



# THE FORECAST OF THE DEVELOPMENT OF THE SLOVAK ECONOMY FOR 2002 AND THE OUTLOOK UNTIL 2005

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*The subject of this paper is a medium-term forecast of macroeconomic indicators for the Slovak economy that has been produced to accommodate the needs of the National Bank of Slovakia. The collective of authors relied primarily on their previous papers in econometry dealing with macroeconomic development of the SR and its external and internal balance. The forecast has been made with the application of the macroeconomic model ISWE01q3, which was constructed on the basis of the database comprising 292 data series with 80 exogenous and dummy variables. In estimating regression equations, for the most part, data series were used for 1Q1993 to 2Q2001. The model consists of 198 equations, of which 155 are identities and 43 are of stochastic nature.*

## The tendencies of the development in the economic environment of the SR in 2001

The beginning of 2001 was marked by the reduction of the import surcharge to 0% and by the increase in some of state-regulated prices. The increase in price indices exerted influence upon development of aggregate values in the first quarter of 2001. The relatively low level of net inflation is associated with the restriction in the demand and growth of competition in the domestic market. Of the external environment the deceleration of the economic growth in the developed countries started to exert its effect. It has an overall effect in certain deterioration of the deficit of the balance of trade.

The average nominal monthly wage in the first half of 2001 amounted to 11,500 SKK, which, with the 7.5 percent growth in consumer prices, entailed a growth in real wages by 0.2 percent. Since the two previous years had been marked by a several-percent downfall in the real monthly wages, this, albeit very slight growth in real wage, is a sign of a turn in its development.

The development in the domestic demand, the balance of trade and in the fiscal domain allows cutting of interest rates. The money supply M2 in the first half of 2001 has increased by 14%, as compared to the same period of last year, of which, quasi money QM increased by 10% and M1 money by 23%, respectively. On the assets side, the year-to-year increase in net foreign assets was 45%, while in domestic net assets there was increase by 10 %, respectively.

The economic development in the first half of 2001 is characterised by an increase in domestic demand and a decline in net exports. The year-to-year private consumption has gone up by 3%, public consumption by 4%, and the gross fixed assets generating by 14%, respectively. The balance of imports and exports of goods and services in the first half of 2001 ended up with a deficit as high as 10 billion SKK (in 2000, it was only 2 billion SKK). These factors have contributed to the resulting growth of GDP for the first half of 2001 by 2.9%, which although involving increased economic growth when compared

to 2000 (2.2%) does not constitute transition to a desirable level of economic growth dynamics which is necessary for early accession to the European Union.

The worsening of the balance of trade is bringing about the aggravation of the current account balance of payments and, consequently, also the worsening of the ratio of the volume of the average three-months imports to the foreign currency reserves of the National Bank of Slovakia.

## The starting point and the prerequisites for the future trends in the development of the economic environment

Characteristic feature of the Slovak economy in the years 1999 and 2000, was the decline in domestic demand. It is also due to the change in the institutional policies following the parliamentary election in 1998. The tightening of institutional policies was aimed at reversing the trends that had been accompanied by considerable degree of disequilibrium. The privatisation process in banking sector which is being completed, creates prerequisites for a more effective allocation of resources in the future. We anticipate the reform process to be still set back by diverse interests of the multi-spectral ruling government coalition. The election year 2002 is creating a major risk of the forecast, as many institutional decisions are bound to be motivated politically, rather than by economic considerations.

We anticipate only a slow consolidation of companies to continue, which will have an adverse effect upon the overall development of the economy. The objective of reforms is achieved inadequately in legislation, which in turn is reflected in inefficient principles of business administration and management, that is still going on. We do not anticipate any significant increase in the competitiveness of production for the domestic market. The overall high import intensity of consumption is expected to prevail, as well as that of export, which have been evident in the course of past months. The small marketplace,

the low purchasing power of the population and the development in the exchange rate of the Slovak crown will remain to be significant factors of protection against foreign competition.

The gross investment growth in 2001 was higher than it had been initially anticipated. Given the high import intensity of the Slovak economy, this has resulted in the aggravation of the current account balance of payment, when the growth in imports was 30%, while that in exports was 19 percent. This deficit, however, was covered by the inflow of direct foreign investment, out of which, 80% was directed to increase holdings in companies. We deem this increase to be, to some extent, abrupt.

The slower change in the performance of industrial companies will be reflected in the development of employment. The growth in labour productivity has become a key parameter for many companies, which has also contributed to significant growth of unemployment. The solution of the chronic problems in businesses will not be favourable to job creation. The consolidation of some enterprises, as well as the privatisation of state-owned monopolies will also lead to significant cuts in the number of employees. New employment opportunities added as a result of the inflow of foreign investment and revitalisation of a number of domestic enterprises will absorb this decrease of employees. This will lead to stagnation on the side of demand for labour. We anticipate a slight increase in employment, supported by policies aimed at reduction of the scope for illegal economy and curb abuses of the social system. Equally, it will take longer for the labour market to respond to the development of the public works scheme. We assume the trend to remain unchanged, in which the growth of GDP will not be accompanied by a corresponding growth in employment. The development in unemployment will constitute a risk from the perspective of the economic management of social security funds and, consequently, the whole fiscal domain. Short-term effects of reforms reaching the years 2001 and 2002, will be accompanied by negative repercussions. We anticipate that the growth of flexibility of the labour market will be slow and with little intensity. An increase in the overall number of jobs is only envisaged in connection with the inflow of direct foreign investment outside privatisation and with active employment policies. The increase of active population will be reduced due to the changes in the transition of pupils of the eighth and ninth grades to secondary schools occurring 4 years ago.

For the forthcoming period we anticipate the action of such factors that will not permit to reduce inflation. The approximation of our price level to that of the European Union should be the leitmotif. The easing of state-regulated prices may contribute to a slight increase of inflation. The development in the exchange rate of the Slovak crown should have a neutral effect upon inflation. In the area of export prices we do not expect significant increase in the price of oil to continue. As a result of sustained high oil prices, there will be infiltration of the existing increased level in all prices of products and services. The growth of domestic demand will also be affected by the rise of demand led inflation pressures. The effects of the paying out of the National Property Fund bonds in the late 2001 will

be carried over, to a degree, to the year 2002. A slight recovery, offset by more cautious policies should not generate the effects of an overheated economy.

The increase of the state budget deficit in 2001 is vindicated by substantial increase of the state paying into public law funds, which is believed to allow operating an essentially balanced public budget (without the state budget). This assumption constitutes considerable risk for the public budget in 2001, since there are a number of components of the public budget over which the central government has very limited control. The unfavourable situation in the pension security fund and the health insurance generates pressures to augment the deficit of public finance. Owing to the need to finance the debt of public finance, interest rates will not be coming down. The necessity to cover new needs and commitments, such as those related to the accession processes and the public administration reform will constitute a risk for the development in public finance. However, slower pace of change on the grounds of priority to secure social acceptance and viability of reforms is envisaged. Consistent regulation of state guaranties will act restrictively on credit supply.

The monetary policy in the following years will mainly be focused on the development of inflation. In the forecast assumptions for 2002 – 2004, a slightly expansive to expansive monetary policy is assumed. The competition in the segment of corporate banking, mainly in providing credit to large Slovak and foreign companies operating in Slovakia, is stiff. Therefore, on the part of firms, pressure to push down interest margins on borrowing will continue. Despite the risk linked to the segment of small and medium size businesses, the interest of banks is growing to provide loans to competitive companies.

The current political development generates risks for the future. Reducing tax rates on the income tax of legal and physical persons is a positive signal. The transfer of responsibilities onto territorial self-government units proceeds very temperately and it may be expected not to have adverse impact upon the economic situation, when disregarding the pressure of initial investment cost and the possibilities of decentralised territorial units to operate with a budget deficit. We expect the political development following parliamentary election in 2002 not to diverge in any significant way from its reform course, but the reform pace before election is bound to significantly slow down. The membership of the SR in the OECD and the efforts to accede to the EU and NATO will exert a positive influence. We deem full inclusion of Slovakia in the common market of the EU and the European Monetary Union by 2006 scarcely likely.

The key factor in the external economic environment is the reduction of the boom in all economic zones. The slowdown of the dynamics in aggregate demand in the United States is accompanied by key interest rates coming down. Despite all risk factors, we anticipate the American economy to retain some growth potential and thus contributing to the growth of international trade.

The development in the countries of the EU and the Czech Republic is most significant for the future development in ex-



ports from Slovakia. Given the great weight of the imports from Russia, the development in world prices of oil is one of the risk factors. The weakening of the trade links between the Czech Republic and Slovakia is caused by similar orientation to markets of the advanced countries and the problems experienced in cooperating companies. Despite this, the share of CEFTA countries in Slovak foreign trade takes a prominent position. These trends lead to a preference of taking into consideration the developments in the Euro zone. We anticipate the economic boom in our major trading partners to continue, albeit on a slightly reduced level in 2001 and further growth in the following years. The foreign trade development of Slovakia will, to a great extent, depend not only on external demand but on the competitiveness of the Slovak producers and exporters.

### **The forecast of the development for 2002 with an outlook until 2005**

#### **Consumer prices**

The main factor that will exert significant anti-inflationary effect will include monetary policy and the growth in import prices. These will grow, particularly as a result of the rising world prices of food and raw materials. This development, however, will not be similar to the extremely sharp growth in oil prices in 2000. Another factor that may have an effect on price development will be the growth of the nominal wage. On the part of fiscal policy we do not envisage applying equally radical instruments as those in the second half of 1999 and in early 2000. We expect the application of moderate deregulations, changes in tax rates or other fees, but not having such significant inflationary impacts as those in 1999 and 2000. We envisage the increase in prices also with regard to the adjustment of the price level of Slovakia to that of the EU. Taking into account these assumptions, we predict the inflation for 2002 at 6.4 percent.

#### **The labour market**

Slow consolidation of manufacturing enterprises, the privatisation of the banking sector and telecommunications, the restructuring of the railways and other state monopolies, raises a tangible problem of the reduced demand for labour. The development of institutional policies does not give evidence of a real support of small and medium size business. The overall economic environment does not indicate an interest to increase demand for labour. The demand for labour can only arise in consolidated companies with clarified ownership relations. On the basis of these assumptions, we do not anticipate any significant increase in demand for labour. We maintain that the newly created employment opportunities, the growth of which is expected, will not be capable to fully absorb the loss of jobs anticipated. The number of workers of the economy according to statistical records will be slightly higher in 2002 than in 2001 (2,043 thousand workers – a growth of 1.5%). According

to the Labour Force Survey, the employment will reach the level of 2,158 thousand employees. Our forecast for 2002 of the average rate of unemployment based on the Labour Force Survey is 18.4 percent. The development in the demand for labour, which we anticipate for the period of 2002 to 2005, as well as the development in the supply of labour will keep the rate of unemployment based on the Labour Force Survey and also the rate of unemployment calculated from the number of unemployed available for work, at the level of 18 percent. In reporting of particular kinds of unemployment, we assume a gradual convergence and a stabilisation of fluctuations of these two methods.

With regard to the development in labour productivity, companies will favour wage growth to recruiting new employees. In the view of gradual spending of stimulating restrictive measures and the increase in dynamics of wage development we predict a 7.6 percent nominal wage growth for 2001. With the inflation at 7.3%, it will lead to the growth in real wage by 1.0 percent. In further years (2002 – 2005) we anticipate the development in nominal wage, somewhat more than proportionally, to take account of the price growth, which will secure progressive growth in real wage of around 2 percent.

#### **Foreign trade and the balance of payments**

For the future we assume factors that will exert influence upon decreasing the rate of growth in imports and exports of goods and services. The reduction of import surcharge to 0% will have an unfavourable effect on the hitherto development in the deficit of the balance of foreign trade. For 2002 we project the growth in imports of goods and services at constant prices to come down to 8.8%, compared to the projected 15.6% for 2001. The growth rate in imports of goods and services will fall to around one-half, or 9.5% in 2002, against 18.3 percent. This development may be expected as a result of the development in domestic consumption, which is, to a considerable extent, met by the import. The nominal deficit in the balance of goods and services will aggravate to 67 billion SKK, its share in GDP in 2002 will rise to 6.2%, against the projected 5.4% for 2001.

The export of goods and services, at constant prices, will be growing in the period between 2003 and 2005 at 7.2 to 9.9 percent. There are factors in the future, however, that might increase these rates of growth. One of them, for example is the increased competitiveness of Slovak products abroad, or greater weakening of the Slovak crown against the dollar and the euro. The growth rate in imports of goods and services will fluctuate at the levels of 7.1 to 9.5 percent. It will mainly be affected by the development in domestic demand and the import intensity of, both, the export and the domestic demand.

The current account balance of payments will be negative by the end of the projected period, at the level of 6 to 7 percent of GDP. We anticipate the capital and the financial account of the balance of payments to be positive, thus contributing to a slight surplus in the balance of payments account. We expect the surplus of capital and financial account to be due mainly to the inflow of direct foreign investment.

### The monetary development

Owing to the need to have adequate volume of money to meet the overall needs of financial transactions, we expect in 2002 a growth in the money aggregate M1 by 13.3%, amounting to 266 billion SKK. In the following years, in consequence of the likely development in interest rates of time bank deposits, and the growing need to service financial transactions (in connection with the growth in nominal pensions and output), there will be a growth in the volume of money M1 of 9 to 20 percent.

In the development of money in circulation outside banks M0, as a sub-aggregate of M1, we do not anticipate the impact of the development in time bank deposit interest rates. In 1999 the significant growth in the money supply in circulation outside banks, by 16% , was due to the transition to 2000 (as of November 1999 only + 4%), the parameter M0 increasing 17% in 2000. For 2001 we expect a 19% rate of growth, and for 2001 we predict the growth rate in M0 at 17.5%, with the volume of 93 billion SKK. This growth will be within the range of 18 and 19 percent in the further years under review.

For 2001, mainly as a result of further decrease in interest rates, we expect a corresponding increase in the volume of demand deposits of population by 32%, amounting to 71 billion SKK. For further years under study, we predict a growth of 21 to 30% annually. This growth will be due to the development in the wage settlements of population, coupled with the competitive effect of time bank deposits, but also the development in foreign currency deposits of the population. For 2001 we anticipate the non time bank deposits of the population to grow 26%, to 84 billion SKK. The growth in the nominal aggregate demand will raise the volume of transactions, which will cause increase in the volume of demand deposits of companies

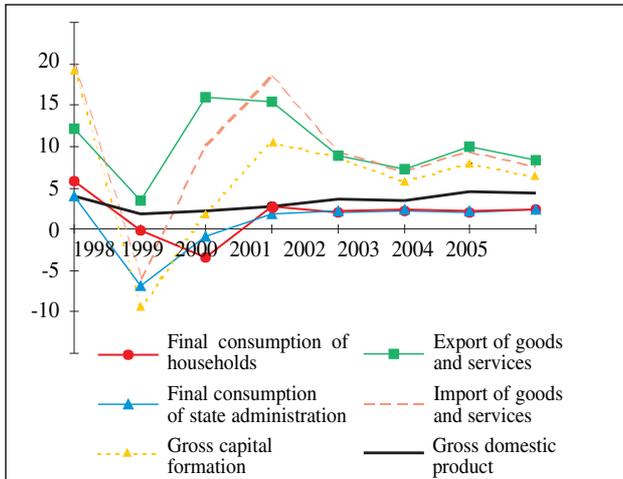
and insurance companies. For the following period we anticipate a stagnation to gradual decline in their volume. It will be caused by the shift of part of potential resources from foreign currency deposits (primarily dollar ones), in part also to time deposits.

The volume of time bank deposits of the population will show a growing trend, though at lower rates of growth than in the past years. It is the consequence of the decline in employment and the real wages in 1999 and 2000. After a significant growth in time deposits of the population in 1998, by 16%, and that of 1999, by 13%, their rate of growth in 2000 was only 5 percent. It is closely linked to the decline in interest rates on time deposits of households. In 2001, mainly due to going back to the growth in real wage, which will be accompanied by further decline in interests rates, their growth rate will only be 4%, to 261 billion SKK. In 2002 to 2005, they will grow 5 to 10% annually.

The volume of time bank deposits of companies came down significantly in 1998 as a result of devaluation expectations, whereas in 1999 and 2000 these deposits increased significantly, which was due to the stabilisation in the rate of exchange and the economic situation in the corporate sphere. Their growth is bound to continue in 2001, though at a slightly lower rate of growth, namely by 23%, to 93 billion SKK. In the further period, their growth will be reduced from 22 to 20 percent.

From the forecast of liquid liabilities of the monetary survey, at the current rate of exchange results a prediction of the money aggregate M2 at the current rate of exchange for 2001 in the volume of 705 billion SKK and the year-on-year rate of growth of 16%, which in the view of the growth in nominal GDP by 11%, may be considered to be an expansive monetary

Indicator	2002	2003	2004	2005
Rate of inflation (%)	1.6	1.7	1.9	2.0
Average number of workers in the SR economy in mil. persons	2 043.4	2 054.0	2 088.3	2 137.4
Number of employees. in mil. persons. according to the Labour Force Survey	2 157.6	2 168.7	2 205.0	2 256.7
Rate of unemployment in % (according to the Labour Force Survey)	18.4	18.7	18.7	18.0
Average monthly wage of workers in the SR economy in SKK	13 296	14 297	15 652	17 214
Balance of exports and imports of goods and services in current prices	-67.1	-83.4	-91.6	-94.3
Liquid liabilities M2 in billion SKK	794.5	886.2	1 002.2	1 172.4
Gross domestic product in constant prices of 95	710.9	735.6	768.6	802.6
Rate of GDP growth in constant prices of 95 in %	3.6	3.5	4.5	4.4
Rate of growth in final consumption of households in constant prices of 95 in %	2.0	2.2	2.1	2.4
Rate of growth in final consumption of state administration in constant prices of 95 in %	2.2	2.3	2.3	2.4
Rate of growth in gross capital formation in constant prices of 95 in %	8.7	5.7	8.0	6.3

**Growth rates for particular components of GDP**

Source: Statistical Office of the SR, a forecast.

development. For the years 2002 to 2005, with regard to maintaining expansive monetary policy, we predict the rate of growth in the money supply M2 in the range of 13 to 17 percent. With the growth in nominal GDP at the level of 10 – 11%, it will be determined by the expected resumed relative reduction in the fiscal expansion.

The development in the lending to companies and households will have lower dynamics in the forthcoming years than the overall assets. In 1998 and 1999 credits to companies and households were moderately rising, in 2000, their volume stagnated. For 2001 we predict the companies and households credit volume at 434 billion SKK, with a year-on-year growth of 6 percent. For further years of 2002 to 2005, for reasons of decreasing the relative deficit of the economy and the expansive monetary policy, the rate of growth in credits to companies and population will be 10 to 17 percent.

**Gross domestic product**

The present development in the Slovak economy is influenced by the expectations of the growth in domestic demand and, at the same time, by the uncertainty of the development in external demand. The prediction of the development in GDP has been arrived at through a model analysis of aggregate demand components. The results of the forecast are given in constant prices of 1995. The table contains the prediction of the development in the main macroeconomic indicators.

A decelerated inflation development and the growth in domestic demand should become the factors of pro-growth development of the Slovak economy in 2002. The projected rate of growth in domestic demand (4.3%) will not be conducive to a more profound increase in the dynamics of the economy. The growth in domestic demand within the interval of 3.5 to 4.5% from 2003 will be a sustained factor of the GDP growth. A moderate increase in internal demand, unlike that in the years 1996 and 1998, will not result in extreme disequilibria in the economy. The dynamics of GDP would still not achieve the level of 5%, whereby we would not approximate sufficiently

with our characteristics the countries of the EU. The growth of the economy based on the growth in domestic demand must be supported by greater competitiveness of domestic businesses and weakening of the non market demand impulses.

The rate of growth in household consumption at 2.8% in 2001 will entail a more significant demand impulse after two years of decline. The payment of the National Property Fund bonds to the population and subsequent short-term preference of consumption over savings should become a factor of increased growth. The slow public administration reform and the deficit state budget will assist in maintaining the purchasing power of a section of consumers. There will be adverse factors in the area of the labour market acting against the growth in consumption of households. The development in employment and wages will not encourage any significant stepping up of the growth in consumption of households in 2002 to 2005. The development in household consumption will, to a great extent, be reduced by the projected greater price growth. The weight of the household consumption in GDP, unfortunately, will be falling throughout the whole projected period. The inertia of the consumer conduct is reflected in the several-year levels of the share of household consumption in the gross disposable income, at 88 percent. However, the changes in consumer conduct will increase the share of consumption to a level just under 90 percent.

The positive effect of controlled decreased demand in public sector in 2000 contributed to the overall reduction of interest rates, which subsequently decreases the cost of financing the state debt. The increase of the fiscal deficit to 38 billion SKK will encourage final consumption of government in 2001 but will also be a factor limiting further cuts in interest rates. The growth in tax and not-tax revenues following from improved performance of the economy will support the growth of public consumption. This growth however, will be lower, given the progressive and long-term reduction of tax burden. In further years, the development in public consumption will depend on the government priorities in the reforms and the accession process to the EU and the NATO. Based on the anticipated development in state budget deficits, the estimated development in the state budget revenues and the priorities of the government we predict a growth in the government consumption at an interval of 2 to 2.4 percent. According to the projected development there would be gradual decrease in the weight of government consumption in the GDP, from 19% in 2001 to 17.8% in 2005. This decrease would be a reflection of the predomination of GDP dynamics over public consumption dynamics.

The growth in gross fixed capital formation, after a decline in 1999 and the stagnation in 2000, is likely to become a positive factor of the future development. We predict a significant increase in 2001 to a level of 12.3%, and oscillations at the level of 8 to 9% in further years. Stronger barriers in the access to financing for non performing companies on a longer term, will hinder a more significant acceleration of the dynamics of the economy. The main negative impact of the growth in investment activity will be the upward pressure in the import. A more significant growth of profitability of businesses and the

acquisition of resources in the capital market would contribute to a higher rate of investment than the one predicted. The difficulty of projecting foreign investment and the capital spending of the state budget brings about uncertainty in estimating future development in gross fixed capital formation. The size of capital spending of the state budget will be influenced mainly by the political cycle and the budgetary control. The investment of businesses and households will be determined, to a great extent, by the business climate and the policies of the National Bank of Slovakia, coupled with the banks involvement. The need for competitiveness in, both, domestic and foreign markets will call for increased investment activity. The higher growth of the gross capital than GDP will entail its increased weight in the GDP, to 37.3% in 2005. The model generates trends of decreased weight of the consumption by households and the government, with a growth in the weight of the gross fixed capital formation. With effective allocation of capital, this creates prerequisites for the growth of competitiveness.

The assumed continuation of the world economy's boom, coupled with sustained competitiveness achieved in exports from Slovakia, will be the base for 15% growth in exports in 2001. In 2002 to 2005, exports should be stabilised at 7 – 10% interval. Following the relaxation of restrictions on imports, the growth of imports in 2001 will go up 18% and in 2002 to 2005 it should be within the interval of 7 to 10 percent. Higher imports may be expected as a result of greater involvement of foreign investors, increased internal demand and a reduction of barriers to import. Resulting from the development in exports

and imports will be the anticipated worsening of the foreign trade balance in 2001. The increased dynamics in internal demand and the stagnation in foreign markets may result in the deficits of trade in goods and services in 2002 to 2005, at an interval of 19.2 billion SKK to 23,4 billion SKK (in constant prices of 1995).

The sustained, slightly increased rate of GDP growth, between 2.8 to 4.5%, will be the result of the rejuvenation of the Slovak economy and the increased dynamics of imports.

### Conclusions

Compared to the growth of the economy in the past years, both the amount and the structure of growth will be changed. In the forthcoming years, the export generated growth in 1999 and 2000 will be replaced by a growth, primarily made up of domestic demand. The net export will be favourably influenced by the restricted domestic demand, the favourable outlooks in external demand, previous exchange depreciation and the stimulation measures of the government.

The achievement of the inflation targets will require close coordination of the monetary and fiscal policies. A joint effort will be necessary in order to consolidate the government and business finance. In connection with the accession to the OECD, Slovakia has assumed commitments, the implementation of which will have an effect upon the change of thought taking place in our institutions. Good timing of particular liberalisation steps will be a prerequisite for successful tackling of the whole process.