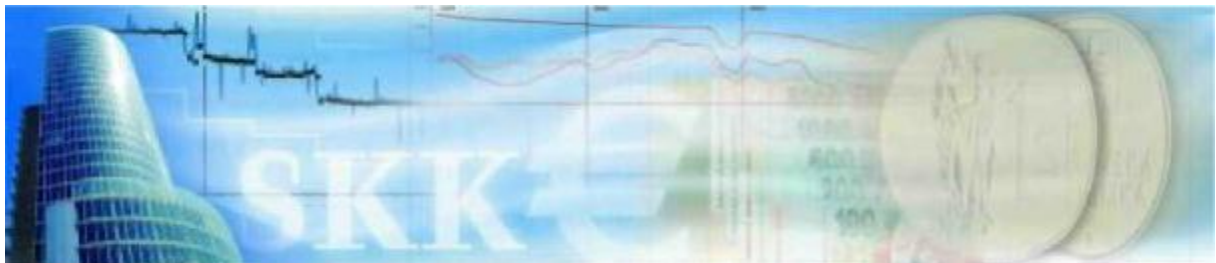




**NATIONAL BANK OF SLOVAKIA**

# **MEDIUM – TERM FORECAST (MTF-2008Q1)**

January 2008



## Equilibrium variables, development of potential output

The starting assumption of the medium-term forecast is that Slovakia is a converging economy with corresponding trends in the main macroeconomic indicators. The basic framework of the medium-term forecast is formed by the equilibrium real interest rates, equilibrium real exchange rate and non-inflationary growth of the economy (potential output). In MTF-2008Q1, no significant changes occurred in the long-term trends in the real monetary variables.

The current medium-term GDP forecast takes into account the revision of annual and quarterly national accounts as well as a change in the methodology of GDP calculation by chain-linking the volume indices, published by the Statistical Office of the Slovak Republic in November 2007. On grounds of revised data the average annual GDP growth in 1997-2006 increased by 0.3 p.p.. Considering the character of the increase (a higher contribution of foreign export and the chain-linking effect), these changes within the above time horizon were reflected in the revaluation of the growth of the economy potential output. This means that the average growth of potential also increased by 0.3 p.p. compared to the previous estimate.

The pro-growth impulse on the side of an increasing export performance of the economy continues to remain the basic assumption of the medium-term forecast. The current medium-term forecast does not include any new information on additional impulses on supply side. This means that the view on the growth of the potential output within the forecast horizon remains unchanged. Thus a significant growth of potential output around the level of 9% in 2007 is anticipated, with a subsequent slowdown.

### Current position of the economy<sup>1</sup>

The estimate of the economy's current position is based on the estimated deviations of the key macroeconomic indicators from their equilibrium trends. The effect of monetary policy through the Real Monetary Conditions Index was still determined by the exchange rate component in the fourth quarter of 2007. The real exchange rate, by means of nominal appreciation, was appreciating faster compared to the assumed appreciation of the equilibrium real exchange rate, hence retaining its restrictive effect. The interest rate of monetary conditions remains only slightly below its equilibrium level, allowing the monetary conditions to retain their restrictive character. The extent of restriction, however, moderated in comparison with the previous quarters of 2007.

The real economic growth in the third quarter of 2007 reached 9.4%. The preceding forecast (MTF-2007Q4) was based on the assumption of an operation of foreign demand and a growing added value in vehicle manufacturing as well as in the entire industrial production. The real growth of GDP in the third quarter was created by foreign as well as domestic demand, in line with assumptions.

From the viewpoint of real economic development in the fourth quarter of 2007, foreign and domestic demand should continue to contribute to the growth of GDP. The development of receipts for own performance and goods in the months of October and November 2007 together with the industrial production index indicate a continuing high growth of value added in vehicle manufacturing as well as in manufacturing of electrical and optical

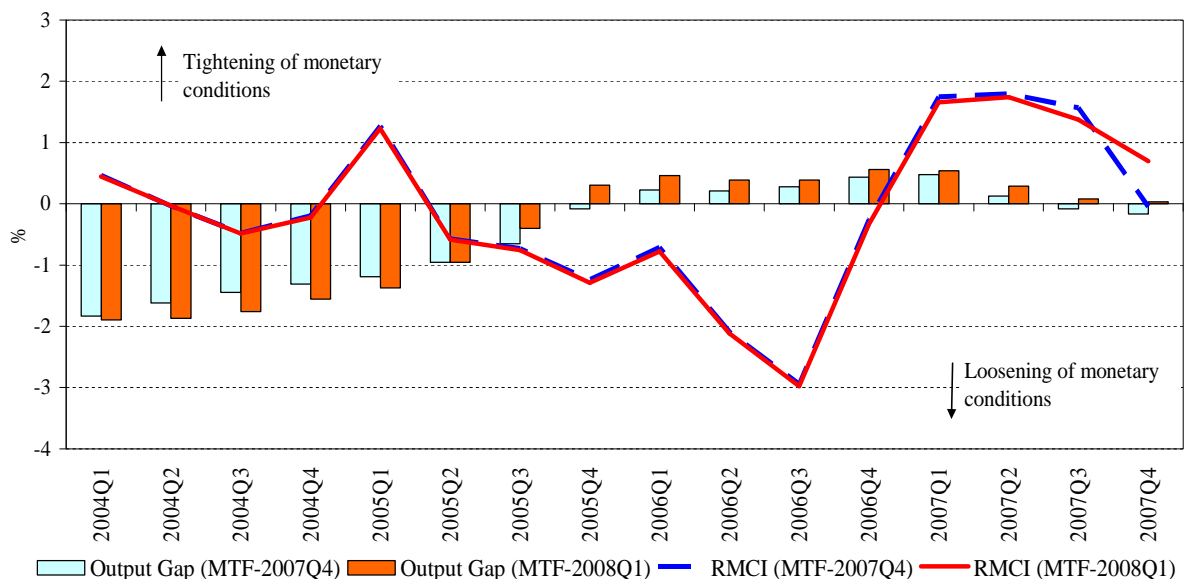
---

<sup>1</sup> The current position of the economy refers to its state in the fourth quarter of 2007 (according to the GDP growth estimate), upon which the short-term as well as medium-term forecasts are based.

appliances. The Slovak economy should thus continue to achieve a high growth of constant prices also in the fourth quarter of 2007.

The forecast of real GDP growth for 2007, similarly to the preceding medium-term forecast, assumes a growth of GDP in constant prices of 9.0% at a concurrence of foreign and domestic demand. From the viewpoint of the structure of domestic demand, a pro-growth effect of all its main components is expected with the exception of a change in stock levels where a negative contribution is assumed (influence of investment imports and their reclassifying into fixed investments).

**Output gap and the Real Monetary Conditions Index (RMCI)**



New information, including data revision and the change of methodology for calculating GDP, did not induce a change in the outlook on the direction of the cyclical position. It is still assumed that the culmination of the economic cycle occurred at the turn of 2006 and 2007, and since the second quarter of 2007 the output gap has been gradually closing. It is assumed that the economy produces close to its production capacities at present (GDP gap is 0.0% in the fourth quarter of 2007).

The increase of nominal as well as real wages was lower in the third quarter of 2007 compared with the expectations of the NBS in the October medium-term forecast. Nominal wages should continue to grow also in the fourth quarter of 2007, which is also indicated by the preliminary data on wage developments in the selected sectors in October and November. Its dynamics, however, should be higher in comparison with the third quarter of 2007, especially in connection with an expected faster growth of wages in the sectors of general government, defence and social security (proceeding from a faster growth of expenses from the national budget on wages and personal settlements). Considering that the present development of nominal wages was slower than the NBS had expected, their dynamics in 2007 should also reach a slightly lower value than was predicated (7.0%) in the MTF-2007Q4.

Growth of real wages in the fourth quarter of 2007 should slow down compared to the preceding quarter due to a higher inflation, which will also manifest itself in a lower growth of real wages in the entire year 2007.

The growth of real wage in the third quarter of 2007 lagged behind the growth of real labour productivity, and we assume the same development in both the fourth quarter of 2007 and the entire year 2007.

No significant changes in the development of the economy occurred in the third quarter of 2007 compared with the previous periods. The continuing strong growth of GDP projected itself, in the third quarter of 2007, also in the growth of employment (ESA95), which was in line with that expected by the NBS in the October medium-term forecast. On the basis of the present development, we assume a dynamic growth of employment also in the fourth quarter of 2007 (which is indicated by the preliminary data on employment development in selected sectors in October and November 2007) and its dynamics should be slightly lower in comparison with the third quarter of 2007 (as in MTF-2007Q4). Employment for the entire 2007 (according to ESA95) should achieve the same growth compared to MTF-2007Q4. Unchanged expectations in the development in employment, with the same growth of value added, resulted in a dynamic growth of labour productivity, which was in line with the NBS assumptions in MTF-2007Q4.

The balance of payments current account showed a deficit amounting to SKK 59.6 billion in the first nine months of 2007, falling year-on-year by SKK 29.9 billion. As expected by the NBS in MTF-2007Q4, a significant year-on-year improvement of the trade balance development took place, which, however, was also supported by revising the foreign trade data that had not been taken into account in the October medium-term forecast. Data were revised as a result of methodological changes in the foreign trade statistics (showing trades in electrical energy, specifying transaction costs, exempting previously included indirect exports and imports from the foreign trade statistics). This revision significantly decreased not only the volumes of export, but mainly import, in all data for the year 2007 that were published by that time, with a subsequent positive impact on the level of the trade balance in the first three quarters of 2007. This, of course, also influenced the assessment of foreign trade development for the fourth quarter of 2007. The above positive influence was only partially compensated by growing oil prices and the current trade balance development in October and November. Compared to the previous medium-term forecast, foreign trade for the entire 2007 should therefore, influenced by the revision, achieve a significantly lower annual deficit. In reverse, the present development of the balance of current transfers (both government and other) showed itself in the estimate of the increased annual deficit of the balance of current transfers, thus moderately dampening the decrease in the current account deficit compared to the previous medium-term forecast. The trade balance deficit, lower on a year-on-year basis, also influenced the development of the share of the balance of payments current account in the GDP, which fell by 3.1 p.p. compared to 2006 (by 0.8 p.p. compared to the October medium-term forecast) to the level of 3.9%. Similarly, the trade balance also recorded the improved development of this indicator of 3.4 p.p. to the level of 1.1% compared to 2006 (0.9% compared to MTF-2007Q4).

In the fourth quarter of 2007, the year-on-year growth rate of consumer prices accelerated to the level of 2.3%. Such development was mainly influenced by an acceleration of the year-on-year food price dynamics. At the same time, the growth rate of prices of services and fuels sped up, with a simultaneous slowdown of the year-on-year decrease in the prices of industrial goods excluding energy. To the contrary, the dynamics of other energy prices (excluding fuel prices) decelerated. Food prices were affected by a global increase in prices of agricultural commodities due to poor crops, a growing demand for food in China and India, as well as the demand for agricultural commodities such as raw material for bio fuels

production. As a result of this, the growth rate of prices of processed as well as unprocessed food increased. Within the framework of processed food prices, there was an increase in the prices of bread and flour products, milk and dairy products, and butter. In the framework of non-processed food, these were especially the prices of fruit and poultry that increased. The prices of non-energy industrial goods were affected especially by the base effect in the prices of medicines, with only a modest increase of their prices in the same period of the last year and a more significant increase in October 2007. This was shown in a more substantial slowdown of a year-on-year decrease in the last quarter of 2007. Within the framework of service prices, there was an acceleration of the dynamics of prices in restaurants as a consequence of an increase in the prices of food, recreational and sport services. The prices of medical and financial services similarly recorded a higher year-on-year dynamics compared to the previous quarter.

## Medium-term forecast

### External environment

The forecast of exogenous indicators was based on the December issue of “Consensus Forecasts” (CF)<sup>2</sup>. The expected development of oil prices is based on the prices of futures as of 3 December 2007.

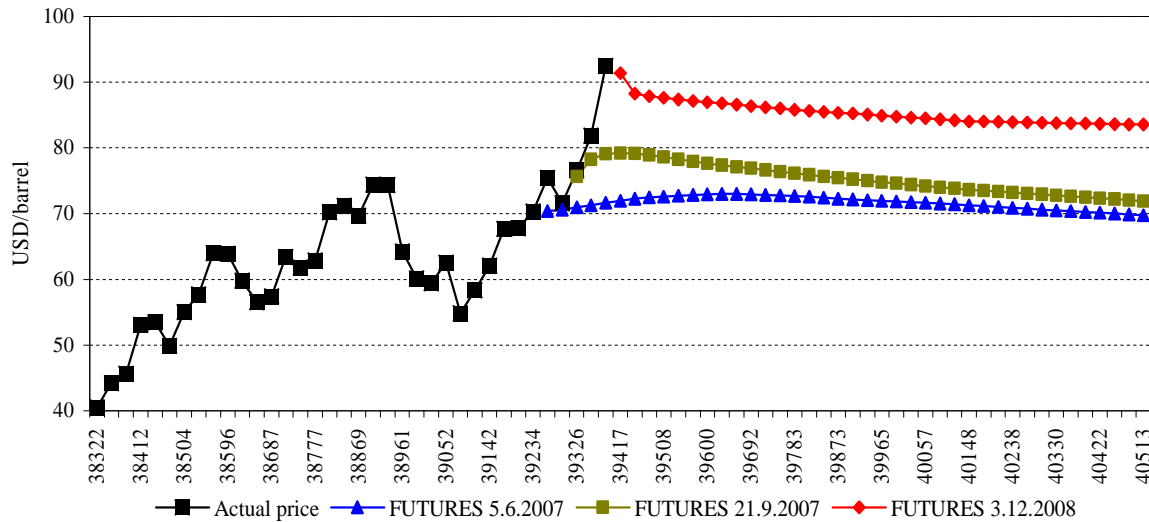
The forecast of oil prices development assumes a relatively significant shift to higher levels within the entire horizon of the forecast in comparison with MTF-2007Q4. Compared to the previous forecast, oil should record a more substantial year-on-year growth in 2008. In the following years, its price should fall modestly. The influence of world oil prices on the domestic price development should be partially dampened by a weaker exchange rate of the dollar.

---

2

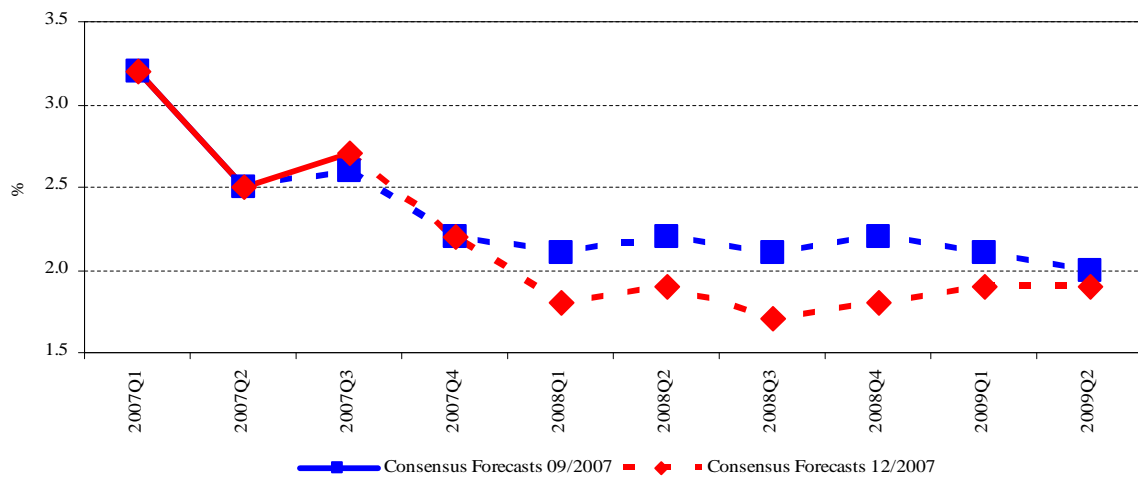
A survey of forecasts made by international economic and financial institutions, from which an average is calculated. This ensures the most unbiased estimate of the trends in foreign sector indicators. With regard to the course and schedule of forecasting at the NBS, the values of input variables were obtained from the Consensus Forecasts of December 2007 and fixed at these levels throughout the forecasting process. Any new information will be taken into account in the next medium-term forecasts.

### Expected oil prices



The growth of the euro area GDP according to CF 12/2007 should be lower by about 0.4 p.p. in 2008 and by 0.1 p.p. in 2009, compared to MTF-2007Q4.

### Euro-area GDP growth forecast based on the Consensus Forecasts



Compared to MTF-2007Q4, inflation in the euro area should be significantly higher in 2008 and it should move above the ECB inflation target. This development should be influenced by a simultaneous high growth of food prices, impact of which should subside by the end of 2008. As a consequence of the base effect of food prices development, the inflation in 2009 should be slightly lower compared to the previous forecast.

As a result of the ongoing crisis on the financial markets and problems with liquidity, the December CF assumed a higher level of three-month EURIBOR for the end of 2007, compared to the previous forecast. This approximately corresponded to the market level as at the beginning of December. However, in the following years the CF expects a more substantial lowering of rates to levels lower than in the September forecast.

	2006	2007	2008	2009
Euro area inflation in %				
CF 09/07 (annual average)	2.2	2.0	2.0	2.0*
CF 12/07 (annual average)	2.2	2.1	2.4	1.9*
Euro area GDP growth in %				
CF 09/07	2.8	2.6	2.2	2.0*
CF 12/07	2.8	2.7	1.8	1.9*
Oil prices in USD/barrel and EUR/barrel, respectively (average p.a.)				
21 September 2007	66.2/52.9	70.0/51.8	77.6/57.0	74.7/55.9
3 December 2007	66.2/52.9	71.7/52.8	86.6/60.1	84.7/61.1
Interest rates (3-month EURIBOR) (the end of the relevant quarter)				
CF 09/07	3.725 (4.Q)	4.4 (4Q)	4.4 (3Q)	4.2* (4Q)
CF 12/07	3.725 (4.Q)	4.9 (4Q)	4.2 (4Q)	4.1* (4Q)
USD/EUR exchange rate (the end of the relevant quarter)				
CF 09/07	1.317 (4.Q)	1.377 (4Q)	1.356 (3Q)	1.330 (3Q)
CF 12/07	1.317 (4.Q)	1.410 (4Q)	1.410 (4Q)	1.361 (4Q)

\* NBS forecast

### Forecast for 2008 and 2009

The current medium-term forecast foresees a year-end inflation rate of 2.8% in 2008 (an average of 2.9%) and its acceleration to the level of 2.9% in 2009 (an average of 3.1%). Compared with the MTF-2007Q4 forecast, the values of the current medium-term inflation forecast in 2008 as well as in 2009 are higher due to the influence of the development of food and oil prices.

In the framework of basic inflation structure, the dynamics of goods and service prices should accelerate in both 2008 and 2009.

In goods prices, the inflation should be pro-inflationary influenced by the prices of industrial goods excluding energy whose dynamics should reach higher values in 2008, due to the base effect in medicines prices among other things, and they should record year-on-year growths. However, in 2008 and 2009 the prices of these goods should continue to be influenced also by a low imported inflation, due to the openness of the Slovak economy and, following the introduction of the euro, the simplification of trade exchange and price comparison.

In the first half of 2008, food prices should be influenced by a continuing increase in the prices of agricultural commodities. However, by the end of 2008 the growth of food prices is expected to slow down, as a consequence of a gradual influence decay of their significant increase in the last months of 2007. Due to this development, the medium-term forecast assumes a fall in food prices dynamics in the last quarter of 2008 (also on grounds of the values of futures on agricultural commodities and assumptions about the crops and the state of wheat reserve according to the International Grains Council). In the second half of 2008, the food prices (as in MTF-2007Q4) should be affected by an increase in excise

duties on cigarettes. This effect should continue to influence food prices in 2009, too. Increasing excise duties on cigarettes constitute a factor outside the effect of monetary policy with a one-time influence, whereas its contribution to the end-of-year inflation in 2008 and 2009 should represent approximately 0.4 percentage point. The food price dynamics should gradually stabilise and there should be no supply shocks such as those recorded at the end of 2007.

Following a slowdown in the year-on-year dynamics in 2007, energy prices should record an increasing year-on-year dynamics due to an increasing year-on-year growth of fuel prices (on the basis of higher Brent oil futures prices comparing to the previous forecast). In the second half of the year 2008 and in 2009, the dynamics of fuel prices should slow down. Within the framework of regulated energy prices, from January 2008 onwards there should be an increase in the prices of electrical energy for households of 2.7%, in the prices of natural gas of 0.2% and heat of 0.4%. Considering the current development of Brent oil futures, the NBS assumes a further increase in gas and heat prices already at the end of the year 2008 (October). In January 2009, there should be a further increase in regulated prices of gas, heat and, in relation to the development on the market for power energy, a further increase in electrical energy prices may be assumed.

According to the NBS assumptions, regulated prices (energy prices and other regulated prices) should increase by 2.5% in 2008 and by 4.0% in 2009 on average. Their contribution to headline inflation should be about 0.7 percentage point in 2008 and 1.2 percentage points in 2009. By the end of 2008 and 2009, regulated prices should increase by 3.8% and 2.8%, respectively.

In service prices, the trend from the end of 2007 should continue in 2008, namely stronger cost pushing impulses resulting from a faster growth of food prices (in the course of the year 2008) should manifest themselves in restaurant services. The prices of financial services should also grow. In 2009, service prices should continue with a trend similar to that in 2008, characterised by a gradual acceleration of their dynamics, and they should also be affected by the impact of the euro introduction (the so-called changeover effect).

The dynamics of goods prices, together with service prices, will also be influenced by the effect of introducing euro coins and banknotes (the so-called euro changeover effect) with a contribution of 0.3 percentage point to headline inflation (equally as was the case of countries which have already introduced euro, such as Slovenia).

Comparison of HICP forecasts (year-on-year change in %, average per period)

		2006	2007	2008	2009
<b>TOTAL (HICP)</b>	<b>MTF-2007Q3</b>	4.3	1.7	1.9	2.2
	<b>MTF-2007Q4</b>	4.3	1.7	2.3	2.7
	<b>MTF-2008Q1</b>	4.3	1.9	2.9	3.1

Comparison of HICP forecasts (year-on-year change in %, end-of -year figures)

		2006	2007	2008	2009
<b>TOTAL (HICP)</b>	<b>MTF-2007Q3</b>	3.7	1.5	2.0	2.5
	<b>MTF-2007Q4</b>	3.7	1.6	2.3	2.8
	<b>MTF-2008Q1</b>	3.7	2.5	2.8	2.9

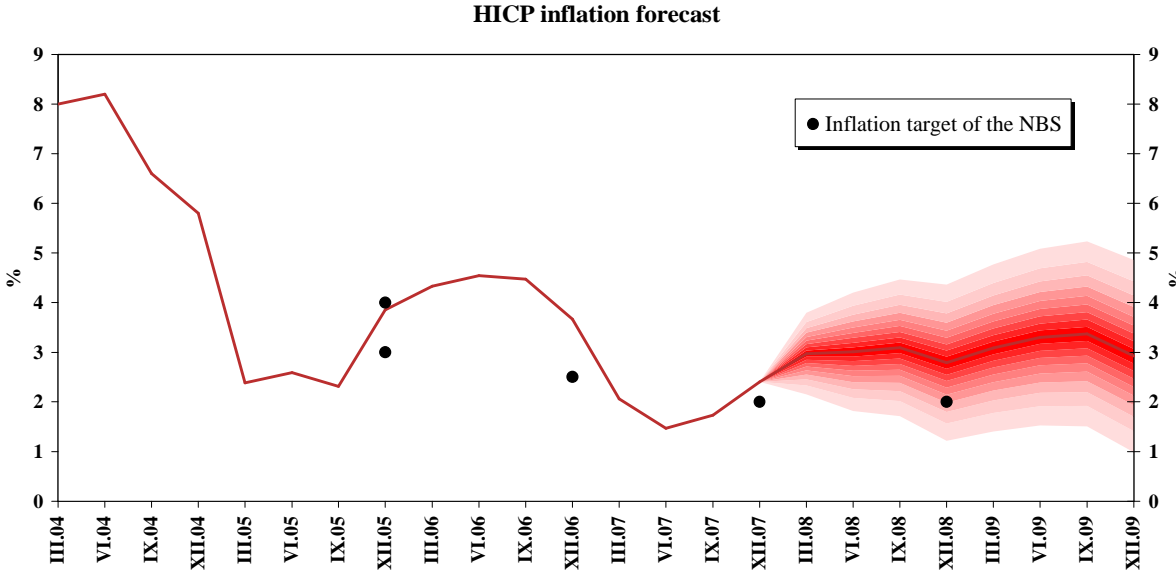
Note: the MTF-2008Q1 forecast does not take into account the published inflation for December 2007 as yet.



Pro-growth inflationary risks of prediction include the development of oil prices and the resulting impacts on fuel prices and on regulated energy prices, which may change the level of inflation rate compared to the current forecast (in the second half of 2008).

Food prices, which may be affected by development in the prices of agricultural commodities in the European market, also pose a persistent inflationary risk. A part of this risk, identified in MTF-2007Q4, has been considerably taken into account in the current forecast. In spite of this, however, there is still a risk that a more substantial growth of their prices may occur.

Service prices still represent an inflationary risk (to the same degree as in the previous forecast) resulting from growing employment, the growth of nominal and real wages and of household final consumption.



In the medium-term real economy forecast for 2008 and 2009, similarly to the October medium-term forecast, a gradual slowdown is expected in the dynamics of real growth of GDP (7.7% or 6.9%). Although it is difficult to compare the current forecast with MTF-2007Q4 due to the change in methodology, it is possible to state that no new facts and information have been identified and thus MTF-2008Q1 predicts an unchanged character of economic development in comparison with the previous medium-term forecast.

Within the structure of domestic demand, a pro-growth effect of all its main components is assumed in 2008-2009.

The forecast of household final consumption development, whose dynamics has been gradually slowing down in the medium-term horizon, is affected by the development in the labour market (a slowing-down trend in the development of real wages and employment compared to MTF-2007Q4).

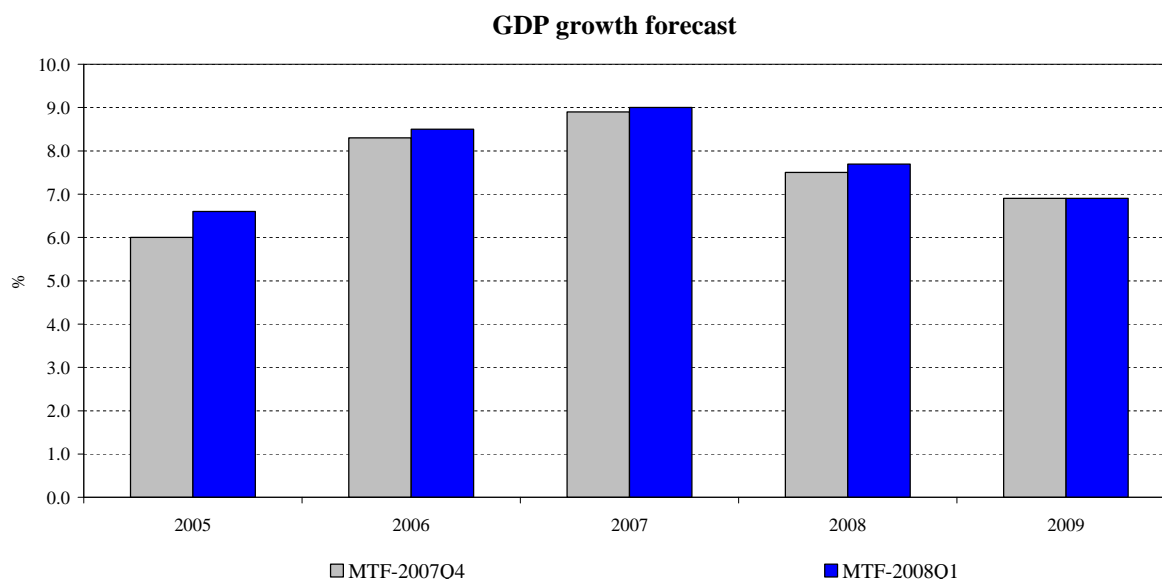
Developments in general government final consumption will be connected with the fulfilment of the general government budget, overall economic development, and drawings from the structural funds. Within MTF-2008Q1, however, there has been no change of assumptions in the development of this GDP component.

The development of gross fixed capital formation will be also affected by drawing of

resources from structural funds. The development of profits of companies, a stable business environment, as well as the entry of the Slovak Republic into the euro area, should all contribute to the growth of fixed investments, in a similar way as in MTF-2007Q4.

From the viewpoint of net export development, MTF-2008Q1 assumes that from 2007 onwards, the net export contribution will gradually lessen. The positive development of the trade balance will continue, but to a lesser extent than in 2007.

Risks to the forecast (upward) comprise, like in the October medium-term forecast, new investments, especially in the power industry (a gas turbine power plant at Malženice, construction of blocks 3 and 4 of a nuclear power plant at Mochovce, a thermal power plant at Trebišov, or investments in renewable energy sources).



The current medium-term forecast (MTF-2008Q1) for 2008 and 2009 does not predict any changes in the nominal wage growth compared with the previous October medium-term forecast (7.1% in 2008, 7.6% in 2009). Real wage growth should be slightly lower compared with the previous medium-term forecast due to a higher growth of consumer prices. In its assumptions, the NBS proceeds from the current wage development where the risk that the wage growth will be affected by a faster growth of labour productivity has not yet been confirmed. However, this assumption remains a risk to the forecast, as in MTF-2007Q4. The assumption that there are pressures for faster wage growth, resulting from a possible shortage of qualified labour in the building industry, automotive industry and electrical engineering, remains a risk in the wage forecast for 2008-2009. At the same time, there is a limited room for nominal wage growth due to the stronger foreign competition.

The MTF-2008Q1 expects the same growth of employment (ESA95) in 2008-2009, as was in the previous forecast (1.7% in 2008, 1.4% in 2009). Growth of employment should be influenced by a favourable economic environment, and investments together with demand for services should remain the main factors of its growth within the entire forecast period.

With the expected development of GDP and employment remaining unchanged, the trend of labour productivity has not changed substantially, compared with the previous October forecast. Based also on the current development, the NBS confirmed in MTF-2008Q1 the

assumption that the fast growth of labour productivity will not fully affect the nominal wage growth. This assumption remains an upward risk of a medium-term nominal wage forecast.

The development in the number of unemployed was slightly higher in the third quarter of 2007 than the NBS had expected. Based on this fact, at a slightly slower employment growth according to LFSS, the unemployment rate (based on an LFSS) should reach slightly higher values in the entire forecast horizon compared with the previous forecast. (10.0% in 2008, 9.8% in 2009).

#### **Access to the EU Member States` labour market**

The new Member States` access to the EU labour market was conditioned by setting transitional periods in the Treaty of Accession to the EU. At the time of implementing these restrictions, the "2+3+2 rule" was put into force, meaning that the old Member States were allowed to apply certain regulations for seven years in total. At present, Slovak citizens may be employed in 21 EU Member States with an open labour market (Cyprus, Czech Republic, Estonia, Finland, Greece, Netherlands, Ireland, Lithuania, Latvia, Luxembourg, Hungary, Malta, Poland, Portugal, Slovenia, Sweden, Spain, Italy, United Kingdom, Bulgaria and Romania). Three countries - Belgium, Denmark and France - have a partially closed labour market, having allowed selected professions, which they lack most, to enter their market. The Danish government have announced that in the course of 2008 they will open their labour market to all EU citizens (however, without announcing the exact date). Belgium and France will continue to apply transitional restrictions until 2009. Countries with a closed labour market, such as Germany and Austria, consider their labour markets threatened by an influx of cheap labour. For this reason, they chose to apply a seven-year transitional period and they are not planning to curb or cancel these limitations. If significant changes occur in relation to cancelling restrictions on the part of countries with closed labour markets prior to the anticipated dates, it could have an influence on unemployment in the Slovak Republic, also with a possible occurrence of pressures on the labour market, which would have an impact on wage development.

In the framework of current account balance in 2008 and 2009, in accord with the previous medium-term forecast, it is anticipated that the high export performance of the economy will continue; in both years the dynamics of export growth should exceed the 10% level. In this period, a major influence of FDI companies is further expected, when the most significant growth should be recorded especially in the automotive and electrical engineering industries. The inclusion of foreign trade revision had a positive influence on the development of the trade balance; however, in the entire horizon this should be moderated by a higher estimate of oil prices. Due to the revision of data, it is not possible to compare the export and import in their commodity structures for the individual years with the values of export and import from the previous medium-term forecast (MTF-2007Q4). In general, however, it can be stated that the basic framework of assumptions have remained unchanged, namely the inclusion of existing as well as supplementary FDI into the Slovak export, as a result of which there should be a yearly improvement of the trade balance.

The export performance of the economy in 2009 should be also supported by the anticipated entry of the Slovak Republic into the euro area. Due to the absence of transaction costs, a positive influence on export especially is assumed, which should manifest itself in the improvement of the foreign trade balance in a longer-term horizon. To the contrary, the possible investments in electrical power engineering, being considered at present, which could manifest themselves in a temporary deterioration of the foreign trade balance, would have a negative impact on the balance of trade development within the period under

review. These assumptions are identical with the October medium-term forecast.

The balance of payments current account deficit should drop, in accord with the previous medium-term forecast, while changes in the estimated trade balance led to an improvement of deficit estimates in 2008 and 2009 of approximately SKK 15 billion annually and to a decrease in the share of the current account deficit in GDP of 0.8 or 0.7 p.p., compared to MTF-2007Q4. The degree of openness of the economy decreased by more than 6 p.p. in the both years compared to the October medium-term forecast, with its estimate having reached the value of 173.5% for 2008 and 174.1% for 2009.

The expected development of the real economy does not differ significantly from the assumptions of the previous medium-term forecast. The increasing export performance of the economy should continue to be the determining factor of the expected fast economic growth while demand pressures are not expected to occur. The production of the economy should stay close to its potential, with a slightly pro-growth impulse associated with the expected entry into the euro area in 2009. Overall, there is no change in the view on the monetary policy setting. Increased inflation caused by a growth of food prices, together with cost impulses caused by rising energy prices, represent the primary shocks which are not to be eliminated by monetary policy.

