NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

MEDIUM-TERM FORECAST

Q2 2014

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1 Summary

This Medium-Term Forecast (MTF-2014Q2) is based on the most recently published figures, including official flash estimates, monthly data, and forward-looking indicators. Technical assumptions are taken from the ECB's latest projections. The forecast also takes account of additional fiscal consolidation measures in 2015 and 2016 and consolidation measures triggered by the debt brake.

The forecast assumes that economic growth in Slovakia's main trading partners will accelerate over the medium term. The German economy in particular has been recording relatively solid growth and thus providing a stimulus to Slovakia's export performance, which has been, and will remain over the medium term, the main driver of growth. The Slovak economy's growth in the first quarter of 2014 was not based solely on exports, but also on a revival in domestic consumption. The improved monthly indicators of private consumption were incorporated into this forecast. **GDP growth is expected to accelerate to 2.4% in 2014** (unchanged from the previous forecast), **and then to 3.2% in 2015** (down by 0.1%) **and 3.5% in 2016** (unchanged)**.** The impact of fiscal measures on GDP growth is projected to be 0.21 percentage point in 2015 and 0.04 p.p. in 2016. The contribution of the domestic part of the economy to GDP growth has been revised up from the previous forecast, while that of exports has been revised slightly down (due in part to current geopolitical uncertainties).

Turning to the labour market, the assumptions of the previous forecast were again confirmed, as the increase in economic activity resulted in firms creating more jobs. It is expected that this trend will continue over the projection horizon and that, correspondingly, the unemployment rate will fall.

Risks to the outlook for the real economy appear to be balanced throughout the forecast period. There is, however, some uncertainty surrounding the risk of an escalation in geopolitical tensions.

Price movements in the first four months of 2014 reflected mainly a decrease in cost-push factors and in food prices, which outweighed even the first signs of a revival in consumer demand. The assumption is that the year-on-year drop in prices is temporary and that the turnaround could happen in the last quarter of this year. **The average inflation rate is expected to be 0.1% in 2014, rising to 1.6% in 2015 and 1.9% in 2016.** The risks to the inflation forecast are balanced, except in 2016, when prices may increase more than projected.

2 Current developments in the external environment and Slovakia

Global economic slowdown owing to temporary factors

Global economic growth was slightly lower in the first quarter of 2014 than in the last quarter of 2013, owing mainly to temporary one-off effects. In the United States, the economy's slowdown was attributed to an unexpectedly severe winter. After relatively strong growth in the second half of 2013, activity remained flat in the first quarter of 2014, with declines in private investment and net exports offset by private consumption expenditure. The world economy was also negatively affected by the closure of several heavy industry firms in China for environmental reasons. The Japanese economy contributed positively to global growth, as it expanded significantly as a result of April's expected hike in sales taxes. The UK's growth, which was relatively stable last year, benefited from improving consumer confidence and a recovery of the property market.

Current developments in the world economy confirm the continuation of recent growth rate trends in advanced and emerging economies. Whereas in advanced countries activity is being supported by the improving financial situation of households and growth-friendly domestic policies, in emerging economies growth is constrained by weakening domestic demand, stricter lending conditions, and, in some countries, also a turnaround in capital flows and geopolitical tensions.

Global economy to continue moderate recovery

Global economic activity is expected to pick up gradually, but its recovery in the near term will be modest. This view is confirmed by confidence indicators; for a majority of key OECD economies, the Composite Leading Indicator increased in 2013 and then rose more slowly (or began to decline) in early 2014. Looking ahead, advanced economies are expected to continue benefiting from the slowdown in private sector restructuring as well as from the moderation of fiscal consolidation measures. This should boost confidence and in due course support domestic demand and the labour market. As for emerging economies, the CLI points to a further slowdown in growth, reflecting the downward contribution of structural factors and, in some countries, the effect of monetary policy normalisation in the United States.

Euro area economic growth unchanged in the first quarter of 2014

According to Eurostat's flash estimate, the euro area economy grew by a lower than expected 0.2% in the first quarter of 2014, the same as its growth rate in the previous quarter. Expectations supported by forward-looking indicators had been for growth of 0.4%. The only major euro area economies to report higher growth were Germany and Spain, with the German rate rising from 0.4% in the fourth quarter of 2013 to 0.8% in the first quarter of 2014 and the Spanish rate increasing from 0.2% to 0.4%. As for other large economies, the French economy remained flat, Italian GDP fell slightly (by 0.1%) and Dutch GDP contracted sharply (by 1.4%). The Dutch figures were probably a consequence of the mild winter, which affected the production, consumption and export of natural gas (with the Netherlands being the fifth largest gas exporter in the world). Abstracting from this effect, euro area growth would have been 0.3%. Economic sentiment among euro area businesses and consumers became slightly less positive towards the end of the quarter and in April, although it remains relatively strong. Thus forward-looking indicators suggest the economy will continue growing in the second quarter of 2014. This growth should be supported by gradual labour market stabilisation and stronger demand growth, though there is a risk to that scenario from geopolitical uncertainties.

The Czech economy remained flat in the first quarter of 2014.

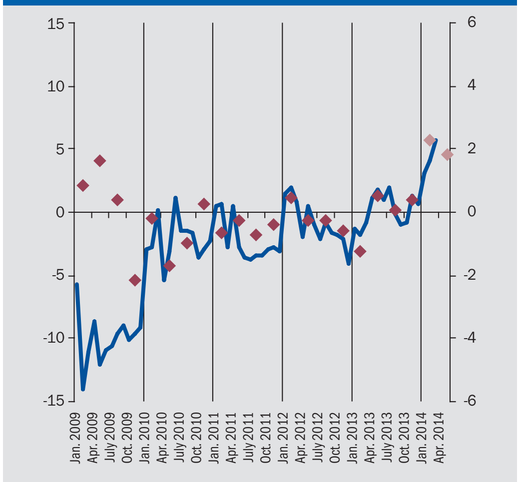
The Czech economy remained flat in the first quarter of 2014, after growing in the previous quarter by 1.8% quarter-on-quarter. The economy's officially reported slowdown was assumed to be due mainly to a substantial decline in revenue from tobacco excise duty in the first and second quarters, caused by the stocking up of cigarettes towards the end of last year.

Česká národní banka remains committed to using the exchange rate as an additional instrument of accommodative monetary policy, and while the original plan was to exit from this commitment in early 2015, that exit may now be postponed.

Slovak economic growth continues to increase gradually

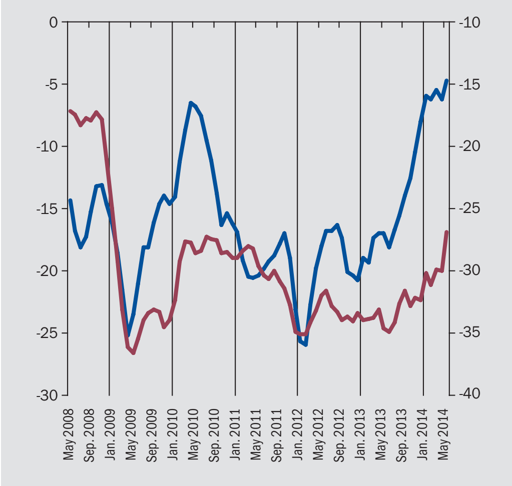
According to the flash estimate, GDP growth accelerated slightly in the first quarter of 2014, to 0.6%, in line with projections in the previous forecast. The contributions to that growth as indicated by monthly figures differed somewhat from projections in MTF-2014Q1. While net exports continued to be the main driver of growth, thanks to the gradual economic recovery in Slovakia's trading partners, there was also a significant positive contribution from domestic demand. The upturn in domestic demand is assumed to reflect a marked pick-up in private consumption growth. The improvement in consumer sentiment, evident from household assessments

Chart 1 Retail sales and private consumption (annual percentage changes)



Source: SO SR and NBS.

Chart 2 Household expectations (3-month moving average; balance of responses)



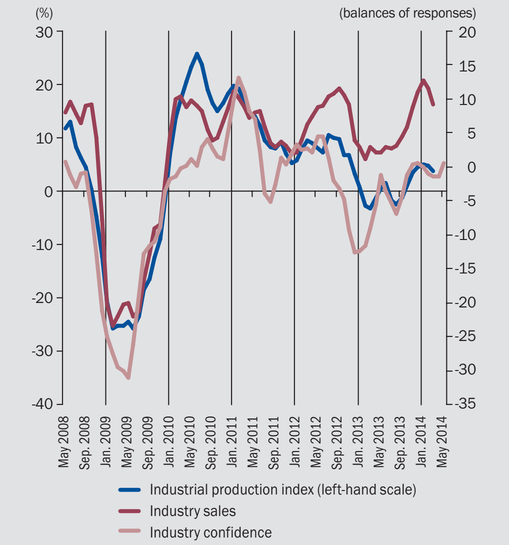
Source: European Commission.

of their financial situation and unemployment, translated into a relatively strong increase in retail sales. This indicated the making of purchases that had been deferred during the previous five years, when private consumption stagnated or fell. According to monthly figures, government expenditure continued to increase (in real terms), although the cause may have been falling prices. The impact of domestic demand might have been even more positive but for the dampening effect of gross capital formation (investment and inventories). Investment, after increasing quite robustly towards the end of 2013 (due in part to the completion of investment projects in the car industry), may have temporarily corrected and probably fell in quarter-on-quarter terms. Abstracting from that base effect, however, investment demand is assumed to have continued its gradual recovery.

Forward-looking indicators pointed to slight drop in expectations

Optimism in the euro area fell in April and May, possibly due to concerns about the geopolitical situation. In Slovakia there was a decline in production expectations (particularly in the car industry), which may reflect firms' responses to indications of a slowdown in external demand growth.

Chart 3 Monthly indicators from the real economy (3-month moving average; annual percentage changes; balances of responses)



Source: SO SR, NBS and European Commission.

Chart 4 Current labour market indicators (annual percentage changes; balances of responses)

Source: SO SR, Central Office of Labour, Social Affairs and Family (ÚPSVR), and the European Commission.

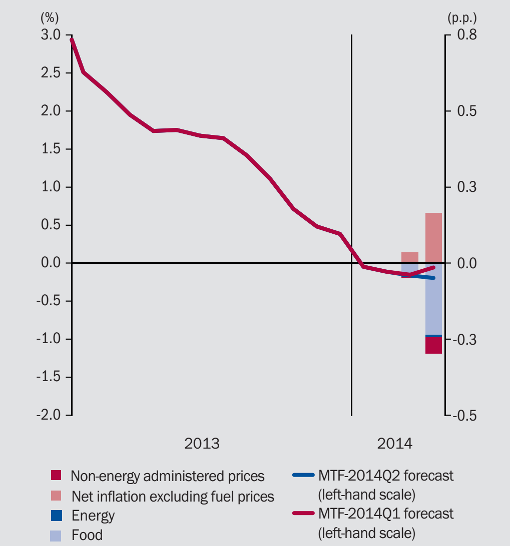
Economic activity is supporting job creation.

Employment continued to increase in the first quarter of 2014, according to the flash estimate. The growth rate of 0.2% was the same as in the previous quarter. Monthly figures indicate that most of the new jobs were created in industry and, with domestic demand rising, in services. With firms still cautious about creating jobs, their expectations for employment remained unchanged in April 2014. Further confirmation of this caution was the fact that unemployment did not fall in April, whereas before it had been on a downward path. Wage growth was higher in the first quarter of 2014 than in the last quarter of 2013. With prices stagnating, real wage growth provided significant impetus to private consumption growth. The first-quarter increase in nominal (and real) wages was greater than that in real labour productivity, and consequently unit labour costs increased markedly. Labour productivity growth had previously been exceeding wage growth, but the latest wage increases are not expected to have made up that difference.

Consumer prices remain flat

Consumer prices as measured by the HICP remained flat quarter-on-quarter in the first quarter of 2014, in line with projections. Inflation in food prices and services prices was offset by falling prices of energy and non-energy industrial goods. It may be that the moderate pick-up in domestic demand is slowly having an effect on prices. In services, the rate of increase in prices related to

Chart 5 Inflation compared with projections (annual percentage changes; contributions in p.p.)



Source: SO SR and NBS.

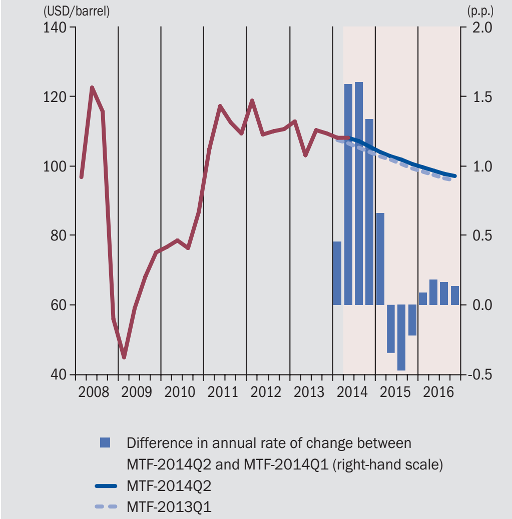
recreation, holidays and accommodation, and in transport prices, accelerated. Since Slovakia is an open economy and part of a highly competitive single market, prices of durable goods are determined largely by import prices. The annual rate of increase in prices of such items was constrained by imported inflation. In the category of industrial goods, however prices of non-durable goods increased moderately, which may also have been indicative of improving domestic demand. After falling in the previous two quarters, food prices increased, with a rise in processed food prices recorded alongside the seasonal increase in non-processed food prices. The decline in energy prices was accentuated by their annual adjustments at the beginning of January.

3 Technical assumptions[1]

In the period between the production of the previous forecast and this forecast, the **exchange rate** of the euro against the US dollar fluctuated between 1.37 and 1.39 USD/EUR and at the end of the period under review it was at the lower end of that range. This forecast assumes that the average exchange rate of USD per EUR will be 1.38[2] in 2014, as well as in 2015 and 2016, therefore slightly stronger than projected in the previous medium-term forecast.

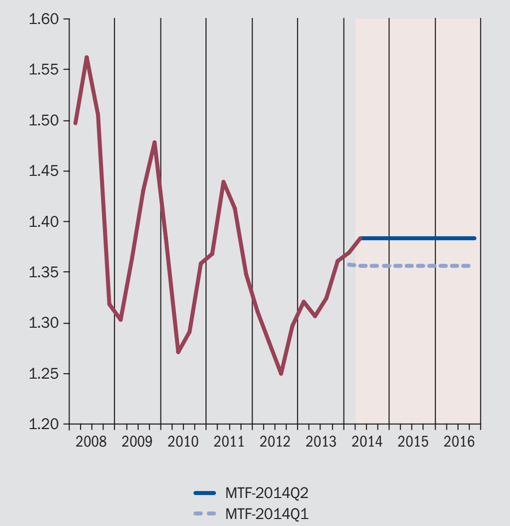
The **price of** a barrel of Brent **crude oil** ranged between USD 103 and USD 111 from mid-February to mid-May 2014. The downward trend in oil prices at the beginning of the year stemmed from weaker outlooks for global oil demand, supported in part by a drop-off in China's industrial activity. The shift in the oil price trajectory from the beginning of April was largly attributable to uncertainty surrounding the crisis in Ukraine. Further upward pressure came from disruptions of oil supplies from Libya and Nigeria. This forecast assumes that the average barrel price will be USD 107.2 in 2015, falling to USD 102.2 in 2015 and USD 98.2 in 2016, and that the price in euro will be €77.7 in 2014, €73.9 in 2015 and €71.0 in 2016. The oil price in dollars is assumed to be slightly higher in this forecast than in the previous forecast, while the price in euro is lower owing to exchange rate appreciation.

Chart 7 Price per barrel of Brent crude oil (USD)



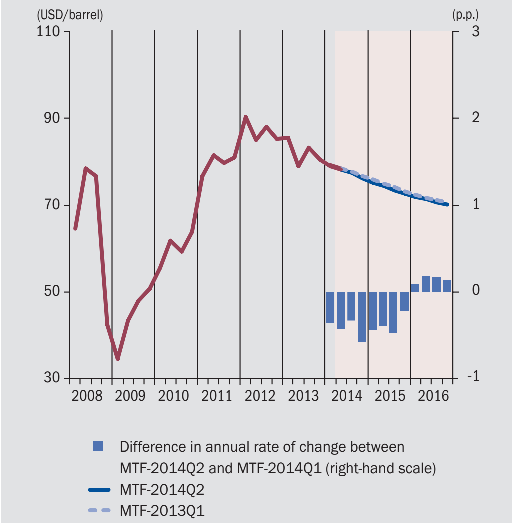
Source: NBS and ECB.

Chart 6 USD/EUR exchange rate



Source: NBS and ECB.

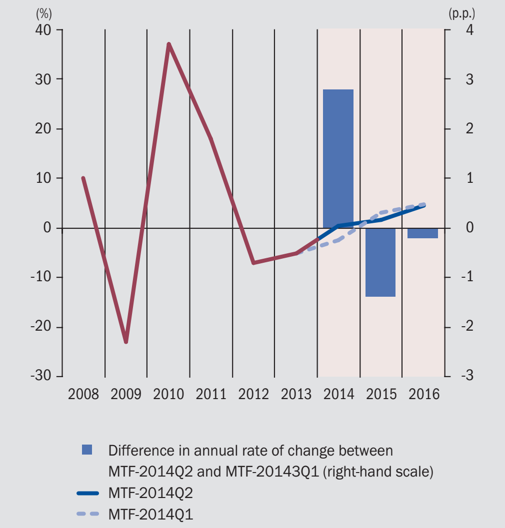
Chart 8 Price per barrel of Brent crude oil (EUR)



Source: NBS and ECB.

1 *The technical assumptions of the Medium-Term Forecast are based on the "June 2014 Eurosystem Staff Macroeconomic Projections for the Euro Area", with a cut-off date of 14 May 2014.*
2 *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.*

Chart 9 Non-energy commodity prices (annual percentage changes)



Source: NBS and ECB.

Prices of non-energy commodities increased at the beginning of 2014, driven up mainly by higher food commodity prices. Metals prices rose moderately. This forecast assumes that non-energy commodity prices will rise by 0.3% in 2014, and then by 1.7% in 2015 and 4.6% in 2016.

Short-term interest rates[3] (three-month EURIBOR) are assumed to average 0.3% in 2014, 0.3% in 2015, and 0.4% in 2016.

The domestic technical assumptions used in this forecast include the projection for additional fiscal consolidation measures in 2015 and 2016 and the fiscal consolidation triggered by the debt brake (after government debt exceeded the 55% of GDP threshold in 2013).

Table 1 Summary of measures and their impact on the economy (EUR millions)

Group of measures	2015	2016
1. Introduction of cash registers + withholding tax for doctors (2015) and annual settlement of payments to the Social Insurance Agency (2016)	**55**	**111**
2. Measures triggered by the debt brake:		
a) impact on government investment	37.5	50
b) impact on transfers	37.5	50
c) impact on intermediate consumption and overall compensation of employees in the public sector	75	100
Measures in total	**205**	**311**

Source: MF SR, NBS calculations.

3 *The technical assumptions about interest rates and commodity prices are based on market expectations, with a cut-off date of 14 May 2014. The assumption for short-term interest rates is of a purely technical nature.*

4 Forecast for the external environment[4]

World economic growth is expected to accelerate from 2.9% in 2013, to 3.3% in 2014, 3.7% in 2015 and 3.8% in 2016. Current uncertainty about future developments in the world economy is centred on emerging economies. Advanced countries have been implementing policies which over the short-term horizon mitigated downward risks to economic activity, and the gradual recovery of these economies indicates that the risks to their impact on global growth are balanced. In emerging economies, however, the situation is uncertain. In particular the less accommodative monetary policy of the United States could lead to risks of higher bond yields and a possible futher tightening of financing conditions in emerging countries. Should market sentiment deteriorate, emerging economies with substantial external and internal imbalances would be most exposed to external shocks. Furthermore, concerns about a possible escalation of tensions between Ukraine and Russia are increasing uncertainty about the outlook for this region in particular, and consequently for the world economy as a whole. Hence emerging economies currently represent the main downward risk to global economic growth.

Euro area real GDP growth is assumed to be moderate in 2014 and to gain momentum in 2015 and 2016, supported by increases in domestic and, to a lesser extent, external demand. Domestic demand is expected to be buoyed by the stronger confidence of economic agents in an environment of reduced uncertainty, by the accommodative monetary policy stance, by the broadly neutral fiscal stance, and by improved financing conditions. At the same time, real disposable income is projected to increase as wages gradually rise and energy prices fall. The adverse impact on economic growth stemming from the repair of public and private sector balance sheets and from high unemployment is expected to diminish only gradually over the projection horizon. External demand is expected to benefit from a gradual global recovery, although initially to a lesser extent owing to the effects of the stronger exchange rate of the euro. GDP growth is projected to increase by 1.0% in 2014, 1.7 % in 2015 and 1.8% in 2016.[5]

Euro area HICP inflation is relatively low, standing at 0.7% in the first quarter of 2014 and, according to Eurostat's flash estimate, at 0.5% in May. The subdued current rate of inflation reflects a stagnation of energy prices, food prices and non-energy industrial goods prices, as well as a subdued trend in services prices. Over the projection horizon, headline **HICP inflation in the euro area** is expected to increase from 0.7% in the first quarter of 2014 to 1.5% in the last quarter of 2016, and to average 0.7% in 2014, 1.1% in 2015 and 1.4% in 2016.[6] The projected pick-up in inflation reflects strengthening demand and a narrowing of the negative output gap in the context of the assumed economic recovery, as well as an increase in commodity prices. Food price inflation is projected to continue to decline until the third quarter of 2014, owing to the delayed pass-through of past declines in food commodity prices and to downward base effects. Given the assumed increase in farm gate prices, food price inflation is expected to rise over the rest of the projection horizon. HICP inflation excluding food and energy is projected to rise over the projection horizon, from 1.0% in 2014, to 1.2% in 2015 and to 1.5% in 2016, reflecting both a moderate pick-up in activity and domestic price pressures in the form of rising growth rates for wages and profits. HICP inflation excluding energy, food and changes in indirect taxes is assumed to rise over the projection horizon, from 0.9% in 2014, to 1.2% in 2015 and to 1.5% in 2016. Increases in indirect taxes that are included in fiscal consolidation plans are expected to make a small upward contribution (of 0.1 percentage point) to HICP inflation in 2014. In 2015 and 2016 their contributions are currently expected to be negligible, given the lack of information on approved fiscal measures for those years.

With regard to domestic price pressures, the annual rate of increase in compensation per employee is expected to edge down to 1.6%, before accelerating to 1.9% in 2015 and 2.2% in 2016. Unit labour cost growth is projected to be dampened, from 0.9% in 2014 to 0.7% in 2015, by

4 The assumptions for developments in the international economy are based on the "June 2014 Eurosystem Staff Macroeconomic Projections for the Euro Area", which were prepared using information available up to 21 May 2014.

5 The figures are in the middle of the forecast range for GDP growth. The ECB's projection ranges for GDP growth are 0.6% – 1.4 % in 2014, 0.6% – 2.8% in 2015, and 0.5% – 3.1% in 2016.

6 The figures are in the middle of the forecast range for the HICP rate. The ECB's projection ranges for the HICP rate are 0.6% – 0.8% in 2014, 0.5% to 1.7% in 2015, and 0.6% to 2.2% in 2016.

a stronger increase in productivity than nominal wage growth (reflecting the cyclical recovery in productivity). In 2016, a continued strengthening of wage growth, together with a weakening of productivity growth, is expected to contribute to a pick-up in unit labour cost growth, to 1.1%.

Profit margins (as measured by the difference between the GDP deflator at factor cost and unit labour cost growth) are expected to increase over the projection horizon, supported by the assumed improvement in economic conditions.

Given current economic developments, **global trade growth** over the projection horizon is expected to be more moderate than projected in the previous forecast. It is still assumed, however, that global trade growth will accelerate, from 2.7% in 2013, to 4.1% in 2014, 5.5% in 2015 and 5.7% in 2016. Its growth rate will remain below pre-crisis levels. The pick-up in global trade will support **Slovakia's export markets**, whose average growth is expected to increase gradually, from 3.9% in 2014, to 5.1% in 2015 and 5.6% in 2016.

5 Macroeconomic forecast for Slovakia

5.1 Economic growth

Gradual increase in demand for Slovak exports

Exports were very strong in the last quarter of 2013, far exceeding external demand growth, and according to monthly figures this trend continued in the first quarter of 2014. In subsequent months firms expect export growth to continue, albeit more slowly than in the previous period (this is already evident from weaker figures for March). These expectations are probably affected by tensions related to the crisis in Ukraine. In both 2015 and 2016, consistent with the convergence of the Slovak economy, export growth is projected to be slightly higher than external demand growth.

Chart 10 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 rise moderately in coming years

Investment demand is expected to have declined in the first quarter of 2014. Abstracting, however, from its strong base at the end of last year (arising from investments in the car industry), investment would have increased moderately. Investment is expected to continue picking up over the projection horizon. The outlooks for the near term remain on the cautious side, since construction firms, operating in a troubled sector, are burdened by both a shortage of demand and financial constraints. The construction sector could start to recover this year, based on an assumed revival in civil engineering construction. Business investment is projected to continue increasing since firms will need to renew capital stock after years of decline. Government investment is also expected to make a positive contribution to investment demand growth. Over the long term, investment growth is projected to increase in line with improving outlooks for economic growth.

Signs of stronger recovery in private consumption

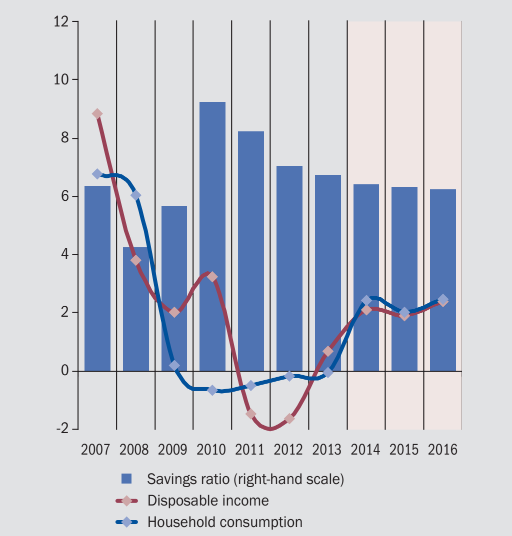
Monthly indicators pointed to a marked pick-up in private consumption in the first quarter of 2014. This development is assumed to be temporary (caused partly by the making of purchases that had been deferred), with consumption growth projected to moderate in the period ahead. The broad recovery of consumption is expected to be supported by improving consumer confidence and expectations for the financial situation and unemployment, and by real wage growth. Over the projection horizon, private consumption growth is projected to stabilise at a level slightly above 2%. Consumption increases should be covered by income, with the savings ratio remaining relatively stable.

Table 2 Forecast for gross fixed capital formation (annual percentage changes)

	2013	2014	2015	2016
Gross fixed capital formation (GFCF)	**-4.3**	**3.0**	**3.5**	**3.8**
– private sector	-3.3	3.0	3.2	4.4
– adjusted to exclude one-off investment in the automotive industry	-4.7	6.8	3.2	4.4
– general government sector	-13.8	2.3	6.7	-2.9

Source: SO SR and NBS.

Chart 11 Household income, consumption (annual percentage changes) and savings ratio (%)



Source: SO SR and NBS.

which should not only meet consumer demand, but also contribute to destocking. It is further assumed that higher imports will reflect the expected increase in investment demand. Import intensity is expected to remain at around the current level. Over the projection horizon, import growth is projected to decrease slightly, in line with assumptions for export performance. The terms of trade (price developments in foreign trade) are expected to be positive this year, given the assumptions of a greater drop in energy prices and its substantial pass-through to import prices. In subsequent years, prices indices are expected to increase at around the same pace without any significant impact on foreign trade. Owing to the acquisition of market share, the nominal current account surplus is expected to increase.

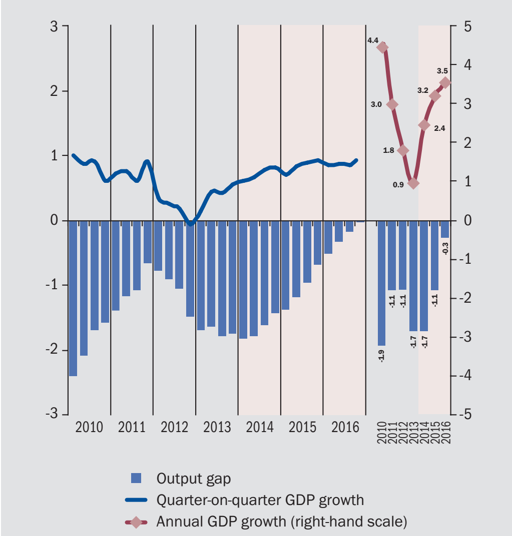
Public consumption to support growth this year

The latest figures in the first months of 2014 point to relatively sharp (real) growth in central government spending. This fact has been reflected in the forecast for this year, which envisages that public consumption growth will be markedly higher compared with the previous year. Looking further ahead, however, public consumption growth is projected to decrease, reflecting fiscal consolidation measures triggered by the debt brake and other additional consolidation measures.

Imports to rise this year in line with pick-up in domestic demand

In 2014 increasing domestic demand is expected to support significant growth in imports,

Chart 12 GDP growth and the output gap (%)



Source: SO SR and NBS.

Table 3 Forecast for public consumption and investment (annual percentage changes)

	2013	2014	2015	2016
General government final consumption (constant prices)	1.4	3.2	1.0	1.2
Public investment (constant prices)	-13.8	2.3	6.7	-2.9
Contribution of public consumption and investment to GDP growth (p.p.)	-0.1	0.6	0.3	0.1

Source: SO SR and NBS.

Economic activity to accelerate moderately over the medium term

Exports are expected to remain the main driver of economic growth. After its prolonged slump, domestic demand is also projected to make a positive contribution, based mainly on consumption (both with private and public). **GDP growth is projected to be 2.4% in 2014 (unchanged from the previous forecast), and then gradually to accelerate to 3.2% in 2015** (down by 0.1%) **and 3.5% in 2016** (unchanged). That growth is assumed to be mainly export driven. Over the projection horizon, the economy's growth is expected to be slightly higher than potential output growth, and thus the negative output gap is expected to close (by the end of 2016).

Box 1

IMPACT OF FISCAL CONSOLIDATION MEASURES ON THE ECONOMY

This forecast takes account of additional fiscal consolidation measures that could affect the real economy. These measures are expected to be implemented from the beginning of 2015, with the first batch comprising measures incorporated in the draft bases of the general government budget for 2015–2017 and in the Stability Programme for 2014–2017, amounting to €55 million in 2015 and €56 million in 2016. These permanent expenditure-based measures are expected to have a reductive effect on household disposable income and consequently on private consumption growth. However, since these measures affect mainly higher-income groups, their negative impact on income should be largely compensated by households dipping into savings. Hence their impact on household final consumption may be mitigated.

The remaining measures have been triggered by the debt brake after government debt exeeded the 55% of GDP threshold. Given preliminary estimates (expected to be set out in greater detail – in terms of both their scope and character – in the draft general government budget of autumn 2014), this forecast assumes that austerity measures will amount to €150 million in 2015 and €200 million in 2016. Measures are expected to affect public investment, transfers, and general govern-

Table A Summary of measures and their impact on the economy in 2015 and 2016

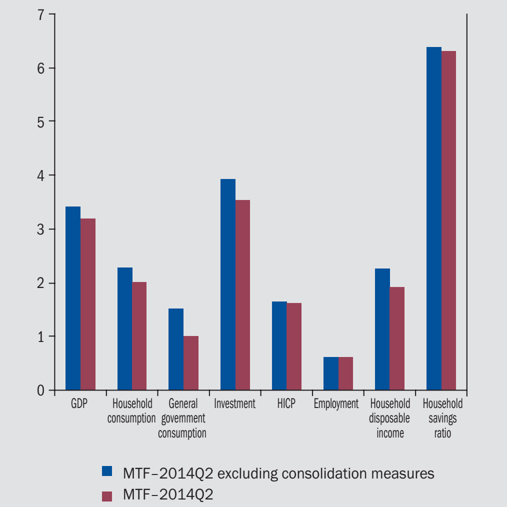
Group of measures	Measures (EUR millions)		Impact on GDP (year-on-year changes in p.p.)		Impact on HICP inflation (year-on-year changes in p.p.)	
	2015	2016	2015	2016	2015	2016
1. Introduction of cash registers + withholding tax for doctors (2015) and annual settlement of payments to the Social Insurance Agency (2016).	**55**	**111**	**-0.02**	**-0.02**	**-0.00**	**-0.01**
2. Measures triggered by the debt brake:						
a) impact on government investment	37.5	50	-0.03	-0.00	-0.00	-0.01
b) impact on transfers	37.5	50	-0.02	-0.00	-0.00	-0.01
c) impact on intermediate consumption and overall compensation of employees in the public sector	75	100	-0.14	-0.01	-0.02	-0.05
Measures in total	**205**	**311**	**-0.21**	**-0.04**	**-0.03**	**-0.07**

Source: MF SR and NBS calculations.

ment final consumption (including intermediate consumption and compensation for employees).

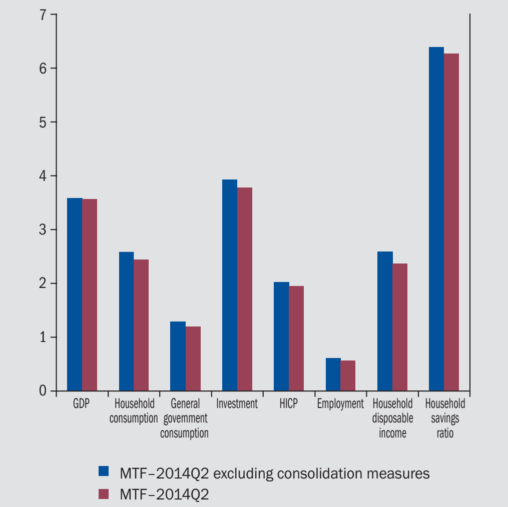
Overall these measures are expected to reduce next year's economic growth by around 0.2 percentage point and to have a minimal impact on price developments.

Chart A Forecast for selected macroeconomic indicators in 2015 (annual percentage changes)



Source: NBS calculations.

Chart B Forecast for selected macroeconomic indicators in 2016 (annual percentage changes)



Source: NBS calculations.

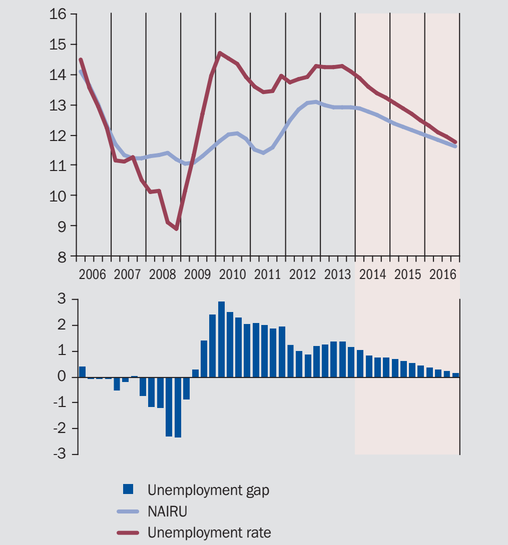
5.2 LABOUR MARKET

LABOUR MARKET CONTINUES TO IMPROVE

The gradual increase in economic growth, and particularly the projected substantial pick-up in domestic demand, is expected to support continuing employment growth. After two years of stagnation and decline, employment is expected to increase in 2014, a view supported by the flash estimate for the first quarter and also by firms' expectations for the period ahead. In line with this development, the unemployment rate is projected to fall and there should be a slight narrowing of the unemployment gap (the difference between the actual rate of unemployment and the NAIRU[7]).

Over the projection horizon, employment is assumed to increase, with firms expected to increase production by both raising hours work and creating new jobs.

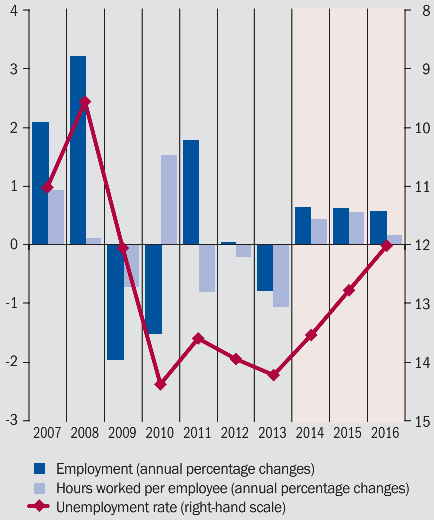
Chart 13 The unemployment rate and NAIRU (%)



Source: SO SR and NBS.

7 *The NAIRU is the non-accelerating rate of unemployment.*

Chart 14 Employment, hours worked and the unemployment rate



Source: SO SR and NBS.

5.3 LABOUR COSTS AND PRICE DEVELOPMENTS

STEADY INCREASE IN LABOUR COSTS

Unit labour costs are expected to increase by around 1.2% over the projection horizon. Nominal compensation per employee growth is projected to be moderately higher than real labour productivity growth. This, and the fact that economic growth is expected to accelerate in each year of the forecast period except 2014, should provide scope for an increase in profit margins.

INFLATION TO REMAIN NEGATIVE IN THE NEAR TERM

The annual rate of change in prices is expected to remain slightly negative until the third quarter of 2014 and to become positive again (at around 1%) towards the end of the year, with food price inflation projected to increase. The downward effect of import prices is expected to lessen as their annual rate of decline gradually moderates. The acceleration of inflation in the second half of 2014 is expected to reflect the base effect of the substantial drop in food prices in 2013.

According to monthly data, private consumption increased significantly in the first quarter of 2014. This pick-up in consumer demand may have an upward effect on prices of services and non-durable goods. The rates of inflation in services and industrial durable goods in the first quarter of 2014, reflecting consumer demand, may therefore have been the first sign of an inflation upturn that will prevent an overall drop in the price level in 2014.

Table 4 Unit labour costs (annual percentage changes)

	2013	2014	2015	2016
Nominal compensation per employee (ESA)	0.8	3.0	3.7	4.2
Real productivity	1.7	1.8	2.6	3.0
Unit labour costs	-0.9	1.2	1.1	1.2
GDP deflator	0.5	-0.1	1.4	2.0

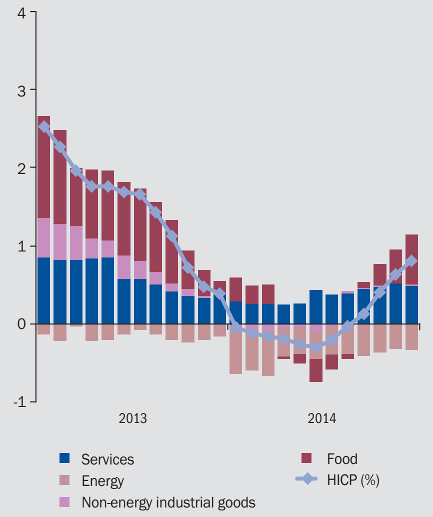
Source: SO SR and NBS calculations.

Table 5 Wages (annual percentage changes)

	2013	2014	2015	2016
Nominal labour productivity	2.2	1.6	4.0	5.0
Whole economy – nominal	2.3	2.8	3.7	4.2
Whole economy – real	0.9	2.7	2.0	2.2
Public administration, education and health care – nominal	3.4	4.3	2.9	2.9
Public administration, education and health care – real	2.0	4.2	1.3	0.9
Private sector – nominal	2.0	2.3	3.9	4.7
Private sector – real	0.6	2.2	2.3	2.6

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 4.0% in 2014, 2.3% in 2015 and 2.9% 2016.

Chart 15 Expected composition of annual inflation in 2014 (p.p.)



Source: SO SR and NBS.

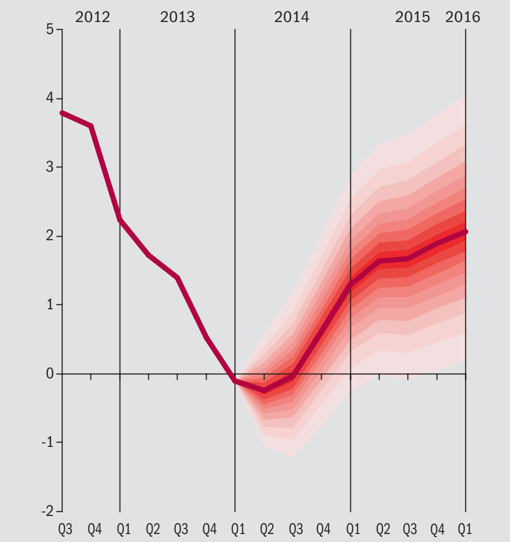
Over the medium-term horizon, inflation is expected to accelerate gradually, up to 2%. As domestic demand rallies and the output gap becomes narrower, prices should come under upward pressure. Among cost-push factors, energy prices (in conjunction with technical assumptions) are expected to continue restraining consumer price growth.

6 Risks to the forecast

In this medium-term forecast, the main risk to the real economy outlook for 2014 is uncertainty about the external environment, which may have been reflected in export performance towards the end of the first quarter. An upward risk to the outlook is the possibility of a stronger than projected pick-up in private consumption in a low-inflation context. Risks over the medium-term horizon appear to be balanced. The downside risks of lower external demand and additional fiscal consolidation measures may be offset by the upside risks of greater acquisition of market share in foreign trade and increased utilisation of EU funds.

The inflation forecast for 2014 seems to be plausible, and the risks to the inflation outlook for subsequent years are balanced. There are upside risks in the technical assumptions (oil price, exchange rate). On the other hand, the possibility of a better than expected harvest represents a downside risk to the inflation outlook. The upward risks in the technical assumptions are expected to remain present in 2016. Downward risks include lower than projected external demand and compensation per employee growth.

Chart 16 Inflation forecast (%)



Source: SO SR and NBS.

The impact of geopolitical risks is estimated in a separate box.

Table 6 Risks to the forecast

	2014	2015	2016
GDP	↓ Export performance (geopolitical risks) ↑ Private consumption	↓ Fiscal consolidation measures, external demand ↑ EU funds, export performance (geopolitical risks)	↓ Fiscal consolidation measures, external demand ↑ Export performance
Inflation		↑ Technical assumptions ↓ Food (good harvest)	↑ Technical assumptions ↓ External demand, compensation per employee

Source: NBS.

Box 2

POTENTIAL REPERCUSSIONS OF GEOPOLITICAL TENSIONS BETWEEN THE EU AND RUSSIA

Part A

The instability in Ukraine, and possibility that tensions between Russia and Western countries will escalate, could lead to the imposition of various sanctions. This box estimates the impact of the potential shocks to which the Slovak economy could be exposed by the pass-through of additional sanctions in:

1. oil prices,
2. the exchange rate,
3. external demand (falling),
4. confidence indicators (deteriorating).

For this purpose, we looked at hypothetical developments in particular indicators in the event of and escalation of tensions, and we separately calculated their impact on the economy. The alternative paths selected for these indicators were substantially different from the baseline projection, so as to better present their impact on GDP and the price level. A combination of some or most of these paths is expected to materialise.

1) Oil prices
The scenario assumes that oil prices will rise by around 22% in 2014, owing to a decrease in Russian oil exports in the order of 1.5 million barrels per day. That represents around 30% of Russian oil exports in 2014 and 36% in 2015. It is assumed that as tensions ease, Russian oil exports will rebound to their previous levels towards the end of 2016.

The negative impact of such an oil price shock on Slovakia's GDP is estimated at -0.1% in 2015, -0.5% in 2015 and -0.2% in 2016. As oil prices climb, their positive contribution to the price level as measured by the HICP would be 0.3% in 2014, 1.1% in 2015 and 0.5% in 2016.

2) Effective exchange rate
Were additional financial and economic sanctions to be imposed on Russia, they could trigger capital outflows, which in turn, along with a decline in the current account surplus (owing to lower oil exports), could lead to the rouble's exchange rate against the euro and the US dollar depreciating by around 30%.

The direct impact of such depreciation on the Slovak economy would not be very severe (GDP in 2015 would not fall by more than around 0.1%, and the price level in 2016 would be lower by 0.2%).

3) External demand
The scenario further assumes that EU exports to Russia will fall by around 20% from the second quarter of 2014 and that they will return approximately to their original levels by the end of 2016. This reduction in exports would correspond to external demand for Slovak goods declining by 1.0% in 2014, 1.4% in 2015 and 0.8% in 2016.

The negative impact of such an external demand shock on Slovakia's GDP would be -0.5% in 2014, -0.8% in 2015, and -0.3% in 2016. The shock to the economy would bring the price level down by 0.4% in 2016.

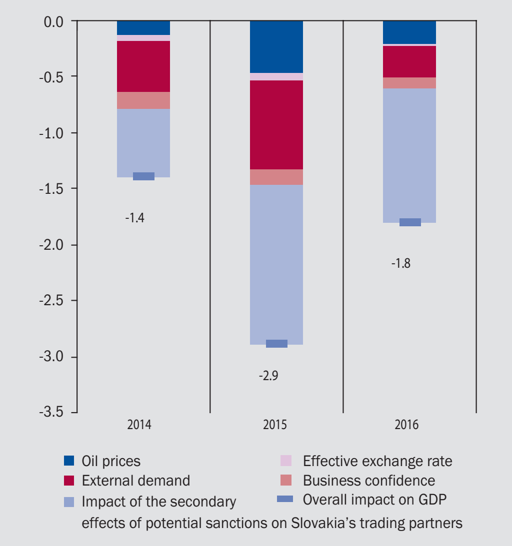
4) Decline in confidence
Amidst escalating tensions with Russia, mounting uncertainty may be expected to show up in declining confidence. Consequently, private investment in the Slovak economy is projected to record a one-off decline of around 1.5% in the first quarter of 2014, when the shock hits, and a decline of 0.4% for the year as a whole. Private investment is then assumed to rebound to its previous levels. The negative impact of this shock on GDP would by -0.2% in 2014, with a gradual correction to 0.1% in 2016. The price level would fall gradually over the projection horizon (by 0.1% in 2016). A summary of the shocks under the different scenarios is provided in Table A.

Table A Summary of impulses and their impact

Impulses (deviations in percent from the baseline projection in MTF-2014Q2)	2014	2015	2016
1) Oil prices	22.0	26.0	5.0
2) Effective exchange rate	-0.6	-1.0	-0.8
3) External demand	-1.0	-1.4	-0.8
4) Decline in confidence	-0.4	0.0	0.0

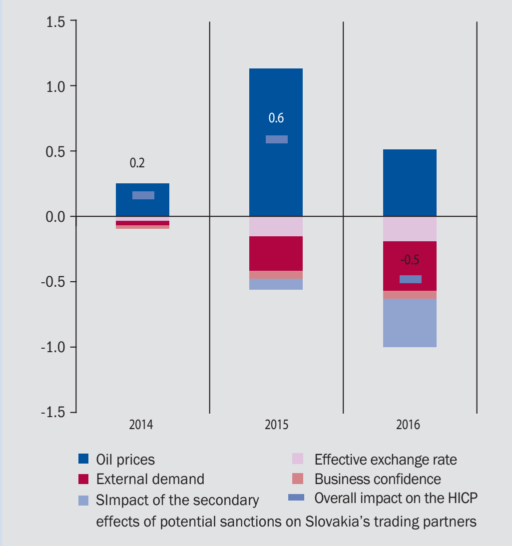
Source: NBS calculations.

Chart A Contributions of shocks – impact on real GDP (p.p.)



Source: NBS calculations.

Chart B Contributions of shocks – impact on the HICP index (p.p.)



Source: NBS calculations.

Incorporation of all these assumed impacts on the Slovak economy

Should the mentioned shocks materialise, their direct impact on the Slovak economy would be escalated by secondary effects of possible sanctions on the economies of the country's main trading partners. The overall impact on Slovakia's economic growth (including the mentioned secondary effects) would be -1.4% in 2014, -2.9% in 2015, and -1.8% in 2016. The most significant impact on the domestic economy would stem from a slowdown of the economies of Slovakia's main trading partners. The impact on the HICP index would be positive in the first two years of the shock, driven by higher oil prices. In 2016, by contrast, prices would decrease owing mainly to the downward effect on domestic demand of weaker external demand, secondary effects of sanctions on Slovakia's trading partners, and the impact of the effective exchange rate shock.

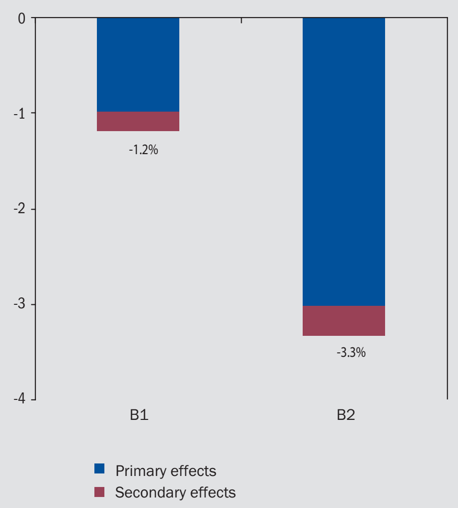
Given the uncertainty about how relations with Russia will develop, it is impossible exhaustively to estimate the nature and scope of potential shocks and to quantify their impact on the Slovak economy. The alternative paths presented here are intended to approximate the sensitivity of the Slovak economy to a shift in the values of certain indicators of one of Slovakia's trading partners. The scope of the negative impact may be amplified by the synergic effects of a combination of several factors. The impact may also be far more complex, depending on its repercussions for households and several sectors, and also owing to the heterogeneity across its constituent factors (including the disruption of gas supplies, which is not incorporated in this scenario, but is assessed separately in Part B below).

Part B

Disruption of natural gas supplies to EU with an impact on the Slovak economy (counter-response)

The projected scenario envisages that natural gas imports from Russia will decline by 15%. Input-output tables for all EU countries and the spending of Russian natural gas in domestic intermediate consumption and final production were used to simulate the impact on the domestic economy, including secondary effects caused by a decrease in demand among Slovakia's trading partners. Given the limitations of the selected methodology (with the economy assumed to have a fixed composition), two alternatives were simulated. The first (B1) assumes that disruptions of natural gas imports would affect only manufacturing industry and those sectors in which natural gas has strategic importance; the extent to which such imports can be immediately substituted is assumed to be small. Under this scenario, GDP is projected to fall by 1.2% (1.0 p.p. of that drop represents the primary effects and 0.2 p.p. represents the additional secondary effects arising from the slackening of demand in Slovakia's trading partners. The second alternative (B2) assumes that supply disruptions would affect all sectors of the economy, given the energy intensity of individual sectors and their interlinkage. In this scenario, the drop in GDP would be more pronounced, at 3.3%, with the primary effects accounting for 3.0 p.p. of that decrease and secondary effects for 0.3 p.p. How these effects are manifested would depend on when supplies were disrupted, as well as on Slovakia's capacity to use emergency reserves of natural gas at this time, probably at the beginning of the disruption. Under this scenario, Slovakia would be expected to slide into recession.

Chart C Contributions to GDP growth (p.p.) of the effects of a 15% reduction in GDP growth (%)



Source: NBS calculations.

7 Comparison with the previous forecast

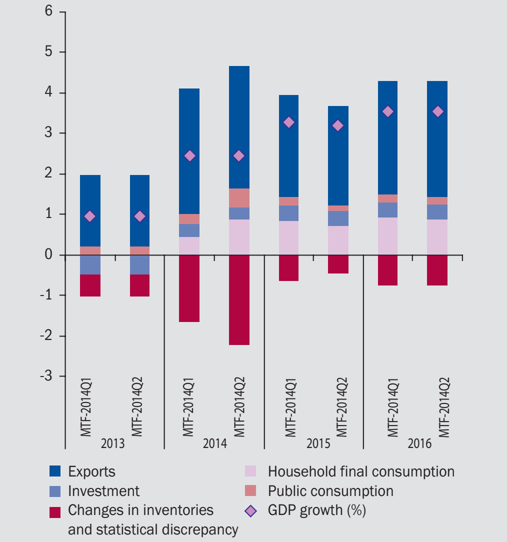
The technical assumptions of this forecast, unlike those of the previous forecast, take account of fiscal consolidation measures for 2015 and 2016 and consolidation measures in 2015 that have been triggered by the debt brake. There are no significant changes in regard to external demand. The exchange rate is projected to be slightly stronger, which, with the oil price in US dollars maintaining its trajectory, has prompted a modest downward adjustment of the oil price in euro. At the same time, foreign inflation is expected to be slightly lower.

Underlying tendencies remain unchanged

The latest official flash estimate for economic growth confirmed the projected GDP growth path and therefore no revisions were necessary in this regard. Monthly indicators, however, suggested that the composition of GDP growth may well differ somewhat from the previous forecast, and so projections for the sources of growth were adjusted slightly. Based on the latest data, the contribution of domestic demand was revised up and that of exports was revised down moderately. In domestic demand, both private and public consumption projections were revised up, while investment was reduced. The wage growth projection was also raised, and is expected to support a stronger upturn in private consumption this year. Over the medium-term horizon there are no significant changes from the previous forecast. The contribution of domestic demand has been revised down slightly. In line with lower growth in disposable income, private consumption is expected to increase more slowly. These adjustments stem from the incorporation of fiscal consolidation measures, whose impact on growth should be most marked in 2015.

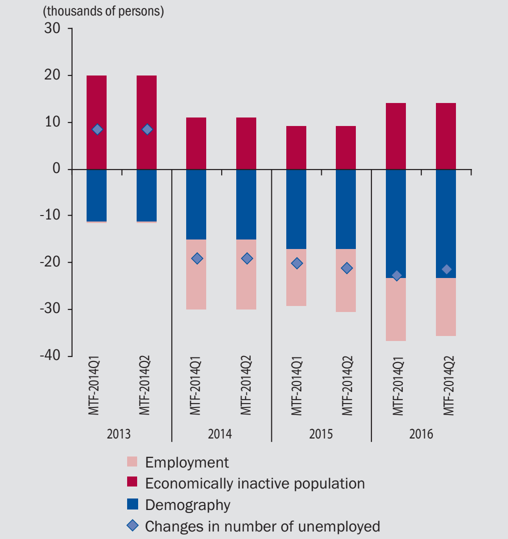
The outlook for the labour market is unchanged from the previous forecast. Since the latest figures confirmed the assumptions of the March medium-term forecast, there was no need to adjust projections for employment and unemployment. As for wages, the situation was slightly different: on the one hand, their recent stronger

Chart 17 Comparison of forecasts for GDP composition[1)] (annual percentage changes; contributions in p.p.)



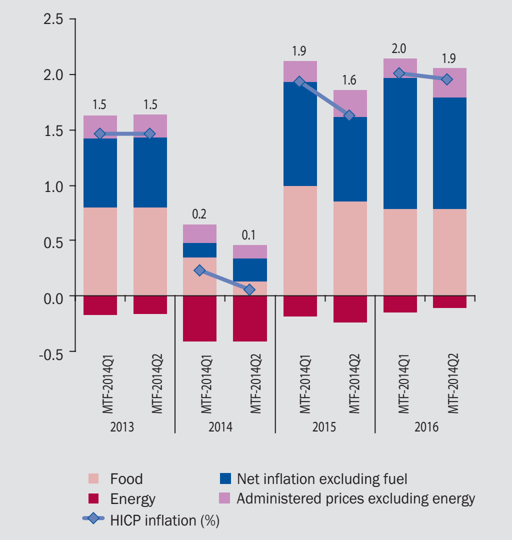
Source: SO SR and NBS.
1) The composition of GDP growth is calculated as the contributions of components to GDP growth after deducting their import intensity. In this case the calculation uses the constant import intensity of the different GDP components (household final consumption – 30%, public consumption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

Chart 18 Comparison of forecasts for labour market indicators (contributions to change in unemployment)



Source: SO SR and NBS.

Chart 19 Comparison of inflation forecasts (annual percentage changes; contributions in p.p.)



Source: SO SR and NBS.

growth prompted an upward revision of their growth rate for this year, while, on the other hand, that increase was moderated by the incorporations of fiscal consolidation measures.

The recent lower than expected price growth, reflecting mainly lower food price inflation, resulted in a downward revision of the projection for average inflation in 2015 and, to a marginal extent, in 2016. The downward adjustment of the inflation forecast stems not only from food prices, but also from a decline in net inflation excluding fuel, in which the decline in import prices is expected to be more marked. Based on technical assumptions, energy prices are now expected to record a larger decrease.

8 Impact of the MTF-2014Q2 macroeconomic forecast on public finances

If the assumptions of the Stability Programme of the Slovak Republic for 2014–2017 incorporated the updated outlook for macroeconomic developments provided in this forecast (MTF–2014Q2), the forecast for fiscal revenue over the projection horizon would be higher. Revenue is boosted mainly by the improved assumptions for the wage base and for real private consumption. On the other hand, nominal GDP growth is assumed to be low, and consequently so are corporate profits. Incorporating the MTF-2014Q2 macroeconomic assumptions sees projected tax and contribution revenues rise by 0.1% of GDP in 2014 and by 0.2% in 2015 and 2016. This positive effect of higher tax revenues would, however, be partially reduced by lower GDP (the denominator effect). The calculation does not include the so-called effective tax rate (i.e. higher / lower collection).

Table 7 Differences in projections for tax and social contribution revenues in Slovakia's public finances

How the tax collection outlook under MTF-2014Q2 assumptions differs from assumption used in the Stability Programme for 2014–2017 (EUR millions unless otherwise stated)	2014	2015	2016
Personal income tax	11	14	14
Corporate income tax	-17	-13	-4
Withholding tax	-1	-1	0
VAT	4	5	24
Excise taxes	25	21	23
Social and health insurance	76	90	90
Total (impact of taxes and contributions)	97	116	147
Total (impact of taxes and contributions; % of GDP)	0.1	0.2	0.2
Impact of nominal GDP on the deficit target[1)]	-18	-13	-3
Total (EUR millions)	**79**	**103**	**145**
Total (% of GDP)	**0.1**	**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 8 Medium-Term Forecast (MTF-2014Q2) for key macroeconomic indicators

Indicator	Unit	Actual	Forecast P2Q-2014			Difference versus MTF-2014Q1		
		2013	2014	2015	2016	2014	2015	2016
Prices								
HICP inflation	year-on-year changes in %	1.5	0.1	1.6	1.9	-0.1	-0.3	-0.1
CPI inflation	year-on-year changes in %	1.4	0.1	1.6	2.0	-0.1	-0.3	0.0
GDP deflator	year-on-year changes in %	0.5	-0.1	1.4	2.0	-0.4	-0.4	-0.3
Economic activity								
Gross domestic product	year-on-year changes in %, constant prices	0.9	2.4	3.2	3.5	0.0	-0.1	0.0
Final consumption of households	year-on-year changes in %, constant prices	-0.1	2.4	2.0	2.4	1.2	-0.4	-0.2
Final consumption of general government	year-on-year changes in %, constant prices	1.4	3.2	1.0	1.2	1.7	-0.3	-0.1
Gross fixed capital formation	year-on-year changes in %, constant prices	-4.3	3.0	3.5	3.8	-0.3	-0.2	0.0
Exports of goods and services	year-on-year changes in %, constant prices	4.5	7.4	5.7	6.6	-0.2	-0.2	0.2
Imports of goods and services	year-on-year changes in %, constant prices	2.9	8.3	5.6	6.2	0.9	0.0	0.1
Net exports	EUR millions in constant prices	9,528	9,733	10,364	11,303	-646	-790	-723
Output gap	% of potential output	-1.7	-1.7	-1.1	-0.3	-0.1	-0.1	-0.1
Gross domestic product	EUR millions in current prices	72,134	73,811	77,249	81,552	-325	-722	-1,033
Labour market								
Employment	thousands of persons, ESA 95	2,192	2,207	2,220	2,233	-1.6	-0.3	-1.5
Employment	year-on-year changes in %, ESA 95	-0.8	0.7	0.6	0.6	0.0	0.0	0.0
Number of unemployed	thousands of persons [1]	386	367	345	324	-0.1	-1.4	-0.2
Unemployment rate	%	14.2	13.5	12.8	12.0	0.0	0.0	0.0
Unemployment gap [2]	p. p.	1.3	0.8	0.6	0.2	-0.1	0.0	-0.1
Labour productivity [3]	year-on-year changes in %	1.7	1.8	2.6	3.0	0.1	-0.1	0.1
Nominal productivity [4]	year-on-year changes in %	2.2	1.6	4.0	5.0	-0.5	-0.6	-0.3
Nominal compensation per employee	year-on-year changes in %, ESA 95	0.8	3.0	3.7	4.2	0.3	-0.3	-0.2
Nominal wages [5]	year-on-year changes in %	2.3	2.8	3.7	4.2	0.3	-0.3	-0.2
Real wages [6]	year-on-year changes in %	0.9	2.7	2.0	2.2	0.4	0.0	-0.1
Households								
Disposable income	constant prices	0.7	2.1	1.9	2.4	0.8	-0.4	-0.2
Savings rate	% of disposable income	6.7	6.4	6.3	6.3	-0.3	-0.4	-0.4
Balance of payments								
Goods balance	% of GDP	5.9	6.1	6.4	7.0	-0.9	-1.3	-1.4
Current acount	% of GDP	2.1	2.1	2.7	2.7	-0.9	-1.3	-1.6
External environment and technical assumptions								
External demand growth for Slovakia	year-on-year changes in %	1.6	3.9	5.1	5.6	-0.2	0.0	0.1
Exchange rate (USD/EUR) [7]	level	1.33	1.38	1.38	1.38	1.7	2.0	2.0
Oil price in USD	level	108.8	107.2	102.2	98.2	1.3	1.2	1.3
Oil price in USD	year-on-year changes in %	-2.8	-1.6	-4.6	-3.9	1.2	-0.1	0.2
Oil price in EUR	year-on-year changes in %	-5.9	-5.3	-4.8	-3.9	-0.5	-0.3	0.2
Non-energy commodity prices in USD	year-on-year changes in %	-5.2	0.3	1.7	4.6	2.8	-1.4	-0.2
EURIBOR 3M [8]	% p. a.	0.2	0.3	0.3	0.4	0.0	-0.1	-0.3
10-Y Slovak government bond yields	%	3.2	2.7	3.2	3.5	0.1	0.2	0.2

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 a cut-off date of 14 May 2014.*

The time series of selected macroeconomic indicators can be found at
http://www.nbs.sk/_img/Documents/_Publikacie/PREDIK/2014/MTF-2014Q2.xls