MONETARY PROGRAMME OF THE NBS FOR 2004

On 19 December 2003, the Bank Board of the National Bank of Slovakia (the "NBS") approved the Monetary Programme for 2004, which includes a medium-term outlook for 2005 to 2007. The Monetary Programme was presented by NBS Governor Marián Jusko at a press conference on 22 December 2003.

The National Bank of Slovakia drew up its Monetary Programme for 2004 on the basis of the actual development of the GDP in the second half of 2003. Although the basic indicators of economic development were not substantially affected by the GDP figures for the third quarter, their publication had been preceded by a methodological revision of the GDP data. Since the Bank's Monetary Programme for 2004 had already been complete when the GDP data was released, the data revision or update for the third quarter of 2003 could not be taken into account in this document. The revised GDP data will be incorporated in the Updated Monetary Programme for 2004. Compared with the figure for first half of 2003 (3.9%), the rate of economic growth accelerated somewhat over the first three quarters (to 4.0%), but was still exclusively determined by foreign demand. Domestic demand continued to fall in the third quarter, due primarily to the continuing decline in private consumption. In the third quarter of 2003, as in the first half of the year, investment demand showed no signs of revival, and continued to fall for the second consecutive year.

The basic trends in macro-economic and monetary developments in 2003 were in line with NBS expectations. Economic development was in large part determined by the renewal of regulated price adjustments and changes in indirect taxes (changes in VAT rates and excise duties). Due to a shortfall in tax revenues within the State Budget, the increase in indirect taxes as of the beginning of the year was supplemented in August with another increase in excise duties on petrol, beer, and cigarettes. Budget revenues from these taxes are expected to provide partial compensation for the shortfall in other revenues and, together with other measures, to contribute to the planned reduction in the fiscal deficit, from 7.2% in 2002 to 4.9% in 2003.

Administrative interventions in price developments caused a noticeable rise in inflation and an increase in household spending on goods and services with regulated prices. This, together with an increase in labour productivity, exceeding the growth in real wages, and along with dynamic growth in export performance, led to a change in the structure of economic growth.

The favourable trend in foreign trade caused an accelerated decrease in the size of the current account deficit, the year-end level of which will probably be less than 50% of the figure predicted by the NBS (2.0% of GDP, compared with 4.5% estimated in the Updated Monetary Programme for 2003). For the Monetary Programme for 2004, the current account deficit for 2003 was estimated on the basis of data available at the time of its preparation (September 2003). Since the trade balance for October was, in contrast with the Bank's estimates, positive and the export & import figures for the previous months of 2003 were adjusted by the Statistical Office of the SR, the deficit in the balance of payments on current account may move towards zero if the estimated course of development until the end of 2003 proves correct. However, such a trend in the current account is not expected to have a major impact on the rate of GDP growth.

In the conditions of renewed price deregulation and increases in indirect tax rates, the primary task of monetary policy in 2003 was to prevent the said administrative measures from producing an undesirable secondary effect, i.e. price inflation. However, the profound impact of administrative measures on effective household demand and the marked growth in labour productivity over growth in real wages, prevented the occurrence of demand-based pressures on price levels and the dynamics of imports. The stagnation in private consumption, accompanied by a decline in investment demand, led to the contraction of domestic demand, which is expected to fall slightly during the year.

In view of the absence of demand-based pressures in the economy and in order to maintain the positive trends of development in the Slovak economy and eliminate the potential risks, the Bank Board of the NBS decided to reduce its key interest rates by 0.25 of a percentage point at the end of September. On the basis of the actual trend in economic development and the expected impact of individual factors on its future course, the Bank Board decided to lower the level of key interest rates by another 0.25 of a percentage point on 19 December 2003.

The development of the Slovak economy from 2004 – 2007 will be substantially affected by numerous institutional changes in the economic system, such as the entry of the Slovak Republic into the European Union, the implementation of reforms in the tax system, the pension system, health care, the public finance sector, and by the gradual consolidation of public finances. However, the cumulative effect of individual reforms and the uncertainty about their impact on economic entities represent a risk for the monetary programme for 2004 and the medium-term outlook until the year 2007. By joining the EU, Slovakia will adopt the Community's Common Agricultural Policy, which, through the institution of agreed intervention prices, will lead to an increase in food prices, mainly in 2004.

The Monetary Programme of the NBS for 2004 anticipates a 12-month overall inflation rate of 5.5 – 7.3% at the end of 2004, corresponding to an average annual inflation rate of 7.2 – 8.2%. Core inflation is expected to reach 1.2 – 3.5% in December 2004. In the next years, both overall and core inflation are expected to fall, primarily as a result of a marked reduction in the range of administrative measures and a decrease in their secondary effects. In 2007, the rates of overall inflation (1.7 – 2.7%) and core inflation (1.6 – 2.7%) are expected to hover at roughly the same level. According to this forecast, the NBS will achieve an inflation rate close to the Maastricht criterion as early as 2006.

In the area of economic activity, investment demand is expected to undergo a revival as early as 2004, with the strongest growth in 2005, mainly as a result of increased foreign direct investment in the automobile industry. In the period under analysis, the inflow of foreign capital via direct investment may lead to a temporary increase in the import volume and the trade deficit (mainly in 2005), but will also contribute to the growth in the competitiveness of the Slovak economy and its export performance in the long term.

The relatively restrictive wage policy in the public sector, backed by the declared intention of the government to reduce the fiscal deficit, will generate only a modest increase in public consumption, representing a small contribution to economic growth.

In the medium term, conditions should be created for the maintenance of the relatively strong dynamics of economic growth. In the coming years, economic growth is expected to be primarily stimulated by a revival in domestic demand, with positive increases in net exports in 2006 and 2007, due to production financed from foreign direct investment in the previous period. The growth in consumer demand will be supported, mainly after 2005, by renewed growth in real wages and the diminishing impact of administrative measures on price levels. The revival of investment demand will be a sign of improvement in the quality of the business environment, increased foreign direct investment, and the implementation of infrastructure-related projects by the government.

In the area of monetary-policy instruments, there will be a change in the minimum reserve requirements in 2004.

As part of the process of the harmonisation of the Bank's monetary policy instruments with those applied by the European Central Bank (ECB), the ratio of required reserves was reduced in 2003 by 1 percentage point, to 3%, for both commercial banks and home savings banks.

In 2004, the reserve ratio will again be reduced by 1 percentage point, to 2%, i.e. the level of required reserves in the euro area. The 2% ratio is considered to be a target level and will no longer be changed in the medium term if developments follow a stable course. In 2004, the amount of required reserves will again be calculated on the basis of all deposits, irrespective of the time of maturity. At the same time, the system of penalisation for non-fulfilment of the reserve requirements will be brought into harmony with that in the euro area. Domestic banks and the branches of foreign banks will have an equal position.

The detailed version of the NBS Monetary Programme for 2004, including an evaluation of 2004 and a medium-term outlook until 2007, is available on the NBS home page (http//:www.nbs.sk) in the section 'Monetary Policy'.