DEVELOPMENTS IN DOMESTIC FINANCIAL MARKETS IN 2005[1]

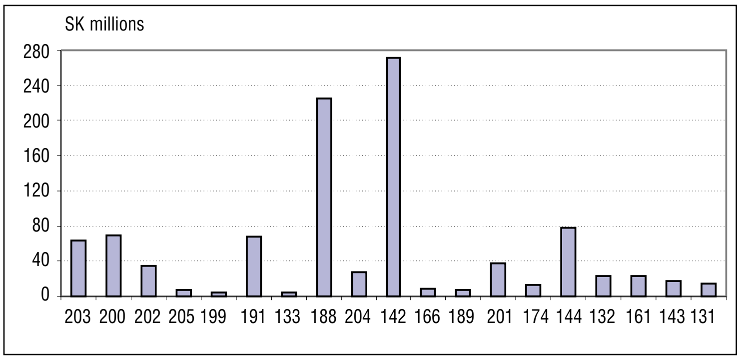
Continuation from Volume 5/2006

Secondary bond market

At the end of the year, 75 bond issues were available for trading on the stock exchange markets (30 on the main quoted market, 38 on the parallel quoted market, and 7 on the regulated open market, of which 1 issue was denominated in euros). There were 2,911 transactions involving 5.7 million bonds totalling Sk 999.7 billion.

The market-maker system saw trading in 10 government-bond issues, 3 corporate-bond issues, and 4 mortgage-bond issues. The volume of transactions within this system totalled Sk 4.6 billion (in 50 transactions), representing 59.0% of the volume of all price-setting transactions in bonds (7.4% in 2004).

Chart 12 Trading in government bonds in 2005[1)]



[1)] With an annual amount of over Sk 5.0 billion.

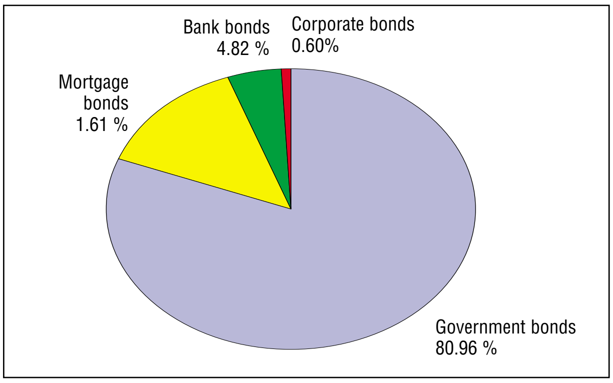
Table 1 Survey of newly registered issues on the BCPB

Type of security	2004		2005	
	Number of issues	Value	Number of issues	Value
Government bonds*	5	101.0	1	7.4
Mortgage bonds	10	6.7	15	11.3
Bank bonds	–	–	2	4.0
Bank bonds	2	2.0	3	0.5

* In 2005, the Bratislava Stock Exchange (BCPB) also recorded capital inflows in the form of increased tranches of previously registered government bonds. Four government bond issues were increased in the nominal value of Sk 59.8 billion.

At the beginning of the year, the Bratislava Stock Exchange (BCPB) decided to cancel the SDX bond index, and to replace it completely by SDX Group indices[2]. The rationale behind this decision is to ensure that the index will not serve as a benchmark for any individual financial market group (banks, insurance companies, asset management companies, pension management companies, investment companies), but should represent all the important segments of the market.

Chart 11 Structure of the bond market



Secondary stock market

Trading in shares over the period under review was very weak. On the last trading day of the year, 306 share issues were available for trading (from 230 issuers), including 51 issues of investment fund shares, of

[1] The authors of this article are on the staff of the Banking Transactions Department of the NBS.

[2] The SDXGroup index is based on the ratio between the present capitalisation of bonds and their initial values. The initial value of the index equalling 100 points was fixed as at 7 January 2004. The index consists of two components: a price component and a performance component. The price component compares the market prices of selected debt securities (basic issues) with the market prices of the same securities from the first day of the period. Apart from changes in market prices, the performance component 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).

Chart 13 SDXG for the public sector represented by government bonds

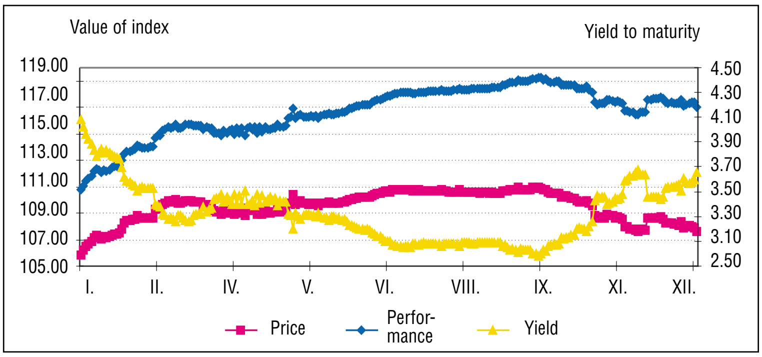
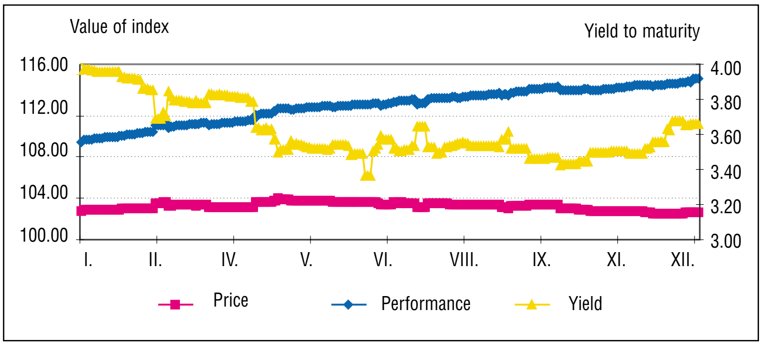


Chart 14 SDXG for the private sector represented by corporate and mortgage bonds



vak capital market is a bond market. The amount of price-setting transactions reached Sk 0.4 billion, representing a decrease of 95% compared with the previous year.

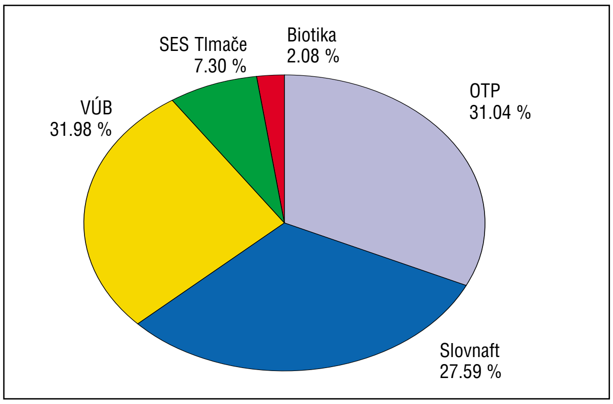
The Slovak Share Index (SAX) followed a rather volatile course in 2005, when longer-term increasing phases alternated with declining periods in share prices. The SAX index reached 413.3 points, representing an appreciation of 26.5% (i.e. 86.7 points) compared with the same period in 2004. The index reached a historical maximum at the end of the first quarter (14 March), amounting to 507.98 points.

The base of the SAX index was revised on two occasions during the year. The first revision was carried out in connection with the exclusion of a quoted Novitech (a.s.) issue from the SAX base (in January). The second revision took place in July, when trading in Nafta (a.s.) shares on the quoted BCPB market was completed.

Table 2 Most successful share issues in 2005

Name of issuer	Volume of transactions in millions of Sk	Number of transactions	Share of transactions in %
Istrokapitál	401.9	14	19.0
Slovnaft	284.0	790	13.5
SES Tlmače	208.8	490	9.9
Slovenská plavba a prístavy	196.7	20	9.4
VÚB	82.3	1 105	3.9

Chart 15 Weights of basic SAX index components as at 31 December 2005



which 5 issues were on the main quoted market, 8 issues on the parallel quoted market, and 293 issues on the free market. No issues were registered on the quoted market at the end of the year.

The total amount traded in equity securities reached Sk 2.1 billion in 7,903 transactions (including compulsory takeover bids), which was the smallest amount in the last 10 years. Transactions in shares accounted for only 0.2% of the total volume of secondary transactions, which confirms that the Slo-

Chart 16 Market capitalisation of shares in 2005 compared with 2004

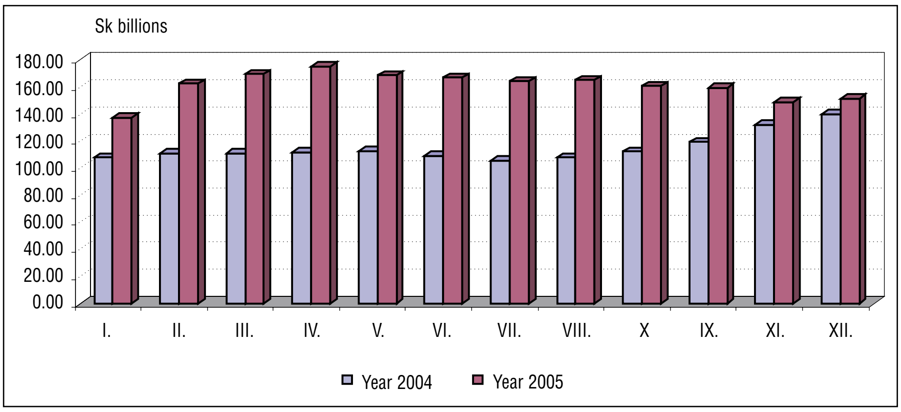


Table 3 Development of investment funds 1) (Sk millions)

	Net sales of investment funds		Net asset value – NAV	
Period	2004	2005	2004	2005
1st quarter	5 856,5	20 115.5	44 750.7	91 967.2
2nd quarter	6 477.7	9 727.7	59 365.4	103 140.4
3rd quarter	9 152.4	10 376.6	61 265.3	115 018.9
4th quarter	8 775.8	7 905.6	70 484.7	123 623.7

Source: Association of Asset Management Companies.

1) The data refer to domestic and foreign funds.

Collective investment

In 2005, collective investment followed the trend from 2003 and 2004, and again represented the most dynamic segment of the domestic financial market. Compared with 2004, the value of assets entrusted to collective investment funds increased by 75.4% in 2005. Despite a fall in interest rates at banks, investors continued to favour conservative forms of investment in money market funds.

This was also confirmed by developments in the net sales of investment funds in the individual quarters. While the first quarter of 2005 saw a notable increase (2.3 times the figure for the last quarter of 2004), the second quarter of 2005 witnessed a sharp decline (48.4%). Developments in the second quarter were mainly affected by the discontinued fall in the price of bank deposits, which was also reflected in the slower growth of the capital market as a whole. This slowdown, coupled with competition from new bank products (e.g. deposits with guaranteed yields, deposits tied to funds or share indices), led to the suspension of restructuring in household savings. Overall developments in net sales were also affected by the transfer of investments between the individual types of funds, mainly in the last quarter of 2005.

Within the structure of funds, net sales underwent changes in all categories of funds. The most significant changes occurred in money funds, where net sales suffered a sharp decline, and in the funds of funds, which followed the opposite trend. Bond funds recorded rather volatile developments, with an increase in net sales followed by a modest decrease at the end of the year. The largest proportion of total net sales was still produced by bond funds, while the increasing share of other funds in net sales in the last quarter indicated that investments were more evenly distributed over the individual types of funds. This development represents a positive trend, since it contributes to the spread of the investment risk.

In the third quarter, investors started to turn to more risky funds. This tendency led to growth in equity funds (40.4% compared with the previous quarter), mixed funds (17.1%), and funds of funds, where the volume of investment increased 7 times since the beginning of the year.

In the period under review, investment opportunities in the financial markets increased, mainly in the area of life insurance, additional pension schemes, and home savings. At the same time, banks entered the market with competing products, which absorbed part of the potential financial resources. Investment companies offered their customers products enabling the spread of the investment risk. Among investment funds, the most significant were the so-called umbrella funds. In August and September 2005, investors invested Sk 2.6 billion in these funds, representing a third of the total volume of financial investments in Slovakia. Umbrella funds belonging to the 'funds of funds' category focus on investment in various types of assets from various regions and sectors. Hence, they are optimal for clients with investment plans lasting longer than one year.

Table 4 Structure of investment funds (in %)

Categories of funds	Net sales 2005				Net assets value – NAV 2005			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Money funds	56.3	38.3	5.1	-19.6	53.6	52.1	47.5	42.6
Bond funds	38.2	50.9	49.3	43.3	33.8	35.2	36.2	36.4
Equity funds	3.1	5.7	13.9	23.5	4.5	4.9	6.1	7.4
Mixed funds	2.4	4.8	9.2	18.6	7.8	7.5	7.9	6.5
Funds of funds	-	0.3	22.5	34.2	0.3	0.3	2.3	4.5
Other funds	-	-	-	-	-	-	-	2.6
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Association of Asset Management Companies.

Central depository for securities

The Central Securities Depository (Centrálny depozitár cenných papierov – CDCP) increased its membership by admitting Citibank Slovakia (a.s.) in 2005. At the end of the year, the CDCP had a total of 20 members, including 12 banks, 7 dealers in securities, and the NBS.

During 2005, a privatisation project was prepared for the CDCP with the capital participation of the State. The project assumes that the State will have a 100% stake in the CDCP, which will be transferred via the National Property

Fund (FNM) to the share capital of the BCPB as a non-monetary deposit in the amount of Sk 230 million. Thus, the CDCP will become a 100% subsidiary of the BCPB, while both institutions will continue operating as independent legal entities. The FNM will subsequently offer its equity share in the BCPB to participants in the capital market, while respecting the pre-emption rights of the present BCPB shareholders. By acquiring voting rights, the successful applicants will have a chance to directly participate in the management of the BCPB, influence the range and quality of services, and thus foster the development of the capital market. The capital market participants expect that the joint ownership of the BCPB and CDCP will create conditions for the provision of comprehensive capital market services and improve the effectiveness of the entire system. This should result, among other things, in the shortening of time limits and the lowering of trading costs.

In March 2006, CDCP shares were transferred to the capital account of the BCPB, and thus the CDCP officially became a 100% subsidiary of the BCPB. The next step of the privatisation project for the CDCP – the offer of FNM shares to potential investors – did not take place, since the Slovak Government suspended the implementation of all privatisation projects until the parliamentary elections in June 2006.

It's a well-known fact that the main problem of the capital market is not the existence of legislative obstacles; its persistently limited operation is attributable to economic, historical, and other causes. Although there are numerous problems in the background, it is first and foremost necessary to eliminate those obstacles that are subject to permanent criticism.

Domestic foreign exchange market

Developments in the domestic foreign exchange market

The Slovak koruna followed a relatively volatile course in 2005. With regard to numerous positive expectations, e.g. the fulfilment of the Maastricht criteria in 2008 and the fast economic growth, investors expected relatively stable appreciation in the Slovak koruna. Their conviction was reflected in their unceasing interest in the purchase of koruna, which intensified at the end of 2004 and in the first quarter of 2005. This interest in the domestic currency was responsible for its steady appreciation, which was assessed by the NBS at the end of 2004 and the beginning of 2005 as too fast.

In view of this trend, the NBS began to intervene against the excessive appreciation of the Slovak koruna. In terms of the amount of purchased foreign currency (EUR), the foreign exchange interventions conducted in that period were the largest in the history of Slovakia. In approximately two months, the NBS purchased EUR 3.62 billion (ca. Sk 138 billion) on the foreign exchange market.

The beginning of the period, when the NBS entered the foreign exchange market with a series of foreign exchange interventions, was marked by a foreign exchange intervention on 22 December 2004 at a rate of SKK/EUR 38.500. The last day of this series of foreign exchange interventions was marked by an intervention on 8 March 2005 at a rate of SKK/EUR 37.500. In 2005, the NBS purchased a total of EUR 3.02 billion in foreign exchange interventions and sold EUR 535 million. The net balance of foreign exchange interventions indicated a purchase of EUR 2.49 billion.

The market's conviction that the koruna was steadily appreciating was so strong that it eliminated the effect of the NBS's foreign exchange interventions. The participants in the market made use of the days when the NBS entered the market for further purchases of Slovak koruna. Naturally, the interventions also caused some depreciation in the exchange rate, which was perceived by the market participants as a good opportunity for purchasing koruna at a more attractive rate. This resulted from the conviction of the market that the appreciating trend in the Slovak koruna cannot be reversed by foreign exchange interventions.

The events that occurred after 8 March 2005 pointed to the fragility of the domestic foreign exchange market and the incorrect estimates of the analysts of most banks. At the same time, the warnings of the NBS about the unreasonably fast appreciation of the Slovak koruna proved to be justified. With regard to the fall in interest rates in V4 countries and the rise in interest levels in the USA, investment in these regional currencies from assets denominated in USD ceased to be attractive for investors in that period. Owing to the transparent monetary policy of the Federal Reserve System, investors gradually realised that it was time to convert their investments from currencies with exhausted potential for appreciation and less attractive interest rates, into other commercially more attractive currencies or back into US dollars.

An outflow of assets was first recorded on the Polish market, since most dollar assets within the Central European region were invested in this currency. The subsequent depreciation of the Polish zloty gave rise to similar movements in other currencies and markets in the region.

This situation mirrored the weaknesses of the Slovak foreign exchange market and its increased dependence on developments in the neighbouring countries, especially in the Polish foreign exchange market. In several days, the investment mood completely changed in Slovakia as well, with the Slovak koruna beginning to weaken to a considerable extent. In less than two months, the koruna weakened from SKK/EUR 37.500 to SKK/EUR 40.000, at which time the NBS decided to intervene in favour of the koruna (29 April 2005). The foreign exchange market subsequently calmed down and the exchange rate strengthened gradually and relatively smoothly, to the level of SKK/EUR 38.000 at the beginning of September.

In the following two months, however, the exchange rate of the Slovak koruna began to weaken again. The depreciation during September and October was partially caused by the same factors as in the second quarter, in addition to some other specific causes such as political uncertainty, the related possibility of early elections, the loss of a practically agreed on direct investment (Hankook Tires), etc.

When the exchange rate of the koruna weakened to SKK/EUR 39.200 in the middle of October 2005, the NBS again decided to intervene in favour of the Slovak koruna. As a result, the koruna began to appreciate at a more stable rate.

Entry of the Slovak Republic into the Exchange Rate Mechanism II (ERM II)

The Government of the SR, together with the NBS, declared its intention to enter the Exchange Rate Mechanism II (ERM II) by the end of the first half of 2006. Thus, most participants in the market did not expect the Slovak koruna to be included in ERM II before the expiration of this period.

Slovakia joined ERM II on Friday, 25 November 2005 (for the foreign exchange markets, the entry took effect on Monday, 28 November 2005). The central rate for the Slovak koruna was set at SKK/EUR 38.4550, with a standard fluctuation band of ±15%. For the foreign exchange market, the earlier entry of Slovakia into ERM II was a big surprise, albeit a positive one. The koruna reacted with a marked appreciation (2%) on the next trading day. The appreciation continued until the end of the year, when the exchange rate approached its maximum from March 2005.

The NBS did not indicate in any way whether it had defined a narrower exchange rate band (within the fluctuation band). However, the existence of an asymmetric exchange rate band was automatically expected by the market, in the belief that the NBS would not tolerate a depreciation of more than 2.25% in the Slovak koruna.

After the entry of the Slovak koruna in ERM II, the Slovak Government and the NBS expressed their hope that the foreign exchange market of Slovakia would break away from its strong correlation with the Polish zloty and the Czech koruna. Except for several days after the entry, however, these expectations remained unfulfilled, especially in relation to the Polish foreign exchange market. The mutual relationship between the Slovak koruna and the currencies of other comparable countries will probably diminish only when it becomes evident that entry into the euro area on 1 January 2009 is a reality. This is also confirmed by the measurement of mutual relations between currencies from the period when the fall in the average floating 6-month correlation (recorded in October and November) was only a temporary phenomenon and, for a short time, the degree of correlation with the Polish zloty again increased to a level around 75% and that with the Czech koruna grew even more significantly (to 85%).

Characteristics of trading on the domestic interbank foreign exchange market

During 2005, the exchange rate of the Slovak koruna against the euro appreciated by 2.44% (from SKK/EUR 38.796 to SKK/EUR 37.848). The average exchange rate reached SKK/EUR 38.593, representing a change of 3.6% in comparison with 2004. The exchange rate of the koruna against the US dollar weakened by 12.11% (from SKK/USD 28.496 to SKK/USD 31.948). The average exchange rate reached SKK/USD 31.022 (an appreciation of 3.8% in comparison with 2004). In relation to the Czech koruna, the Slovak koruna weakened by 2.9%.

The total volume of transactions (including spot currency conversions, currency swaps, and forward transactions on the foreign exchange market, excluding foreign exchange interventions by the NBS) reached USD 648,953.6 billion, representing an increase of 47.1% in comparison with the figure for 2004. Most transactions took place in USD (81.3%), followed by EUR (14.8%) and other currencies (0.9%). Within the structure of transactions, currency swaps accounted for 86.5% (compared with 91.2% in 2004), spot currency conversions accounted for 11.7% (8.7% in 2004), and forward transactions accounted for 0.2% (0.1% in 2004). As a result of NBS interventions in the foreign exchange market, the turnover of currency conversions increased in comparison with 2004 by 98%.

The average daily turnover on the spot market amounted to USD 303 million. If we also take into account the interventions of the NBS, the average daily turnover of spot currency conversions reached

Table 5 Basic characteristics of the Slovak foreign exchange market in 2005

	SPOT			FORWARD			SW			OPTION			Total	
	Volume USD mill.	%	Number of trans-actions	Volume USD mill.	%	Number of trans-actions	Volume mil. USD	%	Number of trans-actions	Volume mil. USD	%	Number of trans-actions	Volume mil. USD	Number of trans-actions
Transactions between domestic banks without the participation of foreign banks	15 790.8	19.0	10 146	36.6	0.0	55	67 172.6	80.9	3 416	68.6	0.1	36	83 068.6	13 653
Transactions between domestic and foreign banks	59 959.3	10.6	28 601	885.2	0.2	375	494 143.5	87.3	22 535	10 897.1	1.9	3 512	565 885.0	55 023
Total foreign exchange market of the SR, excluding the NBS	75 750.1	11.7	38 747	921.8	0.1	430	561 316.1	86.5	25 961	10 965.7	1.7	3 548	648 953.6	68 676

USD 321 million. The market was dominated by trading in EUR, which accounted for 97.4% of the total volume, as a result of 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 (12.8% of the total turnover was in favour of domestic banks and 87.2% in favour of foreign banks). In 2005, the overall balance of transactions between foreign and domestic banks was negative (USD -541.5 million), which means that foreign banks mostly sold foreign currency and purchased Slovak koruna.

Transactions between domestic banks increased by 8.1%, to USD 83,068.6 million. Trading took place mostly in US dollars (64.2%, compared with 78.7% in 2004), followed by the euro with a 34.0% share (20.4% in 2004), and other currencies accounting for 1.8%.

Within the structure of transactions between domestic banks by type, 80.9% of the deals took place in the form of swap operations (88.4% in 2004) and spot currency conversions accounted for 19.0% (11.6% in 2004).

The volume of trading between domestic and foreign banks increased year-on-year to USD 565,885.0 million (by 55.2%). Most trading took place in USD (84.5%, compared with 84.3% in 2004), followed by EUR with a 14.8% share (11.6% in 2004) and other currencies accounting for 0.8%.

The interbank foreign exchange market is traditionally dominated by swap operations, though the level of the exchange rate is substantially affected by spot currency conversions. The dominant position of swaps is connected with the fact that they are mainly used by foreign banks as a substitute for the deposit market, since swap operations are less risky from the credit point of view and are therefore more acceptable; in addition, they practically offer the same yield as time deposits. Most transactions take place in the shortest maturities (overnight to one week), which are permanently renewed. This markedly increases the total interbank foreign exchange market turnover.

Evaluation

Two important facts arise from the actual situation in the domestic financial market. The first is the requirement that some of its segments should be further developed and improved, by using more sophisticated forms of transactions, though their slower development is not surprising if we take into account the objective limitations of the domestic market and the economy. The situation in the capital market is more problematic: especially trading in equity securities is of marginal importance, due to operational inefficiency.

The money market has been stable for the last few years. Its persistent problem is the continuing short-term transaction orientation, mainly in derivatives with a securing function, which is a rather atypical tendency. However, there is probably no other solution than to accept this fact. It is evidently unrealistic to expect significant progress in interbank deposit transactions with a medium and long-term maturity orientation.

The central bank paid special attention to the foreign exchange market throughout 2005 and is expected to do so at least in the medium term. The entry of the Slovak Republic into ERM II and the prospect of integration into the euro area have notably increased the importance of monitoring and analysing the development of this market.