

Rural Finance in Transition Countries

The Czech Republic



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Preface

Rural areas and the agricultural sector continue to be an important factor in the national economy in most transition countries. Like all areas of the economy and society, rural areas in these countries have undergone considerable changes over the past years. Large farms have been broken up and privatised, which has led both to a significant change in the size of these farms and to on-site diversification. Growing sectoral diversification and increasing development of the service sector has become a trend. These concrete changes are taking place in the context of a transformation within rural finance. A rural finance system commensurate with existing needs - a fundamental requirement for the sustainable development of rural areas - does not yet exist in most transition countries. However, a sound analysis of supply and demand in existing rural finance systems is absolutely vital before any concepts for the development of rural financial markets can be elaborated.

Taking into consideration the close relationship between the development of the financial sector on the one hand and the real sector on the other, GTZ is to carry out a series of studies on rural finance in order to shed some light on this relationship within selected transition countries.

The Czech Republic has been chosen for a number of reasons. First of all, the Czech Republic, as a EU accession country, clearly has a well developed banking system, providing a range of financial services similar to EU countries. Secondly, it seems to be one of the few countries with such a small presence (if at all) of non-banking financial institutions (such as microfinance institutions). Furthermore, the Czech Republic, while possessing highly competitive manufacturing and services industries, remains a country of significant agricultural potential. It is interesting to analyse what effect this has on the presence of banks in rural areas? Additionally, is there still scope for improvements in the supply of rural financial services - even in an advanced transition country? And if so, does this concern financial institutions only? The results confirm that it does not.

The study has been conducted by Barbara Breitschopf, Institute for Economic Policy Research, Section System Dynamics and Innovation, University of Karlsruhe. It has been revised by Thérèse Zak and Rainer Schliwa from GTZ. Numerous people from financial institutions, organisations for agricultural and rural policy, chambers of industry and commerce as well as regional and central government agencies in the Czech Republic have contributed to this study. Many thanks to all of them.

In such an analysis of supply and demand, it is by no means a case of designing an ideal rural financial institution or financial system as a best practice case. It does not provide a complete picture of the Czech Republic in the economic and financial sense. The study aims to help take stock of current achievements but may also point out large opportunities to further rural financial development in the Czech Republic as an example for similar undertakings in other Central European transition countries.

Rainer Schliwa
Financial System Development

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List of Abbreviations

CMZRB	Czech-Moravian Guarantee and Development Bank
CSU	Czech Statistical Office (Český Statistický Úřad)
CZ	Czech Republic
CZK	Czech koruna, 33 CZK \approx 1 EUR (as of April 2002)
GDP	Gross Domestic Product
IDARA	Integrated Development of Agriculture and Rural Development
ISPA	Instrument for Structural Policies for Pre-accession
MIT	Ministry for Industry and Trade
MLS	Ministry for Labour and Social Affairs
MRD	Ministry for Regional Development
NDP	National Development Plan
PHARE	Programme of Community Aid to the Countries of Central and Eastern Europe
PSBA	Programmes in Support of Business Activities
RRP	Rural Renewal Programs
SAPARD	Special Action Programme for Agriculture and Rural Development
SFMR	State Fund for Market Regulation
SGFFF	Support and Guarantee Fund for Farmers and Forestry
SME	Small and Medium-sized Enterprises
VUZE	Research Institute of Agricultural Economics (Výzkumný Ústav Zemědělské Ekonomiky)

1. Introduction

1.1 Context of the study

Rural areas and the agricultural sector continue to play an important factor in the national economy in most transition countries. Like all areas of the economy and society, rural areas in these countries are also undergoing considerable change.

Alongside economic changes, rural finance is also undergoing a process of transformation. A rural financial system according to the financial needs of rural enterprises and actors is a major requirement for the sustainable development of rural areas; however, such systems rarely exist in most transition countries. Nevertheless, a sound analysis of potential supply and demand in a country's existing rural finance system is absolutely vital before any concepts for the development of rural financial markets can be elaborated.

In the framework of this study, different approaches in rural finance (banks, credit cooperatives, NGOs) should therefore be studied with reference to the current economic and socio-political context of any given country. This should indicate which types of rural financial institutions offer what solutions for financial problems in rural areas in a given economic context; in addition, it should also reveal the bottlenecks that such institutions have to contend with. The basic issue should therefore be the extent to which the current state of rural finance, the existing institutions and the institutional and legal framework offer solutions in line with the new economic conditions and the resulting demand scenario.

The study should be structured based on the answers to these key questions:

- What is the stage of development of rural areas in the transformation process?
- Which formerly state-run financial institutions have survived, and what is their current potential?
- What new approaches have been developed in rural finance, and what are their opportunities and limitations?
- What gaps remain in the existing range of services, and how might they be filled?

1.2 Procedure of the study

This study approaches the issue of rural finance in the Czech Republic by examining three fields. Firstly, it briefly describes rural areas, their development, infrastructure and drawbacks. Secondly, it analyses the agricultural sector and the non-agricultural SME sector as potential demanders of bank services in rural areas. Thirdly, it outlines the development, structure and products of the financial sector. This part also examines the distinct development between formerly state-owned banks and newly founded financial institutions.

However, it is hard to trace the development path of the former state-owned financial institutions in the Czech Republic, owing to the process of concentration in the banking sector (sales, mergers and takeovers), coupled with a convergence process leading to financial institutions offering rather similar products and services.

2. General information on the Czech Republic

2.1 The economic situation

After two years of recession prompted by the currency crisis in 1997, the Czech Republic began to recover in 1999 (see Table 1). GDP growth was moderate in 2000 and economic activities were strong, with a 10-15% increase in industrial production and construction output in the first quarter of 2001. Growth has been supported by strong foreign direct investment, especially in export-oriented firms, which have benefited from better organization, technology, and access to credit and foreign markets. At the same time, a large number of less dynamic firms in traditional enterprises are still in need of restructuring. However, the base for growth is broadening as an increasing number of local companies are beginning to benefit from the presence of foreign-owned companies. Employment began to increase mid-2000 as new job creation outweighed layoffs owing to enterprise restructuring. Although all regions have experienced a drop in unemployment, large regional disparities in unemployment remain owing to low labor mobility.

Against a background of recovery, the general government deficit increased by almost one percentage point in 2000. This increase reflected rapid growth in expenditure, especially transfers to social benefits and non-financial enterprises and capital expenditures. However, according to the IMF's Country Report 2001, inflation is expected to remain moderate.

Table 1 Overview of the Czech Republic's economic and financial indicators

	1996	1998	2000	2002
Real GDP change as a %	4.8	-2.2	3.1	2.8
CPI inflation (period average), change as a %	8.8	10.7	3.9	1.8
Unemployment (registered) as a %	3.1	6.1	9.0	7.3
Gross debt as a % of GDP	13.3	13.3	17.3	23.7
Total external debt as a % of GDP	36.8	40.4	42.6	34.8
Change in credit to households and enterprises (12-month change as a %)	10.6	-3.5	-3.3	
Current account as a % of GDP	-7.4	-2.4	-4.8	-4.2
Average interest rate (lending) as a % p.a.	12.5	12.9	-6.9	6.2
Share of agriculture in GDP, as a %	4.3	4.3	3.4	3.7
Employment in agricultural sector as a % of total employment	6.0	5.6	4.8	3.9

Source: IMF, Country Report No.1/110, Czech Republic, 2001, Statistical Yearbook of the Czech Republic, CSU 2003

2.2 The National Development Plan

The National Development Plan (NDP) was prepared in 1999 with the support of the EU-PHARE Special Preparatory Programme for the introduction of EU Structural Funds post-accession. The NDP is the first major exercise in the Czech Republic that seeks to define the

core priorities for tackling the economic and social disparities within the country and between it and the European Union.

According to the NDP, the overall priority of the current national economic strategy is to achieve sustainable economic growth. This is accompanied by policies focusing on a convergence of inflation and interest rates, and on the stability of public finance. In addition, these policies seek to support computer science in education and conduct research into high and medium-tech products and services, to reduce high energy demand, to expand the public transport system, and to create conditions increasing demand for domestic products.

As stated in the NDP, the future development of the Czech Republic will be considerably influenced by the implementation of significant national infrastructure projects. This will strengthen the position of those regions through which the new infrastructure lines will pass. Projects planned on the national level comprise the completion, construction or expansion of motorways, railway corridors and airports.

In the agricultural sector, policy emphasis is placed on changing the structure of support from a high degree of liberalism to greater interventionism in accordance with EU approaches.

2.3 Regional development aspects

The NDP contains a rural development plan, which will become operational with the measures in the SAPARD Plan and the regional state development programs. The NDP defines the major trends and problems in regional development:

- A considerable drop in production and employment in heavy industry (coal mining, metalworking, the chemical industry, heavy engineering), which still plays a key role in the economic structure in the northwest and Ostrava regions,
- A decline in production in the textile and electrical goods industries, affecting the northeast region in particular.
- A reduction in the number of employees involved in agriculture, especially in the southeast,
- Uneven development regarding private business, especially of small and medium-sized enterprises,
- Low levels of inter-regional workforce mobility, connected with restricted housing possibilities and a deteriorating public transport system.

The regional development strategy described in the Czech Republic's Regional Development Strategy includes (1) state regional development programs for selected regions, and (2) European programs such as PHARE, SAPARD (agricultural and rural development) and ISPA (transport and environment), as well as pre-accession programs.

- (1) The state regional development programs define which rural, structurally and economically weak regions should be supported. They concentrate on the development of regional infrastructure and communities, SMEs and industrial business (see Chapter 3: Rural Areas). Although many ministries have designed programs for rural development, their outreach remains limited owing to the restricted financial resources of the government.
- (2) The national/European programs focus on overall solutions to bottlenecks and aim at: (i) European integration in terms of legal, financial and administrative matters, (ii) infrastructure – concerning transport and the environment, (iii) the development of human resources in education and the labor market, and (iv) private sector development with regard to SMEs and regional development.

The total financial resources (EUR 367.45 million up to 1999) disbursed by the PHARE programs have been distributed to projects in the field of institutional capacity, civil society development, economic and social cohesion, agriculture, environment, justice, infrastructure, cross border cooperation and road modernization. As a result, cross-border projects, together with infrastructure and economic and social cohesion projects, have received more than 50% of the financial means, while the development of civil society and the agricultural sector have received the smallest share - about 1.5% of the resources in each case.

The SAPARD rural development plan (2000 to 2006) has allocated about EUR 22.4 million for 2000 (and a total of EUR 157.1 million in the period 2000-2006) to measures in the following fields: increasing the competitiveness of agriculture (investments in agricultural holdings, processing and marketing, quality control, land improvement); sustainable development in rural areas (renovation and development of villages, rural infrastructure, promotion of economic activities, environmental production); and technical support (training and assistance). More than 60% of the total financial resources will flow to the agricultural sector, and about 35% to rural development. The total public support ranges between 50-100% of the total project costs, of which the EU will contribute 75%.

At the end of 2000, five projects in the fields of road and railway construction and sewage systems from the ISPA program 2000 were approved for the Czech Republic, an allocation of about EUR 76 million in 2000.

Overall, the allocation of financial resources alone from SAPARD and ISPA programs amounted to about EUR 98 million in 2000, which corresponds to approximately EUR 13 per inhabitant in rural areas of the Czech Republic.

The total financial means of the PHARE programs exceeded EUR 41 per inhabitant in rural areas.

2.4 Summary and conclusion

- The Czech Republic's economic development is considered encouraging, and the economic and financial indicators reveal continuous improvement. Foreign direct investments have greatly contributed to this positive economic development.
- In the context of the targeted EU accession, the Czech Republic has elaborated a substantial national concept for development, with regional development programs. However, national financial means for such programs are scarce.
- Regional projects focus on rural development and on the agricultural sector. Special EU programs or ones from the Czech Republic designed to support directly the development of the financial sector in rural areas – technical assistance, product development, institution building and special training for improved offer of financial services in rural areas – do not exist.
- EU programs aim at supporting and promoting development in rural areas, especially in the agricultural sector, village development and local infrastructure. Several institutions and organizations expect that the SAPARD-approved projects (non-agricultural and farms) will have a positive external effect on their access to bank credit.

3. Rural areas in the transformation process

3.1 Rural areas

About 75.9% of the Czech Republic's population live in significantly rural areas, and only 24.1% in predominantly urban areas. The definition of rural population is based on a population density of less than 100 inhabitants per km. Significantly rural regions are where 15%-50% of inhabitants live in rural municipalities (Czech Development Plan).

On the regional level, all eight regions except those of Prague and Ostrava are identified as rural¹ areas with rural population.

According to the Ministry of Regional Development, economically-weak counties² are mainly located in the southwest, southeast and northeast. Counties affected by structural changes during the transition period are located in the northwest and east. They mainly suffer from the restructuring or liquidation of former state-owned mining and steel companies. Overall, about 21% of the population live in structurally or economically weak regions.

In the past, the strengths of the Czech Republic rural economy were the diversity of activities and a strong and efficient industrial sector that existed parallel to the agricultural sector. Rural dwellers who remained in farming during the communist era were effectively rurally-based industrialized workers. They tended to commute towards regional urban centers for factory-based employment. Many of them brought with them a high level of technical skills and expertise. However, since the transformation process began the prospects for alternative employment for rural dwellers have reduced substantially. This has led to a flow of economically active people towards large urban centers, causing an economic imbalance in some rural areas. The Czech government recognizes the need to mobilize resources and implement a policy at all levels to build a more diversified and dynamic rural economy in which SMEs should have a major role to play.

Owing to the former economic structure, the transition process in combination with economic resources reveals a regional diversity of conditions which can be summarized as follows:

- The northwest and Ostrava regions are experiencing rapid transition in the industrial and agricultural sector, and face an increase in the level of long-term unemployment. These regions are disadvantaged by a lack of entrepreneurial tradition.

¹ The area of the Czech Republic is classified into five levels which comprise the total territory, eight regions, and 14 counties, districts and municipalities. The classification of municipalities to districts and regions has partly changed and the figures of the old classification (Nomenclature of Regions and Districts) are not comparable with those of the new classification (Classification of Territorial Units for Statistics, CZ-NUTS).

² Indicators for economically weak counties are the unemployment rate, the number of employees in the industrial and agriculture sector, average wages, and the number of enterprises per 1,000 inhabitants.

3. Rural areas in the transformation process

- Central Bohemia and the southwest suffer from annual depopulation of up to 2.4%, bringing about an imbalance in the age structure.
- The regions around the economic centers of Prague, Ostrava and Brno face considerable development pressure: these cities provide valuable employment opportunities with higher wages than in adjacent rural regions.
- Some regions, such like Moravia, Polabi or Hana, which have a predominantly agricultural profile in socioeconomic terms, are likely to face further patterns of change and will continue to require fewer agricultural workers.
- Environmental problems are acute in former military, agricultural or industrial regions like the northwest, Ostrava and the Kladno district.
- Structural unemployment is attributed to the lack of mobility owing to insufficient housing.

Table 2 Description of regions

Region	Description
Central Bohemia	Supported by a good transportation infrastructure, the region is the Czech Republic's number one exporter, with economically active regions in the northwest and northeast. The industrial sector comprises the chemical industry, machinery and electrical engineering. The population of this region is growing owing to migration from Prague. Highly qualified laborers and employees often work in Prague and cause a scarcity of qualified labor in the region, leading to high average wages. Surprisingly, the region generates the lowest GDP-level. Despite attracting foreign investors, the communities need to design and develop their own projects to improve their structure and promote their development.
Southwest	
České Budějovice	The region has the lowest population density and a low level of unemployment, the second highest ratio of agricultural production (with 10% of all registered employees), and the second lowest rate of industrial production. Despite the traditionally high education level of its workforce, this region suffers from the low mobility of its inhabitants. Much of the population is accumulated around the regional capital, surrounded by a large number of small and economically weak towns, except for a few established industrialized zones. The region is not included in the national highway network.
Pízen	The region has the lowest population density and a high number of small towns that is above average. Encouraged by Phare and CBC grants, its districts are active in developing partnerships with projects aimed at the technical infrastructure and the environment. To attract new labor, towns are also involved in housing and business-supporting infrastructure projects. The region is linked to the international transportation net, although the town-to-town connections require extended reconstruction. The labor force is highly skilled and educated at secondary and vocational schools. The main problem here is the ecological devastation caused by mining and the contamination of the environment with radon.
Northwest	
Karlovy Vary	Although the urban population ratio (88%) tops all other regions except Prague, the region is one of the least-inhabited. It is isolated from the highway network and does not have any important international railway connections even though it has the third densest railway network in the country. The educational level is low and the business sector is dominated by spas, porcelain and glass supplemented with some businesses from the food, machinery, chemical and coal-mining industries. It contributes the lowest share to the national GDP and export.
Ústí Nad Labem	The region has an industrial, coal-rich basin in the northwest and an agricultural south, with a high concentration of people and large companies around some centers. The restructuring process and the establishment of SMEs is progressing very slowly. The labor force consists of unqualified workers, and unemployment is high. The region has had to cope with the liquidation of about 140 towns due to coal mining and the expulsion of about 510,000 Germans.

3. Rural areas in the transformation process

Northeast	
Liberec	The region has been traditionally strong in the textile, glass, jewelry, plastics and machinery sectors, with the automobile industry booming recently owing to contracts from Škoda. However, several of the largest companies have either cut back their activities or have been broken up into smaller ones. The transportation and infrastructure is limited in some parts of the region, but has an international outreach through the Nisainvest exhibition.
Hradec Králové	The quite heavily industrialized but disproportionately inhabited mountain areas have traditionally relied on the textile and machinery sector, which depends heavily on foreign investments. In contrast, the fertile lowlands offer good conditions for agricultural production. The business structure, benefiting from rising numbers of foreign companies, is dominated by SMEs. The transportation infrastructure is on a low development level.
Pardubice	The region benefits from a good transportation infrastructure but suffers from a population imbalance. GDP has been slowly growing and now amounts to 40% from SMEs. The ground and water are contaminated with oil products, PCBs and heavy metals; as a result, tourism is very small.
Southeast	
Jihlava (Vysočina)	The region is not very industrialized and was until recently known mostly for its potato production. The business structure is heterogeneous, the climate inhospitable and the transportation infrastructure is inefficient and old, inhibiting large-scale movements between towns and leading to vast differences in unemployment among the districts.
Brno (South Moravia)	It has the second highest density of highways and good roads in the country. Brno is the main economic center, employing about 47% of the region's labor force. The industrial production around the center is dominated by machinery and electrical engineering. In contrast, the border districts have to contend with a high unemployment rate and little foreign investment, aggravated by the bad transportation infrastructure in the region's hinterland.
Central Moravia	
Olomouc	The diversified economy of the region is based on the machinery, food, textile and chemical industries. Investments by large companies have been small but the share of SMEs in the region's businesses is high. The restructuring of large companies has not been completed, while export rates are low and the unemployment is relatively large.
Zlín	The division of the two countries has strongly affected the region. Once a central region, it has now become a border region with an customs regime impeding further economic development. In addition, lower demand from the Eastern market, exclusion from the national road network and frequent flooding have depressed wages and GDP below average. Traditional local industries in the past were in rubber, food and leather processing, textiles, shoes, woodwork, aerospace and arms.
Ostrava	The workforce and the industry in the region has been oriented towards coal mining, metallurgy and the energy industry. The regions suffer from uncompleted privatization and restructuring of heavy industries, lack of foreign capital, contamination of land and water and from a poorly developed transportation infrastructure. Public funding has been directed to the region to promote development of the industrial zones and the peripheral micro-regions.

Source: CityInvest 2000, Prague Business Journal

Table 1 provides a short description of the main features of the different regions or sub-regions of the Czech Republic. Some selected economic and demographic indicators are depicted in Table 3, while Table 4 briefly outlines the regional structures and problems.

3. Rural areas in the transformation process

Table 3 Regional economic and demographic indicators, 1999

Region	Population in million	Area, in thousand km ²	Share of rural population to total, as a %	Share of rural area to total, as a %	Population density, inhabitants per km ²	Share of employment in primary sector (1996) as a %	GDP per capita in PPS
Czech Republic	10.3	78.9	75.9	92.3	131	5.9	
Prague	1.2	0.5	0.0	0.0	2418	0.3	25,334
Central Bohemia	1.1	11.0	10.7	14.0	100	6.9	9,996
Southwest	1.2	17.6	11.5	22.3	67	8.5	11,537
Northwest	1.1	8.7	10.9	11.0	131	3.8	10,564
Northeast	1.5	12.4	14.5	15.8	120	9.2	10,574
Southeast	1.7	14.0	16.1	17.7	119	8.1	10,878
Central Moravia	1.2	9.1	12.1	11.5	137	6.5	10,155
Ostrava	1.3	5.6	0.0	0.0	232	3.7	1,1026

Source: Agricultural and Regional Development Plan for 2000-2006, Ministry of Regional Development, NDP 2001

Note: PPS= purchasing power standards, NUTS classification (new).

At present, small firms in rural areas are concentrated in the construction, forestry and services sectors, including retail. There are over 1.5 million registered businesses in the Czech Republic, although less than half of these are economically active. Many rural areas or villages and towns are still dependent on agricultural cooperatives, which represent about 50% of farm holdings and account for approximately 20% of the economically active population.

In 1999, the average monthly gross wage of employees in the civil sector was CZK 12,650 in the Czech Republic. The regional average wage levels ranged between CZK 11,300-11,990 (lowest East Bohemia), except for Central Bohemia, which had an average of CZK 12,600³ (CSU, 2000).

Tourism has become an important factor in the economic development of the Czech Republic. Its share in GDP grew from 1.3% in 1989 to 6.8% in 1998. It accounts for 9% of total employment, which is about twice as much as agriculture. In rural areas, the northeast, followed by the southwest and northwest, is leading in the number of tourist establishments, and in the number of persons working in them.

Migration between regions and districts within the Czech Republic has slightly decreased in the last ten years and now ranges around 4-5 people per 1,000 inhabitants. An increase in inhabitants owing to migration has occurred in the region of Central Prague, where people are moving away from the city into nearby rural districts. In most other regions, migration from one district to another hardly affects the regional population size (according to the Ministry of Regional Development). The population size in the districts shows a slight decrease of 1-2 persons per 1,000 inhabitants in 1999. The regional (on a district and

³ The average wages in the construction sector reflect the same regional structure/distribution.

municipality level) high disparities in unemployment rates derive from the low mobility of laborer and employees. Various factors affect labor mobility, including housing, education, transportation and public transport issues.

Table 4 Structural indicators, regional enterprises and legal forms of businesses in 1999

Region	Share of agricultural land to total, as a %	ILO general unemployment rate	Number of registered business units per 100 inhabitants	Share of enterprises in region as a % of total registered enterprises	Legal forms of businesses as a % of total units registered 1999				
					Private enterprises	Self-employed farmers	Companies and partnerships	Co-operatives	State-owned enterprises
Czech Republic	53.2	9	19.1	100	72.62	5.22	9.58	0.52	0.06
Prague	40.0	4.2	30.4	18.4	12.69	0.06	3.20	0.22	0.01
Central Bohemia	60.9	8	19.0	10.7	8.02	0.60	0.72	0.04	0.01
South Bohemia	50.4	6.7	18.5	6.6	4.69	0.49	0.48	0.03	0.00
West Bohemia	46.8	7.1	18.8	8.2	6.12	0.35	0.57	0.02	0.01
North Bohemia	48.7	13.5	17.3	10.4	7.74	0.48	0.86	0.03	0.01
East Bohemia	59.8	7.4	17.8	11.2	8.08	0.85	0.82	0.05	0.01
South Moravia	60.0	8.7	17.9	18.7	13.17	1.47	1.84	0.08	0.01
North Moravia	49.5	13	15.8	15.8	12.11	0.92	1.10	0.06	0.01

Source: CSU 2000

Note: CSU, old classification.

3.2 Infrastructure

The development of rural physical infrastructure plays an crucial role in the development of economic activities and the improvement of conditions of life. At present, the state of infrastructure is considered to be unsatisfactory. In 1998, about 75.6% of all municipalities had a water supply system. The Central Bohemian region has the lowest share of municipalities (57%) with a water supply system. Furthermore, the share of municipalities with a sewerage system is rather low (25.8%), with Central Bohemia again the region with the lowest level. Similarly, an adequate gas for heating system is only provided by 31.4% of the municipalities, with Central Bohemia once more the least developed region. The network of roads has been neglected and requires costly repairs and reconstruction.

Facilities which can be classified as civic amenities (schools, post offices, police stations, health facilities) are distributed relatively evenly. However, the Southeast, Southwest and Central Bohemia regions and small villages lag behind the Czech national average.

A few exhibitions have been organized in Brno (southeast) and Liberec (northeast), but basically markets for producers (particularly for agricultural products) have hardly been established. In the agricultural sector, farm inputs and marketing of farm produces are mainly supplied by two large private, formerly state-owned companies. Only about 20-30% of the

farms market their products directly or through newly-founded local supply and marketing cooperatives.

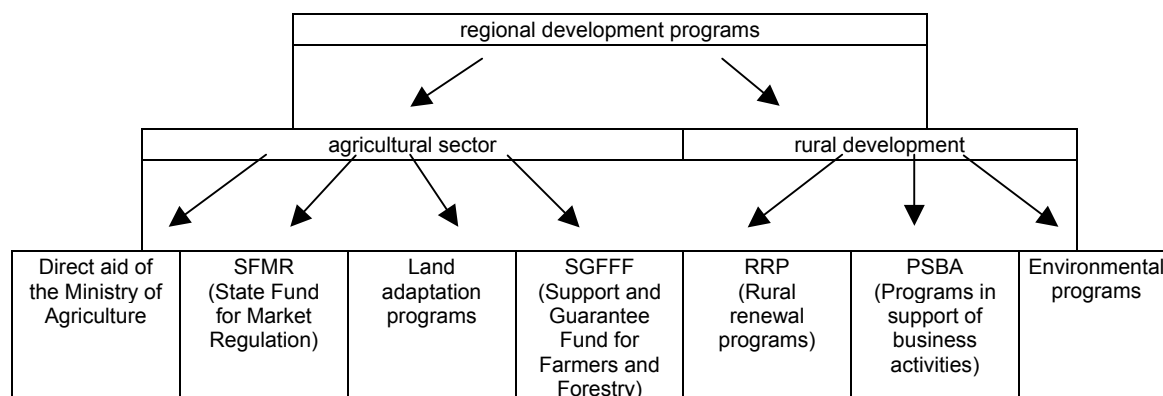
The network of financial institutions is relatively large. Although the number of banks and branches has been decreasing for many years, there are still about 5,700 citizens per banking unit (branch) and 225.6 citizens per banking employee. No evidence or complaint has been found in reports or conversations concerning the lack of physical access to financial institutions.

3.3 Regional development

Until 1990, regional policy in the Czech Republic can only be associated with massive redistribution and reallocation of resources. No substantial regional inequalities existed at the beginning of the 1990s. But the decline in heavy industry and mining and the reduction of employees in the agricultural sector during the transformation process, combined with the low interregional mobility of the workforce and severe environmental problems, all point at problems increasingly emerging in rural areas. In 1996, the newly established Ministry for Regional Development was given a coordinating role in securing the state's regional policy. The regional policy is understood as a conceptual activity on the part of the state and regional authorities with the aim of contributing to development, of reducing differences and of improving structures in rural areas. The regional policy was defined as a state activity aimed at supporting the effective functioning of the market economy. It was clearly oriented toward supporting small and medium-sized enterprises and at improving the infrastructure in structurally or economically weak regions.

Two types of problem region were defined, (1) structurally afflicted regions, where a high concentration of traditional industry and a high level of urbanization and unemployment prevail, and (2) lagging regions, where the standard of living and the population density are low and the share of employment in the primary sector is high. All in all, 18 problem areas have been identified.

In addition to the EU-PHARE, SAPARD and ISPA programs, the Czech Republic has launched many funds and programs to promote regional development and to support the restructuring of the agricultural sector. Large programs or funds explain the development of the agricultural sector and rural areas as depicted in Table 5. Although the national development plan recognizes the need to consider rural development as a holistic and integrated issue, the promotion of agriculture and rural development is strictly separated on the sectoral level and administered accordingly by the corresponding ministries. Nor is there a common coordination of programs, or shared programs between the agricultural ministry and the regional development ministry. These distinct promotion schemes are likely to neglect projects with intersectoral components or with significant intersectoral linkages or effects (agriculture-tourism, agriculture-processing-manufacturing), since their single sectoral impact (evaluated from the "one-sector perspective") may not be convincing or strong enough.

Table 5 Overview of the state programs for regional development

In 1998, direct aid to agriculture amounted to about EUR 131.6 million (EUR 18.1 million in 2000). Further support was given for the implementation of land adaptation and the State Fund for Market Regulation (SFMR). The SFMR regulates the market in selected agricultural and food products (dairy, cereals, beef, starch) through intervention buying. The Support and Guarantee Fund for Farmers and Forestry (SGFFF) is an instrument of agricultural credit policy, and provides loan guarantees (CZK 876 million in 2000) and interest subsidies (CZK 553 million in 2000).

The government has approved rural development programs which include the Rural Renewal Program (RRP), Programs in Support of Business Activities (PSBA) and environmental programs. The programs' link to the financial sector depends on financial institutions providing loans in some of the programs. Hence, the banks' task is to screen thoroughly and evaluate the potential borrowers' creditworthiness and to provide the capital, while the programs assume part of the loan costs and risks. Table 6 gives an overview of the most frequently used programs of selected ministries active in rural development.

Table 6 Programs of selected Czech Ministries

Ministry	Program	% of subsidy
Ministry of Regional Development (MRD)	RRP (Rural Renewal Program) and PSBA (Program in Support of B. A.)	70% of interests max.
	housing construction support	40
	technical infrastructure support for housing reconstruction and modernization of housing	40
	cross-border cooperation	40
	support for SMEs	20% of interests
Ministry of Culture (MoC)	emergency roof scheme	
Ministry of Agriculture (MoA)	water management matters	
Ministry of Industry and Trade (MIT)	fuel and energy alternatives	
Ministry of the Environment (MEn)	landscape measures	
MEn, MRD, Ministry of Finance	revitalization of river systems	
	ecological operations	
MoC, MRD	rural heritage	50
	architectural heritage	50
	protected urban heritage districts	50

Source: Agricultural and Rural Development Plan of the Czech Republic 2000-2006, SAPARD Plan, 2000

3. Rural areas in the transformation process

The total budget for the RRP is planned to amount to EUR 13.6 million in 2,000. The RRP provides grants from EUR 700 to 5,600 for villages and up to EUR 27,800 for associations of municipalities for the renovation and maintenance of housing and civil amenities, for the management of public grounds, for the renovation and establishment of public greenery, for the reconstruction of local roads, paths and public lightening, for the elaboration of urban studies and land-use plans, for municipal projects for training and extension in the area of village renewal, and for integrated projects of rural micro-regions and for infrastructure.

The PSBA consists of many small programs extended to small and medium-sized businesses. In 1999 about EUR 31.9 million was provided for these programs, the most important of which are briefly outlined below:

- VESNICE (village) aimed at medium-sized businesses with less than 250 employees, and active in small communities. It contributes to interest payments, and is conditional upon the creation of one new job.
- REGION (region) offers small businesses that have less than 50 employees in structurally damaged regions or in economically weak regions a contribution towards interest payments. The contribution is conditional upon the creation of two new jobs.
- ZÁRUKA (Guarantee) provides a guarantee for the balance of a bank loan of up to 75%.
- REGENERACE offers a interest payment contribution for small businesses with less than 50 employees in monumental preserve areas. It is conditional upon the creation of two new jobs.
- HRANICE (Border) provides preferential credit with a subsidized interest rate to small businesses with less than 50 employees in border areas. Acceptance is conditional on the creation of two new jobs and cooperation with a foreign partner.

3.4 Summary

- According to prevailing definitions, all regions except those of Prague and Ostrava are said to be significantly rural.
- The disparities in economic development between regions emerged during the transformation process. These regions had a significant concentration of old industries (mining, coal, steel manufacturing), but not necessarily of rural areas.
- The physical infrastructure is considered as an impediment to rural development, although the physical infrastructure of financial institutions seems to satisfy needs or demands. There have been no complaints about the accessibility of banks.
- Rural development programs are implemented by the EU and the state. The Czech Government targets these at SMEs and the agricultural sector, aiming at the extension of infrastructure and at community development. The financial sector in rural areas is not a target sector for programs, but is indirectly affected by the different credit schemes of

the promotion programs in rural areas. Financial institutions partly take on the screening and evaluation of program applicants and provide the capital, while the program itself assumes part of the risks and costs associated with the loan.

- Beside this, the design and administration of programs is separated into sectors and is split between different ministries. This may entail neglecting projects with considerable intersectoral components, linkages or effects but which have insignificant components/effects for one single sector.
- Labor immobility is considered problematic. The low level of emigration from rural areas has so far had no effect on economic development.

4. The agricultural sector

4.1 Agricultural development

The Czech Republic has a long industrial tradition. In the centrally planned period, agriculture played a smaller role in its economy compared to other Central or Eastern European countries. In 1989, agriculture contributed around 7% to GDP and accounted for 10% of total employment. In the early 1990s, however, essential restructuring took place in Czech agriculture, resulting in a substantial fall in the share of agriculture in employment and GDP.

Under the communist regime, approximately 160 private individual farms cultivated about 1,600 ha land (1% of agricultural land and production); nowadays, there are about 51,000 individual farms cultivating over 900,000 ha land. The focus during the communist era was instead on large collective farms, using 62% of the agricultural area and accounting for almost 79% of agricultural production. Next in importance were the 174 state farms which, with an average size of more than 6,000 ha, accounted for 24% of employment in agriculture. The artificially high share of employees in this sector had a major impact on the employment structure and hence on the social structure of the rural population. The large number of layoffs of agricultural employees during the reform process – about 300,000 between 1990 and 1994 – prompted social change in rural areas.

The reform process in the agricultural sector comprised the privatization of state land and the restitution of land to its former private owners. This was constituted in the Land Law (1991), which included principles of restitution of agricultural assets, and in the Commercial Law (1991), which defined the possible legal forms of enterprises. In 1990 the first new individual farms emerged, although most of the current individual farms were established between 1993 and 1995, when the restitution of expropriated agricultural land and the privatization of state farms were approved. Since then, no significant structural shift in terms of individual farms and legal forms has occurred (Ratinger).

Nowadays, between 23,000 and 54,000⁴ agricultural enterprises exist - legal entities as well as individual farms - of which 2,500 cultivate about 75% of the agricultural land. Most of them are legal entities or new cooperatives created out of former collective farms and state farms. The remaining 25% of agricultural land is cultivated by private individual farmers, of which up to 6,000 work full time(Posipil).

⁴ In the agro-census, different definitions of farms based on different farm sizes were applied to count farms.

4. The agricultural sector

Table 7 Development of agricultural structures

	Share of agricultural land ⁵ , as a %		Average farm size in ha		Number of employees or workers, hired or family	
	Before the transformation	1998	Before the transformation	1998	Before the transformation	1998
Cooperatives	61	43	2578	1447	403,200	76,000
State farms	38	2	9443	521	127,900	430
Farms as legal entities	n.a.	32	n.a.	690	n.a.	97,200
Individual farms	n.a.	23	n.a.	34	n.a.	32,000

Source: European Commission, Agricultural Situation and Prospects in the Central and Eastern European Countries, 1998

Lobbying by the different agricultural groups – the agricultural enterprises and individual full-time farms – occurs mainly through the private farmers' association and the agricultural chamber. By contrast, the small-scale farmers are not represented by any organization. The first of these lobbying organizations comprises only full-time family farms, while the latter consists of large agricultural enterprises and food processors. These two economic agents therefore pursue separate interests, leading to two different fundamental targets in the agricultural sector:

- The large enterprises strive for large-scale industrial agricultural production, where the production units are run by one professional manager. They expect financial, legal/regulatory and structural support from the government, as well as corresponding regulations and interventions from the EU, to maintain agricultural production after accession to the EU. Their concept of the agricultural sector is an industrial one.
- The private farmers have a wider perception of their farm activities, which includes new ways or functions of farming such as attractions for tourists and environmental preservation. They focus on rural development, and oppose agricultural subsidies and interventions aiming only at agricultural production. They require support for farms operating under unfavorable natural conditions, and expect support for investment rather than production activities. Their vision of agricultural development is based on family farms and rural development.

4.2 The structure of the agricultural sector

Enterprises and farms

The basic structure of agriculture consists of private farmers, agricultural cooperatives and corporate farms (legal entities, e.g. joint stock or limited). The main features of the sector are the prevalence of large farms, low revenues from farming, and agricultural enterprises that suffer from high levels of indebtedness and a lack of liquidity.

The two agro-censuses of 1995 and 2000 provide a relatively good outline of the farm structure and the situation of individual farmers in the Czech Republic. The 1995 agro-census surveyed all agricultural units cultivating at least 3 ha of agricultural land with

⁵ "Agricultural land" corresponds to the German term "landwirtschaftliche Nutzfläche".

common agricultural crops, or 0.3 ha of special crops. The 2000 agro-census comprises even smaller farms⁶, but the data have not yet been processed. According to the censuses, the individual farm sector comprises (1) family farms which are registered either through a municipal or district authority in the Register of Economic Units, and (2) household farms which are not registered at all.

The 1995 agro-census failed to interview about 31,400 individual farms recorded in the Register of Economic Units, while the 2000 census missed about 8,600 individual farms. The inclusion of smaller farms in the 2000 census largely explains the drop in non-surveyed farms. Those farms not interviewed in 2000 partly include those that have since ceased to exist.

In 1995, the share in the number of individual farms as a percentage of all agricultural active businesses was about 89%, rising to 95% in 2000, while the share in agricultural land of individual farms was 23% (1995) and 26% (2000). In 1995 and 2000, legal entities were cultivating 77% and 74% respectively of the agricultural area (Table 8).

Table 8 Farm structure in the Czech Republic 1995 and 2000

	1995	2000
Individual farms, number	21,156	51,473
Area of individual farms in ha	794,000	952,000
Average size in ha	37.6	18.5
Individual farms not interviewed but registered	31,400	8,600
Legal entities, number	2,488	2,685
Area of legal entities in ha	2,703,000	2,655,000
Average size of legal entities in ha	1,094	998

Sources: Ratering, 2000, VUZE

Note: state farms and cooperatives are not included.

One may reasonably expect that the spectrum of private farms will remain very broad. Most of them will consist of the so-called supplementary household farms, with agriculture as a supplementary income-generating activity. They will be followed by typical family farms where agriculture is the main source of income, and family members who represent the main proportion of the workforce. Estimates (Vuze) show that about 3,500-6,000 family farms of this type existed in the Czech Republic in 1995.

Land

The land ownership structure is heavily fragmented. Much of the land (3.4 million ha) is owned by natural persons and by different corporate farms. About 3.9 million ha of farming land is rented. Despite legislative changes, the market for agricultural land has not yet developed. More than 3 million potential sellers face a few potential buyers of land for agricultural uses. Not surprisingly, the renting and selling prices for agricultural land are low.

⁶ Farms with at least 1 ha of agricultural land with a common crop, or 0.15 ha with a special crop, one head of cattle or two pigs.

4. The agricultural sector

All real estate in the Czech Republic is registered on the basis of ownership in the real estate cadastre; however, for the most part, the latter is not responsible for the updating of ownership structures. This is carried out by the Land Offices in the framework of land consolidation operations.

The distribution of the land size of individual farms shows that about 36% of the individual farms in 1995 were cultivating land between 0.3 and 5 ha, 24% of the individual farmers between 5 and 10 ha, and 33% between 10 and 30 ha. About 20 % of the cultivated land of individual farms with a size up to 10 ha is rented land, while for farms with more than 10 ha, the share of rented land increases by 28% up to 84% for farms with more than 100 ha (1995).

Labor

The share of agriculture in the overall employment figures dropped within 5-6 years from 9.9% to about 5.5% in 1997. This reduction was caused by the outflow of labor to other sectors, the reduced share of agriculture in GDP, increased labor productivity owing to new technology and machinery, and the separation of side-line production. Out of a total of about 400,000 people who left the agricultural sector, 230,000 remained unemployed at the end of 1998. In the process of decreasing employment, many young, enterprising and qualified personnel left the agricultural sector to start either their own businesses outside this sector, or to work for non-agricultural enterprises.

In 1998, approximately about 32,500 persons were active in the private farm sector, while the legal entities in the agricultural sector employ about 173,600 workers. The number of workers on individual farms decreases with increasing farm size from 12 to about 3 workers/100 ha. The high figure of workers per 100 ha for small farm sizes appears to include seasonal workers as well (1995). Under the given mechanization and specialization level, it is possible for most farmers and their families to do everything except the seasonal work, for which seasonal labor (from eastern Europe) or contractors are used.

Production

The main agricultural commodities are cereals, which traditionally dominate crop production and take up 54% of the arable land. In recent years, however, the average cereal hectare yield has stagnated at levels far below the EU average. Rape is the main oil seed crop. About 88% of the harvest is processed in the Czech Republic, including the rape seed oil methyl ester production. Potatoes and sugar beet production ranges after wheat (and barley) production on fourth and second position* as regards agricultural output.

The slight decline in total crop output was mainly due to the decline in yields which, in turn, was probably a result of the reduced input use in response to the price cost squeeze.

Changes in the structure of livestock production are much more marked. Cattle numbers including cows have halved over the past decade. The overall pig herd has fallen by 15%. There has been some increase in average milk yields, thereby offsetting some of the effect of the fall in cow numbers on milk production.

The regional structures and production by type of management are depicted in Table 9 and Table 10.

Table 9 Regional production

Harvest in million t in 1999	Total	Central Bohemia	South Bohemia	West Bohemia	North Bohemia	East Bohemia	South Moravia	North Moravia
Wheat	4.0	0.9	0.5	0.3	0.3	0.6	1.1	0.4
Barley	2.1	0.4	0.4	0.2	0.1	0.3	0.6	0.2
Potatoes	1.4	0.2	0.3	0.1	0.1	0.2	0.4	0.1
Sugar beet	2.7	0.7			0.2	0.6	0.5	0.6
Rape	0.9	0.2	0.1	0.1	0	0.1	0.2	0.1
Share in livestock production as a %								
Cattle	100	13.1	16.8	12.3	5.1	20.2	20.0	12.4
Cows	100	13.0	16.8	12.3	5.0	21.1	19.2	11.6
Pigs	100	14.7	12.5	9.8	6.0	19.9	28.4	13.2

Source: CSU 2000, FAO Project Report Volume 5, 8/1999

Table 10 Agricultural production by management type⁷

Harvest in million t in 1999	Total	Private management	Cooperative management
Wheat	4.0	2.6	1.3
Barley	2.1	1.4	0.7
Potatoes	1.0	1.0	0.3
Sugar beet	1.7	1.5	1.1
Rape	0.9	0.6	0.3
in thousand pieces, 03/2000			
Cattle	1574	922	607
Cows	615	366	230
Pigs	3688	2519	957

Source: CSU 2000

Income

The current farming methods do not provide sufficient income for farms with less than 50 ha. The total family income of individual farms is supplemented by up to 80% with non-farm income like wages or salaries, pensions and other forms of compensation. Farms in the size bracket up to 5 ha receive 80% of their available income from non-farming activities. Even for farm sizes between 10-30 ha, non-farm income contributes around 40% to total family income (IDARA survey, 2001). The optimum area of individual farms appears to be between 100 and 500 ha. However, at this farm size, this group includes only 5.1% of private farms.

⁷ Private type of management, which includes all types of self-employed farms, natural persons, legal entities and private business companies and partnerships.

4. The agricultural sector

According to the Research Institute for Agricultural Economics (VUZE), the overall economic result of agricultural enterprises was negative from 1996 to 1998. The main cause of losses incurred was the diverging increase of the price index for agricultural inputs and agricultural outputs. However, the individual types of enterprises experienced different developments. Private farmers only reported a loss in 1998. It was argued that this was also due to the low interest they paid for loans - if indeed they even had a loan.

Supply, marketing and processing

Analogous to the structure of agricultural enterprises, the structures of agricultural input supply, service, storage and marketing were dominated by a few large former state enterprises (e.g. Agrofert, Agrospol), which were transformed into legal entities. Although private farmers and new cooperatives have opened some new markets through direct marketing, there is a strong monopoly, particularly in the storage of cereals. About 70-80% of private farmers (Pospisil) buy inputs and sell their agricultural products through the channels of these two large agro-enterprises.

The contribution of direct marketing or sales of farm produce to farm income is relatively low for small individual farms and highest for medium-sized farms (10-30 ha) (Table 11). Individual farms only sell approximately 26% of their root crop, 40% of their grain and 34% of their vegetable production, but sell 87% of their rape seed production.

Although the processing of farm products on the farm is recognized as profitable, few initiatives to directly process farm products exist. However, the level of privatization in the foodstuffs and beverages sub-sector is high, and 75% of the total number of enterprises are small and medium-sized food processors. In total, the sector accounted for almost 17% of the overall processing industry's output in 1998.

Table 11 Contribution of direct marketing to farm income

Farm size in ha 2000	0-5	5-10	10-30	30-50	50-100	over 100
Direct sell to total income, as a %	16	31	32	27	26	29
Agricultural income to total income as a %	19	47	61	74	81	96

Source: Ratering 2001, VUZE

4.3 Agricultural policy

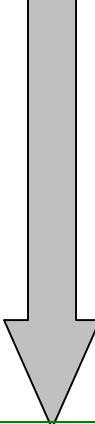
After 1989, agricultural policy focused on the transformation of collective farms, the privatization of state farms and food enterprises and on the settlement of restitution claims and land consolidation. The main emphasis was on productivity issues. Since 1994 the aim of agricultural policy has been to stabilize and gradually develop rural areas. The support programs and aid schemes established by a decree are targeted at non-production functions of agriculture, landscape management and the development of less favored areas.

Competitiveness and the fulfillment of the accession requirements are the present tasks of agricultural policy. In this context, agricultural policy comprises two program stages, whose main measures are listed in Table 12. The first stage focuses on the stabilization of the

agricultural sector up to 2001. Therefore, the programs are dominated by current problems and constraints in agriculture. The second stage, beginning in about 2002, comprises all necessary steps to adapt agricultural policy, including structural, regional, environmental and landscape policies, to the EU level. This includes the requirement that the administration of the Czech Republic can obtain financial resources from the EU, distribute/allocate them and control their actual use.

However, the main targets of the Czech Republic are to match the competitiveness of agriculture in the EU, to maintain the largest, most feasible part of the agricultural area, to secure sufficient income from the farm sector, and to respect all the Czech Republic's international trade obligations (J. Hadova).

Table 12 Agricultural policy measurements

Policy instruments	Stage from 1999
Agricultural policy: initial state promotion of revitalization <ul style="list-style-type: none"> ➤ financial means for landscape and soil preservation ➤ green energy (diesel) program ➤ organic fertilization program ➤ promotion of marketing organizations EU market and intervention <ul style="list-style-type: none"> ➤ preparation for EU market and intervention ➤ introduction of market regulation (without compensation for beef, milk, sugar and cereals) ➤ market regulation with compensation Compensation for unfavorable areas Environmental program	
	Stage of accession

Source: Wirtschaftspolitik 1/2000, J. Hadova

The national policy is supplemented and supported by the EU's PHARE, SAPARD and ISPA programs (see Chapter two). The SAPARD program uses an integrated approach which seeks to solve priority problems with to the aim of achieving a complex mix of desirable social, economic, environmental and cultural effects. This includes the mobilization of EU, national, regional and local resources. This approach will eliminate the weakest points of agricultural and rural areas, such as low productivity levels, modernization, marketing, investment, etc.

4.4 The intersection of the agricultural and financial sectors

Past and current economic conditions continue to affect the restructuring/concentration process and business activities of the banking sector. This in turn has affected the restructuring of other sectors. After a period of recession, the volume of loans provided has grown very slowly, although there has been a reduction in interest rates. Applications for loans are thoroughly scrutinized, while the requirements for collateral have been tightened.

4. The agricultural sector

The stricter credit policy applies especially to the agricultural sector – to large agricultural enterprises as well as to individual farms.

Banks refuse to provide small loans to individual farms owing to high transaction costs and levels of risk. Together with stricter conditions for collateral – banks refuse to accept agricultural land as collateral, and make a low assessment of the values for farm assets such as buildings, equipment or machinery – this behavior hinders the development and restructuring of agricultural primary production as well as the development of small and medium-sized enterprises and thus impedes development in rural areas. According to the EU-SAPARD report, improvements to guarantee schemes and other supporting instruments need to be considered.

The high degree of indebtedness and low level of liquidity of agricultural enterprises – mainly legal entities and cooperatives – mean that around 70% of them face serious financial difficulties (SAPARD). They are as a result credit constrained, since they need external capital for production or investments purposes, but they do not possess sufficient assets and equity to secure a loan. Furthermore, their financial performance is bad.

According to the private farmers' association, most individual farmers prefer to operate their farms without credit as they fear loan-related risks, such as the potential loss of assets pledged as collateral. Furthermore, they are not used to taking credits for investments, as they consider themselves to be self-made men and women. Hence, the typical private farmer prefers to delay investment until s/he is able to finance them with internal resources or without exposure to risk. However, this mode of behavior is changing gradually.

The preference for financing investment with internal resources instead of external funds represents no constraint for development as long as there is sufficient internal capital available in time for investments that are necessary to maintain a certain level of productivity and profitability. In general, only very profitable farms are able to finance investment in production technologies internally, while most farmers seek external financial resources for investments they think will improve their returns, or produce without making new investments in production technologies, and thereby run the risk of losing track of the latest technological trends.

However, there are some different types of credits provided by banks, agro-enterprises and associations which are used by individual farmers. Bank credits are in general guaranteed by the state guarantee fund:

- Household credits: farmers and banks agree to provide a credit to the household instead of the farm. On legal grounds, the bank can only execute in assets which the debtor owns – in this case the household. Moreover, households often own assets – such as houses or cars – which can be used as collateral; farm assets – machinery, building, equipment – are on the other hand not worth much to banks. Furthermore, the equity of a farm is often very small or even negative (over-indebtedness).

- Ecological farm credits: there is a small association of organic farms – pro-bio– which provides financial support for production means to its members to adopt ecological farming methods.
- Green credits: There are a few large agro-enterprises providing inputs and marketing farm outputs. They offer agricultural enterprises and individual farms short-term credits to finance the working capital-farm inputs. In turn, the farms are obliged to sell a certain portion of their harvest at a fixed price to these firms. The credit conditions are difficult to compare because they rely on (expected) prices and yields.
- Savings bank loans: There seem to be three branches of the Austrian Sparkasse in the Czech Republic which provide credits to individual farmers without state guarantees. The credit officers visit the potential borrower's farm and screen the individual farms thoroughly before giving a credit, with the aim of partially surmounting the risks caused by insufficient information.
- Agricultural guarantee fund: The Support and Guarantee Farmer and Forestry Fund provides interest rate subsidies and guarantees of bank credits (up to 60% of the principal) for natural persons and legal entities operating in the field of agriculture, forestry or water management, processing and sales of agricultural products and commodities. The guarantee program is set up and administered by the state (the Ministry of Agriculture), and covers credits for farm operations, investments, new farm successors and export. At the end of December 2000, the banks approved a total of 15,400 credit applications, covering a loan volume of CZK 68 million. Approximately CZK 23 million was guaranteed and the actual paid interest subsidy amounted to CZK 12 million at the end of 2000. Almost 33% (about 5,100) of the borrowers are individual farmers, 37% legal entities and 29% cooperatives. The Komerční Banka (38%) provided most of the credits ,followed by the GE Capital Bank (21%) and the Česká Spořitelna (13%). It is estimated that about 99% of credits to the agricultural sector are guaranteed by this fund. The reduction of risks for banks may play a major role in the high number of loan approvals.

4.5 Results and constraints in agricultural development

The view of the private farmers

The private farmer's association defines a full-time private farmer as someone whose income is almost completely generated by farming activities and who cultivates a farm of more than 100 ha. Accordingly to the 1995 agro-census, roughly 1,500 farmers out of 52,000 were full-time farmers of this type in the Czech Republic. Smaller farms have developed further income sources, such as tourist accommodation, processing and marketing. These type of farms will benefit from the SAPARD program (1) directly through credits and (2) indirectly if a successful participation in the program improves their reputation and hence their creditworthiness. For the association, the main problem for full-time farmers is their dependence on a few large input suppliers and marketing companies which also dominate

the export business. There is practically no market for regional products, although cooperatives do exist which open new marketing channels and provide their members with agricultural input. With the abolishment of the export license to the EU on 1 October 2000, direct export became feasible, too. Furthermore, direct marketing of cereals to private mills has developed, but the storage of grain is still completely in the hands of a few large agro-enterprises. The provision of capital for operations and investments is not a very critical issue for many farmers. There are some sources for external capital, but many farmers fear the risks. Therefore the future issues for the private farmers' association are:

- building cooperatives for input supply and marketing
- creating storage capacity on farms
- supporting direct marketing activities of farmers.

Summary of the main issues and problems in the agricultural sector

- Private farmers, representing 95% of the active agricultural businesses in the sector, cultivate approximately 25% of the agricultural land. About 1% out of those individual private farmers are more or less full-time farmers. The remaining majority of individual farmers combine farming with other income-generating activities. Frequently, they consider farming as a hobby or as an income-supplementing activity. Subsequently, this group of individual farmers has a great impact on rural development if only through its size (45,000) and its wide range of activities. It represents a potential target group for rural development.
- Land ownership is considerably fragmented; consolidation has not yet been completed; and a large share of land is rented. Furthermore, the agricultural land market has not developed, so that subsequently the prices for selling land are low. This has strong implications for the use of land as collateral. Improvements in the land market may occur when the land restitution is completed and when the farm business becomes profitable. However, profitability also depends on modernization/investments, and this in turn, on the access to external capital.
- The high share of arable land and the current technologies used have a significantly adverse effect on the level of soil erosion and compaction. This results in reduced yields and contaminated surface and ground water. Without sustainable and environmentally sound agricultural production, the long-term development of the agricultural sector and rural areas is endangered. This emphasizes the necessity of disseminating sustainable cultivation and access to corresponding equipment and know-how.
- The low financial outcome of all types of agricultural enterprises is a result of a combination of factors: unfavorable price developments, low levels of productivity and modernization, heavily delayed investment activities, a high degree of indebtedness and a lack of input supply and marketing alternatives. The negative financial results and rather high levels of indebtedness inhibit farmers from building up capital reserves and from receiving credits for investments which could, in

turn, positively affect productivity. Improved input supply and marketing facilities as well as access to capital may have a positive impact on the financial performance of selected farms.

- Individual farmers, especially small-sized enterprises, seem reluctant to take out bank loans. Reasons for this are the degree of risk aversion of small farmers in association with tough collateral requirements, a “self-made man/woman” mentality, and the so-called “path-dependent” behavior of people with no entrepreneurial experience. Long-term advice as regards production, technologies, financing and a development plan for the farm (including abandoning the farm business), encouragement to invest and assume some small risks and risk-sharing through risk funds may change the behavior pattern of many small and medium-sized farmers.
- Overall, the completion of land restitution may ease the problem of collateral and stimulate the land market, leading to the needed restructuring of the agricultural sector, whereby farms enlarge or give up production. However, farms simultaneously need access to external capital with a moderate exposure to risk in order to enlarge their farms, apply new production technologies and become more competitive.

5. Small and medium-sized enterprises in the Czech Republic

5.1 SME structure in the Czech Republic

Data on the organizational structure of the economy are compiled on the basis of information kept in the Business Register and updated monthly by the Czech Statistical Office. The term “private entrepreneurs” includes private persons running their businesses according to the Trade Licensing Act, as well as self-employed farmers.

The high number of private enterprises and the low share of state enterprises in the total number of all businesses shows that the economy is in an advanced stage of transformation and privatization (Table 13).

Table 13 Businesses in the business register by main activities and legal form

Year 2000	Total ⁸ number of enterprises	Private entre- preneurs	Business companies (ltd., joint- stock)	Cooperative s	State enter- prises
Agriculture, forestry, hunting	131,390	119,890	3,730	1690	52
Mining and quarrying	587	180	300	240	20
Manufacturing	270,920	237,210	27,830	550	220
Construction	228,140	198,010	15,510	390	80
Electricity, gas, water supply	1,290	430	550	10	33
Wholesale, retail trade, repair service	638,280	521,010	92,190	434	120
Transport, communication, storage	75,570	67,880	7,030	59	27
Financial intermediation	70,800	2,380	1,810	139	0
Real estate, renting and business activities	351,140	269,420	47,780	4,800	440
Community, social and personal service activities	162,570	81,370	4,100	61	31
In relation to total, as a %					
Agriculture, forestry, hunting	6.3	5.7	0.2	0.1	0.0
Mining and quarrying	0.03	0.0	0.0	0.0	0.0
Manufacturing	12.9	11.3	1.3	0.0	0.0
Construction	10.9	9.4	0.7	0.0	0.0
Electricity, gas, water supply	0.1	0.0	0.0	0.0	0.0
Wholesale, retail trade, repair service	30.4	24.8	4.4	0.0	0.0
Transport, communication, storage	3.6	3.2	0.3	0.0	0.0
Financial intermediation	3.4	0.1	0.1	0.0	0.0
Real estate, renting and business activities	16.7	12.8	2.3	0.2	0.0
Community, social and personal service activities	7.8	3.9	0.2	0.0	0.0

Source: CSU 7/2001

Note: The total numbers do not add up since households and non-profit organizations that account for a large part of activities in the other community service (households and non-profit) and financial intermediation (households) sectors are not included.

⁸ There are a total of 2,097,787 registered businesses (Business Register) in the Czech Republic.

5. Small and medium-sized enterprises in the Czech Republic

While the manufacturing sector is leading with respect to its total number of employees (1.1 million) in 1999, followed by the education sector (287,000) and the transport sector (273,000), the trade sector is ranked first with respect to the number of private entrepreneurs, followed by the real estate business and manufacturing sector. The total number of SMEs was about 760,900 in 2000, with the largest number in the trade sector.

As regards the number of employees in SMEs, the wholesale, retail and repair service sector has the highest share in this category with approximately 109,000 enterprises with up to 19 employees, followed by manufacturing (43,000 enterprises), real estate (41,000) and construction (27,000). The agricultural sector has about 20,000 enterprises or farms with 1-19 employees, and about 107,800 without any employees. The total number of employees in the SME sector amounts to 1.8 million, with manufacturing the leading sector with about 630,000 persons.

The total number of all enterprises in 1999 was 1.9 million. The number of enterprises without employees totals 1,602,460 enterprises - 513,500 in the wholesale, retail and repair service sector alone. Only about 2,000 enterprises have more than 250 employees. However, it should be noted that the figures for firms with zero employees include businesses that did not report their employee numbers. Nevertheless, the figures clearly reveal the high percentage of small and medium-sized enterprises registered in the Czech Republic.

The number of businesses registered from 1995 onwards shows a continuously positive development. The set-up of businesses has by far outweighed (between two and ten times) the number of businesses dissolved. The large net increase in business units reflects vibrant economic activity, especially in the SME sector. The increase in the number of SMEs and the number of employees in SMEs from 1999 to 2000 of 15% and 2% respectively supports this impression.

Table 14 Shares of small and medium-sized enterprises with up to 249 employees in different sectors, 2000

As a %	Share of SMEs to total number of enterprises in the same sector in the CR ⁹	Share of SMEs in employees to total sectoral number of employees in the CR	Share of SMEs in output to total sectoral output in the CR	Share of SMEs in investments to total sectoral investment in the CR
Manufacturing industry	99.4	46.6	35.3	27.3
Construction	99.9	78.5	68.8	67.6
Trade	99.9	79.9	87.6	68.3
Restaurants	99.9	88.9	85.7	79.5
Transport	99.7	24.1	44.7	20.2
Financial intermediation	99.9	18.7	25.7	26.0
Services	99.9	82.9	89.1	91.1
Agriculture	99.9	84.6	84.5	86.5
Total	99.8	59.5	52.8	40.6

Source: Usnesení 2001, Vlády České Republiky

⁹ CR: Czech Republic

The importance of the SME sector for economic development and its impact can be seen in Table 14. The total share of SMEs in employees is higher than their share in output. This points to lower productivity levels in the SME sector in comparison to the large enterprises. However, there are sectoral differences. The share in investments of the SMEs is relatively low compared with the share in employees and output, although again there are sectoral differences. However, the relatively low share in investment allows us to conclude that the technical equipment level in SMEs is lower than in large enterprises, a feature that partly explains the differences in productivity.

5.2 Constraints facing SMEs in the Czech Republic

SMEs represent an important economic agent with respect to employees and output, and as such they have to deal with various impediments and bottlenecks. However, the membership of SMEs in the economic and commercial chambers or associations is relatively low and hence their lobbying power is weak. A couple of organizations or institutions mention or recognize problems and drawbacks of SMEs in the following fields:

- Financing: SMEs have more difficulties in obtaining access to financial means for investment purposes due to their marginal number of less valuable real assets and equity
- Business conditions: because of their size, SMEs have limited market power and are hence in a weak position as regards marketing, services, receivables or making payments on time
- Professionalism: professional behavior is sub-optimal
- Technology: the technological level is low owing to a lack of investment
- Assets: the real value of assets is hard to prove
- Administration: administrative requirements are high and SMEs often fail to provide them
- Infrastructure: unreliable infrastructure (communication, electricity supply, transports) inhibits the development of SMEs
- Education: limited access to education, leading to a low level of human capital
- Low levels of profitability.

The Ministry of Trade and Industry considers that training, education, project design and implementation and financing programs are appropriate means to overcome the problems or inconveniences that SMEs face. A few financial support programs are currently being implemented.

5.3 Policy and programs for SMEs in the Czech Republic

Policy support for SMEs

The policy measures are focused on mitigating these disadvantages and creating economic conditions that will support the forming of new and the development of existing SMEs, in addition with respect to the future accession of the Czech Republic to the EU.

The long-term objective of the policy is to create conditions so that SMEs can contribute to the output and employment of the national economy as well as achieve favorable conditions comparable to economically advanced countries in Europe. Based on its overall goal, the mid-term objectives of the policy are to increase the share of SMEs in economic growth, export and employment (especially in economically weak and structurally affected regions), to improve technologies and the competitiveness of SMEs, to support cooperation between SMEs and research centers, to help to set up businesses; and to employ instruments and mechanisms for SME support in accordance with the EU regulations.

In this context, the policy focuses on eight issues to overcome the barriers restricting access to certain markets and limiting the development possibilities of SMEs as depicted in the box below:

Policy issues for SME development

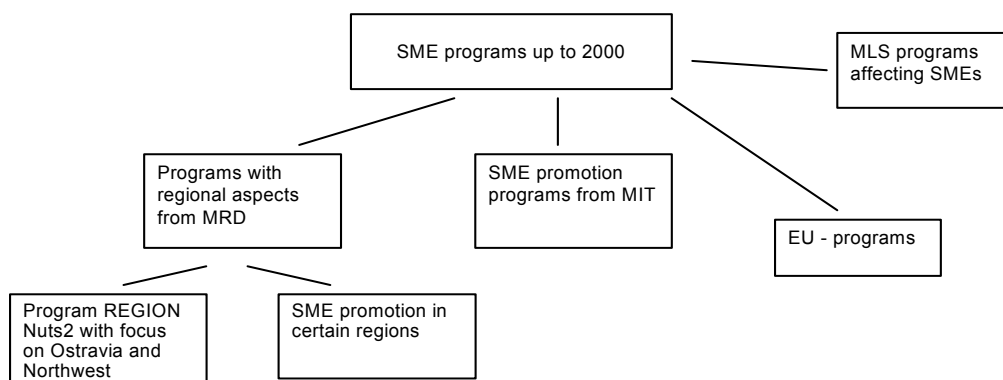
1. Capital market: there will be national programs offering micro loans from state budget funds to facilitate access to capital. Programs offering subsidized export financing and insurance will be expanded. The main instruments of support of SMEs are guarantees, low-interest loans, interest subsidies, and subsidies for payments. The instruments will be secured especially through the Czech-Moravian Guarantee and Development Bank.
2. Information and information technology market: to secure the necessary extent of information for SMEs there will be programs to develop activities in Euro Info Centers, of electronic commerce and export information, of internet access to register for patents, trademarks, models and to inform on laws and regulations.
3. Education market: to improve professional know-how and management skills education programs are elaborated and offered to SMEs managers.
4. Labor market: to secure a qualified work force, there will be programs to improve apprenticeship and qualification of workers.
5. Consulting and advisory services: to provide an offer of reasonably priced consulting and advisory service, the government continues to subsidize these services for SMEs.
6. Technical and non-technical standardization and certification: through subsidies for the implementation of ISO and other types of standard SMEs may obtain various types of certification for products, which may increase their competitiveness.
7. Research and development: discussions take place on the creation of a fund promising innovative business plans.
8. Operating inputs and outputs of business activities: to overcome disadvantages related to purchasing and sales marketing, the government provides subsidies for export and supports the development of networks, joint ventures and subcontracts.

The programs of support for SMEs

Since 1992 SME programs have been launched by the Ministry of Industry and Trade (MIT), the Ministry for Regional Development (MRD) as well as partly the Ministry for Labor and Social Affairs (MLS) (see Table 6). They have closely cooperated with some Czech associations and agencies (Czechinvest, Development Agency), and the Czech-Moravian

Guarantee and Development Bank (CMZRB), which has often disbursed the loans or has provided the guarantees offered in the programs.

Table 15 Programs for SMEs up to the year 2000



Source: USNESENÍ Vlády České Republiky, ze dne 6. června 2001

A few programs (Programy MSP, MPO-vyzkum) for the promotion of SMEs have already been established. SME programs were supplemented by further programs (reconstruction, *male pujcky*, design etc.) up to the year 2000, when the government revised and reorganized these promotional programs. In 2000 about CZK 2.1 billion¹⁰ (about EUR 63.6 million) was disbursed in the framework of the MIT programs for around 3,240 SME projects (EUR 1.05 billion in 1992), and about CZK 511 million (EUR 15.5 million) in the framework of the MRD programs for about 510 projects. Further financial support came from the EU (about CZK 6 million) and from the MLS (CZK 2.5 billion) for employment support in SMEs. The SMEs in the region around Ostrava received most of the financial support as regards the volume, while most of the enterprises benefiting from the programs are located in the southeast region. In 2000, out of 760,900 SMEs, a total of 3,800 SMEs were supported with CZK 2.7 billion.

The revised and reorganized SME programs starting in 2001 can be divided into two main groups. (1) One program group contains a regional development component administered by the MRD, while (2) the other concentrates only on SME development, and is administered by the MIT. For most of the projects the responsible institution for screening and monitoring applicants is the Czech-Moravian Guarantee and Development Bank. It is allowed to disburse loans, provide guarantees and collect the (subsidized) interests.

The revised set of programs is depicted in Table 16. They are intended for medium-sized enterprises with less than 250 employees or for small-sized enterprises with less than 50 employees, with an upper limit of revenues and assets and an independence criterion¹¹. Most of the programs started in 2001 and will continue for the next four years. The duration of the

¹⁰ Includes about 128 projects financed with the PHARE program.

¹¹ Of revenues not exceeding CZK 1.4 billion or CZR 250 million, assets of less than CZK 980 million or CZR 180 million and with an independence of 25% or more from corporations not conforming to the definition of SMEs.

5. Small and medium-sized enterprises in the Czech Republic

program in each year will depend on the volume of available funds. Agricultural enterprises and farms are not allowed to participate in these programs.

Table 16 Programs for SMEs

<i>Program administrator</i>	<i>Program name</i>	<i>Type of aid</i>	<i>aid disburser</i>
MRD	Region	subsidy for payment of interest for the execution of a business plan for SMEs in structurally affected or economically weak regions, 7%-10% of interest on a bank loan.	CMZRB
	Village (Vesnice)	interest payment subsidy for the execution of a business plan for SMEs in small municipalities, max. 6% of interest on a bank loan	CMZRB
	Regeneration	interest payment subsidy for SMEs in urban or rural heritage zones or reserves, max. 3% of interest on a bank loan	CMZRB
	Preference	investment-oriented loan for the execution of a business plan for SMEs in structurally affected regions, max. CZK 5 million with a 5% interest rate p.a.	CMZRB
	Operation	loan for the purpose of acquisition of stock and financial aid, max. CZK 1 million, 9% interest rate p.a.	CMZRB
	Border (Hranice)	investment-oriented loan for execution of a business plan for SMEs in border regions, max. CZK 7 million, 6% interest rate p.a.	CMZRB
	Regional guarantee	guarantee for the remainder of a bank loan up to 75% of the principal for SMEs in structurally affected or economically weak regions	CMZRB
MIT	Guarantee (Záruka)	<ul style="list-style-type: none"> subsidized guarantee for the remainder of a bank loan, max. guarantee amount CZK 3.5 million guarantee for capital investment up to 70% of the investment 	CMZRB
	Credit	subsidized loan for acquisition of fixed assets, fixed interest rate (7%), max. loan amount CZK 4 million	CMZRB
	Market	<ul style="list-style-type: none"> subsidy for interest payment, SMEs with ISO certificate, max. subsidy to 5% of interest rate on a bank loan or to CZK 5 million subsidy for obtaining a certificate, max. 50% of the costs of the fee for a certificate 	CMZRB
	Cooperation	subsidy of max. 50% of the cost of a project or max. CZK 3 million	CMZRB
	Start	interest free loan for execution of a business plan to set up a business, max. CZK 3 million	CMZRB
	Special ¹²	subsidy of CZK 4,000 for newly hired disadvantaged employee.	CMZRB
	Marketing	<ul style="list-style-type: none"> subsidy for costs spent on marketing information, max. 60% of the expenditures or CZK 100,000 subsidy for costs spent on marketing education, max. 60% of the expenditures or CZK 50,000 subsidy for the creation of promotional materials, max. 60% of the expenditures subsidy for export and marketing consulting, max. 60% of the costs subsidy for presentations, trade shows, exhibitions, max. 60% of the costs 	MIT
	Consulting (Poradenství)	<ul style="list-style-type: none"> subsidy for business consulting, innovative enterprises in business innovation centers and for training of entrepreneurs, max. 60% of the costs subsidy for services of the association of business women managers 	MIT
	Small loans (malé půjčky)	returnable financial aid up to CZK 1 million to promote the development of SMEs	MIT
Design	subsidy for independent expertise, organization of presentations of authors, design of consulting services	MIT	

Source: Policy and Program of Support for SMEs, MIT and MRD, 2001

Note: MIT: Ministry of Industry and Trade, MRD: Ministry for Regional Development, CMZRB: Czech Moravian Guarantee and Development Bank.

¹² For any enterprise which employs handicapped people

5.4 Summary and conclusions

The main features of the SME sector in the Czech Republic can be summarized as follows:

- Through both the number of people employed as well as their substantial output, SMEs significantly shape the economic development of the Czech Republic. Consequently, measures aimed at overcoming the major constraints of the sector are of importance to economic development as a whole.
- The main drawbacks of SMEs appear to be the low level of technology at which enterprises operate, including weak management and limited market power. SMEs therefore need to invest in both technology and know-how. Access to capital and business-related training is important. At the same time, a more enabling legal and institutional environment is needed to protect SMEs from being taken advantage of because of their limited market power. Strong associations and networks representing the interests of SMEs could be of assistance here.
- At policy level, SME policy, combining SME development and the development of rural areas, underlines the importance of the SME sector for rural development. However, the state programs mainly consist of financial support, such as subsidies and state guarantees, which are tied to the national budget. As these represent a discretionary and non-market intervention, the use of such subsidies and guarantees in order to promote economic development in a market-oriented economy cannot replace sustainable institutions for financial and advisory services that are specifically designed for small and medium-sized enterprises.

SMEs hold the biggest share in terms of employment, of which trade, construction and manufacturing are the most important sectors. The majority of private entrepreneurs are managers and owners of SMEs. However, the low level of investment activities, and consequently low productivity, are noticeable. Usually, better access to finance, training and advisory services, SME networks and efforts in marketing are part of comprehensive SME strategies which could pave the way for sustainable development within the sector. For rural areas it is essential not only to provide access to more or less similar services everywhere, but also to allow institutions to develop services that are appropriate to their specific rural environment.

6. The Financial Sector

6.1 Development during the transformation process

In the early 1990s, Czechoslovakia embarked on a broad and comprehensive transformation of its centrally planned economy to a market one, impacting all areas of society. The subsequent economic transformation completely changed the position and role of the banking sector in the overall economic system. The centrally planned allocation of resources was replaced by market principles, with commercial banks gaining a key function in securing and allocating funds for the transformation process, a function they had to fulfill under very uncertain conditions.

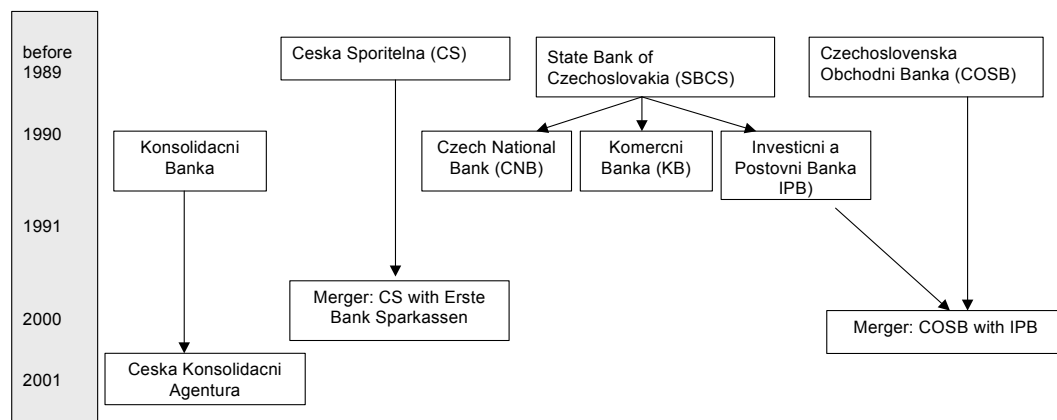
At the beginning of the reform process, there were a few state-owned banks which had begun operations before 1989 either as independent banks or as former departments of the original State Bank of Czechoslovakia (SBCS). These comprised the four largest banks:

- Česká Spořitelna (CS)
- Československá Obchodní Banka (COSB)
- Komerční Banka (KB), a division of SBCS
- Investiční a Poštovní Banka (IPB), a division of SBCS.

Prior to 1989, the SBCS fulfilled the role of both a central bank and a commercial bank. Since 1990, it has subsequently been transformed into the Czech National Bank (CNB), acting as a pure central bank responsible for monetary policy, banking supervision, banking licensing, currency issuance, etc. Initially, services offered by the state banks were dependent on their historic or traditional orientation. The CS primarily collected savings from the households, the COSB was responsible for foreign exchange operations, while the KB and IPB operated within the SBCS and focused on financing large businesses. The Konsolidacni Banka was established for the administration of bad loans provided prior to 1989 by the corporate and banking sector. It was wholly state-owned but ceased operations on 31 August 2001. Most of its business was transferred to its legal successor, Ceska Konsolidacni Agentura.

The dynamic development of the private sector, fostered by the privatization program, enabled a rapid transition to a market economy. However, the newly established entities sector, consisting primarily of SMEs that are considered to be risky even by advanced countries, needed urgent bank backing. As the major banks such as CS, KB, IPB, and COSB had held onto their clients while the foreign banks mostly monitored and financed businesses with foreign participation, these new subjects became the clients of the new small private banks, primarily drawing upon Czech capital. At this time, the banking sector in the Czech Republic was roughly segmented into three main groups:

- large banks – large state-owned banks
- small banks – mostly private banks
- foreign banks or bank branches.

Figure 1. The first large banks in the Czech Republic

Small banks

The small bank group has experienced the stormiest development over the past few years (see Table 17). Part of this group consisted of banks with predominantly Czech capital, which started functioning in the banking sector between 1990 and 1993. These banks were granted their licenses in a period when capital requirements were low and when it was very difficult to find high-quality staff, particularly for senior posts. In a number of cases, shareholders founded these banks to support their own business activities in the short-term and were not interested in the safe and sound development of the bank on a long-term basis. At the same time, the small banks underpinned to a large extent the development of the economy by financing private businesses. However, the considerable riskiness of the environment led to a large number of poor deals being concluded, gradually resulting in heavy losses that these banks were unable to bear. Subsequently, many small banks ceased to operate after 1994. In 1998, small banks managed about 3.5% of the banking sector's total assets, mostly financing their activities from collected primary deposits, as their access to the interbank market was rather limited.

Large banks

Many of the large Czech banks' operations – large in terms of assets, branch networks and number of employees – continued to be undertaken with their former clients, which continued their activities after privatization. A slightly different picture emerges for each of the large banks' subsequent development. The CS slowly began to widen its transactions from collecting savings and financing of household activities to small businesses activities, whereas the transactions of the COSB were still oriented to foreign exchange and business. The KB and IPB focused on large and medium-sized enterprises, although the latter started to compete with the CS for household deposits by using its post office counters. In 1998 the large banks managed about 66% of all assets in the banking sector.

Foreign banks or bank branches

The significance of foreign banks and bank branches has continuously increased since 1991. Originally, these banks were mostly oriented towards wholesale banking, and their clients were large industrial businesses with foreign participation. They mostly relied on funds from

the interbank market, with little deposit collection from the public. Their significance derived from the competition they brought to the banking sector through new products, procedures as well as awareness of risks and opportunities in the Czech banking sector. Although the first foreign banks started operations in the Czech Republic in 1991, the volume of transactions only started to increase considerably in 1995, when the economic environment improved. By 1998, they already managed about 25% of the banking sector's total assets.

Table 17 Number of banks undertaking activities

	1990 ¹³	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Total banks	5	9	24	37	52	55	55	54	50	45	42	40	40	37
Large banks	5	5	6	6	6	6	6	5	5	5	5	4	4	4
Small banks		4	14	19	22	21	18	12	9	8	5	8	8	9
Medium-sized banks												11	11	9
Foreign banks			4	8	11	12	12	13	14	13	13			
Branches of foreign banks				3	7	8	10	10	9	10	10	10	10	9
Specialized banks				1	5	7	9	9	9	9	9	6 ¹⁴	6	6
Banks under conservatorship					1	1	0	5	4	0	0	1	1	0
Banks without license ¹⁵						1	4	6	10	18	21	23	23	27

Source: CNB Banking Supervision 1996-2002

Note: the CNB established a decision-making body for banks under conservatorship. The classification of foreign banks has changed since 2000, when all foreign banks were reclassified as either small or medium-sized banks.

Development

Since 1990 the banking sector has undergone very dynamic development. Many of the newly established banks were unable to cope with the intense competition and risky conditions associated with the economic transformation and were forced to terminate their operations. Furthermore, the tightening of the conditions for setting up new banks has restricted the entry of new entities into the sector. Since 1998, the structure of the banking sector has been affected by mergers between individual banks, leading to concentration in the sector. In 2001 there were 40 banks with a banking license. The development of the number of banks is depicted in Table 17 and in the Annex.

The regulatory and controlling activities of banking supervision have developed alongside the banking sector. Banking supervision was only established within the central bank as a regulatory body for the banking sector in 1991, and has been gradually improved and enlarged since then. Hence, the establishment of new banks was initially relatively easy, but has since become more difficult.

¹³ At the beginning (1 January) of 1990, otherwise at the end of the year (31 December)

¹⁴ The specialized banks are here called building societies.

¹⁵ The sum of banks whose banking licenses have been revoked by the CNB.

Problems

Major problems existed for the establishment of new banks: the lack of skilled staff; difficulties in assessing equity, performing assets and the overall financial performance of clients' businesses; as well as a generally risky economic environment. Similar to many other transition countries in the early and mid 1990s, the Czech banking sector suffered from many deficiencies with regard to the legal and institutional framework of commercial banking. These deficiencies comprised the lack of experience and instruments for secured transactions, and difficulties in loan contracts and general legal enforcement, with the conditions often in favor of the debtor. Furthermore, bankruptcy procedures were still new to the legal system and tended to be quite protracted, with often negative consequences for financial institutions owing to the still-limited capacity of the legal courts. Accurate and timely financial information or transparency were not yet available in the in financial market to the extent needed, which often meant that financial institutions were simply not aware of the risks they were involuntarily incurring.

6.2 Structure of the banking sector

The structure of the banking sector as regards the ownership, capital/equity, assets and deposits as well as employees and branches is provided in the respective tables. Developments in the group of large banks (CS, KB and COSB, which merged with IPB) shows how the former financial institutions, which were the only pre-existing financial institutions in the Czech Republic, have progressed over time. There are no NGOs, non-banking or non-profit financial institutions in the Czech Republic.

Table 18 Number of banks by ownership

	Total banks	Czech-controlled banks					Foreign-controlled banks		
		Total	State financial institutions	State-owned banks	Czech controlled banks	Under conservatism	Total	Foreign-controlled banks	Foreign bank branches
31.12.1999	45	20	1	5	14	0	25	15	10
31.12.2000	40	14	1	4	8	1	26	16	10
31.12.2001	38	12	0	3	8	1	26	16	10
30.12.2002	37	11	0	2	9	0	26	17	9

Source: CNB, 2003

Ownership structure

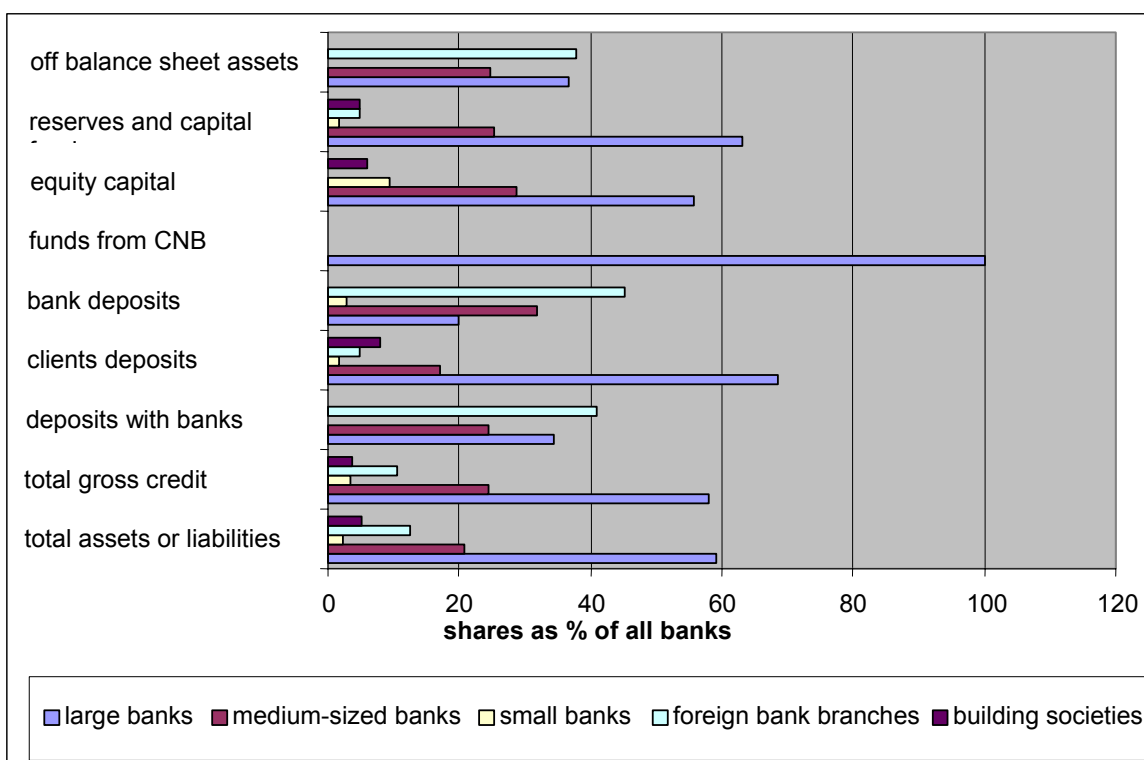
The main factor influencing ownership structures was the ongoing privatization of large banks in particular. At the end of 2001, the Konsolidacni Banka was transformed into an agency administering the remaining bad loans from credit transactions in the banking sector before 1990. While the privatization of the CS was completed in 2000, the KB was only privatized in 2001. The large banks are now predominantly owned by foreign partners. The National Property Fund owns 60% and the Bank of New York 12% of the KB, while the CS is 52% owned by the Erste Bank Sparkasse (Austria) with municipalities holding a further 14.75%. –Finally, the CSOB is 82.3% owned by the KBS (Belgium), 7.4% by the

EBRD, and 4.4% IFC. In 2001, the IPB (100% owned by CSOB) operated as a division of the CSOB.

Foreign banks are increasingly becoming the new shareholders of the large banks. At the end of 2000, foreign-controlled banks numerically outweighed the Czech-controlled banks, while foreign entities held the largest stake in the Czech banking sector with 55% of the total equity capital.

The holdings of the state, which is only involved in banks specifically oriented towards support for government programs in the area of exports and support for small businesses, are falling correspondingly. All in all, as of mid-2001, there were four banks (one large bank (KB) and three medium-sized banks) in which the public authorities, municipalities and/or the National Property Fund had a share of more than 50% of the equity capital, or is a controlling shareholder. Among these banks is the Czech-Moravian Guarantee and Development Bank, which administers government loans and loan guarantee programs.

Figure 2. Assets and liabilities by bank group as of 30 June 2001



Source: CNB 2000

Assets and liabilities

As the table above shows, the four largest banks in the Czech Republic (i.e. CS, KB and CSOB including IPB) dominate the banking sector in almost all fields, except for off-balance sheet assets and interbank deposits, where foreign banks are predominant.

Staff and branch networks

The number of staff and branch networks in each banking group differs and depends primarily on each bank's main type of clientele. The large banks are making cutbacks in both workforce and branch offices, whereas medium-sized banks are showing the opposite trend. This is associated in particular with the further development of foreign banks, which are intent on engaging more in retail banking. This is operationally more demanding and requires at least a minimum branch structure and more staff. The differing trends in the number of banking units and employees has led to some convergence. The large banks employ 76.1% of all bank staff (2000), compared with 79.5% in 1999 and 80% in 1998. Second are medium-sized banks, accounting for 15.5% of all employees (1999: 13.2%). The shares of small banks, foreign bank branches and building societies are rather equal, ranging between 1.8% and 3.6% over the last three years.

The share of banking units of the large banks amounts to 72.1 % in 2000 (74.5% and 76.8% in 1999 and 1998, respectively) while the medium-sized banks' share increased from 21.1% in 1998 to 23.4% in 2000. Within the group of large banks, the CS was foremost with about 800 banking units in 1999.

6.3 Banking sector products

Growing competition in the Czech banking market is leading to a wider range of products and services offered and is generating improvements in quality. The products and services offered depend to a great extent on the type of clientele the bank intends to serve. However, the traditional business of financial institutions, in particular of the former state banks, tends to "select" the type of client. While the foreign banks and branches initially focused on export/import businesses and on new financial products, the large banks widened their product and client range in the traditional savings and lending business and gradually offered new services. Currently, banks are focusing to a greater extent on small clients, who are less risky than corporate clients and where collateral ownership and appraisal are not problematic.

Savings facilities

Since 1990, the banking sector has developed or adopted a variety of savings products, especially for private persons or households:

- deposit book: the former anonymous deposit book has changed and is now a registered deposit book; however, it continues to be the traditional product in the area of deposits
- term deposits
- savings accounts: these combine features of current accounts and term deposits
- "park and ride" accounts for foreign currency
- preferential forms of savings accounts for children, students and young people
- saving for house purchase

- pension insurance with state contribution as from 1994
- various insurance services.

By the end of 2000, more than half of the total deposits at financial institutions were term deposits, with short-term deposits accounting for almost 50% of all deposits. Households provide approximately 66% of total bank deposits, while the share of small business amounts to a modest 3%.

Credit business

In the credit business, the banks not only provide traditional products, such as consumer cash loans or mortgages, but also some new financial services:

- accounts with an overdraft facility for CZK or foreign currency
- credit lines for natural persons to draw credit when needed
- preferential credit for specific groups of people, e.g. students
- leasing operations.

Credit transactions are the most widely used services in the Czech banking sector. They are only approved in combination with the provision of collateral such as real estate, financial or tangible assets or guarantees. They have a maturity of up to 10 years, whereby most of the loan contracts are long-term credits. At the end of 2000, the share of the private sector in total bank credits amounted to about 66%, while households and small businesses accounted for about 9.4% and 2.6%, respectively. All financial institutions offer these types of products.

A range of operations are associated with credit transactions relating to their collateralization, appraisal and recovery. One of the most widespread solutions to problematic credit is the sale, purchase and recovery of debt, which is performed by about 25-30% of the financial institutions operating in the Czech Republic. The appraisal of receivables and the trade with credit derivatives is still limited to a few banks. Credit derivatives such as credit insurance minimize credit risk even before the credit is granted by transferring it to a third person. Further new forms of hedging and administering of credit transactions are now beginning to appear. These concern primary securitization, which involves a decrease in refinancing traditional credit contracts and an increase in the volume of funds allocated through securities. In 1999, some operations relating to the secondary securitization of assets were initiated. Unlike the classic securitization of high quality assets, these involved converting credits into securities. These operations were intended to provide a solution to the problem credits granted by some banks. This range of operations is limited to large financial institutions or to banks integrated into a large financial network.

Other services

To enlarge their range of services, financial institutions in the Czech Republic have switched to new trends or adopted new products. One way is to adapt to their clients' needs, helping them to address these needs and advising them on specific options.

The establishment of financial kiosks located in department stores has brought banks closer to their clients. Furthermore, a direct cooperation between banks and retailers with the latter arranging credit lines for their customers facilitates the access to and issuance of loans. These operations are pursued by some large and medium-sized banks, focusing on small clients such as households or individuals.

In line with the development of communication technology, many financial institutions have extended their services and now offer electronic banking. Typical products include:

- payment cards
- call banking as one form of direct banking
- computer-linked home banking (offered by more than 50% of the banks)
- Internet banking
- GSM, mobile phone banking.

The expansion of electronic banking has made many branch offices, particularly in remote areas, redundant, leading to cuts in branch networks and in the number of employees.

6.4 Special programs/products for SMEs and specific groups of customers

SME loans with the CMZR

The state-owned Czech Moravian Guarantee and Development Bank (CMZR) administers loan and loan guarantee programs for SMEs on behalf of the state. The aim of these programs is to reach those that, although creditworthy, are not served by commercial banks. The programs are as follows:

- the bank guarantees between 50%-70% (new guarantee scheme) or 85% (old scheme up to 1996) of the underlying loan, with prices depending on the contribution of the state, the risk attached to the project and the collateral offered by the client to the commercial bank or leasing company. The collateral and funds provided by the state are sufficient to cover potential losses from the guarantee contingencies. Loan guarantees can cover:
 - investment loans and loans for working capital
 - leasing operations
 - venture capital deals
 - calls for tenders
 - business creation in regions hit by recession and undergoing structural change.

Preferential loans related to these regions can have the following terms:

- Fixed interest rates ranging from 5% to 9% p.a.
- Interest-free business start-up loans
- Interest subsidies.

Procedure for applications

Potential borrowers first contact a commercial bank, which scrutinizes their creditworthiness and transmits the credit and guarantee application to the CMZR, which in turn verifies the credit application. Rough estimations of the CMZR show that about 50% of initial contacts at commercial bank offices are refused. Estimations as to the impact of the programs are not available however, although estimates say that between 5% and 15% of the potential target group can be reached under existing programs. All in all, about 2-5% of all commercial bank SME loans are covered by CMZR guarantee programs.

The main problem even under the assistance programs is high risks associated with SME lending, which stem from difficulties in the appreciation of the value and the performance of the enterprises as well as the lack of appropriate collateral. The commercial banks require collateral such as real estate of more than 120% of the principal. Furthermore, between 30-70% of the collateral value is eligible for lending. Beside risk, the obviously financially bad performance of many businesses do not permit loan approval.

Applicants and performance

In total, the banks provided guarantees, loans or subsidized interests to about 1,390 SME projects in 2000.

The number of guarantees provided since 1996 has increased from 190 to 463 by 2000. The highest proportion of guarantees were for projects implemented in the regions around Ostrava, Hradec Králové, Zlín and Olomouc. An analysis according to industries shows a long-term trend dominating the number of projects in the manufacturing (68%) and retail (15%) sectors.

Most of the debtors asking for a guarantee received loans from the KB (41% in 2000), followed by the CSOB-IPB (21%) and the CS (14%).

The number of preferential loans amounted to about 360 projects with a volume of CZK 985 million in 2000. These loans were directed mainly to the industrial manufacturing and retail sector (70%). Most of the projects were located in the Ostrava region.

In 2000, financial assistance was provided to about 571 projects (CZK 4,222 million of subsidized loans), and was mainly implemented in the regions of Hradec Králové (19.5%) and Brno (14%). The industrial manufacturing (67%) and retail (17%) sectors benefited the most from this assistance.

The high default rate of up to 30% p.a. under the early loan and guarantee program led to a change in the type of guarantee covering just the difference between the principal and the

collateral value. Default figures on the new guarantee scheme started after 1996 do not yet exist as the maturity is about 6 years, but are presumed to be in the range of 10% p.a..

Credit for farming

The “Support and Guarantee Farmer and Forestry Fund” (SGFFF) program was created to overcome a temporary lack of both own funds and financial services in the farm business. SGFFF is administered by the Ministry of Agriculture and provides the following financial services:

- purchase of inputs
- agricultural investments
- assistance to new family farms or businesses, and
- export promotion of agricultural commodities.

As of end 2001, the largest part (71%) of the guarantee program was used for investments, followed by input financing (16%). Credits for export were not requested.

Procedure

Farmers apply simultaneously for a loan at a commercial bank and for the guarantee issued by SGFFF. Upon the approval of the commercial bank, SGFFF issues up to 50% guarantee on the principal and covers a maximum amount per annum. Farmers pay an additional portion of the interest to SGFFF. The portion that is not covered by SGFFF is usually covered by collateral. The coverage of the loan amount by collateral usually exceeds 100%.

Banks can refuse credits to farmers or farming businesses for the following reasons:

- the ownership structure: farmers often rent land from several owners, sometimes under contract conditions which are unclear to banks;
- the financial position of agricultural enterprises: this is generally poor, and often goes hand in hand with little diversification of business activities;
- the low value of agricultural land or buildings as collateral;
- the lack of any kind of loan guarantee that farmers can offer in general – however, a possible registration of pledged tangible fixed assets for loan guarantee purposes could change the situation;
- agricultural lending is exposed to risk arising from uncertainties in production and market prices, and the lack of information on the financial position of farm businesses.

However, from the perspective of some banks, the main constraint to agricultural development is strong competition from Western Europe through subsidized agricultural products which, given the existence of an open market in the Czech Republic, can enter the country at prices which hardly cover domestic production costs. In addition, price pressure

from food processors is named as a further issue hampering the profitability of agricultural production.

Applicants and performance

In 2000, about 34% of the borrowers were individual farmers, 29% cooperatives, 19% joint stock companies and 18% limited liability companies. The individual farmers' share of the guarantee volume reached 15%, while the joint stock and limited liability companies had 37% and 19% respectively.

In 2000 most of the agricultural enterprises and farms had guaranteed credits from the former state-owned banks KB (43%), CS (11%), with a further 21% from the largest foreign-owned and medium-sized bank, GE Capital Bank (which is 98% owned by General Electric Holdings, USA), plus 7% from some foreign bank branches of the Austrian Savings Banks.

Between 40-50% of the initial credit demanders apply for a loan, while approximately 6-9% of loan applications from individual farmers are refused. Rough estimates show a borrower default rate of about 10%. The loan sizes range from about 400,000 to 200 million CZK.

In the entire banking sector, the share of credits to agriculture was between 2-3% of all credits at the end of 2000. From this share approximately 5% of the loans were for individual farmers. 99% of all agricultural credits in the banking sector – except those to very large agricultural companies – are guaranteed by the SGFFF.

Commercial SME credits

Although financial institutions consider SMEs to be high-risk clients, a few foreign-owned commercial banks (for example, the *Raiffeisenbank*) have nevertheless recognized the potential of SMEs for credit operations in the Czech Republic. These banks plan to expand their SME business from merely 1-3% of their credit portfolio at present to about 5-10% in the near future. Most of their current SME clients are located around cities; however, the goal is to reach those SMEs who are based in rural areas as well. The banks believe this can be achieved by means of GMS and Internet banking technology. Furthermore, to keep transaction costs low, including screening and monitoring of SME lending, banks have developed standardized credit application procedures.

Products and procedure

The main credit products are overdraft facilities on the current account, and short to long-term loans for investments or production which are provided as installments or annuity loans. To approve a loan, the borrower needs to demonstrate the exact purpose and use of the loan through documents, accounts etc. In general, the interest rate for short-term loans is variable, based on the PRIBOR plus a margin that depends on the financial and economic situation of the borrower. Mortgage loans have fixed rates of up to 5 years.

The coverage of the credit through collateral generally exceeds 100%, and is normally approximately 120%. Financial institutions prefer mortgages and bank guarantees as

collateral, but do in some cases also accept movable properties, stocks, shares and receivables.

Problems

From the perspective of financial institutions, the main problems are as follows:

- the historical heritage of small-scale businesses: under-capitalization, poor financial statements, lack of own funds for securing loans,
- application procedures which require documents and information prior to the actual loan application procedure, which are not properly provided,
- low or negative profits, equity, value of assets and mostly low expected return on investment or business activities.
- legal constraints to selling pledged assets or land in the case of loan defaults. In the case of land, legal land ownership has to be clarified and courts have to decide on the necessity of selling land – a process that can last up to five years.
- the registration procedures for different classes of assets to be pledged are being revised, because legal owners of pledged assets can at present still veto the seizure of collateral (e.g. of machinery) that they actually own. Therefore, more fungible assets, for example shares instead of investment goods, are preferred as collateral.

Because of these restrictions and problems, a high number of potential borrowers (estimates indicate between 70-80%) decide not to apply for loans or are immediately refused by their financial institution.

6.5 Summary and conclusion

The banking sector in the Czech Republic is characterized by privatization, the creation of new banks, liquidations and mergers. Driven by the upcoming EU accession, the banking sector has been completely privatized and is now predominantly foreign-owned. Nevertheless, the adaptation of western European banking standards has caused some difficulties.

There are hardly any distinctions in products and services offered between the former state-owned financial institutions and the newly founded or foreign banks. Only the outreach of former state banks (measured in number of agencies and employees) remains larger, although this is decreasing in comparison to that of other commercial banks.

The product and service range is large and focuses on households with regular income as well as on large and medium enterprises. Due to business consolidation and electronic banking, large banks' branch networks will be reduced, especially in rural areas. However, there is a trend among some commercial banks to take over the market of very well-performing small enterprises located in rural areas.

A few programs for SMEs mainly target well-performing enterprises that have been left by the commercial banks owing to risk factors and/or missing collateral or guarantees. Demand for credit or guarantees seems to be high, although the difficulty is to separate the wheat from the chaff – as the relatively high default rates indicate. Financing of very small enterprises, start-ups and new projects seems too risky for commercial banks.

The main arguments of financial institutions for refusing credit to SMEs – as in many European countries - are the risk those enterprises represent and the lack of appropriate collateral. However, the perception of risk is related to incomplete information on the borrowers' activities – even if, in the SME sector, single person-related risks, i.e. risks related to the entrepreneur him/herself, are considered to be higher.

All in all, the Czech Republic has a rather modern banking system offering modern communication technologies in similar fashion to banks in western European countries. However, despite their technological sophistication, the major barriers to financing the SME sector are mainly information and communication problems, especially in rural areas. Innovative approaches are lacking to bridge this information gap. The number of loans extended to SMEs is low. For the time being, state-subsidized loan and loan guarantee programs offer only temporary solutions. They may, under certain circumstances, even represent an impediment to the development of better information and communication between SMEs and the banks, leading to adapted products and services between both parties.

7. Summary and Recommendations

7.1 Summary of the study

The overall macroeconomic conditions in the Czech Republic are considered to be sound and stable. The liquidation and privatization of banks in the early phases of economic transition, coupled with subsequent bank mergers, has restructured the entire banking sector and increased its competitiveness. The financial sector is now dominated by mainly foreign-owned banks. Former state-owned banks have been transformed into large private and competitive financial institutions serving a large proportion of companies/enterprises and private persons/households. Private banks created at the beginning of the transformation process initially financed small-scale activities. However, because of the high risks incurred, only a few of these banks survived, and these were subsequently partly or entirely bought up by foreign investors. On the whole, the adoption of western European banking standards concerning the know-how of banks, applied technologies, products and services have led the Czech banking sector to converge with international banking practice and the state-of-the-art.

As regards their clientele, Czech financial institutions focused on traditional customers and products, followed by an extension of consumer credits to households. In line with improved legal conditions, increasing competition, greater know-how and technology in the banking sector, financial institutions began to target small enterprises or single businesses. However, financial institutions seem to focus mostly on very well-performing and well-capitalized enterprises that can provide sufficient collateral. Enterprises with low equity or limited assets, or newly created enterprises, even if promising to some extent, tend not to be financed. Despite sophisticated technological input, the banking sector does not yet seem to have developed the necessary capabilities to cope with the inherent risks and incomplete information of micro and small-scale enterprises. Moreover, an appropriate institutional approach, involving credit technology adapted from financial institutions, information on markets, enterprises and activities as well as the promotion of clients by specialized institutions does not yet seem to have been developed.

The Government of the Czech Republic recognizes the importance of rural areas for the overall economic development of the country. To foster development in rural areas, the Government has elaborated a regional development plan focusing on the promotion of the agricultural sector and the SME sector in rural areas and rural communities. However, programs addressing these target sectors are administered and implemented separately by the respective sectoral ministries. Thus, three different sectoral promotion tracks are pursued separately. Consequently, cross-sectoral issues, programs, components or linkages between each of the target sectors which would be helpful in tackling rural development in more breadth and depth do not have an administrative part.

The involvement of financial institutions in these programs consists in screening loan applicants and providing capital for loans and loan monitoring. The programs addressing rural development through agricultural promotion, SME development and community development rely on subsidized loans or state guarantees concerning their financial

7. Summary and Recommendations

assistance component. Financial institutions act on behalf of the responsible ministries as executing agencies and offer state-supported financial services. There are no means foreseen for developing specific financial services or assisting financial institutions in rural areas, such as technical assistance to rural financial institutions, institution building, training or the setting up of specific rural financial institutions.

The agricultural sector consists of large farms and cooperatives and of a few individual full-time farmers, but only a very limited portion of state-owned farms. Large agricultural enterprises were and still are financed by the now privatized former state-owned banks. In contrast, family farms face enormous difficulties in proving their creditworthiness owing to the special risks prevailing in agriculture, the fragmented nature of land ownership, the refusal of banks to accept land and machinery as collateral, a lack of information on financial performance, and the lack of credit history. Through the Agricultural Support and Guarantee Farmer and Forestry Fund, an agricultural guarantee fund which is administered by the Ministry of Agriculture, natural persons and legal entities active in agriculture and forestry are assisted through loan guarantees and interest subsidies. Three Czech banks act as lending agencies, backed by the agricultural guarantee fund.

Besides the full-time farmers, there are many small farms which are operated by part-time farmers. They do not operate on a commercial basis, but pursue in general a low input-low output strategy to supplement alimentation or the family income. These farms have no access to credit either through commercial bank loans or through the above mentioned guarantee program. The only sources are consumer or household loans used for the farm business, or semi-formal credits in the framework of input supply or output processing, which do not always offer attractive conditions to farmers. By virtue of their large number and variety of activities (agricultural and non-agricultural activities), these small farms could be a target group for specific rural and agricultural finance programs. On the other hand, it was repeatedly reported that family farmers themselves often prefer self-financing as they fear the risk of losing part of their assets offered as collateral.

The rural SME sector contributes more to employment and production in rural areas than it does in more developed urban centers. However, the share of SME in investment and productivity is relatively low. To maintain competitiveness and to ensure sustainable development in this sector, investments in both technology and marketing are required. SME promotion institutions frequently report that the need of investment capital to SMEs is also supported by a high number of credit demands by commercial banks. Refusals mainly occur owing to high risks perceived by banks, insufficient collateral and lack of information on the sectors of activity concerned. The project should be structured based on the answers to these key questions: 1. What is the stage.. process? As in the agricultural sector, there is a lack of information and more specifically communication between SMEs and banks on both the risks and the potential of SME. Moreover, banks in rural areas do not seem to have adapted financial technologies to SMEs, while specialized financial institutions for rural or microfinance services do not seem to exist.

The institutional landscape offers scope for adapting loan procedures and products to a newly emerging type of rural agricultural or non-agricultural enterprise. So far, financial

institutions financing SMEs are concerned about the high levels of risk and missing information as well as about the financial performance and value of the enterprises. Even the guarantee programs only partly compensate for these impediments. The financial means and outreach of the programs is very limited. Furthermore, the programs still require a certain amount of assets for collateral. New projects and ideas are unlikely to be financed.

In sum, despite the notable stage of development of the Czech financial sector, outreach into rural areas remains limited. Compared with other countries in transition, the financial sector of the Czech Republic is quite advanced and offers facilities similar to current EU countries. In addition, financial institutions are present in rural areas. However, the transformation of rural areas, such as the break-up of large farms into smaller units as well as the emergence of a rural SME sector, has brought about specific financial needs that incumbent financial institutions may not yet be able to meet. To fill this gap, substantial financial assistance does not seem to be needed. Moreover, the issues at stake seem to be improved communication, observation of rural markets and enterprises and adaptation of loan application procedures and products. The following section summarizes the principal recommendations of the study.

7.2 Recommendations

The current situation in rural areas of the Czech Republic, as described, offers three entry points for applying measures to improve rural financial services, namely:

- (i) adopting a cross-sectoral approach to promoting and financing the rural economy,
- (ii) identifying potential target groups and their financial needs, and
- (iii) addressing structural constraints to developing rural financial markets.

Cross-sectoral and interdisciplinary approaches to promoting and financing the rural economy:

Rural development is an issue that not only encompasses a single activity but development activities of several sectors. Economic actors in rural areas, such as individual entrepreneurs, SMEs, financial institutions and others represent a broad array of needs for technical assistance, finance, organizational development and management advice. Because of the interrelatedness of the topics, cross-sectoral and interdisciplinary approaches to promote rural development are needed. In addition, linkages between sectors, such as community and infrastructure development and SME promotion or agricultural development and rural finance, need to be taken into consideration in the design and execution of assistance programs to rural areas. Similarly, project appraisals or the creation of economic activities and enterprises need a cross-sectoral approach from those organizations that are in charge of rural development.

Currently, projects comprising both agricultural and non-agricultural activities, small community aspects and business orientation as well as financial support and intensive non-financial aid programs are excluded from any kind of credit program because of “single-sectoral” approaches or “single ministry-tied promotion tracks”. However, cross-sectoral

projects that lie within the responsibility of several ministries may significantly contribute to rural development and may therefore receive greater attention.

A concrete example would be promotion programs that consider projects and initiatives from rural actors according to their impact on the community, the agricultural and SME development as well as their implications in terms of financial needs and the design of financial products. Often, financial support is needed in combination with non-financial assistance such as assistance in marketing and input supply. In sum, an intersectoral and interdisciplinary working group for the design, implementation and evaluation of rural development programs should be established. There may be a need for intersectoral consultations and steering committees to effectively coordinate the existing promotion tracks as well as the funding of both national and EU sources. The related agenda could be as follows:

- Definition of the current needs of economic, social and environmental actors in rural areas (target group of promotion programs). Needs may encompass technical assistance to rural organizations, advisory services, management assistance, finance and information on markets as well as international practices in EU countries and other accession countries.
- The cross-sectoral approach of such a working group could result in the elaboration of programs, including an evaluation component, that take into account all the effects and components of a project or activity on sectors concerned, e.g. an agricultural project with an environmental, infrastructure or tourism component.

Cross-sectoral and interdisciplinary approaches could create an enabling environment for developing activities in rural areas. This would also represent a helpful groundwork for the improvement of rural financial services.

The identification of potential target groups and their financial needs:

To successfully design promotion programs, target groups and their present problem setting need to be identified. These programs could focus on any group or economic actor in rural areas that faces constraints in accessing rural financial services. The following examples provide some initial ideas on this subject:

- Small communities: currently, small communities have limited access to financial means through ministry-approved and financed projects. However, they need further means to finance small infrastructure projects such as small roads, water treatment and public institutions that help to maintain economic activity within the communities. Furthermore, small commercial projects on a community basis such as water, tourism and cultural heritage could be supported in order to create ties between the communities and local SMEs. Small community projects have a dual function: on the one hand, they represent a market for local SMEs, while on the other, they can help create a favorable environment for local economic development.

- Full-time family farms: These rather commercial farms have the potential to become very competitive farms in rural areas. They can be considered as risk-averse commercial units which only take external capital if the risks are limited and collateral requirements are moderate. Although around 5,100 individual farms (full and part-time family farms) have participated in the Ministry of Agriculture's agricultural guarantee program, their capital demand does not seem to be met. To a large extent (99%), commercial banks only approve credits in the context of participation in the guarantee program. Their current main constraints as farmers are input supply, marketing and storage: they need assistance in these areas to organize themselves to build up market channels and storage capacities. Subsequently, parallel to non-financial assistance, they also need financial support to finance these projects. There is a need to improve communication between these actors and the financial institutions in order to explore the scope and limitations of cooperation in more detail. This would also provide a more comprehensive picture of what kind of non-financial services could also help to create and improve financial services that are appropriate to this group of actors, but not yet available to them.
- Small-scale family farms: These family farms consider farming as an income-supplementing activity. Many of them are engaged in additional projects (tourism, processing) or have an other job. Their farm and non-farm activities represent a link to community and SME activities and promise to have a relatively large cross-sectoral impact. The small units of activities represent a good basis for small business start-ups. However, as their activities are rather small scale with little commercial orientation, their aversion to risk is rather high. Further research needs to be undertaken as to the type of potential projects and the acceptance of loan programs among small-scale family farms.
- SMEs with a weak asset and equity base: These enterprises face huge problems in obtaining sufficient capital from financial institutions. In particular, these firms need to invest to make their enterprise productive and hence competitive. Financial institutions catering to these actors should consider the expected profitability of activities. In other words, credit analysis should take into account both managerial capabilities and the economic dimension, rather than just the firms' actual equity or assets. Therefore, highly-qualified expertise is required at financial institutions to carry out different credit analysis procedures. In addition, there is little information available to lenders on customers and their credit histories. In the absence of such credit information, entering this field of activity, such as rural SMEs seem to represent severe risks to banks currently operating in rural areas

Addressing structural constraints to developing rural financial markets

Participants in rural financial markets mainly consist of SMEs, farms, households, small communities and rural financial institutions. This study has shown that many of these participants need capital for projects and activities. The Government's programs currently operating in rural areas give the impression that a rural financial market that can efficiently allocate capital from financial suppliers to rural investors obviously only works with state intervention. Banking activities in rural areas only occur in the context of interventions by the Czech Government, such as credit guarantees or interest subsidies. Although the financial

sector is relatively developed in the Czech Republic, and rural areas physically offer good access to financial institutions, rural financial markets may still fail to establish institutional structures and know-how as well as adapted products and services to deal with the special features of the economic actors in rural areas. To serve those market participants, financial institutions need to overcome the perceived impediments to credit transactions, namely:

- The lack of a credit history for most SMEs: information on past and present financial performance, entrepreneurial skills and efforts made to contribute to the success of activities is insufficient.
- Equity in investments/projects: On the one hand, the contribution of own funds of an entrepreneur provides incentives to invest only in profitable projects and to exert sufficient effort. Hence, the incentive effect of equity partly compensates for the lack of information. Equity is risk sharing. On the other hand, entrepreneurs typically lack equity. Equity requirements by banks should take into account both the incentive aspect of equity and also the structural lack of equity in projects, specifically in the set-up of new activities.
- Usable collateral: A borrower's assets pledged as securities for credit are thought of as an incentive for the borrower to strive for success. Furthermore, they represent a kind of insurance for the financial institutions. As in the case of equity, the absence of usable collateral from a borrower may impede financial cooperation between the borrower and the lender. Banking regulations referring to securization of loans are frequently *not* adapted to the concrete context of the contracting partners in the case of rural finance, and thus may not always create a favorable legal basis for rural and agricultural lending. Financial institutions and borrowers' organizations (farmers' associations, SME promotion agencies) need to consult and exchange information on each sides' scope and limitations in order to cooperate in the sense of securing loans in the given rural environment.
- High degree of exposure of SMEs to market and price risks: in addition to considerable natural risks for agricultural activities, management risks in SME are often higher as the performance of an SME tends to depend greatly on the manager-owner. In transition countries in particular, market positions are highly volatile and competition from imported goods and services is high. Rural financial markets not only deal with financial services but also with non-financial risks which are inherent to those markets, and which have a bearing on the financial position of an enterprise. Financial and non-financial services have to be combined, although not necessarily offered by the same institutions.

Some selected starting points

According to the findings of the present study, some of the following steps may contribute to advancing the development of rural financial markets in the Czech Republic:

- Integrated rural financial markets and the development of rural areas: The factors influencing demand and supply should be worked out. Linkages between small credits for SMEs/households and the economic activities which may include further credit demand need to be established. Moreover, analysis of the effects of the supply and real demand for small credits on the financial sector (structure, lending procedures) is important for future strategies.
- Strengthening the institutional structures and capacity of rural financial institutions: To serve the needs of rural economic actors, further development is required. Technical institutional assistance for financial institutions is needed to assist them in dealing with the special characteristics of rural financial markets (SMEs and farms). This includes advice on the type of banking agency in rural areas and the banking enterprise structure/subsidiaries. A “small loan unit” could be established at commercial banks operating in rural areas, providing intense consulting, training and assistance while screening potential loan applicants. The strengthening of institutional structures and capacity may also involve the identification of additional sources of funds for rural and agricultural lending.
- Credit appraisal procedures: The approval of credit applications should rely more on the evaluation of the project to be financed, i.e. on its economic environment, skills and competencies of the owner, than on the financial performance, equity and available assets of SMEs or farms. Therefore, technical and economic know-how in project appraisal are needed by financial institutions. This may require closer cooperation with consultancy services or NGOs in charge of small enterprise promotion and the development of entrepreneurship. The skills and competence of the owners/entrepreneurs may need specific attention. Hence two levels of technical assistance seem necessary:
 - Assistance in building up consultancy services in rural areas for project screening, including personal interviews with potential borrowers.
 - Assistance in building up interdisciplinary economic and technical know-how for financial institutions to evaluate projects’ overall (cross-sectoral) expected profitability. Agricultural enterprises (survey research) and new co-operatives should be supported through close cooperation between the association of private farmers and separate cooperatives
- Risk management in credit transactions. Advice should be given to establish risk funds or risk insurance to smooth the high levels of risk associated with lending to SMEs and farms. These funds should not cover all credit transaction risks because of moral hazard problems and poor incentives for financial institutions to screen and monitor borrowers properly. Analyses of the risk aversion of agricultural households/SMEs and banks should be undertaken in connection with credit securities and with the proportion of credit securities to the loan amount, and of the credit security to the project type and risk.

7. Summary and Recommendations

A loan model with low-level risks for the supplier and demander, specifically modified for rural areas including communities or villages, could be developed.

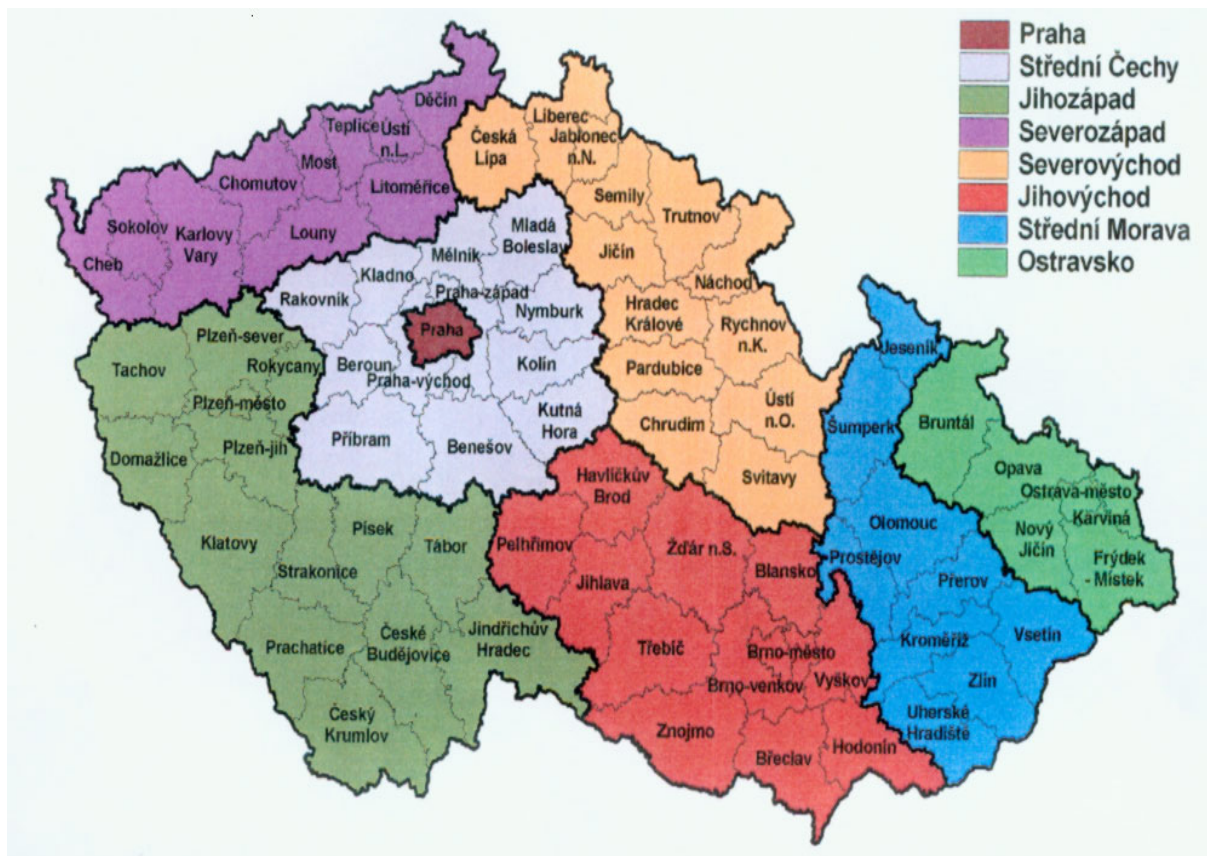
- Cross-sectoral approaches to rural and agricultural lending: All previous measures (guarantees, interest subsidies in agriculture and SME) to support the development of the agricultural and SME sectors yield two effects, one positive and the other negative:
 - Loans granted with additional guarantees to SMEs and agricultural enterprises by commercial banks.
 - Scarcely any credits are distributed to market conditions owing to interest subsidies and thus resulting market distortions.
- (1) Intense consulting of the relevant ministries (Ministry of Agriculture, Ministry of Industry and Trade) administering the fund or creating programs.
 - (2) Development and framing of an effective credit program in cooperation with the Czech Development Bank, and the pooling of several small projects with cross-sectoral components in a community for consideration as a syndicated loan transaction, so that the risks related to the single project are secured and shared by the other projects in the transaction. In this context, detailed technical assistance and knowledge building is required.

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9. Annex

Figure 3. Regions (NUTS 2) of the Czech Republic



Source: Ministry of Regional Development of the Czech Republic, 2001

Note: Stredni Cechy= Central Bohemia, Jihozapad= Southwest, Severozapad= Northwest, Severovýchod= Northeast, Jihovýchod= Southeast, Stredni Moravia= Central Moravia.

Share of bank groups as of 31 December 2002 (as a %)

	Total assets or liabilities	Total gross credit	Deposits with banks	Client deposits	Bank deposits	Funds from CNB	Equity capital	Reserves and capital funds	Off-balance sheet assets
Large banks	61.86	61.65	48.47	68.50	37.12	100	60.38	70.58	54.76
Medium-size banks	16.57	18.36	20.14	14.74	22.66	0	19.68	19.52	23.05
Small banks	3.35	4.65	2.56	2.45	4.51	0	9.89	2.12	0.32
Foreign bank branches	10.05	9.86	15.06	2.96	35.63	0	4.00	2.51	21.63
Building societies	8.16	5.48	13.77	11.35	0.08	0	6.06	5.27	0.25

Source: CNB