The Czech National Bank is pleased to present to the public its Financial Stability Report for 2006. In so doing it is fulfilling its new task stipulated by the Act on the CNB as from last year – to analyse the financial system, see to the sound operation and development of the financial market in the Czech Republic and contribute to the stability of its financial system as a whole.

The structure of the Report is broadly similar to that of the previous reports for 2004 and 2005, but its main part contains one less section. The introduction is followed by a section called The real economy. Its structure is based on the assumption that the financial sector operates in an environment shaped by external and domestic macroeconomic developments. These affect the situation of domestic corporations and households, who are the main debtors and creditors of financial institutions and represent the primary source of credit risk for them. The next section, entitled Asset markets and the financial infrastructure, contains an analysis of the financial markets and deals with an increasingly important segment of the asset market - the property market. It also looks at trends in the financial infrastructure area, where the CNB is actively involved. The last section, The financial sector, focuses on banks and non-bank financial institutions themselves. Attention is paid to the financial sector’s structure, the profitability and efficiency of its institutions, the quality of the loan portfolio and compliance with prudential criteria. All these factors affect the ability of financial institutions to cope with potential shocks and threats.

Like last year, the Report includes four thematic articles relating to financial stability issues. The first article again deals with stress testing of the banking sector. In addition to updating the stress tests conducted in the previous reports, the stress testing system has been extended to include a credit growth forecasting model and a credit risk model. The tests now also deal with the portfolios of non-financial corporations and households in addition to the aggregate loan portfolio. The second article sets out to describe and discuss the methodology of selected financial soundness and financial stability indicators, including the attempts to construct an aggregate financial stability indicator. The third article discusses two FDI-related phenomena that may directly or indirectly affect financial stability, namely the sources of finance in companies founded by FDI and the life cycle of FDI. The last article is concerned with the capital market. It examines the market’s efficiency by analysing the responses of prices on the Czech organised markets to the announcement of specific tender offers for minority shareholders’ shares. The Report ends with a list of all the abbreviations used and a glossary of selected terms.

The Report analyses the evolution of relevant indicators in 2006. Where 2006 data were not available, data for the previous period were used. Data for the first months of 2007 were also used where available.

This Financial Stability Report was approved by the Bank Board of the Czech National Bank on 17 May 2007. It is available in electronic form at http://www.cnb.cz/.