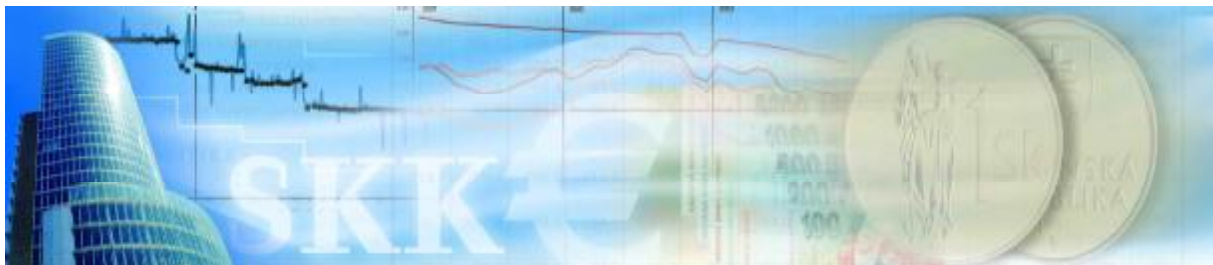




NÁRODNÁ BANKA SLOVENSKA

# MEDIUM-TERM FORECAST (MTF-2008Q2)

April 2008



## Equilibrium variables, development of potential output

The medium-term forecast is based on the assumption that Slovakia is a converging economy, with corresponding equilibrium trends in its main macroeconomic indicators. The basic framework of the forecast is formed, as in the previous quarters, by equilibrium real interest rates, the equilibrium real exchange rate, and non-inflationary growth in the economy (potential output). The long-term trends in the real monetary variables have remained virtually unchanged in the MTF-2008Q2.

As a result of rapid GDP growth in the fourth quarter of 2007, the Slovak economy reached two-digit growth dynamics in 2007. It is reasonable to assume that this development was connected with the stronger-than-expected stimulus of new production capacities to the production side of the economy. Apart from this, the growth in the fourth quarter of 2007 was also influenced by the effect of stocking-up on cigarettes (Box 1). The current data indicate that the increase in production capacities, mainly in the automotive and electrical industries, coupled with the aforementioned stocking-up effect, represents a shift in the economy's non-inflationary output (potential) to a higher level throughout the projection horizon.

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### **Box 1: The impact of stocking-up on cigarettes and tobacco products on the GDP forecast**

An upward effect on GDP growth in the fourth quarter of 2007 was exerted by the stocking-up on cigarettes and tobacco products, owing to an increase in the excise duty on these products with effect from the beginning of 2008. Since excise taxes are planned to be raised again in 2009, a similar impact can also be expected at the end of 2008. This assumption substantially affects the GDP growth forecast for 2007-2010, even if the other conditions remain unchanged.

Stocking-up on cigarettes in the fourth quarter of 2007 is estimated to cover as much as three quarters of the annual cigarette consumption. This means that tax revenues will fall in the first three quarters of 2008 (in equal measure in each quarter). In the final quarter of 2008, however, the same effect is expected as in 2007, i.e. an inflow of additional revenues. Subsequently, in the first three quarters of 2009, tax revenues will again drop in comparison with the estimates from the previous forecast, but without an inflow of additional revenues in the last quarter of 2009.

Compared with the January medium-term forecast, there is an increase in the annual GDP figure for 2007, a neutral forecast for 2008 (decreases in the first three quarters, offset by a stocking-up effect in the fourth quarter), and a fall predicted for 2009. In terms of GDP dynamics, there is an increase of 0.5 of a percentage point in 2007 (compared with the estimate or case without stocking-up), a decrease of 0.5 and 0.4 of a percentage point in 2008 and 2009 respectively, and an increase of 0.4 of a percentage point in 2010 (the base effect of a lower GDP volume in 2009).

These changes in the rate of GDP growth are derived from the mechanical calculation of the stocking-up effect and have no impact on the demand side of the economy. For that reason, these changes are reflected in the actual medium-term forecast in the form of non-inflationary growth in GDP (the economy's potential output) without any impact on the cyclical position of the economy.

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

The estimate of the economy's current position is based on the estimated deviations of its key macroeconomic indicators from the equilibrium trends. In the first quarter of 2008, the setting of monetary policy through the Real Monetary Conditions Index remained slightly restrictive, at virtually the same level as in the last quarter of 2007. Broken down by component, the interest-rate component of the monetary conditions was, as in the previous quarter, loosened somewhat, while the exchange rate component remained restrictive. Despite a slowdown in the nominal appreciation of the exchange rate, the real exchange rate appreciated at a faster rate than the assumption on the equilibrium exchange rate and thus maintained its restrictive character. Compared with the estimates of the previous forecast, however, the average nominal exchange rate was somewhat weaker, as a result of which the overall monetary conditions were less restrictive in the first quarter of 2008.

In the fourth quarter of 2007, the rate of real economic growth reached 14.3%. The previous forecast (MTF-2008Q1) was based on the assumption that foreign demand and value-added growth are reflected in the production of transport vehicles, as well as in overall manufacturing production, which was also confirmed by the actual rate of GDP growth. A change in stocks contributed approximately 4.1 percentage points to the rate of economic growth, mainly as a result of stocking-up on cigarettes. GDP growth in 2007 reached 10.4% at constant prices, due to both foreign and domestic demand (in virtually the same measure).

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### Box 2: GDP development in the final quarter of 2007

According to the principle of continuity in economic development, the marked increase in GDP dynamics in the fourth quarter of 2007 can be classified as non-standard. In our opinion, the estimated growth in the economy's production capacity took place throughout the past year, not only in the final quarter. Given the fact that GDP figures can be revised by the Statistical Office of the SR on a quarterly basis and that the data from 2004 onwards are of a preliminary nature, it is reasonable to assume that data from last year could also be revised in the future. In connection with the non-standard GDP growth in the fourth quarter, the forecast of real economic development is rather uncertain in terms of both dynamics and structure. We assume that GDP figures for the first quarter of 2008 will provide more information on the underlying trend in the economy.

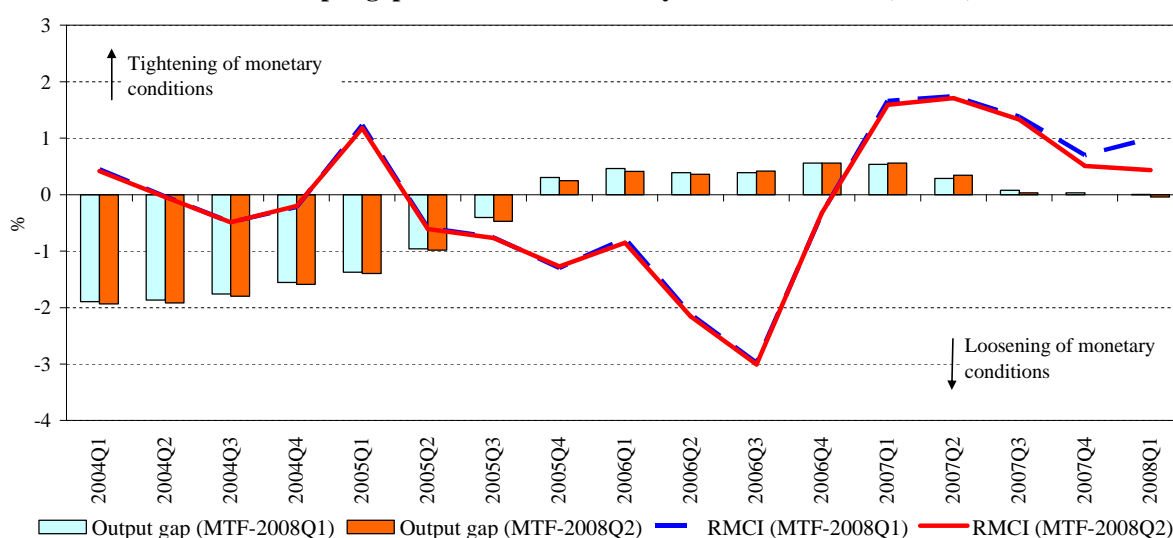
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Regarding real economic development in the first quarter of 2008, GDP growth will probably be again stimulated by foreign as well as domestic demand. On the basis of receipts for own performances and goods for January and February 2008, and the industrial production index, value added is expected to continue increasing steeply in the production of transport vehicles, as well as in the manufacture of electrical and optical equipment. On the other hand, GDP growth may be dampened by a fall in tax revenues, as a consequence of stocking-up on cigarettes at the end of 2007. The Slovak economy is expected to achieve rapid growth at constant prices in the first quarter of 2008.

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<sup>1</sup> The current position of the economy refers to its state in the first quarter of 2008 (according to a GDP growth estimate), upon which the short-term as well as medium-term forecasts are based.

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



Since the effect of stocking-up on cigarettes and the expected marked increase in production capacity were mostly reflected in the supply side of the economy, the cyclical position has remained virtually unchanged, in line with the January forecast. Since the second half of 2007, the economy's output has been close to its production capacity.

The growth in nominal and real wages in the fourth quarter of 2007 was stronger than expected by the NBS in the January forecast, mainly as a result of wage growth in the public sector (mostly in health care and education). Since nominal wages grew over the fourth quarter of 2007 at a faster pace than expected by the NBS, their average dynamics in 2007 slightly exceeded the predicted figure (7.2%). The dynamic nominal wage growth is expected to continue in the first quarter of 2008, which is also indicated by preliminary data on wage developments in the selected sectors in January and February 2008.

In the first quarter of 2008, real wage growth is expected to slow in comparison with the previous quarter, as a result of higher year-on-year inflation. Real wage growth in the fourth quarter of 2007 lagged behind the growth in real labour productivity, and the same trend is expected in the first quarter of 2008. In 2007, real wages achieved a growth rate of 4.3%.

The continuing strong GDP growth in the fourth quarter of 2007 was partly reflected in the growth of employment (ESA95), which was somewhat faster than according to the MTF-2008Q1 forecast. Employment increased by a total of 2.1% during 2007. On the basis of the previous trend, employment is expected to grow dynamically in the first quarter of 2008 (this is also indicated by the preliminary results of employment surveys conducted in the selected sectors in January and February 2008) and its dynamics should remain at the level of the final quarter of 2007.

The balance of payments on current account for 2007 resulted in a deficit of SKK 98.8 billion, representing a year-on-year decrease of SKK 17.7 billion, caused by a smaller trade balance deficit. The other current account components recorded deteriorations in comparison with 2006. The current account deficit exceeded the expectations of the NBS set out in the MTF-2008Q1 by more than SKK 26 billion, which was mainly caused by a higher-than-expected income balance deficit and, in smaller measure, by deteriorations in the current transfers and services balances. On the other hand, the annual balance of foreign trade was in

line with the expectations of the NBS (MTF-2008Q1). The significant year-on-year improvement in the trade balance, supported mainly by new foreign direct investments, was reflected in the strong export dynamics. The year-on-year decrease in the trade deficit also influenced the b.o.p. current account deficit as a share of GDP, which dropped by 1.7 percentage points compared with 2006, to 5.3% in 2007. In the trade balance, an improvement of 3.3 percentage points was recorded in terms of this indicator, to 1.2%.

Over the first quarter of 2008, the year-on-year rate of increase in consumer prices accelerated to 3.4%. This development can be ascribed to increases in year-on-year price dynamics in all groups of the basic structure of consumer-price inflation. The largest increases were recorded in the dynamics of fuel prices and other regulated prices. Prices for services and foodstuffs also rose at an accelerated rate on a year-on-year basis. The year-on-year fall in non-energy industrial goods prices decelerated. Food prices were affected by the global increase in agricultural prices resulting from poor harvests, growing demand for foodstuffs in China and India, and increased demand for agricultural commodities for the production of biofuels. Within the scope of food prices, processed foodstuffs recorded an acceleration of increase in price dynamics. Unprocessed food prices rose at a slower pace on a year-on-year basis (as a result of developments in potato prices). In non-energy industrial goods prices, base effects were mainly reflected in the prices of pharmaceuticals, which rose significantly in January 2008 and falling in the same period a year earlier as a result of lower VAT rates. This development caused a slowdown in the year-on-year fall in industrial goods prices in the first quarter of 2008. The acceleration annual rate of increase in energy prices in the first quarter of 2008 (compared with the previous quarter) was caused by fuel prices, which recorded a marked increase in their year-on-year dynamics, and by other energy prices (heating and electricity). In services, price dynamics increased in transport, housing-related services, personal and recreational services, as a result of cost effects in food and energy price developments. Stronger year-on-year dynamics than in the previous quarter were recorded in prices for medical and financial services.

In comparison with the previous forecast (MTF-2008Q1), the level of inflation in the first quarter of 2008 was higher, due mainly to the stronger-than-expected dynamics of food prices and steeper-than-expected increases in fuel and other energy prices (regulated energy prices – heat). On the other hand, prices for services showed weaker-than-expected dynamics (compared with the MTF-2008Q1), due primarily to the slower-than-expected increase in prices for housing-related services.

## **Medium-term forecast**

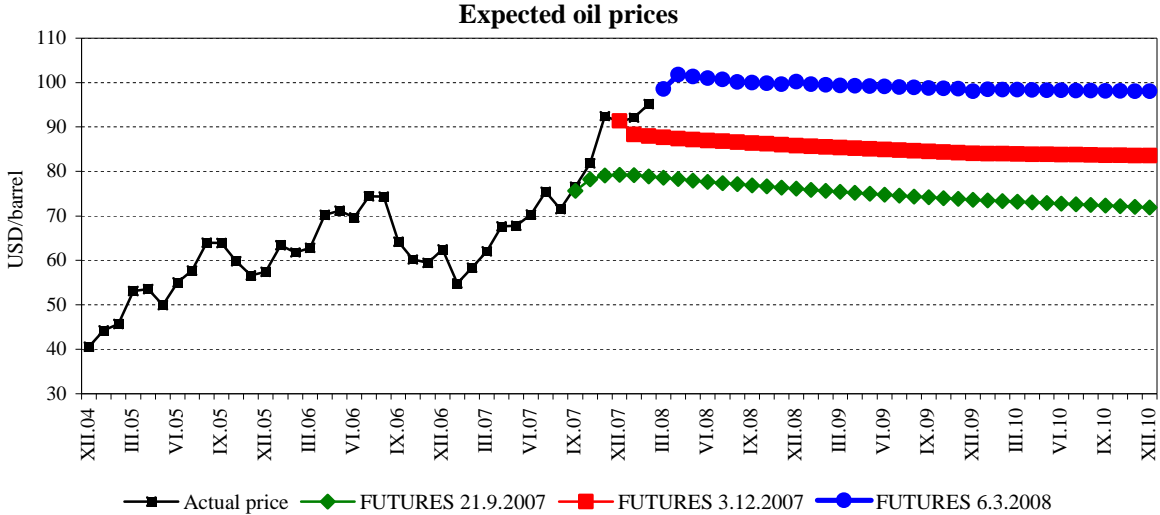
### **External environment**

The current forecast of exogenous indicators is based on the March issue of “Consensus Forecasts” (CF)<sup>2</sup>. The expected development in oil prices is based on the prices of futures as of 6 March 2008.

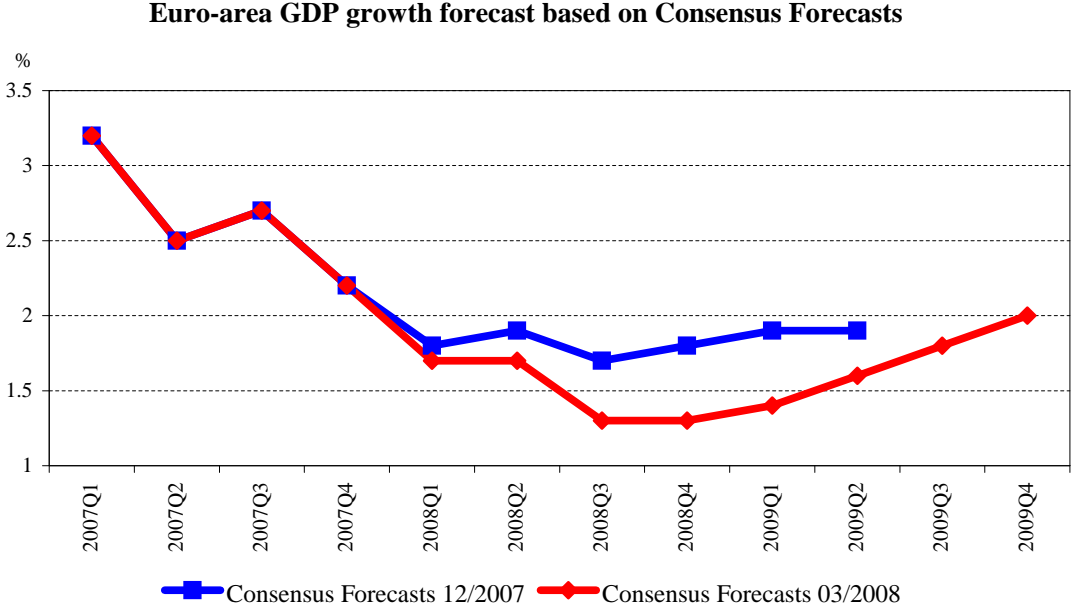
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<sup>2</sup> A survey of forecasts made by the international economic and financial institutions, from which an average is calculated. This ensures the most unbiased estimate of the trends in foreign sector indicators. With regard to the course and schedule of forecasting at the NBS, the values of input variables were obtained from the Consensus Forecasts of March 2008 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 MTF-2008Q1, the oil price forecast predicts another shift to a higher level for the entire projection horizon. Compared with the previous forecast, oil prices are expected to rise significantly on a year-on-year basis, until the first quarter of 2009. During the following period, oil prices should fall somewhat, but to a lesser extent than predicted in the MTF-2008Q1. The influence of world oil prices on domestic price developments should be dampened to some extent by the weaker exchange rate of the dollar. Regarding the actual course and level of the EUR/USD cross-rate, however, the exchange rate of the US dollar will probably have a more significant dampening effect on the koruna equivalents of oil prices.



Euro-area GDP growth according to the CF 03/2008 is likely to slow further in comparison with the previous forecast, by 0.3 of a percentage point in 2008 and by 0.2 of a percentage point in 2009.



Compared with the MTF-2008Q1, the rate of euro-area inflation is expected to be higher in 2008, well above the inflation target of the ECB. This development is likely to be influenced

by the rapid increase in oil prices and the persistent rise in food prices, the impact of which should diminish by the end of 2008. As a result of the base effect of food prices, inflation should go down in 2009, back to the level of the ECB's inflation target.

Owing to the persistent crisis in the financial markets and the expected faster slowdown in the rate of economic growth in the euro area, the March Consensus Forecasts predict a relatively marked fall in interest rates in the second quarter of 2008. The rates are expected to drop by as much as 0.4 of a percentage point in comparison with their average level from the first quarter. Interest rates should continue falling in the following period, more steeply than was predicted in the previous forecast.

	2006	2007	2008	2009
<b>Euro-area inflation in %</b>				
CF 12/07 (annual average)	2.2	2.1	2.4	1.9*
CF 03/08 (annual average)	2.2	2.1	2.7	2.0
<b>Euro-area GDP growth in %</b>				
CF 12/07	2.8	2.7	1.8	1.9*
CF 03/08	2.8	2.7	1.5	1.7
<b>Oil prices in USD/barrel and EUR/barrel respectively (annual average)</b>				
3 December 2007	66.2/52.9	71.7/52.8	86.6/60.1	84.7/61.1
6 March 2008	66.2/52.9	72.1/52.5	99.2/67.1	99.0/70.2
<b>Interest rates (3-month EURIBOR) (end-of-relevant quarter)</b>				
CF 12/07	3.725 (Q4)	4.9 (Q4)	4.2 (Q4)	4.1* (Q4)
CF 03/08	3.725 (Q4)	4.7 (Q4)	4.1 (Q2)	3.8* (Q4)
<b>USD/EUR exchange rate (end-of-relevant quarter)</b>				
CF 12/07	1.317 (Q4)	1.410 (Q4)	1.410 (Q4)	1.361 (Q4)
CF 03/08	1.317 (Q4)	1.456 (Q4)	1.443 (Q4)	1.388 (Q4)

\* NBS forecast.

## Forecasts for 2008 and 2010

The current medium-term forecast expects a year-end inflation rate of 2.8% in 2008 (an average of 3.2%), followed by an acceleration in 2009 to 3.1% (an average of 3.0%), and a slowdown in 2010 to 2.8% (an average of 3.0%) in terms of HICP. In comparison with the MTF-2008Q1 forecast, the values of the current medium-term inflation forecasts for 2008 and 2009 are higher (in 2008 the average is higher and in 2009 the year-end figure). The higher average headline inflation rate predicted for 2008 (compared with the previous forecast) is attributable to the higher-than-expected rate of inflation in the first quarter, mainly as a result of developments in energy and food prices. At the end of 2008 no further increase is expected in the price of heating (in contrast with the previous forecast in which a 5% rise was predicted for October), owing to the March increase in heating prices. The higher rate of year-end inflation in 2009 will probably be caused by an accelerated year-on-year increase in services prices (as a result of developments in energy and food prices in 2008).



Within the basic structure of inflation, average price dynamics are expected to increase in 2008 (compared with 2007) for both goods and services. Besides regulated energy prices, stronger inflationary pressures (compared with the MTF-2008Q1) are expected from fuel prices, which are likely to rise again on a year-on-year basis from 2008 onwards. The current forecast predicts a further increase in the excise duty on cigarettes, which is expected to account for approximately 0.4 of a percentage point in 2008. In the last quarter, the year-on-year inflation rate is expected to slow (as according to the MTF-2008Q1), as a result of a base effect in food and services prices, which will offset the expected rise in regulated prices. On the basis of agricultural price developments, the NBS assumes that the current steep increase in food prices is only a temporary factor. Similarly, prices for services in the financial sector are not expected to rise further at the end of 2008. The maintenance of inflation below 3% in 2008 is also facilitated by the lower inflation expectations for 2008, resulting from the very low inflation achieved in 2007. The weaker dynamics of non-energy industrial goods prices in the euro area (compared with the previous forecast) also contribute to the expectation of a slowdown in non-energy industrial goods prices in Slovakia.

In 2009, the prices of goods and services are likely to follow the trend from 2008. The dynamics of non-energy industrial goods prices, as well as services prices, are expected to increase. After the euro changeover, goods prices are likely to be influenced by the simplified trade relations and price comparison on the one hand, while on the other hand, the euro changeover involves the effect of putting-into-circulation of euro coins and notes, which will cause, as in other countries where the euro has already been adopted, a certain price increase, mainly as a result of rounding-off (the changeover effect). This effect is likely to be reflected in the prices of goods, services, as well as foodstuffs. The current forecast, like the previous ones, predicts the same contribution from the euro cash changeover effect (0.3 of a percentage point) as it happened in the case of Slovenia. The rate of price inflation in 2009 will also be influenced by a further increase in the excise duty on cigarettes. According to the current proposal of the Ministry of Finance SR and the NBS calculations, the planned increase in excise duty on cigarettes would contribute approximately 0.2 of a percentage point to overall inflation (0.2 less than according to the MTF-2008Q1). In 2009, food prices are expected to show dynamics corresponding to the long-term trend (with the supply shocks excluded).

Inflation is expected to stabilise in 2010. The dynamics of non-energy industrial goods and services prices are likely to continue increasing in 2010, but consumer prices should no longer be affected by one-off factors, such as the changeover effect or changes in excise duties. The prices of non-energy industrial goods will probably show dynamics comparable with the long-term trend in the euro area. The faster year-on-year increase in services prices is expected to be influenced, in larger measure, by the price convergence, while being dampened by weaker secondary effects in comparison with 2009, resulting from a smaller increase in regulated prices. Similarly, the aforementioned one-off factor, i.e. the changeover effect, should no longer be reflected in services prices in 2010. The dynamics of food prices are also likely to weaken as a result of one-off factors. Within the scope of energy prices, the consumer prices of fuels are expected to drop on a year-on-year basis (as a result of futures-based fuel price developments) and other energy prices to rise moderately (to a lesser extent than in the previous year).

Regulated prices in total (energy and other regulated prices) should, according to the NBS estimates, increase in 2008 to a greater extent than was predicted in the MTF-2008Q1 (as a result of steeper-than-expected price increases in transport and health services), by an average of 3.5%. In 2009, the dynamics of regulated prices are expected to increase by an average of



3.9%, but this increase should be smaller than according to the previous forecast. In 2010, the dynamics of regulated prices are likely to slow-down to 2.9%, as a result of stable and/or slightly falling oil futures prices. Their contribution to headline inflation should be approximately 0.95 of a percentage point in 2008, approximately 1.05 percentage points in 2009, and approximately 0.8 of a percentage point in 2010. By the end of 2008, regulated prices are expected to rise year-on-year by 4.2%, by the end of 2009 by 3.2%, and by the end of 2010 by 2.6%.

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

		2006	2007	2008	2009	2010
<b>TOTAL (HICP)</b>	<b>MTF-2007Q4</b>	4.3	1.7	2.3	2.2	
	<b>MTF-2008Q1</b>	4.3	1.9	2.8	3.1	
	<b>MTF-2008Q2</b>	4.3	1.9	3.2	3.0	3.0

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

		2006	2007	2008	2009	2010
<b>TOTAL (HICP)</b>	<b>MTF-2007Q4</b>	3.7	1.6	2.3	2.8	
	<b>MTF-2008Q1</b>	3.7	2.5	2.8	2.9	
	<b>MTF-2008Q2</b>	3.7	2.5	2.8	3.1	2.8

### Risks to the forecast

The most serious inflationary risk is posed by developments in oil prices and their possible stronger upward effect on regulated energy prices (as from October 2008), than in the current forecast. On the other hand, however, there is a great uncertainty about the state of the US economy (as a result of the mortgage crisis) and the exchange rate of the US dollar against the euro, which may have a dampening effect on energy prices.

Although the NBS expects no marked supply shocks in the period to come, an upside risk is still posed by developments in agricultural commodity prices. Further risks in food prices are the time and range of impact of the increased excise duty on tobacco products with regarding to substantial of stocking-up in 2007. On the other hand, the recent changes in the retail market (the entry of new retail chains and investments in smaller shops – Box 3) may have a dampening effect on consumer prices (food and industrial goods prices).

Prices for services are exposed to the risk of further increases in regulated energy prices and/or food prices (in restaurants). Services prices are still influenced by the upward effect of growing employment (in the same measure as according to the previous forecast), coupled with nominal and real wage growth. On the other hand, government measures to facilitate employment of unqualified people and the long-term unemployed may dampen the wage demands of employees, and thus restrict the impact of this problem on consumer prices for services and inflation.

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### Box 3: Downside risk to inflation

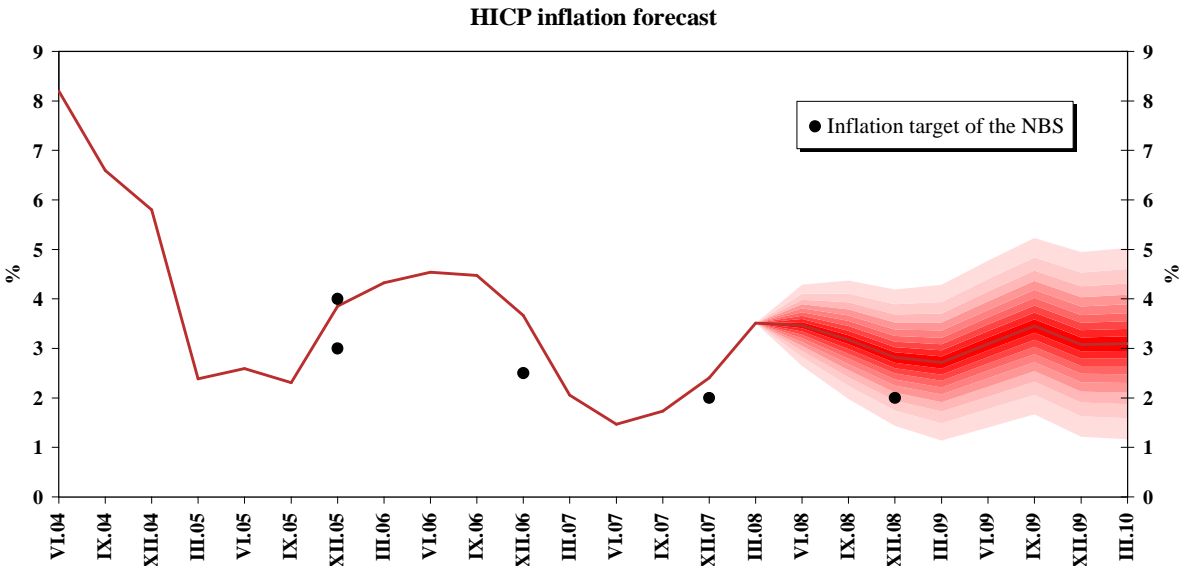
One of the risks that may cause a downward shift in the level of price inflation in 2008 to 2010 is the increasing competition in the retail market.

Since 2000, the number of retail chains has been on the increase in the Slovak market (including the largest retail chains of Europe), as well as the number of large stores (hypermarkets, supermarkets) throughout Slovakia. In 2004, the market was entered by the first discount supermarket chain (LIDL), which launched intense price competition in Slovakia (by selling a limited assortment of goods at the best possible price), forcing the other retail chains to adjust to the lower prices (TESCO, Terno/Coop Jednota, Billa, Kaufland, Hypernova/Albert, etc.). This caused a significant slowdown in the year-on-year dynamics of food prices (HICP, excluding alcoholic beverages and cigarettes), which reached 2.4% in December 2003, followed by a year-on-year fall of 2.8% at the end of 2004 (this representing a slowdown of 5.2 percentage points).

A factor that is likely to influence developments in the retail market is the increasing competition in the sector of small shops, such as BALA, CBA, Prima ZDROJ, COOP Jednota, and other small shops in villages, including convenience stores in suburbs and city centres. Poland’s retail chain ŽABKA is also expected to enter the market. TESCO intends to enter this segment by opening small TESCO Express shops; COOP Jednota also plans to invest in small shops (with a selling area of 300 to 500 m<sup>2</sup>).

In 2010, the Slovak retail market is expected to expand still further with the entry of ALDI/Hofer, Europe’s largest discount retailer, which will generate even sharper competition in the discount market and, in all probability, a further increase in price competition in the entire retail food segment, though smaller than after the entry of the first discount retailer. If we assume that the impact on food prices is 50% weaker (i.e. 2.6 percentage points), the headline inflation rate will be lower by 0.4 of a percentage point than the baseline scenario of the medium-term forecast for 2010.

These factors may increase the level of competition in the retail market, mainly in areas where it has been low so far, such as smaller towns and villages. This may lead to more moderate price developments in the period to come.



In the medium-term forecast of the real economy for the years 2008 to 2010 (as in the MTF-2008Q1), the rate of real GDP growth is predicted to slow gradually (7.4%, 6.9%, and 6.5%), while the growth in 2008 is slower than according to the previous forecast, mainly as a result of the base effect of stocking-up on cigarettes at the end of 2007.

Within the structure of domestic demand, its major components are expected to have growth-promoting effects in 2008-2010, except for the change in stocks in 2008-2009, as a result of the start-up of Samsung and the effect of stocking-up on cigarettes in the previous period.

In the forecast of final household consumption, a moderate increase is expected in dynamics after 2008, mainly as a result of faster growth in real wages. Developments in final general government consumption will be connected with the fulfilment of the general government budget, overall economic development, and the inflow of the EU structural funds. In comparison with the MTF-2008Q1, the rate of growth is unchanged and is in line with the Convergence Programme and the consolidation of public finances.

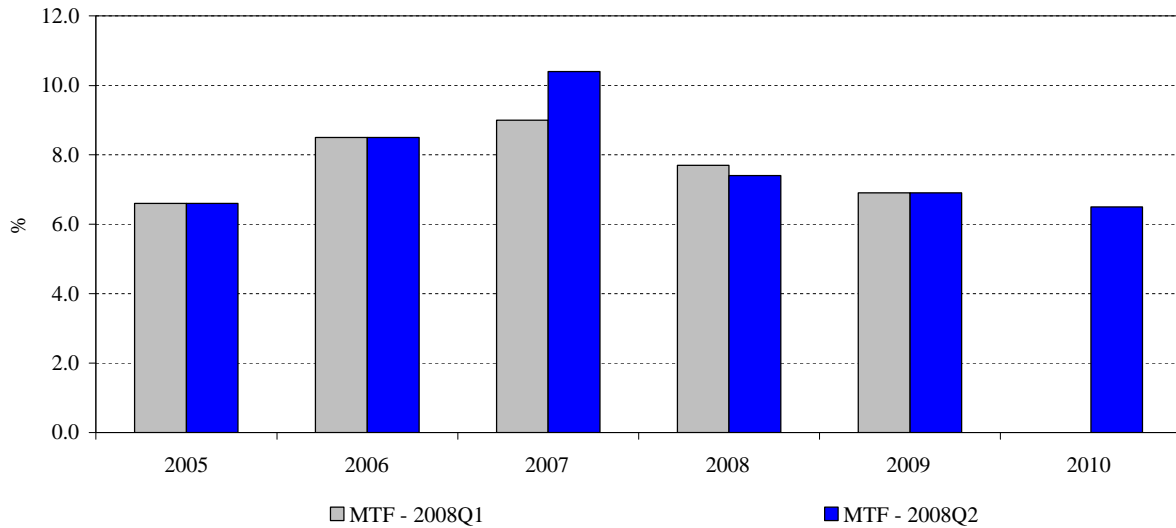
The inflow of the EU structural funds will also influence the formation of gross fixed capital, the dynamics of which are likely to weaken in the medium term. The growth of fixed investments should also be stimulated by the profits of companies, the stable business environment, and the entry of Slovakia into the euro area.

As for net exports, the MTF-2008Q2 predicts, as the previous forecast that their contribution will gradually diminish, to approximately 1 percentage point in 2010.

In comparison with the previous forecast, no substantial change is expected in economic development over the medium term, with a possible slowdown in GDP dynamics. In addition, the impact of stocking-up may be dampened in 2007 and 2008 by the effect of faster-than-expected growth in production capacity from 2007 (which must, however, be confirmed in the development and structure of GDP in the first quarter of 2008).

An upside risk to the forecast is posed, as according to the MTF-2008Q1, by new investments, mainly in the area of power engineering (a gas-fired power plant at Malženice, the third and fourth blocks of the Mochovce nuclear power plant, a thermal power plant at Trebišov, and/or investments in renewable sources of energy).

### GDP growth forecast



The current medium-term forecast (MTF-2008Q2) expects relatively stable nominal wage growth throughout the projection horizon. The forecast predicts the acceleration in nominal wage growth in 2008 (to 7.3%). The stronger nominal wage growth is a direct consequence of the current trend in nominal wages. The assumptions of the NBS used in the forecast are also backed by the available information on wage bargaining in the private and public sectors. According to a higher-level collective agreement made in the public sector for 2008, wage tariffs should grow at a slower rate than according to the agreement for the previous year. However, the higher-level collective agreement came into effect on 1 January 2008, half a year earlier than in the previous years. Thus, the effect of wage growth expected from 1 July 2008 is already reflected in the year-on-year wage dynamics recorded in the first half of 2008. In the private sector, the wage growth agreed for 2008 should not differ markedly from the wage growth achieved in 2007. With regard to the unchanged conditions in economic development in 2009, the NBS expects no change in the rate of nominal wage growth compared with the previous forecast (MTF-2008Q1). For 2010, in connection with the expected slowdown in economic growth, the MTF-2008Q2 predicts nominal wage growth at a pace of 7.5%. At the same time, the medium-term forecast anticipates no pressures on the labour market in 2010, such pressures represent a potential risk.

In line with the updated medium-term GDP forecast, which expects strong growth in labour productivity (like the MTF-2008Q1), and in view of the current developments, the NBS has not modified the assumption in the MTF-2008Q2 that the rapid growth in labour productivity will not be fully reflected in the rate of nominal wage growth. This assumption will remain an upside risk to the medium-term nominal wage forecast.

The current medium-term forecast (MTF-2008Q2) predicts the same growth in employment (ESA95) for 2008-2009 as the previous forecast (1.7% for 2008 and 1.4% for 2009). Employment growth is expected to be influenced by the favourable economic environment. Over the projection horizon, the main factors in employment growth should again be investment and demand for services. In view of the anticipated slowdown in the rate of economic growth, the NBS also expects a gradual slowdown in employment growth, to 0.9% in 2010.

The number of unemployed in 2007 was at approximately the level predicted by the NBS in the MTF-2008Q1. On the basis of this fact, the rate of unemployment (based on a Labour

Force Sample Survey) should, in the conditions of unchanged LFSS-based employment growth, reach the same figures throughout the projection horizon as according to the previous forecast (10.0% in 2008 and 9.8% in 2009). In 2010, the unemployment rate is expected to reach 9.6%.

Within the current account balance, the economy is expected to maintain its strong export performance in 2008 and 2009, with the rate of export growth exceeding the 10% level in both years (in line with the previous forecast). The actual developments in foreign trade in the final quarter of 2007, and especially at the beginning of 2008, provided a basis for additional increases in the estimated volumes of exports and import in both years, which brought about an increase in year-on-year dynamics, mainly in 2008. This fact is reflected in the growing volume of machinery exports. Owing to the existing import intensity, the increased exports have led to increased import expectations. The positive effect of export performance on the trade balance is likely to be eliminated by a negative impact resulting from the estimated developments in oil and oil products prices (higher oil prices are expected than according to the previous forecast).

In the trade balance, the year-on-year rates of export and import growth are expected to slow somewhat in 2010, since the effect of expanding production at newly built plants (in the automotive and electrical industries) is likely to be weaker than in 2009. The automotive and electrical industries should remain the main export sectors of the economy, with a share in total exports exceeding 22%.

Regarding the positive influence of new foreign direct investments on the economy as a whole, the trade balance is expected to continue improving on a year-on-year basis, up to SKK 27.3 billion in 2010. A modest positive effect on the trade balance can be expected in connection with the completion of investments in the automotive industry (investments linked with the expansion of the economy's production capacity are planned for 2008 – 2009).

The export performance of the economy should also be supported by the anticipated entry of Slovakia into the euro area. Due to the absence of transaction costs, exports are expected to be influenced mostly positively; this influence should cause an improvement in the trade balance in the long term. On the other hand, a negative impact on the trade balance in the period under review may be exerted by the planned construction of new nuclear and steam power plants, which may cause a temporary deterioration in the trade balance (through increased imports).

The more negative trend in the balance of other services in the final quarter of 2007 was the main reason behind the fall in the originally predicted services balance surplus in the following years. The forecast of the total income balance deficit was also negatively influenced by developments in the final quarter of 2007, when foreign investors received higher-than-expected dividends. The larger deficit in the balance of income from investments taken into account in 2007 has led to deteriorations in the estimated income balance deficits in the following years.

The more unfavourable than expected trend in the balance of other transfers at the end of 2007 has led to certain deteriorations in the estimated balances of current transfers in 2008 and 2009. In 2010, the balance of current transfers will be significantly influenced by an increase in the estimated amount of inflows from EU funds, as a result of which the balance of current transfers should improve significantly on a year-on-year basis.

The current account deficit is expected to decrease in line with the previous forecast. The changes in the estimates of its individual components have led to deteriorations in the deficits predicted for 2008 and 2009, and to an increase in the current account deficit as share of GDP (to 3.4% and 1.7% respectively, compared with the MTF-2008Q1). Compared with the previous forecast, the openness of the economy increased in both years by more than 3 percentage points, when its estimated degree reached 176.8% in 2008 and 177.4% in 2009. The b.o.p. current account deficit is expected to decrease year-on-year by more than SKK 31 billion in 2010 (to the level of SKK 7.0 billion), while the degree of economic openness remains unchanged, at 177.2%.

The economy should continue growing at a rapid pace; this development is determined by the expansion of its production capacity. During 2008 the economy's actual output is estimated to be very close to its potential capacity, hence no overheating is expected. Like in the previous forecast, price developments are likely to be influenced by factors that are outside the domain of monetary policy – food and energy prices. Their impact is expected to be approximately the same as according to the previous medium-term forecast. Hence, there is no need for a change in the setting of monetary policy, which is aimed at eliminating the secondary effects of increases in food and energy prices.

As from 2009, GDP growth is expected to exceed the expansion of the economy's production capacity to some extent, due to the projected loosening of monetary conditions. The dynamic economic development, however, should not have a profound negative effect on domestic prices in the period to come.

