

NBS Monetary Program for 2003 and Outlook for 2004 – 2006

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1. Introduction

The NBS Monetary Program for 2003 and Outlook for 2004 - 2006 is based on the 2003 State Budget Act and a medium-term outlook (which forms a part of the Act), as well as on estimates as to the impact of a Network Industries Regulatory Authority (NIRA) decision to raise certain regulated prices.

Since the key sections of the NBS Monetary Program for 2003 and Outlook for 2004-2006, in particular those concerning the GDP and the balance of payments, were compiled in November 2002, this paper may not fully reflect all the latest information.

An increase in inflation driven by an alignment of distorted prices is a fact that needs to be accepted in 2003, even though we do not expect it to have any adverse effect on Slovakia's rating by international institutions and investors. In the medium-term, the disinflation process should be restored in 2004.

Anticipated consolidation of public finance is supposed to slow down the end consumption in real terms in 2003. However, the decline should be offset by a revival in investments and foreign demand. Thus, the economic growth of Slovakia's economy should continue.

A continuing improvement in public finance performance in 2004-2006 should help stabilise the macroeconomic environment, facilitating fresh inflow of foreign direct investments (FDIs) into the commercial sector and further expansion of domestic production. Meanwhile, the use of EU structural funds should pave the way to an average GDP growth of 4% in the medium-term horizon, which is considered a prerequisite for real convergence.

Thus, assuming a steadily growing money supply, the scene should be set for an adequate rise in lending activities in the medium-term horizon starting in 2003. Given the assumptions described above, we may expect the ratio of the current account deficit to GDP to decrease gradually decline.

As regards the balance of payments, we expect the government's foreign debt to be revolved in the domestic market in 2003. In the following years, the debt service (both foreign and domestic) is supposed to be financed by privatisation revenues. Considering the elimination of exchange rate risks and a sizeable liquidity surplus, we believe that is the best strategy for the government to follow on this particular issue. We also assume privatisation in 2003 to unfold along the lines of plans published by the National Property Fund. Our medium-term forecasts are based on the assumption that the state will spin off a total of SKK 200 billion worth of its majority interests. In preparation of the monetary program, our assumption was that 50% of the proceeds will be spent to pay off the government debt (foreign first), with the other 50% set aside to save funds needed to implement a pension system reform and, in part, a reform of the health care and education system.

The relatively high rate of growth of the gross domestic product also relies on expectations of a gradual economic recovery in our largest trade partners, especially the EU. In our GDP forecasts for these countries, we have referred to OECD and IMF (World Economic Outlook) estimates. However, the expected growth in the EU countries is likely to be fragile and, if deviating from the projected path, it might affect not only the GDP growth, but also its structure taking into account a high degree of openness of Slovakia's economy.

An open economy and a high level of liberalisation in capital and financial flows will combine to influence the actual monetary policy implementation both in 2003 and in the years thereafter. A major change in conditions, especially growing foreign investor confidence, has set off considerable appreciation pressures (after the elections), which are not based on the real

developments in economic fundamentals. More good news – Slovakia's accession to the NATO and the EU followed by a possible rating upgrade – is likely to spur capital inflow and, subsequently, increasing pressure on the Slovak koruna to appreciate against the benchmark currency. Despite the fact that nominal appreciation would slow down inflation, over-appreciation might backfire in a major setback in competitiveness of Slovak producers and, eventually, a contraction in the GDP. That is why, when implementing its monetary policy, the NBS will bear in mind the exchange rate as well. Should it drift away from real economic situation, the central bank will stand by to intervene.

In the medium-term, economic and monetary developments will be influenced by a probable accession to the ERM II, where it will be maintain to find the right central currency parity and then indispensable the currency within the set limits for at least two years.

The values targeted in the monetary program and the medium-term outlook is based on a technical assumption of a stable average exchange rate against the euro and the U.S. dollar.

2. World economic developments in 2002 and outlook for 2003

The external economic environment predictions are based on the OECD Outlook published in November 2002, and on estimates presented in the IMF Outlook published in September 2002.

The latest OECD prognosis scales down its global economic growth targets from earlier predictions. Despite strong stimuli coming from a relaxed monetary and fiscal policy last year, a setback in world equity markets hurt business and consumer confidence and led to greater caution among both institutional and private investors. As enterprises and financial institutions struggle to improve their performance, investment spending is bound to decrease and employment growth to slow down in the short run. Notwithstanding the above, the OECD countries en bloc are expected to see their economic growth accelerate to 2.2% next year, and then to 3.0% in 2004.

In the first half of 2002, economic activity in different OECD regions was relatively low and uneven. In the U.S., the real GDP growth slumped from 5% in the first quarter to 1.25% in the second quarter, while the eurozone reported an average 0.75% on annual basis in the first half due to very moderate growth in economic superpowers such as Germany and Italy.

In the **eurozone**, after an expected slowdown to 0.7% in 2002 (from 1.5% in 2001), GDP growth is supposed to recover to 1.9% in 2003, and 2.7% in 2004. While in 2002, economic growth will be largely driven by exports, private consumption will deliver an additional incentive in 2003 (up 1.5% from year ago), coupled with a minor decline in inflation and a stabilising saving rate. A rising rate of corporate investments will be supported by growing domestic consumption and external demand. However, economic growth, which should be largely export-driven, may be held back by a possible drop in external demand and/or a continued strengthening of the euro against the U.S. dollar. Likewise, a slump in equity markets, which hit Europe harder than the U.S., may end up hurting confidence and demand worse than first expected.

Headline inflation, measured as HICP, is expected to decline in 2004 below 2%, a level set by the ECB as a medium-term target for price stability. One thing which may raise concerns is a growing momentum in wage growth, coupled by falling productivity and rising unit cost of labour.

Although the structural deficit in the eurozone is supposed to decrease, fiscal consolidation results vary sharply from country to country. Big economies in particular, such as Germany, France, and Italy, find it hard to keep their public finance deficits down to 3% (the benchmark set in the Stability and Growth Pact for medium-term fiscal positions of member states) and strive for a balanced budget in 2004 and 2006. The fiscal position needs to be strengthened in the medium-term horizon to be able to ease off the tax load and tackle problems in the pension and health care systems.

The unemployment rate in the eurozone should peak in 2003 (8.5%) and back down slightly to 8.3% in 2004. The current account surplus of the eurozone will increase from 0.9% of GDP in 2002 and 2003 to 1.2% in 2004.

In **Germany** (Slovakia's largest trade partner), economic growth was affected by its vulnerability to the global economic recession. In 2001, Germany's economic growth slowed down to 0.6% mainly on the back of falling investments. In 2002, according to OECD, real GDP should rise by 0.4%, gaining another 1.5% in 2003 and 2.5% in 2004. The inflation rate (measured as the consumer price index) reached 2.4% in 2001 and is expected to back down to 1.6% by the end of 2002 as a result of energy price stabilisation. In 2003, inflation is set to slip to 1.4% and on to 1.1% in 2004. Nevertheless, the price development will be influenced

by wage negotiations and crude oil prices. The ratio of the current account surplus to GDP is supposed to range between 2.0% and 2.3% in 2002-2003 (2.8% in 2004), well up from the 0.1% recorded in 2001. The main hazards faced by the German economy lie in an aggravating fiscal position and a rigid labour market. By OECD predictions, Germany is expected to run up a budget deficit of over 3% in 2002, i.e. outside the margin set in the Stability and Growth Pact, which is why it will need to take appropriate measures stay inside the limit.

By revised statistics, the **Czech Republic** reported a 3.3% GDP growth in 2001, fuelled mainly by the formation of gross fixed capital. In 2002 and 2003, GDP is expected to post an increase by 2.5% and 3.3%, respectively, but its growth may be hampered in particular by a strong Czech koruna and, to a lesser degree, if economic recovery predictions fail to materialise in EU countries. Unbalanced public finance remains the main hazard to economic growth in the medium run. Amid a firming Czech koruna and the absence of domestic inflation pressures, inflation was reined in and is expected to average 2.1% in 2002 and 2.5% in 2003. In 2001, the unemployment rate reached 8.2% and is expected to drop to 7.4% in 2002 and stay at that level in 2003. The ratio of the current account deficit to GDP has been declining since mid-2001 and the trend is expected to continue at a moderate pace in 2002 (4.2%) and 2003 (4.3%). The current account deficit will be fully covered by incoming foreign direct investments. The appreciating exchange rate of the Czech koruna remains the most obvious threat to the balance of trade.

Poland's economic growth was measured at 1.0% in 2001, and GDP growth is set to stay relatively low (1.2%) in 2002 amid flat domestic demand and a setback in gross investments. The OECD forecasts envision a slight rebound in GDP growth to 2.5% in 2003, and to 2.9% in 2004, fuelled by renewed growth in investment demand. Public spending cuts in the 2002 budget were a major step taken in an effort to contain a widening fiscal gap. Fiscal consolidation will need to continue to prevent public debt from soaring and to make room for a loosening of the monetary policy. A sharp decrease in interest rates over the last year came as a sign of poor economic performance, fairly strong Polish zloty, and low inflation. The inflation fall should bottom out at 2.1% in 2002 (well below the 4-6% inflation target eyed by the central bank), and pick up slightly in 2003 (2.5%) and 2004 (2.7%). The unemployment rate is supposed to reach 19.7% in 2002 and keep on rising in years ahead. The ratio of the current account deficit to GDP should come in at 3.3% in 2002 and increase further to 4.4% in 2003 and even to 5.2% in 2004.

Hungary recorded a slowdown in economic growth to 3.8% in 2001, as compared to 5.2% in 2000, which was caused primarily by private consumption. By OECD predictions, GDP growth is supposed to pick up to 4.1% and 4.0% in 2003 and 2004, respectively. In 2002, the country is expected to see an upturn in fixed investments and heavier government spending sparked by a fiscal policy ease-off. A more relaxed fiscal policy coinciding with rapid wage growth in both the public and private sector can make the inflation target difficult to hold, raise interest rates and, in the medium run, cause problems in sustaining the current account deficit. According to the OECD prognosis, a downtrend in inflation should continue in 2003 (5.2%) and 2004 (4.2%). The above factors, coupled by a late-coming economic revival in Hungary's main trade partners, are likely to end up increasing the ratio of the current account deficit to GDP to 5.4% and 5.5% in 2003 and 2004, respectively, as compared to 2.1% reported in 2001.

In the **U.S.**, GDP growth is expected to come in at 2.3% in 2002, accelerating slightly to 2.6% in 2003 and 3.6% in 2004. A softer monetary policy combined with a continuing improvement in the business sector balance should lead to more dynamic growth in fixed corporate investments. By OECD predictions, the U.S. should record a limited development of consumer price inflation at around 1.9% in 2003, or 1.8% in 2004. In 2002, the U.S. is expected to see the ratio of the current account deficit to GDP reach 4.9%, rising to 5.1% in 2003, and 5.3% in 2004.

In its forecasts, the OECD assumed the U.S. dollar to loose ground against the single European currency in 2003 and 2004 to the point of 0.99 USD/EUR.

Macroeconomic indicator predictions for selected countries (OECD) (%)

	GDP				Inflation ¹				Current account/GDP			
	2001	2002	2003	2004	2001	2002	2003	2004	2001	2002	2003	2004
OECD	0.7	1.5	2.2	3.0	2.8 ²	2.1 ²	1.9 ²	1.5 ²	-1.1	-1.2	-1.2	-1.2
USA	0.3	2.3	2.6	3.6	2.8	1.6	1.9	1.8	-3.9	-4.9	-5.1	-5.3
Japan	-0.3	-0.7	0.8	0.9	-0.7	-1.1	-1.1	-1.1	2.1	3.2	3.8	4.2
EU	1.6	0.9	1.9	2.7	2.1 ²	2.0 ²	2.0 ²	1.8 ²	-0.1	0.5	0.5	0.5
EMU	1.5	0.8	1.8	2.7	2.5	2.4	2.2	2.0	0.1	0.9	0.9	1.2
Germany	0.6	0.4	1.5	2.5	2.4	1.6	1.4	1.1	0.1	2.0	2.3	2.8
France	1.8	1.0	1.9	2.9	1.8	1.9	1.8	1.8	1.6	1.8	1.4	1.4
Italy	1.8	0.3	1.5	2.5	2.3	2.5	2.3	1.9	0.0	-0.8	-0.5	-0.2
Czech Republic	3.3	2.5	3.3	3.6	4.8	2.1	2.5	3.1	-4.6	-4.2	-4.3	-4.2
Hungary	3.8	3.1	4.1	4.0	9.2	5.4	5.2	4.2	-2.1	-5.3	-5.4	-5.5
Poland	1.0	1.2	2.5	2.9	5.5	2.1	2.5	2.7	-3.0	-3.3	-4.4	-5.2

¹ measured as consumer price index

² measured as private consumption deflator

Macroeconomic indicator predictions for selected countries (IMF) (%)

	GDP			Consumer prices			Current account/GDP		
	2001	2002	2003	2001	2002	2003	2001	2002	2003
USA	0.3	2.2	2.6	2.8	1.5	2.3	-3.9	-4.6	-4.7
Japan	-0.3	-0.5	1.1	-0.7	-1.0	-0.6	2.1	3.0	2.9
EU	1.6	1.1	2.3	2.6	2.1	1.8		0.6	0.5
EMU	1.5	0.9	2.3	2.6	2.1	1.6	0.4	1.1	1.0
Germany	0.6	0.5	2.0	2.4	1.4	1.1	0.1	1.9	2.1
France	1.8	1.2	2.3	1.8	1.8	1.4	1.8	1.9	1.4
Italy	1.8	0.7	2.3	2.7	2.4	1.8	0.1	0.2	0.2
Czech Republic	3.3	2.7	3.2	4.7	2.7	3.0	-4.6	-5.2	-4.6
Hungary	3.8	3.5	4.0	9.2	5.5	5.2	-2.2	-3.8	-3.7
Poland	1.0	1.0	3.0	5.5	2.1	2.3	-4.0	-3.6	-4.2

3. Estimated development until the end of 2002

3.1 Inflation

2002 assumptions

Assumptions made in the Updated Monetary Program for 2002 (2002 UMP)

- stabilising prices of energy and industrial raw materials (the price of oil expected to move inside the OPEC benchmark range of 22-28 USD/barrel)
- despite expectations of continuing growth in private spending and real wages, consumer demand should not put unwanted pressure on price growth
- domestic competition and satisfaction of demand by foreign supply should be the key absorbing factors
- higher year-on-year inflation growth in the last months of the year resulting from the base effect, i.e. due to low prices of food and fuel prevailing at the end of 2001

Risks defined in the 2002 UMP

- food prices – potential volatility source, the main assumption in food price development was a sufficient supply of basic food commodities and lower cost impulses
- retail chains – absorbing some of the pressure on prices, but presenting an increased threat of one-off price swings in case of short-term market imbalance (especially in fruits and vegetables)
- scope of administrative measures, excise tax raises
- a state budget deficit overrun, as compared to plan, and higher wage growth could give rise to heavier demand pressure in the second half of 2002
- fluctuations in the exchange rate of the Slovak koruna – more distinct exchange rate movement – impact on price growth especially in the tradable sector
- fuel prices.

There were several factors influencing the actual development in consumer prices during 2002, such as low demand elasticity of prices, a high degree of competition in retail, a basically steady development of oil prices and the exchange rate of the Slovak koruna against the euro, and a depreciation of the U.S. dollar against our benchmark currency. It was particularly owing to the development in the prices of foodstuffs and market services that inflation fell short of the NBS program targets.

Amid a major reduction in cost pressures and no real demand strain, year-on-year price growth has dropped across the board in 2002. Price level was strongly affected by food prices, which slowed down year-on-year to actually record a decline from year ago in July and August. The prices of processed food have developed in line with NBS' expectations.

The greatest impact on food prices came from non-processed foodstuffs, especially in May and June. While in the same period previous year, their prices rose slightly (by 0.4%), they recorded a sharp fall in 2002 (down 8.5%). The drop in non-processed food prices was largely attributed to a lasting decline in meat prices (supply outweighing demand due to cheap imports and threat of BSE disease) and stronger seasonal effects in fruit and vegetable prices.

Month-on-month food price comparison

	Weight in %	May		June		July		August	
		2001	2002	2001	2002	2001	2002	2001	2002
Food	21.4	0.3	0.4	1.1	-1.5	-0.5	-2.3	-0.9	-0.1
Processed food	12.0	-0.1	0.0	-0.4	-0.5	-0.3	-0.3	-0.2	-0.1
Non-processed food	9.4	0.8	0.8	2.9	-2.8	-0.7	-4.8	-1.8	0.0

Inflation was also influenced by the Slovak koruna appreciation against the U.S. dollar in particular, with the effect showing across the entire tradable sector, as well as in fuel prices which dipped 0.1% in October from year ago.

The table below compares actual performance with 2002 UMP targets:

Comparison of actual developments with 2002 UMP at the end of the year

	Year-end 2002 UMP		Actual October	Difference */
	min	max		
Total in %	3.5	4.9	2.9	-0.6
Regulated prices in %	3.4	4.3	5.4	1.1
share in total in percentage points	0.80	1.02	1.25	0.23
Impact of change in indirect taxes in non-regulated prices – share in total in percentage points	0.41	0.41	0.35	-0.06
Core inflation in %	3.2	4.7	1.7	-1.5
share in total in percentage points	2.33	3.52	1.30	-1.03
Food in %	2.4	4.4	-0.2	-2.6
share in total in percentage points	0.50	0.92	-0.03	-0.53
Tradable goods in %	3.2	4.3	2.3	-0.9
share in total in percentage points	1.15	1.58	0.86	-0.29
Market services in %	3.7	5.6	2.6	-1.1
share in total in percentage points	0.67	1.02	0.47	-0.20

*/ negative value signifies that actual performance was below program range, positive value means it was above program range

Actual performance varied from the targets defined in the program in all components comprising the basic inflation structure. As prices of food and market services mentioned above, tradable goods also recorded a lower than expected growth. In contrast, the 2002 UMP growth targets were outstripped in regulated prices, especially in the wake of rising prices of telecommunications, health care, and education.

Expected development until the end of the year

In the two months left (November and December), consumer prices are expected to rise at a moderate pace. Growth should occur in all sectors of the consumer basket. The rate of growth in prices of food and tradable goods should be low, yet higher than in the same period last year. Prices of market services are expected to basically keep the pace observed in previous months. Fuel prices are likely to hold steady. This trend is likely to bring about a minor acceleration in both headline and core inflation at the end of the year, with the base effect showing (the effect of slow price growth in late 2001).

Despite the fact that the trend in year-on-year inflation turned around to a rise from August 2002, headline, core and average inflation are going to close the year below the target band. This is due to a different than expected development in food prices (in summer months), i.e. one of the threats identified in the monetary program coming true.

Based on available inflation data for October, the NBS expects core inflation to end the year somewhere between 1.9% and 2.1%, headline inflation at 2.9-3.2%, and average inflation at 3.3-3.4%.

Consumer prices (%)

		2002 MP	2002 UMP	Actual October 2002	2002 estimates ¹
Core inflation	year-on-year	3.2 - 4.7	3.2 - 4.7	1.7	1.9 - 2.2
Inflation	year-on-year	3.5 - 4.9	3.5 - 4.9	2.9	2.9 - 3.2
	average year-on-year	4.1 - 4.9	3.6 - 4.2	3.3	3.3 - 3.4

¹ estimate based on actual development until October

3.2 Producer prices

UMP assumptions

- world oil prices (the principal external factor) will develop steadily in the first half of the year, and accelerate as the world economy recovers in the second half of the year
- stable development in food product prices (the most significant weight among industrial products) as a domestic cost factor.

Actual development since the beginning of the year

In the period from January to October 2002, industrial producer prices rose by an average 2.1% from year ago, mainly due to a slow price growth in the manufacturing industry (up 0.5%). Prices charged by electricity, natural gas, steam, and hot water producers, with a combined weight of nearly 34% of the industry, mounted by 7.5%, followed by mining and surface excavation products (up 7.2%).

At work behind a lower industrial price growth than projected in the UMP were domestic cost factors, including a slower than expected price growth in food products, especially meat and meat products due to cheaper imports and oversupply. As regards external cost factors, the ten-month period was marked by a fairly stable trend in world oil prices (in line with the UMP since March, within the OPEC benchmark band of 22-28 USD/barrel) and a gradual appreciation of the Slovak koruna, in particular against the USD.

Expected development until the end of the year

In the remaining part of the year, industrial producer prices may again be expected to rise slower than envisioned in the 2002 UMP.

A low demand for oil is bound to push its price towards the bottom of the 22-28 USD/barrel price range. Meanwhile, with the world economy supposed to recover, the oil price was expected to travel near the top of the range. As the Slovak koruna appreciates, estimated by the NBS to gain 6% against the USD in 2002, it will cushion the prices of imported inputs (annual appreciation against the USD likely to reach 14%).

Industrial producer prices will also be held back by domestic market conditions, in particular an ongoing positive trend in food industry prices and a sharp competition fuelled by swelling imports of higher quality products, which forces national producers to cut their sale margins and thus the prices as well.

Looking back at how industrial prices developed until October, and in line with the above assumptions, the NBS has scaled its UMP target for industrial price growth down by 1.4 percentage points to 2.1%.

Average annual price index (same period last year = 100)	2001 actual	2002 UMP	2002 January – October	2002 estimated (mean values)
Industrial producer prices	106.5	103.5	102.1	102.1

The prices of agricultural products, which have been trailing last year's levels in the recent months (the last time a year-on-year drop was recorded in 1999), are likely to follow a similar trend in the rest of the year. This is suggested mainly by developments in vegetable prices (sufficient grain supply on the national market), with meat prices possibly in for a small seasonal increase at the end of the year.

3.3 Foreign accounts

3.3.1 Balance of payments

The current account development has so far confirmed the assumption underlying the UMP, namely that the first half of 2002 will be affected by last effects of the world economic slump of 2001. Another assumption that still stands is that our largest trade partners will see their economies recovering in the second half of the year (although not as fast as initially expected), sparking growth in exports, and subsequently, imports, which will also be influenced by a dynamic development in end consumption.

The 2002 monetary program predicted a trade balance shortfall of SKK 92 billion. With the preliminary 2001 data in hand, but especially after seeing the performance in early 2002, the UMP scaled up the deficit figure to SKK 98 billion, meaning annual improvement by about SKK 5 billion, while the level of exports and imports was reduced. The foreign trade deficit amounted to SKK 73.6 billion for the first 10 months, up SKK 0.5 billion compared to the same period last year.

The development in foreign trade in September and October, when the deficit outstripped last year's figures, brought the cumulative foreign trade shortfall for the January-October period close to the level recorded in the same period in 2001.

The forecasts for the final months, supposed to bring signs of a world economic rebound as well as an expected rise in automobile exports, suggest that the trade balance may fare better in November and December 2002 than in 2001. If these assumptions fulfil, the trade balance deficit might finish at SKK 98 billion, improving by roughly SKK 5 billion from year ago.

SKK billion

Current account items	2002 – MP	2002 – UMP	1-8 / 2002	2002 – estimate
Balance of trade	-92.0	-98.0	-52.7	-98.0 (up to -103.0)
Exports	720.0	660.0	419.0	653.0
Imports	812.0	758.0	471.7	751.0
Balance of services	18.6	20.0	12.5	18.0
Balance of earnings	-16.8	-16.9	-12.2	-17.0
<i>thereof: balance of interest</i>	-14.6	-14.1	-8.6	-14.0
Current transfers	9.0	9.0	4.7	8.0
Current account	-81.2	-85.9	-47.7	-89.0 (up to -94.0)
Ratio of current account to GDP in %	-7.9	-8.3	-	-8.4 (up to -8.8)

The prediction that the foreign trade deficit in November and December might equal previous year's would result in a repeat of the 2001 annual deficit of SKK 103 billion.

The estimate for raw material imports is based on a rising average price of oil. On the other hand, the oil price increase in USD will be compensated by a stronger exchange rate of SKK against USD (if the current exchange rate were to hold until the end of 2002, the average SKK/USD rate would be SKK 45.5, down from the SKK 47.5 foreseen in the UMP), preventing any major upturn in oil imports in the last months of the year. The raw material imports figure will also depend on how the natural gas price behaves. The fact that cheaper gas resulted in a rising volume in 2002 means that, should the price of this commodity go on falling, the months ahead may bring only a slightly smaller drop in raw material imports.

Another important factor influencing the value of imports in 2002 is the development in imports of machinery and equipment (at present, investment demand lags behind expectations) and imports of end consumer products, which tend to swell in the final months of the year.

The development in the balance of services in 2001 inspired more optimistic expectations reflected in a higher surplus target in the UMP. Actual data for the first half of the year reveals a surprisingly heavy spending in the travel industry. Assuming that the trend would continue, the balance of services was scaled down from SKK 20.0 billion to SKK 18 billion.

Even though the balance of earnings ended the first half of 2002 with a deficit of SKK 11.1 billion, higher revenues expected in the second half (growing NBS reserves) as well as the repayment schedule for the second half mean that the UMP balance of earnings target may still be met.

The fact that the only way to project future development in current transfers is to look at past developments (which, however, are marked by a high degree of instability), caused a drop in estimated surplus by SKK 1.0 billion (based on developments so far).

Adjustments to individual components have led to a SKK 3 billion increase in the current account deficit forecast from SKK 85.9 billion (UMP) to SKK 89 billion (estimate). As a result, the ratio of the current account deficit to GDP would edge up from 8.3% to 8.4%. If things go worse than expected, both on import and export side, the current account deficit might reach 8.8% of GDP.

The capital and financial account reflects in particular more precise data on privatisation income (raised in the sale of SPP and distribution network operators) and the inclusion of debt recoveries. Changes in predicted portfolio investments and in the structure of short-term capital were made in accordance with actual developments so far.

The capital and financial account is expected to reach a surplus of SKK 235.1 billion (as compared to a SKK 244.4 billion surplus estimate set out in the UMP).

	SKK billion			
Capital and financial account items	2002 – MP	2002 – UMP	1-8 /2002	2002 – estimate
Capital transfers	1.0	5.0	2.8	5.0
Direct investments	147.0	197.4	147.0	189.9
in Slovakia	149.0	198.4	147.3	190.9
FDI – commercial sector	28.5	28.5	13.9	25.5
FDI – official sector *	120.5	169.9	133.4	165.4
Portfolio investments	20.1	35.4	7.0	32.6
Other long-term financial account	4.8	0.0	-7.2	3.0
<i>Assets</i>	0.0	0.0	-2.1	12.0
<i>Liabilities</i>	4.8	0.0	-5.1	-9.0
<i>Government + NBS</i>	-11.8	-12.5	-3.1	-16.5
<i>Commercial banks</i>	0.6	2.6	1.5	2.7
<i>Corporations</i>	16.0	9.9	-3.5	4.8
Short-term financial account	5.3	6.6	-2.1	38.0
<i>Assets</i>	-8.5	-17.4	5.0	28.0
<i>Liabilities</i>	13.8	24.0	-7.1	10.0
Capital and financial account	178.2	244.4	147.5	268.5
Interventions	0.0	0.0	9.1	-16.3

* FDI official sector – includes income from the sale of SPP (SKK 121.9 billion), Transpetrol (SKK 3.4 billion), SLSP (SKK 2.6 billion), SLKP (SKK 1.0 billion), Slovenská poisťovňa (SKK 6.3 billion), VÚB (SKK 3.8 billion) and expected income for ZSE, VSE, SSE (SKK 26.8 billion in total).

The aggregate net inflow of foreign direct investments dropped from the original SKK 197.4 billion to SKK 189.9 billion. In the official sector, the major change occurred in a lower SKK equivalent for the SPP sale (due to the USD/SKK exchange rate), which was partly offset by higher income from the sale of distribution network operations which rose from the original SKK 20 billion to SKK 26.8 billion, i.e. from USD 421 million to USD 623 million (Slovak government resolutions No. 537, 538, 539 of May 2002). The estimated inflow of FDI into

the commercial sector was scaled down in response to actual FDI developments in the first half of 2002.

A significant change also took place in portfolio investments, mainly on the asset side. The original estimate was adjusted to reflect the actual situation in commercial bank trading in securities.

As regards other long-term capital components, the most obvious change was observed on the asset side due to the inclusion of a financial settlement of a portion of Russian debt in September, with another instalment due in December. On the liability side, there was a lower withdrawal on long-term financing loans both in the government (a World Bank facility postponed) and the corporate sector (borrowing down by SKK 5 billion, with lower fixed asset imports being one of the likely causes).

The most significant changes in the capital and financial account were recorded in the short-term capital department. The estimate reflects not only a change in the volume, but also a change in the structure, building up over 2002. A considerably lower than projected inflow of foreign short-term funding, especially in the corporate sector (short-term liabilities fell from SKK 24 billion to SKK 10 billion), came on the back of the latest development in the balance of payments and the method of short-term financing. Apart from developments in short-term liabilities and portfolio investments, a setback in short-term banking industry assets (in contrast to a rise in short-term assets by SKK 17.4 billion assumed in the UMP, they are estimated to fall by SKK 28 billion) was also due to interventions against further appreciation of the Slovak koruna.

Higher growth in NBS reserves (from SKK 158.5 billion to SKK 179.6 billion) was fuelled by the central bank's foreign exchange market interventions and foreign exchange income from Russian debt recoveries. Foreign exchange reserves should reach USD 8,818.4 million at the end of 2002, which is enough for 5.7 months of average imports of goods and services.

SKK million

	2002	
	Adjusted**	Actual*
Current account	-82 163.0	-88 896.0
Capital and financial account	38 877.6	268 561.5
thereof: FDI in SR – equity interests	25 500.0	190 936.0
Unassigned items	0.0	0.0
NBS interventions	-16 332.0	0.0
Change in net foreign assets of commercial banks (- increase)	59 617.4	
Change in NBS reserves (- increase)		-179 665.5

* original balance of payments construction, i.e. with collections and payments affecting NBS reserves

** eliminating impacts of Slovak government and NBS activities not affecting commercial bank positions against non-residents, which do not represent real current account financing
in the original balance of payments design, interventions are included in NBS foreign exchange reserves

3.3.2 Foreign debt and debt service

Slovakia's gross foreign debt is expected to rise by USD 167.1 million to USD 11.679.6 million at the end of 2002. The increase will be split evenly between long-term and short-term debt. In terms of sectors, commercial sector debt is set to rise, as opposed to government and NBS debt which will decrease, in particular due to the repayment of a National Property Fund loan.

Year-end balance in USD billion	2001	2002 UMP	2002 estimate
Total gross foreign debt of the Slovak Republic	11.4	12.0	11.7
Total long-term foreign debt	8.2	8.3	8.2
thereof: official government and NBS debt	3.3	3.3	3.3
foreign debt of the commercial sector	4.5	4.9	4.9
Total short-term foreign debt	3.2	3.7	3.5
Net foreign debt of the Slovak Republic	2.0	0.1	-0.7

With foreign assets outgrowing gross foreign debt, we will be able to record a decline in net foreign debt (total gross foreign debt minus total foreign assets) to USD 0.7 billion at the end of 2002.

3.4 Gross domestic product

According to the UMP, GDP is expected to keep growing at a range between 3.5% and 3.8% in 2002. A higher base of 2001, as compared to UMP assumptions, and actual trends in selected indicators at the time the UMP was compiled indicated that real economic growth might come closer to the top of the target range.

Assumptions underlying GDP predictions for 2002 in the UMP:

- GDP growth stimulated by both foreign and domestic demand,
- rising domestic demand resulting from slower growth in fixed investments and more rapid growth in private consumption (with faster wage growth affecting consumption dynamics also considered a risk factor),
- despite a slowdown, fixed investments remain the fastest growing component of domestic demand,
- slightly growth stimulating effect of public consumption.

Comparison between the UMP and the GDP estimate for 2002¹

GDP at constant prices, year-on-year change in %

	MP 2002	UMP 2002	Actual 1 st half of 2002	2002 estimate
GDP at constant prices of 1995	3.5-3.8	3.5-3.8	3.9	3.8
Domestic demand therein	2.7	2.5	3.4	3.1
Final consumption total	3.5	3.4	5.8	5.4
<i>Final consumption of households</i>	4.1	3.8	5.6	5.9
<i>Final consumption of government and non-profit institutions</i>	2.1	2.5	6.4	4.3
Gross capital formation	1.0	0.7	-1.8	-2.4
<i>Gross fixed capital formation</i>	6.6	6.3	-0.3	0.5
Net exports				
Exports of goods and services	7.3	3.3	0.6	4.8
Imports of goods and services	6.1	1.8	-0.5	3.9

GDP at current prices and implicit deflator

	MP 2002	UMP 2002	Actual 1 st half of 2002	2002 estimate
GDP at current prices				
SKK billion	1032.0	1032.0	517.6	1063.0
Year-on-year growth in %	6.7	7.0	7.9	7.4
Implicit GDP deflator in % (year-on-year change)	3.0	3.1	3.9	3.5

Deficit of net exports of goods and services at constant prices

	2001	MP 2002	UMP 2002	2002 estimate
SKK billion	-28.7	-9.3	-20.9	-24.4

¹ The 2002 GDP estimate, in contrast to the MP and UMP, is based on revised data published by the Slovak Statistical Office in June 2002. Due to the data revision, the MP and UMP cannot be compared to actual developments according to the above structure.

Different trends as compared to the UMP and expected development until the end of 2002

As a result of ***a revision in national accounts indicators***², the GDP structure has changed since 1993 (the revised national account data were published by the Statistical Office of the Slovak Republic in June 2002).

This resulted in rise in annual GDP volumes in absolute terms at both current and constant prices. A considerable increase was registered in final consumption, in particular in the households sector (imputed rent). Likewise, the general government sector also recorded significant increases, with a relocation of selected institutions from the corporate sector to the general government sector being one of the reasons.

The trend in ***domestic demand*** observed in the first half of 2002 came as proof of a risk materialised, namely that faster wage growth, in particular in the public sector, would spur on final consumption. Final consumption was the dominant factor boosting domestic demand, gaining speed with every quarter. This trend was also driven by strong government and private consumption, which is likely to slow down a little by the end of the year.

The trend in ***final consumption of government*** was determined by anticipated pre-election effects and, in part, by the applicable accounting methodology (some operations, in particular those related to state budget expenditures, are recognised at the time of payment, rather than at the time the claim accrues). This methodology results in greater volatility in this particular segment of consumption, which may not reflect the actual consumption in a given period. With consumption booked in a period other than the one when the activity concerned was carried out, evaluation of public consumption is more difficult and distorted.

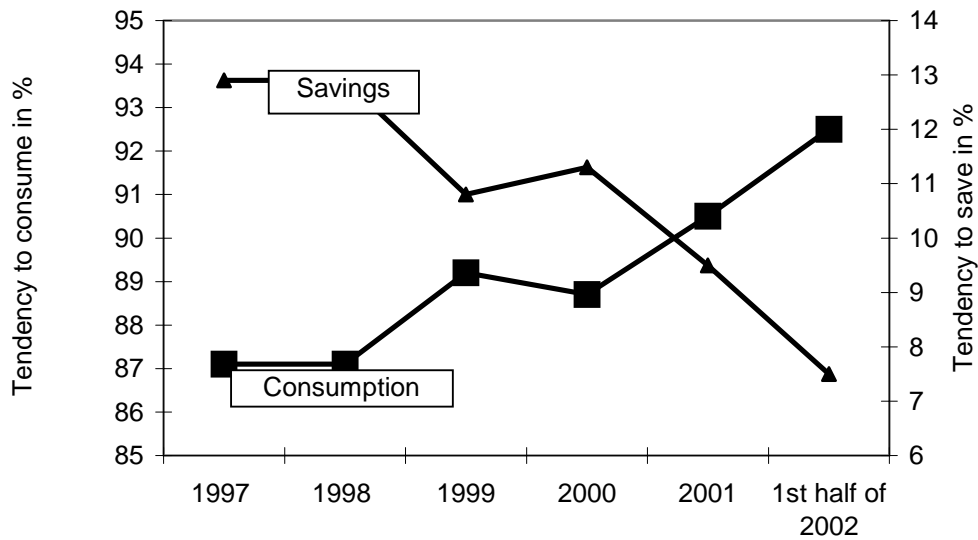
A more rapid growth was also recorded in ***final consumption of households*** as a consequence of rising gross disposable income households have left to spend after paying their current expenditures, in particular in form of taxes and social contributions. Current expenditures took up a smaller part of current income in the first half of 2002 (as compared with the first half of previous years), especially due to a reduced direct tax burden. Thus, households were left with a larger amount of gross disposable income to spend or save. So far, statistics seem to confirm a moderately growing tendency of households to spend, which continued in the first half of 2002 and could be supported by previously restrained household consumption. The upturn in private consumption may have been stimulated to a considerable degree by falling inflation, as past developments in the households account reveal an apparent tendency in households to watch the nominal value of their consumption spending.

Private consumption was on the rise, recording the highest growth since 1999 in the second quarter (5.9%). We are expecting the growth in private consumption to relent a little by the end of the year, also due to higher levels in reference periods (base effect).

² In the compilation of national accounts, the scope of ESA95 implementation was extended to include:

- a) calculation of fixed capital consumption in the general government and non-profit institutions sector
- b) output of insurance providers, broken down into life, general, and supplementary pension insurance
- c) imputed production of housing services to include lost profits
- d) extension in forestry production,
- e) forest crops included in production for final consumption of households
- f) solution of certain borderline cases in sector classification
- g) classified bank loans distinguished according to recovery prospects.

Utilization of gross disposable income



The sharpest contrast between actual values (and 2002 estimates) and the UMP was revealed in the *investment component* of domestic demand. Neither data collected so far nor any hints have sustained the predictions that investment demand would continue to rise at the projected relatively high rate. Fixed investments, the fastest growing item last year, started to decelerate in the last quarter of 2001 already, to turn around into a fall in the first half of 2002 (by 0.3%). Capital expenditures decreased in particular in the area of machinery investments (also reflected in slower investment imports of goods and services). Lower generation of fixed investments was attributed mainly to a major setback in business investments not reckoned with in the UMP. Growth in public sector investments also fell short of UMP expectations (e.g. the outset of the industrial park building program was slower than expected). Still, public investments take credit for preventing a sharp fall in investment demand (especially early in the year). By the end of the year, we expect some positive, though fairly low, growth in fixed investments, which may signal a turnaround to renewed growth in investment demand. A part of investment demand will still be related to industrial parks, reconstruction, and modernisation of existing infrastructure.

The trend in *foreign demand* observed in the first half of 2002 has proven the assumptions of fading (even though slower than expected) echoes of the world economic recession of 2001. Faltering foreign demand, combined with suppressed domestic investment demand, has added their share to slow down imports of goods and services. In the second half, we expect exports to rebound to the point that foreign demand might outstrip domestic demand. The recovery in foreign demand will be accompanied by accelerated growth in imports. After taking into account anticipated developments in import and export deflators (the risky part in foreign trade forecasts), we suppose the *net export* deficit to reach SKK 24.4 billion.

In 2002, neither consumer nor producer prices were rising as rapidly as assumed in the UMP. Actual price trends were reflected in implicit deflators of the basic components of domestic demand (in particular household consumption), which fell short of UMP targets.

With the above trends in mind, we expected GDP growth in 2002 to stay close to the top of the target range, largely due to the consumption element of domestic demand.

3.5 Wages and employment

The 2002 monetary program expected nominal and real wages to gain 7.0-8.0% and 2.4-3.3% year-on-year, respectively, with average annual inflation at 4.5% (midrange). However, as the National Bank of Slovakia pointed out in the monetary program, it would be desirable to keep nominal wage growth within 6%, i.e. at a level ensuring that labour productivity growth would stay ahead of real wages.

The updated monetary program predicted nominal wage growth at 7.5%, i.e. in the middle of the range set in the 2002 MP (7-8%). Real wages should go up to 3.5%, with average inflation at 3.9%.

Actual development

By the Slovak Statistical Office data, the average monthly *nominal wage* mounted 9.6% from year ago to SKK 12,811 in the first half of 2002. It means it outstripped last year's growth by 2 percentage points (and UMP predictions by 2.1 percentage points), recording higher growth in both quarters, notably in the second. As the wage development shows, predictions for growth in nominal wages underestimated the effect of an anticipated slow growth in consumer prices in 2002, but rather sought to align the nominal wage growth to price growth in the previous year and, thus, make up for at least a part of the real wage decline in the recent years. Growth in the second quarter was largely fuelled by mounting wages in non-market services, primarily in health and social care (up 22.9%), education (up 19.6%), and other public, social and personal services (up 19.6%) which can be attributed to the application of laws on state and public service from April 2002. Despite rapid growth, wages in all of these sectors have yet to reach the nation-wide average.

By NBS calculations (which can be taken as a rough guide only due to inconsistent database), individual industries' contributions to nominal wage growth in the first half of this year were as follows: manufacturing industries, agriculture and building industry a total of 3.37 percentage points, market services 3.59 percentage points, and non-market services 2.63 percentage points. Although the effect of wages in the public sector was **in part** reflected in the contribution of non-market services, non-market services include corporations. Excluding sectors subject to the law on state and public service, i.e. disregarding non-market services as well, nominal wages would rise 7.3% in the first half of the year. If nominal wage growth in non-market services reached the UMP level, the average nominal wage in the national economy would gain 7.7%.

The *real wage* was up by 5.5% year-on-year in the first half of the year, growing 5.4% faster than in the same period last year. Real wage growth (highest in four years) was driven not only by surging nominal wages, but was also helped by slower growth in average consumer prices, down 3.6 percentage points from the first half of 2001 to 3.9%.

Productivity of labour in GDP at current prices recorded an increase by 7.7% from year ago (up 7.0% in the first half of 2001), and by 3.7% at constant prices (as compared to 0.5% in the first half of 2001). Faster growth in productivity of labour at constant prices this year (up 3.2 percentage points) was the result of higher GDP growth (up 1 percentage point) and slower unemployment growth (down 2.2 percentage points).

Nominal wage growth outran productivity of labour in GDP at current prices by 1.9 percentage points, while at constant prices real wages outstripped productivity of labour by 1.8 percentage points (in case of nominal wage growth by 6%, as recommended by the NBS in the UMP, productivity of labour could have outstripped real wages by 1 percentage point). In the same period last year, nominal wages outgrew productivity of labour at current prices by 0.6 percentage points, while productivity of labour at constant prices outgrew real wages by 0.4 percentage points.

Productivity of labour in GDP per employee and wages in selected industries in the first half of 2002
(index, same period last year=100)

	Nominal		Real	
	Productivity of labour	Wage	Productivity of labour	Wage
Slovak national economy total	107.7	109.6	103.7	105.5
Thereof				
Agriculture	106.8	107.5	105.8	103.5
Industry	103.4	108.0	100.4	103.9
<i>raw material mining</i>	<i>114.6</i>	<i>107.5</i>	<i>100.7</i>	<i>103.5</i>
<i>manufacturing industries</i>	<i>99.2</i>	<i>107.9</i>	<i>98.1</i>	<i>103.8</i>
<i>production and distribution of electricity, gas, and water</i>	<i>137.9</i>	<i>109.4</i>	<i>132.4</i>	<i>105.3</i>
Building industry	116.7	102.8	110.2	98.9

Source: NBS calculations based on Slovak Statistical Office data

Among the industries mentioned above, the relation between wages and productivity of labour has taken the most adverse turn in manufacturing industries, where GDP dropped 1.8% from year ago (mainly due to a slump in metal and metal product output by over 20%) while employment remained unchanged.

By statistical reports, **employment** in the national economy increased by 0.2% from year ago, but slowed down by 2.2 percentage points as most industries reported falling employment rates.

Some 507,000 people were out of job at the end of June, with the **unemployment rate** reaching 17.6%. The jobless count exceeded last year's by 1,800, but the unemployment rate dipped by 0.1 percentage points. To some extent, the increase in the number of unemployed was the consequence of fewer people employed in publicly beneficial work (from 34,000 in June 2001 down to 18,000 this year). With the impact of public work disregarded, the jobless number would be about 4,000 lower than at the end of June 2002.

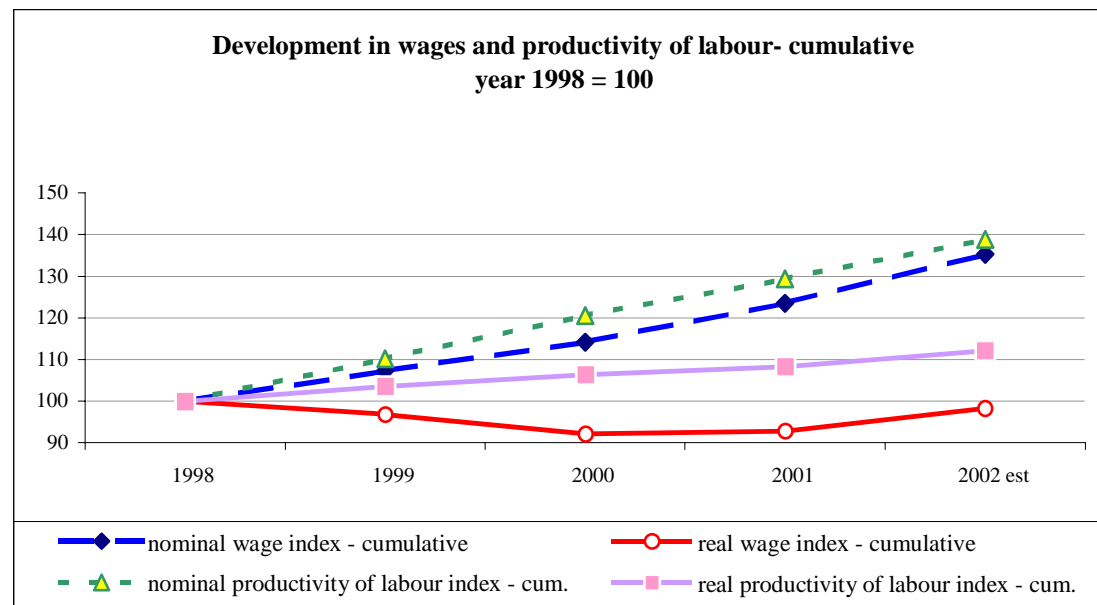
Expected wage development in 2002

We expect no major change in nominal wage trends in the second half of the year as compared to the first half. Wage growth in the public sector is likely to continue in particular in the third quarter at a similar or higher pace than in the second quarter, also due to severance money paid to persons released from the state and public service, prompting a decrease in employment in the process. A higher comparison base in the second half of the year may eliminate a small part of the growth, i.e. the second half of last year, in some economic sectors. Some of the growth momentum may also be absorbed by falling profits at non-financial corporations reported in the first half of this year, reflected mainly in variable wage components.

Consequently, we suppose the average growth in nominal wages might reach 9.7% in 2002, with real wages expected to mount 6%, in connection with the development of average consumer prices (3.5%).

As a result, wages are likely to outstrip productivity of labour in real terms by 2.4 percentage points, which is 1.9 percentage points worse than projected in the UMP and 3.4 percentage points worse than the wage growth recommended by the NBS. At work behind this development should be a nominal wage growth some 2.2 percentage points ahead of the estimate (or 3.7 percentage points above NBS recommendations) and average inflation about 1 percentage point lower than targeted in the MP, or 0.4 percentage points below the revised UMP estimate. However, the impact of the above factors will be compensated to some extent by faster growth in productivity of labour (0.8 percentage points ahead of the MP, and 0.6 percentage points ahead of the UMP) resulting from slower employment growth.

As the graph below indicates, provided that nominal wages and inflation stay on the projected track, real wages will again not quite make it to the 1998 level in 2002 (stopping 1.5 percentage points short), which may produce pressure on continued nominal wage growth in 2003.



Expected developments in employment and unemployment in 2002

A low employment growth in the first half of the year (up 0.2%) marked by a slowdown, or in fact a drop from year ago in most national economy sectors, combined with lower job creation under the publicly beneficial work program (half the 2001 level in the January-June period), imminent layoffs arising from the implementation of new state and public service laws, a sluggish start of industrial parks, and ongoing restructuring associated with downsizing in the banking sector, telecommunications, and other industries, indicate that employment growth in 2002 will not reach the pace set in the MP or UMP, and is more likely to stay around the level seen in the first half of this year. **That is why we expect employment to rise at a rate of 0.1-0.3% in 2002 (midrange 0.2%).**

The jobless number is set to swell in the final months of the year, as every year, as seasonal work in agriculture, forestry, and the building industry comes to an end and jobs in the publicly beneficial work sector are cut back. **We suppose registered unemployment to come in at 17-18% at the end of December.**

Comparison of wages, employment, and productivity of labour year-on-year change in %

	MP 2002	UMP 2002 (midrange)	Actual first half of 2002	2002 estimate midrange
Average monthly nominal wage	7.0 – 8.0	7.5	9.6	9.7
Average monthly real wage	2.4 – 3.3	3.5	5.5	6.0
Productivity of labour in GDP at constant prices	2.6 – 2.9	3.0	3.7	3.6
Real productivity of labour – wage	-0.1	-0.5	-1.8	-2.4
<i>NBS recommended wage growth</i>				
<i>nominal</i>	6.0	6.0	-	
<i>real</i>	1.4	2.0	-	
Average inflation rate	4.5	3.9	3.9	3.5
Employment	0.9	0.7	0.2	0.2

3.6 Public sector finance

With tax revenues expected to bring some SKK 7 billion more into the state budget than projected, and the income raised in Russian debt recoveries used as suggested, the budgetary targets are likely to be attained. Assuming balanced accounts in other public sector segments, this means the public budget deficit will not be exceeded either. However, after excluding one-off revenues (derived from privatisation, debt recoveries, and some non-tax income), and including the cost of bank restructuring and state guarantees exercised, the Ministry of Finance expects a public administration deficit of 7.8% of GDP by ESA95 methodology.

3.7 Monetary policy

3.7.1 Monetary aggregates

As regards monetary aggregates, actual developments in 2002 have strayed from the paths projected in the monetary program or in the updated monetary program especially in credits and money supply. During the year, commercial banks have turned up their lending activities to reach a growth of 12% in October by decreasing past methodology (or 8% by increasing present methodology), with the absolute volume surpassing the mark set in the updated monetary program. After standing virtually still for two years (partly in anticipation of privatisation at the largest banks), loans started to rise again in 2002 which is a trend we expect to last during the rest of the year.

By the end of the year, credits to enterprises and households should rise by 12.2% (decreasing past methodology), or 8.3% (increasing present methodology).

Despite a more rapid growth in credits and inflow of privatisation proceeds, money supply growth has slowed down to 7%, compared to a 11.4% target set in the updated monetary program. This was partly due to the fact that the privatisation income did not go into consumption, but was used to repay debts, with a portion set aside for a pension system reform. (Out of total revenues of SKK 153.9 billion, only 14 billion were used for purposes which did or still may affect consumption and M2. This includes further use of funds from payments made to towns for natural gas installations, health care payments, as well as payments in respect of participating interests).

In the last two months, we are awaiting income from a sale of the remaining portion of distribution network operations worth around SKK 4.6 billion, a setback in FNM's position (down SKK 8 billion from a surplus to level), and a worsening in state budget performance by some SKK 20 billion, as well as in other public sector components (from today's surplus to level). As these funds are released, they should boost money supply. That is why we expect growth in money supply to step up to 10% or so in the last quarter.

3.7.2 Monetary policy implementation

In 2002, the sterilising position of the banking sector has been growing, largely amid expectations of inflow of privatisation funds and NBS' foreign exchange market interventions.

The central bank has changed interest rates on three occasions in 2002, first raising all rates by 0.5 points in April and later cutting the two-week repo limit rate by 0.25 points. Heavier pressure on appreciation of the exchange rate of the Slovak koruna in mid-November prompted the NBS Bank Board to reduce the key NBS rates by 1.5 percentage points. At the same time, the NBS made an increased use of foreign exchange market interventions.

4. Monetary program for 2003

The economic situation and, thus, the environment in which to pursue the monetary policy objectives in 2003 will be determined primarily by Slovakia's planned accession to the European Union. An equally strong factor, make itself felt especially in foreign capital movement, will be Slovakia's invitation to NATO. Both factors are likely to lead to further upgrades in Slovakia's ratings by prominent rating agencies. As reforms get underway in the public sector (pension scheme, social care, health care, etc.), and with Slovakia making a clear commitment to try and meet the Maastricht criteria in the medium-term horizon, investments in Slovakia, or in Slovak assets, make become increasingly attractive.

However, apart from the positive effects – cheaper foreign funding for Slovak entities and possible FDI inflow – there will be some adverse side effects as well (with first signs seen in 2002 already). In particular, the pressure on nominal appreciation of the Slovak koruna is likely to step up. Exchange rate appreciation may have its good sides – it reduces prices and represents a certain way of "catching up" with more advanced countries by increasing the value of national welfare. On the down side, however, excessive appreciation may undermine the price competitiveness of Slovak producers to a point where it can no longer be compensated by higher productivity. The result could be a real production setback, followed by unwanted allocation of funds to non-tradable industries which, in an economy as open as Slovakia's, may cause a lingering recession and throw it off the track of catching up with advanced countries.

Individual economic indicators projected in the monetary program (and in the medium-term outlook) are based on an exchange rate of 41.5 SKK/EUR. This is a technical calculation based on the average exchange rate for the last period (October and November 2002). The annual average rate for 2002 was estimated at 42.6 SKK/EUR. The cross exchange rate of the euro against the dollar is expected to reach 0.99 in 2003, i.e. the SKK/USD rate is 42.

The estimates of individual economic variables in the 2003 monetary program do not assume any new change in NBS interest rates, and the calculations of individual variables were based on constant monetary conditions.

4.1 Inflation

Inflation estimate for 2003

Basic assumptions:

- **a raise in regulated prices** plus a change in VAT in the extent suggested in available information. Their direct impact should cause a rise in headline inflation by some **4.5 percentage points**. Increases in other administered prices are supposed to add **0.4 percentage points** to inflation,
- **a raise in excise taxes** expected to add up to **0.5 percentage points** to inflation,
- **a reduction in the basic VAT rate from 23% to 20% and a raise in the lower VAT rate from 10% to 14% with an estimated impact on inflation of 0.3 percentage points**,
- as in the recent years, cost inflation should again play the main role in the development of consumer prices in 2003,
- indirect impact of higher regulated prices of energy charged to firms, translated into consumer prices,
- relatively steady exchange rate of the Slovak koruna against the euro as the benchmark currency, a stable EUR/USD exchange rate,
- stable development in commodity prices on world markets (oil price ranging between 22 and 28 USD/barrel),
- no major demand inflationary pressure,

- food prices growing faster in 2003 (secondary impact of regulated energy prices),
- low imported inflation and strong retail competition (impact on the pace of growth in tradable goods).

Regulated prices

There are some major changes coming in January 2003 in the institutional jurisdiction in price regulation. Most prices previously regulated by the government, or the Ministry of Finance of the Slovak Republic, will now fall into the competence of regulatory authorities. For more details on price regulation, refer to Annex 1.

The overall impact of changes in individual regulated prices on inflation would add up to 4.5 percentage points if our estimates turn out to be right.

Estimated impacts of regulated price adjustments on inflation in 2003

Representative	Translated weight	Expected raise including VAT change	Contributions in % points
	Electricity	3.9	29.2
Heat	4.8	6.7	0.3
Natural gas	2.4	56.4	1.4
Railway transportation	0.3	19.2	0.1
Bus transportation	2.3	19.2	0.4
Water supply	1	39.9	0.4
Sewerage	0.7	34.7	0.2
Rent	0.6	95.0	0.6
SUM	16		4.5

There is also a likely increase in store in other practically controlled prices, which will add 0.4 percentage points to inflation.

Excise taxes

Excise taxes are also going to change next year in January. Under adopted revisions to relevant laws, the excise on beer and wine are in for an adjustment. In case of beer, the tax on 10° beer is set to increase, while the tax on 12° beer should decrease. In wine, there will be a higher tax on semi-products. Nevertheless, these changes are probably going to have next to no effect on headline inflation.

Due to a commitment to gradually raise excise on cigarettes all the way up to EU level by 2008 (see table in Outlook until 2006), a revised bill was passed which comes into force on 1 January 2003. This means that the impact of changes in excise taxes on headline inflation could reach up to 0.4 percentage points.

Another change expected in the area of excise taxes is a raise in excise on mineral oils, with effect on headline inflation estimated at 0.1 percentage points.

Value-added tax

Effective from 2003, the basic VAT rate is set to go down from 23% to 20%, and the lower rate to go up from 10% to 14%. There is a certain deal of uncertainty as to the impact these changes may have on consumer prices. The effect on prices of goods and services may be bigger or smaller. In goods and services marked by stronger competition, the VAT raise may go completely unnoticed in consumer prices, while the VAT reduction may show in full extent. In contrast, where competition is not as severe, prices of goods and services may come to feel

the full, or a greater, force of the tax raise, whereas the tax cut may not show at all. The impact on headline inflation of new VAT rates in respect of non-regulated prices is estimated at 0.3 percentage points.

Core inflation

The development in core inflation in 2003 will be largely influenced by rising domestic cost pressures set off by price deregulation, resulting in higher growth in prices of foodstuffs and market services.

Food prices

Food prices are likely to bring an element of uncertainty into inflation developments in 2003. Apart from the 2002 harvest, their dynamics will also depend on the ability of processing plants, in particular those of meat processing, to adapt to the veterinary conditions applied by the European Union by the end of 2003. A failure to live up to the challenge may see some processing operations go out of business, spelling major changes for the market. On the other hand, competition in retail trade, gradual liberalisation of trade between Slovakia and the European Union in certain agricultural commodities, and moderate growth in real wages will counteract to cushion prices in this particular sector.

Fuel prices

In fuel prices, as one of the risk factors in inflation predictions, we should feel the effects of a supposedly steady exchange of the Slovak koruna against the U.S. dollar and oil prices staying within the OPEC reference range. One risk, which might affect fuel prices, is a possible military attack of the U.S. against Iraq.

Tradable goods without fuel and market services prices

The key assumption behind price developments in these sub-aggregates is an increasing role of cost factors. For prices of tradable goods and market services, it will be crucial to wait and see how the forthcoming change in VAT rates reflects in consumer prices.

Price growth in the tradable sectors should be kept in check in by low imported inflation and a full-grown competition at retail level.

Regarding prices of market services, cost factors should be the main force at work, which is confirmed by trends in prices of market services in 2002, which in the absence of deregulation of administrative prices, have barely moved. On the other hand, little demand pressure might provide an absorbing effect.

Based on the assumptions described above, headline inflation might reach 7.7-9.7% at the end of the year, with average inflation at 8.2-9.3%, core inflation at 2.7-5.0%, and net inflation at 2.9-4.5%.

Inflation estimates for 2003

	2003 monetary program	
	price increments in % Dec02/Dec01 (share in total increment in %)	
	min	max
Total	7.7	9.7
Regulated prices	19.2 (4.64)	20.6 (4.98)
Impact of changes in indirect taxes in non-regulated prices	(0.80)	(0.80)
Core inflation	2.7 (2.22)	5.0 (3.96)
<i>thereof: Foodstuffs</i>	2.3 (0.57)	6.5 (1.39)
<i>Tradable goods</i>	2.2 (0.86)	3.2 (1.23)
<i>Market services</i>	4.2 (0.79)	7.3 (1.34)
Net inflation	2.9 (1.65)	4.5 (2.57)

Risks to the 2003 estimates:

- development in food prices (as food firms adapt to EU veterinary and phyto-sanitary requirements, which must be met by the end of 2003, with possible impact on prices in the meat processing industry)
- development in fuel prices (oil prices and possible war in Iraq),
- development in domestic demand in relation to wage growth,
- development in the SKK/USD exchange rate, as well as the EUR/USD cross rate,
- change in the extent of adjustments to regulated and practically controlled prices, indirect and excise taxes
- impact of changes in VAT rates on consumer prices
- development in inflation in EU countries
- yet unclear stance of the Slovak Statistical Office on the new form of price regulation (how to replace the current maximum prices in the consumer basket)

		Actual October 2002	2002 UMP	2002 estimate	2003 estimate in 2002 UMP	New 2003 estimate
Inflation (%)	Year-on-year	2.9	3.5-4.9	3.2-3.8	6.5	7.7-9.7
	Average year-on-year	3.3	3.6-4.2	3.4-3.5	6.4	8.2-9.3
Core inflation (%)	Year-on-year	1.7	3.2-4.7	2.2-2.8	4.0	2.7-5.0
	Average year-on-year					2.9-4.1

4.2 Producer prices

Assumptions behind the development in producer prices:

- oil prices stabilising at 22-28 USD/barrel,
- relatively steady exchange rate of the Slovak koruna against the euro as the benchmark currency, a stable EUR/USD exchange rate
- food prices growing faster in 2003 (secondary impact of increased regulated energy prices)

The principal factor determining how industrial prices are going to behave is the expected change in regulated prices charged by electricity, natural gas, and heat suppliers, which are coming under the jurisdiction of the Network Industries Regulatory Authority (hereinafter "NIRA") in 2003.

Electricity

In March 2002, the NIRA published a decision specifying the extent of price regulation in respect of electricity supplies to so-called protected customers³. By NBS estimates, electricity prices charged to the group of firms noted above should grow by an average 18% from 1 January 2003.

Our estimate for the total increase in prices charged by electricity producers is based on the following facts:

1. the price of electricity sold to households will rise by 24.7% (households' share in total national electricity consumption is about 15%, the manufacturing sector accounts for around 85% of total consumption)
2. the price of electricity sold to protected customers (industrial producers) will increase by around 18% (protected customers account for about one-third of electricity consumed by the industrial sector)
3. the price of electricity charged to eligible customers remains probably unchanged (eligible customers take about two-thirds of electricity consumed by the industrial sector)

Based on the above, we suppose the average price charged by electricity producers for all types of deliveries should rise by 8.8%.

Natural gas

The NIRA has also published a decision defining the method for calculation of maximum prices for natural gas deliveries. Under the decision, by early NBS estimates, the average natural gas price (industrial consumption + households) can be expected to go up by 32% (VAT exclusive). In estimating the impact of the price increase on prices charged to the industrial sector, the NBS looked at the current situation on the Slovak market, where natural gas sells to households at prices lower than those paid by industrial consumers despite higher distribution costs. This implies that, assuming that natural gas prices for households rise by 44% (for details see Annex 1) and the average natural gas price rises by 32%, the prices for industrial consumption should go up 28%.

³ Protected customers include enterprises consuming less than 100 GWh of electricity in 2001, which currently account for roughly a half of total electricity consumption. After 1 January 2003, the number of protected customers is bound to fall as the cut off will be lowered to 40 GWh. That will expand the ranks of enterprises (referred to as eligible customers with annual consumption over 40 GWh), which will not be directly subject to the price determined by the NIRA, as they will be free to choose their electricity suppliers (including foreign suppliers) after the opening of the electricity market.

Heat

Heat prices charged to manufacturers will depend on the natural gas price. The cost of fuel makes up about 45% of the price of heat, which means that (assuming a 28% rise in natural gas prices) producers should be paying some 12.6% more for heat supplies in 2003.

Among domestic cost factors, sharpening competition may turn out to be the leading factor absorbing some of the pressure on industrial prices. If Slovakia enters NATO, and if it is fit to join the EU in 2004, foreign investments are likely to grow in 2003, bringing an array of new competitive firms in their wake. In an effort to hold on to their market shares, domestic producers will be forced to keep their product prices at a competitive level (mainly by increasing production efficiency) regardless of the fact that the cost of power inputs will grow faster in the next two years than in other countries.

External cost factors (world oil prices edging down throughout the year) will probably have a stabilising effect on industrial producer prices. This suggestion is based on the assumption that oil prices will hover near the top of the OPEC range in late 2002 (22-28 USD/barrel) and that OPEC will go on trying to hold the price around the middle of the range in 2003.

Provided that energy producer prices will be raised by the NIRA from 1 January 2003 (electricity up 8.8% on average for all types of deliveries, natural gas up an average 32%, heat up an average 12.6%), the average growth in prices charged by electricity, natural gas, steam and hot water producers should come out to 14%, with their contribution to industrial price growth representing about 5.3 percentage points. With the increase in energy prices (especially gas) counted in and with the impact of endogenous and exogenous cost factors considered, prices of industrial products may go up 1.7% on average, adding some 0.6 percentage points to the industrial price growth. **Under the above assumptions, industrial producer prices would post a year-on-year increase by 5.9% (5.3+0.6). A look at the structure of industrial prices dynamics shows that nearly 90% of the increase will come from energy producers' prices. In spite of possible secondary impacts of higher energy prices, prices of industrial products are likely to grow at a moderate pace (1.7%), suggesting that, provided domestic producers outstrip their foreign rivals in terms of growth in productivity of labour as expected, Slovak products should be able to stay competitive.**

Average annual price index (same period last year = 100)	2001 actual	2002 estimate (mean values)	2003 projection
Industrial producer prices	106.5	102.1	105.9

A downtrend in prices of agricultural products in 2002 should turn around into a rise next year due to several cost factors. The greatest growth incentive is likely to come from adjustments in regulated prices of individual types of energy, which will subsequently show through in prices of chemicals and other industrial products used as inputs in agriculture.

Risks to the prediction

The hazard to price developments lies in the process of adaptation of food firms to veterinary requirements of the European Union, which must be met by the end of 2003. In the food industry, this is likely to cause problems especially for meat processing firms, of which only few conform to the conditions. A failure to handle the process may force most business to shut down their operations and leave the market, which in turn will hit farmers who would lose their customers.

Other risks:

- oil price development and possible armed conflict in Iraq
- development in the SKK/USD and EUR/USD exchange rate

4.3 Foreign accounts

4.3.1 Balance of payments

In 2003, we expect the current account deficit to decrease as a result of better performance in the balance of trade.

Current account items	SKK billion
	2003 – MP
Balance of trade	-85.0
Exports	720.0
Imports	805.0
Balance of services	20.0
Balance of earnings	-16.0
<i>thereof: balance of interests</i>	-13.0
Current transfers	8.0
Current account	-73.0
Ratio of current account to GDP in %	-6.2

On the export side, the development in foreign trade will be determined by a gradual economic recovery of our main trade partners in 2003.

The volume of exports should gain 10.3% from year ago. Growing GDP and imports in the EU countries should lead to increased exports of not only semi-finished goods, but machinery and finished products as well. The amount of machinery and equipment exports should be influenced by expanding production and exports of the automobile industry (higher exports also reflect a higher price of a new type of car).

On the import side (up 7.2% from year ago), there will be two contradicting tendencies at work. Rising production (giving rise to yet another increase in imports of semi-finished products) will combine with expected growth in fixed capital to generate higher growth in imports. An increasing investment demand for special types of investments, especially in the area of environmental protection, may rekindle the pressure on larger imports of machinery and equipment in 2003. On the other hand, the expected consolidation in public finance and an increase in regulated prices should keep end consumption in check and, with it, imports satisfying the consumption of households and public administration.

The expected increase in the price of oil from USD 25 to USD 26 per barrel should not cause any major rise in oil imports. The volume of raw material imports will depend on the natural gas price, with an increase putting additional pressure on more imports.

If the assumptions set out above materialised, the foreign trade deficit would reach SKK 85.0 billion.

The **hazards** in the foreign trade estimate for 2003 lie on both the export and import side. Exports may grow slower than expected if the assumptions concerning economic development in EU countries do not materialise, or if the exchange rate of SKK against foreign currencies

takes a different course. A combination of a strengthening Slovak koruna and growing producer prices may undermine the competitiveness of Slovak products and, eventually, slow down exports (plus, a stronger koruna may step up imports in volume terms).

The balance of services is expected to follow the path outlined in 2002. The bulk of the surplus in services will be delivered by steady income collected in form of transit fees for natural gas and crude oil shipments to the Czech Republic and west Europe. An SKK 20 billion surplus in the balance of services will just surpass the 2002 level, with the increase in net income from transportation and tourism partly reduced by growing expenditures on other services.

A stable development in indebtedness will be reflected in the amount of interest paid to other countries. The balance of earnings will close with a shortfall of SKK 16 billion in 2003, expected to dip slightly from 2002 in SKK terms due to the exchange rate of the Slovak koruna. (Despite growing NBS foreign exchange reserves, the balance of earnings is not improving due to falling revenues on this type of assets. The cost of liabilities is falling slower, if at all).

With the balance of current transfers expected to stay at the 2002 level of SKK 8.0 billion, and other items developing as expected, the current account should come in with a deficit of SKK 73 billion, i.e. 6.2% of GDP.

Capital and financial account	SKK billion
	2003 – MP
Capital transfers	8.0
Direct investments	41.0
in Slovakia	42.0
FDI – commercial sector	30.0
FDI – official sector	12.0
Portfolio investments	16.0
Other long-term financial account	-31.5
<i>Assets</i>	0.0
<i>Liabilities</i>	-31.5
<i>Government + NBS</i>	-38.5
<i>Commercial banks</i>	1.0
<i>Corporations</i>	6.0
Short-term financial account	7.7
<i>Assets</i>	-4.0
<i>Liabilities</i>	11.7
Capital and financial account	41.2
Interventions	0.0

Foreign direct investments (FDIs) could amount to SKK 41 billion in 2003. The bulk of the SKK 42 billion worth of FDIs arriving in Slovakia will flow into the commercial sector (SKK 30 billion), while we also expect allocations to investment parks, which will promote green field investments. In 2003, we reckon with privatisation income of SKK 12 billion from the sale of state interests by the National Property Fund (Slovenské elektrárne). (No follow-up privatisation revenues are expected in 2003).

Net portfolio investments might reach SKK 16 billion in 2003. Incoming portfolio investments are supposed to stay around the 2002 level, the better part taking the shape of corporate bond

issues floated on foreign markets (portfolio investments do not include redemption of government bonds which, for the sake of clarity, were included in government liabilities).

Net other long-term investments should end with an outflow of SKK 31.5 billion, primarily influenced by instalments of financing loans on the liability side. Government sector liabilities will be affected by payments of principal on government bonds (some SKK 38 billion). Financing loan withdrawals in the corporate sector are estimated at SKK 57 billion, just ahead of corporate loan repayments, which grow every year.

The balance in short-term capital (SKK 7.7 billion) is the result of a conservative estimate, based on the assumption that short-term capital will not play any important role in the financial account composition.

Foreign exchange reserves will drop to USD 8,058.9 million at the end 2003, covering about 4.4 months of average imports of goods and services.

4.3.2 Foreign debt

The gross foreign debt should drop by USD 167.4 million to USD 11,512.2 million in 2003. Principal repayments on government bonds will reduce the official foreign debt by USD 820.1 million. Other long-term foreign debt is set to expand (by USD 375.1 million), partly due to heavier corporate borrowing in form of financing loans and securities issues floated on foreign markets. Financing of imports by short-term trade loans will lead in 2003 to a rise in short-term indebtedness (by USD 277.9 mil.).

Year-end balance in USD billion	2001	2002 UMP	2002 estimate	2003 MP
Total gross foreign debt of the Slovak Republic	11.4	12.0	11.7	11.5
Total long-term foreign debt	8.2	8.3	8.2	7.8
thereof: official government and NBS debt	3.3	3.3	3.3	2.5
foreign debt of the commercial sector	4.5	4.9	4.9	5.3
Total short-term foreign debt	3.2	3.7	3.5	3.7
Net foreign debt of the Slovak Republic	2.0	0.1	-0.7	0.1

The turnaround from a net creditor to a net debtor position in foreign debt in 2003 by USD 0.8 billion will be the consequence of mounting corporate debt.

4.4 Gross domestic product

We may expect to see some reshuffles in GDP structure in 2003. A shift from domestic to foreign demand will be driven by an expected economic rebound in our largest trade partners combined with the export effects of earlier foreign direct investments made in Slovakia. **Foreign demand** should deliver the greatest thrust to GDP growth, expanding at roughly twice the pace of domestic demand. We suppose the expansion in domestic and foreign demand to translate into real GDP growth between 3.7 and 4.1% in 2003.

GDP at constant prices, year-on-year change in %

	MP 2002	UMP 2002	2002 estimate	MP 2003
GDP at constant prices of 1995	3.5-3.8	3.5-3.8	3.8	3.9 (3.7-4.1)
Domestic demand	2.7	2.5	3.1	3.2
Domestic effective demand (net of change in inventories and statistical discrepancy)	4.5	4.3	4.0	3.2
therein				
Final consumption total	3.5	3.4	5.4	2.5
<i>Final consumption of households</i>	4.1	3.8	5.9	3.0
<i>Final consumption of government and non-profit institutions</i>	2.1	2.5	4.3	1.1
Gross capital formation	1.0	0.7	-2.4	5.1
<i>Gross fixed capital formation</i>	6.6	6.3	0.5	4.9
Net exports				
Exports of goods and services	7.3	3.3	4.8	5.9
Imports of goods and services	6.1	1.8	3.9	5.0

GDP at constant prices, contributions to growth in %

	UMP 2002	Actual 1 st quarter of 2002	Actual 2 nd quarter of 2002	2002 estimate	MP 2003
GDP at constant prices of 1995	3.5-3.8	3.9	4.0	3.8	3.9
Domestic demand	2.5	2.7	3.4	3.2	3.3
Therein					
Final consumption total	2.5	3.7	4.4	4.0	1.9
– <i>Final consumption of households</i>	2.0	2.7	3.0	3.1	1.6
<i>Final consumption of government and non-profit institutions</i>	0.5	1.0	1.4	0.9	0.2
Gross capital formation	0.0	-1.0	-1.0	-0.7	1.5
<i>Gross fixed capital formation</i>	2.0	-0.2	0.0	0.2	1.4
Net exports	1.3	1.2	0.6	0.6	0.6
Exports of goods and services	3.7	-3.4	4.0	3.8	4.7
Imports of goods and services	-2.4	4.6	-3.4	-3.2	-4.1

GDP at current prices and implicit deflator

	MP 2002	UMP 2002	2002 estimate	MP 2003
GDP at current prices SKK billion	1032.0	1032.0	1063.0	1170.0
Year-on-year increase in %	6.7	7.0	7.4	10.1
Implicit GDP deflator in % (year-on-year change)	3.0	3.1	3.5	5.9*

* assuming average inflation rate of 9.0%

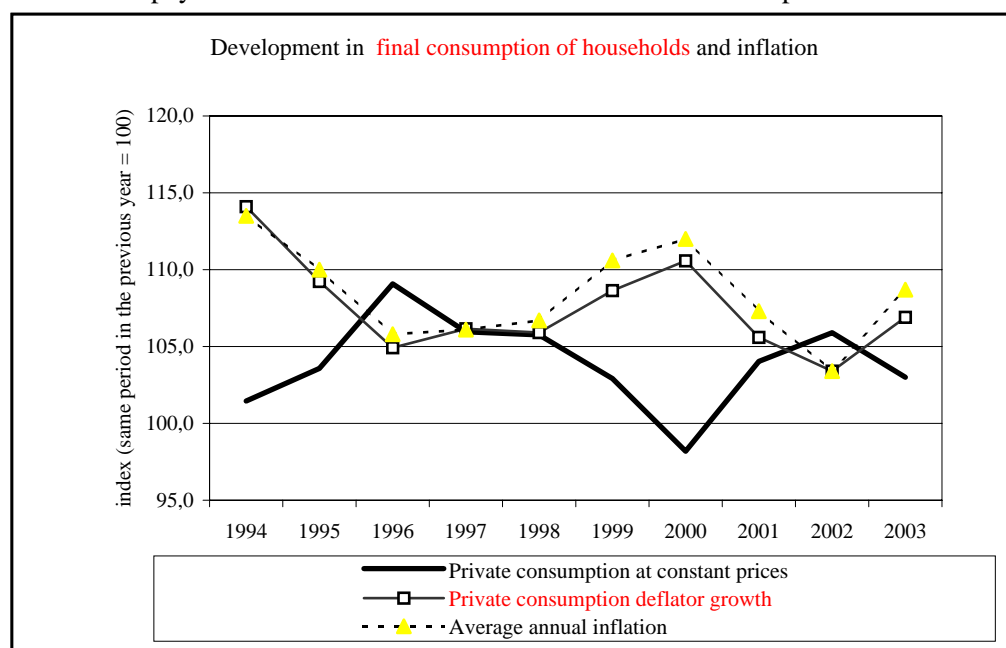
Deficit of net exports of goods and services at constant prices

	2001	MP 2002	UMP 2002	2002 estimate	MP 2003
SKK billion	-28.7	-9.3	-20.9	-24.4	-20.0

As regards the structure of *domestic demand*, we may expect a positive move from consumption to investments. Given an anticipated setback in consumption as opposed to a revival in investment demand, we expect the growth in domestic effective demand (disregarding change in inventories) to slow down from the 4.0% predicted in 2002 to 3.2% in 2003.

A reduced purchasing power of the population caused by higher inflation is supposed to dampen the growth in *private consumption* to roughly half the 2002 level. Unlike in the 1999-2000 period, we should not see any collapse in private demand with an economic action package in place. The reasons described below should bring about an increase in private consumption:

- the predicted nominal wage growth of up to 10% does not lead to a decline in real wages (unlike in 1999 and 2000, when it dropped 3.1% and 4.9%, respectively),
- a fairly high level of private consumption in 2002, and the consequent downtrend in gross savings in the household sector in 2003,
- with the ranks of self-employed swelling in the long run, we are expecting to see a growing share of gross mixed income in current household income (drawn from business profits)
- with the tax and social security burden stabilising, there will be no extra current expenditures (or they will grow at a slower pace) that households have to pay from their current income and cannot choose to spend otherwise.



In the *general government* sector, we do not expect public consumption to further accelerating; on the contrary, it should level out around the 2002 level in nominal terms. An expected growth in total consumption of government by 5.7% at current prices, combined with anticipated inflation (and the implicit deflator of total consumption of government), will result in a slight increase (1.1%) in total consumption of government at constant prices, as compared to the previous period.

As consumption decreases, GDP growth can only be supported by *investments*, provided that conditions are created for a gradual accumulation of own investment funds at enterprises, including easier access to loans for small business in particular.

That is why we expect the following incentives to facilitate further growth in investment demand:

- speedier local government investments in the public sector designed to build the infrastructure, buy up, lease and set aside land needed for industrial parks,
- a considerable part of investments will be required by stricter environmental policy in Slovakia and its harmonisation with the EU policy, including the adaptation of the institutional and business sector to more stringent environmental standards and the implementation of environmental programs,
- continuing highway and expressway construction in Slovakia,
- sharpening competition in the market for real estate building and reconstruction financing, and more affordable credit products (home savings banks, mortgage loans) to finance building investments in the households sector,
- lower interest rates,
- foreign investors perceiving greater economic stability in the context of a rating upgrade and Slovakia's pending accession to NATO and the EU.

Despite an expected rise in fixed investments by 4.9% (at constant prices) in 2003, the share of gross fixed capital formation in GDP should increase only slightly (from 29.4% in 2002 to 29.7% in 2003 at constant prices). With growing fixed investments and an expected decline in inventories, the gross investment rate can thus reach 29.1% at constant prices (28.8% in 2002). The better part of the increase can be covered with gross domestic savings, estimated by NBS to reach 26.5% in 2003 (as compared to 25.4% in 2002). With respect to increasing competitiveness of the Slovak economy (with its beneficial effects on labour productivity and real convergence), this trend may be considered sustainable, given a reasonable fiscal policy and the awaited FDI inflow.

As far as the internal structure of investments, we are expecting no substantial changes. About 55% of investments will go into machinery, 40% into buildings, and the rest into other products and agricultural commodities.

Renewed investment demand (at about half the investment rate recorded in 2001) leads to higher investment imports which, combined with growing output and necessary imports of semi-finished products and raw materials, should step up *imports of goods and services*. With exports and anticipated price trends in foreign trade taken into account, we expect the *net export* deficit to amount to SKK 20.0 billion.

Year-on-year absolute changes in nominal values in SKK billion (current prices)

	1 st half of 2001	1 st half of 2002	2002 estimate	MP 2003
GDP	41.5	38.1	73.7	107.0
Domestic demand, thereof:	75.0	36.3	74.0	92.0
Final consumption total	29.3	31.5	67.4	74.0
Final consumption of households	22.1	23.0	52.1	61.3
Final consumption of government and non-profit institutions	7.2	8.5	15.2	12.7
Gross fixed capital formation	23.6	4.6	8.6	32.8
Net exports	-34.3	0.9	-0.3	15.0
Exports of goods and services	56.4	3.8	43.7	76.0
Imports of goods and services	90.8	2.8	43.9	61.0

Risks to GDP development in 2003

If exports of goods and services fall behind the projected pace, due to overdue economic recovery in EU countries (or due to faster growth in imports), and investment activity increases slower, real economic growth may be expected to move near the bottom of the range (3.7-4.1%) in 2003.

In case foreign direct investments inflow tops expectations and changes in regulated prices have smaller implications on final consumption of households, real economic growth may come close to the top of the range.

4.5 Wages and employment

Assumptions and expectations behind wage development in 2003

We suppose the development in nominal wages in 2003 to be determined mainly by the facts listed below:

- growth in nominal and real wages observed in 2002
- average inflation recorded in 2002
- projected average inflation in 2003 and the situation in employment (and, possibly, wage growth fuelled by money saved by downsizing)
- in the business sector, the financial results achieved in 2002 and forecasts for 2003, developments in the cost and productivity of labour, as well as available funds needed to sustain wage growth
- development in the labour market, in particular in regions afflicted with high unemployment where, despite a fair number of job opportunities, wages are pushed downward
- wage development in the public sector

With average inflation expected to rise at a quite rapid pace in 2003, the stage seems to be set for an adequate increase in nominal wages. Excessive growth should be held in check by a high growth expected in real wages in 2002 (there is no need for a greater alignment of wages from previous periods). Meanwhile, companies applying remuneration policies whereby the current year's wages are adjusted for inflation reported in the previous year are set to take advantage of low average inflation in 2002. Given the share of the private sector in national employment (nearly 70%), we may suppose that one of the main objectives in wage and employment policies will be to link wages to a desirable growth in productivity of labour, leading to a cautious wage policy, also in the context of Slovakia's likely accession to the EU.

In the corporate sector, wage rate adjustments, but especially the bonus system, are tied to financial performance in the previous year as well as financial possibilities in the current year. Financial results reported by non-financial organisations in the first half of 2002 (profits

dropping by more than 14% from year ago in profit makers, and losses soaring by nearly 60% in loss makers), as well as by the financial sector, where financial institutions saw their profits shrink by almost 20% and insurers and pension funds by over one-third, indicate a possibly smaller potential for wage growth in 2003.

Knowing the above and the basic principle applied in wage negotiations, namely that nominal wages should grow at a rate not only making up for inflation, but also increasing real wages by at least 1-2%, we may expect corporate sector wages to grow just ahead of projected average inflation. According to Slovak government statements, real wages in the economy should edge up 0.3%, and 1.5% in the public sector.

The risk with the public sector is to see to what extent a change in laws adopted by the parliament can take place and stave off possible pressure on wage growth through new bills brought during the year. Plus, it also remains to be seen how acceptable the suggested wage and salary growth will be in the current state budget with respect to the structure of state budget expenditures.

Another hazard to keep in mind is the possibility of cancellation of district offices and the resulting dismissals, with the severance pay potentially affecting average wages.

	year-on-year change in %				
	MP 2002	UMP 2002 (midrange)	2002 estimate	MP 2003	MP 2003 mean
Average monthly nominal wage	7.0 – 8.0	7.5	9.7	9.0 – 11.0	10.0
Average monthly real wage	2.4 – 3.3	3.5	6.0	0.3-2.1	1.2
Average inflation rate	4.5	3.9	3.5	8.7	8.7
Productivity of labour in GDP at constant prices	2.6 – 2.9	3.0	3.6	3.4	3.4
Employment	0.9	0.7	0.2	0.5	0.5
Unemployment rate at the end of period	-	-	17.0 – 18.0	17.5-18.0	17.75

Assuming the expected increase in productivity of labour in absolute terms by 3.4%, we believe it would be acceptable for nominal wages to gain up to 10% which, given the average inflation forecasts, would provide enough room for productivity to outgrow real wage.

Assumptions and expectations behind the development in employment and unemployment

Employment is likely to carry on rising in 2003, picking up speed slightly.

Growth should be driven by:

- possibly larger inflow of foreign investments ahead of Slovakia's expected accession to NATO and the EU
- combined with a stable exchange rate of the Slovak koruna, there may be room for a more vigorous investment activity which, in turn, may boost employment
- investments by higher territorial units and local governments which, after a delegation of powers, will gain more room for operating investments, development of the automobile industry, and continued highway construction.

Employment may also be influenced by government activities, specifically:

- pro-active employment activities carried out by employment offices,
- greater commitment on part of the government to support small businesses and self-employed entrepreneurs,
- as legislative conditions are created and harmonised with EU law to facilitate state investments, investment activities should gradually spread to regions troubled by higher unemployment lying further away from the ruling centre and by creating new jobs, tackle the unemployment problem.

On the other hand, employment may be expected to decrease in the process of privatisation and organisational streamlining in the transportation industry (privatisation of the national bus company SAD, railway rationalisation), natural gas industry, power distribution networks, financial sector, telecommunications due to the implementation of EU standards, as well as in connection with the sell-off of state holdings and ownership reshuffles (shedding of non-core operations, narrowing specialisation, and production cost-cutting). In the public sector, possible downsizing in state and public administration (a reduced number of ministries, reorganisation, possible cancellation of district offices) may also take its toll on employment.

In light of the above, we expect unemployment to gain around 0.5% in 2003.

There are no major changes expected in the unemployment trend, as the economy is yet unable to generate the kind of job opportunities needed to turn around the trend.

4.6 Public sector finances

Public sector

The 2003 state budget act targets a shortfall of SKK 56 billion and a public budget deficit of SKK 56.9 by ESA95 methodology.

Compared to 2002, there is an increase in budgeted revenues by SKK 15.5 billion and expenditures by SKK 33.5 billion. The deficit is projected at SKK 56.0 billion, up 18 billion from the 2002 budget. It needs to be noted, however, that a sizeable portion of the raise comes down to a change of methodology, whereby bank restructuring expenditures (SKK 10.7 billion) are charged directly to the budget deficit. Previously, budgetary accounts were distorted by the application of a special provision, which allowed restructuring cost to be incurred in addition to the deficit approved by law.

Other public sector components are supposed to record a surplus of SKK 4.0 billion, broken down as follows:

State funds	+ SKK 2.8 billion
National Employment Office	+ SKK 1.6 billion
Social Insurance Company	+ SKK 0.7 billion
National Property Fund	+ SKK 0.9 billion
Slovak Land Fund	0
municipalities and higher territorial units	0
Health insurance companies	- SKK 2.0 billion
<hr/>	
Sum	+ SKK 4.0 billion

The National Property Fund (FNM) is looking to take in SKK 17.6 billion in revenues, including income under existing contracts (SKK 0.8 billion) as well a new contracts to be entered into in 2003 with the purchasing price, or a part thereof, paid in this period (SKK 12.1 billion). Of course, this sum will depend on how the government decides to carry on privatisation. FNM's list of revenues also features SPP dividends worth SKK 4.0 billion. On the expenditure side, settlement of state guarantees (SKK 7 billion) and SPP dividend transfers to SPA (SKK 4 billion), for further disposal in the state budget, are among the largest items.

The method of payment for claimed state guarantees for bank loans still remains questionable. The Ministry of Finance, after an evaluation of risks, expects these payments to reach SKK 7 billion in 2003. The guarantees should be normally paid from the state budget. However, with a tight-strung state budget, the Ministry of Finance is looking to settle the liabilities from a so-called memorandum item (privatisation proceeds). Even though this would leave the central government deficit unaffected, it remains an item to be reckoned with in the general government deficit.

In this respect, we need to point at an adverse trend in realised state guarantees. Out of the total of SKK 261.7 billion worth of state guarantees extended (as at 31 December 2001), the government has paid the following debts for defaulting borrowers:

SKK billion	
1990	0
1991	0
1992	1.1
1993	0.5
1994	0.1
1995	1.2
1996	1.9
1997	2.1
1998	2.1
1999	4.2
2000	15.5
2001	8.0
SUM	36.7

Out of the total SKK 36.7 billion paid, SKK 18.9 billion came directly from the state budget, and SKK 17.8 billion from the memorandum item (privatisation proceeds). Once the privatisation income is depleted, however, future guarantee calls will put a strain on state budget expenditures. The need to apply stricter conditions to state guarantees is also shown by the fact that, even though in case a guarantee is exercised the government enters into an agreement on repayable assistance with the debtor, most debtors fail to pay back the assistance and, thus, it in fact turns into an indirect form of subsidy.

The criteria for state guarantees have been tightened by Act No. 386/2002 Z.z. on state debt and state guarantees, under which - effective from 1 January 2003 - guarantees assumed in a given budgetary year may not exceed the total principal repayable in that year on loans covered by a state guarantee and the sum of nominal values of state guaranteed bonds maturing in that year (i.e. to revolve old debts). In 2003, this works out a limit of SKK 7.1 billion (to be adjusted for exchange rate on 31 December 2002).

As regards the relationship between the state budget and the NBS, we expect the NBS to add some SKK 0.5 billion to state budget revenues in form of interest accrued on state deposits. In anticipation of high sterilising costs, driving the NBS into a loss, we are not expecting the central bank to pay any taxes to the state budget.

4.7 Monetary policy

- Unlike in 2002, in 2003 the monetary policy will not be exposed to potential shocks set off by the spending of privatisation proceeds, as privatisation is currently winding down, or rather coming to an end.
- On the other hand, there may be a lot more pressure on currency appreciation arising from incoming foreign portfolio investments, including short-term ones.
- A hike in regulated prices may send inflation to the verge of double digits.
- Since consumer prices are subject to domestic supply shocks, any attempts to respond by monetary policy measures would be ineffective, or rather counterproductive (monetary restriction would not produce any decline in the regulated price sector anyway; headline inflation could only be reduced at the expense of deflation in other sectors, which might have an adverse impact on production and GDP growth in the following years).
- With Slovakia looking set to join the EU in 2004, negotiations are likely to start in late 2003 or in the first quarter of 2004 on the central parity of the exchange rate of the Slovak koruna against the euro.

All in all, we are expecting to carry out our monetary policy in 2003 against the backdrop of an improving balance of trade and a more consolidated development in public finance. This kind of development should further improve Slovakia's already positive outlooks, which should not be hampered by an upswing in CPI caused by an adjustment of distorted prices, rather than by disruptive demand pressures. That is why we may expect to face rising pressure on exchange rate appreciation, which can be countered by the NBS if it is disproportionate to the real economic performance.

4.7.1 Monetary aggregates

Unlike in the previous years, the development and reporting of monetary aggregates in 2003 should not be affected by any methodical or accounting reforms, or the disposal of privatisation income anywhere near the extent seen in 2002.

By our forecasts, money supply will expand by 10%, i.e. in touch with gross domestic product at current prices (10.1%). In 2003, money supply could be influenced to some degree by disposal of privatisation income, but only insignificantly compared to the previous year. Out of the total SKK 12 billion raised by a state property sell-off, SKK 7 billion should go into settlement of state guarantees (to foreign creditors). The rest is supposed to be spent on consumption and towards settlement of debts in the health sector, which may have some effect on money supply. If the state budget deficit and other public administration components come out as projected, it should be possible for loans to expand by SKK 32.4 billion, i.e. up 9.3%.

4.7.2 Monetary policy implementation

In the NBS toolkit, there is yet another cut in the required reserves rate (RRR) to 3% coming on 1 January 2003, with the interest accrual system and compliance period evaluation staying the same. This move is consistent with the timetable set for the harmonisation of NBS' instruments with the ECB toolkit, approved in the NBS monetary program for 2000.

As far as liquidity goes, in 2003 we assume foreign debt to be paid off and replaced by domestic debt (in the amount of SKK 38 billion). This operation will lead to a decline in NBS foreign exchange reserves and a decrease in NBS' sterilising position towards the banking sector by SKK 34 billion or so.

5. Conclusion – a summary of the NBS Monetary Program for 2003

Monetary program objective

The NBS monetary program for 2003 targets a year-end headline inflation at 7.7-9.7%, with the average annual inflation at 8.2-9.3%. Core inflation should range between 2.7% and 5.0%, with net inflation at 2.9-4.5%.

Monetary program assumptions

- relatively steady development in the exchange rate of the Slovak koruna against EUR, matching actual economic performance
- GDP at constant prices growing at 3.7-4.1%
- deficit of the current account of the balance of payments to reach 6.2% of GDP
- fiscal deficit to reach SKK 56.9 billion, i.e. 4.92% of GDP

Based on the above assumptions:

- money supply is expected to grow by 10%
- there should be room for corporate and personal loans to expand by 9.3%

Risks:

- strong pressure on exchange rate appreciation
- slow economic growth in our trade partners
- a change in the extent of adjustments to regulated prices and indirect taxes
- volatile oil price (breaking out of the OPEC range of 22-28 USD/barrel)

6. Monetary and macroeconomic outlook until 2006

As Slovakia awaits its invitation in December 2002 to join the European Union in the next round of enlargement, its economy is facing another challenge in the shape of strict criteria set for the admission to the European Monetary Union (EMU) and the successful completion of integration efforts.

In 2004 – 2006, both the economic environment and monetary policy implementation will be determined by Slovakia's membership in the European Union (expected entry on 1 May 2004). Under the EC Treaty, being a full-fledged member means Slovakia will have to co-ordinate its economic policy with other member states in pursuit of common objectives. As part of this approach to economic policy and other activities, a member state should, *inter alia*, observe the rules laid down in the Stability and Growth Pact, followed by the introduction of the euro as the single currency and the accession to the European Monetary Union.

To be eligible to enter the EMU, a candidate must meet the Maastricht criteria for fiscal deficit, state debt, inflation, interest rates, and exchange rate.

One of the critical decisions to be made in the medium-term horizon is to time Slovakia's integration into the European Exchange Rate Mechanism (ERM II).

When deciding about the best point to enter ERM II, Slovakia's ability to meet the other Maastricht criteria will need to be considered. In case of the earliest technically feasible entry to the EMU (2007), the fiscal deficit and inflation criteria seem to be the most difficult to fulfil. The medium-run outlook, incorporated in the 2003 State Budget Act, suggests that the fiscal deficit condition will be satisfied as late as 2006. It is these public finance projections that form the basis for NBS' medium-run outlook, which expects the inflation criterion not to be met before 2006 either. Should this scenario materialise, Slovakia might ask for a special compliance test in 2007 and join the EMU in 2008.

If, however, the government's changes its mind on public finance management⁴ and Slovakia passes the fiscal deficit test already in 2005, stricter budgetary policy will pave the way to speedier disinflation and, thus, the inflation target could also be reached earlier. If the government made a firm commitment to meet the fiscal condition in 2005, Slovakia would be able to gain EMU membership as early in 2007. Such integration strategy would require Slovakia to join the ERM II simultaneously with (or shortly after) EU accession, *i.e.* in 2004.

In months ahead, the NBS therefore expects an intensive dialogue with the Slovak government, which should result in a common document clearly defining the government's and the central bank's strategy on Slovakia's membership in the ERM II and EMU.

⁴ In timing the EMU entry, it will be vital to look at how the other candidate countries, in particular our nearest neighbours and largest trade partners, get along, because if Slovakia joins in later than the others, it might affect its foreign reputation and competitiveness.

6.1 Inflation

The medium-term inflation forecast for the 2004-2006 period rests on the following assumptions:

- the present rules for price regulation in network industries will stay in place, i.e. prices will be determined by the Network Industries Regulatory Authority.
- We have referred to valid and published price assessments relevant to the 2004-2006 period. After that period, prices are supposed to cover reasonable costs and profits, with any future price raises likely to reflect the previous year's inflation,
- in bus and railway transportation, we expect the introduction of a mechanism aligning regular price adjustments to actual price developments in the Slovak economy (annual growth at least at the rate of the previous year's inflation). Also, we assume social fare reduction to be restricted and granted on directness basis, and further price liberalisation,
- another assumption is that taxes will be further adapted to EU standards (excise on tobacco and tobacco products raised every year according to an approved tax schedule),
- Slovakia's accession to the EU in 2004 and the adoption of a common agricultural policy, with its impact on (rising) food prices in part eliminated by retail competition,
- a single VAT rate at 17% to be introduced in 2004,
- a stable exchange rate against EUR and USD, and a stable oil price.

This implies that:

- the trend in adjustments to regulated prices should have a declining tendency and ultimately reflect overall price developments in the Slovak economy (endogenous price development), as well as commodity prices on world markets, and the exchange rate of the Slovak koruna (starting in 2004 in railroad and bus fares and electricity prices, in 2005 in heat and natural gas prices, and in 2006 in water supply and sewerage prices),
- the speed and the extent of administrative measures should be largely determined by the reference date of Slovakia's accession to the EU, i.e. 1 May 2004,
- towards the end of the medium-term horizon, headline inflation could thus near core inflation. The remaining difference should stem in particular from continuing changes in indirect taxes.

Regulated prices

Expected changes in regulated prices and their impact on headline inflation are set out in the tables below.

Item	converted weights in %	2004		2005		2006	
		expected growth, including VAT changes	contribution	expected growth	contribution	expected growth	contribution
Electricity	3.9	11.4	0.4	7.3	0.3	5.0	0.2
Heat*	4.8	6.6	0.3	7.3	0.4	5.0	0.2
Natural gas*	2.4	25.0	0.6	7.3	0.2	5.0	0.1
Railway transportation*	0.3	9.3	0.0	7.4	0.0	3.7	0.0
Bus transportation*	2.3	9.3	0.2	7.4	0.2	3.7	0.1
Water*	1	28.7	0.3	15	0.2	3.7	0.0
Sewerage*	0.7	25.7	0.2	14	0.1	3.7	0.0
Rent	0.6	60.0	0.4				
SUM	16		2.4		1.3		0.7

* price growth equal to inflation from 2004 in case of railway and bus transportation, from 2005 in case of natural gas and heat, and from 2006 in case of water and sewerage.

Increases in other administered prices will affect inflation to the extent of 0.4 percentage points in 2004, 0.2 in 2005, and 0.1 in 2006. This estimate is based on a similar track record in the recent years.

Excise taxes

In the indirect tax department, the most dramatic change lies in store for the tax levied on tobacco and tobacco products. During EU negotiations on the Taxation chapter, Slovakia was given a 5-year transition period to reach the minimum cigarette excise by 31 December 2008. At its meeting in April 2002, the Slovak cabinet approved a revised bill on excise tax on tobacco and tobacco products. Among other things, the bill sought the introduction of a combined rate for cigarettes effective from 1 January 2003. Eventually, this proposal was dismissed by the parliament, yet we are expecting it to come through in 2003. In this respect, the cigarette tax in Slovakia was proposed to mount as follows over the 2003-2008 period.

Period	% of retail price*	EUR/1000 pc**	Tax in SKK/pack (42 SKK/EUR)	Estimated average end-consumer price per pack
1.1.2003	38 %	20	16.80	41.57
1.1.2004	42 %	24	20.16	46.33
1.1.2005	45 %	29	24.36	52.15
1.1.2006	48 %	35	29.40	59.01
1.1.2007	51 %	43	36.12	67.96
1.1.2008	54 %	52	43.68	77.97
1.1.2009	57 %	64	53.76	91.09

* this is the total excise tax measured as a percentage of the retail price charged for the best-selling cigarette brand, i.e. Petra – 70 mm. The minimum EU rate is 57% on the retail price of the best-selling price category.

** The third column shows the progress of the total excise levied on the best-selling cigarette price category in EUR per 1000 cigarettes. Under the relevant directive, a minimum excise tax rate of EUR 60 /1000 pieces must apply from 1 July 2002 at the latest, to rise to EUR 64/1000 cigarettes on 1 July 2006.

Value-added tax

The year 2004 (Slovakia's accession to the EU) is the deadline for a reclassification of goods and services not granted a transition period from the lower to basic VAT rate.

In indirect taxes, the transition periods run beyond the 2004-2006 period, and in some cases a permanent exception has been negotiated. The transition periods basically boil down as follows:

- one-year technical transition period for continued application of the lower VAT rate to natural gas and electricity. (Slovakia used its option under *acquis* to apply a technical transition period, which sets it up for a permanent application of lower VAT in the area concerned during EU membership),
- a four-year transition period for continued application of the lower VAT rate to buildings and construction work for residential purposes until 31 December 2007,
- a five-year transition period for continued application of the lower VAT rate to heat until 31 December 2008.

Since the Slovak government included a single VAT rate in its program memorandum, the above transition periods become irrelevant.

Core inflation

Core inflation is expected to dwindle over the 2004-2006 period. At the end of the medium-term horizon, core inflation should be just above average price growth in the EU, provided the exchange rate holds steady and competition is strong.

Foodstuffs prices

By entering the EU in 2004, Slovakia will adopt the common agricultural policy leading to a common organisation of the market in agricultural commodities and a raise in purchasing prices for agricultural products. The impact on food prices will depend on the overall situation in the national market, on the size of EU subsidies, and a reform of the common agricultural policy itself.

Fuel prices

There are no major changes awaited in fuel prices. The price of crude oil is expected to move inside the OPEC benchmark range, and the exchange rate of the Slovak koruna against USD and EUR to remain stable.

Tradable goods without fuel and market services prices

In the period concerned, prices of tradable goods, excluding fuel, should be around EU level, as a fully opened Slovak market and its integration in the common European market take effect, and retail competition becomes comparable with EU countries.

Prices of market services might be influenced in particular by ongoing deregulation and higher income elasticity. Given the predicted real wage growth, this should make prices of market services outstrip tradable goods.

Inflation forecasts for 2002-2006 (as at December of given year)

		2003	2004	2005	2006
Inflation (%)	year-on-year	7.7-9.7	7.4	3.7	2.8
	average year-on-year	8.2-9.3	7.5	3.9	3.0
Core inflation (%)	year-on-year	2.7-5.0	5.3	2.4	2.1
	average year-on-year	2.9-4.1	5.2	2.6	2.3

/ Only mean estimates shown in 2003-2005

With Slovakia slated to join the EU on 1 May 2004, the first theoretical date for entering the European Monetary Union would be in 2007, provided all convergence criteria are met. The National Bank of Slovakia said it believed EMU membership is a "the sooner the better" situation for Slovakia. If an examination were held in 2006, the examiners would review performance for the previous year, which means that convergence criteria would have to be met as early as 2005, or 2006. One of the EMU admission criteria is the inflation test. Under the EC Treaty, average inflation for the year preceding examination should not exceed the average of three EU member states with the lowest inflation plus 1.5 percentage points. In this case, inflation is measured as a harmonised consumer price index.

This implies that average inflation, gauged as a harmonised consumer price index, should be around 3%⁵. Whether or not this ambitious goal can be met will depend on developments in regulated prices, food prices, fuel prices, excise taxes and, naturally, other consumer basket staples. What makes this goal more difficult to reach is that it will be associated with a relaxing

⁵ The average value of the Maastricht criterion reached 2.7% for the 1993-2001 period.

monetary policy (interest rates dropping to ECB level). However, this fact ought to be offset in part by a tightening fiscal policy. At the same time, a steady or slightly firming exchange rate of the Slovak koruna should act to stabilise or reduce inflation.

6.2 Producer prices

The producer price predictions until 2006 are based on the assumption that structural changes in the industrial and corporate sector are going to continue, pursuing principal aims such as the completion of privatisation, increasing performance and competitiveness, growing exports, technological overhaul, rising productivity of labour, and creation of new jobs. The privatisation process is as good as finished in the consumer goods and light industries, metallurgy, and the chemical industry, with only a few enterprises in the heavy industry and electrical power industry left for sale.

After an abrupt rise in 2003 (pent up from 2002), price deregulation is likely to wind down, its impact on producer prices gradually fading away. Market conditions will become the sole factor determining price developments, a trend proved by unfolding liberalisation in network industries with a rising number of firms free to choose their power suppliers (national or foreign) to cut their costs.

In contrast to expected production cost-cutting due to gradual deregulation of prices of energy inputs and liberalisation of the power market, we may expect inflation pressure from food producers after Slovakia joins the EU. Their prices will be affected by the situation in agricultural production.

As regards external cost pressures, we suppose raw material prices (oil, natural gas) on world markets to stabilise somewhere below current levels, with a positive effect on industrial prices in the medium run.

Industrial producer prices predictions until 2006

	2002	2003	2004	2005	2006
Average annual growth rate	2.1	5.9	5.5	4.6	3.3

As compared to expected development in industrial prices, where most factors will impede growth, prices of farming products will probably grow faster when Slovakia enters the EU (following the adoption of the EU common agricultural policy). Prices of individual farming products will also depend on the degree of adaptation of the processing industry, household income, and the exchange rate. Apart from the prices mentioned above, we also need to look out for growth in prices of labour, land and capital, which may spark an even sharper increase in the price level.

6.3 Foreign accounts

6.3.1 Balance of payments

In the 2004 - 2006 period, we expect a stabilisation in external relations coming in the wake of consolidating public finance in 2003.

Exports are due to gain an average 10.5% a year, with average annual exports worth SKK 871.0 billion. This prediction assumes over-average growth in finished industrial products, which are already on the rise, and in machinery and means of transportation, with the car industry cast in a major role.

Average import growth of 9.6% should trail export growth, with average annual imports amounting to SKK 953.0 billion. The basic assumptions here are stagnant or declining prices of raw materials and no abrupt growth in end-consumption imports. Apart from semi-finished goods, which rise hand in hand with GDP, machines and devices should be the engine behind import growth (anticipated and inevitable re-armament of the economy in preparation for EU entry).

As a result, the balance of payments might reach an average shortfall of SKK 81 billion in the 2004-2006 period.

The balance of services is supposed to stay around the volume and structure recorded in 2002. Transportation and the travel industry remain the leading components, earning the bulk of service income for Slovakia. The overall balance of services should be a surplus of between SKK 20.5 billion and SKK 22.2 billion.

In the balance of earnings, corporate loans are supposed to play the main part, allowing firms to finance some of their business expansion needs. A rise in interest expenses, as opposed to a slight decline in interest income (due to a drop in NBS foreign exchange reserves), should deepen the deficit in the balance of earnings to SKK 18.7 billion in 2004. With interests paid mounting faster than interests earned, the balance of earnings is expected to pick up to SKK 19.9 billion in 2005 and on to SKK 20.7 billion in 2006. The upturn in interest expenses will be fuelled largely by corporate sector activities, as government debt (and thus interest paid by the government) is set to dwindle in the medium run.

Current transfers are expected to generate a surplus of SKK 8.0 billion due to stabilised income from transfers of natural and legal persons (support, indemnities, insurance payments).

Current account	SKK billion		
	2004	2005	2006
Balance of trade	-83.0	-81.0	-80.0
Balance of services	20.5	21.0	22.2
Balance of earnings	-18.7	-19.9	-20.7
Current transfers	8.0	8.0	8.0
Current account	-73.2	-71.9	-70.5
Ratio of current account to GDP in %	-5.7	-5.1	-4.6

Apart from the traditional sources (direct investments and long-term financing loans), the current account deficit should be covered by EU pre-accession funds – capital transfers (we expect incoming pre-accession funds to move from the NBS to commercial banks in the euro, with sums received from and paid to the EU general budget coming to/from the NBS reserves).

A stabilising political and economic situation could boost FDIs into the commercial sector, in particular individual manufacturing industries (2004 – SKK 31.0 billion, 2005 – SKK 30.0 billion, 2006 – SKK 30.0 billion). A continuing sell-off of retained state interests in enterprises privatised in previous years could generate a foreign direct investments inflow into the official sector of SKK 200 billion (2004 – SKK 50.0 billion, 2005 – SKK 50.0 billion, 2006 – SKK 100 billion). Foreign direct investments are expected to reach SKK 80.0 billion in 2004, SKK 79.0 billion in 2005, and SKK 128.5 billion in 2006, and should be sufficient to cover the current account deficit at a rate of 109% to 180%.

Portfolio investments should be influenced by both corporate and government sector transactions and, bar any major swings, may level out between SKK 12.4 billion and SKK 14.4 billion.

In other long-term investments, we are expecting a deficit of SKK 14.5 billion (driven into shortfall by redemption of foreign currency denominated government bonds) in 2004. In 2005 and 2006, long-term investments should go back into surplus of SKK 8.1 billion and SKK 10.3 billion, respectively. With respect to sector breakdown, the corporate sector is expected to play the main role in financing its economic activities by long-term financing and business loans. The actual amount of loans will depend on available pre-accession funds, which as financing loans, will flow into the corporate sphere and probably raise the competitiveness of our economy in both the national and foreign markets.

In 2004, the government sector will have to pay off SKK 24.3 billion worth of foreign currency denominated bonds issued in 1999, with the necessary funds expected to come from the domestic market, also affecting the NBS foreign exchange reserves in the process.

In the prediction, short-term capital is not supposed to play any major part in financing the needs of the economy. The corporate sector is set to be the most active item in its structure with its export receivables and import liabilities.

	SKK billion		
	2004	2005	2006
Capital transfers	8.0	8.0	15.0
Direct investments	80.0	79.0	128.5
Portfolio investments	12.4	13.3	14.4
Other long-term financial account	-14.5	8.1	10.3
Short-term financial account	0.4	4.3	2.4
Capital and financial account	86.3	112.7	170.6

The foreign exchange reserves are set to grow throughout the entire prediction period on the back of privatisation income. Their pace will be turning up along the way (USD 0.3 billion in 2004, USD 1.0 billion in 2005, and USD 2.3 billion in 2006) to reach USD 11.7 billion at the end of 2006. Because of this development, as well as developments in imports of goods and services, the average coverage of imports of goods and services should go up from 4.2 months in 2004 to 4.3 months in 2005, and 4.9 months in 2006.

6.3.2 Foreign debt

The foreign debt forecast for the 2004-2006 period is consistent with the balance of payments. New corporate sector borrowing will be the key factor, which together with direct investments and contributions to capital transfers, should raise the technical level of the Slovak economy. Gross foreign debt is expected to grow from USD 11,617.1 billion in 2004 to USD 12,263.7 million in 2005, and USD 12,975.3 million in 2006.

Year-end balance in USD billion	2004	2005	2006
Total gross foreign debt of the Slovak Republic	11.6	12.3	13.0
Total long-term foreign debt	7.7	8.2	8.7
thereof: official government and NBS debt	1.9	1.9	1.8
foreign debt of the commercial sector	5.8	6.3	6.9
Total short-term foreign debt	3.9	4.1	4.3
Net foreign debt of the Slovak Republic	-0.3	-0.6	-2.3

Net foreign debt is going to decrease in the 2004-2006 period from USD -0.3 billion in 2004 to USD -2.4 billion in 2006, partly due to growing NBS foreign exchange reserves fuelled by privatisation earnings.

6.4 Gross domestic product

Higher GDP increments may bring Slovakia's standard of living closer to EU level. In the 2006 outlook, we expect year-on-year GDP growth above 4% (between 4.2% and 4.6%), stepping up slightly towards the end of the period.

	2004	2005	2006
GDP at constant prices in SKK billion	795.5	830.5	869.0
GDP at current prices in SKK billion	1290.0	1405.0	1525.0
GDP growth at constant prices	4.2	4.4	4.6
Domestic effective demand growth	3.5	3.8	4.2
Foreign demand growth	7.8	7.2	6.8
Net export deficit at constant prices	-18.0	-15.0	-12.0

With respect to GDP structure, we consider needful to increase the export performance of Slovakia's economy, which seems quite likely with FDIs expanding economic capacity. As another essential characteristic of sound economic growth, we should see more rapid growth in investments in ongoing technical and technological modernisation of production facilities, as well as in environmental projects in the industrial sector, which have yet to be implemented. Meanwhile, in the domestic demand department, we expect private consumption growth to trail GDP. A decline in public consumption should be prompted by the government's decreasing share in GDP formation, subject to consolidating public finance. Possible increments in final consumption of government may stem from Slovakia's participation in EU administration authorities and the establishment of an institutional framework within the EU organisational structure. In return for rising export performance and growing investment demand, we will have to accept higher imports of investment and intermediate consumption goods coinciding with a decreasing share of final consumption imports.

The predictions for economic growth and its structure are based on the application of the following economic policy principles:

- a stepping up of structural reforms and consolidation of public finance,
- orientation at FDIs spread across the entire economy, rather than limited to a few industries, with the aim of minimising the risks of swings in foreign demand related to the economic cycle in individual industries,

- orientation at FDIs creating standard conditions in factor productivity, quality, assortment of products, and speed of desired innovations, rather than taking advantage of existing comparative advantages (leading to a high share of intermediate consumption in gross production),
- increased mobility of labour. Assuming that the labour market will be liberalised asymmetrically in the EU accession process (labour mobility increasing just slowly, without any major benefits to unemployment), this should be a good enough reason to keep wages in check in the 2006 horizon. Efforts made by the private sector (makes up 88% of GDP) to maintain adequate growth in productivity of labour may rather bring about a setback in employment.
- In the remaining portion of GDP, not generated by the private sector, it is inevitable to hold wage growth at a rate which will not stimulate private consumption, turn up pressure on public finance, or trigger wage growth in other sectors.
- domestic products taking a firmer hold in the national market, not being crowded out by imports.
- flexible and effective use of structural funds and, starting in 2004, the EU cohesion fund, in order to even out existing contrasts in the standard of living and GDP creation between different regions.

As Slovakia gains greater access to European funds, it should retire various forms of support provided to local businesses and adapt its regulation to EU standards (guarantees, subsidies, state aid).

6.5 Public finance

In public finance, the NBS foresees a gradual contraction of the fiscal deficit in line with the intentions set out in the medium-term outlook included in the 2003 State Budget Act. According to the medium-term forecasts, the public finance shortfall is set to gradually dwindle to a level allowing Slovakia to meet the Maastricht criterion in 2006.

	2002	2003	2004	2005	2006
deficit by IMF methodology (% of GDP)	- 4.9	- 4.5	- 4.0	- 3.4	
deficit by ESA methodology (% of GDP)	- 7.8	- 4.9	- 3.8	- 3.3	3.0

6.6 Monetary policy

Slovakia's possible membership in the ERM II and, beyond the monetary outlook horizon, in the EMU is bound to have an effect on monetary policy and real economic development. From the monetary policy perspective, compliance with the nominal criteria, or rather paving the way to meet them, will be the main issue. This could mean a stricter monetary policy aimed at compliance with the inflation criteria, especially towards the end of the prediction period. On the other hand, however, the monetary development will be constrained by the interest rate condition and, perhaps, by the ERM II fluctuation band as well.

6.6.1 Monetary aggregates

In the medium-run monetary policy, we expect the replacement of foreign debt by domestic debt to continue and privatisation earnings, if any, to be used to repay debt and accumulate funds for a pension system reform. We also expect public finance to consolidate, as an essential condition for balanced macroeconomics and gradual preparation for EMU entry. Given the above, there should be enough room for loans to expand by some SKK 38 billion a year, i.e. by 9.2% in relative terms. Meanwhile, provided privatisation income is spent as supposed, there will be no increase in the money supply dynamics.

6.6.2 Monetary policy implementation

As regards liquidity in commercial banks, we expect a growth stimulating effect of releasing pension reforms funds (SKK 13 billion a year), as well as a servicing of domestic debt. The amount of sterilisation, including funds put aside for a pension system reform, should thus reach around SKK 330 billion in 2006.

With respect to monetary policy instruments, we expect an alignment of the required reserves (RR) rate and base with the ECB standard, as well as a gradual adaptation of both official and interbank interest rates. Their reduction will depend on favourable developments in fiscal performance, the balance of trade, and an expected inflation decline starting in 2005.

An overall RR harmonisation with the ECB will hinge on the implementation of ECB statistical reporting in Slovakia and its review, which will be taking place in the course of 2003. That is why full RR harmonisation cannot be achieved before 2004. While in 2004, RR harmonisation will only involve the RR rate, in 2004 (if ECB reports are put in place successfully) harmonisation should cover both the RR base as well as the evaluation period. Likewise, we do not expect the RR remuneration issues to be opened before 2004.

In the medium run, we expect monetary policy to be implemented under the conditions of Slovak Republic's membership in the European Union. Under Article 4 of the EC Treaty, the member states' activities should aim at the introduction of a single currency and, thus, their integration in the European Monetary Union. Since being an ERM II member for two years is one of the conditions for joining the EMU, it will be necessary for Slovakia to join in the exchange rate mechanism by the end of this medium-term outlook.

According to the Council of Europe's Resolution establishing the exchange rate mechanism at the third stage of economic and monetary union (Amsterdam, 16 June 1997), ERM II membership is voluntary. Nonetheless, as the Resolution goes, "it can be expected" that member states with a derogation will join the ERM II (not specifying when). Meanwhile, a member state not participating in the ERM II from the beginning (its EU entry) has the option to join at a later date.

Main economic and monetary indicators

	2001	2002	2002	2002	2003	2004	2005	2006
	Actual	Monetary program	Updated monetary program	Estimate	Monetary program	Outlook		

(year-on-year change in %)

Gross domestic product (constant prices)	3.3	3.5-3.8	3.5-3.8	3.8	3.7-4.1	4.2	4.4	4.6
Core inflation (end of year)	3.2	3.2-4.7	3.2-4.7	1.9-2.2	2.7-5.0	5.3	2.4	2.1
Consumer price index (annual average)	7.3	4.1-4.9	3.6-4.2	3.3-3.4	8.2-9.3	7.5	3.9	3.0
Consumer price index (end of year)	6.5	3.5-4.9	3.5-4.9	2.9-3.2	7.7-9.7	7.4	3.7	2.8
Gross domestic product (nominal, SKK billion)	989.3	1,032.0	1,032.0	1,063.0	1,170.0	1,290.0	1,405.0	1,525.0
Money supply (M2)	11.9	10.5	11.4	10.4	10.0	10.3	8.7	8.5
Corporate and personal loans	4.7	7.5	6.9	12.2	9.3	9.4	9.3	9.1
Sterilising position against the banking sector (SKK billion)	-67.3	-170.8	-159.6	-156.6	-122.6	-118.7	-151.5	-208.5
Import coverage (monthly average imports of goods and services) by reserves	3.1	4.1	5.6	5.8	4.4	4.2	4.3	4.9
Ratio of current account deficit to GDP (%)	-8.6	-7.9	-8.3	-8.4	-6.2	-5.6	-5.1	-4.7
Official NBS reserves (USD million)	4,346.4	6,575.9	8,455.3	8,976.9	8,058.9	8,363.9	9,319.4	11,664.5

Regulated Prices

January 2003 will bring some major changes in institutional jurisdiction over regulated prices. Most prices previously controlled by the government, or rather by the Ministry of Finance of the Slovak Republic, are coming under the control of special regulatory authorities. Effective from 1 January 2003, the responsibilities for price regulation will be divided as follows:

The Ministry of Finance of the Slovak Republic: net rent in rental flats, selected medications and treatments in health care, bus transportation within 100 km, and passenger railway transportation (other than IC and EC trains),

Network Industries Regulatory Authority: electricity, natural gas, heat, water, and sewerage

Telecommunications Office: telecommunications services,

Post Office: postal services,

Local authorities: urban transportation, heating (priced separately for each source), housing-related services.

Included are also items subject to individually controlled prices, such as coal and coke, selected medication and treatments in health care, school and pre-school boarding and social care services.

Regulated prices also include insurance and fees set by law or by local authorities:

- mandatory insurance of motor vehicles (under the law, premium rates are regulated in 2003 and 2004 and may be adjusted for inflation and actual crash rate),
- radio and television fees,
- pre-school and school tuition,
- fees for authentication of signatures in deeds, issue of passports, criminal records, and other legal fees,
- dog tax.

As the above implies, the Slovak government will retain price control over four items only:

1. Net rent

Rented flats are estimated to make up 2.1% of the total number of houses.¹ These flats are owned by towns and villages. This, coupled with an ongoing sell-off of these flats to private owners, may result in a switch to cost-based rent or its complete liberalisation. Given the small weight of this item in the consumer basket (0.4%), any changes in rent will barely affect the overall inflation.

2. Selected medication and treatments in health care

These prices should change in connection with a forthcoming reform of the health care system and its financing model, with first price raises expected as early as 2003. With its weight in the consumer basket being as small as it is, increasing prices in health care are not going to have any significant effect on headline inflation (no price growth expected in our predictions).

3. Passenger bus transportation within 100 km

Bus fares have last changed on 1 February 2001, when a 20% increase was approved. With the government striving to trim the public finance deficit (also by cutting back expenditures on transportation in public interest), regulated prices could move up by 15% effective

¹ Based on information from the 2001 Census of population, houses and flats.

from 1 January 2003. If, however, the method of price regulation in bus transportation is changed from maximum price setting to practical regulation (economically reasonable costs + profit), prices could rise even higher. It will be also important to see what changes or reduction will take place with respect to discounts.

4. Passenger railway transportation, other than IC and EC trains

Passenger railway transportation is an even more complicated issue. As in bus transportation, the tariffs have risen by 15% on 1 February 2001. However, in the railway business, the regulated price lies far below what would be needed to cover economically reasonable costs and profit. Should we switch to this pricing model, the price would soar so dramatically that railway transportation could no longer compete with other types of transportation. That is why the price adjustment in railway fares is likely to follow public bus transportation.

Other regulated prices

In 2003, the Network Industries Regulatory Authority (NIRA) will take charge of some key regulated prices. Taken together, these prices make up about half the weight that all regulated prices have in the consumer basket.

Network Industries Regulatory Authority

The establishment, status and responsibility of the Network Industries Regulatory Authority (hereinafter "NIRA"), as well as the subject and conditions of state regulation in network industries, are stipulated by Act No. 276 dated 14 June 2001 on regulation in network industries, amending certain other laws. Network industries means the production, transit and distribution of electricity, natural gas, heat, water, and sewerage.

Under the said law, state regulation in network industries has the objective of creating and fostering a near-competitive environment, promoting market forces in network industries, protecting consumers, protecting the interests of license holders in achieving appropriate return on investments and ensuring reliable, economical and quality supplies of goods and services. Among other key areas, the regulatory competence covers price regulation under this Act and under the National Council of the Slovak Republic Act No. 18/1996 Z.z. on prices, as amended.

The NIRA's bodies are its chairman and a regulatory council, which determines the regulatory policy and its application tools. Regulatory council members are appointed and dismissed by the president of the Slovak Republic.

The NIRA submits an annual performance report to the National Council of the Slovak Republic, always by 31 May of the next year.

1. Price regulation in network industries involves:

- a) the determination of the method of calculation of the maximum price or rate charged for a product or service delivered or provided in performing a regulated activity,
- b) the setting of the maximum price or rate for a product or service delivered or provided in performing a regulated activity, as well as the pricing terms and conditions applied to the delivery of such a product or provision of such a service.

2. The method of calculation of the maximum price or rate referred to in paragraph 1, letter a), and the maximum price or rate set under paragraph 1, letter b), must allow for economically reasonable costs and reasonable profit in respect of the regulated activity.

3. The extent of regulation is laid down by the NIRA in form of a decision on price regulation. A decision on price regulation is published in the Collection of Laws of the Slovak Republic.

4. Details on the procedure to be followed in price regulation in network industries and in determining economically reasonable costs and reasonable profits under paragraph 2 are set out in a generally applicable regulation published by the NIRA.

The following price regulation assessments have been issued for the year 2003 and the subsequent years:

Electricity for households

The NIRA has issued a decision on the extent of regulation of prices charged for electricity supplies to protected consumers and its distribution to eligible consumers in the period from 2003 to 2006. It distinguishes between two distinct consumer categories – protected and eligible. Eligible consumers are those allowed to choose a supplier. Protected consumers comprise other customers and households. Prices charged to protected consumers must be set at a rate covering economically reasonable costs and a reasonable profit. The NIRA approves prices to be submitted by a regulated entity no less than two months before the end of a year.

The first original decision laid down the method used to compute maximum electricity prices for households. According to the formula published, the maximum price of electricity was allowed to rise by no more than a four-fold of the arithmetic average of annual consumer price indexes for the period from October 2001 to September 2002 (maximum price raise for each consecutive year was calculated as a 4-fold of the average consumer price index for the period from October of the previous year to September of the current year). This household formula was supposed to apply in the years from 2003 to 2006 until the maximum electricity price charged to households would cover reasonable costs and profits. By available date and NIRA calculations, the price of electricity should increase by 16.9% in 2003. However, after reviewing supporting documents supplied by regional distribution companies, the NIRA decided that household electricity prices would rise by 24.7%. At this rate, the price will cover reasonable costs and profits in two out of three distribution companies. This means that the original regulatory assessment will be voided and the price of electricity will be based on actual growth in price level and inputs in years to come.

Despite this growth, household electricity prices will still lag behind EU level in 2003. For comparison, see the table below:

Comparison of household electricity prices in the Slovak Republic and the EU in 2002 (prices are VAT exclusive)

Consumer category	Standard annual consumption per category		Price for 100kWh in EUR				
	Total	thereof night-time	SR*	Czech Rep.	Belgium	Germany	Denmark
Da	600		9.18 (11.44)	16.36	15.36	17.08-26.63	17.26
Db	1200		8.35 (10.41)	14.62	14.17	14.43-19.12	12.04
Dc	3500	1300	6.28 (7.83)	13.42	11.37	11.45-14.26	8.65
Dd	7500	2500	5.72 (7.13)	9.95	10.95	9.70-12.89	7.63
De	20000	15000	4.05 (5.05)	5.28	7.20	5.17-7.49	6.96

*the figure in brackets is a converted price after expected price increase in 2003
source: EUROSTAT and NBS calculations

As the table shows, electricity prices vary sharply from region to region in the EU. Slovakia's households currently pay less for electricity than households in the Czech Republic, where the price has already levelled up with EU countries.

The actual power tariffs for the next year will be known in late November 2002, when the NIRA is due to publish them.

Natural gas

The NIRA has also published a decision on the method of calculation of maximum prices for natural gas deliveries for the period 2003-2005. In this assessment, it set the maximum price formula so as to prevent cross subsidies and ensure that the maximum price cover economically reasonable costs and profits. For Slovenský plynárenský priemysel, a.s. (SPP), the NIRA issued a regulatory assessment defining coefficients used to compute the maximum price. A regulated entity must present the NIRA with a new price list no less than two months before the end of the year. Meanwhile, the government adopted a resolution in which it vows to include in the privatisation agreement a provision ensuring that the natural gas price will not be set at a level covering economically reasonable costs and profits earlier than in 2004, with the price charged in 2003 set not to exceed 90% of that level.

On 5 November 2002, the NIRA published a decision on tariffs to be charged by SPP. Under the new price list, the average price of natural gas should rise by 32.7% from January. The growth estimate for the natural gas price by NBS calculations for 2004 is based on the assumption of a steady exchange rate of the Slovak koruna at 42.7 and an average oil price of USD 25/barrel.

	2001	2002	2003	2004
Average sales price of natural gas in SKK/m ³ (VAT exclusive)	4.56	5.21	6.87	8.67
Year-on-year growth index	-	1.14	1.32	1.26

The values in the table show the average price charged for natural gas supplies, which means that the effect on individual consumer categories (enterprises, households) may vary. What makes the situation in Slovakia even more complicated is the fact that prices at which natural gas sells to households are lower than those charged to industrial consumers, even though the distribution costs are higher. That is why growth in household prices can be expected to outstrip industrial consumption.

Based on the published NIRA decision and the upcoming raise in the lower VAT rate from 10% to 14%, the average price of natural gas paid by households is expected to jump 56.4%² in 2003. A comparison of old and new prices applicable to individual consumer categories is shown in the table below:

Category	Current price, VAT inclusive	Price after increase, VAT inclusive (14%)
D1 (up to 200 m ³ /year)	7.40 SKK/m ³ + 8.60 SKK/month	10.26 SKK/m ³ + 18.01 SKK/month
D2 (201 – 1700 m ³ /year)	5.10 SKK/m ³ + 46.50 SKK/month	7.70 SKK/m ³ + 60.76 SKK/month
D3 (1701 – 6500 m ³ /year)	4.40 SKK/m ³ + 146.00 SKK/month	6.50 SKK/m ³ + 230.34 SKK/month

It needs to be explained here that one of the reasons for this abrupt rise is that households were spared an increase in the natural gas price in 2002.

² Calculated as weighted average, with the consumer basket weights assigned to individual prices charged to different consumer categories.

Comparison of household natural gas prices in the Slovak Republic and the EU in 2002 (prices are VAT exclusive)

Consumer	Standard annual consumption in GJ	Price per GJ in EUR				
		SR*	Czech Republic	Belgium	Germany	Denmark
D1	8.37	5.08 (6.97)	8.00	15.06	16.25-22.00	15.64
D2	16.74	4.04 (5.74)	6.90	13.92	13.03-19.64	7.53
D3	83.7	3.31 (4.77)	5.63	8.34	8.53-10.92	7.53
D3-b	125.6	3.16 (4.54)	5.63	7.98	8.03-9.97	7.53
D4	1047		5.47	6.75	7.19-9.89	7.53

*the price given in brackets is after the expected raise
source: EUROSTAT and NBS calculations

As the above data implies, the natural gas price in Slovakia currently lies well below the EU level or the price charged in the Czech Republic. Although the hike expected next year still will not bring the price to EU level, it will come closer to the Czech Republic's. The natural gas price paid by households could reach Czech level as late as 2004.

Heating

As in the case of electricity and natural gas, the price of heat is also regulated by NIRA decisions since 2003. The extent of price regulation for heat generation, purchase, and distribution was determined by a NIRA decision, which sets a so-called competitive price. Its price is based on a price a homeowner would have to pay if he decided to disconnect from a central heating system and install his own gas-fired boiler. This is just a basic reference price. The NIRA is going to review the prices separately for each supplier to ensure that the price cover reasonable costs and profits and, if a heat producer later documents additional costs, the NIRA may approve a higher price for the supplier concerned. It is estimated that about 90% of entities will not exceed the price.

The competitive heat price set by the NIRA for 2003 is 480 SKK/GJ. With the price cap included in the consumer basket currently at 450 SKK/GJ, this would mean a 6.7% increase with an impact on the consumer price index estimated at 0.3%. If, however, the Statistical Office of the Slovak Republic decides to use the current average price in the consumer basket and the new average price from 2003 (450 SKK/GJ), the heat price would go up by 18%, with an impact on consumer prices around 0.9 percentage points.³

Water supply and sewerage

The current prices households pay for water supply and sewage disposal represent an average of nearly 70% of what it actually costs to supply and drain water. Under a NIRA decision determining the calculation of water and sewerage fees in 2003, the prices for water supply and sewerage are set to rise 35% and 30%, respectively.

³ By latests information from the Statistical Office, the price applied in the consumer basket will be the competitive price of heat.

Regulated prices in the 2004-2006 period

Under the price assessments published by the Network Industries Regulatory Authority (NIRA), household electricity prices will only be regulated on the basis of actual developments in the price of inputs and overall price growth in the 2004-2006 period.

Likewise, as regards water and sewerage price, regulation in household prices in 2004-2005 should follow the pattern applied in 2003 (maximum price growth index of 1.35 and 1.30 for water and sewerage, respectively). However, as NIRA officials suggest, the water price should cover reasonable costs and profits in western Slovakia in 2004, in central Slovakia in 2005, and in eastern Slovakia in 2006. In case of sewerage, a reverse order applies. This fact has been reflected in the NBS estimate.

The price of natural gas and heat will depend, among other things, on world natural gas price and the exchange rate of the Slovak koruna against the U.S. dollar, which we expect to be stable. The regulated natural gas price for households should cover reasonable costs and profits from 2004 (in 2003, the household price is expected to equal 90% of a regulated price which would cover reasonable costs and profits). In the following years, its price may, provided the Slovak koruna and the price of oil remain stable, rise at a rate of price growth recorded in the previous year.

The price of heat paid by households is supposed to follow the natural gas price from 2004. In the following years, it might rise at the rate of price growth recorded in the previous year.

The actual impact on the consumer price index will depend on how the NIRA assessments are incorporated in its calculation. At present, the consumer price basket includes maximum prices. In heat, the maximum price will cease to apply in 2003. Starting in 2004, the water and sewerage prices are probably going to vary between different water utility operators. The Statistical Office has no clear notion yet of how to reflect these changes in the consumer basket.

In September 2002, regulated prices accounted for over 23% of the consumer basket, with more than a half being the prices, which will now be regulated by the NIRA.

Preliminary predictions of commercial bank analysts for year-end values of selected macroeconomic indicators and expectations of NBS for 2002 and 2003

