

Economic Trends 36

April 2003

Contents

Czech Economy: Spring 2003	2
Czech Interest Rates: Recent Developments	4
Slovakia Before EU Entry	8

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CZECH ECONOMY: SPRING 2003

Kamil Janáček
Eva Zamrazilová

Economic Growth

Final 2002 figures for Gross Domestic Product revealed a more significant slowdown than had been generally expected. Czech economy continued to grow at a bit slower pace in Q4 of 2002 and the full year growth 2.0 % was under the market expectations (2.5 %). The slower growth was influenced by following factors:

- trade with services deteriorated due to August floods and higher purchases of services abroad (commercial, law, advertisement, financial etc.),
- demand for exports remained weak due to low growth dynamics in the EU countries,
- strong CZK led to increased imports and thus diminished demand for domestic-produced goods.

The main growth factor of GDP was domestic demand (4.4 %). Consumer demand remained solid increasing by 3.8 % y/y. Government demand grew by 5.7 %. Investment demand increased by only 0.6 % investment of machines by 1.7 %, construction investment practically stagnated (0.2 %).

Industry continued in solid growth in the beginning of 2003. The industrial output increased by 5.8 %, in the first two months of 2003. Deepening differences have been registered between primary and manufacturing industries. While output in primary industries increased by only 1.6 %, manufacturing grew by 5.5 %. As for manufacturing industries, electronics, car industry and manufacture of oil and coke products grew most significantly (by 7.5 %, 11.1 % and 7.6 %, respectively). It is still true, that the companies under foreign control pull the industrial output due to solid export performance. On the other hand, textile and leather industries continue to decline.

The construction figures for the first two months of 2003 seem to be rather confusing. The

construction output declined by 3 %, January to February 2003. Statistical data are not clear enough to summarise whether this drop was mainly due to the decline of construction works abroad (by more than 80 %), bad weather conditions (low temperatures) or whether a new, less favourable phase of construction development has been emerging.

The recovery of housing, helped by low interest rates on mortgages seems to continue in 2003, nevertheless, this segment of construction is too small to pull the construction output.

Private consumption seems to remain strong in 2003. The growth of retail sales in the first two months of 2003 amounted to 3.9 %. We are witnessing the revival of car sales both in the Czech Republic and in Europe which should be helpful not only for Czech retail trade but also for car producers.

Foreign Trade and Exchange Rate

The trade deficit amounted to CZK 7.1 bill, in the course of first two months of 2003, up from CZK 3 bill. in the same period of 2002. The reason of the deterioration was more rapid growth of imports (5.7 % y/y) against the exports (3.8 %). The acceleration both of imports and exports was caused predominantly by depreciation of CZK. Higher world oil prices were another factor supporting imports, nevertheless, not the dominant one: machinery and transport imports grew at above-average pace.

In the first quarter of 2003, the Czech currency depreciated by 1.8 % against the EUR and appreciated by 4.1 % against the USD (compared with the end of 2002). Slight depreciation of the CZK against the EUR was the consequence of the cut of basic interest rate – repo rate - by 25 basis points, made by CNB at the end of January 2003. After this move, the CZK oscillated in the range between 31.5 and 31.9 for the two following months.

Czech economy continued to grow at a bit slower pace in Q4 of 2002 and the full year growth 2.0 % was under the market expectations (2.5 %).

Industry continued in solid growth in the beginning of 2003. The industrial output increased by 5.8 %, in the first two months of 2003.

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Table 1: Main Macroeconomic Indicators

		1999	2000	2001	2002	01/03	02/03	03/03	2003F
Inflation	%, y/y	2.1	3.9	4.1	0.6	-0.4	-0.4	-0.4	2.0
Inflation	%, m/m	-	-	-	-	0.6	0.2	-0.1	-
Industrial prices	%, y/y	3.4	5.0	0.8	-0.7	-0.8	-0.7	-0.4	1.5
Industrial prices	%, m/m	-	-	-	-	0.0	0.4	0.3	-
Unemployment rate	%, eop.	9.4	8.8	8.9	9.8	10.2	10.2	10.0	9.8
Industrial production	%, real	-3.1	5.1	6.8	4.8	6.4	5.2	n.a.	4.5
Construction output	%, real	-6.5	5.3	9.6	2.5	-2.0	-3.6	n.a.	5.0
Retail sales	%, real	2.1	4.6	4.3	2.7	4.4	...	n.a.	3.5
State budget*	CZK bill.	-29.6	-46.1	-67.7	-45.7	-10.4	-24.9	-31.8	-120
Trade balance	CZK bill.	-69.9	-120.8	-119	-74.5	-2.8	-4.3	n.a.	-80
FOREX reserves	USD bill.	12.9	13.1	14.8	23.7	24.5	24.6	24.7	24.0
PRIBOR 3M	% average	6.85	5.36	5.2	3.55	2.65	2.45	2.39	2.7
CZK/EUR	Average	36.88	35.6	34.1	30.81	31.49	31.65	31.76	30.5
CZK/USD	Average	34.60	38.6	38.0	32.74	29.65	29.37	29.39	29.5
GDP	%, y/y	0.5	3.3	3.1	2.0	n.a.	n.a.	n.a.	2.8

Source: Czech National Bank, Czech Statistical Office, forecasts by Komerční banka (bold figures)

Inflation

In the first quarter of 2003, the disinflation trend continued despite higher world oil prices and standard deregulation of prices at the beginning of the year. The yearly CPI reached record-low in the history of the Czech Republic, being at the lowest level in the past twelve years. From January to March, year-on-year CPI stood at -0.4 %. The effect of rising oil prices on consumer prices was set-off by the decline of food prices. Prices of food are kept by the decline in agriculture prices due to low demand and increasing competition of cheap imports.

On the other hand, increasing world oil prices started to affect the development of producer prices. Although producer prices still stood in the deflation range at the end of first 2003 quarter, the upturn from -0.7 % in February to -0.4 in March was quite significant signalling the return of year-on-year PPI above zero.

Unemployment

The labour market followed regular seasonal trend in the first quarter of 2003. The unemployment rate exceeded the 10% level in

January and February 2003 declining to 10 % at the end of first quarter. At the same time, the number of unemployed has been exceeding the half million bar for several months.

The main reason of increasing number of unemployed has been continuing dismissals (for more than one and half year) in industry. While the employment does not decline in the service sector, the absorption capacity of the services is not sufficient to create enough new job opportunities - partly due to overall low level of conjuncture. Nevertheless, strong pressures on the labour market still preserve due to mainly structural reasons. Even those companies demanding new labour force cannot find workers with appropriate qualification. Almost three quarters of unemployed have only basic (or unfinished secondary) education.

Outlook

Despite the end of the Iraq war, the immediate outlook for the world economy is rather gloomy. The major international institutions have been postponing the long expected recovery of the EU ever since. For the time being, the recovery does not seem probable to come before the end of 2003.

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Especially, this apply for the Czech major trading partner, i.e. Germany. Both the German government and the independent institutes are cutting their GDP 2003 forecasts from 1.4 % to 0.4 – 0.6 %. It is obvious that each reduction in growth forecasts represent a potential loss of Czech exports.

The export outlook and investment climate in the Czech Republic will thus improve only very slowly and slightly. The main driving force of the Czech economic growth will remain consumption – both private and public. We still expect that some moderate improvement of exports and domestic investment demand in the last quarter of 2003 will lead to a slight acceleration of GDP to 2.8 %. Industry will grow approximately by the same pace as in 2002 – the industrial output will increase by 4.5 %. The outlook for construction is nowadays somewhat uncertain but we still expect growth between 4 and 5 %.

Consumer prices – after several months being under zero – will continue to rise again. First, it will be the case of transport and fuel prices. Also we can expect the reversal in the declining trend of food prices. In 2003, we expect the year-end inflation to be slightly under 2 %, and average inflation around 1 %. The growth of producer prices will be in the range 1.5 – 2.0 % at the end of 2003. The inflation development will not affect the monetary policy of the Czech National Bank, at least in the near future.

The recovery of imports in the first two months of 2003 cannot be attributed to increasing oil prices, only. We must wait at least for several next months to conclude whether this short-term tendency will assess and will affect the full-year results. The exports trends go along with the expectations from the beginning of the year: they are attenuated due to weak foreign demand. Nevertheless, one part of exporters (in the first place firms under foreign control) is still able to register solid export growth. For 2003, our forecast of trade balance deficit is at CZK 80 bill.

CZECH INTEREST RATES: RECENT DEVELOPMENTS

Eva Zamrazilová

There was a sharp decline in all interest rates in the Czech Republic in the last three years. The first wave came in 1998 and 1999, and the second wave began in 2001. In the last two years, the monetary policy became more transparent and accommodative, responding to economic developments to a greater extent than before.

Repo Rate Developments

The basic Czech interest rate – the two-week repo rate – was changed most significantly in 1998 and 1999, when it was reduced by 10 % over one and a half years: from 15.25 % in March 1998 to 5.25 % in November 1999. The difference between the repo rate of the Czech National Bank and the refi rate of the European Central Bank (ECB) was 5.5 percentage points at the beginning of 1999, and a mere 2.25 points at the end of the same year. And so in 1999, the repo rate came closer the main ECB rate by more than 3 percentage points – the ECB kept the refi rate throughout the year at the level set at the moment the EUR was introduced, i.e. on 1 January 1999.

Pressures for easing Czech monetary policy in 1998 and 1999 was mainly due to the sharp decline in inflation. Reasons for the low inflation were the slow development of prices abroad, low prices of raw materials on world markets, and the Czech economic recession, which began to abate slowly in the second half of 1999. In 1998 and 1999, the Czech National Bank undershot the inflation target. Net inflation was by almost 4 percentage points below the bottom limit of the target in 1998 and by 2.5 percentage points lower in 1999.

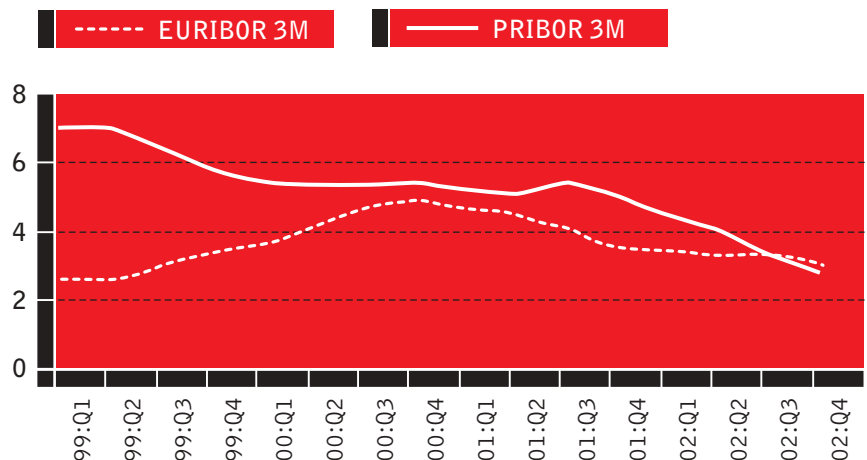
The repo rate remained stable in 2000; it stood at 5.25 % for almost 15 months from November 1999 to February 2001. At that time, the basic Czech interest rate was approximately

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Figure 1: PRIBOR and EURIBOR



Source: ECB, CNB

2 percentage points below the ECB refi rate. The inflationary target was again undershot in 2000, but the extent was more moderate. Temporary acceleration in inflation was recorded in the summer of 2001, and the central bank consequently increased rates – the two-week repo rate rose from 5 % to 5.25 %. Inflation dropped again in the autumn, and so the CNB reduced the basic rate again – this time to 4.75 %.

From the third quarter of 2001, inflation was on a steady decline due to the favourable development of raw material prices on world markets, combined with low demand generally. The crown strengthened sharply in the first half of 2002, and the CNB responded with its instruments – verbal and direct interventions, and several reductions in the main interest rates. In the first half of 2002, the repo rate was reduced from 4.75 % (January 2002) to 3.75 % (end of July 2002). From July 2002, the crown weakened slightly. At the beginning of November 2002, the central bank reduced the basic rate by 0.25 percentage points, which pushed the repo rate to 2.75 %. The central bank reduced basic interest rates five times in 2002.

The last cut (for the time being) came at the end of January 2003, placing the basic Czech interest rate at its record low (2.50 %), and to the level of basic interest rate in the eurozone. The small and opened Czech economy is ever

more intensively integrating into the European economy, and this is one of the causes of the approximation of the main interest rate in this country and the eurozone.

Interest Rates on the Inter-bank Market

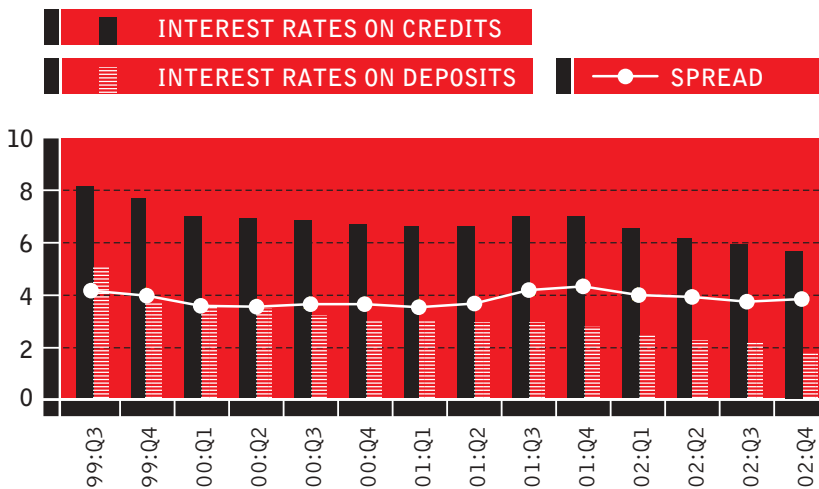
The development of the basic interest rate at which firms borrow money, the three-month PRIBOR, and its Eurozone counterpart, the three-month EURIBOR, is illustrated in Figure 1. The difference in interest rates compared with the Eurozone was at its peak in early 1997, when it exceeded 15 percentage points. In the next two years, the difference declined rapidly to some 6 percentage points at the beginning of 1999. Later on, the decline was slower but stable, and the difference between the two rates was negligible at the beginning of 2001. In the third quarter of 2001, the central bank raised basic interest rates in response to the extremely strong crown. This caused a temporary increase in the 3M PRIBOR, and in turn for a short time increase of the interest difference between PRIBOR and EURIBOR.

In 2002, the development of the two inter-bank interest rates differed. EURIBOR rose slightly in the first half of the year especially at its beginning as a consequence of the introduction of the EUR, which was connected with a bigger rise in inflation

The small and opened Czech economy is ever more intensively integrating into the European economy.

The difference in interest rates compared with the eurozone was at its peak in early 1997, when it exceeded 15 percentage points.

Figure 2: Interest Rates and Spread



Source: Czech National Bank

in the eurozone. EURIBOR somewhat declined in the third quarter of the year. PRIBOR dropped in 2002, from 4.55 % in January to 2.9 % in October, in connection with the general easing of Czech monetary policy. The main interest rate, at which Czech firms borrow money, is now at a record low of 2.4 %. Compared with the European Union, there was the same turn as in the difference in inflation – PRIBOR is now lower than EURIBOR.

Deposit and Credit Interest Rates

The bank interest rates for all economic entities – enterprises, households, and citizens – are derived mainly from the basic interest rates of the central bank. And so, credit and deposit interest rates more or less copy the main interest rates (see Figure 2) but the credit interest rates copy the repo rates and PRIBOR more closely. Whereas deposit interest rates have been in constant decline in the last three years, credit interest rates have been fluctuating in accordance with the repo rate and PRIBOR. The interest rates margin of Czech banks constantly ranges around 4 %.

The most interesting interest rates for the clients have been the real rates of interests on term deposits. The average term deposit real rates have been rather in the negative zone throughout the history of the Czech Republic. The net interest rates, i.e. rates after taxation adjusted for the

inflation have been decisive for the depositor. Figure 3 shows that real rates of interest on term deposits were highest in 1998 and 1999, when they were approximately around 2 %. They declined in the following years, and the real rate was about – 1 per cent in 2001. In 2002 they seemed to be in the positive range, again. The low real rate of interests on deposits was one of the reasons for shift from deposits to other products on the financial market (additional pension insurance, building savings, life insurance, etc.) Moreover, these low real rates indirectly supported the growth of consumer credits. Further reduction of interest rates would be a great risk for the deposit market.

The effect of interest rates on the real economy is best demonstrated by the rate of interest on new credits. It is evident that these rates were declining in 2001 and 2002 more rapidly than rates of interest on deposits and overall credits. From the beginning of 2002, rates of interest on new credits dropped by more than 1.5 percentage points, whereas rates of interest on overall credits dropped by a mere 1 percentage point. The eased monetary policy thus gave the Czech banks the possibility of granting credits to enterprises with good prospects and good projects.

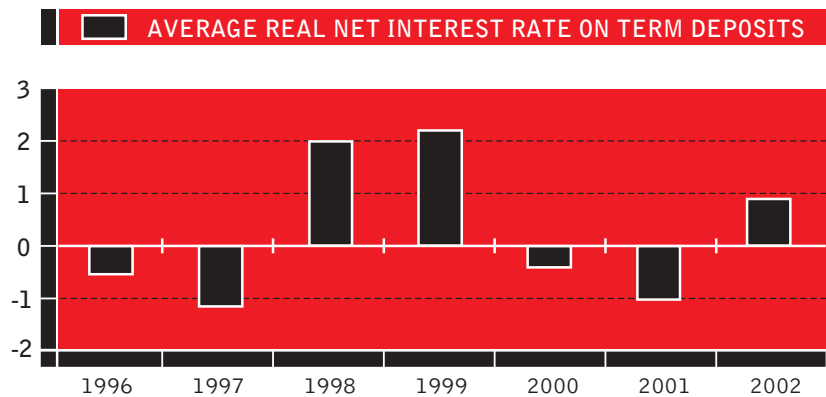
The credit crunch, which had been troubling the Czech credit market almost until the end of

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Figure 3: Average Real Net Interest Rate on Term Deposits



Source: Ministry of Finance

2000, was naturally not due to the actual nominal or real interest rates, but to a crunch of the credit transmission mechanism, caused mainly by problems in the banking sector combined with the bad financial health of the Czech business sector. Let us recall that the important reduction in interest rates in 1998 and 1999 did not boost the issuing of new credits. The Czech banking sector is now almost fully consolidated, banks having sufficient liquidity, and credit-related problems are concentrated mainly on the side of demand.

Following a hesitant start-up in the second half of 2000, the increase in new credits was definitively restored in 2001. In 2002, new credits rose by more than 10 %, while credits granted to households rose more rapidly, by 40 per cent. It is noteworthy that the rate of interest on new credits for households is more than twice as high as the rate of interest on new credits for enterprises (9.7 % and 3.5 %, respectively, in February 2003). The most rapid growth is recorded in consumer credits, which totalled around CZK 50 billion at the end of 2002.

In 2002, new credits granted to the business sector were rising at a good pace around 10 %. New credits granted to enterprises amounted more than ten-fold of the volume of credits granted to households. And yet, the actual

volume of new credits granted to enterprises is rather underestimated – due to the constantly insufficient institutional guarantees for creditors, banks often prefer such products as leasing or factoring. These products do not involve the problem of demanding guarantees.

The restored granting of credits combined with the low interest rates is a positive factor in prospects of the growth of the Czech economy. This does not apply only to the restored growth in credits for the business sector – growth in consumer credits also boosts the economy. The sharp reduction of interest rates in 2002 has not been fully effective as yet – this can be expected in 2003.

In 2003, we expect only a slight rise in consumer and producer prices. The average year-on-year increase in consumer prices at the end of 2003 is estimated at 1.6 to 3 % by the Czech National Bank, and at 2.5 % by analysts. The medium-term trend of the strengthening of the Czech currency will continue concurrently. Forecasts of interest rates are usually very uncertain, but they will probably remain low – at least in the first half of 2003 – at a level similar to those of the second half of 2002. This is supported by the development of ECB rates. The eurozone also expects low inflation in 2003, combined with a weak economic growth.

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SLOVAKIA BEFORE EU ENTRY

Kamil Janáček

Slovakia has been speeding up structural and institutional reform in view of the European Union accession oncoming in May 2004. Re-election of the right-wing coalition in September 2002 parliamentary elections has opened a better space for the long-postponed, unpopular but necessary reforms.

Referendum on EU accession will take place on May 16th and 17th (that is, one month before similar referendum in the Czech Republic). EU accession enjoys a wide support (about 70 % of the population is for the accession). Some problem may occur with respect to voter participation: under Slovak law, at least 50 % of voters must participate, for the referendum to be legitimate. In none of the five previous Slovak referendums, such participation was achieved. Opinion polls however suggest that this time, the 50 % participation will be surpassed.

In 2002, the Slovak economy went on with successful catch-up, both with respect to EU and to Slovakia's more advanced Central-European neighbours (Hungary, Czech Republic). Slovak economy was the fastest-growing one within Central Europe – with GDP growth of 4.4 % (see Table 1). Growth was spurred by domestic demand, as well as by exports – especially in the second and third quarters of 2002. On the other hand, fixed capital investment slowed down significantly compared to 2001 – in 2002, it practically stagnated. The reason was to be seen in lack of confidence of foreign investors with

respect to the outcome of parliamentary elections, leading to postponement of some envisaged projects.

GDP growth, as said, was driven by domestic and foreign demand, and was accompanied by a solid growth of industrial output, as well as by a revival in construction (see Table 2). The table also shows that long-term problems persist with unemployment, and with the twin deficits (in current account and public finance).

The double-digit unemployment rate was typical of the whole period of existence of Slovakia. It is, rather, a structural problem than a cyclical one, as the unemployment rate remains within the interval of 15 – 18 % regardless of the rate of GDP growth. Moreover, a gracious social system (compared to the economic strength of the country) did not much stimulate the unemployed to seek actively a new place in the labour market; many of them preferred, and still prefer, living on social or unemployment benefits.

Measures gradually taken by the Slovak government include also stricter conditions for unemployment benefits and social care. Their aim is both to reduce the deficit of the social chapter of public budgets, and to stimulate the unemployed to be more active in the labour market. It is too early to evaluate the results, but the reaction of trade unions is highly negative, suggesting that positions in collective bargaining can become harder, and even higher strike activity in Slovakia cannot be excluded.

As mentioned already in Economic Trends 35,^{*)} resolute steps of the new Slovak government in starting the reform of public finance, and in

Table 1: GDP Growth, 1994 – 2002
(constant prices, growth rates in %)

1994	1995	1996	1997	1998	1999	2000	2001	2002 ¹⁾
5.2	6.5	5.8	5.6	4.0	1.3	2.2	3.3	4.4

¹⁾ Preliminary

Source: Slovak Statistical Office

^{*)} Economic Trends 35, Komerční banka, February 2003, p. s.

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Table 2: Main Macroeconomic Indicators, 1997 – 2002

	1997	1998	1999	2000	2001	2002
GDP (growth rates in %)	5.6	4.0	1.3	2.2	3.3	4.4
Industrial Production (growth in %)	2.7	4.8	-3.1	9.0	4.6	6.3
Construction Output (growth in %)	8.0	-4.6	-25.8	-0.4	0.8	3.4
Inflation (average, in %)	6.1	6.7	10.6	12.0	7.3	3.3
Unemployment Rate (end of period, in %)	12.5	15.6	19.2	17.9	18.6	17.4
Public Finance Deficit (% of GDP)	4.8	5.1	3.5	12.5	5.4	7.5
Current Account Deficit (% of GDP)	9.3	9.1	4.9	3.6	8.6	8.0

Source: Slovak Statistical Office

further price deregulation, are to cut the public finance deficit from 7.5 % of GDP in 2002 to 5 % in 2003, and to 2.8 % in 2006, so that Slovak Republic could fulfil the Maastricht criteria of nominal convergence and be ready to join the EMU in 2007.

Monetary Policy

Since the start of last quarter of 2002, the Slovak koruna has been appreciating continuously (see Table 3). That trend continues so far in 2003: at the start of April 2003, the Slovak koruna exchange rate was 40.1 SKR/EUR.

However, The National Bank of Slovakia has so far decided not to alter the basic repo rate, keeping it at 6.5 %. The reason was the relatively dynamic growth of both industrial output and GDP in the last months, as well as the perceptible increase of inflation in the first quarter of 2003. Inflation grew from the end-year level of 3.3 %

in December 2002 to 8 % in March 2003. The price rise was due to a resolute deregulation of energy prices and rents, and to an increase of the bottom VAT rate from 10 to 14 %. A significant increase of retail prices (and, due to deregulation, also of wholesale prices) will characterise the whole of 2003, and will lead the central bank to a fairly cautious stance. Another cut of the basic repo rate will thus be likely, rather, within the horizon of two or three quarters, depending on further developments of the trade balance and the koruna exchange rate.

Outlook

Industrial production and external trade continue to grow dynamically at the start of 2003, in spite of the low business activity in European Union countries, and of the further appreciation of Slovak koruna. If these positive achievements continue, GDP growth in Slovakia will be within the interval of 3.5 – 3.8 % over 2003.

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Table 3: Exchange Rate of Slovak Koruna, 1997 – 2002

	1997	1998	1999	2000	2001	2002
SKK/EUR, average	37.93	39.23	44.05	42.54	43.28	42.70
SSK/USD, average	33.62	35.23	41.36	46.20	48.36	45.30
Nominal effective exchange rate (1995=100)	108.1	104.3	94.4	96.8	93.7	93.6
Real effective exchange rate (1995=100)	107.6	108.1	106.4	118.9	119.1	120.4

Source: Slovak Statistical Office

Table 4:Trends in 2003

	January	February	March
Industry (growth rate, %)	12.6	8.7	...
Exports (growth rate, %)	20.0	19.8	...
Imports (growth rate, %)	8.2	11.9	...
Trade Balance (SKK bill.)	-0.83	-4.1	...
Inflation (% ,y/y)	7.3	7.6	8.0
Unemployment (%)	17.7	17.1	...

Source: Slovak Statistical Office

Continuing decrease of unemployment will in this year be based mainly on the novelised Employment Act, which sets stricter rules for unemployment benefits and forces the unemployed to seek a new job more actively. Economic growth will have small influence on the unemployment rate, as Slovak unemployment is predominantly structural, rather than cyclical.

Trends in interest rates and inflation indicate that the year 2003 (and, with high probability, at least half of 2004 as well) will be a period of negative real interest rates. Only a return of inflation to the level of 3 – 4 % can revert this situation.

What are the risks of present economic developments?

First, the continuing low level of economic activity in EU countries is the highest risk, with a quasi-stagnation in Germany. This could threaten the growth of Slovak exports and, finally, GDP growth. As distinct from 2002, one cannot expect in 2003 that domestic consumption, especially household consumption, will be a driving force of economic growth.

Second, the ongoing appreciation of Slovak koruna can have a negative impact, not only on exports (lower competitiveness) but on domestic producers as well (crowding out of domestic produce by cheaper imports).

Third, though a prevailing majority of Slovak

voters will vote for European Union membership, participation in the referendum can become a critical point (as the low participation in Hungary has shown). In Slovakia, should participation be under 50 %, the pro-European majority vote would not have a constitutional force. That would have a negative impact mainly on the growing inflow of foreign investment to Slovakia, and it would slow down the overall process of economic catch-up with EU countries.

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The ongoing appreciation of Slovak koruna can have a negative impact, not only on exports but on domestic producers as well.

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