NÁRODNÁ BANKA SLOVENSKA

Annual Report 2002

Contents

FOREWORD

Slovakia's macro-economic and monetary development in 2002 was characterised by a fall in inflation, gradual acceleration in the rate of economic growth, and by persistent deficits in foreign trade and the balance of payments on current account.

The rate of overall inflation fell to 3.4% in 2002, from 6.5% in 2001, due primarily to a reduction in the schedule of adjustments to regulated prices and a slowdown in the rate of price increase in other basic elements of consumer prices. Core inflation fell by 1.3 points in 2002, to 1.9%. The level of core inflation was determined by the rise in oil prices on the world market and the consequent increase in fuel prices, which was offset by a fall in food prices. Prices in the tradable sector, which were affected by the appreciation of the Slovak koruna (due to the large proportion of imported goods), had a stabilising effect on price development. In the conditions of strong competition in the retail sector, the growth in domestic demand exerted no undue pressure for a rise in consumer price levels.

Economic growth in 2002 was characterised by an acceleration in year-on-year dynamics. A positive factor in the development of GDP was the positive contribution of net exports to GDP growth, resulting from the faster growth dynamics of exports than imports. A moderate increase in output of the export trade (expressed in terms of the contribution to GDP) led to a decrease in the size of the trade deficit. The growth in domestic demand was in large part due to final consumption, and growth in inventories, accompanied by a fall in investment demand. One of the factors contributing to acceleration in the rate of growth in final household consumption was the strong dynamics of real wages, which exceeded the rate of growth in labour productivity. This unfavourable development was mainly due to the high rate of wage increase in the public sector. Relatively dynamic growth was also recorded in final consumption in the public administration sector, the rate of which slowed after the introduction of austerity measures in the second half of the year. The ratio of the fiscal deficit to GDP fell slightly, from 7.3% in 2001 to 7.2% in 2002 (according to the ESA 95 methodology).

The balance of payment on current account remained in deficit in 2002, due to deterioration in all basic components, in addition to the balance of trade. In spite of this, the ratio of the current account deficit to GDP fell from 8.5% to 8.1% as a result of economic growth. Some improvement was recorded in the commodity structure of exports, where the strongest growth dynamics were recorded in the export of finished products. Nevertheless, export trade continued to focus on goods with a low added value, intended for intermediate consumption. The fall in investment demand led to a marked slowdown in the rate of increase in imports of machinery and transport equipment (excluding automobiles), accompanied by reduced imports of finished products, despite growth in real wages.

The implementation of monetary policy in 2002 was affected, on the one hand, by developments in the country's basic economic fundamentals (i.e. continued disinflation, acceleration in the rate of economic growth, persistent large deficit in the balance of payments on current account and in public finance), and, on the other hand, by the formation of expectations (mainly in the area of exchange rate developments) connected with the integration process. Monetary policy continued to be implemented in an environment marked by a growing surplus of free liquidity in the banking sector, which was sterilised through standard methods. A significant pro-liquidity factor in 2002 was the large income from privatisation and its utilisation (mainly the part used for the repayment of the internal debt), which resulted in a substantial increase in the need for liquidity sterilisation.

The deepening external economic imbalance, resulting from the growing trade deficit, coupled with effects of the absence of appropriate measures for the elimination of risks in the public sector, and with the potential stimulus to demand of privatisation proceeds, led, despite a fall in inflation rate, to monetary policy tightening in the first half of the year. At the end of April, the Bank Board of the NBS decided to raise its key interest rates by 0.5 of a percentage point. The growing degree of uncertainty in the expectations of economic entities led to depreciation in the exchange rate of the Slovak koruna to the euro. The NBS regarded the exchange rate depreciation as excessive and conducted direct interventions in June in order to stabilise the situation on the foreign exchange market.

With regard to the negligible effect of demand-based factors on inflation, the improvement in the negative balance of foreign trade and the anticipated adoption of measures for the reduction of risks in public finance in 2003, the Bank Board of the NBS decided, at the end of October, to lower the limit rate for two-week repo tenders by 0.25 of a percentage point, while leaving the rates for overnight operations unchanged. The positive expectations of economic entities, connected with the results of parliamentary elections, the progress achieved during the accession talks with the European Union, improvement in Slovakia's credit rating by international agencies, and the invitation of the SR to accession talks about entry into NATO, led to a marked inflow of short-term capital from abroad (attracted by the positive interest rate differential) and subsequent pressure on the exchange rate of the Slovak koruna. Since the appreciation of the koruna was not based on an adequate improvement in basic economic fundamentals and could have a negative impact on the economy and export performance, the NBS intervened on the foreign exchange market. In support of operations on the foreign exchange market, the Bank Board decided to lower the key interest rates of the NBS by 1.5 percentage points with effect from 18 November 2002, i.e. the limit rate for two-week repo tenders to 6.5%, the rate for overnight sterilisation to 5.0%, and that for overnight refinancing to 8.0%. The cut in key interest rates was subsequently reflected in customer rates for deposits and loans.

The need for the sterilisation of excess liquidity in the banking sector (derived mainly from privatisation proceeds), the placement of part of the proceeds earmarked for the pension reform in a time deposit account at the NBS and the associated interest costs, the interventions in the foreign exchange market against undue appreciation of the koruna and the subsequent inflow of koruna liquidity into the banking sector, as well as the development of the USD/EUR exchange rate, were the factors responsible for the negative financial result of the NBS in 2002, amounting to almost Sk 25 billion.

The process of harmonisation of the Bank's monetary policy instruments with those applied by the ECB continued in 2002, with a reduction in the ratio of required reserves from 5% to 4% with effect from 1 January. At the same time, bills-of-exchange transactions were cancelled, together with the Lombard loan, and the method of setting the discount rate was changed (corresponding to the limit rate of the NBS for two-week repo tenders). On 12 December, the Bank Board of the NBS decided to replace the discount rate with the base interest rate, with effect from 1 January 2003. The base rate is equal to the limit rate for two-week repo tenders, and hence, in generally binding legal regulations, the term 'discount rate of the National Bank of Slovakia' or 'discount rate of the State Bank of Czecho-Slovakia' refers to the base rate of the National Bank of Slovakia. With effect from 1 January 2003, the reserve ratio was cut further, to 3%.

On the whole, macro-economic development in 2002, characterised by a low rate of inflation and stabilised deficit in the balance of trade, was acceptable. Despite the relatively large deficit in public finance, there was room for reduction in key interest rates, which was, however, necessitated primarily by pressure for appreciation in the exchange rate. Since the exchange rate represents such an important transmission channel, undue and disproportionate appreciation could have an unfavourable effect on the competitiveness of the Slovak economy and the potential for growth.

The National Bank of Slovakia assumes that monetary policy in 2003 will be implemented in an environment marked by relatively dynamic economic growth, which will, however, be largely dependent on foreign demand (if domestic demand weakens) and the competitiveness of Slovak exporters. Hence, in implementing its monetary policy, the NBS will continue to take into account a wide spectrum of economic variables, i.e. price development, foreign trade, public finance, economic growth, including its structure, and last but not least, the exchange rate of the koruna.

In the medium term, the NBS will focus its monetary policy on the attainment of its primary objective – the maintenance of price stability, in order to create conditions for the entry of Slovakia into the euro area.

May 2003

Marián Jusko
Governor

Note: The Annual Report of the NBS for 2002 was compiled on the basis of preliminary banking statistics data, due to the fact that a commercial bank had exploited the possibility of putting off the deadline for the submission of tax returns by 3 months in accordance with Act No. 511/1992 Zb. on the administration and taxes and charges and on changes in the system of regional financial authorities.

Members of the NBS Bank Board in 2002

First row, from left to right:
Elena Kohútiková, Deputy Governor
Marián Jusko, Governor
Ivan Šramko, Deputy Governor

Second row, from left to right:
Karol Mrva, Chief Executive Director, Trade and Foreign Exchange Division
Ján Mathes, Chief Executive Director, Currency Division
Jozef Košnár, Professor at the University of Economy in Bratislava