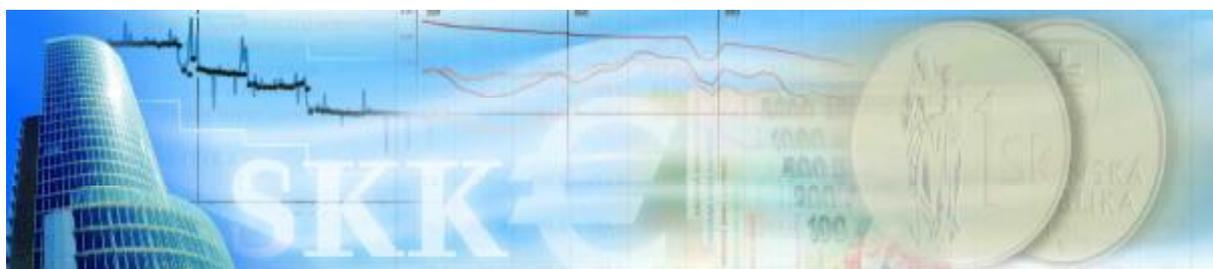




NÁRODNÁ BANKA SLOVENSKA

MEDIUM-TERM FORECAST (MTF- 2006Q3)

July 2006



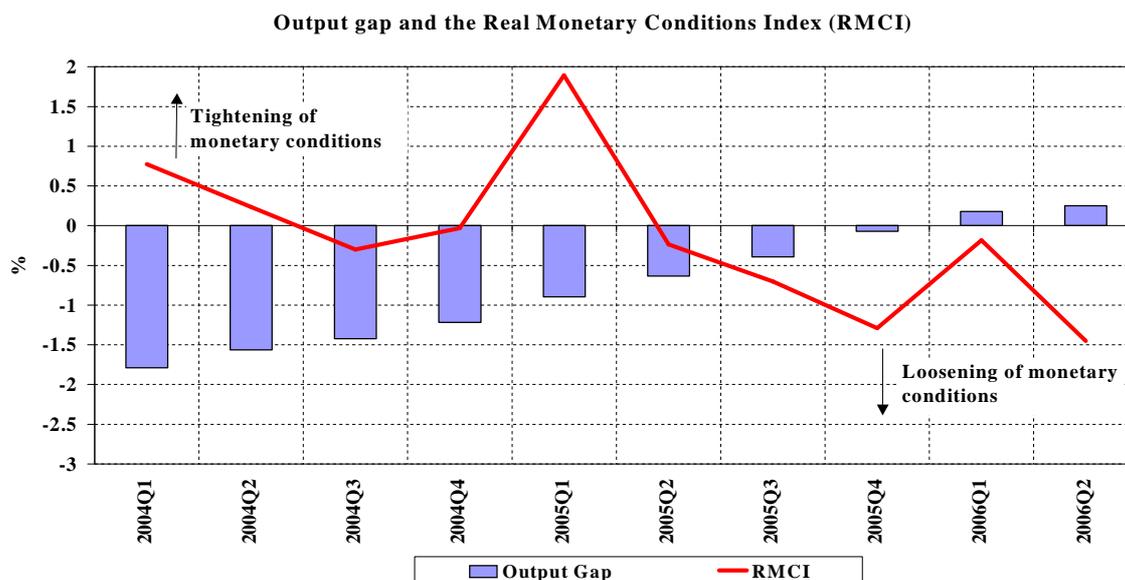
Equilibrium variables, development of potential output

The medium-term forecast is based on the assumption that Slovakia is a converging economy, and that its main macroeconomic indicators follow equilibrium trends. The estimated equilibrium paths of the real interest rates, the real exchange rate, and the non-inflationary growth of the economy (potential output) provide the basic framework of the forecast. In comparison with the April forecast (MTF-2006Q2), no new information has emerged to justify a reassessment of the long-term trends in the key macroeconomic indicators applied in the current July medium-term forecast (MTF-2006Q3).

Due to inflows of foreign direct investment (FDI) as well as domestic investment, the forecast still assumes a gradual increase in the economy's productive capacities, which should lead to accelerating growth in its potential output. There is still room for a long-term real equilibrium appreciation in the exchange rate, which corresponds to the nature of converging economy. The trends in real equilibrium rates have remained unchanged.

Current position of the economy¹

The estimate of the economy's current position is based on estimated deviations in the key macroeconomic indicators from their equilibrium trends. The monetary conditions set in terms of the Real Monetary Conditions Index (RMCI) remained loose in the second quarter of 2006, with contradictory developments in the individual components. The expected loosening of the exchange rate component is a result of depreciation in the nominal exchange rate in the second quarter of 2006. At the same time, real interest rate development was affected by an increase in the nominal rates. Despite this, the real rates are still below their equilibrium level.



The released data on economic growth, as well as the forecast for the second quarter of 2006, have confirmed the assumptions of the April medium-term forecast regarding the continuing trends. In comparison with the previous forecast, however, the risk of possible demand pressures has increased. This is also documented by a change in the structure of GDP, where the growth in final household consumption has accelerated (according to revised data). Based

¹ The current position of the economy refers to its state in the second quarter of 2006 (according to a GDP estimate), on which the short-term as well as medium-term forecasts are based.

on this development, it is assumed that a slight positive output gap has opened in the economy during the economic cycle in the first half of 2006, with domestic demand remaining the main source of economic growth. The persistence of loosened monetary conditions is one of the factors that continue to act as a stimulus to economic growth.

The revision of national accounts had no marked impact on the overall rate of real GDP growth, but the structure of its components has changed, as well as the trends in deflators. The biggest changes occurred in connection with the conversion of the nominal balance of net exports into terms of constant prices of year 2000, as a result of which the contributions of domestic demand and net exports to GDP growth have also changed. Hence, it is not possible to compare the GDP structure and its development with the previous forecast (MTF-2006Q2).

In the first quarter of 2006, the Slovak economy achieved a growth of 6.3% at constant prices (according to revised data from the national accounts), mainly due to acceleration in gross fixed capital formation, which grew year-on-year by 16.1%, and was accompanied by faster growth in public expenditures (6.7%). The increase in fixed investments was influenced by foreign direct investment as well as domestic investment, both in construction and technological equipment.

Based on monthly indicators from selected sectors, the buoyant economic activity is expected to continue in the second quarter of 2006. In terms of structure, the most significant factor in GDP growth will probably be domestic demand, where economic growth will be mostly stimulated by final consumption of households, in addition to the continuing large-scale investment activity.

The growth in nominal and real wages in the first quarter of 2006 was slower than had been expected by the NBS in the April forecast (the nominal wage growth forecast was 7.9%, the actual figure reached 7.5%; the forecast for real wage growth was 3.4%, the actual figure 3.1%).

The slightly slower year-on-year growth in the average nominal wage over the first quarter of 2006 was influenced first and foremost by a marked slowdown in nominal wage dynamics in manufacturing (from 13% in the first quarter of 2005 to 1.7% in the first quarter of 2006), as well as by slower wage growth in most sectors in comparison with the average figure for the national economy. The average nominal wage growth rate was increased by wage developments in financial intermediation, education, and agriculture, including forestry, and fishing.

In the second quarter of 2006, the NBS expects no marked change in the rate of nominal wage growth in comparison with the April forecast. This is indicated by preliminary data on wage developments in selected sectors in April to May. However, a potential risk is involved in wage developments in manufacturing, where wage growth was very slow in the first quarter and was inconsistent with the dynamic growth in labour productivity and profits, which may stimulate faster wage growth in this sector in the following quarters.

With regard to the expected higher average inflation rate compared with the April forecast, real wage growth should slow slightly in the second quarter.

Employment growth in the first quarter of 2006 reached 3.7% according to the Labour Force Sample Survey (LFSS) and 2.3% according to statistical reports, exceeding the figures predicted in the April forecast. The dynamic growth in employment according to LFSS was

stimulated by increased job creation in the domestic economy (an increase in the number of employees) and a marked increase in the number of people working abroad. As a result of investment demand, employment grew at a fast rate (according to statistical reports) in construction, while demand for labour also increased in services, mainly in trade, real estate, renting, and other business activities. Strong growth in employment was recorded in public administration, defence, and compulsory social insurance.

On the basis of preliminary data on employment in selected economic sectors in April and May, the NBS assumes that the dynamic growth in employment will continue in the second quarter of 2006 at a faster rate than was expected in the April forecast.

In the second quarter of 2006, the 12-month rate of increase in consumer prices expressed in terms of HICP continued to accelerate, to 4.6% from 4.2% in the first quarter of 2006. This development was mainly connected with an increase in the dynamics of food prices. Among food prices, the most significant increases took place in the year-on-year dynamics of unprocessed food prices, mainly as a result of a steeper seasonal rise in prices of vegetables in comparison with the previous year. The increased dynamics was also shown by prices of processed food (bakery products, including bread) and the prices of non-alcoholic and alcoholic beverages. These prices began to rise in the second quarter (due to increased excise tax rates as from January 2006), when the old supplies had been sold. The increase in year-on-year consumer price dynamics was also supported by the developments in prices of non-energy industrial goods, which recorded a moderate year-on-year rise in the second quarter, after falling on a year-on-year basis in the first quarter. A disinflationary effect on consumer prices was exerted by a slowdown in the year-on-year dynamics of prices for services (from 3.8% in the first quarter to 3.6% in the second quarter) and energy prices (from 16.5% to 15.7%).

Compared with the assumptions of the MTF-2006Q2, the actual rate of increase in consumer prices was slightly faster in the second quarter of 2006. This was mainly a result of a steeper-than-expected rise in prices of fuels (caused by developments in oil prices on the world market) and food prices (a steeper seasonal increase in unprocessed food prices). On the other hand, the prices of services and non-energy industrial goods followed a favourable course during that period.

Medium-term forecast

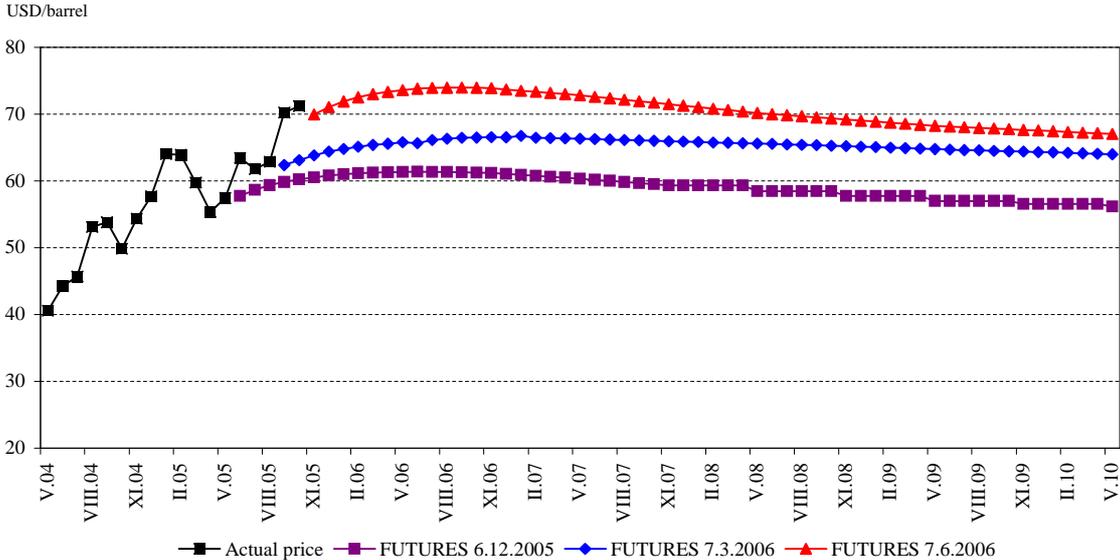
External environment

The present medium-term forecast of exogenous indicators is based on the June issue of the Consensus Forecasts (CF)². The expected developments in oil prices are based on prices of futures as of 7 June 2006.

² A survey of forecasts made by international economic and financial institutions, from which an average is calculated. This ensures the most unbiased estimate of the trends in foreign sector indicators. With regard to the course and schedule of forecasting at the NBS, the values of input variables were obtained from the Consensus Forecasts of June 2006 and fixed at these levels throughout the forecasting process. Any new information will be taken into account in the next medium-term forecasts.

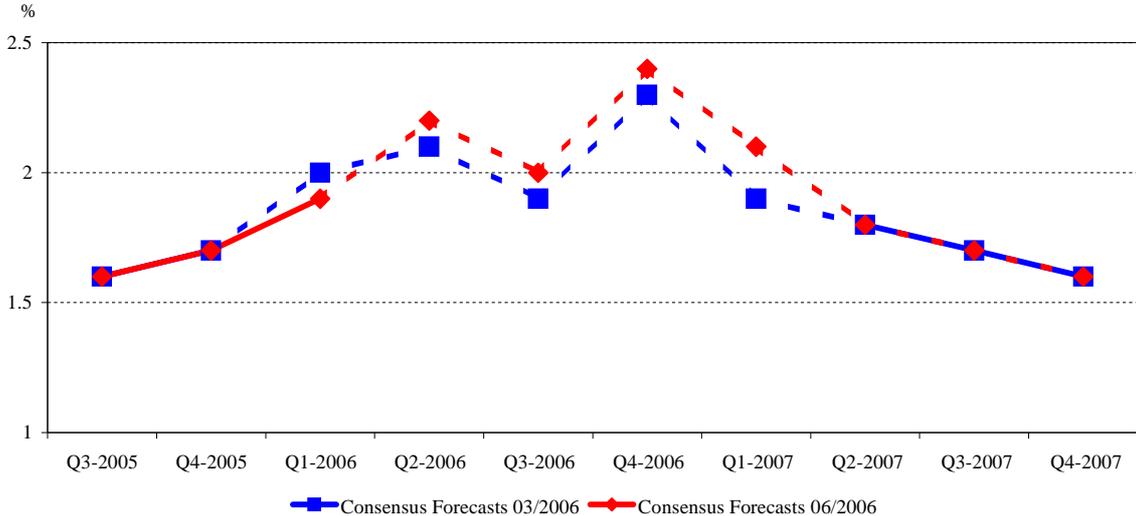
Compared with the assumptions of the external environment as predicted in the MTF-2006Q2, changes mainly occurred in the expected developments in oil prices, which are predicted to reach a higher level than according to the previous forecast. The average price of oil should reach USD 69.6/barrel in 2006 and even USD 73.6/barrel in 2007. The expected development of the USD/EUR cross-rate indicates a somewhat weaker USD vis-à-vis the EUR, compared with the previous forecast.

Expected oil prices



Although the economic growth in the euro area in the first quarter of 2006 lagged somewhat behind expectations (by 0.1 of a percentage point), for the next three quarters of 2006 and the first quarter of 2007, however, the Consensus Forecasts predict a slightly accelerated growth (by 0.1 of a percentage point) in comparison with the previous forecast. In the June Consensus Forecasts, the rate of GDP growth in the euro area is predicted to remain virtually unchanged in both 2006 and 2007, compared with the previous forecast. In 2007, in comparison with 2006, a gradual slow-down in the economic activity of the euro area is expected.

Comparison of euro area GDP growth according to the Consensus Forecasts (03/2006 a 06/2006)



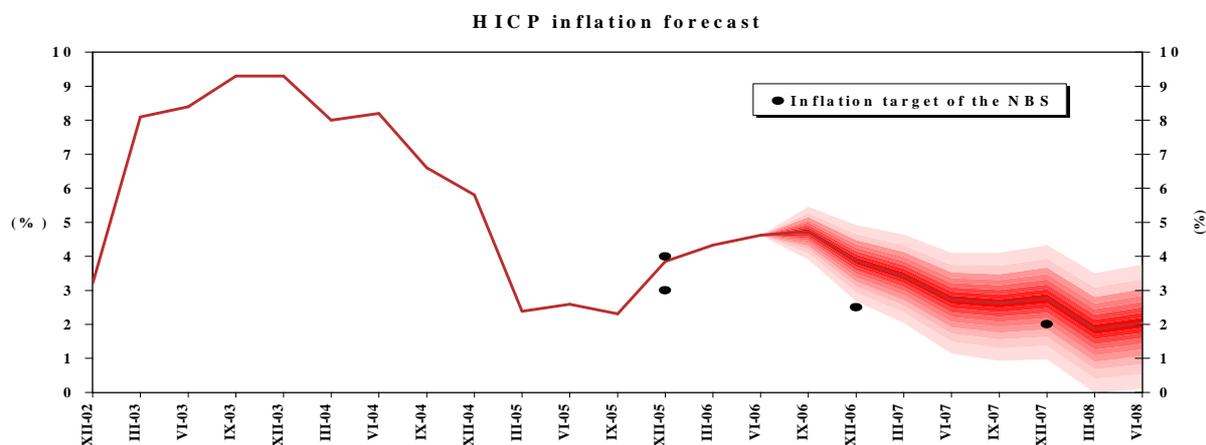
The euro-area inflation forecast based on the June Consensus Forecasts predicts an acceleration in the pace of inflation in 2006 and the first quarter of 2007 in comparison with the previous forecast, owing to the inflationary impulse of oil prices. The inflation forecast also takes into account the expected higher ECB interest rates, what is reflected in their recent increase by 0.25 of a percentage point (June 2006) as well.

	2006	2007
Euro-area inflation in %		
CF 03/06 (annual average)	2.0	2.0
CF 06/06 (annual average)	2.2	2.1
Euro-area GDP growth in %		
CF 03/06	2.1	1.8
CF 06/06	2.1	1.8
Oil prices in USD/barrel and EUR/barrel (annual average)		
7 March 2006	64.0 / 52.7	66.3 / 52.6
7 June 2006	69.6 / 55.6	73.6 / 56.6
Exchange rate USD/EUR (end of the relevant quarter)		
CF 03/06	1.209 (Q2)	1.259 (Q1)
CF 06/06	1.287 (Q3)	1.302 (Q2)

In comparison with the previous forecast, the impact of economic activity in the euro area on the output of the Slovak economy has remained unchanged. The moderate recovery in economic growth in the euro area in 2006 should provide a stimulus, through foreign demand, to the export performance of the Slovak economy. The slowdown in economic growth in the euro area in 2007 is not expected to have a major impact on the Slovak economy. The rising oil prices and their subsequently increased prediction is reflected also in an increased inflation forecast for the Slovak Republic, mainly in the form of risks of wider adjustments in regulated prices.

Forecast for 2006 to 2008

The current medium-term forecast expects an end-of-year inflation rate of 3.9% in 2006 (an average rate of 4.4%), 2.8% in 2007 (an average rate of 2.9%), followed by a slowdown to 2.0% in 2008 (an average rate of 2.0%). Compared with the MTF-2006Q2, the current inflation forecast predicts higher figures for both 2006 and 2007, while consumer prices in 2008 are expected to rise at the same rate as according to the MTF-2006Q2.



The shift in the forecast for 2006 and 2007 to higher levels in comparison with the April forecast was mainly caused by the assumption of a steeper increase in energy prices for consumers (fuel and other energy prices). Food prices are also expected to show stronger dynamics in 2006, due to increases in the prices of alcoholic and non-alcoholic beverages, bread and bakery products, coupled with stronger seasonal impacts on vegetable prices than a year earlier. The impact of these factors on year-on-year developments in food prices should persist even in the first half of 2007. In the second half of 2007, the dynamics of food prices will probably weaken, and in the first half of 2008 the year-on-year growth in prices of food should due to a higher basis level decrease below the level assumed in MTF-2006Q2.

The biggest differences against the assumptions of the MTF-2006Q2 may be expected at the beginning of 2007, primarily as a result of steeper increases in regulated energy prices (gas, heat, electricity), since the assumptions of their development have been re-considered on the basis of recent development of the exchange rate of the Slovak koruna and oil prices on the world markets. In 2008, regulated energy prices are expected to maintain their dynamics at the same level as according to the previous medium-term forecast.

The forecast for 2007 is based on an updated estimate of regulated price increases for electricity, gas, heat, water supply and sewage disposal as from January 2007. The original estimate from the MTF-2006Q2 for increases in energy prices regulated by the Regulatory Office for Network Industries (ÚRSO) as from January 2007 was at the level of 3%, with a contribution of 0.52 of a percentage point to headline inflation. The current forecast foresees an increase of 6.7% in energy prices regulated by ÚRSO, with a contribution of 1.15 percentage points³ to headline inflation.

Within the scope of energy prices, fuel prices should maintain their disinflationary effect, but the pace of the slow-down in their year-on-year dynamics should be slower in 2006-2007 than assumed in the MTF-2006Q2. The differences in the expected developments in fuel prices and the shift in their predicted course to higher levels are a reflection of the initial assumptions of the MTF-2006Q3 (higher levels of the Brent oil futures). Within the basic structure of inflation measured by HICP, consumer price dynamics will be dampened by the effect of a low-inflation environment in the tradable sector in 2007-2008.

Developments in prices for services may also be affected by the increased disposable income of households, which may reduce their dampening effect on inflation. Cost factors in services will continue to dominate and a rise of energy prices higher than expected in MTF-2006Q2 should appear as a second-round effect, mainly in prices of services related to dwelling.

The current medium-term forecast is also associated with certain risks. The greatest risk is posed by developments in oil prices. Their increase may lead to higher fuel prices or higher regulated prices in comparison with the current forecast. Further risks are involved in food prices, which are likely to be affected by increases in energy prices, weather conditions, and developments in the prices of agricultural commodities on the European market.

³ The forecast of energy price developments was prepared on the basis of the NBS's own calculations, using exogenous variables substituted in the formulas of ÚRSO.

Comparison of HICP inflation forecasts (year-on-year change in %, average for the period)

		2006	2007	2008
TOTAL (HICP)	MTF-2006Q1	3.6	1.9	2.0
	MTF-2006Q2	4.1	2.0	2.0
	MTF-2006Q3	4.4	2.9	2.0

Starting from the current MTF, the NBS will include the oil price forecast also in the projected development of the prices regulated in compliance with the ÚRSO procedures.

Comparison of HICP inflation forecasts (year-on-year change in %, average for the period)

		2006	2007	2008
TOTAL (HICP)	MTF-2006Q1	2.8	2.0	2.0
	MTF-2006Q2	3.7	2.0	2.0
	MTF-2006Q3	3.9	2.8	2.0

In the MTF-2006Q3, compared with the April forecast, the NBS foresees no change in the rate of nominal wage growth in 2006. The NBS forecast is based on an expected slowdown in nominal wage growth in the first half of the year, a possible increase in wage dynamics in health services approximately from the middle of the year, and plans for a significant minimum wage adjustment with effect from 1 October 2006 (compared with the previous years), which may lead to accelerated wage growth in the fourth quarter.

In 2007, the NBS expects a slightly stronger nominal wage growth than was predicted in the April forecast, mainly in connection with the expected steeper rise in average inflation in both 2006 and 2007, which may influence inflationary expectations and subsequently wage bargaining. Dynamic wage growth may also be stimulated by faster growth in employment, which increases the demand for a highly qualified labour force and selected professions, where wages are usually higher than the national average. Another source and risk of wage growth is represented by possible higher wage adjustments in the public sector, mainly in education, where a significant wage increase is being prepared for teachers.

In view of the predicted low-inflation environment, nominal wage growth in 2008 is expected to remain at the level of the April forecast. The accelerated wage growth in 2008 may, however, be caused by the transfer of a part of the wage increase from 2007.

Due to higher expected inflation, real wage growth in 2006 and 2007 should be somewhat slower than predicted in the April forecast; in 2008, the real wage dynamics should be virtually consistent with the MTF-2006Q2.

Compared with the April forecast, the growth in real labour productivity is expected to slow slightly in 2006 and 2007, with employment increasing to a greater extent and real GDP growing at a somewhat faster rate. With the employment developments and GDP growth taken into account, the dynamics of labour productivity should remain virtually unchanged in 2008. Although real labour productivity will continue to grow at a faster rate than real wages, the difference will be more modest than according to the MTF-2006Q2. This may indicate that, under certain conditions (faster wage growth and/or slower productivity growth compared with the NBS forecast), the dampening effect on inflation will lessen.

The dynamic growth in employment in the Slovak economy in the first quarter of 2006, exceeding the expectations of the NBS set out in the April forecast, and the continuing rapid growth in employment in most sectors in April and May are the basic conditions for faster growth in employment in 2006 and 2007, compared with the MTF-2006Q2. The trends in

employment should not change in comparison with the previous forecast, as the NBS expects a certain slowdown in the year-on-year rate of employment growth by 2008.

The National Bank of Slovakia assumes that the main factors in the employment growth will be investment, demand for services, and the opening of new labour markets within the EU for the new Member States, as a result of which the dynamically growing trend in employment should continue not only in the second half of 2006, but also in 2007. In 2008, the rate of economic growth is expected to slow, while that of employment growth will probably remain at the level of the MTF-2006Q2.

The predicted faster growth in employment compared with the MTF-2006Q2 should lead, at an unchanged level of labour supply, to a greater reduction in the rate of unemployment.

Over the first four months of 2006, the balance of payments current account ended in a deficit of Sk 38.2 billion, representing a year-on-year increase of more than Sk 14 billion. The deterioration in the current account was mainly caused by a year-on-year increase in the trade deficit, which was in line with the assumptions of the previous forecast. Within the scope of the trade balance, imports grew at a faster rate than exports in comparison with the same period a year earlier. The faster growth in imports was mainly caused by the persistently high (higher than originally expected) machine imports, coupled with high oil prices. Both factors exerted pressure for growth in the trade balance and balance of payments current account deficits.

The foreign trade forecast for 2006 is based on the trade balance as at the beginning of 2006. In export, the first months of the year saw further acceleration in the year-on-year rate of growth; this development was a continuation of the trend from the end of last year, caused by a continuing improvement in the export performance of a large number of small companies. This fact is supported by the loosened monetary conditions and creates room for improvement in the trade balance. However, the increase in exports resulting from the economy's improved export performance will be eliminated by an increase in imports, caused by higher-than-expected machine imports at the beginning of 2006, coupled with the negative effect of the latest oil price estimates, which are higher than according to the April forecast. The overall balance of foreign trade has remained unchanged, at the level of the MTF-2006Q2.

Compared with the April forecast, the development of foreign trade should remain virtually unchanged in 2007 and 2008, though the effect of rising oil prices may cause the trade balance to deteriorate. The increase in the 2007 deficit will also be supported by increased imports for final consumption, resulting from a growing final consumption of households. In the trade balance forecast, the balance for 2007 is expected to increase by a total of Sk 6.8 billion and that for 2008 by Sk 4 billion in comparison with the MTF-2006Q2.

The developments in the services balance to date are in line with the April forecast, while, in contrast with the trade balance, the balance of services showed a surplus. With regard to the current trend in 2006, the July forecast contains lower estimates for both receipts and expenditures. In total, the services balance surplus for 2006 has been reduced slightly in comparison with the MTF-2006Q2 (by Sk 0.5 billion); in the next few years, the balance of services will remain unchanged.

The estimated balance of payments on current account for 2006 remained virtually unchanged in comparison with the April forecast, with a slight deterioration recorded exclusively in the balance of services, while the deficit of the trade balance remained unchanged. In 2006, the current account deficit as a share of GDP decreased by 0.1 of a percentage point. The changes

in the trade balance forecasts for 2007 and 2008 led to an increase in the balance of payments. current account deficit (by approximately Sk 4 to 7 billion). The deficit in the current account will decrease significantly in 2007 and 2008, but its share on GDP will increase in comparison with the April forecast by 0.2 and 0.1 of a percentage point respectively.

In the economic growth forecast for 2006, the NBS expects a pro-growth effect from both domestic demand and net exports. Compared with the April medium-term forecast, the estimate of real economic growth for 2006 has been increased slightly, mainly in connection with the expected changes in domestic demand.

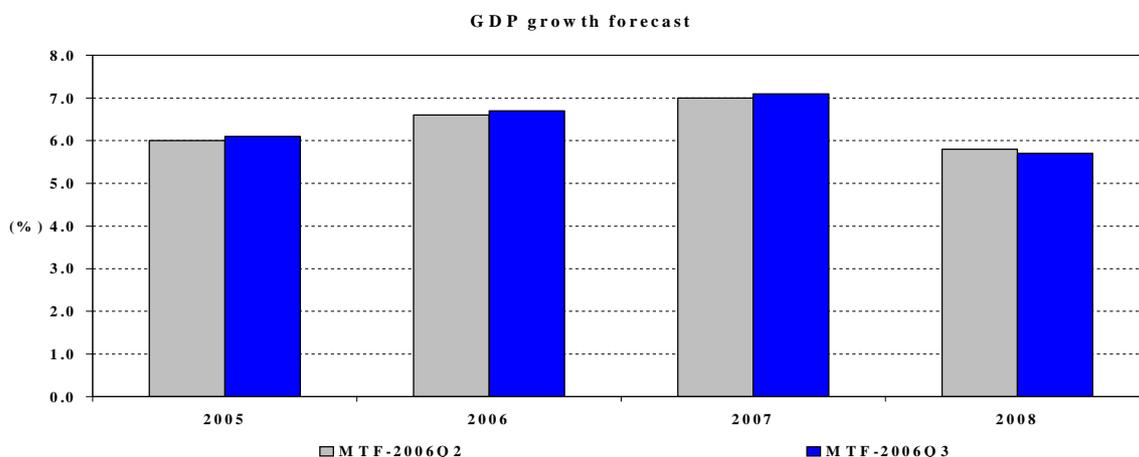
In 2006, final household consumption will probably be dampened by a slightly slower growth in real wages, due to higher expected inflation, while being stimulated by a faster growth in employment. The relatively rapid growth in real government expenditure in the first quarter of 2006, caused by increased purchases of goods and services and increased wage costs in the general government sector, may also indicate accelerated growth in public spending in the quarters to come. The source of rapid gross fixed capital formation in the following quarters of 2006 should be the increased investment activity in a wide spectrum of sectors.

Based on the expected trend in the balance of goods and services, net exports in 2006 should contribute 1.1 percentage points to real GDP growth. The MTF-2006Q3 predicts different developments in net exports in the individual quarters. While real economic growth in the first quarter of 2006 was dampened by net exports, GDP growth in the other three quarters of 2006 is expected to be stimulated through the balance of goods and services, which should improve after the launch of production at the PSA automobile assembly plant.

Thus, GDP growth in 2006 should be influenced by both domestic and foreign demand, while the most significant pro-growth factor should be final consumption. On the basis of these assumptions, real economic growth may reach 6.7% in 2006.

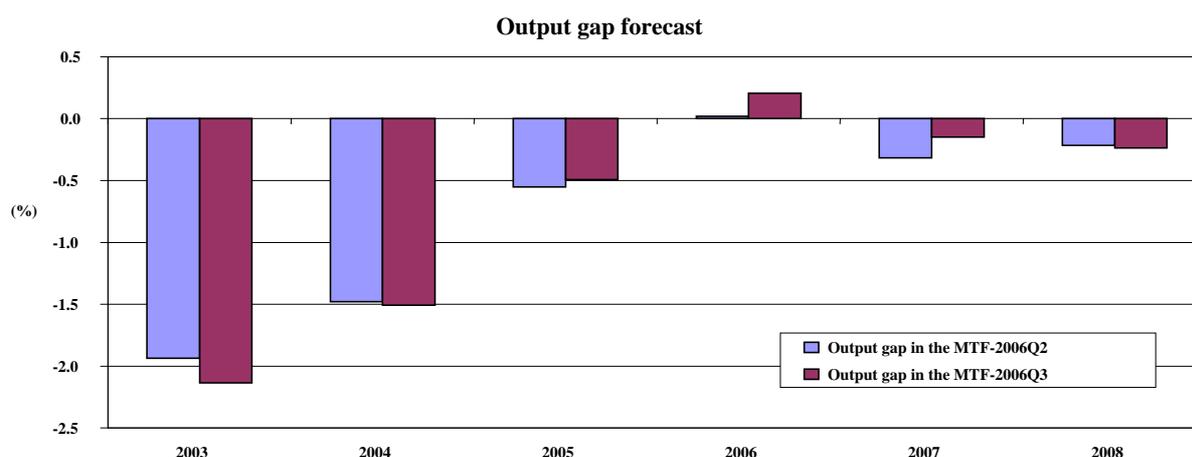
In 2007, the NBS expects an acceleration in the rate of real GDP growth, up to the level of 7.1%, mainly due to the cumulative effect of production in the automotive industry. The increased exports of transport vehicles will cause the balance of goods and services to improve. Thus it is possible to assume that approximately 1/3 of the economic growth in 2007 will be associated with net exports. Economic growth will also be influenced by domestic demand, mainly its consumer component. In final household consumption, a pro-growth effect may also be expected from the rapid growth in employment, in addition to the expected wage developments. As regards its contribution to GDP growth, the increase in private consumption should be offset partly by increased imports of goods for final consumption. However, the rapid growth in final consumption in 2007 should be dampened to some extent by the tightening of monetary conditions, as a reaction to the deviation of inflation from the target rate. These effects are expected to cause a gradual slowdown in the growth rate of private consumption, which should dampen the rate of economic growth, mainly in 2008.

In 2008, the rate of GDP growth is expected to slow on a year-on-year basis (to 5.7%), due to the base effect of growth in transport vehicle exports. The most significant contribution to economic growth will come from domestic demand components, including the effect of an announced additional PSA investment. This investment should lead to increased imports of goods and services, but their dampening effect will be offset by increased gross fixed capital formation, mainly in the second half of 2008.



Note: The MTF-2006Q2 is based on non-revised data from the national accounts.

The setting of monetary policy for 2006 and 2007 is determined by the ongoing developments in the economy and the reassessed inflation forecast. Update of the medium-term forecast is based on a somewhat faster growth in the economy and a higher inflation rate in particular. The inflation forecast exceeds the target rates set for 2006 as well as 2007, when the reassessed increase in regulated prices is expected to contribute 0.6 of a percentage point to the rise in inflation in 2007. At the same time, there is an increased risk that the expected increased secondary effects and the estimated moderate shift in the cyclical position of the economy may cause an additional acceleration in the price increase in 2007. Such an environment signals a need for more intense monetary policy tightening through an increase in interest rates. The restrictive nature of monetary policy should be designed so as to prevent the economy from becoming overheated and to eliminate its possible inflationary effects. The unambiguous commitment to meet the inflation target will require monetary policy to slightly re-open a negative output gap in 2007 and 2008.



With regard to the strong upward effect of autonomous factors (energy prices) on price level, the inflation target for 2007 is highly unlikely to be achieved through monetary policy tightening. However, the current forecast is still within the band that complies with the Maastricht criteria (based on the spring forecast of the EC), since the higher energy prices may affect inflation also in the other EU countries.