DEVELOPMENTS IN DOMESTIC FINANCIAL MARKETS IN 2005[1]

In 2005, the economy of the Slovak Republic continued to show strong growth, which was, as opposed to 2004, accompanied by a fall in inflation. After accelerating in the final quarter (to 7.5%), GDP growth reached an annual average of 6.0%, exceeding the rate of economic growth from the previous year (5.5%).

The average annual inflation rate dropped from 7.5% in 2004, to 2.7% in 2005. Thus, the inflation target of the National Bank of Slovakia ('the NBS'), set in terms of the annual overall HICP inflation rate as at December 2005 in the Monetary Programme of the NBS for the period until 2008 (3.5 % +/-0.5 %), was achieved.

Improvement was also recorded in the area of employment, when the rate of registered unemployment dropped according to data from the Office of Labour, Social Matters, and the Family, from 13.2% to 11.36% at the end of the year. A falling trend in unemployment was also recorded according to the methodology of 'Labour Force Sample Surveys' (a drop from 17.1% to 15.5%).

The trade balance of Slovakia deteriorated in 2005. Compared with Sk 45.2 billion in 2004, an annual trade deficit of Sk 74.3 billion was recorded in 2005. However, a marked improvement is expected in this area with regard to the expected start of production at the Trnava plant of PSA Peugeot and subsequently at KIA Motors in Žilina.

In terms of investment in financial assets, Slovakia was perceived in 2005 as a fast-growing economy, which is to join the euro area in the near future (in 2009). This will be accompanied by the convergence of interest rates as well as the rate of exchange towards the level, at which the Slovak koruna will be replaced by the euro. The expected strong and persistent appreciation of the Slovak koruna led to increased interest in investment in assets denominated in the domestic currency, as from the second half of 2004. The interest of investors in koruna assets was also encouraged by interest rate differentials, which were attractive in relation to both the USD and the EUR.

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Developments in the domestic money market

The interbank money market and its price indicators

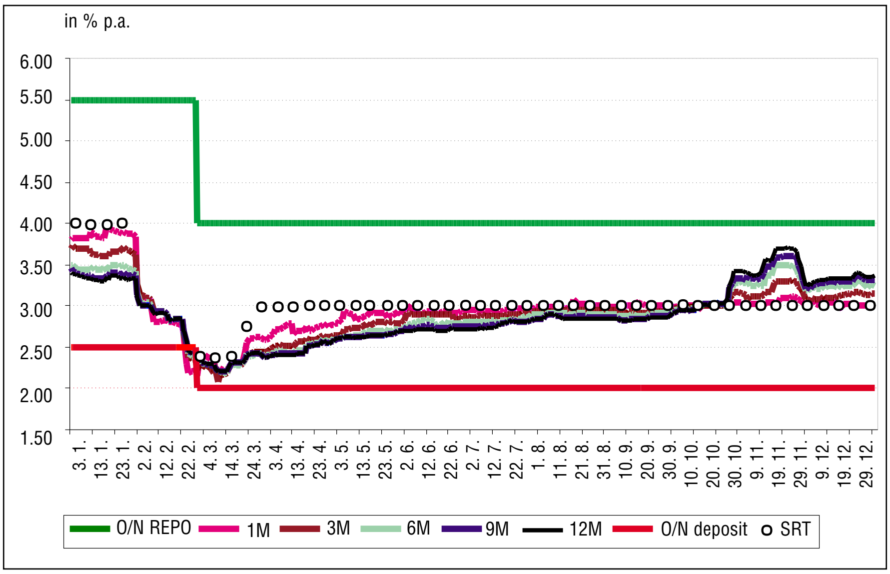
Developments in money market interest rates resulted in marked changes in 2005.

The changes in interest rates were primarily caused by the activities of the NBS. The repeated foreign exchange interventions of the NBS against the excessive appreciation of the Slovak koruna at the beginning of the year, supported by the rejection of bids at repo tenders and the absence of auctions in NBS bills, produced an unreasonably large surplus of interbank liquidity. This situation caused interest rates to fall to a historically low level, when the entire yield curve sank below 2.50%. The yield curve gradually stopped having an inverse shape. Thus, deposit rates did not react to the asymmetrical cuts in the key NBS rates at the end of February. Expectations of interest rate increases in the USA in March caused the Slovak koruna to weaken considerably and the money market yield curve began to steepen due to the renewed acceptance of bids at repo tenders, mainly with maturities close to two weeks.

The growing conviction of banks that the NBS would renew the issuance of three-month NBS bills in April led to a revival in trading in funds due in the medium term, which was accompanied by an increase in their price. The announcement of a reduction in the key rates of the Czech National Bank (CNB) caused concern in the Slovak money market that the NBS may take a similar step. Despite this concern, trading remained balanced, leaving prices at a virtually unchanged level.

In May and June, longer-term rates continued to rise, mainly as a result of repeated NBS statements about the negative effects of certain economic measures on the future course of inflation, the diminishing room for a further cut in NBS interest rates, and concern over wage developments. The upward trend in money market rates was also supported by the unsuccessful referendum in France on the Treaty establishing a Constitution for Europe.

Chart 1 Interest rates on the domestic money market (BRIBOR)



Regarding the structure of interbank transactions by duration, the largest amounts were traded in overnight deposits (77.0% of the volume traded in deposits), overnight swap transactions (84.4% of the swaps), forward rate agreements with one-to three-month maturities (81.7%), and interest rate swaps with two- to five-year maturities.

The basically stable development of the money market discontinued in October 2005. The economic revival in the euro area and the results of elections in Poland were the main reasons behind the depreciation of the koruna, which led to a rise in interest levels. They culminated in November when the Statistical Office published a report on GDP growth in the third quarter and HICP inflation in October, the values of which were higher than expected. The increasing trend in interest rates was reversed by Slovakia's unexpected entry into the exchange rate mechanism II (ERM II) at the end of November. The release of comments on the closing of the production gap and the possibility that the economy may become overheated in 2006, coupled with the announced increase in the key ECB interest rates at the end of the year (by 25 basis points), brought the preceding decline to a halt.

Interbank money market transactions

In 2005, interbank transactions recorded a marked increase (21%) in comparison with the previous period. Transactions between domestic banks accounted for 29.2% and transactions with foreign banks 70.8%. Regarding the type of transactions, domestic banks gave preference to deposits (58.4%), while transactions with foreign banks were dominated by swaps (57.7%). The increase in the volume traded in 2005 took place mostly in swaps (an increase of 28.0%) and deposit transactions (15.0%). In transactions in derivatives, however, decreases occurred in both forward rate agreements (24.0%) and interest rate swaps (5.2%). Some signs of increased activity were also recorded in repo transactions.

The National Bank of Slovakia and its position in the domestic money market

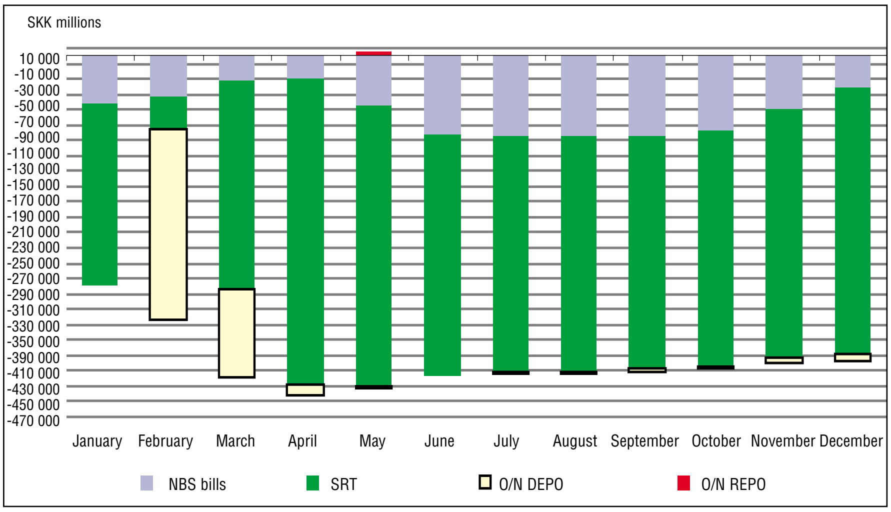
In 2005, the NBS continued to use standard monetary policy instruments, such as two-week repo tenders, issues of 84-day NBS bills, overnight repo transactions, and overnight deposits. The situation changed as of 1 February 2005, when the NBS Bank Board extended and later modified its plan of meetings devoted to monetary policy decisions to include regular meetings on Tuesdays, to analyse the situation in selected markets and decide on repo transactions.

The average daily amount of sterilised excess liquidity reached Sk 399.2 billion in 2005 (compared with Sk 226.6 billion in 2004). The increase in excess liquidity did not follow a regular course. The largest liquidity inflow took place in the first quarter of 2005 as a result of repeated NBS interventions in the foreign exchange market against the excessive appreciation of the Slovak koruna. In addition to interventions, an upward effect on the level of liquidity was also exerted by the transfer of funds from the due time deposits of the SR Treasury held at the NBS. Their effect appeared fully in April, when the average daily amount of sterilised funds reached a record level (Sk 442.1 billion).

Abrupt changes in the amounts of excess funds were recorded in May and October, when foreign exchange interventions against the strengthening of the Slovak koruna reduced the total volume of sterilisation below Sk 400 billion. Over the last two months of 2005, the daily average dropped below the level of Sk 400 billion, to Sk 396.1 billion in December.

In addition to the key monetary policy instruments, i.e. two-week repo tenders and NBS-bill issues, banks regularly used overnight transactions in 2005, for both refinancing and sterilisation purposes.

Chart 2 Developments in the individual types of open market operations

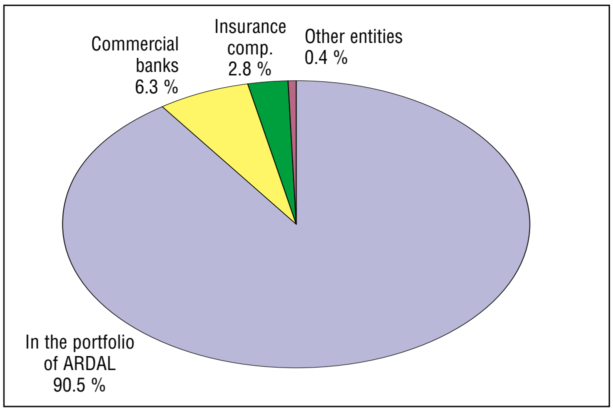


Market for short-term government securities

The market for SR Treasury bills recorded several substantial changes in 2005. These changes occurred as a result of economic developments, mainly the favourable trend in the State budget, when the year-end deficit reached only 55.1% of the approved figure. Another important factor in the development of this market was the tendency to finance the State budget deficit from non-market funds, which started to be applied by the Agency for Debt and Liquidity Management (ARDAL) as early as 2004. The most significant operational-technical change was the new method of placing Treasury bills on the market, consisting of two transactions. In the first phase, the issuer represented by ARDAL issued SR Treasury bills for its own portfolio; in the second phase, the bills were sold via auction to investors according to the issuer's financial needs and circumstances. Sale in this form made it possible for the issuer to manage the financing of the budget deficit more effectively on an ad-hoc basis. This also eliminated the issue of Treasury bills in excessive amounts, which was typical of the previous years, when the issuer issued Treasury bills with maturities up to the next issue (on the basis of the predicted deficit).

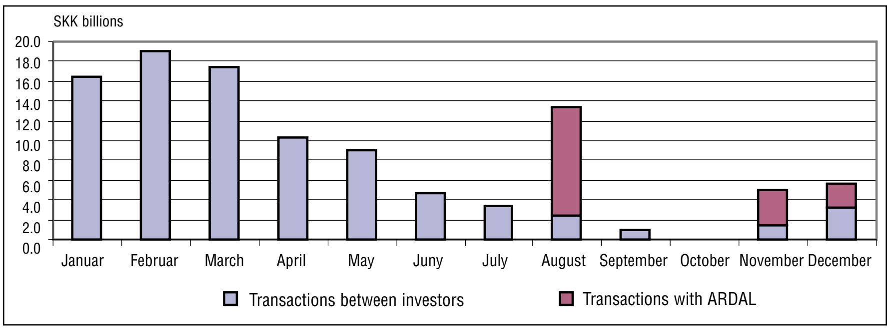
In 2005, ARDAL made three issues for its own portfolio. One of them fell due in October, the same year. The total amount of issued and active (outstanding) Treasury bills reached Sk 61.5 billion as at 31 December 2005, but only a small portion of them was sold to investors (Sk 5.8 billion). The small amount of sold Treasury bills can be explained by the fact that ARDAL used Treasury funds (borrowed at market price) in servicing the national debt. They came from the accumulated free funds of the public sector. In the issuing schedule for 2005, the Agency originally planned to sell Treasury bills from its portfolio in fourteen tranches, in June to December. With regard to the positive results of budgetary performance, however, only the last three tranches were completed, in November and December. On average, the yield on accepted bids was 19 basis points below the BRIBOR rate with the corresponding maturity.

Chart 3 Holdings of SR Treasury bills as at 31 December 2005



Owing to the low issuing activity during the year under review, there was virtually no trading in the secondary market for SR Treasury bills. Trading in Treasury bills in the secondary market was mainly concentrated in the first half of the year, which was followed by a downturn in trading activity ensuing from a shortage of tradable Treasury bills.

Chart 4 Amounts of secondary transactions in SR Treasury bills in 2005

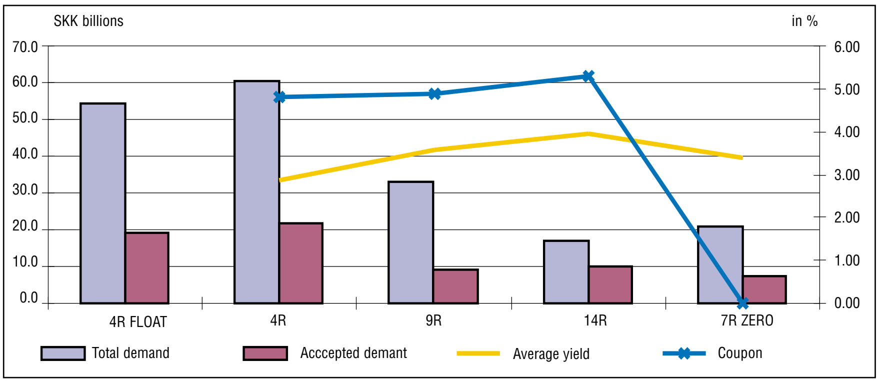


Situation in the domestic capital market

Primary market for government bonds

In 2005, government bonds were placed on the primary market via American auction in the total amount of Sk 67.2 billion. In addition to the continuing tranches of active issues from 2004, a new zero-coupon issue was also placed on the market, with a maturity of 7 years.

Chart 5 Developments in the primary government bond market in 2005



Most trading took place in two government bond issues maturing in 4 years. Although one of them offered a floating yield and was originally regarded by investors as less attractive, it absorbed 50% of the total demand for government bonds on the primary market. The second four-year issue was floated with a fixed coupon and was one of the best performers on the organised secondary market in 2005. It attracted the largest amount and number of price-setting transactions. As in 2004, interest in 14-year issues was mainly shown by insurance companies and commercial banks, which purchased them primarily for their investment portfolios.

Foreign investors had a larger share of the primary market for government bonds than in the previous year. They showed increased interest in this product mainly in periods of increased yields on the bond market. At auctions, the acceptance of bids from non-residents was traditionally higher than in the case of domestic investors, which may be ascribed to their more acceptable price offers.

Chart 7 Developments in benchmark government bond yields in 2005

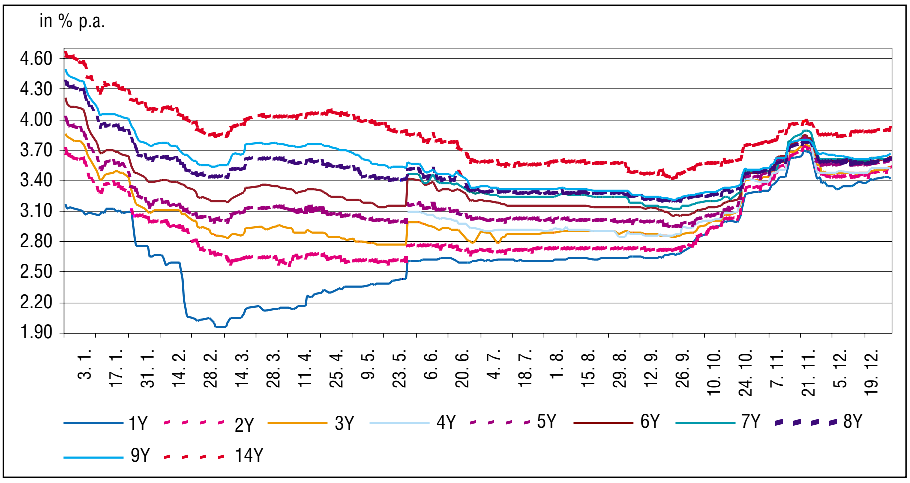
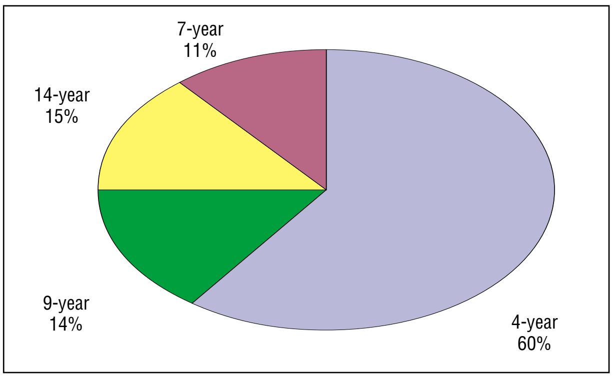


Chart 6 Time structure of primary government bond issues in 2005



Yields on price-setting (benchmark) government bonds

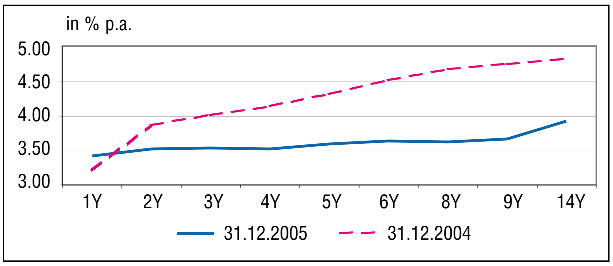
In the period under review, the bond market did not undergo such significant changes in yields as in 2004 and the yield fluctuation was influenced by developments in the euro area in larger measure than in previous years.

The first quarter of 2005 was characterised by a steady decline in yields along the entire length of the yield curve. This tendency was mainly caused by the issuer's statements about the short supply of government bonds, the improved government bond rating from Moody's rating agency, and the expected reduction in the key NBS interest rates. The downward trend changed later in March, when assets started to be sold out in the V4 region owing to the political situation in Poland and the increase in interest rates by the Federal Reserve System in the USA, and investors began to focus increasingly on dollar markets. The yield curve moved upwards in that period, mainly for longer maturities.

Apart from market changes, the shifts in government bond yields were also affected by methodological changes. One of them, i.e. the exchange of government bonds representing benchmark securities, took place on 2 June 2005 and meant the exchange of government bonds used in the compilation of the yield curve according to residual maturity, which visually caused sudden changes in bond yields as a result of their transformation into new residual maturities.

The stabilisation of the situation at the end of March and the change of benchmark bonds were followed by a longer stable period, which was apparent mainly in the third quarter. As of the beginning of October, yields began to rise – first moderately, then, towards the end of the month, more steeply. The increase was caused by the weakening of the Slovak koruna, mainly under the influence of the region (presidential elections in Poland, increase in the key CNB interest rates). Another reason was the statement of the NBS about a possible monetary policy tightening. At that time, investors incorporated their strong expectations of an increase in the key NBS interest rates into their demands for government bond yields. This situation persisted until the end of November. During October and November, the benchmark government bond yield curve rose by 44-95 basis points (the steepest increases occurred in shorter

Chart 8 Upward shift in the government bond yield curve



maturities), and thus the slope of the yield curve moderated substantially. The narrowing of the gap between the individual maturities in the fourth quarter resulted from the sensitive reaction of shorter maturities to the expected monetary policy tightening by the NBS.

The situation changed significantly at the end of November, owing to the entry of Slovakia into the exchange rate mechanism II (ERM II) and the subsequent marked appreciation of the Slovak koruna. As a result, foreign investors showed increased interest in Slovak financial assets, which led to a fall in bond market yields, followed by stabilisation.

Secondary market for securities within the BCPB

In 2005, the capital market of Slovakia remained a market with the lowest capitalisation and the smallest trading amount in the Central European region, and the indicator of market capitalisation of quoted shares stood at only 10.2% of GDP at the end of the month.

At the end of 2005, the Bratislava Stock Exchange (BCPB) registered a total of 381 securities on its markets (shares, equities, and bonds), of which 35 issues were on the quoted main market, 46 on the quoted parallel market, and 300 issues on the free market. One issue on the free market was in eurobonds; it was a ten-year issue of SR government securities launched on 14 April 2000. On the quoted new market, no issue was registered in that period.

During 242 trading days, the financial value of transactions on the BCPB floor reached Sk 1,002 billion, which was 131.8% more than in the previous year. Despite the statistically high annual value of transactions in koruna terms, trading is not considered to be active. In total, 10,814 transactions were

Chart 9 Structure of transactions on the BCPB floor

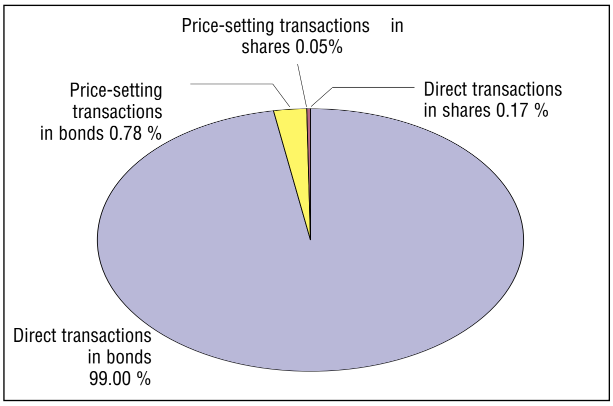
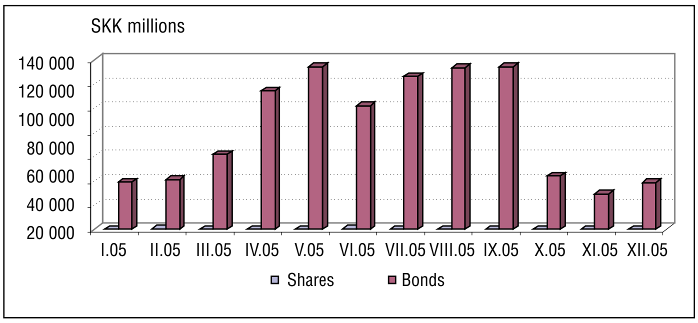


Chart 10 Development of trade in shares and bonds



conducted, in which 19.95 million securities changed hands. On a year-on-year basis, the number of transactions dropped by 38.7%.

A closer look at the structure of transactions shows that the dominant part of the annual trading amount was traded in direct transactions (4,240), amounting to Sk 993.7 billion (an increase of 142.2%). The price-setting function of the main organiser of the Slovak capital market weakened by 63.6% compared with 2004, and Sk 8.2 billion took place in price-setting transactions (in 6,574 contracts). Price-setting transactions accounted for only 0.8% of the total volume traded in 2005, compared with 5.2% in 2004.

To be continued in Volume 6/2006.