NATIONAL BANK OF SLOVAKIA

PORTFOLIO INVESTMENT IN SLOVAKIA

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Portfolio Investment in Slovakia

Foreign capital movements take place mostly in the form of direct foreign investment, portfolio investment, bank loans, and long-term credits.

The most effective form of foreign capital inflow is direct foreign investment (DFI). This form of investment allows investors to acquire stakes in the capital of specific business organisations in the host country. Unlike portfolio investment, direct foreign investment allows direct participation in the production, business or services sectors of the economy concerned.

Direct foreign investment should represent the key form of foreign capital inflow into the Slovak economy. It should create a basis for the modernisation of production, transfer of new technology, know-how, effective competition, and for the closer integration of the country's economy into the international division of labour.

In practice, the deficit in the balance of payments current account can only be financed from a surplus in the capital account, first and foremost from net capital inflows or foreign exchange reserves. The most favourable source of long-term capital is direct foreign investment. Such investment is usually made for the modernisation and comprehensive enhancement of tangible fixed assets in the country, without increasing the level of national debt, or the amount of interest payable.

Direct foreign investment and its current trends in Slovakia were analysed in full detail on the pages of BIATEC, in Volumes 3/1997, 4/1997, and 4/1998.

The least effective form of foreign investment is the inflow of capital in the form of foreign loans. Foreign loans are resources that must be repaid (together with interest) within a fixed time limit and they represent, unless they are correctly invested, e.g. in the promotion of industrial production, a rather ineffective form of investment.

Portfolio investment

Portfolio investment (PI) represents the transfer of ownership of securities, with the aim of earning yields, whereas direct foreign investment (DFI) offers an opportunity to influence the positions of existing or newly established companies, apart from earning yields. Portfolio investment is most affected by factors such as yields on securities, interest rates, and various speculative operations. The effects of these factors may, under certain circumstances, change very quickly either positively or negatively, and so they may destabilise the country's balance of payments. Portfolio share investment is more stable, because it is destined for use in long-term production projects.

The range of foreign investments made in various types of securities depends on the development of the capital market.

Advantages and risks of portfolio investment

A significant advantage of portfolio investment is the investor's increased share in the risk. The foreign investor supports the activity of the company, in which he has invested, because he is interested in the company's prosperity. Large investments in shares may bring significant advantages to the country concerned, accompanied by a transfer of technology, know-how, access to the world market, and stabilisation or growth in employment, etc.

Another advantage is the long-term increase in market oriented capital flows. A functioning stock exchange may contribute to the better allocation of resources. Simultaneously with the effects of foreign competition, downward pressure is exerted on domestic interest levels, mobilising domestic capital for local companies at lower cost.

In this area, there are certain risks as well, e.g. the maturity of bonds may be too short for the financing of long-term projects. There are realistic fears of instability of short-term capital, which has behaved rather erratically in recent years.

Most portfolio investments are made in countries which have made the greatest progress since the lending crisis in the 80ies, i.e. where macroeconomic control has improved, where privatisation projects have been implemented, where there is a well developed capital market, etc. Portfolio investments are made in countries where investors expect rapid economic growth and long-term stability. However, they also take advantage of the possibility of earning high short-term profits, arising from the instantaneous advantages of inconsistent domestic policy[1].

To a lesser extent, portfolio investments are made in countries which have not yet reached the said level, but have the prerequisites for positive development. In this case, foreign investors make largely short-term deposits, designed to earn high short-term profits from the instantaneous advantages, arising from the current imbalance of the economy, accompanied by increased interest levels.

Short-term capital movements take place within the scope of changes in the claims and liabilities of residents vis-a-vis non-residents. The category of residents may include the government, banks, and other financial institutions, financial intermediaries (stock exchange brokers, securities dealers, etc.), as well as industrial and business companies. From this point of view, the most typical short-term instruments are the deposits of central and commercial banks, bills of exchange, loans, etc.

Increased care must be applied in making short-term portfolio investments, which are highly flexible. They are withdrawn from the country as soon as a negative step is taken against them. Such withdrawals in large quantities may lead to serious problems. The best prevention against such development is the provision of up-to-date statistical information. Therefore, increased attention must be paid to the monitoring of portfolio investments in the country, and it is necessary to create a well functioning statistical system for the prevention of their outflow.

The most typical long-term instruments include shares, bonds, stabilisation loans, loans for the financing of imports, tied loans, etc. In obtaining foreign loans, a significant role is played by the preparation of feasible projects, the country's capacity for effective capital absorption, accumulation of loans, interest levels, etc.

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[1] Olsovsky, R.: The Inflow of Foreign Capital Has Both Advantages and Risks. Prague, Banking 1995. Volume 3.

Development of portfolio investment in Slovakia

Until recently, the database applied for the monitoring and analysis of portfolio investment in Slovakia was rather limited. The most comprehensive survey of securities transactions in terms of volume is available at the Centre for Securities in the SR, a.s. Bratislava.

The National Bank of Slovakia (NBS) continuously monitors portfolio investment on the basis of data submitted by selected institutions on request. However, it has not yet been possible to determine the share of portfolio investments (PI) in the total volume of trading in securities. In 1998, the NBS started to report data on PI according to the IMF's Manual of 1993. The format complies with the requirements of the IMF; all problems are represented in this structure.

The Bratislava Stock Exchange, plc. (Burza cennych papierov, a.s., Bratislava - BCPB)]started to monitor the share of foreign investors in the total volume of trading, in 1996. The results are published in the Annual Bulletin of BCPB. The figures do not include the volume of trading through RM System Slovakia, plc., where foreign investors are not expected to reach a significant share. Of the total volume traded by foreign investors, trading via RM System Slovakia, plc. accounts for roughly 5 to 8%; on the basis of this, the share of BCPB, i.e. 92 to 95%, may be regarded as a reliable result.

Data on portfolio investment in Slovakia in the prescribed structure cannot be compared in terms of development, since they were included in this structure for the first time. Development trends can only be monitored in overall data.

Portfolio investment in Slovakia

	Year 1996 (Sk million)	**Year 1997 (Sk million)**
Portfolio investment abroad	**2 094,0**	**-2 895,8**
Portfolio investment in SR	**898,0**	**3 278,0**
Portfolio investment in total	**2 992,0**	**382,2**

Source: Annual Report of the NBS for 1996, 1997; Report on Monetary Development in the SR during August 1998.

The total volume of portfolio investment in Slovakia has shown marked deviations over the course of development.

During 1997 and the first half of 1998, the Slovak capital market recorded an outflow of portfolio investments. Numerous foreign investors sold their stakes (equity shares) in Slovak companies, which resulted in a fall of Sk 2.1 billion in the volume of foreign capital stakes (up to 10%) in Slovak companies.

Data obtained from the Bratislava Stock Exchange show certain differences. On the BCPB floor, trading is organised only in Slovak securities. Of total turnover, foreign portfolio investors reached a share of 9% in sale, 10% in purchase, and 10% in terms of total turnover. The volume of securities sold on the BCPB floor reached Sk 1.6 billion during the 1st half of the year.

The comparable figure from the NBS is Sk 157 million. Both figures are expressed in market prices. The differential may result from the different structures of individual respondents, the different structures of the analysed types of securities, etc. During the coming period, it would be advantageous to utilise both resources for the needs of the country's balance of payments.

Methodological approach to the processing of PI

The currently applied methodological approach to the processing of portfolio investments in individual economies is based on the uniform regulations of the IMF (Manual 1993, Volume V.).

In the Manual, the validity and classification of portfolio investments have been revised to a significant extent. Formal distinction between long-term and short-term investments (the former relates to original maturity of over one year or without specifying the validity, and the latter relates to original validity of one year or less, or at sight) is not made for portfolio investment.

The fact that, for numerous traders, the original maturity is now less important in the course of investment and lending activities, led to the inclusion of further instruments in PI.

The main components of PI, which are classified under assets and liabilities, are property and debt securities, traded on both organised and other financial markets. Debt securities are further divided into bonds and bills of exchange, money market instruments and financial derivatives, including a number of new financial instruments, such as equity securities, debt securities, bonds, promissory notes, money market securities and derivatives, all categorised as assets and liabilities belonging to the central bank, commercial banks, and other sectors.

Problems related to the collection of data on PI in Slovakia

- The NBS monitors portfolio investments through reports obtained from commercial banks and the corporate sector. Reports are not yet available from exchange brokers, since the problem of double reporting (in combination with data from the corporate sector) has not yet been addressed.

- At present, the reporting requirement is still not clearly defined and consequently the required data are not reported consistently to the NBS. For this reason, the occurrence of double reporting has not yet been confirmed.

- In the case of short-term capital market products, it is not possible to record their movements with an appropriate degree of precision and to exclude the possibility of double reporting. After consultation with stock exchange brokers, data on PI in the corporate sector may also be reported to the NBS from two sources. This may happen on account of double reporting, i.e. from the companies concerned and from custodian banks that handle their securities.

- For the needs of the balance of payments, portfolio investments are monitored in market prices, which reflect the flow of money. In this case, if the prices of securities undergo marked changes during the period under review, there will be no information on the actual volumes of securities. The first half of 1998, for example, saw a 51% fall in the price of some securities, which may, at market prices, give the impression that the volume of shares declined. For that reason, PI data should also be given at constant prices, especially for organisations that monitor the volumes of securities.

Conclusions relating to portfolio investment

The second major component of foreign capital, which might affect the country's balance of payments, is foreign portfolio investment. Although this form of investment does not represent a significant volume for the time being, this may change quickly after the situation on the Slovak capital market calms down.

Paradoxically, the recovery of the Slovak capital market is hardly possible without the participation of foreign portfolio investors. At present, it is true to say that the interest of such investors in Slovakia is weak, and shows a tendency to decrease still further.

Foreign investors are repelled mainly by:

- the low degree of political stability in Slovakia;
- low transparency of the market - inadequate access to important information, absence of a price
- setting market, official rates with a low information value;
- absence of legal regulations protecting the rights of investors, especially those of minority shareholders;
- unreliable and inadequately effective market regulation;
- extremely low level of liquidity, with considerably restricted possibilities for portfolio investment; - non-transparent privatisation with consequent inaccuracy in market prices.[2]

With regard to the new political climate in Slovakia, it is possible to expect gradual recovery. For this reason, we should be prepared for such a situation in the area of PI data collection and processing, which may, in larger volumes, have a significant influence on the country's balance of payments.

What possibilities do we have for improving the system of data collection for the monitoring of portfolio investments?

- Since 1998, the NBS has applied a new method for the collection of data on PI, which is based - as in other countries - on IMF methodology. Under the present conditions of PI in Slovakia, the method applied by the NBS can be regarded as appropriate.
- In the future, especially if the situation on the local capital market changes significantly, it will be necessary to monitor portfolio investments in Slovakia in terms of time as well.
- It will be necessary to emphasise the need for discipline in the area of reporting and to consider the possibility of imposing penalties if the reporting requirement is not met - especially for the start-up period reserved for the creation of a high-quality system for the collection and processing of PI in Slovakia, for the needs of the balance of payments.
- It will be necessary to check whether double reporting is made by some respondents and to find solutions for its elimination.
- For the time being, portfolio investment in Slovakia is monitored not only by the NBS, but by the Bratislava Stock Exchange as well. The obtained data show differences. With regard to the fact that BCPB is likely to have a more complex database, especially in the area of property securities and certain types of bonds, it would be a real help if the NBS could have access to this database in the near future, in the interest of accuracy.
- A significant fact is that there is an adequate staff for the statistical processing and analysis of PI data, which is a guarantee for the timely regulation of portfolio investment, especially the inflow of short-term speculative capital from abroad.

[2] Horvath, M.: Capital Market in the Slovak Republic. Lecture conducted at M.E.S.A. 10 on 25 February 1998 in Bratislava.