NÁRODNÁ BANKA SLOVENSKA

THE MONEY MARKET IN THE SR AND THE EU

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Development of the money market in Slovakia

Following the origin of an independent Slovak Republic in 1993 the development of the Slovak money market has been characterised by three periods:

1. from 1993 to 1995
2. from 1995 to 2000
3. from 2000 to the present, where the Slovak money-market has gradually stabilised and become liquid.

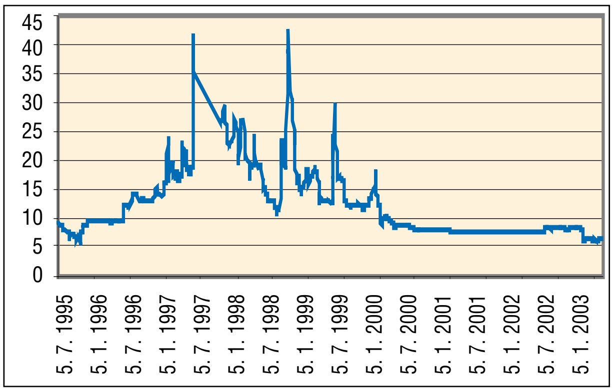
The period shortly after the founding of the SR was characterised primarily by the establishment of the National Bank of Slovakia, laying down rules for the functioning, as well as the formation of the interbank market itself.

The year 1995 was significant from the aspect of important changes being made, including primarily the establishment of reference banks and the setting of an official interbank interest rate – the Bratislava Interbank Bid Rates – BRIBID and the Bratislava Interbank Offered Rates – BRIBOR. The aim of the reference banks was to lay down precise rules for trading on the Slovak interbank market. The development itself of interest rates on the interbank market in 1995 was affected by a surplus of liquidity of short-term money. Besides money deposits, also treasury bills and NBS bills were traded on the money market.

1996, besides bringing a more peaceful situation, brought also many unexpected phenomena. The overall development was also affected by the development of the money aggregate M2, as well as NBS measures preventing any negative development. These concerned its progressive steps in periods of surplus, or lack of liquidity, changes to the repo rate, which had an immediate effect on the level of interest rates. From 1 March the reference banks began to actively quote the interest rates for six-month deposit accounts, which had a positive influence on the further development of the money market. Throughout the whole of 1996 the NBS actively used repo trades for managing liquidity in the banking sector.

From 2 January 1997 the central bank repo rate no longer existed. Repo trades were replaced by repo tenders, i.e. auctions for repo rates. The NBS has declared them on an irregular basis with the aim of minimising the supply of liquidity to the banking sector. Thus the central bank shifted to a method of estimating liquidity

BRIBOR – 1M



(Source: NBS data)

needs, whereby it did not exclude individual repo trades with specific rules. This change in the approach of the NBS to managing liquidity in the banking sector and the subsequent stopping of daily quoting of the repo rate brought about a growth in interest rates for all maturities. Immediately in January the prices of deposits reached their highest level since 1994.

Interest rates for the shortest maturities rose to 25 to 26.4%, three-month deposits traded at the level of 22 to 24%. A fall in rates occurred again, when foreign banks began to sell foreign currency for Slovak koruna in large volumes (USD 200 – 400 million). The prices for individual maturities stabilised in the band 15 – 20%. The period from April was characterised by "attacks" on currencies of new, emerging markets. It may be said that the Slovak currency was not affected as intensively as the currencies of certain other countries, nevertheless the money market remained affected by these events up until the end of the year. Slovak banks stopped quoting interest rates for almost all maturities. They limited their activity on the interbank market to daily settlement of mutual positions. The NBS refinanced the banking sector only within the volume necessary for ensuring a problem-free system of payments. In an effort to prevent exchange rate speculation it recommended commercial banks not to lend koruna to foreign financial institutions. Due to a severe lack of liquidity interest rates reached their highest level. Reference banks stopped quoting BRIBOR and replaced it by the monitoring of interest rates. Up until the end of the year interest rates for all maturities did not fall below 20%.

In 1998 the Slovak money-market recorded instability and subsequent fluctuations in the level of interest rates. The spread of the yield curve moved in an exceptionally broad band from 0 to 250%. The main reasons for the unstable development was the introduction of forced administration in Investičná a rozvojová banka, the negative development of the state budget, as well as the external imbalance of the Slovak economy, the cancellation of the Slovak koruna fluctuation band and, of course, uncertainty surrounding the autumn parliamentary elections. The 14-day refinancing repo tenders remained a significant intervention instrument of the NBS. In April the Ministry of Finance of the SR drew a bridging loan from Nomura International in the amount of USD 195 mill. The conversion of these funds into Slovak koruna caused a fall in monthly deposits below 15%. A liquidity surplus in the banking sector arose and the NBS was forced to undertake sterilisation operations. Devaluation expectations prior to the autumn parliamentary elections caused a crisis on the forex market, which had a direct influence also on the money market.

In 1999 several important situations occurred on the interbank market, that fundamentally influenced events on the Slovak money-market. Immediately the year began with a budgetary stop-gap arrangement and a subsequent package of measures for stabilising the fiscal and monetary position of the SR. The yield curve during this period was relatively balanced. Interest rates for individual periods moved at the level of 17 – 18%. From 1 April the NBS reduced the PMR rate from the hitherto 9% to 8%, which meant releasing SKK 3 billion into the banking sector. The Slovak government's package of measures in May caused sharp fluctuations on the forex and subsequently also on the money market. Uncertainty prior to the presidential elections also contributed to a sharp weakening of the Slovak koruna. The NBS in the interest of stabilising the exchange rate halted the inflow of liquidity to the banking sector. The consequence was a sharp increase in interest rates. Rates for one-month deposits moved in the range of 30 – 40%. For a short period also rates for six-month deposits increased and exceeded the level of 20%. It was possible to stabilise the situation on the money market only following regular interventions by the NBS. The yield curve levelled out, rates again reaching the level of 16 – 17%.

A significant milestone in the development of the Slovak money market was the year 2000, when the NBS ceased to consider growth in the money supply as one of its main aims and began to concentrate on the development of interest rates, whereby occurred a transition from a quantitative monetary policy to a qualitative monetary policy. The development of interest rates at the start of 2000 recorded a sharp decline in six month deposit interest rates. This decline was brought about by surplus liquidity on the money market, which was caused by an inflow of funds from the state budget for cleaning up financial institutions at the end of 1999.

As of 1 February 2000 the NBS started to apply a one-day sterilisation and refinancing repo rate. The initial price was set at 8.0 / 12%. Positive monetary development allowed the central bank at the end of March to reduce the level of repo rates to 7.5 / 10.5%. The prevailing surplus of liquidity was caused by the fact that in May the NBS again reduced this rate to 7.0 / 10.0% and introduced a two-week repo rate at the level of 8.5%. In June the NBS began to fix BRIROR for a period of nine months and one year as a result of the willingness of reference banks to actively quote these maturities. In the framework of the process of approximating monetary policy to the standards of the Central European Bank (ECB) the NBS as of 1 July reduced to the rate for PMR from the original 8.0 to 6.5%. The reduction of the one-day sterilisation and refinancing rate to 6.5 / 9.5% and limit two-week repo rate to 8.25% at the end of August, did not have a significant effect on the reduction of short-term rates, since this change had been expected and incorporated into prices in advance.

As of 1 January 2001 the NBS again reduced the PMR rate from 6.5 to 5%. The level of interest rates was influenced by the level of NBS key rates. The most significant was the limit rate for the two-week sterilisation repo tender. Changes to its actual level gradually became the main determining factor of the level of long-term interest rates. The NBS regularly each month continued to make issues of its own treasury bonds for the purpose of reducing surplus liquidity on the interbank market. Expectations as to the further development of NBS key rates and interest rates were reflected in the shape of the yield curve on the interbank market. At the beginning of the year the overall level of rates fell, which was caused primarily by an adjustment to key rates in December 2000. The limit rate of the two-week tender was set at 8% and its further reduction was expected. The average total annual rates reached their lowest levels for the whole year, 7.56%. The limit rate was reduced in March to 7.75%, which was the only change to NBS key rates during the whole year. Since a further reduction of rates was no longer expected, the yield curve took on a balanced nature. Overall, it may be said that the development of interest rates throughout 2001 was stable and no extraordinary fluctuations were recorded. Changes in the monetary policy of the NBS, as well as the gradual restructuring of the banking sector led toward a standardisation of the Slovak money market , which became liquid and stable.

Also in 2002 the central bank continued to actively intervene in the money market through declaring regular two-week repo tenders with the yield of 7.75%. In this period the Ministry of Finance of the SR organised several issues of one-year bonds with a gradually falling yield from the level of 7.732% to 7.646%. Nevertheless, at the end of April the NBS following a thorough consideration of the negative development of the current account deficit on the balance of payments and under threat of an increased public finance deficit it decided to increase key interest rates by 0.5%. Furthermore the two-week repo rate was increased to 8.25%. This increase was a surprise for the Slovak money market, which had expected these rates to remain unchanged with a medium-term outlook to the gradual reduction of interest rates. Thanks to expectations of favourable results in the autumn parliamentary elections the balance yield curve changed again to a falling one. Monthly deposits achieved a yield of 8.22% and annual deposits a yield of 7.76%. The favourable results of the elections increased foreign investors' confidence in the Slovak koruna, which began to appreciate significantly against the EUR. Significant purchases of the Slovak currency and its subsequent investment in treasury bonds on the primary market and in state bonds on the secondary market caused a further fall in interest rates. The reaction of the NBS was a reduction in the level of the two-week repo rate to the level of 8.0%. Despite significant interventions by the central bank on the Slovak forex market to the detriment of the Slovak koruna vis-_-vis the EUR, interest in the Slovak koruna in the course of November continued to grow, which was confirmed also by a growth in the surplus of liquidity and the activities of the NBS in its sterilisation. An unexpected event was the radical reduction of all key interest rates by the central bank by up to 1.5% on 15 November with effect from 18 November 2002. The most significant two-week repo rate was reduced to 6.5%.

The money market and the EU

The treaty on the introduction of the single currency, the euro, was signed in Maastricht in February 1992. The euro was introduced on 1 January 1999 in all countries fulfilling the "convergence criteria". Exchange rates of the currencies of the individual member countries had been irrevocably fixed. A single monetary policy began to be applied, for which the European Central Bank was responsible. National central banks of the individual countries created together with the ECB the European System of Central Banks. Member states began to issue new state bonds in euro and the financial markets also began using the single currency, the euro.

Through the introduction of the euro as the official European currency, the DEM and the FRF as well as other member state currencies lost their position in the money markets. Prices for trading began to be quoted exclusively in EUR. The market borders of individual countries were removed and a single large European financial market created. One of the results of the move towards the common currency was the lapsing of the reference rates for individual currencies and the creation of a new joint rate fixed daily, the EURIBOR (Euro Interbank Offered Rate) for all maturities. EURIBOR is guaranteed by the European Banking Federation the FBE, and the Association of Financial Markets, the ACI. The group of the reference banks comprises banks from the EU countries as well as large international banks not from EU member countries but having a significant volume of operations in the euro-zone. EURIBOR is officially quoted daily on the page Moneyline Telerate. The rules of the ethics of banks, participating in the EURIBOR quotation, the "EURIBOR Code of Conduct", was drawn up in 1997 by the European Banking Federation the FBE, the Association of Financial Markets, the ACI, a group of European savings banks and the European Association of Co-operative Banks.

The development itself of interest rates in 2000 was characterised by their increase, which was caused by above-average GDP creation in EMU member countries. At the close of the year the most important economic indicators were beginning to point to a slowdown in the rates of economic development - the rate of production, a fall in capital investment and the development of the consumer sector, which was indicated by a freeing of ECB monetary policy. Its policy was to maintain price stability by means of controlling interest rates.

At the start of the year three-month interest rates reached the level of 3.33%, with annual maturities at 3.95%. In June three-month interest rates moved at the level of 4.45%, with annual maturities at 4.95%. The growth of interest rates for three-month maturities continued up until the end of the year. The maximum values were reached in November at 5.14%, with a correction in the second half of December to the level of 4.88%. A similar trend could be seen also for deposit accounts with a maturity of one year. However, the maximum of these accounts was reached at the close of August, at 5.34%, and subsequently their fall was recorded through to the end-of-year value of 4.75%.

In comparison with 2000, the year 2001 may be characterised as a year of a falling interest rates. Interest rates on the money market with short-term maturities ranged at the level of the repo rate of 4.75% for maturities of up to three months and 4.5 - 4.6% for maturities of up to one year.

Representatives of the ECB in this period continued to resist the strong effect of the American economy on the economic cycle in the EU and despite pressure from the side of the IMF and other significant institutions did not lower repo rates. The reason for this was high inflation, which reached 2.6%, whereas the desirable level for the ECB was 2%. The development of individual economic indicators did not confirm the optimistic pronouncement of the ECB on the limited impact of the American recession on the eurozone. Therefore a great surprise was the reduction in May of key interest rates from the level of 4.75% to 4.5%.

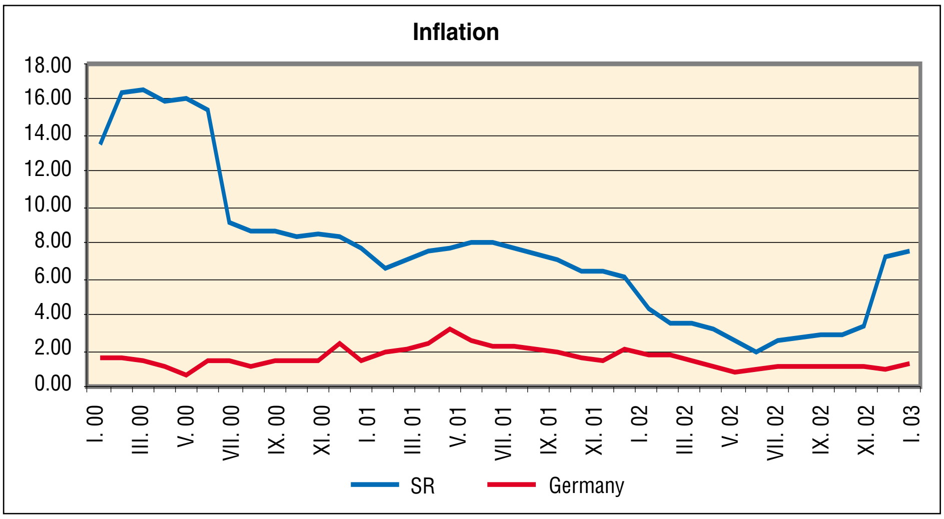
In the third quarter of 2001 the forecast economic growth for Germany was revised, where the ECB admitted a fall in the year–on-year rate of GDP growth for 2001 from the expected 2.3% to a level lower than 2%. The ECB did not move towards halting a reduction of its key repo rate, which remained unchanged at the level of 4.5%, since inflation continued to move above the desired level of 2%. Neither did the ECB react to the significant strengthening of the EUR against the USD to the level of 0.87 against 0.835 at the beginning of July. The main aim of the central bank was to continue to maintain price stability.

The negative development of the US economy increased interest in purchasing securities primarily state bonds of the EMU countries, denominated in EUR, which significantly contributed to the strengthening of the EU against the USD from a value of 0.88 to 0.91. The result of this trend was a reduction of the repo rate of 0.25% to the value of 4.25% in August. The adverse economic indicators and a fall in inflation in all the EMU countries brought about expectations of a further future reduction of base interest rates. Over the course of July and August a decline in interest rates was recorded for all maturities.

Following the September events in New York mainly interest rates for maturities of 2 to 5 years fell significantly (by 0.2 – 0.3%). The reason for this significant reduction was the enormous interest primarily in purchasing German government bonds with this maturity. The reaction of the ECB to this development was a reduction in the base repo rate of 50 base points to 3.75% in mid-September. The significantly falling inflation in the EMU countries signalled the expected depression of the European economy. The fall in interest rates continued also at the end of the year. Under the influence of this development the ECB decided to free up its monetary policy and reduced its repo rate by 0.5% to the level of 3.25%. In this period the difference between the German economy and the economies of other EMU member states had deepened, leading to the announcement by the German government of its inability to comply with the budget deficit at a level of 1.5% of GDP (a Maastricht criterion).

Whereas at the close of 2001 the moods on the market bore witness to the further expected reduction in interest rates by 50 base points, the start of 2002 presaged a dissipation of these predictions. To the overall negative expectations contributed also the prediction of higher inflation in the euro-zone, for example in Germany of up to 3%, which represented a negative inflation outlook for the whole year.

The money market with a maturity of one year in this period reached the level of the ECB repo rate, i.e. 3.25%. Interest rates for maturities of up to nine months moved at the level of 3.3 – 3.5%. Over the course of May the ECB adjusted its inflation estimate for the eurozone for 2002 from 2.2% to 2.4%. It decided to leave the key repo rate unchanged. Likewise, interest rates for the period of three months were over the course of nine months in 2002 stabilised and moved at the level of 3.3 – 3.4%, with the exception of May and June when they reached 3.5%. A more significant change occurred at the end of October and in the course of November, when market expectations increased as regards a reduction in the ECB key repo rate as a reaction to the reduction of key rates in the USA. At the end of November three-month deposits traded at the level of 3.05%. A similar development was occurring also in the trading of one-year money, the price of which had initially began to increase from the January level of 3.4% to the May value of 4.1%. Subsequently, it copied the price of three-month deposits. At the close of November one-



(Data sources: NBS, Statistishces Bundesamt Deutschland) year money traded slightly below the level of 3%. In December the ECB reduced the key repo rate by 0.5% to the value of 2.75% as a consequence of low economic growth in EMU countries.

Interconnection of the SR money market to EU markets

For accession to European Economic and Monetary Union (EMU) it is essential to fulfil the basic macro-economic convergence criteria concerning inflation, currency stability, long-term interest rates, fiscal deficit (3% of GDP) and government debt (60% of GDP). The rate of inflation over the past two years has been of a declining nature, which has been caused by the non-implementation of the deregulation of all prices. The freeing of regulated prices in 2003 has had again as a consequence a renewed growth in the rate of inflation. According to the Monetary Programme of the National Bank of Slovakia a fall in inflation is expected only in 2005, when the estimated inflation should reach 3.7%, or 2.8% in 2006. The inflation criterion says that upon accession to the EMU the rate of inflation should not be higher than the average of the three EMU member countries having the lowest rate of inflation, increased by 1.5%.

One of the Maastricht criteria for accession to EMU and the subsequent introduction of the euro is participation of the Slovak koruna in the European Exchange Rate Mechanism ERM II for a period of at least two years, where its exchange rate must be maintained in a stable band against the EUR ± 15%. This means that Slovakia following its accession to the EU on 1.5.2004 could become an EMU member probably at earliest only some time in 2007 – 2008. Up until that time all other convergence criteria must be fulfilled.

Following the Slovak Republic's accession to EMU and the adoption of the euro as the official currency, the Slovak koruna will lapse. The Slovak money market will become incorporated into the European money market. The current fixed reference interest rate BRIBOR, which is set on the basis of the quotations of 8 reference banks will lapse and be replaced by the reference rate EURIBOR. For a smooth transformation of the Slovak koruna money market to the euro money market, a gradual reduction of koruna interest rates with the aim of approximating to the level of rates applicable in the EMU in the transitional period to the euro currency will be essential. The convergence criterion for interest rates stipulates that the level of long-term interest rates for ten-year government bonds should not exceed the level of the average interest rates of the three EMU member countries with the lowest long-term interest rates by more than 2%.