

# ANNUAL REPORT

2008

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Last year can be described as dramatic from the point of view of monetary policy and financial sector supervision. The financial crisis in the developed nations deepened, gradually impinging on real economic activity and hitting export-oriented economies particularly hard. Monetary policy-making in the Czech Republic was further complicated by increases in regulated prices and indirect taxes combined with a temporary rise in prices of food and energy-producing commodities in the first half of the year and a sharp fall in those prices subsequently. This made it even more important to keep monetary policy forward-looking and not yield too much to the influence of past and currently observed inflation figures.

The year 2008 will undoubtedly remain associated with the deepening of the biggest financial crisis of the past few decades and the subsequent onset of an economic downturn whose exact magnitude is still unknown to us. However, it must be emphasised that the financial crisis started in the developed world and affected the Czech economy only indirectly. While the governments of the USA and some EU countries had to engage actively in rescuing the financial system and the banking sector in particular, no such action was necessary in the Czech economy. The Czech banking sector recorded a net profit of more than CZK 45 billion last year, almost the same as in 2007. However, signs of an economic slowdown emerged in the final quarter of the year.

In the first half of last year it was still unclear how much the ongoing global financial crisis would impact on the real economy. In the spring months it seemed likely that the situation might in fact start to improve. In the summer, however, it became apparent that the problems accumulated in banks' balance sheets around the world were much larger than anyone had initially imagined. The next phase of the financial crisis began in September, when one of the largest US investment banks failed and numerous other banks, both in the USA and in EU countries, had to be bailed out by means of government intervention. At roughly the same time it started to become clear that the Czech real economy would not be spared and that the economic downswing would be more pronounced than previously expected.

The GDP figures for 2008, published in March, confirm that this was indeed the case. GDP grew by 4.4% on average in the first half of 2008, but in the last quarter of the year it rose by just 0.7%. Average growth of 3.1% was recorded for 2008 as a whole.

Monetary policy decision-making was further complicated by several contrary factors during the year. On the one hand, the exchange rate of the Czech koruna appreciated considerably against both the euro and the dollar in the first half of the year. The CNB assessed this appreciation as being excessive in relation to the rest of the economy. Consumer prices, meanwhile, were showing relatively high annual growth over the same period, driven by fast growth in prices of food and energy-producing commodities and by changes to regulated prices and indirect taxes made in January as part of a package of measures adopted by the government. At the same time, the cyclical position of the economy and wage growth were also acting in the inflationary direction. In August, when the CNB Bank Board took its first step towards reducing interest rates, annual growth in consumer prices was still above 5% and GDP was rising by more than 6% according to the information available at the time. Thus, by deciding to lower interest rates, the Bank Board undoubtedly met its commitment to pursue

forward-looking monetary policy aimed at achieving the CNB's primary objective of hitting the inflation target and maintaining price stability and responded in advance to the expected economic downturn.

The financial crisis developments in September transmitted to the Czech financial market in the form of an increase in the difference between the money market interest rate and the CNB's main interest rate, which market interest rates are closely linked to under normal conditions. Thus, market interest rates were showing spontaneous growth at a time when a decline in such rates was more desirable. In addition to the usual withdrawal of excess liquidity from the money market, the CNB allowed banks to borrow liquidity. Although it turned out that the Czech banking system did not really need an injection of liquidity, this decision did help to calm the situation not only on the money market, but also on the secondary bond market. In the autumn, commodity markets also saw a change in trend, with a sharp fall in prices of food, oil and other raw materials. Rising interest rates on the money market, falling commodity prices and worsening expectations about economic activity led the CNB to reduce interest rates sharply in several steps.

As I mentioned above, the Czech banking sector was not hit directly by the global financial crisis. This was because of the low exposure of domestic financial institutions to structured investment instruments linked to risky mortgages, as well as the high liquidity of the domestic banking sector, which reduces banks' reliance on interbank funding. Deposits of households and corporations remain the main source of loan financing. The utter dominance of domestic currency loans also minimises the transfer of exchange rate risk to households and corporations if the exchange rate depreciates. This undoubtedly also contributed to the very slight increase in the proportion of problem loans in the second half of last year. However, given the dominant ownership position of foreign capital in Czech institutions, we certainly need to keep a watchful eye on the domestic financial sector during the current global market upheaval and the relatively sharp fall in economic activity abroad. In this respect, I can say that integrated supervision of the financial market has proven very effective, making it easier for us to monitor the domestic financial market, apply a uniform approach to the supervision of the entire financial market, and coordinate with supervisors in other countries.

While the banking sector was stable last year, the sharp falls on capital markets affected private investment to a large extent. The volume of assets in domestic mutual funds decreased, with money market funds worst affected. A considerable decline in profit was also recorded in the pension fund sector, where the CNB initiated capital increases by shareholders. A fall in overall profit was also reported by the life assurance industry, whereas non-life insurance remained stable.

Finally, I would like to mention that Vice-Governor Luděk Niedermayer left the CNB after his second term of office expired in February 2008. The Czech President appointed the existing Bank Board member Mojmír Hampl in his place and installed Eva Zamrazilová as a new member of the Board. I would like to acknowledge Luděk Niedermayer's long service at the CNB. I firmly believe that the Bank Board in its new composition will build on the successes of its predecessors. Public confidence in the CNB is vital to the performance of the central bank's duties in all the areas entrusted to it by law.



Zdeněk Tůma  
Governor



The CNB is the central bank of the Czech Republic and the supervisor of the Czech financial market. It is established under the Constitution of the Czech Republic and carries out its activities in compliance with Act No. 6/1993 Coll., on the Czech National Bank and other regulations. It is an entity governed by public law having its registered address in Prague. It is vested with the powers of an administrative authority to the extent stipulated by law. It manages the assets entrusted to it by the state independently and with due diligence. Interventions in its activities are only permissible on the basis of a law.

Under Article 98 of the Constitution of the Czech Republic and Act No. 6/1993 Coll., on the Czech National Bank<sup>1</sup>, as amended, the primary objective of the CNB is to maintain price stability. Achieving and maintaining price stability, i.e. creating a low-inflation environment in the economy, is the central bank's ongoing contribution to the creation of conditions for sustainable economic growth. Central bank independence is a prerequisite for having effective monetary instruments that are conducive to price stability. Ever since it came into being in January 1993, the CNB has had a high degree of independence from political structures in performing its statutory functions.

Without prejudice to its primary objective, the CNB also supports the general economic policies of the Government. In accordance with its primary objective, the CNB sets monetary policy, issues banknotes and coins, manages the circulation of currency and interbank payments and settlements, supervises entities operating on the financial market, analyses the evolution of the financial system, sees to the sound operation and development of the financial market in the Czech Republic, and contributes to the stability of the Czech financial system as a whole. As a central bank the CNB provides banking services to the state and the public sector. It maintains the accounts of organisations connected to the state budget and, under authorisation from the Ministry of Finance, conducts transactions relating to government securities.

The CNB as the integrated financial market regulatory and supervisory authority works to ensure the stability of the financial system and the safe and smooth development of the financial market in the Czech Republic. A stable financial system and a dynamically developing financial market, based, among other things, on sound and prospering financial institutions, contribute significantly to the long-term growth of the economy and are in the interests of businesses and the public alike. The principles of supervision are defined in a document entitled *The Mission of the Czech National Bank for the Supervision of the Czech Financial Market* published on the CNB website.

The document *Challenges for the Czech National Bank in 2005–2010* (motto: professionalism, transparency and efficiency) states that the CNB's mission is to continue fostering smooth development of the economy and thereby of society as a whole. A prerequisite for fulfilling these objectives in the monetary and regulatory areas is central bank independence of the political cycle. Independence, however, must be balanced by accountability, which – together with professionalism, transparency and efficiency – reinforces the central bank's credibility.

<sup>1</sup> Act No. 6/1993 Coll., on the Czech National Bank, as amended by Act No. 60/1993 Coll., Act No. 15/1998 Coll., and Act No. 442/2000 Coll., Ruling of the Constitutional Court No. 278/2001 Coll., Act No. 482/2001 Coll., Act No. 127/2002 Coll., Act No. 257/2004 Coll., Act No. 377/2005 Coll., Act No. 57/2006 Coll., Act No. 62/2006 Coll., Act No. 230/2006 Coll., Act No. 160/2007 Coll., Act No. 36/2008 Coll., Act No. 124/2008 Coll. and Act No. 254/2008 Coll.

The CNB's high degree of independence goes hand in hand with a high degree of transparency. The public is kept informed about the CNB's primary monetary policy objective and about the nature of the inflation targeting regime through which this objective is fulfilled. The CNB also keeps the public informed about its inflation target, about its inflation forecasts and the risks attached to those forecasts, and about its monetary policy measures and the reasons for implementing them. To this end, the CNB not only issues quarterly Inflation Reports, but also makes use of minutes of the CNB Bank Board's monetary policy meetings, news conferences, articles and interviews in the press and professional journals and in other media, speeches by Bank Board members and so on.

The CNB issues a number of periodical publications (Inflation Reports, an Annual Report, a Financial Stability Report, and as from 2007, following the integration of supervisory authorities into the CNB, also an annual Financial Market Supervision Report). Research papers are published in the CNB Working Papers, CNB Research and Policy Notes and CNB Research Bulletin series. All these publications are available on the CNB's website. It is the central bank's main information channel and contains detailed information on the various areas of activity of the central bank.

As with commercial banks, the CNB's accounts are inspected by external auditors. The Supreme Audit Office is entitled to carry out inspections in the CNB in the areas of asset acquisition and the bank's operations. The CNB submits an annual financial report, including an external auditor's report, to the Chamber of Deputies for discussion.

Financial data can also be found in the CNB's Annual Report.





# MANAGEMENT AND ORGANISATION



The CNB's organisational structure consists of a headquarters in Prague and seven branches in Prague, České Budějovice, Plzeň, Ústí nad Labem, Hradec Králové, Brno and Ostrava. The CNB has a two-tier management system. The Bank Board makes fundamental decisions relating to monetary policy, the development of core activities and the institutional development of the bank. Responsibility for implementing the Bank Board's decisions and the day-to-day running of the bank is delegated to the executive directors of departments and branches.

#### **BANK BOARD**

The Bank Board is the supreme governing body of the CNB and takes decisions as a collective body by a simple majority of the votes cast. It has seven members: the Governor (who chairs the Board), two Vice-Governors and four Chief Executive Directors. On the basis of a Bank Board decision, the Bank Board members oversee the CNB's core activities as performed by its departments and branches.

The Bank Board sets monetary policy and the instruments for implementing this policy, decides on the monetary policy measures and transactions of the CNB, approves key measures relating to financial market supervision, and rules on appeals in administrative proceedings. It sets the CNB's overall development strategy and decides on the bank's organisational structure and the responsibilities of the organisational units at its headquarters and branches. The Bank Board also approves the CNB's budget and budgetary rules, defines the types, amounts and uses of the CNB's funds and approves the CNB's Annual Financial Report. It also approves Inflation Reports, Financial Stability Reports and Financial Market Supervision Reports.



Following the appointment of Mojmír Hampl as Vice-Governor and Eva Zamrazilová as a new Bank Board member, the Bank Board approved a new division of responsibilities among the Bank Board members in the supervision of the CNB's activities performed by the organisational units at its headquarters and branches with effect from 1 March 2008.

#### **SENIOR MANAGEMENT**

The executive directors of the CNB's departments and branches are responsible – subject to the CNB's overall strategy – for effective performance of the tasks falling within their areas of competence and powers as set out in the Organisational Statute. Their competencies and responsibilities include in particular methodological and direct management activities, including presenting proposals for solutions to issues of fundamental significance at Bank Board meetings. They carry out the decisions adopted by the Bank Board and set targets for the staff under them. The executive directors also perform the employer's rights and duties under labour law in respect of

employees. They are responsible for coordinating with other organisational units of the bank and with domestic and foreign partner institutions.

## HEADQUARTERS

The fundamental organisational units of CNB headquarters are departments, which are responsible for methodological management in specific areas defined by the Organisational Statute. The bank's main activities, including branch management, and ancillary and service activities are concentrated at headquarters. Activities are coordinated across individual areas by standing advisory bodies, committees and project teams. In the area of internal management and organisation, the CNB maintains a transparent and relatively flat organisational structure and applies an internal control system and internal control mechanisms.

The CNB's departments for the supervision of financial market participants were restructured on 1 January 2008 on the basis of a functional model of supervisory management. The original supervisory departments, organised along sectoral lines, were replaced by a Financial Market Regulation and Analyses Department, a Licensing and Enforcement Department and a Financial Market Supervision Department. As a result, the responsibilities of some other organisational units were redefined, in particular in the areas of preparation of reporting methodology, management of foreign exchange inspections, administrative enforcement proceedings in the field of the notification duty and methodological support provided by CNB branches in the supervision of non-bank foreign exchange entities. The CNB's responsibilities in the area of the regulated financial market (prohibition of unfair commercial practices in the provision or offering of services, prohibition of consumer discrimination, supervision of the provision of proper information about the prices of services provided and the setting thereof) were extended by Act No. 36/2008 Coll., amending certain laws in consumer protection, in particular Act No. 634/1992 Coll., on Consumer Protection, as amended. With effect from 1 September 2008, the Bank Board decided to establish a Consumer Protection Department, which is now the CNB's methodological and executive unit for this specific area, and the responsibilities of other units were consequently redefined.

## BRANCHES

The CNB's branches represent the bank in the regions and are its contact points for relations with state and local authorities, banks, financial authorities, the Czech Statistical Office, selected clients and other legal and natural persons that have dealings with the CNB under the relevant legal rules. The CNB's branches are responsible mainly for managing money reserves and maintaining accounts of the state budget and other CNB clients falling within their fields of competence. They make cash and non-cash payments, conduct the accounting of the branch, issue tax documents and operate safe deposit boxes. To a specified extent the branches also conduct administrative proceedings, perform foreign exchange supervision, inspections of anti-money laundering measures and crisis management work falling within their fields of competence, and collect and process data on exchange office operations and regional data for business surveys. They receive and record questions, suggestions, notifications and announcements from the public and deal with them within their defined areas of competence.

The CNB's branches located outside Prague are responsible for labour-law and social administration, for economic administrative activities and for the security and surveillance of the branch. The branch in Ústí nad Labem is responsible for the central processing of statements and statistical data provided by non-bank institutions in compliance with their reporting duties. The České Budějovice branch organises special courses on the identification of suspected counterfeit or altered banknotes and coins and awards certificates to course participants. The Plzeň branch administers and maintains and makes entries in and changes to the register of insurance intermediaries for the whole CNB and conducts related administrative proceedings.

## 1. MANAGEMENT AND ORGANISATION



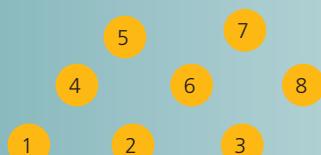
**The Bank Board**



1. Zdeněk Tůma, 2. Miroslav Singer, 3. Robert Holman, 4. Pavel Řežábek,  
5. Mojmír Hampl, 6. Eva Zamrazilová, 7. Vladimír Tomšík



**Executive Directors of Departments**



1. Pavlína Bolfová, 2. Jan Schmidt, 3. Jana Báčová, 4. Marian Mayer,  
5. Zdeněk Virius, 6. Tomáš Hládek, 7. Vladimír Mojžíšek, 8. Karel Bauer



**Executive Directors of Departments**



1. Helena Kolmanová, 2. Kateřina Šmídková, 3. Pavel Hollmann,  
4. Vladimír Kolman, 5. Vilém Čermák, 6. David Rozumek,  
7. Tomáš Holub, 8. Karel Gabrhel, 9. Ota Kaftan

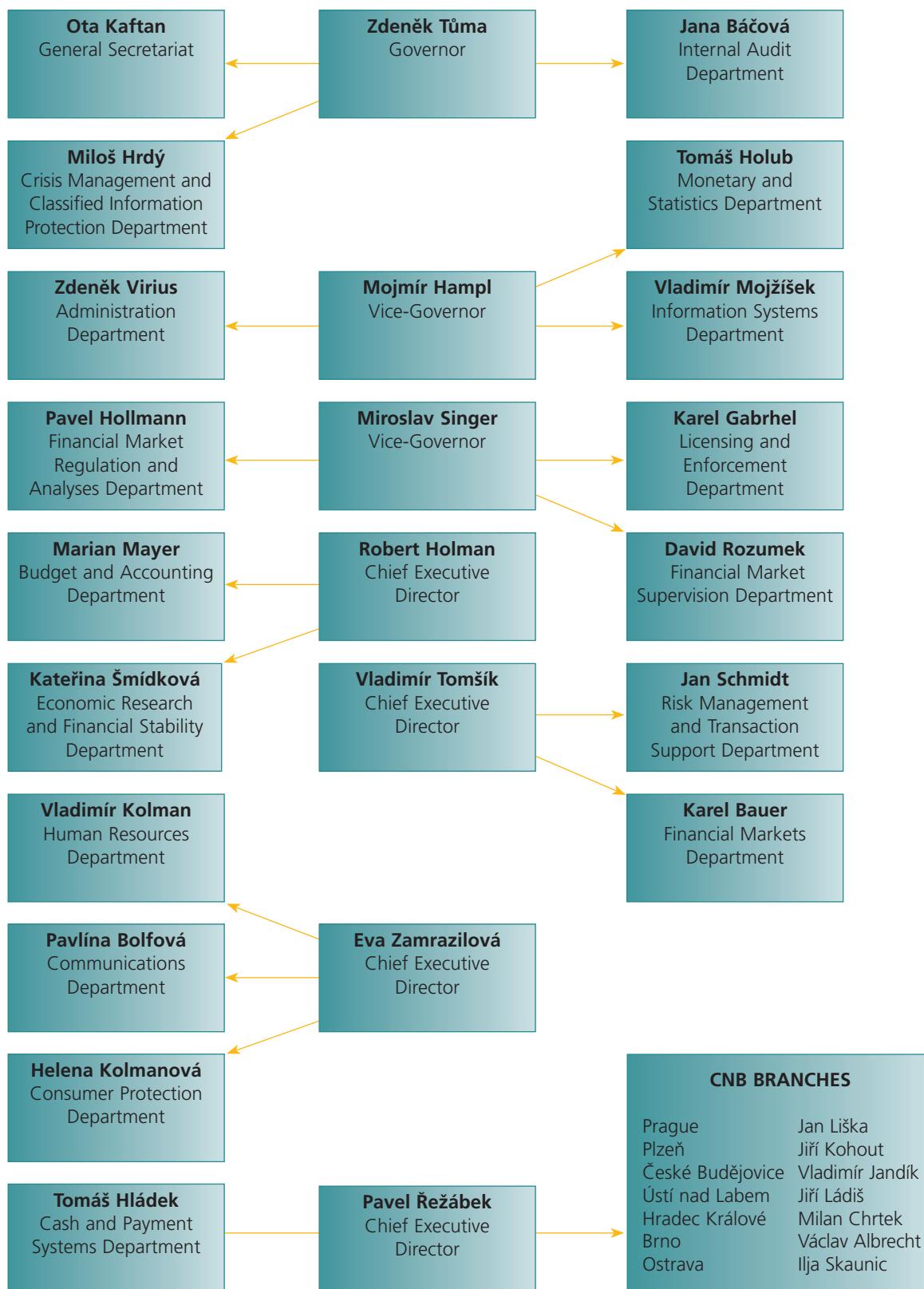


**Executive Directors of Branches**



1. Jan Liška (Prague branch), 2. Václav Albrecht (Brno branch),  
3. Jiří Ládiš (Ústí nad Labem branch), 4. Ilja Skaunic (Ostrava branch),  
5. Milan Chrtěk (Hradec Králové branch), 6. Jiří Kohout (Plzeň branch),  
7. Vladimír Jandík (České Budějovice branch)

## ORGANISATIONAL CHART





## OBJECTIVES AND TASKS AND THEIR FULFILMENT

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## 2. OBJECTIVES AND TASKS AND THEIR FULFILMENT

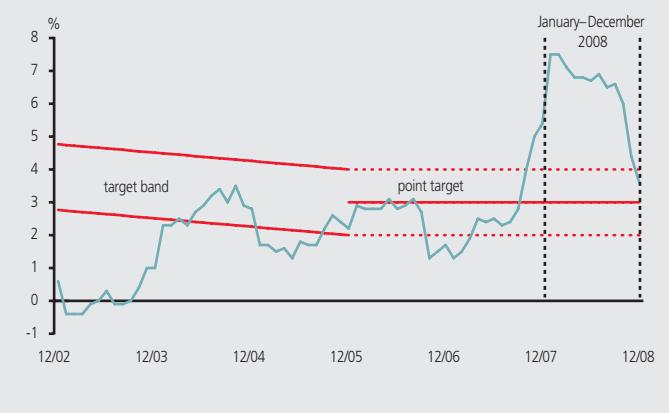
### MONETARY POLICY AND ECONOMIC DEVELOPMENTS

The CNB's primary monetary policy objective as laid down in the Act on the CNB is to maintain price stability. Since January 1998, this has been achieved under an inflation targeting regime in which the CNB tries to keep inflation close to a declared target. Since the start of 2006, the CNB's target for annual consumer price index growth has been set at 3% with a tolerance band of  $\pm 1$  percentage point. In March 2007, the Bank Board decided to lower it to 2% with the same tolerance band with effect from the start of 2010.

2008 was a year of escalation of the global financial and economic crisis, which, through various channels, also affected the domestic economy. Its effects were most pronounced in the final quarter of the year, fostering a marked decline in inflation, a fall in economic growth, a change in trend in the unemployment rate and a depreciation of the koruna's exchange rate. The CNB responded to these developments and their implications for the expected inflation outlook with three interest rate cuts totalling 1.5 percentage points starting in August 2008.

Inflation recorded a further significant rise in early 2008, continuing the sharp growth that had started at the end of the previous year. The rise was due to one-off inflationary cost effects related partly to developments abroad (see below). Then, for most of 2008, inflation showed a very slow decline. A substantial slowdown in consumer price inflation was recorded only after the above inflationary effects subsided and commodity prices on world markets started to fall in the last two months of the year, when inflation returned to the inflation-target tolerance band for the first time in 13 months.

**Fulfilment of the inflation target**



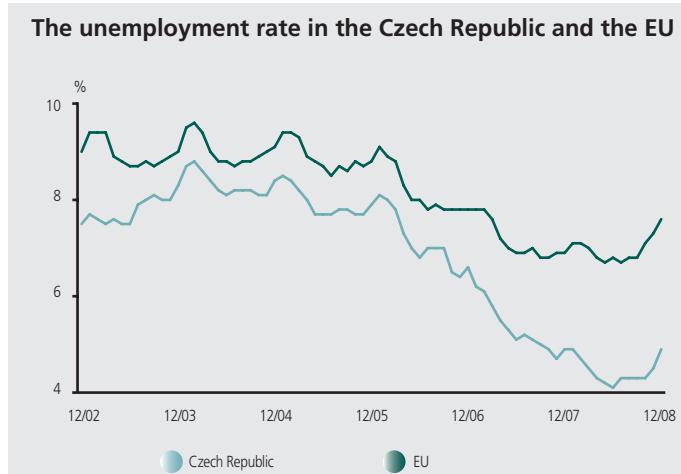
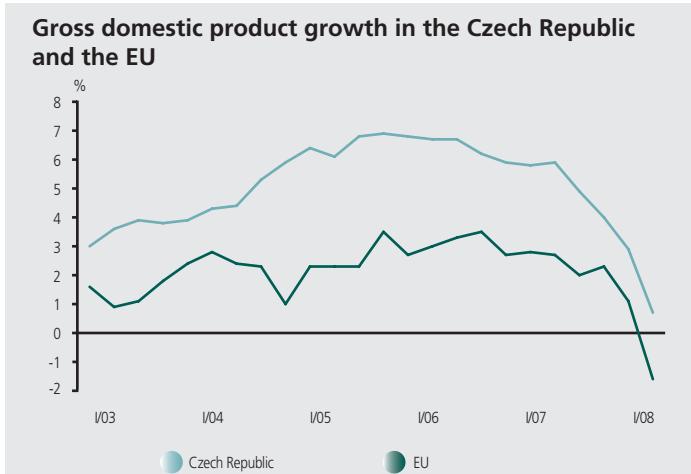
**Inflation in the Czech Republic and the EU**



Inflation as measured by the harmonised index of consumer prices (HICP) was significantly higher than in the EU countries throughout 2008, although some convergence was visible in the final two months of the year.

Inflation in 2008 was determined to a large extent by administrative factors (i.e. regulated prices and indirect tax changes). The rapid increase in regulated prices was due largely to higher rents, rising gas, heat and electricity prices and, last but not least, the introduction of health care fees. Inflation was also significantly affected by indirect tax changes in the form of increases in the lower VAT rate from 5% to 9% and in excise duties on tobacco products. For most of the year, inflation was also fuelled by higher food and fuel prices owing to a surge in world prices of agricultural and energy-producing commodities. However, prices of these commodities dropped significantly in the final months of the year, contributing to the steep decline of inflation towards the target.

The rate of economic growth fell by more than two percentage points in 2008 compared to the previous year. Economic growth slowed steadily during the first three quarters, confirming a gradual decline of the economy from the peak of the business cycle. However, a sharp economic downswing occurred in the last quarter of 2008 and all the evidence suggests that the negative economic growth will continue into this year. This turnaround in the Czech economy is chiefly due to the fall in external demand brought on by the global financial and economic crisis. In 2008, as in the six previous years, the Czech economy grew at a much faster pace than the EU economy as a whole. The GDP growth was mostly fostered by net exports, which partly offset a fall in gross capital formation (which had been dominant the previous year) and a much lower contribution of household consumption. To a lesser extent, the growth was also due to government consumption.

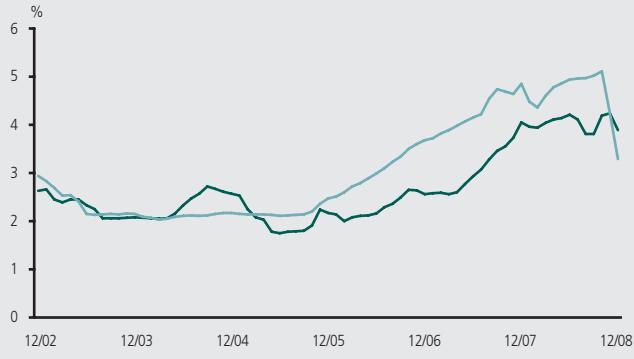


The slowing growth of the Czech economy resulted in a slower rate of employment growth, a marked decrease in the number of vacancies and a subsequent change in trend in the unemployment rate, which rose at the end of 2008. As in previous years, however, the unemployment rate was still below that in the EU and this difference widened further. The abating boom affected wage growth: annual nominal wage growth rose substantially at the start of 2008 and then slowed only gradually. Unlike in the previous year, rapid wage growth in the business sector outweighed the effect of a marked slowdown in wages in the non-business sector. However, real wage growth was strongly dampened by the persisting high inflation.

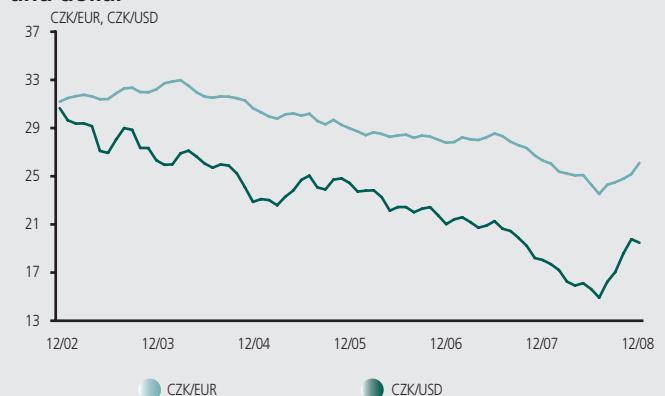
Domestic short-term interest rates (illustrated in the chart by 3-month interbank money market rates) were broadly flat in 2008 as a whole. However, this outcome masks various influences and tendencies that arose during the year. Domestic monetary policy rates were changed quite considerably (see below), tensions spilled over to the domestic interbank market and credit premia saw a related sharp increase, chiefly as a result of the escalating global financial and economic crisis. For most of 2008, as in the previous three years, domestic short-term interest rates were lower than the corresponding rates in the euro area. In November, however, euro area interest rates fell sharply to the level of Czech short-term interest rates, and in December they decreased well below the Czech rates.

## 2. OBJECTIVES AND TASKS AND THEIR FULFILMENT

**Money market interest rates**



**Nominal exchange rate of the koruna against the euro and dollar**



The nominal exchange rate of the koruna appreciated rapidly until July 2008, continuing the trend that started in July 2007. In that period, the koruna appreciated by almost 30% against the dollar and by more than 17% against the euro, becoming the fastest appreciating currency in the world. However, it then started depreciating and by the year-end it had lost much of its previous appreciation. In addition to interest rates, the koruna exchange rate was affected by the global financial market turmoil. Thanks to the favourable economic outlook in the first half of the year, the Central European region – and the Czech Republic in particular – took on the role of a “safe haven” for investment and experienced massive inflows of debt capital. However, the deepening financial and economic crisis led to a substantial reduction of investors’ funds and some investors were forced to withdraw funds invested abroad. This was reflected in a rapid outflow of short-term investment from the Czech Republic and the entire Central European region, whose credibility was moreover impaired by adverse developments in Hungary and the Baltic States. As in previous years, the CNB made no interventions in the foreign exchange market.

The individual CNB forecasts prepared in 2008 differed little from each other. These forecasts, which are important source materials for decision-making and monetary policy-making in the inflation targeting regime, indicated that inflation would be well above the upper boundary of the inflation-target tolerance band for most of 2008 owing to the price shocks experienced at the turn of 2008, but would fall sharply at the turn of 2009 once these shocks had subsided. During the following months of 2009, inflation was forecasted to decline gradually to the new inflation target of 2% valid from 2010 and then stabilise slightly above it. A firm exchange rate of the koruna and a gradual decline in inflationary pressures from the domestic economy were also predicted to foster a decrease in inflation.

To keep inflation close to the point inflation target, it was necessary – according to the forecasts – to lower interest rates in 2008 and then keep them flat. The January forecast additionally indicated that interest rates should first be raised slightly to help anchor inflation expectations in the situation of high inflation. Accordingly, monetary policy rates were increased by 0.25 percentage point at the start of February. After the inflation risks started decreasing and, by contrast, the expected economic growth slowdown combined with the strong koruna started to generate risks of too low inflation, the CNB became one of the first central banks in the world to lower interest rates, doing so by 0.25 percentage point. As the global financial and economic crisis deepened in the autumn, the future inflation risks deviated strongly in the anti-inflationary direction. The CNB responded by cutting interest rates by a total of 1.25 percentage points in November and December.

More detailed information on economic developments and monetary policy management can be found in the quarterly Inflation Reports available on the CNB website (*Monetary policy – Inflation reports*).

In 2008, the CNB took further significant steps to increase monetary policy transparency by publishing the forecast-consistent interest rate path in fan chart form and by disclosing the votes cast by the board members on interest rate changes by name. At its meeting at the end of October, the Bank Board decided that, starting with the first forecast in 2009, the CNB would publish the forecast-consistent path of the nominal koruna-euro exchange rate, also as a fan chart (the relevant press release can be found in the *Public – Media service – Press releases – 2008* section and the *Monetary policy – MP strategic documents – Monetary policy communication* section of the CNB website). This decision made the CNB the only central bank in the world to publish a forecast for a nominal exchange rate vis-à-vis a specific currency (a handful of the most advanced inflation-targeting central banks do currently publish effective exchange rate forecasts, although usually only for one or two selected moments in the future). The disclosure of the exchange rate forecast in numerical form means that full transparency of the CNB forecast has been achieved. This, in turn, enhances the transparency of the Bank Board's monetary policy considerations, giving external observers a better understanding of CNB monetary policy. As in the case of the interest rate path, the published exchange rate path should be understood by the public as being conditional on the assumptions of the forecast and the information available at the time it was prepared, not as a binding commitment or preference of the CNB.

In 2008, the CNB helped to prepare several strategic documents approved by the Government of the Czech Republic. In April 2008, the Czech Government approved the *Joint Agreement between the Government and the CNB* and *Updated Strategy for Dealing with the Exchange Rate Effects of Foreign Exchange Revenues of the State* (both documents are available in the *Public – Media service – Press releases – 2008* section of the CNB website and the latter also in the *Monetary policy – MP strategic documents – Exchange rate* section). They contain a set of measures aimed at preventing public sector operations from having undesirable effects on the foreign exchange market and subsequently on the macroeconomic stability of the Czech Republic. Specifically, this means that currency conversions of financial flows between the Czech Republic and the EU authorities will continue to be effected as far as possible off the foreign exchange market. Similarly, no conversions of privatisation revenues will be conducted on the foreign exchange market. These revenues will be either deposited on a foreign currency account with the CNB or managed in foreign currencies as a reserve for the pension reform. Any bond issues denominated in foreign currency will be hedged against exchange rate risk in such a way as not to affect the exchange rate.

In December 2008, the Czech Government approved the *Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area* drawn up jointly by the CNB and the Ministry of Finance (available in the *Monetary policy – MP strategic documents – Euro area accession* section of the CNB website). This document resulted in a recommendation not to set a target date for adopting the euro yet and thus not to attempt to enter the ERM II during 2009. This recommendation was based on the fact that the outlook for the fulfilment of the Maastricht convergence criteria and the maintenance and further improvement of the Czech economy's alignment with the euro area are very uncertain given the current global financial crisis.

### FINANCIAL MARKET SUPERVISION

#### **The CNB as the integrated supervisory authority**

The Czech National Bank has been the integrated supervisor of the Czech financial market since April 2006. With effect from January 2008, the original sectoral division of the supervisory departments was replaced by a functional organisational structure and three new supervisory departments were established – the Financial Market Regulation and Analyses Department, the Licensing and Enforcement Department and the Financial Market Supervision Department. This set-up, which integrates supervision across all financial market sectors, has numerous advantages compared to the sectoral structure and has proved fully successful amid the global financial and economic crisis. The supervisory departments performed their activities in line with the principles laid down in the strategic document *The Mission of the Czech National Bank for the Supervision of the Czech Financial Market*. The CNB informs the Financial Market Committee about its main activities in the financial market supervision area every six months and the Chamber of Deputies, the Senate, the Czech Government and the public on an annual basis in its Financial Market Supervision Report. The CNB also publishes other significant information on its website on an ongoing basis.

#### **The CNB's competences as a supervisory authority**

The CNB supervises entities operating on the financial market, analyses the evolution of the financial system, sees to the sound operation and development of the financial market in the Czech Republic, and contributes to the stability of the Czech financial system as a whole. When performing its tasks, the CNB cooperates with central banks and authorities supervising the financial markets of other countries and with international financial institutions and international organisations engaged in financial market supervision.

In the financial market area, the CNB focuses on supervision of banks, branches of foreign banks, credit unions, electronic money institutions, branches of foreign electronic money institutions and other entities that issue electronic money and supervision of the sound operation of the banking system. It also supervises investment firms, securities issuers, entities keeping a register of investment instruments, investment companies, investment funds, settlement system operators, investment instrument market operators and other persons specified in special legal rules governing capital market undertakings. The CNB is also responsible for supervising insurance companies, reinsurance companies, pension funds and other entities operating in the financial market area under special legal rules.

CNB supervision covers decisions on applications for licences, authorisations and prior approvals pursuant to special legal rules; inspection of adherence to the conditions stipulated in licences and authorisations; inspection of adherence to laws insofar as the CNB has the power to conduct such inspections under special legal rules, and inspection of adherence to the decrees and provisions issued by the CNB; collection of information needed to perform supervision pursuant to special legal rules and verification of whether such information is true, complete and up-to-date; imposition of remedial measures and penalties pursuant to the Act on the CNB and special legal rules; and proceedings regarding administrative offences.

The CNB works in close partnership with the Czech Ministry of Finance and with other state authorities to create a single strategy and unified rules applying to financial market regulation and supervision and on other essential topics, e.g. crisis management and information sharing in both the national and international context.

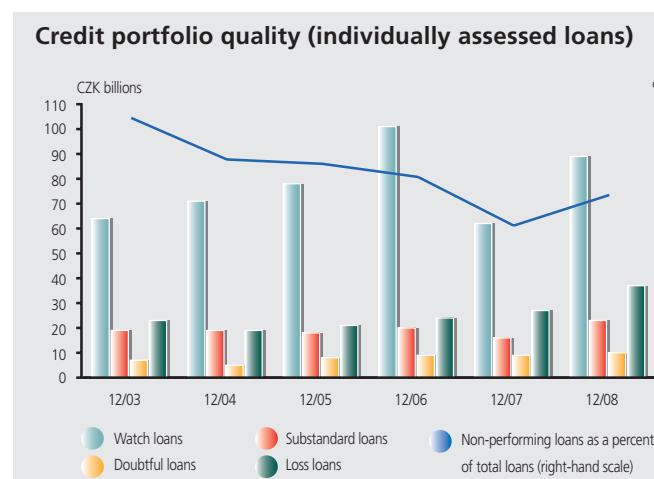
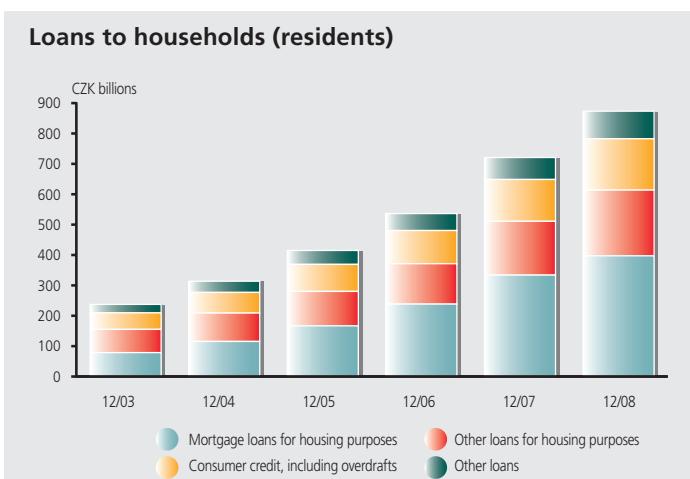
### The financial market

The Czech financial market is dominated by the credit institutions sector, which as of 31 December 2008 consisted of 21 banks (including 5 building societies), 16 foreign bank branches and 17 credit unions. Foreign capital has a key role in this sector. Foreign investors directly or indirectly control about 97% of the total assets of banks and foreign bank branches. The share of credit unions is very small, at about 0.3% of the banking sector's total assets.

The total assets of the banking sector increased by 7.9% to CZK 4,046.0 billion in 2008. Loans provided are the most important item of banks' balance sheets.<sup>2</sup> The annual growth rate of loans decreased year on year at the end of 2008. Nonetheless, Czech households' debt was 20% higher in 2008 than at the end of 2007. Banks' exposure to non-financial corporations increased by 14% year on year.

Sectoral breakdown of claims (in CZK millions)						
	31 Dec. 2003	31 Dec. 2004	31 Dec. 2005	31 Dec. 2006	31 Dec. 2007	31 Dec. 2008
Residents and non-residents, total	950,766	1,010,309	1,178,670	1,413,084	1,783,988	2,075,690
Residents	907,461	969,194	1,118,659	1,338,650	1,668,895	1,926,556
Non-financial corporations	428,318	459,502	525,350	634,876	743,380	848,071
Financial corporations	83,000	81,126	96,932	99,754	147,118	150,832
General government	158,731	114,877	81,463	67,630	57,482	54,279
Households	235,568	311,837	412,895	530,805	707,820	851,470
Households – trades	24,678	28,530	33,361	35,923	39,059	43,113
Households – individuals	210,891	283,307	379,535	494,882	668,761	808,358
Non-profit institutions serving households	1,845	1,852	2,019	5,586	13,096	21,903
Non-residents	43,305	41,115	60,011	74,433	115,092	149,134

The quality of the Czech banking sector's loan portfolio deteriorated slightly in 2008. The share of non-performing loans (i.e. substandard, doubtful and loss loans) rose by 0.5 percentage point year on year to 3.3%.



Client deposits are the largest-volume item on the liabilities side of banks' balance sheet. The growth rate of deposits decreased in 2008, while banks' liabilities to clients rose by 6% year on year. The capital adequacy ratio increased by 0.7 percentage point year on year in 2008, to 12.3%. Banks made capital savings thanks mainly to the implementation of a new risk measurement framework (Basel II).

<sup>2</sup> The data in the table, based on monetary and financial statistics data, differ from the banking supervision data owing to a different methodology. The main differences are described on the CNB website under *FAQ – FAQ on monetary and banking statistics*.

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The Czech banking sector was not directly endangered by the turmoil on world financial markets in 2008 and direct exposures to risky assets in domestic banks' balance sheets are very low. The sector recorded very high profits also in 2008, although the net profit of CZK 45.7 billion generated by banks was CZK 1.3 billion lower than in 2007. An almost 16% annual rise in interest profit accounted for most of the net profit. On the other hand, the banking sector posted worse results for marketable financial instruments.

<b>Banking sector indicators</b>						
	31 Dec. 2003	31 Dec. 2004	31 Dec. 2005	31 Dec. 2006	31 Dec. 2007	31 Dec. 2008
No. of banks and foreign bank branches	35	35	36	37	37	37
Total assets (CZK billions)	2,527.7	2,635.6	2,954.4	3,151.8	3,750.6	4,046.0
Liabilities to clients (CZK billions)	1,665.9	1,731.8	1,919.6	2,102.2	2,430.5	2,596.6
Net profit (CZK billions)	30.2	32.9	39.1	38.0	47.0	45.7
Administrative expenses (CZK billions)	47.5	48.8	51.8	55.7	59.7	61.7
Capital adequacy (%)	14.5	12.5	11.9	11.5	11.6	12.3
Non-performing loans to client loans (%)	4.8	4.0	3.9	3.7	2.8	3.3
Recalculated no. of employees	39,072	38,500	37,199	37,894	38,708	38,579
No. of banking units	1,670	1,785	1,825	1,877	1,865	1,993
No. of ATMs	2,572	2,750	3,005	3,281	3,357	3,406

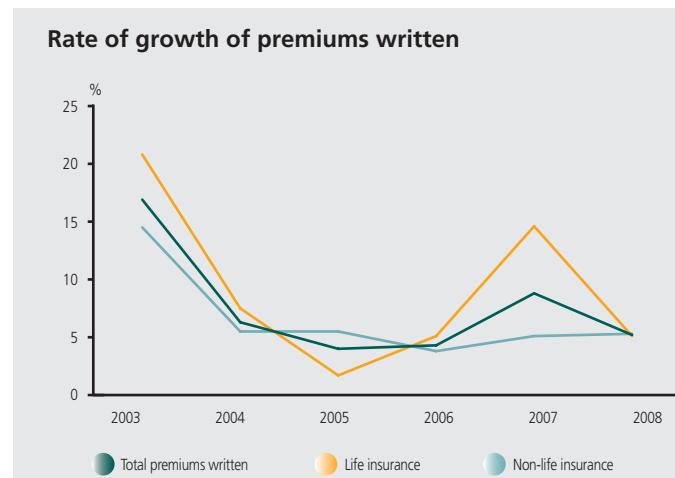
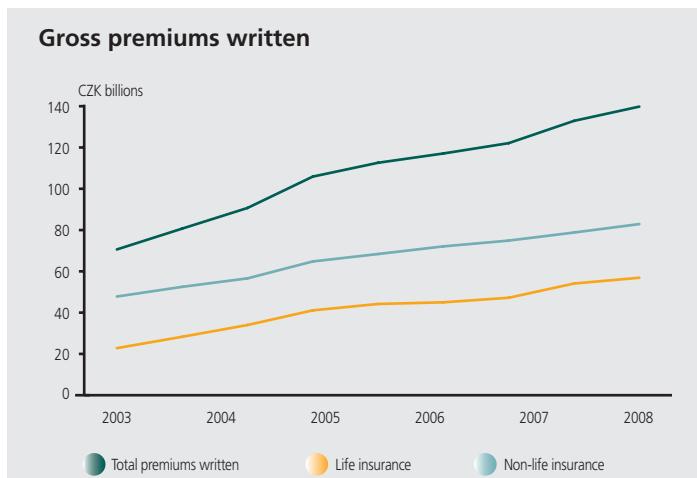
The total assets of the 17 credit unions increased by 34% to CZK 12.1 billion in 2008. Credit unions generated a profit of CZK 74.8 million (down by 10% year on year).

The Czech insurance market experienced no significant negative changes endangering its proper functioning in 2008. Nonetheless, the global financial crisis, which erupted in full last year, had some effects on the performance and functioning of insurance companies, especially in the life insurance area, which saw a decline in the growth rate of premiums written and whose 2008 profit was hit by a decrease in the value of equity and other investments. The continuous stability of the insurance sector in the Czech Republic is based on insurance companies' conservative investment strategy, which is additionally influenced by current legislation limiting investment in risky assets with potentially higher returns.

A total of 35 domestic insurance companies (3 life, 17 non-life and 15 universal) and 18 branches of foreign insurance companies (of which one branch was from a non-EEA member country) were operating on the Czech market as of 31 December 2008. The number of active entities thus increased by one compared to the previous year. In addition, one new universal reinsurance company started operation in the Czech Republic in 2008. As for capital origin, 24 domestic insurance companies are foreign-controlled and 11 are domestically controlled.

Owing to the slowing economic growth in the Czech Republic during 2008, the rate of growth of gross premiums written decreased by 3.6 percentage points to 5.2%, mainly as a result of a decline of 9.5 percentage points in growth of premiums in the life insurance market to 5.1%. Since 2004, life insurance has recorded a significant rise in premiums only in 2007. The non-life insurance market remains stable. Non-life premiums written recorded growth of 5.3% in 2008, roughly the same figure as in the previous year. The non-life insurance market is showing essentially no signs of any major negative impacts of the present financial crisis.

Owing to the lower rate of growth of premiums written, the share of life insurance in total premiums written fell slightly in 2008 – by 0.1 percentage point compared to the previous period to 40.7%. Although this share reached a historical high on the Czech insurance market in 2007, it is still lower than in advanced EU countries.



In 2008, the Czech capital market was affected by the continuing global financial crisis and the slower domestic economic growth resulting from the global economic downturn. The CNB closely monitored the behaviour and situation of supervised capital market entities throughout the year. At the beginning of the second half of the year, the CNB increased the frequency of the information duty for some types of entities so that it had enough information for its decision-making on potential remedial measures. This period was characterised above all by closer cooperation between European regulators, within European structures and in international organisations.

In the collective investment area, the CNB paid greater attention to monitoring the liquidity of collective investment funds, mainly to ensure smooth repurchases of investment units. It also focused on the issue of asset valuation in fund portfolios. The deteriorating situation on the financial markets also manifested itself in the Czech Republic in a decrease in assets managed by domestic open-end mutual funds intended for the public of CZK 51 billion to CZK 123 billion in 2008 due to unit repurchases and a decreasing value of portfolios. A total of 20 investment companies, 16 investment funds, 2 closed-end mutual funds, 142 open-end mutual funds (41 of them standard funds and 101 special funds) and 8 depositaries were subject to CNB supervision as of the end of 2008.

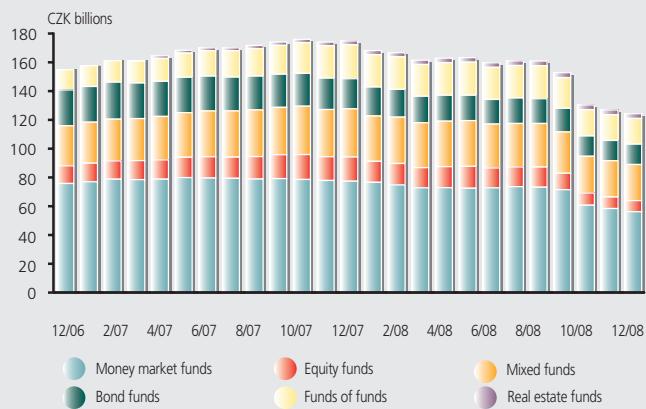
In the investment firms sector, the frequency of the reporting duty regarding orders received and transactions executed (the transactions and orders book) was changed to daily for some firms in the second half of 2008 owing to capital market developments. The data obtained in this way were analysed and assessed on a daily basis. These analyses were aimed primarily at monitoring transfers of liquidity from domestic firms to foreign owners and checking the market valuation of the investment instruments transferred. As of the end of 2008, the CNB registered 38 domestic investment firms (11 of them banks) and 16 foreign entities from EU countries providing investment services in the Czech Republic via a branch (13 of them banks). The total volume of transactions of domestic and foreign investment firms was CZK 28,867 billion, a rise of 14.6% compared to the previous year. Firms carried out transactions worth CZK 11,348 billion (excluding derivatives transactions) for their clients, an increase of 22.2% on a year earlier.

Given the unfavourable financial market developments and their potential impact on the pension scheme sector, the CNB introduced a monthly reporting duty for pension funds' performance at the start of the second half of 2008. Pension fund representatives were called on to adopt measures to foster financial stability and to prepare prudential measures aimed at ensuring sustained financial stability of their funds. In 2008, the pension fund sector consisted of ten entities. The sector's

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aggregate net profit fell from CZK 4.4 billion in 2007 to CZK 718 million in 2008, which represents a decrease of about 83%. The sector's total assets grew by almost 15% year on year, from CZK 167.2 billion to CZK 191.7 billion, and the volume of planholders' funds in pension funds' liabilities rose to CZK 186.7 billion (up by 15% year on year).

**Assets of domestic PFs by fund type**



**Annual PSE trading volumes and PX index**



The Prague Stock Exchange's PX index confirmed the tense capital market situation. It stood at 858.2 points at the end of 2008, a fall of 53.6% compared to its end-2007 value of 1,851.1 points. The annual volume of share trades on the PSE was CZK 852 billion, a decline of 15.9% from the previous year. By contrast, the annual volume of bond trades rose by 26.4% to CZK 643.2 billion. The total trading volume also decreased on the RM-S over-the-counter market, which was converted into a standard stock exchange in December 2008. The RM index fell by 42.9% year on year to 1,943.9 points.

### Financial market regulation

Several acts and implementing regulations were adopted in 2008 that amended and regulated the business activities of financial institutions and other entities subject to regulation. These pieces of legislation also had a major effect on financial market supervision.

The most significant regulatory change was in the capital market area. On 1 July 2008, an amendment to the Capital Market Undertakings Act took effect. The amendment transposes Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments (MiFID). It introduces numerous changes, for example the inclusion of investment advice among the core investment services, the introduction of tied agents, new disclosure duties (pre- and post-trade transparency), additional requirements for best execution, commission disclosure, etc. The amendment also contains other changes going beyond the MiFID framework (e.g. partial liberalisation of securities registers) and amendments of other acts, for example an extension of the permitted number of real estate items owned by one real estate company, a relaxation of the definition of mortgage loans, the possibility of converting commodity exchanges into joint-stock companies and the possibility of commodity exchanges organising derivatives markets.

In connection with the amendment to the Capital Market Undertakings Act the CNB prepared implementing regulations which took effect in July 2008. These consisted of decrees laying down rules for prudent provision of investment services and rules of conduct towards clients, the method of keeping a register of investment instruments,

disclosure duties of investment firms and other capital market participants and also the setting of specimen application forms and the content of their annexes pursuant to the Capital Market Undertakings Act. This amendment generated a need to amend the decree on the manner of compliance with the prudential rules of investment companies and investment funds, which took effect in August 2008, and the decree on prudential rules for banks, credit unions and investment firms. This decree, which also took account of the new Insolvency Act, took effect in September 2008.

The new Act on Certain Measures against Money Laundering (in effect from September 2008), which transposes the EU's Third Money Laundering Directive, meant a change in regulation across all financial market sectors. This Act lowers the threshold for client identification from EUR 15,000 to EUR 1,000, substantially extends the possibility of client identification being taken over from another person, and also extends the provisions on client due diligence for transactions of over EUR 15,000. The accompanying amendment to the Foreign Exchange Act also reflects MiFID requirements, i.e. foreign exchange licences will not authorise their holders to perform derivatives transactions and, in connection with anti-money laundering measures, the licensing and registration requirements for foreign exchange entities will be enhanced. The Act was followed up with a decree on the system of internal principles, procedures and control mechanisms to prevent money laundering and terrorist financing. This decree, which harmonises the requirements for entities supervised by the CNB, took effect in September 2008.

Two legislative changes were made in the area of client and depositor protection schemes. In February, a minor amendment to the Capital Market Undertakings Act was promulgated, according to which the Guarantee Fund of Investment Firms can be financed from state budget subsidies. In December 2008, an amendment to the Act on Banks was promulgated in the Collection of Laws which increases the compensation for insured deposits to 100% with a ceiling of EUR 50,000 (previously 90% with a ceiling of EUR 25,000). This change was made in response to a joint agreement between Member States connected with the financial crisis. The change was confirmed by the deposit insurance directive adopted in December 2008, the full transposition of which will require further legislative changes, particularly as regards the deadlines for payments from the Deposit Insurance Fund.

No major changes were made to the insurance sector regulations in 2008. In the course of the year, the Ministry of Finance, the CNB and representatives of the Czech Insurance Association worked together on a new insurance act. The bill for the new act was approved by the Czech Government in July 2008 and sent to the Chamber of Deputies in August. The act was not passed in 2008 and the legislative process will continue in 2009. The draft Solvency II directive prepared by the European Commission in 2007 was subject to further discussion in 2008. The discussions in the EU Council's financial services working group were delayed because of controversial issues contained in the draft (in particular the delegation of supervisory powers to supervisors in the home countries of the parent companies of insurance groups and an alternative calculation of the capital requirement for equity risk). The Ecofin Council eventually approved a "general approach" in December 2008. This provides a mandate for discussions with the European Parliament. Negotiating a final compromise thus became a task – and one of the priorities – of the Czech Presidency in the financial services area.

The amendment to the Consumer Protection Act which took effect in February 2008 was significant from the point of view of the CNB's powers of financial market supervision. This amendment substantially extends consumer protection in the financial market. The CNB has been assigned the task of supervising compliance with the rules by regulated entities. The CNB's activities were also affected by the Takeover Bids Act, which with effect from April 2008 made changes to the procedure for approving takeover bids, including squeeze-outs.

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Numerous other changes to the regulations were under preparation in 2008, mostly in order to transpose directives. Completion of the legislative process for these amendments is expected in 2009. They include in particular a bill amending the Capital Market Undertakings Act, the Act on Banks, the Act on Credit Unions, the Act on Collective Investment and other acts in connection with the transposition of Directive 2004/109/EC (the transparency directive), Directive 2007/44/EC (the qualifying holdings directive) and Directive 2007/16/EC (the eligible assets directive). The bill was approved by the Czech Government in November and prepared for submission to the Czech Parliament at the end of the year. The transposition of Directive 2007/64/EC on payment services in the internal market into the new Payment Systems Act was prepared in a similar way.

In the pension insurance area, the Czech Government in October 2008 approved a document entitled *Propositions for Drafting a New Act on Pension Insurance*. Based on a new institutional framework for voluntary pension schemes, this act should provide for management of a fund's assets separately from the assets of its manager. The bill, which was circulated for comments from other government departments by the Ministry of Finance at the end of December, is based on the concept of participating funds which do not have legal personality and whose assets are managed by an independent, dedicated manager.

### **International cooperation**

About one-third of the supervisory departments' staff were involved in various ways in the activities of international organisations and working committees (13 committees and 50 working groups and subgroups). 2008 was a year of deepening crisis in the financial markets, and this was reflected in the focus of international cooperation.

Within EU structures, participation in the meetings of the European Commission's committees and working groups – above all the Lamfalussy Level 3 committees (CEBS<sup>3</sup>, CESR<sup>4</sup>, CEIOPS<sup>5</sup>)<sup>6</sup> and the European Central Bank's committees<sup>7</sup> – was of key importance. The intensity of cooperation and the efforts to achieve convergence of supervisory practices at the international level were stepped up during the year. In June, the CNB became a signatory to the Multilateral Memorandum of Understanding on Cross-Border Financial Stability, whose objective is to enhance cooperation in the management and resolution of cross-border financial crises.

Attention was focused on the work of supervisory colleges, above all the effort to create supervisory colleges for all cross-border groups, support information sharing and harmonise the supervisory practices of the individual colleges. The signing of memoranda of understanding should be a further step towards strengthening the work of supervisory colleges and cooperation between partner supervisory authorities.

CNB representatives were involved in the activities of some new working groups created by the Lamfalussy Level 3 committees as a result of the financial market developments. These groups deal, for example, with short sales, the analysis of legal and technical aspects of the delegation of tasks and competences, remuneration policy within the banking sector and the link with the decision-making of finance ministers within the Ecofin Council.

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<sup>3</sup> Committee of European Banking Supervisors

<sup>4</sup> Committee of European Securities Regulators

<sup>5</sup> Committee of European Insurance and Occupational Pensions Supervisors

<sup>6</sup> CNB website: *Financial market supervision – CEBS – CESR – CEIOPS*

<sup>7</sup> CNB website: *EU and international relations – ECB and ESCB*

The CNB is also a signatory to the International Organization of Securities Commissions (IOSCO) Multilateral Memorandum of Understanding, under which the CNB is continuing to work in cooperation with other member states. The CNB is involved mainly in the European Regional Committee and the Emerging Markets Committee.

Cooperation also continued within the International Organisation of Pension Supervisors (IOPS), which the CNB joined in 2007. This membership provides the Czech Republic with access to detailed information about pension systems in the individual member states and gives it more opportunities to find the optimal configuration for its pension reform. The CNB was also actively involved in cooperation within, for example, the International Association of Insurance Supervisors (IAIS) and the Group of Banking Supervisors from Central and Eastern Europe (BSCEE), attended an annual conference on the impacts of globalisation in the financial services area on the activity of regulators, contributed to various surveys and actively monitored work on the preparation of standards and recommendations.

### **Financial market inspection work**

#### *Banks*

On-site inspections were carried out in banks in line with a plan based on supervisory findings and assessments of the risk levels of individual banks. Attention was focused on the management of risks undertaken by banks and on prudent bank business. Nine on-site inspections were carried out in 2008, four of which were comprehensive, focusing on several key risk management areas simultaneously. As for the size of the banks inspected, two were large, four were medium-sized and the rest were small. The comprehensive inspections in all cases focused on credit risk management, internal control systems and selected aspects of corporate governance. Other areas subject to on-site inspections included operational and IT/IS risk management, money laundering prevention systems, liquidity risk management, Central Credit Register data input systems, depository activity and the manner of eliminating shortcomings found during previous on-site inspections.

#### *Insurance companies and insurance intermediaries*

Four comprehensive on-site inspections were carried out in insurance companies during 2008. One inspection of a small insurance company was commenced at the end of the period under review. The on-site inspections focused on checking insurance risk management systems (creation and use of technical provisions, reinsurance systems) and market, credit and liquidity risk management systems. Attention was also devoted to the structure of financial investments and legal and operational risk management (registration and administration of insurance policies, settlement of financial market transactions, payments, and loss adjustment processes). In some cases, administrative and accounting procedures, solvency calculation methods and internal audit functions were also inspected.

In 2008, one on-site inspection in an insurance intermediary was in progress and another – focused on the obligation to carry on insurance intermediary activities with professional care – was terminated. In the latter case, the CNB had received quite a large number of complaints from clients regarding the intermediary's activities. The on-site inspection found that the intermediary had violated the obligation to act with professional care, mainly by not having sufficiently and appropriately arranged contractual relations with persons conducting intermediary activities on its behalf and by not ensuring appropriate control of its network of recruiters.

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### *Investment firms and investment intermediaries*

On-site inspections were conducted in investment firms and investment intermediaries based on an inspection plan drawn up with regard to the risk levels of individual entities and their impact on the sector. Other criteria considered when drawing up the inspection plan include the number and seriousness of complaints received about supervised entities from clients.

Two on-site inspections were conducted in investment firms in 2008. Both were comprehensive, focusing on compliance with rules for prudent provision of investment services (in particular, administrative and accounting procedures, internal control systems, financial risk management systems and liquidity management systems) and rules of conduct towards clients. The findings related to the infringement of rules of conduct towards clients and prevention of conflicts of interest, internal control system settings, risk management and data submitted under the disclosure duty. The inspectors recommended measures to improve internal procedures. Three on-site inspections were conducted in investment intermediaries. These were comprehensive inspections of all activities associated with the receipt and transmission of clients' orders. Special attention was given to records of orders received and transmitted and to conduct towards clients. The findings related to the treatment of clients' orders, mistakes in records of orders received and transmitted, internal control mechanisms and shortcomings in internal regulations in the information systems area.

### *Collective investment*

In the collective investment area, one on-site inspection was conducted in an investment company in 2008. This focused on compliance with the prudential rules, the rules of organisation of investment company internal operations and the rules of conduct and professional care in the management of mutual fund assets and the management of client assets under contract with a client.

One inspection was completed in a depository and three others were in progress in 2008. They concentrated on the treatment of assets of collective investment funds and pension funds, the execution of orders, the method of valuation of assets of collective investment funds and pension funds and the calculation of the present value of mutual fund units or investment fund shares.

### *Pension funds*

In the area of private pension schemes, inspections were carried out in two pension funds, focusing on compliance with the obligation to manage pension fund assets with professional care, on compliance with the obligation to handle assets in a manner consistent with planholders' interests as regards covering the direct and indirect costs of recruiting new planholders and related activities, and in one case on compliance with the Consumer Protection Act. In addition, actions related to inspections conducted in several pension funds in 2007 were completed in 2008.

### **Licensing and penalty activities in the financial market area**

In the credit institutions area, 57 administrative proceedings were conducted and 52 administrative decisions were issued in 2008. Most of them related to prior consents to the acquisition of qualifying holdings in banks. In addition, one new banking licence was issued and two bank mergers were approved. In 2008, two foreign bank branches operating under the single banking licence exercised the right of any bank having a licence from an EU country to expand its business across the entire EU area, either by establishing a branch or by cross-border provision of services not having the character of permanent economic activity. In addition, one medium-sized bank was converted into a foreign bank branch on 1 January 2008. The number of foreign banks from EU countries that had notified the CNB of provision of cross-border

services in the Czech Republic increased to 252 in 2008. In 2008, the CNB issued in administrative proceedings one prior consent to the decision of a members' meeting to terminate operation and return the credit union licence and one prior consent to a merger. Two prior consents to the investment of another membership contribution in a credit union and one consent to acquire a qualifying holding were also issued. A large number of decisions concerned consents in relation to assessments of compliance with the conditions for discharging the office of member of a credit union body or senior officer of a credit union. CNB opinions on nominees for managerial posts were again a standard part of banking supervision in the Czech Republic in 2008. Outside administrative proceedings, the CNB issued decisions relating to the approval of external auditors, decisions relating to shareholder structures prior to general meetings of banks, and decisions on the inclusion of subordinated debt in the capital of a bank or a credit union.

In the insurance sector, 82 administrative proceedings were opened (and 10 were continued from the previous year), of which 88 were closed by administrative decision and four will continue into 2009. The CNB granted its first ever authorisation to carry on reinsurance activities to VIG Re (Vienna Insurance Group). Two other insurance concerns (AXA and Wüstenrot) were granted new authorisations to carry on insurance activities on the Czech non-life insurance market. In administrative proceedings concerning applications for prior consent to change a member of a statutory or supervisory body or a proctor, consent was granted for 61 persons. Prior consent to acquire or increase a qualifying holding was granted in 10 cases. The CNB also approved a merger of one insurance company with its subsidiary and granted two consents to a different financial investment structure. It also conducted 23 administrative proceedings concerning deletion from, or registration in, the register of responsible actuaries (17 were deleted for failure to meet the statutory conditions and five new ones were registered; one proceeding had not been completed by the year-end). A large number of insurance companies and branches of insurance companies from EU and EEA Member States declared their intention to provide services temporarily in the Czech Republic. The CNB received announcements from foreign regulators regarding the notifications of 80 insurance companies and regarding the termination of activities in the Czech Republic of four insurance companies. The number of notified insurance companies from EU countries thus reached 554 in 2008. A gradual increase in the number of notified entities (both through the establishment of branches and through cross-border service provision) and an ensuing increase in their market share in the Czech insurance market can also be expected in the future. Notified entities providing cross-border insurance services are affecting the competitive environment on the non-life insurance market in particular.

A total of 259 administrative proceedings in the area of collective investment and private insurance schemes were conducted in 2008. The CNB granted authorisations to one investment company and nine investment funds. A total of 32 authorisations to establish a mutual fund were issued, and five authorisations to establish a mutual fund were revoked at the request of an investment company. In addition, two administrative proceedings concerning applications for authorisation to establish and operate a pension fund were conducted in 2008 (of which one was terminated at the request of a party to the proceedings and one had not been completed by the end of the year). Other administrative proceedings concerned the approval of directors (54), the approval of changes to statutes (121), consents to the acquisition of qualifying holdings (11), changes to depositaries (1), authorisation to merge mutual funds (2) and authorisation to offer securities of a foreign special fund to the public (10). A total of 1,569 funds or sub-funds managed by 68 foreign investment companies or SICAVs<sup>8</sup> from eight EU countries had made notifications in the collective investment area by the end of 2008. CNB authorisation had also been granted to 27 foreign special funds. The intention to provide investment services

<sup>8</sup> SICAV – société d'investissement à capital variable (investment company with variable capital).

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in the Czech Republic without establishing a branch had been notified by 840 non-bank entities from 19 EU countries.

In the area of investment services, 346 decisions were issued, mainly concerning the issuance or withdrawal of registration of investment intermediaries, the issuance (1 proceeding) or withdrawal (1 proceeding) of investment firm licences or broker's licences (36 proceedings), prior consent to the discharge of office of director of an investment firm or a financial holding entity (12 positive and 3 negative proceedings) and consents to the acquisition of qualifying holdings (2 positive proceedings). Nineteen rounds of broker examinations took place, with 169 participants. As of 30 June 2008, the CNB registered a total of 1,943 entities holding a broker's licence. After the amendment to the Capital Market Undertakings Act took effect on 1 July 2008 (under a transitional provision of Section II, items 25 and 32), all broker's licences ceased to exist by law and uncompleted proceedings were terminated. The CNB will not issue new broker's licences. For this reason the CNB stopped organising broker examinations. The amendment to the Capital Market Undertakings Act also lays down a new approach for ensuring the expertise of persons assisting investment firms in their activities.

In the market infrastructure area, the CNB issued its prior consent to the acquisition of a qualifying holding in the Prague Stock Exchange. One prior consent to the discharge of office of director was granted in connection with the change in the PSE's ownership structure. The CNB granted two UNIVYC requests for the approval of changes in the settlement system rules. Proceedings (with a positive outcome) were also conducted to grant a regulated market operator licence to the Prague Energy Exchange for some commodity derivatives. A total of 149 administrative proceedings were conducted in the securities issuance area, 108 of which concerned the approval of documents connected with securities issues (bond issue conditions and securities prospectuses), 8 concerned takeover bids, 11 concerned the information duties of issuers of listed securities and 22 concerned the application of the squeeze-out principle; the proportion of squeeze-out consents was about 55%. Notifications of managers' transactions undertaken by directors of issuers and shares in voting rights were verified. The CNB also received 166 prospectus notifications from foreign regulators. On 1 April 2008, a significant legislative amendment terminated the CNB's supervision of squeeze-outs of unlisted joint-stock companies and changed the law regulating takeover bids in connection with the transposition of the takeover bids directive (2004/25/EC).

As regards penalty proceedings, 69 administrative proceedings were conducted, 21 of which were continued from 2007 and 48 were opened in 2008. A total of 47 administrative proceedings were closed by a final and conclusive ruling.

As regards supervision of credit institutions, two penalty proceedings were opened in 2008 on the grounds of shortcomings detected in a bank's control system and bookkeeping and of failure to submit a credit union's approved annual report to the CNB within the set time limit.

In the insurance area, four administrative proceedings were opened, one of which related to a breach of the duties of investment intermediaries, two to cancellation of an extraordinary reporting obligation of an insurance company and one to failure to implement remedial measures. Two decisions on the cancellation of an extraordinary reporting obligation of an insurance company took effect in the same period.

A total of 22 administrative penalty or offence proceedings were opened in the capital market area in 2008. Twenty-one decisions became final and conclusive and fines amounting to CZK 2.1 million were imposed.

A total of 18 administrative proceedings were opened in 2008 regarding the violation of foreign exchange regulations. The CNB issued final decisions or

orders in 24 administrative penalty proceedings, of which fines were imposed in 22 cases, a foreign exchange licence was revoked in one case and proceedings were terminated in one case. The total fines imposed amounted to CZK 400,000.

As regards the cancellation of entries in the register of insurance intermediaries, 56 administrative proceedings were opened in 2008 and 113 final decisions were issued regarding failure to prove the expertise of insurance intermediaries.

### **Financial intermediaries**

At the end of 2008, 12,873 entities (most of them natural persons) were registered with the CNB as investment intermediaries. On 1 July 2008, an amendment to the Capital Market Undertakings Act introduced tied agents, a new type of investment services provider representing an investment firm, investment intermediary or investment company. The CNB registered a total of 3,510 tied agents as of the end of 2008.

In 2008, the CNB recorded a total of 18,702 legal/natural persons in the Register of Insurance Intermediaries and Independent Loss Adjusters<sup>9</sup>, 91 of which were insurance agents and 59 insurance brokers. As of the end of 2008, a total of 86,232 insurance intermediaries were entered in the register, 7,118 of them foreign. Following a change to the CNB Organisational Manual, responsibility for registering insurance intermediaries was transferred to the Plzeň branch on 1 January 2008. In connection with the registration of insurance intermediaries, the CNB holds professional examinations of insurance agents and insurance brokers. In all, 627 candidates took these examinations and 610 passed.

### **Central Credit Register**

As of 31 December 2008, the Central Credit Register had 530,000 entries on credit claims, promises, guarantees, etc., relating to 237,000 clients. In 2008, the register handled 180,000 ad hoc enquiries and provided 2.8 million pieces of information on the credit commitments of banks' debtors in aggregate monthly reports. Besides the rising use of the CCR in banks, public interest in information in the form of extracts grew as well; the CNB issued 278 extracts in 2008. For improved access, applications for extracts can now also be submitted via the CNB electronic mail room.

A new aggregation tool was put into operation in 2008, allowing monitoring of month-on-month changes in the values of particular claims or other indicators and tracking of the growth rates of selected indicators in time series. The relevant functions are accessible to bank statisticians and analysts and the CNB through the CCR analytical module and outputs.

### **Information systems**

The integration of financial market supervision into the CNB has greatly extended the scope of information processed, thereby increasing the demands on the existing information systems and the need to unify them. In 2008, four main information systems for supervisory departments were put into routine operation. These systems are intended to rationalise and improve individual activities.

The main information system is the Supervision Information Centre, which is used for processing and presentation of financial sector data obtained from statements and reports submitted by individual financial market entities. This information system, which prior to the integration of supervision was used only for the banking

<sup>9</sup> CNB website: *Financial market supervision – Insurance supervision – Insurance intermediaries and independent loss adjusters*.

## 2. OBJECTIVES AND TASKS AND THEIR FULFILMENT

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sector, was extended in 2008 to cover all financial market entities, i.e. including credit unions, insurance companies, investment companies and collective investment funds, investment firms and pension funds. The system allows data to be kept in methodologically comparable time series and aggregated by classification and hierarchy, necessary calculated indicators to be created, etc. The system is mostly used by off-site surveillance and analyses departments.

The Unified Register of Regulated and Registered Entities ensures effective administration of all regulated and registered entities. This system contains information about all the financial market entities operating in the Czech Republic. It also includes an application allowing direct presentation of regulated and registered entities on the CNB website.<sup>10</sup> This application makes it possible to retrieve 37 basic lists of financial market entities or individual entities and verify whether they are authorised to carry on the services they offer. This system is still under development and will be completed during 2009.

As the licensing and registration authority for financial market entities the CNB conducts numerous administrative proceedings. It is obliged by law to disclose most of its final decisions. An information system called Monitoring of Actions in Administrative Proceedings was created to support these functions. It allows managerial control and oversight of individual administrative proceedings and direct publication of final decisions on the CNB website.<sup>11</sup>

Another information system aimed at providing direct supervisory support is the Risk Profile Assessment System. This information system allows us to integrate and assess all the information obtained during off-site surveillance and on-site examinations, present it in the form of a risk matrix and assign an entity to a specific risk category. The assessment of the entity's riskiness then serves as a basis for further supervisory action. The system is flexible and can be applied to all financial market entities provided that the individual risk factors and assessment parameters are defined.

Financial market supervisors also have a number of other information systems at their disposal, but these are mostly focused only on specific segments of the financial market (e.g. the Capital Market Monitoring system for processing available information on financial market transactions, which is currently under preparation).

### **FOREIGN EXCHANGE SUPERVISION**

Under Act No. 219/1995 Coll., as amended (the Foreign Exchange Act), the CNB supervises almost 3,000 non-bank foreign exchange entities. This category includes both entrepreneurs offering cash purchases or sales of foreign currency and entities engaged in executing or intermediating non-cash foreign exchange transactions or providing money services.

Act No. 130/2000 Coll., amending Act No. 455/1991 Coll., on Trade and Entrepreneurial Activities (the Trades Licensing Act), as amended, and other related acts, took effect on 1 July 2008. The amended Trades Licensing Act includes a revised Annex 3, which contains licensed small businesses. As a result of this revision, licensed small businesses no longer include bureau-de-change activities.

An amendment of the Foreign Exchange Act, implemented by Act No. 254/2008 Coll., amending some laws in connection with the adoption of certain measures

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<sup>10</sup> CNB website: *Financial market supervision – Lists of regulated and registered entities*.

<sup>11</sup> CNB website: *Financial market supervision – Capital market supervision – Final decisions*.

against money laundering and terrorist financing (hereinafter Act No. 254/2008 Coll.), took effect on 1 September 2008. In this amendment, authorisation of foreign currency cash purchases and sales was unified. Under the amended Foreign Exchange Act, bureau-de-change activities are defined as the provision of services to third parties, the subject of which is the purchase or sale of banknotes, coins or cheques in foreign or Czech currency in return for banknotes, coins or cheques in another currency.

Under the legislation in effect until 31 August 2008, bureau-de-change activities were carried out on the basis of licensing certificates issued by trade licensing offices. These certificates authorised entrepreneurs (natural or legal persons) to purchase foreign currency in cash only. Before granting licensing certificates, trade licensing offices would request the CNB's opinion. Entrepreneurs could purchase foreign currency only on premises and in exchange machines approved by the CNB in advance. In 2008, the CNB issued 44 opinions on the granting of licensing certificates and 123 opinions on the approval of premises. The total number of foreign exchange entities with licensing certificates was 2,514 at the end of 2008.<sup>12</sup> The number of foreign exchange entities has been flat since 2002. Compared to 2007 the number slightly declined, as did the number of foreign exchange premises, which totalled 2,313 at the end of 2008. The lower number of foreign exchange premises than licensing certificates is due to non-performance of bureau-de-change activity by licensing certificate holders. Since 1 September 2008, the CNB has been performing registrations for bureau-de-change activity. Such work is carried on by CNB branches. Between 1 September 2008 and 31 December 2008, the CNB received 90 applications for registration for bureau-de-change activity, 82 of which were approved.<sup>13</sup> The number of applications for registration of bureau-de-change activity submitted last year and the manner in which they were dealt with is shown in the following table:

<b>Number of applications for registration of bureau-de-change activity in 2008</b>			
CNB units	No. of applications submitted	Approvals	Refusals
PRAGUE	31	27	1
ČESKÉ BUDĚJOVICE	3	3	0
PLZEŇ	14	14	0
ÚSTÍ NAD LABEM	7	6	0
HRADEC KRÁLOVÉ	10	10	0
BRNO	19	17	0
OSTRAVA	6	5	0
<b>TOTAL</b>	<b>90</b>	<b>82</b>	<b>1</b>

Until 31 August 2008, CNB branches made decisions on the granting of foreign exchange licences for the selling of foreign currency in return for Czech currency in cash. However, the amended Foreign Exchange Act no longer regulates this type of licence, as sales of foreign currency have become a part of bureau-de-change activities. Other foreign exchange licences continue to be issued by CNB headquarters. In 2008, the CNB received 20 foreign exchange licence applications. Most of these applications were approved by the CNB; applications were refused on the grounds of failure to meet the conditions for granting foreign exchange licences. As of 31 December 2008, the CNB registered 328 valid foreign exchange licences.

<sup>12</sup> Under a transitional provision of the amendment to the Foreign Exchange Act (Article XXII(1) of Act No. 254/2008 Coll.), foreign exchange licence holders can carry on such activities until the date of issue of a decision on registration for bureau-de-change activities, although for no longer than 18 months from the date of effect of Act No. 254/2008 Coll., i.e. until 28 February 2010 at the latest.

<sup>13</sup> One application was withdrawn, one application was refused and the decisions on the remainder were not made until after 31 December 2008.

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The number of applications for foreign exchange licences submitted last year and the manner in which they were dealt with are shown in the following table:

<b>Number of foreign exchange licence applications</b>			
CNB units	No. of applications submitted	Approvals	Refusals
PRAGUE <sup>14</sup>	6	6	1
ČESKÉ BUDĚJOVICE	0	0	0
PLZEŇ	1	1	0
ÚSTÍ NAD LABEM	1	0	1
HRADEC KRÁLOVÉ	2	2	0
BRNO	1	1	0
OSTRAVA	3	3	0
CNB HQ <sup>15</sup>	6	2	0
<b>TOTAL</b>	<b>20</b>	<b>15</b>	<b>2</b>

Non-bank foreign exchange entities<sup>16</sup> may carry on bureau-de-change activities or non-cash foreign exchange transactions or provide financial services only on premises registered for this purpose in advance by the CNB. Between 1 September 2008 and 31 December 2008 the CNB registered 97 premises in total.

The CNB conducts on-site foreign exchange inspections through its branches. The aim of these inspections is to inspect all the activities carried on by the non-bank foreign exchange entity and its individual premises. The number and orientation of the on-site inspections<sup>17</sup> carried out by foreign exchange supervisors in 2008 are shown in the following table:

CNB units	Total	Completed		By orientation				
		Violation of forex regulations found	Violation of forex regulations not found	Official record only	Licensing certificates	Forex selling licences	Other forex licences	Other (notification duty, unauthorised business)
PRAGUE	152	70	78	4	124	19	9	0
ČESKÉ BUDĚJOVICE	41	24	9	8	27	10	2	1
PLZEŇ	35	22	10	3	21	13	1	0
ÚSTÍ NAD LABEM	43	37	6	0	43	15	0	0
HRADEC KRÁLOVÉ	53	40	3	10	43	8	1	1
BRNO	40	33	1	6	22	17	1	0
OSTRAVA	35	24	4	7	27	10	4	0
<b>TOTAL</b>	<b>399</b>	<b>250</b>	<b>111</b>	<b>38</b>	<b>307</b>	<b>92</b>	<b>18</b>	<b>2</b>

In the area of foreign exchange supervision, the CNB may open administrative proceedings to impose penalties if it finds that the foreign exchange regulations have been contravened.<sup>18</sup> If a suspicion of contravention of the foreign exchange

<sup>14</sup> One case involved a decision on a foreign exchange licence application carried over from 2007.

<sup>15</sup> The final decisions on the remaining four foreign exchange licence applications had not been taken as of 31 December 2008.

<sup>16</sup> More detailed information is available on the CNB website (*Financial market supervision – Foreign exchange supervision – Complete list of foreign exchange licences from the register of foreign exchange entities*).

<sup>17</sup> The number of inspections completed and the number of inspections by orientation can differ because non-bank foreign exchange entities can be holders of several authorisations granted by the CNB and can also have more than one premises in operation.

<sup>18</sup> A complete list of foreign exchange regulations is available on the CNB website (*Financial market supervision – Foreign exchange supervision – Foreign exchange regulations in force*).

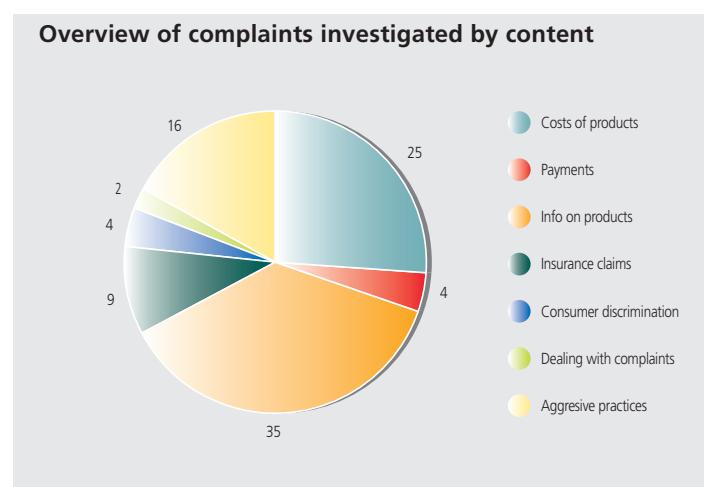
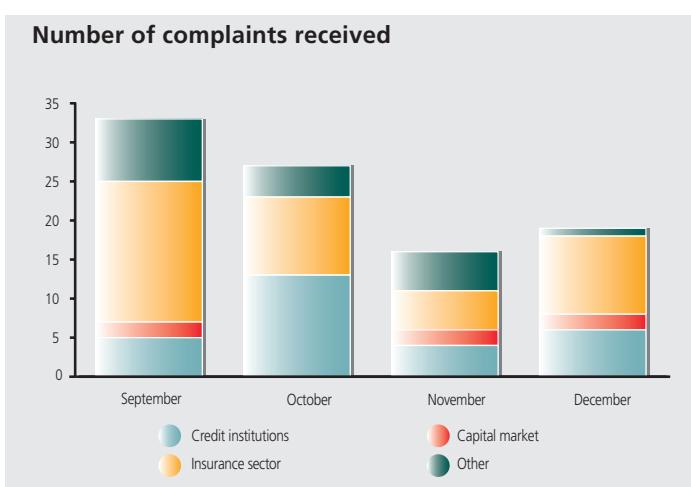
regulations is proved, the participant's activity that is in breach of the foreign exchange regulations may be limited or suspended, the scope or terms of the licence may be changed, the registration for bureau-de-change activity may be cancelled, the foreign exchange licence may be revoked or a fine may be imposed, depending on the extent, manner and duration of the contravention. Administrative proceedings in foreign exchange matters are conducted by CNB headquarters.

In 2008, as in previous years, most of the foreign exchange offences were due to breaches of the conditions for cash purchases/sales of foreign currency in return for Czech currency. These mostly concerned erroneously made out and labelled deductions for foreign currency sales and purchases and insufficient record-keeping in the case of foreign exchange books. The offence of unauthorised offering, performance or intermediation of foreign currency transactions was identified in two cases. Where the CNB finds a contravention of the foreign exchange regulations consisting in the unauthorised offering, performance or intermediation of foreign currency transactions, it either orders the offender to terminate the unauthorised activity or opens administrative penalty proceedings.

### CONSUMER PROTECTION

The Consumer Protection Department (SAOOS) was established at the CNB on 1 September 2008. Its work involves receiving and investigating consumers' complaints in accordance with competences arising under the Consumer Protection Act. Complaints are made against entities operating on the financial market and mostly relate to breaches of the prohibition of unfair commercial practices, discrimination against consumers and requirements for proper information about prices. Information on the new department's competences is available on the CNB website (*Financial market supervision – Consumer Protection*).

Between September and December 2008, the SAOOS received 142 complaints of breaches of the consumer protection regulations from consumers and consumer protection groups. Of this total, 95 were investigated by the SAOOS. The others concerned issues falling within the remits of other supervisory institutions or other supervisory departments at the CNB.



Besides receiving and investigating complaints from consumers, the SAOOS is involved in financial education. The SAOOS has a fundamental vision for the adult population – a *financially educated consumer does not make bad transactions*. To this end, it wrote a series of newspaper articles inspired by complaints received

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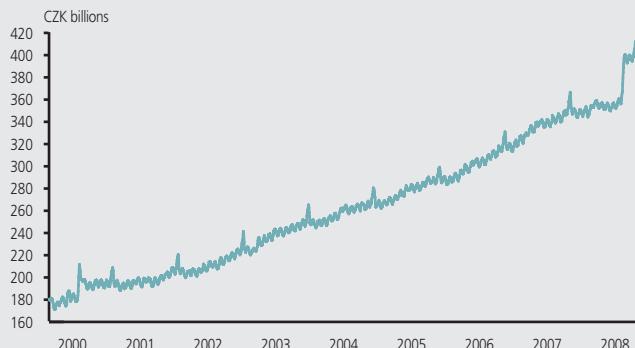
describing the most common mistakes made by consumers and recommending what to beware of when signing contracts for various financial products. The CNB also regards financial education of the young generation as a highly important area. It therefore decided to be involved in and support intellectually and financially the publication of the first-ever comprehensive teaching aid in the field of economic and financial literacy in the Czech Republic. In August 2008 it bought 4,000 copies of the textbook *Financial and Economic Literacy* by Michal Skořepa and Eva Skořepová and distributed them free of charge to all primary and academic secondary schools in the Czech Republic. More information is available on the CNB website (*Financial market supervision*). The SAOOS collaborates with other educational institutions in the field of financial education in schools.

### CURRENCY IN CIRCULATION AND THE PAYMENT SYSTEM

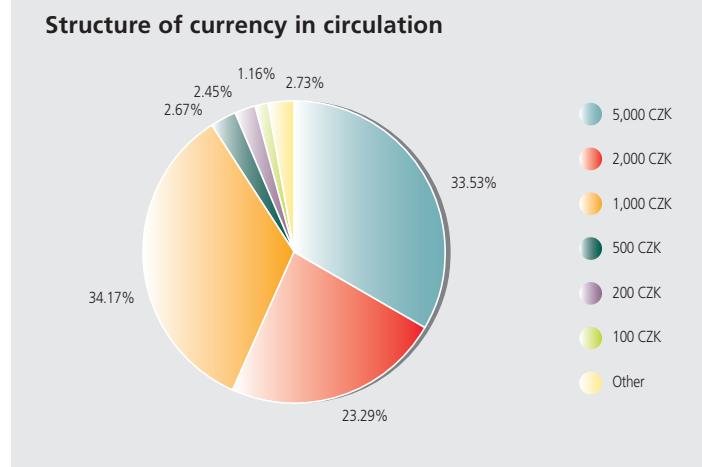
#### Currency in circulation

Currency in circulation amounted to CZK 399.2 billion as of 31 December 2008. The total volume of currency in circulation increased by CZK 45.5 billion, or almost 13%, year on year in 2008. This increase was due largely to the response of banks to households' and corporations' demand for cash in October 2008 linked with the global financial crisis.

**Currency in circulation – 8 Feb. 1993 to 31 Dec. 2008**



**Structure of currency in circulation**



As of 31 December 2008, a total of 360.5 million banknotes and 2,708.8 million coins were in circulation. However, 1,497.3 million of these were ten-heller, twenty-heller and fifty-heller coins, which are no longer legal tender but can still be exchanged at the CNB. The numbers of banknotes and coins in circulation rose by 19.8 million (+5.8%) and 22.5 million (+0.8%) respectively in 2008.

At the end of 2008, 91% of the total amount of currency in circulation was covered by CZK 5,000, CZK 2,000 and CZK 1,000 banknotes and the average value of a banknote in circulation was CZK 1,081. The average value of a coin in circulation (excluding heller coins) increased to CZK 6.75.

Cash turnover at the CNB's branches amounted to CZK 1,587 billion in 2008, up by 5% year on year. A total of 2.7 billion banknotes and coins were accepted or issued at CNB branches. This represents more than 7,000 tonnes of currency.

On 1 April 2008, the CNB put into circulation a new 2008 version of the CZK 1,000 banknote. The 1996 version of the same banknote remained legal tender. The 1993

version is no longer legal tender, but will remain exchangeable at the CNB. Information on differences between individual banknote versions and security features is available on the CNB website (*Public – Publications – Information leaflets*).

In 2008, the CNB put into circulation two gold coins from the Industrial Heritage Sites cycle and six silver commemorative coins, which is a record high for one year. The coin designs and issue dates can be found on the CNB website (*Banknotes and Coins – Numismatics – Schedule of issuance for commemorative coins in 2006–2010*).



A total of 28,000 commemorative gold coins were produced, i.e. the maximum possible number set by the Bank Board. Of this total, 6,300 (22.5%) were of normal quality and 21,700 (77.5%) were of proof quality. The overall nominal value of the coins was CZK 70 million. In all, 153,000 commemorative silver coins were produced in 2008 – 59,100 (38.6%) of normal quality and 93,900 (61.4%) of proof quality. Their total nominal value was CZK 30.6 million.

#### **Non-cash payment system**

By law, the CNB operates the non-cash payment system, i.e. it maintains the accounts of the central bank and arranges interbank payments and settles short-term securities transactions. Non-cash payment transactions are executed through the CERTIS, SKD and ABO systems. The CNB also drafts legal rules for the payment systems area and is involved in the preparation of European legislation.

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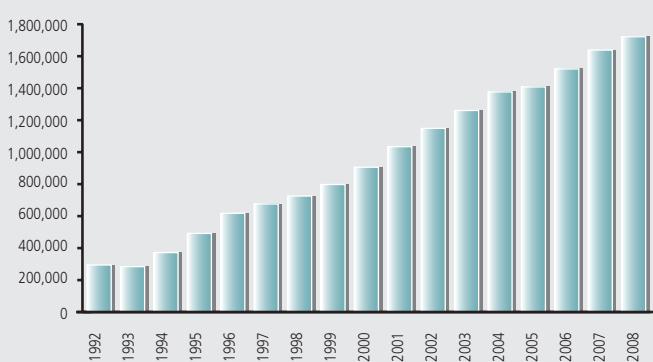
### CERTIS – interbank payment system

The CERTIS system processes interbank payments in the Czech Republic. Banks, credit unions and foreign bank branches are participants in this system. As of 31 December 2008, the system comprised 42 direct participants and 7 third parties – for example, card payment clearing houses and securities clearing and settlement institutions.

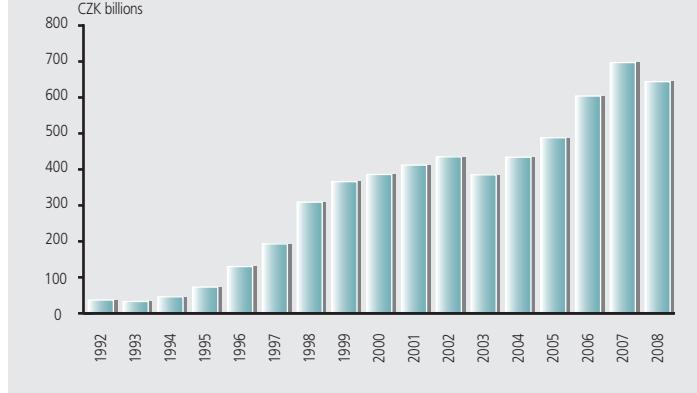
On 1 January 2008, the time bands were changed and the fees paid by system participants were further reduced. These fees began to be cut gradually at the end of 2006, when the core of the CERTIS system was transferred from a mainframe platform to a server environment, resulting in significant cost savings.

CERTIS processed 436 million transactions in 2008 (up by 6% year on year), representing a total value of CZK 162,993 billion (down by 6.8%). The system processed a daily average of 1.72 million transactions. The average daily value of the transactions was CZK 644 billion. The following charts show the number of transactions processed and the volume of funds transferred in the CERTIS system since 1992.

**Average daily number of transactions**



**Average daily turnovers**



### SKD – short-term securities settlement system

The short-term securities settlement system (SKD) operated by the CNB is a separate register of securities and a settlement system for the securities recorded therein. In SKD, records are kept of the securities issued by the Czech Republic (the Ministry of Finance) with maturities of up to one year, the short-term securities issued by the CNB with maturities of up to six months, and other bonds with maturities of up to one year.

SKD is being modified to reflect legal and tax changes. The CNB also monitors developments in EU settlement systems, particularly with regard to the connection of such systems to the TARGET2 single payment system, the proposed Target2-Securities single settlement system and the CCBM2 collateral management system, which will be relevant to the Czech Republic as it prepares to adopt the euro.

As of 31 December 2008, a total of 156 owner accounts – belonging to 110 clients (securities owners) – were registered in SKD. In all, 18 agents and 5 custodians use the system.

Agents are banks that provide securities settlement services to their securities owning clients. They have direct interactive access to the SKD system. Custodians

administer securities accounts owned by persons other than custodians, i.e. customers of custodians.

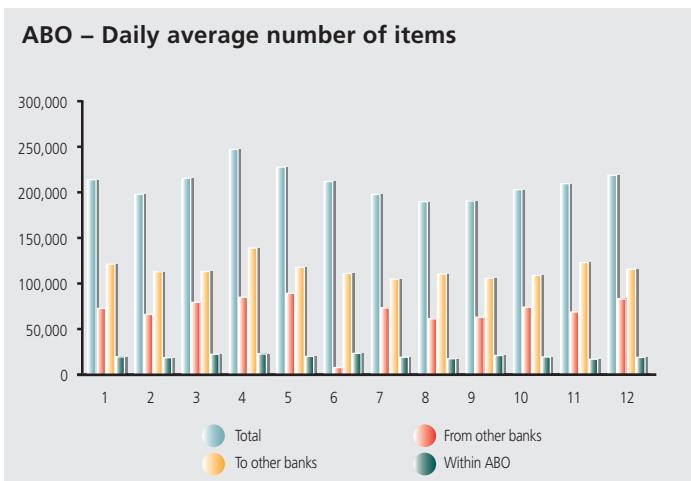
The securities recorded in SKD are used mainly as collateral for intraday credit, which the CNB extends to banks for accounting purposes within CERTIS and for the needs of the CNB's repo operations.

#### **ABO – accounting and payment system**

As of 31 December 2008, the ABO system maintained 41,422 live accounts, 9,511 of which were internal accounts, 4,359 employees' accounts and 27,552 accounts of legal entities. As regards the accounts of legal entities, 24,131 fall into the regulated Treasury accounts category. The other accounts are mostly owned by state institutions, as well as banks, foreign financial institutions, etc.

Development of the ABO system continued in 2008 within the ABO5 project. New functions in the ABO-K internet banking application were put into operation and foreign payment entries were integrated into the ABO. This laid the groundwork for a larger migration of clients to ABO-K with the aim of further reducing written payment orders and terminating the older methods of electronic communication of clients with the CNB (transmission of payment orders and extracts by e-mail and via the Smooth Bulk Payments application) before the end of 2009.

The ABO system processes about 200,000 accounting transactions daily, most of them payments constituting state budget revenues and expenditure. There is minimal year-on-year growth in payments.



#### **Legislation**

Since summer 2008 the CNB has been actively involved in preparing new payment legislation within a working group established by the Ministry of Finance for the purposes of transposing Directive 2007/64/EC on payment services in the internal market. The comment procedure ended on 22 December 2008. The comments received were used in the drafting of a payment system bill with the Ministry of Finance. The bill was submitted to the Government at the beginning of February 2009.

The CNB and the Ministry of Finance also took into account the results of a public consultation document published on the websites of both institutions when transposing the directive on payment services in the internal market into Czech law.

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In 2008, the CNB incorporated into its internal rules the obligations arising from the new Act on certain measures against money laundering and terrorist financing (the "AML" Act) regarding the keeping of accounts and the provision of other banking services.,

### **PREPARATIONS FOR INTRODUCING THE EURO IN THE CZECH REPUBLIC**

In 2008, the CNB continued to be involved in the activities of the National Coordination Group (NCG) responsible for the technical, institutional and legislative arrangements for the introduction of the euro. This process falls within the responsibility of the Ministry of Finance. As no target date has yet been set for euro adoption in the Czech Republic, the NCG is focusing mainly on methodological tasks and communication activities.

The CNB's role in the NCG is significant, as many of the tasks associated with the changeover will fall within the direct competence of the central bank. The CNB is represented in the leadership of the NCG, as a CNB board member is a vice-chairman of the NCG and is also the head of the Financial Sector Working Group (FSWG). The CNB also chairs the Communication Working Group jointly with the Ministry of Finance. Its representatives also participate in all other working groups at the expert level.

In April 2008, the Government approved a *Report on the Fulfilment of the National Changeover Plan*. The CNB and the FSWG chaired by the CNB played a major role in preparing this document. This group also drew up the first methodological recommendations concerning the financial sector's preparations for the changeover, namely in the area of product conversion and dual display of prices of capital market products, interest rate conversion following euro adoption and conversion of account balances.

The CNB and the Ministry of Finance joined a European project of technical assistance in support of euro adoption provided by the National Bank of Belgium.

CNB representatives also attend meetings of the European Commission's working group for technical and organisational issues relating to euro adoption (PAN II) and the working group for communication (DirCom). Valuable information and experience can be gained here from the existing euro area members. The CNB continuously monitored the preparations in neighbouring Slovakia, whose experience will be very valuable and inspiring to us in the future.

The central bank's main tasks in the changeover process are covered in more detail in the CNB's October 2007 document *Updated Tasks Relating to the Introduction of the Euro in the Czech Republic*, which can be found on the CNB website (*International relations, technical assistance – The euro*).

In 2008, the NCG launched an official website devoted to euro adoption – [www.zavedenieura.cz](http://www.zavedenieura.cz). It also organised a number of conferences and seminars on this topic.

### **FINANCIAL MARKET OPERATIONS**

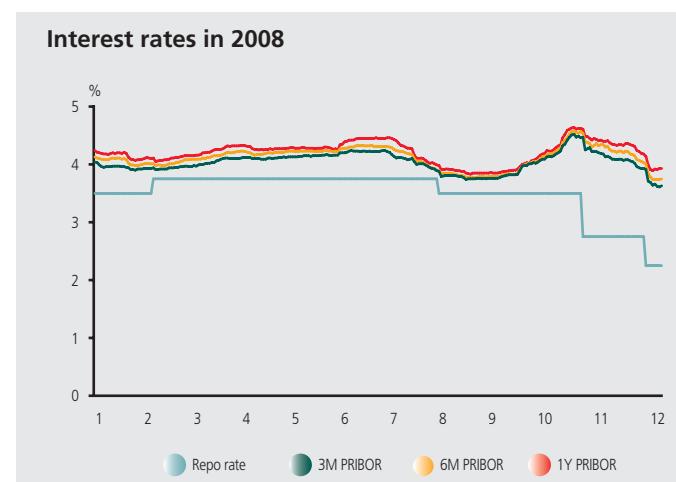
The CNB implements monetary policy by means of a system of monetary policy instruments consisting of financial market operations, automatic facilities and reserve requirements. Financial market operations play a pivotal role in steering interest rates, managing the liquidity of the banking system and signalling the monetary policy stance. The CNB Bank Board sets three interest rates: the two-week repo rate, the discount rate and the Lombard rate. The main monetary policy rate is

the two-week repo rate. By setting this interest rate, the CNB influences the short end of the yield curve. The discount and Lombard rates provide the floor and ceiling respectively for short-term interest rates on the money market. Changes in the repo rate (set half-way between the above two rates) are accompanied by symmetrical changes in the discount and Lombard rates.

February 2008 saw the last step in a series of interest rate increases, with the repo rate reaching 3.75%. In the second half of the year, interest rates were cut in three steps. The repo rate was lowered by 25 basis points to 3.50% with effect from 8 August, by 75 basis points to 2.75% with effect from 7 November and by 50 basis points to 2.25% with effect from 18 December.

The CNB manages the liquidity of the banking sector through money market operations so as to maintain an optimum liquidity level for compliance with the reserve requirement. This ensures that short-term interest rates are stable at the desired level. The decision-making on the central bank's money market operations is based on a daily analysis and forecast of banking sector liquidity and on the money market situation.

In 2008, the main instrument for managing short-term interest rates was again the two-week repo, announced three times a week. Given the persistent excess liquidity in the Czech banking system, the CNB used these operations to absorb excess reserves (unlike for example the ECB, which provides liquidity). The liquidity absorbed is remunerated at the repo rate at most. The excess liquidity absorbed in monetary operations in 2008 was CZK 368 billion on average. The average amount of liquidity absorbed fell by approximately CZK 31 billion relative to the 2007 average.



This decrease was due to steady growth in currency in circulation and to an extraordinary one-off increase in liquidity in October 2008 associated with uncertainty caused by the outbreak of the financial crisis on foreign markets. This one-off fluctuation was partly reversed as some currency was returned to banks in the form of deposits and some continued to be held by households and corporations. The overall increase in currency in circulation in 2008 was CZK 46 billion. The sterilisation volume decreased by the same amount. Other factors affecting the sterilisation volume included the continuing sell-off of a portion of the returns on the international reserves (EUR 747 million sold, effect on sterilisation volume -CZK 18.6 billion), foreign exchange client operations (EUR 319 million purchased, effect on sterilisation volume +CZK 8 billion) and a gradual rise in the reserve requirement (effect on sterilisation volume -CZK 4.9 billion). The fall in

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the sterilisation volume was counteracted by interest paid on monetary operations, which totalled CZK 14.8 billion. Of this, interest paid to banks was CZK 13.2 billion and interest paid on the required reserves was CZK 1.6 billion.

The large decline in the sterilisation volume at the end of the year (of around CZK 103 billion compared to the end of November) was due mainly to seasonal effects. There was an increase in state fixed-purpose funds with the CNB, since they are not allowed to be short-term invested in the market over the end of the year, and the growth rate of currency in circulation rose in connection with Christmas. These factors are short-term and closely linked with the end of the calendar year, and their effect gradually abates during January.

The CNB's instruments also included two "automatic" facilities – the marginal lending facility and the deposit facility. Under the lending facility, the CNB lends overnight funds to banks against eligible collateral in the form of securities. Such loans are charged interest at the Lombard rate. The Lombard rate thus provides a ceiling for short-term interest rates. The CNB accepts CNB-issued bills, bonds issued and unconditionally guaranteed by the Czech Republic and koruna securities issued or unconditionally guaranteed by EU governments and selected multilateral issuers as collateral. The deposit facility gives banks the option of making overnight deposits with the CNB at the discount rate. The discount rate provides a floor for short-term interest rates. The minimum volume for these operations is CZK 10 million. Fine-tuning operations (ad hoc repos and reverse repos under market conditions) are used only rarely. In 2008, the CNB continued issuing its own bills, which it used as collateral for open market operations. In addition, CNB bills are used by banks as collateral against intraday credit from the CNB. Such credit is provided to ensure the smooth running of the payment system at CNB Clearing. The CNB charges no interest on such credit. There is automatic spillover into the marginal lending facility in the event of non-repayment of intra-day credit at the end of the day.

### Extraordinary operations

These operations are not standard instruments. The CNB executed them in October 2008 in response to the financial crisis. Increased cash withdrawals caused a fall in primary deposits in some banks, forcing them to obtain liquidity from other sources. This proved difficult in a situation of limited functioning of the interbank market. The operations were aimed at increasing liquidity on the secondary government bond market and opening other channels for banks to obtain liquidity. They took the form of reverse repos and foreign exchange swaps. In the reverse repos, the CNB supplied liquidity to banks against pledged securities with maturities of 14 days or

**Amount of liquidity provided in extraordinary operations**

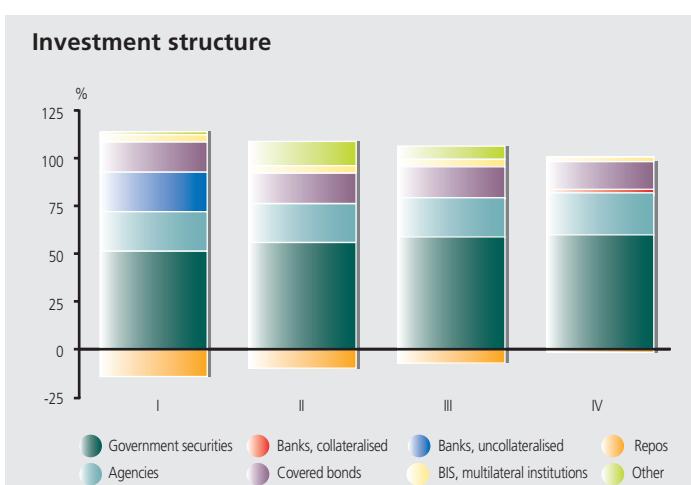


three months. The interest rate on the 14-day operations was set 10 basis points above the CNB's repo rate and the rate on the three-month operations equalled the CNB's repo rate plus 30 basis points. Foreign exchange swaps to provide koruna liquidity against the euro were offered to banks with a maturity of their choice of up to three months. The 14-day liquidity-providing repos were the most frequently used of these operations, the other types being supplementary. These measures were welcomed even by banks that did not use the facilities, as they provided a channel for obtaining liquidity if the need arose.

#### Management of the CNB's international reserves in 2008

International reserves are the CNB's foreign assets in convertible currencies. They comprise deposits in foreign banks, securities, gold, the reserve position with the IMF and other reserve assets. At the end of 2008, the international reserves represented approximately 89% of the CNB's assets, and the return on these reserves was the CNB's most significant revenue item.

The CNB holds international reserves to support its independent monetary and exchange rate policy-making and as a source of foreign exchange liquidity for CNB clients, to whom the CNB sells foreign currency in exchange for koruna. The volume of the reserves is published regularly in the *Financial Markets* section of the CNB website. In managing the international reserves, the CNB aims to attain maximum and stable returns subject to compliance with the stipulated liquidity restrictions and market and credit risk limits. Portfolio managers invest the international reserves in particular instruments in compliance with the principles of the CNB's reserve management policy and subject to investment opportunities and the situation on the financial markets. The largest part of both portfolios is invested in securities issued by the governments of OECD countries, government-guaranteed securities, or securities issued by eligible agencies and multilateral institutions with maturities of more than one year. At the same time, both portfolios are invested mainly in credit instruments with the highest rating – AAA. In the first half of 2008, credit exposure to banks was minimised because of a broad deterioration in ratings. The proportion of investment in government bonds was simultaneously raised to increase the liquidity of the reserves. Lower marketability on the markets in agency and covered bonds led to temporary fixing of investments. The evolution of the investment structure in 2008 is shown in the chart below.



The CNB's international reserves amounted to CZK 706 billion at the end of 2008, up by CZK 81 billion on a year earlier. The rise in the reserves in koruna terms

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was due to portfolio returns (CZK 45 billion), external flows<sup>19</sup> into the reserves (CZK 32 billion) and depreciation of the koruna against the dollar (CZK 14 billion) and the euro (CZK 9 billion). By contrast, the conversion of a portion of the above-mentioned returns into koruna fostered a decrease in the reserves (CZK 19 billion). No foreign exchange interventions were made in 2008. In euro terms, the market value of the international reserves was EUR 26.2 billion (an annual increase of EUR 2.8 billion) and in dollar terms it rose by USD 1.9 billion to USD 36.5 billion. Besides the aforementioned factors, the market value of the international reserves (expressed in these terms) was also affected by the euro-dollar exchange rate.

At the end of 2008, the international reserves were allocated as follows: 59.7% EUR, 31.4% USD, 4.5% JPY, 3.0% GBP and 1.4% SDR and gold. This represents a slight change from the previous year, mainly due to the gradual transfer of a portion of the dollar portfolio into the euro portfolio. The international reserves can be divided into a euro portfolio and a dollar portfolio, which is partly diversified into JPY and GBP using currency forwards. The return on the JPY and GBP positions forms part of the return on the dollar portfolio.

The parameters defining the interest rate risk assumed are also set separately for each portfolio. The parameters set in 2008 continued to be based on the requirement that the portfolios should not record a loss over the investment horizon, which is one year for the euro portfolio and three years for the dollar portfolio. At the end of 2008, the modified duration<sup>20</sup> was 2.5 years for the euro portfolio and around 4.0 years for the dollar portfolio.

The rate of return on the reserve portfolios is measured both in absolute terms and relative to benchmark portfolios. Measuring the relative rate of return indicates how successful the strategies implemented by the portfolio managers were relative to the benchmark portfolios. The rate of return on the euro portfolio was 6.04% and that on the dollar portfolio 8.96% in 2008. The relative rate of return (i.e. the difference between the rate of return on the actual portfolio and that on the benchmark) was -15.5 basis points for the euro portfolio and -46.3 basis points for the dollar portfolio. The rate of return on the gold portfolio, including valuation changes, amounted to 11.09%.

The overall rate of return on the international reserves, measured as a weighted average of all portfolios, was 7.17% (up by 1.45 percentage points compared to 2007). The weighted average of the return on the portfolios in koruna terms, i.e. including exchange rate gains and losses, was 10.91% due to the koruna depreciation, up by 13.24 percentage points on a year earlier. Although the risk profile of the portfolios is relatively conservative, the rate of return for 2008 was exceptionally high. The financial market crisis resulted in extremely strong demand for government bonds, which make up more than half of the portfolios.

The first step in investing in stock indices was taken in 2008. The equity portfolios are managed externally by BlackRock and State Street. At the end of 2008, stocks represented 1.4% of the market value of the international reserves. According to the plan approved by the Bank Board, the equity exposure will increase steadily to 10% of the international reserves in 2011. The strategy of a gradual, and not sudden, increase in equity exposure proved to be wise, as the returns on stock indices were very low owing to the financial crisis. The non-annualised rate of return on the euro portfolio with the MSCI Euro benchmark was -36.88%, the dollar stock portfolio with the S&P 500 benchmark returned -34.28%, the sterling portfolio with

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<sup>19</sup> External flows originate from purchases/sales of foreign currency from/to CNB clients and client deposits in foreign currency. A year-on-year increase in the deposits of the National Fund of the Ministry of Finance, which manages the flows of funds provided by the EU, was the main contributor.

<sup>20</sup> A variable expressing sensitivity to interest rate movements.

the FTSE 100 benchmark generated -25.40% and the return on the yen portfolio with the Nikkei 225 benchmark was -37.40%. Despite the temporary adverse effect on the CNB's financial results, we regard the negative returns on the equity portfolios as confirmation that the chosen strategy is right. The negative correlation with the yield on fixed-income instruments and the volume share set in the international reserves were the main starting points for the inclusion of stock index investments.

### ECONOMIC RESEARCH

Economic research at the CNB creates an analytical and knowledge base for monetary policy-making, financial market supervision and maintaining financial stability, and furthers the development of the central bank's human capital. Economic research also helps to develop the CNB's position within the ESCB and vis-à-vis the domestic and international academic community. More details on research activities at the CNB are available at <http://www.cnb.cz/en/research/>.

The CNB issued numerous interesting research publications in 2008. The book *Evaluation of the Fulfilment of the CNB's Inflation Targets 1998–2007* marked the tenth anniversary of inflation targeting. The ten chapters of this book assess the Czech experience with inflation targeting from various perspectives, serving as a basis for further refinement of this monetary policy regime. In 2008, a total of 15 internationally reviewed articles were published in the CNB Working Paper Series and the CNB Research and Policy Notes. Two issues of the Economic Research Bulletin also came out, focusing on the ten years of inflation targeting in the Czech Republic and the model background of this policy strategy. Many research papers were also published in prestigious international and regional journals. In 2008, CNB economists won the Austrian central bank's Olga Radzyner Award, the Bank for International Settlements' Financial Stability Institute Award and the Czech Economic Society's Karel Engliš Prize for their research publications.

The CNB's research projects focus on topics relevant to the central bank. The relevance and quality of research outputs were assessed in a new review report *CNB Economic Research: Focus on 2005–2006*. The research project coordinators are involved in the monetary policy-making process through the preparation of opinions on the situation reports on economic developments and the minutes of monetary policy meetings. These opinions ensure that the usual analytical activities are subject to internal review, thereby fostering better decision-making. The topics raised during monetary policy discussions are taken into account by the coordinators when setting research priorities. Research results are also used in the Financial Stability Report and the annual Analyses of the Czech Republic's Current Economic Alignment with the Euro Area.

The CNB organised or coorganised three international conferences in 2008. In April it organised an international conference celebrating the 15<sup>th</sup> anniversary of the CNB and the 10<sup>th</sup> anniversary of inflation targeting in the Czech Republic. Ten years of inflation targeting was also the topic of the fourth Research Open Day held in May. In October, the CNB Congress Centre hosted the 11<sup>th</sup> international conference *The Market for Retail Financial Services: Development, Integration and Economic Effects* organised jointly by the CNB, the ECB and the Centre for Financial Studies at the University of Frankfurt am Main.

In addition to international conferences, the CNB organised, as in previous years, five important seminars in cooperation with the Czech Economic Society and the Centre for Economic Research and Graduate Education (CERGE-EI). The speakers included Fabio Canova (Universitat Pompeu Fabra), Thomas J. Sargent (New York University), Gabriel Fagan (European Central Bank), Giuseppe Bertola (Università di Torino) and Oleh Havrylyshyn (University of Toronto).

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CNB economists are actively involved in the international Wage Dynamics Network (WDN), which studies the dynamics of wages and labour costs and their implications for monetary policy throughout Europe. This network is coordinated by the ECB and involves economists from national central banks and the ECB as well as leading external experts. The first outcome was a conference held at the ECB in June 2008, whose agenda is available on the ECB website ([http://www.ecb.int/events/conferences/html/wage\\_dynamics\\_network.en.html](http://www.ecb.int/events/conferences/html/wage_dynamics_network.en.html)).

The CNB Bank Board's advisory body for economic research is the Research Advisory Committee, whose members include leading foreign experts. The Committee's main role is to provide a foundation for the Bank Board's decisions on research projects. In 2008, the members of the Committee were: Iain Begg (European Institute at the London School of Economics), Nicoletta Batini (International Monetary Fund), Andrew Blake (Bank of England), Carsten Detken (European Central Bank) and László Halpern (Hungarian Academy of Sciences). The President of the Committee is CNB Governor Zdeněk Tůma and its Chairman is Chief Executive Director Robert Holman. The internal members of the Committee are the Executive Directors of the CNB's Economic Research Department, Monetary and Statistics Department, Financial Market Regulation and Analyses Department, Financial Market Supervision Department and Risk Management and Transactions Support Department, together with the four research project coordinators.

### **FINANCIAL STABILITY**

Maintaining financial stability is defined in the Act on the CNB as one of the CNB's primary objectives. The most important activities fostering fulfilment of this objective are the monitoring of risks to the stability of the domestic financial system and the assessment of its ability to absorb external shocks. The main focus is traditionally on banks as the primary financial intermediaries. However, the rising importance of the financial markets and non-bank financial institutions and infrastructures and their links with banks, mean that the CNB has to monitor the vulnerability of these elements of the system as well. The CNB defines financial stability as a situation where the financial system operates with no serious failures or undesirable impacts on the present and future development of the economy as a whole, while showing a high degree of resilience to shocks. From this point of view, 2008 was a challenging year.

The pressures on financial stability intensified considerably as a result of the financial market turbulence that began in summer 2007 and turned into a global financial crisis during 2008, causing a slowdown in global economic growth. Although the Czech banking system was not directly affected by the crisis thanks to its sound

balance sheet structure and capitalisation, liquidity declined in some financial market segments as a result of a general lack of market confidence. The CNB responded by adopting measures leading to rapid stabilisation of those segments.

A sharp slowdown in economic growth abroad and a related decline in net export growth, weakening domestic economic activity and a subsequent worsening of the financial sector's performance had been identified as the main risks in the 2007 Financial Stability Report. Unfortunately, these risks materialised in 2008. Subsequent financial stability analyses thus focused on the persisting market instability, the tightening credit conditions, the potential deterioration in banks' financial condition and on appropriate economic policy recommendations.

In 2008, the CNB continued to work in cooperation with other national and international authorities in the area of financial stability, not only in official EU structures (Banking Supervision Committee, Working Group on Macro-Prudential Analysis, Working Group on Banking Developments, EFC Financial Stability Table, Lamfalussy committees, etc.), but also on a regional basis, for example in the area of stress testing. The CNB extended its programme of technical assistance for less developed countries to include financial stability issues. Recognition of the CNB's achievements in this area was manifested, among other things, by the participation of its representative at the prestigious OECD Forum in Paris, which discussed future changes in financial market regulation.

To maintain financial stability, the CNB focuses on prevention and broad communication with the public regarding the potential risks and factors posing a threat to financial stability. One of the areas aiding the fulfilment of this objective is financial education, which is increasingly being addressed by the CNB (see the *Consumer protection* section of this report). A particularly important aspect of communication of the risks to financial stability was an emphasis on preventing a unified negative view of the region in which the Czech Republic is classified from forming. The Financial Stability Report is the most important part of such communication. This report, published annually since 2004, aims to assess developments in the past year and to identify potential risks to the stability of the Czech financial system in the period ahead. The CNB has a legal obligation to submit this report to the Chamber of Deputies (the lower house of the Czech Parliament). The Financial Stability Report for 2008 will be published in June 2009. It will be made available in electronic form in both Czech and English in the *Financial Stability* section of the CNB website.



Research publications in the field of financial stability also serve as a channel of communication with professional economists. The results can be found in research publications (for details, see [www.cnb.cz](http://www.cnb.cz) and the *Economic research* section of this report), in articles and papers published in professional journals and in the thematic articles of the Financial Stability Report.

### STATISTICS

In 2008, CNB statistics continued to provide an information resource for analytical work at the CNB, for professional economists and for the production of EU statistics. The main drivers of development of the statistics were harmonising with EU standards, meeting the requirements of domestic users and keeping the reporting burden at an acceptable level. The requirements of domestic and European users overlap significantly, as analysts are interested in internationally comparable information. Besides the standards valid across all EU Member States, with which the CNB is compliant, there are also requirements for euro area countries. Though these standards are not formally binding until euro adoption, they include an obligation to provide retrospective time series as from EU entry. The CNB is therefore gradually introducing these statistics. CNB representatives continued to participate in the production of new statistics and standards, particularly within European statistical structures both in the ESCB and in cooperation with Eurostat. Specific national requirements are also arising outside the scope of these harmonised statistics. For example, the CNB responded to the growing interest in government finance indicators by starting to publish such indicators.

The collection of source data for individual statistics is a separate area. The CNB has been exploiting the benefits of incorporating financial market supervision into its structure. This organisational set-up enables the CNB to combine the statistical reporting requirements with the supervisory requirements into a single set of statements. In 2008, two joint banking statements were created for securities holdings, on the basis of which data will be collected from 2009. This enabled eight existing statements to be discontinued. In addition, a progressive method of data collection by individual securities was used, under which respondents submit only primary data and do not have to perform any aggregation. This method is very efficient for reporting entities, as the aggregation work passes to the compiler, i.e. the CNB. The availability of individual data additionally enables the compiler to change the output structure where necessary, without creating additional requirements or necessitating changes in reporting. Cooperation with the Czech Banking Association contributed significantly to optimising the structure of the reported information and the way it is transmitted.

#### Monetary and financial statistics

Along with traditional monetary statistics data, the CNB increasingly provides information on financial non-banking institutions – collective investment funds, financial corporations engaged in lending, etc. Some statistics were further developed in 2008. Since April 2008, the long-term interest rate statistics for convergence purposes have been based on a basket of government securities, not just on one security. This was facilitated by the development of the relevant financial market segment. In addition to the aforementioned method of collecting source information on securities from banks, this method was used in the preparation of new statements for collective investment funds.

#### Balance of payments statistics

In addition to quarterly information on the balance of payments and the international investment position and information on the breakdown of foreign direct investment flows by territory and economic activity, users are now accustomed to monthly

disclosure of basic balance of payments data. In 2008, the CNB started sending information on the basic characteristics of securities issued by residents to the ECB statistics database. This should improve the quality of information on securities.

#### **Financial accounts statistics**

The process of developing the existing stock data and the preparatory work on expanding the outputs, particularly in the area of transactions and counterparties, continues in this relatively young area of statistics. The accompanying commentary is being steadily expanded to include analytical indicators of the financial accounts statistics and selected counterparty data. During 2008, cooperation also continued with the CZSO on the harmonisation of the annual (CZSO) and quarterly (CNB) financial accounts statistics, including an extension of the scope of the data transmitted from the CNB's statistics to the CZSO.

### **THE CNB AS THE BANK OF THE STATE**

The CNB provides banking services for the state and the public sector under Act No. 6/1993 Coll., on the Czech National Bank, as amended, and Act No. 218/2000 Coll., on Budgetary Rules and on the Amendment of Some Related Acts (The Budgetary Rules), as amended. It maintains the revenue and expenditure accounts of state organisational units connected to the state budget, revenue and customs offices, the Czech Social Security Administration, labour offices, subsidised organisations, state funds and businesses that receive subsidies from the state budget, and accounts connected to the budget of the European Communities. At the end of 2008, the CNB maintained 26,700 such accounts. The CNB is also responsible for the non-cash payment of state social benefits. For example, 7.1 million transactions relating to state social benefits, 9.2 million health insurance and employment policy contributions and 2.4 million transactions connected with VAT administration were recorded on these accounts in 2008.

#### **Support for Treasury liquidity management**

Since approximately 2000, the CNB has been working in close partnership with the Ministry of Finance on a Treasury development project in the Czech Republic, under which it provides the Treasury with payment services.

Under agreements on the performance of Treasury activities, the CNB created financial tools for the Ministry of Finance enabling automated transmission of information on the intra-day Treasury balance. The CNB also provides the Treasury with an internet application which allows budget chapter administrators to set budget limits for Treasury expenditure accounts interactively and gives them direct access to information on limits and current drawings on individual accounts.

The CNB is also responsible for the daily consolidation of state sector funds<sup>21</sup> on an aggregate Treasury account and works closely with the Ministry of Finance on continuously managing intra-day liquidity on this account, including drafting recommendations for daily lending or investment operations. Current-day expenditures and their coverage by funds on the state accounts are continuously compared within the CNB's payment and settlement system (ABO) so that maximum use can be made of any temporary free liquidity. In the event of any temporary mismatch between revenues and expenditures, either additional funds are obtained

<sup>21</sup> Accounts subject to consolidation are defined in Act No. 218/2000 Coll., on Budgetary Rules. Above all, they include revenue and expenditure accounts of the state budget, state financial assets accounts, revenue offices' accounts, Treasury liquidity management accounts, the reserve fund accounts of organisational units of the state and newly, since March 2008, the reserve fund accounts of cultural and social needs.

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to finance expenditures through sales of T-bills on the financial market, or surplus Treasury funds are invested in bills (T-bills or CNB bills). In this way, Treasury funds are used in the most effective way possible and debt service costs are minimised. The daily average balance on the aggregate Treasury account was about CZK 9 million in 2008, but was reduced to around CZK 7 million in the final quarter thanks to more precise liquidity management.

### **Support for state debt financing**

The CNB acts as a fiscal agent for state debt management on behalf of the Ministry of Finance. In practice, this chiefly involves organising primary sales of government bonds and providing expert consultations.

In 2008, the CNB organised 23 auctions of T-bills on behalf of the Ministry of Finance. The Ministry of Finance issued bills with maturities of between three and twelve months totalling CZK 200.9 billion. Of this amount, bills amounting to CZK 100 billion were purchased by the issuer and placed in its portfolio to be used later on as collateral in financial market operations to bridge short-term liquidity shortages. The bills were sold by Dutch auction. At the end of 2008, the outstanding volume of T-bills was around CZK 78.7 billion.

During the year, the CNB also organised 19 primary auctions of medium- and long-term government bonds on behalf of the Ministry of Finance, totalling CZK 150.5 billion. These involved both the re-opening of existing issues and new issues. The Ministry of Finance's new issues had maturities of 3 and 8 years. The 8-year bond has a variable coupon derived from the 6M PRIBOR (4.28% on the auction day) and was issued in three tranches with a total volume of CZK 32 billion last year. In early June, the Ministry of Finance issued its third eurobond issue on foreign markets, with a maturity of 10 years, a 5.00% coupon and a volume of EUR 2.0 billion. The Ministry of Finance purchased bonds worth almost CZK 53 billion into its own portfolio in primary auctions. Two government bond issues totalling just under CZK 83 billion were redeemed in 2008. The outstanding volume of debt in medium- and long-term bonds increased from CZK 770.9 billion to CZK 873.4 billion compared to 2007.

## **EUROPEAN AND INTERNATIONAL COOPERATION, FOREIGN TECHNICAL ASSISTANCE**

### **European Central Bank, European System of Central Banks**

Since 1 May 2004, the CNB has been a full member of the European System of Central Banks (ESCB), which comprises the European Central Bank (ECB) and the 27 National Central Banks (NCBs) of the EU. The CNB Governor regularly attends meetings of the ECB General Council – one of the ECB's three decision-making bodies, along with the Governing Council and the Executive Board. The General Council meets four times a year. Two teleconferences were held in addition to the regular meetings in the first half of 2008. The agenda of the first involved the approval of the regular ECB Convergence Report. Such reports are prepared every two years for non-euro area countries. The report assessed the fulfilment of the economic and legislative criteria for euro adoption by ten countries – Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Sweden. The other teleconference discussed a change of the Slovak koruna's ERM II central rate.

Important issues discussed at the meetings of the General Council included macroeconomic, monetary and financial developments around the world and developments in the banking sector. The discussions in the second half of 2008 were dominated by current financial market developments amid the continuing global financial and economic crisis.

As in previous years, CNB representatives were involved in the ESCB's 13 committees and numerous working groups. The major items on the agenda included the preparation of major documents on the macroeconomic situation, the government financial position, the prohibition of monetary financing, the functioning of ERM II and on the outlook for the global economy. Issues relating to the counterfeiting of euro banknotes and coins, the preparation of the second series of euro banknotes and the TARGET2 and SEPA projects were also discussed.

More than 130 documents were prepared in written consultations and written procedures at the CNB in 2008. The CNB made comments in 19 cases. Written consultations represent the Member States' duty to consult the ECB on any draft legislation falling within its fields of competence. The number of legislative proposals discussed in the final quarter of 2008 more than tripled compared to previous quarters (to 69). This surge was due to national legislative proposals connected with the financial crisis.

#### **CNB representation in EU Council bodies**

The CNB's representation in bodies linked to the Council of the European Union also plays an important role. The CNB Governor attends the informal meetings of ECOFIN held twice a year in the country that holds the Presidency of the Council of the European Union. The main topics at the 2008 meetings in Ljubljana and Nice included the economic situation, financial stability, financial market supervision, quality of public finances and reform of the IMF. A CNB vice-governor also attends the meetings of the Economic and Financial Committee (EFC), which acts in an advisory capacity to the Council of the European Union. Among other things, the Committee discussed the Convergence Reports of the Commission and the ECB, the current economic situation and financial stability and supervisory issues in 2008. In the second half of 2008, the EFC's discussions concentrated mainly on solutions to the global crisis in the financial sector. The CNB is also actively involved in the work of the EFC Sub-Committee on International Monetary Fund Matters (SCIMF).

#### **EU Committee**

The EU Committee is the main political coordinating body for relations between the Czech Republic and the European Union. It currently operates on two levels. At government level (prime minister and ministers of key departments), it discusses key political issues related to the Czech Republic's EU membership. At working level (deputy ministers), it discusses and approves positions, instructions and mandates for the Czech Republic's representatives in the EU Council and its working groups as well as documents submitted for discussion in the EU Committee at government level. The CNB enjoys the status of an associate member (at governor/vice-governor level). The CNB submits a report on its relations with the ESCB/ECB to the Committee twice a year. Within the CNB, the Coordination Meeting for EU Issues, chaired by a vice-governor, is used to coordinate activities and discuss European issues.

The main topic of the EU Committee's meetings in 2008 was the preparations for the Czech Presidency of the EU Council in the first half of 2009 in terms of both content and organisation. The official programme document – *The Work Programme of the 2009 Czech Presidency* – was published at the start of 2009. The Czech Presidency website was launched on 1 December 2008.

The Work Programme contains the Presidency's main motto "Europe Without Barriers". Its key topics are the Economy, Energy and the European Union in the World (the three Es). The economic and financial topics, which stand at the centre of the CNB's professional interest, have been expanded by comparison with the original plans. As well as references to resolving the current economic situation, including financial sector stability, they include the lifting of barriers to the movement of services and a new financial architecture. In the context of

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the expected Europe-wide debate of changes in the financial market supervisory set-up, the Programme of the Czech Presidency – at the initiative of the CNB – also points out the importance of having an integrated national supervisory set-up (emphasising a functional model across all sectors of the financial market).

### **International Monetary Fund and World Bank Group**

On 28 April 2008, the Board of Governors of the IMF adopted Resolution 63-2 on Quota and Voice Reform following extensive discussions about the reform of members' quotas. The aim of the reform is to provide for fairer reflection of the economic weights of individual countries, in particular the fast-growing Asian economies. The Resolution amends the existing quota system by introducing a quota increase for 54 member countries. The Czech Republic's quota will rise from SDR 819.3 million to SDR 1,002.2 million. In relative terms, its quota and voice will rise from 0.38% to 0.42%.

Current cooperation between the Czech Republic and the IMF mainly takes the form of annual consultations, which are performed in accordance with Article IV of the IMF's Articles of Agreement. The last consultation was held on 13–24 November 2008. The IMF stated that the economy was set to slow sharply in 2009 following three years of rapid growth. Inflation was likely to fall to the inflation target. Export competitiveness was adequate and the external position had remained strong. The modest current account deficit was expected to be comfortably financed by direct investment inflows. The Executive Board of the IMF praised the economic fundamentals, saying that they had helped the Czech economy to weather the initial effects of the global financial crisis relatively well. Owing to its high openness, however, the Czech economy had been buffeted by the crisis. Given the prospect of an economic slowdown in 2009, Executive Directors of the IMF emphasised that it was important to preserve financial stability and mitigate the impact of the downturn, using the flexibility gained from past sound policies. At the same time, it was emphasised that the government should remain mindful of the medium-term fiscal and inflation objectives.

### **Bank for International Settlements**

As in the previous period, the CNB Governor attended the regular meetings of central bank governors of BIS countries held every two months, where strategic issues relating to the international financial system and financial market stability are discussed. In addition, he attended the BIS Annual General Meeting in June 2008. The CNB is represented in the International Liaison Group (ILG) and its working subgroup, the International Liaison Group on Capital (ILGC). Three meetings of the ILG were held in 2008, addressing mainly asset impairment and provisioning, risk-based supervision and microfinance.

### **Organisation for Economic Cooperation and Development**

CNB representatives attended the meetings of the Economic Policy Committee and the Committee on Financial Markets. They were also involved in the activities of the working group on pension systems and in the meetings of the Economic and Development Review Committee. The meetings of these working bodies of the OECD mainly discussed topical issues, in particular the current situation in global financial markets.

The CNB was also actively involved in the preparation and discussion of the OECD's regular review of economic developments in the Czech Republic. The review was discussed in Paris in March 2008 within the Economic and Development Review Committee. The official publication ceremony in Prague in April 2008 was attended by the Secretary-General of the OECD Angel Gurría. The economic situation in the Czech Republic was assessed positively by the OECD. In addition to standard economic issues, this review focused on the recently launched public finance reform.

The process of enlargement of the OECD to include Russia, Chile, Estonia, Slovenia and Israel continued in 2008. The OECD was also actively involved in analysing the causes and consequences of the current financial and economic crisis. It prepared an "OECD action plan" to help resolve the current problems of the financial sector.

### **European Bank for Reconstruction and Development**

On completing the EBRD graduation process at the close of 2007, the Czech Republic became a donor country. The EBRD no longer invests in new projects in the Czech Republic, not even under regional projects. Existing projects will be completed in line with contractual obligations. Recognition of a member country as an advanced nation by such a significant international financial institution as the EBRD is viewed as an important message for foreign investors.

During its two years as a donor, the Czech Republic has built up a respected position and has gained a reputation as an active partner. It is involved in the EBRD's donor activities within the Western Balkans Fund, the aim of which is to support projects and to develop institutions and legislation. The Czech Republic's donor contributions totalled EUR 0.5 million in 2006, EUR 2.5 million in 2007 and EUR 2.0 million in 2008. In 2006–2008, Czech entities won 20 consultancy contracts worth a total of EUR 2.62 million.

A new Czech donor fund has been operating within the EBRD since the start of 2008. It is a tied fund, intended for contracts with Czech consultancies and for projects in countries that are recipients of Official Development Assistance. A promotional seminar was held at the CNB Congress Centre in Prague in April 2008 to inform Czech consultancies about this newly established fund and generally about the EBRD's technical cooperation programmes.

### **Foreign technical assistance**

The CNB continued providing active technical assistance. The foundations for this activity were laid in 2002, when an active FTA programme – designed mainly for countries of South-East Europe and the former Soviet Union – was prepared for the first time.

A total of 30 projects, including 8 seminars, were held within this programme in 2008, attended by almost 150 people from 32 central banks. In addition, the CNB organised 12 consultations for experts from the central banks of Albania, China, Kazakhstan, Latvia, Mongolia, Romania, Serbia, Turkey, Ukraine and Vietnam.



## 2. OBJECTIVES AND TASKS AND THEIR FULFILMENT

CNB staff also provided expert assistance in the form of consultations or lectures at central banks and international organisations in 2008. Numerous consultations took place in recipient banks (for example in Albania, Armenia, Belarus, Egypt, Indonesia and Macedonia). The total amount spent directly by the CNB on such assistance was CZK 780,800. CNB experts also took part in missions of the IMF, the UNDP and other international organisations. In 2008, the CNB became involved in joint EU-funded projects with other ESCB central banks. These included a banking supervision project for the central bank of Egypt and a project for the National Bank of Serbia relating to its preparations for future ESCB membership. This activity of the CNB is valued not only by the seminar and consultation participants themselves, but also by the BIS in Basel, which monitors the technical assistance provided by central banks.

### TECHNOLOGY AND SECURITY

#### **Computing and communication systems**

The central bank's activities are supported and safeguarded by the information and communication systems making up the CNB system environment. The emphasis is on performance, reliability and accessibility, subject to maximum cost-effectiveness and security. Reliable and sufficiently effective communication with the outside world and internal communication between the CNB's premises, as well as safe, economically sound and accessible technology, forms the basis for the CNB's core activities.

As in previous years, the CNB continued cutting the investment and operational costs of its computing and communication systems in 2008. At the same time, their technological level, reliability and performance were enhanced, the secure operation of information systems and technologies was safeguarded and internal expertise was improved. No failure affecting the CNB's activities was recorded in 2008.

A total of 18 new information systems – supporting virtually all the areas of activity of the CNB – were developed and implemented last year. These mostly involved projects to expand major information systems in the fields of statistics, financial market supervision, currency issuance and management and interbank payments and settlements. The regular upgrading of system environment elements continued, with a focus on higher performance and accessibility combined with increased efficiency and security. Replacement of disc arrays started with the purchase of the hardware needed to ensure sufficient capacity for current and planned information systems and to reduce operating expenses. Replacement of a proportion of the CNB's application and database servers and standard PCs was completed successfully. Finally, the CNB's printing strategy continued to be implemented. The acquisition of new multifunctional devices helped to streamline service support, reduce the number and types of reprographic devices and concentrate printing functions into higher performance devices. As a result, total operating expenses were reduced.

#### **Crisis management system**

The CNB has a duty to safeguard the performance and scope of the key activities defined in the Act on CNB, even at times of emergency. The CNB has a comprehensive crisis management system in place to deal with any emergency. In 2008, this system was methodologically managed by the Crisis Management and Classified Information Protection Department.

The measures to be implemented in the event of an emergency at the CNB are defined precisely and are also laid down in the implementing documentation of the CNB'S Crisis Plan. This documentation was tested in 2008. The main aim of the series of practical exercises was to test the coordination between the CNB and the fire-fighting units of the Czech Fire Service in the event of a fire. The exercise in

the CNB's main premises, where its headquarters and Prague branch are located, additionally included a continuity test of the critical activities of the main premises within the CNB's back-up system. The CNB's back-up facility and its Plzeň branch, which is one of the elements of the CNB's back-up system, were activated during the test. The test verified that the critical activities under test can be performed to the expected standard from the designated backup facilities.

In 2008, the contingency plans for critical financial market infrastructure – which falls within the CNB's responsibility – were updated. The individual contingency plans were unified with the emergency plans required by the financial market supervisory authority and were also revised significantly. The resulting document thus fully meets the requirements of both plans.

Another major event was an inspection of the protection of classified information carried out at the CNB by the National Security Office. In addition to the department's ongoing internal control activities, the preparations included a systematic inspection of how classified information is protected by other organisational units of the CNB. The inspection proved that the classified information protection system is configured and secured to a very high standard at the CNB in full compliance with Act No. 412/2005 Coll., on the Protection of Classified Information and on Security Clearance, as amended.



## THE CNB AND THE PUBLIC



### EXTERNAL COMMUNICATIONS

Four topics that greatly affected the CNB's communication work in 2008 were the expected sharp rise in inflation in the first half of the year, the excessive appreciation of the koruna, the global financial crisis and the euro. CNB communication was therefore more intensive and more thematically varied than in previous years. However, the gamble on transparent and open communication has paid off and the CNB still enjoys considerable respect and confidence both from the general public and from specialists. The latest survey conducted by the STEM agency, published in late 2008, revealed that 70% of respondents had confidence in the CNB. This is particularly gratifying because it means we have managed to maintain our reputation even during the current economic and financial crisis.



The issuance of money is traditionally a topic which directly affects the general public. The CNB issued a new 1,000-koruna banknote in April 2008 and decided that 50-heller coins and 20-koruna banknotes would cease to be legal tender at the end of August. An intensive communication campaign was prepared for both events, for both professionals and the general public. The issuance of gold and silver commemorative coins also has a good media image. The high-quality design and execution of the coins combined with generally higher public interest in investing in precious metals are being reflected in greater media coverage of this central bank activity.

In the field of external communication, we have concentrated in the past on restructuring the "communication infrastructure". The CNB website has been redesigned, with a focus on clarity for the various target groups. A toll-free line was introduced following the integration of supervision into the central bank. And great emphasis is also put on the speed at which written enquiries or suggestions from the public are dealt with.

Monetary policy communication also underwent a change towards greater transparency in 2008. The CNB has been publishing the implied interest rate path and the votes cast by the board members by name since the start of 2008. More detailed information can be found in the *Monetary policy and economic developments* section.

As regards the upgrading of technical resources and communication tools, only minor changes were implemented in 2008. One of the these – introduced at the request of CNB website users – was the use of "siblings", i.e. pairs of pages that "belong" to each other in the web structure. In layman's language, this function enables visitors to the site to switch directly to the same page in a different language. During 2008, this

function was configured for most pages that have Czech and English equivalents. The *Calendar* web application, where advisories are posted for published information, speeches or interviews with Bank Board members and other CNB events, became a useful source of information, especially for the media.

Although the CNB's publications, given their specialised terminology, are intended primarily for economists and other specialists, they are increasingly becoming a source of information for students, journalists and the general public. The CNB issues numerous regular publications (the Annual Report, Inflation Reports, the Financial Stability Report and the Financial Market Supervision Report) in Czech and English, in both printed and electronic forms. At the end of 2008, the CNB published a book entitled *Central Banking in the Czech Lands*. This one-off publication is available in university and regional libraries and can also be viewed in the CNB's special library. In the second half of 2008, the CNB also introduced ISBN and ISSN numbering of its publications.

Dealing with written, electronic and telephone enquiries and suggestions from the public is an important part of CNB communication. The number of written submissions handled rose to 577 in 2008 (from 536 in 2007), the number of e-mails sent to info@cnb.cz dealt with rose to 2,648 (from 2,572 in 2007) and the number of Green Line calls answered fell to 3,154 (from 3,850 in 2007). The CNB is one of the institutions subject to Act No. 106/1999 Coll., on Freedom of Information. The number of applications submitted under the above Act increased from 15 to 19 in 2008.

## EXHIBITION

The CNB Exhibition, installed in a former strong-room, is a long-time favourite with visitors. This is demonstrated by the fact that the permanent exhibition *People and Money* welcomed its 100,000<sup>th</sup> visitor in June 2008, eight years after it first opened its doors. In 2008, the exhibition had 15,397 visitors, again slightly more than in the previous year. During term time, most of the visitors were primary and secondary school pupils. Most secondary schools specialising in economics have already incorporated a visit to the exhibition into their curricula. Visits for groups of pupils therefore need to be booked a year or more in advance. Thanks to its attractive setting and large amounts of specialised information, the CNB Exhibition is also popular with the media of all types and is used for filming reports and special-interest programmes. During the summer holidays the exhibition is visited mainly by foreign visitors and organised groups of tourists.



In 2008, the CNB Exhibition was used more frequently for special events such as press conferences, training events and social gatherings, which were attended by around 1,000 foreign and domestic guests of the CNB. Among other things, it hosted the official launch of the book *Central Banking in the Czech Lands* by Jakub Kunert and Jiří Novotný, who work in the Archive of the CNB; the issuance of the commemorative CZK 200 silver coin marking the 650<sup>th</sup> anniversary of the "Issuance of the Decree of Charles IV on Vineyard Planting"; and a gathering to celebrate the 15<sup>th</sup> anniversary of the opening of the Czech Mint.

A new exhibit called the *Golden Showcase* met with a very positive response from visitors. It features four separate areas where "bricks" the size of a gold bar, made of wood, iron, lead and fine gold, are installed. Visitors have the opportunity to touch the exhibits and feel how heavy they are. They can thus not only compare the different surfaces and weights of the materials, but also experience the high density of gold. The opportunity to touch a gold bar weighing about 12.5 kg and worth around CZK 8.5 million is an unforgettable experience for many visitors.

Newly issued gold commemorative coins from the *Industrial Heritage Sites* series, silver coins, Czech banknotes and euro coins of the countries that introduced the euro as their currency on 1 January 2008 were added to the permanent exhibition *People and Money* as the year progressed. Further information is available in the *Exhibition* section of the CNB website.

#### SPECIAL LIBRARY

The CNB's special library has a long tradition, having operated without interruption as a highly specialised public library since 1926. Its collection offers information that is not available anywhere else in the Czech Republic, comprising literature on economics, law, computer technology, politics and history, as well as encyclopaedias, language textbooks and biographies of prominent personalities. A collection of current books and periodicals is deposited in the reading room and is freely accessible to all users. Overall, the library maintains and provides access to more than 54,000 publications, i.e. about 40,000 books and 14,000 study texts, annual reports and research reports and 1,200 periodicals (including documents of central banks, the International Monetary Fund, the World Bank, the European Central Bank and other major international institutions). In 2008, the library acquired 2,121 books, 1,685 study texts, research reports and annual reports and about 7,500 periodicals and other publications. The library provides its users with lending, advisory, reference, bibliographic and research services. In 2008 it continued to provide access to the Internet and to bibliographic, full-text and numerical databases. Electronic law journals were added to its range of publications. Cataloguing of unique collections previously unavailable to users in the library's electronic catalogue continued in 2008. These archives contain various publications from domestic and foreign banks and economic documents dating back to the first half of the 20<sup>th</sup> century.

In 2008, the library registered 6,076 active readers, who made 18,760 visits and borrowed 34,937 publications. The library is open 38 hours a week, Monday to Thursday from 9 a.m. to 5 p.m. and Friday from 9 a.m. to 3 p.m. The public can also get information via the CNB's website (the *CNB special library* section) or directly from its online catalogue (<http://sd.ruk.cuni.cz/tinweb/cnbanka/k6>) and can reserve books, extend borrowing periods, etc. by e-mailing lib@cnb.cz.

#### CONGRESS CENTRE

The CNB Congress Centre, located in the former Commodity Exchange on Senovážné Square, is a venue for meetings between the CNB's top management and representatives

of central banks of other states, deputies and senators of the Parliament of the Czech Republic, financial market representatives, trade unions, financial analysts and journalists. Specialised units of the CNB hold conferences, lectures, presentations, insurance intermediaries' examinations and press conferences there. However, the premises are not only used by the CNB, but are also rented out to institutions such as universities, the Liberal Institute, the Czech Economic Society and the Czech Banking Association. Meetings of committees and working groups of the European Central Bank and the European System of Central Banks were held there last year. They included an informal meeting of the Economic and Financial Committee of the EU, a meeting of the Working Group on Euro Area Accounts, a meeting of the Working Group on Monetary and Financial Statistics and the international conference *Market for Retail Financial Services: Development, Integration, and Economic Effects*. The European Banking and Financial Forum, which took place at the Congress Centre, has become something of a tradition. Other significant events included the conference *Economic and Political Consequences of the Key Milestones 1848, 1918, 1938, 1948, 1968* organised by the University of Economics in Prague and the international conference on *Challenges Faced by Advanced Inflation Targeters* attended by governors of the central banks of numerous countries from all over the world. Other events worth mentioning included the *Computer Crime in Banking* seminar and the lectures given by prominent economists such as Angel Gurría and William Niskanen. A meeting of the Executive Council of the International Association of Deposit Insurers and the CIFA international forum *Investor's Freedom or Consumer's Protection?* were also held there.

The Congress Centre is also used for major social gatherings. In 2008, these included an official ceremony to mark World Water Day and the *Máme otvěrno?* (Are We Open?) charity evening. The Large Congress Hall's excellent acoustics have made it popular with music lovers. Concerts of the Prague Spring and Young Prague international music festivals are performed here regularly.



In 2008, the CNB continued its tradition of hosting exhibitions of photographs in the foyer of the Congress Centre. An exhibition entitled *Golden Collection – Part IV*, focusing on landscape in Czech photography and comprising photographs lent by the National Museum of Photography in Jindřichův Hradec, was organised in 2008. Also highly interesting was an exhibition of coursework by students from the Veronika Bromová studio at the Academy of Arts in Prague entitled *NEW MEDIA II*. The exhibition year ended with the opening of an exhibition of photographs entitled *NUDE – Masters of Black and White Photography* from the collection of the Union of Czech Photographers. Further information is available on the CNB website (*About the CNB – Headquarters – Congress Centre*).



## THE CNB AND ITS PEOPLE

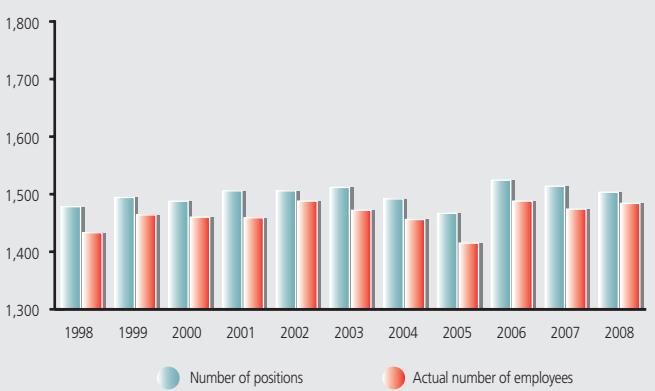


Human resources are vital to successful fulfilment of the CNB's objectives and tasks. Human capital, which the CNB has been working systematically to improve since its establishment, is a foundation we can rely on when managing the difficult tasks we face at this time of global economic crisis. The CNB is therefore devoting particular attention to enhancing the quality of managerial work at all levels of management in the long term.

### Number of employees

At the end of 2008, the CNB had 1,484 employees, up by 10 compared to 2007. This increase was due to the recruitment of staff for consumer-protection related activities and was partly offset by the fading effects of a personnel audit conducted in CNB branches in 2007. More vacancies were also filled in 2008. The number of positions declined by 10 year on year and was roughly the same as in 2001.

**Number of positions and actual number of employees**



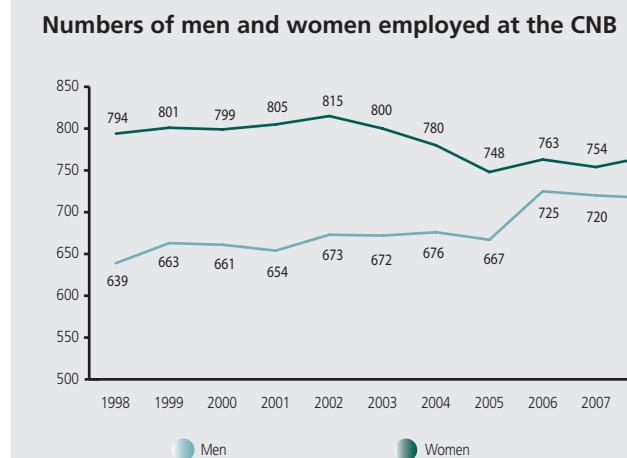
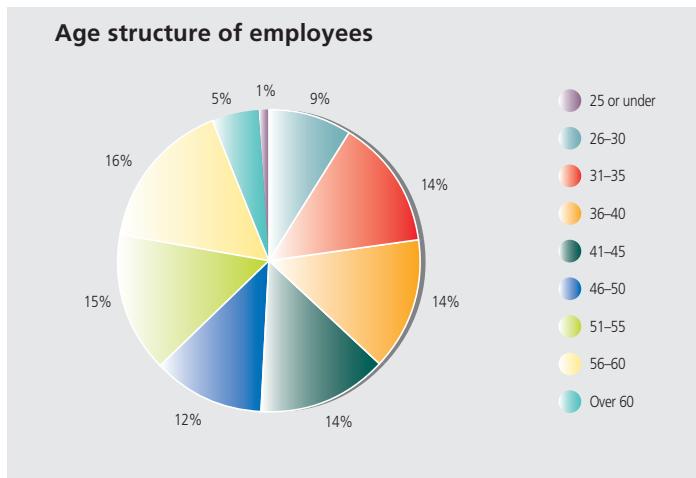
In 2008, a total of 116 new employees were taken on and 106 persons terminated their employment, of whom 29 retired. The number of employees who left the bank in 2008 as a result of the personnel audit in CNB branches in 2007 and other organisational changes was 15. The recruitment of new employees generally takes the form of headhunting and written job applications, direct approaches to selected students in their final years at university, and job advertisements, tenders and selection procedures. Employment is preceded by a demanding interview with the applicant to verify his or her professional qualifications and personal attributes.

### Level of education of CNB employees

As of 31 December 2008, university graduates made up 48% of the total CNB workforce, while employees with secondary school education (ending with a school leaving exam) and higher vocational training recorded a 40% share. The remaining 12% had basic education or vocational training (without a school leaving certificate).

### Age structure and ratio of men to women

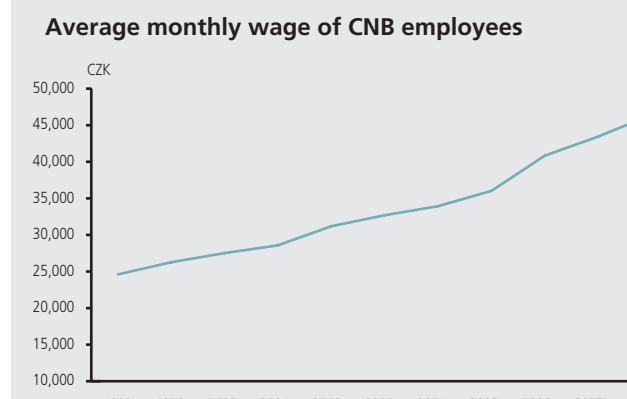
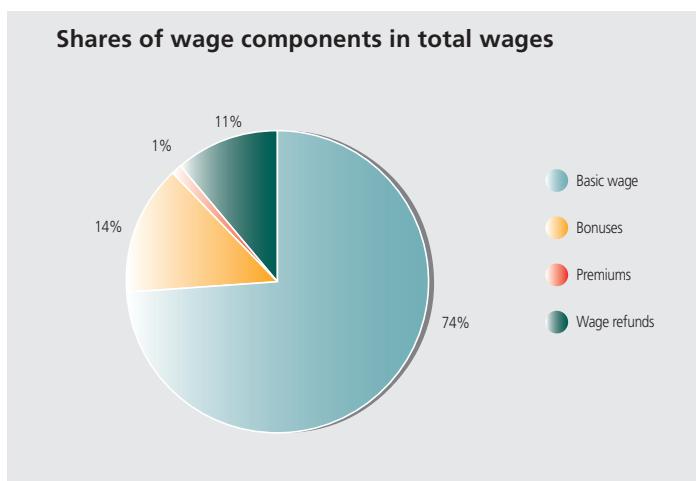
Disregarding the extreme age ranges (i.e. 25 years or under, and over 60 years), the age structure of the CNB's employees is balanced, with all age groups evenly represented. The average age of the CNB's workforce as of 31 December 2008 was 44.5 years.



The ratio between men and women employed at the CNB has gradually been equalising and has stabilised at approximately 48:52 since the fundamental reorganisation of the CNB in 1998.

#### The CNB's salary system

The main component of the CNB's salary system is the basic wage, which is based on a sliding scale. The salary supplement, amounting to 25% of the basic wage, which was intended to compensate CNB employees in part for the increased duties and limits imposed on them by the Labour Code beyond the framework of their general basic duties, was abolished on 1 January 2008 and incorporated into the basic wage. In addition to the basic wage, employees can be given performance-related bonuses.



Personnel expenses totalled CZK 1,159 million in 2008, up by 4.8% on a year earlier. A total of CZK 822 million was paid in salaries, i.e. 6.3% more than in 2007. The average monthly wage was CZK 46,440. The average annual wage increased by 6.9%. Statutory insurance payments amounted to CZK 276 million. Other social costs totalled CZK 24 million. The largest part of these expenses (CZK 18 million) comprised life insurance and pension scheme contributions provided to employees.

**The salaries of Bank Board members were as follows:**

	Gross salary in CZK <sup>1)</sup>	Net salary in CZK <sup>2)</sup>
Zdeněk Tůma	4,518,389	3,703,139
Mojmír Hampl	3,537,146	2,869,083
Miroslav Singer	3,648,324	2,942,224
Robert Holman	2,996,789	2,405,329
Pavel Režábek	3,047,887	2,431,853
Vladimír Tomšík	3,058,887	2,416,363
Eva Zamrazilová	2,551,875 <sup>3)</sup>	2,032,803 <sup>3)</sup>
Luděk Niedermayer	963,167 <sup>4)</sup>	659,280 <sup>4)</sup>

<sup>1)</sup> The gross salary comprises the basic wage, holiday pay, performance-related bonuses and bonuses for working on non-working days.

<sup>2)</sup> The net salary is the gross salary net of "capped" state health insurance contributions, social security contributions, state employment policy contributions and income tax and tax discounts for the taxpayer and dependent children.

<sup>3)</sup> Salary for the period starting with appointment to the post of Bank Board member on 1 March 2008.

<sup>4)</sup> The figure comprises the salary for the period of performance of the duties of Bank Board member until 26 February 2008, and compensation for the bar on working until the end of the "waiting time" (i.e. the period during which Bank Board members are obliged to remain CNB employees and not enter any other employment, owing to protection of the CNB's interests).

**Staff training**

Staff training is one of the CNB's human resource management priorities. It encompasses internal training organised within the CNB, training provided by domestic external organisations (including university studies), language training and training provided in other countries. In 2008, spending on employee training totalled CZK 37 million. Language training was focused on further enhancing employees' language skills, especially in the area of specialised terminology and communication.

As for training abroad, the CNB continued working with partner central banks. Courses and seminars organised by international banking and financial institutions (the International Monetary Fund, the Joint Vienna Institute and the Financial Stability Institute) played a major role in specialised training. There was greater interest in highly specialised seminars and workshops and increasing involvement in the system of education organised within the European System of Central Banks, including a rising number of training events organised by the CNB. There was also an increase in the number of financial market regulatory and supervisory staff attending seminars organised by the CEBS, CESR and CEIOPS within and across the individual sectors of financial market regulation and supervision in the EU.

The internal training event programme saw an increase in the proportion of specialised courses in individual CNB business areas, especially financial market regulation and supervision. Employees remained interested in preparing for international certification such as ACCA, CIA, CFA, FRM and CISA.

Other important elements of staff training included exchange study visits lasting between 2 weeks and 3 months and consultations between central bank staff and financial market regulatory and supervisory institutions in the EU.



# FINANCIAL REPORT



**INDEPENDENT AUDITOR'S REPORT**

To the Bank Board of Česká národní banka:

- I. We have audited the financial statements of Česká národní banka as at 31 December 2008 presented on the enclosed CD-ROM and our audit report dated 20 February 2009 stated the following:

"We have audited the accompanying financial statements of Česká národní banka, which comprise the balance sheet as at 31 December 2008, and the income statement for the year then ended, and a summary of significant accounting policies and other explanatory notes. For details of Česká národní banka, see Note 1 to the financial statements.

***Management's Responsibility for the Financial Statements***

The management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the Czech Republic. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies and making accounting estimates that are reasonable in the circumstances.

***Auditor's Responsibility***

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, International Standards on Auditing as amended by implementation guidance of the Chamber of Auditors of the Czech Republic. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including an assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

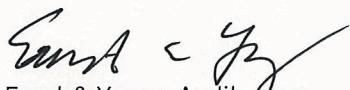
*Opinion*

In our opinion, the financial statements present fairly, in all material respects, the financial position of Česká národní banka as at 31 December 2008, and its financial performance for the year then ended in accordance with accounting principles generally accepted in the Czech Republic."

- II. We have also audited the consistency of the annual report with the above-mentioned financial statements. The management of Česká národní banka is responsible for the accuracy of the annual report. Our responsibility is to express, based on our audit, an opinion on the consistency of the annual report with the financial statements.

We conducted our audit in accordance with International Standards on Auditing and the related implementation guidance issued by the Chamber of Auditors of the Czech Republic. Those standards require that we plan and perform the audit to obtain reasonable assurance as to whether the information presented in the annual report that describes the facts reflected in the financial statements is consistent, in all material respect, with the financial statements. We have checked that the accounting information presented in the annual report in section 5 "Financial report" is consistent with that contained in the audited financial statements as at 31 December 2008. We believe that our audit provides a reasonable basis for our opinion.

Based on our audit, the accounting information presented in the annual report is consistent, in all material respects, with the above-mentioned financial statements.



Ernst & Young Audit, s.r.o.

License No. 401

Represented by Partner



Magdalena Soucek

Auditor, License No. 1291

20 February 2009  
Prague, Czech Republic

## FINANCIAL STATEMENTS

<b>BALANCE SHEET</b>		31 Dec. 2008	31 Dec. 2007
		in CZK millions	
1.	<b>Gold</b>	796	809
2.	<b>Receivables from the International Monetary Fund</b>	24,707	24,209
3.	<b>Receivables from abroad, including securities</b>	707,739	719,681
3.1.	Deposits at foreign banks and financial institutions	2,478	48,928
3.2.	Loans provided to foreign banks	9,973	4,992
3.3.	Securities	695,132	665,645
3.4.	Other receivables from abroad	156	116
4.	<b>Receivables from domestic banks</b>	38,039	9
5.	<b>Fixed assets</b>	5,251	5,519
5.1.	Tangible fixed assets	5,223	5,473
5.2.	Intangible assets	28	46
6.	<b>Other assets</b>	7,863	6,283
6.1.	Other financial assets	3,006	2,687
6.2.	Receivables from former banks	0	0
6.3.	Other	4,857	3,596
	<b>TOTAL ASSETS</b>	<b>784,395</b>	<b>756,510</b>
1.	<b>Currency in circulation</b>	399,248	353,703
2.	<b>Liabilities to the International Monetary Fund</b>	21,008	22,162
3.	<b>Liabilities abroad</b>	2,838	97,366
3.1.	Loans from foreign banks	1,582	96,962
3.2.	Other liabilities abroad	1,256	404
4.	<b>Liabilities to domestic banks</b>	307,883	279,197
4.1.	Bank monetary reserves	31,741	21,421
4.2.	Loans received	193,567	241,530
4.3.	Other liabilities to banks	82,575	16,246
5.	<b>Liabilities to clients</b>	178,592	181,004
5.1.	Liabilities to the state	156,609	152,359
5.2.	Other liabilities to clients	21,983	28,645
6.	<b>Provisions</b>	222	208
7.	<b>Share capital</b>	1,400	1,400
8.	<b>Funds</b>	8,046	8,087
9.	<b>Revaluation reserve</b>	26,925	6,655
10.	<b>Accumulated losses from previous periods</b>	(199,640)	(162,133)
11.	<b>Net (loss) / profit for the period</b>	29,128	(37,507)
12.	<b>Other liabilities</b>	8,745	6,368
	<b>TOTAL LIABILITIES AND EQUITY</b>	<b>784,395</b>	<b>756,510</b>

The CNB changed the structure of the asset and liability items reported in the balance sheet as of 31 December 2008. The reasons for the change compared to 31 December 2007 and a detailed description of the change, including a conversion guide, are given in the notes to the CNB financial statements as of 31 December 2008 on the attached CD-ROM.

<b>OFF BALANCE SHEET</b>		31 Dec. 2008	31 Dec. 2007
		in CZK millions	
1.	<b>Guarantees issued</b>	161,432	161,505
2.	<b>Receivables from spot, term and option transactions</b>	91,187	115,248
3.	<b>Liabilities from spot, term and option transactions</b>	91,166	115,710
4.	<b>Guarantees received</b>	156,954	157,006
5.	<b>Collateral received</b>	62,238	139,965
6.	<b>Values taken into custody and values in own custody</b>	925	925

<b>INCOME STATEMENT</b>		<b>31 Dec. 2008</b>	<b>31 Dec. 2007</b>
in CZK millions			
<b>1.</b>	<b>Interest income and similar income</b>	<b>26,109</b>	<b>31,968</b>
1.1.	Interest from fixed income securities	24,891	27,427
1.2.	Other	1,218	4,541
<b>2.</b>	<b>Interest expense and similar expense</b>	<b>(16,836)</b>	<b>(16,914)</b>
<b>3.</b>	<b>Income from shares and other interests</b>	<b>139</b>	<b>47</b>
<b>4.</b>	<b>Fee and commission income</b>	<b>465</b>	<b>490</b>
<b>5.</b>	<b>Fee and commission expense</b>	<b>(48)</b>	<b>(47)</b>
<b>6.</b>	<b>Gains less losses from financial operations</b>	<b>21,445</b>	<b>(50,889)</b>
6.1.	Net foreign exchange gains / (losses) and foreign exchange spread	20,602	(47,183)
6.2.	Other	843	(3,706)
<b>7.</b>	<b>Other operating income</b>	<b>299</b>	<b>149</b>
7.1.	Income from money issue	86	46
7.2.	Other	213	103
<b>8.</b>	<b>Other operating expense</b>	<b>(432)</b>	<b>(293)</b>
8.1.	Expenses for production of notes and coins	(342)	(264)
8.2.	Other	(90)	(29)
<b>9.</b>	<b>Administration expense</b>	<b>(1,582)</b>	<b>(1,545)</b>
9.1.	Personnel expenses	(1,159)	(1,105)
9.1.1.	Wages and salaries	(822)	(773)
9.1.2.	Social and health security	(276)	(275)
9.1.3.	Training and other expenses	(61)	(57)
9.2.	Other administration expenses	(423)	(440)
<b>10.</b>	<b>Depreciation and amortisation of fixed assets</b>	<b>(433)</b>	<b>(480)</b>
<b>11.</b>	<b>Reversal of provisions for receivables and guarantees, income from receivables already written off</b>	<b>1,110</b>	<b>12</b>
<b>12.</b>	<b>Write offs, additions and utilisation of provisions for receivables and guarantees</b>	<b>(1,108)</b>	<b>(5)</b>
<b>13.</b>	<b>Net (loss) / profit for the period</b>	<b>29,128</b>	<b>(37,507)</b>

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

The year 2008 can be assessed positively from the point of view of the CNB's performance. The CNB recorded a profit of CZK 29,128 million at the year-end, which, in line with financial management principles, was then used to cover past losses to the maximum possible extent. Despite this, an accumulated loss of CZK 170,555 million from past years will remain uncovered.

The primary objective of the CNB is to maintain price stability. Monetary policy-making is fully subordinated to this. Monetary policy operations affect the bank's profit and have a key effect on its final figure. The nominal exchange rate of the koruna is a particularly significant factor, since the CNB has a high share of foreign exchange assets in its balance sheet. The domestic currency was highly volatile against the euro and the dollar in 2008. In the first half of the year, the koruna showed a rapid appreciation trend, reaching historical highs in mid-July. In the second half of the year it started to display a marked depreciation trend due to the problems in world financial markets and the economic slowdown. As a result, the CNB posted exchange rate profits totalling CZK 20,214 million at the year-end.

Owing to the dramatic developments in the financial markets, the CNB implemented a number of measures during 2008 to reduce the financial risks associated with international reserves management. Among other things, investment in unsecured banking instruments and new purchases of covered bonds were stopped altogether. In addition, trading with more than 30 counterparties was individually limited, exposure to U.S. mortgage agencies was restricted and limits on the total nominal value of some foreign government securities were introduced. Besides that, lending of securities was suspended temporarily.

Overall, international reserves management yielded the CNB net income of CZK 25,552 million. Net of capital gains from the revaluation of bonds (revaluation gains are recorded on the capital accounts, i.e. off the income statement), which totalled CZK 24,497 million as of 31 December 2008, the CNB achieved the highest yield on international reserves management of its entire independent existence. The weighted average return on the foreign exchange portfolio was 7.17% p.a., a year-on-year increase of 1.45 percentage point.

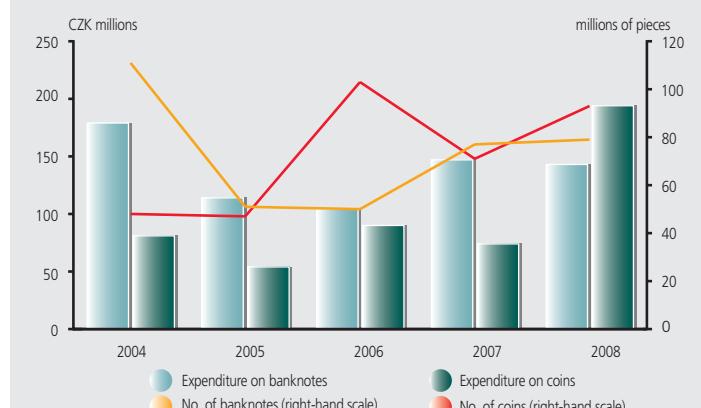
The CNB employed the same monetary policy instruments as in previous years. The costs of open market operations increased year on year, as the CNB's key interest rates were higher than in the previous period for most of 2008, falling substantially only at the close of the year. The higher interest rates also affected the remuneration of commercial banks' minimum reserve holdings with the central bank. Open market operations, conducted in the form of repo operations, and remuneration of banks' minimum reserve holdings brought a loss of CZK 14,873 million.

Owing to the developments in the financial markets, the CNB commenced regular liquidity-providing repo operations in October 2008. The purpose of this technical measure was to support banking sector liquidity and also to ensure the smooth functioning of the government bond market and reduce the spillover of the problems in foreign financial markets to the Czech financial sector. Given their start date and remuneration method (the final interest rate is based on the CNB's 2-week repo rate), the overall impact on the bank's performance was not very significant.

**The CNB's performance 2000–2008**



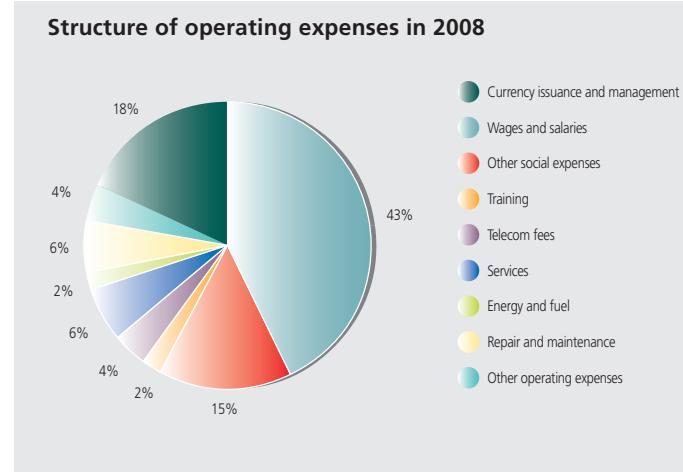
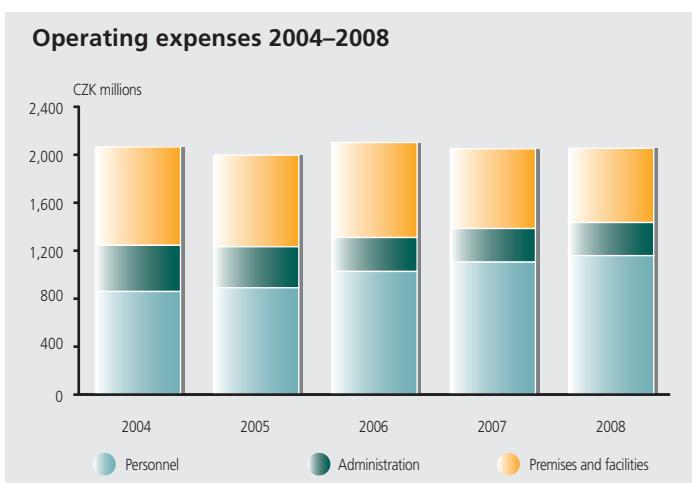
**Expenditure on the purchase of Czech money 2004–2008**



A rise in money in circulation, accompanied by a gradual replenishing of the central bank's money stocks, and the implementation of a project to upgrade the security features of Czech banknotes led to an increase in the CNB's currency issuance and management expenses in the last two years. In 2008, the CNB purchased 79 million banknotes at a cost of CZK 143 million. It paid CZK 193 million for base metal coins and silver and gold commemorative coins, of which CZK 137 million was spent on 93 million base metal coins. Expenditure on the preparation and protection of banknotes and coins fell, as the CNB had already implemented a large part of the project to upgrade the security features of Czech banknotes in previous years. The costs of silver and gold commemorative coin production were fully covered by receipts from their sales, which totalled CZK 86 million in 2008. The remaining income of CZK 18 million consisted of cash deposit and withdrawal fees received from banks.

The CNB terminated the validity of 50-heller coins on 31 August 2008, as they had ceased to perform the fundamental function of circulating currency. These coins will be exchangeable until August 2014. The unreturned proportion of the coins will subsequently be charged to the bank's income.

The CNB has long succeeded in maintaining stable operating expenses, despite the expansion of its responsibilities for financial market supervision and newly also consumer protection in this area. Its steadily rising personnel costs are being offset by a more efficient management of administrative activities and premises and facilities.

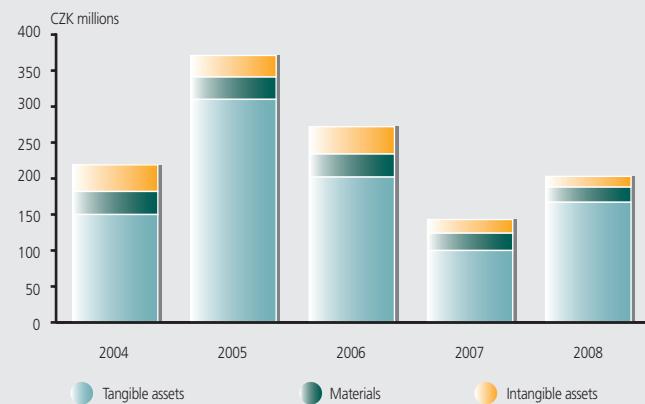
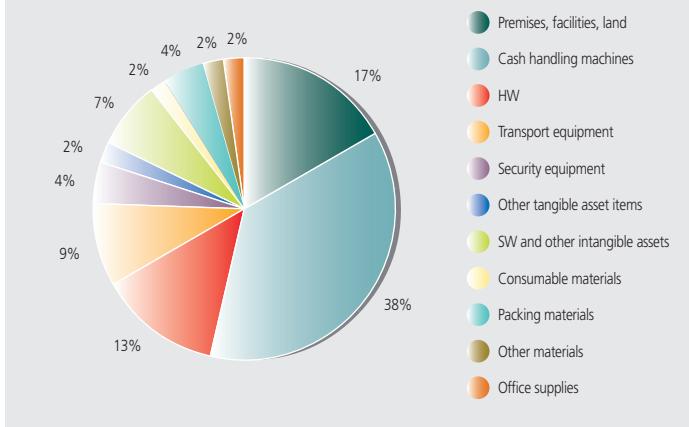


The CNB had 1,484 employees at the end of 2008. The year-on-year increase in the number of employed people (ten employees) was due to the creation of new positions for consumer protection activities (a total of 17 employees). It was partly offset by a reduction in the number of posts at CNB branches. Personnel expenses, i.e. wages including obligatory insurance contributions, training expenses and other social expenses in the areas of health care and food, were 4.8% higher than a year earlier and amounted to CZK 1,159 million.

A write-off of operating claims and the utilisation of related provisions contributed to a marked year-on-year increase in total administration expenses and income. Following the conclusion of bankruptcy proceedings against the bankrupt Pozemní stavby Zlín-Group, a.s., the CNB decided to write off the remaining outstanding claims (mostly arising from unpaid contractual penalties) to costs and simultaneously released a provision fully covering the written-off claims to income. The overall impact on the bank's performance was thus neutral. Administrative expenses totalled CZK 276 million adjusted for operating claims. This represented a year-on-year decline of CZK 4 million compared to the similarly adjusted 2007 costs.

Expenditure on the operation of premises and facilities was CZK 619 million, a year-on-year fall of CZK 46 million. This decrease was due to a higher rate of depreciation of assets (especially computers, including software), which was reflected in lower write-offs, and to a change in contractual terms and conditions and in the scope of maintenance services provided in the IT area. The remaining expenditure on the operation of the bank's premises and facilities was approximately at the previous year's level.

Operating income net of the release of provisions for operating claims amounted to CZK 110 million. Fees levied during financial market supervision, premises rental receipts and the sale of unusable assets accounted for the largest part.

**Asset acquisition costs 2004–2008****Asset acquisition structure in 2008**

Asset acquisition expenditure totalled CZK 203 million in 2008. CZK 167 million was spent on tangible assets, CZK 21 million on materials and CZK 15 million on intangible assets. Compared to 2007, the total expenditure increased by 42%, with a particularly large rise being recorded in the area of cash storage, handling and processing technology.

From the long-term perspective, the largest expenditure item is cash processing technology. This technology periodically has to be replaced and the capacity of the cash processing machines increased. In 2008, the CNB's Ostrava branch launched a pilot project of multi-denominational banknote processing, consisting in upgrading one banknote processing machine to enable simultaneous processing of various denominations of banknotes received from a single client. If the project is successful, multi-denominational banknote processing is expected to be introduced in other branches.

The CNB also spent significant amounts on information system development projects, on software and on necessary upgrades of existing equipment.

Construction costs have fallen substantially since the completion of the CNB's back-up centre in Praha-Zličín in 2006. In 2008, minor alterations were made to existing buildings and equipment. A more significant investment was an expansion of the cooling system in offices and conference rooms at the CNB's headquarters.

Material acquisition expenditure, which was lower than in 2007, went mostly on banknote and coin packing materials, office supplies and computer parts and consumables.



# PROVISION OF INFORMATION UNDER ACT NO. 106/1999 COLL.



The Czech National Bank's procedure for complying with the duties ensuing from Act No. 106/1999 Coll., on Freedom of Information, as amended (hereinafter the "Act"), and in particular its procedure for dealing with applications for information in compliance therewith, is internally regulated by Czech National Bank Directive No. 55 of 13 December 2002, on the communication of the Czech National Bank, as amended by Amendment No. 5 of 1 January 2009.

Under the Act, the CNB provides information to applicants on the basis of applications or by way of public disclosure.

**A) Information provided in 2008 on the basis of applications:**

1. Number of applications for information submitted in compliance with the Act:  
Nineteen.
2. Number of decisions refusing an application:  
One
3. Number of appeals submitted against decisions:  
None
4. Transcript of the relevant parts of each court judgement concerning the examination of the legality of an obliged entity's decision refusing an application for information and an overview of all expenses incurred by the obliged entity in connection with court proceedings on rights and obligations under this Act, including its own staff expenses and legal representation costs:  
None
5. Number of exclusive licences granted, including justification of the necessity to grant exclusive licences:  
None
6. Number of complaints submitted under Article 16a, reasons for their submission and a brief description of the manner in which they were dealt with:  
None
7. Other information relating to the application of the Act:  
Most written, e-mail and telephone applications for information received in 2008 concerned information whose provision went beyond the scope of the existing legislation. In 2008, the CNB answered 577 written and 2,648 e-mail enquiries from the public.

**B) Information provided by way of public disclosure:**

The Czech National Bank publishes and continuously updates information in a manner allowing remote access. The information disclosed pursuant to Articles 5(1) and 5(2) of the Act is provided on notice boards at CNB headquarters and branches, in locations accessible to the public, and also on the CNB website ([www.cnb.cz/en](http://www.cnb.cz/en)). A wide range of other information on the activities and responsibilities of the CNB is also published on the state administration web portal.

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