Report on Monetary Developments in the Slovak Republic in 2004

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2.1. Economic developments

Macroeconomic developments in Slovakia in 2004 were affected by several crucial factors, including primarily the country's entry into the European Union and the completion of its tax reform. The Slovak Republic became a member of the EU on 1 May 2004. This membership comprised the duty to participate in EMU as a member state with a derogation. This means that, by joining the EU, Slovakia undertook to become a member of the monetary union in the future. At the same time, the National Bank of Slovakia became a member of the European System of Central Banks (ESCB), with all the rights and duties arising from this membership. After meeting the criteria of convergence, a member state with a derogation will be allowed to introduce the European single currency and its central bank will become part of the Eurosystem. By joining the European Union, the Slovak Republic has also adopted the Common Agricultural Policy, which comprises a set of economic, financial, legislative, and institutional instruments designed to create a single market for agricultural products. Its primary objective is to provide a basis for effective production, stability, and financial solidarity in the agricultural sector. In 2004, a Convergence Programme for the Slovak Republic covering the period 2004 – 2010 and its update was drawn up and approved. At the same time, the Ministry of Finance and the NBS approved a common document called Specification of the Strategy for Adopting the Euro in the SR. It concluded that the introduction of the euro in 2009 is realistic and that the Maastricht criteria are expected to be met by the Slovak economy by 2007. On 1 January 2004, a complex tax reform entered into effect, introducing a flat value added tax rate (19%) and a flat rate for personal and corporate income tax (19%).

In the area of consumer prices, both overall and core inflation followed a positive trend in 2004, when the 12-month rate of overall inflation slowed by 3.4 percentage points, to 5.9%, and that of core inflation fell by 1.5 percentage points, to 1.5%. Developments in consumer prices were primarily affected by domestic cost factors, which were closely connected with administrative measures applied in the area of regulated prices and indirect taxes (excise tax and value added tax). Within the scope of indirect taxes, May saw increases in excise duties on cigarettes and wine for intermediate products. Compared with 2003, however, the impact of administrative measures on the 12-month inflation rate lessened, from 7.0 to 4.8 percentage points. These measures were reflected as secondary effects in the prices of market services. The modest acceleration in their year-on-year dynamics was also affected by one-off factors, such as a change in methodology, consisting in the transition of charges for compulsory contractual motor vehicle insurance from regulated prices to market services prices, and an amendment to the value added tax law with an impact on the price of canteen meals.

Price developments in the tradable sector were affected during the year by external factors, primarily by fuel prices, which, except for the first three months, showed a tendency to increase year-on-year throughout 2004. The rise in oil prices on the world market was, however, dampened by the strengthening of the Slovak koruna against the euro as well as the US dollar. In addition to fuel prices, the koruna exchange rate also had an impact on price levels in the form of low imported inflation, which led to a slowdown in the year-on-year growth rate or a year-on-year drop in food prices at the end of the year (by 2.1%). Food prices were affected first and foremost by external factors, such as entry into the EU, the opening of the market, growing competition, good harvest, appreciation of the koruna exchange rate, and the adoption of the Common Agricultural Policy.

The rate of economic growth accelerated in comparison with the previous year by 1 percentage point, to 5.5%, representing the fastest rate since 1997. Compared with the past year, the real economy indicators followed a different course in 2004. The structure of economic growth was more balanced, since it was based on both foreign and domestic demand. The year under review saw a gradual revival in all components of gross domestic product, while the increase in GDP in terms of use was generated by domestic demand, primarily as a result of dynamic growth in its investment and consumption components. The increase in domestic demand can be attributed to wage developments, the tax reform, and foreign direct investment. Economic growth was dampened somewhat by an increase in the negative growth of net exports as a share of GDP, which was caused by an excess of imports over exports. The dynamic growth in gross capital was stimulated by an increase in the volume of inventories, concentrated in the supplies of materials and goods connected with the growing trend in the economy. Room for a revival of growth in final household consumption was created first and foremost by an increase in real wages and a tax reduction for current household income, continuing growth of household´s propensity to consume, and the availability of commercial bank loans and new consumer and mortgage loan products. The growth in the interest of households in koruna loans led to an increase of SKK 31.6 billion (37.2%) in such loans. Wage development in 2004 was also faster than expected. Since real labour productivity still exceeded the rate of real wage growth in 2004, wages were not a source of demand-based inflationary pressures in the economy.

In comparison with the previous year, the deficit in the balance of payments on current account as a share of GDP increased in 2004 by 1.5 percentage points to 3.5%. The deterioration took place in the trade and income balances as a result of an increase in yields paid to direct investors. The negative balance of trade was caused by a stronger growth in imports than in exports. Within the structure of exports by commodity, the share of machinery and transport equipment decreased in 2004, primarily as a result of a decline in the exports of automobiles and motor vehicle accessories. The structure of imports changed: the imports of machinery and equipment, which may be classified as imports of technological equipment for the national economy, increased in connection with the growth in investment demand, which may have a direct impact on the restructuring of the economy with a future effect on export growth. The deficit in the balance of payments on current account was covered by a surplus on the capital and financial account. This surplus was partially created by an inflow of foreign capital into the commercial sector in the form of direct investments and partly by portfolio investments, which was affected in 2004 by the interest rate differential and the expectation of an appreciation in the exchange rate of the Slovak koruna among investors.

The economic situation in Slovakia in 2004 was also affected by positive developments in public finances. Budgetary performance in the general government according to the ESA 95 methodology improved year-on-year by 0.4 percentage point, and resulted in a deficit of 3.3% of GDP. The improvement in comparison with the projected deficit (4%) was connected with the implementation of the tax reform, social reforms, and reforms in the financing of regional self-governments, and is in line with the medium-term objective of consolidation in public finances. With effect from 1 January 2004, a new system of debt and liquidity management was introduced via the Agency for Debt and Liquidity Management (ARDAL). With the establishment of ARDAL, the tasks and responsibilities were redistributed among the National Bank of Slovakia, the Ministry of Finance, the Treasury and ARDAL.

The implementation of monetary policy in the area of key interest rates during 2004 was characterised by gradual reductions in March, April, July, and November, by a total of 2 percentage points. Decisions concerning the key rates, which are the main monetary-policy instruments of the NBS, were made with respect to developments in the main macroeconomic indicators, particularly the factors affecting the course of inflation. Thus, the falling inflation rate created room for the lowering of interest rates. The NBS changed its rates in support of a revival in domestic demand and in order to stop speculation on the foreign exchange market. The inflow of short-term capital with a consequent appreciating effect on the exchange rate resulted from the attempt of foreign investors to make use of the positive interest rate differential and the expectation of a further appreciation in the Slovak koruna. In reaction to the excessive strengthening of the exchange rate, causing deflation in certain consumer basket components, the NBS also conducted foreign exchange interventions during the year. The impact of monetary policy in 2004 may be assessed as neutral, despite the cuts in key interest rates necessitated by the restrictive effect of the exchange rate.

The cuts in the official rates of the NBS were accompanied by reductions in interest rates for primary commercial bank clients, particularly in lending rates for enterprises and deposit rates. The lowering of deposit rates led to continued transfers of funds in the household sector to alternative forms of investment, especially mutual funds, despite the fact that such funds are not covered by the Act on Protection of Bank Deposits . As a result of interest rate developments and changes in household tendencies, the dynamics of demand deposits increased in 2004 to the detriment of time deposits, while the growth rate of the M2 money supply slowed in comparison with the figure for 2003.

In line with harmonization of the monetary-policy instruments of the NBS with those of the European Central Bank, the National Bank of Slovakia reduced the required-reserve ratio for the banking sector by 1 percentage point, from 3% to 2% with effect from the beginning of the year, thus harmonising the reserve requirements with the minimum reserve system in the euro area.

In December 2004, the Bank Board of the NBS discussed and approved the Monetary Programme of the

NBS for the period until 2008, which sets the goals and priorities of monetary policy until the adoption of the euro. In connection with the expected entry of Slovakia into the euro area and the requirement to meet the Maastricht criteria by the date of entry, the NBS started setting a framework for monetary policy in the medium-term horizon, in the form of a binding objective (with effect from January 2005). The NBS defines its monetary policy strategy as inflation targeting in the conditions of ERM II. In the Monetary Programme of the NBS for the period until 2008, the 12-month HICP inflation target for December 2006 was set at 2.5% and for December 2007 and 2008 below 2%.

2.1.1. Price developments

Inflation

Inflation in terms of the Consumer Price Index

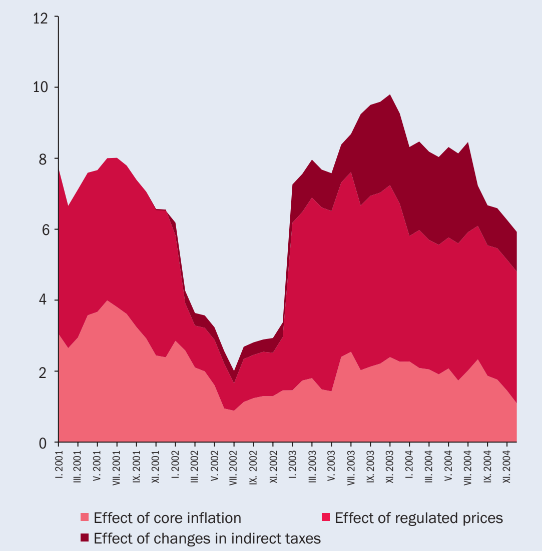
In 2004, consumer prices increased less dynamically than in 2003, with the 12-month inflation rate, expressed in terms of the Consumer Price Index, reaching 5.9% in December (compared with 9.3% in the same period a year earlier). The average rate of consumer-price inflation in 2004 stood at 7.5% (compared with 8.5% in 2003).

The fall in the year-on-year dynamics of consumer prices in 2004[1] (compared with the previous year) was due to a slowdown in the rate of price increases in most basic categories of the consumer basket. Core inflation accounted for 1.09 percentage points of the total increase in consumer prices (5.9%). Administrative adjustments to regulated prices contributed 3.71 percentage points to the overall consumer price increase. Changes in indirect taxes were responsible for 1.12 percentage points of the overall inflation rate.

During the first half of 2004, the 12-month inflation rate hovered around the level of 8.0%, then recorded a marked slowdown over the second half of the year.

Price levels in 2004 were primarily determined by domestic factors (as in previous years), with price developments being affected mostly by administrative measures. January saw an increase in regulated prices and a change in VAT rates (the introduction of a 19% flat VAT rate), followed in May by an increase in excise duties on cigarettes and a moderate increase in excise tax on wine for intermediate products. Administrative measures (changes in regulated prices and indirect taxes) accounted for approximately 82% of the overall price increase in 2004. These measures (the increased energy prices and the change in VAT rates) had a secondary effect on prices for market services, whose year-on-year dynamics increased slightly in comparison with the previous year. Consumer prices were also affected by developments in food prices, which recorded a slowdown in year-on-year dynamics during the year and a year-on-year drop at the end of the year. Food prices were mainly affected by external factors (EU entry, adoption of the Common Agricultural Policy, opening of the market, growing competition, good harvests, and the strengthening of the exchange rate). The appreciation of the Slovak koruna against the euro and the US dollar was also reflected in fuel prices, where the exchange rate development offset the rise in oil prices on the world market. The exchange rate of the koruna also had an impact on price levels in the form of low imported inflation, which led to a slowdown in the dynamics of tradable goods prices and/or a year-on-year fall in price levels.

Chart 7 **Structure of the 12-month inflation rate (percentage points)**



Source: Statistical Office of the SR.

Regulated prices

Consumer price developments were, as in previous years, determined by the application of administrative measures in the area of regulated prices. At the end of the year, the year-on-year dynamics of regulated prices reach ed 15.1%. January saw increases in regulated prices for electricity, gas, heating, bus and railway fares, water supply and sewage disposal.

[1] *Inflation expressed in terms of the Consumer Price Index is, unlike other price indicators, given for December 2004, with regard to the need to calculate the contributions of individual consumer-basket components to overall inflation. For this reason, the table of consumer price developments contains data from the last months of the individual quarters of 2004.*

Table 4 **Consumer price developments**

	Dec. 2002	Dec. 2003	2004 Mar.	2004 June	2004 Sep.	2004 Dec.
Total in %	3.4	9.3	8.2	8.1	6.7	5.9
Regulated prices in %	6.5	18.7	14.7	15.7	15.0	15.1
Share of total, in percentage points	*1.50*	*4.45*	*3.65*	*3.86*	*3.68*	*3.71*
Impact of changes in indirect taxes on non–regulated prices – share of total, in percentage points	*0.41*	*2.54*	*2.48*	*2.54*	*1.13*	*1.12*
Core inflation in %	1.9	3.0	2.8	2.3	2.6	1.5
Share of total, in percentage points	*1.46*	*2.27*	*2.05*	*1.73*	*1.87*	*1.09*
of which:						
Food prices in %	-0.2	2.7	1.6	0.5	1.1	-2.1
Share of total, in percentage points	*-0.04*	*0.54*	*0.31*	*0.10*	*0.20*	*-0.41*
Tradable goods in %[1)]	2.8	1.2	0.7	0.7	0.5	-0.2
Share of total, in percentage points[1)]	*1.05*	*0.44*	*0.25*	*0.23*	*0.18*	*-0.07*
Market services in %[1)]	2.5	7.0	7.8	7.3	7.7	8.2
Share of total, in percentage points[1)]	*0.45*	*1.30*	*1.49*	*1.40*	*1.48*	*1.57*
Net inflation (excluding the impact of changes in indirect taxes) in %	2.7	3.1	3.2	3.0	3.1	2.8
Share of total, in percentage points	*1.50*	*1.73*	*1.74*	*1.63*	*1.67*	*1.50*

Source: Statistical Office of the SR.
1) NBS calculations, based on data from the Statistical Office of the SR.

Price levels also increased during the year for meals at school canteens and accommodation at university dormitories. The following months saw rent increases for state-owned and municipal flats, municipal public transport fares, and prices for health services.

Changes in indirect taxes

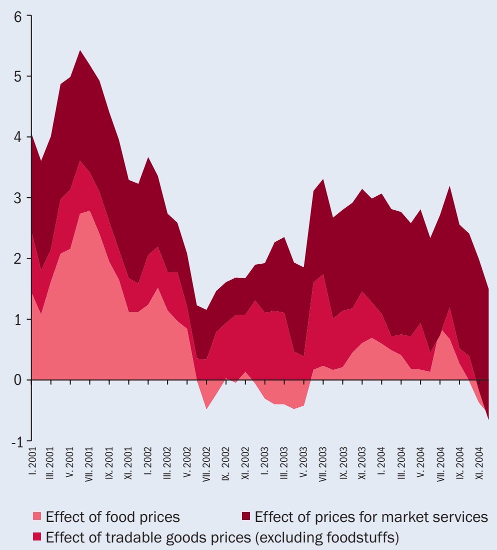
In January, value added tax rates were unified, at the level of 19% (the basic rate was lowered from 20% to 19% and the reduced rate was raised from 14% to 19%); this was followed in May by an increase in the excise duty on cigarettes and, to a lesser extent, in the excise duty on wine for intermediate products. These changes contributed a total of 1.12 percentage points to the overall consumer price increase in 2004.

Core inflation

In December 2004, core inflation reached 1.5%, representing a fall of 1.5 percentage points in comparison with the same period in 2003. Its course during the year was characterised on the one hand by a slowdown in year-on-year dynamics and/or a fall in food and tradable goods prices (excluding fuel prices) and, on the other hand, by an accelerated increase in prices for market services and a rise in fuel prices.

Within the basic structure of core inflation, prices for market services were the determining factor in the price increase (making the most significant contribution to core inflation), for they reflected the secondary effects of the increase in regulated prices (energy prices in particular). The year-on-year increase in market services prices was not only affected by the secondary effects of changes in regulated prices, but also by the transfer of compulsory contractual motor vehicle insurance from regulated prices to market

Chart 8 **Structure of the 12-month core inflation rate** **(percentage points)**



Source: Statistical Office of the SR.

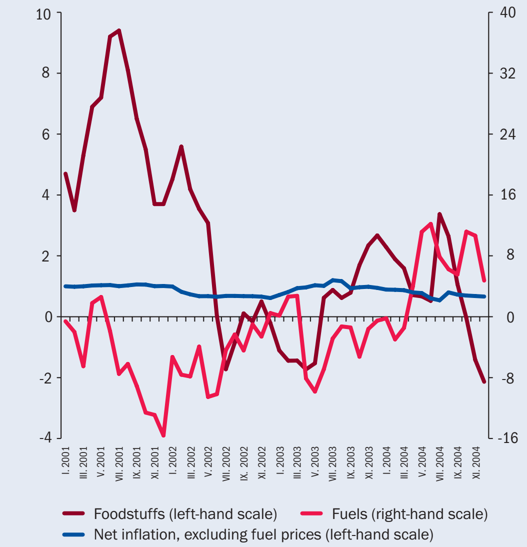
services prices and by the impact of the amendment to the VAT law on prices for canteen meals.

Food prices (excluding non-alcoholic beverages), as a component of core inflation, recorded a year-on-year fall of 2.1% at the end of the year. This development was caused by several factors. The entry of Slovakia into the EU and the opening of the market for new suppliers, increased competition on the market owing to the entry of new retail chains, appreciation in the koruna exchange rate, and the good harvest in both Slovakia and the rest of Europe, had a damping effect on food prices. EU membership was connected with the adoption of the Common Agricultural Policy, which caused increases in the prices of certain foodstuffs (rice, sugar, some tropical fruit, beef). These increases were, however, eliminated by the aforementioned damping factors. Sharper month-on-month drops in food prices were recorded in the second half of the year.

The course of net inflation was characterised by a slowdown in year-on-year dynamics, especially at the end of the year. This was mainly caused by developments in tradable goods prices (excluding fuel prices), which were affected by the appreciation of the Slovak koruna. On a year-on-year basis, net inflation reached 2.8% in December.

Net inflation was dampened by the prices of tradable goods, which fell year-on-year by 0.2% in December. The moderate fall was a result of several factors. In the environment of strong competition in retail trade, the prices of tradable goods were also affected by developments in the koruna exchange rate, when its

Chart 9 **Developments in the prices of core inflation components (year-on-year increase in %)**



Source: Statistical Office of the SR.

marked appreciation at the end of the year exerted pressure on consumer prices, in the form of imported deflation.

In the tradable goods sector, a certain volatility was recorded in fuel prices, which reacted to the changes in oil prices, the exchange rate of the koruna against the dollar, and developments in fuel prices on the commodity markets. In the first few months of the year, the price of oil hovered around the level of USD 30/barrel. The growing demand on the world market, particularly in fast-growing economies (China, India), economic and political problems in certain producer countries (Venezuela, Nigeria, Russia, Iraq), and the unwillingness of OPEC countries to flexibly adjust oil production to the growing demand, caused oil prices to rise in October, to USD 50/barrel. Consequently, oil prices decreased and they reached the level of USD 40/barrel in December. The exchange rate of the koruna against the US dollar appreciated throughout the year and partly offset the increase in oil prices. During 2004, except for the first three months, fuel prices increased on a year-on-year basis.

The prices of market services, which were mostly determined by domestic cost factors in the form of higher regulated prices, increased at a rate of over 7.0% throughout the year, and showed a tendency to accelerate. At the end of the year, the year-on-year rate of price increase in market services reached 8.2%, which was 1.2 percentage points more than in the same period a year earlier. The steepest increases were recorded in prices for housing-related services, education, and insurance (compulsory contractual motor vehicle insurance).

The year-on-year increase in market services prices was not only affected by the secondary effects of changes in regulated prices, but also by the transfer of compulsory contractual motor vehicle insurance from regulated prices to market services prices and by the impact of the amendment to the VAT law on prices for canteen meals.

Inflation in terms of the Harmonised Index of Consumer Prices

Consumer prices, expressed in terms of the Harmonised Index of Consumer Prices (HICP)[2], had increased by 5.8% by end December 2004, representing

[2] *Part of the Treaty on the European Union is Protocol 6 on the criteria of convergence (Article 1), which stipulates that 'inflation is to be measured in terms of a consumer price index on a comparable basis, with respect to the differences between the national definitions'. For that reason, a legal basis started to be created in 1995 for a harmonised methodology for the compilation of consumer price indices in EU member states, since the national price indices failed to meet the above*

Table 5 **Consumer price developments in terms of the HICP** **(year-on-year change in %)**

	2002	2003	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2004 Year
Total	3.5	8.5	8.2	8.0	7.2	6.1	7.4
Goods	2.3	7.6	7.1	7.2	6.0	5.8	6.2
Services	6.7	10.5	10.9	10.0	9.9	9.7	10.1

Source: Statistical Office of the SR.

a slowdown of 3.5 percentage points in dynamics when compared with the end of 2003. The average inflation in 2004 reached 7.4% (compared with 8.5% in the previous year). Prices of goods increased at a slower rate than the average price level (by 6.2%), while prices of services rose by 10.1%.

A factor increasing the dynamics of prices of goods in 2004 were energy prices, especially the prices of regulated components (electricity, gas, and other energy), which rose by an average of 15.3%. Fuel prices were 11.3% higher than in the previous year. The rate of increase in the prices of industrial goods (excluding energy) slowed gradually during the year, hence the price level rose over the course of 2004 by only 1.0%. Within the structure of industrial goods, the steepest increases took place in the prices of short-term consumer goods (3.2%), while the prices of durables dropped by 1.7%. Food prices rose by 5.8%, due to increases in both processed and non-processed food prices (7.5% and 1.4% respectively).[3]

In services, the most rapid increases were recorded in prices for regulated services (in services related to housing: 19.9%, transport: 13.6%) and prices for other recreation and personal services (11.0%). On the other hand, the slowest price increase took place in postal and telecommunications services (1.0%).

Producer prices

Producer price developments in 2004 were affected by numerous factors, such as the completion of regulated price adjustments for domestic energy producers, the prices of imported energy-producing and other industrial raw materials, the exchange rate of the Slovak koruna, and the situation in primary agricultural production. The above factors resulted in a slowdown in the rate of increase in industrial producer prices, an increase in the dynamics of construction and building materials prices, and a rise in the prices of agricultural products as opposed to a fall in the previous year.

Industrial producer prices

The slower year-on-year rate of increase in industrial producer prices in 2004 was mainly a result of do-

Table 6 **Producer price developments (index, same period a year earlier = 100, average for the period)**

	2002	2003	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2004 Year
Industrial producer prices	2.1	8.3	3.0	2.8	3.6	4.5	3.4
Prices of raw materials	7.4	3.9	7.0	8.7	5.4	2.6	5.9
Industrial manufact. product prices	0.7	2.6	1.2	2.6	4.4	5.5	3.4
Prices of electricity, gas, steam and hot water	6.7	17.9	5.0	2.6	2.3	3.2	3.2
Construction prices	5.1	5.2	5.4	6.0	6.4	6.3	6.0
Building materials prices	3.2	3.6	3.5	3.9	7.2	8.0	5.6
Agricultural products prices	-0.7	-4.8	1.0	2.9	1.4	3.1	2.1
Prices of plant products	-1.2	-0.3	13.3	18.1	1.0	9.7	6.8
Prices of animal products	-0.6	-6.5	-1.5	1.1	1.5	-1.1	0.1

Source: Statistical Office of the SR.

criterion. The aim was to create a common and unified system, based on the same principles and respecting the differences in national consumer preferences, rather than a common consumer basket. The guarantor of this methodology was Eurostat. The new methodology provided a basis for the introduction of the Harmonised Index of Consumer Prices (HICP).

[3] *Food prices according to the HICP methodology also include the prices of alcoholic beverages, tobacco and tobacco products (as opposed to food prices according to the CPI methodology, where these items are included in the 'tradable goods' category) and are not adjusted for the effect of changes in indirect tax rates.*

Table 7 Developments in the GDP deflator **(year-on-year change in %, average for the period)**

	2002	2003	2004				
			Q1	Q2	Q3	Q4	Year
Consumer prices	3.3	8.5	8.3	8.2	7.4	6.3	7.5
Industrial producer prices	2.1	8.3	3.0	2.8	3.6	4.5	3.4
GDP deflator	4.0	4.7	7.3	4.1	3.3	4.0	4.6
Export deflator	0.8	-3.4	-2.9	-1.0	-2.9	-1.7	-2.1
Import deflator	-0.2	-3.3	-3.8	0.0	-1.3	-1.9	-1.7

Source: Statistical Office of the SR.

mestic cost factors. These factors caused a marked slowdown in the dynamics of electricity, gas, steam, and hot water prices (to an average of 3.2% in 2004, from 17.9% in the previous year). Owing to external factors, the industrial manufacturing product prices and prices of raw materials increased year-on-year more significantly than a year earlier.

The increase in industrial manufacturing products prices was generated by a modest rise in domestic energy prices and, in particular, by oil price developments on the world market. Starting from May 2004, price levels rose year-on-year mainly in sectors specialising in the processing of energy-producing raw materials, with the steepest increases being recorded in the price of refinery oil products (an average of 14%). The prices of basic metals and finished metal products increased year-on-year by 7.4%.

Price levels in the ‘foodstuffs, beverages, and tobacco’ category rose by an average of 2.9%, mainly as a result of increases in the prices of flour products, starch and starch products, dairy products, industrially prepared animal fodder, and beverages. On the other hand, the prices of meat, meat products, and tobacco dropped.

Construction prices

Construction prices rose year-on-year by an average of 6% in 2004, due to increases in the prices of construction repair and maintenance work (5.6%) and work on new construction, modernisation, and reconstruction projects in residential and civil engineering construction (6.1% equally).

The cost prices of materials and products used in construction (materials and products from domestic industrial producers) increased in comparison with the previous year by 5.6%, while the price of materials used in construction repair and maintenance work rose year-on-year by 5.3% and that of materials used in new construction, modernisation, and reconstruction projects increased by 5.6%.

Agricultural products prices

Agricultural products prices increased in 2004 by an average of 2.1% year-on-year, mainly as a result of a rise in the price of plant products (6.8%), accompanied by a modest increase in the price of animal products (0.1%).

The price increase in plant production was mainly connected with increases in sugar beet, legume, potato, and cereal prices.

Developments in animal products prices were affected by increases in the prices of eggs and fresh cow milk on the one hand, and by drops in the prices of pork, beef including veal, and poultry (live animals) on the other.

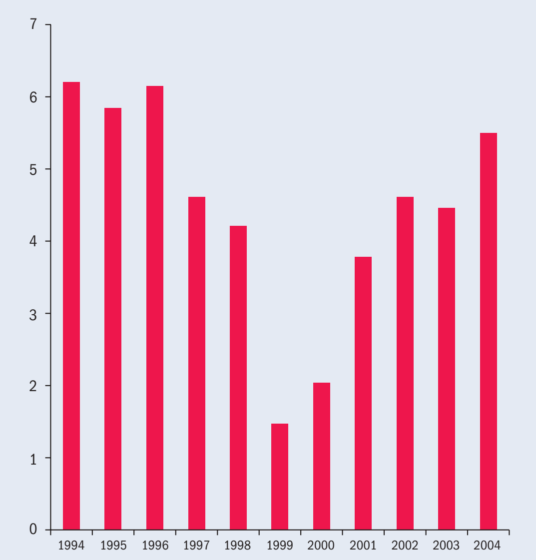
GDP deflator

The general price increase, expressed in terms of an increase in the GDP deflator, reached 4.6% in 2004, which was 0.1 of a percentage point less than in 2003. The development of the implicit GDP deflator was connected with the slower increase in consumer and industrial producer prices, and the appreciating trend in the exchange rate of the Slovak koruna.

The GDP deflator was affected by the domestic demand deflator and the relationship between the export and import deflators. The increase in the domestic demand deflator (5.2%) was primarily due to a rise in price levels for the consumption components of demand (6.8%), especially final household consumption. The price-related change in final household consumption (an increase of 7.0%) resulted mainly from adjustments to regulated prices. The slower increase in the price level of gross investments (1.0%) somewhat dampened the final increase in the domestic demand deflator.

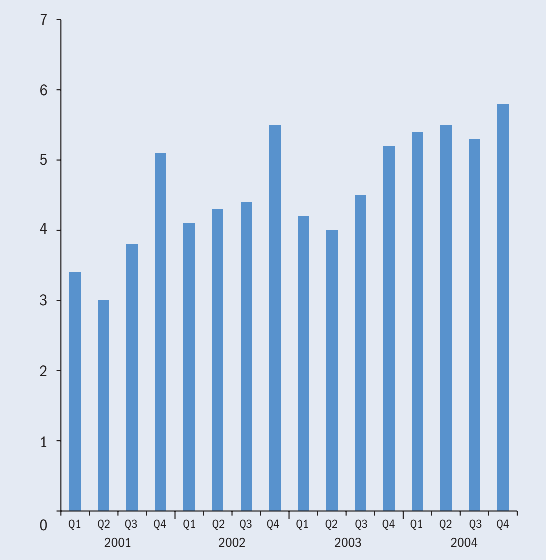
A downward effect on the GDP deflator was exerted by price developments in foreign trade. Developments in the koruna exchange rate and other price factors on foreign markets led to a year-on-year decrease in export as well as import deflators. The prices of

Chart 10 **Growth in gross domestic product (year-on-year growth in %)**



Source: Statistical Office of the SR.

Chart 11 **Real GDP growth by quarter (year-on-year growth in %)**



Source: Statistical Office of the SR.

exported goods and services fell more significantly than the prices of goods and services imported from abroad. The imported foreign supply deflator had a favourable effect on price levels on the domestic consumer market.

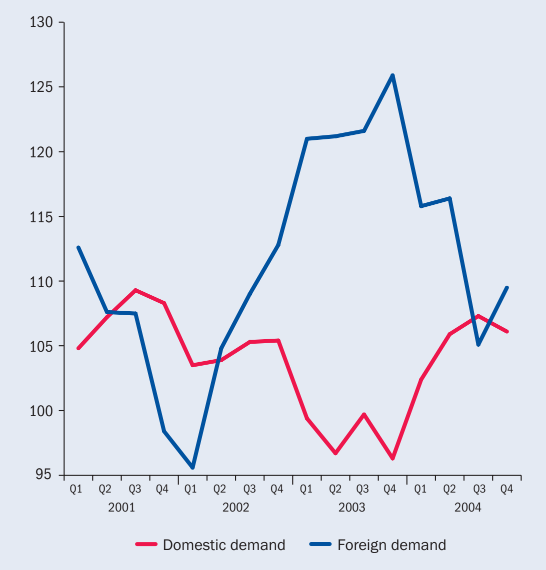
2.1.2. Gross domestic product

In 2004, gross domestic product increased year-on-year by 5.5% in real terms (according to preliminary data from the Statistical Office of the SR), representing the fastest rate of growth in the past eight years. Compared with 2003, the rate of economic growth accelerated by 1 percentage point. In terms of use, GDP growth was connected with an increase in domestic and foreign demand, and was generated mostly in financial intermediation, construction, industry, and trade. The nominal volume of GDP created over the period under review amounted to SKK 1,325.5 billion, which was 10.3% more than a year earlier.

In a breakdown by quarter, the rate of economic growth accelerated significantly in the fourth quarter of 2004, to 5.8% (the fastest growth since the second quarter of 1998). The strengthening of the position of the last quarter within the current year is a long-term trend. This is a result of restructuring and privatisation, including the effect of foreign direct investments in certain industrial sectors (especially in the production of machines, electrical equipment, and transport vehicles) and in certain services (mainly in trade, transport, and telecommunications). In these sectors, the rate of growth in added value accelerated mostly in the last quarter.

In terms of demand, the structure of GDP growth underwent a gradual change. In 2004, the Slovak economy maintained its growing tendency owing to a revival in domestic demand, which increased (after its drop-out for a year) by 5.5%. Although foreign demand grew by as much as 11.4%, its growth slowed in comparison with 2003 by almost 50%. The influence of domestic demand on GDP increased, from the first quarter of 2004, in parallel with the weakening growth in the exports of goods and services, which led to growth in domestic and

Chart 12 **Development of domestic and foreign demand (real year-on-year change in %)**



Source: Statistical Office of the SR.

Table 8 **Aggregate demand and its coverage** **(constant 1995 prices)**

	Volume in billions of SKK			Structure in %		
	2002	2003	2004	2002	2003	2004
Aggregate demand	1,368.8	1,486.1	1,618.5	100.0	100.0	100.0
Domestic demand[1)]	778.3	762.7	812.2	56.9	51.3	50.2
Foreign demand	590.5	723.4	806.3	43.1	48.7	49.8
Coverage of aggregate demand						
Domestic supply	749.9	783.4	826.5	54.8	52.7	51.1
Foreign supply	618.8	702.7	792.0	45.2	47.3	48.9

Source: Statistical Office of the SR.
1) Including statistical discrepancy.

Table 9 **Breakdown of GDP creation by component** **(SKK billions, constant 1995 prices)**

	2002	2003	2004	Growth index[1)]		
				2002/01	2003/02	2004/03
Output	1,778.7	1,870.3	1,928.2	104.4	105.1	103.1
Intermediate consumption	1,106.8	1,164.2	1,181.1	104.7	105.2	101.5
Value added	671.9	706.1	747.1	104.0	105.1	105.8
Net taxes on products[2)]	78.0	77.3	79.4	110.5	99.1	102.7
Gross domestic product	749.9	783.4	826.5	104.6	104.5	105.5

Source: Statistical Office of the SR.
1) Indices based on figures expressed in millions of SKK.
2) Value added tax, excise duties, import taxes, subsidies.

foreign demand at virtually balanced rates at the end of the year.

The development of domestic and foreign demand led to growth in aggregate demand (8.9% at constant prices, compared with 8.6% in the previous year). Within the structure of aggregate demand, the share of foreign demand increased year-on-year by 1.1 percentage points (to 49.8%), to the detriment of domestic demand.

Supply side of GDP

The creation of added value was affected by a marked growth in output and a relatively slow growth in intermediate consumption. Owing to the excess of growth in output over growth in intermediate consumption, the share of added value in the Slovak economy increased to 38.7% (from 37.8% in the previous year).

The real GDP growth was connected with the increased creation of added value in financial intermediation (by 30.1%), construction (by 11.8%), industry (by 11.5%), trade (by 11.3%), and in agriculture, including forestry and fishing, real estate, and other business activities. The creation of added value declined most significantly in non-market services, which are still in the process of restructuring (health care, public administration, education).

The growth in added value in financial intermediation was a consequence of improvement in the banking sector's effectiveness subsequent to restructuring and privatisation. Within the scope of services, added value also increased in wholesale trade, retail trade, and the repair of vehicles and consumer goods. The continuing growth in added value in this sector was a reaction to an increase in consumer demand in the household sector.

The dynamic growth in added value in industry was a result of an upturn in manufacturing production and was also supported by electricity, gas, and water supply. In manufacturing, the growth in added value accelerated in the manufacturing of chemical products, petroleum and rubber products, machines, electrical equipment, transport vehicles, metals and metal products. Developments in electricity, gas, and water supply were mainly connected with the supply of energy for accelerating growth in production, including export-oriented production, and with the extended offer of services by economic entities in the post-privatisation period.

Agriculture

In 2004, as opposed to the previous years (except 2001 and 2002), agriculture achieved a positive economic result. This fact was connected with numerous factors. On the one hand, the output of the agricultural

Table 10 **Gross domestic product by sector** **(year-on-year index, constant 1995 prices)**

	2002/2001	2003/2002	Q1 04/Q1 03	Q2 04/Q2 03	Q3 04/Q3 03	Q4 04/Q4 03	2004/2003
Gross domestic product	104.6	104.5	105.4	105.5	105.3	105.8	105.5
of which:							
Agriculture, forestry, and fishing	98.0	104.7	100.3	112.5	113.6	110.1	109.6
Industry in total	98.7	109.1	107.3	109.1	117.0	112.7	111.5
of which:							
Manufacturing	98.0	106.1	103.1	110.0	119.3	114.8	111.9
Electricity, gas, and water supply	114.3	150.7	135.0	102.4	101.3	95.3	111.3
Construction	108.4	106.8	109.4	104.9	122.5	110.4	111.8
Services in total	107.4	103.6	98.8	103.0	104.0	105.6	103.0
of which:							
Wholesale and retail trade, repairs	96.3	104.3	114.0	108.3	108.1	117.1	111.3
Financial mediation	128.3	112.7	138.2	133.4	163.1	95.2	130.1
Real estate, renting, and business activities	107.5	97.1	104.8	114.4	109.8	104.9	108.3
Public administration, defence, social security	110.3	104.7	94.6	93.1	84.7	102.4	93.8
Other[1)]	107.5	95.9	156.5	107.5	66.6	81.9	98.5

Source: Statistical Office of the SR.
1) Value added tax, excise duty, import tax, minus subsidies and imputed production of banking services.

sector was affected by favourable climatic conditions, which positively influenced the harvest and sales of plant products. On the other hand, the sector was affected by economical measures of agricultural farms, leading to a year-on-year reduction in their costs. The overall economic result was also positively affected by the availability of financial resources from the new system of agricultural support.

Improved business conditions led to an increase in the year-on-year dynamics of GDP creation in agriculture (by 3.9 percentage points compared with the previous year, to 9.7%). The share of agriculture in overall GDP creation also increased slightly (by 0.2 of a percentage point), to 4.7% in 2004.

In 2004, the total receipts of agricultural entities at constant prices were 1% lower than in 2003, due to a fall in revenue from the sale of animal products (by 3.7%), within the scope of which all types of products recorded a decline in sales (except for beef and poultry). Receipts from the sale of plant products increased by a total of 1.5%, with all types of plant products recording a year-on-year increase in sales (except for potatoes). The relatively slow growth in receipts from plant products was due to problems with the realisation of the excessive harvest sale.

The continuing restructuring in agriculture led to a fall in employment in this sector (by 9% year-on-year), which exceeded the figure for the previous year by 5.2 percentage points. The fall in employment and improved economic results probably stimulated dynamic growth in the average nominal wage, which increased year-on-year by 11.6% (in the previous year by 5.1%).

Industry

The dynamic GDP growth in industry accelerated in 2004 compared with the previous year, by 2.4 percentage points at constant prices, to 11.5%. The accelerated growth led to an increase in industry's share in the overall creation of real GDP, by 1.5 percentage points year-on-year, to 27.9%.

In 2004, the 12-month rate of growth in industrial production continued to slow slightly, to 4.0% (from 5.1% in 2003), owing to a decrease in the growth dynamics of manufacturing production and a further decline in mining and quarrying. On the other hand, the level of overall production reflected the pro-growth effect of production in electricity, gas, and water supply.

The manufacturing production output was affected by developments in the individual sectors. As a result of a drop in sales, the production of foodstuffs, beverages, and tobacco products declined on a year-on-year basis. The persistent recession, increased competition from abroad, and probably the insufficient volume of new investments, caused a downturn in production for the second consecutive year in the manufacture of textiles and clothes, chemical products and man-made fibres. As a result of a change in the structure of production and most probably the ongoing recession in the sale of motor vehicles on the world markets, production in the manufacture of transport vehicles declined by 2.4% (after markedly growing in 2003), mainly due to a drop in the second half of the year.

The improved sale conditions, restructuring, and investment in the development of production had a positive effect on the revival of growth in the manufacture of pulp, paper, and paper products, and in the production of coke, refinery oil products, and nuclear fuel. An acceleration in year-on-year dynamics was recorded in the manufacture of machinery and equipment and the manufacture of electrical and optical equipment. A growing tendency, though weaker than in the previous year, was maintained in the manufacture of rubber and plastic products, other non-metal and mineral products, and in the manufacture of metals and metal products.

The development of employment in industry was affected by continuing restructuring in electricity, gas, and water supply, and in mining and quarrying, which recorded a year-on-year fall in employment (by 4% and 8.8% respectively).

At the same time, employment in manufacturing increased by 1.1%, and contributed 0.4% to the growth of overall employment in industry. The average nominal wage in industry recorded a year-on-year increase of 10.2% (compared with 7.3% in the previous year), mainly as a result of wage growth in electricity, gas, and water supply.

Construction

Construction in 2004 not only maintained the growing trend in GDP creation from previous years, but also generated a marked increase in dynamics (by 11.8% at constant prices, compared with 6.8% in the previous year). Thus, the share of construction in overall real GDP creation increased year-on-year by 0.2 of a percentage point, to 3.7%.

The output of the construction sector maintained a relatively fast rate of growth, and increased year-on-year by 5.7% at constant prices (in the previous year by 6%). Its development was affected by a dynamic growth in domestic production in new construction, reconstruction, and modernisation projects, while production in repair and maintenance work abroad suffered a decline.

The attempt of construction firms to keep labour productivity growing was reflected in the development of employment, whose year-on-year growth rate slowed from 4% in 2003 to 2.7% in 2004. This was probably also affected by developments in average monthly nominal wages, which grew year-on-year by an average of 9%, compared with 3.9% a year earlier.

Services

Developments in the services sector were affected by numerous conflicting trends in 2004. The total volume of GDP created in services grew at a relatively slow rate (3% at constant prices, compared with 3.6% in the previous year). Consequently, the share of services in total real GDP creation decreased year-on-year by 1.3 percentage points, to 55.7%.

This decrease was a consequence of restructuring in the public sector (public administration, education, health care, other community and social services), which led to a marked year-on-year fall in added value in public services (by 11.8% at constant prices). On the other hand, in connection with the revival of private consumption and demand for investments, added value in business and financial services (increasing by 7% and 15% respectively) had a pro-growth effect on GDP creation in the services sector.

Thus, the revival in domestic demand led to growth in receipts from own-output and goods in retail trade (after a decline in the previous year) and growth in receipts from the sale and maintenance of motor vehicles, retail trade of fuels, and from postal and telecommunications services (faster than in 2003). After falling in 2003, the receipts of entities involved in wholesale trade, transport services, and other activities in transport, also increased. On the other hand, receipts from hotel and restaurant services, real estate, renting, and other business activities, continued to decline in 2004.

Employment in services followed a relatively favourable course of development, when the number of new jobs increased year-on-year in all branches of services, except for transport, post and telecommunications, health services and education. The growth in employment in individual services ranged from 1% to 2%, with the steepest increase taking place in employment in real estate, renting, and other business services (3.4%).

In 2004, average nominal wages increased in all branches of services, while developments in the individual branches differed considerably. The most rapid growth occurred in the average nominal wage in financial intermediation. Wage growth exceeded the average figure for the SR in wholesale and retail trade, transport and telecommunications, and in other community, social, and public services. On the other hand, wage growth lagged behind the Slovak average in hotel and restaurant services; real estate, renting, and other business services; public administration and defence; education; and in social care and health services.

Table 11 **Absolute year-on-year increases in GDP with contributions** **(constant 1995 prices)**

	2002		2003		2004	
	Growth in SKK billions	Contribution in % points	Growth in SKK billions	Contribution in % points	Growth in SKK billions	Contribution in % points
GDP	33.1	4.6	33.5	4.5	43.1	5.5
Domestic demand	33.9	4.7	-15.9	-2.1	41.9	5.4
Net exports	-0.8	-0.1	49.1	6.5	-6.4	-0.8

Source: Statistical Office of the SR.

Demand side of GDP

In terms of use, the 2004 increase in GDP (5.5%) was generated by domestic demand, while the main stimulus to economic growth in 2003 was foreign demand. This change resulted mainly from a dynamic growth in the investment component and a renewed growth in the consumption component of domestic demand. Domestic demand contributed 5.4 percentage points to the rate of GDP growth. Trading with abroad resulted in a negative contribution of 0.8 of a percentage point, by net exports to GDP. The difference between this figure and the final rate of GDP growth represented a statistical discrepancy.

Domestic demand

Domestic demand grew year-on-year by 5.5% at constant prices. Its growth was mainly caused by increased gross capital formation, which grew by 13.1% at constant prices (after weakening during the previous two years). Gross investment showed a tendency to grow during the year, from 4.4% in the first quarter to 18.4% in the fourth quarter. After a period of stagnation in the previous year, the consumption component of domestic demand recorded a modest increase in dynamics. The renewed growth in consumer demand (1.7% in the first quarter) accelerated over the next two quarters to 3.4%. In the final quarter, the rate of growth slowed to 3.0%, in line with the usual trend of development in previous years. The growth in final consumption during the year (2.9% at constant prices) remained below the rate of overall GDP growth.

Domestic investment demand

The dynamic growth in gross capital was primarily due to a record increase in the volume of inventories (SKK 18.6 billion at constant prices) and a gently accelerating growth in fixed investments. In terms of volume, the positive increase in inventories was only comparable with the figure for 1996 (SKK 15.2 billion), when fast economic growth was connected with macroeconomic imbalances. The growth in inventories in 2004 was concentrated mostly in materials and goods inventories, which was connected with the growing trend in the economy and the consequent upturn in investment in machinery and construction. The volume of non-finished production inventories was stagnant, which indicates that domestic production was satisfac-

Table 12 **Gross domestic product by use** **(year-on-year index, constant 1995 prices)**

	2002 / 2001	2003 / 2002	Q1 04 / Q1 03	Q2 04 / Q2 03	Q3 04 / Q3 03	Q4 04 / Q4 03	2004 / 2003
Gross domestic product	104.6	104.5	105.4	105.5	105.3	105.8	105.5
Domestic demand	104.6	98.0	102.4	105.9	107.3	106.1	105.5
Final consumption	105.3	100.3	101.7	103.4	103.4	103.0	102.9
Households	105.5	99.2	103.0	102.8	103.7	104.3	103.5
General government[1)]	104.9	102.7	97.4	104.7	102.6	100.2	101.2
Non-profit institutions serving households	104.4	110.9	104.2	105.8	105.9	107.2	105.8
Gross capital formation	102.6	91.8	104.4	112.5	116.9	118.4	113.1
Gross fixed capital formation	99.4	98.5	100.9	103.5	105.5	100.1	102.5
Exports of goods and services	105.6	122.5	115.8	116.4	105.1	109.5	111.4
Imports of goods and services	105.5	113.6	112.0	117.0	109.6	112.3	112.7

Source: Statistical Office of the SR.
1) Preliminary data.

torily realised on both domestic and foreign markets. Inventories were also affected by the volume of imports for investment, which were in large part registered as goods; they will be transformed into fixed capital only after the investment process is completed.

Fixed investments increased by 2.5% at constant prices, mainly due to the investment activity of non-financial corporations. For the acquisition of fixed investments (gross fixed capital), the non-financial corporations sector spent 5.5% more than a year earlier, also owing to their positive financial results. The investment activity of financial corporations was at a standstill. Investment in the general government remained below the level of the previous year, even though developments in the first half of the year indicated an upturn in investment activity in the public sector. At constant prices, fewer fixed investments (including residential buildings) were also recorded in the household sector, in an environment of increased bank lending for housing purposes. The investment activities of non-profit organisations increased substantially, but the creation of fixed investments remained virtually unaffected as a whole (due to the small share of such investments).

Gross fixed capital formation was mainly affected by an increase in the creation of new fixed assets (0.8%). At the same time, the acquisition of used long-term property showed a substantial increase in year-on-year dynamics (by 53.5%). The contribution of acquired used long-term property to the growth in assets increased, from approximately 7% in 2003 to 10% in 2004. Such a change in preferences was recorded in all sectors of the domestic economy. Part of the increase in used long-term assets was probably generated by imports.

Investment in machinery, especially in metal products and machines, contributed to the total increase in

Table 13 **Structure of gross fixed capital formation in 2004**

	Gross fixed capital formation (SKK millions)[1]	Share (%)[1]	Index[2] 2004/2003
Economy of the SR in total	327,226	100.0	102.5
of which (by production):			
Buildings	105,643	32.3	90.9
of which: residential buildings	20,123	6.1	93.4
other structures	85,520	26.1	90.3
Machinery	200,119	61.2	109.7
of which: metal products and machines	148,728	45.5	110.6
transport equipment	51,391	15.7	107.2
of which (by sector):			
Non-financial corporations	198,944	60.8	105.5
Financial corporations	44,888	13.7	100.6
General government	30,572	9.3	96.5
Households	52,011	15.9	96.9
Non-profit institutions	811	0.2	128.9

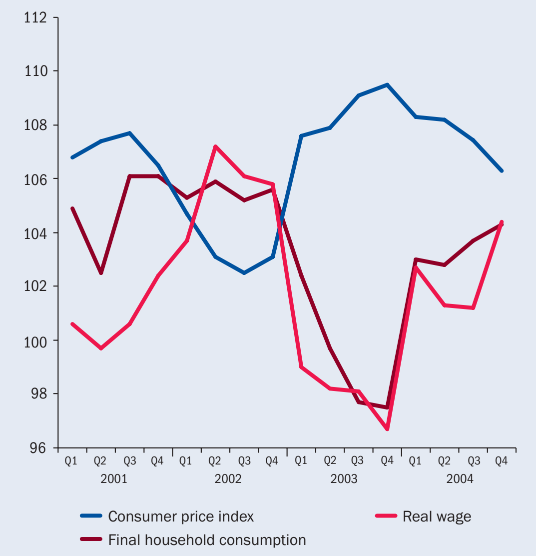
Source: Statistical Office of the SR.
1) At current prices.
2) At constant prices.

Table 14 **Investments and savings** **(%, current prices)**

	2002	2003	2004
Savings ratio[1]	22.2	23.6	24.0
Gross investment ratio[2]	29.3	25.4	26.3
Fixed investment ratio[3]	27.6	25.7	24.7
Coverage of investments by savings[4]	75.8	92.8	90.9

Source: Statistical Office of the SR.
1) Share of gross domestic savings (GDP less final consumption in total) in GDP.
2) Share of gross capital formation in GDP.
3) Share of gross fixed capital formation in GDP.
4) Share of gross domestic savings in gross investment.

Chart 13 **Final household consumption, inflation, and real wages (year-on-year development in %)**



Source: Statistical Office of the SR.

gross fixed capital formation. Investment in buildings declined, mainly as a result of reduced investment allocation for the construction of other structures, including public utilities.

The share of domestic savings in the financing of investment demand decreased slightly in 2004. In 2003, there were almost 93 hellers worth of gross savings in the national economy for 1 koruna worth of gross investments. In 2004, this ratio decreased slightly (to 91 hellers), but in the last two years it has been at the highest level since 1996.

Domestic consumer demand

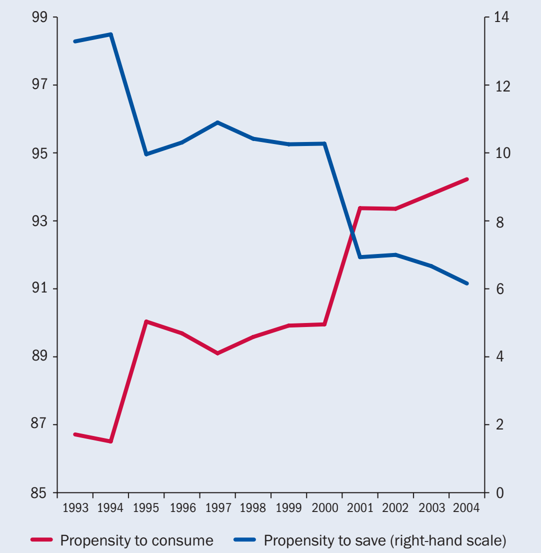
Final consumption increased at constant prices by 2.9% (in the previous year by 0.3%). Growth in final consumption was mainly stimulated by consumption in the household sector, but a significant increase was also generated by non-profit institutions serving households. The final consumption growth in the general government only slightly exceeded the level of the previous year. This was connected with fiscal discipline in institutions financed through the State Budget and the weaker growth in average wages in the public sector. The increase in consumption in non-profit institutions and the slower rate of growth in public consumption were partly connected with the transformation of selected public sector entities into non-profit organisations, which render services for households.

After falling in 2003 (by 0.8%), final consumption in the household sector grew by 3.5% at constant prices. The renewed and relatively balanced growth in private consumption in the first two quarters (up to 3%) accelerated to 4% in the second half of the year. The growth in private consumption, however, still lagged behind the rate of growth achieved before the imposition of administrative restrictions on demand in 2003.

Room for a revival of growth in private consumption was primarily created by the growth in real wages, stimulated by an increase in nominal wages and a fall in inflation. Further factors in the growth of private consumption were a reduction in the tax burden on current household income and the continuing growth in the propensity of households to consume. As a result of reduced tax rates for income from work, small business activity, and property, disposable income achieved the fastest rate of growth in the last five years. The dynamic growth of disposable income in the household sector created adequate conditions for a revival of growth in both consumption and savings.

However, the division of disposable income into consumption and gross savings indicates that the propensity of households to consume increased. The increase in the propensity to consume in 2004 was no longer forced by a shortage of disposable income in the sector as in the previous year, but by certain inert factors. These factors included an upturn in consumption after a forced restriction in 2003, the restitution of property from other sectors to the household sector, and/or the sale of property to other sectors (the sale of land to the non-financial corporations sector or the general government for capital construction). Within the structure of private consumption, the most rapid increases were recorded in expenditure on health serv-

Chart 14 **Propensity to consume and propensity to save** **(%)**



Source: Statistical Office of the SR.

Table 15 **Generation and use of income in the household sector** (current prices)

	Volume in billions of SKK		Index[1)]		Share in %	
	2003	2004	2003/2002	2004/2003	2003	2004
Compensation of employees (all sectors)	494.0	532.1	105.8	107.7	51.3	51.2
of which: Gross wages and salaries	368.3	399.4	105.4	108.4	38.3	38.4
Gross mixed income	264.9	289.0	107.6	109.1	27.5	27.8
Income from property – received	28.1	36.8	93.7	130.9	2.9	3.5
Social security benefits	143.9	148.9	108.8	103.5	14.9	14.3
Other current transfers – received	32.0	32.6	101.0	102.0	3.3	3.1
Current income in total	962.9	1 039.5	106.1	108.0	100.0	100.0
Income from property – paid	6.5	9.3	116.2	142.2	2.6	3.6
Current tax on income, property, etc.	50.3	45.6	105.2	90.7	20.0	17.8
Social security contributions	170.3	176.0	105.6	103.3	67.8	68.9
Other current transfers – paid	24.1	24.6	102.8	102.2	9.6	9.6
Current expenditure in total	251.3	255.5	105.5	101.7	100.0	100.0
Gross disposable income	711.6	783.9	106.4	110.2	100.0	100.0
Adjustment for changes in the net equity of households in the reserves of pension funds	3.3	3.0	136.3	91.4	–	–
Final household consumption	667.5	738.7	106.9	110.7	93.8	94.2
Gross savings of households	47.4	48.3	101.3	101.7	6.7	6.2

Source: Statistical Office of the SR.
1) Based on figures expressed in SKK millions.

ices (29.1%) and furnishings, household equipment, and the routine maintenance of dwellings (19.5%).

Income and expenditure of households

According to preliminary data from the Statistical Office of the SR, the current income of households in 2004 reached SKK 1,039.5 billion, representing a year-on-year increase of 8% in nominal terms (a year-on-year increase in dynamics of 1.9 percentage points). In real terms, current income grew by 0.5%, after falling in 2003 by 2.3%. Current household expenditure (paid to other sectors and not used for direct consumption) totalled SKK 255.5 billion, representing an increase of 1.7%. Thus, the year-on-year growth rate slowed in contrast to last year by 3.8 percentage points. In real terms, current expenditure decreased by 5.4%, compared with 2.8% in 2003.

The growth in current income was mainly affected by increases in gross mixed income (9.1%, compared with 7.6% in the previous year), employee compensation (7.7%, compared with 5.8% in the previous year), and income from property, while the growth in social income slowed and that in current income transfers remained, as in 2003, at a low level.

The year-on-year slowdown in the growth of current expenditure mainly resulted from a drop in current taxes on income and property (9.3% at current prices, compared with an increase of 5.2% a year earlier) and a slowdown in the growth of social contributions (3.3%, compared with 5.6% a year earlier). The development of these items was probably affected by the new tax and social security laws. They were not affected markedly by the continuing dynamic growth in expenditure related to income from property (as of the middle of 2001), due to its low weight in total current expenditure.

With current expenditure being deducted from current income, the gross disposable income of households amounted to SKK 783.9 billion, representing a year-on-year increase of 10.2% (compared with 6.4% in the previous year). Its dynamic growth was due in part to accelerated growth in current income, but in particular to a relatively marked slowdown in the growth of current household expenditure. Of the disposable income, more than 94% was used for final consumption, the remainder went to gross savings. The rate of growth in gross household savings accelerated slightly in comparison with 2003 (by 0.4 of a percentage point), but as a result of rapid growth in final household consumption in 2004, the gross saving ratio again decreased (from 6.7% in 2003 to 6.2% in 2004).

Net exports

The exports and imports of goods and services reached double-digit growth rates. The faster growth

Chart 15 **Export performance and import intensity** **(%)**

Source: Statistical Office of the SR.

Chart 16 **Unemployment rate** **(%)**

Source: Statistical Office of the SR.

in imports over exports led to a year-on-year deterioration in the balance of foreign trade. In nominal terms, net exports resulted in a deficit of SKK 35.6 billion (compared with SKK 17.9 billion in 2003). The increase in the deficit in nominal terms was accompanied by a decrease in the surplus in real terms. With price developments on foreign markets being taken into account, net exports at constant prices generated a surplus of SKK 14.3 billion (compared with SKK 20.7 billion in the previous year).

This development resulted from a marked slowdown in export dynamics (from 22.5% in 2003 to 11.4% in 2004), accompanied by a slight fall in import dynamics (from 13.6% to 12.7%). The decrease in export dynamics was accompanied by a slowdown in the growth rate of imports intended for export-oriented production. However, the dynamics of imports of goods and services intended for the coverage of domestic consumer and investment demand did not decrease and led, inter alia, to a marked increase in inventories in the economy. In the period under review, there was an identifiable relationship between the imports of transport vehicles and machines for the metallurgical, engineering, chemical, glass, and building materials industries on the one hand and increased investment in machines in the Slovak economy on the other. Hence, the maintenance of a relatively high rate of growth in imports was closely connected with the increased domestic demand.

The Slovak economy maintained a relatively strong export performance (76.8% at current prices), though it was 0.9 of a percentage point weaker than in 2003. Import intensity reached 79.5% and was 0.3 of a percentage point higher than a year earlier. The openness of the Slovak economy, expressed in terms of the ratio of exports and imports of goods and services to nominal GDP, stood at 156.9% in 2004.

2.1.3. Labour market developments

Employment and unemployment

Labour market developments in 2004 were characterised by increased labour supply, i.e. an increase in the number of economically active persons on the labour market (by almost 25,000 compared with the previous year). The year-on-year increase took place in the following age categories: 25 – 34 years, 50 – 54 years, and persons older than 55 years. These age categories accounted for 45.8% of the total number of the country's economically active population (compared with 42.6% a year earlier).

In 2004, employment grew at a slower rate than in 2003, when the number of persons employed in the Slovak economy determined on the basis of a labour force sample survey (including employees, entrepreneurs and the contributing family workers) increased year-on-year by 0.3% (in the previous year by 1.8%). The most significant contribution to growth in employment was made by entrepreneurs, both with and without employees, whose number increased by 23.5% (in the previous year by 14.8%). On the other hand, job opportunities for employees diminished and thus the number of employees dropped year-on-year by 2.2% (after growing by 0.3% a year earlier).

Employment followed a positive trend during the year, with a decline (stagnation) in the first two quarters changing into gradual growth in the second half of the year.

In a breakdown by sector, the most dynamic growth in employment in 2004 (according to statistical reports) was recorded in other community, social, and personal services; real estate, renting, and business activities; construction; hotels and restaurants; and in financial intermediation. The level of employment continued to fall in agriculture, transport, education, post and telecommunications, and, in contrast with 2003, in health services.

The number of unemployed determined on the basis of a labour force sample survey increased year-on-year by 4.7% in 2004, in contrast to 2003, when it dropped by 5.7%. The rate of unemployment rose in comparison with the same period a year earlier by 0.7 of a percentage point, to 18.1%.

According to the Central Office of Labour, Social Affairs and Family, the average unemployment rate in 2004 was 14.3% (compared with 15.2% in the previous year). This figure was below the level determined by a sample survey, which can be explained by methodological differences and by differing definitions of unemployment. The trends of development in unemployment according to the two sources of data were, however, practically identical over the course of the year.

Wages and labour productivity

In 2004, the average monthly nominal wage in the Slovak economy increased year-on-year by 10.2%, to SKK 15,825, and its growth was 3.9 percentage points faster than in 2003. The dynamics of wage growth in the individual quarters differed. After accelerating significantly in the first quarter (to 11.2%), wage growth slowed in the second and third quarters, before accelerating again in the fourth quarter (to 11.0%). In the non-financial sector, nominal wage growth culminated in the fourth quarter in electricity, gas, and water supply, trade, and construction, which was connected with the low basis of comparison in the same period a year earlier and with the favourable financial situation of entrepreneurial entities doing business in these areas. In the public sector, nominal wage growth accelerated towards the end of the year in education and health care, which was probably connected with a further decrease in the number of employees.

Average monthly nominal wages increased on a year-on-year basis in all sectors of the national economy in 2004 and their year-on-year dynamics accelerated in most sectors. Compared with 2003, the most dynamic wage growth was recorded in financial intermediation (13.7%); electricity, gas, and water supply (13.5%); trade and repairs (11.9%), and in agriculture, hunting, and forestry (11.6%), which still recorded the lowest average nominal wage among the sectors. The slowest wage growth was reported from health and social services (3.5%), hotels and restaurants (4.5%), and education (7.6%). In other sectors, wages grew at a rate of approximately 9% to 10%.

In a breakdown by sector, the strongest growth in average nominal wages was recorded in the corporate sector, in companies with 20 and more employees (by 12.5%, to SKK 18,296), budgetary organisations (by 9.2%, to SKK 14,271), and in subsidised organisations (by 5.4%, to SKK 13,743).

Table 16 **Labour market indicators**

	Year 2003	Q1 2004	Q2 2004	Q3 2004	Q4 2004	Year 2004
Nominal wage (SKK)	14,365	14,541	15,472	15,299	17,955	15,825
Nominal wage (index)	106.3	111.2	109.6	108.8	111.0	110.2
Labour productivity of GDP (index, current prices)	108.5	113.1	110.6	108.2	108.7	110.1
Nominal wage (index)	98.0	102.7	101.3	101.2	104.4	102.5
Labour productivity of GDP (index, const. prices)	103.6	105.4	106.2	104.7	104.5	105.2
Wage minus productivity (percent. points)	-5.6	-2.7	-4.9	-3.5	-0.1	-2.7
Employment according to statistical records (index)	100.8	100.0	99.3	100.6	101.2	100.3
Employment according to a LFSS[2] (index)	101.8	99.9	99.2	100.6	101.3	100.3
Registered unemployment rate[1] (%)	15.2	16.4	14.5	13.3	12.8	14.3
Unemployment rate according to a LFSS[2] (%)	17.4	19.3	18.5	17.5	17.1	18.1
Consumer prices (average index)	108.5	108.3	108.2	107.5	106.4	107.5

Source: Statistical Office of the SR.
1) Of the disposable number of unemployed, average for the period (NBS estimate).
2) Labour force sample survey (LFSS).

Chart 17 **Developments in real wages and real labour productivity (index, same period a year earlier = 100)**

Source: Statistical Office of the SR.

Real wages increased on a year-on-year basis by 2.5%, after falling over the same period a year earlier by 2%. Apart from the dynamic nominal wage growth, real wages were also affected by the course of inflation, whose average level in 2004 (7.5%) was one percentage point lower than in 2003.

Real growth in average wages was achieved in the vast majority of sectors, with declines being recorded only in health and social services (3.7%) and in hotels and restaurants (2.8%). Wages in education remained virtually at the level of last year (an increase of 0.1%).

Labour productivity (GDP per employee) showed dynamic growth in 2004: it increased in nominal terms by 10.1% and in real terms by 5.2%. Its development was mainly supported by the rapid GDP growth. The average annual rate of growth in nominal labour productivity remained somewhat behind the dynamics of nominal wages (by 0.1 of a percentage point), while the growth in productivity at constant prices exceeded the growth in real wages by 2.7 percentage points. The dynamic growth in nominal wages was also reflected in unit labour costs according to the methodology of the NBS (ratio of nominal wage growth to growth in real labour productivity), which increased by 4.8%, compared with 2.5% in 2003. This means that the growth in nominal costs per employee per real output unit accelerated, but, owing to the high level of inflation, the declining trend in real unit labour costs (a fall of 2.5%, compared with 5.5% in 2003) persisted in 2004. This indicates that, in the Slovak economy, wages were not a source of demand-based inflationary pressure in the past year, but affected the costs of companies.

2.1.4. Financial results of corporations

According to preliminary data from the Statistical Office of the SR, similar to last year, financial and non-financial corporations achieved different financial results in 2004. Financial corporations (banks, including the NBS, insurance companies, and other financial intermediaries) recorded, as in the previous two years, a negative financial result. Their total loss amounting to SKK 12.3 billion was connected with the results of financial institutions (a loss of SKK 22.2 billion), which was mainly affected by the financial result of the NBS (a loss of SKK 36.3 billion). The negative results of financial institutions were partly offset by the profits of other financial intermediaries, insurance corporations, and pension funds.

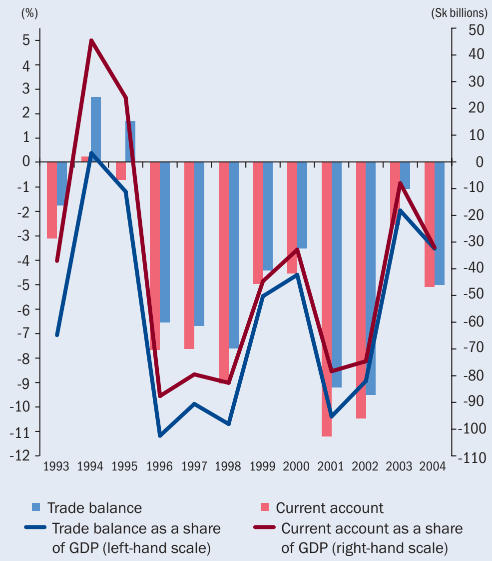
In 2004, according to preliminary data, non-financial corporations generated a total profit of SKK 192.3 billion, which was more than 24% larger than a year earlier. A positive development was the fact that all sectors under review, including agriculture, ended the year with a positive financial result. As in the previous year, the largest profits were generated in manufactu-

Table 17 **Financial results of corporations in 2004**

	2004 SKK millions	**2004/2003 index**
Financial results (before taxation)		
Non-financial and financial corporations in total	180,003	129.2
Non-financial corporations	192,344	124.3
Financial corporations	-12,341	79.7
Number of non-financial corporations (with 20 and more employees)	**2004 Number**	**2004/2003 Change**
Total	5,916	67
Non-loss-making corporations	4,157	238
Loss-making corporations	1,759	-171

Source: Statistical Office of the SR, Statistical report on the basic trends of development in the economy of the SR in 2004.

Chart 18 **Balance of trade and current account developments**



Source: Statistical Office of the SR.

ring; electricity, gas, and water supply; and trade. The most rapid year-on-year growth in profits was achieved in manufacturing; real estate, renting, and business activities; trade; and construction.

The improved financial results (in companies with 20 and more employees) created conditions for growth in the value of long-term tangible and intangible property, which increased from the beginning of 2004 to the end of the year by 4.5%. The favourable financial results led to an increase in the equity of companies (by 9%).

The financial results caused the number of profitable companies to increase and that of loss-making firms to decrease in 2004. Of the total number of non-

Table 18 **Balance of payments on current account (SKK billions)**

	2004	**2003**
Balance of trade	-47.0	-24.4
Services balance	8.6	8.7
Income balance	-13.1	-4.4
Current transfers	5.5	9.0
Current account in total	-46.0	-11.1
Current account as a share of GDP in %	-3.5	-0.8

Source: NBS and Statistical Office of the SR.

financial corporations with 20 and more employees (5,916), profitable companies accounted for more than 70% (compared with 67% a year earlier).

2.2. Balance of payments

2.2.1. Current account

In 2004, the balance of payments on current account resulted in a deficit of SKK 46.0 billion, which was SKK 34.9 billion more than in the previous year. This increase was largely due to a year-on-year deterioration in trade and income balances. The current account deficit reached 3.5% of GDP at current prices. The trade deficit as a share of GDP also increased, from 2.0% to 3.5%.

The trade balance resulted in a deficit of SKK 47.0 billion, representing a year-on-year increase of SKK 22.6 billion. The increase in the trade deficit was caused first and foremost by an excess of growth in imports over growth in exports.

According to preliminary data from the Statistical Office of the SR, goods were exported in 2004 in the

Table 19 **Year-on-year changes in Slovak exports by segments and the contributions of individual segments**

	Year-on-year change in SKK billions		**Contribution to the year-on-year changein percentage points**	
	2004	**2003**	**2004**	**2003**
Raw materials	18.9	2.5	2.4	0.4
Chemicals and semi-finished goods	39.8	14.8	5.0	2.3
of which: chemical products	9.3	0.5	1.2	0.1
semi-finished goods	30.5	14.3	3.8	2.2
Machines and transport equipment	30.7	124.1	3.8	19.0
of which: machines	42.7	28.8	5.3	4.4
transport equipment	-12.0	95.3	-1.5	14.6
Finished products	1.9	9.8	0.2	1.5
Exports in total	91.3	151.2	11.4	23.2

Source: NBS calculations based on Statistical Office of the SR data.

Table 20 **Year-on-year changes in Slovak imports by segments and the contributions of individual segments**

	Year-on-year change in SKK billions		Contribution to the year-on-year change in percentage points	
	2004	2003	2004	2003
Raw materials	23.4	-0.5	2.8	-0.1
Chemicals and semi-finished goods	29.2	20.2	3.5	2.7
of which: chemical products	8.6	10.3	1.0	1.4
semi-finished goods	20.6	9.9	2.5	1.3
Machinery and transport equipment	33.2	49.1	4.0	6.6
of which: machines	27.0	22.2	3.3	3.0
transport equipment	6.2	26.9	0.7	3.6
Finished products	27.8	10.9	3.4	1.4
of which: Agricultural and industrial products	17.8	2.4	2.2	0.3
Automobiles	5.0	1.4	0.6	0.2
Machines and electrical consumer goods	5.0	7.1	0.6	0.9
Imports in total	113.6	79.7	13.7	10.6

Source: NBS calculations based on Statistical Office of the SR data.

total amount of SKK 895.2 billion, which was 11.4% more than in the same period a year earlier (27.1% in USD and 15.5% in EUR).

In the structure of exports by commodity, the share of 'machinery and transport equipment' and 'finished products' decreased in 2004. In the 'machinery and transport equipment' category, a marked decline was recorded in the exports of automobiles and motor vehicle accessories. The automobile industry, which was the driving force behind the growth in exports in 2003, recorded a decline in 2004, mainly as a result of an extended shutdown in the production of automobiles and automobile accessories.

Foreign direct investment still acted as a stimulus to growth in the exports of machines and electrical devices. The year-on-year growth in exports in this category took place in automatic data processing machines, large household appliances, television sets, videophones, illuminating and signalling instruments, bearings, electrical transformers, integrated circuits, neon tubes, cables, etc.

Automobile components include automobile seats, whose exports in 2003 and 2004 followed the trend in the exports of automobiles and automobile accessories. Automobile seats were the main source of decline in furniture exports, which are included in the 'finished products' category. Subdued export activity was also recorded in 'other industrial products', especially in the export of footwear and clothes. In contrast with industrial products, the export of agricultural products increased by almost a third. This increase took place mostly in meat, milk, cocoa, sweets, medicinal herbs, etc.

The volume of goods imported in 2004 totalled SKK 942.2 billion, representing a year-on-year increase of 13.7% (corresponding to 29.8% in USD and 17.9% in EUR).

The dynamics of imports exceeded the dynamics of exports in 2004. Imports recorded a year-on-year increase, which took place in all four basic categories.

Among raw materials, marked increases were recorded in crude oil, black coal, and iron ore imports.

The year-on-year growth in the import of chemical products and semi-finished goods was stimulated by economic growth and developments in oil prices. The year-on-year increase in the import of chemical products was concentrated mainly in inorganic and organic chemicals, plastics in primary form, and rubber compounds. Dynamic growth was also recorded in the import of semi-finished goods. Increased imports in comparison with 2003 in nearly all categories of semi-finished goods (iron and steel, iron and steel products, copper, aluminium, zinc, timber, and paper) indicate that economic growth in 2004 was achieved in an environment of increased demand for material inputs.

In imports, as in exports, the share of machinery and transport equipment decreased slightly in 2004. The slower year-on-year growth in this category in comparison with the overall year-on-year growth in imports, was a result of a modest increase in imports in the automobile industry. On the other hand, above-average year-on-year growth was recorded in the import of machinery and equipment for industry, mainly the metallurgical, printing, chemical, and building materials industries, and in the imports of office machines, machines used in construction, transport, etc. The growth in the imports of machinery and equipment, which may be classified as imports of technological equipment for the individual sectors of the national economy, was connected with the growth in investment demand.

The imports of finished products, which grew at a faster rate than in 2003, was driven by growth in imports in both agricultural (meat, milk, vegetables, fruit, cooking oil, beverages) and industrial products (pharmaceuticals, clothes, footwear, furniture, toys, and sporting goods). In addition to these products, a modest increase in imports was also recorded in automobiles and consumer electronics.

Trade in services during 2004 resulted in a surplus of SKK 8.6 billion. Receipts from the exports of services dropped year-on-year by 0.6% and payments for imported services decreased by 6%.

Receipts from the international transport of goods and persons amounted to SKK 48.1 billion (a year-on-year fall of SKK 3.6 billion) and expenses totalled SKK 32.1 billion (a fall of SKK 0.8 billion). In terms of volume, the largest item in transport services was still income from the transport of natural gas and petroleum, which reached SKK 26.6 billion (55% of the total income from transport). The fall in received transit charges in koruna terms (4.3%) was connected with the appreciation of the Slovak koruna against the US dollar (in dollar terms, transit charges increased by 9.1%).

In international road, railway, and water-borne transport services, as well as in other services directly related to transport, the deficit increased by almost SKK 1.6 billion. The increase in the deficit was mostly generated by increased payments in air passenger services.

The positive balance of foreign tourism diminished year-on-year by SKK 5.7 billion. Foreign exchange receipts from foreign tourism reached SKK 29.1 billion (91.6% of the figure for 2003). The main reason behind the lower receipts from active tourism was a

Table 21 **Balance of services** (SKK billions)

	2004	2003
Balance of services	8.6	8.7
Transport	16.0	18.8
Tourism	5.0	10.7
Other services in total	-12.4	-20.8

Source: NBS.

decrease in the average number of nights spent in Slovakia by visitors from abroad, which dropped from 3.6 in 2003 to 3.3 in 2004. Another major factor was the appreciation of the Slovak koruna against the three basic currencies (the Czech koruna, the euro, and the US dollar). With developments in the koruna exchange rate taken into account, the total income increased year-on-year by almost 2%.

The expenses of Slovak citizens on travel abroad reached SKK 24.0 billion, which was SKK 3.0 billion more than in 2003. The number of Slovak citizens who travelled abroad increased year-on-year by 11.4%. Foreign tourism among Slovak citizens was stimulated by offers of low-priced trips, the development of cross-border tourism in connection with the appreciation of the koruna against the euro as well as other currencies, and by an increase in the disposable income of households.

Although the balance of 'other services in total' (telecommunications, construction, insurance, financial, renting, computer engineering, advertising, business, and technical services, etc.) remained in deficit, the size of the deficit decreased significantly in 2004 (to SKK 12.4 billion, from SKK 20.8 billion in 2003).

Compared with 2003, the exports of these services grew by 14.9%, while imports declined by 4.7%. The growth in exports and decline in imports took place in financial, mediating, and technical services, and in the subsidiaries of foreign companies in the SR. Imports declined to a greater extent than exports in legal, accounting, consulting, and education services, and in royalties and licences. The final balance was negatively affected by developments in insurance, computer engineering, renting, and other business services.

A positive balance, resulting from an excess of receipts from exports over payments for imports, was only recorded in telecommunications services, while construction services, which had been in surplus in previous years, recorded a deficit of SKK 1.1 billion as a result of faster growth in imports than in exports.

In 2004, the income balance resulted in a shortfall of SKK 13.1 billion, representing a deterioration of SKK 8.7 billion in comparison with the previous year. The deterioration was caused by the payment of dividends to foreign investors.

Investment in Slovak equity securities paid foreign direct investors dividends in the amount of SKK 21.1 billion, representing a year-on-year increase of almost SKK 15 billion. The yields of foreign investors from capital invested in the territory of Slovakia (yield from foreign direct investment is calculated as yield on property including interest as a share of the volume of foreign direct investment) reached approximately 3.7%, which represented a marked increase in com-

Table 22 **Capital and financial account of the balance of payments**		**(SKK billions)**
	2004	**2003**
Capital account	4.5	3.7
Direct investment	41.2	21.3
SR abroad	5.0	-0.5
In the SR	36.2	21.8
Portfolio investment and financial derivatives	29.4	-22.2
SR abroad	-30.7	-30.5
In the SR	60.1	8.3
Other long-term investment	-10.1	-13.0
Assets	-2.5	7.0
Liabilities	-7.6	-20.0
Short-term investment	37.1	74.8
Assets	-1.9	-11.2
Liabilities	39.0	86.0
Capital and financial account in total	102.1	64.6

Source: NBS.

parison with 2003, when the same ratio reached 0.5%. Investment in foreign equity securities paid Slovak investors SKK 0.2 billion in dividends (the same amount as a year earlier).

The balance of income from portfolio investment resulted in a deficit of SKK 1.0 billion, representing an improvement of SKK 3.8 billion in comparison with the figure for 2003. In 2004, the steepest increase took place in income from the reserve assets of the NBS and commercial banks.

The deficit in the balance of other investments improved year-on-year by SKK 1.4 billion. On the income side, which was dominated by interest on short-term loans provided to non-residents by Slovak banks, there were no substantial changes, while on the expenditure side, interest levels on long-term loans in the corporate sector fell as a result of an excess of loans repayment over borrowing.

In 2004, the balance of current transfers resulted in a surplus of SKK 5.5 billion, representing a year-on-year decrease of SKK 3.5 billion. The deterioration in the balance of current transfers was caused by a decline in payments from abroad and an increase in payments abroad, in the form of gifts and transfers, by legal entities.

According to data from the Commission of the European Communities, Slovakia received almost SKK 15 billion from the EU budget in 2004. Of this amount, SKK 11.2 billion belonged to current government transfers. On the other hand, the transfers of own funds to the general budget of the EU amounted to SKK 8.8 billion.

2.2.2. Capital and financial account

The capital and financial account resulted in a surplus of SKK 102.1 billion, which was SKK 37.5 billion more than in the same period a year earlier. The surplus in the capital and financial account as a share of GDP increased, from 5.4% to 7.7%. The structure of financial inflows also changed during the year: the share of short-term capital decreased and that of portfolio investments increased.

The capital account, which comprises foreign assistance of investment nature granted by foreign governments or non-governmental entities and the purchase / sale of patents, licences, and copyrights, resulted in a surplus of SKK 4.5 billion, representing a modest increase in comparison with 2003. A substantial part of this amount was made up of funds that came to Slovakia from the EU budget in the form of grants and were classified as 'investment assistance'.

The upturn in foreign direct investment in comparison with 2003 was mainly connected with the development of other capital. Other capital, which expresses the financial and business relations between foreign investors and domestic companies, recorded an inflow of SKK 15.2 billion in 2004, in contrast to 2003, when an outflow of SKK 11.2 billion was reported.

The inflow of foreign capital into the SR (in net terms) totalled SKK 27.1 billion, which was 24.3% less than the figure for the same period a year earlier. Apart from lower income from privatisation, the decline can be attributed to the purchase of shares issued by domestic entities from foreign investors.

In 2004, however, more funds were invested in industrial production than in 2003. Nearly 80% of the funds was invested in industry, mostly in the manufacture of coke, refined petroleum products, and nuclear fuel; chemicals and chemical products; motor vehicles; and machines and equipment.

In the area of portfolio investment, there was increased demand among domestic portfolio investors for foreign securities throughout the year. The major investors in 2004 comprised domestic banks, which invested mostly in long-term bonds. Non-bank entities also took an active part in trading in foreign securities. Apart from investing in bonds, the corporate sector also made use of the possibility of purchasing equity shares in foreign companies, up to 10%. The outflow of funds for the purchase of foreign investments totalled SKK 30.7 billion.

Foreign investors increased their holdings of domestic debt securities by SKK 60.1 billion. Their structure was dominated by government bonds. Koruna-denominated government securities, which were purchased by foreign investors via brokers in Slovakia, showed considerable volatility over the course of the year. Trading in SKK-denominated government securities ended with an excess of purchases over sales on the part of non-residents, in the amount of SKK 32.5 billion For the portfolios of non-residents, SR Treasury bills were sold in the amount of SKK 6.0 billion.

In 2004, the Government issued eurobonds on foreign markets in the amount of SKK 40.1 billion, while government liabilities arising from the maturity of eurobonds issued in previous years were settled in the amount of SKK 20.0 billion.

Other investments resulted in an inflow of funds from abroad in the amount of SKK 27.0 billion. The reduced inflow in comparison with 2003 took place in the official sector (NBS) and the corporate sector, while the banking sector recorded a much larger capital inflow than a year earlier.

Other long-term investments recorded an outflow of funds in the amount of SKK 10.1 billion. The outflow of long-term capital was mainly caused by an excess of repayments over drawings of financial credits in the corporate sector.

Corporate loans were drawn in the amount of SKK 33.8 billion, which was 40% more than in 2003. The upturn in borrowing in 2004 was mainly connected with the growing interest in employing foreign funds in electricity, gas, and water supply; metal production; trade and business services; financial mediation; and real estate activities. The repayment of financial credits in the corporate sector increased by 26%, to SKK 44.2 billion.

Short-term capital, which showed increased volatility during the year (on both sides of the balance sheet), recorded an inflow of SKK 37.1 billion.

The level of short-term liabilities was affected substantially (an increase of SKK 39.0 billion) by commercial banks (an increase of SKK 66.8 billion), which recorded increased capital inflows, mainly in the form of increases in the deposits of non-residents with commercial banks (58% of the increase in short-term capital in commercial banks took place in foreign currency and 42% in domestic currency).

The increase in non-resident deposits at commercial banks operating in Slovakia was, as the increased holdings of Slovak government securities, caused by expectations relating to the appreciation of the Slovak koruna. The increased inflow of such capital caused the Slovak koruna to appreciate by almost 8% during 2004. The marked outflow of short-term capital from the government sector, including the NBS (SKK 28.9 billion), was affected by repo operations conducted within the scope of foreign exchange reserve management by the NBS.

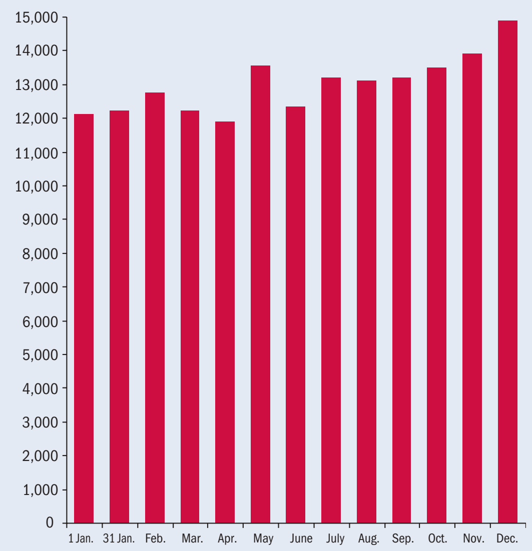
2.2.3. Foreign exchange reserves

At the end of 2004, the foreign exchange reserves of the NBS reached USD 14,913.1 million, representing an increase of USD 2,764.1 million (EUR 2,226.4 million) since the beginning of the year. The total foreign exchange reserves of the NBS were affected by numerous factors during the year. The key factors positively affecting revenues were the borrowing activities of the Government and proceeds from central bank interventions in the market. Expenditures were mainly determined by debt service payments effected on behalf of the Government. The National Bank's foreign exchange reserves were also affected during the year by the exchange rates of fully convertible currencies on international financial markets. The surplus in the balance of revenues and expenditures in 2004 (USD 1,677.1 million) was accompanied by positive exchange rate differentials (USD 1,087.0 million), which resulted from the strengthening of fully convertible currencies (especially the euro) in relation to the US dollar on international financial markets.

The revenue side of foreign exchange reserves was determined in 2004 by the following factors:

- yields from deposits and securities held in the portfolio of the NBS, amounting to USD 282.8 million;
- the drawing of government loans from foreign financial institutions in the amount of USD 1,439.8 million (of which the May issue of eurobonds accounted for USD 1,199.8 million);

Chart 19 **Developments in NBS foreign exchange reserves in 2004 (USD millions)**



Source: NBS.

- revenues from the interventions and direct transactions of the NBS on the interbank foreign exchange market, amounting to USD 2,208.7 million;
- other revenues of the NBS in the amount of USD 601.7 million.

The expenditure side of foreign exchange reserves in 2004 was affected by:

- debt service payments by the Government in the amount of USD 998.1 million, of which the payment of principal and interest on government eurobonds issued in previous years accounted for USD 715.6 million;
- debt service payments by the NBS in the amount of USD 55.9 million;
- other expenditures of the NBS in the amount of USD 856.4 million, incurred mostly in connection with cross-border payments made for NBS clients (USD 834.4 million);
- central bank expenditures, incurred in connection with repo operations (resulting in a negative balance of USD 869.4 million)[4];

At the end of 2004, the foreign exchange reserves of the NBS were 5.5 times greater than the volume of average monthly imports of goods and services to Slovakia in 2004.

The foreign exchange reserves of commercial banks reached USD 1,865.6 million at the end of 2004. The total volume of foreign exchange reserves in the banking sector, including the NBS, stood at USD 16,778.7 million.

2.2.4. External debt of the SR

On 31 December 2004, the total gross external debt of the SR stood at USD 23.718 billion (EUR 17.421 billion), representing an increase of USD 5,627.9 million (EUR 2,952.8 million) compared with the beginning of the year.

Total long-term foreign debt increased by USD 2,962.1 million, while the level of short-term debt also rose during the year. The year-on-year increase in Slovakia's foreign indebtedness (by USD 5,627.9 million) was substantially affected by the EUR/USD cross-rate, which appreciated from 1.250 (1 January 2004) to 1.361 (31 December 2004), i.e. by 8.9%.

Within the scope of long-term liabilities, the year under review saw an increase in the long-term liabilities of the SR Government and the NBS (by USD 2,298.2 million), primarily caused by a bond issue abroad by the SR Ministry of Finance in the amount of EUR 1 billion (USD 1,361.0 million) in May 2004 and a year-on-year increase in the volume of SKK-denominated government bonds held by non-residents (by USD 1,108.3 million). An increase in long-term foreign liabilities (by USD 490.7 million) was also recorded by entrepreneurial entities, as a result of borrowing. In the same period, the long-term foreign liabilities of commercial banks recorded only a modest increase.

Short-term foreign liabilities recorded the steepest year-on-year increase within the commercial sector in commercial banks (USD 2,641.6 million). A substantial part of the increase took place in the 'cash and deposits' item, which was connected with an inflow of short-term capital and led to increases in both foreign exchange and koruna deposits in commercial banks. The other short-term liabilities of commercial banks decreased by USD 433.3 million. The short-term liabilities of entrepreneurial entities increased year-on-year by USD 730.4 million, mainly as a result of trade credits and loans received.

At the end of 2004, Slovakia's per-capita gross foreign debt stood at USD 4,409, compared with USD 3,363 on 1 January 2004. The share of short-term debt in the country's total gross external debt increased slightly over the past twelve months, to 44.05%, from 43.02% on 1 January 2004.

[4] *The fall in foreign exchange reserves caused by repo operations led to a fall in the external debt of the SR. (Repo operations were included in foreign exchange reserves at the request of the ECB). The counterpart for this operation is a change in central bank liabilities.*

Table 23 **External debt**

	In USD millions		In EUR millions	
	31 Dec. 2003	31 Dec. 2004	31 Dec. 2003	31 Dec. 2004
Total external debt of the SR	18,090.2	23,718.0	14,468.3	17,421.1
Long-term external debt	10,308.2	13,270.3	8,244.4	9,747.1
Government and the NBS[1)]	4,347.7	6,645.9	3,477.2	4,881.5
Commercial banks	323.1	496.3	258.4	364.5
Entrepreneurial entities	5,637.4	6,128.1	4,508.7	4,501.1
Short-term external debt	7,782.0	10,447.8	6,223.9	7,674.0
Government and the NBS	915.5	209.3	732.2	153.8
Commercial banks	2,738.6	5,380.2	2,190.3	3,951.8
Entrepreneurial entities	4,127.9	4,858.3	3,301.4	3,568.4
Foreign assets	18,907.5	23,367.5	15,122.0	17,163.3
Net external debt	-817.3	351.1	-653.7	257.9
SKK/USD and SKK/EUR rates	*32.920*	*28.496*	*41.161*	*38.796*
EUR/USD cross exchange rate	–	–	*1.250*	*1.361*

Source: NBS.
1) Including government agencies and municipalities.

The net external debt of Slovakia – expressed as the difference between gross foreign debt, i.e. USD 23.718 billion (liabilities of the Government and the NBS, liabilities of commercial banks, and those of the corporate sector – except for capital participation), and foreign assets, i.e. USD 23.368 billion (foreign exchange reserves of the NBS, foreign assets of commercial banks, and those of the corporate sector – except for capital participation), reached USD 351.1 million (debtor position) at the end of December 2004. On 31 December 2003 (and/or 1 January 2004), the Slovak Republic was in creditor position, with net foreign debt amounting to USD 817.3 million.

2.2.5. Licensing activity of the NBS and foreign exchange supervision

The National Bank of Slovakia performs the tasks of a foreign exchange authority arising from Act No. 202/1995 Coll., Foreign Exchange Act, and the tasks arising from Act No. 566/1992 Coll. on the National Bank of Slovakia.

In connection with the liberalisation of the country's foreign exchange regime, the regulation of individual operations on the balance of payments in current and capital accounts through foreign exchange permits (e.g. investment abroad, opening of foreign-currency accounts with foreign banks) has been cancelled with effect from 1 January 2004.

However, foreign exchange regulations still apply to entrepreneurial activities (trade in foreign exchange assets and foreign exchange services), which are connected with operations in Slovak and foreign currency in cash or non-cash form, and with the transaction of foreign exchange operations on the financial market (which are rather risky and are not covered by the law on securities, i.e. financial derivatives). These activities are subject to a foreign exchange licence issued by the National Bank of Slovakia.

Licensing activity

In 2004, the National Bank of Slovakia issued foreign exchange licences as follows:
- 63 licences for the purchase of funds in foreign currency for Slovak currency in cash (to 36 legal entities and 27 natural persons);
- 16 licences for the sale of funds in foreign currency for Slovak currency (to 7 legal entities and 9 natural persons);
- 2 licences for foreign exchange services, consisting in the transfer of funds in cash to and from abroad via a foreign-based supra-national company;
- 3 licences for non-cash transactions in funds.

Foreign exchange supervision

In line with its approved strategy, the National Bank of Slovakia focussed its supervising activity on monitoring compliance with the reporting requirement by all entrepreneurial entities and fulfilment of the conditions and tasks stipulated by foreign exchange regulations and those laid down in foreign exchange licences.

In total, 63 inspections were carried out within the scope of foreign exchange supervision.

2.3. Public sector

State budget

Budgetary performance in 2004 was governed by the State Budget Act (No. 598 of 12 December 2003), in which total revenue for 2004 was budgeted at SKK 232.0 billion and total expenditure at SKK 310.5 billion. The budget deficit was set at SKK 78.5 billion.

Apart from the fundamental reforms (tax reform, reform of regional self-government financing, social reform), which considerably affected the State budget for 2004, the entry of Slovakia into the European Union was also taken into account in the budget design. Transfers to the EU budget were incorporated in the budget expenditure, while a substantial part of the money expected from EU funds was included in both the revenue and expenditure sides of the budget. Of the total budget revenue, budgetary resources from EU funds accounted for SKK 14.2 billion.

Budgetary performance in 2004 resulted in a deficit of SKK 70.3 billion. The deficit remained below the budgeted figure by more than SKK 8 billion, primarily as a result of increased revenues (by SKK 10.5 billion). Budget revenues reached SKK 242.4 billion, fulfilling the budget to 104.5%. On a year-on-year basis, budget revenues increased by SKK 9.3 billion.

The planned level of budget revenue was set with respect to the introduction of a flat tax rate and other changes (a new item deductible from the tax base, modified tax rates, changes in the basis of assessment and the monthly tax bonus for children). Within the structure of revenues, tax revenue exceeded the budgeted level by SKK 14.2 billion. In the year of the tax reform, tax revenue reached SKK 209.5 billion (a year-on-year increase of SKK 9.3 billion) and fulfilled the budget to 107.3%. A significant contribution to the favourable trend in tax collection came from personal and corporate income tax receipts (fulfilling the budget to 135.2%). On a year-on-year basis, tax revenue remained virtually unchanged (an increase of SKK 0.6 billion). Natural persons paid approximately SKK 7 billion more in income tax and thus fulfilled the budget to 135.6%. On a year-on-year basis, tax revenue in 2004 was SKK 6.6 billion lower. A positive impact on income tax receipts was made by the tax reform, which entered into effect on 1 January 2004.

Value added tax revenues in 2004 were affected by numerous legislative changes, which had a one-off impact on the budget (changes in the VAT rates, reduction in the limit for registration, from SKK 3 million to SKK 1.5 million).

During the year, there was some uncertainty in connection with the change in value added tax, since the system of VAT collection was substantially changed after the entry of Slovakia into the Union. The amount of VAT collected exceeded the projected figure by nearly SKK 2 billion (budget fulfilment to 101.9%). One of the reasons behind this positive result was that the predicted one-off shortfall in tax collection as a result of entry into the EU was smaller than expected. On a year-on-year basis, VAT revenue increased by SKK 15.8 billion.

The annual budget was also surpassed by excise duties, which were collected in the amount of SKK 43.4 billion and exceeded the 2003 figure by SKK 5.4 billion.

Non-tax revenues reached SKK 21.1 billion, which was SKK 8 billion more than the figure budgeted for the whole year.

A different situation was recorded in ‘grants and transfers’, where the funds received from the European Union’s general budget are concentrated. At the end of the year, the volume of these funds was very low, since only SKK 4.5 billion came into the state budget

Table 24 **Planned and actual budgetary performance** **(SKK billions)**

State Budget	2003	2004	Fulfilment in %	Difference
Revenue				
Budgeted	235.4	232.0	98.6	–3.4
Actual	233.1	242.4	104.0	9.3
Fulfilment in %	99.0	104.5	–	–
Expenditure				
Budgeted	291.4	310.5	106.6	19.1
Actual	289.0	312.7	108.2	23.7
Fulfilment in %	99.2	100.7	–	–

Source: Ministry of Finance of the SR.

instead of SKK 14.2 billion, owing to a time delay in transfers from the structural funds. These transfers were so-called ‘special compensation payments’, serving for the elimination of budgetary imbalances after the entry of new countries into the EU. They are not earmarked and thus may be used for the coverage of any expenditure from the State budget.

This fact was also reflected in the expenditure side of the budget, where the funds for the co-financing of EU projects were not withdrawn. Expenditures only slightly exceeded the budgeted level (100.7%).

It may be stated that, in 2004, the budget deficit was kept at the budgeted level, and ended the year at SKK 70.3 billion (SKK 43.9 billion according to the ESA 95 methodology). This represented 89.5% of the projected volume of the annual budget (SKK 78.5 billion). In comparison with the budget, expenditures grew at a slower rate than revenues. The slower growth was partly due to the fact that Slovakia received less funding from the EU budget, as a result of which less money was spent on the co-financing of EU projects. The country’s positive economic results were also supported by the fact that the one-off shortfall in revenues, connected with the entry of Slovakia into the EU, was smaller than expected.

State financial assets and liabilities in 2004

State financial assets underwent numerous changes over the course of 2004, in volume and in particular changes arising from the reform of public finances.

Within the scope of this reform, the powers relating to the management of state financial accounts passed from the NBS to the SR Treasury. The transfer of accounts to the Treasury took place in July 2004.

Compared with the initial level, state financial assets increased at the beginning of 2004 by SKK 8.6 billion (by the end of the year by SKK 16 billion). The increase in the total volume was generated by an increase in state financial assets from the special-purpose funds of the National Property Fund, earmarked for government debt servicing in accordance with Decision No. 974 of the SR Government of 14 October 2003, concerning the State budget for 2004, in which the Government gave permission for the use of National Property Fund assets in the amount of SKK 13.8 billion for the strengthening of state financial assets. This increas e was, however, eliminated by a decrease in the balance on the account of state financial assets obtained from the sale of ČSOB shares (SKK 2.6 billion). During 2004, the other state financial asset accounts recorded only minor changes, which left their overall balance virtually unaffected.

State financial liabilities (liabilities of the State vis-à-vis the NBS) recorded a zero value at the end of 2004.

State funds in 2004

Special tasks, financed in part from the State budget, were performed by two State funds in 2004. In developing and improving the housing fund, the State rendered assistance via the State Housing Development Fund . The State Fund for the Liquidation of Nuclear Power Engineering Facilities and Handling of Spent Fuels and Radioactive Waste accumulated funds for closing down nuclear engineering facilities.

At the end of 2004, the balance of funds in bank accounts, including funds from the previous year, stood at SKK 13.4 billion.

Current budgetary performance resulted in a surplus of SKK 2.5 billion (SKK 5.2 billion according to ESA 95 methodology).

National Property Fund of the SR

In 2004, the budgetary performance of the National Property Fund of the SR NPF resulted in a deficit of SKK 5.1 billion (according to the ESA 95 methodology), representing a slight improvement in comparison with the 2003 budget (by SKK 0.9 billion). On a cash basis, the NPF SR achieved a total surplus of SKK 3.2 billion, of which funds from the previous year accounted for SKK 3.1 billion and income from the sale of shares within the scope of privatisation amounted to SKK 5.4 billion. The latter took place mostly in proceeds from the sale of Paroplynový cyklus, a.s. shares (SKK 2.0 billion) and from the privatisation of the remainder of Slovenská sporiteľňa, a.s. (SKK 2.9 billion). If we exclude these items from the receipts according to ESA 95 methodology, the income of the NPF SR amounted to SKK 11.9 billion, of which SKK 11.5 billion came from dividends (mostly from SPP, a.s. [Slovak Gas Industry]). Expenditures amounted to SKK 17.0 billion, a substantial part of which (SKK 16.3 billion) was incurred in connection with the use of the NPF SR funds in line with the decisions of the SR Government pursuant to Article 28 paragraph 3 letter b/ of Act No. 92/1991 Coll. on the conveyance of state property to other persons, as amended by subsequent regulations. In connection with such use of funds, SKK 13.8 billion was transferred to state financial asset accounts (of which SKK 2.8 billion was earmarked for the realisation of a government guarantee provided for a redistribution loan which was the source of the revolved current assets banking loans)) and SKK 1.8 billion for the repayment of realised government guarantees for bank loans.

Table 25 **Planned and actual budgetary performance in the general government in 2004 (according to the ESA 95 methodology)** **(SKK millions)**

	Budgeted figure	Actual figure	Difference
State budget	-54,370	-56,713	2,343
Veriteľ, a. s.[1)]	–	-4,561	4,561
State funds	4,994	5,188	-194
NPF SR	-5,952	-5,078	-874
Slovak Land Fund	-16	159	-175
Slovak Consolidation Agency	-81	7,521	-7,602
Public universities	0	198	-198
Subsidised organisations[1)]	–	6,668	-6,668
Municipalities	100	-787	887
Higher territorial units	0	126	-126
Social insurance corporation	3,119	835	2,284
Health insurance corporations	224	2,576	-2,352
General government in total	-51,982	-43,868	-8,114
As a share of GDP (%)	-4.0	-3.3	–

Source: Ministry of Finance of the SR.
1) No entities were included in the general government budget for 2004.

Government guarantees

The provision of government guarantees in 2004 was governed by Act No. 386/2002 Coll. on government debts and government guarantees, according to which government guarantees in a given year may be granted up to the limit of SKK 4.6 billion. This limit was not exceeded in the course of 2004.

Of the NPF SR resources, one government guarantee was realised on behalf of Železnice SR [Slovak Railways] in the amount of SKK 1.8 billion and, within the meaning of government decision No. 139/2004, SKK 2.8 billion was transferred to state financial asset accounts for the realisation of a government guarantee provided for a redistribution loan which was the source of the revolved current assets banking loans.

Relationship between the NBS and the State Budget of the SR

During 2004, interest on funds held on the summary memorandum account of the Slovak Republic maintained by the NBS was paid on a quarterly basis, in accordance with the agreement signed between the Ministry of Finance and the NBS. The interest was credited to the account at a rate corresponding to the sterilisation rate of the NBS, which was modified four times during the year.

Interest accrued on the balance of the summary memorandum account of the Slovak Republic kept with the NBS reached SKK 295.6 million during the year, and interest paid on time deposits totalled SKK 3,509 million, of which SKK 3,165 million was in interest on a special account, in which funds obtained from the privatisation of SPP (earmarked for the pension reform) were held. The interest accrued on this account was capitalised, i.e. credited to the principal.

The amount of interest paid to the Ministry of Finance SR by the NBS was almost 25% smaller than a year earlier, due to the gradual shift of clients from the NBS to the SR Treasury and accompanied by a fall in interest rates.

In the State budget for 2004, income from the transfer of the remaining profit of the NBS was not budgeted, and since the NBS ended the previous year with a loss, no transfer was made to the State budget (the last profit transfer from the NBS took place in 2001).

Budgetary performance in public finances according to the ESA 95 methodology

In 2004, budgetary performance in the general government (according to the ESA 95 methodology) resulted in a deficit of SKK 43.9 billion, which represented 3.3% of the GDP (according to the March EDP notification on the deficit and debt in 2004). The achievemen t of more favourable results than was projected in the public budget for 2004 (4.0% of the GDP) is in line with the medium-term goal of consolidation in public finances, which is aimed at meeting the 3% criterion for the public sector deficit by 2007 (taking into account the costs of the second pillar of the new pension system). The deficit was mainly a result of the budgetary performance of the central government (a deficit of SKK 50.9 billion), where the State budget resulted in a shortfall of SKK 56.7 billion. A deficit in budgetary performance was also produced by Veriteľ, a.s. (SKK 4.6 billion) and the National Property Fund (SKK 5.1 billion). Within the central government, positive results were achieved by State funds, i.e. the State Housing Development Fund and the State Fund for the Liquidation of Nuclear Power Engineering Facilities and Handling of Spent Fuels and Radioactive Waste (SKK 3.1 billion and SKK 2.1 billion respectively); Slovak Consolidation Agency, j.s.c. (SKK 7.5 billion); subsidised state organisations (SKK 2.4 billion); the Slovak Land Fund (SKK 0.2 billion); and public universities (SKK 0.2 billion).

Social security funds closed the year with surplus totalling SKK 3.4 billion. The budgetary performance of local governments resulted in surplus amounting to SKK 3.6 billion (this was positively affected by a capital transfer from Veriteľ, a.s. in the amount of SKK 6.1 billion, resulting from the remission of receivables).

At the end of 2004, gross public debt stood at SKK 578.1 billion (43.6% of GDP), representing an increase of SKK 66.3 billion. The increase was attributable to the general government deficit (SKK 43.9 billion) and the ruling of the court in the case of a dispute with ČSOB, as a result of which the debt increased by SKK 25.2 billion. A substantial part of the public debt was formed by state debt amounting to SKK 563.4 billion.

2.4. Monetary policy and monetary developments

In 2004, the NBS implemented its monetary policy in an environment characterised by continuing economic growth, falling inflation and unemployment rates, appreciation in the exchange rate of the Slovak koruna against the reference currency (euro), and by favourable balance of trade developments in comparison with 2003.

2.4.1. Monetary aggregates

At the end of 2004, the M2 money supply (at fixed 1993 exchange rates) increased in comparison with the beginning of the year by SKK 54.4 billion, to SKK 779.9 billion. The year-end dynamics of M2 growth accelerated in comparison with the previous years to 7.5% (from 6.4% in 2003 and 4.7% in 2002), whereas its annual average (5.2%) was 2.1 percentage points lower than in 2003 (7.3%). At current exchange rates, the M2 money supply increased by SKK 46.8 billion, to SKK 785.4 billion, representing a year-end growth rate of 6.3% (compared with 4.8% a year earlier).

The money supply was rather volatile, especially in the first half of 2004, before returning to its standard seasonal course during the next months. The main factors that affected the volatility of the money supply in the first six months were the March deadline for the payment of personal and corporate income tax for the fiscal year 2003, with the effect of income tax payment being concentrated in a single period (owing to the cancellation of the possibility of postponing the deadline for tax payment for tax payers whose tax returns are prepared by tax advisors), as well as the payment of dividends of the corporate sector, the volume of which reached a higher level than in 2003. In December, the M2 money supply recorded a steeper increase than in the previous two years, which was probably connected with an increase in spending in the public sector.

With net foreign assets being relatively stable, the growth in the money supply in 2004 was predominantly affected by domestic factors, first and foremost by the continued interest among companies and households in loans and by the release of funds from the public sector towards the end of the year.

The volume of loans to enterprises and households (at fixed 1993 exchange rates) grew in comparison with the beginning of the year by SKK 28.1 billion, i.e. 7.7% (compared with 14.1% a year earlier), to SKK 394.9 billion at the end of 2004. The growth took place mostly in foreign-currency loans, which increased by

Table 26 **Developments in the M2 money supply**

	Volume at 31 December	Change since the beginning of the year	
	SKK billions	SKK billions	%
Year 2004			
– at current exchange rates	785.4	46.8	6.3
– at fixed 1993 exchange rates	779.9	54.4	7.5
Year 2003			
– at current exchange rates	742.6	34.1	4.8
– at fixed 1993 exchange rates	730.0	43.6	6.4

Source: NBS.

a total of SKK 18.1 billion (in contrast to 2003, when the increase took place predominantly in koruna loans). Koruna loans grew by a total of SKK 10.0 billion, when the increase in loans to households (SKK 31.6 billion) exceeded the decline in loans to enterprises (SKK 21.6 billion).

The volume of koruna loans to enterprises decreased in 2004, mainly due to the realisation of a government guarantee for a loan provided to a state company in January (as a result of which the loan was reclassified as a government sector liability) and the repayment of loans from funds obtained from bond issues.[5] The decrease in the volume of koruna loans to enterprises was also connected with the increased drawing of loans in foreign currency, mainly by companies. Demand for foreign-currency loans in 2004 was stimulated by the appreciating trend in the exchange rate of the Slovak koruna against the euro. Koruna loans to households showed a growing tendency throughout 2004 and the total increase in their volume exceeded the 2003 increase by SKK 8.0 billion.

Net credit to the general government (including the FNM, at fixed 1993 exchange rates) reached SKK 342.2 billion at the end of 2004, representing an increase of SKK 45.1 billion in comparison with the beginning of the year. This development was not affected by the change in the creditor position of the FNM vis-à-vis the banking sector. At the end of 2004, the level of net credit to the general government (excluding the effect of the FNM) stood at SKK 345.4 billion.

Within the structure of net credit to the general government, the share of foreign debt increased, as a result of improved conditions for the acquisition of funds for the coverage of government debt on foreign markets. The increase in foreign debt was affected mainly by issue of eurobonds in May 2004 in the amount of EUR 1 billion with a maturity of 10 years, of which EUR 500 million was used in June 2004 for the repayment of a eurobond issue from 1999. The second part of the eurobond issue was used for the needs of domestic debt service.

The increase in the internal debt position of the general government was largely connected with the deficit in the current budgetary performance of the central government (the central government deficit reached SKK 70.3 billion at the end of December 2004) and partly with an increase in the credit commitment of public sector entities to commercial banks. The pro-growth effect of these factors on the internal debt was partly offset by an increase in state financial assets and the deposits of non-budgetary funds of public sector entities at commercial banks. Pressure for a reduction in the internal debt position was also exerted by an improvement in the budgetary performance of social security funds and the net position of local self-governments.

Another factor that lessened the pro-growth effect of the deficit on the level of net credit to the general government was the incurrence of expenses in December within the current budgetary performance of the central government, while current expenses were in part cleared in 2004, but funds for their actual realisation in 2005 remained deposited in the accounts of the State Treasury.

2.4.2. Structure of the money supply

In 2004, the M2 money supply (at fixed 1993 exchange rates) increased by SKK 54.4 billion, to SKK 779.9 billion at the end of December. The rate of money supply growth showed a decreasing tendency until May 2004 and then accelerated in the next months. The year-on-year dynamics of M2 increased from 6.4% in December 2003 to 7.5% in December 2004. The average annual rate of growth slowed to 5.2% in 2004, from 8.4% in 2002 and 7.3% in 2003.

The volume of currency in circulation outside banks grew by SKK 8.7 billion in 2004, while the year-on-year rate of growth accelerated, from 9.0% in December 2003 to 9.5% in December 2004. The year-on-year dynamics of currency in circulation decelerated in February, but then followed an increasing trend during the year. The average annual growth rate slowed to 6.8%, from 9.7% in 2003 and 14.5% in 2002.

Slovak-koruna deposits (demand and time deposits in total) grew by SKK 42 billion from the beginning of the year, and their year-on-year growth dynamics weakened from 8.0% in December 2003 to 7.6% in December 2004. The year-on-year rate of growth in demand deposits accelerated during the year by 1.4 percentage points (to 14.8% in December 2004), while the dynamics of time deposits diminished by 1.4 percentage points (to 4%). The increase in koruna deposits took place in corporate deposits, which was connected with the accelerated economic growth, accompanied by a year-on-year increase in the profits of non-financial corporations (SKK 37.6 billion). Household deposits in SKK recorded an average year-on-year decrease of 2.4% during the year, but, owing to a modest increase in dynamics in December, ended the year above the level recorded at the beginning of the year.

Development in koruna deposits in 2004 continued to be affected by a preference for short-term and

[5] *If we exclude the stated methodological and non-transaction effects, the year-on-year rate of growth in loans to enterprises and households (at fixed 1993 exchange rates) will reach 10.5% at the end of 2004.*

Table 27 **Developments in deposits**

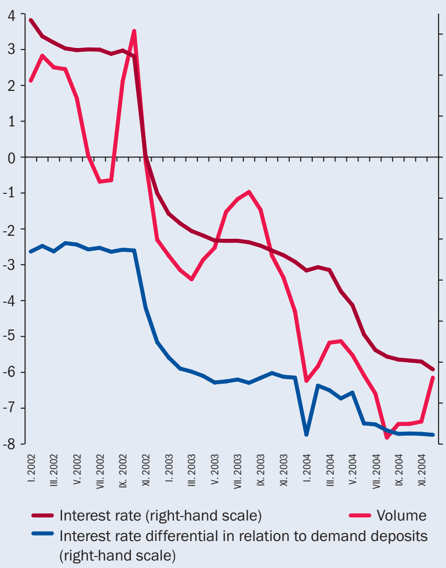
	Year-on-year change in %				Year-on-year change in SKK billions			
	2001	2002	2003	2004	2001	2002	2003	2004
At fixed 1993 exchange rates								
Household deposits	7.8	1.4	-2.8	-1.2	26.7	5.1	-10.7	-4.3
Koruna deposits in total	6.3	0.0	-0.6	0.1	19.1	0.1	-1.9	0.3
demand deposits	24.3	8.9	12.0	18.3	13.1	6.0	8.9	14.9
time deposits	2.4	-2.3	-4.3	-6.1	6.0	-5.9	-10.8	-14.6
Foreign-currency deposits	19.0	10.2	-15.8	-10.0	7.6	5.0	-8.8	-4.6
Corporate deposits	16.8	11.1	21.1	18.6	28.4	22.0	46.7	50.0
Koruna deposits in total	19.7	10.6	22.4	17.6	28.1	18.1	43.1	41.7
demand deposits	21.5	10.4	14.6	12.0	14.2	8.4	13.0	12.3
time deposits	18.3	10.8	29.2	21.9	13.9	9.7	30.1	29.4
of which: insurance cos.	9.1	-22.4	-3.0	65.0	1.9	-5.1	-0.5	10.6
Foreign-currency deposits	1.1	14.2	12.4	25.5	0.3	3.9	3.6	8.3
At current exchange rates								
Household deposits	8.2	0.1	-4.5	-2.5	29.6	0.2	-17.8	-9.2
of which: in foreign currency	18.5	0.1	-22.7	-17.6	10.5	0.1	-15.9	-9.5
Corporate deposits	15.8	9.5	19.3	17.3	28.4	19.7	44.3	47.3
of which: in foreign currency	0.8	4.0	3.3	14.8	0.3	1.5	1.2	5.6

Source: NBS.

demand deposits in the individual sectors of the economy. This trend was primarily apparent in corporate deposits, where demand and short-term deposits with a maturity of up to one month accounted for approximately 93%. Demand deposits increased by SKK 12.3 billion (in the previous year by SKK 13.0 billion), time deposits with a maturity of up to one month grew by SKK 31.8 billion (in the previous year by SKK 38.6 billion), while other time deposits fell in volume by SKK 2.4 billion (in the previous year by SKK 8.5 billion). The second half of 2004 saw a marked increase in the deposits of insurance companies, which had previously been relatively stable in terms of volume. The interest rate differential between demand and time deposits in the corporate sector diminished by 1.1 percentage points (to 2.6 points), as a result of a steeper fall in the average rate for time deposits (by 1.8 percentage points) than in the rate for demand deposits (falling by 0.7 percentage point).

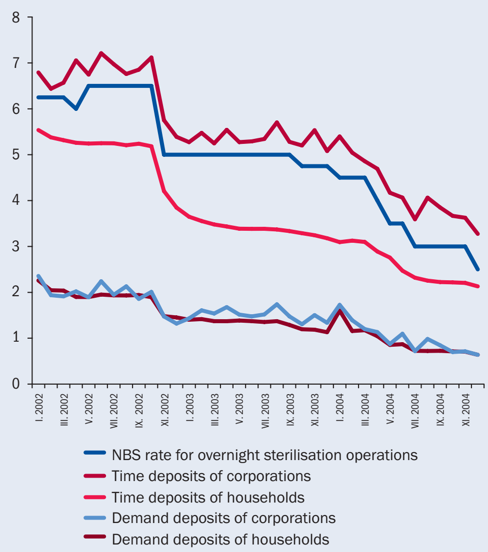
Household deposits were also characterised by a persistent preference for highly liquid resources. The share of demand deposits in total household deposits in SKK increased year-on-year by 4.6 percentage points (to 30.2%), when demand deposits grew in volume by SKK 14.9 billion (in the previous year by SKK 8.9 billion). The rapid increase in demand deposits was probably connected with the growth in the disposable income of households. Time deposits declined in 2004 by SKK 4.3 billion (in the previous year by SKK 2.6 billion) and savings deposits by SKK 10.3 billion (in the previous year by SKK 8.2 billion). Time deposits with a maturity of up to one month decreased by SKK 7 billion, while other time deposits increased slightly. Within the structure of savings deposits, short-term deposits fell in volume by SKK 8.6 billion and long-term deposits with a maturity of 1 to 5 years fell by SKK 4.2 billion. Long-term savings deposits with a maturity of over 5 years recorded an increase of SKK 2.6 billion, due to an increase in deposits at home savings banks. Interest in time deposits as a form of savings is influenced primarily by the rate of interest offered, which, together with the diminishing interest rate differential between time and demand deposits, tended to reduce the relative yield on holdings of less liquid assets. Developments in time deposits in the household sector were also connected with the fall in the savings ratio of households, their growing propensity to consumption, and the transfer of long-term financial assets. This is also documented by the growing popularity of mutual funds: the net sales of open-end mutual funds operating on the Slovak financial market reached SKK 27.5 billion in 2004, of which SKK 26.7 billion was invested in koruna-denominated funds. The interest rate differential between demand and time deposit rates for

Chart 20 **Year-on-year developments in fixed-term household deposits** **(%)**



Source: NBS.

Chart 21 **Comparison of interest rates on household and corporate deposits** **(%)**



Source: NBS.

households diminished by 0.6 percentage point (to 1.5 percentage points) as a result of a greater fall in interest rates on time deposits (by 1.1 percentage points) than in demand deposit rates (by 0.5 percentage point).

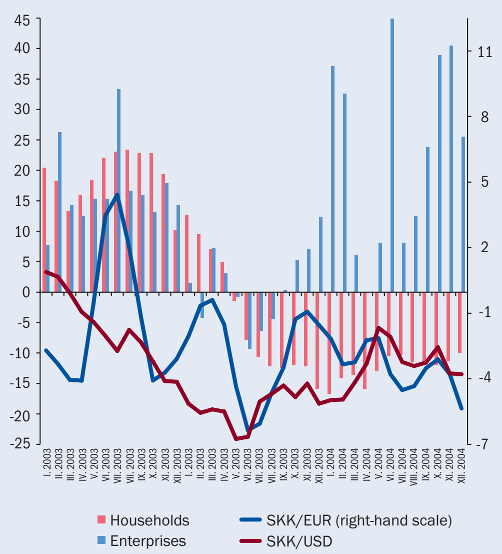
If we compare the rates of interest on household and corporate deposits in SKK, both demand and time deposits showed smaller differences in interest levels in 2004, as a result of a greater fall in interest rates on corporate deposits than on household deposits. In the case of time deposits, the difference between corporate and household deposit rates diminished by 0.8 percentage point, to 1.1 percentage points (the previous year saw a difference of 1.9 percentage points). The difference between interest rates on corporate and household demand deposits diminished to a minimum during the year, while the more volatile corporate deposit rates were somewhat higher in the second and third quarters.

Deposits in foreign currency (at fixed 1993 exchange rates) grew in volume by SKK 3.7 billion in 2004, after declining in 2003 by SKK 5.2 billion. The growth took place in corporate deposits (SKK 8.3 billion), while household deposits fell by SKK 4.6 billion. The year-on-year rate of decline in household deposits in foreign currency slowed in 2004, while the growth dynamics of corporate deposits increased.

With the changes in exchange rates in 2004 (an appreciation of 5.75% against the euro and 13.44% against the US dollar) taken into account, deposits in foreign currency fell in volume by SKK 3.9 billion (at current exchange rates), when household deposits declined by SKK 9.5 billion. At the same time, corporate deposits increased by SKK 5.6 billion.

If we compare the trends in foreign-currency deposits, it is apparent that the strongest reaction to the appreciation of the Slovak koruna (in the form of a reduction in the holdings of deposits in foreign currency) was produced in the household sector. This was connected with the fact that enterprises maintain foreign-cur-

Chart 22 **Year-on-year developments in household and corporate deposits, SKK/EUR and SKK/USD exchange rates** **(%)**



Source: NBS.
(+) depreciation (-) appreciation

rency deposits primarily for financing their trading activities. This factor became even more pronounced in 2004, after the entry of Slovakia into the EU. In the household sector, foreign-currency deposits were used as savings. The koruna value of assets denominated in foreign currency was reduced by the appreciation of the Slovak koruna. This was eliminated in the household sector through the conversion of such assets into domestic assets.

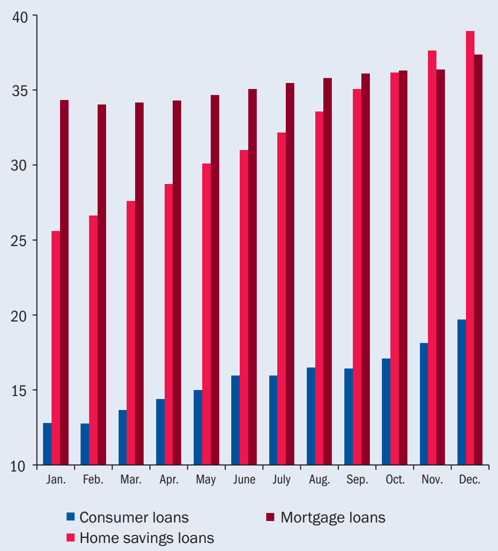
2.4.3. Lending activities

Loans in total (in Slovak koruna and foreign currency, at current exchange rates), provided to enterprises, households, and public sector, are loans reported by the banking sector according to the rules of statistical reporting. From a procedural point of view, they are not to be confused with loans to enterprises and households according to the methodology of the monetary survey, which does not include the government sector.

The volume of loans increased over the course of 2004 by SKK 36.9 billion (8.9%), with koruna loans growing by SKK 17.9 billion (5.4%) and loans in foreign currency by SKK 19.0 billion (23.2%). At the end of the year, the total volume of loans reached SKK 449.3 billion, of which koruna loans accounted for SKK 348.6 billion and loans in foreign currency SKK 100.7 billion. In 2003, total loans increased by SKK 49.7 billion (14.1%), of which koruna loans grew by SKK 27.5 billion (9.4%) and foreign-currency loans by SKK 22.2 billion (37.2%).

Bank lending to enterprises in 2004 was characterised by a continuing dynamic growth in foreign-currency loans and a decline in koruna loans. Despite the diminishing interest rate differential, loans in foreign currency represented a attractive form of financing for entrepreneurs, partly due to the appreciating tendency of the Slovak koruna and the expectation that this appreciation will continue. The marked decline in koruna loans to enterprises in comparison with the beginning of the year (by SKK 21.1 billion, i.e. 9.6%) was connected with a decrease in classified loans (by SKK 24.6 billion, i.e. 37.5% year-on-year), especially in long-term standard special-mention loans (by SKK 15.7 billion). This development was connected with the sale of classified loans outside the banking sector and probably the improving ability of banks to recover non-performing loans, and with the restructuring of debts in certain companies and their financing through the capital market. Loans for current assets also recorded a marked fall (SKK 9.0 billion). A positive development was the relatively steep increase in investment loans (by SKK 12.3 billion), which contributed to the financing of the growing investment demand. Growth in koruna loans to enterprises was also stimulated by current account overdrafts, which increased in comparison with the beginning of the year by SKK 7.5 billion.

Chart 23 **Developments in selected types of loans to households in 2004 (SKK billions)**



Source: NBS.

Developments in koruna loans were most significantly influenced by the household sector, where loans increased by SKK 31.6 billion (a year-on-year increase of 37.2%). The most dynamic growth was recorded in consumer loans and housing loans (a year-on-year increase of 31.1%, i.e. SKK 24.2 billion), of which SKK 14.3 billion took place in mortgage loans (a year-on-year increase of 57.6%). Increased demand for such loans was mainly recorded in the second half of the year (the average monthly growth in mortgage loans increased, from approximately SKK 1 billion in the 1st half of 2004 to SKK 1.3 billion in the 2nd half of 2004). The orientation of banks to the household sector was also reflected in consumer loans, which grew in volume by roughly SKK 7 billion in 2004.[6]

In a breakdown by sector, developments in koruna loans in 2004 were mainly affected by an increase in other sectors, including the household sector (SKK 37.5 billion, i.e. 49.8% of the total volume of loans) and a marked decrease in loans in electricity, gas, and water supply (SKK 13.8 billion, i.e. 5.8% of the total). A marked decline in loans was reported from manufacturing (SKK 8.7 billion, i.e. a share of 11.6%), mainly as a result of a decrease in the volume of loans in metallurgy and machine engineering (SKK 6.2 billion). A slight fall in koruna loans was

[6] *The 'consumer loans' category started to be monitored in January 2004.*

Table 28 **Structure of loans in SKK and foreign currency by term (December 2004)**

	Loans in Slovak koruna		Loans in foreign currency		Loans in total	
	Change against 1 Jan. 2004 (SKK billion)	Share (%)	Change against 1 Jan. 2004 (SKK billion)	Share (%)	Change against 1 Jan. 2004 (SKK billion)	Share (%)
Short-term loans	11.1	31.9	4.0	34.2	15.1	32.4
Medium-term loans	-3.8	27.5	2.5	28.1	-1.3	27.6
Long-term loans	10.6	40.6	12.5	37.7	23.0	40.0
Loans in total	17.9	100.0	19.0	100.0	36.8	100.0

Source: NBS.

also recorded in the 'transport, storage, post and telecommunications' sector (SKK 5.5 billion, i.e. a share of 5.2%). A modest pro-growth effect was exerted by loans to the trade, repair of consumer goods and motor vehicles, and hotels and restaurants segments (an increase of SKK 4.1 billion, i.e. a share of 12.8%).

Within the time structure of koruna loan, short-term loans increased in comparison with the beginning of the year by SKK 11.1 billion and long-term loans by SKK 10.6 billion. Of the total volume of koruna loans at the end of the year, loans to the entrepreneurial sector accounted for 57%, loans to households 33%, loans to the general government 9%, and the remaining 1% being 'other loans' and 'loans to non-profit institutions serving households'.

Loans in foreign currency increased for all maturities, with the steepest increase being recorded in long-term loans (SKK 12.5 billion). Of the total volume of foreign-currency loans, loans to the entrepreneurial sector accounted for 82%, loans to non-residents 11%, and loans to the public sector 6%. The share of foreign-currency loans to households and non-profit institutions serving households was negligible.

2.4.4. Interest rate developments

The level of customer interest rates in 2004 was affected by the decisions of the Bank Board to lower the key interest rates of the NBS (in December 2003, March 2004, April 2004, and July 2004), by 1.75 percentage points in cumulative terms. The impact of another key interest rate cut from the end of November 2004 (by 0.50 point) is expected to be reflected in customer interest rates with a certain delay, in the first months of 2005. However, the reductions in the key NBS rates affected the course of customer interest rates differently. Interest rates on loans to enterprises dropped, while lending rates for households mostly increased. Interest rates on corporate deposits fell to a greater extent than the rates for household deposits.

The methodology applied for calculating the rate of interest for current account overdrafts was changed, with effect from the beginning of 2004. The change consisted in the introduction of the method of cumulative debit turnovers, which caused an increase in the volume of current account overdrafts. Thus, the share of current account overdrafts in loans increased and affected the average level of interest rates. At the same time, the applied method increases the volatility of interest rates in the individual months, mainly as a result of fluctuation in the volume of unauthorised debit balance overdrafts on current accounts.

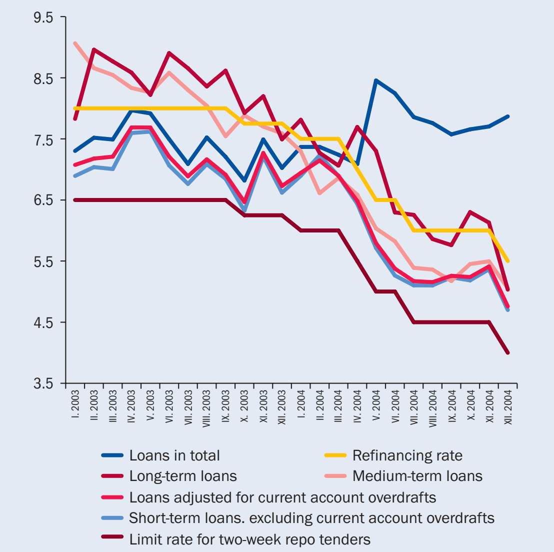
Average interest rates on new loans

The average interest rate in new loans to enterprises (excluding loans at zero interest rate) increased year-on-year by 0.84 percentage point in 2004. If we exclude the impact of current account overdrafts, interest rates on new loans to enterprises recorded a marked fall (1.97 percentage points) and followed the course of the key NBS rates. The marked drop occurred in the price of short-term loans, which have a large share in the total volume of new loans (approximately 91%). Interest rates on long-term loans also fell to a significant extent, but had no marked effect on the overall interest level (owing to the small proportion of long-term loans).

In a breakdown by purpose, interest rates fell most significantly for other loans (by 2.19 percentage points) and investment loans (by 2.79 percentage points). On the other hand, the rates for current account overdrafts rose by 2.84 percentage points (mainly as a result of a change in methodology).

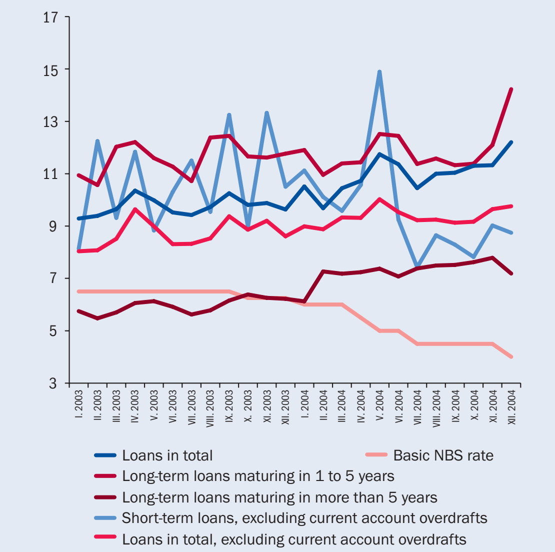
The average interest rate on new loans to households (excluding loans at zero interest rate) showed a slightly increasing tendency in 2004. This development was characterised by a rise in interest rates on short-term loans (affected markedly by a change in the methodology of reporting the rates of interest on current account overdrafts) and long-term loans with

Chart 24 **Developments in interest rates on new loans to enterprises** (%)



Source: NBS.

Chart 25 **Interest rates on new loans to households, excluding zero-rate loans** (%)



Source: NBS.

a maturity of over 5 years. The level of interest rates on long-term loans with a maturity of 1 to 5 years remained virtually unchanged. The average interest rate on the total volume of new loans to households (excluding current account overdrafts) rose by 1.14 percentage points.

New loans to households in total were dominated by long-term loans with a maturity of over 5 years (36%) and short-term loans (35%), with long-term loans with a maturity of 1 to 5 years accounting for 29%. During the year, however, the share of loans with longer maturities increased significantly, which was caused by an upward trend in housing loans.

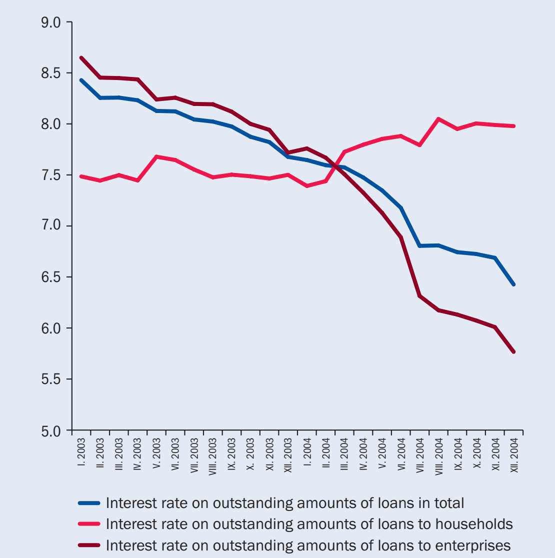
In a breakdown by purpose (with a major impact on interest levels), interest rates on housing loans rose in 2004 by 0.54 percentage point and the interest rate for current account overdrafts increased by 4.78 points (mainly as a result of a change in methodology). Within the scope of housing loans, the steepest increase occurred in interest rates on mortgage loans with a state premium and a moderate rise was recorded in the price of building loans and intermediate loans. The increase in interest rates on mortgage loans was probably affected by the reduction in the level of government support, since interest rates on mortgage loans without a state premium were on the decline during the year.

On the other hand, interest rate on consumer loans fell somewhat during the year (from 14.32% in January to 14.02% in December). Interest rates on consumer loans showed different tendencies, depending on the maturity of the loan. While interest rates on short-term loans and long-term loans with a maturity of 1 to 5 years rose during the year, the price of long-term loans with a maturity of over 5 years dropped.

Average interest rates on outstanding amounts of loans

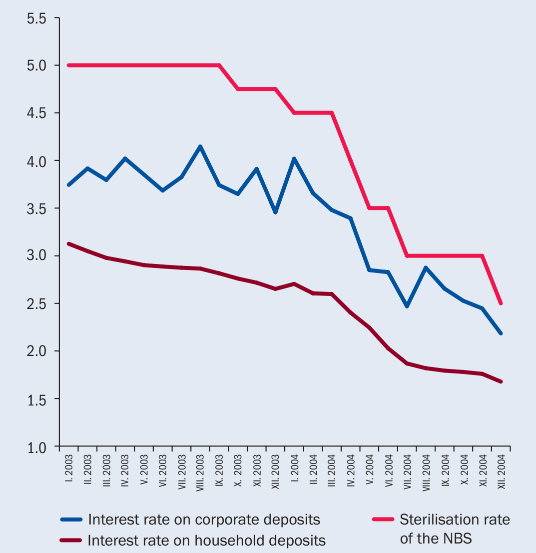
Developments in average interest rates on outstanding amounts of loans in 2004 were characterised by a fall throughout the year, in line with the trend

Chart 26 **Interest rates on outstanding amounts of loans to enterprises and households** (%)



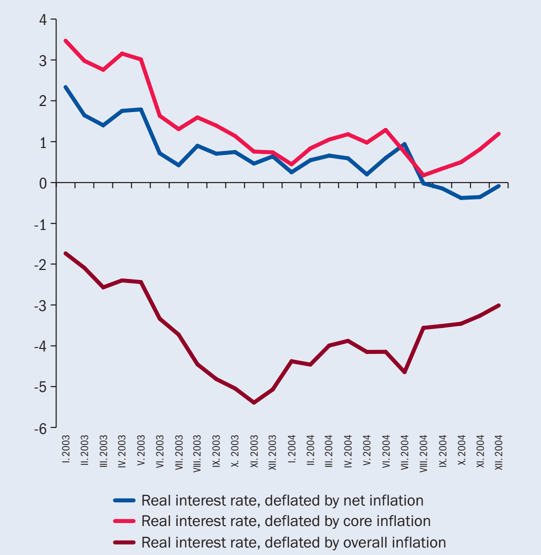
Source: NBS.

Chart 27 **Developments in interest rates on household and corporate deposits** (%)



Source: NBS.

Chart 28 **Developments in real interest rates** (%)



Source: NBS.

from the previous year. Interest levels dropped by 1.08 percentage points, primarily as a result of a fall in interest rates on loans to enterprises. The opposite trend was recorded in interest rates on outstanding amounts of loans to households (a rise of 0.47 point).

The average interest rate on outstanding amounts of loans to enterprises fell year-on-year by 1.95 percentage points in December 2004, with drops being recorded in the prices of all maturities. The sharpest fall was recorded in the rate of interest on outstanding amounts of long-term loans to enterprises (2.13 percentage points). Since loans to enterprises were dominated by short-term loans, the overall interest rate on outstanding amounts of loans to enterprises was mainly determined by the rate for short-term loans (falling by 1.82 percentage points).

In a breakdown by purpose, the sharpest drops were recorded in interest rates on other loans (2.11 points), current account overdrafts (2.04 points) and investment loans (1.71 points).

The interest rate on outstanding amounts of loans to households continued to show a slightly increasing tendency in 2004, owing to a rise in the price of loans with all maturities, with the steepest increase occurring in rates for long-term loans with a maturity of 1 to 5 years.

Interest rates on long-term loans to household were also affected by the reduction in the state premium (by drawing mortgage loans), which was followed by a rise in interestrates.

Average interest rates on deposits

Average interest rates on deposits showed a tendency to fall over the course of 2004, as a result of the cuts in key NBS rates. The decisions of the NBS to change its key interest rates were immediately transferred by the banking sector into customer deposits rates. Interest rates on corporate deposits remained higher than the rates on household deposits, though this difference diminished during the year as a result of a steeper fall in corporate deposit rates than in rates on household deposits.

On a year-on-year basis, interest rates on corporate deposits dropped by 1.27 percentage points in December, to 2.18%. Interest rates fell for demand deposits (by 0.70 of a percentage point, to 0.64%), time deposits (by 1.81 points, to 3.28%), and for savings deposits (by 1.13 points, to 2.06%).

Within the structure of deposits by term, the sharpest drops occurred in interest rates on short- term corporate deposits and long-term corporate deposits (from 1 to 5 years), while the rate for long-term deposits (over 5 years) fell only slightly.

The average interest rate on household deposits dropped year-on-year by 0.97 of a percentage point, to 1.68% in December 2004, with the rate for demand deposits falling by 0.49 of a point (to 0.64%), that for time deposits by 1.33 points (to 2.18%), and the rate for savings deposits by 0.69 of a point (to 2.05%).

Within the structure of deposits by term, interest rates were most significantly reduced for short-term time deposits and long-term (1 to 5 years) savings deposits for households.

Real interest rates

If the rate of interest on the volume of outstanding one-year deposits is deflated by core and/or net inflation, the value of the real interest rate for December 2004 becomes positive (1.19%) and/or negative (0.09%) respectively. On a year-on-year basis, the real interest rates rose by 0.45 of a percentage point and/or fell by 0.73 of a point. This development was affected by a sharper fall in core inflation than in one-year deposit rates and, on the other hand, by a smaller drop in net inflation than in one-year deposit rates.

2.4.5. Monetary policy instruments

Interest rate policy

Basic interest rate of the NBS [7](the rate for two-week repo tenders):

from	22 December 2003	6.00%
from	29 March 2004	5.50%
from	29 April 2004	5.00%
from	1 July 2004	4.50%
from	29 November 2004	4.00%

Interest rate for overnight refinancing operations:

from	22 December 2003	7.50%
from	29 March 2004	7.00%
from	29 April 2004	6.50%
from	1 July 2004	6.00%
from	29 November 2004	5.50%

Interest rate for overnight sterilisation operations:

from	22 December 2003	4.50%
from	29 March 2004	4.00%
from	29 April 2004	3.50%
from	1 July 2004	3.00%
from	29 November 2004	2.50%

Monetary policy instruments of the NBS

Open market operations

a) *Main instrument – standard repo tender with a maturity of two weeks*
The NBS conducts standard repo tenders with commercial banks regularly on a weekly basis, usually on Tuesdays. The NBS also sets an interest rate for such operations (basic interest rate).
b) *Instrument for longer-term liquidity control – issue of 84-day NBS bills for the portfolios of commercial banks*
The NBS conducts auctions in NBS treasury bills generally once a month, by using the American auction technique.
c) *Fine–tuning instrument – quick tender*
An instrument of the NBS for fine-tuning the liquidity of commercial banks on an ad hoc basis. This instrument was not used in 2004.
d) *Structural operations – individual transactions*
An instrument of the NBS enabling a direct purchase or sale of government securities and NBS bills for and from the NBS portfolio. This instrument was not used in 2004.
e) *Foreign exchange swaps*
An instrument for fine-tuning of the liquidity in the koruna area on a temporary basis, through forward exchange transactions. This instrument was not used in 2004.

Automatic operations (standing facilities)

a) *Overnight refinancing operations*
Commercial banks have automatic access to sources of finance (provided they have sufficient amount of acceptable securities), at the rate of interest announced.
b) *Overnight sterilisation operations*
Commercial banks are allowed to deposit excess funds in the form of non-collateralised deposits, at the rate of interest announced.

Other instruments

a) *Redistribution loans*
– Traditional: interest rate = NBS basic interest rate + 0.5% (applied only till December 2004);
– Advantaget loan: interest rate = NBS basic interest rate – 2% + 0.5%.
b) *Short-term loans*
To maintain a bank's liquidity, the NBS may, in exceptional cases, provide a short-term loan to the bank concerned. Such a loan was not provided in 2004.

Minimum reserve requirements

With effect from 1 January 2004, commercial banks, branches of foreign banks, building societies, and

[7] On 12 December 2002, the Bank Board of the NBS decided to set a basic NBS interest rate with effect from 1 January 2003. The basic interest rate of the NBS is identical with the limit rate for standard two-week NBS repo tenders. The term 'discount rate of the National Bank of Slovakia', or 'discount rate of the State Bank of Czecho-Slovakia', used in generally binding legal regulations, corresponds to the basic interest rate of the National Bank of Slovakia.

Table 29 **Currency structure of receipts and payments in foreign currency**

	2001	2002	2003	2004
Total turnover (in billions of SKK)	1,277.9	1,385.6	1,536.8	1,657.5
of which: Euro (including former EMU currencies)	61.3%	63.7%	69.8%	70.2%
Czech koruna	8.7%	9.3%	7.8%	7.5%
American dollar	26.4%	23.2%	19.0%	18.8%
Other currencies[1)]	3.6%	3.8%	3.3%	3.6%
Turnover as a share of GDP (at current prices)	126.5%	126.1%	127.9%	125.1%

Source: NBS.
1) Hungarian forint, Danish crown, Norwegian crown, Swedish crown, Swiss franc, British pound, Australian dollar, Japanese yen, Canadian dollar, and other currencies.

electronic money institutions were required to maintain minimum reserves in the amount of 2%:
- of demand deposits, time deposits, and loans received in Slovak koruna or foreign currency;
- of deposits and loans redeemable at notice received in Slovak koruna or foreign currency;
- of debt securities issued in Slovak koruna or foreign currency, except for mortgage bonds.

Maintained minimum reserves were evaluated in 2004 on a monthly basis. Required minimum reserves held at the NBS on money reserve accounts gain interest at a rate of 1.5%, up to the amount appointed for the given month.

Exchange-rate and foreign-exchange policies

a) Exchange rate system
The National Bank of Slovakia applied a floating exchange rate regime in 2004. The exchange rate of the Slovak koruna was determined in relation to the euro, being the reference currency. The National Bank of Slovakia intervened in the foreign exchange market in the event of excessive volatility in the exchange rate of the Slovak koruna, and/or if the exchange rate did not correspond to the fundamentals of macro-economic development.

b) Nominal exchange rate of the SKK
In relation to the euro, the nominal exchange rate of the Slovak koruna appreciated during the year by 5.8%, to SKK 38.796/EUR on 31 December 2004. As a result of developments in the USD/EUR cross rate on the world markets, the exchange rate of the koruna appreciated against the US dollar by 13.4%, to SKK 28.496/USD at the end of the year.

c) Nominal and real effective exchange rates of the SKK[8]
The nominal effective exchange rate of the Slovak koruna (NEER) was affected in 2004 by the lower rate of appreciation in the average exchange rate of the koruna vis-à-vis the US dollar (12.3%), compared with the year-on-year dynamics of growth in 2003 (18.9%), and by the accelerating rate of appreciation in the koruna against the euro (3.5%, compared with 2.8% in 2003). The average year-on-year rate of growth in the NEER index slowed to 4.9%, from 7.0% in 2003.

The real effective exchange rate of the koruna (REER), calculated on the basis of the producer price index, appreciated year-on-year by an average of 2.2%, compared with 13.2% in 2003. On the basis of manufacturing products prices (excluding energy and mineral raw materials prices) the rate of appreciation in the REER index slowed to 2.2%, after increasing by 7.2% in the previous year.

d) Evaluation of the currency structure of foreign exchange receipts and payments in the Slovak Republic
The total turnover of receipts and payments in convertible currencies in payment categories 1 to 6 reached SKK 1,657.5 billion in 2004. The average monthly turnover stood at SKK 138.1 billion, which was 7.9% more than in 2003. Foreign exchange receipts and payments resulted in a positive balance of SKK 17.2 billion (compared with SKK 13.2 billion in the previous year).

In the long term, the currency structure of the overall turnover is dominated by EUR and USD, with a share of approximately 88 to 90% (since 1999). Since the introduction of the single currency, the share of the

[8] The methodology applied for calculating the nominal and real effective exchange rates of the Slovak koruna (NEER and REER) is the same one used by the IMF. It uses the average exchange rates of the Slovak koruna and the currencies of Slovakia's trading partners against the dollar. The methodology is based on the producer price index – PPI (manufacturing products price index - PPI manufacturing). The initial year for the calculation is 1999, and the weights selected correspond to the structure of foreign trade in 1999, for the sixteen most important trading partners of Slovakia, representing roughly 83% to 89% of the total turnover of foreign trade in 1993–2004. These countries are Germany, the Czech Republic, Italy, Austria, France, the Netherlands, the USA, Great Britain, Switzerland, Poland, Hungary, the Ukraine, Russia, Japan, China, and Turkey.

euro has been increasing, as opposed to the diminishing share of the US dollar and the Czech koruna. In 2004, however, the rate of increase in the share of the euro slowed, to the lowest level since 2000. This was mainly due to developments in the cross rate and the renewed increase in the US dollar's share in foreign-currency payments in connection with the rise in oil prices. After stagnating in the previous years, the share of other currencies increased slightly in 2004.

2.4.6. Chronology of monetary developments

January

• At the beginning of the year, a new income tax law came into effect, introducing a flat tax rate of 19% for all income groups of natural and juristic persons. The value added tax law was also amended with effect from January. The amendment replaced the reduced and basic VAT rates (14% and 20% respectively) with a uniform rate of 19%.

• Fitch Ratings, the international rating agency, increased the long-term foreign exchange liability rating of the Slovak Republic from BBB to BBB+ and the rating for long-term liabilities in domestic currency to A, and confirmed the positive rating outlook for long-term liabilities in foreign currency.

March

• Standard & Poor's (S&P) agency increased the credit rating of Slovakia in foreign currency from BBB/A-3 to BBB+/A-2. The rating outlook remained positive.

• Kia Motors, South Korea's automobile works, officially announced its decision to set up a plant in Slovakia, the first in Europe.

April

• The Government of the SR discussed and approved the Convergence Programme for 2004, together with the budget design for the year.

• The World Bank released the third (final) tranche of the EFSAL loan granted for Slovakia (EUR 70 million) for the restructuring of the domestic corporate and financial sectors, in acknowledgement of the fact that the Slovak Government is successfully implementing the reform of the national economy. Funds were released in the total amount of EUR 200 million, as the prescribed conditions were gradually fulfilled.

May

• On 1 May 2004, the Slovak Republic became a member of the European Union. By signing the Treaty of Accession, Slovakia agreed on entry into the EU, to become a party to the Treaties on which the Union is based. Thus, Slovakia became a participant in EMU as a member state with a derogation, which means that the country is supposed to join the monetary union in the future. At the same time, the National Bank of Slovakia became a member of the European System of Central Banks (ESCB), with all the rights and duties arising from this membership. After meeting the criteria of convergence, a member state with a derogation will be allowed to introduce the European single currency and its central bank will become part of the Eurosystem.

• The Bank Board of the NBS approved the Updated Monetary Programme for 2004, in which the NBS modified its expectations in respect of the future trend in the economy.

June

• Moody's Investors Service changed the rating outlook of Slovakia, from stable to positive. The Slovak Republic was assigned an A3 credit rating. The change in the rating outlook was motivated by the results of structural reforms, price liberalisation, privatisation in the banking sector, pension reform, and reform in education and health services. With this step, Moody's reacted to the introduction of a flat income tax rate for natural and juristic persons, which made Slovakia one of the most liberal economies in Central and Eastern Europe.

• Estonia, Lithuania, and Slovenia became the first countries among the new EU member states, whose national currencies were included in the exchange rate mechanism (ERM II).

September

• The Government of the SR approved Specification of the Strategy for Adopting the Euro in the SR, according to which the country is supposed to join the euro area on 1 January 2009.

• Fitch Ratings increased the long-term foreign exchange liability rating of Slovakia from BBB+ to A- and the rating for long-term liabilities in domestic currency from A to A+. At the same time, the rating for short-term liabilities was confirmed.

December

• Standard & Poor´s agency increased the long-term liability rating of Slovakia from BBB+ to A-, and changed the rating outlook from stable to positive.

• The Bank Board approved the Monetary Programme of the NBS for the Period until 2008, which defines the Bank's monetary policy strategy as inflation targeting in the conditions of ERM II. In the Programme, the NBS, for the first time, set a well-defined framework for monetary policy in the medium term, in the form of a binding target, rather than an outlook. In the medium term, the HICP inflation target was set below 2.5% for end-2006 and below 2% for end-2007 and 2008. This inflation target is in line with the membership of Slovakia in the European Union, as well as the strategy for adopting the euro and reducing the fiscal deficit. Until the date of entry into ERM II, the NBS will continue using the system of managed floating, which is in line with the Bank's inflation target. The Monetary Programme for the Period until 2008 was the last monetary programme specifying the goals of monetary policy until the adoption of the euro in the SR. In the following years, only notes will be presented to the decisions of the National Bank of Slovakia concerning the level of NBS interest rates. The Monetary Programme will be replaced by medium-term forecasts, which will be published on a regular basis.

2.5. Financial markets

2.5.1. Money market

Developments in money market rates

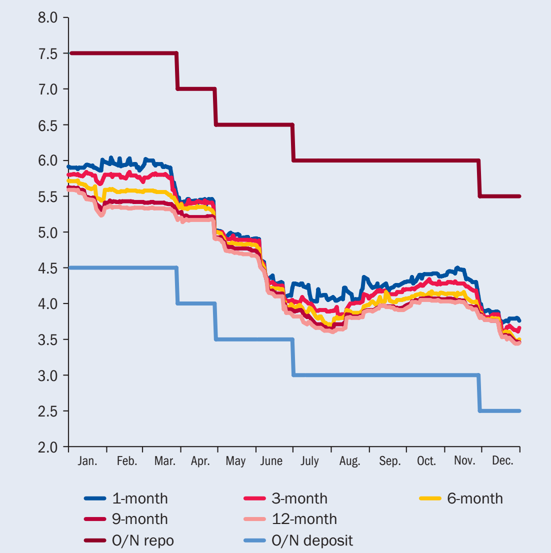
After being stable at the beginning of 2004, money market rates recorded a fall at the end of January, due to the correlation between the money and foreign exchange markets and increased expectations of a reduction in NBS interest rates. The unchanged level of NBS rates and the subsequent release of revised data on foreign trade by the Statistical Office of the SR reversed the falling trend in money market rates.

After verbal interventions from the side of the NBS against the excessive strengthening of the Slovak koruna, the NBS lowered its key interest rates by 50 basis points in March. The NBS took this step in an effort to stimulate a revival in domestic demand and to eliminate the pressure for a further appreciation in the exchange rate. The step was expected by banks, hence the interest rate cut had already been incorporated in their prices. Thus, money market rates fell to a lesser extent after the relevant decision of the Bank Board was announced.

The second interest rate cut, which took place at the end of April, was not expected by banks. Before the decision taken at the Bank Board's meeting was announced, the implied expectations of a 50 basis point cut in NBS rates were reflected in the money market yield curve in the range of six to seven months. As a result of a short-term capital inflow stimulated by the attractive interest rates differential (causing an excessive appreciation in the Slovak koruna), the Bank Board of the NBS decided to lower its key interest rates by another 50 basis points. After the interest rate cut was announced, adequate drops were recorded in money market rates for one-week to two-month maturities, and to a lesser extent, in rates for maturities longer than three months. The consequent change in the shape of the yield curve represented a fall in the implied expectations of a further cut in NBS rates, by no more than 10 basis points in the period of the next four months and by less than 50 basis points in the next nine months.

Chart 29 **BRIBOR in 2004**

(%, p.a.)



Source: NBS.

In April, subsequent to the placement of tax offices under the competence of the SR Treasury, the money market experienced an increase in the influence of the Agency for Debt and Liquidity Management (ARDAL), which manages the resources of the SR Treasury. The increase in the volume of disposable funds on the Treasury account, which markedly exceeded the amount of required minimum reserves in certain periods, continuously strengthened the influence of ARDAL on the money market, which led to an increase in the dependence of banks on Treasury resources and in higher prices of overnight deposits as well in periods of daily liquidity surpluses.

In reaction to the continuing excessive appreciation of the koruna in June, the NBS suspended sterilisations by reducing the amount to be accepted at four repo tenders and rejecting in full the bids at auctions in NBS treasury bills (NBS bills). As a result of a marked liquidity surplus in the banking sector, money market rates dropped and the interest rate spread decreased in comparison with the prices of deposits abroad.

Panel banks reacted to the changed situation by increasing the spread between the purchasing and selling prices of deposits, from 30 to 50 basis points, and by temporarily suspending the quotation of BRIBID/BRIBOR rates. Despite repeated drops in the yield curve, its shape remained unchanged, as well as the implied expectations concerning the future course of interest rates.

At the end of June (with effect from 1 July 2004), the NBS reduced its key rates for the third time (by 50 basis points), in reaction to the renewed pressure for unreasonably fast appreciation in the koruna exchange rate. The money market, where price levels had been low before the announcement of the change in key NBS rates, failed to react to the change in interest rates. After the acceptance in full of bank bids at repo tenders was renewed at the end of July, the situation on the money market stabilised and banks modified the quotation of deposits to a standard spread of 30 basis points.

The closing of koruna positions from the side of foreign investors in August, which was accompanied by a rise in deposit prices, took place at the time when the latest results of Slovak foreign trade and news about an increase in key interest rates in Poland and the Czech Republic were published. The rise in the long end of the yield curve reduced the implied expectations of a further cut in NBS rates, while the expected length of time until a more than 75 basis point reduction increased, from five months in August to seven to eight months in November.

The rise in money market rates was stopped in November and the purchase of Slovak koruna on the foreign exchange market, connected with the placement of deposits on the interbank market, markedly reduced the price of interbank deposits. For this reason, money market rates reacted to the announcement of the fourth cut in key NBS rates (by 50 basis points) very cautiously. The NBS moved to lower its key rates at the end of November (for the last time in 2004) as a result of a favourable trend in inflation, expectations of a marked fall in inflation in 2005, and actual inappropriate appreciation of the Slovak koruna. The change in the shape of the yield curve (a more gentle slope) prolonged the expected length of time until the next reduction in NBS rates (not exceeding 50 basis points) to nine months.

Interbank transactions on the money market

On the interbank market, the turnover of repo operations, deposit and swap transactions, recorded only a modest year-on-year increase in 2004. Domestic banks accounted for 38.9% of the total turnover, the rest was produced by foreign banks (61.1%). The largest share in the turnover (excluding repo operations, which resulted in a minimum turnover) was achieved by domestic banks in deposit transactions (49.6%) and foreign banks in swap transactions (71.8%).

With effect from January 2004, the NBS included two derivatives deduced from money market rates in the statistical reporting of interbank transactions. These derivatives are the Forward Rate Agreement (FRA) and the Interest Rate Swap (IRS). The inclusion of derivatives in the range of statistically reported transactions left the share of domestic and foreign banks in the turnover virtually unaffected. Domestic banks achieved a share of 39.0% and foreign banks 61.0%. The highest turnover was produced by domestic banks in deposit transactions (49.6%) and foreign banks in IRSs (75.7%).

The share of reference banks in the total volume traded among banks (purchases and sales) stood at 85.4%.

In 2004, the most trading took place in deposits with the shortest maturities; transactions with a maturity of up to one week accounted for 89% of the total trading volume and transactions with a maturity of up to two weeks exceeded 95% of the total volume traded in deposits.

Operations of the NBS on the money market

Activities on the money market were indirectly influenced by the NBS in two areas. The first was the provision of opportunities for banks to use intra-day credit from the NBS, secured by securities, with a limit for the amount drawn set at weekly intervals. Thus, banks may draw interest-free funds from the NBS for ensuring the smooth course of payment operations within a day, even in a situation when the level of minimum reserve holdings is low. During the year, intra-day credit were first drawn by two banks, then the number of borrowers increased to eight, with the

Table 30 **Monthly volumes of purchases and sales on the interbank market** **(SKK millions)**

	2004											
	Jan.	**Feb.**	**Mar.**	**Apr.**	**May**	**June**	**July**	**Aug.**	**Sep.**	**Oct.**	**Nov.**	**Dec.**
Deposits	748	603	687	559	735	570	643	650	561	564	557	727
Repos	2	0	0	8	0	0	0	0	0	0	0	0
Swaps	789	642	748	613	627	658	633	572	511	626	564	706
FRAs	38	25	24	29	26	46	2	11	7	10	22	18
IRSs	28	9	7	7	9	10	5	3	4	4	7	9
Total	1,605	1,279	1,466	1,216	1,397	1,284	1,283	1,236	1,083	1,204	1,150	1,460

Source: NBS.

value of securities used as collateral amounting to SKK 43.3 billion at the end of the year. The introduction of the possibility of drawing interest-free intra-day credit led to a fall in pressure for the shortest-term deposits in periods of lower daily liquidity, which reduced the volatility in short-term money market rates. The second area was a change in the form of interest payment on funds held by banks on clearing accounts for the needs of required minimum reserves. Originally, these funds attracted interest according to the amounts of daily balances. The introduction of interest payment according to the average amount of balances in the period under review had a stabilising effect on the money market.

In 2004, the implementation of monetary policy through open market operations underwent no systemic changes and remained based on standard instruments. Changes were, however, recorded in the individual instruments, i.e. open market operations and the method for the valuation of securities, which are used in transactions as security.

The most important instrument were two-week repo tenders, which were held by the NBS on a weekly basis. At the beginning of the year, the share of tenders in the total volume of sterilised funds (56.2% in February) was affected by increased interest in NBS bills. Another increase in the share of tenders was generated by the February 2004 decision of the Bank Board to reduce the share of NBS bills (25% of the total volume). Demand at the tenders increased significantly (with a maximum share of 82.8% recorded in August), and never fell below 75% during the year.

The NBS accepted in full the bids of banks at most repo tenders. Some of the bids were rejected in March, owing to the technical elimination of differences in volume between the active tenders, while demand at curtailed tenders was twofold higher than the volume of due repo tenders. In June, the NBS again refused to accept the bids of banks in full, with the intention of maintaining a surplus of interbank liquidity for the purpose of influencing developments on the foreign exchange market. The reduction in demand led to a fall in the average accepted yield in comparison with the limit rate for repo tenders (by 59 basis points).

As for NBS treasury bills, 2004 saw few changes in the issuing conditions. The first change occurred after the coming into effect of the new income tax law in January, which provided the legal framework for a change in the form of primary sale of NBS bills, from the Dutch auction technique to the American auction. The second change resulted from the February decision of the Bank Board to fix the share of NBS bills in the total volume of liquidity sterilisation, at around 25%. This measure was taken as a result of an increase in interest in NBS bills, which are not regarded by the NBS as a key monetary instrument. The third change was the extension of the range of participants in primary NBS-bill auctions to include the Ministry of Finance, represented by the ARDAL agency. During 2004, the NBS conducted 13 auctions in NBS bills, and accepted none of the bids in one case only. The initial difference between the minimum and maximum accepted yields ranged from 10 to 16 basis points. The NBS accepted no bids in June, which, together with the curtailment of tenders, was an indication of an attempt to prevent the Slovak koruna from a further excessive appreciation. As a result of a renewed issue of NBS bills in July and the determination of banks to succeed at auctions, the spread between the minimum and maximum yields increased from 31 to 48 basis points. Despite this, the average accepted yield was above the level of the three-month money market rate fixed on auction day. At the end of the year, the spread between the accepted yields was reduced further, to 6–20 basis points, while the average yield dropped below the three-month BRIBOR rate fixed on auction day.

The most frequent overnight transactions took place in deposits. Banks tried to maintain a surplus of liquidity (except in periods of liquidity shortage, resulting from an increase in the amounts accepted at tenders in comparison with the due amount), which they subsequently deposited with the NBS. The maximum

Table 31 **Average monthly effects of NBS transactions on the level of banking sector liquidity (SKK millions)**

	2004											
	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sep.	Oct.	Nov.	Dec.
O/N repos	1,371	1,090	236	8	0	439	50	888	737	73	525	0
O/N dep.	-2,779	-3,546	-3,645	-656	-1,471	-8,992	-2,916	-1,546	-415	-838	-508	-2,331
NBS bills	-66,837	-81,164	-77,160	-70,047	-70,000	-43,000	-40,000	-43,226	-60,000	-60,000	-60,000	-60,000
SRT	-113,061	-107,185	-115,526	-125,040	-131,546	-149,067	-189,555	-211,815	-211,577	-202,905	-204,449	-195,815
Total	-181,306	-190,805	-196,095	-195,735	-203,017	-200,620	-232,421	-255,699	-271,255	-263,670	-264,432	-258,146

Source: NBS.

volume of overnight deposits was recorded in June, when the NBS substantially reduced the amount of bids at tenders and thus banks deposited as much as SKK 23.2 billion. Most requests for refinancing were also recorded in June, when the NBS accepted a larger amount at a repo tender, causing a marked shortage of liquidity in the banking sector. On the last trading day in June, banks borrowed SKK 11.2 billion from the NBS (for the purpose of fulfilling the minimum reserve requirements).

Banking sector liquidity

In 2004, the implementation of monetary policy maintained its sterilisation nature, while the sterilisation position of the NBS vis-à-vis the banking sector increased during the year. An exception was the last quarter of 2004, when the level of sterilisation stabilised somewhat, before increasing again towards the end of the year. The sterilisation position of the NBS vis-à-vis the banking sector increased year-on-year by SKK 113.4 billion, to SKK 289.4 billion at the end of the year.

Among the main sources of liquidity inflow were the operations of the NBS on the foreign exchange market against the excessive appreciation of the Slovak koruna. The reserves of commercial banks were most significantly affected by such foreign exchange interventions in July (an increase in liquidity by SKK 30.6 billion) and December (an increase in liquidity by SKK 23.3 billion), and their volume in cumulative terms reached SKK 68.6 billion in 2004.

Another liquidity-providing factor was the gradual release of funds held on a time deposit account of the Ministry of Finance at the NBS and their transfer to the SR Treasury (part of the funds came from an issue of eurobonds made in May 2004, in the koruna equivalent of approximately SKK 18 billion).

Pressure for an increase in the liquidity of commercial banks was also exerted by the gradual transfer of funds from general government accounts, held at the NBS, to the SR Treasury in connection with the commencement of operations on 1 January 2004 and the release of funds from the remaining general government accounts at the NBS into the banking sector.

The liquid resources of the banking sector were also increased in 2004 by certain one-off effects. Among them was the impact of a 1 percentage-point reduction in the required reserve ratio with effect from 1 January 2004 (causing an increase of SKK 6.3 billion in the need for sterilisation in comparison with December 2003) and that of the January transfer of funds from the accounts of State funds at the NBS to the banking sector (a liquidity inflow of SKK 10.8 billion).

The liquidity increase resulting from the above factors was partly offset by a liquidity outflow through an excess of the volume of government securities issued on the domestic money market over the volume of redeemed securities (including government bond yields paid in the amount of SKK 15.7 billion), which reduced the level of liquidity by SKK 6.9 billion.

The volume of currency in circulation, which had a neutral effect in the first half of the year, increased in the second half of the year and thus contributed to the reduction in banking sector liquidity (by approximately SKK 7 billion).

During the implementation of monetary policy, characterised by the dominance of liquidity-providing factors, the volume of sterilised resources ranged from SKK 170 billion to SKK 290 billion during the year and the average annual volume of sterilisation reached SKK 226.2 billion, compared with SKK 162.7 billion in 2003.

Fulfilment of reserve requirements

To complete the process of harmonisation of its monetary-policy instruments with those of the European Central Bank, the NBS reduced the required-reserve ratio for the banking sector by 1 percentage point (from 3% to 2%) in January 2004. With this step, the reserve ratio was brought into harmony with the Eurosystem's minimum reserve system.

As a result of the cut in the reserve ratio, the average level of minimum reserves fell by approximately SKK 6.3 billion. During 2004, the actual reserve-requirement fulfilment was balanced throughout the banking sector, with a marked surplus in April. In the conditions of a marked excess of liquidity and continued sterilisation operations on the part of the NBS, the determined level of minimum reserves was maintained every month and was not exceeded to a significant extent. Average monthly excess reserves ranged from SKK 0.02 billion to SKK 0.32 billion.

The volume of daily reserve holdings ranged from SKK 4.08 billion to SKK 36.31 billion. In the individual reserve-maintenance periods, deviations from the determined amount of daily reserves ranged from a reserve surplus of SKK 20.7 billion to a reserve shortage of SKK 12.03 billion. The largest deviations from the reserve requirements in 2004 were recorded in June and December.

In 2004, no case of failure in reserve-requirement fulfilment was reported from the banking sector.

Table 32 **Reserve requirement fulfilment in 2004** (SKK billions, %)

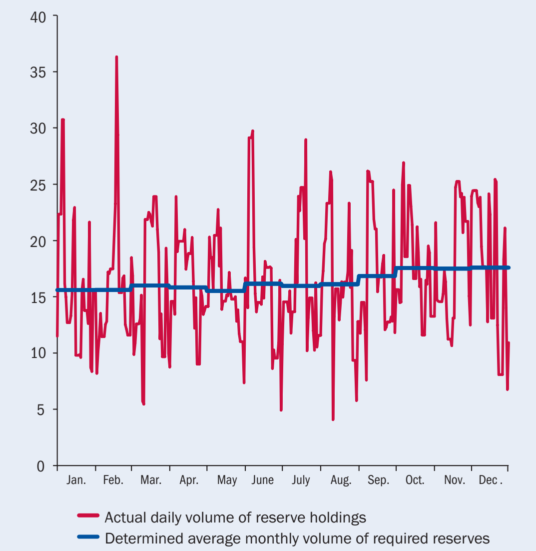
	Required reserves	Actual reserve holdings		
		Average	Fulfilment in %	Standard deviation
January	15.59	15.70	100.70	5.85
February	15.61	15.63	100.13	5.76
March	16.01	16.03	100.14	5.67
April	15.84	16.15	101.99	3.95
May	15.53	15.57	100.27	3.45
June	16.16	16.23	100.45	6.10
July	15.97	16.04	100.40	5.00
August	16.11	16.13	100.13	5.32
September	16.84	16.89	100.30	5.25
October	17.55	17.60	100.27	4.10
November	17.50	17.53	100.18	5.03
December	17.58	17.64	100.32	6.16

Source: NBS.

SR Treasury bills

The Agency for Debt and Liquidity Management (ARDAL), which stipulates the issuing conditions for government securities and decides in auctions on behalf of the Ministry of Finance as of 2004, began to issue SR Treasury bills in February. In the issuing schedule for 2004, ARDAL planned only 1-year issues of Treasury bills, but in October decided to reduce the maturity of all remaining issues to 3 months in view of the rescheduling of government debt repayments. Primary sales have taken place via American-style auction for the past several years, but the tax reform required a change in the auction technique. The new Tax Act sets out the exceptions for when yields on securities are not included in the tax base but are subject to withholding tax. Since the subjects of these exceptions have access to the Treasury-bill market, an American auction would not make it possible to quantify their yields and ensure tax payment by deduction. Hence, the Dutch auction currently represents an indispensable technique for the primary sale of Treasury bills by auction.

Chart 30 **Reserve requirement fulfilment in the banking sector in 2004** (SKK billions)



Source: NBS.

Total sales of SR Treasury bills in 2004 reached SKK 38.8 billion (20% of the total demand at the auctions). The average amount per issue was SKK 1.8 billion, and average demand per auction amounted to SKK 8.7 billion. The small percentage of bids accepted at auctions can be explained by an increase in the proportion of deficit refinancing through credits or short-term loans from the SR Treasury, which reduced the need for deficit financing via the market.

Foreign investors accounted for 15% of the primary purchase. Purchases by domestic commercial banks represented 66% and other domestic investors 19%.

The average interest yield on the primary market for Treasury bills reached 4.28% in 2004. The yields were below the level of domestic money market rates for comparable maturities throughout the year. On average, Treasury bills were placed on the market in 2004 at a rate of 16 basis points below the level of the BRIBOR rate (in the conditions of a comparable tax burden).

2.5.2. Capital market

Primary market

Government bonds

With the establishment of the Agency for Debt and Liquidity Management (ARDAL) on 1 January 2004, a new debt and liquidity management system began to be applied in the Slovak Republic. The tasks and responsibilities among the Ministry of Finance, ARDAL, SR Treasury, and the National Bank of Slovakia were redistributed during the year. Within the meaning of Act No. 386/2002 Coll. on the government debt and government guarantees, which amended Act No. 291/2002 Coll. on the SR Treasury, ARDAL is charged with the task of issuing and repaying government securities, including government bond yields.

In total, 26 government-bond issues were floated during the year in the total amount of SKK 101.0 billion, representing an increase of SKK 2.5 billion in the total amount of issued government bonds (compared with SKK 98.5 billion in the previous year). Total demand amounted to SKK 220.7 billion, which was 18.5% more than a year earlier (SKK 186.2 billion). The average issue-amount was SKK 3.9 billion (a year-on-year decrease of SKK 0.8 billion). The decrease in the issue-amount in comparison with 2003 was a consequence of Treasury-bill issuance throughout the year.

In drawing up the issuing schedule for 2004, ARDAL followed the principle that the best way of making the market for government bonds more attractive is to extend the range of issues, introduce new products, and to prolong the yield curve to 15 years. This was confirmed by the fact that exclusively tap issues were placed on the market (re-openings), with the total issue-amount set at SKK 40.0 billion for each of the five issues. For the first time in history, government bonds were also put on the market with a maturity of 15 years. All issues were placed on the primary market in the traditional form, via American-style auction. Another innovation was the issue of 5-year government bonds with a floating yield (12M BRIBOR), which was set at 5.45% in 2004, and a 3-year issue with a zero-coupon, which was the only issue to be floated in the planned issue-amount (SKK 40.0 billion). In May 2004, a euro-denominated 10-year government bond issue was floated on the international financial market, in the amount of EUR 1 billion.

On 31 December 2004, there were 27 foreign investors (representing 19.1% of the total number of investors) registered on the primary market for government bonds.

Benchmark yield curve for government bonds

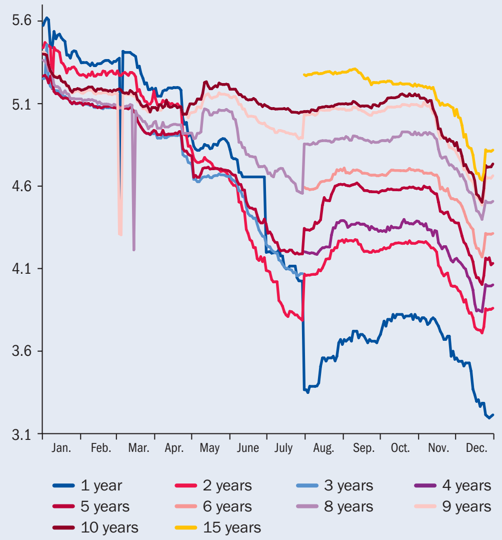
At the beginning of 2004, the NBS started quoting benchmark government bonds. Banks were allowed to quote, on a daily basis, selected government bonds with a maturity of 1 to 15 years. The rationale behind the introduction of a benchmark curve is to provide a basis for the formation of prices for individual securities, from the average value of quotations. Banks use these prices for the valuation of their government bond portfolios for the purpose of measuring the adequacy of its own resources. The benchmark curve is formed by eight entities, which are governed by the Rules for Creation the Benchmark Yield Curve.

Table 33 **Structure of government bond issues by the satisfaction of demand**

	2003			2004		
	Volume in billions of SKK	**Number of issues**	**Percentage of accepted bids in %**	**Volume in billions of SKK**	**Number of issues**	**Percentage of accepted bids in %**
1-year	15.0	3	34.2	–	–	–
1.5-year	16.6	3	42.7	–	–	–
2-year	15.1	2	81.2	–	–	–
3-year	–	–	–	40.0	7	54.4
5-year, floating coupon (12M BRIBOR)	–	–	–	11.3	5	26.2
5-year, fixed coupon	15.0	1	71.2	18.2	5	33.8
7-year	15.0	1	57.7	–	–	–
10-year	22.8	3	60.2	15.5	5	60.5
15-year	–	–	–	15.9	4	64.6

Source: NBS.

Chart 31 **Developments in the benchmark yield curve in 2004**



Source: NBS.

In the first half of 2004, benchmark yields showed a falling tendency, which was affected by the appreciation of the Slovak koruna, the improvement in credit rating, and the reduction in the basic interest rate. On the other hand, these prices were significantly affected by the rates of interest achieved at primary auctions. The August increase in yields was caused by changes in the benchmark portfolio and a slowdown in the appreciation of the koruna. The marked fall in November was a continuation of the trend from the first half of the year. The price increase in December was artificially generated by commercial banks, which use the year-end prices of benchmark issues for the official revaluation and comparison of profits from transactions in 2005.

Yield payment and bond repayment

In 2004, government bond yields were paid in the total amount of SKK 15.6 billion. Foreign investors received SKK 2.2 billion (14.1% of the total amount) and domestic investors SKK 13.4 billion (85.9%), of which bond creditors accounted for SKK 0.1 billion (0.75%).

Government bond yields paid in 2004 fell by 19.0% (compared with SKK 19.2 billion in the previous year). Domestic investors received 85.9% of the total yields paid in 2004, compared with 33% in 2003. The share of foreign investors decreased, from 67% in 2003 to 14.1% in 2004. Yields paid to bond creditors also recorded a year-on-year decline (by 67.0%, from SKK 0.3 billion paid in the previous year).

In 2004, the nominal values of 13 government-bond issues were repaid in the amount of SKK 62.6 billion. Foreign investors received 29.71% and domestic investors 70.29% (of which SKK 0.1 billion went to bond creditors). In 2004, yields and nominal values were repaid in the total amount of SKK 78.2 billion (compared with SKK 79.7 billion in the previous year).

Yield payments and nominal value repayments in 2004 compared with 2003 indicate that the amounts paid to domestic investors changed considerably, which can be explained by a change in the taxation of yields introduced by the amendment to the income tax law, with effect from 1 January 2004. Owing to this amendment, there was no ‘coupon washing’ in 2004.

Non-government bonds

In total, 21 mortgage-bond issues were floated in 2004 (compared with 14 in the previous year). The total volume of issued mortgage bonds reached SKK 16.1

Table 34 **Government bond yields paid** **(SKK billions)**

	Yields in total	Foreign investors	Domestic investors	of which: bond creditors
2003	19.2	12.8	6.4	0.3
2004	15.6	2.2	13.4	0.1

Source: NBS.

Table 35 **Nominal value of government bonds yields** **(SKK billions)**

	Number of issues (pcs)	Repaid nominal value in total	Foreign investors	Domestic investors	of which: bond creditors
2003	24	60.5	50.6	9.9	2.3
2004	13	62.6	18.6	44.0	0.1

Source: NBS.

billion, representing a year-on-year decline of SKK 3.4 billion). The issuers were: Tatra banka, Slovenská sporiteľňa, OTP Banka, VÚB, Unibanka, Istrobanka, HVB, ČSOB, and Ľudová banka.

Secondary market

The secondary market was affected by numerous factors, the most significant being the transformation of the Securities Centre of the SR , a.s. (SCP) into the Central Securities Depository of the SR, a.s. (CDCP). Apart from the introduction of a two-level registration of securities owners and the opening of an over-the-counter market, the most important innovation on the market was the transfer of powers in the area of accounting and settlement, from the Bratislava Stock Exchange (BCPB) to the Central Securities Depository (CDCP). Although the CDCP announced these changes in the system on 20 March 2004, there were no adequate conditions for the provision of services as stipulated by law. Hence, the CDCP, BCPB, and the members of the CDCP agreed on the steps to be taken in the so-called transition period, during which a slightly modified version of the original system of accounting and settlement was used, together with a new registration system. The transition period ended on 30 September and the CDCP commenced operations on 1 October 2004.

On 1 January 2004, numerous legislative changes came into effect in respect of the capital market. One of them was an amendment to the Stock Exchange Act (No. 429/2002 Coll.), pertaining to the approval of a quoting prospectus. Another legislative change was introduced by the new law on collective investment (No. 594/2003 Coll.), which was drawn up with regard to the relevant EU regulations and the new income tax law, introducing a flat 19% rate for both natural and juristic persons.

The changes in the Stock Exchange Rules approved by the Financial Market Authority entered into effect on 1 October 2004.

General overview of stock exchange dealings

In 2004, the Bratislava Stock Exchange (BCPB) made its electronic trading system (EBOS) available for trading purposes. During 245 trading days, 22.38 million securities (shares or bonds) were traded, in the total amount of SKK 432.3 billion (a year-on-year decrease of 60.6%). After 2002 and 2003, 2004 was the third most successful year in the history of the BCPB, in terms of the volume of transactions. This figure was achieved in 17,644 transactions (a year-on-year decrease of 71.9%), which was due to a change in the income tax law (prohibition, with effect from January 2004, of the transfer of securities to foreign entities with the aim of gaining a tax allowance, which had previously caused an artificial increase in the number and amount of transactions).

In 2004, direct transactions continued to surpass price-setting transactions, in the same way as trading in shares was surpassed by bond transactions. The marked decline in trading was in part caused by a reduction in takeover bids (a year-on-year decrease of 92.7%, i.e. SKK 8.3 billion).

Trading in bonds

The volume of bond transactions reached SKK 410.9 billion (2.3 million bonds in 2,636 transactions) in 2004. This represented a sharp decline (i.e. 61.7%) in comparison with 2003 (owing to the amendment to the income tax law). Most investments were again made in risk-free government bonds. Their volume totalled SKK 407.5 billion (in 2,073 transactions), representing 99.2% of the total volume of transactions. Debt securities were again dominated by quoted issues (SKK 410.1 billion, in 2,590 contracts), which accounted for 99.8% of the total volume of bond transactions. In 2004, the volume of electronic order book transactions in bonds reached SKK 14.0 billion (a year-on-year drop of 88.2%).

Trading in government bonds accounted for 98.6% of the total volume of bond transactions (in 933 contracts). The best performers were government bonds – Issue No. 142 (SKK 50.6 billion, 45 transactions), Issue No. 200 (SKK 34.1 billion, 170 transactions), and Issue No. 191 (SKK 9.0 billion, 79 transactions). Among non-government bonds, most trading took place in quoted Istrobanka II bonds (SKK 416.5 million, 5 transactions) and Železiarne Podbrezová bonds (SKK 327.5 million, 3 transactions). In terms of the number of transactions, the best performers were government bonds of Issue No. 191 (170 transactions).

Non-resident investors accounted for 48.7% (SKK 200.0 billion) of the total volume traded in 2004, of which 52.4% were composed of purchases and 44.9% of sales.

In the market-maker module, the following issues were traded over the course of the year: 19 government-bond issues (No's. 166, 174, 187, 188, 189, 191, 199, 200, 202, 203, and 204); 3 corporate-bond issues (B.O.F. 04, B.O.F. 05, and Železiarne Podbrezová II); and 5 issues of mortgage bonds (VÚB VI, VÚB VII, Tatrabanka 01, Istrobanka I, and Istrobanka II). The volume of transactions in the market-maker module amounted to SKK 1.04 billion (in 69 contracts), representing 7.4% of the total volume of electronic order book bond transactions.

On the last trading day of the year, the market capitalisation of debt securities amounted to SKK 362.3 billion (a year-on-year increase of 9.2%), of which SKK 340.1 billion was in quoted issues (a year-on-year increase of 18.9%).

Indices

SDX index

The SDX (Slovak Bond Index) component for corporate and bank bonds closed the year at 259.54% of the nominal value (an annual increase of 8.6%), with an average yield of 4.54% to maturity and a duration of 1.77 years. The index reached a minimum on January 7 (239.08%) and a maximum on December 23 (259.54%).

At the end of the year, the average price of the government-bond portfolio in the SDX base stood at 238.40% (a year-on-year increase of 9.7%), while the average yield was 4.32% and the average duration 3.87 years. The average price recorded a minimum on January 7 (217.41%) and a maximum on December 22 (238.40%).

SDXGroup index

On 2 September 2004, the BCPB started publishing a new group index for bonds, referred to as 'SDXGroup index', which has become the main indicator of the Slovak capital market for debt securities. In the future, the original SDX index will be fully replaced by the SDXGroup index. The SDXGroup index is based on the ratio between the present capitalisation of a bond and its initial value. The initial value of the index (100 points) is tied to 7 January 2004. The index has two components: price and performance. The price component compares the market prices of selected debt securities (basic titles) with the market prices of the same securities at the beginning of the period. Apart from changes in market prices, the performance index monitors the capital yields of the basic components of the index and compares them with the initial values (from the day on which the index was introduced).

The SDXG index for the public sector, represented by government bonds, closed the year at the level of 105.303 (price) and 110.159 (performance), with a yield of 4.20% to maturity and a duration of 4.73 years. The value of the short-term SDXG(<=5) sub-index reached 104.27 (price) and 108.33 (performance), with a yield of 3.743% to maturity and a duration of 2.55 years. The long-term SDXG(>5) sub-index closed the month at 106.225 (price) and 111.832 (performance), with a yield of 4.36% to maturity and a duration of 6.72 years.

The SDXG for the private sector, represented by corporate and mortgage bonds, closed the year at 102.78 (price) and 109.48 (performance), with a yield of 4.02% to maturity and a duration of 3.32 years. The value of the short-term SDXG(<=5) sub-index reached 101.54 (price) and 108.46 (performance) at the end of the year, with a yield of 3.99% to maturity and a duration of 2.31 years. The long-term SDXG(>5) sub-index closed the year at 107.78 (price) and 111.94 (performance), with a yield of 4.04% to maturity and a duration of 6.75 years.

Trading in shares

During the year, 13 new issues of shares and participation certificates were accepted for trading (from 5 issuers), in the nominal value of SKK 2.2 billion. The issues were registered on the open market; none of them was placed on the market for quoted shares. Of six share issues registered on the regulated open market, the shares of Termstav and Rufin were again accepted for the needs of compulsory takeover bids. After the bids, they were withdrawn from the market. The remaining seven issues were participation certificates floated by the PRVÁ PENZIJNÁ management company, in the amount of SKK 16.0 million.

In terms of trading volume, the best performers in addition to compulsory takeover bids were the shares of Nafta (SKK 2.51 billion, 264 transactions), Slovnaft (SKK 1.73 billion, 662 transactions), and Zentiva (SKK 356.5 billion, 67 transactions). The regulated open market was dominated by an issue of Inžinierske stavby Košice (SKK 2.66 billion, 98 transactions), which was at the same time the most successful issue of all registered share issues on the BCPB floor in 2004. The largest number of transactions (2,986) was recorded in the shares of OTP Banka Slovakia. In electronic order book transactions, the best performers in terms of volume were the shares of Všeobecná úverová banka (VÚB).

In the market-maker module, no shares were available for trading at the end of the year. Although trading in the recently withdrawn Slovnaft and Zentiva shares was allowed within the market-maker module until the end of the first quarter of 2004, the market-maker module ended the year without a single transaction.

SAX index

The Slovak Share Index (SAX) appreciated year-on-year by 83.9% (i.e. 149.01 points). The figure recorded

Table 36 **Changes in the SKK/EUR and SKK/USD exchange rates** **(%)**

	Year-on-year change	Average Dec. 2004 / Average Dec. 2003	Average (Jan.– Dec.) 2004 / Average (Jan.– Dec.) 2003
SKK/EUR	-5.75	-5.4	-3.5
SKK/USD	-13.44	-13.5	-12.3

Source: NBS.
Note: - appreciation of the SKK, + depreciation of the SKK.

on the last trading day (December 23) represented an annual and more than 10.5-yearly maximum. SAX index closed the year at 326.63 points, with an increase of 83,9%.

2.5.3. Foreign exchange market

Operations on the foreign exchange market

During the year, the exchange rate of the Slovak koruna against the euro appreciated by 5.75% (from SKK 41.161/EUR to SKK 38.796/EUR). The average exchange rate was SKK 40.045/EUR, representing a year-on-year appreciation of 3.5%. The exchange rate of the koruna against the US dollar appreciated during the year by 13.44%, from SKK 32.920/USD to SKK 28.496/USD. The average exchange rate reached SKK 32.255/USD (an appreciation of 12.3% in comparison with 2003).

During 2004, the NBS intervened in the foreign exchange market on two occasions against the excessive strengthening of the Slovak koruna (on July 8–13 and December 22–23) and purchased during these interventions a total of EUR 1,166 million. The Bank also accepted the offers of commercial banks and purchased EUR 564 million in direct transactions.

Interbank foreign exchange market

The total volume traded on the interbank exchange market (in foreign currency conversion, currency swaps, and forward transactions, excluding foreign exchange interventions by the NBS) reached USD 441,297.8 billion, representing an increase of 10.3% in comparison with the 2003 figure (of which transactions in USD accounted for 83.3%, in EUR 13.1%, and in other currencies 3.6%). Within the structure of transactions, currency swaps accounted for 91.2% (compared with 91.0% in 2003), spot exchange transactions 8.7% (8.9% in 2003), and forward dealings 0.1% (the same figure as in 2003).

The average daily turnover on the spot market amounted to USD 150.95 million. The market was dominated by trading in EUR, which accounted for 96.8% of the total volume, due to the euro being the reference currency. Trading between domestic banks and between domestic and foreign banks on the spot market confirmed the trend of increased activity on the part of foreign banks on the Slovak foreign exchange market (17.4% of the total turnover was in favour of domestic banks and 82.6% in favour of foreign banks). In 2004, the overall balance of transactions between foreign and domestic banks was positive (USD 243.9 million), i.e. foreign banks purchased mostly foreign currency and sold Slovak koruna. Of this figure, however, it is difficult to draw unambiguous conclusions about the interest of foreign banks in the purchase or sale of Slovak koruna. The customers of foreign banks are not only foreign entities, but domestic banks and companies as well. The market for trade in Slovak koruna is a global one, hence numerous domestic entities use the services of foreign banks, mainly in cases, when they need larger amounts to be converted. Therefore, the final balance of transactions between foreign and domestic banks does not reflect the actual inflow or outflow of foreign currency in/from the domestic exchange market.

The volume of transactions between domestic commercial banks increased by 2.2%, to USD 76,841.2 million. Trading took place mostly in US dollars (78.8%; compared with 79.4% in 2003), followed by the euro with a share of 20.4% (20.0% in 2003), and other currencies accounting for 0.8%.

In the structure of transactions by type, 88.4% of the total volume traded between domestic banks took place in the form of swap contracts (85.9% in 2003) and spot exchange transactions accounted for 8.0% (14.1% in 2003).

Trading with foreign banks also recorded a year-on-year increase (12.3%), to USD 364,706.6. The largest volume was traded in US dollars (84.3%; compared with 78.8% in 2003), followed by the euro with a share of 11.6% (12.1% in 2003), and other currencies accounting for 4.1%.