Bank's continuing support to venture capital industry is essential for the raising of a second generation of funds as proved by two closings during 2003.

Overall, the Bank achieved high transition impact in the Financial Sector.

1.3.2 The Enterprise Sector

In the early nineties the Bank was instrumental in attracting foreign strategic investors to companies in need of radical restructuring. Two examples are the privatisation of a local tyre producer (Barum) and a local bus producer (Karosa). The Bank has been less successful working with domestically owned companies where local managers, despite clear managerial shortcomings, have been unwilling to give up control. Several projects with local sponsors proved to be very difficult and resulted in a high volume of impaired assets and significant resources needed for their restructuring (Korado, Skoda).

The Bank's early projects in agribusiness, Cokoladovny (1991/92) and Dobrovice Sugar (1993), sent important signals to potential investors in the agribusiness sector and the economy as a whole, since they were among the first investments into the country at a time of high political risk. The Cokoladovny project further demonstrated successful restructuring (rationalisation of production operations, and distribution and sales), and good corporate governance. Dobrovice Sugar also involved a redefinition of industry-farmer relationships with the introduction of new crop contracts and long-term off-take agreements. Bank's funding of Soufflet's acquisitions of bankrupted major malting plants (2001/02) helped to prevent the closure of the local suppliers of malt. The company is now fully operational, know-how is being transferred and shared between the international group and local management and employees. The successful operation of Soufflet Czech ensures stable purchases of barley from local farmers to the effect that in 2002-2003 all barley purchases were local.

The Bank supports the development of the local property sector through equity participation in regional projects with a significant part of the operations in the Czech Republic (Europolis, Orco) and an equity stake in one of the large developers in the country (EPG). The involvement of the Bank in the real estate sector attracted co-financiers and is instrumental in development of the secondary property market.

Early efforts by the Bank in the telecommunications sector (the first project was in 1993) were aimed at expanding and modernising the Czech telecommunications network and preparing the dominant operator for privatisation. Since then, a 30 per cent stake of the company was sold to a consortium of strategic investors (KPN and Swiss Telecom) though the state continues to maintain a majority stake. The state and the strategic investor now implement a plan leading to a consolidation of ownership of a mobile operator by Cesky Telecom and the subsequent sale of a majority stake of the company. In 2001 the Bank also made an equity investment in the third mobile operator enhancing competition in this sector. The Bank's involvement in financing the acquisition of a cable operator by a competitor supported the consolidation of this sector.

Overall, the Bank achieved a moderate transition impact in the Enterprise Sector.

1.3.3 Infrastructure and Environment

In 1995, the Bank financed a small portion of a major railway infrastructure project in parallel with EIB and other lenders. The project ran into difficulties in implementation mainly because of disagreements between the Bank and the borrower on contracting and procurements, the parties were not able to resolve within the framework of the Bank's Procurement Policies and Rules. In addition, despite the mounting financial problems and negative budgetary implications, the government and railway management appeared unwilling to embrace fundamental industry reforms. In 1999 the Borrower cancelled the major part of the Bank's loan. The operation demonstrated the limited leverage that the Bank has to pursue its transition agenda when its funding contribution is relatively minor and when there is lack of political impetus and support for reform.

The Bank has financed one municipal project to date, with a long-term limited-recourse loan to Brno Water Company BVK to rehabilitate and extend a wastewater treatment plant. As part of the project, the Bank assisted the city in the amendment of an existing long-term concession contract between the city and a joint stock company minority-owned by an international operator. The project successfully improved the regulatory framework by changing the tariff setting mechanisms from cost-plus to a sliding-scale formula that gives incentives for operational efficiency improvements and passes part of the benefits on to consumers. The extended concession contract also phases out cross-subsidies from industrial to household consumers. The project is under implementation. Several municipalities are in discussion with the Bank on financing of projects partly based on the Brno precedent.

Two projects have been signed to date in the energy efficiency sector: one is the first EBRD ESCO (Landis & Gyr); the other one is a portfolio of small district heating projects with Harpen as sponsor. The ESCO concept has been slow to start and found it difficult to establish a customer base, as the ESCO targets primarily the public sector. Demonstration effects have consequently been small. The two projects have however improved the general awareness about the ESCO concept.

Overall, the impact of Bank's involvement in the Infrastructure and Environment Sector has been limited.

1.4 Financial performance of the existing portfolio

During the last two years the quality of the Czech portfolio remained stable on a very good level. The overall portfolio risk category is 4.88, same as in 2001. New assets of high quality have been added during the period, while one project deteriorated from risk rating 8 to 9.

1.5 Mobilisation of co-financing

The overall mobilisation ratio (total project cost/EBRD financing) is 3.35.

The EBRD has worked with over 20 commercial banks, including both foreign and local, in co-financing of projects in the Czech Republic, recent examples of which are: Brno Waste Water Treatment Plant, Dalkia and TES Media. Total syndicated amount reached EUR 508 million. Among the financing institutions involved are: Ceska Sporitelna, CSOB, Zivnostenska banka, Komercni banka, BNP Paribas, Bank Austria Creditanstalt, Commerzbank, Credit Lyonnais, Dexia, Deutsche Bank, EIB, ING Bank, IFC, JBIC, JAIDO, KfW, NIB Capital Bank, Norddeutsche Landesbank.

1.6 Selected Lessons learnt

The Bank's experience in the Czech Republic to date has resulted in a number of lessons learned, the most important of which are the following:

Transparency and adherence to good corporate governance and standards of business conduct are essential considerations. Difficulties encountered in implementing projects missing an alliance with a strategic investor representing a guarantee of such practices should not be underestimated.

In case of equity investments, the Bank should include specific provisions in the shareholders agreement with respect to corporate governance and arms' length inter-company dealings, which would allow the Bank to put the shares to the other shareholder in case of breach of these provisions.

Equity participation in local banks and other non-banking financial institutions proved to successfully contribute to the development of the private sector providing wide range of financing instruments to the market. Pre-privatisation equity can significantly contribute to a successful privatisation (Ceska sporitelna).

However, special attention should be given to strengthening instruments for realising important strategic objectives of the Bank (e.g. SME financing). By insisting that intermediary banks adhere to the strictest credit conditions and legal control even in difficult economic periods, the Bank can help them to mature to a stage of development when they begin to play their role as responsible moderators of credit supply and demand.

Highly needed revitalisation of bad assets can be achievable mainly in co-operation with strategic partners (Soufflet). Restructuring done with local sponsors and institutions proved to be very difficult (Korado, Skoda).

EBRD's active participation at board level is very important not only to contribute to a higher quality debate in these boards, but also to ensure independence from shareholders and government.

2. OPERATIONAL ENVIRONMENT

2.1 The General Reform Environment

The Czech Republic continues to meet the criteria specified in Article 1 of the Agreement Establishing the Bank. It is a pluralist, multiparty democracy. Its human rights record is broadly comparable with that of established Western democracies.

Major early transition reforms, including deregulation of prices and liberalisation of trade and foreign exchange, were quickly and successfully implemented at the beginning of the transition process. Initial reform costs were relatively low, including quickly receding inflation and low unemployment compared to other Central European transition countries. A large number of small private enterprises emerged both through privatisation process and through activities of entrepreneurial individuals seizing newly opened opportunities.

The government implemented an ambitious voucher privatisation programme in 1992-1994, distributing shares in over a thousand large state-owned enterprises to eligible citizens for a nominal sum in public auctions. Voucher privatisation was complemented by sales of selected large enterprises to foreign investors and local managers. However, weak protection of creditor and minority shareholder rights, inadequate bankruptcy legislation, lack of transparency in corporate governance, and other deficiencies in the business climate resulted in an excessive amount of classified loans in the banking sector and poor financial performance of a significant number of locally owned industrial conglomerates. Structural problems were also revealed by growing trade deficit and emerging fiscal pressures, leading to a currency crisis in May 1997 and a recession in 1997-1998. Several large enterprises went bankrupt, a few banks closed down, and unemployment more than tripled between 1995 and 1999. Regional differences in living standards and unemployment rate also increased. Nevertheless the poverty rate, according to the World Bank, has been negligible at less than 1% even throughout this period, partly due to generous social safety net.

Following the 1997 crisis the authorities focused on removal of major structural weaknesses in the financial and enterprise sectors. Stabilisation of the financial sector was assisted by transferring classified loans, worth an equivalent of about 15% of GDP, from the commercial banking sector to the public workout institution, the Consolidation Bank which was later transformed into the Consolidation Agency. All major banks were sold to strategic investors by June 2001 - state owned banks now account for less than 5% of banking sector assets - and public credit registry was established in 2002. Bad loan transfer and stricter credit allocation criteria in privatised banks led to a decline in the share of non-performing loans to below 10 percent by the end of 2002. The authorities also started promoting large investment projects by a comprehensive and transparent package of tax incentives, employment grants, infrastructure subsidies, and streamlined process of obtaining licences, permits and other approvals from the authorities. Investment incentives, reinvigorated privatisation process, and improvements in business climate resulted in an increase in foreign direct investment inflows from US$ 1.3 billion in 1997 to US$ 3.6 billion in 1998. In 2002 the inflows of foreign direct investment reached the highest level since the start of transition at US$ 9 billion, including US$4 billion inflows from the gas sector privatisation.

In recent years the authorities have focused on the adoption of EU acquis communautaire. Following the successful completion of the EU accession negotiations at the end of 2002 and the overwhelming vote for EU accession in the referendum on 13 and 14 June 2003, the Czech Republic is expected to join the European Union in May 2004. The legislative and regulatory framework is now consistent with the principles of the EU single market. However the reform process is far from complete. Many issues associated with the move from central planning to an economy based on free market principles still need be further addressed, including granting of licences and permits, bankruptcy process, corporate governance legislation and reform of the judiciary.
Slow and sometimes inconsistent judiciary hinders the expansion of market interactions between enterprises and a deepening of financial intermediation. Transparency in awarding state contracts and in privatisation process also needs to be improved, not least to allow corruption to be fought effectively. The entry to the European Union may release some legislative capacity for preparation and implementation of necessary reforms to complete the transition process. This is, however, dependent on sufficient support both in the parliament and from other stakeholders.

The accession to the European Union will present many economic opportunities as well as challenges. The Czech Republic will have land borders with enlarged EU member states only, and thus all land border custom controls will be abolished on the day of EU accession. This will lower transaction costs for companies trading across new internal EU borders. In addition, the tariff system will be aligned with the EU system, resulting in more than 80% of current external trade being freed from any customs control. Trade with non-EU countries may be however adversely affected by the adoption of common EU trade policy. Passport control, , will remain in place until the Schengen Agreement becomes applicable (2006 at the earliest). Afterwards restrictions on labour mobility will be lifted. It is also expected that smaller companies and investors with limited experience in Central and Eastern Europe will increase their investments in the Czech Republic after EU accession.

Transfers of EU funds, mainly for infrastructure projects, environment improvements, common agricultural policy and regional development, are expected at EUR 2.8 billion in 2004-6, equivalent to 1.5% of annual GDP. EU funds will be channelled through a single payment authority at the Ministry of Finance to Ministries that will transfer funds to final recipients - implementing authorities for individual EU programmes. There is a concern whether the government will have sufficient implementation capacity to use EU transfers efficiently, although some of the implementing authorities have already had experience of pre-accession EU transfers (ISPA and SAPARD projects), and others will build on existing government agencies, such as the highly-praised investment promotion agency CzechInvest.

2.1.1. Macroeconomic conditions relevant for Bank operations

The output growth slowed down in 2002 due to weak external demand and devastating floods in August 2002. The economy is now driven by private consumption. Economic performance is expected to improve in the medium term, with GDP growth at 3-4%, subject to developments on the main export markets, and the extent and speed of eventual fiscal adjustment. Inflation has been subdued for several years and consumer prices started falling in January 2003. However, inflationary pressures may re-appear within 12-18 months due to tax changes related to the fiscal reform as well as to the EU accession and price increases associated with economic convergence to the EU levels. Exchange rate development has been so far driven by large capital account transactions, political tensions, and speculative flows related to the EU accession and these factors are likely to remain important in the medium term.

The biggest macroeconomic challenge for the government in the next few years will be a fiscal reform. According to the Ministry of Finance the general government deficit excluding net lending (mostly privatisation revenues) reached 6.7% of GDP in 2002 and would remain above 5% of GDP in the medium term unless a comprehensive fiscal reform, focused on lowering budget expenditures, is implemented. Public debt is below 25% of GDP at present. However expansionary fiscal policy would lead to an increase in the public debt to about 40% by 2006 and to unsustainable levels in the longer term. A package of legislative proposals aimed at lowering the consolidated government deficit to 4% of GDP by 2006 was approved by the lower house of the parliament in September 2003 but further efforts are necessary to achieve long term sustainability of public finances. An increase in current account deficit is also worrisome. Trade deficit improved as a result of export performance of mainly foreign owned enterprises but balance of income and services worsened, increasing the current account above 6% of GDP in 2002. Large part of current account deficit may be accounted for by an increase in reinvested earnings in foreign owned enterprises. However, strong balance of payments pressures may appear if foreign investors were to repatriate their profits instead of reinvesting them in the Czech Republic.

2.1.2 Transition Success and Transition Challenges

The Financial Sector

The banking sector has stabilised since the transfer of bad loans to the state Consolidation Agency and completion of the banking privatisation. Three large foreign owned banks (CSOB owned by Belgian KBC, Ceska Sporitelna owned by Austrian Erste Bank, Komercni banka owned by French Société Générale) dominate the banking sector. However a small private bank, Union Banka, closed to customers in February 2003 and its banking licence was withdrawn as a result of insufficient support by an Italian sponsor. Another small bank, Plzenska Banka, with negligible market share and just one branch closed down in March 2003 due to the loss of a protracted criminal case related to a defrauded investment fund. The newly privatised commercial banks also imposed stricter credit criteria, which together with banking sector restructuring led to a 20% decline in credit to enterprises between the end of 2001 and 2002. Domestic credit to the private sector declined, as a share of GDP, from the peak of 54%

in 1997 to 20% at the end of 2002. A sustainable growth of credit to the enterprise sector and an expansion of available financial instruments are now the greatest transition challenges in the banking sector.

Consumer credit and mortgages, provided by both banks and non-banking financial institutions, expanded rapidly during the past few years as changing strategies of financial institutions with greater focus on retail customers coincided with declines in interest rates. Leasing market is well developed and according to the association of leasing companies the Czech leasing market is larger than EU average as a share of GDP. The insurance sector is also developing fast, following de-monopolisation of third party car insurance, completion of the privatisation of former monopoly insurance company to local investors, and adoption of EU consistent legislation. Pension and housing saving schemes are promoted by state subsidies and as a result cover a large part of the population. However the amount of assets managed by these institutions is low - constrained by the available state funds - and the fiscal reform is likely to limit the state support even further in the near future.

The Enterprise Sector

In May 2002 the government agreed on the sale of troubled steelworks Nova Hut to LNM Holdings, a large international steel company. LNM agreed to restructure the debts of Nova Hut, inject new capital and carry out a substantial investment programme over the next 10 years. The sale, supported by a sizeable state aid of CZK 5.7 billion (EUR 180 million), was successfully completed in February 2003, including approval of the state aid package by the European Commission. However, the remaining state-owned large steel works, Vitkovice Steel, still needs to be privatised, Vitkovice holding group, an engineering conglomerate excluding the steel mill, was successfully privatised in August 2002 - as well as the large petrochemical conglomerate Unipetrol. The authorities are also moving towards completion of the mining sector privatisation since this is crucial for the successful restructuring of steel and power sectors.

The enterprise sector is still characterised by a large number of failed but potentially viable companies privatised through vouchers and / or to managers. The Consolidation Agency has been selling impaired loans from the commercial banks to the private sector. The assets of the Consolidation Agency reached CZK 250 billion, equivalent to EUR 8 billion or about 11% of GDP, at the end of 2002, but approximately CZK 100 billion are receivables from the Czech government to cover past losses. Bad loans restructuring costs will add around 1.3% of GDP to the 2003 budget deficit but will fall in the future. However, workouts of impaired assets in the private sector are far from complete and there are also many companies undergoing bankruptcy procedure which may yet be turned around if a strategic investor can be identified.

The industrial restructuring process is also hindered by deficiencies in the investment climate, mainly related to the complex and cumbersome legislative and regulatory framework, lack of transparency of a number of public sector tenders, and corruption. The state support system for large companies is relatively transparent and comprehensive. However SMEs have access only to a limited amount of direct subsidies and lack similar support as larger investors, including well defined tax incentives, grants for newly created jobs, one point contact with the authorities, and subsidised land and infrastructure access. The government is merging all industry support agencies with CzechInvest, a highly successful foreign investment promotion agency, and this may lead to greater availability of state support for local small and medium enterprises as well as to improvements in general business environment, including streamlined legislation and regulation governing enterprise sector.

Infrastructure and Environment
Significant investments, including motorway construction, railway modernisation and environmental upgrades are necessary to remove remaining distortions originating in the central planning period and to facilitate integration into enlarged EU. Given fiscal constraints and limited scope to generate significant privatisation revenues there is a need for innovative ways of financing infrastructure and environment investments by the private sector without government guarantees. In addition, the efficient use of expected EU funds will depend on the ability of infrastructure and environmental projects to attract the required co-financing element.

In April 2002, the government successfully completed privatisation of gas sector distribution and transmission companies to RWE for EUR 4.1 billion. However the sales of majority state stakes in a dominant power generating company, CEZ, regional power distributors, and a former telecommunication monopoly, Czech Telecom, were cancelled by the government due to the lack of acceptable offers. Privatisation of the remaining state utilities will be re-launched as soon as the market conditions improve but at present the timing is highly uncertain.

Restructuring of railways progressed in January 2003 by the split of the national railway monopoly into an infrastructure company and a company operating rolling stock. However, railway infrastructure still requires significant upgrade and the railway sector needs an operational restructuring to create a structure viable in the long term. Motorway construction programme and road network modernisation suffers from the lack of long term planning and access to finance. The government has cancelled a private sector contract, awarded without an open tender by the previous administration, to build and maintain a motorway in Northern Moravia and intends to finance this project on more favourable terms from public resources. Private sector participation in the transport sector has been restricted so far to road transport companies and construction and maintenance contracts.

EU accession will lead to environment compliance investments estimated at around Euro 10 billion. Required annual spending on environmental protection in the Czech Republic is estimated at 2% of GDP - on average twice as much as in the current EU member states. Utility companies, particularly in the water and waste water management sector, are expected to invest substantial amounts of resources into upgrades of existing facilities and expansion of regional coverage. Significant environmental investments will be also required in private industrial enterprises as well as in the public sector.

2.2 Legal Environment

The Czech Republic has made significant reforms to its legal framework, which have led to major improvements in the country's legal environment. The Czech Republic is one of the countries of Central Europe that are due to join the European Union (EU) on 1 May 2004.

Despite the success of the country towards the establishment of a market-oriented economy and stable democratic institutions, efforts are needed to overcome existing challenges.

The Czech Republic is a parliamentary democracy where separation of powers and independence of the judiciary are recognised. However, there are persisting difficulties that need to be addressed by the authorities. Although the judiciary is independent from other branches of the government, deficiencies regarding training and resources for the courts generate major problems and a lack of confidence from the business community.

Alignment of Czech laws with EU law in view of the Czech Republic's accession to the EU appears to be progressing relatively well. The latest regular Report of the European Commission on the Czech Republic's progress towards accession reveals that good progress has been made in such areas as regional government and reform of the judiciary, which are being developed under the Action Plan jointly developed by the European Commission and the Czech Republic in 2002 and revised in January 2003. However, further alignment is needed in certain areas such as administrative reform, fight against corruption and economic crime.

2.3 Access to Capital

Credit to enterprises has been falling in the past few years, due to banking sector restructuring and tightening of credit criteria after privatisation. However, there are sufficient resources in the banking sector for lending to sound companies, including small and medium enterprises and private entrepreneurs, and the interest rates are low, comparable to interest rates in the Eurozone. All major commercial banks now have special programmes for lending to small and medium enterprises and are reportedly willing to provide loans with nominal interest rates at 4-8% and with maturities over 5 years, depending on project features. Entrepreneurs and micro enterprises can now receive loans up to CZK 2 million ($61,000) within a few days on the basis of two most recent tax returns, a registry certificate and a certificate of no overdue social security contributions. However, many companies have insufficient equity to increase their indebtedness. Reported financial performance of enterprises is also often inadequate for having access to commercial loans due to aggressive tax optimisation strategies and complex, non-transparent corporate governance.

Local enterprises have limited options to raise new capital. There has been no initial public offering since the inception of the Prague Stock Exchange. Trading on the capital market is limited to several titles and volumes are low. The corporate bond market is relatively well developed compared to other transition countries, although corporate bonds are issued only by a small number of large corporations. The venture capital market is also underdeveloped due to the limited number of company owners willing to sell and due to the limited exit options. There are relatively few strong indigenous institutional investors, including investment groups emerging from the voucher privatisation and voluntary pension funds. Foreign investors have typically no problem obtaining funding from local banks but often they are financed internally by their headquarters.

3. STRATEGIC ORIENTATIONS

3.1 Bank's Priorities for the Strategy Period

Based on the analysis of the remaining transition challenges the Czech Republic is still facing, the Bank's priorities for the forthcoming period will be to:

- Work with local banks and project sponsors to develop the range of financial products not well supplied to the economy such as equity, mezzanine funding and a broader range of SME finance. Continue to support development of non-banking financial institutions.

- Actively support restructuring and consolidation of the local private sector, mainly through equity investments alongside strategic investors or through equity funds. Support privatisation of the remaining state assets.

- Support foreign direct investment in green-field and brown-field projects, particularly in the regions of higher unemployment.

- In the infrastructure and environment sectors, work closely with local authorities and other parties to create funding structures that would facilitate the use of EU Cohesion and Structural Funds, giving special attention to channelling funds into smaller municipalities and less developed regions of the country.

- Support railways restructuring and modernisation and explore the opportunities for the use of public private funding structures in the road sector.

When working on specific projects, the Bank will observe the Environmental Procedures and incorporate, where appropriate, Environmental Action Plans.

3.2 Sectoral Challenges and Bank Objectives

3.2.1 The Financial Sector

Transition Goals
Developments in the Financial Institutions sector will go in parallel with the development of the local economy and in particular the continued inflow of foreign direct investments. As companies become more sophisticated in their operations, the type and quality level of financial services requested increases and puts pressures on the Financial Institutions sector to improve.

A more stable macro-economic situation and lower interest rates resulted in fierce competition among commercial banks and consumer finance companies. This in turn resulted in improved availability and more accessible terms for loans especially to retail customers. With respect to corporate clients, banks are often not able to increase debt exposures due to the significant equity gap in the corporate sector. This can be addressed through injection of equity by company owners, private equity funds or other private investors, or through quasi-equity and mezzanine financing, however these are not likely to increase the overall equity level in the economy substantially. Therefore, commercial banks are likely to face limited new lending opportunities in the coming years.

Operational Priorities
During the next years the Bank will continue to focus on reducing the equity gap and become a catalyst supporting the upgrading of the quality and range of services offered by financial intermediaries to both retail and corporate customers. This will be crucial especially in view of the fast pace of changes required in the run-up to the accession and thereafter.

In particular, the Bank will focus on following areas:

- *Support of SMEs:* The Bank will seek to extend the EU SME facility to new partner banks and to provide the EU SME leasing facility to one or two additional leasing companies specialised in the small-ticket leasing of equipment, technology and utility vehicles to SMEs. It will consider a partial risk-sharing guarantee facility for an SME portfolio of a Czech subsidiary of a western commercial bank. With respect to equity for SMEs, the Bank is considering investing in a specialised fund providing mezzanine capital in order to reduce the equity gap.
- *Equity Funds*: The Bank will selectively commit capital to new equity funds raised by proven management teams and will focus on monitoring existing investments (including two new second-round funds launched in early 2003). Subject to a positive experience with the Bank's pilot investment in a corporate turnaround fund launched in Slovakia in February 2003 (Value Growth Fund), the Bank may consider investing in a turnaround equity fund operating in the Czech Republic.
- *Mezzanine funding*: In addition to supporting mezzanine funds for SMEs, the Bank is considering investing in a real estate fund investing in real estate generating steady income that would be made accessible to Western as well as Central European retail investors.
- *Pension Funds*: The Bank will continue to support its equity investment in a third pillar pension fund manager (Credit Suisse Life & Pensions Penzijni Fond - former Wintherthur Penzijni Fond). The Bank expects to hold these investments for at least 3 years as the companies are still in growth phases. No future equity investments are expected, however. Should pension reform including mandatory savings in pension funds be launched, the Bank will be involved in the policy dialogue with Czech authorities regarding the strengthening of the funded part of the pension system and the introduction of the 2nd pillar into the pension system. The Bank may consider investment opportunities stimulated by the reforms.
- *Securitisation:* The Bank will explore the possibility to support the securitisation of a pool of commercial loans, most likely from retail or mortgage portofolios of a major Czech bank.

3.2.2 The Enterprise Sector

Transition Goals
There is a significant gap between locally and foreign owned corporate sectors. Many locally owned enterprises still need to improve corporate governance and very often require financial and operational restructuring. Newly established subsidiaries of foreign corporations benefiting from a wide range of support provided by the government represent a flourishing

part of the industry. Given the situation of diminishing privatisation opportunities, it is important for the country to maintain the high level of foreign direct investments to be able to continue the transition of regions with structural problems and high level of unemployment. This implies creation of conditions to attract high value added projects and also investors willing to restructure the local industry. Further development and expansion of the SME sector will be essential for combating growing unemployment. Privatisation of remaining state assets should be completed.

Operational Priorities
In order to help the Czech economy to meet these goals, the Bank will focus on the following:

- *Enterprise Restructuring:* The Bank will promote the restructuring and consolidation of local enterprises, including co-operation with foreign strategic investors through providing equity and acquisition financing for their local operations. Bank will provide guidance to investors with limited country experience.

- *FDI:* The Bank will support FDI, particularly for green-field and brown-field projects in the regions of higher unemployment. FDI is expected to grow further in the automotive, electronic and engineering sectors with focus on higher added value projects. The EBRD will consider equity as well as long term debt. For debt it will co-operate closely with banks based in the Czech Republic.

- *Privatisations:* The Bank will support the privatisation of the remaining state-owned companies such as Unipetrol and Český Telecom as a financial investor.

- *SME:* The Bank will seek to expand spectrum and volume of financing products available for SME's in co-operation with local financial intermediaries with the use of support of EU through EU SME programmes.

- *Property:* The Bank will support commercial property projects in regional centres in addition to Prague and create appropriate instruments for the development of a secondary property market. Financing schemes concerning rehabilitation of existing blocks of flats requiring substantial level of investments will be considered as well.

- *Post and Telecoms:* In addition to its support of the privatisation of Český Telecom, it will assist, on a selective basis, private operators of fixed line and mobile networks in their plans to expand and improve the services. The Bank will review the potential to assist the Czech postal network in its efforts to modernise/expand services and to introduce electronic data networks.

- *Agribusiness:* The Bank will seek opportunities to work with local intermediaries to increase the availability and sophistication of financing to the agribusiness sector.

- *Energy:* The Bank will help to develop ESCO projects in the public sector working closely with relevant ministries (education, defence) to invest into energy efficiency by utilising off-budget financing mechanisms that do not rely on the sovereign borrowing capacity (namely, the Bank's "Public Entity ESCO" concept). The Bank seeks to provide senior debt or guarantees to ESCOs that would be responsible for financing and maintaining energy efficient investments in public sector buildings with a readily identifiable and reliable budget funding source. It will continue to seek opportunities to finance the private sector's energy efficiency activities in the local industry, independent power plants designed to provide industrial facilities with their own sources of thermal and electrical energy and projects that utilise renewable and clean sources of energy (i.e. biomass and wind).

3.2.3 Infrastructure and Environment

Transition Goals
Upgrading of transport, environmental and municipal infrastructure is one of major remaining transition challenges of the Czech Republic. A key transition goal in the transport sector currently is the extension of the highway network in order to facilitate investment and economic development in the underdeveloped regions of the country and to integrate Czech Republic into the European transportation network. The transformation and rationalisation of the railways is critical because of the continuing burden the sector represents for the state budget. The restructuring programme started, but needs to be more radical to bring the desired rationalisation. Czech Republic also has substantial investment needs in environmental and municipal infrastructure and has to upgrade the wastewater and solid waste sector to meet EU environmental standards. These requirements must be set within the tight fiscal framework.

Operational Priorities
The Bank will help the country to address these challenges in infrastructure development. The Bank will seek to develop and implement innovative ways to finance state-owned and municipal entities without state guarantees. This will be especially important for smaller municipalities and regional programmes where much of the future investment will take place. The Bank will seek involvement to support continuing structural reform of state-owned enterprises in the transport sector. A new railway law has separated rail infrastructure from railway operations and new companies have been formed for each. In the short-term the structural shift will not increase efficiency or reduce budgetary impact of the sector but the change, allied with management changes in the railway, may create an industry more receptive to the kinds of reforms, including labour restructuring to improve productivity. In the roads sector the authorities are identifying a number of potential new projects for which PPP solutions are to be developed. The Bank's expertise and experience in area may be able to contribute to the successful delivery of one or more of these schemes once private sponsors have been competitively selected. The Bank is prepared to contribute to the increase of the absorption capacity of the country with respect to EU funding of infrastructure projects through co-financing of eligible projects. The Czech Republic, particularly in the environmental sector, has encountered problems in utilising available EU co-financing, largely through lack of successful project development skills.

Specifically, the Bank will focus on the following:

- The Bank will work closely with municipalities, national and regional authorities and other entities on development of structures facilitating flows of funding into environmental and infrastructure projects with concentration on addressing needs of smaller municipalities.

Many of the larger cities in the Czech Republic, have already upgraded their water and wastewater assets to meet EU requirements. However, much remains to be done at the smaller community level. At the same time, it will be important to encourage the development of regional environmental projects in order to provide for least-cost solutions. This will in many cases require innovative financing structures to provide a sufficiently strong credit to ensure affordable financing for communities that may not have access to borrowing.

- Development of PPP structures and financing for major infrastructure projects in Prague and other large cities. Prague has major infrastructure requirements for upgrades to its wastewater treatment plants and in the transport sector for both mass transit and road networks. With increasingly limited debt capacity and the need to ensure timely project delivery, the city will be looking to utilise the private sector for project development and financing.
- The Bank will support restructuring of Czech Railways through implementation of the labour restructuring program and financing of upgrade of the rolling stock. Increasing operational efficiency will free up funding for needed capital improvements and improvements in rolling stock will help to maintain and potentially increase business.
- The Bank will explore the potential for PPPs for road maintenance and motorway development taking into account the Czech Republic's experience with motorway concessions (e.g. failed D47 highway project) and having in mind the lessons the Bank has learnt with PPPs for motorways in CEE.
- The Bank will seek to contribute to the enhancement of the airport navigation services through supporting technology upgrades on a non-sovereign basis.

3.2.4 Policy Dialogue

The Bank has had a continuing policy dialogue with the Czech authorities with respect to amending the Secured Transaction Law. However, it was decided that an involvement of the Bank would not be appropriate. The Bank will pursue its policy dialogue with the Czech authorities to assess the need for legal assistance in specific areas.
The Bank is also maintaining an intense dialogue with the Czech authorities with respect to the potential role for Bank in assisting the country to maximise the use of Cohesion Funds after accession. Specifically, the Bank is in discussions with the Ministry of Environment, the Ministry of Transport and the Ministry of Regional Development.

With respect to the restructuring of the railways companies, the Bank initiated talks with the Ministry of Finance and the Ministry of Transport to discuss the role the Bank could play in the restructuring.

4. CO-OPERATION WITH THE EU AND OTHER IFI's

- **EU (PHARE/ISPA/SAPARD)** - Under the Phare programme the EU has allocated EUR 919.5 million to the Czech Republic since 1990, of which EUR 680 million were contracted and EUR 603 million disbursed. For the 2000-2003 period the EU has allocated an amount of EUR 391.7 million to the Czech Republic and average annual allocations under PHARE has been EUR 97.9 million. In the period 2000-2002 an amount of EUR 319.2 million has been approved under ISPA. The annual allocation under SAPARD has been EUR 22 million. Fourteen infrastructure projects are approved by the EU under the ISPA. Among these projects seven are under implementation and remaining seven projects are under preparation for tendering. The SAPARD Agency has been accredited by the EU. Co-operation with the EU wil1 continue to include (i) the expansion of the SME Facility in the country (both the loan window and the equity window); (ii) ISPA co-financing; and (iii) as soon as feasible, joint actions with SAPARD.

- **The International Monetary Fond (IMF)** - The Czech Republic became member of the IMF on 1 January 1993. The only financial arrangement to date has been the stand-by facility of SDR 177 million approved on 17 March 1993, which expired in March 1994. There are no current or projected obligations to the IMF. The Czech Republic has been the recipient of a number of technical assistance missions, focusing on fiscal framework and management, monetary and banking system, including financial sector supervision, and on statistical issues. The last Article IV consultation took place on May 2003 in connection with the fiscal reforms in the Czech Republic.

- **The World Bank -** The Czech Republic became a member of the World Bank on 1 January 1993, by joint succession with the Slovak Republic to the membership of the Czech and Slovak Federal Republic. The World Bank has not made any loans to the Czech Republic since September 1993. The outstanding amount of the disbursed loans is USD 167.2 million as of December 2002. In recent years the World Bank has undertaken, at the request of the Czech authorities, several analytic and technical assistance activities. The World Bank and the Czech Republic have started their co-operation in the area of Public Private Partnership (PPP). The first World Bank mission concerning PPP took place in May 2003. At the request of the Czech authorities the World Bank agreed on commencing the graduation process in May 2001. During this process, which will cover the pre-accession period, the World Bank will continue to provide limited technical support on selected issues at the behest of the Czech authorities.

- **The International Finance Corporation (IFC)** - The IFC has approved financing for a total of 18 projects in the Czech Republic, investing USD 402.2 million as of June 2003. Financial markets projects account for 36% of total IFC commitments, iron and steel for 34%, infrastructure for 22%, food and agribusiness for 3%, automotive sector for 3% and cement and construction materials for 2%. The projects include: USD 6.5 million equity participation in the privatisation of Zivnostenska Banka in 1992, USD 75.0 million equity participation in the privatisation of CSOB in 1999, USD 60.0 million loan to Energy Center Kladno in 1997, an independent power company, and USD 75.0 loan to Nova Hut, a large steel making company in 1997-8. In the last years IFC participated only in one transaction, co-investing with Goldman Sachs/ Flow East USD 22.5 million in the portfolio of distressed assets sold by KOB. Today, the IFC covers the Czech Republic from their Bratislava office.

- **The European Investment Bank (EIB)** - Since 1992 the EIB has finalised a number of loans in the Czech Republic, representing total cumulative commitments of EUR 4.17 billion. EIB's operations continue to cover the most important sectors of the economy, with an emphasis on basic transport (rail and road – 49 per cent), environmental and municipal infrastructure (29 per cent) and private sector including global loans to financial institutions for SMEs (22 per cent). Part of this activity concerns projects cofinanced by EBRD, including notably a number of Global Loans and the rail corridor project Berlin-Prague-Vienna.

In the context of preparation for the EU membership and following Accession, EIB’s activity in the Czech Republic will be closely coordinated with the EU Structural and Cohesion funds. Transport infrastructure is likely to remain a major area of EIB’s operations, with emphasis on support to Trans-European Networks. EIB is also willing to increase its support for projects aimed at environmental protection, especially those relating to the implementation of the Acquis Communautaire. Activities in the social sector have started with a first education loan signed for the Masaryk University in Brno (EUR 95 million) and are expected to further develop into the health sector. Supporting industrial projects, together with international and domestic commercial banks - either through guarantees, on-lending or global loan intermediation - remains an important aspect of EIB’s activities and one that shows potential for growth.
The Bank will seek closer co-operation with the European Investment Fund (EIF) with respect to the support of SMEs through equity and mezzanine products.

The Czech Republic has also benefited from significant bilateral assistance programmes. Financing through these programmes is still provided by Belgium, Italy, Israel, Japan, the Netherlands, Norway and Spain. Bilateral assistance programmes financed by Austria, Canada, Denmark, France, Germany, Sweden, Switzerland, Taiwan, United Kingdom, and USA were already terminated.

ANNEX 1 - POLITICAL AND SOCIAL DEVELOPMENTS

Political Developments

On 28 February 2003, the Czech Parliament (the Chamber of Deputies and the Senate) elected by a simple majority Vaclav Klaus, candidate of the right-wing opposition Civic Democratic Party (ODS) and former Prime Minister, as President of the Republic. The previous two attempts to elect the President had failed. Klaus's election was a surprise as well as a blow to the Prime Minister, Vladimir Spidla. Spidla has been in office since June 2002 at the head of a government consisting of his own Social Democratic Party (CSSD), which has 11 ministers, and the Coalition (made up of the neo-liberal Freedom Union and the centrist Christian Democrats), which has six. Voting in parliament was secret, but it is known that at least 10 deputies belonging to the Prime Minister's own Social Democratic Party (CSSD) voted for Klaus rather than the official CSSD candidate, Jan Sokol. The CSSD rebels were supporters of the former Prime Minister, Milos Zeman, Spidla's predecessor both as PM and as CSSD chairman. Zeman's own presidential candidacy in an earlier presidential election round had not been supported by Spidla. Klaus obtained, in addition to the votes of his own ODS and those of the CSSD defectors, also those of the Communist Party of Bohemia and Moravia (KSCM), the third strongest in parliament. The President's powers are limited but Klaus, a charismatic politician of strong views, is expected to use them to the full. Those powers include that to nominate the Prime Minister and to veto legislation and return it to the Chamber of Deputies, which may then override it by a simple majority of members. The President has the right to attend Cabinet meetings and to have a say in foreign policy as well as authority to appoint all 15 members of the Constitutional Court (the 10-year terms of 11 of its current members expire this year) and all seven members of the Board of the Czech National Bank.

On 11 March 2003 PM Spidla asked for a vote of confidence in parliament and got it, with all 101 government coalition deputies supporting the confidence motion and all 99 opposition ones voting against. Later in March Spidla was re-elected CSSD leader, defeating Jiri Rusnok, former Minister of Trade and Industry, whom he had dismissed immediately after Klaus's election. Rusnok was one of the CSSD deputies who had failed to support the official CSSD candidate - and had said so openly. The big hurdle for the cabinet now is the the preparation of the budget later in the autumn of this year. The government's austerity measures, imposed in order to cut the the record budget deficit from 128 billion crowns to 87 billion in three years are unpopular, not least within the ranks of the CSSD, the senior partner in the government. On 26 September the government survived a no-confidence vote that had been suggested by the opposition ODS: 99 deputies voted for the no-confidence motion and 101 against it. On the same day the lower house of the Czech parliament approved 11 government bills on fiscal reform. The bills are intended to trim the budget deficit to 4% of GDP by 2006. The bills must still be approved by the upper house (Senate) and signed by President Klaus before they become law.

Regional Integration and Relations with the Neighbours

The Czech Republic is set to join the European Union on 1 May 2004. The referendum on the EU accession was overwhelmingly approved by 77% of those voting on 13-14 June 2003. Turnout was 55%. The Czech Republic's accession to the EU - together with the three Baltic Republics, Hungary, Poland, Slovakia and Slovenia - scheduled for 1 May 2004 will mean the end of the Central European Free Trade Agreement (CEFTA) set up in 1993. Within the Visegrad Group (the Czech Republic, Hungary, Poland and Slovakia) established in 1992 cooperation on economic, environmental and other issues (including security) will continue - as will that within the 16-member Central European Initiative (CEI). Relations with the Slovak Republic are close and are expected to become even closer after both countries join the EU. The Czech Republic is providing advice and assistance in various sectors (including customs) to Bulgaria and Romania, expecting to join the EU in 2007, as well as to Croatia which in February 2003 lodged an application to join. The Czech Republic's relations with its immediate Western neighbours, Austria and Germany, who are also its largest trade partners and important investors, are good and continue to improve. A visit to Prague in September by Gerhard Schroder, the German Chancellor, was a confirmation of the trend. The Czech Republic has been a member of NATO since March 1999. The Czech Republic participates in UN and peacekeeping operations in Bosnia and Herzegovina, Kosovo, Macedonia, Georgia, Ethiopia/Eritrea and Sierra Leone. The Czech Republic plans to move towards a professional army by 2006, subject to fiscal constraints. The Spidla government has provided a degree of support for the US/UK military action against Iraq.

Investment Climate and Integrity Issues

All surveys indicate that corruption and economic crime remain a serious cause for concern. The Czech Republic has been rated at the 57th place out of 102 countries in Transparency International 2002 Corruption Perceptions Index Survey compared to the 27th place out of 52 countries in 1997. Corruption became firmly embedded in the structure of the country's post-Communist power politics between 1998 and 2002 under the so-called 'Opposition Agreement' between the ruling Social Democrats and the opposition ODS. The agreement, which divided spheres of influence in public life, provided a fertile ground for corruption. In April 2002, two months before the June general election, the then Zeman government approved its own report on corruption, which confirmed that the situation was not improving. It noted that bribery in the public administration and fraud in the private sector continued to be significant problems. It highlighted the fact that corruption continues to affect the proper functioning of the state administration, the police (especially the department dealing with residence permits for aliens and the traffic division), health care, banking, the judiciary and intelligence services and that also influences the political sphere. It concluded that one of the main reasons why the anti-corruption policy was not successful was the lack of political support demonstrated by the absence of a parliamentary consensus on a comprehensive anti-corruption programme. Trafficking in human beings is a cause for concern. The Czech Republic continues to be simultaneously a country of origin, destination and transit. However, according to the European Commission, the Prague government has taken significant steps to combat it. The amendment to the Criminal Code, which came into force in June 2002, extends the scope of the provisions to 'trafficking in human beings', thus also covering children. At the suggestion of the Council for Human Rights, a set of measures aimed at improving the prosecution and punishment of the perpetrators of trafficking in human beings were adopted by the government in 2002, but those measures still need to be implemented. The Czech government cooperates extensively with other Central and East European governments, the EU and the United States during investigation and prosecution of trafficking cases.

One of the first acts of Vladimir Spidla when he took office as Prime Minister in June 2002, was the request for his Ministers to declare all their assets on taking office and to be ready to have them inspected on leaving office. The regular report on Czech Republic's progress towards transition by the European Commission published in Brussels in November 2002, noted steps taken to combat corruption. Among them, the Report noted as a 'major advance' the establishment of specialised units on corruption and economic crime at the Supreme Public

Prosecutor's Office in Brno, with branches in Prague, Ostrava and Olomouc. Another is an amendment adopted in May 2002 which strictly limits the use of emergency 'fast-track' procedures in public procurement.

Social Conditions

The population reached 10.3 million in 1990, following two decades of high birth-rates, but then the rate of natural increase declined, from a high of 6.7 per 1,000 inhabitants in 1975 to 0.1 in 1992. The rate turned negative in 1994. Since then the population has fallen by about 100,000. The ageing of the population is causing a steady rise in the proportion of pensioners to active labour force participants. In 2001, one in seven citizens was over 65. Consequences of the ageing of the population for the pension system and provision of health care require a close attention of the government. The population is spread quite evenly across the country, with Prague the only City with more than 1 million inhabitants. The share of people living in poverty is low, estimated by the World Bank at 0.8% of the population. The population is homogenous in ethnic terms, with little ethnic diversity. The once large German minority disappeared entirety as a result of population transfers after 1945 and now accounts for only 0.2% of the total population. The 300,000 or so Slovaks who remained in the Czech Republic following the break-up of the Czecho-Slovak Federation on 1 January 1993, are highly integrated. Ethnic Poles, concentrated in northern Moravia and Silesia, make up about 0.6% of the total population.

The Roma minority is estimated at 250,000 - 300,000 (though the number of officially registered Roma is only a fraction of that). The unemployment rate among the Roma is 70-90% and more than three quarters of Roma children are placed in special schools for the mentally handicapped, largely owing to their poor language skills. Hundreds of Roma families regularly seek asylum in West European countries with little success, their cases being rejected on the grounds that they do not suffer from systematic political persecution or legal segregation. Meanwhile, increasing numbers of Slovak Roma have been seeking asylum, making them the second largest group of asylum seekers in the Czech Republic. In January 2002 the government updated its policy towards the Roma, first adopted in June 2000. However, as the November 2002 European Commission Report noted, 'in spite of those efforts, widespread discrimination continues to exist and the government's efforts to date have not yet reached a threshold capable of bringing about structural changes'. The Report noted with regret that the Czech parliament had yet again rejected a wider reform of the education system, notably phasing out the system of special schools.

Labour Issues

A total of 32 unions are affiliated to the main trade union organisation, the Czech and Moravian Confederation of Trade Unions (CMKOS), which has about 850,000 members. The total union membership in the Czech Republic stands at 1.2 million. Strikes are rare. Industrial workers' protests have been frequent since the end of the Communist regime in 1989, but trade unions prefer to use 'strike alerts' or short-term 'warning-strikes' instead of prolonged stoppages. The only significant strike for more than a decade was the railway workers' one-week strike in 1997. (The ILO no longer keeps statistics on strikes in the Czech Republic.) However, more recently, in response to the government's austerity measures, the teachers' union staged a 'warning strike' in protest against what the union claimed was the government's failure to deliver the promised 5 billion crowns ($167 million) in salary increases. The strike, described as the biggest in the history of the Czech Republic, took place on 1 September, the first day of the school year. More than half of the country's nearly 72,000 teachers and school administrators took part.

ANNEX 2 - ECONOMIC DEVELOPMENTS

Output Performance and Employment

Annual GDP growth is expected to return to 3% or more in the next few years, provided that higher exports from large-scale FDI inflows are not offset further by weak external demand and there are no abrupt cuts in public spending. Output growth slowed down in 2002 to 2% as a result of the devastating floods in August and weaker investment growth and recovered only marginally in the first half of 2003. Private consumption, by contrast, continues to grow robustly, driven by productivity-led real wage growth in the private sector, strong real wage increases in the public sector, and rapidly expanding consumer finance.

Registered unemployment reached a record high of 10% of the labour force in January 2003 and remained around that level throughout the first three quarters of 2003. Labour force survey data, however, show a more static and lower rate of unemployment at 7.5% of the labour force in the last quarter of 2002. Generous unemployment benefits, particularly for workers released from highly-paid low-skilled jobs in steel and mining companies limit incentives to work, whilst high labour taxation, particularly social welfare contributions curb job creation in the official sector. There are significant regional differences in the unemployment rate, partly due to poor road access to high unemployment regions (Northern Moravia) and shortages of affordable housing in high growth areas like Prague. There is also a significant skills mismatch between the requirements of foreign investors and characteristics of unemployed. However this has not affected competitiveness of the Czech Republic despite growing real wages as productivity also continues to increase.

Public Debt and Fiscal Policy

The general government deficit was 6.7% of GDP in 2002 and a broadly similar outturn is expected this year and next. A large part of the deficit is attributable to discretionary expenditure (losses of the Consolidation Agency responsible for the workout of banking assets transferred to the state, purchase of military aircraft, road construction). In 2003 bank restructuring costs are expected to add around 1.3% of GDP to the deficit but should fall in the future as the Consolidation Agency expects to complete most of its workouts within the next 18-24 months. High transfers to households, particularly unemployment benefits (unemployment more than doubled in the past 5 years) and pensions (up 2 percentage points of GDP between 1994 and 1999) have also boosted the fiscal deficit but are expected to be gradually reduced in the future. The government has agreed on the need to cut the fiscal deficits over the medium term (to 4% of GDP by 2006) and plans to implement some measures to reduce budget expenditures and to rebalance the tax system. In September 2003 the lower house of the parliament approved in the package of eleven legislative proposals forming the core of planned fiscal reform.

Fiscal revenues have remained stable at 36-38% of GDP in the past ten years. The share of taxes on goods and services has fallen but the share of social security contributions has risen. The impact of EU accession on fiscal revenues is unclear - the Finance Ministry will have to cope with the loss of custom duties, which are expected to fall significantly below the current level of 1% of GDP, but will have to raise tariffs and excise duties to EU levels. Public debt was estimated at about 20% of GDP at the end of 2002 and is expected to increase above 35% within the next three years due to expected large fiscal deficits. However low yields on local public bonds have reduced public debt service costs to less than 1% of GDP. A possibility to raise significant privatisation revenues from sales of major utilities limits the risk of a budget crisis in the short term.

Monetary and Exchange Rate Policy

The Czech National Bank (CNB) has consistently undershot its target range for inflation (3-5% from January 2002 declining to 2-4% by December 2005). CPI inflation fell below 1% y-on-y since July 2002 and turned into deflation in January 2003 due to the lack of significant regulated price increases compared to the past, strong retail competition, falling food prices, and appreciating currency. Inflation remained negative in the first eight months of the year, except for June 2003 when a small increase of 0.3% year on year was reported. In 2004 the Czech National Bank expects an inflationary impulse from increases in indirect taxes due to the EU accession (cigarettes, alcohol), but inflation is expected to remain subdued. Labour costs are also expected to remain contained and kept close to productivity growth in real terms. The main interest rates set by the Czech National Bank have been at or below the rates set by the European Central Bank for some time, falling from 2.75% at the end of 2002 to 2% in August 2003, and also the yields on government bonds are below German benchmarks. The strategy for the adoption of the Euro is currently discussed by the Czech National Bank and the government.

Strong capital inflows have led to a rapid appreciation of the Czech crown against the euro in early 2002, but repeated interventions by the Czech National Bank, sterilisation of privatisation inflows, political tensions, and expected late adoption of the Euro has led to the suppression of appreciation trends in the second half of the year and the reversal of appreciation from early 2002 by mid-2003. The capital account is fully liberalised, except for a few specific transactions such as real estate purchases. As a result the entry to the European Union is not expected to have a significant direct impact on the currency. However exchange rate fluctuations within a relatively wide range are expected to remain significant due to the impact of political events, including the fiscal reform approval process, continuous speculation on the adoption of the Euro and volatility of capital inflows, including a small number of sizeable private sector project related transfers through the open market.

Balance of Payments

In 2002 the trade deficit declined to 3.3%. An increase in the current account deficit, to 6.5% of GDP in 2002 from 5.7% of GDP in 2001, was mainly due to the substantial outflows on the income account. Services income was also much lower in the wake of August 2002 floods and greater instability in international politics due to terrorism fears and the build-up to the war in Iraq. The current account deficit is projected to fall below 5% of GDP in the medium term. The export of services is expected to improve within the next 18-24 months even though tourism receipts may still be affected by international instability throughout 2003. EU accession in May 2004 should have a direct impact on merchandise trade but the exact impact of EU accession on the volume of trade, trade balance, and enterprise costs is uncertain. Remaining tariffs, quotas and border controls for more than eighty percent of international trade will be abolished, which is especially significant for trade in steel and agricultural products.

The foreign direct investment inflows continued to be strong in 2002, due to both privatisation of remaining state owned enterprises, greenfield investments and re-flows of income in the form of reinvested earnings. The greenfield and to a lesser extent brownfield foreign investments are expected to continue at similar pace as in the last few years due to expansion of existing facilities. EU accession is expected to trigger an increased interest in investments in the Czech Republic by smaller companies and by investors with little experience in Central and Eastern Europe. The government does not plan any sale of a large state owned company, similar to the gas sector privatisation in 2002, in the short term although in the medium to long term the privatisation of the remaining state assets is set to continue. Portfolio flows are likely to be driven by local investors looking for opportunities abroad as small size and low liquidity of the local stock market pose significant constraints on portfolio inflows.

External Debt and Foreign Exchange Reserves

External debt has been falling since the 1997 currency crisis, to 37.8% of GDP in 2002 from the peak at 42.7% of GDP in 1998. The public sector share of external debt is relatively small. Direct public sector debt accounts for less than 10% of the total. Although the publicly guaranteed external debt, mainly for large infrastructure projects, accounts for almost 40% of the total, it has long maturities and favourable terms. The authorities are keen on using the EIB for debt financing of large infrastructure projects, such as the expansion of the Prague airport and motorway constructions. This may increase the public portion of external debt but financial conditions, including low margins, long maturities and likely adoption of the Euro within the life of those loans, suggest that such development has few risks, beyond risks associated with overall increase in the public debt.

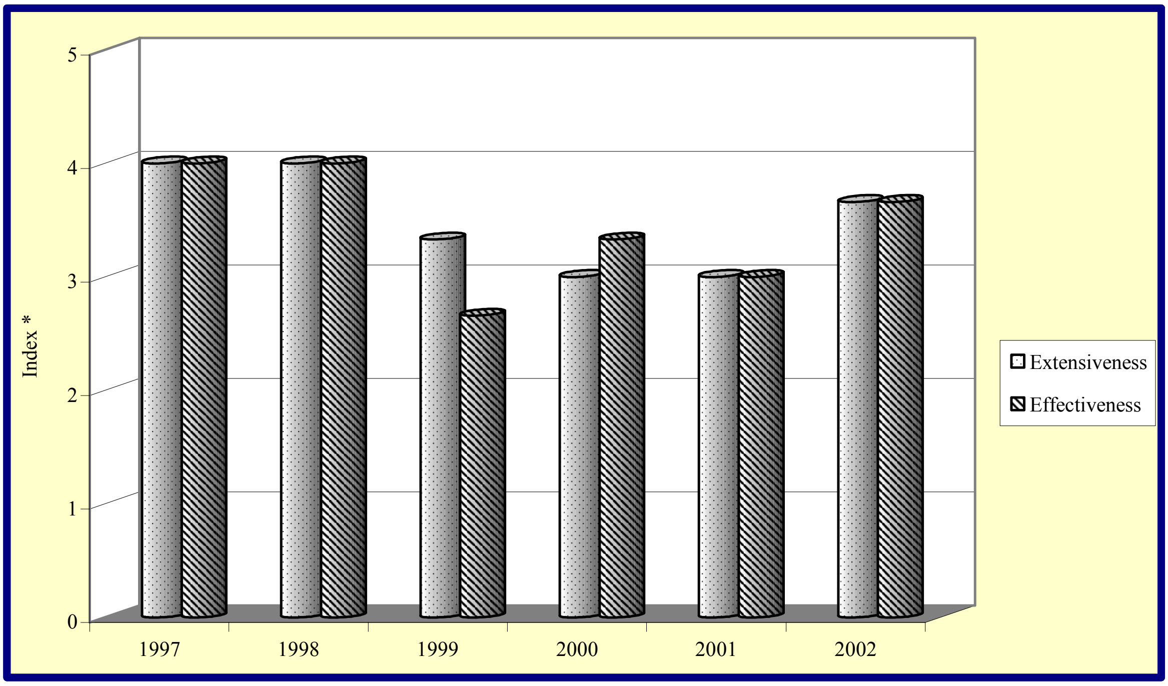
Foreign exchange reserves grew strongly during 2002, from US$ 14.5 billion at the end of 2001 to US$ 23.7 billion at the end of 2002 due to strengthening of the Euro, large balance of payments surpluses, and sizeable central bank interventions against currency appreciation. However the need for Central Bank interventions subsided in the second half of 2002 as the currency stabilised and the balance of payments surpluses are expected to be smaller in the future. As a result an increase in foreign exchange reserves in the medium term is likely to be smaller than in 2002.

ANNEX 3 - LEGAL TRANSITION

COMPARATIVE ASSESSMENT OF THE CZECH REPUBLIC'S COMMERCIAL LAW

I. Assessment Over Time

Extensiveness and Effectiveness of the Czech Republic's Commercial Law[1]



Source: OGC Legal Indicator Surveys; 1997 - 2002
**Note:* Indicators along the y axis range from 1 (little progress) to 5 (substantial progress)

According to the OGC's annual Legal Indicator Survey, the commercial laws of the Czech Republic have improved during the last few years and are broadly in line with the relevant international standards generally accepted. One of the issues still negatively affecting effectiveness of the Czech Republic's Commercial Laws is the weakness of the judicial system, such as the lack of sufficient number of judges and state attorneys and of appropriate training, slow judicial procedures, and the difficulties of foreign investors in trying to enforce their rights as secured creditors and minority shareholders in courts.

[1] The EBRD conducts a Legal Indicator Survey each year to measure the progress in legal reform in Central and Eastern Europe, the Baltic States and the Commonwealth of Independent States, as viewed by local lawyers and academics. The results of such survey are based on responses to the questionnaire sent out to lawyers practising in any given country. The survey represented their perception of the country's legal system and, in particular, the degree to which key commercial and financial laws have reached internationally acceptable standards (extensiveness) and to which extent these laws are implemented and enforced (effectiveness). The survey is based purely on local lawyers' perception of their own country legislation and does not represent EBRD's own view on these legal systems. In addition, it must be noted that each respondent is asked to answer the questionnaire for his/her country only, and not on a comparative basis.

II. Situation in Other Transition Countries

Based on the OGC's 2002 Legal Indicator Survey, which measured the **perception** of lawyers familiar with Czech law, the commercial laws of the Czech Republic can be characterised as "adequate" for supporting investment and other commercial activity. Compared with other countries in Central Europe, the Czech Republic's commercial law is perceived by lawyers in the field as broadly being on the same level as that of Hungary and Estonia.

LEGAL SECTOR ASSESSMENT

Bankruptcy

Currently, the relevant law governing bankruptcy issues is the Law on Bankruptcy and Settlement of Claims No.328/1991, which has been amended some seventeen times since its promulgation. According to preliminary results of the EBRD's Insolvency Law Assessment conducted in 2003, certain areas in the existing law fall short of applicable international standards. The issues identified include: the absence of detailed criteria for enabling a creditor to provide evidence that a debtor is insolvent; the absence of a clear statement of whether a secured creditor is bound by the stay/suspension on enforcement actions; the doubt concerning the effect of a final distribution on the claims of creditors; the somewhat complex provisions relating to priority claims and their payment; the prohibition on opening an insolvency case when the assets of the debtor are insufficient to meet the costs of administration; and the absence of sufficient detail regarding the application of the provisions relating to the avoidance of pre-bankruptcy transactions.

Instead of amending the existing law, the Ministry of Justice is preparing a completely new law. According to the Ministry of Justice, the draft Law on Insolvency and on Dealing with Insolvency is intended to be a comprehensive one and is meant to comply with the relevant EU directives. The draft envisages settlement of the property relations of the insolvent or imminently insolvent debtor by means of bankruptcy, settlement of claims or reorganisation. The latter proceeding is a new departure inspired by US Chapter 11 and German insolvency law.

Another novelty introduced by the draft is that in addition to those debtors who are already insolvent, the imminent insolvency of debtors is also covered. The aim is to settle the property relations of a potentially insolvent debtor at the earliest possible stage when he is not yet insolvent but on the verge of being so. At the end of the proceedings a "bona fide" debtor could emerge clear of debts falling outside the settlement with his creditors. It is thus meant to stimulate insolvency applications and to permit the preservation of indebted but viable businesses. The applicant, the other declared creditors, the insolvency debtor and the insolvency administrator are all expressly stated in the draft to be parties to the proceedings. It is envisaged that the court will retain the power to appoint the administrator, the preliminary administrator (if any) and the creditors committee, although the creditors are expected to have certain powers of control over the activity of the administrator. The administrator is envisaged to be made more accountable to the court and to the creditors. Currently, the draft seems to be controversial and is expected to encounter difficulties in passing through the Czech Parliament.

Capital Markets

The Czech securities market is regulated by a number of laws and decrees introduced gradually since 1991, and amended on several occasions since then, including: the Bonds Act (1990); the Commercial Code (1991); the Securities Act (1992); the Stock Exchange Act (1992); the Investment Companies and Investment Funds Act (1992); and the Securities Commission Act (1998). In 2002, a number of important amendments were enacted with regard to various legislations governing the securities market. These include: (1) amendments to the Commercial Code with the aim to strengthen minority shareholders' rights in case of take-overs; (2) amendments to the Securities Act by tightening disclosure requirements for publicly listed companies; (3) amendments to the Stock Exchange Act with the objective of strengthening the supervisory powers of the CSC; (4) amendments to the Bonds Act by providing for enhanced disclosure requirements and streamlining the approval process for issuing bonds, etc.

Supervision over the securities market was exercised by the Ministry of Finance until 1998 when the Czech Securities Commission (the "CSC") was established. The CSC has enforcement powers in specific areas related to securities issuance and trading, although the enforcement of provisions contained in the Commercial Code (e.g., those governing buy-outs and the obligations of publicly-traded companies) remains with the commercial courts. Pursuant to amendments introduced to the Securities Commission Act in June 2002, the position of the CSC was reinforced whereby it was granted the authority to issue secondary legislation, and the obligations for information provision by market participants were widened.

The insurance sector is supervised by the Insurance Supervision Department at the Ministry of Finance. A new Insurance Act entered into force in April 2000. It sets the framework for an overall restructuring of the sector and improvement of supervision and liberalises the conclusion of insurance contracts with foreign insurance companies. The new Act also strengthens the supervisory role of the Insurance Supervision Department and gives it considerable powers and new resources.

Despite the positive developments mentioned above, there are areas where further improvements are needed. First of all, according to the EU's assessment, the Czech Republic still needs a new legislation on capital markets in order to fully align its legislation with *acquis* principles regarding the functioning of capital markets. A new law on collective investments is needed to replace the Act on Investment Companies and Investment Funds of 1992, since the latter does not transpose all the relevant EU standards. Secondly, the roles of the Ministry of Finance and the CSC in capital market supervision need to be clarified to ensure that the independence of the CSC is established beyond question. In particular, the financial independence of the CSC should be strengthened. Thirdly, while the Insurance Act of 2000 is a progress, amendments are needed in order to fully implement the relevant *acquis*, such as those concerning insurance contracts, intermediaries, and third-party liability motor insurance.

Company Law and Corporate Governance

The primary laws governing corporate governance issues are the Commercial Code of 1991 and the Securities Act of 1992, both of which have been amended several times since their promulgation with the most recent ones (of which may being important) enacted in 2002. So far as corporate governance is concerned, the Commercial Code regulates the establishment and functions of companies in general, rights of shareholders, take-over rules, reporting rules concerning the change of shareholding in a company, merger and acquisition rules, etc., whereas the Securities Act provides for insider trading rules and disclosure requirements. In addition, in early 2001, the CSC finalised a voluntary Code of Corporate Governance, which is said to model on the OECD's Principles of Corporate Governance. Emphasising transparency and responsibility, the Code aims to foster sound governance practices in companies in the Czech Republic.

Under the Commercial Code, a limited liability company ("s.r.o.") can be established by a maximum of 50 members with a minimum registered capital of CKZ 200,000. The s.r.o. is a closed form of corporation and has no strict legal division between ownership and management of the company. The transferability of ownership interests in an s.r.o is restricted. An s.r.o. is managed by one or more individual directors rather than a board. Following a major amendment effective from 2001, members of an s.r.o. are now jointly and severally liable for the debts of the company up to the total of their unpaid capital contributions. In contrast to the s.r.o., the joint stock company ("a.s.") is the open form of corporation with the minimum capital requirement of CZK 2 million. Shares in an a.s. are freely transferable. Management of an a.s. is entrusted to the board of directors whose members are elected by shareholders at a general shareholders' meeting or by the supervisory board if the constituent document of the company so provides. However, if an a.s. has more than 50 employees, one third of the members in the supervisory board shall be elected by the employees of the company. An annual meeting of shareholders shall be held within 6 months from the end of the financial year.

The principle that all shareholders shall be treated equally by the company and its management is codified in the Commercial Code pursuant to a 2002 amendment; any agreements purporting to confer a benefit on any shareholder to the detriment of the company or shareholder is null and void. Depending upon the registered capital of the a.s., shareholders holding 5% or 3% of the company shares have the rights to, among other things, request the holding of a shareholders' meeting and initiate a derivative legal action against the company management. Starting from 5%, mandatory disclosure of shareholding in an a.s. is required to be made each time when there is a 5% increase (or fall). Shareholders failing to comply with this rule will be penalised by a prohibition to acquire further shares and a suspension of exercising relevant voting rights.

According to the 2002 results of the EBRD's Corporate Governance Sector Assessment Project (under which corporate governance related "laws on the book" were assessed against a corporate governance checklist developed by the Bank in 2000 based upon the OECD Principles of Corporate Governance), the Czech Republic was rated as "Medium Compliance" in par with many other EU accession countries. A reform priority for the Czech Republic is to strengthen implementation and enforcement in order to transform good institutions into sound corporate practices.

Concessions

The Czech Republic does not have a general framework concessions law. Furthermore, the country takes a sector-by-sector approach in choosing a suitable concession or privatisation policy and applying it. Several sector-specific acts regulate the right of a private legal entity to utilise public assets in order to provide facilities or services to the public. Among those sector laws are the Water Act, the Energy Act, the Act on Protection and Utilisation of Mineral Resources, the Roads Act, etc.

Existing laws provide some limited basis for the granting of concessions. The Water Act of 28 June 2001 (effective as of 2002) is a detailed piece of legislation. The Water Act provides for a framework for the water supply and sewage sector. However, it does not specifically refer to concession arrangements. The Water Act covers, among other issues, the permission for water use and discharge of waste water, charges and powers of water authorities. The term of permission granted differs depending on the type of use. For instance, waste water discharge permission may not exceed 10 years, and permission for the use of water energy may not be given for less than 25 years.

In addition, the Act on Water Supply and Sewage specifies the conditions of conducting business in the water supply and sewage sector. A person or entity wishing to operate water mains or sewerage must apply to the Regional Office for the relevant licence (a licence to operate water mains or sewerage).

The Energy Management Act of 25 October 2002 refers to the National Energy Policy and Territorial Energy Policies as strategic documents and the basis for policy development. Such policy in turn provides for privatisation of the electricity market (and the gas market). However, it does not specifically provide for granting any concessions in the field of energy

Recent amendments to the Roads Act enable private investment in public infrastructure. Under this Act, the Ministry of Transport may transfer some ownership rights of the state in relation to motorways only, by entering into a concession agreement with a private investor for the financing and construction, operation and maintenance of motorways, for a period of at least 25 but not more than 35 years.

The Natural Riches in the territory of the Czech Republic are in the ownership of the state. The Natural Riches Protection and Exploitation Act (the Mining Act), and the Mining, Explosives and State Mining Authority Act, provide for the basic legal framework for carrying on mining and activity involving mining in the Czech Republic. Only entities duly licensed by the State Mining Authority may perform such activities.

Secured Transactions

In the last two years, the Czech Republic has substantially amended its legal framework on secured transactions with a view to enabling parties to take more efficient security over assets. Amendments which entered into force on 1 January 2002 were introduced to Sections 152-180 of the Civil Code (Act No 40/1946 Coll., as amended). The Civil Code provisions cover both movable assets (tangible and intangible) and immovable assets on which a pledge or a mortgage can be created respectively. Enforcement of the charge is governed by the Civil Procedure Code. The Law on Bankruptcy and Composition, as amended, also contains relevant provisions.

Under the 2002 amendments mentioned above, the parties can agree to create either a possessory or a non-possessory charge over movable assets. Non-possessory charges have to be created by a notarial deed and be registered in a national registry for the registration of charges -- the Collateral Registry, which is operated by the Czech Chamber of Notaries. The Civil Code also provides for assignment of a right in favour of a creditor (Art. 553) and assignment of a receivable (Art 554) to secure a claim (the agreement must then be in writing). The problems with the transfer of title by way of security is that it is subject to VAT if the creditor is not a bank, so the high costs make this instrument unattractive.

The main features of the new regime are:

- The parties can now agree to create a non-possessory charge over a specifically designated movable item, or a charge over a collective asset such as an enterprise, or a set of things. However, there is some uncertainty about the way that a charge over an enterprise would be interpreted by the courts, especially whether it would capture future-acquired assets and whether it would attach on assets of the enterprise subsequently sold (outside of the ordinary course of business).
- Immovable property, which is not subject to registration in the Real Estate Cadastre (like petty buildings, underground structures such as tunnels, storage facilities, etc.) can now be encumbered with a non-possessory charge, which has to be registered in the Collateral Registry.
- A charge can secure, up to an agreed amount, debts of a specific kind arising between the chargeholder and the chargor during a certain period. In practice, this could imply that a charge should be possible over a fluctuating pool of debts, although uncertainties remain as to the position that a court would adopt.
- The new registry, for the first time, provides public notice of the existence of a charge. However, the compulsory notarisation of the charging agreement is likely to cause additional expenses for the parties. Also, it seems that notaries do not specify the collateral in a unified manner which causes problems when searching the database. Finally, searching the Registry can be done only at a notary office and requires the provision of either proof of justified interest or written authorisation from the owner of the charged assets, which may be difficult to obtain.
- The “ordinary” method of enforcement is by public auction led by privately appointed executors or by judicial sale. The latter procedure is complex (since it involves a valuation of the assets, once the writ of execution has become final) and can be expensive and time consuming.

Overall, while the collateral legal regime has substantially improved, there seems to be a number of restrictions and constraints which could limit the scope of transactions to be secured and/or undermine the effectiveness of the security, partly depending on future judicial interpretation.

Telecommunications

The telecommunications sector is currently regulated by the Czech Telecommunication Office (the "CTO") and is governed by Law on Telecommunications 2000 (the "2000 Law"), most recently amended in January 2003. The CTO was created in 1993 as part of the Ministry of Economy, before being transferred to the Ministry of Transport and Communications (the "MTC") in 1996. Following the passage of the 2000 Law, the CTO became an independent regulatory agency exercising state administration including regulation of telecommunications matters. The 2000 Law specified the CTO’s powers of supervision and intervention, the penalties it can impose and procedures for the administration of licences, frequencies, and numbering resources. Since 1 January 2003, all ministerial telecommunications activities were transferred from the MTC to a newly established Ministry of Informatics.

The 2000 Law introduced the principles of market liberalisation in the remaining monopoly areas of the telecommunications sector. It focuses on three principal areas: the conditions for establishing and operating telecommunications equipment and networks; the conditions for providing telecommunications services; and the execution of state administrative duties, including regulation. The legal monopoly of Cesky Telecom on the provision of fixed-line voice telephony services and the operation of a fixed-line network ended in January 2001. Any company wishing to build and operate telecommunications networks and to provide telecommunications services has the right to apply for licences and registrations from the CTO. The only restriction on the number of operators occurs if limited resources, such as frequencies and numbers, are required. The 2000 Law sets out the services for which licences are required.

The Czech Republic has advanced significantly with respect to alignment with EU *acquis* in telecommunications over the last few years, but a number of important outstanding issues remain in the sector. The date of 1 January 2001 for full liberalisation was fixed in 1994, but the provision of carrier selection and number portability facilities that are vital to effective competition appears to have been unjustifiably delayed until the end of 2002 (upon request from the incumbent). This has undermined the market opening and hindered new entrants in gaining market access, thereby affecting the interests of consumers and of investors in companies that compete with the incumbent operator in which the state still has an interest.

Despite the above criticisms, much progress has been made in the telecommunications sector over the last few years and the extent of modernisation of infrastructure is impressive. The CTO has made a good start but the remaining problems regarding the alignment with the *acqui*s should be urgently resolved. In particular, focus now needs to be concentrated on supporting competition, implementing remaining elements of the framework (such as the recently approved local loop unbundling measures) and ensuring cost-oriented tariffing. In addition, the independence of the CTO should be strengthened, any regulatory anomalies should be resolved and the principle of separation of regulatory and operational functions should be fully respected.

ANNEX 4 - ENVIRONMENT

Anticipating entry to EU in May 1 2004, the Czech Republic has been steadily achieving environmental quality improvements as well as harmonisation legislation with EU Environmental Directives (subject to Annex V to Article 24 of the Act of Accession 2003 on temporary and transitional measures for the Czech Republic). EU accession will lead to environment compliance investments estimated at around EUR 10 billion. Required annual spending on environmental protection in the Czech Republic is estimated at twice as much as in the current EU member states. Utility companies, particularly in the water and waste water management sector, are expected to invest substantial amounts of resources into upgrades of existing facilities and expansion of regional coverage. Significant environmental investments will be also required in private industrial enterprises as well as in the public sector.

The main objective of the State Environmental Policy of the Czech Republic is to preserve natural assets and improve environmental quality as well as strike a balance between economic development and environmental protection. The Czech people have high environmental awareness and enjoy increased access to environmental information and decision making process. Despite a slowdown, the Czech Republic has now made progress in the transposition of EC legislation and has effectively overtaken its own legislative timetable in some areas. However, enforcement of legislation in areas such as occupational health and safety and public health is weak. In other areas (e.g. green house gas emissions, solid waste recycling) the Czech Republic's environmental indicators are equal to those of most EU member countries.

Important structural changes in environmental quality include significantly declined industrial pollution induced by the closure of outdated and non-competitive industries in the first half of the 1990s. Furthermore, increased manufacturing production has not been accompanied by an increase in pollution. Nevertheless, there are challenges for full harmonisation with EU Directives as well as further environmental quality improvements as follows: improvement of land fills as well as hazardous waste treatment facilities, exploitation of renewable energy, water quality improvement to meet fully with EU drinking standards as well as to protect public health; strengthening of waste water treatment capacities; and flood controls.

The Bank's environmental approach supports the country's EU *acquis* objectives as well as addressing key environmental concerns and focuses on further improving specific environmental management areas through EBRD's projects in line with the EU *acquis* process. A recent Bank approved industrial project with Siemens-SKV will result in significant environmental, health and safety improvements in the facility along with state of the art paint shops and machinery in full compliance with EU standards. Furthermore, Siemens comprehensive and proactive corporate policy and procedures on environmental, health and safety management will be adopted at the SKV site.

Investing in environmental improvements to meet EU standards is an on-going process and the Bank will continue to co-operate with other institutions such as EU ISPA and EIB to enhance environmental *acquis* and improvements.

ANNEX 5 - SELECTED ECONOMIC INDICATORS

Czech Republic

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	*Projection*
Output and expenditure					*(Percentage change in real terms)*				
GDP [1]	5.9	4.3	-0.8	-1.0	0.5	3.3	3.1	2.0	3.0
Private consumption	5.9	7.9	2.4	-1.8	1.9	2.3	3.8	3.9	na
Public consumption	-4.3	3.6	-4.4	-4.4	2.3	-1.0	5.3	5.7	na
Gross fixed capital formation	19.8	8.2	-2.9	0.7	-1.0	5.3	5.5	0.6	na
Exports of goods and services	16.7	8.2	9.2	10.0	6.1	17.0	11.9	2.8	na
Imports of goods and services	21.2	13.4	8.1	6.6	5.4	17.0	13.6	4.3	na
Industrial gross output	11.8	11.1	0.1	2.8	-0.4	5.1	6.8	4.8	na
Agricultural gross output	3.2	2.5	-1.5	-1.8	2.3	-2.0	1.8	-2.0	na
Employment					*(Percentage change)*				
Labour force (end-year)	0.8	0.7	0.1	0.5	0.4	0.2	0.0	1.0	na
Employment (end-year)	0.7	0.2	-0.7	-1.4	-2.1	-0.7	-0.1	0.8	na
					(In per cent of labour force)				
Unemployment (end-year)	2.9	3.5	5.2	7.5	9.4	8.8	8.9	9.8	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	9.1	8.8	8.5	10.7	2.1	3.9	4.7	1.8	0.2
Consumer prices (end-year)	7.9	8.6	10.0	6.8	2.5	4.0	4.1	0.6	1.2
Producer prices (annual average)	7.6	4.8	4.9	4.9	1.0	4.9	2.9	-0.5	na
Producer prices (end-year)	7.2	4.4	5.7	2.2	3.4	5.0	0.8	-0.7	na
Gross average monthly earnings in economy (annual average)	18.5	18.4	10.5	9.4	8.2	7.0	8.6	7.5	na
Government sector					*(In per cent of GDP)*				
General government balance [2]	-1.1	-1.7	-2.7	-2.4	-2.8	-4.4	-5.1	-6.7	-8.3
General government expenditure [2]	43.0	42.2	41.7	40.9	41.9	43.7	44.2	46.6	48.9
General government debt [3]	15.3	13.2	12.9	13.0	14.5	16.7	18.5	20.0	24.3
Monetary sector					*(Percentage change)*				
Broad money (M2, end-year)	20.3	9.1	10.8	5.4	7.7	5.6	13.0	3.2	15.3
Domestic credit (end-year)	16.5	12.1	9.9	-4.1	-1.7	-2.6	-9.7	-10.0	na
					(In per cent of GDP)				
Broad money (M2, end-year)	75.3	70.6	72.5	69.6	72.8	74.5	73.4	72.4	80.9
Interest and exchange rates					*(In per cent per annum, end-year)*				
2-week repo rate	11.3	12.4	14.8	9.5	5.3	5.3	4.8	2.8	na
3-month PRIBOR	10.9	12.7	17.5	10.1	5.6	5.4	4.7	2.6	na
Deposit rate [4]	7.0	6.8	7.7	8.1	4.5	3.4	3.0	2.2	na
Lending rate [4]	12.8	12.5	13.2	12.9	8.7	7.2	7.0	6.2	na
					(Korunas per US dollar)				
Exchange rate (end-year)	26.7	27.3	34.7	30.0	35.7	38.8	36.5	30.7	28.0
Exchange rate (annual average)	26.5	27.1	31.7	32.3	34.6	38.6	38.0	32.7	27.4
External sector					*(In millions of US dollars)*				
Current account	-1,369	-4,121	-3,564	-1,255	-1,462	-2,718	-3,273	-4,523	-3,700
Trade balance	-3,678	-5,706	-4,893	-2,603	-1,903	-3,131	-3,068	-2,286	-2,000
Merchandise exports	21,463	21,947	22,359	25,853	26,265	29,052	33,378	38,198	42,000
Merchandise imports	25,140	27,654	27,252	28,456	28,167	32,183	36,446	40,484	44,000
Foreign direct investment, net	2,526	1,276	1,275	3,591	6,234	4,943	5,476	9,029	5,000
Gross reserves, excluding gold (end-year)	14,023	12,435	9,774	12,677	12,825	13,139	14,464	23,709	24,009
External debt stock	17,190	21,181	21,617	24,348	22,861	21,608	22,374	26,281	30,000
					(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	5.6	4.4	3.6	4.5	4.5	4.2	4.1	6.1	5.7
					(In per cent of current account revenues, excluding transfers)				
Debt service	8.9	10.4	15.2	14.6	14.2	9.6	6.4	6.3	5.8
Memorandum items					*(Denominations as indicated)*				
Population (end-year, million)	10.3	10.3	10.3	10.3	10.3	10.3	10.3	10.3	10.3
GDP (in millions of korunas)	1,381,049	1,566,968	1,679,921	1,839,088	1,902,293	1,984,833	2,175,238	2,275,609	2,348,760
GDP per capita (in US dollar)	5,049	5,601	5,143	5,535	5,332	4,984	5,547	6,742	8,310
Share of industry in GDP (in per cent)	33.3	33.8	35.9	36.9	35.5	36.0	37.3	38.4	na
Share of agriculture in GDP (in per cent)	4.7	4.9	5.0	4.8	3.9	3.9	3.8	3.7	na
Current account/GDP (in per cent)	-2.6	-7.1	-6.7	-2.2	-2.7	-5.3	-5.7	-6.5	-4.3
External debt - reserves (in US$ million)	3,167	8,746	11,843	11,671	10,036	8,469	7,910	2,572	5,991
External debt/GDP (in per cent)	33.0	36.7	40.8	42.7	41.6	42.1	39.1	37.8	35.0
External debt/current acc. revenues, excl. transfers (in per cent)	58.5	67.7	69.9	69.2	65.0	57.1	52.4	55.4	57.9

[1] GDP and GDP component data in 1995 constant prices.
[2] General government excludes privatisation revenues.
[3] Consolidated outstanding debt including state budget, health insurance, extra-budgetary funds and local governments, but excluding the indirect debt of special state financial institutions (Konsolidacni Agency) and publicly guaranteed debt.
[4] Weighted average over all maturities.

ANNEX 6 - TC FUNDS

TECHNICAL COOPERATION FUNDS PROGRAMME

(in million EUR as of 30 June 2003)

SECTOR	NO. OF COMMITMENTS	AMOUNT	FINANCING SOURCE
OTHER			
Agriculture, Forestry, Fishing	1	41,348	Netherlands
	1	41,912	Finland
Sector Total:	**2**	**83,260**	
CEALs,CoFinancing Lines & RVF's	1	60,000	
Sector Total:	**1**	**60,000**	
Community/Social Services	1	435,336	European Commission
	1	43,216	Netherlands
	1	10,868	United Kingdom
Sector Total:	**3**	**489,420**	
Construction	1	135,000	Denmark
Sector Total:	**1**	**135,000**	
Energy	5	534,570	European Commission
	1	208,492	Germany
	1	74,427	Italy
	1	18,253	Taipei
	1	46,844	United States
Sector Total:	**9**	**882,586**	
Finance, Business	16	688,320	European Commission
	1	1,466,216	
	2	310,074	Japan
	1	36,941	Sweden
	1	50,000	United Kingdom
Sector Total:	**21**	**2,551,551**	
Manufacturing	1	60,000	Italy
	32	1,672,557	European Commission
	8	480,000	
	1	114,806	Netherlands
	2	80,495	Italy
	1	48,400	Spain
	3	94,971	United Kingdom
Sector Total:	**48**	**2,551,230**	
Telecommunications	1	43,080	Austria
	1	39,657	Finland
	1	1,137,629	Japan
Sector Total:	**3**	**1,220,366**	
Transport, Storage	1	29,905	Denmark
	6	500,445	European Commission
Sector Total:	**7**	**530,351**	
CZECH REPUBLIC Total:	**95**	**8,503,764**	

ANNEX 7 - CURRENT PORTFOLIO STOCK

(in million EUR as of 30 June 2003)

Op ID	Op Name	Direct/ Regional	Portfolio	Of which Debt	Of which Equity	Undrawn Commitment	Operating Assets
2486	Advent International (addition to Advent Private Equity)	Direct	9.9	0.0	9.9	0.0	9.9
4844	Brno Waste Water Treatment Plant Upgrading	Direct	27.5	27.5	0.0	13.6	13.9
5426	CSOB Privatisation (portage equity)	Direct	125.0	125.0	0.0	0.0	125.0
1303	Ceske Drahy s.p. - Czech Railway Corridor	Direct	12.4	12.4	0.0	0.0	12.4
4931	Czech Direct Equity Fund	Direct	8.3	0.0	8.3	0.0	8.3
2510	Czech Private Equity Fund	Direct	2.0	0.0	2.0	0.0	2.0
19497	Dalkia Usti Nad Labem	Direct	12.0	12.0	0.0	0.0	12.0
13809	EU/EBRD Phase I - Ext. - Ceska Sporitelna	Direct	20.0	20.0	0.0	2.7	17.4
29267	EU/EBRD Phase II - Ext. - Raiffeisen Leasing	Direct	10.0	10.0	0.0	10.0	0.0
27108	EU/EBRD Phase II - Ext. - Raiffeisenbank a.s.	Direct	10.0	10.0	0.0	6.3	3.8
6372	European Property Group	Direct	34.7	0.0	34.7	12.8	21.9
26872	Genesis Private Equity Fund	Direct	6.0	0.0	6.0	5.9	0.1
11112	Harpen District Heating	Direct	19.0	19.0	0.0	12.0	7.0
3797	Korado	Direct	29.9	0.0	29.9	0.0	29.9
1313	Skoda Kovarny (Forge) a.s.	Direct	12.7	12.7	0.0	3.4	9.3
17457	Soufflet Malting Czech	Direct	8.3	7.2	1.1	0.0	8.3
22364	Soufflet Malting Czech - Expansion	Direct	12.1	12.1	0.0	0.6	11.5
27318	TES Media	Direct	9.7	9.7	0.0	0.1	9.6
7265	TIW Czech N.V	Direct	28.1	0.0	28.1	0.0	28.1
5782	UNIQA - Uniqa Pojistovna (equity)	Direct	2.8	0.0	2.8	0.0	2.8
24715	Winterthur MPF/CS L&P Penzijni Fond	Direct	20.7	0.0	20.7	0.0	20.7
3104	Winterthur MPF/CS L&P Penzijni Fond as (equity)	Direct	0.9	0.0	0.9	0.0	0.9
3103	Winterthur MPF/CS L&P Pojistovna (equity)	Direct	7.8	0.0	7.8	0.0	7.8
21122	Winterthur MPF/CS L&P Pojistovna - Capital Increase	Direct	4.1	0.0	4.1	0.4	3.7
5049	AIG New Europe Fund	Regional	5.9	0.0	5.9	1.6	4.3
8902	Accession Mezzanine Capital LP	Regional	7.5	0.0	7.5	6.1	1.4
4607	Advent Central & Eastern Europe II - Regional Fund	Regional	2.0	0.0	2.0	0.2	1.8
1309	Advent Private Equity Fund - Central Europe LP	Regional	0.7	0.0	0.7	0.0	0.7
23	Alliance ScanEast Fund	Regional	1.6	0.0	1.6	0.0	1.6
8194	Argus Capital Partners	Regional	7.9	0.0	7.9	0.0	7.9
4260	Baring Communications Equity	Regional	2.2	0.0	2.2	0.0	2.2
5058	Central & Eastern Europe Power Fund	Regional	1.3	0.0	1.3	0.0	1.3
346	Czech & Slovak Investment Corp	Regional	1.7	0.0	1.7	0.0	1.7
3491	DBG Osteuropa Holding GmbH	Regional	0.6	0.0	0.6	0.3	0.3
26594	DBG Osteuropa Holding II	Regional	6.8	0.0	6.8	6.5	0.3
13364	DVI, Inc. (debt)	Regional	1.5	1.5	0.0	0.4	1.1
9620	EU/EBRD Phase I - GIMV Czech and Slovak SME Fund	Regional	1.5	0.0	1.5	1.1	0.4
5073	Emerging Europe Capital Investors LDC	Regional	2.9	0.0	2.9	0.3	2.6
5422	Energy Efficiency and Emissions Reduction Fund	Regional	3.0	0.0	3.0	1.1	1.9
2668	Environmental Investment Fund	Regional	1.1	0.0	1.1	0.1	1.0
7004	Heitman Central Europe Property Partners Fund	Regional	8.1	0.0	8.1	0.0	8.1
27587	Heitman Central Europe Property Partners Fund II	Regional	8.1	0.0	8.1	8.0	0.1
19060	IKB Co-Financing Risk Participation Agreement	Regional	7.0	7.0	0.0	7.0	0.0
4442	Info. and Comm. Tech & Industrial Electronic Fund Ltd.	Regional	3.0	0.0	3.0	1.4	1.6
14808	Innova/3	Regional	4.5	0.0	4.5	3.4	1.0
5024	Innova/98 LP	Regional	1.9	0.0	1.9	0.0	1.9
2148	MBA Loan Project (guarantee)	Regional	0.9	0.9	0.0	0.9	0.0

Op ID	Op Name	Direct/ Regional	Portfolio	Of which Debt	Of which Equity	Undrawn Commitment	Operating Assets
6176	MBA Loan Project II (guarantee)	Regional	0.2	0.2	0.0	0.2	0.0
668	New Europe East Investment Fund	Regional	0.1	0.0	0.1	0.0	0.1
2973	New Europe Insurance Ventures	Regional	0.8	0.0	0.8	0.7	0.1
29124	ORCO APARTHOTELS	Regional	1.9	0.0	1.9	1.9	0.0
13199	Raiffeisen EU Enlargement Fund	Regional	3.0	0.0	3.0	1.5	1.5
15978	Regional/Private Equity Fund Facility - Trigranit II	Regional	0.8	0.0	0.8	0.2	0.6
44	Renaissance Fund	Regional	2.5	0.0	2.5	0.0	2.5
17292	Spearhead International	Regional	5.9	5.9	0.0	0.9	5.0
TOTAL			**530.8**	**293.1**	**237.7**	**111.6**	**419.3**