



1 MACROECONOMIC DEVELOPMENTS

1.1 THE EXTERNAL ECONOMIC ENVIRONMENT

1.1.1 GLOBAL TRENDS IN OUTPUT AND PRICES

Compared with the previous year, 2017 was more favourable for the global economy. After two years of slowdown, global GDP growth accelerated to around 3.7%¹ (from 3.2% in 2016). This pick-up was based on recoveries in investment, manufacturing and trade, on the continuation of favourable financial conditions, and on supportive economic policies. At the same time, a broad spectrum of economies were gathering momentum, leading to greater business cycle synchronisation. As regards the contributions to global growth acceleration from different groups of countries, advanced economies had the largest impact and their economic growth was higher than expected. Emerging market economies (EMEs) also contributed positively, with commodity exporters benefiting from rising commodity prices.

The majority of advanced economies reported an increase in growth. In the United States, the economy strengthened, as the improving labour market situation and solid growth in real income further stimulated private consumption. It was investment demand, however, that provided the largest boost to growth, as both infrastructure investment and equipment investment picked up strongly after falling in the previous year. Easy financial conditions remained in place in the United States, contingent on the terminating accommodative monetary policy. During the course of the year, the US Federal Reserve thrice raised the target range for the US federal funds rate; furthermore, in October, the US central bank embarked on a balance sheet normalisation programme under which it will gradually reduce its securities holdings by decreasing the reinvestment of the principal payments received from these securities. Going forward, the direction of the US economy will be shaped by these steps, together with the most extensive tax reform in 30 years, passed at the end of last year. The euro area also supported global economic growth. Although domestic demand eased, the economy benefited from a strengthening of exports and softening

of import growth. The economy continued to be supported by the ongoing accommodative monetary policy stance. The United Kingdom, on the other hand, had a dampening effect on global growth, as the country's economic activity increased more moderately than at any time in the past five years. The slowdown was caused mostly by private consumption, with households reining in their spending in an environment of rising inflation and falling real income. Given the heightened uncertainty surrounding the country's future relations with the EU, it was surprising to see investment demand accelerating. Weakening of the pound supported exports, and with import growth easing, net trade had a positive impact on economic growth. In response to an accelerating headline inflation rate, the Bank of England raised its policy rate for the first time in 10 years.

Turning to emerging market companies the increase in their aggregate growth was driven by China. After six years of declining growth, the country's economy accelerated in 2017 and comfortably exceeded the growth target for the year. This performance, however, stemmed largely from cyclical factors whose impact will gradually fade. Economy activity was boosted by an expansionary fiscal stance in the form of additional spending and tax cuts aimed at supporting demand and employment growth. Furthermore, infrastructure investment (mainly in transportation) compensated for declining capacities in coal and steel production. Efforts to rebalance the country's economy were apparent in the political decision not to set a growth target beyond the 2020 horizon and to focus more on financial stability. Russia's economy returned to growth after two years of a recession brought on by falling oil prices and Western-imposed sanctions. As a result, it made a strongly positive contribution to global GDP growth. By contrast, the Indian economy weighed on global growth, with an expansion that was more modest than in previous years owing to the lagged effects of the November 2016 demonetisation and effects of the July 2017 goods and services tax reform.

Global consumer price inflation accelerated in 2017, with the headline rate responding most

¹ World Economic Outlook Update, January 2018.

notably to energy commodity prices. In other words, energy prices, which were on an upward trend throughout the year after falling in 2016 in year-on-year terms, had the largest impact on global inflation. Food prices also supported the headline rate's increase. For advanced economies, the average annual inflation rose from 0.8% in 2016 to 1.7% in 2017, but core inflation remained flat. Across emerging market economies, on the other hand, headline inflation moderated from 4.3% to 4.1%.

Global commodity prices increased in 2017. Looking at the rise in energy commodity prices, the average oil price increased by more than 20%, year on year, in response to global demand, falling inventories in the United States, and the OPEC+ agreement to limit oil production. Metal prices surged on strong growth in the Chinese construction and manufacturing industries, and they were also buoyed by the bright outlook for the global economy. Average food commodity prices fell in year on year terms, owing to elevated global inventories and the effects of good weather.

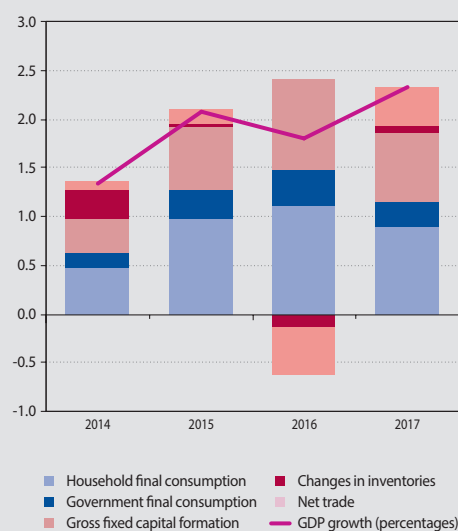
1.1.2 THE EURO AREA

The euro area's annual GDP growth accelerated to 2.3% in 2017, significantly higher than its rate in 2016 (1.8%). While all components had a positive impact on overall growth, private consumption

and investment made the largest contributions. Private consumption was supported by a favourable labour market situation, while investment benefited from easy financing condition in the form of relaxed credit standards, and from an upturn in corporate profits. Exports were boosted by the broad global economic recovery. In contrast to 2016, net trade had a positive impact on growth. Export growth was higher in 2017 than in the previous year and import growth was lower. The economy's upswing was reflected in the labour market, with unemployment falling from 10.0% at the end of 2016 to 9.1% a year later.

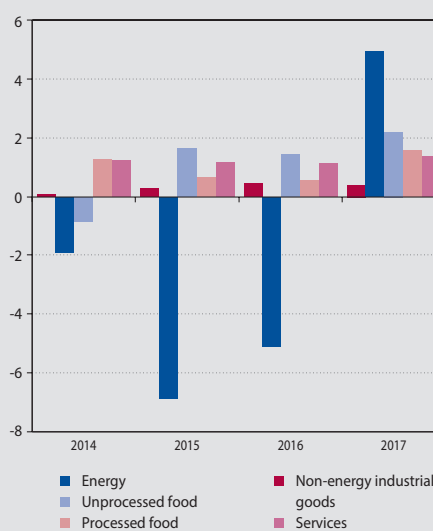
Average annual HICP inflation in the euro area rose to 1.5% in 2017, up by 1.3 percentage points on the previous year. The headline inflation rate in December 2017 was 0.3 percentage point higher year on year, at 1.4%. Among HICP components, energy commodity prices had the largest impact on the inflation rate during the year through their pass-through to energy price inflation, which initially eased and then increased slightly in the second half of the year. Food price inflation also accelerated towards the end of the year. Core inflation (measured by the HICP excluding energy and unprocessed food) accelerated gradually until October and then remained steady. Its average rate for 2017 was 1.1%, up from 0.8% in 2016.

Chart 1 Euro area GDP and its components (annual percentage changes; percentage point contributions)



Source: Eurostat.

Chart 2 Contributions of components to HICP inflation (percentage points)



Source: Eurostat.



The euro appreciated significantly against the US dollar over the course of 2017. The exchange rate's path reflected investor preferences, the monetary and economic policy settings of major world economies, geopolitical developments, and the euro area's growth and inflation outlooks. The euro's exchange rate against the dollar stood more than 14% stronger at the end of 2017 than at the beginning of the year.

1.2 MACROECONOMIC DEVELOPMENTS IN SLOVAKIA

Slovakia's GDP at constant prices increased in 2017 by 3.4% after increasing by 3.3% in 2016. This increase was driven by domestic demand and net exports. The component that recorded the largest drop in growth was government consumption.

The labour market was favourable in 2017, thus continuing its trend of previous years. Employment as defined in the ESA 2010 increased in 2017 by 2.2%, year on year, following its rise of 2.4% in 2016. Most of the new jobs were added in the industry and services sectors. The unemployment rate fell from 9.7% at the end of 2016 to an all-time low of 8.1% at the end of 2017. Average annual nominal wage growth in 2017 was robust (4.6%). Wages grew in all sectors apart from the information and communication technology sector.

In the balance of payments for 2017, the current account showed a deficit of €1.8 billion (€1.2 billion in 2016) owing mainly to a decline in the trade surplus.

The average annual HICP inflation rose to 1.4% in 2017, after recording a negative rate of -0.5% in 2016. All HICP components contributed to the headline rate's acceleration, with food prices having the largest impact.

1.2.1 PRICE DEVELOPMENTS

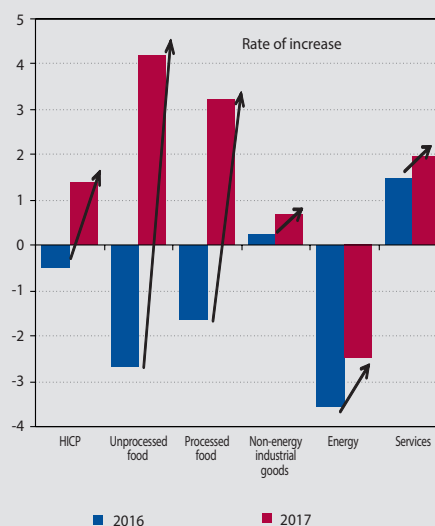
After three years in negative territory, the average annual HICP inflation rate rose to 1.4% in 2017. The acceleration was mostly attributable to external factors that passed through to food price inflation, notably in its acceleration in the second half of the year. Modest increases were also observed in services inflation and in non-energy industrial goods inflation. As for energy inflation, its negative year-on-year rate moderated in 2017.

Agricultural commodity prices were increasing throughout the year, with the largest rises recorded by prices of oils, fats and milk. This trend passed through to processed food price inflation with a slight lag. The year-on-year increase in that component peaked at the end of 2017. Food inflation also came under upward pressure due to the fading of the impact of the January 2016 reductions in VAT on selected foodstuffs. Food prices contributed almost 1.4 percentage point to the average inflation rate in 2017 and were therefore the most significant inflationary factor.

Compared with 2016, oil prices in euro increased strongly on average in 2017 and this trend translated into higher fuel prices. In contrast to 2016, when they were one of the key factors behind the low/negative inflation environment in both Slovakia and other euro area countries, oil prices had an upward impact on the headline inflation rate in 2017. As a result of low wholesale prices of gas and electricity in 2016, consumer gas and electricity prices were reduced in January 2017. With fuel prices rising and regulated energy prices falling, average annual energy inflation was less negative in 2017 than in 2016 (-2.5% versus -3.5%).

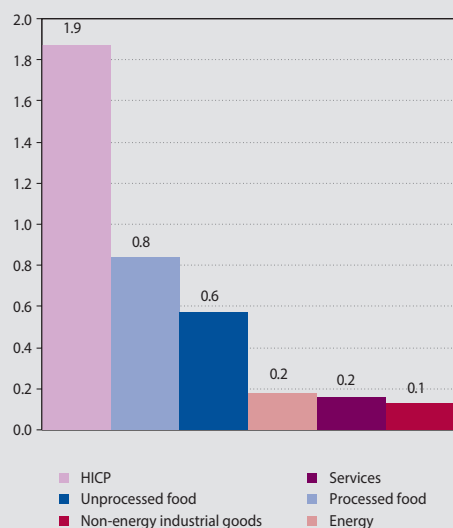
The annual rate of increase in import prices from euro area countries accelerated slightly. The pass-through of imported inflation to non-ener-

Chart 3 HICP components (annual percentage changes)



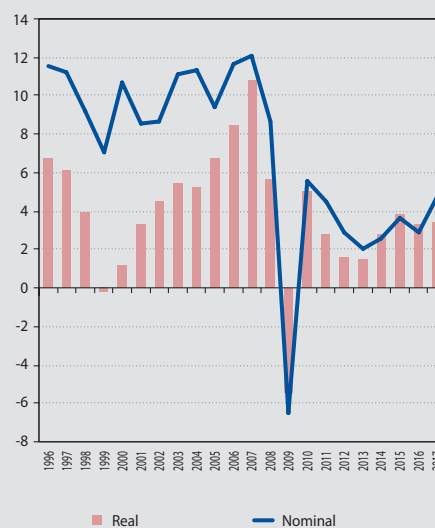
Sources: SO SR and NBS calculations.

Chart 4 Contributions of components to the acceleration of the HICP inflation rate between 2016 and 2017 (percentage points)



Sources: SO SR and NBS calculations.

Chart 5 Real and nominal GDP (annual percentage changes; constant prices)



Source: SO SR.

gy industrial goods inflation resulted in a moderate rise in the latter. As for services inflation, it came under upward pressure from the strong labour market and from household final consumption. In summary, demand-pull pressures and a robust domestic side of the economy gradually came to the forefront of inflation developments.

1.2.2 GROSS DOMESTIC PRODUCT

Slovakia's real GDP increased in 2017 by 3.4% year on year (after rising by 3.3% in 2016). The increase in GDP growth was driven by domestic demand, and in particular by household consumption. Net trade also made a positive contribution. Nominal GDP for the year amounted to €85 billion, which was 4.7% higher compared

with 2016. This strong growth, however, was partly the result of price developments. The GDP deflator, under upward pressure from increases in consumer, producer, import and export prices, rose by 1.3% year on year (after being negative in each of the years from 2014 to 2016).

GDP – THE EXPENDITURE SIDE

Domestic demand increased by 2.8%, which was a marked improvement on its decline of 0.3% in 2016. The driver of this growth was domestic consumption supported by an improving labour market situation. Investment also increased year on year, by 3.2% (albeit largely due to a base effect, with investment having fallen by 8.3% in 2016). Fixed investment spending did not show

Table 1 GDP based on the expenditure approach (annual percentage changes; constant prices)

	2016	2017				
	Q1–Q4	Q1	Q2	Q3	Q4	Q1–Q4
Gross domestic product	3.3	3.1	3.4	3.5	3.5	3.4
Final consumption of households and non-profit institutions serving households	2.7	3.3	3.4	3.9	3.7	3.6
Final consumption of general government	1.6	-0.5	-0.1	0.0	1.6	0.2
Gross fixed capital formation	-8.3	-0.3	-4.0	10.3	7.6	3.2
Exports of goods and services	6.2	8.1	-0.3	3.8	5.6	4.3
Imports of goods and services	3.7	7.6	-0.8	5.9	3.2	3.9

Source: SO SR.

a clear trend in 2017, increasing in two quarters and falling in two quarters. Infrastructure investment is usually strong towards the end of the year, when projects are being brought to completion, but in 2017 it softened. The general government sector, as the principal investor in infrastructure (among a group of sectors that includes also non-financial corporations, financial corporations, and households/non-profit institutions serving households), recorded lower infrastructure investment in 2017, at current prices, than in the previous year. This weaker pace of public investment may be attributed to the slow absorption of European Union funds under the current EU programming period. Net trade had a positive impact on GDP growth, with year-on-year export growth (4.3%) outpacing the increase in imports of goods and services (3.9% year on year).

Domestic demand was driven by household consumption, supported by an increase in household disposable income growth. That increase, stemming from further improvement in the labour market situation, contributed to growth in consumption expenditure on non-essential goods and services (for example, health, recreation, communications, and education).

Export growth in 2017 was responsive to rising demand from Slovakia's trading partners and accelerated to 4.3% for the year as a whole. While goods exports increased strongly, services exports recorded more moderate growth. Car exports increased in real terms by 5.1% year on year, and concerning territories, exports to EU markets went up.

Export performance as measured by the exports-to-GDP ratio increased in 2017 by 0.8 percentage point, to around 101%. Import intensity also increased, but more moderately (by 0.4 percentage point). As for the openness of the Slovak economy, measured by exports and imports of goods and services as a percentage of GDP, it rose by 3.4 percentage points, to 189.2%.

1.2.3 THE LABOUR MARKET

The economy's solid growth was reflected in labour market developments, which maintained their favourable trend of recent years. Employment growth was accompanied by falling unemployment (reflecting also an increased number of long-term unemployed persons finding work), while the unemployment rate reached an all-

time low. The average nominal wage increased as a result of growing labour demand that increased wage competition among employers.

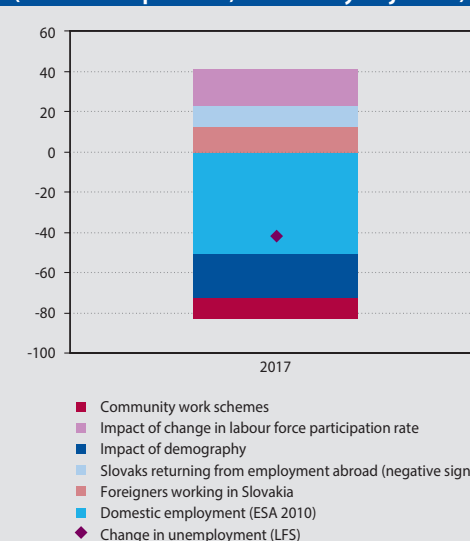
EMPLOYMENT

Employment as defined in the ESA 2010 increased in 2017 by 2.2% year on year (or 51,200 in headcount terms), after rising by 2.4% in the previous year. The sectors that accounted for most of that growth were industry, services and trade. The construction sector also saw job growth, for a second successive year. Public sector employment² increased by 0.9% (1.3% in 2016), with the education sector making the largest contribution to that growth. According to the Labour Force Survey, the number of Slovak citizens working abroad fell significantly in 2017, by 6.5% year on year (or 10,400). This was a reversal of the situation in 2016, when the number of Slovaks working abroad increased. The number of foreigners working in Slovakia is rising from year to year, and in 2017 it increased by 12,400. The inflow of foreign workers and the rising labour participation rate are serving to moderate labour market tightening. Nevertheless, the number of employers that report labour shortages is continuing to increase.

UNEMPLOYMENT

According to the Labour Force Survey (LFS), the number of unemployed fell in 2017, year

Chart 6 Contributions of key labour market variables to the change in unemployment (number of persons; seasonally adjusted)



Sources: SO SR and NBS calculations.

² Including also the health and education sectors.



on year, by 15.8% (or 42,000), and so the unemployment rate fell by 1.6 percentage point, to 8.1%. The registered unemployed rate, based on the records of the Central Office of Labour, Social Affairs and Family, averaged 7.1% in 2017, which was 2.4 percentage points lower than in 2016. The fall in the unemployment rate was related to rising demand for labour, which was reflected in a marked reduction in long-term structural unemployment. The rate also reflected a drop in the economically active population, the first for five years. The fall in the working-age population stems from adverse demographic trends.

WAGES AND LABOUR PRODUCTIVITY

Average annual nominal wages growth increased significantly in 2017, to 4.6%, and the average nominal wage rose to €954. This robust wage growth stemmed from a labour market situation in which labour shortages remain an issue and are putting upward pressure on wages in several sectors. The sectors recording the strongest annual wage growth in 2017 – above the national average – were professional, scientific and technical activities (8.3%), transportation and storage (6.2%), arts, entertainment and recreation (6.0%), education (5.9%), manufacturing (5.4%), and public administration and defence (5.2%). Compared with nominal wages, real wages (adjusted for

inflation, which in 2017 was positive for the first time in three years) recorded lower growth (3.3%). Growth in Labour productivity (GDP per employee) was higher in 2017 than in previous years, but continued to lag behind wage growth. On the one hand, such a dynamic could support price growth; on the other hand, it could weigh on the economy's competitiveness.

1.2.4 FINANCIAL RESULTS

According to the SO SR's preliminary data, the non-financial corporate sector made an aggregate profit of €10.2 billion in 2017, representing a year-on-year fall of 2.2% (after an increase of 1.1% in 2016). The principal negative contributions to that result were from profit declines in the following sectors: real estate brokerage (-19%); electricity, gas, and steam supply (-16%); and manufacture of motor vehicles (-11%). The largest positive contributions were from profit increases in wholesale and retail trade (26%) and manufacture of metals and metal products (10%).

1.2.5 BALANCE OF PAYMENTS

CURRENT ACCOUNT

In Slovakia's balance of payments for 2017, the current account showed a deficit of €1.8 billion, caused mainly by a fall in the trade balance sur-

Table 2 Labour market indicators

	2016	2017				
	Q1–Q4	Q1	Q2	Q3	Q4	Q1–Q4
Nominal wages (index)	3.3	3.5	4.8	5.2	5.2	4.6
Real wages (index)	3.9	2.6	3.8	3.6	3.3	3.2
Nominal compensation per employee – ESA 2010 (index)	2.3	3.1	4.0	5.0	3.9	4.1
Labour productivity – GDP per employee (index; current prices)	0.5	1.8	2.3	2.6	3.1	2.5
Labour productivity – GDP per employee (index; constant prices)	0.9	0.9	1.6	1.0	1.2	1.2
Employment – ESA 2010 (index)	2.4	2.1	2.1	2.3	2.2	2.2
Unemployment rate – LFS ¹⁾ (percentages)	9.7	8.7	8.1	8.0	7.7	8.1
Nominal unit labour costs (ULCs) ²⁾	1.4	2.2	2.4	4.0	2.7	2.8

Source: SO SR and NBS calculations.

1) Labour Force Survey.

2) Ratio of compensation per employee growth at current prices to labour productivity growth (ESA 2010) at constant prices.

plus. The ratio of the current account deficit to GDP (at current prices) therefore increased by 0.6 percentage point year on year, to more than 2.1%.

The services balance surplus was higher in 2017 than in the previous year due mainly to positive trends in the economy. The items that recorded the largest increases in income were *business services* and *transportation*. Under *travel*, income growth stemmed mainly from an increase in the number of foreign tourists. The primary income balance was in surplus, supported by the settlement of funds from EU Structural Funds. The deficit on the secondary income balance remained almost unchanged year on year, as both income and expenditure increased.

The capital account surplus fell significantly year on year, owing to the lower absorption of EU funds.

FINANCIAL ACCOUNT

The balance of payments financial account recorded a net inflow of €3.8 billion in 2017, which compared with 2016 represented an increase of €3.4 billion.

In the direct investment balance of the financial account, the net inflow was caused by the inflow

Table 3 Current account and capital account balances (EUR billions)

	2016	2017
Goods	1.6	0.7
Exports	67.1	71.6
Imports	65.5	70.9
Services	0.5	0.8
Primary income balance	-1.9	-2.0
Secondary income balance	-1.4	-1.3
Current account	-1.2	-1.8
Current account-to-GDP ratio (percentage)	-1.5	-2.1
Capital account	1.6	0.8

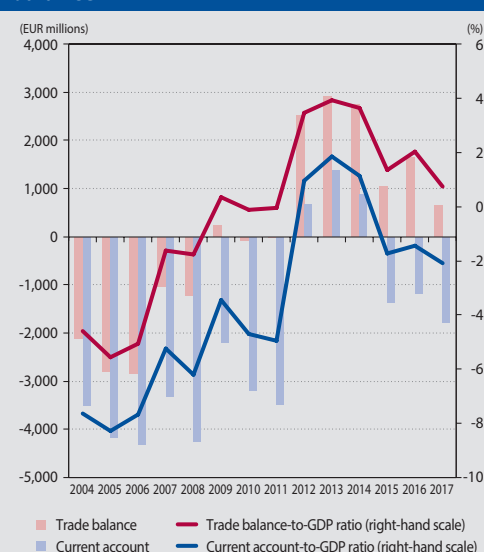
Source: SO SR and NBS calculations.

of debt capital arising from the economic activity of firms. This increase was supported by inflows in the form of non-residents' investments in equity capital. The net inflow in the portfolio investment balance resulted from sales of Slovak debt securities to non-residents. The inflow in the other investment balance was supported mainly by an increase in the amount of funds deposited with NBS.

EXTERNAL DEBT OF SLOVAKIA

The balance of payments transactions in 2017 resulted in Slovakia's external debt increasing by €20.3 billion year on year, to €94.1 billion. Since, however, the increase in the gross external debt was accompanied by an increase in foreign assets, the net external debt increased

Chart 7 Current account balance and trade balance



Sources: SO SR and NBS calculations

Table 4 Financial account balance (EUR billions)

	2016	2017
Direct investment	0.5	-1.7
Portfolio investment and financial derivatives	4.2	-0.6
Other investment	-5.1	-2.0
Reserve assets	0.0	0.5
Financial account	-0.4	-3.8

Source: NBS.

Note: The figures for the financial account balances are shown in net terms (assets minus liabilities), with a positive value denoting a net outflow and a negative value denoting a net inflow.



only slightly. According to preliminary data, Slovakia's ratio of gross external debt to GDP (at current prices) for 2017 was 110.8%, which was 19.9 percentage points higher than the figure for 2016. The ratio of short-term external debt to gross external debt increased by 10.0 percentage points in 2017, to 48.8%. Debt per capita rose by €683 in 2017, to €15,613 as at the end of the year.

NOMINAL AND REAL EFFECTIVE EXCHANGE RATES³

The nominal effective exchange rate (NEER) depreciated in 2017 by an average of 0.2%, year on year, after appreciating by 1.5% in the previous year. Depreciation against the Czech koruna made the largest contribution (0.3 percentage point) to the NEER's decrease. The koruna began appreciating again after the Czech central bank, on 6 April 2017, ended the exchange rate floor that it had been using as an additional instrument for easing monetary policy. Depreciation against the Polish zloty and Russian rouble also had a negative impact on the NEER, 0.2 percentage point in each case. On the other hand, the NEER's overall drop was moderated by the contributions of appreciation against the Chinese renminbi and British pound, 0.3 percentage point

in each case. The pound's weakening stemmed from the continuing high uncertainty surrounding the process of the United Kingdom's withdrawal from the European Union.

Looking at the real effective exchange rate (REER) based on the producer price index, it depreciated in 2017 by an average of 1.4% year on year, which compared with the previous year's depreciation was higher by 0.8 percentage point. In comparison with the NEER, the REER weakened more as a result of the negative inflation differential against Slovakia's most important trading partners. After taking into account trading partners' weights in the REER, the negative inflation differentials that influenced the REER's depreciation the most were those with China (contribution -0.3 percentage point), Hungary and Poland (both contributions -0.2 percentage point). With the REER's estimated equilibrium path continuing to appreciate – due largely to equilibrium labour productivity growth being higher in Slovakia than in its trading partners – the REER's depreciation in 2017 increased its undervaluation. The more undervalued REER continued to support the price competitiveness of domestic firms.

2 EUROSYSTEM MONETARY POLICY

2.1 MONETARY POLICY OPERATIONS

AN AMPLE DEGREE OF MONETARY STIMULUS REMAINS NECESSARY

In 2017 the European Central Bank (ECB) maintained the expansionary monetary policy stance that it had been pursuing since 2014. Acting within the monetary policy operational framework, the ECB implemented monetary policy through the purchasing of selected assets as well as through policy rates (including the particularly significant negative deposit facility rate), with the aim of stimulating an increase in inflation to its medium-term target.

The ECB's Governing Council left the key ECB interest rates unchanged throughout 2017, with

the main refinancing rate standing at 0.00%, the marginal lending facility rate at 0.25%, and the deposit facility rate at -0.40%. Given the environment of abundant liquidity, resulting mainly from Eurosystem asset purchase programmes and unconventional longer-term refinancing operations, short-term money market interest rates remained just above the deposit facility rate. Thus, in 2017, the interest rate on the deposit facility continued to determine the level of the shortest market rates.

The ECB continued to use non-standard measures in the form of asset purchase programmes (APP) as the principal means of implementing monetary policy. These measures complemented the standard open market operations, stand-

³ The methodology used to calculate the effective exchange rate is published on the NBS website at https://www.nbs.sk/_img/Documents/_Statistika/VybrMakroUkaz/EER/NEER_REER_Methodology.pdf.