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Mr. President, Honorable Members of Parliament,

It was on two occasions that the Bank of Slovenia had the opportunity last year to present to Parliament its views on and dilemmas about the problems the monetary and macroeconomic policies were facing and encountered. I am nevertheless pleased to be presenting to you this report and to additionally point out the circumstances and the facts, which decisively influenced the monetary developments. The report includes the Bank of Slovenia Annual Financial Statements and the opinion on the state of the Bank's affairs given by the authorized auditors Price Waterhouse, Zurich.

The domestic and foreign determinants of the environment in which the Bank conducted monetary policy during 1997 were the following: the general government deficit in Slovenia exceeded 1% of GDP for the first time since independence; economic growth failed to meet the forecast and expected level; too high growth of real wages continued albeit more moderately; foreign debt decreased, foreign portfolio and equity investments increased; the balance of payments ended in a slight surplus; controlled prices increased considerably, market prices pursued a downward course and the process of rehabilitation of two commercial banks was completed. Cross rates between the US Dollar, German Mark and the Japanese Yen changed considerably; the economic growth in the United States of America and in Europe was very promising, but followed by a wave of wider financial instability which culminated in the Asian financial crisis; this, in turn, influenced also the countries undergoing structural reforms in transition to market economies.

Low lending rates in developed and stable economies and the considerable interest differentials between domestic and foreign financial instruments encouraged an inflow of foreign capital and this actually became serious competition to domestic financial intermediaries. Due to the less developed domestic money and capital markets, the inflow of foreign capital was unsustainable. Monetary policy was directed towards stemming the inflow of foreign short-term volatile capital. The measures included but were not limited to sterilization of foreign capital inflows, prudential regulations and restrictions in foreign portfolio investments. The currency and exchange rate risks were offset by growing international reserves and other achievements of the economy. The consequent rapidly growing cost of such efficient and effective intervention is evident from the Profit and Loss Account.

Following such developments, many questions have been raised as to the consistency and credibility of monetary policy with respect to the high cost involved, and as to whether a balance of payments deficit could not spur on economic growth. True, the domestic lending rates are still too high; but there is a lack of understanding that they can only be brought further down through additional saving and reduction of expenditure by individuals, the real sector and the government sector; the expectation is rather that the Central Bank should provide for additional money in circulation. Any such change in the monetary policy would only widen the gap between the inflation rate and the exchange rate growths, and would inevitably lead to great financial instability and much higher opportunity cost compared to that incurred currently. The Bank of Slovenia considers the reduction of inflation and interest rates to the level of linked countries as an absolute precondition to any reasonable introduction of a pegged Tolar exchange rate; likewise, the Bank is of the opinion

that the current account should maintain a sustainable level, and – taking into account other economic indicators – prove credible. The Bank also hopes and expects that market players are aware of the fact that the time for structural adjustment and assistance thereof by monetary policy is running out: it will have to operate under the circumstances and conditions already now prevailing in many European countries when Slovenia joins the European Union. Not only is the approaching introduction of a supranational European currency the goal of national economies but also a reminder that once they are members of the European Monetary Union, they will only have two policies left to adapt to the changing market conditions – fiscal and incomes policies.

In spite of the measures taken last year and at the beginning of this year, and the endeavors of the Bank which resulted in a high cost, the inflow of foreign capital increased (due to monetization the broad money increased by SIT 140 billion) and so did the cost of the Bank's sterilized foreign exchange intervention. The value of securities issued by the Bank reached four times the volume of 1996, and surpassed base money by 50%.

Notwithstanding the difficulties we encountered last year in the wider economic area, I consider the achievements as a small joint contribution to overall progress and stabilization. I take this opportunity to thank you for your understanding, your proposals and constructive criticism, for your confidence expressed on the occasion of the appointment of new members to our Governing Board replacing those whose term had expired. I also find this a good opportunity to thank the former and the present members of our board for their efforts and their constructive contribution in finding solutions for the problems the Bank encountered in conducting monetary policy.

We are, no doubt, in for new challenges and new tasks related to accession to the European Union: adoption and implementation of European standards, implementation of pending structural reforms, liberalization of capital movements and financial stability as part of world-wide globalization development. The Bank of Slovenia is aware of them and is determined to pursue appropriate and reasonable solutions in order to help Slovenia be assured of its proper position in the "European Monetary Club". It is quite clear that we need to achieve stability on our own and that it cannot be brought about by third parties; it is only through the achieved stability that we will prove to have matured and shown our capability to be an equal partner in the environment of harder competition on international markets.


Dr. France Arhar
Governor

Ljubljana, March 18, 1998

1. ECONOMIC ENVIRONMENT

1.1. Global Economic Environment

Expansion of economic activity and demand and low interest rates are the main characteristics of the international environment for Slovenia in 1997. The economic growth of EU member countries is estimated to have reached 2.6%, and the growth in imports of the top eight economic partners of Slovenia 8.5%.

Higher growth of imports of economic partners...

Interest rates on the international financial markets recorded a low. The average US Dollar 3 months LIBOR rate amounted to 5.74%, the average DEM FIBOR rate for the same period 3.33%. The interest rates are expected to rise in 1998.

...low interest rates...

The American Dollar appreciated against most major world currencies: 15% against German Mark (and Austrian Schilling), 14% against French Franc, 11% against the Japanese Yen, but depreciated by almost 5% against the British Pound. These changes contributed to a deterioration of Slovenian export prices denominated in US Dollars by 10.7% and import prices by 9.8%.

...and appreciation of the US Dollar.

Petrol prices declined from the average of USD 20.7 to USD 19.2 per barrel. The dollar prices for primary raw materials increased during the year by 2.2%. The average price growth abroad (weighted with the respective share of Slovenian trade for an individual country) amounted to 1%.

Box 1: Economic Relations

Slovenia is an open economy; as much as 80% of its international trade was based on free-trade agreements in 1997. Slovenia became a member of the GATT in October 1994 and of the WTO in July 1995; the Agreement with EFTA members (now Iceland, Liechtenstein, Norway and Switzerland) came into force in July 1995. Slovenia joined the central European free trade initiative (CEFTA) in January 1996. The initiative is targeted towards gradual establishment of free trade in industrial and agricultural products in a market with population of 90 million by 2001 (Czech Republic, Hungary, Poland, Slovak Republic, Slovenia and Rumania). Slovenia has concluded bilateral free-trade agreements with the following countries in transition to market economy: Bulgaria, Estonia, Croatia, Latvia, Lithuania and Macedonia, and an agreement on preferential status for goods from Bosnia and Herzegovina.

Slovenia has adopted full membership in the European Union (EU) as its strategic target, due to traditionally close political, economic and cultural relationships with its member countries. First negotiations started as early as in 1992, followed by conclusion of the Association Agreement in June 1996, which will enter in force after its ratification by the parliaments of Slovenia and of the 15 EU member countries. Slovenian Parliament ratified the Association Agreement in July 1997. Until all EU member countries have ratified the Association Agreement, the Interim Agreement on trade and trade-related matters is valid. As regards trade, the agreement is targeted towards establishment of a reciprocal asymmetrical free trade zone. In January 1997 EU introduced full liberalization of trade in industrial and agricultural products; Slovenia will do so gradually up to the end of 2001. It contains legal clauses and stipulations on capital flows, co-operation in the field of finance and culture, prevention of fraud, etc. Based on a favorable opinion of the European Commission, the European Union adopted a **decision to commence accession negotiations** with Cyprus, Czech Republic, Estonia, Hungary, Poland and Slovenia on December 13, 1997. The candidates for full accession are well aware of the need for full adoption of the *acquis communautaire* (i.e. EU laws, rules and regulations, standards).

**Terms of trade worse
for the first time after 1991**

Taking into account the cross-currency and price fluctuations in the markets of Slovenia's main economic partners, US Dollar export prices fell by 9.9% and import prices by 9.6%. The difference of 0.3% made, for the first time after 1991, the terms of trade unfavorable, and reduced the purchasing power of the Slovenian GDP. The estimated negative impact of the changed terms of trade on GDP amounted to roughly USD 30 million.

1.2. Gross Domestic Product, Employment and Labor Costs

GDP growth rose to 3.3%

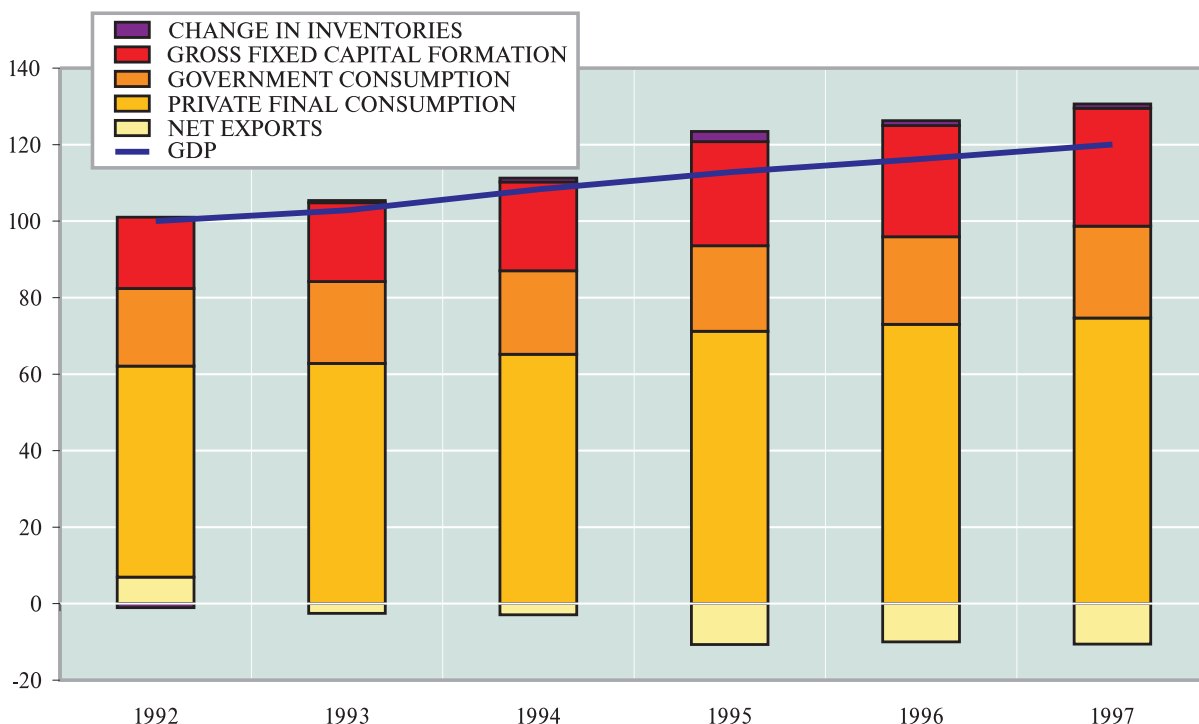
Real GDP growth is estimated to have amounted to 3.3%. The estimate is based on accelerated economic activity in the last quarter, following growth of only 2.9% in the first nine months. GDP growth has still not reached the level of 1994 (5.3%) and 1995 (4.1%), but slightly exceeded that of 1996 (3.1%).

**Moderate growth of
domestic demand...**

Accelerated export growth of 7.5% was offset by import growth of 7.3%. Domestic demand growth was moderate – roughly 3%. Investments expanded by 6%, general government consumption by 5%, and private consumption by 2.3%. The increase in investment and private consumption did not quite reach the level of the previous year, and in the main lower than years 1993-1995. The lower level of funds invested by general government accounts for a slow-down in investment growth against the period 1993-1995; an upswing in investments in the privatized enterprises and in foreign direct investments is still pending. Budgetary expenditure substantially exceeded that of the previous three years; it is primarily due to the growth of salaries, transfers to the Pension Fund and social transfers.

**...due to a slow-down in
private consumption.**

Figure 1: **Gross Domestic Product According to Expenditure Structure**
(1992-1997; GDP 1992=100)



Source: Statistical Office of RS and Institute of Macroeconomic Analysis and Development.

On the output side, growth has been generated by a real increase in value added in hotels and restaurants (8.5%), electricity, gas and water supply (8%) financial intermediation (6%), real estate business, rental (lease) and business services (6%). Growth in value added in production and manufacturing was a modest 1.1%; total value added in industrial production was 1.3%. Therefore, the share in value added of industrial production keeps declining compared to that in services (especially of financial intermediation, real estate business, rental (lease), and business services and public administration). The value added in industrial production accounted for 32% and in services for 60% of the total, against 41% and 53% respectively in 1990.

Services gain in importance at the cost of industrial production

Measured by ILO standards, the level of unemployment diminished slightly against the previous year and reached 7.1%. Registered unemployment, on the other hand, increased and reached 14.4%. Given such stagnation of employment, part-time jobs, contractual work and work by family members, not included in measurements by ILO standards, seem to be gaining in importance.

Stagnation of employment

After the high real wage growth in 1996 (5.1% real average gross wage growth accounted for mainly by growth of wages regulated by individual contracts and those in general government) – against 5.1% in 1995, 4.7% in 1994 and 11.7% in 1993 – the wage growth slowed down last year. This development was mainly due to the consensus reached among social partners over the social pact not signed for the period 1997-1999 (summarized in the Minimum Wage and Wage Adjustment Act, adopted in July 1997). Average gross wage growth reached 2.4%. Growth of other remuneration decreased by 0.9% against the previous year, mainly due to a 2.5% reduction of social contributions in 1996.

Moderate wage growth...

... and reduction of fiscal burden on wages.

While employment stagnated, productivity increased by 3.3% and exceeded the real average gross wage growth for the first time for two years. Productivity in manufacturing is estimated to have grown by 4.8%, the labor costs by 1.8% against the previous year. Labor costs are still relatively high when compared to foreign countries.

Increase in productivity

1.3. Public finance

According to provisional data, general government finance ended up with a deficit of 1.1% of GDP (32 billion Tolars). It is the first time that the general budget was not close to a balance; the results until now had varied between a slight surplus of 0.3% of GDP in 1996 and a slight deficit of 0.2% of GDP in 1994.

For the first time general government deficit (1.1% of GDP)...

General government expenditures increased by 5.9% in real terms, while revenues increased only by 2.8% in real terms. The expenditures increased to 46.1% of GDP (44.9% in 1996), while its revenues slightly declined to 45.1% (from 45.2% in 1996).

...as a consequence of reduction in customs tariffs due to free-trade agreements...

For the second year in a row, there was a shortfall in revenues due to a reduction in customs tariffs and to the decrease in social contribution rates for employers. Labor costs and transfers to households grew quickly during the year (both 7% in real terms); other expenditure was kept moderate since governed by rules on provisional financing. Growth in labor costs was due to additional employment in public administration (tax department and elsewhere in the government) and to increases in wages attained from strikes.

...and of rapid growth in labor costs, pensions and social transfers.

**Pension reform
necessary**

Among social transfers, pensions increased most (as a consequence of the age structure of the population, generous early retirement schemes and indexation (revaluation) of pensions in line with indexation of average wages – as a rule, the latter increase every time employment decreases). Internal transfers to the Pension Fund increased from 3.3% of GDP in 1996 to as much as 3.9% of GDP. The present pension system is unsustainable and pension reform is therefore necessary (Box 2).

**Preparation of 1997 budget
was delayed**

An amended version of the budget for 1997 presented at the end of July was finally approved in December. The budgetary year was extended to include a part of January 1998. During that period budget revenues increased by 17 billion Tolars sales tax collected. On the expenditure side, subsidies and other transfers to business sector and investment outlays accounted for most of the increase (5% and 8% respectively).

Box 2: Privatization and Pension Reform

Following the adoption of the Law on **Ownership Transformation** in November 1992 (focusing on enterprises other than those in public ownership, forestry, co-operatives, banks, insurance companies, casinos and bankrupt enterprises) a total nominal value of 567 billion Tolar of vouchers (ownership certificates) was distributed to citizens. The deadline for such purchase expired in July 1997. Vouchers with a nominal value of as much as 67 billion Tolar remained unused. The above law provided for a combination of several possible methods of privatization of social ownership. Before the end of 1997, privatization was completed (i. e. the second approval was issued by the Agency for Restructuring and Privatization) in as many as 1175 enterprises and 247 still needed to obtain the second approval. The vouchers collected by the authorized investment funds are estimated to exceed the available capital by between 130 and 140 billion Tolars. This “privatization gap” will be - according to the law - covered by the privatization of state property, the concluding stage of the privatization process.

The distribution of shares of total capital, by method of ownership transformation (with second approval), at July 1997 was as follows: internal buyout 26%, public sale of shares 12%, investment and other funds and investment companies 31%, other (state, municipalities, co-operatives, rightful owners under denationalization claims) 31%. 67% of all privatized enterprises (accounting for a share value of only 16%) were majority owned by employees and former employees. Small investors tend to sell shares and spend the proceeds. Authorized investment companies are being criticized for taking over the role of management (holding) companies by striving to collect control package of shares in individual companies. Beside the bank rehabilitation government bonds, shares given as a present to the employees and other individuals are the most traded securities on the secondary capital market.

Slovenia’s existing pay-as-you-go (PAYG) pension system is generous compared to some other transition countries. Given the unfavorable demographic projections (aging population), the present financing scheme of the pension benefits is not sustainable in the long run and the **pension reform** is inevitable. Rapid worsening of pension ratios urges for as early implementation of the reform as possible. In co-operation with the World Bank and with financial support of EC Phare, the Slovenian government has prepared a reform proposal (The White Book on Pension and Disability Insurance, issued in November 1997) based on the three-pillar system and submitted it to Parliament. The first pillar would be a slimmed down version of the PAYG system, with an improved balance between contributions and benefits as a result of incremental measures. The incremental measures include gradual equalization of retirement age to the average EU level for both sexes, changes in calculation of the pension base, changes in retirement age, stimulation of later retirement and discouragement of early retirement, indexation of benefits to prices instead of to wages, more equitable treatment of self-employed and employed, and broadening the base of contributions. The second pillar would be a mandatory individual saving scheme with benefits strictly limited to contributions and managed by mutual, public or other forms of funds. There is a problem of its initial funding without too heavy a burden on the taxpayer. The third pillar would consist of a voluntary supplementary insurance. The government will be seeking a broad consensus on the reform among social partners, experts and politicians, in order to ensure efficient and reliable social security to this and future generations.

Some experts’ proposals combine the solution of the privatization gap, capital market development and initial financing of the second pillar; they propose that it should be made possible to invest the shares acquired with privatization vouchers into the second pension-scheme pillar.

The general government deficit was covered by funds, raised abroad (20 billion Tolars - 0.7% of GDP) and on the domestic market (12 billion Tolars - 0.4% of GDP). The government issued Eurobonds of DEM 400 million with a maturity of seven years and Tolar bonds of 10 billion Tolars with a maturity of three years. Projections envisage a budget deficit in 1998 (estimated to be 1% of GDP) and possibly one in balance in 1999 if value added tax has been introduced.

Necessity to introduce value added tax

1.4. Prices

Inflation measured by retail price growth reached 9.4% against 8.8% in 1996. The consumer price index (CPI) growth, on the other hand, amounted to 8.8% (against 9.0% in 1996). Inflation will be measured by CPI growth from 1998 on.

Inflation rate about 9%...

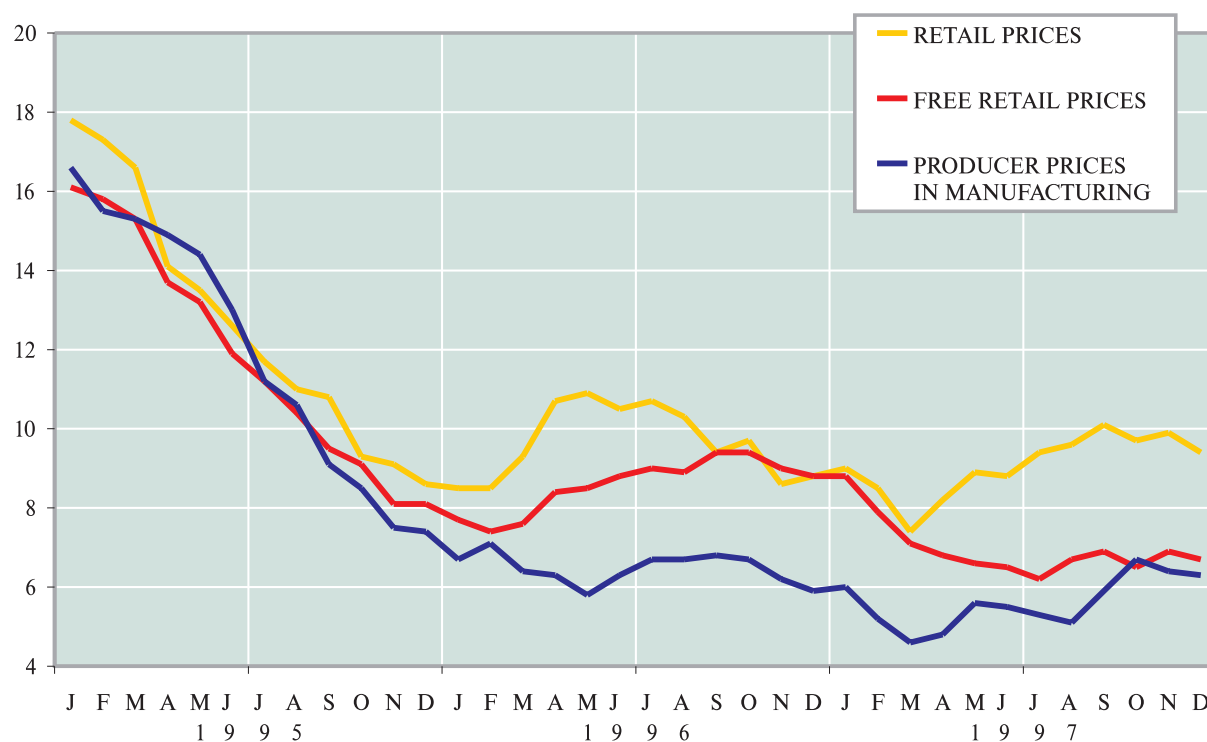
The consumer price index growth was fuelled by substantial increases in controlled prices caused primarily by the government adjustment program in energy sector prices. Oil derivative prices grew in average by 22.5%, electricity by 15%, the regulated price basket (accounting for 27% of the CPI) by 16.1%.

...with substantial increases in controlled prices...

Free market prices increased by 6.9% against 9.2% in 1996. The increase was fuelled by two major factors: the substantial increase in energy prices in the first half of the year, and the exchange rate appreciation between July and September. Stabilization of wage increases was an important development to offset the effects of the two. Among free market prices, prices of services – usually representative for the whole non-tradable sector – increased by 10.9% (against 11.7% in 1996), prices of industrial products, by far more exposed to competition, by 5.9% (against 8.0% in 1996). Prices in manufacturing increased by 6.3% (against 5.9% in 1996).

...and moderate growth in free market prices.

Figure 2: **Prices** (annual growth in %),



Source: Statistical Office of RS and Bank of Slovenia.

1.5. Balance of Payments

Balance of payments developments from 1995 were characterized by the current account equilibrium, and by a significant net inflow of foreign exchange pertaining to financial transactions.

According to provisional data, Slovenian exports amounted to USD 8,372 million (FOB) and imports to USD 9,358 million (CIF). The trade deficit of USD 986 million was less than the level of 1996 by USD 126 million. The export - import ratio amounted to 89.5% against 88.2% in 1996.

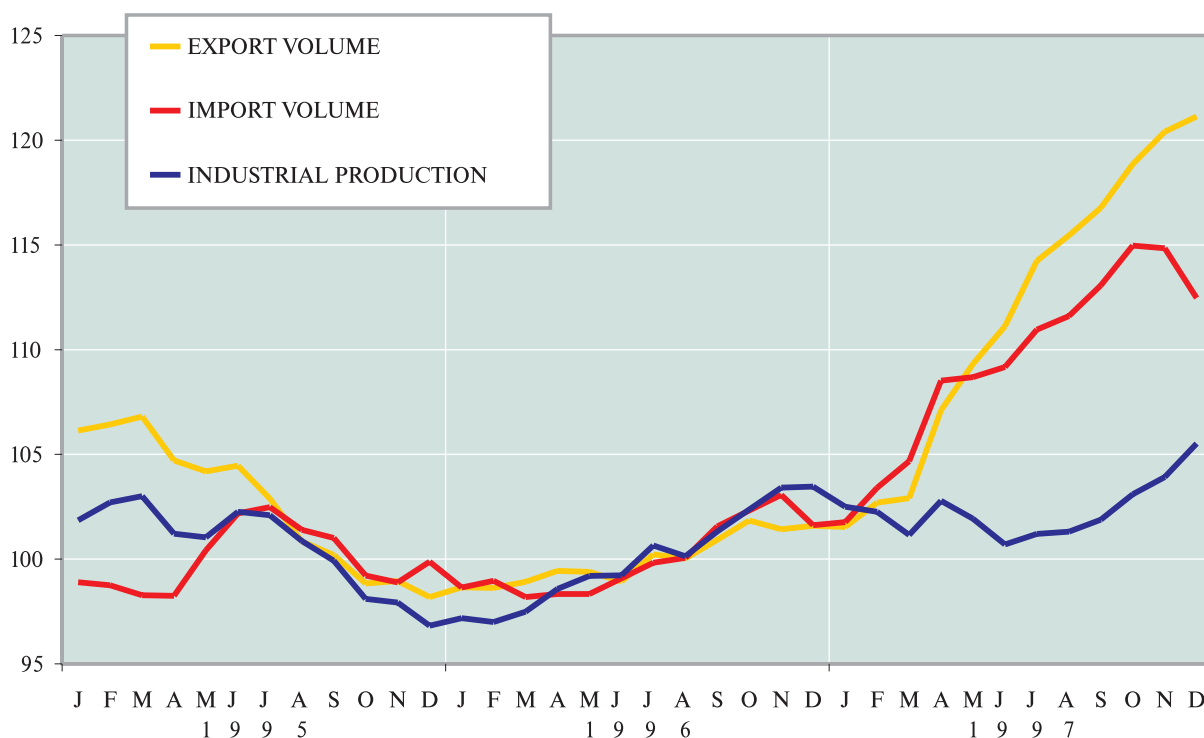
Better export-import ratio

Exports increased by 11% and imports by 10% in real terms

Measured in US Dollars, exports of goods increased by 0.8%, while imports fell by 0.7%. Calculated pursuant to balance of payments methodology, the trade deficit amounted to USD 766,9 million and 4.3% of GDP respectively. In real terms, trade increased even more substantially: exports grew by 11.9%, imports by 10% (changes in import and export price baskets are not taken into account, especially not inter-currency oscillations).

The increase in exports was fuelled by higher foreign demand throughout the year and from the second quarter of the year in particular. According to first estimates, foreign demand increased by a total of 8.5%. After initial deterioration, external competitiveness, measured by unit labor cost against export price, improved after July. However, it declined on average by 0.8% during the first 11 months of the year against the same period of the previous year.

Figure 3: Volume of Exports and Imports and Industrial Production in the Period 1995-1997
(1996 = 100; seasonally adjusted data)



Source: Statistical Office of RS; calculated (including seasonal adjustment with the impulse trend of Economic Institute of Faculty of Law) by Analysis and Research Department of Bank of Slovenia.

The dynamics of imports followed those of exports. Pursuant to the Association Agreement with the EU the customs tariffs for imports of goods were reduced as of January 1, 1997. Higher imports are partly due to lower import prices and partly to possibilities for increased exports. Due to slower wage growth, private consumption growth was modest. As evident from figure 3, industrial production did not keep pace with export and import growth. It only accelerated towards the end of the year.

Higher imports rather a consequence of lower customs tariffs and of higher exports...

...than private consumption.

Within the structure of total exports and imports, the share of consumption goods fell by 1 percentage point. The share of intermediate goods increased by 0.4% on the export and by 1 percentage point on the import side. Exports of capital goods increased by 0.6 percentage points, while imports thereof remained on the 1996 level.

As in the previous year, the bulk of trade took place with the European Union. Exports to the EU accounted for 63.6% and imports from the EU for 67.4% of the total. Germany retained the number one position with a share of 29.4% in exports and 20.7% in imports (against 30.6% and 21.7% respectively in 1996). The trade surplus with Germany increased from USD 501 million in 1996 to USD 526 million in 1997. Among other significant trade partners from the EU, exports increased to Italy by 13.1% (and imports declined by 2.4%). Exports decreased most to France – by 22.5% - while imports from France increased by 6%. On the whole, Slovenia's market share in the EU did not change substantially.

Prevailing trade with EU member countries

Growth was highest in trade with CEFTA countries (increase in exports by 6,6% and imports by 10%) and CIS countries (growth of 10,9% and 20,2% respectively). Slovenia had a surplus in trade with the CIS countries and with successor states to the former SFR Yugoslavia. The trade deficit with EU countries remained on approximately the same level for the third year running.

Growth in trade with CEFTA and CIS countries

Table 1: **Regional Structure of Foreign Trade**
(between 1995 and 1997 in million USD)

| | EXPORTS | | | IMPORTS | | | BALANCE | | |
|---------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|---------------|---------------|-------------|
| | 1995 | 1996 | 1997 | 1995 | 1996 | 1997 | 1995 | 1996 | 1997 |
| Austria | 535 | 551 | 565 | 919 | 835 | 789 | -384 | -284 | -223 |
| France | 681 | 598 | 463 | 798 | 924 | 979 | -117 | -326 | -516 |
| Italy | 1,212 | 1,103 | 1,248 | 1,611 | 1,593 | 1,555 | -399 | -490 | -307 |
| Germany | 2,508 | 2,545 | 2,462 | 2,206 | 2,044 | 1,936 | 302 | 501 | 526 |
| European union (15) | 5,575 | 5,367 | 5,322 | 6,532 | 6,360 | 6,309 | -957 | -994 | -987 |
| CEFTA | 424 | 473 | 504 | 667 | 641 | 705 | -243 | -168 | -201 |
| EFTA | 87 | 83 | 87 | 237 | 249 | 194 | -151 | -166 | -108 |
| Noneuropean members of OECD | 363 | 340 | 341 | 541 | 585 | 542 | -178 | -245 | -202 |
| Successor states to former SFRY | 1,209 | 1,385 | 1,388 | 671 | 709 | 593 | 538 | 676 | 795 |
| Croatia | 891 | 855 | 837 | 576 | 590 | 465 | 315 | 265 | 372 |
| CIS countries | 375 | 390 | 433 | 275 | 236 | 284 | 100 | 154 | 149 |
| Other countries | 283 | 272 | 297 | 569 | 641 | 731 | -286 | -369 | -433 |
| TOTAL | 8,316 | 8,310 | 8,372 | 9,492 | 9,421 | 9,358 | -1,176 | -1,112 | -986 |

Source: Statistical Office of RS; provisional data for 1997.

Overall trade deficit lower...

As in the years 1995 and 1996, the trade deficit was not entirely covered by the surplus in services. The surplus in services was reduced – it amounted to USD 590 million against USD 704 million in 1996. The overall trade deficit amounted to USD 182 million against USD 177 million in 1996.

**...receipts from travel
increased in real terms –
inter-currency oscillations
not taken into account.**

Receipts from travel amounted to USD 1,188 million, a 3.4% decrease against 1996. Deterioration started in the second half of the year when receipts from daily tourism (casinos, duty-free shops, and sale of fuel) slowed down significantly. Given the 15% appreciation of the US Dollar against the German Mark and 10% against the Italian Lira, the same receipts still result in a real growth. Expenditure for travel abroad amounted to USD 544 million, and remained approximately on the 1996 level.

Table 2: **The Balance of Payments, 1992-1997** (provisional data, in million USD)

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---------------------------------------|-------------|-------------|-------------|-------------|-------------|---------------|
| A. CURRENT ACCOUNT | 926 | 192 | 600 | -23 | 39 | 37 |
| 1. Goods | 791 | -154 | -338 | -954 | -882 | -772 |
| 2. Services | 180 | 375 | 676 | 631 | 704 | 590 |
| 2.1. Transport | -164 | 57 | 68 | 70 | 76 | 101 |
| 2.2. Travel | 389 | 429 | 537 | 558 | 687 | 643 |
| 2.3. Other | -45 | -111 | 71 | 3 | -59 | -154 |
| 3. Income | -91 | -51 | 170 | 210 | 155 | 131 |
| 3.1. Labour income | -2 | -8 | 201 | 210 | 210 | 208 |
| 3.2. Investment income | -90 | -44 | -31 | 0 | -55 | -77 |
| 4. Current transfers | 46 | 22 | 92 | 91 | 62 | 88 |
| B. CAPITAL ACCOUNT | ... | 4 | -4 | -18 | -5 | -4 |
| C. FINANCIAL ACCOUNT | -645 | -206 | -519 | 186 | -42 | -99 |
| 1. Direct investment | 113 | 111 | 131 | 170 | 178 | 295 |
| 2. Portfolio investment | -9 | 3 | -33 | -14 | 637 | 236 |
| 3. Other investment | -117 | -209 | 27 | 264 | -270 | 658 |
| 3.1. Assets | -158 | -314 | -306 | -351 | -426 | 288 |
| a) Trade credits | 7 | 93 | 0 | 0 | -162 | -264 |
| b) Loans | -31 | 12 | -11 | -14 | -7 | -67 |
| c) Currency and deposits: banks | -149 | -451 | -335 | -195 | -339 | 599 |
| households | 9 | 87 | 153 | 6 | -103 | 74 |
| other sectors | ... | -20 | -3 | 7 | 28 | 6 |
| d) Other assets * | 6 | -35 | -110 | -155 | 158 | -59 |
| 3.2. Liabilities | 41 | 104 | 334 | 615 | 156 | 369 |
| a) Trade credits (long-term) | -13 | -13 | -11 | -4 | 17 | 14 |
| b) Loans: | 33 | 161 | 326 | 572 | -12 | 334 |
| Bank of Slovenia | - | -14 | -5 | -3 | -3 | -1 |
| Commercial banks | -9 | 2 | 92 | 208 | -178 | 3 |
| General government | -17 | 79 | 82 | 130 | -74 | -5 |
| Other sectors | 59 | 95 | 157 | 237 | 243 | 337 |
| c) Deposits and other liabilities | 21 | -44 | 19 | 47 | 150 | 21 |
| 4. International reserves (BS) | -633 | -111 | -645 | -235 | -587 | -1,287 |
| Net errors and omissions | -281 | 10 | -77 | -145 | 8 | 66 |

Source: Bank of Slovenia; provisional data for 1997.

Minus sign (-) indicates imports or surplus of imports over exports in the current account, increases in assets or decreases in liabilities in the capital and financial accounts, and increases in international reserves of the Bank of Slovenia.

* Includes payments of the Bank of Slovenia to the fiduciary account.

The surplus in transport services increased from USD 76 million in 1996 to USD 101 million. The deficit in remaining services amounted to USD 154 million, representing an increase by USD 95 million against 1996. Deterioration in construction and assembly services accounted for most of the deficit, and so did increased purchase of intellectual property rights (patents) and licenses.

Surplus in transport services increased

Net **income receipts** of USD 208 million remained on the 1995 and 1996 level. Net outflow of **capital income** increased (USD 77 million against 55 million in 1996). Net interest paid abroad increased to USD 64 million due to a stronger US Dollar and higher external indebtedness; interest received decreased by USD 17 million to USD 144 million, interest paid increased by USD 14 million to USD 209 million. Net inflow of **current transfers** amounted to USD 88 million against USD 62 million in 1996.

Higher net inflow in current transfers...

According to preliminary data, the **current account surplus** amounted to USD 37 million against USD 39 million in 1996.

...current account surplus basically unchanged.

The inflow of **foreign equity investments** in Slovenia amounted to USD 321 million (against USD 186 million in 1996), and Slovenian equity investment abroad to USD 26 million, which is three times as much as in 1996. **Foreign portfolio investments** amounted to USD 238 million, the lion's portion thereof (USD 195 million) are proceeds of a Slovenian Eurobond issue in June 1997. Foreign portfolio investments amounted to USD 52 million (there are no comparable data available for 1996, since foreign equity and portfolio investments were not registered separately).

Higher foreign direct investments in Slovenia

Foreign portfolio investments primarily in Eurobond issues

Due to **loans raised** external debt increased by USD 334 million (against USD 453 million in 1996 – not taking into account the liabilities under foreign loans of USD 465 million taken over by the state from banks). Net government external debt repayments amounted to USD 5 million (against USD 74 million in 1996). Loans taken by enterprises increased by USD 94 million and amounted to USD 337 million. Banks net repaid foreign loans during the first three quarters of the year; however, their liabilities under foreign loans increased by USD 3 million due to disbursements in the last quarter of the year. The banks' **claims on foreign borrowers** increased by USD 71 million (against USD 6 million in 1996) under loans given, and by an additional USD 52 million under other headings. **Liabilities of banks to non-residents** increased by USD 20 million (against USD 155 million in 1996).

Net financial inflow amounted to USD 645 million or 3.6% of GDP

The **net financial inflow** amounted to USD 645 million and accounted for 3.6% of GDP. Financial inflow of USD 66 million has not been identified and is carried as statistical error. The actual increment in **international reserves** (those of the Bank and of commercial banks) therefore amounted to USD 681 million, whereof 645 million stemming from financial and 37 million from current transactions.

Incremented international reserves by USD 681 million...

Based on its operations with foreign countries and those on domestic foreign exchange market, the **international reserves of the Bank** increased by USD 1,287 million and reached USD 3315 million.

...and international reserves of the Bank by USD 1,287 million.

1.6. External Debt

| | |
|--|--|
| <p>For the first time since 1991 a decline in external borrowing...</p> <p>...of the central govern- ment...</p> <p>...and of the private sector.</p> | <p>New credit arrangements concluded totaled USD 1,350 million (a decline of 16.3% against 1996). It is for the first time since 1991 that a decline in borrowing abroad was registered. Loans taken or guaranteed by the central government amounted to USD 379.3 million – DEM bond issue accounted for USD 231.2 million thereof – a decrease of 11.2% against 1996. Loans taken by the private sector amounted to USD 970.7 million – a decrease of 18.1% against 1996. Loans granted by international financial institutions amounted to USD 85.4 million, syndicated foreign loans taken by banks USD 165.6 million.</p> |
| <p>A bigger share of short-term loans</p> | <p>Within the overall new external debt the share of short-term loans increased to 21.8%. Average maturity of medium and long-term loans increased and reached seven years and one month. As to currency structure, the share of DEM loans increased to 69.1%.</p> |
| <p>External debt in USD increased by 4.1%</p> | <p>At December 1997, the external debt total amounted to USD 4,176 million, an increase of 4.1% against 1996. Both, the long-term and short-term debts grew. Within the total, the share of short-term debt was 3.1%.</p> |
| <p>International reserves exceeded external debt</p> | <p>International reserves exceeded the external indebtedness by 3.1%.</p> |

2. MONETARY POLICY

2.1. Objectives of Monetary Policy

As in previous years, the Bank pursued a policy targeted at stability of domestic currency and ensuring that the inflation rate moves down further. The Bank sets an intermediate target for monetary aggregate growth. The Bank's interventions within the managed float exchange rate regime were limited by the constraints of the monetary target set. The Bank's clear objective is to bring inflation down to the European level within a few years' time.

Low inflation as monetary policy objective

In 1997, the Bank publicly announced the implementation of a new monetary framework, which employed M3, the broad monetary aggregate, as the intermediate target of its monetary policy. This money aggregate is to stay a medium-term orientation. For current decisions the Bank tracked and took the more significant indicators of monetary policy into account (interest rates, realization of open tenders, excessive mandatory reserves) and measured the current monthly demand for transaction money (M1) and base money.

M3 as new intermediate target

In February 1997, the Bank became a net debtor on the (Tolar) money market (the mandatory reserve accounts of banks not taken into account), and this grew later on. Base money was offered to banks almost exclusively against sale of foreign exchange; loans, on the other hand, (including those under Bank Tolar bills repurchase agreements) remained on the same level. Purchase of foreign exchange and sale of Tolar bills were therefore the main tools for regulation of Tolar liquidity of banks.

Majority of base money offered to banks against sale of foreign exchange...

Broad monetary aggregate (M3) increased primarily due to the increase in net claims to non-residents and only slightly due to the increase in domestic loans granted. The Bank channeled into its foreign exchange reserves a major portion of current and existing foreign exchange reserves of banks by means of purchase of foreign exchange from banks and sale of its foreign currency bills to banks.

... and so was M3.

Box 3: Intermediate Monetary Policy Target for 1997

On May 6, 1997 the Governing Board of the Bank of Slovenia adopted and announced broad money M 3 as the intermediate target of its monetary policy for 1997. M3 was projected to grow by 18% with an error band of +/- 4 percentage points. The projection was calculated with a target budget deficit of 0.5% of GDP and announced adjustments in government regulated prices.

The actual realized M3 growth amounted to 22.9 %, and the error band projected surpassed by 0.9 percentage points. The Governing Board assessed the result on February 24, 1998 and decided that this was due to changes in external factors and that M3 would be kept as intermediate target of monetary policy for 1998.

M3 comprises almost all liabilities of the monetary system in domestic currency, including government deposits and household foreign exchange deposits in banks. Other liabilities of the system - capital and reserves excluded - comprise basically securities issued by banks and by the Bank (4.8% of M3 at end of 1997); there is only a limited number of other secure and liquid non-bank instruments available in the market.

Within the annual M3 growth of 22.9%, M1 grew by 19.4%, foreign exchange deposits by 5.8% (growth is entirely accounted for by exchange rate differentials), and Tolar (sight and time) deposits by 35.7%. Time deposits with maturity over 1 year grew by a considerable 67.7%. Nevertheless, these deposits only accounted for 12.1% (together with foreign exchange deposits with the same maturity 14.6%) of M3.

**Decrease in interest rates
accelerated towards the end
of the year**

The level of domestic deposit and lending rates has remained high in real terms. Lending activities of banks were kept moderate (after their expansion in the period 1995-1996); Bank issued securities represented a safe and sound alternative. The accelerated export and production activities in the second half of the year triggered the demand for bank loans; lending activity of banks increased in the last quarter of the year. More than half of loans taken by enterprises were granted by foreign banks during the year; in view of this fact and of the pending further liberalization of capital flows domestic banks started lowering lending rates. The Bank supported this development by reducing its own interest rates.

**Pressure of general govern-
ment deficit on bank loans**

Monetary policy was confronted with a changing environment: after a balanced general budget during the recent years, it suddenly faced a deficit of 1.1% of GDP. Such deficit exercised additional pressures on bank loans and on interest rates. In addition, government regulated prices of public utilities were increased substantially (by 16.1% against 6.9% growth of free market prices), which led to higher inflation of 9.4% (against 8.8% in 1996).

Table 3: **Supply of Base Money** (in billion SIT)

| | December 31 st | | | Change in quarter 1997 | | | | |
|---|---------------------------|--------------|---------------|------------------------|--------------|--------------|--------------|--------------|
| | 1995 | 1996 | 1997 | I | II | III | IV | Total |
| 1. Net foreign assets | 250.3 | 329.6 | 559.2 | 56.4 | 69.4 | 90.6 | 13.3 | 229.6 |
| 2. Domestic liabilities in foreign currency | -158.6 | -181.1 | -301.0 | -35.1 | -44.4 | -54.7 | 14.3 | -119.9 |
| - foreign currency bills | -120.0 | -162.1 | -289.2 | -43.4 | -22.1 | -62.9 | 1.2 | -127.1 |
| - foreign currency deposits of the budget | -37.1 | -19.0 | -11.8 | 8.2 | -22.3 | 8.1 | 13.1 | 7.1 |
| 3. Net foreign currency assets (1+2) | 91.7 | 148.5 | 258.2 | 21.2 | 25.0 | 35.8 | 27.6 | 109.7 |
| 4. Time deposits of the budget | -7.8 | 0.0 | -9.0 | -1.1 | -6.4 | 0.3 | -1.8 | -9.0 |
| 5. Loans to the banks | 43.1 | 15.7 | 18.1 | -1.7 | 4.5 | -5.9 | 5.5 | 2.4 |
| - liquidity | 7.7 | 1.3 | 0.0 | -0.7 | -0.3 | 0.5 | -0.7 | -1.3 |
| - repurchase | 16.8 | 13.7 | 13.7 | -2.4 | 0.5 | -4.8 | 6.7 | 0.0 |
| - other loans | 18.6 | 0.8 | 4.4 | 1.4 | 4.3 | -1.5 | -0.6 | 3.6 |
| 6. Tolar bills | -6.6 | -16.3 | -75.8 | -10.6 | -9.6 | -21.0 | -18.4 | -59.5 |
| - 60 days | -2.2 | -2.9 | -24.6 | -3.8 | -5.6 | -12.0 | -0.3 | -21.7 |
| - 270 days | - | - | -23.8 | -1.5 | -1.8 | -5.8 | -14.7 | -23.8 |
| - bills with warrants | -1.4 | -9.0 | -17.4 | -6.8 | -3.9 | 0.0 | 2.3 | -8.4 |
| - other bills | -3.0 | -4.4 | -10.0 | 1.5 | 1.7 | -3.2 | -5.7 | -5.6 |
| 7. Other items net | -18.5 | -28.1 | -45.9 | -8.1 | -3.2 | -7.8 | 1.2 | -17.9 |
| 8. Net tolar assets (4 to 7) | 10.2 | -28.7 | -112.6 | -21.5 | -14.7 | -34.3 | -13.5 | -84.0 |
| 9. Base money (3+8) | 101.9 | 119.9 | 145.6 | -0.3 | 10.4 | 1.5 | 14.2 | 25.8 |
| - bank reserves | 38.0 | 48.1 | 63.1 | -1.9 | 9.3 | -1.1 | 8.7 | 15.0 |
| - other sight deposits | 4.0 | 4.9 | 4.4 | -0.6 | 0.2 | 0.3 | -0.4 | -0.5 |
| - currency | 60.0 | 66.8 | 78.1 | 2.3 | 0.8 | 2.3 | 5.9 | 11.3 |

Source: Bank of Slovenia; accrued interest and discount are not included.

Supply of **base money** was weak during the first four months (an actual reduction of base money); it increased with the sterilization of inflow of foreign currency starting in June, and was kept moderate for the rest of the year. The increase of base money at December 1997 against December 1996 amounted to 18.4% (measured with monthly average) or 8.3% in real terms.

8.3% real growth in base money

The Bank issued base money through foreign exchange transactions and withdrew it with Tolar bill transactions. Based on a package of measures adopted by the Bank in 1996, banks were stimulated to either invest in foreign currency denominated bills of the Bank or sell the surplus in their foreign exchange liquidity to the Bank. Purchase of foreign exchange with rights, the instrument first offered to the banks by the Bank in July 1996 and in force until end of May 1997, followed by a new cycle, especially motivated banks to sell their surplus. The international reserves of the Bank increased by a total of USD 226.9 billion Tolars; foreign exchange denominated bills sold to banks account for 127.1 billion SIT, and sale of foreign exchange to the Bank by banks for 92.7 billion SIT. Until May, monetization amounted to about 5 billion SIT per month, over 11 billion SIT per month during summer, and to about 7 billion SIT per month during the rest of the year.

Loans to banks increased by 2.4 billion SIT and time deposits of the central government decreased by 9 billion SIT. By means of Tolar bills 59.5 billion SIT of base money was withdrawn, on average 5 billion SIT per month.

Table 4: **M3 Supply: Consolidated Balance Sheet of the Monetary System**
(in billion SIT)

| | Volume per December 31 st | | | Change in quarter 1997 | | | | |
|--|--------------------------------------|----------------|----------------|------------------------|-------------|-------------|-------------|--------------|
| | 1995 | 1996 | 1997 | I | II | III | IV | Total |
| 1. Net foreign assets | 365.2 | 488.4 | 676.8 | 37.3 | 58.3 | 57.6 | 35.2 | 188.4 |
| 2. Domestic assets | 921.1 | 993.8 | 1,134.6 | 13.9 | 38.0 | 34.9 | 54.0 | 140.8 |
| General Government: bonds* | 264.6 | 228.1 | 249.6 | 4.6 | 3.0 | 6.9 | 7.0 | 21.5 |
| loans | 50.9 | 40.7 | 69.8 | 1.3 | 14.5 | 3.1 | 10.3 | 29.1 |
| Enterprises : securities | 40.9 | 40.9 | 40.8 | 0.7 | -0.2 | 0.6 | -1.3 | -0.2 |
| loans | 404.2 | 477.0 | 534.2 | 5.1 | 6.8 | 12.0 | 33.4 | 57.3 |
| Households: loans | 160.5 | 207.2 | 240.3 | 2.3 | 14.0 | 12.3 | 4.6 | 33.1 |
| 3. Securities issued | -57.1 | -52.2 | -66.8 | 3.2 | -5.7 | -10.1 | -2.0 | -14.6 |
| 4. Foreign currency deposits of the budget | -37.1 | -19.0 | -11.8 | 8.2 | -22.3 | 8.1 | 13.1 | 7.1 |
| 5. Other items net | -252.2 | -278.6 | -339.4 | -24.3 | -13.6 | -22.1 | -7.6 | -60.8 |
| 6. M3 (1 to 5) | 939.9 | 1,132.5 | 1,393.4 | 38.3 | 54.8 | 68.4 | 99.4 | 260.9 |
| - foreign currency deposits at banks | 325.4 | 384.4 | 404.0 | -0.5 | -5.1 | 13.0 | 12.3 | 19.6 |
| 7. M2 | 614.5 | 748.1 | 989.4 | 38.8 | 59.9 | 55.4 | 87.1 | 241.3 |
| - time deposits in banks | 348.1 | 447.9 | 630.8 | 40.0 | 18.6 | 58.0 | 66.3 | 183.0 |
| - time deposits in Bank of Slovenia | 7.8 | 0.0 | 9.0 | 1.1 | 6.4 | -0.3 | 1.8 | 9.0 |
| - saving deposits | 54.7 | 65.2 | 79.1 | 8.1 | 8.6 | -1.5 | -1.2 | 13.9 |
| 8. M1 | 203.9 | 235.1 | 270.5 | -10.4 | 26.4 | -0.8 | 20.2 | 35.4 |
| - sight deposits at banks | 140.0 | 163.3 | 187.9 | -12.1 | 25.3 | -3.4 | 14.8 | 24.6 |
| - sight deposits at Bank of Slovenia | 4.0 | 4.9 | 4.4 | -0.6 | 0.2 | 0.3 | -0.4 | -0.5 |
| - currency in circulation | 60.0 | 66.8 | 78.1 | 2.3 | 0.8 | 2.3 | 5.9 | 11.3 |

* Net of 'other foreign exchange liabilities' of banks to general government (liabilities from banks' external debt taken over by the government in 1996).

Source: Bank of Slovenia.

**Foreign financial inflow
accounted for M3
growth**

Growth of **monetary aggregate M3** reflected the dynamics of foreign financial inflow and the growth in domestic credit activity during the last quarter of the year. M3 growth amounted to 23.8% or 13.2 % in real terms between December 1996 and December 1997.

Net foreign assets of the financial system increased by 188.4 billion SIT. Monetization of 79.8 billion SIT took place in foreign currency exchange offices, that of 61.0 SIT via the foreign exchange market; the Bank purchased foreign exchange from central government to a countervalue of SIT 3.3 billion. Inflow of foreign exchange increased substantially after May; in contrast to previous years, the major part was due to foreign equity and portfolio investment rather than to foreign loans.

Domestic assets increased by a total of 140.8 billion SIT, of which loans by banks were 119.5 billion SIT. Loans to households grew moderately, loans to general government stronger. Until to September, lending to enterprises was weak, but grew stronger in the last quarter of the year. Other domestic bank assets, especially securities, grew primarily due to exchange rate differentials; the estimated actual growth in government securities amounted to about 5 billion SIT, while the December issue of 6 billion SIT was realized in January 1998.

2.2. Interest Rates

**Real interest rates de-
creased...**

Real interest rates defined as the real component above the base rate of interest (TOM), kept decreasing during the year. The Bank increased interest rates for sterilization instruments slightly in mid year, but this did not effect market rates. The reduction in interest rates was actually modest, considering the strong financial inflow from abroad. It wasn't until December that a stronger reduction of domestic interest rates emerged.

...revaluation rate increased.

The reduction in real interest rates hardly had any effect on the overall nominal interest rates due to an increasing revaluation rate (TOM); TOM increased by

Table 5: Bank of Slovenia Interest Rates and Money Market Rates in 1997
(monthly average in % p.a.)

| | Nominal interest rates | | | | TOM | Interest rates over tolar revaluation clause "TOM" | | | |
|-----------|------------------------|--------------|----------|------------------|-------|--|--------------|----------|------------------|
| | Repurchase | Tolar bills: | | Interbank market | | Repurchase | Tolar bills: | | Interbank market |
| | | 60 days | 270 days | | | | 60 days | 270 days | |
| January | 10.66 | 9.76 | - | 9.02 | 6.05 | 4.34 | 3.50 | - | 2.80 |
| February | 12.88 | 11.89 | - | 10.14 | 8.11 | 4.42 | 3.50 | - | 1.88 |
| March | 12.88 | 12.36 | 13.45 | 9.83 | 8.56 | 3.98 | 3.50 | 4.50 | 1.17 |
| April | 12.08 | 11.31 | 12.39 | 8.60 | 7.55 | 4.22 | 3.50 | 4.50 | 0.97 |
| May | 12.93 | 12.90 | 13.99 | 9.47 | 8.56 | 4.02 | 4.00 | 5.00 | 0.84 |
| June | 13.62 | 13.21 | 14.30 | 9.63 | 8.86 | 7.34 | 4.00 | 5.00 | 0.70 |
| July | 13.06 | 12.90 | 13.99 | 9.22 | 8.56 | 4.15 | 4.00 | 5.00 | 0.61 |
| August | 14.70 | 14.51 | 15.88 | 10.35 | 9.84 | 4.43 | 4.25 | 5.50 | 0.46 |
| September | 14.96 | 14.86 | 16.24 | 10.40 | 10.18 | 4.33 | 4.25 | 5.50 | 0.20 |
| October | 14.50 | 14.50 | 15.88 | 9.91 | 9.84 | 4.24 | 2.24 | 5.50 | 0.07 |
| November | 14.51 | 14.50 | 16.24 | 10.19 | 10.18 | 3.93 | 3.92 | 5.50 | 0.01 |
| December | 13.78 | 13.00 | 15.33 | 9.76 | 9.84 | 3.59 | 2.88 | 5.00 | -0.07 |

* Calculated from the overall nominal rates for all interest rates, except rates of the 60-day Tolar bill until April and for the 270-day Tolar bill.

Source: Bank of Slovenia.

7.6% on average during the first quarter and by 10.0% on average during the last quarter of the year. Yet on a year-to-year basis TOM was on average lower than in 1996.

The general level of interest rates is still high. The average nominal interest rate for short-term inter-bank loans amounted to 9.7%, the average deposit rate for time deposits with maturity of 1 month 13.2%, and the average long-term lending rate to 21.3%. Comparable nominal depreciation of the Tolar against the DEM amounted to 3.6%.

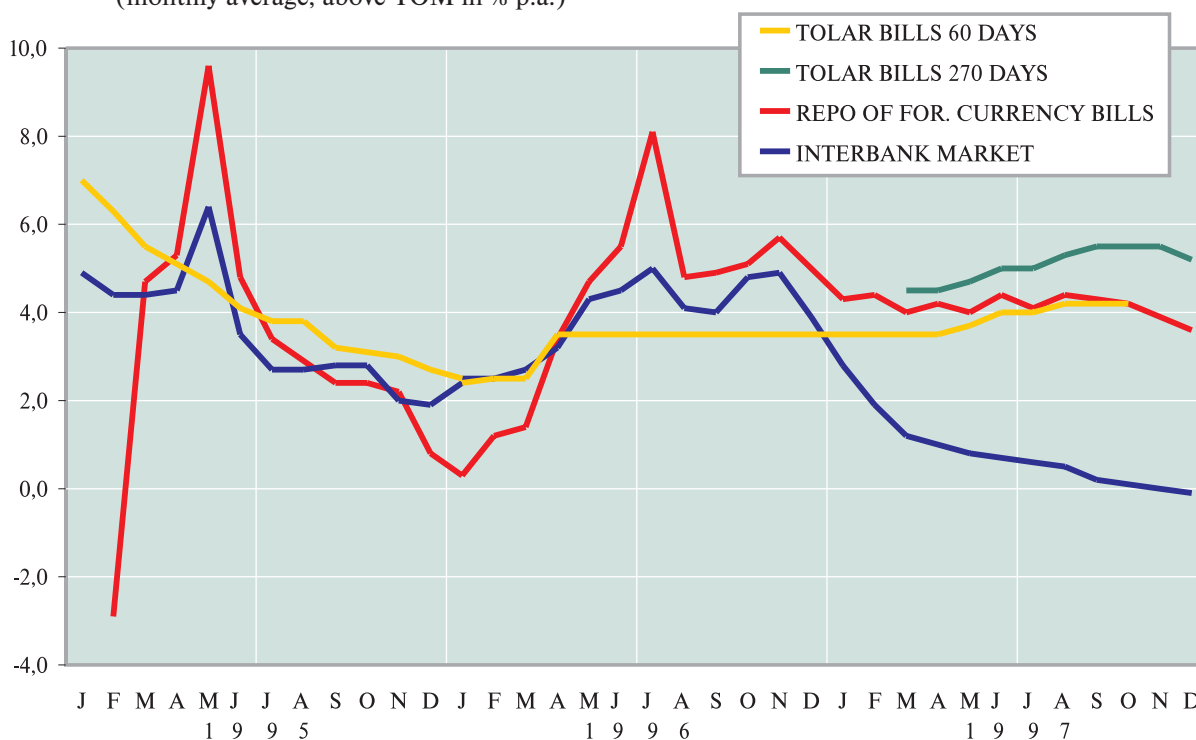
Deindexation: Since 1995 there have been important changes in application and calculation of the revaluation clause TOM. It was initially calculated as an average of inflation rates in the previous three months, and later as an average of previous six months. The period employed in the calculation of the inflation revaluation clause since May 1997 has been an average of the preceding 12 month inflation. This essentially smoothed out the month-to-month volatility in nominal rates.

Revaluation rate volatility smoothed out

The Bank abolished indexation of its instruments with a maturity of up to 30 days early in 1995. The Bank abolished indexation of its Tolar bills with a maturity of 60 days in October 1997.

The **Bank's Discount and Lombard rates** remained unchanged – 10% and 11% respectively. There is hardly any facility offered at the discount rate. Only a few Lombard loans were drawn.

Figure 4: **Bank of Slovenia and Market Rates of Interest**
(monthly average, above TOM in % p.a.)



Source: Bank of Slovenia.

The Bank used Tolar instruments to withdraw the money issued by means of foreign exchange transactions. Among foreign exchange transactions, the standing offer for repurchase of foreign currency bills had a more significant role; the implicit interest rate followed that for Tolar bills with maturity of 60 days owing to the method used in tenders. As a consequence, the realization of such repos was low, in particular in the second half of the year.

Higher interest on Bank bills at the time of Bank interventions

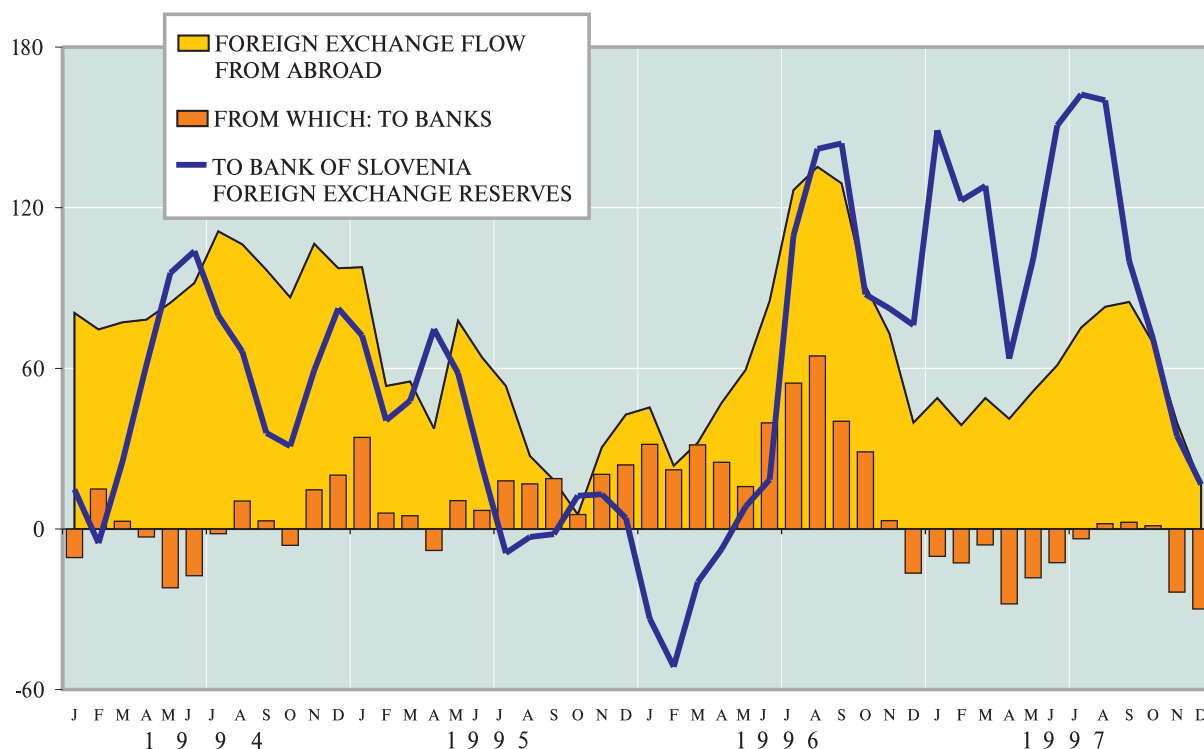
The interest rate applied on Tolar bills with maturity of 60 days until May was 3.5% that applied on bills with maturity of 270 days at the time of issuance (February) 4.5% above TOM. At the time of its stronger foreign exchange intervention in August, the Bank increased the two interest rates in two steps to 4.25% and 5.5% above TOM respectively; the bank lowered the interest rates again in December. The respective interest rates amounted to 2.9% above TOM (or 13.0% nominal rate of interest used from October 1997) and 5.0% above TOM respectively.

Short-term money market rates did not follow the development of Bank of Slovenia Tolar bill rates between May and August, but declined throughout the year. It fell sharply from 3% above TOM to 1% by March, declined further to levels below 1% above TOM and ended up on the level of 0.1% above TOM at the end of the year (9.8% nominal rate).

Net inflow in non-banking sectors

Other markets with representative interest rates have not been developed. The central government has not been very active in domestic borrowing; the budget deficit was mainly covered through three Treasury bond tenders (RS09) with maturity of 3 years. The average interest rate realized in December was 5.5% above TOM.

Figure 5: **Foreign Exchange Flows*** (in million USD monthly; moving average 3)



* Inflow (direct flows not included) from abroad to Bank of Slovenia (interests etc and reduced for net payments from foreign exchange account of the budget).

Source: Bank of Slovenia.

2.3. Exchange Rate

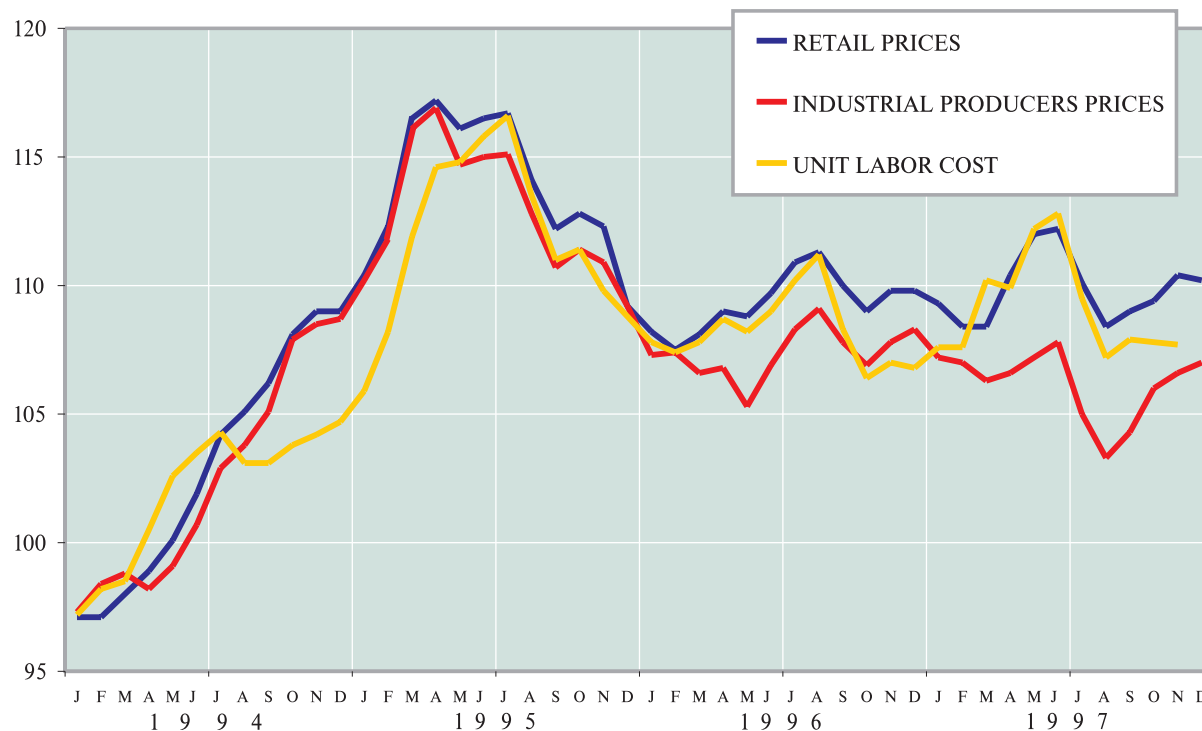
The **inflow of foreign exchange** into foreign exchange reserves of banks and of the Bank amounted to 681 million US Dollars (against 907 million US Dollars or 753 million Dollars without the balance transferred to regular accounts of the Bank from the fiduciary account in Luxembourg in 1996); it was stronger in the last two quarters of the year. Unlike 1996, the inflow of foreign exchange was directed strictly to non-banking sectors (banks had a net-outflow of USD 158 million due to repayment of loans and investments undertaken abroad). The main source of foreign exchange for banks were foreign exchange offices; these net purchased 500 million US Dollars from resident and non-residents. The second source accounting for a net amount of 382 million US Dollars were enterprises on the foreign exchange market.

The amount channeled into foreign exchange reserves through foreign exchange interventions of the Bank exceeded the net amount from abroad. Based on measures adopted in 1996, banks were, among others, obliged to gradually lower their assets and put them into balance with their liabilities in foreign exchange. Purchase of the Bank's foreign currency bills accounted for 761 million US Dollars, and direct purchase of foreign exchange from banks (based on respective instruments) by the Bank for 581 million US Dollars. The sale of foreign exchange by banks to the Bank was regulated by the 'purchase with right to sell' (in June 1997 the new cycle of the instrument replaced the one from July 1996).

Foreign exchange interventions of the Bank exceeded the inflow of foreign exchange from abroad

In early 1997, the **DEM rate** on the foreign exchange market appreciated slightly given the scarce balance of payments inflows up to April (from 91.0 SIT/DEM to 91.2 SIT/DEM by end of March). The rate depreciated again to 90.1 SIT/DEM

Figure 6: **Real Effective Tolar Exchange Rate (1993=100)**



Source: Bank of Slovenia.

by mid June. It appreciated again to 94.5 SIT/DEM by the end of September due to the Bank's intervention. It remained unchanged for most of October, and after that depreciated slowly to reach 94.3 SIT/DEM by the end of the year.

**DEM rate of exchange
grew by 3.6%**

The DEM rate appreciated by 3.6% (against 2.2% in 1996). The rate of exchange in foreign currency exchange offices staggered behind that of the foreign exchange market by about 90 Stotin or 1%. Given the instrument of purchase of foreign exchange with the right-to-sell first made available in July, the difference disappeared. The nominal effective Tolar rate weighted by the currency basket of Slovenian exports, depreciated by 7.4% between December 1996 and December 1997, given faster appreciation of some other currencies, especially the US Dollar.

**7.4% growth of foreign
currency basket**

Real appreciation of the Tolar

The real effective Tolar rate appreciated by 0.4% if compared to growth of domestic and foreign retail price growth, and depreciated by 1.2% if compared to industrial producer price growth. Measured by the relative unit labor costs, Tolar appreciated by about 3% (based on preliminary data for December).

2.4. Monetary Policy Instruments

**Higher claims of banks on
the Bank**

The average volume of the Bank's instruments providing liquidity to banks outstanding shows an increase in claims of banks to the Bank against the previous year. This is mainly due to the Bank's net purchase of foreign exchange to ease the pressure on the exchange rate, and to other autonomous flows with an impact on the banks' reserves.

The net indebtedness of the Bank to domestic persons (primarily banks) calculated as average balance of monetary policy instruments outstanding including mandatory reserves, amounted to 327,106 million Tolars (against 143,726 million Tolars in 1996) or 11.4% of GDP (against 5.6% in 1996). With obligations of the Bank to domestic persons (primarily banks) in foreign currencies excluded, the net Tolar debt of the Bank amounted to 84,651 million Tolars (against 25,356 million in 1996) or 2.9% of GDP (against 1.0% in 1996).

The following instruments had a major impact on the volume of base money and on the exchange rate:

- Purchase of foreign exchange from banks with rights; net purchase of foreign exchange accounted for an increase of base money by 89.5 billion Tolars.
- Temporary purchase of foreign exchange accounted for an increase in base money by 8.4 billion Tolars; the differentials between the purchase and the selling rates are taken into account.
- Loans to banks account for a net increase in base money of 2.5 billion Tolars (supplementary short-term loans account for the major portion of the increase).
- Repurchase agreements under foreign currency bills accounted for withdrawal of base money totaling 9.7 billion Tolars; included in this amount are the differentials between the purchase and selling rates.
- Deposits of central government accounted for withdrawal of 9.0 billion Tolars of base money.
- Tolar bills accounted for net withdrawal of 58.7 billion Tolars; Tolar bills and bills with warrants accounted for most of the amount withdrawn.

The Bank regulated the supply and demand for foreign currencies on the foreign exchange market by means of mandatory reserves of foreign exchange (foreign exchange minimum), by obliging banks to balance their foreign exchange assets with foreign exchange liabilities, and by means of the non-interest-bearing Tolar deposit requirement on drawdowns under non-trade related loans taken abroad.

Loans to banks

The bank issued base money by means of Lombard loans, short-term loans and liquidity loans. Supplementary short-term loans accounted for one third of all loans given (measured by either gross drawings under loans or average daily loans outstanding). The volume of liquidity loans decreased substantially due to the fact that there were no loans providing liquidity support to banks under rehabilitation drawn. Average daily loans outstanding amounted to 4.5 billion Tolars; outstanding loans reached a peak in June (8.7 billion Tolars) and in October (8.5 billion Tolars).

The Bank extended Lombard loans, short-term loans and liquidity loans

Lombard loan: a five-day loan offered at an interest rate one percentage point above the discount rate, i.e. 11% since April 1995. Banks can draw on 2.5% of the collateral pledged in the form of Bank of Slovenia foreign currency bills or Treasury bills. The amount drawn under this loan amounted to 25.6 billion Tolars (against 16.9 billion Tolars in 1996), 5.1 billion Tolars thereof were drawn in September. The loans accounted for a net withdrawal of 209 billion Tolars.

Short-term loan: the Bank first offered the loan in 1994 as regular monthly loan; the Bank introduced supplementary loans in September 1995 to neutralize the effect of the transfer of the budgetary liquidity surplus from banks to the Bank.

Table 6: **Monetary Policy Instruments Used** (in million SIT)

| | Stock | Average daily stock in quarter 1997 | | | | Stock |
|--|----------------------------|-------------------------------------|----------------|----------------|----------------|----------------------------|
| | Dec. 31 st 1996 | I. | II. | III. | IV. | Dec. 31 st 1997 |
| Loans to banks | 1,478 | 2,211 | 5,419 | 4,481 | 5,821 | 3,948 |
| - Lombard loans | 209 | 310 | 536 | 516 | 170 | 0 |
| - Short-term loans | 0 | 1,574 | 4,811 | 3,947 | 5,413 | 3,948 |
| - Liquidity loans | 1,269 | 328 | 73 | 18 | 238 | 0 |
| Repurchase of bills | 13,650 | 12,787 | 11,746 | 8,341 | 5,583 | 5,179 |
| Repurchase of foreign exchange | 0 | 0 | 0 | 903 | 1,997 | 8,473 |
| - Auction | 0 | 0 | 0 | 903 | 69 | 0 |
| - Open tender | 0 | 0 | 0 | 0 | 1,929 | 8,473 |
| Bank of Slovenia bills | 180,631 | 209,876 | 251,233 | 318,937 | 363,914 | 368,910 |
| - Tolar bills - banks and savings banks | 6,921 | 9,367 | 14,722 | 25,621 | 48,355 | 57,985 |
| - Twin bills | 792 | 738 | 67 | 4,124 | 40 | 51 |
| - Bills with warrants | 8,968 | 14,058 | 17,010 | 19,657 | 20,380 | 17,349 |
| - Foreign currency bills | 163,950 | 185,713 | 219,435 | 269,536 | 295,139 | 293,525 |
| Central Government deposits | 0 | 2,357 | 6,259 | 5,985 | 9,703 | 9,000 |
| Required reserves of banks and saving banks | 44,862 | 45,950 | 48,374 | 51,479 | 53,648 | 54,589 |
| Foreign exchange minimum of banks | 328,896 | 339,350 | 339,437 | 338,884 | 352,111 | 352,254 |
| Purchase of foreign exchange | | 16,627 | 25,584 | 36,185 | 21,197 | |
| Sale of foreign exchange | | 1,264 | 2,458 | 5,134 | 1,256 | |

Source: Bank of Slovenia; accrued interest and discount are not included.

Regular short-term loan is intended to regulate intra-month liquidity of banks based on preliminary data on base money, when the Bank is unable to purchase foreign exchange from banks until after availability of the final data. The loan is offered on a regular basis; the share of an individual bank in the total volume offered is determined on the basis of its share in the daily foreign exchange position of banks. The Bank determines monthly total volumes. The interest rate applied was 10% p.a. throughout 1997. The Bank stopped its interventions with regular short-term loans after October 1996.

Over 3/4 of all loans were short-term

Supplementary short-term loan is offered based on time deposits received from the Ministry of Finance for a period equal to the term of deposit, but not exceeding three months. The share of an individual bank in the total volume offered is determined in the same way as in case of regular loans. The interest rate applied is based on the deposit rate (based on Bank of Slovenia bills with comparable maturity) and increased by certain percentage points. The difference between the deposit rate and the lending rate increased gradually from 1 to 6 percentage points.

In total 70 offers for supplementary loans were made to banks. On average, the volume of supplementary loans extended reached 65% of time deposits received; the average maturity of such loans was 13 days. The average amount of loans outstanding was 4.0 billion Tolars (against 7.9 billion Tolars in 1996), with a peak in June (8.4 billion Tolars) and October (8.2 billion Tolars).

Fewer liquidity loans after completion of bank rehabilitation

Liquidity loans serve to regulate the liquidity of the banking system. The volume of such loans extended decreased substantially. Banks were mostly provided with liquidity based on Tolar bills; there were a few overnight loans extended. There were neither last-resort liquidity loans nor liquidity loans with participation of banks drawn upon. The two banks under rehabilitation did not make use of any liquidity loan for the whole year. Such special facility offered to banks under rehabilitation was cancelled when the rehabilitation process was completed in July.

The daily average of liquidity loans drawn amounted to 166 million Tolars (against 4.1 billion Tolars in 1996).

Liquidity loan against pledge of the Bank's Tolar bills can be drawn upon for a maximum of three and five days respectively against pledge of bills with maturity of 12 and thirty days respectively in the amount of up to the nominal value of bills pledged. Six banks drew under such loans against a pledge of 12-day bills. The share of such loan was 79% of the average daily liquidity loans drawn under. The majority of such loans were drawn in December (daily average amounted to 539 million Tolars) while none were drawn in May and August.

The interest rate applied exceeds that of the respective Tolar bill by two percentage points. The interest rate for the loan against a pledge of 12-day bills amounted to 7% p.a. throughout the year, while that for loans against a pledge of 30-day bills changed once during the year and reached 10% p.a.

Overnight liquidity loan is offered to banks, which are not net creditors on the interbank market. The Bank makes such loans available on the evening interbank market when the supply of such loans is scarce in spite of good liquidity of the system or when the market lending rates are too high. The Bank charges a uniform lending rate. Banks can draw on amounts in dependence of collateral available.

The Bank made such loans available in the evening interbank market in January and in mid-year. There was only one loan drawn. The interest rate for such loans remained unchanged (10.5% p.a.) throughout the year.

Liquidity loan of last resort is always available to any bank facing unexpected liquidity problems, i.e. for payment of due obligations and fulfillment of mandatory reserve requirement. The interest rate charged for the loan is that applied for overdue obligations, i.e. base rate plus 18 percentage points.

Special liquidity loan with participation of banks is available to banks facing liquidity problems, which are unexpectedly not able to attract new depositors or borrow on the interbank market, and are not eligible for the Bank's loans due to non-availability of appropriate securities. Any such bank can obtain a liquidity loan from the Bank with one or more banks participating. The participating bank is obliged to pledge Bank or Republic of Slovenia issued securities to the Bank; the lending bank pledges other first-class securities or grade A claims to the participating bank in return.

The Bank concluded the second agreement after the first in 1996 with 20 banks on their availability for participation in loans to banks with liquidity problems during a period of one year against compensation of 3% p.a. of the amount made available. No loan was made available with participation of banks since conclusion of the agreement.

Second agreement on participation of banks in liquidity loans

Temporary purchase of Bank of Slovenia bills

Temporary purchase of foreign currency bills is the most important instrument used to fine-tune base money. They are offered to banks on a permanent basis (except at the end of August and the beginning of September when the Bank offered to purchase foreign exchange from banks, obliging them to repurchase the amounts sold); the offer represented a stable and reliable source of liquidity to banks. The Bank made 236 such offers to purchase foreign exchange totaling 1,912 million German Marks; the actual amounts purchased equaled 120.3 billion Tolars or 69% of the total offered. Demand exceeded the supply until August; after September, the demand decreased, so that it only represented 39% of the total offered in November and December. The instrument served to withdraw a total of 9.7 billion Tolars in base money.

Temporary purchase of the Bank's bills used to fine-tune base money

Temporary purchase totaled 120.3 billion Tolars

The Bank's daily offer for "temporary purchase" for a period of four weeks varied between 8 and 10 million German Marks. Banks auctioned the repurchase exchange rate for the German Marks temporarily sold to the Bank. The average nominal interest rate p.a. applied was calculated based on the ratio between the exchange rate bid for obligatory purchase of Bank's German Mark denominated bills in the amount equal to the amount of German Marks temporarily sold to the Bank and the buying rate of the Bank on the day of transaction; it exceeded the interbank rate throughout the year, on average 3.5 percentage points. The implicit inherent interest rate above the monthly revaluation rate amounted, on average, to 4.2%.

Participating banks are obliged to purchase export proceeds from enterprises in the amount equaling certain percentage of temporarily sold bills during the first week following the auction. The obligation was set at 120%, except in July (150%).

Bank of Slovenia bills

**Tolar bills purchased totaled
465.5 billion Tolars...**

**...foreign currency bills
purchased totaled 7.5 billion
DEM and 590 million USD**

**Nine times as much Tolar
bills purchased
as in 1996**

**3.5 billion Tolars net
withdrawn with Twin bills**

In addition to the variety of bills offered in 1996, the Bank offered a Tolar bill with maturity of 270 days. The bills were offered under terms and conditions reflecting the current monetary policy target and interest rate oscillations in domestic and foreign markets. The volume of bills subscribed increased substantially. The total amount of bills subscribed amounted to 465.5 billion Tolars (six times the amount subscribed in 1996); the amount of those redeemed 404.9 billion Tolars and 48 million German Marks (under Twin Bills). Foreign currency bills purchased totaled in 7.5 billion German Marks and 590 million US dollars, redemptions thereunder 501 million German Marks and 108 million US Dollars; 6.0 billion German Marks and 108 million US dollars were re-employed for new subscription of foreign currency bills.

Tolar bills are short-term registered securities in book-entry form offered under various maturities to banks (2, 12, 20, 30, 60 and 270 days) and savings banks (7, 14, 60 and 270 days). Except for bills with maturities of 60 and 270 days, they are not issued in series. The bills subscribed are registered on a special account with the Bank and a respective certificate issued to the bank. The interest rate applied by the Bank changed from tender to tender, depending on domestic market rates and monetary policy target. The volume of such bills purchased was nine times the volume purchased in 1996. Subscriptions totaled 397.3 billion Tolars, redemptions by 51.5 billion Tolars less than that. Net reduction of base money equaled 51.5 billion Tolars. The share of subscriptions and redemptions by savings banks equaled 0.4% of the total volume sold and redeemed. Within the average daily volume of bills outstanding, 60-day bills held the highest share of 67%.

Twin bills are short-term transferable securities issued to the bearer in hard copy. They comprise a Tolar and foreign currency part, are bought in Tolars against discount and redeemed half in Tolars and half in German marks. The two parts can be traded separately. It is available to banks and via banks to households and enterprises. Revaluation clause applies to the Tolar part. The real yield on series issued in 1997 was as follows: 4% on the Tolar part and 2.75% on the foreign currency part of the 8th issue, 4.25% on the Tolar part and 3.0% on the foreign currency part of the 9th issue.

Two series of twin bills issued in 1997 and one issued in 1996 were available. Subscriptions totaled in 8.4 billion Tolars and redemptions in 4.9 billion Tolars and 48 million German marks. A total of 3.5 billion Tolars of base money were net withdrawn.

Bills with warrants are transferable securities issued to the bearer in hard copy with a face value of half a million Tolars. They are bought at discount in Tolars and bear a nominal interest rate. A warrant attached to the security acts as hedge against higher inflation and smaller rate of exchange depreciation than projected. Holders of warrants are able to buy new Tolar bills or foreign currency bills (without warrants) at a discount depending on the number of warrants of a single series presented, and on the increase in actual inflation compared to official projections for inflation and the Bank's middle exchange rates. The bills are issued twice a year, each time with maturity of six months; the due date of the first issue coincides with the issue date of the next. The interest rate is determined separately for each issue, and so is the number of warrants attached. Bills with warrants are sold at auctions. Issues number seven and eight were issued in 1997, issues number six and seven were redeemed.

A total of 126,234 lots of bills of the sixth, seventh and eighth issues were sold at a discounted total amount of 59.8 billion Tolars (an increase by 88% against 1996) and a total number of 425,776 warrants issued. Redemptions totaled 54.3 billion Tolars – 29.2 billion Tolars under sixth issue and 25.1 billion Tolars under seventh issue.

Discount totaling 15.1 million German Marks, 5.2 million US Dollars and 1,112.7 million Tolars was realized under 258,218 warrant parts employed. Most of the Tolar discounts were realized in May, most of DEM and USD discounts in February and July.

Foreign currency bills are transferable, registered non-series securities issued since January 1992 with maturity between two months and one year. They are available to banks and via banks to other legal entities. They are purchased at a discount in German marks or US Dollars. Those with maturity of 180 days or more can be purchased at a discount based on warrants. The actual discount depends on the number of warrants of a respective series, and on the difference between the actual Bank's middle exchange rate and the official projections for inflation. The interest rate applied reflects the relevant changes on international markets; interest rates for German Marks were changed 16 times, those for US Dollars 19 times.

Foreign currency bills make banks eligible for almost any loan of the Bank – for Lombard, liquidity and short-term loans; claims under foreign currency bills can also serve as collateral. Foreign currency bills with maturity of up to 120 days are used to meet the Bank's requirements regarding minimum foreign exchange holdings.

The volume of foreign exchange bills outstanding had a tendency to increase throughout the year (except in March). It increased from 1,587 million German Marks at December 31, 1996 to 2,626 million German Marks at December 31, 1997 (an increase of 65%). The volume of foreign exchange bills with maturity of up to 120 days increased above the average; the increase is mostly due to the increase in requirements regarding minimum foreign exchange holdings. As regards US Dollar denominated bills, the volume of those with maturity above 180 days increased most. The volume of US dollar denominated bills outstanding increased from 138 million at December 31, 1996 to 270 million at December 31, 1997; the bills reached a peak with 300 million US Dollars in July.

Deposits of central government

Bank of Slovenia provides banking services to the central government pursuant to the respective decree-based agreement concluded. A total of 201.0 billion Tolars (71 deposits) was deposited for a fixed term between 2 and 34 days, a total of 192.0 billion Tolars withdrawn. The average daily balance of such deposits (except in March) amounted to 6,082 million Tolars. The Bank offered supplementary liquidity loans to banks throughout the year with the purpose to neutralize the effect of transfer of budget liquidity surplus from banks to the Bank. The Bank limited extensive borrowing by increasing the interest rate for such loans. Banks drew upon a daily average of 3,952 million Tolars under such loans.

Central government utilized a bridging loan of 800 million Tolars during one single day due to maturity mismatch in budget revenues and expenditure.

Only one single loan drawn by central government

A credit facility (account 630) has been made available to the central government since December for any drawings necessary for the execution of the budget, depending on the balance on all deposit accounts held with the Bank. The credit facility was set at 4.9 billion Tolars in December and at 8.0 billion Tolars for days on which tax revenues were due. Central government did not make use of the facility.

Reserve requirements for banks and savings banks

Banks, savings banks and savings co-operatives are obliged to have minimum reserve holdings with the Bank. This instrument is among the most stable instruments of monetary policy. The requirement applies against Tolar deposits, loans received and bank securities held by non-banks. Minimum reserve requirements at end – 1997 were 12% for sight deposits and time deposits with maturity of up to 30 days, 6% for deposits with maturity between 31 days and up to three months, 2% for deposits with maturity between three and up to six months and 1% for deposits with maturity between six months and up to one year. The interest rate applied to the special minimum reserves account is 1% p.a.

Fast growth of long-term Tolar deposits

Tolar deposits grew on average by 2.4% (against 1.7% in 1996). They increased from 706.0 to 933.1 billion Tolars (32%). Time deposits with maturity of up to one year grew at a monthly average of 1.9%, and those with maturity of over one year at a monthly average of 4.3%. The share of such deposits within all Tolar deposits increased by 4.5 percentage points to 20.3%. The structure of Tolar deposits has changed since 1995 (when minimum reserve requirements were changed) in favor of long-term deposits.

The average minimum reserves on average on the level of 1996

The **calculated reserves** grew at a pace of 1.6% per month (as in 1996). They increased by 9.7 billion Tolars to 54.6 billion Tolars at the end of December. The average calculated requirement for deposits with maturity of up to one year decreased throughout the year, from 7.8% in January to 7.5% in December, and amounted, on average, to 7.6% (as in 1996). The average calculated reserves requirement for all Tolar deposits amounted to 6.1% (6.4% in 1996). The actual reserve holdings (on giro accounts, in cash and on special minimum reserves accounts) exceeded the calculated minimum reserves pursuant to the requirement, on average by 4.9% (between 1.7 billion Tolars in May and 3.1 billion Tolars in July). The requirement compliance period was changed in September from former first-day-until-end-of-month to 27th day of the previous month until 26th day of the current month.

All banks and savings banks may **employ their minimum reserve holdings** for liquidity purposes under the same conditions. Half of the mandatory reserve needs to be held on a special account on a daily basis and may be used for liquidity purposes at a pre-specified penalty rate. The minimum reserves held on the special account amounted to a yearly average of 25.4 billion Tolars. Compensations paid for employment of such holdings amounted to 1.8 million Tolars (against 11.2 million Tolars paid in 1996).

Regulation of supply and demand in foreign exchange market

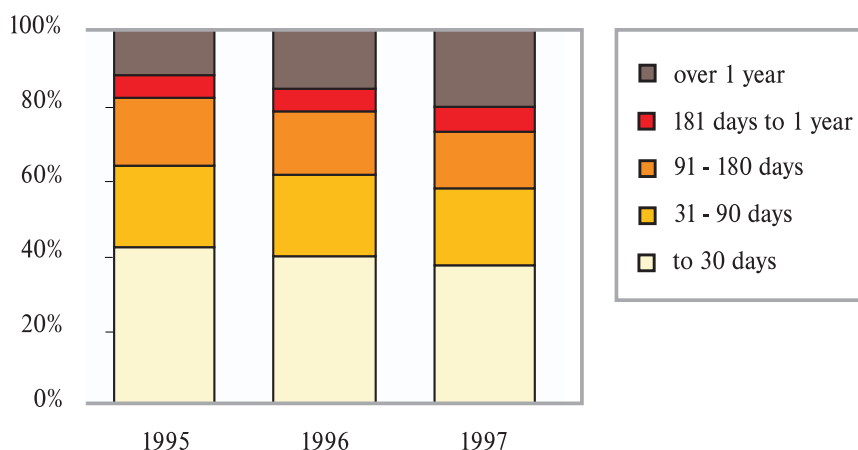
Foreign exchange minimum (the required minimum foreign exchange reserves or assets) is the instrument of monetary policy that ensures general liquidity in payments to foreign countries, and fulfillment of obligations based on foreign currency deposits of residents and non-residents in domestic banks. Banks are obliged to hold at least such minimum foreign exchange assets as prescribed on a daily basis. The monthly requirement is determined based on the volume of a bank's payments abroad (35% of average payments in the last three months), and on foreign currency deposits of residents and non-residents (100% of sight deposits, 75% of time deposits with maturity of up to three months, 35% of time deposits with maturity between three months and one year, 5% of time deposits with maturity of over one year). The calculation methodology changed in April - to the effect that 100% of such non-resident deposits became the calculation-base (against prior 90%), and in July - to the effect that net sale of foreign cash in foreign currency exchange offices was excluded from the calculation-base. Foreign exchange minimum holdings covered 85% of all foreign currency deposits. The actual foreign exchange minimum holdings exceeded foreign currency deposits by 2%.

Foreign exchange minimum covered 85% of all foreign exchange deposits at the end of 1997

Banks complied with the requirement with appropriate balances on accounts with foreign first-class banks, with foreign cash and checks in their vaults, with foreign currency claims against other domestic banks and the Bank, with the Bank's foreign currency bills (with maturities of up to 120 days), with first-class foreign securities and Eurobonds issued by the Republic of Slovenia and listed on international capital markets purchased, and with special rights to purchase foreign exchange from the Bank. The prescribed minimum share of holdings of the Bank's foreign currency bills increased throughout the year and reached 60% of the required reserves in foreign exchange in September.

The minimum reserves in foreign currencies increased from 325.7 billion Tolars at the beginning of the year to 352.3 billion Tolars at the end of the year (8%). This was mostly due to the increasing foreign currency deposits of households (especially time deposits with maturities of up to one year) and the increasing volume of payments abroad. Excess foreign currency reserves reached a low of 14% in February and a peak of 19% at the end of the year.

Figure 7: Average Structure of Tolar Deposits in Years 1995* to 1997



* The 1995 average structure of deposits is calculated in the period April-December.

In addition, the Bank prescribes the so-called net foreign exchange position (the difference between foreign exchange assets and short-term domestic and foreign debt in foreign exchange) to banks. The prescribed foreign exchange position equals at least 75% of the foreign exchange minimum.

Balancing requirement for increases in liabilities to non-residents. The Bank prescribed to banks an obligation to balance any additional liability beyond their position at July 31, 1996 with corresponding claims. Such liabilities comprise any Tolar and foreign currency liabilities to non-residents, and liabilities under pure foreign financial loans taken by domestic legal persons majority-owned by banks.

Since February custody accounts made part of obligation to keep claims and liabilities to foreign persons in balance

In February the Bank prescribed that custody accounts of non-residents held by domestic authorized banks are made part of the obligation of banks to balance claims and liabilities to foreign persons. Exempt from the prescription are any investments by foreigners into enterprises already majority owned by them. According to decision of the Bank taken in June, long-term (more than seven years) foreign portfolio investments were no longer made part of the obligation.

Restrictions on borrowing abroad. The Bank introduced a non-interest bearing Tolar deposit on foreign non-trade-related loans in February 1995. The obligation was set at 40% for loans with maturities under seven years and at 10% for loans with maturities beyond 7 years in May 1997. Exempt from the 10% obligation are the following borrowers: domestic authorized banks, the Republic of Slovenia and the Slovenian Export Agency.

Open foreign exchange position limited to 20% of regulatory capital

Open foreign exchange position. With the purpose of protecting banks against foreign exchange risk, the Bank prescribed to banks involved in dealings with foreign currencies the daily (short and long) foreign exchange positions. In case of short foreign exchange position the total liabilities exceed total assets in foreign currencies, and vice versa in case of long foreign exchange position. Both, the daily short and long positions are not to exceed 20% of regulatory capital of a bank.

Gradual adjustment of the open foreign exchange position of the banks in three years' time

The banks, whose open foreign exchange position exceeded 20% of regulatory capital on the cut-off date June 15, 1997, are obliged to gradually meet the requirement (in semi-annual steps) by July 1, 2000. At June 15, 1997 the open foreign exchange position of seventeen banks exceeded 20% of their regulatory capital. Seven banks had a long foreign exchange position, and ten had a short foreign exchange position. At December 31, 1997, a total of eighteen banks met the requirement.

Purchase and sales of foreign exchange

Throughout the year the Bank purchased more and sold less foreign exchange to banks than in 1996. For the first time after introduction of rehabilitation processes, the Bank did not purchase any foreign exchange from banks undergoing rehabilitation. Its purchases and sales were based on offers made to all banks, or on the needs of central government for payments abroad. As regards volume, the most significant instrument of such intervention of the Bank on the foreign exchange market was the purchase from banks with the right-to-sell and sales of foreign exchange by the Bank to banks for their purchase of the Bank's foreign currency bills.

Purchase of foreign exchange with the **right-to-sell** was first made available to banks in July 1996. It was available to banks once per month with the quantity of

foreign exchange to be purchased by the Bank determined each time. It was available to banks for the last time in November 1996. The participating banks were given the right to sell more foreign exchange to the Bank within the next six months in equal monthly amounts. Banks made their bids for the future exchange rate at which the Bank would purchase further determined quantities and were obliged to purchase a certain amount of foreign exchange from enterprises at the same rate. The two banks participating in the last offer made had the right to sell further foreign exchange to the Bank until May 1997. The total amount so purchased by the Bank amounted to 295 million German Marks (27 billion Tolars) at exchange rate 91.36 SIT/DEM.

In June, the Bank made sales of **foreign exchange for purchase** of its foreign currency bills available to banks. The amount of foreign exchange to be purchased by the Bank from banks was not limited. Under this instrument participating banks were obliged to purchase foreign currency bills issued by the Bank with maturity of 360 days in percentage equal to their bid for sales of foreign exchange to the Bank. The sales rate for such foreign exchange was determined based on the closing rate of the last auction and increased by any positive exchange rate growth in the foreign exchange market in the previous month. The same rate of exchange

Box 4: Capital Flow Liberalization and Safety of Investments in Slovenia

Pursuant to the Association Agreement concluded and about to be ratified by all European Union members, Slovenia will be obliged to lift certain restrictions imposed on capital flows. As regards **current account transactions**, they have been completely free for the last few years.

Foreign direct investments have been a significant tool in restructuring of the economy in transition. In principle, foreigners are allowed to invest into almost any industry. However, foreign investors are not allowed to set up companies in the field of military equipment production, rail and air transport, communications and telecommunications, insurance, publishing and mass media. Foreign investments are limited to a maximum share as follows: 49% in auditing companies, 24% in brokerage houses, 20% in companies for management of investment funds, 10% in authorized investment companies, 33% in mass media; any investment in banks or insurance companies requires prior approval of the competent authority. The pending new Foreign Exchange Law (currently in parliamentary procedure) will regulate, among others, foreign direct investment. Adoption of the new law by Parliament is expected in 1998. Pursuant to the Association Agreement, Slovenia will be able to limit any foreign equity participation in companies privatized pursuant to the Law on ownership transformation to 25% of voting shares for three years following the coming into force of the Agreement. The second important law in parliamentary procedure is the new Banking Act. Its adoption is likewise expected in 1998. A major change incorporated in the new law is the possibility for foreign banks to set up branches in Slovenia.

The gradual capital flow liberalization is to include abolition of present restrictions in borrowing (**commercial credits and financial loans**) abroad and of the obligation imposed on banks by the Bank to balance their claims and liabilities to foreign persons.

Low interest rates in developed countries and high interest rates in countries such as Slovenia encourage **foreign portfolio investments**. Such investments are very sensitive to any changes and problems of in the economic environment of the host country. Their volatility represents a threat to less developed financial markets. Foreign portfolio investments increased sharply following the relatively good country risk rating assigned to Slovenia for the first time in 1996, and due to the relatively high level of domestic interest rates (and about 9% p.a. inflation) and low level in prices of equity of privatized companies. Given the small monetary area and consequently limited possibility of the Bank to neutralize any big-scale adverse effects - pressures of such capital inflows on the exchange rate, the Bank required as of February that non-resident portfolio transactions be channeled through custody accounts with fully licensed domestic banks. Pursuant to revision in July, the requirement exempted committed long-term portfolio investments of at least seven years. The measure was introduced, among others, additionally with the purpose to protect long-term foreign investors against any exogenous market turbulence. Pursuant to the stipulations of the Association agreement with the EU, portfolio investments are to be fully liberalized after four years following the coming into force of the Association Agreement.

applied to foreign exchange purchased by banks from enterprises and foreign currencies purchased from foreign currency exchange offices. Banks were given the right to sell further foreign exchange to the Bank during the five months following the first transaction; monthly quantities were limited to 1/5 of the original amount sold.

751 million DEM of foreign exchange purchased under the instrument purchase of foreign exchange with the right-to-sell and foreign exchange sales for foreign currency bills

Under this instrument, the Bank purchased from banks a total of 751 million German Marks (70.2 billion Tolars), of which 461 million German Marks (43.0 billion Tolars) in auctions and 282 million German Marks (27.3 billion Tolars) under rights. The initial exchange rate of 91.36 SIT/DEM increased to 94.50 SIT/DEM. Participating banks still had the right to sell 81.6 million German Marks to the Bank in 1998.

Under temporary purchase of foreign exchange with obligation of banks to repurchase the same 223 million German Marks purchased by the Bank

In August the Bank made available to banks its **offer to purchase foreign exchange** from banks on a temporary basis, obliging banks to repurchase the foreign exchange. The instrument was first offered in auction (in replacement of temporary purchase of foreign currency bills), and on a permanent basis from September onwards to serve as a tool for the regulation of the foreign exchange position to banks. The Banks sells German Marks to the Bank at the Bank's buying rate, and repurchases them at the Bank's selling rate. The Bank purchased on a temporary basis a total of 223 million German Marks (21 billion Tolars) and re-sold 133 million German marks (12.6 billion Tolars). Most of the transactions took place in September (auctions) and in December (open tender).

Under this instrument banks repurchased 38 million German Marks (4.2 billion Tolars) from the Bank. One bank still has the right to purchase 500 thousand German Marks before August 1998.

Foreign exchange is available to banks at the Bank on a permanent basis at the selling rate increased by certain percentage; participating banks are obliged to purchase the Bank's foreign currency bills with maturity of 120 days in the value purchased. Banks purchased a total of 1.9 million German Marks at the selling rate increased by 2%.

As banker of the central government, the Bank purchased a total of 27 million German Marks (2.5 billion Tolars) and sold 62 million German Marks (5.7 billion Tolars). The Ministry of Finance had the right to sell to the Bank additional 35 million German Marks on account of the extended budgetary year, but did not make use of the right.

Surveillance of implementation of monetary policy measures

The Bank surveys implementation of its monetary policy measures and compliance of banks with rules and regulations determined for its operations on the open market by means of indirect control and direct inspection.

Indirect control is carried out via regular control of reports and other documentation delivered by banks to the Bank. The Bank occasionally also makes on-site inspections.

17 cases of non-compliance stated

The bank established a total of 17 cases of non-compliance in 6 banks, four savings banks and seven savings co-operatives (against 21 cases in 1996). Non-compliance was established in mandatory reserve requirement and in observance of rules and regulations governing the Bank's intervention.

The Bank issued penalty decrees in 16 cases, the measures taken depending on the nature and extent of non-compliance established. Among such measures were temporary prohibition to purchase the Bank's bills and suspension of the opportunity to obtain loans with the Bank, temporary suspension of participation in the Bank's interventions and limitation in growth of loans given. In cases of minor non-compliance the bank issued warnings and requests for correction.

The Bank carried out 33 controls of foreign currency exchange operations, out of which 31 on site-inspections (1 in an authorized bank, 30 in contractual foreign currency exchange offices). The Bank notified the district attorney accordingly of 18 cases, and the state Inspectorate of two cases; the Bank requested cancellation of a contract between a bank and a foreign currency exchange office.

The Bank carried out 9 inspections in the area of foreign operations; based on non-compliance established, the Bank issued 8 penalty decrees. Penalties include limitation in access to the Bank's securities and temporary limitation of issuance of guarantees in favor of non-resident beneficiaries.

Table 7: Purchase and Sale of Foreign Exchange

| | 1996 | | 1997 | |
|---|----------------|--------------------|----------------|--------------------|
| | millions of DM | billions of Tolars | millions of DM | billions of Tolars |
| Purchase | 635.0 | 57.3 | 1,072.5 | 99.6 |
| From bank in rehabilitation | 90.2 | 8.1 | | |
| Triple offer (purchase) | 147.2 | 13.2 | | |
| Purchase with right to sell | 251.4 | 22.9 | 295.0 | 27.0 |
| Purchase with right to sell and subscription of bills | | | 750.8 | 70.2 |
| Other purchases | 1.3 | 0.1 | | |
| Payments for the government | 144.9 | 13.0 | 26.7 | 2.5 |
| Sale | 107.2 | 9.7 | 102.3 | 10.1 |
| From right to sell | 0.9 | 0.1 | 38.3 | 4.2 |
| For purchase of foreign currency bills | 4.0 | 0.4 | 2.0 | 0.2 |
| Payments for the government | 102.4 | 9.2 | 62.0 | 5.7 |
| Temporary purchase | 149.3 | 13.4 | 223.0 | 21.0 |
| Triple offer (swap) | 149.3 | 13.4 | | |
| Temporary purchase (auctions) | | | 33.0 | 3.1 |
| Temporary purchase (open tender) | | | 190.0 | 17.9 |
| Repurchase of foreign exchange | 149.3 | 13.5 | 133.0 | 12.6 |
| Triple offer | 149.3 | 13.5 | | |
| Temporary purchase (auctions) | | | 33.0 | 3.1 |
| Temporary purchase (open tender) | | | 100.0 | 9.5 |

Source: Bank of Slovenia.

3. BANKING SECTOR

3.1. Structure of the Banking Sector

At December 31, 1997 a total of 28 banks, 6 savings banks and 70 savings co-operatives were operational in Slovenia (of which two banks were licensed for operation pursuant to the Constitutional Law). Compared to the previous year the number of banks and savings banks was reduced by one each; the reduction was the consequence of the merger between Banka Noricum d.d. Ljubljana and Banka Celje d.d. Celje and liquidation of Hranilnica in posojilnica d.o.o. Novo mesto.

28 banks operated in Slovenia...

The ownership structure of banks is: 12 are fully owned by local shareholders, 4 are wholly owned or controlled by foreign persons, and local shareholders hold a majority stake in the remaining twelve banks (compared to 13 in 1996); participation of foreign investors in these banks varies from under 1% (8 banks) to 49.0% (1 bank).

...12 thereof fully owned by domestic persons, 4 majority owned by foreign persons.

As regards banking licenses, 15 have a full banking license (7 thereof for commercial and investment banking, 6 for commercial banking only, and 2 for commercial banking and limited investment banking).

7 banks hold a full banking license

There were no new banking licenses issued in 1997, nor were any new representative offices of foreign banks established. The license was withdrawn from one savings bank. No mergers of banks took place, nor did any of the existing banking institutions break up. Regarding formation of banking groups, approval was given to 11 local shareholders to hold a share of 15 percent or more; such approval was refused in one case. Approval was given to 9 foreign persons to hold equity in Slovenian banks; such approval was refused in one case. Four approvals were issued to existing institutions to perform additional bank operations. The license

Box 5: Completion of Bank Rehabilitation

Rehabilitation of the two state owned banks (Nova Ljubljanska Banka d.d. – “NLB” and Nova Kreditna Banka Maribor d.d.) under the auspices of the Bank Rehabilitation Agency (BRA) was successfully completed in 1997 after four years. Most of bad loans were transferred to the BRA in exchange of state bonds. Bad loans have been kept within normal limits since 1993. Capital adequacy got better and liquidity of banks improved, their return on capital reached one of the highest levels in the banking sector.

On June 6, 1997 the Bank determined that both banks had fulfilled the conditions set for completion of rehabilitation process, namely:

- (i) to be liquid,
- (ii) to be able to meet monetary policy requirements,
- (iii) to maintain regulatory capital,
- (iv) to adjust the volume of banking operations so that regulatory capital reaches at least 8 percent of risk-adjusted total and off-balance sheet assets,
- (v) to set up prudent provisions against potential loss,
- (vi) to impose restrictions on individual credit exposure,
- (vii) to observe investment ceilings on land, buildings, and equity stakes in banks and non-bank organizations.

With conclusion of rehabilitation process the Bank ended the special treatment afforded to the two banks. The government and Parliament will attend to their ownership structure.

for securities business was withdrawn from three banks, basically due to the formation of banking groups and subsequent restriction of such business to one institution per group. The Governing Board issued eleven approvals to appointment of presidents and members of the banks' boards, and reconfirmed two presidents of the boards of banks under rehabilitation after this was completed. Approval was refused in one case.

Banking groups emerged

As mentioned above, the first banking groups were established in 1997, which is an important step towards consolidation of the banking sector. In terms of the banking law, a banking group is formed when one bank holds a direct or indirect stake of 40% or more in the capital of another bank and controls it directly or indirectly. The following banking groups emerged:

- Banka Celje Banking Group (Banka Celje and Hmezd Banka d.d., Žalec);
- Nova Ljubljanska Banka Banking Group (Nova Ljubljanska Banka, Pomurska Banka d.d. Murska Sobota, Koroška Banka d.d., Slovenj Gradec, Banka Velenje d.d. Velenje, Banka Zasavje d.d. Trbovlje and Banka Domžale d.d. Domžale);
- SKB Banking Group (SKB Bank and UBK Banka d.d.),
- Banka Koper Banking Group (Banka Koper d.d. and M Banka d.d. Ljubljana).

The Bank determined minimum conditions and requirements to be met by the banking groups. Members of a banking group are contractually bound to co-ordinate the current policies and their further development, in particular that of international business, marketing, development of new products, information technology, credit activity, automated teller network etc. Business risk management is done at the group level. Group members assist possible liquidity constraints if one member has exhausted the possibilities for assistance of the Bank; conditions of which are agreed upon in advance. Members of a banking group also agree in advance on measures to be taken in case of solvency problems of one of them. The controlling bank heads all such activities within the group. Uniform accounting standards and policies are applied. Internal audit and control are carried out in line with rules and regulations for internal audit in force in the controlling bank. The same auditor carries out external audit for all members of the group.

3.2. Banks

At the end of 1996, domestic banks extended 37.2% of all loans taken by domestic non-banking sector and held 94.5% of all deposits of the same sector.

Banks are major players in the banking sector with a **market share** of 98% of the sector balance sheet, compared to savings banks (0.4%) and savings co-operatives (1.6%). Due to the negligible role of the latter two, the report will be dealing with banks only.

According to unaudited data, the **balance sheet total** of all Slovenian banks amounted to SIT 2,013 billion at December 31, 1997, representing a 16.4% nominal increase against 15.5% increase in the previous period. Market shares of banks are fairly stable; the market share of the three biggest banks amounted to about 52%, that of the seven biggest banks to about 72%. The growth rates of banks in nominal terms vary from 5.0% (negative in real terms) to 46.6%. Despite the differences in size of business the growth was in a narrower range compared to 1996. Two banks ended up with a negative growth rate in nominal terms and four in real terms.

The market share of three biggest banks is more than 50%...

In terms of their balance sheet total the market share of the seven biggest banks amounted to 71.6% at December 31, 1997 and approximately remained on the same level as the year before. Banks differ a lot in size: the balance sheet total of the biggest bank amounts to SIT 540 billion, that of the tenth less than 10% thereof, that of the smallest bank (SIT 3 billion) only slightly exceeded the balance sheet total of the largest savings bank.

...that of the biggest seven 70%...

Given that the four banking groups emerged during the year, there were practically only 20 independent banks at December 31, 1997. The market shares and balance sheet totals of the banking groups are as follows:

...that of banking groups 6%, 7%, 12% and 35% respectively.

- Banka Celje banking group: balance sheet total SIT 120,727 million, market share 6.0%;
- Nova Ljubljanska banka (NLB) banking group: balance sheet total SIT 695,907 million, market share 34.6%;
- SKB Bank banking group: SIT 253,929 million, market share 12.6%;
- Banka Koper banking group, market share 133,861 million, market share 6.6%.

Table 8: **Balance Sheet Totals and Market Share of the Seven Biggest Banks**

| Bank | Balance sheet total in millions of Tolars | | | Market share in % | | |
|---------------------|---|----------------------------|----------------------------|----------------------------|----------------------------|----------------------------|
| | Dec. 31 st 1995 | Dec. 31 st 1996 | Dec. 31 st 1997 | Dec. 31 st 1995 | Dec. 31 st 1996 | Dec. 31 st 1997 |
| NLB | 445,096 | 490,319 | 539,856 | 29.7 | 28.3 | 26.8 |
| SKB banka | 17,974 | 206,584 | 241,401 | 12.0 | 11.9 | 12.1 |
| NKBM | 168,587 | 197,201 | 237,654 | 11.2 | 11.4 | 11.8 |
| Banka Koper | 8,265 | 99,695 | 120,299 | 5.5 | 5.8 | 6.0 |
| Banka Celje | 69,401 | 89,504 | 109,246 | 4.6 | 5.2 | 5.4 |
| Abanka | 68,567 | 88,348 | 103,055 | 4.6 | 5.1 | 5.1 |
| Gorenjska banka | 67,008 | 73,164 | 90,706 | 4.5 | 4.2 | 4.5 |
| Total - top 7 banks | 1,081,049 | 1,244,815 | 1,442,217 | 72.1 | 71.9 | 71.6 |
| Total - all banks | 1,499,922 | 1,732,152 | 2,012,975 | 100.0 | 100.0 | 100.0 |

Source: Bank of Slovenia.

Non-bank deposits grew

The **average structure of bank liabilities** shows an increase in non-bank deposits and a decrease in deposits of banks. The development is mainly due to reduced obligations of banks to the Bank and to domestic and foreign banks. The share of deposits from non-banks increased towards the end of the year against 1996 for a total of 4.3 percentage points, whereas that of deposits from banks dropped by 3.6 percentage points. Other liabilities (accrued costs and deferred income, provisions for liabilities and charges and general provisions) dropped by 0.5 percentage points. The share of capital (subscribed capital, share premium, reserves, revaluation adjustment of the capital, accumulated net profit or loss, and current net profit or loss) dropped by 0.1 percentage points, and the share of funds provided through issue of securities and certificates of deposit by 0.1 percentage points.

Household deposits predominate

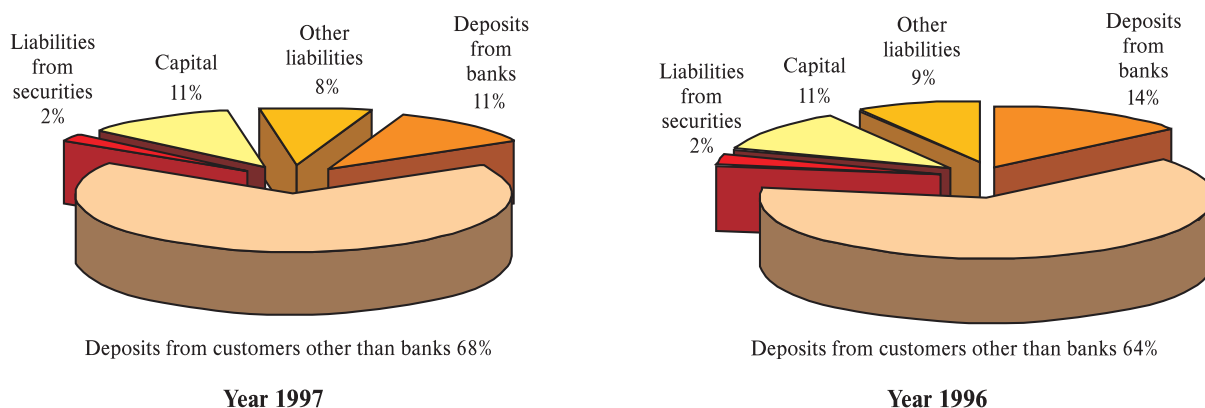
There has been no major change of the structure of deposits other than bank deposits. Household deposits predominated; their share in the average composition of liabilities increased by 1.9 percentage points to a total of 36.1%. Corporate deposits accounted for 16.6% of the average (16.3% in 1996), deposits of the public sector for 8.6% (they increased against 1996, mainly due to the decrease in the share of deposits of other financial institutions and foreign persons).

Household deposits increased by 21.3% in nominal terms between January and December compared to 16.7% growth of corporate deposits against the respective growth of 22.9% and 25.2% in 1996. The level of funds deposited by the banking sector decreased for 8.9% in nominal terms.

Lower share of liabilities in foreign currencies, increase in household Tolar deposits

The average currency structure of liabilities developed in favor of liabilities in the domestic currency: the share of liabilities in foreign currencies decreased from 38.8% in 1996 to 35.8%, mainly as a result of a reduction in liabilities to banks. Household deposits in foreign currencies decreased; household time deposits in domestic currency, on the other hand, increased by 28.6% in real terms.

Figure 8: Average Structure of Bank Liabilities



Source: Bank of Slovenia.

In the course of 1997 the share of investments in securities within **the average structure of assets** increased by significant 6.1 percentage points; this was the result of an increased subscription of Bank of Slovenia Tolar and foreign currency bills, and investment in bonds issued by the Republic of Slovenia and by banks. Thus, the secondary liquidity of banks increased and amounted to the total of SIT 353.3 billion (against SIT 163.8 billion in 1996). As a consequence of the transformation of foreign currency time deposits into investments in securities the share of loans and advances to banks decreased by 4.9 percentage points, that of loans and advances to customers other than banks by 1%, and other assets (equity investments in controlled and related undertakings, tangible fixed assets, intangible long term assets, subscribed but unpaid capital, uncalculated costs and accrued income and other assets) by 0.2 percentage points.

Increased share of bank investments in securities and better secondary liquidity of banks

Within the loans and advances to customers other than bank loans and advances to the corporate sector prevailed with a share of 26.0% (27.6% in 1996); loans and advances to households remained basically unchanged with 11.7% (against 11.4% in 1996).

The growth rate of loans and advances to business and households slowed down to 11.4% (17.4% in 1996) and 15.8% (29.4% in 1996) respectively. Loans and advances to banks decreased by as much as 31.8%.

The share of foreign currency assets within the average asset structure decreased from 34.1% to 32.8%.

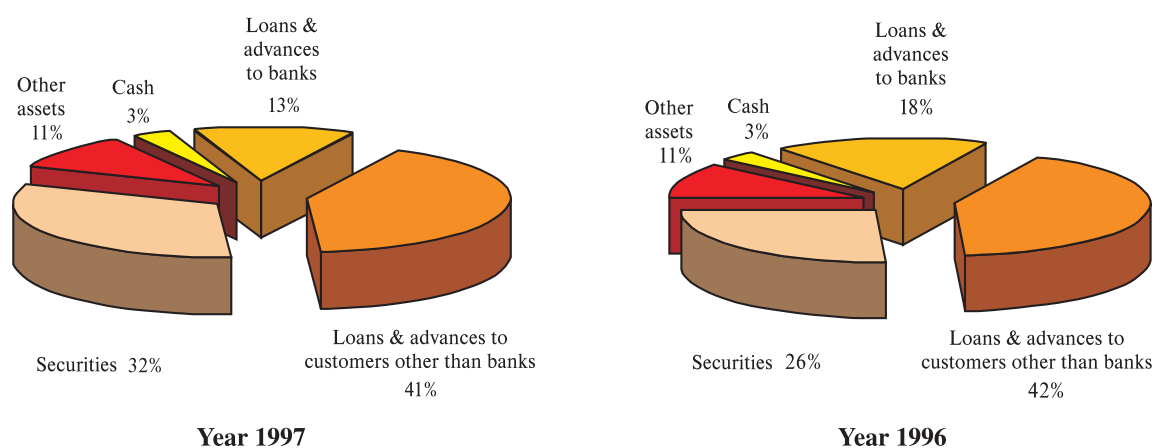
At December 31, 1997 the share of doubtful receivables in the balance sheet total amounted to 9.3% against 10.3% in 1996. 55.5% of such assets were covered with value adjustments and provisions (against 54.8% in 1996)

Smaller share of doubtful receivables

Profitability of Slovenian banks has been rising for some years. The profits before tax increased during 1997 by 16.7% in nominal terms and totaled SIT 21.4 billion (the positive revaluation balance represented 90.0% thereof or SIT 19.2 billion). Four banks (against two in 1996) reported losses.

16.7% increase in profit before tax

Figure 9: Average Asset Structure of Banks



Source: Bank of Slovenia.

Net interest income earned by Slovenian banks increased by 3.6% and amounted to SIT 84.0 billion (thereof earnings from revaluation interest SIT 29.3 billion). Net fees and commissions receivables increased by 13.7% to SIT 26.8 billion but are still low if compared to net interest income. The income from securities amounted to SIT 1.4 billion, profit from dealing (so-called financial operations) SIT 6.2 billion. Due to high general administrative expenses and depreciation the net operating income decreased by SIT 65.2 billion and amounted to SIT 53.2 billion at year-end. Net write-offs increased as much as by 82.9% to SIT 16.6 billion, net provisions, on the other hand, decreased by 67.4% to SIT 4.7 billion.

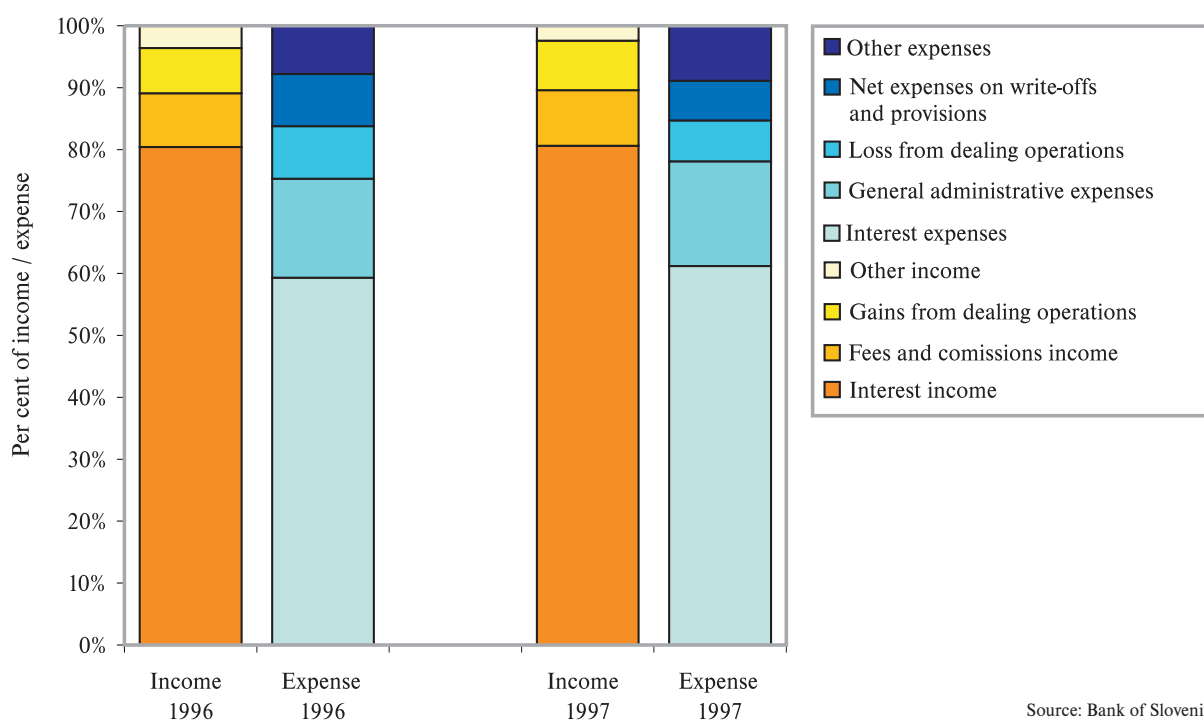
As is evident from the **income structure of banks**, the share of interest income, fees and commissions receivable and profit from financial operations increased at the expense of lower other income, i.e. income from securities and extraordinary income. In the structure of the **banks' expenses**, the share of interest expense rose, as did other expenses (fees and commissions paid, depreciation, other operating expenses, revaluation of capital, of fixed assets and capital investments, and extraordinary expenses). The share of net expenses for write-offs, provisioning and losses in financial operations dropped.

Lower net interest margin

Owing to good operating results the return on average assets of banks and return on average equity grew, while the interest margin dropped. The net interest margin varies between 2.1% and 9.1% from bank to bank.

The interest rate development was under the influence of not only inflation and bank expenses, but substantially so by the change in methodology for the revaluation rate and the new agreement by banks on capping interest rates on deposits.

Figure 10: Structure of Income and Expenses of Banks for 1996 and 1997



Source: Bank of Slovenia.

By decision of the Governing Board of the Bank of Slovenia taken in April 1997, the base for computation of the revaluation rate was extended from 6 to 12-month average. Such decision made the nominal Tolar interest rate less vulnerable and exposed to inflationary movements and more dependent on the real interest rate part.

Revaluation rate for Tolar deposits based on 12 month average

As a consequence of the new bank agreement on capping interest rates on deposits, real deposit interest rates were reduced in April. The average real interest rate for short-term deposits (31 to 90 days) fell from 4.9% in 1996 to 3.7% and remained on that level through the year.

Following the new bank agreement deposit rates fell...

In line with the said interbank agreement and with the recommendation of the Bank Rehabilitation Agency to the two banks under rehabilitation the lending interest rates were also reduced. The declared real interest rates for short-term loans to corporations underwent several reductions and fell from 11.3% in January to 9.6% in December. Likewise, the interest rates for long-term loans to corporations were reduced from 12.9% to 11.7% in December.

...and so did the lending rates.

Interest spread as the difference between the average nominal interest rate receivable and average nominal interest rate payable on assets from customers other than banks increased from 8.3 percentage points in the first quarter to 8.4 percentage points in the last quarter of 1997. The interest spread of the real rate decreased from 5.5 percentage points to 4.9 percentage points in the same period.

Operating expenses on average assets of banks increased slightly (by 0.1%) and accounted for 3.7% of average assets.

Capital adequacy of Slovenian banks has been on average high and amounted to 19.7% at the end of 1996. It reached a peak of 20.1% in June 1997 owing to higher growth of the regulatory capital (8.8%) than that of the risk-weighted assets (7.0%). The regulatory capital reached SIT 179.2 billion at December 31, 1996 (the capital 198.1 billion) and jumped to SIT 194.9 billion (the capital SIT 203.7 billion) at June 30, 1997.

The average capital adequacy increased

Table 9: Indicators of Bank Operation Efficiency

| | Dec. 31 st 1996 | Dec. 31 st 1997 |
|---|----------------------------|----------------------------|
| Return on average assets | 1.1 | 1.1 |
| Return on average equity | 10.2 | 10.5 |
| Net interest margin | 5.6 | 4.9 |
| Labour cost/average assets | 1.9 | 1.9 |
| Other operating expenses/Average assets | 1.7 | 1.8 |

Source: Bank of Slovenia.

3.3. Supervision and Surveillance of Bank Operation

13 full-scope and 20 examinations of selected areas in banks

A total of 33 on-site examinations were carried out by the Bank of Slovenia inspectors in banks and savings banks, 13 thereof as full-scope examinations, the rest examinations of selected areas (target examinations). 23 on-site examinations were carried out in banks, 8 in savings banks, one in a savings co-operative, and one joint inspection in the Slovenian Export Corporation together with the Office for Insurance Supervision.

The full-scope examinations focused primarily on:

- credit and securities portfolio,
- capital adequacy compliance,
- risk management compliance,
- profitability,
- bank liquidity and deposit-taking,
- adequacy and efficiency of internal control,
- equity investments and fixed assets,
- internal audit operation,
- information technology etc.

Examinations of selected areas focused primarily on:

- loans to corporations,
- loans to individuals and individual entrepreneurs,
- securities portfolio,
- correctness of accounting data disclosed,
- controls in the area of information technology etc.

The rating of banks for internal purposes is performed on the basis of the so-called CAMEL method based upon an evaluation of five critical dimensions of a bank's operations that reflect in a comprehensive fashion an institution's financial condition, compliance with banking regulations and statutes and overall operating soundness. The specific dimensions evaluated are capital adequacy, asset quality, management/administration, earnings and liquidity.

Core principles for effective banking supervision published by the Basle Committee on Banking Supervision

The Basle Committee on Banking Supervision published the 25 Core Principles for effective bank supervision in order to strengthen and help develop better standards of prudential supervision worldwide. The principles relate to the preconditions for effective banking supervision, licensing and ownership structure, prudential regulations and requirements, methods of ongoing banking supervision, information requirements, formal powers of supervisors and cross-border banking. The Bank of Slovenia adopted the core principles and started their implementation in May 1997.

4. OTHER FUNCTIONS

4.1. Management of Foreign Exchange Reserves

International reserves of the Bank comprise

- foreign cash and balances on accounts abroad,
- first-class foreign securities purchased,
- monetary gold,
- reserve tranche with the International Monetary Fund,
- SDR holdings with the International Monetary Fund.

Foreign exchange reserves of the Bank (foreign cash, balances on accounts abroad and foreign securities purchased) increased by 2,279 million US Dollars to 3,297 million US Dollars. These include claims of domestic sectors on the Bank (pertaining to foreign currency bills purchased by domestic banks, foreign currency accounts of banks and of the central government held by the Bank); such claims on the Bank increased from 1,278 million US Dollars to 1,779 million US Dollars. The Bank's own foreign exchange reserves (not offset by any liabilities) increased from 971 million to 1,459 million US Dollars. Other Bank's foreign currency assets include the balance of the fiduciary account in Luxembourg.

Foreign exchange reserves of the Bank increased by 1,018 million USD

The guidelines for management of foreign exchange reserves are set by the Governing Board of the Bank and are revised on a quarterly basis. The guidelines include but are not limited to the currency structure, the average maturity of deposits and securities, selection of foreign partner banks (deposits are allowed only with banks with the highest long-term rating by IBCA). Pursuant to respective decisions taken the Bank increased the portion of foreign exchange reserves invested in securities (primarily sovereign issues) and by doing so, increased liquidity and minimized the credit risk.

Guidelines for management of foreign exchange reserves

Table 10: **International Reserves and Foreign Currency Reserves of the Banking System** (in million USD)

| | BANK OF SLOVENIA | | | | | | BANKS | TOTAL |
|----------------------------------|---------------------------------|------------|-------------------------|------------------|----------------|----------------------|---------------------------|---------------------------|
| | International monetary reserves | | | | | Other foreign assets | Foreign exchange reserves | FOREIGN EXCHANGE RESERVES |
| | Gold | SDR`s | Reserve position in IMF | Foreign exchange | Total | | | |
| Dec. 31st 1996 | 0.1 | 0.1 | 18.5 | 2,278.7 | 2,297.4 | 33.7 | 1,851.2 | 4,130.0 |
| Jan. 31 st 1997 | 0.1 | 0.3 | 17.5 | 2,239.1 | 2,256.9 | 38.8 | 1,686.7 | 3,925.7 |
| Feb. 28 th 1997 | 0.1 | 0.0 | 21.7 | 2,431.8 | 2,453.5 | 38.8 | 1,448.4 | 3,880.2 |
| Mar. 31 st 1997 | 0.1 | 0.0 | 25.8 | 2,455.8 | 2,481.6 | 39.0 | 1,477.6 | 3,933.4 |
| April 30 st 1997 | 0.1 | 0.4 | 13.6 | 2,475.9 | 2,489.9 | 39.1 | 1,398.8 | 3,874.6 |
| May 31 st 1997 | 0.1 | 0.1 | 17.7 | 2,681.9 | 2,699.7 | 39.5 | 1,386.3 | 4,068.3 |
| June 30 st 1997 | 0.1 | 0.1 | 17.8 | 2,845.0 | 2,862.9 | 40.1 | 1,325.3 | 4,170.3 |
| July 31 st 1997 | 0.1 | 0.3 | 20.4 | 2,924.5 | 2,945.2 | 39.6 | 1,100.4 | 4,024.9 |
| Aug. 31 st 1997 | 0.1 | 0.1 | 29.0 | 3,089.9 | 3,119.0 | 40.0 | 1,095.1 | 4,185.1 |
| Sep. 30 st 1997 | 0.1 | 0.1 | 17.6 | 3,264.0 | 3,281.7 | 40.2 | 1,059.6 | 4,323.6 |
| Oct. 31 st 1997 | 0.1 | 0.4 | 17.8 | 3,352.8 | 3,371.0 | 40.6 | 1,114.6 | 4,467.4 |
| Nov. 30 st 1997 | 0.1 | 0.1 | 17.5 | 3,341.6 | 3,359.2 | 40.7 | 1,082.9 | 4,424.5 |
| Dec. 31st 1997 | 0.0 | 0.1 | 17.4 | 3,297.0 | 3,314.7 | 41.3 | 1,040.0 | 4,337.2 |

Source: Bank of Slovenia.

**Foreign exchange reserves
of banks decreased**

The Bank assures international liquidity of Slovenia by prescribing to banks the foreign exchange minimum and by requiring that they balance their liabilities to non-resident with respective claims. Foreign exchange reserves of banks decreased from 1,851 to 1,040 million US Dollars (banks purchased more foreign currency bills of the Bank; consequently, the foreign exchange reserves of the Bank increased).

The overall foreign exchange reserves of Slovenia (foreign exchange reserves of the Bank without monetary gold and without reserve tranche with the IMF, but including controlled foreign exchange reserves held by domestic banks) increased by 5 % to a total of 4,337 million US Dollars by the end of the year.

4.2. Banking Services to Central Government

International Payments and Fiduciary Account

Pursuant to the Law on the Bank of Slovenia, the Bank clears payments and performs any other transactions in foreign currencies for the account of the central government. The Bank cleared a 821.4 million German Marks worth of outgoing payments, met obligations under letters of credit of 45.3 million German Marks, processed 10.1 million German Marks outgoing and 2.1 million incoming cash payments, and cleared 432.6 million German Marks of incoming payments.

The Bank sold a total of 62.0 million German Marks to, and purchased 26.7 million German Marks from the central government. Drawdowns under foreign loans and donations from abroad account for the difference between the two amounts.

The Republic of Slovenia had opened a fiduciary account with Dresdner Bank Luxembourg to deposit payments under its successor obligations (roughly 60% of the total) under the 1975 and 1983 Osimo and Rome Treaties respectively, concluded between the former SFR Yugoslavia and Italy. The payments made to this account in 1997 amounted to 5.1 million US Dollars; the balance on the account at December 31, 1997 amounted to 35.1 US Dollars.

Paying Agent

Pursuant to the above-mentioned law, the Bank also acts as paying agent for the Republic of Slovenia in its credit arrangements with foreign countries. The Republic of Slovenia issued bonds on international market in amount of 400 million German Marks to finance the budget. The bonds were sold in June. In January the Republic also drew on the remaining portion of the syndicated loan (25 million German Marks) arranged in December 1996 for the same purpose. The Republic of Slovenia duly met all its obligations under foreign loans; the total repayments amounted to 337.9 million US dollars (including capital, interest and fees).

Securities Services (Fiscal Stamps and Government Bonds)

Pursuant to the respective agreement, the Bank prepared the issue and distribution of, and took custody of fiscal stamps on behalf of and for the account of the Ministry of Finance.

Accordingly, administrative and fiscal stamps of total value of 2.3 billion Tolars, and 217,720,000 different tobacco stamps bearing safety features were issued and distributed.

The Bank also processed 1,412,343 coupons redeemed under government bonds RS 01, and 50,235 coupons redeemed under governmental bonds RS 02.

4.3. Processing and Distribution of Cash

The Bank processed and duly distributed Tolar notes within the country and subsequently exchanged the coupons issued in 1991 for Tolar notes. The new cash processing-machine of type DLRS 3260 helped duly sort out the worn-out notes and contributed to the better and equal quality of banknote distributed.

At December 31, 1997 a total of 84.4 million banknote of nominal value of 85.2 billion Tolars was in circulation (approximately 43 banknotes per inhabitant). The volume of notes in circulation increased by 13%, their value by 20%. The volume increased most with 10,000 Tolar notes (47%). Except for the 200 Tolar note, the quantities of single notes in circulation correspond to the needs. However, the 100 Tolar notes made up for the lack of 200 Tolar notes.

Increased volume of notes in circulation

No irregularities were established in the agencies of the Payments Agency (APP) involving the distribution of banknotes.

A total of 30 million coins with face value of 5, 2 and 1 Tolar was put in circulation in 1997. Together with coins put in circulation since 1993, a total of 232 million coins were in circulation at the end of 1997 (on average 117 coins per inhabitant). The quantity of coins (30,000) represented an increase in number by 15% (or increase per inhabitant by 16 coins), and increase in value by 16% (to 483 millions Tolars).

The Bank issued a memorial coin to commemorate the 250th anniversary of birth of Žiga Zois. The coins minted in gold were issued with face value of 5,000 Tolars, those minted in silver with face value of 500 Tolars, and those minted in cupronickel and zinc (CuZnNi) alloy with face value of 5 Tolars.

Memorial coin issued

The Bank examined and prepared an expert opinion on a total of 1,776 different types of counterfeit notes detected and found on the territory of the Republic of Slovenia (for the most part German Marks, US Dollars and Italian Lira). There were a few attempts to cash in Tolar counterfeit notes produced on color photocopy machines. The value of all Tolar counterfeit notes seized amounted to 45,621,000 Tolars and is, compared to that of cash total in circulation, negligible. The Ministry of the Interior requested examination of 3,788 counterfeit 10,000 Tolar notes, 1,545 counterfeit 5,000 Tolar notes, and 16 counterfeit 1,000 Tolar notes. In most cases, the counterfeit notes were discovered before any attempt was made to use them for payment.

Relatively low value of Tolar counterfeit notes detected

4.4. Payment Systems Reform

**Mandatory reserves'
accounts of banks trans-
ferred to the Bank**

In addition to the Bank, the following institutions are involved in the reform of the payment systems: the Ministry of Finance, Payments Agency, domestic banks, Bankers Association and Statistical Office of the Republic of Slovenia.

The special mandatory reserves' accounts of banks, savings banks and savings co-operatives were transferred to the Bank within the migration framework set.

**The project made
progress...**

Extensive work was done by respective working groups and intensive preparations taken for introduction of Real Time Gross Settlement (RTGS), and progress made in the area of subsystems of low-value payments' clearing, accounts of legal persons and banks, accounts of public finance and tax collection, new cash distribution system, payments statistics, foundation of Association of Payments Systems.

**...in the area of real time
gross settlement...**

Key draft documents were prepared for introduction of a real time gross settlement system, which would serve as the basis for the reformed payment systems. Delivery of hardware and software was contracted in May. Banks and the Bank had the opportunity to test the software; the Bank also organized training for future participants.

**...and in the area of
payments statistics.**

Pursuant to the proposal made, five-digit numbers are to be introduced to mark the different types of transfers, the payer and the recipient. The customer (payer) will insert the relevant characteristic number upon placement of the payment order. The five-digit numbers will serve for statistics on payments made at no cost whatsoever for the participants.

**Standardization of pay-
ments...**

Minimum standards were determined to enable high degree of automation in receiving payment instructions and forwarding payments. The uniform transaction numbers and the payer and payee's account reference numbers were defined.

...and cash payments.

The Bank adopted draft rules and regulations for vault operation for bank notes and for processing and distribution of coins.

4.5. Statistics

Pursuant to the National Program of Statistical Research and pursuant to the Foreign Exchange Law, the Bank is obliged to collect and publish data on banking and monetary statistics, the balance of payments, the international investment position and interest rate statistics.

Main macroeconomic data are published in the Monthly Bulletin, which is available in paper form and on the Bank's Internet home page (Slovenian and in English versions). Data are also regularly disseminated to domestic users and various international organizations, especially the International Monetary Fund and Eurostat.

**New statistical publication
on direct investment**

Data on direct investments collected by the Bank were for the first time published in 1997 in a new annual publication. (The second issue is to be published in the first half of 1998.)

In addition, development of a database on the wider financial market – including non-bank financial institutions and securities market - has started and preparatory work for a new statistical publication to cover these fields has been done.

Development of financial market statistics...

In agreement with the Statistical Office of the Republic of Slovenia and Eurostat the Bank also started producing simplified financial accounts for Slovenia.

... and simplified financial account.

A new computer program was built to assure highly automated production of the Monthly Bulletin from the statistical data base, and a program to support data collection and assure quality control of data on external payments, which is one of the data sources for the balance of payments statistics, was developed.

Automation introduced in production of Monthly Bulletin

Considerable effort was made in designing an upgrade of the statistical database which should assure integrity, consistency, transparency and timeliness of published data together with ready access by all users of statistics as the Bank participates (together with the Statistical Office of the Republic of Slovenia, the Ministry of Finance and the Institute of Macroeconomic Analysis and Development) in a project aiming at introduction and implementation of International Monetary Fund's Special Data Dissemination Standards by the end of the year 1998.

Steering towards IMF Special Data Dissemination Standards

4.6. International Relations and Co-operation

The Bank of Slovenia continued to be the **point of reference** and source of information for any and all foreign institutions and companies interested in establishing or already having an ongoing co-operation or business with Slovenian entities as regards reform processes, economic and financial performance and expected future developments. As a rule, the Bank does not make forecasts or projections of any such developments; it did, however, publicly announce, for the first time since its establishment, its monetary policy target at the beginning of May for the current year.

Source of information for foreign institutions...

The Bank's officials were invited to and actively participated in several **international or regional fora, colloquia, roundtables and conferences** organized abroad by foreign central banks and other organizations and associations. They also participated in membership **negotiations** of Slovenia **with the OECD** and, given the recommendation of the European Commission that Slovenia be one of the five Central and East European countries to negotiate full **EU integration**, in all relevant working groups and delegations of the Republic of Slovenia. The objective of the Republic of Slovenia to become member of the European Union and subsequently adopt the single European currency will require further involvement of the Bank given, among others, the necessity for harmonization of Slovenian legislation with that of the EU, and full adoption and implementation of the *acquis communautaire*.

...participation in conferences...

...preparation for accession to OECD and EU...

Co-operation the Bank has established in the past years with the **central banks** of G 10 countries, Austria and other central banks world-wide has been very rewarding and beneficial in our endeavors to implement the best practices in the various central bank functions by using the experience of such central banks with much longer tradition. The bilateral discussions and consultations have changed from tackling very broad to very specific issues. In addition, a new very important topic emerged: preparation on accession to the European Monetary Union.

...co-operation with central banks...

BIS membership

The proposal for a comprehensive settlement of **succession** to and division of the assets of the former central bank of the former SFR of Yugoslavia held in the books and the shares registered in the name of that central bank made by the **Bank for International Settlements, Basle** in July 1996 had failed to obtain approval of and acceptance by the central banks of all five successor states. Since it seemed unlikely that an agreement to a comprehensive settlement among all interested parties could be reached in the near future, the Board of Directors of the BIS decided on May 12, 1997 to pursue an interim solution with respect to membership in the BIS by exceptionally issuing 10 shares of the third tranche of the capital of the BIS for subscription of four central banks involved. The Bank of Slovenia accepted such proposed interim solution and became member of this last and by no means least international financial organization and as such attended its Annual Meeting in June for the first time. The Bank of Slovenia will further pursue the succession issue in order to bring about a comprehensive solution with respect to the above assets and shares.

End of 1997 the quota of the Republic of Slovenia in the **International Monetary Fund** amounted to SDR 150.5 million, its reserve tranche to SDR 12.9 million (8.55% of the quota), the SRD allocation 25.4 million and its SDR holdings to SDR 55,000. Slovenia fully appreciates the need for and is supportive to the proposed increase of quotas under the Eleventh General Review necessary for the Fund to fulfil its function and continue to carry out its mandate in the future.

**Active role in negotiations
on succession to the former
SFRY**

The Bank of Slovenia continued to play an active role in the **negotiations on succession** to the former SFR Yugoslavia pursuant to the **Dayton Accord** chaired by Sir Arthur Watts, Special Negotiator for Succession Issues under the auspices of the Office of the High Representative in Brussels.

5. FINANCIAL STATEMENTS

Statement of responsibilities of the Governing Board

The Law on the Bank of Slovenia (the Bank) and the Statutes of the Bank require the Governing Board to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Bank and the surplus or deficit of the Bank for that period. In preparing those financial statements the Governing Board is required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Bank will continue in business.

The Governing Board has a general responsibility for taking such steps as are reasonably open to it to safeguard the assets of the Bank.

Report of the Auditors

To the Governing Board of the Bank of Slovenia

We have audited the balance sheet of the Bank of Slovenia ("the Bank") as of 31 December 1997 and the related statement of income and expenditure as set out on pages 53 to 64 ("the financial statements"). These financial statements are the responsibility of the Bank's Governing Board. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements for the year ended 31 December 1996 were audited by KPMG London. Their report dated 10 April 1997 was unqualified except with respect to the omission of a statement of cash flows.

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

As discussed in Note 2 to the financial statements, a statement of cash flows has not been presented as the Governing Board believes that, given the nature of the Bank's operations and the description of its monetary policy in other parts of the annual report, it would not provide meaningful additional information.

In our opinion, except for the omission of the information referred to in the preceding paragraph, the financial statements present fairly, in all material respect the financial position of the Bank as of 31 December 1997, and of the results of its operations for the year then ended in accordance with International Accounting Standards and Slovenian law.

Price Waterhouse AG
A. Schönenberger
Authorised Auditors

G. Andermatt

Zurich, 24 March 1998

Statement of income and expenditure

for the year ended 31 December (in thousands of tolar)

| | Notes | 1997 | 1996 |
|--|-------|-------------------|-------------------|
| Operating income: | | | |
| Income from financial assets | | 19,475,274 | 14,941,300 |
| Net foreign exchange gain | | 16,797,269 | 8,131,032 |
| Total income from financial assets | 4 | 36,272,543 | 23,072,332 |
| Expenses on serviced liabilities | 5 | 17,726,605 | 9,310,312 |
| Net investment income | | 18,545,938 | 13,762,020 |
| Other income | 6 | 381,215 | 510,546 |
| Total operating income | | 18,927,152 | 14,272,566 |
| Operating expenses | 7 | 3,346,753 | 2,328,031 |
| Provisions | | 718,260 | 578,628 |
| Operating surplus available for appropriation | | 14,862,139 | 11,365,907 |
| Appropriations: | | | |
| Transfer to general reserves | | - | 2,311,981 |
| Release of general reserves | | 1,935,130 | - |
| Transfer to foreign exchange reserves | | 16,797,269 | 8,131,031 |
| Total transfer to reserves | 12 | 14,862,139 | 10,443,012 |
| Provision for transfer of surplus | | - | 922,895 |
| Total appropriations | | 14,862,139 | 11,365,907 |

Balance sheet

at 31 December (in thousands of tolar)

| | Notes | 1997 | 1996 |
|---------------------------------------|-------|--------------------|--------------------|
| Assets | | | |
| Financial assets | 8 | 593,440,585 | 361,495,681 |
| Fixed assets | 9 | 2,071,656 | 1,657,393 |
| Total assets | | 595,512,242 | 363,153,074 |
| Liabilities and reserves | | | |
| Serviced liabilities | 10 | 457,733,748 | 253,577,666 |
| Banknotes in circulation | 11 | 85,652,534 | 71,440,570 |
| Provision for transfer of surplus | | - | 922,895 |
| Total liabilities | | 543,386,282 | 325,941,131 |
| Reserves | 12 | 52,125,959 | 37,211,943 |
| Total liabilities and reserves | | 595,512,242 | 363,153,074 |

The notes on pages 54 to 64 form an integral part of the financial statements.

These financial statements were approved by the Governing Board on 24 March 1998 and were signed on its behalf by:

Dr. France Arhar

President of the Governing Board and
Governor of the Bank of Slovenia

In accordance with Article 82 of the Law on the Bank of Slovenia these financial statements have still to be approved by the Parliament of the Republic of Slovenia.

Notes to the financial statements

1 Constitution

The Bank of Slovenia (the Bank) is the central bank of the Republic of Slovenia. It was constituted by the Law on the Bank of Slovenia dated June 25, 1991. The Bank is self governing and is an independent institution with its own distinct legal personality. The Republic of Slovenia guarantees the obligations of the Bank which is supervised by Parliament. The Bank is responsible for the stability of the national currency and for the liquidity of the Slovenian banking system.

2 Accounting standards and conventions

These financial statements have been prepared in accordance with International Accounting Standards (IAS) as promulgated by the International Accounting Standards Committee under the historical cost convention, except as detailed below. These were adopted by the Governing Board at the 90th meeting on 9 May 1995.

The Bank does not provide a cash flow statement, since the Governing Board considers that, given the nature of its operations and the description of its monetary policy in other parts of the annual report, it would not provide meaningful additional information. The Bank's primary responsibility under the law is to maintain stability of the national currency and general liquidity of payments within Slovenia and with foreign countries. As part of this process, the Bank regulates the money supply and ensures general liquidity of banks and payments abroad. Full description of the goals and targets of the monetary policies, interest rates and the monetary policy instruments used are given in a separate section of the annual report. As such, the Governing Board believes that the management of the monetary base is more important in respect of meeting the above objectives.

3 Specific accounting policies

Income recognition

Interest income is recognised in the statement of income and expenditure as it accrues, other than interest of doubtful collectibility which is credited to a suspense account and excluded from interest income. The closing balance of the suspense account is netted in the balance sheet against accrued interest receivable. Suspended interest is written off when there is no longer any realistic prospect of it being recovered.

Fees and commissions receivable mainly arise from payment and settlement services, supervisory and regulatory functions and the distribution of fiscal stamps on behalf of the state.

Foreign currencies

Foreign currency financial assets and liabilities have been translated into Tolars (SIT) using the middle exchange rates of the Bank of Slovenia applying at the balance sheet date. Transactions in foreign currencies have been translated into SIT using exchange rates applying on the settlement dates of those transactions.

Marketable securities

The Bank invests in marketable securities as a part of its management of international reserves. Marketable securities are carried at the lower of cost and market value.

Bills with warrants

The discount and interest on bills with warrants, which are included in serviced liabilities, are amortised over the total period over which the bills and any related financing are outstanding, in proportion to the value of the related indebtedness. Future potential discount costs inherent in the warrants outstanding on bills in issue is estimated by the Bank and the amortisation related to the current year is accrued in the accounts as an expense and liability. Amounts are adjusted in future periods as the actual utilisation and value of warrants presented is determined.

Derivative financial instruments

The bank does not use derivative financial instruments except foreign exchange swap arrangements with domestic banks for purposes of implementing monetary policy and managing loans to banks. The amounts related to foreign exchange swap agreements are not recognised in the balance sheet until the settlement date.

Banknotes in circulation

Banknotes issued by the Bank represent a charge on the Bank in favour of the holder and are recognised as a liability at face value.

Fixed assets

Investment properties located in Austria are carried at fair value and are not depreciated. The Bank's policy is to obtain an outside appraisal and revaluation of these properties once every 5 years. All other fixed assets are stated at cost and net of depreciation except for land, which is not depreciated. Property revaluations are taken to reserves.

Depreciation is provided on a straight line basis so as to write off the cost of the assets over their estimated useful lives at the following annual percentage rates:

| | |
|-------------------------------|---------|
| Buildings | 1.3 |
| Computers and other equipment | 10 - 33 |

Gains and losses on disposal of fixed assets are determined as the difference between net disposal proceeds and the carrying amount of the asset and are recognised as income or expense in the statement of income and expenditure.

Taxation

The Bank is not subject to Slovenian profit taxes.

Reserves

In accordance with the Law on the Bank of Slovenia, net foreign exchange gains are transferred to foreign exchange reserves and are not available for distribution. Any remaining surplus after transfer to the general reserves is appropriated by the Republic of Slovenia. A loss is covered from the Bank's general reserves; if these prove insufficient, the loss shall be covered from the budget of the Republic of Slovenia.

Changes in accounting policies

There have been no changes in accounting policies since the previous year.

4 Income from financial assets

| | 1997 | 1996 |
|--|-------------------|-------------------|
| | SIT 000 `s | SIT 000 `s |
| Income from foreign currency assets | | |
| Interest on deposits | 13,406,427 | 9,120,878 |
| Investment income on marketable securities, net | 4,199,909 | 1,861,740 |
| Interest on International Monetary Fund deposits | 38,792 | 31,056 |
| Net foreign exchange gain | 16,797,269 | 8,131,032 |
| Total | 34,442,396 | 19,144,706 |
| Income from domestic currency assets | | |
| Interest on loans to banks | 1,829,888 | 3,927,626 |
| Interest on loans to the Republic of Slovenia | 259 | 0 |
| Total | 1,830,147 | 3,927,626 |
| Total income from financial assets | 36,272,543 | 23,072,332 |

Investment income on marketable securities consists of the following:

| | 1997 | 1996 |
|--|------------------|------------------|
| | SIT 000 `s | SIT 000 `s |
| Interest income | 5,696,788 | 2,017,000 |
| Gains on sale of securities, net | - | 155,356 |
| Loss on sale of securities, net | 209,976 | - |
| Unrealised loss upon revaluation | 1,286,903 | 310,616 |
| Total investment income on marketable securities, net | 4,199,909 | 1,861,740 |

5 Expenses on serviced liabilities

| | 1997 | 1996 |
|--|-------------------|------------------|
| | SIT 000` s | SIT 000` s |
| Expenses on foreign currency liabilities | | |
| Interest on current accounts and deposits | 481,289 | 1,003,808 |
| Interest on Bank of Slovenia bills | 11,132,978 | 6,721,002 |
| Total | 11,614,267 | 7,724,810 |
| Expenses on domestic currency liabilities | | |
| Interest on current accounts and deposits | 253,206 | 208,035 |
| Interest on Bank of Slovenia bills | 5,536,364 | 749,952 |
| Interest on Republic of Slovenia deposits | 322,768 | 627,515 |
| Total | 6,112,338 | 1,585,502 |
| Total expenses on serviced liabilities | 17,726,605 | 9,310,312 |

6 Other income

| | 1997 | 1996 |
|---------------------------------|----------------|----------------|
| | SIT 000` s | SIT 000` s |
| Fees and commissions receivable | 191,544 | 280,163 |
| Other income | 189,671 | 230,383 |
| Total other income | 381,215 | 510,546 |

7 Operating expenses

| | 1997 | 1996 |
|---|------------------|------------------|
| | SIT 000` s | SIT 000` s |
| Staff costs | 1,575,259 | 1,372,195 |
| Commissions and fees for banking services | 676,430 | 147,182 |
| Administration costs | 931,008 | 723,538 |
| Printing and minting costs | 56,062 | 1,914 |
| Other | 107,994 | 83,202 |
| Total | 3,346,753 | 2,328,031 |

8 Financial assets

| | 1997 | | | | 1996 |
|---|--------------------|-------------------|--------------------|--------------------|--------------------|
| | Repricing period | | | | Total |
| | Up to 3 months | 3 to 12 months | Over 1 year | Total | |
| | SIT 000 's | | | | |
| Foreign currency assets | | | | | |
| Cash and deposits | 350,314,874 | 24,544,726 | - | 374,859,599 | 270,848,400 |
| Marketable securities | 35,064,014 | 64,429,858 | 82,719,367 | 182,213,240 | 53,385,891 |
| Receivables from the Republic of Slovenia | - | 676,163 | 5,806,391 | 6,482,555 | 6,403,986 |
| International Monetary Fund | 2,951,443 | - | - | 2,951,443 | 2,637,980 |
| Accrued interest and other | 3,749,572 | 1,301,977 | 2,721,611 | 7,773,160 | 3,022,513 |
| Total | 392,079,904 | 90,952,724 | 91,247,370 | 574,279,997 | 336,298,770 |
| Domestic currency assets | | | | | |
| Receivables from Succession | | | | | |
| Fund of the RS | - | - | 8,649,807 | 8,649,807 | 8,649,807 |
| Loans to banks | 9,853,502 | 95,665 | 191,276 | 10,140,444 | 16,220,019 |
| Accrued interest and other | 171,526 | 21,684 | 177,126 | 370,337 | 327,085 |
| Total | 10,025,029 | 117,350 | 9,018,209 | 19,160,588 | 25,196,911 |
| Total financial assets | 402,104,932 | 91,070,074 | 100,265,579 | 593,440,585 | 361,495,681 |

Average effective interest rates on financial assets.

| | 1997 | | | | 1996 |
|---|------------------|----------------|-------------|-------|-------|
| | Repricing period | | | | Total |
| | Up to 3 months | 3 to 12 months | over 1 year | Total | |
| | % | | | | |
| Foreign currency assets | | | | | |
| Cash and deposits | 3.85 | 3.75 | - | 3.84 | 3.76 |
| Marketable securities | 4.58 | 4.22 | 4.49 | 4.41 | 4.18 |
| Receivables from the Republic of Slovenia | - | - | - | - | - |
| International Monetary Fund | 1.88 | - | - | 1.88 | 1.35 |
| Domestic currency assets | | | | | |
| Receivables from Succession | | | | | |
| Fund of the RS | - | - | - | - | - |
| Loans to banks | 14.10 | 15.33 | 10.00 | 14.07 | 10.78 |

Deposits with other banks and loans to other banks have a carrying amount equal to the principal less specific provisions (1997: SIT 579 million; 1996: SIT 579 million). Interest is paid on maturity. Marketable securities pay interest mostly semi-annually.

The deposits with the International Monetary Fund represent the Reserve Tranche Position and Special Drawing Rights (SDR) and pay interest on a quarterly basis.

Receivables from the Republic of Slovenia have a carrying value equal to principal and are mostly funded by Special Drawing Rights allocations. Interest borne on the funding is recharged directly to the Republic.

The Succession Fund of the Republic of Slovenia was established in February 1993 (Official Gazette of the Republic of Slovenia 10/93) as an intermediary in the process of the division of assets and liabilities of former Yugoslavia. It assumed, on behalf of the Republic of Slovenia, all the claims on and the obligations to the former National Bank of Yugoslavia which included SIT 8,650 million due to the Bank. This amount will be repaid after the settlement of claims and liabilities of the Republic of Slovenia and the states of the former SFR Yugoslavia. The amount is not interest bearing and has no fixed repayment term and therefore the fair value of this asset is less than the carrying value. Due to the uncertainty relating to the likely repayment term of this asset, no estimation of the fair value has been provided. However, the Governing Board considers that the carrying value of this asset fairly represents the amount which will be recovered.

The Governing Board considers that the fair value of financial assets, except as mentioned above, is not materially different from the carrying value.

The effective interest rates shown represent average interest at the end of the reporting period.

Currency concentration and maturity analysis

The nature and manner in which the Bank conducts its operations, principally in relation to monetary policy management and foreign currency reserve management, give rise to currency concentrations in the financial assets. This primarily arises from country and counterparty concentration of exposures.

Basic guidelines for the management of the Bank's international reserves are set by the Governing Board of the Bank and revised on a quarterly basis; the guidelines prescribe the currency structure, average term of deposits and of investments in foreign securities, as well as selection of foreign banks.

These concentrations of risk by currency and type of counterparty are as follows at 31 December 1997.

| | SIT | DEM | USD | Other | Total |
|--------------------------|-------------|--------------|--------------|--------------|---------------|
| | % | % | % | % | % |
| Sovereign issuers | 1.51 | 19.37 | 8.00 | 5.26 | 34.14 |
| Domestic banks | 3.15 | - | - | - | 3.15 |
| Foreign banks | - | 43.83 | 15.89 | 2.99 | 62.71 |
| december 31, 1997 | 4.66 | 63.20 | 23.89 | 8.25 | 100.00 |
| december 31, 1996 | 6.97 | 60.20 | 22.77 | 10.06 | 100.00 |

Financial assets at 31 December 1997 will mature within the following periods analysed by currency (in SIT 000's):

| | SIT | DEM | USD | Other | Total |
|--------------------------|-------------------|--------------------|--------------------|-------------------|--------------------|
| Up to 1 month | 17,853,814 | 95,025,669 | 61,069,960 | 8,610,636 | 182,560,080 |
| 1 to 3 months | 88,525 | 160,727,692 | 47,636,993 | 7,478,515 | 215,931,725 |
| 3 to 12 months | 117,350 | 70,935,185 | 19,341,375 | 676,163 | 91,070,074 |
| 1 year and over | 9,597,151 | 48,359,526 | 13,733,451 | 32,188,579 | 103,878,707 |
| december 31, 1997 | 27,656,839 | 375,048,073 | 141,781,780 | 48,953,894 | 593,440,585 |
| december 31, 1996 | 25,196,911 | 217,638,190 | 82,323,772 | 36,336,808 | 361,495,681 |

Credit Risk Concentration

All marketable securities are interest bearing bonds. All marketable securities and deposits are held with foreign banks.

All foreign banks in which the Bank places funds have a credit rating of at least AA- as graded by Fitch IBCA. The maximum credit risk exposure at 31 December 1997 in the event other parties fail to perform their obligations is the amount recorded in the financial statements as financial assets. Sovereign issuers' exposure consists of OECD countries, the Republic of Slovenia and the Succession Fund of the Republic of Slovenia. Loans to domestic banks are collateralized. The Governing Board believes that there is no significant concentration of credit risk.

9 Fixed assets

| | Land and buildings | Computers & equipment | Total |
|--------------------------|-----------------------|--------------------------|------------------|
| | SIT 000` s | SIT 000` s | SIT 000` s |
| Cost or valuation | | | |
| At 1 January 1996 | 1,423,083 | 990,629 | 2,413,712 |
| Additions | 188,695 | 284,109 | 472,804 |
| Disposals | -3,015 | -119,846 | -122,861 |
| At 1 January 1997 | 1,608,763 | 1,154,892 | 2,763,655 |
| Additions | 204,386 | 469,536 | 673,922 |
| Disposals | -26,367 | -21,605 | -47,972 |
| At 31 December 1997 | 1,786,782 | 1,602,823 | 3,389,605 |
| Depreciation | | | |
| At 1 January 1996 | 501,223 | 522,877 | 1,024,100 |
| Disposals | -2,708 | -100,735 | -103,443 |
| Charge for the year | 18,132 | 167,473 | 185,605 |
| At 1 January 1997 | 516,647 | 589,615 | 1,106,262 |
| Disposals | -8,973 | -20,291 | -29,263 |
| Charge for the year | 14,011 | 226,939 | 240,950 |
| At 31 December 1997 | 521,685 | 796,263 | 1,317,949 |
| Net book value | | | |
| At 31 December 1997 | 1,265,097 | 806,560 | 2,071,656 |
| At 31 December 1996 | 1,092,116 | 565,277 | 1,657,393 |

Included in land and buildings at 31 December 1997 and 1996 is an amount of SIT 500 million relating to investment properties in Austria. These properties are valued on the basis of outside appraisals received in 1995 as approved by the Governing Board. The basis of the appraisal was a multiple of rental earnings and the price at which property transfers were taking place in the same neighbourhood.

10 Serviced liabilities

| | 1997 | | | 1996 | |
|---|--------------------|--------------------|------------------|--------------------|--------------------|
| | Repricing period | | | | |
| | Up to 3 months | 3 to 12 months | over 1 year | Total | Total |
| SIT 000 `s | | | | | |
| Foreign currency liabilities | | | | | |
| Current accounts and deposits | 12,693,522 | - | - | 12,693,522 | 19,751,613 |
| SDR allocation | 5,804,986 | - | - | 5,804,986 | 5,173,675 |
| IMF and other international financial organisations | - | 77 | 39,901 | 39,978 | 222,384 |
| Bank of Slovenia bills | 227,696,834 | 64,166,068 | - | 291,862,902 | 163,288,484 |
| Accrued interest and other liabilities | 39,601 | 655 | - | 40,256 | 113,272 |
| Total | 246,234,943 | 64,166,800 | 39,901 | 310,441,644 | 188,549,428 |
| Domestic currency liabilities | | | | | |
| Current accounts and deposits | 57,258,570 | - | - | 57,258,570 | 44,740,454 |
| Bank of Slovenia bills | 36,887,902 | 38,786,319 | - | 75,674,220 | 16,299,115 |
| Republic of Slovenia deposits | 11,278,732 | - | - | 11,278,732 | 3,324,647 |
| Accrued interest and other liabilities | 970,018 | 530,681 | 1,579,884 | 3,080,583 | 664,022 |
| Total | 106,395,221 | 39,317,000 | 1,579,884 | 147,292,104 | 65,028,238 |
| Total serviced liabilities | 352,630,164 | 103,483,799 | 1,619,785 | 457,733,748 | 253,577,666 |

Average effective interest rates on serviced liabilities.

| | 1997 | | | 1996 | |
|---|------------------|----------------|-------------|-------|-------|
| | Repricing period | | | | |
| | Up to 3 months | 3 to 12 months | over 1 year | Total | Total |
| % | | | | | |
| Foreign currency liabilities | | | | | |
| Current accounts and deposits | 4.80 | - | - | 4.80 | 4.40 |
| SDR allocation | - | - | - | - | - |
| IMF and other international financial organisations | - | - | - | - | 3.70 |
| Bank of Slovenia bills | 4.55 | 4.08 | - | 4.45 | 4.46 |
| Domestic currency liabilities | | | | | |
| Current accounts and deposits | 0.49 | - | - | 0.49 | 0.50 |
| Bank of Slovenia bills | 11.61 | 12.77 | - | 12.20 | 9.19 |
| Republic of Slovenia deposits | 3.08 | - | - | 3.08 | 1.00 |

The interest rates shown represent average interest at the end of the reporting period.

The SDR allocation liability carried an interest rate of 4,19% at 31 December 1997, (1996: 3,91%). Interest paid by the Bank is recharged directly to the Republic of Slovenia, thereby giving a nil effective interest rate.

Bank of Slovenia bills

Bank of Slovenia bills are comprised of the following at 31 December:

| | 1997 | 1996 |
|-------------------------------------|--------------------|-------------|
| | SIT 000 `s | SIT 000 `s |
| Foreign currency bills | 291,836,953 | 162,911,996 |
| Tolar bills | 58,387,691 | 6,921,116 |
| Bills with warrants | 17,259,789 | 8,952,904 |
| Twin bills | 52,689 | 801,583 |
| Total Bank of Slovenia bills | 367,537,122 | 179,587,599 |

Tolar bills are issued with maturities from two to twohundred and seventy days. Foreign currency bills are issued at a discount in either USD or DEM with maturities from two to twelve months. Twin bills are short-term securities issued in bearer form which are comprised of a Tolar and a foreign currency part. They can be bought in Tolars at a discount with redemption in Tolars and in DEM. Bills with warrants are short-term securities issued in bearer form in Tolars. Warrants attached to the bills enable the holder to buy new Tolar bills (without additional warrant) or foreign currency bills at a discount.

Currency concentration and maturity analysis

Financial liabilities at 31 December 1997 will mature within the following periods analysed by currency (in SIT 000's):

| | SIT | DEM | USD | Other | Total |
|--------------------------|--------------------|--------------------|-------------------|------------------|--------------------|
| Up to 1 months | 99,437,919 | 83,844,668 | 25,204,618 | 1,456,693 | 209,943,898 |
| 1 to 3 months | 6,822,010 | 114,101,825 | 15,822,809 | - | 136,746,643 |
| 3 to 12 months | 39,452,292 | 50,935,211 | 13,230,856 | 77 | 103,618,436 |
| 1 year and over | 1,579,884 | - | 38,573 | 5,806,314 | 7,424,771 |
| december 31, 1997 | 147,292,104 | 248,881,704 | 54,296,856 | 7,263,084 | 457,733,748 |
| december 31, 1996 | 65,028,238 | 144,948,792 | 34,136,256 | 9,464,380 | 253,577,666 |

11 Banknotes in circulation

Value of banknotes in circulation by denomination:

| | | 1997 | 1996 |
|---------------|-------|-------------------|-------------------|
| | | SIT 000 `s | SIT 000 `s |
| SIT | 10 | 240,023 | 210,445 |
| SIT | 20 | 240,762 | 207,610 |
| SIT | 50 | 371,772 | 334,148 |
| SIT | 100 | 1,276,551 | 967,419 |
| SIT | 200 | 623,498 | 809,348 |
| SIT | 500 | 1,429,500 | 1,323,055 |
| SIT | 1000 | 11,959,871 | 11,217,023 |
| SIT | 5000 | 32,877,515 | 31,246,735 |
| SIT | 10000 | 36,225,710 | 24,714,370 |
| Total | | 85,245,202 | 71,030,153 |
| Tolar coupons | | 407,332 | 410,417 |
| Total | | 85,652,534 | 71,440,570 |

12 Reserves

| | | 1997 | 1996 |
|--------------------------------------|--|-------------------|------------|
| | | SIT 000 `s | SIT 000 `s |
| Balance at 1 January | | 37,211,943 | 26,726,532 |
| Contributions to the welfare fund | | 51,877 | 42,399 |
| Transfer to foreign exchange reserve | | 16,797,269 | 8,131,032 |
| Transfer to general reserve | | - | 2,311,980 |
| Release of general reserve | | 1,935,130 | - |
| Balance at 31 December | | 52,125,959 | 37,211,943 |
| Represented by | | | |
| General reserve | | 3,615,749 | 5,550,879 |
| Welfare fund | | 529,975 | 478,098 |
| Investment properties revaluation | | 500,000 | 500,000 |
| Foreign exchange reserve | | 47,480,235 | 30,682,966 |
| Total reserves | | 52,125,959 | 37,211,943 |

The general reserve has been established in recognition of the economic and other risks inherent in the discharge of the Bank's responsibilities, and its portfolio of financial assets. The release of general reserve refers to a relatively high costs of monetary policy instruments in the year 1997. The increase of the general reserve from the operating surplus appropriation for the year 1996 was for this reason previously made.

The foreign exchange reserve relates to cumulative net foreign exchange gains which by law are only available to offset any future net foreign exchange losses and are not distributable.

The welfare fund has been established to provide recreational and other facilities for the staff of the Bank. The assets representing the fund are included in the Bank's balance sheet and any movement in asset values is taken directly to reserves.

13 Commitments and off balance sheet instruments

Letters of Credit

The aggregate amounts of outstanding letters of credit at the year end were:

| | 1997 | 1996 |
|------------------------------------|------------|------------|
| | SIT 000 `s | SIT 000 `s |
| Foreign currency letters of credit | 3,909,277 | 8,047,554 |

Foreign exchange swaps

The Bank entered into certain foreign exchange swap agreements which require the Bank to sell DEM for SIT in 1998 in the total nominal value of SIT 8.5 billion. At 31 December 1997 the settlement dates on open foreign exchange forward contracts which result from foreign exchange swaps entered into with domestic banks are within one month. The amounts to be received for transactions against DEM are as follows:

| | 1997 | 1996 |
|--|------------|------------|
| | SIT 000 `s | SIT 000 `s |
| Amounts to be received forward against DEM | 8,496,251 | - |

Because of the short term nature of these transactions, the fair value does not differ materially.

Bills with warrants

The Bank issued SIT 63 billion of bills during 1997 with 425.776 warrants attached. Each bill has a maximum of five warrants attached. The warrants represent a contractual obligation by the Bank to sell SIT, DEM or USD bills, with maturities of 180 days to 360 days, at an additional discount based on the value of the warrant. The value of the warrant is calculated by the Bank on a monthly basis and represents the difference between the actual inflation and projected inflation for additional discount on SIT bills and between projected inflation and actual devaluation of SIT against DEM and USD for DEM or USD bills respectively. The warrants have a maturity of 12 months from the date of issue. At 31 December 1997, there were 295.831 issued but unexercised warrants. The future potential discount costs of these warrants are estimated by the Bank and amortised over the total period during which the bills with warrants and the newly issued bills (resulting from the presentation of warrants) are outstanding. The provision for the amortisation estimated for unexercised warrants which relates to the year ending 31 December 1997 is recorded as a liability and expense in the accounts. Amounts are adjusted in future periods as the actual utilisation and value of warrants presented is determined.

Litigation and other provisions

There are certain legal claims pending or threatened, where the Bank is involved which have not yet been settled. The Governing Board believes that sufficient provision has been made in the accounts for any expected loss from future settlement.

6. ANNEXES

6.1. Legal Status and Tasks

The Bank of Slovenia ("the Bank") was established on June 25, 1991 pursuant to the Law on the Bank of Slovenia and based upon the Constitutional Law on the Implementation of the Basic Constitutional Charter on independence of the Republic of Slovenia. The Bank actually became the monetary authority upon introduction of Slovenian legal tender, the Tolar, on October 8, 1998.

Pursuant to Article 152 of Constitution of the Republic of Slovenia, the Bank is independent and directly responsible to Parliament.

By Constitution Bank of Slovenia is independent and responsible to Parliament...

The Governing Board of the Bank and the Governor manage the Bank. The Governing Board consists of eleven members: the Governor (Chairman of the Board), Deputy Governor, three Vice-Governors and six external members – independent experts. Parliament appoints the Governor and the six external members upon proposal of the President of State. Parliament appoints the Deputy Governor and the Vice-Governors upon proposal of the Governor. All members of the Board are appointed for a term of six years. The Board takes all decisions by a two third majority vote.

Pursuant to the law, the main responsibility of the Bank is to maintain stability of the domestic currency and general liquidity of payments within the country and with foreign countries. To this end, the Bank

... and maintains stability of Slovenian currency and general liquidity of payments within the country and with the rest of the world.

- regulates the quantity of money in circulation,
- ensures general liquidity of banks and savings banks and of payments to foreign countries,
- supervises banks and savings banks,
- issues banknotes and puts those and coins in circulation,
- prescribes IT systems necessary to its functions,
- prescribes rules for implementation of the deposit guarantee scheme,
- provides banking services to the central government.

The Bank is entrusted with other tasks and responsibilities pursuant to the Law on Banks and Savings Banks, Foreign Exchange Law, Law on Pre-Rehabilitation, Rehabilitation, Bankruptcy and Liquidation of Banks and Savings Banks.

The Bank is independent in carrying out monetary policy and in performing other tasks and responsibilities. The Governing Board and the Governor are responsible to Parliament. The Bank reports to Parliament twice a year, and has its Annual Financial Statements and the financial plan for the current year confirmed by Parliament.

Pursuant to the law, the Bank is only allowed to lend to the Republic of Slovenia short-term; the volume of such loans is limited to a maximum of 5% of the Budget of Republic of Slovenia and of one fifth of the anticipated general budget deficit respectively. Any such loans should be repaid before end of the same fiscal year.

6.2. Important Measures Taken

6.2.1. Monetary Policy Measures

- January** **Amendment to Decree on extension of credit to non-residents**
Restrictions on extension of credit to non-residents were reduced. Banks were allowed to grant financial loans to non-residents in line with their business policy. Non-banks may extend loans to affiliated companies only.
- Decree on compliance requirement on minimum foreign-currency holdings by banks**
Percentage of mandatory investments by banks in the Bank's bills was raised to at least 60% of the total required foreign-currency holdings (the required reserve on foreign exchange liabilities).
- February** **Tolar bill with maturity of 270 days**
The bill with a maturity of 270 days and interest rate of TOM+4.5% was first offered to banks and savings banks on February 17, 1997.
- Credit line for the Ministry of Finance**
The Ministry of Finance drew upon the facility one single time. It repaid the loan the next day. The loan was granted in conjunction with a fixed-term deposit made by the Ministry with the Bank.
- The Bank's interventions in the evening interbank money market**
The Bank stopped intervening in the evening money market; its interventions took place since July 10, 1996.
- Decree on transfer of mandatory reserve accounts of banks and savings banks to the Bank**
- Decree regulating payment transactions with foreign countries**
Rules were set for incoming foreign payments pertaining to foreign portfolio investments.
- Amendment to Instructions regulating payments with foreign countries**
The amendment regulated in detail any and all payments pertaining to foreign equity and portfolio investments. It also defined custody accounts as liability defined in the Decree on balancing of net growth in bank's liabilities to non-residents with respective assets.
- April** **Interbank agreement placing a cap on deposit rates**
New agreement was concluded and came into effect on April 4, 1997. Distinction between natural and legal persons was abolished, the maturity differentiation was increased, and the real component on deposits with a maturity of over two years agreed upon was 7% in addition to TOM (or foreign exchange revaluation clause).
- May** **Decree on base interest rate (BIR - TOM)**
The period employed in calculation of TOM was extended from preceding six to twelve months effective May 1, 1997.
- June** **Purchase of foreign exchange by the Bank with the right-to-sell and foreign exchange sales for foreign currency bills**
The Bank offered to purchase foreign exchange from banks undertaking to purchase more foreign exchange and obliging the participating banks to invest 20% of the amount sold in the Bank's foreign currency bills.

Decree on non-balanced claims and liabilities in foreign currency (Decree on open foreign exchange position of banks)

The decree requires that banks calculate their foreign exchange position on a daily basis. Long foreign exchange position (total assets exceed liabilities in foreign currencies) or short foreign exchange position (total liabilities exceed total assets in foreign currencies) should not exceed 20% of the bank's regulatory capital.

Amendment to Instructions regulating payments with foreign countries

Long-term foreign portfolio investments (exceeding seven years) were no longer regarded as liabilities defined in Decree on balancing of net growth in bank's liabilities to non-residents with respective assets.

Temporary purchase of foreign currency bills by the Bank obliging banks to repurchase them **July**

Mandatory purchase of foreign exchange by banks from enterprises coupled with repos was lowered to 150% of the amount of bills temporarily sold to the Bank and subsequently to 120%.

Purchase of foreign exchange by the Bank with the right-to-sell and foreign exchange sales for foreign currency bills **August**

Banks were required to invest 35% of the amount of foreign exchange sold to the Bank in foreign currency bills (previously 20%).

Temporary purchase of foreign currency bills by the Bank obliging banks to repurchase them

The Bank abolished this instrument and offered to temporarily purchase foreign exchange from banks with the obligation of banks to repurchase that through daily auctions.

Purchase of foreign exchange by the Bank with the right-to-sell and foreign exchange sales for foreign currency bills **September**

The Bank made this instrument available for the last time

Temporary purchase of foreign exchange from banks by the Bank obliging banks to repurchase that

Regular daily interventions were replaced with a standing facility; the Bank also reintroduced the foreign exchange bill repo.

Sale of foreign exchange to banks by the Bank for purchase of foreign currency bills

The Bank reduced the surcharge above its selling rate applying to sale of foreign exchange from 2% to 1.5%.

Amendment to the Decree on mandatory reserves of banks and savings banks

The maintenance was changed and now extends from the 27th day of the previous month to the 26th day of the current month (previously: from the first to the last calendar day of the month).

Cancellation of the Decree on issue of Bank bills against temporary sale of foreign exchange by banks (from March 1995) **October**

Cancellation of Decree on terms and conditions for purchase of foreign exchange from banks with the right given to banks to repurchase it (from 1993)

December Bills with warrants
Starting with the 8th issue, calculation of discount was based on the CPI (formerly: RPI).

Amendments to Decree on terms and conditions for services offered to central government

The amendments determine procedures necessary for utilization of the overdraft facility and methodology for determination of the amount of such overdraft facility.

Decree on Base Interest Rate (BIR - TOM)

Computation methodology of TOM was changed to reflect the change in measurement of inflation (CPI instead of RPI); in force as of January 1998.

6.2.2. Supervisory Measures

January Decree on the Classification of the Balance Sheet Assets and Off- Balance Sheet Items of Banks and Savings Banks

The decree introduced more severe criteria for classification, reduced the weight of pledge of immovable property as collateral, and introduced mandatory provisions for country risk.

Instructions for the Implementation of the Decree on the Classification of Balance Sheet Assets and Off-balance Sheet Items of Banks and Savings Banks
Instructions for Restructuring Non-performing Assets

February Amendment to Decree on Terms and Conditions and a Banking License
Decree on Chart of Accounts for Banks and Savings Banks

Adoption of the two was necessary due to introduction of Custody Accounts

Amendment to Instructions for Implementation of Decree on Financial Statements of Banks and Savings Banks

April Instructions for Calculation of the Most Common Deposit and Lending Interest Rates

Recommendations for Trading Activities in Banks

Recommendations specify responsibilities of the Board of Management, skills of staff necessary, code of behavior, surveillance of risks, organizational aspects, internal controls and audit, give instructions how to handle special cases, etc.

May Amendments to Instructions for Implementation of the Decree on the Classification of Balance Sheet Assets and Off-balance Sheet Items of Banks and Savings Banks
Decree on Special Liquidity Loans in Co-operation with Banks

The decree replaced that adopted in July 1996 which made it possible, during the period of 9 months, for banks with liquidity problems to obtain a liquidity loan from another bank against pledge of first class securities or first class claim.

Amendment to Decree on the Amount of Provisions and the Method of Calculation of Provisions to Protect Banks and Savings Banks Against Potential Losses

Amendment was necessary in view of introduction of mandatory provisions for country risk.

Amendment to Decree on the Method for Calculation of Capital Adequacy for Banks

and Savings Banks

The decree was adopted in line with the decision of the Bank that in calculation of regulatory capital, claims and potential losses with shares of other banks pledged as collateral are to be deducted.

Instructions for Preparation of Reports on Operation of Banking Groups

The controlling bank is obliged to send twice per year a consolidated Balance Sheet and Profit and Loss Account, calculation of regulatory capital and capital adequacy of the group, and a report on Classification of Balance Sheet Assets and Off-balance Sheet Items for the group.

Amendment to Decree on Terms and Conditions and for Banking License

The decree made it possible for banks to open and hold non-resident accounts against irrevocable guarantee at first call of a first-class foreign bank even in the absence of the minimum capital required for such activity.

Amendment to Instructions for Preparation of Monthly Reports on Actual First, Second and Third Grade Asset Position

Loans and securities of actual or residual maturity of up to 30 days were classified as second grade assets; definition for asset classification by banking groups was introduced.

July

Amendment to Instructions for Preparation of Monthly Reports on Actual First, Second and Third Grade Asset Position

Amendment to Instructions for Preparation of Monthly Reports on Large Exposure to Depositors

September

Amendment to Decree on Chart of Accounts for Banks and Savings Banks

Banks were obliged to include some additional accounts into their financial statement report by account, starting December 31, 1997.

November

Amendment to Decree on Financial Statements of Banks and Savings Banks

Amendment to Instructions for Implementation of Decree on Financial Statements of Banks and Savings Banks

6.3. Governing Board and Organizational Structure

6.3.1. Changes in Governing Board

The term of Mag. Janez Košak, Board member and Vice Governor expired in July. He was re-appointed by Parliament for a term of six years.

The term of the following external members of the Board expired in September: Mag. Velimir Bole and Prof. Dr. Jože Mencinger (both Economic Institute of the Faculty of Law, University of Ljubljana), Jurij Kleindienst (enterprise Kolektor, Idrija) and Prof. Dr. Ivan Ribnikar (Faculty of Economics, University of Ljubljana). The following external members of the Board were appointed by Parliament in their place (and one to fill a vacant external member position) for a term of six years: Ms. Tatjana Fink, Mag. Bine Kordež, Mag. Vladimir Lavrač, Dr. Leon Repovž and Prof. Dr. Ivan Ribnikar.

6.3.2. Members of Governing Board at December 31, 1997:

CHAIRMAN OF GOVERNING BOARD

Dr. France Arhar
(Governor of the Bank)

MEMBERS OF GOVERNING BOARD

Samo Nučič
(Deputy Governor)

Mag. Janez Košak
(Vice Governor)

Andrej Rant
(Vice Governor)

Tatjana Fink
(Trimo, Trebnje)

Mag. Bine Kordež
(Merkur, Kranj)

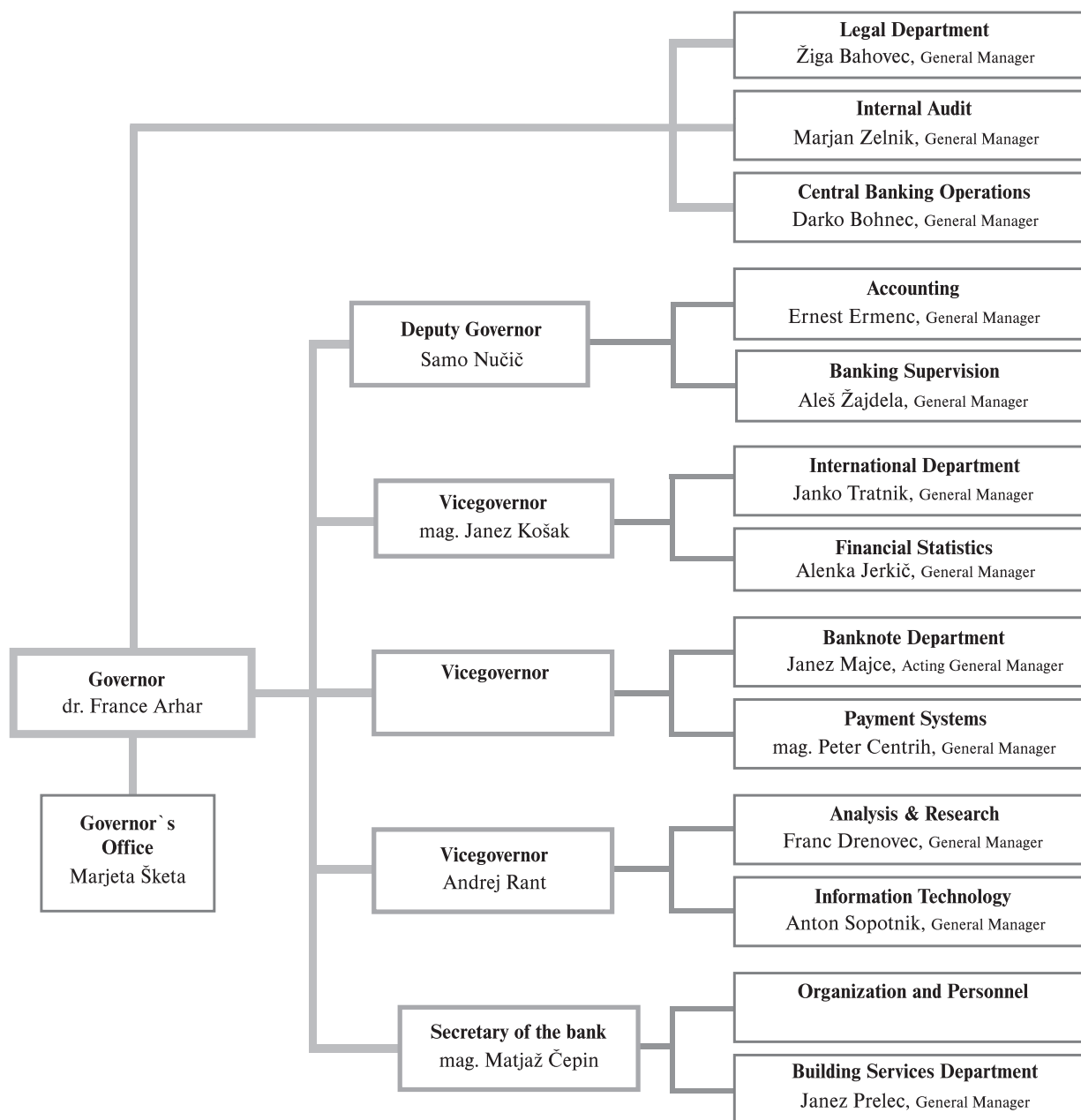
Mag. Vladimir Lavrač
(Institute of Economic Research, University of Ljubljana)

Dr. Leon Repovž
(Faculty of Business Administration and Economics, Maribor)

Dr. Ivan Ribnikar
(Faculty of Economics, University of Ljubljana)

Dr. Dušan Zbašnik
(Faculty of Business Administration and Economics, Maribor)

6.3.3. Organization chart of the Bank of Slovenia at December 31, 1997:



6.4. Publications and Web Site

| Title, frequency of issue, language | Content |
|---|--|
| Monthly Bulletin <ul style="list-style-type: none"> · monthly · Slovenian, English | Macroeconomic statistical data; monetary statistics, exchange rates, data on economic relations with foreign countries. Review of current developments via graphs; notes on methodology; list of banks holding the Bank's license. |
| Annual Report <ul style="list-style-type: none"> · annual (issued in spring) · Slovenian, English | Annual Report as prepared for the Parliament of the Republic of Slovenia. Report on economic development, monetary policy, operation of banks and the Bank. |
| Report on Supervision of Banking Operations <ul style="list-style-type: none"> · annual (first issued in December 1997) · Slovenian, English | Report on operation of banks, on supervision of bank operation, on development of legal supervisory framework as prepared for the Parliament of the Republic of Slovenia |
| Direct investment <ul style="list-style-type: none"> · annual (first issued in June 1997) · Slovenian | Annual statistical data on Slovenian direct investment abroad and foreign direct investment in Slovenia |
| Review and Analyses <ul style="list-style-type: none"> · Quarterly · Slovenian | Speeches held by the Governor in Parliament, analytical and methodological review of monetary area, balance of payments and similar. |
| Web site Home page index: http://www.bsi.si/.../eng/index.html | Presentation of the Bank, presentation of Slovenian banknotes and coins, legal framework concerning activities of the Bank, etc. Up-to-date rates of exchange for foreign currencies, interest rates, securities issued by the Bank. Publications of the Bank. |

6.5. Glossary

Base interest rate (BIR or TOM): Officially established indexation rate for claims and liabilities calculated as average inflation rate (until the end of 1997 based on retail price index, since then on consumer price index) of the last month or of the last few months (since May 1997 of the last 12 months).

Balance sheet total: the aggregate amount of bank assets or liabilities.

Base or high powered money: Currency in circulation, bank reserves and sight deposit money with the Bank.

Capital adequacy: Ratio between the regulatory capital and total risk-weighted assets.

Foreign currency (denominated) bill (FCB): short-term security issued by the Bank of Slovenia, subscribed and redeemed in foreign currency.

Foreign exchange minimum: The minimum amount of foreign exchange reserves or assets that banks are required to hold.

Mandatory reserves: The amount of assets, usually set as percentage of deposits and other bank liabilities, that banks are required to hold on a special account with the Bank and as vault cash.

Money market: Interbank money market where first class short-term securities are traded.

Monetary aggregates (M1, M2 and M3): monetary aggregates with differentiated liquidity grade. **M1** with highest liquidity comprises banknotes and coins in circulation and sight Tolar deposits with domestic banks and with the Bank of Slovenia. **M2** comprises M1, Tolar savings accounts and time deposits in domestic banks and Bank of Slovenia. **M3** comprises M2 and household foreign currency deposits in domestic banks.

Monetization: A change of financial assets that banks and the Bank buy, into money; they namely buy such (financial) assets, i.e. claims, (and extend credits) with newly issued or newly created money.

Net interest margin: The ratio between net interest income (difference between real and revaluation interest income and expenses) and average gross interest bearing assets.

(Nominal) interest rate differential: The difference between the average nominal interest rate earned on assets and the average nominal interest rate paid on liabilities.

Open position (in foreign currencies): A surplus of foreign exchange assets over foreign exchange liabilities of a bank (long position) or vice versa (short position).

Operating expenses: The sum total of general expenses (labor cost and other expenses), depreciation and taxes.

Provisions: General provisions against contingent risks and special provisions against potential losses deriving from balance and off-balance-sheet items and against country risk.

Purchase with warrant: Offer made by the Bank to banks to purchase foreign currencies from them warranting to purchase additional quantities from them in the future.

Regulatory capital: The aggregate amount of primary capital (stockholders' equity), reserves and any other such liabilities designated to cover any business risks or losses.

Revaluation rate: Part of the nominal Tolar lending and deposit rates intended as compensation for the current inflation rate to the lender and depositor respectively.

Secondary liquidity: Tolar and foreign currency denominated bills issued by the Bank and bonds issued by the Republic of Slovenia.

Sterilization: In general, sale of short-term government bonds (Treasury Bills) by the central bank to offset the effect of its purchase of foreign exchange on the quantity of base money. In Slovenia, sterilization means sale of foreign currency bills by the Bank with the purpose to neutralize the inflow of foreign exchange (and reduce its purchase of foreign exchange), and sale of Tolar bills by the Bank with the purpose to offset the effect of purchase of foreign exchange from banks by the Bank on the quantity of base money.

Tolar bills (TB): Short-term Tolar debt securities issued by the Bank.

Withdrawal of money from circulation: operation opposite to issue or creation of money.