National Bank of Slovakia

Monetary Programme of the NBS until the Year 2008

December 2004

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Strategy for the Implementation of Monetary Policy from the Year 2005

Since its establishment in 1993, the National Bank of Slovakia has published its Monetary Programme for each succeeding year, and from 2001 a medium-term outlook for each succeeding three years has also been incorporated. At the same time, usually in May, the NBS has published an update of the Monetary Programme. The objective of both documents has been to inform the public about anticipated macroeconomic development and as part of this in particular to provide information about presumed development of inflation, whereby the programmed interval of its development has represented the implicit monetary policy target. The orientation of the monetary policy on the development of inflation has been further highlighted by the amendment to the National Bank of Slovakia Act of 2001, in which the main objective of maintaining stability of currency has been replaced by the objective of maintaining price stability.

Thus, the Monetary Programme of the NBS should provide sufficient information to economic entities to formulate their decisions. Its one-year framework however has represented a certain limitation from the viewpoint of assessing longer term business plans. Although in recent years the monetary programme has included a medium-term horizon, this however has had the form of an outlook.

In May 2004, Slovakia became a member of the European Union and the NBS joined the European System of Central Banks. With the signing of the Accession Treaty, Slovakia became a member of the Economic and Monetary Union as a Member State with derogation. This means that Slovakia accepted a commitment to join the monetary union in the future. In July 2003, the government of the Slovak Republic discussed common material of the Ministry of Finance of the Slovak Republic and the NBS called "Strategy for Adopting the Euro" and approved the "Joint Declaration of the Government of the Slovak Republic and the NBS on the Procedure of Entry to the Euro Area", where it undertook to do its uppermost for a successful realization of necessary reforms and in cooperation with the NBS to prepare comprehensive preconditions for the introduction of the euro in Slovakia in 2008 to 2009. It confirmed simultaneously that advantages of membership in the euro area would prevail over its disadvantages. The Convergence Programme of Slovakia until 2010, as well as its update, maintain that the economy of Slovakia is heading toward sustainable fulfilment of the Maastricht criteria in 2007. In September 2004, the government adopted common material of the Ministry of Finance of the Slovak Republic and the NBS called "Specification of the Strategy for Adopting the Euro in the Slovak Republic" which states, based on an evaluation of results of analyses and the situation with realization of reforms, that introduction of the euro is realistic in 2009.

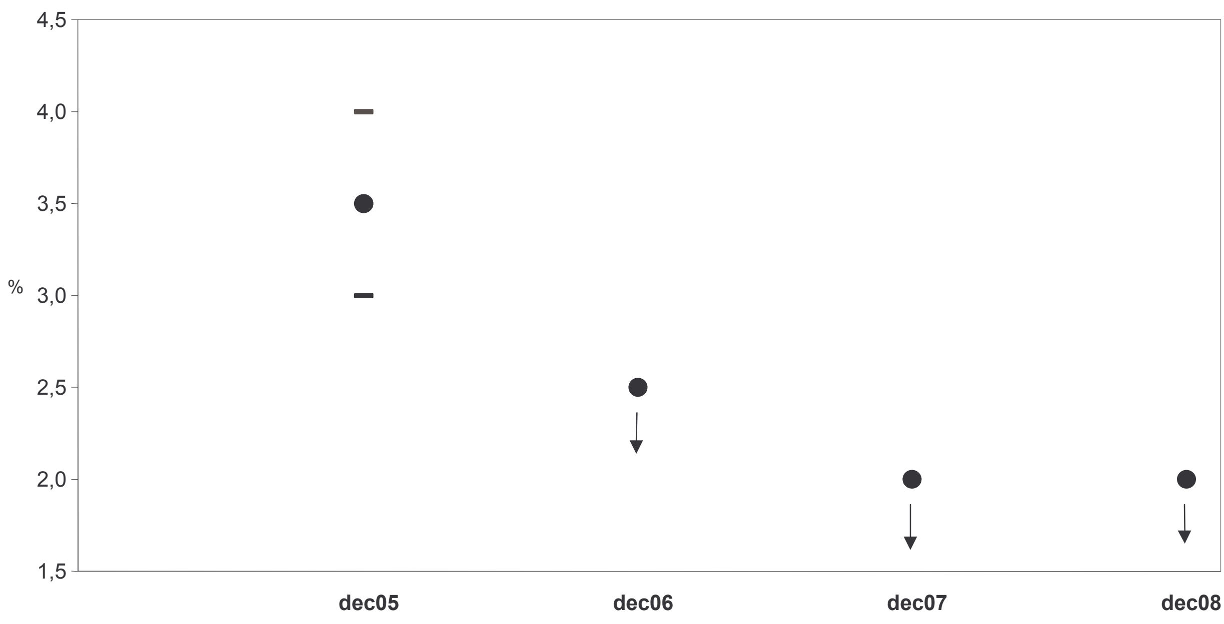
This clear and unambiguous timing of integration ambitions of the Slovak Republic represents a challenge for the central bank as well as for the whole society. For the monetary policy and the NBS as such, a time frame has been outlined within which the NBS will be responsible for the fulfilment of Maastricht inflation and exchange rate criteria. Therefore, the NBS has undertaken to define an unambiguous framework for its monetary policy in the medium term, not in the form of an outlook but in the form of a binding target. **Simultaneously, the NBS defines the conduct of its monetary policy as inflation targeting in the conditions of ERM II.**

The main anchor of the monetary policy in this time horizon is setting the target figure for the development of inflation. In the medium term, consistent with obligations resulting from membership of the EU and the goal of establishing conditions for adopting the common currency the euro, as well as consistent with commitments of the government in the area of reducing the fiscal deficit, the NBS has established a target for the year-on-year rate of inflation measured by the harmonized index of consumer prices (HICP) **below 2.5 percent for December 2006 and below 2 percent for December 2007 and for December 2008, in order to fulfil the Maastricht criterion on the basis of average twelve-month inflation.** The NBS assumes the value of the Maastricht criterion at the level of approximately 2 percent at the beginning of 2008, when the preparedness of Slovakia for entry into the euro area will be assessed.

With regard to the fact that the Maastricht inflation criterion is not fixed but variable, the inflation target for 2007 and 2008 has been set to ensure the fulfilment of this demanding criterion, which results from possible low inflation in the EU Member States.

The value of year-end inflation **for December 2005 at the level of 3.5 percent ± 0.5 percentage points** also has the character of a target, and at the same time this level reflects the extent of administrative adjustments to regulated prices and simultaneously is in line with the medium-term inflation target.

Inflation target of the NBS for year-on-year HICP inflation



The inflation target set in this way is based on the meeting of the Maastricht criterion and represents an unambiguous commitment to which the NBS will subordinate the conduct of monetary policy. The ability of the NBS to meet this inflation target will however be conditioned by the development in the fiscal and wage areas and can be influenced by unexpected development, for example in prices of mineral raw materials and food, and by natural disasters.

Development of inflation will further to a great extent be influenced by an increase of the excise tax on tobacco and tobacco products. Therefore, in order to meet the Maastricht criterion in the area of inflation, the NBS considers it appropriate to adjust the timetable for increasing excise taxes in order to minimize their negative impact on price dynamics in the period important for meeting the set inflation target.

Apart from using interest rates as a monetary policy instrument of the central bank, the NBS will to a greater extent focus on formation of inflationary expectations of the public as another indirect but powerful tool influencing the development of inflation. The NBS expects that determining of a medium-term inflation target will provide individual economic entities with a more transparent and clearer framework for the formulation of their longer-term business and investment plans, for decisions concerning savings, and for the area of wage policy and wage bargaining.

The main instrument of the National Bank of Slovakia in relation to the medium-term target are key interest rates. By changing key interest rates, the central bank reacts to identified economic imbalances and deviations of anticipated inflation development from the set target. Monetary policy thus uses its instruments to influence aggregate demand and inflation. Changes of interest rates, through a change of the interest rate differential, are reflected in the exchange rate, import prices and, with regard to the great degree of openness of the economy, in inflation. The level of the exchange rate however also influences the development of economic activity by its impact on competitiveness of the Slovak economy and choices of economic entities between consumption of foreign or domestic goods. Changes of key interest rates directly determine also interest rates relevant from the viewpoint of enterprises and households (interest rates on credits and deposits), which subsequently influences investment and consumer demand and saving and investment ratios in the entire economy. Depending on the type of identified imbalance, meeting the inflation target may require movement of the key interest rates in both directions.

The set inflation target is consistent with meeting the Maastricht criterion of inflation as well as exchange rate. A necessary condition for achieving inflation within the target range is coordination of fiscal and monetary policies. A deviation from the declared trajectory of consolidation of public finances and an introduction of additional administrative measures and changes of indirect taxes, apart from those assumed at this time, represent factors beyond the influence of the monetary policy and belong among substantial risks influencing the achievement of the inflation target within the set range.

Until the time of entry into the ERM II, the managed floating exchange rate regime will be used, which is in line with meeting the target in the area of inflation. The NBS will be evaluating the development of the exchange rate in relation to the set inflation target over the entire period before the euro is adopted. In connection with faster growth of labour productivity in the Slovak Republic compared with the euro area and with regard to the ongoing process of real convergence, the NBS sees room for real appreciation of the equilibrium exchange rate.

Membership of Slovakia of ERM II should not represent an obstacle to meeting the inflation target. On the contrary, this exchange rate regime should create an appropriate framework for nominal and real convergence. On the one hand, ERM II will represent a certain degree of exchange rate stability and a discipline framework for the macroeconomic policy, and on the other hand, it leaves sufficient room for adjustments to shocks and the economic development.

Price development however is determined by various influences that are induced by cost or demand factors. Measures of the central bank in the form of changes to interest rates as its main instrument can only influence the development of some inflationary effects, in particular of demand character. For this reason, the NBS finds it necessary to set out exceptions from achieving the inflation target, that have the character of unexpected events and influences beyond the scope of monetary policy.

Exceptions from achieving the inflation target / Escape clauses

- meeting the inflation target is conditioned by reducing the fiscal deficit in line with the declared trajectory below the level of 3 percent of GDP in 2007 (including pension reform costs); a higher fiscal deficit in individual years, or a complete change of fiscal policy direction, can threaten meeting the inflation target,
- impact of administrative measures (adjustments to regulated prices and indirect taxes) on the price level exceeding 1.0 percentage point in 2005, 0.6 percentage points in 2006, 0.8 percentage points in 2007, and 1.1 percentage points in 2008,
- significant fluctuations in prices of primary energy sources,
- significant movements in the exchange rate (particularly vis-à-vis the USD) not associated with monetary policy measures and development of economic fundamentals, but can be regionally induced,
- foodstuff prices (resulting from unexpected climatic conditions, possible changes in the common agricultural policy),
- extensive natural disasters.

Monetary Programme of the NBS until the Year 2008

The Monetary Programme of the NBS until the year 2008 mirrors the so-far macroeconomic development in 2004, and at the same time reflects the latest information and current predictions related to the development of basic external factors (such as expected development in the countries of our major trade partners, crude oil prices, cross rate of the EUR/USD). Compared with the Updated Monetary Programme from May 2004, significant changes in assumptions have taken place, particularly in the development of crude oil prices, in the effect of the inflow of foreign direct investments on economic activities, and in the estimated privatization proceeds. At the same time, the medium-term development was influenced by developments in 2004 both in the area of dynamics of final consumption of households and in some items within the structure of the current account of the balance of payments.

Development in 2004

The overall macroeconomic development in 2004 can be characterized by a faster than presumed growth of the real economy, higher deficit on the current account of the balance of payments, while the development of inflation was influenced primarily by cost factors and moved within the programmed interval. From the development in the fiscal area there are indications that the set trajectory will be achieved. At the same time, the exchange rate continued to strengthen against its reference currency, and its dynamics in the first half of the year in relation to the equilibrium exchange rate development can be evaluated as excessive.

Based on GDP data for the first three quarters of 2004 continued dynamics of final consumption of households can be expected, which accelerated in comparison with assumptions of the Updated Monetary Programme. A revival of final consumption came sooner and to a greater extent and this development was influenced by a faster than expected growth of real wages, which however did not achieve the level of growth of real labour productivity. Such acceleration of the growth rate of final consumption, especially after a period of decline, can be considered acceptable. Investment demand was restored in line with expectations, and as at the end of the year its growth should reach the level according to the Updated Monetary Programme. A moderate dampening effect on economic growth should result from a reduced surplus of net export at constant prices. Following the actual development of the GDP structure, as well as the current development of retail sales, the NBS expects higher annual GDP growth, i.e. 5.5 % (mid-point) in comparison with 4.1 % (in the Updated Monetary Programme).

GDP estimate for 2004* constant prices, y/y change in %

	Updated Monetary Programme 2004	Actual Q1-Q3 2004	Estimate for 2004
GDP at constant prices of 1995 - range	**3.8-4.4**		**5.3-5.7**
- mid-point	**4.1**	**5.4**	**5.5**
Domestic demand	4.2	5.3	5.4
of which:			
Final consumption of households	2.5	3.2	3.6
Final consumption of government **	0.9	1.8	2.3
Final consumption of non-profit institutions serving for households	6.9	5.3	5.7
Gross fixed capital formation	5.9	3.4	5.8
Net export			
Export of goods and services	10.0	12.2	10.2
Import of goods and services	10.2	12.9	11.0

* Revised data related to national accounts 2002.
** Estimate of the Statistical Office of the SR for the 1st to 3rd quarter of 2004.

Apart from the trade balance, there was also a change against presumed results in the development of the balance of income and current transfers, where, on the one hand, a higher than expected volume of dividends was paid in 2004. On the other hand, the anticipated inflow of resources from EU funds declined, which has been only minimal in the period until now. Based on these facts, deficit on the current account compared with the Updated Monetary Programme should be more than doubled, i.e. 3.5 percent. Despite the higher deficit on the current account, we do not consider the achieved amount or the character of its increase to be problematic, i.e., such that would indicate the origination of a macroeconomic imbalance.

Current account items in billion SKK	**2004 – MP**	**2004 – UMP**	**2004 – estimate**
Trade balance (TB)	-46.1	-32.0	-46.5
Export	840.3	867.6	879.4
Import	886.4	899.6	925.9
Balance of services	12.9	9.7	9.7
Balance of income	-3.2	-3.6	-14.7
Current transfers	6.0	10.2	5.5
Current account (CA)	-30.4	-15.7	-46.0
Share of CA deficit in GDP in %	**-2.3**	**-1.2**	**-3.5**
Share of TB deficit in GDP in %	**-3.6**	**-2.5**	**-3.5**

Based on development of the capital and financial account so far, a surplus can be anticipated that will more than cover the deficit on the current account of the balance of payments. This surplus on the one hand comprised inflow of foreign direct investments into the commercial sector and long-term capital, which created sufficient volume of resources to finance the deficit on the current account of the balance of payments. On the other hand, the surplus on the capital and financial account also comprised portfolio investments and short-term capital. The inflow of these funds was a consequence of both the interest rate differential and conviction of short-term investors that the exchange rate of the Slovak koruna had room for strengthening.

Cost factors clearly prevailed in the area of inflation development. Compared with expectations and programmed values, regulated prices and prices of motor fuels were rising at a faster rate. In market services, secondary effects resulting from the growth of regulated prices contributed to higher dynamics and prices of items related to the development of demand achieved stable and acceptable dynamics. Compared with expectations, prices of tradable goods developed more favourably, and their growth should be below the bottom level of the programmed interval. The recent appreciation trend of the exchange rate affected their development to a greater extent than expected. They were further influenced by low imported inflation and existing competition in the retail sector. A volatile item in the basic structure of inflation were foodstuffs, which in 2004 were influenced by the adoption of the common agricultural policy, differing seasonal development, as well as widening competition. Foodstuff prices are expected below the bottom level of the programmed interval.

Consumer prices (%)

		2003	Estimate MP 2004	Estimate UMP 2004	Actual November 2004	Estimate for the year 2004[1]
HICP inflation	**year-on-year rate**	9.3	-	5.6-7.1	6.3[4]	6.2-6.6
Headline inflation	**year-on-year rate**	9.3	5.5-7.3	5.7-7.0	6.3	6.1-6.4
	average year-on-year rate	8.5	7.2-8.2	7.3-7.7	7.7	7.5-7.6
Core inflation	**year-on-year rate**	3.0[2]	1.2-3.5[2]	1.9-3.4[3]	2.0[3]	1.8-2.1[3]

[1] Estimate based on the current development until September, HICP based on the development from October.
[2] Without motor third party liability insurance.
[3] Including motor third party liability insurance.
[4] Actual results until October.

Development in the Years 2005-2008

From 2005, the process of disinflation will continue more significantly, which in the medium term will be directed toward meeting the Maastricht inflation criterion in 2007. The basis for a significant slowdown of inflation in 2005 compared with 2004 will be a weaker range of growth in regulated prices. This is linked with the fact that in 2004 price deformations were eliminated in most types of regulated prices. In the following years of the medium term, growth of regulated prices should only reflect rising costs and adequate profit. Consequently, the impact of regulated prices on inflation in this coming period will be significantly lower and gradually declining. With regard to this, development of other components of the consumer basket will only minimally be influenced by secondary effects and the NBS will focus on identifying and influencing the demand character of inflation. Within the prices of tradable goods, the effect of low imported inflation as well as the influence of the competition environment are expected. It can further be expected that the effect of real convergence will appear in prices of market services, since they cannot be substituted by imports. Nevertheless, this effect (the so-called Balassa-Samuelson effect), at presumed appropriate growth of wages in the economy, should not cause problems in meeting the inflation criterion. Development of inflation however will be affected by administrative measures also in this period in the forms of an increase in excise taxes on tobacco and tobacco products, as well as the introduction of an energy tax. Based on current information and the approved timetable specifying the tax burden on tobacco and tobacco products, these taxes should be raised in 2007 and 2008.

From the viewpoint of meeting the Maastricht inflation criterion, as well as the NBS's inflation target, the NBS considers it appropriate to make adjustments to these taxes so as to minimize their negative impact on price development at the time of evaluation of preparedness of Slovakia for entry into the euro area. We presume that the energy tax will be introduced in 2007, but its effect on headline inflation should not be significant.

In the medium term, we assume such macroeconomic development that will not create conditions for demand pressure to arise which would negatively influence inflation development. Assumptions of the NBS are primarily based on the continued consolidation of public finances, specifically by reducing the fiscal deficit in compliance with the Updated Convergence Programme approved by the government. At the same time, the NBS assumes that economic growth in the period of 2005-2008 will reach 5.3 percent on average. Economic growth should temporarily accelerate in 2007 as a result of production in the automotive industry based on foreign direct investments.

Year-on-year change in %

	2005	2006	2007	2008
GDP	**4.9**	**5.2**	**6.6**	**4.6**
Domestic demand	6.1	4.5	2.1	5.5
Final domestic demand *	5.5	5.3	4.5	3.6
Final consumption of households	4.9	4.5	4.7	4.5
Final consumption of government	2.3	2.9	2.3	1.8
Gross fixed capital formation	8.9	8.6	5.5	3.0
Export of goods and services	7.6	9.7	15.8	10.3
Import of goods and services	8.1	9.0	11.7	11.6

* Domestic demand excluding change of inventories.

Apart from the GDP dynamics, foreign direct investments will also influence its structure. In 2005 and 2006, import of investments is expected to rise, which will be reflected in the growth rate of domestic demand as well as in the growth of gross fixed capital. As a result of this, a relatively high trade deficit should be temporarily achieved. In the period when production and export begins from new automotive capacities, particularly in 2007, a decline in the trade deficit is expected, while the contribution of net export to GDP growth should have a pro-growth effect on economic growth. From 2008, after full production is achieved in the automotive industry, the structure of GDP should stabilize.

Growth rate of final consumption of households is expected in the range between 4 and 5 percent. Its development should not be as volatile as before, when in some areas it was first dampened by growth of regulated prices and a decline in real wages, and subsequently, in the following years, it was accelerated by satisfying postponed consumption. Estimated growth of final consumption of households is based on the growth of real wages of approximately 3 percent, as well as on the continued development of lending activities. This growth of real wages should represent a sufficient source for a growth of disposable income ensuring satisfaction of consumption at an acceptable level which would not have any limiting effect on households. At the same time, this development of final consumption of households, below the level of GDP growth, should not create imbalances in the economy.

Development of labour productivity should get a pro-growth impulse from realized FDI in the automotive industry in 2006 and 2007. This would create certain room for non-inflationary growth of nominal and subsequently also real wages. Their dynamics however has certain limits. In order to avoid pressure on inflation growth resulting from the excessive wage growth, we consider growth of nominal wages in the national economy to be sustainable and acceptable maximally at the level of 5-6 percent. As a consequence of this, we expect unit labour costs (ULC)[1] to decline. Under such development, necessary conditions should be established for meeting the inflation target in the medium-term horizon.

Predicted development of wages and productivity for 2005 – 2008 (y/y change in %)

	2005	2006	2007	2008
Average monthly nominal wage – interval	6.0 – 7.0	4.9 - 5.6	4.8 - 5.6	4.8 – 5.6
mid-point	6.5	5.3	5.2	5.2
Average monthly real wage – interval	2.4 - 3.4	2.4 - 3.1	2.8 - 3.6	2.8 - 3.6
mid-point	2.9	2.8	3.2	3.2
Labour productivity of GDP at constant prices	4.3	4.5	5.9	4.0
Real productivity – real wage (percentage points)	1.4	1.7	2.7	2.7
ULC_{NBS}	2.1	0.8	-0.7	1.2

If development does not deviate from the proclaimed goals in the fiscal area, if production and export of automotive producers are not delayed or automotive production strategy changed, and if development of wages does not stimulate a growth of unit labour costs, the origination of demand pressures is not likely which would have a negative impact on development of inflation or on development of the trade balance.

Development of the trade balance in the medium term will be fully determined by the realization of FDI. Also the development of other components of the current account will depend on development of FDI, in particular the balance of income, which should contribute to the deficit on the current account to a greater extent than so far. Development of the balance of income will be influenced both by dividend payments, which the NBS expects in volume comparable to that in 2004, but also by increased reinvested profit as compared with the level of 2004. The deficit of the balance of income from investments in 2005-2008 should reach on average a 1 percent share in GDP. A declining trend of the deficit on the balance of income will be influenced by receipts from growing foreign exchange reserves of the NBS, within which privatization revenues will constitute a major part of the increase.

Current account items in billion SKK	**2005**	**2006**	**2007**	**2008**
Trade balance (TB)	-69.3	-74.4	-24.3	-19.6
Export	919.4	998.2	1 152.7	1 282.0
Import	988.7	1 072.6	1 177.0	1 301.6
Balance of services	10.0	10.5	10.8	11.0
Balance of income	-21.3	-17.3	-14.9	-12.7
Current transfers	11.0	12.8	12.0	12.0
Current account (CA)	-69.6	-68.4	-16.4	-9.3
Share of CA deficit in GDP in %	-4.9	-4.5	-1.0	-0.5
Share of TB deficit in GDP in %	-4.9	-4.9	-1.5	-1.1

[1] Unit labour costs (ULC_{NBS}) are calculated as a share of the growth of the nominal wage per employee in the national economy in the growth of real labour productivity. The subject matter of unit labour costs will be analyzed in greater detail in a special periodical of the NBS and published in one of the following issues of this magazine.

In an evaluation of the development of the current account, it will be necessary to a certain degree to separate out that part of the balance of income, which is influenced by dividend payments and reinvested profit, because worsening of the current account deficit based on this does not signal the start of a macroeconomic imbalance caused by overheating of the economy. At the same time, with reinvested profit, the volume of this profit increases the level of FDI on the capital and financial account of the balance of payments. This means that growth of deficit ensuing on the current account is fully financed. It is further expected that Slovakia will be a net beneficiary of resources from the EU and that the balance of services will continue generating stable surpluses.

Increased import of investments is anticipated in upcoming years. As a result of this, the trade deficit will deepen, however, it will be fully covered by rising FDI on the capital and financial account of the balance of payments. An increase in the share of the trade deficit in 2005 and 2006 to a level close to 5 percent of GDP however should only be temporary. When full production is launched resulting from FDI in the automotive industry, the NBS expects a significant reduction of the trade deficit and as a result also the deficit on the current account of the balance of payments in 2007 and 2008.

On the capital and financial account, the NBS expects in 2007 and 2008 continued inflow of FDI into the commercial sector, however, not to such extent as in 2005 and 2006. In connection with an anticipated decline in the deficit on the current account of the balance of payments, a sufficient volume of resources should thus be created for its financing without any difficulties and without a significantly increasing foreign debt.

The development and the structure of the balance of payments can be deemed realistic. Projection of macroeconomic development does not indicate that imbalances would arise.

In its estimates, the NBS has used crude oil prices based on futures contracts from November 2004. The estimate of the cross rate EUR/USD is consistent with the European Commission's estimate. This means that a decline in crude oil prices to a level of about 35 USD per barrel at the end of the medium term and a moderate appreciation of the USD vis-à-vis the EUR have been incorporated into the figures of the current account as well as the capital account of the balance of payments. In connection with an anticipated effect of FDI in the automotive industry on the reduction of the trade deficit as well as on the growth of labour productivity, which should have a significantly faster dynamics than in the EU Member States, estimates of the NBS are based on continued appreciation of the real equilibrium exchange rate.

Moderate wage development, declared development toward consolidation of public finances, development of the exchange rate in line with the equilibrium one, and a gradual decline in crude oil prices create preconditions for achieving the level of the Maastricht inflation criterion in 2006. In connection with the end of extensive deregulations, inflation will significantly decrease already in 2005 as compared with 2004.

In the event of a change in whichever of these assumptions, the macroeconomic equilibrium and the meeting of the Maastricht criteria in 2007 could be threatened. The NBS will react to prevent any spread of price contagion. The degree of its reaction will depend on the character of shocks and it will also require cooperation with the fiscal and income policy sectors.

In the area of fiscal policy, the main goal is to support economic growth, move toward a sustainable position of public finances, reduce the degree of redistribution through public finances, and meet the Maastricht criteria. Based on these intentions and economic conditions, frameworks for compiling budgets of the general government for the years 2005 to 2007 have been purposely set so that deficits of general government budgets expressed in the ESA 95 methodology, without the effect of introduction of the second pillar of the pension system, were at most at 3.4 percent of GDP in 2005, 2.9 percent of GDP in 2006, and 1.9 percent of GDP in 2007.

Monetary Policy Implementation

In 2004, the implementation of monetary policy remained unchanged, when, in its decisions to change interest rates as its main monetary policy instrument, the Bank Board of the NBS considered all factors that influenced the development of inflation, particularly in the given year. With regard to the fact that the relatively high dynamics of headline inflation was influenced in particular by cost factors originating from rising crude oil prices, indirect taxes, and regulated prices, the NBS did not find it appropriate by restrictive monetary policy to react to growth of the prices which were beyond the scope of the central bank. The NBS concentrated mainly on the elimination of secondary impacts of administrative measures. Based on information about the development of regulated prices and administrative measures, it was apparent that high inflation had temporary character only and after the completion of deregulations, i.e., after adjusting prices to real costs, and after the elimination of cross subsidies, dynamics of inflation should decrease to less than a half of its current level already in 2005.

Development of inflation within the programmed interval and an absence of demand pressures have created space for cutting the interest rates during 2004. The NBS has thus reacted to the fact that through the development of the exchange rate, as a result of its excessive appreciation, there was a restrictive influence on the economy of the Slovak Republic. Development of the exchange rate was taken into account not only in the current year but also on a cumulative basis for previous years. At the same time, this development was put into context with the estimated development of both the equilibrium exchange rate and the structure of the trade deficit, where the balance of the automotive industry has a specific position because its sensitivity to development of the exchange rate is lower.

From 2005, in its monetary policy implementation the NBS will concentrate on, and in relation to the public communicate as to, the medium-term horizon. The bank will make all its decisions in relation to and with the focus on achieving the set inflation target measured by the harmonized index of consumer prices. With regard to the unambiguous commitment of the NBS to achieve a determined value of inflation at a set time horizon, the NBS finds it important to provide households and enterprises with a nominal anchor for their investment and consumption decision-making, as well as for the area of wage bargaining. In particular influencing the inflation expectations of the public is, for the central bank, one of the instruments influencing the achievement of the set goal. In this connection the NBS declares its monetary policy with the main goal in meeting the Maastricht inflation criterion. At the same time the NBS awaits that the creation of a low level inflation environment and expectations will then also be mirrored in wage bargaining reflecting the set level of the inflation target.

In the period of the Slovak Republic's membership of ERM II, the NBS will also monitor the fulfilment of the second Maastricht criterion, which is the exchange rate. In the medium term the fulfilment of the exchange rate criterion in a small open economy is consistent with achieving the set inflation target, and therefore, attention will be paid to the exchange rate in relation to the development of inflation and the overall position of the economy. During the fulfilment of this criterion, the NBS will take into account both its definition and ongoing real convergence of the Slovak Republic. This will be in relation to the estimated equilibrium level of the exchange rate, which should ensure that macroeconomic imbalances would not develop, as well as with regard to development of competitiveness of the economy.

However, meeting the Maastricht criteria in the areas of inflation and exchange rate is conditioned by appropriate fiscal policy, which together with monetary policy will contribute to the creation of a low-inflation environment and respond to unexpected shocks and circumstances, so that the common commitment to meet the Maastricht criteria in 2007 and to adopt the euro in 2009 is successfully achieved.

With entry into the euro area the NBS will not change its monetary policy instruments. These, together with the basis for calculation of the minimum reserve requirements, will presumably be harmonized shortly before entry.

A part of Monetary Surveys will involve, on a quarterly basis, results of a medium-term model simulation. This situation will consistently include the current and anticipated development of individual indicators of economic development, such as the development of GDP, wages, exchange rate, and the fiscal sector, in order to create a framework for the identification of factors and their effect on the development of inflation in the medium term with the aim of adjusting the monetary policy accordingly to achieve the set target.

Conclusion

From the year 2005, the monetary policy regime will change to inflation targeting, however, it will be also necessary to take into account membership of ERM II.

This change in the strategy of monetary policy stems from the integration ambitions of the Slovak Republic to join the euro area, while their timing is set out in official documents. The government of the Slovak Republic and the National Bank of Slovakia in the Specification of the Strategy for Adopting the Euro, which the government approved on 8 September 2004, presume the adoption of the euro from 1 January 2009. This means that convergence criteria required for the euro adoption (the so-called Maastricht criteria) must be met from the year 2007.

With regard to the fact that the level of the inflation criterion is not fixed but variable, the conduct of monetary policy will have to be adapted to its actual level.

The meeting of the Maastricht criteria is not an isolated matter of only monetary or just fiscal policy, but it concerns the entire society. **The primary role of the NBS will be to make such steps and decisions which will meet the Maastricht inflation and exchange rate criteria, however, in coordination and cooperation with fiscal policy, as well as, particularly in the wage area, general income policy.** Any deviation from the programme of declared fiscal consolidation can cause contradictory reactions of the market and increase costs of potential stabilization.

In line with the approved Specification of the Strategy for Adopting the Euro and in line with the approved Updated Convergence Programme and the General Government Budget for the years 2005-2007, the Slovak Republic shall enter ERM II in the first half of 2006, in order to meet one of the conditions of the Maastricht exchange rate criterion, which is at least two-year membership of this exchange rate mechanism. In the area of implementation of the monetary policy, the NBS will unambiguously be oriented toward the medium term and the fulfilment of inflation target.