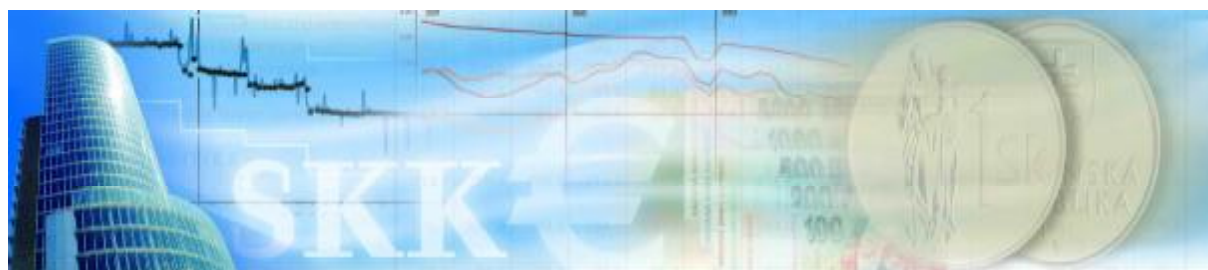




NÁRODNÁ BANKA SLOVENSKA

# MEDIUM-TERM FORECAST (MTF-2007Q1)

January 2007



## 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 by the equilibrium real interest rates, equilibrium real exchange rate, and non-inflationary growth in the economy (potential output). In comparison with the October forecast (MTF-2006Q4), no new information has emerged to justify a reassessment of the long-term trends in the real monetary variables. The forecast still assumes long-term appreciation in the equilibrium real exchange rate, which corresponds to the nature of a converging economy. The trends in equilibrium real interest rates have remained unchanged.

However, the increased export performance of the economy represents a change in the potential output for the entire medium-term horizon. The expanding production capacity, coupled with steady investment demand, provides room for acceleration in the rate of non-inflationary economic growth. This should continue to be marked by improving export performance, accompanied by a modest acceleration in the development in trends of other GDP components. Thus, stronger year-on-year potential GDP growth is expected in 2006-2008 compared with the MTF-2006Q4 (by an average of 1 percentage point), without undue inflationary pressure.

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

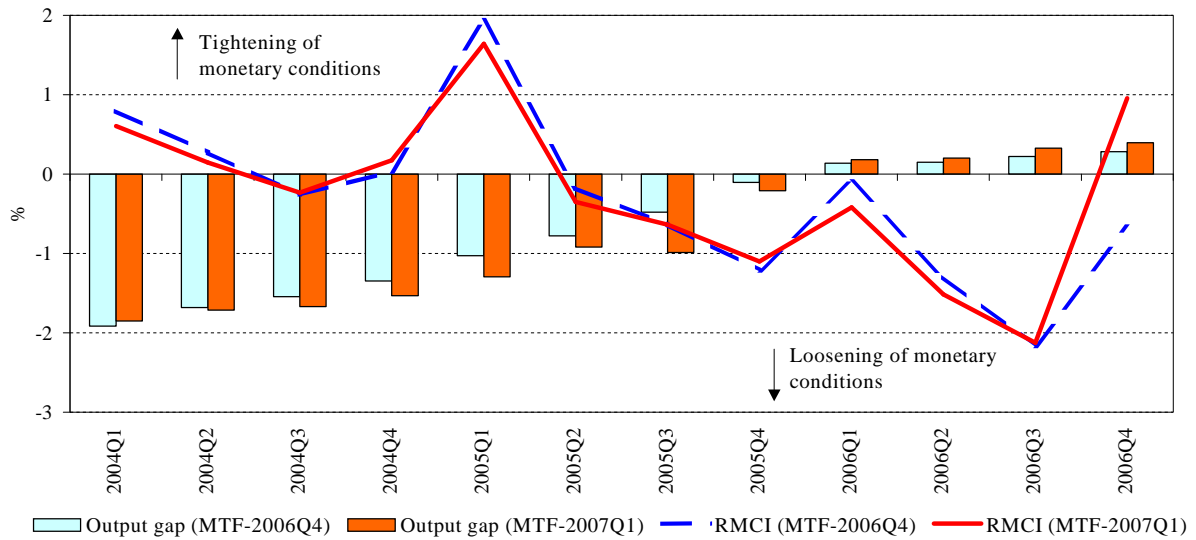
The estimate of the economy's current position is based on the estimated deviations of the key macroeconomic indicators from their equilibrium trends. The monetary conditions, as measured by the Real Monetary Conditions Index (RMCI), were tightened in the fourth quarter of 2006. The stricter than expected tightening of the monetary conditions was mainly a result of rapid appreciation in the nominal exchange rate. The previous loose monetary-policy setting, applied since the second quarter of 2005, was thus changed to a restrictive setting in the fourth quarter of 2006. Rapid appreciation in the nominal exchange rate led to a real exchange rate appreciation of almost 6% in the fourth quarter. Compared with the assumptions of the MTF-2006Q4, the real exchange rate contributed 1.7 percentage points to the tightening of the monetary conditions measured in terms of the RMCI. Real interest rates remained unchanged, which was a result of unchanged nominal rates and unchanged inflation expectations. Thus, real interest rates hovered slightly above their equilibrium level. Their influence on the cyclical position of the economy may, however, be considered as neutral.

The structure of the GDP indicates that the markedly accelerated economic growth in the third quarter of 2006 was caused in large part by an improvement in export performance. The increasing production potential of the economy should create room for dynamic non-inflationary GDP growth in the coming period as well. The estimate of the cyclical GDP component has remained virtually unchanged in comparison with the October forecast. Thus, we can say that the economy is still in a positive output gap (0.4% in the fourth quarter of 2006). The slightly positive output gap (negligible from the viewpoint of inflation), which opened in the course of 2006, may be partly ascribed to the loose monetary conditions in the long term and the faster-than-expected economic revival in the countries of our main trading partners.

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<sup>1</sup> The current position of the economy refers to its state in the fourth quarter of 2006 (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)**



In the third quarter of 2006, the rate of real growth in gross domestic product (GDP) reached 9.8% at constant prices, and thus exceeded the figure predicted in the previous forecast (MTF-2006Q4). The significant improvement in economic performance in the third quarter of 2006 (compared with the expectations) was caused by growth in all components, especially in foreign demand and inventories related to the production.

Regarding the relative contributions to GDP growth at constant prices, the most significant contribution came from inventories (3.9 percentage points, i.e. almost 40%). The steepest increase took place in inventories related to the production process, i.e. the inventories of materials and finished products. The increase in the inventories of finished products indicates that the relatively dynamically growing volume of gross production was not fully realised, but part of the production of finished products was included into the inventories. The increase in finished product inventories was probably connected also with the start-up of new production plants in the automotive industry. The increase in material inventories could be connected with the extension of production and the introduction of new technologies, e.g. in the electrotechnical industry. At first sight, the balance of goods and services for the third quarter of 2006 indicated that net exports made only a minor contribution to GDP growth. However, the increased imports were not only connected with the import intensity of production but also with the import of technologies and the plan to increase the production capacity of the export-oriented sectors in the economy. In this respect, a significant factor was the growing exports of goods and services, which represented the main source of economic growth.

A quarter-on-quarter comparison of short-term indicators (mainly receipts for own performances and goods in industry and transport vehicles) indicates that the relatively dynamic economic growth in the last quarter of 2006 will continue. Information from the business tendency survey indicates an upturn in economic activity in comparison with the third quarter of 2006. In terms of structure, the most significant GDP growth factor in the fourth quarter of 2006 should be net exports in connection with the growth in the economy's production capacity and export performance, as well as the development of foreign demand. Apart from net exports, real economic growth should also be stimulated by domestic demand, with pro-growth effects expected from all its main components. The contribution to real economic growth by production in the new automobile factories will, however, depend on the

structure of new production capacities in the automobile industry, the degree of import intensity, value added, and developments in export prices.

Over the first nine months of 2006, the balance of payments on current account resulted in a deficit of Sk 105.6 billion, representing a year-on-year increase of more than Sk 37.4 billion. The year-on-year increase in the deficit was in line with the expectations of the NBS, and was mainly caused by an increase in the trade balance deficit. The increase in exports resulting from the growing production and export capacities of the economy was exceeded in the third quarter of 2006 by non-standard imports, which were connected with the start-up of new production plants and the extension of their capacities. As a result, the trade deficit slightly exceeded the assumptions of the MTF-2006Q4 in the third quarter. The strengthening year-on-year dynamics of exports and imports were also reflected in the higher export and import figures (compared with the previous forecast), while the faster than expected export growth in the third quarter of 2006 confirms the assumption of increase in export performance. In the fourth quarter of 2006, the trade deficit is expected to decrease on a quarter-to-quarter basis, which is connected with the expected gradual transformation of inventories into exports. In total, the increase in exports resulting from the growing production and export capacities of the economy should be exceeded in 2006 by increased imports in the third quarter. Compared with the previous forecast, the trade balance is expected to deepen by Sk 1.1 billion.

In the last few months of 2006, developments in the services balance were in line with the previous forecast in virtually all components; only the estimated expenditure on transport-related services was somewhat lower, which led to the prediction of a higher surplus in the overall services balance. According to the latest data, the balance of transfers recorded a smaller surplus, mainly due to deterioration in the balance of private transfers. The changes in the estimates of individual current account components led to an increase of almost Sk 6 billion in the current account deficit in 2006, while its share of GDP is also expected to increase (by 0.3 of a percentage point).

The growth in nominal and real wages in the third quarter of 2006 was slower than the figure predicted by the NBS in the October forecast, which was mainly a result of slower wage growth in public administration, defence and social security, trade and industry. The dynamic wage growth is expected to continue in the fourth quarter of 2006, which is also indicated by preliminary data on wage developments in the selected sectors in October and November, and their dynamics should be slightly stronger than in the previous quarter. In 2006, nominal wages are expected to grow at the same rate as forecast in the MTF-2006Q4.

In the fourth quarter of 2006, real wage growth should accelerate in comparison with the previous quarter, as a result of faster nominal wage growth at a lower average inflation rate. In 2006, the average real wage is expected to grow at the same rate as predicted in the MTF-2006Q4.

According to statistical reports, employment continued to grow dynamically year-on-year in the third quarter of 2006, and followed a course in line with the MTF-2006Q4. According to a Labour Force Sample Survey (LFSS), employment recorded a year-on-year increase in the third quarter of 2006, accompanied by a moderate slowdown in dynamics, while its growth was only slightly faster than the figure projected by the NBS in the October forecast. The stronger growth in employment compared with the MTF-2006Q4 (according to the LFSS) was a result of somewhat faster growth in employment in the domestic part of the economy, while employment abroad followed a trend in line with the NBS forecast. The trend in

employment over the first three quarters of 2006, as well as preliminary data on employment in the selected sectors in October and November 2006, indicates that the dynamic employment growth should continue in the last quarter of 2006. Employment (according to the LFSS) is expected to grow at a somewhat faster rate than according to the MTF-2006Q4 forecast, throughout 2006.

Measured in terms of the Harmonised Index of Consumer Prices (HICP), consumer prices recorded a slowdown in the year-on-year rate in the fourth quarter of 2006. Nonetheless, inflation exceeded the inflation target of the NBS, due to developments in the cost components of the consumer basket, i.e. in regulated energy prices.

The course of inflation over the last quarter of 2006 was influenced by a slowdown in the year-on-year dynamics of prices for services as well as goods. Within the scope of goods prices, the year-on-year rate of increase slowed in comparison with the previous quarter in energy prices in particular, due to the base effect of a marked increase in energy prices in the same period a year earlier, and a marked year-on-year fall in fuel prices. Industrial goods prices showed the same dynamics as in the previous quarter. The year-on-year increase accelerated in food prices, due to an increase in the dynamics of processed food prices (bread and bakery products, cigarettes) as well as unprocessed food prices (vegetables including potatoes). Services prices recorded a slowdown in year-on-year dynamics, as a result of developments in the prices of transport services, recreational and personal services, and telecommunications services.

Compared with the previous forecast (MTF-2006Q4), the level of inflation in the fourth quarter of 2006 was lower. This was a result of slower than expected price increases in all categories of services, with the greatest deviations from expectations recorded in prices for recreational and personal services, and services related to transport. Goods prices also recorded somewhat weaker dynamics, with a faster-than-expected increase in goods prices excluding energy offset by a slower-than-expected year-on-year increase in energy prices (due to a steep year-on-year fall in fuel prices and a slower increase in other energy prices, mainly the price of heating) and food prices. As a result of this development in the final quarter, the difference between the actual inflation rate and the inflation target was smaller, compared with the October forecast (MTF-2006Q4).

## **Medium-term forecast**

### **External environment**

The medium-term forecast of exogenous indicators is based on the December issue of the Consensus Forecasts (CF)<sup>2</sup>. The expected developments in oil prices are based on the prices of futures as of 19 December 2006.

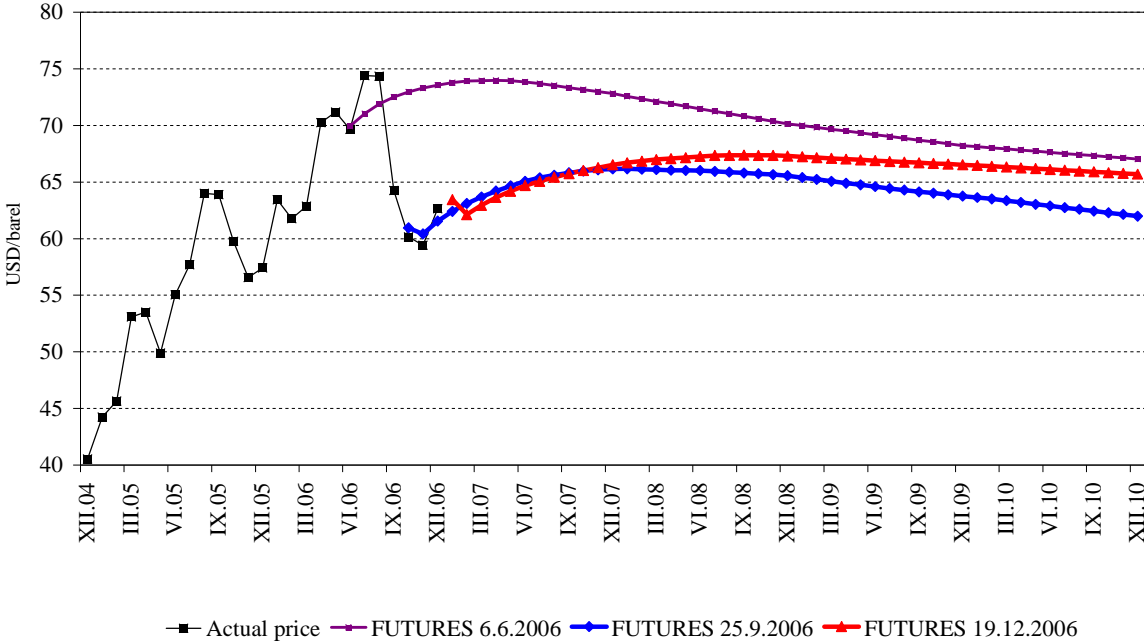
In comparison with the assumptions of the external environment as predicted in the MTF-2006Q4, the assumption of a virtually unchanged rate of oil price increase in 2007 has been maintained. However, in contrast with the previous forecast, in which oil prices were

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<sup>2</sup> 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 2006 and were fixed at these levels throughout the forecasting process. Any new information will be taken into account in the next medium-term forecasts.

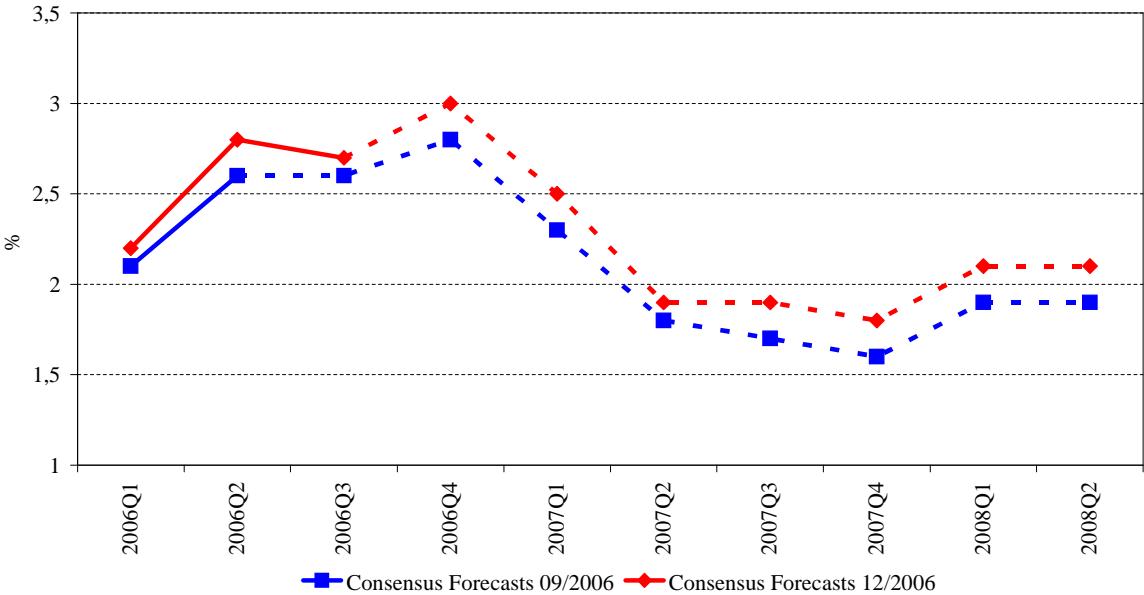
predicted to fall gradually, their level is expected to rise somewhat in 2008, up to USD 67/barrel. The USD is expected to appreciate slightly against the EUR throughout the projection horizon. Although its level predicted for 2007 is lower than according to the MTF-2006Q4, the next year (2008) is expected to witness a shift to a higher (stronger) level.

**Expected oil prices**



In comparison with the MTF-2006Q4, GDP is expected to grow at a somewhat faster rate (by approximately 0.1-0.2 of a percentage point) throughout the projection horizon, but the assumption of a slowdown in 2007 to be followed by a modest revival in 2008 is still maintained. However, the euro-area economy still remains below its potential.

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



The projected euro-area inflation rate should hover around the inflation target of the ECB over the projection horizon, but in 2007, it is expected to be slightly below 2%. This represents a decrease in the year-end inflation rate by approximately 0.2 of a percentage point in comparison with the MTF-2006Q4. The Consensus Forecasts expect a lower inflation rate also in 2008. Compared with the MTF-2006Q4, the EURIBOR interest rate is expected to rise in 2007 by 0.2 of a percentage point, above 3.8%.

	2006	2007	2008
<b>Euro-area inflation in %</b>			
CF 09/06 (annual average)	2.3	2.2	
CF 12/06 (annual average)	2.2	2.1	1.9 (Q2)
<b>Euro-area GDP growth in %</b>			
CF 09/06	2.5	1.8	
CF 12/06	2.7	2.0	2.1 (Q2)
<b>Oil prices in USD/barrel and EUR/barrel</b> (annual average)			
25 September 2006	66.7/53.0	64.5/49.4	
19 December 2006	66.2/52.9	64.7/49.1	67.2/51.7
<b>USD/EUR exchange rate</b> (end of the relevant quarter)			
CF 09/06	1.287 (Q3)	1.302 (Q2)	
CF 12/06		1.323 (Q1)   1.308 (Q4)	1.291 (Q4)

The marked revival in economic growth in the euro area in 2006 and 2007 compared with the previous forecast is expected to strengthen the stimulating effect of foreign demand on the Slovak economy. Price developments in Slovakia should be dampened by inflation in the euro area and by the weaker dollar. In 2008, however, an upward effect is expected from an anticipated rise in oil prices and the stronger dollar.

### Forecasts for 2007 and 2008

The current medium-term forecast expects a year-end inflation rate of 1.5% in 2007 (an average of 1.6%), followed by a slight acceleration in 2008, to 2.0% (an average of 2.0%). Compared with the MTF-2006Q4, the current medium-term inflation forecast predicts a lower figure for 2007 and an unchanged figure for 2008. The marked shift in the inflation forecast, to a lower level for 2007 (compared with the previous forecast), was caused by a fall in regulated prices, a slower-than-expected increase in services prices in the last quarter of 2006, and smaller cost stimuli resulting from a reduction in regulated energy prices (lower secondary effects from energy prices in the prices of services). The rate of inflation should also be slowed in 2007 by the assumption of a marked year-on-year fall in fuel prices.

Within the basic structure of inflation, the course of inflation is also expected to be affected in 2007 by a marked decrease in the dynamics of goods prices and a slight slowdown in the year-on-year rate of increase in services prices. In 2008, prices are expected to rise more rapidly than in 2007, for both goods and services.

The year-on-year dynamics of industrial goods prices are expected to weaken in the course of 2007, due to developments in the prices of non-energy industrial goods and energy (fuel and other energy prices). Starting from the second quarter of 2007, the prices of industrial goods

should fall on a year-on-year basis and the rate of year-on-year fall is expected to accelerate slightly in the following period. From 2008, industrial goods prices should again increase at an accelerating pace. The year-on-year fall in non-energy industrial goods prices and the acceleration of this drop during 2007 are expected to be influenced not only by the low inflation environment, low imported inflation, and low inflation expectations, but also by a cut in VAT rates for pharmaceuticals and sanitary goods with effect from 1 January 2007 (from 19% to 10%), with a negative contribution of approximately -0.1 of a percentage point to overall inflation and approximately -0.3 of a percentage point to the dynamics of industrial goods prices. In 2008, however, their prices are expected to experience a certain slowdown in the year-on-year rate of fall, due to the base effect.

The year-on-year dynamics of energy prices should weaken in 2007. In January, prices should drop for gas, water, and sewage disposal, while the price of electricity should remain unchanged (which is a marked difference in comparison with the previous forecast). In 2008, regulated energy prices are expected to show the same dynamics as according to the MTF-2006Q4 forecast. On the whole, regulated prices (energy prices and other regulated prices) are predicted by the NBS to increase by an average of 2.4% in 2007 (compared with 5.2% according to the MTF-2006Q4) and by 2.0% in 2008 (2.1% according to the MTF-2006Q4). Their contribution to headline inflation should be approximately 0.7 of a percentage point in 2007 and approximately 0.6 of a percentage point in 2008. By the end of 2007, regulated prices should rise by 1% with a contribution of 0.3 of a percentage point to the year-on-year rate of headline inflation, and by the end of 2008 by 1.8% with a contribution to headline inflation of approximately 0.5 of a percentage point.

The lower inflation forecast for 2007 can also be ascribed to the assumption of a marked year-on-year fall in fuel prices, due to the current trend in oil prices on the global market and Brent oil futures in the following period. In 2008, fuel prices are expected again to increase slightly on a year-on-year basis.

Within the scope of goods prices, food prices should reach their strongest year-on-year dynamics at the beginning of 2007 (due to increases in the prices of bread, bakery products, and vegetables, including potatoes), in connection with the poorer harvest in 2006 and the subsequent developments in the prices of agricultural commodities on the domestic and foreign markets. From the second quarter of 2007, the year-on-year dynamics of food prices should be weakening, due to the base effect of marked increases in food prices and the effect of excise tax increases in 2006. In the course of 2008, after the consequences of the poor harvest from 2006 fade away, the rate of increase in food prices is expected to slow, but then in the second half of 2008, it should accelerate again as a result of an increase in excise duty on cigarettes (with the effect of stocking-up on cigarettes taken into account). With regard to the current trend and expected rise in food prices in the next period, the rate of increase in food prices is predicted to be slower than the MTF-2006Q4 forecast, up to the second quarter of 2008.

The year-on-year dynamics of services prices should weaken, due to the absence of cost stimuli resulting from favourable development of energy prices. With regard to the absence of such cost factors, the prices of services should show weaker dynamics in comparison with the figure predicted in the MTF-2006Q4.

In 2008, excise duty on cigarettes is expected to be increased in line with the general government budget, with an estimated contribution to overall inflation of 0.3 of a percentage



point. This inflationary stimulus should not cause a rise in inflation above the target level owing to the prudent monetary policy, and the low inflation in 2007 should favourably influence price developments in 2008 through lower inflation expectations. As a result, the dynamics of other components of inflation structure are expected to weaken.

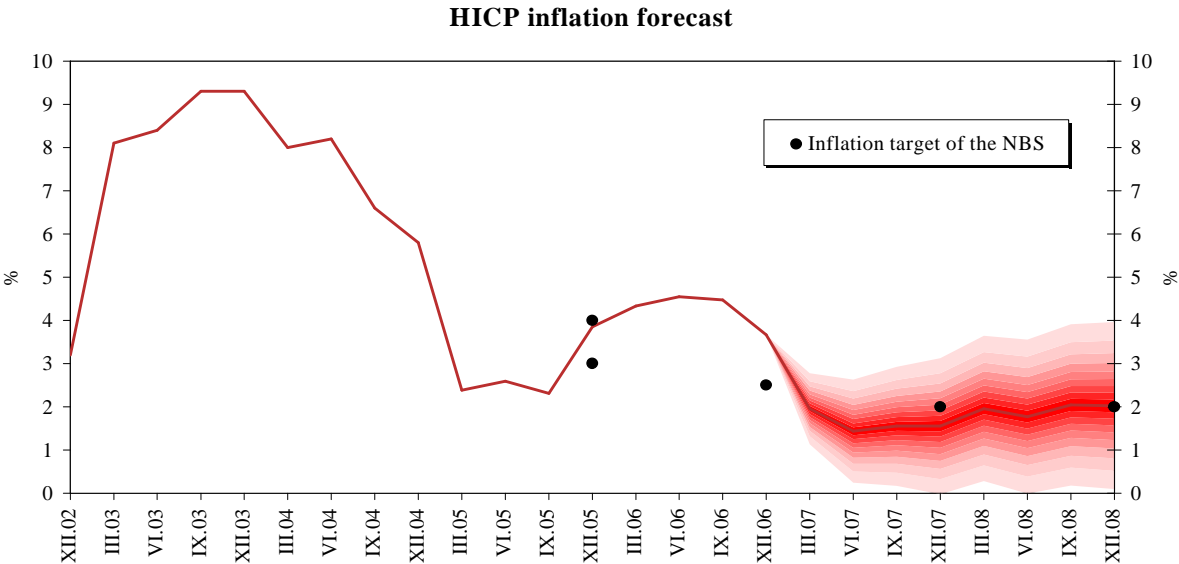
**Comparison of HICP inflation forecasts** (year-on-year change in %, average for the period)

		2006	2007	2008
TOTAL (HICP)	MTF-2006Q3	4.4	2.9	2.0
	MTF-2006Q4	4.4	2.8	2.1
	MTF-2007Q1	4.3	1.6	2.0

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

		2006	2007	2008
TOTAL (HICP)	MTF-2006Q3	3.9	2.8	2.0
	MTF-2006Q4	4.1	2.6	2.0
	MTF-2007Q1	3.7	1.5	2.0

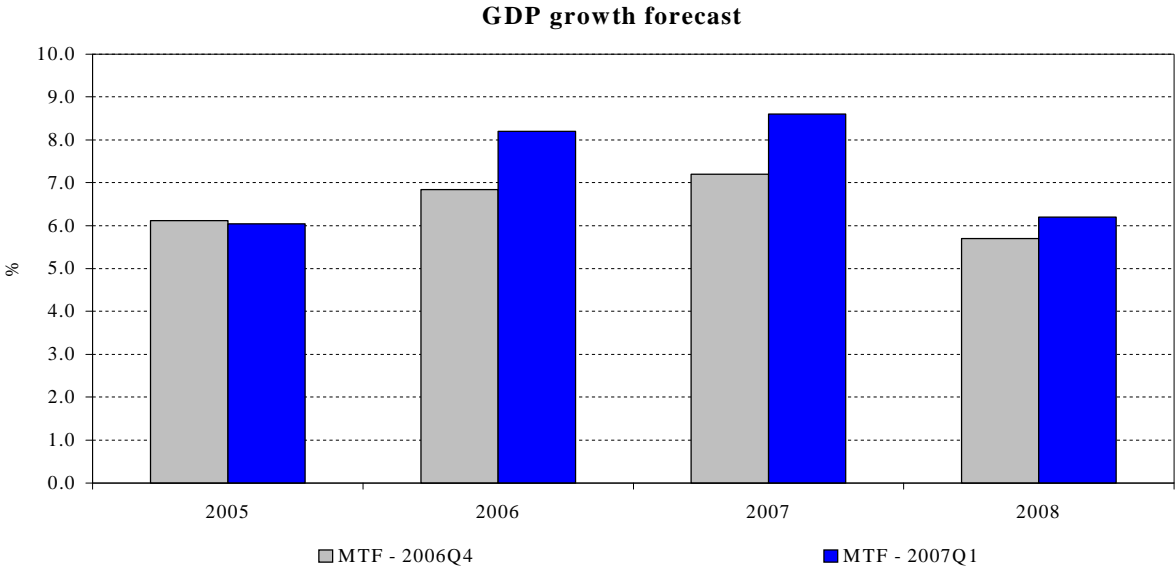
The medium-term forecast is also associated with certain risks. The most serious risks are the developments in oil prices and their impact on fuel prices and regulated energy prices, which may cause a change in inflation compared with the current forecast (at the end of 2007 or the beginning of 2008). Persistent risks are also posed by food prices, which may be affected by the weather conditions and developments in the prices of agricultural commodities on the European market. Another factor that may affect the inflation forecast is the trend in services prices, where the secondary effects of increases in regulated energy prices may be reflected to an extent other than expected, especially in the prices of services related to housing. The prices of services may also be influenced to a greater than expected extent by the effects of growing employment, nominal and real wage growth, and final household consumption.



In the medium-term real GDP growth forecast in comparison with MTF-2006Q4, the development of individual components is predicted to accelerate (especially the export performance), which will also be reflected in the overall GDP dynamics. This change is connected with the expected gradual expansion in production capacities (which is also

indicated by the fact that the last GDP revision for 2005 confirmed the upturn in investment activity in the economy in 2005), whose pro-growth effects should be reflected in increased production, export performance as well as in increased value added creation in the medium term. On the basis of GDP data for the third quarter of 2006, the export performance of the economy is expected to increase mostly in the automotive and electrotechnical industries, which should represent an additional contribution to GDP growth (an average of 1 percentage point) in comparison with the figure predicted in the MTF-2006Q4. Regarding the rate of value added creation, the level of import intensity, and the size of the steadily extending network of sub-contractors, the newly established automobile factories represent a risk for the forecast. Assuming that they produce models with a higher price and higher value added, it may occur that the actually achieved rate of economic growth will be higher than the figure projected in the MTF-2007Q1, which is based on the assumption that the structure of production at the new automobile assembly plants will be the same as according to the previous forecasts.

As for domestic demand, all its major components are expected to have a pro-growth effect. Final household consumption is expected to be influenced by the relatively dynamic growth in employment (in the domestic economy as well as abroad) and wage development. The slight acceleration in private consumption in comparison with the previous forecast is probably connected with the growing trend in gross mixed income (profits and receipts from business activity). Developments in general government final consumption in the coming period will be connected with the fulfilment of the general government budget, with overall economic development, and with the drawing of funds from the structural funds. The growing trend in gross fixed capital formation is expected to continue, due to the profits of companies, the stable business environment, and the increasing production activity in industrial sectors. In 2006, the overall dynamics of fixed investments are expected to weaken somewhat in comparison with the MTF-2006Q4 (a base effect from 2005, and the effect of accounting for completed investment projects in the books of companies). Despite these factors, the expected growth in investment does not lag behind the overall rate of economic growth. In the individual quarters of 2007-2008, the economy’s production capacity is expected to expand still further, which indicates that, despite the projected increased dynamics of real GDP growth (in comparison with the MTF-2006Q4), such economic growth should have no inflationary effect.



In the MTF-2007Q1, compared with the October forecast, the NBS foresees no change in nominal wage dynamics over the projection horizon. The NBS based its assumptions on wage developments over the first three quarters of 2006, which did not deviate markedly from the previous forecast. At the same time, the NBS assumed that the faster growth in labour productivity and employment would not be directly reflected in the rate of nominal wage growth in the short term and that increased earnings could be allocated for the payment of dividends and reinvested earnings. More rapid economic growth in 2008 may exert pressure for an increase in wage levels, but its pace is expected to be dampened by the lower-inflation environment from 2007 compared with the previous forecast. We assume that the greatest risk in the medium-term forecast for 2007-2008 is nominal wage development in the public sector, due to the range and time of the changes anticipated by the government.

Real wage growth is expected to be faster in 2007, due to the lower inflation forecast in comparison with the previous forecast. In 2008, the rate of real wage growth is expected to hover at the level predicted in the MTF-2006Q4.

The growth in real labour productivity is expected to accelerate in 2007 in connection with the stronger GDP growth compared with the previous forecast. In 2008, real labour productivity should grow at the same rate as forecast in the MTF-2006Q4.

In 2007 and 2008, employment should be influenced first and foremost by the favourable economic environment, reflected in the dynamic overall economic growth and the growing output of production sectors and market services. These factors, stimulating growth in labour demand in the domestic part of the economy, should be dampened in part by an anticipated reduction in employment in budgetary and subsidised organisations, which is expected to begin at the end of 2007 and/or the beginning of 2008 (according to the latest information), with an impact on overall employment in 2008.

Developments in employment in the individual sectors in the last few months of 2006 also indicate that the risk of minimum wage increase with effect from October 2006, which was defined in the MTF-2006Q4 and which should have a restricting effect on the creation of new jobs in connection with an expected increase in labour costs, will probably not become a reality to the extent expected by the NBS in the previous forecast.

In view of these assumptions of the MTF-2007Q1, slightly faster employment growth is expected in 2007 and 2008 (according to both statistical reports and Labour Force Sample Surveys) in comparison with the previous forecast, while the assumption of a gradual slowdown in employment growth remains in effect.

The unemployment rate (according to an LFSS) is expected to follow, as according to the previous forecast, a gradually falling trend, but its value will be somewhat lower than forecast in the MTF-2006Q4, due to the projected developments in employment.

The balance of payments on current account for 2006, as well as the new assumptions concerning the external factors affecting the current account, provided a basis for changes in the predicted values of current account components in the next years.

The foreign trade forecast for 2007-2008 reflects previous trade balance developments from 2006. On the export side, the year-on-year rate of export growth accelerated mostly in the

electrotechnical industry, and this development should continue in the next months. As a result of increased imports for inventories in the third quarter of 2006, which should lead to additional growth in export performance in the future, we expect a further improvement in the export capacity of the economy also at the beginning of 2007.

The strongest growth in exports is expected to take place in machines and semi-finished goods. The strong exports should result in increased imports expectations in both semi-finished goods and machines. A modest increase in imports, resulting from the dynamic employment growth and the growth potential of the economy, is also expected in goods intended for final consumption. In the balance of raw materials for 2007-2008, the forecast takes into account the latest oil prices and expectations regarding the shutdown of the V1 blocks at the Jaslovské Bohunice nuclear power plant. The lower electricity production may lead to lower exports or higher imports (or a combination of the two), and the trade deficit is therefore expected to increase by approximately Sk 3.5 billion compared with the October forecast.

In 2007 and 2008, the growth in exports (resulting from an increase in the economy's export potential compared with the MTF-2006Q4) was only partly offset by an increase in imports stemming from the import intensity of the economy, increased imports of goods for final consumption, and increased raw material imports. A risk for the forecast is posed by the price of automobiles that will be exported from the newly established automobile factories. In the trade balance forecast, the balances for 2007 and 2008 are expected to improve by a total of Sk 6.5 billion and Sk 10.6 billion respectively.

With regard to the actual developments in 2006, the estimated level of expenditure for 2007-2008 has only been reduced for services related to transport, which lead to a slightly higher surplus in the overall balance of services.

The projected overall income balance deficit has been changed in comparison with the previous forecast mainly in view of the higher amount of estimated profits in the economy, which is reflected in the higher estimates of reinvested earnings and dividends paid to foreign investors. In total, the income balance deficit is expected to deteriorate by Sk 2 billion in 2007 and Sk 3 billion in 2008.

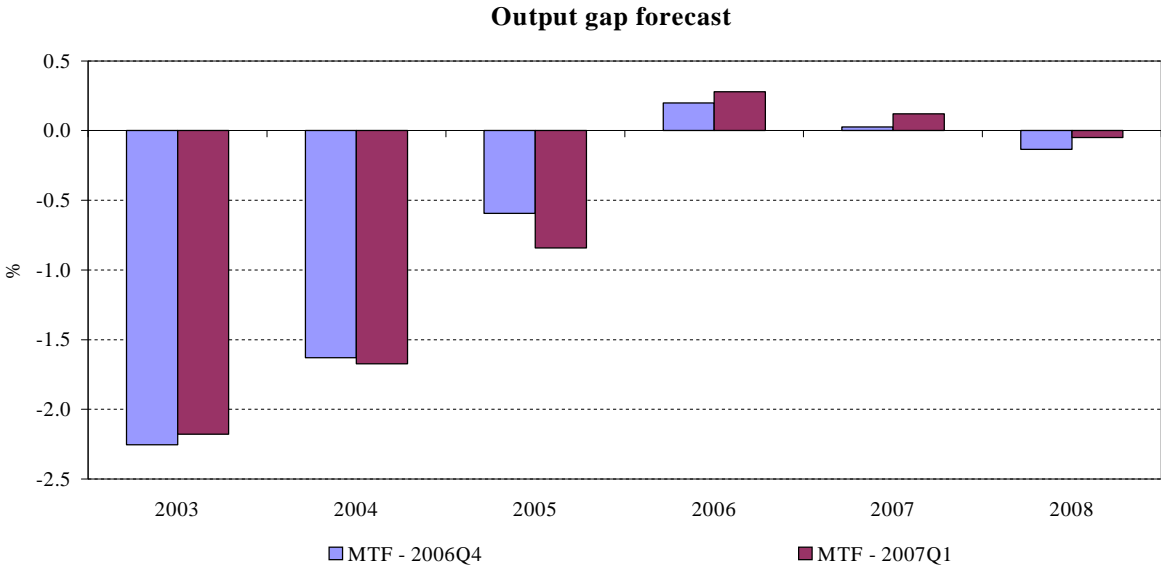
For 2007 and 2008, the data from the previous forecast remain in effect, since the balance of current transfers is expected to improve in the future, mainly as a result of increased drawing of funds from the EU. The amount of funds drawn from the EU also poses a risk for the balance of transfers, since it may affect the achieved balance of current transfers where fixed payments are made to the EU budget.

In 2007 and 2008, the current account balance is expected to improve, due to a marked improvement in the estimated balances of trade and services, which exceeded the increase in the income balance deficit. In line with the previous forecast, the deficit in the balance of payments current account is expected to decrease during 2007-2008, and its share of GDP should be 0.5 of a percentage point less in 2007 and 2008, compared with the previous forecast. The degree of economic openness is expected to increase by 6.2 percentage points in both years, to approximately 174%.

The setting of monetary policy for 2007 and 2008 is determined by the ongoing developments in the economy. Despite increased foreign demand, the cyclical component of the economy is

no longer expected to grow. On the contrary, the output gap is expected to close gradually as a result of the monetary policy setting. Nevertheless, the economy is still expected to perform slightly above its potential in 2007. As for the real economy, there is still a need for the maintenance of prudent monetary policy with the aim of eliminating the potential risk of overheating in the economy.

On the other hand, the shift in inflation to lower levels in 2007 reduces the need to significantly moderate the demand side of the economy. The fall in regulated prices and low imported inflation for a short period should lower the level of inflation below the inflation target in 2007. The low inflation in 2007 should also have a favourable influence on price developments in 2008 through lower inflation expectations. However, their dampening effect should be offset by an additional contribution made by changes in indirect taxes. Under the assumption of stabilised developments in autonomous factors, mainly the low inflation abroad, together with the setting of monetary policy, the inflation rate should hover at the level of the inflation target in 2008.



## Annex

### Medium-term forecast (MTF-2007Q1) of main economic indicators

Indicator	2005	2006*	2007	2008	2006	2007	2008
	Actual				Difference with previous forecast		
<b>Prices (y-o-y change)</b>							
HICP inflation (end-year)	3,9	3,7	1,5	2,0	-0,4	-1,1	0,0
HICP inflation (average)	2,8	4,3	1,6	2,0	-0,1	-1,2	-0,1
HICP excluding energy and unprocessed food (end-year)	1,2	2,5	1,9	2,4	-0,3	-0,7	0,0
HICP excluding energy and unprocessed food (average)	1,7	2,1	1,7	2,3	0,0	-0,8	-0,1
CPI inflation (end-year)	3,7	4,2	1,8	2,1	0,1	-0,7	0,2
CPI inflation (average)	2,7	4,5	2,0	2,0	0,0	-0,7	0,0
Core inflation (end-year)	1,7	2,8	2,3	1,9	0,2	0,1	-0,1
Core inflation (average)	1,1	2,5	1,9	1,9	0,0	0,1	-0,1
PPI (average)	4,7	8,4	1,5	1,6	-0,5	-1,8	0,0
<b>GDP (y-o-y change, unless otherwise indicated)</b>							
Nominal GDP (SKK bil.)	1 472,1	1 642,5	1 811,0	1 954,3	17,5	23,8	32,2
Nominal GDP	8,6	11,7	10,3	7,9	1,3	0,3	0,4
Real GDP	6,1	8,2	8,6	6,2	1,4	1,4	0,5
Domestic demand	8,0	6,1	4,4	5,5	0,7	-0,1	-0,1
Final consumption of households	7,2	6,4	6,9	5,7	0,3	0,8	0,4
Final consumption of general government	0,5	4,5	2,9	2,0	0,0	0,0	0,0
Final consumption of non-profit institutions	-3,0	-1,6	2,9	2,0	-1,2	-2,1	-3,0
Gross fixed capital formation	13,8	8,2	6,9	6,8	-2,7	1,0	0,0
Exports of goods and services	13,5	22,0	16,6	10,0	5,3	1,9	0,7
Imports of goods and services	15,5	18,8	12,4	9,4	4,3	0,6	0,2
<b>Labour market</b>							
Nominal wage (monthly average, y-o-y change)	9,2	8,0	7,2	6,3	0,0	0,0	0,0
Real wage (monthly average, y-o-y change)	6,3	3,4	5,1	4,2	0,0	0,7	0,0
Employment (LFSS, y-o-y change)	2,1	3,9	3,0	2,3	0,2	0,5	0,6
Employment (registered employment, y-o-y change)	2,2	2,3	2,1	1,4	0,0	0,5	0,4
Unemployment rate (LFSS, %)	16,2	13,5	12,3	11,5	-0,2	-0,2	-0,4
Labour productivity (Real GDP/Employment, y-o-y change)	3,8	5,8	6,4	4,7	1,4	0,9	0,0
<b>Balance of payments</b>							
Economic openness (% GDP)	158,0	174,7	174,3	174,0	5,5	6,2	6,2
Trade balance (SKK bil.)	-76,0	-79,5	-36,8	-35,0	-1,1	6,5	10,6
Trade balance (% GDP)	-5,2	-4,8	-2,0	-1,8	0,0	0,4	0,6
Balance of services (SKK bil.)	9,9	17,6	18,1	18,8	1,7	2,0	2,0
Balance of services (% GDP)	0,7	1,1	1,0	1,0	0,1	0,1	0,1
Current account (SKK bil.)	-126,9	-115,2	-69,7	-63,6	-5,9	6,5	9,6
Current account (% GDP)	-8,6	-7,0	-3,8	-3,3	-0,3	0,5	0,5
Current and capital account (SKK bil.)	-127,4	-114,7	-64,2	-58,4	-10,4	6,5	9,6
Current and capital account (% GDP)	-8,7	-7,0	-3,5	-3,0	-0,6	0,5	0,5

\*/ Inflation (HICP, CPI) - actual values

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