

Ladies and Gentlemen,

Let me express my thanks to you for the OECD report which aims in a comprehensive and exhaustive manner to identify all the challenges and possible risks of the future development of the Slovak Republic after the adoption of the common currency. In principle, it is possible to agree with many conclusions of the OECD study. Nevertheless, let me discuss in detail some of the challenges related to our membership of the euro area, which issues have been dealt with in the report or presented on various forums.

As regards the risk of high inflation in Slovakia, or higher than until now, I believe that this risk is a common denominator for all countries. For the time being, inflation in the Slovak Republic is not significantly higher than that of the euro area. In May, Slovak inflation reached 4 per cent and HICP inflation in the euro area was 3.7 per cent, while the euro area inflation was 4 per cent in June according to a flash estimate. Therefore, we do not expect any significant negative real interest rates for now. At present, the real interest rates on loans have positive values in Slovakia (approximately 2 per cent) and are comparable with the real interest rates in the euro area. Similarly as in the euro area, the real interest rates on deposits are zero.

As far as nominal interest rates are concerned, we can agree with the OECD report that there will be convergence of customer interest rates in Slovakia with those in the euro area. In our opinion, however, this convergence will occur in a long run and it will be gradual and slow. As it can be seen in the individual member countries of the euro area, it may not show itself immediately in the years after the adoption of the common currency. With regard to the development of interest rates on loans for real estates in the euro area, as well as the expected growth of the ECB rates, the convergence of interest rates may occur also in an opposite way, i.e. the rates of the euro area may approach the rates in the Slovak Republic. With respect to the given facts, and in terms of the convergence of rates, we consider the estimation of the euro introduction effect on the population as optimistic, or hypothetical. We can, however, use it as reasoning and so help the government to make space for further consolidation.

What we find interesting, and at the same time equally beneficial as in the previous case, is the conclusion that the euro introduction shall have the smallest impact (both in absolute and percentage terms) on the annual expenditures of households of retired and unemployed people, as they consume the smallest proportion of non-tradable goods, the prices of which may increase as a result of insufficient competition. On the contrary, many institutions in the Slovak Republic mostly indicate these groups of the population as the most vulnerable ones with regard only to the process of the currency changeover itself, but not as to its impact on the real pensions. In this case, the psychological effect is probably more important, as there is the generally spread information about how much prices of small but frequently purchased (cup of coffee) products multiplied in the individual countries certain time after the euro introduction. Obviously, we try to take all measures to avoid this situation in Slovakia, although expectations, particularly those negative ones, are very difficult to change.

Further channel for the future faster growth of inflation, which is frequently mentioned, should also be the effect of real appreciation.

Based on the existing development, it is apparent that there has been an increase in the volume of the paid dividends which represented 4.4 per cent of GDP in 2007 compared with approximately 0.9 per cent of GDP in 2003. Such development is expected to continue in the medium term, which fact should dampen the existing dynamic appreciation of the real equilibrium exchange rate. As before, the faster growth of the labour productivity in Slovakia than in the euro area should not, consequently, exert pressure on the increase of the Balassa-Samuelson effect which was identified to have contributed less than 1 percentage point to inflation. The deviations of the actual development from theoretical assumptions of the Balassa-Samuelson effect (published in the banking magazine of the NBS) dampened the pass-through of the productivity differential in the consumer prices. Despite the converging nature of the economy, we assume that these factors will continue to operate. These our assumptions can be considered more-or-less similar to various published studies. At this point, let me please mention further reason why in Slovakia there is a difference between the calculated value of the Balassa-Samuelson effect and the real appreciation based on the HICP. During various periods of liberalisation and deregulation, regulated prices and consequent secondary effects have had a considerable impact on the strong growth of the HICP and inflation differential. Provided the real appreciation of the PPI manufacturing was considered, its average level between 2002 and 2007 would be 3 per cent.

When it comes to the analysis of the Slovak macroeconomic development, such development should be seen against a background of the particularity of the situation in which the Slovak Republic finds itself in regard to the expected euro adoption in 2009, which might determine to a certain extent the behaviour of economic agents. Despite a relatively high rate of competition within the retail market, it is possible that the costs associated with the euro introduction and the one-off nature (at the given moment) of the changes in the central rate could be the cause of the appreciation not being fully reflected in the development of prices. This impact of the exchange rate was analyzed and published (Biatec, 11/2007, pp. 2-17), and the NBS prepared two analyses of the impact of the exchange rate on inflation. Despite the fact that different approaches were adopted, the same results were obtained. The results of the analyses show that the PTE (i.e. the elasticity of the change of the price level at a 1 per cent exchange rate change) is approximately 0.1 - 0.2 (if the bilateral SKK/EUR exchange rate is used, and in relation to the overall HICP index), while the exchange rate is reflected in inflation gradually, in the period of one to two years. The PTE estimated in 2007 is not valid; it is not showing itself. The year 2007 can thus be considered specific. This can be caused by the effort of businessmen to seize the last opportunity of appreciation, before the exchange rate is fixed, to provide for a single increase in profits or, for example, to cover the costs associated with the euro introduction. It can also be influenced by closed hedging transactions (by their setup) or by the businesses' orientation toward the level of the central rate. The inflation development in 2007 could also be influenced by the appreciation of the exchange rate which occurred in the Slovak Republic in the preceding period (in the amount of approximately 3 – 4 per cent), i.e. in a longer period of time, and it was not reflective of the exchange rate development of the beginning of 2007.

Unlike the OECD, we do not expect that, within the basic scenario of the medium-term forecast, the current influence of this appreciation will fully reflect itself in the future price development. Thus we do not consider this factor as pro-growth in terms of the future inflation development. This, however, can be viewed as the only positive risk in the current situation of the crude oil and food prices.

Competition on the retail market is important for the future price development, too. Slovakia follows the Czech Republic, within the Central European region, in terms of hypermarket saturation. The legislative environment in Slovakia is liberal for development of large business chains (without any restrictions on construction and floor space, business hours, and undetermined proportion of local and imported products). At the same time, there exists a high level of openness (and resulting competition) in the sector (as is the rate of participation of foreign capital in the sector). A business in foreign possession can be indicative of more significant opportunities for import of competitive goods to the local consumer market, and of developed foreign business relations with better possibilities for price competition, both locally and regionally.

Given all the above-mentioned reasons, the fixing of the exchange rate should not represent a significant leap in inflation development. On the contrary, it is possible to assume that the introduction of the dual pricing and this year's appreciation of the central rate can start to have a slight stabilization effect on the development of prices in the upcoming period.

To conclude, let me observe that the future development of inflation is, obviously, subject to risks. However, the external risks are much greater than those Slovak internal ones. The growth of the crude oil and food prices has a significant impact on headline inflation, because these items represent 30.9 per cent of the basket. The existing (and increasing) secondary effects are a problem, however. The result is high inflation throughout the basket, high and increasing inflation expectations, and the risk of secondary effects in the form of wage requirements. And, frankly speaking, neither the monetary nor the fiscal policy can resolve it. They can just mitigate it to a certain extent. High or higher inflationary environment can thus become a reality for a longer period of time, while preventing the secondary effects can become more and more difficult. Nevertheless, this does not mean that we will not try!

Ladies and Gentlemen, thank you for your attention.