

# Monetary Programme NBS for 2002 and forecast for 2003 - 2005

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## 1. Monetary Programme for the Year 2002

### 1.1. Inflation

#### *Consumer prices*

The development of consumer prices in 2002 will be characterised by a fall in cost-push inflation, which will be, to a considerable extent, affected by the range of adjustments of regulated prices. The expected slowdown, and/or suspension, in the process of deregulation (despite the fact that most prices of goods and services regulated by the Government, do not cover the costs at the present time) will cause the rate of inflation to fall by more than 2 percentage points in 2002.

Due to the increase in the prices of natural gas in the production sector, only the maximum price of heat for households should be increased within the scope of deregulation, by roughly 7% (this measure will affect only a part of the population which uses heat from external sources, i.e. heating plants). This measure is expected to contribute 0.6 of a percentage point to inflation. In addition, we expect modest adjustments of other regulated prices (education, health care, legal services for households, communal waste disposal – as a result of the amendment to the law on waste disposal), which may contribute roughly 0.7 of a percentage point to the overall price increase. This means that the sector of regulated prices could contribute roughly 1.3 percentage points to the rise in consumer prices in 2002, representing a significant slowdown in comparison with 2001 (in 2001, adjustments of regulated prices contributed roughly 4.2 percentage points to the overall rate of inflation).

**The reduction in price adjustments in comparison with those originally planned by the Government (presented in the schedule of adjustments of regulated prices in 1999) will cause, however, only a short-term fall in inflation in 2002. This fall will give the illusion of disinflation. In the medium term, this will mean a potential increase in the expectations of inflation and a delay in remedy in the distortions in relative prices. The rate of inflation is expected to rise again in 2003 in connection with the renewal regulated prices adjustments as a crucial condition for the integration of Slovakia into the EU. The uncertainty about the range of administrative price adjustments results partly from the fact that there is no binding schedule for such price adjustments in the medium term.**

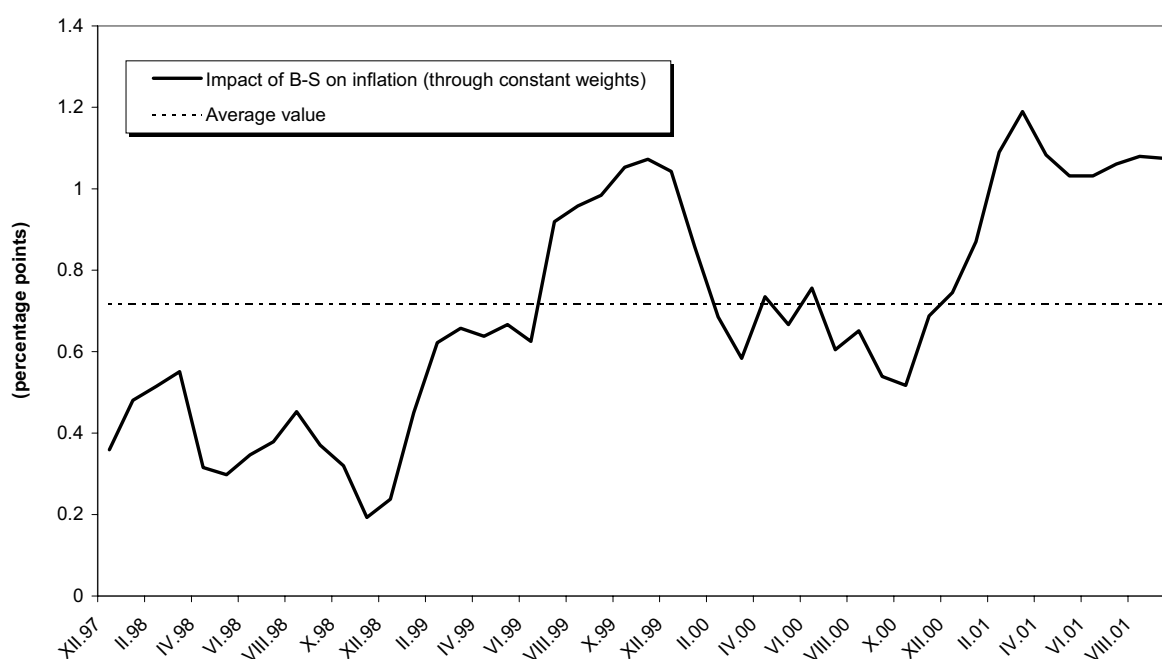
Core inflation in 2002 will be affected by a variety of external and internal factors. The forecast of inflation is based on the assumption that the prices of energy-producing and industrial raw materials (the price of oil is expected to fluctuate within the reference band of OPEC) and the exchange rate of the crown will follow a stable course of development.

In November 2001, the price of oil was below the reference band of OPEC. If this situation persists until the end of the year, the expected correction in the price of this commodity towards the announced band in 2002 will give an inflation impetus in the given year.

Despite the continued growth in private consumption and real wages, consumer demand is unlikely to invoke undesirable upward pressure on price levels. The persistent high rate of unemployment, the domestic competitive environment and the coverage of demand by supply from abroad in particular, will be the key factors dampening the rise in core inflation in 2002.

In view of the reduced range of adjustments of regulated prices, we may assume that domestic cost-based pressure on inflation, which accelerated the rate of increase in the prices of foodstuffs and market services in 2001, will diminish considerably in 2002. In November 2001, the dynamics of prices of market services exceeded the rate of increase in the prices of tradeable goods (excluding foodstuffs) by 6.5 percentage points, and contributed 1.0 percentage point to the rate of inflation (according to the weighting of market services in the consumer basket of the Statistical Office of the SR). As a result of the expected fall in cost-based pressure on inflation, the said difference could diminish in 2002 (to 5-6 percentage points), reducing the Balassa-Samuelson effect<sup>1</sup> to less than 1 percentage point. The existing dual inflation (different price dynamics in the tradeable and non-tradeable sectors) is, in view of the difference in labour productivity in the individual sectors, acceptable.

**Impact of the Balassa-Samuelson Effect on Inflation**



The basic condition for the low dynamics of prices in the tradeable sector should be a low level of imported inflation and a well-developed competitive environment in the

<sup>1</sup> According to the Balassa-Samuelson effect, productivity in the tradeable sector grows at a faster rate than in the non-tradeable sector. Real wages in the tradeable sector are determined by the productivity of labour. Assuming that wages tend to become level in the individual sectors, wages in the non-tradeable sector follow the course of wages in the tradeable sector. Since the growth in productivity in the non-tradeable sector does not correspond to the growth in wages, inflation in the non-tradeable sector is higher than in the tradeable sector.

area of retail sales. The increase in the prices of domestic products is expected to be dampened by the dynamics of industrial producer prices. In addition to market factors, price developments in the tradeable sector may also be affected by administrative measures resulting from the law on waste disposal and the establishment of a 'recycling fund' for the support of the collection, crushing, and processing of selected goods (e.g. motor vehicles, plastics, paper, glass) with a possible impact on inflation (up to 0.2 of a percentage point).

A faster rate of increase in the prices of market services in comparison with price dynamics in the tradeable sector, could be caused by higher income elasticity of services and fewer possibilities for growth in productivity in the non-tradeable sector.

Food prices will, in all probability, again represent a degree of uncertainty into the course of inflation in 2002 and will be a source of volatility. Their dynamics will depend on the ability of the producers (primary producers and manufacturers) to adapt to the developing market mechanism. The basic condition for achieving a more moderate rate of price increase in comparison with 2001 is an adequate supply of basic foodstuffs and reduction in cost-based stimuli. The increased share of hyper- and supermarkets in total sales of foodstuffs, will gradually bring about the dampening pressure on prices in this sector in 2002, while the risk of one-off changes in prices will grow in the presence of a short-term imbalance in the market (mainly in fruit and vegetable prices).<sup>2</sup>

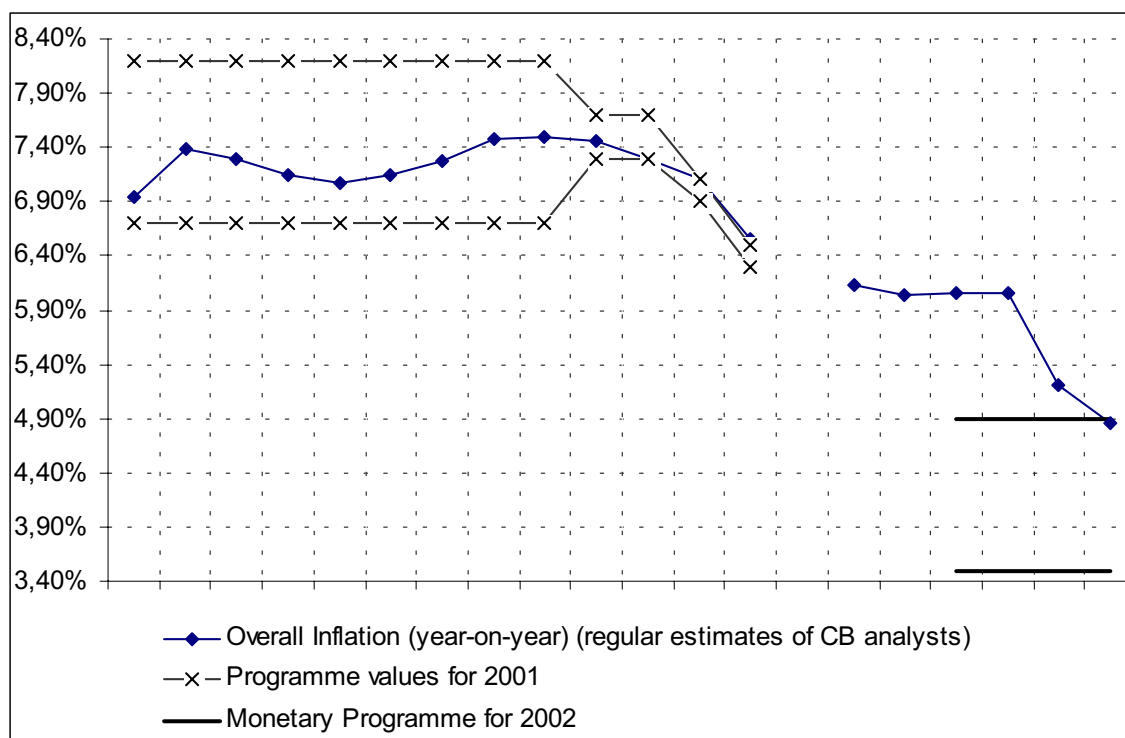
Taking into account the expected effects of individual factors on consumer prices, **core inflation** could reach **3.2 – 4.7%** at the end of 2002. If the process of price deregulation slows down (except the price of heating), the NBS expects a **year-on-year increase of 3.5 – 4.9% in consumer prices** in 2002, corresponding to an **average inflation of 4.1 – 4.9%**.

#### Estimate of inflation in 2002

	Monetary Programme for 2002	
	Price increase in per cents Dec.02/Dec.01 (share in total increase in percentage points)	
	min.	max.
Total	3.5	4.9
Regulated prices	4.7 (1.24)	5.5 (1.44)
Effect of changes in indirect taxes on non-regulated prices	0.00	0.00
Core inflation	3.2 (2.28)	4.7 (3.42)

<sup>2</sup> At present, 65% of basic foodstuffs are sold through hyper- and supermarkets on the Slovak market, which increases the risk of a considerable one-off increase (or fall) in final food prices, in the case of inadequate (or excessive) domestic supply. Due to the imperfect functioning of market mechanisms in agriculture, partial imbalances are a relatively frequent phenomenon on the Slovak food market.

**Survey of year-end estimates of overall and core inflation from MP01, RMP, the estimate for 2001, and MP02, and the forecasts of analysts and the NBS on a monthly basis<sup>3</sup>**



**Producer prices**

In 2002, the rate of increase in industrial producer prices is expected to slow, to the average annual level (5%). The estimate was made with respect to the increase in the price of natural gas for the production sector (19.3% on average) with effect from January 2002 (including a new categorisation of customers) and the price of heat for households (7%).

Adjustments of regulated prices are not expected to have undue indirect effects on industrial producer prices. The previous course of development confirmed the assumption that the transfer of cost stimuli directly into prices is in large part eliminated through a non-price manner. The elimination of price anomalies led to rationalisation in production and a search for reserves (e.g. the adjustments to the price of electricity led to a reduction in energy consumption in the household sector). In addition, developments in producer prices are subject to stronger, mostly external effects. Slovak producers either adapt to the European price standard (metallurgy, chemical industry, paper and pulp industry), or are held back by the low domestic demand (extraction of mineral raw materials), combined with the ongoing restructuring in some sectors (textile industry).

<sup>3</sup> The graphs comparing the forecasts of NBS and the analysts of commercial banks (CBs) are divided into two parts: the first illustrates the forecasts of CB analysts and the values of the Monetary Programme and/or its revised version for the end of 2001, as they were continuously updated from December 2000 to November 2001. The second part compares the forecasts of analysts for the end of 2002, as they were updated from July 2001 to November 2001, with the values of the Monetary Programme for 2002. The forecasts of CB analysts are obtained through questionnaires on a monthly basis. The presented values represent an average of the individual forecasts.

Producer prices in industry rise only in response to a stronger factor with the same effect, which is not expected to occur in 2002 (the boom in the paper industry ended at the beginning of the year, the upturn in metallurgy will probably end at the close of the year, and demand for bulk chemicals, to which Slovakia's chemical industry is oriented, will also slacken off. In the remaining sectors of increased energy-intensity (building materials, pharmaceuticals, food industry), producer prices are expected to show significant changes.

In the area of agricultural prices, current price dynamics can be maintained only if the agricultural policy of the EU is implemented (in the case of its postponement, the high basis for comparison this year will cause lower year-on-year price dynamics next year). A certain moderation in the dynamics of prices of primary producers may be expected at the level of manufacturers, due mainly to the continued concentration of food production, the inflow of foreign capital, and the elimination of redundant production capacities. The same effect can be expected from the downward pressure of hypermarkets on the level of food prices.

The estimated course of producer and consumer prices is based on the following assumptions:

- the price of oil stabilises at USD 22 to 28 /barrel;
- a stable exchange rate of SKK to EUR and USD;
- the world prices of industrial commodities continue to fall or stabilise (as a result of a fall in demand and production), together with the prices of foodstuffs (dependent on the satisfactory grain harvests).

## **1.2. Foreign trade**

### **1.2.1. Balance of payments**

The balance of payments on current account continues to be characterised by a relatively large deficit.

On the export side, Slovakia's trade relations will be affected in 2002 by the rate of economic growth in the countries of our main trading partners, which will probably show only a moderate revival. (However, such a development will neither lead to an increase in the rate of growth in Slovak exports, nor cause any significant slowdown). On the other hand, imports will be affected by an increase in final consumption, which will be stimulated by the use of some of the funds obtained from the redemption of privatisation bonds, the reduction in the tax burden of private individuals, the realisation of deferred consumption from 1999 and 2000 (after the collapse of domestic demand in 1999), the faster growth in real wages in comparison with the previous period, while consumer spending will be drained through increases in regulated prices to a much lesser extent, and the inadequate restructuring of the supply side of the economy.

	2001	2002
	Estimate	Monetary programme
Exchange rate SKK/USD	47.500	47.500
Trade balance	-91.0 to -100	-92.0
Services balance	18.5	18.6
Income balance	-16.1	-16.8
Current transfers	10.5	9.0
Current account	-78.1 to -87.1	-81.2

In 2002, the volume of commodity exports is expected to reach Sk 720.0 billion, with the rate of year-on-year growth fluctuating around 14.5%. The relatively high dynamics of exports will be positively affected by a gradual increase in the export performance of foreign direct investments from the previous years. Imports are expected to grow in volume by roughly 12.2%, to Sk 812.0 billion. The slower rate of growth in comparison with 2001 is connected mainly with the higher basis for its calculation and the expected stabilisation of oil prices. Thus, the negative balance of trade will amount to Sk 92.0 billion and its share in GDP will reach 8.9%, representing a modest improvement in comparison with the previous year (9.4 to 10.3%).

The balance of payments on current account is expected to result in a deficit of Sk 81.2 billion, representing 7.9% of GDP (compared with 8.1 to 9.0% in 2001).

In 2002, the surplus in the capital and financial account is expected to increase significantly, to Sk 178.3 billion. The increase will be determined by the privatisation activities of the Government, resulting in a marked inflow of foreign capital in the form of direct investment. The implementation of privatisation projects is likely to account for almost 81% of the total volume of net capital inflow from abroad. In a conservatives estimate, the NBS estimates receipts from privatisation at roughly Sk 120 billion.

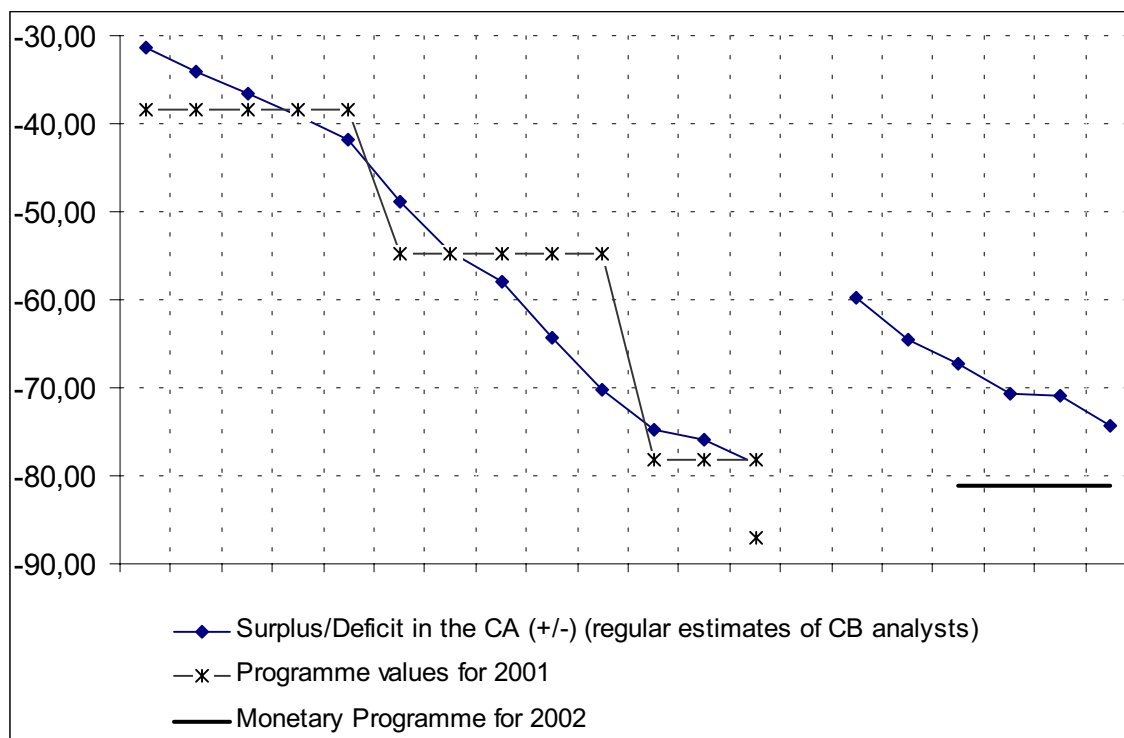
	2001	2002
	Estimate	Monetary programme
Exchange rate SKK/USD	47.500	47.500
Capital transfers	0.5	1.0
Direct investment	52.0	147.1
Portfolio investment	12.5	20.1
Other long-term financial account	14.4	4.8
Short-term financial account	0.2	5.3
Capital and financial account	79.6	178.3

In comparison with 2001, portfolio investment and other forms of long-term investment are expected to follow a different trend of development in 2002, which is connected with the repayment of a fiduciary loan by the NPF. This will lead to a fall in the net volume of financial credits drawn, at the same time as the securities in the holdings of Slovak commercial banks are repaid to non-residents (increase in the net inflow of portfolio investments).

If the current account and the capital and financial account of the balance of payments follow the expected course of development, the foreign exchange reserves of the NBS will grow by more than US\$ 2 billion (Sk 97.1 billion) and their volume at the end of 2002 will be 4.1 times greater than the amount of average monthly

imports of goods and services. In 2002, the volume of foreign exchange reserves will also be affected by a change in the methodology of reporting.

**Survey of developments in the current account according to MP01, RMP, the estimate for 2001, and MP02 in comparison with the forecasts of CB analysts**



**1.2.2. External debt**

The prediction of the size of the foreign debt in the government sector for 2002 is based on the exact schedule of debt servicing and information about the borrowing strategy of the Government for 2002. For the corporate sector, a qualified estimate was made on the basis of the trend recorded in the past nine years. The said prediction is consistent with the forecast of the balance of payments for 2002.

In predicting the trend in foreign debt and debt servicing, we assume that total gross external debt will increase by US\$ 532 million, to US\$ 11.761 billion in 2002. Of this amount, US\$ 173.6 million represents the expected increase in the foreign liabilities of NBS, resulting from a change in the methodology of reporting foreign exchange reserves and foreign liabilities by the NBS. Long- and medium-term foreign debt is expected to reach US\$ 8.83 billion. The foreign debt of the Government will, after taking account of repayments of principal on foreign liabilities (US\$ 86 million) and on condition that the Government makes no new issue of bonds on foreign capital markets and draws only part of the EFSAL-SB loan (US\$ 126 million), increase by US\$ 40 million, to US\$ 2.443 billion. In this prediction, the foreign liabilities of the Government, arising from the ownership of government bonds denominated in Sk by non-residents, are not taken into account.



After the early repayment of part of an AGL II loan from EIB (US\$ 7 million) and part of TSL I-III loans from JBIC (US\$ 91.3 million) in the fourth quarter of 2001, the external debt of the NBS will fall over the course of 2001 to a level below US\$ 200 million. As a result of a change in the methodology of reporting foreign exchange reserves and foreign liabilities by the NBS, the value of the partial indicator concerned will, according to the forecast, increase to US\$ 365 million at the beginning of 2002 and US\$ 322 million at the end of 2002.

With regard to the prepared cancellation of State funds, we expect no foreign borrowing activity on the part of the State Road Fund (which is included in the category 'government agencies' together with NPF) after 2001. The foreign debt of the State Road Fund in the amount of US\$ 367 million (estimated at the end of 2002) will probably be included in direct foreign liabilities after the accession of Slovakia to the EU.

After a predicted increase of US\$ 261 million in 2001, the short-term foreign debt is expected to grow further, by US\$ 250 million in 2002. This development will be due mainly to the financing (supplier credits) of increased imports of goods of consumer and investment nature in 2002. At the end of 2002, the volume of total short-term foreign debt is expected to reach US\$ 2.926 billion.

As far as the estimated volume of debt servicing is concerned, we expect a moderate fall in comparison with 2001. Total repayment of principal is expected to reach US\$ 1.373 billion, of which US\$ 86 million will be paid directly by the Government of the SR. Repayments of foreign liabilities in respect of government guarantees are not included in the predicted volume of debt servicing by the Government. Such repayments are part of debt servicing in the corporate sector. The total amount of interest due, including interest on short-term foreign loans, is estimated at US\$ 593 million.

**Survey of external debt and debt servicing in 2000, with forecasts for 2001-2002**  
(in millions of US\$)

	<b>2000</b>	<b>2001*</b>	<b>2002</b>
<b>Foreign debt in total (PS)</b>	<b>10,517.9</b>	<b>10,804.2</b>	<b>11,403.19**</b>
of which: medium- and long-term (PS)	7,811.9	8,389.2	8,726.77**
Debt servicing in total **	2,460.4	1,971.7	1,965.1
of which: - principal	1,954.4	1,389.0	1,372.6
- interest	506.0	573.6	592.5
New loans	2,609.2	1,566.2	1,480.8
Short-term debt (PS)	2,706.0	2,415.0	2,676.4
Change in the level of short-term debt	-174.9	261.4	250.0
Adjusting item	-193.5	0.0	173.60**
<b>Foreign debt in total (KS)</b>	<b>10,804.2</b>	<b>11,229.6</b>	<b>11,761.4</b>
of which: medium- and long-term (KS)	8,389.2	8,553.2	8,835.0
Short-term debt (KS)	2,415.0	2,676.4	2,926.4

PS – initial level

KS – final level

\* Prediction

\*\* Specific adjusting item relating to the beginning of 2002, consisting of an estimate of the increase in the foreign debt of NBS (US\$ 173.6 million) in connection with the change in the methodology of reporting of foreign exchange reserves and foreign liabilities by the NBS.

Over the course of 2002, the level of net external debt is expected to fall by almost US\$ 1,9 billion, due primarily to an increase in the foreign exchange reserves of the NBS.

### **1.3. Gross domestic product**

The forecast of GDP for 2002 is based on the assumption that both foreign and domestic demand have a pro-growth effect on GDP.

The most dynamically growing component of domestic demand remains gross fixed capital formation (with a predicted year-on-year growth of 6.6% at constant prices), though its dynamics will probably moderate in comparison with the previous year (the estimate for 2001 is 11.5%). The completion of restructuring in the banking sector, together with the improved financial results in the corporate sector and the lower tax burden of legal entities, are expected to be the main stimuli of growth in investment demand in the entrepreneurial sector. Government measures for the support of investment (tax allowances, contributions to the creation of new jobs and re-training) may give rise to a further inflow of foreign capital into the economy, outside privatisation. Growth in fixed investments could be stimulated by investment demand in the government sector, in connection with the continuation of motorway construction. On the other hand, the increase in mortgage lending is creating conditions for growth of investment in the household sector.

At the expected rate of growth in gross fixed capital formation and stocks, the rate of gross investment may reach 33.3% at constant prices (compared with 34.1% a year earlier). Coverage would come mainly from gross domestic savings, the rate of which is likely to reach 32.0% in 2002 (compared with 31.9% in 2001).<sup>4</sup>

Based on wage developments and other factors, we may expect that final household consumption will grow at a relatively fast rate. On a year-on-year basis, the rate of real growth could reach 4.1% (the estimate for 2001 was 3.0%). Next year, the growth in real wages is expected to accelerate as a result of the favourable financial situation in the corporate and banking sectors, growth in labour productivity in industry and other sectors, and an increase in wages in the public sector after the enactment of a new law on the state and public service. This growth, together with the expected increase in the propensity of households to consumption, will be a crucial factor in stimulating the growth in private consumption.

The tendency of households to consumption, recorded since the second half of 2000, is a direct result of the near one-and-a-half-year-long decline in private consumption in connection with the adoption of restrictive measures by the Government for the elimination of macro-economic imbalances. In 2002, the tendency is expected to increase still further, which is indicated by the results of the consumer barometer. Other results from October 2001 indicate that the financial outlook of citizens for the near future is in general favourable, which is reflected

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<sup>4</sup> In predicting the formation of gross capital, the most problematical component is the change in stocks on account of increased volatility. The statistical data published indicate that the volume of stocks develops in the opposite direction even in the short term. Until the 2nd quarter of 2001, it had also contained a statistical discrepancy between the creation and use of GDP. For these reasons, this indicator is used in the forecast only as a residual.

in the expected tendency of households to make purchases of expensive items in the 12 months to come.

The growth in final household consumption may also be stimulated by the reduced tax burden of individuals. Income tax reduction would affect, first and foremost, the current expenditure of households, in which the tax on income, property, etc. represents the second largest item at the present time. Their reduction may create room for growth in the gross disposable income of households, which will subsequently be reflected in the level of consumption.

A moderately pro-growth effect on domestic demand will be brought about by final consumption in public administration. With regard to the projected level of current expenditure in the State Budget for 2002, domestic demand could increase year-on-year by 2.1% at constant prices (the estimate for 2001 was 2.3%). The increased spending in public administration in comparison with 2001, will be due mainly to expenditure on the accession process to the European and transatlantic structures, reform in public administration, and the wages of employees in the public sector.

At the predicted rate of growth in total final consumption and gross capital formation, domestic demand may increase at constant prices by 2.7% year-on-year in 2002 (compared with the estimated 4.8% in 2001). The fall in dynamics in comparison with the previous year, will be due to a slowdown in the rate of growth in investment in gross fixed capital, with an accelerating growth in private consumption. Under these assumptions, the level of domestic demand will be determined mostly by private consumption.

One of the factors stimulating the economy in 2002 will probably be trade of goods and services. Its performance at current prices will be affected mainly by a fall in the dynamics of imports and a moderate slowdown in the rate of growth in exports. After adjustment for the price effects, this assumption should lead to a fall in the trade deficit at constant prices, which could reach roughly Sk 9 billion. This represents a fall of Sk 6 billion in the size of the deficit as compared with the previous year.

On the side of supply, economic growth will considerably be influenced by development of GDP in market services. The creation of GDP in industry will probably be stimulated by foreign demand and foreign direct investment. The growth in public spending will affect developments in non-market services, where the rate of growth in GDP is expected to accelerate somewhat.

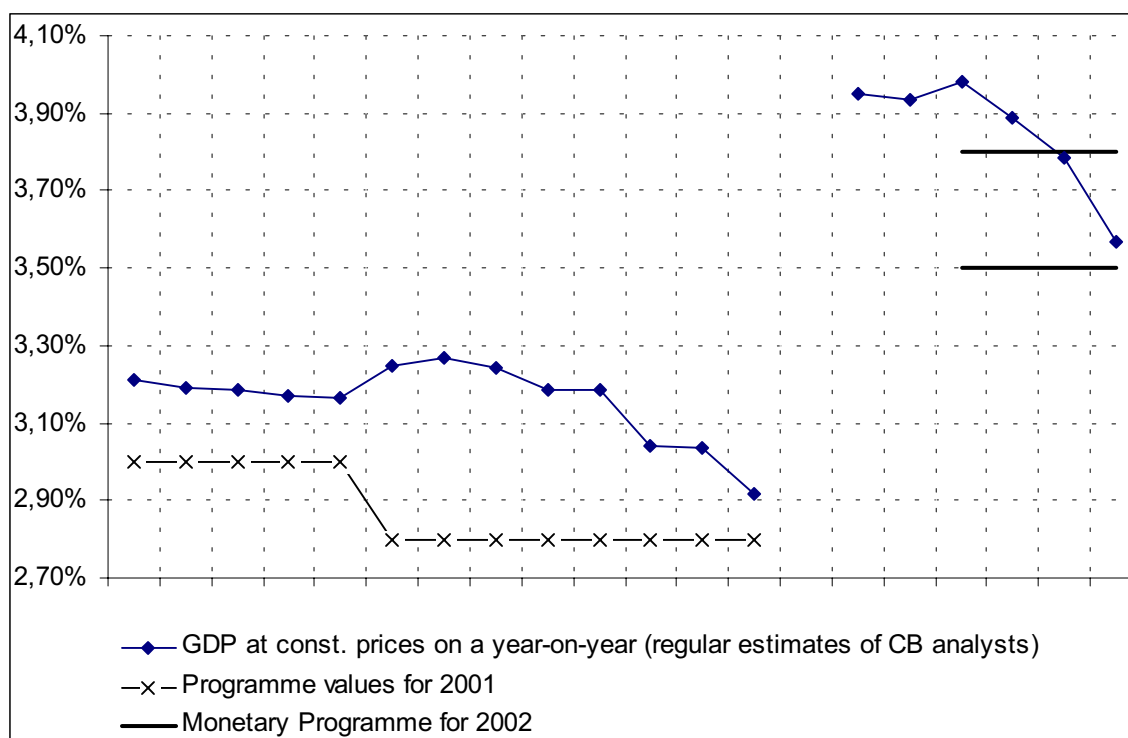
The growth in domestic demand, mainly final household consumption, and the lower deficit in net exports of goods and services will create conditions for **an acceleration in the rate of real economic growth, from 2.8% in 2001 to 3.5-3.8% in 2002 (an average of 3.6%). Under these assumptions, GDP will reach Sk 711 billion at constant prices next year.** With regard to the relatively low predicted dynamics of consumer prices, the GDP deflator is also expected to grow at a slower rate (3%). As a result, **gross domestic product could reach Sk 1,032 billion at current prices.**

(year-on-year change in %)

	Estimate for 2001	Monetary Programme for 2002
<b>GDP at constant 1995 prices</b>	<b>2.8-3.0</b>	<b>3.6</b>
Domestic demand	4.8	2.7
of which:		
Final consumption in total	2.8	3.5
Final consumption of households	3.0	4.1
Final consumption in public administration	2.3	2.1
Gross capital formation	9.1	1.0
Gross fixed capital formation	11.5	6.6
Change in stocks	x	x
Net exports	x	x
Exports of goods and services	6.8	7.3
Imports of goods and services	9.4	6.1
<b>GDP at current prices</b>		
Sk billions	967.0	1,032.0
Year-on-year growth in %	9.0	6.7

The estimated growth in GDP may be negatively affected by the slowdown in the rate of economic growth in the world, which will be reflected first and foremost in exports. A risk is also represented by final consumption, mainly household consumption, whose faster growth in comparison with the figure projected in the monetary programme, may represent a source of increase in the dynamics of imports.

#### Survey of expected GDP growth in MP01, RMP, the estimate for 2001, and MP02 in comparison with the forecasts of analysts of commercial banks



## 1.4. Wages and employment

Wage development in 2002 will be affected mainly by the expected growth in economic performance, the privatisation process, results of budgetary performance in the financial and non-financial sectors, and the approved law on the state and public service including fire-fighting and rescue services, with effect from next April. The dynamics of nominal wages in the corporate sector will also be affected by the pressure resulting from the fall in real wages in previous years or the expected gradual increase in 2001. On the other hand, wage development will continue to be dampened by the excess of supply over demand on the labour market, mainly in regions with a high rate of unemployment, a low mobility of the workforce, and the expected low rate of inflation, which should be embedded, at least in part, in the collective agreements.

One of the factors affecting the development of wages will be the relatively steep increase of wages in the budgetary sector in connection with the coming into effect of the law on the state and public service including fire-fighting and rescue services (1 April 2002), which will affect roughly 300 thousand people, representing ca 15% of the total number of employees in the Slovak economy. On the other hand, the relatively low level of wages in the budgetary sector and the low relative weight, through which they will affect wages in the economy, they are not expected to have a strong effect.

Previous developments in the budgetary sector indicate that the growth in wages depends primarily on the financial possibilities in the public sector, and not on developments in consumer prices. On the contrary, the corporate sector is incorporating the projected course of inflation into the wages. This is demonstrated by the fact that the growth in wages outside the budgetary sector over the following three years to some extent emulated the course of inflation of the previous year. We may assume that the adjustment of wages to the level of inflation was hindered mainly by the deregulation of consumer prices in the last few years. The workforce-supply, which well exceeded demand, acted against the wage increase as well.

### Wage developments in 1998 – 2001

	1998	1999	2000	H1, 2001
<b>Average monthly wage of employees:</b>				
Nominal (incl. the effect of public works)	-	-	106.5	107.6
Nominal (excl. the effect of public works)	109.6	107.2	107.4	108.2
Real (incl. the effect of public works)	-	-	95.1	100.1
Real (excl. the effect of public works)	102.7	96.9	95.9	100.7
Final household consumption at const. prices	105.3	100.1	96.5	102.8
<b>Average inflation</b>	106.7	110.6	112.0	107.5

Index (same period a year earlier = 100)

In the area of nominal wages in the entrepreneurial sector, however, there is some risk that trade unions, through wage bargaining, will attempt to gain an increase in wages based on inflation in 2001, and not on the expected rate of inflation in 2002. It is probable that they will also ask to take into account the actual growth in nominal wages in 2001 and to make up the fall in real wages in 1999 and 2000. This could lead to a substantial increase in real wages and potential pressure on inflation. According to the results of preliminary talks between employers and trade unions, nominal wages will increase by roughly 8%.

In 2002, **the level of employment is expected to rise only slightly, by less than 1%**. On the one hand, employment will be affected positively by the growth in economic performance and the building of industrial parks, and on the other hand, employment will be reduced in connection with the ongoing restructuring of banks and companies. This fact will be demonstrated by the persistent high rate of unemployment or a very modest fall in comparison with the figure for 2001.

The increase in the performance of the Slovak economy accompanied by moderate increase in employment will lead to growth in labour productivity. At the predicted rate of GDP growth, the year-on-year dynamics of labour productivity could increase at constant prices to 2.6 – 2.9%, from 2.0% in 2001.

In view of the predicted effect of factors in the area of wages and the results of collective talks, we expect an increase of 7 to 8% in nominal wages. Although nominal wages will have lower dynamics than in 2001, they could represent a risk factor for economic development.

The expected growth in nominal wages and the average inflation rate would correspond to a 2.4 to 3.3% rise in **the average monthly real wage in 2002**. This would, however, mean the maintenance of the excess of labour productivity over growth in real wages only at the lower figure. With this in mind, **it would be desirable that the average growth in nominal wages should be in the range of up to 6.0%**, i.e. a level that would ensure an excess of labour productivity over growth in real wages.

	Year-on-year change in %	
	Estimate for 2001	Estimate for 2002
Average monthly nominal wage	up to 8.6	7.0-8.0
Average monthly real wage	1.1 -1.2	2.4 -3.3
Employment	0.5 -1.0	0.9

### 1.5. Budgetary performance in the public sector

The Monetary Programme of the NBS for 2002 is based on the draft version of the State Budget Act, which expects a budget deficit of Sk 37 billion and a deficit of Sk 37.6 billion in public budgets.

In billions of Sk	2002
Revenue in total	221.0
- grants and transfers	-2.0*
<b>Net revenue</b>	<b>219.0</b>
Expenditure in total	258.0
- grants and transfers	-2.0
<b>Net expenditure</b>	<b>256.0</b>
Deficit in the State Budget	46.5
- costs of restructuring	-9.5
<b>Net deficit</b>	<b>37.0</b>
% of GDP	3.5%
Deficit in the public budget	37.6
% of GDP	3.6%

\* Estimate of the NBS in connection with the inclusion of State funds into the State Budget.

The State Budget for 2002 includes interest expenses incurred in connection with restructuring in the banking sector in the amount of Sk 9.5 billion. These expenses do not increase the fiscal deficit.

### ***The National Property Fund***

On the basis of the expected receipts of the National Property Fund (NPF) in 2002 and its expenses, which are set by the Government, the National Bank of Slovakia expects the NPF to achieve a zero position at the end of the year.

## **1.6. Monetary policy**

### **1.6.1. Monetary aggregates**

The development of monetary aggregates in 2002 will be affected, first and foremost, by the amount and use of receipts from the privatisation of state property. On the basis of government resolutions, a total of Sk 208 billion of these funds is expected to be used. In the Monetary Programme for 2002, the NBS applied a relatively conservative estimate of privatisation receipts, in the amount of Sk 120 billion. This means that, from privatisation receipts, it will not be possible to cover all the expenses planned, while the National Property Fund is not expected to borrow funds. Of the expected receipts, however, it should be possible to use Sk 69 billion for national debt servicing, and the liabilities of NPF could also be repaid so that the Fund's year-end position is zero.

The inflow of funds from privatisation is expected to lead to growth in net foreign assets (80.2%), while causing a fall in net credit to the Government (9.7%) as a result of the use of the funds for debt servicing (despite a projected fiscal deficit of Sk 37 billion). Part of the increase in net foreign assets will have a pro-growth effect on the dynamics of the M2 money supply (in the range of Sk 7 to 9 billion), which could thus reach 10.5% at the expected rate of growth in real GDP, inflation, and trade deficit. This would allow for growth in bank lending to households and enterprises (up to 7.6%). On the one hand, faster growth in loans in comparison with previous years would be stimulated by the completion of restructuring in the banking sector, and on the other, the relatively large surplus of free funds at commercial banks from bond redemption, which could motivate the banks to step-up their lending activities.

<b>Monetary survey</b>	<b>(year-on-year percentage change)</b>	
	2001 Estimate	2002 Monetary programme
Exchange rate SKK/USD	<b>47.389</b>	<b>47.500</b>
<b>Net foreign assets</b>	<b>4.6</b>	<b>80.2</b>
<b>Net domestic assets</b>	<b>14.1</b>	<b>-4.8</b>
Domestic loans	11.9	-3.9
Net credit to the Government and NPF	19.0	-13.3
Loans to households and enterprises	5.1	7.6
<b>M2</b>	<b>12.5</b>	<b>10.5</b>

The conduct of monetary policy in 2002 will be determined by the use of funds obtained from privatisation and demand-based pressure resulting from the purpose for which they were used. The task of NBS will be to thoroughly analyse the formation of the demand side of the economy in terms of its impact on price levels and foreign trade.

In the case of a higher than expected inflow of receipts from privatisation, net foreign assets are expected to grow and net credit to the Government to fall further, depending on the purpose for which the funds are used.

### **1.6.2. Liquidity of commercial banks**

The amount and use of funds from privatisation will also determine the volume of the NBS's sterilisation position, which could reach, according to a conservative estimate, Sk 170 billion at the end of the year (with the possibility of a further increase of Sk 90 billion). The Monetary Programme of the NBS for 2002 expects these funds to be used for the repayment of the internal debt. From the point of view of monetary policy, it would be more appropriate to use the receipts from privatisation for servicing the external debt, which would reduce the need for the sterilisation of excess liquidity.

The sterilisation position will also be affected in part by a reduction of 1% in the ratio of minimum required reserves. The increase in the volume of sterilised funds will subsequently be reflected in the budgetary performance of the NBS as well. In the balances of commercial banks, the structure of items will probably change in favour of NBS bills to the detriment of government securities. With regard to the maturities of NBS securities, some commercial banks are expected to concentrate on lending activity.

### **1.6.3. Instruments of monetary policy**

In accordance with the decision of the Bank Board of NBS, the ratio of minimum required reserves will be reduced by 1 percentage point (to 4%) with effect from 1 January 2002. From the same day, Lombard loans and bills-of-exchange transactions will be cancelled. At the same time, the discount rate will be re-defined as equivalent to the limit rate of NBS for standard two-week REPO tenders. Since the NBS has approached the EU standards to a significant extent in making the above changes and adopting a qualitative method of monetary control, the year 2002 will see no further changes in the area of monetary-policy instruments.

In connection with the change in the method of setting the discount rate and its planned cancellation (from the date of entry into EMU), some changes in legislation are inevitable i.e. in the laws referring to the discount rate. At the same time, the NBS recommends that this term should no longer be used in business contracts and other documents.

### **1.6.4. Implementation of monetary policy**

In 2002, monetary policy will be implemented in a complex environment, characterised by a fall in inflation on the one hand and a massive trade deficit on



the other. The reaction of monetary policy will not only depend on the actual course of macro-economic indicators (inflation, current account, and public finances), but also on the nature of resources and effects on this development, the analysis and identification of which are rather difficult. The NBS has basically two instruments at its disposal: the interest rate and, to a lesser extent, the exchange rate (the latter cannot be effectively used in conditions of floating exchange rate regime). In the following section, we shall assess the expected development of inflation and foreign trade in the light of the factors that affect them and the possible risks in terms of the effectiveness of the use of monetary-policy instruments.

Definition of the risks:

- development of the external environment;
  - economic growth in the countries of our trading partners;
  - price of oil and gas;
- developments in public finances, in terms of willingness and political will in the area of saving creation, and the lack of stimulation for private and public consumption (including the reassessment of price adjustments, wage development, the use of receipts from privatisation, etc.);
- leaving the fall in inflation out of consideration in wage negotiations, which leads to a faster than expected growth in real wages (even in relation to the expected level of labour productivity);
- rate of saturation of delayed consumption with a subsequent effect on GDP growth and the balance of payments;
- behaviour of foreign investors with an effect on the exchange rate and foreign direct investment;
- failure to privatise the Slovak Gas Company (SPP);
- parliamentary elections;
- full wage increase in the public sector though without adjustments to regulated prices.

## **Inflation**

A false signal for monetary policy is the fall in inflation 2002, which is only of an artificial and temporary nature. Inflation is expected to rise again in 2003. Due to adjustments to regulated prices aimed at gradual deregulation and/or increase up to a level covering the justified costs, a rise in inflation in 2003 is unavoidable. Despite the fact that price deregulation is a prerequisite for entry into the EU, there is still an economic need for adaptation to the level of prices in the European Union. Therefore, increased price dynamics are even desirable in the pre-accession period. Despite the expected volatility in the rate of overall inflation, the NBS expects a relatively continuous disinflation process in the area of core inflation in the medium term. At the same time, the Monetary Programme of the NBS for 2002 expects lower cost-based stimulation in the food sector, and a non-inflationary effect of consumer demand. Irrespective of the results of wage negotiations and the effect of the public sector on consumption, we do not expect these factors to have a marked impact on the level of inflation; they will affect, first and foremost, the balance of trade. A risk in respect of inflation will be posed by external cost factors, such as the price of oil, the exchange rate for EUR and USD, the weather (mainly in food prices), etc. Hence, from the point of view of inflation, there will, in all probability, be no need for a change in monetary policy.

## Trade balance

It is true that the balance of trade is markedly deteriorating not only in relation to the monetary programme, but also in terms of the share of the current account in GDP, which is expected to reach 8.1 - 9.0% in 2001. A similar trend of development is expected in 2002. By analysing the structure of imports and exports, it is possible to identify the causes of the trend and the potential effect or efficacy of monetary policy.

Rate of growth (%)	1998	1999	2000	1-9/2001
Goods for consumption	29	-2	17	28
Goods for intermediate consumption	5	8	38	24
Machines and transport equipment - technology	25	-2	17	31
<b>Total imports</b>	<b>17</b>	<b>2</b>	<b>26</b>	<b>27</b>

The growth in imports is caused by 3 factors:

1. Import of technologies;
2. Import of raw materials;
3. Import of consumables.

The growth in the dynamics of technology imports is acceptable and may be regarded as a certain source of improvement in quality and increase in the volume of exports in the coming period. This development is connected mainly with the inflow of foreign investment capital and is financed by the same, as a result of which there is no pressure on the exchange rate. Against imports of technologies, there is no need for intervention and where such imports are financed from foreign direct investment, there is in fact no possibility of correction by monetary-policy measures.

The high rate of growth in imports for intermediate consumption was connected, mainly in 2000, with the rise in the price of raw materials and the appreciation in the exchange rate of the US dollar. The main reason is, however, the high import intensity of exports (high share of imported semi-finished goods) and the raw materials intensity of the Slovak economy. The dynamic development in this category is connected with external factors (which cannot be influenced) on the one hand, and with the nature of production in the SR (which can be influenced in the long term through measures for the restructuring of the economy, i.e. the micro-sphere) on the other. For that reason, the deficit affected by this segment must be accepted in the short-term.

The only area where there is a possibility for intervention through monetary or fiscal policy is that of imports for private consumption. The restriction of fiscal and monetary policy may have an appreciable, if not exclusive, impact on the imports of consumer goods in a relatively short time and with a relatively favourable result. The above table shows that such an intervention took place in 1999. However, it is obvious that the effect in the area of reduction in consumption is only a short-term one, while consumption is being simply delayed until sometime in the future. Therefore, it is necessary to pursue an active policy in the area of foreign trade and not to rely only on short-term measures, which do not solve the essence of the

problem. With regard to this development, the reduction in taxes for natural persons, increase in wages in the public sector excluding adjustments to regulated prices, as compensation for increased incomes, may be considered counterproductive.

### **Public sector**

Some uncertainty occurs in respect of the use of receipts from privatisation. If these receipts are used in line with the declared goals of the Government, i.e. first of all for servicing the national debt, domestic demand is not expected to be particularly affected. If these funds were used for other purposes, e.g. for development projects, domestic demand would be stimulated by the public sector, with a possible impact on the balance of trade (and on consumer prices with certain delay). Such use of privatisation receipts would, with regard to their one-off nature, generate numerous risks (stimulus to inflation, growth in the deficit of trade balance, problems in financing the national debt in future, poor conditions for the consolidation of public finances). In addition, the assessment of the public sector effect on consumption, however, with an unchanged deficit but by using of funds resulting from claims in respect of classified loans, which reduces the fiscal deficit approximately by 0.5 of a percentage point according to the IMF, is also questionable. At present, it is necessary to regard the approved expenses (resulting from prospective increased tax collection) as limit costs, and to reduce the deficit in the State Budget.

Some risk is connected with the development of nominal wages in the national economy (affected also by an increase in wages in connection with the law pertaining to the state and public service) and the subsequent faster growth in real wages in comparison with labour productivity.

In 2002, the NBS will continue to keep an account for the NPF with the deposit of crown equivalent of receipts from privatisation. Therefore, we do not expect the exchange rate to appreciate as a result of privatisation in 2002.

It is evident from the above that monetary policy will be implemented in an uncertain environment in 2002. An unfavourable mix of events is likely to occur in 2002: implementation of loose fiscal policy combined with an effort at restrictive monetary policy, by which the NBS will try to give the economy the signal not to stimulate consumption instead of restricting it. Real interest rates will increase even at unchanged nominal interest rates.

## **2. Conclusion – summary of the Monetary Programme of NBS for 2002**

### *Goal of the monetary programme:*

The Monetary Programme of the NBS for 2002 expects the year-end rate of overall inflation to reach within the range of 3.5 – 4.9%, which corresponds to an average annual inflation rate of 4.1 – 4.9%. Core inflation is expected to fluctuate within the range of 3.2 – 4.7%.

*Assumptions of the monetary programme:*

- a relatively stable exchange rate of the Slovak crown to EUR;
- growth of 3.5 - 3.8% in GDP at constant prices (3.6% on average);
- a current account deficit of 7.9% as a share of GDP;
- a fiscal deficit of Sk 37.6 billion, i.e. 3.6% of GDP.

*Indicative values of growth in monetary aggregates:*

- growth in the money supply is expected to reach 10.5%;
- on the basis of developments in the balance of payments, net foreign assets are expected to grow by 80.2%;
- net credit to the Government and the National Property Fund is expected to fall by 13.3%, which is consistent with the forecast development in the fiscal deficit, supposed receipts and expenses of the NPF, and the expected use of receipts from privatisation for servicing the national debt;
- with regard to the development of the above aggregate variables, conditions will be created for a year-on-year growth of 7.6% in loans to households and enterprises; however, the actual growth will be determined, first and foremost, by restructuring in the corporate sector and the existence of feasible projects.

*Risks of the monetary programme:*

- **WAGES:** If the growth in labour productivity is exceeded significantly by the dynamics of real wages, the risk arises that consumption will grow at a faster rate with a possible impact on the balance of trade in particular. The increase in nominal wages should therefore reach a maximum of 6%.
- **PUBLIC SECTOR:** The use of receipts from privatisation for purposes other than debt repayment, the non-fulfilment of the expenses approved and the tax reduction will negatively affect the balance of foreign trade or will result in the non-fulfilment of the privatisation programme, which could lead to a slowdown in the process of necessary reform and a possible change in the attitude of foreign investors to Slovakia.
- **RAW MATERIAL PRICES:** The continuation and/or prolongation of the war conflict may lead to a big increase in the prices of strategic raw materials, which would be accompanied by an accelerated increase in consumer prices and imports.
- **GLOBAL ECONOMY:** Delay in the expected revival of the world economy could have a negative impact on the development of Slovak exports.

The Monetary Programme is based on the approved range of adjustments to regulated prices. If additional adjustments are approved to these prices, the estimated values of inflation will have to be modified. With effect from 1 January 2002, the Statistical Office of the SR will revise the consumer basket of goods of services used for the calculation of the Consumer Price Index; changes in the weights of individual consumer-basket items may affect the statistically determined rate of inflation; as a result, it is probable that the values of the monetary programme will have to be corrected for the rate of inflation.

### **3. Forecast of monetary and macro-economic development until 2005**

The medium-term forecast of the NBS for the years 2003 – 2005 is based on the plans 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 deployed mostly in the private sector, while the significance of privatisation will weaken in relative terms. At the same time, public finances are expected to consolidate step by step, which is a vital condition for successful integration. The reduction in the deficit of public finances and the growth of competitiveness in the economy are expected to create conditions for balanced economic growth, improvement in export trade, 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.

The forecast of economic and monetary developments is based on the assumption that the reform and integration process will continue and that the Government's commitments arising from the *acquis communautaire* will be met.

#### **3.1. Inflation**

##### ***Consumer prices***

In the medium-term (until 2005), consumer-price inflation is expected to be determined by continued adjustments of regulated prices, the harmonisation of tax laws with EU standards, and a gradual reduction in core inflation. Thus, administrative measures continue to play a key role in the development of consumer prices. In 2003-2005, the level and course of inflation will be determined by the range of adjustments of regulated prices approved for the individual years.

The schedule and range of administrative measures are delimited by the projected date of Slovakia's entry into the EU, i.e. 1 January 2004. The impact of administrative measures on the level of consumer prices may be divided into two basic sectors: the continued process of deregulation and the harmonisation of indirect tax rates to EU standards. Since Slovakia will propose several transition periods in the area of taxation in negotiating with the EU, we assume that administrative measures will continue to affect the course of inflation even after the date of entry.

In the area of regulated prices, the deregulation process will have to be continued, up to a level covering the justified costs and reasonable earnings. The largest interventions are likely in the prices of natural gas (both for households and the production sector), heating, rents, fares in public transport, electricity, and other administratively determined prices (in health care, education, etc.).

Since there is no medium-term concept for price deregulation in Slovakia (except for adjustments to gas prices), considerations about the range of price deregulation are based on partial analyses carried out in the individual sectors. The degree of uncertainty in the estimate of inflation is also increased by the revision of the consumer basket by the Statistical Office of the SR in 2001 (the estimates of inflation are based on the structure of the actual consumer basket). In connection with the decision of the Government to slow down or suspend the process of deregulation in 2002, the entry of Slovakia into the EU in 2004 increases the risk of a significant one-off rise in regulated prices in 2003.

In the medium term, the harmonisation of excise tax rates with the minimum rates in the EU will continue and certain items will be shifted from the category of goods and services with reduced VAT rates into the basic category (e.g. restaurant services, construction work, legal services for citizens).

Medium-term estimates of inflation are based on the assumption that the transition periods required for the harmonisation of excise duties on cigarettes will be accepted and that energy prices will be shifted from lowered VAT rates into the category of basic VAT ones. If adjustments of prices are spread evenly over the entire transition period, the effects of changes in indirect tax rates would contribute 0.5 of a percentage point to overall inflation per annum.

The slowdown in the deregulation process in 2002 and the expected entry of Slovakia into the EU will invoke pressure for the adoption of an extended package of administrative measures in 2003. Their contribution to overall inflation could amount to roughly 4.1 percentage points (3.6 percentage points due to adjustments to regulated prices and 0.5 of a percentage point resulting from changes in indirect taxes), consequently inflation may again exceed the level of 7% in 2003.

In connection with the expected cessation of deregulation of the prices of public utilities in 2003 (apart from 10% to allow for coverage of the justified costs of natural gas, including a reasonable profit), the effect of regulated prices on inflation will diminish significantly in 2004 and 2005. In these years, regulated prices could rise only by the value of average inflation with the exception of rents, which are expected to increase by roughly 30% during 2004-2005. At the end of medium term, the rate of overall inflation will gradually approach the level of core inflation. The remaining difference will be caused mainly by continued changes in indirect taxes.

The course of core inflation will, in all probability, be characterised by a gradual fall in the medium term. An exception could be the year 2003, when the level of core inflation will probably reflect the secondary effects of large-scale administrative adjustments. A considerable fall cannot be expected even in the following years, since reduction below one-digit figures is a difficult and long-term process. In the medium term, the rate of core inflation is expected to be somewhat higher than the average dynamics of consumer prices in the EU. **This process should take place in an environment characterised by an equal range of administrative measures in individual years, gradual levelling of relative prices, a stable exchange rate, and strong effect of competition in the retail.**

**Estimated course of inflation in 2002-2005 (at December)**

		2001	2002	2003	2004	2005
Inflation (%)	12-month rate	7.3-7.7	3.5-4.9	7.0	5.2	4.5
	Ave. 12-month rate	7.5-7.6	4.1-4.9	6.9	5.5	4.6
Core inflation (%)	12-month rate	4.2-4.6	3.2-4.7	4.0	3.6	3.2
	Ave. 12-month rate	4.5-4.6	3.6-4.6	4.2	3.7	3.3

/ For the years 2003-2005, only the mid values are available.

Although there is an upper limit for inflation as a criterion for entry into EMU, it is also important that Slovak prices should approach the level of prices in EU countries. For that reason, any exaggerated effort to accelerate the process of disinflation may again result in pressure on inflation in the medium term, with an unfavourable impact on the economy as a whole.

***Producer prices***

The estimates of producer prices until 2005 are based on the assumption that restructuring of the Slovak economy will continue, together with the implementation of EU policies in the pre-accession process. In the medium term, the dynamics of foreign and domestic demand are expected to remain stable and the range of adjustments of energy prices to diminish.

A key factor, directly affecting the level of industrial producer prices, are prices of raw materials on the world market. The predicted stabilisation of raw material prices in Europe and in the world at a reduced level, is expected to cause a fall in industrial producer prices. Growth in domestic demand (even though stabilised) may dampen the rate of disinflation, but its impact on producer prices will depend more on the completion of restructuring in the sectors concerned and the situation on the internal market than the pressure on demand.

In the category 'machinery and equipment', Slovak prices are comparable with the level of European prices. In construction and agriculture, domestic prices are at a much lower level.

**Estimates of industrial producer prices in 2001-2005**

	2001	2002	2003	2004	2005
Average annual rate of increase	7.0	5.0	5.3	4.0	3.5

The harmonisation of tax, agricultural, ecological, and other policies with EU standards is connected with the growth in the costs of producers. Similarly, adjustments of energy prices for the production sector (the price of electricity is comparable with that in Europe; the price of natural gas is at a lower level) represent a source of increase in costs. The question is how the increased costs will transfer into prices and impact on price indices (changes in VAT rates do not affect the values of producer price indices; changes in excise duties are reflected in the commonly used index of industrial producer prices).<sup>5</sup> Based on previous developments, we may assume that, in the case of an increase in production costs,

<sup>5</sup> With regard to the lack of a uniform method for assessing the effects of changes in tax rates on the index of industrial producer prices, it would be more appropriate to assess industrial producer prices excluding VAT and excise duties.

the realisation prices of industrial producers will also increase if demand acts in the same direction.

The situation in agriculture is different: the persistently low price compensation to farmers will cause a steeper increase in prices. The concept of Slovakia's agricultural and food policy for the period until 2005, recommends gradual transition to the principles of the Community's agricultural policy, but does not expect the institutional prices of the EU to be achieved in the pre-accession period. The varying degree of success achieved in adopting these principles is connected with the various effects on agricultural prices.

## 3.2. Foreign trade

### 3.2.1. Balance of payments

In 2003-2005, the National Bank of Slovakia expects consolidation and a moderate revival of economic growth in the countries of our major trading partners. This will lead to relatively stable growth in Slovak exports, the average 12-month dynamics of which are expected to fluctuate around 15.0%. The relatively favourable trend expected in Slovak exports will be connected with the positive effect of Slovakia's entry into the EU, while this effect would be bolstered by the productivity of investments made in previous years. Imports are expected to grow at a slower rate (up to 13.0% on average) than exports, which will lead to a gradual fall in the trade deficit. The expected year-on-year growth in imports is connected with the high level of comparison (which was affected by the large volume of imports in previous years, mainly the import of technologies, the growth of which is expected to moderate) and with an expected improvement in domestic supply.

In this period, the balance of services is again expected to be characterised by stable surpluses, which will be determined, as at present, by receipts from transport and tourism.

The negative balance of income in 2003-2005 will result mainly from interest payments in the corporate sector, which will be partly offset by an increase in interest receipts from the foreign exchange reserves of the NBS (due to the increased level).

In the area of current transfers, the NBS expects a stable level of receipts from transfers made by natural and legal persons (benefits, damages, insurance premiums), which will result in a surplus, exceeding Sk 10.0 billion on average.

As a result of this development in the individual components of the balance of payments, the current account deficit is expected to diminish from 5.6% of GDP in 2003 to 3.4% in 2005.

	Sk billions		
	2003	2004	2005
Balance of trade	-78.0	-70.0	-61.0
Services balance	19.0	19.4	19.9
Balance income	-15.1	-15.8	-15.3
Current transfers	10.6	10.2	11.1
Current account	-63.5	-56.2	-45.3



The deficit in the current account is expected to be financed over the entire period under review, from capital inflows channelled via the capital and financial account in the form of direct and portfolio investments, or from long-term loans received from abroad.

With regard to the gradual exhaustion of possibilities for the privatisation of state property, the NBS expects a gradual fall in the inflow of foreign capital in the form of direct investment, while the significance of capital inflows into the commercial sector will gradually increase.

	Sk billions		
	2003	2004	2005
Foreign direct investment	50.0	41.5	23.5
of which:			
Government sector	25.0	18.5	3.5
Commercial sector	25.0	23.0	20.0

In the area of portfolio investment, we expect a gradual increase in the significance of this form of investment, mainly in obtaining resources for the corporate sector. At the same time, we assume that due government securities will be replaced by new issues.

The inflow of funds through other long-term investment will be affected mostly by activities in the corporate sector (on the side of borrowing) and by repayments of government loans, which will be financed from the foreign exchange reserves of the NBS (on the side of repayment).

The short-term capital and financial account will be affected, first and foremost, by export claims and import commitments in the corporate sector.

	Sk billions		
	2003	2004	2005
Capital transfers	2.0	2.0	2.4
Direct investment	48.0	39.5	21.5
Portfolio investment	15.0	17.7	15.0
Other long-term financial account	6.8	2.1	4.2
Short-term financial account	5.2	7.7	6.0
Capital and financial account	77.0	69.0	49.0

Developments in the current and the capital and financial account of the balance of payments will lead to a gradual increase in the foreign exchange reserves of the NBS, which will, however, decrease step by step in individual years. This will be reflected in a fall in the average coverage of imports of goods and services, from 3.9 months in 2003 to 3.2 months in 2005.

The expected developments in the current account, mainly in the balance of trade, are relatively optimistic and, on the export side, dependent on the continuation of restructuring in the economy in preparation for accession to the EU. At the same time, technologies imported in 2000 to 2002 are expected to have a positive effect, i.e. they will gradually increase the export potential of the economy. The outlook for foreign trade expects a marked revival of global economic development in this period. The stabilisation of import dynamics will be connected with the saturation of deferred consumption from 1999 and 2000 during the years 2001 and 2002, and requires a stable development in raw material prices.

In connection with the development of foreign trade, we should realise that this problem cannot be solved on the demand side in the long term; therefore, it is necessary to adapt the supply side of the economy to the structural reform. In the years 2003 to 2005 (mainly in the second half), this process is expected to be facilitated by the structural reform as well.

### 3.2.2. External debt

The prediction of foreign debt for the years 2003-2005 is consistent with the forecast for the balance of payments. During this period, gross external debt will increase only slightly, due to the continued relatively massive inflow of foreign capital in the form of direct investment, which will play a significant role in financing the deficit in the current account.

#### Medium-term forecast of external debt and debt servicing in 2003-2005

(US\$ millions)

	2003	2004	2005
<b>External debt in total (PS)</b>	<b>11,761.4</b>	<b>12,164.2</b>	<b>12,526.8</b>
of which: medium- and long-term (PS)	8,835.0	8,977.6	9,022.4
Total debt service **	2,866.1	2,440.4	1,924.3
of which: - principal	2,264.5	1,812.0	1,296.5
- interest	601.6	628.4	627.8
New loans	2,407.1	1,856.8	1,328.9
Short-term debt (PS)	2,926.4	3,186.6	3,504.4
Change in the level of short-term debt	260.2	317.8	281.7
<b>External debt in total (KS)</b>	<b>12,164.2</b>	<b>12,526.8</b>	<b>12,840.9</b>
of which: medium- and long-term (KS)	8,977.6	9,022.4	9,054.8
Short-term debt (KS)	3,186.6	3,504.4	3,786.1
Foreign assets	10,987.9	11,412.8	11,646.7
<b>Net external debt</b>	<b>1,176.3</b>	<b>1,114.0</b>	<b>1,194.2</b>

PS – Initial volume

KS – Final volume

\*\* - Including interest on short-term debt.

### 3.3. Gross domestic product

The forecast of GDP was made with respect to the basic medium-term goals of macro-economic policy, formulated in the Pre-accession Economic Programme. The priority is to increase the performance of the economy to a level sustainable in the long term, its competitiveness, and to improve the situation on the labour market, which could, together with other factors, facilitate the integration of Slovakia into the European Union. The main conditions for achievement of this goal are structural changes in the corporate and financial sectors, on the labour market, the reform of public finances, social reform, and the development of regions accompanied by the creation of an institutional and legal framework.

During the period until 2005, we may expect a further increase in the capacity of the Slovak economy under these conditions. In 2003, real economic growth may reach 4.2%, in the following year 4.4%, and at the end of the period under analysis

4.6%.<sup>6</sup> The growth in GDP in 2003 to 2005 will be based on exports, supported by fixed investments and private consumption.

The restructuring of companies, together with the expected slower growth in real wages in comparison with the rate of growth in labour productivity, will lead to increased creation of funds for development purposes. This development will, together with the offer of credit resources, contribute to the growth in fixed investments, which will be stimulated mainly by investment demand of non-financial organisations. Gross fixed capital formation is expected to increase year-on-year by 4.8 – 5.1% during the period under review. Thus, the rate of gross fixed investment, expressed in constant prices, will be at the level of 32% during the entire period.

In comparison with the other components of domestic demand, the development of final household consumption appears to be the most complicated. In 2003, its year-on-year dynamics are expected to slow to 3.5% in connection with the predicted development in wages and the absorption of part of the incomes by an increase in the range of price adjustments, but in the following two years, the rate of year-on-year growth will again accelerate to 4.2 and 4.4% respectively.

The relatively balanced economic growth and dynamic increase in labour productivity in the corporate sector, accompanied by a moderate increase in employment and a gradual fall in inflation, will create conditions for growth in real wages. However, the trend of growth in real wages will be interrupted in 2003, when the year-on-year growth in real wages is expected to moderate to 1-2% as a result of increased inflation. During the following period, real wages could again increase by 2-3% each year.

The forecast of final consumption in public administration is based on the medium-term financial outlook for the period until 2004, according to which the redistribution of public funds is to be reduced in the medium term and government spending is to be cut step by step. With regard to the quantification of current expenditure in the public sector and the development of consumer prices, this means that final consumption in public administration will increase only slightly in 2003 compared with 2002 (by 0.1% at constant prices), but in the following years, its growth will accelerate to 2.0-3.3%.

The increased competitiveness of the Slovak economy will lead to growth in the exports of goods and services, which is expected to be the most dynamic component of real GDP throughout the period under analysis. In 2003-2004, the rate of year-on-year growth at constant prices will reach 8-9%, and at the end of the said period, almost 10%, which will represent a major factor of sustainability in the Slovak economy in the long term.

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<sup>6</sup> On the basis of previous preliminary analyses, the rate of potential growth in GDP was estimated at 4.2%. Although the expected rate of GDP growth in 2003 to 2005 exceeds this figure, the economy is not expected to become overheated, since the value of potential product was estimated on the basis of previous data and does not include the effects of technological and institutional progress. With regard to the expected inflow of foreign direct investments and the entry of Slovakia into the EU, which will stimulate progress in these areas, the potential GDP is expected to grow.

The imports of goods and services will be affected by the development of domestic demand, where relatively small year-on-year increases (compared with the rate of GDP growth) will invoke no substantial pressure on imports. The maintenance of the excess of exports dynamics over the rate of growth in imports during the entire period under analysis, will result in a surplus in net exports (after being adjusted for price effects), which will show a tendency to grow until 2005. (Apart from values at current prices, the proportion of exports to imports will be affected by foreign trade relations, where the year-on-year increase in the export deflator is expected to slightly exceed the increase in the import deflator. The excess will also be affected by a gradual growth in the exports of goods with a higher added value, i.e. sophisticated products enabling a price increase).

	(year-on-year change in %)		
	2003	2004	2005
<b>GDP at constant 1995 prices</b>	<b>4.2</b>	<b>4.4</b>	<b>4.6</b>
Domestic demand	2.3	3.2	3.4
of which:			
Final household consumption	3.5	4.2	4.4
Gross fixed capital formation	5.1	4.8	4.8

### 3.4. Public finances

In 2002-2005, the National Bank of Slovakia expects, in accordance with the plans of the Government presented in the Pre-accession Economic Programme, a gradual reduction in the fiscal deficit, to a level of 2% of GDP.

In billion of Sk	2001	2002	2003	2004	2005
Receipts in total	204	221	225	243	259
- grants and transfers	-12	-2	-	-	-
<b>Net receipts</b>	<b>192</b>	<b>219</b>	<b>225</b>	<b>243</b>	<b>259</b>
Share of net receipts in GDP (%)	19.9	21.2	19.8	19.7	19.5
Expenses in total	250	258	258	273	285
-grants and transfers	-12	-2	--	-	-
<b>Net expenses</b>	<b>238</b>	<b>256</b>	<b>258</b>	<b>273</b>	<b>285</b>
Share of net expenses in GDP (%)	24.6	24.8	22.8	22.2	21.5
Deficit in the State Budget	46	46.5	33	30	26
- costs of restructuring	-9	-9.5	-	-	-
<b>Net deficit of central government</b>	<b>37</b>	<b>37</b>	<b>33</b>	<b>30</b>	<b>26</b>
<b>Deficit of general government</b>	<b>35</b>	<b>37.6</b>	<b>35</b>	<b>32</b>	<b>27</b>
Share of central government deficit in GDP (%)	3.8	3.5	2.9	2.4	2.0
Share of general government deficit in GDP (%)	3.6	3.6	3.1	2.6	2.0

### **3.5. Monetary policy**

At the beginning of the period 2003-2005, monetary policy will be conducted in an environment characterised by a temporary increase in the rate of inflation, resulting from the renewed process of adjustments to regulated prices, while the process of disinflation is expected to continue in the following years. The expected macro-economic development in this period will be marked by the gradual consolidation of public finances, a deficit in the current account, and a moderate acceleration in the rate of economic growth. This development is expected to create conditions for a gradual reduction in the key rates of the NBS in the medium term.

In the area of monetary policy instruments, the ratio of minimum required reserves will be gradually reduced, to the level required in euro-zone countries, while the

### **4. Conclusion (2003-2005)**

The presented forecast is not definitive, but is simply one of several possible variants, and is based on the expected entry of Slovakia into the EU and the related institutional environment creating conditions for the convergence of the Slovak economy to advanced market economies.

However, the reliability of this forecast is contingent upon the actual course of the integration process, both on the part of Slovakia and EU Member States. In the same way, the forecast will be affected by developments in the world economy, mainly the economies of our trading partners.

## Main economic and monetary indicators

	2000	2001				2002	2003	2004	2005
	Reality	Monetary programme	Revised monetary programme	Staff monitored programme	Estimate	Monetary program	Forecast		
(year-on-year change in %)									
Gross domestic product (constant prices)	2.2	2.8-3.2	2.8-3.0	3.1	2.8-3.0	3.5-3.8	4.2	4.4	4.6
Consumer price index (year-end, core inflation)	4.6	3.6-5.3	3.6-5.3	3.6-5.3	2.9-3.2	3.2-4.7	4.0	3.6	3.2
Consumer price index (annual average)	12.0	7.1-8.3	7.1-8.3	7.1-8.3	7.3-7.4	4.1-4.9	6.9	5.5	4.6
Consumer price index (year-end figure)	8.4	6.7-8.2	6.7-8.2	6.7-8.2	6.3-6.5	3.5-4.9	7.0	5.2	4.5
Gross domestic product (nominal, Sk billion)	887.2	960.0	962.0	973.0	967.0	1,032.0	1,134.0	1,231.0	1,328.0
Money supply (M2)	14.7	15.9	15.5	15.6	12.5	10.5	8.9	7.6	6.9
Current account deficit as a share of GDP	-3.7	-4.0	-5.7	-4.9	-8.1 to 9.0	-7.9	-5.6	-4.6	-3.4
Official reserves of the NBS (US\$ millions)	4,077.0	5,843.0	4,489.0	5,818.0	4,071.1	6,575.9	6,859.7	7,128.3	7,205.9

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