



National Bank of Slovakia

**Medium-Term Forecast (MTF-2005Q3)**

**July 2005**

## **Medium-Term Forecast – July 2005 (MTF-2005Q3)**

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### **Equilibrium variables, development of the potential output**

In comparison with the April forecast (MTF-2005Q2), the development trends in the main equilibrium variables applied in the July medium-term forecast (MTF-2005Q3) were not substantially reassessed.

In terms of dynamics, GDP growth over the first quarter of 2005 was in line with the expectations of the NBS and the monthly indicators of production and receipts in the individual sectors indicate no such changes in the development trends that would give cause for a substantial reassessment of the rate of economic growth. Nor did we receive any new information on the basis of which the long-term rate of growth in the potential output should be modified. At the same time, the assumption concerning the long-term real equilibrium appreciation of the converging economy was also left unchanged. The fulfilment of the predicted rate of economic growth in the first quarter confirmed the persistence of a negative output gap in the second quarter of 2005.

### **Current position of the economy**

In terms of the growth achieved, the development of the real economy was in line with the expectations of the NBS, while the structure of GDP followed a slightly different trend. The assumptions from the April forecast (MTF-2005Q2) concerning the slowdown in the year-on-year rate of economic growth in the first quarter of the year in comparison with the previous year were also confirmed. In terms of structure, GDP development deviated from the expectations of the NBS, primarily in the area of final household consumption. Its increased dynamics in comparison with the April forecast was mainly a result of accelerated growth in wages throughout the economy.

The improving financial results of companies, coupled with the effect of inflation from the previous period on wage bargaining, stimulated faster growth in real wages, which led to dynamic growth in final household consumption. The dynamic wage growth in the household sector created adequate conditions for the renewal of growth in consumption as well as for savings. However, the share of private consumption in GDP has not yet reached the level of comparable periods from before the imposition of restrictions on demand, i.e. before 2003. As a result of this, the relatively dynamic growth in final household consumption in 2005 may be assessed as acceptable and creating no inflationary pressure. This effect is expected to persist throughout 2005, hence the rate of growth in final household consumption was increased in the MTF-2005Q3, as well as its contribution to GDP. Part of the accelerated growth in household consumption is expected to stimulate growth in the volume of imports. A substantial effect will probably be recorded in the growth of added value in the services sector and in the orientation of consumers to higher quality, where developments in the first quarter indicated that there is room for the development of services without pressure on their price increase.

In the final analysis, the aforementioned effects give cause for a modest increase in the GDP forecast for the second half of 2005, and thus GDP growth should be increased by 0.1 of a percentage point, to 5.1%. Such an increase in the GDP forecast for 2005 is also supported by

the continuing positive financial results of corporations (both domestic and foreign), the continuing growth in the quantitative indicators of economic development (receipts in the individual sectors, wages, employment), and by the marked positive changes in the values of qualitative indicators (the economic sentiment indicator, the confidence indicator in construction).

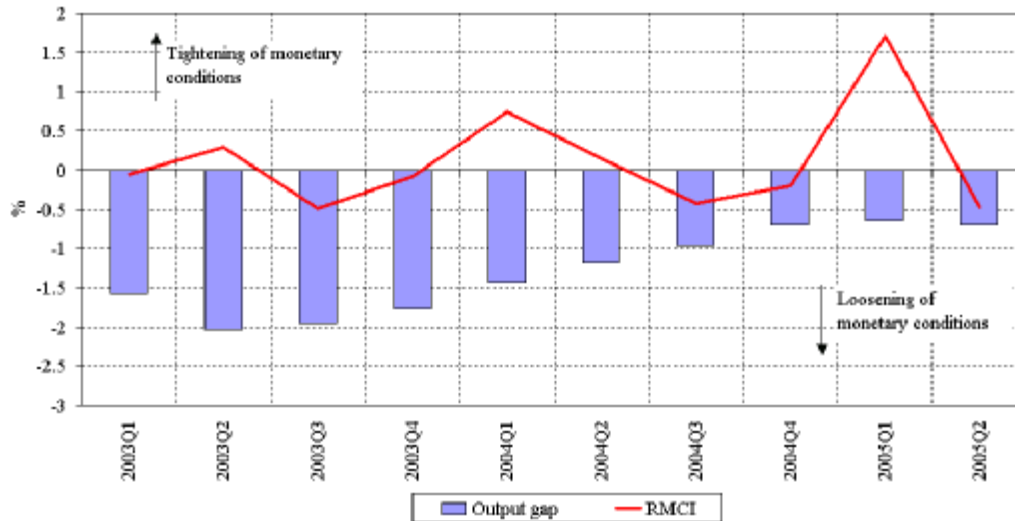
Since economic growth in the first quarter of 2005 corresponded to the expectations, no marked shift was recorded in the economy towards its potential output in comparison with the April forecast. In the second quarter of 2005, the initial position of the economy was again in a moderate negative output gap and recorded no marked deviation from the April forecast.

The current estimate of the monetary policy position confirms the conclusions of the previous forecast. The loosening of monetary policy (the Real Monetary Conditions Index – RMCI) in the second half of 2004 was interrupted in the first quarter of 2005 due to accelerated appreciation in the nominal exchange rate at the end of 2004 and in the first months of 2005. The Central Bank reacted to the restrictive effect of the exchange-rate component by lowering its interest rates, in order to stimulate the development of the economy in the conditions of a negative output gap. The following correction in the nominal exchange rate represented a return to the estimated equilibrium level. It is therefore assumed that monetary policy stimulated the economy in the second quarter of 2005, through both of its components.

In the area of exchange rate developments, the exchange-rate component of the monetary conditions was loosened to a greater than expected extent, owing to its depreciation in the second quarter of 2005. Since exchange rate developments were influenced by the overall regional sentiment of international investors and were not a result of domestic imbalances, the depreciation of the exchange rate was deemed to be a short-term phenomenon. For that reason, the NBS did not correct the loosened exchange-rate component by tightening its interest-rate policy through an increase in interest rates. Thus, the overall monetary conditions changed in character in the second quarter, from restrictive to loosened. However, the degree of loosening of the monetary conditions should, with regard to the expected short-term effect of exchange rate developments, change gradually in the coming period. The monetary conditions are expected to have a neutral or slightly restrictive character, throughout 2005.

Neither the exchange rate nor the character of monetary conditions was reflected in the price development, which continued to be affected in the second quarter by the appreciating trend in the exchange rate from the previous quarters, as well as by the effect of growing competition. Since the exchange-rate component of the monetary conditions is to be loosened for only a short period, it should not have a significant impact on the closing of the output gap with a pro-growth effect on demand-pull inflation.

Output gap and the Real Monetary Conditions Index (RMCI)



In the second quarter of 2005, consumer prices continued to show a decelerating tendency in year-on-year dynamics. This development was mainly affected by items included in net inflation, excluding fuel prices (tradable goods and market services) and the weaker year-on-year dynamics of regulated prices. On the other hand, an acceleration in the year-on-year growth, and/or a slowdown in the year-on-year decline, was recorded in fuel prices (as a result of appreciation in the exchange rate of the dollar against the Slovak koruna, and the situation on international oil markets) and in food prices. In comparison with the April forecast, consumer prices showed weaker dynamics in the second quarter of 2005.

## Medium-term forecast

### External environment

The medium-term forecast of exogenous indicators is based on the June issue of the Consensus Forecasts<sup>1</sup>. The expected developments in oil prices are based on futures prices as at 7 June 2005.

Compared with the predicted developments in the external environment from the April forecast, marked changes occurred in oil prices and the expected values of the USD/EUR cross-rate. The higher price of oil, showing a tendency to fall at a slower rate, and the appreciated value of the USD vis-à-vis the EUR should have an upward effect on price levels in the euro area, mainly in 2005.

Economic growth in the euro area in the first quarter of 2005 (1.4%) was in line with the figure predicted in the March Consensus Forecasts (1.3%). In the following two quarters, the economy is expected to grow at approximately the same rate, with a certain revival at the end of 2005. If these expectations are met, the output gap in the euro area will probably remain

<sup>1</sup> A survey of forecasts of international economic and financial institutions, from which an average is calculated. This method ensures the most unbiased estimate of developments in the relevant indicators in the foreign sector. With regard to the course and schedule of forecasting at the NBS, the values of input variables were taken from the Consensus Forecasts of June 2005 and fixed at these levels throughout the forecasting process. All new items of information will be taken into account in the next medium-term forecasts.

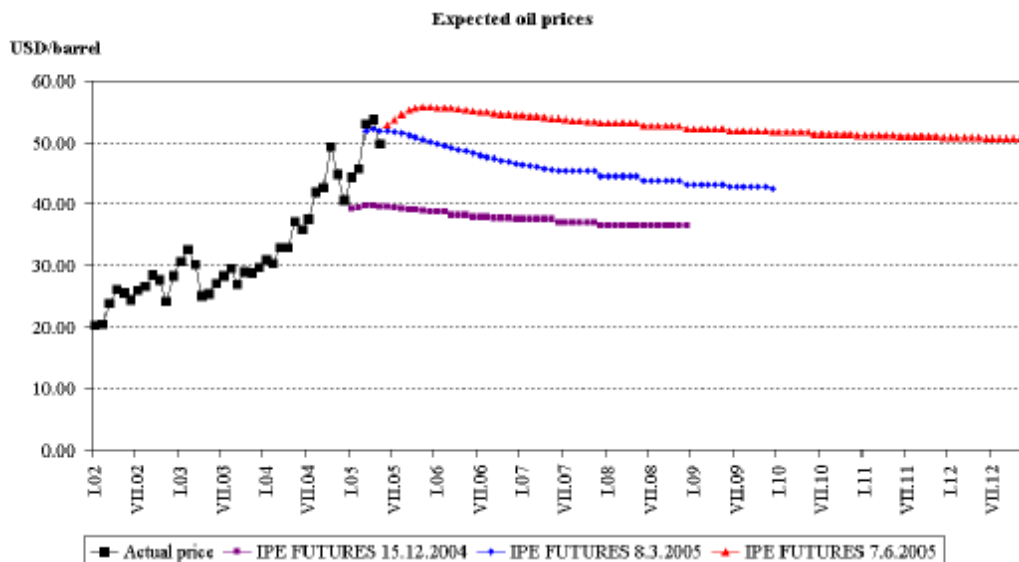
negative, or will widen slightly. Short-term rates will remain at a low level, which is a sign of weak economic activity in EMU countries. Despite the inflationary effect of the rising oil prices, euro area inflation is expected to remain below 2% in 2005 and 2006.

	2005	2006	2007
<b>Euro area inflation in %</b>			
CF 03/05 (annual average)	1.8	1.7	
CF 06/05 (annual average)	1.9	1.7	
<b>Euro area GDP growth in %</b>			
CF 03/05	1.6	2.0	
CF 06/05	1.3	1.8	
<b>Oil prices USD/barrel (annual average)</b>			
8 March 2005	51.4	48.1	
7 June 2005	52.4	55.0	53.7
<b>Exchange rate USD/EUR (end of the relevant quarter)</b>			
CF 03/05	1.328	1.328	1.318
	Q2	Q1	Q1
CF 06/05	1.243	1.281	1.288
	Q3	Q2	Q2

The slight reduction in the projected rate of economic growth in the euro area predicted for 2005 and 2006, in comparison with the March Consensus Forecasts, is likely to affect the persistence of a negative output gap in Slovakia. With regard to the expected course of euro area inflation, import prices are expected to have no inflationary effect on domestic price developments. The higher price of oil and the expected USD/EUR exchange rate in 2005 will have an upward effect on fuel prices, in consequence of which their contribution to inflation will increase. In the following years, developments in fuel prices are not expected to have an inflationary effect, due to a falling trend in oil prices and an expected depreciation in the exchange rate of the USD against the EUR.

### Forecast for 2005 and 2006

In comparison with the assumptions of the NBS in MTF-2005Q2, the impacts of long-term appreciation in the exchange rate, competition in retail trade, and entry into the EU are more significant, which can be seen in the falling rate of inflation in the first half of 2005. The non-tradable sector also experiences a slowdown in price dynamics. This anti-inflationary effect is, however, expected to be offset towards the end of 2005 by a rise in fuel prices. In the baseline scenario of the medium-term forecast, the possibility of an increase in regulated prices for natural gas and heat has not been taken into account.



The dynamic disinflation was caused by the dampening effect of the exchange rate, despite the loosened interest-rate component of the monetary conditions in the first quarter of 2005. The loosening of the exchange-rate component in the second quarter, due to its expected transitional nature, should not affect price developments. Furthermore, we do not expect that the faster than expected growth in nominal and real wages in 2005 will create demand-based inflationary pressure.

In the first quarter of 2005, nominal wages in the economy grew at a faster rate than was forecast in the Monetary Programme of the NBS (MP) until 2008. A possible marked acceleration in their growth in nominal terms was indicated by the dynamic wage growth in the last quarter of 2004 (11.0%) and by preliminary data on wage growth in selected sectors in the first two months of 2005. Since the NBS considered it necessary to confirm developments in the quarterly data, the assumptions of nominal wage development were not modified in the April medium-term forecast (MTF-2005Q2), compared with the MP until 2008. On the basis of nominal wage developments in the first quarter of 2005, monthly data on wage developments in selected economic sectors, and the prepared wage adjustments in the public sector, especially in education with effect from July 2005, the expected dynamics of nominal wages in 2005 were increased in the current medium-term forecast to 8.6%, from 6.5% predicted in the April forecast (MTF-2005Q2). The growth in real wages adequately reflects the changes in nominal wages and inflation in comparison with the MTF-2005Q2.

An analysis of nominal wage developments since the beginning of the year indicates that their dynamic growth was affected by several factors:

- some entrepreneurial entities derived this year's wage growth from the inflation in the previous year rather than from the expected and much lower current inflation rate in 2005, while the NBS predicted a more moderate wage growth for 2005 (in the MP until 2008), due to an expected marked slowdown in the average 12-month inflation rate;
- real wage growth in previous years was well below the growth in real labour productivity, which created room for wage growth in 2005;
- in some sectors, the accelerated growth in nominal wages was affected by a year-on-year decline in employment (in agriculture, education, health care, transport, post and telecommunications);

- the higher wage growth was also supported by the payment of large one-off bonuses in some of the manufacturing sectors, which accounted for 25% of the total employment in the national economy;
- in the first quarter of 2005, the average wage growth in the national economy was exceeded by the rate of wage growth in the 'general government, defence, and compulsory social insurance' sector.

In terms of nominal wage growth, the year 2005 may be characterised as a turning point, reflecting the effect of a marked slowdown in the year-on-year growth in average consumer prices, the growth in real wages catching up with the growth in labour productivity (the previous years saw a long-term outrun of productivity growth), and the effect of wage adjustments in education.

The National Bank of Slovakia expects (on the basis of the above facts) that the accelerated growth in wages will have, in the conditions of a negative output gap in 2005 and 2006, no inflationary effect (such effect is not indicated by the previous developments in prices for market services and such wage growth is not likely to be reflected in final household consumption in full). However, if the dynamic wage growth continues even after 2005, particularly if real wages grow at a faster rate than labour productivity, the balance of foreign trade may be negatively affected or increased demand-based inflationary pressure may result.

Hence, wage developments will be the centre of attention for the NBS, both in relation to labour productivity and in the area of the non-tradable sector, where the highest risk of inflation is involved. The NBS assumes that wage bargaining, which had previously been based largely on the previous year's inflation rate, will be conducted in 2006 on the basis of the expectation that price dynamics in Slovakia will approach the level of the euro area as early as 2005.

The current forecast, similar to the previous one (MTF-2005Q2), expects that the excise duty on cigarettes will be increased to Sk 1.7/pce (from the current Sk 1.4/pce) with effect from 1 January 2006, and will contribute approximately 0.24 of a percentage point to the year-on-year rate of headline inflation. Compared with the previous medium-term forecast (MTF-2005Q2), the inflation rate is expected to fall slightly, owing to the persistence of the effect of the low-inflation environment from 2005.

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**Box: Estimate of the impact of increase in the regulated prices of natural gas and heat**

The higher price of oil, which was not taken into account in the regulated price increase in the baseline scenario, is expected to be mirrored in the increased regulated prices of natural gas for households and in the regulated price of heat. The impact of the prepared increase in regulated prices will, however, depend on the timing and the rate of that increase.

The Slovak Gas Industry (SPP) has already applied to the Regulatory Office for Network Industries (ÚRSO) for a 22% increase in the price of natural gas for households, with effect from 1 October 2005. In the case of heat, the situation is more complicated owing to the larger number of suppliers, which use not only natural gas, and because the price of gas for heat producers is not regulated, which means that the price of heat will increase gradually as the ÚRSO will process the price applications of individual heat producers. On the basis of the

information released, the NBS expects a gradual increase of approximately 5% in the price of heat. According to the NBS estimates, an increase of ca 22% in the regulated price of natural gas at the beginning of October 2005 and a gradual increase of 5% in the price of heat would represent an additional contribution of approximately 1.4 percentage points (1.1 percentage points owing to a change in gas prices and 0.3 of a percentage point as a result of a change in the price of heat) to the rate of the headline inflation in 2005. The secondary effects of such increases in regulated prices are expected to appear in the prices of services mostly at the beginning of 2006.

#### Increases in selected regulated prices in 2005 (in %)

Name of item		2005	
		Increase	Contribution
Heat energy	MTF-2005Q3	6.5	0.3
	Current estimate	11.5	0.6
Natural gas	MTF-2005Q3	12.0	0.6
	Current estimate	34.0	1.7

#### Comparison of year-end headline HICP inflation forecasts (in %)

	2005	2006
MTF-2005Q3	2.6	2.0
Current estimate	3.9	2.1

If the increase in regulated gas and heat prices takes place with effect from January 2006, the inflation target for 2006 (inflation below 2.5%) will be exceeded by approximately 0.9 of a percentage point, with the year-end inflation rate reaching 3.4%.

A deviation from the expected developments in regulated prices is, however, regarded from the NBS point of view and in the inflation targeting strategy as one of the escape clauses. Since the prepared price increase is a cost factor, monetary policy will react to its secondary effects only.

Regarding the development of the real economy in 2005, we expect a higher growth in final household consumption (in connection with the accelerated wage growth and falling inflation), which will probably reach its level from the previous years. While household expenditure on consumption had accounted for 53-54% of GDP before 2003, this share decreased temporarily to 50-51% during the restriction of consumer demand (due to adjustments to regulated prices). In view of the revised forecast of final consumption, and in connection with the updated forecast of nominal exports and imports, which slightly deteriorates the net exports (in real terms), we expect only a modest acceleration in the overall economic growth in 2005 (by 0.1 of a percentage point at constant prices, to 5.1%) in comparison with the MTF-2005Q2.

The development of the real economy in 2006 will be affected by both domestic demand and the growing foreign demand, since net exports are expected to have a pro-growth effect on real GDP in connection with the commencement of production at new plants in the automotive industry. Within the scope of domestic demand, all components are expected to increase, owing to the investment activities of companies and the slight increase in consumer expenditures in connection with the expected developments in wages and inflation. Compared



with the MTF-2005Q3, domestic demand and net exports are expected to stimulate somewhat faster growth in the economy in 2006 (5.5%).

After being loosened to some extent in the second quarter of 2005, the real exchange rate is expected to regain its restrictive nature, which, together with the weak economic growth in the euro area, will be the main reason for the negative output gap persistence in 2005 and 2006, which will not show a rapid closing tendency.

Compared with the April medium-term forecast, there is room in the baseline scenario for further monetary-policy loosening, owing to an expected drop in the inflation rate in 2006. As it was stated in the April forecast, the NBS will set the monetary conditions with respect to the wage development in relation to the development of labour productivity. At present, the NBS must also take into account the uncertainty as to when and to what extent the regulated prices will be increased. This effect will be incorporated in a clear and unambiguous form in the next medium-term forecast, i.e. in October. In view of the expected increase in regulated prices (this or next year), the monetary conditions should be set as restrictive, with limited room for the loosening of the interest-rate component.

The general assumption is that monetary conditions in 2005 will be of a neutral or slightly restrictive nature, which is in line with the April medium-term forecast. In 2006, monetary policy is expected to remain slightly restrictive, which should contribute to the sustainability of inflation at a low level.

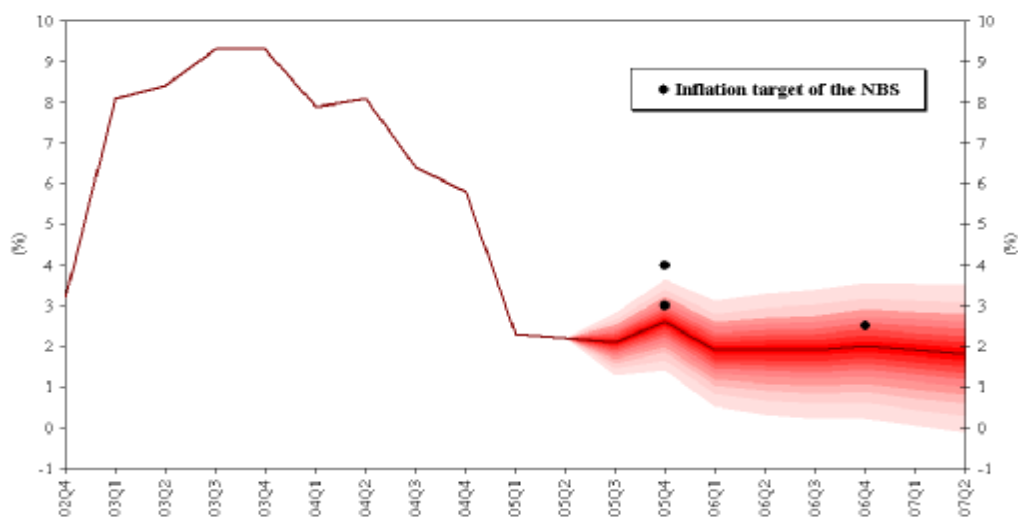
#### **Medium-term forecast (2007 and 2008)**

The medium-term forecast for 2007-2008 contains no principal differences in comparison with the April forecast (MTF-2005Q2). The higher oil prices had an upward effect on fuel prices in the forecast for 2005 in particular, while leaving the medium-term forecast unaffected (due to their falling tendency in the medium term).

In 2007 and 2008, as in the April forecast, price levels are expected to stabilise gradually close to the level of the inflation target, which is likely to be affected by the expected convergence of the exchange rate towards the equilibrium level and by the gradual closing of the output gap.

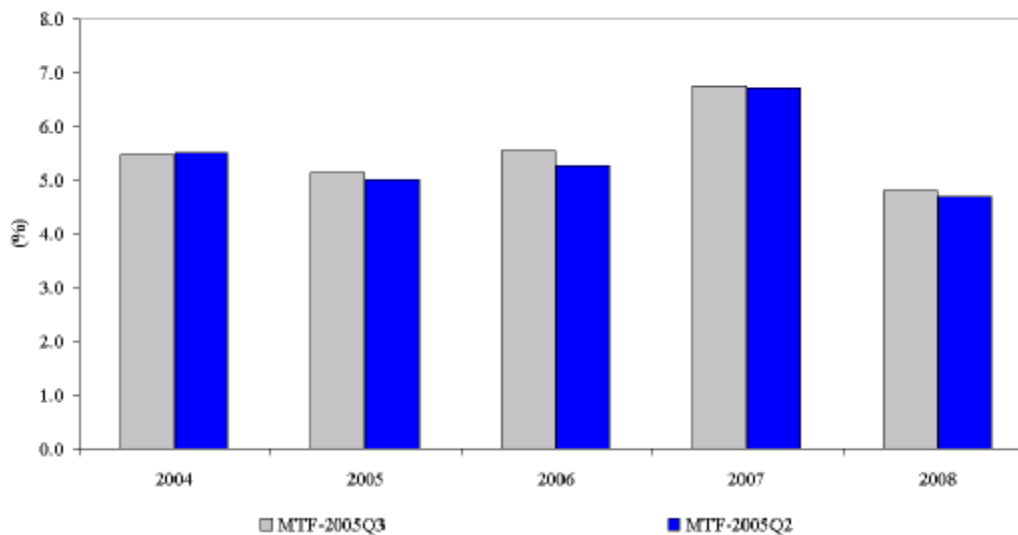
The possible risks involved in a price forecast mainly include the prices of oil and gas, which be reflected in the dynamics of regulated prices (in addition to fuel prices), if they continue rising in comparison with the Consensus Forecasts. Another risk is posed by food prices, the dynamics of which will depend on seasonal factors, the continuation of the reform of the Common Agricultural Policy, and the liberalisation of international trade in food commodities. Another risk is represented by the inappropriate fast growth in wages, greatly exceeding the expectations of the NBS, as well as by the long-term excess of wage growth over growth in labour productivity. However, these effects cannot be reliably assessed or quantified for the time being.

HICP inflation forecast



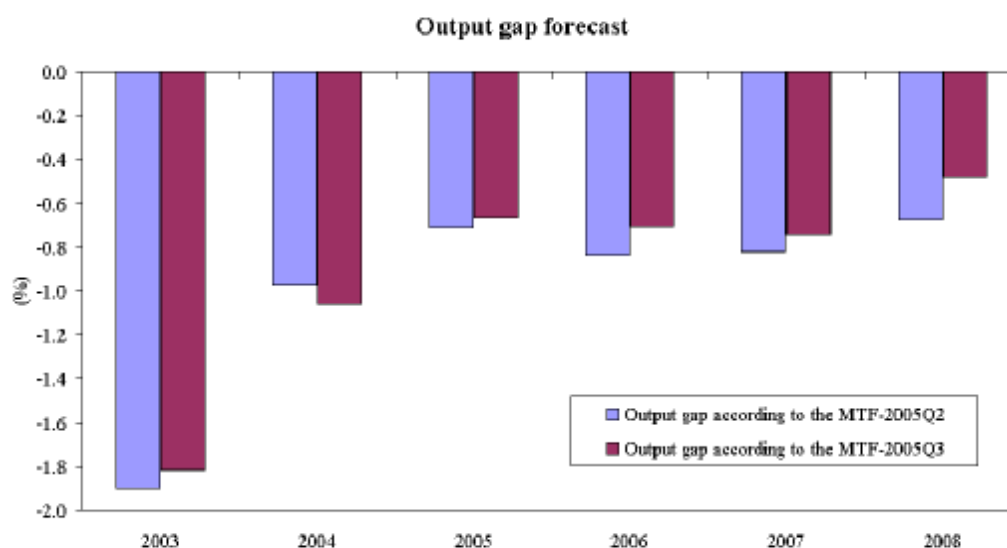
Regarding the expected growth in the real economy and the overall trends in the individual GDP components, only minor changes occurred in comparison with the April medium-term forecast (MTF-2005Q2), within the range of ca 0.1-0.2 of a percentage point, in the dynamics of real GDP growth. The GDP forecast for 2007-2008 is based on the data published on the development of the real economy in the first quarter of 2005, and on adjusted expectations concerning the course of inflation, wage development, and foreign trade.

GDP growth forecast



In the medium term, the convergence of the Slovak economy is expected to continue in real terms, mainly in connection with the inflow of foreign capital in the form of direct investments, on the basis of growth in the competitiveness and performance of the economy, coupled with the relatively balanced combined effect of domestic and foreign demand as factors of real growth.

Within the scope of domestic demand, gross fixed capital formation, final consumption of households and general government are expected to act together in contributing to the overall GDP growth. According to an updated wage forecast, final household consumption will make a more significant contribution to the growth in GDP.



In terms of character, the expected monetary conditions are in line with the April medium-term forecast (MTF-2005Q2). This means that, owing to the expected convergence of the exchange rate towards equilibrium trend, the restrictive nature of the monetary conditions will moderate or loosen to a certain extent. For the interest-rate component, this will mean a reduction in the degree of loosening. As a result of such developments in the monetary conditions, the output gap will close gradually and inflation will approach the target level. In comparison with the April forecast, there are no such changes in the assumptions of the medium-term forecast (for 2007 and 2008), respectively no such risks are identified which would require a monetary policy reaction.

The medium-term forecast also includes two alternative scenarios. The first scenario was constructed for a different trend in the USD/EUR cross-rate, which may appreciate over the course of 2005 to a greater extent in comparison with the baseline scenario, while depreciating in the medium term to a lesser extent. Such a change in the assumption concerning the cross-rate would have an upward effect on inflation through the increased price of imported energy, as of 2005. In the event of such a development, the NBS would have to consider the possibility of tightening the monetary conditions to a certain extent, but without a marked impact on the economy. The degree of such tightening should be set primarily according to the fulfilment of the inflation target, with respect to the defined escape clauses.

The second scenario was drawn up for the case of an increase in regulated prices from October 2005. The expected increase in the prices of natural gas and heat is assumed to contribute approximately 1 percentage point to the acceleration in the rate of headline inflation in the fourth quarter of 2005 and in the first three quarters of 2006, while the year-end inflation rate in 2006 is expected to fall to 2.1%, corresponding to the level according to the baseline scenario. To dampen the secondary effects on price developments the Central Bank would have no room for a reduction in interest rates in comparison with the baseline scenario.

Medium-term forecast (MTF-2005Q3) of main economic indicators

Indicator	2004	2005	2006	2007	2008
	Actual	Forecast			
<b>Prices (y-o-y change)</b>					
HICP inflation (end-year)	5,8	2,6	2,0	1,8	1,8
HICP inflation (average)	7,4	2,4	1,9	1,8	1,8
CPI inflation (end-year)	5,9	2,7	2,0	1,8	2,1
CPI inflation (average)	7,5	2,4	1,8	1,8	1,9
PPI (average)	3,4	2,6	1,8	1,3	1,3
<b>GDP (y-o-y change)</b>					
<b>Nominal GDP</b>	<b>10,3</b>	<b>7,3</b>	<b>7,4</b>	<b>8,4</b>	<b>6,4</b>
Domestic demand	11,0	9,2	7,5	5,2	6,1
Final consumption of households	10,7	8,2	7,0	6,7	6,5
Final consumption of general government	7,6	6,4	5,8	4,2	3,7
Final consumption of non-profit institutions	12,4	10,0	8,3	6,7	6,7
Gross fixed capital formation	6,1	11,2	10,5	7,0	6,0
Exports of goods and services	9,1	4,0	8,3	13,2	6,8
Imports of goods and services	10,8	6,3	8,1	8,8	6,4
<b>Real GDP</b>	<b>5,5</b>	<b>5,1</b>	<b>5,5</b>	<b>6,7</b>	<b>4,8</b>
Domestic demand	5,5	6,8	4,1	1,9	4,3
Final consumption of households	3,5	5,7	5,0	5,0	4,8
Final consumption of general government	1,1	2,9	3,2	2,4	2,0
Final consumption of non-profit institutions	5,8	5,7	6,0	5,0	5,0
Gross fixed capital formation	2,5	8,1	8,6	5,5	4,5
Exports of goods and services	11,4	5,5	9,4	15,2	8,2
Imports of goods and services	12,7	6,3	7,9	10,6	7,9
<b>Labour market</b>					
Nominal wages (average, y-o-y change)	10,2	8,6	6,4	5,6	5,5
Real wages (average, y-o-y change)	2,5	6,1	4,5	3,7	3,5
Employment (LFS)	0,3	1,7	0,8	0,8	0,7
Employment (registered employment)	0,3	1,8	0,8	0,9	0,7
Unemployment rate (LFS, %)	18,1	16,9	16,5	15,9	15,5
Labour productivity (Real GDP/Employment, y-o-y change)	5,2	3,2	4,7	5,7	4,1
<b>Balance of payments</b>					
Import of goods	14,0	6,6	8,7	9,4	6,9
Export of goods	11,5	3,8	9,2	14,6	7,5
Trade balance (bil. Sk)	-47,0	-75,3	-77,0	-32,3	-26,7
Trade balance (% GDP)	-3,5	-5,3	-5,0	-2,0	-1,5
Balance of services (bil. Sk)	8,6	12,0	12,5	13,0	14,0
Balance of services (% GDP)	0,6	0,8	0,8	0,8	0,8
Current account (bil. Sk)	-46,0	-92,7	-91,9	-49,7	-45,2
Current account (% GDP)	-3,5	-6,5	-6,0	-3,0	-2,6
Current and capital account (bil. Sk)	-41,6	-86,7	-84,9	-42,7	-39,2
Current and capital account (% GDP)	-3,1	-6,1	-5,6	-2,6	-2,2