NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

Medium-term forecast

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1 Summary

This Medium-Term Forecast (MTF-2014Q1) is based on national account data for the last quarter of 2013 and on monthly figures for the first two months of this year,[1] while also incorporating technical assumptions from the ECB's latest projections. The projection horizon has been extended to the end of 2016.

The medium-term forecast assumes that the economies of Slovakia's main trading partners will continue their recovery that began in the second half of 2013. As their growth picks up this year, they should provide a boost to the Slovak economy.

Euro area GDP growth increased in the fourth quarter of 2013 and, according to forward-looking indicators, should accelerate further in the next period. However, the pace of that growth is expected to be about the same as projected in the previous forecast.

Slovakia's economic growth in the fourth quarter was in line with expectations, increasing marginally on the basis of external demand for Slovak goods and services and relatively strong growth in investment demand. However, private consumption did not pick up as substantially as projected. Exports are still assumed to be the main driver of future growth. Their projected positive contribution to this year's growth has been revised up from the previous forecast in the light of current developments and the assumed effect of an undervalued real exchange rate. **In 2014 economic growth is projected to be 2.4%. In 2015 and 2016 it should accelerate to 3.3% and 3.5%**, respectively, while at the same time becoming more balanced as domestic demand increases. Turning to the labour market, positive tendencies have appeared earlier than projected and therefore the expectation for this year is that employment growth will accelerate and the unemployment rate will fall more sharply. At the same time, however, wage growth is expected to be slower, with the largest positive contribution coming from an increase in public sector wages.

Compared with previous forecasts, the outlook for risks in the real economy has been adjusted. The positive turn in forward-looking indicators in the euro area and possible underestimation of market-share acquisition indicates an upside risk to the growth forecast for this year. As for the rest of the forecast period, the risks to the outlook appear to be balanced.

Inflation projections have been revised down on the basis of price developments at the beginning of 2014. The very low inflation rate is expected to remain similarly subdued in the first half of the year, before turning upwards and gradually beginning to accelerate. **The average inflation rate is expected to be 0.2% in 2014**, **rising to 1.9% in 2015 and 2.0% 2016,** as the assumed recovery in consumer demand has a gradual upward effect on inflation from the last quarter of 2014.

1 *The data cut-off date was 10 March 2014.*

2 Current developments in the external environment and Slovakia

Differing trends in the global economy

The global economy continued its gradual recovery in the last quarter of 2013. However, while growth gained some momentum in advanced economies, growth in emerging markets softened, owing to weak domestic demand, limited leeway for further supporting domestic policies and tension in financial markets.

In the United States, economic growth slowed in the fourth quarter of 2013; nevertheless, investment and private consumption were boosted by brighter economic outlooks and the improving financial situation of households. Although the general government sector contributed negatively to growth, uncertainty surrounding the fiscal situation has gradually diminished. In Japan and the United Kingdom, expansive policies continued to support economic activity. China saw a shift back to investment-led growth in 2013, as it maintained strong, albeit slightly lower, growth towards the end of the year. A slowdown in activity was likewise observed in other emerging economies, owing to the tightening of global financial conditions.

The global economy will continue to recover

The world economy's gradual recovery is expected to continue over the projection horizon. In the short term, sentiment indicators suggest favourable business conditions, which is consistent with a progressive strengthening of global activity. For a majority of the largest economies, the OECD's Composite Leading Indicator (CLI) increased towards the end of 2013, while for emerging economies it suggests that growth is slowing or stagnating. In advanced economies, diminishing private sector deleveraging and continuing fiscal consolidation should bolster confidence and support domestic demand, although labour markets are expected to improve only slowly. Stronger growth in advanced economies should support emerging market economies and therefore offset factors weighing down on their activity.

Euro area economy grew in the fourth quarter of 2013

According to Eurostat, the euro area's annual GDP growth accelerated by 0.2 percentage point in the fourth quarter, to 0.3%. In Germany, the largest economy in the euro area, growth increased to 0.4% after decelerating in the previous quarter (0.3%). Growth in all other major economies also increased, with the Netherlands reporting the largest rise (0.7%), followed by France (0.3%), Spain (0.2%) and Italy (0.1%). Among economies worst affected by the debt crisis, Portugal recorded GDP growth for a third successive quarter. Business sentiment and consumer confidence in the euro area remain on an upward path. According to several forward-looking indicators, growth remained moderate in the first quarter of 2014. The fragility of the upturn, persisting climate of uncertainty, and weak labour market situation continue to prevent a more robust recovery. The labour market, however, is showing signs of stabilisation and, if that trend continues, may support stronger growth in consumer demand.

Czech economy again surprises, this time with fourth-quarter growth

The Czech economy recorded surprisingly strong quarter-on-quarter growth of 1.9% in the fourth quarter of 2013, after growing by 0.3% in the previous quarter. Fourth-quarter GDP was significantly affected by disproportionate excise revenue from tobacco products. With this duty expected to be hiked in January 2014, the stocking up of tobacco products towards the end of 2013 increased GDP in this quarter at the expense of GDP in the next one or two quarters. A more accurate indicator of how the Czech economy performed in the fourth quarter is provided by gross value added, excluding tax revenues, which increased by 0.6%. The main driver of GDP growth was investment demand, which increased substantially by 5.1% over the previous quarter; this was probably related to investment in transport equipment and in particular to the Czech central bank's decision to use foreign exchange interventions to weaken the Czech koruna's exchange rate. The number of new car registrations increased markedly towards the end of 2013.

Česká národní banka used the exchange rate as a tool for the further easing of monetary conditions when on 7 November 2013 it intervened in the foreign exchange market. The central bank adopted an asymmetric undertaking not to allow the exchange rate to appreciate below 27 CZK/EUR, the main reason being that it had exhausted interest rates as a tool for achieving the medium-term inflation target.

Moderate rise in Slovak GDP growth based mainly on investment and external demand

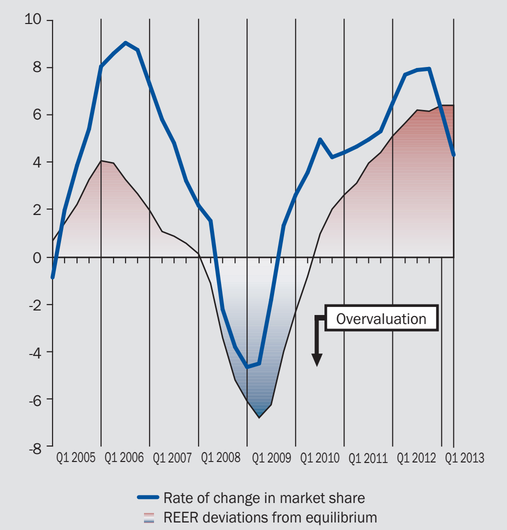
The brightening of economic sentiment in the fourth quarter of 2013 translated into real figures. Boosted mainly by the continuing recovery in the wider euro area, the Slovak economy grew by 0.4% in the fourth quarter, in line with the projections given in the January's medium-term forecast. The composition of growth showed an improvement, since there was a positive contribution not only from external demand, but also from domestic demand (particularly investment activity). Exports increased quite strongly and again more so than external demand. Hence Slovakia was acquiring market share, with an assumed contribution from the undervalued real exchange rate.

The distribution in demand for Slovak goods and services between the euro area and the rest of the world showed an increasing balance. The greater contribution to growth from exports to non-euro area countries (both advanced and emerging economies) was a positive sign. Slovakia's exports were boosted mainly by the strengthening of global trade, with euro area growth also being expert-led. Slovak GDP growth in fourth quarter was also supported by domestic demand, particularly the investment component.

Pick-up in investment demand

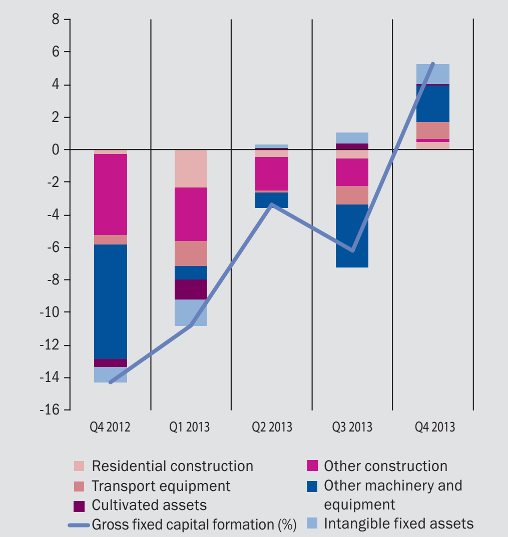
After following a negative trend during the first three quarters of 2013, investment demand picked up relatively strongly in the last quarter of the year owing mainly to investments in large projects in the automotive industry, construction work on the Mochovce nuclear power station, and other infrastructure projects. An upturn in investment was seen throughout the economy, however, notably in certain segments of manufacturing, including machinery and equipment and transport equipment. The substantial contribution from the intangible assets component was

Chart 1 Deviations from equilibrium of the equilibrium exchange rate (REER based on unit labour costs in the manufacturing sector), and the annual growth rate of Slovakia's market share (centred moving average for 5 quarters; percent)



Source: ECB, Eurostat and NBS.

Chart 2 Composition of gross fixed capital formation (annual percentage changes; contributions in p.p.)



Source: SO SR.

Chart 3 Investment and long-term loans (annual percentage changes)

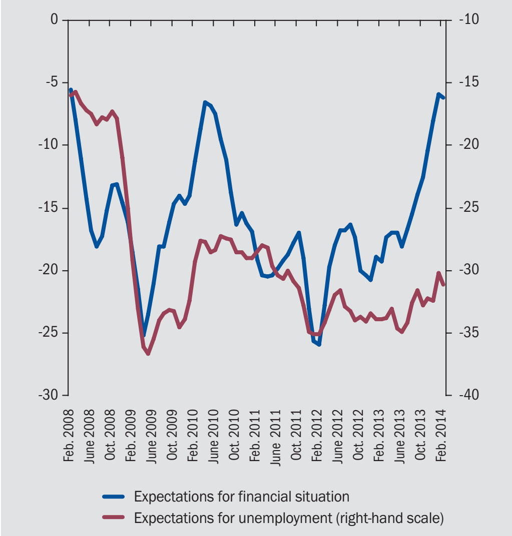
Source: SO SR and NBS.
Note: The figure for Q1 2014 is a projection.

Chart 4 Consumer sentiment and private consumption (balance of responses; annual percentage growth)

Source: SO SR and European Commission.

probably the result of investment in the SEPA payment system. A downward effect continued to be exerted by investment in residential construction, evident from the decline in household investment activity. This reflected the negative income effect in the household sector, the only sector in which investment fell. Investment activity in other sectors (non-financial and financial corporations) increased and was financed mainly with own funds. General government investment in the last quarter of 2013 made up the substantial ground it lost in the previous quarter and therefore made a positive contribution to economic growth.

Chart 5 Household expectations (3-month moving average; balance of responses)



Source: European Commission.

Private consumption remains flat

Although private consumption growth was positive in the fourth quarter of 2013 (at 0.1%), it was lower than expected and was still not picking up. Private consumption for the year as a whole fell by 0.1%, with its downward trend now stretching to four years. The fourth-quarter increase in private consumption was largely attributable to demand for durable goods, which rose after a long-running negative trend. This may indicate a move away from the deferred consumption of the past, in line with the improvement in consumer sentiment. According to current surveys, consumers' assessments of the unemployment rate and their own financial situation are becoming less negative. The upward trend in consumer sentiment was, however, moderated by a decline in real disposable income. Wage developments in the economy could not support stronger consumption growth, and consumption was to some extent funded out of savings. Forward-looking indicators in the first two months of 2014, as well as retail sales for January, point to a further improvement in consumer confidence that may result in consumption growth slightly exceeding its level of the previous year.

Government spending supported growth

General government final consumption continued to grow in the last quarter of 2013, with compensation per employee increasing significantly amid moderate trends in intermediate consumption. Therefore, after two years in decline, public consumption increased and made a positive contribution to growth.

Recovery gathers momentum at the beginning of 2014

The latest monthly figures indicate an acceleration of activity in the first quarter of 2014. In January both industrial production and sales in the economy increased quite sharply, and consequently export growth was relatively robust. Forward-looking indicators continued to improve in January. Their correction in February is expected to be only temporary, since the strength of both soft and hard indicators in the euro area should have a positive effect on sentiment in the Slovak economy.

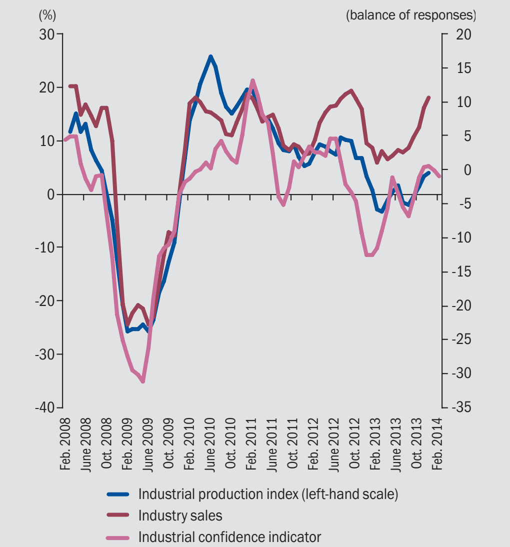
Labour market situation improving

Positive trends appeared in the labour market in the last quarter of 2013. Employment increased by 0.3%, slightly more than expected. While most of that growth was accounted for by an increase in the number of self-employed persons, employment also rose in all major sectors of the economy. Hours worked per employee fell in the fourth quarter of 2013, which indicates that firms in certain sectors had reached the ceiling on hours worked per employee and were having to create new jobs. Positive trends in industry and construction were maintained, as increases in both employment and the number of hours worked per employee reflected the continuing competitiveness of industry.

Amidst rising job creation and employment, the unemployment rate in the last quarter of 2013 fell further than expected, to 14.1%.

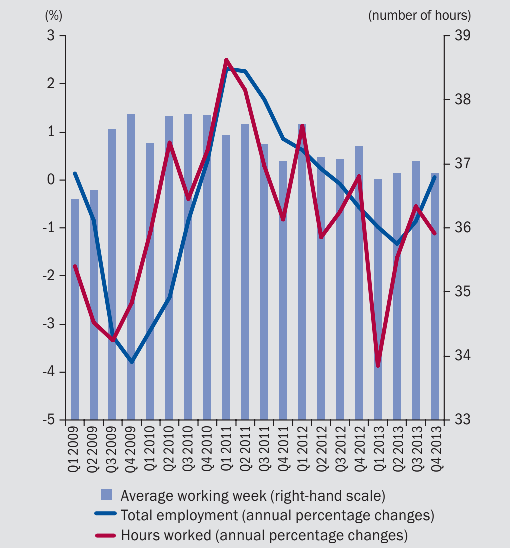
Wage growth in the fourth quarter of 2014 was lower than projected. Nominal wages in the private sector remained flat, and the marginal growth in overall wages was driven mainly by an increase in public sector wages. The longer-run trend of higher wage growth in the public sector than in the private sector may be sending a negative signal as well as weighing on the general government deficit. Wage growth in industry was only marginal owing to a decline in labour productivity. That increase was probably based on gains previously accumulated from higher growth in labour productivity than

Chart 6 Forward-looking indicators (3-month moving average; annual percentage changes)



Source: SO SR and European Commission.

Chart 7 Current labour market indicators



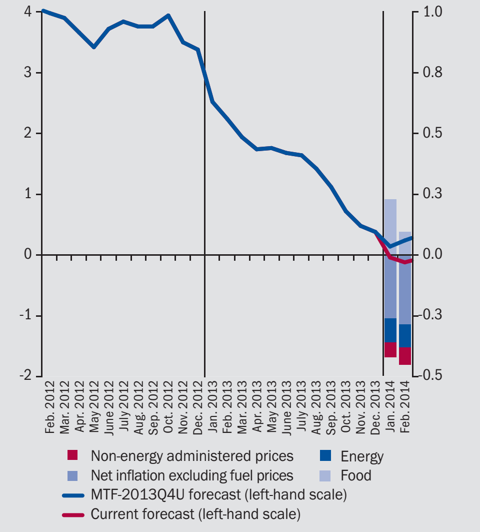
Source: SO SR.

in wages. Labour productivity in the economy as a whole increased moderately. Unit labour costs edged up since compensation per employee increased slightly more than labour productivity.

Prices falling

The quarter-on-quarter inflation rate fell for a second successive quarter in the fourth quarter of 2013, to -0.2%, bringing the annual inflation rate down to 0.5%. The fall in prices was moderately higher than expected, reflecting mainly a decrease in prices of food (particularly the unprocessed component). Unprocessed food prices were pushed down by a combination of a good harvest and the effect of competition amid sluggish consumer demand. Services price inflation was very slight due not only to weak consumer demand, but also to a fall in prices of input cost factors. Energy prices fell moderately as a result of decreases in fuel prices. Inflation maintained its downward trend in the first two months of this year, and in February its annual rate of change even turned negative (-0.1%). Inflation in the first two months was 0.4 percentage point lower than projected, reflecting downward pressure from the food component as well as from prices of energy, services, and non-energy industrial goods.

Chart 8 Inflation (annual percentage changes; contributions in p.p.)



Source: SO SR and NBS forecast.

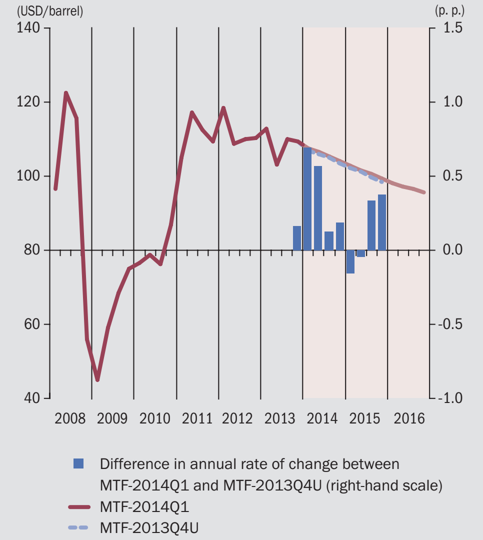
3 Technical assumptions[2]

In the period after the previous forecast was published, the **exchange rate** of the euro against the US dollar fluctuated between 1.35 and 1.38 USD/EUR and at the end of the period under review it was 1.37 USD/EUR. This forecast assumes that the average exchange rate of USD per EUR will be 1.36[3] in 2014, therefore slightly weaker than projected in January's updated forecast.

The **price of a barrel of Brent crude oil** ranged between USD 106 and USD 110 at the beginning of 2014. For most of January the oil price was rising amid favourable conditions on both the supply and demand side. In the latter part of the month and beginning of February, however, it decreased, before climbing back to USD 110/barrel. This forecast assumes that the average barrel price will be USD 105.8 in 2014, falling to USD 101.1 in 2015 and USD 96.9 in 2016[4], and that the price in euro will be €78.0 in 2014, €74.5 in 2015 and €71.5 in 2015. Compared with the previous forecast, the projected oil price in USD is slightly higher; however, the price in EUR will be higher than the price in USD owing to exchange rate depreciation.

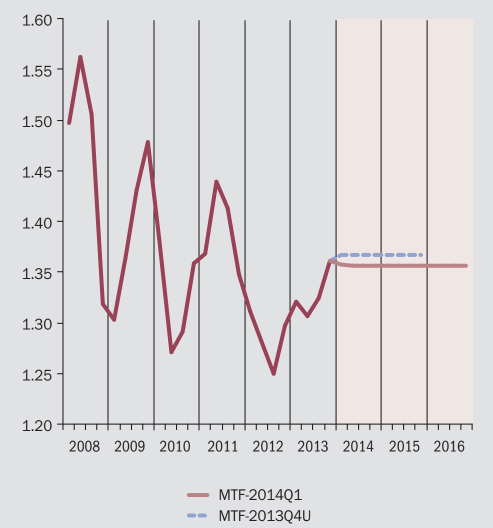
Prices of non-energy commodities remained broadly flat in the last quarter of 2013, as decreases in food prices offset increases in metal prices, which reflected a pick-up in global indus-

Chart 10 Price per barrel of Brent crude oil (USD)



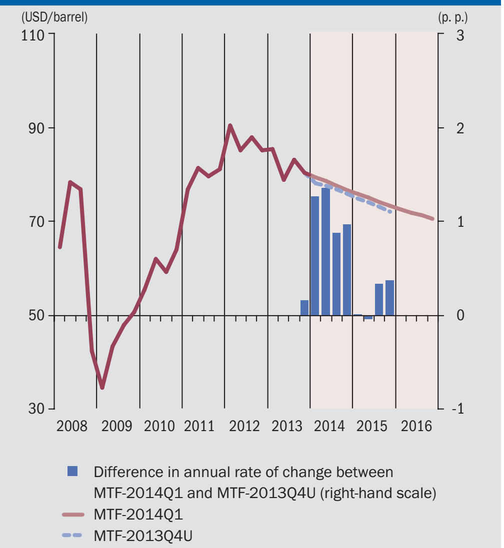
Source: NBS and ECB.

Chart 9 USD/EUR exchange rate



Source: NBS and ECB.

Chart 11 Price per barrel of Brent crude oil (EUR)



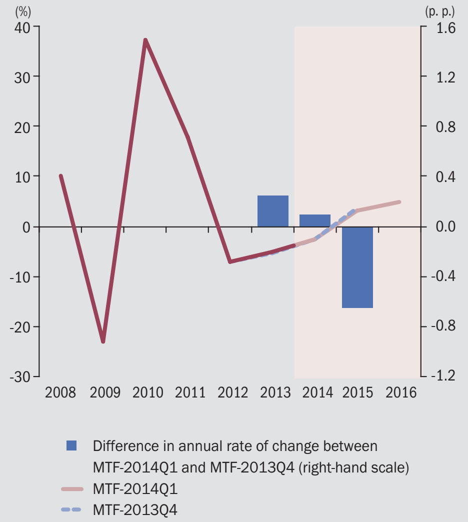
Source: NBS and ECB.

2 The technical assumptions of the Medium-Term Forecast are based on the „March 2014 ECB Staff Macroeconomic Projections for the Euro Area", with a cut-off date of 12 February 2014.

3 The bilateral USD/EUR 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.

4 Current geopolitical tensions represent an upside risk to the oil price projections. Oil price futures after the cut-off date (beginning of March) were only slightly higher than the technical assumptions and are not expected to have a significant impact on the medium-term forecast.

Chart 12 Non-energy commodity prices (annual percentage changes)



Source: NBS and ECB.

trial activity. This trend in non-energy commodity prices continued at the beginning of 2014. The assumption of this forecast is that these prices will decrease by 2.5% in 2014, before rising by 3.1% in 2015 and by 4.8% in 2016.

The assumption about **short-term interest rates**[5] (three-month EURIBOR) is that they will average 0.3% in 2014, 0.4% in 2015, and 0.8% in 2016.

5 *The technical assumptions about interest rates and commodity prices are based on market expectations, with a cut-off date of 12 February 2014. The assumption for short-term interest rates is of a purely technical nature.*

4 Forecast for the external environment[6]

World economic growth is expected to accelerate from 2.8% in 2013 to 3.6% in 2014, increasing to 3.7% in 2015 and 3.8% in 2016. These estimates, however, remain subject to very high uncertainty. The main downside risk to the medium-term outlook for global growth is that fiscal consolidation plans in the United States and Japan do not go far enough and that, as a result, risk premia in long-term interest rates might increase. At the same time, less accommodative monetary policies in non-euro area countries could push up bond yields, with potential repercussions for emerging economies.

Euro area real GDP growth is projected to remain moderate in 2014, gaining pace in 2015 and 2016. A recovery in domestic and external demand is expected to be the driving factor behind the projected increase in activity. External demand will benefit from the global recovery gradually gaining strength. Domestic demand is expected to benefit from improving confidence in an environment of declining uncertainty, the accommodative monetary policy stance and falls in oil prices that should support real disposable incomes. The intensity of fiscal consolidation will lessen over the projection horizon, as will the repair of public and private sector balance sheets, and therefore the negative impact of such measures on economic growth will fade away. GDP growth is assumed to be 1.2% in 2014, 1.5% in 2015 and 1.8% in 2016.[7]

Euro area HICP inflation is fluctuating at relatively low levels, and in February 2014 it stood at 0.7%. This reflects a combination of declining energy prices and moderate increases in food prices, as well as a subdued trend in services prices and non-energy industrial goods prices. Looking ahead, the inflation rate is expected to remain at low levels in the near term, before rising moderately from late 2014 onwards, as activity gradually recovers. The annual inflation rate is projected to be 1.0% in 2014, 1.3% in 2015 and 1.5% in 2016.[8] This moderate inflation outlook is expected to be mainly due to the declining path of oil price futures and the existing slack in the economy. Given, however, the expected gradual recovery in economic activity and domestic demand, HICP inflation is projected to increase. Food price inflation is expected to continue to moderate in the first three quarters of 2014, owing to the past decline in food commodity prices (in euro) and to downward base effects. It is projected to pick up over the remainder of the projection horizon, in line with the assumed increase in food commodity prices. HICP inflation excluding energy and food is projected to increase gradually in the course of 2014, averaging 1.1% in the year as a whole, and to rise to 1.4% in 2015 and 1.7% in 2016. These developments are expected to be driven by the projected gradual pick-up in economic activity. The HICP excluding energy, food and changes in direct taxes is projected to increase from 1.0% in 2014, to 1.4% in 2015 and 1.7% in 2016. Increases in indirect taxes that are included in fiscal consolidation plans are expected to make a significant upward contribution, of around 0.2 percentage point, to HICP inflation in 2014. In 2015 and 2016, such contributions are projected to be negligible, as there is a lack of detailed information on fiscal measures for those years.

Turning to domestic prices pressures, the annual growth rate of compensation per employee is projected to remain broadly unchanged in 2014, before gaining momentum in 2015 and 2016. Unit labour cost growth is expected to decline in 2014, reflecting the cyclical pick-up in productivity growth, given the lagged response of employment in an economic recovery and the broadly unchanged growth rate of compensation per employee over the year. As the recovery gains momentum in 2015 and 2016 and labour markets improve gradually, the stronger growth in compensation per employee than in productivity is expected to lead to a small increase in labour cost growth.

Growth in profit margins is expected to strengthen in 2014 and to rise slightly further over the projection horizon, supported by the expected improvement in economic conditions.

Global trade growth stopped decelerating in 2013 and its consequent gradual recovery reflects the rebound in economic activity. With the latest

6 The assumptions for developments in the international economy are based on the „March 2014 ECB Staff Macroeconomic Projections for the Euro Area", which were prepared using information available up to 20 February 2014.

7 The figures are in the middle of the forecast range for GDP growth. The ECB's projection ranges for GDP growth are 0.8% – 1.6% in 2014, 0.4% – 2.6% in 2015, and 0.7% – 2.9% in 2016.

8 The figures are in the middle of the forecast range for the HICP rate. The ECB's projection ranges for the HICP rate are 0.7% – 1.3% in 2014, 0.6% – 2.0% in 2015, and 0.7% – 2.3% in 2016.

data pointing to an improvement in the short-term outlook, global trade growth is projected to increase from 2.8% in 2013 to 4.6% in 2014, 5.8% in 2015, and 6.1% in 2016. Nevertheless, its growth rate at the end of the projection horizon is expected to remain below that recorded before the global crisis. The recovery in global trade is expected to support growth in **Slovakia's export markets**, which is projected to increase gradually from 4.1% in 2014 to 5.1% in 2015 and 5.5% in 2016.

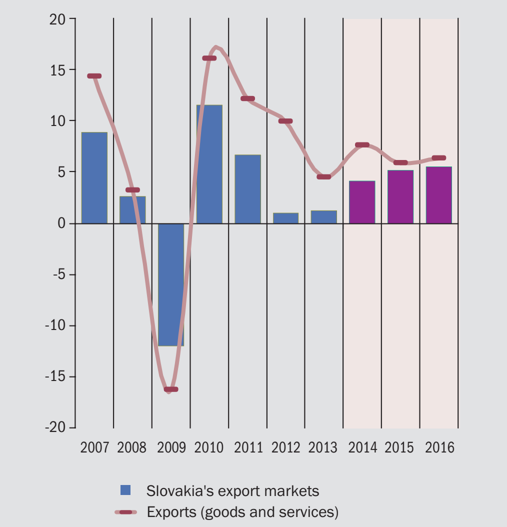
5 Macroeconomic forecast for Slovakia

5.1 ECONOMIC GROWTH

Accelerating demand for Slovak exports

Relatively robust export growth in January 2014 supported a positive outlook for export performance over the year. Export growth is projected to exceed the increase in external demand for Slovak goods and services. Exports are expected to be supported by labour productivity growth, competitive prices due to moderate labour cost growth, and a still undervalued real exchange rate. With this situation assumed to continue over the projection horizon, Slovakia is expected to acquire market share and therefore converge more closely with advanced economies.

Chart 13 Forecast for external demand and for Slovak exports of goods and services (annual percentage changes; constant prices)



Source: SO SR, ECB and NBS calculations.

Investment demand to pick up

After falling sharply in 2013, investment demand is expected to rebound. Investment in several sectors increased in the last quarter of 2013, and the assumption is that investment trends will remain positive over the projection horizon. The downward base effect of heavy investment in the automotive industry is expected to be outweighed by investment in other sectors of the economy. Following the government's fiscal consolidation efforts last year, public investment is expected to gather pace, supported by increased utilisation of EU funds.

Private consumption to recover slowly

Private consumption has failed to pick up since 2009, and therefore it is expected that the recovery in confidence, and impact on consumption growth, will be only gradual. Although consumption showed positive trends in January, it is not projected to increase significantly until the second half of 2014, when real income growth should accelerate. Over the projection horizon, private consumption is expected to accelerate gradually in line with income growth, without any impact on the savings ratio.

Public consumption expected to support growth

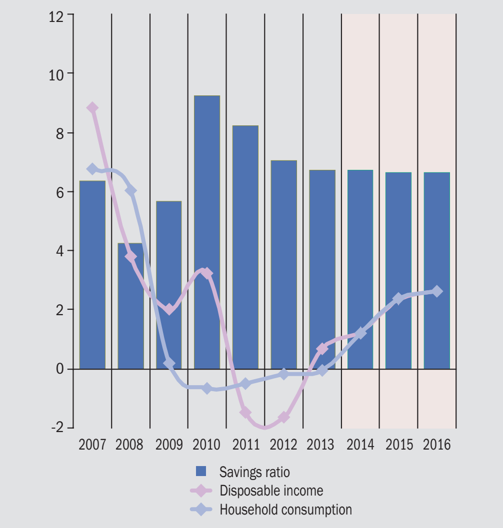
The latest figures in the first months of 2014 point to relatively sharp growth in central government spending. This fact has been reflected in the forecast for this year, which envisages that public consumption growth will be marginally higher compared with the previous year. In 2015 and 2016 it is expected to decelerate slightly. Spending on wages and social transfers is as-

Table 1 Forecast for gross fixed capital formation (annual percentage changes)

	2013	2014	2015	2016
Gross fixed capital formation (GFCF)	**-4.3**	**3.3**	**3.7**	**3.8**
– private sector	-3.3	3.7	3.2	4.4
– adjusted to exclude a one-off investment in the automotive industry	-4.7	7.5	3.2	4.4
– general government sector	-13.8	-0.7	9.2	-2.3

Source: SO SR and NBS.

Chart 14 Household income, consumption (annual percentage changes) and savings ratio (%)



Source: SO SR and NBS.

sumed to make the largest contribution to public consumption growth. Consolidation measures remain unchanged from the previous forecast. Savings are expected to be made mainly as part of the Efficient, Reliable and Open Public Administration (ESO) programme.

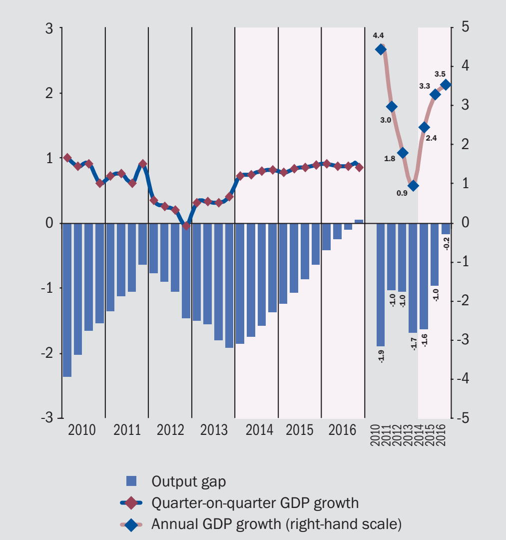
Imports in line with activity growth

Import growth is expected to begin gathering pace in 2014. It should be supported, on the one hand, by relatively robust export growth (with import intensity being maintained) and, on the other hand, by the assumed pick-up in domestic demand and consequent increase in investment imports and consumer goods imports. Over the remainder of the projection horizon, import growth is expected to decrease moderately as export growth is also projected to slow. Price developments are expected to have a neutral impact on terms of trade. It is assumed that favourable terms of trade arising from a decline in energy prices will not affect competitiveness. A gradual increase in the nominal current account surplus is assumed on the basis of export growth exceeding importing growth.

Economic growth to accelerate

Economic growth in 2014 is expected to be driven by both external demand and domestic demand. The contribution of domestic demand to growth is projected to increase in subsequent years. **GDP growth is expected to accelerate to 2.4% in 2014, 3.3% in 2015 and 3.5% in 2016,** still remaining below potential. Slack in the utilisation of productive and human resources is expected to diminish. The output gap should begin narrowing in 2014 and is expected to have closed by the end of the projection horizon.

Chart 15 GDP growth and the output gap (%)



Source: SO SR and NBS.

Table 2 Forecast for public consumption and investment (annual percentage changes)

	2013	2014	2015	2016
General government final consumption (contant prices)	1.4	1.5	1.3	1.3
Public investment (constant prices)	-13.8	-0.7	9.2	-2.3
Contribution of public consumption and investment to GDP growth	-0.2	0.4	0.4	0.2

Source: SO SR and NBS.

Box 1

OUTLOOKS FOR THE ECONOMY AND INFLATION BEYOND THE PROJECTION HORIZON (UP TO 2020)[9]

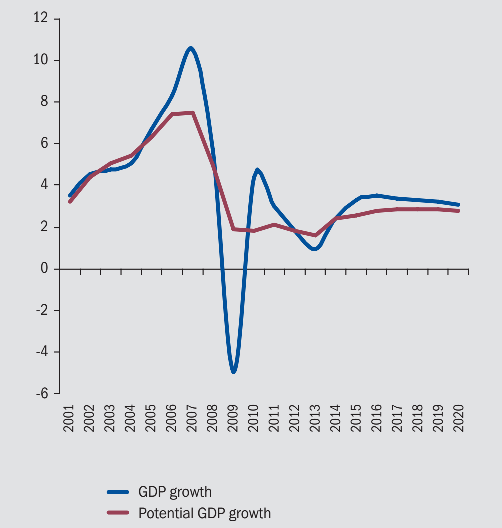
In the period since the 2008 financial crisis, the global economy has decelerated significantly. Despite assumptions that its growth will gradually gather pace, the global economy is not expected to return to pre-crisis trends in coming years, but rather to remain below its pre-2008 long-run average. The purpose of this box is to estimate key trends in the Slovak economy up to 2020.

The basis for determining the economy's long-run trend was so-called β-convergence.[10] By applying this simple approach to developments between 1995 and 2012, with Germany selected as the benchmark economy, **the half-life of real convergence was estimated to be 26 years**. Based on such assumptions, **the average annual growth potential of the Slovak economy for 2017–2020 is estimated to be around 2.7%** (according to NBS estimates, the average growth potential for 2000–2008 was 5.1%, falling to 1.8% for 2009–2013).

By applying the same approach to price level convergence, the **optimal average annual inflation rate for 2017–2020 was estimated to be around 2.3%.**

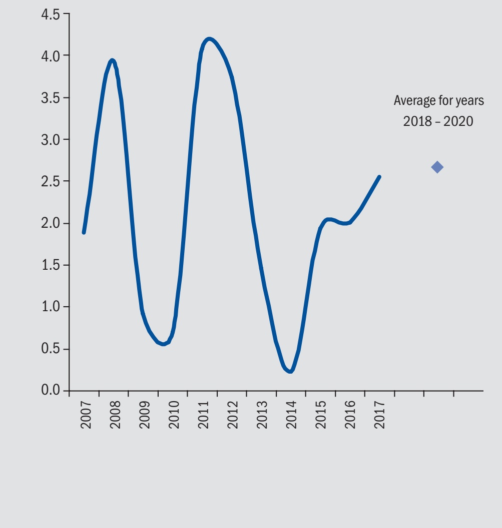
It is assumed that Slovakia's economic growth could exceed potential over the projection horizon. Hence the cyclical position of the economy is expected to improve from the current negative output gap to a positive gap. GDP growth is projected to accelerate to 3.5% in 2016, and may then gradually lose momentum in subsequent years. The composition of growth is expected to be balanced over the projection horizon with the contribution of domestic demand exceeding that of net exports. In line with the convergence process and continuing price competitiveness (real rates), however, export growth is projected to continue exceeding external demand growth, thereby further increasing the acquisition of market share and and openness of the Slovak economy. At the same time, Slovakia benefits

Chart A Growth in GDP and potential GDP (annual percentage changes)



Source: Eurostat and NBS.

Chart B HICP inflation (annual percentage changes)



Source: Eurostat and NBS.

9 *Further details can be found in NBS's Analytical Report.*

10 *β-convergence and the half-life T of convergence– the time it takes the economy to catch up with the benchmark economy by half the initial gap (measured by GDP at purchasing power parity per capita).*

Table A Forecast for key macroeconomic indicators (annual percentage changes)

	2013	2014	2015	2016	2017	Average for years 2018–2020
HICP inflation	1.5	0.2	1.9	2.0	2.5	2.7
HICP inflation excluding energy	2.0	0.8	2.5	2.6	2.8	2.9
Gross domestic product	0.9	2.4	3.3	3.5	3.4	3.2
GDP potential	1.6	2.4	2.6	2.7	2.8	2.8
Output gap[1)]	-1.7	-1.6	-1.0	-0.2	0.3	1.2
Slovakia's export markets	1.2	4.1	5.1	5.5	5.4	5.3

Source: NBS.
1) Output gap expressed as a percentage of potential GDP.

from the strong cyclical position of its largest trading partner, Germany.

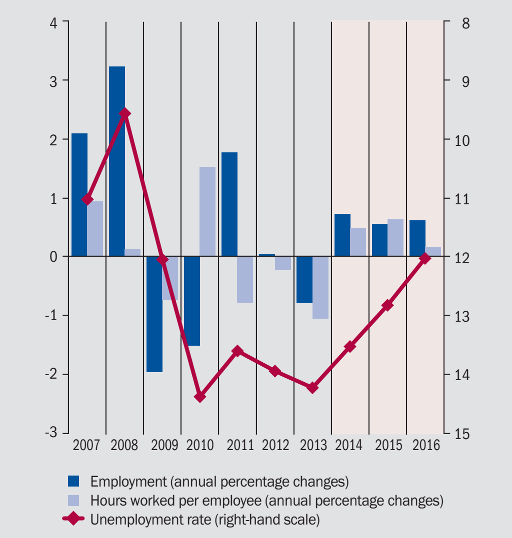
Improvement in the business cycle is expected to be reflected in gradually increasing inflation. The annual inflation rate is projected to be above 2% from 2017, although it should not exceed 3% over the long-term horizon.

5.2 LABOUR MARKET

LABOUR MARKET IMPROVEMENT

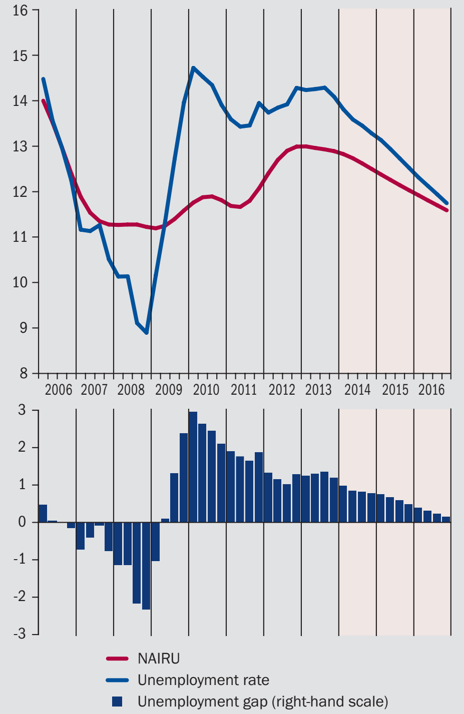
The positive trends that appeared in the labour market towards the end of 2013 are expected to continue in 2014. Firms' expectations about future employment requirement have improved and this should translate into employment growth, particularly in the first half of the year. Thereafter, employment growth should stabilise in line with increasing activity. The unemployment rate is expected to decrease over the projection horizon, down to 11.7% by the end of the period. That level should be close to the non-accelerating inflation rate of unemployment (NAIRU), i.e. the unemployment rate that does not create demand-pull inflation pressures. Labour productivity growth is expected to accelerate over the forecast period, with an upward effect on export performance and domestic demand. It is assumed that activity growth will be covered this year by employment growth and over the remainder of the horizon also by an increase in the number of hours worked.

Chart 16 Employment, hours worked and the unemployment rate



Source: SO SR and NBS.

Chart 17 The unemployment rate and NAIRU (%)



Source: SO SR and NBS.

5.3 LABOUR COSTS AND PRICE DEVELOPMENTS

MODERATE ACCELERATION IN LABOUR COSTS

Unit labour costs are expected to increase over the projection horizon. This should not, however, stoke inflation pressures, since price growth in the economy is assumed to be higher than the increase in unit labour costs. Over the forecast period nominal compensation per employee growth is expected to be higher than real labour productivity growth. The leeway for this was provided by previously accumulated labour productivity gains.

INFLATION TO RISE IN THE SECOND HALF OF 2014

After last year's substantial disinflationary trend, price growth is expected to come almost to a standstill in the first half of 2014. The average inflation rate is projected to be a low 0.2% owing to the expected weakness of consumer demand and declines in import prices of energy and food (commodity prices and low imported inflation from the Czech Republic). The only, moderate,

Table 3 Unit labour costs (annual percentage changes)

	2013	2014	2015	2016
Nominal compensation per employee (ESA)	0.8	2.7	4.0	4.4
Real productivity	1.7	1.7	2.7	2.9
Unit labour costs	-0.9	1.0	1.2	1.4
GDP deflator	0.5	0.3	1.8	2.3

Source: SO SR and NBS calculations.

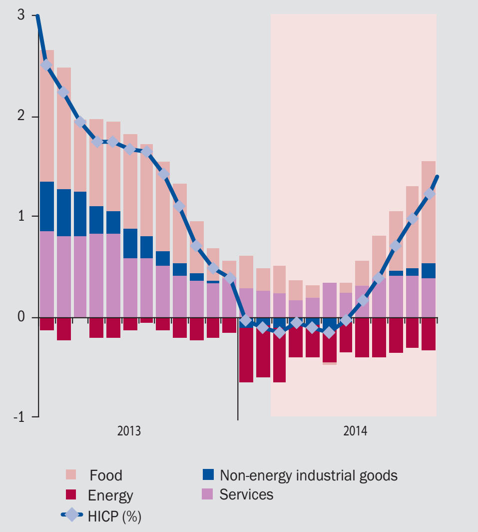
Table 4 Wages (annual percentage changes)

	2013	2014	2015	2016
Nominal productivity	2.2	2.1	4.6	5.3
Whole economy – nominal	2.3	2.5	4.0	4.4
Whole economy – real	0.9	2.3	2.0	2.3
Public administration, education and health care – nominal	3.4	4.0	3.4	3.1
Public administration, education and health care – real	2.0	3.7	1.4	1.0
Private sector – nominal	2.0	2.0	4.2	4.8
Private sector – real	0.6	1.7	2.2	2.7

Source: SO SR and NBS calculations.
Note: Deflated by the CPI. Nominal wage growth in the general government sector (ESA S.13) is projected to be 3.6% in 2014, 3.0% in 2015 and 3.1% 2016.

price increases are expected in non-energy industrial goods and in services. Low average inflation for the year as a whole to some extent masks quarter-on-quarter developments. While inflation is projected to remain flat in the first half of the year, it should begin to increase in the last quarter. This gradual acceleration is expected to reflect seasonal factors and a recovery in consumer demand. This demand should push up inflation over subsequently years, with prices of services and non-energy industrial goods expected to rise. The projected trajectory of commodity prices is expected to dampen energy price inflation over the forecast period, with a downward effect on the headline inflation rate.

Chart 18 Expected composition of annual inflation in 2014 (p.p.)



Source: SO SR and NBS.

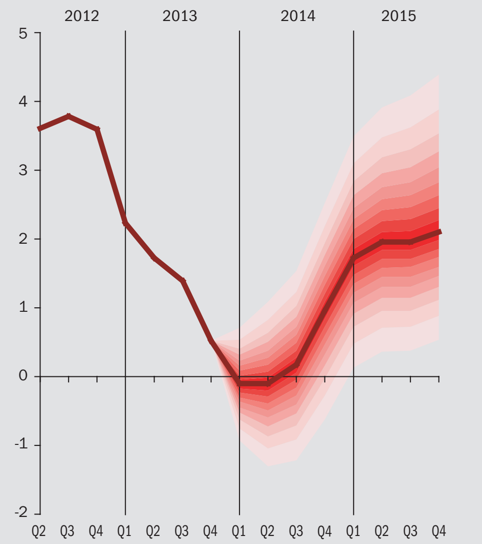
6 Risks to the forecast

In this medium-term forecast, risks to the outlook for the real economy in 2014 are on the upside. The upward risks include the mild winter, continuing acquisition of shares in foreign markets (an increase in export growth), and higher utilisation of EU funds. A partial downside risk may be the escalation of geopolitical risks. The risks to the GDP forecast in 2015 and 2016 appear to be balanced. The downsides risks of lower than projected external demand and any additional consolidation measures are offset by risks of stronger export performance and greater utilisation of EU funds.

The inflation forecast for 2014 seems to be realistic. In subsequent years there are upside risks to the inflation outlook in the technical assumptions (oil price, exchange rate and imported inflation) and in public consumption growth, if it is higher than projected. Downside risks include weaker external demand and lower than projected compensation per employee growth.

A short-term upside risk to the forecast for Slovak exports to the Czech Republic is that the Czech koruna's exchange depreciates and, with the Czech economy consequently more competitive, Czech exports increase. In that case, Slovak exports would be boosted by the import intensity of Czech exports.

Chart 19 HICP inflation forecast (%)



Source: SO SR and NBS.

Table 5 Risks to the forecast

	2014	2015	2016
GDP	↓ Geopolitical risks ↑↑ EU funds, mild winter, export performance	↓ Fiscal consolidaiton measures, external demand ↑ EU funds, export performance	↓ External demand, consolidation measures ↑ Export performance
Inflation		↑↑ Technical assumptions, public consumption ↓ External demand, compenation per employee	↑↑ Technical assumptioins, public consumption ↓ External demand, compensation per employee

Source: NBS.

Box 2

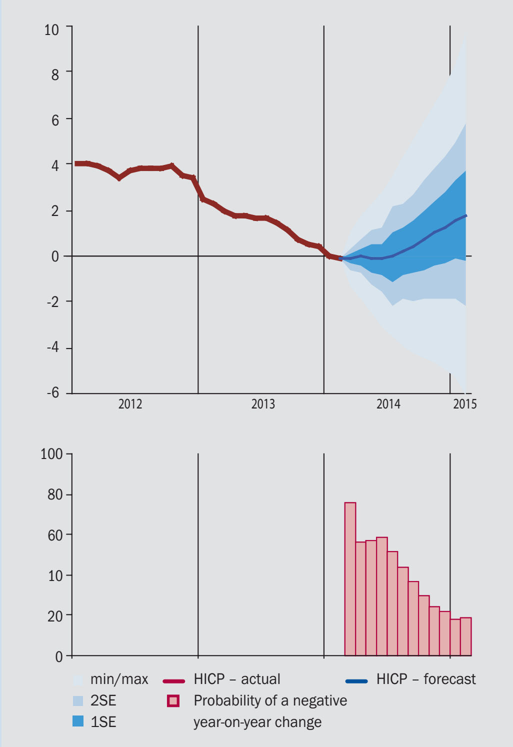
WILL THERE BE DEFLATION IN SLOVAKIA? THE PROBABILITY IS NOT HIGH.[11]

According to the results of an analysis of projection errors and the latest forecast for HICP inflation, the probability of deflation is highest in March 2014 and then decreases gradually, to 22% at the end of the year.

A negative annual rate of change in the price level still does not denote deflation. Only a more sustained decline in prices (for example, over four quarters in a row) could pass through to the real economy, and **the probability of that is not high -currently estimated at between 20% and 25%**.

In coming months the annual inflation rate could be close to 0 (either above or below), owing mainly to volatile food prices and falling energy prices. With food prices assumed to rise slowly in the second half of 2014 (returning to normal levels) and consumers expecting inflation to be higher than its current level, the inflation projection in this forecast (MTF-2014Q1) is around 1.2% at the end of this year, rising to 2.2% in December 2015.

Chart A Estimated probability of a year-on-year decline in prices (%)



Source: NBS.

11 For further details, see the NBS Analytical Report No 9.

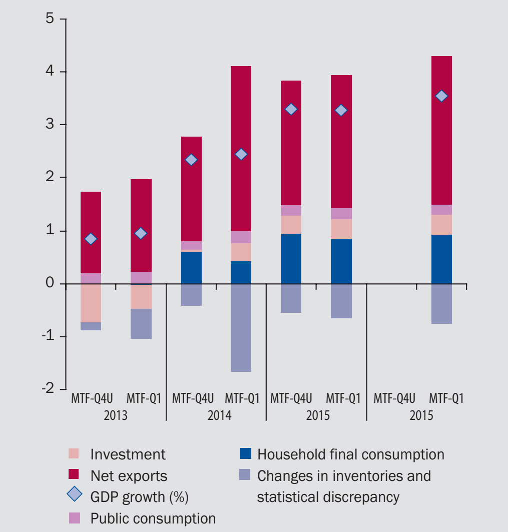
7 Comparison with the previous forecast

Comparing the technical assumptions of this forecast with those of the previous forecast, the projections for external demand are not significantly different and the exchange rate is expected to be weaker. The projected oil price in US dollars is slightly higher owing to exchange rate depreciation, but the price in euro will relatively higher than the USD price.

Maintenance of medium-term trends in the economy

The projection horizon has been extended to the end of 2016, from the end of 2015 in the previous forecast. Therefore the forecasts can be compared only in their projections for 2014 and 2015. The national accounts data for the fourth quarter of 2013 included adjustments to the composition of economic growth in the short-term horizon. The medium-term trends remained unchanged. With the domestic part of the economy performing better than expected in the last quarter of 2013, the growth projections for that year and 2014 have been revised up. The recovery is expected to be supported by a more rapid revival in investment and growth-supporting public consumption. On the other hand, private consumption has been flat for an extended period and, based on the latest data, its recovery is expected to begin later than previously projected. Although the forecast for external demand in 2014 is unchanged, the outlook for foreign trade has been revised up in response to recent developments. On the one hand, the export performance of the economy is expected to be higher while, on the other hand, import growth has been boosted by the effect of import intensity. The projected contribution of exports to economic growth in 2015 has increased, while the contribution of the domestic part of the economy has been revised down. The improved export projections reflect the situation in recent years in which export growth has far exceeded external demand growth. Market share acquisition over the projection horizon is expected to be somewhat lower than before. The improvement in export performance has been partially offset by lower growth in private consumption, which in turn is assumed to reflect lower income growth. For 2014 the economic growth projection is 0.1 percentage point higher in this forecast than in the previous forecast, while for 2015 it remains unchanged.

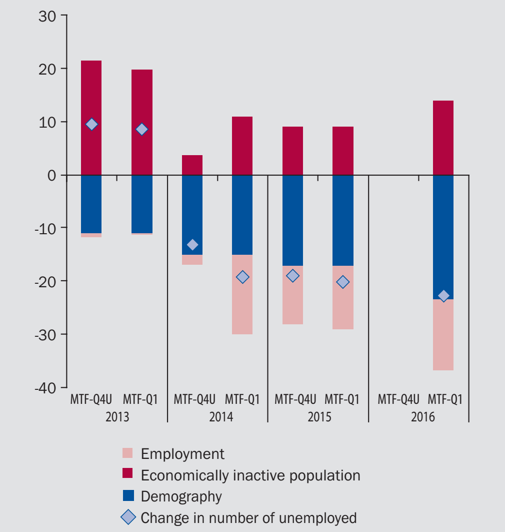
Chart 20 Comparison of forecasts for GDP composition[1] (annual percentage changes; contributions in p.p.)



Source: SO SR and NBS.
1) The composition of GDP growth is calculated as the contributions of components to GDP growth after deducting their import intensity. In this case the calculation uses the constant import intensity of the different GDP components (household final consumption – 30%, public consumption – 7%, investment – 50%, and exports – 60%). Remaining imports were included under changes in inventories and the statistical discrepancy.

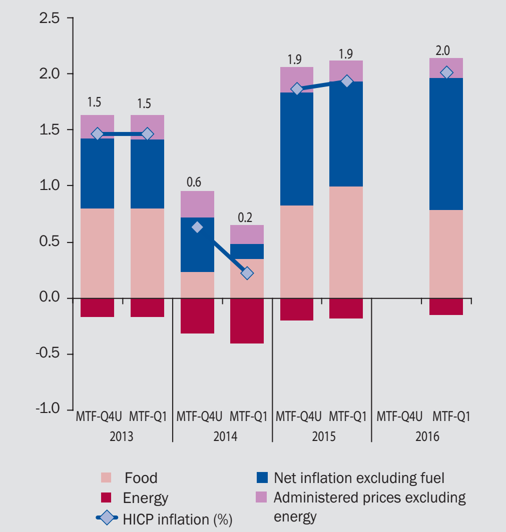
The outlook for the labour market in the short-term horizon has improved following favourable developments in the last quarter of 2013 (including firms' increasingly optimistic expectations) and figures for the first months of this year. The employment growth forecast for this year is higher in this forecast than in the previous forecast, and the unemployment rate is expected to fall more sharply. Owing to negative wage developments in the last quarter of 2013, the wage growth projection for this year has been revised down. This adjustment reflects mainly a carry-over effect; quarter-on-quarter wage growth is projected slightly higher in this forecast, but not to the extent that it would offset the wage figures from the fourth quarter of 2013. Slightly higher employment will have a downward effect on labour productivity growth, although owing to the adverse trend in income, labour cost

Chart 21 Comparison of forecasts for labour market indicators (contributions to change in unemployment; thousands of persons)



Source: SO SR and NBS.

Chart 22 Comparison of inflation forecasts (annual percentage changes; contributions in p.p.)



Source: SO SR and NBS.

growth is not expected to be higher than previously projected.

The inflation forecast was again revised down significantly from the previous forecast, by 0.4 percentage point, reflecting the lower price growth in the first two months of this year. Net inflation excluding fuel is expected to be lower, with downward revisions of projected inflation in non-energy industrial goods prices and services prices. Projected energy price is inflation is also lower in this forecast than in the previous forecast. The decline in headline inflation would be even higher but for an assumed marginal rise in food prices. The average inflation projection for 2015 is unchanged from the previous forecast, and the composition of inflation is also the same.

8 Impact of the MTF-2014Q1 macroeconomic forecast on public finances

As for the impact of the updated macroeconomic assumptions on public finance projections (as published in February by the Tax and Revenue Forecasting Committee), tax and social contribution revenues would be higher by €14 million in 2014, €103 million (0.1% of GDP) in 2015, and €175 million (0.2% of GDP) in 2016. The higher tax and contribution revenues reflect the MTF-2014Q1 forecast's improved assumptions for the wage base, for private and public sector consumption, and, in 2015 and 2016, for government investment, compared with the projections of the Finance Ministry's Institute for Financial Policy (IFP). Since GDP projections are lower in MTF-2014Q1 than in the general government budget, a lower nominal deficit would be required to attain the fiscal targets. The higher tax and contribution revenues under this forecast's more positive macroeconomic scenario would partially reduce the denominator effect (lower GDP).

Table 6 Differences in projections for tax and social contribution revenues in Slovakia's public finances

How the tax collection outlook under MTF-2014Q1 assumptions differs from that based on IFP projections of February 2014 (EUR million unless otherwise stated)	2014	2015	2016
Personal income tax	6	14	19
Corporate income tax	-9	5	23
Withholding tax	0	0	1
VAT	-15	17	49
Excise taxes	1	5	9
Social and health insurance	30	61	75
Total (impact of taxes and contributions)	14	103	175
Total (impact of taxes and contributions; % of GDP)	0.0	0.1	0.2
Impact of nominal GDP on the deficit target	-43	-38	-14
Total (EUR millions)	**-29**	**64**	**161**
Total (% of GDP)	**0.0**	**0.1**	**0.2**

Source: NBS (based on IFP calculations of the estimated impact of macroeconomic developments on the general government balance).
1) Change in nominal deficit resulting from change in GDP, assuming attainment of fiscal target as a percentage of GDP (where „-" denotes an improvement in the nominal deficit and „+" denotes a deterioration in the nominal deficit).

Table 7 Medium-Term Forecast (MTF-2014Q1) for key macroeconomic indicators

Indicator	Unit	Actual	Forecast P1Q-2014			Difference versus MTF-2013Q4U		
		2013	2014	2015	2016	2014	2015	2016
Prices								
HICP inflation	year-on-year changes in %	1.5	0.2	1.9	2.0	-0.4	0.0	-
CPI inflation	year-on-year changes in %	1.4	0.2	1.9	2.0	-0.4	0.2	-
GDP deflator	year-on-year changes in %	0.5	0.3	1.8	2.3	-0.5	-0.2	-
Economic activity								
Gross domestic product	year-on-year changes in %, constant prices	0.9	2.4	3.3	3.5	0.1	0.0	-
Final consumption of households	year-on-year changes in %, constant prices	-0.1	1.2	2.4	2.6	-0.5	-0.2	-
Final consumption of general government	year-on-year changes in %, constant prices	1.4	1.5	1.3	1.3	0.5	-0.1	-
Gross fixed capital formation	year-on-year changes in %, constant prices	-4.3	3.3	3.7	3.8	2.9	0.1	-
Exports of goods and services	year-on-year changes in %, constant prices	4.5	7.6	5.9	6.4	2.8	0.3	-
Imports of goods and services	year-on-year changes in %, constant prices	2.9	7.4	5.6	6.1	3.0	0.2	-
Net exports	EUR millions in constant prices	9,528	10,379	11,154	12,026	20	76	-
Output gap	% of potential output	-1.7	-1.6	-1.0	-0.2	0.1	-0.1	-
Gross domestic product	EUR millions in current prices	72,134	74,136	77,971	82,585	-329	-490	-
Labour market								
Employment	thousands of persons, ESA 95	2,192	2,208	2,221	2,234	10	11	-
Employment	year-on-year changes in %, ESA 95	-0.8	0.7	0.6	0.6	0.4	0.1	-
Number of unemployed 1)	thousands of persons	386	367	347	324	-7	-8	-
Unemployment rate	%	14.2	13.5	12.8	12.0	-0.3	-0.4	-
Unemployment gap 2)	p. p.	1.3	0.9	0.6	0.3	-0.3	-0.5	-
Labour productivity 3)	year-on-year changes in %	1.7	1.7	2.7	2.9	-0.3	-0.1	-
Nominal productivity 4)	year-on-year changes in %	2.2	2.1	4.6	5.3	-0.7	-0.2	-
Nominal compensation per employee	year-on-year changes in %, ESA 95	0.8	2.7	4.0	4.4	-0.5	0.0	-
Nominal wages 5)	year-on-year changes in %	2.3	2.5	4.0	4.4	-0.4	0.0	-
Real wages 6)	year-on-year changes in %	0.9	2.3	2.0	2.3	0.0	-0.3	-
Households								
Disposable income	constant prices	0.7	1.3	2.3	2.6	-0.4	-0.3	-
Savings rate	% of disposable income	6.7	6.7	6.7	6.7	-0.3	-0.3	-
Balance of payments								
Goods balance	% of GDP	5.9	7.0	7.7	8.4	0.6	0.8	-
Current acount	% of GDP	2.1	3.0	4.0	4.3	0.3	0.5	-
External environment and technical assumptions								
External demand growth for Slovakia	year-on-year changes in %	1.2	4.1	5.1	5.5	-0.2	-0.1	-
Exchange rate (USD/EUR) 7)	level	1.33	1.36	1.36	1.36	-0.73	-0.73	-
Oil price in USD	level	108.8	105.8	101.1	96.9	0.5	0.7	-
Oil price in USD	year-on-year changes in %	-2.8	-2.8	-4.5	-4.1	0.4	0.1	-
Oil price in EUR	year-on-year changes in %	-5.9	-4.8	-4.5	-4.1	1.1	0.1	-
Non-energy commodity price in USD	year-on-year changes in %	-5.2	-2.5	3.1	4.8	0.1	-0.7	-
EURIBOR 3M 8)	% p. a.	0.2	0.3	0.4	0.8	0.0	-0.1	-
10-Y Slovak government bond yields	%	3.2	2.6	3.0	3.4	-0.8	-0.8	-

Source: NBS, ECB, SO SR.
1) *Labour Force Survey.*
2) *Difference between unemployment rate and NAIRU (non-accelerating inflation rate of unemployment). Positive value indicates a higher unemployment rate than NAIRU.*
3) *GDP at constant prices / employment – ESA 95*
4) *Nominal GDP divided by employment (quarterly reporting by SO SR).*
5) *Average monthly wages according to SO SR statistical reporting.*
6) *Wages according to SO SR statistical reporting, deflated by CPI inflation.*
7) *Changes against the previous forecast in %.*
8) *Technical assumptions of interest rates and commodity prices are based on market expectations with cut-off date February 12, 2014.*

The time series of selected macroeconomic indicators can be found at
http://www.nbs.sk/_img/Documents/_Publikacie/PREDIK/2014/MTF-2014Q1.xls