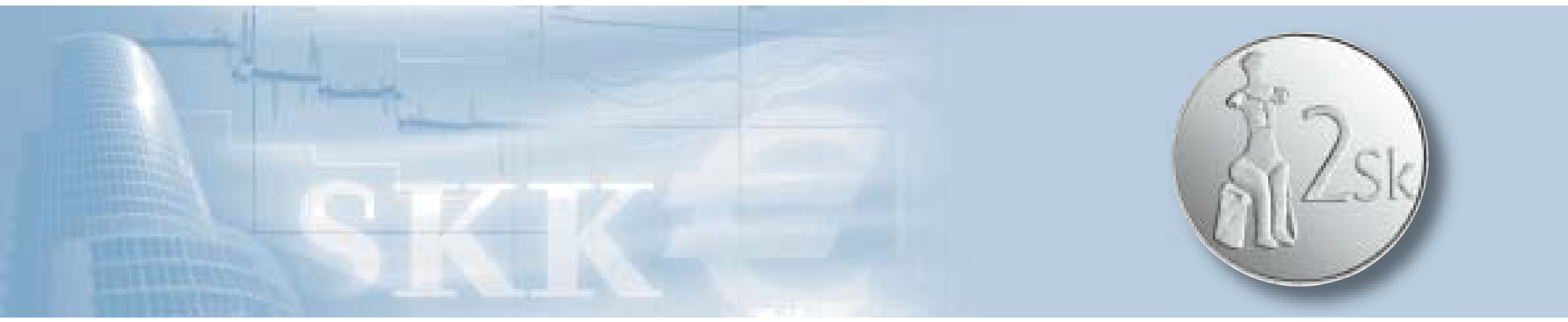
Monetary Developments



2 Monetary Developments

Introduction

Since the beginning of 2005 the NBS has pursued a monetary policy strategy defined as inflation targeting within ERM II conditions in line with the NBS Monetary Programme for the period until 2008. As the main anchor for the NBS monetary policy strategy, targets were defined for future development in inflation. On the one hand, the NBS has in this manner formulated an unambiguous monetary policy strategy focussed on price stability, consistent with the Act on the NBS and meeting Maastricht inflation criterion. On the other hand, this strategy makes it possible to reflect the necessity of meeting the exchange rate criterion and respecting the ERM II system.

In order to comply with EU membership commitments and plans to create conditions for adoption of the single currency, the euro, as well as the government's pledge to reduce the fiscal deficit, in the medium term the NBS defined targets for the year-on-year inflation rate measured by the Harmonised Index of Consumer Prices (HICP) below 2.5% as at December 2006, and below 2% as at December 2007 and 2008, to meet Maastricht criterion based on the average 12-month inflation rate. The level of the year-on-year inflation rate of 3.5% ±0.5 percentage points set for December 2005 also represented a target, reflecting the range of administrative adjustments to regulated prices. At the same time this level was set in line with the medium-term inflation target.

In connection with changes in monetary-policy strategy, an adjustment was also made in communicating monetary policy to the public. In this context the Bank Board approved the 'NBS Communication Strategy to 2009' at the beginning of 2005. NBS monetary programmes were replaced by quarterly published medium-term forecasts, the first of which was released in May 2005. NBS decisions concerning its key interest rates are presented in the form of commentaries. Since May 2005 the voting ratio at the previous month's Bank Board meeting has also been published by the NBS. As of the end of the year the NBS also started releasing the voting ratio of Bank Board members at meetings devoted to interest rates on the day relevant decisions are approved. Monetary policy communication is closely co-ordinated with Slovakia's national communication strategy for adoption of the euro. This strategy, described in the National Euro Changeover Plan for the Slovak Republic, comes under the NBS' jurisdiction.

The National Euro Changeover Plan for the Slovak Republic was approved by the NBS Bank Board in June 2005 and subsequently also in July by the Slovak government. It contains plans for individual steps to be taken for the smooth and successful introduction and use of the single currency in the Slovak economy. In line with the Specification of the Strategy for Adopting the Euro in the SR, a paper approved by the government in 2004, the National Plan assumes Slovakia will enter the euro area in 2009. Part of this strategic paper was the timing of Slovakia's ERM II entry in June 2006 at the latest.

The Slovak koruna was included in the ERM II on 28 November 2005. The central parity was set at SKK/EUR 38.4550 and a standard fluctuation band of ±15% applies for the koruna. Slovakia made no unilateral commitment to use a narrower fluctuation band. On entry into the ERM II Slovakia is obliged to pursue a sound fiscal policy and promote wage developments that remain in line with productivity growth. This policy is fully in line with the Convergence Programme of the Slovak Republic and the NBS Monetary Programme.

Slovakia's ERM II membership should not represent any limitation on meeting the inflation target. On the contrary, this exchange rate regime should provide an appropriate framework for nominal and real convergence. On the one hand, the ERM II will ensure a certain degree of exchange rate stability and create a disciplinary framework for macroeconomic policy, and on the other hand, leave sufficient room to adapt to shocks and economic developments.

Economic and monetary developments in 2005 were characterised by a slowdown in the rate of price increases, acceleration of economic activity, continuing consolidation in public finances, appreciation by the Slovak koruna against the euro and a relatively dynamic development of bank lending to both households and the business sphere.

The price increase already slowed significantly at the beginning of 2005, primarily related to the lower range of regulated price adjustments in comparison with 2004. However, the lower year-on-year HICP inflation rate was also influenced by low imported inflation that reflected ongoing trends in the exchange rate of the Slovak koruna, as well as by increased competition on the retail market. This disinflationary development was also reflected in core inflation (HICP inflation excluding energy and unprocessed food), which dropped to the level of the euro area. In contrast, from the third quarter of 2005 energy price development (oil, natural gas) placed an upward pressure on the price level, reflected in the increased range of regulated price adjustments. In particular the unexpected energy price rises, defined as an exemption within targeted inflation, contributed to the rise in year-on-year inflation. While the year-on-year inflation rate reached almost 2% in July and August, it rose to 3.9% at the end of the year. Although the rise in inflation at the end of the year was affected by factors outside the central bank's influence, the year-end HICP inflation rate was below the upper limit of the target band for 2005 (3.5% ± 0.5 percentage points).

The rate of economic growth accelerated in comparison with the previous year by 0.5 of a percentage point to 6%[4], which was the highest level since 1996. The structure of economic growth was balanced, influenced by both domestic and foreign demand. The acceleration in GDP dynamics was primarily related to faster growth in domestic, mainly investment demand, which took the form of fixed investments and growth in inventories. Foreign direct investments and the financial results of non-financial corporations stimulated growth in investment demand. The marked increase in investments took place mostly in infrastructural structures, which seems to be to a large extent connected with the construction of new automobile plants. Slightly accelerated growth was also recorded in final consumption, mainly in that of households. The rate of growth, however, did not exceed overall GDP dynamics. Accelerated growth in final household consumption was connected with more pronounced wage growth and, as it seems, with increased borrowing. Nevertheless, the growth in real wages was not fully channelled into consumption and also supported the growth in gross household savings at constant prices, which increased for the first time since 2002. GDP growth was dampened by net exports, when higher levels of imports reflected mainly robust investment demand, and, to a lesser extent consumer demand.

The deficit in the balance of payments current account as a share of GDP increased in 2005 by 5.1 percentage points in comparison with the previous year to 8.8%. Its increase was affected by deterioration in the trade balance deficit, and, firstly in the income balance deficit. The trade deficit increase resulted from a downturn in exports of transport vehicles and increased imports of investment and consumer goods, as well as increased raw materials imports. The latter were also affected by price developments on world markets. The increase in the income balance deficit was connected with increased dividend payments and also with a change in the methodology according to which, from 2005 onwards, reinvested earnings started to be recorded.

In 2005 the relatively dynamic growth in lending continued, supported by a further decline in interest rates, improved loan availability, growth in real wages, and accelerated economic growth. Loans to households continued to be dominated by loans for house purchases, but consumer loans also increased. Growing bank lending led to an increase in household debt when household loans as a share of GDP increased from 9.7% in 2004 to 12.6% in 2005. Dynamic loan growth was recorded in other new EU member states as well. Nevertheless, Slovak household debt was the lowest within the V4 group.

In an environment of robust economic growth the conduct of the NBS' monetary policy was, in accordance with the Act on the NBS, focused on maintaining price stability and meeting the inflation target not only for 2005, but also in the medium term. At the beginning of 2005 the Slovak economy was confronted with strong pressures on appreciation of the nominal exchange rate resulting from an influx of short-term capital, motivated by expectations of further appreciation in the exchange rate of the koruna against the euro against the backdrop of increased foreign direct investments and an anticipated increase in labour productivity, as well as positive interest rate differentials. The unduly rapid appreciation, which was inconsistent with equilibrium trajectories, created the risk that the overvalued exchange rate would be corrected in the future and thus hamper meeting the inflation target in the mid term. Inflation forecasts for that period indicated that inflation might be below the inflation target at the end of 2005. Thus, the overvalued exchange rate might have lead to an unjustified decline in inflation to the detriment of economic growth. To mitigate this development the National Bank of Slovakia started to intervene in the foreign exchange market in February and ceased to

[4] *The NBS 2005 Annual Report does not contain revised data on gross domestic product since revised data was unavailable in the required time structure for preparing the report. According to the available data, overall GDP recorded no marked changes in its dynamics, but rather structural changes. Based on revised data GDP growth reached 6.1% in 2005.*

accept bank bids at regular sterilisation repo tenders. The consequent liquidity surplus placed downward pressure on market interest rates and lowered the attractiveness of the Slovak currency. The Bank Board of the NBS decided, with effect from 1 March 2005, to lower its key interest rate by 1 percentage point to 3.0%. Thereafter appreciation pressures eased and, at the same time, partly as a consequence of regional effects, previous trends were corrected. In the following period the exchange rate showed a volatile pattern. After Slovakia's ERM II entry the exchange rate once again strengthened significantly.

The rise in the prices of energy commodities and the related increase in regulated prices, which began in the third quarter, was reflected in an increased inflation forecast for the end of 2005 and for the year 2006. Even though the direct effect of regulated price increases on year-on-year inflation dynamics is a one-off factor, representing an exemption from the inflation target, the price increase may accelerate as a result of secondary effects and increased inflation expectations in the long term. The main cause for the risk increase was the environment of dynamic real wage growth exceeding labour productivity growth and rapid economic growth indicating a closing of the negative output gap. In as early as October 2005 the NBS drew attention to these risks (in its commentaries concerning the Bank Board decision on the set level of interest rates) and the possible need to tighten monetary policy in the coming period. Hence 2006 monetary policy focuses on dampening excessive secondary effects of regulated price adjustments, as well as on identifying possible demand-side pressures with the aim of meeting mid-term inflation targets.

2.1 Economic developments

2.1.1 Price developments

Inflation

Inflation in terms of the Harmonised Index of Consumer Prices

Consumer prices, expressed in terms of the Harmonised Index of Consumer Prices (HICP), had increased by 3.9% by the end of December 2005, representing a slowdown in dynamics of 1.9 percentage points compared with the end of 2004. The average inflation rate reached 2.8% in 2005 (compared with 7.5% in 2004), with the prices of goods and services rising by 1.6% and 5.5% respectively. The year-on-year rate of core inflation (overall inflation, excluding energy and unprocessed food prices) averaged 1.7% in 2005 and was 4.8 percentage points lower than in the previous year.

Goods

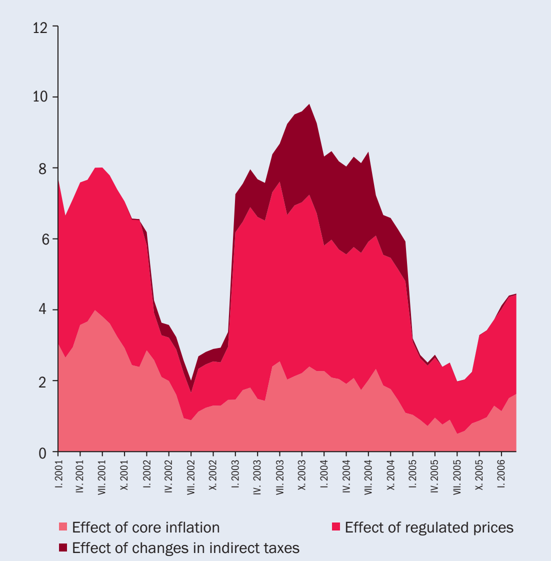
As in previous years, the increase in goods prices was accelerated in 2005 by energy prices again. The most significant increases took place in regulated prices (electricity, gas, and other energy prices, which rose by an average of 8.2%) and fuel prices, which were 6.7% higher than in 2004. The prices of non-energy industrial goods fell during the year by an average of 0.7%, while the year-on-year rate of fall gradually accelerated over this period and closed the year with a drop of 0.9%. Within the structure of this sub-aggregate, the steepest increases occurred in the

Table 3 **Consumer price developments in terms of the HICP (average for the period)**
(year-on-year changes in %)

	2004	2005 Q1	2005 Q2	2005 Q3	2005 Q4	2005 Year
Total	7.5	2.8	2.6	2.2	3.6	2.8
Goods	6.4	1.0	1.2	0.9	3.3	1.6
Industrial goods	6.8	2.2	1.9	2.4	5.8	3.0
Non-energy industrial goods	1.6	0.1	-0.9	-1.1	-1.0	-0.7
Energy	14.5	5.0	5.7	7.0	14.9	8.2
Foodstuffs	5.8	-0.7	0.0	-1.4	-0.7	-0.7
Processed food (including alcohol and tobacco)	7.5	-1.0	-1.5	-2.5	-1.8	-1.7
Unprocessed food	1.4	-0.6	2.8	0.6	1.7	1.1
Services	10.1	6.8	5.7	5.0	4.4	5.5
Core inflation (excluding energy and unprocessed food prices)	6.5	2.6	1.7	1.2	1.2	1.7
Total, excluding energy	6.0	2.3	1.9	1.2	1.2	1.6

Source: NBS calculations based on data from the Statistical Office of the SR.

Chart 7 **Structure of the 12-month inflation rate** **(percentage points)**



Source: Statistical Office of the SR.

prices of non-durable industrial goods (an average of 2.5%), while the prices of durable industrial goods dropped by 5.7%. Food prices were 0.7% lower, with the price of processed food falling by 1.7% and that of unprocessed food rising by 1.1%.

In services, the most rapid increases were recorded in prices for regulated services, mainly services related to housing (an average of 7.6%), and prices for other services (11.9%), which were responsible for this development. The only category of services to record a price fall were post and telecommunications, where prices dropped during the year by an average of 0.3%.

Inflation in terms of the national Consumer Price Index

In 2005, consumer prices increased less dynamically than in 2004, with the year-on-year inflation rate, expressed in terms of the Consumer Price Index (CPI), reaching 3.7% in December (compared with 5.9% in the same period a year earlier). The average inflation rate reached 2.7% in 2005 (compared with 7.5% in 2004).

The fall in the year-on-year dynamics of consumer prices in 2005[5] (compared with the previous year) was due to a slowdown in the rate of price increase in most categories of the consumer basket, except for fuel prices. Of the total increase in consumer prices as at the end of the year (3.7%), core inflation accounted for 1.3 percentage points. Administrative adjustments to regulated prices contributed 2.4 percentage points

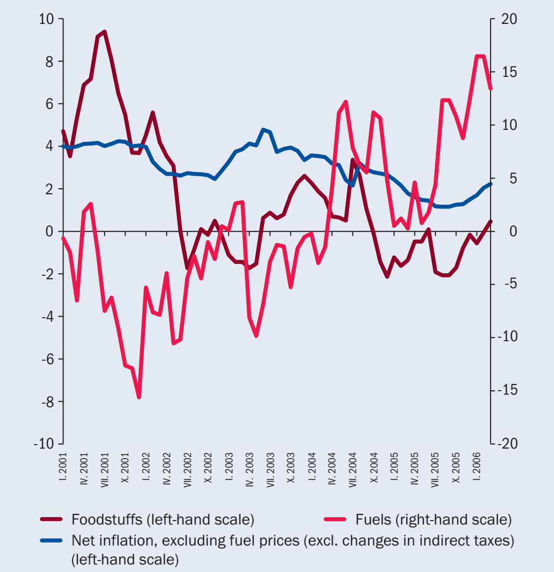
Table 4 **Consumer price developments** **(year-on-year changes in %)**

	2004	2005			
	Dec.	Mar.	June	Sep.	Dec.
Total in %	5.9	2.5	2.5	2.2	3.7
Regulated prices in %	15.1	7.4	7.1	6.4	11.1
Share of total, in percentage points	*3.71*	*1.70*	*1.61*	*1.45*	*2.44*
Impact of changes in indirect taxes on non-regulated prices – share of total, in percentage points	*1.12*	*0.09*	*0.00*	*0.00*	*0.00*
Core inflation in %	1.5	0.9	1.1	1.0	1.7
Share of total, in percentage points	*1.09*	*0.72*	*0.90*	*0.79*	*1.29*
of which:					
Food prices in %	-2.1	-1.3	0.1	-2.1	-0.2
Share of total, in percentage points	*-0.41*	*-0.26*	*0.00*	*-0.36*	*-0.03*
Tradable goods in %1)	-0.2	-1.7	-1.3	-0.4	-0.2
*Share of total, in percentage points*1)	*-0.07*	*-0.59*	*-0.58*	*-0.12*	*-0.06*
Market services in %1)	8.2	6.9	6.3	5.0	5.1
*Share of total, in percentage points*1)	*1.57*	*1.56*	*1.49*	*1.27*	*1.37*
Net inflation (excluding the impact of changes in indirect taxes) in %	2.8	1.7	1.5	1.8	2.1
Share of total, in percentage points	*1.50*	*0.89*	*0.77*	*0.96*	*1.32*

Source: Statistical Office of the SR.
1) NBS calculations based on data from the Statistical Office of the SR.

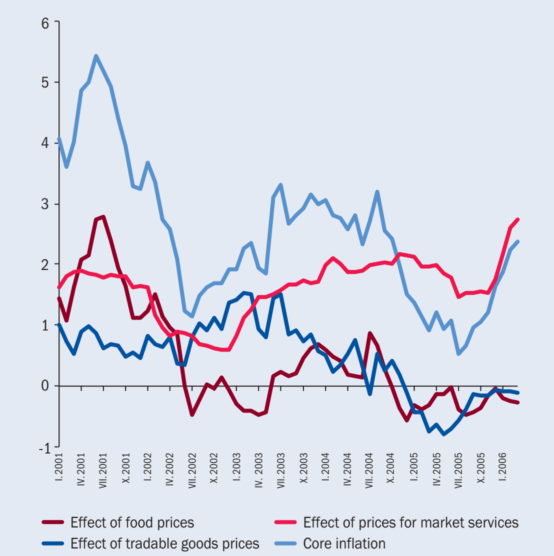
[5] *Inflation expressed in terms of the Consumer Price Index is, unlike other price indicators, evaluated as at December 2005, with regard to the need to calculate the contributions of individual consumer-basket components to headline inflation. For that reason, the Table 4 contains data on consumer price developments from the last months of the individual quarters of 2005.*

Chart 8 **Developments in the prices of core inflation components (year-on-year increase in %)**



Source: Statistical Office of the SR.

Chart 9 **Structure of the year-on-year core inflation rate (percentage points)**



Source: Statistical Office of the SR.

to the overall consumer price increase. The year under review saw no changes in indirect taxes.

During the first half of 2005, the year-on-year inflation rate slowed, to 2.0% in July, then followed a steadily accelerating trend starting in August.

Price levels in 2005 were primarily determined by domestic factors (as in previous years), when price developments were influenced by administrative measures (but to a lesser extent than in previous years). On average, administrative measures (changes in regulated prices) accounted for approximately 67.6% of the overall price increase in 2005. The slowdown in regulated price increases was probably also reflected in the weaker secondary effects of prices for market services, whose year-on-year dynamics gradually diminished during the year.

The strengthening of the Slovak koruna against the euro was reflected in food prices, which fell virtually throughout the year, and in the low level of imported inflation. This led to a slowdown in the rate of increase or a year-on-year fall in tradable goods prices.

Regulated prices

Consumer price developments were, as in previous years, determined by the implementation of administrative measures in the area of regulated prices. At the end of the year, the year-on-year dynamics of regulated prices reached 11.1% (compared with 15.1% in 2004). January saw increases in regulated prices for electricity, gas, heat, water, and sewage disposal. Price levels also increased during the year for meals at school canteens and accommodation at university dormitories. The price of heat was raised with effect from September and that of gas increased from October, due to the rising oil prices.

Changes in indirect taxes

The year under review saw no changes in indirect taxes. In the first months of 2005, year-on-year price dynamics were influenced by the increased excise duty on cigarettes from May 2004.

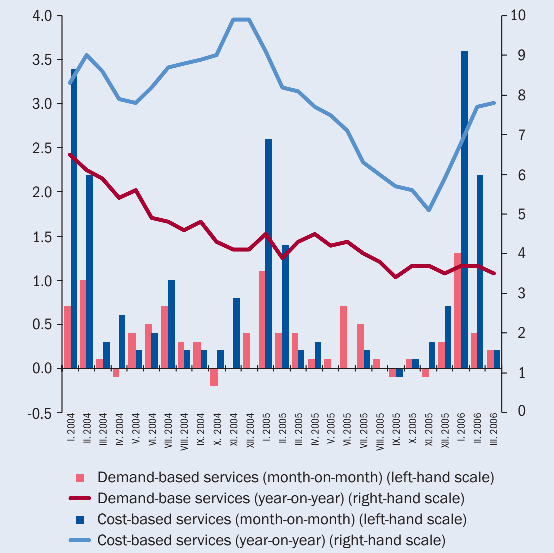
Core inflation

In December 2005, core inflation reached 1.7%, representing an increase of 0.2 of a percentage point in comparison with the same period in 2004. Its course over the first three quarters was characterised by a stable year-on-year rate at a level around 1.0%, with a steeper rise in the final quarter.

Within the basic structure of core inflation, prices for market services were the determining factor in the price increase (making the most significant contribution to core inflation), for they probably reflected the secondary effects of regulated price increases.

Food prices (excluding non-alcoholic beverages), as a component of core inflation, recorded a year-on-year fall of 0.2% at the end of the year. This development resulted from several factors, first and foremost the openness of the market for suppliers from the entire

Chart 10 **Prices for demand-based cost-based market services** (growth in %)



Source: Statistical Office of the SR.

EU, competition on the retail market, and the appreciation of the Slovak koruna, which had a dampening effect on food prices. These factors were reflected mostly in processed food prices.

Core inflation was dampened by the prices of tradable goods, which fell year-on-year by 0.2% in December. This fall was a result of several factors. In the conditions of strong competition in retail trade, the prices of tradable goods were also affected by developments in the exchange rate of the Slovak koruna, when its appreciation was mirrored in consumer prices, in the form of low imported inflation. By the end of the year, the prices of tradable goods excluding fuels had fallen by 1.6%. An upward effect on tradable goods prices was exerted by fuel prices, which increased throughout the year (at a markedly accelerated rate from September). Their level reacted to changes in oil prices and the exchange rate of the koruna against the dollar. The steepest year-on-year increase in fuel prices was recorded in December 2005 (12.5%).

The slowdown in the year-on-year dynamics of prices for market services during the year, which was primarily caused by domestic cost factors, was probably a reflection of the smaller range of regulated price increases than in the previous year. At the end of the year, the year-on-year rate of price increase in this segment reached 5.1%, which was 3.1 percentage points less than in the same period a year earlier. The developments in services prices did not signal the existence of excessive demand pressures, when the steepest increase was recorded in prices for services related to housing (7.8% in December 2005). Among demand-based services, the most rapid increases occurred in services in the area of education (5.4% in December) and recreation and culture (5.2% in December).

Producer prices

Producer price developments in 2005 were affected by numerous factors, the most important being an increase in the prices of energy-producing and other industrial raw materials, which was dampened by a slight appreciation in the exchange rate of the Slovak koruna against the US dollar, coupled with the good crop of agricultural products and pressure from retail chains. As a result of these factors, the dynamics of industrial producer prices increased and agricultural producer prices decreased (after an increase in the previous year). Prices for construction work and building materials increased at a slower rate than a year earlier.

Table 5 **Year-on-year developments in producer prices (average for the period)** (%)

	2004	2005				
		Q1	Q2	Q3	Q4	Year
Industrial producer prices	3,4	2,5	4,0	5,6	6,7	4,7
Raw materials prices	5,9	-0,6	-1,5	1,2	25,6	6,0
Manufacturing products prices	3,4	2,8	2,5	2,0	1,3	2,1
Prices of electricity, gas, steam, and hot water	3,2	2,5	6,6	10,9	13,1	8,3
Construction prices	6,0	5,4	4,4	3,7	3,7	4,3
Building materials prices	5,6	7,7	6,3	2,4	1,3	4,4
Agricultural products prices	2,1	-1,9	1,3	-5,7	-1,3	-2,4
Prices of plant products	6,8	-15,1	-16,8	-14,8	-3,7	-10,8
Prices of animal products	0,1	1,0	3,7	0,6	0,5	1,4

Source: Statistical Office of the SR.

Industrial producer prices

The faster year-on-year rate of increase in industrial producer prices in 2005 was mainly a result of external cost factors. These factors caused a more than twofold year-on-year increase in the dynamics of electricity, gas, steam, and hot water prices (by an average of 8.3% in 2005, compared with 3.2% in 2004). The prices of manufacturing products rose in 2005 to a lesser extent than in the previous year, mainly due to the dampening effect of food prices, which fell over the first eleven months of the year.

The increase in energy prices in 2005 was mostly generated by a marked rise in prices for gas production and the distribution of gaseous fuels by pipeline (21.6%, compared with 3.6% in 2004) and a rise in prices for the production and distribution of steam and hot water (7.8%, compared with 1.9% in 2004). Prices for the production and distribution of electricity rose year-on-year only slightly (by 1% in 2005, compared with 1.8% in 2004).

Despite a certain year-on-year increase in dynamics (mainly in the last quarter), raw materials prices had a relatively weak influence on the level of industrial producer prices in 2005, due to their small weight.

The year-on-year rise in manufacturing products prices (an average of 2.1%) was caused by increases in the prices of refined oil products (24.8%), base metals and finished metal products (7.2%), and chemical products (3.9%), offset partly by a fall in the price of food products (4%). Prices in other subcategories had a negligible impact on the aggregate price of manufacturing products.

Construction prices

The rate of increase in construction prices slowed in 2005 by 1.7 percentage points in comparison with the previous year, to an average of 4.3%. This increase took place in equal measure in prices for construction repair and maintenance work, and work on new construction, modernisation, and reconstruction projects in residential and civil engineering construction.

The rise in the prices of materials and products used in construction (material and products of domestic industrial producers) also slowed in comparison with the previous year (by 1.2 percentage points), to 4.4%. The price of materials used in construction repair and maintenance work rose year-on-year by 3.9% and that of materials used in new construction, modernisation, and reconstruction projects increased by 4.5%.

Agricultural prices

After rising in 2004, the prices of agricultural products fell in 2005 by an average of 2.4%. Their year-on-year fall was caused by a drop in the price of plant products (10.8%), offset partly by a modest year-on-year increase in the price of animal products (1.4%).

Price developments in plant production were mainly connected with drops in the prices of cereals (14.1%), oilseed rape (13.2%), potatoes (10.2%), and fruit (8.6%).

Developments in animal products prices were affected by increases in the prices (for live animals) of beef including veal (4.3%), pork (4%), and unpasteurised cow milk (3.1%) on the one hand, and by drops in the prices of eggs (12.1%) and poultry (2.6%) on the other hand, due probably to a fall in demand as a result of the spreading bird flu virus.

2.1.2 Gross Domestic Product

GDP deflator

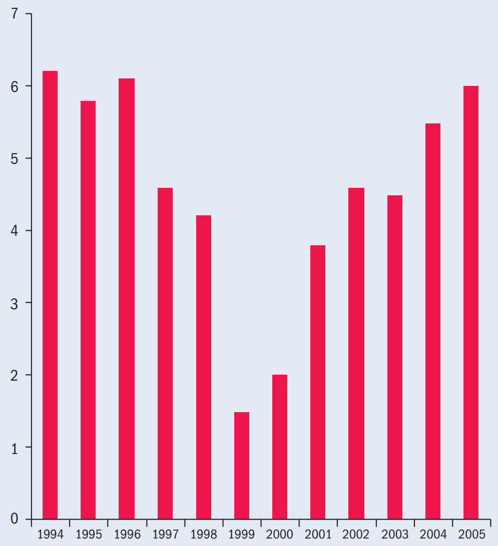
The general price increase, expressed as an increase in the GDP deflator, reached 2.5% in 2005, which was 2.1 percentage points less than in 2004. Developments in the GDP deflator were primarily influenced by the slower year-on-year increase in consumer prices.

Table 6 **Developments in the GDP deflator**
(index, same period a year earlier = 100, average for the period)

	2004	2005				
		Q1	Q2	Q3	Q4	Year
CPI	107.5	102.8	102.5	102.1	103.5	102.7
PPI	103.4	102.5	104.0	105.6	106.7	104.7
GDP deflator	104.6	102.5	103.0	102.2	102.1	102.5
Export deflator	97.9	99.6	100.4	100.0	101.2	100.3
Import deflator	98.3	100.8	102.5	101.2	103.1	102.0

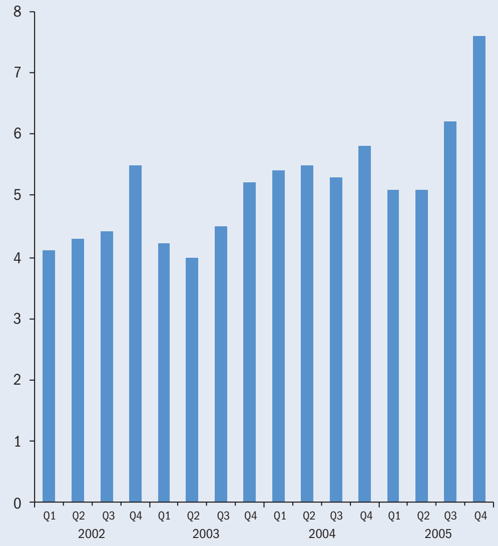
Source: Statistical Office of the SR.

Chart 11 **Growth in real gross domestic product** **(year-on-year growth in %)**



Source: Statistical Office of the SR.

Chart 12 **Real GDP growth by quarter** **(year-on-year growth in %)**



Source: Statistical Office of the SR.

The GDP deflator was affected by the deflator of domestic demand and the relationship between the export and import deflators. The increase in the domestic demand deflator (3.2%) resulted from a virtually identical rise in price levels for the consumption components of demand and gross capital formation. Among the prices of final consumption components, the price level in public consumption rose at a faster rate (4.0%) than the price level in private consumption (3.1%). The increase in the price level of gross investments was mainly caused by a rise in inventory prices, while fixed investments dampened the deflator of gross capital formation.

A downward effect on the GDP deflator was exerted by price developments in foreign trade. Developments in the koruna exchange rate and other price factors on foreign markets led to smaller increases in the export and import deflators (0.3% and 2.0% respectively) in comparison with the domestic price level. The prices of exported goods and services increased more slowly than the prices of goods and services imported from abroad.

Gross Domestic Product

According to data from the Statistical Office of the SR, gross domestic product increased in 2005 by 6.0% year-on-year at constant 1995 prices (at constant 2000[6] prices by 6.1%), representing the fastest rate of growth since 1996. Compared with 2004, the rate of

Table 7 **Aggregate demand and its coverage** **(constant 1995 prices)**

	Volume in billions of SKK			Structure in %		
	2003	**2004**	**2005**	**2003**	**2004**	**2005**
Aggregate demand	1,486.1	1,618.5	1,757.3	100.0	100.0	100.0
Domestic demand	762.7	812.2	863.4	51.3	50.2	49.1
Foreign demand	723.4	806.3	893.9	48.7	49.8	50.9
Coverage of aggregate demand						
Domestic supply	783.4	826.5	876.3	52.7	51.1	49.9
Foreign supply	702.7	792.0	881.0	47.3	48.9	50.1

Source: Statistical Office of the SR.
Note: Domestic demand includes the statistical discrepancy. Foreign demand includes the exports of goods and services. Domestic supply represents GDP and foreign supply is formed by imports of goods and services.

[6] *In May 2006, the Statistical Office of the SR published selected revised data on GDP from the annual national accounts for the years 2000-2005. With regard to the range of revised data so far published, GDP development was analysed on the basis of quarterly national accounts with the basis year being 1995.*

Table 8 **Breakdown of GDP creation by component** **(SKK billions, constant 1995 prices)**

	2003	2004	2005	Growth index 2003/02	2004/03	2005/04
Gross output	1,870.3	1,928.2	2,049.3	105.1	103.1	106.3
Intermediate consumption	1,164.2	1,181.1	1,264.2	105.2	101.5	107.0
Value added	706.1	747.1	785.1	105.1	105.8	105.1
Net taxes on products	77.3	79.4	91.1	99.1	102.7	114.7
Gross domestic product	783.4	826.5	876.3	104.5	105.5	106.0

Source: Statistical Office of the SR.
Note: The growth indices are calculated from figures expressed in millions of SKK. Net taxes on products include value added tax, excise duty, and import tax, minus subsidies.

Table 9 **Sectoral breakdown of gross domestic product**
(index, same period a year earlier = 100, constant 1995 prices)

	2004/2003	Q1 05/Q1 04	Q2 05/Q2 04	Q3 05/Q3 04	Q4 05/Q4 04	2005/2004
Gross domestic product	105.5	105.1	105.1	106.2	107.6	106.0
of which:						
Agriculture, hunting, forestry, and fishing	109.6	114.2	108.0	105.2	106.1	107.9
Industry in total	111.5	107.9	106.5	106.3	114.3	108.7
Mining and quarrying	96.8	101.2	109.5	109.2	105.5	106.5
Manufacturing	111.9	107.4	108.7	106.6	114.9	109.5
Electricity, gas, and water supply	111.3	110.5	85.3	102.0	109.7	103.1
Construction	111.8	110.8	113.7	118.0	118.9	115.6
Services in total	103.0	103.9	104.0	102.5	98.1	102.0
Wholesale and retail trade, repairs	111.3	114.6	105.0	115.1	109.8	110.9
Hotels and restaurants	98.3	98.4	97.3	100.2	107.3	100.8
Transport, storage, post and telecommunications	101.6	104.7	112.9	117.8	102.0	109.2
Financial intermediation	130.1	100.6	97.5	70.1	93.8	90.2
Real estate, renting, and business activities	108.3	103.8	104.8	100.7	91.4	99.6
Public administration, defence, social security	93.8	102.8	105.4	100.2	102.1	102.5
Education	94.5	88.8	88.2	86.0	83.2	86.4
Health and social care	83.8	87.6	94.3	88.2	65.4	83.9
Other community, social, and personal services	74.8	103.9	105.7	107.7	105.2	105.7
Other[1)]	98.5	96.8	102.5	137.5	156.7	119.4

Source: Statistical Office of the SR.
1) Value added tax, excise duty, import tax, minus subsidies and imputed production of banking services (FISIM).

economic growth accelerated by 0.5 of a percentage point. In terms of use, GDP growth was connected with an increase in domestic as well as foreign demand, and was mostly stimulated by value added creation in industry, trade, and construction. The nominal volume of GDP created in the period under review amounted to SKK 1,439.8 billion, which was 8.6% more than a year earlier.

In a breakdown by quarter, real economic growth accelerated from 5.1% in the first and second quarters to 6.2% in the third quarter and 7.6% in the fourth quarter, which represents the strongest real growth ever achieved in the Slovak economy. In terms of structure, the rapid real GDP growth in the fourth quarter was mainly influenced by gross capital formation, which increased year-on-year by 33.5%.

The development of domestic and foreign demand led to growth in aggregate demand (8.6% at constant prices, compared with 8.9% in 2004). Within the structure of aggregate demand, the share of foreign demand increased year-on-year by 1.1 percentage points (to 50.9%), to the detriment of domestic demand.

Within the structure of aggregate demand, the individual halves of the year saw different developments. In the first half, domestic and foreign demand

Table 10 **Breakdown of gross domestic product by use (index, same period a year earlier = 100, constant 1995 prices)**

	2004 / 2003	Q1 05 / Q1 04	Q2 05 / Q2 04	Q3 05 / Q3 04	Q4 05 / Q4 04	2005 / 2004
Gross domestic product	105.5	105.1	105.1	106.2	107.6	106.0
Domestic demand	105.5	105.5	108.4	103.5	111.7	107.3
Final consumption	102.8	104.6	104.3	104.7	105.2	104.8
Households	103.5	105.5	105.6	106.2	105.9	105.8
General government	101.1	101.8	100.7	100.9	103.8	102.0
Non-profit institutions serving households	105.8	105.1	103.2	102.0	102.5	103.2
Gross capital formation	113.1	108.0	118.0	100.7	133.5	114.1
Gross fixed capital formation	102.5	105.8	110.7	116.5	115.1	112.4
Exports of goods and services	111.4	107.2	105.0	116.1	115.0	110.9
Imports of goods and services	112.7	107.9	106.9	111.6	117.7	111.2

Source: Statistical Office of the SR.

affected GDP in roughly equal measure, then in the second half, their growth dynamics increased, but domestic demand grew at a slower rate than foreign demand. Aggregate supply also reacted to the increased foreign demand, which led to faster growth in GDP as well as imports. While foreign demand and foreign supply in 2004 was below the level of domestic demand and/or GDP, they exceeded their volume in 2005. Share of imports and exports of GDP reached 201% in 2005 at constant prices, due to dynamic growth in foreign trade.

Supply side of GDP

The creation of value added was affected by the higher gross output and increased intermediate consumption. In addition to the value added, real GDP growth in 2005 was also promoted by increased net taxes on products. Due to a modest excess of growth in intermediate consumption over growth in gross output, the share of value added in the Slovak economy decreased to 38.3% (from 38.7% in 2004).

The strongest growth in value added (15.6%) was recorded in construction. Its growth was connected with the high demand for construction work, leading to growth in gross fixed capital in the form of investments in construction. The growing demand was also reflected in the service sectors of the economy, with the value added in trade increasing year-on-year by 10.9% and in transport, post and telecommunications by 9.2%. Rapid growth (7.9%) was also recorded in value added in agriculture, including forestry and fishing, which was mainly connected with the drawing of EU funds. Value added creation remained below the level of last year in health and social services, education, and financial intermediation.

Relatively strong growth in value added was recorded in industry (8.7%), mainly as a result of foreign direct investment in manufacturing production. In manufacturing, value added creation showed strong dynamics in the production of foodstuffs, beverages and tobacco products, and in the manufacture of machines, electrical equipment, and transport vehicles.

Demand side of GDP

In terms of use, GDP was influenced in 2005 by real growth in both domestic and foreign demand. The year-on-year growth in domestic demand took place in all its components, but was influenced mostly by an increase in investment demand. Foreign demand failed to reach its dynamics from the previous year, but continued growing at a two-digit rate and increased the export performance of the economy.

Domestic demand grew at a faster rate than in 2004, mainly as a result of developments in its investment component. The year-on-year dynamics of gross capital formation in 2005 increased to 14.1% at constant prices, which was 1 percentage point more than in the previous year. Compared with 2004, when investment demand was mainly generated by the increased volume of inventories, its growth in 2005 was promoted by fixed investments growing at a two-digit rate. The consumer component of domestic demand grew in comparison with 2004 by 4.8% at constant prices, while its growth was supported by final consumption in the household and general government sectors, whose dynamics increased on a year-on-year basis. Real final household consumption grew in comparison with the previous year, but its dynamics in 2005 remained below the level of real economic growth, which means that household spending on consumption did not increase as a share of GDP.

2

Table 11 **Structure of gross fixed capital formation in 2005**

	Gross fixed capital formation (SKK millions)	Proportion (%)	Index 2005/04
Economy of the SR in total	376,736	100.0	112.4
of which (by sector):			
Non-financial corporations	243,189	64.6	119.3
Financial corporations	46,638	12.4	101.3
General government	32,281	8.6	103.0
Households	53,954	14.3	101.2
Non-profit institutions	674	0.2	81.1
of which (by production):			
Buildings and structures	128,289	34.1	118.5
of which: Residential buildings	23,566	6.3	114.2
Other structures	104,723	27.8	119.5
Machinery	224,438	59.6	110.0
of which: Metal products and machines	167,690	44.5	110.7
Transport equipment	56,748	15.1	107.9

Source: Statistical Office of the SR..
Note: Amounts and proportions are at current prices, indices at constant prices.

Domestic investment demand

The dynamic growth in gross capital formation was due to growth in fixed investments (12.4%, after three years of stagnancy) and a record increase in the volume of inventories (SKK 24.7 billion at constant prices). Gross fixed capital formation followed a growing trend over the course of 2005, from 5.8% in the first quarter to 15.1% in the fourth quarter. Fixed capital formation was mainly influenced by investment in new fixed assets, while the volume of corporate acquisitions decreased. The creation of new fixed assets (a growth of 15.2% at constant prices), together with a relatively marked decrease in corporate acquisitions (19.2%), created good conditions for an increase in capital productivity and sound real economic growth in the future.

A sectoral analysis of the structure of capital formation shows that the most significant progress was recorded in the investment activities of non-financial corporations, which can be attributed to foreign direct investments and the financial results of these corporations. Most investment means were produced by non-financial corporations, mainly through the creation of new fixed assets. The year-on-year increase in investment activity in 2005 took place largely in fixed investments in the production of transport vehicles (75%), with automobile factories recording a sixfold increase in gross fixed investments. Within the non--financial corporations sector, entrepreneurial entities also made significant investments in trade; construction; agriculture, including forestry and fishing; and electricity, gas, and water supply. Investment activity also increased in the general government sector, that of financial corporations, and the household sector.

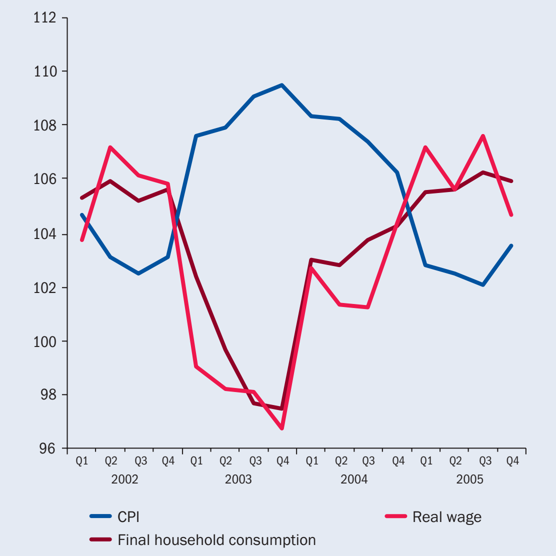
The most rapid growth took place in investment in buildings and structures. Investment in this sector grew

Table 12 **Investments and savings** **(%; current prices)**

	2003	2004	2005
Savings ratio[1)]	23.6	23.9	24.1
Gross investment ratio[2)]	25.4	26.3	28.6
Fixed investment ratio[3)]	25.7	24.7	26.2
Coverage of investments by savings[4)]	92.8	90.9	84.4

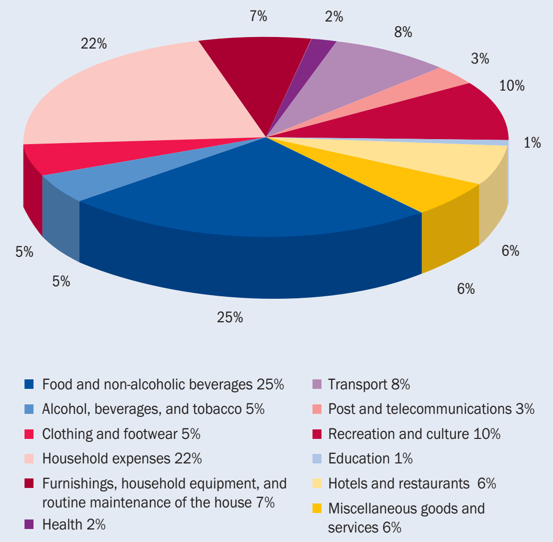
Source: NBS calculations based on data from the Statistical Office of the SR.
1) Ratio of gross domestic savings (GDP less final consumption in total) to GDP.
2) Ratio of gross capital formation to GDP.
3) Ratio of gross fixed capital formation to GDP.
4) Ratio of gross domestic savings to gross investment.

Chart 13 **Final household consumption, inflation, and real wages** **(%)**



Source: Statistical Office of the SR.

Chart 14 **Structure of final household consumption** **(%)**



Source: Statistical Office of the SR.

year-on-year almost twice as fast as investment in machines. Investment in buildings and structures grew mainly as a result of increased investment allocation for other structures, including infrastructural facilities. They were in large part connected with the construction of automobile production plants and related utilities. Hence, investment in buildings and structures as a share of gross fixed capital formation increased year-on-year by 1.8 percentage points, to 34.1%.

Over the course of 2005, the volume of inventories in the economy increased by SKK 34.7 billion at current prices (SKK 24.7 billion at constant prices), with positive increases being recorded in all four quarters. The growth in inventories in 2005 was caused by increases in all components, especially in work in process (18.7%) and goods (15.7%), while materials inventory and livestock contributed to the overall increase in inventories to a lesser extent.

The share of domestic savings in the financing of investment demand decreased slightly in 2005. There were almost 91 haliers worth of gross savings in the national economy for one koruna worth of gross investments in 2004; this ratio decreased in 2005 to 84 haliers. This decrease was caused by the increased year-on-year growth rate of gross fixed capital formation, mainly as a result of foreign direct investment.

Domestic consumer demand

The growth in final consumption in 2005 was caused by increases in all components. While households used their disposable incomes to satisfy their needs relatively evenly over the course of 2005, the general government sector spent a third of its annual expenditure in the final quarter. The growth in spending on consumption by non-profit institutions slowed to roughly half the figure recorded a year earlier, which was probably connected with the slower rate of transformation of selected public sector entities into non-profit organisations rendering services to households.

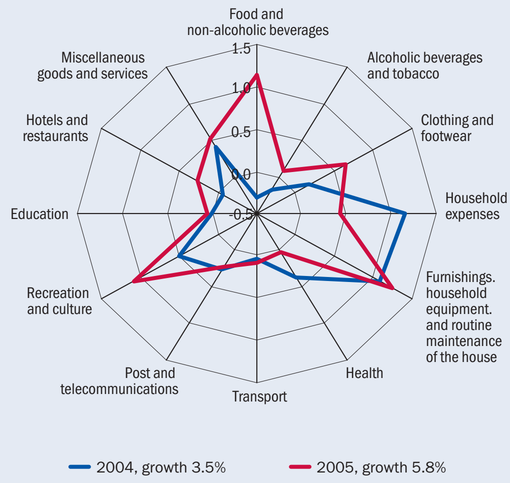
Final household consumption increased year-on-year by 5.8%, but maintained its share of the total volume of GDP from the previous year, which means that households consumed half (50.3%) of the volume of GDP in 2005. The growth in private consumption was stable over the course of 2005, with the relatively highest rate recorded in the third quarter, when real wage growth also reached a record level. The dynamics of final household consumption were affected by accelerated wage growth in a period of relatively low inflation, accompanied by increased borrowing. The growth in real wages was not fully reflected in private consumption, but contributed to the growth in gross household savings, which also increased in 2005 at constant prices (for the first time since 2002).

Within the structure of final household consumption, the strongest growth (19.1% at constant prices) was recorded in spending on furnishings, household equipment, and routine maintenance of the house. The increased utilisation of credit facilities by households was, in all probability, not only connected with investment in new fixed assets, but also with the reconstruction of existing housing units or with home improvement by purchasing new furnishings, household equipment, and domestic appliances. Spending on furnishings, household equipment, and routine maintenance of the house as a share of total household expenditure increased by almost 1 percentage point in 2005.

In terms of structure, consumption was dominated by spending on food and non-alcoholic beverages, but their share of total private consumption decreased somewhat in comparison with 2004 (to 24.9%). Within private consumption, two-digit real growth was recorded in spending on clothing and footwear, as well as on recreation and culture, whose share in total spending on consumption also increased.

The above-mentioned four groups of consumption that made the greatest contributions to the growth in final household consumption in 2005, were responsible for up to 70% of the overall growth in private consumption. These groups were mostly composed of tradable goods, whose consumption was saturated with imported goods as well as domestic products.

Chart 15 **Contributions of individual consumer expenses to growth in final household consumption (percentage points)**



Source: NBS calculations based on data from the Statistical Office of the SR.

Income and expenditure of households

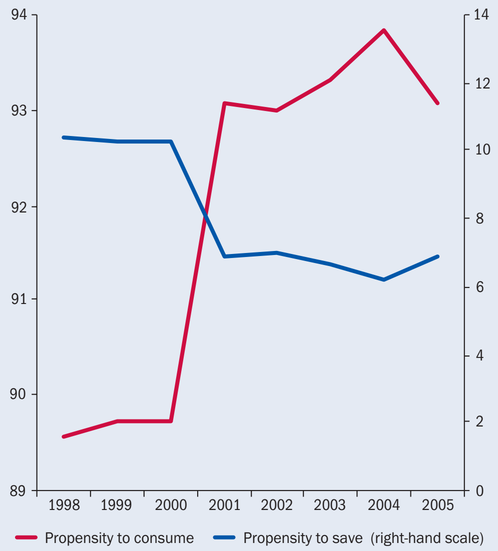
According to preliminary data from the Statistical Office of the SR, the current income of households reached SKK 1,124.2 billion in 2005, representing a year-on-year increase of 8.2% in nominal terms (5.4% in real terms). Compared with 2004, the rate of growth accelerated in nominal terms by 0.2 of a percentage point and in real terms by 4.9 percentage points. Current households expenditure (paid to other sectors and not used for direct consumption) totalled SKK 271.4 billion, representing a year-on-year increase of 6.2% (3.4% in real terms).

Table 13 **Generation and use of income in the household sector** **(current prices)**

	SKK billions		Indices[1)]		Share in %	
	2004	2005	2004/2003	2005/2004	2004	2005
Compensation of employees (all sectors)	532.1	579.3	107.7	108.9	51.2	51.5
of which: Gross wages and salaries	399.4	441.6	108.4	110.6	38.4	39.3
Gross mixed income	289.0	332.1	109.1	114.9	27.8	29.5
Property income – received	36.8	20.7	130.9	56.4	3.5	1.8
Social security benefits	148.9	157.7	103.5	105.9	14.3	14.0
Other current transfers – received	32.6	34.4	102.0	105.4	3.1	3.1
Current income in total	1,039.5	1 124.2	108.0	108.2	100.0	100.0
Property income – paid	9.3	12.7	142.2	136.8	3.6	4.7
Current tax on income, property, etc.	45.6	46.3	90.7	101.6	17.8	17.1
Social security contributions	176.0	185.2	103.3	105.3	68.9	68.2
Other current transfers – paid	24.6	27.1	102.2	110.0	9.6	10.0
Current expenditure in total	255.5	271.4	101.7	106.2	100.0	100.0
Gross disposable income	783.9	852.8	110.2	108.8	100.0	100.0
Adjustment for changes in the net equity of households in the reserves of pension funds	3.0	12.7	91.4	423.5	-	-
Final household consumption	738.7	806.3	110.7	109.2	-	-
Gross savings of households	48.3	59.1	101.7	122.5	6.2	6.9

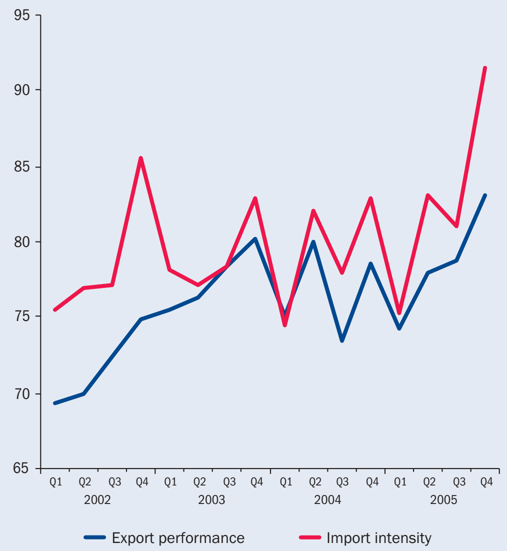
Source: Statistical Office of the SR.
1) Calculated from figures expressed in millions of SKK.

Chart 16 **Propensity of households to consume and save** (%)



Source: NBS calculations based on data from the Statistical Office of the SR.

Chart 17 **Export performance and import intensity** (%)



Zdroj: ŠÚ SR.

The growth in current income was favourably affected by increases in gross mixed income and employee compensation, while a dampening effect was exerted by declining receipts from property.

The year-on-year growth in current expenditure was mainly connected with increases in social security contributions, expenses related to property income, and other current transfers paid. The smallest increase took place in current tax on income and property. The growth in social security contributions was probably influenced by the relevant legal regulations adjusting the basis of assessment for obligatory contributions to social security funds (depending on the average and/or minimum wage), and the growth in employment.

With current expenditure being deducted from current income, the gross disposable income of households amounted to SKK 852.8 billion, representing a year-on-year increase of 8.8% (compared with 10.2% a year earlier). Of this amount, 93.1% was used for final consumption (93.8% a year earlier); the remainder went to gross savings, which include the investment activities of citizens and small entrepreneurs (tangible and intangible investments, plus additional retirement insurance) in addition to their bank deposits. The dynamic growth in gross household savings in 2005 (22.5%) was apparently affected by a marked increase in additional retirement insurance, growth in household income, and by the low basis of comparison from the previous year. The accelerated growth in gross savings was reflected in the trend of development in gross household savings, which started to increase again as an annual average.

Net exports

The exports and imports of goods and services achieved two-digit growth rates in 2005. Imports showed stronger dynamics than exports, which led to deterioration in the trade balance on a year-on-year basis. In nominal terms, net exports resulted in a deficit of SKK 62.9 billion (SKK 35.6 billion in 2004). With price developments on foreign markets taken into account, net exports at constant prices generated a surplus of SKK 12.9 billion in 2005 (SKK 14.3 billion in 2004).

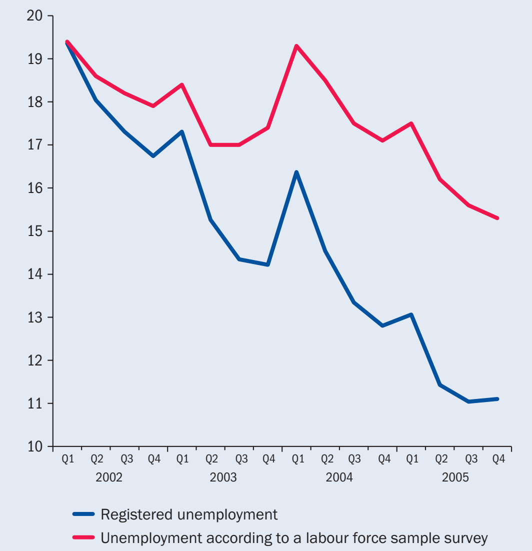
The deficit increased in nominal terms and the surplus decreased in real terms as a result of a marked increase in the dynamics of imports of goods and services (from 10.8% in 2004 to 13.5% in 2005) and a minor acceleration in the growth rate of exports (from 9.1% to 11.3%). The maintenance of a relatively high rate of growth in imports was probably connected with the increased domestic demand, which was largely of an investment nature. The deterioration in the trade balance in 2005 was mainly influenced by developments in the fourth quarter (in December), when more than half of the annual balance of goods and services at current prices was generated. The dynamics of real economic growth were not even dampened in the fourth quarter, since a substantial part of the increased imports took place in the form of an untraditional increase in inventories.

The export performance of the Slovak economy improved in 2005, when the exports of goods and services as a share of GDP at current prices reached 78.7% (compared with 76.8% in 2004). With the growing export performance, import intensity also increased, at an even faster rate, to 83.0% (from 79.5% a year earlier). The openness of the Slovak economy (expressed in terms of the ratio of exports-imports of goods and services to nominal GDP) increased in 2005 by 5.4 percentage points, to 161.7%.

Real growth in the exports of goods and services in 2005 (10.9%) virtually corresponded to the dynamics of imports of goods and services at constant prices (11.2%). The positive balance of foreign trade at constant prices decreased year-on-year, from SKK 14.3 billion to SKK 12.9 billion. Different developments were recorded over the course of the year. In the first half, the intensity of foreign trading moderated, while exports declined to a greater extent than imports, as a result of which net exports dampened the rate of GDP growth in the first six months. In the second half of 2005, however, net exports had a pro-growth effect on overall economic growth, when the increase in net exports in the third quarter was large enough to offset the deteriorated development in the fourth quarter.

Chart 18 **Unemployment rate**

(%)



Source: Statistical Office of the SR; Centre for Labour, Social Matters, and the Family; NBS calculations.

2.1.3 Labour market developments

Employment and unemployment

The favourable economic development in 2005 was also reflected in the level of employment. According to the results of a labour force sample survey (LFSS), the number of workers increased in 2005 by an average of 2.1%, which represented an acceleration in dynamics of 1.8 percentage points compared with 2004. The rate of employment growth fluctuated above the level of 2% virtually throughout the year (except in the third quarter). In terms of structure, the positive trend in employment in 2005 was substantially influenced by the number of employees, which recorded a 1.3% increase (after a decrease in the previous year). The number of entrepreneurs increased year-on-year by 8.2%, due mainly to an increase in the number of entrepreneurs without employees (11.5%, compared with 25.0% in 2004), while the number of entrepreneurs with employees dropped by 0.3% (after growing in 2004 by 19.5%).

According to the ESA 95[7] methodology, employment increased by 1.4% in 2005 (after falling in the previous year). Developments in employment in the individual sectors (based on ESA 95) were accompanied by growth in value added in most sectors. In 2005, numerous sectors recorded a faster growth in employment than in the previous year (construction and trade), or a change from decline to growth (public administration and defence, and other community services). On the other hand, a negative change from growth to decline was recorded in industry (as a result of a downturn in manufacturing). Continuing decline in employment was, as a year earlier, recorded in transport, financial intermediation, education, and health care.

The creation of new jobs in the economy, coupled with the effect of lower labour supply, led to a favourable trend in unemployment. On the basis of a labour force sample survey, the number of people out of work decreased year-on-year by 11.1% in 2005. This decrease was also reflected in the annual rate of unemployment, which reached 16.2% in 2005 (compared with 18.1% in the previous year). The positive trend in unemployment was maintained throughout 2005, with both the number of unemployed and the rate of unemployment decreasing steadily.

The falling trend in the unemployment rate was also confirmed by data on registered unemployment. According to the registers of Offices for Labour, Social Affairs, and the Family, the average unemployment rate in 2005 was 11.6% (compared with 14.3% in 2004). This figure is below the level determined by a sample survey, which can be explained by the differences in the applied methodologies and by differing definitions of unemployment.

[7] *According to the ESA 95, employment (number of employees and self-employed persons) is expressed in terms of the domestic concept, which includes adjustments for items such as the number of residents working abroad, non-residents coming from abroad, employees in collective households, women on maternity leave, etc. The ESA 95 methodology monitors employment in terms of the main or only employment according to the corporate method and numbers in terms of natural persons.*

Table 14 **Labour market indicators**

	2004	2005				
		Q1	Q2	Q3	Q4	Year
Nominal wage (SKK)	15,825	16,022	16,737	16,816	19,466	17,274
Nominal wage (index)	110.2	110.2	108.2	109.9	108.4	109.2
Labour productivity of GDP (index, current prices)	110.1	105.0	105.9	106.9	107.2	106.3
Real wage (index)	102.5	107.2	105.6	107.6	104.7	106.3
Labour productivity of GDP (index, constant prices)	105.2	102.4	102.8	104.6	105.0	103.7
Wage minus productivity (percentage points)	-2.7	4.8	2.8	3.0	-0.3	2.6
Compensation per employee in nominal terms, ESA 95 (index)	110.8	109.5	107.5	109.5	106.5	108.2
Labour productivity of GDP according to ESA 95 (index, current prices)	110.7	106.2	106.9	107.5	107.9	107.1
Compensation per employee in real terms, ESA 95 (index)	103.1	106.5	104.8	107.2	102.8	105.3
Labour productivity of GP according to ESA 95 (index, constant prices)	105.9	103.6	103.8	105.2	105.7	104.6
Employment according to statistical records (index)	100.3	102.6	102.2	101.5	102.5	102.2
Employment according to LFSS[1)] (index)	100.3	102.3	102.1	101.6	102.5	102.1
Employment according to ESA 95 (index)	99.7	101.4	101.3	101.0	101.8	101.4
Registered unemployment rate[2)] (%)	14.3	13.1	11.4	11.0	11.1	11.6
Unemployment rate according to LFSS (%)	18.1	17.5	16.2	15.6	15.3	16.2
Consumer prices (average index)	107.5	102.8	102.5	102.1	103.5	102.7

Source: Statistical Office of the SR and NBS calculations based on data from the Statistical Office.
1) Labour force sample survey (LFSS).
2) Of the disposable number of unemployed, average for the period (NBS calculations).

The situation in the labour market in 2005 was determined by the supply of labour. While the number persons in productive and post-productive age (15 years and above) increased year-on-year by 0.7% in 2005 (in 2004 by 1.2%), the size of the economically active population decreased by 0.5% (after increasing a year earlier by 0.9%). The increase in the number of persons aged 15 and above contributed to the increase in the number of economically inactive population (2.5%, compared with 1.7% a year earlier). In 2005, the activity rate fell in comparison with 2004 by 0.7 of a percentage point, to 59.5%. The growth in employment had a favourable effect on the rate of employment, which rose year-on-year by 0.8 of a percentage point, to 57.7%.

Wages and labour productivity

In 2005, the average monthly nominal wage in the Slovak economy showed relatively dynamic growth (9.2%), and reached SKK 17,274. The rate of wage growth was 1 percentage point slower than a year earlier. Nominal wages increased most significantly in the first and third quarters. The strongest wage growth was recorded in the public sector.

The strongest nominal wage growth in 2005 took place in education (10.3%), public administration and defence (9.4%), real estate and renting activities (9.4%), and electricity, gas, and water supply (8.8%). Relatively dynamic nominal wage growth was also recorded in transport, post and telecommunications (8.5%), health and social care (8.4%), other community and social services (8.4%), and trade and repairs (8.3%). In other sectors, wages grew at a slower rate, with the smallest year-on-year increases occurring in the wages of employees in financial intermediation (5.7%) and construction (6.0%).

Wage growth in education (more than 10% on average) was influenced by the relevant legal regulations issued in August 2005, and most probably by the fall in employment. Despite dynamic growth in 2005, the average wage in this sector reached only 82.3% of the average wage in the national economy. The lowest average wage was recorded in agriculture, hunting, and forestry (76.3% of the national average).

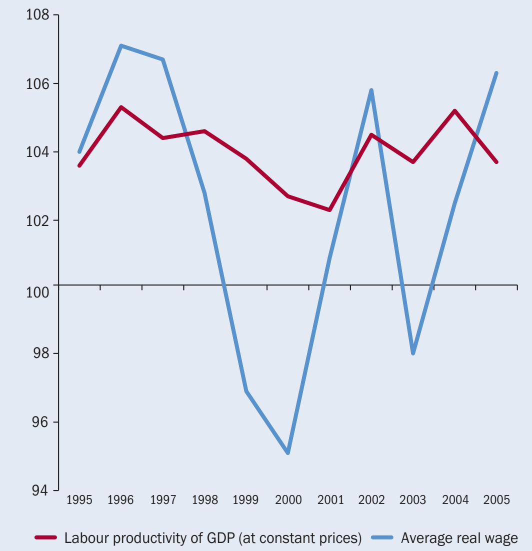
Real wages grew year-on-year by 6.3% in 2005 (a year earlier by 2.5%), when their dynamics were mostly affected by the lower level of average inflation than in 2004. Real wages increased in all sectors of the economy.

Labour productivity (GDP per employee, according to statistical reports) increased in nominal terms by 6.3% and in real terms by 3.7% in 2005. The growth in real productivity was 1.5 percentage points slower than in 2004, due to accelerated growth in employment (an increase of 2.2%, compared with 0.3% in 2004), which, however, was not accompanied by adequate value added growth).

After two years, the relation between labour productivity and wages changed to the detriment of productivity, with productivity growing in real terms at a rate 2.6 percentage points slower than the average monthly real wage.

The slowdown in nominal wage growth and employee compensation growth led to improvement in the development of unit labour costs according to the ECB's methodology (ULC_{ECB}, ratio of nominal compensation per employee to real labour productivity based on ESA 95), whose growth dynamics weakened in comparison with 2004 by 1.1 percentage points, to 3.5%. The opposite trend was recorded in real unit labour costs ($RULC_{ECB,}$ ratio of real compensation per employee to real labour productivity based on ESA 95), which recorded an increase – for the first time since 2002. Their development reflected the excess of growth in real compensation per employee over growth in labour productivity. This excess was caused by a slowdown in the rate of growth in productivity, accompanied by accelerated growth in real compensation per employee. The growth in real unit labour costs was probably connected with the markedly lower inflation in 2005. Growth in real unit labour costs may become a risk where it is a longer-term trend with an unfavourable impact on the trade balance or where it results in demand-side inflationary pressures.

Chart 19 **Developments in real wages and real labour productivity (index, ROMR = 100)**



Source: Statistical Office of the SR and NBS calculations based on data from the Statistical Office.

2.1.4 Financial results of corporations

The positive trend in the financial performance of corporations continued in 2005. From the beginning of the year, financial and non-financial corporations earned a cumulative profit of SKK 249.5 billion, which was more than 40% larger than a year earlier. A substantial part of this profit (88.5%) was generated by non-financial corporations, which achieved a year-on-year growth of 16.4%.

Improved results were also reported by financial corporations (including the NBS), which achieved a profit of SKK 28.7 billion in 2005 (after producing negative financial results for three years). The financial results of financial corporations were substantially affected by the results of the NBS, which considerably reduced its current losses in 2005. Better results than in 2004 were also achieved by other financial corporations, whose annual profits in 2005 were 22.5% higher than a year earlier.

Positive financial results were achieved in all branches of the non-financial sector, except for agriculture. The largest profit (more than 33%) was, as in the previous period, generated in manufacturing. A significant contribution to the total profit in the Slovak economy was made in electricity, gas, and water supply (21.1%) and trade (19%). Among the key sectors, the most significant year-on-year increases in profits were achieved in transport; post and telecommunications; and real estate, renting, and other business activities.

Table 15 **Financial results of corporations**

	2005 SKK millions, current prices	**2005/2004 index**
Financial results (before taxation)		
Non-financial and financial corporations in total	249,525	140.2
Non-financial corporations	220,858	116.4
Financial corporations	28,667	–
of which: NBS	-663	–
Financial corporations excluding the NBS	29,330	122.5

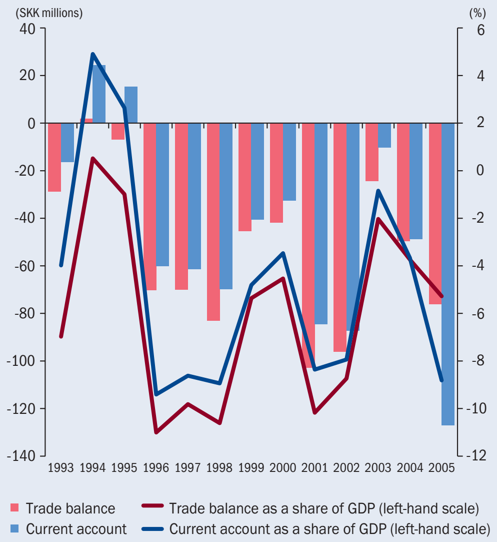
Source: Statistical Office of the SR.

In manufacturing, the strongest year-on-year growth in profits was recorded in the production of chemicals, chemical products, and fibres; metals and metal products; and foodstuffs, beverages, and tobacco products.

After a longer period, financial corporations achieved positive results owing to a change in the budgetary performance of monetary financial institutions, from a loss of SKK 22.3 billion in 2004 (including the NBS, which closed the year with a loss of SKK 36.3 billion) to a profit of SKK 16.2 billion in 2005. Other financial intermediaries contributed SKK 9.1 billion to the overall profit (a year-on-year increase of 28.5%) and insurance corporations and pension funds contributed a total of SKK 3.4 billion.

Of the total number of non-financial corporations with 20 and more employees (6,697), 4,677 were profitable: they generated a total profit of SKK 204.1 billion, representing a year-on-year increase of 19.7%. The remaining corporations recorded a total loss of SKK 31.2 billion (a year-on-year increase of 31.9%).

Chart 20 **Balance of trade and current account developments**



Source: NBS and Statistical Office of the SR.

2.2 Balance of payments

2.2.1 Current account

In 2005, the balance of payments on current account resulted in a deficit of SKK 126.9 billion, which was SKK 78.2 billion more than in 2004. This increase was largely due to a year-on-year deterioration in the trade and income balances. The b.o.p. current account deficit reached 8.8% of GDP at current prices, i.e. 5.1 percentage points more than in 2004. The trade deficit as a share of GDP also increased, from 3.7% to 5.3%.

The trade balance resulted in a deficit of SKK 76.0 billion. The year-on-year increase in the deficit (by SKK 26.4 billion) was a result of faster growth in imports than in exports.

According to preliminary data from the Statistical Office of the SR, goods were exported during 2005 in the total amount of SKK 993.5 billion, which was 11.5% more than in the previous year (15.9% in USD and 15.7% in EUR).

The growth in exports was unevenly distributed over the year. The beginning of the year saw slower growth in exports continuing from the last months of 2004 (exports grew over the first half of 2005 by 5.8%), which markedly accelerated in the second half of 2005 (exports grew by 17.2% in the second half of the year). Increased exports were recorded in a wide spectrum of goods in all basic commodity categories, while steeper year-on-year increases occurred in the exports of machines, transport vehicles, and finished products.

The increased exports in the 'machinery and transport equipment' category was the main factor in the year-on-year growth in exports. The growth in the category as a whole resulted from two conflicting tendencies, with the growth in machine exports being accompanied by decline in exports from the automotive industry. Increased machine exports in comparison with 2004 were already recorded in the first months of 2005; their growth accelerated further during the rest of the year. The acceleration took place mostly in the electronic industry, due to increased exports of television sets and videophones in particular. Automobile exports were on the downturn, partly as a result of preparations (installation of production lines) for the production of a new automobile model, scheduled for 2006.

In the production of automobile components, the exports of automobile seats also suffered a decline, which was the main reason behind the fall in furniture exports and, together with the lower exports of

Table 16 **Balance of payments on current account** **(SKK billions)**

	2005	2004
Balance of trade	-76.0	-49.6
Balance of services	9.9	8.6
Balance of income	-61.3	-13.2
Current transfers	0.5	5.5
Current account in total	-126.9	-48.7
Current account as a share of GDP in %	-8.8	-3.7

Source: NBS and Statistical Office of the SR.

Table 17 **Year-on-year changes in Slovak exports by segment and the contributions of individual segments**

	Year-on-year change in billions of SKK		Contribution to the year-on-year change in percentage points	
	2005	2004	2005	2004
Raw materials	15.6	17.4	1.8	2.2
Chemicals and semi-finished goods	37.3	41.1	4.2	5.1
of which: Chemical products	12.6	9.1	1.4	1.1
Semi-finished goods	24.7	32.0	2.8	4.0
Machinery and transport equipment	41.8	25.4	4.7	3.2
of which: Machines	61.4	44.2	6.9	5.5
Transport equipment	-19.6	-18.8	-2.2	-2.3
Finished products	7.9	4.0	0.9	0.5
Exports in total	102.6	87.9	11.5	10.9

Source: NBS calculations based on data from the Statistical Office.

clothes and toys, caused a year-on-year decrease in the exports of finished industrial products from the beginning of the year. The overall growth in exports in the 'finished products' category was supported by a year-on-year increase in the exports of agricultural products, mainly milk and dairy products, sugar, meat, and fruit.

The main factor in the year-on-year growth in the exports of chemical products and semi-finished goods was the continuation of positive trends from 2004. Strong growth was mainly recorded in the exports of iron and steel, iron and steel products, plastics, wood, copper, and related products.

The accelerated growth in raw material exports was promoted to a significant extent by the rising oil prices, which led to increased exports of oil products. This fact was partly offset by a decline in electricity exports.

The volume of goods imported in 2005 amounted to SKK 1,069.5 billion and its year-on-year growth reached 13.7% (in USD 18.2% and in EUR 18.0%).

In 2005, imports showed stronger dynamics than exports. The total year-on-year increase in imports took place mostly in the imports of machinery and transport equipment, finished products, and raw

Table 18 **Year-on-year changes in Slovak imports by segment and the contributions of individual segments**

	Year-on-year change in billions of SKK		Contribution to the year-on-year change in percentage points	
	2005	2004	2005	2004
Raw materials	31.1	26.1	3.3	3.2
Chemicals and semi-finished goods	21.1	29.2	2.2	3.5
of which: Chemical products	9.0	7.2	1.0	0.9
Semi-finished goods	12.1	22.0	1.3	2.7
Machinery and transport equipment	39.5	27.5	4.2	3.3
of which: Machines	38.1	27.6	4.1	3.3
Transport equipment	1.4	-0.1	0.1	0.0
Finished products	37.3	31.1	4.0	3.8
of which: Agricultural and industrial products	19.4	19.9	2.1	2.4
Automobiles	1.3	5.5	0.1	0.7
Machines and electrical consumer goods	16.6	5.7	1.8	0.7
Imports in total	129.0	113.9	13.7	13.8

Source: NBS calculations based on data from the Statistical Office.

Table 19 **Balance of services** **(SKK billions)**

	2005	2004
Balance of services	9.9	8.6
Transportation	12.1	16.0
Travel	11.3	5.0
Other services in total	-13.5	-12.4

Source: NBS.

materials. The year-on-year growth accelerated in all categories of goods under review.

In comparison with 2004, the strongest growth was recorded in the imports of machinery and transport equipment. The virtually unchanged imports of transport equipment (compared with the previous year) were mainly connected with the lower production and exports of automobiles. This was offset by higher imports of automatic data processing machines, mechanical instruments, and electronic components.

The imports of finished products recorded a larger increase than in 2004 as a result of steadily growing imports of machine engineering products and electrical consumer goods in particular, as well as increased imports of agricultural products (meat, dairy products, cocoa, beverages, etc.). On the other hand, the imports of industrial products (mainly pharmaceuticals) and automobiles grew at a slower rate than last year. The increased imports of agricultural products were probably connected with the upturn in trade after entry into the EU, since increased imports of certain products were accompanied by increased exports of the same products.

The main factor in the increased raw material imports was the rise in oil prices, which was also reflected in the increased imports of oil and oil products. The strong correlation between oil prices and the price of natural gas led to a rise in price levels and an increase in the imports of this commodity.

Trade in services resulted in a surplus of SKK 9.9 billion in 2005, when receipts from exported services as well as payments for imported services increased equally by 13.7%.

The increased services balance surplus was caused by an increase in the positive balance of tourism, while the surplus in the balance of transport services decreased and the deficit in the balance of 'other services in total' increased.

The positive balance of foreign tourism grew year-on-year by SKK 6.3 billion, representing a more than twofold increase. The increase in the balance surplus was caused by increased receipts, whose growth exceeded the growth in the expenses of Slovak residents on services related to tourism. Foreign exchange receipts from foreign tourism reached SKK 37.5 billion, representing a 28.9% increase in comparison with 2004. The decrease in the average number of overnight stays by visitors from abroad (from 3.3 to 3.1) was offset by the increased number of tourists (accommodated visitors), by 8.1%. In 2005, the expenses of Slovak citizens on travel abroad reached SKK 26.2 billion, which was 9.2% more than in 2004. The number of Slovak citizens who travelled abroad increased year-on-year by 9.9%.

Receipts from the international transport of goods and persons amounted to SKK 49.5 billion (a year-on-year increase of 2.9%) and expenses totalled SKK 37.4 billion (an increase of 16.5%). In terms of volume, the largest item in transport services was still income from the transport of natural gas and oil (SKK 26.0 billion), which accounted for more than 55% of the total income from transport. In international road, railway, and water-borne transport services, as well as in other services directly related to transport (excluding transit), the deficit increased by almost SKK 3.4 billion. The increase in the deficit was mostly generated by increased payments for air passenger services.

The balance of 'other services in total' (telecommunications, construction, insurance, financial, renting, computer engineering, advertising, business, and technical services, etc.) remained in deficit as in previous years. Although the exports of these services grew by 15.6% and imports by 14.0% in 2005, the deficit increased somewhat on a year-on-year basis (from SKK 12.4 billion to SKK 13.5 billion), when the larger surplus achieved in telecommunications services and the smaller deficit in insurance services were exceeded by the growing deficits in financial and construction services.

In 2005, the income balance resulted in a shortfall of SKK 61.3 billion, representing a deterioration of SKK 48.1 billion compared with the previous year. The marked year-on-year deterioration was caused by increased dividend payments to foreign investors and a methodological change in the reporting of reinvested earnings.

Investment in Slovak equity securities paid foreign direct investors dividends in the amount of SKK 45.7 billion, representing a year-on-year increase of more than SKK 24.3 billion. The yields of foreign investors from capital invested in the territory of Slovakia (yield from foreign direct investment, calculated as yield on property including interest as a share of the volume of foreign direct investment) reached approximately 11.0%, which represented a marked increase in comparison with 2004, when the same ratio reached 5.4%. Investment in foreign equity securities paid Slovak investors SKK 0.9 billion in dividends (somewhat more than in the previous year).

Reinvested earnings, which started to be reported in 2005 according to a changed methodology, reached SKK 37.8 billion and contributed significantly to the increase in the income balance deficit. The increase in the b.o.p. current account deficit (due to the inclusion of reinvested earnings) was fully offset within the financial account as an inflow of funds, and thus posed no problems for the financing of the increased current account deficit.

Within the overall income balance, the marked deterioration in the balance of income from investment was partially alleviated by an increased surplus in employee compensation. The increased surplus (by SKK 11.7 billion) was caused partly by an increase in the number of Slovak residents working abroad and partly by a methodological change in the reporting of incomes, from net income to gross income (the difference between gross and net incomes is incorporated in the balance of current transfers).

In 2005, the balance of current transfers resulted in a surplus of SKK 0.5 billion, representing a year-on-year decrease of SKK 5.0 billion. The lower positive balance of current transfers was mainly influenced by a methodological change concerning taxes and social security contributions paid by Slovak citizens working abroad as stated in the balance of current transfers. The Slovak Republic received almost SKK 21.8 billion from the EU budget in 2005. On the other hand, the transfers of own funds to the general budget of the EU amounted to SKK 14.5 billion.

2.2.2 Capital and financial account

The capital and financial account resulted in a surplus of SKK 176.8 billion, which was SKK 70.7 billion more than in the same period a year earlier. The surplus in the capital and financial account as a share of GDP increased from 8.0% to 12.3%. The structure of financial inflows also changed during the year: the share of short-term capital increased and that of portfolio investment decreased.

The capital account resulted in a deficit of SKK 0.5 billion, representing a deterioration in comparison with 2004. The change from last year's inflow to an outflow was basically caused by the lower drawing of funds from the EU budget in the form of grants.

The increased foreign direct investment in comparison with 2004 (by SKK 15.2 billion) resulted from the inclusion of a counter-entry to reinvested earnings in the current account. The inflow of foreign capital through direct investment adjusted for reinvested earnings decreased year-on-year by SKK 12.5 billion.

The inflow of equity capital into the SR totalled SKK 23.2 billion, which was 26.6% less than the figure in the same period a year earlier. The lower inflow of equity capital in comparison with the previous year can be attributed in part to privatisation proceeds in 2004, while the inflow of equity capital in 2005 came exclusively from sources other than privatisation.

Estimated reinvested earnings (in net terms) reached SKK 37.8 billion and represented the most signifi-

Table 20 **Balance of payments capital and financial account** **(SKK billions)**

	2005	2004
Capital account	-0.5	4.4
Direct investment	60.5	45.3
SR abroad	-4.9	4.6
of which: reinvested earnings	-1.2	0.0
In the SR	65.4	40.7
of which: reinvested earnings	39.0	0.0
Portfolio investment and financial derivatives	-31.3	29.4
SR abroad	-23.1	-30.7
In the SR	-8.2	60.1
Other long-term investment	-15.0	-10.1
Assets	-9.8	-2.5
Liabilities	-5.2	-7.6
Short-term investment	163.1	37.1
Assets	-4.6	-1.9
Liabilities	167.7	39.0
Capital and financial account in total	176.8	106.1

Source: NBS.

Table 21 **Balance of payments capital and financial account by sector** **(SKK billions)**

	2004	2005
Government and NBS	-40.1	22.9
Banks	143.1	62.0
Other sectors	73.8	21.2
Capital and financial account	176.8	106.1

Source: NBS.

cant item in the balance of direct investments, with a 62.5% share in the total inflow of foreign direct investment.

The inflow of other capital, which expresses the financial and trade relations between direct investors and direct investment companies, totalled SKK 2.1 billion. The year-on-year decrease, i.e. SKK 13.1 billion (after adjustment for reinvested earnings), was caused by liability repayments by domestic entities to direct investment companies abroad and an increase in loans to foreign direct investors.

In 2005, most funds within the scope of foreign direct investment were invested in manufacturing, wholesale and retail trade, financial intermediation, and trade activities related to real estate investment. More than 99% of the funds were invested in these sectors in 2005.

Portfolio investment resulted in a net outflow of SKK 31.3 billion, compared with a net inflow of SKK 29.4 billion in the previous year.

Demand for foreign securities among domestic portfolio investors fell slightly in comparison with 2004, mainly among banks. On the other hand, the corporate sector made more investments in debt securities, which were, however, offset by a decline in investment in equity securities on the part of foreign companies with a share smaller than 10%. The total outflow of funds for the purchase of foreign securities reached SKK 23.1 billion, representing a year-on-year fall of SKK 7.6 billion.

Compared with 2004 when foreign investors increased their holdings of debt securities from Slovak entities by SKK 60.1 billion, a different trend was recorded in 2005 (an outflow of funds totalling SKK 8.2 billion). The year-on-year change was mainly caused by the repayment of eurobonds issued in previous years (SKK 29.2 billion), which was not accompanied by a new issue in 2005 as a year earlier (eurobonds were issued on foreign markets in the amount of SKK 40.1 billion in 2004). The main inflow of funds from trade in securities issued by domestic entities took place in trade in government bonds denominated in Slovak koruna (in the amount of SKK 19.1 billion) and the purchase by foreign entities of equity securities (with a share smaller than 10%) in the amount of SKK 4.2 billion.

Other investment resulted in an inflow of funds in the amount of SKK 148.1 billion, which was SKK 121.1 billion more than in 2004. The increased inflow in comparison with 2004 was shared by all sectors (the government sector including the NBS, banks, and enterprises), while the largest part of the inflow was absorbed in the banking sector. Non-resident deposits at commercial banks in Slovakia could increase, as a result of expectations of a further appreciation in the Slovak koruna. The increased inflow of such capital caused the Slovak koruna to appreciate during 2005 by 1.9%.

Other long-term investment resulted in a capital outflow of SKK 15.0 billion. The outflow of long-term capital from the government sector was significantly influenced by the payment of a due amount to the ČSOB on the basis of an arbitration court ruling (in the amount of SKK 25.0 billion) and by increased lending to foreign entities by Slovak banks.

The corporate sector drew long-term loans in the amount of SKK 35.5 billion in 2005, which was 5.0% more than in 2004. On the other hand, loans repayments in the corporate sector dropped by 40.5%, to SKK 26.3 billion. The excess of drawings over repayments of long-term financial credits by enterprises contributed to the overall year-on-year increase in the inflow of funds in other investment.

Within the scope of short-term capital, a net inflow of SKK 163.1 billion was recorded, i.e. SKK 126 billion more than in the previous year. The main factor in the marked year-on-year increase in funds was the growing volume of short-term non-resident deposits at Slovak banks, reaching SKK 124.7 billion since the beginning of the year (a year-on-year change of SKK 55.5 billion), which significantly contributed to the growth in the total inflow of funds in other investment. In the government sector (including the NBS), the year-on-year growth in investment was also promoted by a year-on-year change in repo operations conducted by the NBS.

2.2.3 Foreign exchange reserves

At the end of 2005, the foreign exchange reserves of the NBS reached USD 15,479.5 million, representing an increase of USD 566.4 million since the beginning of the year. The total foreign exchange reserves of the NBS were affected by numerous factors during the year. The key factors positively affecting revenues were proceeds from central bank interventions in the foreign exchange market. Expenditures were mainly determined by debt service payments made on behalf of the Government. The Bank's foreign exchange reserves were also affected during the year by the exchange rates of fully convertible currencies on international financial markets. The surplus in the balance of revenues and expenditures in the period under review (USD 2,573.4 million) was partly offset by negative exchange rate differentials (USD 2,007 million), which resulted from the weakening of the euro vis-à-vis the US dollar on international financial markets.

The revenue side of foreign exchange reserves was determined in that period by the following factors:
- yields from deposits and securities held in the portfolio of the NBS, amounting to USD 256.2 million;
- net revenues from interventions and direct transactions on the interbank foreign exchange market, amounting to USD 3,292.3 million;
- revenues of the NBS from repo operations (a positive balance of USD 5.9 million);
- loans drawn from foreign financial institutions in the amount of USD 107.2 million;
- other net revenues of the NBS in the amount of USD 221.2 million (positive balance), incurred mostly in connection with cross-border payments made for NBS clients.

The expenditure side of foreign exchange reserves was affected in the same period by:
- debt service payments by the Government in the amount of USD 1,306.9 million, of which the payment of principal and interest on government eurobonds issued in previous years accounted for USD 1,064.1 million;
- debt service payments by the NBS in the amount of USD 2.6 million.

At the end of 2005, the foreign exchange reserves of the NBS were 4.8 times greater than the volume of average monthly imports of goods and services to Slovakia in 2005.

At the end of 2005, the foreign exchange reserves of commercial banks reached USD 1,542.3 million, representing a fall of USD 320.6 million since the beginning of the year. The volume of foreign exchange reserves in the banking sector, including the NBS, stood at USD 17,021.8 million at the end of the year.

2.2.4 External debt of the SR

At the end of December 2005, Slovakia's total gross external debt stood at USD 27.1 billion (EUR 22.8 billion), representing an increase of USD 2.4 billion (EUR 4.7 billion) since the beginning of the year. The structure of external debt by currency was dominated by foreign liabilities in EUR. Total long-term foreign debt dropped in 2005 by USD 2.3 billion, while total short-term foreign debt increased by USD 4.8 billion.

Within the scope of short-term external debt, the short-term foreign liabilities of commercial banks recorded

Table 22 **External debt of the SR**

	USD millions			EUR millions		
	31.12.2004	**1.1.2005**	**31.12.2005**	**31.12.2004**	**1.1.2005**	**31.12.2005**
Total external debt	23,763.6	24,645.0	27,052.4	17,454.6	18,102.0	22,835.3
Long-term external debt	13,315.8	14,197.2	11,850.6	9,780.6	10,428.0	10,003.3
Government and NBS[1)]	6,691.4	7,572.8	5,578.3	4,914.9	5,562.3	4,708.7
Commercial banks	496.3	496.3	866.7	364.6	364.6	731.6
Entrepreneurial entities	6,128.1	6,128.1	5,405.7	4,501.1	4,501.1	4,563.0
Short-term external debt	10,447.8	10,447.8	15,201.7	7,674.0	7,674.0	12,832.0
Government and NBS	209.3	209.3	4.4	153.8	153.8	3.7
Commercial banks	5,380.2	5,380.2	9,360.4	3,951.8	3,951.8	7,901.2
Entrepreneurial entities	4,858.3	4,858.3	5,837.0	3,568.4	3,568.4	4,927.1
Foreign assets	23,367.0	23,367.0	25,455.3	17,163.3	17,163.3	21,487.2
Net external debt	396.6	1,277.5	1,597.2	291.0	938.4	1,348.1
SKK/USD and SKK/EUR rates	*28.496*	*28.496*	*31.948*	*38.796*	*38.796*	*37.848*
EUR/USD cross exchange rate	-	-	-	*1.361*	*1.361*	*1.185*

Source: NBS.
1) Including government agencies and municipalities.

a marked increase (USD 4.0 billion), mainly as a result of an increase in cash and deposits (USD 3.4 billion). The other short-term liabilities of commercial banks increased by USD 511.4 million. The short-term foreign liabilities of entrepreneurial entities increased year-on--year by USD 978.7 million, of which USD 981.0 million took place in trade credits and loans.

Within the scope of long-term external debt, the period under review saw a decrease in the foreign liabilities of the Government and NBS (USD 2.0 billion), mainly in connection with the redemption of two-year foreign bonds by the Slovak Ministry of Finance in the amount of EUR 750 million (USD 948.7 million) and the settlement of Slovakia's liability towards the ČSOB a.s. Praha, in the amount of SKK 25.1 billion (USD 881.4 million). The commercial sector experienced conflicting developments over the period under review, when the long-term foreign liabilities of entrepreneurial entities decreased by USD 722.4 million and the long--term foreign liabilities of commercial bank increased by USD 370.4 million.

At the end of 2005, Slovakia's per-capita gross foreign debt stood at USD 5,029, compared with USD 4,581 on 1 January 2005. The share of short-term foreign debt in the country's total gross external debt increased significantly over the course of the year, from 42.4% at 1 January 2005 to 56.2% at 31 December 2005.

The net external debt of Slovakia – expressed as the difference between gross foreign debt, i.e. USD 27.1 billion (liabilities of the Government, the NBS, commercial banks, and the corporate sector – except for capital participation), and foreign assets, i.e. USD 25.5 billion (foreign exchange reserves of the NBS, foreign assets of commercial banks and the corporate sector – except for capital participation), reached USD 1.6 billion (debtor position) at the end of December 2005. At the beginning of the year, the Slovak Republic was in debtor position, with net foreign debt amounting to USD 1.3 billion.

2.3 Public sector

Budgetary performance in the public sector according to ESA 95

Budgetary performance in the general government sector according to the European System of Accounts (ESA 95), governing the evaluation of compliance with the Maastricht criteria, resulted in a deficit of SKK 42.5 billion (2.9% of GDP) in 2005. The deficit was SKK 5.3 billion smaller than the budgeted figure, amounting to SKK 47.8 billion. This result was mainly caused by improved budgetary performance in comparison with the budget projections, mainly in central budgetary organisations (an improvement of SKK 10.2 billion) and the National Property Fund (an improvement of SKK 3.8 billion, mainly as a result of higher dividends, exceeding the budget by SKK 3.5 billion). Better results were also achieved by State funds (an improvement of SKK 0.2 billion), the Slovak Land Fund (SKK 0.3 billion), state-subsidised organisations (SKK 0.4 billion), and Slovenská konsolidačná, a.s. (SKK 0.072 billion).

Markedly increased budget deficits were recorded in the Social Insurance Corporation (by SKK 6 billion, including the revenues of pension funds), health insurance companies (by SKK 2.3 billion), and higher territorial units (by SKK 2.8 billion).

The positive budgetary performance in the general government sector can be mainly ascribed to the fact that the budgeted level of revenues was exceeded to a greater extent (by SKK 17.2 billion) than budgeted expenditures (by SKK 11.9 billion). The excess of revenues was caused by higher accrued revenues from taxes and social contributions (by SKK 15.3 billion, of which the State budget accounted for SKK 8.5 billion, higher territorial units SKK 1.3 billion, and municipalities SKK 5.4 billion). A positive effect was also exerted by the excess of non-tax revenues, by a total of SKK 15.7 billion in the general government sector. These positive effects were dampened by the negative impact of non-fulfilment of the budgeted amount of grants and transfers (by SKK 13.8 billion), mainly the non-fulfilment of the budgeted income from EU funds. The excess of expenditures was mainly caused by an excess of capital transfers owing to the cancellation of loans to abroad in the amount of SKK 13.7 billion, which were not budgeted. Without this one-off effect, the fiscal deficit would be even more favourable.

State budget (under cash basis accounting)

The State budget of the Slovak Republic for 2005 was approved by Act No. 740/2004 Coll. of the National Council of the SR, in which total revenue was budgeted at SKK 257.2 billion and total expenditure at SKK 318.7 billion. The budget deficit was set at SKK 61.5 billion. Actual revenues reached SKK 258.7 billion, expenditures SKK 292.6 billion, and the budget deficit amounted to SKK 33.9 billion (under cash basis accounting).

Tax revenues reached SKK 222.6 billion and exceeded the budgeted figure by SKK 20.6 billion in 2005 (fulfilment to 110.2%); in 2004, they were SKK 13.1 billion higher. The budgeted revenues were exceeded in all main tax categories, mainly in corporate income tax (by SKK 12.0 billion, a year-on-year increase of SKK 12.5 billion), value added tax (by SKK 5.1 billion, an increase of SKK 22.8 billion), and excise tax (by SKK 4.6 billion, and increase of SKK 7.6 billion).

A marked year-on-year fall (SKK 22.4 billion) was only recorded in personal income tax, which, however, resulted from the fact that, with effect from 1 January 2005, 6.2% of the amount collected in this tax is a revenue for the State budget, the remainder is a revenue for municipalities and higher territorial units. The total revenue from personal income tax reached SKK 40.1 billion, of which SKK 2.8 billion went to the State budget and SKK 37.3 billion to the budgets of local governments.

Non-tax revenues were also fulfilled during the year: they exceeded the budgeted level by SKK 5.5 billion. On the other hand, grants and transfers remained below the budgeted level by SKK 24.6 billion (foreign grants were drawn to 52%, due mainly to the low drawing of funds from the EU budget, and domestic grants to only 7.6%, as a result of the fact that the dividends of enterprises with state ownership interests were not transferred from 'State financial assets' to 'State budget revenue'. This was enabled by the favourable developments in tax revenues. Owing to the combined effect of these factors, the total revenue of the State budget under cash basis accounting was fulfilled to almost 100%.

Significant savings (SKK 26.1 billion) were recorded on the expenditure side of the State budget, mainly in connection with the use by ministries of the possibility to transfer their unused funds to the next year and the lower drawing of funds from the European Union, leading to lower drawing of funds for project co-financing.

2.4 Monetary policy and monetary developments

In 2005, the NBS implemented its monetary policy largely in an environment characterised by accelerating economic growth, falling unemployment rate, and positive developments in public finances. The long-term falling trend in the annual inflation rate came to a halt in the third quarter of 2005. Subsequently, the rate of inflation again accelerated as a result of regulated price increases in October. Despite the rise in regulated prices, the inflation target of the NBS was met in 2005. Unlike in 2004, the exchange rate of the Slovak koruna was rather volatile in 2005 and closed the year with a smaller appreciation vis-à-vis the reference currency, the euro. The size of the trade deficit increased during the year.

In line with the Monetary Programme of the NBS for the Period until 2008 and the monetary policy strategy of inflation targeting in the conditions of ERM II, the NBS began to monitor the Harmonised Index of Consumer Prices (HICP) as its inflation target, with effect from January 2005. At the same time, the NBS replaced its monetary programme with a medium-term forecast published on a quarterly basis. The Bank Board also adopted a Communication Strategy for the NBS, the main function of which is to ensure monetary policy implementation in a transparent manner.

In the first quarter, the determining factor in monetary policy implementation was an excessive appreciation in the exchange rate of the Slovak koruna in nominal terms, which was inconsistent with the development of economic fundamentals. The unreasonable appreciation was mainly caused by an inflow of short-term capital and the so-called 'convergence play' connected with expectations of a further appreciation. The continuing appreciating trend was incompatible with the equilibrium course of the koruna exchange rate and could cause an unjustified fall in inflation to the detriment of economic growth and hamper the achievement of the inflation target in the medium term. As a result, the NBS used direct foreign exchange market interventions in its fight against the strengthening of the koruna and subsequently the Bank Board lowered the basic NBS interest rate by 1 percentage point, with effect from 1 March.

The strengthening of the Slovak koruna against the euro came to a halt in the middle of March, due to developments in other Central European markets, mainly the weakening of the Polish zloty. The koruna began to depreciate in the second quarter, then followed a slightly appreciating trend until the end of the year, but failed to reach its record level from the first quarter. On the contrary, a marked depreciation in April and October required an NBS intervention in support of the koruna. After the entry of Slovakia into the Exchange Rate Mechanism II (ERM II), the Slovak koruna significantly appreciated in relation to its central rate.

In connection with the wage growth and inflation expectations, the NBS began warning of the need for a monetary policy tightening in the second half of 2005.

2.4.1 Monetary aggregates

The M3 monetary aggregate (according to ECB methodology) increased by SKK 60.2 billion in comparison with the end of 2004, to SKK 831.4 billion at the end of 2005. The year-on-year rate of M3 growth[8] reached 7.8% in December.

[8] *The year-on-year growth dynamics of monetary aggregates and their counterparts are calculated from end-of-month data, including non-transaction operations, which comprise all movements in the balance-sheet items, resulting from changes in the valuation of marketable instruments, the depreciation/write-off of loans, exchange rate differentials, reclassification, and other changes.*

Table 23 **Developments in monetary aggregates**

	Volume as at 31 Dec. (SKK billions)	Change since the beginning of the year[1)] (SKK billions)	(%)
Year 2005			
M3 monetary aggregate	831.4	60.2	7.8
Main counterparts of M3			
Long-term financial liabilities	191.0	10.1	5.6
MFI loans and securities	795.2	86.1	12.1
of which: General government	273.5	-21.7	-7.4
Other residents	521.7	107.8	26.0
Year 2004			
M3 monetary aggregate	771.2	90.7	13.3
Main counterparts of M3			
Long-term financial liabilities	180.9	-49.5	-21.5
MFI loans and securities	709.1	45.9	6.9
of which: General government	295.2	21.8	8.0
Other residents	413.9	24.1	6.2

Source: NBS.
1) Since monetary aggregates and the counterparts of the M3 aggregate (according to ECB methodology) are not evaluated as at 1 January of the given year, the values recorded as at 31 December of the previous year are used in the table and the further text as initial values.

The markedly weaker year-on-year dynamics of M3 in December 2005 can be ascribed mainly to the base effect of the previous period and the effect of non-standard factors arising from the methodological changes of 2004, which increased the volatility of the M3 aggregate. If we leave these factors out of account, the year-on-year dynamics of M3 in 2005 may be assessed as adequate.

During 2005, the primary source of M3 growth was the growing trend in the loans to the private sector loans of monetary financial institutions (MFIs), including securities issued by clients and held in the MFI sector. The opposite effect was produced by a decrease in MFI loans to the public sector (mainly as a result of the favourable trend in the budget deficit, which was much smaller than in 2004, so the Ministry of Finance of the SR was not forced to issue Treasury bills in 2005).

During 2005, the M3 monetary aggregate maintained its seasonal course, which was mostly influenced by standard factors. Personal and corporate income tax payments for the year 2004 had a downward effect on M3 in favour of the public sector, while dividend payments in the corporate sector caused a decrease in corporate bank deposits in favour of the public sector and non-resident deposits.

The total annual increase in M3 reached approximately two thirds of the figure for the previous year, due to non-standard seasonal development in June 2004, when M3 recorded a marked month-on-month increase as a result of an inflow of funds from a bond issue in the corporate sector, allocated largely to short-term time deposits[9].

Within the structure of the M3 aggregate, part of the free funds of corporate clients, held mostly in the form of short-term time deposits[10], was converted into a different form during 2005. The fluctuation in deposits with agreed maturity and deposits redeemable on demand was reflected in the increased volatility of the M1 aggregate.

The determining factor in the gradual slowdown in the growth of less liquid M3 components was investment in money market fund shares/units, which showed slower growth as from June, followed by a slight decline from September (after relatively steep increases in the first six months, ranging from SKK 1.6 billion to SKK 3.7 billion per month).

Within the total MFI loans to residents (including securities issued by clients and held by MFIs), which increased by SKK 86.1 billion (compared with 31 December 2004), the individual components again

[9] *The stronger growth in M3 in 2004 was partially influenced by the method of compiling monetary aggregates in 2003, when data on money market fund shares/units were not yet available in monetary and banking statistical statements.*

[10] *Time deposits with the shortest maturities (overnight deposits) are classified in the ECB methodology as deposits redeemable on demand and are included in the M1 aggregate.*

Table 24 **Developments in monetary aggregates in 2005**

	Volume as of 31.12. (SKK billions)	Year-on-year change (SKK billions)	Contributions to M3 growth (percentage points)
Currency in circulation	119.84	19.39	2.51
Deposits and received loans repayable on demand	366.16	61.89	8.02
M1	485.99	81.27	10.54
Deposits and loans taken with an agreed maturity of up to 2 years	285.23	-25.72	-3.33
Deposits redeemable at a period of notice of up to 3 months	14.77	-1.23	-0.16
M2 – M1	300.00	-26.95	-3.49
M2	785.99	54.32	7.04
Money market fund shares/units	45.86	13.12	1.70
Repo operations	0.00	-2.70	0.00
Debt securities issued with a maturity of up to 2 years	-0.42	-4.55	-0.59
M3 – M2	45.44	5.86	0.76
M3	831.43	60.19	7.80

Source: NBS.

recorded contradictory developments, when a decrease in MFI loans to the public sector was fully offset by an increase in MFI loans to the private sector.

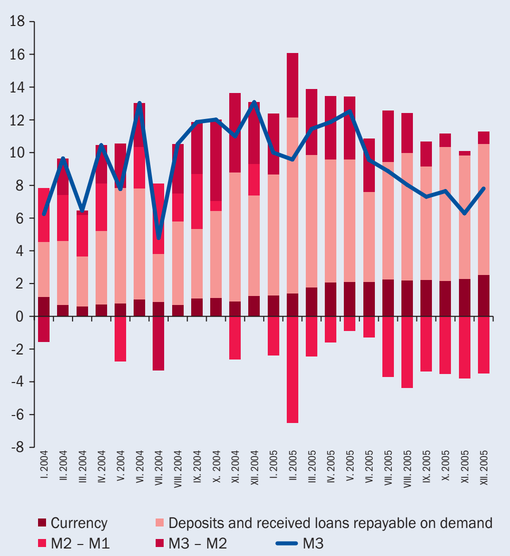
Among MFI loans to the private sector (excluding securities), the year 2005 saw significant increases in loans granted to households (SKK 52.8 billion, of which SKK 31.0 billion took place in loans for house purchases) and loans provided to non-financial corporations (SKK 46.2 billion). The currency structure of loans in these sectors differed substantially: the increase in loans to households was dominated by koruna loans (97%), which represented only approximately 48% of the increase in loans to non-financial corporations. The increase in loans to financial corporations was smaller (SKK 10.8 billion), when the volume of loans to insurance companies and pension funds remained virtually unchanged.

Among the individual components of long-term financial liabilities, the medium-term decreasing trend in the volume of deposits redeemable at notice over 3 months continued. Their volume decreased during 2005 by SKK 6.6 billion, which was, however, a much smaller decrease than in 2004. Among the other components of long-term financial liabilities, the volume of deposits and loans taken with agreed maturity over 2 years increased by SKK 4.7 billion and that of debt securities issued with maturity over 2 years grew by SKK 6.4 billion.

2.4.2 Structure of the money supply

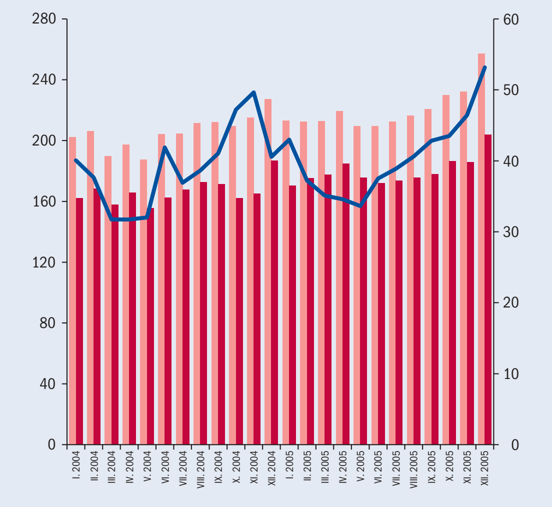
The growth in the money supply was affected first and foremost by increases in the most liquid M1 components, i.e. currency, deposits, and received loans repayable on demand. Their year-on-year dynamics strengthened by 6 percentage points (to approximately 20% in December 2005) in comparison with the same period a year earlier. The volume of currency reached approximately SKK 120 billion at the end of 2005 and the volume of deposits and received loans repayable on demand totalled SKK 366 billion. The marked year-on-year increase in M1 (SKK 81.3 billion) was caused partly by households (an increase of SKK 31.3 billion) and partly by non-financial corporations (an increase of SKK 29 billion).

Chart 21 **Contributions of individual M3 components to its year-on-year dynamics (percentage points)**



Source: NBS.

Chart 22 **Deposits of non-financial corporations** **(SKK billions)**



Source: NBS.

On the other hand, the less liquid M2 components contributed negatively to the year-on-year dynamics of the money supply throughout 2005. Their year-on-year fall (by SKK 26.9 billion, to SKK 300 billion) was mainly caused by a decrease in deposits and loans taken with an agreed maturity of up to 2 years in the household sector. This was offset slightly by an increase in deposits and loans taken with a maturity of up to 2 years in the non-financial corporations sector. The fall in interest rates on household deposits (with agreed maturity and redeemable at notice) stimulated growth in deposits in the most liquid form (M1) throughout 2005 and in the least liquid assets invested in money market fund shares/units in the first half of the year.

The least liquid component of the M3 aggregate are marketable instruments, which include money market fund shares/units, repo operations, and debt securities issued with a maturity of up to 2 years (M3-M2). The volume of marketable instruments increased during the year by SKK 5.9 billion, to SKK 45.4 billion. Developments in this M3 component were mainly determined by money market fund shares/units, which showed strong growth dynamics at the beginning of the year, which weakened considerably towards the end of the year. They recorded an average year-on-year increase of SKK 26 billion in the first half of the year, which gradually decreased during the following period, to SKK 13 billion at the end of 2005. This development was affected by a base effect and, in all probability, by increased interest in investment in funds other than money market funds.

Deposits from non-financial corporations

The growing trend in deposits from non-financial corporations continued in 2005, with their volume reaching SKK 257.1 billion in December, which was SKK 29.7 billion more than in December 2004. This increase took place in both koruna deposits (a year-on-year increase of SKK 17.1 billion) and foreign-currency deposits (a year-on-year increase of SKK 12.6 billion). The increase in foreign-currency deposits took place mainly in the second half of the year (the volume of deposits in foreign currency decreased in the first six months), when these deposits increased by SKK 15.6 billion. Non-financial corporations gave preference to highly liquid deposit products, which led to growth in deposits and received loans repayable on demand (by SKK 29 billion), compared with SKK 21.4 billion in 2004. Deposits and received loans with an agreed maturity of up to 2 years increased year-on-year by almost SKK 1 billion in December (compared with SKK 1.8 billion in 2004). The decrease in deposits and received loans with an agreed maturity of up to 2 years in Slovak koruna (SKK 10 billion) was slightly exceeded by an increase in deposits and loans taken with an agreed maturity of up to 2 years in foreign currency (SKK 10.7 billion). Deposits redeemable at notice of up to 3 months formed a negligible part of the deposits of non-financial corporations and their volume was virtually stagnant in 2005.

Household deposits

Household deposits increased only slightly in 2005, by less than SKK 1 billion (compared with SKK 15.1 billion in 2004). Within the structure of household deposits, the most liquid deposits and received loans repayable on demand increased by SKK 31.3 billion (in 2004 by SKK 15.5 billion), while deposits and received loans with an agreed maturity of up to 2 years decreased by SKK 29.2 billion (in 2004 by SKK 1.3 billion) and deposits redeemable at notice of up to 3 months by SKK 1.2 billion (they grew in 2004 by SKK 0.9 billion). As in the case of non-financial corporations, funds continued to be converted into or held in the most liquid form (non-fixed funds). This development was also supported by the fact that the difference in interest rates on non-fixed deposits and loans taken and fixed-term deposits decreased in 2005, compared with 2004.

In a breakdown by currency, deposits and loans taken in Slovak koruna increased year-on-year by SKK 4.6 billion (in 2004 by SKK 24.5 billion), while deposits and loans taken in foreign currency decreased by SKK 3.7 billion (in 2004 by SKK 9.4 billion).

Developments in deposits and received loans in the household sector were also influenced by investment in investment fund shares/units other than money market fund shares/units, which recorded a marked year-on-year increase in 2005 (95.8%), from SKK 27.2 billion to SKK 53.2 billion.

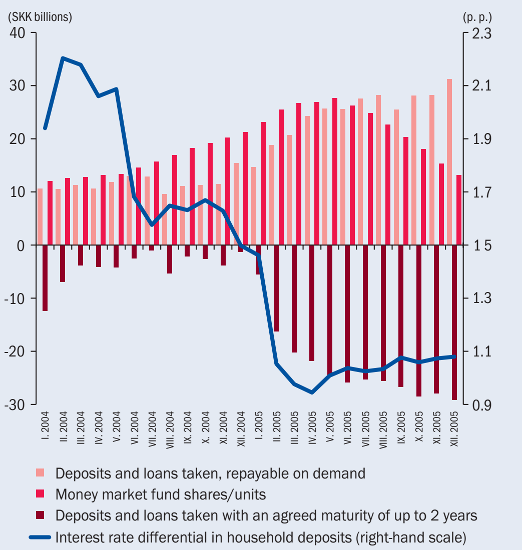
Deposits not included in M3

Of deposits not included in the M3 monetary aggregate, household deposits and loans taken with an agreed maturity of over 2 years increased by SKK 4.9 billion, while deposits and loans taken redeemable at a period of notice of over 3 months decreased by SKK 6.6 billion. The deposits of non-financial corporations not included in the M3 aggregate represented a negligible part of the total deposits of non-financial corporations and remained virtually unchanged in 2005.

2.4.3 Loans of monetary financial institutions to the private sector

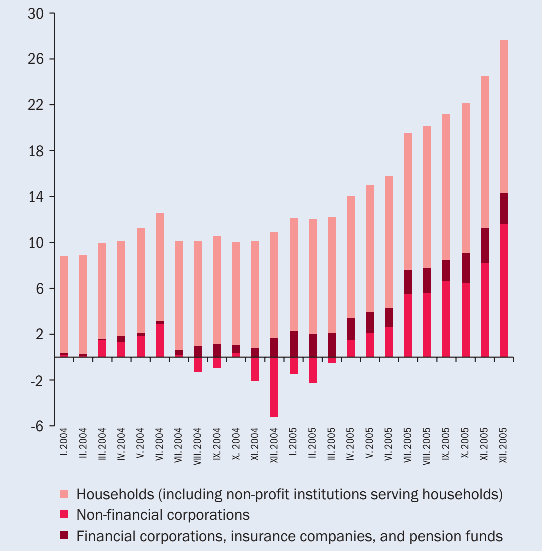
The MFI loans to the private sector (excluding securities) reached SKK 507.5 billion at the end of 2005, representing an increase of SKK 109.8 billion compared with December 2004. Thus, the total year-on-year increase in loans to the private sector was five times larger than the year-on-year increase in 2004 (SKK 21.3 billion). This development took place partly in loans denominated in Slovak koruna (an increase of SKK 79.5 billion) and partly in euro-denominated loans (an increase of SKK 30.3 billion). Loans in other foreign currencies recorded a slight decrease (SKK 0.02 billion). At the end of 2005, koruna loans accounted for 77.5%, euro loans 20.9%, and loans in other foreign currencies 1.6% of the total volume of loans (in 2004, koruna loans represented 79.0%, euro loans 19.0%, and loans in other currencies 2.0%).

Chart 23 **Year-on-year increases in household deposits**



Source: NBS.
Note: Interest rate differential represents the difference between interest rates on less liquid M2 components (deposits and loans taken with an agreed maturity of up to 2 years and deposits redeemable at a period of notice of up to 3 months) and deposits and received loans repayable on demand.

Chart 24 **Contributions to the year-on-year growth in MFI loans to the private sector (percentage points)**



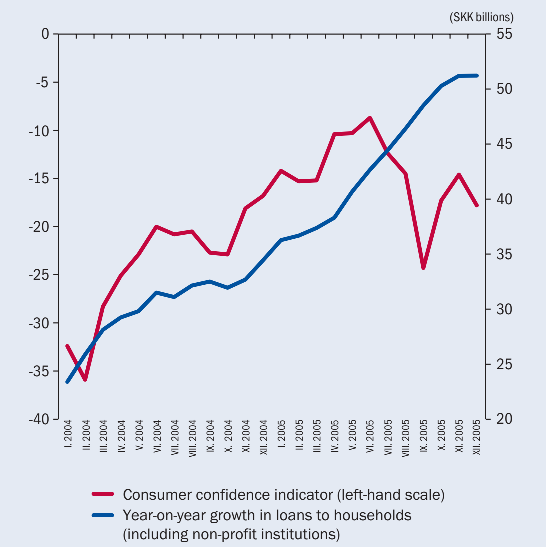
Zdroj: NBS.

The marked absolute increase in loans to the private sector in 2005 led to an acceleration in year-on-year dynamics, from 5.7% in 2004[11] to 27.6% in 2005. The steepest increases occurred in loans to households[12] (SKK 52.8 billion) and non-financial corporations (SKK 46.2 billion). Loans to financial corporations increased year-on-year by SKK 10.8 billion; loans to insurance corporations and pension funds recorded only a modest increase in comparison with 2004. A significant contribution to the year-on-year growth rate was made by loans to households (13.3 percentage points). Growth in loans to non-financial corporations contributed 11.6 percentage points, while the year 2004 saw a decrease in these loans with a dampening effect on the overall year-on-year growth in loans. In comparison with the previous year, the contribution of loans to financial corporations also increased slightly (by 1 percentage point, to 2.7 percentage points).

[11] *The weak growth dynamics of loans to the private sector in 2004 was affected by one-off factors (the sale of classified loans outside the banking sector, debt restructuring by some companies, and subsequent financing via the capital market).*

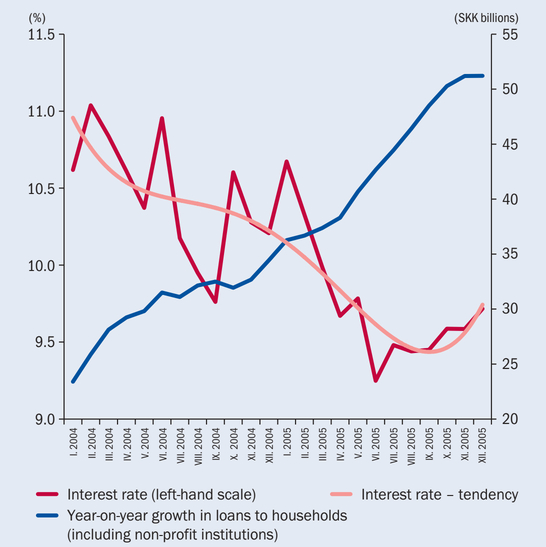
[12] *Including non-profit institutions serving households.*

Chart 25 **Consumer confidence indicator and absolute growth in loans to households**



Source: NBS and Statistical Office of the SR.

Chart 26 **Interest rate of absolute growth in loans to households**



Source: NBS.

The growing absolute year-on-year increases in household loans were accompanied by a faster growth in real wages in comparison with 2004, and a falling trend in interest rates, which came to a halt in the first half of 2005. Interest in borrowing was probably also connected with the strengthening consumer confidence in the first half of 2005, whose upward trend stopped temporarily when the regulated price increases were announced at the beginning of the second half.

Within the structure of loans to households[13], the steepest year-on-year increase was recorded in loans for house purchases (SKK 31.0 billion, compared with SKK 26.1 billion in 2004), which contributed 24.2 percentage points to the year-on-year growth in loans to households (41.2%). In 2005, households used their funds mostly for long-term investment again. The year-on-year rate of growth in loans for house purchase fluctuated between 29% and 37% during 2005.

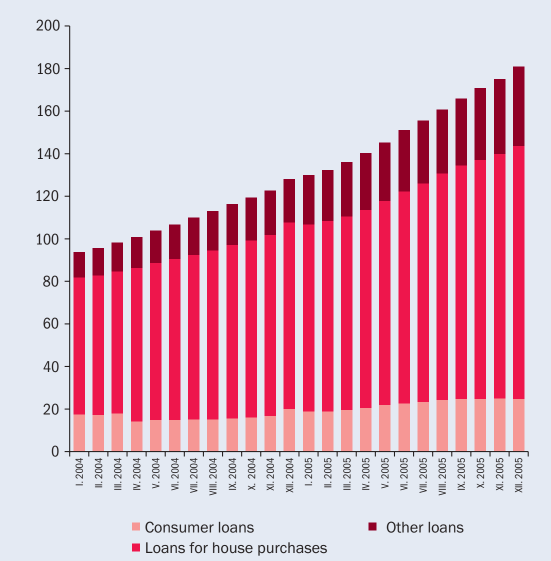
A relatively steep year-on-year increase (SKK 16.9 billion) in the household sector was also recorded in other loans[14], while consumer loans grew only slightly (SKK 4.9 billion). This development was also affected by the inclusion of a new loan product, i.e. loans without special purpose secured by real estate, in the 'other loans' category (as from September 2005). As a result, other loans and consumer loans showed rather volatile year-on-year dynamics during the year, hence a more consistent picture is given by the aggregate of these loans in total. Its growth rate accelerated during 2005, from 44.3% at the beginning of the year to 64.8% at the end of the first half, with a subsequent moderate slowdown during the second half of the year, to 54.2% in December 2005. Thus, the year-on-year increase in other loans and consumer loans in 2005 (SKK 21.8 billion), compared with SKK 8.4 billion in 2004, contributed to the acceleration of final household consumption in 2005.

The continuing dynamic growth in loans in the household sector was accompanied by an increase in indebtedness (expressed as the ratio of loans to households to GDP), which increased from 9.7% in 2004 to 12.6% in 2005. Similar developments in connection with to the process of real convergence were also recorded in other new Member States, while household indebtedness in these countries was much lower than in the euro area (52.6% in 2005).

Loans to the non-financial corporations sector showed less dynamic development than those to the household sector. After they fell in volume by SKK 19.6 billion (8.0% year-on-year) in 2004, the volume of these loans increased in 2005 by SKK 46.2 billion (20.5% year-on-year). Broken down by purpose, the increase in loans to non-financial corporations was concentrated in investment loans and loans for house purchases, which was probably also affected by the accelerated growth in gross fixed capital formation in 2005. Within the time structure of receivables, the

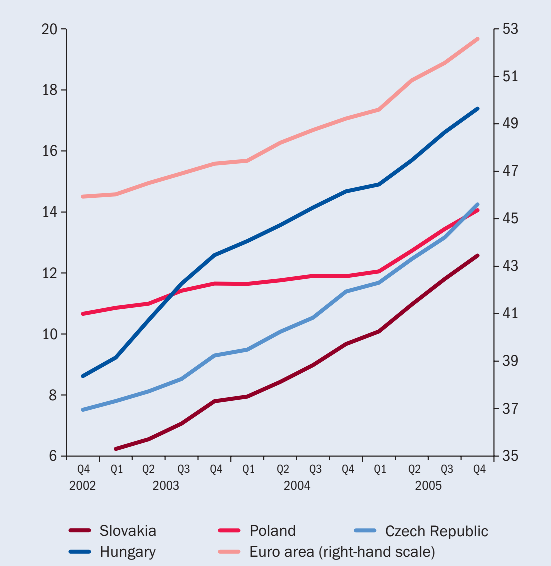
[13] *Of the total volume of loans to households, receivables in Slovak koruna accounted for 99%.*
[14] *Loans to households (including non-profit institutions serving households) broken down by purpose comprise consumer loans, loans for house purchases, and other loans.*

Chart 27 **MFI loans to households (SKK billions)**



Source: NBS.
Note: Including non-profit institutions serving households.

Chart 28 **MFI loans to households as a share of GDP (%)**



Source: ECB and national central banks.

increase in loans to non-financial corporations took place mainly in receivables with a maturity of over 5 years (growing year-on-year by SKK 26.4 billion at a rate of 34.8%) and loans with a maturity of up to 1 year (growing year-on-year by SKK 25.7 billion at a rate of 28.1%). Loans with a maturity of 1 to 5 years recorded a year-on-year decrease of 10.2% (SKK 5.9 billion).

Of the total increase in loans to non-financial corporations in 2005 (SKK 46.2 billion), SKK 24.7 billion took place in euro loans and SKK 21.5 billion in koruna loans. The volume of loans in other foreign currencies recorded a slight decrease. Month-on-month increases in euro-denominated loans to non-financial corporations were recorded throughout the year (except in February and November 2005), with the largest month-on-month increases recorded in March, April, and December. When obtaining funds for minimising their debt service expenses, corporations probably made use of the appreciating trend in the Slovak koruna and the lower interest rates on euro assets.

2.4.4 Interest rate developments

Customer interest rates

Customer interest rates in 2005 were influenced by the cuts in the key NBS interest rates from the end of 2004 (0.5 of a percentage point, with effect from 29 November 2004) and February 2005 (1 percentage point, with effect from 1 March 2005), and by money market developments.

Interest rates on loans

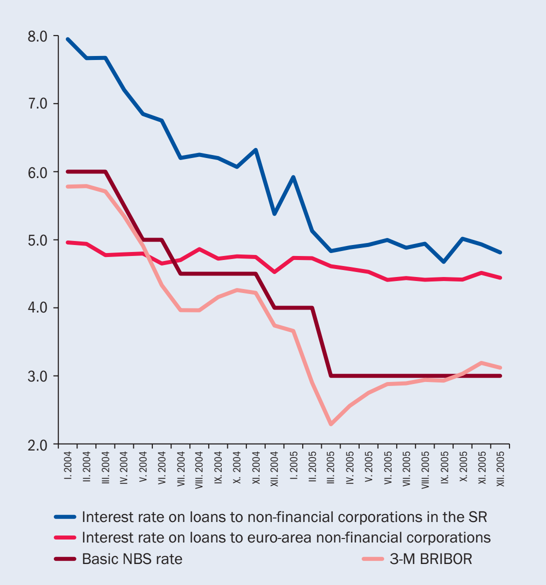
Interest rates on loans to non-financial corporations

Average interest rates on loans to non-financial corporations followed a relatively stable course in 2005. The first quarter saw a falling trend in lending rates, which was connected with the cuts in key interest rates in 2004 and their expected further reduction in response to interbank market developments. Despite the lowering of the key NBS rates with effect from 1 March 2005, interest rates on loans to non-financial corporations ceased to fall and remained relatively stable until the end of the year, at a level close to the euro-area rates.

The difference between lending rates for non-financial corporations and 3-month BRIBOR rates diminished somewhat during the year, which is a sign of improved credit conditions for non-financial corporations. This was probably connected with the dynamic economic growth and increased profits of non-financial corporations.

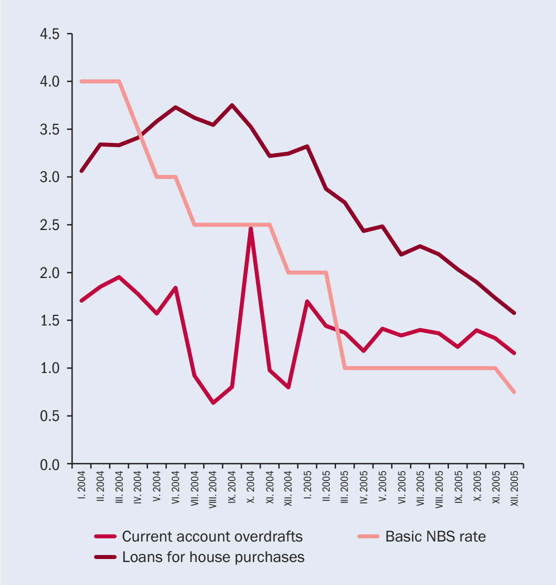
Looking at the breakdown of loans by purpose, the most significant drops in 2005 occurred in interest rates on current account overdrafts (1.53 points), operating loans (0.94 of a point), investment loans (by 0.76 of a point), and other loans (by 0.62 of a point). On the other hand, interest rates on loans for house purchases rose by 0.67 of a percentage point. The average lending rate for non-financial corporations was mainly affected by rates on short-term loans (with a floating rate and an initial rate fixation of up

Chart 29 **Interest rates on loans to non-financial corporations, BRIBOR, and the basic NBS rate** **(%)**



Source: NBS.

Chart 31 **Differences in lending rates in Slovakia and the euro area by type of loan (percentage points)**



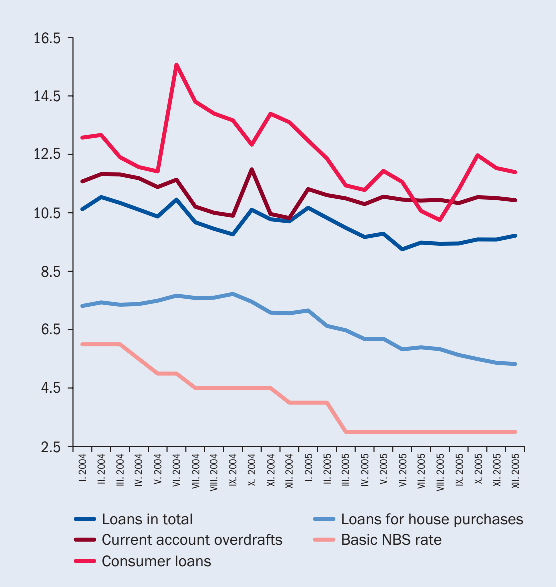
Source: NBS and ECB.

to 1 year), which account for more than 90% of the loans provided. Interest rates on loans with longer periods of fixation followed a relatively volatile course, depending mostly on the amount and type of credit and the client's solvency.

Interest rates on loans to households

Interest rates on loans to households fell slightly in 2005, mainly during the first five months of the year.

Chart 30 **Interest rates on loans to households by type** **(%)**



Source: NBS.

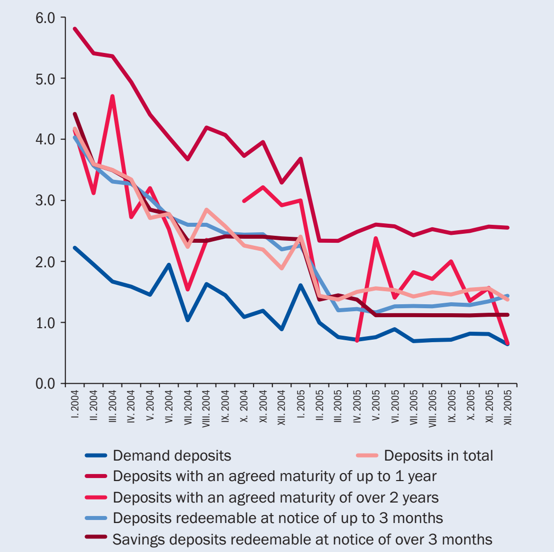
This development was caused by key interest rate cuts in the last quarter of 2004 and the first quarter of 2005.

Interest rates on loans for house purchases followed a downward trend throughout the year, and fell by 1.73 percentage points (to 5.32%). The sharpest drops were recorded in rates for other loans for house purchases and mortgage loans. Interest rates also dropped significantly on intermediate loans from home savings banks.

The average interest rate on consumer loans showed a falling tendency until August 2005, and then increased in the following months. This development was also affected by the unified recording of loans without special purpose secured by real estate within the 'other loans' category (as from September 2005). Before that time, this loan product had been included in two categories (other loans and consumer loans). Interest rates on consumer loans rose significantly in September and October, due to the transfer of these low-interest loans to the 'other loans' category. For 'other loans', incorrect data were reported in 2005 (the data will be revised). For that reason, developments in interest rates on other loans cannot be evaluated. Interest rates on current account overdrafts were stagnant during the year.

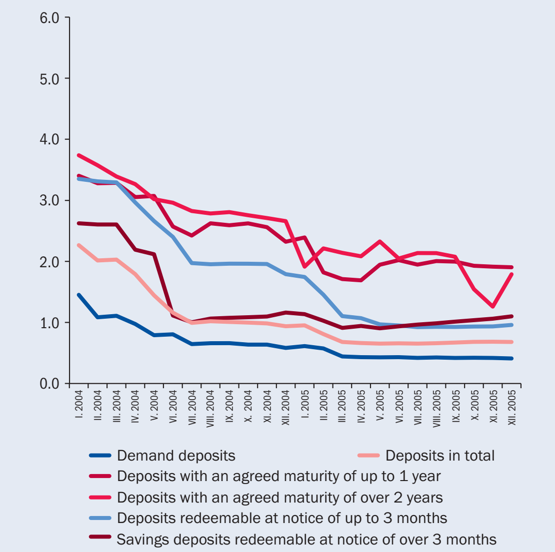
Over the first three quarters, interest rates on household loans gradually converged with the corresponding rates in the euro area. This development was mainly apparent in rates for loans for house purchases as a result of a reduction in rates in Slovakia. The diffe-

Chart 32 **Interest rates on deposits from non-financial corporations** **(%)**



Source: NBS.

Chart 33 **Interest rates on household deposits** **(%)**



Source: NBS.

rences in interest rates on current account overdrafts diminished only slightly, but remained the smallest among all types of household loans. The differences in rates for consumer loans fluctuated between 3.0 and 5.8 percentage points. Their movements were, however, difficult to evaluate with regard to the volatility of interest rates in Slovakia, arising from the methodological differences in the categorisation of these loans until September 2005.

In a breakdown by the period of initial rate fixation, the sharpest drops occurred in interest rates on loans with an initial rate fixation (IRF) of over 1 and up to 5 years (3.2 percentage points) and loans with an IRF of over 10 years (1 percentage point). Rates for loans with an IRF of over 5 and up to 10 years dropped by 0.7 of a point, and that for loans with a floating rate and an IRF of up to 1 year fell by 0.2 of a point.

Interest rates on deposits

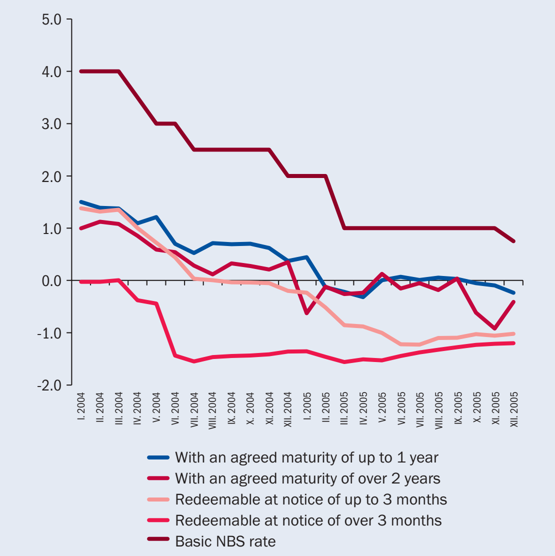
Deposit rates for non-financial corporations and households

The first months of 2005 were characterised by increased volatility in interest rates on deposits from non-financial corporations. After significant drops in interest levels in 2004 and at the beginning of 2005, as a result of a gradual reduction in the key NBS rates, interest rates on deposits from non-financial corporations stagnated.

Similar developments were recorded in interest rates on household deposits. After a sharp fall at the beginning of 2005, interest rates remained virtually unchanged. Interest rates on savings deposits redeemable at a period of notice of over 3 months recorded a modest rise, which was offset by a fall in rates for savings deposits redeemable at a period of notice of up to 3 months.

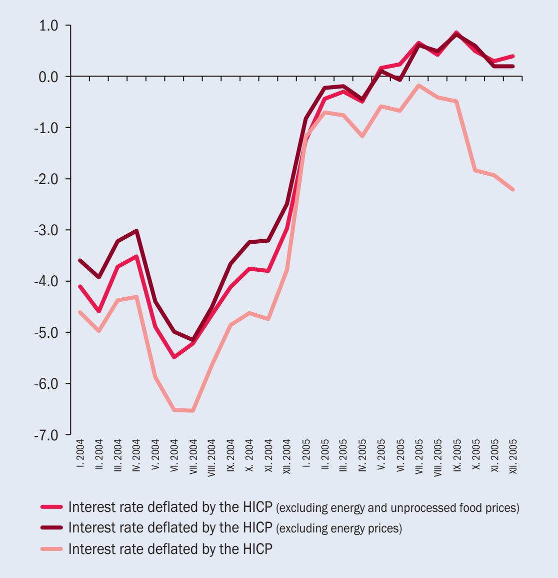
Although the key rates of the NBS were higher than those of the ECB, interest rates on household deposits in the euro area were higher than in Slovakia.

Chart 34 **Differences in interest rates on household deposits in Slovakia and the euro area** **(percentage points)**



Source: NBS and ECB.

Chart 35 **Real interest rates in household deposits** **(%)**



Source: NBS and Statistical Office of the SR.

This difference increased over the course of 2005 as a result of marked drops in interest rates on the individual types of deposits (mainly on deposits redeemable at notice of up to 3 months). This may be a consequence of commercial bank liquidity in Slovakia and the euro area. While the banking sector in the euro area was dependent on ECB refinancing, the central bank of Slovakia sterilised a considerable amount of liquidity.

Real interest rate on household deposits (ex-post)

The rise in real interest rates (calculated by deflating the rate of interest on the volume of one-year household deposits by HICP inflation) was mostly influenced in 2005 by developments in inflation. Despite a drop in nominal interest rates at the beginning of the year, real interest rates showed a slightly rising tendency over the first three quarters of 2005 as a result of fall in inflation. In the following months, inflation rose as a result of an increase in energy prices, which had a negative impact on the level of real interest rates at the end of the year. However, the real interest rate deflated by the HICP excluding energy prices, and/or HICP excluding energy and unprocessed food prices, achieved positive values in the second half of the year.

2.5 Licensing activity of the NBS and foreign exchange supervision

The National Bank of Slovakia performs the tasks of a foreign exchange authority, laid down in the Foreign Exchange Act (Act No. 202/1995 Coll. of the National Council of the SR), and tasks prescribed by the National Bank of Slovakia Act (No. 566/1992 Coll.).

Despite the liberalisation of the country's foreign exchange system and the cancellation of the regulation of balance of payments operations on current and capital accounts through foreign exchange permits, foreign exchange regulations still apply to certain entrepreneurial activities related to operations in Slovak and foreign currency in cash or non-cash form (i.e. trade in foreign exchange assets and foreign exchange services), and to the conduct of certain riskier foreign exchange operations on the financial market that are not covered by the law on securities (financial derivatives). These activities are subject to a foreign exchange licence issued by the National Bank of Slovakia.

Licensing activity

In 2005, the National Bank of Slovakia issued foreign exchange licences as follows:

- 52 licences for the purchase of funds in foreign currency for Slovak currency in cash (to 24 legal entities and 28 natural persons);
- 50 licences for the sale of funds in foreign currency for Slovak currency (to 24 legal entities and 26 natural persons);
- 3 licences for cash-free transactions in financial means.

Foreign exchange supervision

In 2005, the National Bank of Slovakia focussed its supervising activity on monitoring whether the reporting requirement is met by all entrepreneurial entities, and whether the conditions and tasks stipulated by foreign exchange regulations and those laid down in foreign exchange licences are fulfilled.

In total, 59 inspections were carried out within the scope of foreign exchange supervision.

2.6 Monetary policy instruments

Interest rate policy

a) *Basic interest rate of the NBS[15] (the rate for two--week repo tenders):*

from	29 November 2004	4.00%
from	1 March 2005	3.00%

b) *Interest rate for overnight refinancing operations:*

from	29 November 2004	5.50%
from	1 March 2005	4.00%

c) *Interest rate for overnight sterilisation operations:*

from	29 November 2004	2.50%
from	1 March 2005	2.00%

Monetary policy instruments of the NBS

Open market operations

a) *Main instrument – standard repo tender with a maturity of two weeks:*
The NBS conducts standard repo tenders with commercial banks on a weekly basis, usually on Tuesdays. The NBS also sets an interest rate for such operations (the basic interest rate).

b) *Instrument for longer-term liquidity control – 84--day NBS bill issued for the portfolios of commercial banks:*
The NBS generally conducts auctions in NBS treasury bills once a month, by using the American auction technique.

c) *Fine-tuning instrument – quick tender:*
An instrument of the NBS for fine-tuning the liquidity of commercial banks on an ad hoc basis. This instrument was not used in 2005.

d) *Structural operations – individual transactions:*
An instrument of the NBS enabling a direct purchase or sale of government securities and NBS bills for and from the NBS portfolio. This instrument was not used in 2005.

e) *Foreign exchange swaps:*
An instrument for liquidity fine-tuning in the koruna area on a temporary basis, through forward exchange transactions. This instrument was not used in 2005.

Automatic operations (standing facilities)

a) *Overnight refinancing operations:*
Commercial banks have automatic access to sources of finance (provided they have a sufficient amount of eligible securities), at the rate of interest announced.

b) *Overnight sterilisation operations:*
Commercial banks are allowed to deposit excess funds in the form of non-collateralised deposits, at the rate of interest announced.

Other instruments

a) *Redistribution loan:*
The repayment process of the redistribution loan continues.

b) *Short-term loans for a period of up to three months:*
To maintain a bank's liquidity, the NBS may, in exceptional cases, provide such a loan to the bank concerned. This instrument was not used in 2005.

Reserve requirements

With effect from 1 January 2005, commercial banks, branches of foreign banks, home savings banks, and electronic money institutions are required to maintain minimum reserves in the amount of 2%:
- of demand deposits, time deposits, and loans received in Slovak koruna or foreign currency;
- of deposits redeemable at notice and loans received in Slovak koruna or foreign currency;
- of debt securities issued in Slovak koruna or foreign currency, except for mortgage bonds.

Maintained reserves are evaluated on a monthly basis. Required minimum reserves held at the NBS on money reserve accounts are remunerated by a rate of 1.5% p.a., up to the amount set for the given month.

Exchange-rate and foreign-exchange policies

a) *Exchange rate system:*
The National Bank of Slovakia used a floating exchange rate regime in 2005. The exchange rate of

[15] On 12 December 2002, the Bank Board of the NBS decided to introduce a basic NBS interest rate with effect from 1 January 2003. The basic interest rate of the NBS is identical with the limit rate for standard two-week NBS repo tenders. The term 'discount rate of the National Bank of Slovakia', or 'discount rate of the State Bank of Czecho-Slovakia', used in generally binding legal regulations, refers to the basic interest rate of the National Bank of Slovakia.

Table 25 **Currency structure of receipts and payments in 2002 to 2005** (%)

	2002	2003	2004	2005
Total turnover (in billions of SKK)	1,385.6	1,536.8	1,657.5	1,892.5
of which: Euro (including former EMU currencies)	63.7	69.8	70.2	69.0
Czech koruna	9.3	7.8	7.5	7.3
American dollar	23.2	19.0	18.8	19.6
Other currencies[1)]	3.8	3.3	3.6	4.1
Turnover as a share of GDP (at current prices)[2)]	126.1	127.9	125.1	131.4

Source: NBS.
1) Hungarian forint, Danish crown, Norwegian crown, Swedish crown, Swiss franc, British pound, Australian dollar, Japanese jen, Canadian dollar, and other currencies.
2) NBS calculations based on preliminary data from the Statistical Office of the SR, 9 March 2006.

the Slovak koruna was determined in relation to the euro, being the reference currency. The National Bank of Slovakia intervened in the foreign exchange market in the event of excessive volatility in the exchange rate of the Slovak koruna, and/or when the exchange rate development was inconsistent with the macro-economic fundamentals.

On 28 November 2005, the Slovak koruna was included in the Exchange Rate Mechanism II (ERM II). The central parity of the koruna vis-à-vis the euro was set at EUR 1 = SKK 38.4550. In ERM II, the fluctuation band of the koruna will be ±15% around the central rate. The compulsory intervention rates are SKK/EUR 32.6868 (lower limit) and SKK/EUR 44.2233 (upper limit).

b) *Nominal exchange rate of the SKK:*

In relation to the euro, the nominal exchange rate of the Slovak koruna appreciated during the year by 2.4%, to SKK/EUR 37.848 on 31 December 2005. As a result of developments in the USD/EUR cross-rate on the world markets, the exchange rate of the koruna depreciated against the US dollar by 12.11% in nominal terms, to SKK/USD 31.948 at the end of the year.

c) *Nominal and real effective exchange rates of the SKK[16]:*

The average year-on-year dynamics of the nominal effective exchange rate (NEER) of the Slovak koruna weakened in 2005 to 1.1%, from 4.9% in the previous year. The slower appreciation of the NEER in 2005 was primarily caused by a marked fall in the year-on-year dynamics of the average exchange rate of the Slovak koruna against the US dollar (to 3.8%, from 12.3% in 2004), which was partly offset by a modest increase in the appreciation of the koruna against the euro (to 3.6%, from 3.5% in 2004).

In 2005, domestic price levels were influenced significantly by the rise in oil and energy prices on the world market, which was mainly reflected in the real effective exchange rate (REER) based on the producer price index, which appreciated year-on-year by an average of 0.2% (compared with 2.2% in 2004). Based on manufacturing products prices (excluding mineral raw materials and energy prices), the REER index depreciated year-on-year by an average of 2.8%, after appreciating in 2004 by 2.2%.

d) *Evaluation of the currency structure of foreign exchange receipts and payments in the Slovak Republic:*

The total turnover of receipts and payments in convertible currencies in the payment categories 1 to 6 reached SKK 1,892.5 billion in 2005. The average monthly turnover stood at SKK 157.7 billion (which was 14.2% more than in 2004) and foreign exchange receipts and payments resulted in a negative balance of SKK 30.9 billion (compared with a surplus of SKK 17.2 billion in 2004).

In the long term, the currency structure of the total turnover is dominated by the EUR and USD, with a total share of roughly 87% to 89%. The share of the euro decreased last year by 1.2 percentage points (for the first time since the single currency introduction in 1999), while that of the US dollar increased by 0.8 percentage point. Before 2004, the share of the euro had been on the increase and that of the dollar on the decrease. The share of the Czech koruna continued to decrease slowly, to 7.3% (by 0.2 percentage point) and that of other currencies increased, to 4.1% (by 0.6 percentage point).

[16] The methodology applied for calculating the nominal and effective exchange rates of the Slovak koruna (NEER and REER) is identical with that of the IMF. It uses the average monthly exchange rates of the Slovak koruna and the currencies of partner countries against the US dollar. The methodology is based on the producer price index (PPI) and the manufacturing products price index (PPI manufacturing). The initial year for the calculation is 1999, and the weights selected correspond to the structure of foreign trade with the sixteen major trading partners of Slovakia, representing roughly 86 to 89% of the total trade turnover in 1993 – 2004. These countries are Germany, Czech Republic, Italy, Austria, France, the Netherlands, the USA, Great Britain, Switzerland, Poland, Hungary, Ukraine, Russia, Japan, China, and Turkey.

The change in the share of the euro and the dollar in 2005 was caused by a change in the long-term trend in the cross-rate of the dollar and a rise in oil and energy prices on the world market, which affected price levels already in 2004. In 2005, however, the share of the US dollar increased in both foreign exchange payments and foreign exchange receipts

2.7 Chronology of monetary developments

January

• The President of the Slovak Republic appoints Ivan Šramko as Governor of the National Bank of Slovakia. Prior to his appointment (from 11 January 2002 to date), Mr Šramko held the position of Vice-Governor of the NBS.
• The President of the Slovak Republic appoints Martin Barto as Vice-Governor of the National Bank of Slovakia.
• With effect from January 2005, a pension reform is launched in Slovakia. On the one hand, the reform contributes to the sustainability of public finances, but in the short term, its costs represent a burden for public finances before the planned entry into the euro area.
• Moody's Rating Agency increases the long-term foreign exchange liability rating of Slovakia, from A3 to A2, as well as the rating of short-term liabilities, from P-2 to P-1. The Agency justifies this step with the ongoing government reforms, which are expected to lead to a gradual decrease in the public finance deficit. The rating outlook is positive in both cases.

February

• The Bank Board of the National Bank of Slovakia discusses and approves the 'Communication Strategy of the NBS for the Period until 2009', which formulates the Bank's main goals, defines the target groups, and proposes tools for the achievement of these goals. The Strategy pays attention to communication with the general and professional public about monetary policy in connection with the fulfilment of the 'Monetary Programme of the NBS for the Period until 2008'. The aim of the communication strategy is to keep the public informed, in an active and purposeful manner, of the Bank's decisions concerning monetary policy and/or the stability of the financial sector in the Slovak Republic, in order to boost people's confidence in the National Bank of Slovakia.
• With effect from 1 February 2005, the Bank Board of the NBS extends its plan of meetings to include a regular meeting on Tuesdays, devoted to the current situation on the financial market and the results of regular repo tenders conducted for sterilisation purposes.
• An agreement is signed on the settlement of a dispute between the Slovak Republic and Československá obchodná banka (ČSOB), a.s., Praha, between the Ministry of Finance of the SR, represented by Ivan Mikloš, and ČSOB, represented by Pavel Kavánek, Chairman of the Board, and Petr Knapp, Member of the Board of ČSOB. Under this agreement, Slovakia shall pay the bank nearly SKK 25 billion. Of this amount, SKK 16 billion is to be paid to the Czech party by 11 February 2005 at the latest; the financial resources for this transaction are available from state financial assets. According to the agreement, the remaining SKK 8.8 billion is due on 1 January 2006. This obligation has increased the level of public debt.
• At its meeting on 28 February 2005, the Bank Board decides to lower the key interest rates of the NBS to 2.0% for overnight sterilisation operations, 4.0% for overnight refinancing transactions, and 3.0% for two-week repo tenders with commercial banks (with effect from 1 March 2005). In view of the ongoing trend in the koruna exchange rate, the Bank Board of the NBS considers the appreciation of the Slovak koruna against the euro to be still unreasonably fast.

March

• The European Union's finance ministers approve the reform of the Stability and Growth Pact, which sets the rules of budgetary discipline within the Union. The key provisions of the Pact – the limits for the budget deficit (3% of GDP) and the public debt (60% of GDP) – remain unchanged. The reform tightens the Pact for periods of good times, by requiring the Member States to save when economic development is favourable. On the other hand, the amended Pact contains more flexible provisions for times of economic difficulties, when countries will be allowed to slightly exceed the 3% deficit limit (in justified cases).

April

• The Bank Board approves the results of the first round of an anonymous public tender for the designs of the national (Slovak) sides of euro coins, which are to present the history and cultural and natural values of Slovakia, and are to be comprehensible to the citizens of other EU countries as well. Thirty-six designs were selected for the second round.

May

• The Vice-Chairman of the Government and Finance Minister of the SR, Ivan Mikloš, and NBS Governor

Ivan Šramko hold a joint press conference to present 'The National Euro Changeover Plan for the Slovak Republic'. The National Plan has been prepared by the NBS and the Ministry of Finance in co-operation with several other central institutions of the SR. It contains plans for the individual steps that are to be taken in the interest of the smooth and successful adoption and use of the euro in the Slovak economy. The planned date for the introduction of the euro in Slovakia for both cash and cash-free payments is 1 January 2009, with a temporary period of dual use of the Slovak currency and the euro ending 16 January 2009.

June

• Japan's R&I (Rating and Investment Information) agency increases the long-term liability rating of Slovakia for koruna liabilities, to BBB+ with a stable outlook.
• The Bank Board discusses and approves 'The National Euro Changeover Plan for the SR', which contains detailed solutions for the technical and organisational aspects of the introduction of the single European currency in the SR.

July

• The Government of the SR approves the National Euro Changeover Plan for the SR, which expects the euro to be adopted on 1 January 2009.
• At a press conference in Bratislava, Juan Fernandez--Ansola, the head of the IMF mission to Slovakia, presents the International Monetary Fund's report on Slovakia. According to this report, economic growth in Slovakia remains strong despite the unfavourable economic conditions abroad, inflation has been reduced despite the high oil prices, and foreign investors continue to show increased interest in Slovakia. The inflation target of the NBS for 2006 (2.5%) is ambitious but attainable. The report also warns of the risks hampering the achievement of this target. Such risks are the continuing rise in oil prices and wage growth exceeding labour productivity growth.

August

• On 2 August 2005, the Bank Board of the NBS holds its 35th meeting. At the meeting, a bill amending the Act No. 118/1996 Coll. of the National Council of the SR on the protection of bank deposits and on amendments to certain laws, as amended, was discussed and approved. The main aim of this amendment to the deposit protection law, which was put forward on the initiative of the Association of Banks, is to modify the rules governing the calculation of the amounts of annual contributions to be paid by banks to the Deposit Protection Fund.

September

• The NBS publishes its opinion on the 'General Government Budget Projection for the Years 2006 to 2008', prepared by the Ministry of Finance of the SR. Basically, the NBS agrees to the budget, but finds it less ambitious in the area of deficit reduction.

October

• One of the commitments arising from the membership of Slovakia in the International Monetary Fund is participation in the Financial Transactions Plan (FTP), on the basis of the IMF's decision. Through the FTP, economically strong IMF member states lend money to IMF countries with balance of payments problems. Request for the participation of Slovakia in the FTP was handed over to NBS Governor I. Šramko by the head of the IMF mission. For Slovakia, this means a commitment to provide funds in the amount of 50% of the membership quota, which represents approximately USD 270 million. The provision of these funds will lead to a change in the recording of foreign exchange reserves, since the funds provided to the IMF will be registered as Slovakia's reserve position at the IMF. These funds will, however, be fully at disposal in the event of a crisis in Slovakia.
• Fitch Ratings increases the long-term foreign exchange liability rating of Slovakia from A- to A, with a stable outlook.

November

• On 28 November 2005, the Slovak koruna is included in the Exchange Rate Mechanism II (ERM II). The central rate for the koruna vis--vis the euro has been set at EUR 1 = SKK 38.4550. In ERM II, the fluctuation band of the koruna will be ±15% around the central rate. The compulsory intervention rates are SKK/EUR 32.6868 (lower limit) and SKK/EUR 44.2233 (upper limit).

December

• The NBS announces that, with effect from 1 January 2006, financial market supervision in the area of banking, capital market, insurance, and saving for retirement will be fully integrated by the NBS. Within the scope of integrated financial market supervision, the Financial Market Authority will be cancelled by law and its powers will be assumed by the National Bank of Slovakia. Among other things, the NBS will issue permits, approvals, consents, prior consents, and other decisions concerning the financial market (as from the beginning of 2006), which were previously issued by the Financial Market Authority (until the end of 2005).

• Standard & Poor's international rating agency increases the long-term liability rating of Slovakia in foreign currency from A- to A. The increase in the rating is a sign of rapid progress, achieved by Slovakia in the reform of the public sector. Standard & Poor's classifies Slovakia as one of the best countries within the V4.

• The Bank Board of the NBS approves the selection and visualisation of the artistic designs of the Slovak sides of euro coins.