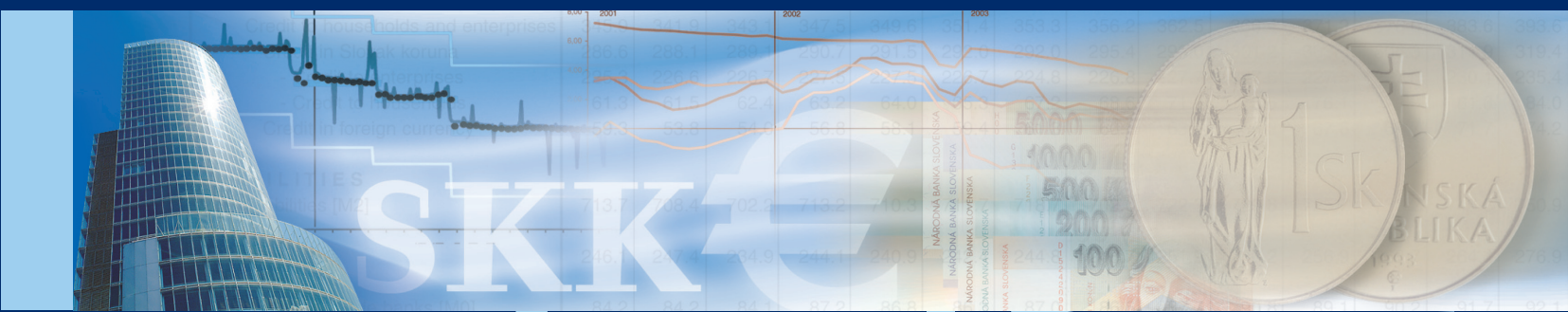




NÁRODNÁ BANKA SLOVENSKA



Annual Report

2005

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Foreword

In 2005 the Slovak economy has come to feel the effects of the ongoing reform process and integration efforts, with the National Bank of Slovakia playing its part as well. This resulted in a gradual convergence in both real and nominal terms. The price and wage levels converged and the gross domestic product level was catching up, as implemented reforms created favourable conditions for the strong economic growth recorded until now, as well as for growth outlooks.

Following its Monetary Programme until 2008, since early 2005 the NBS has pursued an inflation targeting strategy within ERM II, with inflation targets set as the main anchor for the NBS' monetary policy. As a result, the monetary policy of the NBS now explicitly aims at price stability, while allowing for the meeting of the Maastricht criteria (inflation and exchange rate) and respecting the ERM II mechanisms.



In connection with the new monetary policy strategy, in early 2005 the Bank Board approved the NBS Communication Strategy until the year 2009. Monetary programmes were replaced by medium-term forecasts, published quarterly. In May 2005, the NBS started publishing the outcome of votes held at the previous month's Bank Board meeting and from the end of the year the voting results have been published on the date of decision. Communication on monetary policy issues has been closely co-ordinated with Slovakia's national communication strategy for the adoption of the euro.

Economic and monetary developments in 2005 were marked by a slowdown in price growth, accelerating economic activity, continuing consolidation in public finance, the Slovak koruna appreciating against the euro, and a relatively dynamic growth in bank lending to both households and businesses.

Price growth slowed down considerably in early 2005 already, mainly due to smaller changes in regulated prices compared to 2004. However, the lower year-on-year inflation measured by the harmonised index of consumer prices (HICP) was also affected by low imported inflation, reflecting developments in the exchange rate of the Slovak koruna, as well as by strong retail competition. In the last quarter of 2005, a rise in regulated prices had an upward effect on the price level. Nevertheless, HICP ended the year below the upper limit of the 2005 target range.

Economic growth accelerated in comparison with the previous year to reach a new high since 1996. The structure of economic growth was balanced, driven by both domestic and foreign demand. GDP growth was dampened by net exports, with higher imports fuelled mainly by a robust investment demand and, to a lesser extent, consumer demand.

In 2005, the ratio of the deficit in the current account of the balance of payments to GDP increased as compared to 2004. The increase was partly due to a larger deficit in the balance of trade. For the most part, however, it stemmed from the income balance, due to higher dividend payments coupled with a change in the methodology requiring disclosure of reinvested earnings from 2005 onward.

In an environment of robust economic growth, the conduct of the NBS' monetary policy, in line with its objective, focused on maintaining price stability and meeting the inflation target not only for 2005, but also in the medium run. In the face of an unduly rapid exchange rate appreciation in early 2005, straying from the equilibrium paths, the National Bank of Slovakia resorted to foreign exchange market interventions in February and stopped accepting commercial bank bids in regular sterilisation repo tenders. The NBS Bank Board decided, effective from 1 March 2005, to lower its key interest rate by 1 percentage point, to 3.0%.



As a result, appreciation pressures subsided and at the same time, partly as a consequence of regional factors, the trends were realigned. In the following period the exchange rate showed a volatile pattern, recording another major gain in the wake of Slovakia's ERM II entry.

The increase in regulated prices, against the backdrop of a strong real wage growth outstripping productivity and a rapid economic growth implying a closing of the negative output gap, gave rise to the risk of secondary effects and higher inflation expectations. That is why in October 2005 the NBS started, in its rationales behind the decisions of the Bank Board on the set levels of interest rates, to alert to these risks and to the possible need to tighten the monetary policy in the period ahead.

In 2005, steps were taken to carry out the implementation plan for integrated financial market supervision (covering the banking sector, capital market, insurance sector, and pension saving schemes) as set out in a Slovak government resolution. In the process of integrating financial market supervision, and following the law, the Financial Market Authority was abolished on 1 January 2006, with its full jurisdiction taken over by the National Bank of Slovakia. The purpose of integrated supervision over the financial market is to contribute to the stability of the financial market as a whole, as well as to its safe and sound functioning in order to maintain its credibility, protect customers, and respect competition rules.

As regards banking regulation, considerable drafting efforts were made in 2005 to remove several shortcomings in decrees and methodological guidelines prepared by the Banking Supervision Division and to introduce qualitative risk management requirements laid down in the amended European Union Directives into the NBS decree on risks and the risk management system.

In 2005, the National Bank of Slovakia continued to operate the interbank payment system SIPS, seeking to enhance the security and smooth processing and settlement of interbank payments. During the year, it worked on a TARGET2 payment system project. The National Bank of Slovakia agreed to join the forthcoming TARGET2 platform no later than on the date of introduction of the euro as single currency in Slovakia.

2005 was the first year the issue and management of the stock of the Slovak currency took place exclusively in the NBS' own ten storage and processing sites. This facilitated a more efficient and flexible management of currency in circulation.

At the national centre for the analysis and monitoring of counterfeit banknotes and coins, the currency division has verified suspicious national and foreign currency banknotes and coins, provided expert opinions to law enforcement authorities and reported information to the euro counterfeits monitoring system run by the ECB.

The NBS has played an active role in preparations for the adoption of the euro in Slovakia and in implementing the Strategy for Adopting the Euro in the Slovak Republic. It was closely involved in the drafting of the National Euro Changeover Plan for the Slovak Republic and has performed all tasks it was assigned in the National Plan so far.

On 28 November 2005, the Slovak koruna entered the exchange rate mechanism ERM II at a central rate of 38.4550 koruna per euro. Upon ERM II entry, Slovakia made a commitment to continue pursuing a sound fiscal policy and to support a wage growth correlated to productivity. This policy fully complies with Slovakia's Convergence Programme and the NBS Monetary Programme.

As part of the ESCB, the NBS has taken an active part in the Common ESCB Training and open seminars for ECB and NCB staff. On a bilateral level, the NBS has also organised training activities, in particular expert consultations and secondments, for staff of selected central banks, especially from the new EU member states. There has been an uptrend in the NBS' training activities on an international scale, in particular through offering cross-border technical assistance to central banks in the countries outside the European Union.

Ivan Šramko
Governor



Members of the NBS Bank Board as at 31 December 2005

Front row (left to right):

Karol Mrva, Chief Executive Director, Trade and Foreign Exchange Division

Elena Kohútiková, Deputy Governor

Ivan Šramko, Governor

Martin Barto, Deputy Governor

Back row (left to right):

Peter Ševčovic, Chief Executive Director, Monetary Division

Milena Koreňová, Chief Executive Director, Financial Management and Payments System Division

Ladislav Balko, Comenius University, Faculty of Law

External Economic Environment



1 External Economic Environment

1.1 Global trends in output and prices

The world economy in 2005 slowed only slightly in comparison with its strong growth in 2004. Despite a slowdown in the fourth quarter, the main drivers of the growth were the economies of the United States and of East Asia, particularly China, which has maintained an exceptionally high level of growth. The euro area, with its business cycle lagging slightly behind that of the United States, is looking forward to an expected upswing. Above-average growth, albeit slightly declining, was sustained by the economies of the new EU Member States as well as Russia. The recovery of the Japanese economy also continued in 2005.

As in 2004, world economic growth was characterized by persisting regional differences that maintained the situation of long-term global imbalances. The main indicator of these imbalances, the US current account deficit, became even more prominent in 2005. These growing imbalances were once again caused by domestic demand in the United States which, as in the previous year, increased under the conditions of an expansive fiscal policy. On the other hand, East Asian countries and oil-exporting countries continued to report large surpluses and to build up their foreign exchange reserves.

The solid world economic growth continued to be supported by favourable financing conditions, relatively strong corporate profits, and a rising volume of investment in developed economies. The financial markets in 2005 were characterized by unusually low risk premiums and low volatility. Short-term interest rates generally increased, and the interest rate differential between the US dollar and the euro also rose. Long-term interest rates remained, however, below average and therefore the yield curve flattened considerably. Amid ample liquidity and search for yields a rising volume of capital flowed into newly industrialized economies. The generally favourable environment supported an increase in equity prices outside the United States, especially in emerging markets. At the same time, real estate prices were rising, however, at a significantly slower rate than in 2004.

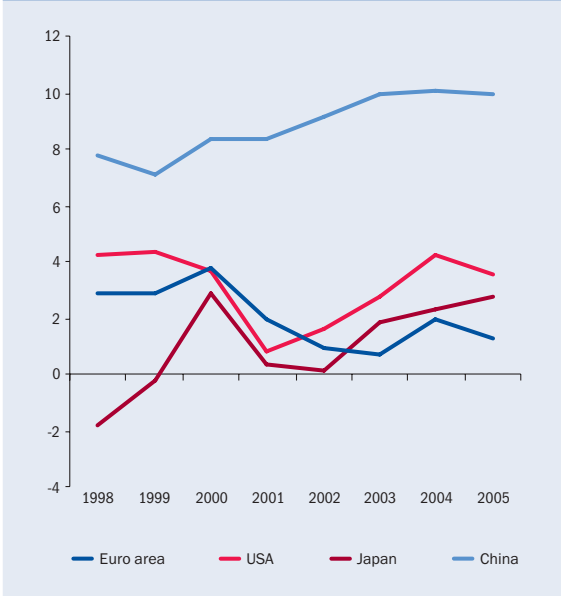
Commodity prices kept an upward course in response to rising global demand. The price of Brent crude oil was relatively volatile in 2005, reaching a highest level of USD 67.5 per barrel in the third quarter and averaging over USD 54 per barrel for the year, an increase of more than 45% in comparison with 2004. The oil price was affected both by rising demand (especially in the United States and China), and by supply-side uncertainty caused by natural disasters, the disruption of production in Nigeria, geopolitical insecurity in Iraq

Table 1 Global output	(year-on-year growth in %)		
	2004	2005	2006 ¹⁾
Global output	5.3	4.8	4.9
Developed economies	3.3	2.7	3.0
United States	4.2	3.5	3.4
Japan	2.3	2.7	2.8
Euro area	2.1	1.3	2.0
European Union (EU-25)	2.5	1.8	2.4
Emerging Asian economies	5.8	4.6	5.2
China	10.1	9.9	9.5
Central and eastern Europe	6.5	5.3	5.2
Russia	7.2	6.4	6.0
Brazil	4.9	2.3	3.5

Source: IMF World Economic Outlook, April 2006.
1) Forecast.



Chart 1 GDP growth in the euro area, the United States, Japan and China (%)



Source: IMF World Economic Outlook, April 2006.

Chart 2 Consumer prices in the euro area, the United States, Japan and China (%)



Source: IMF World Economic Outlook, April 2006.

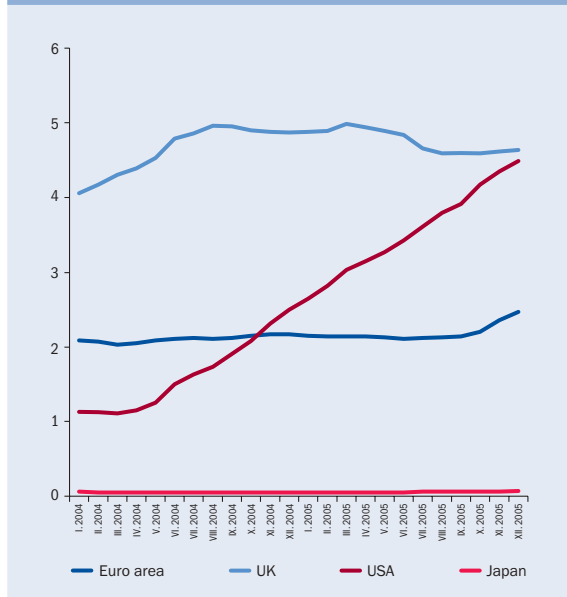
and Iran, and the low oil supply growth in non-OPEC countries. These factors, as well as the increasing oil price itself, had a direct effect on the prices of other energy commodities, which increased most sharply at the beginning and end of 2005. Prices of other (non-energy) commodities also increased over the course of the year, by almost 10% on average.

Despite pressure from rising prices of energy and other commodities, both inflation and inflation expectations were relatively low. Lower sensitivity of inflation and wage costs to price shocks is a result of not only positive globalization effects (the growing trade in cheaper traded goods from emerging economies in exchange for capital from developed economies), but also of the increased credibility of central banks.

The strengthening of the euro and general weakening of the US dollar that had been a feature of previous years came to an end in 2005. In fact, the dollar appreciated by more than 10% overall against both the euro and the yen, largely because of the growing interest rate differential and the improved outlook for economic growth in the United States. The value of the dollar also rose in response to current conditions in commodities trading and the resulting rise in the real prices of commodities. Over the course of the year this market trend changed only for a short period of time, at the beginning of March, when the dollar came under speculative pressure concerning the possibility that certain central banks would diversify their foreign exchange reserves away from dollars. The market, however, swung back to support the dollar, especially after France and the Netherlands voted in early June to reject the European Constitutional

Treaty. Moreover, reports of rising foreign demand for US assets further helped to ease concerns about the financing of the US current account deficit. In July, China formally abandoned its currency's peg to the dollar and revalued the renminbi by 2.1%. However, the new exchange rate regime, a basket peg, did not bring a notable change in the quantitative value of the exchange rate, despite the pressure of the international community to a gradual liberalization of the renminbi exchange rate towards its equilibrium value. The bilateral trade balances therefore

Chart 3 Short-term interest rates on the interbank market (3M) (%)



Source: IMF World Economic Outlook, April 2006.

continued to increase with a surplus in China and a deficit in the US.

The euro was worth USD 1.20 at the end of 2005. During the year it depreciated by more than 10% against the US dollar and by almost 4% against sterling; it also lost ground to the Canadian dollar, Australian dollar and to most of the currencies of the new EU Member States (Hungary being an exception). Against the Japanese yen as well as the Swiss franc, the euro exchange rate remained year-on-year at the same level.

1.2 Developments in the main currency areas: the euro area, United States, Japan and China

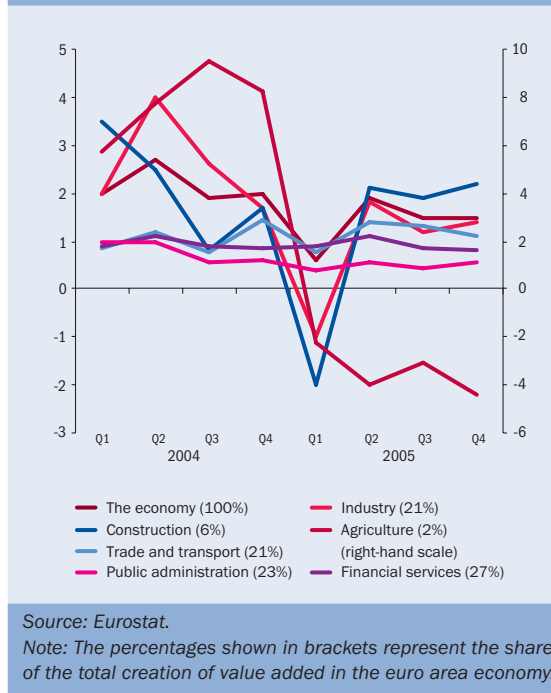
Economic development in the euro area

Economic growth in the euro area stood at 1.3% for 2005, representing a slight slowdown in comparison with 2004. The expected economic recovery was relatively weak, which may be attributed to two main factors. On the one hand, there were rising oil prices and low growth in real disposable income. Household saving stayed largely unchanged, which curbed private consumption and therefore domestic demand. On the other hand, foreign demand was dampened by the delayed effects of the euro appreciation in 2004. Furthermore, labour productivity recorded growth of less than 1%. The subdued productivity growth was partially linked to the rise in employment, as well as to structural aspects of utilizing technological and human capacities. HICP inflation increased only slightly, to an average level of 2.2% (compared with 2.1% in 2004). Inflation in 2005 was also dampened by the strong euro exchange rate against certain currencies and by the effect of ever increasing global competition on prices of tradable goods.

The modest fall in GDP growth in the first quarter of 2005 was caused mainly by a decline in output in agriculture, industry and construction. The lower growth in industry for all quarters of the year, as well as the persisting decline in value-added creation in agriculture (owing to a base effect), were the main factors behind the subdued growth dynamics in the euro area economy (Chart 4).

GDP growth in 2005 decreased year-on-year in all euro area countries except for Spain and Ireland (whose GDP grew by 3.4% and 4.7%, respectively). They along with Greece (3.7%) and Luxembourg (4.2%) recorded the strongest growth among the euro area countries. Growth of less than 1% was recorded in Germany (0.9%) and Portugal (0.3%), while Italy stagnated. The difference between the economies with solid

Chart 4 Structure of value-added creation in the euro area (annual growth rate, in %)



growth and those in stagnation (or with slow growth) therefore widened slightly in 2005 in comparison with the difference in the previous year.

The energy component affected the structure of inflation to a greater extent in 2005 than in the previous year, as energy prices increased at an average annual rate of more than 10%. Despite much larger contribution of the energy component to overall inflation in the euro area (0.8% compared with 0.2% in 2004), overall HICP inflation increased only marginally (by 0.1 of a percentage point to 2.2%). The profile of energy prices over the course of the year also corresponded with the development of the HICP index: both the value of the energy component of inflation and overall inflation peaked in September (at 15.0% and 2.6%,¹ respectively). Other components of inflation were less volatile during the year, and secondary pressures from price growth in the energy component were minimal.

The annual increase in consumer prices in the euro area countries measured by HICP inflation ranged from 0.8% in Finland to 3.8% in Luxembourg.² Inflation of more than 3% was reported in Greece (3.5%) and Spain (3.4%). Inflation in most other countries was close to the overall average for the euro area (between 1.9% and 2.5%).

¹ Year-on-year percentage change in the HICP.

² The energy component of inflation had the greatest effect in Luxembourg, representing as much as 1.4 percentage points, while in other euro area countries it was between 0.5 and 1.0 percentage point.



Costs of oil imports were rising in reaction to oil price increases, which caused a decline in the trade surplus of the euro area. With its other components remaining largely unchanged, the current account balance declined by 1% of GDP and moved into a deficit for the first time in four years.

Regarding public finances in the euro area as whole, there was a moderately restrictive fiscal policy in 2005. The negative output gap widened slightly, which had a mildly adverse effect on the budgets. Government balances differed substantially among euro area countries, as they had in previous years. Portugal, Greece, Italy and Germany exceeded the 3% reference value in 2005 (Germany did so for the fourth consecutive year, while the French deficit was slightly below the limit). The pace of consolidation in 2005 was not sufficient, largely because of lower GDP growth and the overshooting of projected expenditure. The most substantial shortfalls in budgetary consolidation persisted mainly in countries that have a large government deficit. Although the euro area's overall deficit for 2005 narrowed slightly (from 2.8% to 2.4%), it was not enough to reduce the debt-to-GDP ratio, which increased moderately (to 70.8% of GDP) in 2005 after rising also in previous years.

Employment slowly began to increase in 2005, by a very modest 0.2%. While the growth was faster in services and construction, it declined in industry. Part of this development was attributable to labour market policy measures aimed at promoting part-time work. Since the labour supply did not change during the year, the rate of unemployment declined, and by the end of the year stood at 8.3%. Despite some progress in labour market flexibility, further reforms in employment are required in order to address the growing economic competition, the pace of technological advances, and above all the population ageing.

Improving but subdued private consumption in 2005 was held down by the weak growth in disposable income (less than 1%). The low rise in disposable income reflected mainly the modest growth in wages, which declined to 1.5%. Wage development did, however, differ on both sectoral and geographical basis. Wages in industry were the main factor for subdued wage growth, while wages in market-oriented services (trade, transport, and financial and business services) actually recorded higher growth. The secondary effects of rising commodity and energy prices were not felt before the end of the year. Wage indexation posed a risk in those countries where it is more deeply entrenched, though it did not directly exacerbate these effects.

Real estate prices in the euro area continued to increase in 2005 (to June, by 7.7% year-on-year), but the structure of the growth differed substantially from

region to region. Prices recorded the highest rises mainly in Spain, Italy and France, while in Germany they even fell slightly.

The financial account recorded a turnaround in 2005 when, in contrast to 2004, net outflows of direct and portfolio investments were registered. The balance of investment inflows and outflows declined year-on-year by EUR 37 billion, or 0.5% of GDP. The main cause was an unequal reallocation of a part of the capital from direct investments to portfolio investments and shares. The behaviour change of enterprises in the euro area was probably based on expectations of stronger economic growth in countries outside the euro area and on efforts to increase competitiveness through investments in foreign activities. A countering effect may have been the interest of foreign investors in euro-area equity securities, which the market considered to be relatively more attractive.

Economic development in the United States

Economic activity in the United States continued to grow at a relatively fast pace (especially in the first three quarters), and growth for 2005 came to 3.5%. Both the goods and services sectors expanded, although at a weaker pace than in 2004. The conditions for real GDP growth were largely created by consumer spending which, as in 2004, was supported by favourable financing conditions, continuing rise in real estate prices, and growing employment. Another element of real GDP growth was the increase in corporate investments, which were further boosted by rising corporate profits. Profit growth was also supported by the modest increase in wages and the continuing, albeit slight, growth in labour productivity. Despite rising energy prices and the adverse effects of hurricanes, inflation pressures in 2005 were dampened by the appreciation of the dollar, subdued growth in unit labour costs (2.9%), and continuing rise in labour productivity (2.7%). Annual CPI inflation stood at 3.4% (2.2% excluding energy). Nevertheless, modest wage growth and the increase in energy prices put a downward pressure on already insufficient rate of personal saving. Consequently, the ratio of household debt to disposable income increased even further over the course of the year. Household demand continued to be satisfied mainly from net imports of goods, which increased sharply in comparison with the previous year and pushed the current account deficit up to 6.4% of GDP (compared with 5.7% in 2004).

Economic development in Japan

The Japanese economy kept on a recovery course and grew by 2.7%. As in 2004, growth accelerated mainly in the first half of the year (when the economy



grew by 5% year-on-year). The economic recovery was initiated by growth in exports, corporate investments, and investments by non-residents related to rising demand in Asian countries. Investments by residents and increased private consumption, which reflected improving figures for employment and income, followed this development. Capital expenditure by non-residents also rose under the effect of favourable financing conditions, the falling share of non-performing loans, and solid corporate profits. Aided by depreciation of the yen against the US dollar (and therefore against most East Asian currencies), exports to countries with rising demand, especially China and the United States, picked up towards the end of the year. Weakening of the exchange rate and rising commodity prices supported a gradual move away from deflation (though it still amounted to 0.3%), and the prospects are for an increase in the CPI. The price of labour, which recorded a slight increase in 2005 as a result of growing employment, should be conducive to an upturn in the CPI. The banking sector benefited from improving macroeconomic conditions over the course of the year, while the credit risk related to the volume of non-performing loans continued to decline. The Nikkei Stock Average increased by 40% in the second half of the year, reflecting the positive outlook for Japan's economic activity.

Economic development in China and East Asia

China's economic growth, as well as that of other East Asian countries, remained very strong in 2005 and reached 9.9% (compared with 10.1% in 2004). Moreover, the latest revisions of data indicate that growth in recent years was even stronger than previously published. The main element of the growth is the large volume of foreign direct investment (which in 2005 represented some 3% of GDP). The continuing expansion of Chinese net exports is supported by the managed exchange rate of renminbi – still lower than the equilibrium rate – in conjunction with investments. China recorded a record surplus on its current account in 2005, which, along with the surplus on the capital and financial accounts, accounted for the further increase in reserves. By the end of the year, China held dollar reserves amounting to USD 819 billion and had surpassed Japan as the largest holder of dollar reserves in the world. The contribution of net exports to economic growth slightly and temporarily weakened, towards the end of the year. This was largely due to the renminbi effective exchange rate appreciating by approximately 10% over the course of 2005. Consumption, however, continued to increase, supported by income growth both in urban agglomerations and in rural areas. Private sector output, the traditional driver of growth, accounted for almost 60% of GDP. It was private sector companies that created

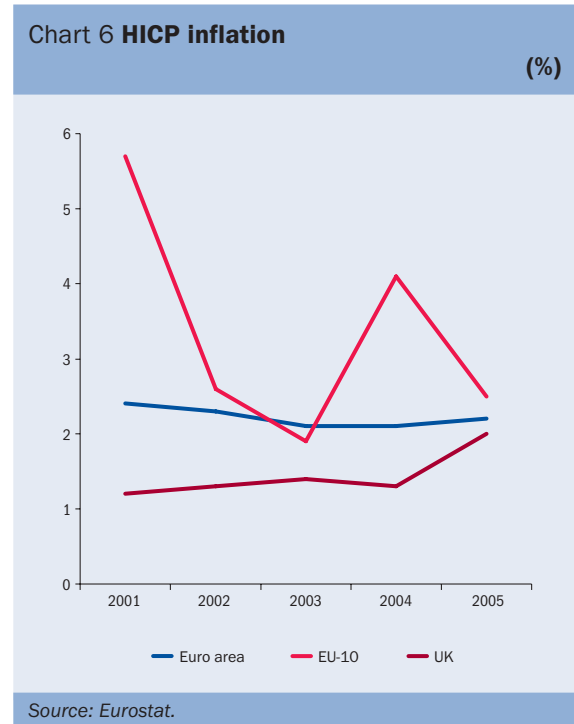
most of new jobs and generated the growth in corporate sector productivity and profitability. This process, moreover, has still far to go. Inflationary pressures from 2004 ceased, even though they stemmed from growth in energy prices and these continued to rise. Inflation in 2005 eased to 1.8%, partly on account of tightened monetary policy. Other East Asian countries also recorded dynamic growth and achieved the same level as in 2004, i.e. 7.9%.

Monetary policy and public finances

The European Central Bank (ECB) made only one change to key interest rate in 2005, when it raised them by 25 basis points to 2.25% (the minimum bid rate on main refinancing operations) in December. This increase resulted from a gradual revision of inflation projections in regard to the growing conviction about long-term growth in energy prices and its effect on price stability. On the fiscal side, there was generally only a small progress towards sounder public finances in 2005. The rate of consolidation did, however, differ substantially between the euro area countries. The total government deficit in the euro area declined only slightly. Moreover, a higher number of countries reported a deficit exceeding the reference value laid down by the Stability and Growth Pact. Government debt in 2005 also averaged in excess of the Pact's 60% limit and increased slightly.

In 2005, the Federal Open Market Committee (FOMC) of the Federal Reserve System (Fed) was progressively raising the target federal funds rate. Eight increases by 25 basis points brought the Fed's key rate to 4.25% by the end of the year. This series of steps, announced in advance and anticipated, continued in the trend of tightening monetary policy that the Fed had embarked on in 2004. In the fiscal sphere, the government deficit narrowed to only 2.6% of GDP (down from 4.4% in 2004) largely because of higher income tax revenues from both natural persons and legal persons.

The Bank of Japan continued to pursue an extremely loose monetary policy in 2005, with the key interest rates fixed at 0%, while flooding the banking sector with liquidity. The emergence of economy from long-term recession strengthened prospects for an end to such central bank policy within the near future. The weak discipline of government authorities, both in 2005 and over many previous years accounted for the large government deficit (6.1% of GDP). This further increased the ratio of gross government debt to GDP, up to almost 170%.



1.3 Developments in non-euro area Member States

Economic and monetary development

Real GDP growth in non-euro area Member States slowed down in 2005 in comparison with 2004. It remained, nevertheless, substantially stronger than the growth in the euro area (Chart 5). The growth rate in 2005 was as usual above average in the Baltic states (over 7%) and in the Czech Republic and in Slovakia (close to 6%). Growth in the vast majority of countries was driven by domestic demand, mainly by private consumption supported by increases in real disposable incomes, especially in the new Member States (except for Poland and Malta). In some countries this trend was encouraged by an expansive fiscal policy and growth in real estate prices. In most of the EU-10 countries domestic demand was supported by the continuing strength of investment growth, based on low interest rates and growing corporate confidence. Investment growth in 2005 was substantially aided by financing from EU funds. Foreign demand fuelled real GDP growth in the Czech Republic, Baltic countries and to a lesser extent also in Hungary.

Strong economic growth along with increasing investment activity created an environment conducive to the creation of new jobs and the improvement of labour market conditions. Employment growth rose on average, especially in those countries with a higher rate of unemployment and high investment activity. The growth in the labour force implies, however, that unemployment is at present falling only gradually.

HICP inflation in the new EU Member States in 2005 was again very close to the average inflation in the euro area. The slowdown of inflation in the first half of the year may be attributed both to a base effect – price growth related to expectations when the ten new Member States acceded to the EU – and to intensifying competition in tradables, especially foodstuffs. A further downward pressure on inflation in 2005 was the gradual appreciation of the effective exchange rates of the Czech, Polish and Slovak currencies. On the other hand, rising prices of oil and energy put upward pressure on inflation (though only partially, since the secondary effects were modest and since energy prices are regulated in most of the new Member States). Thus, these prices along with weakening of the above base effect were a factor behind a moderate increase in inflation in the new Member States towards the end of the year. Moreover, a rise in domestic demand stemming from increased lending to households was to a certain extent a source of inflationary pressures in some countries.

Although inflation in the EU-3 countries came in lower than the average inflation in the euro area, it did increase year-on-year owing to low figures in 2004.

Fiscal policy in the non-euro area countries in 2005 varied in character from one country to another, ranging from a budget surplus in Sweden (2.9% of GDP) and Denmark (4.9% of GDP) to a large deficit in Hungary (6.1% of GDP). The results for fiscal sector are basically in line with the aims of the convergence programmes of 2005. Despite a favourable economic environment, the government balances of non-euro

Table 2 Basic macroeconomic indicators of the non-euro area Member States (%)												
	GDP			HICP inflation			Unemployment rate ¹⁾			Current account (in % of GDP)		
	2004	2005	2006 ²⁾	2004	2005	2006 ²⁾	2004	2005	2006 ²⁾	2004	2005 ³⁾	2006 ²⁾
EU-3												
Denmark	1.9	3.1	3.2	0.9	1.7	2.1	5.5	4.8	4.0	2.3	2.9	3.4
Sweden	3.7	2.7	3.4	1.0	0.8	1.1	6.3	7.8	7.0	6.6	5.9	5.8
United Kingdom	3.1	1.8	2.4	1.3	2.1	2.0	4.7	4.7	5.0	-2.0	-2.6	-3.3
Baltic states												
Lithuania	7.0	7.5	6.5	1.2	2.7	3.5	11.4	8.2	7.1	-7.9	-7.0	-7.3
Latvia	8.5	10.2	8.5	6.2	6.9	6.7	10.4	9.0	8.4	-12.9	-12.4	-13.1
Estonia	7.8	9.8	8.9	3.0	4.1	3.6	9.7	7.9	7.0	-12.7	-10.6	-9.8
Central European states												
Czech Republic	4.7	6.0	5.3	2.6	1.6	2.5	8.3	7.9	7.7	-6.0	-2.3	-2.6
Hungary	4.6	4.1	4.6	6.8	3.5	2.3	6.1	7.2	7.7	-8.4	-7.4	-8.3
Poland	5.3	3.2	4.5	3.6	2.2	1.0	19.0	17.7	16.2	-4.2	-1.5	-2.0
Slovakia	5.5	6.1	6.1	7.5	2.8	4.4	18.2	16.4	15.5	-3.4	-8.5	-5.7
Slovenia	4.2	3.9	4.3	3.7	2.5	2.4	6.3	6.3	6.3	-2.0	-1.1	-1.6
Mediterranean states												
Cyprus	3.9	3.8	3.8	1.9	2.0	2.4	4.7	5.3	5.4	-5.3	-5.7	-6.1
Malta	-1.5	2.5	1.7	2.7	2.5	2.9	7.3	7.3	7.4	-9.6	-12.9	-12.6
For information												
EU-25	2.4	1.6	2.3	2.1	2.2	2.1	9.1	8.7	8.5	0.0	-0.3	-0.9
Euro area	2.0	1.3	2.1	2.1	2.2	2.2	8.9	8.6	8.4	0.5	0.1	-0.5

Source: European Commission Economic Forecast Spring 2006.
 1) In % of labour force.
 2) Forecast.
 3) Estimate.

area countries deteriorated, reflecting various additional and one-off budget expenditures. In most non-euro area countries (except Malta and Cyprus), the debt-to-GDP ratio was safely below the reference value of 60%.

Current account balances had a very mixed development in 2005, ranging from a surplus in Denmark and Sweden to large deficits in the Baltic countries (Table 2). In catching-up economies, however, the significant deficits on current accounts merely reflect a natural development, in which previous inflows of capital allow for the financing of investments with high value added, investments that could not have been financed from domestic funds alone. The net inflow of foreign direct investment in 2005 grew slightly in comparison with 2004, and in all of the new Member States

apart from Slovenia there was recorded a positive net inflow of foreign direct investment. Even though this is an important source of financing, it is not always sufficient to cover current account deficits.

In 2005 new members joined Estonia, Lithuania, Slovenia and Denmark in the exchange rate mechanism ERM II. Cyprus, Malta and Latvia entered the mechanism in May 2005 and Slovakia joined at the end of November, with all the countries officially observing a standard fluctuation band of $\pm 15\%$ around a central parity against the euro.³ ERM II participation in 2005 passed with no serious tensions in any of the foreign exchange markets of the eight member countries. Since joining ERM II the Danish krone, Estonian kroon, Lithuanian litas, Maltese lira and Slovenian tolar traded at or close to their central parities. The

³ Both the Cypriot pound and Latvian lats were unilaterally pegged to the euro prior to joining ERM II. Whereas Cyprus has pegged its currency to the euro since 1999, when the common currency was introduced, Latvia switched its currency's peg at the beginning of 2005, from the SDR (Special Drawing Right – the unit of account used by the IMF, the value of which is based on a currency basket) to the euro and kept within a fluctuation band of $\pm 1\%$. After joining ERM II, the Latvian authorities announced that they would maintain the lats exchange rate within a fluctuation band of $\pm 1\%$ around the central parity against the euro. When the Maltese lira entered ERM II, it abandoned a currency basket that included the euro, the British pound and the US dollar, and became pegged to the euro. The Maltese authorities also declared that they would hold the lira's exchange at the central parity against the euro. As regards the Slovak koruna and Cypriot pound, no formal unilateral obligations for narrower bands have been adopted.



Cypriot pound, Latvian lats and Slovak koruna were somewhat more volatile, though mostly fluctuated on the appreciation side of the fluctuation band, within 2 to 3% of the parity.

The main objective of monetary policy in all non-euro area Member States is price stability. In 2005, monetary policy regimes and exchange rates remained basically unchanged from one country to another. Six countries applied exchange rate targeting (Denmark, Estonia, Cyprus, Latvia, Lithuania, Malta), five countries inflation targeting (the Czech Republic, Poland, Slovakia, Sweden, the United Kingdom), and two countries applied combined regimes – inflation targeting that takes account of the exchange rate (Hungary) and a two-pillar regime tracking monetary, real, external and financial indicators of macroeconomic conditions (Slovenia).

Developments in V4 countries

Strong economic growth of the V4 countries continued in 2005, despite rising oil prices (and higher energy intensity of these economies) and the weak recovery in the euro area.

The Czech Republic recorded its fastest ever growth (6.0%), which was largely accounted for by an increase in net exports. This resulted from the strength of foreign direct investment made in the automotive industry over previous years. The country's external position also improved substantially, in particular the trade balance, which recorded a surplus of 2% of GDP. Growth in private consumption slowed slightly, paralleled with the slow increase in disposable income, mainly owing to lower growth in real wages. Although interest rates were at a record low, the increase in gross fixed capital formation also declined. On the supply side, economic activity was driven by industry, trade and financial services.

Real GDP growth in **Hungary** fell again in 2005, to 4.1%. As in the Czech Republic, the main engine of growth was net exports. Output growth was par-

ticularly strong in the manufacturing of electrical and optical equipment and in the manufacturing of transport equipment. On the other hand, the largest contribution to gross fixed capital formation came from public investment in infrastructure. Private consumption increased only slightly in comparison with previous years, which reflected low growth in disposable income. The lower than predicted trade deficit and growth in foreign direct investment accounted for more than 1 percentage point of the decline in the current account deficit. The rate of inflation declined sharply over the course of the year, while the Hungarian central bank reduced the central base rate by 3.5 percentage points.

In **Poland** real GDP growth in 2005 slowed considerably to 3.2% (by more than 2 percentage points). After pre-election instability in the first half of the year, when investment growth declined to 2.5%, investor confidence was only gradually restored and there was no substantial upswing until the fourth quarter, when the economy grew by 4.2% year-on-year. Domestic demand increased by only 1.9%, dragged down by low consumption and a relatively sharp decline in inventories that was related to excessive demand expectations in 2004. Nevertheless, domestic demand adjusted for the change in inventories was the leading factor behind the economic growth (a contribution of 3 percentage points). The contribution of net exports was relatively weak (1.3 percentage points) amid a substantial decline in the growth of both exports and imports.

Economic growth in **Slovakia** accelerated to 6.1% in 2005. The main driver of growth was domestic demand, especially private consumption and investment. Private consumption benefited mainly from the increase in employment (by 2.1%) and the real wage growth (6.3%); and investment mainly from large investment projects in the corporate sector (especially the automotive industry) and a rising volume of public investment in infrastructure. In contrast to previous years, the contribution of net export was temporarily negative as exports and imports increased only slightly.

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% \pm 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 \pm 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 ($3.5\% \pm 0.5$ 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 led 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

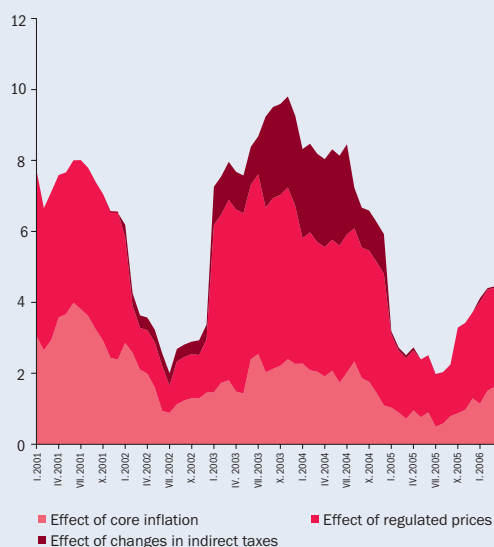
Table 3 Consumer price developments in terms of the HICP (average for the period)
(year-on-year changes in %)

	2004	2005				
		Q1	Q2	Q3	Q4	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 2005⁵ (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

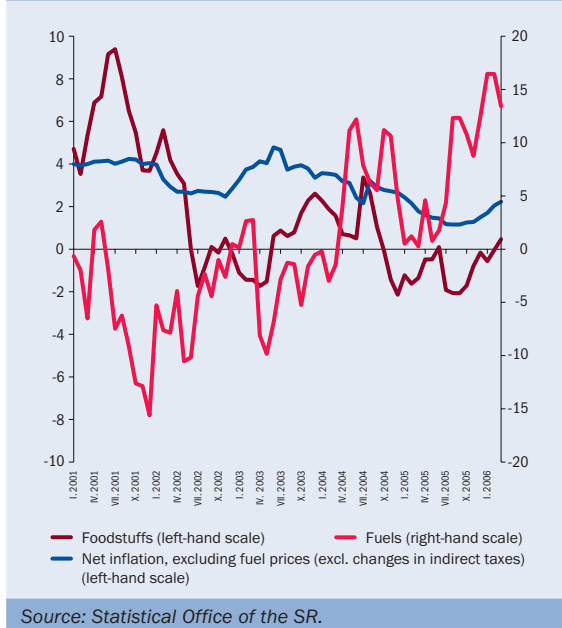
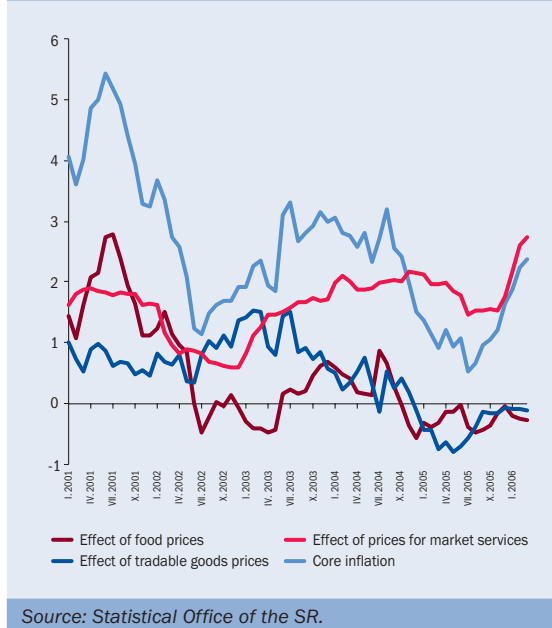
(year-on-year changes in %)

	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 %)

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


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

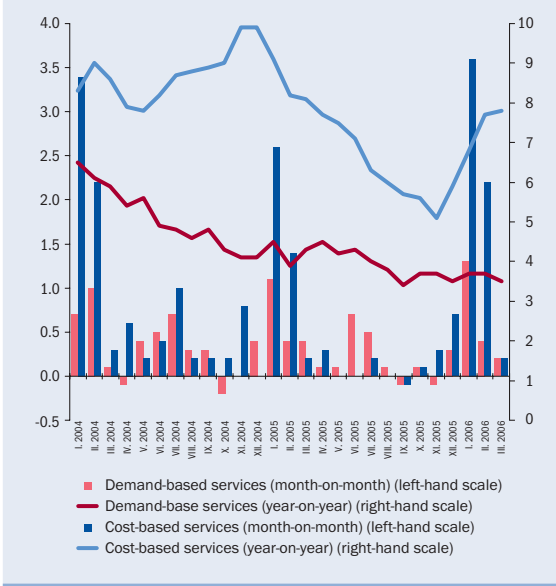
In December 2005, core inflation reached 1.7%, representing an increase of 0.2 of a percentage point in comparison with the same period in 2004. Its course over the first three quarters was characterised by a stable year-on-year rate at a level around 1.0%, with a steeper rise in the final quarter.

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.

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).

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,

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				Year
		Q1	Q2	Q3	Q4	
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 con-

struction, 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.

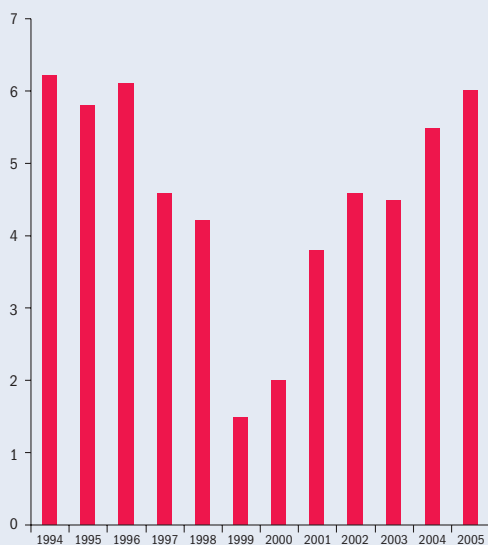
Table 6 **Developments in the GDP deflator**
(index, same period a year earlier = 100, average for the period)

	2004	2005				Year
		Q1	Q2	Q3	Q4	
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.

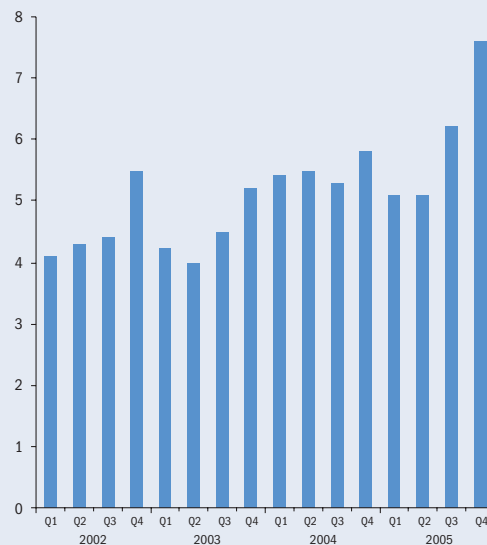


Chart 11 Growth in real gross domestic product (year-on-year growth in %)



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 2000⁶ 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.

	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.

	2004	Q1 05	Q2 05	Q3 05	Q4 05	2005
	2003	Q1 04	Q2 04	Q3 04	Q4 04	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	Q1 05	Q2 05	Q3 05	Q4 05	2005
	2003	Q1 04	Q2 04	Q3 04	Q4 04	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.

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

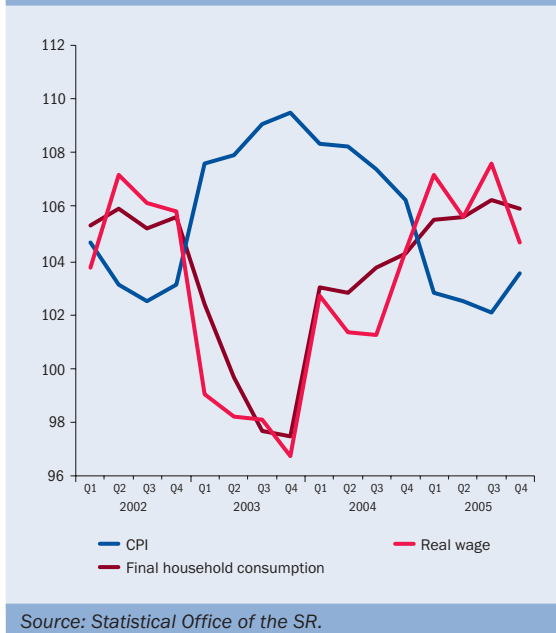
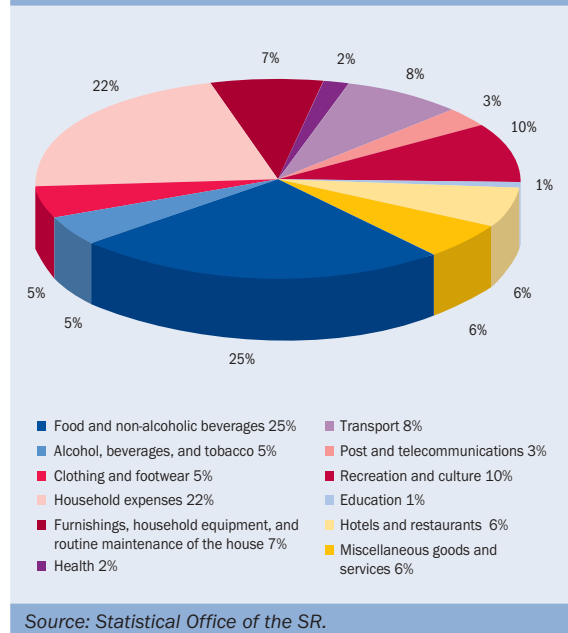
recorded in the investment activities of non-financial corporations, which can be attributed to foreign direct investments and the financial results of these corporations. Most investment means were produced by non-financial corporations, mainly through the creation of new fixed assets. The year-on-year 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 (%)****Chart 14 Structure of final household consumption (%)**

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).

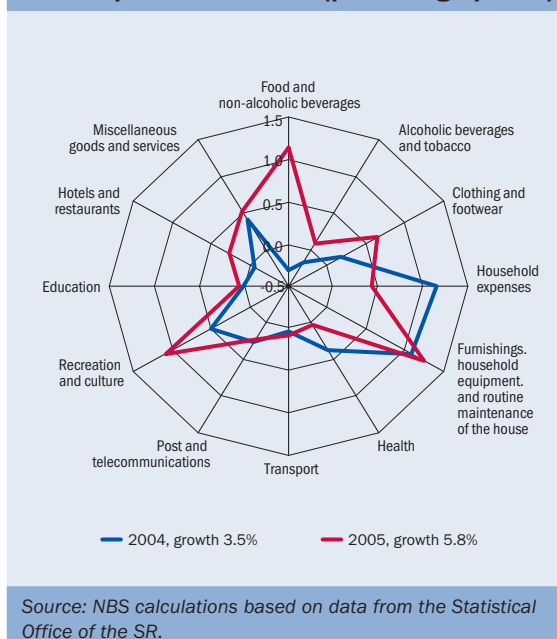
Within the structure of final household consumption, the strongest growth (19.1% at constant prices) was recorded in spending on furnishings, household equipment, and routine maintenance of the house. The increased utilisation of credit facilities by households was, in all probability, not only connected 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)



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

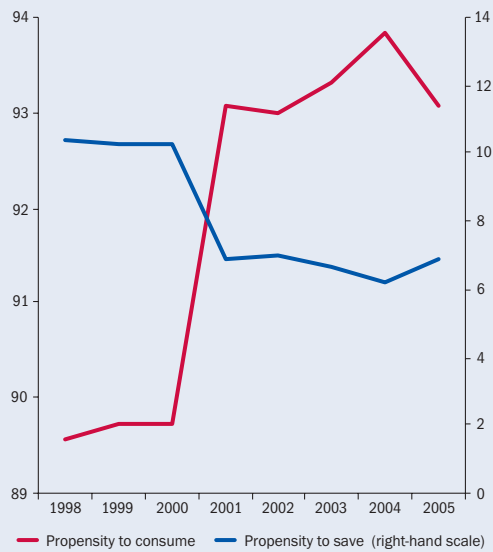
of growth accelerated in nominal terms by 0.2 of a percentage point and in real terms by 4.9 percentage points. Current households expenditure (paid to other sectors and not used for direct consumption) totalled SKK 271.4 billion, representing a year-on-year increase of 6.2% (3.4% in real terms).

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

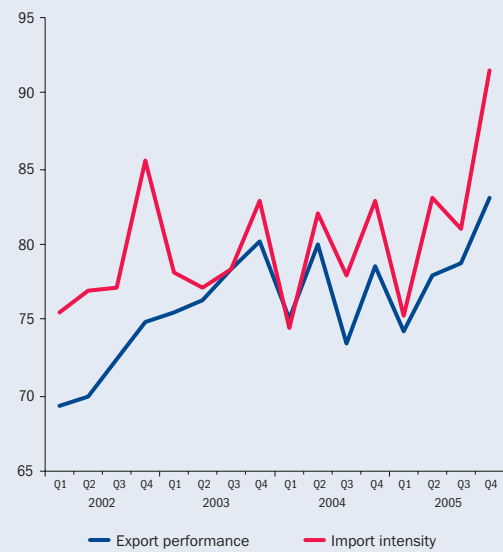
	SKK billions		Indices ¹⁾		Share in %	
	2004	2005	2004 2003	2005 2004	2004	2005
Compensation of employees (all sectors)	532.1	579.3	107.7	108.9	51.2	51.5
of which: Gross wages and salaries	399.4	441.6	108.4	110.6	38.4	39.3
Gross mixed income	289.0	332.1	109.1	114.9	27.8	29.5
Property income – received	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.

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 95⁷ 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

Chart 18 Unemployment rate

(%)



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

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				Year
		Q1	Q2	Q3	Q4	
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).

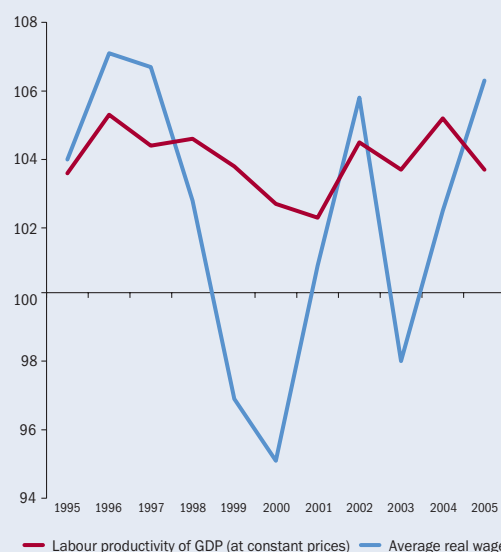
After two years, the relation between labour productivity and wages changed to the detriment of productivity, with productivity growing in real terms at a rate 2.6 percentage points slower than the average monthly real wage.

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.

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%.

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.

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%).

2.2 Balance of payments

2.2.1 Current account

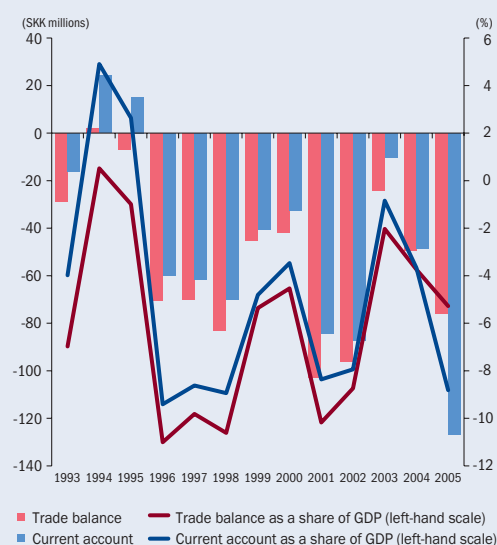
In 2005, the balance of payments on current account resulted in a deficit of SKK 126.9 billion, which was SKK 78.2 billion more than in 2004. This increase was largely due to a year-on-year deterioration in the trade and income balances. The b.o.p. current account deficit reached 8.8% of GDP at current 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.

Chart 20 Balance of trade and current account developments



Source: NBS and Statistical Office of the SR.

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 ex-

ceeded 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 Slo-



vak 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 stra-

tegy 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 growth⁸ 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.	Change since the beginning of the year ¹⁾	
	(SKK billions)	(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 deposits⁹.

Within the structure of the M3 aggregate, part of the free funds of corporate clients, held mostly in the form of short-term time deposits¹⁰, 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.

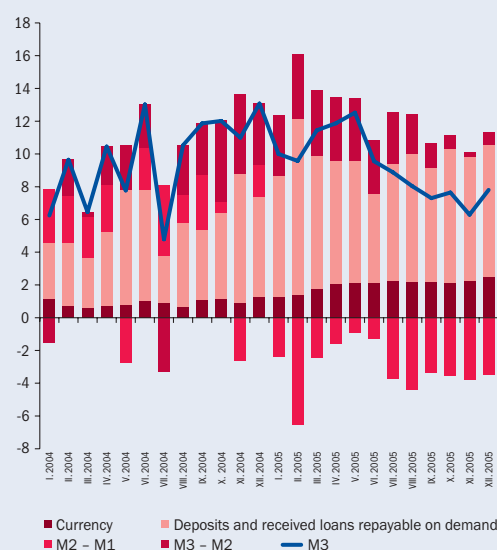
Among MFI loans to the private sector (excluding securities), the year 2005 saw significant increases in loans granted to households (SKK 52.8 billion, of which SKK 31.0 billion took place in loans for house purchases) and loans provided to non-financial corporations (SKK 46.2 billion). The currency 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.

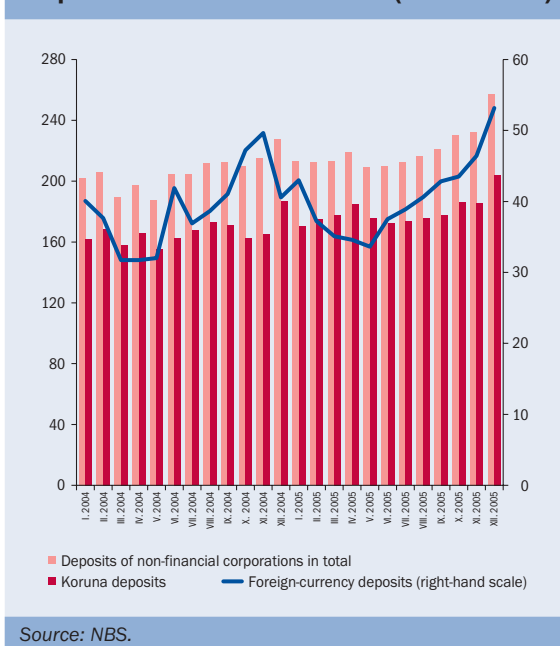
2.4.2 Structure of the money supply

The growth in the money supply was affected first and foremost by increases in the most liquid M1 com-

ponents, 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.

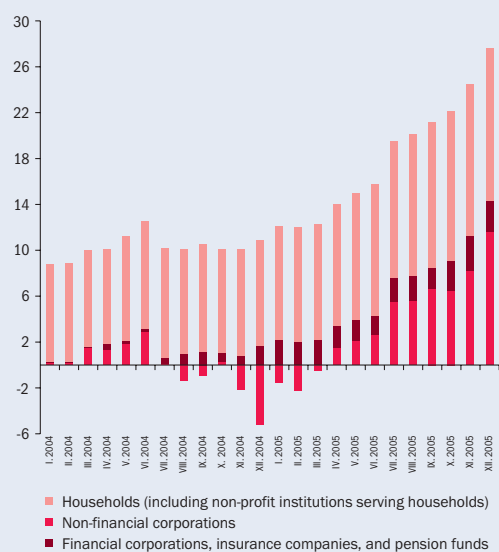
Deposits not included in M3

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

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

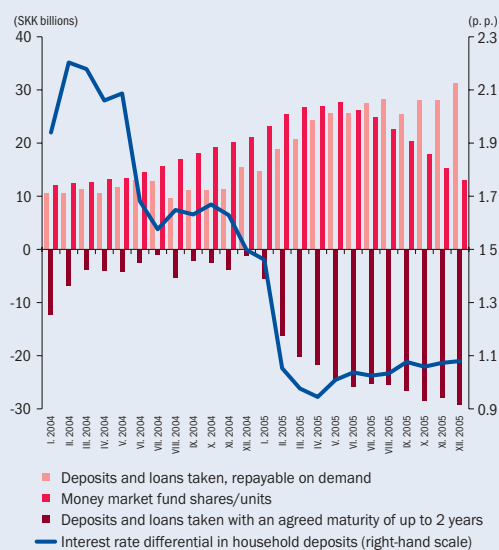


Zdroj: NBS.

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%).

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 2004¹¹ to 27.6% in 2005. The steepest increases occurred in loans to households¹² (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).

Chart 23 Year-on-year increases in household deposits

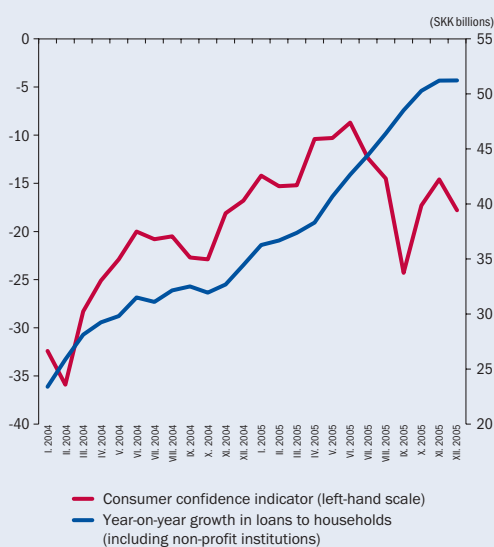


Source: NBS.

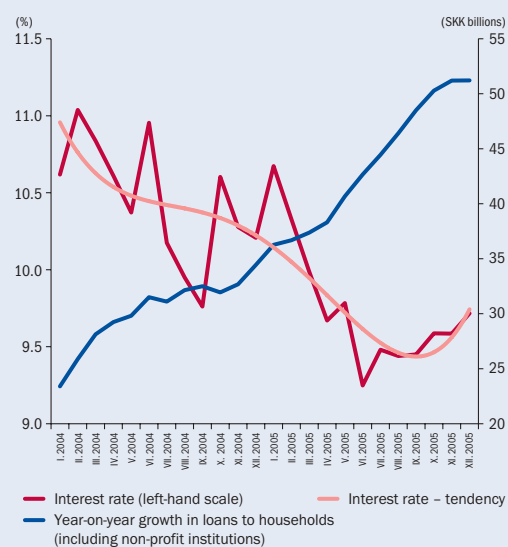
Note: Interest rate differential represents the difference between interest rates on less liquid M2 components (deposits and loans taken with an agreed maturity of up to 2 years and deposits redeemable at a period of notice of up to 3 months) and deposits and received loans repayable on demand.

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 households¹³, 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 loans¹⁴, 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.

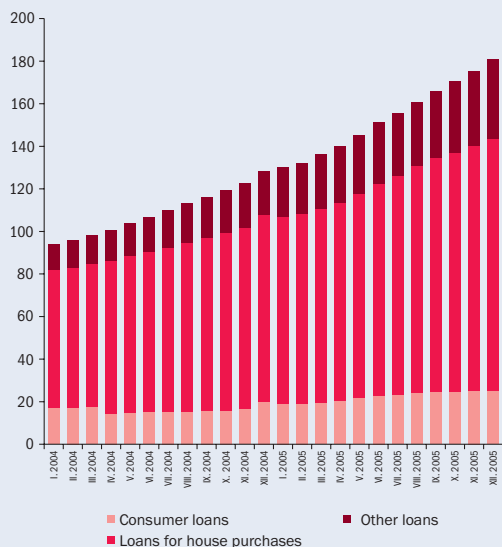
The continuing dynamic growth in loans in the household sector was accompanied by an increase in indebtedness (expressed as the ratio of loans to households to GDP), which increased from 9.7% in 2004 to 12.6% in 2005. Similar developments in connection with the process of real convergence were also recorded 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.

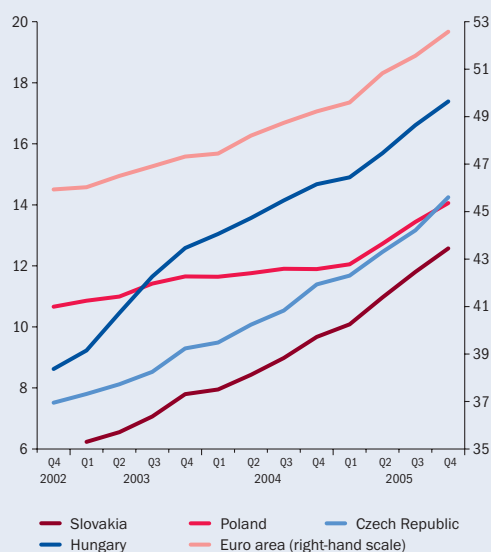
Chart 27 MFI loans to households (SKK billions)



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

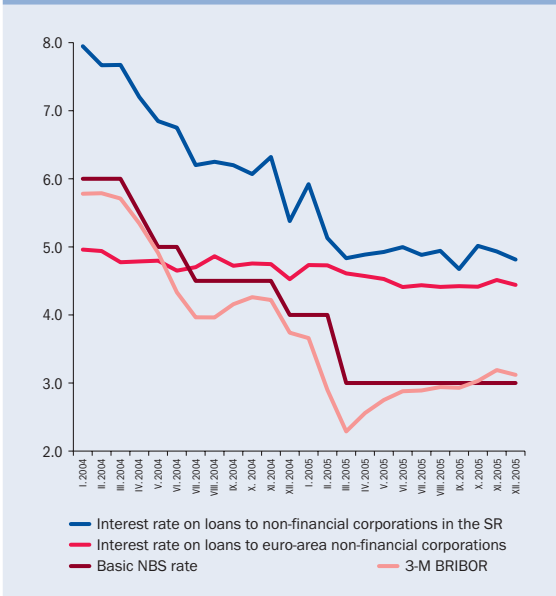
Average interest rates on loans to non-financial corporations followed a relatively stable course in 2005. The first quarter saw a falling trend in lending rates, which was connected with the cuts in key interest rates in 2004 and their expected further reduction in response to interbank market developments. 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

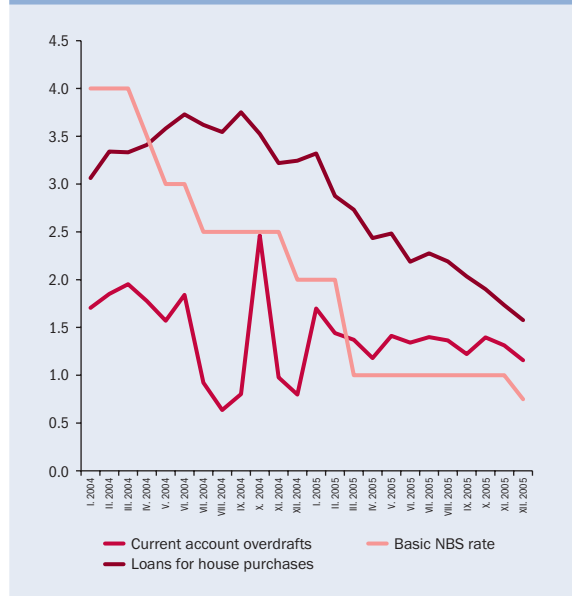


Chart 29 Interest rates on loans to non-financial corporations, BRIBOR, and the basic NBS rate (%)



Source: NBS.

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



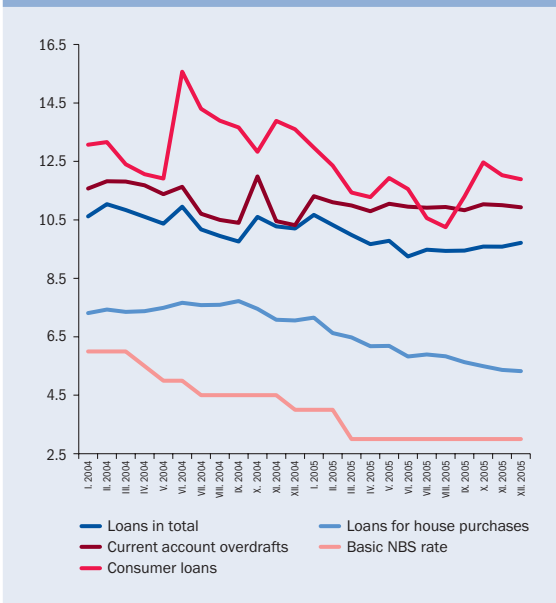
Source: NBS and ECB.

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 (%)



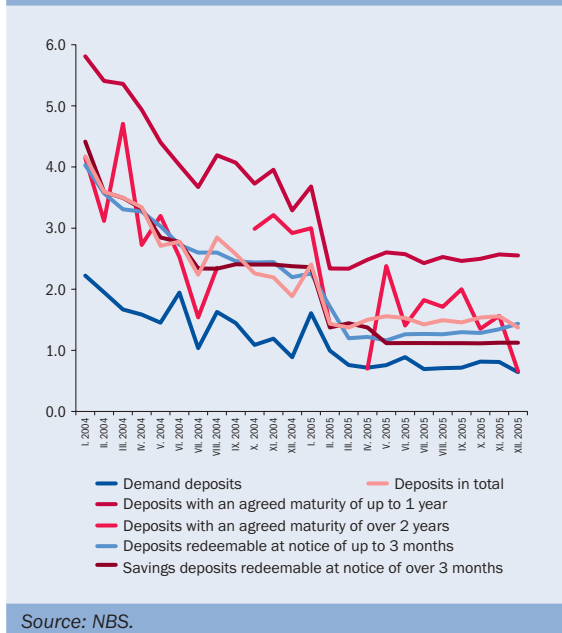
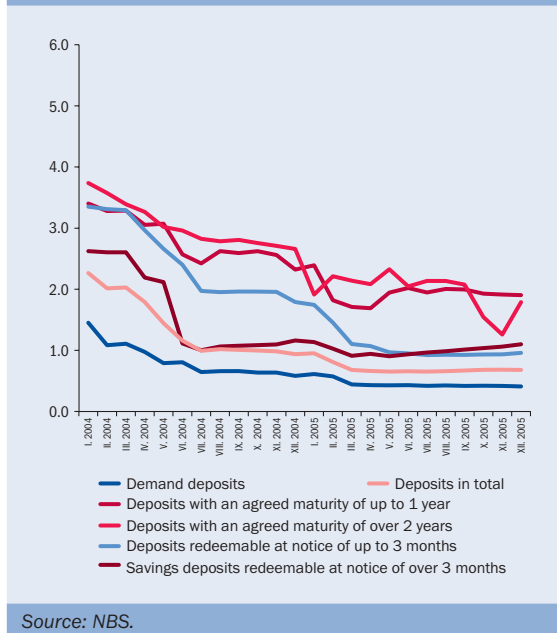
Source: NBS.

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 (%)

Chart 33 Interest rates on household deposits (%)


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.

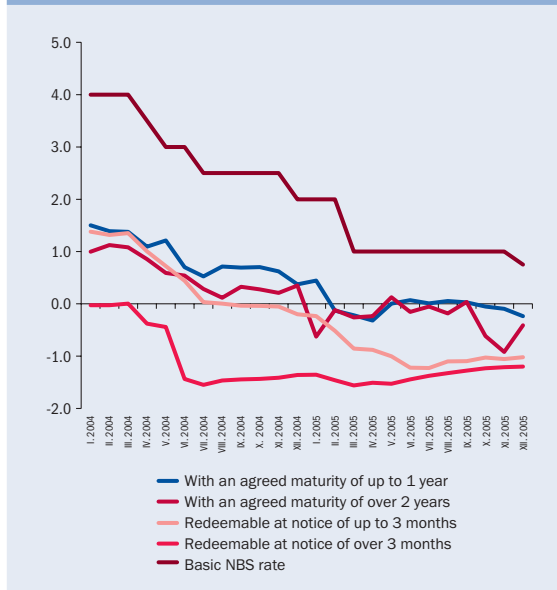
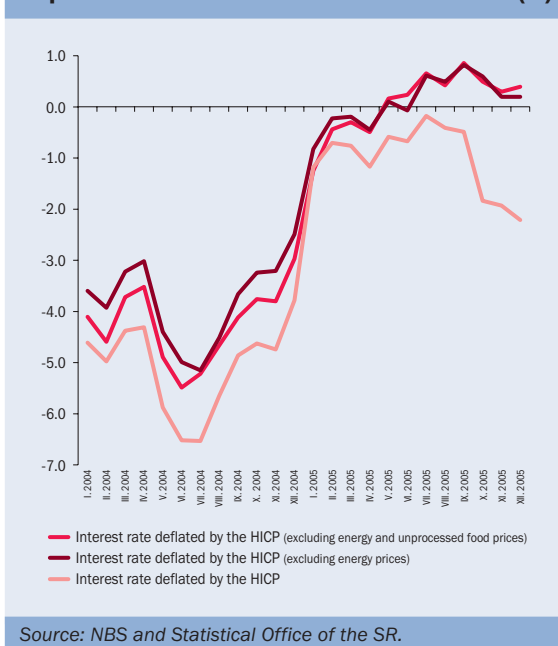
Chart 34 Differences in interest rates on household deposits in Slovakia and the euro area (percentage points)




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 NBS¹⁵ (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 yen, 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 $\pm 15\%$ 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 SKK¹⁶:*

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-à-vis the euro has been set at EUR 1 = SKK 38.4550. In ERM II, the fluctuation band of the koruna will be $\pm 15\%$ 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.

NBS Monetary Operations



3 NBS Monetary Operations, Foreign Exchange Operations and Investment Activities in Foreign Exchange Reserve Management

3.1 Monetary policy operations

Monetary policy implementation underwent several changes in 2005. They mainly applied to the decision-making process used in monetary policy operations and the terms and conditions of specific NBS transactions.

The first significant change introduced by the NBS in February 2005 was target-based decision-making on monetary policy implementation. Decisions are taken at dates fixed in advance according to the plan of Bank Board meetings. This method is based on the directed monitoring of economic and monetary developments, including the price transmission mechanism and its impact on domestic financial markets. The qualitative evaluation of data obtained from such monitoring and the causes of changes in price developments on domestic financial markets are decisive factors in the process of decision-making by the Bank Board of the NBS.

arising from ESCB membership, the NBS decided to modify the rules governing the conduct of monetary policy operations and the payment and securities settlement of such operations (with effect from January 2005). Subject to change were, for example, the selection of banks or other financial institutions for selected monetary policy operations and the selection of financial assets that are eligible in operations for monetary purposes. The NBS also decided to change the rules of risk management, including the rule prohibiting monetary financing of the public sector (Articles 101 and 102 of the EU Treaty). All these changes were published in NBS directives No. 1/2005 and 2/2005. With effect from 2005, the NBS also decided to make adjustments affecting the quality and price of services related to the central register of short-term securities, which is kept at the NBS.

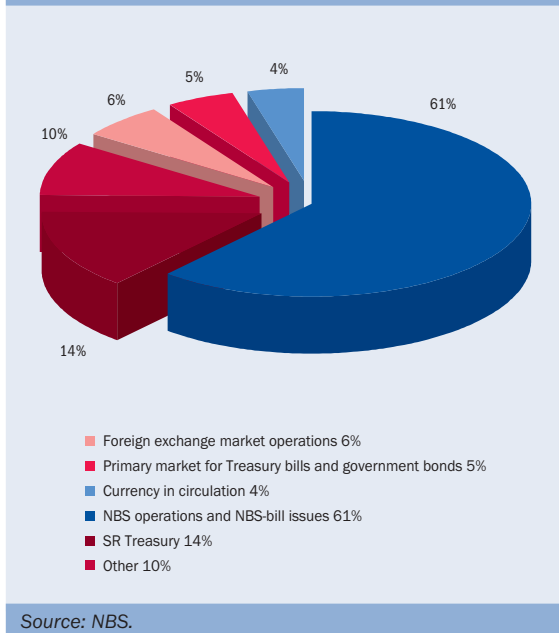
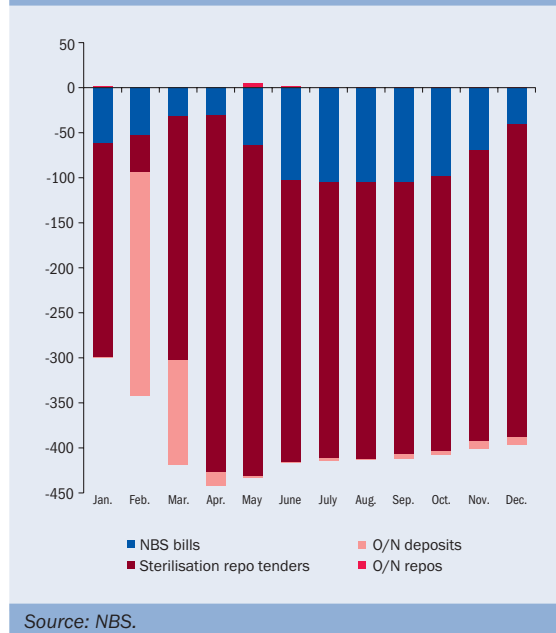
Banking system liquidity management

The monitoring of supply and demand in the banking sector in connection with operations with the central bank is subject to daily liquidity assessment in this sector and is also subject to the decisions of the Bank Board concerning the scope of interventions and the types of operations. Required reserves, currency in circulation, and autonomous factors – financial flows within the SR Treasury and net foreign assets – influence the daily volume of liquidity in the banking sector. In 2005, as in the previous year, the banking sector had a marked excess of liquidity. Its average daily amount sterilised through monetary policy operations stood at SKK 399.2 billion. This liquidity surplus was SKK 172.6 billion higher than in 2004. The average monthly amount of excess liquidity ranged during the year from SKK 298.6 billion to SKK 442.1 billion. The most significant increases in excess liquidity were caused by foreign exchange market interventions, the transfer of funds managed by the SR Treasury from the NBS to commercial banks, and the value of redeemed government securities exceeding the value of new issues.

Chart 36 Required reserves and autonomous liquidity factors in 2005 (SKK millions)



Source: NBS.

**Chart 37 Structure of effects on daily changes in required reserves in 2005 (%)****Chart 38 Developments in open market operations in 2005 by type (SKK millions)**

Main monetary policy operations

In 2005 the main monetary policy operations continued to be 14-day sterilisation repo tenders held on a weekly basis. The volume of these operations, aimed at sterilising the excess liquidity in the banking sector, was high throughout the year. The only exception was February 2005, when the NBS decided to accept no bids from banks at sterilisation repo tenders and thus prevent the Slovak koruna from appreciation, including impact of the exchange rate on interest rates on the domestic money market. Developments in BRIBOR rates were rather volatile over the course of January 2005 and the yield curve became markedly inverse. After the NBS had intervened in the foreign exchange market and rejected the bids of banks at sterilisation repo tenders at the beginning of 2005, money market rates ceased to have an adequate expressive power about this market. They regained this power in March 2005, after the NBS had lowered its basic interest rates (including the refinancing and sterilisation rates for O/N operations) and renewed its main monetary policy operations – sterilisation repo tenders.

Longer-term operations

During 2005 the NBS issued central bank bills (NBS bills) with a maturity of 84 days. The only time when there were no auctions of these bills was a period at the beginning of the year when the NBS reacted to the excessive appreciation of the Slovak koruna. The NBS issued bills with the aim of directly sterilising the excess liquidity of banks. At the same time, however, the NBS also issued these instruments for

its own portfolio and used them in main monetary policy operations for sterilisation purposes. In total, the NBS held 11 auctions of NBS bills on the primary market and issued NBS bills in the total amount of SKK 290.0 billion.

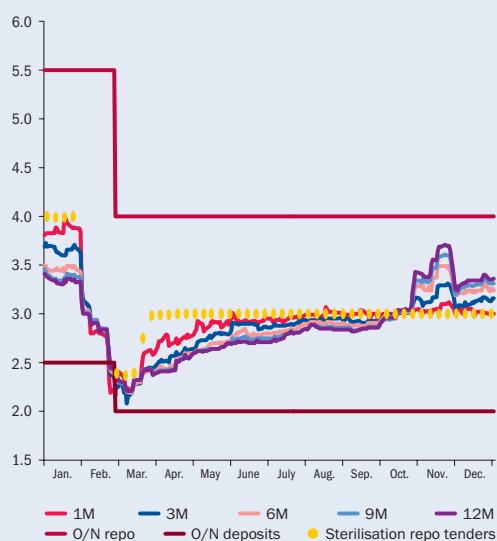
Standing facilities

With regard to the character of the banking sector's liquidity position (ample liquidity), overnight deposit operations with the NBS were frequent, though in terms of value less significant than the main operations. The only exceptions were February and March, the months in which the NBS decided to accept no bids from banks at sterilisation repo tenders. On the other hand, overnight refinancing operations with the NBS were sporadic. For example, an average monthly volume exceeding SKK 1.0 billion was registered only in three months within the first half of 2005. In the following months, the average monthly value of overnight refinancing operations did not exceed SKK 0.6 billion. A supplement to overnight refinancing operations was the possibility to draw intra-day credit via the money reserve account within the SIPS payment system. This possibility was utilised in 2005 by 8 counterparts of the NBS.

Reserve requirements

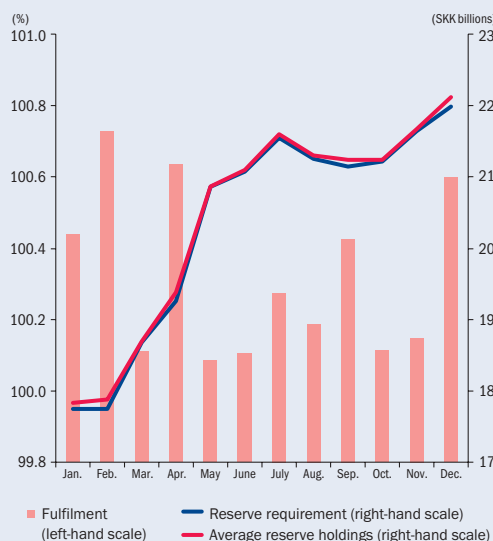
Required minimum reserves are held, in accordance with the relevant NBS decrees and EC directives, by banks, branches of foreign banks, and electronic money institutions. The function of the minimum re-

Chart 39 BRIBOR in 2005
(in % p. a.)



Source: NBS.

Chart 40 Required reserves in 2005



Source: NBS.

serve system ensure the maintenance of short-term liquidity within the banking system. The averaging provision enables banks to adequately regulate the volume of their transactions on the domestic money market within the reserve maintenance period. In 2005 minimum reserves were held by 18 banks and 5 branches of foreign banks, including 2 branches that commenced banking operations in Slovakia on the basis of a single banking licence valid in the EU Member States. The conditions for holding of required reserves remained unchanged in 2005, at the 2004 level, i.e. a reserve ratio of 2% of specific liability items, a reserve maintenance period of one month, and interest at a fixed rate of 1.5%. The value of the total reserve requirement showed a rising trend during the year: it increased by SKK 4.2 billion from January to December 2005. Although there were large fluctuations in the actual reserve holdings in some of the months (e.g. May, June, September, and December 2005), the reserve requirement was fulfilled by the banking sector in each month.

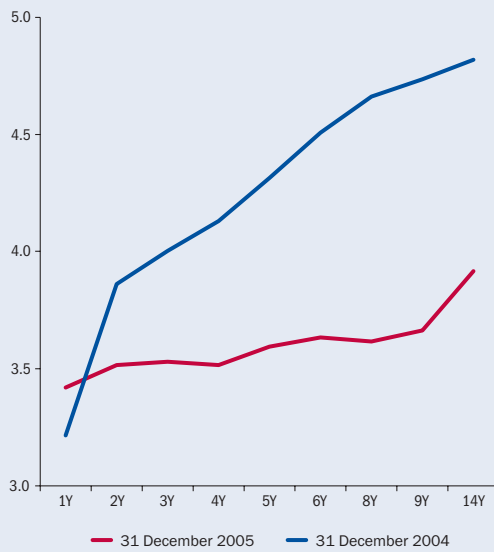
Risk management

Credit, market, and operating risks are monitored and managed within the central bank according to standard risk management practices. These practices refer primarily to the counterparts involved in monetary policy operations and the financial assets used by these parties in such operations. As other central banks belonging to the ESCB, the NBS sets and applies rules for risk management in accordance with the statutes of the ESCB and the ECB. Although the system of credit risk assessment has not yet

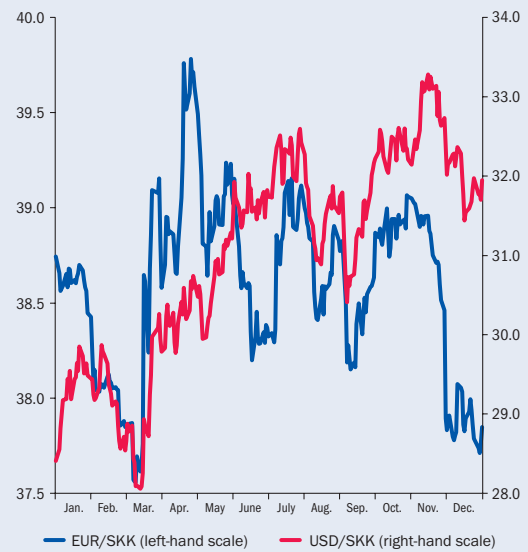
been fully harmonised with the criteria of the ECAF (Eurosystem Credit Assessment Framework), the NBS has developed an appropriate method, which was used effectively during 2005. Since not only the counterparts of the central bank, but also their financial assets must be eligible in terms of risks, the NBS applies a system for the selection of eligible assets, including a system for their market-based valuation (from 2004 onwards). In refinancing operations, the NBS also applies the system of reduction (haircuts) to market prices. In addition, the NBS is making preparations for the harmonisation of procedures to be followed in selecting and valuing financial assets so as to comply with the conditions imposed by the Eurosystem. This mainly includes preparations for the actual use of assets, which will be included in the so-called Single List, for monetary policy operations. These assets are expected to be used starting from the year when Slovakia enters the Eurosystem. The Single List will be introduced by the ECB in 2007. It will mainly cover debt securities and bank loans classified as eligible by both national central banks and the ECB.

Benchmark bond yield curve

In 2005 the NBS continued to coordinate the quotations of prices for benchmark government bond portfolios by commercial banks and to create a benchmark yield curve from these quotations. This project, aimed at obtaining more reliable information on price developments on the domestic bond market, was launched in 2004 on the background of the low volumes of price-setting transactions on bond markets and the

**Chart 41 Benchmark government bond yield curve (%)**

Source: NBS.

Chart 42 Exchange rates of the Slovak koruna against the euro and the dollar in 2005

Source: NBS.

inadequate frequency of trading. The NBS monitors and duly updates the structure of the benchmark portfolio in cooperation with commercial banks. Such an update of the benchmark bond portfolio was applied at the beginning of June 2005. It aimed at broadening the term structure of listed government bonds. One of the criteria for the inclusion of a bond in the benchmark portfolio is a minimum issue-amount of SKK 5 billion. At present, the portfolio includes bonds with a maturity of 1 to 9 years, as well as 14-year bonds. The prices are quoted by eight commercial banks that are active on the market. The publication of indicative bond prices via REUTERS (SKBMK page) takes place on a daily basis, always at 15:00 CET on the relevant trading day. As commercial banks, the NBS also uses indicative benchmark curve prices for the theoretical valuation of financial assets. In the case of the NBS, subject to valuation are assets classified as eligible for use in monetary policy operations.

Movements in the benchmark curve were less volatile in 2005 than in the previous year. Price movements were mostly influenced by developments in the euro area, information about reduced need for government borrowing through bond issues, the ratings of Moody's, fluctuations in the exchange rate of the Slovak koruna, and the decisions of the NBS concerning the basic interest rate. In addition, the Slovak bond market was significantly affected by the entry of the Slovak koruna into the Exchange Rate Mechanism II (ERM II), which attracted the interest of foreign investors in Slovak financial assets, while positively influencing the stabilising level of bond market yields at the end of 2005.

3.2 Foreign exchange operations

Foreign exchange market operations

During 2005, the exchange rate of the Slovak koruna against the euro appreciated by 2.44 percentage points (from SKK/EUR 38.796 at 31 December 2004 to SKK/EUR 37.848 at 31 December 2005). The average exchange rate was SKK/EUR 38.593, representing an appreciation of 3.6 percentage points compared with the figure for 2004. During last year, the exchange rate of the koruna against the US dollar weakened by 12.11 percentage points (from SKK/USD 28.496 at 31 December 2004 to SKK/USD 31.948 at 31 December 2005). The average exchange rate was SKK/USD 31.022, representing an appreciation of 3.8 percentage points compared with the figure for 2004. In relation to the Czech koruna, the Slovak koruna depreciated by 2.9 percentage points.

With regard to the rapid changes in the exchange rates of the Slovak koruna, the NBS intervened on several occasions in 2005 to dampen the unreasonably fast appreciation of the domestic currency. Since the interest of investors in the Slovak koruna, arising from certain facts (e.g. the expected smooth fulfilment of the Maastricht criteria in 2008, strong economic growth, and gradual improvement in the trade balance that began as early as at the end of 2004), continued in the first quarter of 2005, the NBS made further interventions against the excessive strengthening of the domestic currency. These interventions had so far been the most extensive in the Slovak foreign



exchange market. During two months (at the end of 2004 and the beginning of 2005), the NBS purchased EUR 3.62 billion (ca. SKK 138 billion) on the foreign exchange market. The fragility of the Slovak foreign exchange market and its correlation with the markets of neighbouring countries became apparent during the period of weakening of the Polish currency. The warning of the NBS that the appreciation of the Slovak koruna at the beginning of the year was unreasonably fast, also proved justified. During 2005, the NBS purchased EUR 3.02 billion and sold EUR 535 million through foreign exchange market interventions, which resulted in a balance of EUR 2.49 billion.

The expectation that the Slovak foreign exchange market would break away from its strong correlation with the Polish and Czech currencies was not confirmed, even after the entry of Slovakia into ERM II. Such expectations may become more realistic in the period before the country's entry into the euro area.

Investment activities in foreign exchange reserve management

In 2004 the NBS approved an update for the investment strategy pursued in the area of foreign exchange reserve management. The updated strategy delimited the range and limits of investment in international financial markets with respect to the credit, interest rate, and exchange rate risks, as well as the liquidity risk. As a part of investment policy, the structure of decision-making in foreign exchange reserve management was defined. This set of rules continued to be applied in 2005.

The marked appreciation of the Slovak koruna at the beginning of the year led to an increase in foreign exchange reserves. Thus, the intervention and investment portfolios increased in volume. The value of foreign exchange assets at the given exchange rates and market prices increased, from USD 14.9 billion at the end of 2004 to USD 15.5 billion at the end of 2005. In the area of foreign exchange reserve management, the yields ranged from 2.074% for euro-denominated investment portfolios to 3.120% for dollar-denominated investment portfolios. Interest yields earned in the area of foreign exchange reserve management totalled approximately SKK 10.6 billion in 2005.

Banking Supervision



4 Banking Supervision

4.1 Development of the banking sector

Conditions in the banking sector were favourable in 2005. Trends in the banking sector were influenced by positive developments in the economy. The volume of managed assets increased, their structure underlay changes and the profitability of the banking sector improved. The underlying factors in the strong increase in the volume of loans provided were robust economic growth and the improved financial situation of businesses. These positive trends were evidenced by increases in loans provided to almost all of the sectors.

As at 31 December 2005, the following entities operated in the Slovak banking sector:

- 18 banks headquartered in the SR,
- 5 branches of foreign banks in the SR,
- 104 entities freely providing cross-border banking services (99 banks, two electronic money institutions and three financial institutions),
- nine representative offices of foreign banks in the SR.

Of the eighteen banks headquartered in the SR, three were home-savings banks (ČSOB stavebná sporiteľňa, a. s., Prvá stavebná sporiteľňa, a. s. and Wüstenrot stavebná sporiteľňa, a. s.). As at 31 December 2005, licences for the provision of mortgage services were held by nine banks and one branch of a foreign bank (HVB Bank Slovakia, a. s., Dexia banka Slovensko, a. s., ISTROBANKA, a. s., ĽUDOVÁ BANKA, a. s., OTP Banka Slovensko, a. s., Slovenská sporiteľňa, a. s., Tatra banka, a. s., UniBanka, a. s., Všeobecná úverová banka, a. s. and Československá obchodní banka, a. s., branch office of foreign bank).

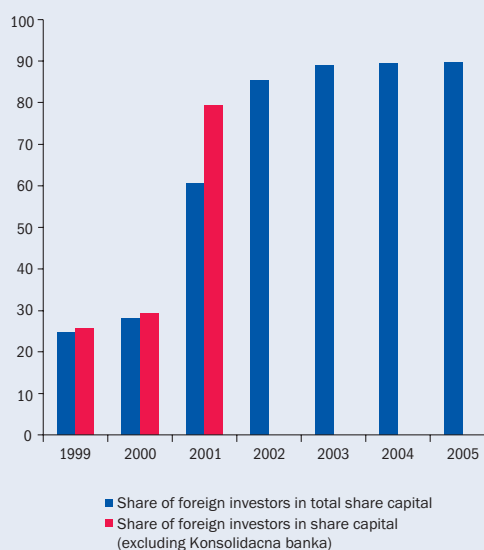
Compared to the end of the previous year, the share of foreign investors in the total subscribed share capital of banks and funds provided by foreign banks to their branches increased only slightly in 2005, from 89.60% to 89.65%. In ĽUDOVÁ BANKA, a. s., changes in the foreign shareholder structure were registered; nevertheless, the share of foreign investors in the total share capital of the above stated banks remained unchanged. In CALYON BANK SLOVAKIA, a. s., the share of Calyon Global Banking (previously named Credit Lyonnais Global Banking S. A.) in the bank's share capital increased from 90% to 100%, due to the acquisition of the 10% share held by VÚB, a. s.

Licensing activity

Banks

In March 2005, the National Bank of Slovakia adopted several decisions amending the banking licences previously granted to all banks (except for home-savings banks) and a branch of a foreign bank providing banking services on the basis of the banking licence issued by the National Bank of Slovakia. By virtue of Act No. 603/2003 Coll. and Act No. 554/2004 Coll. amending Act No. 483/2001 Coll. on banks and on amendments to certain laws, as amended (hereinafter referred to as the "Act on banks"), concepts referred to in the Act on banks and in the Act on the payment system were harmonised, and, in the same vein, activities referred to in the Act on banks were harmonised with activities referred to in the Act on securities and investment services. In order to harmonise the activities described in banking licences with banking activities referred to in the valid Act on banks, the National Bank of Slovakia introduced necessary changes to the banking licences on the basis of the above stated legal provisions.

Chart 43 Share of foreign investors in the share capital and funds provided by foreign banks to their branches (%)



Source: NBS.



By the decision of the National Bank of Slovakia of 14 October 2005, prior approval pursuant to Article 28, paragraph 1, letter e) of the Act on banks was granted to ISTROBANKA, a. s., allowing the bank to become a subsidiary of another parent company, which would come into existence under the name of Bank für Arbeit und Wirtschaft und Österreichische Postsparkasse Aktiengesellschaft by merging Bank für Arbeit und Wirtschaft Aktiengesellschaft Österreichische Postsparkasse Aktiengesellschaft with Kapital & Wert Bank Aktiengesellschaft.

By its decision of 18 October 2005, in accordance with Article 2, paragraph 3, letter d) of the Home Savings Act, the National Bank of Slovakia expanded the banking licence granted to Prvá stavebná sporiteľňa, a. s. By this expansion and pursuant to Article 11, paragraph 1, the NBS allowed the bank to provide home savings loans out of its home savings funds, provided that the liabilities resulting from the home-saving agreements concluded are secured and that neither the time periods for home-loan repayments are shortened nor the periods for the provision of home-savings loans are prolonged.

By the decision of the National Bank of Slovakia of 21 October 2005, prior approval pursuant to Article 28, paragraph 1, letter e) of the Act on banks was granted to HVB Bank Slovakia, a. s., to become a subsidiary of UniCredito Italiano S.p.A., Italy.

In its decision of December 2005, the National Bank of Slovakia supplemented the banking licences to provide mortgage services for Všeobecná úverová banka, a. s., Tatra banka, a. s., Československá obchodní banka, a. s., Praha (through its branch office), OTP Banka Slovensko, a. s., UniBanka, a. s., Slovenská sporiteľňa, a. s., ĽUDOVÁ BANKA, a. s., ISTROBANKA, a. s. and HVB Bank Slovakia, a. s. by stipulating specific conditions for mortgage loan financing. According to this, at least 90% of mortgage loans provided by these banks as of 31 December 2006 must be financed through issuing mortgage bonds.

In 2005 the National Bank of Slovakia granted prior approval for a change in the headquarters of three banks: Banka Slovakia, a. s. (22 February 2005), Citibank (Slovakia), a. s. (25 April 2005) and UniBanka, a. s. (18 August 2005).

On 1 November 2005 the extraordinary general meeting of Banka Slovakia approved the changes in the articles of association of the bank and the change in its name, from Banka Slovakia, a. s. to Privatbanka, a. s.

Branch offices of foreign banks

Following the Slovak Republic's accession to the European Union, credit institutions registered in

the European Economic Area may conduct banking activities without a banking licence granted by the National Bank of Slovakia, provided the bank has a banking licence in its home state (the principle of a single banking licence "single passport").

On the basis of the single banking licence, two notifications by foreign supervisory authorities regarding the notification of two foreign entities to perform banking activities in the Slovak Republic were delivered to the National Bank of Slovakia. As a result, the number of branch offices of foreign banks increased from three to five.

On the basis of the single banking licence granted to HSBC Bank plc registered in London, the bank started to conduct banking activities through its organisational unit, HSBC Bank plc, branch office of foreign bank, on 1 June 2005. The Slovak Deposit Protection Fund protects deposits accepted by this branch office.

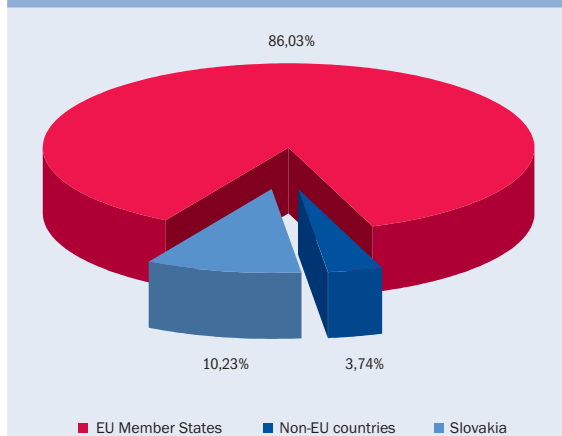
A branch office of another foreign bank, Banco Mais, S. A., opened for business on 19 September 2005. Deposits in this branch office are protected by the Portuguese Deposit Protection Fund.

Table 26 List of providers of cross-border banking services

	Banks	Electronic money institutions	Foreign financial institutions
Cyprus	2		
The Czech Republic	2		
Denmark	2		
France	8		
the Netherlands	2		
Ireland	5		
Iceland	1		
Liechtenstein	1		
Luxembourg	5		
Hungary	3		2
Germany	16		
Norway	1		
Poland	1		
Austria	23		
the United Kingdom	23	2	
Spain	1		
Sweden	1		
Italy	2		1
Total	99	2	3

Source: NBS.

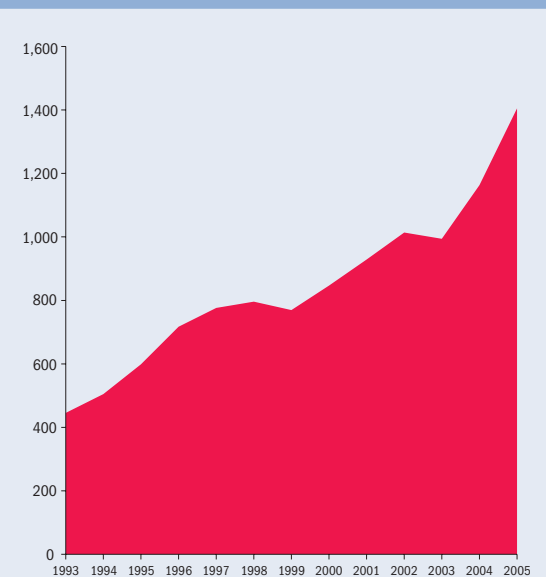
Chart 44 Share of investors in the share capital and funds provided by foreign banks by the country of origin¹⁾ (%)



Source: NBS.

1) EU Member States include the Czech Republic (7.86%), France (1.13%), the Netherlands (1.39%), Luxembourg (28.26%), Hungary (4.53%), Germany (1.94%), Austria (35.38%), Italy (4.27%), Portugal (0.13%), and the United Kingdom (1.14%). Non-EU (foreign) states include the United States and Switzerland.

Chart 45 Development of the Slovak banking sector's total assets (as at 31 December) (SKK billions)



Source: NBS.

On 4 November 2005, the National Bank of Slovakia informed J&T, BANKA, a. s. in writing of the conditions for branch offices of foreign banks to conduct banking activities in the SR on the basis of the single banking licence. This foreign branch office will be a contributor to the Czech Deposit Protection Fund.

Representative offices of foreign banks

In January 2005, the National bank of Slovakia registered the representative office of BANQUE PRIVEE EDMOND DE ROTHSCHILD EUROPE, a. s., Luxemburg in Slovakia. In April 2005, the National Bank of Slovakia acknowledged the receipt of a notification of the establishment of the representative office in Slovakia by Niederösterreichische Landesbank-Hypothekenbank Aktiengesellschaft, Austria. Henceforth, the number of foreign representative offices in Slovakia increased from seven to nine in 2005.

In 2005 the Banking Supervision Division issued 114 decisions related to banking licence expansions, changes of members of statutory body, supervisory boards, bank officers, amendments to articles of association, expansions of banking licences to provide mortgage loans by stipulating conditions for mortgage loan financing, the conduct of non-banking activities related to day-to-day operation of banks, the registration of representative offices of foreign banks and changes to bank headquarters.

4.2 Economic results of the banking sector

The Slovak financial sector experienced positive trends in 2005. Despite its shrinking share, the banking sector continued to dominate the market and managed as much as 84% of the total volume of assets and administered property of the financial sector. During the period under review, the structure of managed assets was changing and the banking sector profitability increased.

As at 31 December 2005, in comparison with the end of 2004, the total assets (total net assets) of the Slovak banking sector (18 banks and 5 branch offices of foreign banks) had grown by SKK 242 billion (20.8%) to SKK 1,405 billion.

The development of the banking sector's total assets was influenced by growth in both secondary funds (SKK 138 billion) and primary funds (SKK 64 billion). The volume of non-anonymous deposits declined by SKK 3 billion (0.8%) to SKK 420 billion, as a result of the amendment to the Act on the protection of deposits.

The volume of earning assets reported by the banking sector grew in comparison with the end of 2004 by SKK 239 billion to SKK 1,330 billion. The share of earning assets in total assets increased moderately over the course of 2005 and reached 94.7%, which is almost 1% more than at the end of 2004.



Table 27 Banking sector of the SR				
	31.12.2004	31.12.2005	Difference Dec. 05/Dec. 04	Change in % Dec. 05/Dec. 04
Number of employees	19,720	19,850	130	0.66
Number of banks in the SR	18	18	0	0.00
Number of branches of foreign banks in the SR	3	5	2	66.67
of which: on the basis of a NBS licence	1	1	0	0.00
under the single licence regime	2	4	2	100.00
Number of representative offices of foreign banks in the SR	7	9	2	28.57
Number of branches in the SR	587	685	98	16.70
Number of sub-branches in the SR	526	457	-69	-13.12
Number of branches in other countries	1	1	0	0.00
Number of sub-branches in other countries	0	0	0	0.00
Number of representative offices in other countries	1	0	-1	-100.00
Number of entities freely providing cross-border banking services	48	104	56	116.67
of which: electronic money institutions	0	2	2	0.00
foreign financial institutions	0	3	3	0.00
Slovak banks freely providing cross-border services abroad	1	1	0	0.00
of which: electronic money institutions	0	0	0	0.00
Total assets (in SKK thousands)	1,162,935,361	1,404,762,510	241,827,149	20.79
Earning assets (in SKK thousands)	1,090,962,975	1,329,618,719	238,655,744	21.88
Total interbank assets (in SKK thousands)	378,117,213	497,667,795	119,550,582	31.62
Total foreign exchange assets (in SKK thousands)	167,212,165	209,621,933	42,409,768	25.36
Securities (in SKK thousands)	377,791,590	332,151,813	-45,639,777	-12.08
Total loans (in SKK thousands)	442,361,143	558,532,224	116,171,081	26.26
of which: classified loans (in SKK thousands)	31,703,394	30,836,078	-867,316	-2.74
loans to households (in SKK thousands)	116,806,841	165,057,419	48,250,578	41.31
loans to non-financial corporations (in SKK thousands)	225,925,388	266,747,351	40,821,963	18.07
Share of classified loans in total loans	7.17	5.52	-1.65	-
Uncovered expected loss (in SKK thousands)	10,355	30	-10,325	-99.71
Provisions for loan losses (in SKK thousands)	25,489,675	23,141,657	-2,348,018	-9.21
Legal reserves (in SKK thousands)	6,961,072	7,219,488	258,416	3.71
Share capital (in SKK thousands)	41,433,475	41,450,201	16,726	0.04
Own funds (in SKK thousands)	100,626,465	107,153,990	6,527,525	6.49
Secondary funds (in SKK thousands)	183,301,896	321,557,694	138,255,798	75.43
Primary funds (in SKK thousands)	791,384,116	855,135,745	63,751,629	8.06
of which: non-anonymous deposits (in SKK thousands)	423,290,430	419,980,621	-3,309,809	-0.78
Current profit (in SKK thousands)	12,287,442	13,911,615	1,624,173	13.22
Current loss (in SKK thousands)	6,614	19,444	12,830	193.98
Net profit/loss (in SKK thousands)	12,280,828	13,892,171	1,611,343	13.12
Cumulative profit/loss (in SKK thousands)	37,722,258	39,878,594	2,156,336	5.72
Adequacy of own funds ratio (%)	18.68	14.79	-3.89	-0.21

Source: NBS.

Table 28 Number of inspections in 2005

	1st quarter		2nd quarter		3rd quarter		4th quarter		1st – 4th quarter	
	Commenced	Concluded	Commenced	Concluded	Commenced	Concluded	Commenced	Concluded	Planned	Concluded
Inspections										
- full-scope	0	0	0	0	0	0	0	0	0	0
- follow-up	0	0	0	0	0	0	3	3	3	3
- targeted	2	0	3	2	3	4	1	3	9	9
Total	2	0	3	2	3	4	4	6	12	12

Source: NBS.

Total loans reported by the banks as of 31 December 2005 were SKK 559 billion. Classified loans fell by SKK 0.9 billion to SKK 31 billion (2.7%). Banks created SKK 23 billion in provisions. Coverage of classified loans by created provisions stood at 75% at the end of the reference period. The share of classified loans among total loans fell to 5.5%.

As at 31 December 2005, banks reported a net profit of SKK 14 billion. This represents a year-on-year growth of SKK 1.6 billion (15.9%). Three banks reported a loss for the current period as at 31 December 2005 (at 31 December 2004, one bank reported a loss).

4.3 Banking supervision performance and evaluation of the prudential conduct of business by banks

The main task and remit of banking supervisors is to promote stability and sound development of banks and the banking system and to protect the interests of depositors.

In 2005 as a part of its pro-active supervision and in accordance with Article 23, paragraph 1 of the Act on banks, the Banking Supervision Division published methodological instruction No. 3/2005 on the internal control system and procedures to be applied by banks and branches of foreign banks. These methodological instruction stipulated the common rules governing the structure of the internal control system of banks and branches of foreign banks. It can be found on the NBS web site and in the Official Journal of the NBS.

In supervising the banking sector, both forms of supervision, i.e. on-site and off-site inspections, were applied. On-site inspections were primarily focused on adherence to regulations, credit, market and operational risks and the assessment of requests to apply internal models for the measurement of capital to cover market risks.

The number of inspections conducted by the Banking Supervision Division in 2005 is presented in Table 28.

The basic banking supervisory instruments are the rules regulating the prudential conduct of banking business and the limits they define.

Banking entities as well as all other businesses are exposed to a variety of risks related to the conditions in their business areas. The basic rules and limits aimed at limiting exposure to risks and the provision of funds to meet possible losses are outlined in the decrees of the banking supervisor. Prudential rules to be applied to bank management as a whole and to individual bank operations as well as the methods of identification, monitoring and control of individual risks remain the basic preconditions for the successful functioning of a bank.

The adequacy of the own funds ratio of the Slovak banking sector reached 14.79% as of December 2005. In a year-on-year comparison with the figure for 31 December 2004 this represents a decline of 3.89%. All banks complied with the limit for own funds adequacy of 8% during 2005, since own fund adequacy ratios ranged from 9.5% to 31.7%.

In addition, banks are subject to certain other asset exposure limits.

In 2005 one bank failed to comply with the limit on its large exposure towards a parent or subsidiary or towards a group of economically connected persons in which the bank is a member (20% of own funds).

Concerning the limit on bank's large exposure towards another person, a group of economically connected persons or countries and central banks (25% of own funds), seven cases of non-compliance were recorded in five banks.

All banks complied with the limit on the sum of a bank's large exposures (800% of own funds) in 2005.



Furthermore, all banks in 2005 complied with the ratio of large exposure towards a natural person to the bank's own funds (at most 2%).

Likewise, all banks complied with the ratio of exposure towards a legal person other than a bank headquartered in a zone A country to the bank's own funds (maximum 10 %) in the period under review.

Similarly, the ratio of exposure towards all persons with a special relation to the bank, to its own funds (at most 40%) was complied with by all banks in 2005.

The limit of the ratio of a bank's fixed and non-liquid assets to its own funds and reserves (maximum 1) was also complied with by all banks in 2005.

4.4 International cooperation

The basic framework for the international cooperation of supervisors of all Member States of the European

Union is the arrangement established at Level 2 by the European Supervisory Committee and at Level 3 by the Committee of European Banking Supervisors. The long-term objective is the achievement of the risk-oriented conduct of supervision of the entire financial market.

Bilateral cooperation agreements in the field of banking supervision

In order to exchange information between supervisory bodies of two different countries and to support the secure and sound functioning of financial institutions, the Banking Supervision Division cooperates with foreign supervisory authorities.

The Memorandum of Understanding on Co-operation between the Banking Supervisors, Central Banks and Finance Ministries of the European Union in Financial Crisis Situations entered into effect on 1 July 2005. The Memorandum was concluded in order to improve the stability of financial systems.

Issuing Activity and Currency in Circulation



5 Issuing Activity and Currency in Circulation

5.1 The issue of Slovak currency

In 2005, in accordance with the needs of currency circulation, the National Bank of Slovakia secured the printing of 34.42 million 1000 Sk banknotes through the British printer De la Rue, and contracted for the printing of 50 Sk banknotes by the Canadian Banknote Company, which is to be concluded in 2006.

Concerning the circulation of coins, the NBS secured the production of 17 million 50 halier coins of the 1996 type and 10 million 1 Sk coins. In addition, 10 Sk, 5 Sk, 2 Sk, 1 Sk and 50 halier coins dedicated for collectors were produced in 2005. The production and sale of annual collector sets of circulation coinage was secured by Mincovňa Kremnica, š. p. mint.

In 2005 the NBS issued five types of commemorative coins to mark certain important events and anniversaries. 200 Sk commemorative silver coins marking the 300th anniversary of the birth of Ján Andrej Segner and, within the theme of "Bratislava Coronations", 200 Sk commemorative coins dedicated to the 350th anniversary of the coronation of Leopold I were produced by the Polish mint, Mennica Państwowa in Warsaw. 5,000 Sk commemorative gold coins marking the 350th anniversary of the

coronation of Leopold I and 200 Sk commemorative silver coins devoted to the 200th anniversary of the signing of the Bratislava Peace Treaty after the victory of Napoleon I's armies near Austerlitz (Slavkov) were produced by Mincovňa Kremnica, š. p. mint. 500 Sk commemorative coins entitled "Protection of Nature and Landscape – Slovenský Kras National Park" were produced and delivered at the end of the year by the Czech mint, Bižuterie Česká Mincovna from Jablonec nad Nisou.

500 Sk commemorative silver coins entitled "Protection of Nature and Landscape – Muránska Planina National Park" and included in the 2006 issue plan, were delivered to the NBS. The coins were struck by Mincovňa Kremnica, š. p.

5.1.1 Currency in circulation and net annual issuance¹⁷ in the SR

As of 31 December 2005, the amount of currency in circulation in the SR (including Slovak and federal commemorative coins) was SKK 130.11 billion. Compared with 31 December 2004, the value of currency in circulation rose by SKK 20.2 billion in 2005. The year-on-year growth index of the value of currency in circulation was 18.4%.

Table 29 Commemorative coins issued by the NBS in 2005

Face value	Event commemorated by the coin	Number of coins issued		Decree of the NBS
		Total	PROOF	
200 Sk ¹⁾	300 th Anniversary of the Birth of Ján Andrej Segner	11,300	3,300	589/2004
500 Sk ¹⁾	Protection of Nature and Landscape – Slovenský Kras National Park	12,100	3,600	52/2005
200 Sk ¹⁾	350 th Anniversary of the Coronation of Leopold I	13,700	4,800	288/2005
5000 Sk ²⁾	350 th Anniversary of the Coronation of Leopold I	5,000	5,000	511/2005
200 Sk ¹⁾	Bratislava Peace Treaty – the 200 th Anniversary of the Signing	8,500	3,400	549/2005

Source: NBS.

1) Commemorative silver coin.

2) Commemorative gold coin.

¹⁷ The net issuance is the difference between the amount of money put into and received from circulation in a specified period of time. The same concept is used by the European Central Bank.



Chart 46 Monthly development of currency in 2005 (SKK billions)



Source: NBS.

Compared with the same period of the preceding years, the amount of currency in circulation as at the end of each month continuously increased, without typical seasonal decline in the first quarter. The monthly net issuance values ranged from SKK 0.58 billion in January 2005 to SKK 5.06 billion in December 2005.

In 2005 the value of currency in circulation varied from SKK 109.5 billion to SKK 134.9 billion. The minimum value of currency in circulation was reached on 3 February 2004 and the maximum value on 23 December 2005, in the pre-Christmas period.

5.1.2 Structure of the net issuance and currency in circulation

On 31 December 2005, 161.8 million banknotes with a value of SKK 127.6 billion, 1,064.8 million circulation coins with a value of SKK 1.7 billion and 830 000 commemorative coins issued by the NBS with a value of SKK 612.2 million were in circulation.

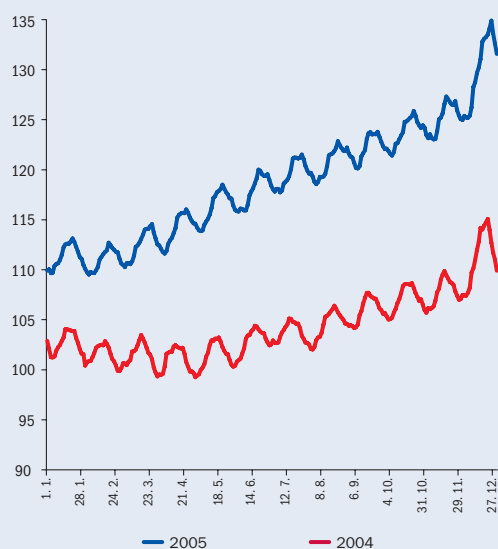
Table 30 Currency in circulation

(in SKK)

	Amount in SKK		Proportion in %	
	31 Dec. 2005	31 Dec. 2004	31 Dec. 2005	31 Dec. 2004
Banknotes				
5000 Sk	60,530,677,500	49,702,892,500	46.52	45.23
1000 Sk	56,298,082,500	47,876,243,500	43.27	43.56
500 Sk	4,864,545,875	4,428,680,875	3.74	4.03
200 Sk	2,055,817,650	1,845,758,050	1.58	1.68
100 Sk	2,386,890,550	2,301,353,750	1.83	2.09
50 Sk	803,035,150	734,480,750	0.62	0.67
20 Sk	668,318,405	638,825,785	0.51	0.58
Total	127,607,367,630	107,528,235,210	98.08	97.84
Circulation coins				
10 Sk	881,097,520	841,644,250	0.68	0.77
5 Sk	307,494,745	285,320,630	0.24	0.26
2 Sk	213,482,432	198,922,848	0.16	0.18
1 Sk	140,241,785	129,606,519	0.11	0.12
50 hal.	25,211,472	23,731,231	0.02	0.02
50 hal. II	63,057,108	53,230,099	0.05	0.05
20 hal.	44,346,033	45,006,309	0.03	0.04
10 hal.	26,998,155	27,304,295	0.02	0.02
Total	1,701,929,248	1,604,766,180	1.31	1.46
Commemorative coins¹⁾	801,298,680	956,268,950	0.62	0.87
Currency in circulation in total	130,110,595,558	109,900,050,240	100.00	100.00

Source: NBS.

1) Including federal commemorative coins.

Chart 47 Daily development of currency in circulation (SKK billions)


Source: NBS.

Of the total value of currency in circulation, banknotes accounted for 98.1%, circulation coins 1.3% and commemorative coins, including federal coins, 0.6%. Of the total number of coins and banknotes in circulation, banknotes accounted for 13.18%, circulation coins 86.75% and commemorative coins 0.07%.

Banknotes comprised SKK 20.1 billion (99.5%), circulation coins SKK 97.2 million (0.48%) and commemorative coins SKK 34.25 million (0.02%) of the total net issuance in 2005 (SKK 20.2 billion).

In 2005, the denominations which represented the largest net issuance (SKK 10.83 billion, 2.17 million pieces) were 5000 Sk banknotes, followed by 1000 Sk banknotes (SKK 8.42 billion, 8.42 million pieces). These two denominations together represented 95.4% of the net issuance in 2005.

As in 2004, the largest share of banknotes in circulation was comprised of banknotes in the denominations of 1000 Sk, 20 Sk and 100 Sk (56.3 million, 33,4 million and 23.9 million banknotes, respectively).

5

Table 31 Currency in circulation (in pieces)

	Amount in pieces		Proportion in %	
	31 Dec. 2005	31 Dec. 2004	31 Dec. 2005	31 Dec. 2004
Banknotes				
5000 Sk	12,106,136	9,940,579	0.99	0.85
1000 Sk	56,298,083	47,876,244	4.59	4.10
500 Sk	9,729,092	8,857,362	0.79	0.76
200 Sk	10,279,088	9,228,790	0.84	0.79
100 Sk	23,868,906	23,013,538	1.94	1.97
50 Sk	16,060,703	14,689,615	1.31	1.26
20 Sk	33,415,920	31,941,289	2.72	2.73
Total	161,757,927	145,547,416	13.18	12.45
Circulation coins				
10 Sk	88,109,752	84,164,425	7.18	7.20
5 Sk	61,498,949	57,064,126	5.01	4.88
2 Sk	106,741,216	99,461,424	8.70	8.51
1 Sk	140,241,785	129,606,519	11.43	11.09
50 hal.	50,422,943	47,462,462	4.11	4.06
50 hal. II	126,114,215	106,460,197	10.27	9.11
20 hal.	221,730,163	225,031,543	18.06	19.26
10 hal.	269,981,546	273,042,950	22.00	23.36
Total	1,064,840,569	1,022,293,646	86.75	87.48
Commemorative coins	830,945	794,682	0.07	0.07
Currency in circulation in total	1,227,429,441	1,168,635,744	100.00	100.00

Source: NBS.



5000 Sk banknotes (totalling SKK 60.53 billion) and 1000 Sk banknotes (totalling SKK 56.3 billion) represented 89.8% of the total value of currency in circulation, which was 1% more than in 2004.

In 2005 the net issuance of coins represented a value of SKK 97.2 million (42.5 million pieces). In all circulation coin denominations, the net issuance was positive, and its highest value was recorded for 10 Sk coins (SKK 39.5 million). The highest increase in number was recorded for 50 halier coins (21.7 million items). In 2005 the effect of the end of validity of 20 and 10 halier coins was minimal – only 3.3 million 20 halier coins and 3.1 million 10 halier coin were returned from circulation (in 2004 it was 49.5 million pieces and 45 million pieces, respectively). As of 31 December 2005, 491.7 million 20 and 10 halier coins remained in circulation, i. e. almost half (46.17%) of the total number of coins issued between 1993 and the end of 2005.

The total number of commemorative coins in circulation grew in 2005 by 35,03 thousand pieces, i.e. by SKK 34.25 million. A total of 1,234 federal commemorative coins with a value of SKK 155.15 thousand were returned from circulation; their validity ended on 30 September 2000.¹⁸

5.1.3 The average value of currency in circulation

The value of currency in circulation including commemorative coins reached SKK 24,184 per capita¹⁹ on 31 December 2005. This consisted of SKK 23,719 in banknotes, SKK 316 in circulation coins and SKK 149 in commemorative coins. In comparison with 2004, the total value of currency in circulation per capita increased by SKK 3,757, of which banknotes accounted for SKK 3,733, circulation coins SKK 18, and commemorative coins SKK 6.

There were 30 banknotes per capita, which is three more than in 2004. The most numerous were 1000 Sk banknotes with 11 per capita and 20 Sk banknotes with 6 per capita. Between 2004 and 2005, the number of circulation coins per capita increased from 190 to 198. Halier coins (10, 20 and 50 halier) still have the largest share with 124 pieces per capita compared to 121 in 2004. Among valid coins, the most numerous is the 50 halier denomination with 36 pieces per capita.

The average value of the currency mark²⁰ reached SKK 106 in 2005, an increase of SKK 12 during the year. Its development corresponds to the development of the quantity and value of currency in circulation.

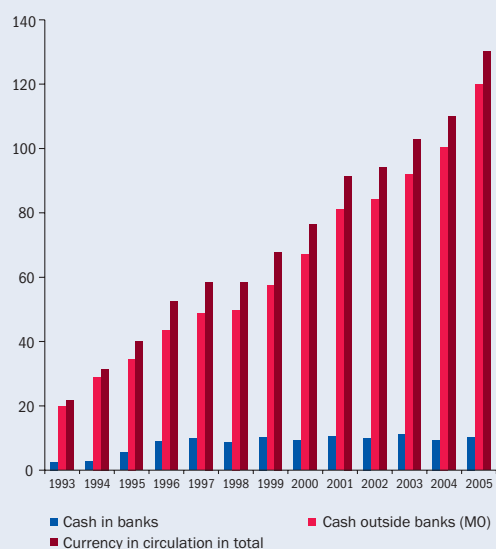
Rok	Banknotes	Circulation coins	Currency including commemorative coins
1993	289.3	3.2	90.2
1994	384.1	2.0	76.4
1995	455.6	1.8	76.7
1996	537.3	1.7	81.8
1997	566.3	1.6	80.5
1998	552.3	1.5	72.2
1999	594.1	1.5	76.1
2000	631.4	1.4	77.1
2001	693.6	1.4	84.4
2002	697.8	1.4	80.3
2003	729.2	1.4	85.0
2004	738.8	1.6	94.0
2005	788.9	1.6	106.0

Source: NBS.

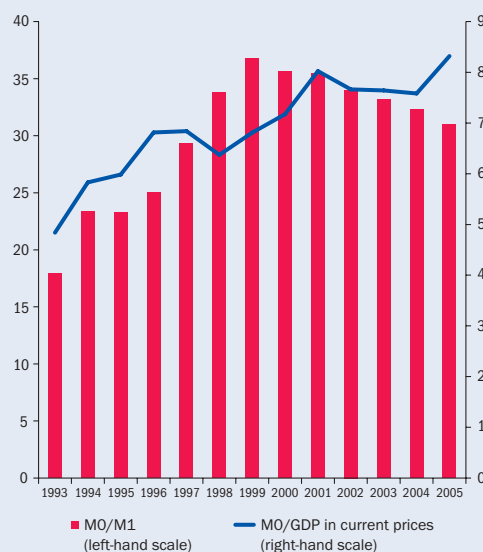
¹⁸ Decree of the NBS No. 278/2000 Coll. on ending the validity of the commemorative silver coins from the Czecho-Slovak currency issued from 21 August 1954 to 31 December 1992.

¹⁹ As of 31 December 2004, population numbered 5,384,822. Source: Statistical Office of the SR.

²⁰ Average value of the currency mark is defined as total value of currency in circulation to the total number of coins and banknotes in circulation.

Chart 48 Currency in circulation held by banks and outside banks (SKK billions)


Source: NBS.

Chart 49 Proportion of M0 to M1 and HDP (%)


Source: NBS.

A comparison of the development in the value of the currency mark since 1994, according to individual types of currency, is given in the following table 32.

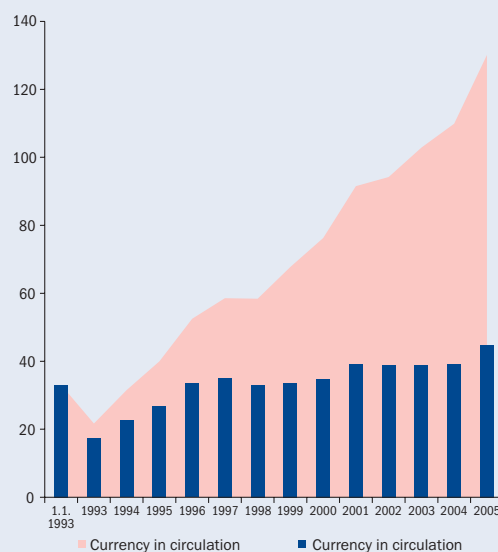
5.1.4 Currency in circulation and selected macroeconomic variables

In a year-on-year comparison, as of 31 December 2005, the total value of currency in circulation increased from SKK 109.9 billion to SKK 130.1 billion (18.4%). Of this, the amount held by the public grew from SKK 100.5 billion to SKK 119.8 billion (19.2%) and the amount held by banks increased from SKK 9.4 billion to SKK 10.3 billion (9.6%).

The share of currency in circulation outside banks (M0) in the monetary aggregate M1²¹ declined from 32.28% in 2004 to 31% in 2005. This indicator had shown a declining trend since 2001, which indicates that the level of cashless payments in Slovakia is gradually increasing.

In 2005 the share of M0 in GDP²² in Slovakia increased by 0.7 percentage points to 8.3%, which is comparable with respective values in the euro area countries (from 3 to 10%).

The value of currency in circulation in constant Sk (adjusted for inflation) stood at SKK 44.83 billion²³ on 31 December 2005. Compared to 2004, it incre-

Chart 50 Effect of inflation on currency in circulation (SKK billions)


Source: NBS.

ased by SKK 5.47 billion. The reason for the growth of currency in circulation in constant SKK is the fact that the annual rate of inflation (3.7%) was lower than the annual growth in the amount of currency in circulation (18.4%), whereas there had been no significant difference between the rate of inflation and currency growth in the previous four years.

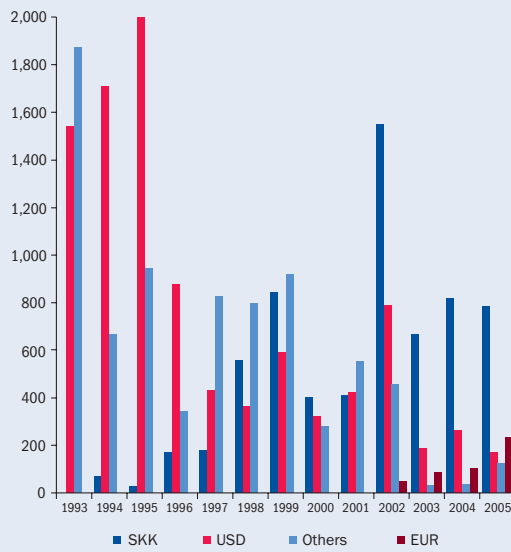
²¹ The aggregates M0 and M1 are calculated according to the NBS methodology (Monetary Survey January 2006)

²² Source: Statistical Office of the SR.

²³ The price level as measured by the CPI had increased by 190.25% since 1993.

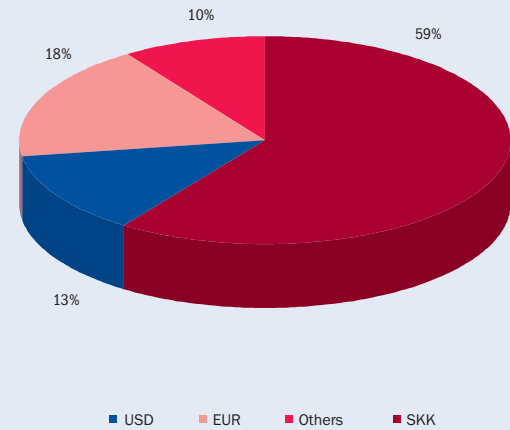


Chart 51 Number of seized counterfeit (in pieces)



Source: NBS.

Chart 52 Structure of counterfeit in 2005 (in %)



Source: NBS.

5.2 Counterfeit money seized in the territory of the Slovak Republic

In 2005, a total of 1,316 items of counterfeit Slovak and foreign currency were seized in the territory of the Slovak Republic. In comparison to 2004, a slight increase in the number of seized counterfeits was registered. Nevertheless, this figure is more than a third lower than the average of 1993-2005. As much as 90% of counterfeits were seized directly from circulation by banks, branch offices of foreign banks and non-banking entities.

Among the withdrawn counterfeits, Slovak koruna together with euro made up the largest shares (59% and 18%, respectively). The share of US dollars reached 13% and of the other currencies 10%.

5.2.1 Counterfeits of Slovak koruna

In 2005, a total of 777 counterfeit Slovak koruna banknotes, 4 composed banknotes, 1 forgery and 2 adapted coins were seized. The highest incidence of counterfeits was in the Prešov and Trnava regions (145 and 126 items, respectively). 1000 Sk and 500 Sk banknotes were the most frequently counterfeited. They made up more than 62% of all the counterfeited Slovak koruna banknotes.

5.2.2 Counterfeits of foreign currency

In 2005, a total of 171 counterfeit US dollar, 232 counterfeit euro, 1 composed euro banknote, 1 altered euro banknote and 127 counterfeits of other foreign currencies were seized in the territory of the Slovak Republic. The largest number of seizures was recorded in the Bratislava region.

Table 33 Number of seized Slovak koruna counterfeits (in pieces)

Year	Denomination									Total	
	5000	1000	500	200	100	50	20	10	5		p ¹⁾
2001	2	278	55	15	54	4	3	0	0	0	411
2002	14	1,307	105	17	49	38	17	2	0	0	1,549
2003	14	396	131	58	31	27	8	0	0	1	666
2004	45	419	203	36	68	36	11	1	0	1	820
2005	23	337	151	103	87	48	28	0	0	7	784

Source: NBS.

1) Forgeries and adapted and composed banknotes and coins.

Table 34 Number of seized US dollar counterfeits								(in pieces)
Year	Denomination						p ¹⁾	Total
	1	5	10	20	50	100		
2001	1	0	3	9	7	398	2	420
2002	4	1	1	1	11	768	4	790
2003	0	0	0	3	3	176	5	187
2004	3	0	1	1	5	252	2	264
2005	0	0	1	1	3	163	3	171

Source: NBS.
1) Manipulated banknotes, forgeries and adapted banknotes.

Table 35 Number of seized euro counterfeits									(in pieces)	
Year	Denomination							p ¹⁾	Total	
	2	5	10	20	50	100	200			500
2002	0	0	0	2	31	14	0	1	0	48
2003	0	0	2	18	41	9	13	4	1	88
2004	3	1	0	1	48	26	17	2	5	103
2005	8	0	0	13	114	26	37	34	2	234

Source: NBS.
1) Manipulated banknotes, forgeries, and adapted and composed banknotes.

Table 36 Number of counterfeits of other foreign currencies								(in pieces)
Year	Other foreign currencies						Others ¹⁾	Total
	GBP	CZK	CAD	PLN	CHF	HUF		
2001	1	243	6	9	1	1	288	549
2002	9	369	1	6	1	0	69	455
2003	20	3	6	2	1	0	0	32
2004	14	12	4	2	1	3	0	36
2005	82	21	3	1	1	18	1	127

Source: NBS.
1) The currencies replaced by the euro, and the Norwegian krone.

Counterfeit US dollars

In comparison to 2004, the number of seized counterfeit US dollars declined by 35%. The largest number of seizures was recorded in the Bratislava region, where 65 items were seized in 50 cases. The most frequently counterfeited denomination was the 100 USD banknote, which formed as much as 95% of the total number of US dollar counterfeits.

Counterfeit euro

The rising trend in the number of counterfeit euro that had persisted since 2002 continued in 2005 as well.

Compared to 2004, the number of counterfeit euro more than doubled in 2005. Counterfeit euro with 234 items accounted for 18% of the total number of seized counterfeits. In 2005, as in the previous period, the most frequently counterfeited were 50 EUR banknotes, which made up 48.7% of the total number of euro counterfeits.

Counterfeits of other foreign currencies

In 2005 the number of counterfeits of other foreign currencies more than tripled and accounted for 10% (127 items) of the total number of seized counterfeits. Counterfeits of British pounds formed the majority.

Payment System



6 Payment System

6.1 The payment system in the Slovak Republic

6.1.1 Legal aspects

The payment system in the Slovak Republic is governed by Act No. 510/2002 Coll. on the payment system and on amendments and supplements to certain laws, as amended (hereinafter “the Payment System Act”).

The Payment System Act primarily regulates domestic and cross-border funds transfers, the issue and use of electronic payment instruments, the establishment and operation of payment systems, the oversight of payment systems, and also complaints and redress procedures or out-of-court settlements of disputes related to the payments.

Other generally binding legal provisions that govern the payment services include the following decrees of the National Bank of Slovakia:

- NBS Decree No. 9/2002 on the method for creating the constant symbols used in the payment system and on the structure and list of these symbols,
- NBS Decree No. 10/2002 on the report submitted by the issuer of an electronic money payment instrument to the National Bank of Slovakia,
- NBS Decree No. 11/2002 on the report submitted by the operator of a payment system to the National Bank of Slovakia,
- NBS Decree No. 7/2003, laying down the structure of a bank identification code for the purpose of domestic transfers, the structure of an international bank account number for the purposes of cross-border transfers and details on the issue of the identification codes conversion table.

The Slovak legal system also includes Regulation No. 2560/2001 of the European Parliament and of the Council of 19 December 2001 on cross-border payments in euro.

6.1.2 Institutional aspects

The Permanent Court of Arbitration (PCA) of the Association of Banks was established with effect from 1

July 2003 and has its registered office in Bratislava; at present it consists of two chambers:

- a) the Chamber for deciding disputes on payments,
- b) the Chamber for deciding disputes arising from other commercial or civil relations, which commenced operation on 1 January 2004.

In November 2005, the NBS approved a new Statute and Rules of Procedure for the PCA of the Association of Banks.

6.1.3 Internal market of the European Union

European law concerning payment systems

On 1 December 2005, the European Commission adopted draft proposal for a Directive of the European Parliament and Council on payment services in the internal market and amending Directives 97/7/EC, 2000/12/EC and 2002/65/EC (hereinafter “the proposed Directive”).

The proposed Directive is based on the aim of the European Commission to create a single payment market for the entire EU, one in which a large number of transactions and increased competition result in lower costs for payment system services.

The aim of the proposed Directive is to harmonize the legal framework for payment services insofar as it concerns entities providing payment services, the transparency of the conditions under which these services are provided, and the rights and obligations of providers of payment services and users of payments services.

The proposed Directive should provide for the creation of conditions in which the potential of the single market may be exploited more efficiently, and should provide legislative support to the establishment of the Single Euro Payments Area (SEPA).

At present, the legal framework for payments in the EU is regulated by legal norms such as:

- Commission Recommendation 97/489/EC, which ensures the protection of clients using electronic instruments, such as payment cards, to verify payments;



- Directive 97/5/EC of the European Parliament and of the Council, which facilitates cross-border transfers in regard to the introduction of common requirements for the protection of clients;
- Regulation No. 2560/2001 of the European Parliament and of the Council on cross-border payments in euro (hereinafter the "Regulation on cross-border payments in euro"), which removed price differences between cross-border and national payments.

The Regulation on cross-border payments in euro introduces the principle of equal charges. This principle applies to cross-border charges for payments up to the amount of EUR 12,500, and from 1 January 2006, up to the amount of EUR 50,000. Charges for cross-border payments up to the amount of EUR 50,000 should be the same as charges for analogous payments in euros made within the Member State.

By means of such legal norms (especially the Regulation on cross-border payments in euro), it has become easier and cheaper to make many kinds of payments in euros in the internal market, and these norms have "launched" an initiative whose end goal is the creation of SEPA. The aforementioned legislation, in particular Recommendation 97/489/EC and Directive 97/5/EC are to be superseded by the prepared Directive on payment services in the internal market.

European Payments Council

In 2002, the European Payments Council with the support of the European banking community set out a vision to create the SEPA area by 2010.

The creation of SEPA primarily involves the transition from national payment instruments – credit transfers, direct debits and payment cards – to pan-European payment instruments. The European Payments Council is focused first of all on the creation of SEPA payment rules for credit transfers, direct debits and debit cards. During 2005, the European Payments Council submitted for comments proposals on SEPA Credit Transfer Scheme Rulebook and on SEPA Direct Debit Scheme Rulebook, the aim of which is to create common rules – i.e. equal conditions for making transfers. The European Payments Council in the meantime approved the SEPA Cards Framework, which should create equal conditions for the acceptance of payment cards.

The Slovak Association of Banks became a member of the European Payments Council on 1 January 2005 and undertook to comply with the Council's Charter, under which the Council's remit and operation are defined. The rights and obligations laid

down by the Charter apply only to members of the European Payments Council, therefore they apply to the Association of Banks but not to the Association's member banks.

The European Payments Council issues its decisions in the form of resolutions, among which are:

- the Credeuro Convention, which sets the maximum period for cross-border transfers within the EU at 3 days;
- the Interbank Convention on Payments, which makes it possible to credit the entire amount of the transfer to the beneficiary's account;
- the Resolution on the PEACH (Pan-European Automated Clearing House), which defines the PEACH systems (the first of which is STEP2),
- the Resolution on receiver capability within the PEACH framework.

The Regulation on cross-border payments in euro has been implemented through the STEP2 system operated by the company Euro Banking Association Clearing (through the first pan-European automated clearing house, i.e. PEACH).

The Resolution on receiver capability within the PEACH framework imposes an obligation on financial institutions to be at least able to receive payments sent through STEP2. The banking sector in the Slovak Republic is connected to STEP2 indirectly through direct participants in the system, and thus the conditions of the resolution are met.

6.1.4 National Euro Changeover Plan

In regard to Slovakia's planned entry into the euro area, the Slovak Government approved in July 2005 the National Euro Changeover Plan for the Slovak Republic. This plan sets out the individual steps that have to be taken in order to ensure smooth adoption of the euro.

The highest authority for managing and coordinating the preparation of the euro changeover in Slovakia is the National Coordination Committee. Expert opinions on individual issues concerning the transition of the Slovak economy to the euro are prepared by working committees. The banking sector falls within the remit of the Working Committee for Banks and the Financial Sector, under the coordination of an NBS representative.

In 2005, this committee discussed issues concerning the future decision on the use of the bank account number in the IBAN format in the domestic payment system, and also issues regarding the introduction of the SWIFT format in the SIPS interbank payment system.

6.2 The Interbank Payment System SIPS

By the end of 2005, the National Bank of Slovakia was operating the interbank payments system SIPS for 28 participants, including 26 direct participants and 2 third parties. The number of direct participants increased during 2005 with the addition of two branches of foreign banks operating in Slovakia on the basis of a "single passport".

SIPS did not undergo any changes to its basic functions in 2005, and the NBS continued the system's operation with the objective of making the processing and settlement of interbank payments increasingly secure and smooth.

6.2.1 Contingency Testing

At the end of 2005, the NBS planned and successfully conducted contingency testing of transmission of data. This compulsory testing involved all the payment system participants and was conducted in accordance with a schedule laid down in advance. The aim of the testing was to verify the technical, personnel and organizational preparedness of SIPS participants in regard to the use of emergency data transmission. This applies where data cannot be delivered through the standard electronic route owing to, for example, a failure of a participant's software or the NBS's software, or a failure of the data transmission infrastructure (the data network NBS UNIVERZAL-NET® or the provider's telecommunications equipment, and so on).

SIPS participants are required to perform a contingency testing at least one time per year, under the Contract on the SIPS payment system that the NBS concludes with each participant in the payment system. The first testing was led by the NBS, and further testing will be conducted on an individual basis under the Contract between the participant and the NBS. The procedures for using contingency testing are laid down in the SIPS operating manual.

6.2.2 Outlook for 2006

Preparatory work on expanding the functionality of the SIPS system continued in 2005. This involved preparation of the project for the automated provision of intraday credit and the management of hold queues of priority payments, which are to be implemented during the course of 2006. This project is also addressing the capacity of SIPS to execute requests related to monetary interventions, possibly arising from the Slovak koruna's entry into ERM II in November 2005.

The aims of the SIPS functionality expansion project include the implementation of technological changes that should increase security and reliability as regards the transition of the SIPS operation from the main technological centre to the backup technological centre. Another aim is to increase the system's capacity for processing and transmitting data on priority payments, as well as potentially to modify the time schedule for the operation of the interbank payment system.

6.2.3 Payments made through SIPS

In 2005, the SIPS payment system processed a total of almost 120 million transactions. The number of transactions increased by 10.12% in comparison with the same period in 2004, confirming the stable rising trend from previous years.

Table 35 shows the number of transactions processed in individual months of 2005 and the corresponding data for 2004 and 2003.

The value of processed transactions reported exceptional growth in 2005. Whereas the value of transactions processed in the previous year amounted to SKK 40,692 billion, the value in 2005 reached almost SKK 80,000 billion, representing nearly a twofold increase.

The growth in transaction value largely reflects activity on the interbank money market and the conduct of monetary policy by the NBS (foreign exchange interventions, open market operations).

	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sep.	Oct.	Nov.	Dec.
2003	7.45	7.45	8.03	8.08	8.11	8.19	8.65	7.67	8.24	8.87	8.23	10.03
2004	8.12	8.09	8.94	8.57	9.11	9.46	8.81	9.06	8.94	9.27	9.42	10.93
2005	8.86	9.14	9.91	9.88	10.25	10.24	9.84	9.91	9.83	10.24	10.28	11.34

Source: NBS.



Chart 53 Number of transactions processed in SIPS (million)

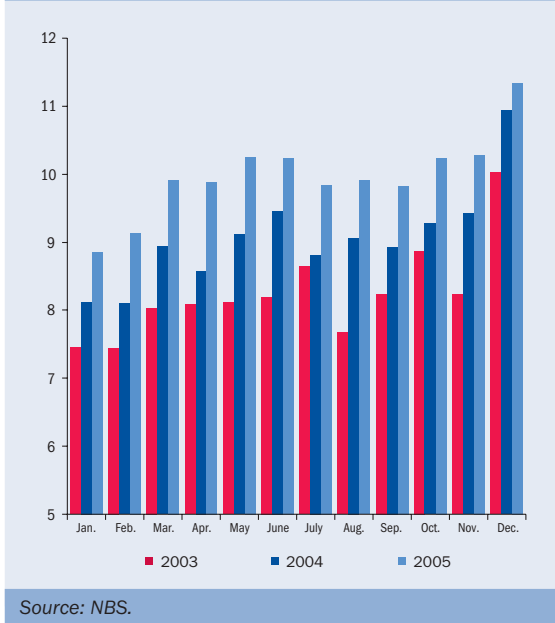


Chart 54 Value of transactions processed in SIPS (SKK billion)

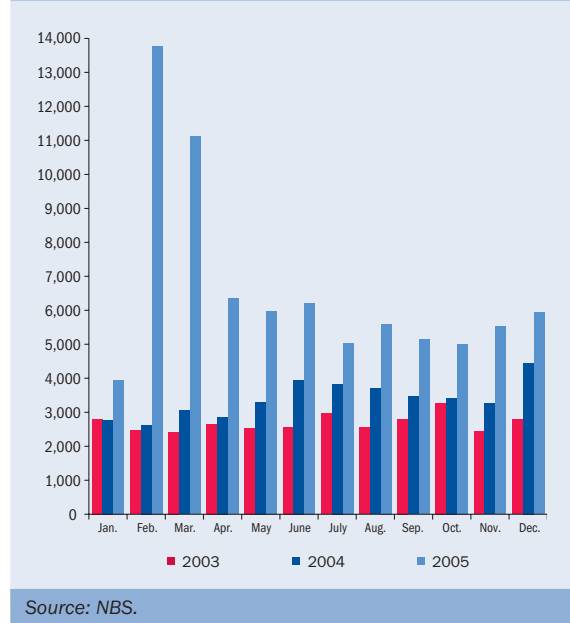


Table 38 shows the value of transactions processed in individual months of 2005 and the corresponding data for 2004 and 2003.

In comparison with the previous year, there was a substantial change as regards the utilization of priority payments. From among all types of transactions, client and interbank priority payment orders recorded the greatest dynamics. Whereas the total number of priority payments processed in 2004 stood at 71,000, the number in 2005 reached more than 156,000, representing an increase of 120%.

Priority payments as a share of the total number of executed transactions continued to stand at only 0.13%. Normal payments accounted for the rest. Although priority payments were very low in number, their settlement value was in excess of SKK 50,334 billion, accounting for more than 63% of the value of all processed payments. The ratio of the value of normal payments to the value of priority payments swung in favour of priority payments from 56:44 in

2004 to 37:63 in 2005 (see Chart 55).

Information on the number and volume of transactions processed in SIPS is published on the NBS website and is updated on a daily basis at 15.50.²⁴

During bank holidays and weekends the payment system is closed and system maintenance is carried out. There were 250 working days in 2005. Per day, SIPS processed and settled an average of 479,000 payments in a total amount of almost SKK 319 billion and with an average value per transaction of approximately SKK 665,000.

To better understand this data, it can be said that over the course of roughly 4.5 days, SIPS processes and settles payments with a cumulative value equivalent to Slovakia's GDP for 2005.²⁵

The National Bank of Slovakia provides intraday credit to those SIPS participants who are required to hold minimum reserves. Intraday credit is offered as an

	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sep.	Oct.	Nov.	Dec.
2003	2.80	2.46	2.42	2.65	2.54	2.57	2.96	2.55	2.80	3.27	2.44	2.79
2004	2.77	2.62	3.05	2.86	3.30	3.95	3.84	3.70	3.46	3.43	3.25	4.46
2005	3.95	13.78	11.12	6.35	5.98	6.22	5.04	5.60	5.14	5.00	5.53	5.93

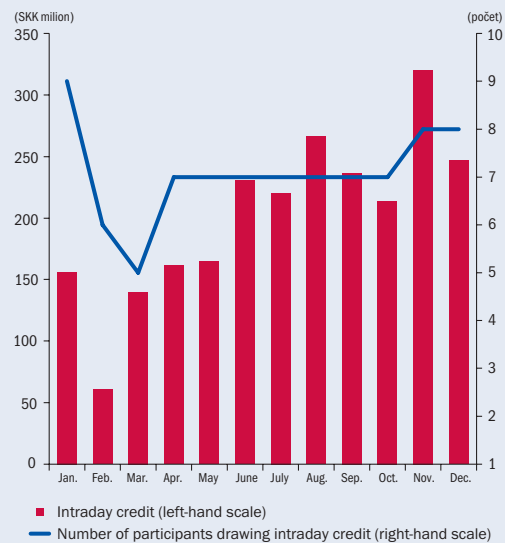
Source: NBS.

²⁴ www.nbs.sk – Payment systems/Statistical data.

²⁵ The GDP for 2005 amounted to SKK 1,439.8 billion. Source: Statistical Office of the Slovak Republic (www.statistics.sk).

Chart 55 Payment types by share of value (%)


Source: NBS.

Chart 56 Intraday credit in 2005 (SKK billion)


Source: NBS.

overdraft facility on the financial reserves account, with a maximum overdraft limit. The credit is payable within one operating day and must be fully secured with collateral, i.e. with the relevant amount of securities which are recorded in the Central Register of Short-Term Securities maintained by the NBS.

In 2005, SIPS participants who applied for intraday credit were provided such credit in the total amount of more than SKK 2,417 billion. The amount of intraday credit provided to participants is monitored on a weekly basis. Per week, the National Bank of Slovakia provided intraday credit in an average amount of SKK 46.484 billion.²⁶

Chart 56 shows the amount of intraday credit provided in individual months of 2005 and the number of SIPS participants who applied for this credit.

6.3 Payment instruments

Among the most used instruments of the non-cash payments are credit transfers and electronic payment instruments. The most used electronic payment instruments are remote access payment instruments – especially bank payment cards as well as electronic banking payment applications, which enable clients to draw funds from a bank account by means of electronic communication media (for example, internet banking, home banking or telephone applications).

As at 31 December 2005, the number of active bank payment cards in circulation stood at 4,036,867, which represents an increase of 11% in comparison with 2004.

Banks are issuers of the following bank payment cards: VISA (VISA and VISA Electron) and MasterCard Europe (MasterCard and Maestro), American Express, Diners Club, and ZBK domestic bank payment cards.

Bank clients in Slovakia may use a network of 1,855 ATMs and 18,981 EFTPOS payment terminals.

In 2005, bank payment card holders made more than 108 million card transactions in a total amount of more than SKK 247 billion. In comparison with 2004, the number of transactions increased by 9% and the value of transactions by 18%.

Payment cards may be used not only for traditional transactions such as cash withdrawal or payment, but also for other payment transactions (e.g. making a transfer order).

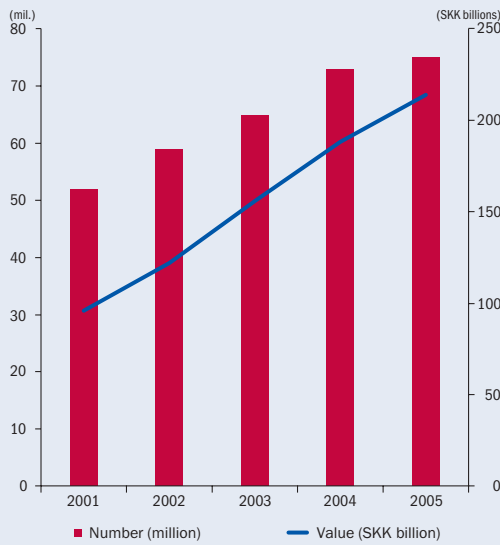
The number of ATM cash withdrawals made in 2005 stood at 72.29 million and their total value was SKK 213.89 billion. This represents a 3% rise in the number of withdrawals and a 14% increase in the value.

Chart 57 shows how the number and value of ATM cash withdrawals developed between 2001 and 2005.

²⁶ The amount of provided intraday credit is deemed to be the value of the securities (decreased by haircut) that the NBS accepted from participants as collateral for the credit. This is the maximum limit up to which participants may draw down the intraday credit. The actual drawing of the credit is not at present subject to statistical tracking.

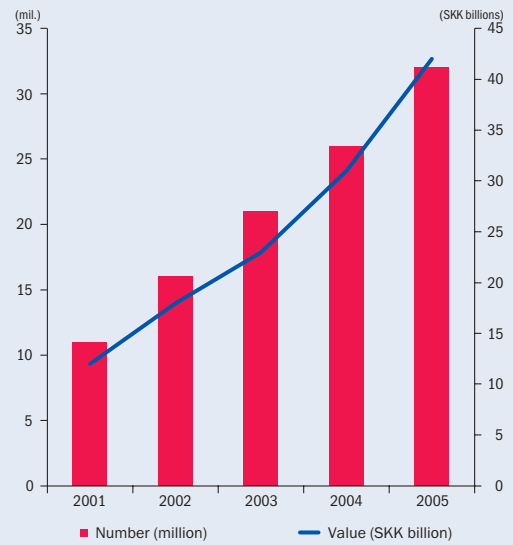


Chart 57 Number and value of ATM cash withdrawals



Source: ZBK SR.

Chart 58 Number and value of EFT POS payments



Source: ZBK SR.

In 2005, EFTPOS terminals were used to make a total of 31.97 million payments with an overall value of SKK 42,063 billion, which in comparison with 2004 represents an increase of 21% in the number of payments and 34% in the value.

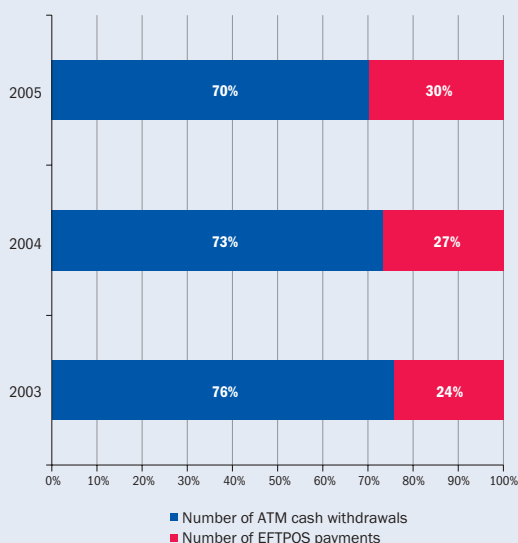
number and value of EFTPOS payments during the period 2001 to 2005.

Although ATM cash withdrawals still predominate, there is a gradually rising trend in payment by cards compared with cash withdrawals.

A trend within bank payment card acceptance is the marked growth in the number of EFTPOS terminals in comparison with the increase in the number of ATMs. In 2005, the former rose by 17% year-on-year and the latter by 9%. Chart 58 shows the development in the

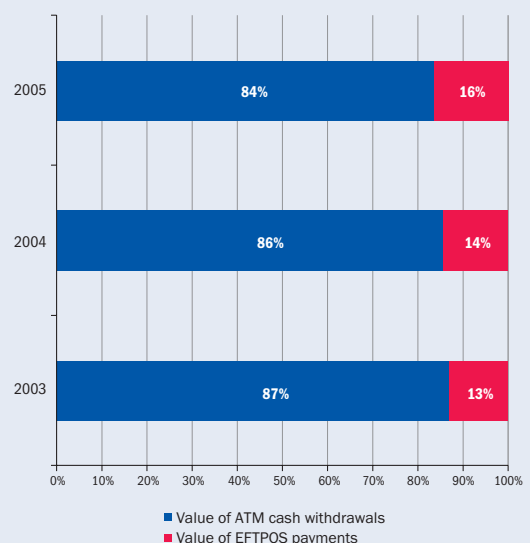
Charts 59 and 60 provide a percentage comparison of the number and value of withdrawals and EFTPOS payments.

Chart 59 Number of ATM and EFT POS transactions (%)



Source: ZBK SR.

Chart 60 ATM and EFTPOS transactions by value (%)



Source: ZBK SR.



6.4 Cooperation with international institutions since accession to the European Union

In the field of payment systems, the National Bank of Slovakia was represented on the respective working committee and working groups of the European System of Central Banks and on the working group of the European Commission in 2005.

At the European Commission, the NBS participated in the drafting of legislation concerning payment services, namely, the proposed Directive on payment services in the internal market and a Proposal for a Regulation of the European Parliament and of the Council on information on the payer accompanying transfers of funds. The aim of the proposed Regulation is to transpose Special Recommendation VII issued by the FATF (Financial Action Task Force on Money Laundering and Terrorist Financing).²⁷

During the course of 2005, the European Commission produced an evaluation report on the implementation of Directive 98/26/EC on settlement finality in payment and securities settlement systems, basing it on information sent by EU Member States. The documents the Commission received from Slovakia for the evaluation report were elaborated by the National Bank of Slovakia.

The European Commission also published a report on the implementation of Regulation 2560/2001 on cross-border payments in euro. The documents it received from Slovakia for the production of this report were elaborated by the National Bank of Slovakia in cooperation with the Association of Banks of the Slovak Republic.

The National Bank of Slovakia contributes to the project of the European Central Bank concerning the collection of payment system statistical data for the ECB Blue Book. Work on the content and structure of the data was carried out during 2005. The database will comprise statistical data covering the past five years, and primarily data on payment instruments and terminals (e.g. payment cards, transactions through terminals, and transactions using non-cash payment instruments – credit transfers, direct debits, chequ-

es). In 2006, the database should be expanded to include data on securities.

The National Bank of Slovakia has introduced the collection of payment system statistical data through a new method – the application programme system STATUS (APS STATUS). Under NBS Decree No. 10/2005 of 13 December 2005, concerning the submission of statements for statistical purposes by banks and the branches of foreign banks, an obligation is imposed on banks to send such data through APS STATUS, beginning with data for 2005.

During 2005, a Working Group of the European System of Central Banks and the Committee of European Securities Regulators (ESCB-CESR) was developing a methodology on standards for securities clearing and settlement in the European Union (known as the ESCB-CESR User Standards). The standards were approved in October 2004 by the Governing Council of the European Central Bank and the CESR for the purposes of evaluating securities settlement systems. The National Bank of Slovakia is represented on this Working Group as well.

Work on the TARGET2 payment system project took place in 2005. Central bank governors were invited to confirm by the middle of January 2005 their future participation or non-participation in the Single Shared Platform (SSP) and to state which non-mandatory modules their central banks planned to use in the future. At the beginning of the year the NBS expressed its agreement with the connection to the prepared SSP, given that the connection is to be made not later than the euro changeover. Also in January 2005, all the other countries expressed agreement with connection to the SSP.

In February 2005, the Eurosystem published on the internet the “First Progress Report on TARGET2”, which focused on issues related to the TARGET2 services – financing and pricing structure.

In October 2005, the “Second Progress report on TARGET2” was published. This report provides information on the planned operational commencement of the SPP, on the approved migration strategy of April 2005 and on the composition of migration groups. The second report also elaborates on the pricing strategy for the TARGET2 core services, the liquidity pooling service and the ancillary system settlement.

²⁷ The FATF is an international body that was established by the G-7 Summit held in Paris in 1987; it is regarded as a rule-making authority for issues of money laundering and terrorist financing.

Foreign Activities



7 Foreign Activities

7.1 European Union

During 2005 – in the second year of EU membership – the National Bank of Slovakia joined the decision-making process of EU bodies by having delegates on selected committees and working groups of the EU Council, European Commission and Commission for EU Affairs.

Governors of national central banks were invited to informal meetings of the EU Council of Economics and Finance Ministers (ECOFIN), held in May in Luxembourg and in September in Manchester. These meetings focused on issues concerning financial crises management, development aid and responses to the challenges of globalization.

The NBS delegates were also regular participants in the meetings of the committees and working groups of the EU Council and European Commission. The NBS played an important role mainly in the activities of the Economic and Financial Committee (EFC), which is responsible for monitoring the economic and financial situation in the EU Member States, financial relations with third countries, and the situation in regard to the movements of capital and payments. The EFC also consulted over the process leading to a decision on the entry of Cyprus, Malta, Latvia and the Slovak Republic into the exchange rate mechanism ERM II. NBS experts attended meetings of the EFC's Euro Coin Sub-committee and Sub-committee on IMF. As regards European Commission committees, NBS delegates took part in the meetings of the Committee of European Banking Supervisors (CEBS) and its expert groups, as well as the Mint Directors Working Group and its sub-committees.

In 2005, the NBS also participated in the EU-related decision-making process within Slovakia. NBS representatives were regular participants in the meetings of the Commission for EU Affairs, the main task of which is to coordinate Slovakia's European policy towards matters discussed by the Committee of Permanent Representatives (COREPER) at the EU in Brussels. The NBS also cooperated in the drafting of instructions for the Commission for EU Affairs, which subsequently approved and forwarded them to the Permanent Representation of the Slovak Republic at the EU in Brussels.

The European System of Central Banks and the European Central Bank

The European System of Central Banks (ESCB) is composed of the European Central Bank (ECB) and the central banks of 25 Member States of the European Union, while the Eurosystem comprises the ECB and the central banks of those Member States that have adopted the euro. The Eurosystem and the ESCB are managed by the ECB decision-making bodies, namely the Executive Board of the ECB and the Governing Council of the ECB. The ECB President, Jean-Claude Trichet, is the Head of these bodies. The third decision-making body is the General Council of the ECB, a transitional umbrella body for those Member States that have not yet adopted the euro (Denmark, Sweden, the United Kingdom and the ten new Member States). Seven out of ten new Member States (including Slovakia) have already entered ERM II, which is one of the necessary steps in the euro changeover process.

The National Bank of Slovakia cooperates with the ECB at several levels. The NBS Governor is a member of the ECB General Council, which convened five times in 2005 including once through a teleconference. The General Council meetings focus mainly on the documents drafted in the ESCB committees. The NBS has two experts on each of the twelve ESCB committees, and they, together with the representatives from the other central banks and the ECB, oversee the fulfilment of specific tasks of the ESCB, including the preparation of documents for discussion by the General Council and Governing Council of the ECB. Other NBS experts participate in the work of the internal structures of individual committees.

A significant part of the NBS's work involves consultation over draft general legal regulations of the NBS, i.e. draft laws, decrees and provisions that fall within the competence of the ECB. In the interests of transparent law-making within the EU, the national authorities of the Member States are required to submit to the ECB for comments, and for access by other Member States, their draft legal provisions that come within the remit of the ECB. In 2005, the National Bank of Slovakia submitted several draft legal regulations for comments, and also commented on ECB's opinions regarding the draft legal provisions of other Member States. In addition, the NBS provided comments on



various regulations and directives issued by the EU Council and European Commission.

The Phare Programme

On the basis of Resolution No. 775/2003, and following the adoption of Act No. 747/2004 Coll., the Slovak Government passed a decision on establishing an integrated supervision of the financial market, as of 1 January 2006. In order to support this process, the steering committee in Brussels approved, within the Financial Memorandum 2002, a joint project for the Financial Market Authority (FMA) and the NBS entitled "Strengthening Financial Sector Supervision", for which it provided a grant of EUR 2 million.

Given its scope, the project was divided into two thematic blocks forming stand-alone sub-projects: "Technical and Legal Assistance" (EUR 1.4 million) and "Software Development and Expert Advice on an Early Warning System for the FMA and NBS" (EUR 0.6 million). The projects were launched in the first half of 2004 and completed in the second half of 2005, implemented by Consortium Wiener Boerse, from Austria, and Asyk S. A, a Greek company.

The main aim of the projects was to strengthen supervision of the capital market, insurance companies and banks by improving the quality of supervisory procedures in the supervision exercised by the FMA and NBS.

The successful implementation of both projects supported the expansion and streamlining of supervisory authorities in their capacity to regulate the financial market effectively and it helped to create the technical bases for the amalgamation of the two supervisory authorities.

The last Slovak banking sector project to be financed by the European Commission under the Phare Programme is "Support for Risk-based Supervision". Provided on the basis of the Financial Memorandum 2003, the grant amounts to EUR 1.25 million. Implementation of the project by the Belgian Banking Academy began in June 2005 and is due to be completed in October 2006. The project represents a logical continuation of the preceding projects and its immediate objective is to improve the quality and effectiveness of the integrated supervision in line with the implementation of Basel II, i.e. to encompass all risks related to business in the financial and capital market and to develop supervision of pension funds, financial companies, electronic commerce, market management and cross-border services.

A stand-alone subproject is the implementation of application software for the collection and assessment of data from entities subject to capital market supervision.

7.2 NBS cooperation with international institutions

International Monetary Fund (IMF)

Relations between the National Bank of Slovakia and the International Monetary Fund have undergone a gradual transformation, and their mutual cooperation has reached a qualitatively new level over recent years. Because of good results in economic policy and its stable economic environment, the Slovak Republic stands as one of the countries that have settled all their financial liabilities towards the IMF, is not drawing any loans, and is among the IMF donor countries.

Preparations were made during 2005 for the participation of the Slovak Republic in the Financial Transactions Plan (FTP), through which the economically strong IMF member countries lend foreign exchange to member countries which have balance of payment problems. In FTP transactions, the National Bank of Slovakia acts on behalf of Slovakia, executing the transactions entirely out of its foreign exchange reserves, up to the maximum amount of the member's quota for Slovakia, i.e. SDR 357.5 million.

In the context of the Slovak Republic's long-term stable relations with the International Monetary Fund, regular IMF missions were conducted during 2005. The IMF mission that visited Slovakia in July 2005 praised the change in monetary policy regime and the adoption of inflation targeting under the conditions of ERM II, as well as the publication of inflation forecasts which provide for more transparent monetary policy. The mission also acknowledged that the NBS had taken a substantial step towards strengthening banking supervision.

The regular consultation, which, in accordance with Article IV, the IMF holds once per year with each member country once a year was held in Slovakia during the IMF missions in November and December 2005. The IMF mission said in its final report that economic performance was strong again in 2005 and that Slovakia was very well prepared for the euro changeover. It also gave a positive assessment of the sound macroeconomic management and the wide range of significant structural reforms in the financial sector. The mission welcomed the NBS's aim of extending supervision to include supervision of non-banking financial institutions.

In 2005, the highest representatives of the National Bank of Slovakia attended the Spring Meetings of the International Monetary Fund and the World Bank, held in Washington in April, and their Annual Meetings, held at the end of September. The focus of the meetings concerned the outlook for the world economy and financial markets, the IMF's mid-term strategy,



and the IMF's role in low-income countries. Other matters discussed included IMF supervision, crises prevention, the fight against money laundering and the financing of terrorism, as well as the utilization of IMF funds and other current issues.

In June 2005, following the Spring Meetings, a meeting was held in Turkey of representatives of the IMF and the World Bank's Belgian Constituency at the level of central bank governors and finance ministers. Besides current issues of the IMF and the World Bank, the participants in the meeting discussed rules in the area of fiscal policy and public debt management.

The World Bank

The position of the Slovak Republic within the framework of the World Bank institutions has been changing in accordance with the completion of the Slovak economy's transformation process.

Within the International Bank for Reconstruction and Development (IBRD), the Slovak Republic is one of the EU-8 countries, which still have the option to receive financial or technical assistance. The objective of the IBRD in Slovakia is to support the achievement of a long-term sustainable development and to make as effective use as possible of the country's EU membership. IBRD activities are also directed at improving living conditions, especially for the most vulnerable sections of the population. Support was provided during 2005 through the ministries concerned and non-governmental organizations.

In the International Development Association (IDA), the Slovak Republic has the position of a donor country providing financial assistance to developing countries. In this regard, the Slovak Government passed Resolution No. 691 of 14 September 2005 to approve the Slovak Republic's accession to the 14th replenishment of IDA funds in the amount of EUR 2,070,144, the payment of which will be made in three instalments between 2006 and 2008.

Bank for International Settlements (BIS)

As a shareholder in the Bank for International Settlements, the National Bank of Slovakia has been actively involved in its operations. Accepting a BIS offer, the NBS purchased 188 shares of the American issue and thereby increased its total holding of BIS shares to 2,858, as at 1 June 2005.

On 27 June 2005, in Basle, the BIS's member central banks held their Annual General Meeting and also an Extraordinary General Meeting. The central bank governors approved the BIS's financial statements

and the distribution of profit. The subject matter of the Extraordinary General Meeting concerned changes to the BIS Statutes.

At their regular meetings held every two months, the governors of the member central banks of the BIS focused their discussions on current issues of the global economy, inflation, BASEL II and financial stability.

European Bank for Reconstruction and Development (EBRD), World Trade Organization (WTO), and Organization for Economic Co-operation and Development (OECD)

The EBRD's 2005 Annual Meeting, held in Belgrade in May, confirmed the shift in EBRD activities towards the Balkans, Eastern Europe and Central Asia. In regard to the EU-8 new Member States, as beneficiaries from the EBRD and countries which have achieved an advanced transformation, the EBRD wants to focus primarily on projects concerning infrastructure, energy saving, and venture capital, on support for small and medium-sized enterprises, and on eliminating regional disparities.

In 2005, the EBRD pursued this strategy also in relation to Slovakia. As at 31 December 2005, the portfolio of EBRD activities in Slovakia had a net cumulative value of EUR 427.5 million, of which current assets represented EUR 308 million.

During the course of 2005, the Slovak Republic, as a member of the EU, expressed its opinion on WTO matters through the 133 Committee of the EU Council, which is responsible for multilateral trade affairs. The NBS was primarily concerned with discussions in the financial services field. In December 2005, the WTO Ministerial Conference was held in Hong Kong, China. The closing Ministerial Declaration approved a new timeframe for completing discussions in the services sphere.

NBS representatives also participated in the work of relevant committees and working groups of the OECD, namely, the Economic Policy Committee (EPC), the Economic and Development Review Committee (EDRC), the Committee on Financial Markets (CFM) and the Investment Committee.

International Investment Bank (IIB) and International Bank for Economic Cooperation (IBEC)

The International Investment Bank (IIB) and the International Bank for Economic Cooperation (IBEC), headquartered in Moscow, are banks founded by



member countries of the former Council for Mutual Economic Cooperation. Slovakia, as an independent republic, became a member of them in 1993. Its share in the paid-up capital of the IIB and IBEC is, respectively, 4.85% and 6%, representing EUR 10.4 million and EUR 8.6 million.

The supreme governing bodies of both banks are the Bank Boards. They meet twice a year, and their 2005 meetings were held in Moscow in spring and summer.

The May Meetings of the IIB and IBEC Bank Boards approved reports on the activities of both banks for 2004, reports on the settlement of claims and liabilities of the IIB and IBEC, the fulfilment of the general operating costs budgets in 2004 and the banks' plans for 2005. They also took note of the report on the activities of the IIB revision commissions for 2004.

At their November Meetings, the Bank Boards approved the report on the banks' activities for the first half of 2005, information on the preparedness of the Russian Federation to implement the second stage in the settlement of its liabilities towards the IBEC, budget proposals for 2006 general operating costs, and a decree on the IIB revision commission and a schedule of its work for 2006. Mr A. A. Serebrjakov was confirmed as the Chairman of the IIB Board of Directors.

The joint meeting of the IIB and IBEC Bank Boards included discussions at which individual delegations presented their ideas for a future development bank that should bring about the transformation of both banks and their future alliance.

7.3 Providing foreign technical cooperation and assistance in training

Activities within foreign technical cooperation

In terms of providing foreign technical cooperation, the NBS primarily focuses on the central banks of the new Member States. In 2005, the Institute of Banking Education, the department responsible for the NBS's activities in this area, held two expert consultations and one workshop.

A consultation at the Central Bank of Malta was held in June 2005. It concerned the issue of managing risks in foreign exchange transactions and focused on the specific role of Middle Office (modelling for the

yield curve shift and estimating future earnings, scenario analysis, stress testing, customized benchmark construction, and profit decomposition).

In February 2005, a consultation concerning protection and security was held at the NBS for 3 experts from the Czech National Bank; it focused on the issues of security and crisis management in the NBS and the protection of confidential information at the NBS.

The host central banks gave a very positive evaluation of the events and praised in particular the high expertise of the NBS specialists, gained from their long-term practical experience in the respective field, and their capacity to communicate knowledge and professional experience to others.

In December 2005, the NBS in cooperation with Deutsche Bundesbank experts held a workshop for experts in banking supervision on the subject of stress testing. The event was attended by 24 employees of the NBS and 7 foreign participants from central banks of the Czech Republic, Poland, Hungary and Slovenia.

Activities within foreign technical assistance

In 2005, the NBS was actively involved in providing foreign technical assistance. It organized two two-day expert consultations for specialists from the Albanian central bank. In March 2005, in Tirana, a consultation was held on a pre-set and tightly defined group of questions concerning risk management and Middle Office (profit decomposition, experience from building a middle office section, measuring portfolio performance and benchmarking). In December 2005, the NBS held a consultation for 2 experts concerning selected questions of human resources management and training (training and development of staff, flexible working time, staff catering, description and specification of workplaces, staff remuneration).

The National Bank of Albania evaluated the events positively and expressed its active interest in continuing cooperation with the NBS through further needs-based training events, either in Albania or at the NBS.

Following to a similar event in 2004, that showed to be a real success, the NBS arranged a one-day study visit for 42 foreign students from the Instituto Tecnológico de Monterrey (Mexico), which included a specialist programme centred on NBS activities in the areas of legislation, training, money issuance and circulation.

Preparation for the Euro Introduction



8 Preparation for the Euro Introduction

Since acceding to the European Union, Slovakia has been a member of the Economic and Monetary Union (EMU) with a derogation from the obligation to introduce the single European currency – the euro. Under the EU Accession Treaty, Slovakia undertook to take the steps that will enable it to adopt the euro. What is more important, according to the analysis made by the National Bank of Slovakia and the Slovak government, adoption of the euro will be beneficial for the Slovak economy. The main potential benefit of the euro introduction will be an acceleration of economic growth by an estimated 0.7 % (± 0.3 %) per year over the decades following entry to the euro area. Other significant advantages of the euro will include elimination of the costs of converting korunas into euros, the removal of the exchange rate risk vis-à-vis the euro, greater price transparency in foreign trade, and a decline in the costs of capital. These benefits outweigh the disadvantages and risks (changeover costs, loss of an independent monetary policy, possible asymmetric shocks, risk of slightly higher inflation). The Government and NBS have therefore decided, under the euro adoption strategy, that Slovakia will adopt the euro as soon as possible after fulfilling the Maastricht Criteria.

In 2005 the National Bank of Slovakia continued to fulfil the Strategy for Adopting the Euro, approved by

the Government and the NBS. Preparations for the euro changeover progressed both from the economic policy aspect and on the technical and organizational side. All these efforts are aimed at making Slovakia ready to introduce the euro from 1 January 2009.

8.1 National Euro Changeover Plan and organizational preparations

In the first half of 2005 the National Euro Changeover Plan for the Slovak Republic was drawn up by the NBS together with the Ministry of Finance of the Slovak Republic (MF SR) and other institutions. Besides the NBS and MF SR the preparation has involved the Ministry of Economy of the SR, Ministry of Justice of the SR, the Ministry of Labour, Social Affairs and Family of the SR, the Ministry of Interior of the SR, the Office of the Government of the SR, the Association of Banks, the Association of Towns and Municipalities of Slovakia, the Antimonopoly Office of the SR, the Statistical Office of the SR, the Financial Market Authority, the Slovak Chamber of Commerce and Industry, Slovak Radio, Slovak Television, the Slovak Trade Inspectorate, the Social Insurance Agency, and other invited organizations.

The euro changeover is a complex process affecting every entity in the Slovak economy and the society as a whole. The Changeover Plan defines the most important organizational and technical tasks that have to be met prior to the euro changeover and it designates the institutions responsible for meeting them. During the euro changeover process, all entities in Slovakia will be able to rely on this document. The euro will be introduced simultaneously into cash and non-cash circulation in Slovakia; without a transition period.

The aim of the Changeover Plan is to introduce the euro quickly and smoothly, to the satisfaction of the whole society. The leading organizational role is performed by the National Coordination Committee for the Euro Changeover in the Slovak Republic (the Committee), under the leadership of the Minister of Finance of the SR and with the NBS Governor as his deputy. Six working committees have been set up

Box 1 Decisions of the Slovak Government and NBS

16 July 2003

Strategy for Adopting the Euro in the Slovak Republic: it is beneficial to adopt the euro as soon as possible after fulfilling the Maastricht Criteria. The euro changeover is expected to take place in 2008 or 2009.

8 September 2004

Specification of the Strategy for Adopting the Euro: the target date for the euro changeover is set as 1 January 2009 with the Maastricht Criteria to be fulfilled in 2007.

6 July 2005

National Euro Changeover Plan for the Slovak Republic: a plan of the practical steps required for a smooth transition to the euro.



to address specialized tasks, and two of them – the Working Committee for Banks and the Financial Sector and the Working Committee for Communication – are led by the National Bank of Slovakia. At the end of 2005 a government commissioner for the euro changeover was appointed in order to coordinate day-to-day activities of the working committees and to present euro changeover issues to the general public.

The tasks set out in the Changeover Plan are divided according to the main areas of economic activity, in other words according to the fields of the individual working groups, as follows: the financial sector, general government, corporate sector and consumers, legislative tasks, communication, and adjustment of information and statistical systems. The Changeover Plan lays down the time requirements for individual tasks, as well as their control dates and fulfilment deadlines. Also stated in the Changeover Plan are the core principles of the euro changeover including: Big Bang (simultaneous introduction of the euro into cash and non-cash circulation), the principle of continuity of contracts, the principle of not harming the citizen, avoidance of unjustified price increases, and the minimizing of euro changeover costs.

During 2005 the National Bank of Slovakia fulfilled all the tasks assigned to it for that year under the Changeover Plan. These included drafting an internal plan for the transition to the euro, adopting core deci-

Box 2 National sides of Slovak euro coins

1 euro and 2 euros – Double cross on three hills (designed by sculptor Ivan Řehák)

The double cross on three hills represents the coat of arms of the Slovak Republic, one of the symbols of the state. It is set in a circular area against a relief of stylised rocks that symbolize the permanence and strength of the state.

10, 20 and 50 cents – Bratislava Castle (designed by Ján Černaj and Pavel Károly)

Bratislava Castle is the dominant sight in the capital city of Slovakia. It is a national cultural monument that is among the best-known symbols of Bratislava. Set within the castle motif is the coat of arms of the Slovak Republic, one of the symbols of the state.

1 cent, 2 cents and 5 cents – Kriváň (design by Drahomír Zobeck)

Kriváň, a peak in the Tatra Mountains, has associations with key events of the Slovak nation. As the destination for tours undertaken by patriots associated with Ľudovít Štúr, it played an important role in the struggle for national awakening. During the Slovak National Uprising, the fight for freedom took place in its vicinity. Consequently, it has come to symbolize the defence of the sovereignty and historical territory of the Slovak nation.

Designs of the national sides of Slovak euro coins



2 euros



1 euro



50 cents



20 cents



10 cents

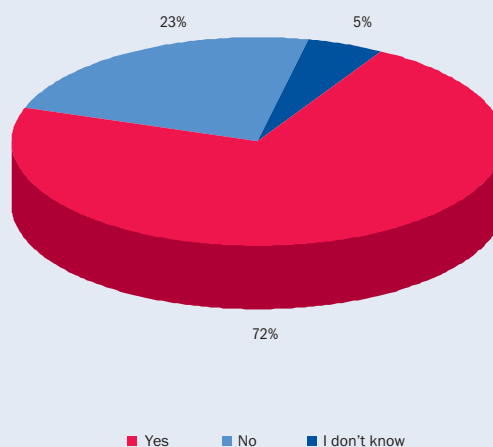


1 cent, 2 cents and 5 cents

sions on the future payment system in Slovakia, and conducting a large number of various communication activities (exhibitions, lectures, seminars, media presentations). The NBS was also involved in preparation of the legislative schedule for the euro changeover.

A special mention should be made about the selection of the national sides of Slovak euro coins, which was carried out with public participation. In July 2004 the National Bank of Slovakia announced a competition for the anonymous submission of designs for the national sides of the euro coins. Altogether 658 designs were entered, and the ten best were selected over two rounds by expert committees and the NBS Bank Board. The NBS then presented the ten designs for a public opinion poll conducted between 12 and 20 November 2005. People could present their preferences via the Internet, SMS or fixed-line telephone. More than 140,000 votes were received. In selecting the designs for Slovak euro coins the NBS Bank Board respected the public opinion and chose the three designs that have received the most votes.

Chart 61 **Public support in Slovakia for the euro introduction** (%)



Source: Eurobarometer 2005.

Box 3 Maastricht Criteria

Before entering the euro area, Slovakia, like any other non-euro area state, must fulfil the four convergence criteria – the Maastricht Criteria under the Maastricht Treaty:

- 1. Public finances:** The general government deficit for the last year before assessment, based on ESA 95 methodology, may not exceed 3% of GDP. A slightly higher deficit is allowed in countries introducing a capitalized pension pillar and in other strictly defined circumstances. At the same time, total government debt may not exceed 60% of GDP.
- 2. Inflation:** Average inflation for the previous 12 months, as measured by the Harmonized Index of Consumer Prices (HICP), may not exceed by

more than 1.5 percentage points the average of the three EU countries with the best performance in terms of price stability.

- 3. Stability of long-term interest rates:** Average market interest rates on long-term government or similar bonds may not exceed by more than 2 percentage points the average of the three EU countries with the best performance in terms of price stability.
- 4. Exchange rate stability:** The Slovak koruna must participate in the exchange rate mechanism (ERM II) for two years prior to assessment. During this period the Slovak koruna may not be unilaterally devalued, nor may it deviate from the agreed fluctuation band; it must remain close to the central parity and there must be no serious severe tensions in the development of its exchange rate.

Table 39 **Process towards the euro changeover**

Fulfilment of Maastricht Criteria	2007 to March 2008
Convergence reports by the ECB and European Commission	April 2008
EC proposal to the EU Council for abrogation of derogation	May 2008
Consultation with the European Parliament	May 2008
EU Council to abrogate the derogation and set the conversion rate	June 2008
Start of mandatory dual pricing	July 2008
Euro area entry – „€-Day“	1 January 2009
Dual circulation of koruna and euro banknotes and coins	1 – 16 January 2009
End of mandatory dual pricing	31 December 2009
Recommended end of voluntary dual pricing	30 June 2010



As for Changeover Plan tasks for which the NBS is not responsible, most of those with a fulfilment deadline in 2005 were completed on time. The majority of unfulfilled tasks were completed at the beginning of 2006 and did not pose any risk to the fulfilment of related activities. Overall, preparations for the euro changeover in Slovakia are progressing satisfactorily, a fact confirmed at the beginning of 2006 by the regular semi-annual report on the fulfilment of tasks under Changeover Plan.

Preparations for the euro changeover in Slovakia have also received positive response from abroad. The European Commission's second report on practical preparations for the future enlargement of the euro area, published in November 2005, described the situation in Slovakia as the best among all the new EU Member States. The Commission commended the Changeover Plan for its comprehensiveness and for providing all sectors and affected persons with the information necessary to make their own preparations.

8.2 Entry into ERM II

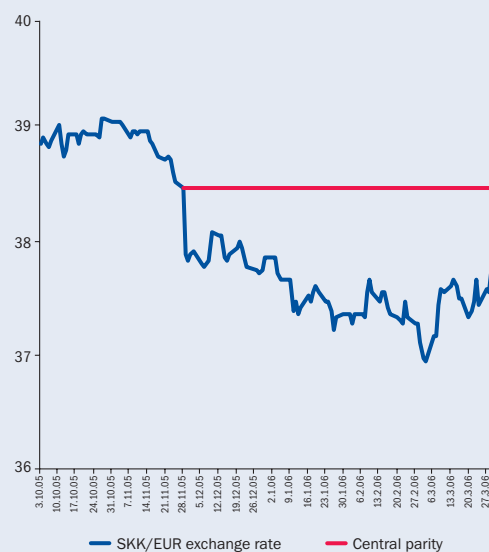
Before a country adopts the euro, its currency must spend at least two years in the European Exchange Rate Mechanism, ERM II. During this period, the country must show that its currency is sufficiently stable against the euro and therefore the exchange rate may be irrevocably fixed upon the euro changeover. The country must also demonstrate during this period that it can maintain exchange rate stability without having to resort to measures at the expense of the stability of the rest of the economy.

The Slovak koruna joined ERM II on 28 November 2005. This agreement was reached on 25 November at a meeting of finance ministers from euro area countries, the ECB president, and finance ministers and central bank governors from Cyprus, Denmark, Estonia, Lithuania, Latvia, Malta, Slovenia and Slovakia. Due in part to very good cooperation between the Ministry of Finance and the NBS, the discussions on ERM II entry were concluded in an exceptionally short time.

Together with the decision on entry, the central parity was set at SKK 38.4550 per euro. At the proposal of Slovakia, the central parity was fixed at the market exchange rate. The Slovak representatives made this proposal on the grounds that the current market rate at that time fully corresponded to the medium-term equilibrium exchange rate.

The koruna observes the standard fluctuation band of $\pm 15\%$ around the central parity in ERM II. The lower compulsory intervention rate is set at 32.6868 SKK/EUR and the upper rate at 44.2233 SKK/EUR.

Chart 62 Exchange rate of the koruna since ERM II entry



Source: NBS.

Should either of these rates be reached, the currency must be defended by the central banks of all euro area countries and of countries participating in ERM II, including the NBS. Naturally, the NBS may intervene to stabilize the exchange rate at any time, not only at the compulsory intervention rates. Since ERM II entry, however, the NBS has not exercised this option in 2005. Unlike the majority of countries that joined ERM II in 2004 or at the beginning of 2005, Slovakia has not made any unilateral commitment to maintain the exchange rate within a band narrower than $\pm 15\%$ around the central parity.

Upon joining ERM II Slovakia pledged to continue pursuing a responsible economic policy that supports the exchange rate stability within ERM II. The main emphasis is on sound fiscal policy and on keeping wage growth in line with productivity growth, though it is also important to continue with structural reforms. These steps are fully in accordance with the Convergence Programme of the Slovak Republic and the NBS monetary programme. While the fulfilment of these commitments is primarily in the interest of Slovakia, it also respects the common interest of all ERM II and euro area members in strengthening exchange rate stability.

The foreign exchange markets reacted very positively to the koruna joining ERM II, and the currency immediately appreciated by around 1.5%. Investors saw entry into ERM II as confirmation of Slovakia's course towards the euro area and a key step on the way to adopting the euro in 2009 as planned. In 2005 the koruna has traded on the stronger side of the fluctuation band in ERM II, between 1% and 4% above the central parity.



Membership in the ERM II and the fixed central parity should contribute to the stable development of the koruna exchange rate. Maintaining exchange rate stability is now a joint responsibility of the Slovak Government and the National Bank of Slovakia. The Government has declared its determination to support the stability of the koruna exchange rate in ERM II with the fiscal policy and structural policies.

8.3 Economic policies for the euro introduction

Prior to the euro introduction in Slovakia, there need to be appropriate economic policies to ensure that

- 1) Slovakia fulfils the Maastricht Criteria on time and is able to adopt the euro on 1 January 2009;
- 2) the Slovak economy is able to function successfully within the euro area and to make maximum use of the potential benefits offered by the single European currency.

With regard to the euro adoption, the most important objective of economic policies for the next two years is to make progress in nominal convergence so that Slovakia fulfils the Maastricht Criteria in 2007. The National Bank of Slovakia shares the responsibility for meeting these criteria. This objective was one of the reasons for the change in monetary policy framework to inflation targeting. Given the need not only to meet an inflation target but also to meet the exchange rate stability criterion, the NBS has introduced a slightly modified system of inflation targeting, called inflation targeting in the conditions of ERM II.

The primary objective of this new method of conducting monetary policy is to fulfil the Maastricht inflation target in 2007 or at the beginning of 2008. Inflation targeting by the NBS had a successful introduction in 2005. The interim target for end-year inflation was set at below 4%, and this was met despite the increase in oil and energy prices and the rise in regulated prices.

The average rate of inflation for 2005 stood at 2.8%, which was slightly higher than the reference value

of the inflation criterion, though at the same time it was the closest to the target in Slovak history. As regards the euro adoption, the most important year will be 2007, for which the NBS has set an HICP inflation target of up to 2%. The target was set low in order to provide sufficient margin in the event of an unexpectedly low the inflation criterion reference value. Besides setting a clear target for inflation, the inflation-targeting regime is able to exert a positive effect on inflation expectations, and thus contribute to the reduction of inflation.

The second objective, for which the NBS is co-responsible, is exchange rate stability in ERM II. The koruna exchange rate followed a stable course in 2005, but the koruna only joined ERM II in November, and the fulfilment of the exchange rate criterion cannot be assessed until the condition of two year membership in ERM II is met. Exchange rate stability is at present a joint responsibility of the Slovak Government and the NBS; the central bank should respond to short-term fluctuations of the exchange rate, and, together with the Government, should both maintain the medium-term development of the exchange rate close to the equilibrium level and prevent creation of imbalances that could affect exchange rate development.

In 2005, the fiscal criterion was fulfilled for the first time. The general government finances were unexpectedly successful, with the eventual deficit of 2.9% of GDP substantially lower than budgeted. This indicator does not, however, include the loss in revenues due to the introduction of the second pension pillar. After taking into account the costs of pension reform, the deficit in 2006 will exceed the limit of 3% of GDP. What will be important, however, is to decrease the deficit to the required level in 2007. This is necessary not only to fulfil the Maastricht Criterion on public finances, but also for other reasons. Fiscal consolidation helps to curb demand pressures and is therefore essential to meeting the inflation criterion. Having a responsible and above all a credible fiscal policy also supports exchange rate stability. Deficit reduction is further required to create room for using discretionary policy tools in worse economic conditions for econo-

Table 40 Fulfilment of the Maastricht Criteria in 2005

Criterion	Value for 2005	Reference value
Inflation (average HICP, in %)	2.8	2.5
Long-term interest rates (%)	3.5	5.4
Government debt (% of GDP)	35.2	60.0
General government deficit (% of GDP) ¹⁾	2.9	3.0
Exchange rate stability	ERM II since November 2005	

Sources: Eurostat, NBS, Ministry of Finance of the SR.

1) Excluding the effect of pension reform.



mic stabilization without fear of breaking the rules of the Stability and Growth Pact. Finally, a low general government deficit is required to ensure the long-term sustainability of government debt.

Long-term interest rates represent the final Maastricht Criterion. Given the decline in inflation and the high credibility of economic policies, Slovak long-term interest rates are substantially below the reference value. Should all the other Maastricht Criteria be met, the fulfilment of the interest rate criterion will not be at risk.

Slovak progress in nominal convergence – in meeting the Maastricht Criteria – also supports gradual real convergence, above all strong economic growth and a rising standard of living. But there is also an opposite relationship – progress in real convergence makes it easier to fulfil the Maastricht Criteria. The ultimate aim of the euro adoption is to further accelerate real convergence. The benefits of joining the euro area can be fully exploited only with a highly flexible economy. That is why the NBS supports structural reforms, especially labour market reforms that make the Slovak economy more flexible and increase its resistance to possible shocks.

Legislation



9 Legislation

The National Bank of Slovakia continued in 2005 to exercise its legislative and approximation competences in the areas of currency, monetary circulation, foreign exchange management, and the banking sector, and in so doing fulfilled all the planned tasks.

Legislative changes to laws within the remit of the National Bank of Slovakia, prepared and implemented in 2005

Act of the National Council of the Slovak Republic (NR SR) No. 566/1992 Coll. on the National Bank of Slovakia, as amended, was amended in 2005 by Act No. 519/2005 Coll. This amendment modified provisions on the Bank Board of the National Bank of Slovakia and its members, raising the number of Bank Board members from eight to eleven. It also modified the NBS Act so as to emphasize the importance of the integrated supervision of the financial market, from 1 January 2006, which along with the conduct of monetary policy, represents one of the two core pillars of the NBS's activities.

Act No. 483/2001 Coll. on banks and on the amendments to certain acts, as amended, was amended in 2005 by Act No. 69/2005 Coll., Act No. 340/2005 Coll., and Act No. 341/2005 Coll. The most important change was made by Act No. 69/2005 Coll., on the basis of which banks and the branches of foreign banks are required to produce an analysis of risks related to the security of operating premises and also to ensure that such premises are secured by legally prescribed measures and other security measures arising from the risk analysis.

Act of the Slovak National Council No. 310/1992 Coll. on home savings, as amended, was amended in 2005 by Act No. 624/2005 Coll. This amendment modified, from 1 January 2006, the rules on the state bonus for home savings, reducing the maximum amount of the state bonus from SKK 2,500 to SKK 2,000.

Act of the NR SR No. 118/1996 Coll. on deposit protection and on the amendments to certain acts, as amended, was amended in 2005 by Act No. 578/2005 Coll. This amendment modified the rules for setting the amount of the annual contributions made by banks and the branches of foreign banks

to the Deposit Protection Fund, allowing for these contributions to be reduced.

Decrees and provisions issued by the National Bank of Slovakia in 2005, under its legislative competences to issue complementary generally binding legal regulations (except for provisions on commemorative coins)

Decree of the National Bank of Slovakia No. 486/2005 Coll. on the second issue and putting into circulation of 1995 pattern SKK 50 banknotes.

Provision of the National Bank of Slovakia of 11 March 2005 No. 1/2005 on consolidated group and sub-consolidated group reporting (Notification No. 98/2005 Coll.).

Provision of the National Bank of Slovakia of 11 May 2005 No. 2/2005 amending Provision of the National Bank of Slovakia No. 11/2004 on the submission of reports by banks and branches of foreign banks for statistical purposes (Notification No. 205/2005 Coll.).

Provision of the National Bank of Slovakia of 28 July 2005 No. 3/2005, stipulating the particulars of an application for prior approval pursuant to Article 28, paragraph 1 of Act No. 483/2001 Coll. on banks and on the amendments to certain acts, as amended (Notification No. 369/2005 Coll.).

Provision of the National Bank of Slovakia of 26 August 2005 No. 4/2005, amending Provision of the National Bank of Slovakia No. 2/2003 on the register of credits and guarantees, as amended by Provision of the National Bank of Slovakia no. 7/2004 (Notification No. 420/2005 Coll.).

Provision of the National Bank of Slovakia of 8 September 2005 No. 5/2005, amending Provision of the National Bank of Slovakia No. 8/2002 on banks' equity exposure, as amended by Provision of the National Bank of Slovakia No. 2/2004 and amending Provision of the National Bank of Slovakia No. 4/2004 on adequacy of banks' own funds of financing, as amended by Provision of the National Bank of Slovakia No. 16/2004 (Notification No. 456/2005 Coll.).



Provision of the National Bank of Slovakia of 13 December 2005 No. 6/2005, amending Provision of the National Bank of Slovakia No. 6/1999, stipulating conditions for regulating the balance of payments of the Slovak Republic, as amended (Notification no. 593/2005 Coll.).

Provision of the National Bank of Slovakia of 6 December 2005 No. 7/2005, amending Provision of the National Bank of Slovakia No. 13/2004 on the classification of assets and liabilities of banks and branches of foreign banks and adjustment of their valuation, on the creation and use of reserves and related reporting (Notification No. 594/2005 Coll.).

Provision of the National Bank of Slovakia of 6 December 2005 No. 8/2005, amending Provision of the National Bank of Slovakia No. 5/2004 on the disclosure of information by banks and the branches of foreign banks, and on the publication method for the annual reports of banks and foreign banks operating in the Slovak Republic (Notification no. 595/2005 Coll.).

Provision of the National Bank of Slovakia of 13 December 2005 No. 9/2005 on the submission of reports of investment funds by asset management companies for statistical purposes (Notification No. 596/2005 Coll.).

Provision of the National Bank of Slovakia of 13 December 2005 No. 10/2005 on the submission of reports by banks and branches of foreign banks for statistical purposes (Notification No. 597/2005 Coll.).

Provision of the National Bank of Slovakia of 20 December 2005 No. 11/2005, stipulating the fees for particular types of operations performed by the National Bank of Slovakia (Notification No. 637/2005 Coll.).

Provision of the National Bank of Slovakia of 20 December 2005 No. 12/2005 on the analysis of

risks related to the security of operating premises of banks and branches of foreign banks (Notification No. 632/2005 Coll.).

Provision of the National Bank of Slovakia No. 656/2005 Coll., amending Provision of the National Bank of Slovakia No. 613/2003 Coll., stipulating the structure, scope, content, breakdown, terms, form, method, procedure and place for submitting certain reported facts pursuant to Article 8 of the Foreign Exchange Act, as amended by Provision of the National Bank of Slovakia No. 708/2004 Coll.

Opinions of the European Central Bank on draft legislation of the Slovak Republic, received in 2005 within consultations prescribed for national authorities and alongside active participation of the National Bank of Slovakia

CON/2005/25 – Opinion on the regulation of lobbying, including lobbying activities in regard to the National Bank of Slovakia.

CON/2005/26 – Opinion on the role of the National Bank of Slovakia in integrated supervision of the entire financial market and on the amendments to the Act on the National Bank of Slovakia.

CON/2005/47 – Opinion on the exempting of the National Bank of Slovakia from the criminal liability of legal persons.

CON/2005/50 – Opinion on the reduction of annual contributions of commercial banks to the Deposit Protection Fund and on monetary financing.

CON/2005/55 – Opinion on the changes to the State Treasury system.

CON/2005/61 – Opinion on accounting standards and financial reporting standards to be used by the National Bank of Slovakia.

Institutional Development



10 Institutional Development

The smooth operation of the NBS is based above all on a rational organizational structure and the competences thereunder, but just as important are the quality, knowledge and motivation of its human resources.

10.1 Organization and management

In line with the need to streamline the bank's activities, the Bank Board of the National Bank of Slovakia made two organizational changes in the course of 2005.

The Section for State Budget and Capital Market Relations underwent a change in the scope of its duties on 1 March, with the entry into force of Addendum No. 36 to the Organizational Order of the National Bank of Slovakia, of 11 February 2005.

The most significant change was approved under Addendum No. 37 to the NBS Organizational Order, of 30 September 2005, as a direct response to the Act No. 747/2004 on financial market supervision. The result of this organizational change was the establishment of a financial market supervision unit within the bank which, from 1 January 2006, in accordance with the law, has a comprehensive remit for supervisory activities concerning supervision of the banking sector, securities dealers, the capital market, the insurance industry, and pension savings.

As regards rationalization of branches, a new concept for managing branches and sub-branches was adopted in December. This breaks from the obsolete historical model under which the central bank is represented through branches in the three original administrative regions, and, following on from their abolition, it envisages sub-branches that are primarily and exclusively places ensuring currency circulation and administration of the money supply.

In the area of organization and management, a planned audit of the bank's management processes and activities was approved in December. The main aim of the audit, which is due to be implemented in 2006, is to assess the effectiveness with which the

national central bank's tasks have been met and to do so through objective knowledge of:

- the current approved status of the organizational management,
- harmonization of management processes and optimization of the organizational and capacity requirements.

10.2 Human resources

10.2.1 Number of employees

The number of planned positions in the NBS was 1,216 as at 31 December 2005, while the number of employees stood at 1,169, of which 550 were men and 619 women. The headcount fell during the course of 2005 – down by 71 in comparison with 31 December 2004 – largely owing to the termination of employment contracts through the implementation of organizational changes approved in 2004. Related to this was the conclusion of the process under which the State Treasury had since August 2004 been assuming from the NBS operations for the management of state budget accounts.

Over the year, 46 new employment contracts were concluded, which in line with internal regulations were typically fixed for a period of one year. Altogether 134 employees ended their contracts. In accordance with promoting the concept of internal mobility, vacated or newly-created positions were firstly offered to existing employees, and only if none applied were they filled by external applicants.

With the inclusion of the National Bank of Slovakia into the European System of Central Banks, the NBS is cooperating in human resources management with central banks of the ESCB and with the European Central Bank. In the context of cooperation with central banks of the ESCB, the Human Resources Management Department regularly participates in meetings of the Human Resources Conference. In concrete terms, cooperation with the ECB in 2005 included the NBS having three members of its personnel employed at the ECB on the basis of ESCB/IO contracts, after successfully completing the ECB selection procedure.



Organisation of NBS as at 31 December 2005

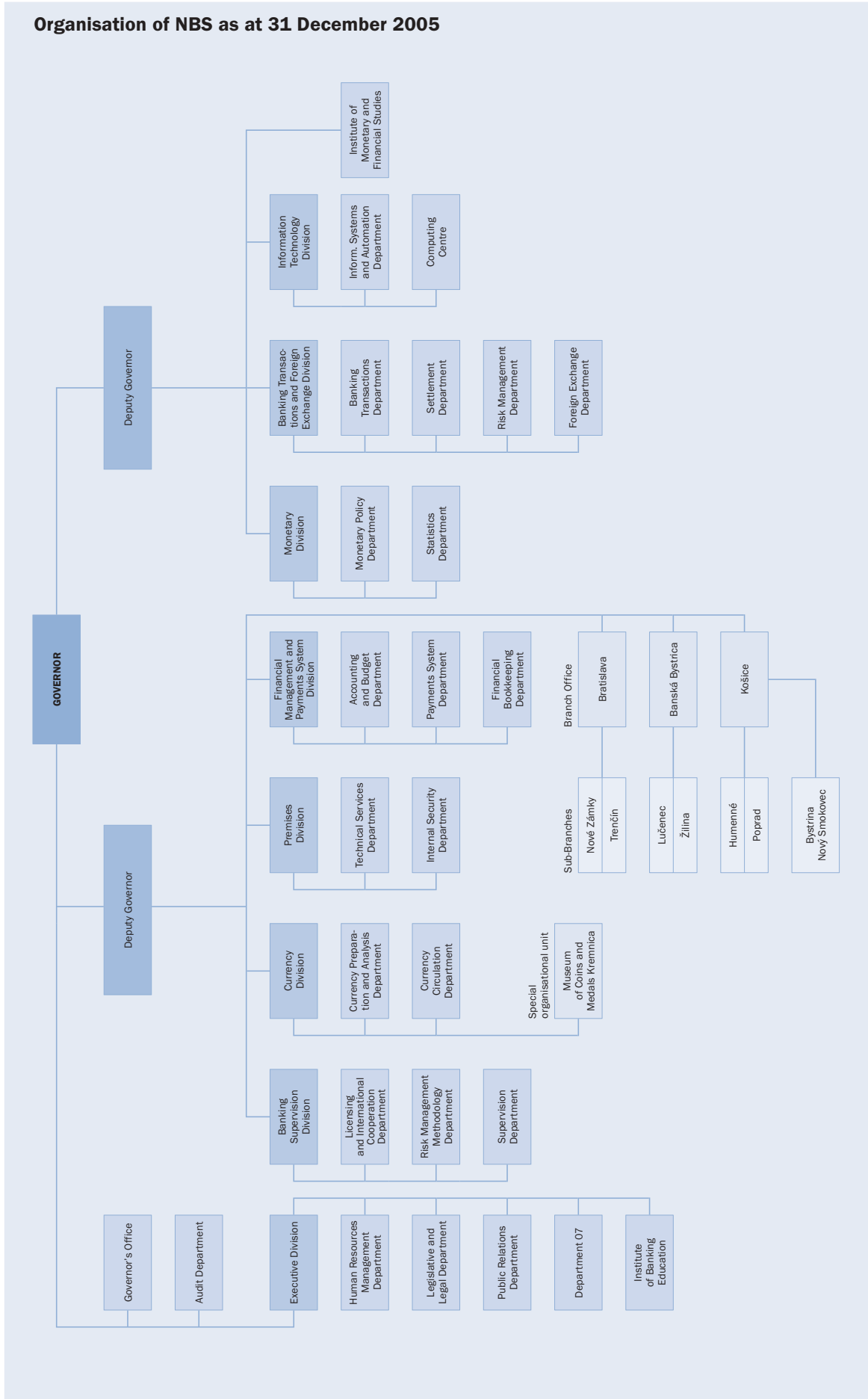
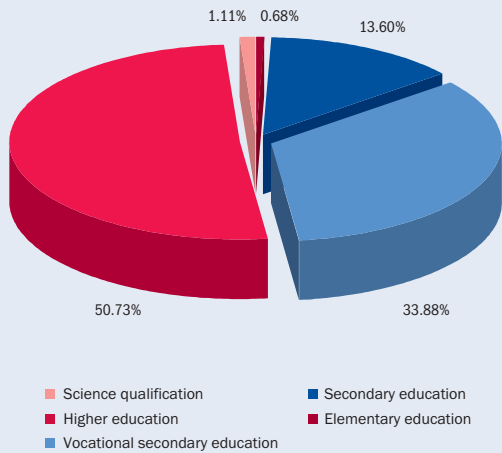
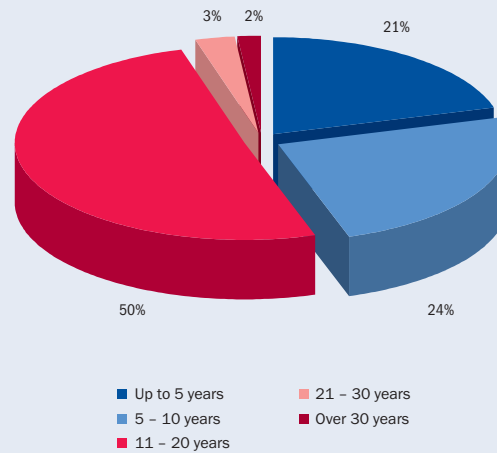


Chart 63 NBS employee structure by qualification (%)



Source: NBS.

Chart 64 Employee structure according to years worked in the NBS (%)



Source: NBS.

10.2.2 Qualifications

People with higher education accounted for 52% of all NBS employees as at 31 December 2005 and holders of secondary-school leaving certificates for 34%. More than 13% of the employees had left secondary school without a leaving certificate and 0.7% had attained only primary education.

10.2.3 Employee structure according to age and years worked

In 2005, the average age of NBS employees increased in comparison with 2004, from 41.5 years to 42.2 years. The age groups 30-40 years and 40-50 years accounted for the same share, 31.5% (735 employees in total). People under 30 years made up 13% (155 employees) and those over 50 years 24% (279 employees).

The NBS marked its 13th anniversary in 2005, having been established on 1 January 1993 as a successor central bank of the State Bank of Czechoslovakia. As at 31 December 2005, 241 employees (21%) had worked in the bank for up to 5 years, 285 employees (24%) for between 5 and 10 years, and 590 employees (more than 50%) for between 11 and 20 years. A further 53 employees (4.5%) had worked in the bank for more than 21 years.

10.2.4 Breakdown by gender

The proportion of men and women became substantially more balanced in 2004 and 2005, especially in

relation to the change in provided activities. As at 31 December 2005, the NBS employed 550 men and 619 women, representing a ratio of 47:53 (45:55 in 2004).

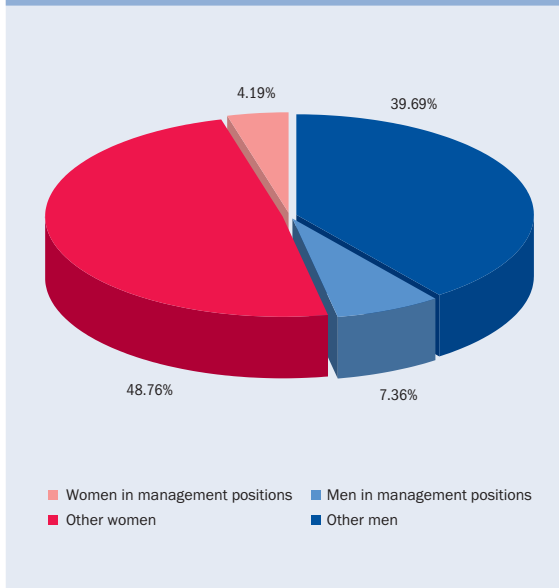
As for employees in management positions, the bank had a total of 135 in 2005 (approximately 11.5% of the total number of employees), of which 86 were men and 49 women, representing a ratio of 63.7 : 36.3.

10.2.5 Employee remuneration

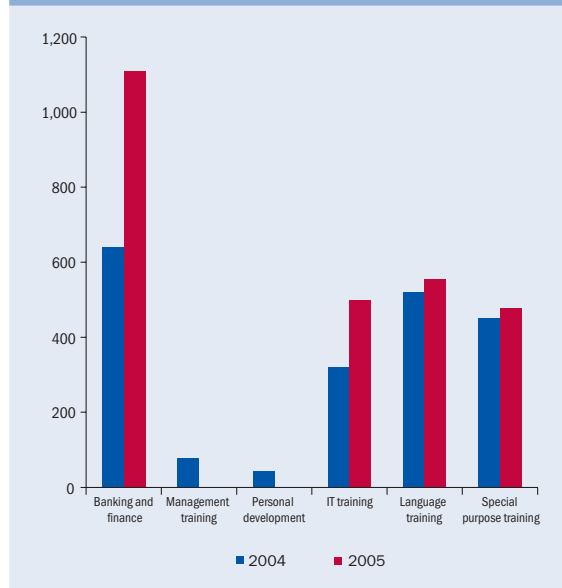
In accordance with the Labour Code, the NBS uses its own composite system of remuneration with the basic wage accounting for a relatively low share of the average wage.

In 2005, employees were paid two extraordinary salaries, and the Bank Board on a quarterly basis decided on the payment of bonuses based on work results. The basic wage was increased and the remuneration system simplified on the basis of an internal regulation on remuneration, which the NBS Directorate approved in December 2005 to take effect from 1 January 2006. In regard to this fact, the Bank Board approved the payment of wage funds accumulated from previous years in the form of an extraordinary annual bonus.

Staff costs in 2005 (excluding contributions and social expenses) amounted to SKK 547,541,000, of which wage costs accounted for SKK 544,585,000 stand-by charges SKK 1,624,000, and other personnel costs SKK 1,332,000. The bank paid an average

**Chart 65 Employee structure by gender and management position (%)**

Source: NBS.

Chart 66 Training of NBS employees (number of participants)

Source: NBS.

wage of SKK 38,528 with an index of 104.9 in comparison with 2004.

Social insurance contributions amounted to SKK 156,536,000 in 2005.

Social expenses in 2005 included reorganization-related severance payments amounting to SKK 14,642,000, and early retirement bonuses in the amount of SKK 5,136,000. In terms of implementing social policy during 2005, the NBS made contributions for employees to supplementary pension insurance and additional pension insurance in the amount of SKK 7,281,000.

10.3 Training

Training is an important activity of the organization, enabling the professional and personal growth of its employees and thereby increasing its quality and value. Training activities in the NBS are comprehensively provided by the Institute of Banking Education, which prepares and organizes training events for NBS employees, as well as employees of the banking sector and other financial institutions, doing so as a holder of and in accordance with the international quality management system standard ISO 9001:2000.

Alongside class-room training events, the Institute of Banking Education organized also several distance learning programmes accredited by the Ministry of Education of the Slovak Republic, the successful completion of which earns a certificate with nationwi-

de validity. In addition, the distance learning course “Banking in the EU”, accredited by the European Bank Training Network, leads to a certificate valid throughout Europe – the European Foundation Certificate in Banking. In 2005, a total of 19 people obtained this certificate.

10.3.1 Training of NBS employees

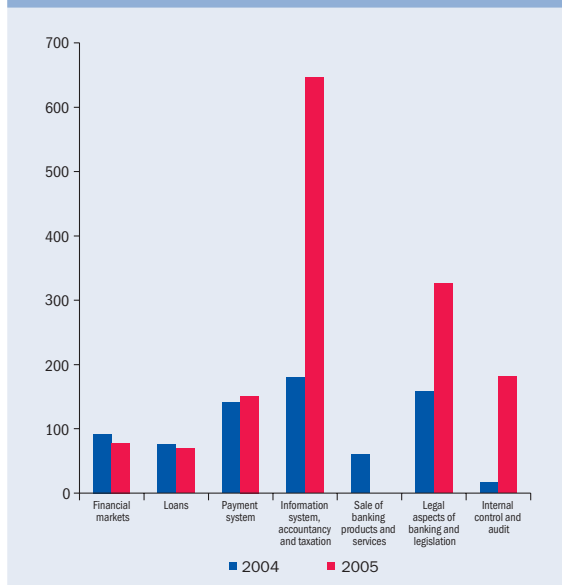
The training of NBS employees in 2005 was primarily aimed at supporting the effective performance in their work, including tasks arising from the NBS’s regular membership of the European System of Central Banks (ESCB) and involvement in the preparations for entry into the Eurosystem and the planned introduction of the euro in Slovakia.

In 2005, there were 513 training events attended by 2,639 NBS employees. A comparison of NBS employee participation in training events in 2004 and 2005, broken down into individual subject areas, is shown in Chart 66.

In 2005, the main focus was on specialist training in banking and finance, and on IT, special purpose and language training, which is a continuation of the trend from previous years. The priority given to specialist training saw a fall-off in training activities in management training and personal development.

Training in the topical issues of banking and finance is aimed at expanding the specialist knowledge and abilities of NBS employees so as to improve the quality and effectiveness of their work, with the objective of

Chart 67 Training of financial institutions employees (number of participants)



Source: NBS.

successful application in the European area and the promotion of NBS interests in the ESCB.

The further specialist training of NBS employees benefits greatly from the training events organized by the national central banks of the ESCB and by other foreign institutions offering participation to NBS employees. In 2005, most NBS employees took part in highly specialized events organized by the International Monetary Fund and the IMF Institute and in events organized by, in particular, the Deutsche Bundesbank and the Oesterreichische Nationalbank. NBS employees also had the possibility to participate in seminars held within the Common ESCB Training programme and in so-called open seminars.

In 2005, as in 2004, there continued to be considerable interest in the subject of accounting within banking and in international accounting standards IAS/IFRS, on which a cycle of 9 seminars was held.

For new NBS employees, there is the course entitled Minimum for NBS Employee. In regard to the incorporation of the Financial Market Authority (FMA) into the NBS, such courses were held especially for FMA employees.

Included in this category of undertakings is also training in topical issues related to European integration, the aim of which is to increase professional awareness regarding the current state of cooperation between the NBS, ECB and ESCB and regarding current developments in the EU. In 2005, special attention was devoted to training employees in connection with the National Euro Changeover Plan for the Slovak Republic.

Another area of focus was, as in previous years, language training. This creates the conditions so that NBS employees are able to learn a foreign language to the level required for representing the NBS at an appropriate standard, for meeting tasks related to the integration of Slovakia into the EU and the NBS into the ECSB, and for expanding cooperation with other foreign central banks and financial institutions. Training in this area is centred mainly on the English language and to a lesser extent on other foreign languages (German, French, Spanish, and Russian).

The reasons for the increasing scope of training in information technology lie in the ever advancing development within this area and the consequent innovations of the NBS information system, which require that employees develop and improve the knowledge and skills they have already acquired.

The NBS also encourages employees who are raising or broadening their qualifications through distance study within higher education and certified training programmes.

Besides training its own employees, the NBS provides specialist work experience to students of economic disciplines at universities and secondary schools (altogether in 2005, for 16 university students and 22 secondary school students).

10.3.2 Training of employees of commercial banks and other financial institutions

In 2005, the NBS prepared 109 training events that were attended by 1,857 employees of banks and other financial institutions.

The scope and specific aim of this training corresponds to banks' current spectrum of needs, as determined from regular surveys and from contact with departments of human resources and training.

Accordingly, training has been divided into the following categories: foundation courses, training for banking specialists, management training, European integration, personal development, language training.

The principal category has long been training events for banking specialists. Chart 5 shows a comparison of participant numbers in this category for 2004 and 2005, broken down into the respective sub-categories.

Compared with 2004, there was substantially greater interest in training events concerning information systems, accountancy, tax, and internal control and



audit. There continued to be strong interest in the legal aspects of banking and legislation. The increased interest in these issues was largely stimulated by changes in the field of legislation and accountancy.

10.3.3 Internal trainers

The preparation and implementation of training events has the active involvement of internal trainers – NBS employees. More and more NBS experts are

taking part in teaching activities within the context of foreign technical cooperation and in the provision of foreign technical assistance, where they present themselves at a highly specialist level.

Altogether in 2005, there were 159 teaching presentations which included the involvement of 67 NBS employees. The extent of teaching activities of NBS employees increased substantially in comparison with 2004 and this positive trend is expected to continue in the future.

Communication



11 Communication

The National Bank of Slovakia considers communication as an integral part of its activities and one of the main tools in implementing monetary policy, and it regards openness and transparency to be a fundamental principle of communication. Details of the aims and methods for informing the public about the activities and decisions of the central bank are set out in the Communication Strategy of the National Bank of Slovakia until 2009.

The core themes of public communication in 2005 were the conduct of monetary policy with focus on inflation targeting, and preparations of the National Bank of Slovakia for the euro changeover and for the incorporation of the Financial Market Authority into the NBS. The principal communication channels were the media, publications, and the NBS website.

The media were kept informed mainly through press releases and regular press conferences, held on the days of the NBS Bank Board's monthly meeting on monetary development. The Bank Board's decisions on interest rates were announced by the NBS also by means of telephone conferences. Since 2005, the medium-term monetary development forecast has been published on a quarterly basis, providing an evaluation of current developments and future prospects.

A key communication channel is the NBS website. The site structure underwent several modifications in 2005, the most important of which were the creation of a new communication platform for authenticated users within the banking sector, and incorporation of the content of the Financial Market Authority's website into the NBS website. In 2005, the NBS website averaged 290,745 hits per month, making it one of the most visited websites in Slovakia.

The National Bank of Slovakia provides the public with a full range of publications and information materials in print and electronic form. In 2005, the NBS's main regular publications – the Annual Report, Financial Stability Report, and the Monetary Survey (economic and monetary statistics monthly review) – continued to provide core analytical and evaluative information for broader professional public, and were produced according to central banking standards. The publications are also provided in English.

Related to the integration process is the interconnection between the communication activities of the National Bank of Slovakia and those of the European Central Bank (the European System of Central Banks – ESCB). NBS representatives participate in discussions and activities of the Eurosystem/ESCB Communications Committee (ECCO), or its working groups, established for the preparation of national language versions of ECB official publications, as well as for the euro changeover information campaign, and communications concerning the security features of the euro banknotes. In the context of communication about the euro changeover, the Public Relations Department collaborates also with partner units of the European Commission and, as part of a twinning programme, with the Oesterreichische Nationalbank (OeNB).

In line with the principles of the ESCB's multilingual communication system, the National Bank of Slovakia ensures the translation into Slovak of official ECB publications. In 2005, this applied to the quarterly issues of the ECB Monthly Bulletin, the updated edition of the publication "The Implementation of Monetary Policy in the Euro Area", and the ECB Annual Report for 2004.

The BIATEC journal also plays an important role in the area of public communications. Running for 13 years, it is a respected platform for the exchange of specialist knowledge in banking, finance and economics. Its authors and readers represent a balanced link between the National Bank of Slovakia, the banking and financial sector, and the academic and educational sphere. The journal has become not only a communication tool of the central bank, but also its contribution to the fulfilment of the Lisbon strategy and the creation of a knowledge-based economy.

The communication activity of the NBS in 2005 also reflected the preparation for the introduction of the euro in Slovakia. In cooperation with the European Commission, the exhibition Euro Coins Genesis Expo was held in Bratislava and Košice from September to November, offering the public a closer look at the selection process for the designs on the common and national sides of the euro coins.

In accordance with the National Euro Changeover Plan for the Slovak Republic, the National Bank of Slovakia prepared a public opinion survey on the



proposed designs for the national sides of Slovakia's euro coins. NBS Governor Ivan Šramko announced the opinion survey at a press conference held on 11 November 2005, and at the same time introduced the ten designs that the public could vote on between 12 and 20 November by means of the Internet, SMS or fixed-line telephone. The survey received a good response from the public and 140,653 votes were received. The final results were announced at a press conference on 20 December 2005.

Under the National Euro Changeover Plan, the Slovak Government in cooperation with the National Bank of Slovakia established six working committees for the euro changeover. The NBS is the coordinator of two committees, one being the Working Committee for Communication.

One of the aims of NBS communication policy is to provide the broad public with appropriate information

about the NBS's activities. It is in this context that the NBS organizes visits for school children and students, comprising a lecture and tour of the exposition "Ten Years of the Slovak Currency". For interested parties, the NBS provides technical information on its headquarters building, including a video film on its construction. In 2005 the NBS organized 15 lectures for approximately 900 participants.

As regards internal and external communication, the NBS also provides library-information services. At the end of 2005, the online library catalogue contained 35,000 documents and 416 periodical titles in the area of economics and central and commercial banking. For meeting the NBS's core tasks, NBS divisions have at their disposal a whole range of specialized databases and electronic tools. Public access to information and documents is provided through the reading room and a full range of reference, bibliographical and research services.

Statistics



12 Statistics

The National Bank of Slovakia collects, compiles and publishes various types of statistics, the main purpose of which is to support the implementation of monetary policy and financial stability. Following the Slovak Republic's accession to the European Union, and based on systematic preparations made in the preceding years, the NBS compiles and publishes harmonized statistics in accordance with the requirements of the European Central Bank (ECB). As regards the mid-term outlook in statistics, the NBS will assist in harmonization activities aimed at meeting the requirements of the ECB, other Community institutions, as well as various international institutions.

Evaluating developments in monetary and banking statistics

The transition from a national methodology for monetary and banking statistics to the harmonized methodology of the ECB began to be made in 2002.

During 2003, this process centred on a new concept for compiling balance sheet statistics for the institutional sector of monetary financial institutions (the central bank, banks and branches of foreign banks, money market investment funds), monetary aggregates, and the M3 aggregate's counterparty assets. To this end, it was necessary to change both the structure of the reported financial instruments, and the methodology of the source reports from which status data on the banking sector is compiled. Data on balance sheet statistics for money market investment funds have been reported since 2004, as have the data for central government (State Treasury), thus completing the harmonization of statistics for the compilation of the monetary aggregate M3. The reporting of data on financial non-transactions (revaluations, credit write-offs, reclassifications) has been introduced for the compiling of balance flow statistics (as net transactions), and from 2005, the year-on-year growth rate for selected items of the monetary survey has been calculated in accordance with the ECB methodology.

For the purpose of compiling statistical balance sheets, updating is carried out on the register for resident monetary financial institutions.

As regards the compilation of interest rate statistics for the banking sector, the harmonization process

was completed during the course of 2004 and 2005 by incorporating the requirements for status data, the reporting of so-called new transactions arising from deposits made and credits provided, as well as the methods used to calculate interest rates (arranged annual, cost). Particular categories of financial instruments have also been adapted to the product innovations on the banking market.

Balance sheet statistics for other financial intermediaries have been provided since 2004, compiled for individual resident investment funds (share, bond and mixed funds, and funds of funds). Preparations are also underway to extend reporting so that it covers companies providing financial leasing, hire purchase and factoring. The first data for this sector will be available during 2006.

For the purpose of examining convergence, the NBS has cooperated with the Bratislava Stock Exchange and the Central Securities Depository to introduce statistical reporting of long-term interest rates for representative long-term government bonds, as well as statistics on activities in the primary and secondary market.

The mutual correlation and usability of monetary and banking statistics with other types of statistics is most clearly shown by the fact that data for balance sheet statistics are employed not only for compiling the monetary survey, but also as bases for compiling quarterly financial account statistics and for ensuring the calculation of mandatory minimum reserves, bank development statistics, financial stability (prudence analyses), balance of payment statistics, structural statistical indicators, and payment system statistics.

In accordance with ECB and Eurostat requirements for compliance with the conceptual bases of monetary statistics, the harmonization of reporting for the central bank and other monetary and financial institutions was successfully continued during the course of 2005. The presentation and accessibility of the data was expanded both on the website and in publications.

A key component is the technical provision for data exchange. A spreadsheet and "upgrade" of the collection system APS Status was implemented in 2005.



In connection with arrangements for incorporation of the Financial Market Authority into the NBS, preparatory work was begun on creating a unified means of collection and database of information on financial market entities. In cooperation with the Statistical

Office of the SR, technical parameters were agreed for data exchange for the purpose of compiling quarterly financial accounts. Data exchange is also arranged with the ECB under the standardized system Gesmes/TS.

**Independent Auditors'
Report and Financial
statements of the NBS
for the year ended
31 December 2005**





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Independent Auditors' Report to the Bank Board of Národná banka Slovenska

We have audited the accompanying financial statements of Národná banka Slovenska ('the NBS') for the year ended 31 December 2005, which comprise the balance sheet, the related profit and loss account for the year then ended and the notes. These financial statements are the responsibility of the Bank Board of the NBS. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures included in the financial statements. An audit also includes assessing the accounting principles used in preparing the financial statements and significant estimates made by the Bank Board of the NBS, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion the accompanying financial statements present fairly, in all material respects, the financial position of the Národná banka Slovenska at 31 December 2005 and of the results of its operations for the year then ended in accordance with the Slovak Act on Accounting.

Bratislava
21 March 2006



Ernst & Young Slovakia, spol. s r. o.
SKAU Licence No. 257



Ing. Dalimil Draganovský
SKAU Licence No. 893

THIS IS A TRANSLATION OF THE ORIGINAL SLOVAK REPORT

Ernst & Young Slovakia, spol. s r. o., IČO: 35 840 463, zapísaná v Obchodnom registri Okresného súdu Bratislava I, oddiel: Sro, vložka číslo: 27004/B a v zozname audítorov vedenom Slovenskou komorou audítorov pod č. 257.



The Ministry of Finance of the Slovak Republic
Decree No. MF/8338/2005-74

BALANCE SHEET
of Národná banka Slovenska
in millions of SKK

Assets

	Notes	As at 31.12.2005	As at 31.12.2004
1. Gold	6.	18,450	14,067
2. Debt securities denominated in foreign currency	7.	447,776	352,075
3. Derivatives	8.	52	25
4. Receivables from banks and central banks	9.	191,864	151,361
4.1. current accounts, deposits, and loans denominated in foreign currency	9.1.	188,028	146,638
4.2. loans related to monetary policy operations in SKK			
4.3. receivables not related to monetary policy operations in SKK	9.2.	3,836	4,723
5. Receivables from the International Monetary Fund	10.	3,934	3,801
6. Receivables from clients	11.	210	7,587
7. Equity shares in subsidiary and affiliated accounting units and other shares and participating interests	12.	483	363
8. Non-current assets	13.	6,422	6,576
8.1. depreciable		6,082	6,250
8.2. non-depreciable		340	326
9. Other assets	14.	119	107
TOTAL ASSETS		669,310	535,962



Liabilities

	Notes	As at 31.12.2005	As at 31.12.2004
1. Currency in circulation	15.	130,110	109,900
2. Liabilities to banks and central banks	16.	559,138	329,426
2.1. current accounts denominated in SKK	16.1.	1,998	1,149
2.2. Overnight deposits, loans and deposits denominated in SKK, and minimum reserves	16.2.	392,577	240,568
2.3. current accounts, deposits, and loans denominated in foreign currency	16.3.	164,563	87,709
3. Liabilities from debt securities	17.	20,004	59,725
3.1. denominated in SKK	17.	20,004	59,725
3.2. denominated in foreign currency			
4. Derivatives	8.	1,545	
5. Liabilities to the International Monetary Fund	10.	3,893	3,762
6. Liabilities to other international financial institutions	18.	670	683
7. Liabilities to clients	19.	3,953	86,054
8. Reserves and other liabilities	20.	362	488
9. Statutory fund		467	467
10. Funds from profit appropriations and capital fund		10,208	10,242
11. Valuation differences from revaluation of		16,260	11,874
11.1. gold		16,260	11,874
11.2. derivatives			
11.3. securities			
11.4. foreign currencies			
12. Retained profit / (outstanding loss) from previous years		(76,637)	(40,370)
13. Profit / (loss) for the current accounting period	21.	(663)	(36,289)
TOTAL LIABILITIES		669,310	535,962



The Ministry of Finance of the Slovak Republic
Decree No. MF/8338/2005-74

INCOME STATEMENT
of Národná banka Slovenska
in millions of SKK

	Notes	At 31.12.2005	At 31.12.2004
1. Interest income and similar revenues		12,733	10,183
1.1. on SKK - denominated loans related to monetary policy operations		32	30
1.2. on SKK - denominated receivables not related to monetary policy operations		165	742
1.3. on receivables and securities denominated in foreign currency		12,536	9,411
a. Interest expense and similar expenses		(13,045)	(16,035)
a.1. on SKK - denominated liabilities related to monetary policy operations and from securities		(12,344)	(11,427)
a.2. on SKK - denominated liabilities not related to monetary policy operations		(556)	(4,276)
a.3. on liabilities and securities denominated in foreign currency		(145)	(332)
I. Net interest (loss)	22.	(312)	(5,852)
2. Revenues from fees and commissions		158	155
b. Expenses on fees and commissions		(31)	(28)
II. Net profit from fees and commissions	23.	127	127
3./c. Net (loss) / profit from operations in, and derivatives involving, securities denominated in foreign currency	24.	(1,592)	1,166
4./d. Net profit / (loss) from operations in, and derivatives involving, foreign exchange and gold	25.	2,939	(29,898)
5. Revenues from dividends and other profit distributions	12.2.	29	40
6. Revenues from currency in circulation		7	49
e. Expenses on currency in circulation		(169)	(218)
III. Net (loss) from currency in circulation	15.	(162)	(169)
7. Revenues from dissolution of provisions and written-off receivables and securities			
f. Expenses on provisioning and the write-off of receivables and securities			
8. Other operating revenues		182	258
g. Other operating expenses	26.	(1,874)	(1,961)
g.1. Staff expenses	26.	(767)	(785)
g.2. Depreciation of tangible & intangible assets	13.	(500)	(483)
g.3. Other operating costs	26.	(607)	(693)
A. Profit / (loss) before appropriations		(663)	(36,289)
h. Profit appropriations			



The Ministry of Finance of the Slovak Republic
Decree No. MF/8338/2005-74

STATEMENT OF CHANGES IN EQUITY
of Národná banka Slovenska
in millions of SKK

	Statutory fund	Capital fund	Reserve fund	Other funds from profit appropriations	Revaluation funds	Retained profit / outstanding (loss)	Equity
1. Balance as at 31.12.2004	467	77	10,165		11,874	(76,659)	(54,076)
2. Changes in accounting methods							
3. Adjusted balance as at 31.12.2004	467	77	10,165		11,874	(76,659)	(54,076)
4. Settlement of loss from previous periods							
5. Appropriation to statutory fund							
6. Appropriation to outstanding loss		(22)				22	
7. Appropriation to reserve funds							
8. Revaluation of securities							
9. Revaluation of derivatives							
10. Change in gold revaluation fund					4,386		4,386
11. Revaluation of foreign currencies							
12. (Loss) / profit for the current accounting period						(663)	(663)
13. Profit appropriations							
14. Appropriation to social fund							
15. Change over the accounting period		(12)					(12)
16. Balance as at 31.12.2005	467	43	10,165		16,260	(77,300)	(50,365)



The Ministry of Finance of the Slovak Republic
Decree No. MF/8338/2005-74

STATEMENT OF CHANGES IN EQUITY
of Národná banka Slovenska
in millions of SKK

	Statutory fund	Capital fund	Reserve fund	Other funds from profit appropriations	Revaluation funds	Retained profit / outstanding (loss)	Equity
1. Balance as at 31.12.2003	467	77	10,165		13,289	(40,370)	(16,372)
2. Changes in accounting methods							
3. Adjusted balance as at 31.12.2003	467	77	10,165		13,289	(40,370)	(16,372)
4. Settlement of loss from previous periods							
5. Appropriation to statutory fund							
6. Appropriation to outstanding loss							
7. Appropriation to reserve funds							
8. Revaluation of securities							
9. Revaluation of derivatives							
10. Change in gold revaluation fund					(1,415)		(1,415)
11. Revaluation of foreign currencies							
12. (Loss) / profit for the current accounting period						(36,289)	(36,289)
13. Profit appropriations							
14. Appropriation to social fund							
15. Change in the accounting period							
16. Balance as at 31.12.2004	467	77	10,165		11,874	(76,659)	(54,076)



NOTES

to the financial statements as at 31 December 2005

Bratislava, 21 March 2006



NÁRODNÁ BANKA SLOVENSKA
Notes to the financial statements as at 31 December 2005
(in SKK millions)

1. General information on Národná banka Slovenska

Národná banka Slovenska (The National Bank of Slovakia – ‘the NBS’ or ‘the Bank’) is the independent central bank of the Slovak Republic. The NBS was established in accordance with Act No. 566/1992 Coll. on the National Bank of Slovakia as amended (‘the NBS Act’). It commenced its activities on 1 January 1993 as the bank of issue of the Slovak Republic. The NBS is a legal entity (Corporate ID: 30 844 789) seated at Imricha Karvaša 1, Bratislava. In respect of its own assets, the NBS acts as a business entity. The NBS has its head office in Bratislava, three branches in the Slovak Republic (in Bratislava, Banská Bystrica, and Košice), as well as special-purpose organisational units.

The Bank’s primary objective is to maintain price stability, therefore the NBS:

- determines monetary policy;
- issues banknotes and coins;
- manages, co-ordinates, and ensures money circulation, payment transactions, and the clearing of payment transaction data;
- supervises the safe functioning of the banking system and bank activities;
- represents the Slovak Republic in international financial institutions and ensures the fulfilment of tasks resulting from such representations; and
- represents the Slovak Republic in international financial market operations related to the implementation of the monetary policy.

The NBS’s supreme executive body is the NBS Bank Board (‘the Bank Board’). Until 15 December 2005, the Bank Board had eight members (in accordance with the NBS Act): the Governor, Deputy Governors, NBS Chief Executive directors, and other members. The term of the office of Bank Board members was five years. The Governor and Deputy Governors are appointed and dismissed by the President of the Slovak Republic. Chief Executive directors and other members of the Bank Board are appointed and dismissed by the Government of the Slovak Republic. According to Act No. 519/2005 Coll. of 27 October 2005, amending the NBS Act with effect from 15 December 2005, the Bank Board has eleven members: the Governor, two Deputy Governors, and eight other members, three of whom may be persons not employed by the NBS. Membership in the Bank Board is limited to a maximum of two consecutive terms of office. The NBS is represented by the Governor.

In 2005, the Bank Board members were:

Name	Term of office		Position	Date of appointment
	from	to		
Ing. Ivan Šramko	1. 1.2005	31.12.2009	Governor	1. 1.2005
Ing. Elena Kohútiková, CSc.	28. 3.2000	27. 3.2006	Deputy Governor	28. 3.2000
Ing. Martin Barto, CSc.	31. 1.2005	30. 1.2010	Deputy Governor	31. 1.2005
RNDr. Karol Mrva	1.12.2000	30.11.2006	Chief Executive Director	15. 2.1996
Ing. Peter Ševčovic	1.10.2004	30. 9.2009	Chief Executive Director	1. 4.2000
Ing. Milena Koreňová	1. 1.2005	31.12.2009	Chief Executive Director	1. 1.2002
Doc. JUDr. Ladislav Balko, PhD.	1.10.2004	30. 9.2009	Member	1.10.2004

All the costs necessary for the Bank’s activities are covered from its revenues. According to Article 38 of the NBS Act over the accounting period, the Bank generates either a profit or loss. Profit generated by the Bank is allocated to the reserve fund and to other profit reserves, or for settling losses from previous years. The remaining profit is transferred to the State budget or, based on the Slovak Government’s decision, to state financial assets under a separate regulation. The NBS may settle the loss for the current period from the reserve fund or from other reserves, or

NÁRODNÁ BANKA SLOVENSKA
Notes to the financial statements as at 31 December 2005
(in SKK millions)

the Bank Board may decide to transfer the outstanding loss to the next accounting period (see Note 21).

The Bank shall submit to the National Council of the Slovak Republic a semi-annual report on monetary development within three months of the end of the relevant calendar half-year, and an annual report on monetary development within five months of the end of the relevant calendar year. The NBS shall also submit and publish reports on the state and development of the financial market.

The Bank shall submit an annual report on its financial results to the National Council of the Slovak Republic, within three months of the end of the calendar year.

2. Basis for preparation of the financial statements

The NBS financial statements for the year ending 31 December 2005 have been prepared in accordance with the generally binding legal regulations, in particular with:

- Act No. 431/2002 Coll. on Accounting as amended by Act No. 562/2003 Coll. and Act No. 561/2004 Coll. ('Accounting Act');
- Directive No. 20 359/2002-92 of the Ministry of Finance of the Slovak Republic from 13 November 2002, setting out details on accounting procedures and the general chart of accounts for banks, branches of foreign banks, the National Bank of Slovakia, the Deposit Protection Fund, dealers in securities, branches of foreign dealers in securities, the Guarantee Fund for Investments, asset management companies, branches of foreign asset management companies, and unit trusts, as amended by Directive No. 13 593/2003-92, Directive No. 504/2004-74, Directive No. MF/6250/2004-74, Directive No. MF/11938/2004-74, and Directive No. MF/5292/2005-74 ('the Directive');
- Directive No. MF/8338/2005-74 of the Ministry of Finance of the Slovak Republic from 14 December 2005, setting out details on the arrangement, the description of items in individual financial statements, the contents of these items, and the extent of data from the financial statements designated for publishing for the National Bank of Slovakia.

The financial statements have been prepared as ordinary financial statements for the year ending 31 December 2005. Negative values in the statements and notes are shown in round brackets.

The financial statements for the year ending 31 December 2004 were approved at the 14th meeting of the NBS Bank Board on 24 March 2005.

3. Accounting principles and accounting method applied

3.1. Recognition rules

In accordance with the Directive, the Bank records an accounting entry on the day the accounting event has occurred, i.e. on the day when cash was paid or received; in the case of a direct debit, on the payment day (when withdrawing money from a third party account); in the case of securities, derivative financial instruments, and gold, on the transaction day; in the case of guarantees, on the day the guarantee was issued or received; in the case of cash in foreign currency, on the day it was credited according to the deal message received; in the case of property relations, on the day when the property title was acquired or terminated; and in the case of a shortage, deficit, or surplus, on the day the difference was identified.



NÁRODNÁ BANKA SLOVENSKA
Notes to the financial statements as at 31 December 2005
(in SKK millions)

Interest income and interest expense, fees and commissions are recognised when incurred. All costs and expenses are accounted for and disclosed in the financial statements in accordance with the accrual principle.

3.2. Principles for classifying receivables

In accordance with the Accounting Act and the Bank's internal legal regulations, the Bank assesses the level of risks related to receivables. These receivables are classified and provisions are set up in compliance with the principle of fair presentation in accounting. According to the risk assessment, the Bank classifies receivables into the following categories: standard, standard with qualification, non-standard, doubtful, and loss making.

Bad debts are written off based on a court decision and upon the Bank Board's decision and the related provisions are released into revenues.

3.3. Conversion of foreign currencies

Assets and liabilities denominated in foreign currencies are converted to SKK applying the NBS rate on the day of the accounting event, and for the financial statements the exchange rate at 31 December 2005. All exchange gains and losses are shown in the income statement.

The exchange rates of main foreign currencies applied for the valuation of assets and liabilities at 31 December 2005 were:

Currency	Amount	2005	2004
EUR	1	37.848	38.796
USD	1	31.948	28.496
JPY	100	27.103	27.455
XDR	1	45.659	44.123

3.4. Transactions related to monetary policy operations and foreign exchange reserve management

In accordance with the NBS Act, the Bank Board defines the NBS's monetary policy, specifies the instruments to be used for its implementation, and decides on monetary policy measures. To ensure the implementation of monetary policy, the Bank has at its disposal the following instruments: base interest rates, open market operations (repo tenders, issues of NBS bills, direct purchase or direct sale of government securities and NBS bills, foreign exchange swaps), overnight refinancing and overnight money withdrawing operations, minimum reserve requirements, and the exchange rate regime (floating or fixed exchange rate for the SKK after the entry the Slovak Republic into exchange rate mechanism ERM II, from 25 November 2005).

The Bank manages its foreign exchange reserves mainly through financial operations in securities denominated in foreign currency, the acceptance of loans from foreign entities, the purchase of foreign currency from banks and branches of foreign banks, and financial operations in foreign currencies and gold aimed at their valuation.

Operations related to monetary policy implementation and foreign exchange reserve management are recorded in lines 1, 2, 3, 4.1 of the balance sheet under assets; lines 2.2, 2.3, 3, 4 under liabilities; and in lines 1.1, 1.3, a.1, a.3, II., 3./c, 4./d in the income statement. Details on the individual items are shown in notes 6, 7, 8, 9.1, 16.2, 16.3, 17, 22, and 25.

NÁRODNÁ BANKA SLOVENSKA**Notes to the financial statements as at 31 December 2005
(in SKK millions)****3.5. Repurchase and reverse repurchase transactions**

Transactions in which the Bank accepted securities in exchange for cash, along with the commitment to return these securities at a certain date in exchange for the transferred cash amount plus interest (reverse repurchase transaction), are recorded as loans provided. The collateral accepted in a reverse repurchase transaction is recorded at fair value in the off-balance sheet and is re-valued at the balance-sheet date. The revaluation of the collateral does not have any impact on either the balance sheet or the income statement.

Transactions in which the Bank provided securities or gold in exchange for cash, along with the commitment to accept back these securities or gold at a certain date in exchange for the original cash amount plus interest (repurchase transaction), are recorded as received loans with a transfer of collateral. The collateral provided in a repurchase transaction remains on the balance sheet and is fair valued at the balance sheet date.

Except for repurchase and reverse repurchase transactions performed by the Bank directly, the Bank has authorised, on the basis of the Securities Lending Agreements, certain banks to trade in securities held by the Bank. Based on these Agreements, the selected banks provide securities held by the NBS in the name of the NBS in exchange for cash, along with the commitment to accept these securities back (repurchase transaction), and subsequently accept securities on the NBS's account in exchange for cash from the previous repurchase transaction, along with the commitment to return these securities (reverse repurchase transaction), or to invest the cash received into term deposits under agreed limits. In these transactions, the Bank receives part of the revenue (which is the difference between the costs of repurchase transactions and revenues from reverse repurchase transactions or term deposits) that is disclosed in the income statement. Transactions the selected banks perform with the NBS securities under the Securities Lending Agreements have been shown on the Bank's balance sheet since 2004 (see Notes 9.1, 16.3.1, 23).

The Bank's market and credit risks in these transactions are minimised through the specification of products in which the cash received can be invested, as well as the counterparties with whom deals are allowed to be performed.

3.6. Provisions

Provisions are liabilities of uncertain timing or amount, arising from past events and the settlement of which is expected to result in an outflow of resources embodying economic benefits. They can be measured in accordance with the Accounting Act and are disclosed in the financial statements.

3.7. Currency in circulation

The NBS administers the issue of banknotes and coins and their withdrawal from circulation. The respective liability from the issue of currency in circulation is stated on the balance sheet at its nominal value.

3.8. Cost of employee benefits

The social fund, the remuneration fund, and the retirement fund, which were set up in the past to cover employee benefits, are recorded on the respective liability accounts.



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The NBS pays regular contributions on behalf of its employees to health insurance agencies for health insurance and to the Social Insurance Agency for sickness, retirement, accident, guarantee, and unemployment insurance, and a contribution to the Guarantee Fund. Contributions are paid in the amounts required by law in the respective year. The Bank also pays a contribution for not employing the obligatory percentage of persons with a disability, as set out in the Employment Act.

In co-operation with agencies offering additional retirement insurance, the NBS has created an additional pension scheme for its employees.

3.9. Taxation

The NBS is only liable to corporate income tax arising from the application of withholding tax in accordance with Article 12 of Act No. 595/2003 Coll. on Income Taxes as amended ('Income Taxes Act').

Since 1 July 2004, the NBS is registered as a VAT payer.

4. Valuation methods

In the valuation of assets and liabilities, the NBS follows the provisions of Articles 24 to 28 of the Accounting Act. At the date of the accounting transaction, assets and liabilities are stated either at their acquisition cost, nominal value, production cost, or at their replacement cost. At the balance sheet date, selected items of assets and liabilities are re-valued as follows:

- securities at their market value, except for shares in the registered capital of accounting units and securities issued by the Bank; and
- derivatives at their market value, or at the value set by an expert valuation.

If it is not possible to determine an objective fair value at the valuation date, the Bank uses the valuation in accordance with Article 25 of the Accounting Act.

4.1. Gold

Gold is stated at its fair value based on the market price of London's commodity market morning fix of gold in USD/oz. (troy ounce). Changes in the fair value of gold affect the Bank's equity. The sale of gold is reflected in the income statement. The Bank uses and records gold as a financial instrument (see Note 6).

As a result of gold revaluation to its fair value in 2003, a gold revaluation fund was created, the balance of which represented the difference between the market price of gold at 31 December 2002 of 342.75 USD/oz. and its historical acquisition cost of 62.54451 SKK/g (see Note 6). When selling gold, the revaluation related to the respective amount of sold gold is transferred from this reserve to the profit/(loss).

Swap transactions in gold are recorded in accordance with the effective regulations as repurchase transactions in gold. This means that gold used in these transactions as collateral is part of the balance sheet amount under the caption 'Gold'.

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Notes to the financial statements as at 31 December 2005
(in SKK millions)

4.2. Securities in portfolio

In accordance with the Accounting Act and the Directive, based on purpose of acquisition, the Bank is obliged to classify securities into the following categories:

- securities held for trading,
- equity shares in accounting units and subsequently they

were valued according to Article 24 and Article 27 of the Accounting Act.

4.2.1. Securities held for trading

When initially recognised, zero-coupon bonds are stated at their acquisition cost, which is gradually increased by the accrued difference between the acquisition cost and the nominal value – the discount. This accrued discount is part of interest income.

Coupon bonds, when initially recognised, are stated at their net acquisition cost (without the purchased coupon) which is gradually amortised for the accrued difference between the net acquisition cost and the nominal value (discount or premium), which is part of interest income. The coupon is interest income that is accrued on a monthly basis.

Securities classified as held for trading are fair valued at the balance sheet date. The fair value is the market price announced on public markets; if the market price is not available, a valuation based on an appropriate estimate is used.

Changes in fair values affect the Bank's profit/(loss).

Upon disposal, securities are valued at the weighted average cost. This valuation method is used for the same type of securities only if they are from the same issuer and are denominated in the same currency.

4.2.2. Shares and ownership interests in affiliated accounting units

The Bank has an ownership interest with significant influence in the company RVS, a.s. Bratislava (see Note 12.1). Shares of RVS, a.s. Bratislava are stated at acquisition cost.

4.2.3. Other investments

The Bank has an equity stake in the Bank for International Settlement, Basel, Switzerland ('BIS'). Shares in the BIS are stated at acquisition cost. The equity interest in the BIS is disclosed in the amount of the paid-up share (25%). The unpaid part (75%) is due upon request.

Dividends are paid out from the NBS's total share in the BIS in Swiss francs (see Note 12.2).

On 1 May 2004, the NBS became a member of the European System of Central Banks ('ESCB'). In accordance with the Statute of the European Central Bank ('ECB'), the NBS has paid the initial minimum contribution to the ECB's capital. The amount of the total capital share of individual national central banks depends on the capital key determined on the basis of the following statistical categories: GDP and population. In accordance with the Protocol on the Statute of the ESCB and the ECB, the capital key is adjusted every five years or when new members enter the ESCB. The Bank has paid an initial contribution to the ECB's capital in the amount of 7% of the



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NBS's total contribution. The remaining share (93%) is due when the Slovak Republic joins the European Monetary Union (see Note 12.2).

4.3. Derivatives

Derivatives are shown on the balance sheet at their fair value. As the conditions for assessing fixed term and option contracts that the Bank concluded in the past do not meet all the criteria for hedge accounting, the Bank has classified these derivatives as held for trading. The Bank uses and records derivatives as financial instruments.

Derivatives are recorded at fair value, based on market prices, discounted cash flows, or (in the case of options) the Black-Scholes model. Changes in their fair values are recorded in the income statement.

The main risks affecting derivatives are the price volatility of gold and changes in interest rates.

Embedded derivatives in other financial instruments are disclosed as separate derivatives when the risks involved are not connected closely with the risks and characteristics of the underlying instrument.

4.4. Loans and provisions

Loans are shown on the balance sheet at the amortised cost, i.e. at the principal amount increased by the accrued but, as yet, unpaid interest. The loans granted are shown after any provisions for potential losses. Provisioning and dissolution of provisions are reflected in the income statement.

4.5. Liabilities arising from debt securities

The Bank issues short-term securities falling due within one year (NBS bills). In 2005, they were issued for creating a sufficient stock of securities to perform money withdrawing repurchase transactions. Money withdrawing repurchase transactions were connected with the implementation of monetary policy in transactions on the open market operations.

From the settlement date of the issue to the due date, the valuation of issued and sold NBS bills is gradually increased by the accrued interest (the so-called amortised cost). On the balance sheet, issued NBS bills are shown set off by any bills repurchased to the NBS portfolio, including the accrued interest.

4.6. Non-current assets

Non-current assets include tangible and intangible assets, the acquisition cost of which is higher than the limit set out in the Income Taxes Act and whose economic useful life is longer than one year. On the balance sheet, they are stated at acquisition cost, including the costs related to their acquisition. The carrying value of depreciated non-current assets is shown net of accumulated depreciation. The respective valuation allowance expresses the difference between the lower realisable value of the asset and its book value after deducting the accumulated depreciation. Land, art collections, and tangible fixed assets in progress are not subject to depreciation.

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The NBS's non-current assets were classified into individual depreciation groups and depreciated on a straight-line basis in accordance with the depreciation plan.

Depreciation group	2005	
	Depreciation period in years	Annual depreciation rate in %
1. Office equipment, data processing machines, passenger cars and vans	4	25.0
2. Devices and personal technical equipment	6	16.7
3. Security equipment	12	8.4
4. Energy equipment	20	5.0
5. Buildings and structures	30	3.4
6. Objects depreciated under a special rate	separately specified	separately specified

4.7. Inventories

Inventories are stated at acquisition cost, i.e. including the costs related to their acquisition.

5. Related party transactions

In 2005, the Bank Board members received remuneration in the total amount of SKK 7 million (SKK 6 million in 2004). The members of the Bank Board employed by the NBS also earned salaries at the Bank, according to their positions.

At 31 December 2005, the Bank recorded receivables from loans granted to Bank Board members in the total amount of SKK 11 million (SKK 9 million at 31 December 2004).

6. Gold

Gold consisted of the following items:

	2005	2004
Bullion in standard form	18,289	13,932
Gold in other form	161	135
	<u>18,450</u>	<u>14,067</u>

During 2005, the NBS used gold deposits in the amount of 200 thousand ounces, in repurchase transactions (see Note 8).

At 31 December 2005, the item 'Gold' comprised 1,126 thousand ounces of gold, of which 516 ounces were deposited in correspondent banks, 600 thousand ounces were used in repurchase transactions, and 10 thousand ounces were held by the Bank.

The value of gold provided as collateral in repurchase transactions amounted to SKK 9,840 million at 31 December 2005 (see Note 16.3.1), (SKK 4,995 million at 31 December 2004).

The market value of gold was 513 USD/oz. at 31 December 2005 (438 USD/oz. at 31 December 2004). The weakening of the SKK/USD exchange rate (see Note 27), coupled with the



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growth in the market price of gold, positively affected the amount reported in the item 'Gold' at fair value and the item 'Gold revaluation fund' (see Note 21). At 31 December 2005, the fund balance was SKK 16,260 million (SKK 11,874 million at 31 December 2004).

During 2005, the Bank sold 60 ounces of gold in the form of commemorative coins.

7. Debt securities

At 31 December 2005, the Bank's portfolio of securities held for trading comprised the following items (at fair value):

	2005	2004
State zero-coupon bonds	111,379	95,533
State coupon bonds	132,011	132,177
Coupons	2,233	1,966
Securities of state bodies - total	245,623	229,676
Zero-coupon bonds of foreign central banks		5,800
Other zero-coupon bonds	27,941	31,916
Other coupon bonds	170,965	83,058
Coupons	3,247	1,625
Securities of other entities - total	202,153	122,399
Securities - total	447,776	352,075

According to the issuer of securities the sector breakdown of the Bank's portfolio of securities is as follows:

	2005	2004
Public sector	268,549	250,791
Financial institutions	129,232	69,171
Financial auxiliaries	49,995	24,342
Non-financial corporations		7,771
Securities - total	447,776	352,075

According to the issuer of securities the Bank registered at 31 December 2005 securities from EMU countries in the amount of SKK 342,964 million (SKK 271,944 million at 31 December 2004) and securities from other countries, including international institutions, in the amount of SKK 104,812 million (SKK 80,131 million at 31 December 2004). The Bank trades in securities on foreign financial markets, mainly in New York, London, Basel, and in euro-zone countries. These mostly involve transactions outside the stock exchanges.

The NBS provided 90 securities as collateral (55 securities at 31 December 2004) in the nominal value of SKK 164,118 million (SKK 81,813 million at 31 December 2004), the fair value of which was SKK 164,215 million at 31 December 2005 (SKK 82,343 million at 31 December 2004).

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8. Derivatives

The fair value of derivatives is as follows:

	2005		2004	
	Assets	Liabilities	Assets	Liabilities
Currency swap		731		
Interest rate swap			25	
Put options purchased	52			
Call options sold		814		
	<u>52</u>	<u>1,545</u>	<u>25</u>	<u>0</u>

At 31 December 2005, the Bank recorded a currency swap with maturity in February 2006, with a possibility for extension. In the initial swap, the Bank sold EUR 840 million and received SKK 32,835 million. At 31 December 2005, the currency swap had a negative fair value SKK 731 million.

The interest rate swap in gold recorded at 31 December 2004 was completed in August 2005.

To eliminate the risk of reducing the market price of gold, the NBS purchased European put options for gold. At present, the Bank records two European put options for 400,000 ounces of gold with a realisation price of 259.00 USD/oz. and 295.30 USD/oz. respectively due in January and March 2007 (see Note 6).

The Bank concluded two repurchase transactions in gold ('gold repos') in 2005. At the beginning of the gold repo transaction, the Bank sold gold and obtained a long-term loan in the amount of USD 85 million (see Note 16.3.1). At the end of the gold repo transaction in August 2005, the Bank will purchase gold at a price agreed in advance and will in this way repay the long-term loan. To eliminate the risk of a decrease in the market price of gold, the NBS purchased two European put options for 200,000 ounces of gold within the scope of the gold repos (see Note 6), with an exercise price of 443.50 USD/oz., and in order to increase its income from the gold reserves, the Bank sold two European call options for the same amount of gold at a realisation price of 750 USD/oz. and 700 USD/oz. The options may be realised at the end of the gold repo transaction in August 2005. Option premiums for the purchased and sold options were not paid, but were incorporated in the rate of interest (lower than the market rate) for the long-term loan accepted by the Bank. The options are embedded derivatives and were therefore separated from the accepted loan (they are recorded separately).



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9. Receivables from banks and central banks

9.1. Current accounts, deposits, and loans in foreign currency

	2005	2004
Securities Lending	154,905	82,998
Loans granted in repurchase transactions in foreign currency	19,481	51,382
Deposits	13,392	11,986
Receivables from banks in the European System of Central Banks	75	45
Loans granted to commercial banks for the support of business activities in foreign currency	61	105
Other	114	122
	<u>188,028</u>	<u>146,638</u>

At 31 December 2005, the Bank recorded based on Securities Lending Agreements, receivable from repurchase transaction of SKK 154,905 million, of which SKK 40,700 million were in USD and SKK 114,205 million in EUR.

The value of securities accepted as collateral within the scope of Securities Lending operations was at SKK 168,247 million at 31 December 2005 (SKK 84,211 million at 31 December 2004), of which SKK 126,410 million were in EUR (SKK 55,214 million at 31 December 2004) and SKK 41,837 million in USD (SKK 28,997 million at 31 December 2004).

Loans provided in repurchase transactions with foreign entities total SKK 19,481 million, which were all granted in EUR. The value of securities accepted as collateral in a Tri-party Reverse Repo transaction at 31 December 2005 was SKK 19,478 million (SKK 51,374 million at 31 December 2004). The collateral accepted was composed of securities in EUR.

The item 'other' covers the Bank's current accounts abroad, in countries outside the European System of Central Banks.

9.2. Receivables not related to monetary policy operations in SKK

	2005	2004
Loans granted to domestic banks for the support of business activities by JBIC (Japan Bank for International Cooperation) and EIB in SKK	528	698
Redistribution loans	3,282	3,913
Other	26	112
	<u>3,836</u>	<u>4,723</u>

Loans accepted from foreign banks (JBIC and EIB) are determined for the support of small and medium-sized enterprises and specific industry of the Slovak economy.

At 31 December 2005, the NBS recorded a state guarantee accepted for a redistribution loan provided of SKK 3,815 million (SKK 4,989 million at 31 December 2004). The state guarantee is provided for the amount of principal, plus interest to maturity. The decrease in the volume of state guarantees is compared to 2004 results from repaying a redistribution loan in 2005.

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10. Receivables from and liabilities to the International Monetary Fund

At 31 December 2005, the Bank recorded a receivable from the International Monetary Fund ('IMF') of XDR 357 million, which corresponded to SKK 16,629 million (SKK 17,713 million at 31 December 2004), from the membership quota of the Slovak Republic, converted to SKK using the representative XDR exchange rate set by the IMF. In accordance with the IMF statutes, 25% of the membership quota is due in XDR and 75% in SKK.

The Bank records a liability to the IMF on the part of the Government of the Slovak Republic in the amount of SKK 16,629 million (SKK 17,713 million at 31 December 2004), representing mainly a non-transferable and non-interest-bearing promissory note payable on demand.

The membership quota in SKK and the related liability are netted off on the balance sheet. The receivable from and liability to the IMF shown on the balance sheet represent 25% of the membership quota paid up in XDR and converted to SKK using the NBS exchange rates at 31 December 2005 and 2004, and 25% of the promissory note payable on demand.

11. Receivables from clients

	2005	2004
Employees	210	206
Other clients		7,381
	<u>210</u>	<u>7,587</u>

The assignment of a receivable from a granted loan of the Deposit Protection Fund affected the amount of the 'Other Clients' caption on a year-on-year basis. The new creditors of the assigned receivables are Slovenská sporiteľňa, a.s., Všeobecná úverová banka, a.s., and Tatrabanka, a.s.

12. Ownership interests in subsidiary and affiliated accounting units and other shares and equities
12.1. Ownership interests in affiliated accounting units

At 31 December 2005, the Bank held 1,080 certificated shares of RVS, a.s. in the amount of SKK 108 million (SKK 108 million at 31 December 2004), which represented a 41.13% share in the share capital (40.51% at 31 December 2004). RVS, a.s. is doing business in the area of relaxation-educational activities. The share capital of the company was in the amount of SKK 263 million at 31 December 2005 (SKK 267 million at 31 December 2004). Based on the general meeting's resolution, the share capital of the company was reduced in July 2005, through the purchase of shares. Since the NBS did not offer to RVS, a.s. shares for sale, its capital stake at this company increased. In 2005, the Bank received no dividends (SKK 11 million in 2004).

Even though the Bank's share in RVS, a.s. Bratislava is significant, the NBS does not prepare consolidated financial statements according to Article 22 of the Accounting Act.



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12.2. Other investments

At 31 December 2005, the Bank held 2,858 shares in the BIS valued at SKK 759 million (SKK 589 million at 31 December 2004), which represented a 0.52% share in the BIS's share capital. Each share has been paid up to 25% of its nominal value. The liability from the unpaid share at 75% of the nominal value of each share amounts to SKK 489 million (SKK 442 million at 31 December 2004). The share in the BIS is disclosed on the balance sheet at SKK 270 million, i.e. 25% of the paid share (SKK 147 million at 31 December 2004).

In 2005, the BIS paid dividends to the NBS of SKK 29 million (SKK 29 million in 2004).

At 31 December 2005, the NBS shows the initial paid-up contribution to the ECB's shares at SKK 105 million (EUR 2,784 thousand), which represented a 7% share of the Bank's total capital share. The total share of the NBS in the ECB's subscribed capital is 0.7147%. The remaining share is due when the Slovak Republic joins the European Monetary Union.

13. Non-current assets

Non-current tangible and intangible assets were recorded in 2005:

	Land	Other non-depreciable tangible assets	Buildings and constructions	Technological equipment and machines	Other depreciable tangible assets	Software and other intangible assets	Advances paid for tangible and intangible assets	Total
Acquisition cost as at 1 January 2005	285	42	5,898	2,119	548	198	86	9,176
Additions		14	35	63	3	23	348	486
Disposals			3	263	14	38	139	457
Acquisition cost as at 31 December 2005	<u>285</u>	<u>56</u>	<u>5,930</u>	<u>1,919</u>	<u>537</u>	<u>183</u>	<u>295</u>	<u>9,205</u>
Acc. depreciation as at 1 January 2005			615	1,417	379	151	38	2,600
Additions			199	235	47	19		500
Disposals			3	261	15	38		317
Acc. depreciation as at 31 December 2005			<u>811</u>	<u>1,391</u>	<u>411</u>	<u>132</u>	<u>38</u>	<u>2,783</u>
Book value of tangible & intangible assets as at 1 January 2005	<u>285</u>	<u>42</u>	<u>5,283</u>	<u>702</u>	<u>169</u>	<u>47</u>	<u>48</u>	<u>6,576</u>
Book value of tangible & intangible assets as at 31 December 2005	<u>285</u>	<u>56</u>	<u>5,119</u>	<u>528</u>	<u>126</u>	<u>51</u>	<u>257</u>	<u>6,422</u>

14. Other assets

These Notes are an integral part of the financial statements of Národná banka Slovenska.

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Other assets comprise items arising from supplier-consumer relations, funds in foreign currency, advance payments, and inventories.

At 31 December 2005, the Bank recorded 2006 provisions for debtors of SKK 47 million and provision for advance of SKK 38 million.

15. Currency in circulation

The issue of banknotes and coins represents the valid national bank notes and coins in circulation:

	2005	2004
Issued coins	2,503	2,372
Issued bank notes	127,607	107,528
	<u>130,110</u>	<u>109,900</u>

At 31 December 2005, net loss from currency in circulation amounted to SKK 162 million (SKK 169 million at 31 December 2004).

The NBS will continue to exchange the 10 and 20 haler coins for free, the validity of which was terminated in 2003, until 31 December 2008.

16. Liabilities to banks and central banks**16.1. Current accounts in SKK**

	2005	2004
Current accounts of banks in SKK	1,990	1,144
Other	8	5
	<u>1,998</u>	<u>1,149</u>

16.2. Overnight deposits, deposits and loans in SKK, and required reserves

	2005	2004
Loans received in repurchase transactions in SKK	363,788	219,041
Required reserve in the NBS	14,264	10,949
Overnight deposits from banks	14,126	8,778
Interbank settlement in SKK	399	1,800
	<u>392,577</u>	<u>240,568</u>

Within the money withdrawing repurchase transactions in the Slovak inter-bank market, the NBS recorded liabilities from repurchase transactions in the total amount of SKK 363,788 million at 31 December 2005 (SKK 219,041 million at 31 December 2004). For money withdrawing activities, NBS bills of SKK 365,381 million (SKK 220,658 million at 31 December 2004 – see Note 17) were used.



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16.3. Current accounts, deposits and loans in foreign currency

16.3.1. Loans received

Type of loan received	Loan maturity in year	FC code	2005		2004	
			FC	SKK	FC	SKK
Securities Lending		EUR	3,077	116,471	1,435	55,671
Securities Lending		USD	1,273	40,697	998	28,455
Gold repo	2015	USD	85	2,507		
Gold repo	2007	USD	115	3,691	115	3,272
AGL II	2009	EUR	3	116	5	194
			x	163,482	x	87,592

At 31 December 2005, the Bank recorded liabilities from Securities Lending Agreements of SKK 157,168 million (SKK 84,126 million at 31 December 2004), of which those in USD totalled SKK 40,697 million and those in EUR totalled SKK 116,471 million, and liabilities of SKK 6,198 million from gold repurchase transactions (SKK 3,272 million at 31 December 2004).

16.3.2. Deposits

	2005	2004
Current accounts of clients	1,068	112
Current accounts of banks within the European System of Central Banks	13	5
	1,081	117

17. Liabilities from debt securities

At 31 December 2005, the NBS issued bills of SKK 520,004 million (SKK 659,725 million at 31 December 2004 – see Note 4.5).

At 31 December 2005, NBS bills of SKK 385,385 million were used for money withdrawing activities (SKK 280,383 million at 31 December 2004), of which SKK 365,381 million (SKK 220,658 million at 31 December 2004) were in the form of money withdrawing repurchase transactions and SKK 20,004 million (SKK 59,725 million at 31 December 2004) in the form of direct issues in the portfolios of domestic banks.

18. Liabilities to other international financial institutions

Liabilities to other international institutions comprise deposits from the World Bank of SKK 669 million (SKK 682 million at 31 December 2004) and PHARE funds in the amount of SKK 1 million (SKK 1 million at 31 December 2004).

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19. Liabilities to clients

	2005	2004
Accounts of government	2,952	10,433
Settlement of special operations with the funds of the Slovak Republic		70,803
Public sector	206	3,424
Current accounts of employees	191	178
Term deposits of employees	507	1,001
Other	97	215
	<u>3,953</u>	<u>86,054</u>

The year-on-year decrease in funds on State accounts and on the accounts of settlement of special operations with the funds of the Slovak Republic are mainly connected with the transfer of clients and the special-purpose term deposit of the Ministry of Finance of the Slovak Republic for the pension reform to the State Treasury.

20. Provisions and other liabilities

	2005	2004
Provisions	176	151
Liabilities to suppliers	108	52
Other	78	285
	<u>362</u>	<u>488</u>

At 31 December 2005, the Bank recorded provisions for liabilities to employees of SKK 157 million (SKK 138 million at 31 December 2004) and provisions for outstanding lawsuits and unbilled supplies of SKK 19 million (SKK 13 million at 31 December 2004).

The item 'other' covers settlement with the State budget and accruals and deferrals.

21. Equity

At 31 December 2005, the NBS recorded a loss of SKK 663 million and negative equity of SKK 50,365 million (SKK 54,076 million at 31 December 2004). On a year-on-year basis, the Bank's negative equity decreased by SKK 3,711 million, due to the revaluation of gold to its market price (see Note 6). The differences from the revaluation of gold to market value were reflected in the gold revaluation fund, which is part of equity, without affecting the Bank's profit/(loss) for the current period. The market price of gold rose by 75 USD/oz., from 438 USD/oz. at 31 December 2004 to 513 USD/oz. at 31 December 2005.

The losses of the NBS will be covered from the Bank's own resources.



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22. Net interest expense

	2005	2004
Interest received in repurchase transactions in SKK	32	30
Interest received on loans in SKK	165	742
Interest received on securities in foreign currency	12,536	9,411
Interest income and similar revenues	12,733	10,183
Interest paid to domestic banks in SKK	(12,344)	(11,427)
Interest paid to the State Treasury in SKK	(529)	(4,138)
Interest paid to other clients in SKK	(27)	(138)
Interest paid in repurchase transactions in foreign currency	(117)	(242)
Other interest paid in foreign currency	(28)	(90)
Interest expense and similar costs	(13,045)	(16,035)
Net interest (loss)	(312)	(5,852)

23. Net income from fees and commissions

	2005	2004
Income from fees and commissions	158	155
Expenses on fees and commissions	(31)	(28)
Net income from fees and commissions	127	127

The result of Securities Lending transactions for 2005 was fee income of SKK 106 million (SKK 79 million at 31 December 2004).

24. Net (loss) / profit from transactions in securities denominated in foreign currency and derivatives

	2005	2004
Revenues from debt securities and revaluations	2,978	4,594
Losses from debt securities and revaluations	(4,570)	(3,428)
Net (loss) / profit from transactions in securities and derivatives	(1,592)	1,166

25. Net profit / (loss) from transactions in foreign exchange, gold, and derivatives

	2005	2004
Revenues from foreign exchange operations	35,999	16,534
Losses from foreign exchange operations	(33,060)	(46,432)
Net profit / (loss) from transactions in FX, gold, and derivatives	2,939	(29,898)

The total net profit from transactions in foreign exchange, gold, and derivatives was most significantly affected on a year-on-year basis by exchange rate differences. The net profit from foreign exchange transactions amounted to SKK 4,358 million (2004 loss of SKK 29,802 million).

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26. Other operating expenses

	2005	2004
Salaries and bonuses	(547)	(576)
Social costs	(165)	(160)
Other personnel costs	(55)	(49)
Staff expenses	(767)	(785)
Depreciation of tangible and intangible assets	(500)	(483)
Other operating costs	(607)	(693)
Other operating expenses	(1,874)	(1,961)

In 2005, the average number of staff employed was 1,178 (1,299 in 2004), of whom 135 held managerial positions (140 in 2004). The average number of staff in banking supervision was 80 in 2005 (81 in 2004).

27. Foreign exchange structure of assets and liabilities

Currency risk results from the open foreign exchange position of the NBS. The impact of exchange rate changes on the NBS's performance is significant. This primarily results from the size of the open foreign exchange position and the volatility in the SKK/EUR and EUR/USD exchange rates.

The Bank Board has set the currency composition of the open foreign exchange position. The USD percentage in the open foreign exchange position is maintained at 30% +/- 2%, while its absolute amount must not exceed USD 3.1 billion. If these limits are mutually exclusive, the rule of the maximum absolute value of open foreign exchange position in USD has priority. The open foreign exchange position is adjusted if the difference between the value of the USD share in the open foreign exchange position and the set limit exceeds +/- USD 10 million. The remaining part of the foreign exchange reserves is denominated in EUR.

Considering the foreign exchange structure of assets and liabilities on the Bank's balance sheet that results from the NBS's specific position and its primary task of maintaining price stability, the Bank cannot effectively hedge against the currency risk.

Day-to-day currency risk management means preserving the respective part of foreign currency assets in accordance with the currency composition of foreign exchange liabilities and the structure of the open foreign exchange position, in compliance with the Bank Board's resolution. Monitoring and measuring sensitivity are focused on measuring current exchange rate differences and on estimating future impacts of the adverse developments in exchange rates (from the profit/(loss) point of view) through the calculation of sensitivity indicators.

During 2005, the exchange rate of SKK to EUR strengthened by 2.44% (from EUR 1 = SKK 38.796 to EUR 1 = SKK 37.848) and exchange rate of SKK to USD weakened by 12.11% (from USD 1 = SKK 28.496 to USD 1 = SKK 31.948).

In 2005, the open foreign exchange position increased by 16.86%, from SKK 416,890 million to SKK 487,189 million compared to the previous year.

The structure of the open foreign exchange position is as follows:



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Line No.	SKK	Foreign currencies converted to				
		SKK - total	USD	EUR	Other	
1. Gold		18,450	18,450			
2. Debt securities denominated in foreign currency		447,776	94,296	353,480		
3. Derivatives	52					
4. Receivables from banks and central banks	3,836	188,028	51,830	136,148	50	
5. Receivables from the International Monetary Fund		3,934			3,934	
6. Receivables from clients	210					
7. Equity shares in subsidiary and affiliated accounting units and other shares and participating interests	108	375		105	270	
8. Non-current assets	6,422					
9. Other assets	92	27	9	13	5	
Assets	1	10,720	658,590	164,585	489,746	4,259
1. Currency issued		130,110				
2. Liabilities to banks and central banks		394,588	164,550	46,895	117,655	
3. Liabilities arising from debt securities		20,004				
4. Derivative instruments		1,545				
5. Liabilities to the International Monetary Fund			3,893		3,893	
6. Liabilities to other international financial institutions		669	1		1	
7. Liabilities to clients		1,029	2,924	5	2,918	
8. Reserves and other liabilities		329	33	1	32	
9. Equity		(50,365)				
Liabilities	2	497,909	171,401	46,901	120,606	3,894
Open foreign exchange position at 31 Dec. 2005	3=1-2	(487,189)	487,189	117,684	369,140	365
Assets	4	19,076	516,886	133,961	378,934	3,991
Liabilities	5	435,966	99,996	31,796	64,431	3,768
Open foreign exchange position at 31 Dec. 2004	6=4-5	(416,890)	416,890	102,165	314,503	223
Year-on-year difference	7=3-6		70,299	15,519	54,637	142

These Notes are an integral part of the financial statements of Národná banka Slovenska.

NÁRODNÁ BANKA SLOVENSKA
Notes to the financial statements as at 31 December 2005
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28. Interest rates on assets and liabilities

The following table gives (in percentages) an interval of the average interest rates on assets and liabilities for 2005 and 2004, by the main currencies:

	2005	EUR	USD	XDR	JPY	SKK
Assets						
Gold			0.01 – 0.05			
Debt securities in foreign currency		2.33	2.45			
Derivatives						
Receivables from banks and central banks	1.52 – 5.21		1.57 – 4.09	0.00 – 3.03	0.00	0.07 – 5.50
Receivables from the IMF				0.00		0.00
Receivables from clients						1.00
Liabilities						
Liabilities to banks and central banks	1.00 – 4.71					1.50 – 5.95
Liabilities arising from debt securities						2.42 – 3.68
Derivatives						
Liabilities to the IMF				0.00		0.00
Liabilities to government and other clients	0.50 – 0.75		1.75 – 3.75			0.50 – 3.65
2004						
Assets						
Gold			0.01 – 0.08			
Debt securities in foreign currency		3.78	1.01			
Derivatives			2.05		2.50 – 3.25	
Receivables from banks and central banks	1.00 – 5.21		0.94 – 2.05	0.00 – 2.24	0.00	0.10 – 7.50
Receivables from the IMF				0.00		0.00
Receivables from clients						1.00
Liabilities						
Liabilities to banks and central banks	1.00 – 4.71		0.25 - 1.14		2.60 – 3.60	1.50 – 6.00
Liabilities arising from debt securities						3.40 – 5.95
Derivatives			0.05 - 4.73			
Liabilities to the IMF				0.00		0.00
Liabilities to government and other clients	0.50 – 1.76		0.50 – 1.75			2.00 – 6.00

These Notes are an integral part of the financial statements of Národná banka Slovenska.

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NÁRODNÁ BANKA SLOVENSKA
Notes to the financial statements as at 31 December 2005
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29. Maturity of assets and liabilities

The analysis of the NBS's assets and liabilities by the remaining time to maturity at 31 December 2005 is as follows:

	due within 1 month incl.	due within 1-3 months incl.	due within 1 year incl.	due within 1- 5 years incl.	due after more 5 years incl.	Not defined	Total
1. Gold		2,377	2,783	6,558	3,281	3,451	18,450
2. Debt securities in foreign currency	34,049	73,670	136,525	198,415	5,117		447,776
3. Derivatives					52		52
4. Receivables from banks and central banks	187,992	98	260	1,262	2,138	114	191,864
4.1 Current accounts, deposits, and loans in foreign currency	187,853	15	12	34		114	188,028
4.2 Loans related to monetary policy operations in SKK							
4.3 Receivables not related to monetary policy operations in SKK	139	83	248	1,228	2,138		3,836
5. Receivables from the International Monetary Fund						3,934	3,934
6. Receivables from clients	2	1	2	46	158	1	210
7. Equity shares in subsidiary and affiliated accounting units and other shares and participating interests						483	483
8. Non-current assets						6,422	6,422
9. Other assets	26	121	1			(29)	119
TOTAL ASSETS	222,069	76,267	139,571	206,281	10,746	14,376	669,310
1. Issue of currency						130,110	130,110
2. Liabilities to banks and central banks	552,832	58		3,774	2,474		559,138
2.1 Current accounts denominated in SKK	1,998						1,998
2.2 Overnight deposits, loans in SKK, and required reserves	392,577						392,577
2.3 Deposits and loans in foreign currency	158,257	58		3,774	2,474		164,563
3. Liabilities from debt securities	14,253	5,751					20,004
3.1 denominated in SKK	14,253	5,751					20,004
3.2 denominated in foreign currency							
4. Derivatives		731			814		1,545
5. Liabilities to the IMF						3,893	3,893
6. Liabilities to other international financial institutions						670	670
7. Liabilities to clients	3,675	112	51	109		6	3,953
8. Reserves and other liabilities	351					11	362
9. Equity						(50,365)	(50,365)
TOTAL LIABILITIES	413,943	6,652	51	3,883	3,288	84,325	669,310

Bank deposits for 24 hours (item 2.2. in liabilities) amounted to SKK 14,126 million.

NÁRODNÁ BANKA SLOVENSKA
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The analysis of the NBS's assets and liabilities by the remaining time to maturity at 31 December 2004 is as follows:

		due within 1 month incl.	due within 1-3 months incl.	due within 1 year incl.	due within 1- 5 years incl.	due after more 5 years incl.	Not defined	Total
1.	Gold	2,382	2,124	3,566	4,995		1,000	14,067
2.	Debt securities in foreign currency	53,956	52,276	60,620	169,921	15,302		352,075
3.	Derivatives		5	20				25
4.	Receivables from banks and central banks	146,798	114	295	1,394	2,760		151,361
4.1	Current accounts, deposits, and loans in foreign currency	146,532	28	15	63			146,638
4.2	Loans related to monetary policy operations in SKK							
4.3	Receivables not related to monetary policy operations in SKK	266	86	280	1,331	2,760		4,723
5.	Receivables from the IMF						3,801	3,801
6.	Receivables from clients	783		2,799	3,851	154		7,587
7.	Equity shares in subsidiary and affiliated accounting units and other shares and participating interests						363	363
8.	Non-current assets						6,576	6,576
9.	Other assets	31	9	10	29		28	107
	TOTAL ASSETS	203,950	54,528	67,310	180,190	18,216	11,768	535,962
1.	Issue of currency						109,900	109,900
2.	Liabilities to banks and central banks	325,960	47	26	3,393			329,426
2.1	Current accounts denominated in SKK	1,149						1,149
2.2	Deposits for 24 hours, loans in SKK, and required reserves	240,568						240,568
2.3	Deposits and loans in foreign currency	84,243	47	26	3,393			87,709
3.	Liabilities from debt securities	19,953	39,772					59,725
3.1	denominated in SKK	19,953	39,772					59,725
3.2	denominated in foreign currency							
4.	Derivatives							
5.	Liabilities to the International Monetary Fund						3,762	3,762
6.	Liabilities to other international financial institutions						683	683
7.	Liabilities to clients	15,635	48	70,278	93			86,054
8.	Reserves and other liabilities	237	80	27	8		136	488
9.	Equity						(54,076)	(54,076)
	TOTAL LIABILITIES	361,785	39,947	70,331	3,494		60,405	535,962

Bank deposits for 24 hours (item 2.2. in liabilities) amounted to SKK 10,597 million.



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30. Post-balance-sheet events

After 31 December 2005, there were no significant events that would require adjustments in the 2005 financial statements.

According to Act No. 519/2005 Coll. as amended Act No. 566/1992 Coll. on the NBS (with effect from 1 January 2006), the Bank started to supervise the entire financial market in the area of banking, capital market, insurance, and retirement savings, and began to perform tasks in the area of international co-operation in financial market supervision.

With effect from this date, the Financial Market Authority has been cancelled by law and its powers have passed to the NBS. After the Financial Market Authority had merged into the NBS, the Bank's balance sheet amount total increased by SKK 195 million (at 1 January 2006). In 2005, the Financial Market Authority earned a profit of SKK 51 million. The equity capital of the Financial Market Authority amounted to SKK 184 million, of which retained earnings from previous years accounted for SKK 11 million.

Ing. Ivan Šramko
Governor

Ing. Milena Koreňová
Bank Board member
Chief Executive Director
of the Financial Management
and Payment Transactions
Division

Ing. Oľga Karellová
Director of the
Accounting Department

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Abbreviations

BRIBOR	Bratislava Interbank Offered Rate
CEBS	Committee of European Banking Supervisors
CPI	Consumer Price Index
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council of the EU
EMU	Economic and Monetary Union
ESCB	European System of Central Banks
EU	European Union
Eurostat	Statistical Office of the European Communities
Fed	Federal Reserve System
FNM	Fond národného majetku – National Property Fund
GDP	Gross Domestic Product
GDP	Gross Domestic Product
HICP	Harmonised Index of Consumer Prices
IBAN	International Bank Account Number
IBRD	International Bank for Reconstruction and Development
IIB	International Investment Bank
IMF	International Monetary Fund
IRF	Initial Rate Fixation
MFI	Monetary Financial Institutions
NBS	Národná banka Slovenska – National Bank of Slovakia
NEER	Nominal Effective Exchange Rate
OECD	Organisation for Economic Co-operation and Development
OPEC	Organisation of the Petroleum Exporting Countries
p.a.	per annum
PPI	Producer Price Index
REER	Real Effective Exchange Rate
SEPA	Single Euro Payments Area
Sk, SKK	Slovak Koruna
SR	Slovak Republic
ZBK SR	Bank Card Association of the Slovak Republic

Glossary

Autonomous liquidity factors – factors other than monetary policy operations influencing banking sector liquidity. Such factors are, in particular, net foreign assets held by the central bank, central government deposits with the central bank and currency in circulation.

Average value of currency mark – the total value of currency in circulation divided by the total number of currency instruments.

Basic NBS rate – the interest rate limit applied to the marginal deposit facility of the NBS – its main monetary policy operations. The NBS has published the basic rate since 1 January 2003; whenever the term “discount interest rate of the National Bank of Slovakia” or “discount rate of the Czecho-Slovak State Bank” appears in older legislation, it means the basic NBS rate.

BRIBOR (Bratislava Interbank Offered Rate) – interest rate fixing in the interbank deposit market calculated from prices offered by reference banks for deposits with maturities ranging from 1 day to 12 months.

Central parity – the exchange rate vis-à-vis the euro of currencies of ERM II member countries, around which the ERM II fluctuation margins are defined. The central parity for the Slovak koruna was set on 28 November 2005 at 38.4550 SKK per euro, with a fluctuation band of $\pm 15\%$.

Classified claims – claims receivable from customers and banks (loans) non-performing for 90 or more days.

Collateral – an asset used to secure a loan. In case of the debtor's default the asset can be sold and the proceeds used to settle the outstanding loan.

Common ESCB Training – a common training program of the European Central Bank (ECB) and national central banks of the European System of Central Banks (ESCB). The program covers manager training designed to learn new knowledge and work procedures, as well as the development of management skills focusing on the effectiveness and efficiency of decision-making in the ESCB and the Eurosystem, to foster a common ESCB culture through sharing of best practices.

Core inflation – measures the rate of growth of the price level on the basis of an incomplete consumer basket. The consumer basket excludes items with regulated prices and items with prices subject to other administrative measures (e.g. change of VAT, consumer taxes, subsidies). It is part of the national index of consumer prices.

Deflation – a decrease in the general price level, the opposite of inflation.

EFCB certificate (European Foundation Certificate in Banking) – an internationally accepted banking certificate awarded in an examination assessing the level of skills required as qualification for a bank employee, comparable within the EU banking sector; the only institution in Slovakia accredited to conduct EFCB training and examinations is the Institute of Banking Education of the National Bank of Slovakia.

Effective exchange rates (nominal: NEER, real: REER) – weighted averages of bilateral SKK exchange rates against the currencies of the main trading partners. The weights used reflect the share of each partner country in Slovakia's foreign trade. Real effective exchange rates are nominal effective exchange rates deflated by a weighted average of foreign, relative to domestic, prices or costs. They are measures of price and cost competitiveness of a country.



Electronic money business – the issue and administration of electronic money and electronic money payment instruments.

Electronic money institution – a legal person other than a bank, foreign bank or the National Bank of Slovakia, holding a license for electronic money business under the Payments Act.

Employee benefits – wage and wage compensations, bonuses, supplementary insurance, severance pay, exit pay, and other non-pecuniary benefits, such as health care.

ERM II (exchange rate mechanism II) – an exchange rate system providing a framework for exchange rate policy cooperation between euro area countries and EU Member States not participating in the third stage of the EMU. Membership in ERM II is one of the Maastricht criteria for the adoption of the euro.

ESA 95 – the European System of Accounts adopted in 1995. A common methodology for the compilation and reporting of GDP, employment and employee compensation data for all EU countries.

Euro area – the area encompassing those EU member states in which the euro has been adopted in accordance with the Treaty. The responsibility for monetary policy in the euro area lies with European Central Bank.

European Economic Area – comprises all EU member states, Norway, Lichtenstein and Iceland.

European Payments Council – an organisation associating European Union banking associations.

Eurosystem – a system of central banks comprising the European Central Bank and the national central banks of those EU member states that have adopted the euro.

Foreign direct investment – a category of international investments reflecting the objective of a resident entity in one economy (direct investor) to acquire a permanent interest in a company residing in an economy other than the investor's (direct investment company). Direct investments include the initial transaction between the two entities - i.e. the transaction giving rise to the investment relationship - and all subsequent transactions between these two entities and affiliated companies.

Foreign exchange reserves – reserves of the Slovak Republic consisting of gold and other financial assets denominated in foreign currency held and managed by the central bank. They are used to directly finance payment imbalances, to indirectly regulate their size through foreign exchange market interventions in order to influence the exchange rate of the currency, or for other purposes.

Free provision of cross-border services – the conduct of banking activities by foreign entities based in the European Economic Area (foreign banks, foreign financial institutions or electronic money institutions) not physically present in the Slovak Republic.

GDP deflator – an aggregate price index reflecting developments in the price of products and services in an economy. It is calculated as a ratio of GDP at current prices to GDP at constant prices.

General government – a sector defined in the ESA 95 as comprising resident entities that are engaged primarily in the production of non-market goods and services intended for individual and collective consumption and in the redistribution of national income and wealth. Included are central, regional and local government authorities as well as social security funds, and any budget-funded or subsidised organisations established by them, whose revenues cover less than 50% of their production costs.

General government debt – gross debt (deposits, loans and other debt securities other than financial derivatives) of the general government at nominal value. A debt-to-GDP ratio of up to 60% is one of the Maastricht convergence criteria for the adoption of the euro.

General government deficit – the difference between total revenues and total expenditures of the general government sector, if expenditures exceed revenues. A deficit-to-GDP ratio of up to 3% is one of the Maastricht convergence criteria for the adoption of the euro.



Gross domestic product (GDP) – the total output of goods and services in an economy in a given period. The main expenditure aggregates that make up GDP are household final consumption, government final consumption, gross fixed capital formation, changes in inventories, and imports and exports of goods and services.

Harmonised Index of Consumer Prices (HICP) – a consumer price index measured on a comparable basis across all EU member states, which accounts for differences in national definitions. The HICP is one of the indicators used to assess price stability in a country (one of the Maastricht convergence criteria).

IBAN (International Bank Account Number) – an international bank account number format allowing unique customer identification and automated payment processing (mostly cross-border payments at present). In Slovakia, IBAN consists of 24 alpha-numerical characters (ISO country code, control number, account number including bank code).

Implied volatility – expected volatility (i.e. standard deviation) in terms of change in the price of an asset (for example, a bond or share). It can be derived from the price of the asset, maturity date and the exercise price of an option for the asset, as well as from a risk-free rate of return using an option valuation model (e.g. the Black-Scholes model).

Inflation – an increase in the general price level.

M1 – a narrow monetary aggregate comprising currency in circulation and overnight deposits with MFIs and central government (e.g. post office or the State Treasury).

M2 – an intermediate monetary aggregate that comprises M1 plus deposits redeemable at notice of up to 3 months (short-term saving deposits) and deposits with an agreed maturity of up to 2 years (short-term time deposits) with MFIs and central government.

M3 – a broad monetary aggregate that comprises M2 plus negotiable instruments, i.e. repurchase agreements, money market fund shares and units as well as debt securities issued by MFIs with a maturity of up to two years.

Maastricht criteria – convergence criteria set out in the Maastricht Treaty that must be fulfilled before a country can join the euro area. There are four criteria regarding: public finances (deficit and debt of the general government sector), inflation, long-term interest rates, and exchange rate.

MFI claims on residents – MFI claims receivable from residents other than MFIs (including the general government sector and the private sector) and securities issued by residents other than MFIs (stocks and other equity and debt securities) held by MFIs.

Minimum reserve requirement – financial reserves held by banks, branches of foreign banks, building societies and electronic money institutions on accounts with the central bank. It is a monetary policy tool with the level set individually by the central bank for each minimum reserve holder.

Monetary financial institutions (MFI) – financial institutions which together form the money-issuing/generating sector. These comprise the central bank (NBS), credit institutions (banks and branches of foreign banks) and all other financial institutions whose business is to receive deposits or redeemable funds from entities other than MFIs and, in their own name and for their own account, to grant credit and invest in securities (in particular money market funds).

Net currency issuance – the difference between the amount of currency put into circulation and currency received in a given period.

Open seminars – seminars organised by individual national central banks of the European System of Central Banks (ESCB) which may be attended by staff of other ESCB national central banks. The aim of this initiative is to strengthen the European dimension of training within the ESCB, enhance expertise, develop mutual understanding within an integrated Europe, understand differences and similarities in the European culture, and foster a common ESCB culture.



Overnight refinancing operation of the NBS – a facility which counterparties (banks) may use to make overnight deposits with the central bank. The overnight refinancing rate is one of the key NBS rates.

Overnight sterilisation operation of the NBS – a facility which counterparties (banks) may use to receive overnight credit from the central bank against eligible assets. The overnight sterilisation rate is one of the key NBS rates.

Own funds adequacy – the ratio of own funds to risk-weighted assets (must not fall below 8%). The adequacy of own funds is an indicator of smooth functioning of a financial institution in the future, i.e. an indicator of its financial strength and credibility.

Parent company – a legal person controlling, i.e. holding over 50% of equity or voting rights in another legal person, or the right to appoint or dismiss the majority of the members of its statutory body, supervisory board or another managing, supervisory or controlling body.

Persons related to the National Bank of Slovakia – legal or natural persons which are subsidiary accounting units of the NBS, affiliated accounting units, members of the NBS Bank Board, close relatives of a member of the NBS Bank Board, accounting units controlled, co-controlled or subject to the influence or significant voting rights exercised or held by members of the NBS Bank Board or their close relatives.

Portfolio investment – net transactions by residents and their holdings of securities issued by non-residents (assets) and net transactions by non-residents and their holdings of securities issued by residents (liabilities). They comprise equities and debt securities (bonds, bills of exchange and money market instruments). For investments to be considered portfolio investments, the interest in the company concerned must be lower than the equivalent of 10% of ordinary shares or voting rights.

Price stability – a year-on-year increase in consumer prices lower than a limit set by the NBS. As a medium-term target, the NBS seeks to maintain consumer price growth as measured by the HICP below 2% at the end of 2007 and 2008.

Real interest rate on household deposits (ex-post) – the interest rate on household deposits adjusted for past inflation.

Redistribution loan – a loan extended by the Czecho-Slovak State Bank to cover loan assets involved in restructuring during the division of the country's banking system into a central bank and commercial banks.

Regulated prices – prices and fees set by ministries or regulators (Network Industries Regulation Office, Slovak Post Office, Slovak Telecommunications Office, etc.) or by regional or local governments. They are included in the national consumer price index.

Reinvested earnings – consists of the share of a direct investor (relative to a direct participating interest) in profit not distributed as dividends by subsidiaries or affiliates and in profit of branches not distributed to the direct investor.

Repo operation – the granting or receiving of a loan against collateral in form of securities.

RTGS (Real Time Gross Settlement) – a real-time gross settlement system.

SEPA (Single Euro Payments Area) – a single euro payments area the objective of which is to create a single internal market for cross-border euro payments.

Single banking license – foreign banks, foreign financial institutions or electronic money institutions may conduct banking activities in other European Economic Area member states in accordance with the European Parliament and Council Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions, if their license was granted in a European Economic Area member state. These entities may provide their services by opening a branch or under the freedom to provide cross-border services.



Single banking licence principle – applies to all banking activities explicitly stated in the Banking Act. In order to provide mortgage loans pursuant to Article 67(1) of the Banking Act and to act as a depositary under the Collective Investment Act, a special license from the National Bank of Slovakia is required.

SIPS – an interbank payment system operated by the National Bank of Slovakia.

Stability and Growth Pact – was designed to ensure sound public finances during the third stage of the Economic and Monetary Union in order to facilitate price stability and a strong sustainable growth contributing to job creation. To that end, the Pact requires member states to set medium-term fiscal targets. It also defines a specific excessive deficit procedure. The Pact consists of the resolution on the Stability and Growth Pact adopted at the Amsterdam summit of the European Council on 17 June 1997 and two Council regulations, namely (i) Regulation 1466/97/EC of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies as amended by Regulation 1055/2005/EC of 27 June 2005 and (ii) Regulation 1467/97/EC of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure as amended by Regulation 1056/2005/EC of 27 June 2005.

STEP2 – a European automated clearing system operated by the Euro Banking Association Clearing, designed to process cross-border euro payments.

Subsidiary – a legal person subject to control (a holding of over 50% of equity or voting rights in the legal person).

TARGET (Trans-European Automated Real-time Gross Settlement Express Transfer) – a real-time gross settlement system for euro payments. It is a decentralised system made up of 15 national RTGS systems, the ECB payment mechanism and the interlinking mechanism.

TARGET2 – a new generation of TARGET in which the current decentralised technical structure will be replaced by a single shared platform.

Two-week repo tender of the NBS – a standard 14-day repo operation of the central bank consisting in lending or borrowing against collateral in form of securities. This repo operation is conducted as a tender. The two-week repo tender rate is the basic NBS rate.

Yield curve – a graphic representation of the relationship between the interest rate/yield and the maturity of an asset with the same credit risk, but different maturities at a specific point in time. The slope of the yield curve can be expressed as the difference between interest rates applied to two selected maturities.

