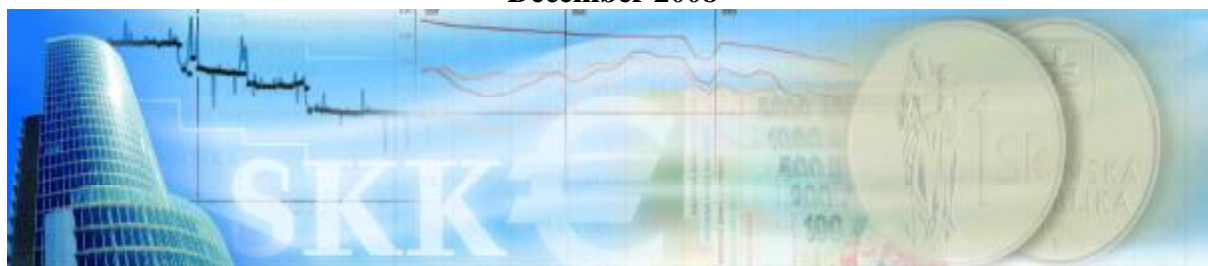




NÁRODNÁ BANKA SLOVENSKA

# MEDIUM-TERM FORECAST (MTF-2008Q4)

December 2008



## Introduction

In connection with the entry of Slovakia into the euro area, Národná banka Slovenska (National Bank of Slovakia, NBS) was required to harmonise the contents, preparation, and publication of its medium-term forecasts (MTF) with the standardised projection process applied within the scope of the ECB's Broad Macroeconomic Projection Exercise (BMPE). This process takes place twice a year (in the second and fourth quarters), with the NBS participating for the first time. During the projection process, which lasts for two months, the individual euro-area Member States present their country-level projections made on the basis of jointly set assumptions, in several rounds. These partial projections are then aggregated into a final medium-term forecast for the euro area as a whole. After being approved by the Governing Council of the ECB, the forecast is published on the ECB's website in June and December. Within the scope of this process, the NBS will also publish its projections, depending on the Bank Board's decision. In the meantime, the NBS will publish an abridged version of its medium-term forecast, so that four macroeconomic forecasts per year are always available.

## Summary

In 2008, Slovakia's GDP is projected to grow by 7.5%, in line with the estimates released to date. This development may be adversely affected by the sharper-than-expected decline in foreign demand in the fourth quarter. In the medium term, economic activity will reflect the current trend in the global economy.

In 2009, GDP is expected to slow considerably, mainly as a result of declines in exports and domestic demand. The contribution of net exports will be reduced by the weakening foreign demand, which will affect the production in most export-oriented companies. Subsequently, on account of developments in export sectors, domestic demand is expected to slow resulting from weakening dynamics of compensation per employee and slower growth in employment, which will lead to a slowdown in the growth of disposable household income. In the medium term, gross fixed capital formation is also expected to be influenced by the trend in global demand. With regard to the favourable situation in the Slovak banking sector, which has so far been affected by the financial crisis to a minimum extent, domestic demand is expected to be influenced by the tighter credit standards only slightly.

In 2010, GDP growth is expected to recover to some extent, due to accelerated growth in domestic and, in particular, foreign demand. The improved external environment should lead to a slight increase in export performance. The contribution of domestic demand should increase, as a result of faster growth in consumption and investment.

Inflation is expected to fall, from its relatively high current level. Average HICP inflation is projected to reach 3.9% in 2008 and 2.7% in 2009. The main determinants of this development will be the base effect of food prices and the recent favourable trend in oil and other commodity prices. In 2010, inflation is expected to accelerate somewhat (to 3.2%), in line with expected recovery in economic activity, which is likely to cause a global rise in oil and other commodity prices.

The basic difference compared with the previous forecast (of July 2008) is in the outlook for 2009. In the MTF-2008Q3 forecast, economic activity was predicted to experience a gradual downturn, i.e. a slowdown in GDP growth, wages, and inflation during 2009 and 2010. The

current forecast predicts a marked deterioration in virtually all macroeconomic indicators in 2009, as a result of the decline in foreign demand. In connection with the current trend in the world prices of oil and other commodities, inflation is expected to slow next year more significantly than according to the MTF-2008Q3.

One of the major risks involved in the forecast is that the financial crisis may last longer than expected and/or may have a more profound impact on export performance, investment and domestic consumption through reduced foreign demand, and on domestic consumption and investment through the tightening of credit standards. For the inflation forecast, the dominant risks are downside risks to inflation, arising from developments in oil and agricultural commodity prices in the event of a deeper global recession.

## Technical assumptions and the international environment

The technical assumptions of the medium-term forecast, as well as the international economic environment, have been adopted from the Eurosystem staff macroeconomic projections for the euro area.<sup>1 2</sup>

The forecast assumes a relatively sharp drop in the average price of oil in 2009, followed by a modest rise in 2010. After a relatively steep increase in 2008, food prices are likely to fall somewhat in 2009; this fall will probably be followed by a slight rise in 2010. After rising somewhat in 2008, the prices of other non-energy commodities are expected to drop significantly in 2009, before rising again in 2010. The EUR/USD cross-rate applied was 1.27 as the average rate for the last two weeks preceding the cut-off date (14 November).

Technical assumptions	(year-on-year changes in %, unless otherwise indicated)		
	2008	2009	2010
Oil (USD/barrel)	99.9	67.3	76.6
Food	28.9	-9.7	4.9
Non-energy commodities	3.5	-22.9	5.4

The outlook for the global economy is relatively unfavourable. The tensions in the financial markets and corrections in the real estate market are gradually transmitted from the United States to other economies as well. Over the short-term horizon, the forecast predicts a cyclical slowdown in the economy, especially in the United States and other advanced economies. However, economic activity is also expected to slow in emerging markets. Overall, global GDP outside the euro-area is projected to grow by an average of 3.9% in 2008, by 2.4% in 2009, and by 5.0% in 2010.

## Medium-term forecast for the euro area

The slowdown in global economic growth and the financial market tensions are also mirrored in the outlook for the euro-area economy. For 2009, an economic decline is projected, followed by a very moderate revival in 2010. The projected low economic activity reflects both the global slowdown and the subdued domestic demand. The low foreign demand is mainly reflected in the weaker export performance, which will also be affected adversely by

<sup>1</sup> The technical assumptions concerning the prices of energy and non-energy commodities are based on market expectations with a cut-off date on 14 November 2008.

<sup>2</sup> More detailed information about the Eurosystem staff macroeconomic predictions is available at [www.ecb.int](http://www.ecb.int).

the lagged effects of past losses in the price competitiveness of the euro area. The subsequent modest acceleration in exports will be supported by a revival in the global economy, coupled with improved price competitiveness in the euro area, mostly stemming from the recent depreciation of the euro.

The tighter financing conditions and the weak global economic activity will be reflected in a marked decline in investment. Investment demand will also be dampened by the declining profit margins and the ongoing corrections in the real estate markets of some euro-area countries. However, investment demand will be supported to some extent by government investments. Consumer demand will also weaken, owing to the adverse effect of a fall in employment on disposable income. The slow consumption growth will be affected also by higher precautionary savings, increased economic uncertainty, the rise in unemployment, and the declines in real property and share prices. On the other hand, government consumption is projected to grow over the projection horizon.

**Projections of selected euro-area indicators** (average year-on-year changes in %) <sup>1) 2)</sup>

	2007	2008	2009	2010
HICP	2.1	3.2-3.4	1.1-1.7	1.5-2.1
Real GDP	2.6	0.8-1.2	-1.0-0.0	0.5-1.5
Private consumption	1.6	0.1-0.5	-0.3-0.7	0.6-1.8
Government consumption	2.3	1.9-2.3	1.3-1.9	1.3-1.9
Gross fixed capital formation	4.2	0.2-1.2	-6.0- -3.0	-2.4-1.0
Exports (goods and services)	5.9	2.4-3.4	-1.4-1.0	2.3-4.9
Imports (goods and services)	5.4	2.0-3.0	-1.9-1.1	1.4-5.2

<sup>1)</sup> The projections for real GDP and its components refer to working-day-adjusted data. The projections for exports and imports include intra-euro-area trade.

<sup>2)</sup> Slovakia is included as part of the euro area in the projection for 2009. The average annual percentage changes for 2009 are based on a euro-area composition that includes Slovakia already in 2008.

Source: ECB.

Price developments will be to a large extent influenced by energy and non-energy commodity prices. After a marked slowdown in 2009, inflation is expected to accelerate somewhat in the next year. HICP inflation, excluding energy prices, is expected to follow a smoother downward path over the projection horizon.

## Medium-term forecast for Slovakia

### Real economy

#### *Current account*

Towards the end of 2008, but mainly in 2009, the current account balance is expected to reflect the negative effects of the financial crisis, influencing the level of Slovak exports through a marked decline in foreign demand. With regard to the economy's existing export intensity, however, lower exports should be accompanied by a reduction in imports, thus mitigating the impact of lower foreign demand on the trade balance. A similar effect is expected from the current fall in oil prices, while the falling trend is likely to continue in the coming months. The lower oil prices are expected to positively influence the balance of trade throughout the projection horizon, compared with the previous forecast. Owing to a fall in the export performance of the economy, the dynamics of exports and imports are expected to go down, mainly in 2009. The lower foreign demand is expected to manifest itself in the fourth

quarter of 2008, but will be partially compensated for by oil prices. Thus, the annual trade balance for 2008 will deteriorate only slightly in comparison with the previous forecast. On the other hand, the lower foreign demand is expected to worsen the trade balance projected for 2009 and 2010 by a significant amount (more than Sk 20 billion), compared with the previous forecast.

The main risk to the forecast is that the economy's export performance will be affected by the financial crisis to a different extent than expected and that the oil price assumptions will remain unfulfilled. The trade balance may be negatively influenced over the projection horizon by the possible construction of new nuclear and steam power plants (which are currently under consideration), which may cause a temporary deterioration in the trade balance through increased imports.

A more negative trend in the balance of services in the last quarter of 2008, as well as in the following years under consideration, can also be attributed to the expected decline in foreign demand, which may result in lower receipts from services provided. The actual drawing-down of resources from EU funds and the new assumptions (based on the previous developments) about their division between current and capital transfers in the next years have caused a deterioration in the estimated balance of current transfers.

The current account deficit is expected to decrease in line with the previous forecast. However, the changed estimates of its individual components have led to deteriorations in the deficits projected for 2008 (by 0.7 of a percentage point) and for 2009-2010 (by almost 2 percentage points).

### ***Labour market***

In the fourth quarter of 2008, the growth of compensation per employee is expected to slow, mainly due to the fading effect of wage tariff revaluation in the general government sector, which was responsible for its faster growth in the first half of 2008. With the expected gradual slowdown in the pace of economic growth, employment growth is also likely to slow somewhat in the fourth quarter of 2008.

In 2009-2010, the growth of compensation per employee is expected to slow gradually because of the financial crisis and its consequences in certain sectors, which will probably reduce the profits of individual companies. The financial crisis is expected to hit first and foremost the export-oriented industries and their suppliers through subdued foreign demand. Companies will probably make attempts to reduce their costs, hence they will be less willing to grant wage increases or bonuses.

In 2009-2010, employment growth is expected to slow as a result of a slowdown in the pace of economic growth. Cost reductions at companies will probably be achieved through the limitation of wage increases; staff reductions will only be considered as a last resort. As a result, the rate of unemployment is expected to fall more moderately throughout the projection horizon.

The main risk to the labour market forecast for 2008-2010 is that the impact of the financial crisis will be the stronger than expected.

## GDP

In the fourth quarter of 2008, the pace of economic growth is expected to slow further. This fact is also supported by the recently published confidence indicator for industry, which reached a historical low. Its value was mainly influenced by a decline in the expected production of and demand for industrial products.

The medium-term real economic forecast for 2009-2010 takes into account the current trend in the global economy. Regarding the expected slowdown (even decline in some countries) in economic activity in Slovakia's main trade partners and the high level of openness of the Slovak economy, GDP growth is expected to slow considerably in 2009 (compared with 2008 and the previous forecast), due to developments in net exports, domestic demand, and in the labour market. In the following period, Slovakia's GDP growth is expected to accelerate gradually, in line with the estimated path of the global economy.

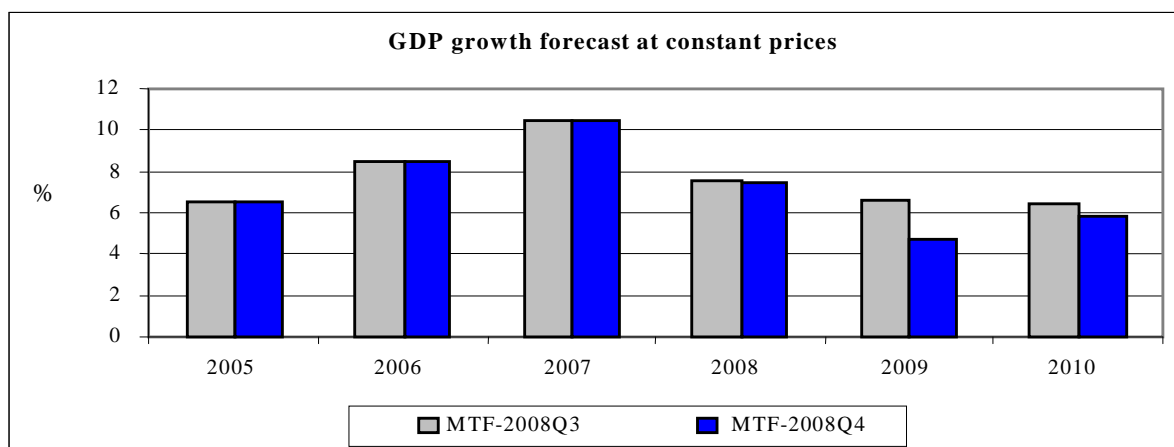
## Domestic demand

Household final consumption is expected to slow on a year-on-year basis in 2009 as a result of slower growth in disposable income of households, caused by a slowdown in the growth of compensation per employee and in employment growth. The tightening of credit standards by banks is not expected to have a marked adverse effect on consumption. In 2010, domestic consumption is expected to undergo a revival, due to accelerated growth in disposable income in connection with the predicted revival in foreign demand.

The projection of fixed investment mainly reflects the negative impact of subdued foreign demand. Regarding its structure, private investment in machinery and transportation equipment is expected to slow more significantly than investment in construction. Investment in construction should be positively influenced by the large number of projects under construction and the drawing-down of eurofunds for infrastructural projects.

## Net exports

The expected slowdown in foreign demand was most clearly reflected in the projection of exports/imports of goods and services, mainly as a result of its negative impact on export-oriented companies in the automotive industry and in other sectors. Since no further decline is expected in foreign trade in 2010, export performance should remain stable or should increase somewhat.

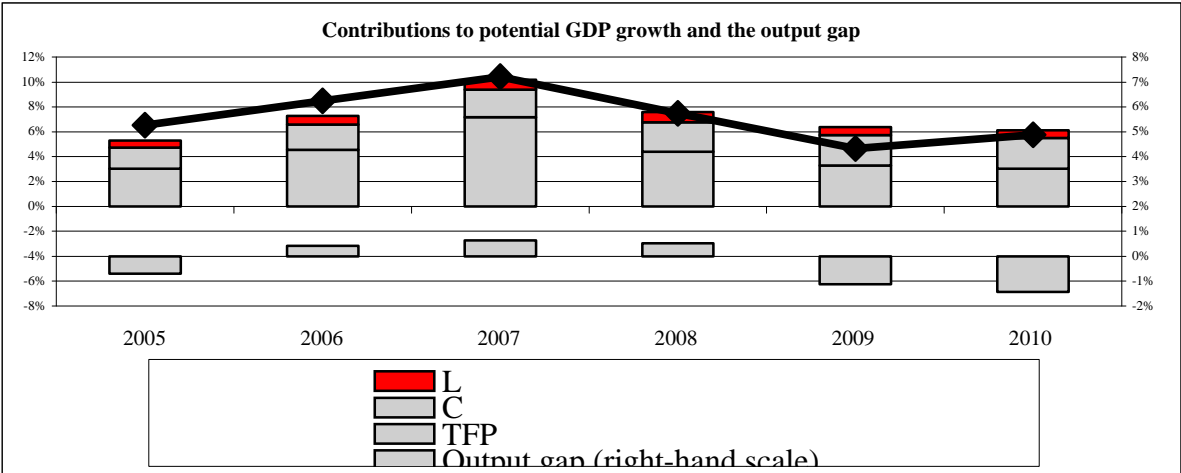


The main (downside) risk to the real economic forecast is that the financial crisis may be longer than expected and may have a more profound impact on export performance, investment and domestic consumption through reduced foreign demand, and on domestic consumption and investment through the tighter credit conditions. GDP growth may be stimulated by the prepared investments in infrastructures through PPP projects and eurofunds.

**Potential GDP and the output gap**

The accelerated economic growth in recent years has been driven mainly by labour productivity growth, stimulated by inflows of foreign direct investment (FDI). FDI inflows and imported technologies created suitable conditions for structural unemployment to fall and for the productive capital to accumulate in the economy. These effects culminated in 2007, when the economy’s potential output increased by 10.1%.

Over the projection horizon, the economy is expected to benefit from the massive FDI inflows of 2006 and 2007, which should maintain the potential output growth above the long-term average. The contributions of labour – L (0.7 of a percentage point) and capital – C (2.4 percentage points) are expected to remain stable, but the contribution of total factor productivity (TFP) is likely to fall gradually, from 7.2 percentage points in 2007 to 3.0 percentage points in 2010.



With regard to the cyclical position, the projected real GDP growth should be slower than the economy’s potential growth. As a result of a marked fall in foreign demand and the related slowdown in export performance, the output gap is expected to reach negative values over the projection horizon, falling from +0.5 in 2008 to -1.1 in 2009 and -1.4 in 2010.

**HICP**

Inflation as measured by the Harmonised Index of Consumer Prices (HICP) recorded a steady rise (since the previous medium-term forecast), from 4.3% in June to 4.5% in September, followed by a slowdown over the following months. The rise in inflation was mainly the result of increases in energy and services prices. Energy prices were influenced by the rise in the world price of oil, which was mostly reflected in prices for heating. Prices for services reflected the price increases in restaurants and canteens (in schools and enterprises), caused by developments in agricultural commodity prices.

The current inflation forecast is based on the external assumptions set jointly by the ECB and euro-area NCBs within the scope of the BMPE projection process for December 2008. The fuel price forecast is based on a set of projection update elasticities and on the common assumptions about Brent oil prices and the USD/EUR exchange rate. The assumptions about oil prices were also used in electricity, gas, and heating price projections, where expert expectations based on the policy of the Regulatory Office for Network Industries were also taken into account. The assumptions about agricultural commodities were used in projections for processed and unprocessed food prices.

In addition to the aforementioned external assumptions, domestic factors and assumptions are also taken into account in the inflation forecast. The main factors taken into account are the situation in the labour market, wage developments, the output gap, producer prices, profit margins, import prices, and assumptions about regulated prices and indirect taxes. The forecast also takes into account the introduction of the euro as from January 2009, the conversion rate fixation, and the estimated impact of the Balassa-Samuelson effect in consumer prices.

The rapid GDP growth in recent years has only slightly exceeded the economy's potential output, with price developments showing no signs of an overheated economy. In the two years ahead, economic activity is expected to slow in comparison with the previous forecast. Hence, GDP will be below its potential and thus the output gap should not represent a risk for inflation. The slowdown in global economic activity should cause a fall in commodity prices. The expected slowdown in inflation abroad, coupled with currency depreciation in the neighbouring countries (major trading partners) against the euro, should reduce the level of import prices and thus dampen the consumer price increase. After rising in 2008, mainly as a result of energy and commodity prices, producer prices are expected to show weakening dynamics in 2009 and 2010. Developments in import prices will exert pressure on producer prices and consequently on the profit margins of economic entities. Hence, profit margins are expected to fall in the next quarters as a result of faster ULC growth (due to a slowdown in labour productivity growth), compared with the GDP deflator. Such development may lead to a price increase in the future (an attempt to increase the margins to the original level), but over the medium-term, it is unlikely to pose a risk to price developments.

As regards labour market and wage developments, compensation per employee is expected to grow dynamically in 2008, due to strong wage growth in the general government sector. In 2009, the aforementioned global slowdown in economic activity is likely to exert pressure on corporate profits, which may subsequently reduce the pace of wage growth. In the case of employment, a marked increase is expected in 2008, due to investment activity and demand for services. In 2009, both export and investment are expected to slow; this slowdown will also be reflected in the dynamics of employment growth, mainly in industry and construction.

#### Administrative prices, indirect taxes

The previous forecast had predicted an increase in heating and gas prices for households, due to the rise in oil prices as of October 2008. The price of heating was increased gradually over the course of 2008. The current trend in oil prices has created room for the Regulatory Office to leave the prices of heating and gas unchanged for households in 2009. A change in legislation has enabled the Regulatory Office to regulate the price of gas used for heating for households as well (from next year). In addition, the Regulatory Office has introduced a new



regulatory method<sup>3</sup>. These changes are expected to ensure the stability of regulated prices in the future and to put pressure on the regulated entities to enhance the effectiveness of the regulated activity. Hence, with regard to the expected favourable trend in oil prices, regulated energy prices are projected to rise very moderately in the coming period with a positive impact on price developments in 2009-2010, compared with the July forecast. In the case of other regulated prices (education, health care, etc.), the trends from the previous years are expected to continue (except in transport).

In the area of indirect taxes, an unchanged pro-growth effect is expected in comparison with the previous forecast, due to an excise tax increase for tobacco and tobacco products (contributing 0.44 to HICP inflation), reflected in the prices of cigarettes since October 2008. In 2009, a further increase is expected in indirect taxes on cigarettes with a contribution of 0.2 of a percentage point to overall inflation during August to December 2009.

In the current medium-term forecast by the NBS, based on the above assumptions, inflation is projected to slow gradually, to 3.4% in December 2008 and to 2.8% in December 2009, as well as in December 2010. The main factors in this development are the base effect in food prices, the recent trend in agricultural commodity prices (a marked slowdown), and the lower world prices of energy commodities. A positive impact is also expected from domestic demand and cost factors.

On average, HICP inflation is projected to reach 3.9% in 2008, 2.7% in 2009, and 3.2% in 2010. Compared with the previous NBS forecast (MTF-2008Q3), the average inflation rate projected for 2008 has not been reduced. Average inflation in 2009 should reach 2.7%, which is 0.7 of a percentage point less than according to the previous forecast, due to a slowdown in energy and food prices. In 2010, the rate of increase in consumer prices is expected to accelerate, mainly in food, non-energy industrial goods, and services prices, due to a revival in global demand and in commodity prices. In 2009-2010, inflation will also be influenced by the euro introduction as from January 2009 and the related changeover effect, the conversion rate fixation, and the Balassa-Samuelson effect.

Overall inflation, excluding energy and unprocessed food prices (core inflation), is expected to reach an average of 3.8% in 2008. In 2009, core inflation is projected to be 2.9% and 3.5% in 2010.

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

		2007	2008	2009	2010
<b>TOTAL (HICP)</b>	<b>MTF-2008Q2</b>	1.9	3.2	3.0	3.0
	<b>MTF-2008Q3</b>	1.9	3.9	3.4	3.1
	<b>MTF-2008Q4</b>	1.9	3.9	2.7	3.2

<sup>3</sup> The Regulatory Office for Network Industries has replaced the REVENUE CAP method with the PRICE CAP method. In the case of the first method, the Regulatory Office specified the revenue that a regulated entity was allowed to achieve from a regulated activity, to cover its justified expenses and to earn an adequate profit. The new regulatory method is designed to regulate the prices of activities under regulation, while leaving the coverage of expenses and the profit achieved to the regulated entity (pressure for effectiveness).

**Comparison of HICP inflation forecasts**

(year-on-year changes in %, end-of-year figures)

		<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
<b>TOTAL (HICP)</b>	<b>MTF-2008Q2</b>	2.5	2.8	3.1	2.8
	<b>MTF-2008Q3</b>	2.5	4.0	2.8	2.9
	<b>MTF-2008Q4</b>	2.5	3.4	2.8	2.8

The risks to the current forecast are largely downside risks, resulting from the downturn in global economic activity, which may cause a sharper-than-expected decline in foreign demand. Such development may lead to lower energy and agricultural commodity prices, as well as to lower import prices. The lower foreign demand would imply lower profits in the corporate sector and pressure for slower-than-expected wage growth. The weaker wage dynamics may lead to lower domestic demand and weaker pressure on prices, mainly in the service sector. A downside risk is also represented by the currency depreciation against the euro in the neighbouring countries.

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