



Assessment of the situation on domestic financial markets in 2008

The article describes the domestic financial market and focuses on substantial market segments, which are currently the money and foreign exchange market and a part of the capital market. A peculiarity of the period under review was the expected, and actually also completed, accession of Slovakia to the euro area, which has had a great impact both on the market entities and on the National Bank of Slovakia.

1 THE INTERBANK MONEY MARKET

1.1 Money market trading

The structure of products traded on the interbank money market was characterized by a slight decrease of the percentage of swap transactions as compared to the previous year. Nevertheless their percentage continued to be the highest. This form of transactions was particularly preferred by nonresidents. Unsecured deposit transactions increased compared to 2007 and they continued to constitute the second largest group of transactions carried out. Residents prevailed in this category of transactions. In 2008, the ratio of derivatives in the form of FRA and IRS to total transactions decreased. Repo operations were not carried out during the period under review.

In terms of maturity, transactions with short-term maturities dominated the money market. An absolute preference of overnight transactions was evident both with swap transactions and with deposit transactions. One- and two-week maturities followed, other maturities made up only a negligible percentage of total transactions. In the case of swaps, this fact was a confirmation of the preference of transactions on the part of foreign investors. Short-term blocking of funds

enabled more flexible reactions to the current foreign exchange rate or interest rate development and the transactions were secured against risk at the same time.

The preference of overnight maturity in the case of deposit transactions was the consequence of the daily closing out of positions and raising of liquidity by domestic banking entities, which subsequently had a negative influence on trading with longer-term maturities in the long run.

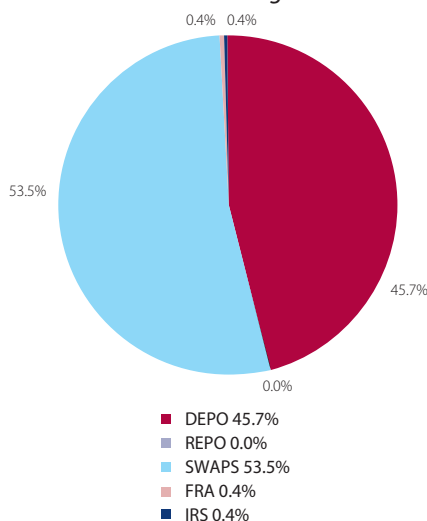
1.2 The development of money market interest rates

The overnight interest rate recorded high volatility as well as in the previous years. As a consequence, it was frequently close to one of the boulder of the NBS key overnight interest rates. The high volatility was the result of an unbalanced liquidity development in the sector. This development was particularly associated with the steps of banks in the case of their own investment activities and with the execution of NBS monetary policy operations, which did not focus on liquidity management in the sector and on the stability of short-term interest rates.

In 2008, the medium-term and long-term interest rates of the domestic money market were particularly influenced by the development of rates with the corresponding maturities in the euro area. This fact seemed to be the most visible from mid-June onwards, when there was a considerable increase in domestic rates under the influence of the growth of rates in the euro area. This tendency changed to a considerable decrease in the last quarter of 2008. The most sensitive perception of this issue occurred in the second half of 2008, after the EUR/SKK conversion rate had been set in connection with the convergence process of domestic interest rates to the interest rates of the euro area.

Expectations of the banking sector associated with the development of NBS key interest rates can be documented by means of the yield curve in the individual parts of the year. The initial decrease of the short end of the yield curve was moderately reversed later on, the curve's central part, by contrast, was stagnating at approximately the same levels. The long end of the yield curve stabilized first and it increased to approximately

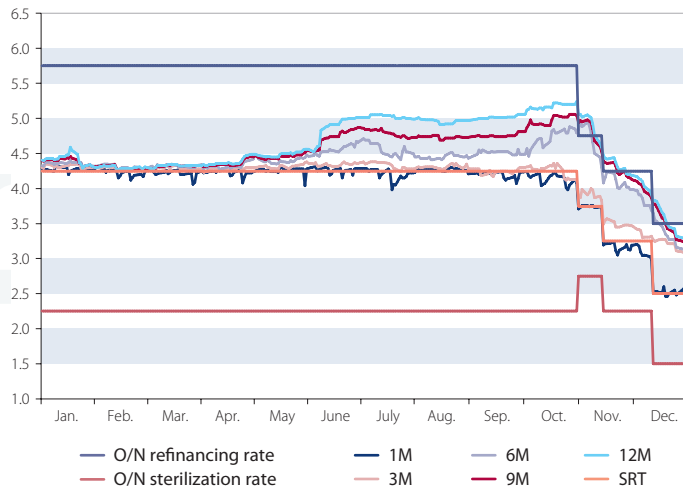
Chart 1 The structure of trading volumes in 2008



Source: NBS.

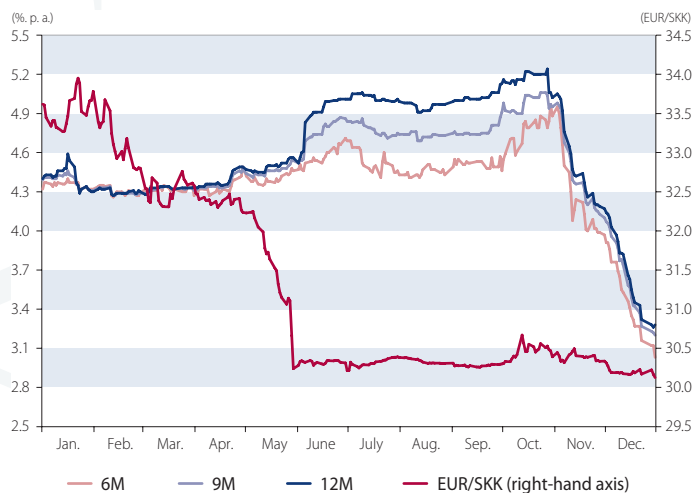


Chart 2 Development of selected money market rates as compared to NBS key rates (% p.a.)



Source: NBS.

Chart 3 Development of the EUR/SKK exchange rate and of the BRIBOR interest rate



Source: NBS.

5.00% later on. In December the yield curve was at a considerably lower level than in other periods, the development of the curve was influenced by gradual considerable NBS key interest rate cuts. The main determinant of the long-term interest rates development on the domestic money market were expectations, influenced particularly by the current and expected economic development, the process of fulfillment the convergence criteria, the subsequent the conversion rate setting of the Slovak koruna against the euro, not excluding the activities of the NBS. The most sensitive indicator of interest rate changes – the foreign exchange market, or the Slovak koruna exchange rate, did not ensure its intermediation function in 2008 to the same degree as in the previous years. This fact is also confirmed by the corresponding chart showing the independent development of those two variables in the period under review. The considerable appreciation of the Slovak koruna until the setting of the new ERM II band at the

end of May 2008 was not reflected in a change, i.e. decrease of longer-term domestic rates. Those interest rates were primarily influenced by the development of the rates with the corresponding maturities in the euro area during that period. Following the setting of the Slovak koruna-to-euro exchange rate, there was a stable development of the foreign exchange rate of the koruna against the euro, which was limited by the conversion rate and the interest rate differential between domestic rates and euro area rates. The subsequent growth of rates, particularly in the third quarter, constituted an adjustment of the domestic rate to the euro area level as a process of gradual convergence in the area of interest rates.

1.3 Reference banks and their status

A dominant position within money market trading continued to be held by a group of seven reference banks, whose structure did not change. The reference banks included the ING Bank, N.V., a foreign bank subsidiary, Slovenská sporiteľňa, a.s., Československá obchodná banka, a.s., Všeobecná úverová banka, a.s., UniCredit Bank Slovakia, a.s., Citibank (Slovakia), a.s. and Tatra Banka, a.s. Československá obchodná banka, a.s., a foreign bank subsidiary, ceased to exist on 1 January 2008 and the independent bank Československá obchodná banka, a.s. was created. The ratio of the trading volume of reference banks to the total trading volume declined slightly as compared to previous years. A high interest of foreign entities in the performance of financial transactions on the Slovak money market continued to prevail. They performed their transactions precisely by means of the reference banks, which considerably increased those banks' percentage in market activities.

1.4 Activities of the NBS on the money market

In 2008, the NBS continued to use standard monetary policy instruments by means of the two-week repo tenders, three-month NBS bills, overnight deposits and overnight refinancing repo operations. The percentages of the individual forms, however, changed in comparison with the previous year. In the first four months, there was an increase in the percentage of NBS bills to 24.35%; the proportion of this instrument in the total sterilization position should be around 25%. For this reason, the NBS cut the demand in three NBS bill auctions (in February, March and April). In the remaining period, the total demand of the participants in NBS bill auctions was gradually decreasing, which was reflected in a fall of the percentage of this longer-term instrument down to 11.15%. The standard maturity (84 days) was shortened in the last three NBS bill auctions – to 75 days in October, to 47 days in November and to 33 days in December. The NBS bills issued in October and November were due on the last day of the calendar year and the maturity date of the last December issue fell on the first day of the



reserve maintenance period following the end of the shortened first period in the euro area. During the year under review, banks raised funds through overnight repo operations (O/N) only in minimum amounts. This fact was not due to the need of liquidity, but rather technological and organizational constraints inside banks. On the other hand, deposited surplus of funds by means of deposit facilities did not exceed the percentage of 2% during three quarters. The growth of their percentage in the total sterilization to 10.58% in the last quarter was caused by the preference of the market participants to dispose of funds for a shorter period, which was automatically reflected in a decrease in the demand in sterilization repo tenders (SRT), but particularly in NBS bills. On the last day of 2008, the NBS carried out a quick sterilization repo tender with a reduced maturity of 7 days. On the first calendar day of 2009, the banking sector had sterilized liquidity in three SRT, one NBS bills issue and one overnight deposit. The total amount of funds drawn this way represented worth of SKK 403 bn. Banking sector expectations related to a decrease in the key rates of the NBS had no impact on the increase in demand in SRT or in NBS bills.

In the first half of 2008, the average monthly sterilization position reached a level of as much as SKK 375 bn. It increased slightly to more than SKK 381 bn. in the following period and adjustments in both directions were only moderate during the remaining months.

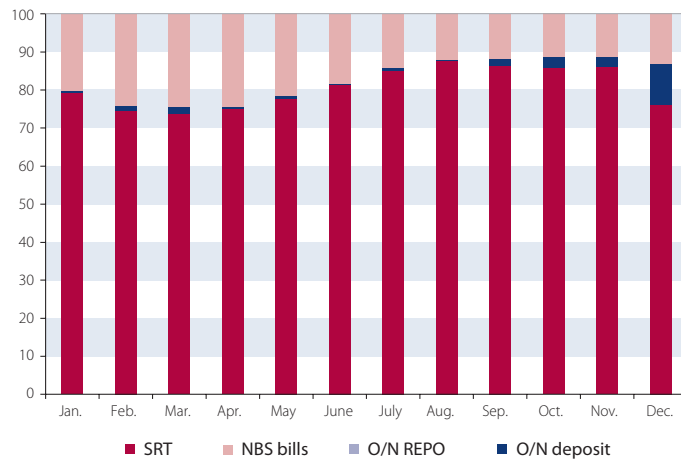
After Slovakia's accession to the euro area, a gradual decrease in excess liquidity of the banking sector through transactions outside Slovakia and within the euro area was expected and confirmed. Another expected factor of the decrease in surplus of funds was the transfer of the funds of foreign entities administered by domestic banks to countries, in which their parent companies are based.

2 THE SHORT-TERM GOVERNMENT SECURITIES MARKET

In 2008, the Ministry of Finance of the Slovak Republic represented by Agentúra pre riadenie dlhu a likvidity (Debt and Liquidity Management Agency, ARDAL) issued Treasury bills (TB) to its own portfolio by means of one 364-day issue worth of SKK 45.2 bn. As opposed to the previous year, the ARDAL started to place the TB on the market in October 2008 through Dutch auctions. The renewal of TB auctions was due to the need of banking entities to dispose of eligible collateral used in the case of raising funds in refinancing operations within monetary policy operations in the euro area. The end-of-year deficit of the government budget of SKK 21.2 bn. (66.3 % of its approved value) was financed through government securities.

As in the previous year, there was no significant trading on the secondary TB market. The amount of total secondary transactions reached SKK 2.0 bn. Trading on the TB secondary market

Chart 4 Percentages of the individual instruments in the sterilization position of the NBS in 2008 (%)



Source: NBS.

was carried out in the last two months of 2008, because the TB were registered with the Bratislava Stock Exchange (BCPB) in October.

3 THE FOREIGN EXCHANGE MARKET

3.1 The ongoing development on the foreign exchange market

The year 2008 was the last year of the existence of the Slovak koruna. During that year, the exchange rate of the Slovak koruna was subject to various influences – the actual macroeconomic indicators, the total development of the region and nearby countries, the geopolitical situation on the world markets and especially Slovakia's accession to the euro area. Investors perceived the situation on the domestic market as favorable and expected Slovakia to be definitively accepted as a euro area member in the first half of the year. In May, Slovakia's accession was supported by the European Commission and in July the European Parliament definitively decided on the introduction of the euro as the domestic Slovak currency. At its meeting of 8 July 2008, the Council of the European Union also set the conversion rate, which was at the level of the current central parity, and which had a considerable impact on the trading and volatility of exchange rate of the Slovak koruna against the euro.

At the beginning of the year, the Slovak koruna traded at 33.600 EUR/SKK. The very good macroeconomic indicators (e.g. the GDP growth for the 4th quarter of 2007 was 14.3% and for the 1st quarter of 2008 8.7%) along with positive comments of the representatives of European structures started to influence the Slovak koruna exchange rate and the koruna continued to appreciate. A similar development on the markets of the surrounding countries (particularly the remaining Visegrád countries) and speculations of the market regarding a possible revaluation of the central parity brought the exchange rate of the Slovak koruna against the euro to a level of 32.500 EUR/SKK



at the end of April. When this level was reached, speculations intensified, which was also due to repeated statements of Slovak representatives that they wish the strongest conversion rate possible. The exchange rate was appreciating considerably in May and was approaching the lower limit of the ERM II band (30.126 EUR/SKK). Following an agreement between the ministers of finance of euro area countries, the ECB president and the ministers of finance and central bank governors of Denmark, Estonia, Lithuania, Latvia and Slovakia, the central parity of the Slovak koruna in ERM II was revalued by 17.6472% effective as from 29 May 2008. The koruna appreciated to a historical maximum of 30.080 EUR/SKK on that day, but the market understood the information on a change in the parity in such a way that the conversion rate would not differ considerably from the new central parity, which was also emphasized by several official representatives.

There was also a decrease in the trading volume on the spot foreign exchange market following the fixation of the conversion rate. The influence of speculative transactions fell considerably, because the volatility of the Slovak koruna decreased and its exchange rate was primarily derived from the interest rates on the Slovak and European money market. In fact, in the case of more considerable deviations, the possibility of risk-less arbitrage would arise. The koruna exchange rate fluctuated in a narrow band until mid-October, but then the koruna depreciated to the level of 30.800 EUR/SKK. This was particularly due to a motivation to buy euros despite a possible loss due to the pending convergence. This motivation was primarily based on the need of foreign banks to have immediate access to euro liquidity. In addition, Slovak banks had a lower interest in selling the euro as a result of drawn-down lines. An exchange rate at the level of 30.800 EUR/SKK, however, was a sufficient motivation to make the banks take advantage of the arbitrage opportunity and to start buying korunas again. In November and December, the koruna to euro exchange rate was again fluctuating within a band, in which

the arbitrage opportunity was low and it was approaching the conversion rate of 30.126 EUR/SKK as time went on.

In the first half of the year (until the central parity change in May 2008), there was an interconnection between the currencies of Central European countries (the Visegrád Group), which took various extents and intensities depending on individual circumstances. Following the setting of the conversion rate, the development of the exchange rate of the Slovak koruna against the currencies of the Visegrád countries changed fundamentally – while the currencies of the other Visegrád countries continued to be subject to the influences of global financial markets, the Slovak koruna exchange rate against the euro was close to the conversion rate.

3.2 Characteristics of trading on the domestic interbank foreign exchange market

The exchange rate of the Slovak koruna against the euro appreciated by 10.4% in 2008 (from 34.573 EUR/SKK to 30.126 EUR/SKK). The average exchange rate level was 31.291 EUR/SKK, which represents a change by 7.4% against 2007. The exchange rate of the koruna against the US dollar appreciated by 6.3% (from 22.831 USD/SKK to 21.385 USD/SKK). The average exchange rate level was 21.346 USD/SKK (representing an appreciation by 13.6% against 2007). The Slovak koruna appreciated by 10.4% against the Czech koruna.

The total extent of transactions including spot foreign exchange conversions, foreign exchange swaps, forward operations and option operation on the interbank foreign exchange market without foreign exchange interventions of the NBS reached USD 1,196,437 m. and increased by 21.3% against the year 2007. The absolute and relative values of the transactions performed are shown in Table 1.

The average daily trading volume on the spot foreign exchange market was USD 377.1 m. Trading in euros dominated the market by making up 94.2% due to the fact that the euro is a reference

Table 1 The structure of foreign exchange transactions by transaction type

	SPOT			FORWARD			SW			OPTION		
	Volume		Number of transactions	Volume		Number of transactions	Volume		Number of transactions	Volume		Number of transactions
	(USD mil.)	(%)		(USD mil.)	(%)		(USD mil.)	(%)		(USD mil.)	(%)	
Transactions of domestic banks without foreign bank participation	16,497.8	18.1	6,925.0	873.0	1.0	80.0	73,423.8	80.6	2,183.0	307.9	0.3	92.0
Transactions of domestic banks with foreign banks	77,776.0	7.0	37,915.0	6,868.4	0.6	18,817.0	1,013,042.8	91.7	24,875.0	7,647.4	0.7	4,985.0
Foreign exchange market in Slovakia excl. the NBS	94,273.8	7.9	44,840.0	7,741.4	0.6	18,897.0	1,086,466.5	90.8	27,058.0	7,955.3	0.7	5,077.0

Source: NBS.



Table 2 The currency structure of foreign exchange transactions

	USD			EUR			Other currencies			Total	
	Volume		Number of transactions	Volume		Number of transactions	Volume		Number of transactions	Volume (USD mil.)	Number of transactions
	(USD mil.)	(%)		(USD mil.)	(%)		(USD mil.)	(%)			
Transactions of domestic banks without foreign bank participation	44,153.6	48.4	1,440	45,311.7	49.7	6,944	1,699.3	1.9	896.0	91,164.6	9,280
Transactions of domestic banks with foreign banks	828,937.6	75.0	22,168	265,822.6	24.1	48,078	10,512.2	1.0	16,346.0	1,105,272.4	86,592
Total foreign exchange market in Slovakia	873,091.2	73.0	23,608	311,134.3	26.0	55,022	12,211.5	1.0	17,242	1,196,437.0	95,872

Source: NBS.

currency. The mutual trading of domestic banks and of domestic banks with foreign banks on the spot market recorded a lower activity of domestic banks as compared to the previous year (17.5% of the total trading volume are made up by domestic banks and 82.5% by foreign banks). The total balance of the foreign bank transactions against domestic ones was positive in 2008 (USD 2,237.7 m.), which, in this incomplete view, means that foreign banks were buying more foreign currency and were selling the domestic Slovak koruna. It is impossible to gain a complete picture of the mutual flows, because available statistics do not contain client foreign exchange transactions of foreign banks with domestic businesses, which close the whole koruna-foreign exchange circuit.

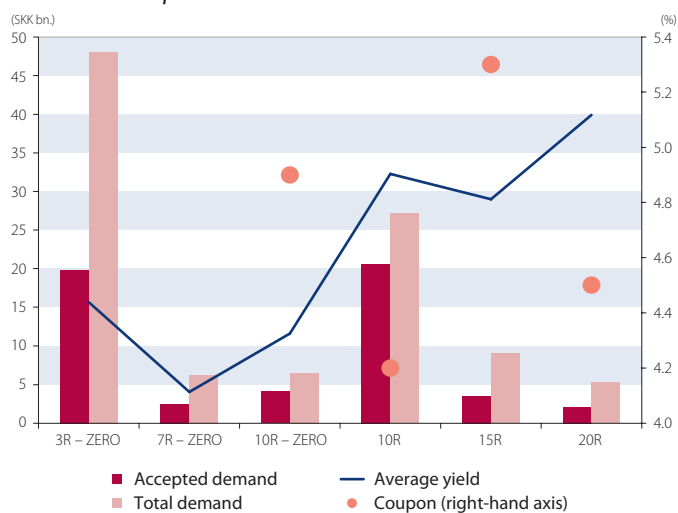
Transactions between domestic banks decreased by 6.8% to USD 91,164.6 m. The euro had the highest percentage in trading (49.7% compared to 29.2% in 2007), followed by the US dollar with a percentage of 48.4% (69.9%) and the other currencies made up 1.9% (0.9%).

In terms of the types of transactions performed between domestic banks, 90.8% took the form of swap operations (76.7% in 2007) and spot foreign exchange conversions constituted 7.9% (22.9% in 2007).

Trading with foreign banks recorded a year-on-year increase by 25.0% to USD 1,105,272.4 m. Trading in USD prevailed with 75.0% (85.9% in 2007), followed by trading in euros with a percentage of 24.0% (13.8%), and other currencies made up 1.0% (0.3%).

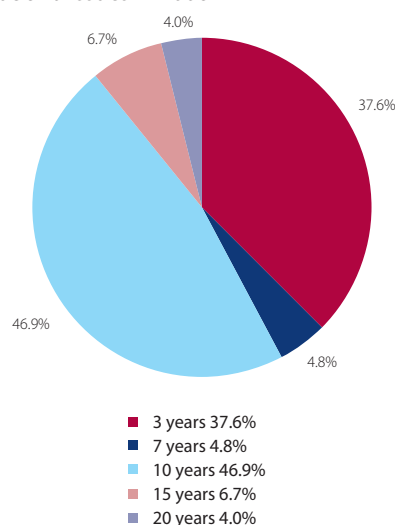
Traditionally, swap operations have constituted a decisive percentage of the interbank foreign exchange market (IFXM). This is due to the fact that this type of trades is used primarily by foreign banks as a replacement of the foreign exchange market, because swap operations are less risky, and hence more acceptable, in terms of credit risk and basically provide the same return as a time deposit. In addition, the shortest maturities (O/N up to one week), which were continuously renewed, continued to be used primarily, which increased the total trading volume of the IFXM. The percentage of spot operations was lower in comparison with the previous year. This was par-

Chart 5 Development in GB auctions in 2008



Source: NBS, Ardal.

Chart 6 The term structure of primary government bond issues in 2008

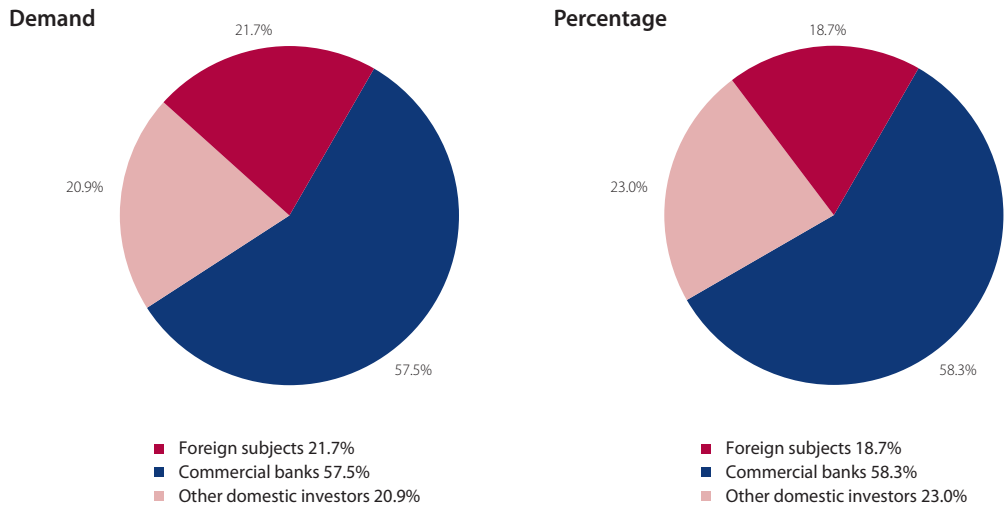


Source: ARDAL, NBS calculations.

ticularly due to a reduction in spot market trading after conversion rate fixation.

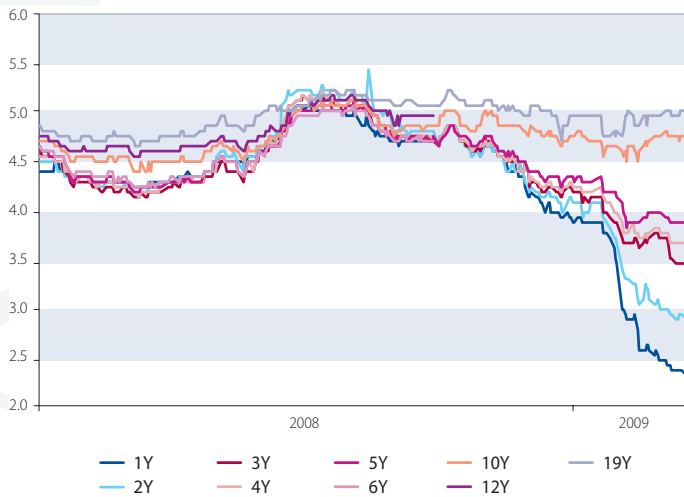


Chart 7 Demand and percentage of investors in the primary GB market in 2008



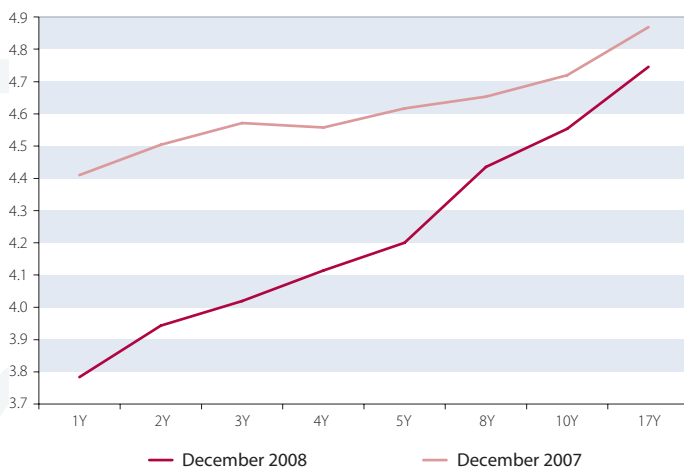
Source: ARDAL, NBS calculations.

Chart 8 Development of the GB benchmark in 2008 (% p.a.)



Source: NBS, Reuters.

Chart 9 Yield curve movement (% p.a.)



Source: NBS, Reuters.

4 THE CAPITAL MARKET

4.1 The primary market for government bond

In 2008, too, government bonds (GB) were the decisive and most frequently traded capital market segment. GB worth of SKK 52.7 bn. were placed on the domestic market in the form of an American auction. The total amount represents a decrease by 27% as compared to 2007. In addition to continuing to gradually increase the six issues opened in the previous years, the issuer introduced one new issue to the market, which replaced an already fulfilled issue of three-year GB. The issue had a maturity of 3 years, a zero coupon and a target sum of SKK 40 bn. The ARDAL also decided not to accept one GB auction carried out in March, one in May and one in September.

The issuing policy of ARDAL can be characterized by a lower percentage of demand satisfaction. The reason for rejects of all bids in auction by the issuer was a favorable development of the government budget, as well as the possibility to borrow at lower costs from other sources, primarily from the temporarily surplus of funds of the State Treasury. During the year, the ARDAL did not perform any auction of GB issued abroad. The main reason for this was the still unfavorable situation on the financial markets.

As in the previous years, investors showed greater interest in bonds with shorter maturities. This was reflected in a considerable demand for the three year maturity bond. An exception among the other maturities was a ten year bond with a 4.20% coupon. In the case of these two bonds, the investors were willing to decrease their yield slightly below the market level. The higher demand in the newly opened issue of the three year bond became visible especially in the first, initial tranche, as with any new product. However, the demand for the three year debt security was only half as high in the second tranche. The total de-



mand for this bond, however, increased considerably at the end of the year and it even exceeded the level reached in the first tranche. Investors showed a lower demand for most of the other GB issues.

The total GB demand reached SKK 102.2 bn. in 2008, which represented a 36% decrease as compared to 2007 (SKK 159.0 bn.). This was due to a shift of a part of resources to the TB, whose issuing was renewed in 2008.

4.1.1 Benchmark GB yields

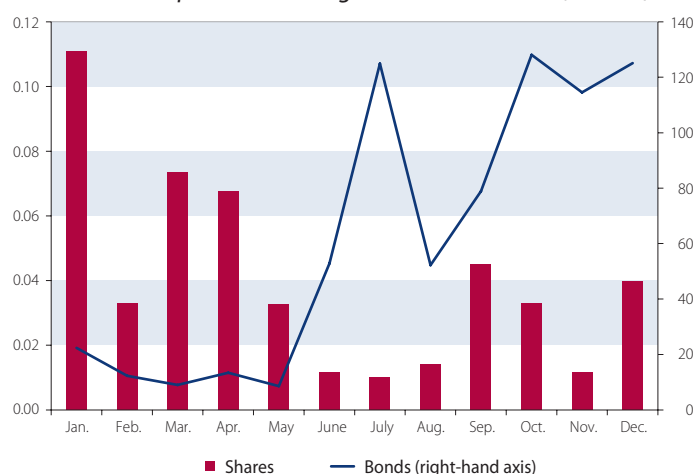
The GB yield curve had an ascending shape all over the year. The initial decrease of the yield curve was adjusted by subsequent increases until the end of the first half of 2008. The yield curve had a falling tendency, which was influenced particularly by multiple decreases of the NBS key interest rates. The decrease of the yield curve in the euro area and an upward interest of market participants in investing excess funds raised by means of cash deposits of domestic population in connection with the euro changeover can be considered the remaining factors having entailed the downward pressure on the domestic yield curve.

In the previous period, the development of the Slovak koruna against the euro was reflected, to a certain extent, into the development of GB yields on the secondary market; in 2008, however, the appreciation of the Slovak koruna against the euro had no impact on the decrease in GB yields as in the previous period.

4.2 The secondary securities market

As at the end of 2008, the BCPB had registered a total of 327 security issues (shares, fund units and bonds) on its market; 27 of them on the main and 110 on the parallel listed securities market and 190 on the free securities market.

Chart 10 Development of trading at the BCPB in 2008 (SKK bn.)



Source: BCPB.

Chart 11 Development of the SAX index in 2008 (points)



Source: BCPB.

Table 3 Overview of the newly admitted issues at the BCPB

Type of security	2008		2007	
	Number of issues	Value in SKK bn.	Number of issues	Value in SKK bn.
Government bonds	19	52.7	12	71.9
Treasury bills	1	45.2	-	-
Mortgage bonds	27	13.2	24	14.0
Bank bonds	4	1.4	3	3.9
Corporate bonds	3	1.7	4	1.7

Source: BCPB.

Table 4 Overview of the most frequently traded shares at the BCPB

Name of the issuer	Volume of trades in SKK bn.	Number of transactions	Percentage of transactions in %
Všeobecná úverová banka	193.4	353	40
Slovnaft	31.9	185	7
SES Tlmače	24.2	270	5

Source: BCPB.



The financial value of transactions at the BCPB reached SKK 742.5 bn. during 246 business days. A total of 4,425 valid transactions took place, within which 5.8 m securities were transferred. In comparison with 2007, when the transactions reached SKK 352.9 bn., the total traded sum increased considerably. The number of transactions, by contrast, decreased by 44%. The increased trading activity was particularly associated with an increase in new government security issues, as well as with an increase in the demand in order to invest surplus of funds obtained from the population.

Outright transactions with listed bonds performed in the negotiated form traditionally made up a significant majority of the traded securities.

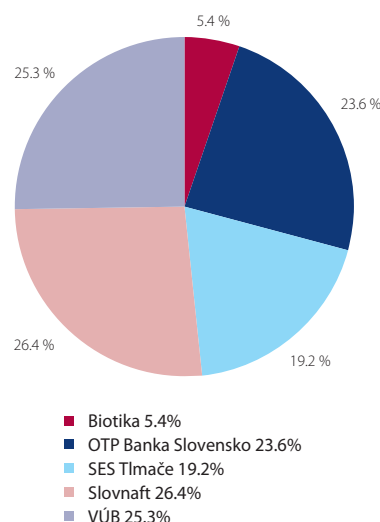
4.2.1 The secondary bonds market

At the end of the year, it was possible to trade on three stock exchange market in 136 issues – 22 on the main and 106 on the parallel listed bonds market and 8 on the free bonds market. The amount of bonds transactions reached the value of SKK 742.0 bn. in 2,301 traded transactions, representing a year-on-year increase by 111%.

In 2008, the BCPB admitted for trading on its listed markets one GB issue with the face value of SKK 1.9 bn. and one TB issue with the face value of SKK 45.2 bn. The inflow of capital to the stock exchange markets by means of government securities also took place in the form of admission of supplementary tranches of previously registered bonds (totaling SKK 50.8 bn.). 34 bond issues in the total value of SKK 16.3 bn. were admitted from private sector issuers to the listed markets of the stock exchange.

The market capitalization of debt issues was SKK 503.6 bn. as at the last day of 2008 (a 12.0%

Chart 12 Weights of basic SAX index components as of 31 December 2008



Source: BCPB.

annual increase), out of which SKK 485.6 bn. fell on listed issues (a 12.8% increase).

4.2.2 The secondary share market

Stock trading continued to be very weak. The total financial value traded in 2,124 transactions reached the amount of 481.2 m. SKK. On the last day of the year, it was possible to enter into transactions with 148 share issues (125 issuers) – 5 on the main and 4 on the parallel listed share market and 139 on the free share market – and with 43 fund unit issues (1 issuer). The ratio of share transactions to the total secondary transactions reached the negligible level of 0.1%, which confirms that the Slovak capital market is largely a bonds market.

Table 6 Development of the NBS and of the ECB key interest rates in 2008

NBS key interest rates in %				
Period	Limit rate for two week repo tenders	Marginal lending facilities	Deposit facilities	Spread
25 April 2007 – 28 October 2008	4.25	5.75	2.25	3.50
29 October 2008 – 11 November 2008	3.75	4.75	2.75	2.00
12 November 2008 – 9 December 2008	3.25	4.25	2.25	2.00
10 December 2008 – 20 January 2009	2.50	3.50	1.50	2.00

ECB key interest rates in %				
Period	Limit rate for two week repo tenders	Marginal lending facilities	Deposit facilities	Spread
13 June 2007 – 8 July 2008	4.00	5.00	3.00	2.00
9 July 2008 – 7 October 2008	4.25	5.25	3.25	2.00
8 October 2008	4.25	4.75	2.75	2.00
9 October 2008 – 14 October 2008	4.25	4.25	3.25	1.00
15 October 2008 – 11 November 2008	3.75	4.25	3.25	1.00
12 November 2008 – 9 December 2008	3.25	3.75	2.75	1.00
10 December 2008 – 20 January 2009	2.50	3.00	2.00	1.00

Source: NBS, ECB.



The development of the Slovak share index (SAX) was considerably volatile in 2008. Due to the low number of components of the index, the development of one of the components of the index often had a considerable influence on the development of the whole index. The SAX reached a the final value of 359.18 points and decreased by 86.5 points as compared to the same period of 2007.

The SAX consisted of 5 shares, among which shares of banks (Všeobecná úverová banka and OTP Banka) dominated.

The market capitalization of all tradable shares was SKK 116.9 bn. at the end of the year, which represents a 26.7% decline compared to the previous year. The market capitalization of the listed market was SKK 70.0 bn. with a 21.7% year-on-year decrease at the end of the period under review.

5 COMPARISON OF THE DEVELOPMENT OF THE SLOVAK FINANCIAL MARKET WITH THE EURO AREA MARKET

The monetary policy steps of the NBS and the ECB (with the exception of the July increase of the ECB key interest rates) were synchronized in the last year. While the NBS kept its key rates unchanged until October, the ECB increased them in that period. When comparing the levels of the key rates of both central banks, it is important to note that the NBS was sterilizing excess liquidity, while the ECB was providing liquidity to the banking sector.

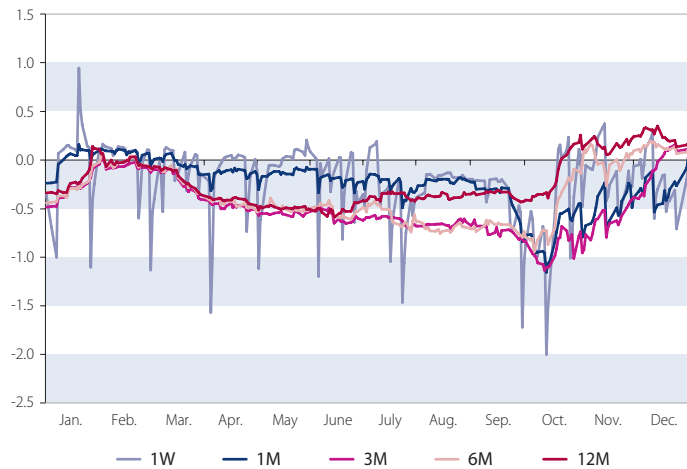
5.1 NBS key rates

The NBS kept the key rates at an unchanged level until October 2008. The reason for this step was primarily the favorable macroeconomic development of Slovakia, particularly the development of inflation, which was the main target of the monetary policy of the NBS. In the remaining period, the NBS eased its monetary policy even outside the monetary policy meetings of the NBS Bank Board, which followed immediately after the cut of the ECB key rates. At the same time, the NBS narrowed the spread between the interest rates for deposit facility and marginal lending facility of the NBS from the previous 350 to 200 basis points. This meant the abandonment of the previous asymmetric corridor and the introduction of the same spread between both overnight interest rates with respect to the NBS two week interest rate. The process of domestic key rates convergence to the euro area level, which was reflected into the development of the domestic market rates BRIBOR, can be considered as the main factor.

5.2 Interest rates of the interbank money market

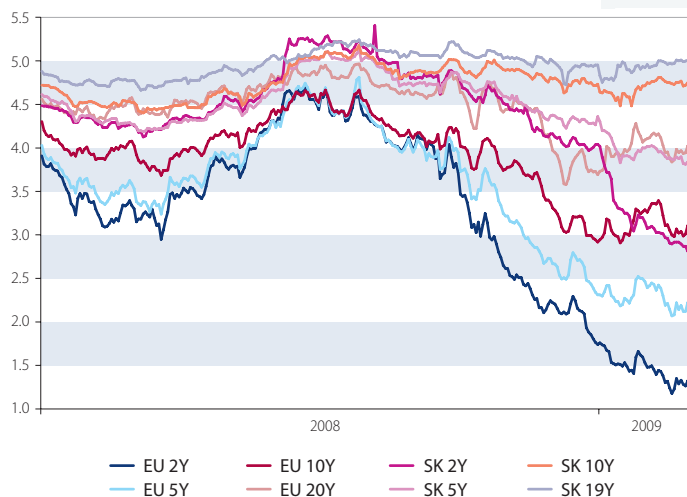
As regards the money market interest rates, the short end of the yield curve was influenced by the liquidity development in the banking sector. In addition to the said difference between the

Chart 13 Comparison of spreads between selected BRIBOR and EURIBOR (p.p.)



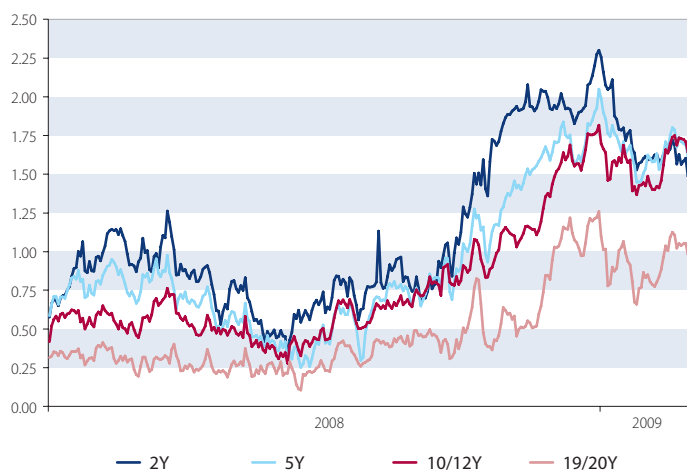
Source: NBS, ECB.

Chart 14 Comparison of the EUR and SKK benchmark (% p.a.)



Source: NBS, Reuters.

Chart 15 Spreads of the EUR and SKK benchmark (p.p.)



Source: NBS, Reuters.



sterilization and refinancing position of the Slovak and euro area banking sector, there is another difference between those markets. The ECB manages the banking sector liquidity, while the NBS did not interfere with that process and left liquidity to the self-regulating ability of banks. The banks, however, often had problems with estimating the liquidity for the period following the individual repo tenders. The result was excessive sterilization of surplus of liquidity in some cases and insufficient absorbing excess resources from the sector in other cases. This situation subsequently influenced the interest rates of the money market, which ultimately a high volatility in Slovakia. In comparison with the policy of the ECB, which does not accept a part of the demand depending on how much available funds the sector needs in the given period in its standard one week tenders (except tenders carried out following the adoption of the decision to conduct fixed rate tender procedures with full allotment), the short-term interest rates of the euro area money market are stable under standard circumstances.

The rates of the long end of the money market yield curve experienced the opposite development. At the beginning of February, the deposits rates with long-term maturities in the euro area decreased and approached the level in Slovakia. However, this was only a short-term period. Subsequently, the long-term maturity rates in the euro area started to grow, particularly under the influence of expectations that the ECB key rates would be increased in connection with inflation growth in the euro area. Domestic interest rates were also growing in this period; they were copying, to a certain extent, the development of rates in the euro area. In the last quarter, the ECB decided on some considerable key interest rate cuts, which was reflected in a substantial decline in money market rates in the euro area. Domestic long-term interest rates thus gradually reached the euro area level, the reason for their decline being the adaptation of monetary policy rates in Slovakia to the euro area. From that time onwards until the last day of the year under review the domestic long-term interest rates on the money market remained above the euro area level.

A comparison of spreads between the Slovak and euro area rates for selected maturities implies that the one week rate had the highest volatility in spreads and the one and twelve month maturity, on the other hand, recorded the lowest volatility.

5.3 The development of bond yields

All over the year, the domestic bond market was influenced particularly by the development of the euro area benchmark and the unexpected procedure in the lowering of the NBS key interest rates. The development of the Slovak koruna exchange rate was reflected in the development of the bonds market to a lesser extent. Slovak bond yields experienced the same development as euro area bond yields. Bonds with shorter maturities recorded a higher spread and the lowest

spreads, by contrast, were peculiar to bonds with a longer maturity.

CONCLUSION

The situation on the domestic financial market was considerably determined by euro adoption expectations. Thus attention focused on the basically single considerably volatile indicator, the exchange rate of the Slovak koruna against the euro. The situation was all the more serious because Slovakia, having been under the ERM II system from 28 November 2005, changed the set band twice – on 19 March 2007 when the parity was revalued by 8%, and on 29 May 2008 to 30.1260 EUR/SKK (by 17.6472%). This value was confirmed by the Council of the EU on 8 July 2008 as the final official conversion exchange rate of the Slovak koruna against the euro within Slovakia's accession process to the euro area.

The environment, in which the individual financial entities were active, was strongly influenced by the longer lasting appreciation of the Slovak koruna, the average koruna to euro exchange rate having reached 37.248 EUR/SKK in 2006 (a year-on-year appreciation by 3.5%), 33.781 EUR/SKK one year later (9.3%) and 31.291 EUR/SKK in 2008 (an appreciation by 7.4%), but with an extraordinarily strong appreciation from April to June 2008. A peculiarity of the year under review was the fact that the NBS did not intervene on the domestic foreign exchange market in the period not even once, which was not typical of the previous years.

As regards the extent and trading structure, the percentage of mutual transactions of domestic banks, which reached 7.6%, decreased slightly, while in 2007 the percentage was 9.9%. The reason is above all a considerably lower activity between domestic entities in the period following the announcement of the conversion rate, which is also visible at the reduction of the average daily spot trading from USD 429.2 m. in 2007 to USD 377.1 m. in 2008. As in the previous years, the trading was dominated primarily by swap transactions, whose percentage increased from 88.3% in 2007 to 90.8%. This change took place to the detriment of spot transactions, which decreased from 11.4% to 7.9%.

A substantial issue of the money market was the preservation of trading and price stability and a continuous transition to a new environment with the opposite liquidity parameter. It can be stated that the convergence of the domestic interest rates was continuous, fostered considerably by adequate adjustments to the level of the NBS interest rates. A special program was the transformation of the existing sterilization position of the domestic banking sector, which reached a value of SKK 403.0 bn. on 31 December 2008. The gist of the procedure chosen were regular monthly issues of NBS bills, whose maturity was phased as at the last day of the year, and which were supplemented by adding several repo tenders including atypical maturity. The (originally only back-up,



finally however used) possibility of a several day security deposit was kept as the definitive collateral.

Several parameters of the money market remained unchanged, similarly to the foreign exchange market, a group of market-makers dominated the activities, no fundamental changes occurred in the structure of the basic types of transactions (deposits, swaps).

As regards the term structure, trading was concentrated (as in previous years) in very short-term maturities; an additional factor was the global (economic and financial) crisis, particularly in the second half of the year under review, which rather stimulated the market in its final phase along with gradual reduction of activity as a result of Slovakia's accession to the euro area.

With the partial exception of government securities, the domestic capital market, which had been underdeveloped for years, did not achieve any remarkable results. In the case of government securities, too, the primary government bond market decreased by 27% compared to 2007. Activities of the issuer and his agent concentrated on supplementing the existing issues and only one new medium-term maturity issue was prepared for the market. In terms of yields, the government bonds reacted in a flexible way particularly on changes in interest rates of the central bank, and their volatility compared to the same type of assets in comparable Central European countries was lower as a result of the decision to adopt the euro in the second half of the year.

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