B. REPORT ON MONETARY DEVELOPMENT IN THE SR IN 1998

1. ECONOMIC DEVELOPMENT

Economic development in 1998 was marked by numerous negative trends, which further increased the country's internal and external imbalances.

The rate of growth in gross domestic product (GDP), expressed at constant prices, slowed to 4.4%. A key role in GDP creation was played by services, while added values fell in both agriculture and construction. With regard to demand, the growth in GDP was supported by domestic as well as foreign demand. The growth in domestic demand was stimulated mainly by gross fixed capital formation, which was involved in the increase in the level of foreign debt. As the dynamics of imports exceeded those of exports, the external imbalance of the economy increased in 1998.

The growing problems in the entrepreneurial sector led to a marked decline in the financial results of financial and non-financial organisations. Profits earned in 1998 were more than 50% lower than in 1997. At the same time, the profit to cost ratio decreased and the insolvency of entrepreneurial entities increased.

In comparison with the previous year, the share of the private sector in GDP creation decreased by 0.2 percentage points, to 82.4%.

The average annual rate of consumer-price inflation reached 6.7%. The average monthly increase in the level of consumer prices fell from 0.53% in 1997, to 0.45% in 1998. The annual rate of inflation reached its maximum in May (7.6%) and minimum in December (5.6%).

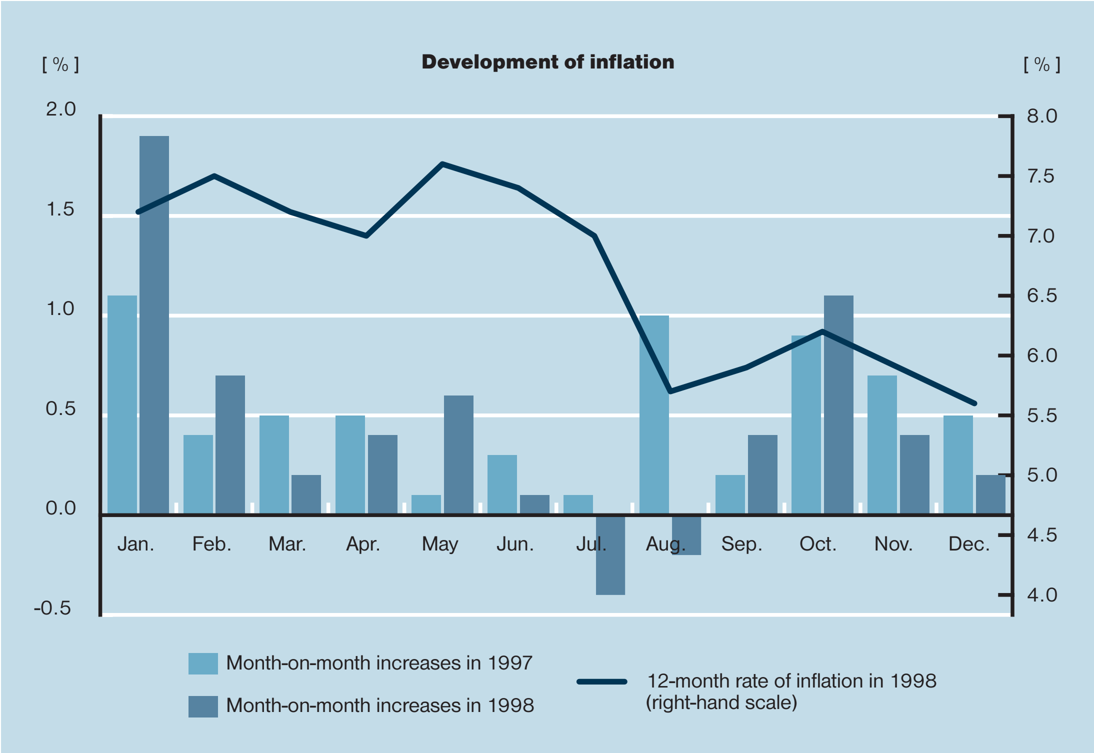
The downward trend in employment continued in 1998, when the average number of employees registered in the Slovak economy decreased by 0.4%. This was due primarily to a reduction in the number of employees in agriculture and industry. Employment was positively influenced by the development of trade and trade-related services. According to data from labour offices, the rate of unemployment increased to 15.6% at the end of the year, i.e. by 3.1 percentage points compared with the same period a year earlier. The average figure for the year was 13.7%. As a result of a decrease in the number of vacancies and increase in the number of unemployed, there were 23 unemployed persons per one vacancy.

1.1. Price Development

In 1998, the increase in the general price level slowed somewhat in comparison with 1997. The 12-month rate of inflation, expressed in terms of the consumer price index, reached 5.6% at the end of December 1998, which was in line with the monetary programme of the NBS for 1998 (5.6 to 5.9% at year-end). In 1998, the average annual rate of price inflation stood at 6.7%.

The slowdown in the rate of year-on-year increase in consumer prices in 1998 resulted from the slowdown in price deregulation and the low rate of inflation 'imported' from abroad.

The slow increase in the prices of domestic regulated commodities and services, combined with a fall in the prices of raw materials and foodstuffs, led to reduction in the prices of production inputs and cost-push inflation. A favourable effect on the level of consumer prices was exerted by the gradual lowering of the import surcharge and the relatively stable exchange rate of the Slovak crown during the first half of 1998. During the second half of the year, fears of currency devaluation and price inflation increased in connection with the growing external imbalance of the economy and the run-up to parliamentary elections. The growth in consumer demand induced by fears of devaluation and the subsequent depreciation in the currency after the cancellation of the crown's fixed exchange rate regime (with effect from 1 October 1998) accelerated the price



increase during September and October. At the close of the year, inflation was at a relatively low level. This was due mainly to the development of consumer prices in November and December, which recorded a marked fall both in comparison with October and the same period of 1997.

Price development in the tradable and non-tradable sectors

According to the structure of the consumer basket by sector, the rate of inflation in the non-tradable sector (6.5%) continued to exceed the figure for the tradable sector (5.2%). The differences between the sectoral rates of

Development of consumer prices in the tradable and non-tradable sectors

Increase in consumer prices in % since previous December		Const. weight in % (valid in 1998)	December 1997[1/]	December 1998	Change in % points
Tradable sector:		66.93	5.52	5.20	-0.32
of which:	**Food prices**	26.76	4.52	4.55	0.03
	Other goods	40.18	6.18	5.62	-0.56
Non-tradable sector:		33.07	8.17	6.46	-1.70
of which:	**Regulated prices**	17.82	7.97	6.30	-1.67
	Market services	15.24	8.39	6.65	-1.75
TOTAL		100.00	6.40	5.63	-0.77

NBS figures based on data from the Statistical Office of the SR
[1/] By the decision of the Ministry of Finance of the SR to liberalise fuel prices in January 1998, fuels were moved from the sector of regulated prices into that of other tradable commodities. For the purpose of year-on-year comparison of price increases by sector, the data for 1997 have been adjusted according to the classification of items from 1998 by sector. This means that fuels are regarded in these adjustments as other tradable goods in 1997 as well (the weighting of fuels in the consumer basket is ca. 2.6% and their prices increased in 1997 by 0.7%).

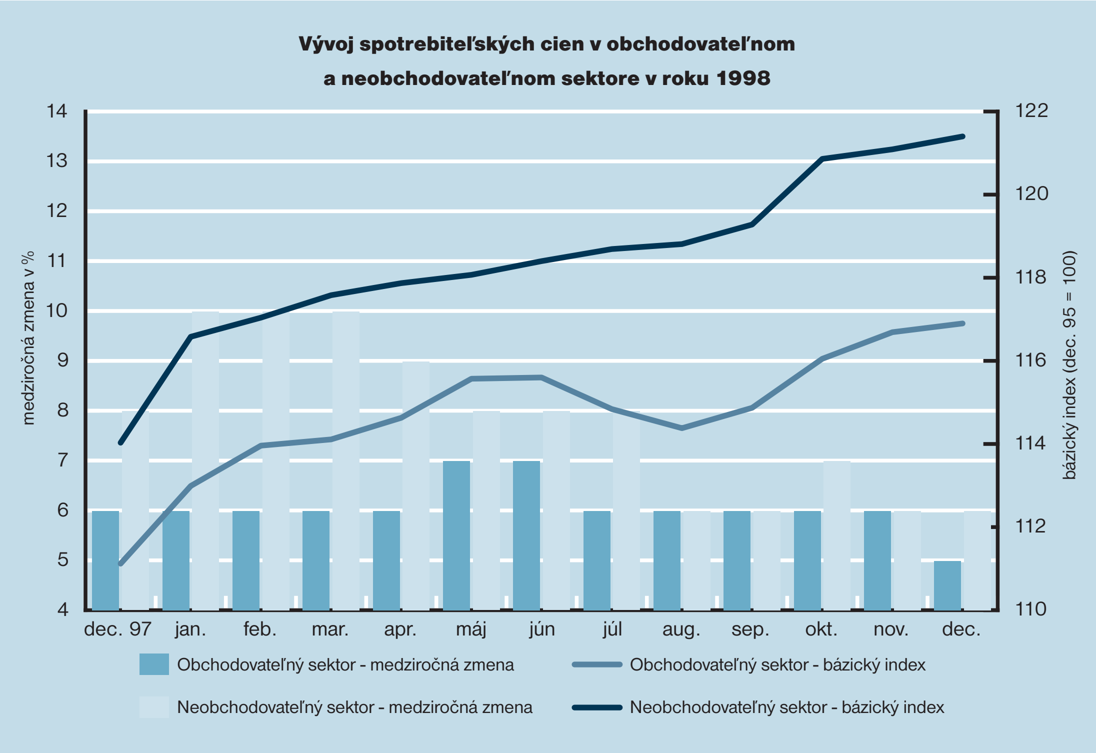
inflation (so-called 'dual inflation') persisted in 1998 in spite of the fact that the non-tradable sector recorded a sharper fall in the 12-month rate of inflation (1.7 percentage points) than the tradable sector (0.3 percentage points).

Food Prices

Food prices (excluding non-alcoholic beverages) recorded almost the same year-on-year increase as a year earlier. On a month-on-month basis, the development of food prices in 1998 differed from the trend recorded in previous years mainly during the second quarter of 1998, when the rate of price increase accelerated in this sector. Apart from seasonal factors, the said development was due to the setting of a minimum guaranteed price for sugar payable to the producer, as of April 1998. During the second half of the year, however, food prices acted as a brake on the rise in the level of consumer prices, as in previous years.

Other Tradable Commodities

In comparison with the same period of the past year, the rate of price increase in the sector of other tradable goods slowed by 0.3 percentage points during the first three quarters of 1998. This reduction was due to the low rate of inflation in the countries of our main trading partners, the relatively stable exchange rate of the Slovak crown, and the gradual reduction in the import surcharge (from 7% to 5% on 1 January 1998; from 5% to 3% on 1 April 1998 and then to be cancelled with effect from 1 October 1998). At the beginning of the last quarter, the price increase accelerated in the sector. This was due mainly to an increase in consumer demand, caused by fears of currency devaluation and inflation, which culminated at the end of September and the beginning of October. The depreciation in the currency after the cancellation of the fixed exchange rate regime on 1 October 1998, also contributed to the acceleration in the rate of price advance in the sector. The increase in the price of other tradable goods in October 1998 was



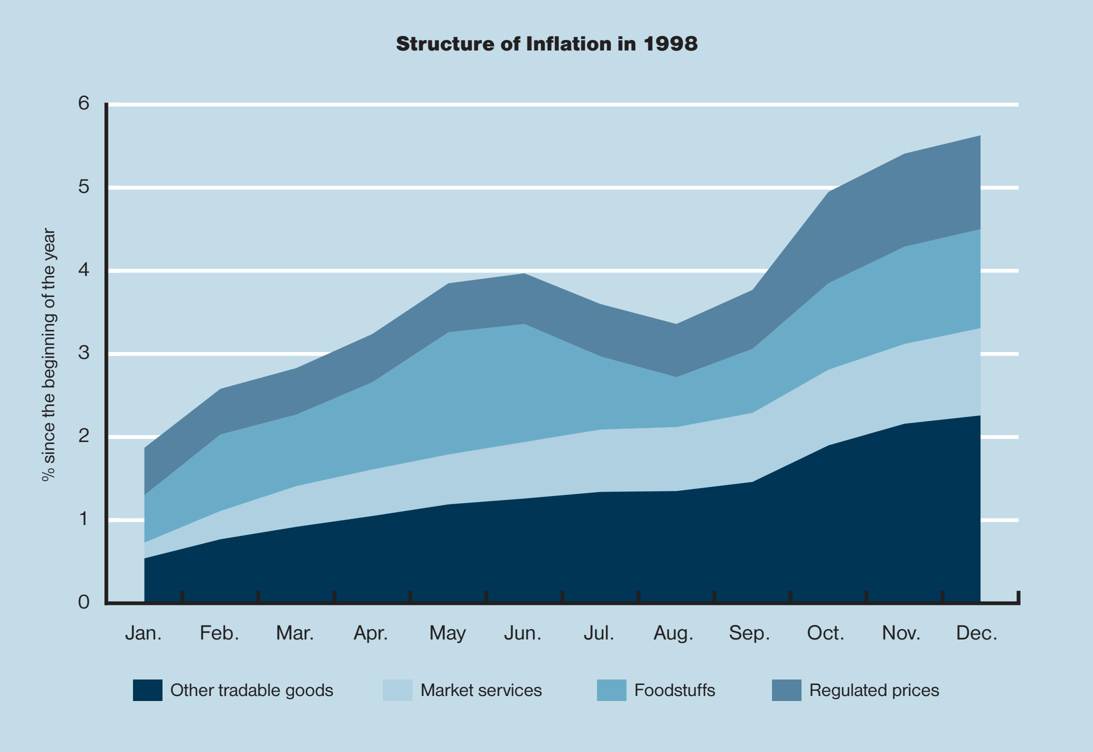
comparable with the figure for the same period a year earlier, when the consequences of the import surcharge introduced in July 1997 became apparent. Thus, the 12-month rate of price inflation in the sector of other tradable goods recorded only a moderate increase in October. As a result of a fall in the level of consumer demand and the stabilisation of the crown's exchange rate at the close of the year, the said prices continued to show a tendency to fall.

Regulated Prices

At the end of December 1998, the prices of services and commodities which were regulated during 1998, recorded an average year-on-year increase of 6.3%, which was 1.7 percentage points less than a year earlier. The contribution of the sector of regulated prices to the 12-month rate of inflation weakened in 1998 by 0.28 percentage points compared with 1997. In comparison with the other sectors of the consumer basket, regulated prices made the largest contribution to the slowdown in the rate of increase in consumer prices over the past year. Apart from a short-term favourable influence on inflation, the slowdown in price deregulation had an unfavourable effect on the functioning of the real economy and the course of price inflation. The slowdown in the rate of increase in regulated prices in comparison with non-regulated prices, changes the level of relative prices and disturbs the effective allocation of resources. Postponement of an adequate increase in regulated prices reduces the profits or increases the losses of producers. The subsequent fall in tax revenues, or pressure to increase subsidies, generates an increase in the deficit of the State budget with an unfavourable impact on price development. Last but not least, the postponement of price deregulation increases the fear of inflation amongst economic entities and thus acts against reduction in core inflation.

Prices of Market Services

Despite a fall of 1.75 percentage points, the prices of market services recorded the most rapid increase among the sectors under review (6.6% year-on-year). The structural causes of the accelerated rate of price increase in services (compared with tradable goods) may be divided into causes related to demand, supply, and causes arising from the characteristics of the market in the given sectors. The demand-related causes of the higher price inflation in services originate from the high income elasticity of services in comparison with the income elasticity of goods. The growth in revenues, which is related to the country's economic growth, causes a relatively higher increase in demand for services than in demand for goods, which exerts increased pressure on price advance in the service sector. Supply-related causes arise from the differences in labour productivity. Since the structure of the service sector offers limited possibilities for the growth of labour productivity, the general increase in wages exerts greater pressure on costs and prices than in the sector of tradable goods. The essential cause of the higher rate of structural price increase in services lies in the market conditions existing in the sector, characterised by an absence of foreign competition and a low level of domestic competition. The weak competition allows the providers of market services to transfer their increased costs into selling prices to a larger extent than producers in the tradable sector, which is exposed to increased competition from abroad. The rate of inflation in the sector of market services got closer to the figure for the sector of tradable goods, due to the lower pressure exerted by regulated prices on the costs of service providers and to the relative decline in demand for services, as a result of the slowdown in economic growth.



Producer Prices

In 1998, producer prices recorded a slowdown in dynamics. The most rapid increases were recorded in the prices of construction work and building materials. Agricultural prices showed even a decline on a year-on-year basis.

The prices of industrial producers recorded a seven-year minimum, and continued to show the lowest dynamics among producer prices (a year-on-year increase of 3.3%). Price development in this category was influenced by a slowdown in the rate of increase in the price of electricity, gas, heating, and hot water (by 3 points). The level of energy prices rose by an average of 4.7%. In mining and surface extraction, prices increased by only 0.5%. The prices of industrial products rose by 3.1%. The most rapid increase was recorded in the price of timber and wood products, which had risen by an average of 6.5% since the beginning of the year. Relatively high increases were recorded in the producer prices of foodstuffs and tobacco (5.8%), leather and leather products (5.8%), textile and textile products (5.3%). In the category 'electrical and optical instruments', producer prices fell by an average of 0.1%.

Development of consumer and producer prices in 1995 - 1998

Average index **Same period of last year = 100**	**1995**	**1996**	**1997**	**1998**
Consumer prices	109.9	105.8	106.1	106.7
Industrial producer prices	109.0	104.1	104.5	103.3
Construction prices	112.0	115.0	109.7	108.9
Building material prices	112.2	107.4	107.6	107.3
Agricultural prices	103.3	105.4	105.6	99.7

The slowdown in the pace of year-on-year increase in industrial producer prices was due mainly to the favourable trend in commodity prices (mainly petroleum) on the world market. This was reflected in the development of producer prices of petroleum refinery products (index: 100.6), chemicals (index: 100.0), and rubber and plastic goods (index: 101.9).

Despite the lasting highest increase among producer prices, the prices of construction work and building materials showed a tendency to slow. Since 1995, the rate of increase in construction prices has slowed by 3.1 points and the price of building materials by 4.9 points.

The purchase prices of agricultural products fell year-on-year by an average of 0.3%. This development was attributable to the prices of plant products, which fell year-on-year by an average of 6.2%. The excess of supply over demand, mainly on the domestic market for animal fee crops, contributed to the fall in prices (8% in the case of grain including corn). The price of potatoes and fruit recorded marked seasonal fluctuations.

The year-on-year increase in the prices of animal products (an average of 3.3%) significantly influenced the purchase prices of animals raised for meat, mainly beef cattle (3.9%). The average price of cow milk of class I. increased by 6.8 %. The fall in agricultural prices acted as a brake on the rise in the producer prices of foodstuffs.

GDP Deflator

The slowdown in the dynamics of consumer and producer prices affected the development of the GDP deflator, which increased by 5.1% (in 1997 by 6.6%) on a year-on-year basis. The most rapid increase was recorded in the deflator of final household consumption (6.4%), the lowest in the deflator of exports (3.9%).

1.2. Gross Domestic Product

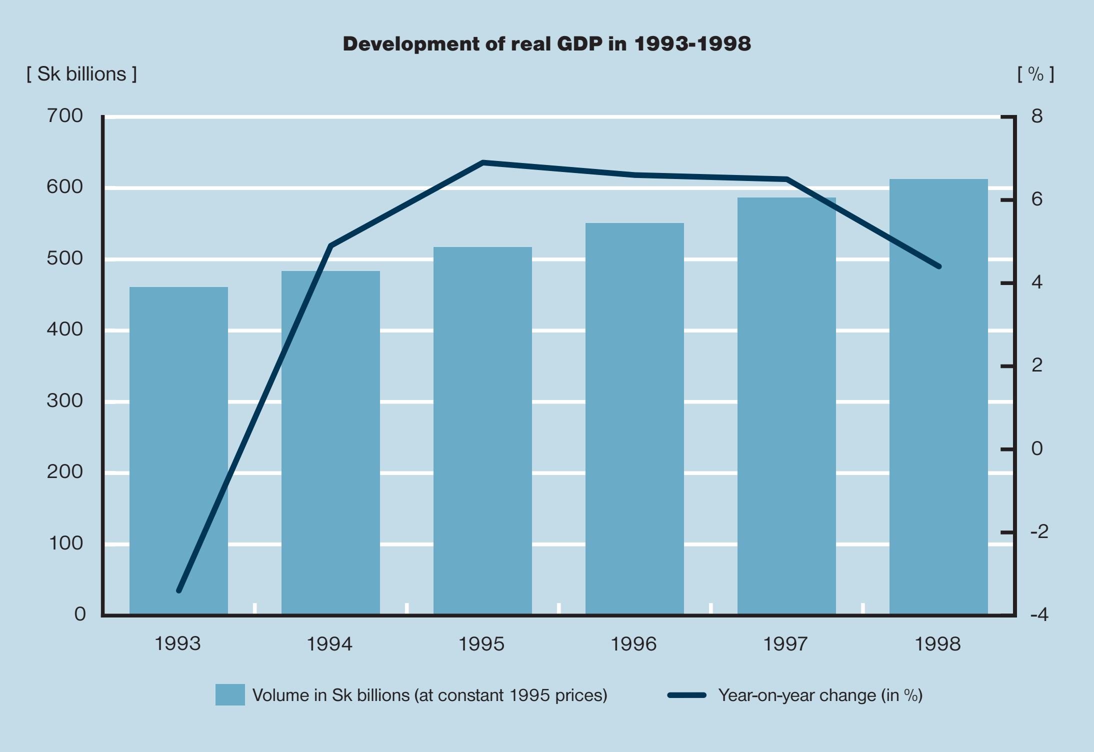
The 12-month rate of economic growth slowed to 4.4% in 1998, compared with the years 1995-1997, when the rate of year-on-year growth was above 6.0%. The slowdown was due mainly to the development of gross domestic product (GDP) during the 4th quarter, when it increased by only 0.5%. The creation of GDP was influenced mainly by the continued rise in the added value of market services, while its utilisation was affected by the level of domestic and foreign demand.

A long-term problem facing the Slovak economy is the imbalance between domestic demand and domestic supply, which is reflected in the growing deficit in the balance of trade and the balance of payments on current account. This disproportion persisted in 1998, when the volume of domestic demand exceeded the volume of domestic supply by 7.2%. The low

Development of aggregate demand and supply

	Sk billions [1/]			Share in %		
	1996	1997	1998	1996	1997	1998
Aggregate supply	931.5	1,002.2	1,067.8	100.0	100.0	100.0
of which: Domestic supply (GDP)	550.8	586.8	612.7	59.1	58.6	57.4
Foreign supply (imports of goods and services)	380.7	415.4	455.1	40.9	41.4	42.6
Aggregate demand	931.5	1,002.2	1,067.8	100.0	100.0	100.0
of which: Domestic demand	606.6	631.2	656.9	65.1	63.0	61.5
Foreign demand (exports of goods and services)	324.9	371.0	410.9	34.9	37.0	38.5

[1/] *Constant 1995 prices*



level of domestic supply (GDP creation) in comparison with that of domestic demand, led to growth in the imports of goods and services (foreign supply). The imports of goods and services reached a share of 42.6% in aggregate supply and was 1.2 percentage points higher than in the previous year. This was due partly to growth in foreign demand, depending on imported components and semi-finished products for further processing.

Aggregate Supply

The development of domestic supply (creation of gross domestic product) was characterised by data on gross production and intermediate consumption. Gross production increased at constant prices by 3.6% compared with 1997, while intermediate consumption grew by 2.9%. The creation of added value, resulting from the difference between gross production and intermediate consumption, increased year-on-year by 4.7%, representing a slowdown of 2.6 points compared with the figure for 1997. The slower rate of year-on-year growth in added

Creation of gross domestic product (Sk billions, constant 1995 prices)

	1996	1997	1998	index 1997/96	index 1998/97
Gross production	1,401.5	1,458.9	1,511.5	104.1	103.6
Intermediate consumption	885.3	904.8	931.4	102.2	102.9
Added value	516.2	554.1	580.1	107.3	104.7
Other [1/]	34.6	32.7	32.6	94.5	99.7
GDP	550.8	586.8	612.7	106.5	104.4

[1/] *Value added tax, tax on imports, input production of banking services* value, accompanied by a fall in the volume of indirect tax revenues, led to a slowdown in GDP creation.

A long-term negative phenomenon in the development of domestic supply was the inadequate appreciation in material, labour, and capital inputs in the production process. This is documented by the share of intermediate consumption in gross production, which reached 61.6% (compared with 62.0% in the previous year). The relatively high share of intermediate consumption in gross production (despite a moderate fall) is associated with the persistent material and energy intensive structure of GDP creation, which is a result of the existing structure of production, marked by a dominant share of production with a low added value and a small share of sophisticated products. Another unfavourable factor was the high share of industrial products dependent on imported components and semi-finished products for further processing.

The creation of GDP can also be defined by data on the development of the added value by sector. The rate of increase in added value at constant prices was in almost every sector slower than in the previous year. The most rapid increases were recorded in added values in market services (mainly in transport and trade) and in non-market services. In industry, the added value recorded only a slight increase, while in industrial production it increased at a faster rate than in the past year. The most significant year-on-year changes were recorded - due to reduction in the investment demand of the Government during the second half of the year - in construction, where the added value fell by 7.3%. The volume of added value also declined in agriculture.

Services

Despite the reduced rate of growth in GDP, the share of services in its creation increased year-on-year by 2 points, due to a rise in the added value of market (8.8%) and non-market services (6.3%).

Of market services, the largest contribution to GDP creation was made by trade, which achieved a year-on-year growth of 5%. Receipts from retail sales were 8.2% higher than in 1997 (at constant prices). The receipts increased mainly during the 2nd and 3rd quarters, when they reached 11.6% and 9.1% respectively, due to fears of currency devaluation. The most rapid increases were recorded in the sales of electronics, building materials, and fuels. A significant growth (more than 43% at constant

Breakdown of gross domestic product by sector (Sk billions, const. 1995 prices)

	1996	1997	1998	index 1997/96	index 1998/97
GDP	550.8	586.8	612.7	106.5	104.4
Agriculture	28.6	28.8	28.5	100.7	99.0
Industry	167.1	171.0	172.5	102.3	100.9
of which: industrial production	138.1	143.1	149.9	103.6	104.8
Construction	23.7	27.3	25.3	115.2	92.7
Market services	230.6	252.4	274.7	109.5	108.8
of which: Trade	120.9	126.7	133.0	104.8	105.0
Transport	33.6	33.8	36.6	100.6	108.3
Non-market services	66.2	74.6	79.3	112.7	106.3
Other [1/]	34.6	32.7	32.4	94.5	99.1

[1/] *Value added tax, tax on imports, input production of banking services* prices) was recorded in receipts from catering, including services. Receipts from hotel services increased year-on-year by 34.7% (at current prices), due to an increase in the number of visitors (by 21.8%), while the average length of visit remained unchanged. Travel agencies also recorded a year-on-year increase in receipts.

In 1998, transport organisations achieved a total income of Sk 25.2 billion, representing a year-on-year increase of 0.7%. A substantial part (more than 71%) of the income was realised in public freight transport. Of this income, 68.1% was generated by railway transport, where receipts increased year-on-year by 4.6%. Public passenger transport recorded a year-on-year decline of 4.6% in receipts, while the dominant part of this income (58%) came from road transport.

Receipts increased by more than 11% in the sector of postal and telecommunications services. In postal services, dynamic growth was recorded in Express Mail Services and in cash services, mainly deposit services for the Postal Bank (index: 140.4). The receipts of telecommunications were positively affected by the continued increase in the number of telephones. In 1998, there were 2.6 times more mobile phones in operation than in 1997.

Receipts from other market services increased by 4.9% (at constant prices) compared with the figure for 1997. The largest part (54.6%) was formed by proceeds from other commercial services, mainly architecture and advertising services. Within the scope of other market services, only real estate services recorded a year-on-year decline (8.6%).

Industry

Industrial output, expressed in terms of production of goods recorded its highest year-on-year increase in the past three years. The volume of production totalled Sk 611.3 billion (at current prices) and its rate of year-on-year growth accelerated by 2.3 points, to 5.0% (at constant prices).

Manufacturing recorded a year-on-year increase of 6.5% (at constant prices), due mainly to the manufacture of transport means, electrical and optical equipment, and other non-metal mineral products. The generation and distribution of electricity, gas, steam, and heating, continued to decline, due mainly to the mild weather at the end of the year and the resulting fall in power consumption. Another factor was the fall in the output of companies, which use a large amount of electricity, mainly in mining and chemical industry. Despite the relatively high dynamics of growth, eight sectors of industrial production (out of fourteen) failed to reach the level of 1997.

The results achieved by the sector were due mainly to growth in the output of the private sector (11.1% at constant prices), which led to an increase in its share of total output from 73.2% in 1997, to 77.8% in 1998.

In 1998, the volume of added value in industry increased by only 0.9% (at constant prices) compared with the 1997 figure. The slowdown in the rate of year-on-year growth reduced the share of the sector in GDP creation, which had been on the decrease since 1995 and reached 28.2% in the year 1998. The development of the added value was affected by the year-on-year increase in manufacturing, the extraction of non-mineral raw materials, and the continued decline in the generation and transmission of electricity, gas and water supply (25.5% at constant prices).

Construction

The trend of revival in construction, recorded in the years 1995-1997, slowed down over the course of 1998; the third and fourth quarters saw even a decline in production. As a result of non-payment for work on government projects, the level of investment activity fell and the construction of motorways and hydroelectric projects declined. The construction sector ran into recession: the volume of construction work started to decline in September and recorded a year-on-year fall of 3.5% at the end of 1998.

The year-on-year decline in construction was due mostly to a fall in the volume of production in the public sector (11.0% at const. prices). As a result, the share of this sector in total production decreased by 1.5 points, to 16.3%. Despite a fall in production (1.9% at const. prices), the private sector continued to dominate the output of the sector (its share increased to 83.7%).

The volume of construction work abroad continued to fall, by 27.7% compared with the previous year, reaching a share of only 4.9% of the total output of the sector. In the area of residence construction, the number of flats completed in 1998 exceeded the previous year's figure by 1,062, representing the highest increase since 1989.

Entrepreneurial entities operating in the construction sector created added values in the total amount of Sk 25.3 billion (at const. prices), representing a year-on-year fall of 7.3% (at const. prices), which reduced the share of the construction sector in GDP by 0.6 points (to 4.1%) in comparison with 1997.

Agriculture

In 1998, the share of agriculture in the creation of GDP reached 4.2%, representing a year-on-year decrease of 0.2 percentage points. Since 1995, the value of this indicator has fallen by 17.6%.

Proceeds from the sale of agricultural products at current prices reached Sk 34.6 billion, i.e. 2.5% less than a year earlier (proceeds from plant produce were 12.3% lower, whereas those from animal products were 3.1% higher). The upward trend in proceeds, which was recorded during the period 1995-1997, came to an end in 1998 due primarily to a surplus of grain crops on the domestic as well as foreign markets. As a result, a marked year-on-year fall was recorded in the purchase price of fodder crops (wheat: -9.4%; corn: -16.4%), since animal production was not able to absorb the entire supply. A negative factor in this respect was the shortage of resources for government intervention in the form of purchases (the low liquidity of the State Fund for Market Regulation) and restrictions in the area of licensing policy. The minimum guaranteed price of wheat for the food industry (Sk 4,200/ton) became economically unsustainable, due to increased imports of subsidised wheat from Hungary (the import was restricted by the Government of the SR). The unfavourable weather conditions caused a fall in the volume and quality of other crops, which normally have a positive effect on the level of proceeds (sugar beet, sunflower, etc.). Sales were also complicated by other factors such as the low level of contractual relations (especially in the area of grain crops), the non-observance of the Act on Agriculture (14-day supply credit), and the non-flexible adoption of the new method of financing pursuant to Act No. 144/1998 Z.z. on warehouse and commodity certificates (with effect from 1 June 1998). The fall in proceeds was due partly to the unsold produce which remained in the warehouses of primary producers.

In animal production, the decline in the sales of animals raised for meat for the processing industry (8.1% year-on-year) was offset by an increase in the purchase prices of beef cattle (3.9%), pigs (2.7%), where the expected high increase in prices (mainly at the close of the year) was held back by imports of pork with pro-export support. The absence of contractual relations between producers and manufacturers also created room for increased pork imports. However, the consumer price of meat and meat products had not fallen significantly by the end of the year.

The development of food prices had without doubt a negative effect on the purchase price of agriculture products, which fell year-on-year by an average of 0.3%, while prices in food processing rose by 3.4% and the consumer prices of foodstuffs and beverages by 5.8%. At the same time, the price of agricultural inputs increased by 4.1%. The most rapid increase in food prices (since 1995) was recorded in food processing (14.4%), which reflected the low utilisation of processing capacities.

The balance of foreign trade in the sector of agriculture and food processing resulted in a deficit of Sk 15.8 billion, which represented a year-on-year increase of Sk 1.6 billion and accounted for 19.5% of the total deficit countrywide. The increase in the deficit was due primarily to meat and meat products, including live animals, amounting to Sk 1.1 billion. Last year, the trade balance was significantly affected by developments on foreign markets (our pork market was affected by the crisis in Russian and Asian markets and by massive support of pork exports in EU countries) and in our common market with the CR within the customs union (more than 63% of the pork imports came from the CR). With regard to the structure of commodities, the balance of trade recorded a year-on-year improvement only in two items: grain crops and grain products, i.e. Sk 2.0 billion (exports grew by Sk +1.1 billion; imports fell by Sk -0.9 billion) and sugar and sugar products, i.e. Sk 0.4 billion (exports: Sk +0.5 billion; imports: Sk +0.1 billion). The increased exports aimed mainly at reducing the excessive stocks of grain and sugar on the domestic market. However, this did not suffice to compensate for the increase in the negative balance of trade in other agricultural commodities. While the competitiveness of the agricultural sector remained low, imports increased even in such areas of production for which we have suitable conditions (dairy and pastry goods, margarine, fats, oils, tobacco products, etc.). The protection of internal markets and producers within the limits of the rules laid down in international agreements (WTO, customs union with the CR and CEFTA) is still a hot subject in this sector.

The downward trend in the level of losses in the agricultural sector ceased in 1998, owing to the fact that yields (index: 93.8) fell at a faster rate than costs (index: 94.8). According to statistical data, the financial performance of the agricultural sector (companies with 20 or more employees and subsidised organisations) resulted in a loss of Sk 1.6 billion, i.e. Sk 0.6 billion more than a year earlier. Of the total number of monitored agricultural organisations (4,536), 2,673 (58.9%) ended the year with a loss. Problems with liquidity and payment discipline persisted. Liabilities were 2.2 times higher than receivables, which is a sign of persistent primary insolvency. Within the scope of modernisation and technological innovation, a negative development was a fall of 18.3% in the level of investment activity (investment in machinery and equipment fell by 33.1%). Bank loans in agriculture (including hunting and fishing) totalled Sk 15.5 billion, representing a year-on-year decline of Sk 2 billion (index: 88.6). The proportion of classified assets to total loans in agriculture amounted to Sk 11.3 billion (72.9%). The yearly limit for the volume of loans provided for the rediscounting of agricultural bills (set by the NBS at Sk 3.0 billion) had been utilised to only 48.5% (Sk 1,455 million) by 31 December 1998.

Development of labour productivity, wages and employment

According to data from the Statistical Office of the SR, the average nominal monthly wage of employees in the Slovak economy reached Sk 10,003 in 1998, representing a year-on-year increase of 9.6% in nominal terms, and 2.7% in real terms. In the same period of 1997, the average wage increased year-on-year by 13.1% and 6.6% respectively. These figures point to a marked year-on-year slowdown in the dynamics of real wages (by 3.9 points), to the lowest level since 1994. The rate of increase in real wages started to slow in 1997, which is documented by the following data:

Comparison by sector indicates that the most rapid increases in real wages were recorded in other public, social, and personal services (13.5%); electricity generation and transmission, gas and water supply (7.9%); and in trade and maintenance (6.5%). Real wages recorded year-on-year decreases in construction, raw material extraction, and education.

The development of average wages was also affected by the wage regulation and by the deteriorating economic situation of non-financial business entities. The marked fall in profits, accompanied by a growth in insolvency, caused serious financial difficulties for some companies, which paid reduced wages in an effort to maintain the level of employment and to avoid laying off employees. Some companies in difficulty paid no wages at all, and also tried to avoid dismissals. Hence, we may assume that these developments were reflected in the level and dynamics of the reported average wages.

Labour productivity in relation to GDP (at current prices) per employee increased year-on-year by 4.3% (compared with 6.9% a year earlier), exceeding the dynamics of real wages by 1.6 points (last year by 0.3 points). Wage development during the year was characterised by a faster growth in labour productivity than in wages during the first three quarters; during the last quarter, however, labour productivity grew by 0.4% and wages increased by 2.4%. The change in the relation between labour productivity and wages in the last quarter was due mainly to a marked year-on-year decline in GDP.

In industry, labour productivity grew at a faster rate than real wages, i.e. by 6.5 points (1997 saw a more rapid increase in wages). In construction, however, the level of real wages fell by 1.4% and labour productivity fell year-on-year by as much as 4.6%. The fall in labour

Development of wages **Index (same period of last year = 100)**

	1996				1997				1998			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Average monthly nominal wage	112.2	112.3	112.6	115.3	114.9	114.5	113.2	110.8	110.8	110.4	108.8	108.4
Average monthly real wage	105.8	105.7	107.2	109.5	108.4	107.7	106.8	104.3	103.3	102.8	102.4	102.4

Development of labour productivity, wages and employment in the national economy

		Index (same period of last year = 100)					
		1993	1994	1995	1996	1997	1998
Labour productivity of GDP	curr. p.	111.7	121.5	114.8	110.5	114.0	109.5
per employee	con.p.[1/]	96.3	106.8	104.6	105.7	106.9	104.3
Average monthly wage per	nom.	118.4	117.0	114.3	113.3	113.1	109.6
employee	real	96.4	103.2	104.0	107.1	106.6	102.7
Total number of employees		99.9	98.2	102.2	100.8	99.6	99.6

[1/] *Constant prices = average of 1995 = 100* productivity in construction started in the 2nd quarter and culminated in the 4th quarter, when it reached almost 20% on a year-on-year basis. This development was due mainly to a decline in the volume of construction during the last quarter (21% year-on-year).

In 1998, the average number of employees in the Slovak economy was 2,032.1 thousand, i.e. 0.4% less than a year earlier. Development during the past year was characterised by a year-on-year increase in employment in the first quarter (0.5%) and decreases in the remaining three quarters (0.5%; 0.4%; and 0.9%).

The development of employment was most affected by the continued decrease in the number of employees in industry (4.1%, i.e. almost 25 thousand) and agriculture and fishing (3.8%, i.e. 6.6 thousand). In construction, the number of employees increased year-on-year by 1.0%. The development of employment was most affected by the continued increase in the service sector, where the total number of employees increased year-on-year by 32.9 thousand. The level of employment fell only in transport, postal and telecommunications services (0.2%), public administration, defence, and compulsory social insurance (0.7%). The share of non-productive sectors in employment increased to 55.7%.

According to data from the National Labour Office, the absolute number of registered unemployed reached 428,209 at the end of December, i.e. 23.1% more than in the same period in 1997. The rate of unemployment, calculated from the number of disposable unemployed, stood at 15.6% at 31 December 1998. The course of unemployment during the year was characterised by an increase, which accelerated mainly during the 4th quarter, when 42,418 new unemployed were registered. In a breakdown by region, the largest increase in unemployment was recorded in the region of Eastern Slovakia (Prešov and Košice districts), where the rate of unemployment exceeded 20%. Unemployment above 20%, which is regarded as a critical level, was recorded in a total of 25 districts in December.

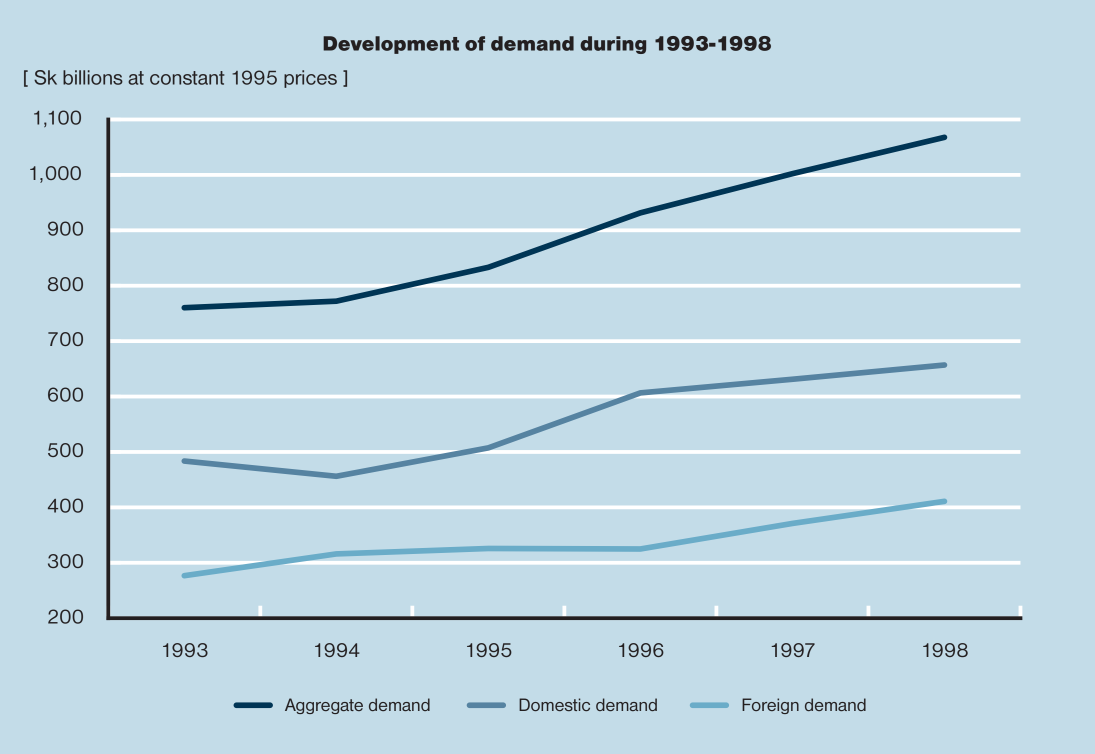
According to preliminary data from the National Labour Office, expenditure on unemployment benefits for registered unemployed increased year-on-year by 40.1% (to Sk 3.9 billion), and transfers for health, sickness, and pension insurance for job applicants receiving unemployment benefits by 30.7% (to Sk 1.6 billion). On the other hand, expenditure on promoting job creation fell by 24.2%, due to a shortage of resources.

Aggregate Demand

The growth in aggregate demand was due primarily to an increase in domestic demand (4.1% at constant prices), which was only 0.3 points less than the growth in GDP. The increase in aggregate demand was supported by the development of foreign demand (export of goods and services), which grew year-on-year by 10.8% at constant prices.

Net Foreign Demand

The development of net foreign demand (exports of goods and services less imports of goods and services) was affected by factors in both demand and supply. The increase in domestic demand, combined with inadequate domestic supply, exerted pressure upon the growth of imports, which caused a rapid increase in imports during the last quarter. The imports of goods and services increased by 15.6% (at current prices). Imports grew at a faster rate than exports, which increased by 15.1%. Thus, net exports of goods and services influenced the development of GDP with a negative value of Sk 80.1 billion (at current prices), which represented -11.2% of GDP



(-10.3% of GDP a year earlier). The deficit in net exports was associated with the shortfall in the trading of goods, while services reached a moderate surplus of revenues over expenditures.

A different course of development was recorded for constant prices. With regard to the slower growth in the deflator of export than in that of import, foreign demand increased at constant prices by 10.8%, while the imports of goods and services grew by 9.6%. As a result of this development, the negative balance of trade in goods and services fell year-on-year by Sk 0.2 billion, to Sk -44.2 billion (i.e. -7.2% of GDP).

Structure of GDP in terms of utilisation (Sk billions, const. 1995 prices)

	1996	1997	1998	index 1997/96	index 1998/97
Gross domestic product	550.8	586.8	612.7	106.5	104.4
Domestic demand	606.6	631.2	656.9	104.1	104.1
of which: Final consumption in total	400.2	417.2	431.8	104.2	103.5
Households	270.2	287.1	301.3	106.3	104.9
Non-profit institutions serving households	2.3	2.4	2.6	104.3	108.3
State administration	127.7	127.7	127.9	100.0	100.2
Gross capital formation	206.4	214.0	225.1	103.7	105.2
Gross fixed capital formation	197.8	226.4	251.2	114.5	111.0
Change in stocks	8.6	-12.4	-26.1	-	-
Net exports	-55.8	-44.4	-44.2	-	-
Exports of goods and services	324.9	371.0	410.9	114.2	110.8
Imports of goods and services	380.7	415.4	455.1	109.1	109.6

The quick growth in exports at constant prices had a stimulating effect on economic growth, which generated an increase in the country's export performance (share of the exports of goods and services in GDP) by 3.9 points compared with the figure for 1997, to 67.1% at constant prices. At the same time, the import intensity of GDP (share of the imports of goods and services in GDP) increased by 3.5 points, to 74.3%. This means that the dynamics of exports were ensured by sectors and/or entrepreneurial entities engaged in export intensive production.

Domestic Demand

One of the factors that increased the external and internal imbalance of the Slovak economy in 1998, was the growth in domestic demand, which affected mainly the formation of fixed capital and the final consumption of households. Final consumption in State administration recorded only a moderate increase.

In domestic demand, the most dynamic component was gross fixed capital formation, the dynamics of which slowed in comparison with the previous year, but still exceeded the rate of growth in GDP. The rate of investment (ratio of gross fixed investment to GDP) increased year-on-year by 2.4 points, to 41% at constant prices.

The rate of investment, expressed as the ratio of gross investment to GDP, reached 36.7% at constant prices. Due to a fall in the level of stocks (Sk 26.1 billion), it was lower than the rate of fixed investment. The increased drawing on stocks, mainly during the last quarter, was one of the factors that slowed the dynamics of economic growth.

The relatively high rate of investment (expressed in terms of gross as well as fixed investments), formed mostly by financially demanding investments in infrastructure, exceeded the level of domestic resources: only 80.4% of gross investment was covered from domestic savings. This fact and the insufficient (though higher than a year earlier) inflow of foreign capital for direct investment created a need for the coverage of the investment demand, in large measure, from foreign resources. The high volume of loans, drawn from abroad by business entities and the Government, caused a further increase in the level of external debt.

The development of investment demand was reflected in the structure of procured investments. A positive moment was the growth in investment in machinery and equipment (16.8% at current prices), which exceeded the growth in investment in building and construction (9.2%). The share of machinery and equipment in the

Development of investments and savings (in %)

	1996	1997	1998
Constant 1995 prices			
Savings rate [1/]	27.3	28.9	29.5
Rate of gross investment [2/]	37.5	36.5	36.7
Rate of fixed investment [3/]	35.9	38.6	41.0
Coverage of investments by savings [4/]	73.0	79.3	80.4
Current prices			
Savings rate [1/]	27.4	28.4	28.2
Rate of gross investment [2/]	39.4	38.7	39.4
Rate of fixed investment [3/]	36.9	38.6	40.8
Coverage of investments by savings [4/]	69.5	73.3	71.7

[1/] *Share of gross domestic savings in gross domestic product*
[2/] *Share of gross capital formation in gross domestic product*
[3/] *Share of gross fixed capital formation in gross domestic product*
[4/] *Share of gross domestic savings in gross investments*

total procured investment increased year-on-year by 2.1 points (to 51.6%), while that of investment in building and construction decreased. In the category ‘machinery and equipment’, the most significant increase was recorded in investment in transportation means, furniture and office equipment, machines, instruments, and equipment. While investment in conveyance carriers increased at a relatively fast rate during the whole year, the dynamics of growth in investment in machines, tools, and equipment slowed rapidly towards the end of the year.

With regard to structure of investments by sector, most capital was invested by non-financial organisations, which accounted for 70% of the total volume of investment. Organisations with 20 or more employees invested mainly in electricity generation, gas and water supply, transport, postal and telecommunications services, trade and business services. Investments in infrastructure, which have a long rate of return, accounted for more than 40% of the total volume of investments in the non-financial sector. In industrial production, most capital was invested in the processing of foodstuffs, beverages, tobacco goods, the production of coke, petroleum refinery products, and nuclear fuels, cellulose, paper, paper products, transport means, and metal working. Only 10.3% (28.2% in 1997) of these investments were covered from own-resources of non-financial organisations, due to a fall in their profits, which confirms the high dependence of the entrepreneurial sector on credit resources.

In the household sector and in financial organisations, the growth in investment only slightly exceeded the previous year’s figure. The most significant changes were recorded in the government sector, in connection with the implementation of infrastructure-related projects. The investment demand of the Government fell significantly during the second half of the year, thus the level of government spending fell by 13.9% and its share in total investment decreased by 3 points, to 9.7%.

The final consumption of State administration (expenditures on its operation and on services provided for society as a whole) increased at constant prices by 0.2%. Due to the relatively small weight of the said increase in total expenditure, the final consumption of State administration did not belong to the key factors of growth in GDP. The development of final consumption was influenced by an increase in average monthly wages in budgetary sectors (mainly public administration and defence), and by other non-investment expenditures (e.g. the costs of parliamentary elections).

The development of domestic demand was affected by both the level of investment demand and the growth in final household consumption, which absorbed almost 50% of GDP in the long run. In 1998, domestic demand continued to grow at a relatively fast rate (11.7% at current prices; 4.9% at constant prices), which exceeded the rate of GDP growth. At the same time, the final consumption of households followed an uneven course of development. During the first half of the year, its level increased by 3.2%, and during the second half by 6.7%. This development was due partly to fears of currency devaluation during the run-up to parliamentary elections and during the period that followed change in the exchange rate regime. In contrast with the previous year, when the growth in private consumption was due largely to a relatively rapid increase in wages, the level of private consumption rose in 1998 to the detriment of household savings. This is documented by data on development of average monthly wages, the rate of household savings, and household deposits.

According to preliminary data from the Slovak Statistical Office, the current income of households increased year-on-year by 7.7% and current expenditure by 12.5%. Compared with 1997, the rate of growth in income slowed by 3.7 points, while the dynamics of growth in expenditure increased by 2.9 points. Development during 1998 was characterised by a sustained surplus of expenditure over income, whereas the previous year saw an opposite trend.

The slowdown in the rate of growth in income was due mostly to a reduction in the dynamics of wages and salaries (3.7 points) and a fall in the level of mixed income from employment and business (6.3%; while the dynamics slowed by 20 points). Social benefits increased year-on-year by 12.8%. In income from social benefits, the highest increases were recorded in income from unemployment benefits (40%) and other social security benefits (20.3%). Despite a marked increase in income from property and business (interest, dividends, income from rented property, land, etc.) and from accident insurance policies - a total of 6.7%, they had no marked influence on the level of income.

Current expenditures were dominated by unrequited current transfers (88.9%), including mainly personal income taxes and contributions to funds (health insurance, unemployment and pension funds). These transfers increased year-on-year by 8.3%, representing a slowdown of 2.4 points. The highest dynamics were recorded in accident insurance transactions, which grew year-on-year by 91.8%, increasing their share in current expenditures from 4.7% to 7.9%. The increased interest in insurance products resulted from the growing uncertainty among the population in the area of social security, induced by the rising unemployment, price inflation, and other consequences of the worsening economic situation.

After the payment of all current expenditures from current incomes, households had a gross

Income and expenditure of household (at current prices)

	1997		1998	
	Sk billions	Index p.y. = 100	Sk billions	Index p.y. = 100
Compensation of employees	302.2	111.5	325.8	107.8
of which: Gross wages and salaries	233.2	112.3	252.4	108.2
Gross operating surplus	100.5	113.2	94.3	93.7
Incomes from property and business	22.9	107.5	31.3	136.9
Accident insurance transactions	4.5	100.0	6.7	150.4
Unrequited current transfers received	98.3	110.9	111.1	113.1
of which: Pensions	52.5	-	58.5	111.4
Sickness insurance benefits	22.7	-	24.8	109.1
Unemployment benefits	2.8	-	3.9	140.1
Other social security benefits	10.5	-	12.6	120.3
Social security payments in total	88.5	111.7	99.8	112.7
Current income in total	528.3	111.4	569.2	107.7
Income from property and business	4.3	78.2	5.0	117.2
Accident insurance transactions	6.7	117.5	12.9	191.8
Unrequited current transfers paid	132.9	110.7	144.0	108.3
of which: Personal income tax to SB [3/]	25.6	125.5	29.4	114.5
Contributions to funds [1/]	93.0	-	100.3	107.8
Current expenditure in total	144.0	109.6	162.0	112.5
Gross disposable income	384.4	112.0	407.2	105.9
Final household consumption	322.3	112.7	360.1	111.7
Gross savings of households	62.1	108.9	47.1	75.9
Rate of gross savings [2/]	16.2	-	11.6	-

[1/] Social contributions paid by employers, employees, self-employed and free-lance persons, non-residents and others.
[2/] Gross savings rate = gross savings of households / gross disposable income.
[3/] SB = State budget

disposable income of Sk 407.2 billion, which was 5.9% more than in the previous year. Of this amount, 88.4% was used for final consumption and the rest (Sk 47.1 billion) was converted into gross household savings. Apart from cash, deposits, and securities, the gross savings of households included household expenditures on investment from private resources, including investment for the development of small businesses and for the purchase or construction of family houses. In comparison with 1997, gross savings declined by 24.1% and dynamics slowed by 33 points.

It may be assumed that the decline in gross savings and growth in final household consumption were closely connected with the slower dynamics of current incomes, mainly wages, salaries, and bonuses, and with fears of currency devaluation, the change in the exchange rate regime, and the orientation of final consumption to long-term consumables. This is indicated by the fact that the sharpest decline in gross savings (more than 50%) took place during the 3rd quarter, when final household consumption recorded the largest increase.

Financial Results of Organisations

In 1998, the financial results of business organisations were rather unfavourable. Financial and non-financial organisations achieved a total profit (before tax) of Sk 31.2 billion (at current prices), i.e. less than a half of the figure for 1997. A marked fall in profits was recorded mainly in non-financial organisations (56.4%), which earned a total profit of Sk 22.8 billion. Financial organisations reported a 26.9% fall in profits, of which insurance companies accounted for 79.7% compared with the previous year.

In the non-financial sector, the sharpest decline in profits was recorded in industry (index 42.2), while the individual sectors of industrial production suffered a loss of Sk 5.2 billion. Construction recorded a profit of Sk 3.2 billion, representing a decline of 29.9% compared with the previous year. Wholesale and retail trade, repair of motor vehicles, motorcycles, and consumer goods generated a profit of Sk 10.1 billion, which represented only 49.7% of last year's figure. Hotels and restaurants, transport, warehousing, postal and telecommunications services also recorded a loss in 1998. Of 7,417 non-financial organisations with 20 or more employees, only 4,208 achieved a positive result (56.7%), the remaining 3,208 ended the year with a loss (38% higher than in 1997). At the end of 1997, 3,056 (47.9%) non-financial organisations achieved a profit, out of a total of 6,381. The remaining 3,325 ended the year with a loss of Sk 58.2 billion, representing an increase of 10% since the beginning of 1996.

According to data from the Ministry of Economy, industrial companies with 20 or more employees generated a profit of Sk 4.4 billion (before tax), i.e. Sk 11.1 billion (71.7%) less than in 1997. During the last few years, these organisations have recorded a permanent fall in profits; the sharpest fall took place in the 4th quarter of 1998, when the industry as a whole became a loss-making sector (with a loss of Sk 4 billion). This result was due partly to manufacturing, especially manufacture of machinery and equipment, which recorded the highest loss in absolute terms (Sk -10.3 billion), representing an increase of 36% compared with 1997. The most serious loss was recorded in the manufacture of machines for special purposes, accounting for 66.7% of the total loss in the given sector. Other loss-making sectors were production of metals (with a loss of Sk -2.6 billion, index: 415.1) and leather processing and shoe making (with a loss of Sk 2.1 billion, index: 180.1).

The fall in profits and growth in expenditures in 1998 had a negative influence on other economic indicators as well. In non-financial organisations, the profit to cost ratio reached 1.2%, representing a fall of 1.9 percentage points compared with 1997, while the share of expenditure reached 98.8 haliers per Sk 1 of income.

These indicators were even worse in industry (organisations with 20 or more employees). The profit to cost ratio in industry reached 0.6%, i.e. 1.6 percentage points less than a year earlier. The value ranged from 10.5% in the generation and distribution of electricity, gas, steam, and hot water supply, to -26.3% in tanning and leather processing, bag, saddle, and shoe making. In industry, the share of expenditure per Sk 1 of income amounted to 99.4 haliers. The only profitable sector in this category was the generation and distribution of electricity, gas, steam, and heating, which generated the highest profit (Sk 12.2 billion), which, however, represented a year-on-year decline of 23.4%. Other profitable sectors were food processing, beverage production (profit: Sk 1.3 billion; index: 107.0) and the production of pulp, paper, and paper products (profit: Sk 1.1 billion; index: 106.7).

The financial results of industrial organisations with 20 or more employees led to growth in insolvency. At 31 December 1998, the debts of these organisations amounted to Sk 76.7 billion, representing a year-on-year increase of Sk 11.8 billion. They exceeded the volume of outstanding liabilities, which increased year-on-year by Sk 8.9 billion, to Sk 70.4 billion.

At the end of December 1998, non-financial organisations with 20 or more employees recorded debts in the total amount of Sk 135.7 billion, representing an increase of 17.5% compared with the figure for 1997.

2. BALANCE OF PAYMENTS

2.1. Current Account

In 1998, one of the most serious problems of the Slovak economy was the persistent deficit in the balance of payments current account, which had been, for the last three years, at the level of 10% of GDP, and which is generally regarded as unsustainable in the long run. After two years of favourable development, the balance of payments on current account began to deteriorate at a fast rate in 1996, which had a negative effect on the country’s economic development. According to the IMF, the critical size of the current account deficit is 3% to 5%, depending on the inflow of foreign capital in the form of direct investment. If the deficit, financed in large part from foreign loans, is permanently above this limit, unsustainable trends may start in the economy, with negative effects on its further development.

The negative balance of foreign trade, which has been a permanent factor negatively affecting the country's balance of payments since 1996, showed a tendency to grow over this period and caused the external imbalance in the economy, expressed in terms of the current account deficit, to increase year by year. The deficit in the current account reached Sk 72.7 billion (i.e. 10.1% of GDP), representing a year-on-year increase of Sk 8.6 billion.

This situation resulted from various factors, such as the chronically bad structure of the economy, power intensive production, inefficient marketing, etc. The Slovak economy is oriented to primary production, where inputs are inadequately valued, which causes problems in its effective integration into external economic relations.

According to the estimates of the Slovak Statistical Office, economic growth in Slovakia continued to be driven, despite a slowdown during the last quarter of 1998, by the expansion of domestic demand, the coverage of which required an increase in the volume of imports, due to the current structure of the national economy. A proof of this is the fact that the rate of real growth in imports exceeded that of GDP, while the imports of goods and services as a share of GDP increased year-on-year by 3.8% (from 71.0% in 1997 to 74.8% in 1998).

In 1998, according to preliminary data from the Slovak Statistical Office, Slovakia imported goods in the total amount of Sk 456.7 billion. The dynamics of imports showed a visible increase: the rate of year-on-year growth in imports reached 16.4%. The growth in imports was due to the dynamics of demand for investment, material inputs for production and, last but not least, for consumer goods. The growth in imports was significantly influenced by the increasing number of companies with foreign capital participation, since their investment, distribution and trading activities are dependent on the imports of goods for investment purposes, components, and finished consumer goods.

The growing importance of trade in international business gave rise to changes in the structure of imports by country, which were reflected mainly in the increasing share of imports from Germany. The share of Germany in total imports increased by 6.1%, to 25.9%. On the other hand, the share of imports from the Czech Republic recorded another decrease (from 21.4% in 1997 to 18.5% in 1998), which was accompanied by a decline in imports from the Russian Federation in 1998 (from 13.5% to 9.9%).

The classification of imported commodities according to economic destination indicates that the key commodities in Slovak imports in 1998 were again machines and components, motor vehicles, non-mineral fuels, and electronic equipment. With the exception of non-mineral fuels, the above groups made a significant contribution to the year-on-year growth in imports (64.3%).

The year-on-year increase in imports of motor vehicles and other means of transport took place mainly in the import of components, elements, accessories and bodies for motor vehicles, the total volume of which increased by Sk 12.5 billion and was in large part connected with the growth in car exports.

According to the individual commodities included in the four-digit code of the harmonised system, the increase in imports of machinery and equipment took place in the following categories: rotary internal combustion engines, transmission shafts, air pumps, fuel cells, and various components and accessories for such machines. On the other hand, imports of machines for the individual sectors of industry, agriculture, and construction, showed a downward trend in most cases.

The year-on-year increase in imports in the category ‘electrical appliances, audio and video equipment’ amounted to Sk 10.5 billion, while, according to NBS estimates, almost a half of the said increase was generated by the import of products that fall into the category of consumer goods (electrical instruments, lighting installations, water heaters, gramophone records, magnetic tapes for sound recording, television sets, etc.).

The increase in imports of consumer goods, which took place in electronics, furniture, clothes, books, toys, sportswear and sports equipment, was also influenced by the gradual reduction in the import surcharge, which was finally cancelled with effect from 1 October 1998. The growth in the imports of consumer goods was due partly to increased purchases in September, which were motivated by fears of currency devaluation, which led to the replenishment of stocks during the following months.

In 1998, Slovakia exported goods in the total amount of Sk 375.9 billion, representing a year-on-year increase of 16.0%. The country's export trade continued to be oriented towards the

European Union. In comparison with 1997, Slovak exports to EU countries increased by 37.6%, to Sk 209.9 billion (i.e. roughly 56%). In terms of structure by country, the most of exports went to Germany (Sk 108.7 billion, representing a year-on-year increase of Sk 31.9 billion), mainly in the form of passenger cars, spare parts, and components (more than 60%). On the other hand, the volume of exports to the Czech Republic recorded a decline, which was spread over the entire range of export commodities, in smaller amounts.

The most significant change in the structure of Slovak exports was an increase in the category 'motor vehicles'. In 1998, the Slovak Republic exported motor vehicles in the amount of Sk 70.9 billion, which represented a 100% increase in comparison with 1997. An even more significant change was recorded in the sub-group 'motor vehicles for passenger transport', the exports of which increased from Sk 16.3 billion in 1997, to Sk 53.1 billion in 1998.

Despite the shortage of foreign capital in Slovakia, foreign direct investment has, with regard to its export orientation, had a visible effect on the economy, which is reflected in the dynamically growing exports of products that are closely connected with foreign investments, over the last few months. Apart from passenger cars, the increase in exports took place in electrical equipment, instruments and appliances, office machines, and equipment for data processing, telecommunications, and audio and video equipment.

A key problem facing the Slovak economy in 1998 was the gradual decline in the export of steel and other ferrous and non-ferrous metals, caused primarily by recession on the world markets. These commodities are very sensitive to price fluctuations and developments on the export markets, where cheap competition is on the increase, not only on the part of post-communist countries, but that of Southeast Asia as well. The problem is that these commodities represent an important part of Slovak exports, and that a huge amount of borrowed funds was invested in their production, which, it was hoped, would be reflected in the growth of exports.

Over the last few years, the imbalance on the current account of the balance of payments has been increased by trade in services, the total balance of which suffered a further decline of Sk 1.8 billion (from Sk 2.5 billion in 1997, to Sk 0.7 billion in 1998). Transport and foreign tourism continued to have a favourable effect on the positive balance of services, but their joint contribution to Slovakia's foreign exchange economy fell year-on-year by more than Sk 5 billion.

The fall in the balance of transport was a result of reduced revenues from freight transport, which recorded a marked increase, combined with increased expenditures in the category 'other transport services' in 1997. These expenditures were associated with services rendered at border crossings, such as the handling, storage, packaging, and insurance of cargoes, etc. Of the total year-on-year increase in the costs of transport services, the aforementioned services - which were connected mainly with the growth in the imports of goods - accounted for more than 85%.

A constant problem of the current account in the past few years has been the diminishing balance of tourism, which is due primarily to a fall in foreign exchange revenues. Tourism made close on a zero contribution (revenues - expenditures) to the creation of GDP, despite the fact that tourism belongs (apart from charges for the transit of gas and oil) to those components of the current account which ought, owing to their potential possibilities, to bring increased revenues into foreign exchange economy of Slovakia.

Within the individual items of the services balance, the largest deficit was recorded in other services (Sk 11.2 billion), which include the entire spectrum of trade and non-trade services. Though the deficit of other services decreased by more than Sk 3 billion in 1998, the structures and balances of individual services indicate that there is not enough room in the Slovak economy for the expansion of such services. In 1998, the proportion of exported services to total exports of goods and services reached 17.7%, while the share of other services (excluding transport and tourism) amounted to only 8.0%.

More than 40% of the deficit in other services was produced in trade services, which include receipts and payments for expert opinions, fairs, exhibitions of commercial nature, etc. This group of services, which is to foster the growth in foreign trade turnover is the most significant in terms of volume; in 1998, the share of this group of receipts from other services reached 14.8% and of payments 20.7%.

The competitiveness of Slovak companies in the area of services, particularly on the domestic market, is connected with the whole range of other services, where payments have exceeded receipts over the last few years. These services included legal, technical, accounting, consulting, computer engineering, licensing, and advertising services, etc., where the range and quality of services are not yet able to compete with services offered abroad. In the last few years, the above sectors have showed high dynamics of global growth and represented a key component in the export of services in countries such as Belgium, Switzerland, Holland, France, and others.

Extensive borrowing from abroad in the last few years has generated a gradual rise in the level of debt servicing, thereby causing a yearly increase in the income-balance deficit (Sk 5.5 billion). As a result of the rise in the level of debt, 1998 saw a further increase in the amount of interest payable by companies and banks on borrowings from abroad, which was partly offset by receipts of interest on NBS reserves and on deposits held by commercial banks abroad.

With regard to the individual items of the current account, the most significant contribution to the foreign exchange economy of Slovakia was made by current transfers, which generated a surplus of Sk 12.9 billion. Money transfers to the Slovak Republic from abroad were made predominantly as private transfers in the form of legacies, gifts, pensions, benefits, etc.

2.2. Capital and Financial Account

A crucial question in 1998 was the size of the current account deficit and its financing. In contrast with the previous years, when the capital and financial account exceeded the deficit in the current account, the inflow of foreign capital in 1998 did not suffice to fully cover the deficit in the current account; it had to be financed partly from the foreign exchange reserves of the Central Bank.

The capital and financial account resulted in a surplus of Sk 63.8 billion, i.e. US$ 1.8 billion. In considering the method of financing the deficit in the current account, it is important to take into account the fact that the net inflow of long-term capital increased year-on-year by Sk 30.4 billion and sufficed to cover 98% of the current account deficit. A positive trend was the growth in coverage of the current account deficit by the balance of foreign direct investments, from 4.4% in 1997 to 21% in 1998.

In 1998, other long-term capital remained the most important source of foreign financing. However, the structure of this source underwent some changes. While the previous years saw a shift from official loans to corporate loans, the year 1998 witnessed drawing on official loans in the total amount of Sk 37.5 billion, exceeding the volume of borrowings in the corporate sector by Sk 35.8 billion. The access of Slovak companies to hard currency resources abroad was hampered by the lowering of the country's credit rating, due to economic and political problems. Difficulties in obtaining new corporate loans arose mainly during the last quarter, when the volume of financial credits increased by only Sk 6.9 billion, representing a decline of 44% on a year-on-year basis.

The allocation of corporate loans within the national economy remained virtually unchanged: over half the loans was utilised in the sectors of electricity generation and transmission, gas and water supply, transport and communications. The utilisation of funds in the individual sectors of industrial production also remained unchanged: they absorbed only 26% of the total volume of credit. The loans were used in the production of coke and petroleum refinery products, metal products and chemicals.

The utilisation of foreign resources for investment purposes in the given sectors not only strengthened the existing structure of industry (the dominant share being primary production), but increased the average rate of return on investment projects as well.

The increased drawing of long-term financial credits, which has been ongoing since 1995, contributed to the rise in the level of Slovakia's external debt and increased demands on debt servicing. During the period under review, the situation was also complicated by the exchange rate risk arising from fluctuations in the values of USD and DEM, and SKK in relation to foreign currencies, which may increase the costs of these loans to a significant extent. The Slovak economy is capital intensive and there is a time gap between the maturity of the loans and the rate of return on investments, which leads to problems in the repayment of borrowings, which began to be manifested as early as 1998.

In the light of the above, it will be inevitable for the Slovak economy to intensify the acquisition of own-capital. The increased inflow of foreign capital in the form of direct investment, or the acquisition of foreign funds through the capital market, should also become a source of finance for domestic investment. The effective allocation of these resources should create conditions for the economy to generate technological progress, which will increase its competitiveness.

The year 1998 saw an increased inflow of foreign capital into the Slovak economy in the form of direct investment. An inflow of Sk 19.9 billion resulted from an increase in direct investment in the form of capital participation in companies, banks, and branches of foreign banks operating in the SR (Sk 13.6 billion) and other capital (balance of trade and financial credits allocated to enterprises with foreign capital participation), amounting to Sk 6.3 billion.

Although the volume of capital participation of foreign investors above 10% in the corporate sector increased in 1998 by Sk 12.2 billion, it is too early to speak a new trend of sustained interest in the Slovak economy. Over the course of the year, the interest of foreign investors was concentrated mainly on two sectors: manufacture of metal products and the processing of food and beverages, which absorbed almost 60% of the total inflow of capital. Apart from the persistent interest in trade, which absorbed 13.4% of corporate direct investments, the remaining part was spread in very small amounts over a large number of economic entities. In most cases, the investment was used to increase the volume of an existing capital stocks.

In 1998, the structure of investments by the country of origin changed slightly in comparison with the previous year. Most foreign capital came from the Netherlands (26%), the USA (20%), and Great Britain (20%), ahead of such traditional investors as Germany (12%) and Austria (7%).

Although the balance of short-term capital showed no significant variations during 1998, its individual segments recorded marked changes on both sides of the balance sheet. In the structure of short-term capital, the most significant change was recorded in the short-term liabilities of commercial banks. This development was to a great extent influenced by short-term deposits by foreign banks, which recorded marked changes over the course of 1998. While the volume of short-term foreign currency deposits held by non-residents with banks operating in the SR increased by almost Sk 25 billion during the period from January to August, the volume of these deposits declined by Sk 35.2 billion during the months of September to December.

The increase and/or decrease in deposits held by non-residents with Slovak banks was due primarily to the introduction of a monetary-policy instrument, i.e. the NBS directive pertaining to the foreign exchange positions of banks and branches of foreign banks for monetary purposes, as a result of which the development of short-term liabilities during the given months was accompanied by roughly the same development in short-term assets.

The situation became more complex in September, when the development of macroeconomic indicators - influenced largely by the run-up to parliamentary elections and the widening deficit in the current account - led to an outflow of short-term capital. Indications that the chances of maintaining the crown's exchange rate within the fluctuation band were diminishing, led to increased turbulence on the foreign exchange market. On the part of foreign entities, short-term deposits held by non-residents at banks operating in the SR declined by Sk 24.3 billion in September, and for domestic entities, increased conversion was reported from crown deposits to foreign currency deposits.

The inflow of funds into the capital and financial account failed to cover the deficit in the current account, which led to a fall in the level of NBS foreign exchange reserves. The annual balance of payments ended the year with a deficit (for the first time in Slovak history), when the foreign exchange reserves of the Central Bank (after the exclusion of valuation changes) fell by Sk 19.5 billion (i.e. US$ 549.9 million).

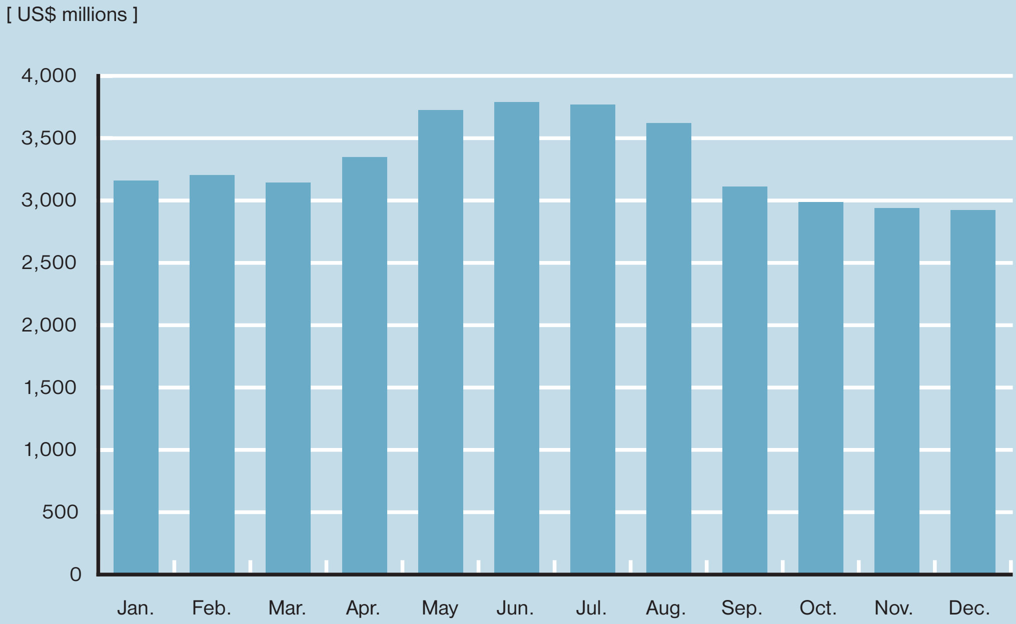
2.3. Development of Foreign Exchange Reserves

At the end of 1998, the foreign exchange reserves of the NBS amounted to US$ 2,923.3 million, representing a decline of US$ 361.6 million compared with the figure for the end of December 1997. Over the course of the year, the total foreign exchange reserves of the NBS were influenced by numerous factors. A key factor that positively influenced revenues was government borrowing from foreign financial institutions. During this period, the expenditure side was affected by the negative balance of transactions in NBS foreign exchange fixing and debt service payments effected by the Government and the NBS. During the period under review, the level of NBS foreign exchange reserves was also affected by the development of conversion rates between fully convertible currencies on world financial markets. The negative balance of revenues and expenditures (US$ -549.9 million) was partly offset by positive exchange rate differentials (US$ 188.3 million), which reflected the actual exchange rate of the D-mark against the US dollar on international financial markets.

The revenue side of foreign exchange reserves was determined by the following factors:
- the drawing of government loans from international financial institutions in the amount of US$ 1,223.4 million (84% of the total revenue);
- income from deposits and securities in the amount of US$ 107.5 million;
- central bank borrowings from international financial institutions (EXIM Bank of Japan, EIB) in the amount of US$ 61.3 million;
- increase in the volume of deposits received (US$ 16.3 million);
- other receipts of the NBS in the amount of US$ 38.9 million.

The expenditure side of foreign exchange reserves was affected by:
- the negative balance of NBS foreign exchange fixing amounting to US$ 992.1 million (50% of total expenditure);

Development of NBS foreign exchange reserves in 1998



- debt service payments by the Government in the amount of US$ 622.6 million, of which US$ 381.6 million was used for the repayment of principal on a short-term 'bridging' government loan;
- debt service payments by the NBS in the amount of US$ 248.0 million, while the repayments of principal on bonds issued by the Central Bank amounted to US$ 110.6 million;
- other expenditures of the NBS totalling US$ 142.9 million, incurred mostly in connection with the realisation of cross-border payments for NBS clients.

At the end of 1998, the foreign exchange reserves of the NBS were 2.3 times greater than the average volume of monthly imports of goods and services to Slovakia in 1998, which represented a decline in coverage by nearly a whole month in comparison with the previous year. Apart from the fall in the level of foreign exchange reserves in 1998, the decline was due to an increase in the average volume of monthly imports of goods and services (23.2% in US$) compared with the previous year.

The foreign exchange reserves of commercial banks may be regarded as short-term foreign exchange assets of commercial banks vis-a-vis non-residents. At the end of 1997, the volume of such assets stood at US$ 3,203.6 million. At 31 December 1998, commercial banks held foreign exchange reserves in the total amount of US$ 3,034.5 million, representing a year-on-year fall of US$ 169.1 million. The total volume of foreign exchange reserves in the banking sector including the NBS stood at US$ 6,488.5 million at the beginning of January, and at US$ 5,957.8 million at the end of December.

2.4. The External Debt of Slovakia and Its Servicing by the NBS and the Government

At 31 December 1998, the total gross external debt of the Slovak Republic reached a level of US$ 11.902 billion. At the end of December, the official debt of the Government and the NBS amounted to US$ 2.407 billion. The indebtedness of the commercial sector, i.e. commercial banks

Foreign exchange liabilities of the commercial sector (US$ millions)

	31 December 1997	31 December 1998
Total foreign exchange liabilities of the commercial sector	8,021.5	9,391.9
Commercial banks	2,905.5	2,665.6
Entrepreneurial entities	5,116.0	6,625.7
Medium and long-term foreign exchange liabilities	3,917.4	4,786.7
Commercial banks	680.2	602.4
Entrepreneurial entities	3,237.2	4,184.3
Short-term liabilities	4,104.1	4,604.6
Commercial banks	2,225.3	2,063.2
Entrepreneurial entities	1,878.8	2,541.4

and entrepreneurial entities, stood at US$ 9.391 billion on the last day of the year. The debt owed by municipalities amounted to US$ 56 million and the foreign debt of government agencies (a loan for the State Road Fund) totalled US$ 47 million at the close of 1998.

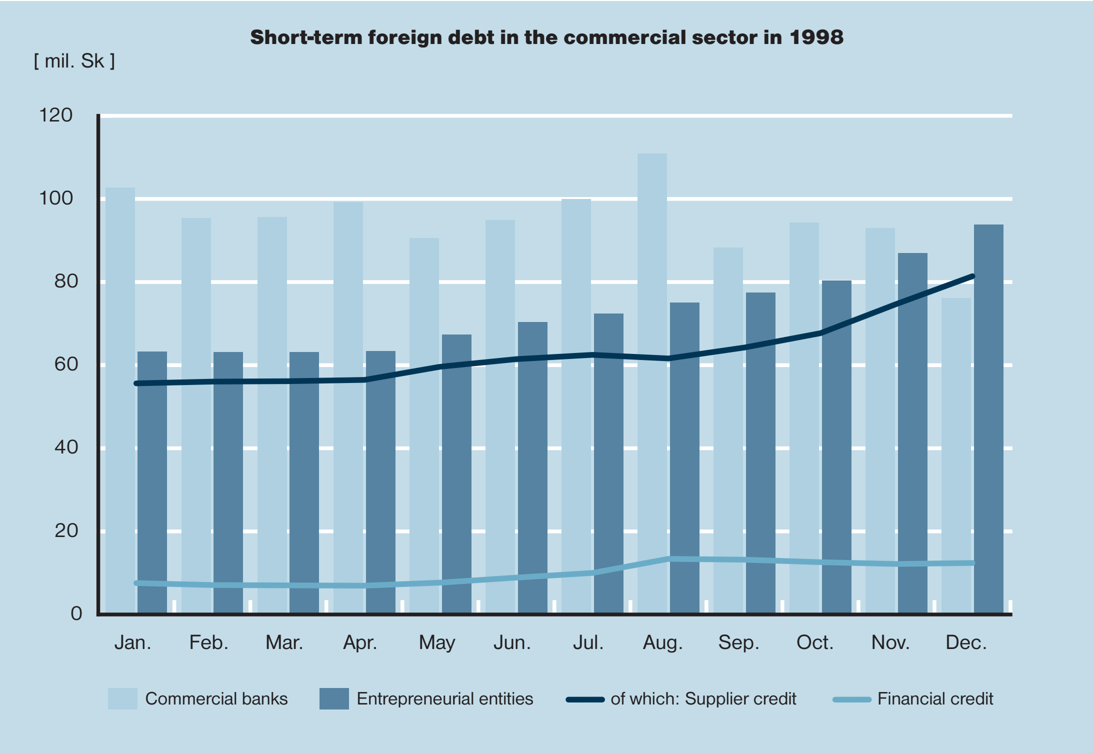
With regard to the structure of the gross external debt, total gross medium and long-term liabilities accounted for US$ 7.297 billion. At the end of December, the volume of short-term debt totalled US$ 4.605 billion. The share of the total gross external debt per capita reached US$ 2,209. During 1998, Slovakia's per-capita external debt increased by US$ 342, representing an increase of US$ 1,647 (393%) since 1 January 1993. The proportion of total short-term debt to the country's total gross external debt came to 38.69%.

In 1998, the equivalent of US$ 489 million was repaid by the NBS to foreign creditors in connection with debt servicing. Of this amount, repayments of principle accounted for the equivalent of US$ 383.5 million and interest (coupon) payments for US$ 105.5 million.

By the end of 1998, Slovakia's total external debt had increased by the equivalent of US$ 2 billion, compared with the figure for end-1997. The most significant rise in the level of gross external debt was reported in October 1998, when the country's total gross external debt reached a level of US$ 12.185 billion. In August, the statistical level of the external debt (US$ 12 billion) was exceeded for the first time (US$ 12.184 billion). In 1998, the total increase in the level of external debt was also influenced by drawings on a government loan (bond issue), in the equivalent of US$ 1 billion, over the course of the year.

The end of the year saw a marked year-on-year increase in the level of debt in the commercial sector, i.e. foreign debt of entrepreneurial entities and commercial banks, which amounted to US$ 1.4 billion in absolute value.

The net external debt of the SR - calculated as the difference between gross foreign debt, i.e. US$ 11.9 billion (liabilities of the Government and the NBS, liabilities of commercial banks and the corporate sector minus import commitments and financial credits) and foreign assets, i.e. US$ 7.7 billion (foreign exchange reserves of the NBS, foreign assets of commercial banks and the corporate sector minus export claims and financial credits), reached US$ 4.2 billion at 31 December 1998. At the beginning of 1998, the volume of net external debt stood at US$ 1.9 billion, equivalent to an increase of US$ 2.3 billion over the course of 1998, while the highest increase in net external debt was recorded in the corporate sector (US$ 1.4 billion).



2.5. Licensing Activity of the NBS

In 1998, the National Bank of Slovakia, acting as a foreign exchange authority in accordance with the relevant provisions of the Foreign Exchange Act, issued:

- foreign exchange permits: 680 permits and 85 supplements;
- foreign exchange licences: 38 licences and 24 supplements.

Foreign Exchange Permits

Investment abroad

In 1998, the NBS issued 64 foreign exchange permits and 5 supplements, of which 52 permits and 5 supplements for direct investment abroad (except OECD countries), in the amount of Sk 98.6 million and 12 permits for portfolio investment abroad (including OECD countries) in the amount of Sk 42.5 million.

Structure of investment by country

	Number of licences and supplements	Investments (in Sk millions)
Ukraine	19	57.4
Russian Federation	14	46.3
Czech Republic	2	19.4
China	1	6.6
Rumania	9	3.9
Brazil	2	2.9
Austria	2	1.2
Azerbaijan	2	0.9
Other	18	2.5
Total	69	141.1

Note: Direct investment in OECD countries has been liberalised.

Of the total number of permits issued for investment abroad, 57 foreign exchange permits and 4 supplements were for investment in the form of cash deposits in the amount of Sk 99.6 million, and 7 permits and 1 supplement were for investment in securities (shares) in the amount of Sk 41.5 million.

Acceptance of financial credits from abroad

In 1998, the NBS granted 141 foreign exchange permits and 36 supplements relating to borrowing from abroad, of which 122 foreign exchange permits were for the acceptance of financial credits totalling Sk 18,793.0 million and 19 permits were for the repayment of credits received in the amount of Sk 719.5 million. Eight foreign exchange permits remained unused. At the same time, exceptions to the surrender requirement were allowed in 3 cases in the total amount of Sk 163.9 million, and there were 6 exceptions to the transfer requirement totalling Sk 592.3 million.

Estimated drawing and repayment of credits approved in 1998, with a maturity of up to 3 years
(Exchange rate as at 31.12.1998) **[Sk millions]**

	1998	1999	2000
Drawing	18,420.9	372.1	0.0
Repayment	4,773.5	13,420.8	598.7
Balance	13,647.4	-13,048.7	-598.7

With regard to structure by term, credits with a maturity of up to one year represented 84.54% (Sk 15,888.7 million), up to two years 15.42% (Sk 2,896.9 million), and those maturing in up to three years accounted for 0.04% (Sk 7.4 million).

Of the total number of loans approved, 46 were provided by non-bank entities (Sk 5,276.9 million) and 76 by foreign banks (Sk 13,516.1 million). A total of 79 loans (Sk 4,436.7 million) were backed by bank guarantees and 4 loans (Sk 6,970.3 million) by government guarantees.

The largest volumes of credits (including international loans) were provided by entities based in Great Britain (Sk 6,447.6 million); the Czech Republic (Sk 2,928.1 million); Luxembourg (Sk 2,780.6 million); Austria (Sk 1,778.8 million); Germany (Sk 1,610.2 million); and France (Sk 1,336.2 million).

Structure of credits by sector

Sector	Numb. of licen.	Vol. in Sk mil.
Transport, tourism, telecommun.	7	7,859.7
Industrial production	49	6,778.6
Trade, catering, hotel services	45	1,867.3
Building and construction	8	93.7
Extraction of raw materials	1	54.1
Agriculture	1	0.1
Other	11	2,139.5
Total	122	18,793.0

Note: The acceptance of loans with a maturity of three or more years, and loans from OECD countries for the purchase of goods and services from abroad, have been liberalised.

The majority of credits (Sk 17,359.6 million, i.e. 92.4%) was provided for the coverage of operating expenses, the remaining amount (Sk 1,433.4 million. i.e. 7.6%) was earmarked for the financing of investments.

Covering the obligations of non-residents by residents

To secure the obligations of subsidiary or dealer companies abroad, the Bank issued 56 foreign exchange permits and 4 supplements to domestic entities, in the total amount of Sk 12,882.7 million.

Provision of financial credits

During the period under review, 3 foreign exchange permits were issued for the provision of financial credits abroad in the amount of Sk 427.2 million. The granting of loans to OECD countries with a maturity of five or more years, and loans to OECD countries for payments for exported goods and services, have been liberalised.

Trading in foreign securities

For the sale and purchase of foreign securities, the Bank issued 226 foreign exchange permits totalling Sk 83.5 million. For the sale of foreign securities, 216 foreign exchange permits were issued in the amount of Sk 37.8 million. For purchase, 10 foreign exchange permits were issued in the amount of Sk 45.7 million.

One foreign exchange permit was issued for the acceptance of foreign securities as payment for financial liabilities vis-a-vis abroad, and three supplements to foreign exchange permits for the purchase of foreign securities - employee shares.

Trading in financial derivatives

The Bank issued 34 permits for the conclusion of option contracts for the purchase of foreign securities (employee shares), and 2 foreign exchange permits and 1 supplement for trading in financial derivatives, in connection with the repayment of loans received in foreign currency.

Opening foreign-currency accounts at foreign banks

- 51 foreign exchange permits and 19 supplements were issued for the purpose of covering necessary expenses incurred in connection with construction, assembly, or repair work abroad, in a total amount of Sk 1,824.4 million (estimated in the contracts);
- 10 foreign exchange permits and 2 supplements were issued for the direct use of funds derived from foreign loans for payment for imported technology, transport means, and raw materials abroad, via the providers of the loans - foreign banks;
- 2 foreign exchange permits and 2 supplements for the opening of foreign-currency accounts - custody accounts;
- 2 special foreign exchange permits and 1 supplement were issued for the purchase of foreign exchange and transfer into accounts held abroad for trading on foreign commodity markets and for the purchase of foreign securities;
- 1 foreign exchange permit was issued in connection with trading on foreign commodity markets.

Opening foreign-currency accounts at domestic banks

- the NBS issued 38 foreign exchange permits and 8 supplements for the promotion of exports; 35 foreign exchange permits and 2 settlements for the conduct of re-export operations;
- 1 foreign exchange permit and 1 settlement to promote the utilisation of foreign credits.

The foreign exchange permits were issued with effect from 1 April 1998.

Purchase of foreign exchange in cash and exceptions to the surrender requirement

- 4 foreign exchange permits were issued for the purchase of foreign exchange to finance

the business journeys of employees;
- 1 foreign exchange permit was granted for the payment of royalties and fees to foreign participants at an international event;
- 1 foreign exchange permit was issued in connection with forwarding activities.

The foreign exchange permits were issued with effect from 1 April 1998.

Foreign Exchange Licences

- 33 foreign exchange licences and 22 supplements were issued for trading in foreign exchange and cheques (non-bank exchange offices);
- 2 supplements were issued to foreign exchange licences for trading in financial derivatives;
- 5 foreign exchange permits were issued for transactions in foreign securities.

3. THE PUBLIC SECTOR

Budgetary Performance

Act No. 375/1997 Z.z. on the State Budget for 1998 set the size of the budget deficit at Sk 5.0 billion, revenue at Sk 179.8 billion and expenditure at Sk 184.8 billion. The budgeted deficit was allowed to be exceeded by the amount of proceeds from the sale of government bonds issued to raise funds for the financing of housing construction and the payment of compensation for the expropriation of land for the purpose of motorway construction in the total value of Sk 3.0 billion.

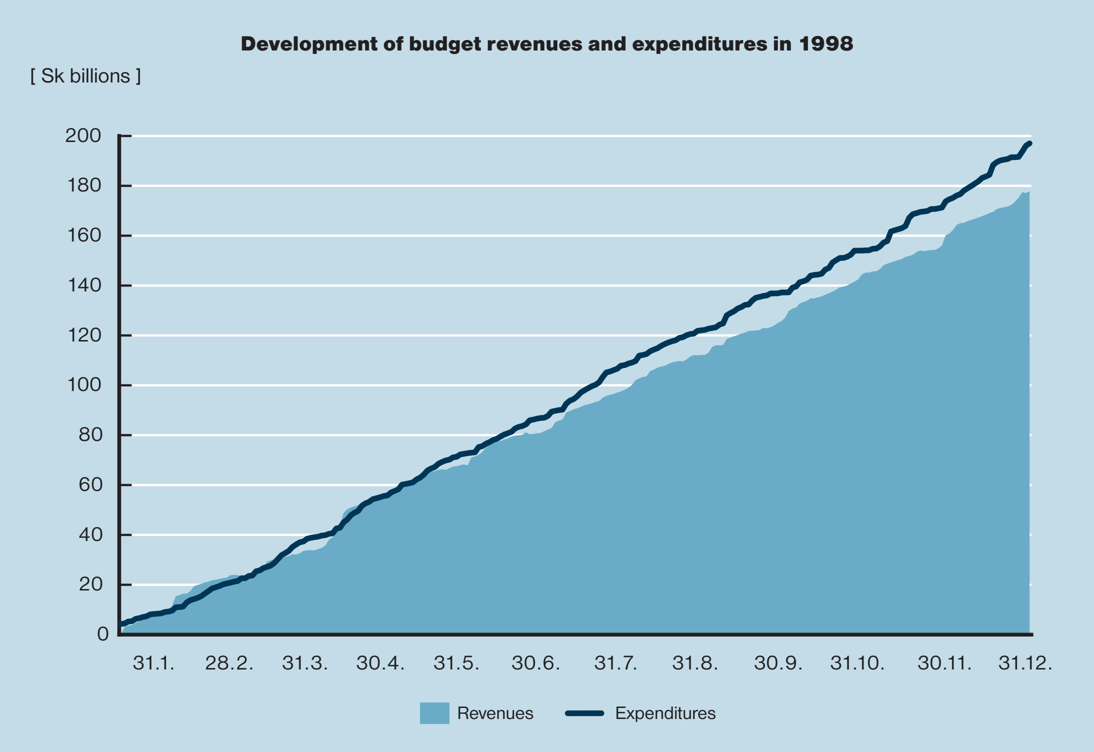
Due to the non-fulfilment of budget revenues, the State budget was modified by the National Council of the SR (Act No. 376/1998 Z.z.) in December 1998. In the new budget, total revenue was reduced to Sk 168.6 billion and the size of the deficit increased to Sk 16.2 billion, with the possibility of an excess of Sk 3.0 billion.

At the end of the year, actual budget revenue reached Sk 177.8 billion, expenditure Sk 197.0 billion, and the size of the deficit Sk 19.2 billion. However, the revenue and expenditure sides of the budget had to be adjusted with so-called grants and transfers, which were used as supplementary budgetary resources, mainly via the accounts of the Ministry of Transport, Postal Services and Telecommunications in connection with the transfer of funds to the State Road Fund for the construction and repair of motorways. The total amount of grants and transfers reached Sk 11.8 billion. This was a neutral accounting operation, which does not affect the size of the deficit, but increases the volume of revenues and expenditures.

The actual volume of revenues (excluding grants and transfers) amounted to Sk 166.0 billion (98.5% of the modified budget), representing a shortfall of Sk 2.6 billion. Shortfalls in tax revenues were recorded mainly in corporate tax revenues (Sk 24.6 billion, compared with the budgeted Sk 27.7 billion) and value-added tax revenues (Sk 55.3 billion, compared with Sk 56.5 billion). This was due partly to the poor economic situation of most entrepreneurial entities, and partly to the slack payment discipline. A significant role was played by the incorrectly estimated dynamics of growth in final consumption, in determining the expected volume of value-added tax revenue.

The import surcharge increased budget revenues by Sk 6.3 billion, but fell behind the budgeted amount by Sk 0.3 billion (it was reduced during the year and was in effect only until 1 October 1998). While revenues from excise duties were fulfilled to 100%; the best results were achieved in personal income tax revenues (they were exceeded by Sk 2.5 billion, especially in the case of employed persons).

The total volume of realised expenditure (excluding grants and transfers) reached Sk 185.2 billion, representing 100.2% of the budgeted figure.



With regard to the unfavourable situation in the area of budget revenues, which were not high enough to cover the expenditures, spending and the creation of revenues were co-ordinated over the entire course of the year, by way of regulation, but which only applied to just over 50% of the expenditures. These were social security benefits, liabilities of the State to health and social insurance institutions, and other items.

Relationship Between the NBS and the State Budget

In 1998, the relationship between the National Bank of Slovakia and the Ministry of Finance of the SR was regulated by a directive passed by the Board of the NBS on 20 March 1998. In accordance with the provisions of Act No. 375/1997 Z.z. of the National Council of the SR on the 1998 State Budget, the Board of the NBS approved zero interest for the balance of government assets and liabilities held at the NBS, for the whole of 1998.

During the year under review, the Central Bank made advances on profits to be transferred to the State budget in the amount of Sk 2.2 billion and paid Sk 66.5 million towards final settlement at the end of March 1999.

Development of State Financial Assets and Liabilities

State financial assets maintained in the form of deposits at the NBS amounted to Sk 2.4 billion at the end of 1998. Over the course of the year, a change was recorded in the area of assets, which fell by Sk 3.7 billion compared with the figure at beginning of January. The decline was due to the repayment of principal on SAL and G 24 loans in the total amount of Sk 3.7 billion. Minimal changes applied to money transfers resulting from Act No. 330/91 Zb. pertaining to land adjustments, out-of-court restitution and the property of the former Communist Party of Czechoslovakia.

State financial liabilities amounted to zero during the whole year.

State Funds

At the end of the year, the accounts of State funds resulted in a balance of Sk -20.5 billion (including loans); the position of State funds was that of a debtor during 1998. The volume of financial assets was significantly influenced by credit facilities granted to the State Road Fund by domestic and foreign banking institutions for the financing of motorway construction. Over the course of the year, the volume of credits granted to the State Road Fund increased by Sk 8.5 billion and reached Sk 22.3 billion. During the period under review, the State Fund for Market Regulation in Agriculture and the State Fund for the Support of Agriculture and Food Processing also reported credit balances. The largest balance (Sk 1.4 billion) was recorded on the account of the State Fund for the Liquidation of JEZ and Handling of Spent Nuclear Fuel (as at 31 December 1998), where the main source of income was a contribution amounting to 10% of the market price of electrical energy generated in nuclear power plants. Another fund where the balance ranged from Sk 0.7 billion to Sk 2.7 billion at the end of the individual months, was the State Fund for Housing Development. At the end of the year, the balance fell to a minimum of Sk 0.7 billion, of which Sk 0.6 billion was allocated to entities who drew the funds gradually from an account. There was a deterioration in the overall development of State funds, due to the aforementioned effect of the State Road Fund.

Internal Debt of the Government vis-a-vis the Banking Sector

At the end of 1998, the net internal debt of the public sector vis-a-vis the banking sector stood at Sk 77.9 billion, representing an increase of Sk 8.6 billion since the beginning of the year. After adding the foreign debt (Sk 60.7 billion) and the value of government bonds held by non-bank entities (Sk 10.0 billion), the total volume of net debt in the public sector reached Sk 148.6 billion.

Over the course of 1998, the level of internal government debt was influenced by the following factors:

- March saw the introduction of the system of a single State account maintained by the NBS; the account comprised not only the revenue and expenditure accounts (including Treasury bills issued during the current year), but all accounts connected with the so-called credit operations of the State conducted in relation to debt servicing. Due to the new system, the level of internal debt fell over the course of the year by Sk 3.8 billion; the budget surplus accounted for almost one third of this amount;
- within the scope of the new system of maintaining the State account at the NBS, a loan received in 1991 was repaid to the National Bank of Slovakia in the amount of Sk 5.5 billion;
- the most significant influence on the reported level of the internal debt, particularly during the second half of the year, was exerted by budgetary performance. During the first quarter, the State budget produced a surplus, and ended the first half of the year with a deficit of Sk 3.9 billion, which gradually increased to almost Sk 9.0 billion during July. Another increase was recorded in November (Sk 12.9 billion), so the size of the deficit reached Sk 19.2 billion at the end of the financial year;
- issues of government bonds during the months of January to October (40 in total, of which no bids were accepted in 7 cases), earmarked for the repayment of principle on government bonds from the previous years; the repayment of a loan to the National Bank of Slovakia (in accordance with Act No. 375/1997 Z.z., Article 14); the conversion of Treasury bills issued in 1997; the financing of housing construction; and for the payment of compensation for the expropriation of land in connection with motorway construction (Act No. 375/1997 Z.z., Article 13). The volume of bids accepted totalled Sk 67 billion; on the

other hand, however, internal and external debt was repaid by the Slovak Republic in the total amount of Sk 44.5 billion during the year.

- the level of internal debt was reduced in May and June by proceeds from the sale of Eurobonds on foreign financial markets, which were converted into crown equivalents. A part of the funds was earmarked for the financing of motorway construction via the State Road Fund; the funds were deposited in bank accounts, which caused a temporary fall in the level of internal debt during the given months and affected the level of the country's external debt.
- over the course of the year, the ownership of government bonds by non-bank entities gained in influence (since the beginning of the 2nd half of the year, when the volume of such bonds ranged from Sk 7.0 billion to Sk 12.7 billion), which is excluded from the net position of the Slovak Government vis-a-vis the banking sector.
- in the third quarter, problems arose in financing of the growing State budget deficit. Five months later in September, Treasury bills started to be used again; in the next month, they were issued almost exclusively for the portfolio of the NBS;
- of other partial items that tend to reduce the overall position of the Government, deposits in the accounts of municipalities declined by Sk 1.6 billion compared with the beginning of the year, insurance funds fell almost to their initial level, and the deficit in the balance of State funds increased by Sk 1.6 billion compared with the figure recorded at the beginning of the year.

4. MONETARY POLICY AND MONETARY DEVELOPMENT

Monetary development in 1998 took place in an environment which saw the continuation of negative trends from the previous two years, namely the growing deficit in the current account of the balance of payments, fiscal expansion, and the slowdown in the growth of real GDP. The development of inflation may be regarded as favourable: its year-on-year dynamics slowing due to stabilisation of the level of regulated prices, favourable development in food prices, and the growing imbalance of foreign trade, which offset the effect on price levels of growth in domestic demand.

The monetary policy of the NBS was affected by external factors such as foreign capital inflow in the form of government loans, crisis on financial markets, fear of currency devaluation among the population, increased fiscal deficit, and large debt service payments by the Government, which increased the volatility of interest rates. After a marked fall in the level of foreign exchange reserves, the Bank Board of the NBS decided to cancel the fixed exchange rate regime. The implementation of monetary policy and its orientation remained unchanged even after the adoption of the floating exchange rate system for the Slovak crown and partial modification of monetary instruments.

4.1. Monetary Development

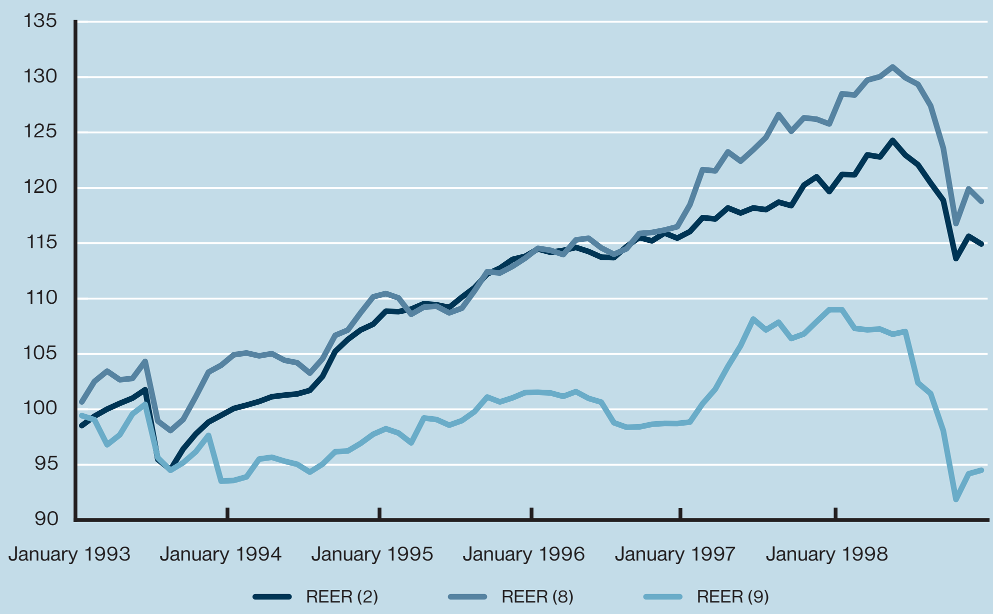
The annual rate of price increase, expressed in terms of the consumer price index, reached 5.6% at the end of December and was within the interval set by the Monetary Programme of the NBS for 1998.

The exchange rate of the Slovak crown fluctuated over the course of the year. Up to the end of July, it had fluctuated within a relatively narrow interval in depreciation part of the fluctuation band, then negative tendencies started to appear in August. Due to the increasing external and internal macroeconomic imbalance, the credit rating assigned to the Slovak Republic by international rating agencies began to slip. The financial crisis in Russia, the consequences of which appeared in August, caused a loss of trust among foreign investors in emerging markets and a subsequent decline in their involvement in the given regions. The massive outflow of capital led to a fall in share indices on local capital markets and in the exchange rates of national currencies.

During the run-up to parliamentary elections, the fear of currency devaluation increased among the population, leading to the conversion of crown assets into foreign currency assets, premature payments for future imports, postponement of collections for imports, the piling up of stocks, and increased purchases of long-term consumables. The heavy demand for foreign exchange led to a depreciation in the exchange rate of the Slovak crown, to the limit of the fluctuation band. The National Bank of Slovakia intervened in favour of the national currency and used US$ 1 billion for this purpose during August and September. To maintain the convertibility of the Slovak crown, the Bank Board of the NBS decided to abandon, with effect from 1 October, the fluctuation band and the fixed exchange rate regime and to replace it by the system of floating exchange rate. During the next few days, the exchange rate of the crown depreciated to the level of 17% compared with the former parity, then it changed and reached Sk 22.081/DM 1 at the end of the year, representing a year-on-year depreciation of 13.83%. The deutschmark, and, from 1 January 1999, the euro, had been chosen as a reference currency for monitoring and setting the exchange rates of the Slovak crown.

In an environment marked by fear of devaluation, accompanied by a decline in crown deposits and a fall in the level of official foreign exchange reserves, the Central Bank (NBS) had several alternatives. The system of fixed exchange rates could have been maintained, but only at the expense of a further, unpredictable (in terms of size as well as duration) fall in the level of NBS foreign exchange reserves, due to the need to refinance the banking sector and the Government. Refusal to supply refinancing to commercial banks would have led to severe liquidity problems in the sector and the suspension of government refinancing would have dangerously complicated the servicing of the national debt. The economic impact of such

REER of the Slovak crown (for 2, 8 and 9 trading partners) - index based on CPI



a situation would have caused lasting damage to the Slovak economy, would have restricted the inflow of foreign exchange resources into the economy, and would have slowed the already insufficient inflow of foreign direct investment. For similar reasons, it was not possible to protect the stability of the exchange rate by raising the level of interest rates to such a high level as in May 1997. After a thorough analysis of all facts and the possible consequences of central bank measures, the Bank Board of the NBS decided to adopt the system of floating exchange rates. This decision led to a depreciation in the value of the currency, but to a smaller extent than would have been the case with the other alternatives. Subsequently, the decision enabled a moderate easing of monetary policy and a reduction in interest rates so that the banking sector was again willing and able to finance the growing financial needs of the State accompanied by a positive impact on the settlement of government liabilities.

Due to the slower rise in price levels compared with 1997 and the depreciation in the crown's nominal exchange rate, the real effective exchange rate of the Slovak crown weakened in relation to the currencies of the country's eight major trading partners by 7.0% in 1998, compared with the previous year. If the Czech Republic is included, the real effective exchange rate of the crown would depreciate by 14.5%. Despite this depreciation, which is expected to generate an increase in the competitiveness of domestic products on the world markets, the balance of foreign trade showed no improvement in 1998.

The share of the current account deficit in GDP reached 10.1% and was negatively affected by the fear of currency devaluation among the population during the 2nd half of 1998, the expansive development of the public sector, and by the increased competitiveness of Asian economies, resulting from the weakening of their domestic currencies. According to NBS estimates, the fiscal deficit reached 5.6% of GDP, consequently the pressure on interest rates increased during the year and private investments continued to be crowded out by public ones.

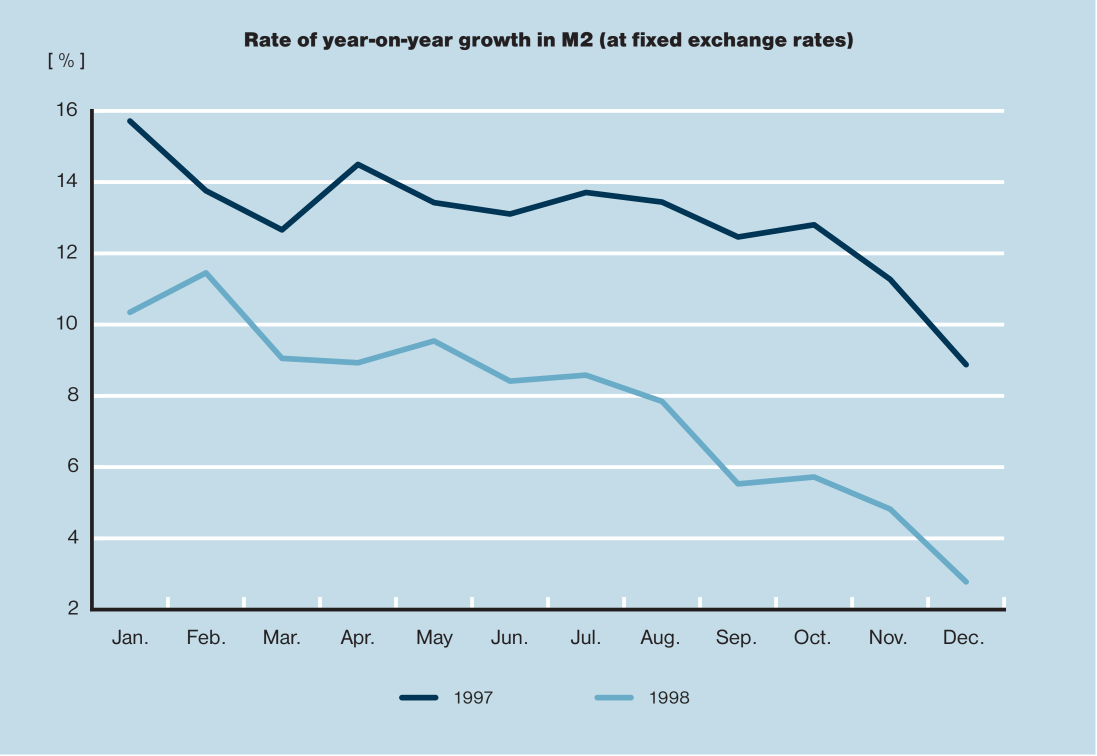
Before July, interbank deposit rates had developed in harmony with the attempts of the NBS to lower their level, which was affected by the inflow of funds from government borrowings from abroad as well. In August, the level of interbank rates began to reflect an outflow of crown liquidity, caused by the fear of currency devaluation among domestic entities. The interest rates culminated in October, when the lack of resources caused by increased purchases in NBS foreign exchange fixing, led to the non-fulfilment of minimum reserve requirements and the average monthly interest rates on deposits fluctuated from 23.4% to 29.4%. The active refinancing policy, pursued by the Central Bank during the last quarter, had a favourable effect on the development of interest rates. In December, the level of average interest rates stabilised between 14.5% and 18.9%. The development of interbank deposit rates also affected the level of interest rates on customer deposits and loans granted to customers.

The development of monetary aggregates was consistent with the Monetary Programme of the NBS, which had to be modified after the adoption of a floating rate. Due to developments on the foreign exchange market, the trend in monetary aggregates changed at the end of September, causing a decline in net foreign assets. In absolute terms, the volume of net foreign assets fell year-on-year by Sk 29.1 billion (at fixed exchange rates), representing a decline of 41.7% in relative terms. The decline was due primarily to a fall in the level of NBS foreign exchange reserves, caused by purchases of foreign exchange by commercial banks via NBS foreign exchange fixing, for the coverage of clients payments.

The money supply, expressed in terms of the M2 aggregate, reached Sk 466.1 billion (at fixed exchange rates) at 31 December 1998. Over the course of the year, the dynamics of growth in M2 slowed to 2.8%, from 8.9% in 1997. From the beginning of 1998, the money supply increased in absolute terms by Sk 12.6 billion, compared with Sk 37 billion in 1997. The slowdown in the dynamics of growth in M2 during the 4th quarter, was not a sign of monetary policy restriction, but a reaction of the public to the expected devaluation of the crown. The decline in net foreign assets was reflected in the development of the money supply, since part of the converted crown resources was used for early payments, particularly for imports from abroad. This led to a marked increase in the deficit of trade in October and caused a slowdown in the rate of year-on-year growth in the money supply.

The growth in M2 was due exclusively to domestic resources, net domestic assets, and the seasonal effects of other net items at the end of the year. In December, other net items fell month-on-month by Sk 14.9 billion, due primarily to the crediting of interest to deposits at the end of the year. Their contribution to the growth in the money supply was lower than a year earlier (when they fell in December by Sk 21.7 billion month-on-month), since the volume of interest credited to deposits was affected by a marked month-on-month fall in crown deposits (Sk 20.1 billion) in September 1998. The smaller increase in M2 in December 1998 was connected with the realisation of budget expenditures during the last few days of the year, as a result of which the funds were actually booked on accounts at commercial banks only at the beginning of January 1999.

The rate of year-on-year increase in net domestic assets reached 10.9%, which was in line with the Monetary Programme of the NBS, as well as the rate of growth in bank lending to households and enterprises (5.5%). In absolute terms, the volume of loans to households and enterprises increased by Sk 20 billion, which was more than twice as large as the increase in 1997. Despite the higher absolute increase in net credit to the Government and the National Property Fund, the dynamics of this aggregate slowed year-on-year by 7.8 percentage points, to 34.7% in 1998. In comparison with the projected value of growth (25.7%), the higher rate of growth in net credit to the Government and the National Property Fund was caused



mainly by the amendment to the State Budget Act in November 1998, which increased the budget deficit for 1998 by Sk 11.2 billion.

4.2. Structure of the Money Supply

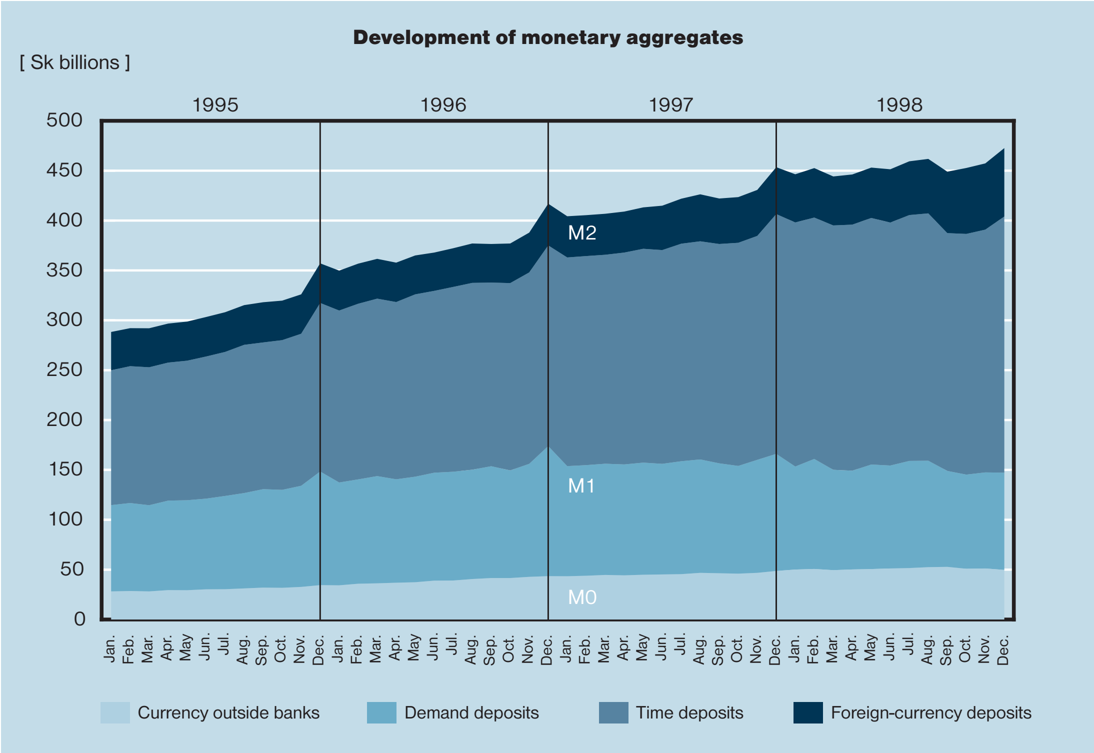
Over the course of 1998, the M2 money supply (at fixed exchange rates) increased by Sk 12.6 billion, to Sk 466.1 billion, due exclusively to growth in quasi-money (Sk 31.4 billion), while the M1 aggregate recorded a decline (Sk 18.8 billion). After a moderate increase in January and February, the dynamics of year-on-year growth in the money supply showed a tendency to slow during the following months. The slowdown in the rate of year-on-year growth in M2 continued during the second half of the year, reaching 2.8% at the end of December. This was due partly to the September development in the area of foreign exchange, and partly to a further fall in the volume of interest credited to accounts at the end of the year.

During the individual quarters, the development of the money supply was influenced by the terms of discharge of liabilities vis-a-vis the State budget, which caused a seasonal fall during the first quarter in particular. In comparison with previous years, the M2 aggregate showed an atypical fall during the third quarter, which was induced by fears of currency devaluation among domestic economic entities, leading to premature payments for imports, which reduced the volume of crown deposits. The December growth in crown deposits, caused by the crediting of interest to accounts, continued to show a tendency to slow during 1998, due to the continued increase in the share of short-term deposits, which earn interest on a continuous basis, in total deposits. The continuation of this trend was attributable to the relatively high level of interest rates on short-term deposits (mainly at 7-day to 6-month notice).

In 1998, the volume of currency in circulation outside the banking sector increased by Sk 1.1 billion. From the beginning of the year to the beginning of April, the issue of currency showed a tendency to decline, with a minimum volume recorded at the beginning of April. During the following six months, currency issue showed an upward trend which culminated in September, due to the conversion of Sk into foreign currency and increased payments in cash. In November, the volume of currency in circulation recorded a marked fall, to the level of May. The Christmas holidays caused a traditional seasonal increase in the volume of cash, with a maximum of Sk 64 billion.

Demand deposits declined by Sk 19.9 billion, due primarily to a fall in corporate deposits (Sk 14.5 billion). However, declines were also recorded in the demand deposits of households and insurance companies. This development was due partly to the aforementioned early payments for imports at the end of the 3rd quarter, the conversion of crown assets into foreign currency deposits, and the relatively high rate of interest on short-term time deposits. In 1998, the dynamics of growth in demand deposits continued to slow, to -17% on a year-on-year basis. In 1997, the rate of year-on-year decline reached -10%, while in 1996, demand deposits had increased by 14.5%.

Time deposits expanded over the course of 1998 by Sk 16.4 billion, due mostly to an increase in household deposits (Sk 28.7 billion). Deposits in the corporate and insurance sector fell by Sk 9.7 billion and Sk 2.6 billion respectively. During the period under review, time deposits followed a more or less upward trend, with the exception of February, June, and September. The September fall (Sk 9.6 billion), caused by developments in the foreign exchange area, was the sharpest and took place in all sectors. The rate of year-on-year growth in time deposits reached 6.8%. In comparison with the previous years, a relatively marked slowdown was recorded in the rate of their year-on-year growth, which reach 19.1% in 1996 and 19.5% in 1997.



With regard to the structure of time deposits by term, the increase in volume took place mostly in extra short-term deposits. In the case of household deposits, deposits at up to 1-month notice increased by Sk 25.9 billion and deposits at up to 3-month notice by Sk 16.3 billion; part of the increase took place in long-term home savings deposits, which grew by Sk 6.0 billion. The share of home savings deposits increase in total time deposits increase in the household sector continued to decrease in 1998. In 1996, the share stood at 39.0%, then it decreased to 22.5% in 1997 and to 20.9% in 1998. On the other hand, the most significant declines were recorded in short-term (Sk 9.3 billion) and medium-term (Sk 11.9 billion) savings deposits. In the corporate sector, the sharpest fall took place in time deposits at up to 1-month notice, which continued to dominate the market with a 65% share in corporate time deposits. The volumes of corporate deposits at up to 1 and 2-year notice also recorded a marked decline.

Slovak-crown deposits, as a component of the money supply, fell by Sk 3.5 billion (1.0%) during 1998 and reached, for the first time, a negative rate of growth. In the previous two years (1996, 1997), the dynamics of year-on-year growth reached positive values (17.2% and 7.9% respectively). The fall was due primarily to a marked decline in corporate deposits (Sk 24.2 billion, i.e. 21.8%) and deposits held by insurance companies (Sk 3.5 billion, i.e. 19.7%), and was more severe than in 1997, when corporate deposits declined by Sk 6.6 billion (5.6%). This marked difference was due primarily to the situation in August and September, when the fear of devaluation among economic entities increased, causing a marked fall in crown deposits. At the same time, household deposits increased in volume by Sk 24.2 billion (10.6%), but their dynamics of year-on-year growth slowed, from 19.3% in 1996 to 17.7% in 1997.

In 1998, foreign-currency deposits recorded an extra high increase of Sk 15.0 billion, while corporate deposits grew by Sk 9.7 billion and household deposits by Sk 5.3 billion. While corporate deposits in foreign currency recorded positive month-on-month increases during the whole year, household deposits were more or less stagnant during the first half of the year. Foreign-currency deposits recorded marked increases in both the corporate and the household sectors, due to increased fear of currency devaluation in September and at the beginning of October. After the fixed exchange rate regime of the Slovak crown had been cancelled, the growth in foreign-currency deposits came to a halt and turned into a slight decline.

4.3. Bank Lending

Bank lending in Slovak crown and foreign currency to the entrepreneurial sector, households, central and local authorities for extrabudgetary purposes, by commercial banks and the NBS, was uneven over the course of 1998. The increase in total credit ranged from Sk 0.5 billion to Sk 5.3 billion (April saw a fall of Sk 10.9 billion, caused by the transfer of liabilities from a branch of a foreign bank to its head office). The highest increases in bank loans were recorded in the 3rd quarter (an average of Sk 3.1 billion per month) and the lowest in the 2nd and 4th quarters (an average of Sk 1.5 billion per month). The month-on-month changes in crown loans ranged from Sk -1.0 billion to Sk 4.2 billion. During the year under review, bank lending increased by a total of Sk 12.7 billion, of which crown loans accounted for Sk 1.2 billion and foreign-currency loans Sk 11.5 billion. At the end of year, the total volume of bank loans reached Sk 398.4 billion, of which crown loans accounted for Sk 340.3 billion and loans in foreign currency Sk 58.1 billion.

A characteristic feature of bank lending was that, despite the slow growth in crown loans (0.4% since the beginning of the year), their volume increased in the household sector by Sk 6.1 billion, in the corporate sector (non-financial organisations) by Sk 2.3 billion, and in small businesses by Sk 2.3 billion. In the financial sector, the volume of crown loans recorded a decline. Due to the lack of crown resources, the most solvent entrepreneurial entities borrowed funds from abroad at lower interest rates, but in much smaller amounts than in 1997. Bank lending in foreign currency increased in 1998 by 24.7%, mainly during the second half of the year. At the end of the year, however, foreign-currency loans accounted for only 14.5% of total credit.

The structure of loans by sector changed during the year as follows: loans in the public sector fell by 7.7 points (to 14.4%), while those in the private sector increased by 4.1 points (to 68.4%) and in the household sector by 1.8 points (to 7.8%), due to the continued, but slow process of privatisation.

During the period under review, the structure of loans by term saw a decrease in the share of medium-term loans in total credit (by 0.6 points, to 21.9%) and stagnation in the share of short-term loans (43.6%), while the share of long-term loans increased (by 0.6 points, to 34.5%).

A significant increase was recorded in the share of long-term loans in foreign currency, and a less significant increase in the share of short-term loans, while the proportion of medium-term loans to total credit in foreign currency recorded a decrease.

In March and April, the structure of loans by sector underwent major changes, due mainly to the aforementioned transfer of liabilities from a branch of a foreign bank to its head office, as a result of which the share of the financial sector decreased from 5.9% to 2.6%. In March, another structural change was recorded in loans allocated to the construction sector, the share of which dropped from 5.9% to 3.0%, while half of the crown loans (Sk 10 billion) was classified as 'other activities' (a change in methodology). The largest share (34.1%) of the total volume of crown loans was taken up by the manufacturing industry; of this, 12.9% in metallurgy and machine engineering and 22.1% in trade, sales, catering and hotel services (year-end figures).

Of the total volume of credit extended in 1998 (Sk 453.1 billion), bank loans to the entrepreneurial sector accounted for 95.6%. They were, however, mostly short-term loans with a maturity of up to 3 months. The household sector absorbed 2.97% of total credit.

Regarding the structure of loans by purpose, operating loans accounted for 51.9% and overdraft facilities 24.8%. Loans granted for development programmes represented only 4.0% of the total volume of credit extended during the given period, which was associated with their structure by term. Short-term loans with a maturity of up to 1 year accounted for 92.5% of the volume of new loans, while most large banks provided loans with a maturity of up to 3 months, which were later renewed for solvent clients over the course of the year. In terms of volume, a significant role was played by 1-day loans. Another significant item was represented by credits extended for the coverage of non-performing loans, which reduced the actual volume of credit available for the financing of specific development projects.

4.4. Interest Rate Development

The level of interest rates for customers was influenced by the economic environment, the budget deficit, the shortfall in the balance of payments, and the shortage of credit resources. Over the course of 1998, marked fluctuations were recorded in interest rates on the interbank money market, which subsequently affected the interest rates for customers as well. Apart from this, customer interest rates were affected by changes in the volume of new loans (from Sk 19.4 billion to Sk 59.5 billion per month), while the biggest changes were recorded in the volume of short-term loans with a maturity of up to 1 month and interest above 20%. The situation on the capital market did not allow bank lending to be replaced by other sources of finance.

In setting their interest rates, commercial banks took into account their economic situation, the quality of their loan portfolios, and other factors.

During the period under review, the development of interest rates on new loans was marked by a decline from January to July, followed by a steep rise to a level of 17 - 24% during the next three months, which turned into a fall again. In December, the level of interest rates reached 18.62%. This development was affected by changes in the level of liquidity in the banking sector and developments in the foreign exchange area, influenced by increased interest in foreign exchange resources on the part of entrepreneurial entities and households in September. Of crown deposits, marked fluctuations were recorded in interest rates on short-term deposits at up to 3-month notice, since commercial banks were reacting very sensitively to changes in their liquidity.

Compared with December 1997, the average interest rate on the total volume of loans remained virtually unchanged (it fell only by 0.05 points, to 16.17%), though it was affected by several factors such as the structure of loans by term, the structure of customers, and the structure of loans by purpose. The average lending rate for short-term loans rose by 1.17 points (to 21.08%); the rates for medium and long-term loans fell by 0.20 points (to 16.20%) and 1.54 points (to 10.36%) respectively, as these rates continued to be influenced by loans granted in the past at fixed and low interest rates.

Over the course of the year, commercial banks maintained the rates of interest they had announced, particularly on short-term loans, at roughly the same level. Compared with December 1997, the actual price of new loans fell by 2.30 points (to 18.62%), while the lowest level was recorded in July (14.17%). With regard to the dominance of short-term loans (annual average: 92.5%), the average interest rate on these loans (18.91%) affected the level of average interest rate on the total volume of new loans. Interest rates on new short-term loans followed the variations in interest rates on the interbank money market. Compared with December 1997, lending rates for medium and long-term loans fell to 14.20% (by 2.10 points) and to 14.81% (by 0.59 points) respectively. With regard to the small volume of these loans, the average lending rate was to a large extent exposed to random structural changes, depending on the purpose of the given loans, with different interest rates.

Over the course of the year, the development of average interest rates on loans by purpose was characterised by marked fluctuations in lending rates for operating loans (from 11.09% to 23.79%); standard loans - debit balances on current accounts (from 16.01% to 32.03%); and for overdrafts (from 18.72% to 30.96%). Average interest rates on consumer loans granted to households fluctuated between 9.64% and 14.99%.

With regard to the rate of inflation, the level of real interest rates on new loans fluctuated during the year from 7.17% (in July) to 19.16% (in September). After taking the prices of industrial producers into account, the above rates ranged from 10.57% (in July) to 21.96% (in September), as a result of marked interest rate fluctuations and the falling rate of inflation.

The development of interest rates on crown deposits was affected by inflation only to a limited extent, it rather reflected a need for resources. In an effort to obtain such resources, commercial banks raised their interest rates, which led to a rise in the level of average interest rates in December 1998 (by 1.7 points), compared with December 1997. In the category of time deposits, marked increases were recorded in interest rates on 6-month deposits (+3.72 points; deposits grew by Sk+2.65 billion); 3-month deposits (+3.45 points; Sk +18.1 billion); and on 1-month deposits (+1.24 points; Sk+13.62 billion). Over the course of the year, the largest fluctuations were recorded in interest rates on 7-day, 3-month and 6-month deposits, depending on the development of interbank deposit rates. The highest values were reached in September and October (17.5% and 22.0% respectively). At the close of the year, interest rates on 7-day, 1-month, and 3-month deposits stood at 17% to 18%. Since December 1997, the volume of total crown deposits (excluding the NBS) has fallen by Sk 7.34 billion.

The average interest rate on total deposits fluctuated around 10% (9.5% to 11.0%) and reached 10.39% at end-December, while interest rates on demand deposits were basically stable (3.6% to 4.2%). Interest rates on time deposits fluctuated from 12.2% to 14.0%, while marked variations were recorded in time deposits at 7-day to 3-month notice. Deposits at 7-day to 3-month notice attracted interest at an average rate of 11.9% to 21.9%, whereas other time deposits earned interest at 10% to 16%. Crown deposits at 1 to 5-year notice earned interest at a rate of 10.0% to 13.6%. The low rate of interest on deposits at over 5-year notice (4.0% to 4.5%) was attributable to home savings deposits, which accounted for 91.9% of the total volume of long-term crown deposits.

In 1998, real interest rates on one-year deposits remained at the level of 3,2% to 6.4%. The fall in the annual rate of inflation (from 6.4% in December 1997 to 5.6% in December 1998) and the increase in the average interest rate on one-year deposits (from 10.51% to 12.01%) led to a rise in the level of real interest rates (by 2.30 points).

4.5. Implementation of Monetary Policy

The basic goal of monetary policy pursued by the NBS in 1998 was to maintain the stability of the national currency, while reducing the interest rates on the interbank money market with a view to lowering the level of interest rates for primary customers and yields on government securities.

Over the course of the year, the conditions for the systematic lowering of interest rates were restricted, by several limiting factors such as the expansive economic performance of the public sector, the increased deficit in the balance of payments current account, and developments on the foreign exchange market. The situation during the first five months of the year allowed the National Bank of Slovakia to pursue a refinancing policy, as a result of which average interest rates showed a tendency to fall across the board, with the exception of April, when interest rates, especially on short-term deposits, increased somewhat in response to the announcement that Moody's had lowered the credit rating of the Slovak Republic.

During the period from June to August, interest rates continued to follow a downward trend. This time, however, the fall in interest levels was not a result of refinancing operations conducted by the NBS, which were suspended during that period, but was caused by an excess of liquidity in the banking sector, resulting from the conversion of foreign exchange assets derived from government borrowings from abroad, into crown assets and their gradual release into the economy. Thus, the NBS shifted its attention from refinancing to sterilisation and started conducting REPO tenders in its own bills (NBS bills) for sterilisation purposes.

At the end of August, the fear of currency devaluation increased among domestic entrepreneurial entities and the population, due partly to the run-up to parliamentary elections and the ongoing financial crisis in Russia, which led to the conversion of crown assets into foreign-currency assets. The draining of crown liquidity through purchases of funds by commercial banks in NBS foreign exchange fixing and the necessity to issue government securities for financing the running budget deficit and the costs of debt servicing, called for the renewal of refinancing operations on the part of the NBS in September.

The National Bank of Slovakia decided to grant 1-day refinancing, with the aim of replenishing bank liquidity and restricting the rapid increase in interest levels (on the interbank market and at auctions in government securities), without

Balance of central bank interventions in 1998

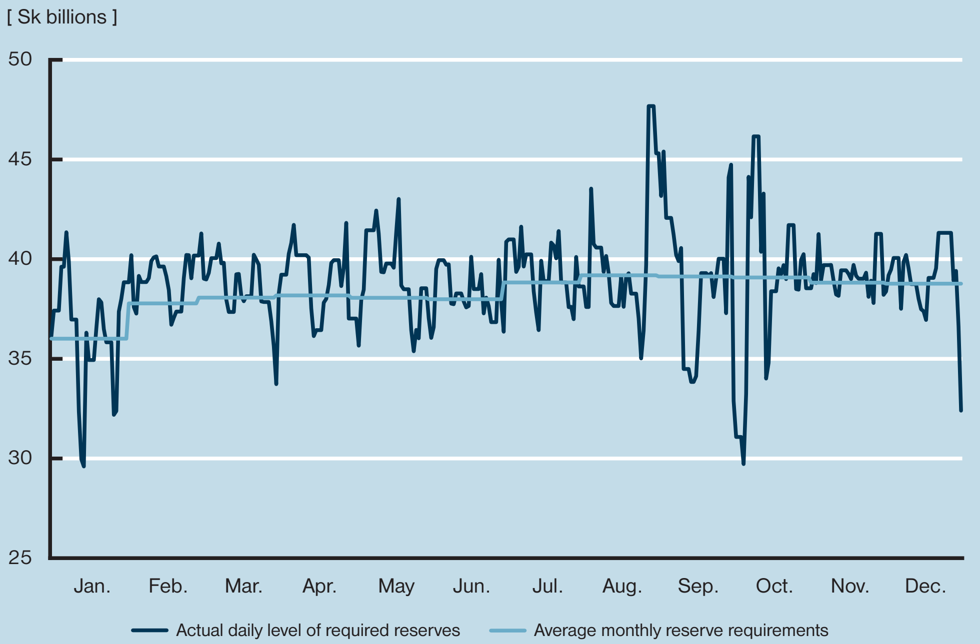
creating, on the other hand, an excess of long-term funds, which would have supported purchases in NBS foreign exchange fixing.

The outflow of central bank reserves through NBS foreign exchange fixing, which continued after the elections, caused the National Bank of Slovakia to abandon the fixed exchange rate regime and to adopt the system of floating rate. In September 1998, it was impossible to influence the development of exchange rates by placing restrictions on the refinancing of purchases made by commercial banks in NBS foreign exchange fixing, followed by a marked rise in interest-rate levels, because this period saw increased debt service payments (compared with May 1997) and fear of devaluation amongst the population, rather than from the short-term speculations of foreign investors. With effect from 1 October, foreign exchange fixing was cancelled and was replaced by central bank intervention in the foreign exchange market as an instrument of exchange rate policy.

In connection with the situation on the foreign exchange market and the performance of the State budget, the need for refinancing increased significantly during the last quarter of 1998. Despite a marked increase in the average daily involvement of the NBS in the banking sector, the sector failed to meet the reserve requirements set for the first period of October. During the remaining periods (until the end of the year), the fulfilment of reserve requirements was free of problems, due primarily to the large volume of refinancing on the part of the NBS.

In 1998, monetary policy continued to be implemented in the manner applied in 1997, i.e. in the form of quantitative management, aimed at regulating the level of excess reserves in the banking sector through the creation of minimum required reserves. In 1998, systemic conditions were not yet created for transition to qualitative management in the area of monetary policy, aimed at monitoring the levels of central bank rates and influencing economic processes and decisions or changes. The uncompleted process of restructuring in the banking sector, persistent problems with state-owned banks,

Fulfilment of reserve requirements in the banking sector in 1998



legislative conditions, under which the rights of creditors and the obligations of debtors are as yet inadequately defined and fixed, represent the key factors that hindered the modification of monetary policy control, with subsequent changes in its instruments. Under present conditions, the management of reserves in the banking sector requires a more direct and firm ability of the central bank to control the development of the economy. The aim of this policy in 1998 was to mitigate the impacts of macroeconomic imbalances - and in implementing the country's monetary policy on the money market, to eliminate the deficit in public finances, and in implementing monetary policy in the area of foreign exchange, to mitigate the imbalance of foreign trade, while supporting the NBS in meeting its monetary-policy objectives, i.e. to maintain the stability and convertibility of the national currency.

4.6. Instruments of Monetary Policy

1. Interest rate policy

a) From 13 January 1996: Discount rate = 8.8%;
b) From 17 July 1996: Lombard rate = 15.0%;

2. Reserve requirements

a) With effect from 1 August 1996, the ratio of primary deposits for the calculation of minimum required reserves was set at 9%, irrespective of the term of deposit, for all commercial banks, with the exception of home savings banks, which are required to maintain minimum reserves amounting to 3% of primary deposits. At the same time, required reserves attracted interest at the rate of 1.5%, up to the level of required reserves set for the period under review.
b) With effect from 1 January 1997, the ratio for required reserves of the volume of non-fulfilled compulsory foreign exchange position for monetary purposes was set at 9%, and the ratio for required reserves of mortgage and municipal bond issues at 3%.

3. System of refinancing

The refinancing of commercial banks took one of the following forms:

a) Redistribution loans:
   - Traditional - at a rate of 9.5%;
   - Soft loans - at a rate of 7.5%;
b) Lombard loans - loans backed by the pledge of securities granted at Lombard rate;
c) Bills-of-exchange deals - bills of exchange are discounted and rediscounted at the discount rate; this form of refinancing included bills discounted for export promotion and bills rediscounted for the support of agriculture. Discounting of bills for export promotion had been cancelled with effect from 17 November 1997. In 1998, the NBS rediscounted bills of exchange only for the support of agriculture;
d) Open market operations.

4. Treasury bills

a) An operative means of financing the State budget deficit;
b) A means of managing the liquidity of commercial banks through:
   - secondary sales and purchases;
   - REPO operations (repurchase agreements).

5. NBS bills

- Instrument used by the central bank to influence the liquidity of commercial banks via the same trading system as for Treasury bills.

6. Exchange-rate and foreign-exchange policy

The currency basket until 30 September 1998

Absolute definition of the currency basket:
1 IDX = 0.012817 USD + 0.029663 DEM

Currency	**USD**	**DEM**
Weight	40%	60%
Exchange rate Sk	31.209	20.227

a) With effect from 1 October 1998, the National Bank of Slovakia ceased to guarantee a fixed nominal exchange rate for the Slovak crown within a fluctuation band. From 1 October to 31 December 1998, the exchange rate of the Slovak crown (Sk) was set in relation to the German mark (DM). The exchange rate of the Sk depended upon the cross-currency rate of the D-mark and US dollar on the world markets, the supply of and demand for the Slovak crown on the foreign exchange market, and upon the policy and goals of the Central Bank. The National Bank of Slovakia attempted to correct the excessive volatility of the crown's exchange rate through direct interventions, i.e. the purchase or sale of foreign exchange on the foreign exchange market.

b) Evaluation of the currency basket of the Sk:
The turnover of foreign exchange operations under payment items specified in groups 1 to 6 in convertible currencies (excluding other convertible currencies, i.e. Czech crown and the Hungarian forint) reached Sk 737.1 billion in 1998. The average monthly turnover (Sk 61.4 billion) increased by 4.9% year-on-year. The balance of foreign exchange receipts and payments resulted in a deficit of Sk 20.7 billion. The currency structure of the turnover was dominated by DEM (47.0%) and US$ (32.3%). The other European currencies, with a strong correlation to DEM, accounted for 19.0%. Together with DEM, these currencies represented 66.0% of the total volume. The percentage of non-continental currencies including GBP was 1.7%, and together with USD accounted for 34.0% of the total turnover.
The turnover of foreign exchange receipts and payments, including other convertible currencies (mainly the Czech crown), reached Sk 825.9 billion in 1998. The balance of foreign exchange receipts and payments resulted in a deficit of Sk 59.4 billion. The large share of CZK in the achieved turnover (Sk 88.4 billion, i.e. 10.7%) and its inclusion in total turnover (converted according to the original currency basket of the CZK, i.e. 65% DEM and 35% USD) changed the structure of the total turnover only slightly to the detriment of DEM (65.9%) and in favour of USD (34.1%). With regard to the introduction of a new exchange rate regime, the above calculations are only of informative nature.

c) Nominal exchange rate of the Slovak crown:
The nominal exchange rate of the Slovak crown depreciated over the course of 1998 by 10.51%, to 12.81% below the level of central parity at 31 December 1998. While during the period of the fixed exchange rate regime, i.e. until 30 September 1998, the Slovak crown had depreciated by 3.65%, after the adoption of the system of floating rate, the rate of depreciation against central parity reached 9.16%. In relation to DEM, the Slovak crown depreciated by 6.35% during the period from 1 October to the end of 1998.

d) Real effective exchange rate of the crown:
The real effective exchange rate of the Slovak crown, calculated on the basis of the

consumer price index, compared with those of Slovakia's eight trading partners having a significant share in the country's foreign trade turnover (USA, Great Britain, Austria, France, Germany, Italy, the Netherlands, and Switzerland), depreciated by 7.0% over the course of 1998; or, when compared with the country's nine trading partners (including the Czech Republic), it depreciated by 14.5%.

e) Management of the foreign exchange positions of banks:
Until 30 September 1998, commercial banks had had free access to NBS foreign exchange fixing; they could adjust their foreign exchange positions by selling or purchasing foreign exchange via foreign exchange fixing. On the day of purchase, however, the ratio of foreign exchange assets to foreign exchange liabilities was not allowed to exceed 1.05. With effect from 1 October 1998, foreign exchange fixing was cancelled in connection with the cancellation of the fluctuation band, so banks could replenish their foreign exchange positions only on the foreign exchange market.

- The foreign exchange position of banks and branches of foreign banks for monetary purposes (FXPMP): The FXPMP ratio was calculated as the proportion of foreign exchange assets of non-residents to the sum of liabilities denominated in Slovak crowns of non-resident banks and foreign exchange liabilities, less capital in foreign currency. The value of this ratio was first set at 0.65, and banks were required to achieve it by 31 December 1996.

Calculation of the foreign exchange position (FXPMP):

$$\text{FXPMP} = \frac{\text{FXAN}}{\text{FXL} + \text{LNSk} - \text{C}}$$

FXAN - Foreign exchange assets of non-residents;
FXL - Foreign exchange liabilities in total;
LNSk - Liabilities of non-residents in Slovak crowns;
C - Capital and non-paid-up capital in foreign currency.

Obligatory values of the FXPMP ratio:
As of 31 December 1996 - min. 0.65;
As of 31 March 1997 - min. 0.70;
As of 30 June 1997 - min. 0.80;

Penalties for non-fulfilment of the obligatory FXPMP ratio:
9% of the volume of the non-fulfilled ratio of FXPMP.

Period of monitoring the FXPMP ratio:
Before 10 July 1997, the FXPMP ratio had been calculated on the basis of average data from the 2nd and 3rd periods of the month N-2 and from the 1st ten-day period of the month N-1 of Survey of Assets and Liabilities V(NBS) 6-36. With regard to the fact that banks, especially branches of foreign banks, circumvented the regulation by increasing FXAN and FXL vis-a-vis non-residents (FXLN) only at the end of the ten-day periods, the NBS issued a regulation whereby FXPMP is monitored on a daily basis, with effect from 16 July 1997.

4.7. Monetary Calendar

January

- The rating agency Moody's Investors Service announced its intention to lower the credit rating of Slovakia, due to the growing deficit in the public sector and the current account, which are financed in large part from foreign, especially short-term loans.

February

- The National Council of the Slovak Republic passed an amendment to the Banking Act;
- The National Council of the Slovak Republic passed an amendment to the Foreign Exchange Act. The amendment has liberalised the foreign exchange regime in accordance with the recommendations of OECD. It has cancelled the surrender requirement relating

to residents - legal entities, removed the limit on foreign exchange purchases in cash by residents, and allowed the placement of securities issued in OECD countries on the Slovak capital market.

March

- The rating agency Moody's Investors Service lowered the rating of Slovakia from Baa3 (investment grade) to Ba1 (speculative grade).

April

- The amendment to the Foreign Exchange Act became effective on 1 April 1998;
- The rating agency Standard & Poor's revised its long-term crown and foreign-currency liability ratings of Slovakia from a stable level to a negative one. At the same time, the agency confirmed the BBB- grade for government bonds issued in foreign currency and the A grade for bonds issued in local currency.
- The American analyst company Dun & Bradstreet Limited lowered the risk rating of Slovakia from DB4b to DB4d.

May

- Thompson Bank Watch, the financial branch of Thompson, lowered the credit rating of Slovakia from BB+ to BB;
- The Bank Board of the NBS decided to replace the deutschmark in the currency basket of the Slovak crown by the euro, with effect from 1 January 1999.

June

- The Japanese rating agency Japan Rating and Investment Information, Inc., formerly known as Japan Bond Research Institution, lowered the credit rating of Slovakia from BBB to BBB-.

July

- The sale of government bonds to private individuals came to an end; bonds were sold in the amount of Sk 983.3 million, representing roughly 50% of the total issue.

August

- The financial crisis in Russia culminated in August. It was accompanied by problems in the repayment of foreign loans and by a rapid devaluation of the rubble. The crisis caused a loss of faith among financial investors, who started to withdraw from the emerging markets, which caused turbulence on the capital and foreign exchange markets of these countries.

September

- The rating agency Standard & Poor's lowered the long-term hard currency liability rating of the SR and the rating of securities issued without state guarantee from BB+ to BBB-; and the rating of securities issued in Slovak currency to BBB+, from AAA. Thus the rating of Slovakia moved from the investment band into the speculative band.
- The rating agency Fitch IBCA assigned a negative rating to Slovakia;
- The Bank Board of the NBS approved some changes in foreign exchange fixing, arising from the introduction of the single European currency. Since 1 January 1999, the exchange rates of the euro, the Hungarian forint, and the Polish zloty have been listed in the central bank's daily list of exchange rates, in addition to the rates of eleven EMU countries.

October

- On 1 October, the Board of the NBS cancelled the fluctuation band of the Slovak crown. At the same time, the Bank's Board cancelled the pegging of the Slovak crown to the currency basket, which consisted of DEM (60%) and USD (40%).

December

- The British rating agency Fitch IBCA, which was the last rating agency to keep the credit rating of Slovakia within the investment band, lowered the country's rating by one degree, to the speculative band. The long-term foreign-currency liability rating of Slovakia was lowered from BBB- to BB+. At the same time, the rating of the Slovak currency was reduced from A- to BBB+.
- On 31 December 1998, the NBS announced, for the first time, the official rate of conversion between the Slovak crown and the single European currency, the euro. At 4 January, the first working day of 1999, the rate of conversion was SKK 43.097 /EUR 1.

5. FINANCIAL MARKETS

5.1. Money Market

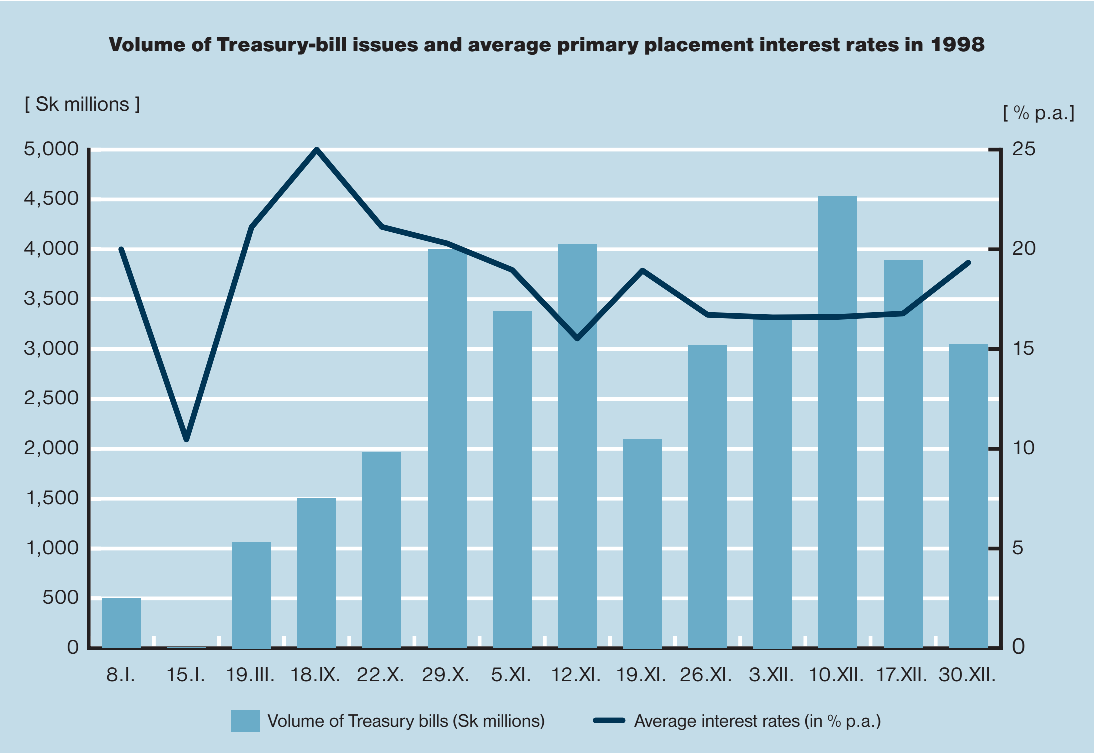
Primary Market for Treasury Bills

In 1998, the primary market for Treasury bills was characterised by a low level of issuing activity on the part of the Ministry of Finance. This was due mostly to the reduced requirements of the State budget for short-term resources. At the end of 1997, Treasury bills represented 41% of all government securities; at 31 December 1998, they accounted for only 18%.

Over the course of the year, the Ministry of Finance of the SR put Treasury bills up for auction in accordance with the schedule for the issue of government securities, which, in accordance with Ministry practice, was released quarterly in advance. Apart from this, the issuer decided to hold a Treasury-bill auction three times during the second half of the year. These decisions were motivated by the unfavourable performance of the State budget during the given period and the high level of interest yields on the primary market for government bonds. The last auction of the year was held on 30 December 1998, in response to the amendment to the State Budget Act, which modified the size of the budget deficit for the year under review. In total, 26 auctions were held, but only 14 were successful. At these auctions, Treasury bills were placed on the short-term securities market in the total amount of Sk 36.41 billion, representing a decline of 59% compared with 1997. In terms of volume, the last quarter was the most significant, when 92% of the Treasury bills issued in 1998 was placed on the market. In November, Treasury bills started to be issued with maturity in 1999. The average amount per issue was Sk 2.6 billion, i.e. 11% more than in the previous comparable period.

A substantial year-on-year change was recorded in the structure of Treasury bills by maturity. While in 1997, Treasury bills were issued with a maturity of from 1 to 11 months; the period under review saw only issues with a maturity of maximum 3 months. This was due mainly to the high volume of government bonds maturing in 1999, mainly from March to October. To avoid the accumulation of due Treasury bills and government bonds, the issuer decided to finance the 1998 budget deficit from Treasury bills maturing during the first three months of 1999.

Investors in Treasury bills were partly direct participants, i.e. domestic commercial banks, insurance companies, and dealers in securities, and partly indirect participants, i.e. other domestic legal entities registered in the Companies Register and foreign investors. In primary purchase via auction, most Treasury bills were acquired by direct participants, i.e. 92% (the same share as in 1997). The share of indirect participants was 8%, representing a year-on-year increase of 3% in absolute terms. The increase was attributable primarily to the increased participation of foreign investors, especially at the end of the year, when Treasury bills were issued with longer maturities (maturing in 1999). In contrast with the previous period,



the NBS was not involved in the primary sale of Treasury bills by auction.

In primary sales, Treasury bills were sold at American-style auctions, with no volume announced in advance and no interest rate limit. The average interest rate at Treasury-bill auctions reached 18.27% p.a., which was 527 base points lower than in 1997. The fall was due mainly to a shift in issuing activities, from Treasury bills to government bonds. The average interest yields on individual issues ranged from 10.47% p.a. to 25.00% p.a. As the Ministry of Finance issued mostly bonds with a maturity of one year, the yields achieved had a significant effect on the level of interest rates demanded by investors at Treasury-bill auctions. The rise in the level of required interest rates was also influenced by developments on the market for interbank deposits. At the end of the year, the rates of interest demanded by investors at Treasury-bill auctions were negatively affected by changes in the taxation of government securities, which became effective on 1 January 1999.

With regard to the time gap between the development of budget revenues, expenditures, and Treasury-bill auctions, the running budget deficit was financed during the period under review, especially during the 4th quarter, from so-called technical issues made with a maturity of from 1 to 7 days, for the portfolio of the NBS. Compared with 1997, when technical issues were floated almost continuously, the volume of Treasury bills issued in this way, recorded a fall of 65%. The interest rate for these issues was set at 12% p.a. in accordance with the provisions of Act No. 375/1998 Z.z. on the 1998 State budget.

Secondary Market

The conduct of monetary policy, based on the system of fixed exchange rates and quantitative control of crown liquidity, left the basic conditions of the money market unchanged for 1998. In operative management, predominantly REPO operations were conducted in the form of auctions (REPO tenders) oriented exclusively towards regulating the level of liquidity in the sector.

Direct sale from the portfolio of the NBS and the non-auction form of REPO tenders were conducted only as a supplement to tenders, without any marked effect on the development of the money market. In the system of liquidity management by the central bank, there was a strong element of uncertainty about the conduct of tenders, accompanied by marked fluctuations in short-term interest rates and frequent inadequacies on the deposit market in the form of a lack of bids for individual tradable items of standardised lengths. Interest rates remained basically unregulated and the NBS, despite verbal statements about the possibility of their reduction, did not intervene directly in the setting of prices for crown resources. With regard to the preference given to the maintenance of the fixed exchange rate regime, the efforts to lower the level of interest rates were effective only in the run-up to the next fluctuation in rates on the foreign exchange market. In spite of this, interest rates fell in the long run on deposits of all maturities, from roughly 28% to below the level of 18%, while 1-month rates fell below 12% at the end of June.

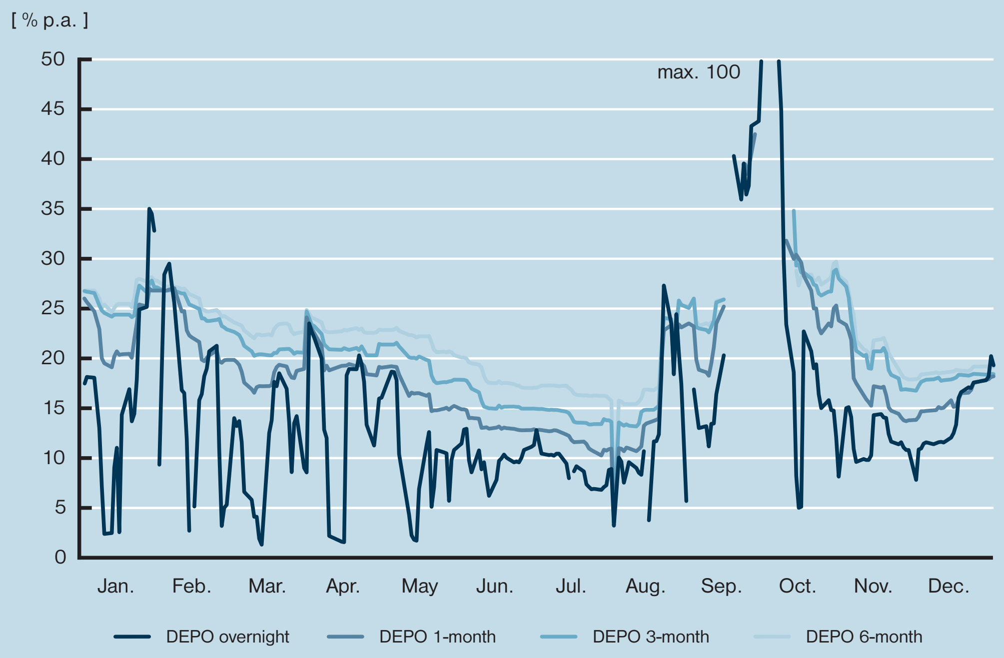
Room for the gradual lowering of interest rates was created during the first quarter, through the inflow of excess liquidity into the banking sector, which led to over-fulfilment of reserve requirements, above the level of 103%, several times. Although extension of the maturity of refinancing REPO tenders to 14 days was a positive development in February, the rates could not be maintained below the level of 20% in the long run. In this respect, a negative influence was exerted by the lowering of Slovakia's credit rating by Moody's agency in March and by Standard and Poor's in April. The lowering of the rates during this period was negatively affected by the acceptance of higher and higher rates at primary sale on the part of the Ministry of Finance. The increasing rates and the subsequent rise in the level of the deposit market confirmed the existence of a link with the foreign exchange market, where the exchange rate of the Slovak crown strengthened for a short time, as a result of increased interest in the Slovak currency on the part of non-residents wishing to take part in government bond auctions. The refinancing of the national debt had a vital effect on the level of interbank deposit rates in May, when the Ministry of Finance could reject funds offered at high rates at local auctions, due to an expected inflow of resources into the State budget from the issue and sale of eurobonds. The resulting surplus of resources exerted downward pressure on the level of rates at further government bond auctions, but mainly on the level of rates on the money market.

The NBS dealt with the surplus of liquidity and the subsequent depreciation in the currency by conducting REPO operations for sterilisation purposes. The total balance of intervention in the crown market shifted to the position of sterilisation, where it remained until September. Sterilisation activity culminated at Sk 18.8 billion at the end of June. Further reduction in the rates was, despite the continued surplus of liquidity, countered by the intention of the NBS to keep the rates within the fluctuation band, which made it necessary to drain free crown resources, and to prevent them from being used for the closing of open foreign exchange positions, and/or for the purchase of foreign exchange. Hence, sterilisation represented a permanent search for compromise between the effort to maintain the favourable development of crown deposit rates and the maintenance of the crown's exchange rate, which was under pressure exerted by the reduction in interest-rate differentials between crown and foreign currency deposit rates. In June, the said pressure was multiplied by the consequences of the financial crisis in Russia. During the ensuing period, the NBS continued to drain liquidity by extending the maturity of REPO tenders to 14 days, and by issuing Central Bank bills (NBS bills) with a maturity of three months, in August. This instrument was last applied in 1996. Despite these efforts, the 1-month rate approached the 13% limit already in June and the average rate for 1-month deposits fell below 12% at the end of July. Further fall was halted by the NBS using sterilisation measures in the form of setting the daily intervention targets in combination with tenders with different dates of maturity. This procedure, which may be characterised as a qualitative shift in the conduct of monetary policy, contributed to the draining of liquidity and disturbed the continuity of the fall in interest levels. The discontinued fall and subsequent rise in the rates was due partly to persistent fears of the consequences of the Russian crisis. The increased activity on the foreign exchange market, reflected in the rising level of demand for funds at NBS fixing, raised the IDX index above 1.05% and simultaneously reduced the surplus of crown liquidity in the banking sector. From August, the balance of sterilisation activities conducted by the NBS showed a tendency to fall and caused, due to foreign exchange purchases, a temporary shortage of liquidity.

The period from the beginning of September, which witnessed the run-up to parliamentary elections, was marked by the effort of the NBS to resist the speculative purchases of foreign exchange and the consequent depreciation in the value of the Slovak currency. The continued demand for foreign exchange raised the market values of IDX above the level of 1.065% and reduced the surplus of liquidity to such an extent that the total balance of intervention returned to refinancing position. Banks tried to handle the tense situation on the market by cancelling the generally binding obligation to publicly list their rates and by cancelling the maximum span between purchasing and selling prices. The subsequent rise in the level of rates above 40% with a 10% span was a natural consequence of a marked shortage of liquidity in the banking sector and the interbank market was limited to trades with a maturity of one day. The introduction of the system of floating exchange rates and the subsequent statements about preference for the domestic crown market, created conditions for the stabilisation of the money market during October.

As a result of the persistent short crown position in the banking sector caused by increased purchases of foreign exchange, the entire last quarter of 1998 was dependent on central bank resources. During the first ten days of October, the NBS supplied liquidity in a total amount of more than Sk 20 billion through short-

Development of interbank offered rates (BRIBOR) in 1998



-term tenders with a maturity of up to 7 days. The first signs of stabilisation appeared as early as October 13, when BRIBOR rates were again listed for all maturities with reduced spans. Parallel with the prolongation of refinancing tenders and the application of government bonds and NBS bills in the form of acceptable and refundable securities, the stabilisation of the market caused a fall in interest rates, which returned into the band of 15% to 20% at the end of November. As government bonds could not be used for refinancing purposes during the stock exchange holidays, interest rates showed a slight increase at the shorter end of the yield curve towards the end of the year.

In conclusion, it is possible to state that the year 1998 brought no significant changes for the money market. The implementation of monetary policy, as well as the money market, were subordinated to the maintenance of the fixed exchange rate regime. A positive factor was the attempt to stabilise deposit rates through the prolongation of refinancing tenders and, in the case of sterilisation, through the setting of daily limits. A positive role was played by the market makers - the reference banks, which managed to find a solution - especially in complicated situations - enabling to preserve the basic structure of the money market.

5.2. Capital Market

Primary Market

In 1998, auctions in government bonds were held at weekly intervals in accordance with the issuing schedule. Of the total number of auctions (44), thirty-three were successful; government bonds were put up for auction in the amount of Sk 66,987 million, representing an increase of 140% compared with the figure for 1997. Of these issues, 27 bonds (in the amount of Sk 51,627 million) had a maturity of one year. In the remaining 6 issues, bonds were floated in the amount of Sk 15,360 million with a maturity of two years. The increase in the volume of government bonds was justified by the need to cover the 1997 budget deficit, the need to finance the debt service, and the growth in government spending on infrastructure. This affected the development of interest rates on the primary market for government bonds, where the rates fluctuated around 22% at the beginning of the year and closed the year at the level of 29%. At the end of May, the financial market showed some signs of stabilisation, due to an issue of government bonds on the international market. This development was reflected in a fall of 10% (to 17-18%) in the level of interest rates on the primary market. In September, the policy pursued by the Ministry of Finance was influenced by the outflow of crown resources via foreign exchange fixing and the subsequent shortage of crown liquidity in the banking sector. Apart from issues sold by auction, the Ministry of Finance launched the 1st issue of government bonds (in paper form with a maturity of one year) on the capital market. The sale of these securities lasted for two months. The amount of issue was limited to Sk 2 billion, the rate of issue was set at 100% of the nominal value, and the total issue was divided into the following nominal values: Sk 1,000; Sk 5,000; Sk 20,000; Sk 50,000; and Sk 100,000. The highest demand was recorded in the case of bonds with a nominal value of Sk 5,000 and Sk 20,000. By the end of sale (20 July), bonds had been sold in the total nominal value of Sk 1,009 million. Over the course of the year, government bonds were issued in the total nominal value of Sk 67,996 million.

Publicly Negotiable Non-Government Bonds

The total amount of publicly negotiable non-government bonds issued in 1998 reached Sk 2,154 million, representing a fall of 70.4% (Sk 7,284 million) compared with the same period in 1997. The fall in the amount of bonds was due mainly to a rise in interest levels and the resulting decline in demand on the part of investors, who gave preference to shorter-term investments offering much higher yields.

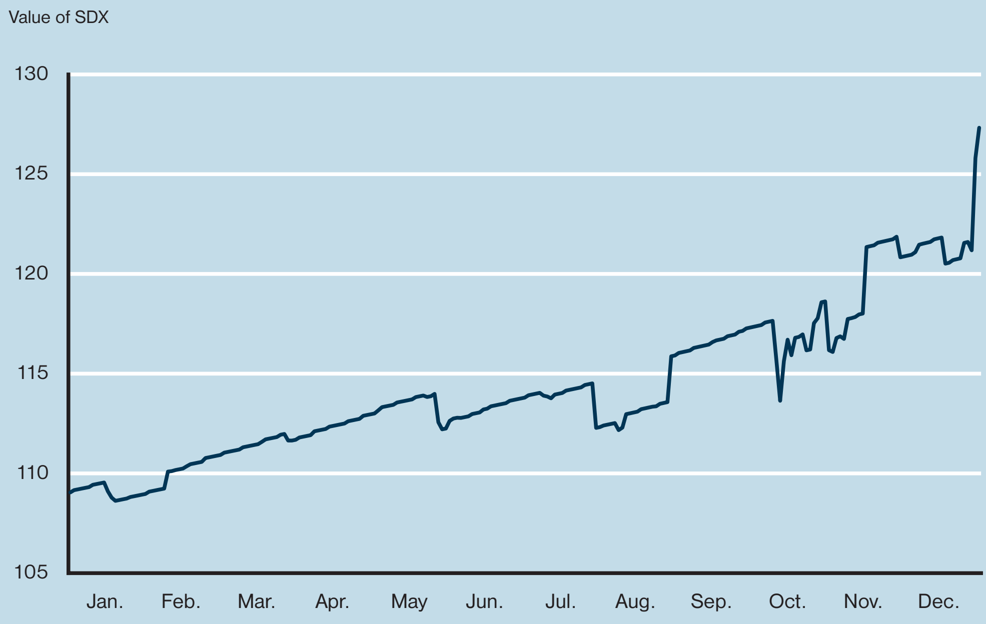
Secondary Market

The total volume of transactions reached, in 243 trading days, Sk 299.1 billion, representing a more than 80% increase in comparison with the previous year. Of the total volume of trading (Sk 299.1 billion), price-setting anonymous contracts accounted for Sk 22.6 billion (7.6%) and direct transactions for Sk 276.5 billion (92.4%). In comparison with the previous year, the percentage of anonymous contracts increased somewhat, due mainly to trading in government bonds. In terms of yields, only government bonds were able to compete with other products on the money market. As a result of the strong demand for government bonds, Slovak companies had little opportunity to obtain funds for their activities. This is documented by the fact that, during the whole year, the Stock Exchange accepted - apart from the aforementioned issues of government bonds - four new issues of municipal bonds, two bank and four corporate bonds for trading. The lowering of Slovakia's credit rating by leading agencies such as Moody's Investors Service (March 1998) and Standard & Poor's (September 1998) worsened the country's prospects for obtaining favourable loans for the support of the private sector.

Bonds

In 1998, the balance of trading on the Bratislava Stock Exchange (BCPB) was again improved, to a considerable extent, by trading in bonds. The sum of all trades reached Sk 261.8 billion, of which anonymous contracts accounted for Sk 20.7 billion, representing an increase of 475% compared with the 1997 figure. During the year as a whole, anonymous contracts were dominated by government bonds, even though the largest financial volume was traded in listed ČSOB 1999 bonds (Sk 3.1 billion). On the BCPB floor, the largest volumes (worth more than Sk 1 billion) were traded in government bonds of Issue No. 65 (Sk 2.8 billion); Issue No.

Development of the Slovak Bond Index (SDX) in 1998



38 (Sk 2.8 billion); Issue No. 57 (Sk 1.3 billion); and Issue No. 51 (Sk 1.2 billion). Direct transactions were dominated by government bonds of Issue No. 17 (Sk 25.7 billion); Issue No. 16 (Sk 16.8 billion); and Issue No. 38 (Sk 13.9 billion).

SDX Index

The component of the Slovak Bond Index (SDX) for bank and corporate bonds recorded a year-on-year increase of 17.4%, to 127.33% of the nominal value of its portfolio. On the last trading day, the average yield to maturity stood at 15.24%. The component for government bonds closed the year 1998 at 127.24% of the nominal value, while the average yield to maturity reached 18.14% and the annual increase 17%. The said increase was due to growth in demand for bonds and increased trading.

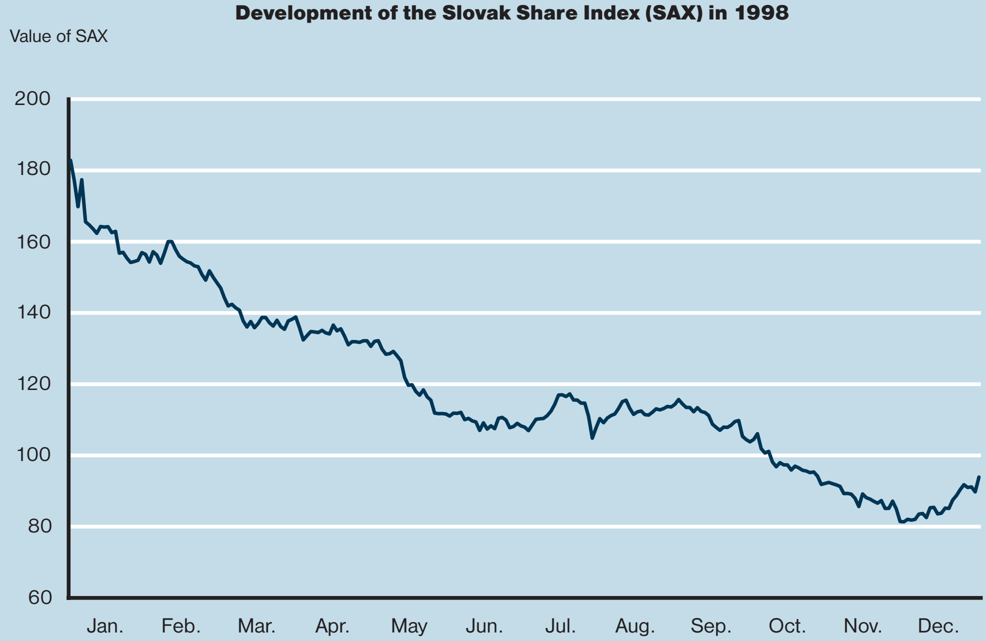
Shares

During the course of the year, the share market recorded a decline, not only in terms of prices, but in terms of liquidity as well. The total volume of trading in shares amounted to Sk 37.3 billion (-54.9% compared with 1997), of which price-setting transactions accounted for Sk 2.0 billion. In terms of the number of trading days, the best performers were listed issues: Slovakofarma shares (162 days; volume of trading: Sk 17.4 million); VSŽ shares (141 days, Sk 51.5 million); VÚB shares (138 days, Sk 14.5 million), and Slovnaft shares (132 days, Sk 62.5 million). On the anonymous market, however, shares were traded only in minimum volumes.

SAX Index

In 1998, the Slovak Share Index (SAX) fell below its initial level (100 points) as at 14 September 1993. The index has followed a negative trend, virtually from the beginning of the year. After temporary stabilisation during the period from June to August, the course of SAX definitely confirmed the downward trend. The run-up to parliamentary elections and the decision of the NBS to cancel the fluctuation band of the SKK in September, brought about a marked fall in the value of SAX. A 'black day' in the history of trading on the BCPB floor was

Development of the Slovak Share Index (SAX) in 1998



2 October, when the value of SAX fell to 98.22 points. For the rest of the year, the level remained below 100 points.

Structure of Share and Bondholders

By 31 December 1998, the structure of government bonds held by domestic investors had changed somewhat in comparison with 1997. While the share of commercial banks decreased by 12.27% (to 81.23%), that of domestic legal entities increased by 3.67% (to 9.27%). The share of foreign investors was 1.17%, i.e. 0.28% more than at the end of 1997. The number of bonds held by non-residents reached higher values as well, which, however, gradually fell towards the end of the year, due to lower interest on the part of foreign investors in government bonds before the parliamentary elections, despite the attractive interest rates. Foreign investors held 9.58% of all securities, which was almost 1% more than in 1997.

5.3. Foreign Exchange Market

Foreign Exchange Fixing

During 1998, foreign exchange fixing (FXF) followed the trend from the past two years, when transactions conducted in NBS foreign exchange fixing were constantly on the decline. Whereas in 1996, the NBS purchased foreign exchange in FXF in the amount of US$ 358.9 million and sold only US$ 164.8 million in 1997, the volume of sales reached US$ 992.1 million (US$ 465.2 million and DM 912.2 million) in 1998. The sales took place predominantly in August and September (US$ 944.5 million).

The first sign of instability of the Slovak crown's exchange rate was seen as early as January, when commercial banks purchased US$ 98.2 million through foreign exchange fixing. In the following months, the situation calmed down and remained unchanged till the beginning of August, when fear of devaluation intensified among entrepreneurial entities and the population, which led to systematic purchases of foreign exchange. The exchange rate was relatively stable during the entire first half of the year. This was due mainly to the fact that the most important participants in the market, domestic and foreign commercial banks, as well as domestic business entities and the population, were aware that a change in the exchange rate regime during the run-up to parliamentary elections was highly unlikely. Then, as the election day approached, the situation began to change. The population and the banking sector accepted the view that the exchange rate system had to be changed irrespective of the final result of the parliamentary elections.

The interbank foreign exchange market was negatively affected by the financial crisis in Russia, which significantly modified the attitude of foreign banks towards their partners operating in Slovakia. Foreign banks began to close their open crown positions, while the crown liabilities of Slovak banks vis-a-vis non-residents decreased by Sk 4 billion (approx. US$ 110-120 million) from the end of July to the beginning of October. In view of a marked fall in foreign exchange reserves and the persistent fears of currency devaluation, the NBS decided to replace the fixed exchange rate regime by the system of floating rates. At the same time, the conditions for trading in foreign exchange fixing and the pegging of the Slovak crown to a currency basket were cancelled. Since 2 October 1998, the value of the Slovak crown has been set according to the supply of and demand for Sk on the interbank foreign exchange market. The reference currency, under basis of which the exchange rate of the Slovak crown is monitored, became the German mark (DM).

In 1998, the volume of transactions conducted in foreign exchange fixing totalled US$ 1.2 billion, of which 48.6% was in US$ (US$ 0.6 billion) and 51.4% in DM (DM 1.1 billion). The number of contracts reached 242, with an average amount of US$ 5.0 million per contract. In comparison with 1997, when the total volume of trading amounted to US$ 2.5 billion, representing an average amount of US$ 6.5 million per contract, the total volume of transactions fell by 51.3%. Foreign exchange fixing transactions were conducted in US$ and DM, with a moderate dominance of DM (51.4%), whereas 1997 saw the opposite.

Basic characteristics of the Slovak foreign exchange market in 1998

	USD			DEM			Other currencies			Total	
	Volume		Number	Volume		Number	Volume		Number	Volume	Number
	(US$ mn)	(%)	of trans.	(US$ mn)	(%)	of trans.	(US$ mn)	(%)	of trans.	(US$ mn)	of trans.
Foreign exchange fixing	590.2	48.6	133	623.1	51.4	109	-	-	-	1,213.3	242
Transactions between Slovak banks	20,994.5	70.6	8,451	7,625.0	25.7	4,494	1,105.5	3.7	1,563	29,724.9	14,508
Interbank foreign exchange market: fixing + transactions between Slovak banks	21,584.7	69.8	8,584	8,248.1	26.7	4,603	1,105.5	3.6	1,563	30,938.2	14,750
Transactions between Slovak and foreign banks	30,055.2	86.2	8,287	4,504.0	12.9	3,289	304.7	0.9	437	34,863.8	12,013
Foreign exchange market in the SR - total	51,639.8	78.5	16,871	12,752.0	19.4	7,892	1,410.1	2.1	2,000	65,802.0	26,763

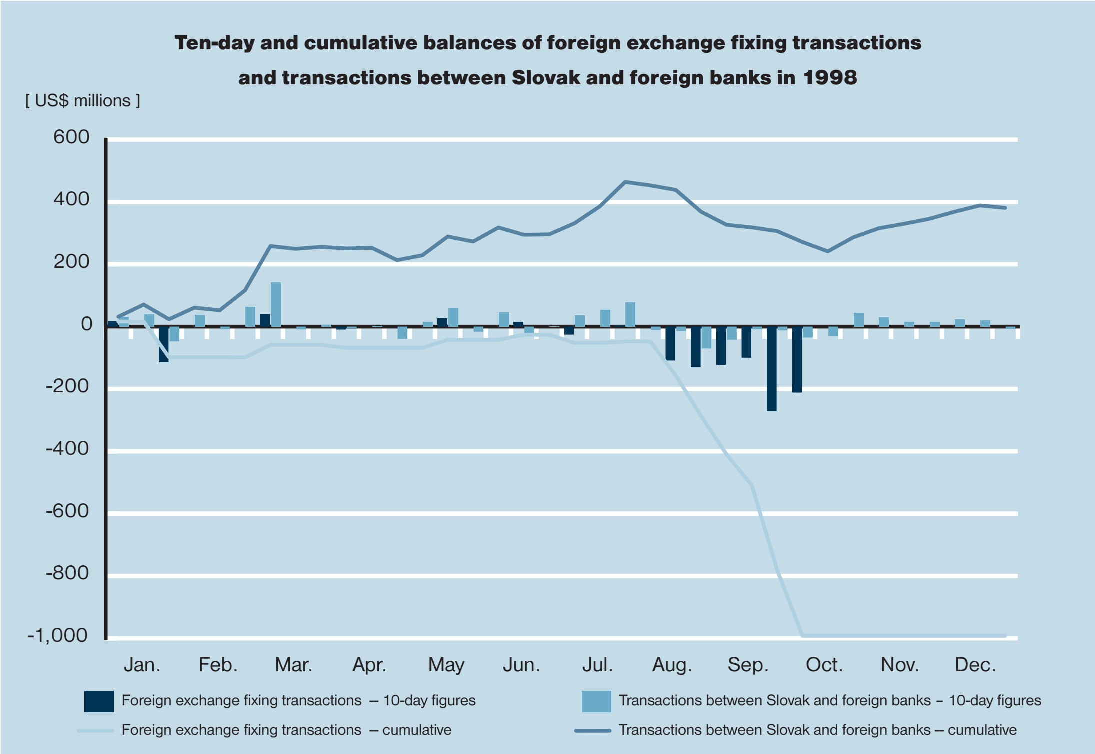
Since the beginning of the year, the value of the currency basket coefficient (IDX) increased from 1.0190 (2 January 1998) to 1.0595 (1 October 1998), which represented a depreciation of 4.05% in the exchange rate of the Slovak crown from the beginning of the year to the cancellation of the fluctuation band. The value of IDX reached its maximum (1.0595) between 25 September and 1 October 1998, and minimum (1.0080) on 18 May 1998. Immediately after the cancellation of the fluctuation band, the exchange rate of the SKK against DEM (DEM/SKK) weakened from 20.833 to 23.093 in three days. Later the rate of the crown stabilised and gradually strengthened, and closed the year at the level of DEM/SKK 22.081. Over the course of the year, SKK weakened against DEM from DEM/SKK 19.398 (31 December 1997) to 22.081 (31 December 1998), i.e. by 13.83%. During the same period, the exchange rate of SKK against USD (USD/SKK) weakened from 34.782 to 36.913, i.e. by 6.12%.

Transactions Between Banks (Except for the NBS)

After a problematic period of marked fluctuations, trading between Slovak commercial banks on the foreign exchange market recorded a decline during the months of May and June 1997 to February 1998. During the following months, trading showed a moderately upward trend with a marked increase in the last two months of the year. In spite of this, the total volume of transactions fell by 27.6% (US$ 29.7 billion) and the number of contracts decreased by 28.1% (14,508), while the average volume per transaction remained unchanged (US$ 2 million).

The structure of trades by currency remained virtually unchanged. Most trading was concluded in USD (70.6%, compared with 70.3% in 1997), followed by DEM (25.7%, compared with 23.7% in 1997), and other currencies (3.7%, compared with 6.0% in 1997). The most significant change in the currency structure of transactions (in favour of DEM) was recorded after the cancellation of the currency basket.

Trading between Slovak and foreign banks appears to have assumed a leading position on Slovakia's interbank foreign exchange market,



with a share of 53% (48.4% in 1997). With regard to trading between foreign banks, the dominance of USD was even more pronounced. However, the last quarter of the year saw an increase in the share of DEM as well. The balance of trading with foreign banks generated a surplus of US$ 0.4 billion.