



NÁRODNÁ BANKA SLOVENSKA  
EUROSYSTEM



# MEDIUM-TERM FORECAST

Q2  
2010

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# 1 SUMMARY

This Medium-Term Forecast (MTF-2010Q2) was produced on the basis of more favourable assumptions for external demand as well as higher estimates for external prices and commodity prices. The expectations for external demand had positive effect on the Slovak economy in comparison with the projections given in the previous forecast.

In the first quarter of 2010, GDP growth on a quarter-on-quarter basis continued to be stronger than expected, according to the flash estimate published by the Statistical Office of the Slovak Republic (SO SR)<sup>1</sup>. Net exports made a positive contribution to GDP growth for the period under review. The economy is expected to continue recording moderate quarter-on-quarter growth in the following quarters of 2010, which in conjunction with current developments should result in higher GDP growth for 2010. As for the individual components of GDP, the slower rise in actual imports caused by a sharper increase in import prices is expected to result both in net exports making an improved contribution to GDP growth and subsequently in an increase in domestic demand. Household final consumption is assumed to rise only slightly, given the modest increment in employee compensation and the continuing decline in employment. At the same time, general government consumption is expected to maintain its positive contribution to economic growth. As economic activity recovers, investment activity should record a gradual upturn, though the increase in gross fixed capital formation in 2010 is expected to be driven mainly by investment in PPP infrastructure projects and investment in the local car industry. As for the effect of rising external demand, it is expected to boost exports and subsequently also imports. The contribution of net exports to GDP growth is projected to be negative owing to the decline in import intensity in 2009, as well as to the gradual increase in domestic demand and restocking. The unfavourable situation in the labour market is assumed to persist in 2010. The employment figures are projected to continue falling, particularly at the beginning of the year, and then to recover moderately only in the second half of the year. This development will subsequently

be reflected in a higher rate of unemployment throughout the projection horizon. Price developments in 2010 have so far been marked by the accelerated rise of energy and food prices on a year-on-year basis, alongside stagnating prices of services and prices of non-energy industrial goods.

The revival in external demand is expected to continue in the medium-term horizon, and this, together with the anticipated expansion of production in the domestic automotive industry in 2011, should lead to an improvement in the Slovak economy's export performance. As for components of domestic demand, investment activity is expected to increase in line with the economy's gradual recovery and to be partially driven by continuing PPP infrastructure projects. The expected consolidation of public finances is expected to result in a slightly slower increase in general government final consumption. The steady rise in output should be reflected in increases in both employment and employee compensation. On the basis of positive developments in the labour market, household consumption will rise at a faster pace. The increasing economic activity should also accelerate inflation in the medium-term horizon.

GDP growth in 2010 is assumed to be sharper than projected in the previous forecast, owing to the higher contribution of net exports. The improvement in net exports is, however, partially offset by slower growth in private consumption, which is a result of employment being projected to fall more sharply than in MTF-2010Q1. With the employment figures expected to deteriorate, the rate of unemployment over the whole projection horizon will also be higher than previously forecast. The projection for the economy's growth in the medium-term horizon is similar to that stated in the previous forecast, with almost all components of GDP recording slightly sharper growth and the labour market situation showing an improvement in 2012.

The risks in the latest medium-term forecast for GDP are mostly on the downside, reflecting in particular the expected effect of the essential

<sup>1</sup> The latest GDP forecast is based on the SO SR's flash estimate for the first quarter of 2010, which does not, however, give data for GDP components. Data on the GDP structure for the first quarter of 2010 were not available at the time of this forecast's completion.



consolidation of public finances in Slovakia and in EU countries. Positive expectations related to the recovery in external demand may be dampened as the effects of stimulus measures fade out.

The medium-term forecast for inflation can be considered realistic since none of the selected inflation-determining factors are reported as a substantial risk, according to risk assessment results. Upside risks include the development of import prices, which could rise more sharply than projected in this forecast if economic activity recovers at a faster pace and if energy prices are higher than expected. Another upside risk

could be stronger wage growth. The consolidation of public finances could represent an upside risk to the inflation forecast, if indirect taxes are higher than projected, but it could also dampen inflation pressures if the reduction in expenditure brings down aggregate demand. The ultimate effect of the consolidation of public finances will depend on the nature of the measures adopted. Similarly, the change in the way energy prices are regulated could have a double-sided effect on inflation – on one hand, as a result of the new regulatory period that is due to commence in 2011, or, on the other hand, because of further potential liberalisation of the energy market for households.



## 2 TECHNICAL ASSUMPTIONS AND THE INTERNATIONAL ENVIRONMENT

The technical assumptions for the medium-term forecast as well as developments in the international economy were taken from the June 2010 Eurosystem Staff Macroeconomic Projections for the Euro Area.<sup>2</sup>

The technical assumptions about interest rates and both energy and non-energy commodity prices are based on market expectations, with a cut-off date of 20 May 2010. The average level of short-term interest rates is expected to be 0.8% for 2010 and 1.1% for 2011. The market expectations for euro area ten-year nominal government bond yields imply an average level of 3.9% in 2010, increasing to 4.2% in 2011. The baseline projection takes into account the recent improvements in financing conditions and assumes that, over the projection horizon, bank lending rate spreads vis-à-vis the above-mentioned interest rates will narrow somewhat. Similarly, credit supply conditions are assumed to ease gradually over the horizon. As regards commodities, oil prices per barrel are assumed to average USD 79.5 in 2010 and USD 83.7 in 2011. The prices of non-energy commodities in US dollars are assumed to rise by 17.9% and 1.2% in 2011. The bilateral EUR/USD exchange rate is assumed to remain unchanged over the projection horizon at the average level prevailing in the ten-working day period ending on the cut-off date. This implies a EUR/USD exchange rate of 1.30 in 2010 and 1.26 in 2011, and an effective exchange rate of the euro that,

on average, depreciates by 6.4% in 2010 and by a further 1.8% in 2011.

Compared with the ECB's March forecast, the Eurosystem's June forecast assumes over the projections horizon higher oil prices, a somewhat more moderate rise in prices of non-energy commodities, substantial weakening of the EUR/USD exchange rate, and sharper depreciation of the euro's effective exchange rate.

The global economic outlook has continued to recover, more robustly than envisaged in the March ECB staff macroeconomic projections. World growth is expected to experience a temporary deceleration in the second half of 2010, reflecting the fading-out of some of the factors that initially supported the recovery, such as fiscal stimuli and the inventory cycle. Thereafter, global economic growth is projected to be supported by a normalisation in financial conditions and by some improvements in confidence and in the labour market. At the same time, however, it is expected to remain below past trends over the projection horizon 2010-2011, as advanced economies in particular experience a subdued recovery following the financial crisis. World real GDP outside the euro area is projected to increase by 4.7% in 2010 and by 4.1% in 2011. Growth in the euro area's export markets is estimated to be 8.6% in 2010 and 6.0% in 2011. Národná banka Slovenska's projection for 2012 assumes a slight increase in commodity prices and the continuing recovery of the global economy.

**Table 1 Technical assumptions (year-on-year changes in %, unless otherwise indicated)**

	Published in	Projection	
		2010	2011
Oil (USD/barrel)	March 2009	75.1	79.8
	June 2010	79.5	83.7
Non-energy commodities	March 2009	18.4	2.7
	June 2010	17.9	1.2
USD/EUR exchange rate	March 2009	1.38	1.38
	June 2010	1.30	1.26

Source: ECB.

<sup>2</sup> More information about the ECB projection is available at [www.ecb.int](http://www.ecb.int) <http://www.ecb.int/pub/pub/mopo/html/index.en.html?sk=staff+macroeconomic+projections>



### 3 MEDIUM-TERM FORECAST FOR THE EURO AREA

Real GDP in the euro area grew modestly in the first quarter of 2010. Inventories contributed strongly to growth, while other factors had a dampening effect on the economy, such as the end of government incentives for car purchases and adverse weather conditions. In the second quarter, real GDP growth is projected to be considerably stronger, benefiting from a rebound in construction activity. However, over the remainder of 2010, growth is expected to remain subdued, as factors such as the fiscal stimuli and the inventory cycle have diminishing effects. Further ahead, the economic pick-up is projected to strengthen, supported by gradually rising domestic demand as well as by improvements in external demand. The effects of monetary policy moves and the measures taken to restore the functioning of the financial system are expected to support economic activity over the full projection horizon. The recovery of exports over the projection horizon – driven by external demand and increased competitiveness – is expected to be reflected in the GDP figures for both 2010 and 2011. Growth in 2010 and 2011 is, however, projected to remain weaker than before the re-

cession, owing to the ongoing need for balance sheet adjustment in various sectors, high unemployment, precautionary savings and modest income growth. In addition, the outlook also takes into account ongoing fiscal adjustments. Potential GDP growth is expected to be modest over the projection horizon, while the output gap should narrow somewhat, but remain negative.

Compared with the March 2010 ECB projections, GDP growth is expected to be stronger in 2010 but more moderate in 2011.

Following a strong pick-up in March 2010, the overall HICP inflation rate is projected to increase slightly further in the second half of 2010, mostly driven by base effects arising from past food price decreases. Thereafter, inflation is expected to moderate slightly, in line with the assumed decline of the rate of increase in energy prices. By contrast, the growth rate of the HICP excluding food and energy is projected to increase gradually over the projection horizon, driven by improvements in economic activity and in the labour market. External price pressures are projected to increase

Table 2 Projections of selected euro area indicators (average year-on-year changes in %)

	Published in	Actual	Projections	
		2009	2010	2011
HICP	December 2009		0.8 – 1.6	0.9 – 2.1
	March 2010	0.3	1.4 – 1.6	1.0 – 2.2
Real GDP	December 2009		0.4 – 1.2	0.5 – 2.5
	March 2010	-4.1	0.7 – 1.3	0.2 – 2.2
Private consumption	December 2009		-0.3 – 0.5	0.2 – 2.0
	March 2010	-1.2	-0.2 – 0.4	-0.2 – 1.6
Government consumption	December 2009		0.1 – 1.1	0.2 – 1.6
	March 2010	2.6	0.3 – 1.3	-0.3 – 1.1
Gross fixed capital formation	December 2009		-3.1 – -0.5	-1.1 – 2.9
	March 2010	-10.8	-3.4 – -1.2	-2.1 – 2.7
Exports (goods and services)	December 2009		3.2 – 7.6	1.4 – 7.8
	March 2010	-13.2	5.5 – 9.1	1.1 – 7.9
Imports (goods and services)	December 2009		1.9 – 5.7	0.7 – 6.5
	March 2010	-12.0	3.8 – 7.0	0.4 – 6.8

Source: ECB.



in 2010, reflecting the path of commodity prices and the depreciation of the euro, but to subside in 2011. Turning to domestic price pressures, the growth in compensation per hour is projected to decrease strongly in 2010. Combined with the projected strong recovery in labour productivity, this wage profile implies a substantial deceleration in unit labour cost growth rates in 2010, followed by a limited rebound. Profit margins in turn

are projected to recover significantly in 2010, and to continue to grow at a steady pace thereafter, supported by the rebound in economic activity and the moderate wage growth prospects.

With regard to HICP inflation, the lower end of the projection range for 2010 is higher than that published in March (while the upper end is unchanged), and the range for 2011 lies somewhat higher.



## 4 MEDIUM-TERM FORECAST FOR SLOVAKIA

### 4.1 THE REAL ECONOMY

#### CURRENT ACCOUNT

In the first quarter of 2010, the **trade balance** component of the balance of payments **current account** developed in line with expectations, as exports grew by 17% and imports only by 10% (with the balance only slightly worse than expected). The export figures were driven up by the recovery of external demand. The stronger recovery of export performance was therefore, as projected, reflected in a year-on-year improvement in the trade balance for the first quarter of 2010. The level of exports is expected to rise due to the assumed acceleration in prices and improved external demand in the medium-term horizon (compared with MTF-2010Q1). The import figures, in comparison with the March forecast, are expected to be boosted by existing import intensity and in particular by the assumed rise in prices of raw materials. As a result of these factors, the trade balance for the whole of 2010 should be worse than projected in the previous forecast. In 2011 and 2012, the trade deficit is expected to be slightly deeper than stated in the March forecast, but there will be a gradual year-on-year improvement stemming largely from the effect of developments in external demand.

As stated in the previous forecast, exports and imports are expected to return to growth in the years 2010 to 2012, after declining by around 20% in 2009 on a year-on-year basis. This recovery should be stronger in 2010 (in line with the revival in external demand).

Risks to the trade balance forecast appear to be balanced. On one hand, the essential fiscal consolidation of public budgets of EU countries could dampen the assumed level of external demand and hence the level of Slovak exports; at the same time, a sharper rise in prices of raw materials could increase imports and also have an adverse effect on the trade balance. On the other hand, the expected effects of domestic consolidation of public finances could reduce imports (through the import intensity of domestic demand) and improve the trade balance.

As for the **balance of services**, the no more than modest improvement of this current account component in the first quarter of 2010 did not substantially affect expectations for its development in the years 2010 to 2012. Furthermore, the deficit is expected to record a gradual and moderate decline year-on-year, as a corollary of the growth in external demand that is expected to continue throughout the projection horizon. The unchanged assumptions for the development of the **balance of income** continue to be based on a modest rise in the profitability of enterprises with foreign participation, offset by the positive effect of steadily rising receipts from residents working abroad. By contrast, the forecast for the **balance of current transfers** has been revised, mainly because of new assumptions for payments to the EU budget. Because of the lower estimate for payments (based on lower assumed VAT receipts and developments in nominal gross national income), the full-year balance of current transfers is expected to improve.

The **current account deficit** to GDP ratio in the years 2010 to 2012 is assumed to rise slightly in comparison with the previous forecast (given the deterioration in the trade balance arising mainly from higher prices of raw materials). As stated in MTF-2010Q1, the current deficit to GDP ratio is expected to improve year-on-year, largely due to a gradual increase in external demand.

#### LABOUR MARKET

Growth in compensation per employee in 2010 is expected to be stronger than projected in the previous forecast, owing to the sharper monthly rise in nominal wage indicators (especially in the industry sector) as well as the stronger increase in labour productivity. In the medium-term horizon, amid the recovery in economic activity, growth in compensation per employee is assumed to accelerate in line with developments in labour productivity.

According to the SO SR's flash estimate, **employment** in the first quarter of 2010 declined sharply in comparison with NBS's expectations. Because of the persisting unfavourable situa-



tion in the labour market, employment is expected to have fallen in the second quarter, too. In the second half of the year, however, the employment figures are expected to improve on those given in the previous forecast. The scope for higher employment growth lies in the improved expectations arising from sentiment indicators, as well as statutory limits on overtime work. In the first half of 2010, labour capacities in the form of more overtime work are expected to have been used more efficiently, but in the second half of the year the use of overtime work will probably reach the limit allowed under the Labour Code, therefore necessitating the recruitment of new staff. The sharper rise in employment in the second half of 2010 will not, however, make up for the substantial decline in employment during the first half of the year, and therefore the full-year growth in employ-

ment should be far lower than projected in the previous forecast.

The upturn in employment in the second half of 2010 is expected to be reflected in employment growth in 2011, which should be stronger than forecast in MTF-2010Q1. Employment in 2012 is assumed to rise at the same pace as projected in the previous forecast.

Because employment in the first half of 2010 fell more sharply than expected, this forecast projects a sharper rise in the **unemployment** rate for the full year. In 2011-2012, the labour market is assumed to pick up gradually as economic growth accelerates, but although the unemployment rate is expected to decline moderately, it should remain higher than projected in the previous forecast.

## Box 1

### RISKS TO THE UNEMPLOYMENT RATE FORECAST

As a consequence of the economic crisis, the number of people in employment fell sharply in 2009 (either by 53,000 using the ESA 95 methodology, or by 68,000 based on the Labour Force Survey). According to the Labour Force Survey, a proportion of these people (40,000, excluding demographic development) became unemployed, but some became economically inactive because of incapacity to work, early retirement, or withdrawal from the labour market, and they also included an increase in the number of students who ceased to be employed. This means that not all of the decline in the number of employed people was automatically reflected in the number of unemployed, and therefore in the unemployment rate. Thus over the course of the year there were discrepancies between the drop in employment and the rise in unemployment.

When forecasting the rate of unemployment, Národná banka Slovenska takes as its basis the forecast for employment, in accordance with other economic indicators, as well as the assumptions for demographic development (i.e. the demographics for persons of productive

and post-productive age) and the trend development for economically inactive people.

As Chart A shows, the number of economically inactive people climbed in the first half

Chart A Contributions of labour market indicators to unemployment



Source: SO SR and NBS calculations.



of 2009 as a consequence of the recession, but it partially fell in the second half of the year as people returned to the labour market. With such marked shifts between the number of economically active and inactive people, a mismatch between the forecasts for employment and the unemployment rate arose during 2009. Given the current unfavourable situation in the labour market, the current forecast envisages that a proportion of the people made redundant will become economically inactive at the beginning of 2010, mostly on grounds of incapacity to work. As the year goes on, however, the situation in the

labour market is expected to stabilise gradually and there should not be substantial numbers of economically active people becoming economically inactive. If this assumption is not borne out, then there will be a risk of a further mismatch between the forecasts for employment and the unemployment rate. If coming periods continue to see an additional movement of people between the economically active and inactive segments of the population, as in 2009, then the unemployment rate could rise to higher levels even though actual development of employment will be in accordance with our expectations.

## GDP

According to the SO SR flash estimate, GDP growth in the first quarter of 2010 was slightly stronger than projected by NBS. Thus economic activity continued to recover, and the assumption is that the GDP growth will accelerate in 2010. This growth will be driven mainly by net exports, as the rise in real imports slows down due to increasing import prices. The positive contribution of domestic demand to GDP growth is assumed to decline slightly, with growth in household final consumption having been revised down due to the continuing downturn in employment. Prices in the economy, as measured by the GDP deflator, continued to fall in the first quarter of 2010, and therefore the projections for the average price level for 2010 as a whole and for the amount of nominal GDP generated over the full projection horizon have been revised down from those stated in MTF-2010Q1.

In the medium-term horizon, economic activity is assumed to recover in conjunction with the upturn in the world economy. Developments in external demand are expected to imply continuing improvement in the export performance of the Slovak economy in 2011 and its further acceleration in 2012. This situation will be reflected in rising domestic demand. Depending on the recovery of the labour market (falling unemployment, rising employment, and growth in employee compensation), household final consumption is expected to rise in 2012, and domestic demand is projected to account for the largest positive contribution to GDP growth for that year.

## Domestic demand

After declining in 2009, **household final consumption** is expected to rise in 2010, although the forecast for growth in private consumption is revised down from MTF-2010Q1 owing to the continuing downturn in employment and the more modest than expected rise in compensation per employee. As the unfavourable situation in the labour market feeds through to household disposable income, the savings rate is expected to come down gradually. In the medium-term horizon, the assumed recovery in employment and the continuing growth in employee compensation is expected to drive up disposable income, and, therefore, also household consumption expenditure. Because of developments in the current year, as well as the slower wage growth in 2011, this expenditure will be lower than projected in the previous forecast.

After the slump in **fixed investments** in 2009, the decline in firms' investment activities is expected to decelerate in 2010 as the economy picks up, while infrastructure investments are assumed to rise. The principal contributors to capital formation should continue to be investments in infrastructure (2nd package of PPP projects) and in the car industry. The expected impact of such investments is assumed to be similar to the previous forecast. In the medium-term horizon, the rise in investments in machinery and construction is expected to accelerate steadily, as world demand gradually revives and leads to a recovery of the Slovak economy and the lending market.



As stated in the previous forecast, restocking of inventories is also expected to make a positive contribution to economic growth in 2010. Over the medium-term horizon, inventory changes are assumed to have a negligible effect on GDP.

### Net exports

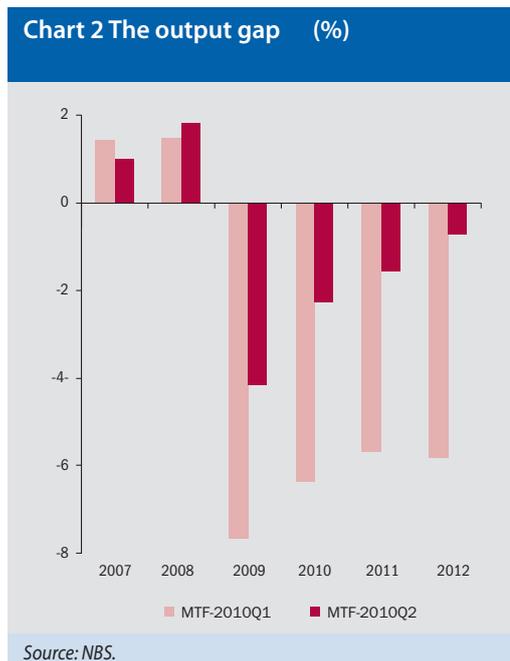
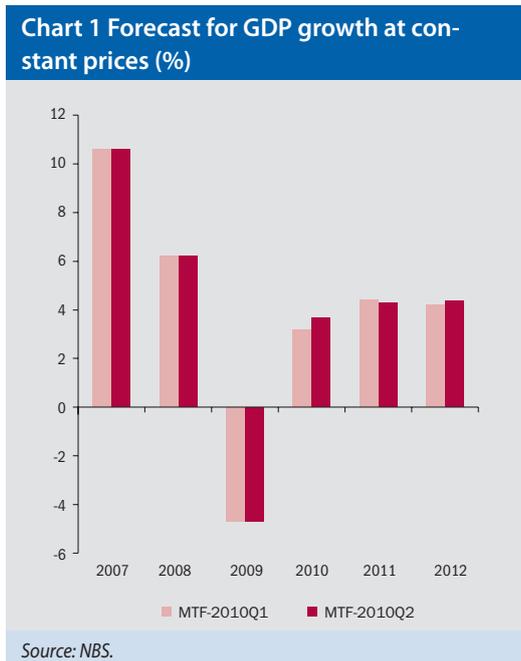
Nominal growth in both exports and imports is expected to accelerate in 2010. However, the combination of a sharper rise in external prices and a marked increase in oil prices will result mainly in lower growth in real imports. The contribution of net exports to GDP growth in 2010 is therefore expected to be stronger than projected in the previous forecast, but, because of its development in 2009 (a positive contribution caused by low imports), this contribution should continue to be negative. In the medium-term horizon, the growth in export performance is expected to continue to be stronger than projected in MTF-2010Q1, driven up by the positive developments assumed for external demand and, as mentioned in the previous forecast, by the expansion of car industry production in 2011.

The risks to this medium-term forecast are predominantly on the downside and stem mainly from the effects of the essential consolidation of both domestic public finances and the public finances of other EU countries. As a consequence of the expected reduction of fiscal deficits and

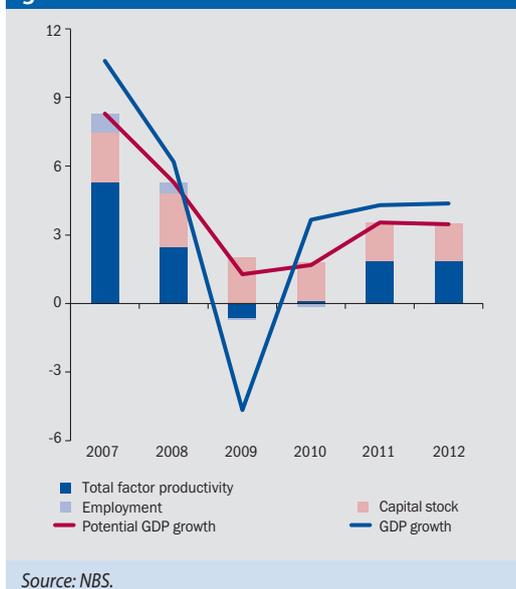
the waning effects of stimulus measures, the positive perception in the external environment of the revival in external demand may appear to be temporary, and its correction represents a downside risk to GDP growth. At the same time, the persisting adverse situation in labour market in the second half of 2010, together with the consequences of floods, could prove to be a drag on economic growth. On the upside, however, GDP growth could be stronger than projected owing to the implementation of the first and third packages of PPP projects, which this forecast does not take into account.

### POTENTIAL GDP AND THE OUTPUT GAP

This forecast substantially revises the view of the output gap and potential GDP from that given in MTF-2010Q1. The forecast for potential GDP growth is lowered on the assumption that the slump in economic activity in 2009 affected the supply-side of the economy more severely than had originally been expected. The deceleration in potential GDP growth – driven by a lower rise in total factor productivity (TFP) and by a higher non-accelerating inflation rate of unemployment (NAIRU) – indicates that the output gap for 2009 may have reached -4.1% and means that the gap can be gradually closed over the projection horizon (in MTF-2010Q1, the output gap was forecast to remain at around -6% until 2012).



**Chart 3 Contributions to potential GDP growth**



and the climbing rate of long-term unemployment, the NAIRU is expected to increase, from 11.4% in 2008 to 13.6% in 2012, meaning that the equilibrium employment will not contribute to the growth of potential output throughout the projection horizon. However, given that economic growth for the years 2010 to 2012 is assumed to exceed potential GDP growth, the Slovak economy could be close to equilibrium by the end of the projection horizon.

More detailed information regarding the current forecast for potential output, with a focus on the effect of the economic and financial crisis, as well as on the consistency between the cyclical position and price developments, is provided in a separate paper published in Slovak on the NBS website: *Premietnutie globálnej ekonomickej a finančnej krízy do vnímania potenciálneho HDP [The impact of the global economic and financial crisis on potential GDP]*.<sup>3</sup>

The latest view of the economy's supply side does not revise the evaluation of the cyclical position in the pre-crisis period – the positive output gap in 2008 is put at almost the same level as in MTF-2010Q1. Although a negative output gap is expected to have opened in 2009, the level of the gap is far lower than that stated in the previous forecast. The persisting deceleration of potential GDP growth in the period 2010-2012 is expected to result in the output gap closing more quickly than projected in MTF-2010Q1.

Despite the sharp decline in economic performance in 2009, along with the substantial problems in the labour market and slowdown in investment activities, it is assumed that potential output has increased even during the recession, albeit to a far lesser extent than in previous years (compare 8.3% in 2007; 5.3% in 2008, and 1.3% in 2009). This growth was supported by capital stock, which increased despite lower investments. By contrast, potential employment and total factor productivity made a negative contribution to potential output growth due to the rising NAIRU and declining labour productivity.

Potential GDP is projected to rise by 1.7% in 2010 and to accelerate in subsequent years as the crisis abates. But given the long-term downturn in the labour market, falling employment in 2010,

## 4.2 INFLATION

The year-on-year inflation rate has been gradually accelerating since February. As measured by the Harmonised Index of Consumer Prices (HICP), the inflation rate has been marked by a steeper year-on-year rise in energy and food prices, while prices of services and non-energy industrial goods have stagnated. As regards food prices, the inflation of both processed and non-processed food prices has accelerated.

Compared with the forecast in MTF-2010Q1, the actual inflation rate for recent months was slightly higher. The largest divergence was recorded in prices of unprocessed food and energy (owing to the sharper rise in fuel prices). At the same time, however, prices of services, non-energy industrial goods and processed foods rose more slowly than projected, which reflected the continuing stagnation of demand and has been further confirmed by retail sales figures.

Compared with MTF-2010Q1, the latest forecast assumes a higher annual average inflation rate for 2010 and 2011 and a slightly lower rate for 2012.

The revised forecast for average annual inflation in 2010 is based on an assumption of higher inflation in the last months of the year, as well

<sup>3</sup> [http://www.nbs.sk/\\_img/Documents/PUBLIK/MU/potential\\_output.pdf](http://www.nbs.sk/_img/Documents/PUBLIK/MU/potential_output.pdf).

as expectations that food and energy prices in particular will rise more sharply than expected in coming months (owing to the inclusion of new technical assumptions in the figures). Prices of services and non-energy industrial goods in 2010 are expected to increase more slowly than projected in the previous forecast.

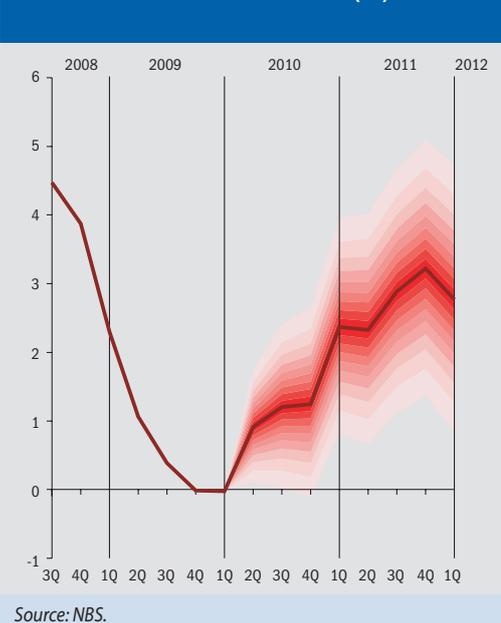
The forecast for 2011 assumes an increase in the average annual rate of HICP inflation in comparison with MTF-2010Q1. The main reason for this is that regulated energy prices are likely to be raised in January 2011 in response to current and expected developments in oil prices and the EUR/USD exchange rate. In 2012, by contrast, regulated energy prices are expected to rise more slowly than projected in the previous forecast, owing to their sharper rise in 2011.

As for other inflation components, food price inflation in the years 2011 and 2012 is assumed to be higher than projected in MTF-2010Q1, largely due to expected developments in prices of agricultural commodities.

In 2011 and 2012, the rise in prices of non-energy industrial goods is expected to accelerate, but not to the extent projected in MTF-2010Q1. The slowdown in economic activity is reflected in prices of services, which rose more slowly than expected in recent months. The rise in these prices in 2011 is expected to be sharper than assumed in the previous forecast, owing to the emergence of secondary effects from the higher inflation in energy prices. **During 2012**, however, prices of services are expected to reflect also the increase in economic activity.

Annual average administrative prices are projected to fall by 0.8% in 2010, and then rise by 4.6% in 2011 and 4.1% in 2012 (in MTF-2010Q1, the respective figures for 2011 and 2012 were 3.3% and 5.5%). That the increase in administrative prices is assumed to accelerate in 2011 and decelerate in 2012 in comparison with the previous forecast is largely attributable to new assumptions regarding regulated prices.

Chart 4 HICP inflation forecast (%)



The medium-term forecast for inflation can be considered realistic since none of the selected inflation-determining factors are reported as a substantial risk, according to risk assessment results. Upside risks include the development of import prices, which could rise more sharply than projected in this forecast if economic activity recovers at a faster pace and if energy prices are higher than expected. Another upside risk could be stronger wage growth. The consolidation of public finances could represent an upside risk to the inflation forecast, if indirect taxes are higher than projected, but it could also dampen inflation pressures if the reduction in expenditure brings down aggregate demand. The ultimate effect of the consolidation of public finances will depend on the nature of the measures adopted. Similarly, the change in the way energy prices are regulated could have a double-sided effect on inflation – on the one hand, as a result of the new regulatory period that is due to commence in 2011, or, on the other hand, because of further potential liberalisation of the energy market for households. The risks in this forecast are as balanced as they were in MTF-2010Q1.



**Table 3 Medium-term forecast MTF-2010Q2**

	2009	Projection 2010Q2			Difference versus MTF-2010Q1		
	Actual	2010	2011	2012	2010	2011	2012
<b>Prices (annual percentage changes)</b>							
HICP inflation (average)	0.9	0.8	2.7	2.8	0.1	0.3	-0.1
CPI inflation (average)	1.6	1.1	2.7	2.9	0.1	0.5	-0.4
ULC <sup>1)</sup> (compensation per employee at current prices / labour productivity ESA 95 at constant prices)	7.2	-3.0	1.4	2.6	-0.9	0.0	-0.1
Labour productivity ESA 95 (GDP at constant prices / employment ESA 95)	-2.4	5.7	3.7	3.9	1.2	-0.3	0.1
Compensation per employee (current prices)	4.7	2.5	5.2	6.6	0.2	-0.2	0.0
<b>Economic activity (annual percentage change; unless otherwise indicated)</b>							
Real GDP	-4.7	3.7	4.3	4.4	0.5	-0.1	0.2
Final consumption of households	-0.7	1.1	3.4	4.1	-0.3	-0.4	0.0
Final consumption of general government	2.8	1.5	2.1	0.3	-0.1	0.1	0.1
Gross fixed capital formation	-10.5	3.6	0.9	3.8	0.0	0.2	0.3
Exports of goods and services	-16.5	14.3	7.8	7.3	0.1	1.3	0.5
Imports of goods and services	-17.6	15.3	6.5	6.4	-0.7	1.7	0.6
Gross real disposable income of households	-0.2	0.7	3.1	4.2	-1.5	-0.3	0.2
Output gap (% of the potential output)	-4.1	-2.3	-1.6	-0.7	4.1	4.1	5.1
<b>Labour market</b>							
Employment, based on ESA 95 (annual percentage change)	-2.4	-1.3	0.4	0.4	-0.1	-0.1	-
Unemployment rate, LFSS-based <sup>2)</sup> (%)	12.1	14.0	13.6	13.3	1.4	1.1	-
<b>Balance of payments</b>							
Economic openness (% of GDP)	139.8	155.0	158.1	160.6	1.0	3.2	3.5
Balance of trade (% of GDP)	1.9	0.9	1.7	2.3	-0.3	-0.5	-0.3
Balance of services (% of GDP)	-2.0	-1.6	-1.3	-1.1	0.0	0.0	0.0
Current account (% of GDP)	-3.2	-3.3	-2.0	-0.9	-0.1	-0.4	-0.2
Current and capital account (% of GDP)	-2.5	-1.8	-0.1	0.9	-0.2	-0.4	-0.2

Source: NBS.

1) ULC – unit labour costs.

2) LFSS – labour force sample survey.