ANNUAL REPORT 2001

CNB CZECH NATIONAL BANK

CONTENS

Commerce originally took place in the form of goods barter, later replaced by exchange for a generally recognised commodity which throughout the history of commerce included such varied tenders as shell, flint stone or tobacco. In time, payments became to be made in special, namely metal, products (talents of copper or bronze, or gold wire coils).
The first to use coins in the territory of what today comprises the Czech Republic were the Celts in the 2nd century B.C. Their coins were struck from gold or silver.

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GOVERNOR'S FOREWORD

GOVERNOR'S FOREWORD

ZDENĚK TŮMA
Governor

The year 2001 was not a good year for the world economy. The unprecedentedly long economic boom in the USA ended, Japan failed to emerge from stagnation, and the difficulties of these, the two largest world economies also affected the advanced countries of the EU. The almost worldwide recession was further exacerbated by the September attack on the USA.

Against this background, the economic growth achieved in the Czech Republic – a country with a highly open and liberalised economy – can be considered a success story. Although some unavoidable deterioration occurred on the current account, the deficit was easily made up for by continuing inflow of long-term capital. The Czech Republic's favour with foreign investors was reflected in the completion of several major privatisation projects and in the ever-expanding construction of new production capacities, all of which bolsters confidence in ongoing relatively favourable development of the Czech economy.

The slowdown in world economic growth brought about a stagnation, or even decline, in world prices. This had a favourable knock-on effect on inflation in the Czech Republic. The restrained development of domestic demand and internal cost factors helped to keep net inflation within the lower part of the target range throughout most of the year. Favourable inflation expectations and forecasts of stable prices allowed the Czech National Bank to lower its interest rates. At the beginning of 2002 these rates were at a historical low.

The excessive appreciation of the koruna's exchange rate at the end of the year – fuelled by privatisation-related demand for the Czech currency – can be considered one of the most serious problems of 2001. Concerns over loss of competitiveness of Czech output, along with a perceptible worsening of the situation of domestic exporters, led the CNB to conclude an agreement with the Government on the strategy for dealing with these unfavourable exchange rate effects. It can reasonably be expected that this agreement will eventually be more successful in influencing the trend on the foreign exchange markets than were the central bank's interventions and interest rate cuts.

The appreciation of the koruna negatively affected the central bank's financial results. The koruna appreciated against the euro by almost ten percent on the year in nominal terms. Consequently, the koruna value of the CNB's international reserves decreased to the same extent. This was the main reason for the loss of CZK 29 million recorded by the CNB in 2001. However, when looking at the accumulated loss (CZK 45 billion), one should bear in mind that around CZK 16 billion of it was caused in the previous year by the decision to liquidate receivables against the National Bank of Slovakia incurred during the splitting of the federal state.

Changes were made to the CNB's organisation in 2001 with the aim of better defining the decision-making powers of the Bank Board and other management elements. The number of organisational sections was reduced, the research area was strengthened, and a selection process was implemented to fill posts at executive director level. Another significant change last year, in my view, was an enhancing of the transparency of the CNB's activities to the general and professional public. This included a new, clearer, formulation of our inflation targets (in the form of consumer price indices), and a more precise formulation of our monetary policy strategy up until the year 2005.

A very important factor as regards the CNB's activities in 2001 was a calming of the highly charged atmosphere ensuing from the earlier disputes surrounding the banking legislation and the changes in the composition of the Bank Board.
I firmly believe that neither the pre-election situation, nor the post-election changes will undermine the positive current trends toward increased mutual confidence and good co-operation with all our partners.

ZDENĚK TŮMA
Governor

I. MANAGEMENT AND ORGANISATION

I. MANAGEMENT AND ORGANISATION

JAN FRAIT
Chief Executive Director

LUDĚK NIEDERMAYER
Vice-Governor

PAVEL ŠTĚPÁNEK
Chief Executive Director

PAVEL RACOCHA
Chief Executive Director

MICHAELA ERBENOVÁ
Chief Executive Director

ZDENĚK TŮMA
Governor

OLDŘICH DĚDEK
Vice-Governor

I.1 THE BANK BOARD

No changes occurred in the Bank Board in 2001. Its composition is as follows:

GOVERNOR:	*Zdeněk Tůma*
VICE-GOVERNOR:	*Oldřich Dědek*
VICE-GOVERNOR:	*Luděk Niedermayer*
CHIEF EXECUTIVE DIRECTOR:	*Michaela Erbenová*
CHIEF EXECUTIVE DIRECTOR:	*Jan Frait*
CHIEF EXECUTIVE DIRECTOR:	*Pavel Racocha*
CHIEF EXECUTIVE DIRECTOR:	*Pavel Štěpánek*

GOVERNOR ZDENĚK TŮMA

Born on 19 October 1960 in České Budějovice. Zdeněk Tůma graduated from the University of Economics, Prague, and worked there after completing his studies. In 1986 he joined the Institute for Forecasting of the Czechoslovak Academy of Sciences as a postgraduate researcher. In 1993–1995 he was an adviser to the Minister of Industry and Trade, and from 1995 he was Chief Economist at Patria Finance. From 1 June 1998 until joining the CNB at the beginning of 1999 he held the post of Executive Director of the European Bank for Reconstruction and Development, representing the Czech Republic, Slovakia, Hungary and Croatia on the Board of Directors. From 1990 to 1998, he lectured on macroeconomics at the Faculty of Social Sciences at Charles University. Between 1999 and 2001 he was President of the Czech Economics Society. He is a member of the Board of Trustees at the University of Economics, Prague, a member of the Graduation Council at the Centre for Economic Research and Graduate Education (CERGE) at Charles University in Prague, a member of the Governing Body of the English College in Prague, an honorary member of the Board of Trustees at the U.S. Business School Praha and a member of the Board of Editors of the economic journal Finance a úvěr (Finance and Credit). He has undertaken study internships at the London School of Economics and the University of Cambridge in the UK, the Tinbergen Institute in the Netherlands and George Mason University in the USA. He regularly publishes articles on macroeconomics and monetary policy in the daily press and in professional journals. On 13 February 1999, he was made a CNB Vice-Governor and member of the Bank Board. He was appointed Governor of the CNB on 1 December 2000.

VICE-GOVERNOR OLDŘICH DĚDEK

Born on 26 November 1953 in Chlumec nad Cidlinou. Oldřich Dědek graduated in agricultural economics from the University of Economics, Prague. After completing his studies in 1978, he was employed by the Economic Institute of the Czechoslovak Academy of Sciences, where he worked as a researcher specialising in economic policy. In 1992, he joined the State Bank of Czechoslovakia as Deputy Director of the Institute of Economics, and in 1996 he was appointed an adviser to the CNB Governor. He was formerly a member of the Scientific Council of the Faculty of Social Sciences at Charles University in Prague, where he lectures on financial market issues. He is currently a member of the Administrative Board of Charles University, a member of the Board of Directors of the Czech Economics Society and a member of the Board of Editors of the journal *Politická ekonomie* (Political Economics). He has participated in internships and study programmes in the United Kingdom (London School of Economics, University of Warwick) and the USA (International Monetary Fund, Federal Reserve Bank of Kansas City). He translated the *Macmillan Dictionary of Modern Economics* and is the author of the *Concise English-Czech Dictionary of Economic Terms and Abbreviations*. He also publishes articles on monetary and economic policy issues in the daily press and in professional journals. As an adviser to the Prime Minister of the Czech Republic in the first half of 1998 he headed the team of authors who prepared the document:

Economic Strategy of Joining the European Union: Starting Points and Directions. Since 13 February 1999, he has been a CNB Vice-Governor.

Vice-Governor Luděk Niedermayer

Born on 13 March 1966 in Brno. Luděk Niedermayer graduated in operational research and systems theory from UJEP Brno (now Masaryk University) in 1989 and worked there for a short time researching the theory of structures. In 1991 he joined the State Bank of Czechoslovakia. In January 1996 he became an Executive Director of the CNB, responsible for foreign exchange reserves administration and money market operations. He has undertaken numerous study programmes and internships, particularly in the areas of the capital market, derivatives trading and risk management. He also focuses on these topics as a conference participant, in lectures at professional courses and in his publishing activities. He has contributed to analyses of the CNB's monetary policy scheme and to the change in its monetary policy implementation method (in particular the switch to inflation targeting). He also focuses on monetary policy issues in his lectures and consultations for the central banks of other countries. Following the crisis in emerging markets in 1997 he has worked in BIS working groups analysing possible changes in the financial system architecture. He participates in the activities of IMF and IBRD working groups on the administration and macroeconomic significance of foreign exchange reserves. On 27 February 1996, he was made a member of the CNB Bank Board. He was appointed a Vice-Governor of the CNB on 1 December 2000 and re-appointed to this post on 27 February 2002.

Chief Executive Director Michaela Erbenová

Born on 24 August 1968 in Prague. Michaela Erbenová graduated in mathematical methods in economics from Moscow State University in 1990 and obtained a Ph.D. in economics from CERGE (Centre for Economic Research and Graduate Education) at Charles University in Prague in 1997. During her postgraduate studies, she undertook study internships at the Tinbergen Institute, University of Amsterdam, the Netherlands, and at Princeton University, USA, (1993) and a research internship at the Harvard Institute for International Development, Harvard University, USA, (1995), where she worked as a research assistant to Prof. Jeffrey Sachs. In 1994–1995 she worked as a Consultant at the Directorate for Education, Employment, Labour and Social Relations at the OECD in Paris. After a brief teaching assignment at CERGE, she worked as an Adviser to the Prime Minister of the Czech Republic, Václav Klaus (1996–1997) and as Head of the Group of Advisers to the Minister of Finance, Ivan Pilip (1997–1998). From November 1998 onwards, she held various managerial posts at Komerční banka, the last being Director of its Investor Relations Division. Since 1997 she has lectured at the Institute of Economic Studies at the Faculty of Social Sciences, Charles University. She was appointed a member of the CNB Bank Board on 1 December 2000.

Chief Executive Director Jan Frait

Born on 28 November 1965 in Slavičín. Jan Frait graduated in 1988 from the Faculty of Economics at the Technical University of Ostrava (VŠB-TU) and completed his doctoral studies there in 1995. The same year, he was awarded the prize of "Young Economist of the Year" by the Czech Economics Society. In 1998, he qualified at the faculty as an Associate Professor in Economics. Between 1990 and 1998 he worked as a special assistant in the Faculty of Economics at VŠB-TU, and then as a senior lecturer, Sub-Dean for Science and Research and as a member of the faculty's Scientific Council and of the university's Scientific Council. He has undertaken study programmes and traineeships at Keele University, University of Reading and Liverpool John Moores University in the UK and at GOTA Bank in Sweden. He is an editor of the economic journal *Finance a úvěr* (Finance and Credit) and a member of the Board of Editors of *Ekonomická revue* (Economic Review). Since December 2001 he has been President of the Czech Economics Society. He is also a member of the Centre for Euro-Asian Studies at the University of Reading in the UK and its Representative for the Czech Republic. He was appointed a member of the CNB Bank Board on 1 December 2000.

Chief Executive Director Pavel Racocha

Born on 23 March 1962 in Plzeň. Pavel Racocha graduated from the Faculty of Management at the University of Economics, Prague, and completed an eighteen-month study programme at Columbia University in New York. In 1991, he joined the newly established banking supervision department of the State Bank of Czechoslovakia. In 1996–97, he worked as a consultant at the World Bank in Washington in the area of financial sector development in emerging economies. From 1998 he worked as Executive Director of the Banking Supervision Group at the CNB. He has participated in a number of internships in the USA, Germany, France, Japan and elsewhere, focusing on banking, risk management and issues of banking regulation and supervision. He is a member of the Core Principles Liaison Group of the Basle Committee on Banking Supervision at the Bank for International Settlements in Basle, which is engaged in developing core principles for effective banking supervision, and has contributed to the development of a new concept of capital adequacy for banks. In 1999–2001, as a member of the steering committee for the privatisation of banks, he contributed to the successful privatisation of Československá obchodní banka, Česká spořitelna and Komerční banka. In 1999–2001 he was project leader of the banking component of the European Commission's programme of technical assistance to the CNB (known as "twinning") in the area of the *acquis communautaire* regarding bank regulation and supervision. He is a member of the advisory body to the Presidium of the Securities Commission. He lectures at seminars and conferences on banking in the Czech Republic and abroad. Since 13 February 1999, he has been a member of the CNB Bank Board.

Chief Executive Director Pavel Štěpánek

Born on 5 September 1956 in Prague. Pavel Štěpánek graduated in finance from the University of Economics, Prague. After completing his studies in 1979, he stayed on there as an assistant lecturer. In 1981, he was employed as a specialist by the Ministry of Finance, where he successively held various posts in the Study-Research Centre, the Public Finance Section and the Financial Policy Department. In 1998, he was appointed Deputy Finance Minister responsible for financial policy, international relations, the capital market and bank privatisation. In the second half of 1998 he became an adviser to the General Director of Česká spořitelna. In 1993–1998, he was a member of the Presidium of the National Property Fund and was also engaged for a short time on the Supervisory Board of Poštovní banka. He has participated in IMF study programmes abroad, focusing on taxes and public finance. He lectures on financial policy at the University of Economics, Prague, and publishes articles in the daily press and in professional journals. Since 13 February 1999, he has been a member of the CNB Bank Board.

I.2 Organisation

On 12 December 2001 the Bank Board approved the Organisational Manual of the CNB, which took effect on 1 January 2002. This decision completed the process of preparation of a new internal management system and organisational arrangement based on a Bank Board decision regarding the orientation of the CNB's core activities, particularly in the context of accession to the European Union and entry into the European System of Central Banks.

The Bank Board had formulated the main principles and reasons for the above changes in the middle of last year. The key attributes are professionalism, transparency and efficiency. The changes also constitute decisive criteria for formulating answers to the following questions: what sort of central bank do we want to take into the European System of Central Banks, what structure should it have, how should it be managed, what activities should it be performing in the period ahead, and how can it be as efficient and effective as possible?

As part of the process of preparing the changes, discussions on these themes took place at Bank Board level, and a series of meetings were held between the Bank Board members and the executive directors of individual departments in several working groups. The Bank Board incorporated the conclusions of these discussions into its decision to prepare fundamental organisational changes to the CNB by the end of 2001. The CNB's 2002 Organisational Manual was drafted in two phases. In the first phase, the basic part of the manual was prepared and approved. The second phase involved the executive directors of each department defining the core activities of their organisational units. Presentations of their managerial plans to the Bank Board took place between mid-October and the start of November 2001. The executive directors then determined the specific responsibilities of the organisational units of the CNB's headquarters and branches and incorporated them into the CNB's Organisational Manual.

A significant change in the CNB's internal organisation is the abolishment of groups headed by Bank Board members as a direct management link. This link has been replaced by oversight by each Bank Board member of the core activities of the departments and branches delegated to him or her. The Bank Board thus directly assigns tasks to the executive directors of each department and to the branch directors. The basic management elements of the CNB are its departments (which have been reduced in number from 16 to 11) and the newly established independent departments, which are not broken down into organisational units and are responsible for specific activities. Some of the CNB's organisational units remain unchanged, while others have been merged into more compact units based on the closeness of their activities. The role of the bank's advisory and co-ordination bodies has been newly defined, and for tackling multidisciplinary problems the emphasis has been placed on making effective use of project teams.

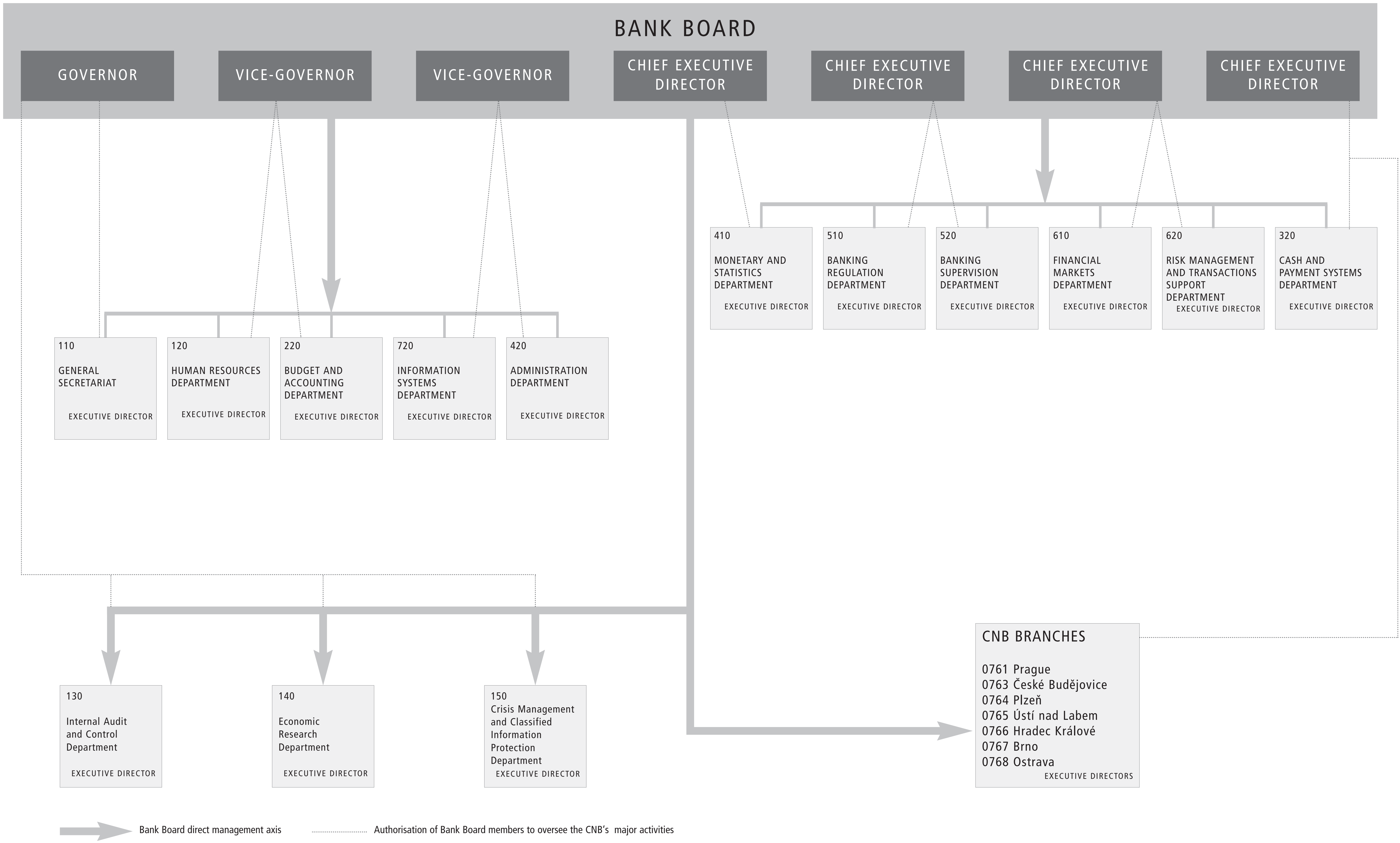
The change in the CNB's internal management system has involved altering the position of the Bank Board, which now manages the organisational units of the CNB's headquarters and branches as a collective body and deals with matters of a conceptual and strategic nature. Powers and responsibilities have been reassigned between the Bank Board and the executive directors of departments so as to enhance the professionalism of the organisational units of the CNB's headquarters and branches and to strengthen the powers of their senior officers as regards methodological and direct line management.

These changes in the CNB's internal management system and internal organisation will be reflected in changes to the CNB's internal regulations to be implemented by the end of 2002, and in a new demarcation of the responsibilities of each organisational unit for the methodological management of its areas of activity. These changes are aimed at making the CNB's internal management more flexible and responsive, and at enhancing communication between organisational units.

The attached CNB organisational chart has been valid since 1 January 2002 and depicts the current structure of the Czech National Bank.

ORGANISATIONAL CHART

ORGANISATIONAL CHART



Responsibilities of the organisational units of the CNB's headquarters and branches (as set out in the CNB Organisational Manual effective 1 January 2002)

110 General Secretariat

Co-ordinates the CNB's relations with the EU and its authorities and institutions, with the ECB and with international economic and financial organisations; responsible for the international commitments of the Czech Republic falling within the competence of the CNB and for the foreign technical assistance provided and received by the CNB; is the legislative authority within the CNB responsible for conformity of the laws and regulations falling within the competence of the CNB with other Czech legislation and their compatibility with EU legislation; responsible for the CNB's internal organisation and for preparing the draft organisational structure and organisational manual; for the CNB's external and internal communications and for releasing information on the CNB's activities; and for the organisation and administration of Bank Board meetings and for foreign and internal protocol for the Governor and other Bank Board members.

120 Human Resources Department

Responsible for human resources management; for labour-law and wage administration, including employee income tax; for processing wages and keeping records in the wage area; for professional development, forms, programmes and organisation of CNB staff training; and for preparing the methodology for provision of staff loans.

130 Internal Audit and Control Department

Responsible for internal auditing; for setting the principles for inspection activities at the CNB; and for carrying out independent and objective internal auditing and inspections at the CNB.

140 Economic Research Department

Co-ordinates and conducts economic research at the CNB; acts as opposer to research projects and provides economic research results to the public; and prepares expert opinions on situational reports and strategic monetary policy documents.

150 Crisis Management and Classified Information Protection Department

Prepares methodology and manages and co-ordinates tasks in the areas of crisis management, economic mobilisation and civil protection; prepares methodology for protection of classified information and for the information protected at the CNB; and co-ordinates activities in the areas of crisis management, protection of classified information and the information protected at the CNB.

220 Budget and Accounting Department

Prepares methodology for and conducts accounting at the CNB; prepares methodology for and prepares the CNB budget; maintains selected client accounts; and co-ordinates the keeping of accounts and related activities for the state.

320 Cash and Payment Systems Department

Drafts regulations in the area of currency circulation and payment systems; prepares methodology for managing payment systems and currency in circulation in cash and cashless form; responsible for managing the reserves of Czech money, gold and other precious metals and for protecting Czech money against counterfeiting; and sets principles for development of systems supporting payments (accounting and payment system, interbank clearing system and short-term bond system) and principles for the development of systems supporting issuance operations and for management of Czech money reserves.

410 Monetary and Statistics Department

Prepares comprehensive analyses and forecasts of monetary and economic developments, including on the external environment and its effect on the domestic economy; prepares conceptual materials and proposals in the monetary policy area, monetary policy documents on the Czech Republic's membership of the EU and EMU, and proposals for the co-ordination of monetary policy and government economic policy; prepares methodology for and collects and processes statistical data; compiles and assesses the balance of payments, and administers and develops the CNB's statistical information system and the CNB's statistical reporting to the ECB and international organisations.

420 Administration Department

Prepares methodology for all administrative activities of the CNB, including security; responsible for management of tangible assets, running non-banking facilities, catering facilities and the CNB's Congress Centre and Exhibition, stock keeping and acquisition and sale of services, materials and operational assets; and responsible for transport, communication, record, archive and library services, for surveillance of premises, and for protection of persons, property and money transport.

510 Banking Regulation Department

Prepares prudential rules for banks and consolidated groups and procedures for banking supervision; provides information and logistical support for banking supervision; conducts comprehensive analytical activity and research activities in the banking regulation area; responsible for developing the internal control system to validate the effectiveness of banking supervision procedures; co-operates with domestic and foreign regulators; and prepares methodology for and administers the central register of credits in the Czech Republic.

520 Banking Supervision Department

Performs off-site and on-site supervision of banks, consolidated groups and foreign bank branches and conducts administrative proceedings pursuant to the Act on Banks; imposes remedial measures to eliminate shortcomings at banks, consolidated groups and foreign bank branches; and co-operates with domestic and foreign institutions responsible for supervising financial market participants.

610 Financial Markets Department

Implements the CNB's monetary policy and monetary policy target; manages the CNB's international reserves; conducts the CNB's interventions on the money and foreign exchange markets; provides and administers credits to banks and non-standard CNB clients; and acts as agent of the Czech Government in administering government debt.

620 Risk Management and Transactions Support Department

Sets the principles for foreign exchange asset and liability management; prepares methodology for foreign exchange inspections; responsible for foreign exchange inspections and administrative proceedings in the defined area; prepares methodology for operational risk management; sets the interest rates on accounts of CNB non-banking clients and accounts of CNB staff; and responsible for administration, support and development of trading systems, settlement of transactions, execution of foreign payments and for the running of the SWIFT system.

720 Information Systems Department

Responsible for methodological management of the development of information systems and information technology at the CNB; for IS/IT security and protection; for developing and running IT, communication systems and IT equipment and services; for developing and running IS, except in the area of banking transactions and collection and processing of statistical data; and for management of IS and IT development projects and technological preparations for accession to the EU and membership of the ESCB in the area of compatibility.

CNB Branches

Responsible for managing money reserves and maintaining the accounts of the state budget and of other branch clients; for making payments; for operating safe deposit boxes; for the accounting of the branch; for administrative proceedings to the extent defined in a special internal regulation of the CNB; for carrying out foreign exchange inspections and processing foreign exchange statistics in the region; for collecting regional data for business surveys; for labour-law and social administration; and for the administrative activities, security and surveillance of the branch.

II. FINANCIAL REPORT

The first to begin minting money as an attribute of sovereignty was Boleslav II in the 10th century A.D. The silver coins were known as deniers, a word derived from denarius, a Latin term for common silver coinage used throughout the European continent. The denier replaced foreign coinages circulating freely in the Czech territory (i. e. Bohemia and Moravia).

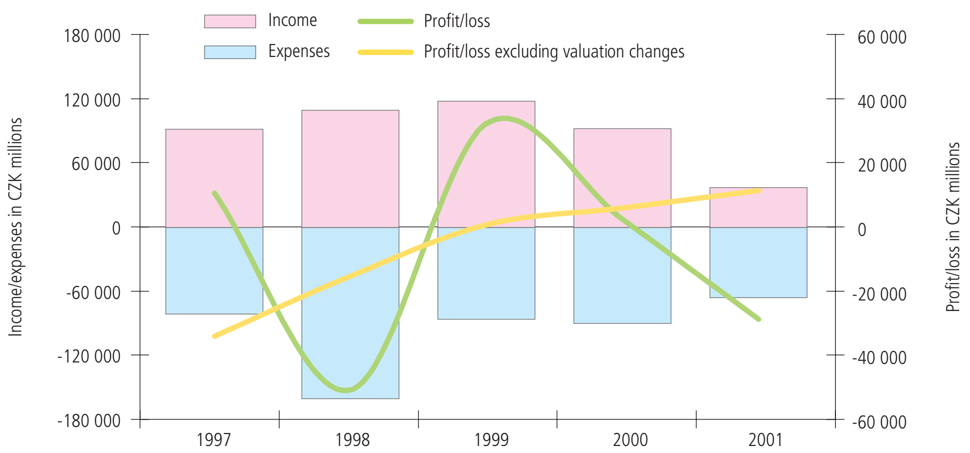
The Czech National Bank made a loss of CZK 28,628 million in 2001, income being CZK 37,202 million and expenses CZK 65,830 million.

The 2001 result was affected above all by exchange rate losses from the koruna conversion of the CNB's foreign exchange assets and liabilities. The negative effect of valuation changes was partly offset by income from international reserves management. The rate of return on the CNB's foreign exchange assets was higher than in previous years thanks to favourable developments on foreign markets. This enabled the bank to cover all its sterilisation expenses and operating expenses, as well as part of its exchange rate losses. The sterilisation expenses were slightly higher than in 2000. The lowering of the reserve requirement and the CNB's interventions on the foreign exchange market led to a rise in commercial banks' liquidity. This the CNB withdrew from the market by means of repos using CNB bills.

Total income and expenses in the area of banking sector consolidation were considerably lower than in previous years. This was because the major part of the expenses (including charges for reserves and provisions) had been incurred in the previous period.

The CNB's operating expenses were lower than a year earlier in absolute terms. This was because in 2000 the bank had been encumbered with nonrecurring expenses associated with organising the IMF/World Bank Group Annual Meetings in Prague, and with write-offs of low-value assets (connected with the completion of the reconstruction of the CNB's headquarters in 2000). On top of its running costs, the CNB in 2001 incurred VAT-related nonrecurring expenses (the final tax invoice for the reconstruction of the CNB's headquarters) and a charge for provisioning for a receivable against construction company Pozemní stavby Zlín Group linked to an outstanding contractual penalty.

CHART II.1 CNB PERFORMANCE 1997–2001



The settings of monetary policy instruments were adjusted several times during the course of 2001 in response to monetary developments. The final change, effective 30 November 2001, moved the limit two-week repo rate to 4.75% p.a., the discount rate to 3.75% p.a. and the Lombard rate to 5.75% p.a. The reserve requirement on primary deposits was left unchanged at 2%. As part of its programme to gradually harmonise the reserve requirement system with European Central Bank rules, the CNB decided to start remunerating the minimum reserves of banks with effect from 12 July 2001. The rate of remuneration equals the current rate for the CNB's two-week repos. In 2001, the reserve requirement remuneration gave rise to interest expenses of CZK 645 million.

Simultaneously with the aforementioned monetary policy instrument, the CNB used repos to sterilise the excess liquidity of commercial banks. An average of CZK 292,000 million was sterilised in 2001, an increase of around 8% compared with 2000. The remuneration on these funds generated a monetary policy implementation loss of CZK 15,819 million.

In the area of international reserves management the CNB made a profit of CZK 28,521 million, constituting a rise of around CZK 6,000 million on the previous year. This was due both to a higher rate of return on the reserves and to a larger reserve volume. The weighted average return on the foreign exchange portfolio was 5.46% p.a., up by 0.39 percentage points from a year earlier thanks to developments on world markets. During 2001, the CNB executed foreign exchange transactions (sales/purchases of foreign currency). It also accepted deposits from the National Property Fund linked to the continuing privatisation of state assets. In koruna terms, the total volume of the reserves reached CZK 529 billion.

Besides the aforementioned returns, the international reserves had another fundamental effect on the CNB's overall loss, namely valuation changes arising from the conversion of the reserves into Czech koruna. The koruna's nominal exchange rate against the dollar weakened at the beginning of 2001, but gradually appreciated in the second half of the year to finish around 4.1% stronger than at the end of 2000. The koruna's nominal exchange rate against the euro continued appreciating, with minor interruptions. At the end of 2001 it was around 9% stronger than a year earlier. Overall valuation changes were thus negative at CZK 40,118 million.

Relative to other areas, the issue of banking sector consolidation had an entirely marginal effect on the CNB's bottom line. Most of the expenses in this area (including charges for reserves and provisions) had been incurred in the previous period. Also, part of the potential expenses are still covered by a CZK 22.5 billion state guarantee issued in 1997 by the Czech Government for the liabilities, guarantees and assets arising from the consolidation of the banking sector. Following the assignment of the CNB's receivable against the National Bank of Slovakia, the state guarantee relates to the consolidation programme as a whole and not to losses on individual assets. (Under an agreement with the Czech Republic, the receivable was transferred to the state for the agreed price of one Czech koruna; the difference between the receivable's nominal value and its selling price constituted a CNB loss). As the CZK 22.5 billion guarantee does not cover the total expenses of the consolidation programme, the CNB has set aside provisions up to the total amount of the potential expenses. The total volume of provisions is reduced during the year by individual payments and may also be used to offset any losses associated with closed bankruptcy proceedings.

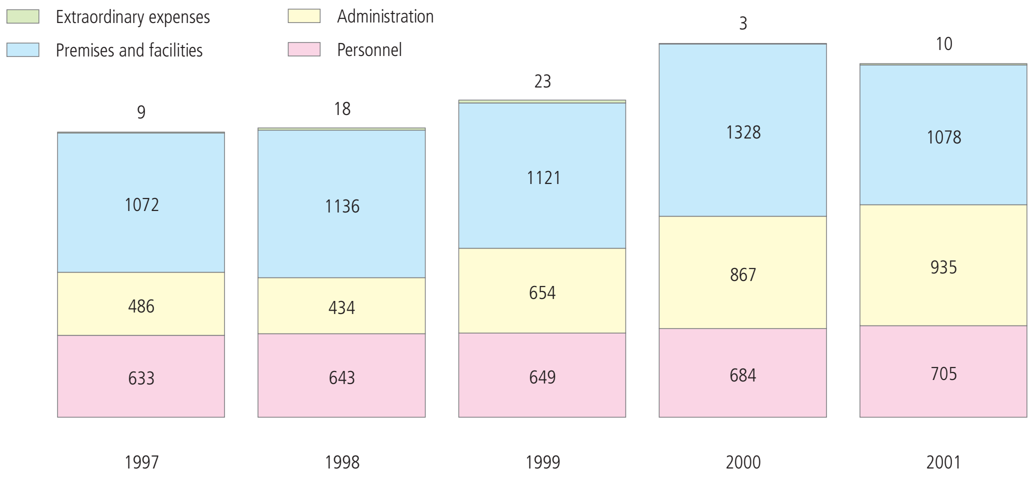
In connection with the restructuring of several transformation institutions, the CNB sold its 100% ownership interest in Česká finanční (Czech Financial) to Konsolidační banka in June 2000. At the same time, it concluded an agreement with Česká finanční to cover operating expenses and losses on assumed assets ensuing from the consolidation programme. Under this agreement, the CNB paid expenses totalling CZK 864 million in 2001 (CZK 426 million of which being an estimated item, since Česká finanční did not give specific figures on its operating expenses ensuing from the consolidation programme). At the end of 2001, the unrealised losses from assumed assets ensuing from the consolidation programme were preliminarily quantified. Based on the results of this process, part of the reserves created for this purpose were released into income. As in previous years, Česká finanční made use of specific loans in 2001, on which the CNB received CZK 792 million in interest.

In the case of Agrobanka Praha, the guarantee issued to creditors by the CNB was cleared at the end of 2001. A related reserve of CZK 362 million was released at the same time. The CNB also paid the Agrobanka liquidator contractual advances totalling CZK 38 million for the 2001 period and created a 100% provision for those advances.

The expenses incurred in the area of issuance and management of circulating currency are determined mainly by the need for new banknotes and coins and by the agreement authorising Komerční banka to manage and redistribute the stocks of Czech money. The vast majority of the expenses relate to the purchase and preparation of banknotes and coins (including silver and gold commemorative coins). In 2001, these expenses stood at CZK 309 million. Around CZK 2 million was laid out on the management of Czech money stocks through Komerční banka's Prague branches. Since the second half of 2001, these stocks have been administered exclusively by the CNB's branches.

In the area of operations the CNB made a loss of CZK 2,301 million, down by CZK 467 million (16.9%) from a year earlier. This fall was chiefly due to the fact that in 2000 the CNB had been encumbered with expenses associated with organising the IMF/World Bank Group Annual Meetings in Prague (CZK 350 million) and with write-offs of property transferred into the use following the completion of the reconstruction of the CNB's headquarters (around CZK 200 million). The return of headquarters staff to the original building caused rental expenses to fall considerably. On top of its running costs, the CNB in 2001 incurred VAT-related nonrecurring expenses (the final tax invoice for the reconstruction of the CNB's headquarters) and a charge for provisioning for a CZK 267 million receivable for an outstanding contractual penalty. In 2001, operating expenses represented 4.1% of the CNB's total expenses and operating income 1.1% of its total income. CZK 705 million was spent on staff (CZK 681 million on wages, including social and health insurance, and the remaining CZK 24 million on training). The biggest operations items by volume also included depreciation and amortisation (CZK 779 million), value added tax (CZK 376 million) and repairs and maintenance of property (CZK 159 million). Other expenses in this area included contracted services (expert opinions, auditing, software support, office cleaning, etc.), telecommunications charges, communications services, travel expenses, energy consumption, printed forms, office supplies and other sundries. Income in this area (particularly fines and penalties, sales of materials and tangible assets, and rent) totalled CZK 427 million.

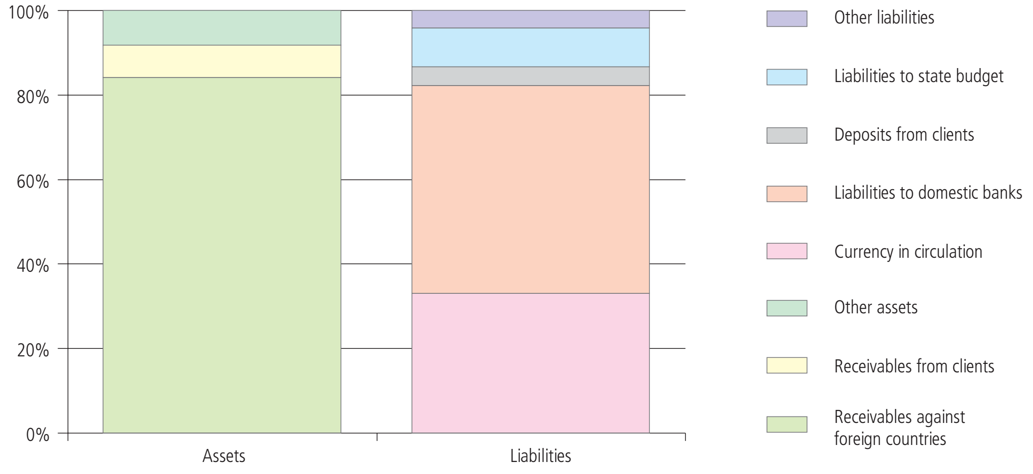
CHART II.2 OPERATING EXPENSES 1997–2001 (CZK MILLIONS)



The CNB had total assets of CZK 629 billion as of 31 December 2001. As in previous years, the most significant items on the liabilities side were liabilities to domestic banks and currency in circulation, which accounted for 82% of the total. On the assets side, receivables from abroad had the biggest share of the total (around 84%, the vast majority being international reserves).

As of 31 December, the CNB had reserves and provisions of CZK 39,175 million to cover potential losses (CZK 11,935 million in reserves and CZK 27,240 in provisions). Relative to the end of 2000, the net decline in reserves was CZK 662 million and the net increase in provisions CZK 246 million.

CHART II.3 CNB BALANCE SHEET STRUCTURE AS AT 31 DECEMBER 2001



In 2001, CZK 323 million was spent on asset acquisition, i.e. around 57% less than in 2000. This decrease was due largely to the completion of the reconstruction of the CNB's headquarters in Prague in 2000. Of the total, CZK 216 million was spent on tangible assets, CZK 37 million on inventories and the remaining CZK 70 million on intangible assets.

The largest part of the spending on acquisition of tangible assets – CZK 127 million – was on computer hardware. Of this total, CZK 47 million was spent on communications equipment for information systems (active elements of the LAN network, components of the optical channel multiplexer, etc.), CZK 33 million on hardware for projects (in particular the IS Backup Project, the IS Archive Project and the Network Active Elements Project), CZK 25 million on PCs and CZK 8 million on disk subsystems.

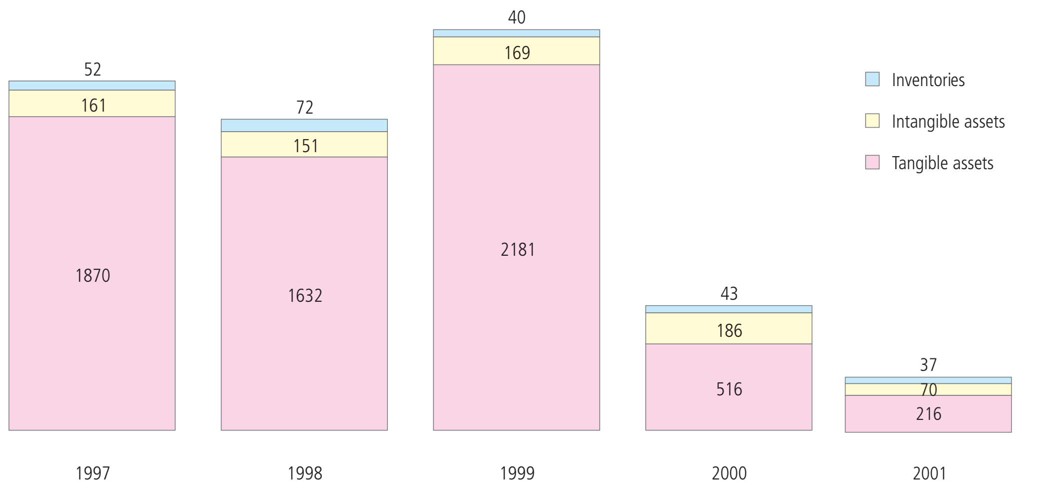
Another significant area of spending on acquisition of tangible assets was structures, buildings and land. This totalled CZK 35 million, most of it going on a UPS backup system for the CNB's headquarters, on the CNB Exhibition and on the general designer's supervision during the rectification of faults and incomplete work at the CNB's reconstructed headquarters. A further CZK 28 million was invested in equipment for safekeeping, handling and processing of cash, CZK 9 million in security equipment, CZK 7 million in vehicles, CZK 6 million in interior furnishings, CZK 1 million in office equipment and consumer electronics, and CZK 3 million in other tangible assets.

The funds for acquisition of inventories were spent on spare parts (CZK 8 million) and other consumables (CZK 29 million). The latter include maintenance materials, office supplies, packing materials for banknotes and coins, printed forms and other operating materials, the biggest item being purchases of packing materials for banknotes and coins (CZK 8 million).

The spending on acquisition of intangible assets was channelled primarily into software applications for statistical projects (in particular the Database Consolidation Project and the Nonbank Data Collection Project – total volume CZK 34 million), system software for IS development projects (in particular the IS Backup Project and the Short-term Bond Market Project – total volume CZK 14 million) and software applications for IS development projects (in particular the IS Archive Project and the CNB Demilitarised Zone Project – total volume CZK 13 million).

The following chart shows asset acquisition expenses between 1997 and 2001. It does not show specific capital investments (e.g. the increase in Česká finanční's capital), as these relate to participating interests connected with the consolidation of the banking sector.

CHART II.4 ASSET ACQUISITION EXPENSES 1997–2001 (CZK MILLIONS)



Given that the CNB recorded a loss in 2001, it was unable to make any allocation to the general reserve fund or to transfer any profit to the state budget. The social fund was replenished (in the amount agreed upon in the collective agreement for 2002) by means of a transfer from the special reserve fund.

Including the 2001 loss, the CNB's balance sheet shows an accumulated loss of CZK 44,532 million. This will be met from future profits (subject to numerous factors whose effects cannot be estimated with certainty at present). The CNB Bank Board is monitoring the situation so that where necessary – and in accordance with the CNB's primary objective – it can take measures to resolve it.

CNB BALANCE SHEET, PROFIT AND LOSS ACCOUNT AND AUDITORS' REPORT

ASSETS

in CZK millions

Item no.	Item	Current accounting period			Previous accounting period
		Gross	Adjustments	Net	
1.	**Gold**	**837**	**0**	**837**	**841**
2.	**Receivables from International Monetary Fund**	**39 800**	**0**	**39 800**	**42 802**
3.	**Receivables from foreign banks, including securities**	**530 242**	**1 573**	**528 669**	**505 351**
3.1.	Deposits at foreign banks	117 446	0	117 446	92 805
3.2.	Credits granted to foreign banks	14 384	0	14 384	14 240
3.3.	Securities	398 363	1 573	396 790	398 246
3.4.	Other receivables against foreign countries	49	0	49	60
4.	**Receivables from domestic banks**	**807**	**14**	**793**	**17 371**
5.	**Receivables from clients**	**52 418**	**4 155**	**48 263**	**37 742**
6.	**Domestic securities and shares**	**19 717**	**19 717**	**0**	**11**
7.	**Current result of state budget**	**0**	**0**	**0**	**0**
8.	**Other receivables against state budget**	**0**	**0**	**0**	**0**
9.	**Cash in CZK**	**1 714**	**0**	**1 714**	**1 898**
10.	**Fixed assets**	**11 780**	**4 011**	**7 769**	**8 329**
10.1.	Tangible fixed assets	10 713	3 294	7 419	7 877
10.2.	Intangible fixed assets	1 067	717	350	452
11.	**Other assets**	**3 150**	**1 781**	**1 369**	**1 672**
11.1.	Deferred revenue and accrued expenses	388	0	388	431
11.2.	Others	2 762	1 781	981	1 241
	ASSETS TOTAL	**660 465**	**31 251**	**629 214**	**616 017**

LIABILITIES

in CZK millions

Item no.	Item	Current accounting period	Previous accounting period
1.	**Currency in circulation**	**207 575**	**197 000**
2.	**Liabilities to International Monetary Fund**	**34 033**	**42 399**
3.	**Liabilities to foreign banks, including securities**	**14 743**	**13 829**
3.1.	Loans taken from abroad	14 275	13 415
3.2.	Debt securities in issue	0	0
3.3.	Other liabilities against abroad	468	414
4.	**Liabilities to domestic banks**	**309 247**	**295 871**
4.1.	Bank monetary reserves	30 273	26 575
4.2.	Other liabilities	278 974	269 296
5.	**Deposits from clients**	**27 916**	**21 573**
6.	**Domestic securities issued**	**0**	**0**
7.	**Current result of state budget**	**0**	**0**
8.	**Other liabilities to state budget**	**57 737**	**36 574**
9.	**Reserves**	**11 935**	**12 597**
10.	**Share capital**	**1 400**	**1 400**
11.	**Funds**	**8 198**	**8 202**
12.	**Retained profits (accumulated losses) from previous periods**	**-15 904**	**-18 393**
13.	**Profit (loss) for the accounting period**	**-28 628**	**2 524**
14.	**Other liabilities**	**962**	**2 441**
14.1.	Deferred revenue and accrued expenses	186	346
14.2.	Others	776	2 095
	LIABILITIES TOTAL	**629 214**	**616 017**

OFF BALANCE SHEET

in CZK millions

Item no.	Item	Current accounting period	Previous accounting period
1.	**Contingent liabilities**	**103 787**	**78 740**
1.1.	Accepted bills of exchange and endorsed bills	0	0
1.2.	Guarantees issued	103 787	78 740
1.3.	Obligations from collateral	0	0
2.	**Other irrevocable liabilities**	**0**	**0**
3.	**Receivables from spots, forwards and options**	**10 867**	**13 694**
4.	**Liabilities from spots, forwards and options**	**10 861**	**13 269**
5.	**Guarantees received**	**62 340**	**30 445**

PROFIT AND LOSS ACCOUNT

in CZK millions

Item No.	Item	Accounting period	
		Current	Previous
1.	**Interest income and similar income**	**28 089**	**28 825**
1.1.	Interest from securities bearing fixed income	22 381	21 696
1.2.	Other	5 708	7 129
2.	**Interest expense and similar expense**	**17 092**	**17 249**
2.1.	Interest from securities bearing fixed income	0	495
2.2.	Other	17 092	16 754
3.	**Income from securities with variable income**	**43**	**41**
3.1.	Income from shares and other securities	43	41
3.2.	Income from shares in subsidiaries and associates	0	0
4.	**Income from fees and commissions**	**555**	**450**
5.	**Expenses from fees and commissions**	**53**	**81**
6.	**Profit (loss) from financial operations**	**-37 753**	**-5 074**
7.	**Other income**	**437**	**116**
7.1.	Income from money issue	17	8
7.2.	Other	420	108
8.	**Administration expenses**	**2 002**	**2 355**
8.1.	Personnel expenses	677	666
8.1.1.	Wages and salaries	501	484
8.1.2.	Social and health insurance	176	182
8.2.	Other operating expenses	1 325	1 689
9.	**Charge for specific and general provisions for tangible and intangible assets**	**0**	**0**
10.	**Release of specific and general provisions for tangible and intangible assets**	**0**	**0**
11.	**Other expenses**	**1 765**	**49 865**
11.1.	Expenses for issuing bank notes and coinage	309	297
11.2.	Other	1 456	49 568
12.	**Charge for specific and general provisions for loans and guarantees**	**325**	**1 351**
13.	**Release of specific and general provisions for loans and guarantees**	**1 245**	**33 008**
14.	**Charge for specific and general provisions for shares and other financial investments**	**0**	**0**
15.	**Release of specific and general provisions for shares and other financial investments**	**0**	**15 814**
16.	**Charge for other specific and general provisions**	**38**	**33**
17.	**Release of other specific and general provisions**	**0**	**1**
18.	**Ordinary profit (loss) after taxation**	**-28 659**	**2 247**
19.	**Extraordinary income**	**42**	**280**
20.	**Extraordinary expenses**	**11**	**3**
21.	**Extraordinary profit (loss) after taxation**	**31**	**277**
22.	**Profit (loss) for accounting period**	**-28 628**	**2 524**

The notes to the financial statements are available on the CNB website, on the attached CD-ROM
and from the CNB's Budget and Accounting Department, Na Příkopě 28, Praha 1

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ENGLISH TRANSLATION

REPORT OF INDEPENDENT AUDITORS

TO THE BANKING BOARD OF THE CZECH NATIONAL BANK

We have audited the accompanying balance sheet of the Czech National Bank (hereinafter "the CNB") as at 31 December 2001, the related income statement and notes for the year then ended (hereinafter the "financial statements"). The financial statements and underlying accounting records are the responsibility of the of the management of CNB. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the Act on Auditors and Auditing Standards of the Chamber of Auditors of the Czech Republic. Those auditing standards require that we plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the management of the CNB, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion the accompanying financial statements present fairly, in all material respects, the assets, liabilities and equity of the CNB as at 31 December 2001, and the results of its operations for the year then ended in accordance with the Act on Accounting and other relevant legislation of the Czech Republic.

26 March 2002

PricewaterhouseCoopers

PricewaterhouseCoopers Audit, s.r.o.
represented by

Paul Cunningham
Partner

Zdeněk Mojžíšek
Auditor, Licence No. 1813

PricewaterhouseCoopers Audit, s.r.o., is registered in the Commercial Register with the Municipal Court in Prague, part C, section No 3637, and in the Register of Audit Companies with the Chamber of Auditors of the Czech Republic under Licence No 21.

III. EU INTEGRATION AND RELATIONS WITH INTERNATIONAL FINANCIAL INSTITUTIONS

The denier coinage became gradually debased with progressively lower silver content. The 13th century saw the coinage of much devalued bracteates which in 1300 forced Bohemian King Václav (Wenceslas) II to enforce a coinage reform, with the royal mint in Kutná Hora (Kuttenberg) striking the famous Prague silver gros.

III.1 EU INTEGRATION

The main events of the integration process in 2001

The main foreign-policy event of the integration process in 2001 was the European Council Meeting (the December EU summit in Laeken). The most important point on the summit agenda for the candidate countries was the approval of the *Laeken Declaration*, in which the most senior representatives of the EU member states declared the creation of a Convention on the future form of the enlarged European Union and set out the Convention's agenda. The Convention will debate the form and purpose of the further integration of 25 or more European countries. In the Presidency conclusions of the summit, the heads of state and heads of government of the "Fifteen" for the first time named ten candidate countries (the Czech Republic, Estonia, Cyprus, Lithuania, Latvia, Hungary, Malta, Poland, Slovakia and Slovenia) with which it will be possible, if the present rate of progress of the negotiations and reforms is maintained, to bring the accession negotiations to a successful conclusion by the end of 2002.

In support of the Czech Republic's accession to the EU, numerous documents were adopted on both sides. Two documents are updated on an annual basis: the *Accession Partnership*, which contains the EU's requirements on the candidate countries, and, on the Czech side, the *National Programme for the Preparation of the Czech Republic for Membership of the European Union*.

As in previous years, the CNB prepared the banking and monetary policy areas of the National Programme. In line with its priorities, the CNB stepped up its legislative activity during 2001 in order to meet the Czech Republic's general commitment to the EU, namely to achieve full compatibility of the Czech legislation with the European legislation by the end of 2002. The following bills were prepared by the CNB: a second harmonisation amendment to the Act on the CNB, a harmonisation amendment to the Act on Banks, a new Payment System Act (including accompanying amendments to related acts), a Financial Arbiter Act and, in co-operation with the Czech Ministry of Finance, an amendment to the Foreign Exchange Act.

Most of the priorities of the 2001 National Programme in the area of banking were fulfilled by the CNB in the period under review. However, owing to the non-adoption of a key amendment to the Act on Banks by the Chamber of Deputies (lower house) of the Czech Parliament, the expected date of effect of this Act, and consequently of the relating banking supervision regulations, has shifted to 2002. In addition, the second harmonisation amendment to the Act on the CNB, discussed by the Government in June 2001, was passed by Parliament only in the first quarter of 2002.

Another important document – in which the European Commission regularly assesses the preparedness of each of the candidate countries for EU membership – is the *Regular Report on Progress towards Accession*. In November 2001, the Commission issued its fourth Regular Report on the Czech Republic. The general tone of this report was more positive than in 2000. In the economic area, the return to economic growth and price and exchange rate stability were praised. Banking sector stability and banking supervisory activities also gained a positive assessment. The high pace of legislative change received particular praise. The Report mentioned the progress made with the work on amendments to the Act on the CNB and the Act on Banks and stated the necessity to enact CNB independence in all the aspects stipulated by European law.

In 2001, a *Pre-accession Economic Programme* was drawn up at the initiative of the European Commission. This Programme, which is being prepared in parallel in each candidate country, should facilitate smooth integration into the convergence programmes for fulfilment of the single currency adoption criteria after accession. CNB representatives were involved in both the creation of, and the final negotiations on, the draft Programme, which was discussed by the Government on 2 April 2001. It was then submitted to the European Commission and discussed at a joint high-level economic meeting of representatives of the Commission and the candidate countries.

An important event at the end of 2001 was the "peer review" of the Czech financial sector conducted on 10–14 December 2001. The programme was co-ordinated by the Ministry of Finance in co-operation with the Securities Commission and the CNB. The peer review built upon the conclusions of the July 2001 FSAP (Financial Sector Assessment Program), to which experts from the International Monetary Fund (IMF) and the World Bank (WB) contributed. The European Commission concentrated on areas which had not been covered by the FSAP and on the progress made in the areas in which the IMF and WB had made their principal recommendations.

The European Commission focused on:
- assessing the compliance of the Czech legislation with EU law;
- evaluating the practical capabilities and methods of supervision, in particular on-site inspections;
- assessing the co-operation between the supervisory authorities and their ability to co-ordinate procedures effectively and exchange information;
- assessing the independence of supervision.

The output from the review was a report on the current situation in this sector of the financial market (a description of the sector, its institutional structure, the nature of the supervision, methods of work, number of inspectors, etc.). After each report has been approved, the European Commission will prepare summaries for groups of three countries for discussion by the ECOFIN Council of Ministers. In 2002, the peer review's conclusions will be worked into an Action Plan for strengthening the administrative and judicial capacity of the Czech Republic. The *National Programme for the Preparation of the Czech Republic for Membership of the EU* will no longer be compiled in its traditional form.

Accession negotiations

In 2001, accession negotiations were preliminarily concluded for two of the chapters in which the CNB has been involved – Free Movement of Capital, and Free Movement of Services. The Economic and Monetary Union chapter was preliminarily concluded in 1999.

As in previous years, the regular meetings of the Europe Agreement bodies – the Association Committee (12 July 2001 in Brussels) and its subcommittees – took place. The CNB is involved in two subcommittees. The Subcommittee on Economic and Monetary Issues, Capital Movements and Statistics met on 14 June 2001 in Prague. The Internal Market Subcommittee, also covering the financial services area, convened on 5–6 April 2001 in Brussels. A large part of these meetings was devoted to the latest economic developments in the Czech Republic and to the legislative and institutional preparations for membership. At the meetings, very careful attention was paid to the status of the central bank, and in particular whether the necessary measures were being taken to remedy the shortcomings pinpointed in the previous

Regular Report. Praise was given to the efforts of the Government and the CNB to tailor their economic and monetary policy to the requirements of EU membership.

Co-operation with the European Central Bank

The year 2001 saw a further strengthening of the co-operation between the CNB and the European Central Bank (ECB), which upon the Czech Republic's accession to the EU will become the CNB's principal partner in the nation's integration into European structures. In 1999, the ECB established a tradition of meetings between the senior representatives of the Eurosystem central banks and the governors and vice-governors of the accession countries. Each meeting is preceded by a preparatory workshop at specialist level dealing with the issues to be discussed. One of these meetings was held in December 2001 in Berlin. The main topic of the seminar was the structure and functioning of the financial sectors in the candidate countries. The debate at the preparatory workshop, held on 24–25 October 2001 at the ECB, focused on the banking sector, the money and foreign exchange market, the bond and stock market and the financial sector. The central banks of the candidate countries prepared studies for the meeting according to a predetermined structure. An important factor in forging closer ties was the visit of a six-member delegation of ECB representatives to the CNB in the first half of 2001. This was followed up with a visit of the CNB Governor to Frankfurt in October 2001, where he was received by ECB Vice-President Christian Noyer and by another member of the ECB Executive Board, Eugenio Domingo Solans.

Co-operation at a working level is initiated either by the ECB (mainly seminars and workshops organised for central bank specialists from the candidate countries) or by the CNB, which as a rule asks for consultations in the form of direct working contacts. All our discussions and contacts with ECB representatives confirm that the central bank of the EU is very well acquainted with the Czech economy, the alignment of Czech banking law with the *acquis communautaire* and with the status of the Czech National Bank within the system of supreme institutions of the Czech Republic. In 2001, the ECB published its *2001 Report on the Status of Legal Preparation of Accession Countries in the Areas of Community Law of Concern to the Eurosystem*. This document was prepared with the participation of the lawyers of the two parties and describes the legal environment in the candidate countries in areas of interest to the ECB.

Phare

In 2001, the Czech banking sector drew EUR 0.75 million (about CZK 28 million) in funding from the Phare 1998 budget. On the basis of the Accession Partnership and the National Programme, the European Commission agreed to provide the CNB with funding of EUR 0.5 million for technical assistance in the form of "twinning" in the banking supervision area. This formed a separate part of a joint project focusing on supervision of banks and insurance companies. The banking supervision project had two objectives: to complete the harmonisation of supervisory legal documents with EU standards, and to foster further development of banking supervisory practice in the Czech Republic, including the involvement of CNB Banking Supervision in international co-operation. The project was implemented over a period of 24 months with the help of German and Greek experts. It was officially completed with a meeting of the steering committee on 15 November 2001. The CNB's Phare Project Implementation Unit (PIU) also prepared a training programme on the implementation of European banking standards in the Czech banking sector. This covered the following areas: strategic management in banks, marketing in financial institutions, risk management in banks, distribution strategies and information technology in banking, and aspects of banking supervision. The project was prepared in co-operation with the Banking Institute and the Banking Association's Commission for European Integration and was implemented by experts from the Phare contractor DFC London.

The European Commission also agreed to fund a EUR 2 million project to strengthen credit risk management methodology in commercial banks. A detailed project specification and an international tender process are currently being prepared under Phare rules.

Foreign technical assistance provided by the Czech National Bank

In 2001, the Czech National Bank continued to provide technical assistance to Central and Eastern European countries. This assistance was covered from a special-purpose fund. The technical assistance mostly took the form of bilateral consultations, seminars (an international seminar entitled "Credit Risk" for banking supervisors organised in co-operation with the Financial Stability Institute; and a "Monetary Policy" seminar organised in co-operation with the Joint Vienna Institute) and a workshop (an international workshop of CEFTA countries – a training event in co-operation with the Bank of England's Centre for Central Banking Studies).

III.2 RELATIONS WITH INTERNATIONAL FINANCIAL INSTITUTIONS

The International Monetary Fund and World Bank Group

In the first quarter of 2001, IMF/WBG experts completed their analysis of the Czech financial sector under the Financial Sector Assessment Program (FSAP). The principal objective of the FSAP was to assess the compliance of the Czech Republic's procedures with international standards and codes and to identify the strengths and weaknesses of the financial sector and its systemic vulnerability to external shocks. The assessment is pretty favourable: the report states that progress has been made in improving the legislative and regulatory framework and in privatising and consolidating the large banks and consolidating nonbank financial institutions. A Financial System Stability Assessment (FSSA) and a Report on Observance of Standards and Codes (ROSC) were published on the websites of the CNB and the Czech Ministry of Finance. In the same period, the two documents and their recommendations were discussed at a meeting of the Czech Government, and the Chamber of Deputies of the Czech Parliament was subsequently informed about them. The specialised press reported details on the documents to the professional public. The recommendations in the area of the banking system and banking supervision have been incorporated into an Action Plan for Banking Supervision, which is expected to be further revised to take on board the recommendations of the European Commission's experts from the peer review programme.

An Article IV consultation took place during April 2001. The IMF's representatives stated that an appropriate macroeconomic policy mix was laying the foundations for medium-term economic growth. This growth was being fostered primarily by inflow of foreign direct investment and its positive effects on productivity growth. At the same time it was emphasised that the completion of the privatisation of the large banks, together with the disposal of bad loans, bade well for the restructuring of the corporate sector and for resolving the long-standing problems of the economy. These conclusions were confirmed during the October visit, which pointed to risks of a slowdown in economic growth in response to the latest developments in the world economy and public finances.

The Bank for International Settlements (BIS)

The Governor of the CNB attends the regular working meetings of central bank governors organised by the BIS. At these meetings, topical issues relating to world economic and monetary developments are discussed. The close co-operation between the CNB and the BIS continued, most notably within the Basle Committee on Banking Supervision, in the Central Bank Governance Steering Group and in the area of co-ordination of foreign technical assistance. Within the Basle Committee on Banking Supervision, the CNB helped to prepare the New Basle Capital Accord and also regularly contributed to the activities of the Core Principles Liaison Group, which is engaged in assessing the implementation of the Core Principles for Effective Banking Supervision. The CNB also commenced co-operation with the BIS Financial Stability Institute and organised a seminar in Prague in May 2001 on the new capital adequacy regulations and credit risk modelling. Within the Central Bank Governance Steering Group, the CNB was involved in questionnaires on monetary policy management, codes of conduct for central bank staff, distribution of powers, decision-making and management policies within central banks, and in particular on the legislation regulating the status and powers of the central bank. The database that the BIS has prepared in this connection, which is based on an analysis of the central bank laws of most countries, was very helpful in formulating the relevant legislation on the CNB.

The Organisation for Economic Co-operation and Development (OECD)

CNB representatives took part in the activities of key committees of the OECD, of which the Czech Republic has been a member since 1995. In the middle of last year, a CNB representative was appointed as Alternate Member of the Capital Movements and Invisible Transactions Committee (CMIT) for the Czech Republic. The CNB actively participated in the CMIT's activities by giving opinions and presentations, particularly as regards the examinations of new OECD member countries' compliance with their liberalisation commitments. It also helped to prepare horizontal projects on selected items of the Codes of Liberalisation. At the end of last year, the CNB – in co-operation with the Ministry of Finance – prepared a draft notification updating the Czech Republic's position on the Codes of Liberalisation based on the new legislation in force as from 1 January 2002. As part of meeting its liberalisation commitments, the Czech Republic announced the lifting of more foreign exchange restrictions. In particular, this involved allowing residents to open accounts abroad, abolishing the transfer obligation, permitting branches of foreign corporations to acquire real estate in the Czech Republic for business purposes, and relaxing the conditions for bond issuance (the previous obligation to obtain a permit being replaced by a notification duty).

In 2001, the Committee on Financial Markets, with the active participation of CNB representatives, discussed two important documents closely connected with banking supervisory activity: *Experience with Saving and Restructuring of Weak Financial Institutions* and *Consolidated Supervision in Theory and Practice*. Also important from the banks' point of view is the issue of electronic financial services. A working material *Electronic Financing: Economic and Institutional Factors*, analysing the main trends in this area of banking, was discussed in detail at both the spring and autumn meetings of the Committee. The CNB was also actively involved in discussing the situation on the financial markets following the terrorist attacks on the USA on 11 September

2001, including the assessment of the aftermath and of the efficacy of the measures adopted by OECD governments and central banks to support the financial markets and to protect them against abuse by terrorists. Again with the CNB's participation a discussion took place on the topic *The Prospects of a Market with Risk Capital* with representatives of the private banking and financial sectors.

In 2001, the OECD's working parties prepared and discussed numerous studies and reviews of the policies applied in the Czech Republic. In the first half of the year, an analytical team from the OECD Secretariat completed the preparation of an economic survey of the Czech Republic for 2000–2001. This was discussed in the Economic and Development Review Committee in June 2001 and presented to the public at a press conference in Prague in July 2001. Particularly important for the Czech Republic is the favourable assessment of its macroeconomic policy (especially the growth in productivity ensuing from strong investment activity and foreign investment inflows) and the OECD's positive comments on the CNB's monetary policy. In addition, the reviews focused on the issue of public finances. In 2001, the OECD Secretariat and relevant Czech bodies (primarily the CNB, the Ministry of Finance and the Ministry of Industry and Trade) also drew up a *Foreign Direct Investment Review of the Czech Republic*, which was published in May 2001. The document assesses the investment climate and privatisation process in the Czech Republic and presents a review of FDI in the Czech Republic and Czech investment abroad from the establishment of the Czech Republic up until the end of 2000. It also includes a wealth of other information and statistical data on the Czech Republic and on other OECD member countries.

The European Bank for Reconstruction and Development (EBRD)

As usual, the Czech delegation, with the participation of the CNB, took part in the EBRD's annual meeting, where it successfully presented the results of the Czech economy to the international forum. The EBRD is also trying to engage in the privatisation process in the Czech Republic. In two cases it was involved directly in the privatisation of the banking sector, investing a total of EUR 199.2 million (a EUR 132.2 million purchase of privatised shares in commercial bank ČSOB in 1999, and a EUR 67 million pre-privatisation purchase of shares in savings bank Česká spořitelna in 2000). This greatly contributed to the stabilisation of the sector and helped to create a good foundation for completing the privatisation process in 2001. Every two years the EBRD prepares and approves strategies for each country in which it invests. A new strategy for the Czech Republic for 2002–2003 was drafted during the course of 2001. This was approved by the Board of Directors on 30 November 2001 and published on 14 December 2001. In the financial sector area, the EBRD will support the development of small and medium-sized businesses, particularly in innovative sectors, through bank and nonbank forms of financing, such as leasing, venture capital, credit lines and support for the development of banking and nonbanking financial services. While the strategy was under preparation, the EBRD President Jean Lemierre visited Prague twice to discuss the main aspects of the strategy with the Prime Minister, the CNB Governor, the Minister of Finance and the Minister of Industry and Trade. During 2001, the EBRD signed contracts to finance three projects in the Czech Republic worth EUR 88.0 million overall. Since its launch up to the end of 2001 the EBRD has approved contracts to finance 35 projects worth a total of EUR 846 million, as well as 32 technical assistance projects totalling EUR 5.4 million.

IV. MONETARY POLICY AND MONETARY DEVELOPMENTS

From the 16th century ducal coinage struck by the house of Šlik (Schlick) in Jáchymov (Joachimsthal) developed a new coinage unit, known as thaler. The new coinage was highly valued and soon spread throughout Central and Western Europe. In time, the name thaler came to be used also for other coinages and in 1792 a derivation of the word gave the name to the dollar, the monetary unit adopted by the United States.

In 2001, the CNB conducted monetary policy under a regime of inflation targeting for the fourth consecutive year. After having successfully brought inflation and interest rates down to a relatively low level (close to that in the EU) the previous year, the CNB set itself the objective in 2001 of maintaining macroeconomic stability and thus establishing the right conditions for continuing economic recovery. This objective was achieved despite the domestic economy being affected by the slowdown in the world economy. The CNB fulfilled its inflation target in 2001, thereby laying the groundwork for favourable macroeconomic development in the period ahead. An inflation target for the January 2002–December 2005 period was announced in April 2001. This target differs from its predecessors in that it is set in terms of overall ("headline") inflation and takes the form of a continuous descending band.

There was also significant progress in the legislative area. The Czech Parliament approved a revision to the Constitution changing the CNB's primary objective from maintenance of currency stability to maintenance of price stability. This, combined with a corresponding change to the Act on the CNB, brought the central bank's primary objective into line with the legislation in the European System of Central Banks. The amendment goes on to state: "Without prejudice to its primary objective, the Czech National Bank shall support the general economic policies of the Government leading to sustainable economic growth". This enacts as law the CNB's previous endeavours to stabilise inflation and macroeconomic development.

CHART IV.1 INFLATION IN THE CZECH REPUBLIC AND IN THE EU

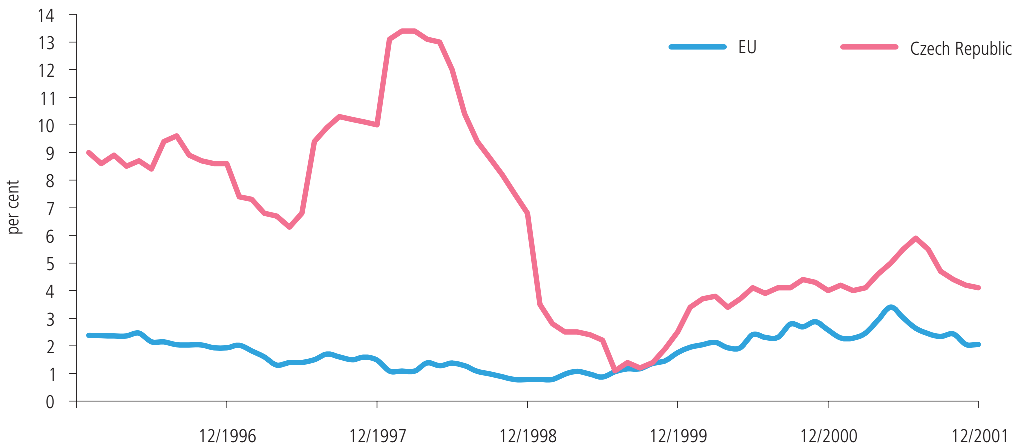
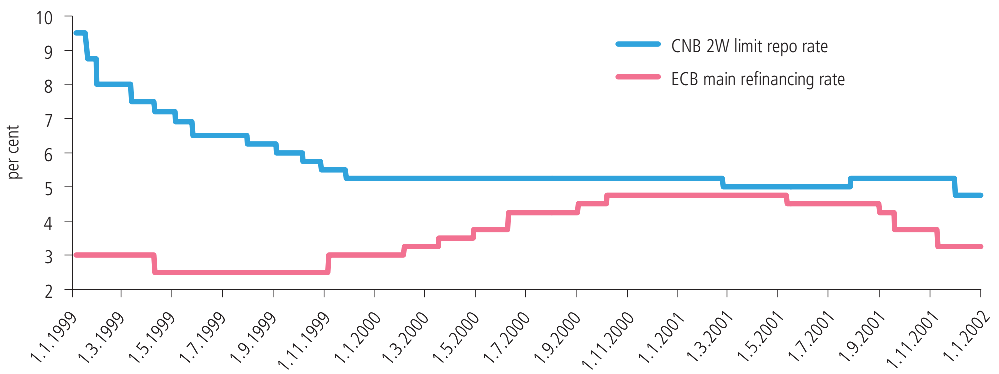


CHART IV.2 KEY CNB AND ECB INTEREST RATES

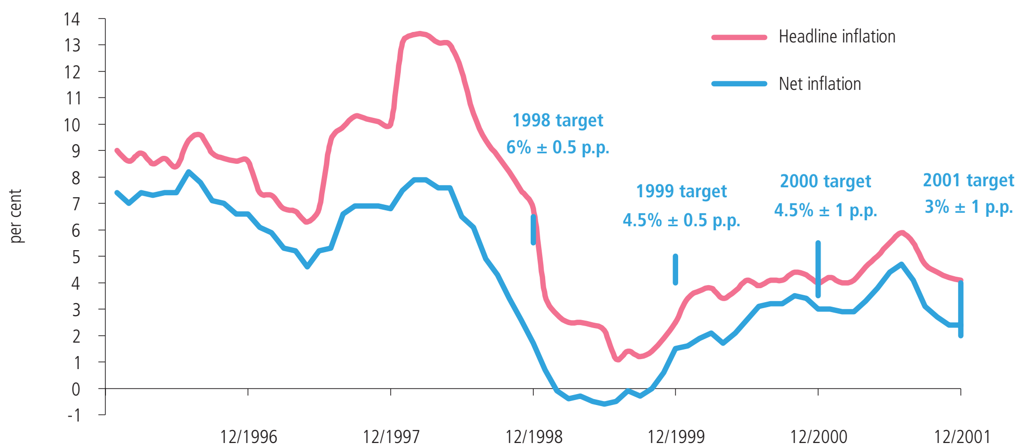


IV.1 MACROECONOMIC AND MONETARY DEVELOPMENTS

The Czech economy recorded a second consecutive year of growth in 2001. The fact that the slackening of the economic boom abroad led to an only modest slowdown in the growth rate of the Czech economy during the year testifies to the robustness of this recovery. The growth for the year as a whole reached 3.6%. Domestic demand growth and inflation abroad exerted no upward pressure on consumer price inflation. The low-inflation environment attained in previous years essentially persisted.

Except for a deviation in the summer months, inflation was subdued in 2001, moving between 4% and 6% throughout the year. In Q1 inflation was flat, despite a rise in annual regulated price inflation. In Q2 it rose, mainly because of atypical seasonality in prices of food and package holidays abroad. From August until the end of the year, consumer price inflation gradually fell back from the relatively high outturns recorded in the summer to the low level witnessed at the start of the year. In December 2001, headline inflation was 4.1% and net inflation 2.4%. This meant that the net inflation target of 2%–4% set for December 2001 was fulfilled.

CHART IV.3 INFLATION TARGETS AND HEADLINE AND NET INFLATION



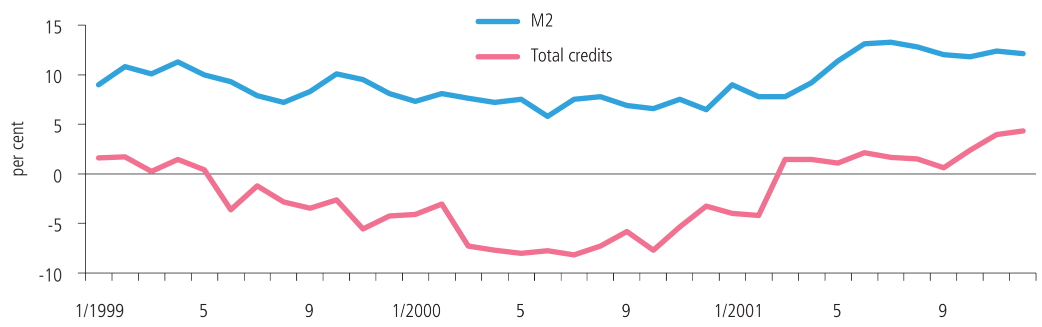
The growth in prices was counteracted, among other things, by appreciation of the koruna's exchange rate against the euro in both real and nominal terms. The appreciation trend strengthened at the close of the year on the back of heightened market expectations that the inflow of privatisation proceeds into the Czech Republic would increase considerably in 2002 and that to a large extent these proceeds would sooner or later have to be converted on the foreign exchange market.

The ongoing economic recovery failed to generate a decline in the unemployment rate, which rose by one tenth of a percentage point during the year to reach 8.9% in December. The adequate supply of labour prevented any excessive growth in unit wage costs. Other cost indicators also had a disinflationary effect. Subdued growth in industrial producer prices and import prices was fostered in particular by declining prices of raw materials – most notably oil – on world markets.

The slowdown in economic growth abroad affected Czech foreign trade. The annual growth rate of exports and imports declined during the course of the year. On average, import growth was higher than export growth, meaning that the contribution of net exports to GDP growth was negative throughout the year. However, the current account deficit was fully offset by a surplus on the financial account. Foreign direct investment, which represented 8.7% of GDP in 2001 (compared with 9.8% in 2000), accounted for the largest proportion of the net inflow of capital.

The money supply growth rate increased in 2001 owing to continuing inflow of foreign capital and a gradual recovery in domestic lending. In 2000, the M2 growth rate had been 7.2%, whereas in 2001 it reached 11.1%. This was attributable in part to a continuing widening of the public finance deficit. Lending also gradually picked up during the course of the year.

CHART IV.4 ANNUAL GROWTH IN THE MONEY SUPPLY AND TOTAL CREDITS



Following two years of annual decline, the total volume of credits adjusted for nonmonetary effects saw renewed growth in 2001. In December 2001, annual growth in credits was 4.3% in nominal terms and 3.4% in real terms. The main factors underlying this recovery were growth in new credits granted to foreign-controlled businesses and a rise in lending to households. The growth in credits suggests that the credit transmission channel of monetary policy began to function again.

IV.2 MONETARY POLICY

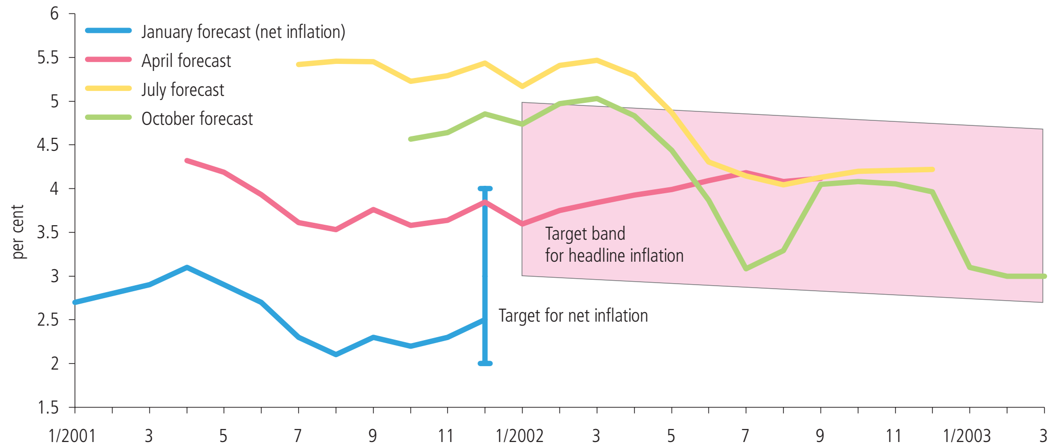
First half of the year

The starting point for monetary policy at the beginning of 2001 was an expectation of continuing recovery in economic activity. This had been supported by favourable prices of energy-producing raw materials at the end of 2000. The January inflation forecast[1] (see Chart IV.5) was based on the assumption that the output gap would gradually narrow during the year. Nevertheless, owing to external factors the net inflation forecast for the end of the year lay within the lower half of the target inflation interval.[2] In January, the koruna's exchange rate, import prices and external demand were viewed as the biggest risks as regards non-fulfilment of this forecast.

1 In the inflation targeting regime, the inflation forecast is the key decision-making criterion for monetary policy. If the inflation forecast at what is known as the "horizon of most effective transmission" (the CNB estimates this to be 4-6 quarters) diverges from the inflation target band, the CNB will consider changing interest rates so as to bring the forecast back within the target band.

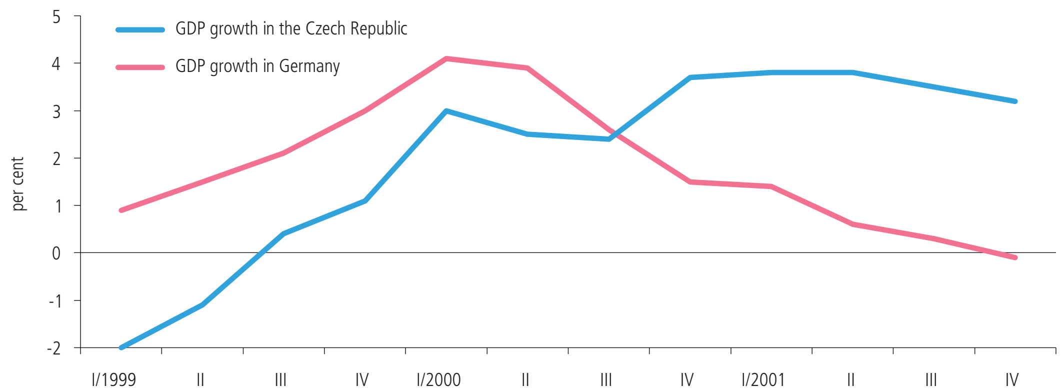
2 The January forecast (marked in blue in the chart) was still focused on net inflation. In April, in line with the switch to targeting headline inflation, the CNB shifted its centre of attention when making monetary policy decisions to the forecast for headline inflation (marked in red).

CHART IV.5 INFLATION FORECASTS 2001



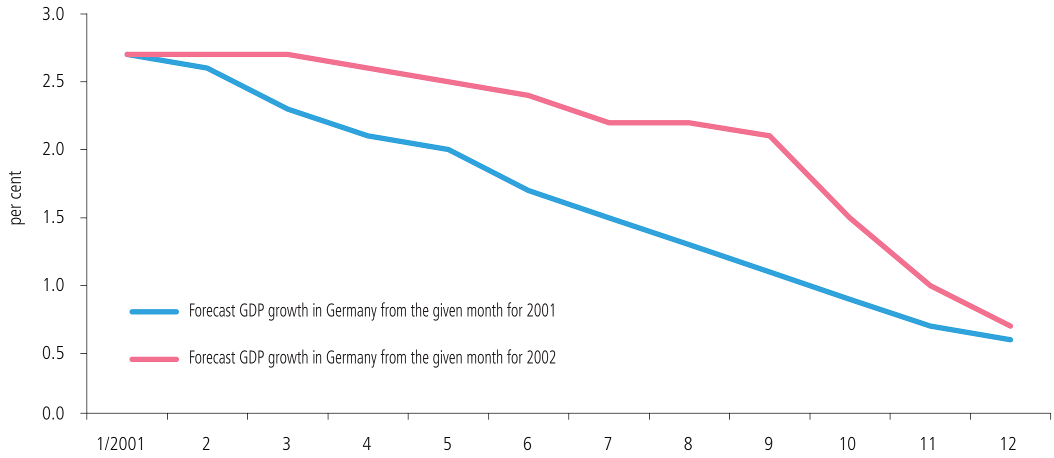
The monetary policy decision-making process in small open economies is affected by the strong dependence of the domestic economy on external exogenous variables. This dependence manifests itself at the price level and at the demand level. The Czech economy is significantly affected by the EU economy, and in particular by the German economy, Germany being the Czech Republic's largest trading partner. Around 38% of Czech exports go to Germany, and 33% of Czech imports come from it. Demand in Germany affects Czech exports and in turn affects the GDP growth rate. The dependence of GDP growth in the Czech Republic on GDP growth in Germany, which displays a lag of several quarters, is depicted in Chart IV.6.

CHART IV.6 ANNUAL GDP GROWTH IN THE CZECH REPUBLIC AND GERMANY



The economic outlook in the EU, and particularly Germany, deteriorated markedly during the course of 2001 H1. Expectations of GDP growth in Germany in 2001 – recorded by Consensus Economics – decreased by more than one percentage point in H1, and the growth expected in 2002 was likewise revised. Other things being equal, the change in the CNB's view regarding the EU economies would have led to a downward revision of the inflation forecast at the horizon of most effective transmission. However, the fall in external demand was offset in H1 by higher-than-expected domestic economic growth, attributable, among other things, to a larger-than-expected public finance deficit.

CHART IV.7 CONSENSUS FORECASTS OF GDP GROWTH IN GERMANY PUBLISHED IN 2001



The figures published in March on economic activity in 2000 Q4 signalled stronger growth in the Czech economy. This growth was driven by domestic demand – primarily gross fixed capital formation and change in inventories. The contribution from household consumption growth was negligible, and government consumption declined. The sluggish growth rate of domestic demand exerted no excessive pressure on consumer price inflation. Of the domestic factors, then, the biggest inflationary risk in H1 was the unsatisfactory trend in public finances. The widening public sector deficit in H1 and considerations of added future fiscal impulses connected with the large privatisation proceeds expected in 2001 increased the risks of a rise in inflation during 2002.

On the other hand, the planned sale of the state-owned stakes in several large corporations to foreign investors had anti-inflationary effects by stimulating market expectations of a further appreciation of the koruna. The koruna's exchange rate against the euro strengthened from CZK 35.01/EUR at the beginning of January to CZK 33.77/EUR at the end of June. The co-ordinated approach between the CNB, the Ministry of Finance and the National Property Fund – based on the flexible employment of a "privatisation account" – was only partly successful in stopping the koruna's appreciation, eliminating short-term swings in demand for the Czech currency but not halting the long-term appreciation trend.

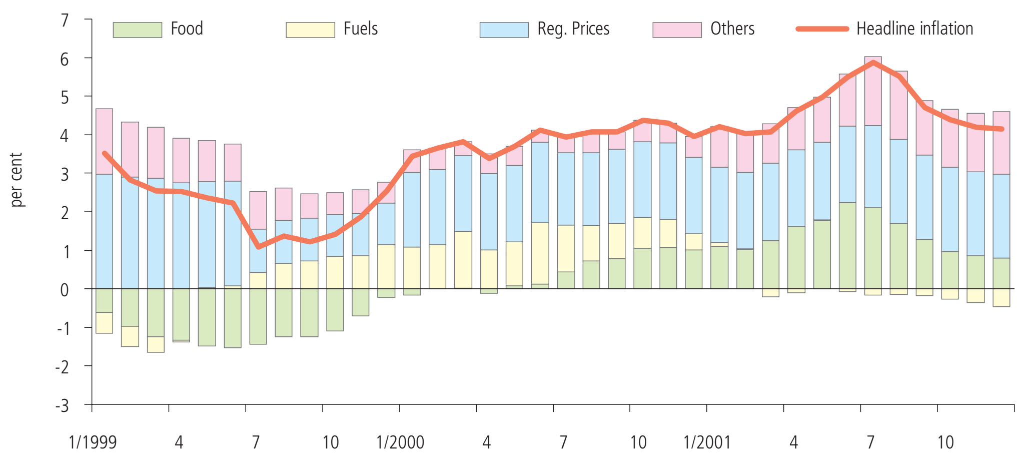
The aforementioned inflation factors – accompanied by favourable (as regards inflation) developments on the labour market and subdued growth in industrial and agricultural producer prices – did not give rise to any major adjustments to the inflation forecast at the horizon of most effective transmission in H1. Monetary policy interest rates were changed only once during 2001 H1. On 22 February, with the February net inflation forecast on course for the lower half of the inflation target range, the CNB Bank Board decided to lower the limit interest rate for two-week repos by 0.25 percentage points to 5%. At the same time, it adopted a rule whereby the discount rate will always equal the repo rate minus 1 percentage point and the Lombard rate will equal the repo rate plus 1 percentage point. This means that the position of the repo rate relative to the discount rate and the Lombard rate has lost its signalling capacity as regards the future direction of monetary policy.

From July to mid-September

In June, the CNB's view on the future development of the Czech economy began to change. First-quarter figures on GDP growth were released at the end of June, along with a revision to the national accounts for previous years. All this cast a rather different light on the contribution of household consumption to economic growth. It turned out that household consumption had been growing throughout 2000 at a faster rate than the previous figures had indicated. The signs of continuing rapid recovery of the Czech economy were consistent with the annual rise in the employment rate in 2001 Q1. Given the expected possible acceleration in the closing of the output gap, the risk of a rise in inflation pressures increased. Since most households form their inflation expectations adaptively, the pick-up in inflation between April and June led to an increased risk of a rise in inflation expectations. At the same time, however, the forecasts for the evolution of exogenous factors changed. In particular, the estimate for economic growth in the EU was revised downwards.

Inflation was strongly cost-push in nature in this period. It was affected above all by food prices, which recorded fast growth between April and June 2001. This growth was attributable to agricultural producer prices, which had been rising rapidly since June 2000. Also surprising was an unusually large upward seasonal deviation in prices of foreign package holidays in June and July. Conversely, fuel prices started to have a disinflationary effect in the summer thanks to falling oil prices on global markets. Against the background of accelerating growth in prices, inflation expectations gradually rose and the slope of the yield curve gradually increased.

CHART IV.8 STRUCTURE OF ANNUAL CONSUMER PRICE INFLATION



As a result of the reassessment of the overall macroeconomic framework, the inflation and economic growth forecasts were both raised. The inflation forecast signalled a modest change in trend in mid-2002 and a deviation above the upper limit of the target band for a several-month period. This forecast moreover assumed relatively small adjustments to regulated prices and a renewed slowdown in food price inflation. In the July forecast, therefore, the upside risks to inflation predominated.

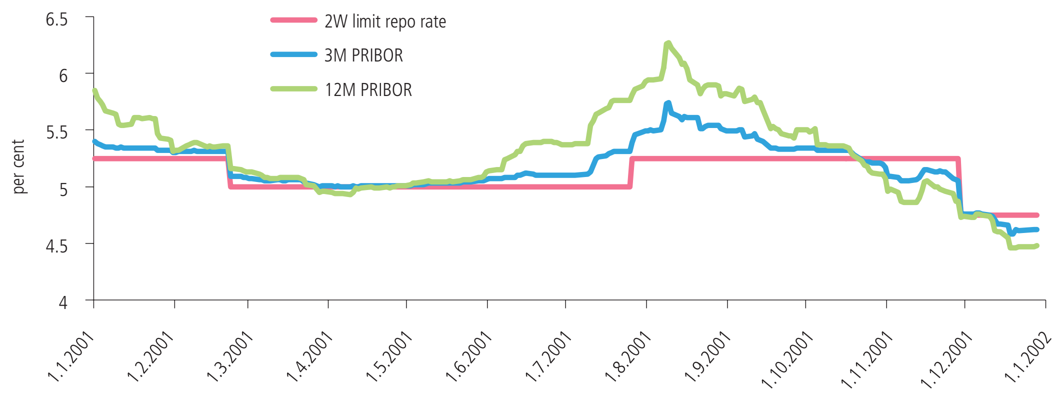
The CNB's change in view on the future inflation factors and its reassessment of the inflation risks led it to raise the two-week repo rate by 0.25 percentage points to 5.25% at the end of July. In line with the rule adopted in February, the discount rate was simultaneously raised to 4.25% and the Lombard rate to 6.25%. This measure was also prompted by concerns about the possible consequences of a rise in inflation expectations of the financial market and households. Table IV.1 shows the expectations of financial analysts, businesses and households for one year ahead.

TABLE IV.1 EXPECTED ANNUAL CONSUMER PRICE INFLATION

	Financial market	Businesses	Households
12/00	5.0	4.7	4.1
1/01	4.5		
2/01	4.3		
3/01	4.2	4.2	4.0
4/01	4.0		
5/01	4.3		
6/01	4.6	4.8	5.1
7/01	4.6		
8/01	4.7		
9/01	4.8	4.8	4.9
10/01	4.4		
11/01	4.0		
12/01	3.9	3.9	4.6

The July rise in interest rates was anticipated by the market. Short-term interest rates increased considerably at the start of July following the announcement of the unfavourable June inflation figures. The rise in market interest rates continued at the beginning of August, when the CNB released a new forecast indicating that headline inflation at the horizon of most effective transmission would be close to the upper limit of the inflation target range. The subsequent release of the annual headline inflation figure for July (5.9% – the highest level since 1998) led to a further rise in rates at all maturities. During the summer months the yield curve changed significantly, becoming steeper and shifting upward. A turnaround in market interest rates occurred in mid-August amid signs of slackening demand in the USA and the EU and related expectations of a further lowering of interest rates by the US and eurozone central banks. As Chart IV.9 shows, domestic interest rates continued declining (with minor fluctuations) until the end of the year.

CHART IV.9 INTEREST RATES



From the second half of September until the end of the year

The proliferating signals of a slowdown in world economic growth received a new impulse with the terrorist attack on the USA in mid-September. Given the dependence of the Czech economy on economic growth in the EU, and most notably in Germany, the greatest weight in the considerations regarding the future inflation risks was attached to information suggesting a fall in German inflation.

In contrast to the external factors, the domestic inflation factors were less than clear. At the beginning of September, unexpectedly favourable figures on consumer price inflation in August were released. A decline in food prices indicated that the cost shocks recorded in the summer had started to unwind without the demand pressures having increased. A halt in the decline in the unemployment rate adjusted for seasonal influences also suggested that the demand-pull inflationary pressures had not increased any further.

Nevertheless, the second-quarter GDP statistics released in September confirmed that the growth in the Czech economy was continuing unabated and was still being driven by growth in household consumption. The contribution of net exports to GDP growth was negative as expected. Owing to the slackening external demand, rapid wage growth seemed to be the most risky of the internal inflation factors. Not only might this growth have generated demand-pull inflationary pressures, but in particular it could have considerably weakened the international competitiveness of Czech producers.

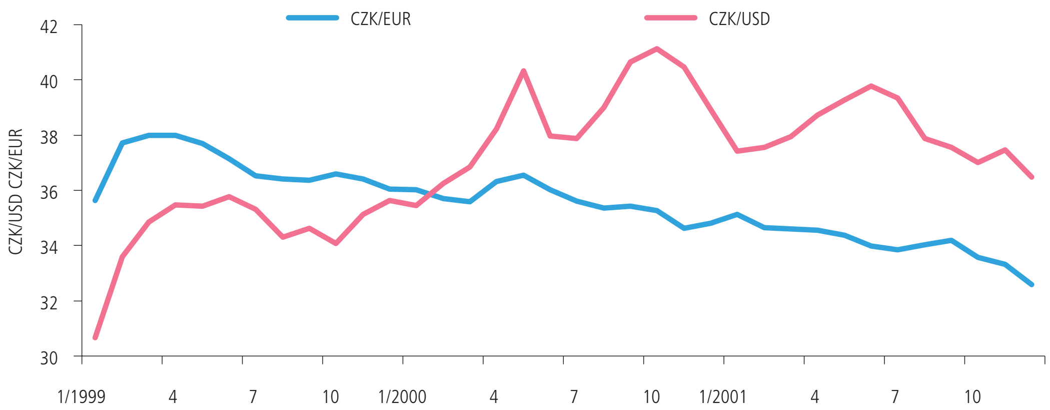
The mixed signals of future macroeconomic developments and of the potential risks – as regards both the internal and external factors – heightened the uncertainty about future inflation. This was also fostered by a lack of information on the state budget for 2002 and on the long-term outlook for public finances as a whole.

The subsequent developments in the domestic economy and in external factors led to a weakening of the inflation risks. In October, headline inflation and inflation expectations fell significantly, industrial and agricultural producer price inflation slowed, import prices declined, money supply growth decreased, the koruna's exchange rate appreciated against the major world currencies in both nominal and real terms, inflation fell in other countries, and the growth rate of external demand slackened further. These developments were reflected in the October inflation forecast, which was lower than the July forecast for the remainder of 2001 and for 2002 (see Chart IV.5).

The growing asymmetry of the risks (towards a decline in inflation) and slowing economic growth at the end of the year, together with continuing appreciation of the koruna (inconsistent with the development of economic fundamentals), led the CNB in November to reduce the two-week repo rate by 0.50 percentage points to 4.75% and to lower the discount and the Lombard rates correspondingly.

At the end of the year the CNB endeavoured to counter the excessive appreciation of the koruna by intervening directly on the foreign exchange market. At the same time, it opened discussions with the Government to find ways of moderating the adverse impact on the koruna's exchange rate of the proceeds from the sale of state assets.

CHART IV.10 NOMINAL EXCHANGE RATE OF THE KORUNA AGAINST THE EURO AND DOLLAR



To sum up the CNB's monetary policy in 2001, the relatively rapid growth in the Czech economy in the first half of the year – against a background of falling external demand – did not give rise to the need for any significant changes to the inflation forecasts. In the middle of the year, however, the inflation risks started to mount and the midpoint of the inflation forecast at the horizon of most effective transmission shifted above the upper limit of the inflation target band. In the final quarter, however, the inflation pressures eased, owing to a deterioration in the prospects for the major world economies and to favourable export prices. Meanwhile, the problem of the koruna's strong appreciation came to the fore at the year-end.

In 2001, monetary policy was affected by a whole range of unpredictable events – most of them exogenous in nature – which injected a high degree of uncertainty into the inflation forecast. The most significant exogenous factors were a decline in external demand and a fall in oil prices on global markets. The uncertainties were reinforced by contradictory signals regarding the domestic economy. Against this background, the CNB succeeded in significantly reducing inflation expectations, particularly those of financial market participants and businesses, and maintaining the inflation expected at the horizon of most effective transmission within the target band. This laid the groundwork for fulfilment of the inflation targets during 2002 and 2003.

IV.3 FULFILMENT OF THE INFLATION TARGET AT THE END OF 2001

In April 2000, a target range of 2%–4% for annual net inflation had been set for December 2001. The actual net inflation outturn in December 2001 was 2.4%, which meant that the inflation target was hit.

Owing to the lag in most effective transmission – which the CNB estimates to be 4–6 quarters – the fulfilment of the December 2001 inflation target was affected most by monetary-policy decision-making in the second half of 2000. In this period, the forecasts of December inflation indicated that monetary conditions were consistent with the inflation target. Specifically, the mid-value of the conditional inflation forecast for December 2001 published in the October 2000 Inflation Report was almost identical to the midpoint of the inflation target set for December 2001. Consequently, the CNB Bank Board did not change its monetary-policy interest rates in 2000 H2.

Even when monetary policy is set optimally, deviations from the inflation target can occur if exogenous inflation factors diverge from their expected path or effect. Although the exogenous factors developed differently in 2001 to the reference scenario of the October forecast, they were not strong enough to cause the inflation outturn to leave the target band. The breakdown of net inflation into its three basic components in Table IV.2 demonstrates that almost the entire deviation of the inflation outturn from the October forecast can be explained by the unexpectedly sharp fall in fuel prices. By contrast, in the case of food prices and adjusted inflation excluding fuel prices the deviations were very small. The annual net inflation outturn in December 2001 was 0.7 percentage points lower than the inflation forecast published in October 2000.

TABLE IV.2 THE OCTOBER 2000 NET INFLATION FORECAST FOR THE END OF 2001, AND THE ACTUAL OUTTURN

PRICE SEGMENT	OCTOBER 2000 FORECAST (%)	OUTTURN IN DECEMBER 2001 (%)	IMPACT ON OVERALL DEVIATION IN NET INFLATION (PERCENTAGE POINTS)*
Annual net inflation	3.1	2.4	-0.7
Annual food price inflation	3.3	2.9	-0.13
Annual fuel price inflation	0	-15	-0.55
Annual adjusted inflation excluding fuels	3.1	3.2	0.1
Rounding error			-0.12

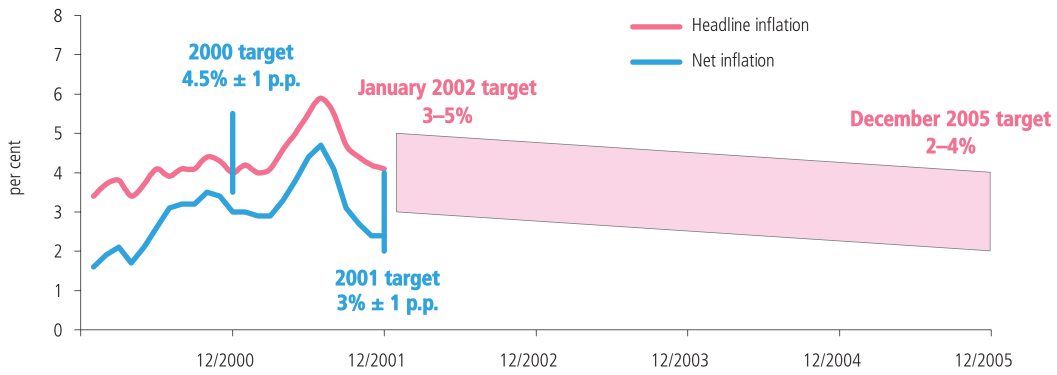
** The calculation uses the constant weights of the new consumer basket introduced at the start of January 2001*

In addition to oil prices on world markets, the koruna's exchange rate against the dollar plays an important role in determining fuel prices. Although in 2001 the koruna was rather weaker against the dollar than had been anticipated in the October 2000 forecast, the deviation of oil prices was much more pronounced, meaning that its impact on fuel prices prevailed. The actual exchange rate of the koruna against the euro also deviated from the October 2000 expectations (the koruna being stronger), as did industrial producer price inflation in Germany, which was higher. In their effects on inflation in the Czech Republic, however, these two factors roughly offset each other.

IV.4 THE SWITCH TO HEADLINE INFLATION TARGETING AND THE ANNOUNCEMENT OF THE TARGET BAND FOR 2002–2005

In 2001 the CNB decided to switch to targeting headline inflation in the form of a target band throughout the year. This decision was based on an evaluation of its experience with net inflation targeting and on the macroeconomic stabilisation of the Czech economy, accompanied by the low-inflation trend. In April 2001, the CNB announced an inflation target for annual consumer price index growth in January 2002 – December 2005. The inflation target takes the form of a continuous band descending evenly from 3%–5% in January 2002 to 2%–4% in December 2005 (see Chart IV.11). This target puts inflation on a trajectory towards the level in the EU, yet leaves enough leeway for price adjustment connected with convergence towards the EU price level.

CHART IV.11 HEADLINE AND NET INFLATION UNTIL THE END OF 2001 AND THE TARGET BAND FOR HEADLINE INFLATION IN 2002–2005



Targeting headline inflation, i.e. growth in the consumer price index, means targeting a wider, and therefore more representative, price index than is the case with net inflation, and one which is well understood by the public. This increases the inflation target's potential for influencing inflation expectations and hence boosts the effectiveness of CNB monetary policy.

On the other hand, targeting headline inflation, which includes the effects of administrative changes in prices and indirect taxes, is more demanding than targeting net inflation, which excludes such effects. The absence of a binding schedule of changes to regulated prices somewhat complicates the forecasting of this component of headline inflation. When setting the target for headline inflation, the CNB assumed that the contribution of deregulation and indirect taxation to headline inflation would be between 1 and 1.5 percentage points in the 2002–2005 period. Should the actual changes in regulated prices and indirect taxes diverge from this assumption, the CNB will apply its "escape clauses" (i.e. justifiable exceptions from hitting the inflation target).

V. CNB OPEN MARKET OPERATIONS AND MANAGEMENT OF INTERNATIONAL RESERVES

During the 17th and 18th centuries, coins of two different coinages, i. e. the thaler and the gulden, were in circulation in Bohemia and Moravia, then part of the Austrian Empire. In 1762, Empress Maria Theresa introduced the first paper money, known as bank papers.

The CNB conducts monetary policy by means of financial market operations, in accordance with Act No. 6/1993 Coll. on the Czech National Bank.

Decision-making

The CNB Bank Board sets three key interest rates: the two-week (2W) limit repo rate, the discount rate and the Lombard rate. The CNB's main monetary policy interest rate is the 2W repo rate, which it uses to signal its monetary policy stance to the market and – via asset operations on the money market (which are remunerated at this rate) – to influence the short end of the yield curve. The discount and the Lombard rates provide the floor and ceiling respectively for short-term interest rates on the money market. Consequently, changes in the repo rate (which is set half-way between the above two rates) are accompanied by symmetrical changes in the discount and Lombard rates.[3]

3 The CNB Bank Board approved a change to the approach used to manage its key interest rates at the end of February. The limit repo rate was declared the only rate relevant to monetary policy for steering short-term market rates and was placed in the middle of the corridor formed by the Lombard rate and the discount rate (1% below the former and 1% above the latter).

Operative (daily) decision-making regarding the central bank's money market operations is based on a daily supply/demand forecast for commercial bank reserves for the day and the next four days. The purpose of such operations is to balance the predicted supply and demand so that the liquidity of the banking system is at the optimal level for compliance with the reserve requirement and hence causes no long-term divergence of short-term interest rates from the desirable level.[4]

4 The desirable level of short-term interest rates is signalled by the two-week limit repo rate.

The reserve supply forecast is composed of:

a) autonomous liquidity factors:
- external sector figures (changes in international reserves resulting from purchases/sales of foreign exchange by the CNB, e.g. due to interventions),
- the government sector (movements on treasury accounts: revenues vs. expenditure of the state budget, financial market operations, demand deposits of state financial assets and revenue office funds; other items of the government's position with the central bank: envisaged secondary-market operations of the Ministry of Finance for managing treasury liquidity, settlement of primary auctions and maturity of government securities)
- currency in circulation (regular monthly pattern),
- other net assets;

b) monetary policy liquidity factors:
- maturity of automatic facilities (lending facility, deposit facility),
- maturity of repos.

The reserve demand forecast is composed of:

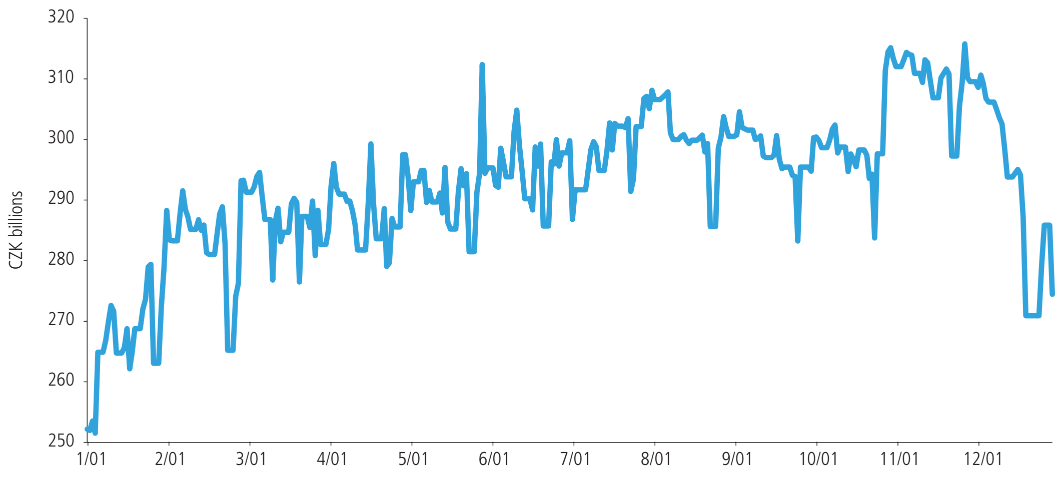
- the reserve requirement + excess reserves corresponding to the desired level of short-term interest rates on the interbank money market,
- a calculation of the difference between the real amount of reserves for the elapsed period (from the beginning of the current reserve requirement cycle) and the average target demand for reserves for the remaining number of days of the current reserve requirement cycle.

CNB instruments

The instruments used by the CNB to conduct monetary policy are fully harmonised with those of the ECB. In 2001, the main instrument for managing short-term interest rates was the two-week repo.[5] Owing to a persistent and considerable excess of liquidity in

5 Execution of three-month repos, which from the monetary point of view and in terms of volume were supplementary instruments, was discontinued in January 2001 the Czech banking system, these operations were used in 2001 for absorbing excess reserves (unlike the ECB, which provides liquidity). The liquidity absorbed is remunerated at the limit repo rate at maximum. Two-week repo tenders were announced daily and settled with same-day value. The volume of excess liquidity absorbed in monetary market operations in 2001 varied between CZK 252 billion and CZK 316 billion, the average being CZK 292 billion. The liquidity absorbed increased by approximately CZK 34 billion on average. This increase was chiefly attributable to the CNB's foreign exchange interventions (CZK 17.8 billion) and to interest paid to banks on monetary operations (CZK 15.1 billion). A fall of approximately CZK 40 billion in the excess liquidity absorbed at the end of the year was due, among other things, to a seasonal increase (of around CZK 18.7 billion) in currency in circulation prior to the Christmas holidays and to a change (of CZK 17.4 billion) in the government position resulting from a revision to the budgetary rules. The budgetary rules in force in 2001 precluded the use of demand deposits of state financial assets and funds on revenue office accounts to cover the state budget deficit as of 31 December. The state budget deficit could thus be financed exclusively via the sale of T-bills on the treasury liquidity management account. This fostered – albeit only temporarily – a fall in excess liquidity. In January 2002 this measure ceased to be effective.

CHART V.1 EXCESS LIQUIDITY ABSORBED IN 2001



The CNB's instruments also included two automatic facilities – the marginal lending facility and the deposit facility. Under the automatic lending facility, the CNB lent any amount of Czech koruna overnight to banks upon request against eligible collateral (T-bills and CNB bills) at the Lombard interest rate. Under the deposit facility, banks had the option of making overnight deposits with the CNB at the discount rate (without receiving collateral in exchange). Fine-tuning operations (ad hoc repos and reverse repos under market conditions) were used only rarely.

In 2001, the CNB continued issuing its own bills, which it used as eligible collateral for open market operations (i.e. repos and the lending facility) and which banks used to secure intraday credit from the CNB. The CNB gave the banks the option of drawing collateralised intraday credit in order to ensure the smooth running of the payment system at the CNB's Clearing Centre. No interest is charged on intraday credit and there is automatic spillover into the marginal lending facility at the end of the day in the event of non-repayment.

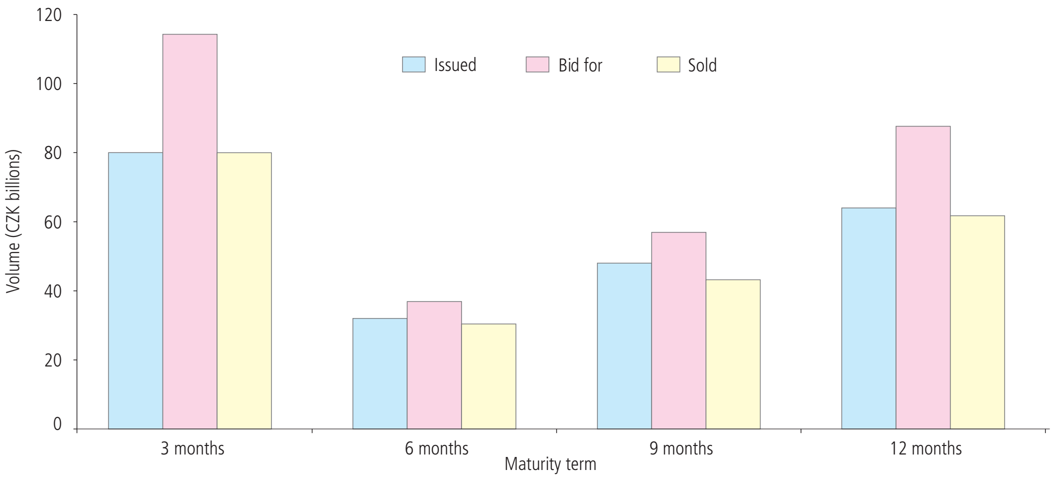
The reserve requirement was further harmonised with the ECB system during the course of 2001. Effective 22 February 2001, the limit for the inclusion of end-of-day balances on settlement accounts in reserve requirement compliance was abolished. This limit was no longer justified given the currently small volume of required reserve holdings and the advanced state of development of the money market. Effective 12 July 2001, remuneration of holdings of required reserves was introduced. This further strengthened the competitiveness of the banks operating within the territory of the Czech Republic. The funds deposited by banks at the CNB were remunerated at the limit two-week repo rate. Only those reserve holdings not exceeding the required reserves for each day of the maintenance period were remunerated. As of the same date, the reserve base was also narrowed, with only the primary liabilities of banks vis-à-vis nonbanks with agreed maturity up to 2 years being subject to the reserve requirement (previously the reserve requirement had been calculated using primary liabilities with agreed maturity up to 5 years). Throughout 2001 the reserve ratio was 2% and averaging of reserve holdings over the maintenance period was permitted. The maintenance period was 14 days, starting on a Thursday and ending on a Wednesday.

In December 2001, further changes to the reserve requirement system were approved. Effective January 2002, a zero reserve ratio was set for liabilities ensuing from repos, the maintenance period was extended from 14 days to one month (starting on the 24th calendar day of each month and ending on the 23rd calendar day of the following month), the remuneration conditions were changed (to remuneration of average real holdings of reserves not exceeding the reserve requirement over the entire maintenance period), and several other technical aspects of the reserve requirement calculation were adjusted. This means that as from 2002 the reserve requirement system is essentially harmonised with the EMU system.

The primary government bond market

The Czech National Bank assists in the management of the Czech Republic's state debt. This it does by organising primary sales of government bonds and providing other expert advice. In 2001, the CNB organised 36 T-bill auctions for the Ministry of Finance. These bills had agreed maturities of 3 months to 1 year and totalled CZK 452 billion. Of this volume, bills with a face value of CZK 295.2 billion were purchased by direct participants in the auctions and the remainder were purchased by the issuer and placed in its portfolio. The bills were sold by Dutch auction. At the close of 2001, the outstanding volume of T-bills was CZK 224 billion. Of this total, bills with a nominal value of CZK 28.7 billion were in the possession of the issuer. Until July 2001 the auctions were announced with a fixed maximum yield, but in August 2001 the announcement of a maximum yield was abolished in order to give the issuer more leeway to decide on the final auction yield. The chart below shows that the investors at T-bill auctions were particularly interested in bills with short maturity. The chart illustrates the sum total of the T-bills offered, bid for and sold in the 2001 auctions, broken down by maturity.

CHART V.2 T-BILL AUCTIONS IN 2001



In 2001, the technique of reopening existing issues continued to be applied to government bonds with agreed maturity over one year. This helped to increase the liquidity of the secondary market. A new 15-year maturity – the longest-ever domestic issue on the emerging markets – was added to the issuance schedule. This proved its worth and found its place with investors. As regards the planning and organising of the auctions, there is a trend towards ensuring greater predictability and providing better information to market participants. This is being fostered by regular and ad hoc informative meetings of CNB and Ministry of Finance representatives with the direct participants in government bond auctions.

In the area of executing auctions, a change to the settlement of issues took effect in January 2002, when the Univyc company was incorporated into the system. In the fourth quarter of 2001, testing of electronic auctions took place in co-operation with Bloomberg agency. The tests were successful, facilitating a gradual transition to the new system mentioned above. The greatest benefits of this change are that the market is now better informed and the auction process is faster.

A total of 15 auctions of medium-and long-term government bonds took place in 2001, with bonds of 3-year to 15-year maturity with a total nominal value exceeding CZK 67 billion subsequently being issued. The following chart gives information on demand at the auctions in 2001.

CHART V.3 AUCTIONS OF MEDIUM-TERM AND LONG-TERM GOVERNMENT BONDS IN 2001

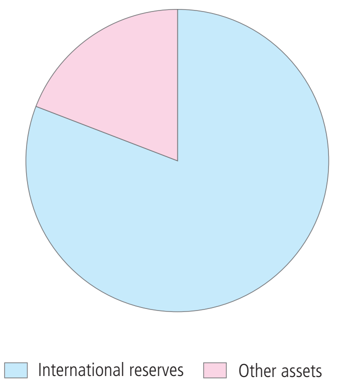
MANAGEMENT OF INTERNATIONAL RESERVES

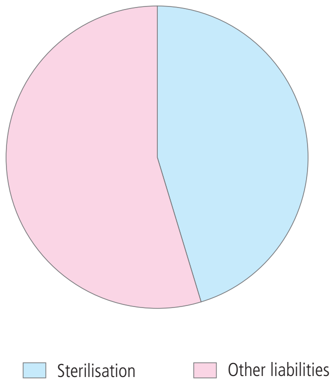
The objectives of international reserves management

The CNB's objective in managing international reserves is to achieve maximum and stable returns subject to the liquidity restrictions and the limits on market and credit risks. These restrictions and limits ensue from the purposes of holding international reserves, the most important of which is to secure the foreign exchange obligations of the state and the CNB. First among these obligations is the CNB's potential to intervene, since foreign exchange interventions constitute the biggest potential foreign currency obligation of the central bank. In the Act on the CNB, international reserves management is defined as one of the main activities of the central bank. When carrying on this activity, the CNB acts independently of the Government of the Czech Republic.

International reserves represent approximately 80% of the CNB's balance sheet, and the income from these reserves is one of the most significant revenues of the central bank. The volume of the reserves is regularly published in the "Statistics" section of the CNB website – www.cnb.cz. The importance of the reserves in the CNB's balance sheet is illustrated in Chart V.4, while Chart V.5 shows the share of sterilisation operations in the CNB's liabilities.

CHART V.4 SHARE OF INTERNATIONAL RESERVES IN CNB BALANCE SHEET ASSETS	**CHART V.5** SHARE OF STERILISATION IN CNB BALANCE SHEET LIABILITIES





The reserves management strategy

The reserves management strategy is based on the aforementioned reserves management objectives. The basic strategy and instruments which can be employed are determined by the Bank Board. The strategy is defined by setting the currency and interest rate allocation of the reserves and stipulating rules for credit and operational risk management and rules for portfolio management. Two separate departments at the CNB – the Risk Management and Transactions Support Department and the Financial Markets Department – ensure mutually independent execution and control of reserves management.

The reserve currencies are the US dollar and the euro. The allocation of the reserves into these currencies takes into account various factors. The most important factor is investment diversification, the aim being to attain the most stable income possible given the exchange rate between the reserve currencies. When setting the ratio between the two currencies in the international reserves, the CNB analyses the historical time series of the yields on American and European markets and the EUR/USD exchange rate. Other factors taken into consideration include the nature of the domestic foreign exchange market, where EUR/CZK is the most important and most traded currency pair. Based on these considerations, the currency composition was set at 73.4% EUR and 26.6% USD.

One portfolio is defined in each of the reserve currencies. Thereafter, foreign exchange risk may not be accepted when managing the portfolios. The parameters defining the interest rate risk accepted – portfolio duration in particular – are also set separately for each portfolio. Duration is set based on the requirement that the portfolio should not record a loss in any three-month period. The search for the target duration again uses historical time series of yields on the relevant financial markets. At the beginning of last year, the duration was set at 1.1 years for the euro portfolio and at 0.98 of a year for the dollar portfolio. In addition to historical data, the methodology for setting duration takes into account the current situation on the financial markets (putting it simply, the higher are short-term interest rates, the higher is the interest rate risk that can be accepted). Consequently, given the general decline in interest rates, the portfolio duration was later shortened to 0.94 of a year for the euro portfolio and to 0.81 of a year for the dollar portfolio.

Credit risk issues can be divided into two groups: issues relating to the selection of the issuers of the financial instruments used for reserves management, and issues relating to the selection of business partners for the execution of reserves management transactions.

The sole acceptable issuers are the governments and central banks of OECD countries as well as certain government and international organisations from those countries (e.g. the World Bank) and selected banks from those countries. The most important criterion for including an institution among the permitted issuers is its rating. The same applies to the selection of business partners, which, in addition to banks that are acceptable as issuers, include a number of investment banks.

The parameters described above are expressed by setting reference portfolios (benchmarks) representing the bank's neutral strategy for the investment of international reserves. In addition to duration these include the credit quality of the investment. These portfolios are defined by the Risk Management and Transaction Support Department – i.e. by a section which is not itself involved in trading.

Rate of return on international reserves management

The above description of the CNB's reserves management strategy demonstrates that the CNB's international reserves are invested in high-quality, liquid instruments. Moreover, maximum maturity is limited to 10 years for government bonds and 3–6 months for claims on banks (depending on the bank's rating). The portfolio management rules permit deviation from the benchmark credit quality, i.e. investment in securities issued by issuers other than those included in the benchmark.

The rate of return on the reserves portfolios is measured both in absolute terms and relative to the benchmark portfolios. Measuring the rate of return relative to the benchmark portfolios indicates how successfully this strategy was realised by the relevant CNB staff members.

In addition to the basic portfolios managed directly by the CNB, portfolios managed by external portfolio managers also form part of the international reserves. These portfolios are subject to the same performance measurement rules and are used to verify and assess certain procedures that could potentially also be used for internal reserves management. These externally managed portfolios constitute approximately 2.3% of the reserves.

The overall return on the international reserves in 2001 (i.e. the weighted average of the rates of return on the individual portfolios) was 5.46%. The return on the euro portfolio was 5.24% and that on the dollar portfolio 6.1%. The relative rate of return (i.e. the difference between the rate of return on the actual portfolio and that on the benchmark portfolio) was 0.07% for the euro portfolio and 0.12% for the dollar portfolio. The rate of return on the external portfolios was 5.44%.

The following charts show the credit, currency and duration allocation of the international reserves last year.

CHART V.6 CREDIT ALLOCATION OF INTERNATIONAL RESERVES

(average of end-of-month figures)

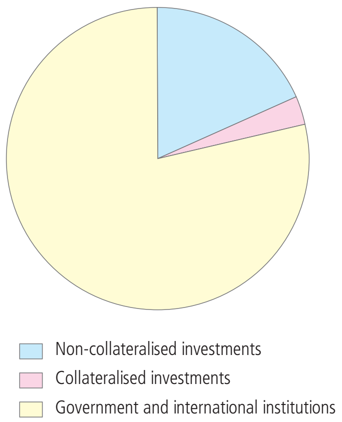


CHART V.7 CURRENCY ALLOCATION OF INTERNATIONAL RESERVES

(in per cent as at the year-end)

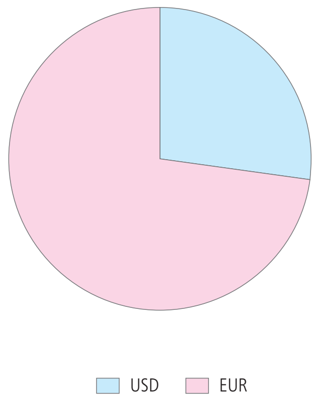
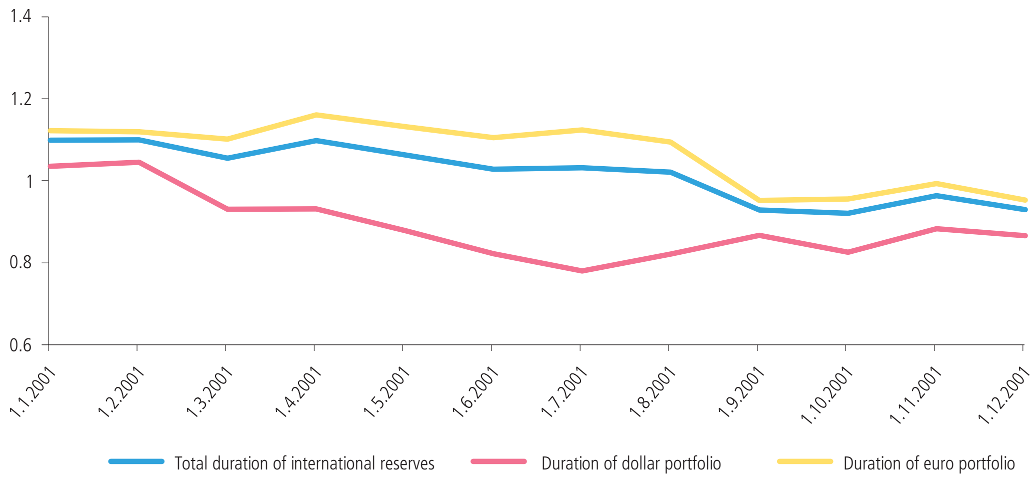


CHART V.8 PORTFOLIO DURATIONS IN YEARS



VI. THE BANKING SECTOR AND BANKING SUPERVISION

The tumultuous 19th century saw a number of monetary reforms, such as the one decreed by Emperor Francis I in 1811 when following a state bankruptcy debenture certificates popularly known as tickets had to be introduced, or the introduction of a new monetary unit, the crown, throughout Austria-Hungary in 1892.

The most important development in the banking sector in 2001 was the completion of the privatisation of the state-owned stakes in commercial banks. The steady improvement in the economic situation helped further stabilise the banking sector. CNB Banking Supervision concentrated fully on further harmonising its regulations with European legislation and on strengthening its practical conduct of banking supervision.

VI.1 THE BANKING SECTOR

As of 31 December 2001, a total of 38 banks and foreign bank branches were offering their services to clients. This meant a decrease of two compared with the end of 2000 owing to the transformation of Konsolidační banka into a nonbank institution – Česká konsolidační agentura (Czech Consolidation Agency) – on 1 September 2001 and the merger of Bank Austria Creditanstalt and HypoVereinsbank into HVB Bank. Conservatorship continued at IP banka.

In 2001, the sale of the state's majority stake in Komerční banka to Société Générale of France completed the privatisation of the large banks. The state has retained a controlling interest in just two specialised banks – Česká exportní banka (Czech Export Bank), which focuses on promoting exports, and Českomoravská záruční a rozvojová banka (Czech-Moravian Guarantee and Development Bank), which provides support to small and medium-sized businesses. Of the total of 38 banks, 16 banks and 10 foreign bank branches are controlled by foreign shareholders, 3 banks are controlled by the state (including municipalities) and 9 banks are controlled by Czech entities (five of which, however, are subsidiaries of Czech banks owned by foreign shareholders).

Foreign entities account for 70% of the sector's total equity, 83% of which is in turn held by shareholders from EU countries. The predominance of foreign capital in the Czech banking sector is particularly visible from the breakdown of total assets by country of origin of the shareholders. As of 31 December 2001, foreign owners of banks – including those who have branches in the Czech Republic – directly or indirectly controlled 94.2% of the total assets of the banking sector.

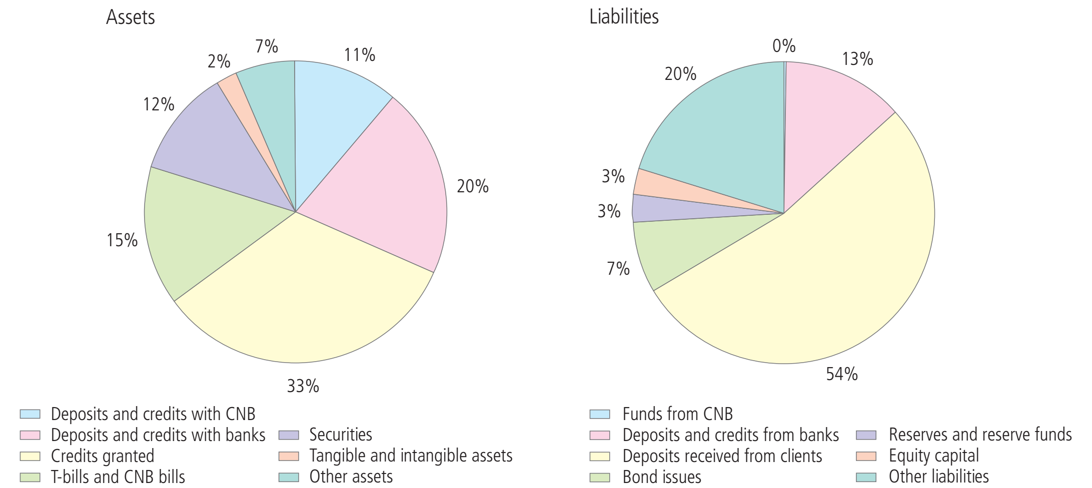
The total assets of the banking sector amounted to CZK 2,784.7 billion as of 31 December 2001, up by 11% compared with the end of 2000. Despite a steady decline, credits to nonbanks still account for the largest proportion of the assets. Gross credits (i.e. prior to provisioning) as of 31 December 2001 amounted to CZK 975.0 billion, an increase of 12.9% on a year earlier. This increase, however, was mostly due to the transformation of Konsolidační banka into the Czech Consolidation Agency and the related reclassification of these credits from interbank credits to credits to nonbanks. Had it not been for this reclassification, the volume of lending would have been unchanged, mainly because of greater prudence on the part of the banks.

A positive trend was recorded for classified credits in 2001. Nonetheless, loan portfolio quality and credit risk still constitute the main problem of the Czech banking sector. As of the end of 2001, classified credits totalled CZK 210.1 billion, down by 18.5% from a year earlier. Much of this decrease is attributable to transfer of credits from the commercial banks Česká spořitelna and Československá obchodní banka to the Czech Consolidation Agency. Excluding these operations, the volume of classified credits was down by around 8%.

Watch (i.e. low-risk) credits and loss (maximum-risk) credits account for most of the total volume of classified credits, with shares of 36.2% and 34.2% respectively. As of 31 December 2001, classified credits made up 21.6% of total credits, while impaired credits (i.e. classified credits excluding watch credits) accounted for 13.8%.

The overall volume of provisions and reserves set aside to cover loan portfolio losses reached CZK 78.6 billion as of 31 December 2001, i.e. 81.0% of the overall volume of the weighted classification, namely the sum of the risk volumes of each type of classified credit (watch 5%, substandard 10%, doubtful 50% and loss 100%). The remainder of the weighted classification is covered by selected collateral, which exceeds the total value of the weighted classification by more than CZK 20 billion.

CHART VI.1 ASSETS AND LIABILITIES STRUCTURE OF THE BANKING SECTOR AS OF 31 DECEMBER 2001

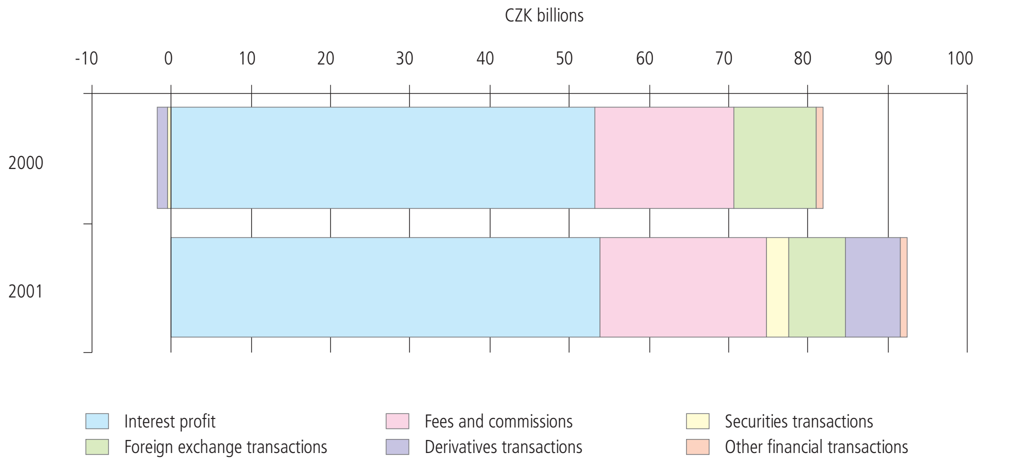


With deposits continuing to show dynamic growth, the persistent problems on the demand side of the credit market (client creditworthiness and rates of return on the business plans for which loans are requested) are causing the banks to allocate funds into other assets. Quick assets (deposits and credits from central banks, T-bills, CNB bills, current accounts with banks, and cash) are continuing to grow rapidly. The volume of quick assets was CZK 780.7 billion as of 31 December 2001, up by 15.6% on a year earlier. Banks are depositing an ever-greater volume of funds with other banks, mostly abroad. Deposits and credits with other banks totalled CZK 560.1 billion at the end of 2001. This was roughly the same as the end-2000 level, but only because of the transformation of Konsolidační banka into the Czech Consolidation Agency. Non-resident banks accounted for 65.7% of the total volume of deposits and credits with banks. The overall volume of securities (excluding T-bills and CNB bills) in bank portfolios was CZK 332.2 billion as of 31 December 2001, 6.9% higher than in 2000. Banks invest mainly in bonds, which account for 79.2% of the total volume of securities. The volume of derivatives increased by more than 50% in 2001, reaching CZK 3,488.1 billion as of 31 December, or 125.3% of total assets. However, only a limited group of banks is involved in this area, most notably some of the medium-sized banks and larger branches of foreign banks. Banks focus primarily on futures, forwards and swaps involving interest rate and currency instruments (49.4% and 50.4% respectively).

Client deposits are the major funding source for the banks' business activities. These stood at CZK 1,474.8 billion at the end of 2001, up by 16.7% compared with a year earlier. Most client deposits (69.8%) are concentrated in the large banks. However, the share of these banks is gradually decreasing, whereas the shares of medium-sized banks (16.1%) and building societies (9%) are rising. Deposits and credits from other banks (amounting to CZK 366.9 billion as of 31 December 2001) are a supplementary source of financing, particularly for foreign banks and foreign bank branches. Compared with the decrease recorded in 2000, these deposits and credits saw a modest rise of 3.0% in 2001. Own issues of securities are of minimal significance in financing banking activities (amounting to CZK 128.8 billion and CZK 80 billion for short-term and long-term securities respectively as of 31 December).

Profit from banking activities reached CZK 92.4 billion in 2001, up by CZK 12.3 billion from 2000. This increase was mostly due to higher profit from derivatives transactions, securities transactions and from fees and commissions. In contrast, profit was negatively affected by a year-on-year decline in profit from foreign exchange transactions. Interest income, which is still the biggest component of profit from banking activities, meanwhile remained virtually unchanged. Banks had general operating expenses of CZK 56.2 billion in 2001, a rise of 6.9% compared with 2000. The share of operating expenses in total assets decreased by 0.07 points to 2.11%. Given the improved situation as regards classified credits, banks were not compelled to create large amounts of provisions. This led to an increase of CZK 2.1 billion in net profit to CZK 17.0 billion.

CHART VI.2 STRUCTURE OF PROFIT FROM BANKING ACTIVITIES (banks with licences as of 31 December 2001, branches abroad included)



In 2001, banks maintained a high level of capital adequacy (which expresses the capital coverage of banking risks). Capital adequacy incorporating credit risk and market risk was 15.5% as of 31 December 2001, which is almost double the prescribed minimum of 8%. All the banks were compliant with this minimum. Only two had capital adequacy of less than 10%, whereas 23 of the total of 28 had capital adequacy of more than 12%.

VI.2 BANKING SUPERVISION

CNB Banking Supervision in 2001 focused on further improving the regulation of the banking sector to bring it into line with European law, and on improving the practical conduct of banking supervision.

Bank regulation and the register of credits

Bank regulation on a solo basis is almost fully compatible with European legislation and other important international standards. In the area of supervision on a consolidated basis, however, the situation is different. The amendment to the Act on Banks passed by the Czech Parliament has created the legislative preconditions for widening supervision on a consolidated basis to include financial and mixed-activity holdings. The Czech National Bank has prepared the text of a decree which will, based on this Act, define the structure of consolidated groups, rules for their formation, requirements for submitting the information necessary for overseeing them, and prudential rules, in particular for capital adequacy and credit exposure. The Czech National Bank will start to exercise consolidated supervision in 2003.

In line with world trends, the CNB intends to focus its bank regulation and banking supervision in future to a much greater extent on the qualitative aspects of banks' activities, and in particular on inspecting their risk measurement and management systems and internal control systems. In April 2001, a CNB provision was issued laying down standards for managing liquidity in banks. This regulation sets out minimum prudential requirements in the area of liquidity management. Banks are obliged to develop these standards taking into account their size and type, the nature of their activities and their manner of management. Adherence to these standards lays the groundwork for fulfilment of the banks' legal obligation to maintain their solvency both in the Czech currency and in foreign currencies at all times.

Standards for managing credit risk, market risk and internal control systems are under preparation and should be issued during the course of 2002. As in the case of liquidity management these standards will set minimum requirements, adherence to which is a precondition for limiting the risks concerned.

Act No. 353/2001 Coll., amending Act No. 563/1991 Coll. on Accounting, took effect on 1 January 2002. Among other things, this extends the applicable valuation methods to include real value and provides for the option of preparing consolidated financial statements in compliance with international accounting standards. Also important is the concept of maintaining accounts as systems of accounting records – the Accounting Act is one of the first Czech laws to regulate electronic documents. Several Ministry of Finance regulations specifying accounting methods took effect as of the same date. One very positive development is that these regulations unify the charts of accounts, accounting procedures and essential elements of the solo and consolidated financial statements of banks, credit unions, securities dealers, investment companies, and pension, investment and mutual funds. At the same time, international accounting standards – especially in the area of financial instruments – have been incorporated into these regulations to the maximum possible extent. The CNB responded to the amendment to the Accounting Act and the related Ministry of Finance regulations with a new methodology for the submission of statements by banks. Specifically, the structure of the basic banking supervision statements is now based on the annual financial statements prepared by banks, making it closely linked with the requirements of the aforementioned Ministry of Finance regulations.

Work on the Central Register of Credits continued throughout 2001. The register is being prepared in co-operation with the Czech Banking Association and with the banks themselves. This register will contain all the banking sector's receivables from business entities, i.e. legal entities and entrepreneurs. The Register is currently in test operation and will go live once the amended Act on Banks (which will serve as the legal basis for its operation at the CNB) has been passed.

International co-operation

A "peer review" took place at the end of 2001. This programme – co-ordinated by experts from the European Commission – focused, on the one hand, on verifying and evaluating the progress made in harmonising Czech laws with the European legislation in the areas of banking, financial markets and transactions, and, on the other hand, on the success with which the law is being implemented in the practical supervision of banks and other subsystems of the Czech financial system. This Programme built upon the results of the FSAP (Financial Sector Assessment Programme) conducted by a joint mission of the IMF and the World Bank, completed in mid-2001. The concluding assessment report was published on the Internet.

Both projects resulted, among other things, in an overall assessment of the regulatory framework for banking business, which in turn gave rise to a series of recommendations for raising the quality of banking supervision in the Czech Republic. The progress made by CNB Banking Supervision received praise. The recommendations included focusing on expanding consolidated supervision to include groups managed by financial and mixed-activity holdings, on further developing co-operation with domestic and foreign regulators, on strengthening the risk approach in bank assessment, and on further improving banking supervision practice. CNB Banking Supervision is paying great attention to all these areas. In the amendment to the Act on Banks and other regulations the groundwork has been laid for complying with the recommendations. In 2001, a "twinning" project was completed. In this project, German and Greek experts helped the CNB improve its banking supervision practice in the areas of market risk management, supervision on a consolidated basis, bank risk profiles, financial analyses and on-site examinations.

CNB Banking Supervision was also actively involved in the preparation of the New Basle Capital Accord. In January 2001, the Basle Committee on Banking Supervision published the second version of the draft Accord. The existing Accord has made a major contribution to the stability and soundness of banking systems, but in an environment of rapidly developing financial markets it has become out of date and is no longer considered adequate. The newly proposed rules adopt a more sensitive approach to credit risk measurement and management. For the first time the rules address operational risks. On the other hand, they bring no major changes in the area of market risk. Other new features include the use of ratings from rating agencies in order to assign risk weights to receivables, an individualised approach by regulators to each bank, and increased demands regarding the disclosure of information by banks and regarding the setting of capital requirements on a consolidated basis. Overall, this is a comprehensive system of regulations that should improve the method for measuring banking risk.

Co-operation with regulators from other countries is based on agreements ("Memoranda of Understanding") defining principal areas of co-operation (exchange of information, common supervisory procedures for subsidiaries and foreign bank branches, etc.). In 1999, a co-operation agreement was signed with the National

Bank of Slovakia, and a similar agreement was signed with the Austrian Ministry of Finance in 2001 (available on the CNB's website). Analogous documents are also being prepared with the supervisory authorities of other states. These documents should be signed once the amendment to the Act on Banks takes effect. This amendment will, among other things, allow foreign regulators to conduct on-site examinations in subsidiaries and branches operating in the Czech Republic.

Co-operation with other regulators and professional organisations

The establishment of the Securities Commission, together with the development of financial banking groups, resulted in 1998 in the signing of a trilateral agreement on co-operation between the Czech National Bank, the Securities Commission and the Ministry of Finance. This formed the basis for systematic co-operation between the regulators active on the Czech market. In 2001, the contracting parties agreed to publish this agreement on the Internet. Currently under preparation is an amendment to the agreement intended to underpin more systematically the concept of supervision on a consolidated basis, which requires effective and in-depth co-operation between all the regulators.

Co-operation is also being developed with the professional organisations active in the banking sector (in particular the Czech Banking Association and the Chamber of Auditors) in the areas of the methodology and practical conduct of banking supervision. New draft regulations are being discussed with the Czech Banking Association, and in particular with its new Commission for Banking Regulation. The centre of attention at the moment is the New Capital Accord, which is expected to be introduced in 2006. This will be a very demanding process, so to smooth the path the CNB, the Czech Banking Association and the Chamber of Auditors are preparing a common strategy.

Practical conduct of banking supervision

In the area of practical conduct of banking supervision, CNB Banking Supervision concentrated primarily on strengthening its on-site inspections (in-depth inspections, examinations focusing on specific risks, and informative visits) and on standardising its procedures for evaluating the financial position of banks and for adopting remedial measures against banks as part of its off-site surveillance. At the end of 2001, CNB Banking Supervision underwent a reorganisation reflecting the strengthening of supervision on a consolidated basis.

In conformity with its legal powers, CNB Banking Supervision issued a total of 17 administrative decisions in 2001 (chiefly concerning changes in banking licences, acquisitions of holdings in banks and sales of businesses or parts thereof) and opened two other administrative proceedings. It also issued 89 decisions outside the framework of administrative proceedings (opinions on proposed bank auditors; approvals of shareholder structure prior to general meetings; consent to the inclusion of subordinated debt in capital; and approvals of consolidated bank groups). CNB Banking Supervision issued 30 opinions on persons nominated for management positions in banks based on assessments of relevant documents and, in most cases, by conducting interviews. A total of 17 standard remedial measures were applied in 13 banks, most of them requiring the elimination of shortcomings in their activities.

As part of its inspection work, CNB Banking Supervision carried out twelve on-site examinations, nine of which were in-depth and three were directed at specific banking risks. Such inspections are focusing increasingly on evaluating the quality of risk management systems and internal management and control systems. In 2001, informative visits took place in eleven banks (19 visits in total), focusing chiefly on strategy, business plans and financial results, partial inspections of loan portfolios, compliance with remedial measures, preparation of on-site examinations, etc. Likewise, discussions were held with senior bank management; in the case of problems these were held on a regular basis.

The tragic events of 11 September 2001 heightened the worldwide perception of the threat of terrorism and led to numerous measures being introduced in the area of the war on the financing of terrorism. CNB Banking Supervision contributed to this activity (along with the fight against money laundering). In addition to inspecting compliance with Act No. 61/1996 Coll.[6] by banks and branches of foreign banks, it acted as co-ordinator between the Financial Analytical Unit of the Ministry of Finance, the Ministry of Foreign Affairs and banks and branches of foreign banks in the adoption of measures to identify the accounts of suspicious persons and financial transactions subject to UN Security Council sanctions under its anti-terrorism resolutions.

6 Act No. 61/1996 Coll., on Certain Measures Against Money Laundering and on the Amendment of Related Acts, as amended

I. Banking sector assets and liabilities

(for banks with licences as of 31 December 2001, branches abroad included)

	31 Dec. 1998	31 Dec. 1999	31 Dec. 2000	2001			
				31 Mar.	30 Jun.	30 Sep.	31 Dec.
	Assets (CZK millions)						
Cash	26 385	36 894	34 777	27 395	30 240	30 226	41 166
Deposits and credits with CNB	264 548	270 439	285 784	320 657	328 404	328 184	319 218
of which: required reserves	85 289	27 754	28 103	29 412	27 461	27 353	30 273
Deposits and credits with banks	479 566	560 986	563 900	586 832	613 990	533 620	560 102
of which: current accounts	18 007	23 179	7 898	8 375	7 216	10 371	18 249
time deposits	379 606	402 809	396 726	416 981	444 321	451 942	455 754
credits granted	81 953	134 998	159 276	159 717	160 686	69 342	84 100
other receivables	0	0	0	1 758	1 768	1 965	1 998
T-bills	50 825	80 331	109 126	91 958	108 238	108 485	144 162
CNB bills	161 636	208 134	240 497	261 481	283 731	289 490	273 681
Credits granted	875 986	808 144	808 605	837 241	840 528	936 109	922 106
of which: to clients	861 168	794 316	757 750	794 620	801 732	792 018	739 324
to state and local authorities	14 817	13 828	50 855	42 620	38 797	144 091	182 782
Trading securities	207 611	210 015	306 015	283 164	298 873	318 473	325 664
of which: for trading	94 878	74 941	92 492	39 285	43 373	50 276	51 648
for selling	55 567	77 267	48 914	110 359	104 764	106 065	110 902
held until maturity	57 166	57 807	164 609	133 519	150 736	162 131	163 114
Tangible and intangible assets	61 557	62 068	61 065	58 097	58 291	58 124	58 033
Other assets	80 086	80 468	99 688	99 016	110 406	116 541	140 565
Total assets	2 208 200	2 317 478	2 509 455	2 565 839	2 672 702	2 719 252	2 784 698
	Liabilities (CZK millions)						
Funds from CNB	20 401	5 449	5 542	4 126	4 368	3 992	4 717
Deposits and credits from banks	433 644	369 578	356 156	380 270	381 422	402 841	366 938
of which: current accounts	12 196	10 017	7 717	11 249	8 050	13 330	14 627
time deposits	317 308	267 132	275 020	293 480	298 769	310 321	260 512
credits received	104 140	92 429	73 419	75 541	74 603	79 190	91 799
Deposits received	1 172 935	1 209 303	1 263 461	1 391 374	1 474 184	1 489 009	1 474 781
of which: from clients	1 118 248	1 156 273	1 219 680	1 339 619	1 415 895	1 413 737	1 394 159
from state and local authorities	54 688	53 030	43 781	51 755	58 290	75 271	80 622
Issues of short-term securities	42 523	127 344	159 267	44 809	38 159	57 236	128 754
Issues of long-term securities	78 588	76 495	80 094	81 030	77 594	78 599	79 956
Subordinated liabilities	19 370	29 921	29 482	29 191	27 273	26 685	26 193
Reserves	34 145	37 946	51 798	52 395	43 977	44 048	45 166
Reserve funds	42 499	35 719	28 877	28 834	29 960	29 781	29 977
Capital funds	33 967	12 958	6 965	7 396	7 434	6 909	8 553
Equity capital	63 804	80 964	83 161	83 025	83 906	83 906	82 580
Other liabilities	266 324	331 802	444 652	463 389	504 424	496 248	537 083
Total liabilities	2 208 200	2 317 478	2 509 455	2 565 839	2 672 702	2 719 252	2 784 698
	Off-balance-sheet assets (CZK millions)						
Total off-balance-sheet assets	1 870 348	2 049 524	2 780 146	3 719 885	3 708 761	4 164 588	3 923 683
of which: receivables from forwards, futures and swaps	1 385 187	1 644 587	2 118 235	2 942 388	2 974 776	3 457 378	3 341 302
receivables from options	83 945	85 101	80 479	130 744	146 288	130 260	146 845

II. Banking sector income and expenses

(for banks with licences as of 31 December 2001, branches abroad included)

	31 Dec. 1998	31 Dec. 1999	31 Dec. 2000	2001			
				31 Mar.	30 Jun.	30 Sep.	31 Dec.
	In absolute terms (CZK millions)						
Interest income	206 711	153 550	132 384	33 239	67 032	101 018	134 540
Interest expenses	141 375	96 991	79 084	20 095	40 576	60 915	80 764
Interest profit	65 336	56 559	53 300	13 144	26 456	40 103	53 776
Income from fees and commissions	16 949	19 959	22 853	5 547	12 318	18 671	25 819
Expenses from fees and commissions	4 071	5 187	5 538	951	2 018	3 122	4 825
Profit from fees and commissions	12 877	14 772	17 316	4 597	10 300	15 548	20 995
Interest profit including fees and commissions	78 214	71 331	70 616	17 741	36 756	55 651	74 771
Profit from securities	3 105	5 735	-578	196	1 156	1 589	2 848
Profit from foreign exchange transactions	10 784	10 080	10 436	2 404	4 636	4 895	7 141
Profit from derivatives transactions	1 593	1 773	-1 228	586	1 706	5 460	6 803
Profit from other financial transactions	2 813	1 351	867	388	530	734	857
Profit from banking activities	96 510	90 271	80 113	21 314	44 784	68 329	92 420
General operating expenses	47 520	51 067	52 601	12 512	26 505	39 671	56 231
Creation of reserves and provisions (net)	14 067	87	-37 379	993	4 354	4 132	5 068
Other operating income (expenses)	-42 048	-46 304	-27 174	-756	-1 566	-6 420	-10 824
Gross operating profit	-7 126	-7 187	37 717	7 053	12 359	18 106	20 298
Extraordinary income (expenses)	2 967	2 700	-24 917	724	773	1 096	2 051
Pre-tax gross profit	-4 158	-4 487	12 800	7 777	13 133	19 202	22 349
Taxes	3 072	1 085	-2 100	1 752	3 089	4 512	5 304
Net profit	-7 231	-5 572	14 901	6 024	10 043	14 690	17 045
	In relative terms (percentages) [1)]						
Profit from banking activities/assets	4.55	3.90	3.33	3.36	3.45	3.47	3.47
Net profit/assets	(1.16)	(0.24)	0.62	0.95	0.77	0.75	0.64
Net profit/core capital	(5.22)	(4.32)	11.97	19.31	15.10	14.72	12.89
Total interest income/interest earning assets	12.10	8.01	6.90	6.62	6.46	6.43	6.35
Total interest expenses/interest bearing liabilities	8.24	5.34	4.39	4.07	3.98	3.92	3.87
Interest rate spread	3.86	2.67	2.52	2.55	2.48	2.50	2.49
Number of banking locations	2 106	2 005	1 807	1 782	1 772	1 762	1 751
Banking sector workforce	51 079	48 924	44 932	43 953	43 081	41 577	40 871
	Per employee (CZK thousands)						
Total assets	43 231	47 369	55 850	58 377	62 039	65 403	68 134
Profit from banking activities 1)	1 889	1 845	1 783	1 940	2 079	2 191	2 261
Net profit 1)	-142	-114	332	548	466	471	417
Operating expenses 1)	930	1 044	1 171	1 139	1 230	1 272	1 376

1) Data annualised for individual quarters of 2001

III. Selected prudential indicators for the banking sector

(for banks with licences as of 31 December 2001, branches abroad included and banks under conservatorship excluded)

	31 Dec. 1998	31 Dec. 1999	31 Dec. 2000	2001			
				31 Mar.	30 Jun.	30 Sep.	31 Dec.
	Capital adequacy 1)						
Capital (CZK millions)	126 047	133 155	124 228	124 092	134 071	134 515	132 335
Capital requirements for banking portfolio (CZK millions)	x	x	x	x	65 960	66 495	62 486
Capital requirements for trading portfolio (CZK millions)	x	x	x	x	4 512	4 488	5 738
Capital adequacy (percentages)	12.10	13.59	14.87	14.30	15.22	15.16	15.52
	Credit portfolio quality 2)						
Classified credits, total (CZK millions)	258 004	291 061	257 762	252 462	243 096	228 362	210 103
of which: watch	58 721	92 124	85 814	84 324	79 998	75 697	75 984
substandard	33 427	39 379	54 910	50 031	45 607	40 465	32 531
doubtful	35 538	38 433	27 276	33 660	33 214	30 299	29 725
loss	130 318	121 125	89 762	84 448	84 277	81 901	71 862
Classified credits as percentage of total credits	26.45	32.15	29.83	28.99	27.74	23.55	21.55
Weighted classification, total (CZK millions)	157 708	152 823	118 672	115 500	114 005	108 923	97 030
Weighted classification as percentage of total credits	16.17	16.88	13.73	13.26	13.01	11.23	9.95
Weighted classification adjusted for collateral (CZK millions)	88 779	98 817	61 852	59 274	64 659	61 251	57 438
Reserves and provisions (CZK millions)	107 995	103 783	77 141	78 260	79 908	77 070	78 618
Surplus (+) or shortfall (-) of reserves, provisions and collateral (CZK millions)	19 216	4 966	15 289	18 986	15 250	15 820	21 181
Coverage of weighted classification with reserves and provisions (percentages)	68.48	67.91	65.00	67.76	70.09	70.76	81.02
	Liquidity						
Quick assets (CZK millions) 3)	514 482	617 851	675 214	706 765	755 497	759 696	780 656
Quick assets as percentage of total assets	23.30	26.66	26.91	27.55	28.27	27.94	28.03
Quick assets as percentage of total client deposits	43.86	51.09	53.44	50.80	51.25	51.02	52.93
Cumulative net balance sheet position, including off-balance sheet, up to 3 months as percentage of total assets 4)	-1.44	-2.27	-3.49	1.87	1.44	-1.51	-0.62

1) Foreign bank branches excluded

2) Classified credits granted to clients, administrative authorities and banks

3) Cash, deposits with CNB, current accounts with other banks, T-bills and other bills

4) After deducting 80% of demand deposits

Note: All figures are for banks with valid banking licences as of 31 December 2001. The 2001 figures are unaudited as at 9 April 2002, so data published later may differ.

VII. BANKNOTES AND COINS, MANAGEMENT OF GOLD RESERVES

The early 20th century saw the emergence of the first Austrian crown currency notes, which after the disintegration of the Austro-Hungarian empire continued circulating in the successor states for some time until the introduction of new national currencies.

Currency in circulation

After two years during which the value of circulating currency was affected by the Y2K preparations (1999) and by an extraordinary increase in currency in circulation caused by the problems of one of the largest Czech banks (2000), the changes in money circulation in 2001 can be viewed as commensurate with those in the advanced European countries, and the development of money circulation can be regarded as stabilised. As of 31 December 2001, currency in circulation amounted to CZK 207.6 billion, a rise of CZK 10.7 billion, or 5.3%, compared with the end of 2000. Of the total value of currency in circulation, banknotes in circulation accounted for 97.2%, coins in circulation for 2.5% and commemorative coins for the remaining 0.3%.

The number of banknotes in circulation rose by 12 million, or 5%, and the number of coins in circulation increased by 181 million, or 8.7%. Coins of the two lowest denominations, very few of which return from circulation, accounted for more than half of the total increase in coins in circulation.

During 2001, some unfavourable changes were recorded in the structure of currency in circulation. The share of the highest-denomination 5000 Kč banknotes fell slightly, owing to the expiration of the 1993 version as legal tender. The share of the 1000 Kč banknotes meanwhile increased to 39.2% of the total amount of circulating banknotes at the end of 2001. The reason is clear: 1000 Kč banknotes are the most frequently used notes in ATMs.

A total of 90.3 million banknotes were destroyed in 2001. One third of them (30 million) were the 1993 versions of the 5000 Kč and 1000 Kč denominations, which ceased to be legal tender on 30 June 2001. Because of a large number of high-quality counterfeits, these were withdrawn from circulation and replaced with new versions of the same denomination. Older issues of other denominations were also gradually withdrawn from circulation as notes were automatically classed as unfit during machine processing and destroyed.

CHART VII.1 STRUCTURE OF CURRENCY IN CIRCULATION (IN CZK)

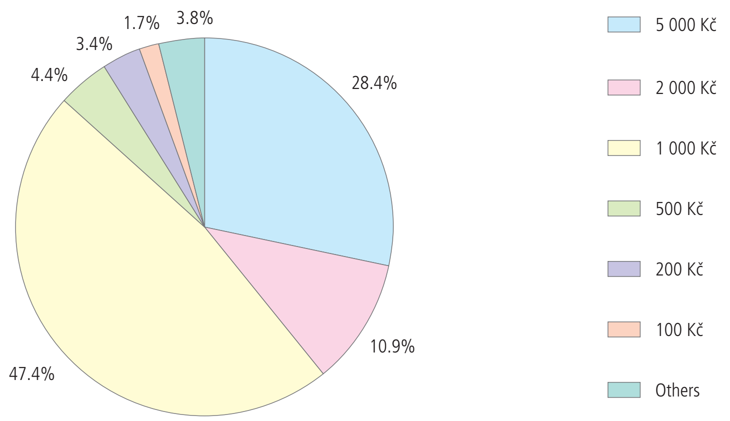


CHART VII.2 STRUCTURE OF BANKNOTES IN CIRCULATION (NUMBER OF NOTES)

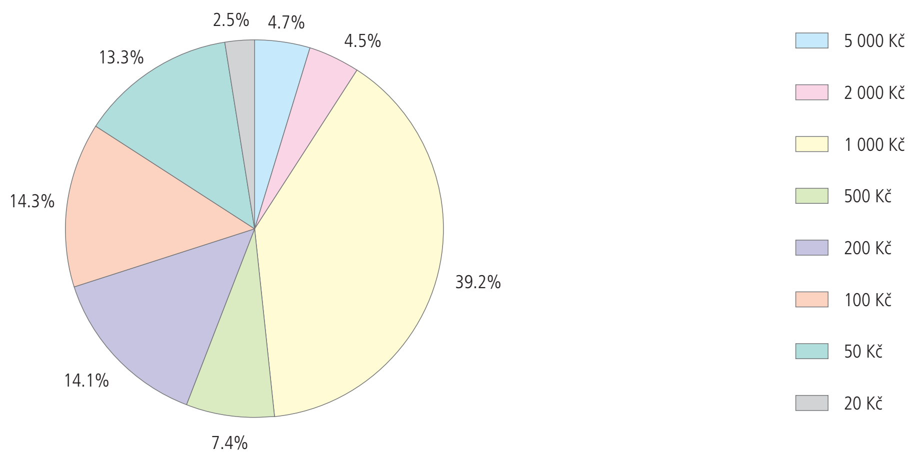
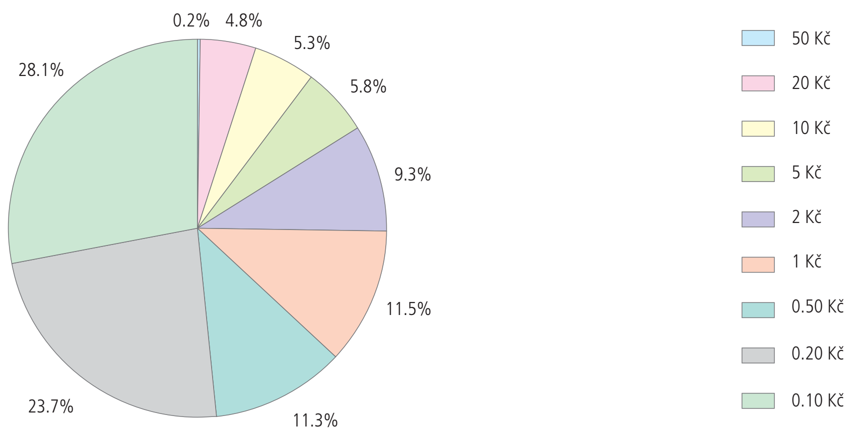


CHART VII.3 STRUCTURE OF COINS IN CIRCULATION (NUMBER OF COINS)



Issuing operations and cash handling

In 2001, the Czech National Bank's branches accepted from circulation and handled 637.9 million banknotes and 445.7 million coins. Compared with 2000, the number of banknotes rose by 8.4% and the number of coins by 6.8%. A total of 671.2 million banknotes and 614.2 million coins were put into circulation, representing a rise of 11.5% for banknotes and 0.3% for coins.

The administration of banknotes and coins by the last unit of Komerční banka was terminated in mid-2001. Czech banknotes and coins are now handled and issued exclusively by the CNB's branches. The Prague branch also checks newly produced banknotes delivered from the printing office using ACCS 5641 machines.

Cash operations are concentrated in the two largest branches, Prague and Brno, which together process and issue 50% of the cash.

In 2001, the CNB issued five silver commemorative 200 Kč coins, marking:

- the 200th anniversary of the birth of František Škroup, composer of the Czech national anthem (30 May),
- the 100th anniversary of the foundation of the Czech Football Association (5 September),
- the 100th anniversary of the birth of Jaroslav Seifert, poet and Nobel prize laureate for literature (19 October),
- the 250th anniversary of the death of Kilián Ignác Dientzenhofer, builder and architect (21 November),
- the introduction of the single European currency, the euro, into circulation (5 December).

In 2001, the CNB issued the first two of ten gold coins from the cycle *Ten Centuries of Architecture*. These 2000 Kč coins contain 6.22 g of fine gold and have a diameter of 20 mm. Like the silver commemorative coins, the gold coins are minted in uncirculated quality (with an evenly polished surface) and in proof quality (with a mirror-polished field and a matt relief). The first gold coin of the cycle, with a motif of the Romanesque rotunda in Znojmo, was officially put into circulation on 21 March. Six months later, on 26 September, a coin depicting the Early Gothic monastery in Vyšší Brod was issued.

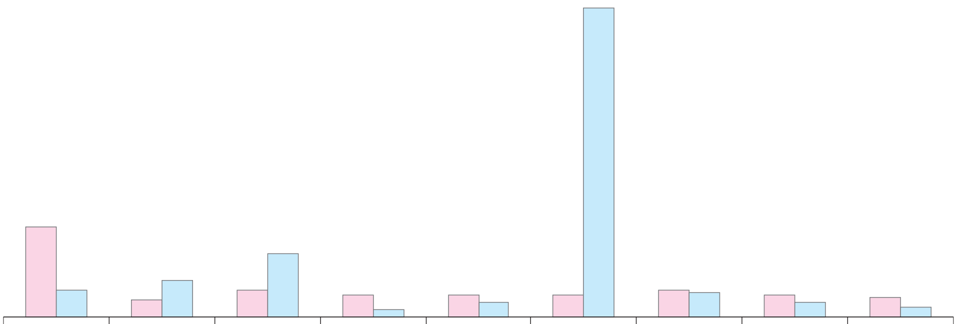
Counterfeits

A total of 3,499 counterfeit Czech banknotes were seized in the Czech Republic in 2001, a decrease of 1,560 from the previous year. Of this total, 2,301 were taken from circulation and 1,198 were seized by the police from suspicious persons. Of particular significance was a decline in the number of counterfeit 1993 versions of the 5000 Kč banknote. This comes as a reaction to the withdrawal of the 1993 version from circulation. On the other hand, during the year we came across counterfeit 1000 Kč, 2000 Kč and 5000 Kč banknotes with relatively well imitated protective elements, in particular the iridescent stripe and UV fluorescence. Also well imitated were the watermark and the windowed thread. The identical method of counterfeiting the protective elements and the identical method of production suggest that an organised group of professional counterfeiters produced the counterfeits of all denominations. Table VII.1 provides a survey of the counterfeit and altered money taken from circulation and seized by the police in the Czech Republic in 2001.

TABLE VII.1 NUMBERS OF NOTES/COINS SEIZED IN 2001

	FROM CIRCULATION	BY THE POLICE	TOTAL
CZK	2301	1198	3499
USD	1129	723	1852
DEM	506	431	937
ITL	397	0	397
Other	214	15	229
Coins	248	3	251
Altered	60	1	61
Total	**4855**	**2371**	**7226**

CHART VII.4 COUNTERFEIT AND ALTERED MONEY TAKEN FROM CIRCULATION AND SEIZED BY THE POLICE 1993–2001



	1993	1994	1995	1996	1997	1998	1999	2000	2001
Circulation	23360	4496	7138	5576	5800	5877	7096	5550	4855
Police	7038	9421	16468	2056	3730	80133	6057	3976	2371

Years

Management of gold and other precious metal reserves

The stock of gold reserves showed no substantial changes in 2001. Almost 14 tonnes of gold remain in the CNB's reserves. The composition of the reserves was also unchanged, with gold coins still prevalent over gold bars.

VIII. THE PAYMENT SYSTEM

The design of a part of the first issue of paper money (government notes) was commissioned by the Finance Ministry's Banking Authority to the world-renowned artist Alfons (Alphonse) Mucha, who likewise designed the Czechoslovak Republic's first postage stamps.

Harmonising the legislation – preparing for accession to the EU

As part of the endeavour to harmonise the Czech legal regulations with European law, the CNB in 2001 completed the crucial preparation phase of the Payment System Bill and another bill containing accompanying amendments. This bill incorporates the EC directives on cross-border transfers, on the business of electronic money institutions and on settlement finality in payment and securities settlement systems.

The aim of the new legislation is to protect consumers during the execution of domestic and cross-border transfers and during the issuance and use of electronic money, to bolster the legal safeguards for clients, and to boost public confidence in electronic means of payment. The bill also regulates the area of payment systems, placing the emphasis on central bank regulation of the establishment and functioning of payment systems and increasing the security of the systems established by law.

Part of the above act and its accompanying amendments is an amendment to the Commercial Code comprehensively regulating current account agreements and deposit account agreements. Another amendment – to the Civil Code – brings a fundamental change to the determination of the moment of settlement of a financial debt through a bank or a post office and ensures conformity with the Commercial Code.

As part of the harmonisation process the CNB prepared a Financial Arbiter Bill. This will introduce into Czech law the possibility of out-of-court settlement of disputes arising from transfers and from the issuance and use of electronic means of payment under the Payment System Act.

The interbank payment system – CERTIS

The Czech National Bank is responsible by law for the administration of payments and clearing and for promoting smooth and efficient operation thereof. The CNB complies with this statutory obligation by preparing laws and regulations, by methodologically regulating banks and by drawing up and issuing payment standards. It administers the General Terms and Conditions for maintaining accounts and providing payment services, which are not a legal regulation but are acknowledged by both the banks and the courts as commercial practice. In these activities the CNB co-operates with the Czech Banking Association.

The CNB operates its own interbank payment system. The system has a new name, CERTIS (the **C**zech **E**xpress **R**eal **T**ime **I**nterbank Gross **S**ettlement System). This system processes all domestic interbank transfers in Czech koruna, checking in real time whether the banks have sufficient coverage for them. If the payer's bank has insufficient funds to carry out the transfer, the payment is suspended until the bank obtains sufficient liquidity, e.g. on the market, in the form of an intraday credit or an overnight credit from the CNB. If the bank is unable to obtain the required funds by the end of the accounting day (which hardly ever happens) the suspended payments are rejected by the system.

At the end of 2001, all 38 banks (including foreign bank branches) operating in the Czech Republic were direct participants in the CERTIS system. Card payment clearing houses (e.g. MUZO) and securities settlement institutions (e.g. Univyc and RM-Systém) are indirect participants. The indirect participants have no accounts with the CNB but may submit payment orders to transfer funds between direct participants.

In 2001, two CERTIS subsystems – relating to data security and automated data transmission – were put into operation. The Data Security System (DSS) is based on modern cipher methods – PKI (Public Key Infrastructure), certificates and electronic signatures. The CNB operates its own certifying authority for this system. The Message Transfer System (MTS) allows automatic transmission of data between banks and the CERTIS system without any operator intervention. The MTS system will be further developed to enable settlement of priority interbank transfers in just a few minutes. At the end of 2001, these subsystems were used by around one third of the participants (banks).

Starting from 2001 the CERTIS system allows for real-time monitoring of state budget revenues (as part of the services the CNB provides to the state). This has helped to optimise the management of state assets.

In 2001, the CERTIS system processed a total of 259.6 million transactions (transfers), totalling more than CZK 103 trillion. This means more than 1 million transactions per day on average, with daily transfers averaging CZK 411.7 billion. The system recorded its daily maximum on 17 December 2001 with almost 3.1 million transactions. On 27 December, the transactions processed were worth almost CZK 756 billion in total.

CHART VIII.1 AVERAGE DAILY NUMBER OF TRANSACTIONS

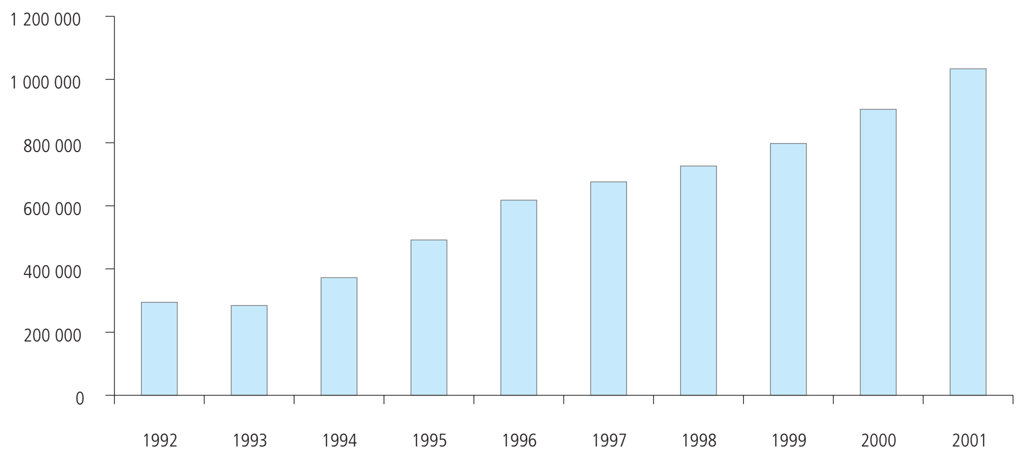


CHART VIII.2 AVERAGE DAILY TURNOVERS (CZK BILLIONS)

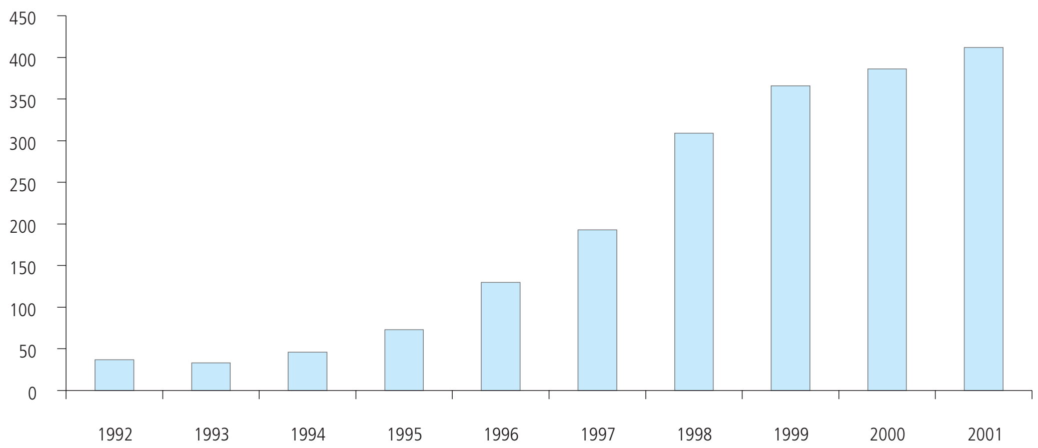


CHART VIII.3 AVERAGE DAILY NUMBER OF TRANSACTIONS IN 2001

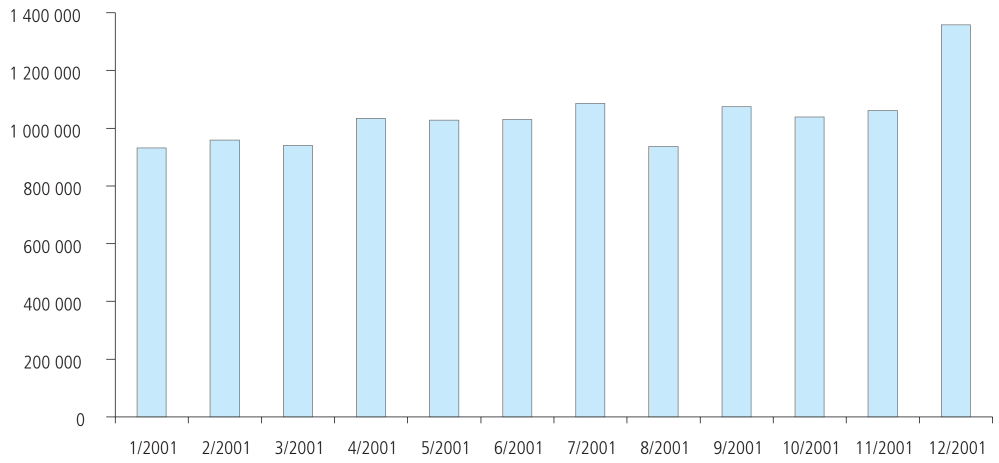
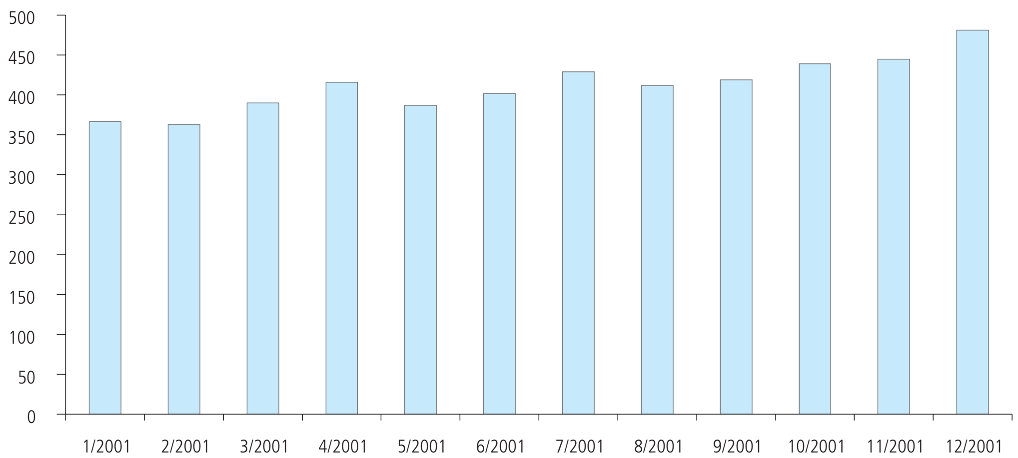


CHART VIII.4 AVERAGE DAILY TURNOVERS IN 2001 (CZK BILLIONS)



Registration and settlement of short-term bond transactions – the TKD system

The CNB is responsible by law for administering and operating the short-term bond market (TKD) system. This system is used for issuing and registering all bonds in book-entry form with maturities up to one year, and for settling trades in these securities. It chiefly comprises T-bills (government bonds used for adjusting short-term imbalances between state budget revenues and expenditures) and CNB-bills (bonds used for managing liquidity for the purposes of monetary policy implementation).

The system ensures transfers of securities on the DVP (delivery-versus-payment) principle, so that the transfer is completed only after crediting/debiting on bank accounts in the CERTIS system. Most of the banks operating in the Czech Republic are direct participants in the TKD-system. In 2001, the system handled transfers of securities worth almost CZK 23 trillion.

The TKD system has been running in its present form since 1995. In addition to the organisation of auctions and settlement of bond transactions, the TKD system has since 1998 been supporting the smooth operation of the CERTIS system, as the securities held by banks serve as collateral for intraday credits extended by the Czech National Bank within the CERTIS system.

A project to modernise the TKD system was launched in 2001. Drawing on the experience it has acquired, the CNB intends to put a new version of the system into operation in 2002. This system will have a higher level of security, will be more efficient and will allow direct automated provision of intraday credits within the CERTIS system according to the banks' instructions and needs. Once the new version has been put into operation, the system will be renamed the Short-Term Bond System ("System krátkodobých dluhopisů" – SKD).

The CNB's accounting and payment system (the ABO system)

For historical reasons, and in compliance with the Act on the Czech National Bank and the new Act No. 218/2000 Coll. on Budget Rules, the central bank also maintains and administers all the accounts of the state budget. This it does through the ABO (Automated Banking Operations) system. In addition, the ABO system is used to keep books on the central bank's own funds (all its assets and liabilities, e.g. foreign exchange reserves, required reserves and cash circulation accounts of banks and the CNB).

As part of the provision of payment services for the state, the ABO system accepts tax payments and executes payments of social transfers, pensions, public sector wages, etc. Under agreements with the National Bank of Slovakia, the ABO system also facilitates payments between the Czech Republic and Slovakia. Using data obtained from the ABO system, the CNB provides the Ministry of Finance with source materials for the state budget accounts.

The ABO system processes more than 100,000 items a day on average (and on peak days more than 300,000 items). Daily turnover exceeds CZK 1 trillion.

Work on the "ABO2" project continued in 2001. This project is intended to simplify and automate the existing procedures, increase the settlement speed, introduce real-time settlement and enhance security. The project is due to be completed in 2003.

Co-operation with international institutions

The CNB monitors developments in the area of international payments with great attention. As part of the Czech Republic's preparations for joining the EU and EMU, the CNB is working closely with the European Central Bank, which pays considerable attention to the payments area and regularly organises meetings with candidate countries on its plans and on topical issues. The CNB also co-operates with other international institutions such as the Bank for International Settlements (BIS) and the IMF.

As part of this co-operation the CNB in 2001 participated in the Financial Sector Assessment Program co-ordinated by the IMF. The CNB's CERTIS system was evaluated as an efficient and reliable system meeting the *Core Principles for Systematically Important Payment Systems* published by the BIS in January 2001 (and officially acknowledged by the G-10 countries as a universal standard). One of the

CNB's payment system experts is a member of an FSAP team conducting similar assessments in other countries.

Thanks to modern technology, issues associated with securities settlement systems are becoming increasingly relevant. The CNB has a representative on the Task Force on Securities Settlement Systems set up jointly by the BIS and the International Organisation of Securities Commissions (IOSCO), which associates experts from 18 countries. The Task Force has issued recommendations which such systems should comply with. In 2001, the Task Force worked on preparing a methodology for assessing such systems based on those recommendations.

IX. FOREIGN EXCHANGE LICENSING

Even prior to the decision on the name of the new currency, the design of the first issue of Czechoslovak coinage was commissioned to the renowned sculptor Otakar Španiel. Some banknotes of the Czechoslovak Republic designed by the famous painter and graphic artist Max Švabinský were criticised for the author's use of nudes on the state tender. Nevertheless, Švabinský's design of a 1000 crown note received a special prize at the 1937 World Exhibition of Applied Arts in Paris.

Legal powers in the area of public administration of foreign exchange matters are divided between the Czech National Bank and the Ministry of Finance. The Ministry of Finance exercises powers vis-à-vis state authorities, local authorities, budgetary organisations and state funds, whereas the Czech National Bank exercises all other powers vis-à-vis other residents (natural persons and legal entities).

After the Foreign Exchange Act (Act No. 219/1995 Coll.) took effect, the interventions of the state in private legal obligations were steadily reduced. Contractual relations with non-residents were gradually exempted from state regulation, as the Foreign Exchange Act empowered the Government to set forth additional cases in which a foreign exchange permit was not required and the Government in turn gradually lifted all the restrictions of the Foreign Exchange Act. Foreign exchange permits were later abolished altogether by Act No. 482/2001 Coll. So, as of 1 January 2001, there are no foreign-exchange civil-law relationships that depend on state consent; each such relationship is fully within the competence of the contracting parties.

State regulation is only applied where the line of business is trading in foreign exchange assets or providing money services. In these cases, the CNB continues to issue foreign exchange licences in administrative proceedings. In practice, foreign exchange licences are provided to nonbank exchange offices for the sale of foreign currencies in cash. Also issued are licences for cashless foreign currency sales and purchases; intermediation of payments and transfers to other countries and receipt of payments and transfers from other countries; intermediation of payments and transfers from client accounts to be credited to other bank accounts in other countries; and receipt of payments and transfers from other bank accounts from other countries. So far, cashless purchases and sales have been permitted under licence as spot transactions only.

In 2001, 80 licences were issued for the sale of foreign currency in cash. These licences are issued by CNB branches. A total of 26 licences were issued for other types of trading, particularly cashless transactions or intermediation thereof. The CNB thus issued 106 foreign exchange business licences.

The number of foreign exchange licences issued was lower than a year earlier. There were two reasons for this. First, business interest is partly saturated. And second, licensing of some types of transactions with a foreign exchange element has been transferred to the Securities Commission, i.e. the two-track regulation has been removed. Pursuant to the Foreign Exchange Act, as revised by an indirect amendment to Act No. 591/1992 Coll., on Securities, starting from 1 January 2001 foreign exchange licences are no longer required for securities transactions and for foreign currency and financial derivatives transactions provided that these transactions are connected with the provision of investment services within the scope of a securities dealer permit granted pursuant to a special act.

At the end of 2001, a total of 2,641 licence holders were registered, 208 of which also had a licence to sell foreign currency in cash. The exchange offices are unevenly distributed, as 775 are in Prague. In 2001, 319 foreign exchange inspections (predominantly of exchange office activities, including compliance with the reporting duty) were conducted.

X. PROVISION OF INFORMATION IN COMPLIANCE WITH ACT Nº 106/1999 COLL., ON FREEDOM OF INFORMATION

The designer of a new series of Czech Republic's banknotes is Oldřich Kulhánek, a leading Czech graphic artist and illustrator holding many international awards. Kulhánek's unique and inimitable art has decorated the new Czech banknotes with portraits of major figures of the Czech history.

The CNB's procedures for performing the tasks ensuing from Act No. 106/1999 Coll. on Freedom of Information (hereinafter the "Act") are defined by internal directives stipulating the principles and procedures for dealing with applications for information.

By law, the CNB provides information to applicants on the basis of their applications or by way of public disclosure.

A) Information provided in 2001 on the basis of applications:

1. Number of applications for information submitted in compliance with the Act: One. This application concerned provision of information in the form of the text of the CNB decision in the matter of the dismissal of an appeal against the CNB decision to impose conservatorship on Investiční a Poštovní banka.
2. Number of appeals submitted against decisions: One.
3. Transcript of the relevant parts of each court judgement: One.
   The municipal court in Prague in Ruling No. 33 Ca 58/2001-25 of 25 October 2001 ruled to rescind the CNB decision of 24 February 2001 issued pursuant to Article 16(3) of Act No. 106/1999 Coll., as amended, and the CNB decision of 24 December 2000 issued pursuant to Article 15(4) of Act No. 106/1999 Coll., as amended, and to return the matter to the CNB for further proceedings.
4. Results of sanction proceedings for non-compliance with the Act: None.
5. Other information relating to application of the Act:
   - The CNB provides information pursuant to Article 2(2) of the Act in cases where it makes decisions on the rights, legally protected interests or obligations of natural persons or legal entities in the area of public administration. The CNB has this legal obligation only in respect of the administrative proceedings which it conducts pursuant to the Act on the CNB, the Act on Banks and the Foreign Exchange Act. The CNB provides information on specific proceedings only if they are terminated by a final and conclusive decision subsequent to the taking effect of the Act, i.e. after 1 January 2000. The scope of information provided in connection with specific administrative proceedings to persons other than the parties to the said proceedings is limited to the information given in the decision.
   - Most written, e-mail and telephone applications for information go beyond the framework of the Act. In 2001, the CNB answered 326 written questions.

B) Information provided by way of public disclosure:

The CNB releases the information pursuant to Articles 5(1) and 5(2) of the Act on notice boards at its headquarters and branches in locations accessible to the public during working hours and also on its website http://www.cnb.cz/

CALENDAR OF EVENTS 2001

1 January	An amendment to the CNB Act takes effect. It contains the following new provisions in particular: – the Governor, Vice-Governors and Bank Board members of the CNB are to be appointed by the President on the proposal of the Government; – the primary objective of the CNB is defined as price stability (whereas the Constitution defines it as stability of the currency); – the CNB, by agreement with the Government, is to set the inflation target and the exchange rate regime; – the CNB budget is to be divided into two parts – investment and operating
4 January	The CNB announces that starting from 2001 it will publish the Bank Board's voting ratios in its decisions on interest rates and foreign exchange interventions. It will do so in the Minutes of Bank Board Meetings released 10 days after each meeting
26 January	The Chamber of Deputies (lower house of parliament) approves a Government proposal for an amendment striking out the CNB's objective (defined as maintenance of the stability of the currency) from the Constitution
14 February	The Senate (upper-house) Economic Committee recommends that the aforementioned constitutional amendment be returned to the Chamber of Deputies. According to the Committee, the CNB's objective should be newly formulated in the Constitution as maintenance of price stability, thereby harmonising the Constitution with the CNB Act.
23 February	The CNB lowers the repo rate to 5.0%, the discount rate to 4.0% and the Lombard rate to 6.0%
26 February	The CNB obtains a report from the European Commission containing objections to the amendment to the CNB Act which took effect on 1 January 2001
21 March	The CNB issues the first of ten commemorative gold coins from the cycle *Ten Centuries of Architecture* to be issued between 2001 and 2005. The 2000 Kč coin is devoted to the Romanesque style (depicting St. Catherine's rotunda in Znojmo)
28 March	MEPs criticise the amendment to the CNB Act and call for it to be revised
2 April	The CNB launches a separate section on its website devoted to the introduction of euro banknotes and coins
9 April	The CNB announces that it is to switch to targeting headline inflation in 2002. It sets a target band descending continuously from 3%–5% in 2002 to 2%–4% at the end of 2005. The CNB will no longer set annual targets

9 April	In accordance with a decision of the Government, all disputes arising from the execution of payments will be dealt with at the CNB
17 April	An IMF mission expresses satisfaction with the central bank's monetary policy, and gives particular praise to the change in the method of inflation targeting
18 April	The Government appoints CNB Governor Zdeněk Tůma as the Czech representative on the IMF Board of Governors and as Minister of Finance Jiří Rusnok's Alternate Governor at the EBRD
25 April	The CNB starts publishing market inflation expectations on its website. These are based on monthly surveys of domestic and foreign analysts
2 May	The Budget Committee recommends that the Chamber of Deputies acknowledge the CNB's Financial Report for 2000
14 May	The Speaker of the Chamber of Deputies, Václav Klaus, visits the CNB at the invitation of Governor Zdeněk Tůma
30 May	The CNB issues a 200 Kč commemorative silver coin to mark the 200th anniversary of the birth of composer František Škroup
5 June	Prime Minister Miloš Zeman visits the CNB at the invitation of Governor Zdeněk Tůma
13 June	The Government approves an amendment to the CNB Act which should eliminate the shortcomings criticised by the European Union
20 June	The Constitutional Court dismisses the Government's motion to overturn President Václav Havel's decision of 29 November 2000 to appoint Zdeněk Tůma as CNB Governor and Luděk Niedermayer as Vice-Governor, and confirms the validity of the decision. The Government had challenged the President's decision, claiming that the appointment of the governor and vice-governors required the countersignature of the Prime Minister, or of a person nominated by him
20 June	The Constitutional Court, petitioned by President Václav Havel, rescinds some parts of the CNB Act, namely the bank's primary objective of maintaining price stability; the appointment of the governor, vice-governors and other Bank Board members on the proposal of the Government; the provision under which the CNB by agreement with the Government sets the inflation target and the exchange rate regime; and the provision dividing the CNB budget into two parts (operating and investment)
23 June	The CNB organises an Open Day, welcoming some 3,500 visitors

26 June	President Václav Havel visits the CNB at the invitation of Governor Zdeněk Tůma
28 June	To mark the 75th anniversary of the foundation of the National Bank of Czechoslovakia, the CNB issues a publication *Monetary Policy in Czech History* (by F. Vencovský). The publication is not intended for sale, but is distributed to special libraries and to high schools and universities for educational purposes
30 June	The 1993 versions of the 1000 Kč and 5000 Kč banknotes cease to be legal tender; over the next three years the notes can be exchanged at commercial banks and after 30 June 2004 at CNB branches
12 July	The CNB starts to remunerate the reserve requirement at the two-week repo rate
26 July	A decision to publish records of the Bank Board's monetary meetings takes effect. The complete texts of the situational reports on monetary and economic developments, including records of the Bank Board members' discussions, will be made available to the public after a six-year time lapse.
27 July	The CNB raises the repo rate to 5.25%, the discount rate to 4.25% and the Lombard rate to 6.25%
3 August	The CNB publishes on its website the agreement and promise of indemnity provided to ČSOB for its purchase of IPB in 2000
9 August	The Bank Board approves further changes to the reserve requirement methodology as part of a programme of gradual alignment with ECB regulations. All the changes take effect on 24 January 2002
16 August	The CNB, with the agreement of the Ministry of Finance, publishes contractual documentation on the Internet relating to the sale of IPB to ČSOB
5 September	The CNB issues a 200 Kč commemorative silver coin to mark the 100th anniversary of the foundation of the Czech Football Association
7 September	An amendment to the Act on Banks takes effect; among other things, the amendment increases the level of deposit insurance
18 September	The Speaker of the Senate, Petr Pithart, visits the CNB at the invitation of Governor Zdeněk Tůma
19 September	The CNB issues a 200 Kč commemorative silver coin to mark the 100th anniversary of the birth of the Nobel-prize-winning author Jaroslav Seifert

24 September	The CNB issues an information leaflet on the introduction of euro banknotes and coins
26 September	The CNB issues a second 2000 Kč gold coin from the cycle *Ten Centuries of Architecture* (depicting an Early Gothic monastery in Vyšší Brod)
12 October	The CNB and the Austrian Ministry of Finance sign an agreement on co-operation in the field of banking supervision. This is the first document to be signed by the CNB in the area of banking oversight with a partner institution of an EU member state
18 October	The Senate restores to the Government's draft constitutional amendment the part defining the CNB's primary objective as maintenance of price stability. The amendment will thus be debated again by the Chamber of Deputies
2 November	The CNB organises a presentation of euro banknotes
15 November	The CNB issues notification of changes in the time and manner of declaring foreign exchange rates as from 2 January 2002
21 November	The CNB issues a 200 Kč commemorative silver coin to mark the 250th anniversary of the death of architect Kilián Ignác Dientzenhofer
27 November	The Chamber of Deputies accepts the Senate's recommendation and restores to the Constitution the part defining the CNB's primary objective as maintenance of price stability
30 November	The CNB lowers the repo rate to 4.75%, the discount rate to 3.75% and the Lombard rate to 5.75%
5 December	The CNB issues a 200 Kč commemorative silver coin to mark the introduction of euro banknotes and coins
7 December	President Václav Havel signs the constitutional amendment defining the CNB's primary objective as maintenance of price stability
18 December	Governor Zdeněk Tůma and Premier Miloš Zeman agree on joint strategy of the CNB and the Government to counter the record-breaking appreciation of the koruna
18 December	The CNB announces that an exhibition *People and Money* is to open to the public on 2 January 2002. The exhibition charts the historical development of money and the monetary environment on Czech territory from the Celtic period to the present

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Design, layout and production: JEROME, s. r. o.