

## Updated Monetary Programme of the NBS for 2004

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## INTRODUCTION

Monetary and economic development in 2003 was influenced by a relatively large extent of administrative interventions in the field of regulated prices, as well as indirect taxes. The implementation of these measures was expressed primarily in the development of consumer prices, where this contributed to an overall price growth of more than 75%. The greater influence of cost factors on price development was however, given the absence of demand-side pressures, not reflected in more significant secondary effects. This is also documented by the relatively low level of core inflation, which in 2003 stood at 3.0%, while overall inflation reached 9.3%. Overall, the development of prices in 2003 was in accordance with the updated monetary programme of the NBS.

The more significant extent of administrative measures in the field of regulated prices and indirect taxes together with the ongoing consolidation of public finances (reduction of the fiscal deficit to 3.5% of GDP in 2003 in comparison with 5.7% in 2002) and the reduction of real wages was reflected in a decline in domestic demand, in particular private consumption. In comparison with the forecasts of the updated monetary programme there was thus seen a significant dampening of household consumption (the updated monetary programme had forecast a slight increase) in consequence of the more significant effect of the administrative measures, as well as the slower wage growth. The decline in domestic demand was also caused in a great deal by the continued fall in investment demand.

Despite the fall in domestic demand economic growth reached a relatively high level (4.2%) in the interval forecast by the updated monetary programme. The structure of GDP growth was however different from that forecast by the NBS, where the fall in domestic demand was compensated by a dynamic growth in exports and by a higher than expected pro-growth contribution of the net export.

The decline in the balance of foreign trade deficit corresponded to trends identified in the updated monetary programme, its decrease however, as a result of the growth in export efficiency, was more significant. Even despite the slower economic growth of our main trading partners (mainly the EU countries) the Slovak export recorded growth of more than 20%. This development was connected primarily to the higher production of the automobile industry and the realisation of a new production programme. Favourable development was similarly recorded in the exports of iron and steel.

The lower balance of trade deficit was reflected also in a considerable reduction in the negative balance of the current account of the balance of payments, the share of which in GDP represented 0.9% (the UMP had forecast 4.5%).

The objective of monetary policy in the environment of the renewed deregulation process was primarily to limit secondary price effects. The significant impact of administrative measures on purchasing demand together with the advance in labour productivity growth ahead of the growth in wages however limited the occurrence of demand-side pressures. With regard to the absence of demand impulses in the economy, as well as the expected continuation of the effect of the deregulation process on purchasing demand also in 2004, the NBS, in the interest of supporting balanced economic growth and with the aim of preventing any unjustified pressure for a fall in prices, reduced key interest rates in September and December 2003, both times by 0.25 percentage points.

These decisions were supported also by a further reduction in key interest rates in March 2004 by 0.5 percentage points, similarly intended for supporting a recovery in domestic demand and in sustainable economic growth alongside a forecast lower contribution from exports. At the same time the reduction in interest rates was intended to support the central bank's endeavour to stop pressures for an appreciation of the exchange rate and thereby corresponded with the objectives of the NBS in supporting sustainable growth.

The updating of the monetary programme for 2004 and the medium-term outlook to 2007 takes into account the economic and exchange rate development in the first months of the year, as well as new information with regard to expected investment activities (FDI), changes in the forecast development of energy prices and assumptions of development of the fiscal deficit on the basis of objectives presented in the Convergence Programme of the SR.

From the aspect of the development of the external environment, the updated monetary programme for 2004 has not seen any significant changes to its expectations as regards the economic development of our main trading partners. Economic growth in the eurozone will probably recover slightly in the coming years, this however will continue to be at a level below its potential. The negative production gap should thus have an effect on a fall in inflation. Economic growth should also accelerate in the Czech Republic, Hungary and Poland. Overall, the macroeconomic development of our trading partners should create relatively favourable conditions for Slovak exports and low imported inflation.

The updated monetary programme for 2004 forecasts that price development will, in comparison with the monetary programme, be influenced from the aspect of structure by slightly different factors, where the rate of overall inflation (mid-interval 6.4%) should remain at the level forecast by the Monetary Programme, though while seeing a narrowing of the interval (to 5.7%-7.0%). The trend of appreciation of the Slovak koruna exchange rate since 2003, and so far over the course of 2004, will be reflected in a slower dynamic in the prices of tradable goods excluding fuels. Fuel prices, conversely, are influenced by the higher price of oil and the development of the dollar exchange rate.

The most significant difference in the inflation prediction in comparison with the Monetary Programme has been caused by the transfer of motor third party liability insurance from the sector of regulated prices to markets services, which has been reflected in a slight increase in the prediction of core inflation (from 2.3% to 2.7% - mid-intervals) and net inflation excluding fuel prices (from 2.3% to 3.0% - mid-intervals). This however has not had any influence on the level of overall inflation.

As in the previous year price development in 2004 will to a significant extent be influenced by administrative measures, which should contribute to approximately 70% of the overall rate of inflation. Even if over the course of the year a slight recovery in domestic demand occurs, the NBS does not foresee any significant influence of secondary effects on prices. The relatively favourable price development should also be supported by low imported inflation. Likewise, the introduction of the common agricultural policy should not bring about any unexpected pressure for a growth in food prices.

In comparison with the monetary programme for 2004 the updated monetary programme forecasts a moderately higher rate of economic growth, but without significant changes in its structure. Even despite the persistent effect of the administrative measures on purchasing

power demand, the expected recovery in real wage growth and deferred consumption from the previous year should be reflected in a recovery in private consumption. Similarly, there may also be expected a more significant recovery in investment demand, primarily in connection with the inflow of FDI into the automobile industry.

Recent foreign trade development indicates a continuation of favourable trends, which should be reflected in a lower current account deficit. This should reach 1.2% of GDP, which is almost half the level of the level forecast by the monetary programme. This development, however, besides being an improvement in the balance of trade, has been also influenced by an increase in the methodological specification of the allocation of transfers from the EU between current and capital (in accordance with the Eurostat guideline).

The more favourable development of foreign trade could be reflected also in an improvement in the contribution of net exports to economic growth. Domestic demand should however, similarly as in the monetary programme, represent a crucial factor in GDP growth.

Similarly as in 2003 the objective of monetary policy in 2004 has been to limit the emergence of excessive secondary impacts of administrative measures on price development. At the same time, however, monetary policy must consider the degree of restriction which the realisation of these measures represents for purchasing power demand.

Given the fact that Slovakia is a small open economy (the share of imports and exports of goods and services in GDP represents 157.5% in 2003 and 156.1% in 2004), in monetary-policy decision making consideration is also given to the development of the nominal exchange rate which has an important position in the monetary policy transmission mechanism. With regard to the existing interest rate differential and the “convergence play” the NBS carefully monitors the effect of the inflow of speculative capital on the volatility of the exchange rate. In case of any emergence of significant pressures for an appreciation of the koruna that is not in accordance with economic fundamentals, the NBS is prepared to use appropriate instruments. These include primarily interventions on the foreign exchange and money market, as well as a possible change in the base rates. The reduction in interest rates with the aim of limiting an unsubstantiated appreciation of the Slovak koruna is however considered in relation to the main goal of the NBS, which is price stability. The National Bank of Slovakia thus reacts to exchange rate development by a change in interest rates, only where this does not threaten its main objective.

It was precisely the excessive appreciation of the Slovak koruna exchange rate against the euro in first months of 2004, influenced by the inflow of short-term capital taking advantage of the interest rate differential, that prompted the NBS to lower key interest rates in April 2004 by 0.5 percentage points. Current macroeconomic development has enabled the central bank to react in a manner giving priority to exchange rate development, especially with regard to the continuing consolidation of public finances, as well as the assumed reduction in year-on-year inflation to below 4% as early as in the first months of 2005.

The development of the Slovak economy over the medium term will be significantly influenced by various changes in the economic environment. These include primarily the Slovak Republic’s entry to the European Union, the implementation of tax and pension reform, healthcare reform, the gradual consolidation of public finances.

Price development over the years 2005-2007 should be in accordance with NBS objectives with regard to meeting the Maastricht inflation criterion, characterised by a progressive disinflationary process, supported by the continuing consolidation of public finances, as well as low imported inflation.

In comparison with the medium-term prediction of the Monetary Program for 2003, the updating of the medium-term outlook forecasts slightly higher price growth, where this takes account of the higher estimate in the development of oil prices, as well as a potentially greater influence of the Balassa-Samuelson effect. The possible introduction of excise duties on electricity and gas could also have a pro-growth effect on price development in 2007. Its influence on inflation however should be only slight.

A significant factor influencing economic development in Slovakia over the years 2005-2007 will be the inflow of foreign direct investment primarily into the automobile industry, where in comparison with the forecasts of the Monetary Program for 2004 the investment by Hyundai-Kia has been increased. Over the medium term the inflow of FDI should thus create the preconditions for an acceleration in the process of real convergence, labour productivity growth and increased competitiveness of the Slovak economy.

GDP growth could thus gradually accelerate from the level of approximately 4.1% (mid-interval) in 2005 over the short term to almost 6.2% in 2007. In view of the expected growth in real wages and a relatively significant recovery in investment demand (in particular as a consequence of the inflow of FDI), domestic demand over the whole period should have a supportive effect on the level of economic growth. In 2005, in connection with the investment imports for the automobile industry, a negative effect of the net export on GDP growth may be expected. However, in the following years the launch of production in this sector can be expected, having a favourable impact on both the overall export and economic growth.

The current account balance of the balance of payments should thus gradually change from a deficit of 2.7% of GDP in 2005 (a slight worsening in comparison with 2004) to a surplus in the amount of 1.8% of GDP in 2007.

In connection with the process of Slovakia's integration into the eurozone, the NBS in co-operation with the Ministry of Finance of the SR has prepared the document "Strategy for Adopting the Euro in the Slovak Republic", which was discussed by the SR Government in the summer of 2003. At the Government's discussions on this document a joint declaration of the SR Government and the NBS was approved, concerning the procedure in the SR's accession to the eurozone. The SR Government and the NBS stated that accession to the eurozone will represent a significant impulse for the healthy growth of the Slovak economy, where the advantages of membership outnumber its disadvantages. The Slovak Republic should therefore introduce the euro as soon as possible after having fulfilled the Maastricht Criteria in a sustainable manner. The SR Government and the NBS at the same time declared their interest in creating the comprehensive preconditions for the euro's introduction in Slovakia over the years 2008 - 2009.

Fulfilling the Maastricht Criteria in a sustainable manner requires close coordination of monetary and fiscal policy. From this aspect the NBS and the Ministry of Finance of the SR are preparing a more detailed version of the "Strategy for Adopting the Euro in the Slovak

Republic”, which will provide the basic timeframe of the process for adopting the euro. Through adopting a single, clear national strategy and timeframe for adopting the euro, together with a significant decline in the effect of administrative measures on the domestic price level, there should in this way be created room for setting a medium-term disinflationary strategy corresponding to fulfilment the Maastricht inflation criterion. At the same time this will set the trajectory as conditional upon fulfilment the undertakings/goals in the field of public finance.

In the field of the exchange rate regime managed floating will, over the medium-term time horizon, be replaced by the ERM II exchange rate mechanism. Slovakia’s accession to ERM II can be expected in 2005, or the following years.

Following accession to ERM II the aim of monetary policy, besides inflation, will also be the exchange rate, where this should continue to be subordinate to fulfilment the main goal that is price stability. Slovakia’s membership in ERM II should not exceed the time necessary for fulfilling the exchange rate Maastricht criterion, given the fact that over the longer term there can emerge a conflict between the aim of price stability and the exchange rate. Even where the NBS’s objective is exchange rate movement close to the central parity, the ongoing process of real convergence, labour productivity growth and related appreciation of the end equilibrium real exchange rate can require the more flexible use of this exchange rate regime. Membership in ERM II, as well as the evaluation of fulfilment the exchange rate criterion should from this aspect be sufficiently flexible and take into account the process of real convergence.

## 1. Forecast of the external environment for the years 2004 and 2005

The assumptions of the external environment development contained in the updated monetary programme are based on the European Commission's forecast published on 7 April 2004 and the Consensus Forecast of March 2004. From the aspect of Slovakia's trading partners it is economic development in the euro area and the V4 countries, in particular the Czech Republic, that is significant for forecasts of the external environment.

The European Commission forecast of April 2004 confirmed the trends of economic development in the EU countries, or the euro area, for the years 2004 and 2005 that had been indicated in the autumn forecast. The differences between both predictions, the Consensus Forecast and that of the European Commission, are not significant, the GDP growth outlook of the Consensus Forecast is slightly more optimistic for acceding countries such as the Czech Republic and Hungary and more pessimistic in relation to the euro area, or certain member states (France). In comparing the prognoses of consumer price development the Consensus Forecast predicts in comparison with the European Commission somewhat higher dynamics, mainly in 2005.

Table 1

Comparison of the GDP forecast of the European Commission and Consensus Forecast

	estimate for 2003			forecast for 2004			forecast for 2005		
	EC	CF	Difference	EC	CF	Difference	EC	CF	Difference
EMU	0.4	0.4	0.0	1.7	1.7	0.0	2.3	2.1	-0.2
Germany	-0.1	-0.1	0.0	1.5	1.7	0.2	1.8	1.8	0.0
France	0.2	0.2	0.0	1.8	1.7	-0.1	2.4	2.1	-0.3
Italy	0.3	0.3	0.0	1.4	1.4	0.0	2.0	2.0	0.0
Czech Republic	2.9	2.9	0.0	2.9	3.3	0.4	3.4	3.8	0.4
Hungary	2.9	2.9	0.0	3.2	3.2	0.0	3.4	3.9	0.5
Poland	3.7	3.7	0.0	4.6	4.6	0.0	4.8	4.7	-0.1
USA	3.1	3.1	0.0	4.2	4.6	0.4	3.2	3.7	0.5
Japan	2.7	2.7	0.0	3.4	2.8	-0.6	2.3	1.6	-0.7

Table 2

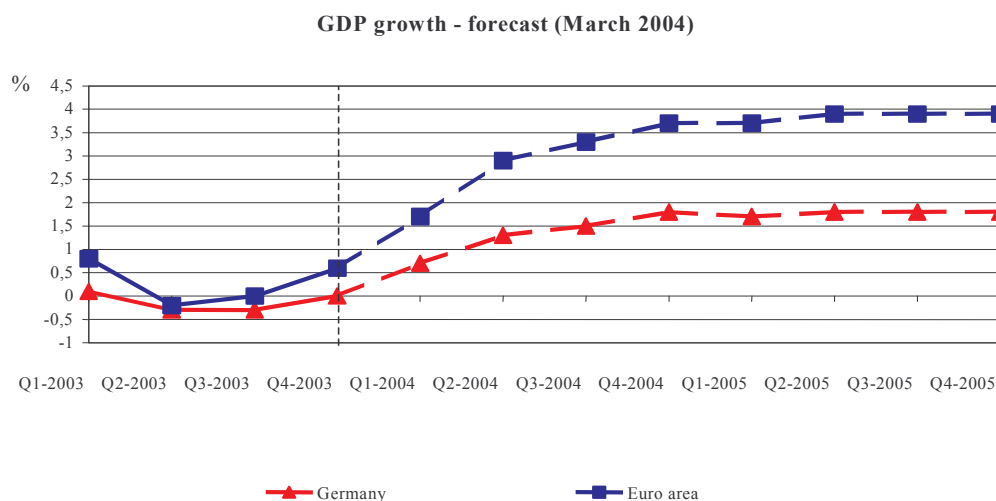
Comparison of consumer price development forecasts of the European Commission and the Consensus Forecast

	estimate for 2003			forecast for 2004			forecast for 2005		
	EC	CF	Difference	EC	CF	Difference	EC	CF	Difference
EMU	2.1	2.1	0.0	1.8	1.7	-0.1	1.6	1.6	0.0
Germany	1.0	1.1	0.1	1.3	1.1	-0.2	1.1	1.2	0.1
France	2.2	2.1	-0.1	1.9	1.8	-0.1	1.5	1.6	0.1
Italy	2.8	2.7	-0.1	2.2	2.2	0.0	1.9	2.1	0.2
Czech Republic	-0.1	0.1	0.2	2.8	3.1	0.3	2.8	2.8	0.0
Hungary	4.7	4.7	0.0	6.9	6.9	0.0	4.6	4.8	0.2
Poland	0.7	0.8	0.1	2.3	2.3	0.0	3.0	2.8	-0.2
USA	2.3	2.3	0.0	1.4	1.7	0.3	1.2	1.9	0.7
Japan	-0.3	-0.3	0.0	-0.2	-0.2	0.0	0.1	-0.2	-0.3

Economic development of the euro area, following stagnation in the first half of 2003, recorded a moderate improvement in the second half of the year. In the 3rd quarter the

growth was driven mainly by exports, in the 4th quarter it is expected that the domestic demand should become a source of the recovery.

Graph 1



Source: Consensus Forecast

Over the years 2004 and 2005 a gradual recovery of the euro area economy is expected, where the main source of economic growth should be domestic demand supported by an acceleration of capital formation. In comparison with 2003, when the consumption expenditure was created in the prevailing part by public sector spending, over the course of 2004 and 2005 there is expected also a gradually, more significant recovery in private consumption. Over the whole time horizon the contribution of net exports to economic growth can be expected to be negative, since the pace of growth of imports will be above that of exports.

Table 3

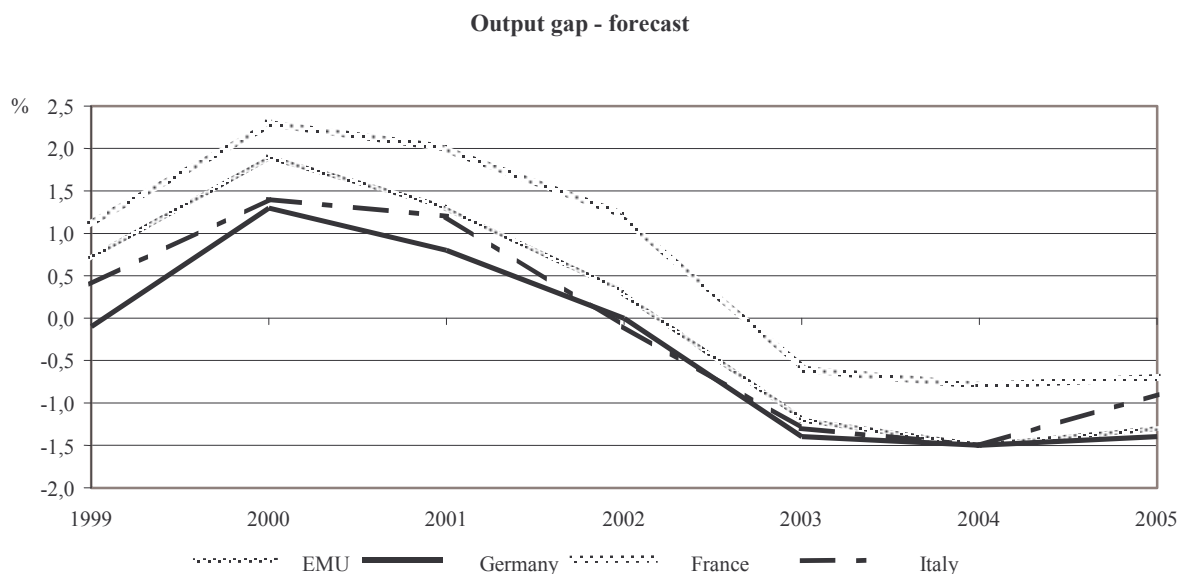
Forecast of economic development in the euro area according to the Consensus Forecast (March 2004)

	2000	2001	2002	2003	2004	2005
GDP	3.5	1.6	0.9	0.4	1.7	2.1
Private consumption	2.7	1.7	0.1	1.0	1.4	2.0
Government consumption	2.1	2.5	2.9	1.9	1.5	1.2
Gross fixed capital formation	4.9	-0.3	-2.8	-1.2	2.1	3.3
Export of goods and services	12.3	3.4	1.5	0.0	4.1	5.1
Import of goods and services	11.0	1.7	-0.1	1.5	4.7	5.6
Consumer prices	2.1	2.4	2.3	2.1	1.7	1.6

Over 2004 and 2005 it is expected that the economic recovery will be moderate, while GDP growth will be below its potential level. The negative output gap together with moderate wage development will have a dampening effect on inflation.



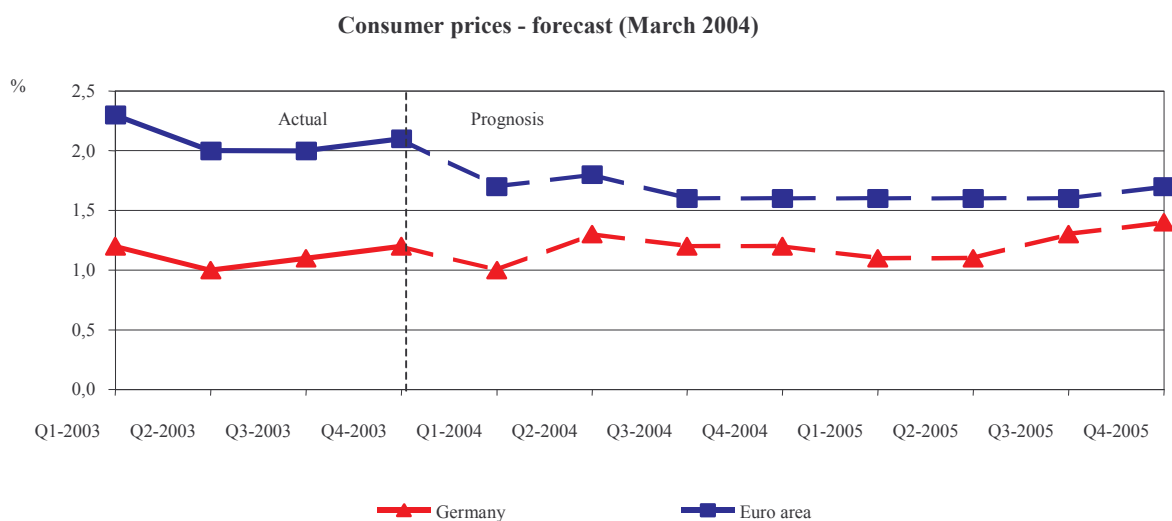
Graph 2



Source: European Commission

Due to weak domestic, as well as insignificant external stimulus of price development, a low level of inflation is expected over the whole time horizon. From the view of external factors the fading the significant past appreciation of the euro away as well as the predicted balance between the supply and demand for oil will have a dampening effect on inflation. Of the domestic factors, other than the already mentioned negative output gap and moderate wage development, the unfavourable situation in the labour market should also have a dampening effect on the level of inflation. A slight decline in labour costs as a consequence of insufficient growth in labour productivity should also have an impact on a slowdown in the dynamics of consumer prices growth.

Graph 3

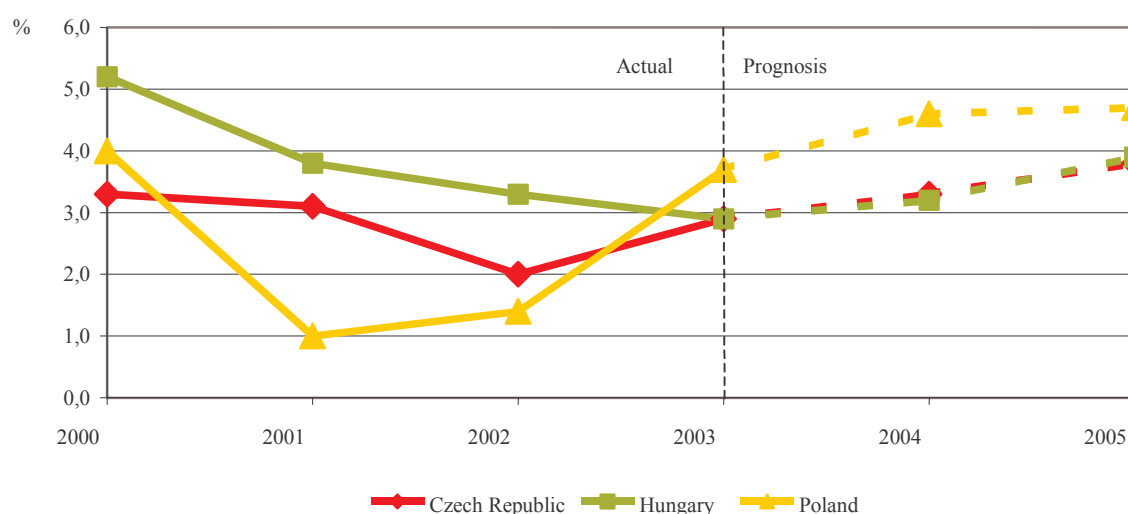


Source: Consensus Forecast

In selected new EU member states, the Czech Republic, Hungary and in particular Poland, there is an expectation of relatively fast economic growth over the years 2004 and 2005 in comparison with the euro area countries. In the case of the Czech Republic and Hungary, in 2003 the growth was driven by private consumption, in Poland it was primarily net exports, in particular as a consequence of the depreciation of the zloty. Over the time horizon of the outlook there is expected a moderation of private consumption growth in the Czech Republic and Hungary, as a consequence of the increase in indirect taxes connected with the countries' accession to the EU as well as a consequence of a moderate wage growth. In both countries more significant support for growth should come from the side of exports, mainly as a result of the influence of the improving external environment (especially in the euro area). In Poland, on the contrary, a gradual reduction of the positive impact of the net export on economic growth and strengthening support for growth from the side of domestic demand is expected, where a loose fiscal policy should represent a significant stimulus. In all the acceding countries significant investment growth is expected.

Graph 4

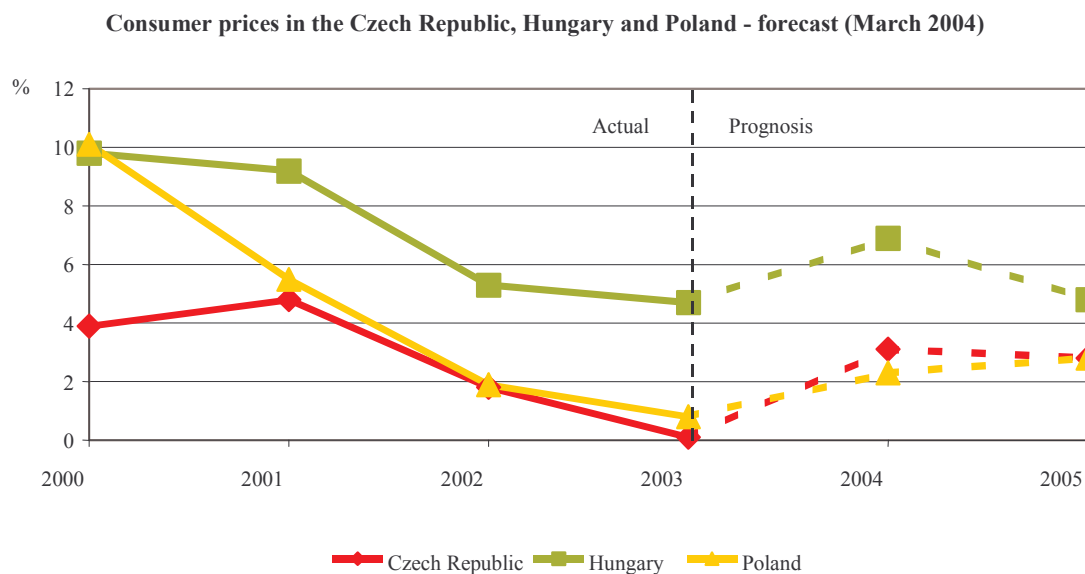
**GDP growth in the Czech Republic, Hungary and Poland - forecast (March 2004)**



Source: Consensus Forecast

With the exception of Hungary, in 2003 inflation in the countries mentioned reached a very low level, comparable with that of the euro area countries. In 2004 and 2005 inflation in these acceding countries is expected to increase as a result of the raise in indirect taxes in connection with tax as well as price harmonisation upon accession to the EU. In the case of Poland an expected recovery in domestic demand will also have an impact on the increase in inflation.

Graph 5



Source: Consensus Forecast

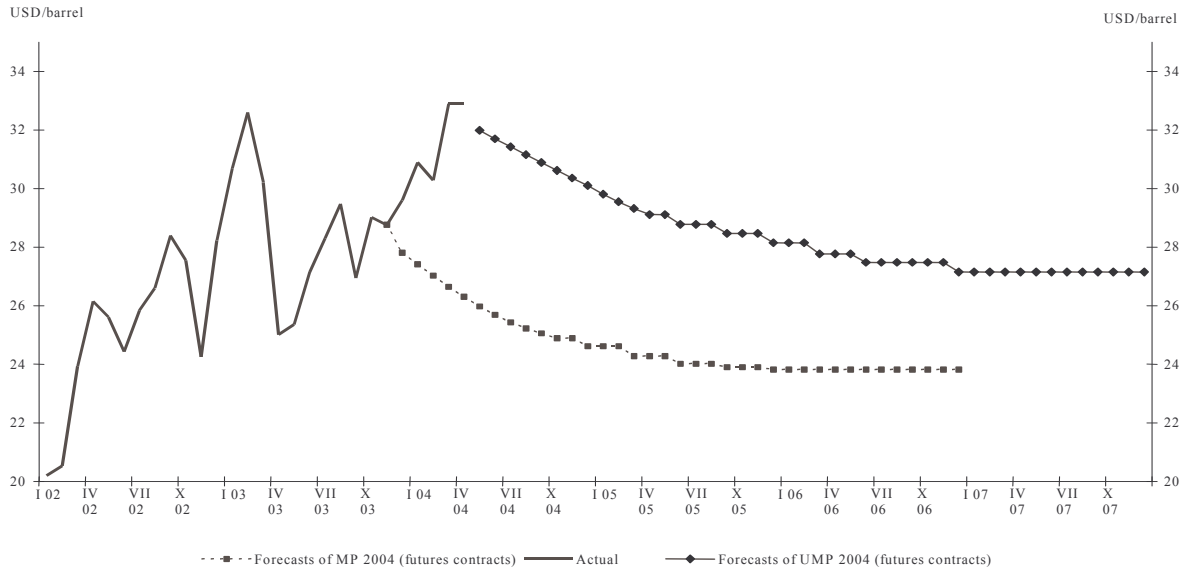
*Assumptions of the exchange rate development*

In comparison with the Monetary Programme, the Updated Monetary Programme takes into account the existing development of the koruna exchange rate against the euro. Over the medium-term horizon, given the prospective development of economic fundamentals, it is likely to expect a gradual appreciation of the equilibrium real exchange rate. For the purpose of cross exchange rate of the dollar and the euro calculations, the Updated Monetary Programme is based on the Consensus Forecast projections (adjusted), i.e. in 2004 and 2005 it counts on an exchange rate of 1.25 USD/EUR and in 2006 on an exchange rate of 1.22 USD/EUR. As the forecast for 2007 is not available in the Consensus Forecast, the Updated Monetary Programme counts on the same level of the cross exchange rates as in 2006.

*Assumptions of the development of oil prices on the world markets*

The assumptions of the oil price are based on market expectations ascertained from the values of futures contracts. On the basis of these values it is expected that the average oil price from May to December 2004 will reach 31 USD/b. In 2005 the average oil price should reach 29 USD/b and in 2006 should fall to 27 USD/b. Given the fact that the values of futures contracts for 2007 are not available, the same average price as in 2006 (27 USD/b) has been used.

# Expected oil price



## 2. Year 2003

### 2.1 Inflation

On a year-on-year basis the overall rate of inflation in 2003 reached 9.3% and core inflation 3.0%, both figures being within the frame of the programme band of the NBS Updated Monetary Programme for 2003.

Price development in 2003 was influenced mainly by domestic cost factors. The overall price development was influenced by administrative measures, where January saw a growth in regulated prices and excise duties, as well as a change in VAT rates, and August again an increase in excise duties. The share of administrative measures in the overall increase in prices represented more than 75%. These measures (primarily the rises in energy prices) were manifested as a secondary effect as a significant increase in the prices of market services. A further domestic factor influencing the price level was an acceleration in the rate of growth of food prices.

The influence of external factors had a dampening effect on the price level. The appreciation of the Slovak koruna exchange rate against the euro as well as the American dollar was manifested in fuel prices. The development of the Slovak koruna exchange rate had an impact on the price level also in the form of low imported inflation, which was reflected in a slow rate of growth in tradable goods prices.

Development of consumer prices in 2003 (%)

		MP 2003	UMP 2003	estimate 2003 <sup>1</sup>	actual 2003
Overall inflation	Year-on-year rate	8.7 (7.7 – 9.7)	9.1 (8.4 – 9.7)	9.4	9.3
	Average y/y rate	8.8 (8.2 – 9.3)	8.1 (8.3 – 8.8)	8.5	8.5
Core inflation	Year-on-year rate	3.9 (2.7 – 5.0)	2.8 (2.1 – 3.6)	3.1	3.0
	Average y/y rate	.	.	2.7	2.6
Net inflation excluding fuels	Year-on-year rate	.	.	3.4	3.8
	Average y/y rate	.	.	.	3.9

<sup>1</sup>Estimate in the 2004 MP framework

### 2.2 Producer prices

Industrial producer prices in 2003 increased on average by 8.3%, which in comparison with the estimate of the updated monetary programme for 2003 as well as their estimate in the framework of the monetary programme for 2004 represented slightly faster growth. This development was connected primarily with the more significant increase in the prices of mineral raw materials, probably due to higher energy costs (the stated sub-category, due to its low weighting, is not included in the NBS predictions). The development of the prices of industrial production products and electricity, gas, steam and hot water prices were almost identical with the development forecast in the UMP for 2003.

Development of industrial producer prices in 2003 (index ROMR=100)

	MP 2003	UMP 2003	estimate 2003*	actual 2003
Average annual index	105.9	108.0	108.0	108.3
of which:				
- industrial production products	.	102.6	102.5	102.6
- electricity, gas, steam, hot water	.	117.8	117.8	117.9

\*estimate in the 2004 MP framework

### 2.3 Balance of payments

The current account of the balance of payments in 2003 reached a deficit of SKK 10.2 billion (0.9% of GDP), thus lower than the NBS prognosis in the updated monetary programme.

2003 balance of payments in SKK bn.	2003– MP	2003 – UMP	2003 – est.	2003
Trade balance	-85.0	-65.0	-38.2	-23.6
Balance of services	8.0	6.0	10.3	8.6
Balance of incomes	-16.1	-4.9	-4.1	-4.4
Current transfers	8.0	4.0	8.7	9.2
<b>Current account</b>	<b>-73.1</b>	<b>-53.9</b>	<b>-23.3</b>	<b>-10.2</b>
Capital transfers	8.0	6.0	4.5	3.7
Direct investment	41.0	43.4	41.9	30.6
Portfolio investment	16.0	7.0	-4.3	-21.5
Other long-term capital	-31.5	-15.9	-18.2	-15.0
<b>Capital and financial account</b>	<b>41.2</b>	<b>62.1</b>	<b>61.4</b>	<b>64.5</b>
<b>Change in reserves (-, growth)</b>	<b>31.0</b>	<b>-8.2</b>	<b>-38.1</b>	<b>-52.4</b>

Development at variance with that predicted by the NBS in the updated monetary programme was recorded in particular in the balance of trade.

The development of the balance of trade was affected by faster export growth. Differences in the rate of export growth 11.2% (UMP) and 23.1% (actual) appeared mainly in the group machinery and transport equipment. In connection with the higher production and export of more expensive types of vehicle, as well as other components, including chassis, exports in the group means of transport were more than 40% higher than the figure forecast in the UMP. The higher-rated growth of exports was subsequently also reflected in a higher rate of growth of imports: 5.6% (UMP) and 10.5% (actual). Increased imports, which were caused in connection with the growth of exports of the automobile industry, were reflected mainly in the group machinery and means of transport. In other items of the current account smaller shifts were recorded, with the exception of current transfers, where in 2003, contrary to the prediction which had been based on the development of this item in preceding years, lower payments to abroad were made, both by natural as well as legal persons.

The capital and financial account for the balance of payments ended the year 2003 with a surplus of SKK 64.5 billion, remaining at the level of the figures predicted in the UMP.

Within its structure the different development was recorded mainly in portfolio investments. An increased outflow occurred due to purchases of foreign securities by commercial banks and was connected with an inflow of foreign short-term funds. Direct investment exceeded SKK 30.6 billion, its lower inflow being caused by the deferment of several incomplete projects until the following year.

The adjusted capital and financial account did not cover the current account deficit. This difference was financed by a reduction in the foreign exchange assets of commercial banks, which in connection with appreciation expectations and for the purpose of increasing profitability had shortened their forex positions.

The higher inflow of sources to the government sector and the NBS was caused by several factors (repatriation of debt, intervention measures, drawing of a government loan and repo operations), the amount of which was manifested in a higher growth of NBS foreign exchange reserves.

The balance of the NBS's foreign exchange reserves as at 31.12.2003 reached USD 12.1 billion, i.e. EUR 9.7 billion. Their level was sufficient to cover 5.7-times the average monthly import of goods and services in 2003.

Foreign debt in 2003 reached USD 18.3 billion, i.e. EUR 14.6 billion. The increase in foreign debt against the UMP (USD 13.5 billion and EUR 12.8 billion) was caused by two factors. A higher difference between drawing and repayment was a consequence of the increased inflow of the short-term liabilities of commercial banks (transactions between parent and subsidiary banks in the framework of the strategies of foreign bank branches in connection with more profitable interest rates), and the higher inflow in consequence of realized NBS's repo operations. The appreciation of the SKK/USD exchange rate from forecasted 39.5 to 32.9 was further factor influencing the level of foreign debt mainly in USD (USD 2.8 billion).

#### ***2.4 Gross domestic product***

GDP growth in 2003 of 4.2% at constant prices reached approximately the middle of the interval forecast by the UMP prognosis for 2003, which forecast real economic growth in the range 3.9% - 4.4%.

The Updated Monetary Programme thus expected a positive contribution from domestic as well as foreign demand to economic growth<sup>1</sup>. Actually it was exclusively foreign demand that contributed to real economic growth in 2003, while domestic demand declined. The year-on-year growth of domestic demand reached 22.6% at constant prices, which was the fastest growth since 1994. Domestic demand in 2003 fell on a year-on-year basis in real terms by 2.3%, where its development was influenced by the decline in gross capital formation, and the fall in final consumption by households and in particular a diminution of inventories. The decline in domestic demand was ameliorated by the growth in final consumption of government and non-profit institutions serving households.

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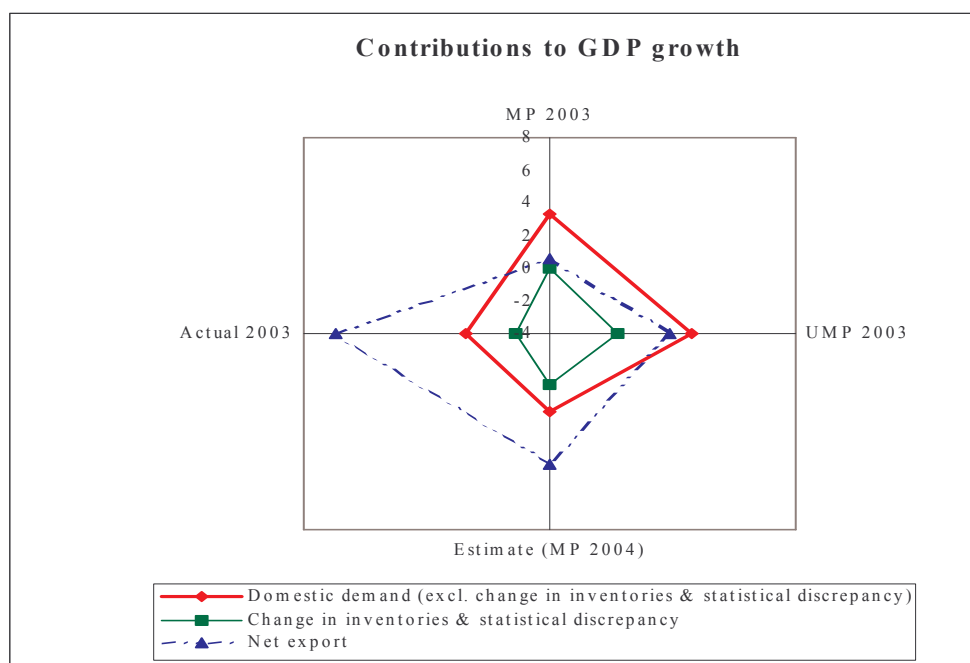
<sup>1</sup> Comparison of the actual GDP development in 2003 with its prognosis in the MP 2003, the UMP 2003 and the estimate in the framework of the MP 2004 may be made only in terms of a framework, since in December 2003 (following the approval of the MP 2004) the whole time series of GDP data for the years 1993-2003 was revised. Through the revision in accordance with the next stage of implementing ESA 95 national accounts methodology, the trends in the development of individuals GDP components were thus changed, as well as their weighting in the structure of GDP.

GDP development in 2003

(constant prices, year-on-year change in %)

	MP 2003	UMP 2003	estimate 2003*	actual 2003
HDP at constant 1995 prices - interval	3.7 – 4.1	3.9 – 4.4	x	x
- mid-interval	3.9	4.1	3.9	4.2
Domestic demand	3.2	2.1	-0.1	-2.3
Net export	x	x	x	x
Export of goods and services	5.9	7.6	19.2	22.6
Import of goods and services	5.0	5.0	13.5	13.8

\* estimate in the MP 2004 framework



The greatest shift (increase in contribution) in the GDP structure compared to the NBS's expectations from 2003 (MP, UMP, estimate), as is clear from the graph, occurred in net exports, which moderated the fall in domestic demand.

### 2.5 Wages and employment

The average monthly nominal wage in the Slovak economy grew in 2003 on a year-on-year basis by 6.3%, real wages, following its growth in the preceding two years, fell by 2.0%. The actual growth in nominal and real wages was below the lower limit of the UMP 2003 interval. The lower than forecast growth of nominal wages was affected primarily by development in the 4<sup>th</sup> quarter, which could have been a consequence of a deferment in the payment of variable components of wages and remunerations into 2004. This is evidenced by unusually low growth in wages in some sectors in the 4<sup>th</sup> quarter of 2003 in comparison with the previous quarters and the same periods of previous years, as well as the development in the first months of 2004, when a marked increase in wages was seen.

Labour productivity (GDP per employee of the economy) in 2003 increased on a year-on-year basis at both current and constant prices. The growth achieved did not create room for the creation of inflationary pressures, since the productivity growth at current prices (8.2%) was faster than the growth in nominal wages by 1.9 percentage points. Real labour



productivity through its growth of 3.4% exceeded real wages growth by 5.4 percentage points. Its development was almost in accordance with the prognosis of the UMP 2003.

According to statistical reporting employment in 2003 grew on the previous year by 0.8%, which was faster than the expectations contained in the UMP 2003. Its development was influenced primarily by the fast growth of employment in services, in particular in financial intermediation, public administration, defence and compulsory social security, in real estate, renting and business activities, as well as in construction.

Unemployment in 2003 developed more favourably than forecast in the UMP 2003. The registered unemployment rate at end of the year reached 15.6%, whereas at the end of the preceding year the figure had been 17.4%. The average registered unemployment rate fell compared to 2002 by 2.6 percentage points, reaching 15.2%. Mainly administrative factors contributed to its decline, in consequence of the amendment to the Act on Employment, which tightened up the conditions for registration of job applicants, though the decline was in part also due to an increase in the number of job vacancies.

Development of the labour market in 2003	(year-on-year change in %)			
	MP 2003	UMP 2003	estimate 2003*	actual 2003
Average monthly nominal wage - interval	9.0 – 11.0	7.5 – 9.5	x	x
mid-interval	10.0	8.5	6.8	6.3
Average monthly real wage - interval	0.3 – 2.1	-1.0 to 0.8	x	x
mid-interval	1.2	-0.1	-1.6	-2.0
Labour productivity of GDP at constant prices	3.4	3.7	3.0	3.4
Real productivity – real wages (p.p.)	2.2	3.8	4.6	5.4
<i>Average rate of inflation – mid-interval</i>	8.7	8.6	8.5	8.5
Employment according to statistical reporting	0.5	0.4	0.9	0.8
Registered unemployment rate - end of the year (%)	17.75	17.2	.	15.6
Registered unemployment rate – average (%)	.	.	15.2	15.2
Average unemployment rate according to LFS** (%)	.	.	17.1	17.4

\* estimate in the MP 2004 framework

\*\* Labour Force Sample Survey

## 2.6 Public sector

Act No 750/2002 Z.z. on the state budget for 2003 set the following parameters for the state budget:

total incomes	SKK 235.4 billion
total expenditures	SKK 291.4 billion
state budget deficit	SKK -56.0 billion

The budget deficit stipulated was adhered to, while the incomes and expenditures actually achieved were SKK 233.1 billion and SKK 289.1 billion respectively.

The shortfall in tax revenues as at the end of the year reached SKK 15.5 billion. This was caused both by low consumption, an over-estimation of the effect of the change in VAT rates, but mainly by the amendment to the Act on VAT (No 511/2002 Z.z.), governing tax

deductions. As a result excise duties were increased on 1 August. This amendment, however, brought an effect only in the amount of approx. SKK 2 billion.

The shortfall in tax revenues was partially compensated by an excess of non-tax incomes (by SKK 13.2 billion). This excess was achieved through the following measures:

- the use of state financial assets in the amount of SKK 4.2 billion,
- the use of privatisation revenues of SKK 3.3 billion. These funds were used for unburdening healthcare facilities of debt by means of the joint-stock company Veritel,
- implementing an excise duty on supplies of mineral oils stored by the State Material Reserves Administration (SKK 2.4 billion)
- incomes from the repatriation of debt (SKK 3 billion).

The public budget deficit on the accrual principle (ESA 95 methodology) was projected at the level of SKK 57.7 billion (5% of GDP). In fact, the results achieved were substantially better, where the deficit reached only SKK 41.5 billion (3.5% of GDP). A reason was the non-drawing of funds on the accounts of individual departments and other organisations (SKK 8.3 billion), as well as the direct savings of budgetary organisations (SKK 4.5 billion) and interest received from the time deposit account in the NBS, intended for the needs of pension reform (SKK 3.9 billion), which had originally not been included in the budget.

## **2.7 Monetary development and monetary policy**

The NBS during the year reduced its main interest rates twice, which in the total extent represented a reduction of 0.5 percentage points. Through its new setting of interest rates the NBS affected primarily the development of domestic demand, which had been negatively influenced by the impact of widespread administrative price adjustments and in the following period it did not count on the operation of any more significant growth impulses. The persistence of these trends could be seen in a slowdown in the rate of economic growth. The reduction in rates should lead to a mitigation of unbalanced trends in the structure of GDP with the aim of maintaining its balanced growth. The reduction in NBS interest rates had also the result of mitigating the positive interest rate differential, though it did not reduce in a more significantly way the interest in buying Slovak koruna.

The year 2003 saw the prevailing appreciation pressures of the Slovak koruna, brought about by favourable economic development, the realisation of crucial reforms, increased interest of foreign investors and an improvement in the international country position. The intensity of the koruna's appreciation exceeded the appreciation rate justified by economic factors. The NBS thus actively intervened on the foreign exchange market. On a year-on-year average the Slovak koruna in 2003 appreciated in nominal terms by 2.8%. The real annual appreciation of the koruna measured by the REER index on a PPI basis in 2003 was significantly higher and in December reached 10.8%, and on a PPI manufacturing basis 4.7%, where over the course of the year significant volatility was recorded (at levels from 8.5% to 17.7%, respectively from 3.7% to 11.1%). This resulted in particular from the high deregulation of energy prices and changes in indirect taxes in 2003. The real appreciation of the koruna slightly exceeded the forecasts of UMP 2003 (by approximately 1 percentage point), which was influenced in particular by the more significant appreciation of the Slovak koruna against the USD than the similar strengthening of the currencies of Slovakia's main trading partners.

The conduct of NBS monetary policy in 2003 retained its sterilisation nature. In comparison with 2002, when the development of the sterilisation position was to a significant extent influenced by the Government's privatisation activities, the development of sterilisation in 2003 may be evaluated as balanced. Over the course of the year no significant fluctuation in the volume of sterilised funds occurred, the average sterilisation volume moved in the range from SKK 153 billion (in January) to SKK 169 billion (in August) and the average annual level of sterilisation was SKK 162.7 billion. The level of the NBS sterilisation position to the banking sector as at 31.12.2003 reached SKK 176.1 billion, which in comparison with the beginning of the year represents a deepening of SKK 32 billion. The level of sterilisation reached was in accordance with the UMP expectations.

The NBS interventions on the foreign exchange market aimed at preventing the undue appreciation of the Slovak koruna (the inflow of liquidity in the volume of approximately SKK 27 billion) and the January reduction of the percentage rate of minimum reserves for the banking sector by 1 percentage point (creation of surplus liquidity in the volume of SKK 6.5 billion) belong to the basic factors contributing to the inflow of liquidity. Banking sector's reserves were also partially increased through the release of privatisation revenues from the special account of the National Property Fund in the NBS (revenue from the sale of VSE and additional payments for the sale of the SPP, ZSE and SSE) and through the standard more-or-less regularly repeating release of funds from a sphere of selected NBS balance accounts.

### *Monetary aggregates*

The development of the money supply M2 in 2003 saw in comparison with previous year changes in the structure of individual components. In the overall growth of the M2 in 2003 dominated primarily koruna deposits, whereas the development of foreign-currency deposits continued on a downward trend persisting from the second half of 2002. A more significant change occurred also in the development of currency in circulation, which grew approximately twice as quickly as in 2002.

The money supply M2 (at the fixed exchange rates of 1993) in December 2003 recorded against the beginning of the year an overall growth of SKK 43.6 billion and reached SKK 730.0 billion. In absolute terms its year-on-year growth of SKK 13.3 billion was higher than in the preceding year (SKK 30.3 billion). The year-on-year rate of growth of the money supply at the close of the year reached the level of 7.1%, while its average over the year (7.3%) was 1.2 percentage points lower than in 2002.

In comparison with the assumptions of the UMP 2003 (10.0%), the money supply M2 achieved a more moderate dynamics in 2003, which was influenced by the more intensive use of alternative investment possibilities (primarily in money market mutual funds). Since liabilities in the form of mutual fund certificates are not a component of the monetary aggregate M2, an moderation in the rate of growth in the money supply occurred as a result of the transformation of bank deposits into alternative forms of investment (the net asset value of open-end mutual funds operating in the SR grew approximately 2.5-fold in 2003, from SKK 16 billion to SKK 40 billion).

From the aspect of the sources of the creation of the money supply, its growth over the course of 2003 was determined primarily by the operation of domestic factors, in particular the continuing growth in credits to enterprises and households and public sector debt. With regard to the fall-off in the privatisation activities of the Government, there has not been repeated the significant effect of an inflow of a large volume of financial resources from abroad.

The total volume of credits to enterprises and households (at the fixed exchange rates of 1993) according to preliminary data reached SKK 378.0 billion in a year-on-year growth of 14.5% at the end of 2003. The dynamics of credits exceeded the UMP assumptions and growth in mortgage loans to households and loans drawn by enterprises in foreign currency contributed mainly to faster growth rate. The attractiveness of credits in foreign currency was increased by a lower interest rates, as well as the expected (and realised) appreciation of the Slovak koruna. The continuing growing trend in the lending activities of commercial banks was caused primarily by koruna credits provided to households and credits in foreign currency, preferred in particular by enterprises, whereas koruna-denominated credits to enterprises recorded an upturn only in the last two months of the year. Within the credits to households, mortgage loans prevailed, and from the beginning of the year grew by SKK 13.5 billion. Other credit products recorded more moderate growth.

	%	MP 2003	UMP 2003	Actual
Net foreign assets		-12.3	0.3	-6.6
Net domestic assets		23.0	15.3	14.6
Domestic credits		19.4	14.4	16.9
Net position of the public sector		33.4	18.2	20.2
Credits to enterprises and households		9.3	11.5	14.5
<b>M2</b>		10.0	10.0	7.1

### **3. Updated Monetary Programme for 2004**

#### ***3.1 Inflation***

##### ***Updated development since the beginning of the year***

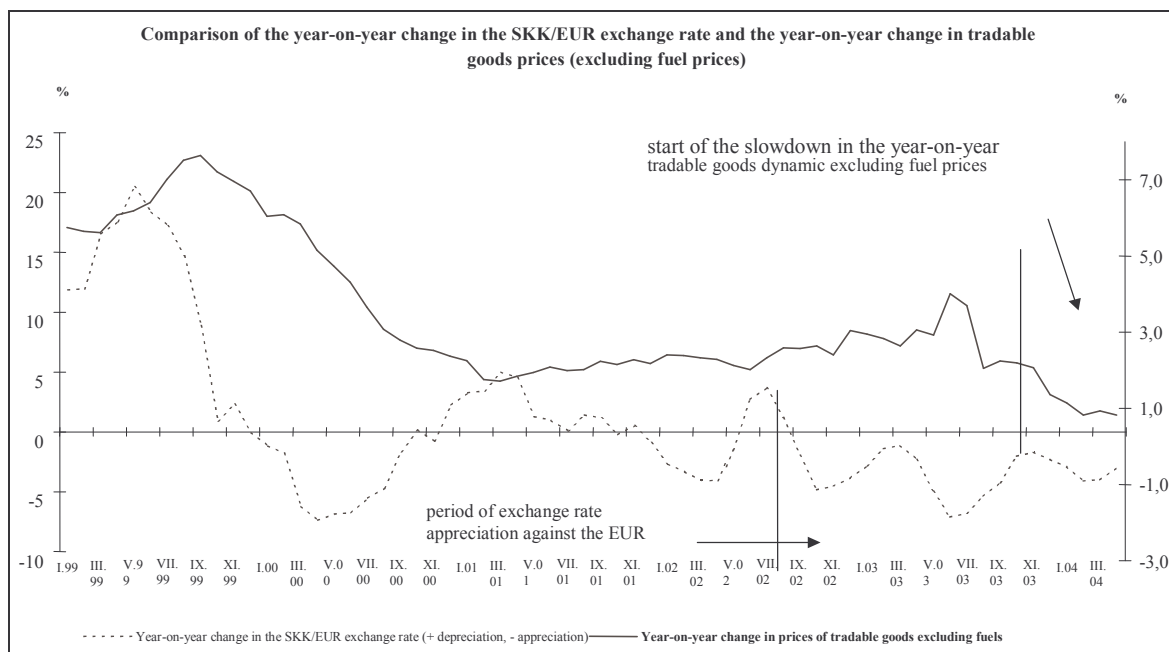
The year-on-year rate of inflation in the first four months of 2004 was characterised by a fall in the rate of its growth below the level of 9%. Consumer prices in April grew on a year-on-year basis by 8.0%, where the highest growth (14.7%) was recorded by regulated prices. The average year-on-year rate of inflation for the first four months reached 8.3%.

The development of consumer prices in the first months of the year was determined mainly by domestic cost factors in the form of increases to regulated prices and changes in VAT rates as of January 2004. From the aspect of external cost factors, the development of consumer prices was influenced by oil prices and an appreciation of the American dollar exchange rate. The oil price over the course of the first three months of 2004 stayed at a value above the reference band of the OPEC oil exporting countries (the average price for the first four months was 31.8 USD/barrel).

The level of core inflation reached, on a year-on-year basis, in April 2.6%, which is in the upper half of the programme band. The main reason was a change to methodology, where the amount of compulsory third-party liability insurance of passenger motor vehicles ceased to be regulated from January and was shifted from the sector of regulated prices to that of market services. Without this effect core inflation would have been in the lower half of the programme band. Thus the lower dynamic of core inflation, excluding the effect of this methodological change of the reclassification of compulsory third-party liability insurance, contrary to the expectation contained in the monetary programme, was caused by a slower rate of price growth in its other sectors (food and tradable goods).

In the development of food prices a long-term fall in the price of meat was seen and a more significant seasonal decline in the price of fruit.

In the tradable goods sector prices were dampened down, on the one hand, by the low growth of real wages and higher household expenses on services connected with living, and, on the other hand, by low imported inflation, by an appreciation of the exchange rate and a persistent strong competitive environment. Even despite the accelerating growth in fuel prices, the first months of the year saw a slowdown in the year-on-year dynamic of tradable goods prices not only as a consequence of the factors mentioned, but probably also due to the long-term appreciation of the koruna exchange rate. The effect of the long-term appreciation of the koruna exchange rate on the tradable goods dynamic is depicted in the following graph.



The lower extent of the deregulation of the administrative prices in 2004 against the preceding year was manifested in a slowdown in the year-on-year dynamic of market service prices. In the first four months secondary effects of the increase in regulated prices have so far been in the scope forecast by the Monetary Programme (where this concerns primarily services connected with living and services of hotels, cafes and restaurants).

### ***Forecasts of the updated monetary programme and expected development to the end of the year***

The inflation prediction for 2004 in the UMP is based on the updated oil price estimate, the exchange rate of the Slovak koruna against the euro and the American dollar against the euro.

As regards the structure of inflation, in the field of **administrative measures** in the updated inflation prediction for 2004 no significant changes in regulated prices are expected against MP 2004. Similarly as in the monetary programme and its updated version, there is expected only a slight increase in excise duties on tobacco and tobacco products (these have grown since May 2004 by 1.9% in the case of short cigarettes and by 1.7% in the case of long cigarettes) with an impact on overall inflation of 0.1 percentage points. Over the course of the year the effect of the increase in excise duties in August of the preceding year should lapse and together with it the related effect of the speculative increase in cigarette prices. Compared to the values of the monetary programme the dynamic of **regulated prices** should however be lower due to the mentioned transfer of compulsory third-party liability insurance from regulated prices to market services.

In the framework of the basic structure of **core inflation** the updated prediction takes account of the methodological change of the classification of compulsory third-party liability of passenger motor vehicles from regulated prices to market services, meaning an increase in the values of the programme band against the forecasts of the monetary programme.

The decrease in the expected growth in **food** prices in the updated monetary programme against the forecasts of the monetary programme was seen primarily in the slow growth of prices in the first months of 2004. Other forecasts of the monetary programme that should influence the development of food prices this year remain unaffected.

Similarly as with the monetary programme for 2004, the updated monetary programme forecasts that the development of **tradable goods** prices should be influenced by the low growth of tradable goods themselves, excluding fuel prices, where the influence of low imported inflation and a developed competitive environment, supported by a EU accession, will continue to be felt. In comparison with MP 2004 fuel prices should stay at higher levels in consequence of the higher oil price on world markets (which should up until the end of the year move at a level above 30 USD/barrel). The year-on-year dynamic in tradable goods should in the summer months fall to very low levels under the influence of the “base effect”, when a year ago saw a significant speculative growth in cigarette prices ahead of the increase in excise duties from August of the previous year. Prices of tradable goods should, on a year-on-year basis, at the end of the year be within the programme band of the MP 2004.

**Prices of market services** have reflected the reclassification of compulsory third-party liability insurance from regulated prices, which has led to the fact that the updated expected trajectory of their development is above the original programme band of the monetary programme. No more significant secondary cost pressures should be seen in the development of market service prices by the end of the year, in accordance with which their further growth should be stabilised and the growth on a year-on-year basis should decline slightly.

As regards price development since the beginning of the year and the effect of the above-mentioned factors, the forecast is that overall inflation in 2004 may reach values within the programme band of MP 2004 and core inflation in 2004 could reach values in the upper half of the MP 2004 programme band. With regard to the known development in the first months, the limits of the programme interval of overall inflation have been narrowed. In the case of core inflation the shift in the programme interval upwards is a consequence of methodological change, the shift of compulsory third-party liability insurance from regulated prices to market services. The narrower core inflation interval compared to the monetary programme is connected, similarly as in the case of overall inflation, with the account taken of its actual development in the first months of the year.

**According to the updated prediction core inflation could in December 2004 reach a value in the band of 1.9-3.4%. Overall inflation may at the end of the year move within the interval of 5.7-7.0%, to which corresponds an average inflation rate in the band of 7.3-7.7%. Net inflation excluding fuel prices should move at the end of the year in the band of 2.6-3.4%.**

Prediction of the development of consumer prices for 2004 (%)

		actual 2003	MP 2004	UMP 2004 <sup>1</sup>
Overall inflation	y/y rate	9.3	6.4 (5.5 – 7.3)	6.4 (5.7 – 7.0)
	average y/y rate	8.5	7.7 (7.2 – 8.2)	7.5 (7.3 – 7.7)
Core inflation	y/y rate	3.0	2.3 (1.2 – 3.5)	2.7 (1.9 – 3.4)
	average y/y rate	2.6	2.4 (1.8 – 3.0)	2.7 (2.4 – 3.0)
Net inflation excl. fuel prices	y/y rate	3.8	2.3 (1.7 – 2.8)	3.0 (2.6 – 3.4)
	average y/y rate	3.9	2.5 (2.1 – 2.8)	3.2 (3.0 – 3.3)

<sup>1</sup> prognosis on the basis of current development to April

### ***Risks in the development of inflation***

A risk to the inflation estimate for 2004 could be possible fluctuations in the koruna exchange rate. A significant movement in the exchange rate, through either its appreciation or depreciation, could affect price growth primarily in the tradable goods sector.

Another risk is that contained in the development of oil prices, where a possible surplus in the summer months could cause a fall in its price, which would subsequently be reflected in a lower growth in consumer prices, in particular under the influence of a lower fuel prices. Conversely, increased demand for oil in connection with a possible recovery in the world economy, a significant growth in demand for commodities in China, and a fall in extraction from the side of the OPEC countries and a worsening of the situation in Iraq, could cause its further growth with this subsequently being reflected in the development of consumer prices.

A risk in food prices may constitute an impact other than that expected from the Common Agricultural Policy and its distribution over the years 2004 and 2005. If the effect of adopting the Common Agricultural Policy is manifested only in this year and the rate of food price growth increases at a more significant rate, then in the following year the opposite should be seen, with a slowdown in their year-on-year growth.

A certain degree of risk may also be represented by a high growth in wages, not covered by a growth in labour productivity with possible demand pressures on the prices of market services and partially also tradable goods.

## **3.2 Producer prices**

### ***Updated development since the beginning of the year***

For the first three months of 2004 industrial producer prices grew on a year-on-year basis on average by 3.0%, as a consequence of a growth in electricity, gas, steam and hot water prices by 5.0% and industrial production product prices by 1.2%. The development of energy industry product prices to date has been in accordance with the expectations outlined in MP 2004, nonetheless, a slight deviation upwards has been recorded in the prices of industrial production products. There are several reasons for this. In food product prices the consequences of lower harvests as a result of the adverse weather in 2003 are



negatively beginning to feed through, also prices of the chemical and metal-processing industry have grown somewhat faster than in comparison with NBS expectations in connection with the growth in prices for these products on world markets. From the aspect of external cost factors price development in industrial production should be influenced by the growth in the oil price on world markets, which has not been compensated for to a sufficient extent by the continuing depreciation of the American dollar against the euro and Slovak koruna.

***Forecasts of the updated monetary programme and expected development to the end of the year***

The prediction of producer prices for 2004 is based on the updated forecasts of the development of the oil price and of the Slovak koruna exchange rate against the euro and American dollar. Forecasts concerning the development of food product prices are identical to the forecasts of the consumer food price prognosis (the influence of the Common Agricultural Policy and low cereal harvest in 2003). Nevertheless, their slightly more significant impact on price development in the processing industry is expected in comparison with end prices for consumers.

The influence of the above-mentioned bases of the UMP 2004 should, in comparison with the MP 2004, be manifested in a faster dynamic of industrial production product prices and subsequently also overall prices in industry.

Prediction of the development of industrial producer prices for 2004 (index, ROMR=100)

	actual 2003	MP 2004	UMP 2004				
			actual 1.Q	2.Q	3.Q	4.Q	year
Average annual index	108.3	102.4	103.0	102.5	103.2	103.5	103.0
of which:							
- industrial production products	102.6	101.4	101.2	101.6	102.9	103.4	102.2
- electricity, gas, steam, hot water	117.9	104.2	105.0	103.7	103.6	103.7	104.2

***Risks to the development of producer prices***

Risks to the development of industrial producer prices may be said to include divergent development of the oil price on world markets, since on the one hand due to a growth in the export of oil from countries outside OPEC, there may occur an increase in its supply on the market and thereby also a fall in its price. On the other hand, in the case of increased growth in demand for oil in consequence of a global economic upturn the oil price might exceed the level forecast in the MP 2004.

Further risks include a more significant appreciation, or depreciation of the American dollar against the euro and thereby also against the Slovak koruna and a more significant appreciation, or depreciation of the Slovak koruna against the euro.

The development of food prices may also be said to be risky, where there may occur divergent development due to the non-fulfilment of the expected effects of the Common Agricultural Policy's adoption on food product prices, as well as due to unforeseeable changes in climatic conditions.

### 3.3 Foreign area

#### 3.3.1 Balance of payments

The monetary programme for 2004 predicted a current account deficit in the amount of SKK 30.4 billion and an inflow of funds on the capital and financial account in the amount of SKK 66.0 billion.

The updating of the balance of payments prediction for 2004 is based on additional information taking account of its development in 2003 and from the beginning of 2004, as well as methodological changes in reporting contributions from and to the European Communities, which are divided between capital and current transfers.

The development of individual items of the current account in 2003 and in the first months of 2004 creates the preconditions for a decrease in the current-account deficit from SKK 30.4 billion to SKK 15.7 billion. This decrease should be caused mainly by a fall in the trade balance deficit, where changes in other items of the current account will, in terms of their volume, be less significant and will have an opposite nature (a fall in the balance of services surplus will in large part be compensated for by a growth in current transfers due to a transfer of part of the funds from the European Communities into this category). The fulfilment of the stated forecasts should lead to a decrease in the deficit of the current account in comparison with the monetary programme by SKK 14.7 billion and its share in GDP by 1.1 percentage points.

The surplus of the capital and financial account should decline against the MP by 16.4 per cent. Besides the lower inflow to the business sector, which is based on the decline in the current account deficit a slight decline in the inflow to the government sector and NBS will be realised (through the third tranche of a World Bank loan drawn at the end of 2003, where in the MP it had been forecast that it will be drawn only in 2004).

Current a/c items in SKK billion	2004 – MP	2004 – UMP
<b>Trade balance</b>	-46.1	-32.0
Exports	840.3	867.6
Imports	886.4	899.6
<b>Balance of services</b>	12.9	9.7
<b>Balance of incomes</b>	-3.2	-3.6
<i>of which: balance of interest payments</i>	-17.2	-17.6
<b>Current transfers</b>	8.0	10.2
<b>Current account</b>	-30.4	-15.7
<b>current a/c in GDP ratio in %</b>	-2.3	-1.2

Despite the fact that the rate of growth of exports fell in the first quarter against the year 2003 by almost 10 percentage points, its growth still remains in double figures. A continuation at these rates of growth would, taking account of seasonal influences, lead to achieving a slightly higher volume of exports for the year as a whole than that presented in the MP and a growth in its rate from 7.1 per cent to 8.0 per cent. The growth of exports also influences the growth in imports, the forecast rate of which has been increased from 7.7 per cent to 8.8 per cent. Taking account of the development of exports and imports points to a fall in the deficit of the trade balance to the value of SKK 32.0 billion.

Exports in SKK billion	2004 – MP	2004 – UMP
Finished goods	116.9	117.9
Machinery and transport equipment	421.1	444.7
Semi-finished goods	253.2	253.6
Raw materials	49.1	51.4
<b>Total</b>	840.3	867.6

The forecast that overall export growth should be concentrated in the growth of machinery and transport equipment has remained unchanged, where there has occurred a slight correction to the estimate of exports in this group, which takes account of the change in the range of motor vehicle production with a focus on terrain vehicles.

Imports in SKK billion	2004 – MP	2004 – UMP
Finished goods	192.3	191.7
Machinery and transport equipment	324.7	329.7
Semi-finished goods	263.9	266.2
Raw materials	105.5	112.0
<b>Total</b>	886.4	899.6

The slightly lower volume of imports in comparison with the Monetary Programme is based on the forecast development of exports, mainly in the group of machinery and transport equipment and the import of raw materials, which reflects the higher oil price (30 USD/barrel).

The Updated Monetary Programme has not forecast any significant changes in the trends of individual items of the balance of services and the balance of incomes. The slight decline in the balance of services takes account of the adverse development in the field of tourism incomes, which began in the second half of 2003 and is continuing also at the start of 2004. Besides a decline in number of foreign tourists the reason of the lower revenues from foreign tourists can ground also on the continuing appreciation of koruna exchange rate against other currencies, which in the case of a more significant appreciation of the koruna exchange rate and other conditions remaining unchanged can lead to decline in revenue from foreign tourism.

The higher current transfers against those of the MP are caused by the application of instructions from the European Commission on the division of transfers of incomes from the European Communities and contributions to the European Communities between capital and current transfers. An increase in current transfers causes for this reason a reduction in capital transfers.

As a consequence of these changes, the share of the current account deficit in GDP should reach 1.2 per cent (compared to the 2.3 per cent predicted in the MP).

The updated prediction of the capital and financial account forecasts a surplus in the amount of SKK 66.0 billion (while the MP forecasts a surplus of SKK 55.2 billion).

<b>Cap. &amp; Fin. a/c items in SKK billion</b>	<b>2004 – MP</b>	<b>2004 – UMP</b>
<b>Capital transfers</b>	10.0	7.0
<b>Direct investments</b>	53.2	50.9
in SR	55.0	52.7
FDI – commercial sector	38.0	40.0
FDI – official sector	17.0	12.7
<b>Portfolio investments</b>	-3.2	-2.5
<b>Other long-term financial account</b>	18.0	4.7
<b>Liabilities</b>	18.0	8.1
<i>Government + NBS</i>	22.6	19.2
<i>Commercial banks</i>	-1.0	-0.5
<i>Enterprises</i>	-3.6	-10.6
<b>Short-term financial account</b>	-12.0	-4.9
<b>Capital and financial account</b>	66.0	55.2

Financing the deficit balance of the current account should be achieved mainly through direct investments and capital funds. In 2004 net incomes (the difference between contributions from the budget and EC funds and to the EC budget) should reach approximately SKK 7.0 billion. With regard to the fact that in 2004 the pre-accession funds will be run down, the larger part of the incomes will be concentrated in capital funds.

A significant role in the inflow of funds in 2004 should, in accordance with the MP, be played by foreign direct investment. The amount of such investment will depend on the success of completing a semi-finished projects, here in the course of 2004 there will probably occur an inflow of such funds in connection with the construction of a car factory in the SR (construction works). The lower inflow of FDI in the framework of privatisation via the National Property Fund is connected with the privatisation of the Gas-Steam Cycle Company (Paroplynov cyklus) to domestic investors, where the MP had anticipated its sale to a foreign investor.

The level of portfolio investments is to a large extent dependent on the strategies of commercial banks and partially also on the business sector, to invest their free funds in a wide range of instruments (whereas deposits abroad are a component of short-term capital, bonds and notes and money market instruments fall in the category of portfolio investments).

The inflow of other capital compared to the monetary programme has been reduced by SKK 13.3 billion. In the framework of other long-term capital on the liabilities side the most significant change occurred in the business sector. The lower inflow of debt funds to the commercial sector compared to the MP was brought about by the decline in the current account deficit of the balance of payments, and thus the lower need for its financing.

<b>Adjusted balance of payments in SKK billion</b>	<b>MP – 2004</b>	<b>UMP - 2004</b>
Current account (CA)	-29.6	-17.5
Capital and financial account (Cap. & Fin a/c)	40.2	36.0
Foreign Direct Investment (FDI)	38.0	40.0
NBS Interventions	0.0	-10.1
Change Net Foreign Assets (- growth)	-10.6	-8.4
<b>Coverage of CA by Cap. &amp; Fin a/c in %</b>	135.8	205.7
<b>Coverage of CA by FDI in %</b>	128.4	228.6

The balance of payments adjusted for the influences of activities of the SR Government and the NBS, which do not have an influence on the position of commercial banks vis-à-vis non-residents and do not represent real financing of the current account, should be in 2004 in surplus, i.e. the inflow of funds to the business sector will exceed the deficit on the current account (the net inflow of funds to the business sector will be realised exclusively in the form of FDI and capital transfers, whereas in the case of financial loans repayment will exceed drawing, or the provision of commercial loans will be greater than their acceptance) and net foreign assets of commercial banks will increase. The level of net foreign assets, however, will to a large extent depend on whether, and to what level the sale of foreign exchange to the central bank from commercial banks is realised in the forthcoming months.

Transactions realised in the government sector and NBS (including the purchase to date of foreign exchange from commercial banks) will reflect in a growth in NBS reserves by USD 1.2 billion, i.e. by EUR 1.0 billion. Foreign exchange reserves at the end of 2004 will reach USD 13.4 billion and will be sufficient to cover 5.1 average months' imports of goods and services.

### **3.3.2 Foreign debt**

In predicting the development of foreign debt the basis used comprised preliminary data at the end of 2003 and a specification of repayments, as well as available information on the aims of the SR Government borrowing strategy in 2004.

In the framework of predicting the development of foreign debt and foreign debt servicing we expect in 2004 a growth in the overall gross debt by EUR 0.8 billion (MP - EUR 0.6 billion). The increase in foreign debt on 2003 will be caused by the growth in government debt and short-term debt of the commercial sector, whereas long-term debt of the commercial sector will decline. The balance of overall indebtedness at the end of 2004 will increase to the value of EUR 15.4 billion.

### **3.4 Gross domestic product**

#### ***Forecasts of the updated monetary programme and expected development to the end of the year***

The prognosis of GDP development for 2004 in the MP 2004 counted on the pro-growth influence of domestic demand, where in particular investment demand was to have contributed to the growth of real GDP. As regards domestic demand, the forecasts of MP 2004 remain almost unchanged in the Updated Monetary Programme, where it is expected that real growth of the economy in 2004 will be influenced by the positive contribution of domestic demand.

Individual components of domestic demand will probably retain the trends of development expected in the monetary programme, where in connection with the forecast higher growth of real wages against MP 2004 there will occur faster recovery in private consumption. Investment demand will retain, in line with MP 2004, a growing trend. Investments of both the business as well as public sector should grow, where these will be directed in particular towards preparing territory for the construction of new automobile factories and industrial estates and in the continuing construction on of transport infrastructure. Experience from past years however points to a relatively high degree of uncertainty in making prognoses as to the development of investment, in consequence of which the growth in gross fixed

capital formation expected in the UMP in comparison with MP 2004 is slightly slower. As a result of the above forecasts the shifts in the structure of domestic demand in the UMP however are not significant and are not therefore a reason for a change in the expected influence of domestic demand on the overall growth of the economy.

The prediction of the development of the balance of products and services in the framework of GDP in the MP 2004 predicted a moderation of the growth of exports as well as imports to approximately half the level in comparison to the previous year. On the basis of the development of the balance of trade since the beginning of 2004 a slight acceleration in real growth of exports and imports of products and services may be forecast, which could reach double-figure growth both in exports as well as imports. The actual higher surplus of the net export at constant prices in 2003 and the more favourable estimate of the development of foreign trade for 2004 in comparison with the forecasts of MP 2004 has been reflected in an expected deficit on the net export (including the influence of the unrecorded economy), which according to an updated prediction should reach SKK 22.3 billion at constant prices (in the MP 2004 this was SKK 2.5 billion). The forecast faster dynamic of the export and import of products and services in relative terms means a change against the MP 2004 in the contribution of the net export to the development of real GDP from being slightly negative to slightly pro-growth.

**The slightly changed expected trend of development of individual components of domestic demand and the increased influence of the net export indicates that real GDP growth in 2004 could move at slightly higher levels than in the MP 2004, i.e. in the interval 3.8-4.4%. As a consequence of this the mid-value of the forecast GDP interval shifts in comparison to the MP 2004 by 0.1 percentage points higher to 4.1% at constant prices.**

Prediction of GDP development for 2004 (constant prices, y/y change in %)

	MP 2004	actual 2003	UMP 2004
<b>GDP at constant 1995 prices - interval</b>	<b>3.7-4.3</b>	<b>x</b>	<b>3.8 – 4.4</b>
<b>- mid-interval</b>	<b>4.0</b>	<b>4.2</b>	<b>4.1</b>
<b>Domestic demand</b>	<b>4.1</b>	<b>-2.3</b>	<b>4.2</b>
Of which:			
Final consumption total	1.8	0.5	2.1
Final consumption of households	2.0	-0.6	2.5
Final consumption of government	1.0	2.9	0.9
Final consumption of non-profit institutions	6.9	11.9	6.9
Gross capital formation	9.9	-9.7	10.2
Gross fixed capital formation	6.1	-1.2	5.9
<b>Net exports</b>	<b>x</b>	<b>x</b>	<b>x</b>
Exports of goods and services	9.4	22.6	10.0
Imports of goods and services	9.5	13.8	10.2

Note: Starting point for MP 2004 was data on GDP structure prior to revision. Revised data was published in December 2003.

Contributions of components to GDP growth at constant prices  
(percentage points)

	MP 2004	Actual2003	UMP 2004
<b>GDP at constant 1995 prices</b>	<b>4.0</b>	<b>4.2</b>	<b>4.1</b>
<b>Domestic demand</b>	<b>4.0</b>	<b>-2.4</b>	<b>4.0</b>
of which:			
Final consumption total	1.3	0.4	1.5
Final consumption of households	1.0	-0.3	1.3
Final consumption of government	0.2	0.6	0.2
Final consumption of non-profit institutions	0.1	0.1	0.1
Gross capital formation	2.8	-2.7	2.5
Gross fixed capital formation	1.7	-0.3	1.5
Net exports	-0.1	6.4	0.1
Exports of goods and services	8.5	17.8	9.3
Imports of goods and services	-8.6	-11.4	-9.2
Statistical discrepancy	0.0	0.2	-0.1

Note: Differences in sub-totals of individual components are due to rounding

The lower level of the GDP deflator in 2003 in comparison with NBS expectations indicates a slight growth in the overall price level, implicitly measured at the macro-level in comparison with the consumer price index. With regard to previous development, as well as in connection to the lower rate of expected inflation in 2004, the updated year-on-year growth of the implicit GDP deflator in 2004 in comparison with 2004 is lower. The volume of the nominal GDP has been influenced by the revision of the national accounts, which shifted the GDP level at current prices upwards. After taking account of the slower price development its volume in 2004 will probably reach SKK 1 300 billion.

GDP at current prices and the implicit deflator

	MP 2004	actual 2003	UMP 2004
GDP at current prices			
SKK billion	1 290.0	1 195.8	1 300.0
year-on-year growth in %	9.3	9.1	8.7
Implicit GDP deflator			
year-on-year growth in %	5.1	4.7	4.4

***Risks to GDP development***

The actual development of the end consumption of households will to a large degree depend on the specific influences of economic reforms (tax, pension, healthcare) on the development of the gross disposable income of households and its use. It is probable that the incomes of certain groups of households will increase as a result of adjustments to the income tax rate, the introduction of a tax bonus for children in the framework of the policy of supporting the family, or changes to pensions. In other types of households the unified rate of value-added tax, adjusted social benefits and contributions to the funds of social security may have a dampening effect on the growth of the households' end consumption. The resultant influence on the development of private consumption will depend on the time and scope in which the effects of the implemented economic reforms will become manifest. The development of end consumption of public administration will depend on the fulfilment of the programmed public finance deficit.

The inflow of foreign direct investment is likely to be affected by adjustments in the business environment of the surrounding countries, as well as the rate of recovery of the economic growth in the eurozone countries. A risk is also the potential non-fulfilment of the expected fast growth in investment demand.

The development of the domestic demand and the dynamics of the GDP growth may be also influenced by the different price and wage developments in comparison to the UMP predictions.

### **3.5 Wages and employment**

#### *Current development from the beginning of the year*

Nominal wages in selected sectors of the Slovak economy grew on average for the first three months of the year at a rather fast pace, where their year-on-year growth moved in the range of 8.8% (construction) to 21.6% (post and telecommunications). Several factors contributed to this development. Primarily, it was a one-off effect of the shift of paying out of variable items of wages and remunerations from the end of 2003 into 2004, related to the introduction of flat-rate tax; more advantageous conditions for paying out retirement benefits in the case of retiring pursuant to the Social Insurance Agency Act that entered into effect on 1st January 2004; as well as the low comparative base of the past year in most of monitored industries. A low growth in wages in most of industries in 2003 though did not correspond to the growth achieved in the labour productivity and the favourable results of financial management in the business sector, which business entities clearly took into account in adjusting wages at the beginning of this year.

Since a part of the wage growth was influenced by the one-off factors, there is an anticipation that in the following month, when the impacts of the single-shot effects will disappear, the dynamics of growth of nominal wages will dampen in comparison with the first three months.

The real monthly wages from January to March exceeded on average in all monitored industries the level from the last year. The growing trend of the real wages was affected by nominal wages, meanwhile the year-on-year inflation (higher by 0.7 percentage points compared to the same period of the last year) had a dampening impact on the real wages.

The relation between wages and labour productivity calculated from the receipts for own performances and goods has been developed differently since the beginning of the year. Favourable development was seen in the sectors of industry, retail trade and transport, where the labour productivity grew faster than wages, whereas in other sectors the growth of wages overtook the development of labour productivity.

The development of employment in selected sectors over the first three months of 2004 indicates the continuation of trends from the previous year. From January to March employment in only construction (by 3.8%) and in the sale and maintenance of motor vehicles (by 1.9%) grew more significantly, whereas in other sectors it remained at approximately last year's level (wholesale), or declined. The largest fall in the number of employees was in hotels and restaurants and in transport. The registered unemployment rate recorded for the first three months of 2004 a negligible fall from 16.6% at the end of January to 16.0% at the end of March.



***Assumptions of the updated monetary programme and expected development by the end of the year***

The development of nominal wages for the first three months of this year in selected sectors and the expected progressive reduction of the average inflation over the course of the year indicate that the development of real wages in 2004 will likely be above the upper limit of the MP 2004 interval. However, the wage development does not indicate inflationary pressures (in the preceding year a decline in real wages occurred), nor is an adverse impact on the balance of trade through consumer imports expected, with regard to the exhaustion in the purchasing power of inhabitants due to the growth of prices for energy, water and sewerage fees and their higher expenses for accommodation and transport. Disproportionate growth in wages in business entities will be probably dampened by efforts to sustain, in the longer-term horizon, the growth of labour productivity ahead of the growth in wages in order to remain competitive; it may also be broken by their higher costs burden in connection with the fulfilment of stricter EU hygienic and environmental standards. The dampening of the growth in wages will also come from the continuing restrictive wage policy in the public sector, when the approved increase in wages of employees in civil and public sector from 1st August 2004 by 5%, or 7% respectively, is lower than both the average inflation of 2003 and the forecast inflation for 2004.

With regard to the relatively dynamic development of nominal wages from the beginning of the year, taking account of the above-mentioned factors, in the UMP the range of the growth of nominal as well as real wages is being shifted upwards. **The updated monetary programme forecasts a growth of nominal wages in 2004 in the interval of 7.9% to 9.5%, which, at the expected average inflation of 7.5% (updated value, mid-interval), represents a growth in the real wages in interval of 0.4% to 1.9%.**

In connection to the forecast economic growth and development of employment, real labour productivity from the GDP per employee of the economy should grow by 3.1%. This means that in 2004 the lead in the growth of real labour productivity by 2 percentage points (mid-interval) ahead of that of real wages will be sustained.

Prediction of the development of labour market for 2004

(y/y change in %)

	Actual 2003	MP 2004	UMP 2004
Average monthly nominal wage	6.3	7.2 – 8.2	7.9 – 9.5
mid-interval	x	7.7	8.7
Average monthly real wage	-2.0	-0.5 – 0.5	0.4 – 1.9
mid-interval	x	0.0	1.1
Labour productivity from GDP at constant prices	3.4	3.0	3.1
Real productivity – real wages (percentage points)	5.4	3.0	2.0
<i>Average rate of inflation – mid-interval</i>	8.5	7.7	7.5
Employment according to statistics reporting	0.8	1.0	1.0
Average registered unemployment rate (%)	15.2	14.4	14.4
Average unemployment according to LFS** (%)	17.4	16.2	16.2

Prediction of the labour market for 2004

(y/y change in %)

	UMP 2004				
	1 <sup>st</sup> quarter	2 <sup>nd</sup> quarter	3 <sup>rd</sup> quarter	4 <sup>th</sup> quarter	year
Average monthly nominal wages	10.5	7.4	7.9	9.1	8.7
Average monthly real wages	2.0	-0.6	0.7	2.5	1.1
Labour productivity from GDP at constant prices	3.3	2.8	3.0	3.1	3.1
Real productivity – real wages (percentage points)	1.3	3.4	2.3	0.6	2.0
<i>Average rate of inflation – mid-interval</i>	8.3	8.1	7.2	6.4	7.5
Employment according to the statistics reports	0.5	1.0	1.3	1.2	1.0
Average registered unemployment rate (%)	16.4	14.1	13.1	14.2	14.4
Average unemployment according to LFS ** (%)	16.6	15.8	14.8	15.3	16.2

Note: The average registered unemployment rate for the 1<sup>st</sup> quarter of 2004 = the actual figure according to the Office of Labour, Social Affairs and the Family data

\*\* Labour Force Sample Survey

The development of the number of employees in selected sectors indicates that **employment** in 2004 should develop in accordance with the forecasts of the MP 2004. **It should achieve a year-on-year growth of 1.0%**, which represents, with regard to the actual figure in 2003, only a slightly faster dynamic. The development of employment will be further affected by the continuing of restructuring of the business sector (in particular by large enterprises with a decisive interest owned by the state, enterprises that will be exposed to strong competitive pressures following the accession to the EU, etc.), as well as by the reforms in the field of public services (health, education) connected with redundancies. The lay-offs of employees from the public sector will nevertheless be probably compensated by a higher growth of jobs in sectors with a prevailing share of foreign capital, as well as a growth in the number of self-employed persons.

In accordance with the MP 2004 the forecast development of the **registered unemployment** also remains unchanged, which could fall in 2004 on a year-on-year basis on average by 0.8 percentage point, to **14.4%**. A positive influence on the reduction in unemployment in 2004 could be provided in particular by measures in the field of employment services, putting greater emphasis on the active labour market policy and supporting motivation on the side of labour supply. **According to Labour Force Sample Survey the rate of unemployment in 2004 could reach the level of 16.2%.**

### 3.6 Public sector

Compared to the government draft state budget for 2004, submitted to the National Council, several changes occurred in consequence of representatives' proposals:

- revenues were reduced from SKK 250.0 billion to SKK 232.0 billion,
- expenditures were increased from SKK 309.5 billion to SKK 310.5 billion,
- the budget deficit increased from SKK 59.5 billion to SKK 78.5 billion.

This was caused by a decision that a one-off failure of tax incomes due to the SR's accession to the European Union would not be covered by privatisation income, but that it directly increase the state budget as well as public budget deficits on the cash principle. The

public budget deficit on the accrual principle will not be affected by this increase and it is expected to be of SKK 52.0 billion (4.0% of GDP).

### **3.7 Monetary policy**

Provided that the UMP starting points in the field of the real economy are fulfilled, also in 2004 the conduct of the monetary policy should be realised in the environment of continuing favourable macroeconomic development. In the field of the price development the NBS, in accordance with the planned lower scope of adjustments of regulated prices compared to the preceding year, forecasts a decline in the year-on-year inflation dynamic. Nevertheless, also in 2004 the determining influence of administrative, cost impulses will persist in price development.

The NBS exchange rate policy is focused on the sustaining the stable development of the Slovak koruna in accordance with the development of economic fundamentals. In the field of the exchange rate development of the Slovak koruna, from the beginning of 2004 the appreciation trends have continued to be accompanied by NBS interventions. On average for the first three months of the year the Slovak koruna has appreciated by 2.2% (against the average exchange rate for the preceding year), while for the whole year 2003 its rate of appreciation reached the level of 2.8%. With regard to the narrowing of the inflation differential on the basis of industrial producers, in 2004 there could occur a slow down in the real appreciation of the exchange rate. The year-on-year appreciation of the REER index on the PPI basis should slow to 4.1% compared to 10.8% in 2003. The year-on-year appreciation of the REER index on the PPI manufacturing basis in 2004 (December) should slow to 3.9% compared to 4.7% in 2003.

Similarly as up to now, all the changes to the monetary policy settings will continue to respect the goal set in the field of inflation. With regard to the favourable actual as well as expected development of inflation that does not indicate an emergence of the risk of demand-side pressures, the Bank Board of the NBS decided in March 2004 to reduce interest rates by 0.5 percentage points. In the environment of the expected mitigation of the effect of the net export this should support the recovery of domestic demand and economic growth in the medium-term horizon. The NBS at the same time expected that the reduction in interest rates would contribute to the Slovak koruna exchange rate stabilisation vis-à-vis the reference currency. The development of the exchange rate nonetheless has persisted to track a trend of appreciation. With regard to the inadequate appreciation of the koruna exchange rate against euro, the Bank Board of the NBS decided in April 2004 to reduce the main interest rates similarly by 0.5 percentage point.

#### ***Monetary basis***

Over the course of the first four months of 2004 the resources of the banking sector were affected in a pro-growth manner by the following factors:

- in accordance with the harmonisation process of the NBS's monetary instruments with the monetary range of instruments of the ECB, in January 2004 the last stage of reducing the minimum reserves rate by 1 percentage point (from 3% to 2%) was realized, representing the last stage of harmonisation of the creation of the minimum reserves with the level of their creation in the eurozone, through the influence of which the banking sector was left with surplus resources in the volume of SKK 6.3 billion

- the liquidity of the banking sector was increased due to the NBS's interventions on the foreign exchange market against the excessive appreciation of the exchange rate of the Slovak koruna (an addition to the liquidity of SKK 11.2 billion)
- an increase in liquidity under the influence of the shift of a part of the resources of state funds from the NBS to the banking sector (SKK 10.8 billion)
- the shift of a part of deposits of extra-budgetary resources of the Slovak authorities from the NBS to the State Treasury (hereinafter referred as "the ST") represented an inflow of liquidity of approximately SKK 2.5 billion.

Compared to the NBS Monetary Programme for 2004 the basic characteristics of the monetary policy implementation background has not seen any substantial changes. Among To the anticipated factors that will affect the level of the sterilisation position of the NBS in 2004 may be included:

1. The Debt and Liquidity Management Agency's access to ensure the Government debt servicing – under the assumption that resources of the foreign loans in the volume of EUR 260 million drawn in 2003 and the part of resources from the intended Eurobond issue in the volume of EUR 1 billion in 2004 (approx. SKK 10 billion) are used for repayment instalments of the domestic debt, in the banking sector will remain the liquidity surplus that will operate in the direction of increasing the volume of sterilisation.
2. The anticipated use of the privatisation revenues (in 2004 approx. SKK 17 billion) - to cover the Government debt service - will reduce the requirements of the Ministry of Finance SR for the amount of the Government securities issues and operate in the direction of increasing the need for sterilisation.
3. Resources intended for the pension reform, deposited since July 2002 on the term account of the Ministry of Finance SR, in the NBS, (at 31. 3. 2004 it was SKK 68.3 billion), will be used until 2005, i.e. in 2004 the NBS expects that their influence on the liquidity of commercial banks will be neutral.
4. A more difficult field to predict remains the influence of the gradual transfer of state resources from the NBS to the State Treasury, which has been being carried out from the beginning of 2004. Following the completion of the whole process the influence of the state resources, administered by the State Treasury, on the level of sterilisation will depend on the ST's approach to the issue of efficiency in the use of resources in question, either on the money market, foreign markets or in the form of a deposit in the NBS.
5. The NBS's operations on the foreign exchange market have since the beginning of 2004 required sterilisation of approximately SKK 11 billion of a sufficient liquidity of the money market.

After taking account of fulfilling the above-mentioned conditions, the NBS predicts an increase in the sterilisation position vis-à-vis the banking sector as at the end of 2004, by approximately SKK 58 billion, i.e. at the level of roughly SKK 234 billion. Compared to the Monetary programme the forecast sterilisation position has been deepened as a consequence of the NBS's interventions carried out on the foreign exchange market in the first quarter of 2004.

### ***Money aggregates***

#### ***Monetary aggregates***

In comparison to the Monetary Programme, the Updated Monetary Programme has changed mostly in the evaluation of the initial exchange rate. While the Monetary

Programme took into account the cross exchange rate against USD (conversion currency of the balance of payments) at the level of 39.5 SKK/USD, the Updated Monetary Programme takes into account the current exchange rate development of the Slovak koruna, as well as the cross exchange rate of EUR/USD, in consequence of which the monetary survey in the UMP is based on the anticipation of achieving the average exchange rate of 32.4 SKK/USD. Since this is a significant appreciation of the conversion exchange rate with an impact on the absolute and relative values of monetary aggregates, it is not possible to compare the programme values of UMP and MP.

Taking account the effect of the NBS key interest rates reduction and their effect on the real interest rates of deposits and credits, as well as influence of the development of alternative forms of investing, in particular into products of money market that are not a part of the money supply M2, we expect a rate of growth of the money supply M2 of 9% at the end of 2004, which is slightly lower growth, compared to the MP 2004 (10%).

The persistent trend of a rather high rate of growth in credits to enterprises and households, continuing also in the first two months of 2004, is also taken into account in the prediction of the development of credits in 2004. Their year-on-year growth could reach approximately 8.8% by the end of the year.

An increase in mortgage loans should not achieve such intensity as in 2003, since the effect of favourable legislative conditions in the preceding year have died away. In connection with the entry of Slovakia to the EU and the expected inflow of foreign investments, usually financed by contractual partners of a foreign investor (or directly by their parent companies), we also expect an increase in credits in foreign currency provided to non-resident entities (these credits do not belong to the aggregate “credits to enterprises and households” which includes only credits provided by the domestic banking sector). In the field of consumer credits for households, we expect a trend of increasing the share of companies providing hire-purchase to the detriment of the traditional banking houses. The decline in, or stagnation of real wages in the past period influenced the consumer behaviour of inhabitants in favour of a willingness to finance their needs through more available and aggressively promoted forms of hire-purchase, despite the less advantageous financial conditions. For 2004 this trend is predicted to persist, despite the forecast recovery of wage development.

<b>Prediction of the development of monetary aggregates</b> (y-o-y change in %, balance at close of 2004)	<b>2003</b> (actual)	<b>MP 2004</b>	<b>UMP 2004</b>
Credits to enterprises and households	13,8	8,0	8,8
Money supply M2	5,6	8,0	9,0

In the framework of the development of the net credit to general government, the assumptions of attaining the higher deficit of the current economy have changed (on the basis of the Act on the State Budget for 2004 the state budget deficit will reach the level of SKK 78.5 billion in 2004, which is, compared to the MP 2004 forecast, a deterioration of SKK 18.5 billion) and in the area of requirement of the higher volume of state bonds issues to cover last year’s state budget deficit (by SKK 14.5 billion). In the area of managing the broader public sphere we consider unchanged conditions, i.e. the surplus operations. The fiscal deficit in 2004 should not exceed, on the accrual principle, 4% of GDP, however, on the cash principle it could move at the level of 5.4% of GDP.

#### **4. Conclusion – summary of the UMP for 2004**

##### *Goal of the updated monetary programme*

The NBS Updated Monetary Programme for 2004 forecasts achieving the overall end-year rate of inflation in the interval of 5.7%-7.0%, which corresponds to an average annual inflation of 7.3%-7.7%. The core inflation should range in the interval 1.9% - 3.4%.

##### *Assumptions of the monetary programme*

- relatively stable development of the Slovak koruna exchange rate against the EUR, corresponding to economic performance
- growth in GDP at constant prices of 3.8% – 4.4%
- the share of the current account deficit in the GDP should reach the level of 1.2%
- the fiscal deficit should reach SKK 52.0 billion, i.e. 4.0% of GDP

##### *On the basis of this development:*

- the growth in the money supply should reach 9.0%
- room should be created for a growth in credits to households and enterprises by 8.8%

##### *Risks:*

- a significant movement in the exchange rate, which is not related to the monetary policy measures or the development of economic fundamentals
- slower economic growth of our trading partners
- change to the scope of adjustments to regulated prices and indirect taxes
- volatile development of oil prices
- food prices (uncertainty of the impact of adopting the Common Agricultural Policy following accession to the EU and a smaller harvest in 2003)
- uncertainty resulting from the accumulation of the effect of individual reforms (tax reform, pension security reform, health reform, public finance administration reform).

## 5. Outlook up to 2007 – Updated

### 5.1 Inflation

The basic determinants of price development in the medium-term horizon include the ongoing adjustments to regulated prices, however their scope should reduce and progressively reflect the overall price development in the Slovak economy. The price development will be also affected by the approximation of the legislation, primarily in the field of excise duties, with EU standards.

The development of regulated prices in the medium-term outlook for 2005-2007 is based on the same forecasts as for MP 2004. It is expected that the regulation of the prices of network sectors will take place according to the existing rules (prices will be determined by the independent Network Industries Regulation Authority). These rules are to be applicable in 2005-2006, from 2007 a complete liberalisation of the market in electricity and gas should begin to apply according to the EU directives, i.e. each household will be able to choose their supplier. In this period it is anticipated that the prices of the currently regulated commodities will cover the eligible cost and reasonable profit, which should not represent any significant movement of prices upwards. Their growth will be influenced only by the development of the prices of energy commodities on the world markets, the development of the exchange rate of the Slovak koruna and possibly also by other cost factors.

From January 2004 the directive on energy taxation entered into force in the EU, implementing, *inter alia*, taxation of electricity and gas. The Slovak Republic has requested a 10-year transitional period for the implementation of this Directive, nevertheless, it will probably have to implement these taxes in half their value from 2007. With regard to their level (0.3 EUR/gigajoule of gas and 1 EUR/MWh of electricity for non-business purposes) their introduction does not represent any significant impact on the price level<sup>2</sup>.

Hitherto development of core inflation indicates that its movement has been affected mainly by household cost factors. Through the progressive decrease in administration interventions in 2005-2007 the influence of demand factors should increase in core inflation. The anticipated recovery of domestic, in particular consumer, demand could be reinforced also by the continuation of the dynamic growth in loans with a potential impact on price development. The currently expected inflow of the FDI should be reflected in the acceleration of the productivity growth in the tradable sector, compared to the non-tradable, the growth in real wages brought about by the productivity growth could thus affect the non-tradable sector for faster growth in prices (greater influence of the Balassa-Samuelson effect). This effect could be seen in particular in prices of market services, the dynamics of which should gradually accelerate and overtake the growth in prices of tradable goods.

The decline in the overall inflation dynamic below the level of the core inflation growth is caused by the falling rate of deregulation as well as a smaller scope of adjustments in indirect taxes that will be shown in a lower contribution of these items to the overall inflation. Since core inflation represents only a part of the basket of consumer goods

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<sup>2</sup> The average household consumes 2700 kWh of electricity annually, meaning an increase in costs from 2007 (0.5 EUR/MWh) of approximately SKK 50 – SKK 55 a year, which is around SKK 4.50 a month. In the case of gas, this would represent an increase in costs from 2007 from SKK 28 up to SKK 110 a month (depending on the type of use of gas – cooking or cooking and heating). The introduction of these taxes would represent an addition to the overall inflation of approximately 0.1 percentage point.

(without the regulated prices and changes to indirect taxes) in 2006 and 2007 its growth should reach higher values than overall inflation.

A degree of uncertainty in the outlook for the inflation development in 2005-2007 is represented by the anticipated development of oil prices and the exchange rate. One of the risks is also the impact of the continuing reform of the Common Agricultural Policy (agreed in June 2003) on consumer food prices, which may result in a gradual reduction in intervention prices of certain commodities and a decline in the protection of domestic producers from imports from the third countries, affecting the decline or decreasing growth in consumer prices of foodstuffs.

		2005	2006	2007
Inflation	year-on-year rate	2.9 (2.4 – 3.3)	2.7 (2.2 – 3.2)	2.4 (2.0 – 2.9)
	average y/y rate	3.0 (2.7 – 3.3)	2.5 (2.3 – 2.8)	2.5 (2.2 – 2.8)
Core inflation	year-on-year rate	2.4 (1.9 – 3.0)	2.9 (2.3 – 3.4)	2.6 (2.0 – 3.2)
	average y/y rate	2.4 (2.1 – 2.7)	2.6 (2.3 – 2.9)	2.8 (2.5 – 3.1)
Net inflation excl. Fuel prices	year-on-year rate	2.6 (2.3 – 2.9)	2.8 (2.5 – 3.1)	2.5 (2.2 – 2.9)
	average y/y rate	2.4 (2.2 – 2.5)	2.5 (2.3 – 2.6)	2.7 (2.6 – 2.9)

## 5.2 Producer prices

The forecast development of industrial producer prices in the horizon up to 2007 is based on the same forecasts as for MP 2004. The cost impulses in the form of energy prices, as in the case of the oil price on foreign markets, so in the case of energy prices of domestic producers, these should gradually weaken over the course of the coming years. A year after adopting the EU Common Agricultural Policy it is likely that the growth in prices for food products will move towards that of the level of the EU countries.

In addition to the mentioned influences, prices in industry will be also influenced by the progressively changing nature of the business environment. Over the period of the coming years labour productivity should, according to the NBS forecasts, continue to maintain a lead ahead of the growth of the real wages, which will enable businesses to realise a flexible pricing policy with view to maintaining their position on the market, taking account of their relatively high efficiency and the demanding competitive environment. In accordance with the above forecasts it may be expected that in the period of 2005-2007 industrial producer prices will be increased at the rate comparable to that of the EU countries.

	2005	2006	2007
Average annual index	102.1	101.0	101.0
of which: industrial production products	102.0	100.8	100.8



## 5.3 Foreign area

### 5.3.1 Balance of payments

In contrast to the MP, which in the development of the balance of payments and subsequently also the current account in 2005-2007 counted on the arrival of one investor in the field of the automobile industry, the UMP takes account for the given years of the production, of the exports as well as imports of two investors operating in this industry.

Current account items (in bn. SKK)	2005	2006	2007
Balance of trade	-53.5	-48.6	15.7
Export	912.6	1 077.5	1 325.6
Import	966.1	1 126.1	1 309.9
Balance of services	9.9	9.6	9.8
Balance of incomes	-7.4	-7.5	-10.7
of which: balance of incomes from investment	-18.7	-19.2	-20.3
Current transfers	14.0	17.8	15.0
<b>Current account</b>	<b>-37.0</b>	<b>-28.7</b>	<b>29.8</b>
<b>Current account in GDP (%) Ratio</b>	<b>-2.7</b>	<b>-1.9</b>	<b>1.8</b>

In the given period there should be seen an increase in the rate of growth of imports (7.4%, 16.6% and 16.3%), which in 2005 and 2006 will be affected by the imports of investment units and in 2006 and 2007 by the imports of components for the production of new cars. The export of the first cars will occur in 2006 (the rate of growth of exports should increase from 5.2% in 2005 to 18.1% in 2006 and 23.0% in 2007).

Export (in bn. SKK)	2005	2006	2007
Finished products	122.3	126.1	131.1
Machinery and transport facilities	485.7	644.6	880.4
Semi-finished products	259.3	263.6	271.8
Raw materials	45.3	43.2	42.3
<b>Total</b>	<b>912.6</b>	<b>1077.5</b>	<b>1 325.6</b>

Higher growth compared to the MP should be achieved over the whole forecast period in the group machinery and transport facilities and this mainly in the part of transport facilities. The updated monetary programme takes account of the production and exports of the Kia-Hyundai car producer, having a significant growth in the car export in 2007.

In other groups of export there is anticipated, as in the MP, stable development with relatively low rates of growth that will move something below the level of 2004.

Import (in bn. SKK)	2005	2006	2007
Finished products	207.8	229.1	252.3
Machinery and transport facilities	374.8	498.6	646.4
Semi-finished products	281.4	300.0	314.7
Raw materials	102.1	98.4	96.5
<b>Total</b>	<b>966.1</b>	<b>1 126.1</b>	<b>1 309.9</b>

The increased import against the MP will, similarly as in exports, be realised in the group of machinery and transport facilities. Besides the more significant growth of components for the production of cars, which will be reflected in the imports of means of transport and partially also machinery, there will also occur a growth in imports of machinery and

technological facilities, related to the launch of the KIA's automobile factory at the end of 2006. In accordance with the MP, from 2005 a slight increase in imports for the end consumption could likewise occur, related to the growth of real wages and increase in private consumption.

In the framework of the balance of services we do not expect any greater fluctuations in either direction. The balance of services will remain in stable surplus despite the growth in net income from transport caused by the forecast slight decline in income from foreign tourism due to the possible appreciation of the SKK, which may bring about, under unchanged conditions, a decline in the number of tourists from abroad.

The deficit in the balance of interest payments will move roughly at the level of SKK 9.0 bn., where stable development will be reported in both the revenue and expenditure parts. On the other hand, the balance of revenues may be affected by the level of the deficit in the item of foreign direct investment, which currently includes only dividends paid out. The absence of results of an annual report on FDI, from which at least the starting value of the re-invested profit would be known, leads to the fact that the prediction of the balance of revenues in 2005-2007 does not include the reinvested revenue representing a part of revenues of enterprises with a foreign equity interest that though belongs to a foreign investor, nevertheless remains in the host country. Despite the fact that inclusion of this item in the balance of payments will not represent any pressures on the external imbalance (reinvested revenue will appear as a debit item on the current account and concurrently as a credit item on the financial account of the balance of payments), it may increase the deficit of the current account in 2005 to 2007. It may be anticipated that foreign investors who will establish themselves in the territory of the SR in 2004 – 2007 will reinvest a part of their revenue into production, which may cause a worsening of the current account deficit by up to 2% of the GDP.

A more significant change against the MP has occurred in the current transfers, where, according to the ECB propositions, a part of the EC funds has been transferred from the capital to the current transfers. Although the mentioned transaction has a neutral impact on the overall balance of payments, it leads towards an improvement on the balance of payments current account.

The development of the balance of trade in 2007, in which it is expected that both automobile factories will be producing cars, may allow the balance of trade to move into surplus. Its amount will to a large extent depend on the flexibility of domestic producers to supply parts and components for the automobile industry, the export of which in 2007 will form almost half the total export. The balance of the current account will, besides the balance of trade, be also affected by the level of the deficit of the balance of revenues (depending on profits reinvested, or dividends paid out), and which may cause that the current account in 2007 will also be in deficit, or balanced.

Cap. & Fin. a/c items SKK billion	2005	2006	2007
Capital transfers	8.3	7.7	7.5
Direct investment	67.2	48.8	15.7
in the SR	69.1	51.5	20.7
of which: FDI – official sector	10.0	7.8	1.9
Portfolio investment	-6.5	2.8	-7.7
Other long-term financial account	-40.6	-25.6	-28.9
<i>Liabilities</i>	-37.0	-22.2	-25.6
<i>Government + NBS</i>	-22.6	-7.3	-3.0
<i>Commercial banks</i>	-1.0	-1.0	-0.9
<i>Enterprises</i>	-13.6	-13.9	-21.6
Short-term financial account	-4.2	-4.6	-18.1
<b>Capital and financial account</b>	<b>24.2</b>	<b>29.1</b>	<b>-31.5</b>

Financing of the negative deficit of the current account in 2005 and 2006 should be ensured in the same way as in 2004, by direct investment.

A decisive role in the inflow of FDI in 2005 and 2006 will be played by the construction of automobile factories in the territory of the SR that will also probably attract other investors from abroad. In the given period the change in structure will be important, where the inflow of foreign direct investment will be directed primarily into industry, where the construction of shopping centres is no longer counted on in to the same extent as in past years.

Other privatisation activities will depend on the government strategy in the field of privatisation of the Slovenské elektrárne (Slovak Power) and other enterprises owned by the state, as well as in completing the privatisation of remaining shares in businesses privatised in preceding years. The NBS prediction counts on the inflow of privatisation sources in the amount of SKK 19.7 billion (revenue from the sale of the last part of SLSP, heating plants, and the possible complete privatisation of distribution networks) for the whole forecast period, where a half of the mentioned funds should be realised in 2005 (revenue from the sale of 49% of shares in Slovenské elektrárne).

The deficit of other long-term investment will gradually fall depending on the decline in instalments of loans of the government and business sector. From the aspect of drawing new loans, it may be expected that the business sector will use foreign funds to a lesser degree than in preceding years.

The prediction does not expect that the short-term capital will play any significant role in financing the economy needs. In its structure the most active will be the business sector with its export receivables, or import liabilities.

Adjusted balance of payments SKK billion	2005	2006	2007
Current account	-37.5	-29.3	29.8
Capital and financial account	50.3	37.3	-10.2
Foreign direct investment (FDI)	59.1	43.7	18.8
NBS interventions	0.0	0.0	0.0
Change in Net Foreign Assets (- growth)	-12.8	-8.0	-19.6
Coverage of the Cap.&Fin.a/c by the current a/c (%)	134.1	127.3	-
Coverage of FDI by the current a/c (%)	157.6	149.1	-

The balance of payments adjusted to remove the influences of the activities of the Slovak Government and NBS, which do not affect the position of commercial banks in respect of non-residents and do not represent the real financing of the current account, should in 2005 to 2007 be in surplus, i.e. the inflow of funds into the business sector will exceed the current account deficit, and growth will be recorded in the net foreign assets of commercial banks. In the inflow of resources into the business sector an important role will be played by the foreign direct investment.

The excess in the repayment of old loans of the government and the NBS over the drawing of new ones, and the relatively low predicted privatisation revenues, will mean a slight decline, or stagnation of foreign exchange reserves over 2005 to 2007. Their balance will fall in 2005 to USD 13.0 billion, i.e. EUR 10.5 billion, and it will stay at roughly this level until the end of 2007. As a consequence of this development, as well as development of imports of goods and services, the average coverage of imports of goods and services will decline to 4.6 months in 2005, 4.0 months in 2006 and 3.4 months in 2007.

Sectors SKK billion	2002	2003	2004	2005	2006	2007
Business	34,9	-7,5	27,6	44,7	31,8	-15,5
Sector of government and NBS	143,4	30,5	36,0	-7,7	5,3	3,6
Banking	53,1	39,0	-8,4	-12,8	-8,0	-19,6
TOTAL	231,4	62,0	55,2	24,2	29,1	-31,5

From the aspect of sectors, the inflow of funds from abroad will in 2005 and 2006 be ensured by the business sector, in which the main role will be played by foreign direct investment. Despite the fact that the prediction is based on an outflow of long-term business capital due to the excess of repayment over the drawing of financial loans and provision over acceptance in commercial loans, the total inflow into the business sector will exceed the deficit of the current account, thus ensuring a growth in net foreign assets. A different situation could occur in 2007 in which the inflow of funds from FDI will be substantially lower than in the preceding years. The forecast surplus of the current account of the balance of payments will however create the precondition for an increase in net foreign assets in that year.

### **5.3.2 Foreign debt**

Foreign debt should, in the period in question, have a stable development at the level of roughly EUR 15.0 billion (in 2005 at EUR 15.0 billion in 2006 at EUR 15.3 billion and in 2007 at EUR 15.0 billion).

### **5.4 Gross domestic product**

In the medium-term horizon a faster real convergence of the Slovak economy is expected, in connection with the inflow of foreign direct investment, based on growth in competitiveness and the economy's efficiency. A pro-growth effect of the domestic and foreign demand with a growth in the influence of foreign demand is anticipated at the end of the medium-term horizon.

In the framework of the domestic demand the growth in private consumption should be maintained at the level not exceeding GDP growth, although in the years of growth of real

wages it may be expected that a part of deferred consumption of inhabitants, from the period of its decline, will be realized. A slight growth in the public consumption should reflect the decline in the state participation in creating GDP, this being conditional upon the consolidation of public finance. Additions in the final consumption of public administration in the medium-term horizon could be connected with the participation of the SR in managing bodies of the EU, with the creation of an institutional environment in the organizational structure of the EU, as well as with the pre-election period.

It is likely that through the influence of accelerating the investment demand in 2005 there will occur increased imports of production technologies, in consequence of which the deficit of net export, and its negative contribution to the GDP growth, will temporarily increase. Nonetheless, in the following period it may be counted on, primarily in connection with the beginning of production at the automobile factories PSA and Kia-Hyundai, a significant growth in the export of products and services, changing the net export deficit into a surplus of foreign trade of products and services. The dynamic growth of the export in 2007 will be shown in the decline of inventories, which should operate to dampen growth of domestic demand. Over 2006-2007, through the influence of the positive contribution of domestic and foreign demand, significant economic growth may be expected, of up to 5.3%, or possibly 6.8%.

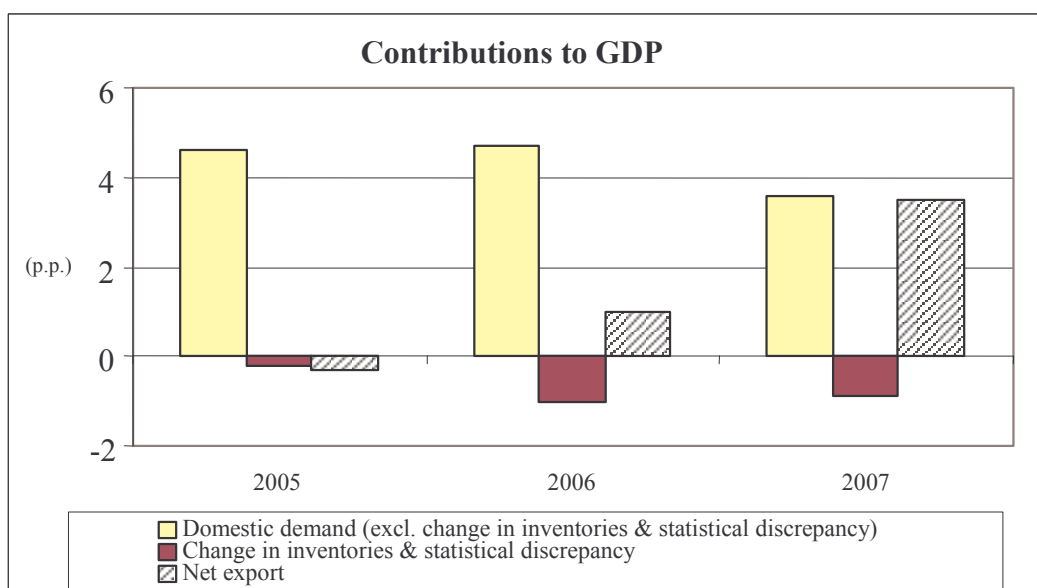
Outlook for the development of GDP and its structure (constant prices, y/y growth in %)

	2005	2006	2007
GDP at constant prices	3.8 – 4.4	4.3 – 5.3	5.6 – 6.8
mid-interval	4.1	4.8	6.2
Domestic demand	4.5	3.8	2.8
Final consumption of households	4.1	4.1	4.3
Gross fixed capital formation	8.5	8.0	4.0
Net export	x	x	x
Exports of goods and services	7.6	18.0	17.8
Imports of goods and services	8.2	17.3	15.2

The dynamic growth of GDP in the medium-term horizon may be supported by the anticipated recovery of economic growth in the eurozone countries, as well as in the neighbouring countries. The growing domestic demand in the countries of our most important trading partners will create greater room for allocating the Slovak export. A stimulus for increasing the competitiveness of exports may be the fulfilment of strategic plans and objectives of several businesses and multinational corporations to invest in the region of the Central Europe as a part of the European Union, a consequence of which will be the increasing efficiency of the Slovak economy.

Outlook for GDP development and the implicit GDP deflator

	2005	2006	2007
GDP at constant prices y/y growth in %	3.8 – 4.4	4.3 – 5.3	5.6 – 6.8
GDP at current prices SKK billion	1 393.5	1 500.0	1 637.5
Implicit GDP deflator y/y increase in %	2.9	2.8	2.8



### 5.5 Wages and employment

The basic assumptions for the development of wages in medium-term horizon on which the monetary programme for 2004 is based do not change in any significant way in the UMP. Compared to the MP 2004 the values of average inflation have been adjusted and the higher inflow of foreign direct investment has been taken into account, in particular investment to automobile production.

The growth of the real wages in the medium-term horizon may be higher compared to the forecast of the MP 2004 (according to the updated prediction it may move in 2005 in interval of 1.7 to 2.7%, in following years in the interval of 2.1 to 3.0%), where it should be influenced to a more significant degree by the declining trend in average inflation, accelerating economic growth and also efforts to keep up the advance of the labour productivity growth to wages in order to sustain the competitiveness of the business sector. The development of wages should also reflect the increasing inflow of foreign direct investment and lower direct tax burden for individual and legal entities.

The inflow of foreign direct investment should, through the expected higher level of wages, act not only on to increase the average wage throughout the economy, but by increasing competitiveness also push for growth in labour productivity in domestic firms, which could subsequently contribute to raising the economy's efficiency. An important investment from the aspect of regional employment, but also with a certain influence on the growth of wages, will be the building-up and launching of production at the car factories PSA Peugeot Citröen and Kia-Hyundai with acceleration over 2006 and 2007, as well as the building of further industrial and technological parks and related investments. It is expected that the level of wages in the car factories (but also in other FDI) will to a certain degree be increasing the average level in the given regions, which will bring about an increase in the level of wages also in other, related industries and services.

The persistent surplus of labour supply over demand on the labour market will, despite the gradual fall in unemployment, probably continue to work against a more significant growth in wages. In the public sector the growth of real wages should according to the

Convergence Programme of Slovakia for 2004-2010 in 2005 to 2007 achieve on average 3.0%, which is in accordance with the development anticipated by the NBS.

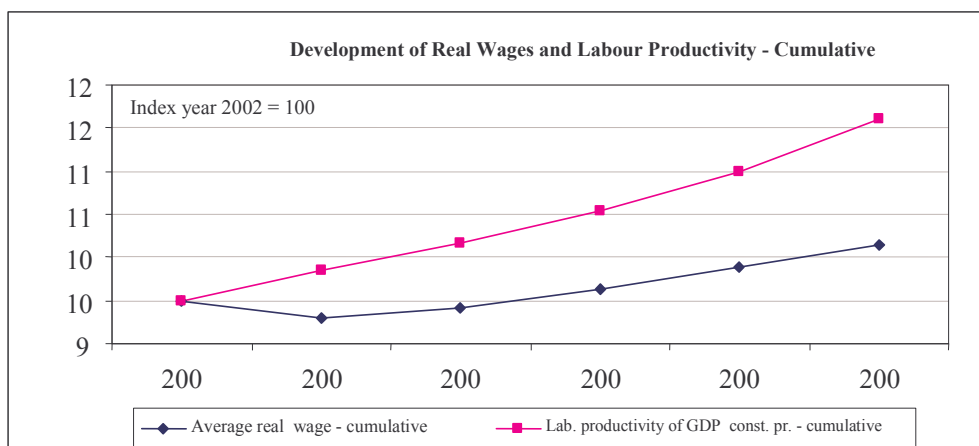
Outlook for the labour market development

(y/y change in %)

	2005	2006	2007
Average monthly nominal wages	4.8 – 5.8	4.7 – 5.3	4.8 – 5.6
mid-interval	5.3	5.0	5.2
Average monthly real wages	1.7 – 2.7	2.1 – 2.7	2.2 – 3.0
mid-interval	2.2	2.4	2.6
Labour productivity from GDP at constant prices	3.5	4.1	5.3
Real productivity – real wages (mid-interval)	1.3	1.7	2.7
<i>Average rate of inflation</i>	3.0	2.5	2.5
Employment according to statistics reporting	0.6	0.7	0.9
Average registered unemployment rate (%)	13.8	13.4	12.7
Average unemployment rate according to LFS ** (%)	15.6	14.8	14.0

\*\* Labour Force Sample Survey

Labour productivity from GDP per employee of the Slovak economy, should in the case of an accelerating growth in the economy's efficiency and a slight growth in employment, keep in the medium-term horizon its lead over the development of real wages, where this advance should at the same time be gradually increased.



In the medium-term outlook employment will be affected by several factors. In context of the Slovakia's accession to the EU business enterprises will be exposed to stronger competitive pressures on foreign markets, which may be reflected in their attempt to make their production more efficient and to increase their labour productivity, which may subsequently lead to subdued growth, or redundancies. On the other hand, a higher inflow of foreign direct investment to automobile industry and related development of other industries over 2005-2007 will have as its consequence an increase in employment. According to the information available about 30 thousand new jobs will be created in this period in manufacturing of transport equipment and in related industries and services sectors, higher demand for labour may be also forecast in construction mostly in connection

with the completion of motorways and the building of related infrastructure in given regions. These factors should be reflected in a gradual growth in employment in the medium-term outlook by approximately 0.6-0.9% annually.

The unemployment rate in 2005-2007 should gradually fall due to several factors. On the one hand, it may be a result of the operation of demographic factors, a lower labour supply, on the other hand it will be affected by economic factors. The accelerating economic growth, lower tax burden of business enterprises, active policy of labour market, financed also from the funds of the European Social Fund, and other factors will be likely to stimulate the creation of jobs of a long-term nature in which the unemployed will also be able to be used in a larger extent. In the context of the inflow of FDI it may be expected that in particular graduates having secondary or secondary specialized education will have better application on the labour market, which will at the same time contribute to a decline of the unemployment rate.

### **5.6 Public sector**

Fiscal policy in the medium-term time horizon will be oriented on fulfilling the Maastricht Criteria – the reduction of the public finance deficit below the level of three percent of the GDP. The situation in this field is complicated by the methodological problem of including the capitalisation pillar of pension reform in the public budget deficits. Without including the expenses of pension reform, it would be possible to achieve fulfilment of this criterion in 2006, in the case of their inclusion then only in 2007. As a consequence of the above, 2 scenarios of the public finance development have been prepared:

SKK billion	2005	2006	2007
public administration deficit*	47.4	45.0	31.9
% of GDP	3.4%	3.0%	2.0%
pension reform effect	10.0	14.8	16.2
% of GDP	0.7%	1.0%	1.0%
public administration deficit**	57.4	59.8	48.1
% of GDP	4.1%	4.0%	3.0%

\* without including the effect

\*\* after including the effect

### **5.7 Monetary development and monetary policy**

The performance of monetary policy in the medium-term horizon will depend on the adopted pre-accession strategy of the SR's membership in the eurozone.

The programme development of inflation has a clearly continual disinflationary nature. The monetary policy will be subordinate to fulfilment of the Maastricht Criteria relevant for the NBS. On the basis of current starting points, the NBS inflation outlook for 2006 and 2007 should be in accordance with the Maastricht inflation criterion. Currently the NBS in predicting inflation uses the national index of consumer prices that will in future be supplemented by predictions of the harmonised index of consumer prices.

The more significant administrative measures to the price development will in the medium-term horizon be represented in particular by the adjustment of indirect taxes that will affect prices of tobacco and tobacco products. Food prices will be influenced by the adoption of the Common Agricultural Policy of the EU (CAP), which will be manifested in a growth of prices for foods in 2004 to 2005 (not exceeding 1 percentage point in the overall inflation).



Reform of CAP connected with the gradual fall in intervention prices for foodstuffs should in the longer-term time horizon be seen in a mitigation of the pro-growth effect of food prices on overall inflation. Prices of tradable goods should be positively affected by the development of the competitive environment, and even despite the assumed pro-growth influence of real convergence, nominal evaluation of the Slovak koruna and faster growth of domestic demand, these should be characterised by stable development. Growth in prices of market services should, on the basis of NBS predictions, overtake the growth of the prices of tradable goods, since it is more sensitive to the process of real convergence and at the same time will be exposed to the influences of secondary impacts of administrative regulation of prices.

The exchange rate regime of the Slovak koruna will in the medium-term horizon record a change from managed floating over to the mechanism of ERM II exchange rates (on the basis of the Convergence Programme SR 2004, at earliest in 2005, or in the following years). With regard to this the exchange rate will similarly become a target of monetary policy. In the interest of eliminating any possible conflict between the inflation and exchange rate targets, the NBS prefers to participate in ERM II only for the period essential for fulfilling the exchange rate criterion. The NBS's objective in the field of exchange rate policy will continue to be the prevention of any more significant fluctuations of the exchange rate from its equilibrium trajectory. Even despite the NBS's preference of the exchange rate's movement close to the central parity within the ERM II, the process of the real convergence may require the nominal appreciation corresponding to the equilibrium exchange rate development. The specific exchange rate strategy prior to the entry to the ERM II and during the membership will depend on the expected date of entry as well as the overall Euro Adoption Strategy.

In the field of the trajectory of short-term interest rates, in the medium-term horizon their convergence with rates applicable in the eurozone is expected. At the same time however, their deviation from this forecast trajectory may not be excluded, if the development of inflation requires so. Long-term interest rates should continue to be close to the eurozone rates with the expectation of the gradual decreasing of the interest rate differential.

### ***Monetary basis***

The development of the NBS sterilisation position in the outlook for 2005 – 2007 should be to the considerable degree influenced by the process of NBS interest rates approaching those in the eurozone. The Debt and Liquidity Management Agency could react to such a development and this through a change in preferences in favour of Government domestic debt servicing. Therefore moderation and stabilisation of the NBS sterilisation position may be expected. Nevertheless its development will to a certain degree be influenced by the additional inflow of privatisation sources and their use in the domestic economy, through releasing funds for pension reform, deposited with the NBS (at 31. 3. 2004 it was SKK 68.3 billion), as well as by the eventual need to realize foreign exchange interventions of the NBS due to the excessive appreciation of the Slovak koruna.

### ***Money aggregates***

In projecting the current outlook of monetary aggregates we make the following assumptions:

- balanced management of the National Property Fund without affecting the development of the net credit to general government,

- decline in deposits of the other public sector due to using the funds intended for pension reform,
- use of privatisation incomes for state debt servicing instalments will reduce the need of issuing state securities and move in the direction of reducing the central government debt.

In accordance with these assumptions, we expect the preservation of the existing trends in monetary aggregates over 2005 to 2007. The favourable development of the balance of payments due to the inflow of FDI should be reflected in a growth in net foreign assets. The development of the growth dynamic of the money supply should continue in its slight slow-down. The more restrictive operation of the public sector will create room for further growth of credits for enterprises and households, which could reach a balanced growth trend in 2005 to 2007.

<b>Outlook for the development of monetary aggregates</b> (%, balance at the end of the period)	<b>2003 *)</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
Net foreign assets	-10.7	13.4	9.1	8.4	7.4
Net credit to the general government	16.6	24.5	15.6	14.3	10.4
Credits to enterprises and households	13.8	8.8	8.6	9.5	9.2
Money supply M2	5.6	9.0	8.6	8.0	8.5

\* actual development (preliminary data)

### ***The NBS monetary policy instruments***

The outlook of the NBS monetary instruments composition in the period of 2004 to 2007 does not record, against the MP, any changes, since the need for the full harmonisation with the monetary-political instruments of the ECB will probably affect only the accession period.

### ***Open market operations and the NBS key interest rates***

The performance of NBS monetary policy will continue to be realised in particular through the standard open market operations (OMO).

The Bank Board of the NBS this year in March decided to gradually limit sterilisation by means of the NBS bills to a level of around 25% of the total volume of sterilisation, so as to optimise the use of open market operations. The NBS reacted to the fact that compared to the Monetary Programme the structure of sterilisation instruments has changed in 2004, when the NBS bills volume reached approximately SKK 90 billion, and their share in the total sterilisation was 37-47%. The share of Sterilisation Repo Tenders in the total sterilisation was 56% to 63% (the balance of O/N deals this year has been reduced, their share being 1% to 2%, where in the past year it oscillated at the level of 0 to 5.2%). The ECB uses an analogous standard longer-term instrument comparable to the NBS bills, they are not however treasury bills, but standard REPO tenders with a 3-month maturity that are held every month.

From 2004 the minimum reserves rate in Slovakia has been identical to the rate applicable in the euro system, i.e. 2%. The base and period of the minimum reserves evaluation has as yet not been harmonised with the ECB.

The minimum reserves in the euro system are fulfilled by two key tasks:

1. to stabilise money market interest rates by means of averaging the holding of funds on the minimum reserves accounts within one period,
2. to increase structural liquidity shortage of the banking sector and to support the demand of banks for re-financing via operations increasing their liquidity in the ECB.

In Slovak conditions the function of the minimum reserves as a monetary policy instrument is significantly limited. The automated access of banks to the over-night refinancing or sterilisation resources of the NBS ensures fully the function of stabiliser of short-term interest rates of the interbanking market. Similarly, the long-term persistent surplus in liquidity and sterilisation dependence of banks on the NBS reduces interest rate volatility. After introduction intraday automated credit in the framework of the RTGS minimum reserves will no longer fulfil the function of ensuring the payments system fluency. In connection with the minimum reserves this will probably be, in the framework of the harmonisation, a perfect copy of the ESCB system.



### Main economic and monetary indicators

	2003		2003		2003		2004		2005		2006		2007	
	UIMP 2003	MP 2004 estimate	Actual	2004		2005		2006		2007		2007		
				MP	UIMP	MP	UIMP	MP	UIMP	MP	UIMP			
(y/y change in %, unless stated otherwise)														
Core inflation (end of the year)	2.1-3.6	3.1	3.0	1.2-3.5	1.9-3.4	1.4-2.5	1.9-3.0	1.7-2.8	2.3-3.4	1.6-2.7	2.0-3.2			
Net inflation excl. fuels (end of the year)	-	3.4	3.8	1.7-2.8	2.6-3.4	1.9-2.5	2.3-2.9	1.9-2.5	2.5-3.1	2.0-3.1	2.2-2.9			
Index of consumer prices (end of the year)	8.4-9.7	9.4	9.3	5.5-7.3	5.7-7.0	2.3-3.3	2.4-3.3	2.0-2.9	2.2-3.2	1.7-2.7	2.0-2.9			
Index of consumer prices (year average)	8.3-8.8	8.5	8.5	7.2-8.2	7.3-7.7	2.8-3.3	2.7-3.3	2.0-2.5	2.3-2.8	1.7-2.2	2.2-2.8			
Index of producer prices (year average)	8.0	8.0	8.3	2.4	3.0	2.2	2.1	1.2	1.0	1.2	1.0			
Gross domestic product (constant prices)	3.9-4.4	3.9	4.2	3.7-4.3	3.8-4.4	3.7-4.4	3.8-4.4	3.9-4.9	4.3-5.3	4.0-5.1	5.6-6.8			
Gross domestic product (nominal, in SKK bn.)	1185.0	1180.0	1195.8	1290.0	1300.0	1385.0	1393.5	1490.0	1500.0	1600.0	1637.5			
Nominal wages	7.5-9.5	6.8	6.3	7.2-8.2	7.9-9.5	5.3-6.3	4.8-5.8	4.3-5.3	4.7-5.3	3.5	4.8-5.6			
Real wages	-1.0 - +0.8	-1.6	-2.0	-0.5 - +0.5	0.4-1.9	2.2-3.2	1.7-2.7	2.0-3.0	2.1-2.7	1.5	2.2-3.0			
Trade balance (SKK bn.)	-65.0	-38.2	-23.6	-46.1	-32.0	-70.4	-53.5	-51.7	-48.6	-48.9	15.7			
Current account (SKK bn.)	-53.9	-23.3	-10.2	-30.4	-15.7	-53.2	-37.0	-32.7	-28.7	-30.1	29.8			
Share of the current account in GDP (%)	-4.5	-2.0	-0.9	-2.3	-1.2	-3.8	-2.7	-2.2	-1.9	-1.9	1.8			
Foreign direct investment (SKK bn.)	43.4	41.9	30.6	53.2	50.9	56.8	67.2	35.0	48.8	27.1	15.7			
NBS official reserves (USD bn.)	9.4	11.1	12.1	12.0	13.4	11.6	13.0	11.5	13.0	11.4	13.0			
Foreign exchange reserves of the NBS to import (monthly average of goods and services) ratio	4.9	5.3	5.7	5.3	5.1	4.6	4.6	4.1	4.0	3.7	3.4			
Money supply (M2)	10.0	6.4	7.1	8.0	9.0	8.0	8.6	7.5	8.0	7.0	8.5			
Credits to households and enterprises	11.5	9.7	14.5	8.0	8.8	5.3	8.6	5.2	9.5	5.3	9.2			
Sterilisation position against the banking sector (SKK bn.)	-173.5	-175.5	-176.1	-222.9	-233.7	-202.2	-219.1	-195.9	-223.1	-187.8	-227.7			
Share of the balance of public sector in GDP excl. costs of the pension reform in ESA 95 (%)	-4.9	-5.0	-3.5	-3.9	-4.0	-3.4	-3.4	-2.9	-3.0	*	-2.0			
Share of the balance of public sector in GDP incl. costs of the pension reform in ESA 95 (%)	-4.9	-5.0	-3.5	-3.9	-4.0	-4.4**	-4.1	-3.9**	-4.0	*	-3.0			

\* / At the time of compiling MP 2004 the fiscal deficit for 2007 was not quantified, its reduction was anticipated in accordance with the principle of the Stability and Growth Pact  
\*\* / MP 2004 forecast an increase in the fiscal deficit of approx. 1 percentage point as a consequence of the pension reform