

*The global financial crisis caused the world economy to slide into an unexpectedly strong recession in 2009. After the acute phase of this recession ended, a gradual recovery started in the second half of the year. This recovery, however, is based not only on renewed private sector confidence, but also on vigorous supportive economic policy measures. Although the Czech economy was not hit directly by the crisis, it was unable to avoid the impacts of the global shocks. However, the Czech financial system has remained stable during the crisis and its position has remained relatively strong. It therefore remains able to withstand the negative second-round impacts of the fading recession.*

*The main risk scenario for the Czech economy over the next two years is a renewed recession in its major trading partner economies and a subsequent slowdown in domestic economic activity. This scenario might materialise owing to worse credit availability because of a lack of funds in some foreign banking sectors, to potential crowding-out of private sector financing by growing government debt issues, or to rising regulatory uncertainty in credit institutions. Other factors might include the need of economic agents in many Western economies to reduce their debt, growth in commodity and energy prices in response to dynamic growth in emerging markets, and the generally adverse labour market situation. In the light of historical experience, renewed pressure for fundamentally unjustified appreciation of the koruna cannot be ruled out.*

*The second key risk is the deteriorating fiscal trend in many countries, including the Czech Republic. Contagion of concerns about the ability to finance government debt in critically indebted countries to other countries whose public finance is also showing some signs of potential unsustainability is a current threat. In the short term this could lead to a sharp rise in government bond yields with a strong negative impact on financial institutions' balance sheets. From the medium and long-term perspectives, growing government bond issuance to finance the high government debt could exert sustained upward pressure on loan interest rates. This would, in turn, have a markedly adverse effect on consumer demand, the creation of new supply capacity and the private sector's ability to repay loans.*

## **DEVELOPMENTS IN 2009 AND 2010 Q1**

After weakening appreciably in 2008 H2, the global economy slid into an unexpectedly strong recession in 2009. Although the Czech economy entered the global financial crisis in good condition, it was unable to avoid the strong impacts of the slump in external demand. A gradual recovery started in 2009 H2. However, the renewed economic growth remains very fragile, since it is based more on exceptionally large economic policy stimuli than on a natural recovery of corporate and household demand.

**In 2009 the global and domestic economies went through a sharp recession and a subsequent fragile recovery**

**Loan growth fell and ex post real lending rates went up**

Most Western economies experienced a sharp fall in lending growth in 2009. Rates of growth of loans to the private sector were very low or even negative. Overall growth in bank loans remained positive in the Czech Republic, but only thanks to rising loans for house purchase. By contrast, the stock of bank loans to corporations decreased, mainly because of a fall in demand for short-term loans linked with the contraction in economic activity. Nominal interest rates on loans to domestic non-financial corporations kept falling during 2009, while those on loans to households rose modestly. Owing to falling nominal income growth, real interest rates on loans to corporations and households measured on an ex-post basis tended to rise.

**Corporations were faced with a sharp decline in demand and – as from the end of 2009 – rising commodity and energy prices**

Corporations – and exporters in particular – coped with the dramatic fall in demand by cutting production, costs and margins, especially in the second half of 2009. This negatively affected their profitability. Corporate sector credit risk increased substantially, as indicated by a rise in the default rate on bank loans to corporations and a growing number of insolvency petitions filed. A recovery in economic activity in Western economies and continuing dynamic growth in Asian emerging economies at the end of 2009 led to a renewed upward trend in prices of commodities and energy-producing materials, adversely affecting corporations' cost situation.

**Households responded to the adverse situation with lower demand for new loans**

The decline in corporate economic activity led to a substantial rise in unemployment and a fall in nominal income growth. In combination with growing debt servicing costs, the household default rate increased with a slight lag. Credit risk was evident not only for bank loans, but also for non-bank loans. The growing risk of loss of employment coupled with growing uncertainty about household disposable income was reflected in slowing household debt growth. New loans for house purchase and consumption recorded substantially negative annual growth in 2009.

**Public finance developed unfavourably**

The recession and the supportive budgetary measures in most advanced countries, including the Czech Republic, were reflected in growth in public finance deficits and a surge in public debt to GDP ratios. Although the Czech Republic ranked among the advanced economies with lower deficits and also recorded relatively low government debt in 2009, the rate of growth of its public finance sustainability indicators began to send warning signals from the medium-term perspective.

**Monetary policies remained easy**

During 2009 and in the first few months of 2010 the key central banks left their monetary policy rates at historically low levels. This significantly helped financial institutions, corporations and households to cope with the crisis and recession. The low interest rate environment will probably have to be maintained for some time to come for the economic recovery to continue and banking sector stability to be preserved.

**The exchange rate of the koruna had a stabilising effect**

The currency market situation calmed during 2009, helping to stabilise the macroeconomic environment. Since spring 2009, the koruna has remained relatively stable at near-equilibrium levels.

International financial markets were influenced by the supportive monetary and fiscal measures adopted in late 2008 and early 2009. On the one hand these measures reduced the extreme uncertainty about potential counterparty default and restored optimism in equity markets in particular. Risk premiums fell, market volatility declined and market liquidity increased. On the other hand, the authorities' direct market interventions reduced market activity and further increased counterparty selection. In late 2009, developments in the government debt markets of some advanced economies started to worsen the overall market situation.

The situation in the Czech financial market was little changed. Low liquidity, weak activity and higher volatility persisted in the money market. The stock market has been showing an upward trend since March last year thanks to increased optimism supported by expansionary economic policy stimuli. The Czech government debt market has recorded no major deterioration and the financial markets' increased sensitivity to the Czech government finance trend has so far affected Czech government bond yields only modestly. Nevertheless, the credit risk premium has remained at an increased level, and not only in the case of the Czech government debt.

Property prices declined in 2009. This had been identified as a risk in previous Financial Stability Reports. The decline was linked primarily with a revision of future income trends, with the adverse labour market developments and with worse demographic factors. The downward movement in prices fostered an improvement in the property price sustainability indicators (the price-to-rent and the price-to-income ratio).

The decline in economic activity in the Czech Republic starting in 2008 H2 led to a rise in NPLs and higher provisioning in the banking sector. Coverage of NPLs by provisions fell slightly to around 56% in March 2010. This can be attributed to a change in the NPL structure towards better secured loans and less risky categories. Analyses indicate that the provisioning is sufficient. This is supported by evidence of banks taking a prudent and conservative approach to loan classification.

In 2009, the banking sector recorded halt in total asset growth but achieved high profits despite a sharp increase in loan impairment. This was due in particular to an increased interest rate margin in a situation of falling market rates and a loan-portfolio pricing policy responding to the current and expected rise in credit risk.

The insurance sector recorded stagnant premiums written in non-life insurance only. Transitory bond and share portfolio losses were settled during 2009 and so the sector achieved high profitability. The favourable financial market situation, particularly as from 2009 Q2, had a positive effect on pension funds as well. At the end of 2009 revaluation differences were close to zero, and at the end of March 2010 they turned slightly positive. Unlike in 2008, therefore, pension funds did not have to bolster their capitalisation through capital injections from shareholders.

**The situation in global financial markets remains to some extent tense...**

**...and the same goes for the Czech financial market**

**A decline in property prices improved their sustainability indicators**

**Growth in non-performing loans in the banking sector was accompanied by sufficient provisioning**

**The banking sector coped well with the adverse economic situation**

**The favourable asset market situation was reflected in the results of insurance companies, pension funds and mutual funds**

**The investment fund sector gradually stabilised**

The situation in the collective investment funds sector calmed in 2009. Whereas 2008 and 2009 H1 had seen outflows of funds from this sector, the more favourable financial market situation in 2009 H2 boosted capital yields and attracted more investors.

**The future risk scenarios consider the possibility of a renewed recession and a loss of investor confidence as a result of uncertainty about public finance sustainability**

Different adverse macroeconomic developments stemming from analyses of trends and weak spots abroad, in the domestic economy and in the financial sector were incorporated into alternative scenarios used to test the financial sector's resilience. These scenarios take into consideration the possibility of a renewed recession in the domestic economy connected with a decline in external demand and a potential loss of investor confidence as a result of concerns regarding Czech public finance sustainability. Banking sector liquidity was also tested.

**RISKS TO FINANCIAL STABILITY**

**Forecasts for the Czech economy predict that unemployment will rise until mid-2011**

The current forecasts predict that in the next two years the Czech economy should see a moderate renewal of economic growth. This would have a positive effect on the stability of the domestic financial system. The recovery process could be complicated by external demand volatility and the fact that economic activity in Germany and the euro area as a whole will grow much more slowly than before the crisis. Therefore, it can be assumed that the recovery of the Czech economy will have an asymmetric W shape and the unemployment rate will rise until 2011 H1. However, the scenario on which these forecasts are based is threatened by numerous risks, most of them originating abroad.

**High private sector debt may return the economy to recession**

Demand in Western economies and particularly in the EU will be subdued in the long term by the need for economic agents to reduce their gross debt, which increased in all sectors in the previous decade. Even a small change in the parameters affecting the debt burden or the capacity to service debts can have a relatively large impact on highly indebted sectors. The overall indebtedness of economic sectors in the Czech economy is relatively low, but it is impossible to rule out adverse impacts related to strong links with highly indebted EU economies.

**Rising unemployment will hinder economic recovery**

Households' main problem in the coming two years will be the labour market situation and the evolution of their income. Rising unemployment and a higher loan default rate will hinder economic recovery through an adverse effect on consumption demand. This, in turn, will further worsen the situation in the corporate sector. This feedback effect could be quite sizeable if the adverse future economic scenarios materialise.

**Corporations and households are facing tighter financial conditions**

The financial conditions for corporations and households remain relatively tight despite flat or falling interest rates on loans. Pessimistic expectations regarding future income, linked with lower-than-previously-expected selling prices of goods and services and slow growth in employees' wages, are becoming a major negative factor from the point of view of debt repayment ability.

The renewed stability of financial markets must be viewed as being very fragile. The steeply rising money market yield curve and sharp increase in the slope of the government debt yield curve can be interpreted as meaning that there is great uncertainty about future market developments. This is being bolstered by the rising credit premium being demanded by investors in return for holding the soaring volume of government bonds.

A greater increase in interest rate levels, linked, for example, to an exit from easy monetary policy, could have a destabilising effect on financial institutions in some countries. The persisting environment of low short-term interest rates is allowing banks to finance relatively cheaply and achieve an income level enabling them to cope with loan impairment losses.

Banking sectors in many countries do not have sufficient funding liquidity, so some large banks in these countries are still having to rely on funding from central banks or through government-guaranteed bond issues. Rising government bond issuance may further hamper banks' access to funds and crowd out private sector lending. This would adversely affect consumer and investment demand.

Loan availability might also be curbed in some countries by shortages of regulatory capital. The high level of uncertainty associated with planned international regulations and additional liquidity and capital requirements may have a restrictive effect on the behaviour of financial institutions.

Banks operating in the Czech market have sufficient funds and capital and their clients have relatively low debt levels by international comparison. However, it cannot be ruled out that corporations may face worse access to credit in the years ahead. A significant rise in the number of corporate insolvencies and a subsequent rise in bank loan losses as a result of a renewed recession would greatly reduce the willingness of banks and other creditors to grant more loans.

Higher growth in NPLs (to both households and corporations) in the case of a renewed recession in the Czech economy would have significant effects primarily on banks, which have more concentrated portfolios. In combination with a potential flattening-out of the yield curve, which would negatively affect banks' operating profits owing to declining interest margins, the sector's profitability would decrease sharply and could even put capital adequacy at risk. Should problems manifest themselves, liquidity risk in the building societies subsector could be reflected in the reputational risk of parent banks.

High public finance deficits and sharply rising government debt in advanced countries are among the main risks to financial stability. Concerns about public finance sustainability could generate financial market turmoil, leading to a sharp increase in government bond yields and endangering the economic recovery via rising debt service costs in the private sector. More costly and less available loans would also result in a slowdown in the creation of new supply capacity, with a negative effect on structural unemployment. There would be very limited monetary policy options for offsetting the tighter financial conditions.

**There is a high level of uncertainty in financial markets**

**The stability of financial institutions in some countries is conditional on a low short-term interest rate level**

**Banks in some countries may not have sufficient funds for lending partly because of rising government debt issuance**

**Access to loans may also be curbed by shortages of capital in banks and by regulatory uncertainty**

**The decline in bank lending to domestic corporations has so far reflected reduced demand for loans, but there are also risks on the supply side**

**The Czech banking sector would be hit by a combination of higher growth in non-performing loans and a fall in interest income due to a flattening-out of the yield curve**

**Concerns regarding public debt sustainability could sharply increase the price of loans**

**The high Czech public finance deficit and rising government debt are increasing the risk of contagion from other countries**

In the absence of additional consolidation measures, the Czech public finance deficit will remain at levels well above the Maastricht reference value in the coming years. Government debt will exceed 40% of GDP at the start of 2011 and the government's annual gross borrowing need will exceed CZK 300 billion. From the short-term perspective, Czech public finance still seems relatively sound in international comparison and the financing of Czech government debt could proceed without any major difficulties in the next few years. However, the events of April and May 2010 show that a deterioration in issuing conditions on government bond markets is a direct risk. This could happen quickly and unexpectedly as a result of contagion of doubts about the ability to finance government debt in critically indebted countries to other countries whose public finances are showing only partial signs of potential debt position unsustainability. This risk is increased by the fact that the financial markets are far less tolerant to small countries than large countries in terms of assessing national debt financing ability.

**Domestic public finance is a strong risk from the medium-term perspective**

In recent years, the Czech Republic has been a member of the group of countries that have rapidly growing public debt-to-GDP ratios. The so far relatively favourable view of Czech public finance sustainability could change quickly. Amid increasing global risk aversion to economies with unfavourable fiscal outlooks the risk premium on Czech government debt could rise faster than generally expected at present.

**Fundamentally unjustified appreciation of the koruna still poses a risk**

A potential renewed and fundamentally unjustified appreciation of the koruna associated with a renewed search for yield by investors must be regarded as an ever-present risk. This risk can be derived from historical experience and also from the fact that the Czech Republic has long been a highly stable country from the macroeconomic point of view.

**Rising prices of commodities and energy-producing materials could generate a negative supply shock**

Growth in commodity and energy prices in reaction to the recovery in Western economies and continuing growth in Asian countries could represent an additional adverse supply shock for economies with subdued demand. Such a shock would lead to a downswing in economic activity and to cost-push inflationary pressures. It would also create a tricky situation for monetary authorities.

**The residential and commercial property markets are not fully stabilised**

The property market still poses a sizeable risk despite the fact that house prices have returned close to equilibrium values. Housing construction has declined sharply and the time to sell new residential projects has increased. Combined with tightening lending standards this has led to a higher risk of insolvency in the developer sector. This is confirmed by the NPL ratio in this subsector. The situation on the commercial property market, which has been virtually abandoned by foreign investors, remains unfavourable as well. The decline in demand has been reflected in a further fall in prices and a related increase in yields in all market segments. There has also been substantial growth in the vacancy rate. The risks of this segment can also be seen in a rising NPL ratio.

With regard to the risks identified above, the resilience of the domestic financial system was assessed by means of stress tests on banks, insurance companies and pension funds using three scenarios of future economic developments entitled Baseline Scenario, Return of Recession and Loss of Confidence. A stress test was also performed on banks' balance-sheet liquidity. The first scenario is considered by the CNB to be the most probable. The other two alternative scenarios are characterised by a sizeable contraction in economic activity. The Loss of Confidence scenario is also used to test the impact of pressures for a sharp depreciation of the koruna and an increase in Czech long-term interest rates due to a negative reaction of the financial markets to the uncertainty about domestic public finance sustainability.

## ASSESSMENT OF THE FINANCIAL SECTOR'S RESILIENCE

According to the stress tests, the Czech financial sector is resilient to the market, credit and some other risks undertaken despite the strongly pessimistic settings of both stress scenarios. No sector as a whole falls below the critical values of the solvency indicators (capital adequacy for banks, solvency for insurance undertakings and capitalisation for pension funds) in any of the stress scenarios. However, if the economy were to develop in line with the alternative scenarios, some institutions would suffer losses which might require capital injections from shareholders

The stress tests indicate good resilience of banks to credit and market risks. This is due not only to a high initial capital buffer, but also to the ability of banks to generate income even in an adverse scenario.

The tests on insurance companies and pension funds show that they are resilient to market risks and some specific risks in all the scenarios. Owing to a pronounced increase in pension funds' capitalisation, this sector has become more resilient to the impact of losses arising from the revaluation of securities. New rules allowing insurance companies and pension funds to value part of their bond portfolios at amortised cost instead of fair value also play a role.

The biggest stress to the Czech financial system was the *Loss of Confidence* scenario, which led to credit and market losses amounting to around 2% of the assets of the entire tested financial sector. This scenario would cause a relatively strong decline in the solvency indicators of banks, insurance companies and pension funds, but would require relatively small capital injections into the financial system as a whole (of about CZK 5 billion, i.e. less than 0.15% of GDP). The other scenarios have smaller impacts – the *Baseline Scenario* requires no capital injections and the *Return of Recession* scenario would require only CZK 2 billion.

One of the risks that might arise if the highly adverse scenarios materialise is heightened nervousness on domestic financial markets. This might happen if, for example, a domestic bank was to fall below the regulatory threshold for the capital adequacy ratio or as a result of

**The domestic financial system was exposed to both expected and highly unlikely shocks in stress tests**

**According to the stress tests the Czech financial sector still seems resilient to a wide range of risks**

**Banks are resilient to credit and market risks**

**Pension funds increased their capitalisation**

**The domestic financial system showed the least resilience in the *Loss of Confidence* scenario, which causes a fall in GDP and a rise in interest rates**

**The stress tests of banking sector liquidity also indicate a high level of resilience**

bad news about the financial condition of a Czech institution's parent bank. Any panic would, in turn, be reflected in a run on the banks and in problems in asset markets. However, the stress test of balance-sheet liquidity, which was performed for two very extreme scenarios assuming, for example, that banks would be unable to boost their funding by borrowing from their parent companies, by issuing bonds or by taking deposits, indicates that the sector has relatively high resilience to market and balance-sheet liquidity risk.

#### **FACTORS CONTRIBUTING TO THE CZECH FINANCIAL SYSTEM'S RESILIENCE**

**The starting position of the financial system, and particularly of the banking sector, remains very good for future years**

The Czech financial system entered the recession in good condition. In 2009, most institutions maintained profitability close to the relatively high levels of previous years. The Czech banking sector's strong position is supported not only by sufficient profitability, but also by good funding liquidity, a high deposit-to-loan ratio and a very low proportion of foreign currency loans. The Czech banking sector has a positive net external position and is thus independent of external funding.

**The banking sector entered 2010 well capitalised**

The Czech banking sector is sufficiently capitalised. Its total capital adequacy ratio was 14.3% at the end of March 2010. In addition, the total capital adequacy ratios of all banks are above 10% for the first time since 2002. Tier 1 capital adequacy was 12.9% at the end of March 2010, indicating that banks have abundant high-quality capital dominated by retained earnings. By international comparison, the sector has a very good capital ratio, i.e. a relatively high ratio of capital to non-risk-weighted assets. In 2009 and early 2010 it still holds true that the Czech Republic has not been forced to adopt any measures to bolster banking sector solvency.

**The riskiness of the Czech banking sector's profile is decreasing**

The loan portfolios of Czech banks are currently dominated by loans to households, primarily loans for house purchase, which are still less risky than corporate loans. The risk related to the concentration of corporate portfolios is also decreasing. The banking sector meanwhile has relatively low connectivity in the interbank market, reducing the risk of rapid risk transmission via interbank exposures.

**Insurance companies and pension funds are also well-capitalised**

The sector of insurance companies and pension funds is also well-capitalised. A new "prudential mechanism" in the pension fund sector ensures that a process to increase a fund's capital is triggered in the event of sizeable losses and a fall in capitalisation.

**The external position of the Czech economy remains stable, decreasing the risk of contagion**

The external position of the Czech economy is stable, as evidenced by current and expected trade surpluses, modest current account deficits and relatively low external financing needs. Only the investment position is showing a deterioration.

CNB monetary policy should continue to foster stabilisation. The CNB's macroeconomic forecast dating from the beginning of May 2010 predicts a significant dampening of inflationary pressures. Accordingly, monetary policy rates, domestic short-term money market rates and client rates should remain at fairly low levels over the next two years. Assuming relative exchange rate stability, the resulting monetary environment should allow corporations and households to cope better with the none-too-favourable income situation.

**Monetary conditions in the Czech Republic should remain easy and create favourable conditions for a recovery in private sector activity**

