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ANNUAL REPORT 2002

CNB CZECH
NATIONAL
BANK

*Time
is money*



ANNUAL REPORT 2002

CNB CZECH
NATIONAL
BANK

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GOVERNOR'S FOREWORD



Zdeněk Tůma, Governor

The first ten years of the Czech National Bank's existence came to a close in 2002, and the Czech currency – the koruna – also celebrated its tenth birthday at the start of 2003. Looking back, we can see that much was achieved in those ten years. Early on, the CNB saw to the smooth launch of the independent Czech currency and the stabilisation of the macroeconomic situation following the partition of Czechoslovakia, and provided general support for the ongoing transformation process. In the years that followed, the focus of its efforts shifted more and more towards standardising the activities of the central bank. Today, thanks to these efforts, the CNB is a modern central bank, comparable in most respects with those in the advanced nations.

But this is no reason to rest on our laurels. The central bank is constantly facing new tasks. That is why the CNB in 2001 published its vision for the future: *Challenges for the Czech National Bank in the Years Ahead*. This expressed our view on the functioning of the central bank in a nation intent on joining the European Union in the foreseeable future and hence committed to introducing the single European currency at some future point. "Professionalism, transparency and efficiency" became the CNB's motto. Any assessment of the year 2002 should therefore reflect on how successfully the CNB realised these principles and this vision.

At the end of 2002, the negotiations between the Czech Republic and the European Union were successfully completed. The CNB played its part in this, stepping up its legislative work in 2002 so that full compatibility could be achieved between the Czech and European legislation in the monetary and financial area by the end of 2002. This work included harmonisation amendments to the Act on the CNB and the Act on Banks, a new Payment System Act, a Financial Arbiter Act and, jointly with the Czech Ministry of Finance, an amendment to the Foreign Exchange Act. All these amendments have now taken effect and have fundamentally changed the legal framework within which the central bank operates.

The CNB's internal rules and organisation were also modified in 2002. The collective decision-making responsibilities of the Bank Board in matters of a conceptual and strategic nature were significantly strengthened. The number of levels in the management hierarchy was reduced, meaning that the departments at CNB headquarters now have greater responsibility for the day-to-day running of the institution. The CNB issued a *Medium-Term Plan for 2002–2004*, fleshing out the general goals outlined in the aforementioned vision.

In the monetary policy area, the inflation targeting system underwent further development: the CNB's forecasting tools were enhanced, the Bank Board became more closely involved in the inflation forecasting process, and there was a switch to a new type of forecast (the "unconditional" forecast).

In 2002, the Czech economy had to withstand a series of unfavourable shocks, including a slowdown in the world economy, excessive appreciation of the koruna against the euro, and catastrophic floods. Inflation was also affected by an annual decline in import prices and a fall in food prices. As a result, economic growth slowed and inflation fell below the CNB's target band. Given the circumstances, though, the results achieved may be judged a success. The CNB contributed to this success by responding to developments during the year with several reductions in interest rates and a series of measures to curb the excessive volatility of the exchange rate.

With regard to the upcoming date of accession to the EU, the CNB issued a document entitled *The Czech Republic and the Euro – Draft Accession Strategy*. This document, which was submitted to the Government for discussion, summarises the basic starting points for the Czech Republic's integration into European monetary structures, discusses the positive effects and potential risks associated with this process, and recommends that the Czech Republic join the eurozone as soon as economic conditions allow for doing so.

Last year saw no dramatic events in the banking sector of the like seen in previous years. Stability was bolstered by the earlier privatisations of the large banks. The generally favourable situation in the sector was reflected in increasing profitability. Another positive factor was the satisfactory trend in lending, which recorded modest growth after a several-year period of stagnation linked with the stabilisation of the banking sector.

The appreciation of the koruna negatively affected the CNB's financial results in 2002. The overall loss of CZK 9.5 billion – around one third of the 2001 figure – was attributable to revaluation of foreign exchange reserves. In the area of operations, the CNB's results improved by more than 10% on the previous year. Short-term interest rates in the Czech Republic fell faster than the returns on international reserves, and this too had a positive bearing on the CNB's results. Owing to massive growth in the volume of the reserves, some significant changes were made in the reserve management area in 2002.

Other areas of the CNB's operations also underwent major changes during 2002, as the reader of this Annual Report will discover. I believe that we succeeded in fulfilling our long-term goals and in rising to the challenges we face. And I hope that for the CNB – and for the Czech Republic as a whole – the year 2003 will be no less successful in this respect than the last.


ZDENĚK TŮMA
Governor



I. MANAGEMENT AND ORGANISATION

Money is today the sinews of affairs.

Bion

THE BANK BOARD



Zdeněk Tůma
Governor



Oldřich Dědek
Vice-Governor



Luděk Niedermayer
Vice-Governor



Michaela Erbenová
Chief Executive Director



Jan Frait
Chief Executive Director



Pavel Ráchocha
Chief Executive Director



Pavel Štěpánek
Chief Executive Director



I.1 THE BANK BOARD

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

Governor: Zdeněk Tůma
Vice-Governor: Oldřich Dědek
Vice-Governor: Luděk Niedermayer
Chief Executive Director: Michaela Erbenová
Chief Executive Director: Jan Frait
Chief Executive Director: Pavel Racocha
Chief Executive Director: Pavel Štěpánek

Governor Zdeněk Tůma

Born on 19 October 1960 in České Budějovice. Zdeněk Tůma graduated from the University of Economics, Prague, and worked there after completing his studies. In 1986 he joined the Institute for Forecasting of the Czechoslovak Academy of Sciences as a postgraduate researcher. In 1993–1995 he was an adviser to the Minister of Industry and Trade, and from 1995 he was Chief Economist at Patria Finance. From 1 June 1998 until joining the CNB at the beginning of 1999 he held the post of Executive Director of the European Bank for Reconstruction and Development, representing the Czech Republic, Slovakia, Hungary and Croatia on the Board of Directors. From 1990 to 1998, he lectured on macroeconomics at the Faculty of Social Sciences at Charles University. Between 1999 and 2001 he was President of the Czech Economics Society.

He is a member of the Board of Trustees at the University of Economics, Prague, a member of the Graduation Council at the Centre for Economic Research and Graduate Education (CERGE) at Charles University in Prague, a member of the Governing Body of the English College in Prague, an honorary member of the Board of Trustees at the U.S. Business School Praha and a member of the Board of Editors of the economic journal *Finance a úvěr* (Finance and Credit). He has undertaken study internships at the London School of Economics and the University of Cambridge in the UK, the Tinbergen Institute in the Netherlands and George Mason University in the USA. He regularly publishes articles on macroeconomics and monetary policy in the daily press and in professional journals.

On 13 February 1999, he was made a CNB Vice-Governor and member of the Bank Board. He was appointed Governor of the CNB on 1 December 2000.

Vice-Governor Oldřich Dědek

Born on 26 November 1953 in Chlumec nad Cidlinou. Oldřich Dědek graduated in agricultural economics from the University of Economics, Prague. After completing his studies in 1978, he was employed by the Economic Institute of the Czechoslovak Academy of Sciences, where he worked as a researcher specialising in economic policy. In 1992, he joined the State Bank of Czechoslovakia as Deputy Director of the Institute of Economics, and in 1996 he was appointed an adviser to the CNB Governor. He was formerly a member of the Scientific Council of the Faculty of Social Sciences at Charles University in Prague, where he lectures on financial market issues.

He is currently a member of the Administrative Board of Charles University and a member of the Board of Editors of the journals *Politická ekonomie* (Political Economics) and *Prague Economic Papers*. He has participated in internships and study programmes in the United Kingdom (London School of Economics, University of Warwick) and the USA (International Monetary Fund, Federal Reserve Bank of Kansas City).

He translated the *Macmillan Dictionary of Modern Economics* and is the author of the *Concise English–Czech Dictionary of Economic Terms and Abbreviations*. He also publishes articles on monetary and economic policy issues in the daily press and in professional journals. As an adviser to the Prime Minister of the Czech Republic in the first half of 1998 he headed the team of authors who prepared the document: *Economic Strategy of Joining the European Union: Starting Points and Directions*.

Since 13 February 1999, he has been a CNB Vice-Governor.



Vice-Governor Luděk Niedermayer

Born on 13 March 1966 in Brno. Luděk Niedermayer graduated in operational research and systems theory from UJEP Brno (now Masaryk University) in 1989 and worked there for a short time researching the theory of structures. In 1991 he joined the State Bank of Czechoslovakia. In January 1996 he became an Executive Director of the CNB, responsible for foreign exchange reserves administration and money market operations. He has undertaken numerous study programmes and internships, particularly in the areas of the capital market, derivatives trading and risk management. He also focuses on these topics as a conference participant, in lectures at professional courses and in his publishing activities.

He has contributed to analyses of the CNB's monetary policy scheme and to the change in its monetary policy implementation method (in particular the switch to inflation targeting). He also focuses on monetary policy issues in his lectures and consultations for the central banks of other countries. Following the crisis in emerging markets in 1997 he has worked in BIS working groups analysing possible changes in the financial system architecture. He participates in the activities of IMF and IBRD working groups on the administration and macroeconomic significance of foreign exchange reserves.

On 27 February 1996, he was made a member of the CNB Bank Board. He was appointed a Vice-Governor of the CNB on 1 December 2000 and re-appointed to this post on 27 February 2002.

Chief Executive Director Michaela Erbenová

Born on 24 August 1968 in Prague. Michaela Erbenová graduated in mathematical methods in economics from Moscow State University in 1990 and obtained a Ph.D. in economics from CERGE (Centre for Economic Research and Graduate Education) at Charles University in Prague in 1997.

During her postgraduate studies, she undertook study internships at the Tinbergen Institute, University of Amsterdam, the Netherlands, and at Princeton University, USA, (1993) and a research internship at the Harvard Institute for International Development, Harvard University, USA, (1995), where she worked as a research assistant to Prof. Jeffrey Sachs. In 1994–1995 she worked as a Consultant at the Directorate for Education, Employment, Labour and Social Relations at the OECD in Paris. After a brief teaching assignment at CERGE, she worked as an Adviser to the Prime Minister of the Czech Republic, Václav Klaus (1996–1997) and as Head of the Group of Advisers to the Minister of Finance, Ivan Pilip (1997–1998). From November 1998 onwards, she held various managerial posts at Komerční banka, the last being Director of its Investor Relations Division. Since 1997 she has lectured at the Institute of Economic Studies at the Faculty of Social Sciences, Charles University.

She was appointed a member of the CNB Bank Board on 1 December 2000.

Chief Executive Director Jan Frait

Born on 28 November 1965 in Slavičín. Jan Frait graduated in 1988 from the Faculty of Economics at the Technical University of Ostrava (VŠB–TU) and completed his doctoral studies there in 1995. The same year, he was awarded the prize of "Young Economist of the Year" by the Czech Economics Society. In 1998, he qualified at the faculty as an Associate Professor in Economics. Between 1990 and 1998 he worked as a special assistant in the Faculty of Economics at VŠB–TU, and then as a senior lecturer, Sub-Dean for Science and Research and as a member of the faculty's Scientific Council and of the university's Scientific Council. He has undertaken study programmes and traineeships at Keele University, University of Reading and Liverpool John Moores University in the UK and at GOTA Bank in Sweden.

He is an editor of the economic journal *Finance a úvěr* (Finance and Credit) and a member of the Board of Editors of *Ekonomická revue* (Economic Review). Since December 2001 he has been President of the Czech Economics Society. He is also a member of the Centre for Euro–Asian Studies at the University of Reading in the UK and its Representative for the Czech Republic.

He was appointed a member of the CNB Bank Board on 1 December 2000.

Chief Executive Director Pavel Racocha

Born on 23 March 1962 in Plzeň. Pavel Racocha graduated from the Faculty of Management at the University of Economics, Prague, and from Columbia University in New York, where he studied economic policy management. In 1991, he joined the newly established banking supervision department of the State Bank of Czechoslovakia. In 1996–1997, he worked as a consultant at the World Bank in Washington in the area of financial sector development in emerging economies. From 1998 he worked as Executive Director of the Banking Supervision Group at the CNB.

He has participated in a number of internships in the USA, Germany, France, Japan and elsewhere, focusing on banking, risk management and issues of banking regulation and supervision. He is a member of the Core Principles Liaison Group of the Basel Committee on Banking Supervision at the Bank for International Settlements, which is engaged in developing core principles for effective banking supervision, and has contributed to the development of a new concept of capital adequacy for banks. He is a member of the steering committee of a joint project of the Czech National Bank, the Czech Banking Association and the Chamber of Auditors to implement the new capital adequacy rules in the Czech Republic. In 1999–2001, as a member of the steering committee for the privatisation of banks, he contributed to the successful privatisation of Československá obchodní banka, Česká spořitelna and Komerční banka. In 1999–2001 he was project leader of the banking component of the European Commission's programme of technical assistance to the CNB (known as "twinning") in the area of the *acquis communautaire* regarding bank regulation and supervision. He is a member of the advisory body to the Presidium of the Securities Commission. He collaborates with the International Monetary Fund in the area of banking supervision and regulation development in emerging economies. He lectures at seminars and conferences on banking in the Czech Republic and abroad.

Since 13 February 1999, he has been a member of the CNB Bank Board.

Chief Executive Director Pavel Štěpánek

Born on 5 September 1956 in Prague. Pavel Štěpánek graduated in finance from the University of Economics, Prague. After completing his studies in 1979, he stayed on there as an assistant lecturer. In 1981, he was employed as a specialist by the Ministry of Finance, where he successively held various posts in the Study–Research Centre, the Public Finance Section and the Financial Policy Department. In 1998, he was appointed Deputy Finance Minister responsible for financial policy, international relations, the capital market and bank privatisation. In the second half of 1998 he became an adviser to the General Director of Česká spořitelna. In 1993–1998, he was a member of the Presidium of the National Property Fund and was also engaged for a short time on the Supervisory Board of Poštovní banka.

He has participated in IMF study programmes abroad, focusing on taxes and public finance. He lectures on financial policy at the University of Economics, Prague, and publishes articles in the daily press and in professional journals.

Since 13 February 1999, he has been a member of the CNB Bank Board.



I.2 ORGANISATION

The CNB's new Organisational Statute, which took effect on 1 January 2002, significantly strengthened the collective decision-making powers of the Bank Board in matters of a conceptual and strategic nature. This entailed a switch from management of departments by individual members of the Board to management by the Board as a whole. The number of levels of management was reduced, meaning that the basic elements of methodological management (i.e. the departments of the CNB) now have greater responsibilities. The number of organisational units has also been reduced, and the role of the CNB's co-ordination and advisory bodies has been strengthened, as has the emphasis on research. The change to the new management system also involved drawing up a plan of activity for the CNB as a whole and plans of activity for each department of the bank.

The changes to the CNB's internal management and organisation system contained in the Organisational Statute led to an overhaul of the CNB's internal regulations in 2002. Following a review and appraisal of the rules previously in force, they were comprehensively redrafted as of 31 December 2002. The new regulations are much more streamlined, straightforward and transparent as regards both methodological management and operations, thanks to the introduction of a one-tier structure (CNB directives) to replace the previous two-level system (directives and working rules).

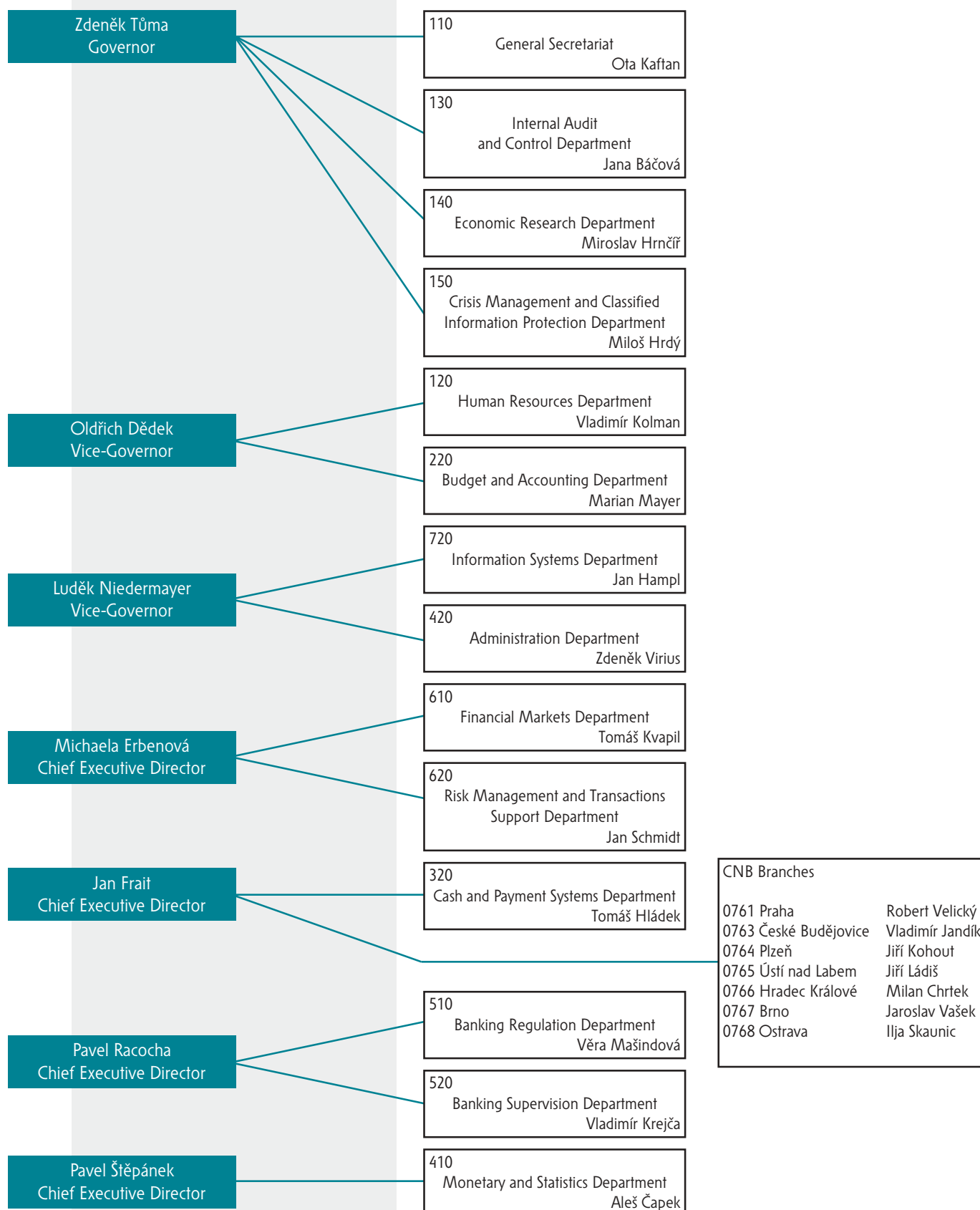
Several changes were made to the Organisational Statute in 2002 to reflect the harmonisation amendment to the Act on the CNB and the amendment to the Act on Banks. The Statute now defines the responsibilities of the CNB's organisational units, and of the bank as a whole, relating to the activities of the Financial Arbiter under the Financial Arbiter Act and to compliance with the Payment System Act (both laws took effect on 1 January 2003). Also incorporated into the Statute were the powers of the CNB's branch offices in the areas of administrative proceedings; the collection, inspection and processing of statistical data from non-banking institutions in compliance with their reporting duties; foreign exchange inspections; and crisis management pursuant to the Constitutional Act on the Establishment of Higher Regional Authorities, as amended. A number of other minor modifications were made to clarify the activities and responsibilities of particular departments.

The attached organisational chart depicts the current structure of the Czech National Bank.



I. MANAGEMENT AND ORGANISATION

ORGANISATIONAL CHART



Notes:

The Bank Board manages the organisational units presented in the organisational chart as a collective body
 — denotes the Bank Board member's powers of supervision over particular organisational units

RESPONSIBILITIES OF THE ORGANISATIONAL UNITS OF THE CNB'S HEADQUARTERS AND BRANCHES (AS SET OUT IN THE CNB ORGANISATIONAL STATUTE)

Headquarters

110 – General Secretariat

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

120 – Human Resources Department

Responsible for human resources and staff policy management at the CNB; for labour-law and wage administration; for professional development, forms, and organisation of CNB staff training; and for preparing the staff loans methodology. Works in co-operation with the Financial Arbiter in the personnel, labour-law and wage area. Defines the structure and content of the collective agreement and the staff remuneration agreement, and is responsible for activities ensuing from the Act on the Protection of Personal Information.

130 – Internal Audit and Control Department

Draws up the internal audit and control methodology and carries out independent and objective internal auditing and control within the CNB. Verifies and evaluates the functionality and effectiveness of the internal audit and control system in relation to the CNB's overall development strategy and the medium-term plans and programmes of activity of the CNB's organisational units.

140 – Economic Research Department

Co-ordinates and conducts economic research at the CNB; responsible for reviewing research projects and providing economic research results to the public; and prepares expert opinions on situational reports and strategic monetary policy documents.

150 – Crisis Management and Classified Information Protection Department

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

220 – Budget and Accounting Department

Prepares methodology for, and conducts accounting at, the CNB; prepares methodology for the CNB budget and prepares the budget itself; maintains selected client accounts; and co-ordinates the keeping of accounts and related activities for the state. Responsible for administrative activities relating to the work of the Financial Arbiter within the framework of the CNB budget.

320 – Cash and Payment Systems Department

Drafts measures relating to the payment system legislation and regulations in the area of currency circulation and payment systems; prepares methodology for managing payment systems and currency in circulation in cash and cashless form; responsible for managing the reserves of Czech money, gold and other precious metals and silver and gold commemorative coins, and for protecting Czech money against counterfeiting; sets principles for development of payment-support systems (accounting and payment system, interbank payment system and short-term bond system); and proposes designs and parameters of new Czech banknotes and coins. Responsible for activities ensuing for the CNB from the Payment System Act. Co-ordinates support for the work of the Financial Arbiter within the CNB, including preparation and administration of the agreement between the Financial Arbiter and the CNB.



I. MANAGEMENT AND ORGANISATION

410 – Monetary and Statistics Department

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

420 – Administration Department

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

510 – Banking Regulation Department

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

520 – Banking Supervision Department

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

610 – Financial Markets Department

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

620 – Risk Management and Transactions Support Department

Sets the principles for foreign exchange asset and liability management and draws up operational risk management methodology; prepares subject matter of the Foreign Exchange Act and drafts legal rules implementing the Foreign Exchange Act in a set area; prepares methodology for co-ordinating and conducting foreign exchange inspections in the CNB; and is responsible for administrative proceedings in a set area.

720 – Information Systems Department

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

CNB Branches

Responsible for circulating-currency transactions in relation to commercial banks and other clients of the CNB; for processing money accepted from circulation; for managing money reserves; for maintaining the accounts of the state budget and other CNB clients falling within the competence of the branch; and for making payments relating to such accounts. Responsible also for conducting foreign exchange inspections and processing foreign exchange statistics in the region; for collecting regional data for business surveys; for labour-law and social administration; and for the administrative activities, accounting and (except for the Prague branch) security and surveillance of the branch.





II. FINANCIAL REPORT

Even to the wisest of us, the people that bring money are more welcome than those who take it away.

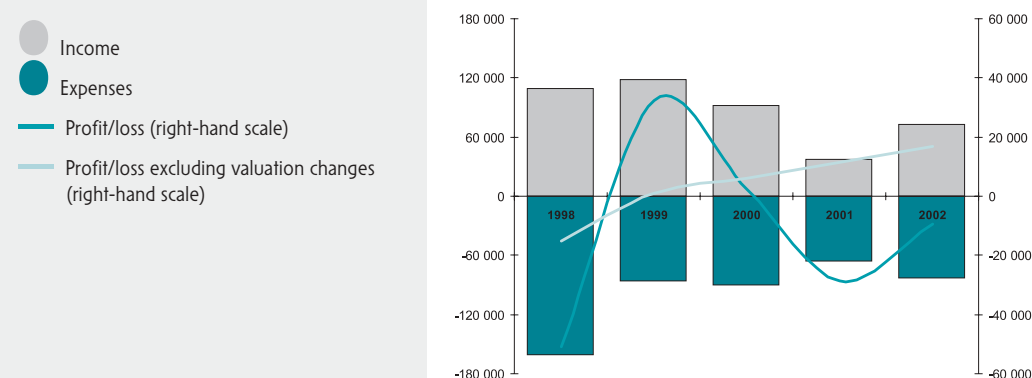
Georg C. Lichtenberg

II. FINANCIAL REPORT

With income of CZK 73,292 million and expenses of CZK 82,760 million, the Czech National Bank made a loss of CZK 9,468 million in 2002.

CHART II.1

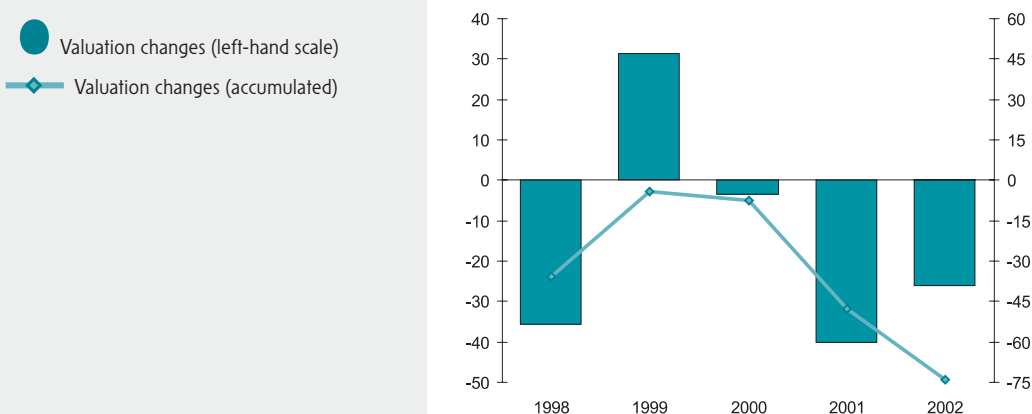
CNB Performance 1998–2002 (in CZK millions)



Foreign exchange reserves and the strength of the Czech koruna were the crucial factors affecting the bank's financial results. As in previous years, in 2002 there was a fairly high degree of volatility in exchange rates between the reserve currencies and the koruna. During the first seven months of the year, the koruna strengthened markedly against the dollar and euro. During the remainder of the year, the koruna weakened against the euro, but at the end of the year it remained about 1.2% stronger than at the end of 2001. The nominal exchange rate of the koruna against the dollar stabilised to a certain extent. On 31 December 2002, it was 16.9% stronger than at the end of 2001. Foreign exchange losses, for this reason, amounted to CZK 26,155 million.

CHART II.2

Valuation changes 1998–2002 (in CZK billions)



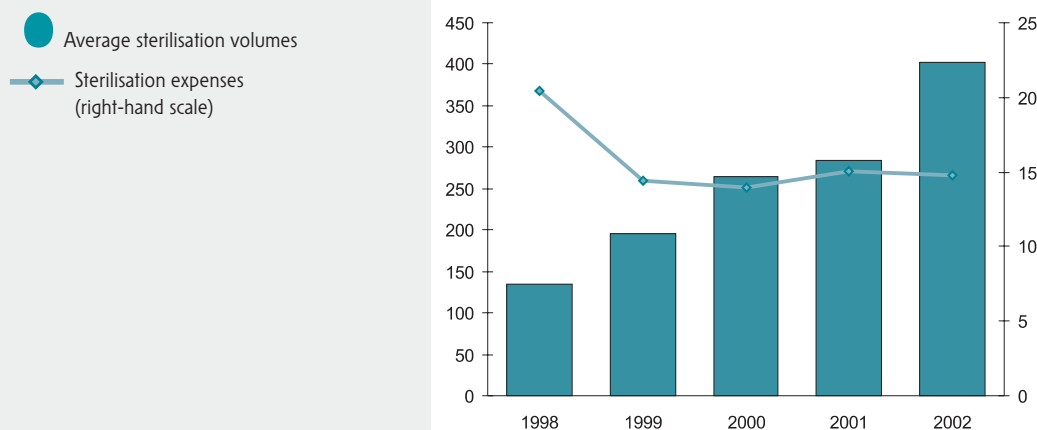
The CNB's foreign exchange reserves increased by USD 9.2 billion over the previous year's figure. The CNB intervened on the foreign exchange market during the course of 2002 and – under an agreement concluded with the Czech government on 16 January 2002 to limit the impact of privatisation revenues on the forex market – converted privatisation income and other state foreign exchange income. Growth was also affected by income generated by the bank in the management of foreign exchange reserves. Income from these foreign exchange reserves amounted to CZK 27,287 million, a fall of CZK 1,234 million from 2001. The lower income resulted from lower returns on the assets administered. Due to interest rate trends on world markets, the weighted average return on the portfolios managed was 4.33% p.a. in total for 2002, a drop of 1.13 percentage points from 2001.

II. FINANCIAL REPORT

The CNB employed the same monetary policy instruments as in 2001. The most important of these were repos carried out in the form of tenders, through which the CNB sterilised the excess liquidity of commercial banks. An average of CZK 402 billion was sterilised in 2002. The CNB adjusted the settings of its monetary policy instruments in response to monetary developments. Its basic interest rates fell during 2002 by 1.75 percentage points. The reserve requirement for primary deposits was left unchanged at 2%.

CHART II.3

Sterilisation volumes versus sterilisation expenses (in CZK billions)



As well as taking advantage of repos, banks used the option of depositing excess liquidity overnight at the CNB at the discount rate (deposit facility) or, conversely, of borrowing liquidity overnight at the Lombard rate (marginal lending facility). In compliance with European Central Bank regulations, the CNB paid interest on banks' required reserve holdings, thus adding to its expenses by about CZK 1 billion.

In 2002, the issue of banking sector consolidation had a wholly marginal impact on the CNB's financial results in comparison with other areas of operations. The overwhelming majority of expenses (including those for the creation of reserves and provisions) had been incurred in previous years. A proportion of the potential expenses continues to be covered by a CZK 22.5 billion state guarantee issued by the Czech government in 1997 for liabilities, guarantees and assumed assets arising from the consolidation and stabilisation of the banking sector. Because this amount does not cover the total expenses of the consolidation programme, the CNB has set aside reserves and provisions up to the level of the total potential expenses. The volume of provisions was reduced in 2002 by repayments of the debts of banks in liquidation and by money recovered from closed bankruptcy proceedings. On the other hand, an increase in reserves was necessitated by the compensation of Česká spořitelna for costs and damages arising in connection with the assumption of clients' receivables from the bankrupt AB Banka.

The CNB made a profit of CZK 6,735 billion on client transactions. To deal with the exchange rate effects of the inflow of capital from privatisation and from other state foreign exchange income, the CNB reached an agreement with the Czech government under which the CNB bought a portion of the state's foreign exchange income into its international reserves. Specifically, this involved the conversion of income from the sale of the state enterprise Transgas and the settlement of Russian debt; the CNB thereby generated a total of CZK 6.8 billion in income, in line with the agreement reached. By converting privatisation income, however, the CNB took on foreign exchange risk. (The revenue from the direct conversion of state privatisation income depends on the amount of funds converted. Up to CZK 50 billion, the rate is 3%; from CZK 50 billion to 100 billion, 6%; and above CZK 100 billion, 9%. Because more than CZK 100 billion was converted in 2002, in subsequent years conversions will be carried out only at the highest rate; at the same time, this rate will fall by two percentage points annually, so that by 2007 it will stand at zero.)

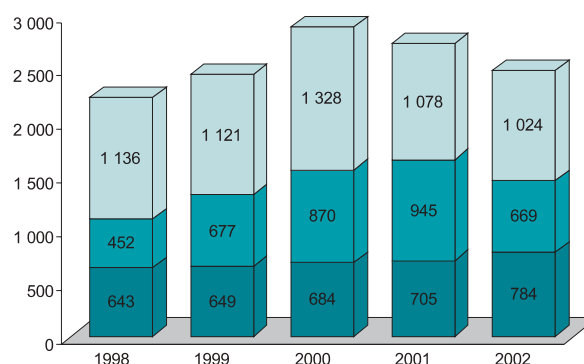
II. FINANCIAL REPORT

The CNB spent CZK 371 million on banknotes from the State Securities Printer in Prague (Státní tiskárny cenin Praha) and coins from the Czech Mint (Bižuterie Česká Mincovna). This amount was engendered by a need to top up the reserves of particular denominations of notes and coins so as to ensure smooth circulation of money. The quantity of banknotes and coins supplied was consistent with the contracts that the CNB has entered into with individual suppliers of Czech money up until the end of 2004.

In the area of operations, the CNB ended 2002 with a loss of CZK 2,053 million, down by CZK 248 million (10.8%) from a year earlier. This was connected with the CNB's payment of value added tax in 2001 upon completing the renovation of its headquarters premises. Operating expenses in 2002 amounted to CZK 2,477 million, of which CZK 784 million was accounted for by personnel costs (CZK 757 million in wages and salaries, including social and health insurance, and CZK 27 million in training), CZK 708 million by depreciation and amortisation, CZK 170 million by property-maintenance costs, and CZK 85 million by value added tax. Other expenses included those for contracted services (expert opinions, auditing, software support, office cleaning, etc.), telecommunications, communications services, travel, energy consumption, printed forms, office supplies and other sundries. Income in the area of operations (mainly from fines and penalties, sales of materials and tangible assets, and rent) totalled CZK 424 million. In 2002, operating expenses represented 3.0% of the CNB's total expenses and operating income 0.6% of its total income.

CHART II.4

Operating expenses 1998–2002 (in CZK millions)

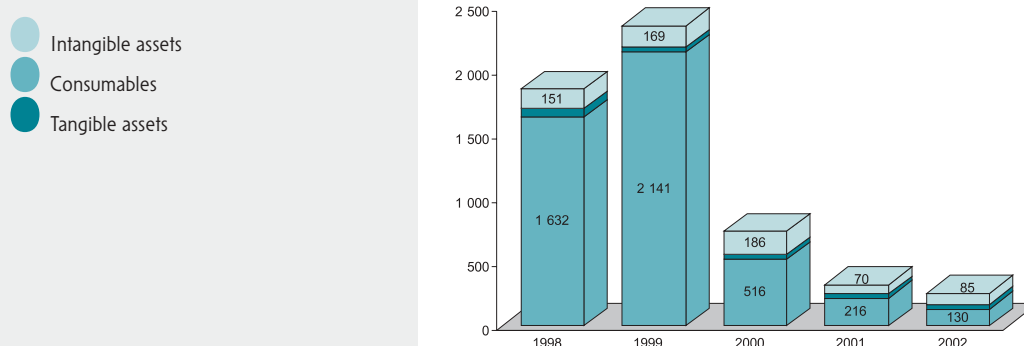


In 2002, CZK 254 million was spent on asset acquisition, i.e. around 21% less than in 2001. This decrease was due in large part to lower expenditure on acquiring computer hardware, related mainly to a fall in the price of hardware and to the postponement of upgrades to personal computers at the CNB until 2003. Out of the total expenditure on asset acquisition, CZK 130 million was on tangible assets, CZK 39 million on consumables, and CZK 85 million on intangible assets.

II. FINANCIAL REPORT

CHART II.5

Asset acquisition expenses 1998–2002 (in CZK millions)



Note: Chart II.5 does not show specific capital investments that are due to the increase in Česká finanční's equity capital, as these are participating interests associated with the consolidation of the banking sector.

In the course of 2002, there was no fundamental change to the CNB's balance-sheet structure. By the end of the year, the CNB's total assets had reached CZK 794 billion, up by CZK 167 billion in absolute terms on the previous year, mainly because of the growth in the CNB's foreign exchange assets. On the liabilities side, as in previous years the most important items were liabilities to domestic banks and currency in circulation, which accounted for 89% of the total. On the assets side, foreign receivables had the largest share of the total (the vast majority being foreign exchange reserves).

As of 31 December 2002, the CNB held reserves and provisions totalling CZK 17,601 million to cover potential losses (CZK 6,210 million in reserves and CZK 11,391 million in provisions). Relative to the end of 2001, there was a net decline in reserves of CZK 5,725 million and a net decrease in provisions of CZK 15,849 million.

Given its loss for 2002, the Czech National Bank was unable to make any allocation to the general reserve fund or to transfer any profit to the state budget. The social fund was replenished (by the amount agreed on in the collective agreement for 2003) by means of a transfer from the special reserve fund.

Including the 2002 loss, the CNB's balance sheet shows an accumulated loss of CZK 54,000 million. This will be met from future profits, subject to numerous factors whose effects cannot be predicted with any certainty at present. The CNB Bank Board is monitoring the situation, so that where necessary – and subject to the CNB's primary objective – it can take measures to resolve it.

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

ASSETS

in CZK millions

Item no.	Item	31 Dec. 2002	31 Dec. 2001	31 Dec. 2000
1.	Gold	833	837	841
2.	Receivables from International Monetary Fund	35 319	39 800	42 802
3.	Receivables from foreign countries, including securities	707 238	528 619	505 301
3.1.	Deposits at foreign banks	90 539	117 446	92 805
3.2.	Loans provided to foreign banks	20 350	14 384	14 240
3.3.	Securities	596 300	396 740	398 196
3.4.	Other receivables against foreign countries	49	49	60
4.	Receivables from domestic banks	115	793	17 371
5.	Receivables from clients	39 820	48 263	37 742
6.	Domestic securities and shares	-	-	11
7.	Fixed assets	7 197	7 769	8 329
7.1.	Tangible fixed assets	6 918	7 419	7 877
7.2.	Intangible fixed assets	279	350	452
8.	Other assets	3 669	1 419	1 722
8.1.	Deferred revenue and accrued expenses	16	388	431
8.2.	Others	3 653	1 031	1 291
	ASSETS TOTAL	794 191	627 500	614 119

LIABILITIES

in CZK millions

Item no.	Item	31 Dec. 2002	31 Dec. 2001	31 Dec. 2000
1.	Currency in circulation	224 402	205 861	195 102
2.	Liabilities to International Monetary Fund	27 869	34 033	42 399
3.	Liabilities to foreign countries	4 735	14 743	13 829
3.1.	Loans from foreign banks	4 289	14 275	13 415
3.2.	Other liabilities to foreign countries	446	468	414
4.	Liabilities to domestic banks	488 233	309 247	295 871
4.1.	Bank monetary reserves	28 359	30 273	26 575
4.2.	Repo operations	455 419	264 847	251 386
4.3.	Other liabilities	4 455	14 127	17 910
5.	Deposits from clients	35 937	27 916	21 573
6.	Domestic treasury bills issued	-	-	-
7.	Other liabilities to state budget	49 968	57 737	36 574
8.	Reserves	6 210	11 935	12 597
9.	Share capital	1 400	1 400	1 400
10.	Funds	8 156	8 198	8 202
11.	Accumulated losses from previous periods	- 44 531	- 15 903	- 18 392
12.	Profit (loss) for the accounting period	- 9 468	- 28 628	2 524
13.	Other liabilities	1 280	961	2 440
13.1.	Deferred revenue and accrued expenses	8	186	346
13.2.	Others	1 272	775	2 094
	LIABILITIES TOTAL	794 191	627 500	614 119

II. FINANCIAL REPORT

OFF BALANCE SHEET

in CZK millions

Item no.	Item	31 Dec. 2002	31 Dec. 2001	31 Dec. 2000
1.	Contingent liabilities	199 962	103 787	78 740
2.	Receivables from spot, term and option operations	101 673	10 867	13 694
3.	Liabilities from spot, term and option operations	101 453	10 861	13 269
4.	Guarantees received	182 500	62 340	30 445

PROFIT AND LOSS ACCOUNT

in CZK millions

Item no.	Item	31 Dec. 2002	31 Dec. 2001	31 Dec. 2000
1.	Interest income and similar income	22 104	28 106	28 291
1.1.	Interest from securities bearing fixed income	16 717	22 381	21 696
1.2.	Other	5 387	5 725	6 595
2.	Interest expense and similar expense	17 032	17 092	16 821
2.1.	Interest from securities bearing fixed income	-	-	523
2.2.	Other	17 032	17 092	16 298
3.	Income from securities with variable income	40	43	41
4.	Income from fees and charges	510	555	450
5.	Expenses from fees and charges	49	53	53
6.	Loss from financial operations	- 13 864	- 37 745	- 4 721
7.	Other income	444	454	121
7.1.	Income from money issue	20	17	8
7.2.	Other	424	437	113
8.	Administration expenses	2 015	2 002	2 355
8.1.	Personnel expenses	751	677	666
8.1.1.	Wages and salaries	554	501	484
8.1.2.	Social and health security	197	176	182
8.2.	Other operating expenses	1 264	1 325	1 689
9.	Other expenses	1 119	1 776	49 868
9.1.	Expenses for issuing bank notes and coinage	371	309	297
9.2.	Other	748	1 467	49 571
10.	Charge for specific and general provisions for loans and guarantees	5 876	325	1 351
11.	Release of specific and general provisions for loans and guarantees	5 997	1 245	33 008
12.	Release of specific and general provisions for shares and other financial investments	-	-	15 814
13.	Charge for other specific and general provisions	23	38	33
14.	Release of other specific and general provisions	184	-	1
15.	Ordinary profit (loss)	- 10 699	- 28 628	2 524
16.	Extraordinary income	22 521	-	-
17.	Extraordinary expenses	21 290	-	-
18.	Extraordinary profit (loss)	1 231	-	-
19.	Profit (loss) for accounting period	- 9 468	- 28 628	2 524

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



REPORT OF INDEPENDENT AUDITORS

TO THE BANK COUNCIL OF THE CZECH NATIONAL BANK

PricewaterhouseCoopers Audit, s.r.o.
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Czech Republic
Telephone +420 251 151 111
Facsimile +420 251 156 111
ID No. 40765521

We have examined whether the financial information presented on pages 15 to 22 in the Annual report (hereinafter "the Report") of the Czech National Bank (hereinafter "the CNB") for the year ended 31 December 2002, which does not form part of the audited financial statements of the CNB, is consistent with the audited financial statements as at 31 December 2002. In our opinion, the financial information included in the Report is consistent with the accounting records of the CNB maintained in support of the audited financial statements in all material respects.

Our audit report on the financial statements as at 31 December 2002 and for the year then ended and which do not form part of the accompanying Report was as follows:

"We have audited the accompanying balance sheet of the Czech National Bank (hereinafter "the CNB") as at 31 December 2002, the related statement of income and notes for the year then ended (hereinafter the "financial statements"). The financial statements and underlying accounting records are the responsibility of the management of the CNB. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion the accompanying financial statements give a true and fair view, in all material respects, of the assets, liabilities and equity of the CNB as at 31 December 2002, and the results of its operations for the year then ended in accordance with the Act on Accounting and other relevant legislation of the Czech Republic."

24 March 2003

PricewaterhouseCoopers Audit, s.r.o.
represented by

Paul Cunningham
Partner

Petr Kříž
Auditor, Licence No. 1140



III. EU INTEGRATION AND RELATIONS WITH INTERNATIONAL FINANCIAL INSTITUTIONS

Riches serve a wise man but command a fool.

Lucius Annaeus Seneca

III.1 EU INTEGRATION

The main events of the integration process in 2002

The main foreign-policy event of the integration process in 2002 was the European Council Meeting (the December EU summit in Copenhagen). The most important point on the summit agenda for the candidate countries was the completion of the accession negotiations and the setting of a date, 1 May 2004, for EU enlargement.

The CNB played a significant role in the successful completion of the accession negotiations. During 2002 it stepped up its legislative activity in order to meet the Czech Republic's general commitment towards the EU, namely to achieve full compatibility of the Czech legislation with the European legislation by the end of 2002. The CNB drafted amendments to acts that are of particular relevance to future integration into the European single market. These were the second harmonisation amendment to the Act on the CNB, the completed harmonisation amendment to the Act on Banks, a new Payment System Act, a Financial Arbitrator Act and, jointly with the Czech Ministry of Finance, an amendment to the Foreign Exchange Act. All these amendments have now taken effect.

The Regular Report on Progress towards Accession issued by the European Commission in 2002 – in which the Commission provides an annual assessment of the preparedness of each of the candidate countries for EU membership – offered a very positive evaluation of the banking and monetary policy areas. The report's conclusions regarding the Czech Republic as a whole were also generally more positive than in 2001. The macroeconomic policy mix was judged to have been adequate, although with the caveat that despite success in re-establishing macroeconomic stability, the fiscal imbalance could put it at risk again. The stability of the banking sector and the activities of the banking supervisor were also positively assessed. There was particular praise for the rapid pace of legislative change and the completion of the privatisation process in the sector. The Report states that in 2002 banking regulation achieved full compatibility with EU law and a high degree of compatibility with other international standards.

At the initiative of the European Commission, the Czech Republic's *Pre-accession Economic Programme* was also updated in 2002. This should facilitate smooth integration into the convergence programmes for fulfilment of the single currency adoption criteria after accession. Expert co-operation with the Commission in the banking area also gained pace: 2002 saw the appointment of contact persons to the EU's Banking Advisory Committee, which is active in banking supervision and regulation.

The CNB set up a European Integration Committee to co-ordinate its procedures and measures within the integration process both before and after the Czech Republic's accession to the EU. The Committee provides a framework for the exchange of information, opinions and approaches to some of the key questions relating to accession and membership of the European Union and integration into the European System of Central Banks (ESCB).

Co-operation with the European Central Bank

Co-operation between the CNB and the ECB was similar to previous years, although changes were introduced to working relations at senior and specialist levels. These changes signal future full integration into the ESCB.

Relations with the ECB have undergone a fundamental change in the sense that co-operation at all levels is becoming increasingly institutionalised. In September 2002, the President of the ECB invited the CNB Governor to attend the ECB's General Council, a body that brings together the governors of the EU central banks. Together with the central bank governors from the other candidate countries, the Governor of the CNB will be regularly invited to attend the meetings of the General Council in the role of an observer.

III. EU INTEGRATION AND RELATIONS WITH INTERNATIONAL FINANCIAL INSTITUTIONS

A further twelve CNB representatives, together with their counterparts from the central banks of the other candidate countries, will regularly attend as observers the meetings of the twelve ESCB committees, which work in key areas of activity of the system. In addition, other CNB representatives will be invited to the meetings of working groups, task forces and suchlike.

This shift towards closer co-operation follows the signing of the Czech Republic's Treaty of Accession in Athens on 16 April 2003. Materially, the co-operation is limited to discussion of common ESCB matters (i.e. matters outside the framework of the Eurosystem). In certain areas, working contacts and specific co-operation arrangements had been initiated before the signing of the accession documents.

The status of observer conferred upon the Czech Republic's representatives following the signing of the Accession Treaty allows them to express their opinions on matters under discussion, but not to actively influence the decision-making. Of increasing importance, however, is the preparation of standpoints for the CNB Governor's participation in the General Council and that of other observers in all ESCB committees.

The closer relations between the CNB and other central banks of the candidate countries on the one hand and the ECB on the other are also evident in the technical aspects of communication. As of the end of 2002, all the national central banks of the candidate countries were connected to the CebaMail secure electronic mail system that links all the EU central banks and the ECB.

Phare

Under the Phare 2002 National Programme, two projects amounting to EUR 1.15 million were proposed and subsequently approved by the European Commission:

- a training project entitled "Implementation of EU Payment Systems Standards in the Czech Banking Sector" (EUR 1 million);
- a "twinning-light" project for CNB Banking Supervision to improve its methods for assessing banks' risk profiles and its internal control system (EUR 150,000).

International tenders for the organisers of both projects will be held in the second half of 2003.

Currently under preparation are technical assistance projects for commercial banks and CNB Banking Supervision to strengthen the Czech banking sector by implementing the rules of the New Basel Capital Accord, with funding of EUR 1.5 million, and a twinning-light consultancy project for CNB Banking Supervision, with funding of EUR 0.15 million.

III.2 RELATIONS WITH INTERNATIONAL FINANCIAL INSTITUTIONS

The International Monetary Fund and World Bank Group

A standard Article IV consultation with the IMF took place in April and May. The mission stated that the continuing economic growth in the face of major macroeconomic shocks testified to the sound condition of the supply side of the Czech economy, with buoyant foreign direct investment and progress in structural reforms in recent years proving particularly beneficial.

The greatest problem in the medium term lies in the fiscal sphere. Reform of the pension and social benefit systems is a priority. Monetary and exchange rate policy is positively assessed. The reduction in interest rates is consistent with the CNB's effort to achieve its inflation target against the background of a marked appreciation of the koruna. Concerning the Czech Republic's preparations for accession to the EU and EMU, the mission recommended prompt clarification of the views on the strategy for the adoption of the euro and the timing of the necessary steps.



III. EU INTEGRATION AND RELATIONS WITH INTERNATIONAL FINANCIAL INSTITUTIONS

The November visit of IMF staff focused chiefly on assessing fiscal policy, medium-term fiscal plans and the implications of these plans for the timing of euro adoption. Above all, the mission emphasised that any delay in the reform of the state budgets could have substantial economic costs and hence cause problems for the adoption of the single currency.

The Bank for International Settlements (BIS)

The Governor of the CNB attends the regular working meetings of central bank governors organised by the BIS. At these meetings, topical issues relating to world economic and monetary developments are discussed. The close co-operation between the CNB and the BIS continued, most notably within the Basel Committee on Banking Supervision, in the Central Bank Governance Steering Group and in the co-ordination of foreign technical assistance.

Right from the outset, the CNB (as one of the transforming countries) has been represented in the Core Principles Liaison Group, which assesses the implementation of the Core Principles for Effective Banking Supervision, and as part of the Capital Group has also helped prepare the New Basel Capital Accord.

In conjunction with the Joint Vienna Institute and BIS, the CNB organised a seminar on monetary policy in Prague in June 2002, which was attended by representatives of the central banks of Central and Eastern Europe. Within the Central Bank Governance Steering Group the CNB participated in the drafting of a wide variety of analyses concerning monetary policy management, the distribution of powers, decision-making and management policies within central banks, chiefly in relation to banking supervision, and legislation governing the status and powers of the central bank. The database that the BIS has prepared in this connection, which is based on an analysis of the central bank laws of most countries, proved very helpful in formulating the relevant legislation on the CNB.

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

CNB representatives took part in the activities of key committees of the OECD. In the middle of last year, the Committee on Capital Movements and Invisible Transactions (CMIT) discussed a report on the Czech Republic's compliance with the liberalisation commitments it undertook upon becoming a member of the OECD in 1995. The report contained a notification of the Czech Republic's position on the Codes of Liberalisation based on the new legislation in force as from 1 January 2002. The Czech Republic lifted its remaining foreign exchange restrictions. In particular, this involved allowing residents to open accounts abroad, abolishing the transfer obligation, permitting branches of foreign corporations to acquire real estate in the Czech Republic for business purposes, and replacing the previous obligation to obtain a permit for bond issues with a notification duty. The Committee stated that the Czech Republic had complied with all its liberalisation commitments and that the level of liberalisation in its economy was comparable with that in the advanced countries of the OECD. The CNB played an active role in the Committee's work, particularly as regards examinations of new OECD member countries' compliance with their liberalisation commitments. It also helped to prepare horizontal projects on selected items of the Codes of Liberalisation. In addition, it co-operated on an OECD study entitled *Forty Years' Experience with the OECD Code of Liberalisation of Capital Movements*, which contains a separate section on the financial liberalisation of the Czech Republic. The study was published at the end of 2002.

During the first half of the year, an analytical team from the OECD Secretariat began to prepare an economic survey of the Czech Republic for 2001–2002. This was discussed in the Economic and Development Review Committee in January 2003. Of particular importance is the favourable assessment of macroeconomic development (especially the growth in productivity ensuing from strong investment activity and foreign investment inflows) and the OECD's positive comments on the CNB's monetary policy.

The European Bank for Reconstruction and Development (EBRD)

Every two years, the EBRD prepares and approves a strategy for each country in which it invests. The new strategy for the Czech Republic for 2002–2003 focuses in the financial sector on providing support for small and medium-sized enterprises, particularly in innovative sectors, through banking and non-banking means of financing such as leasing, venture capital and credit lines.

During 2002, the EBRD signed financing contracts for six projects involving the Czech Republic worth approximately EUR 60 million. Since its launch up to the end of 2002 the EBRD had approved contracts to finance 40 projects with a total budget of around EUR 910 million, and 32 technical assistance projects totalling EUR 5.4 million.

III.3 FOREIGN TECHNICAL ASSISTANCE PROVIDED BY THE CZECH NATIONAL BANK

The year 2002 saw a fundamental change in the CNB's philosophy of providing foreign technical assistance (FTA). Whereas previously the CNB had generally reacted to specific requests for assistance, with effect from 2002 it is also involved in offering projects of its own. In so doing, it employs the experience it has gained during the transformation process, experience that is lacked by traditional providers of assistance (Western European countries, the USA and Japan). Given the Czech Republic's future membership of the EU, active involvement in this process is basically expected of the CNB.

For 2002, the CNB devised an active FTA programme for target territories, particularly countries in South-eastern Europe and the former Soviet Union. The programme contains the following FTA provision methods:

- missions of CNB experts to the target countries, organised either by international institutions or by the CNB (in 2002 missions visited Albania, Turkey, Peru, Kosovo and Mauritius);
- bilateral consultations in the CNB between experts from the central banks of the target countries (in 2002 the central banks of Slovenia, Romania and Azerbaijan and the Chinese State Foreign Exchange Office);
- seminars organised in the CNB for experts from the central banks of the target countries.

A new element of this pro-active FTA approach is the technical seminars organised by the Czech National Bank for experts from the central banks of the target countries. A pilot seminar was organised on the subject *The CNB and Its Experience with the Process of Transformation*. The seminar, held in October 2002, met with a very positive response from the central banks of the target countries (the seminar was attended by 14 experts from the central banks of Albania, Armenia, Belarus, Georgia, the Russian Federation, Romania, Ukraine and Yugoslavia). The participants' comments formed a valuable source of information on the needs and priorities of the central banks of the target countries regarding training and institutional development.

Together with the Joint Vienna Institute a seminar was organised for the countries of Central and Eastern Europe on the theme of *Monetary Policy*. The five-day seminar was attended by 20 foreign experts. This is the third time the seminar has been held, confirming the keen interest in this subject.

A special seminar for thirteen employees of the National Bank of Kazakhstan focused on human resources management, branch management and the circulation of money, and budgets and accounting.

The experience gained was put to use in drafting the FTA plan for 2003. Seminars were focused on the most requested areas, namely the CNB and its experience with the transformation process, monetary policy, banking supervision policy, human resources management, and security and crisis management in central banks. In November 2002, the CNB Bank Board approved the draft plan and a catalogue of seminars was compiled. This can be accessed on the CNB website.





IV. MONETARY POLICY AND MONETARY DEVELOPMENTS

Money is like a sixth sense without which you cannot make a complete use of the other five.

W. Somerset Maugham

IV. MONETARY POLICY AND MONETARY DEVELOPMENTS

In 2002, the CNB continued to pursue a monetary policy based upon the inflation targeting system that it has operated since 1998. Further changes were introduced with the aim of gradually perfecting this system. Chief among these were a consolidation of the forecasting apparatus, greater involvement of the Bank Board in the inflation forecasting process and a switch to "unconditional" forecasts.

The Czech economy in 2002 had to withstand a series of unfavourable exogenous shocks. Economic growth was adversely affected by a continuing slowdown in the world economy and excessive appreciation of the koruna against the euro. Inflation was affected not only by the slowdown in GDP growth and the appreciation of the koruna, but also by a fall in food prices and very low growth in regulated prices. As a result, inflation fell below the CNB's target band and below the average level in the EU countries.

Given the unfavourable circumstances with which it was confronted, however, the Czech economy's macroeconomic results may be judged a success. The CNB contributed to this success by responding to developments during the year with several interest rate reductions and a series of measures to curb the excessive volatility and appreciation of the currency.

IV.1 THE MONETARY POLICY SYSTEM

Since 1998, the CNB's monetary policy has been based upon an inflation targeting system. Under this system, the central bank publicly announces specific inflation targets for particular time horizons. In its monetary policy decisions, the Bank Board takes into account the latest CNB forecast and assesses the risks of the forecast not being realised. On the basis of these considerations, the Board then votes on changes in the monetary policy instruments with the aim of compensating for pressures that might divert expected inflation from the target band.

Inflation targeting, however, should not be understood as the mechanical pursuit of inflation targets. The primary aim is to create a transparent system that can be understood by the public and in which monetary policy decisions are based upon clear rules and procedures. Such a system enables the central bank to commit itself credibly to its long-term price stability target, yet leaves enough leeway for an active, anti-cyclical monetary policy.

Consistent with inflation targeting, the CNB applies a managed floating regime with regard to the exchange rate. The exchange rate of the koruna is left largely to market forces – the central bank does not influence it by announcing any central parity or fluctuation band. Only in cases of excessive volatility in the exchange rate, destabilising effects caused by such volatility, or disturbances to the smooth running of the FX market, does the central bank retain the option of using market-conforming instruments to influence the exchange rate.

Since its introduction, the CNB's current monetary policy system has undergone a number of changes aimed, among other things, at strengthening its transparency and intelligibility, the medium-term orientation of the targets, the quality of the analytical and forecasting apparatus, and the co-ordination of economic policies with the Government. The present inflation target takes the form of a band for annual headline inflation, beginning in January 2002 at 3%–5% and descending evenly to 2%–4% in December 2005. This target was announced in April 2001 by agreement between the CNB and the Government.

Great emphasis is placed on the public communication of monetary policy. This is achieved primarily through the use of press conferences held immediately after the Bank Board's meetings on monetary policy and by publishing minutes of the Bank Board's meetings summarising the discussions on monetary policy and the ratio of the voting on decisions regarding interest rates. The quarterly Inflation Reports, which chart macroeconomic developments and in particular present the current CNB forecast, also play an important role in communicating monetary policy. In addition, the CNB website offers a wide range of information on monetary policy and economic developments.

IV. MONETARY POLICY AND MONETARY DEVELOPMENTS

The CNB continued to fine-tune its inflation targeting system during 2002. It paid particular attention to the forecasting apparatus used to predict the future development of the economy and as a basis for decisions on changes to interest rates. The procedure by which inflation forecasts are drawn up was modified so as to better integrate the priorities of short-term and medium-term forecasting techniques. Another positive change is the more active involvement of the Bank Board in the forecasting process. In relation to the aforementioned measures, in July 2002 the CNB abandoned the so-called "conditional" forecast, which is based on the artificial assumption that interest rates will not change, and started to use an "unconditional" forecast, which inherently contains the interest rate trajectory consistent with the forecast development of the economy. This change required a modification of the internal decision-making process with regard to interest rates and the communication of this process to the public.¹ In an attempt to document the aforementioned step and make it accessible to experts in the field, the CNB recently published a detailed description of its forecasting apparatus in the publication *The Czech National Bank's Forecasting and Policy Analysis System*.²

With regard to the upcoming date of accession to the EU, in 2002 the CNB stepped up its analyses of the consequences for the Czech economy of adopting the euro. The results of this work were published at the end of the year in a document entitled *The Czech Republic and the Euro – Draft Accession Strategy*. In this document the CNB indicated, among other things, that it intends to continue with its current inflation targeting system until such time as the euro is adopted. The minimum two-year membership period in the ERM II exchange rate mechanism, which is one of the criteria for joining the eurozone, is regarded as the gateway to adopting the euro, and not as an alternative to the existing monetary policy regime.

IV.2 MACROECONOMIC AND MONETARY DEVELOPMENTS³

The Czech economy continued to grow in 2002, albeit at a slower rate (2%) than in the previous two years. In addition to the weak economic growth recorded by the Czech Republic's major trading partners, the growth in the Czech Republic was adversely affected by continuing relatively strong appreciation of the koruna, a marked slackening of investment growth and in part also by the August floods.

As in the previous year so in 2002 the economy was characterised by low inflation. Consumer price inflation fell to its lowest level since the beginning of the transformation period. From being almost 4% at the beginning of the year, inflation fell steadily through the first half of the year and in November recorded its lowest figures since 1990 (annually 0.5%). Average inflation in the Czech Republic in 2002 (1.8%) thus fell below the EU level for the first time (see Chart IV.1).

¹ When using the conditional forecast, which is based on the assumption of unchanged monetary policy interest rates, the central bank compares the forecast for inflation in the "period of most effective transmission" with the target band. If this forecast is heading out of the band or towards its upper or lower boundary, the central bank will consider changing interest rates so as to bring the inflation forecast back within the target band. Decision-making on the basis of the unconditional forecast differs from the aforementioned process. Due to the active monetary policy response, the inflation forecast heads towards the inflation target at the medium-term horizon. Monetary policy is thus not decided on the basis of the deviation of the inflation forecast from the target at the horizon of most effective transmission, but with regard to the interest rate trajectory consistent with the unconditional forecast (for more details see page 24 of the July 2002 Inflation Report).

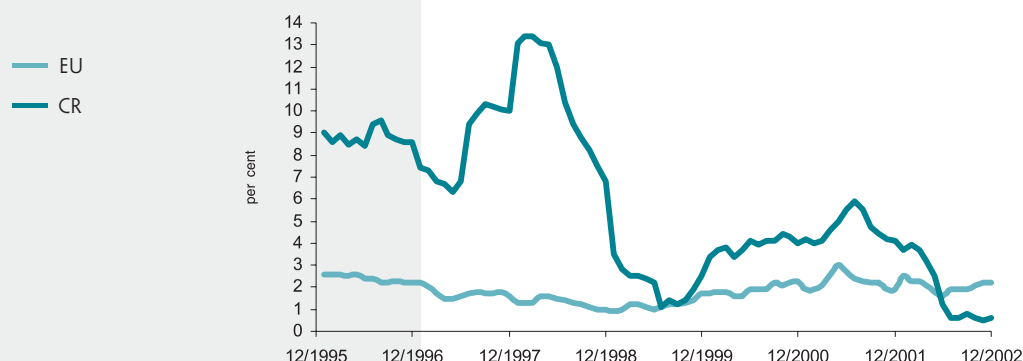
² This publication can be found on the CNB website (www.cnb.cz).

³ A detailed description of macroeconomic and monetary developments can be found in the quarterly Inflation Reports available on the CNB website (www.cnb.cz).

IV. MONETARY POLICY AND MONETARY DEVELOPMENTS

CHART IV.1

Inflation in the Czech Republic and the European Union

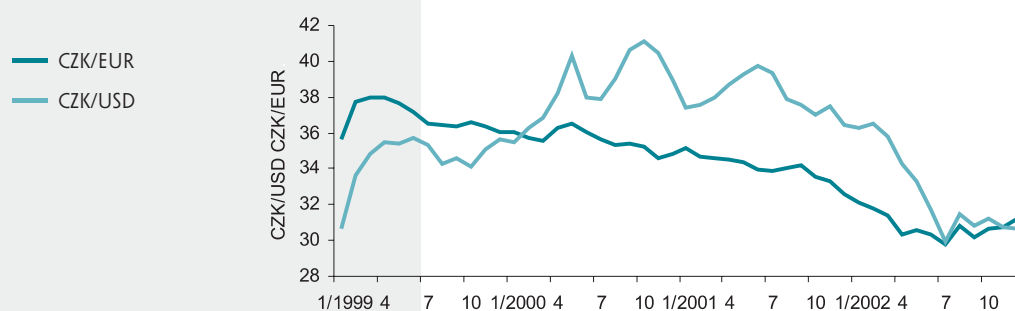


The disinflation was the result of various factors affecting both supply and demand. Domestic consumer demand may have maintained a growth rate of around 4%, but its inflationary impact on prices was attenuated by the below-potential level of GDP, the strongly competitive environment in the retail market and a sharp annual decline in import prices. Unlike in the previous year, external factors also affected regulated prices, primarily via a decrease in the prices of natural gas for households resulting from a long-running fall in import prices. The extremely low inflation figures recorded in the second half of 2002 were also due in part to a sharp fall in food prices.

A significant factor behind both the slowdown in GDP growth and the fall in inflation was the sharp appreciation of the koruna's exchange rate between the end of 2001 and the middle of 2002 (see Chart IV.2). This peaked in the first half of July 2002 at almost 15% to the euro and more than 25% to the dollar in year-on-year comparison. Only at the end of the year did the annual appreciation moderate significantly, primarily in relation to the euro.

CHART IV.2

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



Despite the combination of weak external demand, the strong exchange rate and growing domestic demand, the trade deficit was successfully reduced in 2002. This was helped by improving terms of trade (i.e. positive price factors) and, during the first half of the year, by positive developments in constant prices reflecting (among other things) structural changes in foreign trade. The year 2002, however, saw a deterioration in the services balance, where the strong exchange rate and weak external demand were exacerbated by the one-off factor of the floods. The income deficit also worsened, the most important factor there being the reinvestment of foreign investors' earnings.

IV. MONETARY POLICY AND MONETARY DEVELOPMENTS

On the labour market the gap between supply and demand widened. The unemployment rate rose during 2002, reaching 9.8% in December. The rise in unemployment strengthened the position of employers in wage bargaining, which – together with the fall in inflation – led to a reduction in annual nominal wage growth in the corporate sector. Overall, the average nominal wage in the national economy rose by 7.3% in 2002.

Annual growth of the money supply slowed in 2002. This was consistent with the parallel slowdown in economic growth and inflation. In December 2001 annual money supply growth had been 13.0%, whereas by December 2002 it had fallen to 3.2%. Conversely, the annual growth in lending adjusted for non-monetary effects increased. In December 2002, this amounted to 4.3% in nominal terms and 5.0% in real terms.

IV.3 MONETARY POLICY

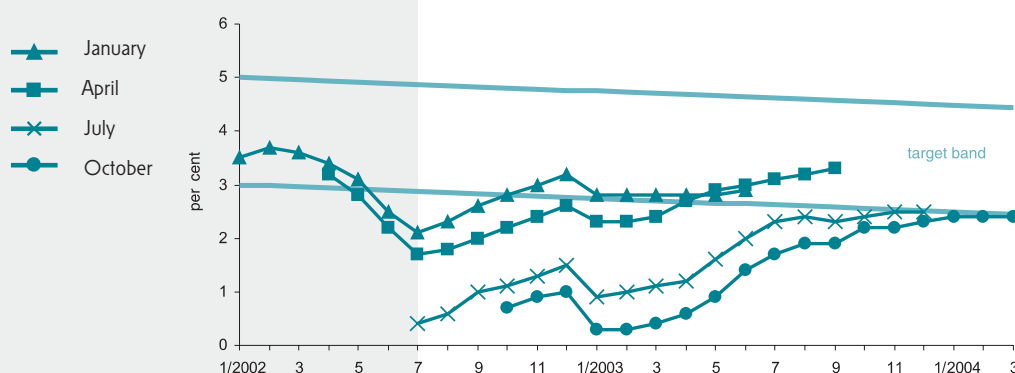
The CNB's monetary policy in 2002 reacted flexibly to developments both in the external environment and in the domestic economy. In the very first weeks of the year it had to contend with the sharp appreciation of the koruna, which deviated markedly from the equilibrium level corresponding to domestic economic fundamentals. A key measure to prevent the koruna's further appreciation was a joint document issued by the Government and the CNB entitled *Strategy for Dealing with the Exchange Rate Effects of Capital Inflows from the Privatisation of State Property and Other Foreign Exchange Revenues of the State*, approved by the Government on 16 January 2002. This agreement made it possible to convert foreign exchange revenue off the market directly into reserves, i.e. without it having any direct impact on the exchange rate. The agreement also covered state compensation for the CNB for the envisaged sterilisation and exchange rate losses. In addition, it included a number of other measures aimed at eliminating the state's influence on the exchange rate, for example the postponement of any eurobond issues by the Ministry of Finance to beyond 2002.

The koruna continued to appreciate, despite the adoption of the aforementioned agreement. This led to another considerable tightening of monetary conditions. As a result, at its extraordinary meeting on 21 January 2002 the Bank Board decided to lower the two-week repo rate by 0.25 percentage points to 4.50%. Together with this measure it also approved intervention in the foreign exchange market.

The subsequent reduction in monetary policy rates at the end of January by a further 0.25 percentage points to 4.25% was consistent with the January forecast for the development of the economy. This forecast, like those that were to follow, envisaged only modest growth in domestic demand, a very gradual closure of the output gap and a fall in inflation due to the disinflationary external environment. Accordingly, the quarterly forecasts predicted a fall in inflation until July and a subsequent rise for the remainder of the year (see Chart IV.3).

CHART IV.3

Inflation forecasts in 2002



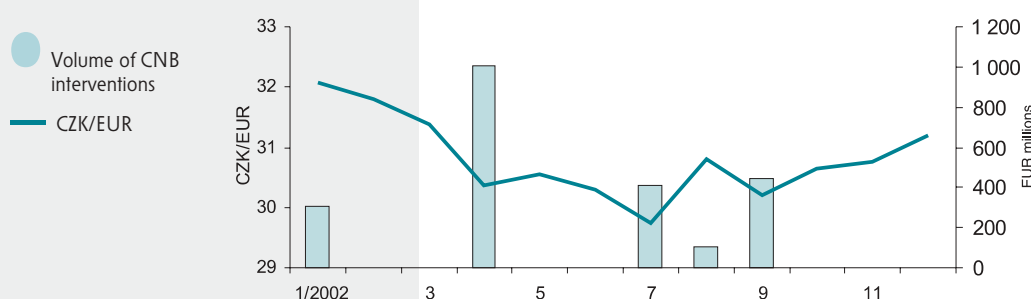
IV. MONETARY POLICY AND MONETARY DEVELOPMENTS

The inflation forecasts were revised downwards as the year progressed. This was caused both by the ongoing appreciation of the koruna and by the gradual postponement of the expected upturn abroad. Later, these disinflationary factors were exacerbated by the unexpectedly low growth in regulated prices and the fall in food prices.

In line with these developments, and on the basis of the April forecast, the Bank Board decided at the end of April to reduce the two-week repo rate by 0.50 percentage points to 3.75%. Also during April, the CNB intervened in the foreign exchange market (see Chart IV.4). At the beginning of July, there was another sharp appreciation of the koruna, bringing it up to CZK 29 to the euro. The Bank Board responded by deciding at an extraordinary meeting on questions of monetary policy to intervene covertly with immediate effect to take advantage of the current conditions on the foreign exchange market. As a result of this measure, the koruna's exchange rate stabilised for the remainder of the year at CZK 30–31 against the euro.

CHART IV.4

CNB interventions in the FX market



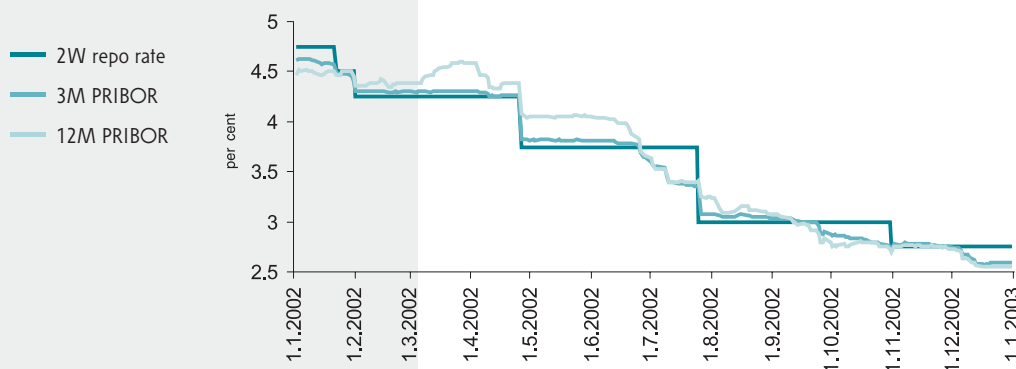
Another forecast was produced in July. The changes in forecasting methodology outlined in Section IV.1 meant that the July forecast inherently contained the interest rate trajectory consistent with the forecast. The forecast confirmed the disinflationary risks anticipated in the April forecast, and, in line with this, predicted a slower return of inflation to the target band, despite the forecast fall in interest rates. After discussing this forecast and the current risks facing the economy, the Bank Board decided to reduce interest rates by 0.75 percentage points to 3.00%. This decision, and continuing interventions in the foreign exchange market, helped to stabilise the koruna.

In August, the Czech economy was hit by severe flooding. The CNB estimated that this would have only a minor impact on GDP and inflation, however, and the floods therefore did not have any significant influence on the decisions of the Bank Board. This perception was reflected in the October forecast. A slight fall in interest rates at the end of 2002 and interest rate stability during 2003 were consistent with this forecast. Unlike previous forecasts, the baseline scenario of the October forecast assumed a slowdown in GDP growth in 2003 due to a slowdown in domestic demand growth. When discussing this forecast, most members of the Bank Board considered the GDP prediction to be too pessimistic. Consequently, in the ensuing discussion great weight was given to an alternative scenario with higher GDP growth, although this had only slight implications for the inflation forecast and for the interest rate trajectory consistent with the forecast. After discussing the October forecast and its associated risks, the Bank Board decided to lower the two-week repo rate by 0.25 percentage points to 2.75%. The rest of the year saw no significant changes to monetary policy instruments.

IV. MONETARY POLICY AND MONETARY DEVELOPMENTS

CHART IV.5

Interest rates



To summarise the CNB's monetary policy in 2002: for a large part of the year it responded to the forecast low growth in prices and slowdown in the economic recovery. Underlying this outlook were weak external demand and a tightening of monetary conditions as a result of the excessive appreciation of the koruna. In addition to the standard monetary policy instrument – the two-week repo rate – the CNB intervened more frequently than previously in the foreign exchange market in order to curb the highly imbalanced development of the koruna's exchange rate.

In 2002, monetary policy was influenced by a series of unforeseeable events, chiefly of an exogenous character, that introduced a high level of uncertainty into the inflation forecasts. The major exogenous factors were a fall in external demand and the actual and expected inflow of foreign investment, which exerted significant appreciation pressure on the koruna. The most important domestic uncertainty was the timing and size of the fiscal impulse. Despite the relatively large external and domestic uncertainties, monetary policy had a stabilising effect on the inflation expectations of financial market analysts, businesses and households. Despite a temporary reduction in inflation, these subjects expected inflation to be at the lower boundary of the inflation target band at the one-year horizon (see Table IV.1).

TABLE IV.1

Expected annual consumer price inflation

	Financial market	Businesses	Households
12/01	3.9	3.9	4.6
1/02	3.8		
2/02	3.5		
3/02	3.5	3.6	3.9
4/02	3.5		
5/02	3.3		
6/02	3.1	2.7	1.6
7/02	2.8		
8/02	2.7		
9/02	3.1	1.9	1.3
10/02	2.5		
11/02	2.4		
12/02	2.3	2.3	2.6

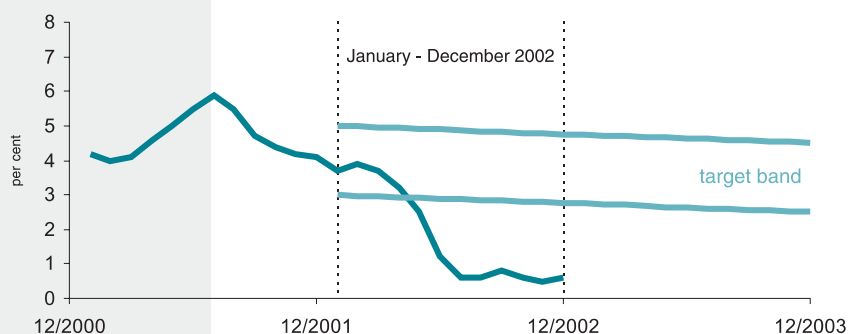
IV. MONETARY POLICY AND MONETARY DEVELOPMENTS

IV.4 FULFILMENT OF THE INFLATION TARGET IN 2002

The inflation target was set in April 2002 in the form of a descending band that begins in January 2002 at 3%–5% and ends in December 2005 at 2%–4%. This target was only hit during the first four months of 2002; in the remaining months of the year inflation fluctuated below the target band (see Chart IV.6).

CHART IV.6

Fulfilment of the inflation target in 2002

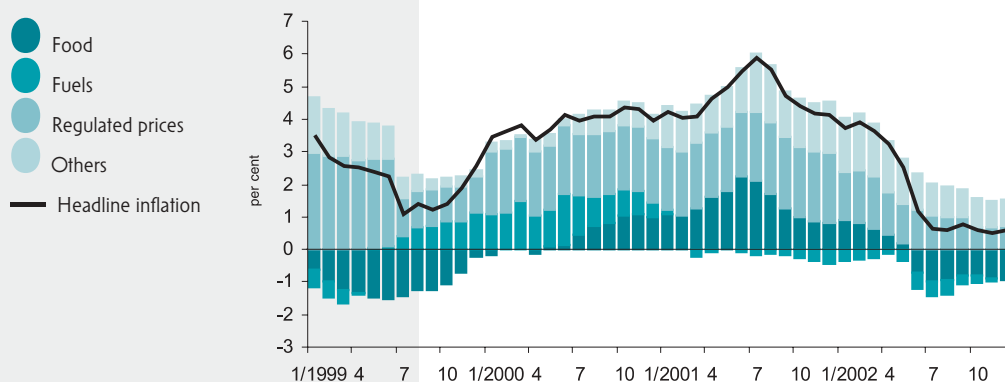


Owing to the lag in most effective transmission, which the CNB estimates at 4–6 quarters, the fulfilment of the inflation target in January 2002 was affected most by the monetary policy decisions made in the second half of 2000 and during 2001. To assess the influence of monetary policy on the size of the divergence of inflation from the target during 2002, it is therefore necessary to evaluate retroactively the monetary policy measures adopted during this period. Broad knowledge of the linkages in the economy and the transmission of monetary policy into inflation makes it possible to roughly evaluate the extent to which the "undershooting" of the target band was due to the non-fulfilment of the exogenous assumptions of the forecasts, their internal mechanisms, or the risks attaching to the forecasts as perceived by the Bank Board.

In large part, the "undershooting" of the inflation target during 2002 was due to the non-fulfilment of the forecasts' assumptions regarding the evolution of exogenous factors (food prices and regulated prices – see Chart IV.7) and the exchange rate. If the forecasts had estimated the evolution of exogenous factors correctly, the monetary policy based on those forecasts would probably have been looser and the undershooting of the inflation target might have been less marked. The aforementioned exogenous factors, however, tend to fluctuate significantly, which complicates any estimate of their future development.

CHART IV.7

Structure of annual consumer price inflation



IV.5 DRAFT STRATEGY FOR ACCESSION TO THE EUROZONE

The negotiations on the financial conditions for the accession of the ten candidate countries to the EU were completed at the Copenhagen summit in December 2002, and in Athens in April 2003 the Czech Republic signed the Treaty on Accession to the EU. An integral part of this Treaty is an undertaking to subsequently introduce the euro (i.e. join the eurozone).

In connection with the Czech Republic's integration into European structures, at the end of 2002 the CNB published and submitted to the Czech Government for discussion a document entitled *The Czech Republic and the Euro – Draft Accession Strategy*. This document summarises the basic starting points for the Czech Republic's integration into European monetary structures, discusses the positive effects and potential risks associated with this process, and recommends that the Czech Republic join the eurozone as soon as economic conditions allow for doing so.

The positive effects of the Czech Republic's entry into the eurozone, which will complete the Czech economy's integration into European monetary structures, will be considerable. The Czech Republic will be able to participate fully in formulating and implementing the single European monetary and exchange rate policy, which aims to strengthen macroeconomic stability in Europe. Membership of the eurozone should have positive impacts on *domestic economic policy*, since the key elements of the system are a requirement for balanced public budgets in the medium term and a requirement to undertake structural reforms supporting sustainable economic growth.

Fiscal policy implemented in accordance with the Stability and Growth Pact, coupled with a decline in the risk premium, will lead to stabilisation of *long-term interest rates* at a low level. Corporations and households will profit not only from the low interest rates, but also from access to the deeper, more liquid and more transparent eurozone capital markets.

The irrevocable fixing of the currency within the EMU will increase the stability of the financial sector and reduce the risks of *monetary turbulence*. Sharp fluctuations in the exchange rate present a significant threat to a small open economy in an environment of liberalised capital flows. The domestic enterprise sector in particular will profit from the elimination of *exchange rate risks vis-à-vis* the eurozone countries, which are the Czech Republic's most important trading partners. These benefits will show up as a decline in transaction and hedging costs and a reduction in investment uncertainty. The household sector will profit from greater *price transparency*, which stimulates competition.

These positive effects will foster a more stable environment for entrepreneurship, more efficient allocation of resources, increased foreign trade and subsequently higher economic growth. Eurozone membership will thus further speed up the real convergence of the Czech economy towards the EU average.

The potential risks of adopting the euro are associated primarily with the response of the economy to economic disturbances under the irrevocably fixed exchange rate within the eurozone. In the event of insufficient cyclical and structural alignment of the Czech economy and its financial sector with the eurozone economies, economic shocks may have unequal and asymmetric impacts in different regions. The cessation of an independent monetary policy able to respond flexibly to such shocks constitutes a challenge for fiscal policy and for the functionality of natural adjustment mechanisms, especially on the labour market. The barriers to fast entry into the eurozone may thus be as follows: (i) *insufficient alignment of the Czech economy with the eurozone economies in the real and financial spheres*, (ii) *low fiscal policy flexibility*, and (iii) *an insufficiently flexible labour market*.

IV. MONETARY POLICY AND MONETARY DEVELOPMENTS

The characteristics of the Czech economy are gradually converging towards those of the EU Member States. Trade with the EU accounts for about two-thirds of the total foreign trade of the Czech economy, and the inflow of foreign direct investment from the EU accounts for as much as four-fifths of all the investment flowing into the Czech economy. Nevertheless, the cyclical development of the Czech economy is less aligned with the cyclical trend in the eurozone than is that of the average eurozone Member State, and there are also differences between the Czech Republic and the eurozone countries in the structures of their economies and financial sectors.

The Czech Republic's large public budget deficits, together with the built-in trends towards a further structural widening of those deficits and inadequate conditions for the symmetrical functioning of automatic stabilisers, represent a serious barrier to effective fiscal stabilisation policy. The aim of fiscal consolidation must be not only to fulfil the Maastricht criteria, but also – in compliance with the Stability and Growth Pact – to achieve in the medium term a balanced public finance budget facilitating the effective action of automatic stabilisers and flexibility of discretionary expenditure. In the absence of an autonomous monetary policy, fiscal policy will – given the irrevocably fixed exchange rate within the eurozone – be the key instrument of macroeconomic stabilisation.

Like the EU labour market, the Czech labour market is characterised by relatively low mobility and flexibility of the labour force. Moreover, for several years following accession, restrictions on the free movement of labour from new member states will have to be reckoned with. To strengthen the adjustment mechanisms on the labour market, steps must be taken to increase the flexibility of the labour market and real wages not only in the institutional area, but also in areas such as transport infrastructure and the housing market.

From the procedural point of view, assuming that the Czech Republic enters the EU in 2004 and fulfils the Maastricht convergence criteria, the first possible year for joining the eurozone is 2007. In the view of the CNB, the evaluation of the positive effects and possible risks speaks in support of the Czech Republic's fast entry into the eurozone. However, the current outlook in the fiscal policy area is not fully consistent with this scenario. Accordingly, the CNB recommends that the aforementioned economic and political measures be implemented in such a way as not to rule out the possibility of joining the eurozone sometime around 2007.

Until the monetary integration process has been completed, independent Czech monetary policy will continue to be implemented by means of the inflation targeting strategy. Continuing participation of the koruna in the ERMII is consistent with this strategy. The ERMII is regarded merely as the gateway to eurozone participation and not as an alternative to the existing monetary policy regime.





V. OPEN MARKET OPERATIONS AND MANAGEMENT OF INTERNATIONAL RESERVES

Money has caused many to lose their senses, but few to come to their senses.

František Vymazal

V. OPEN MARKET OPERATIONS AND MANAGEMENT OF INTERNATIONAL RESERVES

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

Decision-making

The CNB Bank Board sets three key interest rates: the two-week repo rate, the discount rate and the Lombard rate. The CNB's main monetary policy interest rate is the two-week repo rate, which it uses to signal its monetary policy stance to the market and – via asset operations on the money market (which are remunerated at this rate) – to influence the short end of the yield curve. The discount and the Lombard rates provide the floor and ceiling respectively for short-term interest rates on the money market. Consequently, changes in the repo rate (which is set half-way between the above two rates) are accompanied by symmetrical changes in the discount and Lombard rates.⁴

Operative (daily) decision-making regarding the central bank's money market operations is based on a daily supply/demand forecast for commercial bank reserves for the day and the next four days. The purpose of such operations is to balance the predicted supply and demand so that the liquidity of the banking system is at the optimal level for compliance with the reserve requirement and hence causes no long-term divergence of short-term interest rates from the desired level.⁵

The reserve supply forecast is composed of:

a) autonomous liquidity factors:

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

b) monetary policy liquidity factors:

- maturity of automatic facilities (lending facility, deposit facility), and
- maturity of repos.

The reserve demand forecast is composed of:

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

⁴ The CNB Bank Board approved a change to the approach used to manage its key interest rates at the end of February 2001. The repo rate was declared the only relevant monetary policy rate for steering short-term market rates and was placed in the middle of the corridor formed by the Lombard rate and the discount rate (1% below the former and 1% above the latter).

⁵ The desired level of short-term interest rates is signalled by the two-week repo rate.

V. OPEN MARKET OPERATIONS AND MANAGEMENT OF INTERNATIONAL RESERVES

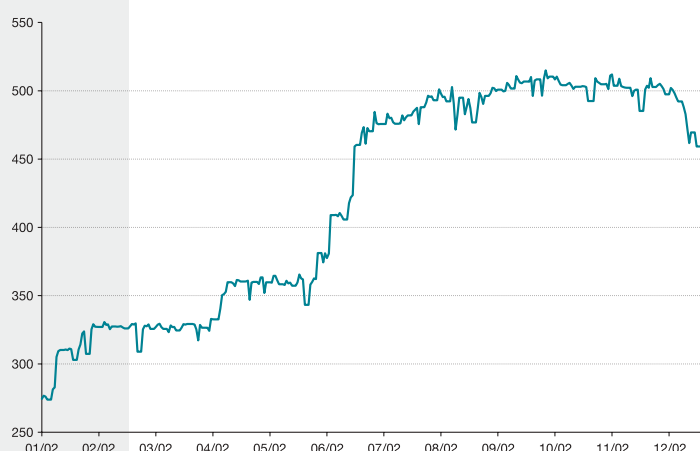
CNB instruments

The instruments used by the CNB to conduct monetary policy are fully harmonised with those of the European Central Bank (ECB).

In 2002, the main instrument for managing short-term interest rates was the two-week repo. Owing to a persistent and considerable excess of liquidity in the Czech banking system, these operations were used for absorbing excess reserves (unlike in the case of the ECB, which provides liquidity). The liquidity absorbed is remunerated at no higher than the repo rate. Two-week repo tenders were announced daily and settled with same-day value. The volume of excess liquidity absorbed in monetary market operations in 2002 varied between CZK 274 billion and CZK 515 billion, the average being CZK 422 billion, an increase of around CZK 130 billion compared to the 2001 average. This increase was chiefly attributable to the CNB's foreign exchange interventions (CZK 69.5 billion) and the conversion of revenue from privatisation and Russian debt (CZK 126.2 billion), especially in the second half of the year, as well as to interest paid to banks on monetary operations (CZK 14.88 billion). A fall of around CZK 50 billion in the excess liquidity absorbed at the end of the year was due, among other things, to a seasonal increase of around CZK 19.9 billion in currency in circulation prior to the Christmas holidays and to a rise of around CZK 36 billion in government deposits with the CNB. Both seasonal factors are short-term and are closely linked with the end of the calendar year. During January their effect usually wears off.

CHART V.1

Excess liquidity absorbed in 2002 (in CZK billions)



The CNB's instruments also included two automatic facilities – the marginal lending facility and the deposit facility.

Under the automatic lending facility, the CNB lends any amount of Czech koruna overnight to banks upon request against eligible collateral by transfer of securities. The CNB accepts T-bills and CNB bills as collateral. Such loans are charged interest at the Lombard rate. The Lombard rate thus provides a ceiling for short-term interest rates.

Under the deposit facility, banks have the option of making overnight deposits with the CNB at the discount rate (without receiving collateral in exchange). The discount rate thus provides a floor for short-term interest rates.

At the end of 2002, the conditions for the two transaction types were unified. The minimum volume for both was set at CZK 10 million and the requirement for whole multiples of CZK 100 million was abolished. This has increased the flexibility of the automatic facilities.

V. OPEN MARKET OPERATIONS AND MANAGEMENT OF INTERNATIONAL RESERVES

Fine-tuning operations (ad hoc repos and reverse repos under market conditions) are used only rarely.

In 2002, the CNB continued issuing its own bills, which it used as eligible collateral for open market operations (i.e. repos and the lending facility) and which banks used to secure intraday credit from the CNB.

The CNB gave the banks the option of drawing collateralised intraday credit in order to ensure the smooth running of the payment system at the CNB's Clearing Centre. No interest is charged on intraday credit and there is automatic spillover into the marginal lending facility at the end of the day in the event of non-repayment. At the end of 2002, in connection with the launch of the short-term bond system (SKD), a number of technical changes were made to the intraday credit facility, leading to greater flexibility and efficiency with regard to the treatment of the collateral provided. Banks may take out and repay credit at any time during the accounting day and in any amount, provided that they are able to secure this credit with eligible collateral.

The reserve requirements were further harmonised with the ECB system during 2002. Effective January 2002, a zero reserve ratio was set for repo liabilities, the maintenance period was extended from 14 days to one month (starting on the 24th calendar day of each month and ending on the 23rd calendar day of the following month), the remuneration conditions were changed (to remuneration of average real holdings of reserves not exceeding the reserve requirement over the entire maintenance period), and several other technical aspects of the reserve requirement calculation were adjusted. This means that as from 2002 the reserve requirement system is essentially harmonised with the European Monetary Union system. Funds deposited by banks at the CNB as required reserves were remunerated at the repo rate. Only those reserve holdings which on average do not exceed the required reserves are remunerated. Primary liabilities of banks vis-à-vis non-banking entities with agreed maturity up to 2 years were subject to the reserve requirement. The reserve ratio was 2%, and averaging of reserve holdings over the maintenance period was permitted.

The primary government bond market

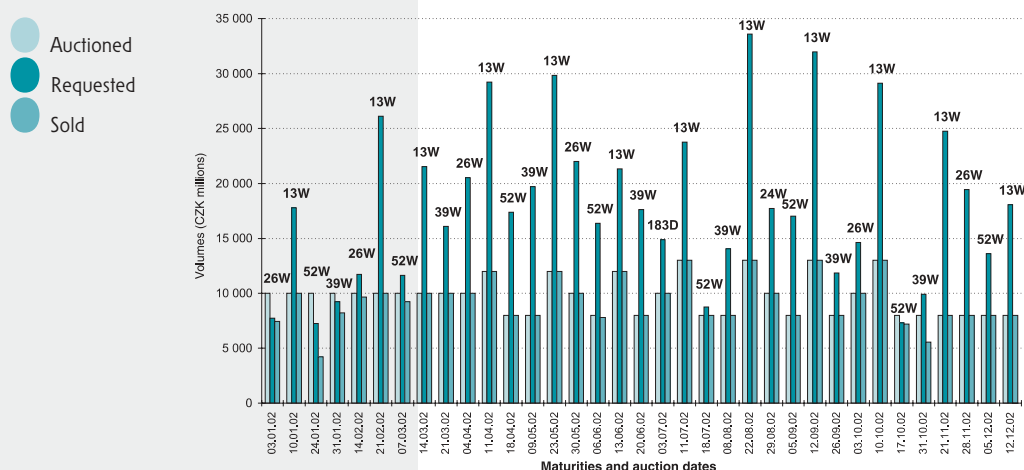
The Czech National Bank assists in the management of the Czech Republic's state debt. This it does by organising primary sales of government bonds and providing other expert advice.

In 2002, the CNB organised 35 T-bill auctions for the Ministry of Finance. These bills had agreed maturities of 3 months to 1 year and totalled CZK 441 billion. Of this volume, bills with a face value of CZK 325 billion were purchased by direct participants in the auctions and the remainder (amounting to CZK 116 billion) were purchased by the issuer and placed in its portfolio. The bills were sold by Dutch auction. At the close of 2002, the outstanding volume of T-bills held by investors was CZK 164 billion. Owing to sufficient liquidity, the issuer cancelled the last T-bill auction in 2002 (totalling CZK 8 billion) and reduced the total volume in the preceding four auctions by CZK 14 billion. The chart below shows that the investors at T-bill auctions were particularly interested in bills with short maturities. The chart gives an overview of the volumes of T-bills auctioned, requested and sold in the 2002 auctions, broken down by maturity.

V. OPEN MARKET OPERATIONS AND MANAGEMENT OF INTERNATIONAL RESERVES

CHART V.2

Results of T-bill auctions in 2002



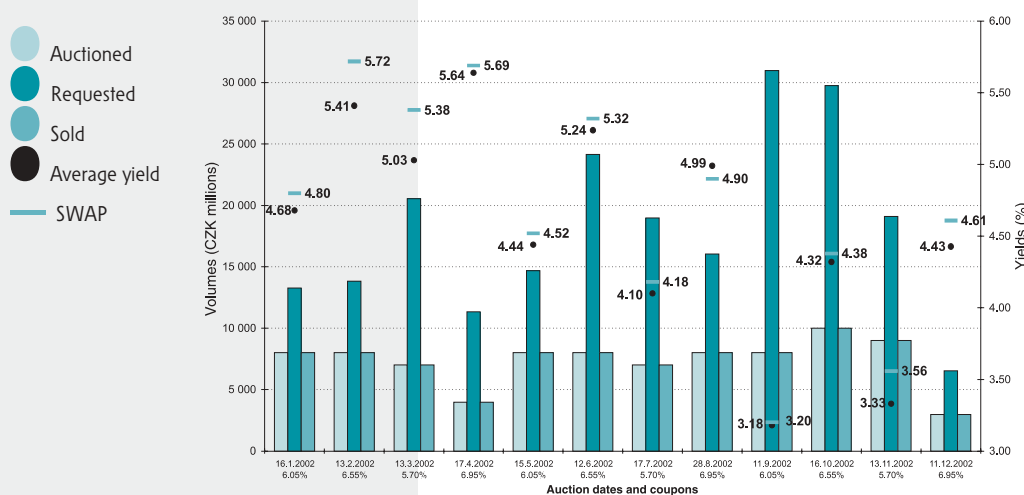
In 2002, the technique of reopening existing issues continued to be applied to government bonds with agreed maturity of over one year. This helped to increase the liquidity of the secondary market. As regards the planning and organising of the auctions, there is a trend towards ensuring greater predictability and providing better information to market participants. This is being fostered by regular and ad hoc informative meetings between CNB and Ministry of Finance representatives and the direct participants in government bond auctions.

In the area of auctions, a change to the settlement of issues took effect in January 2002 with the incorporation of Univyc into the system.

A total of 12 auctions of medium-and long-term government bonds took place in 2002, with a total nominal value of CZK 88 billion. Four bond issues, with a nominal value of CZK 18 billion, were duly redeemed. The following chart gives information on demand at the auctions in 2002.

CHART V.3

Results of government bond auctions in 2002



MANAGEMENT OF INTERNATIONAL RESERVES

The objectives of international reserves management

The CNB's objective in managing international reserves is to achieve maximum and stable returns subject to liquidity restrictions and limits on market and credit risks.

These restrictions and limits ensue from the purposes of holding international reserves, the most important of which is to provide for the foreign exchange obligations of the state and the CNB. First among these obligations is the CNB's potential to intervene, since foreign exchange interventions constitute the biggest potential foreign currency obligation of the central bank. The amount of the reserve holdings is a result of monetary policymaking and of the government decree under which privatisation proceeds were converted.

In the Act on the CNB, international reserves management is defined as one of the core activities of the central bank. When carrying on this activity, the CNB acts independently of the Government of the Czech Republic.

International reserves represent approximately 90% of the CNB's balance sheet, and the income from these reserves is one of the CNB's most significant revenues. The volume of the reserves is regularly published in the "Financial Markets" section of the CNB website – www.cnb.cz. The importance of the reserves in the CNB's balance sheet is illustrated in the following chart. Given the importance of sterilisation transactions to the CNB's financial results, we also present a chart showing the share of sterilisation in the CNB's liabilities.

CHART V.4

Share of international reserves in CNB balance sheet assets

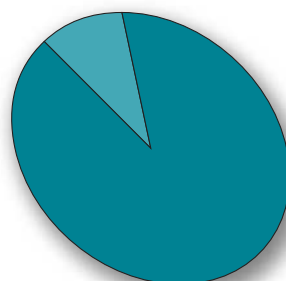
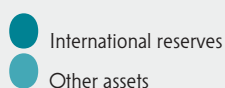
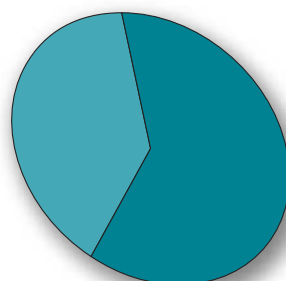
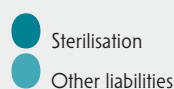


CHART V.5

Share of sterilisation in CNB balance sheet liabilities



The reserves management strategy

The CNB Bank Board approved several major changes to the reserves management strategy in 2002. The most important of these were an increase in the duration of the reserve portfolio (from around 0.8 of a year to twice this figure), authorisation to invest to a limited extent in debt instruments issued by government agencies (Pfandbrief in Germany, Fannie Mae⁶, FHLMC⁷), and authorisation to use futures. The debate on strategy will continue into 2003, the main theme being the currency composition of the reserves. The currency structure of the international reserves is closely tied up with the question of the size of the reserves and with the issue of the risk profile of the CNB's balance sheet. The search for new investment opportunities and approaches is motivated primarily by the massive increase in the reserves linked with inflow of foreign capital and the Czech Republic's upcoming entry into European structures. These factors have, or will have, a direct bearing on the way in which the core functions of the central bank are provided for.

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

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

One portfolio is defined in each of the reserve currencies. Foreign exchange risk may not be accepted when managing the portfolios.

The parameters defining the interest rate risk assumed – portfolio duration in particular – are also set separately for each portfolio. The duration set in 2002 was based on the requirement that the portfolio should not record a loss in any three-month period. The search for the target duration again uses historical time series of yields on the relevant financial markets. At the beginning of last year, the duration was set at 0.94 of a year for the euro portfolio and at 0.84 of a year for the dollar portfolio. In addition to historical data, the methodology for setting duration takes into account the situation on the financial markets (putting it simply, the higher are short-term interest rates, the higher is the interest rate risk that can be accepted). Consequently, given the general decline in interest rates, the portfolio duration was later shortened to 0.93 of a year for the euro portfolio and 0.76 of a year for the dollar portfolio. The portfolio duration is shown in the chart at the end of this section.

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

⁶ Fannie Mae – FNMA (Federal National Mortgage Association) – an agency that finances mortgages in the USA and that enjoys implicit guarantees from the U.S. government.

⁷ Freddie Mac – FHLMC (Federal Home Loan Mortgage Corporation) – an agency that finances mortgages in the USA and that enjoys implicit guarantees from the U.S. government.

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

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

Rate of return on international reserves management

The above description of the CNB's reserves management strategy demonstrates that the CNB's international reserves are invested in high-quality, liquid instruments. Moreover, maximum maturity is limited to 15 years for government bonds and 3–6 months for claims on banks (depending on the bank's rating). The portfolio management rules permit deviation from the benchmark credit quality, i.e. investment in securities issued by issuers other than those included in the benchmark.

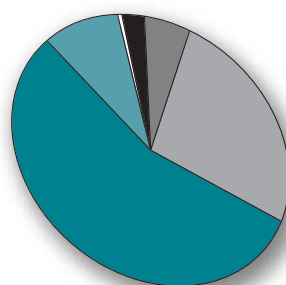
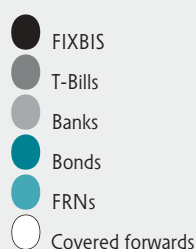
Portfolio managers invest the reserves in particular instruments in compliance with the principles of the CNB's reserve management policy and subject to investment opportunities and developments on the financial markets. The largest part of both portfolios is invested in securities issued by the governments of OECD countries, government-guaranteed securities, or securities issued by eligible agencies and multilateral institutions.

At the end of last year, the portfolio managers took the opportunity to invest a significant part of the portfolios in covered forwards using Japanese bonds and T-bills (see the chart).

Owing to the size of the yield difference between eurobonds (i.e. bonds issued by eligible issuers other than the U.S. government) and U.S. government bonds, approximately 13% of the USD portfolio with maturity of over 1 year is invested in eurobonds. The following charts show the structure of the international reserves broken down by the instruments in which they are invested.⁸

CHART V.6

Breakdown of EUR portfolio by instrument as at 2 January 2002



⁸ **T-bill** – Treasury Bill – issued by a national government.

covered forward – synthetic instrument that involves purchasing a foreign currency, investing it in, say, money market instruments, then reselling that foreign currency in the future when the investment matures.

FIXBIS – money market instrument issued by the Bank for International Settlements (BIS), having the character of a T-bill and only tradable by central banks.

FRN – floating rate note – bond with a variable interest rate.

V. OPEN MARKET OPERATIONS AND MANAGEMENT OF INTERNATIONAL RESERVES

CHART V.7

Breakdown of EUR portfolio by instrument as at 31 December 2002

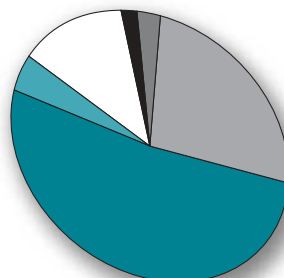
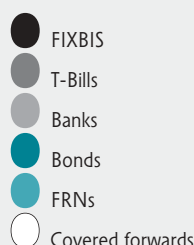


CHART V.8

Breakdown of USD portfolio by instrument as at 2 January 2002

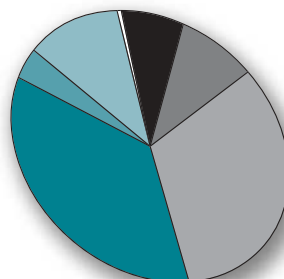
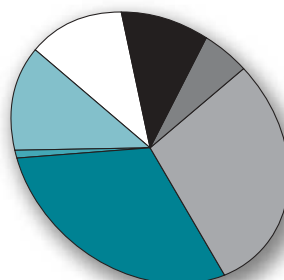


CHART V.9

Breakdown of USD portfolio by instrument as at 31 December 2002



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

In addition to the basic portfolios managed directly by the CNB, portfolios managed by external portfolio managers also formed part of the international reserves. These portfolios were subject to the same performance measurement rules and were used to verify and assess certain procedures that may potentially also be used for internal reserves management. These externally managed portfolios constituted approximately 2% of the reserves. After evaluating the external managers' results in terms of returns and fulfilment of targets (this being the reason for commissioning them in the first place), the CNB decided to terminate their mandate at the end of May 2002 after two years' duration.

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The overall return on the international reserves in 2002 (i.e. the weighted average of the rates of return on the individual portfolios) was 4.33%. The return on the euro portfolio was 4.56% and that on the dollar portfolio 3.53%. The relative rate of return (i.e. the difference between the rate of return on the actual portfolio and that on the benchmark) was 0.10% for the euro portfolio, which is around EUR 13.5 million in absolute terms, and 0.15% for the dollar portfolio, or USD 7.1 million in absolute terms. The table below summarises these annualised returns and also the returns on the external portfolios up to the end of May:

TABLE V.1

Returns on portfolios and average return on managed portfolios for 2002

	EUR portfolios		Multicurrency in USD
	Internal	External	External
	to 31 May 2002		to 31 May 2002
Market value as of 31 Dec. 2002	16 148 792 940	111 031 623	110 249 166
Profit vs. benchmark (b.p.)	9.61	5.05	-10.79
Rate of return p.a.	4.56%	2.21%	9.58%

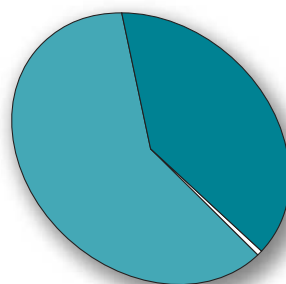
	USD portfolios		Gold in USD (excl.
	Internal	External	exchange rate changes)
	to 31 May 2002		
Market value as of 31 Dec. 2002	6 008 999 837	117 491 738	48 174 785
Profit vs. benchmark (b.p.)	14.94	-15.20	
Rate of return p.a.	3.46%	3.29%	0.26%

	EUR portfolios	USD portfolios	Gold (incl. exchange
			rate changes) in USD
Sum of market values	16 148 792 940	6 008 999 837	48 174 785
Rate of return p.a.	4.56%	3.53%	25.81%
Weighted average rate of return p.a.	4.33%		

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

CHART V.10

Credit allocation of international reserves at the year-end



V. OPEN MARKET OPERATIONS AND MANAGEMENT OF INTERNATIONAL RESERVES

CHART V.11

Currency allocation of international reserves in per cent as at the year-end

● USD
● EUR

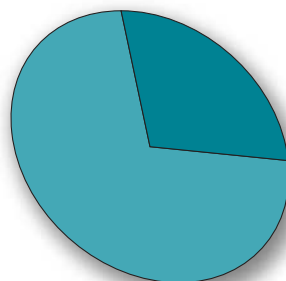
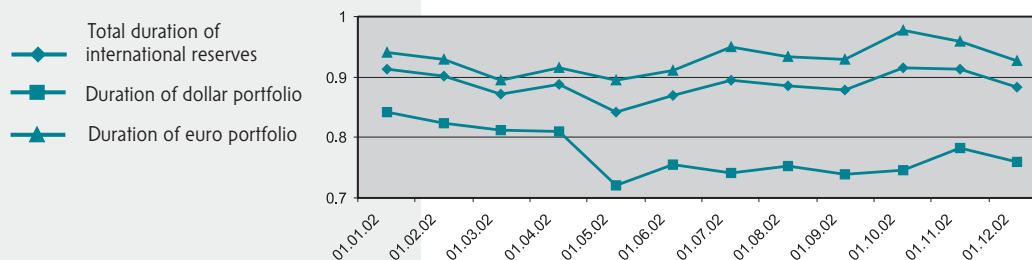


CHART V.12

Portfolio duration in years





VI. THE BANKING SECTOR AND BANKING SUPERVISION

*Sir, money is of all things the master, the lode-star and true compass, the way, the meaning,
the wisdom and the strength, the foundation and the steadfast friend.*

Lope de Vega

VI. THE BANKING SECTOR AND BANKING SUPERVISION

During 2002, the banking sector carried on the process of stabilisation and improving its financial results. Banking supervision was focused mainly on implementing the new provisions of the Act on Banks, improving the performance of banking supervision, and extending co-operation with foreign and domestic financial regulators.

VI.1 THE BANKING SECTOR

As of 31 December 2002, there were 37 banks and branches of foreign banks operating within the Czech Republic, one fewer than the previous year. The branch of the French bank Société Générale ceased independent operation after its activities were subsumed within Komerční banka. Following the conclusion of conservatorship in May 2002, IP banka finally closed its doors in August of that year. The end of the year saw the launch of a new bank, Wüstenrot hypoteční banka.

The completion of privatisation in 2001 has led to marked growth in the proportion of foreign capital in banks operating within the Czech Republic. At the end of 2002, 82% of the equity capital came from abroad, mainly from EU countries, and 93.3% of total assets were administered directly or indirectly by banks controlled by foreign owners.

Lending, which as of 31 December 2002 accounted for almost 36% of total assets, remained one of the most important banking sector activities. The fall in this share by one point from the preceding year (and the absolute fall in the value of credits) was primarily due to the continuing transfer of certain receivables from large Czech banks to the Czech Consolidation Agency (Česká konsolidační agentura). Taking into account these transfers and the effects of valuation changes, write-offs and so on, credits recorded an increase, especially in the second half of the year. Banks were more prudent in their lending, as reflected in the fact that the most striking growth was in loans to natural persons in the form of consumer credit and mortgage loans, which are generally considered low-risk. The second-highest volume of assets is allocated in quick assets, i.e. predominantly in government securities, on central bank accounts, and in CNB bills. As of 31 December 2002, quick assets amounted to CZK 814.1 billion, i.e. 32.4% of total assets. In comparison with the previous year, there was a sharper drop in the amount of funds deposited in other banks (by almost 30% to CZK 398.1 billion). Investment by banks in securities, excluding government securities, stood at CZK 200.0 billion at the end of 2002, i.e. 8.0% of total assets.

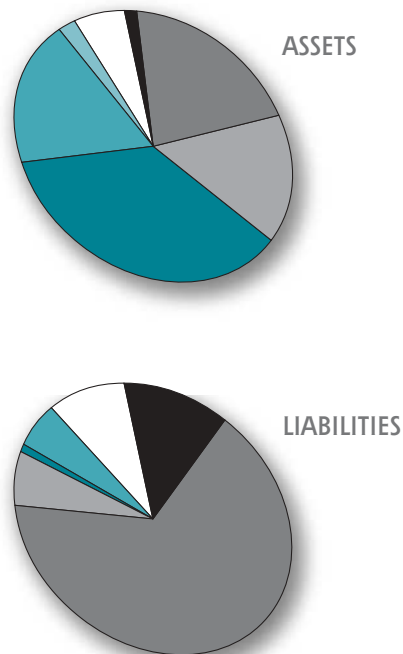
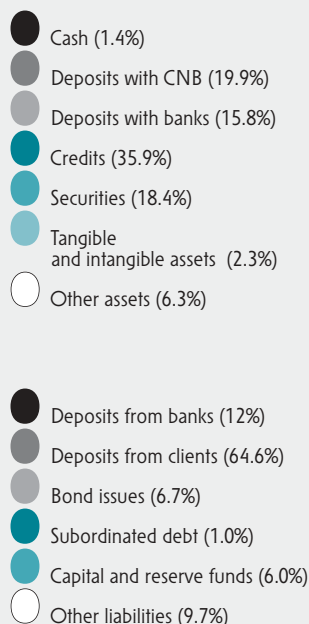
The principal source for commercial banks' asset transactions are deposits from non-bank clients, which stood at CZK 1,624.3 billion at the end of last year, i.e. 7.2% more than at the end of the previous year. However, government institutions, including the Czech Consolidation Agency, accounted for the lion's share of the growth in such deposits; their deposits almost doubled in volume. Deposits by other clients, forming 90% of total primary deposits, rose by 2.4%. A sharp drop – of 17.8% to CZK 301.8 billion – was recorded in 2002 for deposits from other banks. This drop was related to banks' decreased need to augment their funds at a time of relative abundance in primary deposits, which are difficult to invest in suitable commercial activities with acceptable levels of risk. Debt securities remained a negligible source of funds in 2002, amounting to only 6.4% of total assets at the end of year.



VI. THE BANKING SECTOR AND BANKING SUPERVISION

CHART VI.1

Structure of assets and liabilities

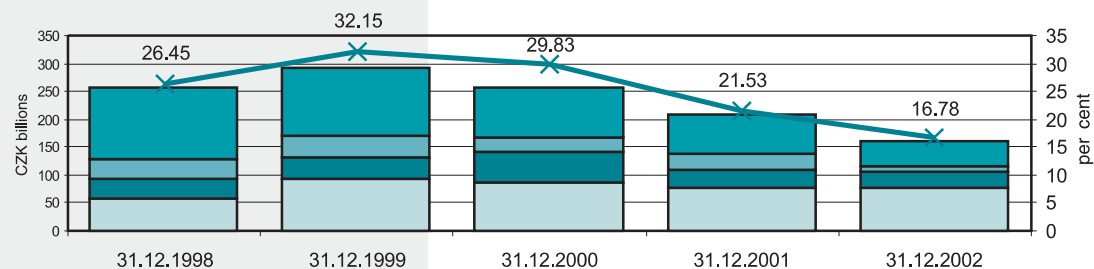
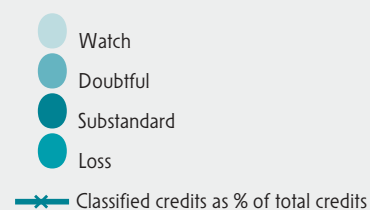


The ever-increasing emphasis banks place on managing specific banking risks is leading to improvements in many of the indicators of their financial soundness and results.

This positive trend is particularly apparent in the quality of credit portfolios. The total volume of classified credits fell during 2002 by 24.1% to CZK 159.2 billion. Although the main factor behind this decline was the transfer of receivables to the Czech Consolidation Agency, the increased prudence of banks in recent years when lending is also beginning to show.

CHART VI.2

Structure of classified credits
(banks with licences as of 31 December 2002)



VI. THE BANKING SECTOR AND BANKING SUPERVISION

The "cleaning-up" of portfolios, mainly by the big banks, is also positively affecting the structure of classified credits. At the end of 2002, watch credits accounted for almost half of all classified credits. In most countries, this type of credit is not considered risky and is not classified as a "non-performing loan". The total volume of non-performing loans (i.e. substandard, doubtful and loss credits) amounted to CZK 83.5 billion as of 31 December 2002, or 8.8% of the total volume of credits granted.

Thanks to the high proportion of watch credits, the weighted classification (expressing the high-risk portion of credit portfolios) stood at only CZK 58 billion at the end of 2002. The volume of reserves and provisions, amounting to CZK 62.3 billion, thus fully covered potential losses from credit portfolios, even without the use of security.

Last year saw a favourable situation with regard to liquidity risk. The surplus of funds coupled with a lack of high-quality opportunities for their allocation led to the aforementioned depositing of free funds in quick assets. The short-term breakdown of assets and liabilities by residual maturity is also positive. Taking into account the invariability of demand deposits, the cumulative net balance-sheet and off-balance-sheet position to three months amounted to only 0.9% of total assets at the end of 2002. Less favourable, however, is long-term liquidity, where there is a negative trend caused by an upward tendency in the volume of long-term credits and a simultaneous trend towards placing deposits in demand accounts.

Banks limit exchange rate risk by exerting pressure for the maintenance of a balanced foreign exchange position. As of 31 December 2002, banks recorded a short foreign exchange position of 2.5% of total assets. The relatively low proportion of foreign exchange activities on banks' balance sheets is having a positive effect here. The ratio of foreign exchange assets to total assets was 17.3% last year and the ratio of foreign exchange liabilities to total liabilities was 16.6%, down by 5.1% and 2.6% respectively.

Transactions with non-residents, which can generate country risk, constituted a fairly high proportion of total banking sector assets (19.5%); with liability transactions, however, the figure was only 12.0%. The majority of transactions with non-residents relate to EU countries, especially in the case of interbank relations, and to former Eastern Bloc countries (most notably Slovakia) as far as client relations are concerned.

During 2002, particularly towards the end of the year, there was a fall in the volume of derivatives transactions, mainly as a result of a decline in the activities of foreign bank branches and certain foreign banks. The total volume of derivatives transactions valued in terms of their underlying assets was CZK 3,057.7 billion, 12.4% less than a year earlier. Banks focus exclusively on transactions in currency and interest rate instruments. In 2002, transactions in interest rate instruments increased by 16.5 points to 65.8%, while those in currency instruments fell by 16.8 points to 33.6%.

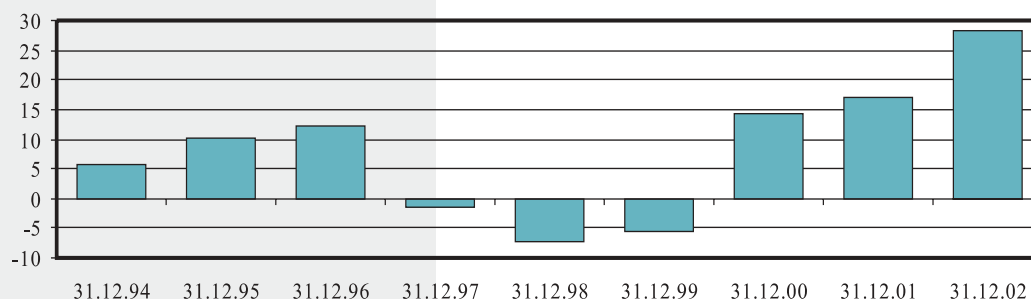
In 2002, banks achieved net profit of CZK 28.4 billion, almost 70% higher than in the previous year. Profit from banking activities rose by CZK 3.4 billion to CZK 92.8 billion, as a result of increased non-interest profit. Interest profit meanwhile fell slightly. Profit from fees and commissions also grew substantially, by CZK 2.8 billion to CZK 23.8 billion. Besides a modest reduction in the interest rate spread, the reason for the stagnation of interest profit was an imbalance in the structure of assets and liabilities from the standpoint of income and expenses. Administrative costs, which fell by 0.1% from the previous year, had a positive effect on net profit. Over the past few years, we have begun to see a marked decline in the number of bank employees and branches, particularly in the large banks, where there has been an absolute decline in administrative costs and, in particular, in personnel expenses. Crucial to the growth in net profit has been a reduction in the creation of reserves and provisions, a trend related to the improving quality of credit portfolios and to the transfer of receivables to the Czech Consolidation Agency, which enables a portion of the provisions already created to be released.



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CHART VI.3

Net profit (CZK billions)
(banks with licences as of 31 December 2002)



As of 31 December 2002, the capital ratio of the sector was 14.2%, roughly 1.2% less than at the end of 2001. Higher capital requirements alongside minimal growth in capital constituted the main reason for this. Primarily it was the banking portfolio requirements that increased; trading portfolio requirements remained at roughly the same level, forming only about 7% of total capital requirements.

VI.2 BANKING SUPERVISION

The Czech National Bank's banking supervisory activities during 2002 were based on the medium-term plan approved for 2002–2004, whose basic goal in the supervisory area is the creation of a comprehensive regulatory framework for banks and consolidated groups that contain banks, a framework that will steer them towards prudent business without stifling healthy competition. This framework must be clear and comprehensible, fulfil the regulatory criteria and principles in force in advanced countries, and form a good basis for the actual conduct of banking supervision.

2002 was, in principle, the last year for completing the harmonisation of the Czech banking legislation with current EU law. A crucial step in this area was the harmonisation amendment to the Act on Banks, which took effect on 1 May 2002. The aim of this amendment was to achieve full compatibility with European Community law and with other international banking regulation standards.

The amendment has introduced the following main changes:

- it provides for tighter and more transparent licensing proceedings and proceedings to grant prior consent to the acquisition or increasing of qualifying holdings in banks;
- it extends consolidated supervision (which previously had been applied only to financial groups headed by a bank) to financial groups controlled by a financial holding company or a mixed-activity holding company;
- it redefines relations between banking supervisors and external auditors;
- it allows inspections to be carried out on site at foreign banks' branches and subsidiaries by home supervisors;
- it introduces a single, unified banking licence for foreign bank branches, enabling them to be established in the Czech Republic without having to go through the licensing process; this will take effect on the date the Treaty of Accession of the Czech Republic to the European Union enters into force;
- it allows a Central Register of Credits to be operated by the Czech National Bank.

The amendment to the Act on Banks (along with the new knowledge and needs of CNB Banking Supervision) has required extensive changes to the prudential rules for banks, which are issued in the form of CNB "provisions" and "decrees". In 2002, three new decrees, six provisions and nine official information notices were issued, dealing with the following areas:

- changes in the licensing requirements and the requirements governing new investors in banks;

VI. THE BANKING SECTOR AND BANKING SUPERVISION

- consolidated supervision of banking groups and groups headed by financial or mixed-activity holdings, in particular by laying down prudential rules for regulated consolidated groups, i.e. concerning the extension of capital adequacy to include the monitoring of market risk, the notification duties of consolidated group members, etc.;
- harmonising the calculation of the prudential rules on a consolidated and solo basis;
- assessing the quality of receivables (with the aim of moving towards a system of classifying receivables according to their level of risk) and the creation of provisions for these receivables (especially in terms of defining non-performing receivables, specifying ways of taking security into account, provisioning, etc.) in line with international practice;
- laying down minimum requirements for credit risk and market risk management and for the verification of internal management and control systems, including risk-management systems;
- the content and structure of information disclosed by banks in relation to the changes outlined in the Ministry of Finance decree on financial statements;
- the content and use of the Central Register of Credits run by the CNB.

The official information notices, which aim to give a more detailed explication of particular provisions of the core legal rules or to set out procedures for implementing them, dealt with assessing the competence of persons nominated for managerial positions in banks, recommended standards of banking business and risk management, control agreements, information disclosure, etc.

An overview of all the decrees and provisions currently in force is given on the CNB website (at www.cnb.cz/leg_bd.php).

The conduct of banking supervision

The actual practice of banking supervision is increasingly concerned with assessing banks' systems for managing individual risks. The organisational structure of CNB Banking Supervision, especially with regard to on-site inspections, has been adapted to reflect this. New sections specialising in credit risk, internal management and control systems, market risks and information systems were set up with effect from 1 January 2002. This arrangement has created improved conditions for the further specialisation of banking supervisors and for the launch of supervision in the area of banks' information systems.

During 2002, inspections were carried out in ten banks; one of these inspections was comprehensive and the remaining nine directed at selected areas of banking risk. As regards off-site supervision, all banks are monitored regularly using information available from an extensive system of statements and reports (which are processed into standard outputs providing a regular quarterly comprehensive analysis of each bank), a warning system to detect negative trends on the basis of monthly changes in selected indicators, quarterly ratings of banks, etc. In order to acquire sufficient information to perform the supervision, 56 information-gathering visits were made in 2002 to 25 banks and foreign bank branches. On the strength of the findings of off-site supervision and on-site inspections, remedial measures were imposed on a total of 13 banks, building societies and branches of foreign banks. Most of these measures required the banks to eliminate shortcomings in their activities within a set timeframe.

In the area of licences and permits, CNB Banking Supervision issued 17 administrative decisions in 2002. As well as new banking licences, these covered the acquisition of holdings in banks. In all, 126 decisions were issued outside the framework of administrative proceedings, including approvals of external bank auditors and specifications of requirements for verifying management and control systems; approvals of shareholder structure prior to general meetings; consent to the inclusion of subordinated debt in capital; approvals of consolidated bank groups; and, in the case of building societies, opinions on proposed changes to general business conditions. CNB Banking Supervision issued 35 opinions on persons nominated for managerial positions within banks.



VI. THE BANKING SECTOR AND BANKING SUPERVISION

The New Basel Capital Accord

In response to the rapid development of financial markets, and in order to promote safety and soundness in financial systems, to enhance competitive equality among banks, and to allow banks to use more comprehensive approaches to risk management, the Basel Committee on Banking Supervision (BCBS) at the Bank for International Settlements (BIS) in 1999 drafted new rules for setting minimum capital requirements: the New Basel Capital Accord (NBCA).

CNB Banking Supervision needs to prepare for a fundamental change in banking sector regulation in connection with the introduction of the NBCA. This will involve elaborating approaches that are as objective as possible, incorporating them into the Czech laws and bylaws, and subsequently applying them in practice. It will also be necessary to establish a uniform interpretation of the NBCA rules and requirements and to ensure sufficient transparency of procedures, especially where the supervisor has the option of taking an individual approach to banks (such as in risk profile assessment and in setting individual capital requirements). At the same time, banks must have the opportunity to adapt to the regulator's methods sufficiently in advance. It is therefore vital that the CNB co-operate with the Czech Banking Association, with individual banks and with the Czech Chamber of Auditors in both the preparatory phase and the implementation phase. This co-operation will be based on a joint Czech financial sector project aimed at establishing an effective communication platform and at involving the interested parties in addressing tasks related to the NBCA implementation. This joint project was launched in September 2002. Each of the institutions taking part is represented in working groups, which are assigned tasks and told the exact form and content of co-operation for each task.

The CNB's working procedure and approach to implementing the NBCA are regularly published on its website (at www.cnb.cz/bd_nbca_struktura.php).

International co-operation

CNB Banking Supervision was involved in international co-operation on several levels. Mostly it took the form of active co-operation with supervisors in countries whose banks operate in the Czech Republic; co-operation with partner supervisory authorities in the area of regulatory issues; involvement in the preparation of new regulatory measures within the Basel Committee's working groups; the beginnings of involvement in European structures, now that Czech entry into the EU is imminent; and co-operation as part of the group of banking supervisors from Central and Eastern European countries.

The new focus on consolidated supervision requires closer co-operation among all regulators at national and international level (depending on the structure of the particular consolidated group). Co-operation with foreign regulators is based on bilateral memoranda of understanding. The first of these was signed with the Slovak Republic in 1999. This was amended in 2002, primarily to take account of the demands of consolidated supervision. During 2002 and at the beginning of 2003, further memoranda of understanding were signed with the regulators in Austria, Germany, France and the USA. Memoranda with Belgium, the Netherlands and Italy are in preparation.

Contact with EU bodies has recently concentrated mainly on harmonising regulatory rules and conducting banking supervision in line with EU standards and directives. This year, co-operation on a much greater scale can be expected. Upon the signing of the accession documents, the CNB will become an observer on a number of European committees, sub-committees and working groups, and will gradually be able to take part in their work.



VI. THE BANKING SECTOR AND BANKING SUPERVISION

The agreement on co-operation with the Ministry of Finance and the Securities Commission

The growing interconnectedness of financial institutions within financial groups is increasing the need for co-operation among regulators. In the Czech Republic, the Czech National Bank is responsible for supervising banks. Insurance companies and pension funds, however, are overseen by the Ministry of Finance, and securities dealers by the Securities Commission. In 1998, these three critical institutions signed a tripartite co-operation agreement. With a view to strengthening co-operation in the area of consolidated supervision, a new agreement was signed on 28 February 2003.

Co-operation with professional organisations in the banking area (in particular the Czech Banking Association and the Czech Chamber of Auditors) also continues to improve. Recently, co-operation in preparing for and implementing the New Basel Capital Accord has been of particular importance. In addition, the Czech Banking Association is becoming the mediator between the banking community and CNB Banking Supervision in the preparation of banking regulations.

The Central Register of Credits

On 1 November 2002, the Central Register of Credits (CRC), operated by the Czech National Bank, commenced its activities. The project to create a central register of the credits of business entities arose in 2002 as a joint initiative of the Czech National Bank and the Czech Banking Association. Despite its logistical complexity, the project was up and running within two years. The CRC allows commercial banks operating on the Czech market to exchange information rapidly on the credit commitments and debt repayment record of particular debtors, thereby helping to improve and streamline credit risk management in the Czech banking sector.

Selected activities of the banking sector				
banks with licences as of 31 December 2002,				
branches abroad included	CZK millions			
	1999	2000	2001	2002
Total assets	2 110 768	2 255 259	2 500 308	2 514 370
of which:				
receivables from central banks	270 439	285 784	319 218	500 323
receivables from other banks	564 699	564 644	561 270	398 109
receivables from non-bank clients	808 144	808 605	921 786	904 014
securities	292 047	418 991	477 837	462 031
Total liabilities	2 110 768	2 255 259	2 500 308	2 514 370
of which:				
liabilities to central banks	5 449	5 542	4 717	2 773
liabilities to other banks	369 578	356 156	367 130	301 812
liabilities to clients	1 238 915	1 309 968	1 514 557	1 624 276
liabilities from debt securities	206 992	271 785	269 590	167 485
equity capital	83 714	73 228	72 492	73 466
Total off-balance-sheet assets	2 049 524	2 689 453	3 872 744	3 638 630
of which:				
commitments, guarantees, letters of credit, etc.	280 126	381 382	310 126	495 073
receivables from derivatives transactions	1 729 689	2 198 714	3 489 272	3 057 940

In the printed version of the Annual Report this table contains erroneous figures in the following items: "receivables from central banks" and "commitments, guarantees, letters of credit, etc.". This table contains the correct figures. We apologize for this mistake.

VI. THE BANKING SECTOR AND BANKING SUPERVISION

Profitability of the banking sector				
banks with licences as of 31 December 2002,				
branches abroad included				
	1999	2000	2001	2002
Profit from financial activities	87 370	77 272	89 447	92 837
Profit from banking activities/average assets in per cent	4.15	3.59	3.77	3.73
Net profit (+) or loss (-)	-5 572	14 385	16 951	28 376
Net profit/average assets in per cent	-0.26	0.67	0.72	1.14
Net profit/Tier 1 capital in per cent	-4.32	13.08	14.41	22.27
Total interest income/interest earning assets in per cent	7.76	6.35	6.23	4.89
Total interest expenses/interest bearing liabilities in per cent	5.34	4.08	3.87	2.79
Interest rate spread in per cent	2.43	2.26	2.37	2.10
Administrative expenses/average assets in per cent	2.02	1.94	2.02	1.93

Selected prudential indicators for the banking sector				
banks with licences as of 31 December 2002,				
branches abroad included				
	1999	2000	2001	2002
Capital adequacy (percentages) ¹⁾	13.59	14.87	15.38	14.20
Classified credits, total (CZK millions) ²⁾	291 061	257 762	209 866	159 245
Classified credits as percentage of total credits	32.15	29.83	21.53	16.78
Non-performing loans as percentage of total credits ³⁾	21.97	19.90	13.73	8.79
Weighted classification as percentage of total credits	16.88	13.73	9.95	6.10
Coverage of weighted classification with reserves and provisions in per cent	67.91	65.00	81.66	107.50
Quick assets as percentage of total assets ⁴⁾	19.49	19.45	20.76	32.38

1) Foreign bank branches excluded

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

3) Substandard, doubtful and loss credits

4) Cash, current accounts with other banks, time deposits with banks up to 24 hours, deposits and credits with CNB, government zero-coupon and coupon bonds, and CNB bills



VII. ECONOMIC RESEARCH

There is no fortress so strong that money cannot take it.

Marcus Tullius Cicero

VII. ECONOMIC RESEARCH

The economic research conducted at the CNB is planned and co-ordinated by the Economic Research Department (ERD). The primary aim of the research work is to help the CNB meet its long-term strategic goals and to foster a European level of analytical and forecasting activity in each specialised division. The organisation and content of the research reflect this aim – the research work is oriented towards the CNB's strategic priorities and is organised into specific projects that address those priorities.

Economic research priorities:

- convergence into European structures
- monetary policy, fiscal policy and financial stability
- macroeconomic modelling and the financial sector
- the real economy
- special studies

At each stage, from the formulation of research priorities through to the assessment of each particular project, the ERD consults with the members of the CNB Bank Board and works in co-operation with the Research Advisory Committee and the specialised divisions of the CNB.

The international Research Advisory Committee, which advises the Bank Board on matters of research planning and assessment at the CNB, has special status. In addition to ERD staff and the directors of specialised divisions, the Committee – chaired by the CNB Governor – consists of invited experts from other central banks (the Bank of England and the Bank of Finland) and international institutions (the International Monetary Fund and the World Trade Organization). The Committee convenes usually twice a year to evaluate the economic research programme for the period ahead and to assess the results of completed projects. Its meetings are usually followed by meetings of the CNB Bank Board, which is responsible for the final assessment and appraisal of the research work.

Research project proposals – submitted by the staff of the ERD and the specialised departments of the CNB, as well as by domestic and foreign experts outside the CNB – go through a three-stage evaluation process: at ERD level, in the Research Advisory Committee, and finally at Bank Board level. The aim of this process is not only to evaluate the technical level of each proposal, but also to assess its conformity with the declared strategic priorities of economic research at the CNB. Of key importance in this assessment is the project's potential contribution to the analytical and forecasting work in the CNB's specialised departments and to strategic decision-making by CNB management.

In the process of elaborating the selected projects, research staff collaborate with the ERD via a co-ordinator for the particular research area. The results of the research take the specific form of refereed papers. The review process is usually public. The committee of referees is made up of CNB specialists plus one Czech expert and one foreign expert who are not CNB staff members.

Successfully refereed projects are published in the "CNB Working Papers Series". Those whose content is more closely linked to internal decision-making processes are published as "CNB Internal Research and Policy Notes". The following papers from the 2002 Economic Research Programme had been published (or were ready for publication) as of March 2003:

Research publications from the 2001–2002 programme

- Monetary policy and the term spread in a macro model of a small open economy (V. Kotlán)
- Estimating market probabilities of future interest rate changes (Martin Hlušek)
- Microfoundations of the wage inflation in the Czech Republic (Kamil Galuščák, Daniel Münich)
- Estimates of fundamental real exchange rates for the five EU pre-accession countries (Kateřina Šmídková, Ray Barrell and Dawn Holland)
- Sectoral productivity and real exchange rate appreciation. Much ado about nothing? (Vladislav Flek, Lenka Marková and Jiří Podpiera)

VII. ECONOMIC RESEARCH

- Price convergence to the EU: What do the 1999 ICP data tell us? (Martin Čihák, Tomáš Holub)
- Determining factors of the Czech foreign trade balance: Structural issues in trade creation (Vladimír Benáček, Ladislav Prokop and Jan Á. Vášek)
- Components of the Czech koruna risk premium in a multiple-dealer FX market (Alexis Derviz)
- FOREX microstructure, invisible price determinants, and the central bank's understanding of exchange rate formation (Alexis Derviz)
- Second-round effects of supply-side shocks on inflation in a dynamic structural model of the Czech economy (Tibor Hlédik)

Besides formulating priorities and organising economic research in the narrower sense, the ERD is responsible for a whole range of related activities, for example co-operation with prominent international research institutions (the Centre for Economic Policy Research and the European Economic Association) and maintaining ties with other central banks. Its key activity in this respect, though, is the organising of international conferences and lectures by leading international economists jointly with domestic institutions such as the Czech Economic Society and the Prague University of Economics.

Lectures organised by the ERD in 2002:

- David Begg: "European integration"
- Mario Nuti: "Costs and benefits of euroisation in Central Eastern Europe"
- Frederic Mishkin: "Inflation targeting: International experience"
- Willem Buiter: "Accession countries meet the Maastricht criteria"

The ERD also puts great emphasis on making the CNB's research output available to economists on the CNB website. The site contains further details on the ERD's research priorities for 2003–2004 together with all the successfully refereed CNB research papers.



VIII. BANKNOTES AND COINS

Money is coined liberty.

Fyodor Mikhailovich Dostoevski

VIII. BANKNOTES AND COINS

Currency in circulation

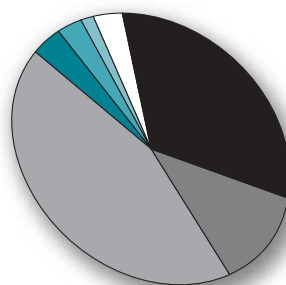
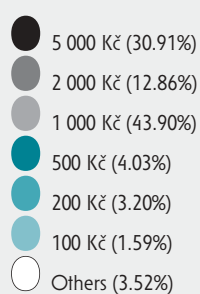
The growth rate of currency in circulation picked up in 2002 compared to 2001. As of 31 December 2002, the currency in circulation amounted to CZK 225.5 billion, a rise of CZK 17.9 billion relative to the end of 2001. Expressed in percentage terms, the increase was 8.6% in 2002, compared with 5.3% in 2001. The reasons for the faster growth rate cannot be specified precisely, since there is no way of clearly determining its specific direct dependence on any of the possible underlying factors, even using long-term statistical data. The main causes include the decline in bank interest rates, which, together with rising charges for some services, may be having a negative effect on the decisions of potential customers. Other possible reasons include a higher number of ATMs, increased charges for their use (leading to larger individual cash withdrawals) and a change to the structure of the banknote denominations paid out by ATMs. In 2002, some financial institutions introduced 2000 Kč banknotes as the highest denomination in their ATMs, replacing the former 1000 Kč.

The increased accumulation of cash is also evidenced by a slight change in the structure of the currency in circulation. Whereas at the end of 2001 the highest denomination banknotes (2000 Kč and 5000 Kč) had accounted for 9.22% of the number of notes and coins in circulation, at the close of 2002 the figure was 11.03%. In terms of value, the share of these, the two denominations most often used for cash accumulation, increased from 39.34% to 43.77%. The share of 1000 Kč notes in the total amount of circulating currency fell from 47.41% to 43.90%. The number of banknotes in circulation rose by just 2.6%, whereas the number of coins in circulation increased by 6.0%.

The highest rise in the number of coins and notes in circulation (of 11.6%) was recorded by the 10-heller piece. The excessively high issuance of this coin (as many as 500,000 a day were issued in the summer months of 2002), coupled with the fact that the 10-heller and 20-heller pieces were failing to return from circulation, led the CNB to issue a draft decree at the end of 2002 proposing to terminate their validity. They will cease to be legal tender as of 31 October 2003, although it will be possible to exchange them at branches of the CNB until 31 October 2009.

CHART VIII.1

Structure of currency in circulation (in CZK)



VIII. BANKNOTES AND COINS

CHART VIII.2

Structure of banknotes in circulation (number of notes)

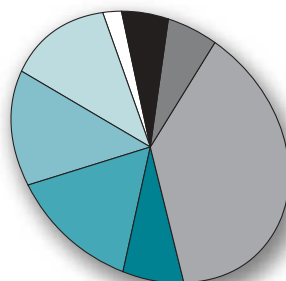
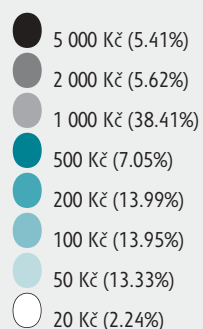
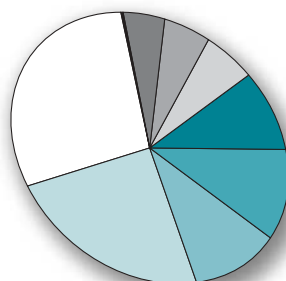
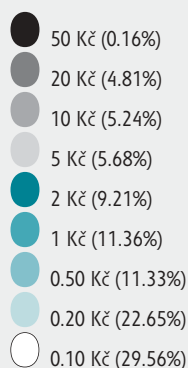


CHART VIII.3

Structure of coins in circulation (number of coins)



Issuing operations and cash handling

In 2002, the CNB's branches accepted 671.9 million banknotes from circulation, 5.3% more than in 2001. They issued 680.5 million notes, up 1.4% on the previous year. In 2002, 444.6 million coins were accepted and 584.7 million were issued. A total of 76.5 million banknotes unfit for further circulation were destroyed. During the year, an automated coin-processing (counting, sorting and packaging) line with a capacity of up to 500,000 coins a day was put into operation at the CNB's Brno branch. At the end of 2002, the other CNB branches were equipped with LCC20 coin-sorting machines, allowing us to check the genuineness and validity of the coins and assess their fitness for further circulation using both the electromagnetic and optical principles.

Issuing activity

Four commemorative silver 200 Kč coins and two gold coins from the cycle *Ten Centuries of Architecture* were issued in 2002. The silver coins were issued to mark the 750th anniversary of the death of St. Zdislava of Lemberk (2 January); the 100th anniversary of the death of the Czech physician, explorer and ethnographer, Emil Holub (20 February); the 550th anniversary of the appointment of George of Poděbrady as Governor of the Crown Lands of Bohemia (24 April); and the 150th anniversary of the birth of the Czech artist Mikoláš Aleš (6 November). All the coins were of the standard parameters and were minted in both normal and proof quality, which differ in surface finish and edge marking. The normal-quality coins have a milled edge, whereas the edges of the proof coins are marked with the name of the issuer, the fineness of the metal and the weight

VIII. BANKNOTES AND COINS

of the coin. As part of the gold coin cycle, a coin depicting a High Gothic fountain in the town of Kutná Hora was issued on 20 March and another showing the Renaissance castle in Litomyšl was issued on 25 September. No new versions of the ordinary banknotes or coins were issued in 2002.

Counterfeits

A total of 4,010 counterfeit Czech banknotes were found in the Czech Republic in 2002. Compared to the previous year, this means not only an increase of 511 in their total number, but also an approximately equal rise in the number of counterfeits seized from circulation. The share of the highest-denomination counterfeits in the total decreased, whereas the number of counterfeit 500 Kč notes increased. Among the latter, counterfeits rated as dangerous were discovered for the first time. Although the ratio of counterfeit notes to the total number of banknotes in circulation is very low, the trend of counterfeit occurrence, and in particular the increasing quality of the counterfeits, should not be underestimated. The suspicion remains that as in previous years these high-quality counterfeits were produced by an organised group of professional counterfeiters.

TABLE VIII.1

Currency	Numbers seized		
	from circulation	by the police	total
CZK	2 870	1 140	4 010
USD	1 089	205	1 294
EUR	212	77	289
DEM	107	58	165
ITL	72	10	82
Other	77	0	77
Coins	61	0	61
Altered	298	1	299
Total	4 786	1 491	6 277



IX. THE PAYMENT SYSTEM

Money is as important as blood, as the old sages knew.

Artemidoros of Ephesus

Harmonising the legislation – Preparing for accession to the EU

The year 2002 was an important year for the harmonisation of Czech law with EU regulations in the payment systems area. In the course of the year, the CNB completed work on bills to implement into the Czech legislation the EC directives on cross-border transfers, on electronic money institutions and on settlement finality in payment and securities settlement systems. In April, a new Act No. 124/2002 Coll., on Transfers of Funds, Electronic Payment Instruments and Payment Systems (the Payment System Act), was passed. This law is intended to protect consumers during the execution of domestic and cross-border transfers and during the issuing and use of electronic payment instruments, to bolster the legal safeguards for customers, and to boost public confidence in electronic payment instruments. For domestic koruna payments, the Act stipulates precise time limits for carrying out transfers and crediting funds to customers' accounts, including the penalties payable by banks to customers if they fail to comply with those time limits. The Act also regulates the area of payment systems, placing the emphasis on central bank regulation of the establishment and operation of payment systems and on enhancing the security of systems established under the Act.

In 2002, the CNB also completed the preparation of Act No. 125/2002 Coll., which contains accompanying amendments linked to the adoption of the Payment Systems Act. The Commercial Code was revised to legislate comprehensively for current account and deposit account agreements. An amendment to the Civil Code brought a fundamental change to the determination of the moment at which a debt is settled through a bank or post office, and ensured conformity with the Commercial Code.

The harmonisation of the payment legislation was concluded in June with Act No. 229/2002 Coll., on the Financial Arbiter. This introduced into Czech law the concept of out-of-court settlement of disputes arising during the execution of transfers and the issuing and use of electronic payment instruments under the Payment System Act.

The CNB also drafted and issued several bylaws connected with the Payment System Act, namely Implementing Decree No. 547/2002, stipulating the essential elements of an application of prior consent to issue electronic money instruments, and Implementing Decree No. 548/2002, stipulating terms and conditions for the settlement principles in payment systems and the essential elements of an application for a payment system operator's licence. In order to protect holders of electronic payment instruments, the CNB issued *Model General Terms and Conditions for the Issuing and Use of Electronic Payment Instruments*. These do not constitute a legal rule, but rather are recommendations of the central bank. All the aforementioned regulations took effect on 1 January 2003.

The interbank payment system – CERTIS

The CNB operates its own interbank payment system, renamed CERTIS (the **C**zech **E**xpress **R**eal **T**ime Interbank Gross **S**ettlement System) in 2001. This system processes all domestic interbank transfers in Czech koruna, checking in real time whether the banks have sufficient coverage for them.

At the end of 2002, CERTIS had 39 direct participants, i.e. the banks (including foreign bank branches) operating in the Czech Republic. Card-payment clearing houses (e.g. MUZO) and securities settlement institutions (e.g. Univyc and RM-Systém) are indirect participants. The indirect participants have no CERTIS accounts with the CNB but may submit payment orders to transfer funds between direct participants, provided that they have the permission of the relevant direct participant.

CERTIS underwent further development in 2002 with the introduction of "client priority items" and with the commencement of work to split transaction processing into two streams: fast and slow (expected to go live in 2003). These modifications will facilitate clearing of client priority interbank transfers (express payments) on the same accounting day.

In 2002, the CERTIS system processed a total of 289.5 million transactions (transfers), totalling more than CZK 109 trillion. This means more than 1 million transactions per day on average, with daily turnovers averaging CZK 434.8 billion. The system recorded its daily maximum on 16 December 2002, with almost 3.2 million transactions. On 27 December, the transactions processed totalled almost CZK 729 billion.

Registration and settlement of short-term bond transactions – SKD (Short-Term Bond System)

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

SKD facilitates the issuance and direct sale (auctions) of bonds, the settlement of bond trades and the redemption of bonds at maturity. The system ensures transfers of securities on the DVP (delivery-versus-payment) principle, so that the transfer is completed only after crediting/debiting on banks' accounts in the CERTIS system. In addition, the SKD system has since 1998 been supporting the smooth operation of the CERTIS system, as the securities held by banks serve as collateral for the intraday credit extended by the Czech National Bank within CERTIS. Most of the banks operating in the Czech Republic are direct participants in SKD. In 2002, the system handled more than 16,000 transactions, representing transfers of securities worth almost CZK 32.5 trillion.

The year 2002 saw the launch of a new version of SKD featuring enhanced security and performance. This new version allows direct automated provision and repayment of intraday credits within the CERTIS system at any time during the accounting day, according to banks' instructions and needs.

The CNB's accounting and payment system – the ABO system

The CNB is responsible by law for maintaining and administering the accounts of state organisational units (ministries, revenue and customs offices, the social security administration, etc.) and organisations connected to the state budget. This it does through the ABO (Automated Banking Operations) system. In addition, the ABO system is used to keep books on the central bank's own funds (all its assets and liabilities, e.g. foreign exchange reserves, banks' required reserves, and the cash circulation accounts of banks and the CNB).

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

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

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

Co-operation with international institutions

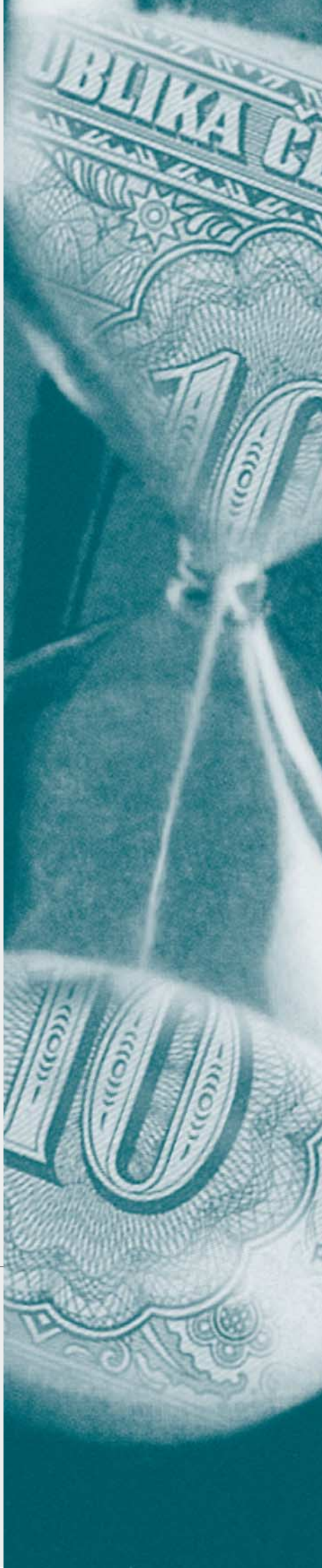
As part of the Czech Republic's preparations for joining the EU and EMU, the CNB is working closely with the European Central Bank, which pays considerable attention to the payments area and regularly organises meetings with candidate countries on its plans and on topical issues.

In 2002, the ECB issued a report entitled *Blue Book – Payment and Securities Settlement Systems in Accession Countries*. This covers legislative and institutional aspects of the payment systems operating in the candidate countries, as well as discussing payment media and describing in detail interbank payment and securities settlement systems. It also contains an annex of tables providing statistical data from the payment systems area. The CNB wrote the chapter on the Czech Republic.

In 2002, the CNB was involved in the ECB's activities to assess the efficiency and security of payment and securities settlement systems in the candidate countries. In collaboration with the Czech Securities Commission, the Ministry of Finance and the operators of the relevant systems (Univyc and RM-Systém), the CNB prepared source documents for this assessment.

The CNB continued working in co-operation with other international institutions such as the Bank for International Settlements (BIS) and the IMF.

In 2002, the CNB was again represented in the Task Force on Securities Settlement Systems set up jointly by the BIS and the International Organisation of Securities Commissions (IOSCO). The Task Force, which contains experts from 18 countries, has issued recommendations which such systems should comply with. In 2002, the Task Force prepared a methodology for assessing such systems based on those recommendations.



X. FOREIGN EXCHANGE LICENSING

Money helps us to overcome poverty.

Alphonse Allais

X. FOREIGN EXCHANGE LICENSING

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

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

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

Further to the amendment to the Foreign Exchange Act, CNB Decree No. 434/2002 Coll., stipulating the essential elements of a foreign exchange licence application, the prerequisites and terms and conditions for the execution of certain foreign exchange transactions, and the procedure for handling counterfeit and altered money, entered into force in 2002. The amendment to the Foreign Exchange Act also requires the Czech National Bank to keep a list of foreign exchange entities and the foreign exchange licences granted to them.

In 2002, 104 licences were issued for the sale of foreign currency in cash, as against 80 the previous year. These licences are issued by the CNB's branches. A total of 7 licences were issued for other types of trading, predominantly non-cash transactions or intermediation thereof, compared to 26 in 2001. The CNB thus issued 111 foreign-exchange business licences, not including consents to the issuing of foreign-exchange cash-purchasing licences (bureau-de-change licences issued by trade licensing offices).

The number of foreign exchange licences issued is constantly falling. There are two reasons for this. First, business interest is partly saturated. And second, licensing of some types of transactions with a foreign exchange component has been transferred to the Czech Securities Commission, i.e. the two-track regulation has been simplified. Under the Foreign Exchange Act, as revised by an indirect amendment to Act No. 591/1992 Coll., on Securities, since 1 January 2001 foreign exchange licences have not been required for foreign securities transactions and for foreign currency and financial derivatives transactions provided that these transactions are connected with the provision of investment services within the scope of securities-dealer permits granted pursuant to a special legislative act.

At the end of 2002, a total of 2,710 bureaux de change (having 3,427 business premises altogether) were registered, 224 of which (with 990 business premises) also had a licence to sell foreign currency in cash. The exchange offices are unevenly distributed, as 861 of them (with 1,717 business premises) are in Prague. In 2002, 305 foreign exchange inspections (predominantly of the activities of bureaux de change, including their compliance with the reporting duty) were conducted. These inspections were focused on bureaux de change because they are the most common type of foreign exchange entity. This has been given an added impetus recently with the increased attention being given to tracking down possible sources of money laundering. Countering illegal activities is an important part of the inspection work.



X. FOREIGN EXCHANGE LICENSING

In all, 59 fines were imposed in 2002, almost double the 2001 figure (31). The average fine amount was three times the previous year's level. Financial errors constitute 36.2% of all mistakes detected, meaning that serious cases do not predominate. In most cases, measures under the State Inspection Act and Foreign Exchange Act are sufficient and there is no need to impose administrative penalties.





XI. DISCLOSURE OF INFORMATION UNDER THE FREEDOM OF INFORMATION ACT

There are many things more important than money, but it takes money to buy them.

Prosper Mérimée

XI. DISCLOSURE OF INFORMATION UNDER THE FREEDOM OF INFORMATION ACT

This Section describes the information provided by the CNB in accordance with Act No. 106/1999 Coll., on Freedom of Information (hereinafter the "Act").

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

A) Information provided in 2002 on the basis of applications:

1. Number of applications for information under the Act:

Two.

2. Number of appeals against decisions:

One.

3. Transcript of relevant parts of each court judgement:

One.

In Ruling No. 33 Ca 21/2002-38 of 30 August 2002, the Municipal Court in Prague ruled to rescind the CNB Governor's decision of 28 January 2002 (Ref. No. 2002/574/110) and the CNB decision of 20 December 2001 (Ref. No. 2001/2600/110) and to return the case to the CNB for further proceedings.

4. Results of sanction proceedings for non-compliance with the Act:

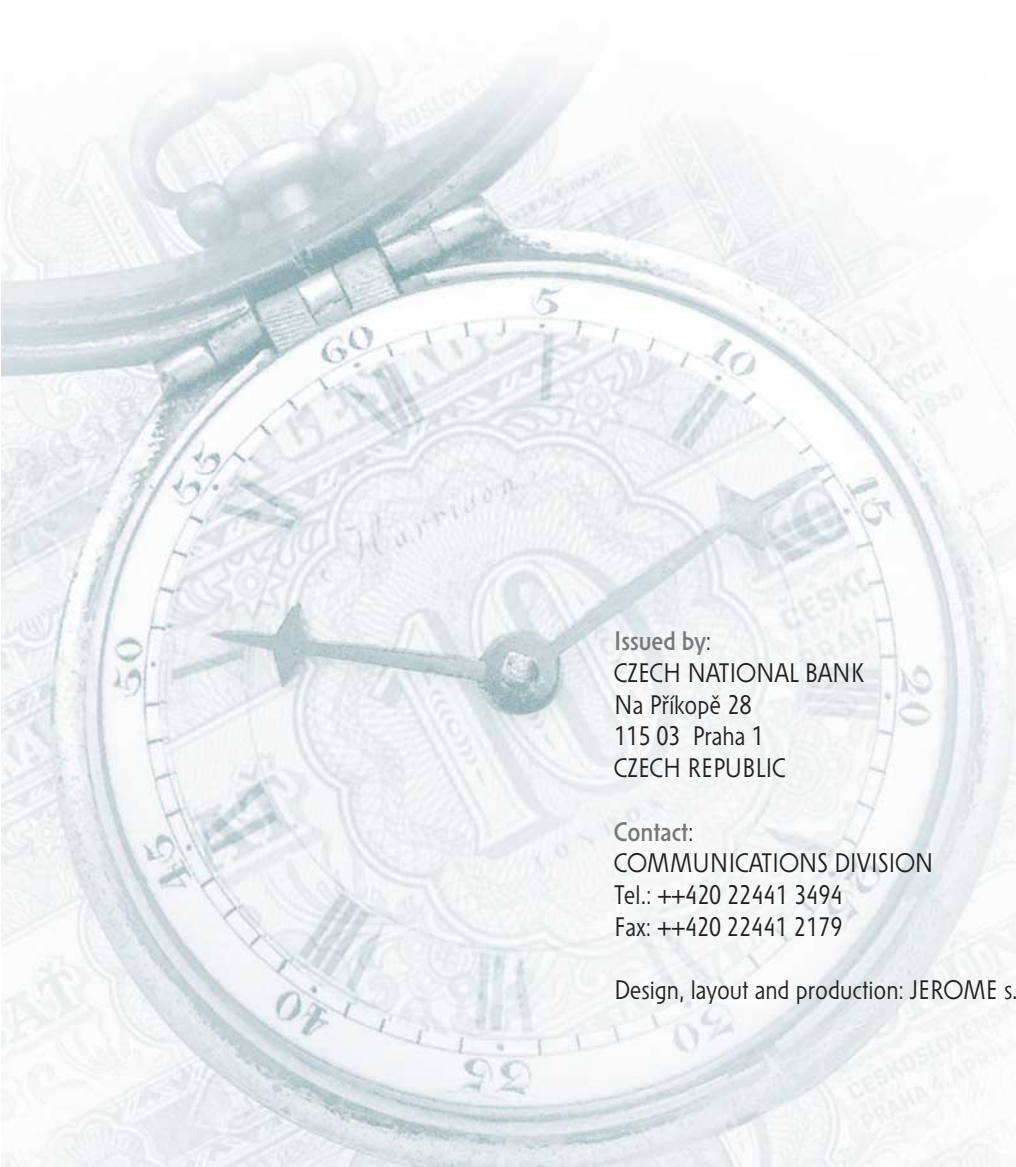
None.

5. Other information relating to application of the Act:

- The CNB's procedure for fulfilling its duties under the Act is defined in an internal directive stipulating the principles and procedure for dealing with applications for information.
- The applications for information under the Act concerned provision of information on the content of the Czech National Bank's ruling dismissing Investiční a Poštovní banka's appeal against the decision to impose conservatorship.
- The CNB provides the information referred to in Article 2(2) of the Act in cases where it makes decisions on the rights, legally protected interests or obligations of natural persons or legal entities in the area of public administration. The CNB has this legal obligation in respect of the administrative proceedings it conducts pursuant to the Act on the CNB, the Act on Banks and the Foreign Exchange Act. The CNB provides information on specific administrative proceedings where such proceedings have been closed by a final and conclusive decision.
- Most written, e-mail and telephone applications for information go beyond the framework of the Act. In 2002, the CNB answered 299 written and 1,905 e-mail enquiries from the public.

B) Information provided by way of public disclosure:

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



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CESKOSLOVENSKYCH

VENSKA

REPUBLIKA

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CESI



2002

**REPORT OF INDEPENDENT AUDITORS
AND FINANCIAL STATEMENTS**

YEAR ENDED 31 DECEMBER 2002

CNB CZECH
NATIONAL
BANK

REPORT OF INDEPENDENT AUDITORS

TO THE BANK COUNCIL OF THE CZECH NATIONAL BANK

We have examined whether the financial information presented on pages 15 to 22 in the Annual report (hereinafter "the Report") of the Czech National Bank (hereinafter "the CNB") for the year ended 31 December 2002, which does not form part of the audited financial statements of the CNB, is consistent with the audited financial statements as at 31 December 2002. In our opinion, the financial information included in the Report is consistent with the accounting records of the CNB maintained in support of the audited financial statements in all material respects.

Our audit report on the financial statements as at 31 December 2002 and for the year then ended and which do not form part of the accompanying Report was as follows:

"We have audited the accompanying balance sheet of the Czech National Bank (hereinafter "the CNB") as at 31 December 2002, the related statement of income and notes for the year then ended (hereinafter the "financial statements"). The financial statements and underlying accounting records are the responsibility of the management of the CNB. Our responsibility is to express an opinion on these financial statements based on our audit.


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

In our opinion the accompanying financial statements give a true and fair view, in all material respects, of the assets, liabilities and equity of the CNB as at 31 December 2002, and the results of its operations for the year then ended in accordance with the Act on Accounting and other relevant legislation of the Czech Republic."

24 March 2003



PricewaterhouseCoopers Audit, s.r.o.
represented by


Paul Cunningham
Partner



Petr Kříž
Auditor, Licence No. 1140

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

ASSETS

in CZK millions

Item no.	Item	31 Dec. 2002	31 Dec. 2001	31 Dec. 2000
1.	Gold	833	837	841
2.	Receivables from International Monetary Fund	35 319	39 800	42 802
3.	Receivables from foreign countries, including securities	707 238	528 619	505 301
3.1.	Deposits at foreign banks	90 539	117 446	92 805
3.2.	Credits granted to foreign banks	20 350	14 384	14 240
3.3.	Securities	596 300	396 740	398 196
3.4.	Other receivables against foreign countries	49	49	60
4.	Receivables from domestic banks	115	793	17 371
5.	Receivables from clients	39 820	48 263	37 742
6.	Domestic securities and shares	-	-	11
7.	Fixed assets	7 197	7 769	8 329
7.1.	Tangible fixed assets	6 918	7 419	7 877
7.2.	Intangible fixed assets	279	350	452
8.	Other assets	3 669	1 419	1 722
8.1.	Deferred revenue and accrued expenses	16	388	431
8.2.	Others	3 653	1 031	1 291
	ASSETS TOTAL	794 191	627 500	614 119

LIABILITIES

in CZK millions

Item no.	Item	31 Dec. 2002	31 Dec. 2001	31 Dec. 2000
1.	Currency in circulation	224 402	205 861	195 102
2.	Liabilities to International Monetary Fund	27 869	34 033	42 399
3.	Liabilities to foreign countries	4 735	14 743	13 829
3.1.	Loans taken from abroad	4 289	14 275	13 415
3.2.	Other liabilities against foreign countries	446	468	414
4.	Liabilities to domestic banks	488 233	309 247	295 871
4.1.	Bank monetary reserves	28 359	30 273	26 575
4.2.	Repos	455 419	264 847	251 386
4.3.	Other liabilities	4 455	14 127	17 910
5.	Deposits from clients	35 937	27 916	21 573
6.	Domestic securities issued	-	-	-
7.	Liabilities to the state	49 968	57 737	36 574
8.	Reserves	6 210	11 935	12 597
9.	Share capital	1 400	1 400	1 400
10.	Funds	8 156	8 198	8 202
11.	Retained profits (accumulated losses) from previous periods	- 44 531	- 15 903	- 18 392
12.	Profit (loss) for the accounting period	- 9 468	- 28 628	2 524
13.	Other liabilities	1 280	961	2 440
13.1.	Deferred revenue and accrued expenses	8	186	346
13.2.	Others	1 272	775	2 094
	LIABILITIES TOTAL	794 191	627 500	614 119

OFF BALANCE SHEET

in CZK millions

Item no.	Item	31 Dec. 2002	31 Dec. 2001	31 Dec. 2000
1.	Contingent liabilities	199 962	103 787	78 740
2.	Receivables from spots, forwards and options	101 673	10 867	13 694
3.	Liabilities from spots, forwards and options	101 453	10 861	13 269
4.	Guarantees received	182 500	62 340	30 445

PROFIT AND LOSS ACCOUNT

in CZK millions

Item no.	Item	31 Dec. 2002	31 Dec. 2001	31 Dec. 2000
1.	Interest income and similar income	22 104	28 106	28 291
1.1.	Interest from securities bearing fixed income	16 717	22 381	21 696
1.2.	Other	5 387	5 725	6 595
2.	Interest expenses and similar expenses	17 032	17 092	16 821
2.1.	Interest from securities bearing fixed income	-	-	523
2.2.	Other	17 032	17 092	16 298
3.	Income from securities with variable income	40	43	41
4.	Income from fees and commissions	510	555	450
5.	Expenses from fees and commissions	49	53	53
6.	Loss from financial operations	- 13 864	- 37 745	- 4 721
7.	Other income	444	454	121
7.1.	Income from money issuance	20	17	8
7.2.	Other	424	437	113
8.	Administration expenses	2 015	2 002	2 355
8.1.	Personnel expenses	751	677	666
8.1.1.	Wages and salaries	554	501	484
8.1.2.	Social and health insurance	197	176	182
8.2.	Other operating expenses	1 264	1 325	1 689
9.	Other expenses	1 119	1 776	49 868
9.1.	Expenses for issuing bank notes and coinage	371	309	297
9.2.	Other	748	1 467	49 571
10.	Charge for specific and general provisions for loans and guarantees	5 876	325	1 351
11.	Release of specific and general provisions for loans and guarantees	5 997	1 245	33 008
12.	Release of specific and general provisions for shares and other financial investments	-	-	15 814
13.	Charge for other specific and general provisions	23	38	33
14.	Release of other specific and general provisions	184	-	1
15.	Ordinary profit (loss)	- 10 699	- 28 628	2 524
16.	Extraordinary income	22 521	-	-
17.	Extraordinary expenses	21 290	-	-
18.	Extraordinary profit (loss)	1 231	-	-
19.	Profit (loss) for accounting period	- 9 468	- 28 628	2 524

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

1 GENERAL INFORMATION

The Czech National Bank (hereinafter the “Bank” or the “CNB”) is the central bank of the Czech Republic (hereinafter the “CR”). The Bank was established on 1 January 1993 following the dissolution of the State Bank of Czechoslovakia to form the Czech National Bank and the National Bank of Slovakia. The Bank was established on the basis of Act No. 6/1993 Col. as amended, The Czech National Bank Act. The Bank is a legal entity governed by public law and is not registered in the Commercial Register. The Bank operates from its headquarters in Prague and from seven branches around the CR (Prague, České Budějovice, Plzeň, Ústí nad Labem, Hradec Králové, Brno and Ostrava).

The primary objective of the Bank is to maintain price stability. Without prejudice to its primary objective, the Bank also aims to support the general economic policies of the Government leading to sustainable economic growth. The Bank acts in accordance with the principle of an open market economy.

In accordance with its primary objective, the Bank sets the monetary rules, issues bank notes and coins, manages the money supply and clearing for interbank settlements, maintains the interbank settlement systems to ensure its fluency and efficiency, supervises the activities of banks and sees to the safe functioning and development of the banking system in the CR. The Bank also performs other activities as defined by the CNB Act and by other legislation.

When pursuing its objectives, the Bank cooperates with the central banks of other countries, the authorities supervising the banks and financial markets of other countries, and with international financial organizations and international organizations involved in the supervision of banks and financial markets.

When carrying out its tasks, the Bank is independent of any instruction given by the Czech Government, the President of the CR, the Czech Parliament or other administrative or regional authorities and reports directly to the Czech Parliament. Matters concerning the exchange rate regime and the setting of the inflation target are discussed with the Czech Government and the Bank submits to the Czech Government upon request reports on such matters. The Bank and the Government inform each other about the principles and measures of monetary and general economic policy.

The highest-ranking management body of the Bank is the Bank Council of the CNB. The Bank Council has seven members. The members include the governor of the Bank, two vice-governors of the Bank, and four other Bank Council members. The members of the Bank Council are appointed and recalled by the President of the CR. The members of the Bank Council are appointed for a period of six years. The Bank Council sets the monetary rules and instruments for their implementation and decides about the primary monetary-political measures of the Bank.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

AS AT 31 DECEMBER 2002 AND FOR THE YEAR THEN ENDED

1 GENERAL INFORMATION (continued)

The members of the Bank Council as at 31 December 2002, 2001 and 2000 were as follows (including information regarding the end of their term):

Mr. Zdeněk Tůma	Governor	Until 12 February 2005
Mr. Oldřich Dědek	Vice-Governor	Until 12 February 2005
Mr. Luděk Niedermayer	Vice-Governor	Until 26 February 2008
Mrs. Michaela Erbenová	member	Until 30 November 2006
Mr. Jan Frait	member	Until 30 November 2006
Mr. Pavel Štěpánek	member	Until 12 February 2005
Mr. Pavel Ráchocha	member	Until 12 February 2005

The statutory representative of the Bank is the Governor. In the event of the Governor's absence the Vice-Governor is appointed by him to represent the Bank.

The Bank uses its income to cover necessary operational costs of its operations. The Bank's profit, if any, is allocated to its reserve fund and other funds created from profit, and for other uses within the Bank's budget. Any remaining profit is transferred to the state budget. Accumulated losses are expected to be covered by future profits, however this depends on a number of factors, the outcome of which are not certain. The Bank Council is monitoring the situation, so that appropriate action, consistent with the Bank's statutory objectives, can be taken should this be necessary.

The CNB submits its annual report on its operations to the Czech Parliament within three months after the calendar year end.

2 ACCOUNTING POLICIES

(a) Basis of preparation

The accounting records are prepared in compliance with the Act on accounting (Act No. 563/1991 Col. as amended) and the Chart of accounts and accounting rules for banks, issued by the Ministry of Finance of the CR under the reference No. 282/73 390/2001 as at 15 November 2001. The financial statements are prepared in compliance with the Act on accounting under the historical cost convention as modified by the revaluation of financial instruments held for trading and available-for-sale to fair values. The financial statements are prepared according to principles of presentation and disclosure determined by the management of the CNB to be appropriate bearing in mind the needs and requirements for the reporting of a central bank. The financial statements are rounded to millions of Czech Crowns (hereinafter "CZK") unless otherwise stated. The Bank does not prepare consolidated financial statements because the Bank has no investments in subsidiary and associated undertakings.

2 ACCOUNTING POLICIES (continued)

(b) Foreign currencies

Transactions in foreign currencies are translated to CZK at the foreign exchange (hereinafter “FX”) rate effective at the transaction date. Assets and liabilities, including all unsettled committed spot or term purchases and sales of foreign currencies, are translated to CZK at the exchange rate announced by the Bank effective at the balance sheet date. All resulting realised and unrealised foreign exchange gains and losses are recognised in the income statement in the net profit or loss from financial operations.

(c) Gold and other precious metals

Gold and other precious metals are valued at historic cost. Gold deposits are accounted for on the gold account and related interest income is accrued.

(d) Securities

The Bank classified all its fixed income securities as available-for-sale securities. Since 2002, shares, other than investments in subsidiary or associated undertakings are included in other assets. Comparative financial information has been reclassified.

Securities transactions are recorded on a settlement date basis.

Foreign securities are purchased in relation to foreign currency reserves administration in accordance with predefined rules. They consist of money market and capital market securities. Part of the bonds portfolio was managed by external managers until 31 May 2002.

Treasury bills and other discounted securities are originally recorded at cost, which is further increased by related accrued interest income (amortised cost). They are subsequently re-measured to their fair value on a quarterly basis.

Bonds are valued at cost, which is further increased by related accrued coupon interest income (amortised cost). The difference between the purchase price and the nominal value of bonds is amortised to interest income. Re-measurement of bonds at their fair value is performed on a quarterly basis.

Transaction costs are not included in cost of purchased securities.

2 ACCOUNTING POLICIES (continued)

(d) Securities (continued)

The fair value of a security is determined as the market value quoted by a relevant stock exchange or other active public market. In other cases the fair value is estimated by:

- the share of the investee's equity for equities;
- the risk adjusted net present value for debt securities and notes.

Changes in the fair values of securities are included in profit (loss) from financial operations.

Dividends received are included in income from securities with variable income.

Disposals of securities are valued at weighted average cost.

The Bank does not have any investments in subsidiary or associated undertakings.

(e) Securities financing arrangements

Securities borrowed or purchased under agreements to resell (reverse repo agreements) are not recognised on the balance sheet. Securities lent or sold under agreements to repurchase (repo agreements) are retained in their original portfolio. The underlying cashflows are recorded as loans and borrowings respectively on a settlement date basis.

(f) Currency in circulation

Notes and coins in circulation represent the liability of the Bank from the issue of currency. Since 1 January 2002 the amount of currency in issue is decreased by the cash in hand denominated in CZK. Comparative financial information has been reclassified.

(g) Membership quota at the International Monetary Fund

The membership quota at the International Monetary Fund (hereinafter the "IMF") is denominated in Special Drawing Rights and is translated to CZK at the last rate advised by the IMF.

2 ACCOUNTING POLICIES (continued)

(h) Issued securities

The amount of treasury bills issued by the Bank is presented in the balance sheet after offsetting against treasury bills repurchased by the Bank. The Bank repurchases the whole issued amount of treasury bills and uses the treasury bills in repo or sell and buy operations with domestic banks.

(i) Derivative financial instruments

Derivative financial instruments include foreign exchange contracts, currency and interest rate swaps and other derivative financial instruments. The Bank enters into derivative transactions only for the purpose of hedging against foreign currency risk and in 2002 carried out only currency forward transactions. The Bank does not apply hedge accounting. Derivative financial instruments are initially recognised on balance sheet at cost and subsequently are re-measured at their fair value. Fair values are obtained from discounted cash-flow models. All derivatives are presented in other assets or in other liabilities when their fair value is positive or negative respectively. Changes in the fair value of derivatives are included in foreign exchange losses from financial operations.

(j) Interest income and expense

Interest income and expense are accrued using usually a linear yield method. Accrued interest is recorded together with the underlying assets and liabilities.

Income on non-performing loans is also accrued and included in the related loan balance at the due date. Such amounts are considered in estimating the specific provisions for non-performing loans. Interest income also includes interest earned on securities. Penalty interest income is suspended in case of a debtor's default and excluded from interest income until received.

Interest expense includes interest expense from loans and deposits received.

(k) Fee and commission income

Fee income from the maintenance of current accounts and other activities is accrued. One-off fees are recognised immediately in the income statement.

2 ACCOUNTING POLICIES (continued)

(l) Specific provisions and reserves

Reserves are created when the Bank has a present obligation as a result of past events, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate of the amount of the obligation can be made.

When creating reserves for issued guarantees related to the consolidation of the banking sector, the guarantee issued by the Czech Government that covers the related risks was taken into consideration (see also Note 30). The received and issued guarantees related to the consolidation of the banking sector are recorded in the off balance sheet of the CNB.

The amount of specific provisions for loans and other assets at risk is based on appraisals of these assets at the balance sheet date after taking into consideration the present forced sale value of collateral. When creating specific provisions for classified assets related to the consolidation of the banking sector, the guarantee issued by the Czech Government that covers these assets was taken into consideration (see also Note 30). A specific credit risk provision for loan impairment is established to provide for the credit losses as soon as the recovery of an exposure is identified as threatened.

Specific provisions adjust the book value of individual assets at risk. Reserves for off balance sheet exposures and reserves for standard loans are included in liabilities.

When a loan is deemed to be not collectable, it is written off and the related provision for impairment is released into the profit and loss account. Subsequent recoveries are credited to the income statement if previously written off.

(m) Tangible and intangible fixed assets

Tangible and intangible fixed assets are recorded at cost, which, with the exception of vehicles, excludes value added tax (hereinafter "VAT").

Tangible fixed assets are depreciated by applying the straight-line basis of depreciation over the estimated useful lives. Intangible fixed assets are amortised over four years unless their usage is limited by contract; in such cases the intangible fixed assets are amortised over the shorter of the contractual period or five years. Low value tangible fixed assets with a unit cost of more than CZK 2,000 and less than or equal to CZK 40,000 and low value intangible fixed assets with a unit cost less than or equal to CZK 60,000 are treated as fixed assets and are fully depreciated / amortised upon the inception of use. Land, art and art collections are not depreciated.

2 ACCOUNTING POLICIES (continued)

(m) Tangible and intangible fixed assets (continued)

Tangible and intangible fixed assets are depreciated as follows:

Buildings and constructions	30 years
Furniture and fittings	6 years
Motor vehicles	4 years
Office equipment and computers	4 years
Software	4 years

In case of a change in the annual depreciation or amortisation rate or classification or valuation of the property, the depreciation charge is modified in the month of the change; depreciation or amortisation charged before that date is not adjusted.

Repairs and maintenance expenditures are charged to expenses as incurred.
Improvement expenditures exceeding CZK 40,000 per unit in one year are included in the costs of the property.

(n) Value added tax

The Bank is registered for VAT. In accordance with the VAT Act, the CNB claims the full amount of input VAT in respect of received taxable supplies used to effect taxable supplies liable to VAT or to generate income or proceeds from output which is not taxable (i.e. the production of Czech coins and notes for circulation and support of the information system for the credit register maintained by the CNB according to Bank Act no. 21/1992 as amended).

(o) Income tax and profit transfer to the state budget

The Bank is exempt from income tax in accordance with Paragraph 17, Article 2 of the Act No. 586/92 Col. on Income Taxes as amended. As a result the Bank does not account for current and deferred tax. The income of the Bank is used to cover necessary operating expenses. Remaining profit is transferred to the state budget.

(p) Pensions

The Bank does not administer its own pension fund but operates defined contribution schemes for its employees administrated by commercial pension funds. Regular contributions are made to the state budget to fund the national pension plan.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

AS AT 31 DECEMBER 2002 AND FOR THE YEAR THEN ENDED

2 ACCOUNTING POLICIES (continued)

(q) Cash flow statement

As the Bank is the central bank of the CR, the management of the Bank is of the opinion that inclusion of a cash flow statement would not provide further significant information to the users of these financial statements.

(r) Extraordinary items and changes in accounting policy

Since 1 January 2002 extraordinary items include one-off effects of events outside the scope of the Bank's activities and effects of changes in accounting policies. Comparative financial information has been reclassified.

As at 1 January 2002 the CNB remeasured available-for-sale securities at fair value and released the provision to available-for-sale securities to extraordinary income.

Any resulting difference is presented as extraordinary income or expense.

Comparative financial information has not been reclassified.

In 2002, the difference between the purchase price and the nominal value of bonds became material and therefore the Bank started amortisation of the difference.

The changes in accounting policies affected the income statement for the year 2002 as follows:

	<u>2002</u> CZK million
Release of provisions to securities	22,521
Re-measurement of securities at fair value	(21,290)
Effects of changes in accounting policies included in extraordinary items:	<u>1,231</u>

Changes in disclosure of assets and liabilities in 2002 are described in Notes 2(d) and 2(f).

As at 1 January 2001 the CNB implemented new definitions of securities portfolios (trading securities, held-to-maturity securities and available-for-sale securities). This change had no impact on the income statement.

There were no significant changes in accounting policies as at 1 January 2000.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

AS AT 31 DECEMBER 2002 AND FOR THE YEAR THEN ENDED

2 ACCOUNTING POLICIES (continued)

(s) Subsequent events

The effects of events, which occurred between the balance sheet date and the date of signing the financial statements, are reflected in the financial statements in the case that these events provide further evidence of conditions, which existed at the balance sheet date.

Where significant events occur subsequent to the balance sheet date but prior to signing of the financial statements that are indicative of conditions which arose subsequent to the balance sheet date, the effects of these events are disclosed, but are not themselves reflected in the financial statements.

3 GOLD

	<u>31 December 2002</u> CZK million	<u>31 December 2001</u> CZK million	<u>31 December 2000</u> CZK million
Gold in total	<u>833</u>	<u>837</u>	<u>841</u>

The market value of gold as at 31 December 2002 was CZK 4,654 million (31 December 2001: CZK 4,470 million, 31 December 2000: CZK 4,640 million).

4 RECEIVABLES AND PAYABLES WITH THE IMF

	<u>31 December 2002</u> CZK million	<u>31 December 2001</u> CZK million	<u>31 December 2000</u> CZK million
Membership quota at IMF	28,006	34,064	42,406
Deposits in IMF	<u>7,313</u>	<u>5,736</u>	<u>396</u>
Total receivables from IMF	<u>35,319</u>	<u>39,800</u>	<u>42,802</u>
Liability to IMF	(27,761)	(33,925)	(42,291)
Current account IMF	<u>(108)</u>	<u>(108)</u>	<u>(108)</u>
Total payables to IMF	<u>(27,869)</u>	<u>(34,033)</u>	<u>(42,399)</u>
Total position with IMF	<u>7,450</u>	<u>5,767</u>	<u>403</u>

Membership quota at IMF is denominated in special drawing rights (SDR) and financed by bills of exchange payable on request issued by the Czech Government.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

AS AT 31 DECEMBER 2002 AND FOR THE YEAR THEN ENDED

5 RECEIVABLES FROM FOREIGN COUNTRIES INCLUDING SECURITIES

	<u>31 December 2002</u> CZK million	<u>31 December 2001</u> CZK million	<u>31 December 2000</u> CZK million
Current accounts with banks	825	555	1,134
Deposits	<u>89,714</u>	<u>116,891</u>	<u>91,671</u>
Total deposits at foreign banks	90,539	117,446	92,805
Total loans provided to foreign banks	20,350	14,384	14,240
Treasury bills and other discounted securities	226,651	79,083	130,125
Bonds and other coupon securities	366,763	319,230	269,177
Unrealised profit (loss) from revaluation to fair value (Note 2(r))	2,886	*	*
Provision when market value lower than accrued cost (Note 18)	*	<u>(1,573)</u>	<u>(1,106)</u>
Total securities	596,300	396,740	398,196
Cash in foreign currencies	49	37	60
Other receivables from abroad	-	<u>12</u>	-
Total other receivables from foreign countries	49	49	60
Total receivables from foreign countries including securities	<u>707,238</u>	<u>528,619</u>	<u>505,301</u>

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

AS AT 31 DECEMBER 2002 AND FOR THE YEAR THEN ENDED

5 RECEIVABLES FROM FOREIGN COUNTRIES INCLUDING SECURITIES (continued)**Loans provided to foreign banks**

Loans provided to foreign banks consist only of reverse repo operations. Securities used in reverse repo operations include state treasury bills, other short-term treasury bills and government and other coupon bonds. Their market value does not materially differ from the carrying value of the agreements.

Reverse repo operations at 31 December 2002 include foreign bonds purchased from counter parties of CZK 20,344 million (31 December 2001: CZK 14,384 million, 31 December 2000: CZK 14,240 million). The maturity of these operations is less than 60 days.

Geographic sector risk concentrations within receivables from foreign countries, excluding securities (Assets Balance sheet lines 3.1., 3.2., 3.4.)

	31 December 2002		31 December 2001		31 December 2000	
	CZK million	%	CZK million	%	CZK million	%
Euro zone	55,219	50	88,433	67	53,098	49
Great Britain	42,618	38	42,871	33	48,819	46
Other European countries	846	1	49	-	4	-
USA	812	1	522	-	5,119	5
Japan	11,438	10	1	-	1	-
Other countries	5	-	3	-	64	-
	<u>110,938</u>	<u>100</u>	<u>131,879</u>	<u>100</u>	<u>107,105</u>	<u>100</u>

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

AS AT 31 DECEMBER 2002 AND FOR THE YEAR THEN ENDED

5 RECEIVABLES FROM FOREIGN COUNTRIES INCLUDING SECURITIES (continued)**Treasury bills and other discounted securities (Assets Balance sheet line 3.3.)**

Treasury bills and other discounted securities can be analysed as follows:

	Fair value 31 December <u>2002</u> CZK million	Accrued cost 31 December <u>2001</u> CZK million	Fair value 31 December <u>2001</u> CZK million	Accrued cost 31 December <u>2000</u> CZK million	Fair value 31 December <u>2000</u> CZK million
Treasury bills	107,452	32,793	32,805	48,823	48,846
Other discounted securities	<u>119,215</u>	<u>46,290</u>	<u>46,289</u>	<u>81,302</u>	<u>81,278</u>
		79,083		130,125	
Provision against securities		<u>(6)</u>		<u>(29)</u>	
Total treasury bills and other discounted securities	<u>226,667</u>	<u>79,077</u>	<u>79,094</u>	<u>130,096</u>	<u>130,124</u>

Geographic sector risk concentrations within treasury bills and other discounted securities

	<u>31 December 2002</u>		<u>31 December 2001</u>		<u>31 December 2000</u>	
	CZK million	%	CZK million	%	CZK million	%
Euro zone	90,662	40	39,137	50	40,962	32
Great Britain	3,285	2	-	-	4,014	3
Switzerland	27,451	12	18,516	23	56,237	43
USA	9,291	4	10,798	14	11,820	9
Japan	79,762	35	-	-	5,943	4
Other countries	<u>16,216</u>	<u>7</u>	<u>10,632</u>	<u>13</u>	<u>11,149</u>	<u>9</u>
	<u>226,667</u>	<u>100</u>	<u>79,083</u>	<u>100</u>	<u>130,125</u>	<u>100</u>

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

AS AT 31 DECEMBER 2002 AND FOR THE YEAR THEN ENDED

5 RECEIVABLES FROM FOREIGN COUNTRIES INCLUDING SECURITIES (continued)

Bonds and other coupon securities (Assets Balance sheet line 3.3.)

Bonds and other coupon securities can be analysed as follows:

	Fair value 31 December 2002 CZK million	Cost 31 December 2001 CZK million	Fair value 31 December 2001 CZK million	Cost 31 December 2000 CZK million	Fair value 31 December 2000 CZK million
State bonds	300,462	257,676	256,930	237,953	238,300
Other foreign bonds	61,028	43,584	43,916	14,431	14,586
Bonds managed by external manager	-	11,695	11,758	11,219	11,219
Accrued interest from bonds	8,143	6,275	6,275	5,574	5,573
		319,230		269,177	
Provision against securities		(1,567)		(1,077)	
Bonds and other coupon securities	<u>369,633</u>	<u>317,663</u>	<u>318,879</u>	<u>268,100</u>	<u>269,678</u>

Bonds and other securities with fixed income reported as trading securities as at 31 December 2002, 2001 and 2000 include solely fixed income securities.

Geographic sector risk concentrations within bonds and other coupon securities

	31 December 2002		31 December 2001		31 December 2000	
	CZK million	%	CZK million	%	CZK million	%
Euro zone	285,654	78	255,387	80	217,526	81
Great Britain	8,488	2	-	-	-	-
USA	74,278	20	62,697	20	50,728	19
Other countries	1,213	-	1,146	-	923	-
	<u>369,633</u>	<u>100</u>	<u>319,230</u>	<u>100</u>	<u>269,177</u>	<u>100</u>

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

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6 RECEIVABLES FROM DOMESTIC BANKS

	<u>31 December 2002</u> CZK million	<u>31 December 2001</u> CZK million	<u>31 December 2000</u> CZK million
Redistribution loans	-	-	12,800
Non-performing loans	14	14	14
Loans provided from European Investment Bank (the "EIB") funds (Note 12)	115	133	169
Other receivables	-	660	4,402
	129	807	17,385
Specific provisions against receivables from domestic banks (Note 18)	(14)	(14)	(14)
Total receivables from domestic banks	<u>115</u>	<u>793</u>	<u>17,371</u>

Redistribution loans

Long-term redistribution loans were provided to Konsolidační banka Praha, s.p.ú. (now Česká konsolidační agentura) in 1990 and 1991. A redistribution loan, under special conditions, was provided to fund the co-operative housing scheme. It is repayable by annual installments based on payments received from clients and its final maturity has not been specified. Since Konsolidační Banka Praha, s.p.ú., was transformed into Česká konsolidační agentura in 2001, this receivable is included in receivables from clients in 2002 and 2001.

Non-performing loans

Non-performing loans represent loans after maturity and loans that show violated contract terms in other respects or which indicate a worsening financial situation of the debtor.

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NOTES TO FINANCIAL STATEMENTS

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7 DUE FROM CLIENTS

	<u>31 December 2002</u> CZK million	<u>31 December 2001</u> CZK million	<u>31 December 2000</u> CZK million
Standard loans	5,723	14,109	15,225
Redistribution loans (Note 6)	10,610	11,651	-
Classified loans gross	<u>32,876</u>	<u>26,658</u>	<u>27,197</u>
	49,209	52,418	42,422
Specific provisions for classified loans (Note 18)	<u>(9,389)</u>	<u>(4,155)</u>	<u>(4,680)</u>
Total due from clients	<u>39,820</u>	<u>48,263</u>	<u>37,742</u>

Classified loans

Classified loans are categorised in accordance with the definitions issued by the Bank into four categories (watch, substandard, doubtful, loss). They consist of total outstanding principal and accrued interest receivable, and are overdue or show other defaults in contractual terms or financial performance.

	<u>31 December 2002</u>		<u>31 December 2001</u>		<u>31 December 2000</u>	
	Net book value CZK million	Fair value CZK million	Net book value CZK million	Fair value CZK million	Net book value CZK million	Fair value CZK million
Watch	-	-	-	-	-	-
Substandard	-	-	-	-	-	-
Doubtful	2	1	4	2	36	18
Loss	<u>32,874</u>	<u>986</u>	<u>26,654</u>	<u>-</u>	<u>27,161</u>	<u>-</u>
Total classified loans	<u>32,876</u>	<u>987</u>	<u>26,658</u>	<u>2</u>	<u>27,197</u>	<u>18</u>

The difference between net book value and fair value of the classified loans is covered by the guarantee issued by the Czech Government (Note 30).

CZECH NATIONAL BANK**NOTES TO FINANCIAL STATEMENTS****AS AT 31 DECEMBER 2002 AND FOR THE YEAR THEN ENDED****7 DUE FROM CLIENTS (continued)**

Classified loans include a portfolio of receivables against Agrobanka Praha, a.s., v likvidaci in the total gross amount of CZK 6,534 million. A specific provision of CZK 5,548 million was created against these receivables and the reserve for exposure to Česká finanční, s.r.o. (hereinafter the "CF") (Notes 18 and 30) was decreased by the same amount.

Except for specific provisions for classified loans the Bank created a reserve for standard loans of CZK 348 million as at 31 December 2002, 2001 and 2000. The reserve must be utilised or written back to income in compliance with Czech accounting rules for banks by 31 December 2005.

8 DOMESTIC SECURITIES AND SHARES

Domestic securities and shares include shares issued by subsidiary or associated undertakings of the Bank in the Czech Republic as follows:

	Fair value 31 December 2002 CZK million	Cost 31 December 2001 CZK million	Fair value 31 December 2001 CZK million	Cost 31 December 2000 CZK million	Fair value 31 December 2000 CZK million
Bankovní institut vysoká škola, a.s.	=	=	=	<u>11</u>	<u>11</u>

Investments in subsidiary undertakings

The Bank had no investments in subsidiary undertakings as at 31 December 2002, 2001 and 2000. In June 2000 the Bank sold its investment in its subsidiary undertaking the CF to Konsolidační banka Praha, s.p.ú. (now Česká konsolidační agentura) for CZK 1 (Note 30).

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

AS AT 31 DECEMBER 2002 AND FOR THE YEAR THEN ENDED

8 DOMESTIC SECURITIES AND SHARES (continued)**Investments in associated undertakings**

At 31 December 2000:

<u>Name</u>	<u>Cost</u> CZK million	<u>Nominal value</u> CZK million	<u>Share capital</u> CZK million	<u>Share</u> %
Bankovní institut vysoká škola, a.s.	<u>11</u>	<u>13</u>	<u>44</u>	<u>30</u>

Changes in investments in subsidiary and associated undertakings can be analysed as follows:

	<u>Investments in subsidiaries</u>		<u>Investments in associates</u>	
	<u>Cost</u> CZK million	<u>Nominal value</u> CZK million	<u>Cost</u> CZK million	<u>Nominal value</u> CZK million
At 1 January 2000	15,814	15,814	11	13
Sale of share in the CF	(15,814)	(15,814)	—	—
At 31 December 2000	-	-	11	13
Sale of share in Bankovní institut vysoká škola, a.s.	—	—	(11)	(13)
At 31 December 2002 and 2001	—	—	—	—

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9 TANGIBLE AND INTANGIBLE FIXED ASSETS**Tangible fixed assets**

	31 December 2000 CZK million	31 December 2001 CZK million	Additions CZK million	Disposals CZK million	31 December 2002 CZK million
<u>Cost</u>					
Land	197	202	1	(29)	174
Buildings	7,046	7,081	10	(51)	7,040
Technical equipment	2,707	2,554	135	(163)	2 526
Equipment	367	355	6	(12)	349
Other	445	447	5	(10)	442
Advances for fixed asset acquisitions	<u>79</u>	<u>74</u>	<u>126</u>	<u>(157)</u>	<u>43</u>
Total cost	<u>10,841</u>	<u>10,713</u>	<u>283</u>	<u>(422)</u>	<u>10,574</u>
<u>Accumulated depreciation</u>					
Buildings	(581)	(817)	(277)	50	(1,044)
Technical equipment	(1,769)	(1,830)	(276)	165	(1,941)
Equipment	(202)	(235)	(48)	19	(264)
Other	<u>(412)</u>	<u>(412)</u>	<u>(8)</u>	<u>13</u>	<u>(407)</u>
Total accumulated depreciation	<u>(2,964)</u>	<u>(3,294)</u>	<u>(609)</u>	<u>247</u>	<u>(3,656)</u>
Net book amount	<u>7,877</u>	<u>7,419</u>			<u>6,918</u>

The original cost of low value tangible fixed assets that have been fully amortised when put into use in 2002 is CZK 4.9 million (2001: CZK 15 million, 2000: CZK 205 million).

9 TANGIBLE AND INTANGIBLE FIXED ASSETS (continued)**Intangible fixed assets**

	31 December 2000 CZK million	31 December 2001 CZK million	Additions CZK million	Disposals CZK million	31 December 2002 CZK million
<u>Cost</u>					
Software	956	1,026	63	-	1,089
Other intangible assets	2	2	-	-	2
Advances for intangible assets acquisitions	<u>38</u>	<u>39</u>	<u>82</u>	(63)	<u>58</u>
Total cost	<u>996</u>	<u>1,067</u>	<u>145</u>	(63)	<u>1,149</u>
<u>Accumulated amortisation</u>					
Software	(543)	(715)	(153)	-	(868)
Other intangible assets	<u>(1)</u>	<u>(2)</u>	-	-	<u>(2)</u>
Total accumulated amortisation	<u>(544)</u>	<u>(717)</u>	<u>(153)</u>	=	<u>(870)</u>
Net book amount	<u>452</u>	<u>350</u>			<u>279</u>

The original cost of low value intangible fixed assets that has been fully amortised when put into use in 2002 is CZK 1.4 million (2001: 1 million, 2000: CZK 0.6 million).

The Bank did not provide any fixed tangible or intangible assets as collateral and does not hold any fixed assets under finance lease contracts.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

AS AT 31 DECEMBER 2002 AND FOR THE YEAR THEN ENDED

10 OTHER ASSETS

	<u>31 December 2002</u> CZK million	<u>31 December 2001</u> CZK million	<u>31 December 2000</u> CZK million
Prepayments	16	16	19
Accrued revenue	-	372	412
Advances	4,321	2,407	2,136
Other financial assets foreign	50	50	50
Other financial assets domestic	-	19,717	19,717
Other precious metals	11	18	16
Foreign currency derivative financial instruments	653	-	415
Other	<u>606</u>	<u>337</u>	<u>151</u>
	5,657	22,917	22,916
Specific provisions to advances and other assets (Note 18)	(1,988)	(21,498)	(21,194)
Total other assets	<u>3,669</u>	<u>1,419</u>	<u>1,722</u>

CNB's investments in the Bank for International Settlement (BIS) and SWIFT are recorded in other assets. The shares of BIS and SWIFT are non-tradable and their holding results from the participation of the CNB in these institutions.

Within other financial assets domestic the Bank discloses its share in GE Capital Bank, a.s. with a fair value of about nil. In 2001 and 2000 this share was disclosed at cost of CZK 19,717 million together with a provision of the same amount.

In 2002 CSOB transferred to the CNB, in compliance with the Agreement and Indemnity Letter (hereinafter the "Indemnity Letter"), free of charge the shares of Agrobanka Praha, a.s. v likvidaci, Kreditní banka Plzeň, a.s. – v likvidaci and BH CAPITAL, a.s. (Note 30). In the opinion of the representatives of the Bank their fair value is about nil.

CZECH NATIONAL BANK

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AS AT 31 DECEMBER 2002 AND FOR THE YEAR THEN ENDED

11 CURRENCY IN CIRCULATION

	<u>31 December 2002</u> CZK million	<u>31 December 2001</u> CZK million	<u>31 December 2000</u> CZK million
Notes in circulation	219,360	201,793	191,584
Coins in circulation	6,114	5,782	5,416
Cash in hand denominated in CZK	<u>(1,072)</u>	<u>(1,714)</u>	<u>(1,898)</u>
Total currency in circulation	<u>224,402</u>	<u>205,861</u>	<u>195,102</u>

12 LIABILITIES TO FOREIGN COUNTRIES

	<u>31 December 2002</u> CZK million	<u>31 December 2001</u> CZK million	<u>31 December 2000</u> CZK million
Repo operations	4,174	14,141	13,246
Loans from the EIB	<u>115</u>	<u>134</u>	<u>169</u>
Total loans from foreign banks	4,289	14,275	13,415
Other liabilities to foreign countries	<u>446</u>	<u>468</u>	<u>414</u>
Total liabilities to foreign countries	<u>4,735</u>	<u>14,743</u>	<u>13,829</u>

Loans from the EIB

The Bank received loans from the EIB. From this source, the Bank granted loans in foreign currencies to commercial banks in the CR (Note 6). Loans were received and provided in the same amount, have the same maturity date and are not secured. The CNB earns a margin on these loans.

Repo operations

State treasury bills and state bonds secure loans granted from repo operations. Their market value does not materially differ from the carrying value of the operations.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

AS AT 31 DECEMBER 2002 AND FOR THE YEAR THEN ENDED

12 LIABILITIES TO FOREIGN COUNTRIES (continued)

Geographic sector risk concentrations within liabilities to foreign countries:

	31 December 2002		31 December 2001		31 December 2000	
	CZK million	%	CZK million	%	CZK million	%
Euro zone	4,325	91	3,461	23	1,973	14
Other European countries	8	-	5	-	-	-
USA	402	9	11,277	77	11,856	86
	<u>4,735</u>	<u>100</u>	<u>14,743</u>	<u>100</u>	<u>13,829</u>	<u>100</u>

13 DUE TO DOMESTIC BANKS

	31 December 2002	31 December 2001	31 December 2000
	CZK million	CZK million	CZK million
Monetary reserves from banks	28,359	30,273	26,575
Repo operations	455,419	264,847	251,386
Other liabilities to domestic banks	<u>4,455</u>	<u>14,127</u>	<u>17,910</u>
Total liabilities to domestic banks	<u>488,233</u>	<u>309,247</u>	<u>295,871</u>

Monetary reserves from banks

Obligatory minimum reserves represent deposits of the banks in the CR held at the CNB. Since 12 July 2001 the CNB pays interest equal to the CZK two-week repo interest rate on these deposits. Obligatory minimum reserves are defined as 2% of deposits with maturity less than two years.

Repo operations

Repo operations as at 31 December 2002 include CZK 455,419 million (31 December 2001: CZK 264,847 million, 31 December 2000: CZK 251,386 million) of loans received from banks in the CR. Repurchased treasury bills of the Bank guarantee these loans. Their market value does not materially differ from the carrying value of the operations.

Other liabilities to domestic banks

Other liabilities to domestic banks represent deposits used for interbank money transfers.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

AS AT 31 DECEMBER 2002 AND FOR THE YEAR THEN ENDED

14 CLIENT DEPOSITS

	<u>31 December 2002</u> CZK million	<u>31 December 2001</u> CZK million	<u>31 December 2000</u> CZK million
Current accounts	8,990	9,730	7,070
Term deposits	11,083	2,046	2,134
Deposits of local government bodies	12,025	11,092	5,970
Other deposits	<u>3,839</u>	<u>5,048</u>	<u>6,399</u>
Total client deposits	<u>35,937</u>	<u>27,916</u>	<u>21,573</u>

15 DOMESTIC SECURITIES ISSUED

	<u>31 December 2002</u> CZK million	<u>31 December 2001</u> CZK million	<u>31 December 2000</u> CZK million
CNB treasury bills	700,000	400,000	400,000
CNB treasury bills repurchased:			
- held in the treasury bills portfolio	(250,582)	(136,826)	(148,631)
- in repo operations	(449,418)	(263,175)	(252,206)
- in reverse repo operations	_____ -	_____ 1	_____ 837
	===== -	===== -	===== -

The treasury bills were issued at zero discount during 2002, 2001 and 2000.

16 OTHER LIABILITIES TO STATE BUDGET

	<u>31 December 2002</u> CZK million	<u>31 December 2001</u> CZK million	<u>31 December 2000</u> CZK million
State funds' accounts	23,111	12,033	7,130
Other state assets denominated in CZK	25,011	24,435	28,681
Other state assets denominated in foreign currency	<u>1,846</u>	<u>21,269</u>	<u>763</u>
Total other liabilities to state budget	<u>49,968</u>	<u>57,737</u>	<u>36,574</u>

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

AS AT 31 DECEMBER 2002 AND FOR THE YEAR THEN ENDED

17 EQUITY

Changes of equity during 2002, 2001 and 2000 were as follows:

	Share capital CZK million	Funds CZK million	Accumulated losses CZK million	Profit / (loss) for the year CZK million	Equity CZK million
Balance at 1 January 2000	1,400	8,203	(50,739)	32,378	(8,758)
Transfer of profit from 1999 to accumulated losses	0	0	32,347	(32,347)	0
Usage of social fund	0	(32)	0	0	(32)
Allocation to social fund from profit	0	31	0	(31)	0
Profit for the year 2000	0	0	0	2,524	2,524
Balance at 31 December 2000	1,400	8,202	(18,392)	2,524	(6,266)
Transfer of profit from 2000 to accumulated losses	-	0	2489	(2,489)	0
Usage of social fund	-	(39)	0	0	(39)
Allocation to social fund from profit	-	35	0	(35)	0
Loss for the year 2001	-	0	0	(28,628)	(28,628)
Balance at 31 December 2001	1,400	8,198	(15,903)	(28,628)	(34,933)
Transfer of loss from 2001 to accumulated losses	-	-	(28,628)	28,628	0
Usage of social fund	-	(42)	0	0	(42)
Loss for the year 2002	-	0	0	(9,468)	(9,468)
Balance at 31 December 2002	<u>1,400</u>	<u>8,156</u>	<u>(44,531)</u>	<u>(9,468)</u>	<u>(44,443)</u>

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

AS AT 31 DECEMBER 2002 AND FOR THE YEAR THEN ENDED

17 EQUITY (continued)

Funds

The major part of funds is represented by the General reserve fund of CZK 7,773 million existing in all reporting periods, which can be used to cover accumulated losses, increase share capital or for any other purpose approved by Bank Council of the CNB.

In compliance with Czech accounting principals the Social fund of CZK 6 million as at 31 December 2002 (31 December 2001: CZK 8 million and 31 December 2000: CZK 13 million) used for coverage of the social needs of employees and employees' programme of the CNB is also included within funds. Allocations to the Social fund are performed each year from the profit of the prior year. If the CNB achieved a loss in the prior year, the allocation to Social fund is done from the Special reserve fund.

18 RESERVES, SPECIFIC PROVISIONS AND WRITE OFFS

At 31 December 2002, 2001 and 2000 the Bank created specific provisions and reserves for assets at risk:

	31 December 2002 CZK million	31 December 2001 CZK million	31 December 2000 CZK million
Specific provisions for non-performing loans due from domestic banks (Note 6)	14	14	14
Specific provisions for classified loans to clients (Note 7)	9,389	4,155	4,680
Specific provisions for securities			
- Foreign securities (Note 5)	-	1,573	1,106
- Domestic securities (Note 10)	-	19,717	19,717
Other specific provisions (Note 10)	<u>1,988</u>	<u>1,781</u>	<u>1,477</u>
Total specific provisions	<u>11,391</u>	<u>27,240</u>	<u>26,994</u>
Reserves for guarantees (Note 20)	348	418	828
Reserves for standard loans (Note 6)	348	348	348
Reserves for guarantee CF (Note 30)	4,916	10,587	10,867
Reserves for guarantee related to consolidation of the banking sector (Note 20 and 30)	<u>598</u>	<u>582</u>	<u>554</u>
Total reserves	<u>6,210</u>	<u>11,935</u>	<u>12,597</u>

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18 RESERVES, SPECIFIC PROVISIONS AND WRITE OFFS (continued)**Write-offs and recovery of amounts written off previously**

The CNB wrote off receivables of CZK 11 million in 2002 (2001: CZK 128 million, 2000: CZK 27 million) and did not receive any payments on debts that had been previously written off in 2002, 2001 and 2000.

Specific provisions

The movements in the specific provisions can be analysed as follows:

	Amounts due from banks and from foreign banks CZK million	Classified loans CZK million	Securities CZK million	Other CZK million	Total CZK million
At 1 January 2000	25,824	5,336	22,648	1,444	55,252
Addition	-	23	1,534	34	1,591
FX difference	-	-	(70)	-	(70)
Usage	(25,810)	(679)	(3,289)	(1)	(29,779)
At 31 December 2000	14	4,680	20,823	1,477	26,994
Addition	-	18	1,190	305	1,513
FX difference	-	-	(84)	-	(84)
Usage	-	(543)	(639)	(1)	(1,183)
At 31 December 2001	14	4,155	21,290	1,781	27,240
Addition	-	5,560	-	312	5,872
Change in accounting policy (Note 2r)	-	-	(21,290)	-	(21,290)
Usage	-	(326)	-	(105)	(431)
At 31 December 2002	<u>14</u>	<u>9,389</u>	<u>-</u>	<u>1,988</u>	<u>11,391</u>

The 2001 and 2000 creation and usage of specific provisions for securities were presented as profit or loss from financial operations (Note 22).

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

AS AT 31 DECEMBER 2002 AND FOR THE YEAR THEN ENDED

18 RESERVES, SPECIFIC PROVISIONS AND WRITE OFFS (continued)**Reserves**

The movements in reserves can be analysed as follows:

	<u>Standard loans</u> CZK million	<u>Consolidation</u> CZK million	<u>Other</u> CZK million	<u>Total</u> CZK million
At 1 January 2000	348	31,900	1,354	33,602
Addition	-	1,317	11	1,328
Usage	-	(21,796)	(537)	(22,333)
At 31 December 2000	348	11,421	828	12,597
Addition	-	28	11	39
Usage	-	(280)	(421)	(701)
At 31 December 2001	348	11,169	418	11,935
Addition	-	16	9	25
Usage	-	(5,671)	(79)	(5,750)
At 31 December 2002	<u>348</u>	<u>5,514</u>	<u>348</u>	<u>6,210</u>

19 OTHER LIABILITIES

	<u>31 December</u> <u>2002</u> CZK million	<u>31 December</u> <u>2001</u> CZK million	<u>31 December</u> <u>2000</u> CZK million
Deferred revenue and accrued expenses	<u>8</u>	<u>186</u>	<u>346</u>
Derivative financial instruments	844	-	-
Settlement accounts of local authorities resources	-	-	1,127
Other liabilities	<u>428</u>	<u>775</u>	<u>967</u>
Total others	<u>1,272</u>	<u>775</u>	<u>2,094</u>
Total other liabilities	<u>1,280</u>	<u>961</u>	<u>2,440</u>

20 CONTINGENCIES AND COMMITMENTS**Received and issued guarantees**

Received and issued guarantees can be divided as follows:

	<u>31 December 2002</u> CZK million	<u>31 December 2001</u> CZK million	<u>31 December 2000</u> CZK million
Issued guarantees for clients	426	514	540
Issued guarantee for CF (Note 30)	4,916	10,587	10,867
Issued guarantees for the consolidation of the banking sector	<u>194,620</u>	<u>92,686</u>	<u>67,333</u>
Total issued guarantees	<u>199,962</u>	<u>103,787</u>	<u>78,740</u>
Guarantee received from the Czech Government for impaired assets taken over by the Bank within the Consolidation Programme (Note 30)	22,500	22,500	22,500
Guarantee received from the Ministry of Finance (Note 30)	<u>160,000</u>	<u>39,840</u>	<u>7,945</u>
Total guarantees received	<u>182,500</u>	<u>62,340</u>	<u>30,445</u>

The issued guarantees for the consolidation of the banking sector include the Indemnity Letter and Guarantee for deposits of IPB (Note 30). The guarantees received included the guarantee provided by the Czech Government in connection with the consolidation of the banking sector (Note 30).

The identified need for reserves for expected losses on the issued guarantees was CZK 5,862 million as at 31 December 2002 (31 December 2001: CZK 11,587 million, 31 December 2000: CZK 12,248 million).

20 CONTINGENCIES AND COMMITMENTS (continued)**Receivables and payables from unsettled transactions with securities**

	31 December <u>2002</u> CZK million	31 December <u>2001</u> CZK million	31 December <u>2000</u> CZK million
Receivables from unsettled transactions with securities	51,490	11,851	98,251
Payables from unsettled transactions with securities	<u>46,164</u>	<u>9,493</u>	<u>94,418</u>
Net position	<u>5,326</u>	<u>2,358</u>	<u>3,833</u>

All receivables and payables from unsettled transactions with securities as at 31 December 2002, 2001 and 2000 matured in January of the following year.

Legal suits

The Bank participates in a legal suit with one of domestic commercial banks about compensation for an alleged claim of about CZK 1,800 million resulting from a transaction performed by the CNB within the consolidation of Czech banking sector. Based on independent analysis and the Bank's own opinion, the management of the CNB does not consider any compensation to be paid by the CNB as probable and therefore did not create any reserve for such compensation.

Investment commitments

The Bank has not entered into any contracts for the purchase of tangible and intangible fixed assets as at 31 December 2002 and 2001 (31 December 2000: CZK 12 million).

Assets held in custody

The Bank has not received any assets from third parties to be held in custody in 2002, 2001 and 2000.

CZECH NATIONAL BANK

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21 INTEREST MARGIN

	<u>2002</u> CZK million	<u>2001</u> CZK million	<u>2000</u> CZK million
Interest income and similar income	22,104	28,106	28,291
Interest expense and similar expense	(17,032)	(17,092)	(16,821)
Interest margin	<u>5,072</u>	<u>11,014</u>	<u>11,470</u>

Interest income and similar income

	<u>2002</u> CZK million	<u>2001</u> CZK million	<u>2000</u> CZK million
Discount on repurchased treasury bills issued by the Bank	-	53	185
Interest on treasury bills and other discounted securities	3,134	3,952	7,322
Interest on bonds and other coupon securities	<u>13,583</u>	<u>18,376</u>	<u>14,189</u>
Total interest from securities with fixed income	<u>16,717</u>	<u>22,381</u>	<u>21,696</u>
Interest on inter-bank transactions	4,320	4,250	5,341
Interest on loans to clients	956	1,450	979
Other interest income	<u>111</u>	<u>25</u>	<u>275</u>
Total other interest and similar income	<u>5,387</u>	<u>5,725</u>	<u>6,595</u>
Total interest income and similar income	<u>22,104</u>	<u>28,106</u>	<u>28,291</u>

Based on the estimate of the Bank's management, in 2002 total income included CZK 7 million from interest income on classified loans (2001: CZK 14 million, 2000: CZK 32 million). Unpaid interest is accrued and is taken into account when calculating the amount of specific provisions.

CZECH NATIONAL BANK

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21 INTEREST MARGIN (continued)

Interest expense and related expense

	<u>2002</u> CZK million	<u>2001</u> CZK million	<u>2000</u> CZK million
Interest and discount from issued treasury bills and bonds	-	-	523
Interest on liabilities to state	391	429	1,020
Interest on liabilities to banks	16,081	16,348	14,959
Interest on liabilities to clients	560	315	319
Total other interest and related expense	17,032	17,092	16,298
Total interest expense and related expense	17,032	17,092	16,821

22 LOSS FROM FINANCIAL OPERATIONS

Loss from financial operations for the year 2002, 2001 and 2000 can be analysed as follows:

	<u>2002</u> CZK million	<u>2001</u> CZK million	<u>2000</u> CZK million
Profit from sale of securities	2,097	3,927	691
Loss from sale of securities	(1,762)	(2,117)	(5,333)
Foreign exchange losses	(26,170)	(40,113)	(3,523)
Other income	7,342	1,101	1,336
Result on swap transactions	-	-	66
Other interest	(197)	8	287
Decrease in fair value of securities	(1,469)	-	-
Increase in fair value of securities	6,295	-	-
Addition to specific provisions for securities	-	(1,190)	(1,534)
Usage of specific provisions for securities	-	639	3,289
	(13,864)	(37,745)	(4,721)

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23 ADMINISTRATION EXPENSES

The administration expenses for the year 2002, 2001 and 2000 can be analysed as follows:

	<u>2002</u> CZK million	<u>2001</u> CZK million	<u>2000</u> CZK million
Wages and salaries	554	501	484
Social security and health insurance	<u>197</u>	<u>176</u>	<u>182</u>
Total personnel costs	<u>751</u>	<u>677</u>	<u>666</u>
Depreciation of tangible fixed assets	556	604	812
Amortisation of intangible fixed assets	152	175	163
Rent	12	16	121
Other	<u>544</u>	<u>530</u>	<u>593</u>
Total other administration expenses	<u>1,264</u>	<u>1,325</u>	<u>1,689</u>
Total administration expenses	<u>2,015</u>	<u>2,002</u>	<u>2,355</u>

Staff statistics

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Average number of employees	1,479	1,448	1,458
Number of members of the Bank Council	7	7	7

24 OTHER OPERATING EXPENSES AND EXTRAORDINARY EXPENSES**Other operating expenses**

	<u>2002</u> CZK million	<u>2001</u> CZK million	<u>2000</u> CZK million
Cost of transfer of the Slovak National Bank receivable	-	-	25,810
Cost of transfer of the share in the CF (Note 30)	-	13	15,814
Settlement of CF losses (Note 30)	565	864	7,394
Expenses for issuing bank notes and coins	371	309	297
Other expenses and damages	<u>183</u>	<u>590</u>	<u>553</u>
Other expenses in total	<u>1,119</u>	<u>1,776</u>	<u>49,868</u>

Due to a change in accounting policy, other damages and selected extraordinary expenses of CZK 11 million in 2001 (2000: CZK 3 million) are included in other operating expenses in 2002.

Transfer of receivable from Národní banka Slovenska

Until 2000 other receivables included receivables towards Slovak National Bank of CZK 25,810 million resulting from the split of the assets and liabilities of the former Státní banka Československá between the central banks of the CR and Slovak Republic and from the losses resulting from the split of federal currency as at 31 December 1992. The agreement concerning the transfer of this receivable to the Czech state for CZK 1 became effective in 2000 and the CNB recognized a loss of CZK 25,810 million and released the established provision of CZK 25,810 million at the same time.

Extraordinary expenses and incomes

	<u>2002</u> CZK million	<u>2001</u> CZK million	<u>2000</u> CZK million
Total extraordinary expenses	<u>21,290</u>	≡	≡
Total extraordinary incomes	<u>22,521</u>	≡	≡

Extraordinary expense and income in 2002 result from the change in accounting policy of the re-measurement of securities to fair value (Note 2 (r)).

25 FINANCIAL RISKS

Liquidity risk

The Bank monitors and manages the structure and duration of its foreign currency reserves in compliance with the mission of the Bank. The table in Note 26 analyses assets and liabilities of the Bank into relevant maturity bands based on the remaining period at the balance sheet date to the contractual maturity date.

Interest rate risk

The Bank takes on exposure resulting from fluctuations in the prevailing levels of market interest rates on its financial position and cash flows. Changes in interest rates result in the change in market value of securities held in the portfolio of the Bank. Rules for investing foreign currency reserves are targeted to keep down the significant risk of a change in interest rates. The table in Note 27 summarizes the Bank's exposure to interest rate risks. Included in the table are the Bank's interest bearing assets and liabilities at carrying amounts, categorized by the earlier of contractual, repricing or maturity dates.

Currency risk

The Bank takes on exposure resulting from fluctuations in prevailing foreign currency exchange rates on its financial position and cash flows. The structure of foreign currency reserves is targeted to keep down the significant risk of the movement of mutual foreign exchange rates of single currencies. The table in Note 28 summarizes the Bank's exposure to the currency risk. Included in the table are the Bank's foreign currency denominated assets and liabilities at carrying amounts, categorized by currency.

Credit risk

The Bank manages the levels of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower or groups of borrowers and to geographical segments. Such risks are monitored on a revolving basis and are subject to an annual or more frequent review. Geographical concentrations of assets and liabilities are stated in Note 29.

CZECH NATIONAL BANK

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25 FINANCIAL RISKS (continued)

Spot operations and derivative financial instruments

The receivables and payables from spot, term and option operations can be analysed as follows:

	<u>31 December 2002</u> CZK million	<u>31 December 2001</u> CZK million	<u>31 December 2000</u> CZK million
Receivables			
- from unsettled spot operations	1,355	2,877	494
- from forward operations	91,420	5	6,368
- from option operations	<u>8,898</u>	<u>7,985</u>	<u>6,832</u>
	<u>101,673</u>	<u>10,867</u>	<u>13,694</u>
Payables			
- from unsettled spot operations	1,359	2,871	493
- from forward operations	91,196	5	5,944
- from option operations	<u>8,898</u>	<u>7,985</u>	<u>6,832</u>
	<u>101,453</u>	<u>10,861</u>	<u>13,269</u>

The Bank has outstanding derivative contracts at the balance sheet date hedging the movement of foreign exchange rates:

	<u>31 December 2002</u> CZK million	<u>31 December 2001</u> CZK million	<u>31 December 2000</u> CZK million
Off balance sheet receivables from forward operations	91,420	5	6,368
Off balance sheet payables from forward operations	91,196	5	5,944
Fair value positive	844	-	-
Fair value negative	653	-	415

The nominal amounts in off balance sheet provide a basis for volume comparison with instruments recognised on the balance sheet but do not indicate the Bank's exposure to credit or price risk.

Despite the fact that these foreign currency forwards provide efficient financial hedging of the Bank's position from a risk management point of view, they do not fulfill the criteria for hedge accounting required by the Czech accounting rules, so that they are treated as trading derivatives. Gains and losses from the change of the fair value of these foreign currency forwards are recorded in the income statement.

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26 LIQUIDTY RISK

As at 31 December 2002	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Un- specified	Total
Assets							
Gold	833	-	-	-	-	-	833
Receivables from IMF	-	-	-	-	-	35,319	35,319
Treasury bills and other discounted securities	39,045	129,177	58,445	-	-	-	226,667
Bonds and other coupon Securities	4,189	3,236	22,558	330,083	9,567	-	369,633
Other receivables against foreign countries	92,873	18,065	-	-	-	-	110,938
Receivables from domestic banks	-	12	12	91	-	-	115
Receivables from clients	23,574	-	5,542	94	-	10,610	39,820
Fixed assets	-	-	-	-	-	7,197	7,197
Other assets	3,603	-	16	-	-	50	3,669
Total assets	<u>164,117</u>	<u>150,490</u>	<u>86,573</u>	<u>330,268</u>	<u>9,567</u>	<u>53,176</u>	<u>794,191</u>
Liabilities and equity							
Currency in circulation	-	-	-	-	-	224,402	224,402
Liabilities to IMF	-	-	-	-	-	27,869	27,869
Liabilities to foreign banks including securities	4,621	12	12	90	-	-	4,735
Liabilities to domestic banks	488,233	-	-	-	-	-	488,233
Deposits from clients	35,288	-	341	308	-	-	35,937
Other liabilities to state budget	45,217	4,485	266	-	-	-	49,968
Reserves	-	-	-	-	-	6,210	6,210
Equity	-	-	-	-	-	(44,443)	(44,443)
Other liabilities	1,272	-	8	-	-	-	1,280
Total liabilities and equity	<u>574,631</u>	<u>4,497</u>	<u>627</u>	<u>398</u>	<u>-</u>	<u>214,038</u>	<u>794,191</u>
Net liquidity gap	<u>(410,514)</u>	<u>145,993</u>	<u>85,946</u>	<u>329,870</u>	<u>9,567</u>	<u>(160,862)</u>	<u>-</u>
As at 31 December 2001							
Total assets	168,615	41,520	123,919	232,035	1,619	59,792	627,500
Total liabilities	403,488	12	1,917	5,174	13	216,896	627,500
Net liquidity gap	<u>(234,873)</u>	<u>41,508</u>	<u>122,002</u>	<u>226,861</u>	<u>1,606</u>	<u>(157,104)</u>	<u>-</u>
As at 31 December 2000							
Total assets	146,087	99,022	114,235	185,480	18,137	51,158	614,119
Total liabilities	350,593	9,912	7,810	1,923	49	243,832	614,119
Net liquidity gap	<u>(204,506)</u>	<u>89,110</u>	<u>106,425</u>	<u>183,557</u>	<u>18,088</u>	<u>(192,674)</u>	<u>-</u>

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27 INTEREST RATE RISK

As at 31 December 2002	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Not sensitive	Total
Assets							
Gold	-	-	-	-	-	833	833
Receivables from IMF	-	-	-	-	-	35,319	35,319
Treasury bills and other discounted securities	39,045	129,177	58,445	-	-	-	226,667
Bonds and other coupon securities	4,524	3,418	23,129	328,995	9,567	-	369,633
Other receivables against foreign countries	92,873	18,065	-	-	-	-	110,938
Receivables from domestic banks	-	12	12	91	-	-	115
Receivables from clients	23,574	-	5,542	94	-	10,610	39,820
Fixed assets	-	-	-	-	-	7,197	7,197
Other assets	3,619	-	-	-	-	50	3,669
Total assets	<u>163,635</u>	<u>150,672</u>	<u>87,128</u>	<u>329,180</u>	<u>9,567</u>	<u>54,009</u>	<u>794,191</u>
Liabilities and equity							
Currency in circulation	-	-	-	-	-	224,402	224,402
Liabilities to IMF	-	-	-	-	-	27,869	27,869
Liabilities to foreign banks including securities	4,621	12	12	90	-	-	4,735
Liabilities to domestic banks	488,233	-	-	-	-	-	488,233
Deposits from clients	35,937	-	-	-	-	-	35,937
Other liabilities to state budget	45,217	4,485	266	-	-	-	49,968
Reserves	-	-	-	-	-	6,210	6,210
Equity	-	-	-	-	-	(44,443)	(44,443)
Other liabilities	1,280	-	-	-	-	-	1,280
Total liabilities and equity	<u>575,288</u>	<u>4,497</u>	<u>278</u>	<u>90</u>	<u>-</u>	<u>214,038</u>	<u>794,191</u>
Net interest sensitivity gap	<u>(411,653)</u>	<u>146,175</u>	<u>86,850</u>	<u>329,090</u>	<u>9,567</u>	<u>(160,029)</u>	<u>-</u>
As at 31 December 2001							
Total assets	173,782	54,159	119,640	219,277	13	60,629	627,500
Total liabilities	405,720	12	12	4,847	13	216,896	627,500
Net interest sensitivity gap	<u>(231,938)</u>	<u>54,147</u>	<u>119,628</u>	<u>214,430</u>	<u>-</u>	<u>(156,267)</u>	<u>-</u>
As at 31 December 2000							
Total assets	207,422	145,539	211,852	2	60	49,244	614,119
Total liabilities	354,187	9,912	5,651	488	49	243,832	614,119
Net interest sensitivity gap	<u>(146,765)</u>	<u>135,627</u>	<u>206,201</u>	<u>(486)</u>	<u>11</u>	<u>(194,588)</u>	<u>-</u>

CZECH NATIONAL BANK

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28 CURRENCY RISK

As at 31 December 2002	CZK	EUR	USD	JPY	Other	Total
Assets						
Gold	-	-	-	-	833	833
Receivables from IMF	27,869	-	-	-	7,450	35,319
Treasury bills and other discounted securities	-	90,108	56,798	79,761	-	226,667
Bonds and other coupon securities	-	290,824	78,809	-	-	369,633
Other receivables against foreign countries	-	75,181	24,248	11,438	71	110,938
Receivables from domestic banks	-	115	-	-	-	115
Receivables from clients	39,820	-	-	-	-	39,820
Fixed assets	7,187	-	-	-	10	7,197
Other assets	3,525	95	-	-	49	3,669
Total assets	<u>78,401</u>	<u>456,323</u>	<u>159,855</u>	<u>91,199</u>	<u>8,413</u>	<u>794,191</u>
Liabilities and equity						
Currency in circulation	224,402	-	-	-	-	224,402
Liabilities to IMF	27,869	-	-	-	-	27,869
Liabilities to foreign banks including securities	446	4,289	-	-	-	4,735
Liabilities to domestic banks	488,233	-	-	-	-	488,233
Deposits from clients	25,479	10,362	96	-	-	35,937
Other liabilities to state budget	48,122	1,846	-	-	-	49,968
Reserves	6,210	-	-	-	-	6,210
Equity	(44,443)	-	-	-	-	(44,443)
Other liabilities	1,279	-	-	-	1	1,280
Total liabilities and equity	<u>777,597</u>	<u>16,497</u>	<u>96</u>	<u>-</u>	<u>1</u>	<u>794,191</u>
Net foreign exchange position	<u>(699,196)</u>	<u>439,826</u>	<u>159,759</u>	<u>91,199</u>	<u>8,412</u>	<u>-</u>
As at 31 December 2001						
Total assets	91,712	363,581	164,402	1	7,804	627,500
Total liabilities	590,423	6,617	30,459	-	1	627,500
Net foreign exchange position	<u>(498,711)</u>	<u>356,964</u>	<u>133,943</u>	<u>1</u>	<u>7,803</u>	<u>-</u>
As at 31 December 2000						
Total assets	106,934	354,842	144,263	5,944	2,136	614,119
Total liabilities	598,422	4,174	11,523	-	-	614,119
Net foreign exchange position	<u>(491,488)</u>	<u>350,668</u>	<u>132,740</u>	<u>5,944</u>	<u>2,136</u>	<u>-</u>

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28 CURRENCY RISK

Long position in JPY in 2002 and 2000 was converted to EUR and USD with the help of foreign exchange forwards.

29 CREDIT RISK AND CONCENTRATION OF LIABILITIES

Geographical concentrations of assets

	<u>31 December 2002</u> CZK million	<u>31 December 2001</u> CZK million	<u>31 December 2000</u> CZK million
Czech Republic	51,683	59,031	66,076
Germany	123,883	83,298	49,807
France	46,568	82,318	63,780
Italy	140,758	111,309	116,437
Other Euro zone countries	120,326	104,711	80,469
Switzerland	27,456	18,516	56,237
Great Britain	54,391	42,871	52,833
Other European countries	2,005	99	4
Canada and USA	119,700	113,565	110,456
Japan	91,200	1	5,944
Other countries	<u>16,221</u>	<u>11,781</u>	<u>12,076</u>
	<u>794,191</u>	<u>627,500</u>	<u>614,119</u>

Geographical concentrations of liabilities

	<u>31 December 2002</u> CZK million	<u>31 December 2001</u> CZK million	<u>31 December 2000</u> CZK million
Czech Republic	761,587	578,724	557,891
Italy	-	-	1,796
Other Euro zone countries	4,325	3,461	177
Other European countries	8	5	-
Canada and USA	<u>28,271</u>	<u>45,310</u>	<u>54,255</u>
	<u>794,191</u>	<u>627,500</u>	<u>614,119</u>

30 CONSOLIDATION OF THE BANKING SECTOR**Consolidation of the banking sector**

Pursuant to its role in supporting and maintaining the stability of the banking sector and monitoring the security of client's deposits the CNB took over certain assets and liabilities or guaranteed certain liabilities of various commercial banks. The Czech Government issued a guarantee of CZK 22,500 million in favour of the Bank (hereinafter the "Guarantee") to cover the exposure of the Bank arising as a consequence of these activities. The Guarantee was issued on 19 March 1997 and is valid for ten years from that date. The CNB has fully provided for the estimated losses resulting from the consolidation of the banking sector not covered by the Guarantee.

The assets taken over and specific provisions and reserves created as at 31 December 2002, 2001 and 2000 can be summarised as follows:

	<u>31 December 2002</u> CZK million	<u>31 December 2001</u> CZK million	<u>31 December 2000</u> CZK million
Receivables from banks	27,175	27,481	27,851
Purchased receivables of banks	308	308	410
Guarantees and commitments	<u>598</u>	<u>581</u>	<u>553</u>
	28,081	28,370	28,814
Specific provisions and reserves for assets related to the consolidation of the banking sector	<u>(5,581)</u>	<u>(5,870)</u>	<u>(6,314)</u>
Total net book value covered by the Guarantee	<u>22,500</u>	<u>22,500</u>	<u>22,500</u>

30 CONSOLIDATION OF THE BANKING SECTOR (continued)**Česká finanční, s.r.o.**

The CF was 100% acquired by the Bank in 1997 as a special purpose vehicle to administer the banking industry Stabilisation and Consolidation Programmes which focused on small and middle sized banks. Further to the resolution of the Czech Government number 1162 dated 8 November 1999, by which the Czech Government approved the restructuring of certain transformation institutions, the CNB sold its 100% ownership interest in the CF for an agreed price of CZK 1 to Konsolidační Banka Praha, s.p.ú., now Česká Konsolidační Agentura (hereinafter “CKA”) based on an agreement for the transfer of the ownership interest in a company concluded between the CNB and CKA in June 2000. The CNB has undertaken to cover all CF losses resulting from the Consolidation Programme and concluded an agreement with the CF on the settlement of operating costs and losses from assumed assets incurred in relation to the implementation of the Consolidation Programme, which would not be set off against the CF share capital of CZK 13,833 million which the CNB had increased in 1997 and 1998.

The Consolidation Programme involved transfers of some doubtful assets of certain banks taking part in this programme to the CF in exchange for an irrecoverable cash advance from the CF. The aim of this programme was to assist certain small banks to regain financial stability. The programme was started in 1997. The CF ceded the portfolio of three receivables against Agrobanka Praha, a.s., v likvidaci included in the Consolidation Programme back to the CNB in 2002. The unaudited book amount of the Consolidation Programme assets administered by the CF (net of provisions created by the CF) was CZK 5,631 million as at 31 December 2002 (audited amount as at 31 December 2001: CZK 26,304 million, 31 December 2000: CZK 28,990 million).

In compliance with this agreement CF’s operating costs will be settled on a quarterly basis and the agreement also specifies CF’s reporting duties to the CNB on a regular basis. The mechanism whereby the CNB retains a certain level of control over the CF activities relating to the Consolidation Programme was agreed by CNB and CKA in the agreement on the settlement of operating costs and losses from assumed assets incurred in relation to the implementation of the Consolidation Programme.

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30 CONSOLIDATION OF THE BANKING SECTOR (continued)

Česká finanční, s.r.o. (continued)

The calculation of the reserve as at 31 December 2002, 2001 and 2000 can be summarised as follows:

	<u>31 December 2002</u> CZK'000	<u>31 December 2001</u> CZK'000	<u>31 December 2000</u> CZK'000
Provided loans	5,542	14,026	15,161
Less expected recoverability of			
- receivables in Consolidation Programme	510	3,334	4,173
- securities in Consolidation Programme	<u>116</u>	<u>105</u>	<u>121</u>
	626	3,439	4,294
Created reserves (Note 18)	<u>4,916</u>	<u>10,587</u>	<u>10,867</u>

Investiční a Poštovní banka, a.s.

In June 2000 the CNB declared the forced administration on Investiční a Poštovní banka, a.s. (hereinafter "IPB"). On 16 June 2000 the CNB issued a guarantee for deposits (hereinafter the "Guarantee for Deposits") covering all commitments resulting from deposits received by IPB and from bonds issued by IPB including accrued interest as at 16 June 2000. Liabilities with a fixed maturity date were guaranteed until the maturity date and liabilities without a fixed maturity date were guaranteed until the end of the 12 month period after the forced administration of IPB is terminated.

The Guarantee for Deposits is regularly updated in the CNB off balance sheet based on an assessment of the liabilities covered by the Guarantee for Deposits performed by Československá obchodní banka, a.s. (hereinafter "CSOB"). The balance of the Guarantee for Deposits as at 31 December 2002 was CZK 32,780 million (31 December 2001: CZK 48,707 million, 31 December 2000: CZK 54,200 million).

CSOB concluded a contract with the forced administrator of IPB about the sale of the business on 19 June 2000 and based on this agreement CSOB took over the assets and liabilities of IPB. On 19 June 2000 the CNB issued an Indemnity Letter in which it irrevocably and unconditionally undertook to pay to CSOB certain losses and it indemnifies CSOB for certain costs related to the transaction.

30 CONSOLIDATION OF THE BANKING SECTOR (continued)**Investiční a Poštovní banka, a.s. (continued)**

On 23 June 2000 the Czech Government issued a Government guarantee in which it undertook that it will refund certain losses incurred by the CNB in connection with the CSOB indemnification based on the Indemnity Letter (hereinafter the “State Guarantee”). This guarantee covers only losses incurred by the CNB resulting from indemnification of CSOB’s losses arising from any unrecorded liabilities relating to IPB, which were not recorded in the IPB accounting records.

During 2001 the CNB granted two advances to CSOB relating to the Indemnity Letter totalling CZK 478 million. Both these advances relate to compensations paid by CSOB resulting from liabilities unrecorded in the IPB accounting records. In 2002 the CNB paid out further advance payments in the total amount of CZK 2,200 million and EUR 3 million. These advance payments are not provided for, since they are considered to be covered by the State Guarantee.

The amounts covered under the Indemnity Letter, advances paid to CSOB and the received State Guarantee can be analysed as follows:

	<u>31 December 2002</u> CZK'000	<u>31 December 2001</u> CZK'000	<u>31 December 2000</u> CZK'000
Potential claims under the Indemnity Letter	157,227	39,362	7,945
Advances paid to CSOB	<u>2,773</u>	<u>478</u>	<u>-</u>
Received State Guarantee	<u>160,000</u>	<u>39,840</u>	<u>7,945</u>

CSOB regularly lists and quantifies the other items under the Indemnity Letter, which may lead to a potential claim, although the final outcome of any potential claim currently cannot be exactly determined by the CNB. The maximum amount of the compensation resulting from the Obligatory declaration from CSOB, which the CNB obtained on 6 November 2002, is CZK 160,000 million. The right of CSOB for compensation from the Indemnity Letter will expire on 31 December 2016. The potential claims from the Indemnity Letter, decreased by the amount of the advances paid and also recoverable under the State Guarantee as at 31 December 2002 quantified by CSOB, was CZK 160,000 million (31 December 2001: CZK 39,840 million, 31 December 2000: CZK 7,945 million).

30 CONSOLIDATION OF THE BANKING SECTOR (continued)**Investiční a Poštovní banka, a.s. (continued)**

In case CSOB will ask the CNB to settle any claim under the Indemnity Letter, the CNB will make the related payment within five working days after the receipt of the CSOB request. The payment calendar related to the State Guarantee is as follows:

<u>Amount claimed by the CNB</u>	<u>Maturity</u>
Below or equal to CZK 2 billion	in the same calendar year
Greater than CZK 2 billion and less than or equal to CZK 5 billion	CZK 2 billion in the same calendar year; the rest in the following calendar year
Over CZK 5 billion	CZK 2 billion in the same calendar year; CZK 3 billion in the following calendar year; the rest in the third calendar year

31 RELATED PARTY TRANSACTIONS

Related party transactions, including transactions with the management and employees of the CNB arose under the same conditions and interest rates as for unrelated parties under the same terms. In the opinion of the management of the Bank, a common interest rate was used in all cases and the deposits do not have different liquidity risk or other unfavourable features.

Related parties include the CF. The objectives and basic activities of the CF are described in Note 30. Transactions were entered into with the CF when performing the Bank's role in stabilisation of the banking sector. Loans were provided on arm's length interest rate terms.

32 SUBSEQUENT EVENTS

The CNB's management is not aware of any subsequent events that would have a material impact on the financial statements.

CZECH NATIONAL BANK

**REPORT OF INDEPENDENT AUDITORS
AND FINANCIAL STATEMENTS**

YEAR ENDED 31 DECEMBER 2002