1 SUMMARY

THE WORLD ECONOMIC BOOM HAS HAD A FAVOURABLE EFFECT ON FINANCIAL SECTOR STABILITY

Over recent quarters the world economic boom has had a favourable effect on the Czech economy and the stability of its financial sector. Despite differences from nation to nation, the economic recovery has generally been stronger than expected. The main engines of the world boom are the USA and the major Asian economies. The new EU member states neighbouring the Czech Republic have achieved relatively buoyant growth. The recovery in the euro area has been slower. Even in Western Europe, however, conditions have steadily been created for renewed economic growth. The risks to the financial sector have gradually diminished.

THE OPTIMISM REGARDING GROWTH HAS BEEN REFLECTED ON THE FINANCIAL MARKETS

This trend has been reflected on international financial markets. The optimistic outlook for the global economy has translated into narrowing spreads between corporate and government bonds. Share prices remain high after recording sharp growth in 2003 and early 2004.

THE UNBALANCED DEVELOPMENT OF THE US ECONOMY POSES A RISK

Several imbalances and problems persist in the world economy which could present a risk to sustainable economic growth in the medium term and to the stability of the financial markets. The chief risk continues to be the internal and external imbalance of the US economy. A sudden unmanaged correction of these imbalances could lead to a fairly marked slowdown in US economic growth, a swing in the exchange rate of the dollar and disturbances on international financial markets. All this, in turn, could impact unfavourably on global economic growth.

STRUCTURAL PROBLEMS PERSIST IN THE EUROPEAN ECONOMY

A hard landing for the US economy could also expose more clearly the persisting structural problems in the European economy, especially if the dollar continues to weaken at the same time. Despite the great emphasis laid within the EU on the Lisbon process, which should revive the European economy, only recently and only in some countries have measures been initiated to enhance the efficiency and adaptability of the European economy.

PRICES OF OIL AND OTHER COMMODITIES POSE A RISK TO GLOBAL GROWTH

In 2004 there was also a sharp rise in the prices of oil and other major commodities. This was fostered by several short-term factors of a geopolitical/climatic nature. However, long-term trends and cyclical factors are also at work. Growing demand for energy resources and key commodities on the part of China and other Asian economies, linked with their buoyant economic growth, will affect the situation on the markets for these commodities in the long term.

ECONOMIC GROWTH HAS ALSO PICKED UP PACE IN THE CZECH REPUBLIC

Thanks to the external recovery, economic growth also picked up pace in the Czech Republic in 2004. One positive sign is that in 2003 the growth was driven in large part by domestic consumption, whereas in 2004 the contribution of investment was stronger. Buoyant growth in industry and exports is continuing, fostering an improvement in the balance of trade.

THE EFFECTS OF PAST FOREIGN DIRECT INVESTMENT ARE MAKING THEMSELVES FELT ON THE SUPPLY SIDE OF THE ECONOMY

The absence of significant demand-side price pressures in 2004 and the improving balance of trade suggest that the economy has not yet run up against its capacity constraints. This could be a sign that the positive effects of past FDI inflow and corporate restructuring on the supply side of the economy and its potential growth are making themselves felt. According to the CNB's October 2004 forecast, however, the output gap should move into positive figures in 2005, and that should translate into a rise in demand-pull inflation. In this situation there is a risk of cost inflationary effects connected with the evolution of oil and other commodity prices and a step increase in public sector wages, which could also affect wages in the enterprise sector.

THE OUTPUT GAP SHOULD CLOSE IN 2005

PUBLIC FINANCES ALSO REMAIN A PROBLEM FOR FINANCIAL STABILITY

Public finances remain a macroeconomic risk. Fast growth in public debt due to persisting public budget deficits has already resulted in a downgrading of the Czech Republic's koruna rating from Standard & Poor's. As regards financial stability, there could be a problem with growth in the risk premium, which would lead to rising interest rates and could generate increased exchange rate volatility.

FINANCIAL INDICATORS IN THE CORPORATE SECTOR SHOWED AN IMPROVEMENT

The continuing economic recovery was reflected in the financial condition and behaviour of the corporate and household sectors. Recent quarters have seen an improvement in the majority of corporate financial indicators. Profitability has been distinctly procyclical, and in 2004 it rose further. On the other hand, corporate sector debt fell slightly, despite the fact that lending to corporations showed a change in trend in 2003, starting to rise again after several years of decline.

THE QUALITY OF THE ASSETS IN FINANCIAL INSTITUTIONS' BALANCE SHEETS IMPROVED

The evolution of the domestic boom, corporations' balance sheets and household indebtedness was reflected in the financial sector. The quality of financial institutions' assets continued to improve in 2003 and 2004. In addition to cyclical effects, past systemic and institutional factors linked with the privatisation of large banks and the clean-out of bad loans from their balance sheets played a role here.

THE BANKING SECTOR IS GENERATING RELATIVELY HIGH PROFITS

The banking sector, which, with roughly three-quarters of total assets, constitutes the core of the financial system, generated high profits for the third consecutive year. In the first half of 2004, it recorded a net profit to assets ratio of around 1.25%. This is roughly double the figure achieved in Western European countries, whose banking sectors have been hit by the past economic downturn. Within the profit structure, the share of interest profit declined and that of profit from fees increased, against a background of low interest rates and a narrowing interest rate spread.

DESPITE FALLING SLIGHTLY, THE CAPITAL ADEQUACY RATIO REMAINS HIGH

Over the long run, profit is financial institutions' primary source of capital. Banks' favourable profitability fostered an increase in their capital. However, the capital adequacy ratio (CAR) fell slightly in 2004, reflecting rising bank lending to customers as well as the previously relatively high CAR. Consequently, in conditions of a stabilised sector and favourable macroeconomic developments, banks reduced their CARs somewhat. Despite the recent fall, the banking sector CAR was roughly 13.6% in mid-2004, well above the required threshold of 8%.

BUT A LARGE PROPORTION OF THE PROFIT IS BEING TRANSFERRED TO FOREIGN OWNERS IN THE FORM OF DIVIDENDS

In recent years an increasingly large proportion of earnings has been transferred to foreign owners in the form of dividends. In 2003 the figure was almost 80% of net profit, which according to balance of payments data represents around 40% of all the earnings repatriated from the Czech Republic abroad. Banks thus represent a major factor in, and at the same time a risk to, the evolution of the external balance of the economy as measured by the current account. Given the life cycle of foreign direct investment in the banking sector, the outflow of earnings abroad can be expected to continue.

CREDIT RISK HAS DECREASED IN THE CORPORATE SECTOR

There have been structural shifts in lending, and hence in credit risk, in the banking sector in the last several years. The improving macroeconomic environment and corporate sector performance have led to a decrease in the risks arising from this sector. This, in turn, has given rise to a further decline in the share of bad loans in banks' balance sheets. In mid-2004, the proportion of classified loans was slightly above 10% and that of non-performing loans around 4.5% of total loans. Banks moreover have their potential losses sufficiently covered by provisions and reserves. The degree of coverage, including collateral, in mid-2004 was more than 150% of the potential losses.

BUT THERE IS A QUESTION MARK HANGING OVER THE FUTURE DEVELOPMENT OF CORPORATE BALANCE SHEETS, OWING TO ONGOING COST SHOCKS AND POSSIBLE WAGE CONTAGION FROM THE PUBLIC SECTOR

This trend, however, should be interpreted with caution. In 2005 credit risk could rise owing to a potential deterioration in corporations' financial results caused by the evolution of oil and other commodity prices and by a possible rise in wage costs due to wage contagion from the public sector. The falling figures on risky loans may also underestimate the true extent of the potential credit risk. In a period of recovery and new lending the loan quality statistics improve, but in reality the potential credit risks can rise as banks' credit exposure grows over the economic cycle. These risks do not become apparent until the boom slows or the economy goes into decline. What until then were quality loans can change quickly into problem loans.

THE HIGH GROWTH IN LENDING TO HOUSEHOLDS IS A RISK

The same applies to loans extended to households. These loans have been rising strongly in recent years. In mid-2004, year-on-year growth of more than 35% was recorded. To date (given their fairly brief history) they have been a relatively high quality item in banks' balance sheets. Owing to the rate of growth of household debt, however, they now pose a major potential risk which might manifest itself in the event of a deterioration of the economy and households' financial situation. This applies not only to consumer credit, which is the lowest quality component of loans to households, but also mortgage loans and building society loans. Collateral in the latter case is of higher quality, but that does not eliminate the risks in the event of a fall in the ability to repay such loans. The long-term nature of mortgage loans, the related possibility of a change in interest rates, the fact that they are secured by real estate, and the danger of price swings on the property market will together present an increasingly significant risk factor for banks as these loans continue to grow.

IN MODEL STRESS TESTS, THE BANKING SECTOR AS A WHOLE PROVED ITS RESILIENCE TO ADVERSE MARKET AND CREDIT SHOCKS

To assess banks' resilience to some of the above risks, the banking sector was stress tested in model simulations of adverse changes in interest rates, the exchange rate and loan quality. The effects of combinations of these shocks were assessed by comparing the capital adequacy ratio before and after the shocks. The banking sector as a whole passed these tests and its capital adequacy ratio did not fall below 10% even after relatively large adverse shocks.

INTERNATIONALISATION AND GROWTH IN COMPETITION ON THE FINANCIAL SERVICES MARKET HAVE THE POTENTIAL TO RAISE THE QUALITY OF SERVICES...

...BUT AT THE SAME TIME MAY CONSTITUTE A NEW CHANNEL FOR THE SPREAD OF ECONOMIC PROBLEMS FROM COUNTRY TO COUNTRY

The banking sector's international linkages and the growing internationalisation of the financial services market are introducing new aspects and potential risks into the banking sector and the financial sector generally. The privatisation of banks into the hands of strong foreign financial companies and the presence of other foreign banks on the domestic market has increased the stability and efficiency of the banking sector. The predominant foreign ownership of banks, however, could also be a potential channel for cross-country transmission of economic problems. Cross-border provision of banking and other financial services, together with the fact that doing business in the sector has been made easier by the single European licence, could also play a role. These forms of financial services provision may be more volatile than the services traditionally provided by domestic institutions and may thus introduce some instability into the financial sector. On the other hand, the growth in competition associated with this trend should have a positive effect on the quality and price of the services offered. There is so far a lack of evidence on the impact of these factors on the financial sector and its stability. Nevertheless, the trend does represent something of a challenge for regulators. International collaboration among banking supervisors is becoming increasingly important.

REGULATORY AND LEGISLATIVE DEVELOPMENTS HAVE BEEN DIRECTED AT MORE ACCURATE MEASUREMENT OF BANKING RISKS

Recent regulatory and legislative developments have been directed primarily at more accurate banking risk measurement and hence at more appropriately calculated capital requirements. The new Basel II capital adequacy framework should act in this direction, as should, for example, the development of international accounting standards. More accurate assessment of the risks undertaken by banks and other financial institutions should thus further enhance their stability and enable them to operate more efficiently.

THE WEIGHT OF THE BANKING SECTOR IS FALLING IN FAVOUR OF OTHER FINANCIAL INSTITUTIONS…

Although the banking sector remains the main component of the financial system, its weight is steadily falling in favour of other financial institutions, most notably insurance companies, pension funds, open-ended mutual funds and leasing companies, as well as other organisations. This trend reflects the low initial level of development in these areas. At the same time it also signifies a gradual change in risk structure in the financial sector. The aforementioned diversification of the financial sector is proceeding in parallel with the establishment of consolidated financial units containing various types of financial service providers. This is creating the potential for efficiency gains linked with rationalisation of resource and infrastructure use in the financial sector. But it may also generate new problems linked with the spread of risks between the individual members of consolidated units and with the need for different approaches to risk management within individual financial services. In this situation an important role is being played by consolidated supervision and co-operation between the domestic regulators (the CNB, the Czech Ministry of Finance and the Czech Securities Commission) within the Committee on the Co-ordination of Financial Market Supervision, formed on the basis of a trilateral memorandum of understanding. In 2004, a plan to integrate financial market supervision was approved by the government.

…AND CONSOLIDATED FINANCIAL UNITS HEADED BY BANKS ARE OPERATING IN THE MARKET

THIS REQUIRES CO-OPERATION BETWEEN REGULATORS

By international comparison the Czech financial sector is the largest among the new EU member states from Central and Eastern Europe in terms of asset size as a percentage of GDP. However, the depth of financial intermediation is still less than in the advanced European economies. There are also some differences in the structure of the financial sector. However, these differences will recede into the background during the process of creating the single European financial services market. The application of the single licence in the financial services area and the cross-border provision of such services will reduce the information value of the data on national financial systems.

FINANCIAL STABILITY HAS ALSO BEEN FOSTERED BY THE SMOOTH OPERATION OF THE FINANCIAL INFRASTRUCTURE

Financial stability was also fostered by the smooth operation of the interbank payment system and the short-term bond system – the elements of the financial infrastructure administered by the Czech National Bank. The interbank payment system processes more than a million transactions a day on average, amounting to hundreds of billions of Czech koruna. The legislative changes in this area last year were directed at harmonising the Czech legislation with EU law and at enhancing the quality and security of the services provided.

FORWARD-LOOKING STRATEGY SHOULD TAKE INTO ACCOUNT THE NEW RISKS ARISING IN A PERIOD OF BOOM

To sum up, we can say that the financial sector further strengthened its position and enhanced its stability over the past year. It was aided by favourable developments in the economic environment and by continuing enhancement of internal control mechanisms. Consequently, the sector’s resilience to external shocks increased. Despite some domestic and external economic problems as mentioned above, the economic boom should continue into 2005 and positively affect the financial condition of businesses and households. The risks to financial stability stemming from the current credit exposure should thus continue to diminish. In an upward phase of the economic cycle, with lending recovering and picking up pace again, new potential risks arising from new credit exposure are simultaneously emerging. In a period of boom, the rational strategy of financial institutions must be based on the principle of setting aside sufficient resources to cover any future risks which might materialise later on when the economy slows.