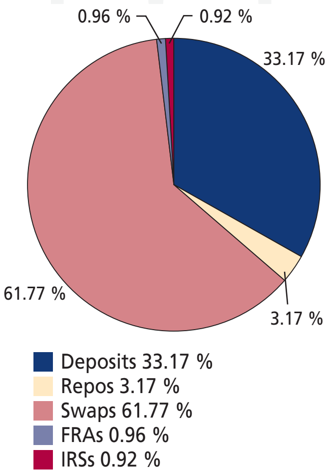
Developments in domestic financial markets during 2006

Chart 1 Structure of turnover in 2006



In 2006, Slovakia's economy was marked by a sharp increase in the year-on-year growth of GDP and employment. GDP in constant prices registered an annual rise of 8.3%, exceeding the previous year's figure by 2.3 percentage points. The main driver of this strong GDP growth was a combination of domestic consumption and foreign demand.

The inflation rate for 2006 measured by the harmonized index of consumer prices (HICP) was higher year-on-year: the average annual rate of inflation for 2006 rose to 4.3%, in comparison with 2.8% for 2005. The development of inflation reflected mainly adjustments made to regulated prices. The NBS's target for HICP inflation in December 2006 was set at 2.5% year-on-year, but the actual figure came to 3.7%.

The labour market, too, reported favourable economic development. In comparison with 2005, employment according to the Sample Workforce Survey increased by 3.8%. Average unemployment in 2006 declined to 13.3% year-on-year.

The trade deficit in 2006 deepened by SKK 15.3 billion to stand at SKK 91.6 billion, with the increase in exports being marginally exceeded by that in imports. The rise in imports was largely accounted for by imports of machines and transport equipment.

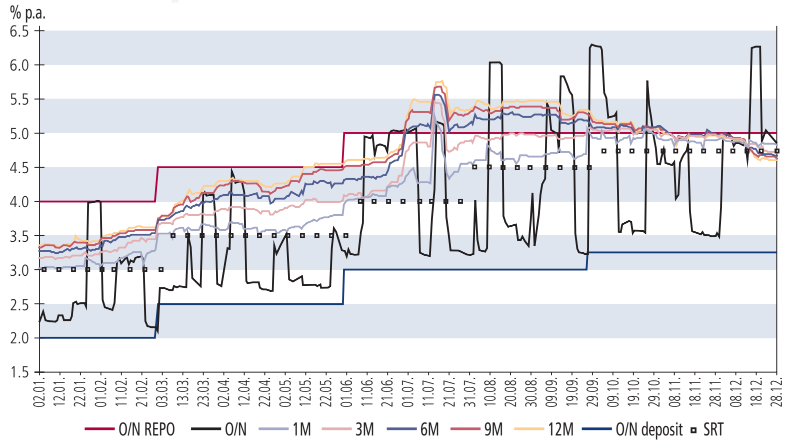
THE DOMESTIC MONEY MARKET

Money market trading

In comparison with the previous year, the interbank money market saw a further shift in favour of swaps in 2006. The growth in this form of transaction was reflected in the greater participation of short-term investors, mainly foreign, in the domestic money market. Unsecured deposit transactions remained the second largest group of transactions conducted in this market. Derivative transactions in the form of forward rate agreements (FRAs) and interest rate swaps (IRS) continued to represent a minority.

As regards maturity periods in the money market, the shortest maturities were the most prevalent. Since funds are restricted for only a short period, the reaction to current exchange rate or interest rate developments can be more flexible. The preferred maturity of deposit transactions was overnight, reflecting the importance of the daily settlement of positions and the securing of liquidity by domestic banking entities. Even so, their dominant position also pointed to persisting low liquidity in respect of deposits with a longer maturity.

Chart 2 Selected money market interest rates in comparison with NBS key rates



Money market interest rates

A closer examination of developments in the overnight interest rate reveals its high volatility resulting from liquidity imbalances in the sector. This was mainly related to the procedure followed by banks in their own investment activities.

Money market rates rose steadily until August 2006, with the highest rise reported in July of that year. During this period, money market rates stepped outside the interest rate corridor formed by the NBS's refinancing and sterilization rates. Only after the NBS adjusted the key rates did the deposit market return to the defined band.

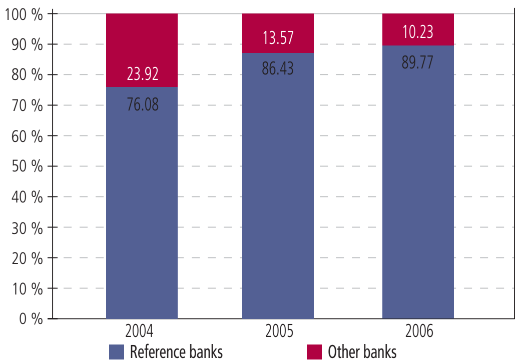
The turnaround in interest rate developments did not occur until the last months of the year, and did so largely in response to substantial appreciation of the Slovak koruna's exchange rate. This situation was seen most clearly with longest-maturity interest rates which, after a short period of stagnation, began to decline to below the limit rate for the NBS's standard repo tenders.

A mediation function for money market interest rates was ensured with increasing intensity by the most sensitive indicator of changes: the foreign exchange market or exchange rate of the Slovak koruna. In the first half of 2006, the gradual weakening of the Slovak koruna was mirrored by a general increase in longer-maturity money market rates. That situation changed in mid-July. The Slovak koruna strengthened continually and rates declined, owing to strong interest among foreign investors and domestic banking entities in depositing funds from foreign exchange conversions.

Reference banks and their position

Trading in the money market is dominated by a group of seven reference banks, and their share of the total turnover is steadily rising. Related to this fact is the growing interest of foreign en-

Chart 3 Share of reference banks in total turnover



tities in making financial transactions in the Slovak money market. For these entities, the group of reference banks is, by virtue of its size and position, becoming an entry point for further activities in this market.

The preferences of foreign entities for trading with reference banks can be seen in the comparison showing that, in all cases, transactions with non-residents accounted for more than 40% of the total turnover.

NBS activities in the money market

The NBS has been ensuring the implementation of monetary policy through a stable long-term structure of money market transactions (repo transactions, issues of NBS bills, overnight fine-tuning operations). Last year, however, the share of each type changed in comparison with the previous year. Demand for three-month issues of NBS bills declined sharply, and in some months their share even fell to below 1%.

In connection with expectations for the entry of Slovakia into the euro area, the structure of the money market may be expected to change, as may its qualitative characteristics. Interest rates will gradually converge with rate levels in the European interbank market.

The current structural changes are the result of growing interest in the Slovak koruna and therefore of the increasing share of foreign investors in transactions carried out in the domestic market.

Market for short-term government securities

In 2006, the Ministry of Finance of the Slovak Republic (MF SR), represented by the Debt and Liquidity Management Agency (DLMA), continued to issue Treasury bills for its own portfolio, with two 364-day issues in a total amount of SKK 62 billion. Unlike in the previous year, when the Treasury bills were subsequently sold to investors by auction, the DLMA was to place the Treasury bills on the market on a case by case basis, according to the financial needs of the MF SR. As at the end of the year, the DLMA still owned all the Treasury bills. Secondary market trading in Treasury bills was not significant during the year under review. The total amount of secondary market transactions represented SKK 90.4 billion, of which transactions with the DLMA accounted for 80.8%.

THE FOREIGN EXCHANGE MARKET

Ongoing developments in the foreign exchange market

The Slovak koruna's exchange rate showed volatility in 2006. Given the strong economic growth, gradually improving trade balance, and expectations that the Maastricht criteria will be met in 2008, investors expected more or less stable appreciation of the Slovak koruna. This conviction was reflected in persistent interest in buying koruny, which had emerged at the end of 2005 following Slovakia's surprise entry into ERM II and continued at the beginning of 2006. After the NBS raised interest rates on 1 March 2006, by 50 basis points to 3.5%, the exchange rate broke through the level 37.000 EUR/SKK for the first time.

The break-up of the governing coalition and the approval of a date for an early general election fueled uncertainty among investors about the future political developments in Slovakia and raised concerns that the country's plan to join the euro area in 2009 would be jeopardized.

The second quarter of 2006 also saw international investors being increasingly sensitive to risks in the currencies of emerging markets, a fact that led to the marked weakening of these currencies. For example, the Turkish lira depreciated against the dollar by 29.5% during May and June and the South African Rand lost 23.5% of its value over the same period. For the first time since Slovakia joined ERM II, the Slovak koruna's exchange rate weakened to the level of the central parity (38.455 EUR/SKK), prompting the NBS to react with foreign exchange interventions. The interventions, which commenced at 38.500 EUR/SKK, were made on 21 June, 29 June and 12 July and involved the NBS selling a total of EUR 3,085 billion. On the last day of the interventions, the NBS sold EUR 1.75 billion, which in

Chart 4 Share of particular instruments in the NBS's sterilization positions in 2006

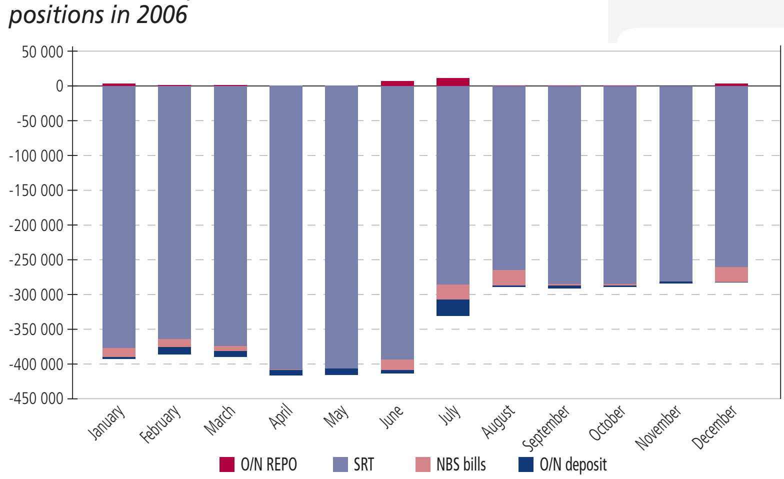
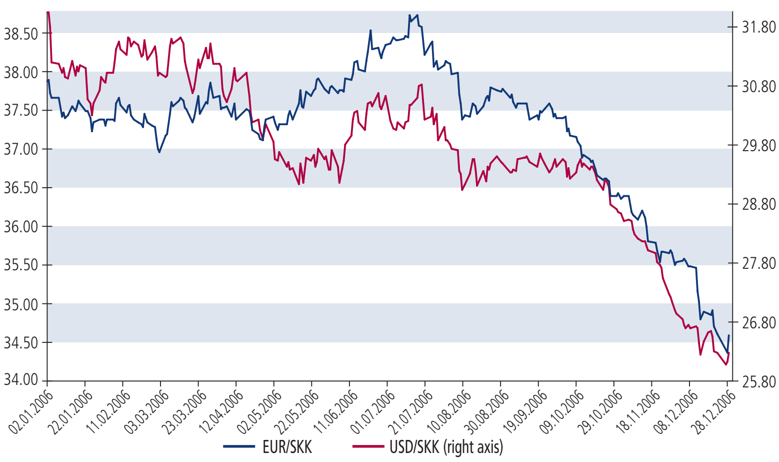


Chart 5 Interconnection between currencies of central European countries

Source: Bloomberg

Chart 6 Exchange rate of the Slovak koruna



terms of the amount of foreign exchange sold in a single day, represented the most extensive intervention in Slovakia's history.

The attitude of investors towards emerging market currencies changed sharply in the second half of the year. The declining likelihood of further key interest rate rises in the United States resulted in the US dollar losing value against the euro, a fact that also profited emerging market currencies. This trend lasted until the end of the year and was accompanied by stable appreciation of the Slovak koruna, which gained an average of 2% per month for the rest of the year and reached its highest ever level.

During the course of December, the value of the koruna against the euro reached 11.43% from the central parity, a movement that reflected growing investor interest in the region's currencies. In reaction to the exchange rate's high volatility, the NBS decided to enter the market at the end of December. Over the period from July's interventions to December 2006, the Slovak koruna's exchange rate shifted by more than 10%.

On 29 December, the NBS entered the foreign exchange market at 34.060 EUR/SKK, the koruna's strongest level of the year, and purchased EUR 495 million. In the net balance of foreign exchange interventions in 2006, the NBS sold EUR 2.59 billion.

The currencies of the V4 countries include a noticeable interconnection, the extent and intensity of which varies according to particular circumstances. This relationship arises from several similarities and a common course towards the advanced industrial countries.

The Slovak koruna's exchange rate against the dollar strengthened by 17.85% over 2006 (from 31.948 to 26.246 USD/SKK), and its average level was 29.724 USD/SKK (an appreciation of 4.2% in comparison with 2005). Against the Czech koruna, the Slovak currency gained 4.0% in value.

Trading characteristics in the domestic interbank foreign exchange market

The total amount of transactions (including foreign exchange spot transactions, foreign exchange swaps, forward transactions and option transactions on the interbank foreign exchange market, excluding foreign exchange interventions by the NBS) came to USD 1,041,429.3 million, which in comparison with 2005 represented an increase of 60.5%.

In 2006, the foreign exchange spot market reported an average daily turnover of USD 373 million. Taking into account the NBS's interventions, the average daily turnover of spot foreign exchange transactions was USD 389.7 million. Since the euro is the reference currency, the vast majority of trading, 96.7%, was conducted in euros. Spot market trading between domestic banks and between domestic banks and foreign banks confirmed a trend of increased activity among foreign banks (domestic banks accounted for 12.2% of the total turnover and foreign banks 87.8%). In 2006, the overall balance of foreign banks' transactions vis-à-vis domestic banks was positive (USD 4,377.5 million), which means that foreign banks mostly purchased foreign currency and sold Slovak koruny.

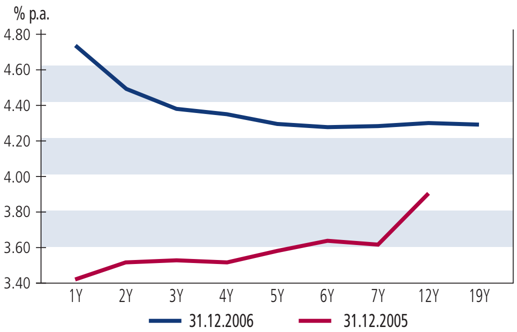
The interbank foreign exchange market (IFEM) has traditionally been dominated by swap transactions. This is related to the fact that swaps are used mainly by foreign banks as a substitute for the deposit market, since these transaction carry less credit risk and are therefore more acceptable, and because they offer practically the same yield as time deposits. In addition, most of the transactions use the shortest maturities (overnight to one week), renewed on a constant basis, which substantially increases the total IFEM turnover.

The capital market

Primary securities market

In 2006, government bonds continued to be the leading and most traded segment of the capital market. The American auction procedure was used to place SKK 33.2 billion worth of government bonds on the market. In addition, the issuer continued to make incremental increases in four issues opened during previous years, and it brought to market a new 20-year bond with a fixed coupon of 4.50% and a standard target amount of SKK 40 billion. This bond has the longest maturity in the domestic market.

Chart 7 Yield curve shift



A low share of accepted demand was characteristic of the DLMA's issuing policy. One reason for the issuer's rejection of auction bids was the favourable development of the state budget, and another reason was the possibility of borrowing cheaply from other sources, in particular, from the temporarily free funds of the State Treasury. As in previous years, investors showed greater interest in shorter-maturity bonds. This was to a large extent influenced by the multiple increases in the NBS key interest rates.

The development of government bond yields in the first half of 2006 was dominated by a rising trend that reflected mainly the rising NBS base rate. In second half of June and the beginning of July, yields were for a short time substantially affected by the domestic political situation. As stability returned, the Slovak koruna began to strengthen and demand grew for assets denominated in Slovak koruny. That put downward pressure on bond yields. The quadruple raising of key rates by the NBS affected mainly the yields on shorter-term maturities, which resulted in the standard slope of the yield curve gradually lessening or flattening out. After the last of the NBS's rate increases, the yield curve became distinctly inverse.

In 2006, a total of 44 non-government bonds were issued with a combined value of SKK 26.7 billion, only SKK 1.2 billion more than in the previous year. Of these issues, 23 were mortgage bonds worth SKK 20.9 billion, representing 78.27% of the total volume. Most of the issues were placed on the market through non-public sales.

Secondary securities market

In 2006, Slovakia's capital market maintained its position as the most undercapitalized among the Visegrad Four countries, and the market capitalization of its listed shares at the end of the year came to only 9.16% of GDP.

At the end of 2006, the Bratislava Stock Exchange (BSSE) was listing a total of 358 securities issues on its markets (shares, mutual fund shares and bonds).

Over 239 trading days, the financial value of transactions on the BSSE floor stood at SKK 992.1 billion. A total of 24,522 valid transactions were made, involving the transfer of 11.6 million units of securities. In comparison with 2005, the total traded amount declined slightly, while the number of transactions rose by 126.8%. The increased trading activity was largely related to the successful completion of mandatory takeover bids made during the course of the year.

The structure of transactions was as usual dominated by floor transactions in listed bonds made in the agreed form.

Secondary stock market

Trading in shares was very weak. A total of 22,045 transactions represented a combined financial value of SKK 2.6 billion. On the last day of the year, 256 share issues were available for trading (from 188 issuers), including 46 issues of mutual fund shares. Of all secondary transactions, share transactions accounted for a negligible 0.3%, confirming that the Slovak capital market is essentially a bond market.

Chart 8 Secondary market trading in bonds and shares

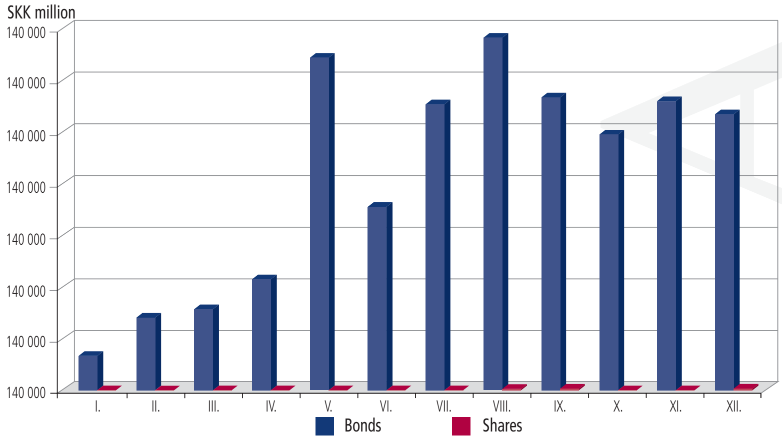


Chart 9 The Slovak Share Index (SAX) in 2006

The Slovak Share Index (SAX) followed a volatile course in 2006, as longer-term phases of rising share prices alternated with periods of decline. The SAX ended the year on 415.6 points, which represented an increase of 2.3 points in comparison with 2005. The index reached a highest ever level of 439.15 points on 25 April. The SAX consisted of 5 issues, mostly the shares of banks.

Compiled by the Banking Transactions Department, National Bank of Slovakia