1. The Committee consulted with the Czech and Slovak Federal Republic on 9 July 1991, in accordance with its terms of reference, pursuant to Article XII:4(a) of the General Agreement and the Declaration of the CONTRACTING PARTIES on Trade Measures Taken for Balance-of-Payments Purposes (BISD 26S/205). The consultation was held under the Chairmanship of Mr. J.-F. Boittin (France). The International Monetary Fund was invited to participate in the consultation in accordance with Article XV.2 of the General Agreement.

2. The Committee had the following documents before it:

- Basic document for the consultation BOP/306
- Background paper by the Secretariat BOP/W/140
- Notifications by the Czech and Slovak Federal Republic pursuant to paragraph 3 of the Declaration on Trade Measures Taken for balance-of-payments purposes L/6812 + Adds. 1 and 2
- International Monetary Fund, Recent Economic Developments, dated 27 December 1990 and Supplementary Background Material for the GATT, dated 17 June 1991.

Opening statement by the representative of the Czech and Slovak Federal Republic

3. The opening statement of the representative of Czechoslovakia is attached as Annex I.

1In this report, "The Czech and Slovak Federal Republic" and "Czechoslovakia" are used interchangeably.
Statement by the representative of the International Monetary Fund

4. The statement made by the representative of the International Monetary Fund is also attached as Annex II.

Balance-of-Payments position and prospects; alternative measures to restore equilibrium: systems, methods and effects of import restrictions

5. Given the particular nature of the consultation with the Czech and Slovak Federal Republic, the Committee agreed to combine the discussion of the different aspects of the consultation.

6. Members of the Committee generally expressed their appreciation for the documents and statements supplied. Support was expressed for the efforts undertaken by Czechoslovakia in embarking on substantial economic and political reform programmes. Significant steps had already been made to liberalize the trade régime. Members of the Committee encouraged Czechoslovakia to continue the reform process.

7. Members of the Committee generally recognized the serious difficulties faced by Czechoslovakia in transforming its economy. The structural adjustment required in the transition to a market-oriented economy, including the dismantling of previous controls on trade, coupled with loss of trade with the Soviet Union and other Central and Eastern European countries and the deterioration of Czechoslovakia's terms of trade had seriously affected the balance-of-payments position. Members recognized the need for the imposition of a temporary import surcharge to prevent further deterioration and avoid a sharp decline in monetary reserves.

8. Members of the Committee recognized that the import surcharge was compatible with the provisions of Article XII of the GATT and the 1979 Declaration. The use of a uniform price-based measure was generally approved. Some members said that this case could constitute a model for the application of balance-of-payments measures. All members of the Committee welcomed the temporary nature of the surcharge, the reductions already implemented in its coverage and level, and the announcement of the intention to eliminate the import surcharge by the end of 1991. Several members of the Committee sought clarification on any specific plan or programme for the elimination of the surcharge by that time.

9. Some members of the Committee requested estimates of the trade effects of the surcharge and its general consequences for domestic producers. Noting that balance-of-payments measures should be applied in a non-discriminatory manner, one member asked why the import surcharge was
not applied to imports from Finland and urged Czechoslovakia to reconsider this situation.

10. One member of the Committee asked whether a flat rate of 15 per cent was really necessary for all products covered. Another noted that the import surcharge did not go beyond what was necessary in the circumstances prevailing when it was introduced. Another said that the balance-of-payments difficulties seemed to be due more to a decline in exports rather than a surge in imports. In this context, he sought information on Czechoslovakia's intentions with regard to expansion of exporting capacity. One member expressed her country's concern about the pace of privatization and banking reform.

11. The representative of the Czech and Slovak Federal Republic, before replying to questions, welcomed the encouragement and support given to his country in the Committee.

12. Czechoslovakia was ready to further reduce and eliminate the import surcharge. Czechoslovakia's federal Financial Council, at ministerial level, had recently decided to continue monitoring the evolution of the balance-of-payments over the next few months and, if positive progress was maintained, to reduce the import surcharge by some 50 per cent, possibly in September or October.

13. He noted that there were some pressures from domestic producers to maintain the import surcharge. However, it was more important to create a competitive environment in Czechoslovakia.

14. Inputs for production and personal imports by tourists had been removed from the surcharge in April 1991. A complete description of these aspects was included in the documentation available for the consultation.

15. The representative of Czechoslovakia noted that the short period of time did not permit a comprehensive and detailed assessment of the trade effects of the surcharge. However, preliminary estimates showed that the share of imports of consumer goods and foodstuffs decreased from 15 to 10 per cent of the total. He therefore considered that the trade effects on trading partners would have been only marginal. He pointed out that Czechoslovakia had not had a market economy for four decades. The psychological effect of import liberalization, which was not quantifiable, should be taken into account.

16. Privatization had already started for some 120,000 "small" units, including restaurants, retail shops and small service units. The industrial output from the private sector in 1989 was lower than 0.5 per cent of the total, because of the high concentration of industrial
activity in the hands of the Government. The main guidelines for "large" privatizations had already been published. Privatization projects would be presented in two phases; the first lasting until 31 October 1991, and the second until not later than the end of May 1992. Privatization would involve foreign investors as well as the distribution of roughly 760 billion Koruna of shares, out of a total value of State property of 2,500 billion, by the "voucher" method.

17. The privatization programme also covered the banking sector. Banking reforms created two separate categories, the State Bank of Czechoslovakia as a central bank, and commercial banks. Moreover, some foreign banks had already started their activity on the Czechoslovak market. Czechoslovakia was also preparing the establishment of two stock exchanges.

18. Czechoslovakia had only one free-trade area agreement, with Finland. In the past, the full possibilities of the agreement had not been exploited. Czechoslovakia exempted Finland from the import surcharge. Estimates of Czechoslovakia's imports from Finland showed that while in the first five months of 1990 they reached US$43 million, in the corresponding period of 1991, they were only US$12 million. He therefore noted that the real impact of such measure was insignificant.

19. Finally, concerning export promotion, he said that Czechoslovakia was trying to establish an export promotion mechanism through the introduction of certain export credit guarantees and market information facilities. He expressed his gratitude to all countries which recognized Czechoslovakia's current economic problems and opened their markets.

Conclusions

20. The Committee commended the authorities of the Czech and Slovak Federal Republic for the breadth of the fundamental economic reforms undertaken and for the progress achieved to date. It encouraged Czechoslovakia to pursue its efforts in the liberalization of its economy.

21. The Committee recognized that, in view of the sharp deterioration in the balance-of-payments situation, it had been necessary for the Czech and Slovak Federal Republic to introduce a temporary import surcharge. It recognized that the measure was transparent and price-based, and recalled that such measures should be applied in a non-discriminatory manner. The Committee noted that the coverage and rate of the surcharge had already been reduced, and that it was Czechoslovakia's intention to eliminate the surcharge by the end of the year.

22. The Committee considered that the surcharge was justified in the light of Article XII and the provisions of the 1979 Declaration. It
encouraged the Czech and Slovak Federal Republic to continue the progressive elimination of the surcharge and expressed the hope that the timetable which had been indicated could be respected.
Annex I
Statement by the Representative of the Czech and Slovak Federal Republic

1. Following the political events in November 1989, our new government decided to transform Czechoslovakia radically and quickly into a market economy. The overall framework for Czechoslovakia's fundamental transition was approved by the Federal Assembly of the Czech and Slovak Federal Republic in September 1990. The transformation programme covers both macro-economic and micro-economic policy changes.

2. The cornerstones of our reform are:
   
   (a) Strict restrictive financial and fiscal policy favouring balanced development over short-term growth. 1990 proved to be the first year in which a slight surplus of State budget was achieved. The same policy is being promoted this year.
   
   (b) Creation of new ownership relations and new economic operators by way of privatization and property restitution. In the case of enterprises which temporarily or permanently remain in the hands of State the abolition of administrative management by central authorities and changes in their organization structure are being reported.
   
   (c) Liberalization of price policy which is to be consistent with market economy principles. In order to minimize the expected explosions of prices in some areas an interim regulation of price increases of certain products and services was introduced.
   
   (d) A marked opening to the world resulting in:
      
      - introduction of the internal convertibility of the Czechoslovak crown (koruna);
      
      - liberalization of foreign trade and abolition of the former monopoly of large foreign trade organizations;
      
      - creation of new legislation and of organizational conditions for foreign direct investment to Czechoslovakia.
   
   (e) Phased restructuring of the Czechoslovak industry with the aim of reducing its energy and raw materials intensity. It is and will be reflected in decrease of crude steel production, phasing out of
environmentally harmful productions, expansion of transport and telecommunications infrastructure, etc. One of the most difficult problems is a conversion of the Czechoslovak defence industry.

3. The first important reform measures were introduced immediately after the elections which took place one year ago. Retail subsidies on food were removed in July 1990 and other important additional measures were taken in the second half of last year (substantial currency devaluations, unification of the commercial and tourist exchange rate, price increase of gasoline, of industrial energy and of transport, etc.)

4. A key element for success of the reform process lies in the advancement of the structural reform and in particular of the privatization, which is progressing under two parallel tracks. Auctions of enterprises under the "small" privatization scheme started in January 1991. The sale of nearly 3,000 small enterprises has been completed so far and the process is continuing. The Government intends to complete small privatization in two years. The "large" privatization law was approved by the Federal Assembly in February this year. A number of large enterprises will be sold by standard methods to foreign or domestic investors. The bulk of approximately 4,000 large enterprises will be privatized through the "voucher scheme". It is expected that the first wave of voucher privatization, comprising several hundred enterprises, will take place in the first half of 1992.

5. Demonopolization and abandonment of central planning were significant steps to liberalize foreign trade. Exclusive trading rights of foreign trade enterprises have been abolished. Both legal and natural persons may engage in foreign trade activities provided they are registered in a companies register at the relevant court.

6. The most dramatic break with the past trade régime is represented by the abolition of all implicit and explicit quantitative controls on imports. A system of import licences remains in effect only for a few items such as arms and ammunition, crude oil, natural gas, etc. The tariffs have become the principal instrument of trade regulation. The export premium scheme on export to convertible currency areas was abolished and export licences removed, except for textile, steel, meat and some intermediate products. Bilateral trade agreements and clearing payments arrangements with the former CMEA countries were abolished and have been replaced by arrangements based upon payments in convertible currencies.

7. Czechoslovakia is facing several immediate internal and external problems. During 1990, the inflation rate in consumer prices was 14 per cent and for 1991 it is expected to exceed the level of 40 per cent.
In 1990, economic activity continued to decline and GDP fell by 3.5 per cent. A sharp fall in the level of economic activity and a considerable increase in unemployment are expected for 1991. During the first five months the industrial output declined by 11 per cent and unemployment rose to 3.5 per cent of the labour force. According to the recent forecast, unemployment may reach between 8 to 10 per cent of the labour force by the end of 1991.

8. Czechoslovakia's trade balance in both convertible and non-convertible currencies deteriorated considerably already in 1990. Exports to the former CMEA countries, especially to the USSR, fell sharply while exports to convertible currency areas stagnated. The imports were growing very fast responding to trade liberalization and in anticipation of devaluation of Czechoslovak koruna particularly imports of consumer goods from developed countries.

9. In 1991, both exports and imports recorded further significant declines. Exports to former CMEA countries registered the sharpest drop of about 40 per cent and exports to the non-CMEA countries decreased by nearly 5-10 per cent. A very important factor that may seriously affect the macro-economic outcome for 1991 is the potential effect of collapsed exports to the USSR. One of the main problems is how to overcome the double short-term shock caused on one side by the increase of prices for raw material imports from the USSR to the level of world market prices and on the other side by declining export volume to the USSR. The direct effects of decline in export to the USSR include among other things unemployment of as much as 200-250,000 workers. The mentioned facts indicate quite clearly that a considerable reorientation of economic relations towards western countries is inevitable.

10. The current balances with both convertible and CMEA area worsened. The convertible currency current account surplus of US$400 million in 1989 fell to a deficit of US$1,105 million in 1990. Original projections for 1991 were for an overall deficit of some US$2.5 billion on current account, with a presently expected US$2 billion deficit with all areas.

11. The collapse of the USSR market, deterioration of trade and payment conditions, oil price increase and shrinking of important traditional markets were main reasons of temporary balance-of-payments difficulties. The import surcharge was introduced on 17 December 1990 on imports of consumer goods and foodstuffs at the rate of 20 per cent. The reason to impose the surcharge on consumer goods and foodstuffs only was to avoid higher production costs for domestic producers that an across-the-board tariff increase would have entailed. The temporary nature of this measure has been stressed. The conditions of application of the surcharge were modified in March 1991. Due to the more positive development of balance of
payments than envisaged, the rate of surcharge was reduced from 20 to 18 per cent on 1 May 1991 and to 15 per cent on 1 June 1991. If any unexpected problems do not occur, the Government's intention is to abolish the import surcharge by the end of this year.

12. Progressive liberalization of surcharge pursued by my Government fully respects the principles of transparency, degressivity and temporary nature of this measure.
Annex II

Statement by the Representative of the International Monetary Fund

1. The Czech and Slovak Federal Republic rejoined the Fund in September 1990 and, by that time, had embarked on a fundamental restructuring of the economy. The provisional Government formed after the fall of the Communist régime on 10 December 1989, was returned to office in the democratic elections held in June 1990. The new Government's economic strategy centred on a bold and rapid transformation of Czechoslovakia to a market economy.

2. Efforts to reform the economic system began in 1987, but these were piecemeal and could not begin to deal with the basic misallocation of resources that stemmed from the monopolistic State dominated industrial structure, the isolation from world markets, the distortions in relative prices; in short, the general legacy of a command economy that led to increasingly inefficient structures of production and consumption. Although the reform efforts of the late 1980s could not bring about significant structural change, prudent monetary and fiscal policies helped to keep macro imbalances relatively small, so that the underlying rate of inflation and the overhang of involuntary savings was relatively small at the end of the decade.

3. The fundamental reform process began in 1990 with the introduction of several important measures. These included: a partial liberalization of prices, with administered price corrections for food and energy; development of the legislative and institutional basis for private economic activity; and establishment of a two-tier banking system through the separation of the State Bank's central banking responsibilities from its commercial banking functions.

4. On the external side, steps were taken toward a rational pricing of foreign exchange with the unification and devaluation of the commercial and non-commercial exchange rates of the koruna at the start of 1990. Parallel steps were taken to liberalize the trade and payments system by granting freedom of entry into international commerce for registered enterprises and more liberal foreign exchange privileges to joint ventures.

5. All these reform measures were backed by strict financial and incomes policies, so that the 18 per cent increase in consumer prices in 1990 (end-period) reflected mainly the impact of administrative price adjustments. However, economic performance was adversely affected by a deterioration in the external environment as well as uncertainties about the next phase of reform: output fell by 3 per cent and unemployment rose. A decline in trade with members of the CMEA and higher imports in
convertible currencies - partly in response to liberalization measures and devaluation expectations, but also because of the need to import oil at world prices following shortfalls in USSR deliveries - led to a deterioration in the external current account. In addition, foreign banks withdrew a substantial amount of their deposits from Czechoslovak banks. As a result, the balance of payments came under strong pressure and gross international reserves in convertible currencies declined from US$2.3 billion at the end of 1989 to US$1.2 billion by end 1990 (equivalent to 1.2 months of imports). In response, in October the authorities devalued the commercial exchange rate by 35 per cent, to Kcs 24 per US dollar, and the tourist rate by 23 per cent, to Kcs 30 per US dollar.

6. The Czechoslovak authorities on 1 January 1991 launched the accelerated phase of their reform effort in the context of a comprehensive programme supported by the Fund under a stand-by arrangement and the compensatory and contingency financing facility. The decisiveness of the effort also unlocked financial assistance from bilateral official creditors under the auspices of the European Community and the Group of 24, and from other multilateral institutions. The programme included an up-front major liberalization of prices, external trade and payments, and the announcement of a rapid privatization programme. The reforms are intended to provide the foundation for an efficient allocation of resources and are backed up by restrictive fiscal and monetary policies. In addition, the public support for rapid transformation from a command to a market economy allowed these policies to be supported by an appropriate incomes policy. These, together, support a stable exchange rate. The programme coincided with a substantial deterioration in Czechoslovakia's terms of trade as a result of high oil prices in the wake of the Middle East crisis and a shift in CMEA trade to settlement in convertible currencies at world market prices. These developments carried risks for both price stability and the balance of payments. It was also recognized that the economic restructuring would initially be accompanied by a decline in output and employment.

7. In anticipation of the comprehensive programme, the exchange market was fully unified on 28 December 1990, at Kcs 28 per US dollar. The exchange rate policy was completed by a major liberalization of the exchange and trade system. As of January 1991, the annual foreign exchange plan was abolished; restrictions on current account transactions of enterprises and private entrepreneurs were largely eliminated; import licensing was limited only to a very few strategic commodities; the export premium scheme which subsidized exports to the convertible currency area was terminated; export licensing requirements on a large number of products were removed; and regulations governing foreign investment were further liberalized. Owing to concerns that imports might initially surge and put undue pressure on the balance of payments, the authorities imposed, on a temporary basis, a 20 per cent import surcharge on consumer goods.
8. The 1991 programme has met with remarkable success in the critical stabilization phase. The initial price surge following the major liberalization of prices and trade has been harnessed and the balance of payments pressures have been contained. After a cumulative rise in consumer prices of 41 per cent in the first quarter, the monthly rise in consumer prices dropped to 2 per cent in April and May. As had been expected, there was a substantial decline in output and employment associated largely with the collapse of CMEA trade and the ongoing restructuring of the economy.

9. Notwithstanding a further decline of exports to CMEA countries in early 1991, the current account deficit in the first quarter has been substantially below initial projections, due both to the decline in oil prices and to the dampening effect on imports of the fall in domestic demand and output. The current account deficit is now projected at about US$2 billion in 1991, compared with a programmed level of US$2½ billion. Despite the better-than-expected current account position, gross international reserves remain under pressure because of delays in the disbursement of external financial support. Most of the financing originally envisaged for 1991 is still expected to be forthcoming by the end of the year, but some disbursements may now fall into 1992.

10. The balance of payments performance so far has permitted the authorities to implement additional measures to liberalize external transactions. Profits and dividends have been made fully remittable; the foreign exchange entitlement for individual travel has been increased; the number of items subject to export licensing has been further reduced; and the import surcharge has been lowered from 20 per cent to 15 per cent and its coverage has been narrowed. With respect to the latter, the Fund supports the authorities' intention to eliminate in stages the import surcharge by the end of the year.

11. The Fund strongly commends the Czechoslovak authorities on launching a comprehensive reform programme designed to rapidly transform the economy through the adoption of market mechanisms. The Fund is encouraged by the far-reaching steps taken by the authorities to liberalize the exchange and trade system; this is an essential element in laying the foundation for an efficient allocation of resources. In this regard, the Fund supports the authorities' intention to pursue their commitment to an exchange system free of restrictions on current payments and to an open trading environment.