THE MONETARY PROGRAMME OF THE NATIONAL BANK OF SLOVAKIA FOR THE YEAR 2002

The Monetary Programme of the NBS for 2002 is based on the projected course of economic variables up to the end of 2001. In 2001, economic development in Slovakia was characterised by continued disinflation, acceleration in the rate of economic growth, and a relatively large deficit in the current account of the balance of payments.

Until November 2001, the development of consumer prices had been determined by the effects of internal as well as external factors. The effect of domestic factors was connected mainly with the continued process of deregulation and an increase in input prices in the production sector. In addition to administrative and cost factors, the development of consumer prices was affected by demand-based factors, but only to a negligible extent, which was indicated by the moderate dynamics of prices for tradeable goods and the stabilised rise in the price of market services.

The impact of external factors was connected with the fluctuation in the world prices of strategic raw materials and the exchange rate of the Slovak crown to the US dollar. In the second half of the year, the world price of oil fell below the lower limit of the reference zone of OPEC countries, with a subsequent downward effect on the level of fuel prices. This factor, together with the favourable trend in food prices and the absence of pronounced demand-based pressure, was responsible for the fall in inflation in the second half of the year. The year-end rate of overall and core inflation will, in all probability, fluctuate below the lower limit of the interval set in the Revised Monetary Programme of the NBS for 2001. According to the latest estimates of the NBS, overall inflation is expected to range from 6.3 to 6.5% and core inflation from 2.9 to 3.2% at the end of 2001.

Compared with the previous year, the rate of economic growth accelerated in 2001, with gross domestic product increasing by 3.1% over the first three quarters. According to the latest estimate of the NBS, real GDP is expected to grow at a rate of 2.8 to 3.0%. In comparison with 2000, the year 2001 saw a change in the structure of economic growth, which was stimulated by domestic, for the most part investment demand. This was connected with the ongoing restructuring in specific sectors, mainly corporate entities, which were the targets of foreign investors. Part of domestic demand is final household consumption, the growth of which was stimulated by an increase in real wages and additional funds received from the redemption of NPF bonds.

The development of domestic demand and the slowdown in the rate of economic growth in the countries of Slovakia's major trading partners, led to dynamic growth in the trade deficit and a shortfall in the balance of payments on current account. The growth in imports was due mainly to the development of investment demand, stimulated by an inflow of foreign capital in the form of direct investment. This was also indicated by the relatively high share of machines and instruments in the total increase in imports (i.e. approximately one third). The dynamic growth in imports was, however, connected with the persistent high material intensity of the Slovak economy and the resulting import of semi-finished goods and raw materials. Imports intended for final consumption were dominated by car imports.

In view of the trade balance in particular, the NBS expects the deficit in the current account to reach 8.1 to 9.0% of GDP in 2001.

The conduct of monetary policy in 2001 was determined by both the actual and predicted courses of macro-economic and monetary development. The fall in inflation over the first months of the year and the forecast for its further development, made it possible for the NBS to cut its key interest rates by 0.25 percentage points in March 2001. With regard to the relatively dynamic growth in domestic demand, imports, and the size of the trade deficit, the NBS applied a more prudent monetary policy during the following period, despite the relatively favourable trend in consumer prices, with the aim of dampening domestic demand and so avoiding the occurrence of undue macro-economic imbalances. The moderate reduction in the official rates of the NBS in the first quarter led to a fall in interest rates for primary customers, with the rate for new loans falling from 9.9% in March (10.8% in December 2000) to 8.8% in October.

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The Monetary Programme of the NBS for the Year 2002 is based on the forecast of macro-economic development for the period until the end of 2001. The key assumptions of the Monetary Programme are the size of the fiscal deficit, which should not exceed 3.6% of GDP, and the planned implementation of privatisation projects and the use of the funds thus obtained for purposes approved by the Government, i.e. for the servicing of the national debt and the reform of social insurance. Such use of the receipts from privatisation is preferred by the National Bank of Slovakia as well. The Monetary Programme is based on the scope of adjustments to regulated prices approved for 2002. If additional price adjustments are approved, the projected inflation figures will have to be modified. With effect from 1 January 2002, the Statistical Office of the SR will revise the consumer basket of goods and services used for the calculation of the Consumer Price Index (CPI). The change in the weights of individual components of the consumer basket may affect the statistically determined rate of inflation; therefore, it will probably be necessary to correct the figures in the Monetary Programme, with respect to inflation.

The development of consumer prices in 2002 is expected to be characterised by another fall in cost-push inflation, which will mainly be due to the reduced range of adjustments to regulated prices in comparison with 2001. The expected slowdown, or suspension, in the process of deregulation will cause the rate of inflation to fall by more than 2 percentage points in 2002.

The reduced range of price adjustments in comparison with the original plans of the Government, presented in the calendar of adjustments to regulated prices for 1999, will cause, however, only a short-term fall in inflation. This will, in fact, create an illusion of acceleration in the process of disinflation. In the medium term, the slowdown in price deregulation in 2002 will lead to a rise in inflation in 2003. The sector of regulated prices creates some uncertainty about the projected course of inflation, for there is no binding schedule for such price adjustments in the medium term.

As far as core inflation is concerned, the forecast of the NBS is based on the assumption that the world prices of energy-producing and industrial raw materials and the exchange rate of the Slovak crown will follow a stable course of development. The price of oil is expected to fluctuate within the reference zone of OPEC countries, in the lower range, i.e. from US$ 22 to 25/barrel.

Taking account of the expected impacts on consumer prices, core inflation should reach 3.2 to 4.7% at the end 2002. In accordance with the expected range of price adjustments, the rate of overall inflation is expected to fluctuate between 3.5 and 4.9%, representing an average inflation rate of 4.1 – 4.9%.

Compared with the expectations of the NBS, the approved State Budget Act foresees a higher rate of inflation in 2002 (an average rate of 6.7%). The Ministry of Finance of the SR made this estimate on the basis of the original calendar of adjustments to regulated prices.

Economic activity in 2002 is expected to be marked by an acceleration in the rate of economic growth, due to both domestic and foreign demand. Investment demand will, in all probability, remain the most dynamic component of domestic demand, but its growth will slow in comparison with 2001. In 2002, the growth in final household consumption is expected to accelerate in comparison with the previous year, as a result of a steeper increase in real wages. In relation to the growth in final household consumption and its possible contribution to the trade deficit, the NBS sees some risk in wage development, which should take into account both the growth in labour productivity and the expected fall in inflation. From this point of view, the NBS views the growth in nominal wages, ensuring the excess of the rate growth in labour productivity over the dynamics of real wages, as adequate up to 6%. In 2002, economic growth will probably be affected favourably by the volume of net exports, which will be determined mainly by a fall in the dynamics of imports and a moderate slowdown in the rate of growth in exports. Leaving the price effects out of account, this development will lead to a fall in the negative balance of net exports at constant prices. **According to the estimates of the NBS, the rate of growth in gross domestic product should reach 3.5 – 3.8% in 2002.**

As yet, for 2002, it is not realistic to expect a marked improvement in the deficit of the country's balance of payments on current account. On the export side, foreign trade will be affected by the persistent slow rate of economic growth in the countries of Slovakia's major trading partners, which is expected to accelerate only in the second half of 2002. On the other hand, imports will be affected by the continued growth in final household consumption, the relatively dynamic growth in investment, and the inadequate restructuring of the supply side of the economy. **Hence, the current account deficit is expected to reach 7.9% of GDP in 2002.**

Monetary policy in 2002 will be implemented in a relatively complicated environment, characterised by a temporary fall in inflation on the one hand and a massive trade deficit on the other. At the same time, however, the NBS must take into account the implementation of privatisation projects and, first and foremost, the use of the funds thus obtained. If these funds are used in accordance with the declared goals of the Government, i.e. for the servicing of the national debt in particular, domestic demand should not be stimulated too much. If, however, the funds are used for other purposes, e.g. for financing development projects, the growth in domestic demand will be supported by the public sector with a possible impact on the balance of trade and inflation. Such use of receipts from privatisation would generate, with regard to their one-off nature, numerous risks – inflationary pressure, growth in the trade deficit, problems in financing the national debt in the future, poor conditions for the consolidation of public finances.

In implementing its monetary policy, the NBS will take into account the risks that may alter the course of development in comparison with that projected in the Monetary Programme. The NBS will pay special attention to wage development, the use of income from privatisation, budgetary performance in the public sector, the prices of raw materials on the world market, and to global economic activity. Leaving the above risks out of account, the NBS assumes that the exchange rate of the Slovak crown to the euro will follow a relatively stable course.

In the area of monetary-policy instruments, the Lombard loan, the Lombard rate, and bills-of-exchange transactions will be cancelled with effect from 1 January. At the same time, the discount rate will be re-defined as an equivalent of the limit rate of NBS for standard REPO tenders. Also, the ratio of required reserves will be reduced by 1 percentage point, to 4.0%. These changes are connected with the need to adjust the monetary-policy instruments of NBS to those applied by the European Central Bank.

In connection with the change in the method of setting the discount rate and its prospective cancellation (on the day of entry into EMU), it is necessary to make some changes in legislation, i.e. especially in laws that refer to the discount rate. The NBS recommends that the above term should no longer be used in trade agreements and other documents and should be replaced with another term, e.g. the limit rate for standard two-week REPO tenders.

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In 2001, the NBS published, for the first time, a medium-term economic forecast for the years 2003 – 2005, as part of the Monetary Programme. The forecast is based on the objectives of the Government as declared in the pre-accession economic programme and on the expected integration of the Slovak economy into the economic system of the European Union.

The expectation of a relatively dynamic growth in the Slovak economy, based on growing productivity and competitiveness, is connected with the continued structural reform and the process of integration. The growth in productivity and competitiveness is expected to be fuelled largely by the continued inflow of foreign capital in the form of direct investment, which is likely to be employed mostly in the private sector. At the same time, public finances are expected to consolidate step by step, which is a vital condition for the integration process. The reduction in the fiscal deficit and the growth of competitiveness in the economy are expected to create conditions for balanced economic growth, an improvement in exports, and gradual disinflation. On the whole, the convergence of the Slovak economy to EU countries is expected to speed up in real terms, while in nominal terms, it will continue in line with the Maastricht criteria.

In the medium term, the development of consumer prices is expected to be determined by continued adjustments to regulated prices, the harmonisation of indirect tax rates with EU standards, and a gradual reduction in core inflation. With regard to the end of deregulation in 2002, the range of adjustments to administratively controlled prices is expected to increase and the rate of inflation to rise in 2003. Extensive adjustments to administratively controlled prices will also be required before the expected entry of Slovakia into the European Union in 2004.

The expected trend of gradual reduction in core inflation might possibly be interrupted in 2003, by the secondary effects of the relatively extensive administrative price adjustments. During ensuing years, core inflation should be reduced only at a moderate rate, with respect to the required approximation to price levels in EU countries. An exaggerated effort to accelerate the process of disinflation could lead to the occurrence of inflationary pressure in the period to come. At the end of the period under analysis, core inflation is expected to be somewhat higher than the average rate of increase in consumer prices in the EU.

Provided the structural changes in the corporate and financial sectors, the labour market, and the reform of public finances and the social sector continue, the development of real GDP during the period until 2005 will probably show a gradual increase in dynamics. The growth in GDP will be determined by the growth in exports, with the support of fixed investments and private consumption.

The expected revival of economic growth in the countries of Slovakia's trading partners in the years 2003 – 2005 will probably lead to relatively stable growth in Slovak exports. This will be connected with the favourable effect of Slovakia's integration into the EU, which will be supported by the productivity of investments made in previous years. At present, the relatively rapid growth in investment creates conditions for an increase in the supply side of the economy, a fall in its dependence on imports, and a consequent slowdown in the rate of growth in imports. Under these conditions, the deficit in the balance of payments on current account is expected to diminish step by step over the period under analysis.

In 2003 – 2005, monetary policy will be implemented in an environment marked by a temporary increase in the rate of inflation and the subsequent renewal of the disinflation process. The expected macro-economic development during this period will be characterised by the gradual consolidation of public finances, a deficit in the current account, and moderate acceleration in the rate of economic growth. Such development is expected to create conditions for a gradual reduction in the key rates of the NBS in the medium term.

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Having in mind the significance and importance of Slovakia's integration into the European structures, the Bank Board of the NBS also dealt with the strategy to be applied in the area of monetary integration, i.e. the entry of Slovakia into the European Monetary Union and the replacement of the Slovak crown by the euro.

As part of these questions, the Bank Board assessed the costs and benefits of Slovakia's entry into the European Monetary Union. The most significant costs of this process will be the implementation of structural reforms and the reform of public finances, which are expected to lead to the consolidation of public budgets. The low level of the fiscal deficit, together with the common monetary policy formulated by the European Central Bank, will create conditions for a fall in interest rates and the mobilisation of resources for the private sector. At the same time, the entry of Slovakia into EMU will eliminate the costs arising from the exchange rate risk (SKK/EUR), which will cease to exist in this area. The advantages of a single currency and common monetary policy will result in a fall in the costs of transactions, which will not be altogether negligible with regard to the orientation of Slovakia's foreign trade to EU Member States and candidate countries. In this connection, it is to be noted that the majority of countries aspiring to gain admission to the European Union, declared an interest in integrating into the European Monetary Union as soon as possible. Such a conclusion was also drawn at the meeting of the governors/presidents of central banks of the candidate countries, which was held recently in Berlin under the aegis of the European Central Bank.

In connection with questions concerning the strategy of the NBS in the area of monetary integration, the Bank Board has discussed the current level and prospects of Slovakia's convergence in structural, real, and nominal terms. The Bank Board has stated that Slovakia has enough potential for the continuation of the process of convergence in all areas. The membership of Slovakia in the euro area could be a further stimulus for real convergence.

The National Bank of Slovakia will support the strategy of Slovakia for gaining admission to the European Monetary Union as soon as possible and implementing a monetary policy in accordance with the Maastricht criteria in the medium term.

Marián Jusko, Governor of the NBS,
speaking at a press conference on 20 December 2001