Developments in the world economy were very favourable; the euro area's results were surprisingly positive, but the cooling of the US economy is considered a risk

Developments in the world economy were favourable from the point of view of financial stability in 2006. Global economic growth strengthened further, with the higher-than-expected growth in the euro area being particularly important for the Czech economy. Commodity prices rose against a backdrop of robust economic activity, and oil prices remained a risk factor. The US economy is expected to cool somewhat during 2007, which could lead to a change in sentiment on the financial markets, which have been very sensitive to bad news recently.

Global imbalances remain sizeable…

Global imbalances, characterised by the US external deficit and the surpluses of Asian countries, were sizeable again in 2006. The risk of a further substantial depreciation of the dollar persists and could lead to fluctuations on the financial markets. Trade surpluses due to relatively weak exchange rates continued to be supported in 2006 by Asian economies through large intervention purchases mainly of dollar assets into their foreign exchange reserves.

…and the global savings surplus is reflected in low long-term interest rates and a "search for yield"

Another important factor is the global savings surplus, which is helping to keep long-term interest rates on major currencies at lower levels. This is fostering a continuing "search for yield", with persisting high investor demand for riskier assets from emerging economies. Therefore, further pressure for excessive appreciation of the koruna cannot be ruled out. This is a risk factor from the point of view of domestic economic activity and the external balance. Excessive appreciation of the koruna could also lead to worse corporate results, which could in turn be reflected in an increased default rate with a negative impact on the financial system.

Domestic macroeconomic developments have been very favourable and the current forecast does not suggest risks

The domestic macroeconomic environment also developed very favourably in 2006. Real GDP growth, which reached 6.1% in 2006, was positively affected above all by stronger investment activity and household consumption, while the contribution of net external demand declined year on year. The CNB's April 2007 macroeconomic forecast expects a slight slowdown in economic growth accompanied by a moderate increase in inflation pressures over the next two years. Despite the strong economic activity, the public finance deficit remains around 3% of GDP. However, financial market indicators suggest that investors do not regard these figures as very negative in the context of developments in other Central European countries.

The position of manufacturing is strong, while concentration in industries is low

The inflow of foreign direct investment in recent years has influenced the structure of the Czech economy, resulting in a high degree of foreign ownership of corporations. Many industries are dominated by large companies, usually foreign-owned, which export a large share of their production. The structure of the Czech economy is characterised by a strong role of manufacturing, which may increase the economy's dependence on global demand for certain manufactured articles. An international comparison dispels these concerns somewhat. Although the share of manufacturing in GDP in the Czech Republic is the highest among all the EU countries, the degree of concentration in the individual branches is the lowest. The strong position of large corporations is no exception either. A thematic article analysing the influence of foreign direct investment on the Czech economy also reveals only relatively weak risks.

Large, medium-sized and small enterprises recorded good results and their default rate is low

Non-financial corporations recorded very good results in 2006. Large corporations were particularly successful. Data on small and medium-sized enterprises also indicate positive trends, especially as regards value added per employee. Compared to the EU-12, corporate indebtedness is still low and does not pose a risk to financial stability. Loans to small enterprises have seen a significant recovery. Along with loans to households, this segment generates the highest yields for banks. Overall, the favourable evolution of the corporate sector is leading to low default rates. The predominance of loans with floating rates or interest rate fixations of up to one year is a risk factor in lending to corporations. This method of setting interest

rates enables banks to react flexibly to market developments. However, the interest payments of corporations on longer-term loans can increase considerably in times of interest rate growth, which may result in more defaults.

The favourable development of the domestic economy creates a risk of excessively optimistic expectations

The Czech economy is currently facing a risk of excessively optimistic expectations regarding its future development. These are based on the relatively high GDP growth rates seen in recent years and expectations of similar results in the coming years. High GDP growth rates, however, are not a sufficiently accurate indicator of growth in income. Other factors include excessively easy fiscal policy and improved access to loans amid low nominal interest rates. Optimism is also being fuelled by growth in asset prices. In the years ahead, this combination of factors could generate excessively high wage demands and excessive household consumption growth accompanied by faster debt growth.

Loans to households rose by almost one-third, with banks competing for more market share in this segment

Buoyant growth in loans to households continued into 2006. The annual growth rate exceeded 30%. This represented a slight slowdown in year-on-year terms, but the overall annual increase was 20% higher than in 2005. In 2006, banks attempted to increase their shares in the household loans market not only by providing new loans, but also by assuming existing loans granted by other banks. In loan consolidation, clients are usually offered lower interest rates or the opportunity to increase the consolidated loan to an amount exceeding the sum of the existing loans.

So far, growth in household debt cannot be regarded as a threat to financial stability…

The growth in household debt poses no significant risk to the financial sector, and Czech households as a whole cannot be regarded as overleveraged. Loans to households amounted to almost 20% of GDP at the end of 2006, while the EU-15 average is above 60%. Despite the buoyant growth in bank loans to households, the aggregate income of households from the interest they receive still exceeds the interest they pay. Given a symmetrical impact on interest received and paid, a rise in interest rates would have a positive effect on the net interest income of households as a whole. However, it would have an adverse effect on those households with deficit financing and subsequently on the overall financial sector via a higher default rate of households.

…but the number of households that are having problems repaying their loans is rising

One of the manifestations of the rise in debt is a rising number of households unable to repay their loans. This applies in particular to low-income households or households with only one breadwinner. This is evidenced, for example, by an ever-increasing number of executions ordered. However, statistics on executions show that the number of executions is stabilising following a rapid rise in 2005. The rise in the growth rate of executions completed in 2006 implies some acceleration of execution proceedings. The new insolvency act also addresses situations where a debtor who is unable to meet his obligations has more than one creditor. Such debtors will be able to declare personal bankruptcy.

World financial markets experienced several minor shocks, but the impact on Czech markets was limited

Several episodes in 2006 and early 2007 tested the level of risk aversion of major players on world financial markets. These episodes were started by seemingly marginal events. In all cases, the volatility of financial markets increased only temporarily and asset prices soon returned to their original levels. The episodes also affected yields on Central European financial markets, in particular stock and bond markets and exchange rates. However, the impact on the Czech financial markets was fairly limited. The currencies of Poland and Hungary mostly depreciated during these episodes, but the Czech koruna held steady. This could indicate a stronger tendency among investors to differentiate between individual countries of the region according to their economic fundamentals. In 2006, the impact of the corrections on the Czech financial markets was also dampened by a negative interest rate differential of the Czech koruna against the euro and the dollar, which is reducing flows of "hot money".

Yields on long-term bonds are anchored at low levels and a flatter yield curve would increase interest rate risk

Yields on ten-year Czech bonds move in line with euro yields. Their spread against euro bonds was negative in the first half of 2006 and in early 2007. The synchronisation of Czech and euro long-term bond yields suggests strong integration of the Czech and euro bond markets and may reflect the market-expected adoption of the euro as well as high credibility of the Czech National Bank. On the other hand, the market-expected rise in short-term interest rates coupled with flat long-term rates could lead to a flatter Czech yield curve. Since the banking sector typically transforms short-term liabilities into long-term assets, a flat or inverted yield curve may squeeze profitability and increase interest rate risk.

Property price growth rebounded in some regions, but it is not always necessarily entirely related to fundamentals…

After remaining flat in 2003–2005, property prices rebounded in 2006. In particular, supply prices of flats in Prague were up by almost 25% year on year at the end of 2006. A comparison of flat prices and income indicates a possibility of an emerging bubble on the property market. At the end of 2006, the ratio of flat prices in Prague to annual wages was approaching the level recorded at the end of 2003, when speculation on flat price growth connected with the Czech Republic's accession to the EU peaked. A comparison of flat prices and income in Prague and German and Austrian cities reveals that part of the price increase is not necessarily related to fundamentals. A comparison of income from the rent return with returns on other assets also shows that real estate prices are relatively high.

…and loans to developers can be relatively risky

The combination of a rising number of flats under construction, a lengthening of the time it takes to sell apartments and a growing level of debt financing of construction also entails certain risks. Loans to companies operating in the real estate business have been growing rapidly for four years, their volume having trebled since the end of 2002. Their growth rate was 35–40% throughout 2006. In the event of a fall in the prices of flats built by developers, the repayment of some loans could be problematic.

The financial architecture ran faultlessly and the new generation of CERTIS went live

The major financial infrastructure systems continue to run faultlessly. The SKD short-term bond settlement system recorded no system-relevant failures in 2006. As its operator, the CNB regularly tests the business continuity plan with the involvement of SKD participants. The CERTIS interbank payment system also ran smoothly in 2006. The new generation of CERTIS was successfully put into routine operation in November. It has a higher capacity, thus reducing the risk of system overload. The new generation also has lower running costs, which made it possible to reduce prices for its users.

The depth of financial intermediation remained stable

Financial intermediation in the Czech Republic, as measured by the volume of assets of financial institutions, grew by 7% year on year in 2006. Owing to similar nominal GDP growth, the depth of financial intermediation (as measured by the ratio of financial sector assets to GDP) was virtually unchanged and continued to fluctuate around 130%. The ratio of the assets of the whole financial sector to GDP is roughly one-third of the figure for the euro area, as is the case with bank assets. Total financial investment of insurance companies is roughly one-fifth of GDP.

The Czech financial sector is dominated by foreign owners

The concentration of the banking sector and the market shares of large banks are comparable with the EU average. Foreign ownership plays an important role in the Czech financial sector. At the end of 2006, foreign capital controlled 97% of the total assets of the banking sector and 75% of the total assets of the insurance sector. The shares of foreign owners in non-bank investment firms and pension funds are lower. Although the positive effects of the Czech financial sector's international links have so far predominated, a negative impact of some of the risks arising from such close links cannot be ruled out in the future.

The share of households in bank loans is converging towards that of non-financial corporations

The overall assessment of the banking sector showed no major changes with regard to financial stability in 2006. Non-financial corporations are still banks' most important clients, although loans to the household sector have been rising strongly

in recent years. Loans to corporations accounted for around 80% of the total bank credit portfolio at the end of the 1990s, but their share is less than 45% today. By contrast, the share of households has gradually risen to 40% today.

Bank loans rose by almost one-fifth

The favourable economic environment supported demand for loans in 2006. The annual growth rate of client loans picked up to almost 20% at the end of 2006, the highest figure since the pre-crisis year 1996. Overall, the growth in lending is associated with the buoyant economic activity and rising household demand for financing for owner-occupied housing. Households accounted for almost 50% of the total annual increase in bank lending.

The share of non-performing loans fell again, but this indicator slightly overestimates the quality of loans

The share of non-performing loans in total loans was 3.6% at the end of 2006, down by 0.5 percentage point year on year. Loan quality expressed as the percentage of non-performing loans is not the best indicator at a time of fast credit growth. The alternative flow indicator – the default rate – suggests that the share of non-performing loans overestimates the quality of loans owing to the buoyant growth in lending. The effect of macroeconomic developments on the credit, interest rate and currency risks of banks was tested as part of the stress testing exercise. The extension of these tests is described in one of the thematic articles, which confirms the resilience of banks to adverse macroeconomic shocks at the end of 2006. The thematic article on the calculation of financial soundness indicators arrives at similar conclusions.

Mortgage loans granted by banks are adequately secured

The share of the rapidly rising loans for house purchase in non-performing loans was 1.6% at the end of 2006, which is comparable with the end of the previous year. Roughly 64% are loans fully secured by property. At the end of 2006, banks granted mortgage loans with an LTV (loan-to-value) ratio of almost 53%, down by 2 percentage points from a year earlier. On average, mortgage loans are thus well secured from the banks' point of view.

Banks' capital adequacy ratio fell slightly despite the high net profit

The Czech banking sector generated a net profit of almost CZK 38 billion in 2006, down by roughly 3% compared to a year earlier. Dividends exceeded CZK 27 billion in 2006, the highest figure ever recorded. The capital adequacy ratio fell slightly to below 11.5% in 2006, mainly because of the slightly lower net profit, the high volume of dividends paid and growth in capital requirements due to the rising lending. However, all the individual banks exceeded the 8% regulatory minimum. The decline in capital adequacy signals a fall in the level of risk coverage by disposable capital, although it may also signify more efficient capital utilisation.

Insurance companies showed high profitability despite slowing growth in premiums written

Growth in premiums written has slowed in recent years and the ratios of financial investment from life and non-life insurance to GDP have remained relatively low compared to advanced EU countries. Insurance companies were compliant with the solvency criteria, i.e. their internal funds were greater than or equal to the required solvency margin. The aggregate available solvency margin under the insurance market supervision methodology was 3.4 times the required solvency margin on the life insurance market and 3.8 times that on the non-life insurance market. Insurance company stability was fostered by high return on equity, which exceeded 25% in 2006. Return on assets was 4.5%.

The groundwork has been laid for continued financial stability in the years to come… but the favourable phase of the business cycle is not a permanent phenomenon

Overall, 2006 can be regarded as a very successful year from the point of view of financial stability. The current trends in the financial sector and the economy as a whole also lay the groundwork for continued financial stability in the years to come. Some risk is associated with the emergence of excessively optimistic expectations regarding the long-term development of the economy, based on perceptions of the current favourable phase of the business cycle. When borrowing and investing, economic agents should bear in mind that the dynamics of the economy also entail less favourable phases of the business cycle.