

3. Monetary Programme of the NBS for 2004 and Outlook for 2005-2007

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Annex

Main economic and monetary indicators

1. Introduction

On Friday, December 19, 2003, the Bank Board of the NBS approved the monetary programme of the NBS for 2004, as well as the medium-term outlook for the years 2005-2007. By this document, the NBS wants to offer to the public a view of the development of the economy of Slovakia in the context of the latest data of macroeconomic indicators as well as other information. A component of the monetary programme for 2004 is also an evaluation of hitherto development in the year 2003 and a prediction until the end of the year.

The NBS based its work on the monetary programme on known figures of GDP development in the second half of 2003. Even though GDP results in the third quarter do not significantly alter the fundamental characteristics of the economic development, at the time of their release, certain methodological revision of GDP data took place. With regard to the fact that at the time GDP data were published, work on the monetary programme for 2004 had been already completed, this document neither takes into account this revision of data nor the new data for the third quarter of 2003. The revised GDP data will be taken into account in the update of the monetary programme for 2004. Although compared with the first half of the year (3.9 percent), the economic growth in the first three quarters (4 percent) accelerated, it continued to be determined completely by foreign demand. Domestic demand continued to decline in the third quarter, primarily as a result of a further drop of private consumption. Similarly as in the first half, investment demand did not pick up in the third quarter and its downward tendency has persisted for almost two years.

The basic tendencies of the macroeconomic and monetary development in the year 2003 were in line with the assumptions of the National Bank of Slovakia. The economic development was to a great extent determined by the renewal of the process of adjustments of regulated prices and by changes of indirect taxes (changes of VAT rates and excise taxes). The increase of indirect taxes at the beginning of the year was, in view of a shortfall of revenues of the state budget, complemented in August by another increase of excise taxes for petrol, beer, and cigarettes. Revenues of the state budget from these taxes should partly compensate for a shortfall of other revenues and help along with other measures to achieve the planned reduction of the fiscal deficit from 7.2 percent in 2002 to 4.9 percent in 2003.

Administrative interventions in the price development have caused a more significant rise of inflation and increased spending of households for goods and services with regulated prices. This, together with a rising labor productivity exceeding the growth of real wages and a dynamic development of export efficiency was reflected in a change of the structure of economic growth.

Adjustments of regulated prices and indirect taxes were manifested in accelerated price growth, when their share in the headline inflation represented almost 80 percent. Increased influence of cost factors, however, in view of the absence of demand impulses, was not mirrored in the form of significant secondary effects, which is documented by a relatively low level of core inflation. Compared to the original assumptions of the NBS, some regulated prices under the government's jurisdiction, or other public institutions (education, health care), grew faster in the course of the year. A slightly higher growth rate within tradable goods, despite a weakening of the US dollar, was recorded also in prices of motor fuels as a result of higher crude oil price on the world market. In the second half of the year, an effort was noted on the food market on the part of primary producers to sell their products for prices corresponding with the costs of their production. This fact will be probably reflected in a

faster growth of food prices, however, the growth rate should move within intentions of the NBS. Greater effects of some cost factors (food, crude oil price, regulated prices) will cause that dynamics of headline and core inflation will probably range in the upper half of the programme interval.

Although the drop of the trade deficit was within the intentions of the NBS assumptions, its decline resulting from a higher growth rate of exports was more remarkable. Faster growth of export was achieved in an environment of slower economic growth of our trading partners and was linked primarily with higher production in the automotive industry and introduction of a new production programme oriented on a higher price class of production. Iron and steel also experienced higher growth of export.

Favorable development of foreign trade was also expressed in a faster decline of the deficit on the current account, the end-year level of which will probably represent less than 50 percent of the original projection of the NBS (2 percent of GDP compared with 4.5 percent of GDP estimated in the updated monetary programme). In the monetary programme for 2004, the current account deficit for 2003 was estimated based on data available at the time it was drawn up (September 2003). With regard to the fact that in contrast to NBS estimates the trade balance in October was positive and the Statistics Office of the Slovak Republic has adjusted export and import data also for the previous months of 2003, then if the presumed trend is confirmed until the end of the year, the deficit on the current account of the balance of payments could approach zero. The influence of this development of the current account of the balance of payments on GDP growth should not be significant.

Development of foreign trade in 2003 documents the importance of foreign direct investments for the Slovak economy and economic growth. With declining domestic demand, relative high dynamics of GDP growth was formed exclusively by foreign demand.

Withdrawn effective demand of the population through growth of regulated prices and indirect taxes has had an attenuating effect on development of final consumption of households. Income effect of administrative interventions into the price development will probably continue in the future, though with a more moderate impact. Based on experience from 1999 and 2000 (when more marked extent of administrative interventions into the price development took place) however, moderate growth of final consumption can be expected in the final quarter of this year. This should be influenced also by adjustments of salaries in the state and public service from August of this year. Overall however, growth of private consumption will be lower almost by half compared with assumptions of the NBS.

Despite expectations of the NBS of a revival of investment demand, its downward trend has been continuing. So far development of gross fixed capital formation however is showing a moderate growth of investments into machinery, which can signal renewed growth of private investments in the upcoming period. Overall, the formation of gross fixed capital in 2003 will presumably reach the level of the previous year.

Hence, GDP growth in 2003 will be supported exclusively by foreign demand. A significant growth rate of export compared with projections of the NBS was expressed in a surplus of net export. The surplus of net export at constant prices should also be remained in annual terms. A positive contribution of net export to economic growth, compared with original projections of the NBS, will be more than 2 percentage points higher (4.0 percentage points compared with 1.9 percentage points).

Although basic tendencies of economic development (influence of administrative interventions into the price development on rising inflation and a slowdown of domestic demand, a decline of the trade deficit and the current account deficit) were in line with assumptions of the NBS, the development so far was characterized by higher growth of export and slower growth of nominal wages with an impact on real wages and private consumption. A development diverging from projections characterized the development of investment demand.

In an environment of a restored deregulation process and growth of indirect taxes, the overriding task of the monetary policy in 2003 was to prevent the formation of significant secondary effects of these administrative measures from arising, i.e., a price infection. A more significant impact of administrative intervention on effective demand of households as well as significantly faster growth of labor productivity over growth of real wages, however, prevented demand pressure from arising on prices or growth of import. Stagnation of private consumption together with a decline of investment demand thus resulted in a contraction of domestic demand, whereby for the full year a moderate decline can be anticipated. With regard to an absence of demand pressure in the economy and in the interest of maintaining positive development tendencies in the Slovak economy and to eliminate potential risks, at the end of September the Bank Board of the NBS decided to cut key interest rates by 0.25 percentage points. Based on the current economic development and presumed effects of individual factors in the future, on December 19, 2003 the Bank Board of the NBS decided to cut key interest rates by additional 0.25 percentage points.

Development of the Slovak economy in the years 2004-2007 will be significantly influenced by several institutional changes of the economic system. Among them rank in particular the entry of the Slovak Republic into the European Union, realization of tax and pension reforms, reform of the healthcare system and public finance administration reform, as well as gradual consolidation of public finances. Accumulation of the influence of individual reforms and uncertainty over their impact on economic subjects however simultaneously represent a risk in the monetary programme for 2004, as well as the medium-term outlook until 2007. In connection with entry into the EU, Slovakia will join the common agricultural policy, which, through agreed-upon intervention prices, will be manifested in 2004 by rising food prices.

Implementation of tax reform, the introduction of a flat 19 percent tax in 2004 will presumably have an impact on the price development (an increase of the lower VAT rate), simultaneously however, this tax system will represent a stimulus for the development of economic activity and an inflow of foreign direct investments.

Based on the Pre-accession Economic Programme as well as the Programme Declaration of the Government, the fiscal deficit (without the effect of pension reform) should gradually decline from 4.9 percent of GDP in 2003 to 3.9 percent in 2004, 3.3 percent in 2005 and 2.9 percent in 2006. The medium-term outlook at the same time presumes a further drop of the fiscal deficit also in 2007.

With regard to a gradually declining extent of administrative interventions in the price development, the year-on-year rate of inflation in 2004 should be lower compared with 2003, whereby acceleration of the disinflation process can be anticipated from 2005.

The pace of disinflation over the entire time horizon will be significantly influenced by the extent of adjustments of regulated prices and indirect taxes. Presumed development of regulated prices is based on valid and issued assessments as well as information issued by the Regulatory Office for Network Industries regarding increases of regulated prices in 2004 - 2007, and assumptions of the Ministry of Construction and Regional Development concerning growth of rent. The prediction also takes into account requirements for growth of regulated prices raised by transport companies and estimated development of other regulated prices (accommodation in university dormitories, healthcare prices, etc.).

Growth of regulated prices (in the jurisdiction of the Regulatory Office for Network Industries as well as other state bodies) will most significantly contribute to the price level rise in 2004, whereby in the upcoming period their influence will weaken. Similarly, some influence of secondary cost effects from an increase of regulated prices on price growth of services can be expected mainly in the year 2004.

Adjustments of indirect taxes belong to the administrative interventions that significantly influence the rate of inflation. Implementation of tax reform in 2004 in the form of the introduction of a flat tax will represent an increase of the reduced VAT rate from 14 percent to 19 percent. At the same time, the base rate will come down from 20 percent. On the whole, the effect of the tax reform should represent a pro-growth impact on headline inflation. Based on current information, in 2004 the Ministry of Finance of the Slovak Republic plans to raise the excise tax on tobacco and tobacco products from May only.

In 2005 to 2006, the process of adjusting excise taxes to standards of the EU should continue, which will result in an annual increase of the excise tax on tobacco and tobacco products. In 2007, the excise tax on tobacco and tobacco products should already be fully harmonized.

Price development in 2004 - 2007 will also be influenced by the adoption of the common agricultural policy of the EU. With regard to the fact that in the middle of 2003, member countries of the EU have agreed to reform the common agricultural policy, which brought about a decline of intervention prices, its impact on growth of food prices should be lower compared with assumptions formulated in the updated monetary programme for 2003. The most significant impact on the common agricultural policy on food prices and headline inflation can be expected in the second half of 2004 and the first half of 2005.

Similarly as in 2003, also in 2004 it can be expected that growth of regulated prices and indirect taxes will have an attenuating effect on consumer demand and through a higher rate of inflation also on development of real wages. Although in the following years consumer demand should pick up, this however should not represent an inflation impulse with continuing consolidation of public finances. Primarily the development of prices of tradable goods should be characterized by stable development, which should copy a moderate price growth in Europe. Further development of the competitive environment in connection with EU entry and simplified trade exchange should have a positive effect on development of prices of tradable goods. Prices of market services in 2004 will be influenced primarily by secondary cost impacts of increased regulated prices. Over the entire time horizon of the forecast, the growth of prices of market services can be expected to be faster than price growth of tradable goods, which, apart from secondary impacts of increased regulated prices, will be influenced also by the process of real convergence of the Slovak economy.

The monetary programme for 2004 presumes that headline inflation at the end of the year will be in the interval of 5.5-7.3 percent, which corresponds to average inflation in the range of 7.2-8.2 percent. Core inflation in December 2004 should reach a value in the interval 1.2-3.5 percent. As a result of a more significant reduction of administrative measures and their secondary impact in the following years, headline inflation as well as core inflation should decline. In 2007, the level of headline inflation (1.7-2.7 percent) and core inflation (1.6-2.7) should be almost identical. Based on this prognosis of the NBS, inflation close to the Maastricht criterion will be achieved already in 2006.

In the area of economic activity, investment demand should recover already in 2004, whereby its highest growth can be expected in 2005, in particular as a result of an inflow of foreign direct investments into the automotive industry. Though within the prognosticated period the inflow of foreign direct investments will reflect in a temporary increase of imports and a trade balance deficit (in particular in 2005), from the longer term perspective however, it will contribute to greater competitiveness of the Slovak economy and its export efficiency.

Anticipated renewal of economic growth of our trade partners will create relatively favorable conditions for development of Slovak exports. After significant acceleration of exports of the automotive industry in 2003 however, in 2004 we can expect the growth rate to slow down. In connection with existing export limits to the EU, stagnation of export of iron and steel can be expected. Also imports should grow at a slower rate, in total however, the trade deficit and the current account deficit will probably widen in 2004. This trend should continue also in 2005 as a result of a higher inflow of FDI. In 2006 and 2007 however, it should contribute to growth of export and a decline of the trade deficit.

Development of foreign trade will also have an impact on the contribution of net export to economic growth, which in 2004 and 2005 will be negative. In 2006 and 2007 however, a moderate pro-growth effect can be expected.

Similarly as in 2003, attenuating effect can be expected from adjustments to regulated prices and indirect taxes on growth of real wages and consumer demand. Compared with 2003 however, household consumption should moderately accelerate. In the following years, perhaps also with regard to a reduced extent of administrative interventions into the price level, renewed growth of real wages and household consumption can be expected. However, development in the wage area should be determined primarily by rising labor productivity and the need to increase competitiveness of local producers under conditions of the common market in the European Union and should not create potential inflation impulses.

Relatively restrictive wage policy in the public sector as well as the declared goal of reducing the fiscal deficit will reflect in only moderate growth of public sector consumption and its low contribution to economic growth.

So, in total over the entire horizon of the medium-term outlook, conditions should be created to maintain a relative high rate of economic growth. Economic growth in the following years should be determined primarily by revived domestic demand, whereby in 2006 and 2007 also a positive contribution of net export can be anticipated as a result of started production from the FDI inflow from the previous period. Growth of consumer demand from 2005 will primarily be supported by renewed growth of real wages and reduced impact of administrative interventions into the price level. Revival of investment demand should reflect

improved quality of the business environment, an inflow of FDI, as well as realization of government infrastructure projects.

In the area of monetary policy instruments in 2004, a change will be made in the area of minimum required reserves.

Within the process of harmonization of instruments of the NBS with instruments of the ECB, in 2003 the rate of minimum required reserves was reduced by 1 percentage point to 3 percent, which at the same time means a unification of the reserve level for commercial banks and home savings banks.

In 2004, the minimum required reserves rate will again be reduced by 1 percentage point to 2 percent, and thus reach the level of required reserves in the eurozone. The level of 2 percent is considered the target level also in the medium-term horizon, and will not be changed under the condition of stable development. In 2004, the calculation basis for the minimum required reserves will still be all deposits regardless of their maturity. Simultaneously, the sanction system for not observing the required reserves will be harmonized with the eurozone. Equal treatment for banks and branch offices of foreign banks will be applied.

2. Development of the world economy in 2003 and outlook for 2004

The prognosis of the external economic environment is based on the European Commission Autumn 2003 Economic Forecasts published in October 2003.

Compared with assumptions from its spring forecast, the European Commission expects in 2003 and 2004 on the one hand a slowdown of economic growth primarily in euro area Member States and in acceding countries and on the other hand, acceleration of the GDP growth in the USA and in Japan.

A comparison of spring and autumn (2003) forecasts of economic growth according to the European Commission (percent)

	Forecast for 2003			Forecast for 2004		
	spring 2003	autumn 2003	difference ¹⁾	spring 2003	autumn 2003	difference ¹⁾
USA	2.4	2.8	0.4	2.5	3.8	1.3
Japan	1.5	2.6	1.1	1.3	1.7	0.4
EU	1.3	0.8	-0.5	2.4	2.0	-0.4
EMU	1.0	0.4	-0.6	2.3	1.8	-0.5
Germany	0.4	0.0	-0.4	2.0	1.6	-0.4
France	1.1	0.1	-1.0	2.3	1.7	-0.6
Italy	1.0	0.3	-0.7	2.1	1.5	-0.6
Czech Republic	2.8	2.2	-0.6	3.9	2.6	-1.3
Hungary	3.7	2.9	-0.8	4.1	3.2	-0.9
Poland	2.5	3.3	0.8	3.7	4.2	0.5

¹⁾ difference between the spring and autumn forecast

According to the forecast, in 2003 the European Commission expects a global economic growth of 3.3 percent with a moderate acceleration to 4 percent in 2004-2005. Although presently the overall economic recovery is not yet reflected in international trade data, in 2004-2005, it is expected that the growth of the world trade of goods will accelerate to approximately 8 percent from a level of 3 percent in 2003. Among the main factors

supporting economic recovery are above all accommodative macroeconomic policies, favorable conditions on the financial markets, and a revival of consumer confidence resulting from easing of geopolitical tensions.

The process of continued disinflation enabled reducing nominal interest rates to historically lowest levels. Because of a declining pressure on prices and wages, the monetary policy will retain its supportive character. Fiscal policy of the USA is expected to remain strongly expansive, in the EU it should play a role of an automatic stabilizer during the whole period of sluggish economic growth.

After a sharp drop of crude oil price resulting from the end of the war in Iraq, its development is characterized by a moderate upward trend (31 USD/barrel in the middle of October 2003). The present price reflects a number of supply side factors, including the difficulty in restoring the Iraq's oil production, political uncertainty in Venezuela and Nigeria, relatively low oil stocks, and the recent decision of OPEC to reduce their production ceiling. Oil prices are expected to diminish gradually over the forecast period, to 24 USD/barrel in the second half of 2005. This gradual decline of oil prices reflects the expectation of faster growth on supply side than on demand side. The low oil prices belong among factors with positive effect on the economic recovery.

The European Commission's forecast assumes that significant progress in structural reforms will in the short run be the sources of returned business and consumer confidence and in the medium term a source of potential economic growth.

Forecast of macroeconomic indicators in selected countries (EC) – October 2003

	GDP				Inflation ¹				Trade Balance/GDP			
	2002	2003	2004	2005	2002	2003	2004	2005	2002	2003	2004	2005
USA	2.5	2.8	3.8	3.3	1.6	2.3	1.4	1.0	-4.7	-5.1	-5.4	-5.6
Japan	0.1	2.6	1.7	1.5	-0.9	-0.3	-0.4	-0.3	2.3	2.7	3.2	3.6
EU	1.1	0.8	2.0	2.4	2.1	2.0	1.9	1.7	1.3	1.0	1.2	1.3
EMU	0.9	0.4	1.8	2.3	2.3	2.1	2.0	1.7	2.4	2.0	2.2	2.3
Germany	0.2	0.0	1.6	1.8	1.3	1.1	1.6	1.3	6.3	6.1	6.8	7.0
France	1.2	0.1	1.7	2.3	1.9	2.1	1.8	1.5	0.1	-0.4	-0.3	-0.3
Italy	0.4	0.3	1.5	1.9	2.6	2.8	2.3	1.9	1.9	1.2	1.5	1.5
Czech Republic	2.0	2.2	2.6	3.3	1.4	0.0	3.3	2.6	-3.3	-3.6	-3.5	-3.7
Hungary	3.3	2.9	3.2	3.4	5.2	4.6	6.1	4.1	-3.1	-5.8	-5.2	-3.6
Poland	1.4	3.3	4.2	4.8	1.9	0.7	1.9	2.7	-2.8	-4.9	-5.3	-5.7

¹ Measured by HICP

For the time being, the economic recovery in the USA has recorded the strongest pace in the second quarter of 2003, mainly because of diminished geopolitical tension together with a significant growth of labor productivity and effects of supportive macroeconomic policy. From the short-term perspective, a strong pace of the economic growth is still expected, however, in 2004 consumer spending from refinancing of mortgage activities should gradually decrease and expansionary effects of tax cuts should be absorbed. In 2005, the economic growth is expected at the level of potential output. The most significant risk in assumed development of the American economy remains the deepening deficit of the trade balance and the deficit of the general government.

Within the **Euro area**, following weak economic results in 2002, the economy stagnated also in the first half of 2003. This development was caused by several factors, such as uncertainty about development of the crude oil price in connection with the war in Iraq, uncertainty about future development of wages and pensions, as well as unfavorable development on the equity markets. At present, first signs of returned consumer confidence are beginning to appear. Part of the awaited recovery in household and business sector spending stems from historically low interest rates (short-term as well as long-term). Real disposable income of households was supported by a low rate of inflation as well as appreciation of the euro. The source of economic recovery should be domestic demand supported by rising foreign demand. Because of stagnant economic growth and persisting rigidities on labor market, the euro area unemployment will continue to rise within the forecast period up to the level of 9.1 percent in 2004, since the growth of the labor force is expected to exceed employment growth. Inflation remains at a low level and it is expected to decline further to 1.7 percent in 2005. In 2003, the situation in public finance should worsen in almost all countries of the euro area, however, to a various extent. A moderate improvement can be expected in 2004.

Within the forecast period, only moderate pace of economic recovery is expected in **Germany**. The reason for this situation is above all a further increase of unemployment rate, which will negatively influence private consumption, as well as an effort to keep the general government deficit at a required level, which will result in only very modest support of growth by the fiscal policy. Very low level of investments in recent years, caused by constraints in credit policy, will also negatively influence potential acceleration of economic growth. With regard to moderate growth of wages, reduced social contributions, and lower crude oil prices, inflation could remain at the level of 1.5-2 percent. Based on the planned development of the general government deficit a rising debt level is expected.

The European Commission in its forecast expects in the **Czech Republic** a moderate economic growth in 2003, when the growth will be driven by domestic demand, while gross capital formation and net export will have a rather negative impact on GDP growth. Development in 2004 and 2005 will largely depend on the level of recovery in the EU, as well as on the impact of the adopted package of fiscal consolidation measures. Due to a high domestic consumption and the economic slowdown in the EU, a slight deterioration of the trade balance is expected in 2003, while in 2004, a gradual improvement should appear as a result of lower import caused by public finance reform. In 2005 the situation should worsen again because of rising import intensive investments. Also in 2003, the general government deficit should remain at a high level (8 percent of GDP) with a subsequent improvement at a level of 5.2 percent of GDP in 2005.

3. Estimated development until the end of 2003

3.1. Inflation

A year-on-year rate of headline as well as core inflation at the end of 2003 should move in the upper range of the programme intervals. Development of consumer prices so far as well as development until the end of 2003 should be in line with expectations of the NBS and end-year levels of headline as well as core inflation should be in the range of programme intervals of the updated monetary programme for 2003, though in their upper halves. The level of average inflation however should be probably in the middle of the programme interval.

The higher actual growth of prices compared with the middle of the estimate was caused by factors that cannot be influenced by monetary policy instruments (regulated prices, changes in excise taxes, food prices).

Development of consumer prices in November 2003 – comparison with forecasts in the updated monetary programme for 2003 (change in percent)

	UMP 2003 at year end		Actual November	Year-end Estimate	Difference of estimate and UMP*
	min.	max			
Total in %	8.4	9.7	9.8	9.4	0.0
Regulated prices in %	18.0	18.9	20.6	19.1	0.2
<i>share in total in percentage points</i>	4.22	4.42	4.85	4.56	0.12
Impact of changes in indirect taxes in non-regulated prices - share in total in percentage points	2.37	2.37	2.56	2.55	0.18
Core Inflation in %	2.1	3.6	3.1	3.1	0.0
<i>share in total in percentage points</i>	1.85	2.97	2.40	2.33	0.00
Food in %	-0.4	2.1	2.3	2.7	0.5
<i>Share in total in percentage points</i>	-0.06	0.44	0.47	0.54	0.10
Tradable goods in %	1.5	2.1	1.7	1.4	-0.1
<i>share in total in percentage points /*</i>	0.74	0.99	0.64	0.50	-0.24
Market services in %	6.2	8.3	6.9	6.9	0.0
<i>Share in total in percentage points /*</i>	1.17	1.55	1.29	1.29	0.00
Net inflation	3.0	4.2	3.4	3.2	0.0
<i>share in total in percentage points</i>	1.91	2.53	1.92	1.79	- 0.12
Net inflation excluding the effect of fuel prices	3.0	4.2	3.8	3.4	0.0
<i>Share in total in percentage points</i>	1.59	2.18	1.98	1.80	0.00

*positive value means a difference from a maximum, negative value a difference from a minimum

Higher growth of **regulated prices** was linked primarily with a more significant growth of prices in education and healthcare, i.e., such regulated prices that are in the jurisdiction of the government or other public institutions. Another factor was that the real impact of changes of excise taxes was slightly higher compared with NBS forecasts.

From items included in core inflation, **food prices** grew faster compared with expectations of the NBS (in May, June, September, and in November), which has caused a change in the trend of year-on-year development of food prices from decline to growth. On one hand, the effort of producers to change the market situation (association into trade cooperatives and common procedure toward customers) and on the other hand, support of the Agricultural Intervention Agency for export of surplus products from the domestic market (in particular milk and butter) had an impact on food prices. Growth of prices of some commodities was caused by higher demand in surrounding countries.

Price dynamics of **tradable goods** was influenced by domestic (competitive environment) as well as external cost factors (low imported inflation, stronger exchange rate, and higher crude oil price). Another factor was year-on-year decline of prices of tobacco and tobacco products (excluding the change of excise taxes) by more than 7 percent.

During 2003, the price of crude oil reacted to several factors on the offer side. After the war in Iraq started, crude oil price fell to a level of 23.30 USD/barrel at the end of April. However,

from the end of April it had a rising trend when in the middle of August it reached levels of 30 USD/barrel. The price thus reacted to problems with restoring oil extraction in Iraq, political risks in Venezuela and Nigeria, declining stocks (mainly in the USA) and a decision of OPEC countries to reduce production. From August, the price of crude oil declined to a level of 28 USD/barrel and this is the average level that according to NBS forecast should be achieved for the whole of 2003.

Development of prices of **market services**, in which projected secondary effects of changes of regulated prices were in line with expectations of the NBS from the updated monetary programme and the level of their year-on-year growth at the end of the year should be within the programme interval.

Consumer prices (percent)

		2002	2003 MP	2003 UMP	Actual November 2003	Updated 2003 Estimate ¹
Headline inflation	Year-on-year	3,4	7,7-9,7	8,4-9,7	9,8	9,4
	average year-on-year	3,3	8,2-9,3	8,3-8,8	8,5	8,5
Core inflation	Year-on-year	1,9	2,7-5,0	2,1-3,6	3,1	3,1
Net inflation excluding the effect of fuel prices	Year-on-year	2,9	3,4-4,4	3,0-4,2	3,8	3,4

¹ Estimate based on actual development up to November

3.2 Producer prices

Current development from the beginning of the year

For the period from January to October 2003, prices of industrial producers grew year-on-year on average by 8.2 percent, and most significantly participating on this development were prices of electricity, natural gas, steam and hot water (by 17.7 percent). Prices of products in industrial manufacturing grew year-on-year by 2.5 percent and prices of mineral raw materials by 3.3 percent.

In the period so far, prices of industrial producers developed in line with their forecast published in the updated monetary programme for 2003, when prices of electricity, natural gas, steam and hot water as well as products in industrial manufacturing grew according to expectations.

Growing faster than expected among industrial manufacturing prices was the price of crude oil refining products, which is linked with a higher price of crude oil on the world markets compared with the updated monetary programme. On the other hand, prices of food products grew at a slower rate than expected, in particular because of continued decline of prices of meat and flour-milling products. Eventually however, the effect of this opposing development of prices of industrial manufacturing products was neutral.

Anticipated development until the end of the year

For the period until the end of the year, industrial producer prices can still be expected to grow in line with the forecast in the updated monetary programme. Prices of products of industrial manufacturing will presumably grow at a slower rate on average at the end of the year compared with the updated monetary programme for 2003 (by 0.1 percentage point), resulting from a lower contribution from growth of food prices. Forecast of the development

of prices of energy, natural gas, steam and hot water remains unchanged in comparison with the updated monetary programme for 2003.

Based on the development of prices in industry up to October 2003 and in line with aforementioned assumptions, the NBS expects until the end of the year, similarly as in the updated monetary programme for 2003, average year-on-year growth of industrial producer prices at the level of 8 percent. Prices of products of industrial manufacturing should grow by 2.5 percent on average, prices of electricity, natural gas steam, and hot water by 17.8 percent.

	Prediction of industrial producer prices for the year 2003		The same period of previous year=100	
	UMP 2003	Result January –October 2003	2003 Estimate (mean values)	
Average annual index thereof:	108.0	108.2	108.0	
- industrial manufacturing products <i>contribution</i>	102.6 1.7	102.5 1.7	102.5 1.7	
- electrical energy, natural gas, steam hot water <i>contribution</i>	117.8 6.3	117.7 6.3	117.8 6.3	

Prices of agricultural products that have been lower compared with last year during the whole of 2003 will presumably continue in this trend until the end of the year. This stems from anticipated development of prices of vegetable as well as animal products, whereby meat prices can seasonally grow slightly at the end of the year.

3.3 Foreign accounts

3.3.1 Balance of payments

The forecast of the current account assumes a deficit of SKK 23.3 billion, i.e., 2.0 percent of GDP (updated monetary programme forecast a deficit of SKK 53.9 billion).

Current account items in SKK bn.	UMP – 2003	Actual 1-8 / 2003	Estimate -2003
Trade balance	-65.0	-11.1	-38.2
Export	725.0	512.7	784.4
Import	790.0	523.8	822.6
Balance of services	14.0	4.5	10.3
Balance of receipts	-6.9	-3.8	-4.1
<i>thereof receipts from investments</i>	-25.6	-14.6	-20.5
Current transfers	4.0	6.8	8.7
Current Account	-53.9	-3.6	-23.3
Share of c/a on GDP in %	-4.5		-2.0

Development of foreign trade in nine months of 2003 has shown a year-on-year improvement of the trade balance by SKK 49.4 billion. The growth rate of exports reached 22.4 percent and its annual growth rate should exceed 20 percent (updated monetary programme forecast 11.2 percent). Faster growth of export should be the consequence of export particularly of transport equipment in connection with higher output and export of more expensive types of vehicles as well as other components, including car bodies.

Export in SKK bn.	2003 UMP	2003 Estimate
Finished products	111.0	110.3
Machines and transport equipment	304.0	377.5
Semi-finished goods	255.0	245.2
Raw materials	55.0	51.5
Total	725.0	784.5

More dynamic exports will be subsequently also reflected in a higher growth rate of import (from 5.6 percent in the updated monetary programme to 10 percent). Higher import will be realized in the group machinery and transport equipment and will be induced by rising import linked with growing output of the automotive industry. Lower import of raw materials will be caused primarily by weaker exchange rate of the USD vis-à-vis SKK (from SKK 39.5 per USD to SKK 37.0 USD). Foreign trade estimates are based on an assumption that on average the SKK/USD will appreciate by 18.3 percent for the whole year. The average level of the exchange rate EUR/SKK should remain at the level of 41.5.

Import in SKK bn.	2003 UMP	2003 Estimate
Finished products	171.0	179.8
Machines and transport equipment	261.0	289.0
Semi-finished goods	241.0	245.1
Raw materials	117.0	108.8
Total	790.0	822.7

Services forecast was based on recent development in 2003, when in the period from January to August a stable year-on-year decline of receipts for export of services was recorded and payments for their import were rising. A continuation of this development, when seasonal effects are taken into account, could lead to a decline of the surplus on the balance of services compared with the forecast in the updated monetary programme, mainly as a consequence of a lower surplus on the balance of transportation and a partly higher deficit of the balance of “miscellaneous services total.” On the other hand, the continuation of a decline of spending of citizens of Slovakia on travels abroad will enable partial compensation of the decline of the surplus on the balance of services compared with the updated monetary programme resulting from the balance of transportation and “miscellaneous services total.”

The balance of receipts should remain at the level predicted in the updated monetary programme, whereby there can be a moderate shift between the balance of receipts from investments (a weaker exchange rate of the USD and lower interest rates on business sector loans) and compensation for employees (a more precise estimate taking into account data reported by partner countries).

Apart from foreign trade, the deficit on the current account will be positively influenced by the balance of current transfers where in 2003 unlike previous years lower payments abroad are pursued by natural as well as legal persons.

The prediction for the capital and financial account assumes a surplus of SKK 61.4 billion. (SKK 62.1 billion was assumed in the updated monetary programme).

Capital and financial account items in SKK bn.	2003 UMP	1- 8 /2003	2003 Estimate
Capital transfers	6.0	2.8	4.5
Foreign direct investments -FDI	43.4	21.8	41.9
FDI in the Slovak Republic	44.5	21.5	41.1
thereof: FDI – official sector	9.4	9.4	10.1
Portfolio investments	7.0	-10.4	-4.3
Other long-term financial account	-15.9	-17.2	-8.7
<i>Assets</i>	0.0	9.1	9.5
<i>Liabilities</i>	-15.9	-26.3	-18.2
<i>Government + NBS</i>	-17.4	-21.3	-16.2
<i>Commercial banks</i>	2.4	0.8	-1.0
<i>Companies</i>	-0.9	-5.8	-1.0
Short-term financial account	21.6	23.8	28.0
Capital and financial account	62.1	20.8	61.4

The volume of the capital and financial account should remain at the level from the updated monetary programme. Three basic changes will appear in its structure that are associated with the development of the trade balance and foreign exchange reserves of the NBS.

Sectors in SKK bln.	2003 UMP	1- 8 /2003	2003 Estimate
Business	42.5	-17.5	25.8
Bank	21.6	29.8	14.9
Government and NBS sector	-2.0	8.5	20.7
Total	62.1	20.8	61.4

A lower inflow of resources into the business sector is associated with growth of export and its financing from short-term business loans on part of customers, while demand from local entities for financing of imports in the form of credits will presumably be at a lower level than predicted in the updated monetary programme. An inflow of resources into the business sector will to a large degree depend on an inflow of foreign direct investments from September to December 2003. Experience from previous years shows that in the last quarter, with regard to completion of projects underway, inflow of foreign direct investments reaches up to 50 percent of the total inflow. A higher inflow of resources into the business sector in the fourth quarter should, with regard to growth of imports, be secured also in the form of foreign financial and commercial credits.

Another change associated with development on the current account and its financing should be a lower decline of net foreign assets of commercial banks than presumed in the updated monetary programme. (If presumed capital inflow into the business sector is not achieved, this can cause a greater drop of net foreign assets, up to the level forecast in the updated monetary programme). All other changes pertaining to the volume of portfolio investments, long-term and short-term capital mean only a change of the structure of drawing or investing in the business or banking sector. Even in case of a lower inflow of resources into the business sector, this inflow should be sufficient to cover the deficit on the current account (adjusted balance of payments). A decline of net foreign assets will more or less reflect sales of foreign currencies as a result of interventions of the NBS during 2003.

The main influence on a higher inflow of resources into the sector of the government and the NBS will come from presumed realization of repo transactions of the NBS. Apart from repo transactions, higher growth of foreign exchange reserves (USD 1 billion) than assumed in the updated monetary programme (USD 0.2 billion) will be influenced also by debt repatriation, higher interventions, and drawing of a government loan in the last quarter of EUR 250

million. Foreign exchange reserves at the end of 2003 will reach USD 11.0 billion and will cover 5.3 average monthly imports of goods and services.

Adjusted balance of payments in SKK bn.	2003 UMP	1- 8 /2003	2003 Estimate
Current account	-51.1	1.5	-17.8
Capital and financial account total	52.3	-11.8	28.7
Foreign direct investments in the SR	35.0	12.1	31.0
Unassigned items	0.0	6.4	0.0
NBS interventions	-22.8	-25.8	-25.8
Change of net foreign assets in commercial banks (- growth)	21.6	29.7	14.9
Coverage of c/a deficit by FDI in %	68.5	--	174.2

Abstracted from activities of the government and the NBS, the adjusted capital and financial account would cover the current account deficit to 161.2 percent.

3.3.2 Foreign debt and debt service

Within the forecast of the development of foreign debt, in 2003 we expect higher growth of the total gross debt (by USD 1.8 billion) than assumed in the updated monetary programme (USD 0.3 billion). This increase is a consequence of greater inflow of speculative short-term liabilities of commercial banks (transactions between parent and subsidiary banks within a strategy of banks and branch offices of foreign banks in connection with higher interest earned on Slovak securities) and exchange rate differential that contribute by more than 50 percent to the total growth of the indebtedness. Total gross foreign debt will reach the level of USD 14.9 billion and the net foreign debt is in a creditor position of USD 1.9 billion.

3.4 Gross domestic product¹

GDP estimate for 2003 constant prices, year-on-year change in %

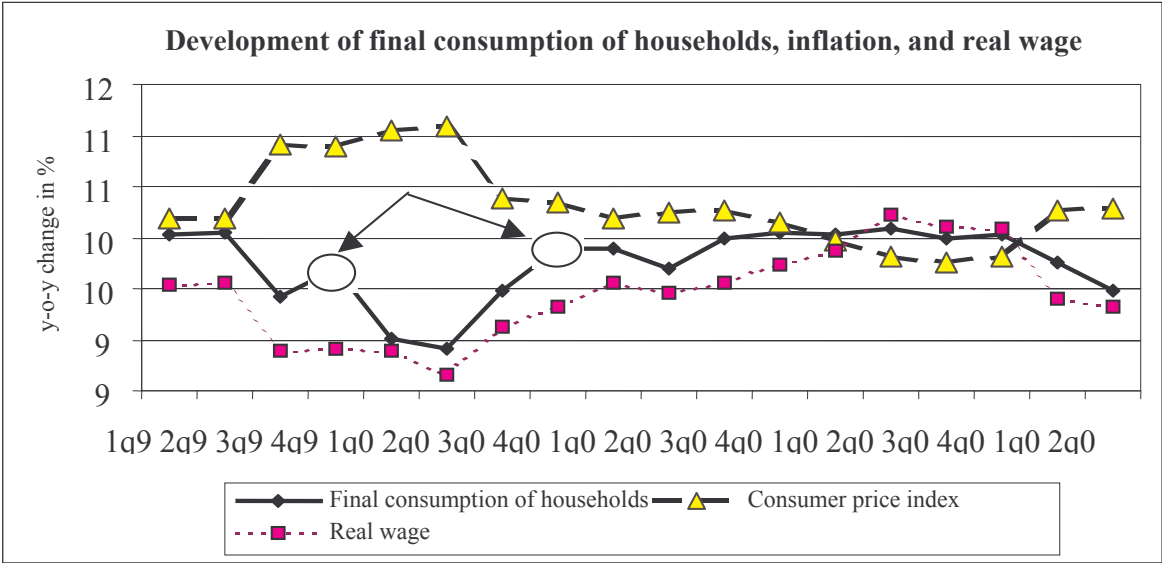
	UMP 2003	Actual H1 2003	Estimate 2003
GDP at constant prices of 1995 - range	3.9-4.4	3.9	3.9
- mid-range	(4.1)		
Domestic demand	2.1	0.0	-0.1
therein:			
Final consumption total	2.2	0.9	1.1
Final consumption of households	2.7	1.2	1.3
Final consumption of the government and nonprofit institutions	1.1	0.4	0.8
Gross capital formation	1.9	-2.2	-3.1
Gross fixed capital formation	4.2	-1.1	0.0
Net export	x	x	x
Exports of goods and services	7.6	22.8	19.2
Imports of goods and services	5.0	15.8	13.5

* statistical discrepancy was included to the change in inventories for forecast purposes

¹Evaluation of development and prognosis until 2007 takes into account GDP for the first half of 2003. At the time the NBS forecast was compiled, neither revised data nor GDP results were available for the third quarter of 2003. In December 2003, the Statistical Office of the Slovak Republic published revised annual data for 1993 -2001 and quarterly data for 2002 and 1st to 3rd quarters of 2003, which incorporate further implementation of ESA 95 methodology used to draw up annual national accounts for years 2000-2001. According to preliminary quarterly national accounts (published on December 11, 2003) GDP grew in the third quarter of 2003 by 4.2 percent at constant prices. Development for three quarters of 2003 has confirmed tendencies from the first half of the year, when real economic growth (4.0 percent for 1st to 3rd quarters) was exclusively the result of the positive contribution of foreign demand, while domestic demand decreased.

Lower growth rate of private consumption in the first half of 2003 compared with expectations of the NBS, as well as a decline of investments instead of their anticipated growth have caused that presumed positive contribution of domestic demand to GDP growth has not occurred. Significantly more dynamic foreign demand compared with forecasts has however fully replaced the stagnating domestic demand. As a result of this development, real growth of the economy in the first half of 2003 reached the bottom level of the projected interval in the updated monetary programme.

While **private consumption** in the first quarter 2003 developed in line with forecasts of the updated monetary programme, in the second quarter (year-on-year decline by 0.2 percent) its development was more significantly marked by effects of adjustments of regulated prices and falling real wages. A similar development is likely to continue in the third quarter, whereby based on knowledge of previous development (growth of consumption of the population in the fourth quarter also in years with significant decline of real wages, which is indicated in the chart below) toward the end of the year, it is possible to expect its renewed growth (the population will presumably use consumer loans and installment purchases in the period before Christmas that offer the possibility of deferring installments until next year). This assumption is to a certain degree supported by the consumer confidence indicator, the level of which was above the annual average in September and October after three months of decline. Similarly, in October the value of the indicator in the retail sector reached its highest level this year. For the whole year, private consumption growth should be slower by a half compared with forecasts in the updated monetary programme.



In the development of **public consumption** the updated monetary programme for 2003 awaited a significantly slower dynamics of public expenses compared with the previous year. This assumption has been confirmed whereby the reduced dynamics of general government consumption in the first half of 2003 was even more significant than assumed by the updated monetary programme. Likely moderate increase in the growth dynamics in the second half of the year will be associated with adjustments of salaries in the state and public service from August of this year, which will be projected particularly into the fourth quarter, as a result of which the total year-on-year growth of general government consumption (including nonprofit institutions serving for households) should be lower compared with the forecast in the updated monetary programme.

Anticipated revival of **investment demand** in the updated monetary programme for 2003 in the first half of the year did not arrive, when fixed investments dropped for the third successive half-year. Businesses usually have to accumulate a greater volume of financial resources to widen their technical base, and this has at this time either not occurred or because of uncertainty about development of operating costs and consumer demand, they have postponed decisions about their investment plans until the second half of the year or later. Real decline of gross fixed capital formation was manifested in particular in investments into machinery; on the other hand, investments into buildings increased that could be a certain development impulse for growth of private investments in the nearest future. A moderate revival of investment activity can be anticipated in the second half of the year in connection with the start of several investment projects (preparation of the area and infrastructure for PSA Peugeot, building of transport infrastructure in Bratislava, a new production unit for coke, refined crude oil products, production expansion in other industrial branches). According to an updated estimate, gross fixed capital formation in a year-on-year comparison will achieve the same level as last year, while the updated monetary programme counted with relative dynamic investment growth.

Development of **foreign trade in goods and services** in the first half of 2003 was characterized by a more dynamic growth of exports of goods and services compared with the updated monetary programme. Even with relatively high growth of imports, export growth has reflected in a surplus of real net export, while the updated monetary programme counted with a deficit. Based on current data about development of foreign trade as well as development of prices and exchange rates, a similar development can be expected also in the second half of the year, which for the whole year means that the surplus of net export at constant prices will be preserved and thus also its positive contribution to real growth of the economy.

Contributions of components to GDP growth at constant prices* percentage points

	UMP 2003	Actual H1 2003	Estimate 2003
GDP at constant prices of 1995	4.1	3.9	3.9
Domestic demand	2.2	0.0	-0.1
therein:			
Final consumption total	1.6	0.7	0.8
Final consumption of households	1.4	0.6	0.7
Final consumption of the government and nonprofit institutions	0.2	0.1	0.2
Gross capital formation	0.6	-0.7	-0.9
Gross fixed capital formation	1.2	-0.3	0.0
Net export	1.9	5.1	4.0
Exports of goods and services	6.0	17.6	15.2
Imports of goods and services	-4.1	-12.5	-11.2
Statistical discrepancy	0.0	-1.1	0.0

*Deviations in subtotals of contributions of individual components are caused by rounding off

Regarding mentioned above, it can be anticipated that domestic demand, unlike the prediction of the updated monetary programme, will slightly decrease. Despite a more favorable development of foreign trade, this assumption will presumably contribute to a moderate slowdown of the year-on-year real growth rate in 2003, while the GDP growth might achieve the lower level of the forecast interval in the updated monetary programme for 2003.

With presumed **real GDP growth at the level of 3.9 percent, the generated GDP in current prices could reach in 2003 SKK 1,180 billion.** With regard to a lower increment of the GDP deflator in the first half of 2003 as compared to the forecast in the updated monetary programme, the increment of the GDP deflator in 2003 should reach 5.7 percent.

GDP in current prices and implicit deflator

	UMP 2003	Actual H1 2003	Estimate 2003
GDP at current prices			
SKK bn.	1 185.0	564.0	1180.0
y-o-y growth in %	10.4	9.0	9.9
implicit deflator of GDP			
(y-o-y growth in %)	6.1	4.8	5.7

3.5 Wages and employment

Actual development from the beginning of 2003

Development of wages, labour productivity, and unemployment in 2003 (index, the same period of previous year=100)

	UMP 2003	Actual the first half of 2003	Estimate 2003
Average monthly nominal wage	107.5-109.5	106.2	106.8
Average monthly real wage	99.0-100.8	98.6	98.4
Productivity of labour in GDP at constant prices	103.7	102.8	103.0
Real productivity – real wage in percentage points	4.7-2.9	4.2	4.6
<i>Average inflation rate</i>	<i>108.6</i>	<i>107.7</i>	<i>108.5</i>
Employment	100.4	101.2	100.9
Average rate of unemployment according to National Labour Office (NLO)	17.2	15.6*	15.2
Average rate of unemployment according to LFS	x	17.7	17.1

*average for January to September

Wage development in the first half of 2003 was characterized by a slowdown of the year-on-year growth dynamics of nominal wages (by more than one-third) and a decline of real wages compared with last year's significant growth.

Most branches have contributed to the decelerated dynamics of the average monthly nominal wage. Growing faster than a year ago were only wages in hotels and restaurants, building industry, financial intermediation, public administration, defence, and compulsory social security. The slowest growth was in transport, posts and telecommunications, trade and repair activities, building industry, and healthcare.

Apart from slower growth of nominal wages, the year-on-year decline of real wages was also influenced by growth of average consumer prices, the dynamics of which has almost doubled compared with the first half of 2002.

Labour productivity (GDP per employee) grew in current prices at the same rate as a year ago, at constant prices it declined by 0.9 percentage points. The factor that contributed to the reduced dynamics of real growth of labour productivity was the development of employment, which was not accompanied by appropriate growth of GDP. While the real GDP growth rate

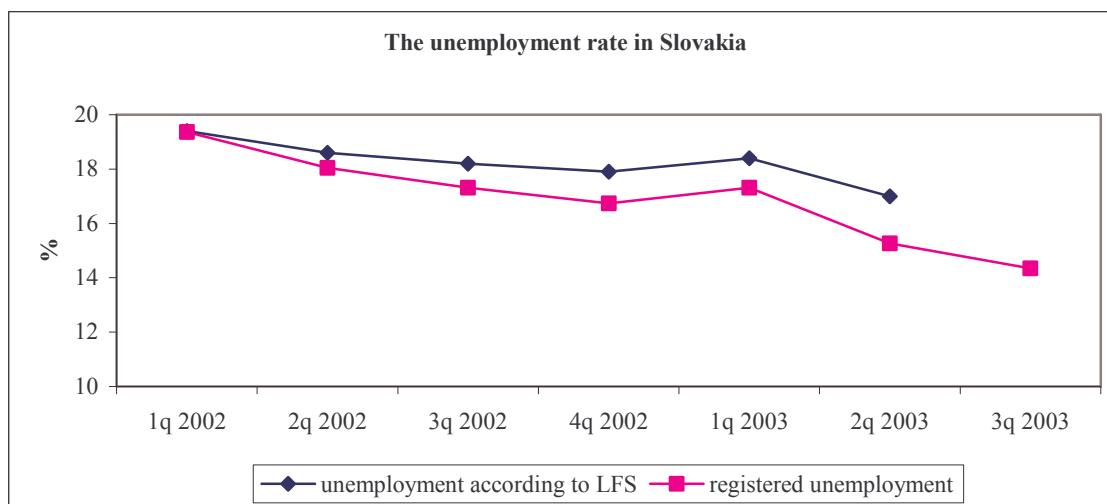
in the first half of 2003 remained at the level from a year ago, the year-on-year growth of employment accelerated from 0.2 percent in the first half of 2002 to 1.2 percent in the first half of 2003.

Growth of **employment** was recorded primarily in area of healthcare and social care, other community, social, and personal services, real estate sector, renting and trade activities. On the other hand, decline of employment was registered particularly in agriculture, hunting and forestry, education, and in transport, storage, posts, and telecommunications.

Development of **unemployment** in the period from January to September 2003 was characterized by a significant decline. While in January the rate of registered unemployment represented 17.7 percent, in September it dropped to 13.9 percent. In nine months on average the rate of registered unemployment reached 15.6 percent.

Factors that contributed to the decline of unemployment in 2003 include mainly administrative measures (an amendment to the law on employment that became effective on January 1, 2003 and which established the duty for the unemployed to report at labour offices once every 14 days), growth of employment (caused by growth of the economy, under the influence of FDI, etc.).

The decline of unemployment from the beginning of the year is also confirmed by data from 1 the labour force sample survey, according to which in the first quarter 18.4 percent of the economically active population was unemployed, in the second quarter it was 17.0 percent. The average rate of unemployment in the first half of 2003 according to the labour force sample survey was 17.7 percent.



Assumptions of the updated monetary programme and expected development until the end of 2003

In the second half of the year we expect the year-on-year growth rate of nominal monthly wages to accelerate compared with the first half of the year in the corporate and the public sector. Possible space for a more dynamic wage growth in the corporate sector has been created by good results of financial performance in the first half of the year as well as growth of labour productivity, which in real terms exceeded the growth rate of wages in the most of branches. In the public sector the higher dynamics is associated with the adjustment of wages

of state and public sector employees from August of this year.

Based on development of wages in the first half of this year and anticipated development in the second half of the year, **for the year 2003 growth of nominal wages can be expected below the lower limit of the interval in the updated monetary programme at the level of 6.8 percent.** Under the influence of slower nominal growth with almost an unchanged estimate of inflation, **real wages should drop by 1.6 percent.**

Anticipated less dynamic nominal wages growth in 2003, below the lower limit of the interval in the updated monetary programme, is associated with a slowdown of wage growth in the business sector in the first half of 2003. Wages growth was presumably suppressed by relatively high growth rate of real wages in 2002 and at the same time the wage policy of businesses could have also been influenced by restrictive wage policy in the public sector.

In connection with anticipated economic growth, which should be moderately slower compared with the updated monetary programme and on the other hand, faster growth of employment, real labour productivity calculated from GDP per employee should grow slower in 2003 (3.0 percent) compared with the updated monetary programme. This means that with estimated decline of real wages, growth of labour productivity will be 4.6 percentage points higher over wages, which is a value at the upper limit from the updated monetary programme for 2003.

The updated monetary programme for 2003 expected year-on-year growth of the number of employees by 0.4 percent, but development in the first half of the year indicates that the average growth of employment for the year 2003 will be higher than the forecast in the updated monetary programme. **Growth of employment for the whole year is estimated at 0.9 percent**, since in the second half of 2003 we assume a slowdown of employment growth under the influence of seasonal factors (finish of seasonal works, etc.) to half of the rate from the first half of the year.

The updated monetary programme for 2003 presumed an average rate of registered unemployment for the whole of 2003 of 17.2 percent. Based on development so far, the rate of unemployment for the year 2003 can be expected to be lower compared with the updated monetary programme. Also, with regard to the usual seasonal growth of unemployment at the end of the year, **the average rate of registered unemployment for the year 2003 could reach 15.2 percent, and the rate of unemployment according to the labour force sample survey 17.1 percent.**

3.6 Performance of the public sector

Development of the state budget in 2003 signals certain risks on the revenue side that we have already pointed out in the updated monetary programme for 2003.

We estimate a shortfall of tax revenues of approximately SKK 19 billion at the end of the year. On the other hand, non-tax revenues as a result of repatriation of the Russian debt as well as settlement of the excise tax on the stock of mineral oils stored by the State Material Reserves Administration will be overstepped by about SKK 5 billion. The total shortfall of revenues represents approximately SK 14 billion. This shortfall will presumably be resolved using state financial assets to support the revenue part of the state budget (SKK 10 billion), savings on interest expenses and binding spending in individual budget chapters. The deficit

target of the state budget and the public budget on the cash principle should thus be achieved. On the accrual principle (ESA 95 methodology) however, the use of state financial assets is ruled out as revenues of the state budget. On the other hand, also ruled out is the negative nonrecurring effect on budget revenues resulting from the amendment of the VAT law. The total impact on the deficit of public finances according to ESA 95 methodology will depend on the calculation of this nonrecurring impact. In case that its volume would be SKK 10 billion and more, the set deficit of 5 percent of GDP will be maintained. If the quantified volume is lower, there is a danger it will be overstepped.

To bridge temporary liquidity shortages and to cover the needs of the state budget, treasury bills will be issued above the framework considered in the updated monetary programme and the aggregate volume of treasury bills in 2003 could exceed SKK 50 billion (updated monetary programme SKK 37.7 billion).

3.7 Monetary policy

3.7.1 Monetary aggregates

Compared with assumptions in the updated monetary programme, money supply at the current exchange rate in 2003 developed with moderated dynamics. On the one hand, this is influenced by appreciation of the exchange rate of the Slovak koruna vis-à-vis the USD, whose starting level was 40.036 SKK/USD and the updated monetary programme counted with an unchanged level. However, from the beginning of the year until November the rate of appreciation of the Slovak koruna exceeded 13 percent. On the other hand, transformation of bank deposits to alternative forms of investments, primarily in shares of mutual funds had a determining effect. Liabilities in the form of shares of mutual funds are not a component of M2 monetary aggregate and for this reason the allocation of resources into collective forms of investing is expressed as a slowdown of the growth rate of money supply. Dynamic demand for investments in shares of mutual funds is motivated above all by negative real interest rates on bank deposits and adopted legislative modifications in the area of collective investing which make this area more attractive.

Dynamics of the net loan to the government in 2003 is developing in line with assumptions of the updated monetary programme. The government has adopted measures to eliminate risks of overstepping the approved deficit of the state budget, as a result of which we expect the end-year deficit at the planned level. The wider circle of public finance is achieving a surplus in its financial management, to which results of social security funds and state funds contribute most. The Ministry of Finance of the Slovak Republic has informed of its intention to draw a foreign loan of EUR 260 million before the end of the year in order to accumulate resources for repayment of government debt at the beginning of 2004. The drawing of this loan would not lead to the anticipated decline in the government's foreign indebtedness, but a part of internal debt would be transformed into foreign debt. At the end of the year, we expect a surplus of the National Property Fund (FNM) at the level of SKK 1.5 billion.

Lending activities of banks in 2003 are more significantly structured by sectors. The growth of loans is concentrated in long-term investment loans to households (mortgages). Credits to enterprises were more significantly focused on providing foreign currency credits. This shift compared with the previous period can be caused by an effort of entities active in foreign trade to ensure their company cash-flow in one currency with minimization of exchange rate losses and last but not least at lower interest cost.

Until the end of the year, we expect a moderate slowdown in the growth of domestic credits which could be influenced by the fading-away of the stimulating effect of state bonuses on mortgages and the impact of rising cost of living in 2003 to the detriment of acceptance of future interest costs. Compared with the updated monetary programme, the growth of credits in 2003 could reach a moderately slower dynamics of 9.7 percent (updated monetary programme 11.5 percent). The risk of this forecast is the possibility to draw a mortgage six months after a mortgage contract was concluded with the possibility to extend this period.

3.7.2 Implementation of monetary policy

Conduct of monetary policy of the NBS in 2003 was realized in an environment of a rising inflation rate, conditioned by administrative adjustments of regulated prices and changes in the tax policy of the government. A more significant growth of cost items has prevented the creation of demand pressures. Under the given conditions the NBS did not react to growth of inflation by changes of key interest rates. Subdued domestic demand was accompanied by an improving trade balance and an improvement of the balance of payments deficit, particularly as a result of rising export efficiency of the Slovak Republic. The Bank Board of the NBS has evaluated the current and anticipated development of the macroeconomic environment after GDP data were released for the first six months of 2003 in September and decided to lower its key interest rate by 0.25 percentage points to 6.25 percent (and a symmetric reduction of interest rates for one-day automatic operations with commercial banks).

Development in the exchange rate area did not necessitate a change of interest rates, although the NBS repeatedly intervened (most significantly in May) in 2003 on the foreign exchange market against excessive appreciation of the Slovak koruna.

The conduct of monetary policy had a sterilization character in 2003 as well; however, compared with the year 2002 the level of the sterilization position was relatively stable. More notable deepening of sterilization occurred in January after the rate of required minimum reserves had been reduced by 1 percentage point, as well as a result of sterilization interventions of the NBS on the foreign exchange market against excessive appreciation of the Slovak koruna. In March with indistinct issuing activity of the Ministry of Finance of the Slovak Republic, repayment of several issues of government securities had accumulated, which brought about an increase of the sterilization position of the NBS. The achieved level of sterilization was stable from March to November and until the end of the year we do not expect a significant change of its level. The government's intention to draw a foreign loan of EUR 260 million in 2003 should not have an effect on NBS sterilization, since the obtained resources should not be used before the end of the year. The sterilization position of the NBS at the end of the year should move close to the level of SKK 175.5 billion, which compared with the beginning of the year represents a deepening by SKK 31 billion. On average the sterilization position in 2003 has deepened compared with 2002 by about SKK 70 billion.

4. Monetary programme for 2004

4.1 Inflation

Estimates of development of consumer prices in 2004

The estimate of development of consumer prices is based on a fixed exchange rate vis-à-vis the euro and average crude oil price of 26 USD/barrel. The expected crude oil price in 2004 is based on the European Commission's forecast (Economic Forecasts, Autumn 2003).

Significant influence of **administrative measures** on development of consumer prices from 2003 should continue also in 2004. The estimated development of consumer prices in 2004 assumes that regulation of prices in network industries will be based on valid and issued assessments as well as information published by the Regulatory Office for Network Industries on assumptions for growth of regulated prices in 2004. The estimate of growth of regulated prices is also based on assumptions of the Ministry of Construction and Regional Development (rent) and assumptions of a demanded increase of transport fares on part of transport companies. Based on development in the past, we also expect an increase of other regulated prices (such as student accommodation in dormitories, school meals, prices in healthcare, etc.). Compared with the updated monetary programme for 2003, a moderately slower growth of regulated prices is expected in 2004, mainly as a result of lower growth of prices natural gas and heat.

Anticipated growth of regulated prices in 2004

Name of representative	2004			
	anticipated growth including VAT change	contribution	anticipated growth including VAT change	contribution
	UMP 2003		MP 2004	
Electrical energy	9.6	0.4	13.5	0.6
Thermal energy	8.7	0.4	4.4	0.2
Natural gas	37.6	1.3	33.3	1.1
Railway transport.	8.6	0.0	10.0	0.0
Bus transport	8.6	0.2	10.0	0.2
Water supply	33.4	0.2	37.8	0.2
Sewerage	30.3	0.1	34.7	0.1
Postage	8.6	0.0	8.5	0.0
Rent	60.0	0.5	60.0	0.5
TOTAL		3.2		3.1

An increase of other regulated prices (such as accommodation in university dormitories, school meals, prices in healthcare) in 2004 should represent a contribution to inflation of 0.4 percentage points.

From administrative measures, the estimate of consumer prices development for 2004 counts with a continued impact of changes of excise taxes from August 2003 and the introduction of a unified VAT rate of 19 percent from January 1, 2004. The introduction of the unified VAT rate of 19 percent means on the one hand an increase of the lower rate of 14 percent and on the other a decrease of the standard rate of 20 percent. According to a calculation of the NBS, this change of the VAT should represent a total impact on the price level of 1.9 percentage points whereby the VAT change in unregulated prices should cause an increase of headline inflation by 1.04 percentage points. The estimate counts with changes of the excise tax on tobacco and tobacco products from May 2004 by SKK 1 per package of cigarettes with an

impact on headline inflation by 0.1 percentage points².

The forecast counts with cancellation of 10 and 20 halier coins and their withdrawal from circulation from January 1, 2004. The impact of this step will depend on the method of rounding off prices. Since pursuant to the approved law on prices, prices will be rounded off in a mathematical way and only the total purchase price will be rounded off, the impact on consumer prices should be minimal or none. However, the assumed price development counts with a maximum impact. The maximum possible impact of rounding off on the development of consumer prices could represent 0.4-0.5 percentage points.

In the tradable sector the highest risk and uncertainty in 2004 are linked with the development of **food prices** under the influence several factors. At the beginning of 2004, the lower harvest from 2003 will probably show on the market and in May the Slovak Republic will become a member of the European Union and adopt the common agricultural policy with higher intervention prices of some commodities. An impact on food prices may also be caused by an effort of primary producers to associate in sales cooperatives and thus change the market situation (where a trade cooperative will a stronger and greater partner toward processing companies and retail chains) and achieve higher distribution prices (which they partly managed to achieve at the end of 2003). Inability or unwillingness of some processing companies to adapt to hygiene standards of the EU can have as consequence that some processing companies will cease to exist in 2004, but with regard to excessive processing capacity this should not have an impact on the market situation.

Primary influence on prices of **tradable goods** should come from low imported inflation and developed competitive environment that will be supported by entry into the European Union, which will simplify import and export of goods as well as access of foreign suppliers to the Slovak market. Prices of motor fuels that are included within tradable goods will develop depending on presumed development of crude oil prices on the world markets and the exchange rate.

In 2004, a pro-growth effect of cost factors should continue of increasing of regulated prices (particularly energy) on prices of **market services** (so-called secondary effects).

An attenuating effect on development of the price level in 2004 will result from continued decline of real wages, however, a shortfall of real income will partly be compensated by growth of employment, development of consumer lending and installment sales, etc.

Based on these assumptions, we can expect headline inflation at the end of 2004 moving in the range 5.5-7.3 percent, which corresponds with average inflation in the range from 7.2-8.2 percent. Core inflation in December 2004 should be in the range 1.2-3.5 percent.

²A timetable of increasing the excise tax on tobacco and tobacco products pursuant to an agreement between the government of the Slovak Republic and the European Commission from the year 2000 on a transition period for this tax until 2008 is no longer effective because in 2003 tax has twice been significantly increased. The increase of the excise tax on tobacco and tobacco products from May 2004 by SKK 1 per package of cigarettes is necessitated by budgetary needs (financing of regional education).

Consumer prices (percent)

		2002	Estimate for the year 2003 ¹	MP 2004
Headline inflation	Year-on-year	3.4	9.4	6.4 (5.5-7.3)
	average year-on-year	3.3	8.5	7.7 (7.2-8.2)
Core inflation	Year-on-year	1.9	3.1	2.4 (1.2-3.5)
Net inflation excluding the effect of fuel prices	Year-on-year	2.9	3.4	2.3 (1.7-2.8)

¹ Estimate based on current development until November

Inflation estimate for 2004

	Monetary Programme for 2004	
	price increments in % Dec04/Dec03 (share in total increment in %)	
	min	max
Total	5.5	7.3
Regulated prices	13.4 (3.48)	14.2 (3.69)
Impact of changes in indirect taxes in non-regulated prices	(1.14)	(1.14)
Core inflation	1.2 (0.87)	3.5 (2.49)
<i>thereof: Foodstuffs</i>	1.2 (0.22)	5.7 (1.09)
<i>Tradable goods</i>	0.4 (0.13)	1.3 (0.45)
<i>thereof: Tradable goods excluding fuel prices</i>	1.0 (0.30)	1.4 (0.45)
<i>motor fuels</i>	-5.6 (-0.17)	-0.1 (0.00)
<i>Market services</i>	2.9 (0.52)	5.3 (0.95)
Net inflation	1.2 (0.65)	2.7 (1.0)
Net inflation excluding fuel prices	1.7 (0.82)	2.8 (1.40)
Average inflation	7.2	8.2
Average core inflation	1.8	3.0
Average net inflation	1.7	2.5
Average net inflation excluding fuel prices	2.1	2.8

Risks linked with inflation forecast for the year 2004

Risk factors in the development of consumer prices in the following year that can have a pro-growth effect, but also suppress growth, will be primarily in crude oil prices on the world markets and in development of the exchange rate (either the exchange rate of the Slovak koruna vis-à-vis the euro or the exchange rate of the euro and the US dollar).

Food prices will presumably pose the greatest risk. Several negative factors will influence their development in 2004. The first will be entry into the EU and adoption of principles of the common agricultural policy that will have a consequence the adaptation of prices of farm commodities in the Slovak Republic to prices on the common organized market (growth of prices of sugar, milk, butter, etc., whereby the price may slightly decrease for some) with an impact on consumer prices. Another risk factor in food prices is the lower harvest in 2003 caused by drought, which can be reflected in prices at the beginning of 2004. Administrative

measures that can have a notable pro-growth effect on food prices include the introduction of a unified VAT rate which will increase the lower VAT rate by which most food items taxed, and the cancellation of 10 and 20 halier coins. The risk must be taken into consideration that retailers can increase prices more than justified by the effect of the VAT change or would round off prices in a way to maximize their revenues and profit. The middle value of the forecast is based on the assumption that these two main risks would not materialize.

A certain degree of uncertainty is also linked with an increase of regulated prices, above all prices of energies and related possible secondary effects in the unregulated area of the consumer basket.

The size of the secondary effects depends on possibilities of individual producers, importers, retailers, and service providers to project the increased costs of energies into the current price level. The possibility to reduce margins has been exhausted for market participants already in 2003, but in case of others, higher labor productivity and a moderate growth of wages in 2003 can create space for a further reduction of margins and not spilling over higher costs into prices.

4.2 Producer prices

Assumptions for development of producer prices:

- stabilization of crude oil price on 26 USD/barrel on average,
- forecast of development of producer prices is based on a fixed exchange rate vis-à-vis the euro,
- more dynamic development of food prices (secondary effect of adoption of the common agricultural policy after entry of the Slovak Republic into the EU in May 2004).

Prices of electricity, natural gas, steam and hot water

Prices of industrial producers in 2004 will be to a significant degree influenced by rising prices of producers of energy for households and for the manufacturing sector. However, their growth will be significantly lower than in 2003, which is connected with the completion of the process of deregulation of prices of energy products and the liberalization of the energy market in Slovakia. According to a draft bill on energy, which is currently under interdepartmental review, the process of deregulation of prices for production consumption should be completed on July 1, 2004, when the energy market for producers would become fully liberalized. Prices of energy for households should be regulated until July 1, 2007.

The process of increasing prices of individual types of energy pursuant to a preliminary decision of the Regulatory Office for Network Industries (URSO) for 2004-2006 and the process of liberalization of the energy market in the given period are described in more detail in the annex below.

Based on anticipated development of prices of electricity, natural gas, and heat and in line with energy market liberalization we assume that the average growth rate of producer prices of electricity, natural gas, steam and hot water in 2004 should reach **4.2 percent**.

Prices of industrial manufacturing products

Apart from non-market factors (higher energy costs as a result of completion of deregulation

of their prices in 2004) various external and local market factors will influence the development of prices of manufacturing industry products.

From the viewpoint of local factors, presumably pro-growth effect on prices of manufacturing industry products in 2004 will stem from secondary impacts of the adoption of the common agricultural policy with the entry of Slovakia into the European Union in May 2004. With the adoption of the common agricultural policy, a part of agricultural commodities will be supported by intervention prices of the EU, which could contribute to an increase of their prices.

One of the assumptions of development of prices of manufacturing industry products is also a declining average price of crude oil from 28 USD/barrel in 2003 to a level of 26 USD/barrel in 2004, which could curb the price dynamics of manufacturing industry products.

Under the influence of energy prices of local producers, as well as under the influence of other aforementioned internal and external factors, prices of manufacturing industry products should achieve average year-on-year growth of **1.4 percent**.

Prices of industrial producers in 2004

Under the condition of aforementioned development of prices of producers of electrical energy, natural gas, steam, hot water, and prices of manufacturing industry products, the NBS expects average growth of prices of industrial producers in 2004 at the level of **2.4 percent**.

Risks of development of prices of industrial producers:

- different development of crude oil price on the world markets, since on the one hand, offer can rise on the market as a result of higher output from countries outside OPEC and thus price can decline, while on the other hand, in case of rising demand for crude oil resulting from economic recovery in the world, the price of crude oil can increase over the level assumed in the monetary programme for 2004
- more significant appreciation or depreciation of the US dollar vis-à-vis the euro and thereby also vis-à-vis the Slovak currency
- in food prices, other than expected development for reasons other than assumed impacts of the adoption of the common agricultural policy on prices or because of unforeseen changes of climatic conditions

4.3 Foreign accounts

4.3.1 Balance of payments

Current account items in SKK bn.	Estimate 2003	MP 2004
Trade Balance	-38.2	-46.1
Export	784.4	840.3
Import	822.6	886.4
Balance of services	10.3	12.9
Balance of receipts	-4.1	-3.2
<i>thereof receipts from investments</i>	-20.5	-17.2
Current transfers	8.7	6.0
Current account	-23.3	-30.4
c/a share of GDP in %	-2.0	-2.3

In 2004, the trade deficit should increase compared with 2003 as a result of a slowdown of the growth rate of export to 7.1 percent. Slower growth rate of export will result from less dynamic export of transport equipment, which in 2003 grew very fast (comparison base effect). Also export of semi-finished goods should post a slower growth rate, where as a result of a high volume of export of iron and steel in 2003 and existing limits, we do not assume its further growth. Export of some chemical products and raw materials will be influenced by development of the crude oil price and exchange rate of the USD.

Growth rate of import of 7.7 percent should remain in individual groups roughly at the level of 2003, with the exception of transport equipment, where as a result of a lower growth rate of export, also the growth rate of import will be lower. Import of raw materials will be influenced, apart from the exchange rate of the USD and the price of crude oil, also by the development of natural gas price, which, with a slight shift, should follow the price development of crude oil. The assumption of a decline of the crude oil price (to 24 USD per barrel until the middle of 2005) was projected into a decline of import of raw materials in 2004 and 2005. When these assumptions materialize, we estimate the trade deficit's share of GDP to rise from last year's 3.2 percent to 3.6 percent.

The balance of services should range within the volume and structure of this category in 2003 (its difference compared with the updated monetary programme stems from a different starting base of the year 2003). Transport together with tourism will remain its main components that will ensure net income from services for the Slovak Republic. The total balance of services will be positive and represent only a slight improvement compared with 2003 (export of services will rise by 7.4 percent and import by 5.7 percent).

The deficit on the balance of receipts from investments of SKK 17.2 billion (without employee compensation) should reach a lower level compared with 2003. The lower negative balance, which will result from lower interest payments, will reflect lower installments in the government sector.

Financing of the negative balance on the current account should primarily be secured from direct investments and resources from pre-accession funds of the EU – capital transfers. In 2004 we expect a net income (the difference between contributions from the budget and funds of the EU and contributions paid to the EU budget) from the European Community of roughly SKK 10 billion, which is approaching the upper limit of possible drawing. The fact that more than 75 percent of this income will be project oriented and a title to drawing only originates after acceptable projects are submitted can cause lower real drawing, which will have to be replaced from other sources.

Capital and financial account items in SKK bn.	Estimate 2003	MP 2004
Capital transfers	4.5	10.0
Foreign direct investments FDI	41.9	53.2
FDI in the SR	41.1	55.0
thereof: FDI in the SR – official sector	10.1	17.0
Portfolio investments	-4.3	-3.2
Other long-term financial account	-8.7	17.9
<i>Assets</i>	9.5	0.0
<i>Liabilities</i>	-18.2	17.9
<i>Government + NBS</i>	-16.2	22.5
<i>Commercial banks</i>	-1.0	-1.0
<i>Businesses</i>	-1.0	-3.6
Short-term financial account	28.0	-12.0
Capital and financial account	61.4	65.9

Foreign direct investments should also play an important role in the inflow of resources in 2004. Their volume will depend on success of completion of projects in progress, whereby in 2004, an inflow of these sources is also likely in connection with the construction of a car production plant on the territory of the Slovak Republic.

Portfolio investments should be influenced by transactions both in the business sector and in the bank sector. This will primarily result from rising demand for foreign securities on part of business entities, which began to appear already in 2003.

A relatively high surplus of other long-term investments will be influenced by transactions in the government sector, where along with a repayment of government debt issued in foreign currency (repayment of government bonds in 2004 totaling USD 580.1 million), also drawing is assumed of additional loans (two more portions of a World Bank loan and a new government loan of EUR 1.0 billion).

Sectors in SKK bn.	Estimate 2003	MP 2004
Businesses	25.8	35.0
Banks	14.9	-10.6
Government and NBS sector	20.7	41.5
Total	61.4	65.9

In 2004, income of the government and the NBS (privatization proceeds, government loans, interest on reserves of the NBS) should exceed spending (debt service, guarantees, and client payment system), which will influence the growth of foreign exchange reserves of the NBS by SKK 35.5 billion, i.e., by USD 1.0 billion. At the end of the year, reserves of the NBS will reach USD 12.0 billion and will cover 5.3 months of average import of goods and services.

Adjusted balance of payments in SKK bn.	Estimate 2003	MP 2004
Current account (c/a)	-17.8	-29.6
Capital and financial account (CFA)	28.7	40.2
Foreign direct investments (FDI)	31.0	38.0
NBS interventions	0.0	0.0
Change of net foreign assets NFA (- growth)	-25.8	-10.6
c/a coverage by CFA in %	14.9	135.8
c/a coverage by FDI in %	174.2	128.4

Adjusted capital and financial account in 2004 should cover the deficit on the current account mainly from an inflow of foreign direct investments.

4.3.2 Foreign debt

Total gross foreign debt should reach USD 15.7 billion (growth compared with 2003 by USD 0.8 billion) and the creditor position of the net foreign debt should rise as a result of short-term assets of companies and commercial banks to USD 2.8 billion.

4.4 Gross domestic product

In 2004, we presume GDP growth at constant prices between 3.7 and 4.3 percent with 4.0 percent as the mean value, which represents created nominal volume of SKK 1,290 billion.

Forecast of GDP for 2004

constant prices year-on-year change in %

	Estimate 2003	Forecast 2004
GDP at constant prices 1995 - range		(3.7-4.3)
- mid-range	3.9	4.0
Domestic demand	-0.1	4.1
therein:		
Final consumption total	1.1	1.8
Final consumption of households	1.3	2.0
Final consumption of government	0.5	1.0
Final consumption of nonprofit institutions	6.8	6.9
Gross capital formation	-3.1	9.9
Gross fixed capital formation	0.0	6.1
Net export		
Exports of goods and services	19.2	9.4
Imports of goods and services	13.5	9.5

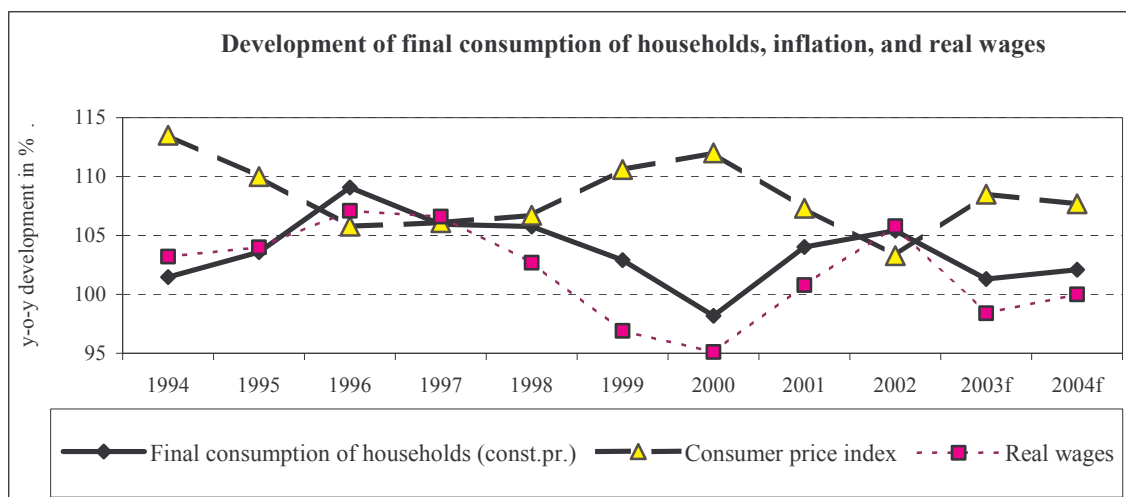
Contributions of components to GDP growth at current prices*

percentage points

	Estimate 2003	Forecast 2004
GDP at constant prices 1995	3,9	4,0
Domestic demand	-0,1	4,0
therein:		
Final consumption total	0,8	1,3
Final consumption of households	0,7	1,0
Final consumption of government	0,1	0,2
Final consumption of nonprofit institutions	0,1	0,1
Gross capital formation	-0,9	2,8
Gross fixed capital formation	0,0	1,7
Net export	4,0	-0,1
Exports of goods and services	15,2	8,5
Imports of goods and services	-11,2	-8,6
Statistical discrepancy	0,0	0,0

*Deviations in subtotals of contributions of individual components are caused by rounding off

Private consumption will probably contribute in the future to GDP growth, although its development is hardly identifiable in 2004 as a result of accumulation of tax and pension reforms as well as ongoing healthcare reform. Anticipated growth of nominal wages (7.7 percent) at a level identical with prognosticated average inflation (7.7 percent) does not open up space for growth of real wages, as a result of which the population will be forced to direct its expenses to a greater degree on food, housing, transport, under simultaneous reduction or postponement of expenses on recreation, culture, and home furnishing. However, even a slight decline of real wages will not automatically cause a drop of private consumption, which even in the previous period developed more favorably than real wages.

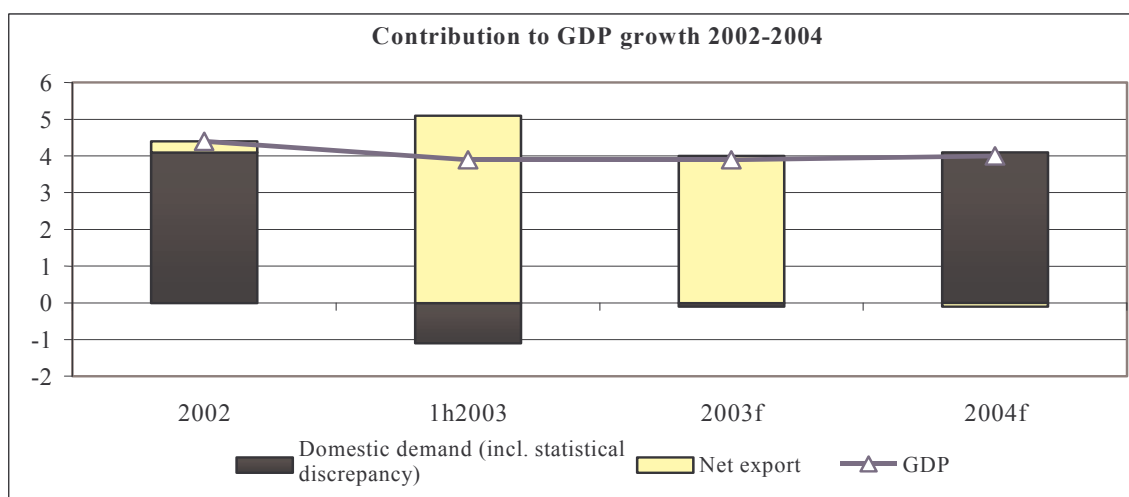


Development of gross disposable income of households will be negatively influenced by a lower level of social benefits, higher contributions from gross wages to funds of social security or higher level of VAT on food and soft drinks. On the other hand, the level of private consumption could be positively influenced by higher net income of certain groups of households resulting from the lower income tax, higher pensions, and anticipated growth of employment, as well as opening of the labour market of a majority of countries of the European Union. In this connection the forecast counts with real growth of private consumption, however, with certain risks. If the risks stemming from individual reforms materialize, private consumption could be less dynamic, which would be subsequently reflected in slower GDP growth (on the bottom limit of the forecast interval). Development of **final consumption of general government** will be influenced by the intention to reduce the deficit of public finance, whereby we do not expect significant growth of public expenses.

Results of financial performance in 2003 (in the first half, nonfinancial corporations increased their profit by one-third), lower interest rates, as well as lower income tax from the year 2004 should give business entities sufficient space to develop and modernize their technical base in an effort to face up to competition pressure of the common market of the European Union. Growth of the **Gross fixed capital formation** could also be supported by increased inflow of foreign direct investments, when the motivating factor for foreign investors should be the lowest tax burden in the Slovak Republic compared with countries in the region of central Europe. Assumed growth of fixed investments in 2004 will to a certain degree also be linked with the low comparison base from the year 2003.

Actual level of investment demand will depend on the business environment in the Slovak Republic within the region, on rating and other economic development (level of tax rates, labour costs, development of infrastructure) and willingness and possibilities of foreign and local entities to realize their investment intentions, which will have a significant effect on GDP growth.

In **foreign trade** as assume stabilization of the year-on-year dynamics of growth of exports and imports of goods and services at around 10 percent at constant prices in 2004, whereby the growth rate of imports will presumably be more approaching the growth rate of exports with regard to expected technological imports and the high comparison base of 2003.



GDP at current prices and implicit deflator

	Estimate 2003	Forecast 2004
GDP in current prices		
SKK billion	1180.0	1290.0
Year-on-year growth in %	9.9	9.3
Implicit deflator of GDP (year-on-year growth in %)	5.7	5.1

Risks in GDP development

- quantification of tax and pension reform effects on gross disposable income and private consumption of households, when a possible slowdown of growth rate of private consumption would cause slower GDP growth
- lower inflow of foreign direct investments caused by potential modifications of the business environment including the income tax rate in neighboring countries,
- failure of the intention to reduce the public sector deficit
- different development of prices and wages compared with the monetary programme for 2004,
- 2004 as a leap year has four working days more than the previous year (three public holidays fewer), by which higher creation of GDP in individual branches could mirror in the usage side in growth of private consumption, inventories, exports, and imports of goods and services. In total, GDP could grow by 0.3-0.4 percentage points faster, which would compensate for risks on the side of its decline, or bring the total growth of the economy close to the upper limit of the forecast interval.

4.5 Wages and employment

Forecast for the year 2004

(index, the same period of previous year = 100)

	Estimate 2003	Forecast 2004
Nominal wage	106.8	107.2-108.2
midrange	-	107.7
Real wage	98.4	99.5-100.5
midrange	-	100.0
Productivity of labour in GDP at constant prices (midrange)	103.0	103.0
CPI average- midrange	108.5	107.7
Employment	100.9	101.0
Average rate of unemployment NLO (%)	15.2	14.4
Average rate of unemployment LFS (%)	17.1	16.2

Wage development forecast for 2004 is based on assumed average inflation in the years 2003 and 2004, purposes of the state budget in wage development in the public sector for the year 2004, and possible impact of tax reform on business subjects and selected branches, from anticipated impacts of the law on social insurance on selected groups of entities, as well as on possible effects in connection with the accession of Slovak Republic into the EU.

It can be assumed that the growth of nominal wages in 2004 will be faster than in 2003. Space for higher growth of wages in the private sector is being created by relatively low growth of nominal wages and a decline of real wages along with growing labour productivity in a majority of branches in 2003, favourable economic results in 2003 indicated in the first half of the year, reduced costs related to the completion of deregulation of energy prices for large corporate customers, as well as the introduction of a unified income tax from 2004 (through reduced tax advance payments). Wage development can be suppressed by higher investment activity (redirecting resources to investments to the detriment of wages) in connection with the need to strengthen or maintain competitiveness of business entities upon accession into the EU.

A major liberalization of wages in 2004 cannot be expected with regard to continued restrictive wage policy in the public sector (in the draft State Budget of the Slovak Republic for 2004, growth of wages in the state and public service of 5 percent and 7 percent respectively is assumed from July, payment of the 13th and 14th wages is not assumed), as well as expected low growth of wages in the branches of building, agriculture, and trade.

In the building industry, the estimate is based on long-term below average wage growth in this branch, as well as presumed impact of tax changes on this branch. In agriculture, a slowdown of wage growth can be expected in connection with economic losses that this branch suffered in connection with drought of 2003, rising excise taxes, as well as in connection with uncertainties linked with the accession of the Slovak Republic into the EU (meeting criteria for accession of commodities to the European market, tighter competition, price effects). Wage development can also become volatile in the retail sector in connection with the changed VAT, since a part of wages in this branch is tied to the volume of revenues from sales.

For small entrepreneurs, wage growth can be limited by adoption of the law on social insurance, which introduces the duty for employers to pay sick leave benefits to employees for the first ten days of illness, which can create pressure to bind a higher volume of disposable resources for this purpose to the detriment of wage growth.

With regard to the above-stated we can assume that **year-on-year wage growth** will reach **nominally 7.2 to 8.2 percent in 2004**, which, with forecast inflation means **development of real wages in the interval -0.5 to +0.5 percent**. With stagnating of real wages (midrange), real labour productivity would exceed their growth rate by 3 percentage points.

Growth of employment in 2004 under the influence of anticipated economic growth and the social insurance law (retirement age moved forward) could in total reach **1 percent**, which is only slightly faster than in 2003. This development will to a great extent be influenced by continued restructuring of the business sphere, where employment growth in branches with strongly represented foreign capital will be to a certain degree curbed by declining employment in branches that will have problems coping with strong competitive pressure from other countries of the EU.

The rate of registered unemployment could decline year-on-year by 0.8 percentage points to **14.4 percent**. The reason should be: growth of the economy and the effect of foreign direct investments, which should generate new jobs, introduction of even stricter conditions of registration of the unemployed (from January 2004, the Employment Services Act should come into force) and declared increased emphasis on an active labour market policy. According to selective labour force surveys, the rate of unemployment in 2004 should reach 16.2 percent on average.

4.6 Performance of the public sector

The National Council of the Slovak Republic approved on December 12, the state budget for 2004 with revenues of SKK 231.9 billion and expenditures of SKK 310.4 billion, and a budgetary deficit of SKK 78.5 billion. Other components of the general government are expected to perform as follows:

SKK bn.	
Municipalities	+0.2
regional governments	0
Social Insurance Company	+3.6
health insurance companies	+0.2
state funds	+2.5
National Property Fund	+1.4
Slovak Consolidation Agency	+0.4
<hr/>	
total	+8,3 SKK bn.

The deficit of the general government in 2004 in cash terms should thus reach SKK 70.2 billion, and on an accrual basis SKK 50.4 billion (3.9 percent of GDP).

Risks of the state budget for 2004 arise from accumulated influences of several factors:

- tax reform
- pension reform
- entry into the EU
- introduction of the State Treasury system

Each of these factors in itself causes a great deal of uncertainty, their parallel effect however significantly increases sensitivity of the whole system.

Tax reform

Tax reform is based on the introduction of a flat tax, a unified VAT and shifting the center of gravity from direct to indirect taxes. The effect of tax reform on the development of public finances will start already in 2004. While the government expects from tax reform strengthening of tax revenues, this scenario could be threatened by other than anticipated development of the tax base.

Hard to estimate is also the impact of the introduction of the so-called “flat tax.” For the personal income tax, the NBS does not have statistical data about the number of taxpayers in individual tax brackets, which prevents it from making reliable calculations; in case of corporate income tax, application of the current system of payment of tax advance, the effects would only appear in 2005. The Ministry of Finance of the Slovak Republic in its draft bill on

the income tax changes this system so that taxpayers will be paying tax advance based on their tax duty from the preceding period, but calculated by the current tax rate (19 percent). Apart from this, the possibility is given to spread installments over a longer period.

The question of reliability of an estimate of the impacts is a topic of the day also for indirect taxes, where too the NBS does not have available statistical data about the share of goods in the basic and the lower VAT rate.

Pension reform

To quantify the impact of pension reform on public finances, the decisive factor is the number of insured who would subscribe for the capitalization pillar.

In case of a very low number there is a threat the system will not be functional, in case of an excessively large interest cost of the system will significantly rise.

Confidence (or distrust) will play a role here of the insured toward asset management companies, in particular after experience with collapsed unlicensed deposit companies. A question remains open about sources of financing of the system.

The question of assessing the impact of pension reform on the general government budget remains open in relation to the Maastricht criterion, since there exists a possibility of elevated tension in public finance because of the pension reform.

Reform of public finances

The central areas of reform are:

- a) reform measures in the area of healthcare, education, and in the social sphere,
- b) decentralization of powers from the state administration to municipalities and regional governments. Financing will be provided by special purpose of subsidies from the state budget. Transfer of property and strengthening of responsibilities of self-governments requires reinforcing the system of internal and external financial control with emphasis on preventive measures,
- c) reform of servicing the government and public debt – this represents separating the public debt from the general government sector and its active management through a specialized Debt and Liquidity Management Agency (DLMA). Emphasis in this area is on medium-term goals, the fulfillment of which is evaluated every year in the form of a strategic material and submitted to the government together with the draft state budget.

State treasury system

Impact on the state budget will depend on the quality of the introduced system. Eventual complications could cause a disintegration of the presently functioning information system and thus a disruption in financial management and ensuring liquidity of the state.

For aforementioned reasons, deviations can be expected of the actual development from the budgeted intentions. Since however, the Ministry of Finance of the Slovak Republic used a conservative approach for its estimate of revenues, we do not expect the budgeted deficit will be overstepped.

In the following years we expect a gradual reduction of the fiscal deficit in line with the government's intentions:

SKK bn.	2004	2005	2006
State budget	-78.5	-57.9	-57.4
General government (ESA 95)	-50.4	-47.4	-43.5
% of GDP	-3.9%	-3.4%	-2.9%

This data does not include the impact of introducing pension reform. These are estimated approximately at 1 percent of GDP.

European Union entry

In connection with entry of the Slovak Republic into the EU it will again be necessary to revise laws regulating the refunding of excess VAT payment on input. The method of VAT and excise taxes collection will change also. Delivery of goods and services from member countries of the EU will be deemed equivalent to delivery from local entities. These taxes will no longer be collected by customs authorities but by tax offices only after a tax return is submitted. This will mean a time shift in VAT and excise tax revenues for the state budget. The Ministry of Finance of the Slovak Republic estimates this shift at two months, which would mean two months of tax revenue shortfall. If the shift lasts longer, the shortfall would be greater.

Entry into the EU will have a dual effect on the state budget. Participation of the state budget on co-financing of projects from EU funds will affect the revenue as well as expenditure side of the state budget. With EU entry, the state budget will have the duty to contribute to the common budget of the European Community. Revenues of the Slovak Republic from the EU will comprise remaining pre-entry aid (PHARE, ISPA, SAPARD – these however do not constitute revenues of the state budget, but are directed straight to beneficiaries) and drawing of resources from structural operations, the guarantee section of the European Agricultural Guidance and Guarantee Fund (EAGGF), special compensation and revenues from internal policies (these are not a component of the state budget revenues). Transfers to the budget of the European Community will be reflected in reduced budget revenues (share of customs duty) and increased expenditures. Pre-entry aid is the item largest by volume, but its effect will gradually fade away. Since it is not a part of the state budget revenues, a difference arises between the total balance of impacts of entry into the EU on the Slovak Republic and on the state budget, or the balance of entry into the EU is positive for the Slovak Republic as a whole, while its effect on the state budget is temporarily negative.

Structural operations to the same extent influence the revenue and expenditure side of the state budget and have a neutral effect on the final balance. Revenues from the guarantee section of the EAGGF can substitute expenditures of the state budget on agriculture. A special compensation payment can substitute any state budget expenditures.

The volume of resources that will be drawn from EU funds remains uncertain. According to experience so far, a much lower level of drawing can be expected compared with the budgeted amount. Since however, they are budgeted both in revenues and expenditures of the state budget, they have a neutral effect on the budget and this would not increase the deficit. Just the opposite, as a result of lower use of resources on co-financing it can mean savings on the expenditure part. On the other hand, pressure can build up to realize a part of the expenses

where financing from EU funds was not successful.

Position of the Slovak republic toward the EU

According to the Medium-term Financial Outlook the following position of the Slovak Republic is assumed in 2004 - 2006:

SKK bn.	2004	2005	2006	Total
Total revenues from the EC	27,5	33,0	35,6	96,1
Contributions to the EC budget	10,2	15,5	16,0	41,7
Net position of the SR	+17,3	+17,5	+19,6	+54,4

Although it is assumed that the net position of the Slovak Republic after entry into the EU will be a surplus, from a narrower view however, the flow of financial resources of the EU will have an effect on the deficit of the general government. This is caused in particular by different character of revenues flowing into the European Community and a different method of their payment to beneficiaries. While some of the financial flows between the Slovak Republic and the European Union are included in the state budget, others do not become its part.

Budgetary impact of EU entry

SKK bn.	2004	2005	2006	Total
Revenues linked with entry	17,6	24,3	28,1	70,0
Costs linked with entry	19,3	33,6	37,9	90,8
Net budgetary position	-1,7	-9,3	-9,8	-20,8

4.7 Monetary Policy

4.7.1 Monetary Aggregates

Money supply in 2004 should again grow at a slower pace than nominal GDP, since we expect influences from 2003 to persist, though to a lesser degree. The basic prediction is founded on an assumption of positive development of foreign trade, maintaining of government goals in the fiscal policy area, and gradually fading stimulating effects of growth of domestic credits.

On the basis of these assumptions we expect money supply measured by M2 monetary aggregate in 2004 to grow by 8 percent. Within foreign resources, contributing to M2 growth will be positive development on the balance of payments, which will be expressed in growth of net foreign assets roughly with the same dynamics as total money supply. Apart from positive development of the trade balance, also the capital account of the balance of payments will contribute to growth of net foreign assets, where along with foreign direct investments, also government's privatization activities will have a pro-growth effect.

Within net domestic assets, we assume the fulfillment of government commitments. The fiscal deficit of the government in 2004 should not exceed 3.9 percent of GDP. Indebtedness of the government in 2004 should increase in the area of the central government, while performance of other components of the public sector should produce a surplus. An assumed rise of foreign indebtedness by EUR 1 billion together with strategic intentions of the DLMA indicates that growth of indebtedness of the general government would be realized primarily in the foreign area. Under the condition of a stable development of the exchange rate of the

Slovak koruna, in the medium-term this could contribute to lower interest costs of servicing the general government debt and easing of pressure on the expenditure side of the state budget.

In the area of domestic credits, we expect growth tendencies to continue, however, at a slower growth rate than in 2003. We assume that deferred demand for investment expenses of the households in 2003 was to a large extent saturated and in the upcoming period their slower growth (8 percent) will also reflect the impact of incurred interest costs.

4.7.2 Implementation of Monetary Policy

Monetary policy in 2004 will be implemented in an environment of a higher rate of inflation, still influenced by adjustments of regulated prices and indirect taxes, dynamic economic growth, improving balance of foreign trade, and public administration reform. Interest rate policy of the NBS will be determined by the goal of the NBS – price stability, as a result of which the NBS will continue to monitor the existence of possible demand pressures. In the area of exchange rate policy, the NBS will continue to hinder excessive and unfounded movements of the exchange rate of the Slovak koruna, which would contribute to creating a macroeconomic imbalance.

Factors conditioning the sterilization character of the monetary policy will remain in effect also in the years to come. The degree of engagement of the NBS toward the banking sector will depend on realization of the government's goals in the area of state administration reform, particularly the activity of the State Treasury (ST) and the Debt and Liquidity Management Agency. Another factor is the timetable for use of the money earmarked for pension reform. The following assumptions are taken into account in the forecast of liquidity development:

- we assume that even after the State Treasury launches its operation, accounts of the government will still be kept in the NBS. The form of keeping these accounts is currently the subject of negotiations between the NBS and the State Treasury.
- money earmarked for pension reform will begin to be dissolved in 2004 in line with the government's plans, however, eventually this will neither influence liquidity of commercial banks nor the sterilization position of the NBS. These financial resources should be transferred from a specialized account of the Ministry of Finance of the Slovak Republic to an account of the Social Insurance Company in the NBS.
- In 2004, the government will use resources from a foreign loan of EUR 260 million drawn in 2003 for an installment in the domestic debt service. Similarly, from the planned foreign loan of EUR 1 billion in 2004, part of the resources after repayment of foreign installments would be used to repay domestic debt. Thus, on the one hand intentions of the DLMA will be carried out in the area of currency restructuring of the government debt, while on the other hand, the need will grow to sterilize liquidity released in this way.
- In 2004, the last reduction of the rate of minimum required reserves will take place linked with harmonization of instruments with the ECB. Analogically with the situation in previous years, this adjustment will have a one-off effect on an increase of the sterilization position of the NBS by about SKK 7 billion.
- The government plans to use privatization proceeds in 2004 to strengthen state financial assets, where these should constitute a financial reserve in case of an unfavorable development of the state budget deficit, or when risks need to be covered ensuing from provided government guarantees.

These factors should have an effect on deepening of the sterilization position of the NBS in 2004. High degree of uncertainty in the area of reform of the public administration (a transfer of accounts of the government into the banking sector) and in the area of the dissolution of resources for pension reform (usage will influence liquidity) could be expressed to the full extent in increased need for sterilization.

Monetary Policy Instruments

In 2003 within the process of harmonization of instruments of the NBS, the minimum reserve requirement rate was lowered by 1 percentage point to 3 percent, which at the same time unified the required reserve rate for commercial banks and home savings banks.

In 2004, the minimum required reserves rate will again be reduced by 1 percentage point to 2 percent, which will mean achieving the level of required reserves in the eurozone, and this will increase the sterilization position by about SKK 7 billion (with an impact on costs of the NBS at unchanged interest rates of SKK 0.4 billion). At the same time, conditions are being unified for banks and branch offices of foreign banks. The 2 percent level is considered the target and in the medium term, if the development is stable, it will not be changed. In 2004, all deposits will be used as basis for the calculation of minimum required reserves regardless of their maturity. Accrual of interest on required reserves in 2004 will remain at an unchanged base. By cancellation of the Ten-day Overview of Assets and Liabilities V (NBS) 6-36, a technical change is taking place for getting the basis for calculation of the minimum reserve requirement, which will now be the Monthly Balance Sheet of Assets and Liabilities. This will have more or less a neutral effect on the base. With transition to monthly reports, with regard to their availability only in the middle of the following month, there will be a greater time shift between the base and the level of minimum requirements determined from it. With regard to the passive role of the minimum reserves in the set of instruments of the NBS, as well as with regard to negligible effect of this time shift on the size of the minimum required reserves, the periodicity of evaluation of minimum reserves will not change.

Before the entry of the Slovak Republic into the eurozone, instruments of the NBS should be fully harmonized with the set of instruments of the ECB. In relation to the minimum reserve requirement, this represents changing the base by only including those liabilities that are payable within two years.

4.7.3 Conclusions 2004 – Summary of the Monetary Programme of the NBS for 2004

Goal of the Monetary Programme

The monetary programme of the NBS for 2004 assumes reaching end-year headline inflation rate in the interval 5.5-7.3 percent, which represents average inflation of 7.2-8.2 percent. Core inflation should range in the interval 1.2-3.5 percent.

Assumptions of the Monetary Programme

- relatively stable development of the exchange rate of the SKK/EUR corresponding to performance of the economy
- GDP growth at constant prices of 3.7-4.3 percent
- share of the current account deficit in the GDP should reach 2.3 percent
- fiscal deficit should reach SKK 50.3 billion, i.e., 3.9 percent of GDP

Based on Aforementioned Development:

- money supply growth should reach 8 percent
- room for growth of credits to households and enterprises by 8 percent should be created

Risks:

- significant exchange rate movements not linked with monetary programme measures and development of economic fundamentals,
- slower economic growth of our trade partners
- change of the extent of adjustment of regulated prices and indirect taxes
- volatile development of crude oil prices (expected crude oil price in 2004 is based on the European Commission's forecast – autumn 2003, and its average value represents 26 USD/barrel.)
- food prices (uncertainty of the impact of adoption of the common agricultural policy after entry into the EU and lower harvest in 2003)
- uncertainty ensuing from accumulation of effects of individual reforms (tax reform, pension reform, healthcare reform, and public finance management reform).

5. Monetary and macroeconomic development outlook until 2007

5.1. Inflation

Estimates of consumer price development in 2005 to 2007

Expectations of development of consumer prices in 2005 to 2007 are similar to those for 2004, based on a fixed exchange rate vis-à-vis the euro at the level of 41.5 SKK/EUR and a fixed exchange rate of the US dollar vis-à-vis the euro at the level of 1.13 USD/EUR.

Anticipated crude oil price in the period from 2005 to 2007 is based on the European Commission's Economic Forecasts, Autumn 2003. This forecast is based on prices of Brent crude oil Futures contracts. The average crude oil price in 2005 to 2007 is assumed at the level of 24 USD/barrel. This price should reflect gradual balancing of the higher offer (in connection with overstepping production quotas and limitations by OPEC member countries and a significant growth of production in nonmember countries) and demand (expected growth resulting from revival of the world economy).

Outlook for the development of consumer prices in 2005 to 2007 assumes that regulation of prices in network industries will proceed according to current rules, i.e., prices for households (electrical energy, natural gas, heat, water and sewage) will be determined by an independent Regulatory Office for Network Industries (URSO) and is based on information released by the URSO about presumed growth of regulated prices in 2005 and 2006. The estimate of growth of regulated prices is also based on assumptions of other public institutions and assumed requirements to increase fares by public transport companies.

Name of representative	2005		2006	
	Anticipated growth	Contribution	Anticipated growth	Contribution
Electrical energy	2.2	0.1	1.6	0.1
Thermal energy	4.0	0.2	2.2	0.1
Natural gas	2.2	0.1	1.3	0.0
Railway transport	7.6	0.0	3.0	0.0
Bus transport	7.6	0.2	3.0	0.1
Water supply	20	0.1	3.9	0.0
Sewerage	20	0.1	3.9	0.0
Postage	7.6	0.0	3.0	0.0
Rent	7.6	0.1	3.0	0.0
TOTAL		0.8		0.4

Increasing other regulated prices (such as accommodation in university dormitories, school meals, prices in healthcare) in 2005 should represent 0.2 percentage points and 0.1 percentage points in the following year (the estimate is based on similar development in previous years). In 2007 in line with EU directives, the energy market should be fully liberalized also for households, when every household will be able to choose a supplier.

In 2005 and 2006, continuation of adapting taxes to EU standards is assumed (annual growth of the tax on tobacco and tobacco products with a likely impact on headline inflation of 0.4 percentage points)³.

³ A timetable of increasing the excise tax on tobacco and tobacco products according to an agreement between the government of the Slovak Republic and the European Commission from the year 2000 on a transition period

In the period from 2005 to 2007, the effect of **administrative measures** on development of consumer prices should diminish and growth dynamics of indirect taxes and regulated prices should be low. As a result of this development, the influence of administrative measures on inflation in 2005 should be 1.5 percentage points, 0.9 percentage points in 2006, and 0.7 percentage points in 2007.

Dynamics of consumer prices in 2005-2007 will be influenced primarily by development of tradable and non-tradable sectors, where with a continued decline of the rate of deregulation and continued liberalization the significance of these sectors will be rising.

Year-on-year dynamics of **food prices** should continue its growth tendency registered in June 2003 until the first half of 2005, when most of the pro-growth effects from 2004, brought about by implementation of the common agricultural policy should vanish. In the following period the growth rate of food prices should be in the range comparable with other member countries of the EU, when their growth should be suppressed by continued reform of the common agricultural policy, which is linked with a gradual annual decline of intervention prices of commodities until 2007.

Also in 2005 to 2007, low imported inflation and developed competitive environment supported by EU entry should continue to project their influence of prices of **tradable goods**. During the whole period from 2005-2007, prices of tradable goods should probably be the most stable component of the consumer basket. Their dynamics should basically copy the development of the rest of Europe. Prices of motor fuels, which are included among tradable goods, should develop depending on the presumed movements of crude oil prices on the world markets and the exchange rate.

In prices of market services from 2005, demand factors rather than cost factors should show, and the growth rate of prices of market services as well as their contribution to headline inflation should be 1.5 percentage points higher compared with tradable goods as a result of the so-called Balassa-Samuelson effect. In 2005 to 2007, restoration of growth of real wages is assumed. At the same time, employment should rise and installment sale and consumer lending should continue to develop. All these factors should contribute to increased consumption and possible demand pressures. Rising demand however should not be reflected in higher prices of tradable goods and food prices, because higher demand will presumably be satisfied by imports. It can however be expected that demand pressure will mostly show during these years on prices of market services that cannot be substituted by imports. It needs to be emphasized however that faster growth of prices of market services over prices of tradable goods will not represent an inflation threat, but would rather be a consequence of real convergence.

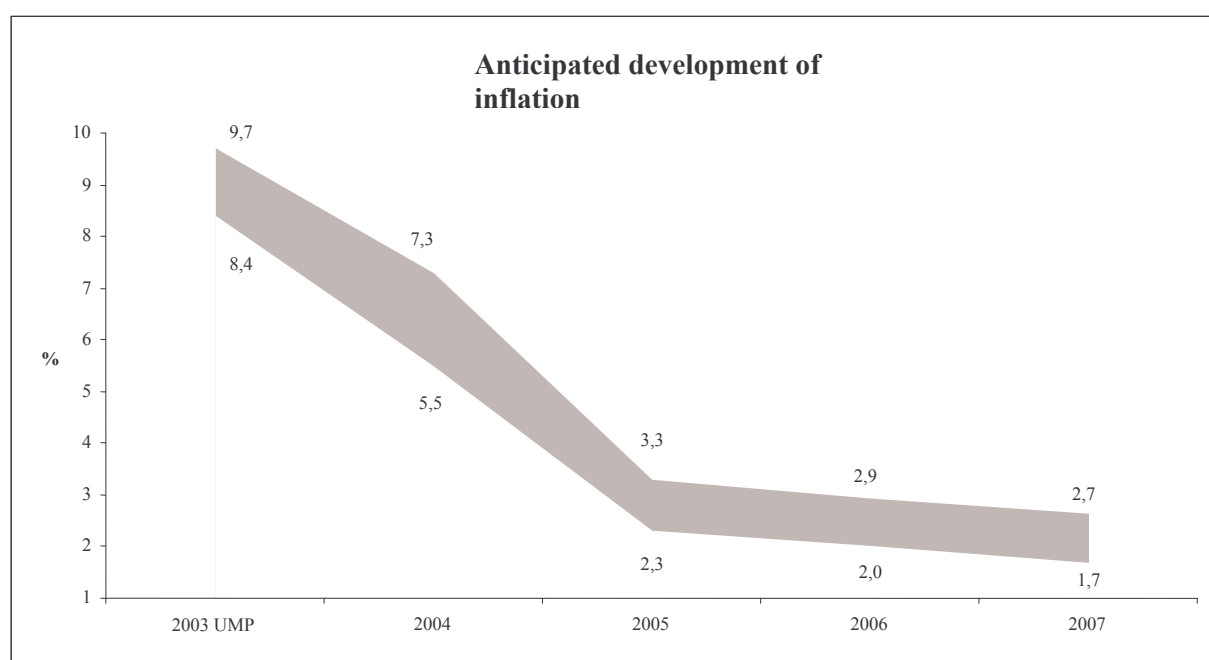
Based on these assumptions we can expect that headline inflation at the end of 2005 should be in the interval 2.3-3.3 percent, in 2006 in the interval 2.0-2.9 percent, and in 2007 in the interval 1.7-2.7 percent. Corresponding to these end-year values is average inflation in the interval 2.8-3.3 percent in 2005, 2.0-2.5 percent in 2006, and 1.7-2.2 percent in 2007. Core inflation in December 2005 should be in the interval 1.4-2.5

for this tax until 2008 is no longer effective because in 2003, this tax was twice significantly increased. The increase of the excise tax on tobacco and tobacco products from May 2004 by SKK 1 per package of cigarettes is caused by budgetary needs (financing of regional education). With regard to these facts, the NBS expects that the required minimum excise tax rate on tobacco and tobacco products will be achieved already in 2006.

percent, at the end of 2006 in the interval 1.7-2.8 percent, and at the end of 2007 in the interval 1.6-2.7 percent.

Estimated inflation development in 2004-2007 (as of December of the pertinent year)

		2004	2005	2006	2007
Inflation (%)	Year-on-year	5.5-7.3	2.3-3.3	2.0-2.9	1.7-2.7
	average year-on-year	7.2-8.2	2.8-3.3	2.0-2.5	1.7-2.2
Core inflation (%)	Year-on-year	1.2-3.5	1.4-2.5	1.7-2.8	1.6-2.7
	average year-on-year	1.8-3.0	2.0-2.6	1.7-2.3	1.7-2.2
Net inflation excluding the effect of fuel prices	Year-on-year	1.7-2.8	1.9-2.5	1.9-2.5	2.0-2.6
	average year-on-year	2.1-2.8	2.0-2.3	2.0-2.3	2.0-2.3



Risks Linked with the Inflation Outlook for 2005-2007

Similarly as for 2004, also for the years 2005-2007 the risk factors that can have a pro-growth but also attenuating effect will primarily be the development of crude oil prices on the world markets and exchange rate development (either the exchange rate of the Slovak koruna vis-à-vis the euro or the exchange rate of the euro vis-à-vis the US dollar).

Since the inflation outlook is based on a fixed exchange rate for the whole period, its **more significant weakening** over a longer interval could be conveyed into prices in the tradable sector through higher prices of imports. At the same time, weakening of the competitive pressure on local producers could create space of them to raise prices. Weakening of the exchange rate could also mean higher prices of energy and subsequently also secondary effects of their change in prices of market services.

In case of an opposite development, **more significant strengthening** of the exchange rate can cause rising competition pressure on local producers, Worsened profitability could lead to a slowdown of the growth dynamics of wages (nominal and real) and thus support a low inflation environment. Subsequently, the low inflation environment could relieve inflation expectations. At the same time, stronger exchange rate would mean lower energy prices and of course, lower costs for producers and providers of services.

Similarly as for 2004, also for the years 2005-2007 the price of crude oil could develop otherwise than expected in case of an escalation of the conflict in the Middle East, political uncertainty in producer countries (Russia, Venezuela, Nigeria), as well as depending on the ability of OPEC to influence the market. Rising crude oil market share in favor of nonmember countries can also lead to a more notable growth of offer and thus a decline of prices. On the other hand, revival of the world economy does not have to be significant and demand for crude oil would not be high enough to cover higher production, which could subsequently mirror in a decline of prices.

A certain degree of risks in food prices is linked with another possible reform of the common agricultural policy under pressure of WTO agreements on trade liberalization, which could mean reduced protection of European producers against imports and subsequent also a decline of prices of food commodities. This development could mean stagnation or a decline of food prices.

A deviation from programme intervals could also be caused a greater than expected extent of administrative measures.

5.2. Producer Prices

Industrial prices in the coming years should be less subjected to influence of major cost factors as is the case now. From the viewpoint of local determinants, on the one hand, prices of energy producers will rise at a slower rate, reflecting the development of energy prices on the world markets and the level of local inflation; on the other hand, more dynamic prices of food products as a result of adoption of the common agricultural policy will presumably last until the end of the first half of 2005. A positive influence on development of industrial prices in 2005 from the viewpoint of external cost factors should come from an expected decline of crude oil prices on the world markets; in the following years the price of this commodity should stabilize.

Apart from these influences, industrial prices will also be affected by gradually changing character of the business environment. For example, we can assume that the present growth of energy prices will be expressed in prices of industrial manufacturers in a different way than in 2001, when rising energy costs had a more significant effect on industrial prices. In the period of recent years, most businesses invested (local or foreign resources) into modernization of production, new technologies, or into education of their employees, which eventually contributes to enhancement of their productivity, which in a majority of branches at present exceeds growth of real wages. Apart from this, unemployment is also gradually declining and employment is rising. When we take into account also growth of competition for local producers after entry into the EU and connected with it greater efforts of companies to maintain their position on the market, we can assume that in the years 2005-2007 producer prices in industry will grow at a rate comparable with EU countries.

Forecast of Producer Prices in Industry until 2007 (The same period of previous year=100)

	2003	2004	2005	2006	2007
Average annual index thereof:	108.0	102.4	102.2	101.2	101.2
industrial manufacturing products	102.5	101.4	102.1	101.0	101.0

5.3 Foreign Accounts

5.3.1 Balance of Payments

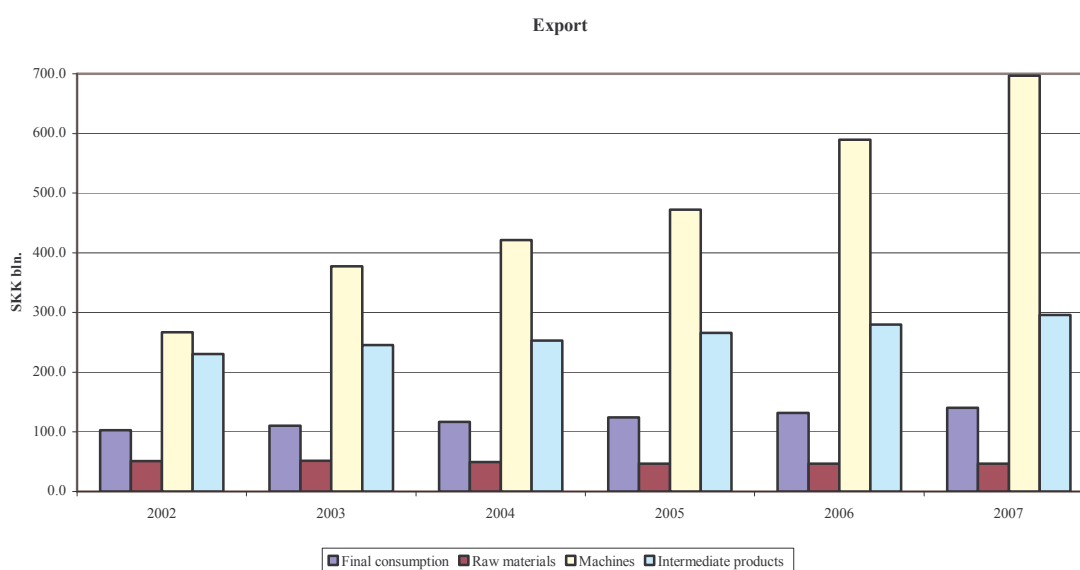
The arrival of a foreign investor in the area of the automotive industry is the main assumption in the development of the trade balance and subsequently also the current account in 2005-2007.

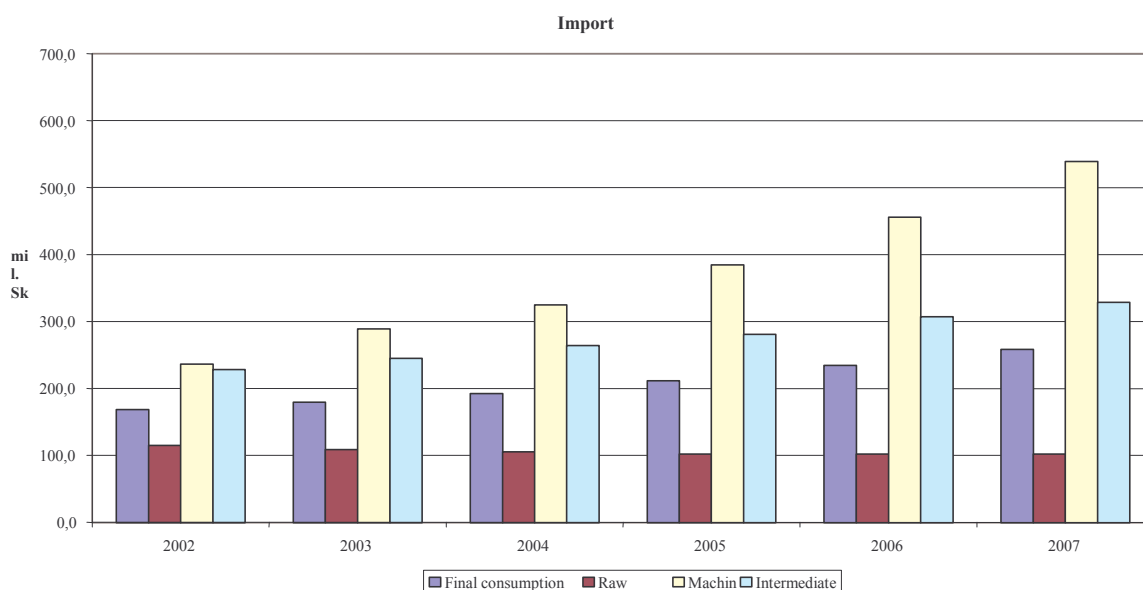
Current account items in SKK bn.	2005	2006	2007
Trade balance	-70,4	-51,7	-48,9
Export	908,8	1 048,3	1 179,7
Import	979,2	1 100,0	1 228,6
Balance of services	15,3	17,4	19,6
Balance of receipts	-4,1	-4,4	-6,8
<i>thereof receipts from investments</i>	-17,1	-17,9	-16,0
Current transfers	6,0	6,0	6,0
Current Account	-53,2	-32,7	-30,1
Share of c/a on GDP in %	-3,8	-2,2	-1,9

In this period there is a high probability of an acceleration of the growth rate of imports (10.5 percent, 12.3 percent and 11.7 percent) that in 2005 will be influenced by import of fixed investment units and in 2006 and 2007 by import of components for the production of new cars. Export of the first cars will take place in 2006 (growth rate of export should increase from 8.2 percent in 2005 to 15.4 percent in 2006 and 12.5 percent in 2007).

In other export groups, stable development is expected with relatively low growth rates, which will remain at the level of 2004 approximately.

In import, apart from notable growth in components for automotive production that will reflect in import of transport equipment and partly also machinery, from 2005 a moderate growth of import for final consumption in connection with growth of real wages and rising private consumption can be expected.





We do not assume significant oscillations in the balance of services in either direction. Rising surplus on the balance of services should be ensured by gradual growth of net income from tourism.

The balance of receipts will range roughly at the level of SKK 16.0 billion, whereby stable development will be reported on both the income part (determined by stable development of foreign exchange reserves of the banking sector) as well as expenditure part (determined by stable development of indebtedness).

Capital and financial account items in SKK bn.	2005	2006	2007
Capital transfers	15.0	17.0	16.0
Foreign direct investments	56.8	35.0	27.1
FDI in the Slovak Republic	58.2	36.3	28.5
thereof: FDI – official sector	10.2	8.1	2.1
Portfolio investments	-3.5	-3.8	-3.4
Other long-term financial account	-27.8	-13.4	-8.4
<i>Assets</i>	0.0	0.0	0.0
<i>Liabilities</i>	-27.8	-13.4	-8.4
<i>Government + NBS</i>	-24.0	-7.9	-3.4
<i>Commercial banks</i>	1.0	1.0	1.0
<i>Companies</i>	-4.8	-6.5	-6.0
Short-term financial account	-3.6	-3.8	-4.8
Capital and financial account	36.9	31.0	26.5

Financing of the negative balance on the current account should be, similarly as in 2004, ensured from resources from capital transfers (net budgetary position of the Slovak Republic) and from direct investments. In 2004 to 2006, net income (the difference between contributions from the budget and funds of the EU and contributions to the EU budget) is assumed from the European Community roughly at the level of SKK 43.0 billion. Revenues of SKK 88.0 billion however do not have to be realized to the full extent because more than 75 percent of revenues from the European Community will be project oriented and a title to draw this money originates only after acceptable project proposals are submitted, as a result of which real drawing can be substantially lower.

Construction of a car assembly plant on the territory of the Slovak Republic will play a decisive role for the inflow of foreign direct investments in 2005, which will probably also attract other foreign investors. A structure change will be important in this period, when the inflow of foreign direct investments will be directed mainly into industry, while building of shopping centers is not considered to a similar extent as in recent years.

Further privatization activities will depend on the government's strategy in the area of privatization of power utility Slovenske elektrarne and other companies owned by the state, such as completing the privatization of remaining shares in companies privatized in recent years. The forecast of the NBS counts with an inflow of privatization proceeds of SKK 20.4 billion (proceeds from the sale of remaining shares in Slovenska sporitelna, gas and steam energy producer PPC, central heating plants, and potential completion of privatization of power distributors) for the entire forecast period, whereby half of this amount should come in 2005 (proceeds from the sale of 49 percent in Slovenske elektrarne).

A deficit of long-term investments will gradually diminish depending on a decline of installments of government and business sector debt repayment. From the viewpoint of drawing new loans, the business sector is expected to be using foreign resources to a lesser degree as in previous years. The volume of loans however, as in 2004, will depend on the ability to draw resources from pre-entry funds, which will be as well as financial loans directed into the business sector and should bring increased competitiveness of the economy on the domestic and foreign markets.

The forecast does not assume that short-term capital would play a significant role in financing needs of the economy. Most active in its structure will be the business sector with its export receivables or import obligations.

Sectors in SKK bn.	2005	2006	2007
Businesses (including sources from the EU)	50.5	30.6	26.8
Banks	-1.8	-1.8	-1.0
Government and NBS sector	-11.8	2.2	0.7
Total	36.9	31.0	26.5

From the sector viewpoint, the business sector will continue playing a decisive role in the inflow of capital.

Excess of repayment of old loans over drawing of new ones and relatively low forecast privatization proceeds will mean a decline of foreign exchange reserves over the entire period. Their volume will decline in 2005 to USD 11.6 billion, in 2006 to USD 11.5 billion and in 2007 to USD 11.4 billion. As a result of this, as well as the development of imports of goods and services, the average coverage of import of goods and services will drop from 4.6 months in 2005 to 4.1 months in 2006 and 3.7 months in 2007.

Adjusted balance of payments in SKK bn.	2005	2006	2007
Current account (c/a)	-53.8	-33.8	-30.9
Capital and financial account (CFA)	55.6	35.6	31.9
Foreign direct investments (FDI)	48.0	28.2	26.5
NBS interventions	0.0	0.0	0.0
Change of net foreign assets NFA (- growth)	-1.8	-1.8	-1.0
c/a coverage by CFA in %	103.3	105.3	103.2
c/a coverage by FDI in %	89.2	83.4	85.8

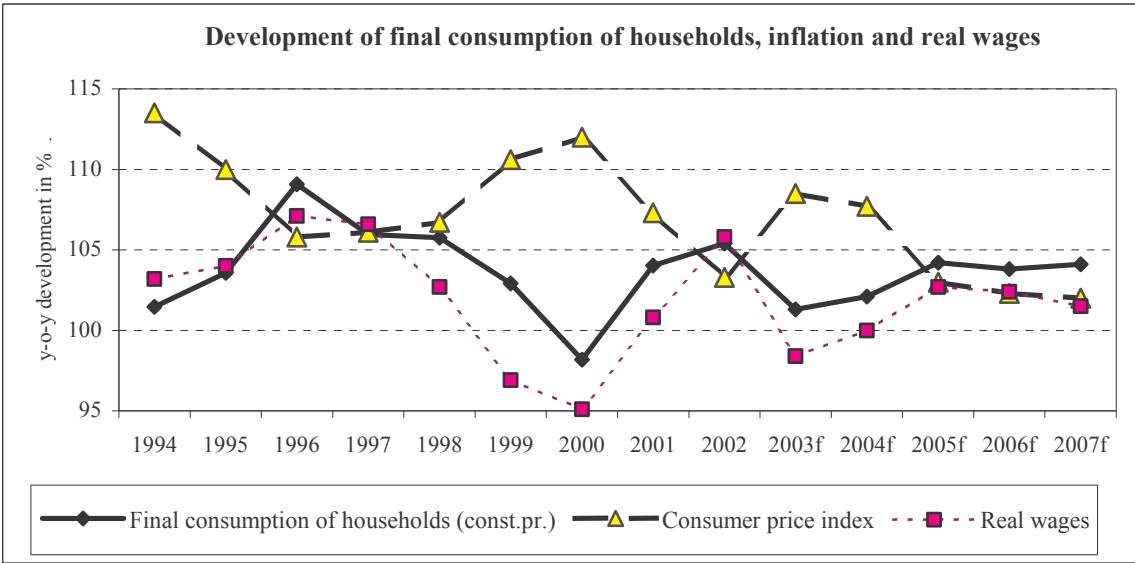
Adjusted balance of payments, excluding the influence of the government of the Slovak Republic and the NBS, that does not affect the position of commercial banks vis-à-vis nonresidents and that does not represent real financing of the current account should be in a surplus in 2005 to 2007, i.e., the inflow of resources into the business sector should exceed the current account deficit and net foreign assets of commercial banks will achieve growth. Foreign direct investments will play an important role in inflow of resources into the business sector, which will cover the current account deficit to more than 80 percent.

5.3.2 Foreign Debt

Foreign indebtedness should fall in 2005 to USD 15.3 billion and remain at this level in the following years. Net foreign debt over the entire period should remain in a creditor position (USD 3.4 billion in 2005, USD 3.9 billion in 2006, and USD 4.3 billion in 2007).

5.4 Gross Domestic Product

In the outlook until 2007 we expect gradual improvement of economic performance, growth of its competitiveness, as well as improvement of the situation on the labour market, which, together with other factors, should help faster growth of the economy in the medium-term horizon. Real convergence of the Slovak economy should ensure the improvement of the standard of living in the Slovak Republic and it’s approaching the standard of living in the European Union.



In the following years, faster growth rate and a contribution of final consumption are anticipated, because only minor adjustments of regulated prices and excise taxes are expected. Thereby, subsequent growth of real wages could open space to satisfy deferred consumption plans from the years 2003-2004, similarly as from the years 1999-2000 in the following period. A declining trend of the tendency to saving will presumably run out and dynamics of private consumption could accelerate in 2005-2007 to twice the rate compared with 2004, as a result of which it will become one of the most important factors with a pro-growth influence on real GDP.

Development of **private consumption** will be influenced by the intention to reduce the fiscal deficit presented in the pre-accession economic programme, as well as the programme statement of the government, which limits possibilities of growth of public expenses. At current prices we assume a gradual decline of the general government deficit and a moderate, approximately constant growth of current expenditures. Under the influence of a gradually declining growth of the price level, we expect only moderate rise of public sector consumption.

In demand for **fixed investments** (machinery and buildings) we assume significant growth in the medium-term. In 2005, with regard to preparations for production in PSA Peugeot we expect the largest increase of fixed investments, when the increased contribution of investment demand to GDP growth will probably be compensated by a higher deficit of net export as a result of imports of technological installations. The investment of PSA Peugeot carmaker will presumably create conditions for a subsequent development of a local market of suppliers, which assumes the fulfillment of investment intentions in the years 2006-2007. Construction investments will be supported by mortgages, infrastructure projects financed by the government, as well as continued construction of industrial parks.

In 2005, the trade balance will probably temporarily worsen, when in particular increased imports of technological units will decelerate GDP growth rate, however, in 2006-2007, after PSA starts producing at full capacity, rising export should ensure a surplus of net export at constant prices and have a pro-growth effect on real GDP.

In connection with the predicted development of domestic demand and net export in the medium-term horizon, gradual acceleration can be expected of economic growth dynamics from 4.1 percent in 2005 to 4.4 percent and 4.5 percent in 2006-2007 (mid-ranges).

GDP and implicit deflator

	Outlook 2005	Outlook 2006	Outlook 2007
GDP at constant prices year-on-year growth in %	3,7-4,4	3,9-4,9	4,0-5,1
GDP at current prices SKK bln.	1385,0	1490,0	1600,0
Implicit GDP deflator (year-on-year increment in %)	3,2	3,1	2,8

5.5 Wages and Unemployment

In the horizon of the years 2005 to 2007, we can assume a gradual consolidation in the development of wages in the private sector, which toward the finish of the forecast period could be heading to a system of wage arrangement similar to other EU countries, where growth of nominal wages in principle is in the range of 1-2 percent above the level of average inflation, however, depending on the achieved labour productivity and results of economic performance.

Development of wages in the public sector should, according to the Pre-accession economic programme until 2006, be slower than the average achieved in the national economy. Valorization of wages should be uniform and for 2005 and 2006 lower than the forecast rate of inflation.

The basic determinants of wage development in the medium term should include in particular

the declining rate of average inflation, accelerating economic growth, growth of real labour productivity exceeding growth of wages, declining costs in the business sector in the interest of competitiveness in connection with entry of the Slovak Republic into the EU, as well as a restrained wage development in the public sector in line with a reduction of the fiscal deficit.

With regard to the development forecast for GDP and employment, it can be assumed that real labour productivity in the medium term should grow faster than real wages, which should also open space to create new jobs.

Outlook for 2005-2007 index (same period previous year = 100)

	Outlook		
	2005	2006	2007
Nominal wage midrange	105.3-106.3 105.8	104.3-105.3 104.8	103.5
Real wage midrange	102.2-103.2 102.7	102.0-103.0 102.5	101.5
Productivity of labour in GDP at constant prices (midrange)	103.4	103.7	103.9
<i>Average CPI – midrange</i>	<i>103.0</i>	<i>102.3</i>	<i>102.0</i>
Employment	100.7	100.7	100.6
Average rate of unemployment according to NLO	13.8	13.0	12.5
Average rate of unemployment according to LFSS	15.5	14.6	14.0

Note: rate of unemployment – average of given period

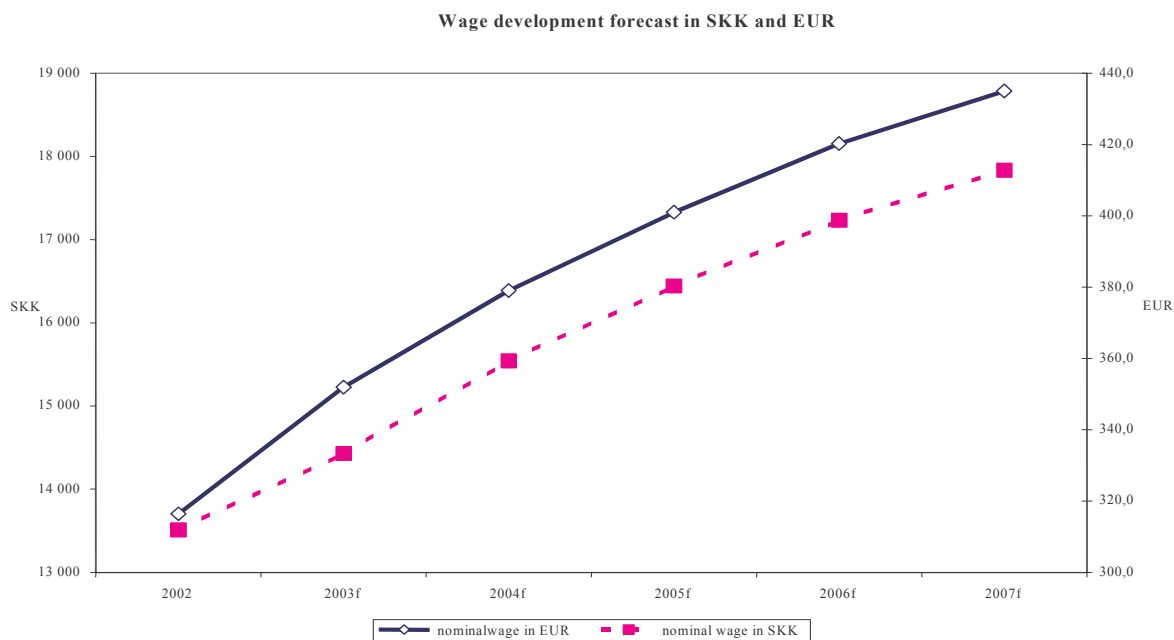
The year 2005 should accumulate a number of factors that should positively influence the development of wages, which would mean an interruption of a two-year tendency of stagnation of real wages. The finish of price deregulation should result in a reduction of average inflation (approximately to less than half the level of 2004), and the income tax cut for private and corporate persons should fully reflect into the development of performance of the business sector, along with adjustments of the VAT valid from 2004, the cost burden should also be clarified regarding payments of sick leave benefits by employers to employees in connection with the reduced rate of contributions to sickness insurance paid by employers.

Remuneration in the public sector will continue to curb faster growth of nominal wages, which, according to the Pre-accession economic programme should be legislatively regulated so as to limit the level of entitlement in some systems of remuneration. A uniform rate should be used for the valorization of wages in this sector, which in 2005 and 2006 should be lower than the forecast rate of inflation and slower than the rate achieved on average in the national economy.

Real labour productivity should grow faster during that year than real wages. The achieved advance in labour productivity over wage growth since 2003 should create sufficient space for wage growth, which in real terms could move in the range from 2 percent to 3 percent.

In 2006 and 2007 we assume continued growth of real wages at the current growth rate of labour productivity exceeding the growth of wages. From the viewpoint of real convergence of accession of the Slovak Republic into the EU however, wage growth should be devised in a

way so that on the one hand, it does not threaten competitiveness of the business sector, while on the other, to make use of the potential created by the achieved advance of labour productivity growth over growth of wages to reduce the degree to which the level of wages in the Slovak Republic lags behind countries of the EU as well as surrounding central European countries accessing the EU.



In the development of employment we expect in **2005** growth to slowdown compared with the previous period resulting from the onset of influences of demographic factors (in particular diminishing population in productive age). Pro-growth effects are expected from economic growth and associated with it new jobs that would be created, and the revision of the social insurance law.

The number of the **unemployed should decline** again in **2005** and the rate of unemployment should decrease by 0.6 percentage points compared with 2004. Factors with positive effects on a decline of unemployment include mainly the creation of new jobs, expected positive influences of the law on employment services, and partly increased mobility on the labour market linked with entry into the European Union.

In **2006** (due to stagnating dynamics of job offers) the growth rate of employment should reach the same level as the year before. Pro-growth influence is again expected from economic growth (to a great extent resulting from foreign direct investments) and creation of new jobs associated with it. In **2007** stagnating dynamics of job offers (primarily due to diminishing population in the productive age) should evolve into a moderate decline, and this despite expected growth of the economy, which should create new jobs.

Expected development of the unemployment rate in **2006 and 2007** reflects anticipated development of other macroeconomic indicators, in particular an inflow and anticipated positive effects of foreign direct investments, etc.

5.6 Public Sector Finances

Since 2002, the share of fiscal deficits to GDP should be diminishing as well as related fiscal impulses should weaken stimulating economic growth. Growth impulses should be substituted by reduction in direct taxes, which should be reflected in the growth of domestic consumption. Stagnation of real wages however could suppress a more marked growth of final consumption with a negative impact on collection of indirect taxes and threaten the planned deficit. Decentralization of powers and their delimitation to regional governments can carry risks of higher spending, mainly in education and healthcare. In the area of general government debt, risks exist from provided government guarantees.

In connection with meeting the Maastricht criterion, based on current knowledge we can assume that in 2006 the public finance deficit would not exceed 3 percent of GDP (without pension reform) and a precondition will be fulfilled that it will be sustainable.

5.7 Monetary Policy

5.7.1 Monetary Aggregates

Our projection of development of monetary aggregates is based on the following assumptions:

- domestic price level will have a more significant disinflation trend,
- the government will be fulfilling its goals in the area of fiscal performance. Increasing indebtedness will be generated by the central government as a result of deficits in current budgetary performance.

Projected installments of the general government debt in 2004 to 2007 in SKK billions

	Government bonds	Treasury bills	Foreign debt	Total
2004	62,7	44,4	26,1	133,2
2005	32,4	49,0	25,7	107,1
2006	35,4	47,7	9,0	92,1
2007	14,3	49,3	3,2	66,8

Risks of overstepping approved deficits stem from realization of loans with a government guarantee. To resolve these risks, the government has adopted a plan to use privatization proceeds to strengthen state financial assets with the possibility of transferring these to revenues of the state budget. The other components of public sector should operate with budget surpluses, with contributions to it from social security funds resulting from a positive effect of social reform. This area however carries certain risks linked with social security reform. The Ministry of Finance of the Slovak Republic cannot quantify these risks. Within indebtedness of the state, in line with intentions of the DLMA, foreign indebtedness should grow faster and these resources should partly replace maturing internal debt.

- development of the balance of payments will be stabilized, privatization activities of the government should contribute to the capital account to a declining degree.

Stabilization of monetary aggregates in 2005 to 2007 is in line with the given assumptions. Money supply dynamics should moderately decelerate, similarly as net foreign assets. Slightly restrictive influence of the general government area will create a space for stable growth of credits to enterprises and households.

(in %)

	2003	2004	2005	2006	2007
M2 money supply	6.4	8.0	8.0	7.5	7.5
Credits to enterprises and households	9.7	8.0	5.3	5.2	5.5

A risk to this development is when fiscal policy assumptions are not fulfilled. Risks also exist in overstepping planned deficits in the current budget performance, the source of which can be lower tax revenue (in particular when an expected economic growth rate is not achieved), realization of government guarantees, as well as social security reform.

With regard to existing signals from commercial banks that they consider the portfolio of government securities sufficient and they will concentrate on retail banking (also in connection with rising available liquidity of banks as a result of foreign debt issuing activity of the government of the Slovak Republic), the result can be dynamic growth of lending activities. Their development and primarily the effect through demand pressure on inflation and the trade balance will have to be closely monitored (including the quality of collateral)⁴.

5.7.2 Implementation of Monetary Policy

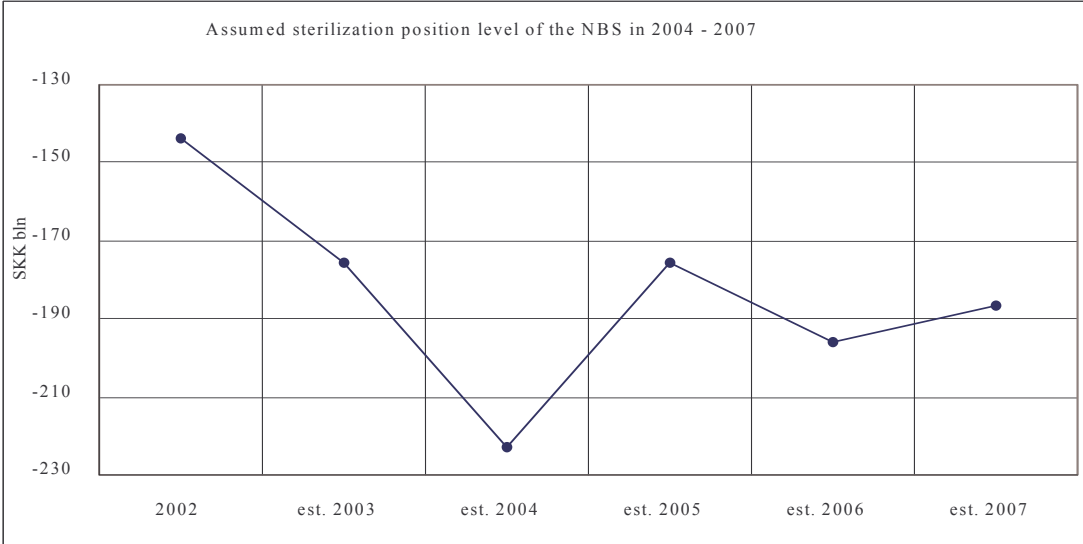
Monetary policy will be conducted in an environment of a declining dynamics of inflation in the medium-term outlook as well as proclaimed consolidation of public finances. At the same time, economy should maintain its growth potential, not only on the side of foreign demand but also in domestic demand. Together with an inflow of foreign direct investments, along with growth of lending activities and achieving positive growth of real wages, preconditions for rising domestic demand should be created. With regard to this, as well as with regard to a more notable reduction of either a primary or a secondary effect of increasing of regulated prices and indirect taxes on inflation, monetary policy can get into a situation when smaller or bigger demand pressures arise on the price level.

With regard to expected decline of inflation, it will be possible in the medium term to reduce key interest rates, their decline however does not need to be continual; it will react to development of the price level, as well as development in the exchange rate area. The process of convergence of interest rates is desirable, however, it is conditioned by development in target values. Convergence itself of short-term interest rates (we already now fulfill long-term interest rates as one of the Maastricht criteria) can take place in a short period before entry into the eurozone.

The degree of uncertainty with regard to liquidity development caused by factors operating in 2004, will increase in 2005 to 2007. Development in the following years will to a decisive degree be influenced by the fulfillment of assumptions in 2004 related to public administration reform. Under the condition that assumptions for development from 2004 are preserved, then the sterilization position of the NBS in 2005 should slightly decline (under the influence of development of the balance of payments) and until 2007 it should remain at a relatively stable level. The government is considering also in the coming years to use its

⁴The task of the central bank, including its monetary policy, will also be to react to a possible “bubble” in property prices. Growth of prices, as well as the volume of credits does not fully correspond to growth of income of the households. In the event of a possible “burst of the bubble,” collateral of banks would lose its value, with a negative effect on their economic performance, which could undercut economic growth of the Slovak Republic in the following period.

declining privatization proceeds to support state financial assets and their use. A pro-growth effect on the sterilization position could stem from realization of intentions of the DLMA in the area of conversion of a part of the domestic debt to foreign debt. A need for an intervention of the NBS on the foreign exchange market against inappropriate strengthening of the Slovak koruna would also require increasing of the sterilization position to the full extent.



Main economic and monetary indicators

	2 002	2 003	2 004	2 005	2 006	2 007
	Actual	Estimate	Monetary programme			Outlook
<i>(year-on-year change in %, unless stated otherwise)</i>						
Core inflation (end-year)	1.9	3.1	1.2-3.5	1.4-2.5	1.7-2.8	1.6-2.7
Net inflation excluding the effect of fuel prices (end-year)	2.9	3.4	1.7-2.8	1.9-2.5	1.9-2.5	2.0-2.6
Consumer Price Index (end-year)	3.4	9.4	5.5-7.3	2.3-3.3	2.0-2.9	1.7-2.7
Consumer Price Index (annual average)	3.3	8.5	7.2-8.2	2.8-3.3	2.0-2.5	1.7-2.2
Producer Price Index (annual average)	2.1	8.0	2.4	2.2	1.2	1.2
Gross Domestic Product (constant prices)	4.4	3.9	3.7 - 4.3	3.7-4.4	3.9-4.9	4.0-5.1
Gross Domestic Product (current prices, in bn. SKK)	1 073.7	1 180.0	1 290.0	1 385.0	1 490.0	1 600.0
Nominal wages	9.3	6.8	7.2 - 8.2	5.3-6.3	4.3-5.3	3.5
Real wages	5.8	-1.6	-0.5 - +0.5	2.2-3.2	2.0-3.0	1.5
Trade balance (bn. SKK)	-96.0	-38.2	-46.1	-70.4	-51.7	-48.9
Current account (bn. SKK)	-87.2	-23.3	-30.4	-53.2	-32.7	-30.1
Share of current account of the balance of payments in GDP (%)	-8.1	-2.0	-2.3	-3.8	-2.2	-1.9
Foreign direct investments (bn. SKK)	179.7	41.9	53.2	56.8	35.0	27.1
Official reserves of the NBS (mil. USD)	9.2	11.0	12.0	11.6	11.5	11.4
Foreign exchange reserves of the NBS to import (monthly average for goods and services) ratio	5.9	5.3	5.3	4.6	4.1	3.7
Money supply (M2)	3.3	6.4	8.0	8.0	7.5	7.0
Credits to households and enterprises	11.7	9.7	8.0	5.3	5.2	5.3
Sterilization position against banking sector (bn. SKK)	-137.2	-175.5	-222.9	-202.2	-195.9	-187.8