From the financial stability point of view, the development of the Czech economy in 2007 can be assessed as very successful, notwithstanding the shocks emanating from foreign financial markets. Despite a predicted moderation in economic growth, the current outlook for the next two years creates good conditions for maintaining the degree of financial stability already achieved. The main risks include a further deepening of the credit crisis in the advanced economies, a more pronounced slowdown in economic growth abroad and a continued very strong exchange rate of the koruna. These risks could slow net export growth, weaken domestic economic activity and, in turn, worsen the performance of the financial sector. In the context of the credit crisis abroad and the global increase in the risk aversion of financial institutions, some tightening of the lending conditions can also be expected in the Czech financial system, fostering slower credit growth. However, these effects can be viewed as a desirable stabilising reaction of the system, which in the previous two years developed very dynamically and was affected by optimistic expectations typical of the peak of the business cycle.

The world economy recorded rapid economic growth, but this will weaken considerably over the next two years owing to the credit crisis in some advanced countries

The successful development of the world economy continued into 2007. However, risks that had built up in the financial sector over the previous ten years started to manifest themselves strongly in the USA and some other advanced countries. They showed up initially in the US subprime mortgage crisis, which gradually spilled over into other financial market segments and turned into credit crisis in the first few months of 2008. This has led to a considerable downward revision of the outlook for global economic growth for the coming two years. In addition to the US economy, which is highly likely to fall into recession, economic activity is likely to slow sharply in Japan and the UK. A downturn can also be expected in the euro area. Yield curve slopes indicate substantial scepticism regarding a quick recovery of these economies.

Owing to banks' losses, countries hit by the crisis will experience a sharp slowdown in growth in lending to the private sector

The credit crisis poses substantial downside risks to economic growth and financial system stability in countries directly hit by the crisis, with potential knock-on effects on other economies. One of biggest risks over the next two years is a potential credit contraction in some advanced countries as problems with mortgage loans and related securities spread to other segments of the credit market. The major losses of some banks will lead to a decrease in the overall capital adequacy of banking sectors. The subsequent recapitalisation of banks will negatively affect growth in lending to the private sector and economic growth.

The turn in the credit cycle prompted mixed reactions from central banks

The turn in the credit cycle strongly affected the monetary policies of the key central banks. The most striking response came from the US Federal Reserve System, which between September 2007 and April 2008 lowered its monetary policy rate by 3.25 percentage points to 2%. The monetary policy tightening in the euro area came to a halt, with the ECB holding its key rate at 4% over the entire period of turbulence. CNB monetary policy responded to rising inflationary pressures. The CNB increased its monetary policy rate four times during 2007 and once again in February 2008 – each time by 0.25 percentage point. The CNB's May 2008 macroeconomic forecast expects the one-off inflationary factors to start unwinding in 2008, with inflation gradually returning to the target. Accordingly, the interest rate environment in the Czech Republic should be stable over the next two years.

The Czech koruna appreciated strongly in response to the financial turbulence

The downward revision of the outlook for interest rates of the main world currencies led to renewed interest in investing in stable emerging markets' assets. Given the perception of the Czech koruna as a "safe haven", the risk of renewed appreciation pressures on the koruna materialised. The koruna appreciated dramatically in the initial phase of the financial turbulence, probably due to the liquidation of carry trades for which the koruna was used as the financing currency, in an environment of growing risk aversion. The increasing appreciation trend in the period that followed was driven both by a shift in foreign investment away from the

depreciating dollar and towards appreciating currencies such as the Czech koruna, and by domestic exporters, who in an environment of faster appreciation of the koruna started hedging on a mass scale by selling euros. The excessively fast appreciation of the koruna combined with falling external demand as a result of the economic slowdown in the euro area could have a negative effect on the domestic economy, primarily through a deterioration in net export growth. Given this risk, the CNB signed an agreement with the Czech Government in April 2008 on measures to prevent public sector operations from having undesirable impacts on the foreign exchange market and subsequently on macroeconomic stability.

The domestic economy started to be affected significantly by the fiscal reform

The domestic macroeconomic situation and financial sector were affected by the approved reform of public finances, whose expected impacts started affecting the behaviour of economic agents as early as 2007. The fiscal measures adopted are having conflicting impacts on the disposable income of households and corporations. The changes in the fiscal impulse and the impacts of the expected changes on the behaviour of economic agents will cause some volatility in aggregate demand. Efforts to buy real estate still at the lower VAT rate gave rise to increased demand for loans for house purchase and also affected the construction industry's performance. The opposite effect can be expected in the coming years, probably compounded by a review of the real estate market risks by banks in response to the problems of this market in advanced economies.

Czech GDP growth will slow over the next two years

At the end of 2007, despite the continued robust growth of the domestic economy, clear signals of a future slowdown were observable, mainly as a result of slower growth in real disposable income due to higher inflation, subdued investment activity and slowing net exports. The CNB's May 2008 macroeconomic forecast expects real GDP growth to slow to 4.7% in 2008 and 4.0% in 2009. The slowing economic growth and declining growth of real disposable income may have some impacts on the ability of households and corporations to repay loans taken out in previous years. On the other hand, it may help to eliminate the excessively optimistic expectations which emerged at the peak of the cycle and supported a rapid rise in the indebtedness of households and some segments of the non-financial corporations sector.

Macroeconomic sustainability indicators recorded a noticeable improvement

The traditional macroeconomic sustainability indicators recorded strongly positive developments in 2007. The public budget deficit under ESA95 methodology fell to 1.6% of GDP and the ratio of public debt to GDP decreased to 28.7%. The current account deficit declined to 2.5% of GDP, while the surplus on the output balance increased.

The good financial condition of corporations fostered low credit risk

Non-financial corporations posted good financial results in 2007, as evidenced by improved profitability indicators, liquidity, value added per employee and inventory ratios. Although the corporate debt ratio continued rising in 2007, the growth rate of loans granted to non-financial corporations decreased. This may indicate a future downswing in corporate sector performance associated with the expected weakening of economic activity. The credit risk of the corporate sector as measured by the 12-month default rate remained below the 3% level during 2007. However, given the expected economic slowdown, the macroeconomic credit risk model assumes a rise in this indicator of 1–2 percentage points during 2008. A slight increase in the corporate sector's credit risk in 2008 is also indicated by the new creditworthiness indicator.

The sharp appreciation of the koruna will be reflected in a rise in the default rate of export-oriented corporations

The economic condition of non-financial corporations started to be affected significantly in the second half of 2007 by the sharp appreciation of the koruna. Although the first-quarter data on the real economy in 2008 suggested that export-oriented corporations were able to cope with this exchange rate shock, some negative effect can be expected to emerge gradually. This will probably be reflected in an increase in the sector's credit risk, as indicated by an analysis of monthly data

on the repayment of loans provided by banks to the largest exporters in the Czech Republic. The analysis revealed that the 12-month default rate is more volatile for exporters than for the economy as a whole, so it can be expected to deviate upwards at a time of strong appreciation. The analysis also revealed that for part of exporting corporations borrowing in foreign currency is a significant way of reducing their sensitivity to appreciation of the koruna.

Despite rapid credit growth, household debt is still low by international comparison

Household debt increased considerably in 2007. As in previous years, the overall debt of households to financial corporations increased by roughly one-third, breaking through the CZK 800 billion level. Loans to households reached CZK 680 billion in banking institutions and CZK 150 billion in non-banking institutions at the close of the year. The growing debt was supported mainly by loans for house purchase, as a result of demand for owner-occupied housing bolstered by the one-off effect of advance financing of construction work owing to a change in the lower VAT rate from 5% to 9% with effect from 1 January 2008. The increasing level of debt is being accompanied by a decreasing gross saving rate of households (5.1% in 2007), which fell to a ten-year low. However, despite the rapid credit growth, the overall Czech household debt level is still low by comparison with the Western European countries and, according to foreign analyses, is at a safe level. In 2008, the rate of growth of household debt should start decreasing, as confirmed by the first-quarter growth in new loans for house purchase.

In the event of adverse macroeconomic developments, overindebted households – particularly those from low-income groups – will get into difficulties

Although Czech households as a whole cannot currently be regarded as overleveraged, some risk of growth in their default rate exists if the less favourable macroeconomic scenarios materialise. One potential source of overindebtedness is growth in mortgage repayments, associated with the purchase of ever more expensive property. Owners of loans for house purchase whose income has been rising nowhere near as fast as property prices are particularly exposed to this risk. This overindebtedness may come out into the open with a lag, for example as a result of a rise in interest rates during the refixation of a mortgage loan. Consumer credit is another possible source of overindebtedness, particularly for low-income households. A sharp rise in the number of executions ordered suggests that this risk is growing over time.

Czech financial markets were affected only slightly by the external shocks

The shocks on the advanced financial markets manifested themselves in declining prices of a whole range of risky assets and rising volatility on equity, bond and foreign exchange markets. However, the domestic interbank money market remained fully operational and interest rates there were affected mostly by expected changes in CNB monetary policy. The Czech financial markets responded to developments in global financial markets similarly as during corrections in previous years. Share prices went down in line with the falls in foreign stock markets, while bond yields initially declined slightly and then stabilised. Nevertheless, it cannot be said that the global financial crisis had no major effect on the Czech financial markets. During 2008 Q1, market signals indicated increased sales of Czech government bonds by foreign investors, fostering growth in the risk premium of the Czech koruna and the euro government debt. The interbank market also recorded a very modest increase in the credit risk premium and a decline in market liquidity. The Czech banking sector responded to the rise in global risk aversion only with a very moderate tightening of the interest rate conditions for loans for house purchase and some riskier segments of the credit market.

Property prices continued rising rapidly in 2007, while rent returns fell further

The property market trends identified as risky in the 2006 Financial Stability Report continued into 2007. Property prices in the Czech Republic rose relatively fast in 2007 despite the problems on real estate markets in many advanced economies. Prices of flats and building land recorded high growth, while prices of family houses rose more slowly. Although the property market growth still cannot be regarded as

a bubble and the rise in prices as manifestly unbalanced, there are some indications that the market is overheating. For example, the ratio of property prices to household income is rising over time. This indicator identifies Prague as the riskiest region. A large rise in supply prices of flats together with considerably lower increases in supply rents led to a further fall in the rent return, which for most large cities in the Czech Republic is below the level of long-term bond yields and the level of interest rates on new loans for house purchase. Speculative property purchases financed by mortgage loans thus become less profitable and more risky.

The risk of default by real estate businesses depends to a large extent on the future evolution of property prices

The share of property developers in total loans to the corporate sector increased to more than 25% in 2007, compared to less than 10% in 2001, against a background of rising prices of both residential and commercial property. Loans provided to real estate companies showed record growth of 50% in 2007. The developments in 2007 confirmed that developers tend to react with a lag to growth in property prices. Before the Czech Republic joined the EU, strong growth in property prices in 2002–2004 gave rise to overly optimistic expectations, which led to higher investment activity by developers. The subsequent sharp slowdown in property prices then brought about a rise in the rate of default by developers in 2005–2006. The property development sector responded with increased activity to the property price growth in 2006 and 2007 again with a lag, so it is highly likely that a negative shock would be reflected in a significant rise in the previously relatively low default rate in this sector.

In response to property market developments, the banking sector tightened its credit standards vis-à-vis the property development sector

The number of housing completions increased by an exceptional 38% year on year in 2007. It cannot be ruled out that the market for new flats will become saturated and that the rise in prices will slow down or stop as a result of the rising supply. An increase in the difference between supply prices and the prices of final transactions may be a signal of decreasing market liquidity or rising property market risk. A cooling of the property market represents quite a sizeable risk for the banking sector. According to stress tests, the banking sector is resilient to this risk at present. In response to the property market problems in some advanced countries, domestic banks considerably tightened their credit standards vis-à-vis the property development sector in early 2008. This can be viewed as an appropriate response to the evolution of the risks in the sector.

The financial infrastructure continued running reliably in 2007, but the further development of the Czech capital market is being hampered by the absence of a central depository

The financial infrastructure continued running reliably in 2007. The CERTIS interbank payment system and the SKD short-term bond settlement system recorded no irregular situations in the period of turbulence in global financial markets. Smooth and stable interbank settlement was aided by a gradual rise in the use of intraday credit by CERTIS participants. The fact that domestic banks did not need to use intraday credit any more often than in the past, despite the liquidity problems on foreign financial markets, is meanwhile evidence that the financial crisis had very small direct impacts on the Czech financial sector. One of the infrastructural shortcomings of the Czech capital market is the absence of a central depository.

The depth of financial intermediation increased significantly, unlike in the previous year

In 2007, as in previous years, the Czech financial sector experienced mostly positive developments. Banks and insurance companies achieved high returns on assets and equity. Provided that a reasonable proportion of the profit remains in financial institutions in the form of equity capital, this lays the groundwork for maintaining a high level of financial stability in the years to come. The depth of financial intermediation in the Czech Republic, as measured by the ratio of financial sector assets to GDP, increased by just under 10 percentage points to 142%. This relatively large increase reflects a rise of almost 18% in financial institutions' assets, due mainly to growth in bank loans of more than 26%.

The characteristics of the Czech housing loan market minimise the risk of a crisis similar to the one that hit the US subprime mortgage segment

The available analyses indicate that the Czech banking sector is not exposed to the risk of a crisis similar to the one that hit the US subprime mortgage segment. This

is due to higher required debtor creditworthiness, the traditional method of interest rate fixation, less use of external mortgage underwriters, the absence of credit securitisation and, in particular, good collateralisation of mortgage loans with property. Mortgage loans, i.e. loans that are fully secured by property, account for 65% of total loans for house purchase. The mortgage loan to property value ratio (the LTV ratio), which for mortgage loans to households was 56% on average at the end of 2007, can be still regarded as conservative. For the same reasons, the ratio of loans in default to mortgage loans was only 1.2% at the end of 2007. The ratio of loans in default to total loans stood at 2.7%, falling by almost 1 percentage point year on year. Given the favourable phase of the business cycle and the high credit growth in 2007, the loan default rate still probably undervalues the magnitude of the banking portfolio credit risk to some degree.

The large volume of client deposits provides domestic banks with protection against any drying up of market liquidity and ensures stable and low-cost sources of financing for credit expansion

Client deposits remain the biggest source of financing for bank loans. At the end of 2007, they were 1.3 times higher than client loans, which, in turn, is more than two times the average in the original EU member countries. The large volume of client deposits provides domestic banks with protection against any rapid drying up of market liquidity and at the same time ensures stable and relatively low-cost funds compared to other forms of external financing. However, deposit growth has been lower than credit growth in the Czech Republic for several years and this trend is likely to continue. As a result, the share of deposits in bank funds will decrease in the future and banks will have to respond with changes in balance-sheet liquidity management. Tests of banks' balance-sheet liquidity indicate that the banking sector is resilient enough to deposit outflows and some other hypothetical changes in the financial market. However, for the extreme variant of pressures on balance-sheet liquidity, only institutions with a strong deposit base are naturally resilient.

Owing to the gradual changeover to Basel II, capital adequacy increased slightly … but an expected rise in household and corporate default rates will lead to an increase in the regulatory capital requirements

The preparations for the implementation of Basel II and the actual changeover to the new prudential rules in several banks on 1 July 2007 were a significant challenge for the banking sector. The remainder of the sector took this step in January 2008. Owing to the switch to Basel II, there was a slight decline in the regulatory capital requirements. The CNB's analyses predict a slight rise in default rates for corporations and households in 2008. This would imply some increase in the regulatory capital requirements in the period ahead.

The insurance and pension scheme industries continued growing in 2007, although higher asset price volatility and growth in the costs of intermediating new contracts are creating risks for pension funds in particular

In the insurance and pension scheme industries, the previous years' trends continued into 2007. Premiums written grew at an increased rate of 9% year on year, mainly due to growth in life insurance. Insurance companies met the solvency criteria – the aggregate available solvency margin under the current legislation was 3.0 times the required solvency margin on the life insurance market and 3.3 times that on the non-life insurance market. Contributions from pension planholders increased by more than 14% in 2007. Insurance companies and pension funds saw marked growth in the costs of intermediating new contracts. The growth in these costs may encumber the private pension system in particular. Growing volatility on the asset market and potential asset revaluation losses in particular may have an adverse effect on the funds' assets and performance, particularly in the event of higher and faster payments of benefits. Commensurate capital increases by funds' shareholders would be desirable as protection against the existing risks.

According to stress tests, the financial sector seems to be resilient to a wide range of risks. Only an extreme macroeconomic scenario would necessitate capital injections to maintain sufficient capitalisation

According to stress tests, the financial sector is currently resilient to the market, credit and some specific risks to which it is exposed. However, an extreme macroeconomic scenario with significant adverse impacts on interest rates, the exchange rate and GDP growth would necessitate capital injections to ensure compliance with the regulatory limits and maintain sufficient capital adequacy in financial institutions. The aggregate banking sector stability indicator confirms a continuing process of capital optimisation in the banking sector, with unchanged resilience to the main risks.