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2005 was undoubtedly one of the most successful years ever for the Czech economy. This positive assessment applies both to the rate of economic growth recorded and to the level of macroeconomic and price stability achieved.

A key fact from the monetary policy point of view is that inflation was successfully maintained at a low and stable level. The only marked deviation occurred in the autumn, due to higher prices of energy-producing raw materials, but even this did not fundamentally affect inflation. I can therefore say that in 2005 the CNB successfully achieved its objective of making a low-inflation environment a permanent feature of the Czech economy. Owing to the low inflation and the appreciating exchange rate of the Czech koruna, interest rates reached historical lows, even staying below the euro area level for a large part of the year.

A surprising and positive economic result was last year's high GDP growth, which according to figures from the Czech Statistical Office reached 6%. A particularly positive feature was that inflation was kept in check at the low level of around two per cent and price stability was maintained. The factors and structure of the growth can also be considered favourable. The faster growth was fostered above all by a very good foreign trade performance, despite continuing appreciation of the exchange rate, and by solid growth in investment activity. These provide a sound foundation for sustaining the desired growth rate going forward.

The positive trends seen in the banking sector in past years continued into 2005. Total assets rose by CZK 319 billion. Lending to households recorded particularly buoyant growth, but credit to the corporate sector also rose significantly. The positive developments are additionally illustrated by the banking sector's net profit of CZK 39.4 billion, a rise of CZK 6.6 billion compared to 2004. The sector's capital adequacy continued to comply with the required standards.

The structure of the banking sector remained broadly unchanged in 2005. Two foreign bank branches opened for business under the single licence principle effective in the Czech Republic since our accession to the EU, and another branch was created by conversion from a bank under the same system. A total of 24 banks (including 6 building societies) and 12 foreign bank branches were operating in the Czech Republic at the end of 2005.

The decision to integrate the regulatory and supervisory work on the financial market has far-reaching implications for the future organisation and performance of financial market regulation and supervision, not to mention the CNB's internal structure. Following amendments to the relevant legislation, financial market supervision was integrated and concentrated into the CNB on 1 April 2006. The central bank is responsible for preparing implementing regulations, e.g. decrees and methodological guidelines, while the Ministry of Finance is responsible for most of the laws covering the financial market area. This one-step integration has evident advantages over the originally planned two-step process. The shortening

and simplifying of the entire integration process will mean considerable cost savings in terms of technical, organisational and institutional implementation.

Even for the CNB, with its professional teams and high-quality infrastructure, the integration of financial market supervision represents a major new challenge. The integration of the previous "sectoral" supervisors is merely a necessary condition for greater efficiency and transparency. Our efforts to achieve the expected synergies are thus only beginning. The economies of scale and more efficient use of existing technical and human resources must be accompanied by standardisation of supervisory methods across the individual segments of the financial market, harmonisation of procedures and elimination of duplications and gaps. I am confident that we have what it takes to cope successfully with this challenge.

Last year was also associated with a search for internal reserves with the aim of streamlining the central bank's operations. Following a personnel audit and other cost savings during the year we succeeded in cutting the number of employees at the CNB's headquarters by ten per cent. Such a considerable reduction also required organisational changes and new procedures enabling the institution to maintain the same performance with a smaller workforce.

Three members of the Bank Board were replaced in February last year. In its new line-up the Bank Board continued implementing the existing responsible and open policy, a policy which results in the CNB being seen as a credible and transparent institution and which is vital to the performance of the central bank's duties in all the areas entrusted to it by law.



Zdeněk Tůma
Governor

The CNB's mission is defined in the Constitution of the Czech Republic and in the Act on the CNB.¹ The Act defines the CNB's primary objective as the maintenance of price stability. It also stipulates that without prejudice to this primary objective, the CNB shall support the general economic policies of the Government leading to sustainable economic growth. The CNB fulfils its mandate in accordance with the principles of an open market economy. In performing its tasks the CNB co-operates with other domestic institutions, foreign central banks, banking and financial market supervisory authorities in other countries and international institutions.

Price stability is defined by the inflation target. The CNB endeavours to hit the target by changing its monetary policy interest rates and using other monetary policy instruments and measures specified by the Bank Board.

The fulfilment of this mission – to maintain low and stable inflation – is the foundation of every credible and stable currency. However, a good currency is also characterised by reliable legal tender, smooth circulation thereof, and trouble-free operation of the payment system. Therefore, the CNB has the exclusive right to issue banknotes and coins and the obligation to manage the circulation of currency, the payment system and clearing between banks.

A currency's credibility depends heavily on the stability of the financial system, which derives from the reliability of its individual components and the functioning of its segments. These also determine its overall resilience to individual business failures and economic fluctuations. The CNB therefore engages in identifying weaknesses and threats to the stability of the financial system: as from 1 April 2006, it performs integrated financial market supervision in the Czech Republic, analyses information on the conduct of non-bank financial intermediaries, and assesses the economic situation, the economic outlook and the developments in financial markets also from the viewpoint of risks to the domestic financial system, examining their impact and extent (should they materialise). The CNB's mission also includes activities aimed at mitigating such risks. Besides regulatory activities vis-à-vis banks (or other entities carrying on banking business), which have the decisive weight in the domestic financial sector and financial intermediation, these include bolstering the financial infrastructure and the safety and soundness of domestic and cross-border payment and clearing systems. In exceptional cases, the CNB can support the liquidity of a banking institution by providing short-term collateralised credit.

Since the Czech Republic's accession to the European Union, the CNB has been part of the European System of Central Banks (ESCB). As a member of ESCB and other international organisations, it is obliged to participate in their activities and contribute to the improvement of European and international monetary systems.

¹ The Constitution of the Czech Republic of 16 December 1992, Constitutional Act No. 1/1993 Coll., as amended by Act No. 347/1997 Coll., Act No. 300/2000 Coll., Act No. 448/2001 Coll., Act No. 395/2001 Coll. and Act No. 515/2002 Coll. Act No. 6/1993 Coll., on the Czech National Bank, as amended by Act No. 60/1993 Coll., Act No. 15/1998 Coll., and Act No. 442/2000 Coll., the ruling of the Constitutional Court No. 278/2001 Coll., Act No. 482/2001 Coll., Act No. 127/2002 Coll., Act No. 257/2004 Coll. and Act No. 377/2005 Coll.

The CNB provides the public with information on facts, data and decisions related to its professional activities, and information whose disclosure is stipulated by law, using both traditional and electronic forms of communication. The CNB issues a number of periodical publications (quarterly Inflation Reports and annual Financial Stability Reports, Banking Supervision Reports and Annual Reports). All CNB publications are available in electronic form on the CNB website (www.cnb.cz), which is a key information channel of the central bank. The CNB also deals with written enquiries filed by individuals and legal entities relating to its activities.



Under the Act on the CNB, the CNB is obliged to submit periodical reports on monetary developments to the Chamber of Deputies (the lower house) of the Czech Parliament. These reports consist of Inflation Reports and, since 2004, also Financial Stability Reports. The reports are submitted by the CNB Governor, who participates in the debate in the Chamber of Deputies and responds to questions.

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

In addition, financial data can be found in the CNB's Annual Report, which also contains basic information on organisation, monetary developments and the bank's activities in other areas.

MANAGEMENT AND ORGANISATION



The CNB has a two-tier management system. The Bank Board makes fundamental decisions relating to monetary policy, the development of core activities and the management and institutional development of the bank. Responsibility for implementing the Bank Board's decisions and the day-to-day running of the bank is delegated to the executive directors of departments and branches.

THE BANK BOARD

The seven-member Bank Board is the supreme governing body of the CNB and consists of seven members: the Governor (who chairs the Board), two Vice-Governors and four Chief Executive Directors. It decides as a collective body by a simple majority of the votes cast. On 11 February 2005, following the expiration of the six-year terms of office of four Bank Board members, the President of the Czech Republic appointed Governor Zdeněk Tůma, Vice-Governor Miroslav Singer and Chief Executive Directors Robert Holman and Pavel Řežábek as Bank Board members.



The Board sets monetary policy and the instruments for implementing this policy and decides on the fundamental monetary policy measures and transactions of the CNB. It approves key measures arising from the supervision of the banking sector and rules on appeals in administrative proceedings. It sets the CNB's overall development strategy, decides on the bank's organisational structure, and appoints and dismisses senior officers of the CNB. The Bank Board also approves the CNB's budget and budgetary rules, and defines the types, amounts and uses of the CNB's funds.

SENIOR MANAGEMENT

The executive directors of the CNB's departments and branches are responsible – subject to the CNB's overall strategy, the approved Medium-term Plan for 2005–2010 and annual work programmes – for effective performance of the tasks falling within their areas of competence as set out in the Organisational Statute. Their competencies and responsibilities include in particular: methodological and management activities and preparing proposals and solutions to issues of fundamental significance and presenting them at Bank Board meetings. They carry out the decisions adopted by the Bank Board and set targets for the staff under them. The executive directors also perform the employer's rights and duties under labour law in respect of employees. They propose appointments and dismissals of senior employees in their areas of competence. They are responsible for co-ordinating with other organisational units of the bank and with domestic and foreign partner institutions.

HEADQUARTERS

The CNB's organisational structure consists of a headquarters in Prague and regional branches. The fundamental organisational units of its headquarters are departments, which are responsible for methodological management in specific areas defined by the Organisational Statute. The bank's main activities, branch management, and ancillary and service activities are concentrated at headquarters. Co-ordination of activities, which in many cases covers the areas of competence of several departments and depends on close co-operation between them, is provided for by standing advisory bodies, committees and project teams.

In 2005 the Bank Board decided to make some changes. Following the replacement of three Board members the Board decided on a new division of responsibilities among the Board members and entrusted them with overseeing the CNB's core activities within the areas of competence of the individual departments and branches of the CNB. Organisational changes were made in the communications area. The Communications Division was taken out of the General Secretariat to form an independent Communications Department overseen directly by a Vice-Governor of the CNB.

A change in the organisational structure of the Banking Regulation and Supervision Department resulted in a reduction in the number of divisions from seven to five. Their activities were revised and the names of the new divisions were specified. Responsibility for drafting statements of intent for the Act on Banks, managing administration procedures and for the department's legal issues was assigned to the Licensing and Enforcement Division. It is now also responsible for activities associated with the single licence system and for the preparation of opinions on draft legislation in the area of the financial market and supervision of financial market participants. Activities relating to the setting of the content and deadlines for submitting statements, information and technical support data for supervisory needs have been concentrated in the Supervisory Support Division.

The responsibilities of some units were revised and made more specific; for example the responsibilities of the Financial Analyses and Financial Accounts Statistics Division of the Monetary and Statistics Department were extended to include issues relating to the quarterly financial accounts and government finance statistics. The Budget and Accounting Department is now responsible for the enforcement and collection of fines imposed by the Financial Arbiter. Act No. 412/2005 Coll., on Protection of Classified Information and Security Competence imposes some new obligations on the CNB. On 1 January 2006 these obligations were added to the fields of competence of the Crisis Management and Classified Information Protection Department.

Following the personnel audit performed in 2005, responsibility for preparing, editing, printing and publishing the CNB Gazette and CNB Bulletin was transferred to the General Secretariat, the Administration Department and the Communications Department. The Internal Audit and Control Department was renamed the Internal Audit Department and its control function was replaced by the testing of selected activities and operations within the organisational units.

BRANCHES

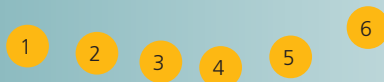
The CNB's branches represent the bank in the regions and are its contact points for relations with bank representatives, state and local authorities, financial authorities, the Czech Statistical Office, selected clients and other legal and natural persons. The CNB's branches are responsible mainly for managing money reserves, maintaining accounts of the Treasury and other CNB clients, making cash and non-cash payments, conducting the accounting of the branch and operating safe deposit boxes. In a specified scope the branches also conduct administrative proceedings, perform foreign exchange supervision, inspections of anti-money laundering measures and crisis management work within their fields of competence, and collect and process data on exchange office operations and regional data for business surveys.

**The Bank Board**

1. Luděk Niedermayer, 2. Jan Frait, 3. Pavel Řežábek, 4. Zdeněk Tůma,
5. Michaela Erbenová, 6. Robert Holman, 7. Miroslav Singer

**Executive Directors of Departments**

1. Jan Hampl, 2. Ota Kaftan, 3. Zdeněk Virius, 4. Jana Báčová,
5. Tomáš Kvapil, 6. Marian Mayer, 7. Pavlína Bolfová, 8. Tomáš Holub

**Executive Directors of Departments**

1. Vladimír Kolman, 2. Tomáš Hládek, 3. Kateřina Šmídková,
4. Jan Schmidt, 5. Miloš Hrdý, 6. Leoš Pýtr

**Executive Directors of Branches**

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

ORGANISATIONAL CHART



THE CNB'S OBJECTIVES AND TASKS AND THEIR FULFILMENT

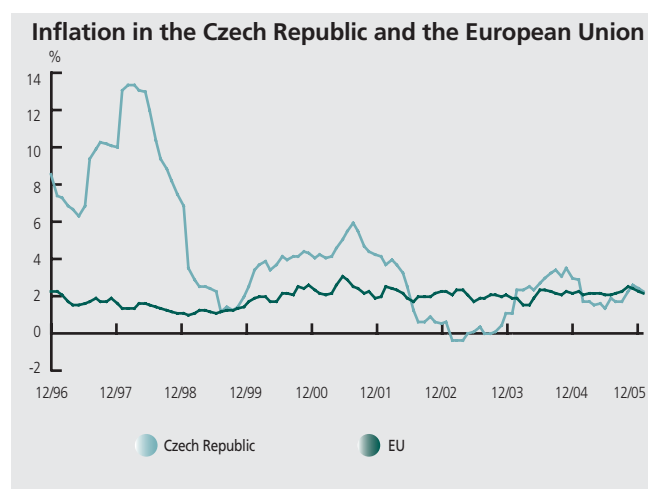
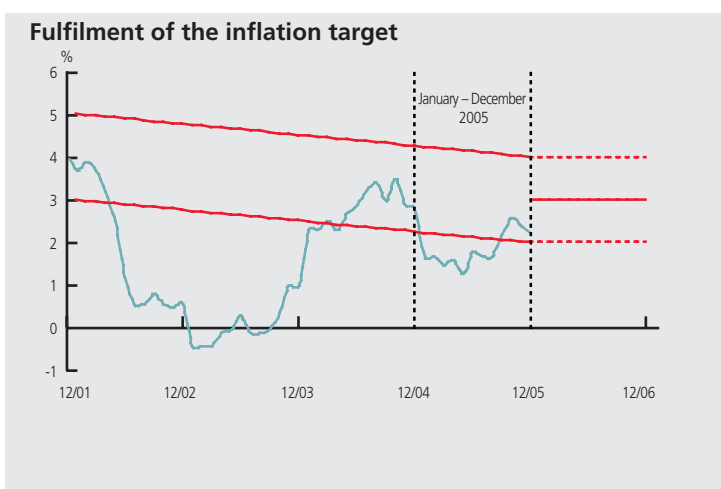


In its strategic document *Challenges for the Czech National Bank in 2005–2010*, the CNB published the main subject areas that will be crucial for successful fulfilment of its mission in the years ahead. *The Czech National Bank's Medium-term Plan for 2005–2010*, approved by the Bank Board at the end of 2004, builds on this document by specifying the key areas, processes and methods in detail (see www.cnb.cz: *About the CNB – Mission and functions*). The CNB's main objectives for 2005–2010 include the following:

- To stabilise inflation at the low level defined by the inflation target (3%). To clarify monetary policy strategy in the run-up to the adoption of the euro and particularly during the Czech Republic's stay in ERM II. To monitor the experience of countries that have gone through this process.
- To work closely with the Government to lay the groundwork for smooth adoption of the euro and stable development of the Czech economy within the European Monetary Union.
- To improve the use of forecasting and analytical instruments and to gradually adopt the ECB's instruments in the global economy area.
- To study the possibility of using new investment instruments in the area of international reserves management. To develop the co-operation between the CNB and the Ministry of Finance in relation to debt management – to co-ordinate all activities, exchange information and draw on the CNB's expertise.
- To develop reporting (including reporting to the ECB) and to improve risk management methods.
- To deliver relevant, high-quality and transparent economic research (for the 2007–2012 priorities, see *CNB Economic Research 2007–2012*).
- To expand, intensify and integrate the analysis of the various aspects of financial stability in the Czech economy and to analyse the possible effect of external factors and risks on the stability of the financial sector and its individual segments.
- To perform supervision of the Czech financial market following its integration into the CNB. To harmonise standards and procedures with foreign and domestic regulators. To prepare changes to the primary and secondary legislation and to revise and create new methodological procedures taking EU requirements into account.
- To prepare comprehensively for the introduction of the single European currency, including putting euro cash into circulation and connecting the domestic payment and settlement system to EU systems.
- To harmonise with EU standards in the introduction of new statistics and the revision of existing statistics. To improve data availability and quality through more intensive communication with users.
- To develop human capital so as to make the CNB an open institution capable of adapting to new requirements, with a corporate culture based on professionalism, transparency and efficiency.
- To safeguard the operations of the central bank by means of information and communication technology enabling smooth operation and safe and reliable connection to external systems, while emphasising effectiveness and efficiency of investment.
- To identify future changes in the CNB's activities, determine their impacts and ensure timely institutional adjustment of the CNB to the conditions for joining the Eurosystem.
- To ensure a high level of information openness. One of the key tasks in this area will be to draw up a communication strategy for the introduction of the euro, which will require close co-operation particularly with the Ministry of Finance, the Government, Parliament and other ministries and institutions.
- To optimise the financial management system and further rationalise expenditure (costs). To undertake changes in financial accounting and reporting arising from the Maastricht Treaty.
- To test and continuously update the CNB's Crisis Plan. To launch the CNB's back-up facility and incorporate it into the Crisis Plan.
- To enhance the internal audit function's ability to provide the CNB's managers with independent and objective feedback on the CNB's activities.

MONETARY POLICY AND ECONOMIC DEVELOPMENTS

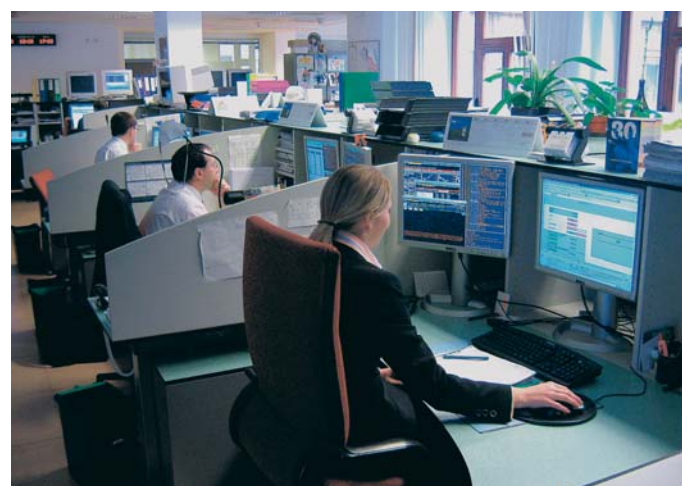
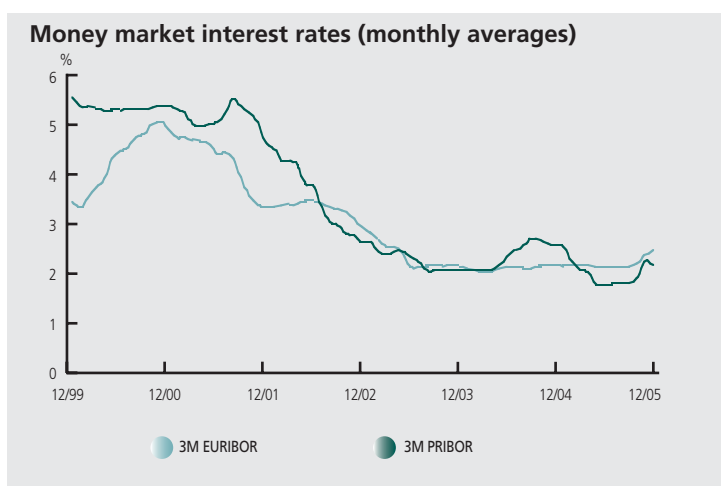
The CNB's primary monetary policy objective is expressed as an inflation target, i.e. the level at which the CNB tries to keep inflation in the period in question. The inflation target for 2002–2005 was set in the form of a continuous band descending evenly from 5%–3% in January 2002 to 4%–2% in December 2005. In March 2004 a new inflation target of 3% was set for the period ahead. This target will apply from the beginning of 2006 until the Czech Republic's accession to the euro area (see www.cnb.cz: *Monetary policy* for details).



Inflation in 2005 was lower than in the previous year. It was below the lower boundary of the target band in the first eight months of the year and fluctuated in the lower half of the band in the remainder of 2005.

Annual consumer price inflation declined by more than one percentage point at the start of 2005 compared to the end of 2004. For the first time in twelve months inflation thus returned below the 2% level (reaching a low of 1.3% in May) and stayed below it until August. In the remaining months it increased, peaking at 2.6% in October. In the first three months of 2005, consumer price inflation was below the inflation level in the EU countries, and in the final quarter it was only slightly higher.

Domestic interest rates (as represented in the chart by 3-month interest rates) showed a broadly similar pattern. With the exception of the first two months of the year, they were lower than the EURIBOR interest rates with the same maturity.

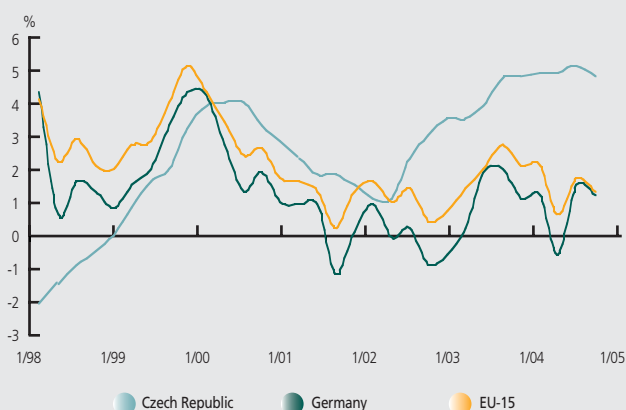


The considerable slowdown in consumer price inflation in 2005 was mainly due to food prices, which were falling or only very slightly rising year on year, in line with agricultural producer prices. Relatively slow growth in adjusted inflation excluding fuels – reflecting the evolution of agricultural producer prices and import prices (which were affected, in turn, by appreciation of the koruna's exchange rate against the euro and the favourable evolution of prices of most commodities except energy-producing materials) – had a smaller effect. The lower inflation was also fostered in part by smaller changes to indirect taxes than in the previous year (in essence only an increase in excise duties on cigarettes, which, moreover, had a lagged and as yet only small effect). Regulated prices (increases in telecommunication services prices, natural gas prices and television and radio licence fees) and fuel prices (affected by the high and, for most of the year, rising prices of energy-producing materials on world markets) had the opposite effect. The output gap (the gap between actual and non-inflationary output) was negative throughout the year, hence the demand-pull inflationary pressures remained subdued.

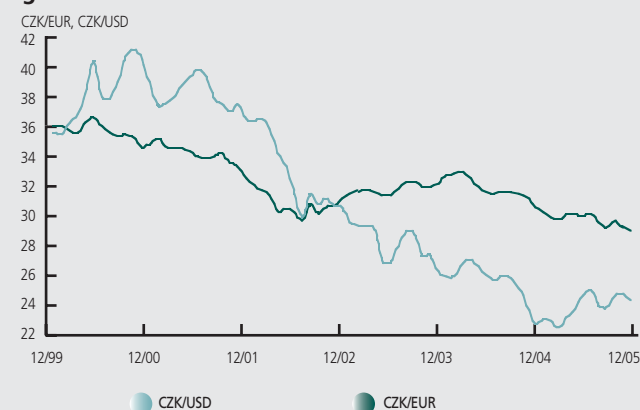
Inflation in 2005 was lower than indicated by the inflation forecasts for this period prepared in 2003 H2 and during 2004. This difference was particularly visible in the first eight forecasted months and was most marked against the April 2004 forecast. The forecasts were not fulfilled mainly because of lower-than-expected growth in adjusted inflation excluding fuels, reflecting slower closure of the output gap (resulting from a combination of lower external demand, a smaller fiscal impulse and tighter monetary conditions compared to the April 2004 forecast) and the stronger exchange rate of the koruna. The non-fulfilment of the forecasts was also due to lower-than-expected food prices, reflecting agricultural producer price inflation. The forecasts in 2004 H2 were also affected by the postponement of changes to indirect taxes and subsequently by slower pass-through of those changes into prices.

The rate of growth of the Czech economy in 2005 was roughly the same as in 2004 H2 (around 5%). As in the previous four years or so, it was higher than in Germany and the "old" EU countries. The growth was driven primarily by the external sector, or more precisely by a continuing sizeable lead of growth in goods and services exports over imports. The effect of investment, which had been dominant in the previous year, and of household and government consumption was considerably lower, especially in H1.

Gross domestic product



Nominal exchange rate of the koruna against the euro and dollar



The nominal exchange rate of the koruna against the euro appreciated during 2005, despite the fact that domestic interest rates were lower than euro area rates for most of the year. The stronger koruna-euro rate reduced the prices of most imported commodities, thereby contributing to the low inflation level. The koruna's nominal exchange rate against the dollar for the most part depreciated, as a result of the appreciating exchange rate of the dollar against the euro for most of the year. The effect of the high prices of energy-producing materials on world markets was therefore not alleviated by the dollar exchange rate. As in the previous year, no interventions were made in the foreign exchange market.

Neither the stronger exchange rate of the koruna against the euro year on year, nor the other adverse factors in 2005 (sluggish external demand growth, one-off imports of military equipment, considerable growth in oil and natural gas prices, year-on-year deterioration of the terms of trade) stopped the trend of an improving trade balance observed the previous year. The balance of trade showed a surplus (of CZK 41.9 billion) for the first time in the Czech Republic's history. The main effect of the favourable balance of trade was a decrease in the current account deficit, which declined by almost half compared to the previous year despite a growing outflow of earnings paid abroad (chiefly in the form of dividends). Compared to the previous year, the financial account surplus was roughly one quarter lower, even though the direct investment surplus was the second highest in Czech history. The reason was a change in trend for portfolio and other investment, which, unlike in the previous year, recorded an overall outflow from the Czech Republic.

The inflation forecasts in 2005 (for 2006–2007 H1) initially suggested that interest rates would have to come down to keep inflation near the target. Underlying this prediction was a lowering of the estimate for import price inflation and expected slower closure of the output gap, reflecting a downward revision of external demand growth, tighter monetary conditions and slower easing of the demand-led anti-inflationary pressures observed in the past. This resulted in interest rates being lowered in three steps by a total of 0.75 percentage point to 1.75% during 2005 H1 (in early January and early and late April).

The July forecast envisaged no further reduction in interest rates; on the contrary, it indicated a modest increase in rates at the longer horizon. The change in view regarding interest rates going forward was confirmed by the October forecast, which signalled a need for a gradual rise in rates, despite the fact that the expected closure of the output gap had again moved to a later date. The main reason was an upward revision to the impact of external cost factors on domestic inflation and to the contribution of regulated prices. In line with the October forecast, the Bank Board decided at its monetary meeting at the end of October to raise interest rates by 0.25 percentage point to 2%.

More detailed information on economic developments and monetary policy management can be found in the regular quarterly Inflation Reports available in the *Publications* section of the CNB website.

A document drawn up jointly by the CNB, the Ministry of Finance and the Ministry of Industry and Trade entitled *Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Alignment of the Czech Economy with the Euro Area*, which analysed the current and expected situation in that area, was completed in the autumn of 2005 and approved by the Government on 23 November. Based on these analyses, the document recommended that the Czech Government should not attempt to enter the ERM II during 2006. As part of the preparations for this document the CNB wrote and published a document entitled *Analyses of the Czech Republic's Current Economic Alignment with the Euro Area* (for details see www.cnb.cz: Monetary policy).

THE BANKING SECTOR AND ITS REGULATION

The Czech banking sector did not undergo any fundamental changes in 2005. In terms of the number of banks and their ownership, the sector has been stable in structure for several years now. More than 96% of the sector's total assets are directly or indirectly controlled by foreign banks.

Two banks were merged and one converted into a branch operating under the single licence regime during 2005. The single licence principle enables banks from EU countries to carry on business for which they have a licence from their home country within the territory of another EU Member State without having to apply for consent in the host country. This means that any European bank can easily expand into other EU countries, either by establishing a branch, or by cross-border provision of services. In 2005, two foreign bank branches opened for business in the Czech Republic under

the single licence principle. This meant that 24 banks (including 6 building societies) and 12 foreign bank branches were operating in the Czech Republic as of December of 2005. In addition, the CNB in 2005 received notifications from further 45 institutions from EU Member States on their intention to operate in the Czech Republic through cross-border provision of services. Of this number, 43 were banks, 1 was a financial institution and 1 was an institution authorised to issue electronic money instruments (taking the total number of such institutions to 108 as of 31 December 2005). Provision of cross-border banking services is not subject to any reporting duty to the CNB, although it is not permitted to have the character of permanent economic activity.

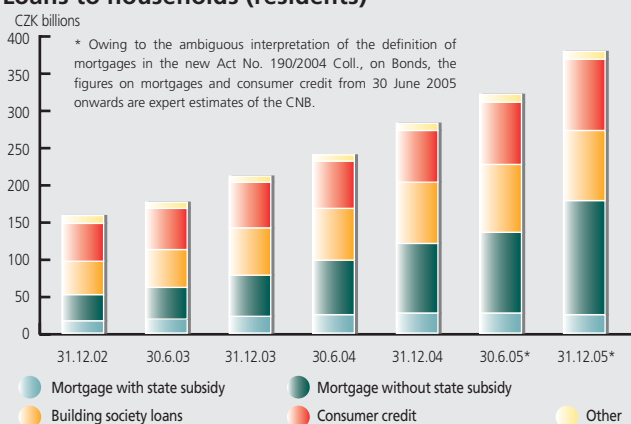
In 2005, the total assets of the banking sector rose by CZK 319 billion to CZK 2,955 billion.² The continuing growth in lending, above all to households, was particularly significant. Loans to households showed annual growth of almost 34%. Loans to corporations rose by 14.3%.

Sectoral breakdown of claims (CZK billions)

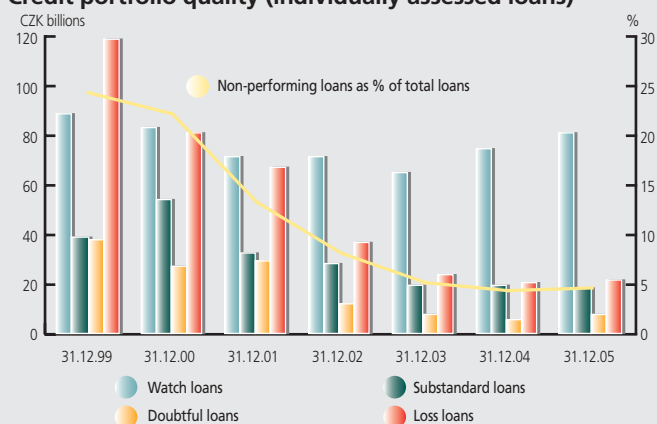
	31 Dec. 2003	31 Dec. 2004	31 Dec. 2005
Residents and non-residents, total	951	1,010	1,186
Residents	907	969	1,119
Non-financial corporations	428	460	525
Financial corporations	83	81	97
General government	159	115	81
Households	236	312	413
Households - trades	25	29	33
Households - individuals	211	283	380
Non-profit institutions serving households	2	2	2
Non-residents	43	41	67

Alongside the growth in the loan portfolio, the volume of non-performing loans (i.e. loans classified by banks as substandard, doubtful or loss) rose by CZK 2.2 billion to CZK 46.7 billion in 2005. However, their share of the total volume of loans remains low, at 4.3% as of 31 December.

Loans to households (residents)



Credit portfolio quality (individually assessed loans)



Client deposits continued to grow, increasing by almost 11% year on year to CZK 1,919 billion in 2005. Growth was recorded both by demand deposits (an annual increase of CZK 116 billion, or 13.7%) and by time deposits (CZK 71.6 billion, or 8.1%).

The capital adequacy of the banking sector continues to be sufficient to cover the risks undertaken. The regulatory capital used to calculate capital adequacy increased by CZK 20.5 billion to CZK 167 billion overall in 2005, mainly as a result of an increase in retained earnings. However, there was an increase in the volume of risk-

² The figures for the banking sector are based on unaudited results of banks as of 31 December 2005.

weighted assets and capital charges, connected with the growth in loans provided, which resulted in the capital ratio falling from 12.6% to 11.9% year on year. All banks constantly exceeded the minimum capital adequacy requirement of 8%.

The banking sector recorded net profit of CZK 39.4 billion in 2005, up by CZK 6.6 billion on 2004. The profit was positively affected by some extraordinary revenues of several banks, linked mainly with the restructuring of their financial groups, the resolution of a number of long-running legal disputes and the completion of obligatory releasing of reserves for standard loans. Interest profit rose by CZK 4.3 billion to CZK 64 billion, while profit from fees and commissions increased by CZK 0.5 billion to CZK 31.8 billion. Administrative expenses increased by CZK 2.8 billion to CZK 51.6 billion and write-offs and creation of provisions rose by the same amount, reaching CZK 13.1 billion in 2005.

A total of 37,540 people were employed in the banking sector as of 31 December 2005, a decline of 618 from the end of 2004.

What's new in regulation

The Act on Banks underwent some minor changes connected with the adoption of the Act on Financial Conglomerates during 2005. This amendment to the Act on Banks essentially introduced some definitional revisions ensuing from relevant Community law regulations. It introduced a requirement to prove the trustworthiness and experience of natural persons in the management of a financial holding entity that controls a bank. Under the Act, the CNB issued Decree No. 14/2006 Coll., governing the supporting documents proving the trustworthiness and experience of such persons.

The Act on Financial Conglomerates itself introduces a new level of supervision of regulated entities in the financial sector, namely "supplementary supervision" of national and international groups which in terms of the activities they carry on are relatively heterogeneous, i.e. they have significant positions both in the insurance industry and in banking and investment services (financial conglomerates). Responsibility for supplementary supervision of such groups will fall to a co-ordinator, which in principle is the authority that performs supervision of the most significant regulated entity in the group. Supplementary supervision will commence on 30 September 2006, when the act becomes fully effective and when an implementing decree will have been issued for it.

From the point of view of banks and other financial institutions and their regulators, the Act on Financial Conglomerates was also significant because it transposed the directives on the reorganisation and winding-up of credit institutions and insurance undertakings and in particular the directive on financial collateral arrangements into Czech law (the Bankruptcy and Composition Act, the Commercial Code, the Act on International Civil Law and Civil Procedure and a number of other acts). It is thus legislatively ensured that the effects of financial collateral arrangements and close-out netting cannot be affected by an adjudication of bankruptcy or similar measure in respect of one of the contracting parties, something that financial market participants had been calling for for years.

Major changes to the Act on Banks and the related subordinate regulations are expected at the end of 2006 in connection with the adoption of the new capital framework (see later).

Development of the Central Register of Credits

The Central Register of Credits has been reliably mediating the exchange of client information between banks since it opened in November 2002. Phase 2 of the development of the Central Register of Credits, which will give bank users and selected CNB employees a closer analytical view of the aggregated data collected in this database, was implemented by agreement with the banks in 2005. In Phase 2, preparations will also be made for bank users to be able to enter groups of connected clients and to acquire aggregated data on the credit exposures of such groups. Simultaneously with

the development of the new services, additional information was added to the outputs on clients' credit exposures, including information on the quality of claims.

Co-operation between the Czech National Bank, the Ministry of Finance and the Czech Securities Commission

The co-operation between the CNB, the Ministry of Finance and the Czech Securities Commission, based on a trilateral memorandum of understanding signed in February 2003, continued in 2005. Regular meetings took place of working groups for individual consolidated groups whose members were subject to supervision by the Ministry of Finance or the Securities Commission in addition to the CNB. The Committee on the Co-ordination of Financial Market Supervision, which co-ordinates co-operation between these three institutions, met three times in 2005. Besides the exchange of information and standpoints on topical issues (e.g. implementation of Basel II in the banking sector and the Solvency II directive for insurance companies), the Committee dealt in particular with the integration of financial market supervision. In mid-2005, the plan to integrate supervision was changed in favour of faster integration and merger of all the supervisory authorities into the CNB. The Committee discussed the progress achieved in the discussions on changes to the competency laws and related sector laws. The law integrating financial market supervision into the CNB was approved by Parliament and signed by the President of the Czech Republic at the beginning of 2006. At the same time, practical integration measures were launched (relocation into a single premises, interconnection of information systems, etc.) so that the single financial market supervisory authority in the Czech Republic could start operating at the CNB on 1 April 2006.

Introduction of the new capital framework

In November 2005, the Basel Committee on Banking Supervision published an updated version of the new capital framework, often referred to as Basel II. Given the Czech Republic's membership of the EU, Basel II – in the form resulting from its transformation into Community law, i.e. the relevant directives – is and will continue to be crucial for the Czech Republic. These directives were approved by the European Parliament and the EU Council in autumn 2005, although they are not expected to be published in the EU Official Journal until mid-2006 and should then take effect in 2007. In the Czech Republic, therefore, the CNB's bilateral co-operation with individual banks on the implementation of the new capital framework intensified. Co-operation also continued within the joint trilateral project of the CNB, the Czech Banking Association and the Chamber of Auditors of the Czech Republic. This project entered the legislative phase, which focused on incorporating the Basel II framework into Czech law. The CNB prepared a draft amendment to the Act on Banks and the draft structure and wording of a related CNB decree and introduced them to the banking community in a series of presentations at the end of 2005. The CNB also worked closely with the Ministry of Finance in preparing other legal rules implementing Basel II, namely an amendment to the Credit Unions Act and an amendment to the Capital Market Undertakings Act. CNB Banking Supervision also held face-to-face meetings with selected foreign supervisory authorities on the implementation of the new framework and the related division of labour between home and host supervisors with regard to individual consolidated groups. The CNB is also involved in the relevant committees and working groups operating within European structures (see below). The CNB's progress with, and approach to, implementing the new capital framework is published and regularly updated in the *Banking Supervision* section of the CNB website.

International co-operation

The bilateral co-operation of banking supervision representatives with partner banking supervisory institutions and co-operation within international, and especially European, structures was stepped up in 2005. This was due in particular to the need to work closely with home supervisory authorities in preparing the implementation of the new capital adequacy rules and greater involvement in the working groups of the Committee

of European Banking Supervisors (CEBS) and the European Central Bank (ECB). Under the new conditions, the CNB is in most cases in the position of host authority, which is why it strongly supports uniform interpretation of rules and co-ordination of procedures. Around one-third of the CNB's supervisory staff are currently involved, either actively or passively, in the work of 20 committees and working groups of the European Commission, the ECB and the Bank for International Settlements (BIS).

Inspection activities in 2005 in figures

- 12 on-site inspections were carried out in banks; 6 were comprehensive inspections and 6 partial inspections directed at selected areas of risk management. 2 information-gathering visits were made in order to acquire additional data.
- 13 remedial measures were imposed to eliminate shortcomings.
- 14 administrative decisions were issued in the area of licensing and authorisation, relating to banks' applications for the extension of licences, consents to acquire qualifying holdings in banks, prior approvals for mergers, plans to establish a branch in an EU Member State, etc.
- In 2005, CNB Banking Supervision conducted no penalty proceedings directed at revoking licences or imposing fines for violations of the Act on Banks.
- 106 decisions were issued relating to the approval of external auditors, shareholder structures prior to general meetings, the inclusion of subordinated debt in a bank's capital, etc.
- 16 opinions on nominees for managerial posts were issued.

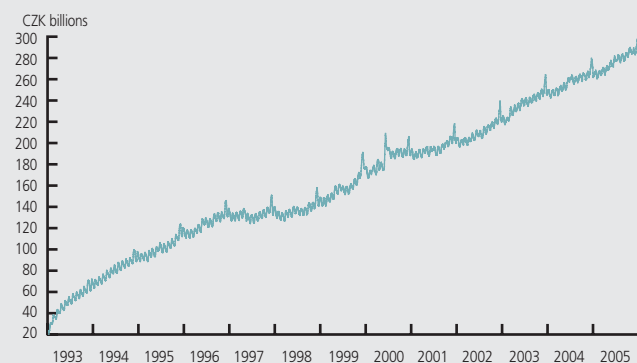
Detailed information on developments in the banking sector and supervisory activities is published in the CNB's annual Banking Supervision publications, which, together with other analytical publications, including the latest banking sector indicators, are available on the CNB website.

CURRENCY IN CIRCULATION AND THE PAYMENT SYSTEM

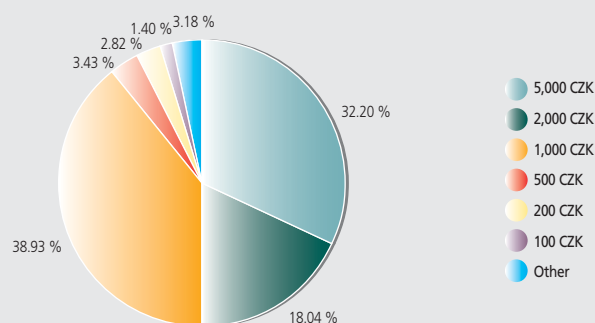
Currency in circulation

The volume of money in circulation increased by CZK 24.4 billion during 2005, reaching CZK 287.8 billion at the end of the year. This represents a rise of 9.3% compared to the end of 2004, the largest increase in currency in circulation in five years. Growth in the amount of money in circulation is, with greater or lesser intensity, a constant feature of the Czech economy; the long-term average annual increase is around CZK 17 billion.

**Currency in circulation in the Czech Republic
8 Feb. 1993–31 Dec. 2005**



Structure of currency in circulation (in CZK)



The number of banknotes in circulation is rising more slowly than currency in circulation in koruna terms. This is due to favourable changes in the structure of

banknotes in circulation; the highest-denomination banknotes account for more than 95% of the growth in currency in circulation.

Although more than 2.5 million ten-heller and twenty-heller coins were withdrawn from circulation, the number of coins in circulation rose by more than 93 million. Fifty-heller coins, which increased by more than 37 million, accounted for the largest share.

The growth in money in circulation is being accompanied by an increase in the volumes of banknotes and coins accepted from circulation and processed by the CNB's branches. More than 746 million banknotes and 452 million coins accepted from circulation – i.e. around 6,000 tonnes of banknotes and coins – passed through the hands of cashiers, sorting machine operators and money stock custodians during 2005. The same growth trend is certainly not visible in the case of money issuance. Issuance of banknotes is increasing but issuance of coins has decreased, mainly because the ten-heller and twenty-heller coins are no longer legal tender. This factor also strongly affected the number of coins accepted in 2003 and 2004.



The CNB issued four silver 200 Kč commemorative coins in 2005: to mark the 100th anniversary of the births of actors Jan Werich and Jiří Voskovec, the 100th anniversary of the production of the first car at Mladá Boleslav, the 200th anniversary of the Battle of Austerlitz and the 450th anniversary of the birth of poet and politician Mikuláš Dačický of Heslov. The last two gold 2000 Kč coins were issued from the cycle Ten Centuries of Architecture: the cubist spa building in Bohdaneč (in April) and the contemporary Dancing House in Prague (in September).



In 2005, training programmes were held for sellers of foreign currency, who, under CNB Decree No. 434/2002 Coll. (implementing Article 9(3) of Act No. 219/1995 Coll., the Foreign Exchange Act), are required to submit a certificate demonstrating that they have completed a course on counterfeit recognition. More than 1,400 people attended these courses.

The quantity of counterfeit Czech and foreign currency seized in the Czech Republic was similar to that in previous years. The denomination structure of the counterfeits seized and the ratio of counterfeits seized from circulation and by the police from counterfeiters and distributors prior to circulation saw only minor changes compared to 2004.

Counterfeit and altered banknotes and coins seized from circulation and by the police in 2005

	From circulation	Seized By the police	Total
Counterfeit CZK banknotes	3,243	1,756	4,999
Counterfeit EUR banknotes	739	271	1,010
Counterfeit USD banknotes	648	323	971
Other counterfeit banknotes	177	1	178
Counterfeit CZK coins	213	2	215
Other counterfeit coins	64	0	64
Altered CZK banknotes and coins	1,530	325	1,855
Other altered banknotes and coins	3	0	3
Total	6,617	2,678	9,295

The payment system

The legislative process for the amendment to Act No. 124/2002 Coll., on Transfers of Funds, Electronic Payment Instruments and Payment Systems (the Payment System Act) continued in 2005. In line with European law, the amendment should above all introduce electronic money institutions into Czech law. The conditions under which the CNB grants prior consent to issue electronic money instruments to entities other than banks have also been simplified and clarified. In 2005, the CNB again conducted a number of administrative proceedings on the issuing of electronic money instruments, within which 19 prior consents were granted, particularly in the bus transport area.

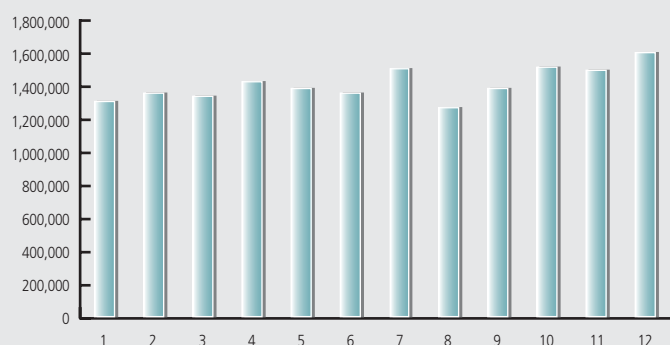
In September 2005, Act No. 377/2005 Coll., on Financial Conglomerates, took effect. This simultaneously amended several dozen other acts. Under an amendment to Act No. 6/1993 Coll., on the Czech National Bank, credit unions may now participate in the interbank payment system operated by the CNB. The scope of a CNB decree issued to provide for a single payment and settlement system in the Czech Republic (currently Decree No. 62/2004 Coll.) was also extended to credit unions under this amendment.

In 2005, the CNB worked in partnership with the Financial Arbiter on preparing a second amendment to the Act on the Financial Arbiter. The amendment reacts to the adoption of new administrative procedure rules and eliminates their negative effects on the principles of informality, speed and flexibility of proceedings brought before the Arbiter. It also incorporates into the Act the experience gained from the Arbiter's work.

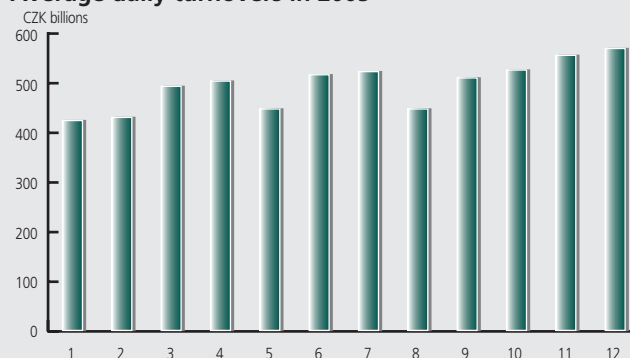
Under the Act on the Czech National Bank, the Act on Banks and the Payment System Act, the CNB operates the Czech Express Real Time Interbank Gross Settlement System (CERTIS). This system processes all domestic interbank transfers in Czech koruna, checking in real time whether banks have sufficient coverage for such transfers. Processing of the data sent electronically by banks is fully automated. Banks have an information system at their disposal to monitor settlement in real-time. 2005 saw the launch of a CERTIS 2 project, whose main objective is to transfer the core of the existing system to a new platform while maintaining its current functionality.

The CNB by law administers and operates the Short-Term Bond System (SKD). This system is used for issuing and registering all book-entry securities with maturities of up to one year, and for settling trades in these securities. SKD registers primarily T-bills and CNB bills. The system enables the execution of sales of securities, repos and sell and buy operations, as well as pledges and exchanges of securities. It allows automated provision and repayment of the intraday credit extended to banks by the CNB within CERTIS at any time during the accounting day.

Average daily number of transactions in 2005

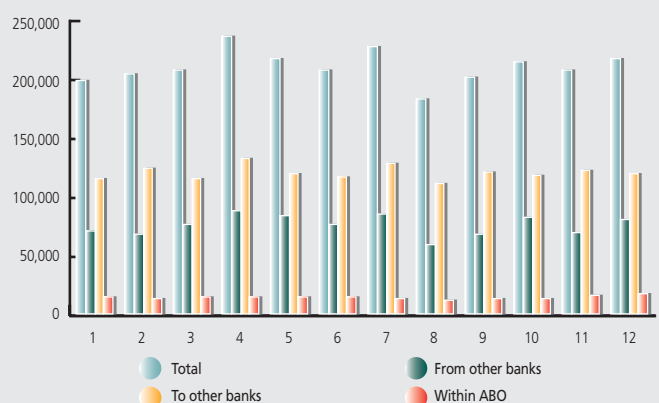


Average daily turnovers in 2005

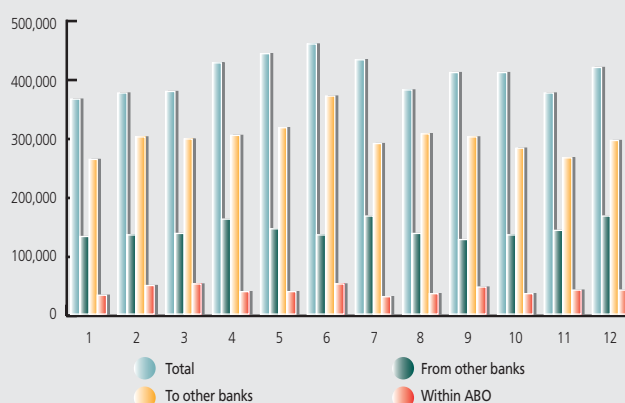


The SKD Rules were fundamentally revised in 2005. The new version takes into account the changes made to SKD, which have extended its functionality, made it more user-friendly and enhanced its security. The Rules also reflect changes in the legislation regulating the securities area (the Act on Capital Market Undertakings and the Act on Securities) which entered into force on the Czech Republic's accession to the EU. The biggest change was the creation of the function of custodian in SKD. Custodians maintain customer accounts within the legally permitted two-tier registration of securities.

ABO - Daily average number of items-2005



ABO - Maximum daily number of items-2005



The CNB is responsible by law for maintaining and administering the accounts of state organisational units 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. Using data obtained from the ABO system, the CNB provides the Ministry of Finance with inputs for the national accounts and manages the Treasury's daily liquidity for the Ministry of Finance. In 2005, work continued on a new project intended to simplify and automate the existing procedures, increase

settlement speed and enhance security. Work is continuing on the development of an Internet gateway for direct e-banking for CNB clients, and new functions for creating instruments to monitor and manage Treasury liquidity are being prepared.

The legal framework for the relationships between the CNB and the Ministry of Finance in providing payment services to the Treasury is laid down in an agreement signed between the two institutions in accordance with the Act on Budgetary Rules. Other CNB activities carried out for the Treasury are covered by specific agreements with the Ministry of Finance.

In 2005, CNB representatives continued to attend on a regular basis the meetings of EU bodies dealing with payment systems, particularly within the European Commission and the European Central Bank. Key topics included the preparation of a new directive on payment services in the internal market (the New Legal Framework), the adoption of a directive on prevention of the use of the financial system for the purpose of money laundering and financing terrorism, the preparation of a regulation on information about the payer accompanying transfers of funds, the development of the European TARGET payment system (the TARGET 2 project) and the revision of securities settlement system standards by the European Central Bank together with the Committee of European Securities Regulators (CESR).

In preparing both national and European legislation, the CNB works at expert level mainly with the Czech Banking Association, the Association of Mobile Network Operators and the Bank Card Association and makes use of their experience in these areas.

PREPARATIONS FOR INTRODUCING THE EURO IN THE CZECH REPUBLIC

Although the Czech Republic has yet to fix a date for introducing the euro (the expected date is 1 January 2010), preparations for this complex operation, which will affect all areas of the economy, need to begin. On the basis of a joint document of the CNB and the Ministry of Finance entitled *Institutional Provision for the Introduction of the Euro in the Czech Republic*, approved by the Government in November 2005, a National Co-ordination Group has been established for the introduction of the euro. This Group has been tasked with drawing up the first version of the National Plan for the Introduction of the Euro in the Czech Republic, which is planned to be submitted to the Government of the Czech Republic by the end of 2006. In addition to the challenging job of managing monetary policy in the run-up to joining the euro area, the main tasks of the central bank in the switch to the single currency will include introducing euro-denominated banknotes and coins, adjusting payment systems and the financial sector, and communicating with the public. These areas are covered in more detail in the CNB document *Overview of Tasks in the Field of Competence of the CNB and Outline of Other Tasks Relating to the Introduction of the Euro in the Czech Republic* of January 2005, which can be found on the CNB website (www.cnb.cz).

FINANCIAL MARKET OPERATIONS

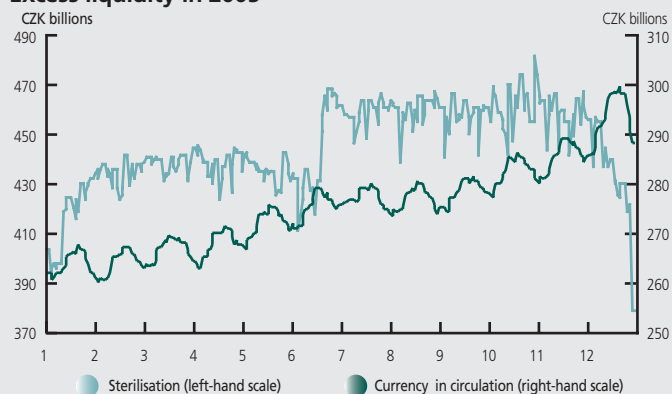
The CNB implements monetary policy by means of its operations on the financial market. The CNB Bank Board sets three interest rates: the two-week repo rate, the discount rate and the Lombard rate. The main monetary policy rate is the two-week repo rate. By setting this interest rate, the CNB influences the short end of the yield curve. The discount and Lombard rates provide the floor and ceiling respectively for short-term interest rates on the money market. Changes in the repo rate (set half-way between the above two rates) are accompanied by symmetrical changes in the discount and Lombard rates.

The Bank Board decided to change the two-week repo rate four times last year. With effect from 28 January, 1 April and 29 April it lowered the rate in three steps of 0.25 basis point from 2.50% to 1.75%. With effect from 31 October it decided to increase the rate by 0.25 basis point to 2%.

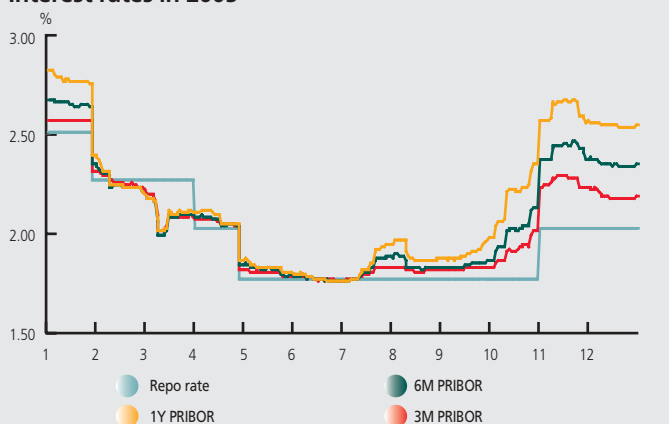
Using money market operations, the CNB daily influences the liquidity of the banking sector so that it is at the optimum level for compliance with the reserve requirement. This ensures that short-term interest rates are stable at a desirable level. The daily decision-making on the central bank's money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

In 2005, the main instrument for managing short-term interest rates was again the two-week repo. Owing to persistent and considerable excess liquidity in the Czech banking system, the CNB used these operations to absorb excess reserves (unlike the ECB, which provides liquidity). The liquidity absorbed is remunerated at the repo rate at maximum. Two-week repo tenders were announced daily and settled with same-day value. The volume of excess liquidity absorbed daily in monetary operations in 2005 varied between CZK 378 billion and CZK 481 billion, the average being CZK 444 billion. The average amount of liquidity absorbed fell by approximately CZK 25 billion relative to the 2004 average.

Excess liquidity in 2005



Interest rates in 2005



This decrease was due to steady growth in currency in circulation (see the chart). Another factor reducing the volume of sterilisation was the continuing sell-off of a portion of the returns on the international reserves. The volume of returns sold was around CZK 13.9 billion for 2005 as a whole. A large decline in the volume of sterilisation at the end of the year (of around CZK 111.8 billion compared to November) was due mainly to seasonal effects. There was an increase in state fixed-purpose funds with the CNB, since they are not allowed to be short-term invested in the market over the end of the year (around CZK 96 billion) and the rate of growth of currency in circulation rose in connection with Christmas (around CZK 3.8 billion). These factors are short term and closely linked with the end of the calendar year, and their effect will gradually abate during January. In December 2005, the volume of sterilisation was affected by a one-off repayment of a Czech Consolidation Agency redistribution loan (CZK 8.1 billion) and the payment of a state guarantee for banking sector consolidation (CZK 5 billion). Interest paid to banks as a result of monetary operations totalled around CZK 8.75 billion in 2005.

The CNB's instruments also include two "automatic" facilities – the marginal lending facility and the deposit facility. Under the lending facility, the CNB lends funds overnight to banks against eligible collateral in the form of securities. Such loans are charged interest at the Lombard rate. The Lombard rate thus provides a ceiling for short-term interest rates. The CNB accepts T-bills, CNB bills, Czech Consolidation Agency bills and koruna securities issued by EU governments and selected multilateral issuers as collateral. The deposit facility gives banks the option of making overnight deposits with the CNB at the discount rate. The discount rate thus provides a floor for short-term interest rates. The minimum volume for these operations is CZK 10 million, increasing in multiples of CZK 1 million. Fine-tuning operations (ad hoc repos and reverse repos under market conditions) are used only rarely.

In 2005, the CNB continued issuing its own bills, which it used as collateral for open market operations. In addition, CNB bills are used by banks as collateral against intraday credit from the CNB. Such credit is provided to ensure the smooth running of the payment system at CNB Clearing. The CNB charges no interest on such credit. There is automatic spillover into the marginal lending facility in the event of non-repayment of intra-day credit at the end of the day.

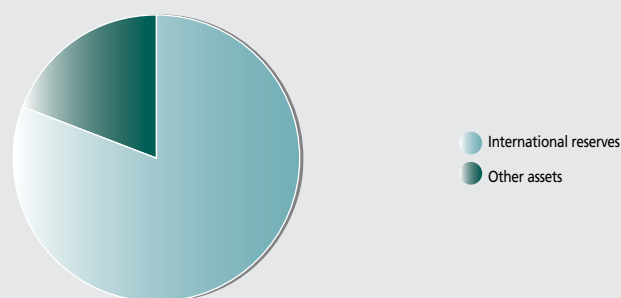
Management of the CNB's international reserves

International reserves are the Czech National Bank's foreign assets in convertible currencies. They comprise deposits in foreign banks, securities, gold, the reserve position with the IMF and other reserve assets.

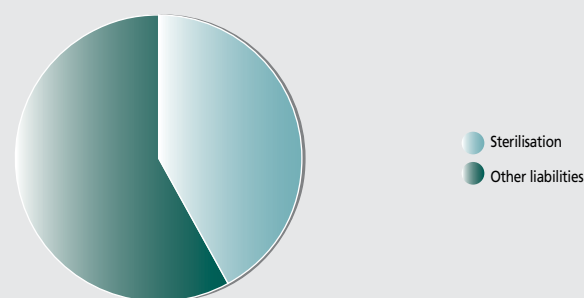
In managing the international reserves, the CNB aims to attain maximum and stable returns subject to compliance with the stipulated liquidity restrictions and market and credit risk limits. The international reserves are invested so that the state's foreign exchange obligations and, if necessary, interventions in the foreign exchange market are secured. The volume of the reserves is regularly published in the Financial Markets section of the CNB website – www.cnb.cz.

The international reserves represent approximately 81% 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 international reserves in the central bank's balance sheet is shown in the chart below. Given the importance of sterilisation operations to the CNB's financial results, we also present a chart showing the share of sterilisation in the CNB's liabilities.

Share of international reserves in CNB balance sheet assets



Share of sterilisation in CNB balance sheet liabilities



The CNB's international reserves amounted to CZK 726.7 billion at the end of 2005, up by CZK 90.5 billion on a year earlier. They recorded sizeable growth in June, when privatisation proceeds of EUR 2.7 billion (around CZK 81 billion) were transferred to them. Another reason was a depreciation of the koruna against the dollar by almost 10%, while against the euro the koruna appreciated by almost 5%. The volume of the reserves was also affected by income on investment activities and the sell-off of returns realised in the previous period.

In euro terms, the international reserves amounted to EUR 25.1 billion (an annual increase of EUR 4.2 billion) and in dollar terms they rose by USD 1.1 billion to USD 29.6 billion. Besides the aforementioned factors, the change in the international reserves (expressed in these terms) was also affected by the euro-dollar exchange rate.

At the end of 2005 the international reserves were allocated as follows: 51.31% EUR, 47.23% USD and 1.46% SDR and gold. 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 2005 continued to be based on the requirement that the portfolio should not record a loss in any twelve-month period. At the beginning of last year, the duration was set at 1.72 years for the euro portfolio and 1.32 years for the dollar portfolio. In addition to historical data, the methodology for determining the duration takes into account the situation on the financial markets. Consequently (given the increase in interest rates), the duration of the dollar portfolio was extended during 2005 to 2.29 years. The duration of the euro portfolio was increased only once, to 1.82 years.

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

The rate of return on the international reserves is measured both in absolute terms and relative to benchmark portfolios. Measuring the relative rate of return indicates how successful the strategies implemented by the portfolio managers were relative to the benchmark portfolios.

The rate of return on the euro portfolio was 2.69% and that on the dollar portfolio 2.45%. The relative rate of return (i.e. the difference between the rate of return on the actual portfolio and that on the benchmark) was 0.08% for the euro portfolio, which is around EUR 9.2 million in absolute terms, and 0.16% for the dollar portfolio, or USD 20.8 million in absolute terms. The rate of return on the gold portfolio, including valuation changes, amounted to 17.8% due to a large increase in the gold price. The price of gold rose from USD 438 per ounce to USD 513 per ounce last year. The overall rate of return on the international reserves³ in 2005 was 2.64% (down by 0.17 percentage point compared to 2004). The weighted average of the return on the koruna portfolios, i.e. including exchange rate gains and losses, was 4.07%.

ECONOMIC RESEARCH

The mission of economic research at the CNB is to create a knowledge base for conducting monetary policy, banking supervision and financial stability analyses in a fast developing international environment.

In 2005, a strategic discussion went on within the CNB on the economic research priorities for the period 2007–2012. The priorities, which were formulated jointly by the Bank Board, the Economic Research Department, the CNB Research Advisory Committee and the CNB's experts, will determine the direction of the CNB's two-year Economic Research Programmes in the forthcoming six-year period. A strategic document *CNB Economic Research 2007–2012*, identifying the priority research issues for five areas (monetary policy, macroeconomic modelling and forecasting, financial stability, fiscal policy and the real sector and convergence), was published on 6 February 2006 in the *Research* section of the CNB website www.cnb.cz.

The Research Advisory Committee, which is an advisory body to the CNB Bank Board, had the following line-up in 2005: Nicolleta Batini (International Monetary Fund), Aleš Bulíř (International Monetary Fund), Carsten Detken (European Central Bank), László Halpern (Hungarian Academy of Sciences), Eduard Hochreiter (Oesterreichische Nationalbank) and David Mayes (Bank of Finland). The President of the Committee is the Governor of the CNB Zdeněk Tůma. The Committee is chaired by the Vice-Governor of the CNB, Miroslav

³ The weighted average of the rates of return on the individual portfolios (the rates of return on the dollar, euro and gold portfolios are weighted by their share in the overall volume of the international reserves).

Singer. The internal members of the Committee are the Executive Directors of the CNB's Economic Research Department, Monetary and Statistics Department, Banking Supervision and Regulation Department and Risk Management and Transactions Support Department, together with the co-ordinators of the five research areas.

The main outputs of the economic research are published by the CNB in two research paper series: CNB Working Papers and CNB Research and Policy Notes. In 2005, a total of 19 research papers were published, 14 of which in the CNB WP series and 5 in the CNB RPN series. As shown in the table, this number is comparable with those published by other inflation-targeting central banks in small open economies.

Numbers of research publications: comparisons for 2003–2005

Central banks in small open economies	Number of papers in 2003	Number of papers in 2004	Number of papers in 2005
CNB	14	14	19
New Zealand	10	8	7
Sweden	12	17	14
Poland	3	1	10
Hungary	12	12	12
Central banks of smaller euro area economies	Number of papers in 2003	Number of papers in 2004	Number of papers in 2005
Finland	35	31	27
Austria	6	6	11
Portugal	19	20	15
Greece	8	10	10
Belgium	5	22	12
Ireland	9	10	10
Spain	20	22	40

Research papers published in 2005

CNB Working Paper Series

14/2005	Stephen G. Cecchetti	The brave new world of central banking: The policy challenges posed by asset price booms and busts
13/2005	Robert F. Engle Jose Gonzalo Rangel	The spline GARCH model for unconditional volatility and its global macroeconomic causes
12/2005	Jaromír Beneš Tibor Hlédik Michael Kumhof David Vávra	An economy in transition and DSGE: What the Czech National Bank's new projection model needs
11/2005	Marek Hlaváček Michael Koňák Josef Čada	The application of structured feedforward neural networks to the modelling of daily series of currency in circulation
10/2005	Ondřej Kameník	Solving SDGE models: A new algorithm for the sylvester equation
9/2005	Roman Šustek	Plant-level nonconvexities and the monetary transmission mechanism
8/2005	Roman Horváth	Exchange rate variability, pressures and optimum currency area criteria: Implications for the Central and Eastern European countries
7/2005	Balázs Égert Luboš Komárek	Foreign exchange interventions and interest rate policy in the Czech Republic: Hand in glove?
6/2005	Anca Podpiera Jiří Podpiera	Deteriorating cost efficiency in commercial banks signals an increasing risk of failure
5/2005	Luboš Komárek Martin Melecký	The behavioural equilibrium exchange rate of the Czech koruna
4/2005	Kateřina Arnoštová Jaromír Hurník	The monetary transmission mechanism in the Czech Republic (evidence from VAR analysis)
3/2005	Vladimír Benáček Jiří Podpiera Ladislav Prokop	Determining factors of Czech foreign trade: A cross-section time series perspective
2/2005	Kamil Galuščák Daniel Münich	Structural and cyclical unemployment: What can we derive from the matching function?
1/2005	Ivan Babouček Martin Jančar	Effects of macroeconomic shocks to the quality of the aggregate loan portfolio

CNB Research and Policy Notes

5/2005	Jan Stráský	Optimal forward-looking policy rules in the quarterly projection model of the Czech National Bank
4/2005	Vít Bárta	Fulfilment of the Maastricht inflation criterion by the Czech Republic: Potential costs and policy options
3/2005	Helena Šúvová Eva Kozelková David Zeman Jaroslava Bauerová	Eligibility of external credit assessment institutions
2/2005	Martin Čihák Jaroslav Heřmánek	Stress testing the Czech banking system: Where are we? Where are we going?
1/2005	David Navrátil Viktor Kotlán	The CNB's policy decisions – Are they priced in by the markets?

In addition to research papers, the CNB also published two issues of its “Economic Research Bulletin” presenting in brief the results of research projects in the field of financial stability and potential output.

CNB Economic Research Bulletin – topics of individual issues

November 2005	Financial stability
May 2005	Potential output
October 2004	Fiscal issues
May 2004	Inflation targeting
December 2003	Equilibrium exchange rate



All research publications are available to the public on the CNB website.

In 2005, the CNB held its first ever Research Open Day, which provided an opportunity to see some of the best of the CNB's current research work, to learn about the CNB's research strategy and to meet CNB researchers informally. Jointly with the Czech Economic Society and CERGE-EI (The Centre for Economic Research and Graduate Education of Charles University – The Economic Institute of the Academy of Sciences of the Czech Republic), the CNB organised three lectures by leading world economists, two of them Nobel Prize Laureates in Economics. The open day and the lectures are all open to the public. Information on them is available in the *Research* section of the CNB website.

Seminars organised in 2005

Finn E. Kydland	7 Sep. 2005	Quantitative Aggregate Economics
Stehen Cecchetti	14 Apr. 2005	Should Central Bankers Respond to Asset Price Movements: Theory and Evidence
Robert F. Engle	17 Mar. 2005	Downside Risk: Implications for Financial Management

**FINANCIAL STABILITY**

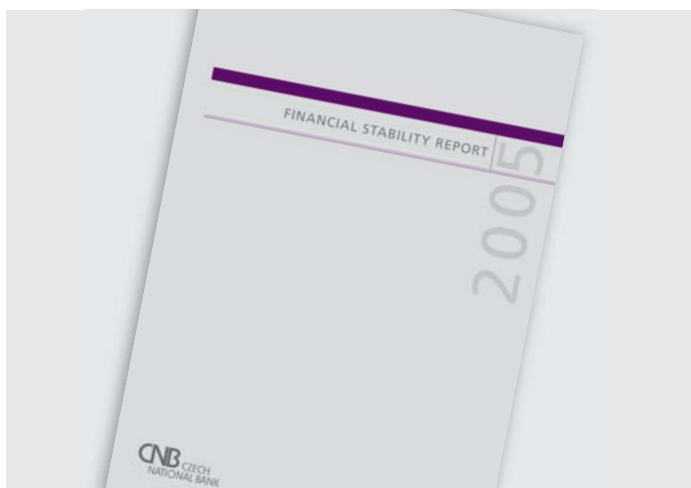
The Czech financial sector operates in an open-economy environment shaped by external and domestic macroeconomic developments, developments in the financial markets and developments in non-financial corporations and households, which are the main debtors and creditors in the balance sheets of financial institutions. The financial sector's resilience to potential adverse shocks stemming from this environment can significantly reduce the negative impacts of such shocks on the real economy. Financial institutions' ability to cope with potential financial imbalances depends on their capital strength, performance, efficiency and risk management quality. The regulatory framework and due supervision of financial institutions are also of great significance as regards preventing financial instability. Smooth operation of the financial infrastructure, including payment systems and securities settlement systems, is also vital.

Financial stability analysis in some respects differs significantly from other analytical activities at the CNB. Unlike banking supervision analysis, it covers not only banks, but also non-bank financial institutions (pension funds, insurance companies, etc.). The target of interest is not the stability of individual financial institutions, but the stability of the financial sector as a whole. The main difference compared to the CNB's macroeconomic analysis and forecasting is that financial stability analysis is not aimed at modelling the most probable development of the economy. Instead, it involves testing the impact of improbable, but plausible, adverse scenarios which could threaten the stability of the entire financial system.

Financial system stability is a subject which has been enjoying growing interest from central banks in recent years. The CNB has been monitoring and analysing the financial stability of the Czech economy since 2004. The growing significance of financial stability was reflected in the preparation of the Act on Integration of Financial Market Supervision, which amends the Act on the CNB and tasks the CNB with analysing developments in the financial system and related risk factors. It includes an obligation to submit a Financial Stability Report to the Chamber of Deputies (the lower house of the Czech Parliament) once a year.

The first Financial Stability Report was published at the end of 2004 and covered the developments up to the end of the first half of 2004. The 2005 Report,

analysing financial stability for the entire 2005, will be published at the end of May 2006. It will be available in electronic form in both Czech and English in the *Financial Stability* section of the CNB website www.cnb.cz.



One of the CNB's key tasks is to build up and improve its analytical resources and expertise in the financial stability area. A twinning project between the CNB and Deutsche Bundesbank, launched in spring 2005, has been of significant help in this respect. As part of this project, 29 seminars were held last year, attended by experts from the two central banks. In addition, two long-term and two short-term study programmes at the German central bank were organised for CNB experts.

Financial stability is also gradually gaining significance at the level of international co-operation. Financial stability experts represent the CNB in the official committees and working groups of the European System of Central Banks (Banking Supervision Committee, Steering Committee of the ECB-CFS Research Network on Capital Markets and Financial Integration in Europe, Working Group on Macro-Prudential Analysis, Working Group on Banking Developments, Task Force on Enlargement).

Financial stability analysis is also one of the CNB's five research areas. The emphasis being put on this subject, and the improving quality of analytical tools, are reflected in a growing number of research publications dedicated to various aspects of financial stability (for details, see www.cnb.cz and the Economic Research section of this Annual Report).

STATISTICS

The CNB's statistical work in 2005 was dominated by two factors: continuing harmonisation with the statistical requirements of European institutions, and assessment of the burden on respondents. For the second year, the CNB's representatives participated in the work of the committees and working groups of the ECB and the European Commission and its statistics office (Eurostat). Statistics is one of the areas in which these bodies have the widest networks. The CNB's statisticians were also involved in the activities of authorities preparing revisions to international methodological standards, and also provided technical assistance to developing countries. Although the introduction of the new harmonised statistics expanded the group of respondents, ways were sought for preventing the burden on them from increasing above tolerable limits. These included limiting the reporting requirements for less significant items and breakdowns, agreements on data exchange with natural partners (the CZSO in particular), the use of samples of respondents and, in some areas, the use of estimation methods. The focal point in the statistics area thus moved further away from just data collection to compilation and presentation of individual statistics. The decision to accelerate the integration of financial

market supervision added a new dimension to the statistical work. The location of the supervisory authorities at the CNB will make it possible to use common data.

Monetary and banking statistics

The development and regular production of harmonised statistics for the monetary financial institutions sector continued in 2005 in the area of balance-sheet items and monetary aggregates (including their counterparts) and in the area of interest rates. Attention was focused on compiling and publishing collective investment fund statistics and on the initial collection of data from asset financing intermediaries (covering leasing, hire purchase agreements and consumer credit). Another important step in the development of the public information service was the launch of a monthly publication *Monetary Statistics* in the *Statistics* section of the CNB website. The experience gained was also used in compiling statistics for other areas of information, e.g. payment system statistics, which are sent to the ECB.

Balance of payments statistics

The increasing demands for harmonised statistics – in particular more detailed breakdowns of individual items – necessitated the introduction of more effective data collection methods. As in other European countries, key respondents are addressed directly and the division of labour between national statistics offices and national central banks is subject to constant fine-tuning. The CNB is working with the CZSO to introduce statistical surveys of exports and imports of services. It is also concentrating on improving the process of compilation of financial account items and streamlining the collection of data from respondents. Reporting to the World Bank was terminated following the Czech Republic's "graduation" from this institution.

Financial accounts statistics

The financial accounts statistics – covering, in their final form, the relationships between all sectors of the economy, including the external sector – are one of the fastest growing areas of statistics. The complexity of these statistics requires very close co-operation with the CZSO. In 2005 this partnership saw dynamic development, with division of responsibilities for primary data collection by sector and exchange of information. The CZSO continues to provide information on the non-financial and government sectors, while the CNB concentrates on the financial sector. In 2005, the first sets of quarterly financial accounts were compiled experimentally in a "short-term unharmonised approach".

Preparations for the integration of financial market supervision

In the areas of statistical reporting and reporting for the purposes of regulatory authorities, the CNB established intensive co-operation with the Czech Securities Commission (CSC) and the Finance Ministry's Office of State Supervision of Insurance Companies and Private Pension Schemes. The initial meetings organised in 2005 indicated possibilities for future sharing of information. The first outcome of this co-operation was a reduction of some parts of a legislative amendment on the information duties of collective investment funds being prepared by the CSC. The information that the CNB already collects for monetary purposes will also be used for the purposes of the new supervisory set-up.

THE CNB AS THE BANK OF THE STATE

The CNB is authorised by law to perform banking services, and under this authorisation it maintains accounts for the state and the public sector. At the end of 2005, the CNB maintained more than 25,000 such accounts, including in particular the revenue and expenditure accounts of state organisational units connected to the state budget,

revenue and customs offices, the Czech Social Security Administration, labour offices, subsidised organisations, state funds and businesses that receive subsidies from the state budget, and accounts connected to the budget of the European Communities. The CNB is also responsible for the payment of state social benefits. For example, 11.6 million transactions relating to state social benefits, 9.1 million health insurance and employment policy contributions and 2.1 million transactions connected with VAT administration were recorded on these accounts in 2005.

Support for Treasury liquidity management

The CNB is working in partnership with the Ministry of Finance on a Treasury development project⁴, under which it has taken on responsibility for the "Payment System" sub-project. Another major change in 2005 was the signing of a general agreement between the CNB and the Ministry of Finance on the provision of support for Treasury activities, together with related implementing agreements.

In day-to-day practice, the CNB is responsible for the consolidation of state sector funds⁵ on an aggregate Treasury account and works closely with the Ministry of Finance on continuously managing the liquidity of this account. Current-day expenditures and their coverage by funds on these state accounts are continuously compared in the CNB's payment and settlement system (ABO) in order to make maximum use of any temporary free liquidity. In the event of any temporary imbalance between revenues and expenditures, either additional funds are obtained to finance expenditures through sales of T-bills on the financial market, or surplus Treasury funds are invested in T-bills. In this way, the Treasury funds are used in the most effective way possible and hence debt service costs are minimised. The intraday average balance on the aggregate Treasury account again gradually decreased last year, fluctuating between CZK 13 million and CZK 14 million (meaning a reduction in the costs of the state).

During the day, the CNB provides partner departments of the Ministry of Finance with information on the liquidity on the aggregate Treasury account, including recommendations for daily borrowing or investment operations. At the end of the day it also provides detailed information on state budget revenues and expenditures broken down by type and state budget chapter, etc.

Support for state debt financing

The Czech National Bank assists in the management of the Czech Republic's national debt. This it does by organising primary sales of government bonds and providing expert advice. In line with the Ministry of Finance's strategy of extending the average maturity of the national debt, debt issued in the area of medium-term and long-term koruna bonds grew by CZK 90.5 billion compared to 2004. Conversely, the volume of T-bill issues declined by CZK 31 billion. The Ministry of Finance moreover issued a foreign bond with a face value of EUR 1 billion and a maturity of 15 years. The income from the bond issue was hedged against exchange rate fluctuations.

In 2005, the CNB organised 34 T-bill auctions for the Ministry of Finance. These bills had maturities ranging from 3 months to 1 year and totalled CZK 308 billion. Of this amount, bills with a face value of around CZK 182 billion were purchased by direct participants in the auctions and the remainder (amounting to CZK 126 billion) were purchased by the issuer and placed in its portfolio. The bills were sold by Dutch auction. At the close of 2005, the outstanding volume of T-bills was around CZK 124 billion. The investors at T-bill auctions were particularly interested in bills with short maturities.

⁴ Under Government Resolution No. 169/2005 of 9 February 2005.

⁵ The accounts subject to consolidation are defined by Act No. 218/2000, on Budgetary Rules – revenue and expenditure accounts of the state budget, state financial assets accounts, revenue offices' accounts, Treasury liquidity management accounts and, starting from October 2005, the reserve fund accounts of organisational units of the state.

In 2005, the technique of reopening existing issues continued to be applied to government bonds with maturities of over 1 year. This helped to increase the liquidity of the secondary market. In addition, the Ministry of Finance issued four new government bonds, with maturities of 3, 5, 10 and 15 years. A total of 17 auctions of medium-term and long-term government bonds took place in 2005, with a total face value of CZK 112.5 billion. One bond issue with a face value of CZK 22 billion was duly redeemed.

THE CNB AS AN ADMINISTRATIVE BODY

Under powers contained in Act No. 219/1995 Coll., the Foreign Exchange Act, as amended, the CNB is responsible for regulation and supervision in the foreign exchange area. These activities include issuing licences for certain types of foreign exchange transactions (cash sales of foreign currency and non-cash foreign exchange transactions) and for money services, and overseeing compliance with the foreign exchange regulations. The CNB performs supervision by means of foreign exchange inspections conducted in compliance with Act No. 552/1991 Coll. on State Inspection, as amended. In these inspections, the CNB also checks compliance with Act No. 61/1996 Coll., on Some Measures against Money Laundering and on the Amendment of Related Acts. If the foreign exchange regulations are contravened, the CNB imposes corrective measures or is authorised to impose penalties in administrative proceedings. The CNB may, in administrative proceedings, impose a fine of up to CZK 50 million or restrict, suspend or withdraw a foreign exchange licence, depending on the extent, nature and duration of the infringement of the foreign exchange regulations.

Number of foreign exchange licence applications submitted in 2005				
	Total	Decisions to grant a foreign exchange licence	Decisions to refuse a foreign exchange licence	Foreign exchange licences valid as of 31 Dec. 2005
Prague	6	8*	0	86
Č. Budějovice	2	1	1	25
Plzeň	12	12	0	33
Ústí nad Labem	3	2	1	33
H. Králové	1	1	0	13
Brno	10	10*	1	35
Ostrava	7	5	1	35
Headquarters	6	4	1	65
Total	47	43	5	325
* some of these administrative proceedings were opened in 2004				

More detailed information on individual foreign exchange licence holders is available in the *Foreign Exchange Supervision* section of the CNB website under *Entities granted a foreign exchange licence*.

In 2005, the CNB issued 24 final and conclusive rulings on foreign exchange offences under administrative proceedings opened in 2004. A total of 54 proceedings were opened, of which 42 were closed by a final and conclusive ruling during 2005. Total fines imposed in 2005 amounted to CZK 4,838,000. These fines constitute revenues to the state budget. In one case, the CNB withdrew a foreign exchange licence as a penalty for foreign exchange offences.

In 2005, as in the previous period, most of the foreign exchange offences were associated with breaches of the conditions for cash purchases/sales of foreign currency in return for Czech currency (in particular incorrect deductions for foreign currency sales and purchases, insufficient identification of clients in transactions exceeding CZK 100,000, and failure to fulfil the reporting duty). The offence of unauthorised offering, performance or intermediation of foreign exchange trading (be it cash or non-cash) was identified in 16 cases.

EUROPEAN AND INTERNATIONAL CO-OPERATION, FOREIGN TECHNICAL ASSISTANCE

Since 1 May 2004, the CNB has been a full member of the European System of Central Banks (ESCB), which comprises the European Central Bank (ECB) and the 25 National Central Banks (NCBs) of the EU. The CNB Governor regularly attends meetings of the ECB's General Council – one of the ECB's decision-making bodies (along with the Governing Council and the Executive Council), which meets four times a year and where the governors of all the NCBs of the EU countries are represented. Since June 2005, the meetings of the General Council have also been attended, in an observer capacity, by the governors of the central banks of Bulgaria and Romania, which signed accession treaties with the EU in April 2005.

Key issues discussed by the General Council in 2005 included regular documents on macroeconomic, monetary and financial developments in the EU broken down by euro area countries and non-euro area countries, the functioning of ERM II, financial stability issues and the revision of the Stability and Growth Pact.

After the relevant procedure, which also involves the members of the ECB's General Council, four more EU Member States were admitted into the ERM II system in 2005: Cyprus, Latvia and Malta at the end of April and Slovakia at the end of November.

CNB representatives actively participate in the work of the ESCB's 13 committees and numerous working groups. The major items discussed in the BANCO and the LEGCO committees included, for example, issues associated with the modification of the legal framework for euro adoption (an amendment to Council Regulation (EC) 974/98 on the introduction of the euro), and the issue of primary and secondary frontloading of banknotes in countries that are to adopt the euro.

In written consultations or written procedures, the CNB is, on the one hand, obliged to consult the ECB on any draft legislative provisions within its fields of competence and, on the other hand, has the opportunity to comment on the opinions issued by the ECB on new European and national legal regulations concerning the fields of competence of the ESCB/ECB. In 2005, almost 90 such documents were processed at the CNB. In twelve cases the CNB made comments in the form of a Governor's letter to the President of the ECB. In six cases, this procedure was initiated by the Czech Republic, with the CNB being the initiator four times.

The CNB's representation in bodies linked either to the Council of the European Union or to the European Commission also plays an important role. The CNB Governor attends the informal meetings of ECOFIN held twice a year in the country that holds the Presidency of the Council of the European Union. The main topics in 2005 were the current economic situation and financial stability. A CNB representative also attends the meetings of the Economic and Financial Committee (EFC), which acts in an advisory capacity to the Council of the European Union. Among other things, the Committee dealt with the revision of the Stability and Growth Pact and its implementation, legal aspects of the adoption of the single currency in the new Member States and financial services issues.

The CNB is also involved in the work of the EFC Sub-Committee on International Monetary Fund Matters (SCIMF), which deals among other things with the strategic review of the IMF and development financing.

The most important domestic platform for co-ordination of policies towards the EU is the EU Committee established by the Czech Government and run by the Ministry of Foreign Affairs. The CNB is involved in this Committee at vice-governor level. The Committee assists primarily in forming and approving positions, instructions and mandates for the Czech Republic's representatives in the Council of the European Union and its working groups. Within the CNB, the Co-ordination Meeting for EU Issues, chaired by a vice-governor, is used to co-ordinate activities and discuss European issues.

The International Monetary Fund and World Bank Group

In the field of bilateral relations, an Article IV consultation with the IMF took part on 11–24 May 2005. The IMF's assessment of the current situation was relatively positive. It believes that the main political challenge for the Czech Republic lies in the fiscal area, where there is a risk of procyclical expansionary fiscal policy in the short term. In the medium term, in the context of ERM II entry and adoption of the single European currency, the general government deficit will have to be reduced and the plan for public finance consolidation implemented. In the long term, fiscal policy will have to deal with the need to implement structural reforms in the areas of pensions, health care and social benefits. Monetary and exchange rate policy was assessed positively. Inflation is expected to remain low. In the IMF's opinion, intensifying wage pressures and unexpectedly large exchange rate deviations could pose a risk. The banking sector is sound and resilient to macroeconomic shocks. The rapid growth in household credit, including support for long-term saving, requires a strengthening of supervision and monitoring capacity. Turning to structural issues, the IMF stressed the need to improve the legal framework for the development of private enterprise and to increase the flexibility of the labour market.

On 1 February 2005, the IMF's regional office opened in Warsaw. Its role, among other things, is to assist the eight new EU Member States, including the Czech Republic, in the macroeconomic area during adoption of the euro.

Following the two World Bank missions conducted in the Czech Republic in 2004, focused on corporate governance in the banking sector and the assessment of bank insolvency management systems, a joint World Bank and Czech National Bank seminar was organised in Prague in January 2005. At this seminar, the results of the assessments of the two missions were presented and the latest diagnostic products in the financial market vulnerability assessment system were discussed. A significant event was the “graduation” of the Czech Republic from the IBRD (the main part of the World Bank), which was officially completed on 15 April 2005. This means that the Czech Republic was formally transferred from the “Part 2” group of member countries, which are entitled to be IBRD clients, to the “Part 1” group of member countries, i.e. the advanced countries, which cannot obtain aid from the World Bank.



The Bank for International Settlements (BIS)

The bilateral co-operation between the CNB's banking supervisory representatives and the Basel Committee on Banking Supervision (BCBS) continued in 2005. The BCBS provides a platform for regular discussion of banking supervisory issues in the G10 countries. Recently, however, it has been dealing increasingly with the development of

regulation. CNB Banking Supervision has representatives in the Core Principles Liaison Group and the Core Principles Working Group. Two meetings of these groups took place last year, focused primarily on some key aspects of the new capital adequacy framework (e.g. national discretion, principles of co-operation between home and host supervisors) and on the amendment of the Core Principles for Effective Banking Supervision, which should be in line with best international practices. The draft amended Core Principles are based on the principles of development of services in the banking sector, elimination of duplication, harmonisation with other international standards, specification of some principles in more detail and preservation of continuity, simplicity, flexibility and general applicability and the same number of principles.

In the first half of 2005, the BIS offered to sell to member banks its shares from the American issue, which it had previously repurchased from private shareholders. The CNB took up this offer and participated in the purchase of the shares.

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

One of the most important areas of co-operation between the CNB and the OECD in 2005 was the discussion of topical economic issues at the meetings of the Economic Policy Committee (EPC). Attention was also given to the continuing reform of the OECD and the topics discussed by the Financial Markets Committee.

CNB representatives attended meetings of the Economic and Development Review Committee (EDRC), especially in cases where the Czech Republic was designated as an examiner. During the preparation of the Economic Survey of the Czech Republic, a mission of OECD experts visited Prague in September 2005 and met with representatives of the Czech administration, including the CNB. In December 2005, the management of the OECD's Economic Department and the OECD's Chief Economist Jean-Philippe Cotis held discussions in Prague with the Czech Minister of Finance and the management of the CNB.

The European Bank for Reconstruction and Development

In 2005, the EBRD signed seven projects in the Czech Republic – most of them regional projects – worth EUR 51.7 million in total. The largest was a capital investment in Connex Central Europe, a regional holding company providing bus and rail transport services. In two cases, the investments in existing export promotion projects were increased (SG Equipment Finance Czech Republic and Deutsche Leasing). The other investments went towards strengthening the financing of smaller companies by means of joint regional funds in the countries of Central and Eastern Europe. The EBRD's total investment in the Czech Republic since its launch up to the end of 2005 amounted to EUR 1.4 billion and involved 59 projects. The EBRD had also financed 32 technical assistance projects for the Czech Republic, worth EUR 5.4 million.

In October 2005, after discussions with the Ministry of Finance, the CNB and other relevant central authorities (in August 2005) and at an EBRD Workshop (in September 2005), the EBRD's Board approved the EBRD Strategy for the Czech Republic for 2006 and 2007. According to this document, the EBRD's activities will focus on the private sector, in particular the financial and enterprise sectors, and on infrastructure and the environment. Compared to the original strategies, the EBRD's mandate has moved significantly towards more sophisticated, more labour intensive and much more selective projects.

Foreign technical assistance

The CNB continued providing technical assistance in 2005. The foundations for this activity were laid in 2002, when an active FTA programme – designed mainly for countries of South-East Europe and the former Soviet Union – was prepared for the first time.

A total of 31 projects, including 8 seminars, were held at the CNB last year, attended by 154 people from 30 central banks. In addition, the Czech National Bank organised 15 consultations for 43 experts from the central banks of Albania, Armenia, Botswana, Kazakhstan, Moldova, Romania, Russia, Slovakia, Slovenia, Tajikistan and Ukraine. Six consultations took place in recipient banks (Belarus, Macedonia, Romania and Slovakia). The direct expenses of these projects amounted to CZK 721,000.

The CNB's activities in this area are mutually beneficial and enriching. CNB experts also take part in missions of the International Monetary Fund and other international organisations. Opportunities to become involved in joint EU-funded projects with other central banks are opening up. This activity of the CNB is valued not only by the seminar and consultation participants themselves, but also by the BIS in Basel, which monitors the technical assistance provided by central banks.



Phare and the Transition Facility

A technical assistance project for Czech commercial banks and the CNB relating to the implementation of the New Basel Capital Accord (budget: EUR 1.5 million) and a Twinning project for the CNB (expert assistance between partner institutions) for the development of a system for monitoring and analysing financial stability in partnership with the German central bank (budget: EUR 0.5 million) were implemented as part of the technical assistance received under the Phare and Transition Facility programmes in 2005. Furthermore, a Twinning Light project for the CNB in the banking supervision and internal audit areas (total budget: EUR 0.5 million) was completed. A Twinning Light project for the Czech Financial Arbiter (total budget: EUR 0.25 million) and a Twinning project in the area of supervision of insurance companies and capital markets for the single regulator are in the preparation phase. Under the above projects, the Czech National Bank and commercial banks each received technical assistance amounting to about EUR 0.7 million in 2005.

TECHNOLOGY AND SECURITY

Computing and communication systems

All the key activities of the central bank are supported by information systems and the CNB's internal system environment. The CNB's IT development strategy defines key priorities for 2005–2010 – the development of a reliable, sufficiently efficient and accessible IT and IS environment with maximum cost-effectiveness and security, compliant with IT standards and with the security standards applied within the ESCB.

Great attention is paid to external communication security, particularly with respect to connections to branches, commercial banks and the ECB, internet services and communication between the CNB's premises. Particular emphasis is laid in both the development and operation of information systems and information technology on efficiency and justified use of funds

In line with the above strategy, the following major projects were implemented in 2005:

- Migration to a new platform of a standard client workstation system environment – MS Windows 2003 and MS Windows XP – was completed.
- Work took place on the construction of a fully fledged back-up centre, taking maximum account of standards in EU countries and also reflecting the need to safeguard the CNB's functionality in crisis situations. The main contribution of the staff of the Information System Department was to specify the communication link and IT equipment for the centre in such a way as to ensure that it is capable of performing the CNB's core functions in emergency situations.
- In the area of interbank payments, the CERTIS 2 project continued. In addition to introducing some new functions relating, among other things, to the preparations for joining TARGET 2, the aim of the project is to replace the mainframe computer platform with a more cost-effective system environment. As regards the CNB's payment and accounting systems, a project implementing internet banking for CNB clients will soon be completed. The new functions of this project are being prepared so as to take into account the needs of the planned Treasury system being developed by the Ministry of Finance.

The downward trend in IT expenditure continued into 2005. Operating expenses were 9% lower than a year earlier. Asset acquisition expenditure was 56% of the 2004 level. A personnel audit conducted in 2005 resulted in more efficient use of human resources in this area: the number of staff was reduced by about 15% with no negative effect on the activities performed.

The CNB's crisis management system

The aim of crisis management is to eliminate potential security risks and to increase the organisation's resistance to potential threats. At the CNB, these issues are addressed by the Crisis Management and Classified Information Protection Department. Its key tasks include co-ordinating the drafting and updating of crisis documentation, organising co-operation at the level of central administrative authorities in crisis situations and conducting security analyses. Last but not least, it plays an important role in dealing with any emergencies arising at the CNB.

2005 was the first year of operation of the CNB's Crisis Plan under Act No. 240/2000 Coll., on Crisis Management. This, of course, generated a need to test whether the individual parts of the plan are implementable. Testing of the crisis documentation under a special methodology was commenced and will continue in 2006. However, preparedness for dealing with emergencies is a complex problem which cannot be reduced to the mere preparation and testing of plans. Security incidents are a result of failure of an organisation's security culture and the crisis plan is one of the key factors affecting the quality of this security culture. The preparation, updating and testing of the crisis plan should therefore be viewed as one way of positively affecting the development of the CNB's security culture.

Protection of critical infrastructure – an issue addressed at national level – became a major task in 2005. In the Czech Republic, protection of critical infrastructure is divided into several sectors. The CNB is responsible for the co-ordination of part of the banking and financial sectors. The changes to the structure of financial market supervision in the Czech Republic will extend the CNB's critical infrastructure protection competences.

Last year, the CNB, together with the stipulated critical infrastructure entities of the banking sector in the Czech Republic, completed the first phase of development of contingency plans and defined the critical infrastructure of the branch networks of the selected entities. Branches were selected taking into account the activities they perform and security and technical parameters. Their number and distribution meet the requirements for maintaining the continuity of the core functions of the banking sector in crisis situations across the entire territory of the Czech Republic.

Last year also saw substantial progress with the implementation of one of the CNB's priority crisis management objectives – the building of the CNB's back-up centre in Prague-Zličín. The construction work was completed and officially approved in January 2006. The work, which had started with an archaeological examination in 2004, was performed by Skanska CZ in line with the schedule stipulated in the contract. The acquisition costs for the work under the contract are around CZK 170 million (excluding VAT). The back-up centre will be fully operational by the start of 2007, once the technology has been installed and test operation completed.



THE CNB AND THE PUBLIC



EXTERNAL COMMUNICATIONS

Clear and transparent communication remained one of the priorities of the Czech National Bank in 2005. It is difficult today to imagine monetary policy operating efficiently in the inflation targeting regime without this basic precondition. The CNB therefore publishes the minutes of the Bank Board's monetary policy meetings eight days after these meetings on its website (see *Minutes of the CNB Board Meetings* in the *Monetary Policy* section of the CNB website www.cnb.cz). However, the communication openness of the CNB does not apply to monetary policy only, but affects all the areas of activity delegated to the central bank by law. Naturally, the public is most interested in information on money circulation, banknotes and coins and counterfeits thereof. These issues are part of our everyday life, so the CNB pays close attention to them. However, it does not neglect information from areas such as statistics (banking statistics, in particular, are followed very carefully by the public), banking supervision and the payment system.

In August 2005, the Government approved a proposal of the Ministry of Finance and the Czech National Bank to integrate supervision of the financial markets into the CNB as from 1 April 2006. This decision started off intensive preparations for the merger, including communication activities. The central bank used various channels to address market participants and explain the reasons for this step and assure them that this solution would bring them numerous specific positive effects, for example a reduction in administrative workload in the reporting area. The public was continuously informed about all steps taken in the preparatory phase. The CNB also devoted considerable attention to communicating with the staff of the supervisory institutions concerned in order to prevent the emergence of uncertainties, which might have reduced their performance.

The CNB dealt with many issues in 2005, but one topic dominated. Adoption of the euro was the subject of economic debate and of discussions at the highest political level. The Czech Government declared itself in favour of the Czech Republic joining the euro area in 2010. This date may seem quite a long way off, but the preparations for euro adoption involve numerous obligations which have to be met in advance. One of the tasks of the National Co-ordination Group is to draw up and implement a communication strategy for euro area accession. The CNB, as one of the members of the NCG working group responsible for communication, will be significantly involved in this area.

In 2005, the CNB implemented a new editorial system for updating its website. The website remains the most heavily used information channel. It can be flexibly updated by the CNB's staff and the number of visits to each page can be monitored. The present version of the site was put into operation in 2003 and since then has steadily become less user friendly owing to the huge amounts of information placed on it. For this reason, a comprehensive analysis of the site was conducted in the second half of 2005 and a new version with a new structure and a new graphic design will be prepared in 2006.

PROVISION OF INFORMATION UNDER ACT NO. 106/1999 COLL., ON FREEDOM OF INFORMATION

The Czech National Bank's procedure for complying with the duties ensuing from the Act, and in particular its procedure for dealing with applications for information in compliance therewith, is internally regulated by Czech National Bank Directive No. 55 of 13 December 2002, on the communication of the Czech National Bank, as amended by Amendment No. 1 of 29 July 2005, stipulating the principles and procedure for dealing with applications for information.

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

Information provided in 2005 on the basis of applications:

Number of applications for information under the Act:	None
Number of appeals against decisions:	None
Transcript of the relevant parts of each court judgement:	None
Results of sanction proceedings for non-compliance with the law:	None

Other information relating to the application of the Act: 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, the Payment System Act 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 legal framework of the Act. In 2005, the CNB answered 166 written and 1,415 e-mail enquiries from the public.

Information provided by way of public disclosure:

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

EXHIBITION

In 2005, the CNB's permanent exhibition *People and Money*, installed in a former strong-room, was partly updated, as more than three years had passed since it opened to the public. In late 2004 and early 2005, some of the texts, tables and charts were updated and the new commemorative silver and gold coins from the cycle *Ten Centuries of Architecture* were placed in the showcases. The exhibition now contains a simplified "dealing room" providing visitors with statistical information on inflation movements since the foundation of the Czech Republic, koruna-euro and koruna-dollar exchange rates and current interest rates. At the entrance to the strong room visitors can now view a container in which banknotes and coins are stored at the CNB and see the actual size of a bundle of banknotes worth CZK 5 million. A newly installed set of graphic designs of current Czech banknotes by the prominent Czech designer Oldřich Kulháněk is also attracting great interest.

Thanks to its unique character, the *People and Money* exhibition is still in high demand. Unfortunately, this is reflected in long booking periods. It is not unusual for school groups, which still account for the majority of visitors, to reserve one year in advance. This has led to a slight rise in the number of cancelled or unclaimed tickets.

The pupils and students of many primary and secondary schools visit the exhibition several times. According to some teachers from secondary schools specialising in economics, a visit to the exhibition has become part of the tuition they provide and has been incorporated into curricula. Since the exhibition constitutes a unique set of information about the development of money and monetary policy in the Czech Republic, concentrated in one location, it is also often visited by students seeking information for their dissertations and theses.

During the summer holidays the exhibition attracts foreign tourists and visitors from outside Prague. In order to increase visitor numbers in this period, various media activities are being prepared in collaboration with the Communications Department, for example radio interviews and TV spots in the programme *Toulavá kamera* (Wandering Camera).

In March 2005, the exhibition welcomed its 50,000th visitor. A total of 60,693 people visited the exhibition between January 2002 and December 2005. This figure, however, does not include participants at foreign technical assistance courses and other official guests, for whom a visit to the exhibition represents an interesting complement to their stay at the CNB. In 2005, the number of visitors was 14,168 and the average attendance (including summer holidays, when there are no school groups) was 69.6% of the exhibition's capacity.

At the end of 2005, a temporary exhibition and presentation of the State Printing Office Prague and the Czech Mint, held in the vestibule of the permanent exhibition, came to an end. Work simultaneously began on installing a new exhibition to mark the 80th anniversary of central banking in the Czech Republic. This exhibition was officially opened at the end of the first quarter of 2006.

Further information is available on the CNB website at http://www.cnb.cz/cz/expozice_cnb/.

SPECIAL LIBRARY

The CNB's special library has a long tradition and provides services to CNB employees and to the professional public. Its highly specialised collection offers information which is not available anywhere else, comprising literature on economics, law, computer technology, politics and history, as well as encyclopaedias, language textbooks and biographies of prominent personalities. A collection of current books and periodicals is deposited in the reading room and is freely accessible to all users. Overall, the library maintains and provides access to more than 48,000 books and research reports and 1,300 periodicals, daily newspapers and items of grey literature, representing about 200,000 copies in total. In 2005, the library acquired 2,860 books and research reports and about 8,000 periodicals and grey literature items. Users have access to a whole range of electronic information sources in the reading room.



In 2005, the library continued expanding its electronic reading-room, allowing users to search for information from all available sources. The proportion of periodicals in electronic form and access to various databases increased to the detriment of printed periodicals. A collection of electronic books by renowned world publishers of special literature was also made available. In addition to the basic lending services, the library provides advisory and reference services and bibliographic and research services. The library is open Monday to Thursday from 9 a.m. to 5 p.m. and Friday from 9 a.m. to 3 p.m. People can also obtain information through the library's

website http://www.cnb.cz/cz/knihovna_cnb/ or directly from its online catalogue <http://sd.ruk.cuni.cz/tinweb/cnbbanka/k6>, and can reserve books, extend borrowing periods, etc. by e-mailing lib@cnb.cz.

The expansion and improved service quality have met with a favourable response from the public, as reflected in further growth in the number of visitors and borrowings. In 2005, the library registered 3,423 active readers, who made 16,118 visits and borrowed 22,830 publications.

CONGRESS CENTRE

The Czech National Bank's Congress Centre is located in the historic former Commodity Exchange on Senovážné Square. The Commodity Exchange Palace was built between 1893 and 1895 in the neo-Renaissance style by Bedřich Ohman and Rudolf Krighammer. In 1928–1929, the building was modernised and an functionalist extension designed by Bohumil Hypšman was added. The building, which the CNB bought in 1994 in a very bad technical condition and subsequently completely reconstructed and modernised in 1996–2000, is listed in the National Directory of Historical Monuments. In addition to the Congress Centre, it houses a special library open to the public, the CNB training complex (which includes language and computer classrooms) and catering facilities.



The Congress Centre consists of a Large Hall seating up to 360 people, a Small Hall with a seating capacity of 70, a common foyer and essential technical facilities. The halls are fully equipped with multi-media technology and can host international events with interpreting into numerous languages, data projection and connection to international networks (video conferences, on-line presentations, etc.). The Czech National Bank uses the Congress Centre chiefly for domestic and international conferences, seminars, educational events, social gatherings and regular press conferences. The major events organised last year included a World Bank seminar entitled The Results of Bank Insolvency Management and the Assessment of Corporate Governance, the CNB Research Open Day, a conference of personnel directors of the European System of Central Banks, a cycle of training seminars on the new Basel II capital accord and a workshop of ESCB facility managers. However, the premises are not only used by the Czech National Bank, but are rented out to institutions such as economic universities, the Liberal Institute, the Czech Economic Society and the Czech Banking Association for economic conferences and seminars. For example, the Macroeconomic Workshop given by Professor Prescott and the traditional Economic and Banking Forum, attended by many prominent

representatives of banks and financial institutions from around the world, met with great interest.

The Congress Centre, however, is not solely a venue for conferences and seminars. It also hosts important social events, for example the official ceremony held by the Embassy of the Grand Duchy of Luxembourg to mark the end of the Luxembourg Presidency of the EU. Its excellent acoustics have made the Large Congress Hall popular with music lovers. Concerts of the Prague Spring and Young Prague international music festivals and the autumn Prague Chamber Music Festival are performed here regularly. Last year, for example, the Centre hosted concerts given by the celebrated Czech violinists Václav Hudeček and Pavel Šporcl. The Prague Chamber Philharmonic Orchestra gave a concert here devoted to the 200th anniversary of the Battle of the Three Emperors at Austerlitz, performing, among other works, Beethoven's famous Eroica Symphony.

The CNB's cultural activities are not limited to classical music concerts, but also include exhibitions of photographs in the foyer of the Congress Centre. An exhibition entitled *Gold Collection – Part I*, consisting of photographs from the National Museum of Photography in Jindřichův Hradec and presenting a cross-section of Czech 20th century photography, opened in 2005. Another fascinating exhibition was *Madonnas and Demons* by the well-known Czech photographer Ludvík Baran, which was devoted to folk costumes and carnival masks from various regions of the Czech Republic and Slovakia. In the second half of the year, visitors had the opportunity to view a *Ten Centuries of Architecture* exhibition, held to mark the completion of an issue of ten gold commemorative coins with motifs of well-known Czech monuments – starting with the Romanesque rotunda in Znojmo, through the Renaissance palace in Litomyšl to the contemporary "Dancing House" in Prague.



Further information is available on the CNB website at www.cnb.cz/ocnb_sidlo_kcentrum.php.

THE CNB AND ITS PEOPLE



The basis of the CNB's success is human capital, which the CNB strives constantly to improve:

...The human resources area is of key significance, since successful fulfilment of the challenges in the period ahead will depend on the quality, knowledge and motivation of each member of staff. Up until now, personnel work has focused on acquiring people with the required qualifications in areas of central banking in the market economy. It has also been necessary to stabilise central bank staffing in the competitive environment of the developing commercial banking sector. The target for the future is to develop the professionalism of CNB staff members and motivate them to cope with a qualitatively different period of CNB operation...

Challenges for the Czech National Bank in the Years Ahead

Number of employees

At the end of 2005, the CNB had 1,415 employees, down by 304 compared to ten years ago. A personnel audit conducted in 2005 resulted in the abolition of 84 posts, from which employees are gradually being released (between October 2005 and May 2006). The resulting decrease in the workforce will thus manifest itself in both 2005 and 2006.

Number of positions and actual number of employees



In 2004, a total of 77 new employees were taken on and 97 people terminated their employment. In 2005, the respective figures were 85 and 143, of whom 24 retired. The number of employees who had left the bank by the end of 2005 as a result of the personnel audit was 35. The recruitment of new employees generally takes the form of headhunting and written job applications, or of directly approaching selected students in their final years at university, or of taking on job applicants proposed by labour offices, and to a lesser extent of job advertisements, tenders and selection procedures. Employment is preceded by a demanding interview with the applicant to verify his or her professional qualifications and personal attributes.

Level of education of CNB employees

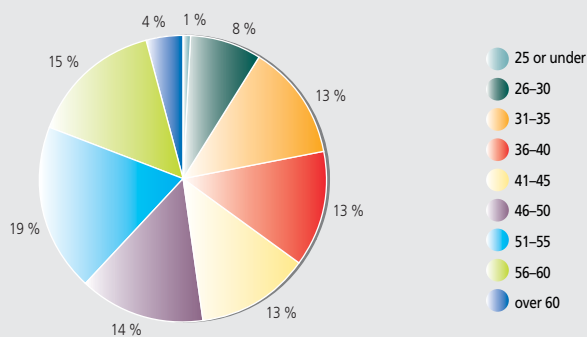
As of 31 December 2005, university graduates made up 42% of the total CNB workforce, while employees with secondary school education (ending with a school leaving exam) and higher vocational training recorded a 41.7% share. The remaining 16.3% had basic education or vocational training (without a school leaving certificate).

Age structure and proportion of men and women

Disregarding the extreme age ranges (i.e. 25 years or under, and over 60 years), the age structure of CNB's employees is balanced, with all age groups evenly represented. The average age of the CNB's employees as of 31 December 2005 was 44.6 years.

The ratio between men and women employed at the CNB has gradually been equalising and has stabilised at approximately 47:53 since the fundamental reorganisation in 1998.

Age structure of employees as of 31 December 2005



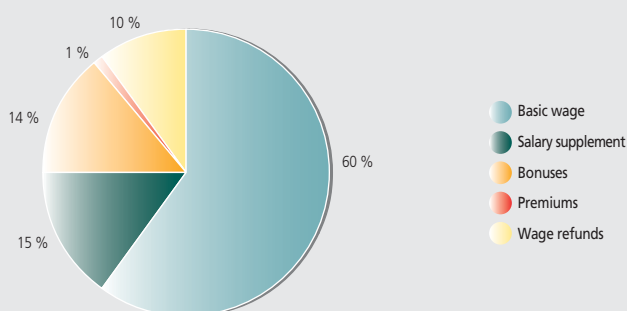
Proportion of men and women



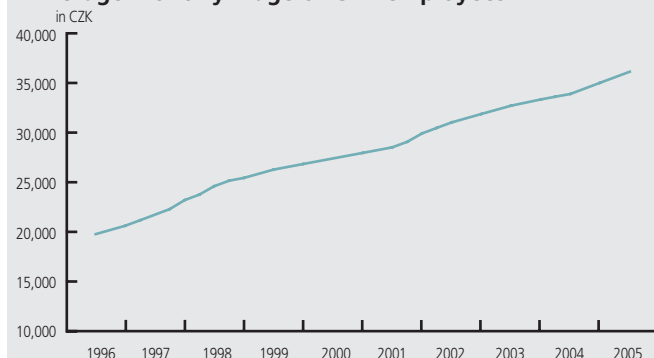
Salary system

The main component of the CNB's salary system is the basic wage, which is based on a sliding scale. Another component is the salary supplement, amounting to 25% of the basic wage, which is intended to compensate CNB employees in part for the limits imposed on them by the Labour Code. Employees can be given performance-related bonuses.

Shares of wage components in total wages paid in 2005



Average monthly wage of CNB employees



Personnel expenses totalled CZK 891 million in 2005, up by 3.5% on a year earlier. A total of CZK 627 million was paid in salaries, i.e. 4.6% more than in 2004. The average monthly wage was CZK 36,021. The average annual wage increase was 5.8%. Statutory insurance payments amounted to CZK 219 million. Other social costs totalled CZK 18 million. The largest part of these costs comprised life insurance and pension scheme contributions provided to employees.

The salaries of Bank Board members were as follows:

	Gross CZK ¹	Net CZK ²
Zdeněk Tůma	3,639,248	2,229,089
Luděk Niedermayer	2,995,472	1,839,543
Miroslav Singer	2,577,849 ³	1,584,543 ³
Michaela Erbenová	2,530,927	1,569,638
Jan Frait	2,521,605	1,564,092
Robert Holman	2,176,936 ³	1,354,985 ³
Pavel Řežábek	2,204,004 ³	1,362,105 ³
Oldřich Dědek	2,123,972 ⁴	1,308,399 ⁴
Pavel Rácocha	1,792,858 ⁴	1,116,387 ⁴
Pavel Štěpánek	1,763,826 ⁴	1,099,112 ⁴

¹ The gross salary comprises the basic wage, the salary supplement (25% of the basic wage), holiday pay, performance-related bonuses and bonuses for working on non-working days.

² The net salary is the gross salary net of state health insurance contributions, social security contributions, state employment policy contributions and income tax (calculated from adjusted gross income, i.e. total monthly gross salaries less deductible items for the taxpayer) and including the tax benefit for dependent children.

³ Salary for the period starting with appointment to the post of Bank Board member on 13 February 2005.

⁴ The figure comprises the salary for the period of performance of the duties of Bank Board member until 12 February 2005, a bonus for the entire period of performance of these duties, compensation for the bar on working until the end of the "waiting time" (i.e. the period during which Bank Board members are obliged to remain CNB employees and not enter any other employment, owing to protection of the CNB's interests) and termination of employment at the CNB as of 31 May 2005, and compensation for claimed and unclaimed holiday entitlement.

Staff training

Staff training is one of the priorities of personnel work and encompasses a wide range of opportunities, from internal training organised within the CNB, through training provided by domestic external organisations, including university studies and language tuition, to training provided in other countries. In 2005, spending on employee training amounted to CZK 26 million.

Language training was focused on preparing employees for prescribed standardised language exams. A total of 428 employees were meant to have fulfilled this duty by the end of 2005, and 88% of them had done so as of this date. Some employees were exempted from this duty and the remainder (around 30 people) are expected to prove their language skills in the near future. Regardless of the duty to prove a language qualification, more than 60% of the employees at the CNB's headquarters (535 people) have a proven language qualification at level 1 or above within the meaning of Government Resolution No. 1088 of 6 November 2002.

As for foreign training, the CNB works mainly with partner central banks. Top-level training still consists of courses and seminars organised by international banking and financial institutions. 2005 saw a large increase in the proportion of training events held within the European System of Central Banks.

The bulk of the internal training events held in 2005 again consisted of specialised banking courses offered in the CNB's annual catalogue of training events.

FINANCIAL REPORT



REPORT OF INDEPENDENT AUDITORS

TO THE BANK BOARD OF THE CZECH NATIONAL BANK

We have examined whether the financial information presented in the section 5 of the Annual Report entitled Financial report (hereinafter “the Section”) of the Czech National Bank (hereinafter “the CNB”) for the year 2005, which does not form part of the audited financial statements, is consistent with the audited financial statements of the CNB as at 31 December 2005 and for the year then ended. In our opinion, the financial information included in the Section 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 2005 and for the year then ended which do not form part of the accompanying Annual report of CNB for the year 2005 was as follows:

“We have audited the accompanying balance sheet of the Czech National Bank (“the CNB”) as at 31 December 2005, the related income statement and notes for the year then ended (“the financial statements”). The financial statements, which include a description of the activities of the CNB in accordance with the Act on the Czech National Bank as amended, 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, International Standards on Auditing and related application guidance 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 management, as well as evaluating the overall financial statements 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 2005, 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.”

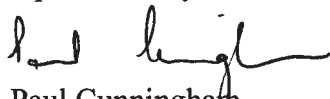
Czech National Bank
Report of Independent Auditors

The maintenance and integrity of the CNB's website is wholly the responsibility of the management of the CNB. The work undertaken by us does not include consideration of these matters and, accordingly, we accept no responsibility for any changes that may have occurred to the annual report since they were initially presented on the CNB's website. Legislation in the Czech Republic governing the preparation and dissemination of the annual report may differ from legislation in other jurisdictions.

30 March 2006

PricewaterhouseCoopers Audit, s.r.o.

PricewaterhouseCoopers Audit, s.r.o.
represented by


Paul Cunningham
Partner



Eva Loulová
Auditor, Licence No. 1981

INCOME STATEMENT AND BALANCE SHEET

Assets			
in CZK millions			
	31.12.2005	31.12.2004	
1. Gold	821	825	
2. Receivables from International Monetary Fund	29,146	31,611	
3. Receivables from foreign countries including securities	803,065	645,830	
3.1. Deposits at foreign banks	140,921	44,021	
3.2. Loans provided to foreign banks	34,031	21,235	
3.3. Securities	627,991	580,448	
3.4. Other receivables from foreign countries	122	126	
4. Receivables from domestic banks	29,050	70	
5. Receivables from clients	12,470	12,856	
6. Receivables from the state	8,683	22,435	
7. Fixed assets	6,135	6,319	
7.1. Tangible fixed assets	6,064	6,211	
7.2. Intangible fixed assets	71	108	
8. Other assets	5,970	4,231	
8.1. Prepayments and accrued income	23	20	
8.2. Other	5,947	4,211	
Total assets	895,340	724,177	

Liabilities			
in CZK millions			
	31.12.2005	31.12.2004	
1. Currency in circulation	287,762	261,430	
2. Liabilities to International Monetary Fund	24,210	22,159	
3. Liabilities to foreign countries	87,077	23,551	
3.1. Loans from foreign banks	86,669	23,145	
3.2. Other liabilities to foreign countries	408	406	
4. Liabilities to domestic banks	399,305	428,337	
4.1. Bank monetary reserves	17,249	20,311	
4.2. Repo operations	377,757	402,997	
4.3. Other liabilities	4,299	5,029	
5. Deposits from clients	68,094	57,573	
6. Domestic treasury bills issued	0	0	
7. Liabilities to the state	112,663	37,507	
8. Provisions	4,097	4,781	
9. Share capital	1,400	1,400	
10. Funds	8,044	8,075	
11. Revaluation reserve	-433	0	
12. Accumulated losses from previous periods	-125,670	-71,953	
13. Profit/loss for the accounting period	19,957	-53,717	
14. Other liabilities	8,834	5,034	
Total liabilities	895,340	724,177	

Off Balance Sheet			
in CZK millions			
	31.12.2005	31.12.2004	
1. Guarantees issued	166,018	166,102	
2. Receivables from spot, term and option transactions	109,672	129,599	
3. Liabilities from spot, term, option and reverse repo transactions	135,200	118,764	
4. Guarantees received	165,846	165,535	

Income Statement

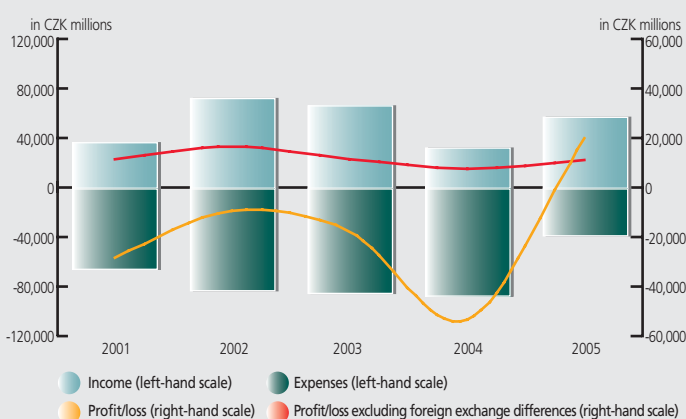
in CZK millions	31.12.2005	31.12.2004
1. Interest income and similar income	20,587	13,744
1.1. Interest from fixed income securities	17,173	12,243
1.2. Other	3,414	1,501
2. Interest expense and similar expense	11,819	11,597
2.1. Interest from fixed income securities	0	0
2.2. Other	11,819	11,597
3. Income from securities with variable income	45	46
4. Fee and commission income	430	419
5. Fee and commission expense	37	37
6. Gains less losses from financial operations	11,957	-55,104
7. Other income	625	112
7.1. Income from money issue	28	40
7.2. Other	597	72
8. Administration expenses	1,878	1,919
8.1. Personnel expenses	891	860
8.1.1. Wages and salaries	627	599
8.1.2. Social and health security	219	212
8.1.3. Training and other expenses	45	49
8.2. Other operating expenses	987	1,059
9. Other expenses	467	541
9.1. Expenses for issuing bank notes and coinage	170	261
9.2. Other	297	280
10. Charge for specific and general provisions for loans and guarantees	63	477
11. Utilisation and release of specific and general provisions for loans and guarantees and write-offs of loans	1,087	1,598
12. Charge for other specific and general provisions	510	1
13. Utilisation and release of other specific and general provisions and write-offs of other receivables	0	40
14. Ordinary profit/loss	19,957	-53,717
15. Extraordinary profit	0	0
16. Profit/loss for the period	19,957	-53,717

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

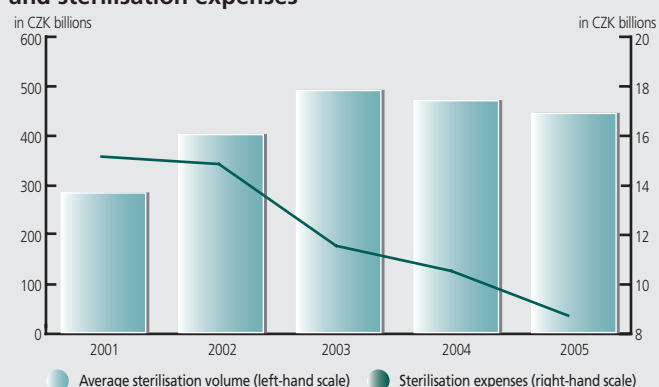
With income of CZK 56,877 million and expenses of CZK 36,920 million, the Czech National Bank made a profit of CZK 19,957 million in 2005.

Foreign exchange differences, which in past years had fundamentally influenced the final profit/loss of the CNB, had only a partial effect in 2005. As of 31 December 2005, they were positive to the tune of CZK 8,734 million. The exchange rate of the domestic currency developed differently against the two reserve currencies in the period under review. Against the euro the koruna appreciated from CZK/EUR 30.465 to CZK/EUR 29.005 year on year, while against the dollar it depreciated from CZK/USD 22.365 to CZK/USD 24.588. Overall, therefore, the foreign exchange losses on euro assets were fully offset

The CNB's performance 2001–2005



Comparison of the CNB's sterilisation volume and sterilisation expenses



by foreign exchange profits achieved on dollar assets. This area thus showed a profit for the first time in six years.

The CNB's international reserves amounted to CZK 727 billion at the end of 2005, up by CZK 91 billion on a year earlier. The main source of the increase was receipt of foreign currency deposits (EUR 1.5 billion) and purchase of foreign currency connected with the privatisation of Český Telecom (EUR 1.2 billion). Other factors included the sell-off of part of the returns realised in the previous period, market income on investment activities, client operations and the change in the koruna's exchange rate against both reserve currencies, i.e. the euro and the dollar.

The CNB's sterilisation expenses and operating costs were more than offset by international reserves management income. The total net return on international reserves management in 2005 was CZK 20,273 million. The average sterilisation volume fell by 5% year on year in 2005. Sterilisation expenses declined by CZK 1.7 billion year on year.

The prescribed reserve requirement, set at 2% of the base used for calculating the minimum reserves (i.e. the volume of the bank's primary liabilities with maturity up to two years), remained unchanged in 2005. The CNB paid commercial banks interest on minimum reserves totalling CZK 0.6 billion in 2005, i.e. CZK 0.1 billion less than in the previous year. The decline in interest expenses was associated with a fall in the repo rate at which the central bank pays interest on the minimum reserves.

The CNB's performance was also affected by a gradual termination of several cases relating to the consolidation of the banking sector. In its Resolution No. 51 of 22 January 1997, the Czech Government approved the issuing of a state guarantee of CZK 22.5 billion to the CNB for claims, guarantees issued and assets assumed in connection with the banking sector consolidation and stabilisation process for a period of 10 years. This state guarantee applies to the consolidation programme as a whole and not to losses on individual activities. The Czech Ministry of Finance made partial payments under this state guarantee of CZK 0.5 billion in 2004 and CZK 5 billion in 2005, so the outstanding amount at the end of 2005 was CZK 17 billion. Nevertheless, this does not cover the total expenses relating to the consolidation programme. The CNB has in the past therefore set aside provisions and reserves up to the total amount of the estimated expenses. The volume of the provisions is continuously updated on the basis of changes in the estimated return on these assets and as a result of repayments of the debts of banks in liquidation and partial satisfaction of the CNB's claims in bankruptcy proceedings.

Under an agreement on the settlement of operating costs and losses from assets assumed in relation to the consolidation programme, the CNB paid Česká finanční costs of CZK 147 million for 2005. Based on a preliminary quantification of the unrealised losses from the assets assumed, part of the reserve created to cover the losses of Česká finanční was released. This meant that the outstanding amount of this reserve was CZK 3,815 million at the end of 2005. Specific loans to Česká finanční totalling CZK 4,054 million were recorded. The CNB received interest on these loans totalling CZK 112 million.

In 2005, the Czech Consolidation Agency (CCA) repaid to the CNB in full a redistribution loan provided to fund a co-operative housing scheme. In connection with this, the CNB released into income general provisions totalling CZK 348 million created in the past and posted interest received for 2005 totalling CZK 169 million.

In relation to its clients, the CNB recorded a profit of CZK 1,218 million. The Czech National Bank's financial results were affected on the income side primarily

by fees from the conversion of a portion of the privatisation revenues of around CZK 1 billion from the sale of Český Telecom (the fees charged arise under an agreement signed in the past between the CNB and the Czech Government relating to the strategy for dealing with the foreign exchange effects of capital inflows from privatisation of state property and from other foreign exchange revenues of the state). The costs related mainly to interest paid to the state budget and to the National Property Fund (funds deposited on the central bank's accounts).

The CNB purchased a total of 51 million banknotes at a cost of CZK 114 million. A total of 47 million base metal coins and silver and gold commemorative coins were supplied. The CNB purchased these for CZK 54 million. There were also costs for the preparation and protection of banknotes and coins (development of new security features). In 2005, as in previous years, the total banknote and coin acquisition costs declined. This was partly due to the fact that there were sufficient reserves of some denominations, hence it was not necessary to order their production in the same volumes as in previous years, and partly to the fact that 10-heller and 20-heller coins ceased to be legal tender. Income in the area of currency circulation and management was CZK 28 million, linked primarily with the sale of numismatic material.

In the area of operations, the CNB made a net loss of CZK 1,952,000, down by CZK 46 million year on year.

An increase in personnel costs (chiefly wages and salaries, obligatory insurance contributions and training) was fully offset by a decline in administration expenses and premises and equipment running costs.

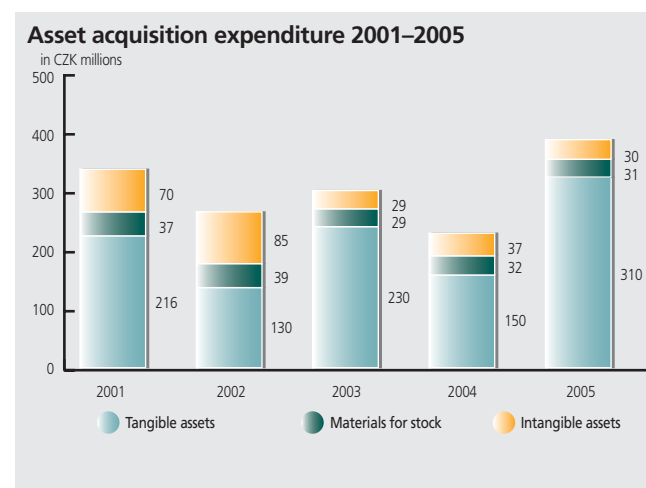
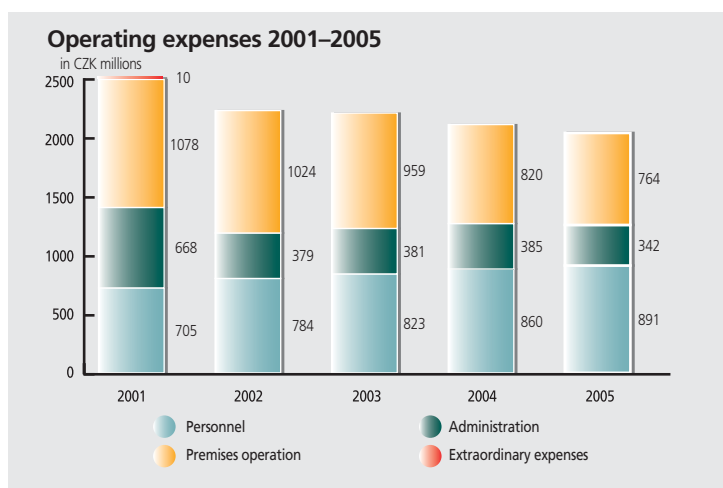
The bank paid out CZK 627 million (i.e. 4.6% more than in 2004) in wages, salaries and severance pay and in connection with employment contracts and service contracts with external employees. It also paid out CZK 217 million in statutory insurance payments.

The CNB spent a total of CZK 1,106 million on administration expenses and premises and equipment running costs (net of provisions for operating claims). This represented a decline of CZK 99 million year on year, due mostly to depreciation of tangible and intangible fixed assets (a year-on-year decline of CZK 47 million owing to a higher rate of depreciation of the bank's assets), value added tax (a decrease of CZK 30 million) and the gradual termination of sales of non-operating assets.

The long-term decline in operating expenses is associated, inter alia, with consistent application of the principles of optimising the bank's scope of activities and cost-effectiveness, while maintaining the quality of the services provided. In 2005 the CNB was particularly successful in cutting its IT repair and maintenance costs, advisory and typographical costs, premises technical support expenses, travelling expenses, food purchase costs and expenditure on repair and maintenance of cash handling equipment. This decrease offset increases in operating services and energy prices. Outsourcing of services was one of the successful optimisation tools in the facility management area. Act No. 40/2004 Coll., on Public Orders, which has been incorporated into the CNB's internal regulations, is consistently enforced in the procurement area. Particular emphasis is placed on transparency of procedures.

In 2005, CZK 371 million was spent on asset acquisition, i.e. CZK 152 million (69%) more than in 2004. This increase was due to higher expenditure on tangible assets (up by 107%), linked in particular with the building of the CNB's back-up centre and with the acquisition (upgrading) of cash storage, handling and processing equipment. Expenditure on materials for stock was down by 3%. A decline of

19% was also recorded for acquisition of intangible assets, particularly software. A considerable decline in asset acquisition expenditure is expected in 2006 (approximately to the 2002 level), owing to the completion of the CNB's back-up centre and the completion of the upgrading of banknote counting and processing equipment at CNB branches. This expenditure should decline further in 2007.



Note: Administration expenses realised between 2001 and 2005 are adjusted for provisions created by the CNB for operating claims (arising mainly from contractual penalties applied against the bankrupt PS – Zlín Group, a.s.)

October 2005 saw the completion of a Supreme Audit Office audit focusing on expenditure on asset acquisition and CNB operations, which started in November 2004. The audit revealed no systemic problems in the CNB's internal finances or tendering procedures.

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CZECH NATIONAL BANK
NOTES TO FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2005

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CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

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 which lead 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 inter-bank settlements, maintains the inter-bank settlement systems to ensure their fluency and efficiency, supervises the activities of banks and branches of foreign banks and sees to the safe functioning and development of the banking system in the CR. The Bank also performs management of foreign currency reserves and 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 organisations and international organisations involved in the supervision of banks and financial markets.

When carrying out its business, the Bank is independent of any instruction given by the President of the CR, the Czech Parliament, the Czech Government and administrative or other authorities and its relationship to the Chamber of Deputies of the Czech Parliament is defined by the law. The Bank and the Government communicate with each other about the principles and measures of monetary and general economic policy.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

1 GENERAL INFORMATION (continued)

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

On 12 February 2005, the term of four Bank Board members expired so that the President of the Czech Republic re-appointed the governor and appointed new Bank Board members on 11 February 2005. As at 31 December 2005, the members of the Bank Board were as follows (including information regarding the end of their term):

Mr. Zdeněk Tůma	Governor	until 12 February 2011
Mr. Miroslav Singer	Vice-Governor	until 12 February 2011
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. Robert Holman	member	until 12 February 2011
Mr. Pavel Řežábek	member	until 12 February 2011

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 the 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 is not certain. The Bank Board is monitoring the situation so that appropriate action, consistent with the Bank's statutory objectives, can be taken should it be necessary.

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

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

2 ACCOUNTING POLICIES

(a) Basis of preparation

The financial statements, comprising a balance sheet, statements of income and accompanying notes including statement of changes in equity, are prepared in accordance with the Act on accounting (Act No. 563/1991 Col. as amended), decrees and Czech Accounting Standards for financial institutions issued by the Ministry of Finance of the CR. The financial statements are prepared under the historical cost convention as modified by the revaluation of financial instruments at fair value through profit or loss and available-for-sale to fair values. The financial statements are prepared according to the 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 of CNB were prepared to give a true and fair view of its financial transactions and the results of its operations. The financial statements are rounded to millions of Czech Crowns (hereinafter "CZK") unless otherwise stated. The Bank is not required to prepare consolidated financial statements according to the decree no. 501/2002 as amended issued by the Ministry of Finance.

(b) Foreign currencies and Special Drawing Rights

Transactions in foreign currencies are translated to CZK at the foreign exchange rate effective at the transaction date. Assets and liabilities denominated in foreign currencies (including Special Drawing Rights (Note 2(g)), including all unsettled committed spot or term purchases and sales of foreign currencies, are translated to CZK at the exchange rate effective as at the balance sheet date. All resulting realised and unrealised foreign exchange gains and losses are recognised in the income statement in the gains less losses from financial operations except for foreign exchange gains and losses from equity securities in available-for-sale portfolio which are recognised in equity since 15 January 2005 (Note 2(d)). Previously all such gains and losses were recognised in the statement of income.

(c) Gold and other precious metals

Gold and other precious metals are valued at historic cost. Deposits and securities denominated and payable in gold, which the CNB intends to hold to maturity, are included in the gold balance and valued at historical cost. Interest income resulting from the interest bearing securities and deposits denominated in gold is accrued.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

2 ACCOUNTING POLICIES (continued)

(d) Securities

The Bank classified all its fixed income securities as available-for-sale securities. The CNB does not hold securities valued at fair value through profit or loss. Shares other than investments in subsidiary or associated undertakings are included in other assets. Securities transactions are recorded on a settlement date basis.

Foreign securities are purchased in relation to the foreign currency reserves administration, in accordance with predefined rules set by the Bank Board. They consist of money market and capital market securities.

Treasury bills, other discounted securities and bonds are stated at fair value. Treasury bills, other discounted securities and bonds are originally recorded at cost. Interest income is accrued based on the difference between the purchase price and the nominal value using effective yield method (amortised cost). The difference between fair value and amortised cost is recorded in equity.

The effective interest rate is the rate that exactly discounts estimated future cash receipts through the expected life of the security to the net carrying amount of the security.

Cost of the securities at the initial recognition includes expenses incurred in connection with their acquisition.

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, in the absence of any other measure the historical cost less impairment;
- the risk adjusted net present value of cash flows for debt securities and notes.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

2 ACCOUNTING POLICIES (continued)

(d) Securities (continued)

Since 1 January 2005 subsequent gains and losses arising from changes in the fair value of available-for-sale securities are recognised directly in equity until the financial asset is derecognised or impaired at which time the cumulative gain or loss previously recognised in equity should be recognised in the income statement. In 2004, changes in the fair value of available-for-sale securities were recognised in the income statement. Comparative figures were not restated as required by Czech accounting rules. Interest calculated using the effective interest rate method, dividends and foreign exchange differences on debt securities are recognised in the income statement. Foreign exchange differences on equity securities are recognised in the revaluation reserve in equity. Dividends received are included in income from securities with variable income.

Disposals of debt securities are valued at the weighted average cost of the amortised costs.

During 2005 and 2004, the Bank did 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 cash-flows are recorded as received or provided 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. The Bank recognises the amount of currency in issue, decreased by the cash in hand, denominated in CZK.

(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 (hereinafter the “SDR”) and is translated to CZK at the rate advised by the IMF on a yearly basis.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

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 as collateral in repo operations with domestic banks.

(i) Derivative financial instruments

Derivative financial instruments including foreign exchange contracts, interest rate futures, currency and interest rate swaps and other derivative financial instruments are initially recognised on the balance sheet at cost and subsequently are re-measured at their fair value. Fair values of futures are obtained from quoted market prices, in other cases the market value is derived from discounted cash flow models. Fair values of derivatives are presented in other assets or in other liabilities when they are positive or negative respectively. The Bank does not apply hedge accounting. Changes in the fair value of derivatives are included in the gains less losses from financial operations.

(j) Interest income and expense

Interest income and expense are accrued using a linear yield method for loans and deposits. Interest income for available-for-sale securities is calculated using an effective yield method derived from purchase price. Accrued interest is recorded together with 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 recognition is suspended in case of a debtor's default and excluded from interest income until received. Non-interest earning assets, such as long-term receivables are not discounted.

Interest expense includes interest expense from loans and deposits received.

(k) Fee and commission income

Fee and commission income from the maintenance of current accounts and other services are generally recognised on an accrual basis when the service has been provided, usually monthly. One-off fees are recognised immediately in the income statement when earned.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

2 ACCOUNTING POLICIES (continued)

(l) Receivables

Receivables originated by the Bank are stated at nominal value less allowances. Irrecoverable receivables are written off upon completion of bankruptcy proceedings against the debtor.

(m) Provisions

Provisions 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. These provisions are recognised in liabilities.

Additions to provisions are recognised in the income statement, their utilisation is recognised together with expenses or losses, for which purpose they were created in the income statement. Release of provisions in case they are no longer necessary is recognised as income.

When creating provisions 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 (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. In addition, general provision for standard loans recorded prior to 1 January 2002 was recognised in the balance sheet, however, this provision was released to income in 2005 (Note 7).

(n) Specific provisions for impairment

Specific provisions adjust the book value of individual assets at risk. The amount of specific provisions for loans and other assets at risk is based on appraisals of these assets at the balance sheet date including collateral.

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. When creating specific provisions for assets at risk related to the consolidation of the banking sector, the guarantees issued by the Czech Government that cover these assets were taken into consideration (Note 30).

Specific provisions and provisions are not discounted for the effects of expected timing of cash flows.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

2 ACCOUNTING POLICIES (continued)

(n) Specific provisions for impairment (continued)

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

(o) 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") and are depreciated / amortised by applying the straight-line basis of depreciation over the estimated useful lives following annual rates stated below.

If usage of intangible fixed assets is limited by contract, the intangible fixed assets are amortised over the contractual period. Low value tangible fixed assets with a unit cost of more than CZK 2,000 and less than or equal to CZK 40,000, as well as 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.

Tangible and intangible fixed assets are depreciated as follows:

Buildings and constructions	30 years
Furniture and fittings	5 – 6 years
Motor vehicles	4 years
Office equipment and computers	3 – 4 years
Software	3 – 4 years
Other intangible assets	6 years

In the 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 cost of the property.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

2 ACCOUNTING POLICIES (continued)

(p) 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 affect taxable supplies liable to VAT; apart from this the allowance reduced by coefficient according to Paragraph 76 of the VAT Act is claimed.

(q) 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 or deferred tax. The income of the Bank is used to cover necessary operating expenses. Profit after allocations to funds and other budgeted usage is transferred to the state budget.

(r) Staff costs, pensions and social fund

Staff costs are included in Administration expense and they also include the Bank Board emoluments.

The Bank does not administer its own pension fund but operates defined contribution schemes for its employees, administrated by commercial pension funds. Contributions paid by the Bank are accounted for directly as an expense.

Regular contributions are made to the state budget to fund the national pension plan.

The CNB creates a social fund to finance the social needs of its employees and the employees' programme. The allocation to the social fund is not recognised in the income statement, but as a transfer between funds. Similarly, the usage of the social fund is not recognised in the income statement, but as a decrease of the fund.

(s) 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.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

2 ACCOUNTING POLICIES (continued)

(t) 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 the financial statements which are indicative of conditions that arose subsequent to the balance sheet date, the effects of these events are disclosed, but are not themselves reflected in the financial statements.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

3 GOLD

	<u>31 December 2005</u>	<u>31 December 2004</u>
	CZK million	CZK million
Gold in total	<u>821</u>	<u>825</u>

Gold as at 31 December 2005 includes a gold bond issued by the International Bank for Reconstruction and Development with maturity on 15 December 2007, at the book value of CZK 283 million (31 December 2004: CZK 283 million). The nominal value of the purchased bond was 150,115 oz of gold and the market value of this gold as at 31 December 2005 was CZK 1,905 million (31 December 2004: CZK 1,460 million).

The total market value of gold as at 31 December 2005 was CZK 5,527 million (31 December 2004: CZK 4,254 million).

4 RECEIVABLES AND PAYABLES FROM/TO IMF

	<u>31 December 2005</u>	<u>31 December 2004</u>
	CZK million	CZK million
Membership quota at IMF	24,499	22,277
Deposits in IMF	<u>4,647</u>	<u>9,334</u>
Total receivables from IMF	<u>29,146</u>	<u>31,611</u>
Liability to IMF	17,347	20,009
Current account IMF	<u>6,863</u>	<u>2,150</u>
Total payables to IMF	<u>24,210</u>	<u>22,159</u>

The membership quota at the IMF is denominated in SDR and financed by bills of exchange payable on any request issued by the Czech Government and co-accepted by the CNB.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

5 RECEIVABLES FROM FOREIGN COUNTRIES INCLUDING SECURITIES

	<u>31 December 2005</u>	<u>31 December 2004</u>
	CZK million	CZK million
Current accounts with banks	1,480	30
Deposits	<u>139,441</u>	<u>43,991</u>
Total deposits at foreign banks	140,921	44,021
Total loans provided to foreign banks	34,031	21,235
Treasury bills and other discounted securities	179,239	209,064
Bonds and other coupon securities	<u>448,752</u>	<u>371,384</u>
Total securities	627,991	580,448
Cash in foreign currencies	<u>122</u>	<u>126</u>
Total other receivables from foreign countries	122	126
Total receivables from foreign countries including securities	<u>803,065</u>	<u>645,830</u>

Foreign banks are banks with residence abroad. Foreign banks do not include branches of foreign banks with residence in the Czech Republic.

Loans provided to foreign banks

Loans provided to foreign banks consist only of reverse repo operations. Securities received 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.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

**5 RECEIVABLES FROM FOREIGN COUNTRIES INCLUDING SECURITIES
(continued)**

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

	<u>31 December 2005</u>		<u>31 December 2004</u>	
	CZK million	%	CZK million	%
Euro zone	84,267	48	20,415	31
Great Britain	56,508	32	22,534	35
Other European countries	25	-	22	-
USA and Canada	853	1	13,673	21
Japan	33,420	19	8,730	13
Other countries	<u>1</u>	<u>-</u>	<u>8</u>	<u>-</u>
	<u>175,074</u>	<u>100</u>	<u>65,382</u>	<u>100</u>

Treasury bills and other discounted securities (Assets Balance sheet line 3.3.)

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

	<u>Fair value</u> <u>31 December 2005</u>	<u>Fair value</u> <u>31 December 2004</u>
	CZK million	CZK million
Treasury bills	84,591	107,363
Other discounted securities	<u>94,648</u>	<u>101,701</u>
Total treasury bills and other discounted securities	<u>179,239</u>	<u>209,064</u>

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

**5 RECEIVABLES FROM FOREIGN COUNTRIES INCLUDING SECURITIES
(continued)**

Geographic sector risk concentrations within treasury bills and other discounted securities

	<u>31 December 2005</u>		<u>31 December 2004</u>	
	CZK million	%	CZK million	%
Euro zone	78,689	44	60,676	29
Great Britain	16,090	9	4,557	2
Switzerland	13,058	7	19,431	9
USA and Canada	33,841	19	46,336	22
Japan	25,062	14	68,233	33
Other countries	<u>12,499</u>	<u>7</u>	<u>9,831</u>	<u>5</u>
	<u>179,239</u>	<u>100</u>	<u>209,064</u>	<u>100</u>

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

Bonds and other coupon securities can be analysed as follows:

	<u>Fair value</u> <u>31 December 2005</u> CZK million	<u>Fair value</u> <u>31 December 2004</u> CZK million
State bonds	281,865	223,890
Other foreign bonds (bonds issued by foreign financial institutions)	<u>166,887</u>	<u>147,494</u>
Total bonds and other coupon securities	<u>448,752</u>	<u>371,384</u>

Bonds and other coupon securities reported as at 31 December 2005 and 2004 include solely fixed income securities.

Geographic sector risk concentrations within bonds and other coupon securities

	<u>31 December 2005</u>		<u>31 December 2004</u>	
	CZK million	%	CZK million	%
Euro zone	233,425	52	246,094	66
Great Britain	3,512	1	4,902	1
USA and Canada	<u>211,815</u>	<u>47</u>	<u>120,388</u>	<u>33</u>
	<u>448,752</u>	<u>100</u>	<u>371,384</u>	<u>100</u>

CZECH NATIONAL BANK**NOTES TO FINANCIAL STATEMENTS****FOR THE YEAR ENDED 31 DECEMBER 2005****6 RECEIVABLES FROM DOMESTIC BANKS**

	<u>31 December 2005</u> CZK million	<u>31 December 2004</u> CZK million
Receivables from reverse repo transactions	29,002	-
Non-performing loans	14	14
Loans provided by European Investment Bank (hereinafter the "EIB") funds (Note 12)	<u>48</u>	<u>70</u>
	29,064	84
Specific provisions against receivables from domestic banks (Note 18)	<u>(14)</u>	<u>(14)</u>
Total net receivables from domestic banks	<u>29,050</u>	<u>70</u>

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.

7 RECEIVABLES FROM CLIENTS

	<u>31 December 2005</u> CZK million	<u>31 December 2004</u> CZK million
Standard loans	4,153	4,539
Classified loans	<u>17,057</u>	<u>17,397</u>
	21,210	21,936
Specific provisions for classified loans (Note 18)	<u>(8,740)</u>	<u>(9,080)</u>
Total net receivables from clients	<u>12,470</u>	<u>12,856</u>

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

7 RECEIVABLES FROM CLIENTS (continued)

Classified loans

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

	<u>31 December 2005</u>	<u>31 December 2004</u>
	CZK million	CZK million
Loss loans	17,057	17,397
Specific provisions (Note 18)	<u>(8,740)</u>	<u>(9,080)</u>
Net book value	<u>8,317</u>	<u>8,317</u>

The net book value and fair value of classified loans reflects the guarantee received from the Czech Government (Note 30).

Classified loans include a portfolio of receivables from Agrobanka Praha, a.s., v likvidaci of total gross amount of CZK 5,004 million as at 31 December 2005 (31 December 2004: CZK 5,204 million). A specific provision of CZK 5,004 million as at 31 December 2005 was created against this receivable (31 December 2004: CZK 5,204 million).

Excluding specific provisions for classified loans, the Bank created a general provision for standard loans of CZK 348 million (Note 18) as at 31 December 2004. The provision was released to income in 2005 as required by Czech accounting rules (Note 2(m)).

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

8 RECEIVABLES FROM THE STATE

	<u>31 December 2005</u>	<u>31 December 2004</u>
	CZK million	CZK million
Redistribution loans	-	8,752
Receivables from the state arising from an exercised state guarantee	<u>8,683</u>	<u>13,683</u>
Total receivables from the state	<u>8,683</u>	<u>22,435</u>

Redistribution loans

Long-term redistribution loans were provided to former 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 cooperative housing scheme. Česká konsolidační agentura fully repaid the loan in 2005.

Receivables from the state arising from an exercised state guarantee

As a result of the consolidation of the banking sector, the CNB had a receivable from a former bank covered by the state guarantee (Note 30). Since the liquidation of this former bank was finished and the bank was deleted from the Commercial register, this receivable does not exist any more and the CNB claimed under the state guarantee. This claim is disclosed within receivables from the state. In 2005, the CNB received partial repayment from the Ministry of Finance of CZK 5,000 million (in 2004: CZK 500 million).

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

9 FIXED ASSETS

Tangible fixed assets

	31 December <u>2004</u> CZK million	<u>Additions</u> CZK million	<u>Disposals</u> CZK million	31 December <u>2005</u> CZK million
<u>Cost</u>				
Land	174	22	-	196
Buildings	6,831	14	(31)	6,814
Technical equipment	2,776	161	(163)	2,774
Equipment	332	5	(5)	332
Other	435	3	(4)	434
Tangible assets in the course of construction	23	174	(183)	14
Advance payments for tangible assets	<u>2</u>	<u>196</u>	<u>(37)</u>	<u>161</u>
Total cost	<u>10,573</u>	<u>575</u>	<u>(423)</u>	<u>10,725</u>
<u>Accumulated depreciation</u>				
Buildings	(1,468)	(229)	8	(1,689)
Technical equipment	(2,206)	(221)	162	(2,265)
Equipment	(287)	(24)	4	(307)
Other	<u>(401)</u>	<u>(3)</u>	<u>4</u>	<u>(400)</u>
Total accumulated depreciation	<u>(4,362)</u>	<u>(477)</u>	<u>178</u>	<u>(4,661)</u>
Net book amount	<u>6,211</u>			<u>6,064</u>

The original cost of low value tangible fixed assets that have been fully depreciated when put into use in 2005 was CZK 3 million (2004: CZK 21 million).

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

9 FIXED ASSETS (continued)

Intangible fixed assets

	31 December <u>2004</u> CZK million	<u>Additions</u> CZK million	<u>Disposals</u> CZK million	31 December <u>2005</u> CZK million
<u>Cost</u>				
Software	1,166	31	(1)	1,196
Other intangible assets	6	1	-	7
Intangible assets not yet put into use	9	32	(32)	9
Advance payments for intangible assets	<u>-</u>	<u>1</u>	<u>(1)</u>	<u>-</u>
Total cost	<u>1,181</u>	<u>65</u>	<u>(34)</u>	<u>1,212</u>
<u>Accumulated amortisation</u>				
Software	(1,071)	(68)	1	(1,138)
Other intangible assets	<u>(2)</u>	<u>(1)</u>	<u>-</u>	<u>(3)</u>
Total accumulated amortisation	<u>(1,073)</u>	<u>(69)</u>	<u>1</u>	<u>(1,141)</u>
Net book amount	<u>108</u>			<u>71</u>

The original cost of low value intangible fixed assets that have been fully amortised when put into use in 2005 was CZK 1 million (2004: CZK 0.9 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

FOR THE YEAR ENDED 31 DECEMBER 2005

10 OTHER ASSETS

	<u>31 December 2005</u>	<u>31 December 2004</u>
	CZK million	CZK million
Accrued income	23	20
Advances in relation to the Indemnity letter (Note 30)	2,430	2,744
Other advances in relation to the consolidation of the banking sector	56	69
Other foreign financial assets	2,985	404
Other precious metals	18	18
Positive fair value of foreign currency forwards (Note 25)	364	877
Margin account including fair value of futures (Note 25)	53	18
Other	<u>1,125</u>	<u>655</u>
	7,054	4,805
Specific provisions to advances and other assets (Note 18)	<u>(1,084)</u>	<u>(574)</u>
Total other assets	<u>5,970</u>	<u>4,231</u>

The Bank discloses its share on European Central Bank's (hereinafter only "ECB") share capital within other foreign financial assets. The Czech Republic joined the European Union on 1 May 2004 and consequently the CNB became a member of the European system of central banks (hereinafter only "ESCB"). In line with the article 28 of the Statute of European central banks and European central bank (hereinafter only "Statute"), the CNB became a shareholder of the ECB. The membership share is set in line with the Article 29.3. of the Statute and must be adjusted every 5 years. The share of the Czech Republic, 1.4584%, was calculated according to the Article 29 of the Statute based on the population and gross domestic product. The Czech Republic is not a member of the Euro zone, so transition provisions included in the Article 48 of the Statute are applied and the CNB paid the contribution of 7% from its share on subscribed share capital in the total amount of EUR 5.7 million. The residual part will be paid after the accession of the Czech Republic into the Euro zone.

The CNB's investments in BIS and SWIFT are also disclosed in other foreign financial assets. The shares of BIS and SWIFT are non-tradable and their holding results from the participation of the CNB in these institutions.

The shares in ECB and SWIFT are measured at cost less any impairment other than temporary.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

10 OTHER ASSETS (continued)

At 31 December 2005 the shares in BIS are measured at CNB's share on the paid up portion of BIS net assets (or equity) reduced by 30%, which reflects the valuation of shares used by BIS. Arising revaluation difference including foreign exchange difference was included in revaluation reserve in equity. As at 31 December 2004, the shares in BIS was valued at cost revalued for the impact of foreign exchange differences that were recognized in the income statement (Note 2(b)).

Within other assets, the Bank disclosed its shares in Agrobanka Praha, a.s. v likvidaci, Kreditní banka Plzeň, a.s. – v likvidaci and BH CAPITAL, a.s., transferred free of charge from Československá obchodní banka, a.s. (hereinafter "CSOB") to the CNB, in compliance with the Agreement and Indemnity Letter (hereinafter the "Indemnity Letter") in 2002 (Note 30).

Within other assets, the Bank also discloses its shares in EKOAGROBANKA, a.s. v likvidaci and COOP Banka, a.s. v likvidaci, purchased in 2004 from Česká finanční, s.r.o. (hereinafter "CF") within the Consolidation programme under the conditions, which did not cause a financial loss to the CNB. These shares are not treated as investments in subsidiaries, because in the opinion of representatives of the Bank, it is the liquidator and not the general meeting who makes decisions about activities of these companies, and therefore the CNB cannot control the management of these companies.

The shares are measured at fair value and in the opinion of the Bank the fair value of these shares is approximately nil.

11 CURRENCY IN CIRCULATION

	<u>31 December 2005</u>	<u>31 December 2004</u>
	CZK million	CZK million
Notes in circulation	280,727	256,649
Coins in circulation	7,046	6,692
Cash in hand denominated in CZK	<u>(11)</u>	<u>(1,911)</u>
Total currency in circulation	<u>287,762</u>	<u>261,430</u>

CZECH NATIONAL BANK**NOTES TO FINANCIAL STATEMENTS****FOR THE YEAR ENDED 31 DECEMBER 2005****12 LIABILITIES TO FOREIGN COUNTRIES**

	<u>31 December 2005</u> CZK million	<u>31 December 2004</u> CZK million
Repo operations	86,621	23,075
Loans from the EIB (Note 6)	<u>48</u>	<u>70</u>
Total loans from foreign countries	86,669	23,145
Other liabilities to foreign countries	<u>408</u>	<u>406</u>
Total liabilities to foreign countries	<u>87,077</u>	<u>23,551</u>

Loans from the EIB

From the loans received from the EIB, 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.

Geographic sector risk concentrations within liabilities to foreign countries:

	<u>31 December 2005</u>		<u>31 December 2004</u>	
	CZK million	%	CZK million	%
Euro zone	51	-	70	-
Other European countries	5	-	5	-
USA and Canada	<u>87,021</u>	<u>100</u>	<u>23,476</u>	<u>100</u>
	<u>87,077</u>	<u>100</u>	<u>23,551</u>	<u>100</u>

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

13 DUE TO DOMESTIC BANKS

	<u>31 December 2005</u> CZK million	<u>31 December 2004</u> CZK million
Bank monetary reserves	17,249	20,311
Repo operations	377,757	402,997
Other liabilities to domestic banks	<u>4,299</u>	<u>5,029</u>
Total liabilities to domestic banks	<u>399,305</u>	<u>428,337</u>

Monetary reserves from banks

Obligatory minimum reserves represent deposits of the banks in the CR held at the CNB which banks cannot dispense with. The CNB pays interest equal to the CZK two-week repo interest rate on these deposits, which has been 2.0% p.a. as at 31 December 2005 (2004: 2.5% p.a.). Obligatory minimum reserves are defined as 2% of received deposits and loans from non-banking clients or selected issued securities.

Repo operations

Repo operations as at 31 December 2005 include CZK 377,757 million (31 December 2004: CZK 402,997 million) of loans received from banks in the CR. These operations are collateralized by re-purchased treasury bills of the Bank. 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 for handling cash and deposits used for inter-bank money transfers.

CZECH NATIONAL BANK**NOTES TO FINANCIAL STATEMENTS****FOR THE YEAR ENDED 31 DECEMBER 2005****14 DEPOSITS FROM CLIENTS**

	<u>31 December 2005</u> CZK million	<u>31 December 2004</u> CZK million
Current accounts	9,260	19,199
Term deposits	46,957	1,912
Deposits of local government bodies	9,065	31,992
Other deposits	<u>2,812</u>	<u>4,470</u>
Total deposits from clients	<u>68,094</u>	<u>57,573</u>

15 DOMESTIC TREASURY BILLS ISSUED

	<u>31 December 2005</u> CZK million	<u>31 December 2004</u> CZK million
Bank's treasury bills	700,000	700,000
from which:		
- held in the treasury bills portfolio	(327,333)	(300,738)
- in repo operations	<u>(372,667)</u>	<u>(399,262)</u>
Total domestic treasury bills issued	<u>-</u>	<u>-</u>

The treasury bills were issued at zero discount.

16 LIABILITIES TO THE STATE

	<u>31 December 2005</u> CZK million	<u>31 December 2004</u> CZK million
State funds' accounts	12,940	8,716
State assets denominated in CZK	89,365	19,959
State assets denominated in foreign currency	<u>10,358</u>	<u>8,832</u>
Total liabilities to the state	<u>112,663</u>	<u>37,507</u>

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

17 EQUITY

Changes in equity during 2005 and 2004 were as follows:

	Share <u>capital</u> CZK million	<u>Funds</u> CZK million	Accumulated <u>losses</u> CZK million	Revaluation <u>reserve</u> CZK million	Profit/(loss) <u>for the year</u> CZK million	<u>Equity</u> CZK million
Balance as at 1 January 2004	1,400	8,109	(53,780)	-	(18,173)	(62,444)
Transfer of accumulated losses	-	-	(18,173)	-	18,173	-
Usage of social fund	-	(34)	-	-	-	(34)
Loss for the year 2004	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(53,717)</u>	<u>(53,717)</u>
		-				
Balance as at 31 December 2004	<u>1,400</u>	<u>8,075</u>	<u>(71,953)</u>	<u>-</u>	<u>(53,717)</u>	<u>(116,195)</u>
Transfer of accumulated losses	-	-	(53,717)	-	53,717	-
Usage of social fund	-	(31)	-	-	-	(31)
Revaluation differences not included in profit	-	-	-	(433)	-	(433)
Profit for the year 2005	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>19,957</u>	<u>19,957</u>
Balance as at 31 December 2005	<u>1,400</u>	<u>8,044</u>	<u>(125,670)</u>	<u>(433)</u>	<u>19,957</u>	<u>(96,702)</u>

Funds

The major part of funds is represented by the General reserve fund of CZK 7,773 million existing at both year ends, which can be used to cover accumulated losses, increase share capital or for any other purpose approved by the Bank Board of the CNB, as well as the Special reserve fund.

The Social fund of CZK 6 million as at 31 December 2005 (31 December 2004: CZK 3 million) is used for coverage of the social needs of employees and the employees' programme of the CNB. Allocations to the Social fund are performed each year from the profit of the previous year. If the CNB achieved a loss in the previous year, the allocation to the Social fund is made from the Special reserve fund.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

18 PROVISIONS, SPECIFIC PROVISIONS AND WRITE-OFFS

The Bank created specific provisions and provisions for assets at risk:

	<u>31 December 2005</u>	<u>31 December 2004</u>
	CZK million	CZK million
Specific provisions		
Non-performing loans due from domestic banks (Note 6)	14	14
Classified loans to clients (Note 7)	8,740	9,080
Other (Note 10)	<u>1,084</u>	<u>574</u>
Total specific provisions	<u>9,838</u>	<u>9,668</u>
Provisions		
Standard loans (Note 7)	-	348
Guarantee for CF (Notes 20 and 30)	3,815	4,176
Guarantees for clients (Note 20)	<u>282</u>	<u>257</u>
Total provisions	<u>4,097</u>	<u>4,781</u>

Specific provisions for classified loans to clients include the provisions resulting from the Consolidation programme of CZK 3,487 million as at 31 December 2005 (31 December 2004: 3,622 million) (Note 30).

Write-offs and recovery of amounts written off previously

The CNB wrote off receivables of CZK 32 million in 2005 (2004: CZK 1,400 million) and did not receive any payments on debts which had been previously written off in 2005 and 2004.

Receivables written off in 2004 primarily represented advances of CZK 1,400 million, paid in the past within the consolidation of the banking sector. They were fully provided for. The impact of this write-off is disclosed net in line Utilisation and release of other specific and general provisions and write-offs of other receivables.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

18 PROVISIONS, SPECIFIC PROVISIONS AND WRITE OFFS (continued)

Specific provisions

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

	Amounts due <u>from banks</u>	Classified <u>loans</u>	<u>Other</u>	<u>Total</u>
	CZK million	CZK million	CZK million	CZK million
As at 1 January 2004	14	9,101	2,012	11,127
Addition	-	470	1	471
Utilisation and release	-	(491)	(1,439)	(1,930)
As at 31 December 2004	<u>14</u>	<u>9,080</u>	<u>574</u>	<u>9,668</u>
Addition	-	-	510	510
Utilisation and release	-	(340)	-	(340)
As at 31 December 2005	<u>14</u>	<u>8,740</u>	<u>1,084</u>	<u>9,838</u>

Provisions

The movements in provisions can be analysed as follows:

	Standard <u>loans</u>	Consolidation <u>programme</u>	Other <u>guarantees</u>	<u>Total</u>
	CZK million	CZK million	CZK million	CZK million
As at 1 January 2004	348	5,237	296	5,881
Addition	-	-	7	7
Utilisation and release	-	(1,061)	(46)	(1,107)
As at 31 December 2004	<u>348</u>	<u>4,176</u>	<u>257</u>	<u>4,781</u>
Addition	-	38	25	63
Utilisation and release	(348)	(399)	-	(747)
As at 31 December 2005	<u>-</u>	<u>3,815</u>	<u>282</u>	<u>4,097</u>

CZECH NATIONAL BANK**NOTES TO FINANCIAL STATEMENTS****FOR THE YEAR ENDED 31 DECEMBER 2005****18 PROVISIONS, SPECIFIC PROVISIONS AND WRITE OFFS (continued)****Provisions (continued)**

In 2005, utilisation and release of provisions to activities within the consolidation of the banking sector includes the release of the provision created to cover the losses of Česká Finanční, s.r.o. incurred in relation to the implementation of the Consolidation programme in the amount of CZK 399 million (Note 30) (2004: CZK 1,061 million of which CZK 594 million related to Česká Finanční, s.r.o.). In 2004, the Bank purchased shares of COOP Banka, a.s. v likvidaci (Note 10) from Česká Finanční, s.r.o. within the Consolidation programme. Purchase price of these shares was netted off against the loans provided to Česká Finanční, s.r.o. (Note 30).

19 OTHER LIABILITIES

	<u>31 December 2005</u>	<u>31 December 2004</u>
	CZK million	CZK million
Negative fair value of foreign currency forwards (Note 25)	170	1,121
Advance received in relation to the State guarantee (Note 30)	2,433	2,744
Liabilities to the European Community	5,919	861
Other liabilities	<u>312</u>	<u>308</u>
Total other liabilities	<u>8,834</u>	<u>5,034</u>

20 CONTINGENCIES AND COMMITMENTS

	<u>31 December 2005</u>	<u>31 December 2004</u>
	CZK million	CZK million
Issued guarantees		
Clients	315	286
CF (Note 30)	3,815	4,176
Consolidation of the banking sector (Note 30)	<u>161,888</u>	<u>161,640</u>
Total issued guarantees	<u>166,018</u>	<u>166,102</u>

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

20 CONTINGENCIES AND COMMITMENTS (continued)

	<u>31 December 2005</u> CZK million	<u>31 December 2004</u> CZK million
Received guarantees		
From the Czech Government for impaired assets taken over by the Bank within the Consolidation programme (Note 30)	8,317	8,317
From the Ministry of Finance in relation to the Indemnity Letter (Note 30)	<u>157,529</u>	<u>157,218</u>
Total guarantees received	<u>165,846</u>	<u>165,535</u>

The issued guarantees for the consolidation of the banking sector primarily include the Indemnity Letter and the Guarantee for IPB deposits (Note 30).

The identified need for provisions for expected losses (Note 18) on the issued guarantees was as follows:

	<u>31 December 2005</u> CZK million	<u>31 December 2004</u> CZK million
Guarantees for clients (Note 18)	282	257
Guarantee for CF (Note 18 and 30)	<u>3,815</u>	<u>4,176</u>
	<u>4,097</u>	<u>4,433</u>

Receivables and payables from unsettled transactions with securities

	<u>31 December 2005</u> CZK million	<u>31 December 2004</u> CZK million
Receivables from unsettled transactions with securities	15,893	12,432
Payables from unsettled transactions with securities	<u>12,768</u>	<u>1,672</u>
Net position	<u>3,125</u>	<u>10,760</u>

20 CONTINGENCIES AND COMMITMENTS (continued)

Receivables and payables from unsettled transactions with securities (continued)

All receivables and payables from unsettled transactions with securities matured in January of the following year.

Legal suits

The Bank is the defendant in a legal suit brought by Union banka, a.s. “v likvidaci” relating to compensation for an alleged claim of approximately CZK 1.8 billion resulting from a transaction performed by the CNB during the consolidation of the Czech banking sector. Based on the Bank’s own opinion resulting from cooperation with an external law firm, as well as the result of arbitration, the CNB does not consider it probable that any compensation will have to be paid by the CNB and therefore has not created any provision for such compensation.

The Bank is the defendant in a legal suit brought by INVESTMART B. V. resulting from a transaction performed by the Bank within the supervision activities over the banking sector. The amount of the suit is EUR 188 million. Based on the Bank’s own opinion the CNB does not consider it probable that any compensation will have to be paid by the CNB and therefore has not created any provision for such compensation.

Other contingencies

The Bank received a letter from the administrator of Union Banka, which states that the Bank did not pay an amount of CZK 20 million resulting from a transaction performed by the CNB during the consolidation of the Czech banking sector. Based on the opinion of the Bank’s lawyers opinion the whole case is statute-barred and therefore no provision has been created.

Investment commitments

The Bank has not entered into any contracts for the purchase of tangible and intangible fixed assets as at 31 December 2005 and 2004.

Assets held in custody

The Bank has not received any assets from third parties to be held in custody in 2005 and 2004.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

21 INTEREST MARGIN

	<u>2005</u> CZK million	<u>2004</u> CZK million
Interest income and similar income	20,587	13,744
Interest expense and similar expense	<u>(11,819)</u>	<u>(11,597)</u>
Interest margin	<u>8,768</u>	<u>2,147</u>

Interest income and similar income

	<u>2005</u> CZK million	<u>2004</u> CZK million
Treasury bills and other discounted securities	3,863	2,207
Bonds	<u>13,310</u>	<u>10,036</u>
Interest from securities with fixed income	<u>17,173</u>	<u>12,243</u>
Inter-bank deposits	2,961	1,000
Receivables from the clients	286	330
Other	<u>167</u>	<u>171</u>
Total other interest income	<u>3,414</u>	<u>1,501</u>
Total interest income and similar income	<u>20,587</u>	<u>13,744</u>

Based on the estimate of the Bank's management, the 2005 total income included CZK 0.1 million from interest income on classified loans (2004: CZK 0.5 million). Unpaid interest is accrued and is taken into account when calculating the amount of specific provisions.

Interest expense and similar expense

	<u>2005</u> CZK million	<u>2004</u> CZK million
Liabilities to the state	204	140
Liabilities to banks	11,285	11,394
Liabilities to clients	<u>330</u>	<u>63</u>
Total interest expense and similar expense	<u>11,819</u>	<u>11,597</u>

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

22 GAINS LESS LOSSES FROM FINANCIAL OPERATIONS

Gains less losses from financial operations can be analysed as follows:

	<u>2005</u> CZK million	<u>2004</u> CZK million
Realised gain from securities	2,193	2,466
Realised loss from securities	(2,647)	(1,807)
Net foreign exchange gains/(losses)	5,504	(60,135)
Net gains from currency forwards	6,553	1,449
Realised and unrealised gains less losses from interest futures	36	(21)
Unrealised gains less losses from securities (Note 2(d))	<u>-</u>	<u>2,944</u>
Total gain/(loss) from financial operations	<u>11,957</u>	<u>(55,104)</u>

23 ADMINISTRATION EXPENSES

The administration expenses can be analysed as follows:

	<u>2005</u> CZK million	<u>2004</u> CZK million
Wages and salaries	627	599
Social security and health insurance	219	212
Training and other expense	<u>45</u>	<u>49</u>
Total personnel costs	<u>891</u>	<u>860</u>
Depreciation of tangible fixed assets (Note 9)	477	505
Amortisation of intangible fixed assets (Note 9)	69	87
Rent	13	13
Other	<u>428</u>	<u>454</u>
Total other administration expenses	<u>987</u>	<u>1,059</u>
Total administration expenses	<u>1,878</u>	<u>1,919</u>

Staff statistics

	<u>2005</u>	<u>2004</u>
Average number of employees	1,433	1,464
From which: Number of members of the Bank Board	7	7

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

24 OTHER EXPENSES

	<u>2005</u> CZK million	<u>2004</u> CZK million
Settlement of CF losses	147	134
Expenses for issuing bank notes and coinage	170	261
Other expenses and damages	<u>150</u>	<u>146</u>
Total other expenses	<u>467</u>	<u>541</u>

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 and assigns assets and liabilities of the Bank into relevant maturity bands based on the remaining period as 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 a change in market value of securities held in the portfolio of the Bank. Rules for investing foreign currency reserves are targeted to limit the significant risk of a change in interest rates. The table in Note 27 summarises the Bank's exposure to interest rate risks. Included in the table are the Bank's interest bearing assets and liabilities at carrying amounts, categorised by the earlier of contractual, re-pricing 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 reflects the main functions of the central bank and foreign currency reserves, i.e. support for the ability of CNB to perform intervention, insurance against a Balance of Payments crisis and reflects the basic principle of management of assets, being diversification. Due to the necessity to keep foreign currency reserves, the CNB cannot reduce the risk of the strengthening of the Czech currency against main foreign currencies. The table in Note 28 summarises 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, categorised by currency.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

25 FINANCIAL RISKS (continued)

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.

Spot transactions and derivative financial instruments

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

	<u>31 December 2005</u>	<u>31 December 2004</u>
	CZK million	CZK million
<u>Off-balance sheet receivables:</u>		
- from future transactions	3,862	14,232
- from unsettled spot transactions	15,893	12,432
- from forward transactions	58,825	77,035
- from option transactions	<u>31,092</u>	<u>25,900</u>
	<u>109,672</u>	<u>129,599</u>
<u>Off-balance sheet payables:</u>		
- from future transactions	3,862	14,232
- from unsettled spot transactions	12,768	1,672
- from forward transactions	58,478	76,960
- from option transactions	31,092	25,900
- securities received in reverse repo operations	<u>29,000</u>	<u>-</u>
	<u>135,200</u>	<u>118,764</u>

The Bank has outstanding currency forwards as at the balance sheet date hedging the movement of foreign exchange rates:

	<u>31 December 2005</u>	<u>31 December 2004</u>
	CZK million	CZK million
Off-balance sheet receivables from forward transactions	58,825	77,035
Off-balance sheet payables from forward transactions	58,478	76,960
Positive fair value (Note 10)	364	877
Negative fair value (Note 19)	170	1,121

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

25 FINANCIAL RISKS (continued)

Spot transactions and derivative financial instruments (continued)

The nominal or notional amounts recognized in the 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 risk.

Despite the fact that these foreign currency forwards provide efficient financial hedging of the Bank's position from a foreign exchange reserves administration point of view, they do not fulfil 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 loss from financial operations (Note 22).

The Bank has outstanding futures as at the balance sheet date:

	<u>31 December 2005</u>	<u>31 December 2004</u>
	CZK million	CZK million
Off-balance sheet receivables from futures transactions	3,862	14,232
Off-balance sheet payables from futures transactions	3,862	14,232
Net gain/(loss) from change in fair values of futures transactions open at the year-end	3	(1)

Gains or losses from change in fair values of futures transactions are settled daily against cash on margin account reported within other assets.

	<u>31 December 2005</u>	<u>31 December 2004</u>
	CZK million	CZK million
Net gain/(loss) from change in fair values of futures transactions open at the year-end	3	(1)
Cash on margin account	<u>50</u>	<u>19</u>
Margin account including settled change in fair value of futures transactions (Note 10)	<u>53</u>	<u>18</u>

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

26 LIQUIDITY RISK

As at 31 December 2005	Up to <u>1 month</u> CZK m	1-3 <u>months</u> CZK m	3-12 <u>months</u> CZK m	1-5 <u>years</u> CZK m	Over <u>5 years</u> CZK m	Un- <u>specified</u> CZK m	<u>Total</u> CZK m
Assets							
Gold	538	-	-	283	-	-	821
Receivables from IMF	-	-	-	-	-	29,146	29,146
Treasury bills and other discounted securities	55,706	65,631	57,902	-	-	-	179,239
Bonds and other coupon securities	25,531	14,586	56,390	237,644	114,601	-	448,752
Deposits, loans and other receivables from foreign countries	175,074	-	-	-	-	-	175,074
Receivables from domestic banks	29,002	10	10	28	-	-	29,050
Receivables from clients	-	-	4,054	8,323	93	-	12,470
Receivables from the state	-	-	-	8,683	-	-	8,683
Fixed assets	-	-	-	-	-	6,135	6,135
Other assets	<u>3,442</u>	<u>-</u>	<u>23</u>	<u>-</u>	<u>-</u>	<u>2,505</u>	<u>5,970</u>
Total assets	<u>289,293</u>	<u>80,227</u>	<u>118,379</u>	<u>254,961</u>	<u>114,694</u>	<u>37,786</u>	<u>895,340</u>
Liabilities and equity							
Currency in circulation	-	-	-	-	-	287,762	287,762
Liabilities to IMF	-	-	-	-	-	24,210	24,210
Liabilities to foreign countries	87,029	10	10	28	-	-	87,077
Liabilities to domestic banks	399,305	-	-	-	-	-	399,305
Deposits from clients	21,137	29,197	367	16,207	1,186	-	68,094
Liabilities to the state	112,663	-	-	-	-	-	112,663
Provisions	-	-	-	-	-	4,097	4,097
Equity	-	-	-	-	-	(96,702)	(96,702)
Other liabilities	<u>6,324</u>	<u>71</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>2,439</u>	<u>8,834</u>
Total liabilities and equity	<u>626,458</u>	<u>29,278</u>	<u>377</u>	<u>16,235</u>	<u>1,186</u>	<u>221,806</u>	<u>895,340</u>
Net liquidity gap	<u>(337,165)</u>	<u>50,949</u>	<u>118,002</u>	<u>238,726</u>	<u>113,508</u>	<u>(184,020)</u>	<u>-</u>
Balance as at 31 December 2004							
Total assets	148,327	89,290	166,859	190,676	79,512	49,513	724,177
Total liabilities	<u>547,198</u>	<u>83</u>	<u>381</u>	<u>310</u>	<u>1,280</u>	<u>174,925</u>	<u>724,177</u>
Net liquidity gap	<u>(398,871)</u>	<u>89,207</u>	<u>166,478</u>	<u>190,366</u>	<u>78,232</u>	<u>(125,412)</u>	<u>-</u>

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

27 INTEREST RATE RISK

As at 31 December 2005	Up to <u>1 month</u> CZK m	1-3 <u>months</u> CZK m	3-12 <u>months</u> CZK m	1-5 <u>years</u> CZK m	Over <u>5 years</u> CZK m	Un- <u>specified</u> CZK m	<u>Total</u> CZK m
Assets							
Gold	-	-	-	-	-	821	821
Receivables from IMF	-	4,737	-	-	-	24,409	29,146
Treasury bills and other discounted securities	55,706	65,631	57,902	-	-	-	179,239
Bonds and other coupon securities	32,374	20,014	53,129	228,634	114,601	-	448,752
Deposits, loans and other receivables from foreign countries	175,074	-	-	-	-	-	175,074
Receivables from domestic banks	29,002	10	10	28	-	-	29,050
Receivables from clients	-	-	4,054	8,323	93	-	12,470
Receivables from the state	-	-	-	8,683	-	-	8,683
Fixed assets	-	-	-	-	-	6,135	6,135
Other assets	<u>457</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>5,513</u>	<u>5,970</u>
Total assets	<u>292,613</u>	<u>90,392</u>	<u>115,095</u>	<u>245,668</u>	<u>114,694</u>	<u>36,878</u>	<u>895,340</u>
Liabilities and equity							
Currency in circulation	-	-	-	-	-	287,762	287,762
Liabilities to IMF	-	-	-	-	-	24,210	24,210
Liabilities to foreign countries	87,029	10	10	28	-	-	87,077
Liabilities to domestic banks	399,305	-	-	-	-	-	399,305
Deposits from clients	68,094	-	-	-	-	-	68,094
Liabilities to the state	112,663	-	-	-	-	-	112,663
Provisions	-	-	-	-	-	4,097	4,097
Equity	-	-	-	-	-	(96,702)	(96,702)
Other liabilities	<u>244</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>8,590</u>	<u>8,834</u>
Total liabilities and equity	<u>667,335</u>	<u>10</u>	<u>10</u>	<u>28</u>	<u>-</u>	<u>227,957</u>	<u>895,340</u>
Net interest sensitivity gap	<u>(374,722)</u>	<u>90,382</u>	<u>115,085</u>	<u>245,640</u>	<u>114,694</u>	<u>(191,079)</u>	<u>-</u>
Balance as at 31 December 2004							
Total assets	159,407	117,711	143,645	182,395	79,512	41,507	724,177
Total liabilities	<u>548,086</u>	<u>10</u>	<u>10</u>	<u>50</u>	<u>-</u>	<u>176,021</u>	<u>724,177</u>
Net interest sensitivity gap	<u>(388,679)</u>	<u>117,701</u>	<u>143,635</u>	<u>182,345</u>	<u>79,512</u>	<u>(134,514)</u>	<u>-</u>

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

28 CURRENCY RISK

As at 31 December 2005	<u>CZK</u>	<u>EUR</u>	<u>USD</u>	<u>JPY</u>	<u>Other</u>	<u>Total</u>
	CZK m	CZK m	CZK m	CZK m	CZK m	CZK m
Assets						
Gold	-	-	-	-	821	821
Receivables from IMF	24,210	-	-	-	4,936	29,146
Treasury bills and other discounted securities	-	66,205	87,972	25,062	-	179,239
Bonds and other coupon securities	-	230,167	218,098	-	487	448,752
Deposits, loans and other						
receivables from foreign countries	-	57,525	84,081	33,420	48	175,074
Receivables from domestic banks	29,002	48	-	-	-	29,050
Receivables from clients	12,470	-	-	-	-	12,470
Receivables from the state	8,683	-	-	-	-	8,683
Fixed assets	6,125	-	-	-	10	6,135
Other assets	<u>2,843</u>	<u>264</u>	<u>43</u>	<u>-</u>	<u>2,820</u>	<u>5,970</u>
Total assets	<u>83,333</u>	<u>354,209</u>	<u>390,194</u>	<u>58,482</u>	<u>9,122</u>	<u>895,340</u>
Liabilities						
Currency in circulation	287,762	-	-	-	-	287,762
Liabilities to IMF	24,210	-	-	-	-	24,210
Liabilities to foreign countries	408	48	86,621	-	-	87,077
Liabilities to domestic banks	399,305	-	-	-	-	399,305
Deposits from clients	21,700	46,350	44	-	-	68,094
Liabilities to the state	102,305	10,090	268	-	-	112,663
Provisions	4,097	-	-	-	-	4,097
Other liabilities	<u>2,964</u>	<u>5,870</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>8,834</u>
Total liabilities	<u>842,751</u>	<u>62,358</u>	<u>86,933</u>	<u>-</u>	<u>-</u>	<u>992,042</u>
Net assets / (liabilities)	(759,418)	291,851	303,261	58,482	9,122	(96,702)
Net off-balance sheet assets / (liabilities)	<u>(29,000)</u>	<u>48,837</u>	<u>13,113</u>	<u>(58,478)</u>	<u>-</u>	<u>(25,528)</u>
Net foreign exchange position	<u>(788,418)</u>	<u>340,688</u>	<u>316,374</u>	<u>4</u>	<u>9,122</u>	<u>(122,230)</u>
Balance as at 31 December 2004						
Total assets	67,476	331,007	235,824	76,962	12,908	724,177
Total liabilities	<u>806,431</u>	<u>10,823</u>	<u>23,117</u>	<u>-</u>	<u>1</u>	<u>840,372</u>
Net assets / (liabilities)	(738,955)	320,184	212,707	76,962	12,907	(116,195)
Net off-balance sheet assets / (liabilities)	<u>-</u>	<u>47,623</u>	<u>40,171</u>	<u>(76,959)</u>	<u>-</u>	<u>10 835</u>
Net foreign exchange position	<u>(738,955)</u>	<u>367,807</u>	<u>252,878</u>	<u>3</u>	<u>12,907</u>	<u>(105,360)</u>

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

29 CREDIT RISK AND CONCENTRATION OF LIABILITIES

Geographical concentrations of assets

	<u>31 December 2005</u>	<u>31 December 2004</u>
	CZK million	CZK million
Czech Republic	59,810	46,052
Germany	139,889	136,305
France	74,959	49,345
Italy	51,654	64,523
Other Euro zone countries	130,043	77,183
Switzerland	15,882	19,665
Great Britain	76,167	31,993
Other European countries	4,766	17
USA and Canada	275,938	212,293
Japan	58,482	76,963
Other countries	<u>7,750</u>	<u>9,838</u>
	<u>895,340</u>	<u>724,177</u>

Geographical concentrations of liabilities

	<u>31 December 2005</u>	<u>31 December 2004</u>
	CZK million	CZK million
Czech Republic	778,134	678,723
Euro zone countries	5,970	931
Other European countries	5	5
USA and Canada	<u>111,231</u>	<u>44,518</u>
	<u>895,340</u>	<u>724,177</u>

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

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 the clients' deposits in the CR, 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 CNB obtained a payment of CZK 5,000 million from the Guarantee in 2005 (2004: CZK 500 million).

The assets taken over and specific provisions and provisions created as at 31 December 2005 and 2004 can be summarised as follows:

	<u>31 December 2005</u>	<u>31 December 2004</u>
	CZK million	CZK million
Receivables from banks	11,615	11,716
Purchased receivables of banks	<u>189</u>	<u>223</u>
	11,804	11,939
Specific provisions (Note 18)	<u>(3,487)</u>	<u>(3,622)</u>
Total net book value covered by the Guarantee (Note 20)	<u>8,317</u>	<u>8,317</u>

Česká finanční, s.r.o.

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 Czech Government resolution 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 CF for an agreed price of CZK 1 to Konsolidační Banka Praha, s.p.ú., now Česká Konsolidační Agentura (hereinafter the "CKA") in June 2000. The CNB has undertaken to cover all CF losses resulting from the Consolidation programme and concluded an agreement with CF on the settlement of operating costs and losses from assumed assets incurred in relation to the implementation of the Consolidation programme, which would exceed the share capital of CF and therefore could not be offset against the CF share capital of CZK 13,833 million. The CNB increased the share capital in CF in 1997 and 1998.

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

30 CONSOLIDATION OF THE BANKING SECTOR (continued)

Česká finanční, s.r.o. (continued)

The Consolidation Programme involved transfers of certain doubtful assets of certain banks taking part in this programme to CF. CF purchased these assets from the CNB and other banks without any further claims. The aim of this programme was to regain financial stability and the programme was started in 1997. 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 net book value of the remaining Consolidation Programme assets administered by CF (net of provisions created by CF but reflecting the guarantee received from the CNB) was CZK 1,857 million as at 31 December 2005 (audited net book value as at 31 December 2004: CZK 2,361 million).

In compliance with this agreement concluded by CF and the CNB, the relevant part of the operating costs of CF will be settled on a quarterly basis by the CNB. The agreement also specifies CF's reporting duties to the CNB on a regular basis and the mechanism whereby the CNB retains a certain level of control over CF activities relating to the Consolidation Programme.

The calculation of the provision can be summarised as follows:

	<u>31 December 2005</u>	<u>31 December 2004</u>
	CZK million	CZK million
Provided loans	4,054	4,427
Less expected recoverability of:		
- receivables in Consolidation programme	(46)	(110)
- securities in Consolidation programme	<u>(193)</u>	<u>(141)</u>
Created provisions (Note 18 and 20)	<u>3,815</u>	<u>4,176</u>

Investiční a poštovní banka, a.s.

In June 2000, the CNB declared forced administration in 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 June 2003.

30 CONSOLIDATION OF THE BANKING SECTOR (continued)

Investiční a poštovní banka, a.s. (continued)

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 CSOB. The balance of the Guarantee for Deposits in the off-balance sheet of the CNB as at 31 December 2005 was CZK 361 million (31 December 2004: CZK 421 million).

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

On 23 June 2000, the Czech Government issued a State guarantee in which it undertook that it will refund certain losses incurred by the CNB in connection with CSOB indemnification based on the Indemnity Letter (hereinafter the “State Guarantee”). The State guarantee covers losses incurred by the CNB resulting from indemnification of CSOB’s losses (damages) arising from unrecorded liabilities relating to IPB that were transferred to CSOB.

On 6 November 2002, the CNB obtained a unilateral obligatory declaration from CSOB according to which all claims for compensations under the Indemnity letter from the CNB will be made by CSOB and will be settled by the CNB by 31 December 2016 and the maximum amount of the compensation is CZK 160 billion. Based on this declaration, the CNB expects that the maximum compensation from the State Guarantee would be in the same amount. The CNB received a Binding representation from CSOB on 28 June 2004. A final List of claims is enclosed to this Binding representation. The CNB accepted this Binding representation on 28 June 2004. This does not mean that the CNB accepted or approved individual claims in the enclosure; however, further claims not included in the Binding representation may not be brought by CSOB.

CZECH NATIONAL BANK**NOTES TO FINANCIAL STATEMENTS****FOR THE YEAR ENDED 31 DECEMBER 2005****30 CONSOLIDATION OF THE BANKING SECTOR (continued)****Investiční a poštovní banka, a.s. (continued)**

The amounts covered under the Indemnity letter, advances and final payments to CSOB, the available state guarantee, advances received and final payments from the State Guarantee can be analysed as follows:

	<u>31 December 2005</u> CZK million	<u>31 December 2004</u> CZK million
Potential future claims under the Indemnity Letter	157,532	157,218
Advances paid to CSOB (Note 10)	2,430	2,744
Settlement to CSOB	<u>38</u>	<u>38</u>
	160,000	160,000
Advances received from the State Guarantee (Note 19)	(2,433)	(2,744)
Settlement from the State guarantee	<u>(38)</u>	<u>(38)</u>
Available State Guarantee (Note 20)	<u>157,529</u>	<u>157,218</u>

The CNB has not created a provision for these claims as no claims not covered by the State Guarantee have been raised so far and the CNB is currently not able to assess reliably the expected outcome of legal proceedings or the amount of damages, if any, which may be incurred by CSOB, then claimed from the CNB, but would not be covered by State Guarantee.

In the case that CSOB asks the CNB to settle any claim under the Indemnity Letter, based on the agreement the CNB should 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 3 years after the request of the CNB

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2005

31 RELATED PARTY TRANSACTIONS

Related parties and parties with special relations to the Bank are defined as follows:

- Members of the Bank Board, senior management and their relatives;
- Subsidiaries;
- CF.

CNB grants members of the Bank Board and senior management in accordance with internal rules special purpose loans, especially for housing. These loans are financed from special reserve fund created from the profits of previous periods of the CNB. The loans to the members of the Bank Board and senior management are provided under the same conditions as loans to other employees.

CNB has no subsidiaries.

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 basis interest rates.

32 SUBSEQUENT EVENTS

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